# FAC 4866 LESSON PLAN

| | |
|---|---|
| **LEARNING UNIT NUMBER** | **2** |
| **TITLE OF LEARNING UNIT** | **Consolidated and separate financial statements**<br>**Business combinations**<br>**Fair value measurement**<br>**Revenue from contracts with customers**<br>**Events after reporting period**<br>**Provisions, Contingent Liabilities and Contingent Assets** |
| **NOTIONAL STUDY HOURS** | **30** |
| **NUMBER OF PLANNED SELF-REFLECTIVE ACTIVITIES** | **7 Examples**<br>**3 Questions**<br>**2 Case studies** |
| **NUMBER OF ASSESSMENT LINKED ACTIVITIES** | **1 (Test 2)** |

## 1.1 Introduction

Within learning unit 2 we will discuss the following individual topics:

| Topic | IFRS Standard | Description |
|---|---|---|
| 2.1 | IAS 27; IFRS 10 | Consolidated and separate financial statements |
| 2.2 | IFRS 3 | Business combinations |
| 2.3 | IFRS 13 | Fair value measurement |
| 2.4 | IFRS 15 | Revenue from contracts with customers |
| 2.5 | IAS 10 | Events after the reporting period |
| 2.6 | IAS 37 | Provisions, contingent liabilities and contingent assets |

## 1.2 Purpose of learning unit

Students should be able to:

- Apply financial reporting in integrated case studies as set out in the Conceptual Framework for Financial Reporting.
- Assess the recognition and derecognition criteria of an element as specified in the relevant IFRS Accounting Standards in an integrated case study.
- Evaluate the measurement basis that is applicable to an element as guided by the relevant IFRS Accounting Standards in an integrated case study.
- Prepare and discuss general purpose financial statements, including consolidated financial statements, in accordance with IFRS Accounting Standards.

## 1.3 Assessment criteria

- Interrogate integrated case studies to evaluate the Conceptual Framework for Financial Reporting.
- Recognise an item that is an asset, a liability, equity, income, or expense for inclusion in the financial statements.
- Derecognise from the financial statements an item that is no longer an asset, a liability, equity, income or expense.
- Interpret the recognition and/or derecognition of an asset, a liability, equity, income, or expense in a given scenario against the applicable IFRS Accounting Standards.

- Assess the measurement basis for an asset or a liability in a given scenario against the requirements of the applicable IFRS Accounting Standards.
- Propose improvements to the measurement basis for an asset or a liability based on the requirements of the applicable IFRS Accounting Standards.
- Compile the general financial statements, including consolidated financial statements, in accordance with IFRS Accounting Standards.
- Assess the appropriateness of disclosures of financial information in relation to general purpose and consolidated financial statements, prepared in accordance with IFRS Accounting Standards.

**1.4 How to approach each learning unit**

- Please read the prescribed study material for each individual topic in the learning unit thoroughly before you study the additional information.
- Study the overview of the individual topic – we have included an overview for each individual topic.
- Answer the examples/questions in the individual topic, if applicable, and make sure you understand the principles contained in the questions.
- Consider whether you have achieved the exit level outcomes (refer to learning unit 0).
- After you have completed all the individual topics in the learning units, answer the integrated questions to test whether you have mastered the contents of this learning unit.
- You will be assessed in test 2 on the contents of this learning unit.

**Discussion forum**

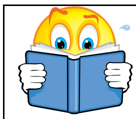
A general discussion forum has been set up for each topic within this learning unit. It is strongly recommended that you post your questions and comments on the forum as you work through the learning unit. Your lecturers are more than happy to assist you on your learning journey.

# TOPIC 2.1 - CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

**INTRODUCTION**

IAS 27 prescribes accounting and disclosure requirements on how to account for the cost of an investment in the separate records of the investor for investments in subsidiaries, joint ventures and associates (joint ventures and associates will be covered in learning unit 5).

IFRS 10 deals with the definition of control and establishes control as the basis for consolidation. IFRS 10 also sets out how to apply the principle of control and sets out the accounting requirements for preparation of consolidated financial statements. IFRS 10 deals with the principles that should be applied to a business combination (including the elimination of intragroup transactions, consolidation procedures, etc.) from the date of acquisition until the date of loss of control.



**PRESCRIBED STUDY MATERIAL**

**IAS 27 *Separate Financial Statements***

SAICA Student Handbook 2024/2025; Volume 1; Part A2

**IFRS 10 *Consolidated Financial Statements***

SAICA Student Handbook 2024/2025; Volume 1; Part A1

Please note that consolidations were covered thoroughly in your undergraduate studies and therefore this topic is a revision of the basic consolidation principles. It is very important to spend enough time to revise these principles.

Also note that Unisa follows the limited open-book policy as prescribed by SAICA and that you will be allowed to use the SAICA Student Handbook during assessments.

| Description | Level | Notes |
|---|---|---|
| IFRS 10 is assessed at Proficiency Level 3, except | | |
| Scope | 1 | |
| Investment entities | Excluded | |
| Delegated power | Excluded | |
| Principal/agent considerations | Excluded | Principles covered under IFRS 15 |
| Control of specified assets | Excluded | |
| Subsidiaries acquired with a view to resale | Excluded | Principles covered under IFRS 5 |
| Subsidiaries classified as held for sale or distribution | Excluded | Principles covered under IFRS 5 |

| Description | Level | Notes |
|---|---|---|
| IAS 27 is assessed at Proficiency Level 3, except | | |
| Scope | 1 | |
| Investment entity | Excluded | |
| Fair value in the separate accounts | Excluded | |
| Equity method in the separate accounts | Excluded | |
| Group reorganisations | Excluded | |

Let's look at the overview of IAS 27 and IFRS 10.

## Overview of Consolidated and separate financial statements

The accounting treatment, applicable Standards and the interaction between the relevant Standards can be schematically presented as follows:

Investor makes an **investment** in another entity. Depending on the degree of influence or control, the investment may be treated as follows:

**Significant influence** in terms of IAS 28

**Joint control** in terms of IFRS 11

**Control** in terms of IFRS 10

No significant influence or control

The investor can choose to account for its investment in another entity in its **separate** (individual) statements at cost **or** in accordance with IFRS 9 **or** using the equity method in accordance with IAS 28.

Account for as a financial asset in terms of IFRS 9

**The investment in another entity is included in the consolidated financial statements as follows:**

**Significant influence** in terms of IAS 28

**Joint control** in terms of IFRS 11 over joint venture

**Control** in terms of IFRS 10

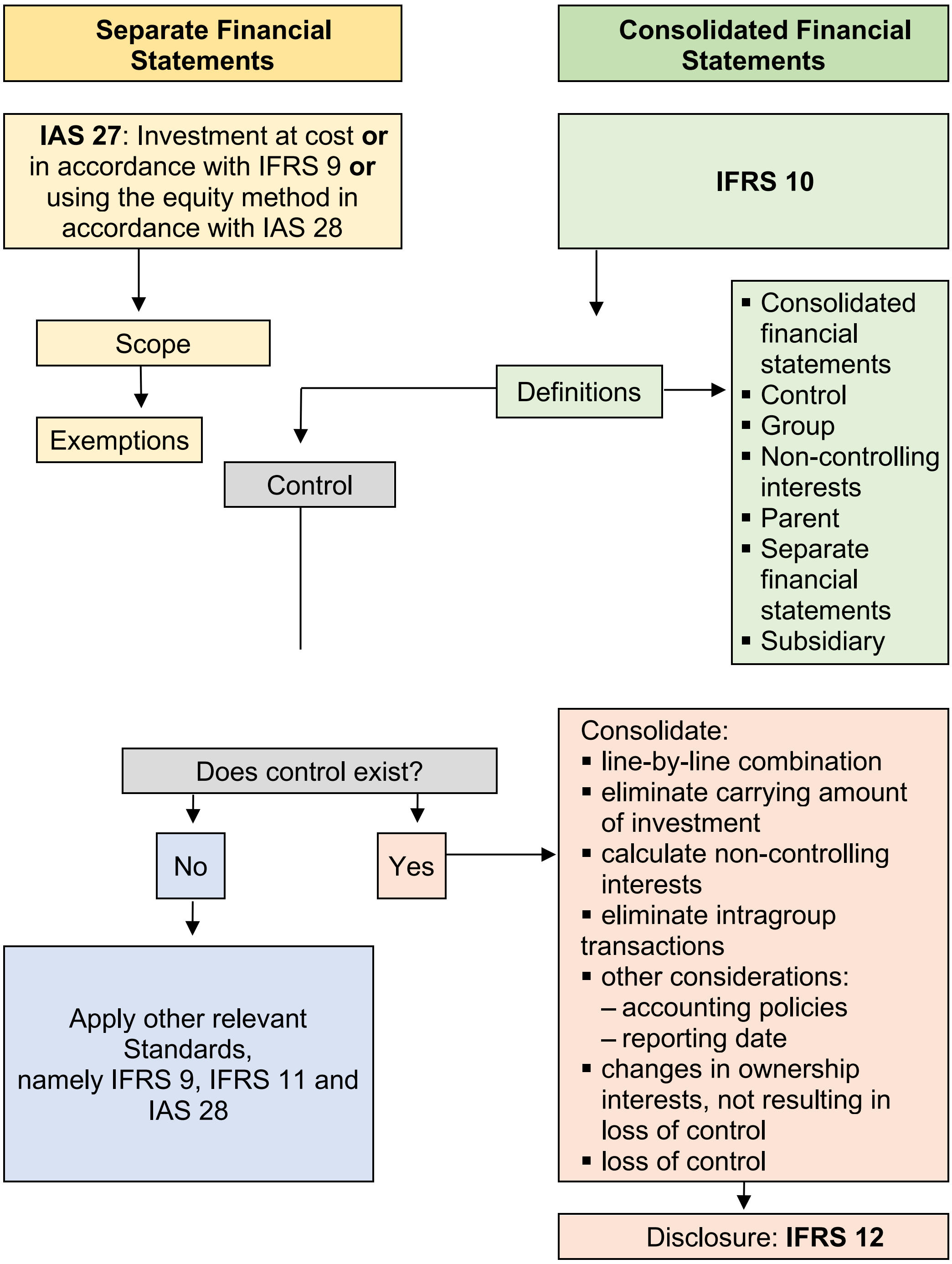
**Equity method** in terms of IAS 28

As a **business combination** on the date control is obtained in terms of IFRS 3

**Consolidation** thereafter in terms of IFRS 10

**Disclosure** in terms of IFRS 12

**The following is a schematic presentation of the contents of IAS 27, IFRS 10 and IFRS 12**



## EXAMPLES

**EXAMPLE 2.1** (45 marks – 90 minutes)

The following trial balances at 31 December 20.24 are presented to you:

| | Mickey Ltd R | Minnie Ltd R |
|---|---|---|
| **Debits** | | |
| Investment property – Land | - | 700 000 |
| Factory buildings | 1 200 000 | - |
| Equipment | 236 000 | 125 000 |
| Investment in Minnie Ltd | | |
| - 112 000 Ordinary shares at cost | 140 000 | - |
| - 12 000 12% Preference shares at cost | 26 880 | - |
| Inventory | 80 000 | 26 000 |
| Trade receivables | 114 953 | 40 000 |
| Bank | 90 000 | - |
| Cost of sales | 1 375 000 | 591 499 |
| Other expenses | 254 320 | 406 000 |
| Finance cost | 14 000 | - |
| Income tax expense | 239 260 | 88 700 |
| Preference dividends paid (up to 30 June 20.24) | - | 7 200 |
| Ordinary dividends | | |
| - Final dividend for the year ended 31 December 20.23 (declared and paid on 29 February 20.24) | - | 20 000 |
| - Interim dividend for 20.22: paid 30 September 20.24 | 60 000 | - |
| | 3 830 413 | 2 004 399 |
| **Credits** | | |
| Issued ordinary shares (640 000 shares; 160 000 shares) | 640 000 | 160 000 |
| Issued 12% preference shares (20 000 shares) | - | 40 000 |
| Retained earnings (1 January 20.24) | 260 000 | 174 950 |
| Deferred tax | 150 500 | 102 449 |
| Trade payables | 61 593 | 122 000 |
| Bank overdraft | - | 25 000 |
| Revenue | 2 700 000 | 1 200 000 |
| Other income | 18 320 | 180 000 |
| | 3 830 413 | 2 004 399 |

**Additional information**

1. Mickey Ltd obtained its interest in the non-redeemable cumulative preference shares of Minnie Ltd on 1 January 20.24 at a cost of R26 880. Minnie Ltd is obliged to pay a preference dividend for a financial year if an ordinary dividend is declared during the financial year. You may assume that the preference shares were correctly classified as equity. The interest in the ordinary shares was also acquired on 1 January 20.24. From this date, Mickey Ltd had control over Minnie Ltd as per the definition of control in terms of IFRS 10 *Consolidated Financial Statements*. The acquisition of Minnie Ltd also met the definition of acquiring a business, as defined in IFRS 3 *Business Combinations*.

2. The details of the acquisition of the interest in the ordinary shares in Minnie Ltd were as follows:

   - The purchase price agreed upon was payable in cash and a portion in shares.
   - A cash amount of R154 000 was payable by Mickey Ltd on 31 December 20.24.
   - The share portion was settled by the issue of 1 000 ordinary shares of Mickey Ltd worth R105 000 on 1 January 20.24 and R110 000 on 31 December 20.24.
   - A contingent consideration of R10 000 was also payable on 30 June 20.25 if certain profits were met. The fair value of the contingent consideration was R8 000 on 1 January 20.24 and R9 000 on 31 December 20.24.
   - The agreement determined that the seller of the shares will pay the cost relating to the agreement and valuation expenses. The amount is R10 000 and is included in the purchase price. You may assume that the tax effect of the R10 000 is correctly accounted for.
   - With the exception of the items listed below, all assets and liabilities of Minnie Ltd were deemed to be fairly valued on the acquisition date:

| | **Carrying amount**<br>**R** | **Fair value**<br>**R** |
|---|---|---|
| Inventory | 20 000 | 36 000 |
| Trade receivables | 27 000 | 19 500 |

   The fair value of inventory represents the value at which it can be purchased.

3. Mickey Ltd, a manufacturer of equipment, sold equipment to Minnie Ltd to the value of R50 000 on 1 January 20.24. Mickey Ltd sells equipment at cost plus 25%. Minnie Ltd uses the equipment in the production of inventory and depreciates equipment at 20% per annum according to the straight-line method.

4. Minnie Ltd purchases all its inventory from Mickey Ltd at a gross profit percentage of 20%. Inventory purchased from Mickey Ltd still on hand at year end was as follows:

   31 December 20.24 – R30 000

   The inventory on hand at 31 December 20.24 was written down to net realisable value by Minnie Ltd.

   The total sales of Mickey Ltd to Minnie Ltd for the year ended 31 December 20.24 amounted to R80 000.

5. Minnie Ltd acquired the land on 30 June 20.24 at R550 000 for investment purposes. The land is rented by Mickey Ltd at R5 000 per month and used as a storage facility for its inventory. Rent paid and received are included in other expenses and other income respectively. No rent was in arrears at 31 December 20.24. Minnie Ltd elected the fair value model to measure the investment property. The investment property value increased with R150 000 for the year ended 31 December 20.24.

6. It is the group accounting policy to disclose land at revalued amounts.

7. It is the policy of Mickey Ltd to account for investments in subsidiaries at cost in accordance with IAS 27.10(a) in its separate financial statements.

8. Mickey Ltd elected to measure non-controlling interests at fair value at acquisition for all acquisitions. On 1 January 20.24 the fair value of the ordinary and preference share non-controlling interests were R100 000 and R17 920 respectively.

9. A market-related pre-tax discount rate is 10%, compounded annually.

10. Assume a normal income tax rate of 27% and a capital gains tax inclusion rate of 80%. Ignore tax on financial instruments. Ignore the effects of dividend tax and value added tax (VAT).

**REQUIRED**

| | Marks |
|---|---|
| 1. Prepare the consolidated statement of profit or loss and other comprehensive income of the Mickey Ltd Group for the year ended 31 December 20.24. Income and expenditure should be indicated in terms of their function. | 22 |
| 2. Prepare the consolidated statement of financial position of the Mickey Ltd Group as at 31 December 20.24. | 22 |
| X1: Communication skills - presentation | 1 |
| **Please note**<br>• Comparative figures are not required.<br>• Notes are not required.<br>• Show all your calculations.<br>• Round all calculated amounts off to the nearest rand.<br>• Your answer must comply with IFRS Accounting Standards. | |

**EXAMPLE 2.1** – **Suggested solution**

## 1. MICKEY LTD GROUP

### CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.24

| | **R** | |
|---|---|---|
| **Revenue** [C7] | 3 770 000 | (4) |
| Cost of sales [C8] | (1 862 499) | (4) |
| Gross profit | 1 907 501 | |
| Other income [C9] | - | (4) |
| Other expenses [C10] | (633 820) | (4) |
| Finance cost (given) | (14 000) | (1) |
| **Profit before tax** | 1 259 681 | |
| Income tax expense [C11] | (290 565) | (5) |
| **PROFIT FOR THE YEAR** | 969 116 | |
| **Other comprehensive income** | | |
| **Items that will not be reclassified to profit or loss** | | |
| Gains on property revaluation [150 000 – (150 000 x 27% x 80%)] | 117 600 | (1) |
| **Other comprehensive income for the year, net of tax** | 117 600 | |
| **TOTAL COMPREHENSIVE INCOME FOR THE YEAR** | 1 086 716 | |
| | | |
| Profit attributable to: | | |
| Owners of the parent (balancing) | 917 637 | (1) |
| Non-controlling interests (49 559 [C2] + 1 920 [C3]) | 51 479 | (1) |
| | 969 116 | |
| | | |
| Total comprehensive income attributable to: | | |
| Owners of the parent (balancing) | 999 957 | |
| Non-controlling interests (51 479 + 35 280 [C2]) | 86 759 | (1) |
| | 1 086 716 | |
| | Total | (26) |
| | Maximum | (22) |
| | X1: Communication skills - presentation | (1) |

**DISCUSSION**

The land will be recognised as an investment property in the separate financial statements of Minnie Ltd, as it was acquired for investment purposes. The fair value adjustment and the deferred tax adjustment were thus recognised in profit or loss.

Since the land is rented by Mickey Ltd (parent), it now becomes owner-occupied property, plant and equipment in the group financial statements (IAS 40.15). The fair value adjustment and deferred tax adjustment recognised in profit or loss by Minnie Ltd must thus be reversed.

It is the group accounting policy to measure land in accordance with the revaluation model. The increase in fair value of R150 000 must thus be recognised in other comprehensive income, net of deferred tax.

## 2. MICKEY LTD GROUP

### CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.24

| | R | |
|---|---|---|
| **ASSETS** | | |
| **Non-current assets** | | |
| Property, plant and equipment* | 2 253 000 | (3) |
| Goodwill [C1] | 6 645 | (10) |
| | 2 259 645 | |
| **Current assets** | | |
| Inventory (80 000 + 26 000 – 2 000[C5]) | 104 000 | (1) |
| Trade receivables (114 953 + 40 000) | 154 953 | (1) |
| Cash and cash equivalents | 90 000 | (1) |
| | 348 953 | |
| **Total assets** | 2 608 598 | |
| | | |
| **EQUITY AND LIABILITIES** | | |
| **Equity attributable to owners of the parent** | | |
| Share capital (640 000 + 105 000[C6]) | 745 000 | (1) |
| Retained earnings (260 000 + 917 637 (from 1 above) – 60 000 (div)) | 1 117 637 | (1) |
| Other components of equity [C2] | 82 320 | (1) |
| | 1 944 957 | |
| **Non-controlling interests** (178 839[C2] + 16 000[C3]) | 194 839 | (1) |
| **Total equity** | 2 139 796 | |
| | | |
| **Non-current liabilities** | | |
| Deferred tax (150 500 + 102 449 – 2 160[C4] – 540[C5]) | 250 249 | (2) |
| | 250 249 | |
| **Current liabilities** | | |
| Bank overdraft | 25 000 | (1) |
| Trade payables (61 593 + 122 000 + 9 000[C6] (J2 Mickey)) | 192 593 | (1) |
| Dividends payable [C3] | 960 | (1) |
| | 218 553 | |
| **Total liabilities** | 468 802 | |
| **Total equity and liabilities** | 2 608 598 | |
| | Total | (25) |
| | Maximum | (22) |

| | |
|---|---|
| * Land (550 000 + 150 000) | 700 000 |
| Factory buildings | 1 200 000 |
| Equipment (236 000 + 125 000 – 8 000 [C4]) | 353 000 |
| | 2 253 000 |

**DISCUSSION**

Note that the investment in Minnie Ltd was only carried at R140 000 in the trial balance of Mickey Ltd, which thus indicates that the share issue, the contingent consideration and the acquisition cost have not yet been recorded in the records of Mickey Ltd.

## CALCULATIONS

### C1. Goodwill

| | | |
|---|---|---|
| Purchase price | (243 000) | |
| Share issued (1 000 x 105) | 105 000 | [1] |
| Fair value of contingent consideration | 8 000 | [1] |
| Acquisition cost | (10 000) | [1] |
| Cash (FV = 154 000; n = 1; I = 10%; PV = 140 000) | 140 000 | [3] |
| Equity at acquisition | 336 355 | |
| - Share capital | 160 000 | |
| - Retained earnings | 176 355 | |
| - Given | 174 950 | |
| - Preference dividend | (4 800) | [1] |
| - Inventory (16 000 x 73%) | 11 680 | [1] |
| - Trade debtors (7 500 x 73%) | (5 475) | [1] |
| Non-controlling interests | (100 000) | [1] |
| Goodwill | 6 645 | |
| | | [10] |

**DISCUSSION**

**Preference dividend**

The preference dividend of R7 200 paid up to 30 June 20.24 relates to a dividend for the year ended 31 December 20.23 amounting to R4 800 (R40 000 x 12%). This amount has to be accrued for at acquisition, since the preference shares are cumulative. The remaining R2 400 (R7 200 – R4 800 or R40 000 x 12% x 6/12) relates to the six-month period ended 30 June 20.24. An amount of R2 400 must thus still be accrued for the last six months, refer to [C3].

**Inventory and trade debtors**

The IFRS 3 fair value adjustments made to trade debtors and inventory at acquisition must again be reversed when the underlying assets are derecognised. Since trade receivables and inventory are current assets, they are expected to realise within 12 months if no other information is provided. These fair value adjustments are therefore reversed at year end.

## C2. Analysis of owners' equity of Minnie Ltd – ordinary shares

| | Total | Mickey Ltd (70%) | | NCI |
|---|---|---|---|---|
| | | At | Since | |
| **At acquisition** | | | | |
| Share capital | 160 000 | | | |
| Retained earnings: | | | | |
| Balance given | 174 950 | | | |
| Debtors (7 500 x 73%) | (5 475) | | | |
| Inventory (16 000 x 73%) | 11 680 | | | |
| Preference dividend in arrears | (4 800) | | | |
| | 336 355 | 235 449 | | 100 906 |
| Equity represented by goodwill | 6 645 | 7 551 | | (906) |
| Consideration and NCI | 343 000 | 243 000 | | 100 000 |
| **Since acquisition** | | | | |
| **Current year** | | | | |
| Profit (1 200 000 – 591 499 – 406 000 + 180 000 – 150 000 [J13] – 88 700 + 32 400 [J14]) | 176 201 | | | |
| Profit attributable to preference shareholders | (4 800) | | | |
| Debtors | 5 475 | | | |
| Inventory | (11 680) | | | |
| Total current year profit | 165 196 | | 115 637 | 49 559 |
| Revaluation – land | | | | |
| [150 000 x (100% – (80% x 27%))] | 117 600 | | 82 320 | 35 280 |
| Dividend | (20 000) | | (14 000) | (6 000) |
| | 605 796 | | 183 957 | 178 839 |

## C3. Analysis of owners' equity of Minnie Ltd – preference shares

| | Total | Mickey Ltd (60%) | | NCI |
|---|---|---|---|---|
| | | At | Since | |
| **At acquisition** | | | | |
| Share capital | 40 000 | 24 000 | | 16 000 |
| Dividend in arrears | 4 800 | 2 880 | | 1 920 |
| | 44 800 | 26 880 | | 17 920 |
| Equity represented by goodwill | - | - | | - |
| Consideration and NCI | 44 800 | 26 880 | | 17 920 |
| **Since acquisition** | | | | |
| **Current year** | | | | |
| Profit attributable to preference shareholders (40 000 x 12%) | 4 800 | | 2 880 | 1 920 |
| Dividend | (7 200) | | (4 320) | (2 880) |
| Dividend accrued | (2 400) | | (1 440) | (960) |
| | 40 000 | | (2 880) | 16 000 |

**DISCUSSION**

Preference shares have a preference to dividends over ordinary shares.

The profit attributable to preference shareholders of R4 800 is the preference dividend for the current year. Please note that this profit attributable to preference shareholders is deducted in the analysis of ordinary shares to ensure we do not double account.

The preference dividend of R7 200 that was paid (as per the trial balance) includes preference dividends up to 30 June 20.24 only. The preference dividend for the period 1/7/20.24 to 31/12/20.24 is R2 400, which is calculated as R4 800 x 6/12. The parent thus has to accrue for this as preference dividends as the amount is owed to the preference shareholders at year end.

### C4. Equipment sold by Mickey Ltd to Minnie Ltd

| | Minnie Ltd | Group | Difference | Tax |
|---|---|---|---|---|
| Unrealised profit<br>(50 000 x 25/125) | 50 000 | 40 000 | 10 000 | 2 700 |
| Depreciation<br>(10 000 x 20%) | | | 2 000 | (540) |
| | | | 8 000 | 2 160 |
| Deferred taxation at 27% | | | 2 160 | |
| Net | | | 5 840 | |

### C5. Unrealised profit in inventory

Closing balance: (30 000 x 20%) = R6 000 limited to R2 000*
Taxation effect: (2 000 x 27%) = R540

* The inventory was already written off from R30 000 to R26 000 (per trial balance) by Minnie Ltd, an adjustment of R4 000. Therefore, the remaining unrealised profit for group statement purposes is R2 000 (R6 000 – R4 000).

### C6. Journals in the records of Mickey Ltd

| | | Dr<br>R | Cr<br>R |
|---|---|---|---|
| J1 | Investment in Minnie Ltd (SFP) | 105 000 | |
| | Share capital (SCE) | | 105 000 |
| J2 | Investment in Minnie Ltd (SFP) | 8 000 | |
| | Contingent consideration liability (SFP) | | 9 000 |
| | Fair value adjustment (P/L) | 1 000* | |
| J3 | Acquisition cost (P/L) | 10 000# | |
| | Investment in Minnie Ltd (SFP) | | 10 000 |

* Not tax deductible.
\# The given information states that you may assume that the tax effect of the R10 000 is correctly accounted for.

**DISCUSSION**

Transaction cost should be carefully analysed as not all transaction cost has the same accounting treatment. Acquisition-related cost (finder's, advisory, legal, valuation, professional and administration fees) should be expensed in **profit or loss** in the **consolidated** financial statements of the acquirer in accordance with IFRS 3.53.

Cost to issue debt or equity is **not** acquisition-related cost as defined in accordance with IFRS 3. Share issue cost must be accounted for as a **deduction from equity** in terms of IAS 32.35 in the separate and consolidated financials of the acquirer.

The parent will measure its investments in subsidiaries at cost in accordance with IAS 27.10(a) in its separate financial statements. Acquisition-related cost in the separate financial statements of the parent should thus also be **expensed**. Students should read carefully how the parent treated the transaction cost in its separate financial statements.

In this question, acquisition-related cost of R10 000 will be paid by the seller of the shares (Minnie Ltd) and is included in the purchase price to be paid by Mickey Ltd. However, in accordance with IFRS 3.53, this cost should be expensed.

### C7. Revenue

| | | |
|---|---|---|
| Mickey | 2 700 000 | [1] |
| Minnie | 1 200 000 | [1] |
| Total intragroup sales | (80 000) | [1] |
| Intragroup equipment sold [C4] | (50 000) | [1] |
| | 3 770 000 | |
| | | [4] |

### C8. Cost of sales

| | | |
|---|---|---|
| Mickey | (1 375 000) | |
| Minnie | (591 499) | |
| Total intragroup sales | 80 000 | |
| Intragroup equipment sold [C4] | 40 000 | [1] |
| Depreciation on intragroup equipment [C4] | 2 000 | [1] |
| Unrealised profit – closing inventory [C5] | (2 000) | [1] |
| Reversal of at acquisition inventory adjustment [C2] | (16 000) | [1] |
| | (1 862 499) | |
| | | [4] |

**DISCUSSION**

The depreciation on the intragroup equipment will be included in cost of sales instead of operating expenses as the specific machine is used in the production of inventory.

### C9. Other income

| | | |
|---|---|---|
| Mickey | 18 320 | |
| Minnie | 180 000 | |
| Intragroup rent paid | (30 000) | [1] |
| Reversal of fair value adjustment on investment property | (150 000) | [1] |
| Ordinary dividend elimination [C2] | (14 000) | [1] |
| Preference dividend elimination [C3] | (4 320) | [1] |
| | - | |
| | | [4] |

**C10. Other expenses**

| | | |
|---|---|---|
| Mickey | (254 320) | |
| Minnie | (406 000) | |
| Fair value adjustment on contingent consideration [C6] | (1 000) | [1] |
| Acquisition cost [C6] | (10 000) | [1] |
| Reversal of at-acquisition debtors' adjustment [C2] | 7 500 | [1] |
| Intragroup rent paid | 30 000 | [1] |
| | (633 820) | |
| | | [4] |

**C11. Income tax expenses**

| | | |
|---|---|---|
| Mickey | (239 260) | |
| Minnie | (88 700) | |
| Deferred tax on unrealised profit [C4] | 2 700 | [1] |
| Deferred tax on depreciation [C4] | (540) | [1] |
| Deferred tax on unrealised profit [C5] | 540 | |
| Deferred tax on reversal of at-acquisition inventory adjustment [C2] | 4 320 | [1] |
| Deferred tax on reversal of at-acquisition debtors' adjustment [C2] | (2 025) | [1] |
| Reversal of deferred tax on fair value adjustment on investment property (150 000 x 80% x 27%) | 32 400 | [1] |
| | (290 565) | |
| | | [5] |

## C12. Pro forma consolidation journals

The pro forma journals are provided for completeness only and explain the adjustments made to the statement of profit or loss and other comprehensive income.

| | | Dr<br>R | Cr<br>R |
|---|---|---|---|
| | **Investment in ordinary shares** | | |
| J1 | Share capital (SCE) | 160 000 | |
| | Retained earnings (SCE) (174 950 – 4 800) | 170 150 | |
| | Inventory (SFP) | 16 000 | |
| | Debtors (SFP) | | 7 500 |
| | Deferred tax (SFP) [(16 000 – 7 500) x 27%] | | 2 295 |
| | Investment in Minnie (SFP) | | 243 000 |
| | Non-controlling interests (SCE/SFP) | | 100 000 |
| | Goodwill (SFP) (balancing) | 6 645 | |
| | At-acquisition elimination journals | | |
| J2 | Cost of sales (P/L) | 16 000 | |
| | Inventory (SFP) | | 16 000 |
| | Reversal of fair value adjustment at acquisition | | |
| J3 | Debtors (SFP) | 7 500 | |
| | Other expenses (P/L) | | 7 500 |
| | Reversal of fair value adjustment at acquisition | | |
| J4 | Deferred tax (SFP) [(16 000 - 7 500) x 27%] | 2 295 | |
| | Income tax expense (P/L) | | 2 295 |
| | Reversal of deferred tax on fair value adjustments at acquisition | | |
| J5 | Revenue (Mickey) (P/L) (50 000 x 25/125) | 50 000 | |
| | Cost of sales (Mickey) (P/L) (50 000 x 100/125) | | 40 000 |
| | Equipment (Minnie) (SFP) | | 10 000 |
| | Elimination of unrealised profit on intragroup equipment sale | | |
| J6 | Deferred tax (SFP) (10 000 x 27%) | 2 700 | |
| | Income tax expense (P/L) | | 2 700 |
| | Deferred tax on intragroup sales | | |
| J7 | Accumulated depreciation (Minnie) (SFP) (10 000 x 20%) | 2 000 | |
| | Cost of sales (Depreciation) (Mickey) (P/L) | | 2 000 |
| | Elimination of intragroup depreciation | | |
| J8 | Income tax expense (P/L) (2 000 x 27%) | 540 | |
| | Deferred tax (SFP) | | 540 |
| | Deferred tax on intragroup depreciation | | |
| J9 | Sales (Mickey) (P/L) | 80 000 | |
| | Cost of sales (Minnie) (P/L) | | 80 000 |
| | Elimination of intragroup sales | | |
| J10 | Cost of sales (Mickey) (P/L) [(30 000 x 20%) – 4 000] | 2 000 | |
| | Inventory (Minnie) (SFP) | | 2 000 |
| | Elimination of unrealised profit on intragroup sales | | |
| J11 | Deferred tax (SFP) (2 000 x 27%) | 540 | |
| | Income tax expense (P/L) | | 540 |
| | Deferred tax on intragroup unrealised profit | | |
| J12 | Other income (rental income) (Minnie) (P/L) (5 000 x 6) | 30 000 | |
| | Other expenses (rental expense) (Mickey) (P/L) | | 30 000 |
| | Elimination of intragroup rental income and expense | | |

| | | Dr<br>R | Cr<br>R |
|---|---|---|---|
| J13 | Other income (fair value adjustment) (P/L) | 150 000 | |
| | Investment property (SFP) | | 150 000 |
| | Reversal of the fair value adjustment on land included in P/L | | |
| J14 | Deferred tax (SFP) (150 000 x 27% x 80%) | 32 400 | |
| | Income tax expense (P/L) | | 32 400 |
| | Reversal of deferred tax raised on the fair value adjustment | | |
| J15 | Property, plant and equipment (SFP) | 550 000 | |
| | Investment property (SFP) | | 550 000 |
| | Reclassification of the land to owner-occupied PPE | | |
| J16 | Property, plant and equipment (SFP) | 150 000 | |
| | Revaluation surplus (OCI) | | 150 000 |
| | Recognising the increase in the fair value of the owner-occupied land | | |
| J17 | Deferred tax (OCI) (150 000 x 27% x 80%) | 32 400 | |
| | Deferred tax (SFP) | | 32 400 |
| | Deferred tax on the revaluation surplus | | |
| J18 | Non-controlling interests (P/L) | 49 559 | |
| | Non-controlling interests (SCE/SFP) | | 49 559 |
| | NCI's share of profit for the year | | |
| J19 | Non-controlling interests (OCI) | 35 280 | |
| | Non-controlling interests (SCE/SFP) | | 35 280 |
| | NCI's share of other comprehensive income for the year | | |
| J20 | Other income (dividend received) (P/L) | 14 000 | |
| | Non-controlling interests (SCE/SFP) | 6 000 | |
| | Dividends paid (SCE) | | 20 000 |
| | Elimination of dividends paid | | |
| | **Investment in preference shares** | | |
| J21 | Share capital (SCE) | 40 000 | |
| | Retained earnings (SCE) | 4 800 | |
| | Non-controlling interests (SCE/SFP) | | 17 920 |
| | Investment in Minnie (SFP) | | 26 880 |
| | At-acquisition elimination journals | | |
| J22 | Non-controlling interests (P/L) | 1 920 | |
| | Non-controlling interests (SCE/SFP) | | 1 920 |
| | NCI's share of profit for the year | | |
| J23 | Other income (dividend received) (P/L) | 4 320 | |
| | Non-controlling interests (SCE/SFP) | 2 880 | |
| | Dividends paid (SCE) | | 7 200 |
| | Elimination of dividends paid | | |
| J24 | Non-controlling interests (SCE/SFP) | 960 | |
| | Dividends payable (SFP) | | 960 |
| | Reclassification of dividends payable | | |

**EXAMPLE 2.2** (31 marks – 62 minutes)

Great White Ltd was established in 20.15 and its main business is to take tourists on shark-cage-diving expeditions in Gansbaai. Great White Ltd has several investments as indicated below:

**Whales Ltd**

On 1 March 20.22, Great White Ltd acquired 60% of the issued share capital of Whales Ltd, a company that arranges whale-watching expeditions in the Hermanus area. One voting right is attached to each share. The remaining 40% of the issued share capital is owned by Mr Hlongwane, the managing director of the company. Mr Hlongwane is a meteorologist and an expert in predicting weather patterns. According to a contractual agreement, Mr Hlongwane has the right to keep the boats of Whales Ltd from going out to sea when he expects severe weather conditions that may damage the boats and/or place the lives of the crew and tourists in danger. Great White Ltd has the right to make all other decisions about operating activities.

**Dolphins Ltd**

On 1 September 20.24, Great White Ltd acquired 50% of the issued share capital of Dolphins Ltd, a company situated in Ballito. Dolphins Ltd organises dolphin-watching expeditions on the North Coast. One voting right is attached to each share. Mrs Yen, a retired widow, acquired the remaining 50% interest. Mrs Yen lives in Japan along with her children and rarely visits South Africa and Dolphin Ltd. Mrs Yen has the right to make decisions about the investment of surplus funds. Great White Ltd has the right to make decisions about the purchasing and disposal of boats, organising expeditions and appointing staff.

**Rent-a-Boat Ltd**

On 1 November 20.24, a new company was formed in Gansbaai, namely Rent-a-Boat Ltd, which rents out charter boats. Hundred percent (100%) of the issued share capital is held by Mrs Nkwane, a local businesswoman in the Gansbaai area. In terms of a contractual agreement, Rent-a-Boat Ltd must have boats available for Great White Ltd at any given period. Great White Ltd also has the right to determine the accounting policies and to appoint the directors in terms of the contractual agreement. The customers of Rent-a-Boat Ltd, other than Great White Ltd, contribute a very small fraction of the revenue. Mrs Nkwane has the right to decide which suppliers are used for the purchase of boats.

**REQUIRED**

| | **Marks** |
|---|---|
| Discuss, with reasons, whether or not each of the companies indicated above is a subsidiary of Great White Ltd for the year ended 31 December 20.24. Your answer should address: | |
| (a) Whales Ltd | 12 |
| (b) Dolphins Ltd | 9 |
| (c) Rent-a-Boat Ltd | 10 |
| **Please note**<br>• Your answer must comply with IFRS Accounting Standards. | |

**EXAMPLE 2.2 – Suggested solution**

**General theory**

Great White Ltd as the investor has to determine whether it is a parent by assessing whether it controls the investee, Whales Ltd (IFRS 10.5).

An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee (IFRS 10.6).

**(a) Whales Ltd**

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, thus the activities that significantly affect the investee's returns (IFRS 10.10).

The power that Great White Ltd has over Whales Ltd results from the voting rights of 60%, which are the majority voting rights. (1)

Mr Hlongwane has the right to keep the boats from going out to sea when he suspects adverse weather conditions, due to his technical expertise as a meteorologist. (1)

Mr Hlongwane can only protect the company and its assets and thus his own interest in the company by keeping boats from going out in severe weather conditions, as boats may be damaged and the crew's and tourists' lives may be in danger should Mr Hlongwane not exercise his rights. (1) (1)

The right that Mr Hlongwane has is deemed to be a protective right, as it is a right designed to protect the interests of Mr Hlongwane without giving him power over Whales Ltd (IFRS 10 Appendix A). (1) (1)

Great White Ltd has the right to make decisions about all other operating activities, which are seen as relevant activities, as the activities of Whales Ltd significantly affect the returns (IFRS 10 Appendix A). (1)

Great White Ltd has, in terms of the 60% voting rights together with the right to make decisions about the relevant activities of Whales Ltd, power over Whales Ltd. (2)

Great White Ltd has the right to variable returns in the form of dividends due to its involvement with Whales Ltd as a shareholder. (1)

The power, together with the exposure to variable returns and the ability to affect the amount of the returns, result in Great White Ltd having control over Whales Ltd. (1)

Whales Ltd is thus a subsidiary of Great White Ltd. (1)

(12)

**(b) Dolphins Ltd**

Great White Ltd owns 50% of the voting rights of Dolphins Ltd, which does not constitute the majority voting rights. (1)

Great White Ltd has the right to make decisions about the purchasing and disposal of boats, organising expeditions and appointing staff. (1)

These activities are deemed to be relevant activities, as they significantly affect the returns of Dolphins Ltd. This results in Great White Ltd having power over Dolphins Ltd. (2)

Mrs Yen has the right to make decisions about the investment of surplus funds, which is not deemed to be a relevant activity. (1)

Mrs Yen does thus not have power over Dolphins Ltd. (1)

Great White Ltd has exposure, or the right, to variable returns from its involvement with the investee by means of the dividends received from the shares owned. (1)

The power, together with the exposure to variable returns and the ability to affect the amount of the returns, result in Great White Ltd having control over Dolphins Ltd. (1)

Dolphins Ltd is thus a subsidiary of Great White Ltd. (1)
(9)

**(c) Rent-a-Boat Ltd**

Great White Ltd does not own any voting rights from shares in Rent-a-Boat Ltd and does not have power in terms of voting rights. (1)

Great White Ltd has the right, in terms of a contractual agreement, to make decisions (1) about the accounting policies and appointment of directors of Rent-a-Boat Ltd, which are deemed to be relevant activities as they significantly affect the returns of Rent-a-Boat Ltd. (1)

Mrs Nkwane has the rights to decide which suppliers are used for the purchase of boats, which also constitutes a relevant activity. (1)

If two or more investors each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee, has power over the investee (IFRS 10.13).

The right that Great White Ltd has in terms of the relevant activities together with the (1) contractual agreement that grants it almost exclusive use of Rent-a-Boat Ltd's boats, constitute power over Rent-a-Boat Ltd. (1)

Great White Ltd has exposure, or the right, to variable returns from its involvement with the investee by means of the contractual agreement stating that Rent-a-Boat Ltd must supply boats to Great White Ltd (IFRS 10.B57(c)). (2)

The power, together with the exposure to variable returns and the ability to affect the amount of the returns by means of the contract, result in Great White Ltd having control over Rent-a-Boat Ltd. (1)

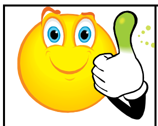
Rent-a-Boat Ltd is a structured entity as defined and a subsidiary of Great White Ltd. (1)
(10)

**EXAMINATION TECHNIQUE**

Please note that **NO** marks will be awarded for theory in a discussion question. However, the suggested solutions for discussion questions will include the theory for purposes of completeness, and to assist students with the application of the theory.

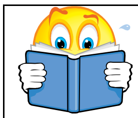
Students should not waste time by stating the theory in the tests or the examination as no marks are awarded for theory.

# TOPIC 2.2 - BUSINESS COMBINATIONS



**INTRODUCTION**

IFRS 3 deals with accounting for a business combination on the date of acquisition and outlines the principles on how to account for identifiable assets acquired and liabilities assumed, non-controlling interests and goodwill or gain from a bargain purchase taking into account certain exceptions to recognition, measurement and classification principles as established in other IFRS standards.



**PRESCRIBED STUDY MATERIAL**

**IFRS 3 *Business Combinations***

SAICA Student Handbook 2024/2025; Volume 1; Part A1

IFRS 3 was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

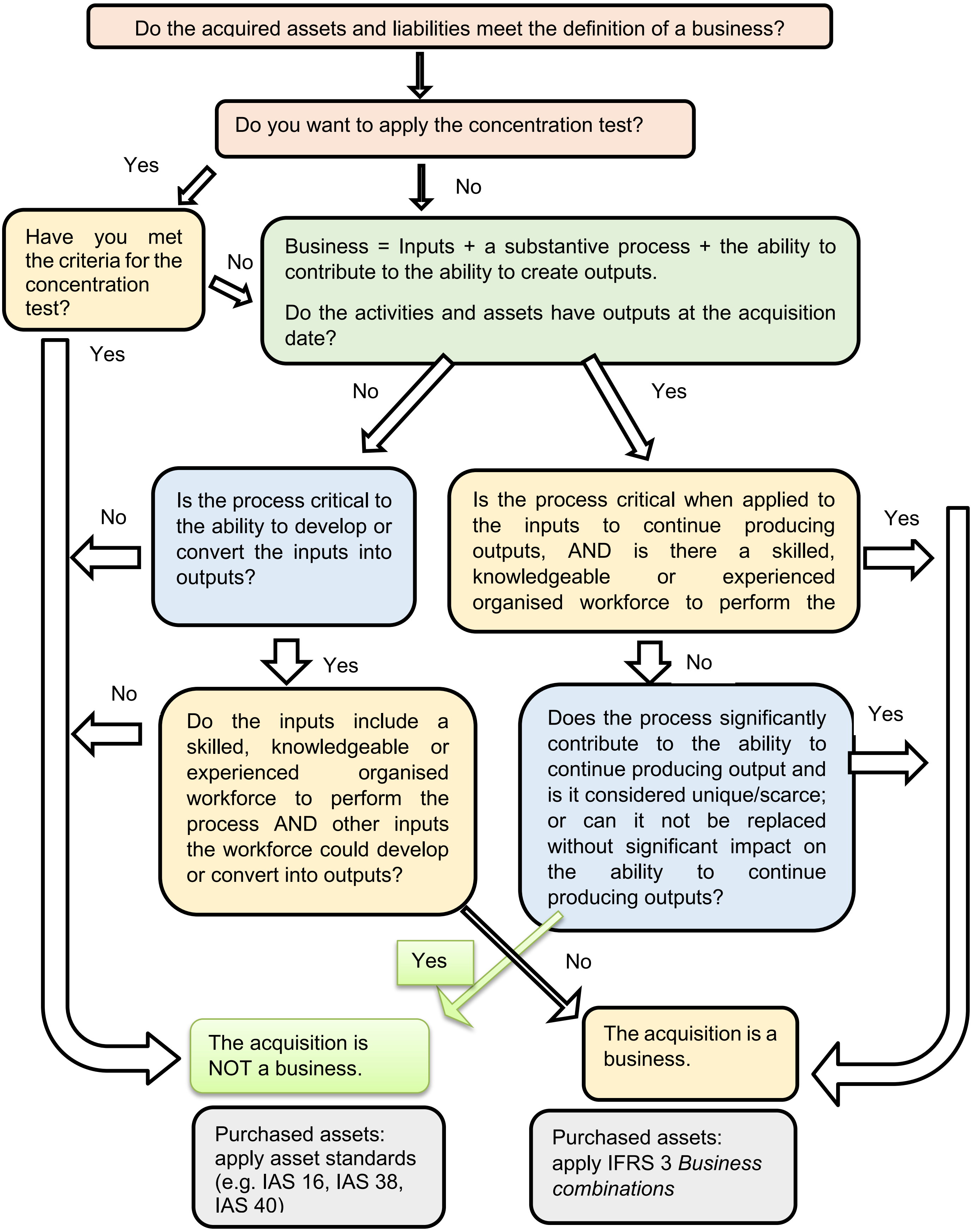
Also, note that Unisa follows the limited open-book policy prescribed by SAICA and that you will be allowed to use the SAICA Student Handbook during assessments.

| **Description** | **Level** | **Notes** |
|---|---|---|
| IFRS 3 is assessed at Proficiency Level 3, except | | |
| Scope | 1 | |
| Investment entities | Excluded | |
| Common control | Excluded | |
| Identifying a business combination | 1 | |
| Identifying the acquirer | Excluded | |
| Pre-existing relationships | Excluded | |
| Reacquired rights | Excluded | |
| Mutual entities | Excluded | |
| Share-based payment awards (replaced or of the acquiree) | Excluded | |
| Reverse acquisitions | Excluded | |
| Put options to NCI | Excluded | |

Let's look at the overview of IFRS 3.

# Overview of IFRS 3 Business Combinations

**APPLICATION GUIDANCE TO DETERMINE ACQUISITION OF A BUSINESS** (SAICA – adapted)



## ACQUISITION METHOD (applying IFRS 3 *Business Combinations*)

**Step 1**

**Who** is the acquirer?

→ The **entity** that obtains **control** of the acquiree (IFRS 3.6–.7). See control as defined in IFRS 10.5–.18.

**Step 2**

**When** did the acquisition occur?

→ The **date** on which the acquirer obtains **control** of the acquiree (IFRS 3.8–.9).

**Step 3**

**Recognise** the identifiable assets and liabilities acquired in the business combination.

→ **Recognition criteria**

To qualify for recognition the

- assets and liabilities should meet the **definitions** of the conceptual framework
- assets and liabilities must be **part** of what is exchanged in the business combination (not a separate transaction)

**Exceptions**

- **Contingent liabilities** should be recognised if there is a **present obligation** and its **fair value** can be measured reliably (IFRS 3.22–.23).
- Recognise the **indemnification asset** (debtor) only if the **indemnification item** (liability) is recognised on the acquisition date (IFRS 3.27–.28).

**Note** that the <u>acquiree</u> may not have recognised certain assets and liabilities in its own financial statements that do qualify for **recognition** in the **group financial statements.** Examples are:

- **identifiable intangible assets** not recognised by the acquiree (IFRS 3.13)
- **restructuring provisions** (meeting the liability definition)

**Step 4**

**Measure** the assets and liabilities acquired in the business combination.

→ **Measurement criteria**

Assets and liabilities acquired should be measured at their **fair value** at the acquisition date.

**Remember**

- Restatement of assets and liabilities to fair value has **deferred tax** implications for the business combination.
- The restatement of assets to fair value may also result in an additional **depreciation/amortisation** charge in the consolidated financial statements (and have deferred tax implications).

**Step 5**

Recognise and measure **NCI**.

Measure NCI at (IFRS 3.19)
- **fair value** or
- **the proportionate share** of the acquiree's identifiable net assets

**Step 6**

Measure the **consideration** transferred.

Consideration is measured at **fair value** on the acquisition date (except for share-based payments)

Consideration includes
- assets transferred
- liabilities incurred
- equity interests issued

**Note**: If the transferred asset remains within the group, the asset should be measured at its **carrying amount** at acquisition.

**Step 7**

Recognise and measure **goodwill**.

**Goodwill** = Consideration transferred + NCI – Net assets acquired

Goodwill is recognised as an asset and tested annually for **impairment**.

The **gain on bargain purchase** is recognised as a gain in profit or loss on the acquisition date.

## EXAMPLES

**EXAMPLE 2.3** (45 marks – 90 minutes)

Italia Ltd is a glass-manufacturing company operating in Johannesburg. The management of Italia Ltd has identified external acquisition as an area of expansion. As a result, Italia Ltd purchased a 60% interest in Colour Ltd on 1 January 20.24. On this date, Italia Ltd obtained control over Colour Ltd when the share capital and retained earnings of Colour Ltd amounted to R800 000 and R1 050 000 respectively.

All the companies in the group have a 31 December year end.

The following matters were identified to be taken into account in calculating the identifiable assets and liabilities of Colour Ltd at fair value at the acquisition date:

1. The fair value of the non-controlling interests was R805 000 on 1 January 20.24.

2. Machinery was valued at R300 000 more than the carrying amount. The remaining useful life from the date of acquisition is four years. Colour Ltd continued to account for machinery in accordance with the cost model as per IAS 16.

3. Land with a cost price of R300 000 had a fair value of R400 000 on 1 January 20.24. The value of the land has increased to R450 000 at 31 December 20.24. It is the policy of Colour Ltd to account for land in accordance with the cost model as per IAS 40 *Investment Property*.

4. Colour Ltd disclosed a contingent liability of R450 000 in its financial statements on 1 January 20.24 relating to a court case involving a patent right not meeting industry standards. The claim represents a present obligation, but at this time the attorneys of Colour Ltd are of the opinion that it is unlikely to lead to an outflow of economic benefits due to a lack of evidence to support the claim. The R450 000 is the fair value of the claim taking into account all possible outcomes on 1 January 20.24.

   As part of the purchase agreement by Italia Ltd, the shareholders have guaranteed to reimburse Italia Ltd 40% of the claim, should it be successful.

   On 31 December 20.24, the court case has progressed to such an extent that it is virtually certain that Colour Ltd will have to pay R550 000. Colour Ltd recognised a provision of R550 000 in its financial statements on 31 December 20.24. The related transaction has been recorded correctly in Colour Ltd's financial statements.

   The claim will not be deductible for taxation purposes should it succeed.

5. Details of the consideration transferred to the shareholders of Colour Ltd are as follows:

   - A cash consideration of R620 000 was paid on 1 January 20.24 into the lawyer's trust account.
   - Italia Ltd will make a cash payment of R225 060 on 31 December 20.25. The South African Revenue Service agrees with the accounting treatment and will allow the tax deduction for an interest expense.
   - Italia Ltd issued 1 000 ordinary shares to the shareholders of Colour Ltd. The fair value of the shares was R460 each on 1 January 20.24. On the registration date of the shares on 22 January 20.24, the shares were valued at R465 each. The total number of shares in issue by Italia Ltd was 1 000 000 at 1 January 20.24.

- Italia Ltd is required to make an additional cash payment of R150 000 on 30 June 20.26 if the share price of Colour Ltd increases by more than 20%. The fair value of the contingent consideration was estimated to be R60 000 on 1 January 20.24 and R85 000 on 31 December 20.24. The share price of Colour Ltd increased by 32% by 31 December 20.24. The changes in fair value on the contingent consideration is as a result of events after the acquisition date.

Included in the cash consideration paid is acquisition-related cost in respect of valuations and lawyer's fees of R120 000 which was paid by Italia Ltd.

6. Colour Ltd has a licensed customer list on 1 January 20.24. The agreements relating to the customer list does not prohibit the selling or leasing thereof. The useful life of the customer list is four years on 1 January 20.24 and the fair value is R175 794. Colour Ltd has not recognised an asset in this regard.

7. The abridged statement of profit or loss and other comprehensive income of Italia Ltd and Colour Ltd for the year ended 31 December 20.24 is as follows (before taking the above information into account):

| | Italia Ltd | Colour Ltd |
|---|---|---|
| | R | R |
| **Statement of profit or loss and other comprehensive income** | | |
| Profit for the year after tax | 2 600 000 | 601 876 |
| Dividends paid on 31 December 20.24 | | 150 000 |

**Additional information**

- It is the group's policy to measure investment property using the fair value model as per IAS 40 *Investment Property*.
- Intangible assets are accounted for using the cost model as per IAS 38 *Intangible Assets*.
- Italia Ltd elected to measure the non-controlling interests in Colour Ltd at fair value.
- Investments in subsidiaries are accounted for at cost in terms of IAS 27.10(a).
- The normal income tax rate is 27% and the capital gains tax inclusion rate is 80%. Ignore value added tax (VAT) and dividend tax.
- A market-related interest rate (before tax) is 10%, compounded annually.
- The acquisition of Colour Ltd also met the definition of acquiring a business, as defined in IFRS 3 *Business Combinations*.

**REQUIRED**

| | | Marks |
|---|---|---|
| (a) | Prepare the journal entries in the separate records of Italia Ltd for the year ended 31 December 20.24 relating to the information in the question. Journal entries relating to deferred taxation are also required. | 12 |
| (b) | Prepare the pro forma journal entries for the Italia Ltd Group for the year ended 31 December 20.24. Journal entries relating to deferred taxation are also required. | 32 |
| | X1: Communication skills - presentation | 1 |
| **Please note** | | |
| • | Round off all amounts to the nearest rand. | |
| • | Your answer must comply with IFRS Accounting Standards. | |

**EXAMPLE 2.3 – Suggested solution**

**(a) Journal entries in the accounting records of Italia Ltd**

| | | Dr<br>R | Cr<br>R | |
|---|---|---|---|---|
| | **1 January 20.24** | | | |
| J1 | Investment in Colour Ltd (SFP) (balancing or [C1]) | 1 206 000 | | (1) |
| | Acquisition cost (P/L) (given) | 120 000 | | (1) |
| | Share capital (SCE) (1 000 x R460) | | 460 000 | (2) |
| | Contingent consideration (SFP) (given) | | 60 000 | (1) |
| | Deferred consideration (SFP) [C6] | | 186 000 | (3) |
| | Bank (SFP) | | 620 000 | (1) |
| | Accounting for the investment in Colour Ltd | | | |

**DISCUSSION**

Transaction cost should be carefully analysed as the accounting treatments for transaction cost are not all the same.

Acquisition-related cost (finder's, advisory, legal, valuation, professional and administration fees) should be expensed in **profit or loss** in the **consolidated** financial statements of the acquirer in accordance with IFRS 3.53.

Cost to issue debt or equity is **not** acquisition-related cost as defined in accordance with IFRS 3. Share issue cost must be accounted for as a **deduction from equity** in terms of IAS 32.35 in the separate and consolidated financials of the acquirer.

The parent will measure its investments in subsidiaries at cost in accordance with IAS 27.10(a) in its separate financial statements. Acquisition-related cost in the separate financial statements of the parent should thus also be **expensed**. Students should read carefully how the parent treated the transaction cost in its separate financial statements.

In this question, acquisition-related cost of R120 000 was paid by the acquirer and **included** in the cash payment of R620 000 that was paid on 1 January 20.24. The acquisition-related cost should thus be expensed in accordance with IFRS 3.53.

| | | | | |
|---|---|---|---|---|
| | **31 December 20.24** | | | |
| J2 | Fair value adjustment (P/L) (85 000 – 60 000) | 25 000 | | (1) |
| | Contingent consideration (SFP) | | 25 000 | (1) |
| | Fair value adjustment on contingent consideration payable | | | |

**DISCUSSION**

As part of the acquisition of the subsidiary, a contingent consideration is due if the share price of the subsidiary, Colour Ltd, were to increase by more than 20% at 30 June 20.26. In terms of IFRS 3.39, this contingent consideration is recognised at fair value of R60 000 at the acquisition date. Subsequently, the contingent consideration is measured at fair value and the liability needs to be remeasured to **fair value** at year end of R85 000.

| | | Dr R | Cr R | |
|---|---|---|---|---|
| J3 | Finance cost (P/L) (10% x R186 000 (J1)) | 18 600 | | (1) |
| | Deferred consideration (SFP) | | 18 600 | (1) |
| | Interest on the deferred payment | | | |
| J4 | Bank (SFP) (150 000 x 60%) | 90 000 | | (1) |
| | Other income (P/L) | | 90 000 | (1) |
| | Dividends received from Colour Ltd | | | |
| | | | Total | (15) |
| | | | Maximum | (12) |

**DISCUSSION**

The carrying amount and the tax base of the liability are equal since the interest on the liability is deductible for tax purposes. There are therefore no deferred tax implications on journals 2 and 3.

No journals are necessary in the records of Colour Ltd as the transaction by Italia Ltd to acquire the shareholding involves the **previous shareholders** of Colour Ltd. It therefore does not have an impact on the issued share capital of Colour Ltd.

**(b) Pro forma journal entries in the group's accounting records**

| | | Dr R | Cr R | |
|---|---|---|---|---|
| | **1 January 20.24** | | | |
| J1 | Share capital (SCE) (given) | 800 000 | | |
| | Retained earnings (SCE) (given) | 1 050 000 | | |
| | Machinery (SFP) (given) | 300 000 | | (1) |
| | Land (SFP) (400 000 – 300 000) | 100 000 | | (1) |
| | Intangible asset – customer list [C2] (SFP) | 175 794 | | (1) |
| | Goodwill (SFP) [C3] or (balancing) | 5 270 | | (1) |
| | Indemnification asset (SFP) (450 000 x 40%) | 180 000 | | (2) |
| | Non-controlling interests (SFP/SCE) (given) | | 805 000 | (1) |
| | Recognised contingent liability (SFP) (given) | | 450 000 | (1) |
| | Deferred tax (SFP) [C4] | | 150 064 | (3) |
| | Investment in Colour Ltd (SFP) (part (a)) | | 1 206 000 | (1) |
| | Elimination of investment – at-acquisition journal | | | |

**DISCUSSION**

Italia Ltd recognises and measures all identifiable assets acquired and the liabilities assumed in the business combination at their acquisition date **fair values**.

Take note of the group's policy in terms of the measurement of **non-controlling interest** (NCI). In this case, it is mentioned in the information that the NCI is measured at fair value and it is given as R805 000 at the acquisition date.

The **contingent liability** in respect of the legal claim is recognised as a liability assumed in a business combination since it is a **present obligation** resulting from past events and its **fair value** can be measured reliably (IFRS 3.23).

Also take note that the **indemnification asset** (debtor) may only be recognised if the **indemnification item** (in this case the contingent liability) was recognised on the acquisition date (IFRS 3.27). The indemnification asset should be measured on the same basis as the indemnification item (fair value in this case).

**DISCUSSION**

**Deferred tax on the contingent liability**

The tax base of a liability is the carrying amount less any amount that would be deductible for tax purposes in future periods. The question states that the claim will **not** be deductible for taxation purposes should it succeed. This will result in the tax base being the **carrying amount**. There is thus no temporary difference, and deferred tax will not be provided.

| | | Dr<br>R | Cr<br>R | |
|---|---|---|---|---|
| | **31 December 20.24** | | | |
| J2 | Depreciation (P/L) (300 000 x ¼) | 75 000 | | (1) |
| | Accumulated depreciation (SFP) | | 75 000 | (1) |
| | Provision for depreciation on machinery revalued | | | |
| J3 | Deferred tax (SFP) (75 000 x 27%) | 20 250 | | (1) |
| | Income tax expense (P/L) | | 20 250 | (1) |
| | Taxation on depreciation adjustment | | | |

**DISCUSSION**

At acquisition, the fair value of machinery was R300 000 higher than the carrying amount in the separate records of Colour Ltd. Colour Ltd recognised depreciation in its separate financial statements on the cost price of the machinery (in terms of its accounting policy). At consolidation, however, the value of the machinery is R300 000 higher resulting in an additional depreciation charge that is calculated over the remaining useful life (four years) of the machinery.

| | | | | |
|---|---|---|---|---|
| J4 | Contingent liability (SFP) (given) | 450 000 | | (1) |
| | Indemnification asset (SFP) | | 180 000 | (1) |
| | Legal expense (P/L) | | 270 000 | |
| | Reversal of contingent liability raised at acquisition | | | |

**DISCUSSION**

**Colour Ltd** raised a **provision** in its own accounting records of R550 000 at 31 December 20.24 relating to the legal claim. A **contingent liability** was also recognised as a liability (in respect of the legal claim) in the **consolidated financial statements** at the acquisition date (R450 000). This contingent liability and indemnification asset previously recognised in the group's financial statements (J1) on the acquisition date must now be reversed in order to avoid "double accounting" for this liability.

| | | Dr<br>R | Cr<br>R | |
|---|---|---|---|---|
| J5 | Amortisation – customer list (P/L) (175 794 [C2] / 4) | 43 949 | | (1) |
| | Intangible asset – customer list (SFP) | | 43 949 | (1) |
| | Amortisation of customer list | | | |
| J6 | Deferred tax (SFP) (43 949 x 27%) | 11 866 | | (1) |
| | Income tax expense (P/L) | | 11 866 | (1) |
| | Taxation on amortisation | | | |

**DISCUSSION**

The customer list is recognised as an intangible asset and is accounted for in accordance with IAS 38. We therefore amortise the intangible asset over the useful life of the asset.

| | | Dr<br>R | Cr<br>R | |
|---|---|---|---|---|
| J7 | Land (SFP) (450 000 – 400 000) | 50 000 | | (1) |
| | Fair value remeasurement (P/L) | | 50 000 | (1) |
| | Remeasurement in terms of IAS 40 | | | |
| J8 | Income tax expense (P/L) (50 000 x 27% x 80%) | 10 800 | | (1) |
| | Deferred tax (SFP) | | 10 800 | (1) |
| | Taxation on fair value adjustment | | | |

**DISCUSSION**

Land is carried at cost in the separate records of Colour Ltd. However, it is the group's policy to account for investment property (which includes land) in accordance with the fair value model as per IAS 40. We therefore need to account for the fair value movement in the value of land at year end. In this case, we use the CGT inclusion rate of 80% as the fair value adjustment is higher than the original cost price.

| | | Dr<br>R | Cr<br>R | |
|---|---|---|---|---|
| J9 | Non-controlling interests (P/L) [C5] | 329 697 | | (5) |
| | Non-controlling interests (SFP/SCE) | | 329 697 | (1) |
| | NCI share of profits | | | |

**DISCUSSION**

At consolidation, we add 100% of the line items of the statement of profit or loss and other comprehensive income of the subsidiary to the statement of profit or loss and other comprehensive income of the parent to calculate the consolidated figures.

However, we are only entitled to 60% of the line items of the statement of profit or loss and other comprehensive income of the subsidiary. We therefore allocate the 40% share of the non-controlling interests via one line item: non-controlling interests (P/L).

| | | Dr R | Cr R | |
|---|---|---|---|---|
| J10 | Other income – dividends received (P/L) (150 000 x 60%) | 90 000 | | (1) |
| | Non-controlling interests (SFP/SCE) (150 000 x 40%) | 60 000 | | (1) |
| | Dividends paid (SCE) (given) | | 150 000 | (1) |
| | Elimination of intragroup dividends | | | |
| | | | Total | (35) |
| | | | Maximum | (32) |
| | | | X1: Communication skills - presentation and layout | (1) |

**CALCULATIONS**

**C1. Consideration transferred**

| | | |
|---|---|---|
| Cash (given) | 620 000 | |
| Shares (1 000 x R460) | 460 000 | |
| Deferred consideration [C6] | 186 000 | |
| Contingent consideration (given) | 60 000 | |
| Acquisition cost paid (given) | (120 000) | |
| | 1 206 000 | [1] |

**C2. Customer list**

| | | |
|---|---|---|
| Intangible asset – customer list (given) | 175 795 | [1] |

**C3. Calculation of goodwill (IFRS 3.32)**

| | | |
|---|---|---|
| + Consideration transferred | [C1] | 1 206 000 |
| + Non-controlling interests | (given) | 805 000 |
| | | 2 011 000 |
| – Net identifiable assets acquired | | 2 005 730 |
| Share capital | (given) | 800 000 |
| Retained earnings | (given) | 1 050 000 |
| **Adjustments to the net assets (J1)** | | |
| Contingent liability recognised | (J1) | (450 000) |
| Machinery – revaluation surplus | (J1) | 300 000 |
| Land – fair value adjustment | (J1) | 100 000 |
| Indemnification asset raised recognised | (J1) | 180 000 |
| Intangible asset (customer list) | (J1) | 175 794 |
| Deferred tax | [C4] | (150 064) |
| **Goodwill** | | 5 270 |

**C4. Deferred tax**

| | | |
|---|---|---|
| Machinery (300 000 x 27%) | 81 000 | [1] |
| Land (100 000 x 27% x 80%) | 21 600 | [1] |
| Intangible asset – customer list (175 794 x 27%) | 47 464 | [1] |
| Indemnification asset | - | |
| Recognised contingent liability (indemnified item) | - | |
| | 150 064 | |
| | | [3] |

**DISCUSSION**

A deferred tax liability is **recognised** on the **customer list** (intangible asset) since the carrying amount of the customer list exceeds its tax base (the tax base of the customer list is nil as no amount in respect of this asset will be deductible for tax purposes in the future against any taxable economic benefits) (IAS 12.7).

Deferred tax is **not recognised** on the **indemnification asset** since the carrying amount and tax base of the indemnification asset is equal (the economic benefits from the indemnification asset will not be taxable in the future) (IAS 12.7).

Deferred tax is **not recognised** on the **recognised contingent liability** (indemnification item) since the carrying amount and tax base of the liability are equal. The tax base of the contingent liability is its carrying amount minus amounts that will be tax deductible in the future. In this case no amounts will be deductible in the future in respect of this liability, therefore the carrying amount and tax base are equal (IAS 12.8).

## C5. Non-controlling interests

| | | |
|---|---|---|
| Profit for the year (given) | 601 876 | [½] |
| Depreciation on machinery (J2) | (75 000) | [½] |
| Income tax on depreciation (J3) | 20 250 | [½] |
| Legal expense (J4) | 270 000 | [½] |
| Amortisation (J5) | (43 949) | [½] |
| Income tax on amortisation (J6) | 11 866 | [½] |
| Fair value remeasurement on land (J7) | 50 000 | [½] |
| Income tax on fair value remeasurement (J8) | (10 800) | [½] |
| | 824 243 | |

∴ NCI for the year = 824 243 x 40% = 329 697 [½]

[4½]

## C6. Deferred consideration

| HP 10BII | SHARP EL-733A | SHARP EL-738 | |
|---|---|---|---|
| 1. 2nd F C (Clear All) | 1. 2nd FC (Clear All) | 1. 2nd F MODE (Clear All) | |
| 2. 0 PMT | 2. 0 PMT | 2. 0 PMT | |
| 3. 10 I/YR | 3. 10 i | 3. 10 I/Y | [1] |
| 4. 2 N | 4. 2 n | 3. 2 N | [1] |
| 5. 225 060 FV | 5. 225 060 FV | 5. 225 060 FV | [1] |
| 6. PV ⇒ 186 000 | 6. Comp PV ⇒ 186 000 | 6. Comp PV ⇒ 186 000 | |

[3]

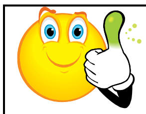
## C7. Analysis of owners' equity of Colour Ltd

| | Total | Italia Ltd 60% | | NCI |
|---|---|---|---|---|
| | | At | Since | |
| **At acquisition** | | | | |
| Share capital | 800 000 | | | |
| Retained earnings | 1 050 000 | | | |
| Equity (contingent liability) | (450 000) | | | |
| Equity (machinery) | 300 000 | | | |
| Deferred tax | (81 000) | | | |
| Equity (land) | 100 000 | | | |
| Deferred tax | (21 600) | | | |
| Equity (indemnification asset) | 180 000 | | | |
| Intangible asset (customer list) | 175 794 | | | |
| Deferred tax | (47 464) | | | |
| | 2 005 730 | 1 203 438 | | 802 292 |
| Equity represented by goodwill | 5 270 | 2 562 | | 2 708 |
| Consideration and NCI | 2 011 000 | 1 206 000 | | 805 000 |
| **Since acquisition** | | | | |
| **Current year** | | | | |
| Comprehensive income for the year | 601 876 | | | |
| Depreciation on machinery | (75 000) | | | |
| Income tax on depreciation | 20 250 | | | |
| Legal expense | 270 000 | | | |
| Amortisation | (43 949) | | | |
| Income tax on amortisation | 11 866 | | | |
| Fair value adjustment on land | 50 000 | | | |
| Income tax on fair value adjustment | (10 800) | | | |
| Total current year profit | 824 243 | | 494 546 | 329 697 |
| Dividends | (150 000) | | (90 000) | (60 000) |
| | 2 685 243 | | 404 546 | 1 074 697 |

**EXAMINATION TECHNIQUE**

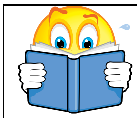
It was not necessary to use an owners' equity analysis in this question. Nonetheless, one is provided for those students who use the analysis method.

## TOPIC 2.3 - FAIR VALUE MEASUREMENT



**INTRODUCTION**

The Standard defines fair value, stipulates how fair values must be determined and sets out disclosure requirements relating to fair values.



**PRESCRIBED STUDY MATERIAL**

**IFRS 13 *Fair Value Measurement***

SAICA Student Handbook 2024/2025; Volume 1; Part A1

IFRS 13 was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

Also note that Unisa follows the limited open-book policy as prescribed by SAICA and that you will be allowed to use the SAICA Student Handbook during assessments.

IFRS 13 is assessed at Proficiency Level 3 to the extent that it provides guidance on fair value measurement relating to items included in the syllabus. However, paragraphs 48 to 56 relating to offsetting positions are excluded from the syllabus.

Let’s look at the overview of IFRS 13.

# Overview of IFRS 13 Fair value measurement

**Objective**

IFRS 13 presents a framework for defining and measuring fair value and disclosing fair value measurements.

**Scope**

All IFRSs that permit fair value measurement and disclosure except for:

- share-based payment transactions within scope of IFRS 2;
- leasing transactions within the scope of IFRS 16 *Leases*;
- measurement of net realisable value of inventories within the scope of IAS 2;
- measurement of value in use within the scope of IAS 36;
- disclosure of plan assets measured at fair value within the scope of IAS 19;
- disclosure of retirement benefit investments within the scope of IAS 26; and
- disclosure when recoverable amount is fair value less costs to sell within the scope of IAS 36.

**Definitions**

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

- **Asset or liability**
  Consider characteristics of assets and liabilities.
- **Transaction**
  Orderly transaction in either the principal or most advantageous market
- **Market participants**
  Consider their assumptions.
- **The price**
  Exit price, before transaction costs that is directly observable, or by using a valuation technique.

**Measurement and application**

- **Non-financial assets**
  Fair value at highest and best use of market participants.
- **Liabilities and own equity**
  At quoted price and if not available:
  - If held as assets by other parties: Measure from perspective of market participant that holds the asset.
  - If not held by other parties as assets: Measure from perspective of market participant that owes the liability or issued the claim on equity.

  Include non-performance risk and restrictions preventing the transfer.
- Application to financial assets and liabilities with offsetting options: Permits measurement of a group of assets and liabilities on a net basis.
- Application of fair value at initial recognition: Differences between transaction price and fair value are taken to profit or loss.
- **Valuation techniques**
  - Market approach: Quoted prices.
  - Cost approach: Adjusted replacement cost.
  - Income approach: Present value techniques.
- **Fair value hierarchy**
  - **Level 1 – Inputs**: Quoted prices for identical items in an active market.
  - **Level 2 – Inputs**: Observable inputs. Quoted prices for similar items in an active market, quoted prices for identical items in an inactive market or observable interest rates and yields.
  - **Level 3 – Inputs**: Unobservable inputs or significant adjustments to observable inputs.

**Disclosure**

Refer to IFRS 13.91 to .99.

## EXAMPLES

**EXAMPLE 2.4** (10 marks – 20 minutes)

Umhlanga Holdings (Pty) Ltd (Umhlanga) owns an investment property (land and a building) situated in Tongaat, KwaZulu-Natal. The building is a warehouse that is leased to an unrelated third party who uses the building as a distribution facility. Recently, residential development has taken place in the area surrounding the property. This has led to substantial increases in the value of residential properties in the area. The most recent development is that the town council has in principle approved the rezoning of the Tongaat property owned by Umhlanga, for residential development.

Umhlanga is seriously considering the possibility of developing the land into a residential estate, in which units will initially be leased out. Umhlanga has already enlisted the services of an architect who drew up plans for the proposed development. The architect was paid for his services in December 20.24.

Umhlanga has been in negotiations with a contractor to develop the residential property. The contractor will commence work after the existing building has been demolished. The scope of the contractor's work will include all relevant earthworks, infrastructure development and construction of the residential units.

After doing extensive research into the planned residential property development, Umhlanga determined that the fair value of the property would be R4 million if it were to pursue the opportunity. The valuation committee of Umhlanga questioned the significant difference between the R4 million fair value of the residential development and the current fair value (determined on the income approach) of the investment property of R2 518 000, as disclosed in the draft annual financial statements for the year ending 31 December 20.24.

**REQUIRED**

| | **Marks** |
|---|---|
| Discuss, with reasons, whether the fair value measurement of the Tongaat investment property included in the draft annual financial statements for the year ending 31 December 20.24 is appropriate in terms of IFRS 13 *Fair Value Measurement*. | 9 |
| X1: Communication skills - logical argument | 1 |

(Source: SAICA ITC [revised])

**EXAMPLE 2.4 – Suggested solution**

IFRS 13 *Fair Value Measurement* defines fair value as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date (IFRS 13.9).

IFRS13.15 requires that the price to sell the asset should be determined at measurement date (31 December 20.24). It also appears that Umhlanga has access to the principal (or most advantageous) market for this property at the measurement date. (1)

The valuation included in the draft financial statements for the year ending 31 December 20.24 (R2 518 000) used an income approach. This is an appropriate valuation technique in terms of IFRS 13. (1)

The fair value measurement should take into account a market participant's ability to generate economic benefits by putting the asset to its highest and best use (IFRS13.27).

The highest and best use of a non-financial asset is the use by market participants that would maximise the value of the asset (Tongaat property) within which the asset would be used. (1)

The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows (IFRS13.28):

- A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (e.g. the location or size of a property) – it is physically possible to use the property either as a warehouse (current use) or to convert it into residential property (potential use). (1)

- A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (e.g. the zoning regulations applicable to a property) – it is legally permissible to use the property under its current use as a warehouse or to rezone the property for potential use as residential. (1)

- A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash to produce an investment return that market participants would require from an investment in that asset put to that use – the current use as a warehouse generates cash flows from leasing, and potential use and conversion into residential property also appear financially feasible (taken into account the costs to convert and the return that will be earned). (1)

It appears that the residential development is the highest and best use over the leasing alternative based on the following:

- Recent residential development has taken place in the area surrounding the property. (1)
- Substantial increases in the value of residential properties in the area indicate that the higher and best use is the residential development. (1)
- If the property is zoned for residential development, the costs to finalise are marginal. (1)
- Umhlanga is seriously considering the development, which would also imply that it has identified the opportunity to unlock value. (1)
- Based on the valuation performed, the higher and better use value is the residential estate of R4 000 000 rather than the R2 518 000 value based on the current use of leasing out the premises. (1)

**Conclusion**

It appears that the valuation should be based on the residential development use. It is unlikely that the fair value of R2 518 000 (based on current use) is appropriate in the current circumstances. (1)

| | |
|---|---|
| Total | (12) |
| Maximum | (9) |
| X1: Communication skills - logical argument | (1) |

**EXAMPLE 2.5** (10 marks – 20 minutes)

Desert Storage Ltd (Desert) is a company that owns two self-storage unit complexes in Kimberley. These units are rented to individuals or companies as secure storage spaces to be used as needed. Desert has a 31 December year end.

Desert's storage complexes are unique in that the units are made up of individual shipping containers that are stacked in a specific manner. Desert obtains its shipping containers from Johannesburg, where the market for containers is highly liquid due to the large number of containers stored there. During 20.24, the average price for a container similar to the size and condition used by Desert in Johannesburg was R28 000. There is a small market for containers in Kimberley. The average price of a container in Kimberley was R29 000 during 20.24. On 29 December 20.24, Desert purchased 10 new containers from an insolvent estate at R24 000 each.

The financial director decided to use a discounted cash flow method to determine the fair value of the containers. The financial director determined that the fair value of the containers was R30 750 each.

During the year, Desert became aware of a new alternative use for shipping containers. The metal used for the containers has excellent anti-corrosion qualities and is thus in demand in coastal areas for roof sheeting and other construction elements. Desert was offered R29 500 by three different steel merchants for disassembled containers in December 20.24. The costs to disassemble each container are negligible. The managing director indicated that Desert is a family business and is not interested in selling the containers to the steel merchants.

**REQUIRED**

| | **Marks** |
|---|---|
| Discuss, with reasons, the appropriate fair value in terms of IFRS 13 *Fair Value Measurement* of each container for the year ended 31 December 20.24. | 9 |
| X1: Communication skills - logical argument | 1 |
| **Please note:**<br>• Your discussion should make reference to all the possible amounts that Desert Storage Ltd will consider in determining the appropriate fair value.<br>• Your answer must comply with IFRS Accounting Standards. | |

**EXAMPLE 2.5 – Suggested solution**

**Orderly transaction**

IFRS 13.24 states that fair value is the price that would be received to sell an asset in an orderly transaction in the principal (or most advantageous market) at the measuring date.

The R24 000 that was paid per container was not indicative of an orderly transaction as liquidation sales are, in this case, not ordinary transactions. (1)

Thus, the transaction price of R24 000 is not appropriate to use as fair value. (½)

**Principal market vs most advantageous market**

The principal market is the market in which the entity would normally enter into a transaction to sell the asset (IFRS 13.17), or it is the market with the greatest volume and level of activity.

The principal market is the Johannesburg market, as this is the market with the greatest volume. (½)

The most advantageous market is in Kimberley at R29 000 per container, but an entity can only use the most advantageous market in the absence of a principal market (IFRS 13.17). (½)

Thus, the R28 000 in the principal market will be considered appropriate fair value. (½)

**Discounted cash flow valuation method**

An entity should maximise the use of relevant observable inputs and minimise the use of unobservable inputs when using valuation techniques (IFRS 13.61).

IFRS 13 establishes a fair value hierarchy that gives the highest priority to quoted prices in active markets for identical assets (level 1 inputs) and the lowest priority to valuation methods that use unobservable inputs (level 3 inputs) (IFRS 13.72).

The discounted cash flow calculation uses unobservable inputs in the way of future income and occupancy rates. This results in this valuation technique being classified at level 3. (1)

The market value obtained from the principal market uses quoted prices in an active market as the trade in containers in Johannesburg is highly liquid. This valuation can be classified at level 1. (1)

The fair value calculation using quoted prices is more preferable than the discounted cash flow valuation method in the fair value hierarchy. Therefore, the fair value of R28 000 should be considered an appropriate fair value. (1)

Fair value is also a market-based measurement and not an entity-specific measurement (IFRS 13.2).

The R30 750 is entity specific as it reflects the use that the company will receive from using the asset. The company valuation of R30 750 per container is thus not appropriate. (1)

**Highest and best use**

The fair value measurement of non-financial assets requires that one takes into account market participants' ability to generate economic benefits by putting the asset to its highest or best use (IFRS 13.27).

The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible (IFRS 13.28).

There is an alternative use for the containers (other than their use as storage units). The containers can be disassembled and used as roof sheeting. This alternative use is physically possible as the cost to disassemble is negligible, it is legally permissible and it is financially feasible. (2) (1)

Desert has no intention to dispose of the containers in this manner, but the highest and best use is determined from the perspective of market participants (IFRS 13.29). (½)

Thus, the R29 500 will be considered an appropriate fair value.

**Conclusion**

The two possible fair value amounts per container were the principal market amount of R28 000 and the highest and best use amount of R29 500. The highest and best use for non-financial assets will be considered the appropriate fair value (R29 500). (2)

| | |
|---|---|
| Total | (12½) |
| Maximum | (9) |
| X1: Communication skills - logical argument | (1) |

# TOPIC 2.4 - REVENUE

**INTRODUCTION/ PURPOSE**

IFRS 15 establishes a single framework for the recognition and measurement of revenue. The core principle is that a vendor recognises revenue when control over the good or service is transferred to a customer.

**PRESCRIBED STUDY MATERIAL**

**IFRS 15 *Revenue from Contracts with Customers***
(including the illustrative examples)

SAICA Student Handbook 2024/2025; Volume 1; Part A1

IFRS 15 was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

Also note that Unisa follows the limited open-book policy as prescribed by SAICA and that you will be allowed to use the SAICA Student Handbook during assessments.

| Description | Level | Notes |
|---|---|---|
| IFRS 15 is assessed at Proficiency Level 3, except | | |
| Scope | 1 | |
| Step 1 - contracts: identification and combination | 1 | |
| Step 1 - modifications | 1 | |
| Step 3 - changes in transaction price | 2 | |
| Application Guidance: | | |
| • Principal vs agent considerations | 2 | |
| • Customer options for additional goods or services | 2 | |
| • Customers unexercised rights | 2 | |
| • Repurchase agreements | 2 | |
| • Licensing | Excluded | |

**VIDEOS**

Watch the video for a discussion of revenue.

Let’s look at the overview of IFRS 15 *Revenue from Contracts with Customers*.

## Overview of IFRS 15 Revenue

The Standard describes a five-step revenue model (directs the recognition of revenue from contracts with customers).

| | | |
|---|---|---|
| **Step 1** | Identify the **contract**. | ▪ Single contract<br>▪ Combined contract<br>▪ Contract modification |
| **Step 2** | Identify the **performance obligations** in the contract. | ▪ Goods or services that are distinct<br>▪ A series of distinct goods or services |
| **Step 3** | Determine the **transaction price**. | ▪ Variable consideration<br>▪ Time value of money<br>▪ Non-cash consideration<br>▪ Consideration payable to customers<br>▪ Collectability |
| **Step 4** | **Allocate** the transaction price to the performance obligations in the contract. | ▪ Allocation based on stand-alone selling price<br>▪ Allocate discounts<br>▪ Allocate variable consideration |
| **Step 5** | **Recognise** revenue when (or as) the entity satisfies a performance obligation. | ▪ Control<br>▪ Over a period of time<br>▪ At a point in time |

### Five-step revenue model

| | | |
|---|---|---|
| **CONTRACT** | **Combination contract**<br>Account as a single contract when:<br>▪ entered into near the same time with the same customer; and<br>▪ contracts have a single commercial objective; or<br>▪ consideration depends on price of another contract; or<br>▪ goods/services under contracts constitute a single performance obligation. | **Contract costs.**<br>Recognise an asset when:<br>▪ the cost is not in the scope of another IFRS; and<br>▪ costs are directly related to the contract; and<br>▪ costs generate resources that help satisfy the performance obligations; and<br>▪ costs are recoverable. |
| | **Modification** is **a new separate** contract when:<br>▪ additional goods or services are distinct; and<br>▪ the consideration reflects stand-alone selling prices of goods or services. | |
| **PERFORMANCE OBLIGATIONS** | Performance obligations in a contract are accounted for **separately** when the goods or services are distinct, that is:<br>▪ capable of being distinct; and<br>▪ distinct within the context of the contract. | |
| **DETERMINE TRANSACTION PRICE** | **Consider the following to determine the transaction price**:<br>▪ Variable consideration (revenue is the expected value or most likely amount but constrained).<br>▪ Time value of money (reflect time value of money when significant financing component exists).<br>▪ Non-cash consideration (recognised at fair value).<br>▪ Consideration payable (reduce revenue if payment is not for distinct goods or services).<br>▪ Collectability (losses due to credit risk do not adjust transaction price). | |

| | |
|---|---|
| **ALLOCATE TRANSACTION PRICE** | ▪ Allocate transaction price to separate performance obligations based **on stand-alone selling prices**.<br>▪ Allocate **discount** (sum of stand-alone selling prices > transaction price) to separate performance obligations.<br>▪ Allocate **variable consideration**. |

| | |
|---|---|
| **RECOGNISE REVENUE** | Recognise revenue when the performance obligation is satisfied by transferring **control** of the asset to the customer.<br>**Performance obligations are satisfied at a point in time; or**<br>**Performance obligations are satisfied over time and revenue is recognised by measuring the progress towards completion when**:<br>▪ customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs; or<br>▪ the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or<br>▪ the entity's performance does not create an asset with an alternative use. |

## EXAMPLES

**EXAMPLE 2.6** (25 marks – 50 minutes)

You were recently appointed as the new financial director of Confident Ltd ('Confident') and you are also responsible for the consolidated statements of the Confident Group. Confident is listed on the JSE Ltd and owns shares in two other companies, namely Positive Ltd ('Positive') and Brave Ltd ('Brave'). All companies in the group have a financial year end of 31 December.

The consolidated annual financial statements of the Confident Group for the year ended 31 December 20.23 are in the process of being finalised.

**ROOT division operating within Positive Ltd**

Positive also has a division called Running-out-of-time Ltd (ROOT). ROOT is not a separate legal entity and operates within the legal entity of Positive.

ROOT only designs and sells state-of-the-art Rolux watches to the rich and famous. ROOT prides itself that they put their customers first and that their satisfaction is guaranteed. The watches (Rolux and customised watches) are sold with a two-year warranty from the date of purchase. The warranty provides the customer assurance that the product complies with agreed-upon specifications and that it will operate as promised for a period of two years.

In September 20.23, ROOT signed a contract with KeKe, a famous model, in terms of which Root promised to design and manufacture a custom-made JUST TIME watch according to KeKe's specifications. KeKe will fund the custom-made JUST TIME watch from her various sponsorships. The terms and conditions of the contract determines that any payments made to ROOT in advance are refundable and that ROOT has the right to cancel the contract if they cannot perform as stipulated in the contract. If KeKe is not satisfied with the watch and does not accept it, ROOT will easily be able to sell the watch to one of KeKe's fans.

A standard JUST TIME watch is normally sold at a stand-alone price of R45 000. Warranties, packaging and accessories are not sold separately from the watches. ROOT incurs the following costs for each standard JUST TIME watch manufactured:

| | **R** |
|---|---|
| Wooden box (packaging) | 500 |
| Alternative leather band | 1 000 |
| Artwork, precious gems and gold | 8 000 |
| 904L steel (special type of stainless steel) | 10 000 |
| Consumables | 5 000 |
| | 24 500 |

Because of the specifications of KeKe's design, ROOT had to incur an additional cost of R4 000. ROOT considers a mark-up of 25% (on the additional cost) as an appropriate profit margin.

KeKe agreed to be the new face of ROOT's 20.24 winter watch collection. ROOT agreed to pay her R10 000 as an upfront, non-cancellable deposit to secure her availability for the winter launch. On 30 September 20.23, ROOT invoiced her for a net amount of R40 000.

ROOT completed KeKe's watch on 30 November 20.23. KeKe only collected the watch set on 21 June 20.24, since she was in the United Kingdom promoting her new cosmetics line. KeKe settled the outstanding amount with ROOT on 31 July 20.24.

**REQUIRED**

| | Marks |
|---|---|
| Write an email to the financial director of Positive Ltd, discussing the recognition and measurement of revenue from the sale of the watch to KeKe in accordance with IFRS 15 *Revenue from Contracts with Customers.* Use the five steps listed in IFRS 15 to structure your answer. | 24 |
| X1: Communication skills - logical flow, conclusion and format | 1 |
| **Please note:**<br>• Round off all amounts to the nearest rand.<br>• Ignore any normal income tax implications.<br>• Ignore any value-added taxation (VAT) implications.<br>• Your answer should comply with IFRS Accounting Standards. | |

(**Source**: North-West University)

**EXAMPLE 2.6 – Suggested solution**

From: CTA@gmail.com
To: Student@Yahoo.co.za
Subject: Recognition and measurement of Revenue from the sale of the watch

Dear Financial Director

In terms of IFRS 15 an entity recognises and measures revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

**1. Identify the contract with a customer:**

ROOT should account for a contract with a customer when **all** the following criteria are met:

1.1 The parties to the contract have approved the contract. Approval might be in **writing, orally or implied** by customary business practice. ROOT and KeKe **signed** a contract in September 20.23, creating a legally enforceable contract. (1)

1.2 The entity can identify each party's rights regarding the goods or services to be transferred.
- ROOT has agreed to **design and manufacture** a custom-made watch for KeKe and is also obliged to provide a warranty service. ROOT has the **right** to receive payment for the watch set. (1)
- The customer (KeKe) agrees to take l**egal ownership and effective control** of the watch and to **pay for the watch.** KeKe has the right to receive the watch and under the warranty is entitled to, for example, "free" repairs or replacement. (1)

Although ROOT has the right to cancel the contract if they cannot perform as stipulated in the contract, it prides itself in putting their customers first and guaranteeing their satisfaction. (1)

It seems as if both (ROOT and KeKe) are committed to perform their obligations (KeKe has **sufficient funds** to pay for the watch and ROOT wants to keep its promise of customer satisfaction). (1)

1.3 The entity can determine the payment terms for the goods or services to be transferred.
- Customers can pay in advance (included in terms and conditions of the contract) or make a once-off payment once the watch is completed (implied). (1)

1.4 The contract has commercial substance.
- The contract has commercial substance in terms of the risk, timing and amount of cash flows for ROOT. ROOT will receive R50 000 (see discussion below) and will settle the manufacturing costs of R24 500 plus an additional R4 000. (2)
- Further potential cash flows could result due to the warranty. (1)

1.5 It is probable that the entity will collect the consideration to which it is entitled in exchange for goods/services transferred to customer.
- There is no indication that ROOT will not collect the consideration from KeKe. (1)

**Conclusion**

In light of the above, a contract with a customer exists. (1)

## 2. Identify the performance obligations in the contract

- In order for goods and services in a contract to each be accounted for as separate performance obligations, ROOT has to assess at contract inception the goods and services promised in the contract and identify, as a performance obligation, each promise to transfer either
  (a) a good or service (or a bundle of goods or services) that is distinct, or
  (b) a series of distinct goods and services that are substantially the same and that have the same pattern of transfer to the customer (IFRS 15.22). (1)

- A good or service is distinct if both the following criteria are met:
  (a) The customer can benefit from the goods or services, either on their own or together with other resources, AND
  (b) Their promise to transfer the goods and services is separately identifiable from other promises in the contract (IFRS 15.27).

**Watch**
- The watch is a distinct separate performance obligation, as the customer can enjoy it on its own or together with other resources, such as the warranty and wooden box promised in the package. (1)
- IFRS 15.30 states that if a promised good is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.
- The wooden box and alternative leather band are highly dependent on the sale of the watch (packaging and accessories are not sold separately from the watches) and the artwork, precious gems and gold (input to produce the combined output specified by the customer (a custom-made watch)) are not separately identifiable and should be combined with the watch as one performance obligation. (3)

**Warranty**
- The warranty does not provide the customer with a good or service in addition to the assurance, nor does the customer have the option to purchase the warranty separately; therefore, the entity does not account for the warranty as a separate performance obligation. (2)
- The warranty will be accounted for in terms of IAS 37. (1)

**Finance component**
- Although KeKe only paid 8 months after the watch was completed, this is not a significant financing component and not a separate performance obligation, as the practical expedient would apply (one year or less between settlement and transferring of control of good). (2)

## 3. Determine the transaction price

- The transaction price of KeKe's custom-made JUST TIME watch is R50 000, calculated as the stand-alone price of R45 000 for a standard JUST TIME watch plus the revenue from the additional cost (R4 000 plus 25% profit margin = R5 000). (2)
- ROOT cannot recognise revenue for the net amount of R40 000 (R50 000 revenue from the watch less R10 000 deposit to secure KeKe's availability for the winter launch). The consideration payable to KeKe is an upfront payment for a distinct service (advertising/marketing) receivable from KeKe and should be accounted for as a purchase from a supplier. (2)

## 4. Allocate the transaction price to the performance obligations in the contract

- Transaction price should be allocated on the relative stand-alone selling prices of goods. The total transaction price of R50 000 will be allocated to the watch set. (1)

## 5. Recognise revenue when the entity has satisfied the performance obligations

- Revenue can be recognised at a point in time or over a period of time (IFRS 15.32).
- ROOT should recognise revenue when KeKe (the customer) obtains control of the asset (IFRS 15.31).
- Control indicators (IFRS 15.38 (a-e)) include the following:
  - ROOT having the right to receive payment once the watch is completed on 30 November 20.23 and/or KeKe having title to the asset/taking physical possession of the asset/accepting the asset on 21 June 20.24. (1)
  - KeKe does not control the asset, as it is created (the terms and conditions of the contract determines that ROOT has the right to cancel the contract if they cannot perform as stipulated in the contract). (1)
  - ROOT's performance does not create an asset with no alternative use (although KeKe specifically asked for a custom-made JUST TIME watch, any rich fan would buy the watch from ROOT). (1)
  - Although ROOT has an enforceable right to payment for performance completed to date (the contract determines that any payment made in advance is refundable if ROOT cannot perform), they are still able to sell the watch to a KeKe fan if she does not accept the watch. (1)
  - ROOT has the ability to direct the watch to another customer until KeKe takes legal title/possession of the watch. (1)
- Revenue should thus be recognised on 21 June 20.24 (at a point in time), the date when ROOT has a present right to payment and legal ownership passed to KeKe, i.e., the date control passed to KeKe. (1)
- The fact that ROOT invoiced KeKe on 30 September 20.23 does not necessarily mean it had an unconditional right to consideration nor that control passed to KeKe. (1)

**Conclusion**

Revenue should be recognised on 21 June 20.24 (at a point in time) and measured at R50 000 (the stand-alone transaction price of the watch set). (1)

| | |
|---:|---:|
| Total | (34) |
| Maximum | (24) |
| X1: Communication skills - logical flow, conclusion and format | (1) |

**Example 2.7** (14 marks – 28 minutes)

Coolworth Ltd (Coolworth) is a respected retail chain company that supplies clothing, food and homeware. Coolworth launched a new customer loyalty programme on 1 January 20.23 that rewards a customer with one customer loyalty point for every R150 of purchases. Each point is redeemable for discount on future purchases of Coolworth products. The estimated stand-alone selling price of one point is R0,90.

Sales to Coolworth customers amounted to R2 700 000 (the stand-alone selling prices of the products) during the financial year ended 31 December 20.23. Coolworth expects that 12 000 points will be redeemed during the financial year ending 31 December 20.23. At the end of the 20.23 financial year, 10 000 points have been redeemed by customers. On 31 December 20.24, 11 800 points have been redeemed cumulatively in respect of the 20.23 sales. Coolworth continues to expect that 12 000 points will be redeemed in respect of the 20.23 sales.

Sales to Coolworth customers amounted to R3 300 000 (the stand-alone selling prices of the products) during the financial year ended 31 December 20.24. At the end of the 20.24 financial year, 12 500 points on the 20.24 sales were redeemed by customers and Coolworth expects that 15 000 points will be redeemed in total in respect of the 20.24 sales.

All sales made in 20.23 and 20.24 were cash sales.

**REQUIRED**

| | **Marks** |
|---|---|
| Provide the journal entries to account for the customer loyalty program in the financial statements of Coolworth Ltd for the year ended 31 December 20.23 and 31 December 20.24. | 13 |
| X1: Communication skills - presentation and layout | 1 |
| **Please note:**<br>• Ignore any normal income tax implications.<br>• Ignore any value-added taxation (VAT) implications.<br>• Journal narrations are required.<br>• Round off all amounts to the nearest rand.<br>• Your answer must comply with IFRS Accounting Standards. | |

**QUESTION 2.7 - Suggested solution**

**COMMENT**

In this case the contract with a customer includes two performance obligations, i.e., the promise to provide goods and the promise to provide loyalty points to the customer. Since these two performance obligations are **distinct** in terms of IFRS 15.27, the entity has to allocate the transaction price to these two performance obligations.

**Journal entries to account for customer loyalty program**

| | | Dr<br>R | Cr<br>R | |
|---|---|---|---|---|
| | **31 December 20.23** | | | |
| J1 | Bank (given) | 2 700 000 | | (1) |
| | Revenue: products (P/L) [C2] | | 2 683 897 | (3) |
| | Revenue: loyalty points (P/L)<br>(10 000/12 000 x R16 103 [C2]) | | 13 419 | (2) |
| | Contract liability (SFP) [C3] | | 2 684 | (1) |
| | Recognition of revenue from products and loyalty points | | | |
| | **31 December 20.24** | | | |
| J2 | Contract liability (SFP) | 2 415 | | (1) |
| | Revenue: loyalty points (P/L)<br>((11 800 – 10 000)/12 000 x R16 103 [C2]) | | 2 415 | (1) |
| | Recognise revenue from 20.23 loyalty points redeemed in 20.24 | | | |
| J3 | Bank (given) | 3 300 000 | | (1) |
| | Revenue: products (P/L) [C5] | | 3 280 318 | (3) |
| | Revenue: loyalty points (P/L)<br>(12 500/15 000 x R19 682 [C5]) | | 16 402 | (2) |
| | Contract liability (SFP) [C6] | | 3 280 | (1) |
| | Recognition of revenue from products and loyalty points | | | |
| | | | Total | (16) |
| | | | Maximum | (13) |
| | | | X1: Communication skills - presentation and layout | (1) |

**CALCULATIONS**

| | | | |
|---|---|---|---|
| **C1.** | Loyalty points incurred during 20.23 (R2 700 000/R150) | 18 000 | [1] |
| | Stand-alone selling price of loyalty points (18 000 x R0,90) | R16 200 | [1] |
| **C2.** | Allocation of transaction price in 20.23 | | |
| | Revenue allocated to products<br>[2 700 000 x (2 700 000/(2 700 000 + 16 200 [C1]))] | 2 683 897 | [1] |
| | Revenue allocated to points<br>[2 700 000 x (16 200 [C1]/(2 700 000 + 16 200[C1]))] | 16 103 | [1] |
| **C3.** | Contract liability for 20.23<br>16 103 x 2 000 unredeemed points / 12 000 expected points | 2 684 | [1] |
| **C4.** | Loyalty points earned during 20.24 (R3 300 000/R150) | 22 000 | [1] |
| | Stand-alone selling price of loyalty points (22 000 x R0,90) | R19 800 | [1] |

| | | | |
|---|---|---|---|
| **C5.** | Allocation of transaction price in 20.24 | | |
| | Revenue allocated to products | | |
| | [3 300 000 x (3 300 000/(3 300 000 + 19 800 [C4]))] | 3 280 318 | [1] |
| | Revenue allocated to points | | |
| | [3 300 000 x (19 800 [C4]/(3 300 000 + 19 800[C4]))] | 19 682 | [1] |
| **C6.** | Contract liability for 20.24 | | |
| | 19 682 x 2 500 unredeemed points/15 000 expected points | 3 280 | [1] |

**COMMENT**

In this question, you were given both the estimated future price and the stand-alone selling price/value for the points. Where the stand-alone selling price is given, it is used in calculating the allocation of the transaction price.

Note: Where the stand-alone selling price is not given, an estimation of the selling price/value should be used. Also, refer to IFRS 15.78 and IFRS 15.B42. You can also refer to Example 52 that deals with customer loyalty programs in the illustrated examples to IFRS 15.

The principle behind the allocation of the transaction price is that the transaction price that is usually given constitutes two performance obligations and each performance obligation needs to be allocated a transaction price.

**EXAM TECHNIQUE**

The first process in allocating the transaction price in two performance obligations that are **distinct** in terms of IFRS 15.27 is to get the stand-alone selling price of the loyalty points (the other performance obligation)

# TOPIC 2.5 - EVENTS AFTER THE REPORTING PERIOD

**INTRODUCTION/ PURPOSE**

Events after the reporting period are events, both favourable and unfavourable, that occur between the reporting date and the date when the financial statements are authorised for issue. The most important aspect is to determine when an entity should adjust its financial statements for events after the reporting period, as well as the disclosure requirements.

**PRESCRIBED STUDY MATERIAL**

**IAS 10 *Events after the Reporting Period***

SAICA Student Handbook 2024/2025; Volume 1; Part A2

IAS 10 was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

Also note that Unisa follows the limited open-book policy as prescribed by SAICA and that you will be allowed to use the SAICA Student Handbook during assessments.

IAS 10 is assessed at Proficiency Level 3 to the extent that it provides additional presentation and disclosures relating to IFRS/Topic that are included in the syllabus.

**VIDEOS**

Watch the video discussing events after the reporting period.

Let's look at the overview of IAS 10 *Events after the Reporting Period.*

## Overview of IAS 10 Events after the Reporting Period

### EVENTS AFTER THE REPORTING PERIOD

Events that occur after the reporting period are those favourable or unfavourable events that occur between the end of the reporting period and the date of authorisation of the financial statements for issue.

### ADJUSTING EVENTS

- Provide evidence of conditions that existed at the end of the reporting period;
- irrespective of whether the fact was actually known at the end of the reporting period;
- results in an update of the relevant amounts in financial statements to reflect adjusting events.

### NON-ADJUSTING EVENTS

- Indicative of conditions that arose after the reporting period;
- unrelated to conditions that existed at the end of the reporting period;
- results in disclosure in note to the financial statements, if material, of:
  - nature of events;
  - financial effect or a statement that the financial effect cannot be determined.

### SPECIFIC ISSUES

**Dividends**

Declared after the reporting period:

- not a present obligation at reporting period;
- therefore do not recognise the obligation at reporting period;
- disclose in note to financial statements (IAS 1).

**Going concern**

Financial statements must not be prepared on the basis of a going concern if:

- entity plans to go into liquidation; or
- ceases its commercial activities; or
- if there is no realistic alternative but to liquidate.

# TOPIC 2.6 - PROVISIONS, CONTINGENT LIABILITIES AND ASSETS

**INTRODUCTION/ PURPOSE**

The most important aspect of this topic is determining whether an item is a provision or a contingent liability. A provision is a liability (a current obligation) as defined, except that the **timing or amount** of the obligation is uncertain. A contingent liability is a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events or a present obligation that is not recognised because:

- an outflow of resources is not probable or
- the amount cannot be measured with sufficient reliability

**PRESCRIBED STUDY MATERIAL**

**IAS 37 *Provisions, Contingent Liabilities and Contingent Assets***

SAICA Student Handbook 2024/2025; Volume 1; Part A2

IAS 37 was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

Also note that Unisa follows the limited open-book policy as prescribed by SAICA and that you will be allowed to use the SAICA Student Handbook during assessments.

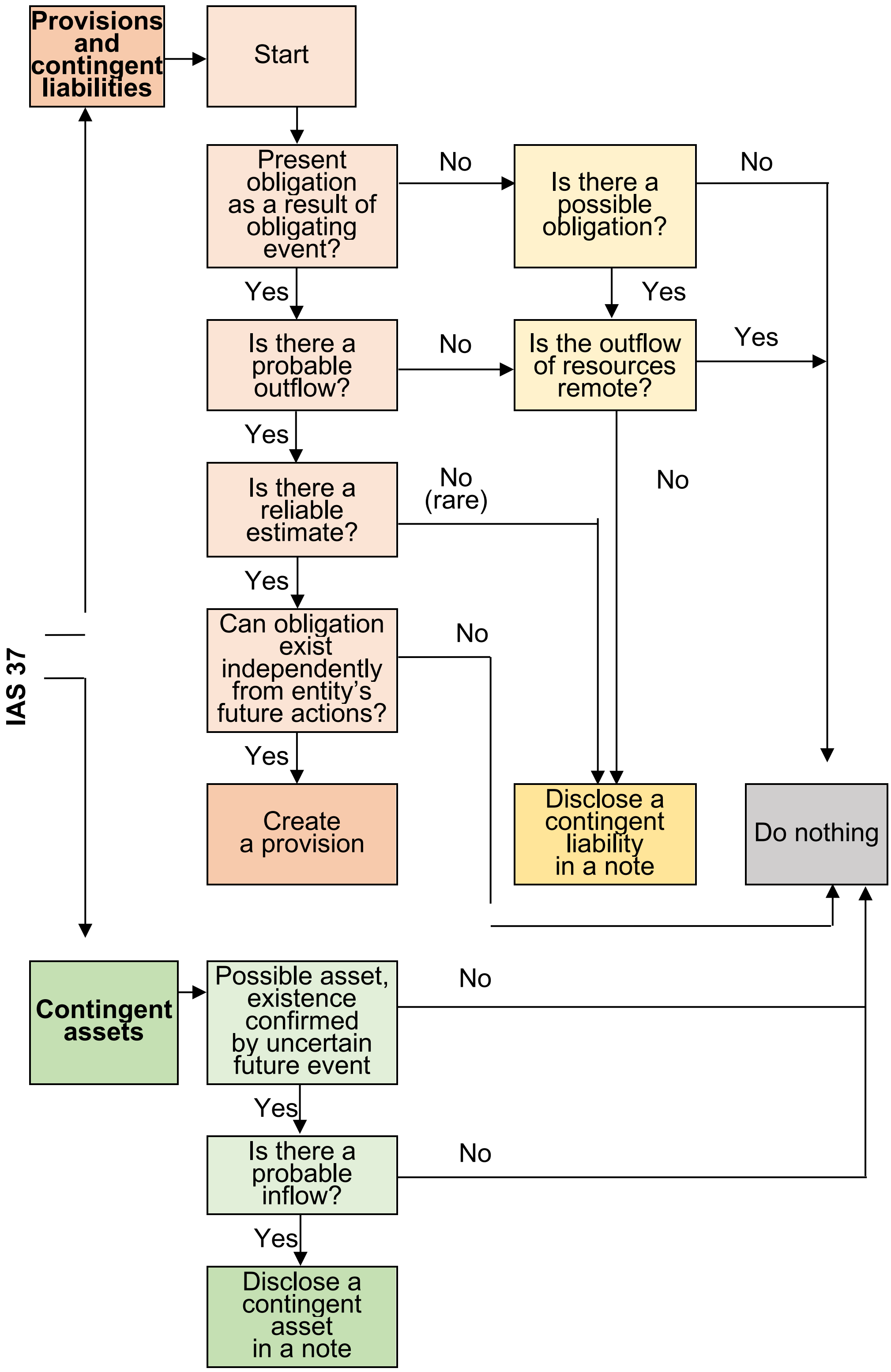
| Description | Level | Notes |
|---|---|---|
| IAS 37 is assessed at Proficiency Level 3, except | | |
| Scope | 1 | |
| Restructuring | 2 | |

**VIDEOS**

Watch the video discussing provisions, contingent liabilities and contingent assets.

Let’s look at the overview of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

## Overview of IAS 37 Provisions, Contingent Liabilities and Contingent Assets



## INTEGRATED QUESTIONS

| Question | Question name | Marks | Topics covered |
|---|---|---|---|
| 1 | Top Blinds Ltd | 40 | Presentation of consolidated statement of financial position<br>Discussion on accounting of customers list<br>Discussion on power |
| 2 | Oneity Ltd | 40 | Discussion on assets and liabilities acquired – recognition and measurement |
| 3 | Paintpro Ltd | 40 | Journal entries in the separate records of the parent<br>Discussion on the acquisition of a subsidiary after year end |
| **Case study** | | | |
| 1 | School4u Ltd | 40 | Discussion of IFRS 10 and IFRS 13<br>Proforma consolidation journal entries |
| 2 | Cellular Connect Ltd | 53 | IFRS 15 |

**QUESTION 1** **40 marks**

| YOU HAVE 80 MINUTES TO ANSWER THIS QUESTION |
|---|

Top Blinds Ltd is a company that specialises in the manufacturing and installation of blinds and security shutters. Top Blinds Ltd is listed on the Johannesburg Stock Exchange and has a 31 December year end.

On 1 March 20.24, Top Blinds Ltd acquired a 55% controlling interest in Bamboo Ltd. Bamboo Ltd supplies eco-friendly and sustainable products to manufacture bamboo blinds.

Top Blinds Ltd will be settling the purchase price at the dates as specified below:

| | |
|---|---|
| On 1 March 20.24 | • R750 000 in cash.<br>• Issue of 25 000 ordinary shares in Top Blinds Ltd to the shareholders of Bamboo Ltd.<br>• Issue of 70 000 mandatory redeemable, 8% cumulative R2 preference shares in Top Blinds Ltd. The preference shares are redeemable three years after the acquisition date, at a premium of 5% on the face value.<br>• Financial assets owned by Top Blinds Ltd, with a carrying amount of R350 000 and a fair value of R420 000, were transferred to the shareholders of Bamboo Ltd.<br>• Included in the R750 000 cash payment are a R18 500 share issue cost related to the 25 000 issued ordinary shares and a R22 300 acquisition-related cost in respect of valuations and lawyers' fees. Top Blinds Ltd expensed these amounts in its separate financial statements. |
| On 28 February 20.26 | • R300 000 cash depending on the following:<br>• The profit before tax of Bamboo Ltd for the year ended 28 February 20.26 increases by at least 5%. The fair value of this obligation was deemed to be R165 000 on 1 March 20.24 and R185 000 on 31 December 20.24. |

All the assets and liabilities of Bamboo Ltd were deemed to be fairly valued at the acquisition date with the exception of the following:

- Inventory was overvalued with R72 000. At 31 December 20.24, 70% of the inventory was sold to unrelated third parties.
- Bamboo Ltd has a unique customer list that consists of detailed information about customers. The customer list's terms of confidentiality prohibit Bamboo Ltd from selling this list. The fair value of the customer list on 1 March 20.24 amounted to R330 000. The customer list has an indefinite useful life.
- Bamboo Ltd manufactures bamboo blinds that have a unique shape. Before the date of acquisition, Bamboo Ltd incurred development cost of R220 000 for the development of a trade dress (unique colour, shape and package design) for these blinds. Bamboo Ltd expensed this development cost when incurred. The registration of the trade dress was not finalised at the date of acquisition and the fair value was therefore estimated as R245 000 on 1 March 20.24. On 1 March 20.24, it is expected that this trade dress will have a useful life of five years. The trade dress was registered on 31 May 20.24. Bamboo Ltd obtained the official valuation report on this day, which indicated that the fair value of the trade dress amounted to R280 000.
- On 1 March 20.24, a liability with a fair value of R195 000 was correctly recognised in the consolidated financial statements of the Top Blinds Ltd Group in accordance with IFRS 3. This liability relates to a legal claim instituted against Bamboo Ltd. The previous shareholders agreed to reimburse Top Blinds Ltd for 45% of the damages payable if the legal claim against

Bamboo Ltd is successful. The claim will not be deductible for taxation purposes should it be successful. The fair value of the contingent liability remained unchanged at year end.

No additional assets, liabilities or contingent liabilities were identified at the acquisition date.

Bamboo Ltd revalued its investments in equity instruments on 28 February 20.24. This was the only revaluation on investments in equity instruments that Bamboo Ltd performed during the current financial year.

Since the date of the acquisition, Top Blinds Ltd has been selling inventory to Bamboo Ltd at a profit of 20% on cost. Inventory purchased from Top Blinds Ltd, still on hand at year end amounted to R185 700. Total sales from Top Blinds Ltd to Bamboo Ltd for the current financial year amounted to R320 000. Included in the separate records of both Top Blinds Ltd and Bamboo Ltd on 31 December 20.24, is an amount of R77 800 that Bamboo Ltd still owes Top Blinds Ltd for inventory purchased on 31 December 20.24.

On 1 August 20.24, Top Blinds Ltd sold equipment with a carrying amount of R110 500 to Bamboo Ltd for R150 000. The equipment had a remaining useful life of three years on that date.

**Safe Shutters Ltd**

Safe Shutters Ltd is a well-established company that manufactures quality security shutters. On 1 July 20.23, Top Blinds Ltd acquired a 30% interest in Safe Shutters Ltd for a cash consideration of R200 000, as well as the transfer of equipment. The equipment transferred to Safe Shutters Ltd at the date of acquisition had a carrying amount of R90 000 and a fair value of R115 000 on 1 July 20.23. This equipment had a remaining useful life of three years on 1 July 20.23. In addition to the cash payment of R200 000, Top Blinds Ltd also paid lawyers' fees of R10 000 on 1 July 20.23. From 1 July 20.23, Top Blinds Ltd exercised significant influence over the financial and operating policy decisions of Safe Shutters Ltd. Safe Shutters Ltd's equity consisted of the following on 1 July 20.23:

| | R |
|---|---|
| Ordinary share capital (100 000 shares) | 100 000 |
| Retained earnings | 783 160 |
| Revaluation surplus | 250 400 |
| | 1 133 560 |

All the assets and liabilities of Safe Shutters Ltd were deemed to be fairly valued at the acquisition date and no additional assets or liabilities were identified.

During the current financial year, Safe Shutters Ltd sold inventory to Top Blinds Ltd at a gross profit percentage of 25%. Included in Top Blinds Ltd's inventory on hand on 31 December 20.24 is inventory amounting to R130 000 in respect of purchases from Safe Shutters Ltd.

**ABC Logistics Ltd**

Top Blinds Ltd is in the process of incorporating a new company, ABC Logistics Ltd. In accordance with its proposed memorandum of incorporation, ABC Logistics Ltd's agreed purpose will be to perform administrative and operational activities necessary to run a delivery scheme for Top Blinds Ltd. In accordance with this scheme, 100 employees of Top Blinds Ltd will become shareholders and employees of ABC Logistics Ltd. Top Blinds Ltd plans to acquire 40% of the ordinary share capital and voting rights of ABC Logistics Ltd. The remaining 60% of the ordinary share capital will be allocated equally between the 100 employees. Each ordinary share confers one voting right to the shareholder. The 100 employees have an agreement to vote in unison.

The relevant activities of ABC Logistics Ltd will include the following:

- arranging financing in order to purchase 50 delivery vehicles to be used

- purchasing the delivery vehicles to be used by the employees
- obtaining insurance and maintenance for the delivery vehicles

As per the memorandum of incorporation of ABC Logistics Ltd, the managing director can make all decisions relating to the operations of the company (including those relating to the activities described above), except for selecting the insurance and maintenance companies that should be used by ABC Logistics Ltd. Top Blinds Ltd will have the right to select the insurance and maintenance companies which ABC Logistics Ltd should use.

Mr J Jonas, one of the employees, was elected managing director by a majority vote of the other employees.

**Other financial information**

The following is an extract from the separate trial balances of the different companies as at 31 December 20.24:

| | **Top Blinds Ltd R Dr/(Cr)** | **Bamboo Ltd R Dr/(Cr)** | **Safe Shutters Ltd R Dr/(Cr)** |
|---|---|---|---|
| Ordinary share capital | (631 500) | (200 000) | (100 000) |
| Preference share capital | (252 500) | - | - |
| Retained earnings (1 January 20.24) | (2 842 900) | (2 397 746) | (940 610) |
| Mark-to-market reserve (1 January 20.24) | (589 420) | (333 060) | - |
| Revaluation surplus (1 January 20.24) | (384 100) | - | (250 400) |
| Property, plant and equipment | 3 000 580 | 2 391 790 | 1 219 810 |
| Investments in equity instruments | 672 950 | 765 800 | - |
| Inventory | 944 550 | 880 600 | 645 700 |
| Cash and cash equivalents | 286 340 | 158 530 | 80 690 |
| Trade receivables | 899 450 | 410 285 | 280 440 |
| Trade payables | (746 020) | (389 650) | (200 900) |
| Long-term borrowings | (684 651) | (100 540) | (133 130) |
| Deferred tax | (87 530) | (120 485) | (50 800) |
| Profit after tax for the year | (1 800 710) | (1 234 824) | (445 800) |
| Fair value adjustments on investments in equity instruments | (240 600) | (150 700) | - |
| Gain on revaluation of land | (170 000) | - | (280 000) |
| Dividends paid on 31 December 20.24 | 500 000 | 320 000 | 175 000 |

**Additional information**

1. It is the accounting policy of Top Blinds Ltd to account for investments in subsidiaries and investments in associates at cost in accordance with IAS 27.10(a) in its separate financial statements.

2. It is the accounting policy of all the companies in the Top Blinds Ltd Group to account for all other investments in equity instruments in accordance with IFRS 9 *Financial Instruments*. All the companies in the Top Blinds Ltd Group have irrevocably elected to present subsequent changes in the fair value of these investments in other comprehensive income in a mark-to-market reserve.

3. All the companies in the Top Blinds Ltd Group have a 31 December year end.

4. The fair value of the ordinary shares of Top Blinds Ltd was R22 per share on 1 March 20.24.

5. Assume that the profits of all the companies in the Top Blinds Ltd Group accrued evenly throughout the respective years.

6. An appropriate pre-tax discount rate is 9% per annum, compounded annually.
7. You can correctly assume that a consolidated deferred tax liability was recognised in the consolidated financial statements of the Top Blinds Ltd Group for the year ended 31 December 20.24.

8. There were no changes in the issued ordinary share capital of Bamboo Ltd or Safe Shutters Ltd.

9. It is the accounting policy of all the companies in the Top Blinds Ltd Group to account for plant and equipment according to the cost model, and land according to the revaluation model in terms of IAS 16 *Property, Plant and Equipment*.

10. Top Blinds Ltd elected to measure non-controlling interests at the proportionate share of the acquiree's net identifiable assets at the acquisition date for all acquisitions.

11. Assume an income tax rate of 27% and a capital gains tax (CGT) inclusion rate of 80%. Ignore value added tax (VAT) and dividend tax.

12. The acquisitions of the subsidiaries also met the definition of acquiring a business, as defined in IFRS 3 *Business Combinations*.

**REQUIRED**

| | | Marks |
|---|---|---|
| (a) | Prepare only the assets section of the consolidated statement of financial position of the Top Blinds Ltd Group as at 31 December 20.24. | 29 |
| | X1: Communication skills - presentation and layout | 1 |
| (b) | Discuss, with reasons, how the customer list of Bamboo Ltd should be accounted for in the consolidated financial statements of the Top Blinds Ltd Group. | 3 |
| (c) | Discuss, with reasons, whether Top Blinds Ltd will have power over ABC Logistics Ltd. | 6 |
| | X1: Communication skills - logical flow and conclusion | 1 |
| **Please note** | | |
| • | Round off all amounts to the nearest rand. | |
| • | Show all your calculations. | |
| • | Your answer must comply with IFRS Accounting Standards. | |

**QUESTION 1** – Suggested solution

**(a) Prepare only the assets section of the consolidated statement of financial position**

**TOP BLINDS LTD GROUP**

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.24**

| | R | |
|---|---|---|
| **ASSETS** | | |
| **Non-current assets** | | |
| Property, plant and equipment [C1] | 5 358 356 | (3) |
| Investments in equity instruments (672 950 + 765 800) | 1 438 750 | (1) |
| Intangible assets [C2] | 233 333 | (2) |
| Investment in associate [C3] | 548 793 | (8) |
| Goodwill [C4] | 153 516 | (15) |
| | 7 732 748 | |
| **Current assets** | | |
| Trade receivables [C7] | 1 231 935 | (1) |
| Inventory [C8] | 1 762 850 | (3) |
| Cash and cash equivalents (286 340 + 158 530) | 444 870 | |
| Indemnification asset (195 000 x 45%) | 87 750 | (1) |
| | 3 527 405 | |
| **Total assets** | 11 260 153 | |
| | Total | (34) |
| | Maximum | (29) |
| | X1: Communication skills - presentation and layout | (1) |

**EXAMINATION TECHNIQUE**

It is important to remember to transfer the answer you get in the calculations to your solution. No marks were allocated in this question to students who calculated goodwill but did not reflect it in the solution. Furthermore, only the assets section was required, therefore do not waste time completing other sections.

**(b) Discuss, with reasons, how the customer list of Bamboo Ltd should be accounted for in the consolidated financial statements of the Top Blinds Ltd Group**

**Customer lists**

Top Blinds Ltd must recognise, separately from goodwill, the identifiable intangible assets acquired in a business combination (IFRS 3.B31). (1)

Top Blinds Ltd has a unique customer list and as customer lists are frequently licensed, it meets the separability criterion. It is also standard practice in the industry to license customer lists. (1)

The terms of confidentiality of Bamboo Ltd's customer list prohibits Bamboo Ltd from selling this list. This customer list would thus not meet the separability criterion, as the list cannot be sold (IFRS 3.B33). (1)

Top Blinds Ltd will thus not account for this list in its consolidated financial statements, as it is not identifiable and does not meet the separability or contractual-legal criterion. (1)

Total (4)

Maximum (3)

**(c) Discuss, with reasons, whether Top Blinds Ltd will have power over ABC Logistics Ltd**

**Power over the investee**
Top Blinds Ltd will have power over ABC Logistics Ltd when it has existing rights that give it the current ability to direct the relevant activities, that is, the activities that significantly affect ABC Logistics Ltd's returns. (1)

**Relevant activities**
ABC Logistics Ltd will be incorporated with the ability to conduct the following relevant activities: (1)

- arranging financing to fund the purchase of operating assets
- acquiring operating assets to be used by the employees
- obtaining insurance and maintenance for the operating assets

**Existing rights**
Although Top Blinds Ltd has voting rights, it does not possess a majority of voting rights as it plans to only acquire 40% of the ordinary share capital and voting rights. However, Top Blinds Ltd can have power even if it holds less than a majority of the voting rights. (1)

As per the memorandum of incorporation of ABC Logistics Ltd, Mr J Jonas, the managing director, can make all decisions relating to the operations of the company, except for selecting the insurance and maintenance companies that should be used by ABC Logistics Ltd, which resides with Top Blinds Ltd. (1)

The design of ABC Logistics Ltd therefore confers the significant decision-making rights over the majority of relevant activities to the **managing director** and not to Top Blinds Ltd. The managing director is appointed by the employees and not by Top Blinds Ltd. (1)

The rights held by Top Blinds Ltd in respect of insurance and maintenance service providers are not seen as key in comparison with the other relevant activities and appear to be a protective right in order to ensure that the operating assets of ABC Logistics Ltd are properly maintained. (1)

**Conclusion**
Top Blinds Ltd will not have power over ABC Logistics Ltd as it will not have existing rights to direct the relevant activities of ABC Logistics Ltd. (1)

| | |
|---|---|
| Total | (7) |
| Maximum | (6) |
| X1: Communication skills - logical flow and conclusion | (1) |

**CALCULATIONS**

**C1. Property, plant and equipment**

| | | |
|---|---|---|
| Top Blinds Ltd plus Bamboo Ltd (3 000 580 + 2 391 790) | 5 392 370 | [1] |
| Unrealised profit in closing equipment of Bamboo Ltd (150 000 – 110 500) | (39 500) | [1] |
| Realisation of unrealised profit in equipment (39 500/3 x 5/12) | 5 486 | [1] |
| | 5 358 356 | |
| | | [3] |

**C2. Intangible assets**

| | | |
|---|---|---|
| Trade dress (IFRS 3 recognition at acquisition of Bamboo Ltd) | 280 000 | [1] |
| Customer list (cannot be sold) (see part (b)) | - | |
| Amortisation of trade dress (280 000/5 x 10/12) | (46 667) | [1] |
| | 233 333 | |
| | | [2] |

**C3. Investment in associate (Safe Shutters Ltd)**

| | | |
|---|---|---|
| Cost of investment (200 000 + 10 000 [IAS 28.10 E2] + 115 000) | 325 000 | [1] |
| Excess at acquisition [(1 133 560 x 30%) – 325 000] | 15 068 | [1] |
| Recognition of opening equity [(940 610 – 783 160) x 30%] | 47 235 | [1] |
| Equity accounting in current year | 165 240 | [2] |
| Share of profit or loss of associate (445 800 x 30%) | 133 740 | |
| Share of OCI of associate (280 000 x 30%) | 84 000 | |
| Dividend received (175 000 x 30%) | (52 500) | |
| Unrealised profit included in opening equipment of Safe Shutters Ltd [(115 000 – 90 000) x 30% = 7 500 – (7 500/3 x 6/12)] | (6 250) | [2] |
| Realisation of unrealised profit in current year (7 500/3) | 2 500 | [1] |
| | 548 793 | |
| | | [8] |

**C4. Goodwill**

**Acquisition of Bamboo Ltd**

| | | |
|---|---|---|
| Share capital | 200 000 | |
| Retained earnings (1 January 20.24) | 2 397 746 | |
| Profit (1/1/20.24 – 1/3/20.24) (1 234 824 x 2/12) | 205 804 | [1] |
| Mark-to-market reserve (1 January 20.24) | 333 060 | |
| Mark-to-market reserve (OCI) | 150 700 | [1] |
| Inventory (72 000 x 73%) | (52 560) | [1] |
| Intangible asset (trade dress) (280 000 x 73%) | 204 400 | [1] |
| Contingent liability | (195 000) | [1] |
| Indemnification asset (195 000 x 45%) | 87 750 | [1] |
| Identifiable net assets | 3 331 900 | |
| Non-controlling interests (3 331 900 x 45%) | (1 499 355) | [1] |
| Consideration transferred [C5] | (1 986 061) | [8] |
| | (153 516) | |
| | | [15] |

**C5. Consideration transferred for the acquisition of Bamboo Ltd**

| | | |
|---|---|---|
| Cash payment | 750 000 | [1] |
| Issue of ordinary shares (25 000 x R22) | 550 000 | [1] |
| Share issue cost | (18 500) | [1] |
| Acquisition-related cost (IFRS 3.53) | (22 300) | [1] |
| Issue of preference shares [C6] | 141 861 | [2] |
| IFRS 9 investment at fair value | 420 000 | [1] |
| Contingent consideration | 165 000 | [1] |
| | 1 986 061 | |
| | | [8] |

## C6. Issue of preference shares as consideration

| HP 10BII | SHARP EL-733A | SHARP EL-738 | |
|---|---|---|---|
| 1. 2nd F C (Clear All) | 1. 2nd FC (Clear All) | 1. 2ndF MODE (Clear All) | |
| 2. 1 2nd F PMT | 2. - | 2. - | |
| 3. 70 000 x 2 x 8% PMT | 3. 70 000 x 2 x 8% PMT | 3. 70 000 x 2 x 8% PMT | [1] |
| 4. 9 I/YR | 4. 9 i | 4. 9 I/Y | [1] |
| 5. 3 N | 5. 3 n | 5. 3 N | [1] |
| 6. 70 000 x 2 x 1,05 FV | 6. 70 000 x 2 x 1,05 FV | 6. 70 000 x 2 x 1,05 FV | [1] |
| 7. PV = 141 861 | 7. Comp PV = 141 861 | 7. Comp PV = 141 861 | |
| | | Total | [4] |
| | | Maximum | [2] |

## C7. Trade receivables

| | | |
|---|---|---|
| Top Blinds Ltd plus Bamboo Ltd (899 450 + 410 285) | 1 309 735 | |
| Elimination of intragroup trade receivables | (77 800) | |
| | 1 231 935 | |
| | | [1] |

## C8. Inventory

| | | |
|---|---|---|
| Top Blinds Ltd plus Bamboo Ltd (944 550 + 880 600) | 1 825 150 | |
| IFRS 3 adjustment (acquisition of Bamboo Ltd) | (72 000) | |
| 70% of inventory above sold at year end (72 000 x 70%) | 50 400 | [1] |
| Unrealised profit in closing inventory of Bamboo Ltd (Top Blinds Ltd sold to Bamboo Ltd) (185 700 x 20/120) | (30 950) | [1] |
| Unrealised profit in closing inventory of Top Blinds Ltd (Safe Shutters Ltd sold to Top Blinds Ltd) (130 000 x 25% x 30%) | (9 750) | [1] |
| | 1 762 850 | |
| | | [3] |

**C9. Analysis of owners' equity of Bamboo Ltd** (for completeness)

| | Total | Top Blinds Ltd: 55% | | NCI |
|---|---|---|---|---|
| | | At | Since | |
| **At acquisition (1 March 20.24)** | | | | |
| Share capital | 200 000 | | | |
| Retained earnings | 2 397 746 | | | |
| Mark-to-market reserve | 333 060 | | | |
| Profit for two months (1 234 824 x 2/12) | 205 804 | | | |
| Mark-to-market reserve (OCI) | 150 700 | | | |
| Inventory (72 000 x 73%) | (52 560) | | | |
| Intangible asset (trade dress) (245 000 x 73%) | 178 850 | | | |
| Contingent liability | (195 000) | | | |
| Indemnification asset (195 000 x 45%) | 87 750 | | | |
| | 3 306 350 | 1 818 493 | | 1 487 857 |
| Goodwill | 167 568 | 167 568 | | - |
| Consideration [C5] and NCI | 3 473 918 | 1 986 061 | | 1 487 857 |
| **Measurement period adjustment** | | | | |
| Intangible asset (trade dress) ((280 000 x 73%) – 178 850) | 25 550 | | | |
| Adjusted net assets (3 306 350 + 25 550) | 3 331 900 | 1 832 545 | | 1 499 355 |
| Adjusted goodwill | 153 516 | 153 516 | | - |
| Consideration [C5] and NCI | 3 485 416 | 1 986 061 | | 1 499 355 |
| **Current year** | | | | |
| Profit (1 234 824 x 10/12) | 1 029 020 | | | |
| Amortisation (280 000/5 x 10/12) | (46 667) | | | |
| Deferred tax (46 667 x 27%) | 12 600 | | | |
| Inventory sold (72 000 x 70%) | 50 400 | | | |
| Deferred tax (50 400 x 27%) | (13 608) | | | |
| **Total current year profit** | 1 031 745 | | 567 460 | 464 285 |
| Dividend | (320 000) | | (176 000) | (144 000) |
| | 4 197 161 | | 391 460 | 1 819 640 |

**QUESTION 2** **40 marks**

## YOU HAVE 80 MINUTES TO ANSWER THIS QUESTION

Oneity Ltd (Oneity) is a retail holding company listed on the Johannesburg Stock Exchange (JSE) based in South Africa. The Oneity group has an extensive global footprint comprising 400 stores in ten countries and specialises in retail sectors such as household appliances, furniture and fashion apparel.

Key information pertaining to all companies within the Oneity group:

- The Oneity group prepares its financial statements in accordance with International Financial Reporting Standards (IFRSs).
- The Oneity group earlier adopted IFRS 16 *Leases* for the financial year ended 28 February 20.25.
- All companies have a 28 February year end.

**Acquisition of assets and liabilities of UB Appliances**

On 8 November 20.23, the Oneity Board unanimously decided to propose a takeover of UB Appliances (UBA), South Africa's biggest appliance retailer. This would further diversify the Oneity product offerings and leverage off several synergies that could be derived from Oneity's well-established supply chain. Oneity and UBA entered into a sale of business agreement on 19 December 20.23.

Ownership of UBA was made up as follows prior to this takeover:

| Shareholders | Shareholding |
|---|---|
| VestBid Ltd is a private equity firm with a diversified investment portfolio | 30% |
| Mr Lace (COO of UBA) and Mr Trainer (CEO of Oneity), each held a 35% equity interest in UBA | 70% |
| | 100% |

**Accounting for the acquisition of the assets and liabilities of UBA**

The purchase agreement stipulated that specified assets and liabilities of UBA were to be transferred to Oneity on 1 March 20.24. Oneity therefore obtained control, as defined in IFRS 10 *Consolidated Financial Statements*, over these assets and liabilities on this date. The takeover also met the definition of acquiring a business, as defined in IFRS 3 *Business Combinations*.

The financial accountant of Oneity, on instruction of Mr Trainer, processed journal entry JNL: NR-458 for 20.25 to account for the acquisition of the specified assets and liabilities of UBA.

| JNL: NR-458 | | | | |
|---|---|---|---|---|
| | | **Notes** | **Dr** | **Cr** |
| **Account description** | **Financial statement** | | **R'000** | **R'000** |
| Property, plant and equipment | SFP | 1 | 10 000 | |
| Investment property | SFP | 2 | 6 550 | |
| Intangible assets: Goodwill | SFP | 3 | 4 500 | |
| Non-current assets held for sale | SFP | 4 | 7 500 | |
| Inventory | SFP | 5 | 29 700 | |
| Bank and cash (R14 800 000 – R325 000 – R900 000 – R5 500 000) | SFP | 6; 8; 9; 12 | 8 075 | |
| Right-of-use asset | SFP | 7 | 1 650 | |
| Intangible assets: Workforce (R3 500 000 + R5 500 000) | SFP | 8 | 9 000 | |
| Share issue cost | P/L | 9 | 900 | |
| Intangible assets: Legal fees incurred | SFP | 12 | 325 | |
| Gain on bargain purchase (balancing figure) | P/L | | 9 160 | |
| Lease liability | SFP | 7 | | 1 760 |
| Share capital (300 000 x R253 [25 300 cents]) | SCE | 9 | | 75 900 |
| Provision: Earn-out bonus | SFP | 10 | | 3 100 |
| Provision: Contingent payment | SFP | 11 | | 5 000 |
| Provision: Claim from customer | SFP | 13 | | 1 600 |
| ***Acquisition of UBA*** | | | **87 360*** | **87 360*** |

* The casting of the journal entry is correct.

1. UBA's property, plant and equipment consist of several buildings and equipment and a piece of owner-occupied land. All of these assets were considered to be fairly valued in terms of IFRS 3 at the acquisition date, except for the owner-occupied land. This land is currently held for industrial use as a site for one of UBA's factories. Similar sites have recently been developed into office buildings. On the acquisition date, the land in question had no restrictions to prevent it from being developed into office buildings. The fair value of all UBA's property, plant and equipment amounted to R10 million (if the site were to be held for industrial use) and R12 million (if the site were to be developed into office buildings) on the acquisition date.

2. The investment property is an office building, which was subject to a market-related lease agreement between Oneity and UBA. The lease came to an end on 28 February 20.24. Oneity leased the building from UBA for office space and will continue to use it for this purpose. The carrying amount of this building in the separate financial statements of UBA on the acquisition date did not materially differ from its fair value.

3. The goodwill recognised is a result of a previous business combination between UBA and an unrelated third party a number of years ago. The goodwill has never been impaired.

4. The non-current assets held for sale consist of a factory building that was correctly classified as a non-current asset held for sale in terms of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. The estimated cost to sell is R250 000 and the fair value of the factory building was R7 500 000 on the acquisition date. Oneity intends to sell the building within 12 months.

5. The inventory balance is correctly reflected at the lower of cost and net realisable value in accordance with IAS 2 *Inventories* and this value approximates the fair value of the inventory on the acquisition date.

6. The bank and cash of UBA at the acquisition date were R14 800 000 (favourable balance).

7. The right-of-use asset and corresponding lease liability are a result of a lease agreement between UBA and an unrelated third party and the amounts reflected are based on the original contract. Per the lease agreement, UBA leases a number of specialised machines that are used in the supply chain process. The lease agreement does not qualify for the recognition exceptions stipulated in IFRS 16.5. On the acquisition date, the remaining lease term amounted to four years and the correctly calculated present value of the remaining lease payments, as if this lease were a new lease on the acquisition date, amounted to R1 850 000. UBA's lease payments are higher than what market participants are currently paying. On the acquisition date, the fair value of this "off-market" component amounted to R292 000.

8. The purchase agreement stipulates that UBA's key personnel and executives (an assembled workforce) would be employed by Oneity subsequent to the takeover. Mr Trainer valued this workforce at R3 500 000 on the acquisition date. Oneity was required to pay retrenchment packages of R5 500 000 in cash on 1 March 20.24 to the employees not employed by Oneity after the takeover.

9. Oneity settled the purchase consideration with an immediate cash payment of R32 400 000 to UBA on 1 March 20.24. In addition, Oneity issued 300 000 ordinary shares on 8 March 20.24. Oneity incurred share issue cost amounting to R900 000 on the issue date. Oneity's share price was as follows on the relevant dates:

| **Date** | **Quoted on the JSE** |
|---|---|
| 1 March 20.24 | 25 200 cents per share |
| 8 March 20.24 | 25 300 cents per share |

10. An earn-out bonus of R3 500 000 will be payable to Mr Lace on 28 February 20.27 if he were to remain in the employ of Oneity until that date. If he were to resign before that date, the bonus will be forfeited. The fair value of the earn-out bonus was reliably determined to be R3 100 000 on the acquisition date.

11. Cash payments of R2 500 000 each are payable to Messrs Lace and Trainer, in the event of Oneity's price-earnings multiple (P/E ratio) exceeding 18 by 28 February 20.27. The fair value of these further payments was reliably determined as being R4 600 000 in total on the acquisition date.

12. Oneity incurred legal fees amounting to R325 000 in drafting the purchase agreement, which it paid in cash on the acquisition date.

13. On the acquisition date, the following facts were identified from the draft separate financial statements of UBA for 20.24:

    - UBA expensed an amount of R1 900 000 incurred with the development and registration of a patent for a specific appliance developed and manufactured by the company during 20.24 as it did not meet the requirements for recognition as an intangible asset per IAS 38 *Intangible Assets*. Oneity's management decided not to continue using the patent. A fair value could reliably be placed on the patent and amounted to R1 200 000 on the acquisition date.

- An amount of R1 800 000 was correctly disclosed as a contingent liability in terms of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The contingent liability is a result of a claim from a customer who was allegedly injured using an UBA appliance. The classification as a contingent liability was based on the fact that only a possible obligation, as defined in terms of IAS 37.10, existed at the end of 20.24. This conclusion was still applicable and correct at the acquisition date as none of the circumstances, which resulted in the conclusion, had changed. The fair value of this contingent liability was reliably determined to amount to R1 600 000 on the acquisition date.

**Additional information**

- All items of property, plant and equipment are accounted for on the cost model in terms of IAS 16 *Property, Plant and Equipment*.
- All intangible assets are accounted for on the cost model in terms of IAS 38.
- All items of investment property are accounted for on the fair value model in terms of IAS 40 *Investment Property*.
- Ignore any tax consequences.

(SAICA – adapted)

**DISCUSSION**

This question is an opportunity to analyse and illustrate an understanding of and insight into IFRS 3. You should be able to formulate your concerns about the given information and provide adequate responses supported by reasons in line with IFRS.

**REQUIRED**

| | Marks |
|---|---|
| Discuss any concerns you have relating to the recognition and measurement of the various elements of the accounting entry (JNL: NR-458).<br><br>Provide reasons to support your concerns, as well as recommendations on how to correctly account for the matter. | 39 |
| X1: Communication skills - clarity of expression; appropriate style | 1 |
| **Please note**<br><br>• Round off all amounts to the nearest rand.<br>• You are not required to refer to the conceptual framework.<br>• You are not required to recalculate the goodwill or gain from the bargain purchase.<br>• You are not required to provide any correcting journal entries.<br>• Discussions about disclosure are not required.<br>• Support your discussion with calculations, where appropriate.<br>• Your answer must comply with IFRS Accounting Standards. | |

**QUESTION 2 – Suggested solution**

**Discuss any concerns you have relating to the recognition and measurement of the various elements of the accounting entry (JNL: NR-458).**

**Provide reasons to support your concerns, as well as recommendations on how to correctly account for the matter.**

**1 Property, plant and equipment**

The property, plant and equipment were measured at the incorrect fair value because, in terms of IFRS 13.27, the fair value of a non-financial asset takes into account the market participants' ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use. (1)

As there are no restrictions in developing the land for a site of office buildings, this would be its highest and best use. (1)

The property, plant and equipment should therefore be measured at the fair value of R12 000 000 on the acquisition date and not R10 000 000. (1)

**2. Investment property**

The recognition of the office building as investment property is incorrect because, in terms of IFRS 3.15, at the acquisition date the acquirer should classify or designate the identifiable assets acquired and the liabilities assumed as necessary to apply other IFRSs. (1)

Since the building will be used by Oneity for office space (administrative purposes), it becomes owner occupied in terms of IAS 40.5. (1)

The building should therefore be recognised as property, plant and equipment in terms of IAS 16 on the acquisition date and should not be recognised as investment property in terms of IAS 40. (1)

**3. Goodwill recognised as an intangible asset**

The goodwill was incorrectly recognised as an intangible asset on the acquisition date because, in terms of IFRS 3.10, only identifiable assets acquired should be recognised separately from goodwill on the acquisition date. (1)

The goodwill is not identifiable since it is not separable, nor does it arise from contractual or other legal rights. (1)

The goodwill should therefore not be recognised as an intangible asset on the acquisition date but should rather be subsumed into the goodwill recognised as a result of the business combination. (1)

**4. Non-current assets held for sale**

The non-current assets held for sale were incorrectly measured at fair value on the acquisition date because, in terms of IFRS 3.31, the acquirer should measure non-current assets held for sale at fair value less cost to sell, as determined in terms of IFRS 5. (1)

The non-current assets held for sale should therefore be measured at fair value less cost to sell of R7 250 000 (R7 500 000 – R250 000) on the acquisition date and not the fair value of R7 500 000. (1)

5. **Right-of-use asset and lease liability**
The right-of-use asset and lease liability were measured at the incorrect amounts because, in terms of IFRS 3.28B, the acquirer should measure the lease liability at the present value of the remaining lease payments as if the lease was a new lease at the acquisition date. Furthermore, the right-of-use asset should be measured at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared to market terms. (1)

The lease liability should therefore be measured at R1 850 000 on the acquisition date and not R1 760 000. (1)

As UBA's lease payments are higher than what market participants are currently paying, the "off-market" component of R292 000 is unfavourable. (1)

The right-of-use asset should therefore be measured at R1 558 000 (R1 850 000 – R292 000) on the acquisition date and not R1 650 000. (1)

6. **Workforce recognised as an intangible asset**
The workforce was incorrectly recognised as an intangible asset separately from goodwill on the acquisition date because, in terms of IFRS 3.B37, an assembled workforce is not an identifiable asset at the acquisition date. In terms of IAS 38.15, an entity has insufficient control over the expected future economic benefits arising from a team of skilled staff to meet the definition of an intangible asset. (1)

The assembled workforce should therefore not be recognised as an intangible asset separately from goodwill on the acquisition date but should rather be subsumed into goodwill recognised as a result of the business combination on the acquisition date. (1)

7. **Retrenchment packages recognised as an intangible asset**
The retrenchment packages were incorrectly recognised as an intangible asset separately from goodwill on the acquisition date because, in terms of IFRS 3.51, amounts that are not part of the exchange for the acquiree must be accounted for as separate transactions. The retrenchment packages were not primarily paid for the benefit of the acquiree (or its former owners) and should therefore not form part of the business combination. (1)

The amount paid should therefore be recognised as an expense in profit or loss when it is incurred and should not be recognised as an intangible asset on the acquisition date. (1)

8. **Immediate cash payment**
The immediate cash payment was not included as part of the consideration paid, although IFRS 3.37 requires the consideration transferred in a business combination to be measured at fair value, which includes the fair value of assets such as cash transferred by the acquirer. (1)

The immediate cash payment should therefore be recognised at fair value of R32 400 000 as part of the consideration transferred and credited to bank. (1)

9. **Issue of ordinary shares: acquisition date**
The incorrect price was used to measure the ordinary shares issued as part of the consideration transferred because, in terms of IFRS 3.37, the acquirer should measure the consideration transferred at the acquisition date at fair value – this includes equity instruments issued by the acquirer. (1)

The issue of the share capital should therefore be measured at R252 (25 200 cents) per share (i.e. the unadjusted quoted price on the JSE) on the acquisition date and not R253 (25 300 cents) per share. The issue of the share capital should therefore be measured at R75 600 000 (300 000 x R252) and not R75 900 000.

This is because control, in terms of IFRS 10, was obtained on 1 March 20.24, irrespective of the fact that Oneity issued the shares on 8 March 20.24. (1)

10. **Issue of ordinary shares: share issue cost**
The share issue cost has incorrectly been expensed because, in terms of IFRS 3, transaction cost should be accounted for in terms of other IFRS Accounting Standards and, in terms of IAS 32.35, transaction cost on the issue of the shares should be debited to the share capital (i.e. accounted for as a deduction from equity). (1)

The share issue cost of R900 000 should therefore be recognised directly in equity (debited to share capital) and should not be expensed in profit or loss. (1)

11. **Earn-out bonus**
The earn-out bonus was incorrectly included as part of the consideration transferred because, in terms of IFRS 3.B55(a), when contingent payments to employees or selling shareholders are automatically forfeited if employment terminates, this payment is remuneration for post-combination services. (1)

Since the earn-out bonus is dependent on Mr Lace still being in the employ of Oneity on 28 February 20.27, the earn-out bonus should be recognised as a separate expense as the services are being rendered by Mr Lace and should not be recognised as a provision on the acquisition date. (1)

12. **Further cash payment (contingent payment)**
The further cash payment (contingent payment) of R5 000 000 (R2 500 000 to each of Mr Lace and Mr Trainer) was measured at the incorrect amount because, in terms of IFRS 3.37, the consideration transferred in a business combination should be measured at fair value. (1)

The additional payment should therefore be measured at its fair value of R4 600 000 on the acquisition date and not an amount of R5 000 000. (1)

13. **Legal fees incurred**
The legal fees incurred by Oneity in drafting the purchase agreement was incorrectly recognised as an intangible asset on the acquisition date because, in terms of IFRS 3.53, acquisition-related cost incurred to effect the business combination should be recognised as an expense in the period it is incurred. (1)

The legal fees should therefore be recognised as an expense in profit or loss when it is incurred and should not be recognised as an intangible asset on the acquisition date. (1)

14. **Registered patent expensed in previous years**
The registered patent was incorrectly **not** recognised as an identifiable asset separately from goodwill on the acquisition date because, in terms of IFRS 3.10 / IFRS 3.B31, all identifiable intangible assets acquired on the acquisition date should be recognised separately from goodwill on the acquisition date. (1)

The patent is identifiable since it is registered, that is, it arises from a contractual right. (1)

The fact that Oneity does not intend to use the patent going forward is irrelevant. The fair value is determined on what market participants are willing to pay to transfer the asset (IFRS 13.9). (1)

The patent should therefore be recognised as a separate intangible asset on the acquisition date at its fair value of R1 200 000. (1)

**15. Contingent liability recognised**

The contingent liability in connection with the claim from the customer was incorrectly recognised separately from goodwill on the acquisition date because, in terms of IFRS 3.23, the acquirer should only recognise contingent liabilities assumed in a business combination separately from goodwill on the acquisition date if it is a present obligation that arises from past events and its fair value can be determined reliably. (1)

Although the fair value of the contingent liability could be determined reliably at R1 600 000, no present obligation existed at the acquisition date and the contingent liability should therefore not be recognised as a provision on the acquisition date. (1)

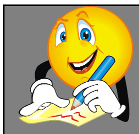
**16. Gain from a bargain purchase recognised**

The recognition of a gain from a bargain purchase as a debit entry is incorrect because, in terms of IFRS 3.32, the acquirer must only recognise a gain from a bargain purchase if the consideration transferred is less than the fairly valued net identifiable assets at the acquisition date. (1)

Based on the entry provided, goodwill should have been recognised and not a gain from a bargain purchase. (1)

The amount is also incorrect as a result of the errors and concerns noted above. (1)

| | |
|---|---|
| Total | (40) |
| Maximum | (39) |
| X1: Communication skills - clarity of expression; appropriate style | (1) |



**EXAMINATION TECHNIQUE**

The recalculation of goodwill or gain on bargain purchase and correction journal entries were not required. Do not provide the solution that was not required. Providing a theory reference without application and highlighting concerns without supporting reasons do not earn marks.

**QUESTION 3** **40 marks**

| YOU HAVE 80 MINUTES TO ANSWER THIS QUESTION |
|---|

You have recently been appointed as the group accountant for the Paintpro Ltd Group. Paintpro Ltd (Paintpro) is listed on the Johannesburg Stock Exchange and has a 31 December year end.

**Investment in Paintlux Ltd**

Paintpro acquired a significant investment in a subsidiary in the current financial year. The accountant of Paintpro was uncertain how to account for the transaction and only processed the following journals in the accounting records of Paintpro for the year ended 31 December 20.24:

| | | Dr<br>R | Cr<br>R |
|---|---|---|---|
| J1 | Investment in subsidiary (SFP) | 700 000 | |
| | Bank (SFP) | | 700 000 |
| | *Acquisition of subsidiary* | | |
| J2 | Bank (SFP) | 60 000 | |
| | Other income (P/L) | | 60 000 |
| | *Cum div dividend received* | | |
| J3 | Administration expenses (P/L) | 15 000 | |
| | Bank (SFP) | | 15 000 |
| | *Share issue costs accounted for* | | |

Paintpro acquired a *cum div* 75% controlling shareholding in Paintlux Ltd (Paintlux) on 1 June 20.24. The share capital and retained earnings of Paintlux amounted to R500 000 and R1 750 000 respectively at that date. No additional assets, liabilities or contingent liabilities were identified at the acquisition date.

The consideration paid for the acquisition of Paintlux on 1 June 20.24 was as follows:

- A cash consideration of R700 000 was paid on 1 June 20.24 into the lawyer's trust account. Included in the R700 000 were lawyer's fees relating to the acquisition of R40 000.

- The transfer of a delivery truck with a carrying amount of R810 000 and a fair value of R860 000 on the acquisition date to the previous shareholders of Paintlux. The delivery truck's historical cost price was R1 100 000 and depreciation for the 20.21 financial year amounted to R180 000. As at 31 December 20.24 the delivery truck has not yet been removed from the asset register.

- An additional amount of R150 000 in Paintpro shares will be paid if the profit after tax increased with 5% year-on-year by the end of the 20.24 financial year. The fair value of the consideration was estimated to be R140 000 at acquisition date. At 31 December 20.24 the profit target was achieved and Paintpro issued 15 000 shares as final settlement. Share issue costs relating to this transaction amounted to R15 000 and were paid cash.

On 2 December 20.24 Paintlux declared and paid a final dividend of R25 000.

**Investment in Brushes Ltd**

Paintpro acquired a 30% interest in Brushes Ltd (Brushes) in the 20.23 financial year. Since acquisition Paintpro has exercised significant influence over the financial and operating policy decisions of Brushes. The 30% investment in Brushes was acquired for R220 000. At acquisition, Paintpro also issued a long-term loan to Brushes for R30 000. Settlement of the loan is not planned or likely to occur in the foreseeable future.

Due to the economic downturn in the 20.23 financial year, the accountant of Paintpro recognised an impairment loss of R60 000 in the separate accounting records of Paintpro relating to the investment in associate for the year ended 31 December 20.23.

The equity of Brushes consisted of the following at the various dates:

| | **At acquisition** | **31 December 20.23** | **31 December 20.24** |
|---|---|---|---|
| | **R** | **R** | **R** |
| Share capital | 250 000 | 250 000 | 250 000 |
| Retained earnings | 460 000 | (410 000) | (230 000) |

On 31 December 20.24 Brushes declared and paid a final dividend of R25 000.

**Additional information**

1. Investments in subsidiaries and associates are accounted for at cost in accordance with IAS 27.10(a).
2. On 5 March 20.25 the annual financial statements of the Paintpro Group were approved by the board of directors.
3. Ignore all tax consequences.

**REQUIRED**

| | | Marks |
|---|---|---|
| (a) | Prepare the correcting and/or additional journal entries required in the **separate accounting records** of Paintpro Ltd to account for the recognition and subsequent measurement of the acquisition of Paintlux Ltd for the year ended 31 December 20.24. | 20 |
| | X1: Communication skills - presentation and layout | 1 |
| (b) | Assume the investment in Paintlux Ltd was acquired on 10 January 20.25 instead of 1 June 20.24.<br><br>Discuss the accounting and reporting implications for the financial statement of the Paintpro Ltd Group for the year ended 31 December 20.24 in terms of IAS 10 *Events after the Reporting Period* and IFRS 3 *Business Combinations*. | 5 |
| (c) | Prepare the pro forma journal entries to account for the investment in Brushes Ltd in the consolidated financial statements of the Paintpro Ltd Group for the year ended 31 December 20.24. | 14 |
| **Please note:** | | |
| • | Show all your calculations. | |
| • | Round off all amounts to the nearest Rand. | |
| • | Journal narrations are required. | |
| • | Your answer must comply with IFRS Accounting Standards. | |

**QUESTION 3 - Suggested solution**

**(a) Prepare the correcting and/or additional journal entries required in the separate accounting records of Paintpro Ltd to account for the recognition and subsequent measurement of the acquisition of Paintlux Ltd for the year ended 31 December 20.24.**

| | | Dr<br>R | Cr<br>R | |
|---|---|---|---|---|
| | **At acquisition** | | | |
| J1 | Administrative expenses (acquisition cost) (P/L) | 40 000 | | (1) |
| | Investment in subsidiary (SFP) | | 40 000 | (1) |
| | Reclassification of acquisition cost to P/L | | | |
| J2 | Accumulated depreciation - delivery truck (SFP) (1 100 000 – 810 000) | 290 000 | | (2) |
| | Investment in subsidiary (SFP) | 860 000 | | (1) |
| | Cost - delivery truck (SFP) | | 1 100 000 | (1) |
| | Other income (Profit on sale of truck) (P/L) | | 50 000 | (1) |
| | Recognition of profit on sale of truck | | | |
| J3 | Other income (Dividends received) (P/L) | 60 000 | | (1) |
| | Investment in subsidiary (SFP) | | 60 000 | (1) |
| | Acquisition of shares cum div | | | |
| J4 | Investment in subsidiary (SFP) | 140 000 | | (1) |
| | Financial liability (SFP) | | 140 000 | (1) |
| | Recognition of contingent consideration | | | |
| | **Subsequent measurement** | | | |
| J5 | Administrative expenses (FV adjust) (P/L) (150 000 - 140 000) | 10 000 | | (1) |
| | Financial liability (SFP) | | 10 000 | (1) |
| | Remeasurement of financial liability to fair value | | | |
| J6 | Financial liability (SFP) | 150 000 | | (1) |
| | Share capital (SCE) | | 150 000 | (1) |
| | Issue of shares to previous shareholders | | | |
| J7 | Bank (SFP) [25 000 x 75%] | 18 750 | | (1) |
| | Other income (Dividends received) (P/L) | | 18 750 | (1) |
| | Dividends received from subsidiary | | | |
| J8 | Share capital (SCE) | 15 000 | | (1) |
| | Administration expenses (P/L) | | 15 000 | (1) |
| | Reclassification of share issue cost to equity | | | |
| J9 | Accumulated depreciation - truck (SFP) (180 000 x 7/12) | 105 000 | | (1) |
| | Depreciation - delivery truck (P/L) | | 105 000 | (1) |
| | Correction of depreciation for the current year | | | |
| | | | Total | (21) |
| | | | Maximum | (20) |
| | X1: Communication skills - presentation and layout | | | (1) |

**COMMENT**

Cost associated with the acquisition of a subsidiary can be one of two types of costs. The first is **acquisition-related cost**, for example finder's fees, advisory, legal, accounting, valuation and other professional or consulting fees. These costs are **expensed** in terms of IFRS 3.53. Therefore, if the acquirer capitalised the cost as part of the consideration paid to the "investment in subsidiary" account, it will have to be reclassified to profit or loss as indicated in J1 above. The second type often seen with the acquisition of a subsidiary is the **cost to issue equity/debt instruments**. These costs are **capitalised to equity/debt** depending in the instrument issued. Therefore, if the acquirer capitalised the cost as part of the consideration paid to the "investment in subsidiary" account or expensed the cost in profit or loss, it will have to be reclassified to equity/debt as indicated in J8 above.

**(b) Assume the investment in Paintlux Ltd was acquired on 10 January 20.25 instead of 1 June 20.24. Discuss the accounting and reporting implications for the financial statement of the Paintpro Ltd Group for the year ended 31 December 20.24 in terms of IAS 10 *Events after the Reporting Period* and IFRS 3 *Business Combinations.***

According to IAS 10, events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue [IAS 10.3]. (1)
The reporting date of Paintpro was 31 December 20.24 and the date the financial statements were authorised for issue (approved by the board of directors) was 5 March 20.25. Therefore, the acquisition of Paintlux on 10 January 20.25 qualifies as an event after the reporting period in terms of IAS 10. (2)
As the acquisition of a subsidiary are indicative of conditions that arose after the reporting period, it will be a non-adjusting events, meaning the acquisition of Paintlux will not be recognised in the financial statements of Paintpro for the year ended 31 December 20.24. (1)

However, IAS 10.21 states that if the non-adjusting event is material to the reporting entity additional information shall be disclosed in the annual financial statements. The standard also refers to a major business combination as an example of a non-adjusting event that would give rise to additional disclosure [IAS10.22(a)]. (1)

The investment in Paintlux is considered "significant" and therefore may influence the users of the financial statements and should be disclosed in the annual financial statements for the year ended 31 December 20.24. (1)

To adhere to the disclosure requirements of IAS 10 and IFRS 3.59, the detail disclosure of IFRS 3.B64 for the acquisition of Paintlux should be included in the annual financial statements of Paintpro for the year ended 31 December 20.24. (1)

Total (7)
Maximum (5)

**(c) Prepare the pro forma journal entries to account for the investment in Brushes Ltd in the consolidated financial statements of the Paintpro Ltd Group for the year ended 31 December 20.24.**

| | | Dr R | Cr R | |
|---|---|---|---|---|
| J1 | Investment in associate (SFP) | 60 000 | | (1) |
| | Retained earnings (SCE) | | 60 000 | (1) |
| | Reversal of impairment loss recognised in prior year | | | |
| J2 | Retained earnings (SCE) (balancing) | 250 000 | | (1) |
| | Investment in associate (SFP) (given) | | 220 000 | (1) |
| | Long-term loan receivable (SFP) (given) | | 30 000 | (1) |
| | Accounting for associate prior year loss | | | |
| J3 | Long-term loan receivable (SFP) [C2] | 30 000 | | (1) |
| | Investment in associate (SFP) [C2] OR (balancing) | 29 500 | | (4) |
| | Share of profit of associate (P/L) [C2] or (balancing) | | 59 500 | (1) |
| | Accounting for associate current year profit | | | |
| J4 | Other income (dividends received) (P/L) (55 000 x 30%) | 16 500 | | (2) |
| | Investment in associate (SFP) | | 16 500 | (1) |
| | Dividends received from associate | | | |
| | | | | (14) |

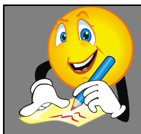
**CALCULATIONS**

**C1. Calculation of loss recognised for the FY20.23 - Brushes Ltd**

| | |
|---|---|
| Retained earnings 31 December 20.23 | (410 000) |
| Retained earnings at acquisition | (460 000) |
| Loss for the 20.23 financial year | (870 000) |
| | |
| Paintpro's share (870 000 x 30%) | (261 000) |
| | |
| Net investment in associate | |
| - Carrying amount (given) | 220 000 |
| - Long-term loan (given) | 30 000 |
| | 250 000 |
| | |
| Recognition of loss | |
| - Carrying amount | (220 000) |
| - Long-term loan | (30 000) |
| | (250 000) |
| Unrecognised portion of loss (261 000 – 250 000) | (11 000) |

**C2. Calculation of profit recognised for the year ended 31 December 20.24 - Brushes Ltd**

| | |
|---|---|
| Retained earnings 31 December 20.24 | (230 000) |
| Retained earnings 31 December 20.23 | (410 000) |
| Movement for the 20.24 financial year | 180 000 |
| Dividend declared and paid | 55 000 |
| Profit for the 20.24 financial year | 235 000 |
| | |
| Paintpro's share (235 000 x 30%) | 70 500 |
| Unrecognised portion of loss for FY20.23 [C1] | (11 000) |
| | 59 500 |
| | |
| Recognition of profit | |
| - Long-term loan | 30 000 |
| - Carrying amount (balancing) | 29 500 |
| | 59 500 |



**DISCUSSION**

If an entity's share of losses of an associate equal or exceeds its interest in the associate, the entity **discontinues recognising its share of further losses**. The interest in an associate is the carrying amount of the investment in the associate determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future. If the associate subsequently reports profits, the entity resumes recognising its share of those profits **only after its share of the profits equals the share of losses not recognised** (IAS 28.38 and .39)

**C3. Analysis of owners' equity of Brushes Ltd (**for completeness only**)**

| | Total | Paintpro Ltd (30%) | |
|---|---|---|---|
| | | At | Since |
| **At acquisition** | | | |
| Share capital | 250 000 | | |
| Retained earnings | 460 000 | | |
| | 710 000 | 213 000 | |
| Goodwill (balancing) | | 7 000 | |
| Consideration | | 220 000 | |
| **Since acquisition until beginning of year** | | | |
| Retained earnings (- 410 000 – 460 000) | (870 000) | | (261 000) |
| Correction | | (11 000) | 11 000 |
| **Current year** | | | |
| Profit for the year (- 230 000 + 410 000 + 55 000) | 235 000 | | 70 500 |
| Correction | | 11 000 | (11 000) |
| Dividends | (55 000) | | (16 500) |
| | 20 000 | | (207 000) |

**CASE STUDY 1** **40 marks**

## YOU HAVE 80 MINUTES TO ANSWER THIS QUESTION

School4U Ltd was established in 20.01 and their primary purpose is to provide stationary, school clothing and school sporting equipment to schools in South Africa. All the companies in the School4U Ltd Group have a 31 March year end. School4U Ltd has several investments as indicated below:

**Extreme-School Ltd**

On 15 May 20.23, Extreme-School Ltd, a new company based in Bloemfontein was incorporated. Mr. Rocky, the CEO of Extreme-School Ltd and a well-known local businessman in Bloemfontein, is the sole owner of Extreme-School Ltd and holds 100% of its issued share capital.

On 15 May 20.23, a contractual agreement was entered into by Extreme-School Ltd and School4U Ltd in which Extreme-School Ltd will supply Schoo4U Ltd with sports equipment. School4U Ltd leases sports equipment to schools located in the Free State Province. In terms of the agreement, Extreme-School Ltd must have the sports equipment readily available for School4U Ltd as and when required by them. Extreme-School Ltd will supply the sports equipment to School4U Ltd at market-related prices. Mr Rocky has the right to decide which suppliers are used to manufacture the sports equipment from. School4U Ltd controls the trademarks that are critical to Extreme-School Ltd for the manufacturing of sports equipment and they appoint the board of directors of Extreme-School Ltd.

Apart from School4U Ltd, Extreme-School Ltd has numerous other small customers, from which it generates a much smaller revenue percentage than is the case with School4U Ltd.

**SchoolBoutique Ltd**

In order to further diversify its business, School4U Ltd acquired 65% of the ordinary shares in SchoolBoutique Ltd on 30 November 20.23. School4U Ltd is exposed to variable returns from its involvement with SchoolBoutique Ltd and has the ability to affect those returns through its power over SchoolBoutique Ltd from that date.

SchoolBoutique Ltd had the following equity balances in its accounting records on the relevant dates:

| | **30 November 20.23<br>R** | **31 March 20.24<br>R** |
|---|---|---|
| Ordinary share capital (150 000 shares) | 1 500 000 | 1 500 000 |
| Retained earnings | 9 874 225 | 10 924 426 |
| Mark-to-market reserve | 458 650 | 458 650 |
| | 11 832 875 | 12 883 076 |

All the assets and liabilities of SchoolBoutique Ltd were deemed to be fairly valued on 30 November 20.23, except for the following:

- In 20.22, SchoolBoutique Ltd launched newly designed light-weight sport equipment, which is suitable for school children during their various stages of development. This design has not yet been patented by SchoolBoutique Ltd and has also not been recognised as an asset in its accounting records. The fair value of this design, based on similar market conditions, amounted to R1 285 480 on 30 November 20.23, and is expected to have an indefinite useful life. The South African Revenue Service (SARS) does not allow any deductions against taxable income in respect of this design.

- SchoolBoutique Ltd owns land that is currently being developed for industrial use as a site for a factory. The current use of the land is presumed to be its highest and best use unless market or other factors suggest a different use. Nearby sites have recently been developed for residential use. Based on the residential development, recent zoning and other changes to facilitate the residential development, the entity determines that the land currently used for the construction of the factory could also be used for residential purposes because market participants would consider the potential to develop the site for residential use when pricing the land.

No additional assets, liabilities or contingent liabilities were identified on the acquisition date.

The consideration paid by School4U Ltd for the acquisition of SchoolBoutique Ltd consisted of the following:

- A cash amount of R5 805 400 paid on 30 November 20.23 to the transacting attorneys.

- Costs directly related to business combinations amounted to R68 480, this amount was included in the cash payment on 30 November 20.23.

- The transfer of furniture to SchoolBoutique Ltd to be used for business purposes, with a carrying amount and a fair value of R680 800 on 30 November 20.23.

- 1 000 Ordinary shares of School4U Ltd to be issued to SchoolBoutique Ltd.

- Included in the cash amount paid on 30 November 20.23 were R46 540 share issue costs related to the issuing of the 1 000 ordinary shares of School4U Ltd.

The contract for this acquisition was drafted on 30 September 20.23, but due to an administrative delay, the 1 000 ordinary shares were only issued to SchoolBoutique Ltd on 12 January 20.24.

The price per share of School4U Ltd's shares amounted to the following on the various dates:

| | **30 September 20.23** | **30 November 20.23** | **12 January 20.24** | **31 March 20.24** |
|---|---|---|---|---|
| Price per share | R685,93 | R687,66 | R695,88 | R705,42 |

On 31 March 20.24 the accountant of School4U Ltd confirmed that the following item relating to the business combination is yet to be finalised in the accounting records:

- On 30 November 20.23, a lump sum of R2 045 600 was paid to the CEO of SchoolBoutique Ltd, in a separate transaction as an incentive to remain with the company after the acquisition. On 30 November 20.23 the contract with the CEO was signed, but it was not made available to the accountant of School4U Ltd. In the absence of the contract, the lump sum was included in the payroll of School4U Ltd as an incentive bonus to a future employee. The contract was provided to the accountant on 1 April 20.24, when he enquired why the CEO would not need to repay this amount should he resign at any time after 30 November 20.23. You may assume that this is material and has been corrected in the separate financial statements of School4U Ltd on 31 March 20.24. This matter concluded the accounting of the acquisition.

On 1 January 20.24, SchoolBoutique Ltd sold a delivery truck to School4U Ltd for an amount of R406 240. SchoolBoutique Ltd originally purchased this delivery truck for an amount of R1 062 350 on 1 March 20.19. At that date, SchoolBoutique Ltd assessed the useful life of the delivery truck at seven (7) years, which remained unchanged on 1 January 20.24.

**Additional information**

- It is the accounting policy of School4U Ltd to account for investments in subsidiaries at cost in accordance with IAS 27.10(a) *Separate Financial Statements* in its separate financial statements.

- The group has elected to measure non-controlling interests at the proportionate share of the acquiree's net identifiable assets at the acquisition date for all acquisitions.

- The group has elected to measure property, plant and equipment in accordance with the cost model in accordance with IAS 16 *Property, plant and equipment.*

- It is the accounting policy of the group to depreciate property, plant and equipment over its remaining useful life on the straight-line method.

- The issued share capital of all companies included in the group remained unchanged throughout the current financial year.

Assume a normal income tax rate of 27% and a capital gains tax inclusion rate of 80%. Ignore the effects of dividend tax and value added tax (VAT).

**REQUIRED**

| | | Marks |
|---|---|---|
| (a) | Discuss, with reasons, whether or not Extreme-School Ltd is a subsidiary of School4U Ltd, in accordance with IFRS 10 *Consolidated Financial Statements,* for the year ended 31 March 20.24. | 14 |
| | X1: Communication skills - clarity of expression | 1 |
| (b) | Explain, in accordance with IFRS 13 *Fair Value Measurement,* the factors that should be considered to determine the highest and best use of the land of SchoolBoutique Ltd at the date of acquisition by Schools4U Ltd. | 4 |
| | X1: Communication skills - clarity of expression | 1 |
| (c) | Provide the pro forma consolidation journal entries to account for the investment in SchoolBoutique Ltd in the consolidated financial statements of the School4U Ltd Group for the year ended 31 March 20.24.<br><br>**Please note:**<br>• You may assume that the highest and best use of the land was taken into account at the acquisition date and that the fair value of land was assessed as R1 600 000 higher than the carrying amount.<br>• Round off all amounts to the nearest rand.<br>• All calculations must be shown clearly.<br>• Journal narrations are not required.<br>• Journal entries relating to deferred taxation are required. | 20 |
| **Please note:**<br>• Your answer must comply with IFRS Accounting Standards. | | |

**CASE STUDY 1 – Suggested solution**

**(a) Discuss, with reasons, whether or not Extreme-School Ltd is a subsidiary of School4U Ltd, in accordance with IFRS 10 *Consolidated Financial Statements,* for the year ended 31 March 20.24.**

A subsidiary is an entity that is controlled by another entity (IFRS 10 Appendix A).

Extreme-School Ltd will be a subsidiary of School4U Ltd if its **controlled** by School4U Ltd. (1)

School4U Ltd needs to determine whether it is the parent of Extreme-School Ltd by **assessing whether it controls** Extreme-School Ltd regardless of the nature of its involvement. (IFRS 10.5 or IFRS 10.B2) (1)

An investor controls an investee if and only if the investor has all the following:
1. Power over the investee.
2. Exposure, or rights, to variable returns from its involvement with the investee.
3. The ability to us its power over the investee to affect the amount of the investor's returns. (IFRS 10.7)

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, ie the activities that significantly affect the investee's returns (IFRS 10.10).

School4U Ltd **does not own any voting rights** from shares in Extreme-School Ltd and also does not have power in terms of voting rights, since 100% of the issued share capital is held by Mr. Rocky. (1)

Power arises from rights. Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements. (IFRS 10.11)

Consideration is given when considered that the investor's rights are sufficient to give it power over the investee:
1. The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities. (IFRS 10.B18)

However, School4U Ltd can **still have power, even without a majority of the voting rights. In this case** the rights conferred in the contractual agreement should be assessed (IFRS 10.B18). (1)

Sometimes there will be indications that the investor has a special relationship with the investee, which suggests that the investor has more than a passive interest in the investee. However, having more than a passive interest in the investee may indicate that the investor has other related rights sufficient to give it power or provide evidence of existing power over an investee.

The investee's operations are dependent on the investor, such as in the following situations:
1. the (investor controls assets such as licences or trademarks that are critical to the investee's operations. (IFRS 10.B19(b)(iv)).

| | |
|---|---|
| School4U Ltd **controls**, in terms of the contractual agreement, **the trademarks** that are critical to Extreme-School Ltd for the manufacturing of the sport equipment and **appoint the board of directors** of Extreme-School Ltd, which are **deemed to be relevant activities** as they significantly affect the returns of Extreme-School Ltd (IFRS 10.B12(b)); IFRS 10.B15(c)). | (1)<br>(1)<br>(1) |
| As School4U Ltd controls the trademarks that are critical to Extreme-School Ltd for the manufacturing of the sport equipment indicate, that School4U Ltd has more than a **passive interest in Extreme-School Ltd and may indicate power (IFRS 10.B19(b)(iv))**. | (1) |
| However, Mr. Rocky has the **right to decide which suppliers** are used for the purchase of the school sport equipment, which **also constitutes a relevant activity** as the main business of Extreme-School Ltd is to provide sports equipment (IFRS 10.B15(e))**.** | (1)<br>(1) |
| If two or more investors each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee, has power over the investee (IFRS 10.13). | |
| The **right that School4U Ltd has in terms of the relevant activities** together with the **contractual agreement** that grants it almost exclusive use of Extreme-School Ltd's school sport equipment, **constitute power over** Extreme-School Ltd (IFRS 10.13, IFRS 10.B38(b)). | (2) |
| Extreme-School Ltd **does depend on School4U Ltd to fund a significant portion** of its operations, since **other customers of Extreme-School Ltd contribute in a much lesser degree towards** their revenue. (IFRS 10.B19(b)(i)) | (1)<br>(1) |
| School4U Ltd **does not have exposure**, or the right, to variable returns from its involvement with the investee, since School4U Ltd **doesn't have shareholding rights** in Extreme-School Ltd as Mr Rocky owns all the shares. | (1)<br>(1) |
| Although School4U Ltd does not have any rights to the variable returns it has the ability to use its power over Extreme-School Ltd, to affect the amount of its revenue, thus will affect its returns indirectly and by doing this School4U Ltd **does have control over Extreme-School Ltd** (IFRS 10.B20). | (1) |
| Extreme-School Ltd **will be classified as a subsidiary** of School4U Ltd. | (1) |
| Total | (18) |
| Maximum | (14) |

**(b) Explain, in accordance with IFRS 13 *Fair Value Measurement,* the factors that should be considered to determine the highest and best use of the land of SchoolBoutique Ltd at the date of acquisition by Schools4U Ltd.**

A fair value measurement of land takes into account a market participant's ability to generate economic benefits by **using the asset** in its highest and best use or **by selling it** to another market participant that would use the asset in its highest and best use. (1)

The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

1. A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (e.g. the location or size of a property).
2. A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (e.g., the zoning regulations applicable to a property).
3. A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use. (IFRS 13.28)

The highest and best use of the land would be determined by comparing both of the following:

- the value of the land as **currently developed for industrial use** (i.e. the land would be used in combination with other assets, such as the factory, or with other assets and liabilities). (1)

- the value of the land as a **vacant site for residential use**, taking into account the **costs of halting and demolishing the factory and other related costs** (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (i.e., **the land is to be used by market participants on a stand-alone basis**). (1)

The highest and best use of the land would be determined on the basis of the higher of those values. In situations involving real estate appraisal, the determination of highest and best use might take into account factors relating to the factory operations, including its assets and liabilities. (1)

The highest and best used is determined from the perspective of market participants, even if the entity intends a different use. (1)

| | |
|---|---|
| Total | (5) |
| Maximum | (4) |
| X1: Communication skills - clarity of expression | (1) |

**(c) Provide the pro forma consolidation journal entries to account for the investment in SchoolBoutique Ltd in the consolidated financial statements of the School4U Ltd Group for the year ended 31 March 20.24.**

| | | Dr R | Cr R | |
|---|---|---|---|---|
| J1 | Ordinary share capital (SCE) (given) | 1 500 000 | | |
| | Retained earnings (SCE) (given) | 9 874 225 | | (1) |
| | Mark-to-market reserve (SCE) (given) | 458 650 | | |
| | Intangible asset (SFP) (given) | 1 285 480 | | (1) |
| | Land (SFP) (given) | 1 600 000 | | (1) |
| | Deferred tax (SFP) [(1 285 480 + 1 600 000) x 27% x 80%] | | 623 264 | (2) |
| | Gain on bargain purchase (P/L) (balancing) [C2] | | 57 369 | (1) |
| | NCI (SFP) (14 095 091 [C2] x 35%) | | 4 933 282 | (1) |
| | Investment in SchoolBoutique Ltd (SFP) [C1] | | 9 104 440 | (5) |
| | At acquisition elimination journal | | | |
| J2 | Other income (P/L) [C3] | 77 417 | | (2½) |
| | Delivery truck (SFP) | | 77 417 | (½) |
| | Eliminate intragroup sale of PPE | | | |
| J3 | Deferred tax (SFP) [C3] (77 417 x 27%) | 20 903 | | (1) |
| | Income tax expense (P/L) | | 20 903 | (½) |
| | Tax effect of intragroup transaction | | | |
| J4 | Accumulated depreciation (SFP) | 8 933 | | (2) |
| | Other income (depreciation) (P/L) [C3] | | 8 933 | (½) |
| | Realisation of unrealised profit | | | |
| J5 | Income tax expense (P/L) [C3] | 2 412 | | (1) |
| | Deferred tax (SFP) | | 2 412 | (½) |
| | Tax effect of realisation of unrealised profit | | | |
| J6 | Non-controlling interests (P/L) [((10 924 426 – 9 874 225 = 1 050 201) - 56 514 [J2/J3] + 6 521[J4/J5]) x 35%] | 350 073 | | (2½) |
| | Non-controlling interests (SFP) | | 350 073 | (½) |
| | Account for NCI's share in profit and OCI | | | |
| | | | Total | (23½) |
| | | | Maximum | (21) |
| | | | X1: Communication skills - presentation and layout | (1) |

**CALCULATIONS**

**C1. Consideration transferred**

| | | |
|---|---|---|
| Cash amount paid | 5 805 400 | [½] |
| Costs directly related to drafting of the acquisition | (68 480) | [1] |
| Carrying amount of furniture (stays in group) | 680 800 | [1] |
| Issue of shares (1 000 x R687,66) | 687 660 | [1] |
| Costs relating to issue of shares | (46 (540) | [½] |
| | 7 058 840 | |
| Measurement period adjustment – lump sum to CEO | 2 045 600 | [1] |
| | 9 104 440 | |
| | | [5] |

## C2. Gain in bargain purchase

| | | |
|---|---|---|
| Share capital | 1 500 000 | [½] |
| Retained earnings | 9 874 225 | [½] |
| Mark to market reserve | 458 650 | [½] |
| Intangible asset remeasurement IFRS 3 | 1 285 480 | [½] |
| Deferred taxation (1 285 480 x 27% x 80%) | (277 664) | [½] |
| Land remeasurement IFRS 3 | 1 600 000 | [½] |
| Deferred taxation (1 600 000 x 27% x 80%) | (345 600) | [½] |
| | 14 095 091 | |
| | | |
| School4U Ltd (14 095 091 x 65%) | 9 161 809 | [½] |
| Consideration paid [C1] | (9 104 440) | [½] |
| | (57 369) | |
| | | [8] |

## C3. Unrealised profit and depreciation for disposal of delivery truck

| | | |
|---|---|---|
| Original cost price | 1 062 350 | [½] |
| Accumulated depreciation till 1 January 20.24 (1 062 350/84 x 58) | (733 527) | [1½] |
| Carrying amount | 328 823 | |
| Selling price to School4U Ltd | 406 240 | [½] |
| Unrealised profit | 77 417 | |
| Deferred tax (77 417 x 27%) | (20 903) | [½] |
| | 56 514 | |
| | | |
| Realising of unrealised profit through depreciation for 20.24 (77 417 / (84-58 = 26) x 3) | 8 933 | [2] |
| Deferred tax (8 933 x 27%) | (2 412) | [½] |
| | 6 521 | |
| | | [5½] |

**CASE STUDY 2** **53 marks**

| YOU HAVE 106 MINUTES TO ANSWER THIS QUESTION |
|---|

Cellular Connect Ltd (Cellular) is a South African telecommunications company listed in the wireless telecommunications sector on the Johannesburg Stock Exchange. Cellular was established in 20.01 and listed in 20.05 Cellular provides over 12 million customers with voice, messaging and data services. Cellular is the third largest mobile network in South Africa.

**Industry information**

South Africa has one of the largest telecommunications markets on the African continent. The telecommunications industry is a capital-intensive industry which requires continuous investment in technology and infrastructure to ensure a reliable network that is technologically up to date and that has the capacity to deal with growth. There are approximately 80 million active cell phone activations in South Africa, a country with a population of about 53 million.

The voice revenue in the South African cellular industry has been under pressure over the past three years due to limited growth in voice minutes and declining voice rates per minute. The major players have been reducing voice rates in response to competitive pressure. Changing customer needs and cheaper smart phones have resulted in significant growth in mobile data usage over the past few years and this trend is expected to continue.

Innovation in product offerings occurs frequently in the industry. Rewarding loyalty by means of free data and minutes, based on usage, has also become very popular. Customer care remains an important differentiator between cellular networks and, as a result, network operators are placing more and more emphasis on customer experience, especially as competition becomes fiercer.

**Cellular Connect**

In the 20.24 financial year Cellular had two types of customers, namely mobile contract customers and mobile prepaid customers.

Mobile contract customers may choose between a number of different contracts, offering a variety of voice minutes, numbers of short message service (SMS) messages and units of data, depending on the specific package. Most mobile contracts include ‘in bundle’ voice calls, SMS messages and units of data. All voice calls, SMS messages and units of data used outside bundles are charged to customers over and above their monthly contract fee. All contracts are of 24 months’ duration and customers receive handsets upon signing the contracts.

Mobile prepaid customers need to purchase ‘airtime’ which they then use to make voice calls, send SMS messages and access data. These customers need to buy their own handsets.

**Outstanding matters**

The Chief Financial Officer (CFO) of Cellular is in the process of analysing the service revenue performance of the company for the 20.24 financial year and is considering a number of financial reporting matters arising from its contracts.

**Financial reporting matters**

Cellular offers different types of cellular packages to serve the needs of its customers. The latest offerings are the following:

**1. Pay-now-and-then-go**

The *Pay-now-and-then-go* options allow customers to purchase data, SMS messages and voice minutes (or bundles thereof) separately for cash up front (based on *Pay-now-and-then-go* rates) without the commitment of a 24-month contract and the additional cost of financing a smartphone or tablet. The observable stand-alone selling prices of data, SMS messages and voice minutes are as follows:

| ***Pay-now-and-then-go* rates** | **Per unit** | **Per bundle** |
|---|---|---|
| Data | R0,20 per MB | R17,00 for 100 MB |
| SMS messages | R0,30 per SMS | R25,50 for 100 SMS messages |
| Voice minutes | R1,65 per minute | R140,25 for 100 minutes |

**2. MyLife contracts**

The *MyLife100* contract is an example of the *MyLife* contracts. This contract offers 100 MB of data, 100 SMS messages and 100 voice minutes per month in return for a fixed monthly payment in advance, for the duration of a 24-month contract period, as well as an iFoni SPEED smartphone (iFoni SP), supplied to the customer once the contract has been concluded and signed. The fixed monthly fee for a *MyLife100* contract is R589 per month.

To enter into a *MyLife* contract, customers select a contract based on their requirements, complete an application form and provide the required regulatory documentation (Regulation of Interception of Communications and provision of communication-related information, known as RICA documentation) to Cellular. Cellular performs a credit check to assess the creditworthiness of the customer. This normally takes 25 minutes to complete and is done while the customer waits. Cellular makes use of a credit verification system offered by CreditCheck (Pty) Ltd. Once the credit check has been successfully completed, a sales representative explains the contract terms and conditions to the customer, who then signs the contract.

Data, SMS messages and voice minutes that form part of a *MyLife* contract are priced at a discount of 15% to the equivalent stand-alone bundle selling prices applicable to the *Pay-now-and-then-go* options.

Data, SMS messages and voice minutes not used by a customer in a particular month are not carried forward to the next month and are thus forfeited.

The iFoni SP is the latest smartphone in the iFoni line of smartphones and incorporates a 3D touch screen, 12-megapixel camera and 4G LTE. The price of an iFoni SP, if sold separately and not as part of a *MyLife* contract, is R8 000.

## 3. 12-month warranty

A smartphone or tablet granted by Cellular to customers is covered by a 12-month warranty provided by Cellular. If a faulty device is returned within seven days of purchase, the customer receives a new device as a replacement. If it is returned after seven days, Cellular will repair the device at Cellular's expense. The warranty only covers manufacturing defects and excludes liquid contact damage and cosmetic damage such as scratches, dents and broken screens or ports as required by the Consumer Protection Act. Defective devices returned after the 12-month warranty period are still repaired, but at the cost of the customer.

Every smartphone has its own unique serial number. Cellular's systems link the serial number to the warranty, the date of purchase and the customer's details. Customers do not have the option of purchasing the 12-month warranty separately from Cellular.

Cellular's management made the following reliable estimates in respect of warranties:

(a) Smartphones offered in terms of *MyLife* contracts are returned for repairs as follows:
- 0% is returned for exchange during the first week after signing the contract.
- 28% are returned for repairs during the 12 months following sale. 25% of these returns are as a result of liquid contact or cosmetic damage.
- 15% are returned for repairs after the 12-month warranty period.

(b) The probable cost per smartphone that Cellular will incur to repair a smartphone covered by the 12-month warranty is as follows:
- 60% probability that Cellular will incur an average cost of R4 800.
- 40% probability that Cellular will incur an average cost of R6 700.

## 4. Computer and data contracts

Cellular introduced a new type of contract in the 20.25 financial year which bundles a computer, sim card and 3 gigabyte (GB) of monthly mobile data at a special promotional price of R349 per month over a 24-month period, payable monthly in arrears. There is no upfront connection fee.

The stand-alone selling price of the computer is R5 000. The 3 GB of mobile data are provided at the beginning of each month and can be rolled over to the following month, at the end of which the unused data will expire. The stand-alone selling price of a 3 GB mobile data bundle is R180 per month. Extra mobile data is charged at normal out of bundle rates as and when used.

The contract also stipulates a returns policy. The contract can be cancelled without penalty within seven days of signature, provided that no data on the contract has been used. It is expected that, on average, 3% of computers will be returned under the returns policy.

Following a successful credit application, the computer is given to the customer and the sim card and data are activated. Cellular sold 100 contracts on 1 December 20.24. Of the 100 sold, one customer cancelled the contract in terms of the returns policy. With regard to the remaining 99 contracts, actual information shows that 75% of the data was used in the first month and the rest was carried forward to the next month. Cellular purchased the computers for R3 500 each in November 20.24.

## 5. Other information

- An appropriate discount rate in respect of the contracts is 9% per annum, compounded monthly where required.
- Cellular has:
  - a 31 October year end
  - not applied the portfolio approach as defined in par. 4 of IFRS 15
- All contracts are within the scope of IFRS 15.

**REQUIRED**

| | | Marks |
|---|---|---|
| (a) | Discuss the following with regard to a *MyLife100* contract in terms of IRFS 15: | |
| | (i) Whether the 12-month warranty offered on the iFoni SP should be identified as a separate performance obligation. Do not discuss the seven-day returns policy. | 9 |
| | (ii) Whether a significant financing component exists for each separate performance obligation in a *MyLife100* contract. | 6 |
| | (iii) The allocation of the transaction price to the separate performance obligations in a *MyLife100* contract. Assume that the iFoni SP, data, SMS messages and voice minutes are each separate performance obligations in the *MyLife100* contract. Ignore the 12-month warranty. | 14 |
| | X1: Communication skills - presentation and layout | 1 |
| (b) | Prepare the journal entries to be processed in December 20.24 for Cellular Connect Ltd to account for all consequences arising from the 100 computer and data contracts sold on 1 December 20.24. Assume there are only two distinct performance obligations in the contract, namely the computer and 3 GB of mobile data. The cost of the sim card is negligible and can be ignored. | 23 |
| | **Please note:**<br>• Round off all amounts to the nearest rand.<br>• Journal narrations are not required.<br>• Ignore any normal income tax implications.<br>• Ignore any value-added tax (VAT) implications.<br>• Your answer must comply with IFRS Accounting Standards. | |

**CASE STUDY 2 – Suggested solution**

**(a) Discuss the following with regard to a *MyLife100* contract in terms of IFRS 15:**

**(i) Whether the 12-month warranty offered on the iFoni SP should be identified as a separate performance obligation. Do not discuss the seven-day return policy.**

Determine whether the 12-month warranty should be identified as a separate performance obligation in the MyLife100 contract that Cellular has to assess at contract inception, if the 12-month warranty is distinct: (1)

- a good or service (or a bundle of goods or services) that is distinct, or
- a series of distinct goods and services that are substantially the same and that have the same pattern of transfer to the customer (IFRS 15.22).

Goods and services promised are distinct if both of the following criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available (i.e., the good or service is capable of being distinct), and
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract) (IFRS 15.27).

The customer cannot benefit from the warranty on its own, since the warranty will only entitle the holder of an iFoni SP with a unique serial number to specified repairs. Without the iFoni SP, the warranty will not provide any benefit to the customer. Customers do not have the option of purchasing the 12-month warranty separately. (2)

The customer can, however, benefit from the warranty together with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity), or a resource that the customer has already obtained from the entity (including goods or services that the entity has already transferred to the customer under the contract). (1)

The iFoni SP is, therefore, a readily available resource, which the customer has already obtained from the entity (CC).

The warranty is, therefore, capable of being distinct, as the customer can benefit from it together with other resources that are readily available. (1)

Factors that indicate that an entity's promise to transfer a good or service to a customer is separately identifiable (in accordance with IFRS 15.27(b)) include, but are not limited to, the following:

- The entity does not provide a significant service of integrating the goods or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted.
- The good or service does not significantly modify or customise another good or service promised in the contract.
- The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract (IFRS 15.29).

The warranty is highly dependent on and highly interrelated with the iFoni SP, since the customer cannot choose to buy the warranty without buying the iFoni SP. (1)

The warranty is, therefore, not separately identifiable (i.e., not distinct within the context of the contract). (1)

The 12-month warranty is, therefore, not distinct. (1)

Furthermore, IFRS 15 gives specific guidance to identify whether a warranty should be identified as a separate performance obligation in the contract. If a customer does not have the option to purchase the warranty separately, the entity shall account for the warranty in terms of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, unless the promised warranty, or part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with the agreed-upon specifications (IFRS 15.B30).

Customers do not have the option to purchase the 12-month warranty separately. (1)

In assessing whether the warranty provides the customer with a service in addition to the assurance that the product complies with the agreed-upon specifications, the following facts should be considered: (IFRS 15.B31)

- Whether the warranty is required by law – indicating that the warranty is not a separate performance obligation.
- Whether the 12-month warranty provided by Cellular is required by the Consumer Protection Act of South Africa. (1)
- The length of the warranty coverage period – the longer the coverage, the more likely it is that the warranty is a separate performance obligation.
- The warranty provided by Cellular is for 12 months only, which is considered to be a short period when compared to actual warranties on electronics. (1)
- The nature of the tasks that the entity promises to perform – if the entity has to perform specified tasks to provide assurance that the product complies with agreed-upon specifications, then those tasks likely do not give rise to a separate performance obligation.
- CC will repair a defective iFoni SP at its own cost within the first 12 months. This suggests that Cellular is only providing assurance that their product will function as intended for a period of at least 12 months. (1)

To conclude, the warranty does not provide a service in addition to the assurance that the iFoni SP will function as intended for a period of at least 12 months, and should not be identified as a separate performance obligation in the MyLife100 contract, but should rather be bundled with the sale of the iFoni SP. (1)

Total (13)

Maximum (9)

**(ii) Whether a significant financing component exists for each separate performance obligation in a *MyLife 100* contract. Provide reasons to support your discussion**

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component.

A significant financing component may exist, regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed upon between the parties to the contract (IFRS 15.60).

An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component, and whether that financing component is significant to the contract, including both of the following:

- the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services, and
- the combined effect of both of the following:
    - the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services, and
    - the prevailing interest rates in the relevant market (IFRS 15.61)

The data, SMS and voice minutes are transferred to the customer on the same day the monthly payment is received, and consequently there is no timing difference between transferring the goods and services and receiving the consideration – no significant financing component. (2)

The following factors support that a significant financing component exists upon the transfer of an iFoni SP in a MyLife100 contract:

- The difference between the promised consideration and the current cash selling price of the iFoni SP is considered to be significant. (1)
- The combined effect of the 24-month period between the transfer of the iFoni SP at inception of the contract and receipt of the final instalment and the discount rate is also considered to be significant. (1) (1)

Furthermore, none of the following factors, which indicate that a significant financing component does not exist, is present in the contract: (IFRS 15.62)

- The customer did not pay in advance for the iFoni SP. The iFoni SP is transferred at contract inception (therefore, not at the customer's discretion) and deferred payments are received. (1)
- The consideration promised in the *MyLife100* contract is fixed at R589 per month for 24-months, and is neither variable nor dependent on the occurrence or non-occurrence of a future event. (1)
- *Pay-now-and-then-go* options: The wording *without the commitment of a 24-month contract and the additional cost of financing a smartphone*, as in the case of a *MyLife100* contract, supports that the difference between the promised consideration and the cash selling price of the iFoni SP is as a result of a significant financing component in the contract, and does not arise for reasons other than the provision of finance. (1)

The practical expedient is not available for the transfer of an iFoni SP in a *MyLife100* contract, because the full settlement/payment for the iFoni SP only takes place after 24 months; thus, after the transfer of the iFoni SP (a timing difference of more than 12 months and, therefore, not one year or less). (1)

It can be concluded that a significant financing component does exist for the transfer of the iFoni SP in a *MyLife100* contract. (1)

Total (10)

Maximum (6)

**(iii) The allocation of the transaction price to the separate performance obligations in a *MyLife100* contract. Assume that the iFoni SP, data, SMS messages and voice minutes are each separate performance obligations in the *MyLife100* contract**

The transaction price should be allocated to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled to, in exchange for transferring the promised goods or services to the customer (IFRS 15.73).

The transaction price must be allocated to each performance obligation identified in the contract on a relative stand-alone selling price basis as at contract inception (IFRS15.74).

**STAND-ALONE SELLING PRICES**

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer.

- The best evidence of the stand-alone selling price of the iFoni SP is its observable price of R8 000 when Cellular sells the phone separately. (1)
- The best evidence of the stand-alone selling prices of the data, SMS messages and voice minutes are the observable prices when Cellular sells these items separately under Pay-now-then-go options. (1)

| Performance obligation | Option 1 (per unit) | Option 2 (per unit) | |
|---|---|---|---|
| iFoni SP | R8 000 | R8 000 | (1) |
| Data | R480 (R20 x 24) | R408 (R17 x 24) | (2) |
| SMS messages | R720 (R30 x 24) | R612 (R25,50 x 24) | (1) |
| Voice minutes | R3 960 (R165 x 24) | R3 366 (R140,25 x 24) | (1) |
| | **R13 160** | **R12 386** | |

**TRANSACTION PRICE**

The promised amount of consideration of R14 136 (R589 per month x 24) or R589 per month must be allocated to each performance obligation based on the relative stand-alone selling prices as determined above (calculations below are based on Option 2, above, but can also be based on Option 1). (1)

| **Performance obligations** | **Relative stand-alone selling prices R** | | **Allocation of cash consideration R** |
|---|---|---|---|
| iFoni SP | 8 000 | (8 000/12 386 x 14 136) | 9 130 |
| Data | 408 | (408/12 386 x 14 136) | 466 |
| SMS messages | 612 | (612/12 386 x 14 136) | 698 |
| Voice minutes | 3 366 | (3 366/12 386 x 14 136) | 3 842 |
| | **12 386** | | **14 136** |

(2)

Since a significant financing component exists in respect of the iFoni (see part d(ii)), the promised amount of consideration must be adjusted for the effects of the time value of money to determine the transaction price (IFRS15.60). (1)

- Therefore, the promised amount of consideration allocated to the iFoni must be discounted at 9% over 24 months to determine the present value of the consideration receivable. (1)

- **Alternative 1:**
  BGN; PMT = 380,42 (9 130 / 24); P/YR = 12; i = 9%; n = 24; compute PV = 8 389 (2)

- **Alternative 2:** OR
  BGN; PMT = 589; P/YR = 12; i = 9%; n = 24; compute PV = 12 989
  PV attributable to iFoni: 8 000 / 12 386 x 12 989 = 8 389 (2)

The allocation of the transaction price to each separate performance obligation will, therefore, be as follows: (2)

| **PO's** | **Relative stand-alone selling price R** | **Allocation of cash consideration R** | **Finance element** | **Allocation of transaction price R** |
|---|---|---|---|---|
| iFoni SP | 8 000 | 9 130 | Yes | 8 389 |
| Data | 408 | 466 | No | 466 |
| SMS messages | 612 | 698 | No | 698 |
| Voice minutes | 3 366 | 3 842 | No | 3 842 |
| | **12 386** | **14 136** | | **13 395** |

**DISCOUNT**

A customer receives a discount for purchasing a bundle of goods or services if the sum of the stand-alone selling prices of those promised goods or services exceed the promised consideration (IFRS 15.81).

| | Option 1 (per unit) | Option 2 (per unit) | |
|---|---|---|---|
| Sum of stand-alone selling prices | R13 160 | R12 386 | (1) |
| Promised consideration | R14 136 | R14 136 | (1) |
| | No discount | No discount | |

Except when an entity has observable evidence that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract (IFRS 15.81).

| | |
|---|---|
| Total | (18) |
| Maximum | (14) |
| X1: Communication skills - presentation and layout | (1) |

**(b) Prepare the journal entries for Cellular to account for all consequences arising from the 100 computer and data contracts for the month of December 20.24.**

| | | Dr R | Cr R | |
|---|---|---|---|---|
| | **1 December 20.24** | | | |
| J1 | Contract debtor (SFP) (4 098 [C1] x 100) | 409 800 | | (3) |
| | Revenue – computer (P/L) | | 397 506 | (1) |
| | Refund liability (SFP) (409 800 x 3%) | | 12 294 | (1) |
| | Recognition of computer revenue | | | |
| J2 | Cost of sales (P/L) (3 500 x 100 x 97%) | 339 500 | | (1) |
| | Inventory (SFP) | | 339 500 | (1) |
| | Recognition of cost of sales | | | |
| J3 | Asset for right to recover product to be returned (SFP) | 10 500 | | (1) |
| | Inventory (SFP) (3 500 x 100 x 3%) | | 10 500 | (1) |
| | Recognition of right to recover inventory | | | |
| | **7 December 20.24** | | | |
| J4 | Refund liability (SFP) [J1] | 12 294 | | (1) |
| | Contract debtor (SFP) [C1] | | 4 098 | (1) |
| | Revenue – computer (P/L) (balancing) | | 8 196 | (1) |
| | Accounting for the returns policy and return of one computer | | | |
| J5 | Inventory (SFP) | 3 500 | | (1) |
| | Cost of sales (P/L) (10 500 – 3 500) | 7 000 | | (1) |
| | Asset for right to recover product to be returned (SFP) | | 10 500 | (1) |
| | Accounting for the returns policy and return of one computer | | | |
| | **31 December 20.24** | | | |
| J6 | Contract debtor (SFP) (4 098 x 99 x 9% x 1/12) | 3 043 | | (2) |
| | Interest income (P/L) | | 3 043 | (1) |
| | Interest income accrued | | | |

| | | Dr R | Cr R | |
|---|---|---|---|---|
| J7 | Bank (349 x 99) | 34 551 | | (1) |
| | Revenue – data (P/L) (161,79 [C2] x 99 x 75%) | | 12 013 | (5) |
| | Income received in advance (SFP) (161,79 x 99 x 25%) | | 4 004 | (1) |
| | Contract debtor (balancing) | | 18 534 | (1) |
| | Recording receipt of cash and data revenue | | | |
| | | | Total | (26) |
| | | | Maximum | (23) |

**EXAMINATION TECHNIQUE**

As the customers are allowed to return the laptops, the consideration received from the customer on 1 December is variable. Cellular will recognise a refund liability on that date, which will realise once the laptops are returned or the period for return lapses (7 December). Also refer to IFRS 15 Example 22 for additional practice.

## CALCULATIONS

### C1. Transaction price

| HP | | | Sharp | | | |
|---|---|---|---|---|---|---|
| FV | = | 0 | FV | = | 0 | |
| N | = | 24 | N | = | 24 | [1] |
| P/YR | = | 12 | I | = | 9%/12 | [1] |
| I | = | 9% | PMT | = | 349 | [1] |
| PMT | = | 349 | PV | = | 7 639 | |
| PV | = | 7 639 | | | | |

| | | | |
|---|---|---|---|
| PV attributable to computer: 5 000/9 320 [C2] x 7 639 | = | 4 098 | [1] |
| PV attributable to data: 4 320/9 320 [C2] x 7 639 | = | 3 541 | [1] |
| | | Total | [5] |
| | | Maximum | [3] |

### C2. Allocation of transaction price

| | Relative stand-alone selling prices | Allocation of transaction price | Financing element | Allocation of cash consideration | Final Revenue for the PO | |
|---|---|---|---|---|---|---|
| Computer | 5 000 | 4 098 | Financed | 4 493 | 4 098 | [1] |
| Data | 4 320 (180 x 24) | 3 541 | Not financed | 3 883 | 3 883 or 161,79 per month | [3] |
| | 9 320 | 7 639 [C1] | | 8 376 (349 x 24) | | [2] |
| | | | | | Total | [6] |
| | | | | | Maximum | [4] |