The following group financial statements relate to the Kutchen Group which comprised Kutchen, House and Mach, all public limited companies.

Group statement of financial position as at 31 December 20X6

	$m
Assets:	
Non-current assets	
Property, plant and equipment	365
Goodwill	-
Intangible assets	23

	388
Current assets	133

Total assets	521

Equity and liabilities	
Share capital of $1 each	63
Retained earnings	56
Other components of equity	26
Non-controlling interest	3

	148

Non-current liabilities	101
Current liabilities	
Trade payables	272

Total liabilities	373

Total equity and liabilities	521

Acquisition of 70% of House

On 1 June 20X6, Kutchen acquired 70% of the equity interests of House. The purchase consideration comprised 20 million shares of $1 of Kutchen at the acquisition date and a further 5 million shares on 31 December 20X7 if House's net profit after taxation was at least $4 million for the year ending on that date.

The market price of Kutchen's shares on 1 June 20X6 was $2 per share and that of House was $420 per share. It is felt that there is a 20% chance of the profit target being met.

In accounting for the acquisition of House, the finance director did not take into account the non-controlling interest in the goodwill calculation. He determined that a bargain purchase of $8 million arose on the acquisition of House, being the purchase consideration of $40 million less the fair value of the identifiable net assets of House acquired on 1 June 20X6 of $48 million. This valuation was included in the group financial statements above.

After the directors of Kutchen discovered the error, they decided to measure the non-controlling interest at fair value at the date of acquisition. The fair value of the non-controlling interest (NCI) in House was to be based upon quoted market prices at acquisition. House had issued share capital of $1 each, totalling $13 million at 1 June 20X6 and there has been no change in this amount since acquisition.

Initial acquisition of 80% of Mach

On 1 January 20X6, Kutchen acquired 80% of the equity interests of Mach, a privately owned entity, for a consideration of $57 million. The consideration comprised cash of $52 million and the transfer of non-depreciable land with a fair value of $5 million. The carrying amount of the land at the acquisition date was $3 million and the land has only recently been transferred to the seller of the shares in Mach and is still carried at $3 million in the group financial statements at 31 December 20X6.

At the date of acquisition, the identifiable net assets of Mach had a fair value of $55 million. Mach had made a net profit attributable to ordinary shareholders of $3.6 million for the year to 31 December 20X5.

The directors of Kutchen wish to measure the non-controlling interest at fair value at the date of acquisition but had again omitted NCI from the goodwill calculation. The NCI is to be fair valued using a public entity market multiple method. The directors of Kutchen have identified two companies who are comparable to Mach and who are trading at an average price to earnings ratio (P/E ratio) of 21. The directors have adjusted the P/E ratio to 19 for differences between the entities and Mach, for the purpose of fair valuing the NCI. The finance director has determined that a bargain purchase of $3 million arose on the acquisition of Mach being the cash consideration of $52 million less the fair value of the net assets of Mach of $55 million. This gain on the bargain purchase had been included in the group financial statements above.

Acquisition and disposal of 80% of Niche

Kutchen had purchased an 80% interest in Niche for $40 million on 1 January 20X6 when the fair value of the identifiable net assets was $44 million. The partial goodwill method had been used to calculate goodwill and an impairment of $2 million had arisen in the year ended 31 December 20X6. The holding in Niche was sold for $50 million on 31 December 20X6. The carrying value of Niche's identifiable net assets other than goodwill was $60 million at the date of sale. Kutchen had carried the investment in Niche at cost. The finance director calculated that a gain arose of $2 million on the sale of Niche in the group financial statements being the sale proceeds of $50 million less $48 million being their share of the identifiable net assets at the date of sale (80% of $60 million). This was credited to retained earnings.

Business segment restructure

Kutchen has decided to restructure one of its business segments. The plan was agreed by the board of directors on 1 October 20X6 and affects employees in two locations. In the first location, half of the factory units have been closed by 31 December 20X6 and the affected employees' pension benefits have been frozen. Any new employees will not be eligible to join the defined benefit plan. After the restructuring, the present value of the defined benefit obligation in this location is $8 million. The following table relates to location 1.

	Location 1 - $m
Value before restructuring:	
Present value of defined benefit obligation	(10)
Fair value of plan assets	7
Net pension liability	(3)

In the second location, all activities have been discontinued. It has been agreed that employees will receive a payment of $4 million in exchange for the pension liability of $2.4 million in the unfunded pension scheme.

Kutchen estimates that the costs of the above restructuring excluding pension costs will be $6 million. Kutchen has not accounted for the effects of the restructuring in its financial statements because it is planning a rights issue and does not wish to depress the share price. Therefore there has been no formal announcement of the restructuring.

Subsequent acquisition of 20% of Mach

When Kutchen acquired the majority shareholding in Mach, there was an option on the remaining 20% non-controlling interest (NCI), which could be exercised at any time up to 31 March 20X7. On 31 January 20X7, Kutchen acquired the remaining NCI in Mach. The payment for the NCI was structured so that it contained a fixed initial payment and a series of contingent amounts payable over the following two years.

The contingent payments were to be based on the future profits of Mach up to a maximum amount. Kutchen felt that the fixed initial payment was an equity transaction. Additionally, Kutchen was unsure as to whether the contingent payments were either equity, financial liabilities or contingent liabilities.

After a board discussion which contained disagreement as to the accounting treatment, Kutchen is preparing to disclose the contingent payments in accordance with IAS® 37 Provisions, Contingent Liabilities and Contingent Assets. The disclosure will include the estimated timing of the payments and the directors' estimate of the amounts to be settled.

Required:

(a) (i) Explain to the directors of Kutchen, with suitable workings, how goodwill should have been calculated on the acquisition of House and Mach showing the adjustments which need to be made to the consolidated financial statements to correct any errors by the finance director. (10 marks)

(ii) Explain, with suitable calculations, how the gain or loss on the sale of Niche should have been recorded in the group financial statements. (5 marks)

(iii) Discuss, with suitable workings, how the pension scheme should be dealt with after the restructuring of the business segment and whether a provision for restructuring should have been made in the financial statements for the year ended 31 December 20X6. (7 marks)

Note: Marks will be allocated in (a) for a suitable discussion of the principles involved as well as the accounting treatment.

(b) Advise Kutchen on the difference between equity and liabilities, and on the proposed accounting treatment of the contingent payments on the subsequent acquisition of 20% of Mach. (8 marks)

(30 marks)