Q.288 A hypothetical high-tech industry is composed of three companies. Some notes regarding the three companies are given below:
Company A: Low leverage, low coverage ratio
Company B: Low leverage, high coverage ratio
Company C: High leverage, high coverage ratio

Taking into account both ratios, the most solvent company is *most likely*:

A. Company A.

B. Company B.

C. Company C.

The correct answer is **B.**

Low leverage: Relatively small debt.
High coverage ratio: The firm can easily cover its interest payments with earnings.

Therefore, Company B is the most solvent.

Q.545 Which of the following cases would *most likely* result in the creation of a net pension asset?

A. Carrying value of the pension trust's assets: $240 million
Fair value of the pension trust's assets: $167 million
Present value of pension obligations: $196 million

B. Carrying value of the pension trust's assets: $240 million
Fair value of the pension trust's assets: $267 million
Present value of pension obligations: $196 million

C. Carrying value of the pension trust's assets: $240 million
Fair value of the pension trust's assets: $267 million
Present value of pension obligations: $296 million

The correct answer is **B.**

The creation of a net pension asset occurs when the fair value of the pension trust's assets exceeds the present value of the pension obligations. This situation indicates that the pension plan is overfunded, meaning it has more assets than needed to meet its future obligations to retirees. This is a positive scenario for the pension plan as it suggests financial stability and the ability to meet future pension payments without additional funding.

A is incorrect. In this scenario, the fair value of the pension trust's assets is $167 million, which is less than the present value of the pension obligations at $196 million. This situation indicates an underfunded pension plan, where the assets available are not sufficient to cover the future obligations. Therefore, instead of creating a net pension asset, this scenario would result in a net pension liability, reflecting the shortfall between the assets and the obligations.

C is incorrect. In this case, the fair value of the pension trust's assets is $267 million, while the present value of the pension obligations is $296 million. Despite the high value of assets, they are still less than the obligations, resulting in a $29 million shortfall. This scenario would lead to a net pension liability rather than a net pension asset, as the plan does not have sufficient assets to cover its future obligations, indicating an underfunded status.

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Q.547 According to US GAAP, interests incurred on a capital lease are *most likely* classified under:

A. cash flow from financing activities.

B. cash flow from operating activities.

C. either cash flow from operating or financing activities.

The correct answer is **B.**

An interest expense is classified as a cash outflow from operating activities under US GAAP.

A and C are incorrect. IFRS allows the option to classify it either as a financing activity or an operating activity.

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Q.548 Company A gives a car on a 'sales-type lease' to Company B. Company A is involved in the sale and purchase of furniture. Under which would the lease principal be recognized by company A under US GAAP?

A. Cash flow from investing activities.

B. Cash flow from operating activities.

C. Either operating or investing (management's choice).

The correct answer is **A.**

Under US GAAP, when Company A gives a car on a 'sales-type lease' to Company B, the lease principal received by Company A should be recognized under cash flow from investing activities. This classification is consistent with the accounting treatment of the receipt of principal amounts from investments, which are considered investing activities. The rationale behind this classification is that the lease transaction, in essence, represents an investment made by the lessor (Company A) in the leased asset (the car). The return of the principal amount is akin to the return of investment, thus justifying its classification under investing activities.

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Q.2353 A lumber company leased lumber cutting equipment for five years with an end-yearly payment of $20,000 at an interest rate of 7%. What are the nature and the beginning value of the lease that the firm will report if the equipment's economic life is only five years?

A. The firm will report the lease as an operating lease with no liability on its balance sheet.

B. The firm will report the lease as a finance lease with a beginning lease liability of $67,744.

C. The firm will report the lease as a finance lease with a beginning lease liability of $82,004.

The correct answer is **C.**

Since the lease period is the same as the economic life of the lease, the lease is reported as a finance lease and the beginning lease value is $82,004. (Calculated using the financial calculator as N=5; I=7%; PMT=20,000; FV=0; CPT->PV). Therefore, $82,004 is recognized as an asset and a liability in the accounts of the lumber company (as given in the following table).

Year	Beginning Book Value (Lease Liability)	Interest Expense at 7%	Annual Lease Payment	Ending Lease Liability (Beginning Lease Liability + Int. Exp. -) Lease Payment	Book Value Asset (Beginning Book Value - Dep. Exp)
1	$82,003.90	$5,740.27	$20,000	$67,744.17	$65,603.12
2	$67,744.17	$4,742.09	$20,000	$52,486.27	$49,202.32
3	$52,486.27	$3,674.04	$20,000	$36,160.30	$32,801.52
4	$36,160.30	$2,531.22	$20,000	$18,691.51	$16,400.72
5	$18,691.52	$1,308.41	$20,000	-$0.07	-$0.08

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Q.2354 A lumber company leased lumber cutting equipment for 5 years with the annual payment of $20,000 at the interest rate of 7%. Determine the amount of interest or rent expense that the firm will report in the first year if the leased asset is transferred to the lumber company at the end of the lease.

A. Rent expense of $3,674.

B. Interest expense $5,740.

C. Interest expense of $4,752.

The correct answer is **B.**

Since the leased asset is transferred to the lumber firm (lessee), the lease is classified as a finance lease. At the lease initiation, the lessee reports the asset and liability of the amount equal to the beginning book value of the liability (or the present value of periodic lease payments). During the asset's life, the lessee will reduce the lease liability by the amount of principal repayment (Lease payment minus Interest expense) and will reduce the book value of the asset by the straight-line depreciation amount.
Using the financial calculator:
N = 5; I/Y = 7; PMT = 20,000; FV = 0; CPT => PV = -82,004

The interest expense for the first year is simply the present value of liability multiplied by the interest rate:

$$\begin{aligned}\text{Interest expense} &= \text{Beginning lease liability} \times \text{Interest}\\ &= \$82,004 \times 7\%\\ &= \$5,740\end{aligned}$$

Note that the amortization schedule is also given in the following table:

Year	Beginning Book Value (Lease Liability)	Interest Expense at 7%	Annual Lease Payment	Ending Lease Liability (Beginning Lease Liability + Int. Exp. -) Lease Payment	Book Value Asset (Beginning Book Value - Dep. Exp)
1	$82,003.90	$5,740.27	$20,000	$67,744.17	$67,744.17
2	$67,744.17	$4,742.09	$20,000	$52,486.27	$49,202.32
3	$52,486.27	$3,674.04	$20,000	$36,160.30	$32,801.52
4	$36,160.30	$2,531.22	$20,000	$18,691.51	$16,400.72
5	$18,691.52	$1,308.41	$20,000	-$0.07	-$0.08

Q.2360 A plastic moulding company promised its employee five years ago that it would provide specific benefits upon retirement. . Today, the pension fund's assets are greater than the pension obligations. Determine the *most appropriate* status of the fund.

A. Overfunded defined benefits pension plan.

B. Overfunded defined contribution pension plan.

C. Underfunded defined contribution pension plan.

The correct answer is **A.**

When a company promises its employees specific benefits upon retirement, it is referring to a defined benefit pension plan. This type of plan specifies the benefits that employees will receive upon retirement, which are usually based on factors such as salary history and years of service. The company is responsible for ensuring that there are enough funds in the plan to meet these obligations. In this scenario, since the pension fund's assets exceed the pension obligations, the plan is considered overfunded. This means that the fund has more assets than needed to meet the future pension obligations to its employees. An overfunded status is generally favorable as it indicates financial health and stability of the pension plan, ensuring that the promised benefits can be provided to the employees upon retirement.

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Q.2361 Under IFRS, the actuarial gains and losses due to remeasurement are reported under:

A. the income statement.

B. liabilities on the balance sheet.

C. other comprehensive income on the balance sheet.

The correct answer is **C.**

The presentation of defined benefits plans is different under IFRS and US GAAP. Under IFRS, the actuarial gains and losses due to remeasurement are reported in the equity side of the balance sheet under other comprehensive income (OCI).

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Q.4850 Which of the following is *least likely* a criterion for a contract to be classified as a lease under IFRS?

A. Identify a specific underlying asset.

B. The asset must be separable from the company.

C. Give the customer the ability to direct how the asset is used.

The correct answer is **B.**

For a contract to be classified as a lease under IFRS, it must identify a specific underlying asset and allow the customer to direct how and for what purpose the asset is used. Separability from the company is not a requirement.

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Q.4851 Which of the following is *least likely* to be considered a benefit of leasing an asset compared to purchasing it?

A. Lower upfront cash outflow.

B. Lower overall cost of financing.

C. Reduced risk of obsolescence.

The correct answer is **B.**

Leasing often results in a lower effective interest rate compared to unsecured loans or bonds, making it a cost-effective financing option, but it might not always result in a lower overall cost of financing.

A is incorrect. Leasing usually requires little to no down payment, resulting in lower upfront cash outflow.

C is incorrect. Leasing mitigates risks such as obsolescence by allowing the lessee to avoid ownership, making it easier to upgrade to newer technology.

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Q.4852 Which of the following statements is *most accurate* regarding the classification of leases under IFRS?

A. A lease term covering a minor part of the asset's useful life is classified as a finance lease.

B. The present value of the lease payments equaling the asset's fair value classifies the lease as an operating lease.

C. A lease transferring ownership to the lessee by the end of the lease term is classified as a finance lease.

The correct answer is **C.**

One of the criteria for classifying a lease as a finance lease under IFRS is that the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

A is incorrect. A lease term covering a minor part of the asset's useful life would typically be classified as an operating lease.

B is incorrect. If the present value of the lease payments equals the asset's fair value, it indicates a finance lease, not an operating lease.

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Q.4853 For a lease to be classified as a finance lease under US GAAP, which of the following criteria must be met?

A. The lease term must cover a minor part of the asset's useful life.

B. The present value of the lease payments must be insignificant compared to the asset's fair value.

C. The lease must transfer ownership of the underlying asset to the lessee by the end of the lease term.

The correct answer is **C.**

One of the criteria for a finance lease under US GAAP is that the lease must transfer ownership of the underlying asset to the lessee by the end of the lease term.

A is incorrect. For a finance lease to be classified as a finance lease, the lease term must cover a major part of the asset's useful life.

B is incorrect. For finance lease classification, the present value of the lease payments must be significant compared to the asset's fair value.

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Q.4854 Which of the following statements about lessor accounting under IFRS is *most accurate*?

A. In an operating lease, the lessor recognizes a lease receivable.

B. In a finance lease, the lessor continues to recognize the leased asset on the balance sheet.

C. In a finance lease, the lessor recognizes interest income based on the lease receivable.

The correct answer is **C.**

In a finance lease, the lessor recognizes interest income based on the lease receivable. This reflects the financing nature of the transaction.

A is incorrect. In an operating lease, the lessor retains the asset on its balance sheet and recognizes lease revenue, not a lease receivable.

B is incorrect. In a finance lease, the lessor removes the leased asset from its balance sheet and recognizes a lease receivable.

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Q.4855 Under US GAAP, which of the following *best* describes the accounting treatment for a lessee in an operating lease?

A. The lessee records a lease liability and a right-of-use asset.

B. The lessee recognizes interest expense and amortization expense separately.

C. The entire lease payment is reported as a financing activity in the statement of cash flows.

The correct answer is **A.**

Under US GAAP, the lessee records both a lease liability and a right-of-use asset for operating leases. This reflects the lessee's obligation to make lease payments and the right to use the leased asset.

B is incorrect. In an operating lease, the lessee does not separately recognize interest and amortization expense; instead, a single lease expense is recognized.

C is incorrect. The entire lease payment is reported as an operating activity in the statement of cash flows.

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Q.4856 ABC Ltd. enters into a lease agreement with an annual lease payment of $50,000, a lease term of 3 years, and a discount rate of 5%. The lease liability recorded at the inception of the lease is *closest to:*

A. $135,750

B. $136,160

C. $137,450

The correct answer is **B.**

To calculate the lease liability using a BA II Plus calculator:

- N = 3 (number of periods)
- I/Y = 5 (interest rate)
- PMT = 50000 (annual lease payment)
- FV = 0 (future value)

Compute the present value by pressing `CPT` `PV`. The calculator will display the present value (PV) as approximately $136,160.

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Q.4857 In the context of lease accounting under US GAAP, which of the following is *least likely* to be considered a finance lease criterion?

A. The lease term covers a significant portion of the asset's remaining economic life.

B. The asset can be used by the lessor after the lease term ends without significant modification.

C. The present value of the lease payments equals or exceeds substantially the fair value of the asset.

The correct answer is **B.**

The asset having no alternative use to the lessor after the lease term is a finance lease criterion, not that it can be used without significant modification.

A is incorrect. The lease term covering a significant portion of the asset's economic life is a finance lease criterion.

C is incorrect. The present value of the lease payments equaling or exceeding the fair value is a finance lease criterion.

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Q.4858 XYZ Corporation enters into a lease agreement with DEF Leasing for a piece of equipment. The terms of the lease are as follows: Annual lease payments of $150,000, payable at the end of each year for five years.

- The interest rate implicit in the lease is 7%.
- At the end of the lease term, the equipment will be returned to DEF Leasing.
- The lease does not include a purchase option.
- The equipment has an estimated useful life of eight years.
- The fair value of the equipment at the inception of the lease is $620,000.

Assuming that the corporation reports under IFRS, determine whether this lease should be classified as a finance lease or an operating lease and calculate the impact on XYZ Corporation's balance sheet at the inception of the lease.

A. Finance lease, recognize a lease liability only.

B. Operating lease, recognize lease expense only.

C. Finance lease, recognize a right-of-use asset and a lease liability.

The correct answer is **C.**

For a lease to be classified as a finance lease under IFRS, it must meet at least one of the following criteria:

1. The lease transfers ownership of the asset to the lessee by the end of the lease term.
2. The lease contains a purchase option that the lessee is reasonably certain to exercise.
3. The lease term is for the major part of the asset's economic life.
4. The present value of the lease payments equals or exceeds substantially all of the fair value of the asset.
5. The asset is of such a specialized nature that only the lessee can use it without major modifications.

Given the details:

- The lease does not transfer ownership.
- There is no purchase option.
- The lease term (5 years) is less than the major part of the asset's useful life (8 years).
- The equipment is not of such a specialized nature that only the lessee can use it.

Calculate the present value of the lease payments: N = 5, I/Y = 7, PMT = 150000, FV = 0, CPT PV.

The present value (PV) is approximately $610,000, which is 98.4% of the fair value of the asset ($620,000), meaning it meets the finance lease criterion of substantially all the fair value.

Regarding the impact on the balance sheet, recognize a right-of-use (ROU) asset and recognize a lease liability of $610,000

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Q.4859 Which of the following statements is *most likely* correct regarding the financial reporting of defined benefit pension plans under IFRS?

A. The service cost component includes interest income on plan assets.

B. Actuarial gains and losses are recognized as pension expenses over time.

C. The net pension asset or liability changes have three components recognized on the income statement.

The correct answer is **C.**

Under IFRS, the change in the net pension asset or liability each period is generally viewed as having three components, two of which (service costs and net interest expense or income) are recognized as pension expense on the income statement. The third component, remeasurements, is recognized in other comprehensive income and is not amortized into profit or loss over time.

A is incorrect. The service cost component does not include interest income on plan assets. Instead, it represents the present value of the increase in pension benefits earned by employees during the current period.

B is incorrect. Under IFRS, actuarial gains and losses (part of remeasurements) are recognized immediately in other comprehensive income, not as pension expenses over time.

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Q.4860 Which of the following is *least likely* a component of the pension expense recognized on the income statement under US GAAP?

A. Actuarial gains and losses.

B. Service cost for the period.

C. Interest expense on the pension obligation.

The correct answer is **A.**

Under US GAAP, actuarial gains and losses are initially recognized in other comprehensive income and then amortized over time into pension expense, permitting companies to "smooth" the impact on pension expense over time for these elements.

B is incorrect. Service cost for the period is a component of the pension expense recognized on the income statement.

C is incorrect. Interest expense on the pension obligation is also a component of the pension expense recognized on the income statement.

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Q.4861 Which of the following *best* describes the accounting treatment for defined contribution plans?

A. The employer records a liability for the estimated future pension benefits.

B. The employer's obligation is limited to the contributions it has agreed to make.

C. The employer must make assumptions about future salary levels and years of service.

The correct answer is **B.**

In a defined contribution plan, the employer's obligation is limited to the contributions it has agreed to make to the plan. The employer records an expense for the amount of its contribution in each period and does not have further obligations regarding the amount that will be available to employees upon retirement.

A is incorrect. The employer does not record a liability for the estimated future pension benefits in a defined contribution plan.

C is incorrect. The employer does not need to make assumptions about future salary levels and years of service in a defined contribution plan.

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Q.4862 Which of the following is *most likely* true regarding share-based compensation?

A. The compensation expense for stock options is recognized immediately at the grant date.

B. The compensation expense for stock options is based on the fair value at the grant date.

C. The compensation expense for stock options is based on the market price at the exercise date.

The correct answer is **B.**

Under both IFRS and US GAAP, the compensation expense for stock options is based on the fair value at the grant date and recognized over the vesting period.

A is incorrect. The compensation expense for stock options is not recognized immediately at the grant date but over the vesting period.

C is incorrect. The compensation expense for stock options is not based on the market price at the exercise date.

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Q.4863 Which of the following statements about defined benefit pension plans under IFRS is *most accurate*?

A. Actuarial gains and losses are amortized into profit or loss over time.

B. Net interest expense or income is recognized in other comprehensive income.

C. Service costs and net interest expense are recognized as pension expense on the income statement.

The correct answer is **C.**

Under IFRS, service costs and net interest expense are recognized as pension expense on the income statement. Remeasurements, which include actuarial gains and losses, are recognized in other comprehensive income and are not amortized into profit or loss over time.

A is incorrect. Actuarial gains and losses are recognized in other comprehensive income and not amortized into profit or loss over time.

B is incorrect. Net interest expense or income is recognized on the income statement, not in other comprehensive income.

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Q.4864 Which of the following statements is *most accurate* regarding share-based compensation under IFRS and US GAAP?

A. Changes in stock price after the grant date affect the compensation expense.

B. Companies are required to use the Black-Scholes model for valuing stock options.

C. The fair value of share-based compensation is estimated at the grant date and recognized over the vesting period.

The correct answer is **C.**

Under both IFRS and US GAAP, the fair value of share-based compensation is estimated at the grant date and recognized over the vesting period.

A is incorrect. Changes in stock price after the grant date do not affect the compensation expense.

B is incorrect. Companies are not required to use the Black-Scholes model specifically; they can choose any appropriate valuation model.

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Q.4865 Which of the following is *most likely* a disadvantage of share-based compensation?

A. It requires a significant cash outlay.

B. It can lead to excessive risk-taking by managers.

C. It does not align employee interests with those of shareholders.

The correct answer is **B.**

Share-based compensation, particularly in the form of stock options, can lead to excessive risk-taking by managers, as options have skewed payouts that reward the upside while limiting the downside.

A is incorrect. Share-based compensation typically requires no cash outlay.

C is incorrect. Share-based compensation is designed to align employee interests with those of shareholders.

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Q.4866 Which of the following *best* describes the accounting treatment for restricted stock grants? The compensation expense is:

A. recognized immediately on the grant date.

B. spread over the employee's service period.

C. based on the market value at the exercise date.

The correct answer is **B.**

The compensation expense for restricted stock grants is measured as the fair value of the shares at the grant date and is allocated over the employee's service period.

A is incorrect. The expense is not recognized immediately on the grant date but over the service period.

C is incorrect. The expense is based on the market value at the grant date, not the exercise date.

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Q.4867 Which of the following components of a defined benefit pension plan is *most likely* recognized in other comprehensive income under IFRS?

A. Service cost.

B. Net interest expense.

C. Actuarial gains and losses.

The correct answer is **C.**

Under IFRS, actuarial gains and losses are recognized in other comprehensive income and are not amortized into profit or loss over time.

A is incorrect. Service cost is recognized on the income statement.

B is incorrect. Net interest expense is recognized on the income statement.

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Q.4868 Under US GAAP, which of the following components of a defined benefit pension plan is amortized into pension expense over time?

A. Service cost

B. Interest expense

C. Past service costs

The correct answer is **C.**

Under US GAAP, past service costs are initially recognized in other comprehensive income and then amortized over time into pension expense.

A is incorrect. Service cost is recognized in the period incurred.

B is incorrect. Interest expense is recognized in the period incurred.

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Q.4869 Which of the following statements *best* describes the treatment of stock appreciation rights (SARs)?

A. SARs dilute existing shareholders' ownership.

B. SARs are a form of cash-settled share-based compensation.

C. SARs require employees to hold the shares to benefit from share price appreciation.

The correct answer is **B.**

Stock appreciation rights (SARs) are a form of cash-settled share-based compensation that provides compensation based on the increase in the company's share price.

A is incorrect. SARs do not dilute existing shareholders' ownership.

C is incorrect. SARs do not require employees to hold the shares.

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Q.4870 Under IFRS 16, which of the following must be disclosed by lessees to provide a comprehensive understanding of their lease obligations?

A. The fair value of right-of-use assets at the reporting date.

B. The total expected future lease payments for the next ten years.

C. The reconciliation of opening and closing balances of lease liabilities.

The correct answer is **C.**

Under IFRS 16, lessees must disclose a reconciliation of the opening and closing balances of lease liabilities, including changes during the reporting period. This provides detailed information on how lease liabilities have evolved.

A is incorrect. IFRS 16 does not require the fair value of right-of-use assets to be disclosed, but rather their carrying amounts and depreciation.

B is incorrect. Total expected future lease payments are disclosed, but not necessarily for the next ten years; a maturity analysis is typically required.

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Q.4871 In the context of IFRS 16, which of the following would *most likely* require significant judgment and estimation by the lessee?

A. Determining the discount rate for lease liabilities.

B. Reporting the total lease payments made during the period.

C. Calculating the depreciation expense on right-of-use assets.

The correct answer is **A.**

Determining the discount rate for lease liabilities often requires significant judgment and estimation, particularly when the rate implicit in the lease is not readily determinable, and the lessee must estimate its incremental borrowing rate.

B is incorrect. Reporting the total lease payments made during the period is a factual disclosure and does not involve significant judgment.

C is incorrect. Calculating depreciation expense is relatively straightforward compared to determining the discount rate.

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Q.4872 Which of the following *best* describes the required disclosure for share-based compensation under IFRS 2 in terms of valuation methods?

A. The company must disclose the expected future value of the shares.

B. The company must disclose the market price of the shares at the reporting date.

C. The company must disclose the valuation model used to estimate the fair value of options granted.

The correct answer is **C.**

Under IFRS 2, companies must disclose the valuation model used to estimate the fair value of options granted, along with key assumptions and inputs used in the model. This helps users understand how the fair value was determined.

A is incorrect. Disclosing the expected future value of the shares is not required and would be speculative.

B is incorrect. Disclosing the market price of the shares at the reporting date is not required under IFRS 2 for valuation purposes.

CFA Level I, Volume 2, Topic 5—Financial Statements Analysis, Learning Module 8: Analysis of Long-Term Assets, LOS 8c: describe the financial statement presentation of and disclosures relating to long-term liabilities and share-based compensation