Professional Level – Essentials Module

Corporate Reporting (International)

Tuesday 11 December 2007

Paper P2 (INT)

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

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The question paper begins on page 3.

Section A – This ONE question is compulsory and MUST be attempted

1 Beth, a public limited company, has produced the following draft balance sheets as at 30 November 2007. Lose and Gain are both public limited companies:

	Beth	Lose	Gain
	$m	$m	$m
Assets			
Non current assets			
Property, plant and equipment	1,700	200	300
Intangible assets	300		
Investment in Lose	200		
Investment in Gain	180		
	2,380	200	300
Current assets			
Inventories	800	100	150
Trade receivables	600	60	80
Cash	500	40	20
	1,900	200	250
Total assets	4,280	400	550
Share capital of $1	1,500	100	200
Other reserves	300		
Retained earnings	400	200	300
Total equity	2,200	300	500
Non-current liabilities	700		
Current liabilities	1,380	100	50
Total liabilities	2,080	100	50
Total equity and liabilities	4,280	400	550

The following information is relevant to the preparation of the group financial statements of the Beth Group:

(i)

Date of acquisition	Holding acquired	Retained earnings at acquisition	Purchase consideration
		$m	$m
Lose: 1 December 2005	20%	80	40
1 December 2006	60%	150	160
Gain: 1 December 2006	30%	260	180

Lose and Gain have not issued any share capital since the acquisition of the shareholdings by Beth. The fair values of the net assets of Lose and Gain were the same as their carrying amounts at the date of the acquisitions.

Beth did not have significant influence over Lose at any time before gaining control of Lose, but does have significant influence over Gain. There has been no impairment of goodwill on the acquisition of Lose since its acquisition, but the recoverable amount of the net assets of Gain has been deemed to be $610 million at 30 November 2007.

(ii) Lose entered into an operating lease for a building on 1 December 2006. The building was converted into office space during the year at a cost to Lose of $10 million. The operating lease is for a period of six years, at the end of which the building must be returned to the lessor in its original condition. Lose thinks that it would cost $2 million to convert the building back to its original condition at prices at 30 November 2007. The entries that had been made in the financial statements of Lose were the charge for operating lease rentals ($4 million per annum) and the improvements to the building. Both items had been charged to the income statement. The improvements were completed during the financial year.

(iii) On 1 October 2007, Beth sold inventory costing $18 million to Gain for $28 million. At 30 November 2007, the inventory was still held by Gain. The inventory was sold to a third party on 15 December 2007 for $35 million.

(iv) Beth had contracted to purchase an item of plant and equipment for 12 million euros on the following terms:

Payable on signing contract (1 September 2007)	50%
Payable on delivery and installation (11 December 2007)	50%

The amount payable on signing the contract (the deposit) was paid on the due date and is refundable. The following exchange rates are relevant:

2007	**Euros to 1 dollar**
1 September	0·75
30 November	0·85
11 December	0·79

The deposit is included in trade receivables at the rate of exchange on 1 September 2007. A full year's charge for depreciation of property, plant and equipment is made in the year of acquisition using the straight line method over six years.

(v) Beth sold some trade receivables which arose during November 2007 to a factoring company on 30 November 2007. The trade receivables sold are unlikely to default in payment based on past experience but they are long dated with payment not due until 1 June 2008. Beth has given the factor a guarantee that it will reimburse any amounts not received by the factor. Beth received $45 million from the factor being 90% of the trade receivables sold. The trade receivables are not included in the balance sheet of Beth and the balance not received from the factor (10% of the trade receivables factored) of $5 million has been written off against retained earnings.

(vi) Beth granted 200 share options to each of its 10,000 employees on 1 December 2006. The shares vest if the employees work for the Group for the next two years. On 1 December 2006, Beth estimated that there would be 1,000 eligible employees leaving in each year up to the vesting date. At 30 November 2007, 600 eligible employees had left the company. The estimate of the number of employees leaving in the year to 30 November 2008 was 500 at 30 November 2007. The fair value of each share option at the grant date (1 December 2006) was $10. The share options have not been accounted for in the financial statements.

(vii) The Beth Group operates in the oil industry and contamination of land occurs including the pollution of seas and rivers. The Group only cleans up the contamination if it is a legal requirement in the country where it operates. The following information has been produced for Beth by a group of environmental consultants for the year ended 30 November 2007:

Cost to clean up contamination	**Law existing in country**
$m	
5	No
7	To come into force in December 2007
4	Yes

The directors of Beth have a widely publicised environmental attitude which shows little regard to the effects on the environment of their business. The Group does not currently produce a separate environmental report and no provision for environmental costs has been made in the financial statements. Any provisions would be shown as non-current liabilities. Beth is likely to operate in these countries for several years.

Other information

Beth is currently suffering a degree of stagnation in its business development. Its domestic and international markets are being maintained but it is not attracting new customers. Its share price has not increased whilst that of its competitors has seen a rise of between 10% and 20%. Additionally it has recently received a significant amount of adverse publicity because of its poor environmental record and is to be investigated by regulators in several countries. Although Beth is a leading supplier of oil products, it has never felt the need to promote socially responsible policies and practices or make positive contributions to society because it has always maintained its market share. It is renowned for poor customer support, bearing little regard for the customs and cultures in the communities where it does business. It had recently made a decision not to pay the amounts owing to certain small and medium entities (SMEs) as the directors feel that SMEs do not have sufficient resources to challenge the non-payment in a court of law. The management of the company is quite authoritarian and tends not to value employees' ideas and contributions.

Required:

(a) Prepare the consolidated balance sheet of the Beth Group as at 30 November 2007 in accordance with International Financial Reporting Standards. (35 marks)

(b) Describe to the Beth Group the possible advantages of producing a separate environmental report. (8 marks)

(c) Discuss the ethical and social responsibilities of the Beth Group and whether a change in the ethical and social attitudes of the management could improve business performance. (7 marks)

Note: requirement (c) includes 2 professional marks for development of the discussion of the ethical and social responsibilities of the Beth Group.

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Macaljoy, a public limited company, is a leading support services company which focuses on the building industry. The company would like advice on how to treat certain items under IAS19, 'Employee Benefits' and IAS37 'Provisions, Contingent Liabilities and Contingent Assets'. The company operates the Macaljoy (2006) Pension Plan which commenced on 1 November 2006 and the Macaljoy (1990) Pension Plan, which was closed to new entrants from 31 October 2006, but which was open to future service accrual for the employees already in the scheme. The assets of the schemes are held separately from those of the company in funds under the control of trustees. The following information relates to the two schemes:

Macaljoy (1990) Pension Plan

The terms of the plan are as follows:

(i) employees contribute 6% of their salaries to the plan
(ii) Macaljoy contributes, currently, the same amount to the plan for the benefit of the employees
(iii) On retirement, employees are guaranteed a pension which is based upon the number of years service with the company and their final salary

The following details relate to the plan in the year to 31 October 2007:

	$m
Present value of obligation at 1 November 2006	200
Present value of obligation at 31 October 2007	240
Fair value of plan assets at 1 November 2006	190
Fair value of plan assets at 31 October 2007	225
Current service cost	20
Pension benefits paid	19
Total contributions paid to the scheme for year to 31 October 2007	17

Actuarial gains and losses are recognised in the 'statement of recognised income and expense'.

Macaljoy (2006) Pension Plan

Under the terms of the plan, Macaljoy does not guarantee any return on the contributions paid into the fund. The company's legal and constructive obligation is limited to the amount that is contributed to the fund. The following details relate to this scheme:

	$m
Fair value of plan assets at 31 October 2007	21
Contributions paid by company for year to 31 October 2007	10
Contributions paid by employees for year to 31 October 2007	10

The discount rates and expected return on plan assets for the two plans are:

	1 November 2006	31 October 2007
Discount rate	5%	6%
Expected return on plan assets	7%	8%

The company would like advice on how to treat the two pension plans, for the year ended 31 October 2007, together with an explanation of the differences between a defined contribution plan and a defined benefit plan.

Warranties

Additionally the company manufactures and sells building equipment on which it gives a standard one year warranty to all customers. The company has extended the warranty to two years for certain major customers and has insured against the cost of the second year of the warranty. The warranty has been extended at nil cost to the customer. The claims made under the extended warranty are made in the first instance against Macaljoy and then Macaljoy in turn makes a counter claim against the insurance company. Past experience has shown that 80% of the building equipment will not be subject to warranty claims in the first year, 15% will have minor defects and 5% will require major repair. Macaljoy estimates that in the second year of the warranty, 20% of the items sold will have minor defects and 10% will require major repair.

In the year to 31 October 2007, the following information is relevant:

	Standard warranty (units)	Extended warranty (units)	Selling price per unit (both)($)
Sales	2,000	5,000	1,000
		Major repair $	Minor defect $
Cost of repair (average)		500	100

Assume that sales of equipment are on 31 October 2007 and any warranty claims are made on 31 October in the year of the claim. Assume a risk adjusted discount rate of 4%.

Required:

Draft a report suitable for presentation to the directors of Macaljoy which:

(a) (i) Discusses the nature of and differences between a defined contribution plan and a defined benefit plan with specific reference to the company's two schemes. (7 marks)

(ii) Shows the accounting treatment for the two Macaljoy pension plans for the year ended 31 October 2007 under IAS19 'Employee Benefits'. (7 marks)

(b) (i) Discusses the principles involved in accounting for claims made under the above warranty provision. (6 marks)

(ii) Shows the accounting treatment for the above warranty provision under IAS37 'Provisions, Contingent Liabilities and Contingent Assets' for the year ended 31 October 2007. (3 marks)

Appropriateness of the format and presentation of the report and communication of advice. (2 marks)

(25 marks)

3 Ghorse, a public limited company, operates in the fashion sector and had undertaken a group re-organisation during the current financial year to 31 October 2007. As a result the following events occurred:

(a) Ghorse identified two manufacturing units, Cee and Gee, which it had decided to dispose of in a single transaction. These units comprised non-current assets only. One of the units, Cee, had been impaired prior to the financial year end on 30 September 2007 and it had been written down to its recoverable amount of $35 million. The criteria in IFRS5, 'Non-current Assets Held for Sale and Discontinued Operations', for classification as held for sale, had been met for Cee and Gee at 30 September 2007. The following information related to the assets of the cash generating units at 30 September 2007:

	Depreciated historical cost	Fair value less costs to sell and recoverable amount	Carrying value under IFRS
	$m	$m	$m
Cee	50	35	35
Gee	70	90	70
	120	125	105

The fair value less costs to sell had risen at the year end to $40 million for Cee and $95 million for Gee. The increase in the fair value less costs to sell had not been taken into account by Ghorse. (7 marks)

(b) As a consequence of the re-organisation, and a change in government legislation, the tax authorities have allowed a revaluation of the non-current assets of the holding company for tax purposes to market value at 31 October 2007. There has been no change in the carrying values of the non-current assets in the financial statements. The tax base and the carrying values after the revaluation are as follows:

	Carrying amount at 31 October 2007	Tax base at 31 October 2007 after revaluation	Tax base at 31 October 2007 before revaluation
	$m	$m	$m
Property	50	65	48
Vehicles	30	35	28

Other taxable temporary differences amounted to $5 million at 31 October 2007. Assume income tax is paid at 30%. The deferred tax provision at 31 October 2007 had been calculated using the tax values before revaluation. (6 marks)

(c) A subsidiary company had purchased computerised equipment for $4 million on 31 October 2006 to improve the manufacturing process. Whilst re-organising the group, Ghorse had discovered that the manufacturer of the computerised equipment was now selling the same system for $2·5 million. The projected cash flows from the equipment are:

Year ended 31 October	Cash flows
	$m
2008	1·3
2009	2·2
2010	2·3

The residual value of the equipment is assumed to be zero. The company uses a discount rate of 10%. The directors think that the fair value less costs to sell of the equipment is $2 million. The directors of Ghorse propose to write down the non-current asset to the new selling price of $2·5 million. The company's policy is to depreciate its computer equipment by 25% per annum on the straight line basis. (5 marks)

(d) The manufacturing property of the group, other than the head office, was held on an operating lease over 8 years. On re-organisation on 31 October 2007, the lease has been renegotiated and is held for 12 years at a rent of $5 million per annum paid in arrears. The fair value of the property is $35 million and its remaining economic life is 13 years. The lease relates to the buildings and not the land. The factor to be used for an annuity at 10% for 12 years is 6·8137. (5 marks)

The directors are worried about the impact that the above changes will have on the value of its non-current assets and its key performance indicator which is 'Return on Capital Employed' (ROCE). ROCE is defined as operating profit before interest and tax divided by share capital, other reserves and retained earnings. The directors have calculated ROCE as $30 million divided by $220 million, i.e. 13·6% before any adjustments required by the above.

Formation of opinion on impact on ROCE. (2 marks)

Required:

Discuss the accounting treatment of the above transactions and the impact that the resulting adjustments to the financial statements would have on ROCE.

Note: your answer should include appropriate calculations where necessary and a discussion of the accounting principles involved.

(25 marks)

4 The International Accounting Standards Board (IASB) has begun a joint project to revisit its conceptual framework for financial accounting and reporting. The goals of the project are to build on the existing frameworks and converge them into a common framework.

Required:

(a) Discuss why there is a need to develop an agreed international conceptual framework and the extent to which an agreed international conceptual framework can be used to resolve practical accounting issues. (13 marks)

(b) Discuss the key issues which will need to be addressed in determining the basic components of an internationally agreed conceptual framework. (10 marks)

Appropriateness and quality of discussion. (2 marks)

(25 marks)

End of Question Paper