

Professional Level – Essentials Module

Corporate Reporting (International)

Tuesday 19 June 2012



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

Paper P2 (INT)

ACCA

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

- 1 The following draft statements of financial position relate to Robby, Hail and Zinc, all public limited companies, as at 31 May 2012:

	Robby \$m	Hail \$m	Zinc \$m
Assets			
Non-current assets:			
Property, plant and equipment	112	60	26
Investment in Hail	55		
Investment in Zinc	19		
Financial assets	9	6	14
Jointly controlled operation	6		
Current assets	5	7	12
Total assets	<u>206</u>	<u>73</u>	<u>52</u>
Equity and Liabilities			
Ordinary shares	25	20	10
Other components of equity	11	–	–
Retained earnings	70	27	19
Total equity	<u>106</u>	<u>47</u>	<u>29</u>
Non-current liabilities	53	20	21
Current liabilities	47	6	2
Total equity and liabilities	<u>206</u>	<u>73</u>	<u>52</u>

The following information needs to be taken into account in the preparation of the group financial statements of Robby:

- (i) On 1 June 2010, Robby acquired 80% of the equity interests of Hail. The purchase consideration comprised cash of \$50 million. Robby has treated the investment in Hail at fair value through other comprehensive income (OCI).

A dividend received from Hail on 1 January 2012 of \$2 million has similarly been credited to OCI.

It is Robby's policy to measure the non-controlling interest at fair value and this was \$15 million on 1 June 2010.

On 1 June 2010, the fair value of the identifiable net assets of Hail were \$60 million and the retained earnings of Hail were \$16 million. The excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

- (ii) On 1 June 2009, Robby acquired 5% of the ordinary shares of Zinc. Robby had treated this investment at fair value through profit or loss in the financial statements to 31 May 2011.

On 1 December 2011, Robby acquired a further 55% of the ordinary shares of Zinc and gained control of the company.

The consideration for the acquisitions was as follows:

	Shareholding	Consideration \$m
1 June 2009	5%	2
1 December 2011	55%	16
	<u>60%</u>	<u>18</u>

At 1 December 2011, the fair value of the equity interest in Zinc held by Robby before the business combination was \$5 million.

It is Robby's policy to measure the non-controlling interest at fair value and this was \$9 million on 1 December 2011.

The fair value of the identifiable net assets at 1 December 2011 of Zinc was \$26 million, and the retained earnings were \$15 million. The excess of the fair value of the net assets is due to an increase in the value of property, plant and equipment (PPE), which was provisional pending receipt of the final valuations. These valuations were received on 1 March 2012 and resulted in an additional increase of \$3 million in the fair value of PPE at the date of acquisition. This increase does not affect the fair value of the non-controlling interest at acquisition. PPE is to be depreciated on the straight-line basis over a remaining period of five years.

- (iii) Robby has a 40% share of a joint operation, a natural gas station. Assets, liabilities, revenue and costs are apportioned on the basis of shareholding.

The following information relates to the joint arrangement activities:

- The natural gas station cost \$15 million to construct and was completed on 1 June 2011 and is to be dismantled at the end of its life of 10 years. The present value of this dismantling cost to the joint arrangement at 1 June 2011, using a discount rate of 5%, was \$2 million.
- In the year, gas with a direct cost of \$16 million was sold for \$20 million. Additionally, the joint arrangement incurred operating costs of \$0.5 million during the year.

Robby has only contributed and accounted for its share of the construction cost, paying \$6 million. The revenue and costs are receivable and payable by the other joint operator who settles amounts outstanding with Robby after the year end.

- (iv) Robby purchased PPE for \$10 million on 1 June 2009. It has an expected useful life of 20 years and is depreciated on the straight-line method. On 31 May 2011, the PPE was revalued to \$11 million. At 31 May 2012, impairment indicators triggered an impairment review of the PPE. The recoverable amount of the PPE was \$7.8 million. The only accounting entry posted for the year to 31 May 2012 was to account for the depreciation based on the revalued amount as at 31 May 2011. Robby's accounting policy is to make a transfer of the excess depreciation arising on the revaluation of PPE.
- (v) Robby held a portfolio of trade receivables with a carrying amount of \$4 million at 31 May 2012. At that date, the entity entered into a factoring agreement with a bank, whereby it transfers the receivables in exchange for \$3.6 million in cash. Robby has agreed to reimburse the factor for any shortfall between the amount collected and \$3.6 million. Once the receivables have been collected, any amounts above \$3.6 million, less interest on this amount, will be repaid to Robby. Robby has derecognised the receivables and charged \$0.4 million as a loss to profit or loss.
- (vi) Immediately prior to the year end, Robby sold land to a third party at a price of \$16 million with an option to purchase the land back on 1 July 2012 for \$16 million plus a premium of 3%. The market value of the land is \$25 million on 31 May 2012 and the carrying amount was \$12 million. Robby accounted for the sale, consequently eliminating the bank overdraft at 31 May 2012.

Required:

- (a) Prepare a consolidated statement of financial position of the Robby Group at 31 May 2012 in accordance with International Financial Reporting Standards.** (35 marks)

- (b) (i)** In the above scenario (information point (v)), Robby holds a portfolio of trade receivables and enters into a factoring agreement with a bank, whereby it transfers the receivables in exchange for cash. Robby additionally agreed to other terms with the bank as regards any collection shortfall and repayment of any monies to Robby. Robby derecognised the receivables. This is an example of the type of complex transaction that can arise out of normal terms of trade. The rules regarding derecognition are quite complex and are often not understood by entities.

Describe the rules of IFRS 9 *Financial Instruments* relating to the derecognition of a financial asset and how these rules affect the treatment of the portfolio of trade receivables in Robby's financial statements.

(9 marks)

- (ii) Discuss the legitimacy of Robby selling land just prior to the year end in order to show a better liquidity position for the group and whether this transaction is consistent with an accountant's responsibilities to users of financial statements.**

Note: Your answer should include reference to the above scenario.

(6 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 William is a public limited company and would like advice in relation to the following transactions.

- (a) William owned a building on which it raised finance. William sold the building for \$5 million to a finance company on 1 June 2011 when the carrying amount was \$3.5 million. The same building was leased back from the finance company for a period of 20 years, which was felt to be equivalent to the majority of the asset's economic life. The lease rentals for the period are \$441,000 payable annually in arrears. The interest rate implicit in the lease is 7%. The present value of the minimum lease payments is the same as the sale proceeds.

William wishes to know how to account for the above transaction for the year ended 31 May 2012.

(7 marks)

- (b) William operates a defined benefit scheme for its employees. At June 2011, the net pension liability recognised in the statement of financial position was \$18 million, excluding an unrecognised actuarial gain of \$15 million which William wishes to spread over the remaining working lives of the employees. The scheme was revised on 1 June 2011. This resulted in the benefits being enhanced for some members of the plan and because benefits do not vest for these members for five years, William wishes to spread the increased cost over that period. However, part of the scheme was to be closed, without any redundancy of employees.

William requires advice on how to account for the above scheme under IAS 19 *Employee Benefits* including the presentation and measurement of the pension expense.

(7 marks)

- (c) On 1 June 2009, William granted 500 share appreciation rights to each of its 20 managers. All of the rights vest after two years service and they can be exercised during the following two years up to 31 May 2013. The fair value of the right at the grant date was \$20. It was thought that three managers would leave over the initial two-year period and they did so. The fair value of each right was as follows:

Year	Fair value at year end \$
31 May 2010	23
31 May 2011	14
31 May 2012	24

On 31 May 2012, seven managers exercised their rights when the intrinsic value of the right was \$21.

William wishes to know what the liability and expense will be at 31 May 2012.

(5 marks)

- (d) William acquired another entity, Chrissy, on 1 May 2012. At the time of the acquisition, Chrissy was being sued as there is an alleged mis-selling case potentially implicating the entity. The claimants are suing for damages of \$10 million. William estimates that the fair value of any contingent liability is \$4 million and feels that it is more likely than not that no outflow of funds will occur.

William wishes to know how to account for this potential liability in Chrissy's entity financial statements and whether the treatment would be the same in the consolidated financial statements.

(4 marks)

Required:

Discuss, with suitable computations, the advice that should be given to William in accounting for the above events.

Note: The mark allocation is shown against each of the four events above.

Professional marks will be awarded in question 2 for the quality of the discussion.

(2 marks)

(25 marks)

3 Ethan, a public limited company, develops, operates and sells investment properties.

- (a) Ethan focuses mainly on acquiring properties where it foresees growth potential, through rental income as well as value appreciation. The acquisition of an investment property is usually realised through the acquisition of the entity, which holds the property.

In Ethan's consolidated financial statements, investment properties acquired through business combinations are recognised at fair value, using a discounted cash flow model as approximation to fair value. There is currently an active market for this type of property. The difference between the fair value of the investment property as determined under the accounting policy, and the value of the investment property for tax purposes results in a deferred tax liability.

Goodwill arising on business combinations is determined using the measurement principles for the investment properties as outlined above. Goodwill is only considered impaired if and when the deferred tax liability is reduced below the amount at which it was first recognised. This reduction can be caused both by a reduction in the value of the real estate or a change in local tax regulations. As long as the deferred tax liability is equal to, or larger than, the prior year, no impairment is charged to goodwill. Ethan explained its accounting treatment by confirming that almost all of its goodwill is due to the deferred tax liability and that it is normal in the industry to account for goodwill in this way.

Since 2008, Ethan has incurred substantial annual losses except for the year ended 31 May 2011, when it made a small profit before tax. In year ended 31 May 2011, most of the profit consisted of income recognised on revaluation of investment properties. Ethan had announced early in its financial year ended 31 May 2012 that it anticipated substantial growth and profit. Later in the year, however, Ethan announced that the expected profit would not be achieved and that, instead, a substantial loss would be incurred. Ethan had a history of reporting considerable negative variances from its budgeted results. Ethan's recognised deferred tax assets have been increasing year-on-year despite the deferred tax liabilities recognised on business combinations. Ethan's deferred tax assets consist primarily of unused tax losses that can be carried forward which are unlikely to be offset against anticipated future taxable profits. (11 marks)

- (b) Ethan wishes to apply the fair value option rules of IFRS 9 *Financial Instruments* to debt issued to finance its investment properties. Ethan's argument for applying the fair value option is based upon the fact that the recognition of gains and losses on its investment properties and the related debt would otherwise be inconsistent. Ethan argued that there is a specific financial correlation between the factors, such as interest rates, that form the basis for determining the fair value of both Ethan's investment properties and the related debt. (7 marks)

- (c) Ethan has an operating subsidiary, which has in issue A and B shares, both of which have voting rights. Ethan holds 70% of the A and B shares and the remainder are held by shareholders external to the group. The subsidiary is obliged to pay an annual dividend of 5% on the B shares. The dividend payment is cumulative even if the subsidiary does not have sufficient legally distributable profit at the time the payment is due.

In Ethan's consolidated statement of financial position, the B shares of the subsidiary were accounted for in the same way as equity instruments would be, with the B shares owned by external parties reported as a non-controlling interest. (5 marks)

Required:

Discuss how the above transactions and events should be recorded in the consolidated financial statements of Ethan.

Note: The mark allocation is shown against each of the three transactions above.

Professional marks will be awarded in question 3 for the quality of the discussion. (2 marks)

(25 marks)

- 4 (a) The existing standard dealing with provisions IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, has been in place for many years and is sufficiently well understood and consistently applied in most areas. The IASB feels it is time for a fundamental change in the underlying principles for the recognition and measurement of non-financial liabilities. To this end, the Board has issued an Exposure Draft, 'Measurement of Liabilities in IAS 37 – Proposed amendments to IAS 37'.

Required:

- (i) **Discuss the existing guidance in IAS 37 as regards the recognition and measurement of provisions and why the IASB feels the need to replace this guidance;** (9 marks)
- (ii) **Describe the new proposals that the IASB has outlined in the Exposure Draft.** (7 marks)
- (b) Royan, a public limited company, extracts oil and has a present obligation to dismantle an oil platform at the end of the platform's life, which is 10 years. Royan cannot cancel this obligation or transfer it. Royan intends to carry out the dismantling work itself and estimates the cost of the work to be \$150 million in 10 years time. The present value of the work is \$105 million.

A market exists for the dismantling of an oil platform and Royan could hire a third party contractor to carry out the work. The entity feels that if no risk or probability adjustment were needed then the cost of the external contractor would be \$180 million in ten years time. The present value of this cost is \$129 million. If risk and probability are taken into account, then there is a probability of 40% that the present value will be \$129 million and 60% probability that it would be \$140 million, and there is a risk that the costs may increase by \$5 million.

Required:

Describe the accounting treatment of the above events under IAS 37 and the possible outcomes under the proposed amendments in the Exposure Draft. (7 marks)

Professional marks will be awarded in question 4 for the quality of the discussion. (2 marks)

(25 marks)

End of Question Paper