Professional Level – Essentials Module

Corporate Reporting (International)

Tuesday 10 December 2013

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 group financial statements relate to Angel, a public limited company:

Angel Group: Statement of financial position as at 30 November 2013

	30 November 2013 $m	30 November 2012 $m
Assets		
Non-current assets		
Property, plant and equipment	475	465
Goodwill	105	120
Other intangible assets	150	240
Investment in associate	80	–
Financial assets	215	180
	1,025	1,005
Current assets		
Inventories	155	190
Trade receivables	125	180
Cash and cash equivalents	465	355
	745	725
Total assets	1,770	1,730
Equity and liabilities		
Share capital	850	625
Retained earnings	456	359
Other components of equity	29	20
	1,335	1,004
Non-controlling interest	90	65
Total equity	1,425	1,069
Non-current liabilities		
Long-term borrowings	26	57
Deferred tax	35	31
Retirement benefit liability	80	74
Total non-current liabilities	141	162
Current liabilities		
Trade payables	155	361
Current tax payable	49	138
Total current liabilities	204	499
Total liabilities	345	661
Total equity and liabilities	1,770	1,730

Angel Group: Statement of profit or loss and other comprehensive income for the year ended 30 November 2013

	$m
Revenue	1,238
Cost of sales	(986)
Gross profit	252
Other income	30
Administrative expenses	(45)
Other expenses	(50)
Operating profit	187
Finance costs	(11)
Share of profit of equity accounted investees (net of tax)	12
Profit before tax	188
Income tax expense	(46)
Profit for the year	142
Profit attributable to:	
Owners of parent	111
Non-controlling interest	31
	142
Other comprehensive income:	
Items that will not be reclassified to profit or loss	
Revaluation of property, plant and equipment	8
Actuarial losses on defined benefit plan	(4)
Tax relating to items not reclassified	(2)
Total items that will not be reclassified to profit or loss	2
Items that may be reclassified to profit or loss	
Financial assets	4
Tax relating to items that may be reclassified	(1)
Total items that may be reclassified subsequently to profit or loss	3
Other comprehensive income (net of tax) for the year	5
Total comprehensive income for year	147

Total comprehensive income attributable to:

	$m
Owners of the parent	116
Non-controlling interest	31
	147

Angel Group: Statement of changes in equity for the year ended 30 November 2013

	Share capital	Retained earnings	Other components of equity – financial assets reserve	Other components of equity – revaluation reserve	Total	Non-controlling interest	Total
	$m	$m	$m	$m	$m	$m	$m
Balance 1 December 2012	625	359	15	5	1,004	65	1,069
Share capital issued	225				225		225
Dividends for year		(10)			(10)	(6)	(16)
Total comprehensive income for the year		107	3	6	116	31	147
Balance 30 November 2013	850	456	18	11	1,335	90	1,425

The following information relates to the financial statements of the Angel Group:

(i) Angel decided to renovate a building which had a zero book value at 1 December 2012. As a result, $3 million was spent during the year on its renovation. On 30 November 2013, Angel received a cash grant of $2 million from the government to cover some of the refurbishment cost and the creation of new jobs which had resulted from the use of the building. The grant related equally to both job creation and renovation. The only elements recorded in the financial statements were a charge to revenue for the refurbishment of the building and the receipt of the cash grant, which has been credited to additions of property, plant and equipment (PPE). The building was revalued at 30 November 2013 at $7 million.

Angel treats grant income on capital-based projects as deferred income.

(ii) On 1 December 2012, Angel acquired all of the share capital of Sweety for $30 million. The book values and fair values of the identifiable assets and liabilities of Sweety at the date of acquisition are set out below, together with their tax base. Goodwill arising on acquisition is not deductible for tax purposes. There were no other acquisitions in the period. The tax rate is 30%. The fair values in the table below have been reflected in the year-end balances of the Angel Group.

	Carrying values $million	Tax base $million	Fair values $million (excluding deferred taxation)
Property, plant and equipment	12	10	14
Inventory	5	4	6
Trade receivables	3	3	3
Cash and cash equivalents	2	2	2
Total assets	22	19	25
Trade payables	(4)	(4)	(4)
Retirement benefit obligations	(1)		(1)
Deferred tax liability	(0·6)		
Net assets at acquisition	16·4	15	20

(iii) The retirement benefit is classified as a long-term borrowing in the statement of financial position and comprises the following:

	$m
Net obligation at 1 December 2012	74
Net interest cost	3
Current service cost	8
Contributions to scheme	(9)
Remeasurements – actuarial losses	4
Net obligation at 30 November 2013	80

The benefits paid in the period by the trustees of the scheme were $6 million. Angel had included the obligation assumed on the purchase of Sweety in current service cost above, although the charge to administrative expenses was correct in the statement of profit and loss and other comprehensive income. There were no tax implications regarding the retirement benefit obligation. The defined benefit cost is included in administrative expenses.

(iv) The property, plant and equipment (PPE) comprises the following:

	$m
Carrying value at 1 December 2012	465
Additions at cost including assets acquired on the purchase of subsidiary	80
Gains on property revaluation	8
Disposals	(49)
Depreciation	(29)
Carrying value at 30 November 2013	475

Angel has constructed a machine which is a qualifying asset under IAS 23 *Borrowing Costs* and has paid construction costs of $4 million. This amount has been charged to other expenses. Angel Group paid $11 million in interest in the year, which includes $1 million of interest which Angel wishes to capitalise under IAS 23. There was no deferred tax implication regarding this transaction.

The disposal proceeds were $63 million. The gain on disposal is included in administrative expenses.

(v) Angel purchased a 30% interest in an associate for cash on 1 December 2012. The net assets of the associate at the date of acquisition were $280 million. The associate made a profit after tax of $40 million and paid a dividend of $10 million out of these profits in the year ended 30 November 2013.

(vi) An impairment test carried out at 30 November 2013 showed that goodwill and other intangible assets were impaired. The impairment of goodwill relates to 100% owned subsidiaries.

(vii) The following schedule relates to the financial assets owned by Angel:

	$m
Balance 1 December 2012	180
Less sales of financial assets at carrying value	(26)
Add purchases of financial assets	57
Add gain on revaluation of financial assets	4
Balance at 30 November 2013	215

The sale proceeds of the financial assets were $40 million. Profit on the sale of the financial assets is included in 'other income' in the financial statements.

(viii) The finance costs were all paid in cash in the period.

Required:

(a) Prepare a consolidated statement of cash flows using the indirect method for the Angel Group plc for the year ended 30 November 2013 in accordance with the requirements of IAS 7 *Statement of Cash Flows*.

Note: The notes to the statement of cash flows are not required. (35 marks)

(b) The directors of Angel are confused over several issues relating to IAS 7 *Statement of Cash Flows*. They wish to know the principles utilised by the International Accounting Standards Board in determining how cash flows are classified, including how entities determine the nature of the cash flows being analysed.

They have entered into the following transactions after the year end and wish to know how to deal with them in a cash flow statement, as they are unsure of the meaning of the definition of cash and cash equivalents.

Angel had decided after the year end to deposit the funds with the bank in two term deposit accounts as follows:

(i) $3 million into a 12-month term account, earning 3·5% interest. The cash can be withdrawn by giving 14 days' notice but Angel will incur a penalty, being the loss of all interest earned.

(ii) $7 million into a 12-month term account earning 3% interest. The cash can be withdrawn by giving 21 days' notice. Interest will be paid for the period of the deposit but if money is withdrawn, the interest will be at the rate of 2%, which is equivalent to the bank's stated rate for short-term deposits.

Angel is confident that it will not need to withdraw the cash from the higher-rate deposit within the term, but wants to keep easy access to the remaining $7 million to cover any working capital shortfalls which might arise.

Required:

Discuss the principles behind the classifications in the statements of cash flows whilst advising Angel on how to treat the two transactions above. (9 marks)

(c) All accounting professionals are responsible for acting in the public interest, and for promoting professional ethics. The directors of Angel feel that when managing the affairs of a company the profit motive could conflict with the public interest and accounting ethics. In their view, the profit motive is more important than ethical behaviour and codes of ethics are irrelevant and unimportant.

Required:

Discuss the above views of the directors regarding the fact that codes of ethics are irrelevant and unimportant. (6 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 (a) Havanna owns a chain of health clubs and has entered into binding contracts with sports organisations, which earn income over given periods. The services rendered in return for such income include access to their database of members, and admission to health clubs, including the provision of coaching and other benefits. These contracts are for periods of between 9 and 18 months. Havanna feels that because it only assumes limited obligations under the contract mainly relating to the provision of coaching, this could not be seen as the rendering of services for accounting purposes. As a result, Havanna's accounting policy for revenue recognition is to recognise the contract income in full at the date when the contract was signed. (6 marks)

(b) In May 2013, Havanna decided to sell one of its regional business divisions through a mixed asset and share deal. The decision to sell the division at a price of $40 million was made public in November 2013 and gained shareholder approval in December 2013. It was decided that the payment of any agreed sale price could be deferred until 30 November 2015. The business division was presented as a disposal group in the statement of financial position as at 30 November 2013. At the initial classification of the division as held for sale, its net carrying amount was $90 million. In writing down the disposal group's carrying amount, Havanna accounted for an impairment loss of $30 million which represented the difference between the carrying amount and value of the assets measured in accordance with applicable International Financial Reporting Standards (IFRS).

In the financial statements at 30 November 2013, Havanna showed the following costs as provisions relating to the continuing operations. These costs were related to the business division being sold and were as follows:

(i) A loss relating to a potential write-off of a trade receivable which had gone into liquidation. The trade receivable had sold the goods to a third party and the division had guaranteed the receipt of the sale proceeds;
(ii) An expense relating to the discounting of the long-term receivable on the fixed amount of the sale price of the disposal group;
(iii) A provision was charged which related to the expected transaction costs of the sale including legal advice and lawyer fees.

The directors wish to know how to treat the above transactions. (9 marks)

(c) Havanna has decided to sell its main office building to a third party and lease it back on a 10-year lease. The lease has been classified as an operating lease. The current fair value of the property is $5 million and the carrying value of the asset is $4·2 million. The market for property is very difficult in the jurisdiction and Havanna therefore requires guidance on the consequences of selling the office building at a range of prices. The following prices have been achieved in the market during the last few months for similar office buildings:

(i) $5 million
(ii) $6 million
(iii) $4·8 million
(iv) $4 million

Havanna would like advice on how to account for the sale and leaseback, with an explanation of the effect which the different selling prices would have on the financial statements, assuming that the fair value of the property is $5 million. (8 marks)

Required:

Advise Havanna on how the above transactions should be dealt with in its financial statements with reference to International Financial Reporting Standards where appropriate.

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

Professional marks will be awarded in question 2 for clarity and quality of presentation. (2 marks)

(25 marks)

3 (a) Bental, a listed bank, has a subsidiary, Hexal, which has two classes of shares, A and B. A-shares carry voting powers and B-shares are issued to meet Hexal's regulatory requirements. Under the terms of a shareholders' agreement, each shareholder is obliged to capitalise any dividends in the form of additional investment in B-shares. The shareholder agreement also stipulates that Bental agrees to buy the B-shares of the minority shareholders through a put option under the following conditions:

– The minority shareholders can exercise their put options when their ownership in B-shares exceeds the regulatory requirement, or
– The minority shareholders can exercise their put options every three years. The exercise price is the original cost paid by the shareholders.

In Bental's consolidated financial statements, the B-shares owned by minority shareholders are to be reported as a non-controlling interest. (7 marks)

(b) Bental has entered into a number of swap arrangements. Some of these transactions qualified for cash flow hedge accounting in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. The hedges were considered to be effective. At 30 November 2013, Bental decided to cancel the hedging relationships and had to pay compensation. The forecast hedged transactions were still expected to occur and Bental recognised the entire amount of the compensation in profit or loss.

Additionally, Bental also has an investment in a foreign entity over which it has significant influence and therefore accounts for the entity as an associate. The entity's functional currency differs from Bental's and in the consolidated financial statements, the associate's results fluctuate with changes in the exchange rate. Bental wishes to designate the investment as a hedged item in a fair value hedge in its individual and consolidated financial statements. (6 marks)

(c) On 1 September 2013, Bental entered into a business combination with another listed bank, Lental. The business combination has taken place in two stages, which were contingent upon each other. On 1 September 2013, Bental acquired 45% of the share capital and voting rights of Lental for cash. On 1 November 2013, Lental merged with Bental and Bental issued new A-shares to Lental's shareholders for their 55% interest.

On 31 August 2013, Bental had a market value of $70 million and Lental a market value of $90 million. Bental's business represents 45% and Lental's business 55% of the total value of the combined businesses.

After the transaction, the former shareholders of Bental excluding those of Lental owned 51% and the former shareholders of Lental owned 49% of the votes of the combined entity. The Chief Operating Officer (COO) of Lental is the biggest individual owner of the combined entity with a 25% interest. The purchase agreement provides for a board of six directors for the combined entity, five of whom will be former board members of Bental with one seat reserved for a former board member of Lental. The board of directors nominates the members of the management team. The management comprised the COO and four other members, two from Bental and two from Lental. Under the terms of the purchase agreement, the COO of Lental is the COO of the combined entity.

Bental proposes to account for the transaction as a business combination and identify Lental as the acquirer. (10 marks)

Required:

Discuss whether the accounting practices and policies outlined above are acceptable under International Financial Reporting Standards.

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

Professional marks will be awarded in question 3 for clarity and quality of presentation. (2 marks)

(25 marks)

4 **(a)** Due to the complexity of International Financial Reporting Standards (IFRS), often judgements used at the time of transition to IFRS have resulted in prior period adjustments and changes in estimates being disclosed in financial statements. The selection of accounting policy and estimation techniques is intended to aid comparability and consistency in financial statements. However, IFRS also place particular emphasis on the need to take into account qualitative characteristics and the use of professional judgement when preparing the financial statements. Although IFRS may appear prescriptive, the achievement of all the objectives for a set of financial statements will rely on the skills of the preparer. Entities should follow the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when selecting or changing accounting policies, changing estimation techniques, and correcting errors.

However, the application of IAS 8 is additionally often dependent upon the application of materiality analysis to identify issues and guide reporting. Entities also often consider the acceptability of the use of hindsight in their reporting.

Required:

(i) Discuss how judgement and materiality play a significant part in the selection of an entity's accounting policies.

(ii) Discuss the circumstances where an entity may change its accounting policies, setting out how a change of accounting policy is applied and the difficulties faced by entities where a change in accounting policy is made.

(iii) Discuss why the current treatment of prior period errors could lead to earnings management by companies, together with any further arguments against the current treatment.

Credit will be given for relevant examples.

Note: The total marks will be split equally between each part. (15 marks)

(b) In 2013, Zack, a public limited company, commenced construction of a shopping centre. It considers that in order to fairly recognise the costs of its property, plant and equipment, it needs to enhance its accounting policies by capitalising borrowing costs incurred whilst the shopping centre is under construction. A review of past transactions suggests that there has been one other project involving assets with substantial construction periods where there would be a material misstatement of the asset balance if borrowing costs were not capitalised. This project was completed in the year ended 30 November 2012. Previously, Zack had expensed the borrowing costs as they were incurred. The borrowing costs which could be capitalised are $2 million for the 2012 asset and $3 million for the 2013 asset.

A review of the depreciation schedules of the larger plant and equipment not affected by the above has resulted in Zack concluding that the basis on which these assets are depreciated would better reflect the resources consumed if calculations were on a reducing balance basis, rather than a straight-line basis. The revision would result in an increase in depreciation for the year to 30 November 2012 of $5 million, an increase for the year end 30 November 2013 of $6 million and an estimated increase for the year ending 30 November 2014 of $8 million.

Additionally, Zack has discovered that its accruals systems for year-end creditors for the financial year 30 November 2012 processed certain accruals twice in the ledger. This meant that expenditure services were overstated in the financial statements by $2 million. However, Zack has since reviewed its final accounts systems and processes and has made appropriate changes and introduced additional internal controls to ensure that such estimation problems are unlikely to recur.

All of the above transactions are material to Zack.

Required:

Discuss how the above events should be shown in the financial statements of Zack for the year ended 30 November 2013. (8 marks)

Professional marks will be awarded in question 4 for clarity and quality of presentation. (2 marks)

(25 marks)

End of Question Paper