Professional Level – Essentials Module

Corporate Reporting (International)

Tuesday 14 June 2011

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

ACCA

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

1 Rose, a public limited company, operates in the mining sector. The draft statements of financial position are as follows, at 30 April 2011:

	Rose $m	Petal $m	Stem Dinars m
Assets:			
Non-current assets			
Property, plant and equipment	370	110	380
Investments in subsidiaries			
Petal	113		
Stem	46		
Financial assets	15	7	50
	544	117	430
Current assets	118	100	330
Total assets	662	217	760
Equity and liabilities:			
Share capital	158	38	200
Retained earnings	256	56	300
Other components of equity	7	4	–
Total equity	421	98	500
Non-current liabilities	56	42	160
Current liabilities	185	77	100
Total liabilities	241	119	260
Total equity and liabilities	662	217	760

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

1 On 1 May 2010, Rose acquired 70% of the equity interests of Petal, a public limited company. The purchase consideration comprised cash of $94 million. The fair value of the identifiable net assets recognised by Petal was $120 million excluding the patent below. The identifiable net assets of Petal at 1 May 2010 included a patent which had a fair value of $4 million. This had not been recognised in the financial statements of Petal. The patent had a remaining term of four years to run at that date and is not renewable. The retained earnings of Petal were $49 million and other components of equity were $3 million at the date of acquisition. The remaining excess of the fair value of the net assets is due to an increase in the value of land.

   Rose wishes to use the 'full goodwill' method. The fair value of the non-controlling interest in Petal was $46 million on 1 May 2010. There have been no issues of ordinary shares since acquisition and goodwill on acquisition is not impaired.

   Rose acquired a further 10% interest from the non-controlling interest in Petal on 30 April 2011 for a cash consideration of $19 million.

2 Rose acquired 52% of the ordinary shares of Stem on 1 May 2010 when Stem's retained earnings were 220 million dinars. The fair value of the identifiable net assets of Stem on 1 May 2010 was 495 million dinars. The excess of the fair value over the net assets of Stem is due to an increase in the value of land. The fair value of the non-controlling interest in Stem at 1 May 2010 was 250 million dinars.

   Stem is located in a foreign country and operates a mine. The income of Stem is denominated and settled in dinars. The output of the mine is routinely traded in dinars and its price is determined initially by local supply and demand. Stem pays 40% of its costs and expenses in dollars with the remainder being incurred locally and settled in dinars. Stem's management has a considerable degree of authority and autonomy in carrying out the operations of Stem and is not dependent upon group companies for finance.

Rose wishes to use the 'full goodwill' method to consolidate the financial statements of Stem. There have been no issues of ordinary shares and no impairment of goodwill since acquisition.

The following exchange rates are relevant to the preparation of the group financial statements:

	Dinars to $
1 May 2010	6
30 April 2011	5
Average for year to 30 April 2011	5·8

3 Rose has a property located in the same country as Stem. The property was acquired on 1 May 2010 and is carried at a cost of 30 million dinars. The property is depreciated over 20 years on the straight-line method. At 30 April 2011, the property was revalued to 35 million dinars. Depreciation has been charged for the year but the revaluation has not been taken into account in the preparation of the financial statements as at 30 April 2011.

4 Rose commenced a long-term bonus scheme for employees at 1 May 2010. Under the scheme employees receive a cumulative bonus on the completion of five years service. The bonus is 2% of the total of the annual salary of the employees. The total salary of employees for the year to 30 April 2011 was $40 million and a discount rate of 8% is assumed. Additionally at 30 April 2011, it is assumed that all employees will receive the bonus and that salaries will rise by 5% per year.

5 Rose purchased plant for $20 million on 1 May 2007 with an estimated useful life of six years. Its estimated residual value at that date was $1·4 million. At 1 May 2010, the estimated residual value changed to $2·6 million. The change in the residual value has not been taken into account when preparing the financial statements as at 30 April 2011.

Required:

(a) (i) Discuss and apply the principles set out in IAS 21 *The Effects of Changes in Foreign Exchange Rates* in order to determine the functional currency of Stem. (7 marks)

(ii) Prepare a consolidated statement of financial position of the Rose Group at 30 April 2011, in accordance with International Financial Reporting Standards (IFRS), showing the exchange difference arising on the translation of Stem's net assets. Ignore deferred taxation. (35 marks)

(b) Rose was considering acquiring a service company. Rose stated that the acquisition may be made because of the value of the human capital and the opportunity for synergies and cross-selling opportunities. Rose estimated the fair value of the assets based on what it was prepared to pay for them. Rose further stated that what it was willing to pay was influenced by its future plans for the business.

The company to be acquired had contract-based customer relationships with well-known domestic and international companies and some mining companies. Rose estimated that the fair value of all of these customer relationships to be zero because Rose already enjoyed relationships with the majority of those customers.

Required:

Discuss the validity of the accounting treatment proposed by Rose and whether such a proposed treatment raises any ethical issues. (6 marks)

Professional marks will be awarded in part (b) for clarity and quality of the presentation and discussion. (2 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Lockfine, a public limited company, operates in the fishing industry and has recently made the transition to International Financial Reporting Standards (IFRS). Lockfine's reporting date is 30 April 2011.

(a) In the IFRS opening statement of financial position at 1 May 2009, Lockfine elected to measure its fishing fleet at fair value and use that fair value as deemed cost in accordance with IFRS 1 *First Time Adoption of International Financial Reporting Standards*. The fair value was an estimate based on valuations provided by two independent selling agents, both of whom provided a range of values within which the valuation might be considered acceptable. Lockfine calculated fair value at the average of the highest amounts in the two ranges provided. One of the agents' valuations was not supported by any description of the method adopted or the assumptions underlying the calculation. Valuations were principally based on discussions with various potential buyers. Lockfine wished to know the principles behind the use of deemed cost and whether agents' estimates were a reliable form of evidence on which to base the fair value calculation of tangible assets to be then adopted as deemed cost. (6 marks)

(b) Lockfine was unsure as to whether it could elect to apply IFRS 3 *Business Combinations* retrospectively to past business combinations on a selective basis, because there was no purchase price allocation available for certain business combinations in its opening IFRS statement of financial position.

As a result of a major business combination, fishing rights of that combination were included as part of goodwill. The rights could not be recognised as a separately identifiable intangible asset at acquisition under the local GAAP because a reliable value was unobtainable for the rights. The fishing rights operated for a specified period of time.

On transition from local GAAP to IFRS, the fishing rights were included in goodwill and not separately identified because they did not meet the qualifying criteria set out in IFRS 1, even though it was known that the fishing rights had a finite life and would be fully impaired or amortised over the period specified by the rights. Lockfine wished to amortise the fishing rights over their useful life and calculate any impairment of goodwill as two separate calculations. (6 marks)

(c) Lockfine has internally developed intangible assets comprising the capitalised expenses of the acquisition and production of electronic map data which indicates the main fishing grounds in the world. The intangible assets generate revenue for the company in their use by the fishing fleet and are a material asset in the statement of financial position. Lockfine had constructed a database of the electronic maps. The costs incurred in bringing the information about a certain region of the world to a higher standard of performance are capitalised. The costs related to maintaining the information about a certain region at that same standard of performance are expensed. Lockfine's accounting policy states that intangible assets are valued at historical cost. The company considers the database to have an indefinite useful life which is reconsidered annually when it is tested for impairment. The reasons supporting the assessment of an indefinite useful life were not disclosed in the financial statements and neither did the company disclose how it satisfied the criteria for recognising an intangible asset arising from development. (6 marks)

(d) The Lockfine board has agreed two restructuring projects during the year to 30 April 2011:

Plan A involves selling 50% of its off-shore fleet in one year's time. Additionally, the plan is to make 40% of its seamen redundant. Lockfine will carry out further analysis before deciding which of its fleets and related employees will be affected. In previous announcements to the public, Lockfine has suggested that it may restructure the off-shore fleet in the future.

Plan B involves the reorganisation of the headquarters in 18 months time, and includes the redundancy of 20% of the headquarters' workforce. The company has made announcements before the year end but there was a three month consultation period which ended just after the year end, whereby Lockfine was negotiating with employee representatives. Thus individual employees had not been notified by the year end.

Lockfine proposes recognising a provision in respect of Plan A but not Plan B. (5 marks)

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

Required:

Discuss the principles and practices to be used by Lockfine in accounting for the above valuation and recognition issues.

(25 marks)

3 Alexandra, a public limited company, designs and manages business solutions and IT infrastructures.

(a) In November 2010, Alexandra defaulted on an interest payment on an issued bond loan of $100 million repayable in 2015. The loan agreement stipulates that such default leads to an obligation to repay the whole of the loan immediately, including accrued interest and expenses. The bondholders, however, issued a waiver postponing the interest payment until 31 May 2011. On 17 May 2011, Alexandra felt that a further waiver was required, so requested a meeting of the bondholders and agreed a further waiver of the interest payment to 5 July 2011, when Alexandra was confident it could make the payments. Alexandra classified the loan as long-term debt in its statement of financial position at 30 April 2011 on the basis that the loan was not in default at the end of the reporting period as the bondholders had issued waivers and had not sought redemption.
(6 marks)

(b) Alexandra enters into contracts with both customers and suppliers. The supplier solves system problems and provides new releases and updates for software. Alexandra provides maintenance services for its customers. In previous years, Alexandra recognised revenue and related costs on software maintenance contracts when the customer was invoiced, which was at the beginning of the contract period. Contracts typically run for two years.

During 2010, Alexandra had acquired Xavier Co, which recognised revenue, derived from a similar type of maintenance contract as Alexandra, on a straight-line basis over the term of the contract. Alexandra considered both its own and the policy of Xavier Co to comply with the requirements of IAS 18 *Revenue* but it decided to adopt the practice of Xavier Co for itself and the group. Alexandra concluded that the two recognition methods did not, in substance, represent two different accounting policies and did not, therefore, consider adoption of the new practice to be a change in policy.

In the year to 30 April 2011, Alexandra recognised revenue (and the related costs) on a straight-line basis over the contract term, treating this as a change in an accounting estimate. As a result, revenue and cost of sales were adjusted, reducing the year's profits by some $6 million. (5 marks)

(c) Alexandra has a two-tier board structure consisting of a management and a supervisory board. Alexandra remunerates its board members as follows:

– Annual base salary
– Variable annual compensation (bonus)
– Share options

In the group financial statements, within the related parties note under IAS 24 *Related Party Disclosures*, Alexandra disclosed the total remuneration paid to directors and non-executive directors and a total for each of these boards. No further breakdown of the remuneration was provided.

The management board comprises both the executive and non-executive directors. The remuneration of the non-executive directors, however, was not included in the key management disclosures. Some members of the supervisory and management boards are of a particular nationality. Alexandra was of the opinion that in that jurisdiction, it is not acceptable to provide information about remuneration that could be traced back to individuals. Consequently, Alexandra explained that it had provided the related party information in the annual accounts in an ambiguous way to prevent users of the financial statements from tracing remuneration information back to specific individuals. (5 marks)

(d) Alexandra's pension plan was accounted for as a defined benefit plan in 2010. In the year ended 30 April 2011, Alexandra changed the accounting method used for the scheme and accounted for it as a defined contribution plan, restating the comparative 2010 financial information. The effect of the restatement was significant. In the 2011 financial statements, Alexandra explained that, during the year, the arrangements underlying the retirement benefit plan had been subject to detailed review. Since the pension liabilities are fully insured and indexation of future liabilities can be limited up to and including the funds available in a special trust account set up for the plan, which is not at the disposal of Alexandra, the plan qualifies as a defined contribution plan under IAS 19 *Employee Benefits* rather than a defined benefit plan. Furthermore, the trust account is built up by the insurance company from the surplus yield on investments. The pension plan is an average pay plan in respect of which the entity pays insurance premiums to a third party insurance company to fund the plan. Every year 1% of the pension fund is built up and employees pay a contribution of 4% of their salary, with the employer paying the balance of the contribution. If an employee leaves Alexandra and transfers the pension to another fund, Alexandra is liable for, or is refunded the difference between the benefits the employee is entitled to and the insurance premiums paid. (7 marks)

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

Required:

Discuss how the above transactions should be dealt with in the financial statements of Alexandra for the year ended 30 April 2011.

(25 marks)

4 The publication of IFRS 9, *Financial Instruments*, represents the completion of the first stage of a three-part project to replace IAS 39 *Financial Instruments: Recognition and Measurement* with a new standard. The new standard purports to enhance the ability of investors and other users of financial information to understand the accounting of financial assets and reduces complexity.

Required:

(a) (i) Discuss the approach taken by IFRS 9 in measuring and classifying financial assets and the main effect that IFRS 9 will have on accounting for financial assets. (11 marks)

(ii) Grainger, a public limited company, has decided to adopt IFRS 9 prior to January 2012 and has decided to restate comparative information under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The entity has an investment in a financial asset which was carried at amortised cost under IAS 39 but will be valued at fair value through profit and loss (FVTPL) under IFRS 9. The carrying value of the assets was \$105,000 on 30 April 2010 and \$110,400 on 30 April 2011. The fair value of the asset was \$106,500 on 30 April 2010 and \$111,000 on 30 April 2011. Grainger has determined that the asset will be valued at FVTPL at 30 April 2011.

Required:

Discuss how the financial asset will be accounted for in the financial statements of Grainger in the year ended 30 April 2011. (4 marks)

(b) Recently, criticisms have been made against the current IFRS impairment model for financial assets (the incurred loss model). The issue with the incurred loss model is that impairment losses (and resulting write-downs in the reported value of financial assets) can only be recognised when there is evidence that they exist and have been incurred. Reporting entities are not allowed currently to consider the effects of expected losses. There is a view that earlier recognition of loan losses could potentially reduce the problems incurred in a credit crisis.

Grainger has a portfolio of loans of \$5 million which was initially recognised on 1 May 2010. The loans mature in 10 years and carry an interest rate of 16%. Grainger estimates that no loans will default in the first two years, but from the third year onwards, loans will default at an annual rate of about 9%. If the loans default as expected, the rate of return from the portfolio will be approximately 9·07%. The number of loans are fixed without any new lending or any other impairment provisions.

Required:

(i) Discuss briefly the issues related to considering the effects of expected losses in dealing with impairment of financial assets. (4 marks)

(ii) Calculate the impact on the financial statements up to the year ended 30 April 2013 if Grainger anticipated the expected losses on the loan portfolio in year three. (4 marks)

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

(25 marks)

End of Question Paper