Professional Level – Essentials Module

Corporate Reporting (International)

Tuesday 9 December 2014

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)

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The question paper begins on page 3.

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

1 (a) Joey, a public limited company, operates in the media sector. Joey has investments in two companies. The draft statements of financial position at 30 November 2014 are as follows:

	Joey $m	Margy $m	Hulty $m
Assets:			
Non-current assets			
Property, plant and equipment	3,295	2,000	1,200
Investments in subsidiaries and other investments			
Margy	1,675		
Hulty	700		
	5,670	2,000	1,200
Current assets	985	861	150
Total assets	6,655	2,861	1,350
Equity and liabilities:			
Share capital	850	1,020	600
Retained earnings	3,340	980	350
Other components of equity	250	80	40
Total equity	4,440	2,080	990
Non-current liabilities	1,895	675	200
Current liabilities	320	106	160
Total liabilities	2,215	781	360
Total equity and liabilities	6,655	2,861	1,350

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

1. On 1 December 2011, Joey acquired 30% of the ordinary shares of Margy for a cash consideration of $600 million when the fair value of Margy's identifiable net assets was $1,840 million. Joey treated Margy as an associate and has equity accounted for Margy up to 1 December 2013. Joey's share of Margy's undistributed profit amounted to $90 million and its share of a revaluation gain amounted to $10 million. On 1 December 2013, Joey acquired a further 40% of the ordinary shares of Margy for a cash consideration of $975 million and gained control of the company. The cash consideration has been added to the equity accounted balance for Margy at 1 December 2013 to give the carrying amount at 30 November 2014.

   At 1 December 2013, the fair value of Margy's identifiable net assets was $2,250 million. At 1 December 2013, the fair value of the equity interest in Margy held by Joey before the business combination was $705 million and the fair value of the non-controlling interest of 30% was assessed as $620 million. The retained earnings and other components of equity of Margy at 1 December 2013 were $900 million and $70 million respectively. It is group policy to measure the non-controlling interest at fair value.

2. At the time of the business combination with Margy, Joey has included in the fair value of Margy's identifiable net assets, an unrecognised contingent liability of $6 million in respect of a warranty claim in progress against Margy. In March 2014, there was a revision of the estimate of the liability to $5 million. The amount has met the criteria to be recognised as a provision in current liabilities in the financial statements of Margy and the revision of the estimate is deemed to be a measurement period adjustment.

3. Additionally, buildings with a carrying amount of $200 million had been included in the fair valuation of Margy at 1 December 2013. The buildings have a remaining useful life of 20 years at 1 December 2013. However, Joey had commissioned an independent valuation of the buildings of Margy which was not complete at 1 December 2013 and therefore not considered in the fair value of the identifiable net assets at the acquisition date. The valuations were received on 1 April 2014 and resulted in a decrease of

$40 million in the fair value of property, plant and equipment at the date of acquisition. This decrease does not affect the fair value of the non-controlling interest at acquisition and has not been entered into the financial statements of Margy. Buildings are depreciated on the straight-line basis and it is group policy to leave revaluation gains on disposal in equity. The excess of the fair value of the net assets over their carrying value, at 1 December 2013, is due to an increase in the value of non-depreciable land and the contingent liability.

4. On 1 December 2013, Joey acquired 80% of the equity interests of Hulty, a private entity, in exchange for cash of $700 million. Because the former owners of Hulty needed to dispose of the investment quickly, they did not have sufficient time to market the investment to many potential buyers. The fair value of the identifiable net assets was $960 million. Joey determined that the fair value of the 20% non-controlling interest in Hulty at that date was $250 million. Joey reviewed the procedures used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non-controlling interest and the consideration transferred. After that review, Hulty determined that the procedures and resulting measures were appropriate. The retained earnings and other components of equity of Hulty at 1 December 2013 were $300 million and $40 million respectively. The excess in fair value is due to an unrecognised franchise right, which Joey had granted to Hulty on 1 December 2012 for five years. At the time of the acquisition, the franchise right could be sold for its market price. It is group policy to measure the non-controlling interest at fair value.

   All goodwill arising on acquisitions has been impairment tested with no impairment being required.

5. Joey is looking to expand into publishing and entered into an arrangement with Content Publishing (CP), a public limited company, on 1 December 2013. CP will provide content for a range of books and online publications.

   CP is entitled to a royalty calculated as 10% of sales and 30% of gross profit of the publications. Joey has sole responsibility for all printing, binding, and platform maintenance of the online website. The agreement states that key strategic sales and marketing decisions must be agreed jointly. Joey selects the content to be covered in the publications but CP has the right of veto over this content. However on 1 June 2014, Joey and CP decided to set up a legal entity, JCP, with equal shares and voting rights. CP continues to contribute content into JCP but does not receive royalties. Joey continues the printing, binding and platform maintenance. The sales and cost of sales in the period were $5 million and $2 million respectively. The whole of the sale proceeds and the costs of sales were recorded in Joey's financial statements with no accounting entries being made for JCP or amounts due to CP. Joey currently funds the operations. Assume that the sales and costs accrue evenly throughout the year and that all of the transactions relating to JCP have been in cash.

6. At 30 November 2013, Joey carried a property in its statement of financial position at its revalued amount of $14 million in accordance with IAS 16 *Property, Plant and Equipment*. Depreciation is charged at $300,000 per year on the straight line basis. In March 2014, the management decided to sell the property and it was advertised for sale. By 31 March 2014, the sale was considered to be highly probable and the criteria for IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* were met at this date. At that date, the asset's fair value was $15·4 million and its value in use was $15·8 million. Costs to sell the asset were estimated at $300,000. On 30 November 2014, the property was sold for $15·6 million. The transactions regarding the property are deemed to be material and no entries have been made in the financial statements regarding this property since 30 November 2013 as the cash receipts from the sale were not received until December 2014.

Required:

Prepare the group consolidated statement of financial position of Joey as at 30 November 2014.

(35 marks)

(b) The Joey Group wishes to expand its operations. As part of this expansion, it has granted options to the employees of Margy and Hulty over its own shares as at 7 December 2014. The awards vest immediately. Joey is not proposing to make a charge to the subsidiaries for these options.

Joey does not know how to account for this transaction in its own, the subsidiaries, and the group financial statements.

Required:

Explain to Joey how the above transaction should be dealt with in its own, the subsidiaries, and the group financial statements. (8 marks)

(c) Joey's directors feel that they need a significant injection of capital in order to modernise plant and equipment as the company has been promised new orders if it can produce goods to an international quality. The bank's current lending policies require borrowers to demonstrate good projected cash flow, as well as a level of profitability which would indicate that repayments would be made. However, the current projected cash flow statement would not satisfy the bank's criteria for lending. The directors have told the bank that the company is in an excellent financial position, that the financial results and cash flow projections will meet the criteria and that the chief accountant will forward a report to this effect shortly. The chief accountant has only recently joined Joey and has openly stated that he cannot afford to lose his job because of his financial commitments.

Required:

Discuss the potential ethical conflicts which may arise in the above scenario and the ethical principles which would guide how a professional accountant should respond in this situation. (7 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 **(a)** Coatmin is a government-controlled bank. Coatmin was taken over by the government during the recent financial crisis. Coatmin does not directly trade with other government-controlled banks but has underwritten the development of the nationally owned railway and postal service. The directors of Coatmin are concerned about the volume and cost of disclosing its related party interests because they extend theoretically to all other government-controlled enterprises and banks. They wish general advice on the nature and importance of the disclosure of related party relationships and specific advice on the disclosure of the above relationships in the financial statements. (5 marks)

(b) At the start of the financial year to 30 November 2013, Coatmin gave a financial guarantee contract on behalf of one of its subsidiaries, a charitable organisation, committing it to repay the principal amount of $60 million if the subsidiary defaulted on any payments due under a loan. The loan related to the financing of the construction of new office premises and has a term of three years. It is being repaid by equal annual instalments of principal with the first payment having been paid. Coatmin has not secured any compensation in return for giving the guarantee, but assessed that it had a fair value of $1·2 million. The guarantee is measured at fair value through profit or loss. The guarantee was given on the basis that it was probable that it would not be called upon. At 30 November 2014, Coatmin became aware of the fact that the subsidiary was having financial difficulties with the result that it has not paid the second instalment of principal. It is assessed that it is probable that the guarantee will now be called. However, just before the signing of the financial statements for the year ended 30 November 2014, the subsidiary secured a donation which enabled it to make the second repayment before the guarantee was called upon. It is now anticipated that the subsidiary will be able to meet the final payment. Discounting is immaterial and the fair value of the guarantee is higher than the value determined under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Coatmin wishes to know the principles behind accounting for the above guarantee under IFRS and how the transaction would be accounted for in the financial records. (7 marks)

(c) Coatmin's creditworthiness has been worsening but it has entered into an interest rate swap agreement which acts as a hedge against a $2 million 2% bond issue which matures on 31 May 2016. The notional amount of the swap is $2 million with settlement every 12 months. The start date of the swap was 1 December 2013 and it matures on 31 May 2016. The swap is enacted for nil consideration. Coatmin receives interest at 1·75% a year and pays on the basis of the 12-month LIBOR rate. At inception, Coatmin designates the swap as a hedge in the variability in the fair value of the bond issue.

	Fair value 1 December 2013 $000	**Fair value 30 November 2014 $000**
Fixed interest bond	2,000	1,910
Interest rate swap	Nil	203

Coatmin wishes to know the circumstances in which it can use hedge accounting and needs advice on the use of hedge accounting for the above transactions. (7 marks)

(d) Coatmin provides loans to customers and funds the loans by selling bonds in the market. The liability is designated as at fair value through profit or loss. The bonds have a fair value increase of $50 million in the year to 30 November 2014 of which $5 million relates to the reduction in Coatmin's creditworthiness. The directors of Coatmin would like advice on how to account for this movement. (4 marks)

Required:

Discuss, with suitable calculations where necessary, the accounting treatment of the above transactions in the financial statements of Coatmin.

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

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

(25 marks)

3 **(a)** Kayte operates in the shipping industry and owns vessels for transportation. In June 2014, Kayte acquired Ceemone whose assets were entirely investments in small companies. The small companies each owned and operated one or two shipping vessels. There were no employees in Ceemone or the small companies. At the acquisition date, there were only limited activities related to managing the small companies as most activities were outsourced. All the personnel in Ceemone were employed by a separate management company. The companies owning the vessels had an agreement with the management company concerning assistance with chartering, purchase and sale of vessels and any technical management. The management company used a shipbroker to assist with some of these tasks.

Kayte accounted for the investment in Ceemone as an asset acquisition. The consideration paid and related transaction costs were recognised as the acquisition price of the vessels. Kayte argued that the vessels were only passive investments and that Ceemone did not own a business consisting of processes, since all activities regarding commercial and technical management were outsourced to the management company. As a result, the acquisition was accounted for as if the vessels were acquired on a stand-alone basis.

Additionally, Kayte had borrowed heavily to purchase some vessels and was struggling to meet its debt obligations. Kayte had sold some of these vessels but in some cases, the bank did not wish Kayte to sell the vessel. In these cases, the vessel was transferred to a new entity, in which the bank retained a variable interest based upon the level of the indebtedness. Kayte's directors felt that the entity was a subsidiary of the bank and are uncertain as to whether they have complied with the requirements of IFRS 3 *Business Combinations* and IFRS 10 *Consolidated Financial Statements* as regards the above transactions. (12 marks)

(b) Kayte's vessels constitute a material part of its total assets. The economic life of the vessels is estimated to be 30 years, but the useful life of some of the vessels is only 10 years because Kayte's policy is to sell these vessels when they are 10 years old. Kayte estimated the residual value of these vessels at sale to be half of acquisition cost and this value was assumed to be constant during their useful life. Kayte argued that the estimates of residual value used were conservative in view of an immature market with a high degree of uncertainty and presented documentation which indicated some vessels were being sold for a price considerably above carrying value. Broker valuations of the residual value were considerably higher than those used by Kayte. Kayte argued against broker valuations on the grounds that it would result in greater volatility in reporting.

Kayte keeps some of the vessels for the whole 30 years and these vessels are required to undergo an engine overhaul in dry dock every 10 years to restore their service potential, hence the reason why some of the vessels are sold. The residual value of the vessels kept for 30 years is based upon the steel value of the vessel at the end of its economic life. At the time of purchase, the service potential which will be required to be restored by the engine overhaul is measured based on the cost as if it had been performed at the time of the purchase of the vessel. In the current period, one of the vessels had to have its engine totally replaced after only eight years. Normally, engines last for the 30-year economic life if overhauled every 10 years. Additionally, one type of vessel was having its funnels replaced after 15 years but the funnels had not been depreciated separately.

(11 marks)

Required:

Discuss the accounting treatment of the above transactions in the financial statements of Kayte.

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

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

(25 marks)

4 **(a)** An assessment of accounting practices for asset impairments is especially important in the context of financial reporting quality in that it requires the exercise of considerable management judgement and reporting discretion. The importance of this issue is heightened during periods of ongoing economic uncertainty as a result of the need for companies to reflect the loss of economic value in a timely fashion through the mechanism of asset write-downs. There are many factors which can affect the quality of impairment accounting and disclosures. These factors include changes in circumstance in the reporting period,the market capitalisation of the entity, the allocation of goodwill to cash generating units, valuation issues and the nature of the disclosures.

Required:

Discuss the importance and significance of the above factors when conducting an impairment test under IAS 36 *Impairment of Assets*. (13 marks)

(b) **(i)** Estoil is an international company providing parts for the automotive industry. It operates in many different jurisdictions with different currencies. During 2014, Estoil experienced financial difficulties marked by a decline in revenue, a reorganisation and restructuring of the business and it reported a loss for the year. An impairment test of goodwill was performed but no impairment was recognised. Estoil applied one discount rate for all cash flows for all cash generating units (CGUs), irrespective of the currency in which the cash flows would be generated. The discount rate used was the weighted average cost of capital (WACC) and Estoil used the 10-year government bond rate for its jurisdiction as the risk free rate in this calculation. Additionally, Estoil built its model using a forecast denominated in the functional currency of the parent company. Estoil felt that any other approach would require a level of detail which was unrealistic and impracticable. Estoil argued that the different CGUs represented different risk profiles in the short term, but over a longer business cycle, there was no basis for claiming that their risk profiles were different.

(ii) Fariole specialises in the communications sector with three main CGUs. Goodwill was a significant component of total assets. Fariole performed an impairment test of the CGUs. The cash flow projections were based on the most recent financial budgets approved by management. The realised cash flows for the CGUs were negative in 2014 and far below budgeted cash flows for that period. The directors had significantly raised cash flow forecasts for 2015 with little justification. The projected cash flows were calculated by adding back depreciation charges to the budgeted result for the period with expected changes in working capital and capital expenditure not taken into account.

Required:

Discuss the acceptability of the above accounting practices under IAS 36 *Impairment of Assets*.

(10 marks)

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

(25 marks)

End of Question Paper