Professional Level – Essentials Module

Corporate Reporting (United Kingdom)

September/December 2015

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

This question 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 question 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 (UK)

ACCA

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The question paper begins on page 3.

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

1 The following draft financial statements relate to Bubble, a public limited company, and two other companies in which it owns investments.

Draft statements of financial position as at 31 October 2015

	Bubble $m	Salt $m	Tyslar Dinars m
Assets			
Non-current assets			
Property, plant and equipment	280	105	390
Investment in Salt	110		
Investment in Tyslar	46		
Financial assets	12	9	98
	448	114	488
Current assets			
Inventories	20	12	16
Trade and other receivables	30	25	36
Cash and cash equivalents	14	11	90
	64	48	142
Total assets	512	162	630
Equity and liabilities			
Equity shares	80	50	210
Retained earnings	230	74	292
Other components of equity	40	12	
Total equity	350	136	502
Non-current liabilities	95	7	110
Current liabilities	67	19	18
	162	26	128
Total equity and liabilities	512	162	630

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

1. Bubble acquired 80% of the equity shares of Salt on 1 November 2013 when Salt's retained earnings were $56 million and other components of equity were $8 million. The fair value of the net assets of Salt was $120 million at the date of acquisition. This does not include a contingent liability which was disclosed in Salt's financial statements as a possible obligation of $5 million. The fair value of the obligation was assessed as $1 million at the date of acquisition and remained unsettled as at 31 October 2015. $5 million is still disclosed as a possible obligation with no change in its fair value. Any remaining difference in the fair value of the net assets at acquisition relates to non-depreciable land. The fair value of the non-controlling interest at acquisition was estimated as $25 million. Bubble always adopts the full goodwill method under IFRS 3 *Business Combinations*.

2. Bubble also owns 60% of the equity shares of Tyslar, a company located overseas which uses the dinar as its functional currency. The shares in Tyslar were acquired on 1 November 2014 at a cost of 368 million dinars. At the date of acquisition, retained earnings were 258 million dinars and Tyslar had no other components of equity. No fair value adjustments were deemed necessary in relation to the acquisition of Tyslar. The fair value of the non-controlling interest was estimated as 220 million dinars at acquisition.

   An impairment review of goodwill was undertaken as at 31 October 2015. No impairment was necessary in relation to Salt, but the goodwill of Tyslar is to be impaired by 20%. Neither Bubble, Salt nor Tyslar has issued any equity shares since acquisition.

3. On 1 February 2015, Bubble gave an interest-free loan to Tyslar for $10 million. Tyslar recorded this correctly in its financial statements using the spot rate of exchange. Tyslar repaid $5 million on 1 July 2015 when the spot exchange rate was $1 to 10 dinars. Tyslar therefore reduced its non-current liabilities by 50 million dinars. No further entries were made in Tyslar's financial statements. The remaining balances remain within the financial assets of Bubble and the non-current liabilities of Tyslar.

4. Bubble wished to expand its overseas operations and on 1 May 2015 acquired an overseas property with a fair value of 58·5 million dinars. In exchange for the building, Bubble paid the supplier with land which Bubble had held but had yet to determine its use. The carrying amount of the land was $5 million but it had an open market value of $7 million. Bubble was unsure as to how to deal with this transaction and so has transferred $5 million from investment properties to property, plant and equipment. The transaction has commercial substance.

   In addition, Bubble spent $0·5 million to help relocate staff to the new property and added this amount to the cost of the asset. Bubble has made no other entries in its financial statements in relation to the property. Bubble has a policy of depreciating properties over 35 years and follows the revaluation model under IAS 16 *Property, Plant & Equipment*. Due to a surge in the market, it is estimated that the fair value of the property is 75 million dinars as at 31 October 2015.

5. Bubble operates a defined benefit scheme for its employees but has yet to record anything for the current year except to expense the cash contributions which were $6 million. The opening position was a net liability of $15 million which is included in the non-current liabilities of Bubble in its draft financial statements. Current service costs for the year were $5 million and interest rates on good quality corporate bonds fell from 8% at the start of the year to 6% by 31 October 2015. In addition, a payment of $3 million was made out of the cash of the pension scheme in relation to employees who left the scheme. The reduction in the pension scheme liability as a result of the curtailment was $4 million. The actuary has assessed that the scheme is in deficit by $17 million as at 31 October 2015.

6. The following exchange rates are relevant for the preparation of the group financial statements:

	Dinars to $
1 November 2014	8
1 February 2015	9
1 May 2015	9
31 October 2015	9·5
Average for the year to 31 October 2015	8·5

Required:

(a) **Prepare the consolidated statement of financial position of the Bubble Group at 31 October 2015 in accordance with International Financial Reporting Standards.** (35 marks)

(b) Bubble is considering purchasing a UK subsidiary and has heard that FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* has different accounting requirements for deferred taxation than IFRS for SMEs and, in particular, as regards accounting for a deferred tax asset.

Required:

Discuss the difference in the general recognition principle between FRS 102 and IFRS for SMEs in accounting for deferred taxation and the difference in the way in which deferred tax assets are dealt with under these two standards. (9 marks)

(c) The directors of Bubble are thinking of acquiring further overseas investments in the near future but the entity currently lacks sufficient cash to exploit such opportunities. They would prefer to raise finance from an equity issue as Bubble already has significant loans within non-current liabilities and they do not wish to increase Bubble's gearing any further. They are therefore keen to maximise the balance on the group retained earnings in order to attract the maximum level of investment possible. One proposal is that they may sell 5% of the equity interest in Tyslar during 2016. This will improve the cash position but will enable Bubble to maintain control over Tyslar. In addition, the directors believe that the shares can be sold profitably to boost the retained earnings of Bubble and of the group. The directors intend to transfer the relevant proportion of the exchange differences on translation of the subsidiary to group retained earnings, knowing that this is contrary to accounting standards.

Required:

Discuss why the proposed treatment of the exchange differences by the directors is not in compliance with International Financial Reporting Standards, explaining any ethical issues which may arise. (6 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 (a) Chemclean trades in the chemical industry. The entity has development and production operations in various countries. It has entered into an agreement with Jomaster under which Chemclean will licence Jomaster's know-how and technology to manufacture a chemical compound, Volut. The know-how and technology has a fair value of $4 million. Chemclean cannot use the know-how and technology for manufacturing any other compound than Volut. Chemclean has not concluded that economic benefits are likely to flow from this compound but will use Jomaster's technology for a period of three years. Chemclean will have to keep updating the technology in accordance with Jomaster's requirements. The agreement stipulates that Chemclean will make a non-refundable payment of $4 million to Jomaster for access to the technology. Additionally, Jomaster will also receive a 10% royalty from sales of the chemical compound.

Additionally, Chemclean is interested in another compound, Yacton, which is being developed by Jomaster. The compound is in the second phase of development. The intellectual property of compound Yacton is put into a newly formed shell company, Conew, which has no employees. The compound is the only asset of Conew. Chemclean is intending to acquire a 65% interest in Conew, which will give it control over the entity and the compound. Chemclean will provide the necessary resources to develop the compound. (8 marks)

(b) In the year to 30 June 2015, Chemclean acquired a major subsidiary. The inventory acquired in this business combination was valued at its fair value at the acquisition date in accordance with IFRS 3 *Business Combinations*. The inventory increased in value as a result of the fair value exercise. A significant part of the acquired inventory was sold in the post-acquisition period but before 30 June 2015, the year end.

In the consolidated statement of profit or loss and other comprehensive income, the cost of inventories acquired in the business combination and sold by the acquirer after the business combination was disclosed on two different lines. The inventory was partly shown as cost of goods sold and partly as a 'non-recurring item' within operating income. The part presented under cost of goods sold corresponded to the inventory's carrying amount in the subsidiary's financial statements. The part presented as a 'non-recurring item' corresponded to the fair value increase recognised on the business combination. The 'non-recurring item' amounted to 25% of Chemclean's earnings before interest and tax (EBIT). Chemclean disclosed the accounting policy and explained in the notes to the financial statements that showing the inventory at fair value would result in a fall in the gross margin due to the fair value increase. Further, Chemclean argued that isolating this part of the margin in the 'non-recurring items', whose nature is transparently presented in the notes, enabled the user to evaluate the structural evolution of its gross margin. (6 marks)

(c) In the consolidated financial statements for 2015, Chemclean recognised a net deferred tax asset of $16 million, which represented 18% of its total equity. This asset was made up of $3 million taxable temporary differences and $19 million relating to the carry-forward of unused tax losses. The local tax regulation allows unused tax losses to be carried forward indefinitely. Chemclean expects that within five years, future taxable profits before tax would be available against which the unused tax losses could be offset. This view was based on the budgets for the years 2015–2020. The budgets were primarily based on general assumptions about the development of key products and economic improvement indicators. Additionally, the entity expected a substantial reduction in the future impairment of trade receivables and property which the entity had recently suffered and this would result in a substantial increase in future taxable profit.

Chemclean had recognised material losses during the previous five years, with an average annual loss of $19 million. A comparison of Chemclean's budgeted results for the previous two years to its actual results indicated material differences relating principally to impairment losses. In the interim financial statements for the first half of the year to 30 June 2015, Chemclean recognised impairment losses equal to budgeted impairment losses for the whole year. In its financial statements for the year ended 30 June 2015, Chemclean disclosed a material uncertainty about its ability to continue as a going concern. The current tax rate in the jurisdiction is 30%. (9 marks)

Required:

Discuss how the above items should be dealt with in the financial statements of Chemclean 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 2 for clarity and quality of presentation. (2 marks)

(25 marks)

3 **(a)** **(i)** Gasnature is a publicly traded entity involved in the production and trading of natural gas and oil. Gasnature jointly owns an underground storage facility with another entity, Gogas. Both parties extract gas from offshore gas fields, which they own and operate independently from each other. Gasnature owns 55% of the underground facility and Gogas owns 45%. They have agreed to share services and costs accordingly, with decisions regarding the storage facility requiring unanimous agreement of the parties. The underground facility is pressurised so that the gas is pushed out when extracted. When the gas pressure is reduced to a certain level, the remaining gas is irrecoverable and remains in the underground storage facility until it is decommissioned. Local legislation requires the decommissioning of the storage facility at the end of its useful life. Gasnature wishes to know how to treat the agreement with Gogas including any obligation or possible obligation arising on the underground storage facility and the accounting for the irrecoverable gas. (9 marks)

(ii) Gasnature has entered into a 10-year contract with Agas for the purchase of natural gas. Gasnature has made an advance payment to Agas for an amount equal to the total quantity of gas contracted for 10 years which has been calculated using the forecasted price of gas. The advance carries interest of 6% per annum, which is settled by way of the supply of extra gas. Fixed quantities of gas have to be supplied each month and there is a price adjustment mechanism in the contract whereby the difference between the forecasted price of gas and the prevailing market price is settled in cash monthly. If Agas does not deliver gas as agreed, Gasnature has the right to claim compensation at the current market price of gas. Gasnature wishes to know whether the contract with Agas should be accounted for under IFRS 9 *Financial Instruments*. (6 marks)

Required:

Discuss, with reference to International Financial Reporting Standards, how Gasnature should account for the above agreement and contract, and the issues raised by the directors.

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

(b) Grevely is finalising its financial statements for the year ended 31 August 2015 and has the following issues: Grevely purchased a machine on 1 January 2015 and the directors estimated that a major overhaul is required every two years. The costs of the overhaul are approximately $50,000 which comprises $30,000 for parts and equipment and $20,000 for labour. The directors proposed to accrue the cost of the overhaul over the two years of operations up to that date and create a provision for the expenditure.

Grevely utilises IFRS for SMEs in its financial statements and wishes to change its accounting policy for property, plant and equipment (PPE) from a cost basis to a revaluation basis.

Required:

(i) **Discuss whether the above accounting policy regarding the overhaul of PPE is acceptable under IFRS for SMEs.** (4 marks)

(ii) **Explain the differences between IFRS for SMEs and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* as regards the proposed change in accounting policy relating to property, plant and equipment.** (4 marks)

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

(25 marks)

4 There has been significant divergence in practice over recognition of revenue mainly because International Financial Reporting Standards (IFRS) have contained limited guidance in certain areas. The International Accounting Standards Board (IASB) as a result of the joint project with the US Financial Accounting Standards Board (FASB) has issued IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 sets out a five-step model, which applies to revenue earned from a contract with a customer with limited exceptions, regardless of the type of revenue transaction or the industry. Step one in the five-step model requires the identification of the contract with the customer and is critical for the purpose of applying the standard. The remaining four steps in the standard's revenue recognition model are irrelevant if the contract does not fall within the scope of IFRS 15.

Required:

(a) (i) Discuss the criteria which must be met for a contract with a customer to fall within the scope of IFRS 15. (5 marks)

(ii) Discuss the four remaining steps which lead to revenue recognition after a contract has been identified as falling within the scope of IFRS 15. (8 marks)

(b) (i) Tang enters into a contract with a customer to sell an existing printing machine such that control of the printing machine vests with the customer in two years' time. The contract has two payment options. The customer can pay $240,000 when the contract is signed or $300,000 in two years' time when the customer gains control of the printing machine. The interest rate implicit in the contract is 11·8% in order to adjust for the risk involved in the delay in payment. However, Tang's incremental borrowing rate is 5%. The customer paid $240,000 on 1 December 2014 when the contract was signed. (4 marks)

(ii) Tang enters into a contract on 1 December 2014 to construct a printing machine on a customer's premises for promised consideration of $1,500,000 with a bonus of $100,000 if the machine is completed within 24 months. At the inception of the contract, Tang correctly accounts for the promised bundle of goods and services as a single performance obligation in accordance with IFRS 15. At the inception of the contract, Tang expects the costs to be $800,000 and concludes that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will occur. Completion of the printing machine is highly susceptible to factors outside Tang's influence, mainly issues with the supply of components.

At 30 November 2015, Tang has satisfied 65% of its performance obligation on the basis of costs incurred to date and concludes that the variable consideration is still constrained in accordance with IFRS 15. However, on 4 December 2015, the contract is modified with the result that the fixed consideration and expected costs increase by $110,000 and $60,000 respectively. The time allowable for achieving the bonus is extended by six months with the result that Tang concludes that it is highly probable that the bonus will be achieved and that the contract still remains a single performance obligation. Tang has an accounting year end of 30 November. (6 marks)

Required:

Discuss how the above two contracts should be accounted for under IFRS 15. (In the case of (b)(i), the discussion should include the accounting treatment up to 30 November 2016 and in the case of (b)(ii), the accounting treatment up to 4 December 2015.)

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

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

(25 marks)

End of Question Paper