Professional Level – Essentials Module

Corporate Reporting (Irish)

Tuesday 9 December 2008

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 (IRL)

ACCA

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

1 The following draft group financial statements relate to Warrburt, a public limited company:

Warrburt Group: Balance sheet as at 30 November 2008

	30 Nov 2008 €m	30 Nov 2007 €m
Fixed assets		
Tangible assets	350	360
Goodwill	80	100
Other intangible assets	228	240
Investment in associate	100	–
Available-for-sale financial assets	142	150
	900	850
Current assets		
Stocks	135	198
Debtors	92	163
Cash at bank and in hand	312	323
	539	684
Creditors – amounts falling due within one year:		
Creditors	(115)	(180)
Current tax payable	(35)	(42)
Short term provisions	(5)	(4)
	(155)	(226)
Net current assets	384	458
Total assets less current liabilities	1,284	1,308
Creditors: amounts falling due after more than one year:		
Bank and other borrowings	(20)	(64)
Provisions for liabilities		
Deferred tax	(28)	(26)
Pension liability	(100)	(96)
	(148)	(186)
Net assets	1,136	1,122
Capital and reserves:		
Called up share capital	650	595
Other reserves	27	20
Profit and loss reserve	389	454
Total shareholders funds	1,066	1,069
Minority interests	70	53
Capital employed	1,136	1,122

Warrburt Group: Profit and loss account for the year ended 30 November 2008

	€m
Turnover	910
Cost of sales	(886)
Gross profit	24
Other income	31
Distribution costs	(40)
Administrative expenses	(35)
Group operating loss	(20)
Interest payable	(9)
Share of profit of associate	8
Loss on ordinary activities before tax	(21)
Tax on ordinary activities	(31)
Loss for the year on ordinary activities	(52)
Equity-minority interests	(22)
Loss for year	(74)

Statement of group total recognised gains and losses for year ended 30 November 2008

	€m	€m
Loss for financial year		(74)
Available-for-sale financial assets after tax	27	
Gains on property revaluation	4	
Actuarial losses on defined benefit plan	(6)	25
Total recognised losses for year		(49)

Reconciliation of movements in group shareholders funds for year ended 30 November 2008

	€m
Loss for financial year	(74)
Dividends	(9)
Other recognised gains and losses for year (above)	25
Proceeds of ordinary shares for cash	55
Net change in shareholders funds	(3)
Shareholders funds at 30 November 2007	1,069
Shareholders funds at 30 November 2008	1,066

The following information relates to the financial statements of Warrburt:

(i) Warrburt holds available-for-sale (AFS) financial assets which are owned by the holding company. The following schedule relates to those assets.

	€m
Balance 1 December 2007	150
Less sales of AFS financial assets at carrying value	(38)
Add gain on revaluation of AFS financial assets	30
	142

The sale proceeds of the AFS financial assets were €45 million. Profit on the sale of AFS financial assets is shown as 'other income' in the financial statements. The deferred tax arising on the revaluation gain of €3 million has been taken into account in arriving at the gain in the statement of group total recognised gains and losses for the year. Profit held in equity on the AFS financial assets that were sold of €24 million, has been transferred to profit and loss reserve.

(ii) The defined benefit liability is shown in provisions for liabilities in the Balance Sheet and comprises the following:

	€m
Liability at 1 December 2007	96
Expense in profit and loss account	8
Contributions to scheme (paid)	(10)
Actuarial losses	6
Liability at 30 November 2008	100

The benefits paid in the period by the trustees of the scheme were €3 million. There is no tax impact with regards to the defined benefit liability.

(iii) The tangible assets in the balance sheet comprise the following:

	€m
Carrying value at 1 December 2007	360
Additions at cost	78
Gains on property revaluation	4
Disposals	(56)
Depreciation	(36)
Carrying value at 30 November 2008	350

Plant and machinery with a carrying value of €1 million had been destroyed by fire in the year. The asset was replaced by the insurance company with new plant and machinery which was valued at €3 million. The machines were acquired directly by the insurance company and no cash payment was made to Warrburt. The company included the net gain on this transaction in 'additions at cost' and other income.

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

The remaining additions at cost comprised imported plant and machinery from an overseas supplier on 30 June 2008. The cost of the plant and machinery was 380 million dinars with 280 million dinars being paid on 31 October 2008 and the balance to be paid on 31 December 2008.

The rates of exchange were as follows:

	Dinars to €1
30 June 2008	5
31 October 2008	4·9
30 November 2008	4·8

Exchange gains and losses are included in administrative expenses.

(iv) Warrburt purchased a 25% interest in an associate for cash on 1 December 2007. The net assets of the associate at the date of acquisition were €300 million. The associate made a profit after tax of €24 million and paid a dividend of €8 million out of these profits in the year ended 30 November 2008. Assume a tax rate of 25%.

(v) An impairment test had been carried out at 30 November 2008, on goodwill and other intangible assets. The result showed that goodwill was impaired by €20 million and other intangible assets by €12 million. No additional amortisation had been charged in the period.

(vi) The short term provisions relate to finance costs which are payable within six months.

(vii) The movement on the profit and loss reserve and other reserves was as follows:

		Profit/loss reserve €m	Other reserves €m
Opening balance at 1 December 2007		454	20
Loss for financial year		(74)	
Available for sale financial assets	– net gain		27
	– transfer to profit/loss reserve	24	(24)
Gain on property revaluation			4
Dividends paid		(9)	
Actuarial loss on defined benefit scheme		(6)	
Closing balance at 30 November 2008		389	27

Warrburt's directors are concerned about the results for the year and the subsequent effect on the cash flow statement. They have suggested that the proceeds of the sale of tangible fixed assets and the sale of available-for-sale financial assets should be included in 'cash generated from operations'. The directors are afraid of an adverse market reaction to their results and of the importance of meeting targets in order to ensure job security, and feel that the adjustments for the proceeds would enhance the 'cash health' of the business.

Required:

(a) Prepare a group cash flow statement for Warrburt for the year ended 30 November 2008 in accordance with FRS1, 'Cash Flow Statements', using the indirect method. (35 marks)

(b) Discuss the key issues which the cash flow statement highlights regarding the cash flow of the company. (10 marks)

(c) Discuss the ethical responsibility of the company accountant in ensuring that manipulation of the cash flow statement, such as that suggested by the directors, does not occur. (5 marks)

Note: requirements (b) and (c) include 2 professional marks in total for the quality of the discussion.

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Marrgrett, a public limited company, is currently planning to acquire and sell interests in other entities and has asked for advice on the impact of FRS 2 'Accounting for Subsidiary Undertakings', FRS 7 'Fair values in Acquisition Accounting', FRS 10 'Goodwill and intangible assets' and any other relevant standards on these plans.

The company is considering purchasing additional shares in an associate, Josey, a public limited company. The holding will increase from 30% stake to 70% stake by offering the shareholders of Josey, cash and shares in Marrgrett. Marrgrett anticipates that it will pay €5 million in transaction costs to lawyers and bankers including the costs of raising capital for the acquisition. Josey had previously been the subject of a management buyout. In order that the current management shareholders may remain in the business, Marrgrett is going to offer them share options in Josey subject to them remaining in employment for two years after the acquisition. Additionally, Marrgrett will offer the same shareholders shares in the holding company which are contingent upon a certain level of profitability being achieved by Josey. Each shareholder will receive shares of the holding company up to a value of €50,000, if Josey achieves a pre-determined rate of return on capital employed for the next two years.

Josey has several marketing-related intangible assets that are used primarily in marketing or promotion of its products. These include trade names and internet domain names. These are not currently recognised in Josey's financial statements. Josey operates in a country where depreciation is calculated in accordance with local tax law rather than by reference to the estimated useful life of the fixed assets. Because of its plans to change the overall structure of the business, Marrgrett wishes to recognise a re-organisation provision at the date of the business combination and has assigned provisional values to some of the assets of Josey.

To finance the acquisition of Josey, Marrgrett intends to dispose of a partial interest in two subsidiaries. Marrgrett will retain control of the first subsidiary but will sell the apparent controlling interest in the second subsidiary, Wells, a public limited company. Marrgrett decided to dispose of Wells, partially to its management. The group will retain 45% of the ordinary shares, management will have 35% of the ordinary shares and other shareholders will hold 20%. All shareholders will hold share options which are convertible into ordinary shares. The options are held in the same proportion as the ordinary shares. Management's options are only convertible if certain profit targets are met. The remainder are convertible after three years.

Required:

Discuss the principles and nature of the accounting treatment of the above plans under Financial Reporting Standards.

Note: this requirement includes 2 professional marks for the quality of the discussion.

(25 marks)

3 Johan, a public limited company, operates in the telecommunications industry. The industry is capital intensive with heavy investment in licences and network infrastructure. Competition in the sector is fierce and technological advances are a characteristic of the industry. Johan has responded to these factors by offering incentives to customers and, in an attempt to acquire and retain them, Johan purchased a telecom licence on 1 December 2006 for €120 million. The licence has a term of six years and cannot be used until the network assets and infrastructure are ready for use. The related network assets and infrastructure became ready for use on 1 December 2007. Johan could not operate in the country without the licence and is not permitted to sell the licence. Johan expects its subscriber base to grow over the period of the licence but is disappointed with its market share for the year to 30 November 2008. The licence agreement does not deal with the renewal of the licence but there is an expectation that the regulator will grant a single renewal for the same period of time as long as certain criteria regarding network build quality and service quality are met. Johan has no experience of the charge that will be made by the regulator for the renewal but other licences have been renewed at a nominal cost. The licence is currently stated at its original cost of €120 million in the balance sheet under fixed assets.

Johan is considering extending its network and has carried out a feasibility study during the year to 30 November 2008. The design and planning department of Johan has identified five possible geographical areas for the extension of its network. The internal costs of this study were €150,000 and the external costs were €100,000 during the year to 30 November 2008. Following the feasibility study, Johan chose a geographical area where it was going to install a base station for the telephone network. The location of the base station is dependent upon getting planning permission. A further independent study was carried out by third party consultants to provide a preferred location in the area, as there is a need for the optimal operation of the network in terms of signal quality and coverage. Johan proposes to build a base station on the recommended site on which planning permission has been obtained. The third party consultants have charged €50,000 for the study. Additionally Johan has paid €300,000 as a single payment together with €60,000 a month to the government of the region for access to the land upon which the base station will be situated. The contract with the government is for a period of 12 years and commenced on 1 November 2008. There is no right of renewal of the contract and legal title to the land remains with the government.

Johan purchases telephone handsets from a manufacturer for €200 each, and sells the handsets direct to customers for €150 if they purchase call credit (call card) in advance on what is called a prepaid phone. The costs of selling the handset are estimated at €1 per set. The customers using a prepaid phone pay €21 for each call card at the purchase date. Call cards expire six months from the date of first sale. There is an average unused call credit of €3 per card after six months and the card is activated when sold.

Johan also sells handsets to dealers for €150 and invoices the dealers for those handsets. The dealer can return the handset up to a service contract being signed by a customer. When the customer signs a service contract, the customer receives the handset free of charge. Johan allows the dealer a commission of €280 on the connection of a customer and the transaction with the dealer is settled net by a payment of €130 by Johan to the dealer being the cost of the handset to the dealer (€150) deducted from the commission (€280). The handset cannot be sold separately by the dealer and the service contract lasts for a 12 month period. Dealers do not sell prepaid phones, and Johan receives monthly revenue from the service contract.

The managing director, a non-accountant, has asked for an explanation of the accounting principles and practices which should be used to account for the above events.

Required:

Discuss the principles and practices which should be used in the financial year to 30 November 2008 to account for:

(a) the licences; (8 marks)

(b) the costs incurred in extending the network; (7 marks)

(c) the purchase of handsets and the recognition of revenue from customers and dealers. (8 marks)

Appropriateness and quality of discussion. (2 marks)

(25 marks)

4 Whilst acknowledging the importance of high quality corporate reporting, the recommendations to improve it are sometimes questioned on the basis that the marketplace for capital can determine the nature and quality of corporate reporting. It could be argued that additional accounting and disclosure standards would only distort a market mechanism that already works well and would add costs to the reporting mechanism, with no apparent benefit. It could be said that accounting standards create costly, inefficient, and unnecessary regulation. It could be argued that increased disclosure reduces risks and offers a degree of protection to users. However, increased disclosure has several costs to the preparer of financial statements.

Required:

(a) Explain why accounting standards are needed to help the market mechanism work effectively for the benefit of preparers and users of corporate reports. (9 marks)

(b) Discuss the relative costs to the preparer and benefits to the users of financial statements of increased disclosure of information in financial statements. (14 marks)

Quality of discussion and reasoning. (2 marks)

(25 marks)

End of Question Paper