Professional Level – Essentials Module

Corporate Reporting (Irish)

Tuesday 15 December 2009

Paper P2 (IRL)

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 Grange, a public limited company, operates in the manufacturing sector. The draft balance sheets of the group companies are as follows at 30 November 2009:

	Grange €m	Park €m	Fence €m
Fixed assets:			
Tangible assets	251	311	238
Investments in subsidiaries			
Park	340		
Fence	134		
Investment in Sitin	16		
	741	311	238
Current assets	481	304	141
Creditors: amounts falling due within one year			
Trade creditors	(178)	(71)	(105)
Provisions for liabilities	(10)	(6)	(4)
	(188)	(77)	(109)
Net current assets	293	227	32
Total assets less current liabilities	1,034	538	270
Creditors: amounts falling due after more than one year	(172)	(124)	(38)
Net assets	862	414	232
Capital and reserves			
Called up share capital	430	230	150
Profit and loss reserve	410	170	65
Other reserves	22	14	17
Capital employed	862	414	232

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

(i) On 1 June 2008, Grange acquired 60% of the equity interests of Park, a public limited company. The purchase consideration comprised cash of €250 million. Excluding the franchise referred to below, the fair value of the identifiable net assets was €360 million. The excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

Park held a franchise right, which at 1 June 2008 had a fair value of €10 million. This had not been recognised in the financial statements of Park. The franchise agreement had a remaining term of five years to run at that date and is not renewable. Park still holds this franchise right at the year-end.

The profit and loss reserve of Park was €115 million and other reserves were €10 million at the date of acquisition.

Grange acquired a further 20% interest in Park on 30 November 2009 for a cash consideration of €90 million when the fair value of the net assets of Park was not materially different from their book value. Group policy is not to amortise goodwill but to annually impairment test. There has been no impairment of goodwill to date.

(ii) On 31 July 2008, Grange acquired a 100% of the equity interests of Fence for a cash consideration of €214 million. The identifiable net assets of Fence had a provisional fair value of €202 million, including any contingent liabilities. At the time of the business combination, Fence had a contingent liability with a fair value of €30 million. At 30 November 2009, the contingent liability met the recognition criteria of FRS12 '*Provisions, contingent liabilities and contingent assets'* and the revised estimate of the fair value of this liability was €25 million. The accountant of Fence is yet to account for this revised liability.

Grange had not completed the valuation of an element of fixed assets of Fence at 31 July 2008 and the valuation was not completed by 30 November 2008. The valuation was received on 30 June 2009 and the excess of the fair value over book value at the date of acquisition was estimated at €4 million. The asset had a useful economic life of 10 years at 31 July 2008.

The profit and loss reserve of Fence was €73 million and other reserves were €9 million at 31 July 2008 before any adjustment for the contingent liability.

On 30 November 2009, Grange disposed of 25% of its equity interest in Fence for a consideration of €80 million. The disposal proceeds had been credited to the cost of the investment in the balance sheet.

(iii) On 30 June 2008, Grange had acquired a 100% interest in Sitin, a public limited company for a cash consideration of €39 million. Sitin's identifiable net assets were fair valued at €32 million.

On 30 November 2009, Grange disposed of 60% of the equity of Sitin when its identifiable net assets were €36 million. Of the increase in net assets, €3 million had been reported in the profit and loss account and €1 million had been reported in the Statement of Recognised Gains and Losses as profit on an available-for-sale asset. The sale proceeds were €23 million. Grange could still exert significant influence after the disposal of the interest. The only accounting entry made in Grange's financial statements was to increase cash and reduce the cost of the investment in Sitin.

(iv) Grange acquired a plot of land on 1 December 2008 in an area where the land is expected to rise significantly in value if plans for regeneration go ahead in the area. The land is currently held at cost of €6 million in fixed assets until Grange decides what should be done with the land. The market value of the land at 30 November 2009 was €8 million but as at 15 December 2009, this had reduced to €7 million as there was some uncertainty surrounding the viability of the regeneration plan.

(v) Grange anticipates that it will be fined €1 million by the local regulator for environmental pollution. It also anticipates that it will have to pay compensation to local residents of €6 million although this is only the best estimate of that liability. In addition, the regulator has requested that certain changes be made to the manufacturing process in order to make the process more environmentally friendly. This is anticipated to cost the company €4 million.

(vi) Grange has a property located in a foreign country, which was acquired at a cost of 8 million dinars on 30 November 2008 when the exchange rate was €1 = 2 dinars. At 30 November 2009, the property was revalued to 12 million dinars. The exchange rate at 30 November 2009 was €1 = 1·5 dinars. The property was being carried at its value as at 30 November 2008. The company policy is to revalue property whenever material differences exist between book and fair value. Depreciation on the property can be assumed to be immaterial.

(vii) Grange has prepared a plan for reorganising the parent company's own operations. The board of directors has discussed the plan but further work has to be carried out before they can approve it. However, Grange has made a public announcement as regards the reorganisation and wishes to make a reorganisation provision at 30 November 2009 of €30 million. The plan will generate cost savings. The directors have calculated the value in use of the net assets of the parent company as being €870 million if the reorganisation takes place and €830 million if the reorganisation does not take place. Grange is concerned that the parent company's fixed assets have lost value during the period because of a decline in property prices in the region and feel that any impairment charge would relate to these assets. There is no reserve within other reserves relating to prior revaluation of these fixed assets.

(viii) Grange uses accounting policies which maximise its return on capital employed. The directors of Grange feel that they are acting ethically in using this approach as they feel that as long as they follow 'professional rules', then there is no problem. They have adopted a similar philosophy in the way they conduct their business affairs. The finance director had recently received information that one of their key customers, Brook, a public limited company, was having serious liquidity problems. This information was received from a close friend who was employed by Brook. However, he also learned that Brook had approached a rival company, Field, a public limited company, for credit and knew that if Field granted Brook credit then there was a high probability that the outstanding balance owed by Brook to Grange would be paid. Field had approached the director for an informal credit reference for Brook who until recently had always paid promptly. The director was intending to give Brook a good reference because of its recent prompt payment history as the director felt that there was no obligation or rule which required him to mention the company's liquidity problems. (There is no change required to the financial statements as a result of the above information.)

Required:

(a) Calculate the gain or loss arising on the disposal of the equity interest in Sitin. (6 marks)

(b) Prepare a consolidated balance sheet of the Grange Group at 30 November 2009 in accordance with RoI Financial Reporting Standards. (35 marks)

(c) Discuss the view that ethical behaviour is simply a matter of compliance with professional rules setting out whether the finance director simply had to consider 'rules' when determining whether to give Brook a good credit reference. (7 marks)

Professional marks will be awarded in part (c) for clarity and expression. (2 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 **(a)** Key, a public limited company, is concerned about the reduction in the general availability of credit and the sudden tightening of the conditions required to obtain a loan from banks. There has been a reduction in credit availability and a rise in interest rates. It seems as though there has ceased to be a clear relationship between interest rates and credit availability, and lenders and investors are seeking less risky investments. The directors are trying to determine the practical implications for the financial statements particularly because of large write downs of assets in the banking sector, tightening of credit conditions, and falling sales and asset prices. They are particularly concerned about the impairment of assets and the market inputs they use in impairment testing. They are afraid that they may experience significant impairment charges in the coming financial year. They are unsure as to how they should test for impairment and any considerations, which should be taken into account.

Required:

Discuss the main considerations that the company should take into account when impairment testing fixed assets in the above economic climate. (8 marks)

Professional marks will be awarded in part (a) for clarity and expression. (2 marks)

(b) Additionally there are specific assets on which the company wishes to seek advice. The company holds certain fixed assets, which are in a development area and carried at cost less depreciation. These assets cost €3 million on 1 June 2008 and are depreciated on the straight-line basis over their useful life of five years. An impairment review was carried out on 31 May 2009 and the projected cash flows relating to these assets were as follows:

Year to	**31 May 2010**	**31 May 2011**	**31 May 2012**	**31 May 2013**
Cash flows (€000)	280	450	500	550

The company used a discount rate of 5%. At 30 November 2009, the directors used the same cash flow projections and noticed that the resultant value in use was above the carrying amount of the assets and wished to reverse any impairment loss calculated at 31 May 2009. The government has indicated that it may compensate the company for any loss in value of the assets up to 20% of the impairment loss.

Key holds a fixed asset, which was purchased for €10 million on 1 December 2006 with an expected useful life of 10 years. On 1 December 2008, it was revalued to €8·8 million. At 30 November 2009, the asset was reviewed for impairment as a result of current conditions and written down to its recoverable amount of €5·5 million.

Key committed itself at the beginning of the financial year to selling a subsidiary that was underperforming following the economic downturn. As a result of the economic downturn, the subsidiary was not sold by the end of the year. However, shortly after the year-end, the company accepted an offer to sell the subsidiary for €15 million. There is no binding sale agreement. The net assets and purchased goodwill of the subsidiary were €17 million and €3 million respectively at 30 November 2009 and it is assumed that the subsidiary makes neither profit nor loss to any subsequent date of disposal.

Required:

Discuss with suitable computations, how to account for any potential impairment of the above assets in the financial statements for the year ended 30 November 2009. (15 marks)

Note: The following discount factors may be relevant

Year 1	0·9524
Year 2	0·9070
Year 3	0·8638
Year 4	0·8227

(25 marks)

3 Burley, a public limited company, operates in the energy industry. It has entered into several arrangements with other entities as follows:

(i) Burley and Slite, a public limited company, jointly control an oilfield. Burley has a 60% interest and Slite a 40% interest and the companies are entitled to extract oil in these proportions. An agreement was signed on 1 December 2008, which allowed for the net cash settlement of any over/under extraction by one company. The net cash settlement would be at the market price of oil at the date of settlement. Both parties have used this method of settlement before. 200,000 barrels of oil were produced up to 1 October 2009 but none were produced after this up to 30 November 2009 due to production difficulties. The oil was all sold to third parties at €100 per barrel. Burley has extracted 10,000 barrels more than the company's quota and Slite has under extracted by the same amount. The market price of oil at the year-end of 30 November 2009 was €105 per barrel. The excess oil extracted by Burley was settled on 12 December 2009 under the terms of the agreement at €95 per barrel.

Burley had purchased oil from another supplier because of the production difficulties at €98 per barrel and has oil stock of 5,000 barrels at the year-end, purchased from this source. Slite had no stock of oil. Neither company had oil stock at 1 December 2008. Selling costs are €2 per barrel.

Burley wishes to know how to account for the recognition of revenue, the excess oil extracted and the oil stock at the year-end. (10 marks)

(ii) Burley also entered into an agreement with Jorge, and Heavy, both public limited companies on 1 December 2008. Each of the companies holds one third of the equity in an entity, Wells, a public limited company, which operates off shore oilrigs. Any decisions regarding the operating and financial policies relating to Wells have to be approved by two thirds of the venturers. Burley wants to account for the interest in the entity by using the gross equity method, and wishes advice on the matter.

The oilrigs of Wells started operating on 1 December 1998 and are measured at cost. The useful life of the rigs is 40 years. The initial cost of the rigs was €240 million, which included decommissioning costs (discounted) of €20 million. At 1 December 2008, the carrying amount of the decommissioning liability has grown to €32·6 million, but the net present value of decommissioning liability has decreased to €18·5 million as a result of the increase in the risk-adjusted discount rate from 5% to 7%. Burley is unsure how to account for the oilrigs in the financial statements of Wells for the year ended 30 November 2009.

Burley owns a 10% interest in a pipeline, which is used to transport the oil from the offshore oilrig to a refinery on the land. Burley has joint control over the pipeline and has to pay its share of the maintenance costs. Burley has the right to use 10% of the capacity of the pipeline. Burley wishes to show the pipeline as an investment in its financial statements to 30 November 2009. (9 marks)

(iii) Burley has purchased a transferable interest in an oil exploration licence. Initial surveys of the region designated for exploration indicate that there are substantial oil deposits present but further surveys will be required in order to establish the nature and extent of the deposits. Burley also has to determine whether the extraction of the oil is commercially viable. Past experience has shown that the licence can increase substantially in value if further information as to the viability of the extraction of the oil becomes available. Burley wishes to capitalise the cost of the licence but is unsure as to whether the accounting policy is compliant with RoI Financial Reporting Standards. (4 marks)

Required:

Discuss with suitable computations where necessary, how the above arrangements and events would be accounted for in the financial statements of Burley.

Professional marks will be awarded in question 3 for clarity and expression. (2 marks)

(25 marks)

4 The definition of a financial instrument captures a wide variety of assets and liabilities including cash, evidence of an ownership interest in an entity, or a contractual right to receive, or deliver cash or another financial instrument. Preparers, auditors and users of financial statements have found the requirements for reporting financial assets and liabilities to be very complex, problematical and sometimes subjective. The result is that there is a need to develop new standards of reporting for financial instruments that are principle-based and significantly less complex than current requirements. It is important that a standard in this area should allow users to understand the economic substance of the transaction and preparers to properly apply generally accepted accounting principles.

Required:

(a) (i) Discuss how the measurement of financial instruments under RoI Financial Reporting Standards can create confusion and complexity for preparers and users of financial statements. (9 marks)

(ii) Set out the reasons why using fair value to measure all financial instruments may result in less complexity in the application of FRS 26 '*Financial Instruments: recognition and measurement*' but may lead to uncertainty in financial statements. (9 marks)

Professional marks will be awarded in part (a) for clarity and expression. (2 marks)

(b) A company borrowed €47 million on 1 December 2008 when the market and effective interest rate was 5%. On 30 November 2009, the company borrowed an additional €45 million when the current market and effective interest rate was 7·4%. Both financial liabilities are repayable on 30 November 2013 and are single payment notes whereby interest and capital are repaid on that date.

Required:

Discuss the accounting for the above financial liabilities under current accounting standards using amortised cost, and additionally using fair value as at 30 November 2009.

(5 marks)

(25 marks)

End of Question Paper