Professional Level – Essentials Module

# Corporate Reporting (United Kingdom)

Tuesday 10 June 2014

Paper P2 (UK)

**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** The following draft financial statements relate to Marchant, a public limited company.

**Marchant Group: Draft statements of profit or loss and other comprehensive income for the year ended 30 April 2014.**

| | Marchant | Nathan | Option |
|---|---|---|---|
| | $m | $m | $m |
| Revenue | 400 | 115 | 70 |
| Cost of sales | (312) | (65) | (36) |
| Gross profit | 88 | 50 | 34 |
| Other income | 21 | 7 | 2 |
| Administrative costs | (15) | (9) | (12) |
| Other expenses | (35) | (19) | (8) |
| Operating profit | 59 | 29 | 16 |
| Finance costs | (5) | (6) | (4) |
| Finance income | 6 | 5 | 8 |
| Profit before tax | 60 | 28 | 20 |
| Income tax expense | (19) | (9) | (5) |
| Profit for the year | 41 | 19 | 15 |
| Other comprehensive income – revaluation surplus | 10 | | |
| Total comprehensive income for year | 51 | 19 | 15 |

The following information is relevant to the preparation of the group statement of profit or loss and other comprehensive income:

1. On 1 May 2012, Marchant acquired 60% of the equity interests of Nathan, a public limited company. The purchase consideration comprised cash of $80 million and the fair value of the identifiable net assets acquired was $110 million at that date. The fair value of the non-controlling interest (NCI) in Nathan was $45 million on 1 May 2012. Marchant wishes to use the 'full goodwill' method for all acquisitions. The share capital and retained earnings of Nathan were $25 million and $65 million respectively and other components of equity were $6 million at the date of acquisition. The excess of the fair value of the identifiable net assets at acquisition is due to non-depreciable land.

   Goodwill has been impairment tested annually and as at 30 April 2013 had reduced in value by 20%. However at 30 April 2014, the impairment of goodwill had reversed and goodwill was valued at $2 million above its original value. This upward change in value has already been included in above draft financial statements of Marchant prior to the preparation of the group accounts.

2. Marchant disposed of an 8% equity interest in Nathan on 30 April 2014 for a cash consideration of $18 million and had accounted for the gain or loss in other income. The carrying value of the net assets of Nathan at 30 April 2014 was $120 million before any adjustments on consolidation. Marchant accounts for investments in subsidiaries using IFRS 9 *Financial Instruments* and has made an election to show gains and losses in other comprehensive income. The carrying value of the investment in Nathan was $90 million at 30 April 2013 and $95 million at 30 April 2014 before the disposal of the equity interest.

3. Marchant acquired 60% of the equity interests of Option, a public limited company, on 30 April 2012. The purchase consideration was cash of $70 million. Option's identifiable net assets were fair valued at $86 million and the NCI had a fair value of $28 million at that date. On 1 November 2013, Marchant disposed of a 40% equity interest in Option for a consideration of $50 million. Option's identifiable net assets were $90 million and the value of the NCI was $34 million at the date of disposal. The remaining equity interest was fair valued at $40 million. After the disposal, Marchant exerts significant influence. Any increase in net assets since acquisition has been reported in profit or loss and the carrying value of the investment in Option had not changed since acquisition. Goodwill had been impairment tested and no impairment was required. No entries had been made in the financial statements of Marchant for this transaction other than for cash received.

4. Marchant sold inventory to Nathan for $12 million at fair value. Marchant made a loss on the transaction of $2 million and Nathan still holds $8 million in inventory at the year end.

5. The following information relates to Marchant's pension scheme:

| | $m |
|---|---|
| Plan assets at 1 May 2013 | 48 |
| Defined benefit obligation at 1 May 2013 | 50 |
| Service cost for year ended 30 April 2014 | 4 |
| Discount rate at 1 May 2013 | 10% |
| Re-measurement loss in year ended 30 April 2014 | 2 |
| Past service cost 1 May 2013 | 3 |

   The pension costs have not been accounted for in total comprehensive income.

6. On 1 May 2012, Marchant purchased an item of property, plant and equipment for $12 million and this is being depreciated using the straight line basis over 10 years with a zero residual value. At 30 April 2013, the asset was revalued to $13 million but at 30 April 2014, the value of the asset had fallen to $7 million. Marchant uses the revaluation model to value its non-current assets. The effect of the revaluation at 30 April 2014 had not been taken into account in total comprehensive income but depreciation for the year had been charged.

7. On 1 May 2012, Marchant made an award of 8,000 share options to each of its seven directors. The condition attached to the award is that the directors must remain employed by Marchant for three years. The fair value of each option at the grant date was $100 and the fair value of each option at 30 April 2014 was $110. At 30 April 2013, it was estimated that three directors would leave before the end of three years. Due to an economic downturn, the estimate of directors who were going to leave was revised to one director at 30 April 2014. The expense for the year as regards the share options had not been included in profit or loss for the current year and no directors had left by 30 April 2014.

8. A loss on an effective cash flow hedge of Nathan of $3 million has been included in the subsidiary's finance costs.

9. Ignore the taxation effects of the above adjustments unless specified. Any expense adjustments should be amended in other expenses.

**Required:**

**(a)** **(i)** **Prepare a consolidated statement of profit or loss and other comprehensive income for the year ended 30 April 2014 for the Marchant Group.** (30 marks)

**(ii)** **Explain, with suitable calculations, how the sale of the 8% interest in Nathan should be dealt with in the group statement of financial position at 30 April 2014.** (5 marks)

**(b)** Marchant has carried out impairment reviews of goodwill annually and has recorded the reversal of the impairment of goodwill, reflecting this in profit or loss. Two of the directors of Marchant are qualified accountants who were trained in the use of UK GAAP and are still finding it difficult to understand the key differences between UK GAAP and IFRS, particularly in this area.

**Required:**

**Explain the key differences between UK GAAP and IFRS as regards (i) the recognition of reversals of impairments of intangible assets and (ii) the recognition of intangible assets generally.** (9 marks)

**(c)** Marchant plans to update its production process and the directors feel that technology-led production is the only feasible way in which the company can remain competitive. Marchant operates from a leased property and the leasing arrangement was established in order to maximise taxation benefits. However, the financial statements have not shown a lease asset or liability to date.

A new financial controller joined Marchant just after the financial year end of 30 April 2014 and is presently reviewing the financial statements to prepare for the upcoming audit and to begin making a loan application to finance the new technology. The financial controller feels that the lease relating to both the land and buildings should be treated as a finance lease but the finance director disagrees. The finance director does not wish to recognise the lease in the statement of financial position and therefore wishes to continue to treat it as an operating lease. The finance director feels that the lease does not meet the criteria for a finance lease and it was made clear by the finance director that showing the lease as a finance lease could jeopardise the loan application.

**Required:**

**Discuss the ethical and professional issues which face the financial controller in the above situation.**

(6 marks)

**(50 marks)**

**Section B – TWO questions ONLY to be attempted**

**2** Aspire, a public limited company, operates many of its activities overseas. The directors have asked for advice on the correct accounting treatment of several aspects of Aspire's overseas operations. Aspire's functional currency is the dollar.

**(a)** Aspire has created a new subsidiary, which is incorporated in the same country as Aspire. The subsidiary has issued 2 million dinars of equity capital to Aspire, which paid for these shares in dinars. The subsidiary has also raised 100,000 dinars of equity capital from external sources and has deposited the whole of the capital with a bank in an overseas country whose currency is the dinar. The capital is to be invested in dinar denominated bonds. The subsidiary has a small number of staff and its operating expenses, which are low, are incurred in dollars. The profits are under the control of Aspire. Any income from the investment is either passed on to Aspire in the form of a dividend or reinvested under instruction from Aspire. The subsidiary does not make any decisions as to where to place the investments.

Aspire would like advice on how to determine the functional currency of the subsidiary. (7 marks)

**(b)** Aspire has a foreign branch which has the same functional currency as Aspire. The branch's taxable profits are determined in dinars. On 1 May 2013, the branch acquired a property for 6 million dinars. The property had an expected useful life of 12 years with a zero residual value. The asset is written off for tax purposes over eight years. The tax rate in Aspire's jurisdiction is 30% and in the branch's jurisdiction is 20%. The foreign branch uses the cost model for valuing its property and measures the tax base at the exchange rate at the reporting date.

Aspire would like an explanation (including a calculation) as to why a deferred tax charge relating to the asset arises in the group financial statements for the year ended 30 April 2014 and the impact on the financial statements if the tax base had been translated at the historical rate. (6 marks)

**(c)** On 1 May 2013, Aspire purchased 70% of a multi-national group whose functional currency was the dinar. The purchase consideration was $200 million. At acquisition, the net assets at cost were 1,000 million dinars. The fair values of the net assets were 1,100 million dinars and the fair value of the non-controlling interest was 250 million dinars. Aspire uses the full goodwill method.

Aspire wishes to know how to deal with goodwill arising on the above acquisition in the group financial statements for the year ended 30 April 2014. (5 marks)

**(d)** Aspire took out a foreign currency loan of 5 million dinars at a fixed interest rate of 8% on 1 May 2013. The interest is paid at the end of each year. The loan will be repaid after two years on 30 April 2015. The interest rate is the current market rate for similar two-year fixed interest loans.

Aspire requires advice on how to account for the loan and interest in the financial statements for the year ended 30 April 2014. (5 marks)

Aspire has a financial statement year end of 30 April 2014 and the average currency exchange rate for the year is not materially different from the actual rate.

| Exchange rates | $1 = dinars |
|---|---|
| 1 May 2013 | 5 |
| 30 April 2014 | 6 |
| Average exchange rate for year ended 30 April 2014 | 5·6 |

**Required:**

**Advise the directors of Aspire on their various requests above, showing suitable calculations where necessary.**

**Note: The mark allocation is shown against each of the four issues above.**

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

**(25 marks)**

**3 (a)** Minco is a major property developer which buys land for the construction of housing. One aspect of its business is to provide low-cost homes through the establishment of a separate entity, known as a housing association. Minco purchases land and transfers ownership to the housing association before construction starts. Minco sells rights to occupy the housing units to members of the public but the housing association is the legal owner of the building. The housing association enters into loan agreements with the bank to cover the costs of building the homes. However, Minco negotiates and acts as guarantor for the loan, and bears the risk of increases in the loan's interest rate above a specified rate. Currently, the housing rights are normally all sold on completion of a project.

Minco enters into discussions with a housing contractor regarding the construction of the housing units but the agreement is between the housing association and the contractor. Minco is responsible for any construction costs in excess of the amount stated in the contract and is responsible for paying the maintenance costs for any units not sold. Minco sets up the board of the housing association, which comprises one person representing Minco and two independent board members.

Minco recognises income for the entire project when the land is transferred to the housing association. The income recognised is the difference between the total sales price for the finished housing units and the total estimated costs for construction of the units. Minco argues that the transfer of land represents a sale of goods which fulfils the revenue recognition criteria in IAS 18 *Revenue*. (7 marks)

**(b)** Minco often sponsors professional tennis players in an attempt to improve its brand image. At the moment, it has a three-year agreement with a tennis player who is currently ranked in the world's top ten players. The agreement is that the player receives a signing bonus of $20,000 and earns an annual amount of $50,000, paid at the end of each year for three years, provided that the player has competed in all the specified tournaments for each year. If the player wins a major tournament, she receives a bonus of 20% of the prize money won at the tournament. In return, the player is required to wear advertising logos on tennis apparel, play a specified number of tournaments and attend photo/film sessions for advertising purposes. The different payments are not interrelated. (5 marks)

**(c)** Minco leased its head office during the current accounting period and the agreement terminates in six years' time. There is a clause in the operating lease relating to the internal condition of the property at the termination of the lease. The clause states that the internal condition of the property should be identical to that at the outset of the lease. Minco has improved the building by adding another floor to part of the building during the current accounting period. There is also a clause which enables the landlord to recharge Minco for costs relating to the general disrepair of the building at the end of the lease. In addition, the landlord can recharge any costs of the repairing the roof immediately. The landlord intends to replace part of the roof of the building during the current period. (5 marks)

**(d)** Minco acquired a property for $4 million and annual depreciation of $300,000 is charged on the straight line basis. At the end of the previous financial year of 31 May 2013, when accumulated depreciation was $1 million, a further amount relating to an impairment loss of $350,000 was recognised, which resulted in the property being valued at its estimated value in use. On 1 October 2013, as a consequence of a proposed move to new premises, the property was classified as held for sale. At the time of classification as held for sale, the fair value less costs to sell was $2·4 million. At the date of the published interim financial statements, 1 December 2013, the property market had improved and the fair value less costs to sell was reassessed at $2·52 million and at the year end on 31 May 2014 it had improved even further, so that the fair value less costs to sell was $2·95 million. The property was sold on 5 June 2014 for $3 million. (6 marks)

**Required:**

**Discuss how the above items should be dealt with in the financial statements of Minco.**

**Note: The mark allocation is shown against each of the four issues above.**

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

**(25 marks)**

**4 (a)** The difference between debt and equity in an entity's statement of financial position is not easily distinguishable for preparers of financial statements. Some financial instruments may have both features, which can lead to inconsistency of reporting. The International Accounting Standards Board (IASB) has agreed that greater clarity may be required in its definitions of assets and liabilities for debt instruments. It is thought that defining the nature of liabilities would help the IASB's thinking on the difference between financial instruments classified as equity and liabilities.

**Required:**

**(i) Discuss the key classification differences between debt and equity under International Financial Reporting Standards.**

Note: Examples should be given to illustrate your answer. (9 marks)

**(ii) Explain why it is important for entities to understand the impact of the classification of a financial instrument as debt or equity in the financial statements.** (5 marks)

**(b)** The directors of Avco, a public limited company, are reviewing the financial statements of two entities which are acquisition targets, Cavor and Lidan.They have asked for clarification on the treatment of the following financial instruments within the financial statements of the entities.

Cavor has two classes of shares: A and B shares. A shares are Cavor's ordinary shares and are correctly classed as equity. B shares are not mandatorily redeemable shares but contain a call option allowing Cavor to repurchase them. Dividends are payable on the B shares if, and only if, dividends have been paid on the A ordinary shares. The terms of the B shares are such that dividends are initially payable at a rate equal to that of the A ordinary shares. Additionally, Cavor has also issued share options which give the counterparty rights to buy a fixed number of its B shares for a fixed amount of $10 million. The contract can be settled only by the issuance of shares for cash by Cavor.

Lidan has in issue two classes of shares: A shares and B shares. A shares are correctly classified as equity. Two million B shares of nominal value of $1 each are in issue. The B shares are redeemable in two years' time at the option of Lidan. Lidan has a choice as to the method of redemption of the B shares. It may either redeem the B shares for cash at their nominal value or it may issue one million A shares in settlement. A shares are currently valued at $10 per share. The lowest price for Lidan's A shares since its formation has been $5 per share.

**Required:**

**Discuss whether the above arrangements regarding the B shares of each of Cavor and Lidan should be treated as liabilities or equity in the financial statements of the respective issuing companies.** (9 marks)

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

**(25 marks)**

**End of Question Paper**