Professional Level – Essentials Module

Corporate Reporting (United Kingdom)

March/June 2018 – Sample Questions

P2 UK ACCA

Time allowed: 3 hours 15 minutes

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.

This question paper must not be removed from the examination hall.

Paper P2 (UK)

Think Ahead ACCA

The Association of Chartered Certified Accountants

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

1 (a) The following draft statements of financial position relate to Bread and its subsidiary Butter, both public listed entities, as at 31 December 2017.

	Bread	Butter
	$m	$m
Assets		
Non-current assets		
Property, plant and equipment	1,435	915
Intangible assets	435	70
Investments in		
Butter	1,000	
Jam	1,250	
	4,120	985
Current assets:	865	786
Total assets	4,985	1,771
Equity and liabilities		
Equity share capital ($1 each)	2,100	620
Retained earnings	1,555	482
Other components of equity	164	78
Total equity	3,819	1,180
Non-current liabilities	792	304
Current liabilities	374	287
Total liabilities	1,166	591
Total equity and liabilities	4,985	1,771

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

1. Bread acquired an 80% equity interest in Butter on 1 January 2014 for a consideration of $1,000 million. At this date the retained earnings and other components of equity were $344 million and $46 million respectively. The fair value of the identifiable net assets of Butter at 1 January 2014 was $1,070 million. The difference between the carrying amount and the fair value of the net assets at 1 January 2014 was due to unrecognised intangibles with a remaining useful life of five years. It is group policy to measure non-controlling interests using the proportional method of the fair value of the net assets.

   Goodwill has been reviewed annually for impairment and, as at 1 January 2016, none had occurred. The recoverable amount of the net assets of Butter at 31 December 2017 was estimated as $1,328 million.

2. Bread acquired all of the equity shares in Jam on 1 January 2015 for a consideration of $1,250 million. The carrying amount and fair value of the identifiable net assets at acquisition were $1,230 million. At 31 December 2017, Bread was in the process of selling its entire shareholding in Jam and so it was decided that Jam should be treated as a disposal group held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* at that date. The carrying amounts of Jam's net assets before classification as held for sale at 31 December 2017 in the individual financial statements are as follows:

	$m
Property, plant and equipment	836
Intangibles (excluding goodwill)	428
Current assets (at recoverable amount)	584
Non-current liabilities	(322)
Current liabilities	(254)
Total	1,272

The group has a policy of revaluing its property, plant and equipment in accordance with IAS 16 *Property, Plant and Equipment*. There have been no revaluations or any other gains or losses included within Jam's other components of equity since the date of acquisition as the carrying amount was deemed to be a close enough approximation to fair value. However, at 31 December 2017, property with a carrying amount of $330 million was deemed to have a fair value of $340 million. No adjustment has yet been made for this fair value.

The total fair value less costs to sell of the disposal group at 31 December was estimated to be $1,220 million. There have been no previous impairments to the goodwill of Jam.

3. Bread operates a defined benefit scheme which at 31 December 2016 was in deficit by $120 million. Details for the current year are as follows:

	$ millions
Current service cost	55
Cash contribution to scheme	100
Benefits paid in the year	80
Net loss on curtailment	11
Gain on remeasurement of liability at 31 December 2017	9

The rate of interest applicable to good quality corporate bonds was 5% at 31 December 2016. The cash contributions for the scheme have been correctly accounted for in the financial statements for the year ended 31 December 2017. This is the only adjustment which has been made in respect of the scheme.

4. On 1 January 2016, Bread gave 10,000 of its employees 200 share options each conditional that they worked for Bread for a further three years. During 2016, 980 employees left and a figure was correctly recorded in the financial statements of $3·9 million for the year ended 31 December 2016. During 2017, a further 950 employees left and it was estimated that 920 would leave in the following year. Details of the fair value of each option are given below.

1 January 2016	$8
31 December 2016	$9
31 December 2017	$10

Bread has not made any accounting entries in respect of the share option scheme for the year ended 31 December 2017.

5. Bread owns a 25% share in a manufacturing facility which had a total construction cost of $200 million and was completed and ready for use on 31 March 2017. The facility is expected to have a useful life of 20 years. All economic decisions concerning the facility require the unanimous consent of Bread and two other investors who own the remaining 75% of the facility. The investment in the manufacturing facility was correctly deemed to be a joint operation and trading from the facility started from 30 June 2017. Revenues earned from the facility for the period ended 31 December 2017 were $57 million. Production costs for goods sold and other operating costs were $36 million. Bread has not made any accounting entries for the year ended 31 December 2017 in relation to the facility, except for $50 million construction costs included within property, plant and equipment. It has been agreed that profits and losses should be split evenly across the three investors.

Required:

Prepare the consolidated statement of financial position of the Bread group for the year ended 31 December 2017. (35 marks)

(b) At 1 March 2018, Bread acquired 100% of the equity interests in an SME in exchange for cash of \$1 million. The fair value of the SME's identifiable net assets was calculated as \$1·2 million. At acquisition, the directors of the entity felt that the value of the identifiable assets was accurate but, three months later, are now reconsidering the fair value attributed to an item of plant. The plant was fair valued at \$200,000 but the directors have concluded that its fair value should have been \$180,000. Additionally, there is a contingent liability which is not capable of reliable measurement, but the directors estimated its value to be approximately \$300,000 at 1 March 2018. The price paid by the entity also reflected the fact that the SME is in need of restructuring but the conditions for recognising a restructuring provision have not been met. The directors estimate this provision to be \$100,000.

Required:

Advise the directors on whether any goodwill arises under IFRS for SMEs on the acquisition of the SME, and discuss whether there are any differences in the accounting treatment of the resulting figure between IFRS for SMEs and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

(6 marks)

(c) The Bread group has always measured the non-controlling interest using the proportional share of the fair value of the net assets method. Bread, Butter and Jam are all listed and therefore have readily ascertainable market value for their shares. The directors of Bread are contemplating changing their policy retrospectively to measuring the non-controlling interest at fair value as a reliable and fair calculation of the non-controlling interest is obtainable. They are therefore proposing that they analyse the impact of the alternative valuations of the non-controlling interest on a subsidiary by subsidiary basis for current group members and any proposed future acquisitions. They believe that it is the directors' responsibility to maximise the wealth of the entity's shareholders and intend to choose a valuation which will maximise profitability and equity. The directors of Bread have a history of changing accounting policies on a regular basis should they believe that it would have a positive impact on the financial statements.

Required:

Discuss whether the proposed change in accounting policy is permitted by International Accounting Standards and how it could impact on future group profitability ratios. Consider any ethical issues which may arise from the scenario. (9 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 (a) Spamgate is a financial institution which acts in the retail sector providing loans and mortgages to companies and individuals. This is its core business model and it seldom buys or sells financial assets. In January 2017, it provided a loan to Bosey, a public limited company, however, shortly after obtaining the loan, Bosey reported significant operating losses during the financial year ended 31 May 2017. Bosey has made unsuccessful attempts to attract new investors by offering them a low preference share subscription price. The poor liquidity position of Bosey has forced Spamgate to accept these preference shares in exchange for part of the loan. The preference share price used to calculate the exchange rate for the loans was three times higher than the subscription price for the unsuccessful share issue. Spamgate accounted for the exchange of its loan investments for preference shares in Bosey by reducing the carrying amount of the loans, and increasing the value of the investment in Bosey's shares. Spamgate intends to sell the preference shares held in Bosey as soon as it is feasible but does not consider this transaction to have changed its core business model.

In the year ended 31 May 2018, Spamgate has measured the loan to Bosey at amortised cost and the preference shares held in Bosey at fair value through other comprehensive income (FVOCI).

The directors of Spamgate would like advice on the measurement of the loan and preference shares held in Bosey and the accounting treatment of the share exchange in the year ended 31 May 2018. (9 marks)

(b) Spamgate also owns a majority holding in Manni, which operates in the gas industry. Spamgate holds the investment in Manni to generate cash flows through dividend payments. Manni has a contract for the storage of gas at a local facility. This contract expires in 2020. Manni has deemed the storage contract to be a single cash generating unit (CGU) which comprises several assets. The contract for gas storage has been recognised as an intangible asset at cost. The storage contract requires Manni to make regular rental payments irrespective of the use of the gas storage facility but, in the year ended 31 May 2018, Manni had not used the facility. It was unlikely that the gas storage facility would be used in the future but Manni will have to continue to make regular payments until 2020.

The directors intend to leave the gas storage contract as part of the assets of the CGU because they are worried about the potential impact on the financial statements if it is accounted for separately. The directors would like to know how the gas storage contract should be treated in the financial statements of Manni and whether it should remain allocated to the CGU. (6 marks)

Required:

Advise the directors of Spamgate on how each of the above issues should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards (IFRSs).

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

(c) Spamgate, whose functional currency is the dollar, also has a majority holding in Rooble, a small and medium sized entity, which operates in an overseas country. The country in which Rooble operates is currently suffering an economic crisis and has international sanctions on its trade. When compared to the dollar, the exchange rate in the country has dropped more than 35% in the current financial year. The inflation rate in the country is 12%. Rooble had started to build a commercial centre there but, because of the difficult economic environment, it had ceased the building work. However, the directors of Spamgate are currently negotiating the sale of the commercial centre on Rooble's behalf and anticipate that a significant profit will be made on the sale compared to its carrying amount. Rooble had suffered significant trading losses in its financial statements to 31 May 2018, which had led to negative equity and unused tax losses from trading. The tax losses can only be offset against profit arising from trading. Spamgate wishes to recognise a deferred tax asset in the financial statements of Rooble relating to the unused tax losses of the subsidiary.

Required:

Advise the directors of Spamgate as to the recognition of the deferred tax asset in the financial statements of Rooble under IFRS for SMEs and whether there would be any recognition difference under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. (8 marks)

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

(25 marks)

3 (a) Medsupply operates in the medical supply industry and has a financial year end of 31 May 2018. Medsupply sells technology needed to perform highly complex operations. When a hospital purchases equipment from Medsupply, it provides a very specialised piece of instrumentation, which is an integral part of the surgical process, free of charge.

The legal ownership of the instruments remains with Medsupply. The instruments are returned to Medsupply if they become faulty or at the end of their useful life, which is normally 1·5 years. At this point, Medsupply replaces them with new instruments but retains the right to be reimbursed if the instruments are not returned. The instruments are nearly always returned at the end of their useful life and disposed of as clinical waste.

The directors of Medsupply would like advice on the accounting treatment for the instruments loaned to hospitals. (8 marks)

(b) Medsupply imports medical equipment which is manufactured under a patent. It subsequently adapts the equipment to fit the market in its jurisdiction and sells the equipment under its own brand name. Medsupply originally spent $3 million in developing the know-how required to adapt the equipment and, in addition, it costs around $50,000 to adapt each piece of equipment. Medsupply has capitalised the cost of the know-how and also the cost of the adaptation of each piece of equipment sold, as patent rights.

Medsupply is being sued for patent infringement by Cosine, the owner of the original patent, on the grounds that Medsupply has not materially changed the original product by its subsequent adaptation. If Cosine is able to prove infringement, the court is likely to order Medsupply to pay damages and to stop infringing its patent. Medsupply's lawyers feel that the court could conclude that Cosine's patent claim is not valid. Cosine has sued Medsupply for $5 million for the use of a specific patent and an additional $8 million for lost profit due to Medsupply being a competitor in the market for this product. Medsupply has offered $7 million to settle both claims but has not received a response from Cosine. As a result, Medsupply feels that the damages which it faces will be between the amount offered by Medsupply and the amount claimed by Cosine.

The directors of Medsupply would like advice as to whether they have correctly accounted for the costs of the adaptation of the equipment and whether they should make a provision for the potential damages in the above legal case, in the financial statements for the year ended 31 May 2018. (9 marks)

(c) Medsupply conducts clinical trials to gain regulatory approvals for the development of its products. The majority of these clinical trials are carried out by contract research organisations (CRO). The CROs help with medical discovery, clinical development and commercialisation of products. The terms of the contracts require Medsupply to make advanced payments before the CROs will perform the clinical trial management services. These advance payments are normally non-refundable and made up to six months before the activity commences.

Medsupply has recently paid $4 million as an advanced payment to Clinical Unit Trials (CUT) who has been contracted to aid and support research in the field of tropical disease. They provide advice on the early development and design of research proposals. The research is to start in four months' time. In addition, Medsupply has received a non-refundable fee of $2 million as an advanced payment from a government department who has contracted with Medsupply to provide a vaccine in the same field of tropical disease. The contract has a total value of $10 million and the non-refundable fee of $2 million is not a government grant under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

The directors of Medsupply would like advice on the accounting treatment of the above advanced payments both made by and received by Medsupply. (6 marks)

Required:

Advise the directors of Medsupply on how each of the above issues should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards (IFRSs).

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

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

(25 marks)

4 Almost all assets and liabilities have some level of uncertainty relating to them. In the current *Conceptual Framework for Financial Reporting*, uncertainty is referred to in the definition of assets and liabilities and the recognition criteria. This is important because the way in which uncertainty is dealt with in International Financial Reporting Standards (IFRS) affects the definition, recognition, classification and disclosure of assets and liabilities.

IAS 1 *Presentation of Financial Statements* requires the disclosure of material uncertainties related to events and conditions which may cast doubt on the entity's ability to continue as a going concern. The International Accounting Standards Board (IASB) helps in this regard by further defining the nature of materiality in the *Conceptual Framework* and the Practice Statement, *Application of Materiality to Financial Statements*.

Required:

(a) Discuss the way in which uncertainty affects:

(i) the existence and recognition of assets and liabilities as defined in the *Conceptual Framework*.
(5 marks)

(ii) the definition, recognition, classification and disclosure criteria in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.
(5 marks)

(b) Discuss the nature of materiality and whether practising accountants will use similar principles as preparers of financial statements when making judgements in applying the concept of materiality to financial statements.
(6 marks)

(c) Lamyard operates in a jurisdiction which for many years has had a trade, tariff and legal agreement with other countries within the region. The jurisdiction has decided to break with the agreement and, as a result, there has been a devaluation of the currency of the jurisdiction. The National Bank has also revised down its forecasts for growth throughout the next two years and the stock markets have fallen significantly in value.

The directors of Lamyard want to know the potential effects on the financial statements of these uncertainties, particularly the disclosure of risks and the valuation of non-current assets.

In the year to 28 February 2018, Lamyard has undertaken a significant number of foreign currency transactions, the result of which is that the entity is disclosing a net foreign exchange gain of $1 million. The foreign exchange difference is made up of foreign exchange gains of $25 million and a single foreign exchange loss of $24 million which resulted from one speculative forward foreign exchange transaction. The directors of Lamyard feel that the disclosure of a foreign exchange gain of $1 million with no further detail complies with International Financial Reporting Standards and that there are no materiality issues involved in this disclosure.

Required:

Discuss the issues raised by the above events with reference to relevant International Financial Reporting Standards (IFRSs). (7 marks)

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

(25 marks)

End of Question Paper