

RELEVANT TO ACCA QUALIFICATION PAPER P2

Corporate reporting case studies

The quality of candidates' performance in the Paper P2, *Corporate Reporting* case study varies widely. Some clearly understand what is required of them, while others struggle – and it is often lack of technique, rather than a lack of technical knowledge, that undermines their answer.

This article attempts to give some advice on how to attempt the Paper P2 case study, and I have included an illustrative question example (see page 2) based on a past exam question.

Case study format

The examiner has 50 marks to play with, but tends to split the marks strictly between 35 marks for calculations and 15 marks for narrative. The usual format is:

- Part (a) – 35 marks for numbers
- Parts (b) and (c) – 15 marks for narrative.

The 35 marks for Part (a) are based around a group accounting problem, but the question will also draw from many other areas of the syllabus and certainly will not be exclusively groups.

You will see my answer in the following example on page 2 has almost no narrative. In an exam, where you have limited time to score as many of the 35 marks as you can, it's important to keep your number answer to the point.

The remaining 15 marks of narrative for Parts (b) and (c) are often the easiest part of the entire exam. The main reason that students score low in these is because they do not do them. This is presumably because they spend too long on Part (a), and so leave little time to attempt the narrative in Parts (b) and (c). Time management is vital in this exam, and you should allocate times to each part according to the number of marks on offer within that part.

Here is an example of a question and answer.

QUESTION

The following draft statements of financial positions relate to Rodders, a public limited company, Tommy, a limited company, and Jimmy, a limited company, as at 30 November:

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	<i>Rodders</i>	<i>Tommy</i>	<i>Jimmy</i>
	\$m	\$m	\$m
Non-current assets			
Property plant and equipment	1,800	406	250
Investment in Tommy	900	–	–
Investment in Jimmy	220	400	–
	2,920	806	250
Current assets			
Inventory	540	160	165
Trade receivables	140	150	140
Cash at bank	190	50	180
	870	360	485
Total assets	3,790	1,166	735
Equity			
Share capital	500	300	100
Share premium	300	100	50
Retained earnings	<u>2,630</u>	<u>676</u>	<u>525</u>
	3,430	1,076	675
Non-current liabilities	230	20	10
Current liabilities	<u>130</u>	<u>70</u>	<u>50</u>
Total equity and liabilities	3,790	1,166	735

It is the group's policy to value the non-controlling interest at fair value. The following information is relevant to the preparation of the group financial statements:

- (i) Rodders had acquired 70% of the ordinary share capital of Tommy on 1 December three years ago, when the retained earnings of Tommy were \$200m. The fair value of the non-controlling interest (NCI) was \$354m at acquisition. The fair value of the net assets of Tommy was \$700m at that date. Any fair value adjustment related to machines with a life of 10 years.
- (ii) Rodders and Tommy had acquired their holdings in Jimmy as part of an attempt to mask the true relationship. Rodders acquired 20% and Tommy acquired 40% of the ordinary share capital of Jimmy both on the same day two years ago. The fair value of the NCI in Jimmy was \$449m at acquisition. The retained earnings of Jimmy and Tommy on that date

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- were \$400m and \$350m respectively. The fair values of the net assets of Jimmy at acquisition were not materially different from their carrying values. There had been no new issues of shares in the group since the current group structure was created.
- (iii) The goodwill resulting from the Tommy acquisition was impairment tested at the first and second year-end after acquisition and again at the current year-end. The first and second impairment reviews revealed no problems. However, the current review identified a recoverable value of \$1,374m for Tommy. There has been no impairment in Jimmy's goodwill since acquisition.
 - (iv) The group operates in the pharmaceutical industry and has had problems with some of its products. Tommy holds inventory carried at a cost of \$60m, which at the year-end was estimated to be worth \$50m, but in the event the goods were sold for \$40m shortly thereafter.
 - (v) Rodders had purchased a significant amount of new production equipment early in the year. The cost before trade discount of this equipment was \$80m. The trade discount of \$8m was taken to the income statement. Depreciation is charged on the straight-line basis over a four-year period.
 - (vi) At the year start, Rodders negotiated the early repayment of a \$10m loan. The liability is included in non-current liabilities, but now a contract has been signed agreeing to the repayment one month after the new year start plus an early repayment fee of \$1m.
 - (vii) Immediately prior to the year-end, Rodders has publicly accepted responsibility for an environmental issue. The estimated rectification costs are \$3m, but lawyers advise that Rodders has a very strong legal position and it is unlikely that any legal action would be able to prove any negligence by Rodders. Despite this, Rodders has every intention of taking responsibility for the rectification following the public announcement and making payment shortly after the new year start. Rodders is also considering a further payment of \$1m to implement improvements across the country to prevent such accidents occurring again, but have made no announcement as regards these considerations.

Required

- (a) Prepare a consolidated statement of the financial position of the Rodders Group as at 30 November. (Round answer to nearest \$1m)
(35 marks)

Following consolidation, a non-executive director reviews the draft financial statements of the group and queries the impairment of the mid subsidiary, Tommy. He notes that Tommy has grown since acquisition and cannot understand the need for an impairment.

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Required

(b) Comment on the director's comments above regarding impairment.
(6 marks)

Finally, the non-executive director has become aware of the attempt to mask the relationship with Jimmy described in paragraph (ii) above. He is concerned that such behaviour by his fellow directors is likely to have a negative impact on market perceptions of the group should the information ever be leaked.

Required

(c) Comment on the director's comments above regarding the relationship with Jimmy.
(9 marks)

(Total 50 marks)

I would tend to approach answering this question by starting with Parts (b) and (c).

ANSWER

Part (b) 1 mark per point (any reasonable point scores)

Unusual

Growth means profitability and it is unusual for a profitable sub to suffer an impairment.

Impairment

An impairment in goodwill occurs if the recoverable value of the whole sub falls below carrying value.

Recoverable value

The recoverable value is the higher of value in use (VIU) and fair value less costs to sell (essentially net realisable value (NRV)).

Forward

Both these two look forward, whereas profit looks backward. It is possible for a sub to have a bleak future but a profitable past.

Example

An example would be a sub that has a profitable pharmaceutical product that is just coming out of its copyright period. The projected flood of generics would hit VIU very hard.

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Example further explained

So in the above example, a pharmaceutical business may have little tangible assets and so a minimal fair value (NRV). Now that the reduced sales give a very low VIU, the recoverable value could fall below the carrying value and the bleak future of the sub would result in an impairment.

Part (c) 1 mark per point

Control

Control is the power to direct activities. It is the ability to make an entity do what you want.

Subsidiary

Of course, a subsidiary is an entity over which the parent has control.

50%

There is a tendency for accountants to think that majority ownership constitutes control. This is not the case. Majority ownership constitutes majority ownership. Rodders has cleverly and cynically used this misunderstanding to pretend it does not control Jimmy.

Voting

Control of Jimmy is understood by looking at the voting. Rodders controls 20% of the votes directly and another 40% of the votes through Tommy. So Rodders controls 60% of the votes, can force through a majority resolution and therefore has control of Jimmy.

Ownership

The ownership is 48%. So Rodders has a 48% sub with a 52% NCI.

Creative accounting

The attempt to mask the relationship with Jimmy is a form of creative accounting. It is sometimes called 'quasi-sub accounting' because it attempts to avoid treating a sub like a sub.

Enron

It is the main creative accounting scam that was used by Enron. If the market discovered that Rodders is behaving like Enron, it is very likely to react negatively.

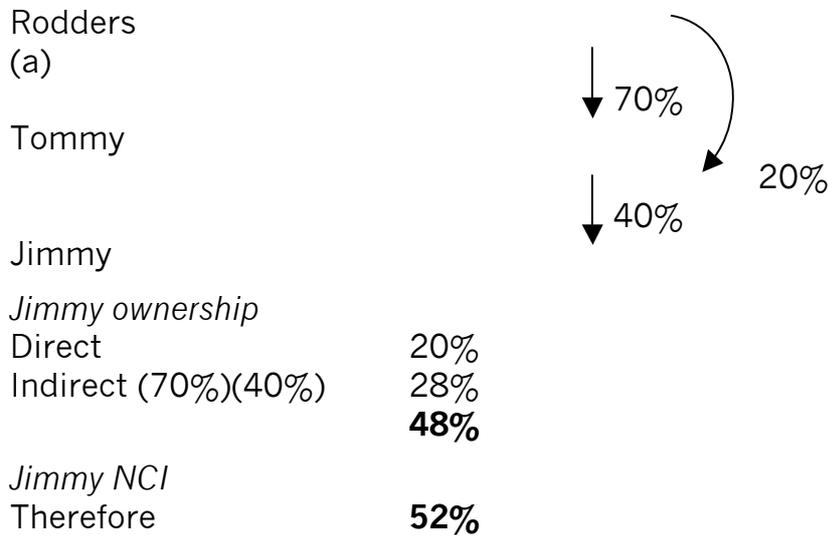
Two years

However, the acquisition was two years ago. So, hopefully, Jimmy was consolidated as a sub last year-end. In which case, I think that the initial attempt at creative accounting is too old to really matter to the market. But if Jimmy has never been consolidated Rodders has a big problem. Careful spin will be required to confess to the control of Jimmy now.

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Now I would start with the Part (a) number answer.

**Net assets**

	<i>Tommy</i>		<i>Jimmy</i>	
	<i>Acq</i>	<i>B/S</i>	<i>Acq</i>	<i>B/S</i>
Share capital	300	300	100	100
Share premium	100	100	50	50
Profits reserve	(i)200	676	(ii)400	525
FVA (PPE) (balance)	100	70	–	–
Inventory (iv)	–	(20)	–	–
	(i)700	1,126	550	675

(7 marks)

Explanatory notes

The following two explanatory notes are just that, and are certainly not required in the exam.

First the FVA

Note that the FVA is calculated as a balancing figure. Note also that the FVA is depreciating over 10 years, three of which have passed, with seven remaining.

Second the inventory (iv)

The actual sale proceeds are used because the sale is an adjusting post balance sheet event. The correcting double entry is:

Dr	retained earnings	20
Cr	inventory	20

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Goodwill

This is required of course.

	Tommy	Jimmy
Fair value of consideration	900	
Jimmy direct		220
Jimmy indirect (70%)(400)		280
Fair value of NCI	354	449
Fair value of net assets	<u>(700)</u>	<u>(550)</u>
Goodwill at acquisition	554	399
Impairment (below)	<u>(306)</u>	<u>—</u>
Goodwill at year-end	<u>248</u>	399
Carrying value (554 + 1,126)	1,680	(4 marks)
Impairment (balance)	<u>(306)</u>	
Recoverable value	1,374	
	(4 marks)	

Goodwill impairment

The goodwill impairment is split between the parent and the NCI based on the ownership of shares, regardless of the ownership of goodwill. So this impairment is split 70%/30%.

Group statement of financial position

Non-current assets	
Goodwill (248 + 399)	647
PPE (1,800 + 406 + 250 + 70 FVA – 6 (v) discount)	2,520
Current assets	
Inventory (540 + 160 + 165 – 20(iv))	845
Receivables (140 + 150 + 140)	430
Bank (190 + 50 + 180)	<u>420</u>
	4,862
	(2 marks excluding the 7 marks for net assets and the 8 marks already given to goodwill)

Equity

Share capital	500
Share premium	300
Reserves	2,764
Non-controlling interest	784
Non-current liabilities (230 + 20 + 10 – 10(vi))	250
Current liabilities (130 + 70 + 50 + 11(vi) + 3(vii))	<u>264</u>
	4,862
	(7 marks excluding RE and NCI)

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Reserves

Parent (2,630 – 70%(306) impairment – 6 (v) – 1(vi) – 3(vii))	2,406
Tommy (1,126 – 700)(70%)	298
Jimmy (675 – 550)(48%)	<u>60</u>
	2,764
	(6 marks)

NCI (roll forward)

Tommy (354 – 30%(400inv) + 30%(1,126 – 700) – 30%(306imp))	270
Jimmy (449 + 52%(675 – 550))	<u>514</u>
	784
	(5 marks)

Explanatory notes

Again, these notes are purely for your learning benefit and are not required in the exam.

Discount error (v)

$$\text{Discount error} = (3/4)(8) = (6)$$

The erroneous recognition of the discount in the income statement has caused a corresponding overstatement of NCA of \$8m at the year start. But NCA is depreciating, so the error is itself depreciating. Over the year \$2m of error has dropped off the B/S into the income statement as depreciation. So only \$6m is still left on the B/S in net assets at the year-end. The correcting double entry is:

Dr discount (i/s)	8	(to remove the erroneous discount)
Cr tangibles (B/S)	6	(to get the NCA back to where they should be)
Cr depreciation charge (i/s)	2	(to strip out the over-depreciation)

Repayment fee (vi)

The repayment fee is a cost.

Environmental (vii)

The announcement creates a constructive obligation to pay out the \$3m. No such obligation applies to the \$1m.

Exam strategy comment

Note that you can score very high marks even completely ignoring paragraphs (v) (vi) and (vii). Truthfully, paragraphs (vi) and (vii) are fairly easy and really you should put those adjustments through. But paragraph (v) is very tricky, so given the time pressure of an exam, I would recommend you ignore that paragraph. You will still score 32/35. But for completeness, here is the story behind the \$6m deduction to PPE. The original overvaluation of PPE was \$8m

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at the year start as given. However, the error has depreciated with the PPE. So one quarter (\$2m) has depreciated off the b/s and three quarters remains (\$6m).

Conclusion

The above is designed to give you a feel as to how to attempt the Paper P2, *Corporate Reporting* case study. I would recommend you deal with the narrative first and then quickly crunch through the numbers without over-elaborating on explanation or getting bogged down by the tricky bits. However, it is important to note that however you approach the question, you need to have careful time management so that you can give enough time to each part of the question.

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