CURRENT ISSUES ARE AT THE HEART OF PAPER P2, CORPORATE REPORTING, AND PERMEATE THE ENTIRE SYLLABUS. BUT IT IS THE LAST QUESTION IN THE EXAM PAPER, QUESTION 4, THAT REALLY DELVES INTO THE POLITICAL AND INTELLECTUAL DEBATE THAT REPRESENTS CURRENT ISSUES IN FINANCIAL REPORTING.

CURRENT

RELEVANT TO ACCA QUALIFICATION PAPER P2

This article first looks at some of the hot topics in financial reporting. Then, by using an illustrative question, it shows you how to use this information to formulate an answer to a current issues question.

The *Framework*

The examiner's advice is that if you are not sure where to start your answer to a current issues question, then begin with the *Framework*. The *Framework for Financial Reporting* sets out the conceptual basis for the development of standards, and is itself based on the elements of assets and liabilities. To paraphrase the *Framework*, 'an asset/liability is a right/obligation to a future economic outflow/inflow'. This focus on financial position has permeated all the standards issued in recent years, and continues to dominate current issues.

But the *Framework* also refers to other concepts, such as relevance, reliability and entity. Which brings us to fair value.

Fair value

This is *the* hot topic in financial reporting. In order to make the position statement a genuine statement of financial position, rather than simply a balance sheet, the International Accounting Standards Board (IASB) has been pushing financial reporting towards fair value. Fair value accounting attempts to present all assets and liabilities at market value and, as such, is highly subjective. But the IASB is prepared to accept reduced reliability in favour of increased relevance.

Convergence

Also red hot is the subject of convergence, which the IASB interprets essentially as the convergence of IFRS with US accounting. This process has received a major boost in recent months, with the US Securities and Exchange Commission (SEC) coming out in favour of fair value and the IASB.

Business combinations

Tangled up in the process of convergence is the project to make sense of group accounting. The IASB has long accepted that the US slant on groups was better suited to the entity concept and the reality of acquisitions. So the IASB issued and reissued IFRS 3, *Business Combinations*, in order to reflect this. But perhaps the rarity of non-controlling interest (NCI) in the US has led to the IASB creating unnecessary complications as regards the NCI goodwill.

Management commentary

The spiralling complexity of financial reporting has led to most companies translating their financial statements into a more digestible report, tagged on to the financial statements in the annual report. This 'management commentary' is largely unregulated at the moment, but the IASB has a standard under development that, once issued, will produce some conformity in management commentaries.

ILLUSTRATIVE QUESTION

The following is an illustrative current issues question. It is partly based on past examples of Question 4, but it also looks forward to current issues that are topical now and which will remain so for the next few sittings. So the question, therefore, takes its lead from the examiner, Graham Holt, and his comments (made at the February 2009 ACCA teachers' conference) that lecturers should try to write questions of the future, especially in the context of current issues. As you look through the question, you will note the use of numbers, rarely seen in previous Question 4 examples. This also takes its lead from the examiner's comments at the conference, when he warned that future current issues questions might use numbers to draw out conceptual issues.

Studying Paper P2?
Performance Objectives 10 and 11 are linked

ISSUES

> THE FIRST THING TO ADVISE IN THE CONTEXT OF A QUESTION LIKE THIS IS: 'DO NOT BECOME OBSESSED BY THE NUMBERS'. IT IS CLEAR FROM THE EXAMINER'S COMMENTS THAT GROUP ACCOUNTING UNDER IFRS 3 (REVISED) WILL BE AN IMPORTANT TOPIC FOR EXAMINATION IN THE FUTURE.

Question 4: Fudge

Fudge is a medium-sized industrial group that is listed on a major world stock exchange. It has finally succeeded in acquiring a controlling interest in its principle supplier, Sugar. This acquisition is seen by the board as a great achievement, since in the past, concerns over supply have frustrated the Board and worried the shareholders.

You are advising the chief finance officer (CFO) regarding the issues raised by the acquisition. She has various concerns, most of which relate to the financial reporting of the acquisition and the conceptual reasons underlying the financial reporting. The acquisition of Sugar was achieved in stages. Sugar is a traditional raw materials supplier and had, until recently, been under family ownership and control. Fudge has, for a number of years, been in negotiations with the family to purchase shares, but only last year, for the first time, was Fudge offered shares in Sugar. Fudge purchased 25% (25,000 shares) at the end of last year for \$2m, and obtained a seat on the main Board. The fair value of the identifiable net assets of Sugar at that time was \$4m.

Last week, Fudge acquired a further 35% (35,000 shares) for \$3.5m and obtained control. The fair value of the identifiable net assets of Sugar at this second point of purchase was \$5m. The fair value of the previous ownership of 25% was measured at \$2.25m, and the fair value of the NCI was measured at \$3.2m. These latter two fair values have been measured using appropriate models.

It is approaching the year end, and the CFO wants to understand how the above purchase will be reported, both in the financial statements and elsewhere. She understands that there are new rules regulating group accounting, and that these have been motivated partly by the need for global accounting convergence. She is particularly keen to understand the underlying principles behind the accounting and also the application of fair value to the process of measuring goodwill. However, she is also concerned that the acquisition, which is a major strategic success, might not be communicated to shareholders appropriately, because the focus is primarily on the accounting. Negotiations with Sugar shareholders continue, and Fudge hopes to purchase a further 10% (10,000 shares) early next year. It is expected that the consideration will be \$1m, and that the identifiable net assets of Sugar will be \$6m at this anticipated third point of purchase. The CFO would like to understand how this third purchase will be reported, should it go ahead. Goodwill remains unimpaired throughout. The group has the policy of recognising full goodwill.

Required

Write a report for the CFO that addresses the following requirements:

(a) Calculate the goodwill attributable to Sugar at the current year end. Explain the conceptual basis for the calculation of goodwill.
(13 marks)

(b) Explain how the important strategic reasons for the acquisition could be communicated to Fudge shareholders.
(5 marks)

(c) Calculate the transfer in equity and the reduction to equity that is attributable to the parent shareholders that would result from the third purchase, assuming it occurs as predicted. Explain the conceptual basis for this transfer.
(7 marks)

(Total 25 marks)

Comments on the question

Perhaps the first thing to advise in the context of a question like this is: 'do not become obsessed by the numbers'. It is clear from the examiner's comments that group accounting under IFRS 3 (Revised) will be an important topic for examination in the future. It is also clear that the examiner's articles in the February and April 2009 issues of *student accountant* will be important. But it is also clear from the question above that discussion of the issues is at least as important as the numbers.

I would also advise students not to try to be too clever. The examiner regularly complains of answers that are technically wonderful, but which do not answer the question and therefore achieve few marks. So do not attempt to dazzle markers with excessive detail; instead, use your understanding of the key issues to simply and clearly answer the question.

MODEL ANSWER

Report

To: Chief Finance Officer
From: Me
Date: Today
Subject: Acquisition issues

Introduction

The following report discusses the issues raised by the acquisition of Sugar.

(a) The financial reporting of the acquisition

Goodwill

The goodwill in Sugar at the point of obtaining control at the coming year end will be calculated as follows:

		$'000
Fair value of consideration	35%	3,500
Fair value of previous ownership	25%	2,250
Fair value of NCI	40%	3,200
Fair value of the business	100%	8,950
Fair value of net assets		(5,000)
Goodwill at acquisition		3,950

(Calculation worth 5 marks)

Conceptual basis

The above calculation is based on the entity concept within the *Framework for Financial Reporting*. This concept notes that the group is one entity under the control of the parent shareholders. This key concept notes that the parent has control over the parent assets and liabilities, as well as the assets and liabilities of the sub.

Parent viewpoint

From the point of view of the parent as a single entity, the parent simply acquires first 25,000 shares, then another 35,000 shares. So the parent sees two purchases.

Group viewpoint

But the group perspective is quite different. The group acquires the sub when it obtains control, and clearly that happens when the second purchase of 35,000 shares occurs. That is the point at which the sub enters the group.

Effect

The effect of this is that we must recognise only one point of acquisition of the sub. In order to achieve this, we deem the group to have sold its associate and acquired a sub at the point the group obtains control. So the first 25,000 shares are deemed to have been sold and then immediately bought back at fair value at acquisition.

Fair value

This leads to one of the more unusual features of IFRS 3 (Revised). The fair value of the shares deemed sold and bought back need not be in line with that of those actually acquired (or even those retained) by the NCI. A simple calculation can show this:

Share volume	**Fair value given**	**Fair value per share**
35,000	$3.5m	$100
25,000	$2.25m	$90
40,000	$3.2m	$80

Fair value elsewhere

The above divergent fair value is most odd, given that in other situations, for example, the fair valuation of financial assets at fair value with gains and losses to the profit and loss, the transaction price on one share gives the fair value of all the others at this point. This divergence of fair value results in goodwill attributable to the NCI far below that of the goodwill attributable to the controlling interest. This makes part (c) below much harder.

THE EXAMINER REGULARLY COMPLAINS OF ANSWERS THAT ARE TECHNICALLY WONDERFUL, BUT WHICH DO NOT ANSWER THE QUESTION AND THEREFORE ACHIEVE FEW MARKS. SO DO NOT ATTEMPT TO DAZZLE MARKERS WITH EXCESSIVE DETAIL; INSTEAD, USE YOUR UNDERSTANDING OF THE KEY ISSUES TO SIMPLY AND CLEARLY ANSWER THE QUESTION.

Goodwill split

Goodwill is split between the controlling and the NCI as follows:

	$'000
Goodwill (controlling interest) (3,500 + 2,250 - (60%)(5,000))	2,750
Goodwill (NCI) (3,200 - (40%)(5,000))	1,200
Goodwill at acquisition (see above)	3,950

Notice that the NCI is 40%, but that they own less than one third of the goodwill.

Convergence

It is true that the revision of IFRS 3 was motivated by the desire to improve financial reporting in the context of the entity concept. However, it is also true that the project has been dominated by the desire to converge IFRS with US accounting standards.
(1 mark per point to give 9 marks for discussion, therefore one extra point)

(b) The communication with shareholders

Management commentary

Management commentary is the generic name for the unaudited operating and financial review that accompanies most financial statements in the annual report presented to shareholders.

The idea

The idea of this report is to translate the performance and position of the group from the hard numbers, as presented in the financial statements, into softer words and pictures for easier understanding.

NOTE THE STYLE OF THE ANSWER. THE LANGUAGE IS SIMPLE AND THE IDEAS ARE CLEAR. BUT NOTICE ALSO HOW THE ANSWER HAS BEEN TUNED TO THE MARKING GUIDE FOR QUESTION 4, SUMMED UP BY THE EXAMINER AS 'SUBJECTIVE: 1 MARK PER POINT'. SEE HOW MY ANSWER USES ONE HEADING FOR EACH POINT TO AID THE MARKING PROCESS.

Sugar acquisition

The Sugar acquisition is exactly the kind of issue that management commentary is designed to accommodate. The numbers, as presented in the financial statements, do not give the reader a flavour of the purpose behind the purchase.

Presentation

The Fudge group should use the management commentary to explain the importance of the Sugar acquisition in terms of supply stability, and should also explain the extended negotiations that resulted in the step acquisition.

Regulation

The IASB has published a discussion document on management commentaries, and the group should read this before publishing. The group should also look at other management commentaries and at how others have dealt with acquisitions.

Website

The group should also consider using its website to communicate the acquisition, maybe even considering a press conference.
(1 mark per point to give 6 marks for discussion)

(c) The financial reporting of the transfer

Transfer

The following will transfer out of NCI:

	$'000
Net assets attributable to NCI at transfer (40%)($6m)	2,400
Goodwill attributable to NCI at transfer (unchanged from (a))	1,200
NCI before transfer of 10% ownership	3,600
Transfer to controlling equity (10%/40%)	(900)
NCI remaining	2,700

(Calculation worth 3 marks)

Reduction in the equity attributable to the parent shareholders

The above transfer into controlling equity will meet the cost of the consideration to create the following reduction:

	$'000
Transfer to controlling equity (above)	900
Consideration cost recognised directly in equity	(1,000)
Reduction to equity that is attributable to the parent shareholders	(100)

(Calculation worth 1 mark)

Conceptual basis

The above financial reporting is again based on the entity concept and the related concept of control. Once the group has absolute control of the sub at acquisition, then the group has control. This occurred last week when the 35,000 shares were purchased.

Control

Control is an absolute: either you have it or you do not. The group cannot get more control by buying more shares later.

Ownership

Ownership is quite different. Clearly, if the group does increase its ownership to 70%, then the NCI will decrease to 30%. This results in the transfer between the equity owners, from non-controlling to controlling.

Goodwill

If Fudge successfully purchases the further 10,000 shares, this will not be a sub acquisition. Therefore, if there is no acquisition, there is no new goodwill calculation.
(1 mark per point to give 4 marks for discussion)

I RECOMMEND THAT STUDENTS REVIEW AND WORK THROUGH PAST CURRENT ISSUES QUESTIONS TO IMPROVE THEIR KNOWLEDGE OF CURRENT ISSUES, TO IMPROVE THEIR DELIVERY OF CLEAR ANSWERS, AND DRAW FROM THE BROAD RANGE OF ISSUES DISCUSSED ABOVE TO DEMONSTRATE THEIR UNDERSTANDING.

COMMENTS ON THE ANSWER

Note the style of the answer. The language is simple and the ideas are clear. But notice also how the answer has been tuned to the marking guide for Question 4, summed up by the examiner as 'Subjective: 1 mark per point'. See how my answer uses one heading for each point to aid the marking process. Also notice that when I am aiming for five marks, I give six points.

Next, note that the answer draws widely from across current issues. Of course, the answer is founded on the new IFRS on business combinations, but look how I bring in the conceptual framework, fair value, convergence, management commentary, and other issues.

Finally, note that 'subjective' implies that there are other issues that could alternatively have been discussed, and the following would all have been acceptable:

- Accounting for the entity, Sugar, over the year in the statement of comprehensive income, would have been as an associate up to acquisition and as a sub thereafter.
- The deemed disposal of the associate at acquisition would generate a profit on disposal.
- The models used for share valuation are highly subjective and open to manipulation.
- The family company was privately owned and that is why there is no market price before or after the acquisition.

The examiner has, on numerous occasions, made it clear that alternative answers that consider alternative issues are welcomed by markers.

CONCLUSION

I recommend that students review and work through past current issues questions to improve their knowledge of current issues, improve their delivery of clear answers, and draw from the broad range of issues discussed above to demonstrate their understanding.

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