Professional Level – Essentials Module

Corporate Reporting (International)

September/December 2016 – Sample Questions

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 (INT)

Think Ahead ACCA

The Association of Chartered Certified Accountants

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

1 The following draft financial statements relate to Zippy, a public limited company. Zippy is a manufacturing company but also has a wide portfolio of investment properties. Zippy has investments in Ginny and Boo, both public limited companies.

Draft statements of profit or loss and other comprehensive income for the year ended 30 June 2016

	Zippy	Ginny	Boo
	$m	$m	$m
Revenue	420	132	90
Cost of sales	(304)	(76)	(72)
Gross profit	116	56	18
Investment income	42	19	5
Administrative costs	(22)	(12)	(18)
Other expenses	(34)	(18)	(15)
Operating profit	102	45	(10)
Net finance costs	(2)	(6)	(9)
Profit before tax	100	39	(19)
Income tax expense	(30)	(7)	3
Profit for the year	70	32	(16)
Other comprehensive income			
Items that will not be reclassified to profit or loss			
Gains on property revaluation	14	16	
Total comprehensive income for year	84	48	(16)

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

1. On 1 July 2014, Zippy acquired 60% of the equity interests of Ginny, a public limited company. The purchase consideration comprised cash of $90 million and the fair value of the identifiable net assets acquired was $114 million at that date. Zippy uses the 'full goodwill' method for all acquisitions and the fair value of the non-controlling interest (NCI) in Ginny was $50 million on 1 July 2014. Goodwill had been reviewed annually for impairment and no impairment was deemed necessary.

2. Zippy disposed of a 20% equity interest in Ginny on 31 March 2016 for a cash consideration of $44 million. The remaining 40% holding had a fair value of $62 million and Zippy exercised significant influence over Ginny following the disposal. Zippy accounts for investments in subsidiaries at cost and has included a gain in investment income of $14 million within its individual financial statements to reflect the disposal. The net assets of Ginny had a fair value of $118 million at 1 July 2015 and this was reflected in the carrying amounts of the net assets. All gains and losses of Ginny have accrued evenly throughout the year. The disposal is not classified as a separate major line of business or geographical operation.

3. Zippy acquired 80% of the equity interests of Boo, a public limited company, on 30 June 2014. The purchase consideration was cash of $60 million. The fair value of the NCI was calculated as $12 million at this date. Due to a tight reporting deadline, the fair value of the identifiable net assets at acquisition had not been finalised by the time the financial statements for the year ended 30 June 2014 were published. Goodwill of $28 million was calculated using the carrying amount of the net assets of Boo. The fair value of the identifiable net assets of Boo was finalised on 31 December 2014 as $54 million. The excess of the fair value of the identifiable net assets at acquisition is due to plant which had a remaining useful life of five years at the acquisition date.

   Due to the losses of Boo, an impairment review was undertaken at 30 June 2016. It was decided that goodwill had reduced in value by 10%. Goodwill impairments are charged to other expenses.

4. Zippy holds properties for investment purposes. At 1 July 2015, Zippy held a 10-floor office block at a fair value of $90 million with a remaining useful life of 15 years. The first floor was occupied by Zippy's staff and the

second floor was let to Boo free of charge. The other eight floors were all let to unconnected third parties at a normal commercial rent. It was estimated that the fair value of the office block was $96 million at 30 June 2016. Zippy has a policy of restating all land and buildings to fair value at each reporting date. The only accounting entries for the year ended 30 June 2016 in relation to this office block have been to correctly include the rental income in profit or loss. It can be assumed that each floor is of equal size and value. Depreciation is charged to administrative costs.

5. During April 2016, an explosion at a different office block caused substantial damage and it was estimated that the fair value fell from $20 million at 30 June 2015 to $14 million at 30 June 2016. Zippy has estimated that costs of $3 million would be required to repair the block but is unsure whether to carry out the repairs or whether to sell the block for a reduced price. The property has been left in the financial statements at a value of $20 million. A provision of $3 million for the repair costs was charged to other expenses.

6. The following information relates to Zippy's defined benefit pension scheme:

	$m
Net pension deficit at 30 June 2015	14
Service cost for year ended 30 June 2016	10
Contributions into the scheme	8
Discount rate at 1 July 2015	10%
Discount rate at 30 June 2016	12%
Remeasurement gains in year ended 30 June 2016	4

   No entries have been entered in the financial statements except that the contributions into the scheme have been correctly added to the pension scheme's assets.

7. On 1 January 2016, Zippy entered into a contract to sell 10,000 units of a new product, the Whizoo, to a customer for $1,000 per unit. It was agreed that if the customer ordered an additional 5,000 units, a volume discounted price of $950 per unit would apply. 6,000 units were manufactured and delivered in the four months to 30 April 2016.

   Minor defects were discovered in the first 6,000 units due to an error in the manufacturing process and it was agreed that a credit note of $40 per unit would be issued as compensation. Zippy and the customer agreed to net this amount off against subsequent payments for future orders. A further 7,000 units had been manufactured and delivered by 30 June 2016 without any defects. Zippy has included $6 million in revenue (6,000 x $1,000) for the first 6,000 units but has not recorded any additional revenue, as the directors are unsure of the correct accounting treatment.

Required:

(a) Prepare the consolidated statement of comprehensive income for the Zippy Group for the year ended 30 June 2016. (35 marks)

(b) The directors of Zippy have heard that under alternative accounting practices actuarial gains and losses (the remeasurement component) can be immediately recognised in profit or loss or deferred using an applicable systematic method. Additionally, past service cost can be recognised initially in other comprehensive income and then recycled to profit or loss. The directors are unsure as to the differences between other comprehensive income and profit or loss and the rationale as to why some gains can be and others cannot be recycled.

Required:

With reference to pension schemes, discuss the differences between other comprehensive income and profit or loss and the rationale as to why some gains and losses can be and others cannot be recycled to profit or loss. Include in your answer a brief discussion of the benefits of immediate recognition of the remeasurement component under IAS 19 *Employee Benefits*. (8 marks)

(c) On 1 July 2016, there was an amendment to Zippy's defined benefit scheme whereby the promised pension entitlement was increased from 10% of final salary to 15%. A bonus is paid to the directors each year which is based upon the operating profit margin of Zippy. The directors of Zippy are unhappy that there is inconsistency on the presentation of gains and losses in relation to defined benefit schemes. Additionally, they believe that as the pension scheme is not an integral part of the operating activities of Zippy, it is misleading to include the gains and losses in profit or loss. They therefore propose to change their accounting policy so that all gains and losses on the pension scheme are recognised in other comprehensive income. They believe that this will make the financial statements more consistent, more understandable and can be justified on the grounds of fair presentation.

Required:

Discuss the accounting and ethical implications arising from the proposed change of accounting policy on Zippy's defined benefit scheme. (7 marks)

(50 marks)

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Question 2 begins on page 6.

Section B – TWO questions ONLY to be attempted

2 **(a)** Suntory, a private limited company, has two overseas subsidiaries, Maior and Minor. Suntory is based in a country which has a currency of the dollar. Maior is based in Japan where the currency is the yen. Minor is based in Portugal which has the currency of the euro. Suntory and Minor sell golf clothing and Maior sells golf equipment. Maior and Minor are financed by the provision of long-term loans at market interest rates in dollars from Suntory.

Suntory's sales are mainly in its own jurisdiction, and are priced and collected in dollars. The legal requirements and the business environment in Suntory's jurisdiction determines the pricing of Suntory's products. Goods and services are sourced locally and paid in dollars but occasionally the entity trades in small amounts in other currencies.

Maior conducts its business with significant autonomy from Suntory as it manufactures golf equipment which it sells mainly in Japan in yen. Local management determines prices based upon the local legal and business conditions. Most raw materials and labour are sourced from local suppliers with a small amount of specialised equipment sourced from China. Maior sells a small amount of golf clothing, which it purchases from Suntory and pays in dollars.

Minor imports golf clothing manufactured by Suntory and pays Suntory in dollars. All other operating expenses are paid in euros. Suntory gives Minor a discount on the normal selling price of its products. Minor sells its products mainly in Portugal in euros. The local legal and business conditions and the cost of the product from Suntory dictate the pricing of products but all prices have to be agreed by Suntory. At the month end, an intra-group dividend is paid in cash to Suntory in euros which amounts to the net profit made by Minor for the month.

The directors require advice on the determination of each of the functional currencies of Suntory, Maior and Minor. (9 marks)

(b) On 1 December 2012, Suntory acquired a trademark, Golfo, for a line of golf clothing for $3 million. Initially, Suntory expected to continue marketing and receiving cash flows from the Golfo product-line indefinitely. However, because of the difficulty in determining its useful life, Suntory decided to amortise the trademark over a 10-year life, using the straight-line method. In December 2015, a competitor unexpectedly revealed a technological breakthrough which is expected to result in a product which, when launched, will significantly reduce the demand for the Golfo product-line. The demand for the Golfo product-line is expected to remain high until May 2018, when the competitor is expected to launch its new product.

At 30 November 2016, the end of the financial year, Suntory assessed the recoverable amount of the trademark at $500,000 and intends to continue manufacturing Golfo products until 31 May 2018.

The directors of Suntory require advice as to how to deal with the trademark in the financial statements for the year ended 30 November 2016. (7 marks)

(c) At 30 November 2016, three people own the shares of Suntory. The finance director owns 60%, and the operations director owns 30%. The third owner is a passive investor who does not help manage the entity. All ordinary shares carry equal voting rights. The wife of the finance director is the sales director of Suntory. Their son is currently undertaking an internship with Suntory and receives a salary of $30,000 per annum, which is normal compensation.

The finance director and sales director have set up an investment company, Baleel. They jointly own Baleel and their shares in Baleel will eventually be transferred to their son when he has finished the internship with Suntory.

In addition, on 1 June 2016 Suntory obtained a bank loan of $500,000 at a fixed interest rate of 6% per annum. The loan is to be repaid on 30 November 2017. Repayment of the principal and interest is secured by a guarantee registered in favour of the bank against the private home of the finance director.

The directors of Suntory require advice on the identification and disclosure of the company's related parties in preparing its separate financial statements for the year ending 30 November 2016. (7 marks)

Required:

Discuss the advice which should be given to Suntory in each of the above cases with reference to relevant International Financial Reporting Standards.

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

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

(25 marks)

3 **(a)** Evolve is a real estate company, which is listed on the stock exchange and has a year end of 31 August.

On 21 August 2016, Evolve undertook a scrip (bonus) issue where the shareholders of Evolve received certain rights. The shareholders are able to choose between:

(i) receiving newly issued shares of Evolve, which could be traded on 30 September 2016; or

(ii) transferring their rights back to Evolve by 10 September 2016 for a fixed cash price which would be paid on 20 September 2016.

In the financial statements at 31 August 2016, Evolve believed that the criteria for the recognition of a financial liability as regards the second option were not met at 31 August 2016 because it was impossible to reliably determine the full amount to be paid, until 10 September 2016. Evolve felt that the transferring of the rights back to Evolve was a put option on its own equity, which would lead to recording changes in fair value in profit or loss in the next financial year. Evolve disclosed the transaction as a non-adjusting event after the reporting period.
(8 marks)

(b) At 31 August 2016, Evolve controlled a wholly owned subsidiary, Resource, whose only assets were land and buildings, which were all measured in accordance with International Financial Reporting Standards. On 1 August 2016, Evolve published a statement stating that a binding offer for the sale of Resource had been made and accepted and, at that date, the sale was expected to be completed by 31 August 2016. The non-current assets of Resource were measured at the lower of their carrying amount or fair value less costs to sell at 31 August 2016, based on the selling price in the binding offer. This measurement was in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. However, Evolve did not classify the non-current assets of Resource as held for sale in the financial statements at 31 August 2016 because there were uncertainties regarding the negotiations with the buyer and a risk that the agreement would not be finalised. There was no disclosure of these uncertainties and the original agreement was finalised on 20 September 2016.
(9 marks)

(c) Evolve operates in a jurisdiction with a specific tax regime for listed real estate companies. Upon adoption of this tax regime, the entity has to pay a single tax payment based on the unrealised gains of its investment properties. Evolve purchased Monk whose only asset was an investment property for $10 million. The purchase price of Monk was below the market value of the investment property, which was $14 million, and Evolve chose to account for the investment property under the cost model. However, Evolve considered that the transaction constituted a 'bargain purchase' under IFRS 3 *Business Combinations*. As a result, Evolve accounted for the potential gain of $4 million in profit or loss and increased the 'cost' of the investment property to $14 million. At the same time, Evolve opted for the specific tax regime for the newly acquired investment property and agreed to pay the corresponding tax of $1 million. Evolve considered that the tax payment qualifies as an expenditure necessary to bring the property to the condition necessary for its operations, and therefore was directly attributable to the acquisition of the property. Hence, the tax payment was capitalised and the value of the investment property was stated at $15 million. (6 marks)

Required:

Advise Evolve on how the above transactions should be correctly dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

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 The International Accounting Standards Board (IASB) is undertaking a broad-based initiative to explore how disclosures in IFRS financial reporting can be improved. The Disclosure Initiative is made up of a number of implementation and research projects. The IASB has decided that the project should include a discussion on whether the definition of materiality should be changed and whether IAS 1 *Presentation of Financial Statements* should include additional guidance which clarifies the key characteristics of materiality. Materiality is a matter which has been debated extensively in the context of many forms of reporting, including the International Integrated Reporting Framework. There are difficulties in applying the concept of materiality in practice when preparing the financial statements and it is thought that these difficulties contribute to a disclosure problem, namely, that there is both too much irrelevant information in financial statements and not enough relevant information. Further, the IASB has published for public comment an Exposure Draft of proposed amendments to IAS 7 *Statement of Cash Flows*. The proposal responds to requests from investors for improved disclosures about an entity's financing activities and its cash and cash equivalents balances.

Required:

(a) **(i)** **Discuss the current definition of materiality and how the current application of the concept of materiality may be leading to a reduction in the clarity and understandability of financial statements.** (7 marks)

(ii) **Discuss how the concepts of materiality would be used in applying the International Integrated Reporting Framework.** (4 marks)

(iii) **Discuss the current issues with IAS 7 *Statement of Cash Flows* and briefly describe the proposed amendments to IAS 7 set out in the recent Exposure Draft.** (7 marks)

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

(b) Sanchera, a listed company, has prepared a statement of cash flows for the year ended 31 August 2016. In financing activities, it has shown an increase in long-term borrowings to $140 million and an increase in the capital element of finance lease liabilities to $17 million. At 1 September 2015, Sanchera had shown in its financial statements long-term borrowings of $50 million and the capital element of lease liabilities at $5 million. During the financial year, Sanchera has taken out a long-term loan with a financial institution of $55 million and had acquired Pecuna, a listed company, for $150 million on 1 July 2016. Pecuna had a long-term loan of $35 million at acquisition. Further, Sanchera had taken out finance leases liabilities totalling $15 million and had paid $3 million off the capital element of the lease liabilities. Sanchera showed interest paid on lease liabilities of $5 million in operating activities. Finally, Sanchera had an overdraft with the bank of $2 million.

Required:

Show the note to the statement of cash flows, which would be required under the Exposure Draft of proposed amendments to IAS 7, which sets out the components of financing activities. (5 marks)

(25 marks)

End of Question Paper