Strategic Professional – Essentials

Strategic Business Reporting – International

Thursday 6 September 2018

SBR INT ACCA

Time allowed: 3 hours 15 minutes

This question paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – BOTH questions are compulsory and MUST 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 SBR – INT

Think Ahead ACCA

The Association of Chartered Certified Accountants

Section A – BOTH questions are compulsory and MUST be attempted

1 Background

Banana is the parent of a listed group of companies which have a year end of 30 June 20X7. Banana has made a number of acquisitions and disposals of investments during the current financial year and the directors require advice as to the correct accounting treatment of these acquisitions and disposals.

The acquisition of Grape

On 1 January 20X7, Banana acquired an 80% equity interest in Grape. The following is a summary of Grape's equity at the acquisition date.

	$ millions
Equity share capital ($1 each)	20
Retained earnings	42
Other components of equity	8
Total	70

The purchase consideration comprised 10 million of Banana's shares which had a nominal value of $1 each and a market price of $6·80 each. Additionally, cash of $18 million was due to be paid on 1 January 20X9 if the net profit after tax of Grape grew by 5% in each of the two years following acquisition. The present value of the total contingent consideration at 1 January 20X7 was $16 million. It was felt that there was a 25% chance of the profit target being met. At acquisition, the only adjustment required to the identifiable net assets of Grape was for land which had a fair value $5 million higher than its carrying amount. This is not included within the $70 million equity of Grape at 1 January 20X7.

Goodwill for the consolidated financial statements has been incorrectly calculated as follows:

	$m
Share consideration	68
Add NCI at acquisition (20% x $70 million)	14
Less net assets at acquisition	(70)
Goodwill at acquisition	12

The financial director did not take into account the contingent cash since it was not probable that it would be paid. Additionally, he measured the non-controlling interest using the proportional method of net assets despite the group having a published policy to measure non-controlling interest at fair value. The share price of Grape at acquisition was $4·25 and should be used to value the non-controlling interest.

The acquisition and subsequent disposal of Strawberry

Banana had purchased a 40% equity interest in Strawberry for $18 million a number of years ago when the fair value of the identifiable net assets was $44 million. Since acquisition, Banana had the right to appoint one of the five directors on the board of Strawberry. The investment has always been equity accounted for in the consolidated financial statements of Banana. Banana disposed of 75% of its 40% investment on 1 October 20X6 for $19 million when the fair values of the identifiable net assets of Strawberry were $50 million. At that date, Banana lost its right to appoint one director to the board. The fair value of the remaining 10% equity interest was $4·5 million at disposal but only $4 million at 30 June 20X7. Banana has recorded a loss in reserves of $14 million calculated as the difference between the price paid of $18 million and the fair value of $4 million at the reporting date. Banana has stated that they have no intention to sell their remaining shares in Strawberry and wish to classify the remaining 10% interest as fair value through other comprehensive income in accordance with IFRS® 9 *Financial Instruments*.

The acquisition of Melon

On 30 June 20X7, Banana acquired all of the shares of Melon, an entity which operates in the biotechnology industry. Melon was only recently formed and its only asset consists of a licence to carry out research activities. Melon has no employees as research activities were outsourced to other companies. The activities are still at a very early stage and it is not clear that any definitive product would result from the activities. A management company provides personnel for Melon to supply supervisory activities and administrative functions. Banana believes that Melon does not constitute a business in accordance with IFRS 3 *Business Combinations* since it does not have employees nor carries out any of its own processes. Banana intends to employ its own staff to operate Melon rather than to continue to use the services of the management company. The directors of Banana therefore believe that Melon should be treated as an asset acquisition but are uncertain as to whether the International Accounting Standards Board's exposure draft *Definition of a Business and Accounting for Previously Held Interests ED 2016/1* would revise this conclusion.

The acquisition of bonds

On 1 July 20X5, Banana acquired $10 million 5% bonds at par with interest being due at 30 June each year. The bonds are repayable at a substantial premium so that the effective rate of interest was 7%. Banana intended to hold the bonds to collect the contractual cash flows arising from the bonds and measured them at amortised cost.

On 1 July 20X6, Banana sold the bonds to a third party for $8 million. The fair value of the bonds was $10·5 million at that date. Banana has the right to repurchase the bonds on 1 July 20X8 for $8·8 million and it is likely that this option will be exercised. The third party is obliged to return the coupon interest to Banana and to pay additional cash to Banana should bond values rise. Banana will also compensate the third party for any devaluation of the bonds.

Required:

(a) Draft an explanatory note to the directors of Banana, discussing the following:

(i) how goodwill should have been calculated on the acquisition of Grape and show the accounting entry which is required to amend the financial director's error; (8 marks)

(ii) why equity accounting was the appropriate treatment for Strawberry in the consolidated financial statements up to the date of its disposal showing the carrying amount of the investment in Strawberry just prior to disposal; (4 marks)

(iii) how the gain or loss on disposal of Strawberry should have been recorded in the consolidated financial statements and how the investment in Strawberry should be accounted for after the part disposal. (4 marks)

Note: Any workings can either be shown in the main body of the explanatory note or in an appendix to the explanatory note.

(b) Discuss whether the directors are correct to treat Melon as a financial asset acquisition and whether the International Accounting Standards Board's proposed amendments to the definition of a business would revise your conclusions. (7 marks)

(c) Discuss how the derecognition requirements of IFRS 9 *Financial Instruments* should be applied to the sale of the bond including calculations to show the impact on the consolidated financial statements for the year ended 30 June 20X7. (7 marks)

(30 marks)

2 Background

Farham manufactures white goods such as washing machines, tumble dryers and dishwashers. The industry is highly competitive with a large number of products on the market. Brand loyalty is consequently an important feature in the industry. Farham operates a profit related bonus scheme for its managers based upon the consolidated financial statements but recent results have been poor and bonus targets have rarely been achieved. As a consequence, the company is looking to restructure and sell its 80% owned subsidiary Newall which has been making substantial losses. The current year end is 30 June 20X8.

Factory subsidence

Farham has a production facility which started to show signs of subsidence since January 20X8. It is probable that Farham will have to undertake a major repair sometime during 20X9 to correct the problem. Farham does have an insurance policy but it is unlikely to cover subsidence. The chief operating officer (COO) refuses to disclose the issue at 30 June 20X8 since no repair costs have yet been undertaken although she is aware that this is contrary to international accounting standards. The COO does not think that the subsidence is an indicator of impairment. She argues that no provision for the repair to the factory should be made because there is no legal or constructive obligation to repair the factory.

Farham has a revaluation policy for property, plant and equipment and there is a balance on the revaluation surplus of $10 million in the financial statements for the year ended 30 June 20X8. None of this balance relates to the production facility but the COO is of the opinion that this surplus can be used for any future loss arising from the subsidence of the production facility. (5 marks)

Sale of Newall

At 30 June 20X8 Farham had a plan to sell its 80% subsidiary Newall. This plan has been approved by the board and reported in the media. It is expected that Oldcastle, an entity which currently owns the other 20% of Newall, will acquire the 80% equity interest. The sale is expected to be complete by December 20X8. Newall is expected to have substantial trading losses in the period up to the sale. The accountant of Farham wishes to show Newall as held for sale in the consolidated financial statements and to create a restructuring provision to include the expected costs of disposal and future trading losses. The COO does not wish Newall to be disclosed as held for sale nor to provide for the expected losses. The COO is concerned as to how this may affect the sales price and would almost certainly mean bonus targets would not be met. The COO has argued that they have a duty to secure a high sales price to maximise the return for shareholders of Farham. She has also implied that the accountant may lose his job if he were to put such a provision in the financial statements. The expected costs from the sale are as follows:

Future trading losses	$30 million
Various legal costs of sale	$2 million
Redundancy costs for Newall employees	$5 million
Impairment losses on owned assets	$8 million

Included within the future trading losses is an early payment penalty of $6 million for a leased asset which is deemed surplus to requirements. (6 marks)

Required:

(a) Discuss the accounting treatment which Farham should adopt to address each of the issues above for the consolidated financial statements.

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

(b) Discuss the ethical issues arising from the scenario, including any actions which Farham and the accountant should undertake. (7 marks)

Professional marks will be awarded in question 2 for the quality of the discussion. (2 marks)

(20 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 **(a)** Skizer is a pharmaceutical company which develops new products with other pharmaceutical companies that have the appropriate production facilities.

Stakes in development projects

When Skizer acquires a stake in a development project, it makes an initial payment to the other pharmaceutical company. It then makes a series of further stage payments until the product development is complete and it has been approved by the authorities. In the financial statements for the year ended 31 August 20X7, Skizer has treated the different stakes in the development projects as separate intangible assets because of the anticipated future economic benefits related to Skizer's ownership of the product rights. However, in the year to 31 August 20X8, the directors of Skizer decided that all such intangible assets were to be expensed as research and development costs as they were unsure as to whether the payments should have been initially recognised as intangible assets. This write off was to be treated as a change in an accounting estimate.

Sale of development project

On 1 September 20X6, Skizer acquired a development project as part of a business combination and correctly recognised the project as an intangible asset. However, in the financial statements to 31 August 20X7, Skizer recognised an impairment loss for the full amount of the intangible asset because of the uncertainties surrounding the completion of the project. During the year ended 31 August 20X8, the directors of Skizer judged that it could not complete the project on its own and could not find a suitable entity to jointly develop it. Thus, Skizer decided to sell the project, including all rights to future development. Skizer succeeded in selling the project and, as the project had a nil carrying value, it treated the sale proceeds as revenue in the financial statements. The directors of Skizer argued that IFRS 15 *Revenue from Contracts with Customers* states that revenue should be recognised when control is passed at a point in time. The directors of Skizer argued that the sale of the rights was part of their business model and that control of the project had passed to the purchaser.

Required:

(i) **Explain the criteria in both the 2010 version of the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*) of the International Accounting Standards Board and the 2015 proposed revision to the *Conceptual Framework* for the recognition of an asset and whether the criteria are the same in IAS® 38 *Intangible Assets*.** (6 marks)

(ii) **Discuss the implications for Skizer's financial statements for both the years ended 31 August 20X7 and 20X8 if the recognition criteria in IAS 38 for an intangible asset were met as regards the stakes in the development projects above. Your answer should also briefly consider the implications if the recognition criteria were not met.** (5 marks)

(iii) **Discuss whether the proceeds of the sale of the development project above should be treated as revenue in the financial statements for the year ended 31 August 20X8.** (4 marks)

(b) External disclosure of information on intangibles is useful only insofar as it is understood and is relevant to investors. It appears that investors are increasingly interested in and understand disclosures relating to intangibles. A concern is that, due to the nature of disclosure requirements of IFRS Standards, investors may feel that the information disclosed has limited usefulness, thereby making comparisons between companies difficult. Many companies spend a huge amount of capital on intangible investment, which is mainly developed within the company and thus may not be reported. Often, it is not obvious that intangibles can be valued or even separately identified for accounting purposes.

The *Integrated Reporting Framework* may be one way to solve this problem.

Required:

(i) **Discuss the potential issues which investors may have with:**

- **accounting for the different types of intangible asset acquired in a business combination;**
- **the choice of accounting policy of cost or revaluation models, allowed under IAS 38 *Intangible Assets* for intangible assets;**
- **the capitalisation of development expenditure.** (7 marks)

(ii) **Discuss whether integrated reporting can enhance the current reporting requirements for intangible assets.** (3 marks)

(25 marks)

4 (a) Toobasco is in the retail industry. In the reporting of financial information, the directors have disclosed several alternative performance measures (APMs), other than those defined or specified under IFRS Standards. The directors have disclosed the following APMs:

(i) 'Operating profit before extraordinary items' is often used as the headline measure of the Group's performance, and is based on operating profit before the impact of extraordinary items. Extraordinary items relate to certain costs or incomes which are excluded by virtue of their size and are deemed to be non-recurring. Toobasco has included restructuring costs and impairment losses in extraordinary items. Both items had appeared at similar amounts in the financial statements of the two previous years and were likely to occur in future years.

(ii) 'Operating free cash flow' is calculated as cash generated from operations less purchase of property, plant and equipment, purchase of own shares, and the purchase of intangible assets. The directors have described this figure as representing the residual cash flow in the business but have given no detail of its calculation. They have emphasised its importance to the success of the business. They have also shown free cash flow per share in bold next to earnings per share in order to emphasise the entity's ability to turn its earnings into cash.

(iii) 'EBITDAR' is defined as earnings before interest, tax, depreciation, amortisation and rent. EBITDAR uses operating profit as the underlying earnings. In an earnings release, just prior to the financial year end, the directors disclosed that EBITDAR had improved by $180 million because of cost savings associated with the acquisition of an entity six months earlier. The directors discussed EBITDAR at length describing it as 'record performance' but did not disclose any comparable information under IFRS Standards and there was no reconciliation to any measure under IFRS Standards. In previous years, rent had been deducted from the earnings figure to arrive at this APM.

(iv) The directors have not taken any tax effects into account in calculating the remaining APMs.

Required:

Advise the directors whether the above APMs would achieve fair presentation in the financial statements.

(10 marks)

(b) Daveed is a car retailer who leases vehicles to customers under operating leases and often sells the cars to third parties when the lease ends.

Net cash generated from operating activities for the year ended 31 August 20X8 for the Daveed Group is as follows:

Year ended 31 August 20X8	**$m**
Cash generated from operating activities	345
Income taxes paid	(21)
Pension deficit payments	(33)
Interest paid	(25)
Associate share of profits	12
Net cash generated from operating activities	278

Net cash flows generated from investing activities included interest received of $10 million and net capital expenditure of $46 million excluding the business acquisition at (iii) below.

There were also some errors in the presentation of the statement of cash flows which could have an impact on the calculation of net cash generated from operating activities.

The directors have provided the following information as regards any potential errors:

(i) Cars are treated as property, plant and equipment when held under operating leases and when they become available for sale, they are transferred to inventory at their carrying amount. In its statement of cash flows for the year ended 31 August 20X8, cash flows from investing activities included cash inflows relating to the disposal of cars ($30 million).

(ii) On 1 September 20X7, Daveed purchased a 25% interest in an associate for cash. The associate reported a profit after tax of $16 million and paid a dividend of $4 million out of these profits in the year ended

31 August 20X8. The directors had incorrectly included a figure of $12 million in cash generated from operating activities as the cash generated from the investment in the associate. The associate was correctly recorded at $23 million in the statement of financial position at 31 August 20X8 and profit for the year of $4 million was included in the statement of profit or loss.

(iii) Daveed also acquired a digital mapping business during the year ended 31 August 20X8. The statement of cash flows showed a loss of $28 million in net cash inflow generated from operating activities as the effect of changes in foreign exchange rates arising on the retranslation of this overseas subsidiary. The assets and liabilities of the acquired subsidiary had been correctly included in the calculation of the cash movement during the year.

(iv) During the year to 31 August 20X8, Daveed made exceptional contributions to the pension plan assets of $33 million but the statement of cash flows had not recorded the cash tax benefit of $6 million.

(v) Additionally, Daveed had capitalised the interest paid of $25 million into property, plant and equipment ($18 million) and inventory ($7 million).

(vi) Daveed has defined operating free cash flow as net cash generated by operating activities as adjusted for net capital expenditure, purchase of associate and dividends received, interest received and paid. Any exceptional items should also be excluded from the calculation of free cash flow.

Required:

Prepare:

(i) an adjusted statement of net cash generated from operating activities to correct any errors above; (4 marks)

(ii) a reconciliation from net cash generated by operating activities to operating free cash flow (as described in note (vi) above); and (4 marks)

(iii) an explanation of the adjustments made in parts (i) and (ii) above. (5 marks)

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

(25 marks)

End of Question Paper