Professional Level – Essentials Module

Corporate Reporting (International)

March/June 2017 – 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

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The question paper begins on page 3.

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

1 (a) The following draft statements of financial position relate to Diamond, Spade and Club, all public listed entities, as at 31 March 2017.

	Diamond $m	Spade $m	Club $m
Assets			
Non-current assets			
Property, plant and equipment	1,062	1,210	1,265
Investments in subsidiaries			
Spade	1,140		
Club	928		
Investment in Heart	68		
Other financial assets	190		
	3,388	1,210	1,265
Current assets:	885	782	224
Total assets	4,273	1,992	1,489
Equity and liabilities			
Equity share capital ($1 each)	1,650	720	700
Retained earnings	1,180	880	364
Other components of equity	128	78	59
Total equity	2,958	1,678	1,123
Non-current liabilities	1,143	189	172
Current liabilities	172	125	194
Total liabilities	1,315	314	366
Total equity and liabilities	4,273	1,992	1,489

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

1. On 1 April 2016, Diamond acquired 70% of the equity interests of Spade paying cash of $1,140 million. At 1 April 2016, the retained earnings and other components of equity of Spade were $780 million and $64 million respectively.

   The fair value of the identifiable net assets of Spade at 1 April 2016 was $1,600 million. It is group policy to value non-controlling interests at fair value and, at the date of acquisition, this was $485 million. The excess in fair value of the identifiable net assets is due to non-depreciable land.

2. On 1 April 2015, Diamond acquired 40% of the equity interests of Club for cash consideration of $420 million. At this date the carrying amount and fair value of the identifiable net assets of Club was $1,032 million. Diamond treated Club as an associate and equity accounted for Club up to 31 March 2016. On 1 April 2016, Diamond took control of Club, acquiring a further 45% interest for cash of $500 million and added this amount to the carrying amount of its investment in Club. On 1 April 2016, the retained earnings and other components of equity of Club were $293 million and $59 million respectively and the fair value of the identifiable net assets was $1,062 million. The difference between the carrying amounts and the fair values was in relation to plant with a remaining useful life of five years. The share prices of Diamond and Club were $5 and $1·60 respectively on 1 April 2016. The fair value of the original 40% holding and the fair value of the non-controlling interest should both be estimated using the market value of the shares.

3. Diamond has owned a 25% equity interest in Heart for a number of years. Heart had profits for the year ended 31 March 2017 of $20 million which can be assumed to have accrued evenly. Heart does not have any other comprehensive income. On 30 September 2016, Diamond sold a 10% equity interest for cash of $42 million. Diamond was unsure of how to treat the disposal and so has deducted the proceeds from the

carrying amount of the investment at 1 April 2016 which was $110 million (calculated using the equity accounting method). The fair value of the remaining 15% shareholding was estimated to be $65 million at 30 September 2016 and $67 million at 31 March 2017. Diamond no longer exercises significant influence and has designated the remaining shareholding as fair value through other comprehensive income.

4. Goodwill has been reviewed for impairment and no impairment was deemed necessary.

5. On 1 April 2015, Diamond acquired $50 million of 6% listed bonds at their nominal value. Diamond may sell or hold bonds to maturity and so, based on this business model, has designated the bonds as fair value through other comprehensive income. The effective rate of interest on the bonds is also 6%. The bonds had a fair value of $42 million at 31 March 2016 and were correctly treated in the financial statements of that year.

   On 31 March 2017, Diamond received the coupon interest of $3 million, which was recorded within interest received, and then sold the bonds on the same day for $35 million. The disposal proceeds were substantially below the fair value of the bonds which was $38 million at 31 March 2017. A $7 million loss on disposal was charged against profits. Diamond has an option to repurchase the bonds at any time up to 31 December 2018 for $36 million. The fair value is expected to increase in the future and it is highly likely that Diamond will exercise this option.

6. Diamond operates a defined benefit pension scheme. On 31 March 2017, the company announced that it was to close down a business division and agreed to pay each of its 150 staff a cash payment of $50,000 to compensate them for loss of pension arising from wage inflation. It is estimated that the closure will reduce the present value of the pension obligation by $5·8 million. Diamond is unsure of how to deal with the settlement and curtailment and has not yet recorded anything within its financial statements.

7. On 1 April 2016, Diamond acquired a manufacturing unit under an eight-year finance lease. The lease rentals have been recorded correctly in the financial statements of Diamond. However, Diamond could not operate effectively from the unit until alterations to its structure costing $6·6 million were completed. The manufacturing unit was ready for use on 31 March 2017. The alteration costs of $6·6 million were charged to administration expenses. The lease requires Diamond to restore the unit to its original condition at the end of the lease term. Diamond estimates that this will cost a further $5 million. Market interest rates are currently 6%.

Note: The following discount factors may be relevant:

Periods	6%
7	0·665
8	0·627

Required:

Prepare the consolidated statement of financial position of the Diamond Group as at 31 March 2017 in accordance with International Financial Reporting Standards. (35 marks)

(b) Diamond is looking at ways that it may improve its liquidity. One option is to sell some of its trade receivables to a debt factor. The directors are considering two possible alternative agreements as described below:

1. Diamond could sell $40 million receivables to a factor with the factor advancing 80% of the funds in full and final settlement. The factoring is non-recourse except that Diamond has guaranteed that it will pay the factor a further 9% of each receivable which is not recovered within six months. Diamond believes that its customers represent a low credit risk and so the probability of default is very low. The fair value of the guarantee is estimated to be $50,000.
2. Alternatively, the factor would advance 20% of the $40 million receivables sold. Further amounts will become payable to Diamond but are subject to an imputed interest charge so that Diamond receives progressively less of the remaining balance the longer it takes the factor to recover the funds. The factor has full recourse to Diamond for a six-month period after which Diamond has no further obligations and has no rights to receive any further payments from the factor.

Required:

If Diamond decides to go ahead with the debt factoring arrangements, explain the financial reporting principles involved and advise how each of the above arrangements would impact upon the financial statements of future years.

(9 marks)

(c) Diamond has debt covenants attached to some of the loan balances included within liabilities on its statement of financial position. The covenants create a legal obligation to repay the debt in full if Diamond fails to maintain a liquidity ratio and operating profit margin above a specified minimum. The directors are concerned about the negative impact which any potential debt factoring arrangements (as described in part (b) above) may have on these covenants. If they proceed, they are proposing to treat the factoring arrangements in accordance with their legal form so that it is consistent with the legal obligation created by the covenants. Any discount arising from the factoring arrangement would be disclosed separately on the face of the statement of profit or loss and other comprehensive income. The directors believe that this will achieve consistency, though they are aware that the proposed treatment may be contrary to accounting standards.

Required:

Discuss the ethical issues which arise from the proposal by Diamond. (6 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Canto Co is a company which manufactures industrial machinery and has a year end of 28 February 2017. The directors of Canto require advice on the following issues:

(a) On 1 March 2014, Canto acquired a property for $15 million, which was used as an office building. Canto measured the property on the cost basis in property, plant and equipment. The useful life of the building was estimated at 30 years from 1 March 2014 with no residual value. Depreciation is charged on the straight-line basis over its useful life. At acquisition, the value of the land content of the property was thought to be immaterial.

During the financial year to 28 February 2017, the planning authorities approved the land to build industrial units and retail outlets on the site. During 2017, Canto ceased using the property as an office and converted the property to an industrial unit. Canto also built retail units on the land during the year to 28 February 2017. At 28 February 2017, Canto wishes to transfer the property at fair value to investment property at $20 million. This valuation was based upon other similar properties owned by Canto. However, if the whole site were sold including the retail outlets, it is estimated that the value of the industrial units would be $25 million because of synergies and complementary cash flows.

The directors of Canto wish to know whether the fair valuation of the investment property is in line with International Financial Reporting Standards and how to account for the change in use of the property in the financial statements at 28 February 2017. (8 marks)

(b) On 28 February 2017, Canto acquired all of the share capital of Binlory, a company which manufactures and supplies industrial vehicles. At the acquisition date, Binlory has an order backlog, which relates to a contract between itself and a customer for 10 industrial vehicles to be delivered in the next two years.

In addition, Binlory requires the extensive use of water in the manufacturing process and can take a pre-determined quantity of water from a water source for industrial use. Binlory cannot manufacture vehicles without the use of the water rights. Binlory was the first entity to use water from this source and acquired this legal right at no cost several years ago. Binlory has the right to continue to use the quantity of water for manufacturing purposes but any unused water cannot be sold separately. These rights can be lost over time if non-use of the water source is demonstrated or if the water has not been used for a certain number of years. Binlory feels that the valuation of these rights is quite subjective and difficult to achieve.

The directors of Canto wish to know how to account for the above intangible assets on the acquisition of Binlory. (7 marks)

(c) Canto acquired a cash-generating unit (CGU) several years ago but, at 28 February 2017, the directors of Canto were concerned that the value of the CGU had declined because of a reduction in sales due to new competitors entering the market. At 28 February 2017, the carrying amounts of the assets in the CGU before any impairment testing were:

	($m)
Goodwill	3
Property, plant and equipment	10
Other assets	19
Total	32

The fair values of the property, plant and equipment and the other assets at 28 February 2017 were $10 million and $17 million respectively and their costs to sell were $100,000 and $300,000 respectively.

The CGU's cash flow forecasts for the next five years are as follows:

Date year ended	Pre-tax cash flow ($m)	Post-tax cash flow ($m)
28 February 2018	8	5
28 February 2019	7	5
28 February 2020	5	3
28 February 2021	3	1·5
28 February 2022	13	10

The pre-tax discount rate for the CGU is 8% and the post-tax discount rate is 6%. Canto has no plans to expand the capacity of the CGU and believes that a reorganisation would bring cost savings but, as yet, no plan has been approved.

The directors of Canto need advice as to whether the CGU's value is impaired.

The following extract from a table of present value factors has been provided.

Year	Discount rate 6%	Discount rate 8%
1	0·9434	0·9259
2	0·8900	0·8573
3	0·8396	0·7938
4	0·7921	0·7350
5	0·7473	0·6806

(8 marks)

Required:

Advise the directors of Canto on how the above transactions should be 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 2 for clarity and quality of presentation. (2 marks)

(25 marks)

3 Carsoon Co is a company which manufactures and retails motor vehicles. It also constructs premises for third parties. It has a year end of 28 February 2017.

(a) The entity enters into lease agreements with the public for its motor vehicles. The agreements are normally for a three-year period. The customer decides how to use the vehicle within certain contractual limitations. The maximum mileage per annum is specified at 10,000 miles without penalty and the vehicle cannot be used in other jurisdictions. Carsoon is responsible for the maintenance of the vehicle and insists that the vehicle cannot be modified in any way. At the end of the three-year contract, the customer can purchase the vehicle at a price which will be above the market value, or alternatively hand it back to Carsoon. If the vehicle is returned, Carsoon will then sell the vehicle on to the public through one of its retail outlets. These sales of vehicles are treated as investing activities in the statement of cash flows.

The directors of Carsoon wish to know how the leased vehicles should be accounted for, from the commencement of the lease to the final sale of the vehicle, in the financial statements including the statement of cash flows.

(8 marks)

(b) On 1 March 2016, Carsoon invested in a debt instrument with a fair value of $6 million and has assessed that the financial asset is aligned with the fair value through other comprehensive income business model. The instrument has an interest rate of 4% over a period of six years. The effective interest rate is also 4%. On 1 March 2016, the debt instrument is not impaired in any way. During the year to 28 February 2017, there was a change in interest rates and the fair value of the instrument seemed to be affected. The instrument was quoted in an active market at $5·3 million but the price based upon an in-house model showed that the fair value of the instrument was $5·5 million. This valuation was based upon the average change in value of a range of instruments across a number of jurisdictions.

The directors of Carsoon felt that the instrument should be valued at $5·5 million and that this should be shown as a Level 1 measurement under IFRS 13 *Fair Value Measurement*. There has not been a significant increase in credit risk since 1 March 2016, and expected credit losses should be measured at an amount equal to 12-month expected credit losses of $400,000. Carsoon sold the debt instrument on 1 March 2017 for $5·3 million.

The directors of Carsoon wish to know how to account for the debt instrument until its sale on 1 March 2017.

(8 marks)

(c) Carsoon constructs retail vehicle outlets and enters into contracts with customers to construct buildings on their land. The contracts have standard terms, which include penalties payable by Carsoon if the contract is delayed, or payable by the customer, if Carsoon cannot gain access to the construction site.

Due to poor weather, one of the projects was delayed. As a result, Carsoon faced additional costs and contractual penalties. As Carsoon could not gain access to the construction site, the directors decided to make a counter-claim against the customer for the penalties and additional costs which Carsoon faced. Carsoon felt that because claims had been made against the customer, the additional costs and penalties should not be included in contract costs but shown as a contingent liability. Carsoon has assessed the legal basis of the claim and feels it has enforceable rights.

In the year ended 28 February 2017, Carsoon incurred general and administrative costs of $10 million, and costs relating to wasted materials of $5 million.

Additionally, during the year, Carsoon agreed to construct a storage facility on the same customer's land for $7 million at a cost of $5 million. The parties agreed to modify the contract to include the construction of the storage facility, which was completed during the current financial year. All of the additional costs relating to the above were capitalised as assets in the financial statements.

The directors of Carsoon wish to know how to account for the penalties, counter claim and additional costs in accordance with IFRS 15 *Revenue from Contracts with Customers*. (7 marks)

Required:

Advise Carsoon on how the above transactions should be 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 (a) The existing *Conceptual Framework* has several notable omissions. It does not include an explicit reference to substance over form nor does it define derecognition or when derecognition should occur. The International Accounting Standards Board has also removed prudence from its framework and has attracted criticism from the academic and practitioner communities for doing so. However, the Exposure Draft on the *Conceptual Framework* attempts to explain the roles of prudence and substance over form in financial reporting whilst putting forward proposals to clarify the aims of the accounting requirements for derecognition.

Required:

(i) Discuss the features of the concept of prudence and the arguments for and against its re-introduction into the *Conceptual Framework*. (6 marks)

(ii) Explain why it is important for there to be guidance in the *Conceptual Framework* on the role of substance over form, and the principles relating to derecognition set out in the Exposure Draft on the *Conceptual Framework*. (8 marks)

(b) (i) Skye has B shares in issue which allow the holders to request redemption at specified dates and amounts. The legal charter of Skye states that the entity has a choice whether or not to accept the request for repayment of the B shares. There are no other conditions attached to the shares and Skye has never refused to redeem any of the shares up to the current year end of 31 May 2017. In all other respects the instruments have the characteristics of equity.

Skye also has preference shares in issue which are puttable by the holders at any time after 31 May 2017. Under the terms of the shares, Skye has to satisfy the obligation for the preference shares only if it has sufficient distributable reserves. Local legislation is quite restrictive in defining the profits available for distribution as dividends.

The directors of Skye wish advice on how to account for the above financial instruments in the company's financial statements at 31 May 2017. (5 marks)

(ii) Skye faces a claim for infringement of the intellectual property rights of a competitor company. On 31 May 2017, Skye agreed to settle the claim and has paid $15 million to the competitor plus a variable amount of 2% based upon future sales. The variable amount represents compensation for the use of the intellectual property in the past (0·5%) and for its use in the future (1·5%). The directors of Skye have recently heard that the ED *Conceptual Framework* has changed the definition of a liability and now feel that there is no future liability arising on the settlement of the claim as it has paid the compensation due to date.

The directors of Skye, however, still require advice on the matter. (4 marks)

Required:

Advise the directors of Skye on how the above transactions should be 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 4 for clarity and quality of presentation. (2 marks)

(25 marks)

End of Question Paper