Strategic Professional – Essentials

# Strategic Business Reporting – International (SBR – INT)

March/June 2019 – Sample Questions

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.**

SBR – INT

Think Ahead ACCA

**The Association of Chartered Certified Accountants**

**Section A – BOTH questions are compulsory and MUST be attempted**

**1** Background

Carbise is the parent company of an international group which has a presentation and functional currency of the dollar. The group operates within the manufacturing sector. On 1 January 20X2, Carbise acquired 80% of the equity share capital of Bikelite, an overseas subsidiary. The acquisition enabled Carbise to access new international markets. Carbise transfers surplus work-in-progress to Bikelite which is then completed and sold in various locations. The acquisition was not as successful as anticipated and on 30 September 20X6 Carbise disposed of all of its holding in Bikelite. The current year end is 31 December 20X6.

Bikelite trading information

Bikelite is based overseas where the domestic currency is the dinar. Staff costs and overhead expenses are all paid in dinars. However, Bikelite also has a range of transactions in a number of other currencies. Approximately 40% of its raw material purchases are in dinars and 50% in the yen. The remaining 10% are in dollars of which approximately half were purchases of material from Carbise. This ratio continued even after Carbise disposed of its shares in Bikelite. Revenue is invoiced in equal proportion between dinars, yen and dollars. To protect itself from exchange rate risk, Bikelite retains cash in all three currencies. No dividends have been paid by Bikelite for several years. At the start of 20X6 Bikelite sought additional debt finance. As Carbise was already looking to divest, funds were raised from an issue of bonds in dinars, none of which were acquired by Carbise.

Acquisition of Bikelite

Carbise paid dinar 100 million for 80% of the ordinary share capital of Bikelite on 1 January 20X2. The net assets of Bikelite at this date had a carrying amount of dinar 60 million. The only fair value adjustment deemed necessary was in relation to a building which had a fair value of dinar 20 million above its carrying amount and a remaining useful life of 20 years at the acquisition date. Carbise measures non-controlling interests (NCI) at fair value for all acquisitions, and the fair value of the 20% interest was estimated to be dinar 22 million at acquisition. Due to the relatively poor performance of Bikelite, it was decided to impair goodwill by dinar 6 million during the year ending 31 December 20X5.

Rates of exchange between the $ and dinar are given as follows:

| | |
|---|---|
| 1 January 20X2: | \$1:0·5 dinar |
| Average rate for year ended 31 December 20X5 | \$1:0·4 dinar |
| 31 December 20X5: | \$1:0·38 dinar |
| 30 September 20X6: | \$1:0·35 dinar |
| Average rate for the nine-month period ended 30 September 20X6 | \$1:0·37 dinar |

Disposal of Bikelite

Carbise sold its entire equity shareholding in Bikelite on 30 September 20X6 for $150 million. Further details relating to the disposal are as follows:

| | |
|---|---|
| Carrying amount of Bikelite's net assets at 1 January 20X6 | dinar 48 million |
| Bikelite loss for the year ended 31 December 20X6 | dinar 8 million |
| Cumulative exchange gains on Bikelite at 1 January 20X6 | \$74·1 million |
| Non-controlling interest in Bikelite at 1 January 20X6 | \$47·8 million |

**Required:**

**(a) Prepare an explanatory note for the directors of Carbise which addresses the following issues:**

**(i) What is meant by an entity's presentation and functional currency. Explain your answer with reference to how the presentation and functional currency of Bikelite should be determined.** (7 marks)

**(ii) A calculation of the goodwill on the acquisition of Bikelite and what the balance would be at 30 September 20X6 immediately before the disposal of the shares. Your answer should include a calculation of the exchange difference on goodwill for the period from 1 January 20X6 to 30 September 20X6.** (5 marks)

**(iii) An explanation of your calculation of goodwill and the treatment of exchange differences on goodwill in the consolidated financial statements. You do not need to discuss how the disposal will affect the exchange differences.** (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) Explain why exchange differences will arise on the net assets and profit or loss of Bikelite each year and how they would be presented within the consolidated financial statements. Your answer should include a calculation of the exchange differences which would arise on the translation of Bikelite (excluding goodwill) in the year ended 31 December 20X6.** (7 marks)

**(c) (i) Calculate the group profit or loss on the disposal of Bikelite.** (3 marks)

**(ii) Briefly explain how Bikelite should be treated and presented in the consolidated financial statements of Carbise for the year ended 31 December 20X6.** (4 marks)

**(30 marks)**

## 2 Background

Hudson has a year end of 31 December 20X2 and operates a defined benefit scheme for all employees. In addition, the directors of Hudson are paid an annual bonus depending upon the earnings before interest, tax, depreciation and amortisation (EBITDA) of Hudson.

Hudson has been experiencing losses for a number of years and its draft financial statements reflect a small loss for the current year of $10 million. On 1 May 20X2, Hudson announced that it was restructuring and that it was going to close down division Wye. A number of redundancies were confirmed as part of this closure with some staff being reallocated to other divisions within Hudson. The directors have approved the restructuring in a formal directors meeting. Hudson is highly geared and much of its debt is secured on covenants which stipulate that a minimum level of net assets should be maintained. The directors are concerned that compliance with International Financial Reporting Standards (IFRS® Standards) could have significant implications for their bonus and debt covenants.

### Redundancy and settlement costs

Hudson still requires a number of staff to operate division Wye until its final expected closure in early 20X3. As a consequence, Hudson offered its staff two settlement packages in relation to the curtailment of the defined benefit scheme. A basic settlement was offered for all staff who leave before the final closure of division Wye. An additional pension contribution was offered for staff who remained in employment until the final closure of division Wye.

The directors of Hudson have only included an adjustment in the financial statements for those staff who left prior to 31 December 20X2. The directors have included this adjustment within the remeasurement component of the defined benefit scheme. They do not wish to provide for any other settlement contributions until employment is finally terminated, arguing that an obligation would only arise once the staff were made redundant. On final termination, the directors intend to include the remaining basic settlement and the additional pension contribution within the remeasurement component. The directors and accountant are aware that the proposed treatment does not conform to IFRS Standards. The directors believe that the proposed treatment is justified as it will help Hudson maintain its debt covenant obligations and will therefore be in the best interests of their shareholders who are the primary stakeholder. The directors have indicated that, should the accountant not agree with their accounting treatment, then he will be replaced.

### Tax losses

The directors of Hudson wish to recognise a material deferred tax asset in relation to $250 million of unused trading losses which have accumulated as at 31 December 20X2. Hudson has budgeted profits for $80 million for the year ended 31 December 20X3. The directors have forecast that profits will grow by 20% each year for the next four years. The market is currently depressed and sales orders are at a lower level for the first quarter of 20X3 than they were for the same period in any of the previous five years. Hudson operates under a tax jurisdiction which allows for trading losses to be only carried forward for a maximum of two years.

**Required:**

**(a) Explain why the directors of Hudson are wrong to classify the basic settlement and additional pension contributions as part of the remeasurement component, including an explanation of the correct treatment for each of these items. Also explain how any other restructuring costs should be accounted for.** (8 marks)

**(b) Explain whether a deferred tax asset can be recognised in the financial statements of Hudson in the year ended 31 December 20X2.** (5 marks)

**(c) Identify any ethical issues which arise from the directors' proposed accounting treatments and behaviour. Your answer should also consider the implications for the accountant arising from the directors' behaviour.** (5 marks)

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

**(20 marks)**

**Section B – BOTH questions are compulsory and MUST be attempted**

**3 (a) (i)** Crypto operates in the power industry, and owns 45% of the voting shares in Kurran. Kurran has four other investors which own the remaining 55% of its voting shares and are all technology companies. The largest of these holdings is 18%. Kurran is a property developer and purchases property for its renovation potential and subsequent disposal. Crypto has no expertise in this area and is not involved in the renovation or disposal of the property.

The board of directors of Kurran makes all of the major decisions but Crypto can nominate up to four of the eight board members. Each of the remaining four board members are nominated by each of the other investors. Any major decisions require all board members to vote and for there to be a clear majority. Thus, Crypto has effectively the power of veto on any major decision. There is no shareholder agreement as to how Kurran should be operated or who will make the operating decisions for Kurran. The directors of Crypto believe that Crypto has joint control over Kurran because it is the major shareholder and holds the power of veto over major decisions.

The directors of Crypto would like advice as to whether or not they should account for Kurran under IFRS® 11 *Joint Arrangements*. (6 marks)

**(ii)** On 1 April 20X7, Crypto, which has a functional currency of the dollar, entered into a contract to purchase a fixed quantity of electricity at 31 December 20X8 for 20 million euros. At that date, the spot rate was 1·25 dollars to the euro. The electricity will be used in Crypto's production processes.

Crypto has separated out the foreign currency embedded derivative from the electricity contract and measured it at fair value through other comprehensive income (FVTOCI). However, on 31 December 20X7, there was a contractual modification, such that the contract is now an executory contract denominated in dollars. At this date, Crypto calculated that the embedded derivative had a negative fair value of 2 million euros.

The directors of Crypto would like advice as to whether they should have separated out the foreign currency derivative and measured it at FVTOCI, and how to treat the modification in the contract. (5 marks)

**Required:**

**Advise the directors of Crypto as to how the above issues should be accounted for with reference to relevant IFRS Standards.**

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

**(b)** Previous leasing standards have been criticised about the lack of information they required to be disclosed on leasing transactions. These concerns were usually expressed by investors and so IFRS 16 *Leases* was issued in response to these criticisms.

**Required:**

**(i) Discuss some of the key changes to financial statements which investors will see when companies apply the lessee accounting requirements in IFRS 16.** (6 marks)

**(ii) For a company with significant off-balance sheet leases, discuss the likely impact that IFRS 16 will have generally on accounting ratios and particularly on:**

- **Earnings before interest and tax to interest expense (interest cover);**
- **Earnings before interest and tax to capital employed (return on capital employed);**
- **Debt to earnings before interest, tax, depreciation and amortisation (EBITDA).** (6 marks)

Professional marks will be awarded in question 3b for clarity and quality of discussion. (2 marks)

**(25 marks)**

**4** **(a)** In the 2015 Exposure Draft on the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*), the accounting model is built on the definitions and principles for recognition of assets and liabilities. The understandability and consistent application of these definitions and principles are crucial. However, it appears that standard setters have interpreted the existing definitions differently for many years and the result is that the *Conceptual Framework* (2010) is inconsistent with many existing IFRS Standards.

**Required:**

**(i)** **Discuss and contrast the criteria for recognition of assets and liabilities in financial statements as set out in the current *Conceptual Framework* (2010) and the 2015 Exposure Draft on the *Conceptual Framework*.** (7 marks)

**(ii)** **Discuss how the recognition of assets and liabilities under IAS® 12 *Income Taxes* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are both inconsistent with the definitions in the *Conceptual Framework* (2010) and how certain items recognised in a business combination may not be recognised in the individual financial statements of the group companies.** (6 marks)

**(b)** Zedtech is a software development company which provides data hosting and other professional services. As part of these services, Zedtech also securely hosts a range of inventory management software online which allows businesses to manage inventory from anywhere in the world. It also sells hardware in certain circumstances.

Zedtech sells two distinct software packages. The first package, named 0inventory, gives the customer the option to buy the hardware, professional services and hosting services as separate and distinct contracts. Each element of the package can be purchased without affecting the performance of any other element. Zedtech regularly sells each service separately and generally does not integrate the goods and services into a single contract.

With the second package, InventoryX, the hardware is always sold along with the professional and hosting services and the customer cannot use the hardware on its own. The hardware is integral to the delivery of the hosted software. Zedtech delivers the hardware first, followed by professional services and finally, the hosting services. However, the professional services can be sold on a stand-alone basis as this is a distinct service which Zedtech can offer any customer.

Zedtech has decided to sell its services in a new region of the world which is suffering an economic downturn. The entity expects the economy to recover and feels that there is scope for significant growth in future years. Zedtech has entered into an arrangement with a customer in this region for promised consideration of $3 million. At contract inception, Zedtech feels that it may not be able to collect the full amount from the customer and estimates that it may collect 80% of the consideration.

**Required:**

**(i)** **Discuss the principles in IFRS 15 *Revenue from Contracts with Customers* which should be used by Zedtech to determine the recognition of the above contracts.** (5 marks)

**(ii)** **Discuss how the above contracts should be recognised in the financial statements of Zedtech under IFRS 15.** (7 marks)

**(25 marks)**

**End of Question Paper**