

Professional Level – Essentials Module

# Corporate Reporting (International)

Tuesday 9 June 2009

**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

This 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 paper until instructed by the supervisor.**

**During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

The Association of Chartered Certified Accountants

# Paper P2 (INT)

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The question paper begins on page 3.**

**Section A – This ONE question is compulsory and MUST be attempted**

- 1 Bravado, a public limited company, has acquired two subsidiaries and an associate. The draft statements of financial position are as follows at 31 May 2009:

	Bravado \$m	Message \$m	Mixed \$m
Assets:			
Non-current assets			
Property, plant and equipment	265	230	161
Investments in subsidiaries			
Message	300		
Mixed	128		
Investment in associate – Clarity	20		
Available-for-sale financial assets	51	6	5
	<u>764</u>	<u>236</u>	<u>166</u>
Current assets:			
Inventories	135	55	73
Trade receivables	91	45	32
Cash and cash equivalents	102	100	8
	<u>328</u>	<u>200</u>	<u>113</u>
Total assets	<u>1,092</u>	<u>436</u>	<u>279</u>
Equity and liabilities:			
Share capital	520	220	100
Retained earnings	240	150	80
Other components of equity	12	4	7
Total equity	<u>772</u>	<u>374</u>	<u>187</u>
Non-current liabilities:			
Long-term borrowings	120	15	5
Deferred tax	25	9	3
Total non-current liabilities	<u>145</u>	<u>24</u>	<u>8</u>
Current liabilities			
Trade and other payables	115	30	60
Current tax payable	60	8	24
Total current liabilities	<u>175</u>	<u>38</u>	<u>84</u>
Total liabilities	<u>320</u>	<u>62</u>	<u>92</u>
Total equity and liabilities	<u>1,092</u>	<u>436</u>	<u>279</u>

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

- (i) On 1 June 2008, Bravado acquired 80% of the equity interests of Message, a private entity. The purchase consideration comprised cash of \$300 million. The fair value of the identifiable net assets of Message was \$400 million including any related deferred tax liability arising on acquisition. The owners of Message had to dispose of the entity for tax purposes by a specified date and, therefore, sold the entity to the first company to bid for it, which was Bravado. An independent valuer has stated that the fair value of the non-controlling interest in Message was \$86 million on 1 June 2008. Bravado does not wish to measure the non-controlling interest in subsidiaries on the basis of the proportionate interest in the identifiable net assets but wishes to use the 'full goodwill' method. The retained earnings of Message were \$136 million and other components of equity were \$4 million at the date of acquisition. There had been no new issue of capital by Message since the date of acquisition and the excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

- (ii) On 1 June 2007, Bravado acquired 6% of the ordinary shares of Mixed. Bravado had treated this investment as available-for-sale in the financial statements to 31 May 2008 but had restated the investment at cost on Mixed becoming a subsidiary. On 1 June 2008, Bravado acquired a further 64% of the ordinary shares of Mixed and gained control of the company. The consideration for the acquisitions was as follows:

	Holding	Consideration \$m
1 June 2007	6%	10
1 June 2008	64%	118
	<u>70%</u>	<u>128</u>

Under the purchase agreement of 1 June 2008, Bravado is required to pay the former shareholders 30% of the profits of Mixed on 31 May 2010 for each of the financial years to 31 May 2009 and 31 May 2010. The fair value of this arrangement was estimated at \$12 million at 1 June 2008 and at 31 May 2009 this value had not changed. This amount has not been included in the financial statements.

At 1 June 2008, the fair value of the equity interest in Mixed held by Bravado before the business combination was \$15 million and the fair value of the non-controlling interest in Mixed was \$53 million. The fair value of the identifiable net assets at 1 June 2008 of Mixed was \$170 million (excluding deferred tax assets and liabilities), and the retained earnings and other components of equity were \$55 million and \$7 million respectively. There had been no new issue of share capital by Mixed since the date of acquisition and the excess of the fair value of the net assets is due to an increase in the value of property, plant and equipment (PPE).

The fair value of the PPE was provisional pending receipt of the final valuations for these assets. These valuations were received on 1 December 2008 and they resulted in a further increase of \$6 million in the fair value of the net assets at the date of acquisition. This increase does not affect the fair value of the non-controlling interest. PPE is depreciated on the straight-line basis over seven years. The tax base of the identifiable net assets of Mixed was \$166 million at 1 June 2008. The tax rate of Mixed is 30%.

- (iii) Bravado acquired a 10% interest in Clarity, a public limited company, on 1 June 2007 for \$8 million. The investment was accounted for as an available-for-sale investment and at 31 May 2008, its value was \$9 million. On 1 June 2008, Bravado acquired an additional 15% interest in Clarity for \$11 million and achieved significant influence. Clarity made profits after dividends of \$6 million and \$10 million for the years to 31 May 2008 and 31 May 2009.
- (iv) On 1 June 2007, Bravado purchased an equity instrument of 11 million dinars which was its fair value. The instrument was classified as available-for-sale. The relevant exchange rates and fair values were as follows:

	\$ to dinars	Fair value of instrument – dinars
1 June 2007	4.5	11
31 May 2008	5.1	10
31 May 2009	4.8	7

Bravado has not recorded any change in the value of the instrument since 31 May 2008. The reduction in fair value as at 31 May 2009 is deemed to be as a result of impairment.

- (v) Bravado manufactures equipment for the retail industry. The inventory is currently valued at cost. There is a market for the part completed product at each stage of production. The cost structure of the equipment is as follows:

	Cost per unit \$	Selling price per unit \$
Production process – 1st stage	1,000	1,050
Conversion costs – 2nd stage	500	
Finished product	<u>1,500</u>	1,700

The selling costs are \$10 per unit and Bravado has 100,000 units at the first stage of production and 200,000 units of the finished product at 31 May 2009. Shortly before the year end, a competitor released a new model

onto the market which caused the equipment manufactured by Bravado to become less attractive to customers. The result was a reduction in the selling price to \$1,450 of the finished product and \$950 for 1st stage product.

- (vi) The directors have included a loan to a director of Bravado in cash and cash equivalents of \$1 million. The loan has no specific repayment date on it but is repayable on demand. The directors feel that there is no problem with this accounting entry as there is a choice of accounting policy within International Financial Reporting Standards (IFRS) and that showing the loan as cash is their choice of accounting policy as there is no IFRS which says that this policy cannot be utilised.
- (vii) There is no impairment of goodwill arising on the acquisitions.

**Required:**

- (a) **Prepare a consolidated statement of financial position as at 31 May 2009 for the Bravado Group.** (35 marks)
- (b) **Calculate and explain the impact on the calculation of goodwill if the non-controlling interest was calculated on a proportionate basis for Message and Mixed.** (8 marks)
- (c) **Discuss the view of the directors that there is no problem with showing a loan to a director as cash and cash equivalents, taking into account their ethical and other responsibilities as directors of the company.** (5 marks)
- Professional marks will be awarded in part (c) for clarity and expression of your discussion. (2 marks)
- (50 marks)**

**Section B – TWO questions ONLY to be attempted**

2 The directors of Aron, a public limited company, are worried about the challenging market conditions which the company is facing. The markets are volatile and illiquid. The central government is injecting liquidity into the economy. The directors are concerned about the significant shift towards the use of fair values in financial statements. IAS 39 'Financial Instruments: recognition and measurement' defines fair value and requires the initial measurement of financial instruments to be at fair value. The directors are uncertain of the relevance of fair value measurements in these current market conditions.

**Required:**

**(a) Briefly discuss how the fair value of financial instruments is determined, commenting on the relevance of fair value measurements for financial instruments where markets are volatile and illiquid.** (4 marks)

**(b)** Further they would like advice on accounting for the following transactions within the financial statements for the year ended 31 May 2009:

(i) Aron issued one million convertible bonds on 1 June 2006. The bonds had a term of three years and were issued with a total fair value of \$100 million which is also the par value. Interest is paid annually in arrears at a rate of 6% per annum and bonds, without the conversion option, attracted an interest rate of 9% per annum on 1 June 2006. The company incurred issue costs of \$1 million. If the investor did not convert to shares they would have been redeemed at par. At maturity all of the bonds were converted into 25 million ordinary shares of \$1 of Aron. No bonds could be converted before that date. The directors are uncertain how the bonds should have been accounted for up to the date of the conversion on 31 May 2009 and have been told that the impact of the issue costs is to increase the effective interest rate to 9.38%. (6 marks)

(ii) Aron held 3% holding of the shares in Smart, a public limited company. The investment was classified as available-for-sale and at 31 May 2009 was fair valued at \$5 million. The cumulative gain recognised in equity relating to the available-for-sale investment was \$400,000. On the same day, the whole of the share capital of Smart was acquired by Given, a public limited company, and as a result, Aron received shares in Given with a fair value of \$5.5 million in exchange for its holding in Smart. The company wishes to know how the exchange of shares in Smart for the shares in Given should be accounted for in its financial records. (4 marks)

(iii) The functional and presentation currency of Aron is the dollar (\$). Aron has a wholly owned foreign subsidiary, Gao, whose functional currency is the zloti. Gao owns a debt instrument which is held for trading. In Gao's financial statements for the year ended 31 May 2008, the debt instrument was carried at its fair value of 10 million zloti.

At 31 May 2009, the fair value of the debt instrument had increased to 12 million zloti. The exchange rates were:

	Zloti to \$1
31 May 2008	3
31 May 2009	2
Average rate for year to 31 May 2009	2.5

The company wishes to know how to account for this instrument in Gao's entity financial statements and the consolidated financial statements of the group. (5 marks)

(iv) Aron granted interest free loans to its employees on 1 June 2008 of \$10 million. The loans will be paid back on 31 May 2010 as a single payment by the employees. The market rate of interest for a two-year loan on both of the above dates is 6% per annum. The company is unsure how to account for the loan but wishes to classify the loans as 'loans and receivables' under IAS 39 'Financial Instruments: recognition and measurement'. (4 marks)

**Required:**

**Discuss, with relevant computations, how the above financial instruments should be accounted for in the financial statements for the year ended 31 May 2009.**

Note. The mark allocation is shown against each of the transactions above.

Note. The following discount and annuity factors may be of use

	Discount factors			Annuity factors		
	6%	9%	9.38%	6%	9%	9.38%
1 year	0.9434	0.9174	0.9142	0.9434	0.9174	0.9174
2 years	0.8900	0.8417	0.8358	1.8334	1.7591	1.7500
3 years	0.8396	0.7722	0.7642	2.6730	2.5313	2.5142

Professional marks will be awarded in question 2 for clarity and quality of discussion.

(2 marks)

**(25 marks)**

**3** Carpart, a public limited company, is a vehicle part manufacturer, and sells vehicles purchased from the manufacturer. Carpart has entered into supply arrangements for the supply of car seats to two local companies, Vehiclex and Autoseat.

**(i) Vehiclex**

This contract will last for five years and Carpart will manufacture seats to a certain specification which will require the construction of machinery for the purpose. The price of each car seat has been agreed so that it includes an amount to cover the cost of constructing the machinery but there is no commitment to a minimum order of seats to guarantee the recovery of the costs of constructing the machinery. Carpart retains the ownership of the machinery and wishes to recognise part of the revenue from the contract in its current financial statements to cover the cost of the machinery which will be constructed over the next year. (4 marks)

**(ii) Autoseat**

Autoseat is purchasing car seats from Carpart. The contract is to last for three years and Carpart is to design, develop and manufacture the car seats. Carpart will construct machinery for this purpose but the machinery is so specific that it cannot be used on other contracts. Carpart maintains the machinery but the know-how has been granted royalty free to Autoseat. The price of each car seat includes a fixed price to cover the cost of the machinery. If Autoseat decides not to purchase a minimum number of seats to cover the cost of the machinery, then Autoseat has to repay Carpart for the cost of the machinery including any interest incurred.

Autoseat can purchase the machinery at any time in order to safeguard against the cessation of production by Carpart. The purchase price would be the cost of the machinery not yet recovered by Carpart. The machinery has a life of three years and the seats are only sold to Autoseat who sets the levels of production for a period. Autoseat can perform a pre-delivery inspection on each seat and can reject defective seats. (9 marks)

**(iii) Vehicle sales**

Carpart sells vehicles on a contract for their market price (approximately \$20,000 each) at a mark-up of 25% on cost. The expected life of each vehicle is five years. After four years, the car is repurchased by Carpart at 20% of its original selling price. This price is expected to be significantly less than its fair value. The car must be maintained and serviced by the customer in accordance with certain guidelines and must be in good condition if Carpart is to repurchase the vehicle.

The same vehicles are also sold with an option that can be exercised by the buyer two years after sale. Under this option, the customer has the right to ask Carpart to repurchase the vehicle for 70% of its original purchase price. It is thought that the buyers will exercise the option. At the end of two years, the fair value of the vehicle is expected to be 55% of the original purchase price. If the option is not exercised, then the buyer keeps the vehicle.

Carpart also uses some of its vehicles for demonstration purposes. These vehicles are normally used for this purpose for an eighteen-month period. After this period, the vehicles are sold at a reduced price based upon their condition and mileage. (10 marks)

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

**Required:**

**Discuss how the above transactions would be accounted for under International Financial Reporting Standards in the financial statements of Carpart.**

**Note.** The mark allocation is shown against each of the arrangements above.

**(25 marks)**

- 4 (a) Accounting for defined benefit pension schemes is a complex area of great importance. In some cases, the net pension liability even exceeds the market capitalisation of the company. The financial statements of a company must provide investors, analysts and companies with clear, reliable and comparable information on a company's pension obligations, discount rates and expected returns on plan assets.

**Required:**

- (i) **Discuss the current requirements of IAS 19 'Employee Benefits' as regards the accounting for actuarial gains and losses setting out the main criticisms of the approach taken and the advantages of immediate recognition of such gains and losses.** (11 marks)

- (ii) **Discuss the implications of the current accounting practices in IAS 19 for dealing with the setting of discount rates for pension obligations and the expected returns on plan assets.** (6 marks)

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

- (b) Smith, a public limited company and Brown a public limited company utilise IAS 19 'Employee Benefits' to account for their pension plans. The following information refers to the company pension plans for the year to 30 April 2009:

- (i) At 1 May 2008, plan assets of both companies were fair valued at \$200 million and both had net unrecognised actuarial gains of \$6 million.
- (ii) At 30 April 2009, the fair value of the plan assets of Smith was \$219 million and that of Brown was \$276 million.
- (iii) The contributions received were \$70 million and benefits paid were \$26 million for both companies. These amounts were paid and received on 1 November 2008.
- (iv) The expected return on plan assets was 7% at 1 May 2008 and 8% on 30 April 2009.
- (v) The present value of the defined benefit obligation was less than the fair value of the plan assets at both 1 May 2008 and 30 April 2009.
- (vi) Actuarial losses on the obligation for the year were negligible for both companies.
- (vii) Both companies use the corridor approach to recognised actuarial gains and losses.

**Required:**

**Show how the use of the expected return on assets can cause comparison issues for potential investors using the above scenario for illustration.** (6 marks)

**(25 marks)**

**End of Question Paper**