Professional Level – Essentials Module

Corporate Reporting (International)

Tuesday 15 June 2010

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)

ACCA

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

1 The following financial statements relate to Ashanti, a public limited company.

Ashanti Group: Statements of comprehensive income for the year ended 30 April 2010.

	Ashanti	Bochem	Ceram
	$m	$m	$m
Revenue	810	235	142
Cost of sales	(686)	(137)	(84)
Gross profit	124	98	58
Other income	31	17	12
Distribution costs	(30)	(21)	(26)
Administrative expenses	(55)	(29)	(12)
Finance costs	(8)	(6)	(8)
Profit before tax	62	59	24
Income tax expense	(21)	(23)	(10)
Profit for the year	41	36	14
Other comprehensive income for the year, net of tax:			
Available-for-sale financial assets (AFS)	20	9	6
Gains (net) on PPE revaluation	12	6	–
Actuarial losses on defined benefit plan	(14)	–	–
Other comprehensive income for the year, net of tax	18	15	6
Total comprehensive income and expense for year	59	51	20

The following information is relevant to the preparation of the group statement of comprehensive income:

1. On 1 May 2008, Ashanti acquired 70% of the equity interests of Bochem, a public limited company. The purchase consideration comprised cash of $150 million and the fair value of the identifiable net assets was $160 million at that date. The fair value of the non-controlling interest in Bochem was $54 million on 1 May 2008. Ashanti wishes to use the 'full goodwill' method for all acquisitions. The share capital and retained earnings of Bochem were $55 million and $85 million respectively and other components of equity were $10 million at the date of acquisition. The excess of the fair value of the identifiable net assets at acquisition is due to an increase in the value of plant, which is depreciated on the straight-line method and has a five year remaining life at the date of acquisition. Ashanti disposed of a 10% equity interest to the non-controlling interests (NCI) of Bochem on 30 April 2010 for a cash consideration of $34 million. The carrying value of the net assets of Bochem at 30 April 2010 was $210 million before any adjustments on consolidation. Goodwill has been impairment tested annually and as at 30 April 2009 had reduced in value by 15% and at 30 April 2010 had lost a further 5% of its original value before the sale of the equity interest to the NCI. The goodwill impairment should be allocated between group and NCI on the basis of equity shareholding.
2. Bochem acquired 80% of the equity interests of Ceram, a public limited company, on 1 May 2008. The purchase consideration was cash of $136 million. Ceram's identifiable net assets were fair valued at $115 million and the NCI of Ceram attributable to Ashanti had a fair value of $26 million at that date. On 1 November 2009, Bochem disposed of 50% of the equity of Ceram for a consideration of $90 million. Ceram's identifiable net assets were $160 million and the fair value of the NCI of Ceram attributable to Bochem was $35 million at the date of disposal. The remaining equity interest of Ceram held by Bochem was fair valued at $45 million. After the disposal, Bochem can still exert significant influence. Goodwill had been impairment tested and no impairment had occurred. Ceram's profits are deemed to accrue evenly over the year.
3. Ashanti has sold inventory to both Bochem and Ceram in October 2009. The sale price of the inventory was $10 million and $5 million respectively. Ashanti sells goods at a gross profit margin of 20% to group companies and third parties. At the year-end, half of the inventory sold to Bochem remained unsold but the entire inventory sold to Ceram had been sold to third parties.
4. On 1 May 2007, Ashanti purchased a $20 million five-year bond with semi annual interest of 5% payable on 31 October and 30 April. The purchase price of the bond was $21·62 million. The effective annual interest rate

is 8% or 4% on a semi annual basis. The bond is classified as available-for-sale. At 1 May 2009, the amortised cost of the bond was $21·05 million and the loss recognised in equity was $0·6 million, resulting in a carrying value of $20·45 million (no change to the effective annual interest rate). The issuer of the bond did not pay the interest due on 31 October 2009 and 30 April 2010. Ashanti feels that as at 30 April 2010, the bond is impaired and that the best estimates of total future cash receipts are $2·34 million on 30 April 2011 and $8 million on 30 April 2012. The current interest rate for discounting cash flows as at 30 April 2010 is 10%. No accounting entries have been made in the financial statements for the above bond since 30 April 2009.

5. Ashanti sold $5 million of goods to a customer who recently made an announcement that it is restructuring its debts with its suppliers including Ashanti. It is probable that Ashanti will not recover the amounts outstanding. The goods were sold after the announcement was made although the order was placed prior to the announcement. Ashanti wishes to make an additional allowance of $8 million against the total receivable balance at the year end, of which $5 million relates to this sale.

6. Ashanti owned a piece of property, plant and equipment (PPE) which cost $12 million and was purchased on 1 May 2008. It is being depreciated over 10 years on the straight-line basis with zero residual value. On 30 April 2009, it was revalued to $13 million and on 30 April 2010, the PPE was revalued to $8 million. The whole of the revaluation loss had been posted to the statement of comprehensive income and depreciation has been charged for the year. It is Ashanti's company policy to make all necessary transfers for excess depreciation following revaluation.

7. The salaried employees of Ashanti are entitled to 25 days paid leave each year. The entitlement accrues evenly over the year and unused leave may be carried forward for one year. The holiday year is the same as the financial year. At 30 April 2010, Ashanti has 900 salaried employees and the average unused holiday entitlement is three days per employee. 5% of employees leave without taking their entitlement and there is no cash payment when an employee leaves in respect of holiday entitlement. There are 255 working days in the year and the total annual salary cost is $19 million. No adjustment has been made in the financial statements for the above and there was no opening accrual required for holiday entitlement.

8. Ignore any taxation effects of the above adjustments and the disclosure requirements of IFRS 5 *Non-current assets held for sale and discontinued operations*.

Required:

(a) Prepare a consolidated statement of comprehensive income for the year ended 30 April 2010 for the Ashanti Group. (35 marks)

The directors of Ashanti have heard that the International Accounting Standards Board (IASB) has issued amendments to the rules regarding reclassification of financial instruments. The directors believe that the IASB has issued these amendments to reduce the difference between US GAAP and IFRS in respect of reclassification of financial assets. Reclassification, which was previously severely restricted under the IFRS, is now permitted in specific circumstances if the conditions and disclosure requirements are followed. They feel that this will give them the capability of managing their earnings, as they will be able to reclassify loss-making financial assets and smooth income. They feel that there is no problem with managing earnings as long as the shareholders do not find out and as long as the accounting practices are within the guidelines set out in International Financial Reporting Standards (IFRS).

Required:

(b) Describe the amendments to the rules regarding reclassification of financial assets issued in October 2008 by the IASB, discussing how these rules could lead to 'management of earnings'. (7 marks)

(c) Discuss the nature of and incentives for 'management of earnings' and whether such a process can be deemed to be ethically acceptable. (6 marks)

Professional marks will be awarded in question 1(c) for clarity and quality of discussion. (2 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 **(a)** Cate is an entity in the software industry. Cate had incurred substantial losses in the financial years 31 May 2004 to 31 May 2009. In the financial year to 31 May 2010 Cate made a small profit before tax. This included significant non-operating gains. In 2009, Cate recognised a material deferred tax asset in respect of carried forward losses, which will expire during 2012. Cate again recognised the deferred tax asset in 2010 on the basis of anticipated performance in the years from 2010 to 2012, based on budgets prepared in 2010. The budgets included high growth rates in profitability. Cate argued that the budgets were realistic as there were positive indications from customers about future orders. Cate also had plans to expand sales to new markets and to sell new products whose development would be completed soon. Cate was taking measures to increase sales, implementing new programs to improve both productivity and profitability. Deferred tax assets less deferred tax liabilities represent 25% of shareholders' equity at 31 May 2010. There are no tax planning opportunities available to Cate that would create taxable profit in the near future. (5 marks)

(b) At 31 May 2010 Cate held an investment in and had a significant influence over Bates, a public limited company. Cate had carried out an impairment test in respect of its investment in accordance with the procedures prescribed in IAS 36, *Impairment of assets*. Cate argued that fair value was the only measure applicable in this case as value-in-use was not determinable as cash flow estimates had not been produced. Cate stated that there were no plans to dispose of the shareholding and hence there was no binding sale agreement. Cate also stated that the quoted share price was not an appropriate measure when considering the fair value of Cate's significant influence on Bates. Therefore, Cate estimated the fair value of its interest in Bates through application of two measurement techniques; one based on earnings multiples and the other based on an option–pricing model. Neither of these methods supported the existence of an impairment loss as of 31 May 2010. (5 marks)

(c) At 1 April 2009 Cate had a direct holding of shares giving 70% of the voting rights in Date. In May 2010, Date issued new shares, which were wholly subscribed for by a new investor. After the increase in capital, Cate retained an interest of 35% of the voting rights in its former subsidiary Date. At the same time, the shareholders of Date signed an agreement providing new governance rules for Date. Based on this new agreement, Cate was no longer to be represented on Date's board or participate in its management. As a consequence Cate considered that its decision not to subscribe to the issue of new shares was equivalent to a decision to disinvest in Date. Cate argued that the decision not to invest clearly showed its new intention not to recover the investment in Date principally through continuing use of the asset and was considering selling the investment. Due to the fact that Date is a separate line of business (with separate cash flows, management and customers), Cate considered that the results of Date for the period to 31 May 2010 should be presented based on principles provided by IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. (8 marks)

(d) In its 2010 financial statements, Cate disclosed the existence of a voluntary fund established in order to provide a post-retirement benefit plan (Plan) to employees. Cate considers its contributions to the Plan to be voluntary, and has not recorded any related liability in its consolidated financial statements. Cate has a history of paying benefits to its former employees, even increasing them to keep pace with inflation since the commencement of the Plan. The main characteristics of the Plan are as follows:

(i) the Plan is totally funded by Cate;
(ii) the contributions for the Plan are made periodically;
(iii) the post retirement benefit is calculated based on a percentage of the final salaries of Plan participants dependent on the years of service;
(iv) the annual contributions to the Plan are determined as a function of the fair value of the assets less the liability arising from past services.

Cate argues that it should not have to recognise the Plan because, according to the underlying contract, it can terminate its contributions to the Plan, if and when it wishes. The termination clauses of the contract establish that Cate must immediately purchase lifetime annuities from an insurance company for all the retired employees who are already receiving benefit when the termination of the contribution is communicated. (5 marks)

Required:

Discuss whether the accounting treatments proposed by the company are acceptable under International Financial Reporting Standards.

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

The mark allocation is shown against each of the four parts above.

(25 marks)

3 Seltec, a public limited company, processes and sells edible oils and uses several financial instruments to spread the risk of fluctuation in the price of the edible oils. The entity operates in an environment where the transactions are normally denominated in dollars. The functional currency of Seltec is the dollar.

(a) The entity uses forward and futures contracts to protect it against fluctuation in the price of edible oils. Where forwards are used the company often takes delivery of the edible oil and sells it shortly afterwards. The contracts are constructed with future delivery in mind but the contracts also allow net settlement in cash as an alternative. The net settlement is based on the change in the price of the oil since the start of the contract. Seltec uses the proceeds of a net settlement to purchase a different type of oil or purchase from a different supplier. Where futures are used these sometimes relate to edible oils of a different type and market than those of Seltec's own inventory of edible oil. The company intends to apply hedge accounting to these contracts in order to protect itself from earnings volatility. Seltec has also entered into a long-term arrangement to buy oil from a foreign entity whose currency is the dinar. The commitment stipulates that the fixed purchase price will be denominated in pounds sterling.

Seltec is unsure as to the nature of derivatives and hedge accounting techniques and has asked your advice on how the above financial instruments should be dealt with in the financial statements. (14 marks)

(b) Seltec has decided to enter the retail market and has recently purchased two well-known brand names in the edible oil industry. One of the brand names has been in existence for many years and has a good reputation for quality. The other brand name is named after a famous film star who has been actively promoting the edible oil as being a healthier option than other brands of oil. This type of oil has only been on the market for a short time. Seltec is finding it difficult to estimate the useful life of the brands and therefore intends to treat the brands as having indefinite lives.

In order to sell the oil, Seltec has purchased two limited liability companies from a company that owns several retail outlets. Each entity owns retail outlets in several shopping complexes. The only assets of each entity are the retail outlets. There is no operational activity and at present the entities have no employees.

Seltec is unclear as to how the purchase of the brands and the entities should be accounted for. (9 marks)

Required:

Discuss the accounting principles involved in accounting for the above transactions and how the above transactions should be treated in the financial statements of Seltec.

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

The mark allocation is shown against each of the two parts above.

(25 marks)

4 **(a)** Leasing is important to Holcombe, a public limited company as a method of financing the business. The Directors feel that it is important that they provide users of financial statements with a complete and understandable picture of the entity's leasing activities. They believe that the current accounting model is inadequate and does not meet the needs of users of financial statements.

Holcombe has leased plant for a fixed term of six years and the useful life of the plant is 12 years. The lease is non-cancellable, and there are no rights to extend the lease term or purchase the machine at the end of the term. There are no guarantees of its value at that point. The lessor does not have the right of access to the plant until the end of the contract or unless permission is granted by Holcombe.

Fixed lease payments are due annually over the lease term after delivery of the plant, which is maintained by Holcombe. Holcombe accounts for the lease as an operating lease but the directors are unsure as to whether the accounting treatment of an operating lease is conceptually correct.

Required:

(i) Discuss the reasons why the current lease accounting standards may fail to meet the needs of users and could be said to be conceptually flawed; (7 marks)

(ii) Discuss whether the plant operating lease in the financial statements of Holcombe meets the definition of an asset and liability as set out in the 'Framework for the Preparation and Presentation of Financial Statements.' (7 marks)

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

(b) Holcombe also owns an office building with a remaining useful life of 30 years. The carrying amount of the building is \$120 million and its fair value is \$150 million. On 1 May 2009, Holcombe sells the building to Brook, a public limited company, for its fair value and leases it back for five years at an annual rental payable in arrears of \$16 million on the last day of the financial year (30 April). This is a fair market rental. Holcombe's incremental borrowing rate is 8%.

On 1 May 2009, Holcombe has also entered into a short operating lease agreement to lease another building. The lease will last for three years and is currently \$5 million per annum. However an inflation adjustment will be made at the conclusion of leasing years 1 and 2. Currently inflation is 4% per annum.

The following discount factors are relevant (8%).

	Single cash flow	Annuity
Year 1	0·926	0·926
Year 2	0·857	1·783
Year 3	0·794	2·577
Year 4	0·735	3·312
Year 5	0·681	3·993

Required:

(i) Show the accounting entries in the year of the sale and lease back assuming that the operating lease is recognised as an asset in the statement of financial position of Holcombe; (6 marks)

(ii) State how the inflation adjustment on the short term operating lease should be dealt with in the financial statements of Holcombe. (3 marks)

(25 marks)

End of Question Paper