

Professional Level – Essentials Module

Corporate Reporting (International)

Tuesday 11 June 2013



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)

The ACCA logo, consisting of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

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

- 1 (a) Trailer, a public limited company, operates in the manufacturing sector. Trailer has investments in two other companies. The draft statements of financial position at 31 May 2013 are as follows:

	Trailer \$m	Park \$m	Caller \$m
Assets:			
Non-current assets			
Property, plant and equipment	1,440	1,100	1,300
Investments in subsidiaries			
Park	1,250		
Caller	310	1,270	
Financial assets	320	21	141
	<u>3,320</u>	<u>2,391</u>	<u>1,441</u>
Current assets	895	681	150
Total assets	<u>4,215</u>	<u>3,072</u>	<u>1,591</u>
Equity and liabilities:			
Share capital	1,750	1,210	800
Retained earnings	1,240	930	350
Other components of equity	125	80	95
Total equity	<u>3,115</u>	<u>2,220</u>	<u>1,245</u>
Non-current liabilities	985	765	150
Current liabilities	115	87	196
Total liabilities	<u>1,100</u>	<u>852</u>	<u>346</u>
Total equity and liabilities	<u>4,215</u>	<u>3,072</u>	<u>1,591</u>

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

- On 1 June 2011, Trailer acquired 14% of the equity interests of Caller for a cash consideration of \$260 million and Park acquired 70% of the equity interests of Caller for a cash consideration of \$1,270 million. At 1 June 2011, the identifiable net assets of Caller had a fair value of \$990 million, retained earnings were \$190 million and other components of equity were \$52 million. At 1 June 2012, the identifiable net assets of Caller had a fair value of \$1,150 million, retained earnings were \$240 million and other components of equity were \$70 million. The excess in fair value is due to non-depreciable land.

The fair value of the 14% holding of Trailer in Caller was \$280 million at 31 May 2012 and \$310 million at 31 May 2013. The fair value of Park's interest in Caller had not changed since acquisition.

- On 1 June 2012, Trailer acquired 60% of the equity interests of Park, a public limited company. The purchase consideration comprised cash of \$1,250 million. On 1 June 2012, the fair value of the identifiable net assets acquired was \$1,950 million and retained earnings of Park were \$650 million and other components of equity were \$55 million. The excess in fair value is due to non-depreciable land.

It is the group's policy to measure the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's net assets.

- Goodwill of Park and Caller was impairment tested at 31 May 2013. There was no impairment relating to Caller. The recoverable amount of the net assets of Park was \$2,088 million. There was no impairment of the net assets of Park before this date and any impairment loss has been determined to relate to goodwill and property, plant and equipment.
- Trailer has made a loan of \$50 million to a charitable organisation for the building of new sporting facilities. The loan was made on 1 June 2012 and is repayable on maturity in three years' time. Interest is to be charged one year in arrears at 3%, but Trailer assesses that an unsubsidised rate for such a loan would have been 6%. The only accounting entries which have been made for the year ended 31 May 2013 are the cash

entries for the loan and interest received which have resulted in a balance of \$48.5 million being shown as a financial asset.

5. On 1 June 2011, Trailer acquired office accommodation at a cost of \$90 million with a 30-year estimated useful life. During the year, the property market in the area slumped and the fair value of the accommodation fell to \$75 million at 31 May 2012 and this was reflected in the financial statements. However, the market recovered unexpectedly quickly due to the announcement of major government investment in the area's transport infrastructure. On 31 May 2013, the valuer advised Trailer that the offices should now be valued at \$105 million. Trailer has charged depreciation for the year but has not taken account of the upward valuation of the offices. Trailer uses the revaluation model and records any valuation change when advised to do so.
6. Trailer has announced two major restructuring plans. The first plan is to reduce its capacity by the closure of some of its smaller factories, which have already been identified. This will lead to the redundancy of 500 employees, who have all individually been selected and communicated with. The costs of this plan are \$9 million in redundancy costs, \$4 million in retraining costs and \$5 million in lease termination costs. The second plan is to re-organise the finance and information technology department over a one-year period but it does not commence for two years. The plan results in 20% of finance staff losing their jobs during the restructuring. The costs of this plan are \$10 million in redundancy costs, \$6 million in retraining costs and \$7 million in equipment lease termination costs. No entries have been made in the financial statements for the above plans.
7. The following information relates to the group pension plan of Trailer:

	1 June 2012 (\$m)	31 May 2013 (\$m)
Fair value of plan assets	28	29
Actuarial value of defined benefit obligation	30	35

The contributions for the period received by the fund were \$2 million and the employee benefits paid in the year amounted to \$3 million. The discount rate to be used in any calculation is 5%. The current service cost for the period based on actuarial calculations is \$1 million. The above figures have not been taken into account for the year ended 31 May 2013 except for the contributions paid which have been entered in cash and the defined benefit obligation.

Required:

Prepare the group consolidated statement of financial position of Trailer as at 31 May 2013. (35 marks)

- (b) It is the Trailer group's policy to measure the non-controlling interest (NCI) at acquisition at its proportionate share of the fair value of the subsidiary's net assets. The directors of Trailer have used this policy for several years and do not know the implications, if any, of changing the policy to that of accounting for the NCI at fair value. The fair value of the NCI of Park at 1 June 2012 was \$800 million. The fair value of the NCI of Caller, based upon the effective shareholdings, was \$500 million at 1 June 2011 and \$530 million at 1 June 2012.

Required:

Explain to the directors, with suitable calculations, the impact on the financial statements if goodwill was calculated using the fair value of the NCI. (9 marks)

- (c) The directors of Trailer are involved in takeover talks with another entity. In the discussions, one of the directors stated that there was no point in an accountant studying ethics because every accountant already has a set of moral beliefs that are followed and these are created by simply following generally accepted accounting practice. He further stated that in adopting a defensive approach to the takeover, there was no ethical issue in falsely declaring Trailer's profits in the financial statements used for the discussions because, in his opinion, the takeover did not benefit the company, its executives or society as a whole.

Required:

Discuss the above views of the director regarding the fact that there is no point in an accountant studying ethics and that there was no ethical issue in the false disclosure of accounting profits. (6 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 (a) In its annual financial statements for the year ended 31 March 2013, Verge, a public limited company, had identified the following operating segments:

- (i) Segment 1 local train operations
- (ii) Segment 2 inter-city train operations
- (iii) Segment 3 railway constructions

The company disclosed two reportable segments. Segments 1 and 2 were aggregated into a single reportable operating segment. Operating segments 1 and 2 have been aggregated on the basis of their similar business characteristics, and the nature of their products and services. In the local train market, it is the local transport authority which awards the contract and pays Verge for its services. In the local train market, contracts are awarded following a competitive tender process, and the ticket prices paid by passengers are set by and paid to the transport authority. In the inter-city train market, ticket prices are set by Verge and the passengers pay Verge for the service provided. (5 marks)

(b) Verge entered into a contract with a government body on 1 April 2011 to undertake maintenance services on a new railway line. The total revenue from the contract is \$5 million over a three-year period. The contract states that \$1 million will be paid at the commencement of the contract but although invoices will be subsequently sent at the end of each year, the government authority will only settle the subsequent amounts owing when the contract is completed. The invoices sent by Verge to date (including \$1 million above) were as follows:

Year ended 31 March 2012	\$2.8 million
Year ended 31 March 2013	\$1.2 million

The balance will be invoiced on 31 March 2014. Verge has only accounted for the initial payment in the financial statements to 31 March 2012 as no subsequent amounts are to be paid until 31 March 2014. The amounts of the invoices reflect the work undertaken in the period. Verge wishes to know how to account for the revenue on the contract in the financial statements to date.

Market interest rates are currently at 6%. (6 marks)

(c) In February 2012, an inter-city train did what appeared to be superficial damage to a storage facility of a local company. The directors of the company expressed an intention to sue Verge but in the absence of legal proceedings, Verge had not recognised a provision in its financial statements to 31 March 2012. In July 2012, Verge received notification for damages of \$1.2m, which was based upon the estimated cost to repair the building. The local company claimed the building was much more than a storage facility as it was a valuable piece of architecture which had been damaged to a greater extent than was originally thought. The head of legal services advised Verge that the company was clearly negligent but the view obtained from an expert was that the value of the building was \$800,000. Verge had an insurance policy that would cover the first \$200,000 of such claims. After the financial statements for the year ended 31 March 2013 were authorised, the case came to court and the judge determined that the storage facility actually was a valuable piece of architecture. The court ruled that Verge was negligent and awarded \$300,000 for the damage to the fabric of the facility. (6 marks)

(d) Verge was given a building by a private individual in February 2012. The benefactor included a condition that it must be brought into use as a train museum in the interests of the local community or the asset (or a sum equivalent to the fair value of the asset) must be returned. The fair value of the asset was \$1.5 million in February 2012. Verge took possession of the building in May 2012. However, it could not utilise the building in accordance with the condition until February 2013 as the building needed some refurbishment and adaptation and in order to fulfil the condition. Verge spent \$1 million on refurbishment and adaptation.

On 1 July 2012, Verge obtained a cash grant of \$250,000 from the government. Part of the grant related to the creation of 20 jobs at the train museum by providing a subsidy of \$5,000 per job created. The remainder of the grant related to capital expenditure on the project. At 31 March 2013, all of the new jobs had been created.

(6 marks)

Required:

Advise Verge on how the above accounting issues should be dealt with in its financial statements for the years ending 31 March 2012 (where applicable) and 31 March 2013.

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

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

(2 marks)

(25 marks)

- 3 (a) Janne is a real estate company, which specialises in industrial property. Investment properties including those held for sale constitute more than 80% of its total assets.

It is considering leasing land from Maret for a term of 30 years. Janne plans to use the land for its own office development but may hold the land for capital gain. The title will remain with Maret at the end of the initial lease term. Janne can lease the land indefinitely at a small immaterial rent at the end of the lease or may purchase the land at a 90% discount to the market value after the initial lease term. Janne is to pay Maret a premium of \$3 million at the commencement of the lease, which equates to 70% of the value of the land. Additionally, an annual rental payment is to be made, based upon 4% of the market value of the land at the commencement of the lease, with a market rent review every five years. The rent review sets the rent at the higher of the current rent or 4% of the current value of the land. Land values have been rising for many years.

Additionally, Janne is considering a suggestion by Maret to incorporate a clean break clause in the lease which will provide Janne with an option of terminating the agreement after 25 years without any further payment and also to include an early termination clause after 10 years that would require Janne to make a termination payment which would recover the lessor's remaining investment. (12 marks)

- (b) Janne measures its industrial investment property using the fair value method, which is measured using the 'new-build value less obsolescence'. Valuations are conducted by a member of the board of directors. In order to determine the obsolescence, the board member takes account of the age of the property and the nature of its use. According to the board, this method of calculation is complex but gives a very precise result, which is accepted by the industry. There are sales values for similar properties in similar locations available as well as market rent data per square metre for similar industrial buildings. (5 marks)

- (c) Janne operates through several subsidiaries and reported a subsidiary as held for sale in its annual financial statements for both 2012 and 2013. On 1 January 2012, the shareholders had, at a general meeting of the company, authorised management to sell all of its holding of shares in the subsidiary within the year. Janne had shown the subsidiary as an asset held for sale and presented it as a discontinued operation in the financial statements at 31 May 2012. This accounting treatment had been continued in Janne's 2013 financial statements.

Janne had made certain organisational changes during the year to 31 May 2013, which resulted in additional activities being transferred to the subsidiary. Also during the year to 31 May 2013, there had been draft agreements and some correspondence with investment bankers, which showed in principle only that the subsidiary was still for sale. (6 marks)

Required:

Advise Janne on how the above accounting issues should be dealt with in its financial statements.

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) Developing a framework for disclosure is at the forefront of current debate and there are many bodies around the world attempting to establish an overarching framework to make financial statement disclosures more effective, coordinated and less redundant. It has been argued that instead of focusing on raising the quality of disclosures, these efforts have placed their emphasis almost exclusively on reducing the quantity of information. The belief is that excessive disclosure is burdensome and can overwhelm users. However, it could be argued that there is no such thing as too much 'useful' information for users.

Required:

- (i) **Discuss why it is important to ensure the optimal level of disclosure in annual reports, describing the reasons why users of annual reports may have found disclosure to be excessive in recent years.** (9 marks)

- (ii) **Describe the barriers, which may exist, to reducing excessive disclosure in annual reports.** (6 marks)

- (b) The directors of Lizzer, a public limited company, have read various reports on excessive disclosure in the annual report. They have decided to take action and do not wish to disclose any further detail concerning the two instances below.

- (i) Lizzer is a debt issuer whose business is the securitisation of a portfolio of underlying investments and financing their purchase through the issuing of listed, limited recourse debt. The repayment of the debt is dependent upon the performance of the underlying investments. Debt-holders bear the ultimate risks and rewards of ownership of the underlying investments. Given the debt specific nature of the underlying investments, the risk profile of individual debt may differ.

Lizzer does not consider its debt-holders as being amongst the primary users of the financial statements and, accordingly, does not wish to provide disclosure of the debt-holders' exposure to risks in the financial statements, as distinct from the risks faced by the company's shareholders, in accordance with IFRS 7 *Financial Instruments: Disclosures*. (4 marks)

- (ii) At the date of the financial statements, 31 January 2013, Lizzer's liquidity position was quite poor, such that the directors described it as 'unsatisfactory' in the management report. During the first quarter of 2013, the situation worsened with the result that Lizzer was in breach of certain loan covenants at 31 March 2013. The financial statements were authorised for issue at the end of April 2013. The directors' and auditor's reports both emphasised the considerable risk of not being able to continue as a going concern.

The notes to the financial statements indicated that there was 'ample' compliance with all loan covenants as at the date of the financial statements. No additional information about the loan covenants was included in the financial statements. Lizzer had been close to breaching the loan covenants in respect of free cash flows and equity ratio requirements at 31 January 2013.

The directors of Lizzer felt that, given the existing information in the financial statements, any further disclosure would be excessive and confusing to users. (4 marks)

Required:

Discuss the directors' view that no further information regarding the two instances above should be disclosed in the financial statements because it would be 'excessive'.

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

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

(25 marks)

End of Question Paper