Strategic Professional – Essentials

Strategic Business Reporting – United Kingdom (SBR – UK)

Thursday 6 December 2018

SBR UK 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.

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The Association of Chartered Certified Accountants

Section A – BOTH questions are compulsory and MUST be attempted

1 Background

The following are extracts from the consolidated financial statements of the Moyes group.

Group statement of profit or loss for the year ended 30 September 20X8:

	$m
Revenue	612
Cost of sales	(347)
Gross profit	265
Operating expenses	(123)
Share of profit of associate	67
Profit before tax	209

Extracts from the group statement of financial position:

	30 September 20X8	30 September 20X7
	$m	$m
Inventories	126	165
Trade receivables	156	149
Trade payables	215	197

The following information is also relevant to the year ended 30 September 20X8:

Pension scheme

Moyes operates a defined benefit scheme. A service cost component of $24 million has been included within operating expenses. The remeasurement component for the year was a gain of $3 million. Benefits paid out of the scheme were $31 million. Contributions into the scheme by Moyes were $15 million.

Goodwill

Goodwill was reviewed for impairments at the reporting date. Impairments arose of $10 million in the current year.

Property, plant and equipment

Property, plant and equipment (PPE) at 30 September 20X8 included cash additions of $134 million. Depreciation charged during the year was $99 million and an impairment loss of $43 million was recognised. Prior to the impairment, the group had a balance on the revaluation surplus of $50 million of which $20 million related to PPE impaired in the current year.

Inventory

Goods were purchased for Dinar 80 million cash when the exchange rate was $1:5 Dinar. Moyes had not managed to sell the goods at 30 September 20X8 and the net realisable value was estimated to be Dinar 60 million at 30 September 20X8. The exchange rate at this date was $1:6 Dinar. The inventory has been correctly valued at 30 September 20X8 with both the exchange difference and impairment correctly included within cost of sales.

Changes to group structure

During the year ended 30 September 20X8, Moyes acquired a 60% subsidiary, Davenport, and also sold all of its equity interests in Barham for cash. The consideration for Davenport consisted of a share for share exchange together with some cash payable in two years. 80% of the equity shares of Barham had been acquired several years ago but Moyes had decided to sell as the performance of Barham had been poor for a number of years. Consequently, Barham had a substantial overdraft at the disposal date. Barham was unable to pay any dividends during the financial year but Davenport did pay an interim dividend on 30 September 20X8.

Discontinued operations

The directors of Moyes wish advice as to whether the disposal of Barham should be treated as a discontinued operation and separately disclosed within the consolidated statement of profit or loss. There are several other subsidiaries which all produce similar products to Barham and operate in a similar geographical area. Additionally, Moyes holds a 52%

equity interest in Watson. Watson has previously issued share options to other entities which are exercisable in the year ending 30 September 20X9. It is highly likely that these options would be exercised which would reduce Moyes' interest to 35%. The directors of Moyes require advice as to whether this loss of control would require Watson to be classified as held for sale and reclassified as discontinued.

Required:

(a) Draft an explanatory note to the directors of Moyes which should include:

(i) a calculation of the cash generated from operations using the indirect method; and
(ii) an explanation of the specific adjustments required to the group profit before tax to calculate the cash generated from operations.

Note: Any workings can either be shown in the main body of the explanatory note or in an appendix to the explanatory note. (12 marks)

(b) Explain how the changes to the group structure and dividend would impact upon the consolidated statement of cash flows at 30 September 20X8 for the Moyes group. You should not attempt to alter your answer to part (a). (6 marks)

(c) Advise the directors as to whether Watson should be classified as held for sale and whether both it and Barham should be classified as discontinued operations. (6 marks)

(d) The 2010 version of the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*) of the International Accounting Standards Board (the Board) specifies that it must be probable that any future economic benefit associated with an asset or liability will flow to or from an entity in order for the asset or liability to qualify for recognition.

Current accounting standards have been criticised for not necessarily applying the probability criterion relating to future economic benefits on a consistent basis. The Board issued Exposure Draft ED/2015/3 *Conceptual Framework For Financial Reporting* in which new recognition criteria were proposed to address this issue.

Required:

Explain how the probability criterion has not been applied consistently across accounting standards. Illustrate your answer with reference to how there may be inconsistencies with the measurement of assets held for sale, provisions and contingent consideration. Your answer should also discuss how the Board's proposed changes to the recognition criteria address the issue. (6 marks)

(30 marks)

2 Background

The following is an extract from the statement of financial position of Fiskerton, a public limited entity as at 30 September 20X8.

	$'000
Non-current assets	160,901
Current assets	110,318
Equity share capital ($1 each)	10,000
Other components of equity	20,151
Retained earnings	70,253
Non-current liabilities (bank loan)	50,000
Current liabilities	120,815

The bank loan has a covenant attached whereby it will become immediately repayable should the gearing ratio (long-term debt to equity) of Fiskerton exceed 50%. Fiskerton has a negative cash balance as at 30 September 20X8.

Halam property

Included within the non-current assets of Fiskerton is a property in Halam which has been leased to Edingley under a 40-year lease. The property was acquired for $20 million on 1 October 20X7 and was immediately leased to Edingley.

The asset was expected to have a useful life of 40 years at the date of acquisition and have a minimal residual value. Fiskerton has classified the building as an investment property and has adopted the fair value model.

The property was initially revalued to $22 million on 31 March 20X8. Interim financial statements had indicated that gearing was 51% prior to this revaluation. The managing director was made aware of this breach of covenant and so instructed that the property should be revalued. The property is now carried at a value of $28 million which was determined by the sale of a similar sized property on 30 September 20X8. This property was located in a much more prosperous area and built with a higher grade of material. An independent professional valuer has estimated the value to be no more than $22 million. The managing director has argued that fair values should be referenced to an active market and is refusing to adjust the financial statements, even though he knows it is contrary to international accounting standards.

Sales contract

Fiskerton has entered into a sales contract for the construction of an asset with a customer whereby the customer pays an initial deposit. The deposit is refundable only if Fiskerton fails to complete the construction of the asset. The remainder is payable on delivery of the asset. If the customer defaults on the contract prior to completion, Fiskerton has the right to retain the deposit. The managing director believes that, as completion of the asset is performed over time, revenue should be recognised accordingly. He has persuaded the accountant to include the deposit and a percentage of the remaining balance for construction work in revenue to date.

Required:

(a) Discuss how the Halam property should have been accounted for and explain the implications for the financial statements and the debt covenant of Fiskerton. (7 marks)

(b) In accordance with International Financial Reporting Standard (IFRS®) 15 *Revenue from Contracts with Customers*, discuss whether revenue arising from the sales contract should be recognised on a stage of completion basis. (4 marks)

(c) Explain any ethical issues which may arise for the managing director and the accountant from each of the scenarios. (7 marks)

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

(20 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 (a) On 1 December 20X6, Fill purchased an open cast coal mine in the UK and incurred borrowing costs on the acquisition of a coal mining licence. It also acquired equipment which will be used for the construction of various mines throughout the UK. Fill wishes to capitalise the borrowing costs on the acquisition of the licence and the equipment.

However, during the last six months of the year ended 30 November 20X8, there has been a significant decline in the spot price of coal and it is expected that future reductions in selling prices may occur. Currently, the forward contracts being signed over the next two years by Fill indicate a reduction in the price of coal. At 30 November 20X8, the mine has a useful remaining life of four years. As a result of the decline in the price of coal, Fill has decided to sell the mine and has approached several potential buyers.

Required:

Advise the directors of Fill on how to treat the above events under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. (8 marks)

(b) Several years ago, Fill had purchased an interest of 10% in another mining company. However, over the last two years, Fill has made several other purchases of shares with the result that, at 30 November 20X8, it owned 51% of the equity of the mining company. Fill had incurred significant legal and advisory costs in acquiring control.

The mining company has reserves which contain different grades of coal. As the entity cannot process some high quality coal for several years, contingent consideration for the purchase of the entity has been agreed. On the date that Fill gained control of the mining company, the fair value of the contingent consideration was estimated at $10 million.

The remaining non-controlling interest (NCI) was owned by a rival company. The directors of Fill do not wish to apply FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* to value NCI. Instead, they want to apply IFRS 3 *Business Combinations* to fair value NCI for use in the published financial statements. Their rationale for this is that users of the financial statements will get a more realistic indication of the value of the investment in the mining company.

Required:

Advise the directors of Fill on the differences in treatment of the above purchase of the mining company between IFRS 3 *Business Combinations* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. (7 marks)

(c) Fill also jointly controls coal mines with other entities. The Theta mine is owned by four participants. Fill owns 28%, and the other three participants each own 24% of the mine. The operating agreement requires any major decisions to be approved by parties representing 72% of the interest in the mine. Fill is considering purchasing one of the participant's interests of 24%.The directors of Fill wish advice on whether the proposed revision to the *Conceptual Framework* will affect the decision as to whether Fill controls the mine. The directors are also wondering whether the acquisition of the interest would be considered a business combination under IFRS Standards.

Required:

Advise the directors of Fill on how the above transaction should be dealt with in its financial statements with reference to relevant IFRS Standards and the *Conceptual Framework* and its proposed revision where indicated. (10 marks)

(25 marks)

4 **(a)** The IFRS Practice Statement *Management Commentary* provides a broad, non-binding framework for the presentation of management commentary which relates to financial statements which have been prepared in accordance with IFRS Standards. The management commentary is within the scope of the *Conceptual Framework* and, therefore, the qualitative characteristics will be applied to both the financial statements and the management commentary.

Required:

(i) Discuss briefly the arguments for and against issuing the IFRS Practice Statement *Management Commentary* as a non-binding framework or as an IFRS Standard. (4 marks)

(ii) Discuss how the qualitative characteristics of understandability, relevance and comparability should be applied to the preparation of the management commentary. (5 marks)

(b) Holls Group is preparing its financial statements for the year ended 30 November 20X7. The directors of Holls have been asked by an investor to explain the accounting for the taxation in the financial statements.

The Group operates in several tax jurisdictions and is subject to annual tax audits which can result in amendments to the amount of tax to be paid.

The profit from continuing operations was $300 million in the year to 30 November 20X7 and the reported tax charge was $87 million. The investor was confused as to why the tax charge was not the tax rate multiplied by the profit from continuing operations. The directors have prepared a reconciliation of the notional tax charge on profits as compared with the actual tax charge for the period.

	$ million
Profit from continuing operations before taxation	300
Notional charge at local corporation tax rate of 22%	66
Differences in overseas tax rates	10
Tax relating to non-taxable gains on disposals of businesses	(12)
Tax relating to the impairment of brands	9
Other tax adjustments	14
Tax charge for the year	87

The amount of income taxes paid as shown in the statement of cash flows is $95 million but there is no current explanation of the tax effects of the above items in the financial statements.

The tax rate applicable to Holls for the year ended 30 November 20X7 is 22%. There is a proposal in the local tax legislation that a new tax rate of 25% will apply from 1 January 20X8. In the country where Holls is domiciled, tax laws and rate changes are enacted when the government approves the legislation. The government approved the legislation on 12 November 20X7. The current weighted average tax rate for the Group is 27%. Holls does not currently disclose its opinion of how the tax rate may alter in the future but the government is likely to change with the result that a new government will almost certainly increase the corporate tax rate.

At 30 November 20X7, Holls has deductible temporary differences of $4·5 million which are expected to reverse in the next year. In addition, Holls also has taxable temporary differences of $5 million which relate to the same taxable company and the tax authority. Holls expects $3 million of those taxable temporary differences to reverse in 20X8 and the remaining $2 million to reverse in 20X9. Prior to the current year, Holls had made significant losses.

Required:

With reference to the above information, explain to the investor, the nature of accounting for taxation in financial statements.

Note: Your answer should explain the tax reconciliation, discuss the implications of current and future tax rates, and provide an explanation of accounting for deferred taxation in accordance with relevant IFRS Standards.

(14 marks)

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

(25 marks)

End of Question Paper