Professional Level – Essentials Module

Corporate Reporting (International)

Tuesday 9 June 2015

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 Kutchen, a public limited company, operates in the technology sector and has investments in other entities operating in the sector. The draft statements of financial position at 31 March 2015 are as follows:

	Kutchen $m	House $m	Mach $m
Assets:			
Non-current assets			
Property, plant and equipment	216	41	38
Investment in subsidiary			
Mach	52		
Finance lease receivables	50	14	8
	318	55	46
Current assets	44	25	64
Total assets	362	80	110
Equity and liabilities:			
Share capital of $1 each	43	13	26
Retained earnings	41	24	15
Other components of equity	12	5	4
Total equity	96	42	45
Non-current liabilities	67	12	28
Current liabilities			
Trade and other payables	199	26	37
Total current liabilities	199	26	37
Total liabilities	266	38	65
Total equity and liabilities	362	80	110

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

1. On 1 October 2014, Kutchen acquired 70% of the equity interests of House, a public limited company. The purchase consideration comprised 20 million shares of $1 of Kutchen at the acquisition date and 5 million shares on 31 March 2016 if House's net profit after taxation was at least $4 million for the year ending on that date. The market price of Kutchen's shares on 1 October 2014 was $2 per share and that of House was $4·20 per share. It is felt that there is a 20% chance of the profit target being met.

   Kutchen wishes to measure the non-controlling interest at fair value at the date of acquisition. At acquisition, the fair value of the non-controlling interest (NCI) in House was based upon quoted market prices. On 1 October 2014, the fair value of the identifiable net assets acquired was $48 million and retained earnings of House were $18 million and other components of equity were $3 million. The excess in fair value is due to non-depreciable land. No entries had been made in the financial statements of Kutchen for the acquisition of House.

2. On 1 April 2014, Kutchen acquired 80% of the equity interests of Mach, a privately owned entity, for a consideration of $57 million. The consideration comprised cash of $52 million and the transfer of non-depreciable land with a fair value of $5 million. The carrying amount of the land at the acquisition date was $3 million and the land has only recently been transferred to the seller of the shares in Mach and is still carried at $3 million in the financial records of Kutchen at 31 March 2015. The only consideration shown in the financial records of Kutchen is the cash paid for the shares of Mach.

   At the date of acquisition, the identifiable net assets of Mach had a fair value of $55 million, retained earnings were $12 million and other components of equity were $4 million. The excess in fair value is due to non-depreciable land. Mach had made a net profit attributable to ordinary shareholders of $3·6 million for the year to 31 March 2014.

Kutchen wishes to measure the non-controlling interest at fair value at the date of acquisition. The NCI is to be fair valued using a public entity market multiple method. Kutchen has identified two companies who are comparable to Mach and who are trading at an average price to earnings ratio (P/E ratio) of 21. Kutchen has adjusted the P/E ratio to 19 for differences between the entities and Mach, for the purpose of fair valuing the NCI.

3. Kutchen had purchased an 80% interest in Niche for $40 million on 1 April 2014 when the fair value of the identifiable net assets was $44 million. The partial goodwill method had been used to calculate goodwill and an impairment of $2 million had arisen in the year ended 31 March 2015. There were no other impairment charges or items requiring reclassification. The holding in Niche was sold for $50 million on 31 March 2015 and the gain on sale in Kutchen's financial statements is currently recorded in other components of equity. The carrying value of Niche's identifiable net assets other than goodwill was $60 million at the date of sale. Kutchen had carried the investment in Niche at cost.

4. Kutchen has decided to restructure one of its business segments. The plan was agreed by the board of directors on 1 January 2015 and affects employees in two locations. In the first location, half of the factory units have been closed by 31 March 2015 and the affected employees' pension benefits have been frozen. Any new employees will not be eligible to join the defined benefit plan. After the restructuring, the present value of the defined benefit obligation in this location is $8 million. The following table relates to location 1.

Value before restructuring	**Location 1 – $m**
Present value of defined benefit obligation	(10)
Fair value of plan assets	7
Net pension liability	(3)

In the second location, all activities have been discontinued. It has been agreed that employees will receive a payment of $4 million in exchange for the pension liability of $2·4 million in the unfunded pension scheme. Kutchen estimates that the costs of the above restructuring excluding pension costs will be $6 million. Kutchen has not accounted for the effects of the restructuring in its financial statements because it is planning a rights issue and does not wish to depress the share price. Therefore there has been no formal announcement of the restructuring. The pension liability is shown in non-current liabilities.

5. Kutchen manufactures equipment for lease or sale. On 31 March 2015, Kutchen leased out equipment under a 10-year finance lease. The selling price of the leased item was $50 million and the net present value of the minimum lease payments was $47 million. The carrying value of the leased asset was $40 million and the present value of the residual value of the product when it reverts back to Kutchen at the end of the lease term is $2·8 million. Kutchen has shown sales of $50 million and cost of sales of $40 million in its financial statements.

6. Kutchen has impairment tested its non-current assets. It was decided that a building located overseas was impaired because of major subsidence. The building was acquired on 1 April 2014 at a cost of 25 million dinars when the exchange was 2 dinars to the dollar. The building is carried at cost. At 31 March 2015, the recoverable amount of the building was deemed to be 17·5 million dinars. The exchange rate at 31 March 2015 is 2·5 dinars to the dollar. Buildings are depreciated over 25 years.

   The tax base and carrying amounts of the non-current assets before the impairment write down were identical. The impairment of the non-current assets is not allowable for tax purposes. Kutchen has not made any impairment or deferred tax adjustment for the above. Kutchen expects to make profits for the foreseeable future and assume the tax rate is 25%.

   No other deferred tax effects are required to be taken into account other than on the above non-current assets.

Required:

(a) Prepare the consolidated statement of financial position for the Kutchen Group as at 31 March 2015.
(35 marks)

(b) When Kutchen acquired the majority shareholding in Mach, there was an option on the remaining non-controlling interest (NCI), which could be exercised at any time up to 31 December 2015. On 30 April 2015, Kutchen acquired the remaining NCI which related to the purchase of Mach. The payment for the NCI was structured so that it contained a fixed initial payment and a series of contingent amounts payable over the following two years. The contingent payments were to be based on the future profits of Mach up to a maximum amount. Kutchen felt that the fixed initial payment was an equity transaction. Additionally, Kutchen was unsure as to whether the contingent payments were either equity, financial liabilities or contingent liabilities.

After a board discussion which contained disagreement as to the accounting treatment, Kutchen is preparing to disclose the contingent payments in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The disclosure will include the estimated timing of the payments and the directors' estimate of the amounts to be settled.

Required:

Advise Kutchen on the difference between equity and liabilities, and on the proposed accounting treatment of the contingent payments on acquisition of the NCI of Mach. (8 marks)

(c) The directors of Kutchen are considering the purchase of a company in the USA. They have heard that the accounting standards in the USA are 'rules based' and that there are significant differences of opinion as to whether 'rules based' standards are superior to 'principles based' standards. It is said that this is due to established national approaches and contrasting regulatory philosophies. The directors feel that 'principles based' standards are a greater ethical challenge to an accountant than 'rules based' standards.

Required:

Discuss the philosophy behind 'rules based' and 'principles based' accounting standards, setting out the ethical challenges which may be faced by accountants if there were a switch in a jurisdiction from 'rules based' to 'principles based' accounting standards. (7 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 The directors of Yanong, a public limited company, have seen many different ways of dealing with the measurement and disclosure of the fair value of assets, liabilities and equity instruments. They feel that this reduces comparability among different entities' financial statements. They would like advice on several transactions where they currently use fair value measurement as they have heard that the introduction of IFRS 13 *Fair Value Measurement*, while not interfering with the scope of fair value measurement, will reduce the extent of any diversity and inconsistency.

(a) Yanong owns several farms and also owns a division which sells agricultural vehicles. It is considering selling this agricultural retail division and wishes to measure the fair value of the inventory of vehicles for the purpose of the sale. Three markets currently exist for the vehicles. Yanong has transacted regularly in all three markets. At 30 April 2015, Yanong wishes to find the fair value of 150 new vehicles, which are identical. The current volume and prices in the three markets are as follows:

Market	Sales price – per vehicle $	Historical volume – vehicles sold by Yanong	Total volume of vehicles sold in market	Transaction costs – per vehicle $	Transport cost to the market – per vehicle $
Europe	40,000	6,000	150,000	500	400
Asia	38,000	2,500	750,000	400	700
Africa	34,000	1,500	100,000	300	600

Yanong wishes to value the vehicles at $39,100 per vehicle as these are the highest net proceeds per vehicle, and Europe is the largest market for Yanong's product. Yanong would like advice as to whether this valuation would be acceptable under IFRS 13 *Fair Value Measurement*. (6 marks)

(b) The company uses quarterly reporting for its farms as they grow short-lived crops such as maize. Yanong planted the maize fields during the quarter to 31 October 2014 at an operating cost of $10 million. The fields originally cost $20 million. There is no active market for partly grown fields of maize and therefore Yanong proposes to use a discounted cash flow method to value the maize fields. As at 31 October 2014, the following were the cash flow projections relating to the maize fields:

	3 months to 31 January 2015 $ million	3 months to 30 April 2015 $ million	Total $ million
Cash inflows		80	80
Cash outflows	(8)	(19)	(27)
Notional rental charge for land usage	(1)	(1)	(2)
Net cash flows	(9)	60	51

In the three months to 31 January 2015, the actual operating costs amounted to $8 million and at that date Yanong revised its future projections for the cash inflows to $76 million for the three months to April 2015. At the point of harvest at 31 March 2015, the maize was worth $82 million and it was sold for $84 million (net of costs to sell) on 15 April 2015. In the measurement of fair value of the maize, Yanong includes a notional cash flow expense for the 'rent' of the land where it is self-owned.

The directors of Yanong wish to know how they should have accounted for the above biological asset at 31 October 2014, 31 January 2015, 31 March 2015 and when the produce was sold. Assume a discount rate of 2% per quarter as follows:

	Factor
Period 1	0·980
Period 2	0·961

(6 marks)

(c) On 1 May 2012, Yanong granted 500 share appreciation rights (SARs) to its 300 managers. All of the rights vested on 30 April 2014 but they can be exercised from 1 May 2014 up to 30 April 2016. At the grant date, the value of each SAR was $10 and it was estimated that 5% of the managers would leave during the vesting period. The fair value of the SARs is as follows:

Date	Fair value of SAR
30 April 2013	$9
30 April 2014	$11
30 April 2015	$12

All of the managers who were expected to leave employment did leave the company as expected before 30 April 2014. On 30 April 2015, 60 managers exercised their options when the intrinsic value of the right was $10·50 and were paid in cash.

Yanong is confused as to whether to account for the SARs under IFRS 2 *Share-based Payment* or IFRS 13 *Fair Value Measurement*, and would like advice as to how the SARs should have been accounted for from the grant date to 30 April 2015. (6 marks)

(d) Yanong uses the revaluation model for its non-current assets. Yanong has several plots of farmland which are unproductive. The company feels that the land would have more value if it were used for residential purposes. There are several potential purchasers for the land but planning permission has not yet been granted for use of the land for residential purposes. However, preliminary enquiries with the regulatory authorities seem to indicate that planning permission may be granted. Additionally, the government has recently indicated that more agricultural land should be used for residential purposes.

Yanong has also been approached to sell the land for commercial development at a higher price than that for residential purposes.

Yanong would like advice on how to measure the fair value of the land in its financial statements. (5 marks)

Required:

Advise Yanong on how the above transactions should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

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)

Note: Ignore any deferred tax implications of the transactions above.

(25 marks)

3 Klancet, a public limited company, is a pharmaceutical company and is seeking advice on several financial reporting issues.

(a) Klancet produces and sells its range of drugs through three separate divisions. In addition, there are two laboratories which carry out research and development activities.

In the first of these laboratories, the research and development activity is funded internally and centrally for each of the three sales divisions. It does not carry out research and development activities for other entities. Each of the three divisions is given a budget allocation which it uses to purchase research and development activities from the laboratory. The laboratory is directly accountable to the division heads for this expenditure.

The second laboratory performs contract investigation activities for other laboratories and pharmaceutical companies. This laboratory earns 75% of its revenues from external customers and these external revenues represent 18% of the organisation's total revenues.

The performance of the second laboratory's activities and of the three separate divisions is regularly reviewed by the chief operating decision maker (CODM). In addition to the heads of divisions, there is a head of the second laboratory. The head of the second laboratory is directly accountable to the CODM and they discuss the operating activities, allocation of resources and financial results of the laboratory.

Klancet is uncertain as to whether the research and development laboratories should be reported as two separate segments under IFRS 8 *Operating Segments*, and would like advice on this issue. (8 marks)

(b) Klancet has agreed to sell a patent right to another pharmaceutical group, Jancy. Jancy would like to use the patent to develop a more complex drug. Klancet will receive publicly listed shares of the Jancy group in exchange for the right. The value of the listed shares represents the fair value of the patent. If Jancy is successful in developing a drug and bringing it to the market, Klancet will also receive a 5% royalty on all sales.

Additionally, Klancet won a competitive bidding arrangement to acquire a patent. The purchase price was settled by Klancet issuing new publicly listed shares of its own.

Klancet's management would like advice on how to account for the above transactions. (7 marks)

(c) Klancet is collaborating with Retto Laboratories (Retto), a third party, to develop two existing drugs owned by Klancet.

In the case of the first drug, Retto is simply developing the drug for Klancet without taking any risks during the development phase and will have no further involvement if regulatory approval is given. Regulatory approval has been refused for this drug in the past. Klancet will retain ownership of patent rights attached to the drug. Retto is not involved in the marketing and production of the drug. Klancet has agreed to make two non-refundable payments to Retto of $4 million on the signing of the agreement and $6 million on successful completion of the development.

Klancet and Retto have entered into a second collaboration agreement in which Klancet will pay Retto for developing and manufacturing an existing drug. The existing drug already has regulatory approval. The new drug being developed by Retto for Klancet will not differ substantially from the existing drug. Klancet will have exclusive marketing rights to the drug if the regulatory authorities approve it. Historically, in this jurisdiction, new drugs receive approval if they do not differ substantially from an existing approved drug.

The contract terms require Klancet to pay an upfront payment on signing of the contract, a payment on securing final regulatory approval, and a unit payment of $10 per unit, which equals the estimated cost plus a profit margin, once commercial production begins. The cost-plus profit margin is consistent with Klancet's other recently negotiated supply arrangements for similar drugs.

Klancet would like to know how to deal with the above contracts with Retto. (8 marks)

Required:

Advise Klancet on how the above transactions should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

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 IAS 1 *Presentation of Financial Statements* defines profit or loss and other comprehensive income. The purpose of the statement of profit or loss and other comprehensive income is to show an entity's financial performance in a way which is useful to a wide range of users so that they may attempt to assess the future net cash inflows of an entity. The statement should be classified and aggregated in a manner which makes it understandable and comparable. However, the International Integrated Reporting Council (IIRC) is calling for a shift in thinking more to the long term, to think beyond what can be measured in quantitative terms and to think about how the entity creates value for its owners. Historical financial statements are essential in corporate reporting, particularly for compliance purposes, but it can be argued that they do not provide meaningful information. Preparers of financial statements seem to be unclear about the interaction between profit or loss and other comprehensive income (OCI) especially regarding the notion of reclassification, but are equally uncertain about whether the IIRC's Framework constitutes suitable criteria for report preparation. A Discussion Paper on the Conceptual Framework published by the International Accounting Standards Board (IASB) has tried to clarify what distinguishes recognised items of income and expense which are presented in profit or loss from items of income and expense presented in OCI.

Required:

(a) (i) Describe the current presentation requirements relating to the statement of profit or loss and other comprehensive income. (4 marks)

(ii) Discuss, with examples, the nature of a reclassification adjustment and the arguments for and against allowing reclassification of items to profit or loss.

Note: A brief reference should be made in your answer to the IASB's Discussion Paper on the Conceptual Framework. (5 marks)

(iii) Discuss the principles and key components of the IIRC's Framework, and any concerns which could question the Framework's suitability for assessing the prospects of an entity. (8 marks)

(b) Cloud, a public limited company, regularly purchases steel from a foreign supplier and designates a future purchase of steel as a hedged item in a cash flow hedge. The steel was purchased on 1 May 2014 and at that date, a cumulative gain on the hedging instrument of $3 million had been credited to other comprehensive income. At the year end of 30 April 2015, the carrying amount of the steel was $8 million and its net realisable value was $6 million. The steel was finally sold on 3 June 2015 for $6·2 million.

On a separate issue, Cloud purchased an item of property, plant and equipment for $10 million on 1 May 2013. The asset is depreciated over five years on the straight line basis with no residual value. At 30 April 2014, the asset was revalued to $12 million. At 30 April 2015, the asset's value has fallen to $4 million. The entity makes a transfer from revaluation surplus to retained earnings for excess depreciation, as the asset is used.

Required:

Show how the above transactions would be dealt with in the financial statements of Cloud from the date of the purchase of the assets.

Note: Candidates should ignore any deferred taxation effects. (6 marks)

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

(25 marks)

End of Question Paper