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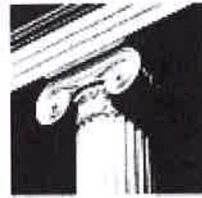
School of Business
& Finance



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ACCA Paper P2
(International)
Corporate Reporting

Recent Past Paper Pack

June 2012

ACCA PAPER P2 (INT & UK)

CORPORATE REPORTING

Recent past paper pack

June 2012

The following is a pack of recent past p2 exam questions with answers to each. The typesetting is my own and horrendous. I am not a typesetter and it shows.

The answers are my own also. They will certainly be good enough for any prize winner, but also it is almost certain there will be typos. Please inform me of any problems you see.

Thanks,

Martin Jones

April 2012.

QUESTION 34 Ribby (Q1 June 2008)

The following draft statements of financial position relate to Ribby, Hall and Zian, all limited companies, as at 31 May 2008:

	Ribby $m	Hall $m	Zian Dinars m
Assets			
Non-current assets			
Property, plant and equipment	250	120	360
Investment in Hall	98	-	-
Investment in Zian	30	-	-
Financial assets	10	5	148
Current assets	22	17	120
Total assets	410	142	628
Share capital	60	40	209
Other components of equity	30	10	-
Retained earnings	120	80	299
Total equity	210	130	508
Non-current liabilities	90	5	48
Current liabilities	110	7	72
Total equity and liabilities	410	142	628

The group values non-controlling interest at fair value (full goodwill). The following information needs to be taken account of in the preparation of the group financial statements of Ribby:

(i) Ribby acquired 70% of the ordinary shares of Hall on 1 June 2006, at the start of the previous accounting period, when Hall's other reserves were $10 million and retained earnings were $60 million. The fair value of the non-controlling interest and net assets of Hall were $40million (nci) and $120 million (na) respectively at the date of acquisition. Ribby acquired 60% of the ordinary shares of Zian for 330 million dinars later that same day on 1 June 2006 when Zian's retained earnings were 220 million dinars. The fair value of the non-controlling interest and net assets of Zian on 1 June 2006 were 210 million dinars (nci) and 495 million dinars (na). The excess of the fair value over the net assets of Hall and Zian is due to an increase in the value of non-depreciable land. There have been no issues of ordinary shares since acquisition and goodwill on acquisition is not impaired for either Hall or Zian.

(ii) Zian is located in a foreign country and imports its raw materials at a price which is normally denominated in dollars. The product is sold locally at selling prices denominated in dinars, and determined by local competition. All selling and operating expenses are incurred locally and paid in dinars. Distribution of profits is determined by the parent company, Ribby. Zian has financed part of its operations through a $4 million loan from Hall which was raised on 1 June 2007, at the start of the current accounting period. This is included in the financial assets of Hall and the non-current liabilities of Zian. Zian's management have a considerable degree of authority and autonomy in carrying out the operations of Zian and other than the loan from Hall are not dependent upon other companies for finance.

(iii) Ribby has a building which it purchased on 1 June 2007 for 40 million dinars and which is located overseas. The building is carried at cost and has been depreciated on the straight-line basis over its useful life of 20 years. At 31 May 2008, as a result of an impairment review, the recoverable amount of the building was estimated to be 36 million dinars.

(iv) Ribby has a long-term loan of $10 million which is owed to a third party bank. At 31 May 2008, Ribby decided that it would repay the loan early on 1 July 2008 and formally agreed this repayment with the bank prior to the year end. The agreement sets out that there will be an early repayment penalty of $1 million.

(v) The directors of Ribby announced on 1 June 2007 that a bonus of $6 million would be paid to the employees of Ribby if they achieved a certain target production level by 31 May 2008. The bonus is to be paid partly in cash and partly in share options. Half of the bonus will be paid in cash on 30 November 2008 whether or not the employees are still working for Ribby. The other half will be given in share options on the same date, provided that the employee is still in service on 30 November 2008. The exercise price and number of options will be fixed by management on 30 November 2008. The target production was met and management expect 10% of employees to leave between 31 May 2008 and 30 November 2008. No entry has been made in the financial statements of Ribby.

(vi) Ribby operates a defined benefit pension plan that provides a pension of 1.2% of the final salary for each year of service, subject to a minimum of four years service. On 1 June 2007, Ribby improved the pension entitlement so that employees receive 1.4% of their final salary for each year of service. This improvement applied to all prior years' service of the employees. As a result, the present value of the defined obligation on 1 June 2007 increased by $4 million as follows:

	$m
Employees with more than four years service	3
Employees with less than four years service (average service of two years)	1
	4

Ribby had not accounted for the improvement in the pension plan.

(vii) Ribby is considering selling its subsidiary, Hall. Just prior to the year end, Hall sold inventory to Ribby at a price of $6 million. The carrying value of the inventory in the financial records of Hall was $2 million. The cash was received before the year end, and as a result the bank overdraft of Hall was virtually eliminated at 31 May 2008. After the year end the transaction was reversed and it was agreed that this type of transaction would be carried out again when the interim financial statements were produced for Hall, if the company had not been sold by that date.

(viii) The following exchange rates are relevant to the preparation of the group financial statements:

	Dinars to $
1 June 2006	11
1 June 2007	10
31 May 2008	12
Average for year to 31 May 2008	10.5

Required:

(a) **Discuss and apply the principles set out in IAS 21 *The Effects of Changes in Foreign Exchange Rates* in order to determine the functional currency of Zian.** (8 marks)

(b) **Prepare a consolidated statement of financial position of the Ribby Group at 31 May 2008 in accordance with International Financial Reporting Standards.** (35 marks)

(c) **Discuss how the manipulation of financial statements by company accountants is inconsistent with their responsibilities as members of the accounting profession setting out the distinguishing features of a profession and the privileges that society gives to a profession. (Your answer should include reference to the above scenario.)** (7 marks)

Note: Requirement (c) includes 2 marks for the quality of the discussion.

(Total: 50 marks)

QUESTION 35 Norman (Q2 June 2008)

(a) Norman, a public limited company, has three business segments which are currently reported in its financial statements. Norman is an international hotel group which reports to management on the basis of region. It does not currently report segmental information under IFRS 8 *Operating Segments*. Norman proposes to present the results of the regional segments for the year ended 31 May 2008 as follows:

Region	**Revenue External**	**Revenue Internal**	**Segment results profit/ (loss)**	**Segment assets**	**Segment liabilities**
	$m	**$m**	**$m**	**$m**	**$m**
European	200	3	(10)	300	200
South East Asia	300	2	60	800	300
Other regions	500	5	105	2,000	1,400

There were no significant inter company balances in the segment assets and liabilities. The hotels are located in capital cities in the various regions, and the company sets individual performance indicators for each hotel based on its city location.

Required:

Discuss the principles in IFRS 8 *Operating Segments* for the determination of a company's reportable operating segments and how these principles would be applied for Normal plc using the information given above. (11 marks)

(b) Norman is also addressing various problems regarding revenue recognition and would like to understand how the following would be recognised under current revenue guidance:

(i) One of the hotels owned by Norman is a hotel complex which includes a theme park, a casino and a golf course, as well as a hotel. The theme park, casino, and hotel were sold in the year ended 31 May 2008 to Conquest, a public limited company, for $200 million but the sale agreement stated that Norman would continue to operate and manage the three businesses for their remaining useful life of 15 years. The residual interest in the business reverts back to Norman after the 15 year period. Norman would receive 75% of the net profit of the businesses as operator fees and Conquest would receive the remaining 25%. Norman has guaranteed to Conquest that the net minimum profit paid to Conquest would not be less than $15 million. (4 marks)

(ii) Norman has recently started issuing vouchers to customers when they stay in its hotels. The vouchers entitle the customers to $30 discount on a subsequent room booking within three months of their stay. Historical experience has shown that only one in five vouchers are redeemed by the customer. At the company's year end of 31 May 2008, it is estimated that there are vouchers worth $20 million which are eligible for discount. The income from room sales for the year is $300 million and Norman is unsure how to report the income from room sales in the financial statements. (4 marks)

(iii) Norman has obtained a significant amount of grant income for the development of hotels in Europe. The grants have been received from government bodies and relate to the size of the hotel which has been built by the grant assistance. The intention of the grant income was to create jobs in areas where there was significant unemployment. The grants received of $70 million will have to be repaid if the cost of building the hotels is less than $500 million. (4 marks)

Appropriateness and quality of discussion. (2 marks)

Required:

Discuss how the above income would be treated in the financial statements of Norman for the year ended 31 May 2008.

(Total: 25 marks)

QUESTION 36 Sirus (Q3 June 2008)

Sirus is a large national public limited company (plc). The directors' service agreements require each director to purchase 'B' ordinary shares on becoming a director and this capital is returned to the director on leaving the company. Any decision to pay a dividend on the 'B' shares must be approved in a general meeting by a majority of all of the shareholders in the company. Directors are the only holders of 'B' shares.

Sirus would like advice on how to account under International Financial Reporting Standards (IFRSs) for the following events in its financial statements for the year ended 30 April 2008:

(a) The capital subscribed to Sirus by the directors and shareholders is shown as follows in the statement of financial position as at 30 April 2008:

Equity

	$m
Ordinary 'A' shares	100
Ordinary 'B' shares	20
Retained earnings	30
Total equity	150

On 30 April 2008 the directors had recommended that $3 million of the profits should be paid to the holders of the ordinary 'B' shares, in addition to the $10 million paid to directors under their employment contracts. The payment of $3 million had not been approved in a general meeting. The directors would like advice as to whether the capital subscribed by the directors (the ordinary 'B' shares) is equity or a liability and how to treat the payments out of profits to them. (6 marks)

(b) When a director retires, amounts become payable to the director as a form of retirement benefit as an annuity. These amounts are not based on salaries paid to the director under an employment contract. Sirus has contractual or constructive obligations to make payments to former directors as at 30 April 2008 as follows:

(i) Certain former directors are paid a fixed annual amount for a fixed term beginning on the first anniversary of the director's retirement. If the director dies, an amount representing the present value of the future payment is paid to the director's estate.

(ii) In the case of other former directors, they are paid a fixed annual amount which ceases on death.

The rights to the annuities are determined by the length of service of the former directors and are set out in the former directors' service contracts. (6 marks)

(c) On 1 May 2007, Sirus acquired another company, Marne plc. The directors of Marne, who were the only shareholders, were offered an increased profit share in the enlarged business for a period of two years after the date of acquisition as an incentive to accept the purchase offer. After this period, normal remuneration levels will be resumed. Sirus estimated that this would cost them $5 million at 30 April 2008 and a further $6 million at 30 April 2009. These amounts will be paid in cash shortly after the respective year ends. (5 marks)

(d) Sirus raised a loan with a bank of $2 million on 1 May 2007. The market interest rate of 8% per annum is to be paid annually in arrears and the principal is to be repaid in 10 years' time. The term of the loan allow Sirus to redeem the loan after seven years by paying the full amount of the interest to be charged over the ten year period, plus a penalty of $200,000 and the principal of $2 million. The effective interest rate of the repayment option is 9.1%. The directors of Sirus are currently restructuring the funding of the company and are in initial discussions with the bank about the possibility of repaying the loan within the next financial year. Sirus is uncertain about the accounting treatment for the current loan agreement and whether the loan can be shown as a current liability because of the discussions with the bank. (6 marks)

Appropriateness of the format and presentation of the report and quality of discussion. (2 marks)

Required:

Draft a report to the directors of Sirus which discusses the principles and nature of the accounting treatment of the above elements under International Financial Reporting Standards in the financial statements for the year ended 30 April 2008.

(Total: 25 marks)

QUESTION 37 Transition (Q4 June 2008)

The transition to International Financial Reporting Standards (IFRSs) involves major change for companies as IFRSs introduce significant changes in accounting practices that were often not required by national generally accepted accounting practice. It is important that the interpretation and application of IFRSs is consistent from country to country. IFRSs are partly based on rules, and partly on principles and management's judgement. Judgement is more likely to be better used when it is based on experience of IFRSs within a sound financial reporting infrastructure. It is hoped that national differences in accounting will be eliminated and financial statements will be consistent and comparable worldwide.

Required:

(a) **Discuss how the changes in accounting practices on transition to IFRSs and choice in the application of individual IFRSs could lead to inconsistency between the financial statements of companies.** (17 marks)

(b) **Discuss how management's judgement and the financial reporting infrastructure of a country can have a significant impact on financial statements prepared under IFRS.** (6 marks)

Appropriateness and quality of discussion. (2 marks)

(Total: 25 marks)

Answer 34 Ribby

(a) Marking guide

Part a carries the usual 1 mark per idea. All the examiner was looking for was evidence of understanding of the idea of the functional currency.

Functional Currency
This is simply the currency that the entity functions in.

Principles
In order to work out the functional currency in an entity like Zian that does use more than one currency we simply weigh up the significance of the currencies.

Competition
IAS 21 makes a point of saying the most significant currency is that of the competitive behaviour.

Application to Zian
To determine Zian's currency we work through its use of currencies.

Supply
This is in $

Selling Prices
This is in Dinars

Competition
This is in Dinars. As discussed above, the currency of competition is given particular significance by IAS21.

Expenses
This is in Dinars

Dividends
This in $

$4m Loan
This is in $

Management
Management think in Dinars as illustrated by FS.

Other Finance
This is in Dinars

Conclusion
On balance the functional currency of Zian is Dinars.

(b) Answer commentary
Note how little explanation is required to answer this question. This minimal approach is entirely appropriate to the numbers in answering question (1). One problem that some students encounter in this exam is that they overexplain their answer in question (1) where there are no marks for explanations and then underexplain their answers in the B section where the marks are allocated to explanation.

Net Assets

	Hall		Zian	
	Acq	**YE**	**Acq**	**YE**
Share Capital	40	40	209	209
Other CE (i)	10	10	-	-
Retained Earnings (i)	60	80	220	299
FVA (Land)	β10	10	β66	66
PUP (6-2) (vii)		(4)		
(i)	120	136	(ii) 495	574

Note: Both FVA balances are calculated as balancing figures.

Goodwill	**%**	**Working**	**H**	**%**	**Working**	**Z**
FV of Consideration	70%		98	60%	(11)($30m)	330
FV of NCI	30%	(i)	40	40%	(i)	210
FV of NA			(120)			(495)
Goodwill (Full)			18			45

Note: The 330 million Dinar consideration is given. But it can also be derived as above from the dollar value ($30m) multiplied by the exchange rate (11).

Further note: the original version of this question used partial goodwill because it was examined before the existence of full goodwill. The above NCI balances were added to the question to bring it up to date.

Group Statement of Financial Position

		$m
Non Current Assets		
Goodwill	(18 +45/12)	22
Property, Plant & Equipment	{250 + 120 + 10FVA + [360 + 66FVA]/12-0.8(iii)}	415
Financial Assets	(10 + 5 – 4(ii) + 148/12)	23
Current Assets	(22 + 17 + 120/12 – 4PUP(vii))	45
		505
Equity		
Share Capital		60
Other components of equity (30 + 1.8(v))		32
Retained Earnings (see below)		122
Non Controlling Interest (see below)		65
Non Current Liabilities	[90 + 5 + (48 – 48(ii))/12 -10(iv)]	89
Current Liabilities	[110 + 7 + 72/12 + 11(iv)]	137
		505

Working (iii)

		Building $m
Cost	(D40m/10)	4
Depreciation	($4m/20years)	(0.2)
Before		3.8
Impairment	Balance β	(0.8)
After	(D36m/12)	3.0

RE

		$m
Parent		120
(iii)	Unrecorded impairment	(0.8)
(iv)	Repayment fee	(1)
(v)	Cash bonus	(3)
(v)	Share based payment	(1.8)
(vi)	Past service cost	(4)
See below	forex	(2.5)
		106.9
Hall	(136 – 120)(70%)	11.2
Zian	(574 – 495)(60%)/12	3.95
		122

FOREX

Retranslation of cost of investment measured in the original Dinars to closing rate from acquisition rate.

330/12	=	27.5
330/11	=	(30)
	Loss	(2.5)

NCI

Nci calculated on the roll forward basis is acquisition nci plus the growth in nci

H	40 + (136-120)30% = 44.8	=44.8
Z	210 + (374-495)40% =241.6/12	=20.1
		65

Note: this is the end of the answer for exam purposes. No more would be required for the exam.

Comment on workings
The following workings are for explanatory purposes. Write as little as you can in the actual exam.

Working (ii)
Most obviously the $4m loan asset in Hall financial assets must be removed from group financial assets. Also fairly obviously, the equivalent balance must come out of ncl. however, the examiner does not tell us which rate has been used to include the $4m loan liability in the D48m ncl. Maybe the $4m is in there at the at the opening rate (10) and the retranslation has not been done. Or maybe the loan has been translated and retranslated and is in there at the closing rate (12). The paragraph does not say.

The easiest assumption is to assume the translation and retranslation has been done and the loan is in the D48m at the closing rate of 12. But 12*$4m is D48m. so that tells us the whole of the Zian ncl is taken up by the loan from the fellow sub and that Zian has no ncl due outside the group. Personally that is how I read the phrase "and other than the loan from Hall are not dependent upon other companies for finance". But the other assumption would be marked right.

Working (iii)

		Building
		$m
Cost	(D40m/10)	4
Depreciation	($4m/20years)	(0.2)
Before		3.8
Impairment	Balance β	(0.8)
After	(D36m/12)	3.0

Note: The question tells us that the depreciation has been recorded but that the impairment has not been recorded. So the impairment appears in PPE above and RE below.

Working (iv)
The reclassification moves the loan from ncl to cl; but also we pick up the fee of $1m.

Working (v)
The cash bonus results in a simple cl of ½($6m).

But the sbp obligation results in an equity reserve in OCE measured as follows:

Sbp obligation = (90%)($3m)(12/18) = $1.8m

Working (vi)
The scenario simply tells us that the pension amendment results in an increase in the obligation of $4m. so that is what we do. The question does not say whether there is a net pension asset (which would be in nca) or a net pension liability (which would be in ncl). But in all other questions the examiner assumes a net pension liability, hence the increase in ncl.

Of course, there is a corresponding past service cost recognised below.

(C) Ethical Responsibilities

The ethical responsibilities of accountants are given by the ACCA as follows:-

- Professionalism
- Integrity
- Competence
- Confidentiality
- Objectivity

Professionalism & Integrity

Professionalism involves avoiding behaviour that brings the profession into disrepute. Integrity means honesty & straight forwardness.

Distinguishing Feature of a Profession

The distinguishing feature of a profession is that professional bodies require that members adhere to ethical standards.

Privileges of Profession

The two main privileges of being a member of a profession are pay & respect.

Manipulation of Figures

Manipulation of figures and bending of rules to suit a personal agenda is often called creative accounting in the context of financial reporting. Creative accounting is lying and is clearly a breach of professionalism and integrity.

Ribby Group

The transaction in paragraph (vii) is creative accounting and is deliberately designed to cheat a purchaser of Hall.

ACCA

If the ACCA discover the above, disciplinary action is likely to be follow.

Answer 35 Norman

Marking guide

Usual B section stipulation of 1 mark per point applies.

Answer commentary

Most students are happier with the revenue in part (b). if this applies to you, then do it first. But do not be too concerned if the voucher unbundling in pat (b) is beyond you. This is possibly the most difficult revenue question element ever set by the examiner and nobody got the answer actually dead right in the real exam.

(a)

Principle

The principal of segmental reporting is disclosure. The purpose is to give users a flavour of how the individual parts of the business have performed.

Consolidation

Segmental reporting is almost consolidation in reverse. First and foremost, shareholders want to know how the whole group has performed. That is where consolidation comes in. but once shareholders have a handle on group's performance, they then want to know about the relative performances of the business units. This is where segmental reporting comes in.

Disclosure

You can see from the above that the segmental information is secondary to the primary fs. This is why there is a minimum requirement of only four figures; revenue, profit, assets and liabilities for each segment.

Norman disclosure

Norman has used these four headings across the top. So this part of the note is satisfactory.

Norman segments

It is in the area of division into segments where Norman has problems. Norman appears to have little idea how to do this.

Operating segments

The newish IFRS uses a clever idea called "the managerial philosophy" to define operating segments. The IFRS argues that the people best able to divide a business down into its component parts are the directors. It argues that a remote body such as the IASB would have no way of knowing the best way to divide the business up.

Chief operating decision maker

To express this idea, the IFRS uses the above phrase. It means the main board of directors, but because different words are used in different countries for the main board, the IFRS could not simply use the phrase main board.

Main board

So what the IFRS says essentially is that the segmental divisions that the main board analyse in their board meetings are the operating segments and these are the divisions that should be communicated to the shareholders.

Aggregation

Sometimes that is the end of the story and the performance and position of the operating segments is disclosed. But often this would result information overload. So aggregation is necessary.

Norman application

In the context of Norman, directors might assess performance across many small geographic business units. We do not know. This might mean the following were operating segments:-

Liverpool

Manchester

Leeds

Etc going around the whole globe city by city.

Clearly this will result in information overload for Norman shareholders.

Reportable segments

So this brings us to the concept of the reportable segment. This is done by gathering any small operating segments together to make a useful report.

Guidance (25% rule)

There is some detailed guidance in IFRS8 as to how this is done. But the detailed guidance is only guidance and common sense works just as well. But one rule that may be worth a mention is that at least 75% of the business must be separately reported. The effect of this is that "other" cannot be bigger than 25%.

Other regions

Very obviously the Norman note is pathetic. Shareholders would ask "Where is this place called Other?" This huge unknown accounts for half the revenue. This is completely unacceptable.

Recommendation

Norman has started well. Words like "European" and "South East Asia" work well. Norman should use other similar words like "North America", "South America" and "Africa" to divide "Other" properly. Personally I can see no need for the word "Other" at all.

Management

But there is something else. Even though I do not know, I feel convinced that Norman directors also talk about performance using business divisions. Maybe they look at performance in city hotels then resort hotels then budget hotels. If this is true, then directors must do business segmental report as well as a geographic segmental report.

Further recommendation

So I further recommend that Norman do two segmental reports. One based on geographic distribution and the other based on the business divisions identified by the board.

Guidance (10% rule)

By the way, there is another guidance rule in IFRS8, but I mention it only in passing as I do not see it as applying to Norman. The IFRS suggests that any operating segment that is more than 10% of the whole business should be reported. The guidance is just guidance; so the 10% can be applied to any major figure (revenue, profit, assets etc). also the guidance is just guidance; so of course smaller segments can be reported if the directors think the information might be useful.

(b)(i)

Hotel complex sale

A sale of goods occurs at the point risks and rewards are transferred. But this transaction looks suspicious, maybe risks and rewards did not transfer.

Risks and rewards

The most obvious risk is the risk of profits falling below expectations. The most obvious reward is the reward of profits rising above expectations. Norman retains most of this even after the transaction.

Loan

So there is no sale of the hotel complex. The $200m cash inflow is in substance a secured loan.

Interest

So the annual payment of a minimum $15m is interest.

(b)(ii)

Voucher sales

This difficult accounting technique is a specific application of the concept of unbundling. When Norman sell a room and a voucher for a sale price of say $100, they sell two things; a room and a voucher. Or to rephrase this idea, Norman is selling a full room now and a part room later for $100. This marketing technique of selling two things at one price is called bundling.

Unbundling

Unbundling is what we accountants do. We must split the $100 between the two. The $100 must be broken into the bit that represents the room now and the bit that represents the part room later.

Example

You can only see this with an example. Even then it is tricky. If you pay me $100 for a room tonight purporting to be a $100 room and a voucher representing a free room in two weeks purporting to be another $100 room, then something has to give. The $100 cash has to be worth $100. so the two $100 rooms cannot be both each individually worth $100. they must be both together worth $100. so $50 and $50 each.

Next year

Back to the numbers in the Norman scenario. Approximately one in five vouchers are redeemed. This gives us $4m at the year end ($20m/5).

Current revenue

So some of the $300m received this year relates to the delivery of room value next year. We have received $300m. That is a fact. It purports to be related to $300m room value this year and $4m room value next year. But $304m room value does not go into $300 cash. So the split is:-

Current revenue = $300m(300/300+4)) = $296.053m

Deferred revenue = $300m(4/(300+4)) = $3.947m

(b)(iii)

Grant income

Under the IFRS for grants, grant income must be recognised to match against the cost for which it was granted.

Norman grant

The Norman scenario tells us that the grant income was for hotels.

Conclusion

So the grant income must be deferred under deferred income in liabilities and released to the income statement over the life of the related hotel. This will match to depreciation which will not start until the hotel opens for use.

Unemployment

The creation of jobs and unemployment issues are irrelevant for accounting purposes. The grant is for hotels and that is it. However, if the grant had been directly for labour costs, then it would be recognised in line with those labour costs.

Answer 36 Sirus

Marking guide

The usual 1 mark for each point clearly explained.

Answer commentary

The examiner commented on this question at a conference. The essential point he was making was that this was a particularly good example of a question where an answer with low technical content scored very highly. He commented that the students who simply analysed the information and did not try to be too clever scored very highly. He also commented that students who tried to be technical usually came up with irrelevant nonsense and so scored poorly.

However, because of the high analytical content and low technical content, it cannot be denied that this was a tricky question.

Report to the directors

Subject: debt equity issues

Date: today

From: me

To: directors

(a)

Framework

the framework for financial reporting defines assets and liabilities as follows (to paraphrase) "an asset/liability is a present right/obligation to a future economic outflow/inflow".

Equity

So equity is simply the defined as the difference between these two. This is not great and so the IASB are looking into defining equity properly.

Approximation

In the meantime, we must do with the approximate distinction between a liability and equity being the obligation. If the there is an obligation then the finance is a liability. If there are no obligations then the finance is equity.

B shares

The scenario appears to indicate that the $3m is not obligatory. But it is not the form; it is the substance that matters.

Substance

I suspect in reality the group has no option but to pay the directors their $3m. I suspect that when directors leave they will be repaid their part of the $3m. Otherwise there is no reason they would agree to handing the money over in the first place.

Conclusion

I suggest the B shares are a liability and the $3m is interest.

(b)

Obligation

The scenario tells us there is an obligation. So that is the answer. Where there is an obligation there is a liability and it should be recognised.

Measurement

Measurement is an issue. One is easy to measure. The other not so easy.

Fixed

The fixed annual amount for a fixed period can be measured easily using the technique of discounted cash flow.

Death

But the annual payments that cease upon death are difficult to measure. This is because one can never know the date of death.

Actuary

So I suggest an actuary is employed to value both. His expertise in valuation will be especially relevant in the second obligation.

Prior period adjustment

The group will have had equivalent liabilities at the beginning of the year. These have clearly been ignored. So comparatives will need restatement.

Pensions

This story sounds very like a defined benefit pension liability. It sounds like the group have simply ignored this obligation until now. If so then Sirus may be in breach of pension's legislation and should talk to the actuary on what should be done next.

(c)

PRP

In this story, there is the potential to interpret the further payments of $5m and $6m as profit related pay.

Owner managers

However, the recipients of the cash flows were formally both shareholders and directors. So the cash flows may represent consideration or remuneration.

Incentive

The scenario uses the very telling word 'incentive'. The reason for the payment was to get the shareholders to sell and not to motivate the directors to perform.

Point of view

Of course, the former shareholders and the current directors are the same people. So they do not really care why the payments are due. But we care. From our point of view, the incentive reveals that the cash flows are share consideration and not performance related pay.

Acquisition

So the two cash flows should be added to the immediate share consideration when measuring the fair value of consideration of the acquisition at acquisition and a corresponding liability will appear at the bottom of the b/s.

Discounting

As the numbers are fairly big, I suggest discounting will be material and therefore required.

(d)

Negotiations

The uncertainty is understandable. There are a couple of choices of repayment timings and some negotiations clouding the nature of this liability.

Liability

The best solution is simply to go back to the definition of a liability. To paraphrase again "a liability is a present obligation to a future economic outflow".

Key

This is the key to the problem. Forget all the choices and negotiations and maybes and ifs. Look at the obligation. The obligation currently is to pay back $2m in ten years with 8% interest as we go. That is it.

Conclusion

So we have a 10 year loan and 8% interest.

Option

By the way, if we had already exercised the option then that would change the obligation.

Negotiations

In a similar way, if we had finished the negotiations and signed a deal prior to the year end, then that too would change the obligation. But as it is we have a simple 10 year loan.

Answer 37 Transition

Marking guide

The usual 1 mark per point for (a) and (b).

Answer commentary

Do not be fooled into thinking something more clever, more erudite, more technical than the following will get you more marks. It will not. The following would be a comfortable 25 marks and a more technical answer could easily score far less as a result of confusing the marker.

(a)

Transition

The process of transition is covered in IFRS1 First time adoption. It describes three stages of transition

One: policies

Firstly we adopt IFRS policies and apply those to the current year figures.

Two: comparatives

Then we go back to last years fs and make those comparable.

Three: reconciliation

Then we revisit the current year figures, this time using the old local policies. The result is local current fs. The profit is then extracted from those local current fs and that is slotted into a note in the current international fs and reconciled to the current international profit.

Inconsistency

But the question was about inconsistency. This arises in the area of transition most frequently because some companies put a lot of effort into doing their transition properly and others do not. I shall consider inconsistency in each of the three above in reverse order:-

Inconsistency in three: reconciliation

Some companies really tell the shareholders in detail why the profit is higher (or lower) under IFRS. Other companies do not.

Inconsistency in two: comparatives

Some companies go back to last year and try to make the comparables genuinely comparable. Other companies essentially copy last year's fs.

Inconsistency in one: policies

This is all about the choices in IFRS mentioned in the second part of (a). Annoyingly the IFRS give various choices. The choice you make is called your policy. There are loads of these choices. Here are a few:-

Revaluation

Perhaps most famously there is a choice between the cost or revaluation model in PPE accounting. If we do one and some else does the other, then obviously inconsistency is the result.

Goodwill

Shockingly, IFRS will allow full or partial goodwill on a transaction by transaction basis. If we do one and some else does the other, then obviously inconsistency is the result.

Pensions

Under the old IAS for pensions, actuarial gains can go to the p/l, the OCI or the b/s. The IASB has recently limited this choice to OCI only, but many companies are still using the old IAS until it expires in 2013.

Joint Ventures

In the old IFRS on JVs there was a choice. The old IFRS allowed either associate accounting or proportional consolidation for JVs. The IASB limited this to associate accounting only in the new IFRS on JVs (IFRS11), but many companies are still using the old IFRS until it expires in 2013.

Investment properties

In theory, the IFRS will allow the cost or fair value model. In practice everyone adopts the fair value model, but it is confusing that a theoretical alternative is floating in the background. The IASB plan to limit this to fair value only.

Grants

In theory, the IFRS will allow net or gross recognition. Again in practice there is a strong culture of gross recognition and net recognition is very rare. But the choice is confusing. So The IASB plan to limit this, but haven't said how.

Fair value option

The IFRS on financial instruments (IFRS9) will allow any financial asset which is naturally classed at amortised cost to be classed at fair value instead provided there is a mismatch. This introduces yet more confusion and inconsistency.

Note

Accountants should be careful not to mix up choice with differences. Here are two examples:-

Example one: leasing

There are two different ways to account for leases at the moment. But there is no choice. A finance lease must be accounted for as a finance lease. You cannot choose to account for a finance lease as an operating lease because you feel like it. But you can choose revaluation of ppe because you feel like it.

Example two: depreciation

Depreciation is not a choice. There are different lives; that is true. But you cannot choose to depreciate a machine with a life of three years over fifty years because you feel like it. But you can use partial goodwill because you feel like it.

(b)

Judgement

Judgement is an absolutely massive part of financial reporting. Almost everything in IFRS fr comes down to judgement. Here are two examples stolen from above.

Judgement one: leasing

An accountant must use his judgement to figure out where the risks and rewards lie. Depending on the judgement, either a finance lease or operating lease would result.

Judgement two: depreciation

An accountant must use his judgement to guess lives. Depending on judgement, either a longer or shorter depreciation life will result.

Infrastructure

The main thing inside any countries structures is its people. So I am going to read this question as asking about cultural differences. I am going to read the phrase "infrastructure" as meaning "culture".

Culture one: USA

Famously, the USA is highly litigious. It is all about rules over there. And the result is that their fs read like the fulfilment of rules and are very dry and impenetrable.

Culture two: Japan

Japan has a reputation for being a secretive culture. This spills into secretive Japanese fs. Stick "Japanese financial statements" into google and you will see what I mean.

Question 38 Warrburt (Q1 December 2008)

The following draft group financial statements relate to Warrburt, a public limited company:

Warrburt Group: Statement of financial position as at 30 November 2008

	30 Nov 2008	30 Nov 2007
	$m	$m
Assets		
Non-current assets		
Property, plant and equipment	350	360
Goodwill	80	100
Other intangible assets	228	240
Investment in associate	100	–
Financial assets	142	150
	900	850
Current assets		
Inventories	135	198
Trade receivables	92	163
Cash and cash equivalents	312	323
	539	684
Total assets	1,439	1,534
Equity and Liabilities		
Equity attributable to owners of the parent:		
Share capital	650	595
Retained earnings	391	454
Other components of equity	25	20
	1,066	1,069
Non-controlling interest	70	53
Total equity	1,136	1,122
Non-current liabilities:		
Long-term borrowings	20	64
Deferred tax	28	26
Long-term provisions	100	96
Total non-current liabilities	148	186
Current liabilities:		
Trade payables	115	180
Current tax payable	35	42
Short term provisions	5	4
Total current liabilities	155	226
Total liabilities	303	412
Total equity and liabilities	1,439	1,534

Warrburt Group: Statement of comprehensive income for the year ended 30 November 2008

	$m
Revenue	910
Cost of sales	(886)
Gross profit	24
Other income	31
Distribution costs	(40)
Administrative expenses	(35)
Finance costs	(9)
Share of profit of associate	8
Loss before tax	(21)
Income tax expense	(31)
Loss for the year from continuing operations	(52)
Loss for the year	(52)
Other comprehensive income for the year (after tax):	
Financial assets	27
Gains on property revaluation	2
Actuarial losses on defined benefit plan	(4)
Other comprehensive income for the year (after tax)	25
Total comprehensive income for the year	(27)
Profit/loss attributable to:	
Owners of the parent	(74)
Non-controlling interest	22
	(52)
Total comprehensive income attributable to:	
Owners of the parent	(49)
Non-controlling interest	22
	(27)

Warrburt Group: Statement of changes in equity for the year ended 30 November 2008

	Share Capital $m	Retained Earnings $m	Financial Asset Gains $m	Revaluation Surplus $m	Total $m	Non-Controlling $m	Total Equity $m
Balance at 1 December 2007	595	454	16	4	1,069	53	1,122
Share capital issued	55				55		55
Dividends		(9)			(9)	(5)	(14)
Total comprehensive income for the year		(78)	27	2	(49)	22	(27)
Transfer to retained earnings		24	(24)				
Balance at 30 November 2008	650	391	19	6	1,066	70	1,136

Note to Statement of changes in equity:

	$m
Profit/Loss attributable to owners of parent	(74)
Actuarial losses on defined benefit plan	(4)
Total comprehensive income for year – retained earnings	(78)

The following information relates to the financial statements of Warrburt:

(i) Warrburt holds financial assets classified as fair value through the other comprehensive income (FVTOCI) which are owned by the holding company. The following schedule relates to those assets.

	$m
Balance 1 December 2007	150
Less sales of financial assets at carrying value	(38)
Add gain on financial assets	30
	142

The sale proceeds of the financial assets were $45 million. Profit on the sale of financial assets is shown as 'other income' in the financial statements. Deferred tax of $3 million arising on the revaluation gain above has been taken into account in 'other comprehensive income' for the year. The profit held in equity on the financial assets that were sold of $24 million, has been transferred to retained earnings.

(ii) The retirement benefit liability is shown as a long-term provision in the Statement of Financial Position and comprises the following:

	$m
Liability at 1 December 2007	96
Expense for period	10
Contributions to scheme (paid)	(10)
Actuarial losses	4
Liability at 30 November 2008	100

Warrburt recognises actuarial gains and losses in the statement of comprehensive income in the period in which they occur. The benefits paid in the period by the trustees of the scheme were $3 million. There is no tax impact with regards to the retirement benefit liability.

(iii) The property, plant and equipment (PPE) in the Statement of Financial Position comprises the following:

	$m
Carrying value at 1 December 2007	360
Additions at cost	78
Gains on property revaluation	4
Disposals	(56)
Depreciation	(36)
Carrying value at 30 November 2008	350

Plant and machinery with a carrying value of $1 million had been destroyed by fire in the year. The asset was replaced by the insurance company with new plant and machinery which was valued at $3 million. The machines were acquired directly by the insurance company and no cash payment was made to Warrburt. The company included the net gain on this transaction in 'additions at cost' and 'other income'.

The disposal proceeds on PPE were $63 million. The gain on disposal is included in administrative expenses. Deferred tax of $2 million has been deducted in arriving at the 'gains on property revaluation' figure in 'other comprehensive income'.

The remaining additions of PPE comprised imported plant and equipment from an overseas supplier on 30 June 2008. The cost of the PPE was 380 million dinars with 280 million dinars being paid on 31 October 2008 and the balance to be paid on 31 December 2008. The rates of exchange were as follows:

	Dinars to $1
30 June 2008	5.0
31 October 2008	4·9
30 November 2008	4·8

Exchange gains and losses are included in administrative expenses.

(iv) Warrburt purchased a 25% interest in an associate for cash on 1 December 2007. The net assets of the associate at the date of acquisition were $300 million. The associate made a profit after tax of $24 million and paid a dividend of $8 million out of these profits in the year ended 30 November 2008. Assume a tax rate of 25%.

(v) An impairment test had been carried out at 30 November 2008, on goodwill and other intangible assets. The result showed that goodwill was impaired by $20 million and other intangible assets by $12 million.

(vi) The short term provisions relate to finance costs which are payable within six months.

Warrburt's directors are concerned about the results for the year in the statement of comprehensive income and the subsequent effect on the cash flow statement. They have suggested that the proceeds of the sale of property, plant and equipment and the sale of financial assets should be included in 'cash generated from operations'. The directors are afraid of an adverse market reaction to their results and of the importance of meeting targets in order to ensure job security, and feel that the adjustments for the proceeds would enhance the 'cash health' of the business.

Required:

(a) Prepare a group statement of cash flows for Warrburt for the year ended 30 November 2008 in accordance with IAS7, 'Statement of Cash Flows', using the indirect method.

(35 marks)

(b) Discuss the key issues which the statement of cash flows highlights regarding the cash flow of the company.

(10 marks)

(c) Discuss the ethical responsibility of the company accountant in ensuring that manipulation of the statement of cash flows, such as that suggested by the directors, does not occur.

(5 marks)

Note: requirements (b) and (c) include 2 professional marks in total for the quality of the discussion.

(50 marks)

Question 39 Marrgrett (Q2 December 2008)

Marrgrett, a public limited company, is currently planning to acquire and sell interests in other entities and has asked for advice on the impact of IFRS3 (Revised) 'Business Combinations'. The company is particularly concerned about the impact on earnings, net assets and goodwill at the acquisition date and any ongoing earnings impact that the new standards may have. The company is considering purchasing additional shares in an associate, Josey, a public limited company. The holding will increase from 30% stake to 70% stake by offering the shareholders of Josey, cash and shares in Marrgrett. Marrgrett anticipates that it will pay $5 million in transaction costs to lawyers and bankers. Josey had previously been the subject of a management buyout. In order that the current management shareholders may remain in the business, Marrgrett is going to offer them share options in Josey subject to them remaining in employment for two years after the acquisition. Additionally, Marrgrett will offer the same shareholders, shares in the holding company which are contingent upon a certain level of profitability being achieved by Josey. Each shareholder will receive shares of the holding company up to a value of $50,000, if Josey achieves a pre-determined rate of return on capital employed for the next two years.

Josey has several marketing-related intangible assets that are used primarily in marketing or promotion of its products. These include trade names, internet domain names and non-competition agreements. These are not currently recognised in Josey's financial statements. Marrgrett 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 on the transaction. Marrgrett is unsure as to whether this method is mandatory, or what the effects are of recognising 'full goodwill'.

Additionally the company is unsure as to whether the nature of the consideration would affect the calculation of goodwill. To finance the acquisition of Josey, Marrgrett intends to dispose of a partial interest in two subsidiaries. Marrgrett will retain control of the first subsidiary but will sell the controlling interest in the second subsidiary which will become an associate. Because of its plans to change the overall structure of the business, Marrgrett wishes to recognise a re-organisation provision at the date of the business combination.

Required:
Discuss the principles and the nature of the accounting treatment of the above plans under International Financial Reporting Standards setting out any impact that IFRS3 (Revised) 'Business Combinations' might have on the earnings and net assets of the group.

Note: this requirement includes 2 professional marks for the quality of the discussion.

(25 marks)

Question 40 Johan (Q3 December 2008)

Johan, a public limited company, operates in the telecommunications industry. The industry is capital intensive with heavy investment in licences and network infrastructure. Competition in the sector is fierce and technological advances are a characteristic of the industry. Johan has responded to these factors by offering incentives to customers and, in an attempt to acquire and retain them, Johan purchased a telecom licence on 1 December 2006 for $120 million. The licence has a term of six years and cannot be used until the network assets and infrastructure are ready for use. The related network assets and infrastructure became ready for use on 1 December 2007. Johan could not operate in the country without the licence and is not permitted to sell the licence. Johan expects its subscriber base to grow over the period of the licence but is disappointed with its market share for the year to 30 November 2008. The licence agreement does not deal with the renewal of the licence but there is an expectation that the regulator will grant a single renewal for the same period of time as long as certain criteria regarding network build quality and service quality are met. Johan has no experience of the charge that will be made by the regulator for the renewal but other licences have been renewed at a nominal cost. The licence is currently stated at its original cost of $120 million in the statement of financial position under non-current assets.

Johan is considering extending its network and has carried out a feasibility study during the year to 30 November 2008. The design and planning department of Johan identified five possible geographical areas for the extension of its network. The internal costs of this study were $150,000 and the external costs were $100,000 during the year to 30 November 2008. Following the feasibility study, Johan chose a geographical area where it was going to install a base station for the telephone network. The location of the base station was dependent upon getting planning permission. A further independent study has been carried out by third party consultants in an attempt to provide a preferred location in the area, as there is a need for the optimal operation of the network in terms of signal quality and coverage. Johan proposes to build a base station on the recommended site on which planning permission has been obtained. The third party consultants have charged $50,000 for the study. Additionally Johan has paid $300,000 as a single payment together with $60,000 a month to the government of the region for access to the land upon which the base station will be situated. The contract with the government is for a period of 12 years and commenced on 1 November 2008. There is no right of renewal of the contract and legal title to the land remains with the government.

Johan purchases telephone handsets from a manufacturer for $200 each, and sells the handsets direct to customers for $150 if they purchase call credit (call card) in advance on what is called a prepaid phone. The costs of selling the handset are estimated at $1 per set. The customers using a prepaid phone pay $21 for each call card at the purchase date. Call cards expire six months from the date of first sale. There is an average unused call credit of $3 per card after six months and the card is activated when sold. Johan also sells handsets to dealers for $150 and invoices the dealers for those handsets. The dealer can return the handset up to a service contract being signed by a customer. When the customer signs a service contract, the customer receives the handset free of charge. Johan allows the dealer a commission of $280 on the connection of a customer and the transaction with the dealer is settled net by a payment of $130 by Johan to the dealer being the cost of the handset to the dealer ($150) deducted from the commission ($280). The handset cannot be sold separately by the dealer and the service contract lasts for a 12 month period. Dealers do not sell prepaid phones, and Johan receives monthly revenue from the service contract.

The chief operating officer, a non-accountant, has asked for an explanation of the accounting principles and practices which should be used to account for the above events.

Required:
Discuss the principles and practices which should be used in the financial year to 30 November 2008 to account for:

(a) the licences;

(8 marks)

(b) the costs incurred in extending the network;

(7 marks)

(c) the purchase of handsets and the recognition of revenue from customers and dealers.

(8 marks)

Appropriateness and quality of discussion.

(2 marks)
(25 marks)

Question 41 High Quality (Q4 December 2008)

Whilst acknowledging the importance of high quality corporate reporting, the recommendations to improve it are sometimes questioned on the basis that the marketplace for capital can determine the nature and quality of corporate reporting. It could be argued that additional accounting and disclosure standards would only distort a market mechanism that already works well and would add costs to the reporting mechanism, with no apparent benefit. It could be said that accounting standards create costly, inefficient, and unnecessary regulation. It could be argued that increased disclosure reduces risks and offers a degree of protection to users. However, increased disclosure has several costs to the preparer of financial statements.

Required:

(a) Explain why accounting standards are needed to help the market mechanism work effectively for the benefit of preparers and users of corporate reports.

(9 marks)

(b) Discuss the relative costs to the preparer and benefits to the users of financial statements of increased disclosure of information in financial statements.

(14 marks)

Quality of discussion and reasoning.

(2 marks)
(25 marks)

Answer 39 WARRBURRT

(a) Cash flow statement

Profit before tax (actually a loss)		(21)
Associate		(8)
Finance		9
Operating Profit (24 + 31 – 40 - 35)		(20)
Inventory (198 - 135 + 0)		63
Receivables (163 - 92 + 0)		71
Payables (180 – (115 – 21) + 0)		(86)
Depreciation		36
Disposal (63 – 56)		(7)
GW Impairment & intangible impairment (20 + 12)		32
➢ Pension expense (add back to remove effect)(same for next 3 below)		10
➢ Strategic equity profit on disposal (45 – 38)		(7)
➢ Insurance gain (3 – 1)		(2)
➢ Forex loss (1 + 1)		2
Cash generated from operations		92
Interest paid (4 – 5 + 9)		(8)
Tax paid		(39)
Operating cashflow		45
Investment		
➢ Pension Investment		(10)
➢ Associate Dividend (25%)(8)		2
➢ Associate Acquisition		(96)
➢ Strategic Equity Disposal		45
➢ PPE	Additions	(57)
	Disposals	63
Finance		
➢ Share Issue (650 – 595)		55
➢ Loan Repaid (20 – 64)		(44)
➢ Dividends		(9)
➢ NCI Dividends		(5)
Cashflow		(11)
Opening		323
Closing		312

Cash Flow Workings

Associate	
Opening	0
Closing	(100)
I/S (share of PBT from i/s)	8
I/S (share of tax hidden in $31m)	(2)
Dividend (associate dividend makes associate smaller)	(2)
Acq	96

Tax	
Opening	42
Closing	(35)
Opening	26
Closing	(28)
I/S (31 – 2) (the $2m associate tax that should be in the associate)	29
OCI (AFS)	3
OCI (Revaluation)	2
	39

Goodwill	
Opening	100
Closing	(80)
	20

Other Intangibles	
Opening	240
Closing	(228)
	12

NCI	
Opening	53
Closing	(70)
I/S	22
	5

PPE Liability Paid Forex	
	280 / 5 = 56
	280 / 4.9 = (57)
	(1) Loss

PPE Liability Unpaid Forex	
	100 / 5 = 20
	100 / 4.8 = (21)
	(1) Loss

Notes on workings
Some of the workings are very simple. Others near impossible.

PPE Liability
The ppe delivery results in a liability of D380m. But because the liability is part paid during the current year and part unpaid, it is best to split the one liability into two, the paid element and the unpaid element. Both liabilities start with an exchange rate of 5 at delivery. But the paid element closes out earlier with a rate of 4.9 and the unpaid element is measures at the year end using a rate of 4.8.

Payables
This leads to the adjustment of $21m to the closing payables. The inventory, receivables and payables balances are all trade balances or should be. But the closing ppe liability of $21m (100/4.8) is a ppe liability obviously. Less obviously it must have been slotted into trade payables because we cannot see the balance elsewhere on the balance sheet. So the $21m non trade payable must be pulled out of payables to make pure trade payables.

Tax
All charges increase liabilities. That is obvious. That is why the i/s charge increases the tax liability. But less obvious is that the two OCI charges are both charges. And as mentioned all charges increase liabilities.

Associate
The associate working is horrible. Its logic is hidden. The examiner does not make it clear in the question but the share of profit of $8m on the i/s has to be the share of PBT. Of course we know it should be the share of PAT. But we know it is not as the share of PAT is $6m. We know this for a fact because paragraph (iv) tells us that the ownership is 25% and the PAT is $24m ($24m*25%=$6m). so this means $2m tax that should be in the single line for the associate must have drifted into the tax charge of $31m. Very hard!

(b) Marking guide
Usual 1 mark per reasonable issue clearly discussed.
Operating cash flow
Directors have mentioned their concerns about results and their concerns about how that reflects on cash flow. Operating profit is a loss and that is clearly not good. However, the operating cash flow is a healthy inflow of $45m. so directors should not be concerned about that.
Cash flow
The overall cash flow is an outflow of $11m. however, in the scale of this enormous business that is essentially a net cash breakeven. So again directors should not be overly concerned about cash flow.
Cash
Turning now to the cash itself. The company has a closing asset balance of $312m. this is a huge pot of cash. Directors should not worry about having too little cash. In fact they should be concerned about having too much cash. Perhaps they should pay a couple of hundred million out to shareholders if they do not know what to do with this huge balance themselves.
Working capital management
This is satisfactory. The net working capital cash flow is an inflow of $48m (63 + 71 – 86). This is more good news. It appears the central functions of customer credit, supplier credit and stock control are indeed under control.
Inventory
This is particularly notable. It appears the guys in stock control have substantially reduced stock and this has freed up an enormous amount of cash.
Receivables
There is a similar story in receivables. The balance has come right down. This apparently indicates that the company is getting its cash from its customers much quicker this year than last year. This too has freed up an enormous amount of cash.
PPE additions
The company has invested heavily in new PPE ($57m). it looks like this was financed simply by selling the old PPE ($63m). this appears to very neat cash management.
Loan repaid
There is a similar story in finance. A big chunk of debt has been paid off ($44m). however, this appears to have been balanced by a share issue ($55m). very neat.
Associate
A whopping great $96m went into buying a new associate. This appears to have been financed from operations. More evidence of good cash flow management.
Conclusion
In conclusion it appears that directors concerns about cash flow are misplaced. It appears that the group is managing its cash flows very well. What is of concern is that directors do not know that they are managing cash flow well. Someone in the group appears to know what they are doing even if it is not the directors.

(c) **Marking guide**

Usual 1 mark per point.

Fiduciary duty

Directors have a responsibility to run the company for the benefit of the shareholders. This duty is sometimes called the fiduciary duty. This duty includes showing a true and fair view in the fs.

Ethical guidelines

The chief financial officer (CFO) has ethical duties based on his professional accounting body. They are:

P professionalism
I integrity
C confidentiality
C competence
O objectivity

Proposal

The proposal to include investing and financing cash flows in operating cash flows is creative accounting. It is clearly an attempt to bend and break accounting rules to manipulate the fs to improve the picture.

Unethical

Very obviously the proposal is unethical. It is a breach of fiduciary duty for the directors in general and a breach of integrity for the CFO in particular.

Conclusion

It is also a very stupid proposal. The cash flow is fine and does not need manipulation. It is also a blatant lie to classify PPE and financial asset flows under operating. The proposal is likely to cost directors their jobs.

Answer 39 Marrgrett

Marking guide
Usual 1 mark per valid point clearly stated.

IFRS3 Business Combinations

The above IFRS covers the process of group accounting. It was re-issued in 2008 to tidy up some of the imperfections relating to the original IFRS3 issued in 2003.

Big change

The big change related to goodwill. The new IFRS3 introduced the concept of full goodwill. This is based on the idea that goodwill in group fs should be reported in a similar way to all the other assets.

Control

All the other assets on the balance sheet are recognised based on control. That is, for stock for example, we do not simply show the inventory that we own in the sub (say 80%); we show the inventory that we control (100% or all the stock).

Full goodwill

This is the idea behind full goodwill. Under full goodwill we show the goodwill in the sub that we control; we show all the goodwill. This idea of full goodwill is effectively recommended by IFRS3.

Partial goodwill

The old way of doing goodwill is called partial goodwill (or sometimes proportionate goodwill). This used to show only the goodwill in the sub that was owned by the parent (say 80%) and was of course criticised because it was inconsistent with the rest of the balance sheet where we have always shown the assets and liabilities that we control (so 100% of stock, 100% of receivables etc.).

Choice

But rather annoyingly IFRS3 does not replace partial goodwill with full goodwill. It allows both. This occurred because the IASB members could not agree on which basis was best.

Inconsistency

Obviously this was less than brilliant standard setting by the IASB as the choice will introduce inconsistency in goodwill accounting. Some will use the full policy and others will use the partial policy.

Policy

In an even more bizarre piece of standard setting the IASB allow us to adopt an approach to goodwill on an acquisition by acquisition basis. It seems likely that most groups will adopt a policy for goodwill. But it is possible for one parent to buy two similar subs in one year and go full goodwill with one and go partial goodwill with the other.

Schedule

The new IFRS also adopts a new schedule for goodwill calculation. It is as follows:-

	$m
Fair value of consideration	x
Fair value of non-controlling interest	x
Fair value of net assets	(x)
Goodwill	x

NCI

Actually the way that IFRS3 achieves the two methods of goodwill calculation is by two different methods of measuring the NCI. Full goodwill simply uses the fair value of the nci shares but partial goodwill uses the nci proportion of na.

MI

As a minor but valid point, IFRS3 also changes the name of NCI from minority interest (MI) to non-controlling interest (NCI). This is certainly an improvement as sometimes the nci can be in the majority.

Another big change

The other big change from old IFRS3 to new IFRS3 related to changes in ownership. The new IFRS has a simple model that requires that a group recognise a sub acquisition when the group attains control and requires that the group recognises a sub disposal when the group loses control.

Transfers

This means the group cannot recognise an acquisition or disposal if there is no change in control. So when a group gets more ownership whilst retaining control, then the group simply recognises an increase in ownership. The nci have a decrease in ownership; so a transfer between the owners occurs. Ownership transfers from the nci to the group. A similar thing is recorded when a group gets less ownership whilst retaining control.

Fair value

A less significant but still important change relates to fair value. The new IFRS3 requires that when we say fair value we actually recognise fair value. This is particularly noticeable when recording net assets during an acquisition.

Contingencies

In fact the area where this fair value focus stands out most is contingencies. Under IAS37 we have a somewhat strange black and white approach to contingencies. Essentially under IAS37 if the cash outflow is probable then we recognise the liability in full, if not then we recognise nothing. IFRS3 requires simple fair value.

Illustration

An illustration would help to see the point:

Outflow	IAS37 valuation	IFRS3 valuation
70% chance of $100k	$100k	$70k
20% chance of $100k	Zero	$20k

You can see that IFRS3 has a view of fair value that is fairer.

IAS27 Consolidated and separate fs

Of course, if the basic group IFRS changes (IFRS3) then the partner IFRS had to change to fit (IAS27). But really there was little change to IAS27 in 2008.

IFRS10 Consolidated fs

On the other hand there was a sizeable change to IAS27 in 2011 when it was replaced by IFRS10. This new IFRS did not radically change group accounting but it did clarify the definition of control. Now control is defined as the "power to direct activities".

Marrgrett

Now it is time to turn to Marrgrett (daft spelling by the way):

Josey

Increasing ownership from 30% to 70% will give Marrgrett control (assuming all the shares have equal votes). So this is an acquisition.

Josey goodwill

IFRS3 requires that we deem ourselves to have sold the 30% and bought 70% to achieve the single point of purchase. So the goodwill is as follows:

	$m
Fair value of consideration (40%)	x
Fair value of previous interest (30%)	x
Fair value of non-controlling interest	x
Fair value of net assets	(x)
Goodwill	x

Transaction costs

These are written off straight to the p/l.

Options

These appear to be motivation to stay rather than motivation to sell. So I suggest that they are treated as normal motivational sbp rather than consideration.

Share consideration

The share consideration with the contingency will need careful fair valuation. The value will depend on the likelihood of Josey hitting the profit targets. The more likely the success of hitting the targets the more likely the contingent share consideration will flow and so the greater the fair value.

Intangibles

All the intangibles appear to be separable. That is, the trade names, internet domain and the non-competition agreements could be sold after the acquisition. So I suggest that they are all included in the fair value of net assets at fair value.

Full goodwill

Of course Marrgrett can use full goodwill, but it is not mandatory.

First sub

The sale of shares in the first sub does not involve the loss of control. So the groups will record a transfer between owners in equity. The non-controlling interest will go up and the controlling interest will go down.

Second sub

The sale of shares in the second sub does involve the loss of control. So the group will record a sub disposal and an associate acquisition.

Re-organisation provision

Provisions require obligations. There appears to be no obligation to re-organise. So there will be no provision.

Answer 40 Johan

Answer commentary
Hard question. The answer is easy enough, but the scenario is dense and confusing and a lot to cope with in 45 minutes. The other two B section questions were much easier. It is important to realise that the B section choice you make can make all the difference.
Marking guide
As ever, markers will give 1 mark per valid point.

(a) The licences

Intangibles

Intangibles can and must be recognised if they are measureable. The IFRS on intangibles identifies measureable as purchased, either individually or as part of a sub acquisition.

Intangible assets

Intangibles are also assets. So must meet the definition of an asset. That is the intangible must be a source of future economic inflow.

Licence

The licence was separately purchased so was correctly capitalised.

Life

There is reference to the licence being renewed at nominal cost. However, this is uncertain and so I suggest a finite life be applied.

Depreciation start

The asset was purchased a year before it could be used. This was because it took one year to ready the infrastructure. Depreciation matches cost with use. The asset was not in use in the first year. So I suggest Johan was right to charge no depreciation in the first year.

Five years

So that leaves five of the six original years. The current depreciation is therefore $24m.

Impairment

I believe I see indications of impairment. Johan is described as "disappointed" in demand from customers. An impairment test is required.

Cash generating unit

It is likely that this test would be most meaningful done on a cgu basis. The poor customer demand affects the whole foreign sub.

(b) Extending the network

Feasibility study

The feasibility study appears to be research work. There is no obvious profit horizon at this point. So the whole lot should be written off, internal and external spending.

Development

The further independent study sounds like it has moved to development expenditure. It appears at this stage the criteria for the recognition of development has been fulfilled. So the further $50k should be capitalised (see below).

Defer criteria

The criteria for the deferral of development expenditure are as follows

D definite intent and ability to complete project: clearly the project will be completed
E expenditure measurable: the $50k is uniquely identifiable with the above
F feasible: it certainly appears possible to get the planning permission
E expected benefits: the project looks likely to attract profitable customers
R resources adequate: Johan has the cash to do the job

Government payments

The government payments are for access to land. The deal is just a lease by another name.

Operating lease

Obviously the risks and rewards of the land stay with the government and so this is an operating lease. Thus the $60k per month just goes straight to operating costs.

Premium

Rather confusingly, even though this is an operating lease, the upfront payment of $300k must be matched to the period of use. Therefore this $300k is capitalised and depreciated over the 12 years. In fact the earlier $50k development costs should now move into PPE to meet this $300k as they both relate to land used for 12 years.

Land

By the way, it is not the land that is being depreciated here. The land is not on our balance sheet. The land is on the government balance sheet. What is on our balance sheet is the upfront payments of $50k and $300k to access the land for 12 years and that is what is being depreciated.

(c) Revenue

Revenue

Under old IAS18 revenue has two forms and so two forms of recognition:

Goods: revenue recognised at the point risks and rewards transfer
Services: revenue recognised over the period of the service.

First deal

The first deal, the prepaid deal, looks a bit daft to me. The customer pays a combined $171 for a phone that costs $200 and gets calls on top. That sounds very odd. I would have to understand the logic of the transaction to make a real suggestion for revenue recognition.

Suggestion

But here is my suggestion based on the little I do know from the story. I think this is a loss leader style transaction. I think Johan is prepared to sell this stuff at a loss in order to get its name into the press, onto twitter and into people's minds.

Unbundling

On that basis I suggest simple unbundling. I suggest the sale of the phone is recognised at delivery, thus the $150 sale income and $201 cost is recognised at contract start. Maybe the loss of $51 could go into distribution costs as advertising. Then separately the $21 is recognised over the six month deal, as the calls are rung up.

Unused credit

I suggest any unused credit that expires on a phone card at the end of a six month deal is simply swept into the p/l at the end of the six month deal.

Second deal

The second deal is even harder to understand. Again in real life, I would need to really understand how the deal operates and how Johan makes its money.

Suggestion

But here are some suggestions based on what I can gleam from the scenario. Firstly, it sounds like the delivery to the dealers is on a sale or return basis. So no revenue should be recognised on handsets as they are delivered to the dealers.

Handset revenue

Instead the handset revenue of $150 should be recognised at the point the retail customer takes delivery. It is at this point the handset cost of $200 is also swept in to the p/l.

Commission

The commission cost of $280 should be capitalised at this point also and then released to the i/s over the period of retail customer contract (12 months).

Net $130

This is achieved by the following journal based on the net cash outflow of $130:

Dr Commission cost (b/s)	280
Cr Handset revenue (i/s)	150
Cr Bank	130

Other issues

Johan should also consider agency issues regarding the deals with dealers and maybe Johan should also look at stock impairment if the handsets a known to be loss leaders at delivery of the stock to Johan. But I think I have said enough without complicating things further.

Commercial comment

But just for a moment I suggest Johan forget about the accounting and look at the commercial aspects of these two revenue deals. They appear far from profitable and Johan should be sure of the commercial logic otherwise the entity will soon be too dead to worry about double entry.

Answer 41: HIGH QUALITY

Marking guide
As ever, 1 mark per point.
(a)
Market Mechanism
The market mechanism defined in the introduction is the flow of information from directors to the market.

(EMH) Efficient Market Hypothesis
This idea is usually analysed by reference to the EMH. The EMH suggests that information flows freely from the company to the market.

Evidence
The EMH is really old so there is plenty of evidence but, it is all conflicting.

Evidence for EMH
The evidence in favour of EMH is that share prices hardly move after announcement because the market already knew the announced information before the announcement. This evidence was used by Fama in 1970 in ground breaking work on the EMH.

Evidence against EMH
But there is loads of evidence against EMH. Perhaps the best is ENRON.

ENRON
ENRON was famously manipulating its p/l and B/S using all manner of creative accounting (like 'special purpose vehicles').

CFS
But also famously, the ENRON CFS did say that cash was flooding out of ENRON but, somehow the market did not see that. This was at least in part because of the low quality US FRS made US fs hard to read.

Need
This clearly shows that high quality accounting standards are needed to help the market mechanism which otherwise does not work effectively.

(b)
Benefit of Users
Accounting standards are really for the benefit of users. High quality standards lead to high quality FS that users can use.

Benefit to preparers
But there are benefits of high quality standards to preparers. One is that preparers can get their message across if they use high quality accounting standards.

Cost to Preparer (1)
There are lots of costs of accounting disclosures. Perhaps the most obvious is the greater the disclosure, the bigger the FS and so the more paper consumed.

Cost to Preparer (2)
But also the greater the disclosure, the more accountants required to create the FS. And each accountant costs money.

Cost to Preparer (3)
In a similar way the greater the complexity of disclosures means that each accountant must be more qualified and therefore cost more.

Cost to Preparer (4)
Then the combination of increased volume and complexity of disclosure will lead to increased audit cost.

Benefit to User (1)
There is one big benefit to the user of increased disclosures. The greater the disclosures, the better the shareholders understand the investment.

Benefit to User(2)
Following on from that, the greater the understanding of the investment, the better the shareholders can assess the performance of directors.

Benefit to User(3)
Also, the better that shareholders understand their investment, the more accurately they can value their shares.

Benefit to User (4)
Finally, the greater the disclosure, the more difficult it is to fool users with creative accounting.

Increasing Disclosure
There has been an increase in disclosure in FS since the clay tablets from 5000 years ago in Ancient Iraq. Here are a few since 1990:

1. CFS
There was a massive leap in the quality of FS when CFS were first disclosed in the early 1990s.

2. Risks
In the late 1990s a standard brought in the requirement to disclose risks and this resulted in even more shareholder understanding.

3. SBP (IFRS2)
More recently the standard on SBP (share based payment) gave a much better feel for how much directors really cost.

4. FI (IFRS9)
Most recent is the brand new standard on financial assets. It removes all the nonsense names in IAS39 (eg. Available for sale) and simply uses FA at amortised cost or FA at Fair Value.

5. FVM (IFRS13)
Looking forward to the proposed standard on the Fair Value Measurement, we see that this has three methods of FVM and required the disclosure of method used.

6. Control (IFRS 10 & IFRS 12)
IFRS10 defines control and then IFRS12 requires the disclosure of the relationship in the FS.

Question 42 Bravado (June 2009)

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

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 Mixted. Bravado had treated this investment as fair value through other comprehensive income (FVTOCI) in the financial statements to 31 May 2008 but had restated the investment at cost on Mixted becoming a subsidiary. On 1 June 2008, Bravado acquired a further 64% of the ordinary shares of Mixted 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
	70%	128

Under the purchase agreement of 1 June 2008, Bravado is required to pay the former shareholders 30% of the profits of Mixted 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 Mixted held by Bravado before the business combination was $15 million and the fair value of the non-controlling interest in Mixted was $53 million. The fair value of the identifiable net assets at 1 June 2008 of Mixted 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 Mixted 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 Mixted was $166 million at 1 June 2008. The tax rate of Mixted 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.

(b) 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	1,500	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.

(b) 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.

(c) 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 Mixted.**

(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)

Question 43 Aron (Q2 June 2009)

The directors of Aron, a public limited company, are worried about the challenging market conditions which the company is facing. The all markets are volatile and some markets are 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. IFRS9 'Financial Instruments' refers to 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 fair value through other comprehensive income (FVTOCI) and at 31 May 2009 was fair valued at $5 million. The cumulative gain recognised in equity relating to the 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 amortised cost.

(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.

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

(2 marks)

(25 marks)

Question 44 Carpart (June 2009)

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)

Question 45 Smith (Q4 June 2009)

(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 30 April 2009, plan obligations of both companies were valued at $200 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 plan for Smith was wound up. A further $4 million was paid to employees to close out the scheme.

(iv) The plan for Brown was reviewed. It was estimated that present value of the reductions in the future contributions would be only $50 million.

Required:

Show how the above issued should be recognised in the current financial statements.

(6 marks)
(25 marks)

Answer 42: Bravado

(a)(i) **Net assets**

	message Acq	*message* Y/e	*mixted* Acq	*mixted* Y/e
SC	220	220	100	100
RE	(i)136	150	55	80
OCE	4	4	7	7
FVA (land) β{balance}	40	40		
FVA (plant)			14	12
[(i)400=given]	(i)400	414		
Growth	14			
[(ii)176=170 plus further increase of 6]			(ii)176	199
FVA (DT) {(176cv-166tb)30%}			(3)	(3)
			173	196
Growth			23	

(3 marks: 1 mark for each FVA)

Note: FVA depreciation on plant was $2m (14/7years) giving $12m at ye. The FV of $176m at acq is derived from adjusting the original estimate for the further increase. The deferred tax FVA does not really make much sense. But as you see above, it can be calculated from the $176m carrying value, the $166m tax base given and the tax rate.

Goodwill

	%	Working	Message	%	Working	Mix
FV of consideration	80%		300	64%	{118+12}	130
				6%	{10+5}	15
FV of NCI	20%		86	30%		53
FV of NA			(400)			(173)
Goodwill			(14)			25

(6 marks)

Group position statement

Non-current assets	
Goodwill (only positive)	25
Property plant and equipment [656+40FVA +12FVA]	708
Associate [acq20+(10growth)25%]	23
Financial assets [62 -17.4(iv)]	45
Current assets	
Inventory [263-18(v)]	245
Receivables [168+1(vi)]	169
Bank [210-1(vi)]	209
	1424
Equity	
Share capital	520
Retained earnings	271
Other components of equity [12-17.4(iv)]	(5)
Non-controlling interest	149
Non-current liabilities	
Borrowings	140
Deferred tax [37+3FVA]	40
Current liabilities	
Trade [205+12(ii)contingency]	217
Current tax	92
	1424

(6 marks)

NCI

		Message		*Mix*	
Acquisition		86		53	
Growth	[14(20%)]	2.8	[23(30%)]	6.9	
NCI		89		60	149

(2 marks: 1 mark each NCI)

Paragraph (iii) Associate

Influence attained at beginning of current year when 25% accumulated.

Associate [acq20+(10growth)25%]	23

(2 marks)

Paragraph (iv) Foreign equity

Equity is FVTOCI. Be careful to multiply. Note how the rate is quoted.

	Dinar m	Rate	Value $m
Current opening	11	5	51.0
Impairment (balance) to OCI and OCE			(17.4)
Current closing	7	4.8	33.6

(4 marks)

Paragraph (v) Inventory impairment

This is a simple matter of nrv below cost.

	WIP	Finished
Selling price	950	1450
Selling costs	(10)	(10)
NRV per unit	940	1440
Cost per unit	(1000)	(1500)
Loss per unit	(60)	(60)

Loss= $60(per unit)*300K(units) = $18m

(3 marks)

Paragraph (vi) Reclassification

The loan asset is clearly not cash at bank. It is clearly a receivable. So move from bank to receivables.

(2 marks)

Reserves	*RE*
Parent	240
(i) bargain purchase (negative goodwill)	14
(ii) gain on previous 5%	5
(iii) associate growth	2.5
(iv) FA (FVTOCI)	n/a
(v) inventory impairment	(18)
(vi) reclassification	n/a
Message	
14(80%)	11.2
Mix	
23(70%)	16.1
	270.8

(7 marks: 1 mark per line restricted to max)

(b) Marking guide

6 marks for goodwill again! Plus 1 mark per point.

Goodwill

	%	WorkingMessage	%	Working	Mix
FV of consideration	80%	300	64%	{118+12}	130
			6%	{10+5}	15
FV of NCI {20%*400 & 30%*173}	20%	80	30%		52
FV of NA		(400)			(173)
Goodwill		(20)			24

(6 marks)

Partial goodwill

Partial goodwill (proportionate goodwill) is based upon assuming that the nci is a simple proportion of na. therefore the nci is taken to have no goodwill.

Effect

So as the nci is smaller under the proportionate assumption, so the goodwill is usually smaller on the partial basis. As you can see this logic is turned on its head for a bargain purchase.

(c) Marking guide

Usual 1 mark per valid point plus 2 marks for clarity and expression.

Loan asset repayable on demand

The scenario tells us that the loan asset is repayable on demand. The directors are using this information to claim that the asset is cash.

Cash

But the IFRS on CFS (IAS7) defines cash as short term highly liquid investments with little risk.

Conclusion

But the balance due from the director is unlikely to be any of these. Most obviously a huge loan to any individual with no security attaches great risk no matter how rich that guy might be.

Reclassification

So clearly the balance must be reclassified as a receivable and further the balance must be disclosed in the notes as a related party transaction.

Creative accounting

It is possible that directors do not know the details of the IFRS on CFS (although they should). But is very unlikely that directors really think a receivable from one of their number is actually a genuine bank balance. Directors know what a bank balance is.

Ethics

This deliberate attempt to hide a loan asset due from a director is in breach of directors' ethical and legal responsibilities to show a true and fair view. This creative accounting may cost the whole board their jobs.

Answer 43: Aron

This was a focus question on financial instruments based on the old IAS39. The question works well with the new IFRS9, however, so presented here is the answer based on the new standard. Part (a) is reasonably straight forward. However, part (b) is a real challenge. Part (b) benefits from being answered backwards. So the following answer shows part (b) in reverse order.

Marking guide

Usual 1 mark per point.

(a)

Fair Value

This is the transaction price between market participants at the measurement date (IFRS13).

Measurement

Ideally fair value is taken from a current transaction price (observable inputs; level one or level two). But sometimes when no transaction data is available fair value must be taken from financial models (unobservable inputs; level three).

Volatile

In a volatile market, usually there are lots of transactions but prices are fluctuating. This means it is easy to get a fv (level one or two) but it also means the fv soon becomes irrelevant.

Illiquid

In an illiquid market there are few transactions. If the volume of transactions falls to zero then it may be necessary to use financial models to guess a fv (level three).

(b)(iv)

Financial asset classification

IFRS9 uses two tests for amortised cost; the cash flow characteristics test (to test if the asset is a simple loan with interest, principal repayment and no other features) and the business model test (to test if the asset is held for collection that is with an intent to keep to maturity). If either test is a fail then the asset is carried at fair value.

Employee loan assets

The scenario is not crystal clear, but it does appear both tests are fulfilled. So the asset will be carried at amortised cost.

Cf characteristics: the loan has interest (0%) and principal repayment ($10m) and no other features.

Business model: it appears Aron has every intention of waiting for that principal at the end.

Initial fair value

This is calculated by discounted cash flow (dcf):-

Year	cf $k	df	pv $k
1	0	0.943	0
2	10,000	0.890	8,900
Initial fv			8,900

Amortised cost

The asset then unwinds as follows:-

Year	opening	interest	instalment	closing
1	8,900	534	(0)	9,434
2	9,434	566	(0)	10,000

(b)(iii)

Gao perspective

First we look at the asset from the perspective of the sub itself. The reference to "held for trading" gives away that the business model test is failed. So the asset must be carried at fair value through profit or loss (FVTPL).

Gao accounting

So Gao simply records a gain:

Dr	investment	(b/s)	Z2m
Cr	finance gain	(p/l)	Z2m.

Group perspective

Then the sub is translated using the usual rules before consolidation:

Fs	Rate
b/s	closing
i/s	average

Aron b/s

So Aron has the following:-

Investment [Z12m/2] $6m

Aron i/s

And Aron has the following:-

Finance gain [Z2m/2.5] $0.8m

(b)(ii)

FVTOCI

The question tells us that the investment is FVTOCI. So we do not need to know the characteristics of FVTOCI. However, here they are:

There are two. FVTOCI must be strategic equity. That is the investment must be equity and there must be a strategic intent to keep.

Rise in value

The takeover results in a rise in value:

Dr	investment (Smart)	0.5
Cr	strategic equity gain (OCI and OCE)	0.5

Equity swap

Then there is the equity swap:

Dr	investment (Given)	5.5
Cr	investment (Smart)	5.5

Realisation

Then the previously unrealised reserve is realised:

Dr	strategic equity reserve (OCE) {0.5above+0.4previous}	0.9
Cr	retained earnings (RE)	0.9

(b)(i)

Financial liability

The second word in the scenario is "issued". The borrower issues debt and the lender purchases debt. So Aron is the borrower and has a financial liability (fl).

FL classification

New IFRS9 uses the same criteria as old IAS39; intent. An intent to keep gives amortised cost and an intent to trade gives fair value.

Aron

The scenario tells us nothing about intent. But we do know for a fact that Aron did keep the debt for the whole three years. So amortised cost seems to make sense.

Initial fair value

This is calculated by discounted cash flow (dcf). Note the effective interest rate is 9.38% because of the impact of the issue costs. IFRS9 continues to include transaction costs in debt at amortised cost in the same way as IAS39:-

Year	cf $k	df	pv $k
1	6000	0.9142	5485
2	6000	0.8358	5015
3	106000	0.764163	81001
Initial fv of debt			91501

Initial recognition

But of course this liability is not pure debt. It is part debt and part equity:

Dr	bank {$100m inflow - $1m outflow for transaction costs}	99,000
Cr	debt {liability} (from above)	91,501
Cr	equity {conversion reserve (OCE)} (balance)	7,499

The debt then unwinds back up to $100m but the equity just sits there in equity until conversion.

Amortised cost

The debt unwinds as follows:-

Year	opening	interest	instalment	closing
1	91501	8583	(6000)	94084
2	94084	8825	(6000)	96909
3	96909	9091	(6000)	100000

At the end the debt drops to zero of course. Aron may be half expecting this to happen by a cash outflow of $100m to clear the above final balance. But this does not happen. Instead the bond holders demand equity.

Debt equity swap

the bond holders demand equity and that is what they get. So the whole $100m moves from debt to equity. The $100m moves into share capital, however, that share capital is split between nominal and premium.

Dr	debt {liability}	100,000
Cr	share capital (nominal)	25,000
Cr	share capital (premium)	75,000

Conversion reserve

The conversion reserve can only live whilst the conversion option lives. The transfer of the conversion reserve depends on whether the option is exercised or lapsed.

Conversion to share capital	transfer
Yes	to share capital
No	to retained earnings

This bond is converted to share capital. So the following is recorded:

Dr	equity {conversion reserve (OCE)} (balance)	7,499
Cr	share capital (premium)	7,499

Answer 44: Carpart

This was a relatively challenging industry question requiring the application of a mix of standards, with a heavy leaning towards revenue. The following answer works equally well under the old IAS18 and the new revenue standard.

Marking guide

The marking guide throughout was a simple "1 mark per point". So as usual, very different answers to this question could score full marks.

(i)

Machinery

The machinery will be constructed next year. There is absolutely no way that Carpart can recognise revenue on machinery that they have not even built!

Next year

Even when the machinery is built next year, Carpart will continue to retain control over the asset. At no stage is control delivered to Vehiclex. Also all the risks and rewards remain with Carpart. Vehiclex have no commitment to a minimum order to cover the cost of constructing the machine.

Conclusion

So the machinery is never sold. There will never be any revenue on the machinery.

Revenue

But there will be revenue. This will be on the sale of the seats and that revenue will be recognised as seats are delivered.

(ii)

Multiple element contract

This complex story is a multiple element contract. There are three things that have been bundled together and sold as one; the know-how, the specialised machinery and the car seats.

Unbundling

The single contract price must be broken down into the elements discussed above and each element accounted for individually. This tricky process is often called "unbundling".

Know-how

The know-how is described as "royalty free", but I suspect it does have a value. This fair value must be measured and extracted from the contract price.

Know-how revenue

The know-how revenue should be recognised when transferred to Carpart. It is not clear when this occurs but perhaps the know-how is transferred during a training course for Autoseat.

Specialised machinery

Again it is not entirely clear how the contract is working. But it does appear that the machinery is designed to Autoseat specifications. Also the purchase option seems to give Autoseat some control.

Capitalisation

I suggest that whilst the machinery is being built, Carpart simply capitalise the costs onto the Carpart b/s.

Revenue

However, once the machinery is finished, I suggest that Carpart transfer the costs to cost of sales and recognise a fair value revenue in sales.

Car seats

This seems to be the only simple part of the contract. The seats are sold on a seat by seat basis.

Revenue

But even this element is not dead straight. Car seat sales would normally be recognised at delivery. But it appears that Autoseat have control of production throughout and that risks and rewards pass at inspection. So I suggest car seat revenue is recognised at each Autoseat inspection.

(iii)

Three deals

This paragraph describes three deals. The four year deal, the two year deal and the demonstration deal.

Four year deal

The user must maintain the car. The buy back is well below market value.

Substance

The risks and rewards of the cars on four year deals transfers to users at delivery.

Revenue

So revenue should be recognised as the cars are delivered under four year deals.

Buy back

The buy back transactions should simply be recorded as the buying back of stock.

Two year deal

The option is what is called a "put option". The option can force Carpart to buy back. The option is so favourable it is almost certain to be exercised.

Substance

So the risks and rewards remain with Carpart even after delivery.

Operating lease

Under old IAS17 the deal would be called an operating lease and the approximate $6k would be spread over the two years whilst the car stays in nca [$6k=(100%-70%)$20k].

Lease

Under the new proposed rules, this deal would be simply a lease. But there would be nothing simple about the accounting. All the rights and obligations created by the deal would require recognition as they really are. Because this deal is very complicated, the accounting would be necessarily complicated. In summary, Carpart would derecognise the car ($16k), recognise the cash ($20k), recognise the obligation to buy back (70% of $20k) and the right to the residual value (55% of $20k). The balance would be the net revenue. Then applying the ideas of the new lease accounting combined with the new ideas on revenue the double entry may be something like this:-

Dr	bank	20
Dr	residual asset value	11
Cr	buy back obligation	14
Cr	revenue (balance)	17

Plus:-

Dr	cost of sales	16
Cr	inventory	16

This would give a net revenue of $1k. Actually even the above is a simplification as discounting and unwinding would apply too.

Demonstration cars

These should be held in nca (ppe) whist being used for demonstration. Then each car would be moved to ca (inventory) once a price tag goes into the window. Then the cost will go to cost of sales when a customer takes a car away to match the cash sale proceeds in revenue.

Answer 45: Smith

This was a lovely current issues question on pensions, based largely on the problems with old IAS19, especially the corridor. IAS19 has since been reissued by the IASB and this has removed some of the glaring problems. However, problems still remain. So I think the question is still valid. The following is based on the new IAS19 and is therefore completely different to the original answer.

Marking guide

As ever, we have a mark for each idea.

(a)(i)

Actuarial gains

These are calculated as balancing figures in the asset and liability working for defined benefit pensions. They are called "actuarial" gains because the actuary gives us accountants the actual closing in each. But in truth it is us accountants that actually calculated the actuarial gains.

Asset

The gain in the asset comes from the following (figures made up):-

Market value at start of the year	390
Expected return on the assets	39
Contributions	34
Benefits paid	(26)
Actuarial gain (loss) – balancing fig	(67)
Market value at end of the year	370

Liability

The loss on the liability comes from the following (figures made up):-

Obligation at start of the year	400
Interest	40
Service cost (14 + 100)	114
Benefits paid	(26)
Actuarial (gain) loss – balancing fig	2
Obligation at end of the year	530

OCI

The two gains are then brought together in the other comprehensive income statement (OCI) to give the combined actuarial gain. So using the figures from above:-

Other Comprehensive Income

Actuarial (loss) on assets	(67)
Actuarial (loss) on obligations	(2)
Net Actuarial (loss)	(69)

Corridor

There used to be various alternatives in old IAS19 for the recognition of the above net actuarial loss. The old IAS19 also allowed OCI recognition. Most companies have always used the OCI. However, the old IAS19 also allowed companies to capitalise their losses as if they were assets on b/s. so the above $69m would have been treated as an asset under the old corridor method.

Criticism of old IAS19

Clearly treating a loss as an asset is very silly and deeply misleading. The main reason for the reissue of IAS19 was to remove the corridor method.

Immediate recognition

Clearly the new requirement to always recognise the loss in the OCI in the period it occurred makes greater sense.

Criticism of new IAS19

But the new standard is not perfect. Any loss on the value of assets in pension portfolio is very real. Often these figures are huge. So OCI recognition seems dangerously like hiding away big bad news.

Argument for OCI

The argument for OCI recognition is that any loss in value in the current year can be compensated for in later years. So those who like OCI recognition tend to refer to the losses as unrealised.

Argument against OCI

The argument against OCI recognition is that if a company has assets and those assets have fallen in value then that company has made losses and the shareholders should be told in bold. It is always true that the future might be bright, but that does not prevent us from being honest about a poor performance in the immediate past. Hiding away in the OCI looks just like that.

Other criticism

Another criticism of new IAS19 is that it still allows assets to be net against liabilities. If a company has an asset bank and an overdraft then one goes in assets and the other in liabilities. Disaggregation is required. And yet under IAS19 aggregation is allowed.

(a)(ii)

Discount rates

The discount rates used in pensions accounting are essentially those applied by the actuary. It is the actuary's job to assess the obligation and measure the liability by using statistics and discounting. The accountant then simply takes the rate given by the actuary.

Corporate bonds

IAS19 gives clear guidance. The actuary should use the discount rates applied by the market to high quality corporate bonds.

Effect

The effect of this is that it should be fairly difficult for the company to manipulate the discount rates upwards and therefore manipulate the liability down in size. But it may be possible. This is where the following comes in.

Expected returns

Under old IAS19 expected returns on assets were just that. The result was that companies tended to be ridiculously over optimistic and thereby inflate i/s gains.

New IAS19

So the IASB outlawed this practice by dictating that the expected return must be derived from the discount rate and not from expectations.

Effect

The effect of this is twofold. First it means directors optimism is not reflected in the expected return. Second it means that any attempt to manipulate the discount rate up will have the negative effect of making assets smaller as well as the positive effect of making liabilities smaller.

(b)

Smith

The closure of the scheme is called "curtailment". The accounting simply involves totting up the assets and liabilities to calculate a gain or loss.

Loss

Smith has made a sizable loss:-

	$m
Asset	219
Liability	(200)
Net asset	19
Further cash	4
Loss	23

Disclosure

This loss is so large and unusual that it would probably qualify for separate disclosure on the face of the i/s (so called "superexceptional" disclosure required for material single balances under IAS1).

Brown

Brown has been caught out by an asset ceiling. The present value of the reductions in the future contributions is called the "asset ceiling" and it limits the size of net asset recognised.

Loss

So Brown has a loss too:-

	$m
Asset	276
Liability	(200)
Net asset	76
Loss (balance)	(26)
Asset ceiling = recognised net asset	50

Disclosure

Again this loss is so large and unusual that it would probably qualify for separate disclosure on the face of the i/s. The net asset of only $50m would go into nca.

QUESTION 46 Grange (Q1 December 2009)

Grange, a public limited company, operates in the manufacturing sector. The draft statements of financial position of the group companies are as follows at 30 November 2009:

	Grange $m	Park $m	Fence $m
Assets:			
Non-current assets			
Property, plant and equipment	257	311	238
Investments in subsidiaries			
Park	340		
Fence	134		
Investment in Sitin	16		
	747	311	238
Current assets	475	304	141
Total assets	1,222	615	379
Equity and liabilities:			
Share capital	430	230	150
Retained earnings	410	170	65
Other components of equity	22	14	17
Total equity	862	414	232
Non-current liabilities	172	124	38
Current liabilities			
Trade and other payables	178	71	105
Provisions for liabilities	10	6	4
Total current liabilities	188	77	109
Total liabilities	360	201	147
Total equity and liabilities	1,222	615	379

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

(i) On 1 June 2008, Grange acquired 60% of the equity interests of Park, a public limited company. The purchase consideration comprised cash of $250 million. Excluding the franchise referred to below, the fair value of the identifiable net assets was $360 million. The excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

Park held a franchise right, which at 1 June 2008 had a fair value of $10 million. This had not been recognised in the financial statements of Park. The franchise agreement had a remaining term of five years to run at that date and is not renewable. Park still holds this franchise at the year-end.

Grange wishes to use the 'full goodwill' method for all acquisitions. The fair value of the non-controlling interest in Park was $150 million on 1 June 2008. The retained earnings of Park were $115 million and other components of equity were $10 million at the date of acquisition.

Grange acquired a further 20% interest from the non-controlling interests in Park on 30 November 2009 for a cash consideration of $90 million.

(ii) On 31 July 2008, Grange acquired a 100% of the equity interests of Fence for a cash consideration of $214 million. The identifiable net assets of Fence had a provisional fair value of $202 million, including any contingent liabilities. At the time of the business combination, Fence had a contingent liability with a fair value of $30 million. At 30 November 2009, the contingent liability met the recognition criteria of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the revised estimate of this liability was $25 million. The accounting of Fence is yet to account for this revised liability.

However, Grange had not completed the valuation of an element of property, plant and equipment of Fence at 31 July 2008 and the valuation was not completed by 30 November 2008. The valuation was received on 30 June 2009 and the excess of the fair value over book value at the date of acquisition was estimated at $4 million. The asset had a useful economic life of 10 years at 31 July 2008.

The retained earnings of Fence were $73 million and other components of equity were $9 million at 31 July 2008 before any adjustment for the contingent liability.

On 30 November 2009, Grange disposed of 25% of its equity interest in Fence to the non-controlling interest for a consideration of $80 million. The disposal proceeds had been credited to the cost of the investment in the statement of financial position.

(iii) On 30 June 2008, Grange had acquired a 100% interest in Sitin, a public limited company, for a cash consideration of $39 million. Sitin's identifiable net assets were fair valued at $32 million.

On 30 November 2009, Grange disposed of 60% of the equity of Sitin when its identifiable net assets were $36 million. Of the increase in net assets, $3 million had been reported in profit or loss and $1 million had been reported in comprehensive income as profit on an available-for-sale asset. The sale proceeds were $23 million and the remaining equity interest was fair valued at $13 million. Grange could still exert significant influence after the disposal of the interest. The only accounting entry made in Grange's financial statements was to increase cash and reduce the cost of the investment in Sitin.

(iv) Grange acquired a plot of land on 1 December 2008 in an area where the land is expected to rise significantly in value if plans for regeneration go ahead in the area. The land is currently held at cost of $6 million in property, plant and equipment until Grange decides what should be done with the land. The market value of the land at 30 November 2009 was $8 million but as at 15 December 2009, this had reduced to $7 million as there was some uncertainty surrounding the viability of the regeneration plan.

(v) Grange anticipates that it will be fined $1 million by the local regulator for environmental pollution. It also anticipates that it will have to pay compensation to local residents of $6 million although this is only the best estimate of that liability. In addition, the regulator has requested that certain changes be made to the manufacturing process in order to make the process more environmentally friendly. This is anticipated to cost the company $4 million.

(vi) Grange has a property located in a foreign country, which was acquired at a cost of 8 million dinars on 30 November 2008 when the exchange rate was $1 = 2 dinars. At 30 November 2009, the property was revalued to 12 million dinars. The exchange rate at 30 November 2009 was $1 = 1.5 dinars. The property was being carried at its value as at 30 November 2008. The company policy is to revalue property, plant and equipment whenever material differences exist between book and fair value. Depreciation on the property can be assumed to be immaterial.

(vii) Grange has prepared a plan for reorganising the parent company's own operations. The board of directors has discussed the plan but further work has to be carried out before they can approve it. However, Grange has made a public announcement as regards the reorganisation and wishes to make a reorganisation provision at 30 November 2009 of $30 million. The plan will generate cost savings. The directors have calculated the value in use of the net assets (total equity) of the parent company as being $870 million if the reorganisation takes place and $830 million if the reorganisation does not take place. Grange is concerned that the parent company's property, plant and equipment have lost value during the period because of a decline in property prices in the region and feel that any impairment charge would relate to these assets. There is no reserve within other equity relating to prior revaluation of these non-current assets.

(viii) Grange uses accounting policies, which maximise its return on capital employed. The directors of Grange feel that they are acting ethically in using this approach as they feel that as long as they follow 'professional rules', then there is no problem. They have adopted a similar philosophy in the way they conduct their business affairs. The finance director had recently received information that one of their key customers, Brook, a public limited company, was having serious liquidity problems. This information was received from a close friend who was employed by Brook. However, he also learned that Brook had approached a rival company Field, a public limited company, for credit and knew that if Field granted Brook credit then there was a high probability that the outstanding balance owed by Brook to Grange would be paid. Field had approached the director for an informal credit reference for Brook who until recently had always paid promptly. The director was intending to give Brook a good reference because of its recent prompt payment history as the director felt that there was no obligation or rule which required him to mention the company's liquidity problems. (There is no change required to the financial statements as a result of the above information.)

Required:

(a) **Calculate the gain or loss arising on the disposal of the equity interest in Sitin.** (6 marks)

(b) **Prepare a consolidated statement of financial position of the Grange Group at 30 November 2009 in accordance with International Financial Reporting Standards.** (35 marks)

(c) **Discuss the view that ethical behaviour is simply a matter of compliance with professional rules and whether the finance director should simply consider 'rules' when determining whether to give Brook a good credit reference.** (7 marks)

Professional marks will be awarded in part (c) for clarity and expression. (2 marks)

(Total: 50 marks)