Mock One

Corporate Reporting (International)

P2CR-MK1-Z17-Q

Paper P2

Time allowed: 3 hours and 15 minutes

This paper is divided into two sections

Section A: This ONE question is compulsory and MUST be attempted
Section B: TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.

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

1 Traveler, a public limited company, operates in the manufacturing sector. The draft statements of financial position at 30 November 2017 are as follows:

	Traveler	*Data*	*Captive*
	$m	$m	$m
Assets			
Non-current assets			
Property, plant and equipment	439	810	620
Investments in subsidiaries			
Data	820		
Captive	541		
Financial assets	108	10	20
	1,908	820	640
Current assets	1,067	781	350
Total assets	2,975	1,601	990
Equity and liabilities			
Share capital	1,120	600	390
Retained earnings	1,066	442	169
Other components of equity	60	37	45
Total equity	2,246	1,079	604
Non-current liabilities	455	323	73
Defined benefit liability	72		
Current liabilities	202	199	313
Total liabilities	729	522	386
Total equity and liabilities	2,975	1,601	990

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

(1) On 1 December 2016, Traveler acquired 60% of the equity interests of Data, a public limited company. The purchase consideration comprised cash of $600 million. At acquisition, the fair value of the non-controlling interest in Data was $395 million. Traveler wishes to measure the non-controlling interest at fair value at the date of acquisition. On 1 December 2016, the fair value of the identifiable net assets acquired was $935 million and retained earnings of Data were $299 million and other components of equity were $26 million. The excess in fair value is due to non-depreciable land.

On 30 November 2017, Traveler acquired a further 20% interest in Data for a cash consideration of $220 million.

(2) On 1 December 2016, Traveler acquired 80% of the equity interests of Captive for a consideration of $541 million. The consideration comprised cash of $477 million and the transfer of non-depreciable land with a fair value of $64 million. The carrying amount of the land at the acquisition date was $56 million. At the year end, this asset was still included in the non-current assets of Traveler and the sale proceeds had been credited to profit or loss.

At the date of acquisition, the identifiable net assets of Captive had a fair value of $526 million, retained earnings were $90 million and other components of equity were $24 million. The excess in fair value is due to non-depreciable land. Non-controlling interest at acquisition is measured at its proportionate share of the fair value of the subsidiary's net assets.

(3) Goodwill was impairment tested after the additional acquisition in Data on 30 November 2017. The recoverable amount of Data was $1,099 million and that of Captive was $700 million.

(4) Included in the financial assets of Traveler is a 10-year 7% loan that was purchased on 1 December 2016. The normal business model of Traveler is to hold assets of this type until maturity. At 30 November 2017, the borrower was in financial difficulties and its credit rating had been downgraded. The loan asset is currently held at amortised cost of $29 million. Traveler now wishes to measure the loan at fair value using current market interest rates. Traveler has agreed for the loan to be restructured; there will only be three more annual payments of $8 million starting in one year's time. The original effective interest rate is 6.7% and the effective interest rate under the revised payment schedule is 6.3%. At the year end Traveler measured the lifetime credit losses for this loan asset at $850,000. The financial asset does not meet the derecognition criteria of IFRS 9 *Financial Instruments.* All other financial assets are classified at fair value through profit or loss.

(5) Included in property, plant and equipment is a new factory which Traveler acquired on 1 December 2016. The cost of the factory was $50 million and it has a residual value of $2 million. The factory has a flat roof, which needs replacing every five years. The cost of the roof was $5 million. The useful economic life of the factory is 25 years. No depreciation has been charged for the year. Traveler wishes to account for the factory and roof as a single asset and depreciate the whole factory over its economic life. Traveler uses straight-line depreciation.

(6) The defined benefit pension liability in the statement of financial position of $72 million is the opening net liability position after adjusting for the cash contribution paid in the period of $49 million. The service cost for the current year has been calculated by the actuary to be $45 million and the interest on the opening net liability is $6 million. The actuary has also calculated the remeasurement for the period to be $15 million. The obligation to pensioners at 30 November 2017 was $1,274 million and the fair value of the assets, managed by the trustees of the scheme, at this date totalled $1,136 million. Traveler uses a separate fund managed by trustees to settle pension benefits; the cash benefit paid to pensioners in the period was $26 million.

The only accounting entry made by Traveler in respect of the pension in the current period is to debit contributions paid against the opening net liability position.

Required:

(a) **Prepare the consolidated statement of financial position for the Traveler Group as at 30 November 2017.** (35 marks)

(b) Traveler has three distinct business segments. The management has calculated the net assets, turnover and profit before common costs, which are to be allocated to these segments. However, they are unsure as to how they should allocate certain common costs and whether they can exercise judgement in the allocation process. They wish to allocate head office management expenses, pension expense, the cost of managing properties and interest and related interest-bearing assets. They are also uncertain whether the measurement of costs has to conform with the accounting policies used in the financial statements. Management is also unsure of the disclosure requirements regarding the cost allocation.

Required:

Advise the management of Traveler on the points raised in the above paragraph. (8 marks)

(c) Segmental information reported externally is more useful if it conforms to information used by management in making decisions. The information can differ from that reported in the financial statements. Although reconciliations are required, these can be complex and difficult to understand. Additionally, there are other standards where subjectivity is involved and often the profit motive determines which accounting practice to follow. The directors have a responsibility to shareholders to disclose information to enhance corporate value but this may conflict with their corporate social responsibility.

Required:

Discuss how the ethics of corporate social responsibility disclosure are difficult to reconcile with shareholder expectations. (7 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

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

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

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

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

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

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

Required:

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

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

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

(25 marks)

3 Cohort is a private limited company and has two 100% owned subsidiaries, Legion and Air, which are both private limited companies. Cohort acquired Air on 1 January 2018 for $5 million when the fair value of the net assets was $4 million, and the tax base of the net assets was $3·5 million. The acquisition of Air and Legion was part of a business strategy to build the "value" of the Cohort group over a three-year period and then list its existing share capital on the Stock Exchange.

(a) The following information relates to the acquisition of Air, which manufactures electronic goods:

(i) The carrying amount of Air's net assets on 1 January 2018 was $3.8 million; the $200,000 excess in fair value of the identifiable net assets is due to non-depreciable land. The directors have adjusted the tax base of the land to reflect this increase in its carrying amount.

(ii) Air has sold goods for $3 million to Cohort since acquisition and made a profit of $1 million on the transaction. Inventory relating to these goods included in Cohort's statement of financial position at the year end, 31 May 2018, was $1·8 million.

(iii) Retained earnings of Air at acquisition were $2 million. The directors of Cohort have decided that, during the three years to the date that they intend to list the shares of the company, they will realise earnings through future dividend payments from the subsidiary amounting to $500,000 per year. Tax is payable on any remittance or dividend and no dividends have been declared for the current year. (10 marks)

(b) Legion was acquired on 1 June 2017 and is a company which undertakes various projects ranging from debt factoring to investing in property and commodities. The following details relate to Legion for the year ended 31 May 2018:

(i) Legion has a portfolio of readily marketable government securities which are held as current assets. These investments are stated at fair value in the statement of financial position with any gain or loss recognised in profit or loss. These gains and losses are taxed when the investments are sold. Currently, accumulated unrealised gains are $4 million.

(ii) Legion has calculated that it requires a loss allowance of $2 million against its total loan portfolio. Tax relief is available when a specific loan is written off. Management feels that this part of the business will expand and therefore the amount of the loss allowance will increase.

(iii) When Cohort acquired Legion it had unused tax losses brought forward. At 1 June 2017, it appeared that Legion would have sufficient taxable profits to realise the deferred tax asset created by these losses but subsequent events have proven that the future taxable profit will not be sufficient to realise all of the unused tax loss. (13 marks)

Any impairment of goodwill is not allowed as a deduction in determining taxable profit. The current tax rate is 30% for Cohort and 35% for Air and Legion.

Required:

Discuss the deferred tax implications of the above information for the Cohort Group of companies.

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

Professional marks will be awarded in question 3 for clarity and quality of the presentation and discussion. (2 marks)

(25 marks)

4 In response to issues raised by the Korea Accounting Standards Board about IAS 21 *The Effects of Changes in Foreign Exchange Rates,* the IASB carried out a research project into the standard. Although several concerns were identified during the project, the IASB decided not to include this topic in its draft work plan 2017-2021.

Required:

(a) **Discuss the practical issues in the application of IAS 21 and suggest the reasons why regulators may not include projects in their current work plan.** (10 marks)

(b) Misson, a public limited company, has carried out transactions denominated in foreign currency during the financial year ended 31 October 2017 and has conducted foreign operations through a foreign entity. Its functional and presentation currency is the dollar. The following information summarises two foreign currency activities:

(i) Misson has a 100% owned foreign subsidiary, Chong, which was formed on 1 November 2015 with a share capital of 100 million euros (€s) which has been taken as the cost of the investment. The total shareholders' equity of the subsidiary as at 31 October 2016 and 31 October 2017 was €140 million and €160 million, respectively. Chong has not paid any dividends to Misson and has no other reserves than retained earnings in its financial statements. The subsidiary was sold on 31 October 2017 for €195 million.

Misson would like to know how to treat the sale of the subsidiary in the parent and group accounts for the year ended 31 October 2017. (8 marks)

(ii) Misson has purchased goods from a foreign supplier for €8 million on 31 July 2017. At 31 October 2017, the trade payable was still outstanding and the goods were still held by Misson. Similarly, Misson has sold goods to a foreign customer for €4 million on 31 July 2017 and it received payment for the goods in euros on 31 October 2017. Additionally Misson had purchased an investment property on 1 November 2016 for €28 million. At 31 October 2017, the investment property had a fair value of €24 million. The company uses the fair value model in accounting for investment properties.

Misson would like advice on how to treat these transactions in the financial statements for the year ended 31 October 2017. (5 marks)

Exchange rates	*€ per $*	*Average rate (€ per $) for year to*
1 November 2015	1·1	
31 October 2016	1·4	1·2
1 November 2016	1·4	
31 July 2017	1·6	
31 October 2017	1·3	1·5

Required:

Discuss the accounting treatment of the above transactions in accordance with the advice required by the directors.

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

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

(25 marks)

End of Question Paper