Strategic Professional – Essentials

Strategic Business Reporting – International (SBR – INT)

September/December 2019 –
Sample Questions

SBR INT ACCA

Time allowed: 3 hours 15 minutes

This question paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – BOTH questions are compulsory and MUST be attempted

Do NOT open this question paper until instructed by the supervisor.

This question paper must not be removed from the examination hall.

SBR – INT

Think Ahead ACCA

The Association of Chartered Certified Accountants

Section A – BOTH questions are compulsory and MUST be attempted

1 Background

Luploid Co is the parent company of a group undergoing rapid expansion through acquisition. Luploid Co has acquired two subsidiaries in recent years, Colyson Co and Hammond Co. The current financial year end is 30 June 20X8.

Acquisition of Colyson Co

Luploid Co acquired 80% of the five million equity shares ($1 each) of Colyson Co on 1 July 20X4 for cash of $90 million. The fair value of the non-controlling interest (NCI) at acquisition was $22 million. The fair value of the identifiable net assets at acquisition was $65 million, excluding the following asset. Colyson Co purchased a factory site several years prior to the date of acquisition. Land and property prices in the area had increased significantly in the years immediately prior to 1 July 20X4. Nearby sites had been acquired and converted into residential use. It is felt that, should the Colyson Co site also be converted into residential use, the factory site would have a market value of $24 million. $1 million of costs are estimated to be required to demolish the factory and to obtain planning permission for the conversion. Colyson Co was not intending to convert the site at the acquisition date and had not sought planning permission at that date. The depreciated replacement cost of the factory at 1 July 20X4 has been correctly calculated as $17·4 million.

Impairment of Colyson Co

Colyson Co incurred losses during the year ended 30 June 20X8 and an impairment review was performed. The recoverable amount of Colyson Co's assets was estimated to be $100 million. Included in this assessment was the only building owned by Colyson Co which had been damaged in a storm and impaired to the extent of $4 million. The carrying amount of the net assets of Colyson Co at 30 June 20X8 (including fair value adjustments on acquisition but excluding goodwill) are as follows:

	$ millions
Land and buildings	60
Other plant and machinery	15
Intangibles other than goodwill	9
Current assets (recoverable amount)	22
Total	106

None of the assets of Colyson Co including goodwill have been impaired previously. Colyson Co does not have a policy of revaluing its assets.

Acquisition of Hammond Co

Luploid Co acquired 60% of the 10 million equity shares of Hammond Co on 1 July 20X7. Two Luploid Co shares are to be issued for every five shares acquired in Hammond Co. These shares will be issued on 1 July 20X8. The fair value of a Luploid Co share was $30 at 1 July 20X7. Hammond Co had previously granted a share-based payment to its employees with a three-year vesting period. At 1 July 20X7, the employees had completed their service period but had not yet exercised their options. The fair value of the options granted at 1 July 20X7 was $15 million. As part of the acquisition, Luploid Co is obliged to replace the share-based payment scheme of Hammond Co with a scheme of its own which has the following details:

> Luploid Co issued 100 options to each of Hammond Co's 10,000 employees on 1 July 20X7. The shares are conditional on the employees completing a further two years of service. Additionally, the scheme required that the market price of Luploid Co's shares had to increase by 10% from its value of $30 per share at the acquisition date over the vesting period. It was anticipated at 1 July 20X7 that 10% of staff would leave over the vesting period but this was revised to 4% by 30 June 20X8. The fair value of each option at the grant date was $20. The share price of Luploid Co at 30 June 20X8 was $32 and is anticipated to grow at a similar rate in the year ended 30 June 20X9.

Required:

Draft an explanatory note to the directors of Luploid Co, addressing the following:

(a) (i) **How the fair value of the factory site should be determined at 1 July 20X4 and why the depreciated replacement cost of $17·4 million is unlikely to be a reasonable estimate of fair value.** (7 marks)

(ii) **A calculation of goodwill arising on the acquisition of Colyson Co measuring the non-controlling interest at:**

– **fair value;**
– **proportionate share of the net assets.** (3 marks)

(b) **Discuss the calculation and allocation of Colyson Co's impairment loss at 30 June 20X8 and why the impairment loss of Colyson Co would differ depending on how non-controlling interests are measured. Your answer should include a calculation and an explanation of how the impairments would impact upon the consolidated financial statements of Luploid Co.** (11 marks)

(c) (i) **How the consideration for the acquisition of Hammond Co should be measured on 1 July 20X7. Your answer should include a calculation of the consideration and a discussion of why only some of the cost of the replacement share-based payment scheme should be included within the consideration.** (4 marks)

(ii) **How much of an expense for the share-based payment scheme should be recognised in the consolidated profit or loss of Luploid Co for the year ended 30 June 20X8. Your answer should include a brief discussion of how the vesting conditions impact upon the calculations.** (5 marks)

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

(30 marks)

2 Background

Stent Co is a consumer electronics company which has faced a challenging year due to increased competition. Stent Co has a year end of 30 September 20X9 and the unaudited draft financial statements report an operating loss. In addition to this, debt covenant limits based on gearing are close to being breached and the company is approaching its overdraft limit.

Cash advance from Budster Co

On 27 September 20X9, Stent Co's finance director asked the accountant to record a cash advance of $3m received from a customer, Budster Co, as a reduction in trade receivables. Budster Co is solely owned by Stent Co's finance director. The accountant has seen an agreement signed by both companies stating that the $3m will be repaid to Budster Co in four months' time. The finance director argues that the proposed accounting treatment is acceptable because the payment has been made in advance in case Budster Co wishes to order goods in the next four months. However, the accountant has seen no evidence of any intent from Budster Co to place orders with Stent Co. (4 marks)

Preference shares

On 1 October 20X8, the CEO and finance director each paid $2m cash in exchange for preference shares from Stent Co which provide cumulative dividends of 7% per annum. These preference shares can either be converted into a fixed number of ordinary shares in two years' time, or redeemed at par on the same date, at the choice of the holder. The finance director suggests to the accountant that the preference shares should be classified as equity because the conversion is into a fixed number of ordinary shares on a fixed date ('fixed for fixed') and conversion is certain (given the current market value of the ordinary shares). (4 marks)

Deferred tax asset

Stent Co includes a deferred tax asset in its statement of financial position, based on losses incurred in the current and the previous two years. The finance director has asked the accountant to include the deferred tax asset in full. He has suggested this on the basis that Stent Co will return to profitability once its funding issues are resolved. (3 marks)

Required:

(a) **Discuss appropriate accounting treatments which Stent Co should adopt for all issues identified above and their impact upon gearing.**

Note: The mark allocation is shown against each issue above.

(b) The accountant has been in her position for only a few months and the finance director has recently commented that 'all these accounting treatments must be made exactly as I have suggested to ensure the growth of the business and the security of all our jobs'. Both finance director and accountant are ACCA qualified accountants.

Required:

Discuss the ethical issues arising from the scenario, including any actions which the accountant should take to resolve the issues. (7 marks)

Professional marks will be awarded in question 2 for the application of ethical principles. (2 marks)

(20 marks)

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Question 3 begins on page 6.

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Section B – BOTH questions are compulsory and MUST be attempted

3 Background

Digiwire Co has developed a new business model whereby it sells music licences to other companies which then deliver digital music to consumers.

Revenue: sale of three-year licence

Digiwire Co has agreed to sell Clamusic Co, an unlisted technology start-up company, a three-year licence to sell Digiwire Co's catalogue of classical music to the public. This catalogue contains a large selection of classical music which Digiwire Co will regularly update over the three-year period.

As revenue for the three-year licence, Clamusic Co has issued shares to Digiwire Co equivalent to a 7% shareholding. Voting rights are attached to these shares. Digiwire Co received the shares in Clamusic Co on 1 January 20X6, which is the first day of the licence term.

Digiwire Co will also receive a royalty of 5% of future revenue sales of Clamusic Co as revenue for the licence.

Clamusic Co valuation and revenue

On 1 January 20X6, Clamusic Co was valued at between \$4–\$5 million by a professional valuer who used a market-based approach. The valuation was based on the share price of a controlling interest in a comparable listed company.

For the financial year end of 31 December 20X6, sales of the classical music were \$1 million. At 31 December 20X6, a further share valuation report had been produced by the same professional valuer which indicated that Clamusic Co was valued in the region of \$6–\$7 million.

Investment in FourDee Co

Digiwire Co has agreed to work with TechGame Co to develop a new music platform. On 31 December 20X6, the companies created a new entity, FourDee Co, with equal shareholdings and shares in profit. Digiwire Co has contributed its own intellectual property in the form of employee expertise, cryptocurrency with a carrying amount of \$3 million (fair value of \$4 million) and an office building with a carrying amount of \$6 million (fair value of \$10 million). The cryptocurrency has been recorded at cost in Digiwire Co's financial statements. TechGame Co has contributed the technology and marketing expertise. The board of FourDee Co will comprise directors appointed equally by Digiwire Co and TechGame Co. Decisions are made by a unanimous vote.

Pension plan

Digiwire Co provides a pension plan for its employees. From 1 September 20X6, Digiwire Co decided to curtail the plan and to limit the number of participants. The employees were paid compensation from the plan assets and some received termination benefits due to redundancy. Due to the curtailment, the current monthly service cost changed from \$9 million to \$6 million. The relevant financial information relating to the plan is as follows:

Date	Net defined liability ($m)	Discount rate %
1 January 20X6	30	3
1 September 20X6	36	3·5
31 December 20X6	39	3·7

Required:

(a) Advise the directors of Digiwire Co on the recognition and measurement of the:

(i) Clamusic Co shares received as revenue for the sale of the three-year licence and how they should be accounted for in the financial statements for the year ended 31 December 20X6; and

(ii) royalties which Clamusic Co has agreed to pay as revenue for the sale of the three-year licence in the financial statements for the year ended 31 December 20X6. Your answer to (a)(ii) should demonstrate how it is supported by the revised *Conceptual Framework for Financial Reporting* (2018). (9 marks)

(b) Based on International Financial Reporting Standards (IFRS®), advise the directors on the following:

(i) the classification of the investment which Digiwire Co has in FourDee Co;

(ii) the derecognition of the assets exchanged for the investment in FourDee Co and any resulting gain/loss on disposal in the financial statements of Digiwire Co at 31 December 20X6; and

(iii) whether the cryptocurrency should be classified as a financial asset or an intangible asset. Your answer should also briefly consider whether fair value movements on the cryptocurrency should be recorded in profit or loss. (9 marks)

(c) (i) Explain the reasons behind the issue of the amendment to International Accounting Standard (IAS®) 19: *Plan Amendment, Curtailment or Settlement* and discuss why the changes to the calculation of net interest and current service cost were considered necessary. (3 marks)

(ii) Advise the directors of Digiwire Co on the impact of the amendment to IAS 19 on the calculation of net interest and current service cost for the year ended 31 December 20X6. (4 marks)

(25 marks)

4 Background

Guidance Co is considering the financial results for the year ended 31 December 20X6. The industry places great reliance on the return on equity (ROE) as an indicator of how well a company uses shareholders' funds to generate a profit.

Return on equity (ROE)

Guidance Co analyses ROE in order to understand the fundamental drivers of value creation in the company. ROE is calculated as:

$$\text{Return on equity} = \frac{\text{Net profit before tax}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$$

Guidance Co uses year-end equity and assets to calculate ROE.

The following information in *table 1* relates to Guidance Co for the last two years:

	20X5 ($m)	20X6 ($m)
Net profit before tax	30	38
Sales	200	220
Assets	250	210
Equity at 31 December	175	100

Special purpose entity (SPE)

During the year ended 31 December 20X6, Guidance Co stated that it had reorganised its assets and set up a SPE. Guidance Co transferred property to the SPE at its carrying amount of $50 million, but had incorrectly charged revaluation reserves with this amount rather than showing the transfer as an investment in the SPE. The property was the SPE's only asset. However, Guidance Co still managed the property, and any profit or loss relating to the assets of the entity was remitted directly to Guidance Co. Guidance Co had no intention of consolidating the SPE.

Miscellaneous transactions

Guidance Co has bought back 25 million shares of $1 for $1·20 per share during the year ended 31 December 20X6 for cash and cancelled the shares. This transaction was deemed to be legal.

Guidance Co also raised loan capital for the first time during the year ended 31 December 20X6 of $20 million in order to help with the buy-back of the company's shares.

Guidance Co had purchased a 25% interest in an associate company on 1 July 20X6 for cash. The investment had cost $15 million and the associate had made profits of $32 million in the year to 31 December 20X6. Guidance Co accounted for the purchase of the associate correctly.

All of these miscellaneous transactions have been accounted for in the financial information for the year ended 31 December 20X6 in *table 1*.

(a) Management's intent and motivation will often influence accounting information. However, corporate financial statements necessarily depend on estimates and judgement. Financial statements are intended to be comparable but their analysis may not be the most accurate way to judge the performance of any particular company. This lack of comparability may be due to different accounting policy choices or deliberate manipulation.

Required:

Discuss the reasons why an entity may choose a particular accounting policy where an International Financial Reporting Standard allows an accounting policy choice and whether faithful representation and comparability are affected by such choices. (6 marks)

(b) (i) **Discuss the usefulness to investors of the ROE ratio and its component parts provided above and calculate these ratios for the years ended 31 December 20X5 and 20X6. These calculations should be based upon the information provided in table 1.** (5 marks)

(ii) **Discuss the impact that the setting up of the SPE and miscellaneous transactions have had on ROE and its component parts. Given these considerations, adjust table 1 and recalculate the ROE for 20X6 thereby making it more comparable to the ROE of 20X5.** (12 marks)

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

(25 marks)

End of Question Paper