SECTION A

QUESTION 1.

Greer Co is a listed parent company of a manufacturing group. Greer Co is preparing the group financial statements for the year ended 31 December 20X7.

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Acquisition of Layout Co - describes a business combination.
2. Goodwill on acquisition of Layout Co - describes the values attributed to the calculation of goodwill on the business combination with Layout Co.
3. Investment in Gae Co - describes an additional investment in the year.
4. Loan agreement - describes the terms of a bank loan agreement.

EXHIBIT 1. Acquisition of Layout Co

Greer Co whose shares are listed on a stock exchange and Layout Co, an unlisted company, entered into a business combination in two stages. On 1 January 20X7, Greer Co purchased 35% of the share capital and voting rights of Layout Co for cash. On 1 April 20X7, Greer Co acquired the remaining 65% of the share capital by issuing new shares to Layout Co's shareholders.

On 1 April 20X7, Greer Co had a market value of $70 million and Layout Co had a value of $90 million. Greer Co's business represents 44% and Layout Co's business 56% of the total value of the combined businesses. After 1 April 20X7, the former shareholders of Greer Co owned 51% and the former shareholders of Layout Co owned 49% of the voting rights of the combined entity.

On 1 April 20X7, the purchase agreement provided for a new board of directors of the combined entity comprising six board members of Greer Co and two board members of Layout Co. The CEO of Layout Co is the CEO of the combined entity. The board of directors nominates the members of the management team but the CEO has significant influence over the selection of the team. The management team comprises the CEO and five other members, three from Greer Co and two from Layout Co.

EXHIBIT 2. Goodwill on acquisition of Layout Co

On 1 January 20X7, Greer Co paid $34 million cash for 35% of the share capital of Layout Co.

On 1 April 20X7, Greer Co issued 25 million shares of $1 to Layout Co's shareholders in order to acquire the remaining 65% of the share capital. The shares of Greer Co were quoted on the stock exchange at $2·85 on 1 April 20X7.

On 1 April 20X7, Greer Co had a market value of $70 million and Layout Co had a value of $90 million. Greer Co had treated its 35% holding as an associate and its carrying amount on 1 April 20X7 was $36 million. The fair value of the identifiable net assets of Layout Co was $87 million on 1 April 20X7.

EXHIBIT 3. Investment in Gae Co

Greer Co acquired a 10% interest in Gae Co, a listed company, on 1 January 20X7 for $23 million. Greer Co elected at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) as the investment was not held for trading.

On 1 July 20X7, Greer Co acquired an additional 12% interest in Gae Co for $30 million and achieved significant influence. On 1 July 20X7, the fair value of a 10% interest in Gae Co was $26 million. Gae Co made profits of $20 million before dividends for the year to 31 December 20X7. Greer Co received a dividend of $0·2 million on 31 March 20X7. This was the only dividend paid in the year. Greer Co uses fair value as the 'deemed cost approach' in its financial statements.

EXHIBIT 4. Loan agreement

Greer Co took out a $27 million bank loan on 1 January 20X6, repayable after five years. Interest is charged at 5% per annum, payable annually on 31 December. Transaction costs of $675,000 were paid on 1 January 20X6. The effective interest rate was calculated as 5·6%.

Greer Co has negotiated a change to the terms of its loan on 31 December 20X7 at no cost. This has resulted in the waiver of the interest payment due on that date with all other contractual cash flows remaining payable. The modification to the financial terms of the original bank loan is not considered substantive.

The present value of the modified contractual cash flows at the original effective interest rate is $26,841,000.

REQUIREMENTS (30 MARKS)

(a) Using exhibit 1, evaluate the reasons why Greer Co, rather than Layout Co, can be identified as the acquirer in the business combination.

(10 marks)

(b) Using exhibit 2, explain, with calculations, how the goodwill on the acquisition of Layout Co on 1 April 20X7 will be determined within the consolidated financial statements of the Greer Group for the year ended 31 December 20X7.

(5 marks)

(c) Using exhibit 3, explain, with calculations, how the Greer Group would account for the investment in Gae Co in the consolidated financial statements for the year ended 31 December 20X7.

(9 marks)

(d) Using exhibit 4, calculate and briefly outline, in accordance with IFRS 9 *Financial Instruments*, how the loan would be accounted for during the period 1 January 20X6 to 31 December 20X7.

(6 marks)

QUESTION 2.

Cutherd is a successful division within a multi-national company, Herding Co. The financial year end of Herding Co is 31 December 20X8.

The following **exhibit**, available on the left-hand side of the screen, provides information relevant to the question:

1. New system - describes the purchase of an unauthorised procurement system by the Cutherd division on 1 August 20X8 and the implications of that decision.

EXHIBIT 1. New system

New procurement system

In 20X8, Herding Co upgraded its computerised systems and centralised its procurement (purchasing) processes. All divisions of Herding Co were required to use the same procurement system. However, on 1 August 20X8, the divisional head of the Cutherd division (Mr Bookman) purchased a procurement system without authority, which is incompatible with the other systems in Herding Co.

The new system is specific to the Cutherd division and cannot be used by other divisions in Herding Co. Mr Bookman has stated that the Cutherd division will use this new system to make purchases in the future rather than the company's centralised system. As a result of using the new system, the Cutherd division has developed a poor purchasing strategy which has resulted in unfavourable pricing decisions. Even though the Cutherd division has made purchases with the new system, it is not fully operational because it is incompatible with the company's centralised systems.

Accountant and internal auditor

The accountant of Herding Co (Mr Ebrima) is considering the impact of the poor purchasing decisions and how to improve the financial control over the Cutherd division. However, he does not wish to introduce controls which Mr Bookman may feel are 'excessive' because Mr Bookman is a dominant individual who often puts pressure on him. Mr Bookman is on the management committee of Herding Co to whom the internal auditor (Mr Franklin) reports. Mr Ebrima has reported his concerns to the internal auditor who is a qualified member of ACCA and known to be a personal friend of Mr Bookman.

Procurement costs

Herding Co's policy is normally to upgrade systems every four years. The cost of the Cutherd division's new system was $5 million. There were additional development costs incurred by the Cutherd division of $100,000 which related to payroll. All of these costs (totalling $5·1 million) have been written off in the statement of profit or loss of Herding Co in the year ended 31 December 20X8. At the year end, the Cutherd division's new system is still not yet fully operational because of the incompatibilities with the centralised systems. There are also doubts about the security of the system and potential short-term technological obsolescence.

REQUIREMENTS (20 MARKS)

(a) Discuss how the advancement of information technology impacts on the ethical responsibilities of an accountant.

Note: There is no need to refer to any specific exhibit to answer part (a).

(4 marks)

(b) Discuss the ethical issues faced by the accountant (Mr Ebrima) and the internal auditor (Mr Franklin) in Herding Co and any actions they should take to address these issues.

(6 marks)

Professional marks will be awarded in part (a) and (b) for the quality of the ethical discussion and identification of appropriate actions.

(2 marks)

(c) Explain the possible effects of IAS 38 *Intangible Assets* and IAS 36 *Impairment of Assets* on the accounting treatment of the purchase of the Cutherd division's procurement system and development costs, in the financial statements for the year ending 31 December 20X8.

(8 marks)

SECTION B

QUESTION 3.

Fernanda Co is the parent company of a group which constructs industrial properties. Fernanda Co is currently preparing the consolidated financial statements for the year ended 31 December 20X7.

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Roof collapse - describes the potential liability for a section of a roof collapsing which was constructed by Fernanda Co.
2. Financial instruments - describes the accounting treatment by Fernanda Co of a put option and non-redeemable preference shares.
3. Cash flow issues - describes the treatment of cash flows on the sale and purchase of subsidiaries.

EXHIBIT 1. Roof collapse

Fernanda Co is a group which constructs industrial properties. In September 20X7, a section of the roof of one of the buildings which it had constructed partially collapsed, injuring 10 people. Production, which was taking place inside the building, had to be stopped. However, no legal action had been brought against Fernanda Co as at 31 December 20X7, as accident investigators were still trying to find out the reason for the collapse.

The investigators were assessing the responsibilities of the various parties involved, with the report expected in February 20X8. The extent of the damage and the details of any compensation payments to be made had not as yet been determined.

Fernanda Co felt that given the current stage of the investigation into the accident, there was no requirement to record any liability in the consolidated financial statements as at 31 December 20X7, especially as Fernanda Co felt that any compensation payable would be covered by insurance.

EXHIBIT 2. Financial instruments

Put options

On 1 January 20X7, as a result of a business combination, Fernanda Co has written put options to purchase the non-controlling interest shareholding in a newly acquired subsidiary, Runda Co. This means that Fernanda Co would be obliged to purchase the non-controlling interest shareholdings in the subsidiary if the put options were exercised by the non-controlling interest shareholders. At 31 December 20X7, Fernanda Co disclosed a contingent liability in the consolidated financial statements for the estimated cost of redeeming the put options.

Preference shares

In addition, in order to partly fund the purchase of the subsidiary, on 1 January 20X7, Fernanda Co issued non-redeemable preference shares and recognised them as equity instruments in the consolidated financial statements at 31 December 20X7.

The preference shareholders receive an annual fixed cash dividend of 5% and a participating dividend which was 7% of the ordinary dividend. Fernanda Co stated that the instrument had characteristics of equity capital as it provided for participation in the future income of the company.

Fernanda Co concluded that compliance with IAS 32 *Financial Instruments: Presentation* would be so misleading that it would conflict with the objective of financial statements set out in the *Conceptual Framework*. Fernanda Co considers the classification of the preference shares to be equity rather than a compound instrument.

EXHIBIT 3. Cash flow issues

On 31 December 20X7, Fernanda Co sold its entire holding in a subsidiary company, Interactive Co. Fernanda Co had loaned $3 million to Interactive Co on 1 April 20X6 and this remained outstanding after its sale.

As a result, the loan to the former subsidiary was recorded in the consolidated financial statements at 31 December 20X7. Therefore, Fernanda Co presented the full amount of the loan as a cash outflow in investing activities in its consolidated statement of cash flows at that date, despite the fact that there had been no cash movement on the loan during the period.

Investing activities showed a cash inflow of $2 million. This was made up of the $10 million cash received as consideration for the sale of the subsidiary, less $8 million paid to acquire the shares in a newly acquired subsidiary, Runda Co.

Cash and cash equivalents held by Interactive Co at the date of disposal were $3 million.

REQUIREMENTS (25 MARKS)

(a) Discuss the acceptability of Fernanda Co's decision not to record any liability for the roof collapse in the consolidated financial statements for the year ending 31 December 20X7.

(7 marks)

(b) Discuss the acceptability of Fernanda Co's decisions, in the consolidated financial statements:

(i) to disclose a contingent liability for the estimated cost of redeeming the put options; and

(4 marks)

(ii) to record the non-redeemable preference shares as equity rather than a compound financial instrument.

(6 marks)

(c) In accordance with IAS 7 *Statement of Cash Flows*:

- **explain the importance of and the distinction between classification of cash flows from investing activities and cash flows from financing activities;**
- **outline the circumstances where cash flows may be reported on a net basis; and**
- **discuss the issues with Fernanda Co's treatment of the cash flows for the year ended 31 December 20X7.**

(8 marks)

QUESTION 4.

Eloa Co is the parent company of a group and a multinational sports clothing manufacturer. The company is preparing its group financial statements for the year ended 31 December 20X7.

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Operating segments - outlines information about the various divisional activity of the company for the year ended 31 December 20X7.
2. Divisional performance - sets out the performance of the divisions for the year ended 31 December 20X7.
3. Investment in Ganic Co - describes the relationship with two partners in setting up a manufacturing entity.

EXHIBIT 1. Operating segments

Eloa Co's equity instruments are listed. In the year ended 31 December 20X7, it operated four divisions: Tennisgear, Badmintonwear, Squashracket and Casualwear.

Casualwear operates overseas and produces sports clothing. It sells 90% of its production to the other three divisions of Eloa Co.

Badmintonwear and Squashracket sell the same clothing with different brand names.

Eloa Co has stated that making the specific disclosures required by IFRS 8 *Operating Segments* might affect its competitive position and be misleading. Therefore, the company has currently elected not to disclose any segment information.

The company's chief executive officer (CEO) is the chief operating decision maker. Each division has a manager who reports directly to the CEO and their compensation is partly based upon the division's results. Every quarter of the year, the CEO reviews the statement of profit or loss and the key performance measures such as earnings before interest, tax, depreciation and amortisation (EBITDA) for each division. The division managers meet the CEO each quarter to review the division's performance and compare the actual results to the budgeted figures. The final budgets for each division are based upon performance and are approved by the CEO.

EXHIBIT 2. Divisional performance

The table sets out the divisional performance for the year ended 31 December 20X7.

Division	Revenue External $million	Revenue Internal $million	Profit $million	Assets $million
Tennisgear	16	nil	2	15
Badmintonwear	1.6	nil	0.3	3
Squashracket	1.8	nil	0.5	4
Casualwear	1.2	10.8	3.6	20
Total	**20.6**	**10.8**	**6.4**	**42**

EXHIBIT 3. Investment in Ganic Co

On 1 January 20X7, Eloa Co has undertaken a venture with two other venturers and called the entity Ganic Co. Ganic Co will manufacture tennis and badminton rackets and will supply rackets to Tennisgear and Badmintonwear.

Each venturer owns equity with one-third of the voting interests which also carries rights to the net assets. All key decisions which affect the venture are made by a unanimous vote of the shareholders, as outlined in an agreement between the venturers. However, Eloa Co has the option to purchase an additional 5% of Ganic Co's equity shares from each of the other two venturers for a fixed price at any time.

Ganic Co's financial results are scrutinised quarterly by the CEO of Eloa Co and the other venturers. Eloa Co's CEO reviews the results to help make decisions about the allocation of future resources and to determine whether to continue with the venture.

REQUIREMENTS (25 MARKS)

(a)(i) Using exhibit 1 only, discuss, in accordance with IFRS 8 *Operating Segments*, whether the four divisions owned by Eloa Co should be classified as operating segments.

(a)(ii) Using exhibits 1 and 2, determine, in accordance with IFRS 8, whether:

- **the four divisions owned by Eloa Co should be identified as separate reportable segments; and**
- **whether it is necessary or possible for any of the divisions to be combined into a single reportable segment for Eloa Co.**

(9 marks)

(b) Discuss how the investment in Ganic Co should be accounted for in the consolidated financial statements of Eloa group and discuss whether Ganic Co can be classified as an operating segment.

(7 marks)

(c) Segmental reporting provides information about an entity's operations which enables users of financial reports to assess and make informed decisions on the true position and performance of an entity with diversified segments.

Explain why segmental information is important to investors.

Note: You do not need to refer to any exhibit when answering part (c).

(7 marks)

Professional marks will be awarded in part (c) for clarity and quality of the explanation of the importance of segmental information to investors.

(2 marks)