

QUESTION BANK

SECTION C

REPORTING THE FINANCIAL PERFORMANCE OF ENTITIES

C

1 Segment reporting and hedge of net investment - Bling Bling Accessories Limited

(a) Segment reporting

In your capacity of Assistant Accountant, write a report to the Chief Accountant of Bling Bling Accessories Limited (BBAL), advising him of the practical problems arising on the application of the new rules arising, under IFRS 8 Operating segments, on the identification of and reporting for operating segments.

(10 marks)

(b) Overseas entity – hedge of a net investment

On 30 June 20X7, BBAL acquired all of the ordinary share capital of Shiny Jewels Limited (SJL), an overseas entity, for PP 20 million. A loan of PP 20 million was raised on this date to finance the purchase of the overseas equity investment. BBAL, in its consolidated financial statements, designates the loan as a hedging loan, and BBAL is committed to topping up or reducing the PP loan so that the loan remains highly effective as a hedge of the overseas equity investment over the whole period of the loan.

The fair value of the underlying separable net assets of the overseas subsidiary had increased to PP 22.8 million on 30 June 20X8, from PP 17.8 million on the date of acquisition. The increase is wholly attributable to trading profit in the period. The functional currency of SJL is its own currency, PP.

Non-controlling interest at acquisition date is determined by reference to share of fair value of identifiable net assets at acquisition date and goodwill is to be determined in accordance with IFRS 3R. One-quarter of the goodwill paid on acquisition is determined, following impairment testing at 30 June 20X8, to be impaired.

The rates of exchange, \$ to PP were as follows:

30 June 20X7	\$1 = PP 10.5
30 June 20X8	\$1 = PP 12.0
Average for the year to 30 June 20X8	\$1 = PP 11.2

Required:

Discuss, briefly, the factors that need to be considered in determining the functional currency of an overseas entity. Calculate, for the consolidated financial statements of BBAL at and for the year ended 30 June 20X8, the exchange differences arising on the translation of SJL into \$, the presentation currency of the BBAL Group, on the basis that the functional currency of SJL is PP. Apply the rules of IAS 21. Outline another permitted approach to determining goodwill on acquisition and advise the BBAL directors as to the approach to adopt.

(15 marks)
(25 marks)

2 Operating Segments - Norman

(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 IFRS8 'Operating Segments'. The results of the regional segments for the year ended 31 May 2008 are as follows:

Region	Revenue		Segment results profit/(loss)	Segment assets	Segment liabilities
	External	Internal			
	\$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

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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 IFRS8 'Operating Segments' for the determination of a company's reportable operating segments and how these principles would be applied for Norman plc using the information given above.

(11 marks)

(b) 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)

Norman has recently started issuing vouchers to customers when they stay in its hotels. The vouchers entitle the customers to a \$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)

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.

(25 marks)
(June 2008)

3 Assorted adjustments - Brilliant Power Supplies Limited

Brilliant Power Supplies Limited (BPSL) is a company listed on the national stock exchange of its country and mindful of its obligations as to compliance with the Code of Corporate Governance.

BPSL prepares financial statements made up to 30 June each year. Rafael Lim, Chief Accounting Officer, is provided with the following details relating to two of its properties:

(i) BPSL was recently granted an operating license by the government to operate an ecologically sound power station on the condition that it is dismantled at the end of its life which is estimated to be twenty years. BPSL constructed the power station at a cost of \$200 billion and commenced operations on 1 July 20X7 with depreciation being charged straight-line over twenty years. It was estimated, at 30 June 20X8, that it will cost \$30 billion, in terms of present value using a discount rate of 5%, to restore the site to its original condition. 95% of these costs relate to the removal of the power station and 5% relates to environmental damage caused through generating energy over a twenty-year period.

(ii) BPSL has property interests and all properties are accounted for as owner occupied properties measured at cost less depreciation and impairment losses. In order to raise medium-term finance, BPSL sold one of its properties to an unrelated party on 1 July 20X7 and immediately leased the property back under a twenty year lease which is also the remaining useful life of the property. The carrying value of the property on the date of sale was \$12 million and the sale price, based on the present value of the minimum lease payments, amounted to \$15 million. The rental is \$1.2 million per annum in advance commencing on 1 July 20X7. The rate of interest implicit in the lease is approximately 5.6%. The lease agreement includes the transfer of the title to the property back to BPSL at the end of the lease period at nil cost. Didier Charlotte, Finance Director of BPSL, insists on accounting for the transaction so as to strictly comply with the requirements of IAS 17 in this regard. The draft financial statements have accounted for the sale and finance leaseback accordingly.

Required:

- (a) Explain, under IAS 16 and IAS 37, the recognition and measurement issues involved in respect of the newly constructed, ecologically sound power station in (i) above and decommissioning costs to be incurred in the future. (7 marks)
- (b) Explain to Didier why accounting strictly under IAS 17 may not be wholly appropriate for the transaction in (ii) above. (5 marks)
- (c) Show the accounting entries, with explanations, to change from what the draft accounts show (accounting for form) to accounting for the substance of the transaction per IAS 1 and SIC 27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease (7 marks)
- (d) Construct an argument for the case that companies should, from an ethical and practical point of view, present an Environmental Report as a part of their Annual Report. (6 marks)
- (25 marks)**

4 Assorted adjustments - Environmentally Sound Paper Products Limited

Environmentally Sound Paper Products Limited (ESPPL) was incorporated in 19V2 and listed on the London stock exchange since 19W7. It wishes to comply with the Code of Corporate Governance of its Stock Exchange that complies with the UK Combined Code.

(i) It has a factory in Lantau that it has leased to Shakti, an Indian owned company, at the year-end, 30 June 20X8. ESPPL prepares financial statements to 30 June each year. Under the terms of the lease arrangement, beneficial and legal ownership of the power station remains with ESPPL and, should the company's other paper-making factory encounter major production problems, ESPPL can terminate the agreement with Shakti. Fernando Teo, newly appointed non-executive director on the main board of ESPPL, insists on the lease being treated as an operating lease in ESPPL's financial statements with \$85 million (present value of total income from the lease) recognised as rental income in the statement of comprehensive income. The fair value of the power station is \$150 million on 30 June 20X8 and a deposit of \$20 million (included in the present value of income above) was received by ESPPL on that date.

(ii) ESPPL granted 400 share options to each of its 5,000 employees on 1 July 20X7. The options vest if the employees remain in the employment of the Group for the next two years. On grant date, ESPPL estimated that 500 employees would leave the Group in each year up to the vesting date. At 30 June 20X8, 300 initially eligible employees had left the Group. The estimate, at 30 June 20X8, of the number of employees leaving in the year to 30 June 20X9 was 250. The fair value of each share option at the grant date was \$10 and the share options have not been accounted for in the statement of financial position and statement of comprehensive income of ESPPL. Accounting cost is not deductible for tax purposes. The company is given a tax allowance for tax purposes based on the intrinsic value of the options, defined as the excess of the market value of the company's shares over the exercise price of the options. The tax rate is 15%. The exercise price of the options during the exercise period (1 July 20X9 to 30 June 20Y1) was fixed at \$39 per share. Market values of ESPPL shares were:

1 July 20X7	\$38 per share
30 June 20X8	\$46 per share

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(iii) ESPPL has entered into the following transactions dealing with financial instruments during the year to 30 June 20X8:

- ESPPL generates some of its revenues in foreign currency. ESPPL can demonstrate that the forecast currency revenues for the two years to 30 June 20Y0 are "highly probable". It enters into a foreign currency borrowing, in the same currency as the anticipated future revenues and designates the currency borrowing as a cash flow hedge of the future revenue stream.
- ESPPL has, at 30 June 20X8, a foreign currency liability payable in 6 months' time and it wishes to hedge, on 30 June 20X8, the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract, on 30 June 20X8, to buy the foreign currency in six months' time. ESPPL is unsure as to whether, under IAS 39, the hedge should be treated as a fair value hedge of the liability or a cash flow hedge of the amount to be settled in the future and has asked you to describe the accounting treatment in each case.

Required:

- (a) In the context of IAS 17 and IAS 18, discuss whether Fernando's treatment of the lease arrangement in (i) above is appropriate. (5 marks)
- (b) Discuss the basis for the recognition and measurement of the cost of the employee share options for ESPPL in its 2008 financial statements **and** discuss the need for and quantify the amount of deferred tax that should be recognised by ESPPL for the equity-settled share-based transaction in (ii) above in its 20X8 financial statements. (10 marks)
- (c) Discuss how the three transactions in (iii) above should be treated in the financial statements of ESPPL so as to comply with the requirements of IAS 39. (10 marks)
- (25 marks)**

5 Impairment of asset - Haerbin Ice

You are an accounting manager of Haerbin Ice, a manufacturer of cooling appliances and systems for both national and international markets. Owing to the adverse impact of a prolonged poor economic environment and deflation, the revenues of the company over the last few years have been substantially lower than previously expected. The situation has been made worse by the bird-flu disease, swine-flu and spitting cobra contagion. The management of Haerbin Ice believes that the assets of the company might have been impaired. You have been provided with the following information for the purpose of conducting an impairment review:

- (i) A list of relevant tangible and intangible assets of Haerbin Ice and their respective carrying amounts to be included in the impairment review on 30 June 20X8 are as follows:

	\$m
Property, plant and equipment	104.20
Goodwill	8.80
Other relevant assets	48.00

- (ii) Haerbin Ice comprises two divisions: the national division (NAD) and the overseas or export division (EXD). Each division is a separate cash-generating unit.
- (iii) The carrying amounts of property, plant and equipment held by NAD and EXD are \$40 million and \$32 million respectively. The whole of the goodwill balance is attributable to EXD (i.e. there is a reasonable basis for the allocation of goodwill to individual cash-generating units). The carrying amount of the other relevant assets held by each of the two divisions is \$24 million.