An Approach to Advanced Corporate Reporting Examinations Questions

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1. Introduction

In the CPA Professional 2 Stage examination papers students will often be faced with answering questions that are based closely on 'real world' situations. The case study questions in the Advanced Corporate Reporting paper are, as would be expected, based upon the financial reporting requirements for common business events such as mergers and acquisitions. As per the CPA syllabus these questions will test technical knowledge developed through your studies in financial accounting and reporting. That said, clients and employers expect accountants to provide advice and alternative solutions to a range of financial reporting issues, in addition to having a technical knowledge of accounting standards. Application of technical knowledge is extremely important at P2 where professional judgement and ethical awareness are expected. In order to achieve this there is a need for students to review the scenario(s) referred to in the case study and plan their answers, similar in some ways to the approach one would use in relation to challenges presented in the workplace.

Examiners are looking for students to:

- Provide structured answers which address key issues, arising from the case questions, in a logical format
- Engage in a focused discussion of issues with arguments applied to specific aspects of the case study
- Where relevant, quantification of issues and if necessary, the preparation of financial statements/ratios/disclosure notes
- Understand that a range of solutions/alternatives may be applicable
- Demonstrate higher skills by synthesising, analysing and evaluating the material in the case study.

Every examination case scenario is different, making any generalisation difficult. However, there are some key characteristics of weak examination scripts including:

- Failure to address (or even read) the question asked and poor communication in explaining particular points
- Repetition of information from the case, without any application or analysis
- Ignoring the broader aspects of various issues and their wider implications
- Technically incorrect solutions with no attempt to discuss or relate to the case question
- Too much emphasis on knowledge as opposed to problem solving
- Ignoring elements of the requirements set out in questions.

2. Approach to questions

In helping you develop an approach to answering case study type questions we will discuss the question, Shane PLC, shown below. This is not a full case study but rather a 'scenario' which can be used to illustrate important issues in terms of some of the ideas highlighted in the introduction above.

Shane PLC is a listed Irish company which manufactures high quality furniture for the residential market. The company operates from three separate locations in Ireland, with each factory operating as a separate division under different brand names. The three divisions are called Up, Down and Sideways. It is 29 February 2012 and you have recently been employed as a financial accountant for the company but have been concerned that your brother, who works for one of Shane PLC's competitors, another listed company, has recently been told in confidence that his company will not meet its profit forecasts for the year ended 31 March 2012. He has made you aware of this information but you are unsure as to what action to take.

Certain technical specifications are provided by the central technical support team which service all three divisions. You have been provided with the following extract from the corporate social responsibility section of the 2010 annual report and financial statements:

Finance
Each division prepares budgets and business plans which are reviewed and updated on a regular basis. Monthly financial reports are prepared for each operating division and performance is assessed against budget and forecasts. The group's management board meets on a monthly basis to review performance of each of the divisions. Each division is reported as a separate segment in the annual financial statements because the results for each are regularly reported to Shane PLC's chief executive John Collins.

Quality and safety
The technical compliance team assesses and approves raw material suppliers, audits the quality control systems across all divisions, provides guidance on health and safety legislation, sets technical specifications and offers expertise on a wide range of quality and safety matters. The company operates a zero tolerance approach to quality issues.

The Up division produces 'premium' table furniture for Holden, a specialist furniture retailer, in addition to selling own brand products through independent outlets.

On 1 November 2011 a fire safety scare in relation to tables manufactured by the Up division was reported extensively in the national press. The Government Product Standards Board (GPSB) immediately closed down the production plant. Production restarted on 1 February 2012. At that time the GPSB had initiated legal proceedings against Shane PLC for failing to meet adequate health and safety requirements. The maximum fine payable is €2 million and Shane PLC's lawyers have indicated the case will be heard on 1 May 2012 and their advice is that Shane PLC should not contest the case.

Holden returned its entire inventory of tables on hand at 1 December 2011. These products had been purchased by Holden at a cost of €800,000. The sub-standard products were disposed of by Up before 31 December 2011. A number of production assets were also deemed to be below quality and their carrying values were reduced to zero. €100,000 was incurred in January 2012 to ensure that these assets were disposed of in an environmentally friendly way. Under the terms of the agreement between Holden and Shane PLC, Holden is entitled to €500,000 compensation for each month that Shane PLC is unable to supply products.

As would be expected, the adverse publicity has had a negative effect on the other two divisions of Shane PLC. Holden, who is a significant customer for all the divisions, has reduced its level of business and overall sales volumes have reduced dramatically. On 28 December 2011 Shane PLC publicly announced a relaunch of all three divisions. This promotion meant a revision of all product offerings and the incurring of €3 million in additional marketing and promotion expenditure.

At the end of 2011 the following information is available:

	Up	***Down***	***Sideways***
	€'000	€'000	€'000
Carrying amount of assets	6,000	5,000	7,000
Recoverable amount	2,000	6,400	7,600
Remaining useful life (years)	5	10	10

Corporate assets comprise the central functions including technical, health and safety and finance functions. The carrying amount of corporate assets at the end of 2011 is €1.8 million. Shane PLC allocates corporate assets to divisions on a weighted basis on the basis of the estimated remaining useful lives of each division's assets.

The pre-tax discount rate applicable to the risks inherent in Up's production of furniture products is 10%.

On 1 March 2008 Shane PLC acquired a government bond at a cost of €4 million. The fair value of the government bond at 31 December 2010 was €4.4 million and a gain was recognised in other comprehensive income and held in equity. In accordance with the company's treasury policy the bond was sold on 28 December 2011 for €4.2 million. A loss of €0.2 million has been recognised in operating expenses.

Requirement

Discuss the financial reporting treatment in the 31 December 2011 financial statements of Shane PLC in relation to the main issues referred to in the case. Your answer should quantify the effects on the financial statements were relevant.

NB. *Preparation of financial statement extracts or full disclosure notes are not required.*

3. Writing your answer

- Strong answers will address the requirements of the question as opposed to writing chunks of material out of notes, manuals or textbooks which have been brought into the examination.
- Your analysis should be appropriate to the context of the question and should refer to the facts provided in the case (including any relevant appendices).
- In quantifying the effects you should consider both initial measurement and the effect on the key financial statements. A useful way of thinking about your answer is to consider: how should the item be recognised (e.g. asset/liability/expense/income)?; how should the item be measured on recognition?; how should the item be presented in financial statements?; and, how should the item be disclosed (e.g. key judgements).
- Normally answers will be able to demonstrate more 'added value' where the issues are significant and where judgement is required in discussing the issue. In addition, it is important to plan your answer before writing.

In relation to Shane PLC the business issue could give rise to additional liabilities and bring into question the recoverability of business assets. Also, it is important not to ignore wider business/ethical issues which may be apparent within the case study. While the following suggested answer is designed to be reasonably comprehensive, credit would normally be given to candidates who raised valid alternative issues. At P2, the cases will normally be such that there is no one 'correct' answer.

All case studies will have a set of questions and it is important that you analyse them carefully. You should read carefully and consider the requirements. Ask yourself the following:

- What are the requirements?
- Am I required to give appropriate professional advice (to a client or the board)?
- Is there a particular format such as notes, draft financial statements, report or memorandum?
- Is there anything I need to be aware of in formulating my answer or particular things I need to prepare (financial statements etc)?
- What is the weighting of each part of the requirements? Where does my emphasis need to be?

Suggested answer

i. Legal Case

IAS37 *Provisions, Contingent Liabilities and Contingent Assets* requires that a provision should be made for the potential fine. It would appear that the three criteria set out in IAS 37 have been met:

- A legal obligation exists as a result of a past event. The obligating event was fire safety which occurred during the year
- The transfer of economic benefits is probable. Legal advice has suggested that Shane PLC should not contest the case
- The provision can be measured reliably since the maximum liability is known.

The advice of the legal advisor is so persuasive that it would be sensible to provide for the maximum fine (€2 million). Any legal fees would also have to be provided for. The amount is likely to be payable in twelve months time. The provision should be discounted where the effect of discounting would be material. (2/1.1). In 2012 the discount would be unwound as a finance cost. Disclosures surrounding the uncertainties and judgements made are required.

The statements made in the corporate social responsibility statement appear to be inconsistent with the financial statements.

ii. Holden Agreement

The inventory of furniture returned by Holden does not have any resale value. Trade receivables from Holden would need to be reduced by €800,000, with a corresponding reduction in revenue. The disposal costs of the faulty production assets should also be provided for in the financial statements. A provision of €100,000 in the statement of financial position would be prudent. IFRS 5 *Non-current Assets Held for Disposal and Discontinued Operations* does not apply to these assets, as they are being abandoned, not sold.

In addition, Shane PLC will have to pay €1.5 million of compensation to Holden. This is €500,000 per month for each of the three months that no production has taken place. One of these months fall after the financial year end. However, the obligating event occurred before the year end and a provision for the full amount of what is in effect an onerous contract should be recognised.

iii. Products

The announcement of a relaunch of products does not constitute an obligation that is independent of the entity's actions. No provision for the relaunch costs should be recognised. Marketing expenditure should be included in financial statements as incurred.

iv. Impairment test

The safety problem and the significant reduction in sales volume would be in indicator of impairment under IAS 36, *Impairment of Assets.* As the three divisions operate and report their financial results separately, they should be classified as three separate cash-generating units (CGUs). The corporate assets are not revenue generating but contiribute to the cash generating activities of the overall business. The corporate assets should be allocated on a reasonable and consistent basis to the CGUs under review. The recoverable amounts for the units should then be compared to the carrying amounts of the CGUs including the allocated corporate assets.

The carrying amount of the corporate assets €1.8 million is allocated to CGUs on a weighted average basis as the remaining life of the Up division assets is shorter than the other divisions. The revised carrying amounts should then be compared to the recoverable amount to quantify any impairment loss.

	Up	***Down***	***Sideways***	***Total***
	€'000	€'000	€'000	€'000
Carrying amount of assets (A)	6,000	5,000	7,000	18,000
Useful life	5 years	10 years	10 years	
Weighting based on useful life	1	2	2	
Carrying amount after weighting	6,000	10,000	14,000	30,000
Pro-rata allocation of corporate assets	6/30	10/30	14/30	100%
Allocation of corporate assets based on pro-rata weightings (B)	360	600	840	1,800
Carrying amount including building (C=A+B)	6,360	5,600	7,840	19,800
Recoverable amount (D)	2,000	6,400	7,600	16,000
Impairment losses (C-D)	4,360	Nil	240	4,600

The impairment losses should be allocated between the assets of the CGUs and the corporate assets.

	Up		***Sideways***	
	€'000		€'000	
Corporate assets	247	(4,360 x360/6,360)	26	(240 x 840/7,840)
CGUs	4,113	(4,360 x6,000/6,360	214	(240 x7,000/7,840)
	4,360		240	

The impairment losses in the CGUs should be apportioned to the assets within each CGU. The impairment should be apportioned to any goodwill first and then pro-rata to other assets.

v. *Available-for-sale investments*

The government bonds are appropriately classified as available-for-sale financial instruments. They are not held for trading and so do not meet the criteria to be classified as at fair value through profit and loss. Similarly, they were not acquired with the intention of holding to maturity.

The €0.2 million loss on disposal has been calculated by comparing the disposal proceeds of €4.2 million with the carrying amount of €4.4 million at that date. However, a disposal of €0.4 million cumulative gain previously recognised in other comprehensive income and held in equity should now be reclassified to profit and loss. Therefore the loss on disposal of €0.2 million should be corrected to a gain of €0.2 million. The net effect is to eliminate the previous reserve in equity and to increase operating profit.

vi. *Disclosure*

The costs relating to the health and safety scare are significant. The presentation of the non-recurring expenses as a separate line in the income statement and an explanation of the liabilities recognised would provide relevant information. In accordance with IFRS 8 'exceptional' expenses should be analysed by operating segment if they are separately reported to the chief executive.

vii. *Ethics*

The ethical problem relates, in part, to confidentiality. Confidentiality is one of the key principles outlined in the International Federation of Accountants (IFAC) Ethical Code and the CPA Code of Ethics. You must respect confidentiality and should never disclose information about Shane PLC to an outsider. The information about the competitor, of which you are now aware because of a personal contact, could possibly be of benefit to Shane PLC, and so you could be tempted to argue that you should disclose it to your employers out of loyalty. However, professional accountants must be guided not only by the terms but also the 'spirit of the Code. Taking this into account, confidentiality must be maintained. In addition, professional accountants must avoid any behaviour that discredits their profession.

4. Conclusion

At P2, students are expected to apply their professional judgement and technical ability in the preparation and analysis of financial statements for a range of business entities. For the well prepared students, these examinations allow them to demonstrate both their technical competence and their skills in applying, and communicating, their professional judgement to a variety of accounting issues. Indeed, the Shane PLC scenario illustrates areas were judgement is required in terms of impairment of assets, accounting for provisions and ethical dilemmas. Communication skills are essential for anyone entering the accountancy profession and it is important that future students ensure that they pay attention to presentation requirements which specifically ask for reports/memoranda etc. In an open book examination, students are expected to be familiar with the current developments in corporate reporting and to be able to demonstrate wider reading beyond the textbook/manual. In many cases there is not one 'correct' solution that can somehow be found within the reference material taken into the examination hall.

This article has set out some of the key reasons why those sitting the ACR examination fail to perform to their true potential, and students would be well advised to take these on board when preparing for future examinations.