Dealing With Case Study Questions in Advanced Corporate Reporting

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When you are preparing for the Professional P2 Advanced Corporate Reporting examination, you can expect questions that encompass issues and challenges that Certified Public Accountants (CPAs) encounter as a professional accountant. A CPA is expected to demonstrate technical expertise, analyse and reflect on different scenarios and present suggested solutions and alternatives to interested parties. Your work experience as a CPA will benefit your examination performance and vice versa. Furthermore, it is essential that ethical and judgemental issues associated with a range of solutions are considered as part of providing advice. In helping students to develop an approach to financial reporting questions, this article will focus on a question (shown below) called ABC Limited.

Worked Example

You are a qualified CPA accountant at ABC Limited (ABC), an Irish company which prepares its financial statements in accordance with International Financial Reporting Standards (IFRS) up to 31 March each year. The company has ambitious growth plans in the retail and property sectors and is considering a listing on the Irish Stock Market. ABC has grown rapidly and has taken on a high level of debt. The Finance Director, Paul, has provided you with the following extracts from the accounting policies from the financial statements for the year ended 31 March 2015.

Non-current assets are stated at cost less accumulated depreciation and impairment charges. Depreciation is computed using the straight-line method.

Grants and subsidies receivable, from the Industrial Development Board, to assist in the promotion of indigenous investment are carried in the statement of financial position as deferred income. The amounts are reversed to profit or loss during the useful life of the respective assets.

1. As at 31 March 2015, ABC has two freehold properties as follows:

(i) A retail outlet acquired on 1 April 2011 for €20 million, of which €2 relates to land. The useful life of the building was assessed at 40 years. On 31 March 2015 the fair value of the property was assessed at €24 million, of which land amounted to €4 million. The useful life was reassessed to 30 years from that date.

(ii) ABC acquired office premises on 1 October 2014 for a total cost of €8 million of which €1 million related to land. The useful life of the premises was estimated at 35 years at that date. The premises are rented to local businesses under short-term agreements with a view to generating returns from rental income. ABC has not previously owned any investment properties. On 31 March 2015 the fair value of the premises was assessed at €8.5 million of which land amounted to €0.6 million. The useful life remained the same.

The premises are located in an area of high unemployment and social disadvantage. The Irish Government has contributed €0.6 million to the cost of the premises to support initiatives for the creation of employment opportunities in the area. As a condition of the grant, ABC has agreed to reduce the rents charged to local businesses by €0.2 million per annum over the three years to 30 September 2017.

The managing director is concerned about how the company accounts for non-current assets and believes that current value must be used as opposed to cost. Such an approach, he believes, will reduce gearing and enable ABC to borrow more.

2. On 1 January 2014, new legislation came into force, in Ireland, requiring companies such as ABC to fit smoke detectors in their factories. As at 31 March 2015, ABC had still not installed such detectors. The expected cost of fitting these has always been estimated at €250,000 and ABC plans to start this work in May 2015. However, a number of other companies, like ABC, have failed to conform with the legislation and have been fined by the National Health and Safety Executive. ABC's lawyers have advised that there is a 75% chance that the company will be fined for failing to comply with the legislation. Their best estimate of the fine at 31 March 2015 is €45,000. At 31 March 2014 the lawyers' equivalent best estimate was €60,000.

3. On 1 June 2014, ABC issued a total of 1 million €1 preference shares at par to Paul (Finance Director) and the chief executive, who each own 30% of the company's ordinary share capital. The preference shares do not have voting rights, or a redemption date, and they confer no right to a dividend. On 1 January 2015, ABC's board approved the payment of a dividend of 5 cents per preference share. The dividend was paid in April 2015. ABC has recognised the preference shares at par under long-term borrowings, and has included the dividend paid as part of finance costs in the statement of comprehensive income and profit or loss.

Discuss the financial reporting treatment in the financial statement for the year ended 31 March 2015 for the issues above. Where possible, your answers should quantify the effects on the financial statements.

Suggested approach.

In any case study question students should read the question thoroughly (annotate the paper as the read it through) and, bearing in mind the requirements of the question, identify any relevant accounting standards issues and issues (financial reporting/ethical/current) that need to be addressed. In essence, students need to deconstruct the case, reflect on the key issues and then being to write. In terms of the requirements students should ask themselves:

- What are the requirements?
- Is there a need to provide advice in a particular context (e.g. meeting with the board of directors)?
- Is a certain format required such as briefing notes, report or memorandum?
- Apart from numerical aspects, are there other wider issues that need to be addressed?
- What is the weighting of each part of the question?

Consider depth when writing answers. This is where understanding and added value can be demonstrated.

Issue 1
There are a number of financial reporting issues that need addressed.

Non-current asset – measurement (IAS16)
Investment property – measurement (IAS40)
Government grants – recognition (IAS20)

Both IAS16 and IAS40 permit cost and fair value models (i.e. choice)

Impacts on financial statements for future years (Statement of Profit or Loss and Other Comprehensive Income (SPLOCI), Statement of Financial Position (SFP) and Statement of Cash Flow).

- Retail outlet – increased depreciation, increased asset carrying amounts (and capital employed)
- Office building – volatility, difficult to predict, increases and decreases taken to profit or loss.

Financial ratios affected:
- Retail outlet – lower EPS, gearing and return on capital employed (ROCE)
- Office building – uncertain due to year on year movements.

What are the financial reporting issues?
- Retail outlet – voluntary change of accounting policy if move to fair value
- Office building – subsequent changes to policy difficult.

Ethical issues?
- Influence and dominance by managing director

Other considerations?
- Costs of revaluations and keeping asset values updated
- View of lenders.
- Move towards fair value accounting (IFRS13).

(i)
The 2015 accounting policy describes the accounting treatment for the retail outlet as a non-current asset using the cost model. If that model is continued, then the fair value at 31 March 2015 is irrelevant as it is greater than cost and there would not be any impairment under IAS36.

IAS16, *Property Plant and Equipment* allows property, plant and equipment (PPE) to be measured at fair value where it can be measured reliably. All assets of same class should be revalued if one is revalued. The retail outlet appears to be the only property classified under IAS16.

IAS8 *Accounting Polices, Changes in Accounting Estimates and Errors,* requires the initial application of a policy to revalue assets in accordance with IAS16 as a change in accounting policy to be dealt with as a revaluation under the standard. In effect, it does not permit retrospective application.

If the revaluation is implanted on 31 March 2015, the depreciation expense will be the same as if the new policy had not been adopted. The reduction in useful life is a change in accounting estimate which must be applied prospectively from 1 April 2015.

	Cost model	*Revaluation Model*
	€	€
SPLOCI		
Depreciation (20m-2m)/40	450,000	450,000
SFP		
Freehold land and buildings (20m less 4 years x 0.45)	18,200,000	24,000,000
Equity		
Revaluation surplus (24m -18.2m)	-	5,800,000

(ii)

The office building was acquired with the view to earning rental income and meets the definition of an investment property to be accounted for in accordance with IAS40 *Investment Property.*

ABC has not previously owned any investment property. The introduction of a new accounting policy is not regarded as a change of policy by IAS8 because it is the application of a policy to a new transaction. Regardless of the policy adopted, the property should be measured on initial recognition at cost of €8m. The subsequent measurement is a choice between cost and fair value model. If the cost policy is adopted, the IAS40 requires the property to be measured in accordance with IAS16. The property should be stated at cost less depreciation and impairment losses. If the fair value policy is adopted, then the property should be measured at fair value. Any movement in fair value should, of course, be recognised in the SPLOCI.

The accounting policy for government grants is consistent with the grants related to assets outlined in IAS20 *Accounting for Governemnt Grants and Disclosure of Government Assistance.* However, the grant should be recognised over the three-year period of rent reduction. This matches it with the reduced income that it is intended to compensate.

	Cost model	*Revaluation Model*
	€	€
SPLOCI		
Depreciation (8m-1m)/35 x 6/12	100,000	-
Increase in fair value of investment property income		500,000
Other income (0.6/3 x 6/12)	100,000	100,000
SFP		
Investment property (Cost model 8m-0.1m)	7,900,000	8,500,000
Current liabilities : Government grants	(200,000)	(200,000)
Non-current liabilities; Government grants	(300,000)	(300,000)

In general, management are restricted in relation to the accounting policies that they adopt. They must comply with IFRS and can only exercise judgement where IFRSs provide a choice. The adoption of revaluation model for PPE is a voluntary change in accounting policy and can only be made if it results in more reliable and relevant information for users. The key considerations are whether fair values are available and the information is more relevant to users. Such considerations are not required for the investment property, as the company has not previously had an accounting policy. However, it would be appropriate for Paul to consider users and their information needs. IAS40 does not prefer either model explicitly. The directors may wish to place the financial position and performance in the best possible light. A change in accounting policy could help this if it enhances profitability and reduces gearing. Non-financially qualified directors may consider that such polices may be more relevant. CPA qualified managers, however, should ensure that policies are only changed where the qualitative evaluative criteria in IAS8 are met. They may have to argue that an accounting policy change is not appropriate and stand by their professional judgement.

Issue 2

ABC has not yet fitted the smoke detectors in its factories as required by legislation which came into force on 1 January 2014. Although the company plans to start the installation in May 2015, companies in similar situations have been fined for non-compliance. The year-end provision should be based on the lawyers' best estimate of such a fine (€45,000). There is no obligating event under IAS37 to provide for the costs of fitting smoke detectors.

Issue 3

The issue to be decided here is whether the preference shares constitute a liability under IAS32 *Financial Instruments: Presentation*. There appears to be no obligation on the part of ABC to redeem the shares, nor is the payment of a dividend obligatory. Both of these conditions would suggest that the financial instrument is not a liability. Although the shares have no voting rights, their correct classification would appear to be equity. €1 million should therefore be transferred from liabilities to equity in the statement of financial position. The payment of dividend (1million x 0.5cents = €5,000) should be deducted from finance costs in the SPLOCI, as this treatment is incorrect. Instead, it should be recognised as a transaction with owners in the statement of changes in equity.

Finally, the chief executive and Paul are related parties of ABC, the reporting entity, because they are part of the management team. Disclosure of this transaction is required in accordance with IAS24 *Related Party Disclosures.*