Diploma in International Financial Reporting and Auditing

MONDAY 10 DECEMBER 2001

QUESTION PAPER

Time allowed **3 hours**

This paper is divided into four sections

Section A	BOTH questions are compulsory and MUST be answered
Section B	ONE question ONLY to be answered
Section C	This ONE question is compulsory and MUST be answered
Section D	ONE question ONLY to be answered

Section A – BOTH questions are compulsory and MUST be attempted.

1 Humbug acquired 80% of Spyder's $1 ordinary shares on 1 October 1999 paying $2·50 per share and acquired half of its 10% loan notes at par on the same date. The balance on Spyder's accumulated profits at the date of its acquisition was $750,000. One year later, on 1 October 2000, Humbug acquired 50% of Juke Box's $1 ordinary shares for $3·00 per share. Juke Box specialises in the manufacture of musical equipment and was previously a wholly owned subsidiary of Music Man. From the date of Humbug's investment, Juke Box was managed as a joint venture by its two shareholders.

The balance sheets of the three companies at 30 September 2001 are shown below:

	Humbug		Spyder		Juke Box	
Non-current assets	$000	$000	$000	$000	$000	$000
Property, plant and equipment		11,250		4,800		1,800
Investments		6,000		400		nil
		17,250		5,200		1,800
Current assets						
Inventory	1,120		640		600	
Accounts receivable	950		380		320	
Bank	180	2,250	nil	1,020	280	1,200
Total assets		19,500		6,220		3,000
Equity and liabilities						
Capital and reserves:						
Ordinary shares of $1 each		5,000		2,000		1,000
Reserves:						
Accumulated profits b/f	11,140		1,500		1,000	
Profit – year to 30 September 2001	1,500	12,640	900	2,400	500	1,500
		17,640		4,400		2,500
Non-current liabilities						
10% Loan notes		nil		500		nil
Current liabilities						
Accounts payable	1,300		850		400	
Taxation	560		350		100	
Overdraft	nil	1,860	120	1,320	nil	500
Total equity and liabilities		19,500		6,220		3,000

The following information is relevant:

(i) Fair value adjustments:

At the date of acquisition, 1 October 1999, Spyder owned an item of plant that had a fair value of $700,000 in excess of its book value. The plant had a remaining life of five years. All plant and equipment is depreciated on the straight-line basis.

At the same date Spyder also owned the copyright to the software of a computer game. The software had been fully written off, but sales of the game remain high. At the date of acquisition, Humbug expected strong sales of the game for a further three years and estimated the commercial value of the software to be $300,000. Humbug's expectations have not changed since acquisition.

The fair value of Spyder's remaining net assets and all of Juke Box's net assets were equal to their book values at the relevant dates of acquisition.

Humbug uses the **benchmark treatment** in IAS 22 'Business Combinations' to allocate the cost of acquisition.

(ii) On 1 October 2000 Humbug purchased some musical equipment from Juke Box for $200,000. It was sold at a mark up of 25% on cost. The equipment is in use by Humbug and is included in property plant and equipment and being depreciated over a four-year life.

(iii) All inter company current account balances were settled prior to the year-end.

(iv) The group accounting policy for goodwill is to write it off on a straight-line basis over a period of five years.

(v) Juke Box is to be treated under the **benchmark treatment** for jointly controlled entities in IAS 31 'Financial Reporting of Interests in Joint Ventures'. Humbug uses a 'line-by-line' presentation.

Required:

(a) Prepare the consolidated balance sheet of Humbug as at 30 September 2001. (20 marks)

(b) Explain, with illustrations, the relevant features and accounting treatment of jointly controlled operations and jointly controlled assets in IAS 31. (5 marks)

(25 marks)

2 The summarised draft financial statements of Vitalise to 30 September 2001 are shown below.

Vitalise Income Statement year to 30 September 2001:

	$000
Sales revenue	3,900
Cost of sales	(2,500)
Gross profit	1,400
Operating costs	(250)
	1,150
Finance costs	(65)
Profit before tax	1,085
Taxation	(260)
Profit after tax	825
Extraordinary items	(210)
Net profit for the period	615

Balance Sheet as at 30 September 2001:

Assets	**$000**	**$000**
Non-current		
Property, plant and equipment		3,810
Investment property		390
		4,200
Current assets		1,200
Total assets		5,400
Equity and liabilities		
Capital and reserves		
Ordinary shares of $1 each		1,000
Reserves:		
Revaluation reserve (note (iii))	250	
Accumulated profits (note (vi))	1,850	2,100
		3,100
Non-current liabilities		
8% Convertible Loan Note (2004)		500
Current liabilities		1,800
Total equity and liabilities		5,400

The following information is relevant to the draft financial statements:

(i) Sales and re-purchase agreement:

Sales revenues include an amount of $250,000 for the sale of maturing goods to Easyfinance. The sale was made on 1 October 2000 and the goods had a cost of $100,000 at the date of sale. Vitalise has an option to repurchase the goods at anytime within the next five years. The repurchase price will be the original selling price plus interest at 10% per annum compounded annually. The above transaction has been treated as a normal sale by Vitalise.

(ii) Extraordinary item:

This is the cost ($300,000 less tax relief of $90,000) of a failed take over bid for Dunsters. A rival company of Vitalise eventually acquired Dunsters. As the cost of the attempted acquisition will never recur, it has been treated as an extraordinary item.

(iii) Property, plant and equipment:

Property, plant and equipment contains an amount of $750,000 (FRF 3 million at an exchange rate of 4 to the $) for the purchase of a light aircraft on 1 July 2001. The aircraft was purchased from a company located in France and the purchase price of FRF3 million is payable in French francs on 1 November 2001.The following exchange rates applied:

1 July 2001	FRF 6 to	$1
30 September 2001	FRF 4 to	$1

This is the only foreign currency transaction that Vitalise has entered into and the company chose not to use any form of hedging. Ignore depreciation on the aircraft.

Properties:

Vitalise owns two properties. One is used as the company's head office and is included in property, plant and equipment and the other is an investment property that is leased to a third party on a five-year operating lease. Vitalise's policy has been to revalue both properties each year and transfer the movements on them to a revaluation reserve. Relevant details of the cost and fair values of the properties are:

	Head Office	**Investment property**
	$	**$**
Cost	300,000	250,000
Valuation 30 September 2000	410,000	390,000
Valuation 30 September 2001	375,000	350,000

The valuations at the 30 September 2001 have not yet been incorporated into the financial statements. The management of Vitalise have become aware of the issue of IAS 40 'Investment Property' and wish to apply the fair value model to its investment property for the current reporting period. Ignore depreciation.

(iv) 8% Convertible Loan Note

On 1 October 2000 a convertible loan note with a nominal value of $500,000 was issued at par. It is redeemable on 30 September 2004 also at par, or it may be converted (at the option of the holder) into ordinary shares of Vitalise on the basis of 100 new shares for each $100 of loan note. An equivalent loan note without the conversion option would have carried a coupon rate of 12%. Interest of $40,000 has been paid and charged as a finance cost.

The present value of $1 receivable at the end of each year, based on discount rates of 8% and 12% should be taken as:

	8%	**12%**
End of year 1	0·93	0·88
2	0·86	0·78
3	0·79	0·70
4	0·73	0·64

(v) Bonus issue:

On 30 October 2001 (i.e. one month after the year-end), Vitalise made a bonus issue of one share for every five held. The company's financial statements had not been finalised by this date.

(vi) The balance of the accumulated profit is made up of:

	$000
balance b/f 1 October 2000	1,500
profit for the period	615
dividends paid	(265)
	1,850

Required:

(a) Redraft the financial statements, including a statement of changes in equity, of Vitalise for the year to 30 September 2001 to comply with relevant International Accounting Standards in relation to items (i) to (v) above. (20 marks)
Note: ignore taxation on all of the above items other than item (ii).

(b) Calculate the basic and diluted Earnings Per Share for Vitalise in accordance with IAS 33.
Note: assume only the actual loan interest paid is allowable as a tax deductible expense and the bonus issue does not affect the terms of the 8% convertible loan note. Ignore deferred tax. (5 marks)

(25 marks)

Section B – ONE question ONLY to be attempted

3 IAS 35 'Discontinuing Operations' was approved by the IASC in April 1998 and published in June 1998. It is mainly a presentation and disclosure standard that expands on the requirements of IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies'. The IAS contains detailed requirements relating to discontinued operations. Many commentators feel that these requirements were prompted by a previous lack of a definition of such operations and inconsistencies in their accounting treatment including the timing of their recognition.

Required:

(a) (i) Define a Discontinuing Operation and comment on the defining criteria; (4 marks)

(ii) Describe how users of financial statements benefit from information relating to discontinuing operations; and summarise the main disclosures required in respect of discontinuing operations. (5 marks)

(b) (i) Sandown is a diversified public company. It has three main operating divisions: a chain of restaurants, a car rental agency, and the sale of computer equipment through an Internet website. In March 2001 the Board of Sandown held a meeting to consider the deteriorating performance of its Internet selling activities. The decision of the Board was that the continued losses could no longer be tolerated and the website would be closed down on 31 December 2001. In June 2001 a detailed closure plan was formulated, staff redundancy notices were issued, advertising and promotion of the website ceased and various notices to terminate contracts with service suppliers were issued.

Relevant details of Sandown's turnover and profit before taxation are:

Year to 30 September:	2001	2000
	$ million	$ million
Turnover	1,000	900
Cost of sales	(650)	(600)
Gross profit	350	300
Other operating expenses	(220)	(150)
Profit before tax	130	150

The following analysis of the Internet website operation has been obtained:

Year to 30 September:	2001	2000
	$ million	$ million
Turnover	80	50
Cost of sales	(50)	(70)
Gross profit	30	(20)
Other operating expenses	(140)	(30)
Profit (loss) before tax	(110)	(50)

Required:

Prepare an analysis of the income statement into continuing and discontinuing operations as required by IAS 35 for Sandown for the year to 30 September 2001 including the comparative figures for 2000. (4 marks)

(ii) The 'other operating expenses' of the website for the year to 30 September 2001 were calculated as:

		$ million
Operating costs incurred		50
Provision for closure costs:		
Penalties on termination of contracts	15	
Staff redundancy costs	10	
Retraining of retained staff	12	
Estimated losses on sale of net assets of the Internet site	25	
Estimated operating losses to date of closure (31 December 2001)	28	90
		140

Required:

Comment on the calculation of the closure costs of the website. (2 marks)

Do not amend your answer to part (i) as a result of your comments in part (ii). Ignore taxation.

(15 marks)

4 **(a)** IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' was issued in July 1998 and became effective for accounting periods from 1 July 1999 onwards. The Standard's main objective is to specify when provisions should, and should not be made. Prior to its introduction there had been widespread inconsistencies in the use, and some would say, the abuse of provisioning.

Required:

Describe the circumstances where a provision should, and should not be made. Give two examples of the previous abuse of provisioning, and explain how the requirements of IAS 37 are intended to prevent them occurring in the future. (8 marks)

(b) Stonemaster has recently acquired a ten-year licence to mine stone from land that it owns. Stonemaster has constructed some temporary buildings on the site and transferred some heavy plant to be used in the quarrying. A condition of the licence is that at the end of quarrying Stonemaster has to remove the building and plant and restore the land to an environmentally satisfactory condition through a landscaping scheme. Due to the weight of the vehicles that will be used to transport the stone, Stonemaster expects to have to pay various amounts of compensation on an annual basis for damage done to public roadways.

Required:

Describe how, if at all, Stonemaster should provide for the above restoration costs and roadway damage. Explain how your answer might differ if the government attached no conditions to the granting of the licence. (7 marks)

(15 marks)

Section C – This ONE question is compulsory and MUST be attempted

5 **(a)** ISA 400 'Risk Assessments and Internal Control' requires auditors to perform an assessment of the risk of material misstatement in the financial statements of an entity as part of the planning process.

Your firm has recently been appointed as auditor to Vostok, a 'dot.com' company listed on a stock exchange. This is your first year as the company's auditors. The company provides a variety of Internet-based auction services to subscribers and its main revenue comes from commission taken from vendors based on the price obtained for the goods or services sold. A significant source of other income is from the sale of advertising space on the web-site. Some of this advertising revenue is in cash, other revenue is in the form of barter transactions in which advertising for other companies on Vostok's web-site is traded for advertising for Vostok on other companies' web-sites.

The company has been financed partly by venture capital and partly by equity and bank loans. The venture capital raised was partly on the basis of non-traditional performance measures such as the projected number of 'hits' on the web-site (the number of visitors), the conversion rate (the ratio of subscribers to transactions), and the average value per transaction. A large part of the remuneration of the company's directors and employees is in the form of share options.

The company has very few assets and the balance sheet shows net liabilities. Like many 'dot.com' companies, the financial returns have been below expectations and the company, which has been in existence for four years, has still not made a profit. The company experienced a rapid increase in its share price during the first three years of its existence that was followed by sharp decline in the share price in the current year. One effect of this is that several key employees have left the company as their share options are now of little value.

The company is now seeking to restructure its financing with its venture capitalists and bankers who will shortly require profit and cash flow projections. Two directors have significant shareholdings and have resigned from the Board of the company and are in negotiation with the other directors for the sale of their shares.

The previous auditors issued an unmodified audit report on the financial statements in the previous year. Your investigations indicate that financial controls and internal controls are weak.

Required:

(i) **On the basis of the information given above, explain your assessment of the risk of material misstatement in the financial statements of Vostok;** (10 marks)

(ii) **Describe the different types of audit report that can be issued when there is uncertainty as to the going concern status of a company.** (5 marks)

(b) Directors of companies sometimes threaten to 'dismiss' their auditors if the auditors issue an audit report that makes reference to uncertainty over the going concern status of the company.

Required:

Describe the problems faced by auditors when they believe that a reference to the going concern status of a company should be made in their report but where directors strongly oppose such a reference. (5 marks)

(20 marks)

Section D – ONE question ONLY to be attempted

6 The objective of quality control for auditors is to ensure that audits are conducted in accordance with auditing standards, relevant national standards, and the firm's own standards, if any. ISA 220 'Quality Control for Audit Work' requires that quality control policies and procedures be implemented at the level of the audit firm, and at the level of individual audits.

Required:

(a) Describe the main quality control policies and procedures that can be applied in a firm of auditors that has seven offices and 150 employees at:

(i) the level of the audit firm; (7 marks)

(ii) the level of the individual audit. (4 marks)

(b) Explain how a firm can attempt to ensure that commercial pressures do not take precedence over the requirements of quality control. (4 marks)

(15 marks)

7 ISA 500 'Audit Evidence' requires that auditors obtain sufficient appropriate evidence in relation to financial statement assertions such as existence, rights and obligations, occurrence, completeness, valuation, measurement, and presentation and disclosure.

There are a variety of ways of collecting evidence in relation to these assertions and the methods vary depending on the account balance or transactions examined.

Required:

(a) In relation to receivables:

(i) explain the difference between a positive direct confirmation and a negative direct confirmation;

(ii) explain the main advantages of obtaining evidence by direct confirmation. (7 marks)

(b) Describe the work that can be performed to provide evidence in relation to receivables and bad debt provisions in the balance sheet (other than direct confirmation). (5 marks)

(c) Briefly describe and explain the detailed substantive tests that can be performed on the transactions and entries in the accounting records from which the receivables figure in the balance sheet is derived. (3 marks)

(15 marks)

End of Question Paper