Diploma in International Financial Reporting and Auditing

MONDAY 9 DECEMBER 2002

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

This is a blank page.
The question paper begins on page 3.

Section A – BOTH questions are compulsory and MUST be attempted

1 Hyper acquired 80% of Syphon's ordinary shares on 1 April 2002 at a cost of $8·70 per share. On the same date it also acquired 40% of Andean's ordinary shares at a cost of $6 per share. Both Hyper's and Andean's reporting year-end is 30 September. Prior to its acquisition Syphon had last reported for the year ended 30 June 2001. The following income statements of the three companies have been drafted:

	Hyper 12 months to 30 September 2002 $ million	Syphon 15 months to 30 September 2002 $ million	Andean 12 months to 30 September 2002 $ million
Sales revenue	420	375	150
Cost of sales	(320)	(190)	(90)
Gross profit	100	185	60
Operating expenses	(40)	(30)	(10)
Interest payable	(12)	(10)	(2)
Dividend from Syphon	8	nil	nil
Profit before tax	56	145	48
Income tax	(20)	(35)	(12)
Profit after tax	36	110	36

The share capital and reserves of Syphon and Andean at 30 September 2002 were:

Syphon	$ million	$ million	Andean	$ million	$ million
Ordinary shares of $1 each		30	Ordinary shares of $1 each		20
Reserves:					
Accumulated profits:			Accumulated profits:		
at 30 June 2001	40		at 30 September 2001	14	
15 months to 30 September 2002	110		year to 30 September 2002	36	
Dividends paid (for 15 month period)	(10)	140	Dividends paid	nil	50
Revaluation reserve (note (ii))		20	Revaluation reserve		nil
		190			70

The following information is relevant:

(i) In May 2002 Hyper sold $20 million of goods to Syphon at a mark up on cost of 25%. Half of these goods had been processed and resold by Syphon by 30 September 2002.

(ii) The revaluation reserve of Syphon relates to a plot of land carried at its fair value on 30 June 2001. At the date of acquisition its fair value had increased by a further $5 million.

(iii) At the date of acquisition, the fair value of Andean's plant was $18 million in excess of its book value and it had a remaining life of three years. Plant depreciation is charged to cost of sales.

(iv) Assume that all income statement items accrue evenly throughout the period.

(v) Goodwill is to be amortised on a straight-line basis over a five-year life using time apportionment in the year of acquisition.

(vi) Dividends are deemed to accrue evenly on a time basis. Hyper treats any dividends paid out of pre-acquisition profits as a partial return of the cost of the investment.

Required:

(a) Calculate the consolidated goodwill in respect of the acquisition of Syphon and Andean. (9 marks)

(b) Prepare the consolidated income statement of Hyper for the year to 30 September 2002. (13 marks)

(c) Calculate the carrying value of the investment in Andean at 30 September 2002. (3 marks)

(25 marks)

2 The following list of account balances relates to Vincible at 30 September 2002:

		$000	$000
Sales revenue			473,300
Purchases		310,500	
Operating expenses		18,400	
Loan stock interest		5,000	
Dividends paid		15,500	
Leasehold building at cost (note (ii))		200,000	
Plant and equipment at cost (note (ii))		124,800	
Deferred development expenditure (note (iii))		75,000	
Joint venture (note (iv))		62,000	
Depreciation at 1 October 2001	– leasehold		56,000
	– plant and equipment		48,800
	– development expenditure		15,000
Trade receivables		49,200	
Inventory – 1 October 2001		27,500	
Bank		12,100	
Trade payables			82,200
Ordinary shares of 25 cents each			100,000
10% Convertible loan stock – issued 2000 (note (vi))			100,000
Deferred tax at 1 October 2001 (note (v))			11,400
Profit and loss reserve at 1 October 2001			13,300
		900,000	900,000

The following notes are relevant:

(i) The cost of the inventory at 30 September 2002 was $37·7 million (excluding joint venture inventory – see note (iv)).

(ii) Non-current assets:
On 1 October 2001 Vincible's leasehold building was revalued at $270 million by an independent surveyor. The lease was for a 25-year period when Vincible acquired it. The directors wish to incorporate the revalued amount in Vincible's financial statements. The revaluation reserve will be deemed to be realised in line with the remaining life of the lease.
Plant is depreciated at 20% per annum on the reducing balance basis.
All depreciation is charged to cost of sales.

(iii) The deferred development expenditure relates to a new product. The project was successfully completed on 1 October 2000 and sales of the new product commenced on that date. The development costs are being depreciated on a straight-line basis over the expected product life of five years. Early in the current year, a review of the sales figures for the new product showed that they were disappointing. In view of this Vincible has estimated that the present value of the expected net future cash flows from sales of the new product is $30 million, however Vincible has been approached by a rival company with an offer of $40 million for the rights to the product. At this stage Vincible intends to continue to market and sell the product.

(iv) On 1 October 2001 Vincible entered into a joint venture with two other companies. Each venturer contributes their own assets and pays their own expenses. The agreement stipulates that the joint venture will be terminated on 30 September 2005. Vincible is entitled to 30% of the joint venture's total revenues. The joint venture is not a separate entity.

Details of Vincible's joint venture transactions are:	$000
Plant and equipment at cost	70,000
Share of joint venture sales revenues (30% of total sales revenues)	(18,000)
Related cost of sales excluding depreciation	8,000
Inventory 30 September 2002	2,500
Accounts receivable 30 September 2002	3,500
Accounts payable 30 September 2002	(4,000)
Net balance included in the above list of balances	62,000

Plant should be depreciated on a straight-line basis. It is not expected to have any residual value at the end of the joint venture.

(v) The directors have estimated the required provision for income tax for the year to 30 September 2002 is \$15 million. The deferred tax provision at 30 September 2002 is to be adjusted to reflect the tax base of the company's assets being \$70 million less than their carrying values. \$28·8 million of this \$70 million is attributable to the revaluation of the leasehold. Vincible's rate of income tax is 25%.

(vi) The convertible loan stock is redeemable at par on 31 March 2004, or at the option of the stockholders, it can be exchanged for ordinary shares on the basis of 60 new shares in Vincible for each \$100 of loan stock.

(vii) In June 2000 the directors and senior staff of Vincible were given options to purchase 50 million ordinary shares (in total) in the company. The options are exercisable on 1 July 2004 at a price of \$2·40 per share. The stock market price of Vincible's ordinary shares over the current year has been \$4·00.

(viii) The directors have proposed a final ordinary dividend of 6 cents per share. Vincible discloses proposed dividends as part of shareholders' funds.

Required:

Prepare for Vincible in accordance with International Accounting Standards as far as the information permits:

(a) (i) the Income Statement; and (7 marks)
(ii) the Statement of Changes in Equity for the year to 30 September 2002; and (4 marks)
(iii) a Balance Sheet as at 30 September 2002 (10 marks)

Notes to the financial statements are not required.

(b) Calculate the basic and diluted earnings per share for Vincible for the year to 30 September 2002. (4 marks)

(25 marks)

Section B – ONE question ONLY to be attempted

3 Petroplant is a large company whose activity is the construction of oil refineries. Petroplant prepares its financial statements to 30 September each year. On 1 April 2000 it was successful in securing a contract to construct an oil refinery for Oiltex.

The contract is scheduled for completion on 30 June 2002.The contract contains a completion clause whereby if the contract is completed within one month of the scheduled date, the agreed price of $1,500 million will be paid. However, if completion is more than one calendar month ahead of schedule then an incentive of 2% of the agreed price is payable by Oiltex. Conversely if the contract is more than one month late then Oiltex will deduct a penalty on equivalent terms to the incentive.

In addition to the completion clause, the contract contains a cost escalation clause whereby a 3% increase in the contract price will be paid if labour costs rise by more than 10% from the start of the contract (as measured by a Government index). This occurred in May 2002.

During the construction of the oil refining plant the price of crude oil increased dramatically and Oiltex negotiated a variation to the design and construction of the plant such that it would be suitable to produce petrol from coal instead of crude oil. Oiltex agreed a price of a further $200 million for the variation. Petroplant estimated the cost of adapting the plant would be $120 million. The incentive/penalty clause does not apply to the variation nor does the labour escalation clause. No adjustment was made to the scheduled completion date as a result of the variation.

The following details relate to the progress of the contract. All estimates are at the end of the relevant year and can be taken as being reliable.

Year to 30 September	2000	2001	2002
	$ million	$million	$ million
Estimated total cost (original contract)	1,200	1,230	
Actual costs to date (original contract)	300	740	1,265
Estimated variation costs		120	
Actual variation cost to date		70	115
Estimated date of completion	on time	6 weeks early	completed 10 August 2002
Agreed value of work completed			
– original contract	330	800	1,250
– variation		60	150
Cumulative progress billings received	280	1,100	paid in full

Petroplant determines the stage of completion of its contracts by the proportion that the cost incurred to date bears to the total estimated contract costs. Contract revenues should include the appropriate proportion of cost escalations and incentives/penalties from the time they are reasonably foreseeable. The variation is considered to be part of the original contract (from the date it was agreed), and not a separate contract.

No profit is recognised on contracts until they are at least 20% complete.

Required:

(a) Prepare extracts of the Income Statement and Balance Sheet of Petroplant for the years to 30 September 2000, 2001, and 2002 in respect of the above contract. (12 marks)

(b) Discuss the matters to be considered in determining whether a contract variation should be considered part of the same contract or as a different contract. (3 marks)

Note: Your answer should refer to IAS 11 'Construction Contracts'. Do not amend your answer to part (a) in respect of this discussion.

(15 marks)

4 Shown below are the summarised financial statements of Sundown for the year to 30 September 2002, together with a comparative balance sheet:

Income statement	$ million
Sales revenue	662
Cost of sales	(396)
Gross profit	266
Operating expenses	(124)
Profit from operations	142
Interest payable	(6)
	136
Income tax	(48)
Profit for the period	88

Balance Sheet as at:	30 September 2002:			30 September 2001:		
	$ million	$ million	$ million	$ million	$ million	$ million
Assets	Cost/valuation	Depreciation	NBV	Cost/valuation	Depreciation	NBV
Non-current assets						
Property, plant and equipment	650	155	495	615	160	455
Current assets						
Inventory		86			72	
Trade accounts receivable		74			41	
Insurance claim		15			nil	
Bank		nil	175		12	125
Total assets			670			580
Total Equity and Liabilities						
Capital and reserves:						
Ordinary shares of $1 each			120			100
Reserves:						
Share premium		38			30	
Revaluation reserve		40			15	
Accumulated profits		294	372		256	301
			492			401
Non-current liabilities						
Deferred tax		21			32	
10% Redeemable Preference shares		30	51		50	82
Current liabilities						
Trade accounts payable		74			65	
Provision for income tax		40			32	
Overdraft		13	127		nil	97
Total equity and liabilities			670			580

The following information is relevant:

(i) Non-current assets
Depreciation of property, plant and equipment during the year was $45 million included in cost of sales. During the year plant with a carrying value of $60 million was sold for $48 million. The loss was included in cost of sales.

(ii) Share capital

During the year some preference shares were redeemed at a premium of 10%. The company operates in a country where premiums on redemption of shares can be charged to an available share premium account. Sundown has taken advantage of this allowance. There was no issue of preference shares during the year. The increase in the ordinary share capital during the year was due to a cash issue.

(iii) Revaluation reserve:

The revaluation reserve was increased during the year by the surplus on the revaluation of the company's head office. A transfer of $4 million was made from the revaluation reserve to accumulated realised profits representing the realisation of previous surpluses.

(iv) Ordinary dividends

The ordinary dividends paid during the year are part of the movement on the accumulated profits.

(v) Insurance claim:

On 1 March 2002 an employee of Sundown suffered a serious accident. Sundown accepted responsibility for the accident and paid compensation of $18 million to the employee and his family. The company is partly insured against such liabilities and has agreed with the insurance company a settlement figure of $15 million (payable to Sundown). Sundown has accounted for the net cost of the claim as part of its operating expenses. It has not yet received the settlement from the insurance company, but it has recognised the $15 million receivable.

Required:

(a) Prepare a Cash Flow Statement for Sundown for the year to 30 September 2002 in accordance with IAS 7 'Cash Flow Statements'. (11 marks)

(b) IAS 7 encourages companies to disclose additional information on operating capacity cash flows (included as investing activities) and segment activity cash flows.

Required:

Briefly describe these additional disclosures and how they may be of use to users of financial statements. (4 marks)

(15 marks)

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

5 It has been suggested that external auditors should not be permitted to provide additional services to their audit clients under any circumstances, or that there should be greater limitations on the provision of these services. The rules relating to services that can be provided by external auditors vary from country to country. Some countries permit external auditors to provide the following services to their audit clients, others do not:

(i) internal audit;
(ii) accountancy and bookkeeping services;
(iii) legal services;
(iv) systems advisory and implementation services.

It is also suggested that the external auditors of companies listed on stock exchanges should be rotated periodically to avoid an overly familiar relationship between auditor and client.

Required:

(a) (i) Outline the requirements of ACCA's *Rules of Professional Conduct* and IFAC's *Code of Ethics for Professional Accountants* relating to the services noted above; (4 marks)

(ii) For each of items (i) to (iv) above, discuss whether there should be a total ban, or greater limitations, on the provision of the service by external auditors. (12 marks)

(b) Comment on the compulsory rotation of senior audit staff, and external audit firms, for companies listed on stock exchanges. (4 marks)

(20 marks)

Section D – ONE question ONLY to be attempted

6 The audit of accounting estimates is often problematic. Many estimates are material to the financial statements and involve the application of a high degree of subjective judgement. It is important that accounting estimates are adequately disclosed in the financial statements. There have been a number of cases in which auditors were accused of issuing unmodified reports on financial statements with inadequate disclosure of such estimates.

ISA 540 *Audit of Accounting Estimates* states that the determination of an accounting estimate may be simple or complex, depending on the nature of the item.

Required:

(a) Give examples of accounting estimates and explain why they are important to the financial statement audit. (4 marks)

(b) Describe the approach to the audit of accounting estimates and explain the problems in applying the approach. (7 marks)

(c) Describe the extent to which auditors may seek to rely on management representations during the course of their audit of accounting estimates in accordance with ISA 580 *Management Representations*. (4 marks)

(15 marks)

7 You are conducting a test of authorisation controls on a sample of large credit notes taken from your client's receivables ledger. Of the ten credit notes you selected, four have been properly authorised. When you enquire as to why the others were not properly authorised, the credit controller explains to you that in two cases, controls were not applied because the credit notes were issued in a period after the previous credit controller had resigned, but before the new controller was appointed. In two further cases the credit controller had given verbal authorisation, but because she was new to the job no record of the authorisation had been made. In one further case authorisation had not been made at all because of the confusion that arose during a computer breakdown.

ISA 500 *Audit Evidence* states that when auditors obtain evidence from tests of control, they should consider the sufficiency and appropriateness of the audit evidence to support the assessed level of control risk.

Required:

(a) How should you, the external auditor, respond to these explanations? (10 marks)

(b) Explain the limitations of, and suggest alternatives to, this type of test for obtaining evidence on the operation of internal controls. (5 marks)

(15 marks)

End of Question Paper