Diploma in International Financial Reporting and Auditing

MONDAY 17 JUNE 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

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

1 (a) Holding acquired 75% of Sandham's equity shares on 1 April 2001 when the accumulated retained profits of Sandham were $4 million. The draft balance sheets of the two companies at 31 March 2002 are:

	Holding		Sandham	
	$000	$000	$000	$000
Assets				
Non-current assets				
Property, plant and equipment		12,000		12,200
Investment property		6,000		nil
Investment in Sandham		8,850		nil
		26,850		12,200
Current assets				
Inventories	7,800		3,450	
Trade receivables	3,600		2,300	
Cash and bank	150	11,550	nil	5,750
Total assets		38,400		17,950
Equity and Liabilities				
Capital and reserves				
Equity shares 25 cents each		5,000		2,000
Accumulated profits		27,150		5,000
		32,150		7,000
Non-current liabilities				
12% Loan note, 2005		nil		6,000
Current liabilities				
Trade payables	6,250		3,700	
Operating overdraft	nil	6,250	1,250	4,950
Total Equity and Liabilities		38,400		17,950

The following information is relevant:

(i) The 12% loan note of Sandham is repayable at par on 31 March 2005. The loan carries a fixed interest rate and cannot be redeemed without severe penalties. Since the loan was taken out interest rates have fallen significantly. Because of this, Holding has estimated that the fair value of the liability for the loan at the date of acquisition was $6·6 million. Based on this liability the interest charge for the year to 31 March 2002 in Sandham's income statement was overstated by $200,000.

The fair value of Sandham's plant and equipment was $4 million in excess of its carrying value at the date of acquisition. It had a remaining estimated life of four years. Plant is depreciated on a straight-line basis. The fair values of Sandham's other net assets approximated to their carrying values.

(ii) The investment property of Holding was acquired at a cost of $5 million on 1 April 1999. It had an estimated life of 20 years. Until the acquisition of Sandham the property had been let to a third party, however, from the date of acquisition it was let to Sandham on commercial terms. In its entity financial statements Holding has applied the fair value model in IAS 40 'Investment Properties'. The group policy for owner occupied properties is to carry them at depreciated cost.

Details of the movement in the fair value of the property are:

At 31 March 2000 5·2 million
At 31 March 2001 5·4 million
At 31 March 2002 6·0 million

(iii) During the year to 31 March 2002, Holding sold goods to Sandham for \$3 million at a mark up on cost of 20%. Sandham had half of these goods in its inventory at 31 March 2002. The reconciled intercompany current account balances at the year-end showed Sandham owing \$700,000 to Holding. Intercompany balances are included in trade payables and receivables as appropriate.

(iv) Consolidated goodwill is written off on a straight-line basis over a six-year life.

Required:

Prepare the consolidated balance sheet of Holding at 31 March 2002 using the allowed alternative treatment for the allocation of the purchase consideration in IAS 22 'Business combinations'.

Ignore taxation. (20 marks)

(b) Shortly before the year-end of 31 March 2002, the board of Holding discovered a report that had been commissioned by the previous board of Sandham. The report was dated only a short while prior to the acquisition and related to the valuation, made by independent consultants, of Sandham's main brand. The valuation of \$3 million was essentially made on a multiple of earnings basis. Sandham had not included this brand in its balance sheet. The consultants had estimated that the remaining life of the brand was 30 years.

Required:

(i) Discuss whether the brand could have been recognised in Sandham's entity financial statements at the date of the report; and

(ii) whether it can be recognised by Holding in its consolidated financial statements at 31 March 2002 and, if so, describe its accounting treatment. (5 marks)

Note: you are not required to amend your answer to (a) in respect of the information in part (b).

(25 marks)

2 The following list of account balances relates to Finbush at 31 March 2002:

	$000	$000
Equity shares of $1 each		50,000
6% Loan notes		20,000
Accumulated profit at 1 April 2001		8,400
Property, plant and equipment at cost (note (i))	115,000	
Depreciation of property, plant and equipment at 1 April 2001 (note (i))		15,000
Investment (note (ii))	8,000	
Inventory – 31 March 2002 (note (iii))	12,400	
Trade receivables	8,300	
Bank		2,000
Trade payables		6,700
Deferred tax (note (v))		3,300
Provisions		500
Sales revenues (note (ii)		137,500
Cost of sales (note (iii))	85,000	
Environmental costs (note (iv))	500	
Operating expenses	12,400	
Loan note interest paid	600	
Dividends paid – equity shares	1,200	
	243,400	243,400

Finbush has previously prepared its financial statements under local statutory and accounting regulations, however, for the year to 31 March 2002 it has decided to use International Accounting Standards. Any changes of accounting policy are to be treated under the benchmark treatment in IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies' as far as the information permits. The following notes are relevant:

(i) Non-current assets
Property plant and equipment, and its accumulated depreciation, is made up of the following assets:

	$000 30 year leasehold	$000 Mine	$000 Plant	$000 Total
Cost	60,000	10,000	45,000	115,000
Depreciation 1 April 2001	nil	nil	15,000	15,000

The 30-year leasehold property was acquired on 1 April 1997. The directors of Finbush do not depreciate leasehold properties until the lease has only 10 years left to run. This is based on the view that the value of a long leasehold property generally increases in value until it nears the end of its life.

The mine was acquired on 1 April 2001. It has an estimated yield of 20 billion tonnes. During the year to 31 March 2002, 1·6 billion tonnes were extracted.

Plant is depreciated at 20% on cost with time apportionment in the year of acquisition. On 1 October 2001 new plant was purchased at a cost of $6 million. At 31 March 2001 $5 million of plant had been fully depreciated although it is still in use.

(ii) Investment
The investment of $8 million represents an interest free loan note that was accepted by Finbush on 1 April 2001 from one of its major customers. It will be repaid on 31 March 2004. The interest free status is in consideration of the large amount of business undertaken by the customer. A normal commercial rate for this type of loan would be 12% per annum. $1 compounded for three years at 12% per annum can be taken as $1·40.

(iii) Inventory/cost of sales
Finbush decided that for the preparation of the current year's financial statements it would change its policy of valuing inventory. It had previously used LIFO and now intends to use the FIFO method. The value of the inventory at 31 March 2002 applying FIFO is $12·4 million. The value of the inventory at 31 March 2001 is included in the cost of sales figure at a value of $8·2 million which is based on the previous LIFO method. Its value would have been $9 million if a FIFO valuation had been used.

Also included in cost of sales is $3 million for repairing the uninsured cost of earthquake damage to the company's property.

Tax relief at 20% has been utilised against this cost. The auditors have advised that they consider these costs to be a material item.

(iv) Environmental costs
The charge of $500,000 for an environmental provision in the above list of balances relates to the estimated cost of the site restoration of the mine that Finbush acquired on 1 April 2001. Mining is expected to last for 10 years. The $500,000 has been calculated as 1/10th of $5 million, which is the total amount of the estimated restoration costs based on today's prices. Discounting of environmental costs should be ignored.

(v) Taxation/deferred tax
An income tax provision of $3 million for the year to 31 March 2002 is required. This includes the tax relief relating to the earthquake costs.

Included in the deferred tax balance is an amount of $190,000 (credit) being the difference between the income tax provision made in the year to 31 March 2001 and the amount that the tax liability was settled for during the current year. The tax department of Finbush has calculated that the deferred tax liability at 31 March 2002 is $4 million. The increase in deferred tax should be charged to the income statement.

Required:

Prepare for Finbush for the year to 31 March 2002:

(a) An Income Statement reflecting the adjustments required by notes (i) to (v) above; (8 marks)
(b) A Balance Sheet; and (9 marks)
(c) A Statement of Changes in Equity. (3 marks)

(d) The directors of Finbush are concerned that certain aspects of IAS 32 'Financial Instruments: Disclosure and Presentation' are in conflict with the local statutory requirements. The directors wish to state that the financial statements comply with International Accounting Standards (IASs) as they are seeking a cross-border stock market listing. They feel that the resolution of this issue is to comply with local statute and disclose the effect that applying IASs and IFRAs would have made. The directors believe that local statutory rules give a fairer presentation of the financial statements.

Required:

Discuss the directors' views and reach a conclusion on whether they are acceptable. (5 marks)

(25 marks)

Section B – ONE question ONLY to be attempted

3 IAS 19 'Employee Benefits' was issued in February 1998. Amongst other things the standard deals with the treatment of post-employment benefits such as pensions and other retirement benefits. Post-employment benefits are classified as either defined contribution or defined benefit plans.

Required:

(a) **Describe the relevant features and required accounting treatment of defined contribution and defined benefit plans under IAS 19.** (7 marks)

(b) Klondike operates a defined benefit post-retirement plan for its employees. The plan is reviewed annually. Klondike's actuaries have provided the following information:

	at 31 March 2001 $000	at 31 March 2002 $000
Present value obligation	1,500	1,750
Fair value of plan assets	1,500	1,650
Current service cost – year to 31 March 2002		160
Contributions paid – year to 31 March 2002		85
Benefits paid to employees – year to 31 March 2002		125
Net cumulative unrecognised gains at 1 April 2002	200	
Expected return on plan assets at 1 April 2001 is	12%	
Discount rate for plan liabilities at 1 April 2001	10%	

The average remaining working lives of Klondike's employees at 31 March 2001 is 10 years.

Required:

Prepare extracts of Klondike's financial statements for the year to 31 March 2002 in compliance with IAS 19 'Employee Benefits' insofar as the information permits. (8 marks)

(15 marks)

4 Consolidated financial statements effectively aggregate the results of members of the group. Whilst this achieves the objective of showing the results of the group as if it were a single entity, it does have the disadvantage of hiding the relative performance of the different components of the entity. The International Accounting Standards Board's solution to this problem is to require disclosures relating to the different segments of the entity.

Required:

(a) (i) Discuss the objectives and usefulness of reporting segment information. (3 marks)

(ii) Define a reportable segment under IAS 14 'Segment Reporting'. (3 marks)

(iii) Identify the main problems of providing segment information. (3 marks)

(b) Portico has identified the following distinguishable business segments, together with their relative sizes:

Engineering	23%
Textiles	22%
Chemicals	20%
Travel agency	8%
House building	7%
Four others of 5% each	20%

None of the smaller segments are similar enough to be combined with other segments. The sizes above can be taken to relate to segment revenues, profits and assets.

The following additional information has been obtained:

(i) For cost control purposes, Portico's holding company is invoiced centrally and pays the utility costs (electricity and water) of each of its three reportable segments.

(ii) In its management accounts, central head office expenditure on research and development expenditure is allocated to reportable segments in relation to the relative turnover of each segment.

(iii) Certain assets, liabilities and expenses for the segments have been identified:

	Engineering	Textiles	Chemicals
	$000	$000	$000
Leased assets at cost	12,000	25,000	18,000
Annual depreciation based on life of lease	1,200	1,250	1,500
Outstanding lease liability (at year end)	7,000	15,000	8,000
Lease interest for current year	800	1,300	600

Required:

Identify the reportable segments for Portico and state how you would recommend the items in (i) to (iii) above should be treated in Portico's segment report. (6 marks)

(15 marks)

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

5 Your friend has been reading the annual report and financial statements of a company in which he has invested and has shown you the auditor's report which appears with the financial statements. He has asked you to explain the meaning of parts of it. The report reads as follows:

AUDITOR'S REPORT

To the shareholders of Omsk Company

We have audited the accompanying balance sheet of the Omsk Company as of 31 December 2001 and the related statements of income and cash flows for the year then ended. These *financial statements are the responsibility of the Company's management*. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with *International Standards on Auditing*. Those Standards require that we plan and perform our audit to obtain *reasonable assurance* about whether the financial statements are *free of material misstatement*. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a *true and fair view* of the financial position of the Company as of 31 December 2001 and of the results of its operations and its cash flows for the year ended, in accordance with International Accounting Standards.

XYZ Auditors
30 March 2002

Required:

Explain the meaning of each of the five phrases highlighted in italics in the auditor's report above.
All of the phrases carry equal marks.

(20 marks)

Section D – ONE question ONLY to be attempted

6 Your client, Tomsk, manufactures and distributes vacuum cleaners. Tomsk is a large company listed on a stock exchange. The company employs a sales force who are all provided with computer notebooks and motor vehicles. Motor vehicles and computer notebooks are replaced, on average, every 3·5 years. The company leases the computer notebooks and motor vehicles from a leasing company and has always accounted for all of them as operating leases under IAS 17 'Accounting for Leases'. If these assets were accounted for as finance leases, they would be material to the balance sheet of Tomsk. Tomsk is suffering from declining profit margins and market share and its share price has declined in recent years.

This is your first year as auditor of Tomsk. The previous auditors, a large firm, gave the company an unmodified audit report but declined to offer themselves for reappointment. The explanation for the change in auditors is that the previous auditors had become too expensive. The previous auditors have indicated to you that they consider that the directors of the company are aggressive in their attitude to earnings management. Your firm is not as large as the previous firm of auditors.

You have discovered during your audit that whilst the leases do *not* fit the requirements for finance leases in IAS 17, technically, the contracts with the suppliers appear to be engineered so that this is the case. You feel that the leases should probably be accounted for as finance leases in substance.

The company also holds a few other assets that are accounted for as finance leases.

Required:

(a) State the objectives of internal control procedures relating to leases that you would expect to see in place at Tomsk. (4 marks)

(b) Explain how you would audit the figures and disclosures in Tomsk's financial statements relating to leases. (8 marks)

(c) Explain why the accounting treatment for leases is important and describe the problems that you are likely to experience as auditor of Tomsk in relation to the leases. (3 marks)

(15 marks)

7 Statistical and non-statistical sampling techniques are commonly used by auditors performing substantive tests on financial statement assertions. This subject is dealt with by ISA 530 'Audit Sampling and Other Selective Testing Procedures'. Analytical procedures are also used for substantive testing, as well as for planning and review purposes under ISA 520 'Analytical Procedures'.

Required:

(a) Explain how audit sampling and analytical procedures are used for substantive testing purposes, giving examples. (9 marks)

(b) Discuss the relative merits of sampling and analytical procedures for collecting audit evidence. (6 marks)

(15 marks)

End of Question Paper