Diploma in International Financial Reporting and Auditing

MONDAY 9 JUNE 2003

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 Hilda acquired 80% of Sybil's ordinary shares on 1 April 2002 from Greta. Hilda paid an immediate $1·50 per share in cash and agreed to pay a further $1·50 per share in cash on 1 April 2004. Hilda has not recorded the amount yet to be paid. To help finance the acquisition, on 1 April 2002 Greta agreed to accept a $100 million 10% loan note repayable at par on 31 March 2005 from Hilda. Interest on this loan note will be 'rolled up' and paid together with the capital amount on the due date of redemption.

The balance sheets of the two companies at 31 March 2003 are shown below:

	Hilda		Sybil	
	$ million	$ million	$ million	$ million
Property, plant and equipment		300		293
Investments at cost		nil		60
Investment in Sybil		120		
Goodwill		75		nil
		495		353
Current assets				
Inventory	56		44	
Accounts receivable	64		29	
Bank	nil	120	14	87
Total assets		615		440
Equity and liabilities				
Capital and reserves:				
Ordinary shares of $1 each		50		100
Share premium		50		40
Accumulated profits – 1 April 2002	63		185	
– profit/loss for year	100	163	(5)	180
		263		320
Non-current liabilities				
Provision for restructuring	nil		20	
10% Loan note	100	100	nil	20
Current liabilities				
Accounts payable	175		75	
Taxation	61		25	
Overdraft	16	252	nil	100
Total equity and liabilities		615		440

The following information is relevant:

(i) Sybil's provision for restructuring was made prior to its acquisition by its previous board. Hilda intends to go ahead with the restructuring of Sybil, but more extensively than previously planned. At the date of acquisition Hilda had developed a detailed plan that estimated the restructuring of Sybil would cost a further $23 million. The costs relate to compensation to employees, penalties on termination of contracts, loss on sale of assets, and also include $3 million for staff retraining. Although the restructuring has been delayed for legal reasons, Hilda expects it to be completed within the next year.

(ii) The fair value of Sybil's investments at the date of acquisition was $90 million. Hilda has a policy of marking its investments to market prices. On 31 March 2003 Sybil's investments had a market value of $70 million.

(iii) Hilda has not yet provided for the interest on the loan note to Greta.

(iv) There are no intra group balances.

(v) Hilda's cost of capital can be taken as 10%. $1 receivable in the future at a discount rate of 10% can be taken as:

	$
end of year 1	0·909
end of year 2	0·825
end of year 3	0·751

(vi) In addition to the restructuring costs in note (i), Hilda expected its share of Sybil's losses (excluding any movement in the market value of Sybil's investments) to be $9 million before Sybil returned to profitability. These losses did not represent an identifiable liability at the date of acquisition and have not been provided for. For the purposes of realising any negative goodwill, the remaining weighted average useful life of Sybil's depreciable non-monetary assets can be taken as five years. The group accounting policy for any positive goodwill is to write it off on a straight-line basis over a period of ten years.

(vii) Hilda uses the allowed alternative treatment in IAS 22 'Business Combinations' to account for the fair value of identifiable assets and liabilities on acquisition.

Required:

(a) Prepare the consolidated balance sheet of Hilda as at 31 March 2003. (20 marks)
Note: work to the nearest $ million.

(b) Describe the circumstances in which negative goodwill may arise and how it should be treated in the financial statements. (5 marks)

(25 marks)

2 Beachwood is a large diversified public company. The following list of account balances relates to Beachwood at 31 March 2003:

	$000	$000
Sales revenue		15,100
Cost of sales	8,570	
Loss on sale of net assets of discontinuing operation (note (i))	350	
Income tax (note (ii))	210	
Operating expenses	840	
Dividends paid (note (iii))	680	
Investment income		200
Leasehold buildings at 31 March 2003	17,800	
Chemical plant (note (iv))	1,250	
Plant and equipment at 31 March 2003	5,600	
Investment property (note (v))	3,000	
Trade receivables (note (vi))	2,200	
Inventory – 31 March 2003	650	
Bank	420	
Ordinary shares of 20 cents each		12,500
Accumulated profits at 1 April 2002		5,170
6% Redeemable preference shares $1 each (2005)		6,000
Deferred tax at 1 April 2002 (note (ii))		920
Trade payables		1,680
	41,570	41,570

The following notes are relevant:

(i) Included in the above figures are the results of Beachwood's motorcycle retailing operations which were closed down on 31 December 2002. Its results for the period up to its closure are:

	$000
Sales revenues	2,120
Cost of sales	1,970
Operating expenses	250

In addition to the above costs, Beachwood suffered a gross loss on the sale of net assets of its motorcycle operations of $500,000 less associated tax relief of $150,000. The closure of the motorcycle retailing operation can be taken to meet the definition of a discontinuing operation.

(ii) The balance on the income tax account above is the remaining amount after the settlement of the previous year's provision. The tax department has calculated that the provision for income tax for the current year should be $900,000 and a transfer of $220,000 to deferred tax is required.

(iii) The dividends paid (included in the above balances) are half of the preference dividend and an interim ordinary dividend. On 24 March 2003, the directors declared but have not accounted for a further ordinary dividend of 2 cents per share.

(iv) On 1 April 2002, Beachwood brought into commission a new chemical plant. The plant has a relatively short life of only ten years, after which it will be decommissioned. The plant produces toxic heavy metals as a waste product. The estimated present value, using a discount rate of 8%, of compulsory decommissioning costs due to this pollution is $750,000. Beachwood has not provided any amount for the decommissioning costs nor has it yet depreciated the plant.

(v) The investment property was valued on 31 March 2003 at a surplus of $160,000 on its book value. This has not been reflected in the above figures. Beachwood uses the fair value model in IAS 40 'Investment Property'.

(vi) The trade receivables figure contains a translated balance from Franco of $300,000. The sale occurred on 1 March 2003 and was denominated in Euros (€). Both the sale and the receivable were translated at the exchange rate at 1 March 2003 of $1 = €1·50 and included in the above balances on that basis. The rate of exchange at 31 March 2003 had changed to $1 = €1·80.

Required:

Prepare for Beachwood for the period to 31 March 2003:

(a) an Income Statement; (10 marks)

(b) a Statement of Changes in Equity; and (3 marks)

(c) a Balance Sheet, (12 marks)

in accordance with International Financial Reporting Standards as far as the information permits. Notes to the financial statements are not required.

(25 marks)

Section B – ONE question ONLY to be attempted

3 (a) IAS 24 'Related Party Disclosures' deals with the issues and disclosures of related party relationships and transactions. Motorworld is a wholly owned subsidiary of the Prestige group. You are looking at the entity financial statements of Motorworld with a view to making a bid to purchase the company.

Required:

Explain the relevance of related party transactions and why their disclosure may be important under the following circumstances

(i) Where no related party transactions have occurred between Motorworld and its other subsidiaries; (2 marks)

(ii) Where related party transactions have occurred on normal commercial terms between Motorworld and its other subsidiaries; and (2 marks)

(iii) Where related party transactions have occurred on favourable (non arms length) trading terms between Motorworld and its other subsidiaries (3 marks)

(b) IAS 23 'Borrowing Costs' has a benchmark treatment that requires borrowing costs to be recognised as an expense in the period in which they are incurred. It also permits an allowed alternative treatment for certain borrowing costs to be capitalised as part of the cost of a qualifying asset.

Required:

(i) Discuss the arguments in favour of, and those against, the capitalisation of borrowing costs as part of the cost of an asset. (4 marks)

On 1 April 2002, Webster commenced the construction of a large development consisting of several separate retail premises. It has a policy of capitalising borrowing costs where this is permissible under IAS 23. At 31 March 2003 the amount of expenditure on the development totalled $12 million. These expenditures can be taken to have been incurred evenly throughout the year. The development is being financed from funds generally borrowed for the construction of similar development projects. Webster's cost of capital on these funds can be calculated from the following:

$2 million overdraft at 15% per annum
$3 million 5 year secured 8% loan note
$5 million 5 year unsecured 10 % loan note

Construction of the development was halted twice during the accounting period to 31 March 2003. The first occasion, for a two-week period, was due to the discovery of ancient artefacts unearthed during excavation work. The second, an extended period of two months, was due to an industrial relations dispute.

Required:

(ii) Calculate the amount of finance costs that Webster should capitalise for the period to 31 March 2003. (4 marks)

(15 marks)

4 The IASB issued IAS 33 'Earnings per Share' in 1997 with the objective of determining the principles for the calculation and presentation of earnings per share in order to improve performance comparison. Its main focus is on the denominator of the calculation.

Required:

(a) Explain the usefulness of disclosing:

(i) A company's basic earnings per share; (2 marks)

(ii) A company's diluted earnings per share. (3 marks)

(b) Below are extracts from the financial statements of Bovine for the year to 31 March 2003:
Income statement:

	Continuing operations $000	Discontinuing operations $000	Total $000
Profit (loss) before tax	1,580	(200)	1,380
Tax (charge) relief	(280)	50	(230)
Profit from the ordinary activities	1,300	(150)	1,150
Extraordinary item as part of continuing operations (net of tax relief of $60)			(120)
			1,030

Balance sheet:

Ordinary shares of 25 cents each	1,800
6% Non-redeemable preference shares	500
10% Convertible preference shares $1 each	1,000
Non-current liabilities	
8% Convertible loan stock	1,500

Notes: all shares and loan stocks were in issue prior to the beginning of the current accounting year. The 10% convertible preference shares are convertible to ordinary shares on the basis of three ordinary shares for every five preference shares on 31 March 2005 at the option of the preference shareholders. The 8% convertible loan stock is redeemable on 31 March 2005 or can be converted to ordinary shares on the basis of 120 ordinary shares for each $100 of loan stock at the holders' option.

There are also in issue directors' share options for four million ordinary shares. These were issued on 31 March 2002 and are exercisable on 31 March 2005 at a price of $1·40 per share. The market price of Bovine's shares can be taken as $2·00 each.

Preference dividends are paid out of taxed profits. Interest on loan stock is an allowable tax deduction. The rate of income tax is 25%.

Required:

Calculate Bovine's basic and diluted earnings per share for the year ended 31 March 2003 (10 marks)

(15 marks)

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

5 ISA 260 'Communication of audit matters with those charged with governance' deals with audit matters of governance interest to be communicated and the timing and form of communications. Communication is important for the effective performance of the audit and in order for external auditors to properly discharge their duties.

There are certain circumstances in which the duty of auditors to communicate matters to those charged with governance, and the auditor's duty of confidentiality, may be overridden by a duty to report to third parties. These situations are dealt with by ACCA's 'Rules of Professional Conduct'. They are also often dealt with by national legislation.

Required:

(a) Discuss the identity of those charged with governance and the nature of the matters to be communicated to them by external auditors. (11 marks)

(b) Describe the issues faced by external auditors where they believe that senior management lack integrity, and where external auditors have strong suspicions, but no proof, that senior management may be engaging in illegal activities. (9 marks)

(20 marks)

Section D – ONE question ONLY to be attempted

6 You are an audit partner in a large firm of accountants. A large multi-national group, Ibex, which has many different business interests in many different countries, has approached your firm. Ibex is listed on several stock exchanges throughout the world and it currently employs several different firms of auditors to audit group companies.

Your firm has been asked to prepare a proposal for the audit of companies in the Americas, and for the holding company which is located in Europe, but not for other group companies in Europe where another large firm of auditors has recently been appointed. Your firm has several offices in the Americas but it wishes to extend its presence there. Your firm is also particularly keen to acquire this client as it has significant oil and gas interests around the world and your firm has considerable experience with other clients in this area.

You are aware that ISA 720 'Other information in documents containing audited financial statements' imposes certain obligations on auditors for other information produced by Ibex in its annual report. You are also aware that Ibex's annual report is likely to contain a substantial element of information relating to sustainability issues (environmental, social and economic issues). Your firm does not have significant experience in dealing with sustainability issues.

Required:

(a) Describe the risks to your firm and difficulties associated with taking on Ibex as an audit client. (8 marks)

(b) Describe the responsibilities your firm would have in relation to the other information in Ibex's annual report under ISA 720 and describe how your firm might deal with the sustainability issues contained therein. (7 marks)

(15 marks)

7 You are the auditor of Chamoix, a manufacturing company with a large property portfolio. None of the properties are investment properties. Some of the properties are carried in the balance sheet at historical cost, others have been revalued. During the year the company has extended the estimated useful lives of certain assets and changed the depreciation methods, although there has been a downturn in the property market. The effect of this has been to increase profits by a material amount.

Required:

In relation to properties, describe the audit work you would perform and the audit evidence you would seek in order to form an opinion as to whether the:

(a) carrying amount of the revalued assets; and (10 marks)

(b) depreciation charges, (5 marks)

are not materially misstated in the financial statements of Chamoix.

(15 marks)

End of Question Paper