# Diploma in International Financial Reporting

**MONDAY 14 JUNE 2004**

**QUESTION PAPER**

Time allowed **3 hours**

**This paper is divided into two sections**

**Section A** This ONE question is compulsory and MUST be answered

**Section B** THREE questions ONLY to be answered

**Do not open this paper until instructed by the supervisor**

**This question paper must not be removed from the examination hall**

**The Association of Chartered Certified Accountants**

**Section A – This ONE question is compulsory and MUST be attempted**

1 You are the chief accountant of Alpha. Alpha has investments in a number of other enterprises. The two most significant investments are in Beta and Gamma. The income statements and summarised statements of changes in equity of the three enterprises for the year to 31 March 2004 were as follows:

Income Statements

| | Alpha | Beta | Gamma |
|---|---|---|---|
| | $'000 | $'000 | $'000 |
| Revenue | 65,000 | 60,000 | 50,000 |
| Cost of sales | (32,000) | (30,000) | (24,000) |
| Gross profit | 33,000 | 30,000 | 26,000 |
| Distribution costs | (7,000) | (6,000) | (5,000) |
| Administrative expenses | (8,000) | (6,500) | (6,000) |
| Profit from operations | 18,000 | 17,500 | 15,000 |
| Income from investments | 6,500 | – | – |
| Finance cost | (4,000) | (3,000) | (2,500) |
| Profit before tax | 20,500 | 14,500 | 12,500 |
| Income tax expense | (5,000) | (3,600) | (3,200) |
| Net profit for the period | 15,500 | 10,900 | 9,300 |
| **Summarised Statements of Changes in Equity** | | | |
| Balance at 1 April 2003 | 44,000 | 42,000 | 38,000 |
| Net profit for the period | 15,500 | 10,900 | 9,300 |
| Dividends paid 31 December 2003 | (6,000) | (3,500) | (4,000) |
| Balance at 31 March 2004 | 53,500 | 49,400 | 43,300 |

Other information

1. Investments in Beta and Gamma
   - On 1 April 1994 Alpha purchased 80% of the equity capital of Beta for $19·6 million. The net assets of Beta at that date were $22 million and there was no significant difference between fair values and book values.
   - On 1 April 1994 Alpha provided Beta with a loan of $25 million that is repayable by Beta on 31 March 2014. The rate of interest on the loan was fixed at 8% per annum for its duration.
   - On 1 August 2003 Alpha purchased 30% of the equity capital of Gamma for a cash payment of $14·13 million. No other single investor owns more than 25% of the equity of Gamma. From 1 August 2003 one of the directors of Alpha was given a place on the board of directors of Gamma. Since 1 August 2003 Alpha has been able to exercise considerable influence over the operating and financial policies of Gamma but on one occasion other investors acting together were able to prevent Gamma from pursuing a policy favoured by Alpha.

2. Intra-group trading

   Alpha supplies a component that is used by Beta in its manufacturing process. The component is supplied at a transfer price of manufactured cost plus 40%. The revenue of Alpha for the year ended 31 March 2004 included $6 million in respect of supplies of the component. The inventory of Beta included goods supplied by Alpha as follows [valued in both cases at the intra-group transfer price]:
   - $1·05 million at 31 March 2003.
   - $1·54 million at 31 March 2004.

3. Accounting policy regarding purchased goodwill
   Purchased goodwill is amortised on the monthly basis over its expected useful economic life. In the case of the acquisitions of Beta and Gamma this estimate was 10 years. Amortisation of goodwill on acquisition of subsidiaries is presented as an administrative expense in the consolidated income statement.

4. Profits of Gamma for the year ended 31 March 2004
   These profits accrued evenly throughout the year.

5. Treatment of investment income
   Alpha has included its full share of the dividend received from Gamma on 31 December 2003 without applying time apportionment.

Your assistant has prepared the consolidated financial statements of Alpha for a number of years. He has expressed the opinion that Gamma is a subsidiary of Alpha because Alpha is the largest single shareholder with a representative on the board of directors.

**Requirements:**

**(a) Assess the opinion of your assistant that Gamma is a subsidiary of Alpha and outline the appropriate treatment of Gamma in the consolidated financial statements of Alpha.** (6 marks)

**(b) Prepare the consolidated income statement and the consolidated statement of changes in equity for Alpha for the year ended 31 March 2004.** (19 marks)

**(25 marks)**

**Section B – THREE questions ONLY to be attempted**

**2** Delta is an enterprise that prepares its financial statements to 31 March each year. The financial statements for the year ended 31 March 2004 are being prepared and you are provided with the following trial balance at that date.

| | $'000 | $'000 |
|---|---|---|
| Revenue [Note 1] | | 120,000 |
| Production costs [Note 1] | 70,000 | |
| Distribution costs [Note 1] | 8,000 | |
| Administrative expenses [Note 1] | 12,000 | |
| Loss on sale of business segment [Note 1] | 3,000 | |
| Inventories at 31 March 2003 [Note 2] | 18,200 | |
| Interest paid and payable on interest bearing borrowings | 3,000 | |
| Income tax [Note 3] | | 250 |
| Dividends paid on equity shares | 2,000 | |
| Land and buildings – at cost [Note 4] | 30,000 | |
| Plant and equipment – at cost [Note 4] | 27,000 | |
| Accumulated depreciation on property, plant and equipment: | | |
| – Land and buildings [Note 4] | | 3,240 |
| – Plant and equipment [Note 4] | | 7,500 |
| Trade receivables | 44,000 | |
| Bank balances | 26,790 | |
| Trade payables | | 10,000 |
| Long term interest bearing borrowings | | 40,000 |
| Lease rentals [Note 5] | 17,000 | |
| Deferred tax [Note 3] | | 6,000 |
| Construction contract [Note 6] | 21,000 | |
| Issued equity capital | | 50,000 |
| Accumulated profits | | 45,000 |
| | 281,990 | 281,990 |

Notes to the Trial Balance

Note 1 – Disposal of business segment

During the year Delta disposed of a business segment whose results were separately reported in accordance with IAS14 – *Segment Reporting*. The business segment was entirely financed by equity capital and its results for the period up to the date of disposal were as follows:

| | $'000 |
|---|---|
| Revenue | 14,000 |
| Cost of sales | (8,000) |
| Gross profit | 6,000 |
| Distribution costs | (1,000) |
| Administrative expenses | (1,500) |
| Profit before tax | 3,500 |
| Income tax expense | (900) |
| Profit after tax | 2,600 |

The above amounts are after providing for all necessary depreciation on property, plant and equipment [see Note 4 below]. However the income tax expense **excludes** tax relief of $600,000 available for the loss on sale. This figure is included in the overall income tax estimate for the year [see Note 3 below].

**Note 2 – Inventories at 31 March 2004**

The carrying value of inventories at 31 March 2004 [**excluding** any amounts in respect of the construction contract – see note 6 below] was $21 million. The figure was computed in accordance with the principles of IAS2 – *Inventories*.

**Note 3 – Tax**

– The estimated income tax on profits for the year to 31 March 2004 was $2·5 million.
– During the year $2·05 million was paid in full and final settlement of income tax on the profits for the year ended 31 March 2003. Payables at 31 March 2003 had included $2·3 million in respect of this liability.
– A transfer of $400,000 is required to increase the deferred tax liability in the balance sheet.

**Note 4 – Property, plant and equipment**

**Details are as follows:**

| | Property | | Plant and equipment | |
|---|---|---|---|---|
| | **Land** | **Buildings** | **Plant** | **Fixtures** |
| | **$'000** | **$'000** | **$'000** | **$'000** |
| Cost at 31 March 2004 | 12,000 | 18,000 | 21,000 | 6,000 |
| Depreciation rate [%] | 0 | 2 | 33·3 | 25 |
| Depreciation method | None | Straight line | Reducing balance | Straight line |
| Accumulated depreciation at **31 March 2003** | 0 | 3,240 | 6,000 | 1,500 |

Depreciation of property, plant and equipment is allocated as follows:
– Plant and buildings to cost of sales.
– Fixtures to administrative expenses.

**Note 5 – Lease rentals**

On 1 April 2003 Delta began to lease a specialised machine that was used exclusively in the production process. The lease was for four years and Delta paid a deposit of $8 million with four annual payments [in arrears] of $9 million on 31 March, the first annual payment being made on 31 March 2004. The lessor paid $40 million for the machine on 31 March 2003. The machine will have no residual value on 31 March 2007 and Delta is responsible for maintaining and insuring it. Apart from the non-payment of rentals the lease cannot be prematurely terminated by either party. The lessor has advised Delta that the rate of interest in the lease can be taken as 5%.

**Note 6 – Construction contract**

On 1 October 2003 Delta signed a fixed term construction contract. Details are as follows:
– fixed contract price $60 million.
– Due date of completion 30 September 2005.
– Costs incurred to date on the contract have been $26 million. These comprise materials, labour and overheads of $12 million and plant of $14 million [purchased on 1 October 2003]. The plant will have no scrap value at the end of the contract.
– Future material, labour and overhead costs are estimated at $25 million. No further investment in plant will be needed.
– Before the year end the contract was certified as 30% complete by an independent expert. This entitled Delta to a progress payment of $5 million, which was received before the year end.

**Requirements:**

**(a) Prepare the income statement for Delta for the year ended 31 March 2004.** (16 marks)

**(b) Prepare the balance sheet for Delta as at 31 March 2004.** (9 marks)

**(25 marks)**

**Notes to the income statement and balance sheet are NOT required.**

**3** You are the accountant of Global. Global operates in a jurisdiction that allows International Financial Reporting Standards to be used for local reporting purposes. Global has subsidiaries in a number of different countries and raises finance on a number of capital markets. You have been approached by a non-executive director who, whilst not an accountant, takes a keen interest in financial reporting. He has asked you a number of questions regarding the financial reporting practices of the group.

**(a)** 'I have been reviewing the financial reports which were sent to the securities exchanges for the different capital markets where we raise finance. I have noticed that when we report to the securities exchanges in the USA and Japan, we provide a reconciliation of key figures in our financial reports to the equivalent figures under USA and Japanese standards. However we don't provide this reconciliation when we report to securities exchanges in Europe. Surely this is inconsistent! I thought that International Financial Reporting Standards were being used all over the world now and that standard setters in individual countries were abandoning their own standards in favour of International Financial Reporting Standards. Since we already use International Financial Reporting Standards I don't understand the need for these reconciliations. Please explain why we include them in our reporting to some securities exchanges and not others. Please also confirm (or otherwise) my understanding of the current situation regarding International Financial Reporting Standards.' (9 marks)

**(b)** 'You will be aware that our enterprise has been the target of some unwelcome takeover bids in the recent past. The finance director stated that it might be beneficial for the group to restate its properties at current values since this would increase the non-current assets in the balance sheet. I have a vague recollection of being told that the balance sheet can only include assets at historical cost [I know that this is currently what we do]. If I am right then I would doubt that what the finance director proposes is in line with International Financial Reporting Standards. If we can use current values then I suggest restricting the revaluation exercise to properties that are located in buoyant sectors of our business. If we apply revaluation techniques to all our properties there might well be some properties that have a current value below their historical cost based carrying value. This would have the opposite effect to what the finance director intended. We should also consider the effect on income and earnings per share, a key performance indicator for our group. If we can include gains on the upward revaluation of non-current assets this would provide a boost to earnings per share. Please advise me if:

– I am correct in believing that assets must be included in the financial statements based on their historical cost and provide me with three examples of any allowed departure from historical cost.
– It is acceptable to revalue only properties that have a current value that is above their historical cost based carrying value.
– Any surplus on revaluation can be included in income and therefore improve earnings per share.'

(7 marks)

**(c)** 'Please keep this confidential but our enterprise is considering a major restructuring of our distribution network. We have more or less decided to go ahead but will delay making an announcement until after the next year end – 30 June 2004. Even though we haven't gone public yet we have a pretty good idea of what the likely costs are going to be. We will start the restructuring on 1 August 2004 and it is likely to take two months to complete. These are the costs we are likely to incur:

– $5 million in staff redundancies and other direct restructuring costs.
– $2 million in retraining existing staff who will continue to be employed in the new network.
– $1·5 million operating losses for August and September 2004 due to a reduced scale of operations in the restructuring period.
– $500,000 anticipated losses on the scrapping of obsolete plant and equipment.
– This is all partly offset by a probable $1 million profit on the sale of a surplus property.

I suggest charging this year's income statement with a provision of $8 million [the net sum of all the items I have mentioned] in the financial statements for the year ended 30 June 2004. Can you see any problems with this?'

(9 marks)

**Required:**

**Draft a reply to each of the queries raised by the non-executive director. You should make reference to international financial reporting standards where relevant.**

**The mark allocation is shown against each of the three queries above.**

**(25 marks)**

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**Question 4 begins on page 8.**

**4 (a)** The IASC *Framework for the Preparation and Presentation of Financial Statements* states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. International Financial Reporting Standards have been developed in the light of this objective. IAS14 – *Segment Reporting* – was issued in its current form in 1997. The standard applies to all enterprises whose equity or debt is publicly traded.

**Requirement:**

**Discuss the contribution of segment reporting to making financial information useful to users and identify the limitations of segment reporting.** (10 marks)

**(b)** Worldwide is a multinational enterprise that has business activities located in three sectors. Relevant details are as follows:

1. **Allocation of net income and net assets**

| Location | Relevant percentages for allocation of: Revenue and costs* | Assets and liabilities (see note 2) |
|---|---|---|
| Europe | 40 | 38 |
| North America | 35 | 36 |
| Asia | 25 | 26 |

* The allocation percentage is to be applied to revenues and costs **net** of intra-group revenue (see note 3).

2. **Details relating to Head Office**

The enterprise has a head office that procures all necessary finance for the enterprise's activities and allocates this finance to operating units through current accounts. Certain costs, assets and liabilities relate solely to head office and cannot be allocated to segments on a rational basis. These amounts are as follows:
- Operating costs of $10 million in the year to 31 March 2004.
- Non-current financial assets.
- Trade receivables.
- Bank balances totalling $18 million at 31 March 2004.
- All liabilities except trade payables.

3. **Intra-group revenues – year to 31 March 2004**

| Selling segment | Intra-group sales | Intra-group sales made to Europe | North America | Asia |
|---|---|---|---|---|
| | $'000 | $'000 | $'000 | $'000 |
| Europe | 20,000 | | 14,000 | 6,000 |
| North America | 16,000 | 11,000 | | 5,000 |
| Asia | 13,000 | 7,000 | 6,000 | |

There are no unrealised intra-group profits.

4. Extracts from the consolidated financial statements of Worldwide for the year ended 31 March 2004

INCOME STATEMENT – YEAR ENDED 31 March 2004

| | $'000 |
|---|---|
| Revenue | 665,000 |
| Cost of sales | (312,000) |
| Gross profit | 353,000 |
| Distribution costs | (99,000) |
| Administrative expenses | (118,000) |
| Profit from operations | 136,000 |
| Income from investments | 6,000 |
| Finance cost | (25,000) |
| Profit before tax | 117,000 |
| Income tax expense | (28,000) |
| Profit after tax | 89,000 |
| Minority interests | (8,000) |
| Net profit for the period | 81,000 |

BALANCE SHEET AS AT 31 March 2004

| | $'000 | $'000 |
|---|---|---|
| **ASSETS** | | |
| **Non-current assets:** | | |
| Property, plant and equipment | 340,000 | |
| Financial assets | 50,000 | |
| | | 390,000 |
| **Current assets:** | | |
| Inventories | 75,000 | |
| Trade receivables | 104,000 | |
| Bank balances | 24,000 | |
| | | 203,000 |
| | | 593,000 |
| **EQUITY AND LIABILITIES** | | |
| **Capital and Reserves:** | | |
| Issued capital | 150,000 | |
| Accumulated profits | 180,000 | |
| | | 330,000 |
| **Non-current liabilities:** | | |
| Interest bearing borrowings | 140,000 | |
| Deferred tax | 36,000 | |
| | | 176,000 |
| **Current liabilities:** | | |
| Trade and other payables | 70,000 | |
| Short term borrowings | 17,000 | |
| | | 87,000 |
| | | 593,000 |

**Requirement:**

**Prepare a segment report for Worldwide for the year ended 31 March 2004 that complies with IAS14. You need not address disclosures required by IAS14 that cannot be given from the information available.**

(15 marks)

**(25 marks)**

**5** **(a)** One of the issues dealt with by the International Accounting Standards Committee in its *Framework for the Preparation and Presentation of Financial Statements* published in July 1989 is the measurement of assets and liabilities in financial statements. The framework notes that the historical cost system is the one most widely used in financial statements at present. However, the framework suggests that other models and concepts, apart from the historical cost system, may be more appropriate in order to meet the objective of providing useful information. Developments in financial reporting over the last decade suggest that a mixed measurement system has evolved in some jurisdictions, in which some assets and liabilities are measured based on historical cost, whilst others are measured on current values.

In March 1995 the IASC issued IAS32 – *Financial Instruments: Disclosure and Presentation*. IAS32 required the disclosure of information regarding current values of financial instruments. Then in December 1998 the IASC issued IAS39 – *Financial Instruments: Recognition and Measurement*. IAS39 required that certain categories of financial instruments be measured at their current values and allowed hedge accounting in certain circumstances.

**Requirements:**

**(i) Identify the strengths and weaknesses of using a historical cost system of measurement for assets and liabilities.** (5 marks)

**(ii) Explain why a current value measurement system may be more appropriate for financial instruments than a historical cost system.** (3 marks)

**(iii) Explain why the disclosure requirements of IAS32 were insufficient on their own to satisfy the needs of users.** (3 marks)

**(b)** Iota is an enterprise that prepares financial statements to 31 December each year. On 1 January 2003 the enterprise originated two transactions in financial instruments:

(i) Iota borrowed $15 million – incurring transaction costs of $100,000 to obtain the loan. The terms of the loan are that the enterprise pays interest of $900,000 on 31 December each year and the loan is repayable at a substantial premium on 31 December 2007. The effective annual interest rate associated with this loan is 10%. The annual interest was paid on 31 December 2003 and Iota intends to retain the loan until its repayment date. The fair value of the loan on 31 December 2003 was $16 million.

(ii) Iota made a strategic investment of $10 million in another enterprise, Lambda. This investment represents an equity stake of 18%. Iota is unsure whether or not this investment will be sufficient to give Iota significant influence over the operating and financial policies of Lambda. The investment has no fixed maturity date and Iota has no plans to dispose of it. During the year ended 31 December 2003, Lambda made a net profit of $3 million but paid no dividends. The fair value of the investment at 31 December 2003 was $11 million.

**Requirement:**

**Show how the two financial instruments will be treated in the financial statements of Iota for the year ended 31 December 2003. For instrument 2 you should indicate the effect, if any, on the investment giving Iota significant influence over Lambda.** (14 marks)

**(25 marks)**

**End of Question Paper**