Diploma in International Financial Reporting

MONDAY 11 DECEMBER 2006

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 The income statements and summarised statements of changes in equity of Alpha, Beta and Gamma for the year ended 30 September 2006 are given below:

Income Statements

	Alpha	Beta	Gamma
	$'000	$'000	$'000
Revenue	125,000	100,000	90,000
Cost of sales	(70,000)	(60,000)	(51,000)
Gross profit	55,000	40,000	39,000
Other operating expenses	(20,000)	(15,000)	(15,000)
Income from investments	9,000	5,000	4,500
Finance costs	(11,000)	(8,000)	(7,500)
Profit before tax	33,000	22,000	21,000
Income tax expense	(9,000)	(6,000)	(5,400)
Profit for the year	24,000	16,000	15,600

Summarised Statements of Change in Equity

Balance at 1 October 2005	110,000	60,000	56,000
Profit for the year	24,000	16,000	15,600
Dividends paid	(14,000)	(5,000)	nil
Balance at 30 September 2006	120,000	71,000	71,600

Notes to the Financial Statements

Note 1

(i) On 1 October 2002 Alpha purchased an 80% equity shareholding in Beta. The equity of Beta as shown in its own financial statements at that date was $35 million. At the date of acquisition Beta owned some land with a book value of $25 million and a market value of $35 million, and some plant with a book value of $12 million and a market value of $16 million. The plant is depreciated on a straight line basis and the remaining useful economic life of the plant at 1 October 2002 was estimated at four years.

(ii) On 1 February 2006 Alpha purchased a 75% shareholding in Gamma. At the date of acquisition Gamma had registered a brand name that had a fair value of $27 million. Gamma had not recognised this amount in its own individual financial statements. The directors of Alpha estimated that this brand would provide Gamma with significant competitive advantage for a 15-year period from 1 February 2006.

(iii) Other than mentioned in notes (i) and (ii) above there were no fair value adjustments necessary on acquisition of Beta or Gamma.

(iv) Alpha presents depreciation and amortisation charges as part of cost of sales.

(v) No impairment of goodwill on acquisition of either company has been identified up to and including 30 September 2006.

(vi) In addition to the equity investments made by Alpha in Beta and Gamma, on 1 February 2006 Alpha lent $20 million to Beta at an effective annual interest rate of 8%.

Note 2

Alpha supplies products used by Beta and Gamma. Sales of the products to Beta and Gamma during the year ended 30 September 2006 were as follows (all sales were made at a mark up of 25% on cost):

– Sales to Beta $10 million.
– Sales to Gamma (all in the post-acquisition period) $3 million.

At 30 September 2006 and 30 September 2005 the inventories of Beta and Gamma included the following amounts in respect of goods purchased from Alpha.

	Amount in inventory at: 30/9/2006	30/9/2005
	$'000	$'000
Beta	2,000	1,200
Gamma	1,000	Nil

Required:

(a) **Prepare the consolidated income statement and summarised consolidated statement of changes in equity for Alpha for the year ended 30 September 2006. Ignore deferred tax.** (20 marks)

(b) **Explain – WITHOUT reworking your answer in detail – the effect on the statements required in part (a) were deferred tax to be taken into account.** (5 marks)

(25 marks)

Section B – THREE questions ONLY to be attempted

2 Delta's accounting year end is 30 September. The trial balance of Delta as at 30 September 2006 showed the following balances:

	$'000	$'000
Revenue (Note 1)		240,000
Purchases	90,000	
Employment costs (Note 2)	60,000	
Operating overheads (Note 2)	45,000	
Inventories as at 1 October 2005 (Note 3)	35,000	
Property, plant and equipment (Notes 4 and 5):		
– At cost 30 September 2006	100,000	
– Accumulated depreciation at 1 October 2005		26,500
Construction contract (Note 6)	7,000	
Financial asset (Note 7)	12,500	
Investment income (Note 7)		500
Long term loan (fixed rate of interest 10% per annum)		30,000
Interest paid on long term loan	3,000	
Trade receivables	50,000	
Cash and bank balances	43,300	
Trade and other payables		30,000
Current tax payable (Note 8)	200	
Deferred tax at 1 October 2005 (Note 9)		4,000
Equity share capital (ordinary shares of $1)		50,000
Share premium account		40,000
Dividend paid on ordinary shares	5,000	
Retained earnings at 1 October 2005		30,000
	451,000	451,000

Notes to the trial balance

Note 1 – Revenue

On 29 September 2006 Delta sold a consignment of products for $30 million and credited the entire amount to revenue, the debit entry being to trade receivables. The terms of sale of the products were that Delta would provide an after sales service which required Delta to correct any defects that became apparent in the products for a one year period from the date of sale. The directors of Delta estimated that the cost of correcting defects in the consignment over the relevant period would be $1 million. A reasonable gross profit margin for corrective work of this nature would be 20%.

Note 2 – Apportionment of costs

Employment costs and operating overheads (including depreciation and impairment of property, plant and equipment) should be apportioned between cost of sales, distribution costs and administrative expenses in the ratio 7:1:2.

Note 3 – Inventories

The carrying value of closing inventories at 30 September 2006 was $40 million.

Note 4 – Property, plant and equipment

	Cost at 30/09/06 $'000	Accumulated depreciation at 01/10/05 $'000
Properties	40,000	3,800
Plant and equipment	60,000	22,700
Total	100,000	26,500

Property, plant and equipment is depreciated on a straight line basis (with a full year's charge in the year of purchase and no charge in the year of sale) at the following rates:

– 2% per annum for properties.

– 25% per annum for plant and equipment (other than that used on the construction contract – see note 6 below)

Note 5 – Revaluation of properties

On 30 September 2006 the properties were revalued to their market values as indicated below:

	Cost at 30/9/06	Accumulated Depreciation at 01/10/05	Market Value at 30/09/06
	$'000	$'000	$'000
Property A	15,000	1,500	20,000
Property B	15,000	300	18,000
Property C	10,000	2,000	6,000
	40,000	3,800	44,000

This revaluation is not reflected in the trial balance of Delta but the directors wish to reflect it in the financial statements.

Note 6 – Construction contract

On 1 January 2006 Delta commenced a construction contract that was estimated to last for a period of 24 months. Costs incurred on the contract to date (and debited to the contract account) and estimated future costs are as follows:

	Costs to Date	Estimated future Costs
	$'000	$'000
Materials	5,000	3,000
Plant and equipment	6,000	–
Overheads	4,000	6,000

The purchased plant and equipment is not expected to have any residual value at the end of the contract.

The contract price was fixed at $32 million. On 20 September 2006 an independent expert certified that 25% of the contract work had been completed satisfactorily. The customer immediately made a progress payment of $8 million, which Delta received on 27 March 2006 and credited to the contract account.

Note 7 – Financial asset

On 1 October 2005 Delta purchased a loan investment that had a nominal value of $10 million at a cost of $12·5 million. The investment entitled the holder to a fixed rate of interest of 5% on the nominal value of the loan. Delta designated the investment as fair value through profit and loss. The investment had a fair value of $13 million at 30 September 2006.

Note 8 – Current tax payable

The current tax payable figure at 1 October 2005 comprised $5 million in respect of the estimated income tax liability of Delta for the year ended 30 September 2005. This liability was finally agreed at $5·2 million in early 2006 and this amount was duly paid and debited to current tax payable. The estimated income tax liability for the year ended 30 September 2006 is $6 million. The rate of income tax that is relevant for Delta is 20%.

Note 9 – Deferred tax

A transfer of $500,000 needs to be made to the deferred tax account at 30 September 2006. This transfer does not include any potential deferred tax implications of the properties revaluation (see note 5 above)

Required:

(a) Prepare the income statement for Delta for the year ended 30 September 2006. (11 marks)

(b) Prepare the statement of changes in equity for Delta for the year ended 30 September 2006. (3 marks)

(c) Prepare the balance sheet for Delta as at 30 September 2006. (11 marks)

Notes to the income statement and balance sheet are not required. However your workings should justify your treatment of items referred to in the trial balance and the notes with appropriate references to international financial reporting standards.

(25 marks)

3 You are the chief accountant of Epsilon. An executive of Epsilon, who is not an accountant but takes keen interest in financial matters, has reviewed the most recent financial statements of the entity and compiled a series of questions:

1. The accounting policies note states that purchased goodwill is included in the balance sheet and reviewed annually for impairment. The note also states that internally generated goodwill is not recognised in the balance sheet. Surely it is inconsistent to include purchased goodwill whilst not recognising internally generated goodwill? I also don't understand the meaning of the word 'impairment'. Please explain it to me and also explain how we would review goodwill for impairment. (9 marks)

2. The accounting policies note also states that our investments in the equity shares of other entities are measured at their fair values, with changes in fair value being taken directly to retained earnings. Surely unless all value changes are reported in the income statement the shareholders will have an incomplete picture of financial performance. In addition investments in redeemable preferred shares of other entities are measured at amortised cost. I don't understand the meaning of 'amortised cost' and would like an explanation please. It seems inconsistent to treat similar investments in different ways. Please explain this too. (9 marks)

3. The balance sheet of our entity shows a net liability that is the difference between the obligation to pay retirement benefits to our workforce and the value of the assets of their pension plan. I do not understand why these amounts are in our financial statements at all. Our entity pays contributions to the plan and then the plan pays the retirement benefits. All our contributions are up to date so why is there a liability in our books and why are we including the assets of a plan that is a separate legal entity? (7 marks)

Required:

Draft a reply that responds to the queries raised by the executive. Where relevant, you should refer to appropriate international financial reporting standards.

Note: 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 The draft income statement of Kappa for its year ended 30 September 2006 is given below:

	$'000
Revenue	90,000
Cost of sales	(35,000)
Gross profit	55,000
Other income	7,000
Distribution costs	(9,000)
Administrative expenses	(15,000)
Finance costs	(10,000)
Profit before tax	28,000
Income tax expense	(7,000)
Profit for the year	21,000

The following information is relevant to the draft income statement:

1. At the year end the entity was in the process of defending a legal case brought against it for breach of copyright. The entity's lawyers provided the following estimates of the likely outcome of the case:
   – A 30% chance of defending the case successfully.
   – A 60% chance of being required to pay $3 million in damages.
   – A 10% chance of being required to pay $6 million in damages.

   The draft financial statements included a provision for $2·4 million (30% x nil + 60% x $3 million + 10% x $6 million). The charge in the income statement was made to administrative expenses.

2. During the period a development project that had been started on 1 April 2005 reached a stage where the likely outcome of the project was such that the expenditure qualified for recognition as an intangible asset in accordance with the criteria laid down in IAS 38 – *Intangible Assets*. This stage was reached on 31 March 2006. Details of relevant expenditure are as follows:
   – $2 million was incurred in the period 1 April to 30 September 2005 and charged to cost of sales in the previous period.
   – $1·5 million was incurred in the period 1 October 2005 to 31 March 2006.
   – $1 million was incurred in the period 1 April to 30 September 2006.

   The draft financial statements include an intangible asset of $4·5 million, with the $2 million charged as an expense in the previous year shown in the current year income statement as 'other income'.

3. On 1 April 2006 Kappa sold a piece of land to a bank for $14 million. Prior to the sale the land was included in the financial statements at a cost of $9 million. The gain on sale was included in other income. Kappa has an option to repurchase the land for $15·4 million on 31 March 2007 and the bank has an option to require Kappa to repurchase the land for $15·4 million on the same date.

4. When computing depreciation for the year ended 30 September 2006, Kappa reassessed the estimated useful economic lives of its property, plant and equipment. Of the depreciation provided for the period, $6 million related to additional depreciation that would have been provided in previous periods had the new estimated asset lives been used in those previous periods. In the draft financial statements this additional depreciation has been treated as a change in accounting policy and taken directly to equity. Normally depreciation is included in the income statement as part of cost of sales.

5. On 30 September 2006 Kappa owed an overseas supplier a foreign currency denominated amount of $6 million. Since the financial year end the dollar has weakened against the relevant foreign currency and at the date the draft financial statements were produced the amount payable had a dollar equivalent of $6·5 million. The draft financial statements included a payable of $6·5 million, with $500,000 being debited to the income statement as an administrative expense.

6. On 1 October 2005 Kappa purchased some land for $20 million with the intention of building a factory. Activities necessary to prepare the factory for use began on 1 December 2005 and were completed on 30 June 2006. The factory was gradually brought into use from 1 July 2006 and has just become fully operational. The building work was sub-contracted and the total building cost of $15 million was paid to the sub-contractors on 31 March 2006. Both payments were financed by a loan at a fixed interest rate of 9% per annum. The entity decided to

capitalise the finance costs incurred and a total of $2·475 million (($20 million x 9%) + ($15 million x 9% x 6/12)) was added to the cost of property, plant and equipment, with a corresponding reduction in the finance cost taken to the income statement.

7. The entity pays income tax at a marginal rate of 25%. Any adjustments made to the income statement can be assumed to affect the income tax charge at this rate.

Required:

Redraft the income statement of Kappa to reflect any adjustments you consider necessary as a result of the information given in notes 1–7. In all cases you should explain the adjustments you make by referring to appropriate international financial reporting standards.

(25 marks)

5 Omega is an entity that owns three properties. All three properties were purchased on 1 October 2004. Details of the purchase price and market values of the properties are as follows:

	Property 1	Property 2	Property 3
	$'000	$'000	$'000
Purchase price	15,000	10,000	12,000
Market value 30 September 2005	16,000	11,000	13,500
Market value 30 September 2006	17,000	9,000	14,500

Properties 1 and 2 are used by Omega as factories whilst property 3 is let to a non-related third party at a commercial rent. Omega does not depreciate any of the properties on the basis that they are valued at market values that are generally expected to increase over time.

Required:

(a) **Assess whether Omega's policy of non-depreciation of properties 1–3 is in accordance with international financial reporting standards.** (7 marks)

(b) **Show how the movements in the carrying amount of each property will be reflected in the financial statements of Omega for the years ended 30 September 2005 and 2006. You can assume that any relevant depreciation is immaterial.**
Where necessary you should justify your treatment with reference to appropriate international financial reporting standards. Where more than one treatment is permitted under international financial reporting standards you should show the impact of both treatments. (6 marks)

(c) On 1 October 2005 Omega brought into use an industrial site that had been constructed at a total cost of $50 million. Omega has the legal right to use the site for a 10 year period, at the end of which the site has to be returned to the legal owner in its original condition. The directors of Omega estimate that the cost of restoring the site on 30 September 2015 will be $15 million (in 2015 prices). The construction cost includes the right to use the site without further payment for the 10 year period. The rate to use in any discounting calculations is 8%. The present value of $1,000 receivable in 10 years when the cost of capital is 8% is $463.

Required:

Show the amounts that will appear in the balance sheet of Omega as at 30 September 2006 in respect of the site and the amounts that will appear in the income statement for the year ended 30 September 2006. You should state where in the balance sheet and where in the income statement the relevant amounts should be presented. Where necessary you should justify your treatment with reference to appropriate international financial reporting standards. (7 marks)

(d) On 1 October 2005 Omega granted 50 employees options to purchase 500 shares in the entity. The options vest on 1 October 2007 for those employees who remain employed by the entity until that date. The options allow the employees to purchase the shares for $10 per share. The market price of the shares was $10 on 1 October 2005 and $10·50 on 1 October 2006. The market value of the options was $2 on 1 October 2005 and $2·60 on 1 October 2006. On 1 October 2005 the directors estimated that 5% of the relevant employees would leave in each of the years ended 30 September 2006 and 2007 respectively. It turned out that 4% of the relevant employees left in the year ended 30 September 2006 and the directors now believe that a further 4% will leave in the year ended 30 September 2007.

Required:

Show the amounts that will appear in the balance sheet of Omega as at 30 September 2006 in respect of the share options and the amounts that will appear in the income statement for the year ended 30 September 2006.
You should state where in the balance sheet and where in the income statement the relevant amounts will be presented. Where necessary you should justify your treatment with reference to appropriate international financial reporting standards. (5 marks)

(25 marks)

End of Question Paper