Diploma in International Financial Reporting

MONDAY 12 JUNE 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 Alpha holds investments in two other entities, Beta and Gamma. All three entities prepare financial statements to 31 March and the balance sheets of the three entities at 31 March 2006 were as follows:

	Alpha $'000	Beta $'000	Gamma $'000
Assets			
Non-current assets:			
Property, plant and equipment	90,000	80,000	80,000
Available for sale investments (Notes 1+2)	113,000	–	–
	203,000	80,000	80,000
Current assets:			
Inventories (Note 3)	30,000	28,000	25,000
Trade receivables (Note 4)	35,000	25,000	27,000
Other current assets	4,000	3,000	3,000
Cash and cash equivalents	10,000	9,000	8,000
	79,000	65,000	63,000
Total assets	**282,000**	**145,000**	**143,000**
Equity and Liabilities			
Share capital	100,000	60,000	60,000
Retained earnings	63,000	25,000	20,000
Total equity	163,000	85,000	80,000
Non-current liabilities:			
Long term borrowings	50,000	24,000	25,000
Deferred tax	36,000	13,000	14,000
Total non-current liabilities	86,000	37,000	39,000
Current liabilities:			
Trade and other payables (Note 4)	18,000	13,000	14,000
Short-term borrowings	6,000	4,000	4,000
Current tax payable	9,000	6,000	6,000
Total current liabilities	33,000	23,000	24,000
Total equity and liabilities	**282,000**	**145,000**	**143,000**

Note 1 – purchase of shares in Beta

On 1 April 2004 Alpha purchased 45 million shares in Beta at an agreed price of $2·20 per share, paid in cash. This investment is carried in the balance sheet of Alpha at cost, as permitted by IAS 27 – *Consolidated and Separate Financial Statements*. At that date the balance sheet of Beta showed retained earnings of $15 million. The directors of Alpha carried out a fair value exercise on the net assets of Beta at that date as required by IFRS 3 – *Business Combinations*. The following matters arose out of the exercise:

(i) Property, plant and equipment comprised non-depreciable land with a carrying amount of $30 million and a market value of $50 million, plus plant and equipment with a carrying amount of $30 million and a market value of $39 million. The estimated future economic life of the plant and equipment at 1 April 2004 was three years. None of the property, plant and equipment held by Beta at 1 April 2004 had been disposed of by 31 March 2006.

(ii) Inventories were included at cost to Beta of $20 million. The equivalent selling price of the inventories was estimated at $25 million and a reasonable allowance for profit on the sale $4 million. Disposal costs were not considered to be material. All the inventories as at 1 April 2004 had been sold by 31 March 2006.

(iii) At 1 April 2004 Beta was subject to legal action from a customer. The customer was claiming damages of $3 million. The directors of Beta had made no provision for this amount because they considered the case could be successfully defended. However at 1 April 2004 they would have been prepared to make a payment of $600,000 to have the case dismissed. In the event the case was successfully defended and no payment was necessary.

(iv) At 1 April 2004 Beta had a brand name that it had protected by a legal process preventing any other business from using the name. This brand was not included in the individual balance sheet of Beta because the directors did not consider that it met the recognition criteria in IAS 38 – *Intangible Assets* – for internally developed intangible assets. The directors of Alpha considered that the brand name had a market value of $10 million at 1 April 2004 and that it would give Beta a competitive advantage for 10 years from that date.

Note 2 – purchase of shares in Gamma

On 1 June 2005 Alpha purchased 10 million shares in Gamma for $1·40 per share. This purchase was made with a view to further purchases in future. The current shareholding has not resulted in the directors of Alpha being able to exercise any influence over the operating and financial policies of Gamma. The fair value of a share in Gamma at 31 March 2006 was $1·60. The balance sheet of Alpha continues to carry this investment at cost.

Note 3 – inventories

The inventories of Beta at 31 March 2006 include components purchased from Alpha at a cost of $15 million. Alpha paid $12 million to produce the components.

Note 4 – trade receivables and payables

The trade receivables of Alpha included $5 million receivables from Beta in respect of the purchase of components (see Note 3). Beta paid this amount on 30 March 2006 but the cash was not received and recorded by Alpha until 2 April 2006. There were no other intra-group current account balances.

Note 5 – other information

(i) The share capital of all three entities comprises equity shares of $1. All equity shares carry one vote and no special controlling powers exist other than through the ownership of equity shares.

(ii) Despite owning a reasonably substantial number of equity shares in Gamma, Alpha does not have the power to appoint any representatives to the board of directors of Gamma.

(iii) The goodwill arising on acquisition of Beta has not suffered any impairment since 1 April 2004.

(iv) The fair value adjustments give rise to temporary differences. The rate of taxation to apply to temporary differences is 25%

Required:

(a) Prepare the consolidated balance sheet of Alpha at 31 March 2006. Your workings should include references to international financial reporting standards where appropriate. (21 marks)

(b) Explain the effect on your answer to (a) if the investment in Gamma gave Alpha representation on the board of directors of Gamma and the ability to participate in its policy making process. You do NOT need to prepare the consolidated balance sheet under this revised assumption. (4 marks)

(25 marks)

Section B – THREE questions ONLY to be attempted

2 Delta is an entity that prepares its financial statements to 31 March each year. The financial statements for the year ended 31 March 2006 are being prepared and you are provided with the following trial balance at that date:

	$'000	$'000
Revenue (Note 1)		215,000
Inventories at 1 April 2005 (Note 2)	30,000	
Raw material purchases	90,000	
Production costs (Note 3)	50,000	
Distribution costs (Note 3)	15,000	
Administration costs (Note 3)	30,000	
Property, plant and equipment:		
– at cost (Note 4)	100,000	
– accumulated depreciation at 31 March 2005 (Note 4)		30,000
Suspense account (Note 5)		13,000
Construction contact (Note 6)	12,000	
Interest paid on long-term borrowing	4,000	
Income tax account (Note 7)	1,000	
Deferred tax (Note 7)		7,000
Trade receivables	50,000	
Cash and cash equivalents	48,000	
Trade payables		15,000
Long-term borrowings (10% interest rate)		40,000
Equity share capital ($1 shares)		90,000
Dividend paid 31 December 2005	20,000	
Retained earnings at 31 March 2005		40,000
	450,000	450,000

Notes to the Trial Balance

Note 1 – revenue
Revenue includes a sale of goods on 1 March 2006 for $10 million. The goods cost Delta $5 million to manufacture. The terms of the sale gave Delta an option to repurchase the goods for $11 million on 30 April 2006. The buyer had an option to require Delta to repurchase the goods for $11 million on 30 April 2006.

Note 2 – inventories
On 31 March 2006 the inventories at Delta's premises was counted. The appropriate value of the inventories – measured in accordance with the principles of IAS 2 – *Inventories* – was $35 million.

Note 3 – production, distribution and administration costs
The amounts contained in the trial balance do not include depreciation of property, plant and equipment. Depreciation (including any gains or losses on sale of plant and equipment and other than that of the construction contract plant (Note 6)) should be allocated 70:10:20 between production, distribution and administration.

Note 4 – property, plant and equipment

	Cost	Accumulated depreciation at 31 March 2005
	$'000	$'000
Property	60,000	10,000
Plant and equipment	40,000	20,000
	100,000	30,000

(i) The depreciable element of the property has an allocated cost of $25 million and is being depreciated on a straight-line basis over 50 years.

(ii) The plant and equipment is being depreciated on a straight-line basis over five years, with a full year's depreciation in the year of purchase and no depreciation in the year of disposal. None of the plant and equipment held at 31 March 2005 was fully depreciated at that date.

(iii) On 30 September 2005 Delta sold plant that cost $10 million on 1 September 2001 for $1 million. The proceeds of sale were included in a suspense account (see Note 5 below).

Note 5 – suspense account

This account consists of two amounts:

(i) The proceeds of sale of plant (see note 4 above).

(ii) The proceeds of issue on 1 April 2005 of a bond carrying a zero interest rate but redeemable at an amount of $16,105,100 on 31 March 2010. As an alternative to redemption, the bond-holders have the option to convert the bond into equity shares. Had the option not been available the bond-holders would have only been prepared to invest $10 million given their requirement for a 10% return on their investment.

Note 6 – construction contract

On 1 October 2005 Delta commenced work on a construction contract that had been signed on 15 September 2005. The contract was for a fixed price of $40 million. Delta purchased plant at a cost of $10 million for use on the contract. This plant will have no value when the contract is completed on 30 September 2006. Other costs incurred on the contract, together with estimated costs to complete, were as follows:

	Incurred to date	Estimated costs to complete
	$'000	$'000
Purchase of materials	8,000	4,000
Labour and other overheads	6,000	7,000

The costs incurred to date were all debited to the contract account. On 31 March 2006 the contract was certified as being 40% complete and the customer made a progress payment of $12 million. This payment was credited to the contract account. No other entries have been made in respect of this contract.

Note 7 – income tax

– On 30 September 2005 Delta made full and final payment of $8 million to discharge the income tax liability for the year ended 31 March 2005. The amount originally provided was $7 million.

– The estimated income tax liability for the year ended 31 March 2006 is $6 million.

– A further credit of $2 million is required to the deferred tax account.

Required:

(a) Prepare the income statement for Delta for the year ended 31 March 2006. (11 marks)

(b) Prepare the statement of changes in equity for Delta for the year ended 31 March 2006. (3 marks)

(c) Prepare the balance sheet for Delta as at 31 March 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 a qualified accountant who supervises a number of trainee accountants. Your company is a listed company located within the European Union that raises capital on a number of capital markets. The European Union has recently passed a regulation that requires listed companies to use international financial reporting standards (IFRSs) when preparing consolidated financial statements for publication. The regulation applies to accounting periods beginning on or after 1 January 2005. The financial statements for the year ended 31 March 2006 have just been published. One of your trainees has left you a memorandum that contains four questions relating to the financial statements.

(a) I have noticed that the 2006 financial statements have been prepared using IFRSs, whilst the 2005 statements were based on our own domestic standards. Why has this happened? Have our domestic standards become discredited? Why have the 2006 financial statements included reconciliations of the 2005 numbers between those originally presented and the equivalent numbers under IFRSs? Were the reconciliations optional or are they required in the financial statements of first time adopters of IFRSs? (8 marks)

(b) You will be aware that we acquired a new subsidiary during the previous accounting period. Following this acquisition the intangible assets that are shown in the consolidated balance sheet contain a number of items relating to this subsidiary:

(i) The value of customer lists.
(ii) The value of trademarks.
(iii) The value of an internet domain name.

These assets do not appear in the individual balance sheet of the subsidiary to which they relate so why are they in the consolidated balance sheet? (5 marks)

(c) The financial statements disclose that in the previous year a number of subsidiaries made errors in counting their inventories. These errors affected last year's closing inventories and their effect has been reported in the statement of changes in equity. The financial statements also disclose that in the current year a number of subsidiaries revised the estimated useful economic lives of their plant. The effect of the revision has all been included in the consolidated income statement. In order to be consistent with the treatment of the inventories error shouldn't the prior period effect of the change in estimate be shown in the statement of changes in equity? (5 marks)

(d) I remember that on 1 April 2005 the company issued options that allowed employees to purchase shares for $10 per share on 31 December 2005 provided they satisfied certain performance conditions in the nine-month period between 1 April 2005 and 31 December 2005. The market value of the shares on 1 April 2005 was only $10, although by 31 December 2005 the market value had risen to $12 and 200,000 options were exercised, generating $2 million. I do not understand why the 2006 financial statements, prepared in accordance with IFRSs, include a charge in the income statement income of $360,000 relating to these share options. This represents a charge of $1·80 per share but since our company hasn't paid anything why should there be a charge in the income statement at all? (7 marks)

Required:

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

The mark allocation is shown against each of the four questions above.

(25 marks)

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Question 4 begins on page 8.

4 **(a)** Omega is an entity that requires a consistently high level of investment in property, plant and equipment. Historically the investment has always been financed either using equity or by arranging appropriate borrowings. More recently a greater proportion of the finance has been provided in the form of borrowing because conditions for a share issue have been unfavourable. This has led to Omega's borrowings increasing to such a level that the directors would be uncomfortable about the impact of further significant borrowings on the balance sheet. However, conditions for a share issue remain unfavourable, but the demand for additional investment in property, plant and equipment continues.

Your assistant has approached you with the suggestion that a future solution to this dilemma might be to lease property, plant and equipment rather than purchase it. This strategy, according to your assistant, would enable Omega to procure the additional property, plant and equipment it needs without additional borrowings that would have an unfavourable impact on the balance sheet.

Required:

Draft a reply that responds to the suggestion made by your assistant. Where relevant, you should refer to appropriate international financial reporting standards. Your answer should explain the way in which the characteristics of a lease determine its accounting treatment. (7 marks)

(b) Your requirements for capital investment in the next accounting period are set out below. In each case your assistant has identified an alternative leasing option for your consideration:

New fleet of vehicles

Omega needs a new fleet of vehicles for its sales staff. The new fleet would cost $800,000 to purchase outright and would have an expected useful economic life of four years from the date of purchase. As an alternative to outright purchase, Omega could lease the vehicles on a two-year lease for annual rentals of $180,000, payable monthly in arrears. At the end of two years the lease could be re-negotiated or the vehicles returned to the lessor. The lessor provides a full repair and maintenance service for the fleet of vehicles that is free of charge throughout the two-year lease period.

New production plant

Omega needs to re-fit one of its production plants with new machinery. The machinery would cost $2·4 million to buy and would have an expected useful economic life of six years. As an alternative to outright purchase the machines could be leased on a four-year lease with payments of $760,000 annually in arrears. At the end of the four-year period Omega has the option to continue to lease the machinery for a further two years for an annual rental of $1, payable in arrears. Omega is responsible for the repair and maintenance of the machinery throughout the primary and secondary rental period. At the end of six years the machinery is likely to have a negligible residual value.

Required:

Assuming the leasing option is taken up in both cases, compute all relevant amounts (excluding cash) that would appear in the income statement and the balance sheet for the first year of the lease. Assume in both cases that the leases commenced on the first day of the accounting period and that all payments in arrears have been made by the balance sheet date. Where relevant, you should refer to appropriate international financial reporting standards. Assume, where necessary, an annual finance cost of 10%. (12 marks)

(c) Omega is likely to need to acquire at least one new property in the near future. A potential property has been identified which would cost $10 million to purchase outright. The purchase price of $10 million could be reasonably apportioned 50:50 between the land and the buildings. The buildings are estimated to have a useful economic life of 25 years. As an alternative to outright purchase, two leasing options exist:

(i) To lease the property on a 25-year lease. At the end of the lease term the title to the property would pass to Omega

(ii) To lease the property on a 25-year lease but at a lower rental than in (i) above). At the end of the 25-year period the title to the property would remain with the lessor and Omega would have to vacate it.

Required:

Assuming Omega wants to lease the property rather than purchase it outright, EXPLAIN (<u>without</u> performing any detailed calculations) how the lease would be treated in the financial statements of Omega under <u>both</u> options. Where relevant, you should refer to appropriate international financial reporting standards. (6 marks)

(25 marks)

5 Epsilon prepares consolidated financial statements under international financial reporting standards. Your assistant has prepared the first draft of the financial statements for the year ended 31 March 2006 but there are a number of transactions about which she is unsure. These are listed below:

(a) Transaction 1

(i) On 1 April 2005 Epsilon acquired a new subsidiary, Kappa, purchasing all 100 million shares of Kappa. The terms of the sale agreement included the exchange of three shares in Epsilon for every two shares acquired in Kappa. On 1 April 2005 the market value of a share in Epsilon was $10 and the market value of a share in Kappa $13·50.

(ii) The terms of the share purchase included the payment of an additional $1·21 per share acquired provided the profits of Kappa for the two years ending 31 March 2007 exceeded a target figure. Current estimates are that it is 75% probable that the management of Kappa will achieve this target.

(iii) Legal and professional fees associated with the acquisition of Kappa shares were $1,200,000, including $200,000 relating to the cost of issuing shares. The senior management of Epsilon estimate that the cost of their time that can be fairly allocated to the acquisition is $100,000. This figure of $100,000 is not included in the legal and professional fees of $1,200,000 mentioned above.

(iv) The individual balance sheet of Kappa at 1 April 2005 comprised net assets that had a fair value at that date of $1,200 million. Additionally Epsilon considered Kappa possessed certain intangible assets that were not recognised in its individual balance sheet:

– Customer relationships had a reliable estimate of value of $100 million. This value has been derived from the sale of customer databases in the past.

– Employee expertise had a reliable estimate of value of $80 million.

(v) The directors of Epsilon were unsure how long the goodwill on acquisition of Kappa would last but they thought that 10 years might be a prudent estimate of its useful economic life. However, they considered that the goodwill had not suffered any impairment up to 31 March 2006.

(vi) The annual discount rate to use in any relevant calculations is 10%.

Required:

Compute the goodwill on consolidation of Kappa that will appear in the consolidated balance sheet of Epsilon at 31 March 2006. You should make appropriate references to international financial reporting standards. (9 marks)

(b) Transaction 2

On 1 April 2005 Epsilon issued convertible loan notes for total proceeds of $500 million. The notes were repayable at $500 million on 31 March 2009 or convertible into equity shares on that date. Interest of $40 million was payable annually in arrears. The finance cost of a non-convertible loan at 1 April 2005 would have been 10% per annum.

Required:

Show how the convertible loan note would be presented in the balance sheet of Epsilon at 31 March 2006. You should make appropriate references to international financial reporting standards. (8 marks)

(c) Transaction 3

Epsilon is planning a major equity investment in Europe towards the end of 2006. Latest indications are that this investment will cost 100 million euros and that the funds will be required on 30 November 2006. However, at the balance sheet date Epsilon had not entered into a contractual commitment to purchase the shares.

Epsilon wanted to provide a measure of certainty regarding the cost of the investment in $s. Therefore, on 31 January 2006 the entity entered into a contract to purchase 100 million euros for $140 million, with a delivery date of 30 November 2006. On 31 March 2006, the rate of exchange was such that this contract was a favourable one for Epsilon and had a fair value of $1,500,000.

Required:

Show how the equity investment and currency contract will affect the consolidated balance sheet of Epsilon as at 31 March 2006. Indicate how any changes in carrying value will be reported in the statement of changes in equity and/or income statement for the year ended 31 March 2006. You should make appropriate references to international financial reporting standards. (8 marks)

(25 marks)

End of Question Paper