Diploma in International Financial Reporting

Thursday 6 December 2007

Dip IFR

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

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

Section B – THREE questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet 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. The balance sheets of the three entities at 30 September 2007 were as follows:

	Alpha $'000	Beta $'000	Gamma $'000
Assets			
Non-current assets:			
Property, plant and equipment (Notes 1 & 2)	132,000	100,000	90,000
Investments (Note 1)	139,000	Nil	Nil
	271,000	100,000	90,000
Current assets:			
Inventories (Note 3)	40,000	34,000	32,000
Trade receivables (Note 4)	40,000	32,000	30,000
Financial assets (Note 5)	10,000	Nil	Nil
Cash and cash equivalents	9,000	11,000	8,000
	99,000	77,000	70,000
Total assets	370,000	177,000	160,000
Equity and Liabilities			
Equity			
Share capital ($1 shares)	100,000	60,000	70,000
Retained earnings	138,000	48,000	29,000
Total equity	238,000	108,000	99,000
Non-current liabilities:			
Long-term borrowings	60,000	30,000	25,000
Deferred tax	30,000	12,000	10,000
Total non-current liabilities	90,000	42,000	35,000
Current liabilities:			
Trade and other payables (Note 4)	35,000	20,000	20,000
Short-term borrowings	7,000	7,000	6,000
Total current liabilities	42,000	27,000	26,000
Total equity and liabilities	370,000	177,000	160,000

Note 1 – investments

Investment in Beta:
Alpha subscribed for 48 million shares in Beta at par on the date of Beta's incorporation on 1 October 1999. This investment is shown at original cost.

Investment in Gamma:
On 1 April 2007 Alpha purchased 49 million shares in Gamma for a cash payment of $91 million. This investment is also shown at original cost.

The profit of Gamma for the year ended 30 September 2007 was $8 million. Gamma did not pay or declare any dividends in the period.

The directors of Alpha carried out a fair value exercise to measure the identifiable assets and liabilities of Gamma at 1 April 2007. The following matters emerged:

A property having a carrying value of $20 million had an estimated market value of $30 million (including non-depreciable land of $15 million). The estimated future economic life of the depreciable element at 1 April 2007 was 30 years. In the year ended 30 September 2007 Gamma charged depreciation of $320,000 on this property.

Plant and equipment having a carrying value of $60 million had an estimated market value of $65 million. The estimated future economic life of the plant at 1 April 2007 was five years.

Inventory having a carrying value of $10 million had an estimated fair value of $12 million. All of this inventory was sold prior to 30 September 2007.

The fair value adjustments will be regarded as temporary differences for the purposes of computing deferred tax.

Note 2 – sale of plant to Beta

On 1 October 2006 Alpha purchased an item of plant for $4 million and immediately sold it to Beta for $4·4 million. The estimated useful economic life of the plant is four years from 1 October 2006.

Note 3 – intra-group sale of inventories

The inventories of Beta and Gamma at 30 September 2007 included components purchased from Alpha during the year at a cost of $25 million to Beta and $15 million to Gamma. Alpha supplied these components at cost plus a mark up of 25%. All the supplies were made after 1 April 2007.

Note 4 – trade receivables and payables

The trade receivables of Alpha included $6 million receivable from Beta and $5 million receivable from Gamma in respect of the purchase of components (see Note 3). The trade payables of Beta and Gamma include an equivalent amount payable to Alpha.

Note 5 – financial assets

During the period Alpha made a temporary investment of $10 million in listed securities and designated the investments as fair value through profit and loss. The market value of the portfolio (none of which was sold before the year end) was $9·5 million.

Note 6 – other information

The goodwill arising on acquisition of Gamma has not suffered any impairment since 1 April 2007.

The rate of tax to apply to temporary differences is 25%. You can ignore the temporary differences caused by any adjustments for unrealised profits.

Required:

Prepare the consolidated balance sheet of Alpha at 30 September 2007.

(25 marks)

Section B – THREE questions ONLY to be attempted

2 Delta's financial statements for the year ended 30 September 2007 are being prepared and you are provided with the following trial balance at that date:

	$'000	$'000
Revenue (Note 1)		325,000
Inventories at 1 October 2006	50,000	
Raw material purchases	160,000	
Production costs	40,000	
Distribution costs	15,000	
Administrative expenses	25,000	
Property, plant and equipment:		
– at cost (Note 3)	160,000	
– accumulated depreciation at 30 September 2006 (Note 3)		35,000
Suspense account (Note 4)	10,000	
Interest paid on long-term borrowing	11,000	
Income tax account (Note 5)		500
Deferred tax (Note 5)		5,000
Trade receivables	125,000	
Cash and cash equivalents	54,500	
Trade payables		55,000
Long-term borrowings at 10% interest rate		110,000
Equity share capital ($1 shares)		100,000
Equity dividend paid 30 September 2007	25,000	
Retained earnings at 30 September 2006		45,000
	675,500	675,500

Notes to the trial balance

Note 1 – Revenue

On 20 September 2007 Delta sold goods that cost Delta $6 million to manufacture at a gross profit margin of 20%. Delta recognised the sale as revenue when the goods were sent to the customer. The goods were supplied on a sale or return basis, with a right to return up to and including 31 January 2008. The customer had returned 50% of the goods by 30 November 2007. It is uncertain as to how many of the remaining goods will be returned prior to 31 January 2008.

Note 2 – Inventories

On 30 September 2007 the value of the inventories at Delta's premises was $55 million.

Note 3 – Property, plant and equipment

	Cost	Accumulated depreciation at 30 September 2006
	$'000	$'000
Property	80,000	20,000
Plant and equipment	80,000	15,000
	160,000	35,000

(i) Depreciation of all property, plant and equipment should be charged to cost of sales.

(ii) The depreciable element of the property has an allocated cost of $40 million and is being depreciated on a straight-line basis over 50 years.

(iii) On 1 October 2006 the property was revalued to its market value of $90 million. It was estimated that $56 million of this value was attributable to the depreciable element. This revaluation has not yet been recorded in the accounting records of Delta.

(iv) No change in the estimated useful economic life of the depreciable element was anticipated at the date of the revaluation. The directors of Delta wish to make an annual transfer of excess depreciation on revalued assets from the revaluation reserve to retained earnings.

(v) 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 30 September 2007 was fully depreciated at that date. No disposal of property, plant and equipment occurred in the period.

Note 4 – Suspense account
On 1 October 2006 Delta began to lease a number of specialised production machines under a finance lease. The lease was of four years duration and Delta was required to pay a deposit of $10 million on 1 October 2006 followed by three further payments of $5 million each on 1 October 2007, 2008 and 2009. The rate of interest implicit in the lease is 8% and the fair value of the leased assets at 1 October 2006 was approximately $22·9 million. The only entry made by Delta was to debit the deposit paid to the suspense account.

Note 5 – Income tax
(i) On 30 June 2007 Delta made full and final payment to discharge the income tax liability for the year ended 30 September 2006. The balance on the income tax account in the trial balance is the residue after making that payment.
(ii) The estimated income tax liability for the year ended 30 September 2007 is $10 million.
(iii) A credit of $2·4 million is required to the deferred tax account. This does not include any deferred tax that needs to be recognised on the property revaluation (see note 3 above).
(iv) Delta pays income tax at a rate of 25% on net taxable gains.

Required:

(a) Prepare the income statement for Delta for the year ended 30 September 2007. (9 marks)

(b) Prepare the statement of changes in equity for Delta for the year ended 30 September 2007. (5 marks)

(c) Prepare the balance sheet for Delta as at 30 September 2007. (11 marks)

Note: notes to the income statements and balance sheet are not required.

(25 marks)

3 Epsilon is a listed entity. You are the financial controller of the entity and its consolidated financial statements for the year ended 30 September 2007 are being prepared. Your assistant, who has prepared the first draft of the statements, is unsure about the correct treatment of a number of transactions and has asked for your advice. Details of the transactions are given below:

Transaction (a)

On 1 October 2006 Epsilon signed a contract to construct a dam at a fixed price of $50 million. The contract has a scheduled completion date of 30 September 2008. However, if the contract is completed satisfactorily on or before 30 June 2008 Epsilon becomes entitled to a bonus of $5 million. If the contract is completed later than 31 December 2008, then Epsilon will forfeit $15 million of the fixed price and only receive $35 million. Latest estimates regarding completion dates are as follows:

Prior to 1 July 2008 – 20% probability.
1 July 2008 to 31 December 2008 – 70% probability.
After 31 December 2008 – 10% probability.

Epsilon incurred costs of $28 million on the contract up to 30 September 2007 and expects to incur further costs of $12 million to complete the contract. Your assistant has shown a net balance of $13 million in inventories on the balance sheet. This is the difference between the costs incurred to date ($28 million), the loss of $5 million ($35 million – ($28 million + $12 million)) that would arise on the contract if it was completed after 31 December 2008, and a progress payment of $10 million made by the customer before 30 September 2007. The loss of $5 million has been charged to the income statement and justified by the assistant on the grounds of prudence. An independent expert has recently certified that at 30 September 2007 the construction of the dam was 45% complete. The assistant proposes deferring recognition of any revenue until the contract is completed. (8 marks)

Transaction (b)

On 1 October 2006 Epsilon opened a new factory in an area designated by the government as an economic development area. On that day the government provided Epsilon with a grant of $20 million to assist them in the development of the factory. This grant was in two parts:

(i) $12 million of the grant related to the construction of a large factory at a cost of $60 million. The land was leased so the whole of the $60 million is depreciable over the estimated 30 year useful life of the factory.
(ii) The remaining $8 million was received subject to keeping at least 200 employees working at the factory for a period of at least five years. If the number drops below 200 at any time in any financial year in this five year period then 20% of the grant is repayable in that year. From 1 October 2006 250 workers were employed at the factory and estimates are that this number is likely to increase over the next four years.

Your assistant has recognised the $12 million received in respect of the factory as a credit to the income statement in the current year, on the basis that the factory has been constructed and brought into use. He has not recognised any of the $8 million employment grant on the basis that this is potentially repayable. He has charged $2 million in depreciation to the income statement. (10 marks)

Transaction (c)

On 1 October 2006 Epsilon purchased an aircraft for use by its executives on business trips. The purchase price paid was $15 million plus recoverable sales taxes of $1·5 million. The expected useful economic life of the aircraft is 15 years. Every five years the aircraft needs a major overhaul in order to renew its safety certificate. The current cost of such overhauls is $1·8 million. Your assistant has included $16·5 million ($15 million + $1·5 million) in property, plant and equipment and has charged depreciation of $1·1 million ($16·5 million x 1/15) to the income statement. He has charged $360,000 ($1·8 million x 1/5) to the income statement in respect of the overhaul, intending to build up a provision of $1·8 million over the next five years in order to cover the cost of the first overhaul. (7 marks)

Required:

Evaluate the proposed accounting treatments and (where incorrect) explain the appropriate accounting treatment (preparing relevant calculations where necessary) of the three transactions in the financial statements for the year ended 30 September 2007.

Note: the mark allocation is shown against each of the transactions above.

(25 marks)

4 **(a)** As the worldwide financial community gets more and more sophisticated the nature of financial instruments is changing rapidly. Entities can use financial instruments to radically alter their risk profile and users are entitled to information about the impact of financial instruments on the business.

Required:

(i) Define a financial asset, a financial liability and an equity instrument in accordance with IAS 32 – *Financial instruments: presentation*. (4 marks)

(ii) Explain where the following financial instruments would be presented in the balance sheet:

1 A portfolio of listed investments held for trading.
2 An investment in the shares of a supplier that is being held for the long term.
3 A loan made to the company that is repayable in equal instalments over the next five years.
4 Preference shares issued by the company that require payment of a dividend each year and are redeemable at the option of the investor. (5 marks)

(iii) Describe the categories into which IAS 39 – *Financial instruments: recognition and measurement* – requires financial assets and financial liabilities to be classified. For each category explain how the financial assets and liabilities should be measured in the balance sheet. Where the financial assets or liabilities are measured at fair value, your explanation should include the way in which changes in fair value are recognised in the performance statements (income statement and statement of changes in equity). (9 marks)

(b) Kappa is a listed entity whose year end date is 30 September 2007. On 1 October 2006 Kappa issued a \$6 million convertible loan note. The quoted rate of interest on the loan note was 2% per annum, payable on 30 September in arrears. The loan note was repayable at an amount of \$7 million on 30 September 2009. As an alternative to repayment the lender may choose to receive 1 million shares in Kappa (having a nominal value of \$1 each).

The required rate of return for providers of this type of loan finance at 1 October 2006 was 10% per annum.

Required:

Prepare extracts that show how the loan would be presented in the financial statements of Kappa for the year ended 30 September 2007. (7 marks)

(25 marks)

5 Omega prepares financial statements using International Financial Reporting Standards. In the year ended 30 September 2007 the following transactions occurred:

(a) On 1 October 2006 Omega acquired a new subsidiary, Sigma, purchasing all 150 million shares of Sigma. The terms of the sale agreement included the exchange of four shares in Omega for every three shares acquired in Sigma. On 1 October 2006 the market value of a share in Omega was $10 and the market value of a share in Sigma $12·00.

The terms of the share purchase included the issue of one additional share in Omega for every five acquired Sigma if the profits of Sigma for the two years ending 30 September 2008 exceeded a target figure. Current estimates are that it is 80% probable that the management of Sigma will achieve this target.

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

The individual balance sheet of Sigma at 1 October 2006 comprised net assets that had a fair value at that date of $1,200 million. Additionally Omega considered Sigma possessed certain intangible assets that were not recognised in its individual balance sheet:

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

An in process research and development project that had not been recognised by Sigma since the necessary conditions laid down in International Financial Reporting Standards for capitalisation were only just satisfied at 30 September 2007. However, the fair value of the whole project (including the research phase) is estimated at $50 million.

Employee expertise – directors' estimate of value $80 million.

The market value of a share in Omega on 30 September 2007 was $11.

Required:

Compute the goodwill on consolidation of Sigma that will appear in the consolidated balance sheet of Omega at 30 September 2007. (10 marks)

(b) On 1 October 2005 Omega granted 1,000 employees options to purchase 5,000 shares each in the entity. The options vest on 1 October 2008 for those employees who remain employed by the entity until that date. The options allow the employees to purchase the shares for $9 per share. The market price of the shares and the fair values of the share options (estimated using an appropriate option pricing model) varied as follows:

Date	Market price of share	Fair value of option
1 October 2005	$9	$2
1 October 2006	$10	$2·50
1 October 2007	$11	$2·70

When preparing the financial statements for the year ended 30 September 2006 the directors estimated that 50 of the relevant employees would leave in each of the years ended 30 September 2006, 2007 and 2008. 50 of the relevant employees did leave in both of the years ended 30 September 2006 and 2007. However, the directors now believe that no further relevant employees will leave in the year ended 30 September 2008.

Omega is entitled to a tax deduction in respect of the options when they are exercised based on their intrinsic value at that date. The intrinsic value of a share option at a particular date is the difference between the exercise price of the option and the market value of the share at that date. The rate of corporate income tax in the jurisdiction in which Omega operates is 25%.

Required:

Prepare extracts that show the amounts that will appear in the balance sheet of Omega as at 30 September 2007 in respect of the share options and the amounts that will appear in the income statement for the year ended 30 September 2007. You should state where in the balance sheet and where in the income statement the relevant amounts will be presented. (7 marks)

(c) On 31 July 2007 Omega decided to dispose of a 100% owned subsidiary Theta. The business activities of Theta are substantially different from those of the rest of the group. The net assets of Theta at 31 July 2007 were included in the consolidated financial statements of Omega at a net carrying amount of $200 million, made up as follows:

	$m
Unimpaired goodwill	40
Other assets	260
Liabilities	(100)
	200

On 31 July, Omega immediately began to seek a buyer and initial expectations were that the sale price (net of incremental selling costs) would be $170 million. None of the identifiable assets of Theta had suffered obvious impairment at 31 July. The carrying value of the identifiable net assets of Theta in the consolidated balance sheet at 30 September 2007 was approximately the same as their carrying amount on 31 July 2007. The latest position is that negotiations are at a relatively advanced stage with a buyer who is expected to pay $170 million (net of selling costs). Completion of the transaction is expected in early 2008.

Required:

Explain how the prospective sale of Theta will affect the consolidated financial statements of Omega for the year ended 30 September 2007 (preparing relevant calculations where necessary). (8 marks)

(25 marks)

End of Question Paper