Diploma in International Financial Reporting

MONDAY 11 JUNE 2007

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 2007 were as follows:

	Alpha $'000	Beta $'000	Gamma $'000
Assets			
Non-current assets:			
Property, plant and equipment	125,000	85,000	75,000
Investments (Note 2)	32,000	—	—
	157,000	85,000	75,000
Current assets:			
Inventories (Note 3)	33,000	30,000	28,000
Trade receivables (Note 4)	43,000	30,000	31,000
Cash and cash equivalents	11,000	10,000	9,000
	87,000	70,000	68,000
Total assets	**244,000**	**155,000**	**143,000**
Equity and liabilities			
Equity			
Share capital ($1 shares)	70,000	50,000	50,000
Retained earnings	55,000	44,000	28,000
Total equity	125,000	94,000	78,000
Non-current liabilities:			
Long term borrowings	50,000	25,000	22,000
Deferred tax	35,000	12,000	17,000
Total non-current liabilities	85,000	37,000	39,000
Current liabilities:			
Trade and other payables (Note 4)	25,000	17,000	20,000
Current tax payable	9,000	7,000	6,000
Total current liabilities	34,000	24,000	26,000
Total equity and liabilities	**244,000**	**155,000**	**143,000**

Note 1 – purchase of shares in Beta

On 1 April 2006 Alpha purchased 40 million shares in Beta by issuing one share in Alpha for every two shares purchased in Beta. This share issue has not been recorded in the books of Alpha.

The quoted price of an Alpha share at 1 April 2006 was $6 and the quoted price of a Beta share at the same date was $2·40. Alpha incurred incremental legal and professional costs of $2 million in connection with the acquisition, of which $800,000 related to the cost of issuing its shares. These acquisition costs have been charged as an expense in the income statement of Alpha for the year ended 31 March 2007.

The retained earnings of Beta as shown in its balance sheet at 31 March 2006 were $35 million. The directors of Alpha carried out a fair value exercise on the net assets of Beta at that date. The following matters arose out of the exercise:

(i) Property, plant and equipment comprised non-depreciable land with a carrying amount of $50 million and a market value of $60 million, plus plant and equipment with a carrying amount of $30 million and a market value of $38 million. The estimated future economic life of the plant and equipment at 1 April 2006 was four years (straight line depreciation). None of the property, plant and equipment held by Beta at 1 April 2006 had been disposed of by 31 March 2007.

(ii) At 1 April 2006 Beta was engaged in legal action against a supplier in respect of damages caused by the supply of faulty products. Beta was claiming damages of $5 million. In the middle of March 2006 the customer had offered an out of court settlement of $3 million and Beta's lawyers advised that this was a fair offer given the likelihood of success in court. However Beta refused the offer, took the case to court, and subsequently won the case. The directors of Beta had not recognised any receivable in respect of the case in the balance sheet at 31 March 2006 because the claim was a contingent asset. The directors of Alpha considered that the fair value of the contingent asset at 1 April 2006 was $3 million.

(iii) At 1 April 2006 Beta had a long standing portfolio of loyal customers that regularly ordered goods and services from Beta. In addition, the workforce of Beta was highly trained and the expertise of the workforce was seen by the directors as conferring significant competitive advantage to Beta. The customer relationships and the expertise of the workforce were not included in the balance sheet of Beta at 31 March 2006 because the directors did not consider that they met the recognition criteria in IAS 38 – *Intangible Assets* – for internally developed intangible assets. The directors of Alpha considered that the customer relationships had a market value of $20 million at 1 April 2006 and that based on the life cycle of the existing products, the existing customers would continue to order goods and services from Beta for at least five years from that date. They estimated that the fair value of the competitive advantage conferred by the workforce was $15 million at 1 April 2006 and that the average period to retirement for a typical employee was twenty years.

(iv) The financial director of Alpha has stated that the fair value adjustments will create temporary differences for deferred tax purposes.

Note 2 – purchase of shares in Gamma

On 1 April 2005 Alpha purchased 20 million shares in Gamma for a cash payment of $1·60 per share. The retained earnings of Gamma were $15 million at 1 April 2005. This shareholding has resulted in the directors of Alpha being able to exercise a significant influence over the operating and financial policies of Gamma. The fair value of the net assets of Gamma at 1 April 2005 was equal to their carrying amounts in Gamma's balance sheet.

Note 3 – inventories

The inventories of Beta and Gamma at 31 March 2007 included components purchased from Alpha during the year at a cost of $20 million to Beta and $16 million to Gamma. Alpha supplied these components at cost plus a mark up of 25%.

Note 4 – trade receivables and payables

The trade receivables of Alpha included $5 million receivable from Beta and $4 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 – other information

(i) Neither the goodwill arising on acquisition of Beta nor the investment in Gamma has suffered any impairment since the dates of investment by Alpha in these entities.

(ii) The rate of tax to apply to temporary differences is 25%.

Required:

(a) Prepare the consolidated balance sheet of Alpha at 31 March 2007. (21 marks)

(b) Explain the effect on your answer to (a) if the acquisition agreement with the former shareholders of Beta provided for an additional cash payment of 50 cents per share acquired. The additional amount, payable on 31 March 2008, is contingent on the profits of Beta exceeding a given level in the two years ending 31 March 2008.

Note: you do NOT need to prepare the consolidated balance sheet under this revised assumption or perform any detailed numerical calculations. (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 2007 are being prepared and you are provided with the following trial balance at that date:

	$'000	$'000
Revenue (Note 1)		265,000
Inventories at 1 April 2006	35,000	
Raw material purchases	107,000	
Production costs	50,000	
Distribution costs	10,000	
Administration costs	20,000	
Property, plant and equipment:		
– at cost (Note 3)	140,000	
– accumulated depreciation at 31 March 2006 (Note 3)		33,000
Suspense account (Note 4)		15,000
Lease rentals (Note 5)	25,000	
Interest paid on long-term borrowing	5,000	
Income tax account (Note 6)	1,000	
Deferred tax (Note 6)		9,000
Trade receivables	86,000	
Cash and cash equivalents	48,000	
Trade payables		35,000
Long-term borrowings (10% interest rate)		50,000
Equity share capital ($1 shares)		100,000
Dividend paid 31 December 2006	20,000	
Retained earnings at 31 March 2006		40,000
	547,000	547,000

Notes to the Trial Balance

Note 1 – Revenue
Revenue includes a sale of goods on 30 September 2006 for $30 million. The terms of the sale include the provision by Delta of after sales service for a period of two years. The cost to Delta of the after sales service is expected to be $2 million per annum and a reasonable profit margin on the service would be 20%.

Note 2 – Inventories
On 31 March 2007 the value of Delta's inventories was $40 million.

Note 3 – Property, plant and equipment

	Cost	Accumulated depreciation at 31 March 2006
	$'000	$'000
Property	60,000	15,000
Plant and equipment	80,000	18,000
	140,000	33,000

(i) The amounts contained in the trial balance do not include depreciation of property, plant and equipment for the year ended 31 March 2007. Depreciation of all property, plant and equipment should be allocated 80:10:10 between production, distribution and administration.

(ii) 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.

(iii) On 1 April 2006 the property was revalued to its market value of $120 million. It was estimated that $40 million of this value is attributable to the depreciable element. This revaluation has not yet been recorded in the accounting records of Delta. No change in the estimated useful economic life of the depreciable element is anticipated.

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

Note 4 – suspense account
On 1 April 2006 Delta issued 15 million $1 preferred shares at par. The proceeds were credited to a suspense account. The shareholders will not receive a dividend but the shares are redeemable on 31 March 2011 for $1·61 per share. This is equivalent to an annual return of 10% for the shareholders.

Note 5 – lease rentals
On 1 April 2006 Delta began to use a new specialised network of machines. The network was leased on a five year lease with annual payments of $25 million payable in advance. The network would have cost $108 million to purchase outright and the lessor was seeking a return of 8% per annum on this investment.

The network is expected to have only a negligible value at the end of the five year period and Delta has the option to purchase the network at that time for a nominal sum of $100.

Note 6 – income tax
(i) On 30 September 2006 Delta made full and final payment of $7·5 million to discharge the income tax liability for the year ended 31 March 2006. The amount originally provided was $6·5 million.

(ii) The estimated income tax liability for the year ended 31 March 2007 is $8 million.

(iii) A credit of $3 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 30% on net taxable gains.

Note 7 – other information
The directors of Delta do not wish to make an annual transfer of excess depreciation on revalued assets from the revaluation reserve to retained earnings.

Required:

(a) Prepare the income statement for Delta for the year ended 31 March 2007. (11 marks)

(b) Prepare the statement of changes in equity for Delta for the year ended 31 March 2007. (3 marks)

(c) Prepare the balance sheet for Delta as at 31 March 2007 (11 marks)

Note: 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.

(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 31 March 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)

Epsilon has an 80% subsidiary that it acquired on 31 March 2005 for a cash payment of $80 million. The fair value exercise revealed that the fair value of the identifiable net assets of the subsidiary at that date was $90 million. The fair value adjustments were incorporated into the individual financial statements of the subsidiary at 31 March 2005. The summarised balance sheet of the subsidiary at 31 March 2007 showed the following balances:

	$'000
Non-current assets	100,000
Current assets	30,000
	130,000
Equity	85,000
Non-current liabilities	35,000
Current liabilities	10,000
	130,000

Your assistant is aware that the goodwill of the subsidiary had not suffered any impairment loss when it was tested for impairment at 31 March 2006. However he is unsure what this means. He also provides you with the information that the value in use of the non-current assets of the subsidiary (a single cash-generating unit) is $97 million, and that one of the non-current assets (included in the above balance sheet at a carrying value of $4 million) has been destroyed and is in fact worthless. (10 marks)

Transaction (b)

On 1 April 2006 Epsilon began to lease a property on a 100 year lease. The property had a market value of $10 million at the start of the lease. The lease provides for annual rentals of $250,000 payable on 31 March each year. Because the lease terms do not provide for title to the property to pass to Epsilon at the end of the lease, nor is there any right to purchase the property at a favourable price at that time, your assistant has concluded that the lease is an operating lease. Therefore in the draft financial statements your assistant has taken $250,000 to the income statement. (10 marks)

Transaction (c)

In previous periods Epsilon had included relevant borrowing costs as part of the carrying value of property, plant and equipment. On 31 March 2006 property, plant and equipment included $500,000 relating to capitalised finance costs. During the current period the directors decided to change their treatment of such costs and charge them as an expense when incurred. In the draft financial statements your assistant has charged $500,000 as an expense in the income statement. However he has questioned whether changing the treatment of the finance costs is appropriate since the financial statements ought to be comparable from one year to another. (5 marks)

Required:

Explain to your assistant the appropriate accounting treatment of the three transactions in the financial statements for the year ended 31 March 2007 and answer any queries specifically raised by him. When evaluating transaction (a) you should compute the carrying value of the goodwill following the impairment review. When evaluating transaction (b) you do NOT need to prepare detailed calculations.

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

(25 marks)

4 (a) Kappa is an entity that operates in a sector where the recruitment and retention of high quality employees is particularly important in order to achieve corporate goals. You are the financial controller of Kappa and you have recently received a memorandum from a member of the board of directors. The memorandum includes the following key issues:

(i) The board is eager to reward employees appropriately but is aware that large salary payments have an immediate impact on the liquidity and earnings per share of Kappa.

(ii) A more appropriate method of remuneration is to grant key employees share options that will vest at a future date if the employees comply with specified conditions (such as continued employment) or achieve specific performance targets (such as completing an assignment to a specified standard or achieving a specified growth in the share price). This would allow employees to exercise the options at an appropriate time for them and would prevent an immediate impact on the liquidity or earnings per share of Kappa at the grant date.

Required:

Draft a reply that responds to the observations made by the board. Your reply should focus on the impact on the balance sheet and income statement of Kappa rather than the personal tax positions of the employees. Your reply should contain a summary of the appropriate provisions of IFRS 2 – *Share-based payment*.

(10 marks)

(b) On 1 April 2006 the board of Kappa granted key employees share options that are subject to vesting conditions. Details of the award are as follows:

(i) 50 employees can potentially receive 5,000 options each on 31 March 2008. The options that vest (see below) will allow the employees to purchase shares in Kappa at any time in the year to 31 March 2009 for $15 per share. The par (or nominal) value of the shares is $1 per share.

(ii) The options only vest if the employees remain as employees of Kappa until 31 March 2008 and if the share price of Kappa is at least $20 by that date.

(iii) On 1 April 2006 the board of Kappa estimated that five of the 50 employees would leave in the following two years. Three of the employees left in the year ended 31 March 2007 and at that date the board considered that a further three would leave in the year to 31 March 2008.

(iv) On 1 April 2006 the share price of Kappa was $15. The price had risen to $18 by 31 March 2007 and the directors are reasonably confident that the price will exceed $20 by 31 March 2008.

(v) On 1 April 2006 the directors estimated that the fair value of one of the granted options was $4·50. This estimate had risen to $5 by 31 March 2007.

Required:

Show the impact of the granting of the options on the income statement of Kappa for the year ended 31 March 2007 and on the balance sheet of Kappa as at 31 March 2007. Ignore deferred taxation.

(7 marks)

(c) Having read your reply and seen the impact of the granting of the options on the financial statements for the year ended 31 March 2007, the directors want to know the likely impact of the transactions in (b) on the financial statements of future years under the following assumptions:

The directors' estimates about the number of relevant employees who leave in the year ended 31 March 2008 proving to be accurate.

The employees exercising their options in 90% of cases in the year ended 31 March 2009 and the unexercised options lapsing on 31 March 2009.

Required:

Show the impact of the above assumptions regarding the options on the income statements of Kappa for the years ended 31 March 2008 and 2009 and on the balance sheet of Kappa as at 31 March 2008 and 2009. Ignore deferred taxation. (8 marks)

(25 marks)

5 Omega prepares financial statements under International Financial Reporting Standards. In the year ended 31 March 2007 the following transactions occurred:

Transaction 1

On 1 April 2006 Omega began the construction of a new production line. Costs relating to the line are as follows:

Details	**Amount $'000**
Costs of the basic materials (list price $12·5 million less a 20% trade discount)	10,000
Recoverable sales taxes incurred not included in the purchase cost.	1,000
Employment costs of the construction staff for the three months to 30 June 2006 (Note 1)	1,200
Other overheads directly related to the construction (Note 2)	900
Payments to external advisors relating to the construction	500
Expected dismantling and restoration costs (Note 3)	2,000

Note 1
The production line took two months to make ready for use and was brought into use on 31 May 2006.

Note 2
The other overheads were incurred in the two months ended 31 May 2006. They included an abnormal cost of $300,000 caused by a major electrical fault.

Note 3
The production line is expected to have a useful economic life of eight years. At the end of that time Omega is legally required to dismantle the plant in a specified manner and restore its location to an acceptable standard. The figure of $2 million included in the cost estimates is the amount that is expected to be incurred at the end of the useful life of the production plant. The appropriate rate to use in any discounting calculations is 5%. The present value of $1 payable in eight years at a discount rate of 5% is approximately $0·68.

Note 4
Four years after being brought into use, the production line will require a major overhaul to ensure that it generates economic benefits for the second half of its useful life. The estimated cost of the overhaul, at current prices, is $3 million.

Note 5
Omega computes its depreciation charge on a monthly basis.

Note 6
No impairment of the plant had occurred by 31 March 2007.

(13 marks)

Transaction 2

On 31 December 2006 the directors decided to dispose of a property that was surplus to requirements. They instructed selling agents to find a suitable purchaser and advertised the property at a commercially realistic price.

The property was being measured under the revaluation model and had been revalued at $15 million on 31 March 2006. The depreciable element of the property was estimated as $8 million at 31 March 2006 and the useful economic life of the depreciable element was estimated as 25 years from that date.

On 31 December 2006 the directors estimated that the market value of the property was $16 million, and that the costs incurred in selling the property would be $500,000. The property was sold on 30 April 2007 for $16·1 million. Omega incurred selling costs of $550,000. The actual selling price and costs to sell were consistent with estimated amounts as at 31 March 2007.

The financial statements for the year ended 31 March 2007 were authorised for issue on 15 May 2007.

(12 marks)

Required:

Show the impact of the above transactions on the income statement of Omega for the year ended 31 March 2007, and on its balance sheet as at 31 March 2007. You should state where in the income statement and the balance sheet relevant balances will be shown.

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

(25 marks)

End of Question Paper