Diploma in International Financial Reporting

Thursday 5 June 2008

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.

Dip IFR

The Association of Chartered Certified Accountants

ACCA

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 31 March 2008 are given below:

Income Statements

	Alpha	Beta	Gamma
	$'000	$'000	$'000
Revenue	150,000	100,000	96,000
Cost of sales	(110,000)	(78,000)	(66,000)
Gross profit	40,000	22,000	30,000
Distribution costs	(7,000)	(6,000)	(6,000)
Administrative expenses	(8,000)	(7,000)	(7,200)
Profit from operations	25,000	9,000	16,800
Investment income	5,000	500	500
Finance cost	(4,000)	(3,000)	(3,200)
Profit before tax	26,000	6,500	14,100
Income tax expense	(7,000)	(1,800)	(3,600)
Net profit for the period	19,000	4,700	10,500
Summarised Statements of Changes in Equity			
Balance at 1 April 2007	122,000	91,000	82,000
Net profit for the period	19,000	4,700	10,500
Dividends paid on 31 January 2008	(6,500)	(3,000)	(5,000)
Balance at 31 March 2008	134,500	92,700	87,500

Note 1 – purchase of shares in Beta

On 1 October 2005 Alpha purchased an 80% equity shareholding in Beta. The equity of Beta as shown in its own financial statements at that date was $32 million.

Alpha issued 20 million shares to the former shareholders of Beta in exchange for the shares purchased. The market value of Alpha's shares on 1 October 2005 was $2.

At the date of acquisition Beta owned a property with a book value of $28 million and a market value of $35 million. Beta had purchased the property for $30 million on 1 October 2000 and estimated that the depreciable amount of the property (the buildings element) was $16 million at 1 October 2000. The estimated useful economic life of the building at 1 October 2000 was 40 years.

The directors of Alpha estimated that the buildings element of the property comprised 50% of its market value at 1 October 2005. They considered that the original estimate of the total useful economic life of the buildings element (40 years from 1 October 2000) was still valid.

At 1 October 2005 the plant of Beta had a book value of $12 million and a market value of $15 million. The plant is depreciated on a straight line basis and the remaining useful economic life of the plant at 1 October 2005 was estimated at five years.

All depreciation is charged on a monthly basis and presented in cost of sales. No adjustments were made to the individual financial statements of Beta to reflect the information given in this note.

Note 2 – purchase of shares in Gamma

On 1 July 2007 Alpha purchased 40% of the equity shares of Gamma. This purchase allowed Alpha to exercise a significant influence over Gamma, but Alpha was not able to control its operating and financial policies. No material differences between the market value and the book value of the net assets of Gamma was apparent at the date of the share purchase.

Note 3 – impairment reviews
An impairment review at 31 March 2008 indicated that 25% of the goodwill on acquisition of Beta needed to be written off. Apart from this, no other impairments of goodwill on acquisition of Beta have been required.

No impairment of the investment in Gamma has yet been necessary.

All impairments are charged to cost of sales.

Note 4 – inter-company sales
Alpha supplies products used by Beta and Gamma. Sales of the products to Beta and Gamma during the year ended 31 March 2008 were as follows (all sales were made at a mark up of 25% on cost):

– Sales to Beta $12·5 million.
– Sales to Gamma (all in the post-acquisition period) $4 million.

At 31 March 2008 and 31 March 2007 the inventories of Beta and Gamma included the following amounts in respect of goods purchased from Alpha.

	Amount in inventory at	
	31 March 2008	31 March 2007
	$'000	$'000
Beta	3,000	1,600
Gamma	2,000	Nil

Note 5 – dividend payments
The dividend received from Gamma on 31 January 2008 was credited to the income statement of Alpha as investment income as the post-acquisition profits of Gamma were in excess of the dividend received.

Required:

(a) Prepare the consolidated income statement for Alpha for the year ended 31 March 2008. (18 marks)

(b) Prepare the summarised consolidated statement of changes in equity for Alpha for the year ended 31 March 2008.

(7 marks)

Note: ignore deferred tax.

(25 marks)

Section B – THREE questions ONLY to be attempted

2 The trial balance of Delta at 31 March 2008 (its financial reporting date) is as follows:

	$'000	$'000
Revenue (Note 1)		164,000
Production costs (Note 2)	90,000	
Distribution costs	8,000	
Administrative expenses	26,000	
Inventories at 31 March 2007	19,710	
Interest paid on interest bearing borrowings (Note 4)	3,000	
Income tax (Note 5)		100
Dividends paid on equity shares	5,000	
Property, plant and equipment (Note 6):		
At cost at 31 March 2008	77,000	
Accumulated depreciation at 31 March 2007		22,610
Trade receivables	53,000	
Cash and cash equivalents	33,000	
Trade payables		12,000
Long term interest bearing borrowings (Note 4)		50,000
Lease rentals (Note 7)	20,000	
Deferred tax (Note 5)		7,000
Issued equity capital		50,000
Retained earnings at 31 March 2007		29,000
	334,710	334,710

Notes to the Trial Balance

Note 1 – revenue
On 1 April 2007 Delta sold goods for a price of $12·1 million. The terms of the sale allowed the customer extended credit and the price was payable by the customer in cash on 31 March 2009. Delta included $12·1 million in revenue for the current year and $12·1 million in closing trade receivables. A discount rate that is appropriate for the risks in this transaction is 10%.

Note 2 – production costs
During the year ended 31 March 2008 Delta sold goods to the value of $20 million under warranty. The terms of the warranty were that if the goods were defective within 12 months of the date of sale, Delta would repair or replace them. The warranty was not offered by Delta in respect of goods sold in previous periods.

The directors of Delta estimate that, for each product sold, there is an 80% chance no defects will occur in that product. Therefore they have not made a provision for the cost of any future warranty claims on the grounds that, for each item sold, the most likely outcome is that no additional costs will be incurred.

Any warranty costs that were incurred were included in the production costs for the year. Where warranty costs were incurred, on average they amounted to 50% of the revenue received from the initial sale of the product. Warranty costs of $800,000 were incurred before the year end and included within production costs in the trial balance.

Note 3 – inventories at 31 March 2008
The carrying value of inventories at 31 March 2008 was $25 million.

Note 4 – long term interest bearing borrowings
On 1 April 2007 Delta borrowed $50 million for five years at an annual interest rate of 6%. The market interest rate on loans at this time was 8% and so the terms of the contract provide for a repayment on 1 April 2012 of more than $50 million. The repayment makes the effective interest rate applicable to the loan 8%. At 31 March 2007 the market value of a loan with identical cash flows was $53 million. Delta does not consider that the loan is part of a trading portfolio.

Note 5 – tax

- The estimated income tax on the profits for the year to 31 March 2008 is $1·5 million.
- During the year $1·3 million was paid in full and final settlement of income tax on the profits for the year ended 31 March 2007. The statement of financial position at 31 March 2007 had included $1·4 million in respect of this liability.
- At 31 March 2008 the carrying amounts of the net assets of Delta exceeded their tax base by $28 million. This information is before taking account of the property revaluation (see Note 6 below)
- The rate of income tax in the jurisdiction in which Delta operates is 30%.

Note 6 – property, plant and equipment

Details are as follows:

	Property		Plant and
	Land	**Buildings**	**equipment**
	$'000	**$'000**	**$'000**
Cost at 31 March 2008 (see below)	22,000	28,000	27,000
Estimate of useful economic life (at date of purchase)	Infinite	50 years	4 years
Accumulated depreciation **at 31 March 2007**	0	5,600	17,010

On 1 April **2007** the open market value of the property was $60 million, including $32 million relating to the building. The directors wish to reflect this revaluation in the financial statements, but no entries regarding the revaluation have yet been made. The directors do not wish to make an annual transfer of excess depreciation to retained earnings. The original estimate of the useful economic life of the building is still considered valid. No assets were fully depreciated at 31 March 2008.

All of the depreciation is to be charged to cost of sales.

Note 7 – Lease rentals

On 1 April 2007 Delta began to lease a large group of machines that were used in the production process. The lease was for 4 years and the annual rental (payable in advance on 1 April each year) was $20 million. The lessor paid $71 million for the machines on 31 March 2007. The lessor has advised Delta that the lease is a finance lease and that the rate of interest implicit in the lease can be taken as 9% per year.

Required:

(a) Prepare the statement of comprehensive income for Delta for the year ended 31 March 2008. (14 marks)

(b) Prepare the statement of financial position for Delta as at 31 March 2008 (11 marks)

Note: notes to the statement of comprehensive income and statement of financial position 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 31 March 2008 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 April 2007 Epsilon began to extract minerals from a large site that it had recently constructed. The direct costs of constructing the site totalled \$25 million. The directors of Epsilon estimate that an appropriate allocation of general administrative costs to this project would be \$2·5 million. The site has an expected useful economic life of 10 years and at the end of that period the cost of rectifying the damage to the environment caused by the construction of the site is estimated at \$6 million. Epsilon is under no legal obligation to rectify this damage, but its published policies indicate that rectification is its usual practice in such circumstances.

Your assistant has included \$27·5 million in property, plant and equipment and charged \$2·75 million depreciation in the income statement. He has not included any provision for the cost of rectifying the environmental damage because Epsilon has no legal obligation to rectify it and could therefore choose not to.

The relevant discount rate to be used in any calculations is 8% per annum and the present value of \$1 receivable at the end of 10 years at this rate is 46·32 cents. (7 marks)

Transaction (b)

Since 1 July 2006 Epsilon has been engaged in a development project with the aim of improving the efficiency of its mineral extraction process. In the year ended 31 March 2007 Epsilon incurred costs of \$4 million on this project and charged them to the income statement.

On 31 December 2007 the directors of Epsilon formally evaluated this project and concluded that it was technically feasible and commercially viable. They further concluded that the likely cost savings the project would generate would be \$1 million per annum for at least 10 years from 1 October 2008.

In the year ended 31 March 2008 Epsilon incurred costs of \$500,000 per month on this project for the first six months and \$400,000 per month for the second six months, an annual total of \$5·4 million.

In the draft financial statements, the assistant has adjusted opening retained earnings in the statement of changes in equity to reflect the error made in writing off the \$4 million costs to the income statement in the year ended 31 March 2007. This amount, plus the costs incurred during the year of \$5·4 million, a total of \$9·4 million, has been shown as an intangible asset in the draft statement of financial position. (4 marks)

Transaction (c)

On 1 January 2008 Epsilon signed a contract to take delivery of a machine on 30 June 2008 for a fixed price of 20 million Euros. In order to provide a measure of certainty regarding the cash outflow in dollars, the directors entered into a contract on 1 January 2008 to purchase 20 million Euros on 30 June 2008 for \$24 million. The treasury department estimated that this contract had a fair value of \$1 million (a financial asset) at 31 March 2008.

In the draft financial statements your assistant has included a payable and an asset of \$24 million in current liabilities and non-current assets respectively. (6 marks)

Transaction (d)

On 1 April 2007 Epsilon began to lease a property on a 50 year lease. The useful economic life of the **buildings** was estimated to be 50 years from 1 April 2007.

The market values of the leasehold interests in the property at the start of the lease were equally split between land and buildings and the present value of the minimum lease payments was \$5 million – equal to the property's fair value. The annual rentals were \$500,000, payable in arrears, the first payment being made on 31 March 2008. The annual rate of interest implicit in the lease was 8%. The property was to be vacated at the end of the lease and there was no option available to Epsilon to purchase it at a favourable price.

Your assistant considered that the lease was an operating lease, since the property was to be vacated at its termination. Therefore he charged \$500,000 as a rental expense in the income statement. (8 marks)

Required:

Explain and quantify the appropriate accounting treatment of the four transactions in the financial statements for the year ended 31 March 2008. For each transaction your explanation should include an evaluation of the treatment that is proposed by your assistant.

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

(25 marks)

4 The draft income statement of Kappa for its year ended 31 March 2008 is given below:

	$'000
Revenue	110,000
Cost of sales	(50,000)
Gross profit	60,000
Other income	4,000
Distribution costs	(5,000)
Administrative expenses	(10,000)
Finance costs	(14,000)
Profit before tax	35,000
Income tax expense	(9,000)
Profit for the year	26,000

The following notes are relevant to the draft income statement:

Note 1
On 31 March 2008 Kappa was in the process of defending a legal case brought against it for damages caused due to the supply by Kappa of faulty products. Kappa's lawyers provided the following estimates of the likely outcome of the case:

– A 70% chance of defending the case successfully.
– A 20% chance of being required to pay $3 million in damages.
– A 10% chance of being required to pay $5 million in damages.

The draft financial statements included a provision for $1·1 million (70% x nil + 20% x $3 million + 10% x $5 million). The charge in the income statement was made to administrative expenses.

The directors of Kappa have estimated that the legal costs of defending the case will total $400,000. $300,000 of this has already been invoiced by the lawyers covering fees up to and including 31 March 2008. Kappa has included $300,000 in trade payables and charged $300,000 to administrative expenses, but has not provided for the expected future costs of $100,000.

In the event of successfully defending the case, the directors of Kappa believe there is a 'good chance' that they will be able to recover their legal costs, but they have not yet reflected this fact in the draft financial statements.

Note 2
On 1 April 2007 Kappa issued a bond to finance an acquisition. The proceeds of the bond were $50 million. The bond did not permit the holders to receive interest, but it was repayable on 31 March 2012 at an amount of $64·4 million. As an alternative to repayment, the bond-holders can elect to receive equity shares in Kappa on 31 March 2012. On 1 April 2007 the required annual rate of return on bonds that did not carry a conversion option was 10% and without the conversion option the bond issue would only have raised $40 million. On 1 April 2007 the directors of Kappa considered it highly probable that the bond-holders would elect to receive shares on 31 March 2012 and so credited $50 million to equity. No charge has therefore been made in the draft income statement in respect of this bond.

Note 3
On 1 January 2008 Kappa began work on the construction of a substantial asset for a customer. The construction period is estimated at two years, ending on 31 December 2009. The directors of Kappa faced a great deal of competition to secure this contract and so agreed a very competitive fixed price of $30 million. On 1 January 2008 they purchased plant and machinery for use on the contract at a price of $10 million. This plant will have no value at 31 December 2009. Other costs incurred on the contract in the three month period to 31 March 2008 totalled $2 million. The directors of Kappa estimate that further costs of $20 million will be necessary to complete the contract. Expenditure of $12 million ($10 million (plant) + $2 million (other)) has been included as work in progress in the statement of financial position, but no other entries have been made. The contract was $12^1/_2$% complete at 31 March 2008. It is the normal policy of Kappa to record revenue on construction contracts based on the percentage of completion applied to total contract revenue.

Note 4
On 1 April 2007 Kappa sold a property to a third party for $20 million. The carrying value of the property immediately before sale was $16 million. The profit on sale of $4 million was included in other income in the draft income statement. Kappa leased the property back on a five year lease at an annual rental of $2 million, which was included in administrative expenses. The future useful economic life of the property at 1 April 2007 was estimated at 30 years. At the end of the lease (1 April 2012) Kappa has an option to repurchase the property for its market value at 1 April 2012.

Note 5
On 1 April 2007 Kappa borrowed 40 million euros for 20 years at a fixed annual rate of interest of 6%, payable in arrears. Relevant exchange rates ($ to 1 euro) are:

1·2 on 1 April 2007.
1·25 on 31 March 2008.

The draft financial statements have included interest payable of $3 million (2·4 million euros x 1·25) in the income statement and an exchange loss on the loan of $2 million (40 million euros x ($1·25 – $1·20)) in the statement of comprehensive income.

Note 6
During the year ended 31 March 2008 Kappa carried out a major advertising campaign. This campaign was carefully targeted and the directors of Kappa considered that it had been highly successful and would result in significant additional revenue in the current year and for at least four years afterwards. Therefore the total amount spent – $10 million – was not charged to administrative expenses as would normally be the case with advertising expenditure. Instead the advertising costs were capitalised as an intangible asset and amortised over a five year period. A $2 million amortisation charge was included in administrative expenses for the year ended 31 March 2008.

Note 7
Kappa 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 why you have, or have not, made adjustments.

(25 marks)

5 Omega prepares financial statements under International Financial Reporting Standards. In the year ended 31 March 2008 the following transactions occurred:

(a) Transaction 1

On 1 October 2007 Omega purchased 8 million of Target's 12 million equity shares. The acquisition was financed as follows:

A cash payment of $2·00 per share, $1·20 per share being payable on 1 October 2007 and $0·80 being payable on 30 September 2008. Any discounting calculations should be performed using a cost of capital of 8% per annum.

A share exchange of 1 equity share in Omega for every 2 shares acquired in Target. The market value of a Target share was $3·90 on 1 October 2007. The market values of an Omega share were $4 on 1 October 2007 and $4·20 on 31 March 2008.

A further share issue by Omega on 30 September 2008 of 1 share for every 8 shares acquired in Target provided the profits after tax of Target exceeded a given figure. Estimates indicate that this share issue is likely to be made.

Omega incurred acquisition costs of $600,000. $350,000 of these costs were external due diligence costs, $100,000 were Omega's best estimate of management time spent in negotiating the acquisition, and $150,000 were costs incurred in connection with the issue of Omega's shares.

The directors of Omega carried out a fair value exercise on 1 October 2007 and the following matters emerged:

The net assets of Target that were recognised in Target's own financial statements were $30 million based on their carrying values in the individual financial statements of Target.

On 1 October 2007 the carrying value of Target's freehold property was $15 million. The property had been purchased on 1 October 1997 for $17·5 million and the buildings element of the property (allocated cost $10 million) was being depreciated over its estimated useful economic life of 40 years. On 1 October 2007 the market value of the property was $22 million, of which $12 million related to the buildings element. The original estimate of the useful economic life of the buildings is still considered valid.

On 1 October 2007 Target was engaged in contracts with three different customers under which they supplied each customer for a five year period from 1 October 2007. The directors of Omega believe that this creates an intangible asset with a fair value of $7·5 million. In addition the directors of Omega believe that the fair value of the assembled workforce of Target creates an intangible asset with a fair value of $15 million. The average remaining working life of the employees of Target at 1 October 2007 is 15 years. Neither of these intangible assets has been recognised in the individual financial statements of Target.

At 1 October 2007 Target was engaged in a legal dispute with a customer. The directors of Target consider that the case can be successfully defended and have made no provision for legal costs in its financial statements. The directors of Omega estimated that the fair value of the claim at 1 October 2007 was $600,000. Events since 1 October 2007 have reduced this estimate to $500,000 by 31 March 2008 (these events do not affect the fair value of the claim at 1 October 2007).

Due to the acquisition of Target the directors of Omega intend to reorganise the group, starting in June 2009. The estimated cost of this reorganisation is $20 million.

In the year ended 31 March 2008 Target reported a post-tax profit of $6 million (accruing evenly over the period) and paid a dividend of $1·5 million on 31 December 2007 out of post-acquisition profits. The retained earnings of Omega at 31 March 2008 were $18 million. This figure includes the dividend received from Target but does not include any other adjustments to its own earnings that are required as a result of the acquisition of Target. The acquisition costs of $600,000 referred to above have been charged to retained earnings by Omega. Omega has no subsidiaries other than Target and no associates or joint venture entities.

The goodwill on acquisition of Target had not suffered any impairment at 31 March 2008.

Required:

(i) Compute the goodwill on acquisition of Target as initially measured at 1 October 2007. (10 marks)

(ii) Compute the balance of retained earnings that will be shown in the consolidated statement of financial position of Omega at 31 March 2008. (9 marks)

Note: your figures should be supported by appropriate explanations, both for amounts you include and for amounts you exclude.

(b) Transaction 2

Omega follows the cost model when measuring its property, plant and equipment. One of its properties was carried in the statement of financial position at 31 March 2007 at $6 million. The depreciable amount of this property was estimated at $3·6 million at 31 March 2007 and the estimated future economic life of the property at 31 March 2007 was 18 years. Omega depreciates its properties on a monthly basis

On 1 January 2008 Omega decided to dispose of the property as it was surplus to requirements and began to actively seek a buyer. On 1 January 2008 Omega estimated that the market value of the property was $7·1 million and that the costs of selling the property would be $80,000. These estimates remained appropriate at 31 March 2008.

The property was sold on 1 June 2008 for net proceeds of $7 million.

Required:

Explain, with relevant calculations, how the property would be treated in the financial statements of Omega for the year ended 31 March 2008 and the year ending 31 March 2009. (6 marks)

(25 marks)

End of Question Paper