Diploma in International Financial Reporting

Thursday 4 June 2009

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 The statements of comprehensive income and summarised statements of changes in equity of Alpha, Beta and Gamma for the year ended 31 March 2009 are given below:

Statements of Comprehensive Income

	Alpha $'000	Beta $'000	Gamma $'000
Revenue	340,000	180,000	126,000
Cost of sales	(210,000)	(108,000)	(76,000)
Gross profit	130,000	72,000	50,000
Distribution costs	(9,000)	(7,000)	(5,000)
Administrative expenses	(12,000)	(8,000)	(7,200)
Profit from operations	109,000	57,000	37,800
Investment income	20,300	500	500
Finance cost	(8,000)	(5,000)	(3,200)
Profit before tax	121,300	52,500	35,100
Income tax expense	(27,000)	(16,800)	(8,600)
Net profit for the period	94,300	35,700	26,500
Other comprehensive income for the period	Nil	Nil	Nil
Total comprehensive income for the period	94,300	35,700	26,500
Summarised Statements of Changes in Equity			
Balance at 1 April 2008	232,000	121,000	92,000
Comprehensive income for the period	94,300	35,700	26,500
Dividends paid on 31 December 2008	(26,000)	(20,000)	(15,000)
Balance at 31 March 2009	300,300	136,700	103,500

Note 1 – purchase of shares in Beta

On 1 October 2005 Alpha purchased a 60% equity shareholding in Beta. Alpha paid $45 million cash for this shareholding. The directors of Alpha estimated that the fair value of the non-controlling interest in Beta on 1 October 2005 was $30 million. It is Alpha's policy to value the non-controlling interest at the date of acquisition at fair value in its consolidated financial statements.

The equity of Beta as shown in its own financial statements at 1 October 2005 was $62 million. At that date Beta owned a property with a book value of $20 million and a market value of $28 million. The directors of Alpha estimated that:

– $16 million of the market value of $28 million related to the buildings element of the property, and
– the useful economic life of the buildings was 32 years from 1 October 2005.

The individual financial statements of Beta have included an annual depreciation charge of $350,000 on this property since its purchase. All depreciation is charged on a monthly basis and presented in cost of sales.

Note 2 – purchase of shares in Gamma

On 1 August 2008 Alpha purchased 42% 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 were apparent at the date of the share purchase.

Note 3 – impairment reviews

An impairment review at 31 March 2009 indicated that 20% 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 – purchase of shares in Lambda

On 1 October 2008 Alpha purchased shares in Lambda, a key supplier. The shareholding did not give Alpha sole control, joint control, or significant influence over the operating and financial policies of Lambda. The directors of Alpha designated this investment as an Available for Sale financial asset. The investment is shown at its cost of $20 million in the financial statements of Alpha. On 28 February 2009 Alpha received a dividend of $1.5 million from Lambda and included this amount in investment income. The fair value of Alpha's shareholding in Lambda at 31 March 2009 was $22 million.

Note 5 – inter-company sales

Beta supplies products to Alpha and Gamma. Sales of the products to Alpha and Gamma during the year ended 31 March 2009 were as follows (all sales were made at a mark-up of 25% on cost):

– Sales to Alpha $15 million.
– Sales to Gamma (all since 1 August 2008) $6 million.

At 31 March 2009 and 31 March 2008 the inventories of Alpha and Gamma included the following amounts in respect of goods purchased from Beta.

	Amount in inventory at	
	31 March 2009	31 March 2008
	$'000	$'000
Alpha	3,300	1,700
Gamma	2,500	Nil

Note 6 – dividend payments

The dividends received from Gamma and Lambda during the period were credited to the income statement of Alpha as the post-acquisition profits of Gamma and Lambda were in excess of the dividends received.

Required:

(a) Prepare the consolidated statement of comprehensive income for Alpha for the year ended 31 March 2009. (19 marks)

(b) Prepare the consolidated statement of changes in equity for Alpha for the year ended 31 March 2009. Ignore deferred tax. (6 marks)

(25 marks)

Section B – THREE questions ONLY to be attempted

2 The trial balance of Delta at 31 March 2009 (its financial reporting date) was as follows:

	$'000	$'000
Revenue (Note 1)		234,000
Production costs (Note 2)	120,000	
Distribution costs	11,000	
Administrative expenses	31,000	
Inventory at 31 March 2008	64,540	
Interest paid on interest bearing borrowings (Note 4)	5,000	
Income tax (Note 5)	120	
Dividends paid on equity shares	6,000	
Property, plant and equipment (Note 6):		
At cost at 31 March 2009	147,000	
Accumulated depreciation at 31 March 2008		24,660
Trade receivables	66,000	
Cash and cash equivalents	39,000	
Trade payables		24,000
Long-term interest bearing borrowings (Note 4)		100,000
Deferred tax (Note 5)		9,000
Issued equity capital		60,000
Retained earnings at 31 March 2008		38,000
	489,660	489,660

Notes to the Trial Balance

Note 1 – revenue

On 1 April 2008 Delta sold goods for a price of $22 million and credited $22 million to revenue. The terms of the sale required Delta to provide two years servicing of the goods at no additional cost. The directors of Delta estimated that the annual cost of providing the servicing would be $3 million. Delta would normally expect to make a gross profit of 25% on servicing activities

Note 2 – production costs

During the year ended 31 March 2009 Delta supplied goods to a number of different customers that they later discovered to be faulty. These goods had not been supplied in earlier periods and Delta ceased selling them prior to 31 March 2009. The customers have jointly taken legal action against Delta, claiming total damages of $12 million. Delta's legal advisers have provided the following estimates of the likely outcome:

– There is a 10% chance that all cases can be successfully defended.
– There is a 25% chance that the total damages will be $4 million.
– There is a 45% chance that the total damages will be $8 million.
– There is a 20% chance that the total damages will be $12 million.

In the draft financial statements the directors have made a provision of $7 million (10% x nil) + (25% x $4 million) + (45% x $8 million) + (20% x $12 million). They have debited this amount to production costs and included an equivalent amount in trade payables.

Note 3 – inventory at 31 March 2009

The carrying value of inventory at cost at 31 March 2009 was $67·5 million. This amount includes faulty components (see note 2 above) at their cost of $3 million. The directors of Delta estimate that these components can be modified at a cost of $600,000 and then sold for $1·8 million.

Note 4 – long-term interest bearing borrowings

On 1 April 2008 Delta borrowed $100 million at an annual interest rate of 5%. The interest is payable annually in arrears and the principal amount of $100 million is repayable on 31 March 2013. As an alternative to repayment the investors can elect to convert their loans into equity shares on 31 March 2013. The annual market interest rate on non-convertible loans at 1 April 2008 was 8%. Discount factors are as follows:

	Annual discount factor	
	5%	**8%**
Present value of $1 payable in 5 years	78 cents	68 cents
Cumulative present value of $1 payable at the end of years 1–5	$4·33	$3·99

Note 5 – tax

– The estimated income tax on the profits for the year to 31 March 2009 is $11·5 million.

– During the year $10·3 million was paid in full and final settlement of income tax on the profits for the year ended 31 March 2008. The statement of financial position at 31 March 2008 had included $10·18 million in respect of this liability.

– At 31 March 2009 the carrying amounts of the net assets of Delta exceeded their tax base by $38 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 25%.

Note 6 – property, plant and equipment

Details are as follows:

	Property		Plant and equipment
	Land	**Buildings**	
	$'000	**$'000**	**$'000**
Cost at 31 March 2009 (but see below)	42,000	48,000	57,000
Estimate of useful economic life (at date of purchase)	Indefinite	50 years	4 years
Accumulated depreciation at **31 March 2008**	0	9,600	15,060

On 31 March 2009 the open market value of the property was $110 million. The directors wish to reflect this revaluation in the financial statements but no entries regarding the revaluation have yet been made.
No assets were fully depreciated at 31 March 2009. All of the depreciation is to be charged to cost of sales.

Required:

(a) Prepare the statement of comprehensive income for Delta for the year ended 31 March 2009. (13 marks)

(b) Prepare the statement of financial position for Delta as at 31 March 2009 (12 marks)

Note: notes to the statements 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 2009 are being prepared. The board of directors is responsible for all key financial and operating decisions, including the allocation of resources. Your assistant is preparing the first draft of the statements. He has a reasonable general accounting knowledge but is not familiar with the detailed requirements of all relevant financial reporting standards. There are two issues on which he requires your advice and he has sent you a note as shown below:

Issue 1

We intend to apply IFRS 8 – *Operating Segments* – in this year's financial statements. I am aware that this standard has attracted a reasonable amount of critical comment since it was issued in November 2006.

The board of directors receives a monthly report on the activities of the five significant operational areas of our business. Relevant financial information relating to the five operations for the year to 31 March 2009, and in respect of our Head Office, is as follows:

Operational area	Revenue for year to 31 March 2009 $'000	Profit/(loss) for year to 31 March 2009 $'000	Assets at 31 March 2009 $'000
A	23,000	3,000	8,000
B	18,000	2,000	6,000
C	4,000	(3,000)	5,000
D	1,000	150	500
E	3,000	450	400
Sub-total	49,000	2,600	19,900
Head office	Nil	Nil	6,000
Entity total	49,000	2,600	25,900

I am unsure of the following matters regarding the reporting of operating segments:

– How do we decide on what our operating segments should be?
– Should we report segment information relating to Head Office?
– Which of our operational areas should report separate information? Operational areas A, B and C exhibit very distinct economic characteristics but the economic characteristics of operational areas D and E are very similar.
– Why has IFRS 8 attracted such critical comment?

(11 marks)

Issue 2

I note that on 31 January 2009 the board of directors decided to discontinue the activities of a number of our subsidiaries. This decision was made, I believe, because these subsidiaries did not fit into the long-term plans of the group and the board did not consider it likely that the subsidiaries could be sold. This decision was communicated to the employees on 28 February 2009 and the activities of the subsidiaries affected were gradually curtailed starting on 1 May 2009, with an expected completion date of 30 September 2009. I have the following information regarding the closure programme:

(a) All the employees in affected subsidiaries were offered redundancy packages and some of the employees were offered employment in other parts of the group. These offers had to be accepted or rejected by 30 April 2009. On 31 March 2009 the directors estimated that the cost of redundancies would be $20 million and the cost of relocation of employees who accepted alternative employment would be $10 million. Following 30 April 2009 these estimates were revised to $22 million and $9 million respectively.

(b) Latest estimates are that the operating losses of the affected subsidiaries for the six months to 30 September 2009 will total $15 million.

(c) A number of the subsidiaries are leasing properties under non-cancellable operating leases. I believe that at 31 March 2009 the present value of the future lease payments relating to these properties totalled $6 million. The cost of immediate termination of these lease obligations would be $5 million.

(d) The carrying values of the freehold properties owned by the affected subsidiaries at 31 March 2009 totalled \$25 million. The estimated net disposal proceeds of the properties are \$29 million and all properties should realise a profit.

(e) The carrying value of the plant and equipment owned by the affected subsidiaries at 31 March 2009 was \$18 million. The estimated current disposal proceeds of this plant and equipment is \$2 million and its estimated value in use (including the proceeds from ultimate disposal) is \$1.8 million.

I am unsure regarding a number of aspects of accounting for this decision by the board. Please tell me how the decision to curtail the activities of the three subsidiaries affects the financial statements.

(14 marks)

Required:

Draft a reply to the questions raised by your assistant.

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

(25 marks)

4 IAS 19 – Employee benefits – is applied to all employee benefits other than those to which IFRS 2 – Share-based payment – applies. Accounting for short-term employee benefits is relatively straightforward. However, accounting for post-employment benefits can be rather more complex. This particularly applies where post-employment benefits are provided via defined benefit plans.

Required:

Explain:

(a) The meaning of post-employment benefits and the manner in which such benefits that are provided via defined contribution plans should be measured and recognised in the financial statements of employers. (3 marks)

(b) Why accounting for post-employment benefits provided via defined benefit plans is more complex than those provided via defined contribution plans in the financial statements of employers. (2 marks)

(c) The amounts that should be included in the financial statements of employers regarding post-employment benefits provided via defined benefit plans (ignore the effect of actuarial gains and losses at this stage). (6 marks)

Kappa provides post-employment benefits to its employees through a defined benefit plan. The following data relates to the plan:

	Year ended 31 March	
	2009	2008
	$'000	$'000
Present value of obligation at year end	36,000	33,000
Fair value of plan assets at year end	31,000	30,000
Current service cost	6,000	5,700
Benefits paid by plan	8,000	7,500
Contributions paid into plan	5,800	5,600
Discount rate at the start of the year	10%	9%
Expected rate of return on plan assets at the start of the year	7%	6%
Average remaining service lives of participating employees	20 years	20 years

On 1 April 2008 Kappa had net unrecognised actuarial losses of $4·2 million. Kappa accounts for actuarial gains and losses using the 'corridor method'.

Required:

(d) Prepare extracts from Kappa's statement of financial position at 31 March 2009 and from its income statement for the year ended 31 March 2009 relating to the defined benefits plan. (11 marks)

(e) Explain the various alternatives to the 'corridor approach' that IAS 19 allows for recognising actuarial gains and losses. (3 marks)

(25 marks)

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Question 5 begins on page 10.

5 In the year ended 31 March 2009, Omega carried out the following two transactions:

(a) Transaction 1

On 1 May 2008 Omega began to lease some land. The lease was for 50 years and was correctly assessed by Omega to be an operating lease. The annual lease rentals were $400,000, payable on 30 April in arrears. However, during its negotiations with Omega, the lessor agreed to a two-year rent free period at the start of the lease. Therefore the first payment is not due until 30 April 2011 and Omega will make only 48, rather than 50, payments.

Omega intended to build a factory on this land and on 1 June 2008 borrowed $8 million at an annual interest rate of 9% to partly finance its construction. Construction commenced on 1 July 2008 and Omega incurred the following costs from that date:

– Construction materials purchased totalled $5·5 million. They should have only needed materials costing $5 million but materials costing $0·5 million were wasted during the construction period due to an error by the construction team.
– The construction team were paid at the rate of $800,000 per month throughout the construction period.
– It is the policy of Omega to allocate general administrative costs to all projects to ensure that their profitability can be accurately assessed. The amount of such costs that were allocated to the factory construction was $250,000 per month, using Omega's standard cost allocation model.
– The factory was completed on 31 October 2008 and began production on 1 January 2009. In the two-month period from 31 October 2008 to 1 January 2009 Omega spent $500,000 publicising the new factory and arranged for an opening ceremony to take place on 1 January 2009 at a cost of $100,000. The directors estimate that the factory will generate economic benefits for Omega until 30 April 2058.

Required:

(i) Compute the amounts that will be included in the income statement for the year ended 31 March 2009 in respect of the lease of the land. Your figures should be supported by appropriate explanations.

(4 marks)

(ii) Compute the carrying amount of the factory in the statement of financial position at 31 March 2009. Your figures should be supported by appropriate explanations, both for amounts you include and for amounts you exclude. (9 marks)

(b) Transaction 2

On 1 January 2009 Omega signed a contract to supply a customer with a large item of plant and equipment that was expected to take eight months to manufacture. Omega began construction immediately. The fixed price payable to Omega on completion and delivery was agreed at $6 million. If the machine is completed to the specified standard and delivered to the customer before 31 August 2009 then Omega would receive a bonus payment of $1 million. Latest estimates are that the machine will be completed half-way through August 2009 and delivered before 31 August 2009. However, there is a 15% chance that delivery could be delayed until after 31 August 2009. Relevant costs relating to the contract were as follows:

– On 1 January 2009 Omega purchased materials costing $2 million to use in the construction work.
– Salaries of staff employed on the construction of the machine totalled $200,000 per full month from 1 January 2009.
– Construction staff used tools that had a carrying value of $4·2 million on 1 April 2008 and an estimated future useful economic life of five years from that date, with no residual value. It is expected that throughout the construction period these tools will only be used on this contract. However, both before and after the construction period the tools are used for other purposes.
– Omega has an insurance policy to protect it against claims arising on its construction contracts. The directors estimate that a monthly premium of $50,000 can reasonably be allocated to this contract, together with general administrative overheads of $40,000 per month.

After the year end the directors of Omega obtained an independent assessment of the stage of completion of the contract at 31 March 2009. The results were that the contract was 40% complete at that date. In accordance with the terms of the contract, Omega invoiced the customer for a progress payment of $1·8 million on 30 April 2009 and the customer paid this amount to Omega on 31 May 2009.

Required:

Explain, with relevant calculations, how the contract would be treated in the financial statements of Omega for the year ended 31 March 2009. (12 marks)

(25 marks)

End of Question Paper