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# Diploma in International Financial Reporting

Thursday 10 June 2010

**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.**

**ACCA**

**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 statements of financial position of the three entities at 31 March 2010 were as follows:

	Alpha \$'000	Beta \$'000	Gamma \$'000
<b>ASSETS</b>			
Non-current assets:			
Property, plant and equipment (Note 1)	135,000	100,000	110,000
Investments (Notes 1 and 2)	139,000	15,000	Nil
	<u>274,000</u>	<u>115,000</u>	<u>110,000</u>
Current assets:			
Inventories (Note 4)	45,000	32,000	27,000
Trade receivables (Note 5)	50,000	34,000	35,000
Cash and cash equivalents	10,000	4,000	8,000
	<u>105,000</u>	<u>70,000</u>	<u>70,000</u>
Total assets	<u>379,000</u>	<u>185,000</u>	<u>180,000</u>
<b>EQUITY AND LIABILITIES</b>			
Equity			
Share capital (\$1 shares)	120,000	80,000	60,000
Retained earnings	163,000	44,000	55,000
Total equity	<u>283,000</u>	<u>124,000</u>	<u>115,000</u>
Non-current liabilities:			
Long-term borrowings	40,000	25,000	30,000
Deferred tax	20,000	8,000	10,000
Total non-current liabilities	<u>60,000</u>	<u>33,000</u>	<u>40,000</u>
Current liabilities:			
Trade and other payables	30,000	22,000	20,000
Short-term borrowings	6,000	6,000	5,000
Total current liabilities	<u>36,000</u>	<u>28,000</u>	<u>25,000</u>
Total equity and liabilities	<u>379,000</u>	<u>185,000</u>	<u>180,000</u>

**Note 1 – Alpha's investment in Beta:**

On 1 April 2009 Alpha purchased 60 million shares in Beta for an immediate cash payment of \$100 million. The retained earnings of Beta at 1 April 2009 were \$35 million.

It is the group policy to value the non-controlling interest in subsidiaries at the date of acquisition at fair value. The fair value of an equity share in Beta at 1 April 2009 was estimated at \$1.70. This fair value is considered by the directors of Alpha to be an appropriate basis for measuring the non-controlling interest in Beta on 1 April 2009.

The terms of the business combination provide for the payment of an additional \$15 million to the former shareholders of Beta on 31 March 2011. On 1 April 2009 Alpha's credit rating was such that it could have borrowed funds at an annual finance cost of 8%. The statement of financial position of Alpha includes this investment at its original cost of \$100 million.

The directors of Alpha carried out a fair value exercise to measure the identifiable assets and liabilities of Beta at 1 April 2009. The following matters emerged:

- A property having a carrying value of \$40 million (depreciable amount \$24 million) had a fair value of \$60 million (depreciable amount \$36 million). The estimated future economic life of the depreciable amount of the property at 1 April 2009 was 30 years.
- Plant and equipment having a carrying value of \$51 million had a fair value of \$54 million. The estimated future economic life of the plant at 1 April 2009 was three years.

The fair value adjustments have not been reflected in the individual financial statements of Beta. In the consolidated financial statements the fair value adjustments will be regarded as temporary differences for the purposes of computing deferred tax. The rate of tax to apply to temporary differences is 30%.

The goodwill arising on acquisition of Beta has not suffered any impairment since 1 April 2009.

**Note 2 – Alpha’s investment in Gamma:**

On 1 October 2009 Alpha paid \$39 million for 30% of the equity shares of Gamma. This investment gave Alpha significant influence over Gamma. The retained earnings of Gamma on 1 October 2009 were \$60 million. You can ignore any deferred taxation implications of the investment by Alpha in Gamma. The investment in Gamma has not suffered any impairment since 1 October 2009.

**Note 3 – Beta’s investment:**

Beta’s investment is a strategic equity investment in Sigma – key supplier. This investment does not give Beta control or significant influence over Sigma. Sigma is not a joint venture for Beta. The investment in Sigma is correctly classified as available for sale and on 1 April 2009 was included in the financial statements of Beta at its fair value of \$15 million. The fair value of the investment in Sigma on 31 March 2010 was \$17 million. In the tax jurisdiction in which Beta is located unrealised profits on the revaluation of equity investments are not subject to current tax. Any such profits are taxed only when the investment is sold.

**Note 4 – Inter-company sale of inventories:**

The inventories of Beta and Gamma at 31 March 2010 included components purchased from Alpha during the year at a cost of \$10 million to Beta and \$12 million to Gamma. Alpha generated a gross profit margin of 25% on the supply of these components. You can ignore any deferred tax implications of the information in this note.

**Note 5 – 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 4). The trade payables of Beta and Gamma do not include any amounts payable to Alpha. This is because on 29 March 2010 Beta and Gamma paid \$5 million and \$4 million respectively to Alpha to eliminate the balances. Alpha received and recorded these payments on 2 April 2010.

**Required:**

**Prepare the consolidated statement of financial position of Alpha at 31 March 2010.**

The following mark allocation is provided as guidance for this question:

25 marks

**(25 marks)**

**Section B – THREE questions ONLY to be attempted**

- 2 Delta's financial statements for the year ended 31 March 2010 are being prepared and you are provided with the following trial balance at that date:

	\$'000	\$'000
Revenue (Note 1)		350,000
Inventories at 31 March 2009	36,400	
Raw material purchases	180,000	
Production costs	70,000	
Distribution costs	10,000	
Administrative expenses	30,000	
Research and development expenditure (Note 3)	4,100	
Property, plant and equipment:		
– at cost (Note 4)	200,000	
– accumulated depreciation at 31 March 2009 (Note 4)		60,000
Finance cost of long-term borrowing	4,800	
Income tax account (Note 5)		300
Deferred tax (Note 5)		6,000
Trade receivables (Note 6)	100,000	
Cash and cash equivalents	34,500	
Trade payables		60,000
Long-term borrowings at 6% repayable 2014		80,000
Equity share capital (\$1 shares)		100,000
Equity dividend paid 31 December 2009	31,000	
Retained earnings at 31 March 2009		44,500
	<u>700,800</u>	<u>700,800</u>

**Notes to the trial balance****Note 1 – Revenue:**

On 29 March 2010 Delta sold goods for a total sales price of \$7.5 million. The goods were sold by Delta at a mark-up of 25% on cost. The goods were supplied on a sale or return basis – the return period expiring on 30 June 2010. It was not possible to accurately estimate the extent to which these customers would exercise their rights to return the goods. Delta has treated this transaction as a normal sale and eliminated the goods from inventories. Trade receivables includes \$7.5 million in respect of this transaction.

**Note 2 – Inventories:**

On 31 March 2010 the value of the inventories at cost at Delta's premises was \$40 million.

**Note 3 – Research and development expenditure:**

On 1 April 2009 Delta commenced a project investigating a new production technique that would significantly reduce wastage. A team of 50 staff were employed on the project and the total annual salary cost of this team was \$2 million, accruing evenly over the year. Other direct costs of the design and testing of the new technique were \$200,000 per month from 1 April 2009 to 31 December 2009 and \$100,000 per month in January, February and March 2010.

By 30 June 2009 the team had developed an initial proposal and the technique was refined over the next six months, being subject to rigorous field-testing. This testing was completed on 31 December 2009 and the new production technique was approved as being technically feasible and commercially viable from that date. It was decided that the new production technique would be brought into practical use from 1 July 2010. On 31 December 2009 the directors estimated that the present value of the potential future cost savings the technique would generate were approximately \$5 million.

**Note 4 – Property, plant and equipment:**

	Cost	Accumulated depreciation at 31 March 2009
	\$'000	\$'000
Property	100,000	20,000
Plant and equipment	100,000	40,000
	<u>200,000</u>	<u>60,000</u>

- (i) Depreciation of all property, plant and equipment should be charged to cost of sales. It has **not** been included in the cost of sales figure in the trial balance.
- (ii) The plant and equipment is being depreciated using the diminishing balance method at  $33\frac{1}{3}\%$  per annum. No disposals of property, plant and equipment occurred in the period.
- (iii) The depreciable element of the property has an allocated cost of \$40 million and is being depreciated on a straight-line basis over 40 years from the date of original purchase. On 1 April 2009 the directors of Delta revalued this property for the first time. The property had an estimated market value at 1 April 2009 of \$115 million. It is further estimated that \$30 million of this value relates to the depreciable element. The original estimate of the useful economic life is still considered valid.
- (iv) The directors have decided to make an annual transfer of excess depreciation on revalued assets to retained earnings.

**Note 5 – Income tax:**

- (i) On 31 December 2009 Delta made a full and final payment to discharge the income tax liability for the year ended 31 March 2009. 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 31 March 2010 is \$8 million.
- (iii) On 31 March 2010 the carrying values of the net assets of Delta exceeded their tax base by \$60 million, creating a taxable temporary difference of that amount. This includes a taxable temporary difference of \$35 million that arose as a result of the revaluation of the property on 1 April 2009 (see note 4 above).
- (iv) The rate of corporate tax in the jurisdiction in which Delta operates is 25%.

**Note 6 – Trade receivables:**

On 1 March 2010 Delta sold trade receivables with an invoiced value of \$25 million to a factor. The factor paid \$20 million to Delta on 1 April 2010 and took over the duties of collecting the debts. The balance of \$5 million (less an administrative fee of 1% of the amount advanced to Delta for every month the debts remain outstanding) will be paid to Delta when the invoices are settled. None of the outstanding debts were settled in March 2010. If the factor is unable to collect the receivables within three months the legal title on the uncollected receivables returns to Delta. When Delta received the cash from the factor they debited cash and credited trade receivables with \$20 million.

**Required:**

**(a) Prepare the statement of comprehensive income for Delta for the year ended 31 March 2010.**

**(b) Prepare the statement of financial position for Delta as at 31 March 2010.**

Notes to the statement of comprehensive income and statement of financial position are not required.

The following mark allocation is provided as guidance for this question:

- (a) 12 marks
- (b) 13 marks

**(25 marks)**

- 3 Epsilon is a listed entity preparing financial statements to 31 March each year. Details of the following complex transactions that have occurred in recent periods appear below:

- (a) On 1 April 2007 Lambda, another entity, issued 200,000 bonds that had a nominal value of \$100 per bond. The bonds were issued at \$90 per bond and were redeemable at nominal value on 31 March 2012. Epsilon purchased all 200,000 of these bonds and intended to hold them to their maturity date. Annual interest payments of \$6 per bond were due on 31 March in arrears. The effective annual rate of interest inherent in the bonds was 8.5%. Lambda paid the interest due on 31 March 2008 and 31 March 2009 in full. On 31 March 2009 it became apparent that Lambda was in financial difficulty and would be unable to make all the repayments due on the loan. An agreement was reached whereby Lambda would make reduced interest payments of \$2 per bond on 31 March 2010, 2011 and 2012 and would then redeem the bonds at nominal value on 31 March 2012. On 31 March 2009 Epsilon would have required an annual effective return of 7.5% on new investments of this nature.

The reduced interest of \$2 per bond was received by Epsilon on 31 March 2010. On 31 March 2010 there was every expectation that the revised future repayment terms would be adhered to by Lambda. Epsilon does not wish to measure financial instruments at fair value unless this is required by International Financial Reporting Standards.

Relevant discount factors are as follows:

**Present value of \$1 receivable in:**

	7.5%	8.5%
1 year	93.0 cents	92.2 cents
2 years	86.5 cents	84.9 cents
3 years	80.5 cents	78.3 cents

**Required:**

**Produce relevant extracts that show how the bond investment would be reported in the statement of financial position of Epsilon at 31 March 2008, 2009 and 2010 and in the statement of comprehensive income for the years ended 31 March 2008, 2009 and 2010. Provide any explanations you consider relevant. (12 marks)**

- (b) On 1 April 2009 Epsilon began to lease an office building on a 10-year operating lease. For the first five years of the lease the annual lease rentals were set at \$400,000, payable in advance. For the second five years this annual rental is to increase to \$450,000, payable in advance. On 1 April 2009 Epsilon carried out some alterations to the property involving the erection of temporary partitions to create suitable office space. The total cost of the alterations was \$600,000. Under the terms of the lease the building had to be returned to the owner in its original condition. The estimated cost of removing the partitions at the end of the lease term is \$300,000. A relevant risk adjusted discount rate is 5% per annum. The present value of \$1 payable in 10 years at a discount rate of 5% is 61.4 cents.

**Required:**

**Produce relevant extracts that show how this transaction would be reported in the statement of financial position of Epsilon at 31 March 2010 and in the statement of comprehensive income for the year ended 31 March 2010. Provide any explanations you consider relevant. (9 marks)**

- (c) On 1 October 2009 Epsilon ordered a quantity of inventory from a customer whose functional currency was the Euro. The agreed purchase price was 200,000 Euros. The inventory was delivered on 1 December 2009 and paid for on 31 January 2010. Half the inventory was sold prior to 31 March 2010. Relevant exchange rates are as follows (\$s to 1 Euro):

1 October 2009 – 1.20  
1 December 2009 – 1.25  
31 January 2010 – 1.30  
31 March 2010 – 1.35.

Epsilon made no attempt to hedge the exchange risk arising out of the purchase of inventory denominated in Euros.

**Required:**

**Produce relevant extracts that show how this transaction would be reported in the statement of financial position of Epsilon at 31 March 2010 and in the statement of comprehensive income for the year ended 31 March 2010. Provide any explanations you consider relevant.** (4 marks)

**(25 marks)**

- 4 (a) Revenue is usually one of the largest numbers that appears in the financial statements of an entity. Therefore it is important to ensure that revenue is recognised and measured appropriately. IAS 18 – *Revenue* – was issued in order to provide standard accounting practice in this area.

**Required:**

- (i) **Describe the meaning of revenue and the basis on which it should be measured under the principles of IAS 18;** (3 marks)
- (ii) **Outline the criteria that need to be satisfied before revenue can be recognised under the principles of IAS 18. You should consider revenue from the sale of goods and from the rendering of services separately.** (5 marks)

- (b) Kappa is an entity that prepares financial statements to 31 March each year. During the year ended 31 March 2010 the following transactions occurred:

- (i) On 29 March 2010 Kappa delivered two machines to a customer. Details relating to the machines are as follows:

Machine	Construction cost	Invoiced price
	\$	\$
A	190,000	250,000
B	200,000	300,000

Machine A was unpacked and connected to the power supply necessary to operate the machine on 2 April 2010. As soon as this was done, the machine was able to operate immediately.

Machine B needed to be installed by an expert fitter before it was capable of operating in the intended manner. The installation process was complete, and the machine passed ready for use, on 4 April 2010.

The customer paid for both machines on 30 April 2010.

(5 marks)

- (ii) On 15 March 2010 Kappa transferred goods to a third party, Omicron, on a consignment basis. Omicron undertook to sell the goods on behalf of Kappa and remit the proceeds, less a commission of 10%, when the final purchaser paid Omicron for them. The invoiced value of these goods (the price payable by the **final purchaser** was \$400,000). The goods cost Kappa \$320,000 to manufacture. By 31 March 2010 Omicron had sold goods at an invoiced price of \$240,000 and received payments of \$160,000. No payment had been made to Kappa by Omicron by 31 March 2010. Since 31 March 2010 Omicron has sold the remaining goods, received all the proceeds, and remitted \$360,000 (\$400,000 x 90%) to Kappa.

(5 marks)

- (iii) On 1 April 2009 Kappa sold a property it owned to a bank for \$3,000,000. The carrying value of the property at 1 April 2009 was \$2,000,000, of which \$1,200,000 was depreciable. The remaining useful economic life of the depreciable element was 30 years from 1 April 2009. Kappa continued to occupy the property and be responsible for its security and maintenance. The market value of the property on 1 April 2009 was \$5,000,000 and it is considered unlikely that this will fall significantly in the foreseeable future. Kappa measures all its property, plant and equipment under the cost model.

The terms of the sale allowed Kappa the option to repurchase the property as follows:

- On 31 March 2010 for \$3,300,000.
- On 31 March 2011 for \$3,630,000.
- On 31 March 2012 for \$3,993,000.

(7 marks)



**Required:**

**For each of the above transactions:**

- Explain and compute, by applying the principles of IAS 18, how much revenue should be recognised in the statement of comprehensive income for the year ended 31 March 2010.
- Identify and compute any other amounts relating to each transaction that will be included in the statement of comprehensive income for the year ended 31 March 2010 and the statement of financial position at 31 March 2010.

**(25 marks)**

- 5 Omega prepares financial statements under International Financial Reporting Standards (IFRS). In the two-year period ended 31 March 2010 the following events occurred:

- (a) On 1 October 2008 Omega began the construction of a new factory. Costs relating to the factory were as follows:

Details	Amount \$'000
Purchase of land on which to build the factory	20,000
Cost of levelling the land prior to beginning construction	850
Cost of materials needed to construct the factory (Note 1)	8,000
Monthly employment costs of the construction staff (Note 1)	500
Monthly amount of other overheads directly related to the construction (Note 1)	200
Payments to external advisors relating to the construction	500
Income from temporary use of part of the site as a car park during the construction period.	(250)
Costs of relocating staff to work in the new factory	400
Costs relating to the public opening of the factory (Note 2)	200

#### Note 1

In December 2008 a fire destroyed materials costing \$500,000. The cost of these materials is included in the material figure that is given above. Construction work was suspended for two weeks because of the fire. The construction workers continued to be paid during this two-week period and other additional overheads of \$40,000 were incurred in this period. These related to keeping the construction site secure during the temporary cessation of construction.

#### Note 2

Construction of the factory was completed on 28 February 2009 and the construction workers transferred to other projects from that date. The factory was not available for use until 31 March 2009, when the factory was inspected by local government officials (as required by local legal regulations) and certified as safe for use. The factory was not actually brought into use until 31 May 2009, following a public opening ceremony.

#### Note 3

The costs of construction were mainly financed by a loan of \$30 million that was arranged during September 2008. The effective annual interest rate on the loan was 8%. The proceeds were invested prior to being needed to finance the construction cost and in the period ended 31 March 2009 the temporary investment produced income of \$300,000.

#### Note 4

The depreciable element of the factory comprises the building costs. The majority of these costs have an estimated useful economic life of 40 years. However, the factory roof will need to be replaced after 20 years. The estimated cost of replacing the roof at current prices is \$2.4 million.

#### Note 5

Omega computes its depreciation charge on a monthly basis and measures property, plant and equipment using the cost model.

#### Note 6

No impairment of the factory had occurred by 31 March 2010.

#### Required:

**Compute the carrying value of the factory in the statement of financial position of Omega at 31 March 2010. You should support your computations with appropriate explanations of the amount you have included for the cost of the factory and for its subsequent depreciation.** (17 marks)

- (b) On 31 December 2009 the directors of Omega decided to dispose of two properties in different locations. Both properties were actively marketed by the directors from 1 January 2010 and sales are expected before the end of July 2010.

Summary details of the two properties are as follows:

Property	Carrying amount at 31 March 2009 \$'000	Depreciable amount at 31 March 2009 \$'000	Estimated future economic life at 31 March 2009 \$'000	Estimated fair value less costs to sell at 31 December 2009 \$'000
A	25,000	15,000	30 years	28,000
B	22,000	16,000	40 years	18,000

Property A was available for sale without modifications from 1 January 2010 onwards. On 31 March 2010 the directors of Omega were reasonably confident that a sale could be secured for \$28 million. However, after the year-end property prices in the area in which property A is located started to decline. This was due to an unexpected adverse local economic event in April 2010. Following this event the directors of Omega estimated that property A would now be sold for \$22 million less selling costs and they are very confident that this lower price can be achieved.

Property B needed repair work carried out on it before a sale could be completed. This repair work was carried out in the two-week period beginning 10 April 2010. The costs of this repair work are reflected in the estimated fair value less costs to sell figure for property B of \$18 million (see above). This estimate remains valid.

**Required:**

**Compute:**

- The carrying values of both properties in the statement of financial position of Omega at 31 March 2010.
- The amounts charged to the statement of comprehensive income in respect of both properties for the year ended 31 March 2010.

You should support your computations with appropriate explanations of the treatments you have adopted.

(8 marks)

**(25 marks)**

**End of Question Paper**