Diploma in International Financial Reporting

Thursday 9 June 2011

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

ALL FOUR questions are compulsory and MUST 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.

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The question paper begins on page 3.

ALL FOUR questions are 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 2011 are given below:

Income Statements

	Alpha $000	Beta $000	Gamma $000
Revenue	470,000	434,000	226,000
Cost of sales	(256,000)	(218,000)	(176,000)
Gross profit	214,000	216,000	50,000
Distribution costs	(18,000)	(17,000)	(15,000)
Administrative expenses	(19,000)	(16,000)	(17,000)
Investment income (Note 5)	37,300	Nil	Nil
Finance cost (Note 6)	(68,000)	(65,000)	(44,000)
Profit/(loss) before tax	146,300	118,000	(26,000)
Income tax expense	(41,000)	(33,000)	Nil
Profit/(loss) for the year	105,300	85,000	(26,000)
Summarised Statements of Changes in Equity			
Balance at 1 April 2010	540,000	390,000	192,000
Comprehensive income for the year	105,300	85,000	(26,000)
Dividends paid on 31 December 2010	(52,000)	(40,000)	Nil
Balance at 31 March 2011	593,300	435,000	166,000

Note 1 – purchase of shares in Beta

On 1 October 2009 Alpha purchased 75 million of the 100 million equity shares in Beta. Details of the share purchase were as follows:

– Alpha issued two new equity shares for every three shares acquired in Beta. On 1 October 2009 the market value of an Alpha share was $6 and the market value of a Beta share was $3·20.

– Alpha agreed to make an additional cash payment of $1 for every share acquired in Beta to be paid on 30 September 2011. This payment is contingent on the profits of Beta exceeding a cumulative target in the two-year period ending 30 September 2011. The fair value of this contingent payment was $55 million on 1 October 2009. The fair value had risen to $58 million by 31 March 2010 and to $64 million by 31 March 2011. The directors of Alpha correctly accounted for this contingent consideration in its financial statements for the year ended 31 March 2010 but no changes have been made to the carrying value of the contingent consideration since 31 March 2010.

– Alpha incurred legal and professional costs of $5 million connected with the acquisition; $2·4 million of these costs related to the cost of issuing shares. Alpha correctly accounted for these acquisition costs in its financial statements for the year ended 31 March 2010.

Alpha decided to value the non-controlling interest in Beta at the date of acquisition at fair value in its consolidated financial statements. The market value of a Beta share at that date was used to calculate the fair value of the non-controlling interest.

The equity of Beta as shown in its own financial statements at 1 October 2009 was $300 million. At that date the property, plant and equipment (PPE) of Beta had a carrying value of $240 million and a fair value of $280 million. The estimated future useful economic life of the PPE of Beta was four years from 1 October 2009. No disposals of PPE occurred between 1 October 2009 and 31 March 2011.

On 1 October 2009 the directors estimated that the internally generated brand name of Beta had a fair value of $30 million and a future useful economic life of 30 years.

All depreciation and amortisation is charged on a monthly basis and presented in cost of sales.

Note 2 – impairment review

On 31 March 2010 and 31 March 2011 the goodwill on consolidation of Beta was reviewed for impairment. No impairment of the goodwill was necessary as a result of the review on 31 March 2010. Beta is regarded as a single cash generating unit for impairment purposes and at 31 March 2011 its recoverable amount was estimated as $550 million. Any impairment of goodwill is charged to cost of sales.

Note 3 – purchase of shares in Gamma

On 1 October 2010 Alpha purchased 40% of the equity shares of Gamma for $75 million in cash. This purchase allowed Alpha to exercise a significant influence over Gamma. 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. On 31 March 2011 an impairment review was conducted resulting in an impairment required of $1·8 million.

Note 4 – inter-company sales

Beta supplies products to Alpha and Gamma. Sales of the products to Alpha and Gamma during the year ended 31 March 2011 were as follows (all sales were made at a mark-up of $33^1/_3$% on cost):

- Sales to Alpha $18 million.
- Sales to Gamma $12 million.

At 31 March 2011 and 31 March 2010 the inventories of Alpha and Gamma included the following amounts in respect of goods purchased from Beta.

	Amount in inventory at	
	31 March 2011	31 March 2010
	$000	$000
Alpha	3,600	2,100
Gamma	2,700	Nil

Note 5 – Equity investments

At 1 April 2010 Alpha had two equity investments that it designated as fair value through other comprehensive income in accordance with IFRS 9 *Financial Instruments*. At the date of acquisition:

Name	Original cost	Fair value at 31 March	
		2010	2011
	$000	$000	$000
Delta	12,000	15,000	n/a
Epsilon	11,000	14,000	15,400

On 31 January 2011 Alpha disposed of its investment in Delta for $19·5 million and showed a profit on sale of $4·5 million ($19·5 million – $15 million) as part of investment income. Apart from recording the receipt of dividend income no other entries have been made in the financial statements for the year ended 31 March 2011 regarding the investment in Epsilon. Both investments had been correctly treated in the financial statements for the year ended 31 March 2010.

Note 6 – Convertible notes

On 1 April 2010 Alpha issued 300 million loan notes of $1 per note at par. The loan notes entitled the holders to an interest payment of 5 cents per note, payable annually in arrears. The loan notes are repayable at par on 31 March 2015. As an alternative to repayment the holders can elect to convert the notes into equity shares in Alpha. On 1 April 2010 investors in non-convertible notes would expect an annual return of 8%. You are given the following discount factors:

Discount rate	Present value of $1 payable	
	At the end of year 5	Cumulatively at the end of years 1–5
5%	78·4 cents	$4·33
8%	68·1 cents	$3·99

On 1 April 2010 the directors of Alpha recorded a loan liability of $300 million and in the year ended 31 March 2011 a finance cost of $15 million (300 million x 5 cents) in respect of these notes.

Note 7 – Environmental damage

During the year ended 31 March 2011 Alpha began production at three newly acquired factories. The normal production process at each factory results in environmental damage. Alpha has a policy of only rectifying such damage when legally required to do so. Details of the damage caused at the three sites up to and including 31 March 2011 are as follows:

Factory	Damage caused by 31 March 2011	Clean-up legislation in place at 31 March 2011?
	$000	
A	3,000	Yes
B	1,000	No
C	2,000	No but legislation passed since year end with retrospective effect

No provision for environmental damage has been made in the financial statements. Any appropriate provision should be reported as part of cost of sales.

Required:

(a) Prepare the consolidated statement of comprehensive income for Alpha for the year ended 31 March 2011; (33 marks)

(b) Prepare the summarised consolidated statement of changes in equity for Alpha for the year ended 31 March 2011. Your summarised statement should include a column for the non-controlling interest. (7 marks)

Ignore deferred tax.

(40 marks)

2 Kappa is a listed entity that prepares financial statements to 31 March each year. Below are details of two transactions of the entity:

Transaction one

On 31 January 2010 Kappa signed a contract with a fuel company to purchase a large quantity of fuel for its own use. The fuel was delivered and paid for on 30 April 2010. The supplier's functional currency is the Euro and the contracted price was 500,000 euros. Kappa's functional currency is the dollar. In order to protect Kappa from exchange fluctuations, on 31 January 2010 the directors entered into a forward contract to purchase 500,000 euros for 700,000 dollars on 30 April 2010.

The dollar strengthened against the euro between 31 January 2010 and 31 March 2010 and on 31 March 2010 the contract to purchase 500,000 euros for 700,000 dollars had a value of 20,000 dollars (financial liability). The dollar strengthened further during April 2010 and on 30 April 2010, when the spot exchange rate was 1·35 dollars = 1 euro, Kappa made a payment of 25,000 dollars to settle the forward contract. The fuel was delivered in accordance with the terms of the contract and used evenly in the 12 month period from 1 May 2010 to 30 April 2011. The directors wish to use cashflow hedge accounting where this is permitted by International Financial Reporting Standards. You can assume that the contract to purchase the euros was a perfectly effective hedge of the potential exchange fluctuations arising out of the contract to purchase the fuel. (10 marks)

Transaction two

On 1 April 2009 Kappa began to lease an office block on a 20-year lease. The useful economic life of the office buildings was estimated at 40 years on 1 April 2009. The supply of leasehold properties exceeded the demand on 1 April 2009 so as an incentive the lessor paid Kappa $1 million on 1 April 2009 and allowed Kappa a rent-free period for the first two years of the lease, followed by 36 payments of $250,000, the first being due on 1 April 2011.

Between 1 April 2009 and 30 September 2009 Kappa carried out alterations to the office block at a total cost of $3 million. The terms of the lease require Kappa to vacate the office block on 31 March 2029 and leave it in exactly the same condition as it was at the start of the lease. The directors of Kappa have consistently estimated that the cost of restoring the office block to its original condition on 31 March 2029 will be $2·5 million at 31 March 2029 prices.

An appropriately risk-adjusted discount rate for use in any discounting calculations is 6% per annum. The present value of $1 payable in 19½ years at an annual discount rate of 6% is 32 cents. (10 marks)

Required:

Prepare extracts from the financial statements for both transactions that show their impact on:

(a) The statements of financial position at 31 March 2010 and 2011;

(b) The statements of comprehensive income for the years ended 31 March 2010 and 2011.

In both cases your extracts should be supported by appropriate explanations and computations.

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

(20 marks)

3 **(a)** IAS 38 – *Intangible assets* – deals with the recognition and subsequent measurement of intangible assets.

Required:

Explain the following:

(i) The meaning of the term 'intangible asset' and those intangible assets that are within the scope of IAS 38;
(ii) The criteria that need to be satisfied before expenditure can be recognised as an intangible asset under IAS 38;
(iii) How recognised intangible assets should be subsequently measured. (9 marks)

(b) Lambda is a listed entity that prepares consolidated financial statements. Lambda measures assets using the revaluation model wherever this is possible under International Financial Reporting Standards. During its financial year ended 31 March 2011 Lambda entered into the following transactions:

(i) On 1 October 2009 Lambda began a project to investigate a more efficient production process. Expenses relating to the project of $2 million were charged in the statement of comprehensive income in the year ended 31 March 2010. Further costs of $1·5 million were incurred in the three-month period to 30 June 2010. On that date it became apparent that the project was technically feasible and commercially viable. Further expenditure of $3 million was incurred in the six-month period from 1 July 2010 to 31 December 2010. The new process, which began on 1 January 2011, was expected to generate cost savings of at least $600,000 per annum over the 10-year period commencing 1 January 2011.

(ii) On 1 April 2010 Lambda acquired a new subsidiary, Omicron. The directors of Lambda carried out a fair value exercise as required by IFRS 3 – *Business Combinations* – and concluded that the brand name of Omicron had a fair value of $10 million and would be likely to generate economic benefits for a ten-year period from 1 April 2010. They further concluded that the expertise of the employees of Omicron contributed $5 million to the overall value of Omicron. The estimated average remaining service lives of the Omicron employees was eight years from 1 April 2010.

(iii) On 1 October 2010 Lambda renewed its licence to extract minerals that are needed as part of its production process. The cost of renewal of the licence was $200,000 and the licence is for a five-year period starting on 1 October 2010. There is no active market for this type of licence. However, the directors of Lambda estimated that at 31 March 2011 the fair value less costs to sell of the licence was $175,000. They further estimated that over the remaining 54 months of its duration the licence would generate net cash flows for Lambda that had a present value at 31 March 2011 of $185,000.

Requirements:

Assuming the Lambda group has no intangible assets other than those mentioned above, compute the carrying value of intangible assets in the consolidated statement of financial position of Lambda as at 31 March 2011. You should provide relevant explanations to support your figures. You are NOT required to compute the goodwill arising on acquisition of Omicron. (11 marks)

(20 marks)

4 You are given details of three transactions affecting the financial statements of Omega:

Transaction One

On 1 April 2009 Omega granted share options to 20 senior executives. The options are due to vest on 31 March 2012 provided the senior executives remain with the company for that period. The number of options vesting to each director depends on the cumulative profits over the three-year period from 1 April 2009 to 31 March 2012:

– 10,000 options per director if the cumulative profits are between $5 million and $10 million.
– 15,000 options per director if the cumulative profits are more than $10 million.

On 1 April 2009 and 31 March 2010 the best estimate of the cumulative profits for the three-year period ending on 31 March 2012 was $8 million. However, following very successful results in the year ended 31 March 2011, the latest estimate of the cumulative profits in the relevant three-year period is $14 million.

On 1 April 2009 it was estimated that all 20 senior executives would remain with Omega for the three-year period, but on 31 December 2009 one senior executive left unexpectedly. None of the other executives have since left and none are expected to leave before 31 March 2012.

A further condition for vesting of the options is that the share price of Omega should be at least $12 on 31 March 2012. The share price of Omega over the last two years has changed as follows:

– $10 on 1 April 2009.
– $11·75 on 31 March 2010.
– $11·25 on 31 March 2011.

On 1 April 2009 the fair value of the share options granted by Omega was $4·80 per option. This had increased to $5·50 by 31 March 2010 and $6·50 by 31 March 2011.

Required:

(a) Produce extracts, with supporting explanations, from the statements of financial position at 31 March 2010 and 2011 and from the statements of comprehensive income for the years ended 31 March 2010 and 2011 that show how transaction one will be reflected in the financial statements of Omega.

Note: Ignore deferred tax. (8 marks)

Transaction Two

On 1 April 2009 Omega purchased ten new machines for $12 million each. Each machine had an overall estimated useful economic life of 10 years. The estimated residual value of each machine was zero. Each machine will require a substantial overhaul after five years in order to maintain its operating capacity and the cost of such an overhaul at 1 April 2009 prices was $3 million per machine. In the year ended 31 March 2010 Omega charged total depreciation of $12 million on the machines but the directors have subsequently realised that this may have been an error that could have a material impact on the financial statements.

Required:

(b) Produce extracts, with supporting explanations, from the statements of comprehensive income for the years ended 31 March 2010 and 2011 and from the statement of changes in equity for the year ended 31 March 2011 that show how transaction two will be reflected in the financial statements of Omega.

Note: Ignore deferred tax. (5 marks)

Transaction Three

On 1 June 2010 Omega signed a contract to construct a machine for one of its customers and to subsequently provide servicing facilities relating to the machine. Omega commenced construction on 1 July 2010 and the construction took two months to complete. Omega incurred the following costs of construction:

- Materials $1 million.
- Other direct costs $2 million.
- Allocated fixed production overheads $1 million. This allocation was made using Omega's normal overhead allocation model.

On 1 October 2010 the machine was delivered to the customer. The customer paid the full contract price of $7·5 million on 30 November 2010. The servicing and warranty facilities are for a three-year period from 1 October 2010. This is not considered to be an onerous contract at 31 March 2011. In the six-month period from 1 October 2010 to 31 March 2011 Omega incurred costs of $200,000 relating to the servicing and this rate of expenditure is estimated to continue over the remainder of the three-year period. Omega would normally expect to earn a profit margin of 20% on the provision of servicing facilities of this nature.

Required:

(c) Produce extracts, with supporting explanations, from the statement of financial position at 31 March 2011 and from the statement of comprehensive income for the year ended 31 March 2011 that show how transaction three will be reflected in the financial statements of Omega.

Note: Ignore deferred tax. (7 marks)

(20 marks)

End of Question Paper