Diploma in International Financial Reporting

Thursday 10 December 2009

DipIFR

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

ACCA

Section A – This ONE question is compulsory and MUST be attempted

1 The income statements of Alpha, Beta and Gamma for the year ended 30 September 2009 are given below:

	Alpha $'000	Beta $'000	Gamma $'000
Revenue	240,000	150,000	120,000
Cost of sales	(190,000)	(110,000)	(100,000)
Gross profit	50,000	40,000	20,000
Distribution costs	(7,000)	(6,000)	(6,000)
Administrative expenses	(10,000)	(7,000)	(8,000)
Investment income	18,000	Nil	Nil
Finance cost	(8,000)	(4,000)	(7,200)
Profit/(loss) before tax	43,000	23,000	(1,200)
Income tax expense	(12,800)	(7,500)	Nil
Net profit/(loss) for the year	30,200	15,500	(1,200)

Note 1 – purchase of shares in Beta

On 1 October 2005 Alpha incorporated Beta and subscribed for 100% of its equity shares. Alpha also made a loan of $40 million to Beta at a fixed annual interest rate of 5%. The annual interest for the year ended 30 September 2009 was paid by Beta to Alpha before the year end. The loan is due for repayment on 30 September 2015.

Note 2 – purchase of shares in Gamma

On 1 January 2009 Alpha purchased 80% of the equity shares of Gamma. The purchase consideration was as follows:

- Alpha issued 30 million shares to the shareholders of Gamma. The market price of an Alpha share on 1 January 2009 was $2·00.
- Alpha agreed to make an additional payment of $25 million to the shareholders of Gamma on 31 December 2010. This payment was contingent on the post-acquisition profits of Gamma reaching a specified level in the two-year period ending on 31 December 2010. The directors of Alpha assessed that the fair value of this contingent consideration was $14 million on 1 January 2009. They reassessed the fair value of the contingent consideration at $9 million on 30 September 2009. The decline in the fair value of the contingent consideration was caused by the losses of Gamma made in the post-acquisition period.
- Alpha incurred incremental legal and professional fees of $1 million in connection with the acquisition of Gamma and debited these costs to the cost of investment in Gamma. $400,000 of this amount related to the costs of issuing the Alpha shares.

Note 3 – fair value exercise

The individual financial statements of Gamma as at 1 January 2009 showed net assets of $80 million. The directors of Alpha carried out a fair value exercise on Gamma's net assets. The fair values of the net assets of Gamma were the same as their book values with the exception of:

- Plant and equipment that had a book value of $60 million and a fair value of $66 million. The estimated remaining useful economic life of this plant and equipment was three years at 1 January 2009. Depreciation of plant and equipment is charged to cost of sales.
- A loan liability that was carried at its amortised cost of $32 million. The fixed annual rate of interest payable in arrears on this loan was 10%. The loan is repayable on 31 December 2013. The market rate of interest for this type of loan was 8% per annum at 1 January 2009, therefore the fair value of this loan at that date was $34·55 million.

Note 4 – basis of measurement of non-controlling interests

It is the policy of Alpha to measure non-controlling interests based on their fair value at the date of acquisition. The estimated fair value of the non-controlling interest in Gamma at 1 January 2009 was $15 million.

Note 5 – impairment review

On 30 September 2009 the directors of Alpha reviewed the goodwill on acquisition of Gamma for impairment. They measured the recoverable amount of Gamma (as a single cash-generating unit) at $86 million at that date. All impairments are charged to cost of sales.

Note 6 – intra-group sales

Alpha supplies products used by Beta and Gamma. Sales of the products to Beta and Gamma during the year ended 30 September 2009 were as follows (all sales were made at a profit margin of 20%):

- Sales to Beta $20 million.
- Sales to Gamma (all since 1 January 2009) $10 million.

The inventories of Beta and Gamma included the following amounts in respect of goods purchased from Alpha.

	Amount in inventory at	
	30 September 2009	30 September 2008
	$'000	$'000
Beta	4,000	2,400
Gamma	2,500	nil

Note 7 – dividend payments

In the year ended 30 September 2009 Alpha and Beta paid dividends to their equity shareholders of $20 million and $10 million respectively.

Note 8 – losses of Gamma

The individual financial statements of Gamma do not recognise a deferred tax asset in respect of the losses of Gamma. However, in the tax jurisdiction in which the group operates it is possible for the tax losses of one group company to be relieved against the taxable profits of another, but only to the extent that these losses arise after the date of acquisition of the relevant group company. The directors of Alpha estimate that a post-acquisition tax benefit of $300,000 will accrue to the group as a result of this possibility.

Required:

Prepare the consolidated income statement of Alpha for the year ended 30 September 2009.

Note: ignore deferred tax on adjustments for fair value and intra-group profits. Ignore the impact of discounting on the measurement of the contingent consideration.

(25 marks)

Section B – THREE questions ONLY to be attempted

2 The trial balance of Delta at 30 September 2009 (its financial reporting date) was as follows:

	$'000	$'000
Revenue (Note 1)		184,800
Lease rentals paid (Note 1)	7,200	
Suspense account (Note 1)	25,600	
Production costs (Note 2)	115,000	
Distribution costs	9,000	
Administrative expenses	20,000	
Inventories at 30 September 2008	37,500	
Dividends paid (Note 4)	7,900	
Income tax (Note 5)		200
Property, plant and equipment (Note 1 and 6):		
At cost at 1 October 2008	125,000	
Accumulated depreciation at 1 October 2008		32,000
Trade receivables	51,000	
Cash and cash equivalents	13,800	
Trade payables		18,000
Preference shares issued (Note 4)		64,000
Deferred tax (Note 5)		8,000
Issued equity capital		70,000
Retained earnings at 30 September 2008		35,000
	412,000	412,000

Notes to the Trial Balance

Note 1 – revenue

On 1 October 2008 Delta sold some of its plant and equipment to a finance company. Delta credited the sales proceeds of $25·6 million to revenue. The plant and equipment was purchased by Delta on 1 October 2007 at a total cost of $32 million and was being depreciated over its estimated useful life of five years. On 1 October 2008 Delta removed the cost and accumulated depreciation on this asset from the cost and accumulated depreciation accounts. They included these amounts in a suspense account. The recoverable amount of the plant on 1 October 2008 was in excess of its carrying amount.

On 1 October 2008 Delta began to lease the plant and equipment from the finance company on a four-year lease. Lease rentals were $7·2 million, payable annually in advance. Had Delta borrowed funds from the finance company on 1 October 2008, the annual interest rate would have been 8·5%.

Note 2 – production costs

Production costs include the following amounts relating to a construction contract that commenced on 1 October 2008 and is expected to be of two years duration:

	$'000
Purchase of materials for use on the contract	10,000
Purchase of plant for use on the contract. This plant is expected to have no residual value at the end of the contract	24,000
Other direct costs of the contract	8,000
Progress payment received on 30 September 2009	(25,000)
	17,000

Contract estimates indicate that further material purchases totalling $8 million and other direct costs totalling $6 million will be necessary to complete the contract. The estimates also indicate that the contract was 50% complete on 30 September 2009. When the contract was signed the agreed price was $75 million.

Note 3 – inventories at 30 September 2009

The carrying value of inventories at cost at 30 September 2009 was $39·5 million.

Note 4 – issue of preference shares

On 1 October 2008 Delta issued 65 million preference shares at their par value of $1 each. Costs of issue were $1 million so the net proceeds of the issue were $64 million. The preference shareholders will receive an annual dividend on 30 September each year of $3·9 million. The shares will be redeemed at par on 30 September 2013. The effective annual finance cost attaching to these shares is approximately 6·4%. The first annual dividend was paid on 30 September 2009 and is included in dividends paid. The equity shareholders were paid a dividend of $4 million in the year.

Note 5 – tax

- The estimated income tax on the profits for the year to 30 September 2009 is $4·5 million.
- During the year $4·2 million was paid in full and final settlement of income tax on the profits for the year ended 30 September 2008. The balance sheet at 30 September 2008 had included $4·4 million in respect of this liability.
- At 30 September 2009 the carrying amounts of the net assets of Delta exceeded their tax base by $35·8 million.
- 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
	Land	Buildings	equipment
	$'000	$'000	$'000
Cost	32,000	38,000	55,000
Estimate of useful economic life (at date of purchase)	Infinite	50 years	5 years
Accumulated depreciation **at 1 October 2008**	0	9,120	22,880

On 31 March 2009 the directors decided to sell the property because more suitable leasehold property had become available at a very competitive cost. They advertised the property for sale at that date at what was considered to be a realistic asking price of $68 million. They estimated that costs of $3 million would be necessary in order to sell the property. On 1 September 2009 they reduced the asking price to $64·5 million and they sold the property at this price shortly after the year end. Costs to sell totalled $2·5 million.

Required:

(a) Prepare the income statement for Delta for the year ended 30 September 2009. (11 marks)

(b) Prepare the statement of financial position for Delta as at 30 September 2009 (14 marks)

Note: notes to the statements are not required. You do not need to prepare a statement of changes in equity.

(25 marks)

3 You are the financial controller of Epsilon. Your assistant is preparing the first draft of the financial statements for the year ended 30 September 2009. He has a reasonable general accounting knowledge but is not familiar with the detailed requirements of all relevant financial reporting standards. There are four issues on which he requires your advice and he has sent you a memorandum as shown below:

Issue 1

We delivered a quantity of components to a customer on 30 June 2009. The invoiced amount was $500,000. We expected to receive payment on 31 August 2009. We have received no cash as yet and on 31 October 2009 our credit control department were informed that the customer has major cash flow problems as a result of the failure of one of its projects sometime in August 2009. They have agreed to allow the customer until 30 September 2010 to settle the debt, by which time they are confident the cash flow problems will be resolved. I'm a little concerned about the time we're allowing here. I believe we would currently expect annual interest of 6% on any money we lend out and we seem to be allowing this customer an interest free payment period. It may be that none of this is relevant anyway because we didn't find out about this problem until 31 October 2009. I don't know what accounting adjustments to make, if any. (8 marks)

Issue 2

On 1 October 2008 we bought a property, consisting of land and buildings, for $20 million (land element $12 million). I have the following information regarding this property.

- The estimated market value of the property on 30 September 2009 was $22 million (land element $13·5 million) and on 30 September 2010 $24 million (land element $14·5 million).
- The estimated useful economic life of the buildings on 1 October 2008 was 40 years. This estimate remains valid.
- We make an annual transfer to retained earnings of the excess depreciation on revalued assets.

I know we use the revaluation model to measure our properties but I have no experience of computing the figures and I do not know what excess depreciation means. Please show me how to compute the figures in the statement of financial position for the property and the revaluation surplus at 30 September 2009 and 2010. Please also show me how to calculate the depreciation charge that will be included in the income statement for the years ended 30 September 2009 and 2010. (7 marks)

Issue 3

On 1 October 2006 we bought a machine for $5 million. We originally estimated a useful economic life of five years with no residual value. This estimate was used in previous years and the carrying value of the asset in the financial statements last year was $3 million. At the start of the year ended 30 September 2009 we looked at these estimates again and now we think the original estimate was over optimistic. The machine is unlikely to generate economic benefits for us after 30 September 2010 but we could expect a scrap value of $200,000 at today's prices. We haven't charged enough depreciation in 2007 and 2008 but I'm not sure how to reflect this – should I change my brought forward figures? (5 marks)

Issue 4

During the year ended 30 September 2009 we supplied a customer with a product that turned out to be faulty. This led to the customer suffering financial loss and the customer has taken out a legal claim against us for the loss suffered. The claim has not yet been settled but it looks like we will have to make a payment of $800,000 to settle the claim sometime early in January 2010. We have investigated the cause of the fault and it turns out it relates to a defective component supplied to us by one of our suppliers. Our legal department intends to make a counter-claim for $800,000 against this supplier so overall we should get compensation. We think this will take around four months. I assume nothing needs to be provided for here because we are covered but do I need any note disclosures? (5 marks)

Required:

Draft a reply to the questions raised by your assistant. Your reply should include any additional explanations you consider relevant. In all cases you should compute the impact on the reported earnings for the years ended 30 September 2009 and 2010.

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

(25 marks)

4 In recent years it has become increasingly common for entities to enter into transactions with third parties that are settled by means of a share based payment. IFRS 2 – *Share-based payment* – was issued in order to provide a basis of accounting for such transactions. Share based payments can be equity settled or cash settled.

Required:

(a) Define cash and equity settled share based payments. (3 marks)

(b) Explain the basis of measurement of the fair value of equity settled share based payments. (3 marks)

(c) Explain the accounting treatment of both equity and cash settled share based payment transactions with employees. (8 marks)

(d) Lambda prepares financial statements to 30 September each year. Lambda has a number of highly skilled employees that it wishes to retain and has put two schemes in place to discourage employees from leaving:

Scheme A

On 1 October 2007 Lambda granted share options to 200 employees. Each employee was entitled to 500 options to purchase equity shares at $10 per share. The options vest on 30 September 2010 if the employees continue to work for Lambda throughout the three-year period. Relevant data is as follows:

Date	Share price ($)	Fair value of option ($)	Expected number of employees for whom 500 options will vest
1 October 2007	10	2·40	190
30 September 2008	11	2·60	185
30 September 2009	12	2·80	188

Scheme B

On 1 October 2006 Lambda granted two share appreciation rights to 250 employees. Each right gave the holder a cash payment of $100 for every 50 cent increase in the share price from the 1 October 2006 value to the date the rights vest. The rights vest on 30 September 2009 for those employees who continue to work for Lambda throughout the three-year period. Payment is due on 31 January 2010. Relevant data is as follows:

Date	Share price ($)	Fair value of right ($)	Expected number of employees for whom two rights will vest
1 October 2006	9	500	240
30 September 2007	10	520	235
30 September 2008	11	540	240
30 September 2009	12	600	238 (the actual number in whom 2 rights vested)

Required:

Explain:

(i) For both schemes, compute the charge to the income statement for the year ended 30 September 2009. (8 marks)

(ii) For both schemes, compute the amount that will appear in the statement of financial position of Lambda at 30 September 2009 and state where in the statement the relevant amount will appear. (3 marks)

(25 marks)

5 Omega prepares financial statements to 30 September each year. The financial statements for the year ended 30 September 2009 have not yet been authorised for issue.

(a) On 1 July 2009 the directors decided to terminate production at one of the company's divisions. This decision was publicly announced on 31 July 2009. The activities of the division were gradually reduced from 1 October 2009 and closure is expected to be complete by 31 March 2010. At 31 July 2009 the directors prepared the following estimates of the financial implications of the closure:

(i) Redundancy costs were initially estimated at $2 million. Further expenditure of $800,000 will be necessary to retrain employees who will be affected by the closure but remained with Omega in different divisions. This retraining will begin in early January 2010. Latest estimates are that redundancy costs will be $1·9 million, with retraining costs of $850,000.

(ii) Plant and equipment having an expected carrying value at 30 September 2009 of $8 million will have a recoverable amount $1·5 million. These estimates remain valid.

(iii) The division is under contract to supply a customer for the next three years at a pre-determined price. It will be necessary to pay compensation of $600,000 to this customer. The compensation actually paid, on 30 November 2009, was $550,000.

(iv) The division will make operating losses of $300,000 per month in the last three months of 2009 and $200,000 per month in the first three months of 2010. This estimate proved accurate for October and November 2009.

(v) The division operates out of leasehold premises. The lease is a non-cancellable operating lease with an unexpired term of five years from 30 September 2009. The annual lease rentals (payable on 30 September in arrears) are $1·5 million. The landlord is not prepared to discuss an early termination payment. Following the closure of the division it is estimated that Omega would be able to sub-let the property from 1 April 2010. Omega could expect to receive a rental of $300,000 for the six-month period from 1 April 2010 to 30 September 2010 and then annual rentals of $500,000 for each period ending 30 September 2011 to 30 September 2014 inclusive. All rentals will be received in arrears. Any discounting calculations should be performed using a discount rate of 5% per annum. You are given the following data for discounting at 5% per annum:

Present value of $1 received at the end of year 1 = $0·95
Present value of $1 received at the end of years 1–2 inclusive = $1·86
Present value of $1 received at the end of years 1–3 inclusive = $2·72
Present value of $1 received at the end of years 1–4 inclusive = $3·54
Present value of $1 received at the end of years 1–5 inclusive = $4·32

Required:

Compute the amounts that will be included in the income statement for the year ended 30 September 2009 in respect of the decision to close the division. Your figures should be supported by appropriate explanations. Where financial information provided above does NOT result in a charge to the income statement you should explain why this is so. (13 marks)

(b) The rate of tax that applies to all companies in the Omega group is 25%.The deferred tax liability of Omega at 30 September 2008 was $2 million. This liability related to taxable temporary differences for property, plant and equipment of $8 million. The following information is relevant regarding the computation of deferred tax for the year ended 30 September 2009:

(i) At 30 September 2009 the carrying value of property, plant and equipment was $44 million and its tax base was $27 million. The carrying value of $44 million incorporates a surplus of $6 million that arose as a result of a property revaluation on 30 September 2009. This property revaluation had no effect on the tax base of the property. This property had not previously been revalued.

(ii) Since June 2008 Omega has been carrying out a project to develop a more efficient production process. On 1 April 2009 the project was assessed and found to be at a stage that justified capitalising future costs incurred on the project. Accordingly an intangible asset of $900,000 was included in the draft statement of

financial position at 30 September 2009. Amortisation is expected to begin sometime in the year ended 30 September 2010. All expenditure on the project qualifies for tax relief as the expenditure is incurred.

(iii) On 1 September 2009 Omega sold goods to one of its subsidiaries for $4,000,000. The goods cost Omega $3,000,000 to manufacture. Prior to 30 September 2009 the subsidiary sold 40% of the goods to a non-group company for $2,200,000.

(iv) On 30 September 2009 Omega borrowed $20 million from a non-group company. The financial liability is not designated as fair value through profit and loss. Omega incurred costs of $1 million in connection with the borrowing and this qualified for tax relief in the year ended 30 September 2009.

(v) There were no other temporary differences affecting the Omega group at 30 September 2009.

Required:

Compute the charge or credit for deferred tax that will appear in the consolidated income statement of Omega for the year ended 30 September 2009. You should support your figures with relevant explanations.

(12 marks)

(25 marks)

End of Question Paper

Answers

Marks

1 Consolidated income statement of Alpha for the year ended 30 September 2009

	$'000	
Revenue (W1)	450,000	1½ (W1)
Cost of sales (balancing figure)	(348,547)	½
Gross profit (W2)	101,453	12½ (W2)
Distribution costs (7,000 + 6,000 + 9/12 X 6,000)	(17,500)	½
Administrative expenses (10,000 + 7,000 + 9/12 X 8,000 + 600 (Note 2))	(23,600)	1½
Investment income (W6)	6,000	2 (W6)
Finance cost (W7)	(15,073)	1½ (W7)
Other income (decrease in fair value of contingent consideration)	5,000	1
Profit before tax	56,280	
Income tax expense (12,800 + 7,500 – 300 (Note 8))	(20,000)	½ + 1
Net profit for the period	36,280	
Net profit attributable to		
Non-controlling interest (W8)	(600)	2 (W8)
Controlling interest	36,880	½
Net profit for the year	36,280	25

WORKINGS – DO NOT DOUBLE COUNT MARKS

Working 1 – revenue

	$'000	
Alpha + Beta + 9/12 X Gamma	480,000	1
Intra-group sales	(30,000)	½
	450,000	1½

Working 2 – gross profit

	$'000	
Alpha + Beta + 9/12 X Gamma	105,000	1
Unrealised profit adjustments:		
Alpha: (20% (4,000 – 2,400))	(320)	1
Gamma: (20% X 2,500)	(500)	½
Extra depreciation (W3)	(1,500)	1½ (W3)
Impairment of goodwill (W5)	(1,227)	8½ (W5)
	101,453	12½

Working 3 – extra depreciation of plant and equipment

	$'000	
(66,000 – 60,000) X 1/3 X 9/12	1,500	1½ ⇒ (W2)

Working 4 – goodwill on acquisition of Gamma

	$'000	$'000	
Cost of investment:			
Share exchange (30,000 X $2·00)		60,000	1
Contingent consideration		14,000	1
Fair value of non-controlling interest at date of acquisition		15,000	½
		89,000	
Net assets of Gamma at date of acquisition:			
Per own records	80,000		½
Fair value adjustments:			
Plant and equipment (66,000 – 60,000)	6,000		½
Loan (34,550 – 32,000)	(2,550)		½
For consolidation purposes		(83,450)	
So goodwill		5,550	½
			4½ ⇒ (W5)

Marks

Working 5 – impairment of goodwill of Gamma

	$'000	$'000	
Carrying value of Gamma:			
Fair value at date of acquisition (W4)		83,450	$^1/_2$
Post-acquisition loss:			
Per own records (1,200 X 9/12)	(900)		$^1/_2$
Extra depreciation (W3)	(1,500)		$^1/_2$
Reduced finance cost ((3,200 – (34,550 X 8%)) X 9/12)	327		1
Additional benefit of tax loss	300		1
		(1,773)	
Goodwill (W4)		5,550	$4^1/_2$ (W4)
		87,227	
Recoverable amount		(86,000)	$^1/_2$
So impairment equals		1,227	$^1/_2$
			$8^1/_2$

Working 6 – investment income

	$'000	
Per accounts of Alpha	18,000	$^1/_2$
Dividend received from Beta	(10,000)	$^1/_2$
Interest received from Beta (40,000 X 5%)	(2,000)	1
Residue in consolidated income statement	6,000	2

Working 7 – finance cost

	$'000	
Alpha + Beta + 9/12 X Gamma	17,400	$^1/_2$
Interest paid by Beta to Alpha (W6)	(2,000)	$^1/_2$
Fair value adjustment (W5)	(327)	$^1/_2$
Residue in consolidated income statement	15,073	$1^1/_2$

Working 8 – non-controlling interest in Gamma

	$'000	
Net adjusted post-acquisition loss of Gamma (W5)	(2,073)	$^1/_2$
Benefit of transfer of tax loss	300	1
Impairment of goodwill	(1,227)	1
	(3,000)	
Non-controlling interest (20%)	(600)	$^1/_2$
		3

Note: There are other acceptable methods of allocating the impairment of goodwill between the group and the NCI. Marks will be awarded for sensible alternatives where assumptions are stated.

2 (a) – Delta income statement for the year ended 30 September 2009

	$'000	
Revenue (W1)	196,700	$1^1/_2$ (W1)
Cost of sales (W2)	(141,780)	6 (W2)
Gross profit	54,920	
Distribution costs	(9,000)	$^1/_2$
Administrative expenses	(20,000)	$^1/_2$
Finance cost (W5)	(5,660)	1 (W5)
Profit before tax	20,260	
Income tax expense (W6)	(5,250)	$1^1/_2$ (W6)
Net profit for the year	15,010	11

			Marks
(b) – Delta statement of financial position as at 31 March 2009			
	$'000	**$'000**	
ASSETS			
Non-current assets:			
Property, plant and equipment (W7)		52,320	3 (W7)
Current assets:			
Non-current assets held for sale (W8)	60,500		1½ (W8)
Amounts due from customers under construction contract (W9)	14,500		2½ (W9)
Inventories	39,500		½
Trade receivables	51,000		½
Cash and cash equivalents	13,800		½
		179,300	
		231,620	
EQUITY AND LIABILITIES			
	$'000	**$'000**	
Capital and Reserves:			
Issued capital	70,000		½
Retained earnings (W10)	46,010		1 (W10)
		116,010	
Non-current liabilities:			
Finance lease payable (W11)	12,764		1 (W11)
Preference shares (W12)	64,196		1 (W12)
Deferred tax (25% X 35,800)	8,950		½
		85,910	
Current liabilities:			
Trade and other payables (W13)	29,700		1½ (W13)
		29,700	
		231,620	14
WORKINGS – ALL FIGURES IN $'000 – DO NOT DOUBLE COUNT			
1. Revenue			
As per TB		184,800	½
Deduct revenue proceeds of sale and leaseback classified as a finance lease		(25,600)	½
Add contract revenue (50% X $75 million)		37,500	½
Per Income Statement		196,700	1½
2. Cost of sales			
Opening inventories		37,500	½
Production costs excluding contract costs (115,000 – 17,000)		98,000	½
Closing inventories		(39,500)	½
Contract costs (W3)		28,000	3 (W3)
Depreciation (W4)		17,780	1½ (W4)
Per Income Statement		141,780	6
3. Contract cost of sales			
Total costs			
Materials (10,000 + 8,000)		18,000	½
Plant		24,000	½
Other (8,000 + 6,000)		14,000	½
		56,000	
Fixed contract price		75,000	½
So expected profit equals		19,000	
50% earned to date		9,500	½
Revenue recognised to date (W1)		37,500	
So cost of sales equals		28,000	½
			3 ⇒ W2

		Marks
4. Depreciation of non-current assets included in cost of sales		
Buildings – 6 months until classified as held for sale – 38,000 X 1/50 X 6/12	380	$^1/_2$
Plant and equipment – as per TB – 1/5 X 55,000	11,000	$^1/_2$
Leased plant – 1/5 X 32,000	6,400	$^1/_2$
Total depreciation for the period	17,780	$1^1/_2 \Rightarrow$ W2
5. Finance costs		
On finance lease (8·5% X ($25·6 million – $7·2 million))	1,564	$^1/_2$
On preference shares (6·4% X $64 million)	4,096	$^1/_2$
	5,660	1
6. Income tax expense		
Estimate on the profits of the current year	4,500	$^1/_2$
Over-provision in the previous year	(200)	$^1/_2$
Deferred tax ((25% X 35,800) – 8,000)	950	$^1/_2$
	5,250	$1^1/_2$
7. Property, plant and equipment		
Plant and equipment at cost (55,000 + 32,000)	87,000	$^1/_2$
Cost of plant purchased for construction contract	24,000	$^1/_2$
Opening accumulated depreciation – per TB	(22,880)	$^1/_2$
Opening depreciation on finance lease (32,000 X 1/5)	(6,400)	$^1/_2$
Charge for the period in cost of sales (11,000 + 6,400 – W4)	(17,400)	$^1/_2$
Depreciation of plant purchased for construction contract (24,000 X $^1/_2$)	(12,000)	$^1/_2$
	52,320	3

Tutorial Note: The treatment of the asset sold and leased back under a finance lease has been to treat the transaction as a secured loan, with no de-recognition of the asset. An alternative treatment, which would result in the same ultimate answer, would be to remove the asset from PPE and then immediately reinstate it at a new 'cost' of $25·6 million, with a remaining useful life of four years. Either treatment, correctly applied, would be acceptable.

8. Non-current assets held for sale		
Carrying value at start of the year (32,000 + 38,000 – 9,120)	60,880	$^1/_2$
Depreciation to date of classification (W4)	(380)	$^1/_2$
Include at this amount as less than fair value less costs to sell	60,500	$^1/_2$
		$1^1/_2$
9. Amounts due from customers under construction contract		
Costs to date:		
Materials	10,000	$^1/_2$
Depreciation (W7)	12,000	$^1/_2$
Other	8,000	$^1/_2$
Attributable profit (W3)	9,500	$^1/_2$
Progress payment received	(25,000)	$^1/_2$
	14,500	$2^1/_2$
10. Retained earnings		
Opening balance	35,000	$^1/_2$
Net profit for the period	15,010	
Equity dividends	(4,000)	$^1/_2$
	46,010	1
11. Non-current portion of finance lease		
The closing liability is 25,600 – 7,200 + 1,564 = 19,964		$^1/_2$
Since the payments are in advance 7,200 of this is current and the balance of 12,764 non-current. The current liability could be split into accrued finance costs (1,564) and an accrued capital balance of 5,636.		$^1/_2$
		1

		Marks
12. Preference shares		
Initial liability	64,000	$^1/_2$
Finance cost (W5)	4,096	
Dividend paid	(3,900)	$^1/_2$
	64,196	1
13. Trade and other payables		
Trade payables per TB	18,000	$^1/_2$
Income tax estimate	4,500	$^1/_2$
Finance lease payable (W11)	7,200	$^1/_2$
As per closing balance sheet	29,700	$1^1/_2$

3 Issue 1

We do need to take account of the information regarding the financial difficulties of the customer because these arose prior to 30 September 2009. IAS 10 – *Events after the reporting date* – would classify such an event as adjusting since it provides additional evidence of conditions existing at the reporting date. In this case the additional information relates to evidence of impairment of a financial asset. IAS 39 – *Financial instruments: recognition and measurement* – requires that financial assets be reviewed at each reporting date for evidence of impairment. Such evidence exists here because although the customer is expected to pay the amount due the payment date has been deferred. In such circumstances IAS 39 requires that the asset be re-measured at the present value of the expected future receipt, discounted (in the case of a trade receivable) at a current commercial rate of interest. Therefore in the financial statements for the year ended 30 September 2009 asset should be measured at $471,698 ($500,000/1·06) and an impairment loss of $28,302 ($500,000 – $471,698) recognised in the income statement. In the year ended 30 September 2010 interest income of $28,302 ($471,698 X 6%) should be recognised in the income statement.

Issue 2

Properties are treated as 'component assets' for depreciation purposes. The two components are a land component and a buildings component. The buildings component is depreciated and the land component is not. In this case the buildings component is $8 million ($20 million – $12 million) on 1 October 2008 so the depreciation charge for the year ended 30 September 2009 is $200,000 ($8 million X 1/40).

Since the property is carried under the revaluation model its carrying value at 30 September 2009 will be $22 million. The difference between its market value of $22 million and its carrying value immediately before the revaluation of $19·8 million ($20 million – $200,000) will be credited to a revaluation surplus and shown as a component of equity. The balance on this reserve at 30 September 2009 will be $2·2 million ($22 million – $19·8 million).

Following revaluation the depreciable component of the asset is $8·5 million ($22 million – $13·5 million). Since the remaining estimated useful life of the buildings at 1 October 2009 is 39 years the annual depreciation for the year ended 30 September 2010 will be $217,949 ($8·5 million/39).

The excess depreciation is $17,949, which is the difference between the depreciation actually charged on a revalued asset ($217,949) and the depreciation that would have been charged if the asset had never been revalued ($200,000). IAS 16 – *Property, plant and equipment* – allows entities to transfer this amount from the revaluation surplus to retained earnings on an annual basis. This transfer does not affect the income statement.

Following the revaluation at 30 September 2010 the property will have a carrying value of $24 million. Its carrying value immediately prior to the revaluation will be $21,782, 051 ($22 million – $217,949). Therefore a further transfer to the revaluation reserve of $2,217,949 ($24 million – $21,782,051) will be made. The closing balance on the revaluation surplus at 30 September 2010 will be $4·4 million ($2·2 million – $17,949 (the excess depreciation) + $2,217,949).

Issue 3

The calculation of depreciation of a non-current asset involves the making of a number of accounting estimates. In this case two of the estimates, the useful economic life of the asset and the expected residual value, have changed. IAS 8 – *Accounting policies, changes in accounting estimates and errors* – states that when accounting estimates change the change should be made prospectively. Brought forward values are not adjusted.

In this case the future depreciation required on the non-current asset from 1 October 2008 is $2,800,000 ($3,000,000 – $200,000). This should be charged to the income statement over the remaining expected future useful life of the asset from 1 October 2008, in this case two years. Therefore depreciation of $1,400,000 will be charged in 2009 and 2010, unless the accounting estimates change again next year.

Issue 4

It is necessary to consider the two parts of this issue separately. The claim made by our customer needs to be recognised as a liability in the financial statements for the year ended 30 September 2009. IAS 37 – *Provisions, contingent liabilities and contingent assets* – states that a provision should be made when, at the reporting date:

– An entity has a present obligation arising out of a past event.
– There is a probable outflow of economic benefits.
– A reliable estimate can be made of the outflow.

All three of those conditions are satisfied here and so a provision of $800,000, with a corresponding charge to the income statement is appropriate.

The counter-claim against our supplier is a contingent asset. IAS 37 states that contingent assets should not be recognised until their realisation is virtually certain, but should be disclosed where their realisation is probable. This appears to be the situation we are in here. Therefore the contingent asset would be disclosed by way of note in the 2009 financial statements and, assuming that realisation occurs as expected, recognised as income in the 2010 financial statements.

4 **(a)** A share based payment arises out of a transaction where a third party:

– Receives equity instruments of the entity (including share options) in exchange for goods or services – equity settled share based payment; or

– Receives cash or other assets of the entity of a value that is based on the value of the equity shares of the entity – cash settled share based payment.

(b) In all cases other than transactions with employees, the fair value of equity settled share based payments should be measured with reference to the value of the goods or services provided by the third party. For transactions with employees fair value should be measured with reference to the value of the equity instruments granted.

(c) For equity settled share based payments the amounts recognised should be based on the fair value (see part (b)) of the payments at the grant date, with no adjustments to subsequent changes to fair value. The total cost should be built up over the vesting period (the period between the grant date and the date the third party is unconditionally entitled to the relevant equity instruments). The annual charge to the income statement is the difference between the cumulative amount recognised at the beginning and end of the period. The cumulative balance at the end of the period will be shown within equity. Where the vesting is subject to conditions the cumulative cost should be based on the number expected to vest based on information available at the date the financial statements are authorised for issue. After the vesting date there will be no further increase or decrease within equity. However there may be a transfer from one component of equity to another relating to the exercising or lapsing of equity options.

For cash settled share based payments the liability should be recognised over the vesting period based on its fair value at the date the financial statements are authorised for issue. After the vesting date the liability will continue to be re-measured at fair value until settled.

(d) **(i)** Scheme A

The total expected cost of the scheme at 30 September 2009 was $225,600 (500 X 188 X $2·40). So the cumulative charge to the income statement up to that date was $150,400 ($225,600 X 2/3).

The total expected cost of the scheme at 30 September 2008 was $222,000 (500 X 185 X $2·40). So the cumulative charge to the income statement up to that date was $74,000 ($222,000 X 1/3).

Therefore the charge to the income statement for the year is $76,400 ($150,400 – $74,000)

Scheme B

The final cost of the scheme at vesting date (30 September 2009) was $285,600 (2 X 238 X $600).

The total expected cost of the scheme at 30 September 2008 was $259,200 (2 X 240 X $540). So the cumulative charge to the income statement up to that date was $172,800 ($259,200 X 2/3).

Therefore the charge to the income statement for the year is $112,800 ($285,600 – $172,800).

(ii) Scheme A

The amount recognised in the statement of financial position is the cumulative amount recognised in the income statement to date – $150,400 (see part (d)(i) above). This amount will be recognised in equity.

Scheme B

Again the cumulative amount is recognised – in this case $285,600 (see part (d)(i) above). This amount will be recognised as a current liability.

5 **(a)** The closure of the division is a restructuring as defined in IAS 37 – *Provisions, contingent liabilities and contingent assets*. IAS 37 states that a constructive obligation to proceed with the restructuring arises when at the reporting date the entity has:

– Commenced activities connected with the restructuring; or
– Made a public announcement of the main features of the restructuring to those affected by it.

In this case a public announcement has been made and so a provision will be necessary at 30 September 2009. This will result in the following charges to the income statement:

(i) Redundancy costs of $1,900,000 (information note (i)). The amount provided is the best estimate of the expenditure at the date the financial statements are authorised for issue. Changes in estimates after the reporting date are taken account of for this purpose as an adjusting event after the reporting date. No charge is necessary for the retraining costs as these are not incurred in 2008/09 and cannot form part of a restructuring provision as they are related to the ongoing activities of the entity.

(ii) Impairment of plant and equipment of $6·5 million (information note (ii)). Although not strictly part of the restructuring provision the decision to restructure before the year end means that related assets need to be reviewed for impairment. In this case the recoverable amount of the plant and equipment is only $1·5 million and under the provisions of IAS 36 – *Impairment of assets* – should be written down to this amount, resulting in a charge of $6·5 million to the income statement.

(iii) Compensation for breach of contract of $550,000 (information note (iii)). The same principle applies here as applied to the redundancy costs (see (i) above).

(iv) No charge is necessary in respect of future operating losses (information note (iv)). Future operating losses relate to future events and provisions are made only for the consequences of past events.

(v) A charge relating to the onerous contract of $4,520,000 (information note (v)). IAS 37 states that an onerous contract is one for which the expected cost of fulfilling the contract exceeds the benefits expected from the contract. Provision is made for the lower of the expected net cost of fulfilling the contract and the cost of early termination (not available in this case). The net cost of fulfilling the contract is $4,510,000 ($1,500,000 X 4·32 – $300,000 X 0·95 – $500,000 X (4·32 – 0·95)).

(b) The charge or credit for deferred tax in the income statement is essentially the movement in the liability from one period to the next, excluding movements that are recognised in other comprehensive income. Therefore the charge is as follows:

(i) Property, plant and equipment. The carrying value is $44 million and the tax base is $27 million. This creates a taxable temporary difference of $17 million and an associated deferred tax liability of $4·25 million ($17 million X 25%). The movement in this liability over the period is $2·25 million ($4·25 million – $2 million). $1·5 million ($6 million X 25%) of this movement relates to the property revaluation and this is recognised in other comprehensive income. $750,000 ($2·25 million – $1·5 million) is recognised in the income statement.

(ii) Intangible asset. The carrying value of the intangible is $900,000 and its tax base is nil because tax relief has already been given. Therefore there is a taxable temporary difference of $900,000 on which deferred tax of $225,000 ($900,000 X 25%) would be recognised. This would create a charge to the income statement of $225,000.

(iii) Intra-group sale. The intra-group sale will result in an adjustment for unrealised profit of $600,000 (60% ($4,000,000 – $3,000,000). Inventory that cost the subsidiary $2,400,000 (60% X $4,000,000) will be included in consolidated inventory at $1,800,000 (60% X $3,000,000). However, when the inventory is sold the group will obtain a tax deduction of $2,400,000. Therefore, at group level, the carrying value of the inventory is $1,800,000 and its tax base is $2,400,000. This creates a deductible temporary difference of $600,000 and a deferred tax asset of $150,000 ($600,000 X 25%) will arise. The existence of larger, offsettable, taxable temporary differences means that there is no problem with recognising this asset. This will lead to a credit of $150,000 in the income statement.

(iv) $20 million loan. The issue costs of the loan will be offset against its carrying value in the financial statements. The issue costs effectively create a taxable temporary difference because the future write off of these issue costs (as part of the future finance cost of the loan) will not attract any tax relief because the tax relief has already been given. Therefore the taxable temporary difference is $1,000,000 and the related deferred tax liability $250,000 ($1,000,000 X 25%). This will create a charge for deferred tax in the income statement.

The overall charge will be $1,075,000 ($750,000 + $225,000 – $150,000 + $250,000).

			Marks
1	Marks as annotated on model answer		25
2	Marks as annotated on model answer		25
3	**(Issue 1)**	Appropriate comments on date information used – up to	2
		Explain asset impaired – with reason – up to	2
		Measure 30 September asset using 6% discount rate – up to	2
		Compute impact on earnings for 2009 and 2010 (1 each)	2
		Total	8
	(Issue 2)	Compute and explain depreciation for year ended 30 September 2009	1
		Compute and explain carrying value at 30 September 2009	1
		Compute revaluation reserve balance at 30 September 2009	1
		Compute depreciation charge for year ended 30 September 2010	1
		Compute carrying value at 30 September 2010	$^1/_2$
		Compute excess depreciation for 2010	1
		Compute revaluation reserve balance at 30 September 2010	$1^1/_2$
		Total	7
	(Issue 3)	Depreciation is an accounting estimate	1
		General description of how to treat	1
		Compute amounts for 2009 and 2010 – up to	3
		Total	5
	(Issue 4)	General principle dealt with in two parts	1
		Deal with provision – up to	2
		Deal with contingent asset – up to	2
		Total	5

			Marks
4	**(a)**	Award up to 3 marks	3
	(b)	Award up to 3 marks	3
	(c)	Base equity settled on fair value at grant date	1
		Principle spread cost over vesting period – with explanation	1
		Explain re-measure based on changes in vesting expectations	1
		Explain 'cumulative nature' of measurement	1
		Principles cash settled measurement to fair value updated	1
		Equivalent comments re: vesting conditions and spreading cost – up to	2
		Treatment at maturity for cash settled – fair valued until settled	1
		Total	8
	(d) **(i)**	Compute charge to date for scheme A – up to	2
		Compute equivalent amount brought forward for scheme A	1
		So charge for the year is the difference	1
		Compute total charge for scheme B – up to	2
		Compute equivalent amount brought forward for scheme B	1
		So charge for the year is the difference	1
		Total	8
	(ii)	Appreciate cumulative amount in SFP	1
		Scheme A amount in equity	1
		Scheme B amount in liabilities	1
		Total	3
5	**(a)**	General principle make restructuring provision – with reason	2
		Include redundancy but not retraining – with reason	2
		Include impairment – with reason	2
		Include compensation on contract	1
		Don't include operating losses	1
		Principle (v) is onerous contract	1
		Principle provide for net cost of fulfilling	1
		Numbers for onerous contract – up to	3
		Total	13
	(b)	Basic principle charge is movement in liability	1
		Computation of $750,000 re: PPE – up to	3
		Computation of $225,000 for intangible – up to	2
		Computation of $150,000 credit for inventory – up to	3
		Computation of $250,000 for loan – up to	2
		Aggregate together to produce overall charge	1
		Total	12