PILOT PAPER

Diploma in International Financial Reporting

Paper DipIFR

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

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

ALL FOUR questions are compulsory and MUST be attempted

1 The statements of comprehensive income of Alpha, Beta and Gamma for the year ended 31 March 2011 are given below:

	Alpha	Beta	Gamma
	$'000	$'000	$'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)
Profit from operations	33,000	27,000	6,000
Investment income	18,000	Nil	Nil
Finance cost	(8,000)	(4,000)	(7,200)
Profit before tax	43,000	23,000	(1,200)
Income tax expense	(12,800)	(7,500)	Nil
Net profit for the year	30,200	15,500	(1,200)
Other comprehensive income (net of tax)	6,000	2,000	1,500
Total comprehensive income for the year	36,200	17,500	300

Note 1 – purchase of shares in Beta

On 1 April 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 loan is due for repayment on 30 September 2015.

Note 2 – purchase of shares in Gamma

On 1 July 2010 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 July 2010 was $2.00.
- Alpha agreed to make an additional payment of $25 million to the shareholders of Gamma on 30 June 2012. This payment was contingent on the post-acquisition profits of Gamma reaching a specified level in the two-year period ending on 30 June 2012. The directors of Alpha assessed that the fair value of this contingent consideration was $15 million on 1 July 2010. They reassessed the fair value of the contingent consideration at $9 million on 31 March 2011. The decline in the fair value of the contingent consideration was caused by the losses of Gamma 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

A set of individual financial statements prepared for Gamma at 1 July 2010 showed that its net assets at that date were $80 million. The directors of Alpha carried out a fair value exercise on the net assets of Gamma on that date. 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 3 years at 1 July 2010. Depreciation of plant and equipment is charged to cost of sales.
- A loan of $32 million that carried a fixed annual rate of interest of 10% and was repayable on 30 June 2015. Because annual market rates of interest were 8% at 1 July 2010 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 July 2010 was $15 million.

Note 5 – impairment review

On 31 March 2011 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 $87,025,000 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 31 March 2011 were as follows (all sales were made at a profit margin of 20%):

- Sales to Beta $20 million.
- Sales to Gamma (all since 1 July 2010) $10 million.

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

	Amount in inventory at	
	31 March 2011	31 March 2010
	$'000	$'000
Beta	4,000	2,400
Gamma	2,500	Nil

Note 7 – dividend payments

In the year ended 31 March 2011 Alpha and Beta paid dividends to their equity shareholders of $20 million and $10 million respectively.

Note 8 – sale of investment

On 1 August 2006 Alpha purchased an equity investment that was designated as a financial asset at fair value through other comprehensive income. On 31 March 2010 the equity investment had a fair value of $7 million and was included at this amount in Alpha's statement of financial position. On 1 April 2010 Alpha disposed of this investment for net proceeds of $7 million. The cumulative gain of $500,000 previously recognised in other comprehensive income has been reclassified and included within investment income.

Note 9 – alterations to leased asset

On 1 April 2010 Alpha completed alterations to a property that was being leased on an operating lease with a remaining term of 10 years from 1 April 2010. Under the terms of the lease the property must be returned to the lessor in its original condition on 31 March 2020. The costs of restoring the property on 31 March 2020 were estimated at $3.5 million (at 31 March 2020 prices). An appropriately adjusted discount rate appropriate to this transaction is 6% per annum. When preparing the financial statements for the year ended 31 March 2011 the directors made a provision of $350,000 ($3.5 million x 1/10) and charged this amount as an administrative expense. When using a discount rate of 6% the present value of $1 payable in 10 years is 56 cents.

Note 10 – Foreign currency loan

On 1 April 2010 Alpha borrowed 20 million francs from a foreign bank when the exchange rate was $1 = 4 francs. The loan attracts no interest but 26.62 million francs is repayable on 31 March 2013. This represents an effective interest rate of 10% per annum. The average and closing exchange rate for the year ended 31 March 2011 was $1 = 5 francs. Alpha initially recorded the loan in its financial statements at $5 million and has made no further entries regarding this loan.

Note 11 – Development expenditure

On 1 January 2010 Alpha began a project to develop a more cost-effective method of disposing of its waste products. Alpha incurred costs of $2 million on this project from 1 January 2010 to 30 April 2010. On 1 May 2010 the project was formally assessed as being technically feasible, commercially viable, and capable of generating economic benefits over a five year period. Alpha incurred further expenditure of $4 million on developing the process between 1 May 2010 and 31 December 2010. They began to benefit from the process from 1 January 2011. Alpha has charged all the costs of developing the process to cost of sales.

Note 12 – Convertible loan

On 1 April 2010 Alpha issued 100 million $1 bonds at par. The bonds carry no interest entitlement but are redeemable on 31 March 2015 at $1.16 per bond. The bond-holders have the option to convert the bonds into equity shares on 31 March 2015. On 1 April 2010 investors would have required an annual return of 5% on bond investments that were not convertible. The present value of the bond assuming no conversion rights was $90.48 million. Alpha has not charged any finance cost in respect of this bond.

Required:

Prepare the consolidated statement of comprehensive income for Alpha for the year ended 31 March 2011. Ignore deferred tax.

(40 marks)

2 You are the financial controller of Delta. Your assistant is preparing the first draft of the financial statements for the year ended 31 March 2011. He has a reasonable general accounting knowledge but is not familiar with the detailed requirements of all relevant financial reporting standards. There are three 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 31 December 2010. The invoiced amount was $500,000. We expected to receive payment on 28 February 2011. We have received no cash as yet and on 30 April 2011 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 February 2011. They have agreed to allow the customer until 31 March 2012 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 30 April 2011. I don't know what accounting adjustments to make, if any.

(8 marks)

Issue 2

On 1 April 2010 we began to lease an office building on a 10 year operating lease. For the first five years of the lease the annual lease rentals are 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 2010 we 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 has to be returned to the owner in its original condition. There is a file note which says that estimated cost of removing the partitions at the end of the lease term is $300,000. The note says that the present value of this amount on 1 April 2010, using a relevant discount rate of 5% per annum, is $184,200.I don't know why this information is relevant and how to account for these transactions.

(7 marks)

Issue 3

On 1 April 2008 we bought a large machine for $5 million. We originally estimated a useful economic life of 5 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 1 April 2010 we looked at these estimates again and now we think the original estimate was overoptimistic. The machine is unlikely to generate economic benefits for us after 31 March 2012 but on that date we could expect a scrap value of $200,000. We haven't charged enough depreciation in 2008/09 and 2009/10 but I'm not sure how to reflect this – should I change my brought forward figures?

(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 31 March 2011. For issues 1 and 3 you should also compute the impact on reported earnings for the year ended 31 March 2012.

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

(20 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 2011 are being prepared. Your assistant, who has prepared the first draft of the statements, is unsure about the correct treatment of a number of transactions and has asked for your advice. Details of the transactions are given below:

Transaction (a)

On 1 April 2010 Epsilon began to extract minerals from a large site that it had recently constructed. The direct costs of constructing the site totalled $25 million. The directors of Epsilon estimate that an appropriate allocation of general administrative costs to this project would be $2.5 million. The site has an expected useful economic life of 10 years and at the end of that period the cost of rectifying the damage to the environment caused by the construction of the site is estimated at $6 million. Epsilon is under no legal obligation to rectify this damage but its published policies indicate that rectification is its usual practice in such circumstances.

Your assistant has included $27.5 million in property, plant and equipment and charged $2.75 million depreciation in the income statement. He has not included any provision for the cost of rectifying the environmental damage because Epsilon has no legal obligation to rectify it and could therefore choose not to.

The relevant discount rate to be used in any calculations is 8% per annum and the present value of $1 receivable at the end of 10 years at this rate is 46.32 cents.

(6 marks)

Transaction (b)

On 1 January 2011 Epsilon signed a contract to take delivery of a machine on 30 June 2011 for a fixed price of 20 million Euros. In order to provide a measure of certainty regarding the cash outflow in dollars the directors entered into a contract on 1 January 2011 to purchase 20 million Euros on 30 June 2011 for $24 million. The treasury department estimated that this contract had a fair value of $1 million (a financial asset) at 31 March 2011.

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

(6 marks)

Transaction (c)

On 1 April 2010 Epsilon began to lease a property on a 50 year lease. The useful economic life of the buildings was estimated to be 50 years from 1 April 2010.

The market values of the leasehold interests in the property at the start of the lease were equally split between land and buildings and the present value of the minimum lease payments was $5 million – equal to the property's fair value. The annual rentals were $500,000, payable in arrears, the first payment being made on 31 March 2011. The annual rate of interest implicit in the lease was 8%. The property was to be vacated at the end of the lease and there was no option available to Epsilon to purchase it at a favourable price.

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

(8 marks)

Required:

Explain and quantify the appropriate accounting treatment of the three transactions in the financial statements for the year ended 31 March 2011. For each transaction your explanation should include an evaluation of the treatment that is proposed by your assistant.

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

(20 marks)

4 You are the accountant of Omega, an entity that has business interests all around the world. The financial statements for the year ended 31 March 2011 are currently in the process of preparation. The directors have sought your advice on the financial reporting implications of the following issues:

Issue 1

On 28 February 2011 the directors decided to close down a business segment. The decision was taken out of a desire to refocus the strategic direction of the group and the segment being closed did not fit in to the new strategy. The closure commenced on 5 April 2011 and was due to be completed on 31 July 2011. On 6 March 2011 letters were sent to employees offering voluntary redundancy or redeployment in other sectors of the business. On 13 March 2011 negotiations commenced with relevant parties with a view to terminating existing contracts of the business segment and arranging sales of its assets. Latest estimates of the financial implications of the closure are as follows:

(a) Redundancy costs will total $20 million, excluding the payment referred to in (b) below.

(b) The pension plan (a defined benefit plan) will make a lump sum payment totalling $10 million to the employees who accept voluntary redundancy in termination of their rights under the plan. Omega will pay this amount into the plan on 31 July 2011. The actuaries have advised that the accumulated pension rights that this payment will extinguish have a present value of $7.5 million and this sum is unlikely to alter significantly before 31 July 2011.

(c) The cost of redeploying and retraining staff who do not accept redundancy will total $5.5 million.

(d) The costs of terminating existing contracts, including professional fees, will total $5 million.

(e) Plant having a net book value of $11 million at 31 March 2011 will be sold for $2 million.

(f) A freehold property having a net book value of $10 million at 31 March 2011 will be sold for $15 million. The potential purchaser is not interested in acquiring the plant.

(g) The operating losses of the business segment for April, May and June 2011 will total $9 million.

(14 marks)

Issue 2

On 1 October 2010 Omega granted 250,000 options that allowed employees to purchase shares for $10 per share. The options are to vest on 30 June 2011 provided the employees satisfy certain performance conditions in the nine-month period between 1 October 2010 and 30 June 2011. The market value of the shares on 1 October 2010 was only $10, although by 30 June 2011 the market value was expected to rise to $12. The fair value of each share option was estimated to be $1.80 per share at 1 October 2010. This estimate had increased to $1.90 per share by 31 March 2011. On 1 October 2010 it was anticipated that all the options would vest. However employee performance in the period since 1 October 2010 has been such that it is now likely that only 200,000 of the options will vest.

(6 marks)

Required:

Advise the directors on the financial reporting implications of the two issues in the consolidated financial statements for the year ended 31 March 2011. For each issue you should indicate the amounts that would be included in the financial statements and the nature of any disclosures that might be appropriate in the notes. You should justify your conclusion with reference to appropriate international financial reporting standards and include any other explanations you consider relevant.

The allocation of marks to each individual issue is given above after the description of the issue.

(20 marks)

End of Question Paper

Answers

1 Consolidated income statement of Alpha for the year ended 31 March 2011

	$'000	Marks
Revenue (W1)	450,000	1.5 (W1)
Cost of sales (balancing figure)	(345,547)	0.5
Gross profit (W2)	104,453	13.5 (W2)
Distribution costs (7,000 + 6,000 + 9/12 X 6,000)	(17,500)	0.5
Administrative expenses (10,000 + 7,000 + 9/12 X 8,000 + 600 (Note 2) – 154 (W6))	(23,446)	1.5 + 3 (W6)
Investment income (W8)	5,500	2.5 (W8)
Finance cost (W9)	(19,115)	7.5 (W9)
Other income (decrease in fair value of contingent consideration)	6,000	1
Profit before tax	55,892	
Income tax expense (12,800 + 7,500)	(20,300)	0.5
Net profit for the year	35,592	
Other comprehensive income (W12)	9,625	1 (W12)
Total comprehensive income	45,217	0.5
Net profit attributable to		0.5
Non-controlling interest (W13)	(820)	2.5 (W13)
Controlling interest	36,412	0.5
Net profit for the year	35,592	
Total comprehensive income attributable to		0.5
Non-controlling interest (W14)	(595)	2 (W14)
Controlling interest	45,812	0.5
	45,217	40

WORKINGS – DO NOT DOUBLE COUNT MARKS

Working 1 – revenue	**$'000**	**Marks**
Alpha + Beta + 9/12 x Gamma	480,000	1
Intra-group sales	(30,000)	0.5
	450,000	1.5

Working 2 – gross profit	**$'000**	**Marks**
Alpha + Beta + 9/12 x Gamma	105,000	1
Unrealised profit adjustments:		
Beta: (20% (4,000 – 2,400))	(320)	1
Gamma: (20% x 2,500)	(500)	0.5
Extra depreciation (W3)	(1,500)	1.5 (W3)
Reversal of capitalisation of development costs (Note 11)	4,000	1
Amortisation of above (4,000 x 1/5 X 3/12)	(200)	1
Impairment of goodwill (W5)	(2,027)	7.5 (W5)
	104,453	13.5

Working 3 – extra depreciation of plant and equipment	**$'000**	**Marks**
(66,000 – 60,000) x 1/3 x 9/12	1,500	1.5 (W2)

Working 4 – goodwill on acquisition of Gamma	**$'000**	**$'000**	**Marks**
Cost of investment:			
Share exchange (30,000 x $2.00)		60,000	1
Contingent consideration		15,000	1
Fair value of non-controlling interest at date of acquisition		15,000	0.5
		90,000	
Equity of Gamma at date of acquisition:			
Per own records	80,000		0.5
Fair value adjustments:			
Plant and equipment (66,000 – 60,000)	6,000		0.5
Loan (34,550 – 32,000)	(2,550)		0.5
For consolidation purposes		(83,450)	
So goodwill		6,550	0.5
			4.5 (W5)

Working 5 – impairment of goodwill of Gamma	**$'000**	**$'000**	**Marks**
Carrying value of Gamma:			
Fair value at date of acquisition (W4)		83,450	0.5
Profits and OCI from date of acquisition to reporting date:			
Per own records (300 x 9/12)	225		0.5
Extra depreciation	(1,500 (W3))		0.5
Reduced finance cost ((32,000 x 10%) – (34,550 x 8%)) x 9/12	327		1
		(948)	
Goodwill (W4)		6,550	4.5 (W4)
		89,052	
Recoverable amount		(87,025)	0.5
So impairment equals		2,027	
			7.5

Working 6 – adjustment to admin expenses re: provision	**$'000**	**Marks**
Reduce by inappropriate provision	(350)	0.5
Depreciation on capitalised restoration costs (W7)	196	2 (W7)
So net reduction equals	(154)	0.5
		3

Working 7 – capitalised restoration costs	**$'000**	**Marks**
Required provision (3,500 x 0.56)	1,960	1
Depreciation (1/10)	196	1
		2 (W6)

Working 8 – investment income	**$'000**	**Marks**
Per accounts of Alpha	18,000	0.5
Dividend received from Beta	(10,000)	0.5
Interest received from Beta (40,000 x 5%)	(2,000)	1
Gain on sale of investment incorrectly reclassified (Note 8)	(500)	0.5
Residue in consolidated statement of comprehensive income	5,500	2.5

Working 9 – finance cost	**$'000**	**Marks**
Alpha + Beta + 9/12 x Gamma	17,400	0.5
Interest paid by Beta to Alpha (W6)	(2,000)	0.5
Fair value adjustment (W5)	(327)	0.5
Residue in consolidated income statement	15,073	1.5
Finance cost on foreign currency loan (20,000 x 10% x 1/5)	400	1.5
Exchange gain on foreign currency loan (W10)	(1,000)	2 (W10)
Unwinding of discount (W11)	118	1.5
Finance cost on convertible loan (90,480 x 5%)	4,524	1
	19,115	7.5

Working 10 – exchange gain on foreign currency loan	**Francs'000**	**Rate**	**$'000**	**Marks**
Opening balance	20,000	4	5,000	0.5
Finance cost	2,000	5	400	0.5
Exchange gain			(1,000)	0.5
Closing balance	22,000	5	4,400	0.5
				2 (W9)

Working 11 – unwinding of discount	**$'000**	**Marks**
Initial provision (W7)	1,960	0.5
Unwinding of discount (6%)	118	1
		1.5 (W9)

Working 12 – other comprehensive income	**$'000**	**Marks**
Alpha + Beta + 9/12 x Gamma	9,125	0.5
Gain on sale of investment incorrectly reclassified (W8)	500	0.5
Total in consolidated statement of comprehensive income	9,625	1

Working 13 – non-controlling interest in profit of Gamma	**$'000**	**Marks**
Net adjusted post-acquisition loss of Gamma (– 1,200 x 9/12) – 1,500 + 327)	(2,073)	1
Impairment of goodwill	(2,027)	1
	(4,100)	
Non-controlling interest (20%)	(820)	0.5
		2.5

Working 14 – non-controlling interest in total comprehensive income of Gamma	**$'000**	**Marks**
Other comprehensive income of Gamma (1,500 x 9/12)	1,125	0.5
Non-controlling interest (20%)	225	0.5
Non-controlling interest in profit (W13)	(820)	0.5
Total non-controlling interest	(595)	0.5
		2

2 Issue 1

We do need to take account of the information regarding the financial difficulties of the customer because these arose prior to 31 March 2011. *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 31 March 2011 asset should be measured at $471,698 ($500,000/1.06) and an impairment loss of $28,302 ($500,000 - $471,698) recognised in profit and loss. In the year ended 31 March 2012 interest income of $28,302 ($471,698 X 6%) should be recognised in profit and loss.

Issue 2

The lease is an operating lease so the rentals are charged as an expense in the statement of comprehensive income. *IAS 17 – Leases* – states that this charge should be on a straight line basis unless another pattern is clearly more appropriate. The total lease rentals are $4,250,000 ($400,000 X 5 + $450,000 X 5). Therefore the charge to the income statement each year will be $425,000 (4,250,000 X 1/10). Since the rental actually paid in the year to 31 March 2010 is $400,000 there will be an accrual of $25,000 ($425,000 – $400,000) in the statement of financial position as at 31 March 2010.

Even though the lease is operating the lease improvements are capitalised as a non-current asset with a useful economic life of 10 years. This means that depreciation of $60,000 ($600,000 X 1/10) will be required and the closing non-current assets balance relating to the improvements at 31 March 2010 will be $540,000 ($600,000 – $60,000).

Under the principles of *IAS 37 – Provisions, contingent liabilities and contingent assets* – the carrying out of alterations to the leased asset creates an obligating event to restore the asset at the end of the lease and so a provision must be recognised. The amount of the provision is the present value of the expected future payments, which is $184,200. This expenditure provides access to future economic benefits so it is capitalised along with the alterations themselves. This creates additional depreciation of $18,420 ($184,200 X 1/10) and an addition to non-current assets at 31 March 2010 of $165,780 ($184,200 – $18,420).

As the date for restoration approaches the discount unwinds and this is reflected by a finance cost in the statement of comprehensive income. For the year ended 31 March 2010 this cost is $9,210 ($184,200 X 5%). The closing provision will be $193,410 ($184,200 + $9,210).

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 numbers are not adjusted.

In this case the future depreciation required on the non-current asset from 1 April 2010 is $2,800,000 ($3,000,000 - $200,000). This should be charged to the income statement the remaining expected future useful life of the asset from 1 April 2010, in this case two years. Therefore depreciation of $1,400,000 will be charged in the year ended 3 March 2011 and 2012, unless the accounting estimates change again next year.

3 Transaction (a)

The assistant should initially have included $25 million, rather than $27.5 million in property, plant and equipment (PPE). *IAS 16 – property, plant and equipment* states that only the direct costs of getting an asset ready for use should be capitalised. IAS 16 specifically forbids capitalisation of allocated general overheads.

The treatment of the damage caused by construction and rectification is also incorrect. Under the provisions of *IAS 37 – provisions, contingent liabilities and contingent assets* – Epsilon can have an obligation in respect of these costs as obligations do not need to be legally enforceable. Where an entity has indicated by its published policies and by an established pattern of past practice that it accepts certain responsibilities in certain situations then IAS 37 indicates that it has a constructive obligation where those situations arise.

Because the event giving rise to the obligation has already occurred by the balance sheet date Epsilon needs to provide for the whole of the rectification cost, $6 million in this case. However IAS 37 also states that where the effect of discounting is material the provision should be discounted to its present value. In this case the required provision at 1 April 2010 (in $'000) will be:

$6,000 x 0.4632 = $2,779.

As time passes and the discount unwinds the provision increases and this increase is shown as a finance cost. The finance cost for the year ended 31 March 2011 will be $222 ($2,779 x 0.08) and the provision at 31 March 2011 $3,001 ($2,779 + $222).

When the initial provision is made the debit entry is to PPE as this is part of the cost of gaining access to the economic benefits from the site. Therefore the total cost should be $27,779 ($25,000 + $2,779) and the depreciation for the year ended 31 March 2011 $2,778 ($27,779 X 1/10). The carrying amount of PPE at 31 March 2011 will be $25,001 ($27,779 – $2,778).

Transaction (b)
The assistant is incorrect to include an asset and liability of $24 million in respect of the purchase of the machine. A contract to take delivery of a machine three months after the year end is an executory contract. IAS 37 states that no provision should be made for executory contracts unless the contract is onerous. IAS 16 states that non-current tangible assets should be recognised at cost. The costs relating to this item are yet to be incurred and therefore no recognition of an item of PPE is appropriate at the year end.

Under the provisions of *IAS 39 – financial instruments: recognition and measurement* – the contract to purchase Euros on 30 June 2011 should have been recognised from 1 January 2011, the date Epsilon became party to its contractual provisions. At the year end 31 March 2011 the contract is recognised as a financial asset of $1 million because it is a contractual right to exchange financial assets with another entity under potentially favourable conditions. Furthermore, it is a derivative because its value changes in response to a specific exchange rate and it requires little or no investment.

IFRS9 – financial instruments – requires that derivatives be measured at fair value. The general requirement is that gains or losses arising on fair value changes should be recognised in the income statement. However where the derivative is a hedging instrument (it can be identified with a quantifiable financial risk – in this case foreign exchange risk) then IAS 39 allows entities to use hedge accounting. If the contract is designated as a hedge of the foreign exchange risk inherent in the purchase of the machine in the following period then the change in fair value is not recognised in the income statement of the current period. Instead it is taken to other comprehensive income and recognised in the income statement in the same period (or periods) as the cost of the asset that is attributable to the hedged risk.

Transaction (c)
The assistant is should not classify and treat the property lease as a whole amount. Under the provisions of *IAS 17 – Leases* – if possible then property leases should be split into their land and buildings components in order to evaluate the correct accounting treatment.

Since the property must be vacated at the end of the lease the land element (50% of the total) would be regarded as an operating lease and it would be correct to take the rental to the income statement as an expense. Therefore a rental expense of $250,000 (50% X $500,000) should be taken to the income statement.

In contrast the buildings element of the lease would be evaluated as a finance lease since it is for the whole economic life of the building. Therefore $2.5 million ($5 million X 50%) should have been debited to PPE and credited as a finance lease.

Depreciation of $50,000 ($2.5 million X 1/50) should have been charged to the income statement together with a finance cost of $200,000 ($2.5 million X 8%).

The balance sheet would contain a closing liability (in $'000) of 2,450 (2,500 + 200 – 250). The current element of this liability would be 54 (250 – 2450 X 8%).

4 First issue

Two key financial reporting standards inform the correct treatment of this issue:

IAS 37 – Provisions, contingent liabilities and contingent assets – requires that provisions should be made for the unavoidable consequences of events occurring before the reporting date.

IFRS 5 – Non-current assets and held for sale and discontinued operations – states that non-current assets that are held for sale should be separately classified on the statement of financial position and measured at the lower of existing carrying value and fair value less costs to sell. IFRS 5 further states that the results of discontinued operations should be separately disclosed in the income statement.

As far as the issue of a provision is concerned the steps taken before the reporting date have effectively committed the entity to the closure. The basic principle laid down in IAS 37 is that provision should be made for the direct costs associated with the closure. On this basis the expected redundancy costs and the contract termination costs (items (a) and (d) – total $20 million + $5 million = $25 million) should be provided for.

A further cost associated with the closure is the net cost of terminating the pension rights of the employees who accept redundancy (item (b) ($10 million – $7.5 million = $2.5 million). *IAS 19 – Employee Benefits* – requires that the costs of settlement or curtailment of pension rights are a one-off amount that should be recognised in the income statement of a contributing entity. Given that a provision is appropriate, then this cost should be recognised.

The cost of redeployment and retraining (item (c)) is an ongoing cost associated with the continuing business and IAS 37 specifically states that restructuring provisions should not include those items.

The treatment of expected operating losses (item (g)) is also dealt with in IAS 37. IAS 37 states that a provision is inappropriate unless the losses are anticipated to arise on an onerous contract.

Therefore the total provision for closure should be $25 million. The net pension asset/liability will be reduced/increased by the excess of the amount to be paid into the plan ($10 million) over the liabilities the payment will extinguish ($7.5 million)

As far as the non-current assets of the segment are concerned these satisfy the IFRS 5 criteria for assets held for sale. An asset is classified as held for sale if its value will be recovered principally through sale as opposed to continuing use. The implications of this classification is that the plant and property will be classified as held for sale on the balance sheet and measured at the lower of existing carrying value and fair value less costs to sell. This means that Epsilon will write down the plant and equipment by $11 million to $2 million but that the property will continue to be carried at $10 million. The net assets of the segment will be regarded as a disposal group and separately classified on the statement of financial position under a separate heading.

Under the principles of IFRS 5 it would be correct to show the results separately if the segment can be regarded as a discontinued operation. In order for this to be the case the segment would have to be:

A component of the entity (where operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity) that either has been disposed of or is classified as held for sale and:

- Represents a separate major line of business or geographical area of operations or:
- Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or:
- Is a subsidiary acquired exclusively with a view to resale.

In this case it appears that the segment would be regarded as a discontinued operation. This means that Epsilon needs to disclose (as a minimum) a single amount on the face of the income statement comprising the total of:

- The post-tax profit or loss of the discontinued operation and
- The post-tax gain or loss recognised on the measurement to fair value less costs to sell of the assets of the discontinued operation.

Further disclosures relating to discontinued operations are required either on the face of the income statement or in the notes:

- The revenue, expenses and pre-tax profit or loss.
- The related income tax expense.
- The gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets of the discontinued operation (both before and after tax).

Second issue

This is a share based payment transaction that is dealt with under the provisions of *IFRS 2 – Share-based payment*. This is an equity settled share-based payment that is measured at the fair value of the equity instruments that are likely to be issued (ie share options), rather than the fair value of the related goods or services provided. In the case of share options that fair value is measured at grant date and not amended subsequently so the transaction is measured at $1.80 per option.

Where there are non market-based vesting conditions, the total cost of the transaction is measured with reference to the likelihood of these conditions being satisfied so the total cost of the share-based payment in this case will be 200,000 X $1.80 = $360,000. This is recognised in the statement of comprehensive income over the vesting period so a charge of 6/9 X $360,000 = $240,000 will be made in the year ended 31 March 2011. The credit is to a share options account that is presented in equity.

IFRS 2 requires disclosure of information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period. Therefore the key terms and vesting conditions would need to be disclosed in the financial statements.

			Marks
1		Marks as annotated on model answer	**40**
2	(Issue 1)	Appropriate comments on date information used – up to	2
		Explain asset impaired – with reason – up to	2
		Measure 31 March asset using 6% discount rate – up to	2
		Compute impact on earnings for 2011 and 2012 (1 each)	2
		Total marks for Issue 1	8
	(Issue 2)	Principle rental expense in statement of comprehensive income	0.5
		Compute charge for year	1
		Identify accrual as non-current liability (only ½ if this not stated)	1
		Principle capitalise improvements and depreciate	0.5
		Calculations re: above	1
		Principle recognise provision and debit non-current assets	0.5
		Principle use present value	0.5
		Compute depreciation and finance cost	2
		Total marks for Issue 2	7
	(Issue 3)	Depreciation is an accounting estimate	1
		General description of how to treat	1
		Compute amounts for 2011 and 2012 – up to	3
		Total marks for Issue 3	5
	Total marks for question 2		**20**
3	**(a)**	Do not capitalize $2.5 million	1/2
		Provide for whole of rectification cost	1
		Discount provision for rectification cost	1
		Finance cost for year ended 31 March 2008	1
		Provision at 31 March 2008	1
		Total cost $27,779	1/2
		Total marks for part (a)	6
	(b)	No recognition of machine purchase yet appropriate	1
		However recognition of forward contract as a derivative is appropriate	1
		Derivative should be measured at fair value	1
		Recognise the possibility of using hedge accounting in this case	1
		Describe the application of hedge accounting in this context	2
		Total marks for part (b)	6
	(c)	Discuss lease classification in two parts	1
		Land element an operating lease	1
		So rental expense of $250,000 in statement of comprehensive income	1
		Buildings element a finance lease	1
		So include PPE and a payable	1
		Depreciation charge of $50,000 in statement of comprehensive income	1
		Finance charge of $200,000 in statement of comprehensive income	1
		Compute closing liability and split	1
		Total marks for part (c)	8
	Total marks for question 3		**20**

			Marks
4	**(Issue 1)**	Obligating event has occurred by reporting date	1
		Principle for inclusion of redundancy costs and contract termination costs	1
		Treatment of pension settlement	2
		Explain why redeployment excluded	1
		Discussion of operating losses	1
		Explain why segment held for sale	2
		Conclude on measurement issues	2
		Present results for current period as discontinued operation	2
		Present as separate caption in SOFP	1
		Charge in income statement reported separately	1
		Total for part (a)	**14**
	(Issue 2)	Charge based on fair value of option at grant date	2
		Performance conditions taken into account	1
		So compute total cost	1
		Credit is to equity	1
		Discuss disclosure issues	1
		Total for part (b)	**6**
	Total marks for question 4		**20**