Diploma in International Financial Reporting

MONDAY 13 DECEMBER 2004

QUESTION PAPER

Time allowed **3 hours**

This paper is divided into two sections

Section A	This ONE question is compulsory and MUST be answered
Section B	THREE questions ONLY to be answered

Do not open this paper until instructed by the supervisor

This question paper must not be removed from the examination hall

The Association of Chartered Certified Accountants

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

1 Alpha has investments in two other entities, Beta and Gamma. Balance sheets of the three entities at 30 September 2004, their year end date, were as follows:

	Alpha		Beta		Gamma	
	$'000	$'000	$'000	$'000	$'000	$'000
Assets						
Non-current assets:						
Property, plant and equipment (Note 3)	35,800		25,000		20,000	
Financial assets (Notes 1 and 2)	29,200		nil		nil	
		65,000		25,000		20,000
Current assets:						
Inventories (Notes 3 and 4)	18,000		12,000		11,000	
Trade and other receivables (Notes 3 and 5)	15,000		10,000		9,000	
		33,000		22,000		20,000
Total assets		98,000		47,000		40,000
Equity and Liabilities						
Capital and reserves:						
Issued capital ($1 shares)	35,000		25,000		10,000	
Accumulated profits	24,000		8,000		13,300	
		59,000		33,000		23,300
Non-current liabilities						
Interest bearing borrowings	20,000		nil		4,000	
Deferred tax	2,000		1,000		1,500	
		22,000		1,000		5,500
Current liabilities						
Trade and other payables (Note 5)	12,000		9,000		7,000	
Bank overdraft	5,000		4,000		3,000	
Provisions	Nil		Nil		1,200	
		17,000		13,000		11,200
Total equity and liabilities		98,000		47,000		40,000

Notes to the balance sheets

Note 1
On 1 October 2001, Alpha purchased 15 million $1 ordinary shares in Beta for $22·9 million. The balance of accumulated profits of Beta on 1 October 2001 (as shown in the financial statements of Beta) was $3 million.

Note 2
On 1 October 2002 Alpha purchased three million $1 shares in Gamma for $6·3 million. The balance of accumulated profits of Gamma on 1 October 2002 was $6 million. All the remaining shares in Gamma are held by a large number of investors, with no single investor holding a significant number of shares.

Note 3
Following the acquisitions of Beta and Gamma the directors of Alpha carried out a fair value exercise as required by IAS 22 – *Business Combinations*. They concluded that no fair value adjustments were necessary in respect of the acquisition of Gamma on 1 October 2002 but the following fair value adjustments were necessary to record the acquisition of Beta on 1 October 2001:

Description of item	Relevant carrying amount 1 October 2001 Book value $'000	Fair value $'000	Comment
Property	12,000	14,000	Any adjustment to depreciation is immaterial
Plant and equipment	8,000	8,800	Useful economic life four years from 1 October 2001
Inventory	9,000	9,500	All inventory sold shortly after 1 October 2001
Trade and other receivables	8,000	8,200	Difference relates to an outstanding insurance claim that was settled shortly after 1 October 2001 by the receipt of $200,000.

Note 4
Alpha supplies a component that is used by the other two entities in their production processes. Alpha marks up its production cost by 25% when computing the sales price. On 30 September 2004 the inventories of Beta and Gamma contained the following amounts (at cost to the purchasing entity) in respect of components purchased from Alpha:

– Beta $800,000.
– Gamma $750,000.

Note 5
At 30 September 2004 the trade receivables of Alpha included the following amounts in respect of the sale of components to Beta and Gamma:

– Receivable from Beta $600,000.
– Receivable from Gamma $500,000.

The same amounts were included in the trade payables of Beta and Gamma at 30 September 2004. There was no other trading between the three entities.

Note 6
– All shares in Beta and Gamma are ordinary shares and carry one vote in general meetings.
– The policy of Alpha is to amortise purchased goodwill over a five year period. Alpha has not adopted IFRS 3 – *Business Combinations* – in its financial statements for the year ended 30 September 2004.

Required:

(a) Prepare the consolidated balance sheet of Alpha at 30 September 2004. (21 marks)

(b) Explain, without any additional calculations, how your answer to part (a) would have been affected if Alpha had the power to appoint a majority of the board of directors of Gamma. (4 marks)

(25 marks)

Section B – THREE questions ONLY to be attempted

2 Delta is an entity that prepares its financial statements to 30 September each year. The financial statements for the year ended 30 September 2004 are being prepared and you are provided with the following trial balance at that date.

	$'000	$'000
Revenue (Note 1)		128,000
Production costs	75,000	
Distribution costs	8,000	
Administrative expenses (Note 2)	22,000	
Suspense account (Note 1)	13,000	
Inventories at 30 September 2003 (Note 3)	18,200	
Interest paid and payable on interest bearing borrowings	3,000	
Income tax (Note 4)		200
Dividends paid on equity shares	2,000	
Property, plant and equipment – at cost (Notes 5 and 6)	57,000	
Accumulated depreciation on property, plant and equipment at 30 September 2003 (Notes 5 and 6)		10,790
Trade receivables	44,000	
Bank balances	33,790	
Trade payables		12,000
Provisions (Note 2)		10,000
Long term interest bearing borrowings		40,000
Lease rentals (Note 7)	8,000	
Deferred tax (Notes 4 and 6)		6,000
Issued equity capital		50,000
Accumulated profits		27,000
	283,990	283,990

Notes to the Trial Balance

Note 1 – Revenue and suspense account
The balance in the suspense account is made up of two related amounts:

– $5 million paid by the company on 1 October 2003 for a licence to export one of its products to an overseas entity. The licence is required by the authorities in the jurisdiction in which the overseas entity is based and allows Delta to export this product for 10 years.
– $8 million being the present value at 1 October 2003 of the expected future net income from the exports secured by the licence. This amount was credited to revenue on 1 October 2003.

Apart from the $8 million already mentioned, revenue represents the amounts receivable in respect of goods and services supplied during the accounting period.

Note 2 – Administrative expenses
Administrative expenses includes a provision of $10 million for the possible costs of a legal claim lodged against Delta by one of its customers before 30 September 2004. The directors of Delta consider that it is probable that Delta can successfully defend the case but they are providing for the worst possible outcome on the grounds of prudence. The provision of $10 million is for the amount sought by the customer ($9·6 million) plus the directors' best estimate of the legal costs incurred in defending the case. If Delta successfully defends the case then based on the outcomes of similar cases in the past it is likely (but not certain) that the customer will be required to reimburse Delta for its legal costs.

Note 3 – Inventories at 30 September 2004
The carrying value of inventories at 30 September 2004 was $23 million. This figure was computed in accordance with the principles of IAS 2 – *Inventories*.

Note 4 – Tax

- The estimated income tax on the profits for the year to 30 September 2004 is $2·5 million.
- During the year $2·2 million was paid in full and final settlement of income tax on the profits for the year ended 30 September 2003. The balance sheet at 30 September 2003 had included $2·4 million in respect of this liability.
- A transfer of $1,400,000 is required to increase the deferred tax liability in the balance sheet. $900,000 of this amount was necessary as a result of the taxable temporary difference caused by the property revaluation (see note 6 below)

Note 5 – Property, plant and equipment
Details are as follows:

	Property		Plant and equipment
	Land	**Buildings**	
	$'000	**$'000**	**$'000**
Cost at 30 September 2004	12,000	18,000	27,000
Estimate of useful economic life (at date of purchase)	Infinite	50 years	4 years
Accumulated depreciation at 30 September 2003	0	3,240	7,550

Depreciation of property, plant and equipment is allocated as follows:

- 80% to cost of sales.
- 10% to distribution costs.
- 10% to administrative expenses.

None of the non-current assets were fully depreciated at 30 September 2003. The above allocation excludes any depreciation charged on the leased asset (see note 7 below) which should be fully charged to cost of sales.

Note 6 – Revaluation
Since the purchase of its property on 1 October 1994 Delta has always followed the benchmark treatment laid down in IAS 16 and carried the property at depreciated historical cost. However on 1 October 2003 the directors of Delta decided to revalue the property to its market value of $40 million, including $19·5 million for the land. The original estimate of the useful economic life of the property was still considered valid. The directors wish to make an annual transfer of excess depreciation from the revaluation reserve to realised profits following the revaluation.

Note 7 – Lease rentals
On 1 October 2003 Delta began to lease a group of machines that were used in the production process. The lease was for five years and the total annual rental (payable in arrears) was $8 million. The lessor paid $30 million for the machines on 30 September 2003. The lessor has advised Delta that the lease is a finance lease and that the rate of interest implicit in the lease can be taken as 10%.

Note 8 – Share issue
On 1 November 2004 Delta issued a further 10 million ordinary shares for $40 million. The shares have no par value and the share issue has not been reflected in the trial balance that appears above.

Required:

(a) Prepare the income statement for Delta for the year ended 30 September 2004. (11 marks)

(b) Prepare the statement of changes in equity for Delta for the year ended 30 September 2004. (6 marks)

(c) Prepare the balance sheet for Delta as at 30 September 2004. (8 marks)

Notes to the income statement and balance sheet are not required. However, your workings should justify your treatment of items referred to in the trial balance and the notes with appropriate references to International Financial Reporting Standards.

(25 marks)

3 Eptilon is listed in a jurisdiction that allows entities to file financial statements that are prepared under either local accounting standards or International Financial Reporting Standards (IFRSs). The stock exchange on which Eptilon is listed does not require any interim financial statements and Eptilon does not currently produce such statements. Eptilon is seeking a listing on another stock exchange that also allows financial statements to be filed that are prepared under IFRSs but would not accept financial statements that are prepared under the local accounting standards that are relevant to Eptilon. This stock exchange requires comparative figures for the previous year only and interim financial reports, prepared in accordance with IFRSs, on a half-yearly basis. Therefore Eptilon wishes to adopt IFRSs for the first time in its financial statements for the year ending 31 December 2005. The Chief Executive Officer has three questions regarding the adoption of IFRSs in 2005:

1. I am aware that the adoption of IFRSs will require us to make a number of changes to our existing accounting practices and that the International Accounting Standards Board has issued IFRS 1 to detail the procedures that need to be undertaken when adopting IFRSs for the first time. I know very little about this standard and need a summary of what IFRS 1 requires us to do together with an indication of any practical difficulties this will give us. Please provide me with this information addressing issues concerning the annual financial statements. (12 marks)

2. I don't know anything about interim financial reports. Please outline what we will need to disclose when we prepare our first interim report for the six months to June 2005. (6 marks)

3. One of the most sensitive aspects of the change we are making is the future need to disclose transactions with certain related parties. Please outline the disclosures that are needed and the parties that the disclosures apply to. (7 marks)

Required:

Draft a reply that answers the questions raised by the Chief Executive Officer. You should refer to specific International Financial Reporting Standards where relevant to your reply.

(25 marks)

4 Iota is an entity holding securities that are publicly traded. Extracts from the income statement of the entity for the year ended 30 September 2004 are given below:

	Year ended 30 September	
	2004	2003
	$'000	$'000
Profit from operations	70,000	60,000
Finance cost	(10,000)	(10,000)
Profit before tax	60,000	50,000
Income tax expense	(15,000)	(12,500)
Extraordinary item	(8,000)	
Profit for the period	37,000	37,500

Before 1 April 2004 the issued capital of Iota had been 400 million $1 shares for a number of years. Then on 1 April 2004 the entity made a rights issue of one share for every four held at $4 per share. The market value of an Iota share immediately before the rights issue was $5.

On 31 October 2004 Iota made a bonus issue of one ordinary share for every one ordinary share held at that date. No other changes to the issued ordinary share capital occurred in October 2004. The 2004 financial statements were approved by the directors on 30 November 2004.

Throughout the year ended 30 September 2004 Iota has had the following potential ordinary shares in issue:

– Options to buy 50 million shares at $3. The average price of an ordinary share in Iota for the year ended 30 September 2004 was $5.
– A $100 million loan with an annual finance cost of 10%. The loan is repayable on 30 September 2008 or convertible into 40 million ordinary shares on that date. The rate of corporate income tax in the jurisdiction in which Iota operates is 25%.

Required:

(a) Explain the value that disclosure of the basic and diluted earnings per share figures adds to financial statements. You should include an analysis of the limitations of the earnings per share figures in your discussion, bearing in mind the characteristics of useful financial information. (14 marks)

(b) Compute the basic and diluted earnings per share for Iota that will be published in the financial statements for the year ended 30 September 2004. You should compute a comparative figure for the basic earnings per share but not for the diluted earnings per share. (11 marks)

(25 marks)

5 Agriculture is a key business activity in many parts of the world, particularly in developing countries. Following extensive discussions with, and funding from, the World Bank, the International Accounting Standards Committee (IASC) developed an accounting standard relating to agricultural activity. IAS 41 – *Agriculture* – was published in 2001 to apply to accounting periods beginning on or after 1 January 2003.

Sigma prepares financial statements to 30 September each year. On 1 October 2003 Sigma carried out the following transactions:

– Purchased a large piece of land for $20 million.
– Purchased 10,000 dairy cows (average age at 1 October 2003 two years) for $1 million.
– Received a grant of $400,000 towards the acquisition of the cows. This grant was non-returnable.

During the year ending 30 September 2004 Sigma incurred the following costs:

– $500,000 to maintain the condition of the animals (food and protection).
– $300,000 in breeding fees to a local farmer.

On 1 April 2004 5,000 calves were born. There were no other changes in the number of animals during the year ended 30 September 2004. At 30 September 2004 Sigma had 10,000 litres of unsold milk in inventory. The milk was sold shortly after the year end at market prices.

Information regarding fair values is as follows:

Item	**Fair value less point of sale costs**		
	1 October 2003	**1 April 2004**	**30 September 2004**
	$	$	$
Land	20 million	22 million	24 million
New born calves (per calf)	20	21	22
Six month old calves (per calf)	23	24	25
Two year old cows (per cow)	90	92	94
Three year old cows (per cow)	93	95	97
Milk (per litre)	0·6	0·55	0·55

Required:

(a) Discuss how the IAS 41 requirements regarding the recognition and measurement of biological assets and agricultural produce are consistent with the IASC Framework for the Preparation and Presentation of Financial Statements. (8 marks)

(b) Prepare extracts from the income statement and the balance sheet that show how the transactions entered into by Sigma in respect of the purchase and maintenance of the dairy herd would be reflected in the financial statements of the entity for the year ended 30 September 2004. You do not need to prepare a reconciliation of changes in the carrying amount of biological assets. (17 marks)

(25 marks)

End of Question Paper