Diploma in International Financial Reporting

Thursday 9 December 2010

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

This paper is divided into two sections:

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

Section B – THREE questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

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

1 Alpha holds investments in three entities, Beta, Gamma and Foster. The statements of financial position of Alpha, Beta and Gamma at 30 September 2010 were as follows:

	Alpha $'000	Beta $'000	Gamma $'000
ASSETS			
Non-current assets:			
Property, plant and equipment (Note 1)	165,000	100,000	100,000
Intangible assets (Note 1)	Nil	12,000	Nil
Investments (Notes 1–3)	50,000	Nil	Nil
	215,000	112,000	100,000
Current assets:			
Inventories (Note 4)	65,000	37,000	30,000
Trade receivables (Note 5)	35,000	32,000	32,000
Cash and cash equivalents	10,000	7,000	8,000
	110,000	76,000	70,000
Total assets	325,000	188,000	170,000
EQUITY AND LIABILITIES			
Equity			
Share capital ($1 shares)	80,000	60,000	60,000
Retained earnings	140,000	56,000	54,000
Total equity	220,000	116,000	114,000
Non-current liabilities:			
Long-term borrowings	35,000	30,000	20,000
Contingent consideration (Note 1)	20,000	Nil	Nil
Deferred tax	15,000	10,000	10,000
Total non-current liabilities	70,000	40,000	30,000
Current liabilities:			
Trade and other payables	30,000	24,000	20,000
Short-term borrowings	5,000	8,000	6,000
Total current liabilities	35,000	32,000	26,000
Total equity and liabilities	325,000	188,000	170,000

Note 1 – Alpha's investment in Beta:

On 1 October 2009 Alpha acquired 45 million shares in Beta. The terms of the business combination were that:

– Alpha issued three new shares in Alpha to the previous shareholders of Beta for every five acquired in Beta. On 1 October 2009 the market value of a share in Alpha was $3·60 and the market value of a share in Beta was $1·90. The share issue was **not** recorded in the financial statements of Alpha.

– A further payment of $1·00 per share acquired will be made to the previous shareholders of Beta on 1 January 2012 provided the profits of Beta in the two years immediately after the acquisition exceed a target level. On 1 October 2009 the fair value of this potential additional payment was $20 million. By 30 September 2010 the fair value had risen to $24 million due to changes in circumstances since the date of acquisition. The investments of Alpha include $20 million in respect of this potential further payment.

Beta is located in a jurisdiction that uses locally developed accounting standards to prepare financial statements. The retained earnings of Beta at 1 October 2009, measured under these standards, were $44 million. These standards are identical to International Financial Reporting Standards (IFRS) in all respects other than the recognition criteria for intangible assets. None of the intangible assets of Beta would have qualified for recognition under IFRS, either at 1 October 2009 or 30 September 2010. The financial statements of Beta that are given in this question are prepared

under local accounting standards. The carrying value of the intangible assets in the financial statements of Beta at 1 October 2009 was $11 million.

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

– Plant and equipment having a carrying value of $38 million had an estimated market value of $42 million. The estimated future economic life of the plant and equipment at 1 October 2009 was two years.

– Inventory having a carrying value of $10 million had a market value of $11 million. Beta sold this inventory prior to 30 September 2010.

The fair value adjustments have not been reflected in the individual financial statements of Beta.

Note 2 – Alpha's investment in Gamma:
On 1 October 2006 Alpha acquired 15 million shares in Gamma on incorporation of Gamma for a cash payment of $1 per share. Three other investors acquired 15 million shares on the same date and under the same terms. The acquisition was a strategic decision by the four investors to exercise joint control over the operating and financial policies of Gamma.

Gamma prepares its financial statements using IFRS.

Note 3 – Alpha's investment in Foster
Alpha's investment in Foster is an available for sale investment that has a fair value of $12 million at 30 September 2010. Adjustments to the fair value of available for sale investments will constitute a temporary difference for deferred tax purposes (see note 6).

Note 4 – inter-company sale of inventories
The inventories of Beta and Gamma at 30 September 2010 included components purchased from Alpha during the year at a cost of $8 million to Beta and $6·4 million to Gamma. In arriving at the selling price Alpha marked up these components by 1/3 of their total production cost. There were no outstanding amounts payable by Beta or Gamma in respect of these purchases at 30 September 2010.

Note 5 – trade receivables
On 30 September 2010 Alpha sold trade receivables with a carrying value of $25 million to a finance company. The finance company paid $20 million to Alpha and will pay the remaining balance, less a collection charge that is based on the time taken to collect the cash from the relevant customers, when the customers pay. If the customers do not pay by 31 March 2011 then any amounts advanced to Alpha are fully refundable. There is currently no indication that any of the customers will not pay in full by that date.

When accounting for this receipt Alpha debited cash with $20 million, credited trade receivables with $25 million, and charged $5 million as a finance cost in its statement of comprehensive income.

Note 6 – deferred tax
In the consolidated financial statements the accounting policy adjustment and fair value adjustments arising on the acquisition of Beta will be regarded as temporary differences for the purposes of computing deferred tax. Any unrealised profits on inter-entity trading will also be regarded as temporary differences for this purpose.

The rate of tax to apply to temporary differences is 25%. Any deferred tax debit balances can be assumed to be recoverable and offsettable against deferred tax credit balances.

Note 7 – other information
It is the group policy to value the non-controlling interest in subsidiaries at the date of acquisition at fair value. The fair value of an equity share in Beta at 1 October 2009 should be used for this purpose.

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

Where permitted by IFRS Alpha uses proportionate consolidation in preparing its consolidated financial statements.

Required:

Prepare the consolidated statement of financial position of Alpha at 30 September 2010.

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

25 marks

(25 marks)

Section B – THREE questions ONLY to be attempted

2 Delta's financial statements for the year ended 30 September 2010 are being prepared and you are provided with the following trial balance at that date:

	$'000	$'000
Revenue (Note 1)		315,000
Inventories at 30 September 2009	32,000	
Raw material purchases	150,000	
Production costs	60,000	
Distribution costs	12,000	
Administrative expenses	22,000	
Lease rentals paid (Note 3)	23,000	
Property, plant and equipment:		
– at cost (Note 4)	180,000	
– accumulated depreciation at 30 September 2009 (Note 4)		35,000
Income tax account (Note 5)	400	
Deferred tax (Note 5)		7,200
Trade receivables (Note 6)	50,000	
Cash and cash equivalents	24,800	
Trade payables		30,000
Equity share capital ($1 shares)		154,000
Equity dividend paid 31 December 2009	30,000	
Retained earnings at 30 September 2009		43,000
	584,200	584,200

Notes to the trial balance

Note 1 – Revenue
On 20 September 2010 Delta signed a contract to supply a customer with inventory during November 2010. The customer paid a deposit of $5 million when the contract was signed and Delta credited this amount to revenue. Delta did not make any adjustment to inventory on 20 September 2010 as a result of receiving the deposit.

Note 2 – Inventories
On 30 September 2010 the value of the inventories at cost at Delta's premises was $40 million. This included 200,000 units of partly completed inventory that had cost $20 per unit to manufacture. The estimated costs to complete this inventory are $6 per unit and the selling costs are estimated at $1 per unit. Until recently the selling price of this product was $30 per unit. However, a competitor has developed a new product which has affected the ability of Delta to sell the product at the normal price and it is estimated that they will need to reduce the price to $22·50 per unit (selling costs unaffected) in order to be able to sell these items.

Note 3 – Lease rentals
On 1 October 2009 Delta entered into two leasing contracts:

The first contract was a contract to lease motor vehicles for a two-year period. The estimated useful economic lives of the vehicles at the start of the lease was five years. It was the responsibility of the lessor to repair and insure the vehicles. The lease contract stated that Delta should pay a deposit of $600,000 at the start of the lease followed by monthly payments of $200,000 in arrears. The lease rentals figure includes $3 million in respect of this lease. The cars were used by office staff.

The second contract was to lease a number of machines. The lease was for a four-year period, which was the estimated useful economic life of the machines. Delta is required to repair and insure the plant, which has no estimated residual value at the end of the lease. The lease rentals were set at $10 million every six months, payable in advance. The lease rentals figure included $20 million in respect of this lease. The rate of interest implicit in this lease was 5% per six-monthly period and the present value of the minimum lease payments was very close to the fair value of the assets at the inception of the lease, which was estimated at $70 million.

Note 4 – Property, plant and equipment

	Cost	Accumulated depreciation at 30 September 2009
	$'000	$'000
Property	90,000	5,000
Plant and equipment	90,000	30,000
	180,000	35,000

(i) Depreciation of all property, plant and equipment should be charged to cost of sales. Depreciation has not yet been charged for the year.

(ii) The plant and equipment is being depreciated on a straight-line basis at 25% per annum. No disposals of property, plant and equipment occurred in the period.

(iii) The depreciable element of the property has an allocated carrying value of $50 million and is being depreciated on a straight-line basis over 50 years from the date of original purchase. On 1 October 2009 the directors of Delta revalued this property for the first time. The property had an estimated market value at 1 October 2009 of $100 million. It is further estimated that $54 million of this value relates to the depreciable element. The original estimate of the useful economic life is still considered valid.

(iv) The directors have decided not to make an annual transfer of excess depreciation on revalued assets to retained earnings.

Note 5 – income tax

(i) On 31 December 2009 Delta made full and final payment to discharge the income tax liability for the year ended 30 September 2009. The balance on the income tax account in the trial balance is the residue after making that payment.

(ii) The estimated income tax liability for the year ended 30 September 2010 is $5 million.

(iii) A transfer of $600,000 needs to be made to the deferred tax account for the period. This includes the impact of all the adjustments necessary to prepare the financial statements apart from the initial revaluation of the property (Note 4)

(iv) The rate of income tax in the jurisdiction in which Delta operates is 25%.

Note 6 – trade receivables

The closing trade receivables includes an amount of $10 million owed by a customer who experienced cash flow problems prior to the year end. Delta agreed to accept a payment of $8 million in full and final settlement of the debt and to defer the payment until 30 September 2011. Delta would expect a return of 10% on sums invested for one year.

Required:

(i) Prepare the statement of comprehensive income for Delta for the year ended 30 September 2010;

(ii) Prepare the statement of financial position for Delta as at 30 September 2010.

Note: You are not required to produce notes to the financial statements or a statement of changes in equity.

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

25 marks

(25 marks)

3 Epsilon is a listed entity. You are the financial controller of the entity and its consolidated financial statements for the year ended 30 September 2010 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 October 2009 Epsilon issued 5 million loan notes that had a value of $1 per note. The issue costs were 3 cents per note. Each note holder will receive interest of 5 cents per note on 30 September of each year starting on 30 September 2010. The loan notes are repayable on 30 September 2019 at $1·20 per note. As an alternative to repayment the loan note holders can elect to exchange their notes for shares in Epsilon. On 1 October 2009 the credit rating of Epsilon was such that it would have had to offer investors in non-convertible loan notes a rate of return of 9% per annum on any investment. The impact of issue costs would increase the effective interest rate on such loan notes to 9·45%.

The following information regarding discount rates may be relevant:

Discount rate	Present value of $1 receivable at the end of year 10	Cumulative present value of $1 receivable at the end of years 1–10
5%	61 cents	$7·72
9%	42 cents	$6·42

(6 marks)

Transaction (b)

On 1 October 2009 Epsilon began to lease a property which it intended to use as office space. The lease was for a 10-year period at the end of which the property had to be returned to the lessor in its original condition.

The lease rentals were set at $800,000 per annum, payable in arrears on 30 September each year. However, as an inducement to persuade Epsilon to sign the leasing contract the lessor paid Epsilon $1 million on 1 October 2009.

Shortly after beginning to use the property Epsilon began work in altering the internal design of the property to more adequately suit its purposes. This work was completed on 31 March 2010 at a total cost of $1·2 million. It is estimated that it will cost Epsilon $600,000 to restore the property to its original condition on 30 September 2019. An appropriate risk adjusted discount rate is 10% per annum. The present value of $1 payable in 9½ years time at an annual discount rate of 10% is approximately 40·4 cents. (11 marks)

Transaction (c)

On 1 October 2003 Epsilon had purchased an equity investment in a listed entity. Epsilon purchased 1 million shares at the then quoted price of $2 per share. This shareholding does not allow Epsilon to exercise control or significant influence over the listed entity. Epsilon intended to keep the shares for their growth potential rather than treat them as part of a trading portfolio. All the shares were still held by Epsilon on 30 September 2009 and at that date their quoted price was $3·20 per share.

On 30 June 2010 Epsilon sold 600,000 of the shares for $3·60 per share. On 30 September 2010 the quoted price of the shares was $3·50 per share. (8 marks)

Required:

For each transaction prepare extracts from the financial statements for the year ended 30 September 2010. Your extracts should be supported by appropriate explanations.

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

(25 marks)

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Question 4 begins on page 8.

4 **(a)** IAS 33 – *Earnings per share* – requires certain entities to disclose information about earnings per share (EPS) in their financial statements.

Required:

Describe:

(i) Those entities to which IAS 33 applies;
(ii) The way in which EPS (both basic and diluted) should be computed – in outline ONLY;
(iii) The numerical disclosure requirements regarding EPS for entities that have no discontinued operations;
(iv) The additional numerical disclosure requirements regarding EPS for entities that report discontinued operations. (7 marks)

(b) Kappa is a listed entity that made a profit after tax of $35 million for the year ended 30 September 2010. There were no discontinued operations. At 1 October 2009 Kappa had 70 million ordinary shares and 30 million preferred shares in issue. The preferred shares were correctly presented in equity within the statement of financial position. In the year ended 30 September 2010 Kappa declared and paid a dividend of 12 cents per share to the ordinary shareholders and 6 cents per share to the preferred shareholders.

On 31 December 2009 Kappa made a fully subscribed rights issue of two ordinary shares for every seven held at $1·35 per share. The fair value of an ordinary share at 31 December 2009 was $1·80.

Throughout the financial year Kappa had 20 million convertible loan notes on which interest of 5 cents per note was payable annually in arrears. The carrying value of the liability element of the loan note at 1 October 2009 was $23 million and the effective rate of interest was 7%. The rate of income tax in the jurisdiction in which Kappa operates is 20% and the finance cost that is charged in the statement of comprehensive income is subject to income tax at that rate.

The notes are convertible into ordinary shares from 1 October 2011 at the option of the note-holder. The conversion terms are one ordinary share for every loan note held.

Required:

Compute the basic and diluted EPS of Kappa for the year ended 30 September 2010. (8 marks)

(c) In recent years it has become increasingly common for entities to issue equity instruments in exchange for goods and services. Such transactions are collectively referred to as equity settled share based payments.

Required:

Explain:

(i) When equity settled share based payments should be recognised in financial statements;
(ii) How equity settled share based payments should be measured (distinguishing between payments to employees and payments to other parties);
(iii) Where in the statement of comprehensive income and statement of financial position equity settled share based payments should be reported. (5 marks)

(d) On 1 October 2008 Kappa granted share options to 500 sales staff. The entitlement of each member of staff depended on the achievement of overall sales targets in the three-year period to 30 September 2011. Details are as follows:

- Cumulative sales less than $100 million: 100 options each.
- Cumulative sales between $100 million and $150 million: 150 options each.
- Cumulative sales more than $150 million: 200 options each.

The options had a fair value of $1·20 per option on 1 October 2008. This had increased to $1·30 per option by 30 September 2009 and by 30 September 2010 the fair value of an option was $1·35 per option.

When the options were granted and at 30 September 2009 management estimated that total sales in the three-year period would be $130 million. However, following a very good year in the year to 30 September 2010 that estimate was revised to $160 million.

Required:

Compute the charge to the statement of comprehensive income for the year ended 30 September 2010 in respect of the above arrangement and the amount included in the statement of financial position at 30 September 2010. (5 marks)

(25 marks)

5 **(a)** Omega is an entity with a number of subsidiaries. The year end of the entity is 30 September. On 1 January 2008 Omega acquired an 80% interest in Friendly. Details of the acquisition were as follows:

- Omega acquired 800,000 shares in Friendly by issuing two equity shares for every five acquired. The fair value of an Omega share on 1 January 2008 was $4 and the fair value of a Friendly share $1·40. The costs of issue were 5 cents per share.
- Omega incurred further legal and professional costs of $100,000 that directly related to the acquisition.
- The fair values of the identifiable net assets of Friendly at 1 January 2008 were measured at $1·3 million.

Omega initially measured the non-controlling interest in Friendly at fair value. They used the market value of a Friendly share for this purpose. No impairment of goodwill arising on the acquisition of Friendly was required at 30 September 2008 or 2009.

Friendly comprises three cash generating units A, B and C. When Friendly was acquired the directors of Omega estimated that the goodwill arising on acquisition could reasonably be allocated to units A:B:C on a 2:2:1 basis. The carrying values of the assets in these cash generating units and their recoverable amounts are as follows:

Unit	Carrying value (before goodwill allocation) $'000	Recoverable amount $'000
A	600	740
B	550	650
C	450	400

Required:

(i) Compute the carrying value of the goodwill arising on acquisition of Friendly in the consolidated statement of financial position of Omega at 30 September 2010 following the impairment review.

(ii) Compute the total impairment loss arising as a result of the impairment review, identifying how much of this loss would be allocated to the non-controlling interests in Friendly. (11 marks)

(b) During the year ended 30 September 2010 Omega acquired a subsidiary, Newsub, that was located in a jurisdiction that allows individual entities to use either local accounting standards or international financial reporting standards (IFRS). In previous periods Newsub has prepared financial statements under local accounting standards. Having become part of the Omega group the directors of Newsub have decided to prepare the individual financial statements of that company using IFRS for the year ended 30 September 2010. The directors of Newsub are aware that there is a set procedure under IFRS for entities that adopt IFRS having previously used local accounting standards but they are unaware of the details.

Required:

Explain the procedure that will need to be adopted by Newsub in preparing its financial statements under IFRS for the year ended 30 September 2010 given that previous financial statements were prepared under local accounting standards. You do NOT need to describe any exceptions to the normal procedure in detail but referring to them in general terms will gain you credit. (6 marks)

(c) On 1 October 2009 Omega sold a property it owned for $90 million and leased it back on a 10-year operating lease for rentals of $8 million per annum, payable on 30 September in arrears. The carrying value of the property in the financial statements of Omega at 1 October was $55 million and its market value on that date was $70 million.

Required:

Compute the amounts that will be shown in the statement of comprehensive income for the year ended 30 September 2010 and in the statement of financial position at 30 September 2010 in respect of the sale and leaseback. (5 marks)

(d) During the year ended 30 September 2010 Omega sold a machine to a customer that proved to have a design fault. The customer has returned the machine to Omega and demanded repayment of the purchase price of $5 million plus compensation for lost sales of $500,000. It is highly likely that Omega will make this payment in January 2011. The directors of Omega consider it probable that the $4·8 million of the above amount can be recovered from the original manufacturer of the machine and this amount could reasonably be expected to be received in March 2011.

Required:

Explain how both the claim and the counter-claim will be treated in the financial statements of Omega for the year ended 30 September 2010. (3 marks)

(25 marks)

End of Question Paper