# Diploma in International Financial Reporting

Tuesday 13 December 2011

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

ALL FOUR questions are compulsory and MUST be attempted.

**Do NOT open this paper until instructed by the supervisor.**

**During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

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**The question paper begins on page 3.**

**ALL FOUR questions are compulsory and MUST be attempted**

**1** Alpha holds investments in Beta and Gamma. The statements of financial position of the three entities at 30 September 2011 were as follows:

| | Alpha $'000 | Beta $'000 | Gamma $'000 |
|---|---|---|---|
| ASSETS | | | |
| Non-current assets: | | | |
| Property, plant and equipment (Note 1) | 210,000 | 165,000 | 120,000 |
| Investments: | | | |
| – in Beta (Note 1) | 180,000 | Nil | Nil |
| – in Gamma (Note 3) | 52,000 | Nil | Nil |
| – in Sigma (Note 6) | 15,000 | Nil | Nil |
| | 457,000 | 165,000 | 120,000 |
| Current assets: | | | |
| Inventories (Note 4) | 65,000 | 36,000 | 29,000 |
| Trade receivables (Note 5) | 55,000 | 38,000 | 35,000 |
| Cash and cash equivalents | 12,000 | 7,000 | 9,000 |
| | 132,000 | 81,000 | 73,000 |
| Total assets | 589,000 | 246,000 | 193,000 |
| EQUITY AND LIABILITIES | | | |
| Equity | | | |
| Share capital ($1 shares) | 180,000 | 100,000 | 60,000 |
| Retained earnings | 183,000 | 67,000 | 64,000 |
| Other components of equity | 90,000 | 5,000 | Nil |
| Total equity | 453,000 | 172,000 | 124,000 |
| Non-current liabilities: | | | |
| Contingent consideration (Note 1) | 20,000 | Nil | Nil |
| Long-term borrowings (Note 8) | 50,000 | 35,000 | 30,000 |
| Deferred tax | 15,000 | 9,000 | 12,000 |
| Total non-current liabilities | 85,000 | 44,000 | 42,000 |
| Current liabilities: | | | |
| Trade and other payables | 34,000 | 23,000 | 21,000 |
| Short term borrowings | 17,000 | 7,000 | 6,000 |
| Total current liabilities | 51,000 | 30,000 | 27,000 |
| Total equity and liabilities | 589,000 | 246,000 | 193,000 |

**Note 1 – Alpha's investment in Beta**

On 1 April 2010 Alpha acquired 80 million shares in Beta by means of a share exchange. Alpha issued one share for every two shares acquired in Beta. On 1 April 2010 the market value of an Alpha share was $4 and the market value of a Beta share was $1·80. The terms of the business combination provide for an additional cash payment to the former shareholders of Beta on 30 June 2012 based on its post-acquisition financial performance in the first two years since acquisition. The fair value of this additional payment was $20 million on 1 April 2010. The post acquisition performance of Beta was such that the fair value of this payment had increased to $22 million by 30 September 2011. The investment in Beta and the non-current liabilities of Alpha at 30 September 2010 include $20 million in respect of the additional payment due to be made on 30 June 2012.

On 1 April 2010 the individual financial statements of Beta showed the following reserves balances:

- Retained earnings $41 million.
- Other components of equity $3 million.

The directors of Alpha carried out a fair value exercise to measure the identifiable assets and liabilities of Beta at 1 April 2010. The following matters emerged:

- A property, having a carrying amount of $50 million (depreciable amount $30 million), had a fair value of $70 million (depreciable amount $33 million). The estimated future economic life of the depreciable amount of the property at 1 April 2010 was 30 years. This property was still held by Beta at 30 September 2011.
- Plant and equipment, having a carrying amount of $60 million, had an estimated market value of $64 million. The estimated future economic life of the plant at 1 April 2010 was four years. This plant was still held by Beta at 30 September 2011.
- Inventory, having a carrying amount of $30 million, had an estimated market value of $31 million. All of this inventory had been sold since 1 April 2010.

The fair value adjustments have not been reflected in the individual financial statements of Beta. In the consolidated financial statements the fair value adjustments will be regarded as temporary differences for the purposes of computing deferred tax. The rate of tax to apply to temporary differences (where required but see notes 3, 4, 6 and 7 below) is 20%.

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 April 2010 can be used for this purpose.

**Note 2 – Impairment reviews – Beta**

On 1 April 2010 the directors of Alpha identified that Beta comprised five cash-generating units and allocated the goodwill arising on acquisition equally across each unit. No impairment of goodwill was apparent in the year ended 30 September 2010.

During the year ended 30 September 2011 four of the five cash-generating units performed very satisfactorily and no impairment of the goodwill allocated to these units had occurred. However the performance of the other unit was below expectations. During the impairment review carried out at 30 September 2011 assets (excluding goodwill) having a carrying amount in the consolidated financial statements of $50 million were allocated to this unit. The recoverable amount of these assets was estimated at $52 million.

**Note 3 – Alpha's investment in Gamma**

On 1 October 2010 Alpha paid $52 million for 40% of the equity shares of Gamma. The retained earnings of Gamma on 1 October 2010 were $60 million. You can ignore any deferred taxation implications of the investment by Alpha in Gamma. The investment in Gamma has not suffered any impairment since 1 October 2010.

**Note 4 – Inter-company sale of inventories**

The inventories of Beta and Gamma at 30 September 2011 included components purchased from Alpha during the year at a cost of $16 million to Beta and $10 million to Gamma. Alpha generated a gross profit margin of 25% on the supply of these components. You can ignore any deferred tax implications of the information in this note.

**Note 5 – Trade receivables and payables**

The trade receivables of Alpha included $5 million receivable from Beta and $4 million receivable from Gamma in respect of the purchase of components (see Note 4). The trade payables of Beta and Gamma included equivalent amounts payable to Alpha.

**Note 6 – Alpha's investment in Sigma**

Alpha's investment in Sigma does not give Alpha sole control, joint control or significant influence. The investment was purchased on 1 January 2011 for $15 million. The investment was classified as fair value through other comprehensive income. The fair value of the investment in Sigma on 30 September 2011 was $16 million. In the tax jurisdiction in which Alpha is located unrealised profits on the revaluation of equity investments are not subject to current tax. Any such profits are taxed only when the investment is sold.

**Note 7 – Employees share option scheme**

On 1 October 2009 Alpha granted 5,000 share options to 1,000 key employees. The options are due to vest on 30 September 2013 provided the employees remain in employment at 30 September 2013. On 1 October 2009 the directors of Alpha estimated that 90% of the key employees would satisfy the vesting condition. Actual employee turnover was such that this estimate was revised to 92% on 30 September 2010 and 93% on 30 September 2011.

At 1 October 2009 the fair value of each share option was estimated to be $1·20. This estimate was revised to $1·25 on 30 September 2010 and $1·28 on 30 September 2011. You can ignore the deferred tax implications of the information in this note.

Alpha correctly recognised this transaction in the financial statements for the year ended 30 September 2010. However, they have made no additional adjustments in the financial statements for the year ended 30 September 2011.

**Note 8 – Long-term borrowings**

On 1 October 2010 Alpha issued 50 million loan notes of $1 each at par. The annual interest payable on these notes is 5 cents per note, payable in arrears. The notes are redeemable at par on 30 September 2015 or convertible (at the option of the note-holders) into equity shares on that date. On 1 October 2010 investors in loan notes with no conversion option would have required an annual rate of return of 8%. On 1 October 2010 the directors of Alpha included $50 million in long-term borrowings in respect of the loan notes. The actual interest paid of $2·5 million was charged as a finance cost in Alpha's income statement for the year ended 30 September 2011.

Relevant discount factors are as follows:

| | 5% | 8% |
|---|---|---|
| Present value of $1 payable at the end of year 5 | 78·4 cents | 68·1 cents |
| Cumulative present value of $1 payable at the end of years 1-5 | $4·33 | $3·99 |

**Note 9 – Modification of vehicles**

On 1 January 2011 legislation was passed requiring Alpha to carry out modifications to its motor vehicles to enable harmful emissions to be reduced. The modifications should have been completed by 30 June 2011 at an estimated cost to Alpha of $3 million. In fact by 30 September 2011 none of the vehicles had been modified although they continued to be used. It is likely that Alpha will be fined $500,000 per month for the illegal use of the vehicles. The directors of Alpha are uncertain exactly when they will carry out the modifications but they intend to do so sometime during the year ended 30 September 2012. They expect that a fine will become payable very shortly as legal action has commenced against Alpha.

**Required:**

**Prepare the consolidated statement of financial position of Alpha at 30 September 2011.**

**(40 marks)**

**2** Kappa is an entity that prepares consolidated financial statements to 30 September each year. Below are details of two events ((a) and (b)) that occurred during the year ended 30 September 2011, followed by some questions concerning their treatment in the financial statements for the year. The financial statements are due to be authorised for issue on 20 December 2011.

**(a)** On 31 July 2011, the directors decided to discontinue the business of one of Kappa's wholly owned subsidiaries, Lambda. They decided to cease production on 31 October 2011, with a view to disposing of the property, plant and equipment soon after 30 November 2011, the date scheduled for the completion of the sale of all Lambda's inventory and the settlement of all liabilities due to its suppliers and employees. Any amounts still owing by Lambda's customers at 30 November 2011 would be collected by other group companies on Lambda's behalf.

On 15 August 2011, the directors made a public announcement of their intentions and offered the employees of Lambda termination payments or alternative employment opportunities elsewhere in the group. Relevant financial details are as follows:

- On 31 July 2011, the directors estimated that termination payments to employees would total $10 million and, although full details are not yet available, the costs of re-training employees who would remain employed by other group companies is expected total $1 million. Actual termination costs paid out on 30 November 2011 were $10·5 million and the latest estimate of total re-training costs is $800,000.
- Lambda was leasing a property under an operating lease that expires on 31 December 2020. On 30 September 2011 the present value of the future lease rentals (using an appropriate discount rate) was $4 million. On 30 November 2011 Lambda made a payment to the lessor of $3·8 million in return for early termination of the lease. There were no rental payments made in October or November 2011.
- The loss after tax of Lambda for the year ended 30 September 2011 was $12 million. Lambda made further operating losses totalling $5 million for the two month period 1 October 2011 to 30 November 2011.
- At 30 September 2011, the property, plant and equipment of Lambda had a carrying amount of $20 million ($12 million for its owned property and $8 million for its plant and equipment) and a recoverable amount of $22 million ($17 million for its owned property and $5 million for its plant and equipment). The carrying amount of $20 million is after deducting a full year's depreciation.

A number of questions have arisen from the decision to discontinue.

**Required:**

**(i) Is any provision for closure costs necessary and if so for what amount?**

**(ii) How should the decision to discontinue the business of Lambda be presented on the consolidated statement of comprehensive income?**

**(iii) What is the correct carrying amount for the property, plant and equipment? Should it be presented as non-current assets held for sale given that we know it was sold after the year end?**

Note: You should provide any supporting explanations you consider relevant.

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

(i) 6 marks
(ii) 4 marks
(iii) 2 marks

(12 marks)

**(b)** On 1 July 2011, another wholly-owned subsidiary, Epsilon, signed a contract to manufacture a machine for a customer for a fixed price of $12 million. The customer paid a deposit of $3 million on 1 July 2011 and the balance is payable upon completion and delivery of the machine. This is expected to take place on 31 December 2011. Relevant financial details are as follows:

- Epsilon has purchased materials costing $5 million for use on the contract. $4 million of these materials had been used by the year end.
- The manufacture of the machine started on 1 August 2011 and was completed on 30 November 2011. During this period certain property, plant and equipment of Epsilon was used exclusively in the manufacturing process. Annual depreciation on this property, plant and equipment is $3 million.
- Epsilon incurred direct labour costs and other production overheads totalling $300,000 per month throughout the manufacturing period.
- General administrative overheads of $150,000 per month were allocated to the contract using Epsilon's normal cost allocation model.
- Epsilon determines the extent of completion of construction contracts by comparing the costs incurred on the contract to date with the total expected contract costs.

There are two key questions that have arisen in relation to the above outlined contract.

**Required:**

**(i) How much revenue and profit on this contract should be reported in the statement of comprehensive income?**

**(ii) How should the contract be reported in the statement of financial position?**

Note: You should provide any supporting explanations you consider relevant.

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

(i) 6 marks
(ii) 2 marks

(8 marks)

**(20 marks)**

**3** **(a)** IAS 19 – *Employee benefits* – is a comprehensive standard that deals with the financial reporting of short and long-term employee benefits. The most complex type of employee benefit dealt with in IAS 19 is post-employment benefits. Such benefits are usually provided via a separate plan into which the employer makes contributions. The impact of such arrangements on the financial statements of contributing employers depends on the type of retirement benefit plan.

One of the particularly complex aspects of the standard is the treatment of actuarial gains and losses arising on the measurement of obligations relating to post-employment benefits. IAS 19 allows a number of alternative treatments.

**Required:**

**You are required to provide an explanation of:**

**(i) The difference between a defined contribution and a defined benefit plan. Your explanation should include an analysis of which party bears the risks attaching to the level of benefits.**

**(ii) The difference, in the financial statements of contributing employers, between the method of accounting for contributions to defined contribution plans and contributions to defined benefit plans.**

**(iii) The two alternative ways other than the corridor method of reporting actuarial gains and losses arising in respect of defined benefit plans.**

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

(i) 3 marks
(ii) 3 marks
(iii) 2 marks

(8 marks)

**(b)** Omicron prepares financial statements to 30 September each year. Omicron makes contributions to a defined benefit post-employment benefit plan for its employees. Omicron accounts for actuarial gains and losses arising on these arrangements using the corridor method. Relevant data is as follows:

(i) At 1 October 2010 the plan obligation was $35 million and the fair value of the plan assets was $30 million. Unrecognised actuarial losses at that date totalled $6·5 million.

(ii) The actuary advised that the current service cost for the year ended 30 September 2011 was $4 million. Omicron paid contributions of $3·2 million to the plan on 30 September 2011. These were the only contributions paid in the year.

(iii) The expected annual rate of return on plan assets at 1 October 2010 was 5%. The actuary revised this estimate to 4% at 30 September 2011.

(iv) The appropriate annual rate at which to discount the plan liabilities was 6% on 1 October 2010 and 5·5% on 30 September 2011.

(v) The plan paid out benefits totalling $2 million to retired members on 30 September 2011.

(vi) At 30 September 2011 the plan obligation was $41·5 million and the fair value of the plan assets was $32·5 million.

(vii) The average remaining service lives of plan members still in employment was estimated to be 20 years.

**Required:**

**Compute the amounts that will appear in the statement of comprehensive income of Omicron for the year ended 30 September 2011 and the statement of financial position at 30 September 2011 in respect of the post-employment benefit plan.**

Note: You should indicate where in each statement the relevant amounts will be presented. (12 marks)

**(20 marks)**

**4** You are the financial controller of Omega. Omega has subsidiaries located in a number of different countries. Omega has a strategy of growth by acquisition and regularly evaluates potential acquisition targets from different countries and financial reporting regimes. Omega regularly seeks to raise capital on a number of different markets to fund new acquisitions. All subsidiaries currently prepare financial statements using applicable local accounting standards. The consolidated financial statements have been prepared using local accounting standards that apply in Omega's jurisdiction up to and including the year ended 30 September 2011. Local regulations allow financial statements to be prepared either using local accounting standards or International Financial Reporting Standards (IFRS). The directors are giving serious consideration to using IFRS from the year ending 30 September 2012 onwards. One of the directors is unsure of the wisdom of this proposal and has identified a number of issues about which he is uncertain.

Issue (a)
Changing from using local standards to using international standards is bound to have short-term cost implications. I need to be convinced that the benefits of a change justify these costs. Please describe **three** ways we would benefit from a move to IFRS. (6 marks)

Issue (b)
Before I can agree with a move to IFRS I need to understand how the standard setting process works. Someone told me there are **four** different bodies involved! Please give me a brief description of each one of these, highlighting their role in the standard setting process. (8 marks)

Issue (c)
I'm unclear about the practicalities of adopting IFRS in the year ending 30 September 2012. I've heard that we need to start with the opening IFRS statement of financial position. I'm unclear what this means and for what date it is prepared. Please explain the process for me, including any additional disclosures we need to make in the first set of financial statements prepared under IFRS. (6 marks)

**Required:**

**Prepare a response to the three issues raised by the director.**

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

**(20 marks)**

**End of Question Paper**