

Diploma in International Financial Reporting

Friday 10 June 2016



Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

ALL FOUR questions are compulsory and MUST be attempted.

Do NOT open this question 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.

REF
DIP

Think Ahead

ACCA

The Association of
Chartered Certified
Accountants

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The question paper begins on page 3.**

ALL FOUR questions are compulsory and MUST be attempted

1 Alpha's investments include subsidiaries, Beta and Gamma. The statements of profit or loss and other comprehensive income and summarised statements of changes in equity of the three entities for the year ended 31 March 2016 were as follows:

Statements of profit or loss and other comprehensive income

	Alpha \$'000	Beta \$'000	Gamma \$'000
Revenue (Notes 3 and 4)	360,000	210,000	190,000
Cost of sales (Notes 1–3)	(240,000)	(110,000)	(100,000)
Gross profit	120,000	100,000	90,000
Distribution costs	(20,000)	(16,000)	(15,000)
Administrative expenses	(30,000)	(19,000)	(18,000)
Investment income (Notes 5 and 6)	19,800	Nil	Nil
Finance costs (Note 7)	(12,000)	(17,000)	(13,000)
Profit before tax	77,800	48,000	44,000
Income tax expense	(15,000)	(12,000)	(11,000)
Profit for the year	62,800	36,000	33,000
Other comprehensive income:			
Items that will not be reclassified to profit or loss			
Gains/(losses) on financial assets designated at fair value through other comprehensive income (Note 5)	Nil	Nil	Nil
Total comprehensive income	62,800	36,000	33,000

Summarised statements of changes in equity

Balance on 1 April 2015	200,000	150,000	130,000
Comprehensive income for the year	62,800	36,000	33,000
Dividends paid on 31 December 2015	(30,000)	(12,000)	(11,000)
Balance on 31 March 2016	232,800	174,000	152,000

Note 1 – Alpha's investment in Beta

On 1 April 2004, Alpha acquired 80% of the equity shares of Beta and gained control of Beta. Alpha paid \$64 million in cash for these shares.

On 1 April 2004, the net assets of Beta had a fair value of \$70 million. None of the assets and liabilities of Beta which existed on 1 April 2004 were still assets or liabilities of Beta on 31 March 2015.

Alpha measured the non-controlling interest in Beta using the proportion of net assets method. The resulting goodwill on acquisition of Beta was correctly recognised in the consolidated financial statements of Alpha. No impairment of goodwill on acquisition of Beta has been necessary up to and including 31 March 2015.

On 31 March 2016, the annual impairment review of the goodwill on acquisition of Beta indicated that the recoverable amount of the total net assets of Beta (including the goodwill) at that date was \$180 million. Beta is regarded as a single cash generating unit for impairment purposes. Any impairment of goodwill should be charged to cost of sales.

Note 2 – Alpha's investment in Gamma

On 1 October 2015, Alpha acquired 60% of the equity shares in Gamma and gained control of Gamma. Gamma had 50 million equity shares in issue on 1 October 2015 and has not issued any new shares since that date. The acquisition was financed as follows:

- Alpha issued two new shares to the former shareholders of Gamma for every three shares Alpha acquired in Gamma. On 1 October 2015, the fair value of an equity share in Alpha was \$2.80 and the fair value of an equity share in Gamma was \$3.70.

- Alpha agreed to pay a total of \$24.2 million to the former shareholders of Gamma on 30 September 2017. Alpha's incremental borrowing rate at 1 October 2015 was 10% per annum.
- Alpha agreed to pay a further amount to the former shareholders of Gamma on 31 December 2019 if the cumulative profits of Gamma for the four-year period from 1 October 2015 to 30 September 2019 exceed \$150 million. On 1 October 2015, the fair value of this obligation was measured at \$40 million. On 31 March 2016, this fair value was remeasured at \$42 million.

Alpha has resolved to use the fair value method for measuring the non-controlling interest when recognising the goodwill on acquisition of Gamma. The fair value of an equity share in Gamma on 1 October 2015 can be used for this purpose. No impairment of the goodwill on acquisition of Gamma is necessary in the consolidated financial statements of Alpha for the year ended 31 March 2016.

On 1 October 2015, the fair values of the net assets of Gamma were the same as their carrying amounts in the financial statements of Gamma with the exception of:

- Property – whose fair value exceeded the carrying amount by \$25 million (\$10 million of this excess relates to land). The estimated remaining useful life of the buildings element of the property at 1 October 2015 was 20 years.
- Plant and equipment – whose fair value exceeded the carrying amount by \$8 million. The estimated remaining useful life of the plant and equipment of Gamma at 1 October 2015 was four years.

All depreciation of property, plant and equipment is charged to cost of sales. You can assume that the profit of Gamma for the year ended 31 March 2016 accrued evenly over the year.

Note 3 – Intra-group trading

Alpha supplies a component used by both Beta and Gamma. Alpha earns a profit margin of 10% on these supplies. Details of the sales of the component, and the holdings of inventory of the component by group entities, are as follows:

	Beta \$'000	Gamma \$'000
Sales of the component (for Gamma all sales since 1 October 2015)	15,000	8,000
Inventory of component at 31 March 2015 (at cost to Beta/Gamma)	2,000	Nil
Inventory of component at 31 March 2016 (at cost to Beta/Gamma)	3,000	2,800

Note 4 – Revenue of Alpha

On 1 October 2015, Alpha sold a large machine to a customer for a total price of \$51.2 million and credited \$51.2 million to revenue. As part of the sales agreement, Alpha agreed to provide annual servicing of the machine for four years from 1 October 2015 for no additional payment. The normal selling price of this without any annual servicing would have been \$60 million and Alpha would normally charge the customer an annual fee of \$1 million to service the machine. You should ignore the time value of money in respect of this transaction.

Note 5 – Alpha's other investment

Apart from its investments in Beta and Gamma, Alpha has one other investment – in entity X. Alpha purchased this equity investment on 1 July 2015 for \$40 million and designated the investment as fair value through other comprehensive income. In order to protect against a prolonged decline in the fair value of the investment in entity X, Alpha purchased a put option to sell this investment. The cost of the option was \$6 million and the option was regarded as an effective hedge against a prolonged decline in the fair value of the investment in entity X. On 31 March 2016, the fair value of the equity investment in entity X was \$37 million and the fair value of the put option was \$8.7 million. Apart from recognising the investment in entity X and the put option at cost, Alpha has made no other entries in its draft financial statements. Alpha wishes to use hedge accounting whenever permitted by International Financial Reporting Standards.

Note 6 – Investment income

All of the investment income of Alpha has been correctly recognised in the individual financial statements of Alpha.

Note 7 – Bond issue

On 1 April 2015, Alpha issued a convertible zero-coupon bond to a single institutional investor. The bond was issued for total proceeds of \$250 million and will be redeemed or converted into equity shares on 31 March 2020. If the

investor chooses to redeem the bond on 31 March 2020, the investor will receive \$362.32million. The incremental borrowing rate of Alpha on 1 April 2015 is 10% per annum. The present value of \$1 received in five years at a discount rate of 10% per annum is 62.1 cents.

Required:

- (a) **Using the information in notes 1 and 2, compute the goodwill arising on the acquisitions of Beta at 1 April 2004 and Gamma at 1 October 2015.** (8 marks)
- (b) **Prepare the consolidated statement of profit or loss and other comprehensive income of Alpha for the year ended at 31 March 2016. You do not need to consider the deferred tax effects of any adjustments you make.** (25 marks)
- (c) **Prepare the summarised consolidated statement of changes in equity of Alpha for the year ended 31 March 2016, including a column for the non-controlling interest.** (7 marks)

Note: You should show all workings to the nearest \$'000.

(40 marks)

- 2 Delta is an entity which prepares financial statements to 31 March each year. Each year the financial statements are authorised for issue on 20 May. The following events are relevant to the year ended 31 March 2016:

Event (a)

On 1 April 2014, Delta granted 2,000 employees 1,000 share options each. The options are due to vest on 31 March 2017 provided the relevant employees remain in employment over the three-year period ending on 31 March 2017.

On 1 April 2014, the directors of Delta estimated that 1,800 employees would qualify for the options on 31 March 2017. This estimate was amended to 1,850 employees on 31 March 2015, and further amended to 1,840 employees on 31 March 2016.

On 1 April 2014, the fair value of an option was \$1.20. The fair value increased to \$1.30 by 31 March 2015 but, due to challenging trading conditions, the fair value declined after 31 March 2015. On 30 September 2015, when the fair value of an option was 90 cents, the directors repriced the options and this caused the fair value to increase to \$1.05. Trading conditions improved in the second half of the year and by 31 March 2016 the fair value of an option was \$1.25. Any additional costs that have occurred as a result of the repricing of the options on 30 September 2015 should be spread over the remaining vesting period from 30 September 2015 to 31 March 2017. (9 marks)

Event (b)

On 1 August 2015, Delta supplied some products it had manufactured to customer C. The products were faulty and on 1 October 2015 C commenced legal action against Delta claiming damages in respect of losses due to the supply of the faulty products. Upon investigating the matter, Delta discovered that the products were faulty due to defective raw materials supplied to Delta by supplier S. Therefore on 1 December 2015, Delta commenced legal action against S claiming damages in respect of the supply of defective materials. Since that date Delta has consistently estimated that it is probable that both of the legal actions, the action of C against Delta and the action of Delta against S, will succeed.

On 1 October 2015, Delta estimated that the damages Delta would have to pay to C would be \$5 million. This estimate was updated to \$5.2 million as at 31 March 2016 and \$5.25 million as at 15 May 2016. This case was eventually settled on 1 June 2016, when Delta was required to pay damages of \$5.3 million to C.

On 1 December 2015, Delta estimated that they would receive damages of \$3.5 million from S. This estimate was updated to \$3.6 million as at 31 March 2016 and \$3.7 million as at 15 May 2016. This case was eventually settled on 1 June 2016, when S was required to pay damages of \$3.75 million to Delta. (6 marks)

Event (c)

On 1 June 2015, the spouse of one of the directors of Delta purchased a controlling interest in entity X, a long-standing customer of Delta. Sales of products from Delta to entity X in the two-month period from 1 April 2015 to 31 May 2015 totalled \$800,000. Following the share purchase by the spouse of one of the directors of Delta on 1 June 2015, Delta began to supply the products at a discount of 20% to their normal selling price and allow entity X three months' credit (previously entity X was only allowed one month's credit, Delta's normal credit policy). Sales of products from Delta to entity X in the ten-month period from 1 June 2015 to 31 March 2016 totalled \$6 million. On 31 March 2016, the trade receivables of Delta included \$1.8 million in respect of amounts owing by entity X. (5 marks)

Required:

Explain and show (where possible by quantifying amounts) how the three events would be reported in the financial statements of Delta for the year ended 31 March 2016.

Note: The mark allocation is shown against each of the three events above. You should assume that all amounts described here are material. When discussing event (a), you are not required to consider disclosure requirements.

(20 marks)

- 3 (a)** A deferred tax liability is the amount of income tax payable in respect of taxable temporary differences. A deferred tax asset is the amount of income tax recoverable in future periods in respect of deductible temporary differences. A temporary difference is the difference between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Required:

- (i) **Define the tax base of an asset as outlined in IAS 12 – *Income Taxes*. Use your definition to compute the tax base of the following assets:**
- **A machine was purchased during the current accounting period for \$250,000. Depreciation of \$50,000 was charged in arriving at the accounting profit for the current period. A deduction of \$100,000 was given against taxable profits by the local tax authorities against the taxable profits of the current period. The remaining cost will be deductible in future periods, either as depreciation or as a deduction on disposal.**
 - **A current asset of \$60,000 relates to interest receivable. The related interest revenue will be taxed on a cash basis when it is received.** (4 marks)
- (ii) **Define the tax base of a liability as outlined in IAS 12. Use your definition to compute the tax base of the following liabilities:**
- **\$120,000 is included in trade payables. This amount relates to purchases which qualified for a tax deduction when the purchase was made.**
 - **\$40,000 is included in accrued liabilities. A tax deduction relating to this liability will be given when the liability is settled.** (4 marks)
- (b) Epsilon prepares financial statements to 31 March each year. The rate of income tax applicable to Epsilon is 20%. The following information relates to transactions, assets and liabilities of Epsilon during the year ended 31 March 2016:
- (i) Epsilon has an investment property which it carries under the fair value model. The property originally cost \$30 million. The property had an estimated fair value of \$35 million on 31 March 2015 and \$38 million on 31 March 2016. In the tax jurisdiction in which Epsilon operates, gains on the fair value of investment properties are not subject to income tax until the properties are disposed of.
- (ii) Epsilon has a 40% shareholding in Lambda. Epsilon purchased this shareholding for \$45 million. The shareholding gives Epsilon significant influence over Lambda but not control and therefore Epsilon accounts for its interest in Lambda using the equity method. The equity method carrying value of Epsilon's investment in Lambda was \$70 million on 31 March 2015 and \$75 million on 31 March 2016. In the tax jurisdiction in which Epsilon operates, profits recognised under the equity method are taxed if and when they are distributed as a dividend or the relevant investment is disposed of.
- (iii) Epsilon measures its head office property using the revaluation model. The property is revalued every year on 31 March. On 31 March 2015, the carrying value of the property (after revaluation) was \$40 million and its tax base was \$22 million. During the year ended 31 March 2016, Epsilon charged depreciation in its statement of profit or loss of \$2 million and claimed a tax deduction for tax depreciation of \$1.25 million. On 31 March 2016, the property was revalued to \$45 million. In the tax jurisdiction in which Epsilon operates, revaluation of property, plant and equipment does not affect taxable income at the time of revaluation.

Required:

Assuming that there are no other temporary differences other than those indicated above, compute:

- **The deferred tax liability of Epsilon at 31 March 2016.**
- **The charge or credit to both profit or loss and other comprehensive income relating to deferred tax for the year ended 31 March 2016.**

You should include brief explanations to support your computations.

(12 marks)

(20 marks)

- 4 You are the financial controller of Omega, a listed entity which prepares consolidated financial statements in accordance with International Financial Reporting Standards (IFRS). The managing director, who is not an accountant, has recently attended a business seminar at which financial reporting issues were discussed. Following the seminar, she reviewed the financial statements of Omega for the year ended 31 March 2016. Based on this review she has prepared a series of queries relating to those statements:

Query One

'One of the issues discussed at the seminar was 'impairment of financial assets'. On reviewing our financial statements I have noticed that we have two types of financial assets – Type A (those measured at amortised cost) and Type B (those measured at 'fair value through profit or loss'). It appears we carry out impairment reviews of Type A assets but not Type B assets. Please explain to me why this is the case and also please explain exactly how an impairment review of Type A assets is carried out.'

(8 marks)

Query Two

'Another issue discussed at the seminar was financial reporting by farming entities. The issue of 'biological assets' was mentioned. I don't really understand what these are or how they're recognised and measured in the financial statements. Please explain this to me.'

(5 marks)

Query Three

'During a break-out session I heard someone talking about accounting policies and accounting estimates. He said that when there's a change of these items sometimes the change is made retrospectively and sometimes it's made prospectively. Please explain the difference between an accounting policy and an accounting estimate and give me an example of each. Please also explain the difference between retrospective and prospective adjustments and how this applies to accounting policies and accounting estimates.'

(7 marks)

Required:

Provide answers to the three questions raised by the managing director. Your answers should refer to relevant provisions of International Financial Reporting Standards.

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

(20 marks)

End of Question Paper