Dip IFR

Diploma in International Financial Reporting

Tuesday 9 December 2014

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.

The Association of Chartered Certified Accountants

ACCA

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1 Alpha holds investments in two other entities, 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 30 September 2014 were as follows:

Statements of profit or loss and other comprehensive income

	Alpha	**Beta**	**Gamma**
	$'000	**$'000**	**$'000**
Revenue (Note 3)	260,000	200,000	180,000
Cost of sales (Notes 1-3)	(130,000)	(110,000)	(90,000)
Gross profit	130,000	90,000	90,000
Distribution costs	(20,000)	(15,000)	(13,500)
Administrative expenses (Note 4)	(25,000)	(20,000)	(18,000)
Redundancy and reorganisation costs (Note 5)	(14,000)	Nil	Nil
Investment income (Note 6)	12,600	Nil	1,500
Finance costs (Note 7)	(26,000)	(15,000)	(12,000)
Profit before tax	57,600	40,000	48,000
Income tax expense	(14,000)	(10,000)	(12,000)
Profit for the year	43,600	30,000	36,000
Other comprehensive income:			
Items that will not be reclassified to profit or loss			
Gains on financial assets designated at fair value through other comprehensive income (Note 8)	9,000	Nil	1,400
Total comprehensive income	52,600	30,000	37,400
Summarised statements of changes in equity			
Balance on 1 October 2013	180,000	140,000	120,000
Comprehensive income for the year	52,600	30,000	37,400
Dividends paid on 31 December 2013	(30,000)	(10,000)	(14,000)
Balance on 30 September 2014	202,600	160,000	143,400

Note 1 – Alpha's investment in Beta

On 1 October 2001, Alpha acquired 75% of the equity shares of Beta. This gave Alpha control over Beta. On 1 October 2001, the net assets of Beta had a fair value of $80 million. None of the assets and liabilities of Beta which existed on 1 October 2001 were still assets or liabilities of Beta on 30 September 2013. On 1 October 2001, Alpha measured the non-controlling interest in Beta at its fair value of $22 million. Goodwill on consolidation of $18 million arose on the acquisition of Beta. No impairment of goodwill on the acquisition of Beta has been necessary up to and including 30 September 2013.

Beta has four operating segments which are also cash generating units (CGUs) for the purposes of impairment reviews. On 1 October 2001, the goodwill on acquisition of Beta was allocated between these units on the following basis:

Unit 1 – $8 million.
Unit 2 – $4 million.
Unit 3 – $3 million.
Unit 4 – $3 million.

On 30 September 2014, the carrying amounts of the net assets (excluding goodwill) and recoverable amounts of the four CGUs of Beta were as follows:

	Unit 1 $'000	Unit 2 $'000	Unit 3 $'000	Unit 4 $'000	Total $'000
Carrying amount	45,000	55,000	30,000	30,000	160,000
Recoverable amount	50,000	65,000	35,000	35,000	185,000

Any impairment of goodwill should be charged to cost of sales.

Note 2 – Alpha's investment in Gamma

On 1 February 2014, Alpha acquired 80% of the equity shares in Gamma and gained control of Gamma.

On 1 February 2014, the fair value of Gamma's property, plant and equipment exceeded the carrying amounts in the individual financial statements of Gamma as follows:

– Property **excess** $20 million (land element of excess $11 million). The estimated remaining useful life of the buildings element of the property at 1 February 2014 was 25 years.

– Plant and equipment **excess** $7·2 million. The estimated remaining useful life of the plant and equipment of Gamma at 1 February 2014 was three years.

All depreciation of property, plant and equipment is charged to cost of sales.

Alpha measured the non-controlling interest in Gamma on 1 February 2014 at its fair value of $28 million. There was no impairment of the goodwill arising on the acquisition of Gamma in the year ended 30 September 2014. The profit of Gamma for the year ended 30 September 2014 accrued evenly over the year, but see note 8 regarding the other comprehensive income of Gamma.

Note 3 – Intra-group trading

Alpha supplies a component used by both Beta and Gamma. Alpha applies a mark-up of 25% to cost when computing the intra-group selling price. All of the sales of this component by Alpha to Gamma occurred after the acquisition of Gamma on 1 February 2014. 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	12,000	5,000
Inventory of component at 30 September 2014 (at cost to Beta/Gamma)	2,400	2,000
Inventory of component at 30 September 2013 (at cost to Beta/Gamma)	1,800	Nil

Note 4 – Post-employment benefits

The group makes contributions into both defined benefit and defined contribution retirement benefit plans. All the employees of Beta and Gamma are members of defined contribution plans but many of the employees of Alpha are members of a defined benefit plan. The following are relevant details regarding the defined benefit plan:

– Obligation at 30 September 2014: $40 million (30 September 2013: $32 million).
– Fair value of plan assets at 30 September 2014: $34 million (30 September 2013: $27 million).
– Current service cost for the year ended 30 September 2014: $6 million.
– Contributions paid into the plan by Alpha in the year ended 30 September 2014: $5·4 million.
– Benefits paid to retired members: $2 million.
– Relevant market yield: 5% per annum throughout the period.

Alpha has charged the contributions paid into the defined benefit plan in the year ended 30 September 2014 ($5·4 million) as an administrative expense. Alpha has made no other entries in respect of the plan in the statement of profit or loss and other comprehensive income. However, Alpha correctly accounted for the defined benefit plan in the financial statements for the year ended 30 September 2013.

Note 5 – Redundancy and reorganisation costs

Following the acquisition of Gamma on 1 February 2014, the directors of Alpha formulated a plan to reorganise the group. The plan involved some redundancies and some employees changing their roles within the group. As a result of the reorganisation, certain non-current assets of Alpha will no longer be required. The final version of the plan was agreed on 31 July 2014 and made public on 15 August 2014. The plan was implemented from 1 November 2014. The total cost of the plan will be borne by Alpha. The directors of Alpha made a provision, with a corresponding charge to profit or loss, in respect of the plan as follows:

	$'000
Redundancy costs	10,000
Costs of training staff in new roles	5,500
Expected profit on the sale of surplus non-current assets	(1,500)
	14,000

Note 6 – Investment income

All of the investment income of Alpha, including dividends received from subsidiaries, has been correctly recognised in the individual financial statements of Alpha.

Note 7 – Bond issue

On 1 October 2013, Alpha issued 300 million $1 bonds at par. The interest payable on the bonds is 5% per annum, payable on 30 September in arrears. The bonds are repayable at par on 30 September 2023. Alternatively, the investors have the option to convert the bonds into equity shares in Alpha on 30 September 2023.

On 1 October 2013, Alpha recognised a financial liability of $300 million in its statement of financial position. On 30 September 2014, Alpha recognised the interest paid on that date as a finance cost in its statement of profit or loss.

On 1 October 2013, investors would have expected an annual return of 8% on non-convertible bonds. At a discount rate of 8% per annum, the present value of $1 receivable at the end of year 10 is 46·3 cents and the present value of $1 receivable at the end of each of years 1 to 10 is $6·71.

Note 8 – Other comprehensive income

Both Alpha and Gamma have financial assets which are appropriately classified as fair value through other comprehensive income. On 1 February 2014, the fair value of the financial assets of Gamma had not changed from 30 September 2013.

Note 9 – Forward currency contract

On 15 August 2014, Alpha entered into a commitment to supply a large consignment of components to a foreign customer whose currency is the Kroner. The agreed value of the order was 25 million Kroner and this amount is expected to be paid by the customer on 30 November 2014. On 15 August 2014, Alpha entered into a contract to sell 25 million Kroner for $13 million on 30 November 2014. Currency fluctuations in August and September 2014 were such that on 30 September 2014 the fair value of this currency contract was $1·1 million (a financial liability). The draft financial statements of Alpha do not include any amounts in respect of this currency contract since it has a zero cost. Alpha wishes to use cash-flow hedge accounting whenever permitted by International Financial Reporting Standards. The directors of Alpha have estimated that the currency contract is a perfectly effective hedge of the commitment to supply the components.

Required:

(a) Prepare the consolidated statement of profit or loss and other comprehensive income of Alpha for the year ended at 30 September 2014. You do not need to consider the deferred tax effects of any adjustments you make. (32 marks)

(b) Prepare the summarised consolidated statement of changes in equity of Alpha for the year ended 30 September 2014, including a column for the non-controlling interest. (8 marks)

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

(40 marks)

2 Delta is an entity which prepares financial statements to 30 September each year. Each year the financial statements are authorised for issue on 30 November. During the year ended 30 September 2014, the following transactions occurred:

(a) On 1 October 2013, Delta sold a machine to a customer for a total price of $500,000. Delta invoiced the customer for $500,000 on 1 October 2013 and the customer made a payment of $500,000 to Delta on 15 October 2013. The terms of sale included an arrangement that Delta would service and maintain the machine for a four-year period from 1 October 2013. Delta would normally charge an annual fee of $37,500 for a service and maintenance arrangement of this nature.

The normal selling price of the machine without a service and maintenance arrangement was $450,000. The saving available to the customer as a result of purchasing the machine and the service and maintenance arrangement should be allocated to the two components of the transaction in proportion to their stand-alone fair values. (9 marks)

(b) On 1 October 2013, Delta completed the construction of a factory at a total construction cost of $40 million. The factory was constructed on land which was being leased on an operating lease until 30 September 2053. Annual lease rentals were $800,000, payable on 30 September in arrears. The expected useful economic life of the factory at 1 October 2013 was 40 years. Under the terms of the leasing agreement, Delta is required to dismantle the factory on 30 September 2053 and return the land to its original state. The latest estimated cost of this process, **at 30 September 2053 prices**, is $55 million. An appropriate discount rate to use in any relevant calculations is 5% per annum. At this discount rate, the present value of $1 receivable in 40 years is 14·2 cents. (8 marks)

(c) On 15 May 2014, Delta was notified that a customer (Chi) was taking legal action against Delta in respect of financial losses incurred by Chi. Chi alleged that the financial losses were caused due to the supply by Delta of faulty products on 30 November 2013. Delta defended the case but considered, based on the progress of the case up to 30 September 2014, that there was a 75% probability they would have to pay damages of $20 million to the customer. The case was ultimately settled by Delta paying damages of $18 million to Chi on 15 November 2014. (3 marks)

Required:

Explain and show (where possible by quantifying amounts) how the three events would be accounted for in the financial statements of Delta for the year ended 30 September 2014.

Note: The mark allocation is shown against each of the three events above. You should assume that all transactions described here are material.

(20 marks)

3 **(a)** IFRS 3 – *Business Combinations* – prescribes the method of accounting to be used when an entity (the acquirer) obtains control of a business. Control is not defined in IFRS 3 but a definition is provided in IFRS 10 – *Consolidated Financial Statements*.

Required:

(i) Define 'control' as outlined in IFRS 10. Where relevant, you should provide appropriate explanations for the terms you use in your definition. (4 marks)

(ii) Explain the way in which goodwill on acquisition and gains on bargain purchases should be initially computed and subsequently accounted for. (5 marks)

(b) Epsilon prepares consolidated financial statements to 30 September each year. On 1 January 2014, Epsilon acquired 75% of the equity shares of Kappa and gained control of Kappa. Kappa has 12 million equity shares in issue. Details of the purchase consideration are as follows:

– On 1 January 2014, Epsilon issued two shares for every three shares acquired in Kappa. On 1 January 2014, the market value of an equity share in Epsilon was $6·50 and the market value of an equity share in Kappa was $6·00.

– On 31 December 2014, Epsilon will make a cash payment of $7·15 million to the former shareholders of Kappa who sold their shares to Epsilon on 1 January 2014. On 1 January 2014, Epsilon would have needed to pay interest at an annual rate of 10% on borrowings.

– On 31 December 2015, Epsilon may make a cash payment of $30 million to the former shareholders of Kappa who sold their shares to Epsilon on 1 January 2014. This payment is contingent upon the revenues of Epsilon growing by 15% over the two-year period from 1 January 2014 to 31 December 2015. On 1 January 2014, the fair value of this contingent consideration was $25 million. On 30 September 2014, the fair value of the contingent consideration was $22 million.

On 1 January 2014, the carrying values of the identifiable net assets of Kappa in the books of that company totalled $60 million. On 1 January 2014, the fair values of these net assets totalled $70 million. The rate of deferred tax to apply to temporary differences is 20%.

During the nine months ended on 30 September 2014, Kappa had a poorer than expected operating performance. Therefore on 30 September 2014 it was necessary for Epsilon to recognise an impairment of the goodwill arising on acquisition of Kappa, amounting to 10% of its total computed value.

Required:

Compute the impairment of goodwill and explain how this impairment should be recognised in the consolidated financial statements of Epsilon. You should do this under BOTH the methods permitted by IFRS 3 for the initial computation of the non-controlling interest in Kappa at the date of acquisition.

(11 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 been appointed. She formerly worked for Rival, one of Omega's key competitors. She has reviewed the financial statements of Omega for the year ended 30 September 2014 and has prepared a series of queries relating to those statements:

Query One

'I was very confused by the note that included financial information relating to our operating segments. This note bears very little resemblance to the equivalent note included in the financial statements of Rival. Please explain how the two notes can be so different.' (8 marks)

Query Two

'The notes to our financial statements refer to equity settled share-based payments relating to the granting of share options. When I joined Omega, I was granted share options but I can only exercise those options if I achieve certain performance targets in my first three years as managing director. I know that other directors are also granted similar option arrangements. I don't see why they affect the financial statements when the options are granted though, because no cash is involved unless the options are exercised. Please explain to me exactly what is meant by an 'equity settled share-based payment'. Please also explain how, and when, equity settled share-based payments affect the financial statements of entities that grant them to their employees. I would like to know how such 'payments' are measured, over what period the 'payments' are recognised, and exactly what accounting entries are involved.' (8 marks)

Query Three

'I was confused when I looked at the statement of financial position and saw that the assets and liabilities were divided up into three sections and not two. The current and non-current sections I understand but I don't understand the 'non-current assets held for sale' and 'liabilities directly associated with non-current assets held for sale' sections. Please explain the meaning and accounting treatment of a non-current asset held for sale. Please also explain how there can be liabilities directly associated with non-current assets held for sale.' (4 marks)

Required:

Provide answers to the three queries 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