Diploma in International Financial Reporting

Friday 9 June 2017

Dip IFR

Time allowed 3 hours 15 minutes

ALL FOUR questions are compulsory and MUST be attempted.

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

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

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 holds investments in a number of entities, including 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 2017 were as follows:

Statements of profit or loss and other comprehensive income

	Alpha $'000	Beta $'000	Gamma $'000
Revenue (Note 3)	468,000	260,000	240,000
Cost of sales (Notes 1-3)	(312,000)	(135,000)	(120,000)
Gross profit	156,000	125,000	120,000
Distribution costs	(26,000)	(20,000)	(18,000)
Administrative expenses (Note 4)	(44,000)	(28,000)	(27,000)
Investment income (Note 5)	28,000	Nil	Nil
Finance costs	(20,000)	(22,000)	(21,000)
Profit before tax	94,000	55,000	54,000
Income tax expense	(24,000)	(14,000)	(13,500)
Profit for the year	70,000	41,000	40,500
Other comprehensive income:			
Items that will be reclassified to profit or loss			
Gains/(losses) on effective cash-flow hedges (Note 6)	Nil	Nil	Nil
Total comprehensive income	70,000	41,000	40,500

Summarised statements of changes in equity

	Alpha $'000	Beta $'000	Gamma $'000
Balance on 1 April 2016	250,000	193,000	166,500
Comprehensive income for the year	70,000	41,000	40,500
Dividends paid on 31 December 2016	(40,000)	(18,000)	(16,000)
Balance on 31 March 2017	280,000	216,000	191,000

Note 1 – Alpha's investment in Beta

On 1 April 2001, Alpha acquired 80 million of the 100 million $1 equity shares of Beta and gained control of Beta. Alpha paid $150 million in cash for these shares.

On 1 April 2001, the net assets of Beta had a fair value of $147 million, all of which had been disposed of or settled by 31 March 2016.

Alpha used the fair value method for measuring the non-controlling interest when recognising the goodwill on acquisition of Beta. The fair value of an equity share in Beta on 1 April 2001, which was $1·50, was used for this purpose. No impairments of goodwill on acquisition of Beta have been necessary in the consolidated financial statements of Alpha up to and including 31 March 2016.

Beta has three cash generating units. On 31 March 2017, the annual impairment review indicated that the recoverable amounts of the net assets, including goodwill, of the three cash generating units of Beta at that date were as follows:

- Unit 1 – $87 million.
- Unit 2 – $84 million.
- Unit 3 – $80 million.

Net assets and goodwill are allocated equally to the three units and any impairments of goodwill should be charged to cost of sales.

Note 2 – Alpha's investment in Gamma

On 1 August 2016, Alpha acquired 60 million of the 80 million $1 equity shares in Gamma and gained control of Gamma. 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 August 2016, the fair value of an equity share in Alpha was $4·50.

– Alpha agreed to pay a total of $16·2 million in cash to the former shareholders of Gamma on 31 July 2017. Alpha's incremental borrowing rate at 1 August 2016 was 8% per annum.

– Alpha agreed to issue additional shares in Alpha to the former shareholders of Gamma on 30 September 2019 if the cumulative profits of Gamma for the three-year period from 1 August 2016 to 31 July 2019 exceed a target amount. On 1 August 2016, the fair value of this contingent equity consideration was $26 million.

Alpha has not yet accounted for this acquisition in its individual financial statements. However, you can assume that no impairment of the goodwill on acquisition of Gamma is necessary in the consolidated financial statements of Alpha for the year ended 31 March 2017. Alpha has resolved to use the proportion of net assets method for measuring the non-controlling interest when recognising the goodwill on the acquisition of Gamma.

On 1 August 2016, 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:

– Land – whose fair value exceeded the carrying amount by $30 million.

– Plant and equipment – whose fair value exceeded the carrying amount by $12 million. The estimated remaining useful life of the plant and equipment of Gamma at 1 August 2016 was five 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 2017 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 20% 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 August 2016)	20,000	10,000
Inventory of component at 31 March 2016 (at cost to Beta/Gamma)	4,000	Nil
Inventory of component at 31 March 2017 (at cost to Beta/Gamma)	6,000	4,800

Note 4 – Decommissioning provision

On 1 April 2016, Alpha completed the construction of an energy generating facility and brought the facility into use immediately. The cost of construction of the facility was included in property, plant and equipment and was also appropriately depreciated over the useful life of the facility, which was estimated at 16 years at 1 April 2016. At the end of the useful life of the facility, Alpha has an obligation to decommission the facility and restore its location to its former condition. The estimated cost of this decommissioning and restoration is $8 million, payable on 31 March 2032. The directors of Alpha made a provision of $8 million in respect of this liability, and charged $8 million to administrative expenses in the year ended 31 March 2017. An appropriate discount rate to use in any discounting calculations is 8% per annum. At 1 April 2016, the present value of $1 payable in 16 years' time at 8% can be taken as 30 cents.

Note 5 – Investment income

The investment income which is shown in Alpha's statement of profit or loss represents dividends received from Beta and Gamma and also dividends received from a portfolio of other equity investments. This portfolio is classified by Alpha as fair value through profit or loss. The gain on remeasurement of the portfolio to fair value at 31 March 2017 was $6·5 million. This gain has not yet been recognised in the financial statements of Alpha.

Note 6 – Cash flow hedge

On 1 January 2017, Alpha agreed to purchase goods from a foreign supplier. This purchase is due to be made and paid for on 30 June 2017. The directors of Alpha decided to hedge the cash-flow risk attaching to this future purchase by entering into a derivative contract and to formally designate the derivative as a hedging instrument. The hedge met all of the effectiveness requirements for the use of hedge accounting. On 31 March 2017, the derivative had a positive fair value resulting in a gain to Alpha of $5 million. Between 1 January 2017 and 31 March 2017 the expected cash flows in respect of the purchase of goods on 30 June 2017 had increased by $4·2 million. Alpha has not made any accounting entries in respect of this arrangement.

Required:

(a) Using the information in notes 1 and 2, compute the goodwill arising on the acquisitions of Beta and Gamma in the consolidated financial statements of Alpha. (7 marks)

(b) Prepare the consolidated statement of profit or loss and other comprehensive income of Alpha for the year ended at 31 March 2017. You do not need to consider the tax effects of any adjustments you make. (26 marks)

(c) Prepare the summarised consolidated statement of changes in equity of Alpha for the year ended 31 March 2017, 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 25 May. The following events have occurred which are relevant to the year ended 31 March 2017:

Event (a)

On 1 April 2016, Delta purchased an asset for $771,000 and immediately leased this asset to entity X. The lease term was for five years and the lease rental, receivable annually in arrears on 31 March, was $200,000. Delta incurred direct costs of $20,000 in arranging this lease. The annual rate of interest implicit in this lease was 10%. Under the terms of the lease, entity X is responsible for insuring the asset and for carrying out any necessary repairs and maintenance of the asset. At a discount rate of 10% per annum the present value of $1 receivable annually in arrears for five years is $3·80. (8 marks)

Event (b)

On 1 April 2016, Delta entered into a joint arrangement with entity Y to jointly operate a delivery depot. Entity Y is located, and has major customers in, the same geographical region as Delta. Delta and entity Y each made the following payments in respect of the arrangement on 1 April 2016:

– $25 million each to purchase a joint 25-year leasehold interest in a depot which was close to both Delta and entity Y's business premises. This depot was to act as headquarters for the delivery vehicles (see below).

– $7·5 million each to purchase a fleet of delivery vehicles. The vehicles have an expected useful life of five years, with no expected residual value.

Delta and entity Y agreed to jointly use the delivery vehicles to deliver products to their customers, and to share the operating costs of the depot equally. Any delivery charges to customers were levied by Delta and entity Y directly at the discretion of the individual entities. During the year ended 31 March 2017, the total cash cost of operating the depot was $8 million. This was paid equally by Delta and entity Y. In the year ended 31 March 2017, Delta charged its customers a total of $2 million in delivery charges. (7 marks)

Event (c)

On 31 March 2017, Delta was owed $10m by entity Z. The amount was due for payment by 30 April 2017. Entity Z has been a customer for many years and has an excellent payment record. At 31 March 2017, there was no reason to suppose that entity Z would fail to pay the $10m owed to Delta by 30 April 2017. By 20 April 2017, entity Z's going concern status was in considerable doubt. (5 marks)

Required:

Explain and state (where possible by quantifying amounts) how the three events would be reported in the financial statements of Delta for the year ended 31 March 2017.

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

(20 marks)

3 **(a)** Non-current assets are often a highly significant component of the total assets of an entity. Therefore, a number of different International Financial Reporting Standards have been published which regulate their definition, recognition, measurement and disclosure. IAS 1 *Presentation of Financial Statements* distinguishes between current and non-current assets. IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* specifically regulate the recognition, measurement and disclosure of tangible and intangible assets respectively.

Required:

Explain how:

(i) **IAS 1 distinguishes between current and non-current assets.** (3 marks)

(ii) **IAS 16 defines property, plant and equipment and IAS 38 defines intangible assets.** (4 marks)

(b) Epsilon prepares financial statements to 31 March each year. The following events have occurred which are relevant to the year ended 31 March 2017:

(i) On 1 April 2016, Epsilon purchased a new head office property for $60 million. On 1 April 2016, Epsilon leased out the top three floors of the property to a third party on a long-term operating lease. The annual rental receivable by Epsilon was $2 million, starting on 31 March 2017. The top three floors of the property were capable of being sold in a separate transaction. On 1 April 2016, the directors of Epsilon estimated that the initial cost of the property should be allocated as follows for accounting purposes:

	$ million
Top three floors of building	15
Remainder – buildings component	20
Remainder – land component	25
Total initial cost	60

On 31 March 2017, the property had an estimated total fair value of $64 million. The directors consider that 25% of this fair value was attributable to the top three floors of the property. The directors of Epsilon wish to use the cost model for measuring property, plant and equipment and the fair value model for measuring investment property. Epsilon depreciates the buildings component of properties over an estimated useful life of 50 years, with no estimated residual value. The rental payable to Epsilon on 31 March 2017 was paid in accordance with the terms of the lease. (8 marks)

(ii) On 1 April 2016, Epsilon purchased a brand from a competitor for an agreed price of $80 million. The directors of Epsilon believe that the useful life of the brand is indefinite. On 31 March 2017, no reliable estimate of its selling price was available but the directors of Epsilon estimated that the value in use of the brand was $85 million. The directors of Epsilon wish to use the fair value model for measuring intangible assets whenever permitted by International Financial Reporting Standards. (5 marks)

Required:

Explain and state how the two events should be reported in the financial statements of Epsilon for the year ended 31 March 2017.

Note: The mark allocation is shown against each of the two events above.

(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). One of your assistants, a trainee accountant, is involved in the preparation of the consolidated financial statements for the year ended 31 March 2017. She is also involved in the preparation of the individual financial statements for the entities in the group. She has sent you an email with the following queries:

Query One

On 1 April 2016 we acquired a new subsidiary. This subsidiary has always prepared its financial statements in $ but has used IFRS for the first time this year. Previously, they have used local standards. This means that the comparative figures (they present comparatives for one year only), taken from last year's financial statements, will be based on local standards not IFRS. How do I make sure we are comparing like with like in the current year individual financial statements of the subsidiary? Please just give me the general procedure, rather than dealing with any specialised exemptions. (7 marks)

Query Two

I notice that on 1 April 2016 we lent $50 million to a key supplier. The loan has an annual rate of interest of 5%, with interest of $2·5 million payable on 31 March each year in arrears. The loan is repayable on 31 March 2026 but I believe that if interest rates change, we might consider assigning the loan to a third party. As it turns out, interest rates have fallen since 1 April 2016 and the fair value of the loan asset at 31 March 2017 was $52 million. I have been told that this loan asset should be measured at 'fair value through other comprehensive income'. Why is this? I thought loan assets were measured at amortised cost. If the loan asset is measured at fair value through other comprehensive income, does the interest income get recorded in other comprehensive income rather than profit or loss? (6 marks)

Query Three

I'm not sure whether we need to make any entries in respect of the equity settled share-based payment scheme we started on 1 April 2016. I believe we granted options to 1,000 employees to purchase 100 shares in Omega for a fixed price. The options vest on 31 March 2021 subject to two conditions. The first vesting condition is that the employees remain employed by Omega throughout the five-year period up to the date of vesting. Best estimates are that 900 of the 1,000 will stay for that period – only 25 left in the year ended 31 March 2017. The other condition is that the Omega share price on 31 March 2021 should be at least $10. The share price on 31 March 2017 was only $8·50 so it doesn't look like this condition is satisfied yet. I've also noticed that the fair value of one share option was $1 on 1 April 2016, rising to $1·05 on 31 March 2017. Do we need any accounting entries and, if so, what should they be? (7 marks)

Required:

Provide answers to the three queries raised by the trainee accountant. Your answers should refer to relevant provisions of International Financial Reporting Standards.

Note: The split of the mark allocation is shown against each of the items above.

(20 marks)

End of Question Paper