Diploma in International Financial Reporting

Tuesday 10 June 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

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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 two other entities, Beta and Gamma. The statements of profit or loss and other comprehensive income of the three entities for the year ended 31 March 2014 were as follows:

Statements of profit or loss and other comprehensive income

	Alpha $'000	Beta $'000	Gamma $'000
Revenue (note 4)	420,000	335,000	292,000
Cost of sales (note 4)	(240,000)	(192,000)	(168,000)
Gross profit	180,000	143,000	124,000
Distribution costs	(20,000)	(16,000)	(14,000)
Administrative expenses	(40,000)	(32,000)	(28,000)
Contributions to retirement benefit plan (note 5)	(5,000)	Nil	Nil
Finance costs	(20,000)	(15,000)	(12,000)
Investment income (note 6)	33,000	Nil	Nil
Profit before tax	128,000	80,000	70,000
Income tax expense	(32,000)	(20,000)	(16,000)
Profit for the year	96,000	60,000	54,000
Other comprehensive income:			
Items that will not be reclassified to profit or loss			
Gain on property revaluation (note 7)	25,000	Nil	12,000
Total comprehensive income for the year	121,000	60,000	66,000

Notes to the statements

Note 1 – Acquisition of Beta

On 1 April 2005, Alpha purchased 80% of the equity shares of Beta and gained control of Beta. Goodwill arising on the acquisition of Beta totalled $80 million. At 1 April 2005, Beta had three cash-generating units and the goodwill on acquisition was allocated to the three units as follows:

– Unit 1 – 40%
– Unit 2 – 35%
– Unit 3 – 25%.

No impairment of this goodwill had occurred in the years ended 31 March 2006 to 2013 inclusive. However, in the year ended 31 March 2014, despite Beta making a profit overall, Beta suffered challenging trading conditions. Therefore the directors of Alpha carried out an impairment review on the goodwill at 31 March 2014 and obtained the following results:

Unit	Carrying value of net assets (excluding goodwill) at 31 March 2014 $'000	Recoverable amount at 31 March 2014 $'000
1	215,000	255,000
2	185,000	220,000
3	130,000	140,000
Total	530,000	615,000

None of the assets or liabilities of Beta which Alpha identified on 1 April 2005 remained in the statement of financial position of Beta at 31 March 2013 or 2014. Any impairment of goodwill should be charged to cost of sales.

Alpha measures all non-controlling interests based on their fair values at the date of acquisition of the relevant subsidiary.

Note 2 – Acquisition of Gamma

On 1 July 2013, Alpha acquired 40% of the equity capital of Gamma. The purchase consideration comprised the following:

– An issue of equity shares.

– A cash payment of $65·34 million due on 30 June 2015. On 1 July 2013, Alpha's borrowing rate was 10% per annum. No entry has yet been made in Alpha's financial statements regarding this future cash payment.

The other 60% of Gamma's shares are held by a wide variety of investors, none of whom owns more than 0·5% individually. None of the other shareholders has any arrangements to consult any of the others or make collective decisions. Since 1 July 2013, Alpha has actively participated in establishing the operating and financial policies of Gamma.

When reviewing the net assets of Gamma as at 1 July 2013, the directors of Alpha ascertained the following:

– The properties of Gamma had been revalued at 31 March 2013 and there was no significant difference between their carrying values at 1 July 2013 and their fair values at 31 March 2013.

– The plant and equipment of Gamma had a carrying value at 1 July 2013 of $70 million and a fair value at that date of $78 million. The estimated future useful life of the property, plant and equipment at 1 July 2013 was four years, with zero residual value.

– On 1 July 2013, Gamma was in the process of completing the development of a new method of production which will significantly reduce wastage. As at 1 July 2013, Gamma had recognised an intangible asset of $10 million in its financial statements in respect of this development. The directors of Alpha believed that, as at 1 July 2013, the process had a fair value of $22 million and that the process will produce economic benefits evenly for ten years from 1 January 2014.

– On 1 July 2013, Gamma had a contingent liability which it did not recognise in its own financial statements. This contingent liability still existed, and was still unrecognised by Gamma, at 31 March 2014. As at 1 July 2013, the directors of Alpha believed that the contingent liability had a fair value of $16 million. On 31 March 2014, they reassessed its fair value at $12 million. The reassessment was due to a change in circumstances after 1 July 2013.

The directors of Alpha believe that the facts described in this note mean that Gamma has been a subsidiary of Alpha since 1 July 2013 and wish to consolidate it. Based on the assumption that Gamma is consolidated, no impairment of the goodwill on consolidation is required at 31 March 2014. The profit of Gamma for the year ended 31 March 2014 accrued evenly over the year. However, as noted above, all of the other comprehensive income of Gamma arose after 1 July 2013. Any consolidation adjustments which are necessary as a result of the information given in this note should be regarded as temporary differences for the purpose of computing deferred taxation. The rate of corporate income tax in the jurisdiction in which all three entities are located is 25%.

Note 3 – Presentation of depreciation and amortisation

All depreciation and amortisation charges should be presented as part of cost of sales

Note 4 – Trading between Alpha and Beta

1. Alpha supplies a component to Beta which is used by Beta in its production process. Alpha marks up its cost of production by one-third in arriving at the selling price. In the year ended 31 March 2014, the revenues of Alpha included $30 million in respect of the sale of these components. On 31 March 2014, the inventories of Beta included $6 million. On 31 March 2013, the inventories of Beta included $4·4 million in respect of identical unsold components purchased from Alpha at the same mark up on cost.

2. During the year ended 31 March 2013, Alpha manufactured a machine which was to be used by Beta from 1 April 2013. The costs of manufacture totalled $12 million. On 1 April 2013, Alpha transferred the machine to Beta for an invoiced price of $16 million, including relevant amounts in revenue and cost of sales. Beta included the machine in its property, plant and equipment and depreciated the machine over its estimated useful life of four years, with no residual value.

Any consolidation adjustments which are necessary as a result of the information given in this note should be regarded as temporary differences for the purpose of computing deferred taxation.

Note 5 – Defined benefit retirement benefits plan

Certain senior executives of Alpha belong to a defined benefit retirement benefits plan. In the financial statements of Alpha, the contributions paid into this plan have been shown as an expense in the statement of profit or loss and other comprehensive income. Relevant information regarding this plan is as follows:

- The pension liability was $60m at 31 March 2013. This liability increased to $68m by 31 March 2014.
- The pension asset was $40m at 31 March 2013. This asset increased to $46m by 31 March 2014.
- The current service cost was $4·5m.
- Alpha's borrowing rate at 31 March 2014 was 9% per annum. On that date market yields on government bonds were 8% per annum.

The salary costs of the senior executives who belong to this plan are presented in administrative expenses. You should ignore any adjustment to deferred tax as a result of the information included in this note.

Note 6 – Payment of dividends

On 31 December 2013, Beta paid a dividend of $30 million and Gamma paid a dividend of $20 million. Alpha recognised its share of both dividends in its investment income.

Note 7 – Property revaluations

It is the policy of the Alpha group to measure freehold properties using the fair value model and all freehold properties were revalued on 31 March 2014. Beta leases all of its properties and all of Beta's property leases are operating leases. The gains shown in the financial statements of Alpha and Gamma do not take account of the deferred tax implications of the revaluations.

Note 8 – Hedge of future property purchase

On 1 February 2014, Alpha entered into a firm commitment to purchase a property on 31 May 2014 for €40 million. In order to eliminate the impact of currency fluctuations, on 1 February 2014 Alpha entered into a contract to purchase €40 million for $48 million on 31 May 2014. This contract had no cost and Alpha did not record it in the financial statements for the year ended 31 March 2014. On 31 March 2014, the contract had a fair value of $3·6 million (financial asset). Alpha uses hedge accounting whenever permitted by International Financial Reporting Standards. Where a choice of hedge accounting method exists, Alpha uses cash-flow hedge accounting.

You should ignore any adjustment to deferred tax as a result of the information included in this note.

Required:

(a) Discuss the appropriateness of the directors' view that Gamma became a subsidiary of Alpha on 1 July 2013. (5 marks)

(b) Prepare the consolidated statement of profit or loss and other comprehensive income of Alpha for the year ended 31 March 2014. For this part you should assume that Gamma is a subsidiary of Alpha from 1 July 2013. (35 marks)

(40 marks)

2 Delta is an entity which prepares financial statements to 31 March each year. During the year ended 31 March 2014 the following events affected Delta:

(a) On 1 April 2012, Delta had granted share appreciation rights to 200 senior executives. Each executive will receive 2,000 rights on 31 March 2015 provided he or she continues to be employed by Delta at that date. On 1 April 2012, the directors estimated that all the executives would remain employed by Delta for the three-year period ending on 31 March 2015. However, 10 executives left in the year ended 31 March 2013 and at 31 March 2013 the directors believed that a further 10 executives would leave in the following two years. Five executives actually left in the year ended 31 March 2014 and the directors now believe that seven more directors will leave in the year ended 31 March 2015. Since 1 April 2012, the fair value of the share appreciation rights has fluctuated as follows:

Date	Fair value of one right
	$
1 April 2012	1·60
31 March 2013	1·80
31 March 2014	1·74

(8 marks)

(b) On 1 April 2013, Delta completed the manufacture of some inventory at a total cost of $800,000. In order to be suitable for sale in the ordinary course of business, the completed inventory needed to be stored in controlled conditions for a two-year period. The inventory is expected to sell for $1,200,000 after the two-year storage period. On 1 April 2013, Delta sold the inventory to Epsilon, a bank. The agreed sales proceeds were $810,000 but Epsilon charged Delta an administration fee of $10,000, so the net amount received by Delta was $800,000. Delta retained physical custody of the inventory and continued to ensure that it was stored in the appropriate conditions. Delta indemnified Epsilon against any losses caused by theft or inappropriate storage of the inventory. Delta has the option to repurchase the inventory on 31 March 2015 for $933,120. On 1 April 2013, Epsilon would have required an annual return of 8% on loans made to customers such as Delta.

(7 marks)

(c) On 1 April 2013, Delta leased a machine from Kappa on a three-year lease. The expected future economic life of the machine on 1 April 2013 was eight years. If the machine breaks down, then under the terms of the lease, Kappa would be required to repair the machine or provide a replacement. Kappa agreed to allow Delta to use the machine for the first six months of the lease without the payment of any rental as an incentive to Delta to sign the lease agreement. After this initial period, lease rentals of $210,000 were payable six-monthly in arrears, the first payment falling due on 31 March 2014. (5 marks)

Required:

Explain and illustrate (where possible by quantifying amounts) how the three events would be reported in the financial statements of Delta for the year ended 31 March 2014.

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

(20 marks)

3 **(a)** Deferred tax is the tax on temporary differences. Temporary differences are identified on individual assets and liabilities in the statement of financial position. Temporary differences arise when the carrying value of an asset or liability differs from its tax base.

Required:

Explain:

(i) **How IAS 12 – *Income Taxes* – defines the tax base of assets and liabilities.** (3 marks)

(ii) **How temporary differences are identified as taxable or deductible temporary differences.** (2 marks)

(iii) **The general criteria prescribed by IAS 12 for the recognition of deferred tax assets and liabilities. You do NOT need to identify any specific exceptions to these general criteria.** (2 marks)

(b) Epsilon prepares consolidated financial statements to 31 March each year. During the year ended 31 March 2014, the following events affected the tax position of the group:

(i) Lambda, a wholly owned subsidiary of Epsilon, made a loss adjusted for tax purposes of \$3 million. Lambda is unable to utilise this loss against previous tax liabilities and local tax legislation does not allow Lambda to transfer the tax loss to other group companies. Local legislation does allow Lambda to carry the loss forward and utilise it against its own future taxable profits. The directors of Epsilon do not consider that Lambda will make taxable profits in the foreseeable future. (2 marks)

(ii) Just before 31 March 2014, Epsilon committed itself to closing a division after the year end, making a number of employees redundant. Therefore Epsilon recognised a provision for closure costs of \$2 million in its statement of financial position as at 31 March 2014. Local tax legislation allows tax deductions for closure costs only when the closure actually takes place. In the year ended 31 March 2015, Epsilon expects to make taxable profits which are well in excess of \$2 million. On 31 March 2014, Epsilon had taxable temporary differences from other sources which were greater than \$2 million. (3 marks)

(iii) During the year ended 31 March 2014, Epsilon capitalised development costs which satisfied the criteria in paragraph 57 of IAS 38 – *Intangible Assets*. The total amount capitalised was \$1·6 million. The development project began to generate economic benefits for Epsilon from 1 January 2014. The directors of Epsilon estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31 March 2014. (3 marks)

(iv) On 1 April 2013, the total goodwill arising on consolidation in Epsilon's consolidated statement of financial position was \$4 million. On 31 March 2014, the directors reviewed the goodwill for impairment and concluded that the goodwill was impaired by \$600,000. There was no tax deduction available for any group company as a consequence of this impairment charge as at 31 March 2014. (2 marks)

(v) On 1 April 2013, Epsilon borrowed \$10 million. The cost to Epsilon of arranging the borrowing was \$200,000 and this cost qualified for a tax deduction on 1 April 2013. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31 March 2016 will be \$13,043,800. This equates to an effective annual interest rate of 10%. Under the tax jurisdiction in which Epsilon operates, a further tax deduction of \$3,043,800 will be claimable when the loan is repaid on 31 March 2016. (3 marks)

Required:

Explain and show how each of these events would affect the deferred tax assets/liabilities in the consolidated statement of financial position of the Epsilon group at 31 March 2014. Where relevant, you should assume the rate of corporate income tax is 25%

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

(20 marks)

4 You are the financial controller of Omega, a listed company which prepares consolidated financial statements in accordance with International Financial Reporting Standards (IFRS). The year end of Omega is 31 March and its functional currency is the $. Your managing director, who is not an accountant, has recently prepared a list of questions for you concerning current issues relevant to Omega:

(a) One of my fellow directors has informed me that on 1 January 2014 his spouse acquired a controlling interest in one of our major suppliers, Sigma. He seemed to think that this would have implications for our financial statements. I cannot understand why. Our purchases from Sigma were $1·5 million for each month of our year ended 31 March 2014 and I acknowledge this is a significant amount for us. However, I can't see how the share purchase on 1 January 2014 affects **our** financial statements – all the purchases from Sigma were made at normal market rates, so what's the issue? Please explain this to me and identify any impact on our financial statements. (7 marks)

(b) You will be aware that we intend to open a new retail store in a new location in the next few weeks. As you know, we have spent a substantial sum on a series of television advertisements to promote this new store. We paid for advertisements costing $800,000 before 31 March 2014. $700,000 of this sum relates to advertisements shown before 31 March 2014 and $100,000 to advertisements shown in April 2014. Since 31 March 2014, we have paid for further advertisements costing $400,000. I was chatting to a colleague over lunch and she told me she thought **all** these costs should be written off as expenses in the year to 31 March 2014. I don't want a charge of $1·2 million against my 2014 profits! Surely these costs can be carried forward as intangible assets? After all, our market research indicates that this new store is likely to be highly successful. Please explain and justify the treatment of these costs of $1·2 million in the financial statements for the year ended 31 March 2014. (6 marks)

(c) As you know, on 1 January 2014 we purchased a machine for 2 million kroner. At that date the exchange rate was $1= 10 kroner. We don't have to pay for this purchase until 30 June 2014. The kroner strengthened against the $ in the three months following purchase and by 31 March 2014 the exchange rate was $1 = 8 kroner. I thought these exchange fluctuations wouldn't affect our financial statements because we have an asset and a liability denominated in kroner which was initially the same amount. We're depreciating this machine over four years so the future year-end amounts won't be the same, of course. Something I heard at a seminar, but didn't really grasp, made me think I could be mistaken. Please explain the impact of this transaction on our financial statements for the year ended 31 March 2014. (7 marks)

Required:

Provide answers to the issues raised by the managing director.

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

(20 marks)

End of Question Paper