Diploma in International Financial Reporting

Tuesday 11 June 2013

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

Dip IFR

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ALL FOUR questions are compulsory and MUST be attempted

1 Alpha holds investments in two other entities, Beta and Gamma. The statements of financial position of the three entities at 31 March 2013 were as follows:

	Alpha $'000	Beta $'000	Gamma $'000
ASSETS			
Non-current assets:			
Property, plant and equipment (Note 1)	280,000	225,000	200,000
Investments (Notes 1, 2 and 3)	78,500	40,000	10,000
	358,500	265,000	210,000
Current assets:			
Inventories (Note 4)	85,000	56,000	42,000
Trade receivables (Note 5)	70,000	42,000	38,000
Cash and cash equivalents	14,000	11,000	9,000
	169,000	109,000	89,000
Total assets	527,500	374,000	299,000
EQUITY AND LIABILITIES			
Equity			
Share capital ($1 shares)	160,000	120,000	100,000
Retained earnings	211,396	115,000	76,000
Other components of equity (Notes 2, 3 and 6)	5,604	4,000	2,000
Total equity	377,000	239,000	178,000
Non-current liabilities:			
Provision (Note 7)	1,500	Nil	Nil
Long-term borrowings (Note 8)	60,000	50,000	60,000
Deferred tax	22,000	25,000	17,000
Total non-current liabilities	83,500	75,000	77,000
Current liabilities:			
Trade and other payables (Note 5)	45,000	40,000	34,000
Short-term borrowings	22,000	20,000	10,000
Total current liabilities	67,000	60,000	44,000
Total equity and liabilities	527,500	374,000	299,000

Note 1 – Alpha's investment in Beta

On 1 April 2012, Alpha acquired 90 million shares in Beta by means of a share exchange. The terms of the business combination were as follows:

– Alpha issued eight shares for every nine shares acquired in Beta. On 1 April 2012, the market value of an Alpha share was $2·80.

– Alpha will make a further cash payment to the former shareholders of Beta on 30 June 2015. This payment will be based on the adjusted profits of Beta for the three-year period to 31 March 2015. On 1 April 2012, the fair value of this additional payment was estimated at $25 million. This estimate had increased to $28 million by 31 March 2013 due to changes in circumstances since the date of acquisition.

– Neither component of the investment in Beta has been recorded in the draft financial statements of Alpha presented above.

It is the group policy to value the non-controlling interest in subsidiaries at the date of acquisition at fair value. The market value of an equity share in Beta at 1 April 2012 can be used for this purpose. On 1 April 2012, the market value of a Beta share was $2·60.

On 1 April 2012, the individual financial statements of Beta showed the following reserves balances:

– Retained earnings $86 million.
– Other components of equity $2·4 million.

The directors of Alpha carried out a fair value exercise to measure the identifiable assets and liabilities of Beta at 1 April 2012. The following matters emerged:

– Property having a carrying value of $140 million (depreciable component $80 million) had an estimated market value of $160 million (depreciable component $92 million). The estimated future economic life of the depreciable component at 1 April 2012 was 16 years and this estimate remains valid.

– Plant and equipment having a carrying value of $111 million had an estimated market value of $120 million. The estimated future economic life of the plant and equipment at 1 April 2012 was three years and this estimate remains valid. Beta has not disposed of any of this plant and equipment since 1 April 2012.

– Intangible assets with an estimated market value of $8 million had not been recognised in the individual financial statements of Beta. The estimated future economic lives of these intangible assets at 1 April 2012 was four years.

– 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 deferred tax to apply to temporary differences is 20%.

No impairment of the goodwill on acquisition of Beta has occurred since 1 April 2012.

Note 2 – Alpha's investment in Gamma

On 1 April 2012, Alpha acquired 40 million shares in Gamma for a cash payment of $1·85 per share and debited $74 million to investments in its own statement of financial position. This enabled Alpha to exercise significant influence over Gamma but not to control Gamma. In its own financial statements, Alpha treated the investment in Gamma as a financial asset and made an election to measure it at fair value through other comprehensive income.

On 1 April 2012, the individual financial statements of Gamma showed the following reserves balances:

– Retained earnings $66 million.
– Other components of equity $1·2 million.

On 1 April 2012, there were no material differences between the carrying values of the net assets of Gamma in the individual financial statements and the fair values of those net assets.

On 31 March 2013, the fair value of Alpha's investment in Gamma was estimated at $78·5 million and this is the balance recorded in Alpha's individual financial statements. On 31 March 2013, Alpha credited $4·5 million to other components of equity. No deferred tax was recognised when making this entry.

In the consolidated financial statements you can ignore deferred tax when measuring the investment in Gamma.

Note 3 – Investments by Beta and Gamma

These investments are financial assets that are measured at fair value through other comprehensive income and have been correctly treated by Beta and Gamma. The other components of equity of Beta and Gamma relate entirely to these investments.

Note 4 – Inter-company sale of inventories

The inventories of Beta and Gamma at 31 March 2013 included components produced by Alpha. The selling price of the components included in the inventories of Beta was $14 million. The selling price of the components included in the inventories of Gamma was $12 million. Alpha applied a mark-up of one-third of its production cost in arriving at the sales price of these components. You can ignore deferred tax when making any adjustments due to the information in this note.

Note 5 – Trade receivables and payables

The trade receivables of Alpha included $9 million receivable from Beta and $7·5 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 – Share based payment

On 1 April 2011, Alpha granted share options to senior executives that are due to vest on 31 March 2014. The maximum number of options that can vest is 10 million. However, there are vesting conditions that are service conditions. Each option allows the holder to purchase a share in Alpha for $2·50. Further details are as follows:

Date	Share price	Fair value of an option	Number of options expected to vest on 31 March 2014
1 April 2011	$2·50	36 cents	9 million
31 March 2012	$2·80	55 cents	9·2 million
31 March 2013	$3·00	90 cents	9·3 million

On 31 March 2012, the directors of Alpha correctly credited other components of equity and debited profit or loss with $1,104,000 in respect of these share options. No entries have been made in the financial statements since then in respect of the options.

Ignore any deferred tax implications of the granting of these share options.

Note 7 – Provision

On 1 October 2011, Alpha entered into a 10-year lease of office premises at an annual rental of $20 million. This lease was correctly classified as an operating lease and the rentals appropriately charged to profit or loss.

On 1 October 2011, Alpha began carrying out alterations to the premises. These alterations were completed on 31 March 2012 at a total cost of $18 million. Alpha included $18 million in its property, plant and equipment at 31 March 2012 and charged depreciation in the current year based on a 9½ year useful economic life.

The terms of the lease require Alpha to vacate the premises on 30 September 2021 and leave them in the same condition as they were on 1 October 2011. The directors estimate that this will require restoration expenditure of $14,250,000 on 30 September 2021. Accordingly, the directors recognised a provision of $1,500,000 ($14,250,000/9·5) at 31 March 2013. The directors debited $1,500,000 to profit or loss when recognising this provision.

A relevant discount rate to use in any discounting calculations is 8% per annum. The present value of $1 payable in 9½ years at this discount rate is 48 cents.

Note 8 – Long-term borrowings

The long-term borrowings of Alpha include $20 million that was received from a consortium of banks on 1 April 2012. The loan does not carry any interest but $30·6 million is repayable on 31 March 2017. Alpha incurred incremental costs of $1 million in arranging the loan which were charged to profit or loss in the year ended 31 March 2013. The effective annual rate of interest applicable to this loan is 10%.

Required:

Prepare the consolidated statement of financial position of Alpha at 31 March 2013.

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. The functional currency of Delta is the \$. During the year ended 31 March 2013 the following events occurred:

(a) On 1 April 2012, Delta raised loan finance from European investors. The investors subscribed for 50 million €1 loan notes at par. Delta incurred incremental issue costs of €1 million. Interest of €4 million is payable annually on 31 March, starting on 31 March 2013. The loan is repayable in € on 31 March 2022 at a premium and the effective annual interest rate implicit in the loan is 10%. The appropriate measurement basis for this loan is amortised cost. Relevant exchange rates are as follows:

– 1 April 2012 – €1 = \$1·40.
– 31 March 2013 – €1 = \$1·45.
– Average for year ended 31 March 2013 – €1 = \$1·42. (7 marks)

(b) On 1 April 2012, Delta began joint construction of a pipeline with another investor. Delta and the other investor have signed a contract that provides for joint operation and ownership of the pipeline. All of the ongoing expenditure, comprising maintenance plus borrowing costs, was to be shared equally. The pipeline was completed on 1 October 2012. It was first used on 1 January 2013, at which date its estimated useful economic life was 20 years. The total cash cost of constructing the pipeline was \$40 million. This cost was partly financed by a loan of \$10 million taken out on 1 April 2012. The loan carries interest at an annual rate of 10% with interest payable in arrears on 31 March each year. Between 1 January 2013 and 31 March 2013, it was necessary to spend \$400,000 on maintenance costs. (7 marks)

(c) On 1 April 2012, the directors of Delta formed a new company, Epsilon. The directors of Delta own all the voting shares in Epsilon. In exercising their votes, the directors of Delta have agreed to act in Delta's best interests. Epsilon leased an asset from a financial institution and correctly classified this lease as a finance lease. Epsilon immediately leased the asset to Delta on a one year lease. The rentals payable by Delta to Epsilon were set at the same amount as the rentals payable by Epsilon to the financial institution. The terms of the lease from Epsilon to Delta gave Delta the option to extend the lease under exactly the same terms. This extension option will continue to be available on an annual basis until the lease between Epsilon and the financial institution expires. The asset is a vital one in Delta's production process. Epsilon does not undertake any other transactions. (6 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 2013.

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

(20 marks)

3 **(a)** Revenue is often the largest single amount in the financial statements of a company and therefore it is very important to establish appropriate criteria for its recognition and measurement. IAS 18 – *Revenue* – was issued to establish such criteria.

Required:

(i) **State the meaning of the term 'revenue' as it is used in IAS 18 and describe the requirements of IAS 18 for the measurement of revenue;**

(ii) **Summarise the criteria that need to be satisfied before revenue from the sale of goods can be recognised and identify any additional criteria that need to be satisfied in order to recognise revenue from the rendering of services.**

Note: The total marks will be split equally between each part. (6 marks)

(b) Kappa prepares financial statements to 31 March each year. During the year ended 31 March 2013, Kappa entered into the following transactions:

(i) On 1 January 2013, Kappa supplied goods on credit to a customer. The goods had a list price of $450,000. Due to the size of the order, the customer received a volume discount of $50,000 and the invoice to the customer showed an amount payable of $400,000. The terms of sale allowed the customer a prompt payment discount of $20,000 provided payment was made before 31 January 2013. On 30 January 2013, the customer paid $380,000 in full and final settlement of the amount payable. (2 marks)

(ii) On 31 March 2013, Kappa supplied two machines to a customer. Both machines were accepted by the customer on 31 March 2013. Machine 1 was a machine that was routinely supplied by Kappa to many customers and the installation process was very simple. Machine 1 was installed on 2 April 2013 by employees of the customer. Machine 2 was more specialised and the installation process more complicated, requiring significant assistance from Kappa. Machine 2 was installed between 2 and 5 April 2013. Details of costs and sales prices are as follows:

	Machine 1	Machine 2
	$'000	$'000
Sales price	320	300
Cost of production	160	150
Cost of installation (to Kappa)	Nil	10

(4 marks)

(iii) On 30 September 2012, Kappa sold a property to a bank for $2 million. The carrying amount of the property at the date of sale was $1·5 million and its market value was $3·5 million. Property prices are expected to rise at an annual rate of 5% for the foreseeable future. Kappa continued to occupy this property but paid no rent to the new owners. Kappa has the option to repurchase the property on 30 September 2017 for $3·221 million. Kappa's credit rating is such that financial institutions would require an annual interest rate of 10% on loan finance to Kappa. (4 marks)

(iv) On 30 September 2012, Kappa delivered a machine to a customer that had been manufactured to that customer's requirements. The machine cost Kappa $600,000 to manufacture and the agreed selling price was $1,007,557. Kappa agreed to accept payment on 30 September 2015. Kappa would expect an annual rate of return of 8% on loan investments. The present value of $1 receivable in three years' time at an annual discount rate of 8% is approximately 79·4 cents. (4 marks)

Required:

Explain and show how the four transactions would be reported in the financial statements of Kappa for the year ended 31 March 2013 and (for transaction (ii) ONLY) the year ended 31 March 2014.

Note: The mark allocation is shown against each of the four 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). Your managing director, who is not an accountant, has recently attended a seminar and has prepared a number of questions for you concerning two issues raised at the seminar:

(a) 'I was confused regarding a number of references to fair value and a new accounting standard on the subject. I thought financial statements were prepared on a historical cost basis. Please give me three examples of where fair value might be relevant for us. I was told the new standard removed an inconsistency in the definition of fair value and applied three levels of input into the measurement of fair value. Please explain how the new standard defines fair value and what the previous inconsistency was. Please also explain each level of input and how each level is applied in measuring the fair value of a particular item in the financial statements.' (10 marks)

(b) 'One of the topics discussed at the seminar was segment reporting. I believe I heard someone say that segment reporting varies from company to company depending on its internal structure. Please explain how we should identify the segments we use to provide our segment reporting information. I do not need to know the detailed content of a segment report.' (10 marks)

Required:

Provide answers to the questions raised by the managing director.

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

(20 marks)

End of Question Paper