Diploma in International Financial Reporting (Dip IFR)

Friday 7 June 2019

IFR INT ACCA

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.

Dip IFR

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 has one subsidiary, Beta. The draft statements of profit or loss for both entities for the year ended 31 March 20X7 are given below:

	Alpha $'000	Beta $'000
Revenue (notes 3 and 4)	400,000	280,000
Cost of sales (notes 1–3)	(240,000)	(170,000)
Gross profit	160,000	110,000
Distribution costs	(40,000)	(25,000)
Administrative expenses (note 5)	(50,000)	(29,000)
Investment income (note 6)	45,000	nil
Finance costs	(35,000)	(20,000)
Profit before tax	80,000	36,000
Income tax expense	(25,000)	(12,000)
Profit for the year	55,000	24,000

Note 1 – Alpha's investment in Beta

On 1 April 20X5, Alpha acquired 90 million of Beta's 120 million issued equity shares for a cash payment of $327 million. On 1 April 20X5, the directors of Alpha measured the non-controlling interest in Beta using Alpha's proportionate share of the net assets of Beta at that date.

On 1 April 20X5, the net assets of Beta as shown in the individual financial statements of Beta totalled $380 million. The directors of Alpha carried out a fair value exercise to measure the fair value of the identifiable assets and liabilities of Beta at 1 April 20X5. The following matters emerged:

– Plant and equipment having a carrying amount of $120 million had an estimated fair value of $140 million. The estimated remaining useful life of this plant at 1 April 20X5 was four years.

– A brand name relating to Beta had a fair value of $30 million. This brand name was not recognised in the individual financial statements of Beta as it was internally developed. The directors of Alpha considered that the useful life of this brand name was 10 years from 1 April 20X5.

– A contingent liability relating to a pending legal case was disclosed in the notes to the financial statements of Beta at 1 April 20X5. This contingent liability had a fair value of $15 million at 1 April 20X5. The contingency was settled during the year ended 31 March 20X6.

The fair value adjustments have not been reflected in the individual financial statements of Beta. The fair value adjustments are temporary differences which attract deferred tax at a rate of 20%.

All depreciation and amortisation of non-current assets is to be charged to cost of sales in the consolidated financial statements.

On 1 April 20X5, Alpha made a loan to Beta of $200 million. The loan carried an annual interest rate of 10%. Interest is payable annually in arrears and the loan is repayable by Beta on 31 March 20X9. The loan interest payable on both 31 March 20X6 and 31 March 20X7 was paid by Beta on the due date and recognised by Alpha as investment income.

Note 2 – Impairment review of goodwill on acquisition of Beta

The goodwill on acquisition of Beta was reviewed for impairment on 31 March 20X6 and no impairment was considered necessary. On 31 March 20X6, the individual financial statements of Beta showed net assets of $390 million.

Beta paid a dividend of $12 million on 1 March 20X7 (see note 6).

Beta is a single cash-generating unit for impairment purposes. On 31 March 20X7, the estimated recoverable amount of Beta as a single cash-generating unit was $448 million.

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

Note 3 – Intra-group trading

Alpha provides Beta with a product which Beta uses as a raw material in its production process. Sales of the product by Alpha to Beta for the year ended 31 March 20X7 totalled $30 million. Alpha supplies this product to Beta at a mark-up of 20% on its cost of production.

On 31 March 20X7, the inventories of Beta included $6 million in respect of raw materials supplied by Alpha. On 31 March 20X6, the equivalent figure in the inventories of Beta was $4·8 million.

Any adjustments for unrealised profits are temporary differences which attract deferred tax at a rate of 20%.

Note 4 – Alpha revenue

On 1 October 20X6, Alpha sold a machine to a customer for a total sales price of $27 million. The terms of the sale were that Alpha would provide the customer with a three-year service warranty. The service warranty covered all repairs which might be necessary should the machine break down in the three-year period. The normal selling price of the machine without the inclusion of any service warranty would have been $24 million. Alpha would normally charge a customer a total of $6 million to provide a three-year service warranty covering breakdown costs on a machine of this nature.

On 1 October 20X6, Alpha recognised revenue of $27 million and charged the cost of manufacture to cost of sales. Any costs incurred by Alpha under the service warranty arrangements during the period from 1 October 20X6 to 31 March 20X7 were charged as cost of sales. The service warranty arrangement does not represent an onerous contract for Alpha at 31 March 20X7.

Note 5 – Research and development project

On 1 April 20X6, Alpha began a research project. The aim of the project was to investigate ways of streamlining its production process. The initial costs of setting up the project were $5 million. From 1 April 20X6 to 30 June 20X6 ongoing project costs were $500,000 per month. On 1 July 20X6, the project was considered to be technically feasible and commercially viable and from this date project costs increased to $600,000 per month. The project was completed on 31 December 20X6 and the new production process began to be used from 1 January 20X7. The new process is likely to produce economic benefits for Alpha for five years from 1 January 20X7. Alpha charged all the costs to complete the project to administrative expenses.

Note 6 – Alpha's investment income

The figure for investment income in the consolidated financial statements of Alpha comprises:

	$'000
Dividend received from Beta (note 2)	9,000
Interest received from Beta (note 1)	20,000
Dividend received from investment in Gamma (note 7)	4,500
Dividends received from portfolio of equity investments (note 8)	11,500
	45,000

Note 7 – Alpha's investment in Gamma

On 1 October 20X6, Alpha purchased 18% of the equity shares of Gamma at a cost of $102 million. No other single shareholder owns more than 5% of Gamma's equity shares and there are no agreements in place for any of the other equity shareholders to collaborate to influence Gamma's operating or financial policies. Alpha has the right to appoint four of the ten directors of Gamma.

Gamma prepares financial statements to 31 March 20X7 and its profit before tax for the year ended 31 March 20X7 was $78 million. Its income tax expense for that year was $6 million. Gamma's profits accrue evenly.

Gamma paid a dividend of $25 million on 1 March 20X7.

Alpha's investment in Gamma has not suffered any impairment since 1 October 20X6.

Note 8 – Alpha's portfolio of equity investments

Alpha's portfolio of equity investments is held for short-term trading. During the year ended 31 March 20X7, Alpha made additional purchases at a total cost of $8·5 million which were added to the portfolio. During the year ended 31 March 20X7, Alpha received $7 million from the proceeds of sale of investments from the portfolio. These proceeds

were deducted from the carrying amount of the portfolio. On 31 March 20X6, the fair value of the portfolio was $75 million and this amount was recognised in the financial statements of Alpha at that date. On 31 March 20X7, the fair value of the portfolio was $84 million. No adjustments have yet been made to the financial statements of Alpha to reflect this change in fair value.

Required:

(a) Explain how Alpha should classify its investment in Gamma (note 7) in its consolidated financial statements for the year ended 31 March 20X7. (2 marks)

(b) Compute the carrying amount of Alpha's investment in Gamma (note 7) in its consolidated statement of financial position at 31 March 20X7. Ignore deferred tax. (2 marks)

(c) Prepare the consolidated statement of profit or loss of Alpha for the year ended 31 March 20X7. Unless specifically referred to in the notes, ignore deferred tax. (36 marks)

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

(40 marks)

2 Gamma prepares its financial statements to 31 March each year. Notes 1 and 2 contain information relevant to these financial statements:

Note 1 – Sale and leaseback of property

On 1 April 20X6, Gamma sold a property to entity A for its fair value of $1,500,000. The terms and conditions of the sale satisfy the sale and leaseback requirements of IFRS® 15 – *Revenue from Contracts with Customers*. The carrying amount of the property in the financial statements of Gamma at 1 April 20X6 was $1,000,000. The estimated future useful life of the property on 1 April 20X6 was 20 years. On 1 April 20X6, Gamma entered into an agreement with entity A under which Gamma leased the property back. The lease term was for five years, with annual rentals of $100,000 payable in arrears. The annual rate of interest implicit in the lease was 10% and the present value of the minimum lease payments on 1 April 20X6 was $379,100. (12 marks)

Note 2 – Purchase of new machine

On 1 April 20X6, Gamma purchased a machine from a foreign supplier. The cost of the machine was 900,000 dinars. Gamma paid this amount to the supplier on 30 June 20X6. The estimated useful life of the machine at 1 April 20X6 was eight years. However, the machine contains a component which will need replacing after four years. On 1 April 20X6, the directors of Gamma estimated that 30% of the original cost of the machine was attributable to this component. Relevant exchange rates (dinars to $1) were as follows:

Date	Exchange rate (dinars to $1)
1 April 20X6	3
30 June 20X6	2·5
31 March 20X7	2·4

Gamma uses the cost model to measure all of its property, plant and equipment. (8 marks)

Required:

Using the information in notes 1 and 2 explain and show how the two events would be reported in the financial statements of Gamma for the year ended 31 March 20X7.

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

(20 marks)

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Question 3 begins on page 8.

3 **(a)** It has become increasingly common for entities to use share-based payment methods and the most common example is to grant employees share options as part of a remuneration package. These options often vest at the end of a specified period, and are subject to vesting conditions. IFRS 2 – *Share-based Payment* – has been issued to provide financial reporting guidance for entities which engage in this type of transaction.

Required:

(i) Explain how share options granted to employees with a future vesting date and subject to vesting conditions should be recognised and measured in the financial statements of the employing entity. Your explanation need only include the treatment of non-market based vesting conditions. (6 marks)

(ii) Explain what would be the changes to your answer if instead the entity granted share appreciation rights which are payable in cash to the employees at the end of the vesting period. (3 marks)

(b) Delta prepares financial statements to 31 March each year. The information in note 1 and 2 is relevant for the year ended 31 March 20X7.

Note 1 – Granting of options to sales staff

On 1 April 20X5, Delta granted share options to 100 sales staff. The options are due to vest on 31 March 20X8. The granting of the options was subject to two conditions:

– The staff member remains employed by Delta on 31 March 20X8.

– The sales revenue of Delta grows by a cumulative amount of at least 40% in the three-year period ending on 31 March 20X8 (see the table below).

Cumulative growth in revenue in the three-year period	Number of options each employee is entitled to (subject to satisfying other vesting conditions)
Between 40% and 50%	200
Over 50%	250

On 1 April 20X5, the fair value of a share option was $4·20. This had increased to $4·50 by 31 March 20X6 and to $4·80 by 31 March 20X7.

During the two years ended 31 March 20X7, expectations of revenue growth and employee retention in the three-year period ending on 31 March 20X8 changed as follows:

	Growth in revenue		Employees leaving	
Year ended 31 March	In the year	Expected cumulative growth in the three-year period	In the year	Expected FUTURE departures in the three-year vesting period
20X6	12%	42%	10	20
20X7	18%	54%	5	9

You can assume that this transaction was correctly accounted for by Delta in its financial statements for the year ended 31 March 20X6. (6 marks)

Note 2 – Granting of share appreciation rights to senior executives

On 1 October 20X5, Delta granted 500 share appreciation rights to 20 senior executives. The rights are redeemable in cash on 30 September 20X9 provided the executives remain employed by Delta until at least 30 September 20X9.

On 1 October 20X5, Delta estimated that two of the 20 executives would leave in the period from 1 October 20X5 to 30 September 20X9 and this estimate remained unchanged at 31 March 20X6.

During the year ended 31 March 20X7, one executive left Delta and on that date Delta estimated that the other 19 executives would remain in employment until 30 September 20X9 and so be entitled to the share appreciation rights.

On 1 October 20X5, the fair value of a share appreciation right was estimated to be $6. The fair value of a right had increased to $6·20 by 31 March 20X6 and to $6·40 by 31 March 20X7.

You can assume that this transaction was correctly accounted for by Delta in its financial statements for the year ended 31 March 20X6. (5 marks)

Required:

Briefly explain and show how the transactions described in notes 1 and 2 would be reported in the financial statements of Delta for the year ended 31 March 20X7.

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

(20 marks)

4 You are the financial controller of Epsilon, a listed entity. The financial statements of Epsilon for the year ended 31 March 20X7 are currently being prepared. Your managing director has sent you three questions regarding the financial statements. The questions appear in notes 1–3.

Note 1 – Farming subsidiary

I've recently been reviewing the financial statements of one of our subsidiaries. This subsidiary specialises in both dairy farming and beef farming. There are amounts included in both non-current and current assets:

- The non-current assets include farm machinery which has been purchased. I understand why this machinery has been included as we have spent money on it. However, the non-current assets figure also includes a figure for the dairy and beef herds. These existing herds were not purchased but are made up of animals the farming subsidiary has bred.
- The inventories include amounts for milk and beef. The milk comes from the dairy herd and the beef comes from the animals we have slaughtered.
- Is there an international financial reporting standard which deals with these issues and how does it require the subsidiary to value and account for the herds and the inventories? (8 marks)

Note 2 – Equity investments

I've been analysing Epsilon's equity investments and they appear to be being treated inconsistently in the financial statements. I have noted the following:

- We have a portfolio of equity investments which we use for the short-term investment of surplus cash. When we need cash for business purposes we sell some investments from this portfolio. The portfolio is measured at its fair value each year end. Any surpluses or deficits on re-measurement to fair value are recognised in investment income as part of the profit or loss for the period.
- We have two long-term equity investments in key suppliers which we have held for some time and have no intention of selling. These investments are also measured at fair value but changes in fair value are recognised as 'other comprehensive income'.

How can it be consistent to report changes in the fair values of our equity investments as different line items in the same financial statement? Please explain the measurement requirements of the relevant international financial reporting standard. Additionally, what difference does it make to Epsilon whether gains or losses are reported in other comprehensive income rather than as part of the profit or loss for the period? (7 marks)

Note 3 – Redundancy programmes

You will be aware that the board of directors met on 10 March 20X7 to discuss over-capacity in parts of the group. The decision was reluctantly taken to implement a programme of redundancies. The programme was to be implemented in two phases:

- Phase 1 involves 300 redundancies on 30 June 20X7. This phase of the programme was planned out in detail at the meeting on 10 March 20X7. The redundancy costs were calculated in some detail at the meeting and this first phase was made public to all affected parties on 25 March 20X7.
- Phase 2 involves 200 redundancies on 30 September 20X7. This phase of the programme was also planned out in detail at the meeting on 10 March. The redundancy costs were estimated at the meeting and this second phase was announced on 25 April 20X7.

The financial statements for the year ended 31 March 20X7 include a provision for the first phase of the redundancies but not the second phase. Both phases were agreed and the costs calculated at the same meeting. Surely both costs should be accounted for consistently? (5 marks)

Required:

Provide answers to the questions raised by your managing director. Your answers should refer to relevant provisions of International Financial Reporting Standards (IFRS® Standards).

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

(20 marks)

End of Question Paper