Diploma in International Financial Reporting

Tuesday 10 December 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.

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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 financial position of the three entities at 30 September 2013 were as follows:

	Alpha $'000	Beta $'000	Gamma $'000
ASSETS			
Non-current assets:			
Property, plant and equipment (Notes 1 and 3)	320,000	235,000	220,000
Intangible assets (Notes 1 and 4)	55,000	60,000	Nil
Investments (Notes 1 and 2)	322,000	Nil	Nil
	697,000	295,000	220,000
Current assets:			
Inventories (Note 5)	88,000	61,000	42,000
Trade receivables (Note 6)	65,000	49,000	38,000
Cash and cash equivalents	12,000	10,000	9,000
	165,000	120,000	89,000
Total assets	862,000	415,000	309,000
EQUITY AND LIABILITIES			
Equity			
Share capital ($1 shares)	195,000	150,000	120,000
Retained earnings	185,000	115,000	75,000
Other components of equity (Notes 2 and 3)	192,000	11,000	Nil
Total equity	572,000	276,000	195,000
Non-current liabilities:			
Long-term borrowings (Note 8)	170,000	54,000	50,000
Deferred tax	50,000	35,000	20,000
Total non-current liabilities	220,000	89,000	70,000
Current liabilities:			
Trade and other payables (Note 6)	48,000	45,000	34,000
Short-term borrowings	22,000	5,000	10,000
Total current liabilities	70,000	50,000	44,000
Total equity and liabilities	862,000	415,000	309,000

Note 1 – Alpha's investment in Beta

On 1 July 2012, Alpha acquired 120 million shares in Beta by means of a share exchange. The terms of the business combination were as follows:

– Alpha issued five shares for every six shares acquired in Beta. On 1 July 2012, the market value of an Alpha share was $2·40. This share issue has been correctly reflected in the financial statements of Alpha.
– Alpha will make a further cash payment of $50 million to the former shareholders of Beta on 30 June 2015. Alpha has made no entry in its financial statements in respect of this additional payment. At 1 July 2012, Alpha's credit rating was such that it could have borrowed funds at an annual interest rate of 10%.

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 July 2012 was $1·70 and can be used for this purpose.

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

– Retained earnings $98 million.
– Other components of equity $5 million (see Note 3 below).

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

– Plant and equipment having a carrying value of $120 million had an estimated market value of $130 million. The estimated future economic life of the plant and equipment at 1 July 2012 was four years and this estimate remains valid. Beta has disposed of 20% of this plant and equipment since 1 July 2012.
– Intangible assets with an estimated market value of $12 million had not been recognised in the individual financial statements of Beta. At 1 July 2012, the estimated future economic lives of these intangible assets was five 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 July 2012.

Note 2 – Alpha's investment in Gamma

On 1 October 2012, Alpha acquired 48 million shares in Gamma for a total cash payment of $80 million. This share purchase followed an agreement with two other investors (who each purchased 36 million shares in Gamma on 1 October 2012) to exercise joint control over Gamma. All key operating and financial policies, including the distribution of profits, require the unanimous consent of the three investors. 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 30 September 2013, the fair value of Alpha's investment in Gamma was $82 million. Alpha did not recognise any deferred tax in respect of this restatement to fair value. Therefore on 30 September 2013 Alpha credited $2 million to other components of equity.

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

– Retained earnings $66 million.
– Other components of equity $Nil

On 1 October 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.

You do not need to consider the deferred tax implications of Alpha's investment in Gamma when preparing the consolidated statement of financial position of the Alpha group.

Note 3 – Property, plant and equipment of Beta

Beta measures its land under the revaluation model. The other components of equity of Beta consist entirely of revaluation surpluses arising on the revaluation of its land. On 1 July 2012, the carrying value of Beta's land in Beta's own financial statements was the same as its fair value. On 30 September 2013, Beta revalued its land by $7·5 million. As a result of this revaluation, Beta recognised an additional deferred tax liability of $1·5 million and credited $6 million to other components of equity. The policy of Alpha and Gamma is to use the cost model to measure all property, plant and equipment. This is the policy to be adopted in the consolidated financial statements.

Note 4 – Intangible assets of Alpha and Beta

The intangible assets of Alpha comprise expenditure incurred during the year on a project to reduce wastage incurred during the group's production processes. The project began on 1 November 2012 and is expected to be complete by 31 May 2014. Expenditure to date has been $5 million each month. On 1 June 2013, the directors were able to assess the technical feasibility and commercial viability of the project with reasonable certainty. At this date they also received assurance that the economic benefits the project was likely to bring to the group were likely to exceed the total project costs.

The intangible assets in the individual financial statements of Beta represent goodwill which arose on acquisition of an unincorporated business in 2008. No impairment of this goodwill has been necessary since the date of acquisition of Beta by Alpha.

Note 5 – Inter-company sale of inventories

The inventories of Beta and Gamma at 30 September 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 6 – Trade receivables and payables

The trade receivables of Alpha included $8 million receivable from Beta and $7 million receivable from Gamma in respect of the purchase of components (see Note 5). The trade payables of Beta and Gamma included equivalent amounts payable to Alpha.

Note 7 – Forward currency contract

During July and August 2013 Alpha conducted a large marketing effort in Country X. The currency in Country X is the Euro. Alpha made no sales to customers in Country X in the year ended 30 September 2013 but is very confident of making substantial sales to such customers in the year ended 30 September 2014. On 5 September 2013, Alpha entered into a contract to sell €20 million for $28 million on 31 October 2013. Currency fluctuations in September 2013 were such that on 30 September 2013 the fair value of this currency contract was $1·1 million (a financial asset). 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 hedge accounting whenever permitted by International Financial Reporting Standards. Alpha expects sales to customers in Country X to be at least €22 million in October 2013.

Note 8 – Long-term borrowings

The long-term borrowings of Alpha include a loan at a carrying amount of $60 million which was taken out on 1 October 2012. The loan does not carry any interest but $75·6 million is repayable on 30 September 2015. This represents an effective annual rate of return for the investors of 8%. As an alternative to repayment, the investors can exchange their loan asset for equity shares in Alpha on 30 September 2015. The annual rate of return required by such investors on a non-convertible loan would have been 10%. Alpha has not charged any finance cost in respect of this loan for the year ended 30 September 2013.

The present value of $1 payable/receivable in three years' time is as follows:

– 79·4 cents when the discount rate is 8% per annum.
– 75·1 cents when the discount rate is 10% per annum.

Required:

Prepare the consolidated statement of financial position of Alpha at 30 September 2013.

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 2013 the following transactions occurred:

(a) On 1 April 2013, Delta subscribed for 40 million $1 loan notes in Epsilon. The loan notes were issued at 90 cents and under the terms of issue were redeemable at $1·20 on 31 March 2018. Interest is payable on 31 March in arrears at 4% of par value. This represents an effective annual rate of return for Delta of 9·9%. Delta's intention is to hold the loan notes until redemption. Until 31 October 2013 Epsilon was a successful company with a good reputation for settling all its liabilities on their due dates. However, due to an event which occurred on 31 October 2013, three of Epsilon's major customers became insolvent and this caused liquidity problems for Epsilon. During November 2013 Epsilon entered into negotiations with all its creditors, including Delta. Delta agreed to forego the interest payments due on 31 March 2014 and 2015, with the payments from 31 March 2016 onwards resuming as normal. (8 marks)

(b) On 1 June 2013, Delta decided to dispose of the trade and assets of a business it had acquired several years previously. This disposal does not involve Delta withdrawing from a particular market sector. The carrying values on 1 June 2013 of the assets to be disposed of were as follows:

	$m
Goodwill	10
Property, plant and equipment	20
Patents and trademarks	8
Inventories	15
Trade receivables	10
	63

Delta offered the business for sale at a price of $46·5 million, which was considered to be reasonably achievable. Delta estimated that the direct costs of selling the business would be $500,000. These estimates have not changed since 1 June 2013 and Delta estimates that the business will be sold by 31 March 2014 at the latest.

None of the assets of the business had suffered obvious impairment at 1 June 2013. At that date the inventories and trade receivables of the business were already stated at no more than their recoverable amounts. (7 marks)

(c) On 1 April 2013 Delta sold a property for $20 million. The carrying amount of the property was $23 million and its market value on 1 April 2013 was $25 million. On 1 April 2013, Delta entered into an agreement to lease the property on a five-year lease. On that date the useful economic life of the property was estimated at 25 years. Annual lease rentals of $1·8 million were payable on 1 April in advance. These rentals reflected the fact that the property had been sold at a price which was lower than its fair value. (5 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 30 September 2013. You do not need to quantify amounts which are only shown in the notes to the financial statements.

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)** When preparing financial statements it is important to ensure that the tax consequences of all transactions are appropriately recognised. IAS 12 – *Income Taxes* – prescribes the treatment of both current and deferred tax assets and liabilities.

Current tax is the amount of income tax payable or recoverable in respect of the taxable profit or tax loss for a period. Deferred tax is tax on temporary differences. A temporary difference is the difference between the carrying amount of an asset or liability and its tax base. A taxable temporary difference leads to a potential deferred tax liability and a deductible temporary difference leads to a potential deferred tax asset.

Required:

Explain how the tax base of both an asset and a liability is computed and state the general requirements of IAS 12 regarding the recognition of both deferred tax liabilities and deferred tax assets. You do not need to identify any of the exceptions to these general requirements which are set out in IAS 12. (5 marks)

(b) Kappa prepares consolidated financial statements to 30 September each year. During the year ended 30 September 2013 Kappa entered into the following transactions:

(i) On 1 October 2012, Kappa purchased an equity investment for $200,000. The investment was designated as fair value through other comprehensive income. On 30 September 2013, the fair value of the investment was $240,000. In the tax jurisdiction in which Kappa operates, unrealised gains and losses arising on the revaluation of investments of this nature are not taxable unless the investment is sold. Kappa has no intention of selling the investment in the foreseeable future. (5 marks)

(ii) On 1 August 2013, Kappa sold products to Omega, a wholly owned subsidiary operating in the same tax jurisdiction as Kappa, for $80,000. The goods had cost Kappa $64,000. By 30 September 2013, Omega had sold 40% of these goods, selling the remaining 60% in October and November 2013. (6 marks)

(iii) On 31 March 2013, Kappa received $200,000 from a customer. This payment was in respect of services to be provided by Kappa from 1 April 2013 to 31 January 2014. Kappa recognised revenue of $120,000 in respect of this transaction in the year ended 30 September 2013 and will recognise the remainder in the year ended 30 September 2014. Under the tax jurisdiction in which Kappa operates, the $200,000 received on 31 March 2013 was included in the taxable profits of Kappa for the year ended 30 September 2013. (4 marks)

Required:

Explain and show how the tax consequences (current and deferred) of the three transactions would be reported in the statement of financial position of Kappa at 30 September 2013 and its statement of profit or loss and other comprehensive income for the year ended 30 September 2013.

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

You should assume that:

– The rate of income tax in the jurisdiction in which Kappa operates is 25%.
– Both Kappa and Omega are profitable companies which consistently generate annual taxable profits of at least $1,000,000.

In answering this part, you do NOT need to consider the possible offset of deferred tax assets against deferred tax liabilities.

(20 marks)

4 Omega is a listed company which prepares financial statements in accordance with International Financial Reporting Standards (IFRS).

(a) On 1 October 2012, Omega purchased some land for \$10 million (including legal costs of \$1 million) in order to construct a new factory. Construction work commenced on 1 November 2012. Omega incurred the following costs in connection with its construction:

– Preparation and levelling of the land – \$300,000.
– Purchase of materials for the construction – \$6·08 million in total.
– Employment costs of the construction workers – \$200,000 **per month**.
– Overhead costs incurred directly on the construction of the factory – \$100,000 **per month**.
– Ongoing overhead costs allocated to the construction project using Omega's normal overhead allocation model – \$50,000 **per month**.
– Income received during the temporary use of the factory premises as a car park during the construction period – \$50,000.
– Costs of relocating employees to work at the new factory – \$300,000.
– Costs of the opening ceremony on 31 July 2013 – \$150,000.

The factory was completed on 31 May 2013 and production began on 1 August 2013. The overall useful life of the factory building was estimated at 40 years from the date of completion. However, it is estimated that the roof will need to be replaced 20 years after the date of completion and that the cost of replacing the roof at current prices would be 30% of the total cost of the building. At the end of the 40-year period Omega has a legally enforceable obligation to demolish the factory and restore the site to its original condition. The directors estimate that the cost of demolition in 40 years' time (based on prices prevailing at that time) will be \$20 million. An annual risk adjusted discount rate which is appropriate to this project is 8%. The present value of \$1 payable in 40 years' time at an annual discount rate of 8% is 4·6 cents.

The construction of the factory was partly financed by a loan of \$17·5 million taken out on 1 October 2012. The loan was at an annual rate of interest of 6%. During the period 1 October 2012 to 28 February 2013 (when the loan proceeds had been fully utilised to finance the construction), Omega received investment income of \$100,000 on the temporary investment of the proceeds.

Required:

Compute the carrying amount of the factory in the statement of financial position of Omega at 30 September 2013. You should explain your treatment of all the amounts referred to in this part in your answer.

(14 marks)

(b) On 1 October 2011 Omega granted share options to 200 senior executives. The options will vest on 30 September 2014 subject to the following conditions:

– Each executive will be entitled to 1,000 options if the cumulative profit in the three-year period from 1 October 2011 to 30 September 2014 exceeds \$30 million. If the cumulative profit for this period is between \$35 million and \$40 million, then 1,500 options will vest. If the cumulative profit for the period exceeds \$40 million, then 2,000 options will vest.
– If an executive leaves during the three-year vesting period, then that executive would forfeit any rights to share options.
– Notwithstanding the above, no options will vest unless the share price at 30 September 2014 exceeds \$5.

Details of the fair values of the shares and share options at relevant dates are as follows:

Date	Fair value of An Omega share	Fair value of One of the options
	\$	\$
1 October 2011	4.00	0.50
30 September 2012	4.40	0.60
30 September 2013	4.60	0.75

The estimate of the cumulative profit for the three-year period ending 30 September 2014 was revised each year as follows:

Date	Expected profit for the three-year period
	$m
1 October 2011	32
30 September 2012	39
30 September 2013	45

On 1 October 2011, none of the relevant executives were expected to leave in the three-year period from 1 October 2011 to 30 September 2014 and none left in the year ended 30 September 2012. However, 10 executives left unexpectedly on 30 June 2013. None of the other executives are expected to leave before 30 September 2014.

Omega correctly reflected this arrangement in its financial statements for the year ended 30 September 2012.

Required:

Prepare relevant extracts from the statement of financial position of Omega at 30 September 2013 and its statement of profit or loss and other comprehensive income for the year ended 30 September 2013. You should give appropriate explanations to support your extracts. (6 marks)

(20 marks)

End of Question Paper