Diploma in International Financial Reporting

Friday 9 December 2016

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.

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1 Alpha holds investments in two entities, Beta and Gamma. The draft statements of financial position of the three entities at 30 September 2016 were as follows:

	Alpha	Beta	Gamma
	$'000	$'000	$'000
Assets			
Non-current assets:			
Property, plant and equipment (Notes 1 and 3)	524,000	370,000	162,000
Investments (Notes 1 and 3)	423,000	Nil	Nil
	947,000	370,000	162,000
Current assets:			
Inventories	120,000	75,000	60,000
Trade receivables (Note 4)	90,000	66,000	55,000
Cash and cash equivalents	15,000	12,000	10,000
	225,000	153,000	125,000
Total assets	1,172,000	523,000	287,000
Equity and liabilities			
Equity			
Share capital ($1 shares)	140,000	100,000	80,000
Retained earnings (Notes 1 and 3)	573,000	210,000	90,000
Other components of equity (Notes 1 and 3)	250,000	10,000	Nil
Total equity	963,000	320,000	170,000
Non-current liabilities:			
Provisions (Note 5)	1,250	Nil	Nil
Long-term borrowings	82,750	90,000	48,000
Deferred tax	45,000	28,000	30,000
Total non-current liabilities	129,000	118,000	78,000
Current liabilities:			
Trade and other payables	60,000	50,000	30,000
Short-term borrowings	20,000	35,000	9,000
Total current liabilities	80,000	85,000	39,000
Total equity and liabilities	1,172,000	523,000	287,000

Note 1 – Alpha's investment in Beta

On 1 October 2013, Alpha acquired 80 million shares in Beta by means of a share exchange of one share in Alpha for every two shares acquired in Beta. On 1 October 2013, the market value of an Alpha share was $7·00.

Alpha incurred directly attributable due diligence costs of $3 million on acquisition of Beta. The directors of Alpha included these acquisition costs in the carrying amount of the investment in Beta in the draft statement of financial position of Alpha. There has been no change to the carrying amount of this investment in Alpha's own statement of financial position since 1 October 2013.

On 1 October 2013, the individual financial statements of Beta showed the following balances:

– Retained earnings $150 million.
– Other components of equity $5 million.

The directors of Alpha carried out a fair value exercise to measure the identifiable assets and liabilities of Beta at 1 October 2013. The following matters emerged:

– Property having a carrying amount of $160 million (land component $70 million, buildings component $90 million) had an estimated fair value of $200 million (land component $80 million, buildings component $120 million). The buildings component of the property had an estimated useful life of 30 years at 1 October 2013.
– 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 October 2013 was four years. None of this plant and equipment had been disposed of between 1 October 2013 and 30 September 2016.
– On 1 October 2013, the notes to the financial statements of Beta disclosed a contingent liability. On 1 October 2013, the fair value of this contingent liability was reliably measured at $6 million. The contingency was resolved in the year ended 30 September 2014 and no payments were required to be made by Beta in respect of this contingent liability.
– 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%.

The directors of Alpha used the proportion of net assets method when measuring the non-controlling interest in Beta in the consolidated statement of financial position.

Note 2 – Impairment review of goodwill on acquisition of Beta

No impairment of the goodwill on acquisition of Beta was evident when the reviews were carried out on 30 September 2014 and 2015. On 30 September 2016, the directors of Alpha carried out a further review and concluded that the recoverable amount of the net assets of Beta at that date was $400 million. Beta is regarded as a single cash generating unit for the purpose of measuring goodwill impairment.

Note 3 – Alpha's investment in Gamma

On 1 October 2015, Alpha acquired 60 million shares in Gamma by means of a cash payment of $140 million. The purchase agreement provided for an additional payment on 31 October 2017 to the former holders of the 60 million acquired shares. The amount of this additional payment is dependent on the financial performance of Gamma in the two-year period from 1 October 2015 to 30 September 2017. On 1 October 2015, the fair value of this additional payment was estimated to be $20 million. This estimate was revised to $24 million on 30 September 2016. Alpha has not made any entries in its draft financial statements to record this potential additional payment.

On 1 October 2015, the individual financial statements of Gamma showed a balance on retained earnings of $75 million.

On 1 October 2015, the fair values of the net assets of Gamma were the same as their carrying amounts with the exception of some land which had a carrying amount of $50 million and a fair value of $70 million. This land continued to be an asset of Gamma at 30 September 2016. The fair value adjustment has not been reflected in the individual financial statements of Gamma. In the consolidated financial statements the fair value adjustment will be regarded as a temporary difference for the purposes of computing deferred tax. The rate of deferred tax to apply to temporary differences is 20%.

No impairment issues arose concerning the measurement of Gamma in the consolidated statement of financial position of Alpha at 30 September 2016.

The directors of Alpha used the full goodwill (fair value) method when measuring the non-controlling interest in Gamma in the consolidated statement of financial position. On 1 October 2015, the fair value of a share in Gamma was $2·30.

Note 4 – Trade receivables and payables

Group policy is to clear intra-group balances on a given date prior to each year end. Beta complied with this policy at 30 September 2016 but Gamma was late in making the required payment of $10 million to Alpha. The payment was made by Gamma on 29 September 2016 and received and recorded by Alpha on 2 October 2016.

Note 5 – Provision

On 1 October 2015, Alpha completed the construction of a non-current asset with an estimated useful life of 20 years. The costs of construction were recognised in property, plant and equipment and depreciated appropriately. Alpha has a legal obligation to restore the site on which the non-current asset is located on 30 September 2035. The estimated cost of this restoration work, at 30 September 2035 prices, is $25 million. The directors of Alpha have made a provision of $1·25 million (1/20 x $25 million) in the draft statement of financial position at 30 September 2016. An appropriate annual discount rate to use in any relevant calculations is 6% and at this rate the present value of $1 payable in 20 years is 31·2 cents.

Required:

Prepare the consolidated statement of financial position of Alpha at 30 September 2016. You need only consider the deferred tax implications of any adjustments you make where the question specifically refers to deferred tax.

(40 marks)

2 Delta is an entity which prepares financial statements to 30 September each year. The financial statements for the year ended 30 September 2016 are shortly to be authorised for issue. The following events are relevant to these financial statements:

(a) On 1 October 2014, Delta purchased an asset for $20 million. The estimated useful life of the asset was 10 years, with an estimated residual value of zero. Delta immediately leased the asset to Epsilon. The lease term was 10 years and the annual rental, payable in advance by Epsilon, was $2,787,000. Delta incurred direct costs of $200,000 in arranging the lease. The lease contained no early termination clauses and responsibility for repairs and maintenance of the asset rest with Epsilon for the duration of the lease. The directors of Delta correctly computed the annual rate of interest implicit in the lease as 8%. At an annual discount rate of 8% the present value of $1 receivable at the start of years 1–10 is $7·247. (8 marks)

(b) On 1 September 2016, Delta sold a product to Customer X. Customer X is based in a country whose currency is the florin and Delta has a large number of customers in that country to whom Delta sell similar products. The invoiced price of the product was 500,000 florins. The terms of the sale gave the customer the right to return the product at any time in the two-month period ending on 31 October 2016. On 1 September 2016, Delta estimated that there was a 22% chance the product would be returned during the two-month period. The product had not been returned to Delta by 15 October 2016 (the date the financial statements for the year ended 30 September 2016 were authorised for issue). On 15 October 2016, the directors estimated that there was an 8% chance the product would be returned before 31 October 2016. The directors of Delta considered that the most reliable method of measuring the price for this transaction was to estimate any variable consideration using a probability (expected value) approach. Exchange rates (florins to $1) are as follows:

- 1 September 2016 – 2 florins to $1.
- 30 September 2016 – 2·1 florins to $1.
- 15 October 2016 – 2·15 florins to $1.
- 31 October 2016 – 2·2 florins to $1. (7 marks)

(c) On 1 October 2014, Delta granted 250 share appreciation rights to 100 senior executives. The rights vest on 30 September 2017 provided the executives remain with Delta for the three-year period from 1 October 2014 to 30 September 2017. The rights can be exercised from 30 November 2017 to 31 December 2017. On 1 October 2014, it was expected that 10 executives would leave over the three-year period from 1 October 2014 to 30 September 2017. This estimate was confirmed on 30 September 2015 but two executives left unexpectedly during the year ended 30 September 2016 and Delta now expects that 12 executives will leave over the three-year period ending on 30 September 2017. Delta further estimated that all executives who were eligible to exercise the rights would do so. On 1 October 2014, the fair value of a share appreciation right was $3·20. The fair value increased to $3·50 by 30 September 2015 and to $3·60 by 30 September 2016. (5 marks)

Required:

Explain and show how the three events would be reported in the financial statements of Delta for the year ended 30 September 2016.

Notes:
1. **The mark allocation is shown against each of the three events above.**
2. **In explaining event (b), you do not need to consider the impact on inventory and cost of sales.**

(20 marks)

3 **(a)** One of the matters addressed in IFRS 9 – *Financial Instruments* is the initial and subsequent measurement of financial assets. IFRS 9 requires that financial assets are initially measured at their fair value at the date of initial recognition. However, subsequent measurement of financial assets depends on their classification for which IFRS 9 identifies three possible alternatives.

Required:

Explain the three classifications which IFRS 9 identifies for financial assets and the basis of measurement which is appropriate for each classification. You should also identify any exceptions to the normal classifications which may apply in specific circumstances. (8 marks)

(b) Kappa prepares financial statements to 30 September each year. During the year ended 30 September 2016 Kappa entered into the following transactions:

(i) On 1 October 2015, Kappa made an interest free loan to an employee of $800,000. The loan is due for repayment on 30 September 2017 and Kappa is confident that the employee will repay the loan. Kappa would normally require an annual rate of return of 10% on business loans (5 marks)

(ii) On 1 October 2015, Kappa made a three-year loan of $10 million to entity X. The rate of interest payable on the loan was 8% per annum, payable in arrears. On 30 September 2018, Kappa will receive a fixed number of shares in entity X in full settlement of the loan. Entity X paid the interest due of $800,000 on 30 September 2016 and entity X has no liquidity problems. Following payment of this interest, the fair value of this loan asset at 30 September 2016 was estimated to be $10·5 million. (4 marks)

(iii) On 1 October 2015, Kappa purchased an equity investment in entity Y for $12 million. The investment did not give Kappa control or significant influence over entity Y but the investment is seen as a long-term one. On 30 September 2015, the fair value of Kappa's investment in entity Y was estimated to be $13 million. (3 marks)

Required:

Explain and show how the above transactions would be reported in the financial statements of Kappa for the year ended 30 September 2016.

Note: The mark allocation for part (b) is shown against each of the three transactions 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). You have recently produced the final draft of the financial statements for the year ended 30 September 2016 and these are due to be published shortly. The managing director, who is not an accountant, reviewed these financial statements and prepared a list of queries arising out of the review.

Query One

One of the notes to the financial statements gives details of purchases made by Omega from entity X during the period. I own 100% of the shares in entity X but I do not understand why it is necessary for any disclosure whatsoever to be made in the Omega financial statements. The transaction is carried out on normal commercial terms and is totally insignificant to Omega, representing less than 1% of Omega's purchases. (5 marks)

Query Two

The notes to the financial statements say that plant and equipment is held under the 'cost model'. However, property which is owner occupied is revalued annually to fair value. Changes in fair value are sometimes reported in profit or loss but usually in 'other comprehensive income'. Also, the amount of depreciation charged on plant and equipment as a percentage of its carrying amount is much higher than for owner occupied property. Another note says that property we own but rent out to others is not depreciated at all but is revalued annually to fair value. Changes in value of these properties are always reported in profit or loss. I thought we had to be consistent in our treatment of items in the accounts. Please explain how all these treatments comply with relevant reporting standards. (7 marks)

Query Three

As you know, in the year to September 2016 we spent considerable sums of money designing a new product. We spent the six months from October 2015 to March 2016 researching into the feasibility of the product. We charged these research costs to profit or loss. From April 2016, we were confident that the product would be commercially successful and we fully committed ourselves to financing its future development. We spent most of the rest of the year developing the product, which we will begin to sell in the next few months. These development costs have been recognised as intangible assets in our statement of financial position. How can this be right when all these research and development costs are design costs? Please justify this with reference to relevant reporting standards.

(5 marks)

Query Four

On reviewing our financial statements, I found a note giving information about the different segments of our business and also the disclosure of the earnings per share of our entity. Neither the segment note nor the earnings per share disclosure appears in the financial statements of entity X (see query 1 above). Even though entity X is unlisted, both entities report under full International Financial Reporting Standards so I do not understand how this difference can occur. Please explain this to me. (3 marks)

Required:

Provide answers to the queries raised by the managing director.

Note: The mark allocation is shown against each of the four queries above.

(20 marks)

End of Question Paper