Diploma in International Financial Reporting

Tuesday 11 December 2012

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.

Dip IFR

The Association of Chartered Certified Accountants

ACCA

ALL FOUR questions are compulsory and MUST be attempted

1 The statements of comprehensive income of Alpha, Beta and Gamma for the year ended 30 September 2012 are given below:

Statements of comprehensive income

	Alpha $'000	Beta $'000	Gamma $'000
Revenue	240,000	150,000	120,000
Cost of sales	(190,000)	(110,000)	(70,000)
Gross profit	50,000	40,000	50,000
Distribution costs	(7,000)	(6,000)	(8,000)
Administrative expenses	(10,000)	(7,000)	(8,000)
Profit from operations	33,000	27,000	34,000
Investment income	15,300	Nil	Nil
Finance cost	(8,000)	(4,900)	(7,300)
Profit before tax	40,300	22,100	26,700
Income tax expense	(10,100)	(6,000)	(6,700)
Net profit for the period	30,200	16,100	20,000
Other comprehensive income	4,000	Nil	Nil
Total comprehensive income	34,200	16,100	20,000

Note 1 – Purchase of shares in Beta

On 1 October 2011, Alpha purchased 80% of the equity shares of Beta. The purchase consideration was as follows:

– Alpha issued 32 million shares to the shareholders of Beta. The market price of an Alpha share on 1 October 2011 was $2·50.

– Alpha agreed to make an additional payment of $30 million to the shareholders of Beta on 30 September 2013. This payment was contingent on the post-acquisition profits of Beta reaching a specified level in the two-year period ending on 30 September 2013. The directors of Alpha assessed that the fair value of this contingent consideration was $20 million on 1 October 2011 and debited $20 million to the cost of investment in Beta. They reassessed the fair value of the contingent consideration at $22 million on 30 September 2012. The increase in the fair value of the contingent consideration was caused by the better than expected performance of Beta in the post-acquisition period. The directors of Alpha made no change to the carrying value of the cost of investment in Beta as a result of this reassessment.

– Alpha incurred incremental legal and professional fees of $1·5 million in connection with the acquisition of Beta and debited these costs to the cost of investment in Beta. $500,000 of this amount related to the costs of issuing the Alpha shares.

Note 2 – Fair value exercise

The directors of Alpha carried out a fair value exercise on the net assets of Beta on 1 October 2011. On 1 October 2011, the equity of Beta as shown in its own financial statements was $88 million. The fair values of the net assets of Beta were the same as their book values with the exception of:

– Plant and equipment that had a book value of $80 million and a fair value of $84 million. The estimated remaining useful economic life of this plant and equipment was two years at 1 October 2011. Depreciation of plant and equipment is charged to cost of sales.

– An intangible asset that had a fair value of $6 million but was not recognised by Beta because it was internally developed. The useful life of this asset was estimated at 18 months from 1 October 2011. Amortisation of intangible assets is charged to cost of sales.

– Inventory that had a book value of $3 million and a fair value of $3·2 million. All this inventory was sold in the year ended 30 September 2012.

– The fair value adjustments are temporary differences that attract deferred tax at a rate of 25%.

Note 3 – Basis of measurement of non-controlling interests

It is the policy of Alpha to measure non-controlling interests based on their fair value at the date of acquisition. The estimated fair value of the non-controlling interest in Beta at 1 October 2011 was $20 million.

Note 4 – Other information regarding Beta

– On 1 October 2011, Alpha made a loan of $40 million to Beta at a fixed annual interest rate of 5%. Both Alpha and Beta have correctly accounted for the interest on this loan in their individual statements of comprehensive income.
– On 31 March 2012, Beta paid a dividend of $10 million to its equity shareholders.

Note 5 – Impairment review

On 30 September 2012, the directors of Alpha reviewed the goodwill on acquisition of Beta for impairment. They measured the recoverable amount of Beta (as a single cash-generating unit) at $118 million at that date. Impairment of goodwill is charged to cost of sales.

Note 6 – Purchase of shares in Gamma

– On 1 January 2012, Alpha and another investor both purchased 50% of the equity capital of Gamma for a cash payment of $50 million. These investments enabled the two investors to jointly control Gamma.
– On 31 March 2012, Gamma paid a dividend of $10 million to its equity shareholders.
– The recoverable amount of the investment in Gamma by Alpha was estimated at $50 million on 30 September 2012.
– Ignore the deferred tax implications of the investment in Gamma.

Note 7 – Inter-company sales

Alpha supplies products used by Beta and Gamma. Sales of the products to Beta and Gamma during the year ended 30 September 2012 were as follows (all sales were made at a profit margin of 20%):

– Sales to Beta $25 million.
– Sales to Gamma (all since 1 January 2012) $12 million.

At 30 September 2012, the inventories of Beta and Gamma included the following amounts in respect of goods purchased from Alpha. Ignore the deferred tax implications of the inter-company sales to Beta and Gamma.

	$'000
Beta	5,000
Gamma	4,000

Note 8 – Share based payments

On 1 October 2011, Alpha granted 1,000 senior employees 2,500 share options each, provided they remained as employees for the two years ending 30 September 2013. On 1 October 2011, the fair value of one share option was $5 and this had increased to $5·40 by 30 September 2012. On 1 October 2011, the directors estimated that 950 employees would qualify for these options. At 30 September 2012, this estimate was 960 employees. Ignore the deferred tax implications of this transaction.

Note 9 – Other comprehensive income of Alpha

On 1 September 2011, Alpha entered into a contract to sell €60 million for $85 million. This contract was to hedge against an expected sales receipt from a customer on 31 January 2012 that was denominated in €. On 30 September 2011, the contract was a financial asset with a fair value of $1 million. Alpha designated the contract as a cash-flow hedge of the expected future sales in € and credited $1 million to other comprehensive income in the year ended 30 September 2011. On 31 January 2012, the sales in € were made to the customer and the customer paid for the goods on that date. On 31 January 2012, the fair value of the contract to sell €60 million for $85 million was $5 million. Therefore Alpha credited a further $4 million to other comprehensive income and recorded the sales revenue at €60 million, translated at the spot rate of exchange on that date.

Note 10 – Investment by Alpha in Zeta

On 1 October 2011, Alpha purchased 100,000 equity shares in Zeta for $10 per share. The investment did not give Alpha control or significant influence over Zeta and was designated by Alpha as fair value through other comprehensive income. Alpha incurred transaction costs of $50,000 which it recorded as part of its finance costs. During the period Alpha received a dividend of $2 per share from Zeta and at 30 September 2012 the fair value of a Zeta share was $11. Alpha recorded both the dividend and the increase in fair value of its holding as investment income. Ignore the deferred tax implications of this transaction.

Required:

Prepare the consolidated statement of comprehensive income for Alpha for the year ended 30 September 2012.

(40 marks)

2 You are the financial controller of Delta. Your assistant is preparing the first draft of the financial statements for the year ended 30 September 2012. He has a reasonable general accounting knowledge but is not familiar with the detailed requirements of all relevant international financial reporting standards. There are three issues on which he requires your advice and he has sent you a memorandum as shown below:

(a) On 1 October 2011, we lent \$2 million to a supplier in order to assist them with their expansion plans. The loan cost us \$100,000 to arrange, so I guess we need to charge \$100,000 as a cost in the current year? We agreed not to charge interest on this loan to help our supplier's short-term cash flow but expected the supplier to repay \$2·4 million on 30 September 2013. This will mean we can't take any profit this year but there will be a nice bonus next year when we receive repayment. I was told by the finance department that the effective annual rate of interest on this loan is 6·9%. I don't understand the relevance of this information as no interest is payable.

Just before the year end, I heard from the customer that the poor economic climate has caused them significant problems and in order to help them we agreed to reduce the amount repayable by them on 30 September 2013 to \$2·2 million. This still means we will report a profit next year though, doesn't it? (7 marks)

(b) On 1 October 2010, we bought a large machine for \$20 million. This machine has an estimated useful life of eight years, but will need a substantial overhaul on 30 September 2014 in order to enable it to be used for the final four years of its estimated life. This overhaul is likely to cost \$4 million, based on prices prevailing at 1 October 2010. If the overhaul occurs, the machine is expected to have a reasonable resale value at the end of its useful life. On 1 October 2010, the estimated residual value of the machine was \$1 million. On 30 September 2011, this estimate was revised to \$1·1 million and on 30 September 2012, the estimate was revised to \$1·2 million. For some reason we didn't charge depreciation on this asset in the year to 30 September 2011. I think this was a mistake, so I suppose I should correct this by charging two years depreciation in the current year? (8 marks)

(c) During the year ended 30 September 2012, we provided consultancy services to a customer regarding the installation of a new production system. The system has caused the customer considerable problems, so the customer has taken legal action against us for the loss of profits that has arisen as a result of the problems with the system. Our legal department considers that there is a 25% chance the claim can be successfully defended, but a 75% chance that we will be required to pay damages of \$1·6 million. We shouldn't suffer any overall loss because our legal people also tell me they are reasonably confident we are covered by insurance against these types of loss. We'll make a claim as soon as the outcome of the case is confirmed. I assume nothing needs to be provided for here because we are covered but do I need any note disclosures? (5 marks)

Required:

Draft a reply to the questions raised by your assistant. Your reply should include any additional explanations you consider relevant. In all cases, you should compute the impact on the reported earnings for the year ended 30 September 2012

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

(20 marks)

3 **(a)** Revenue is often the largest single amount appearing in the financial statements of an entity. In some circumstances the timing of recognition of revenue, and the measurement of its amount, can be extremely subjective. IAS 18 – *Revenue* – was published to provide guidance regarding this issue.

Required:

Explain, with regard to the guidance in IAS 18:

(i) **The criteria that need to be satisfied before revenue from the sale of goods can be recognised;** (3 marks)

(ii) **The ADDITIONAL criterion that applies to the recognition of revenue from the rendering of services;** (1 mark)

(iii) **The basis on which revenue is measured.** (2 marks)

(b) Epsilon prepares financial statements to 30 September each year. During the year ended 30 September 2012, the following transactions occurred:

(i) On 1 August 2012, Epsilon supplied motor vehicles it had manufactured to a car dealer. The normal selling price of the vehicles was $400,000 but Epsilon did not invoice the dealer at the date the vehicles were supplied, and Epsilon retained legal title to the vehicles. The terms of the transaction were that Epsilon would invoice the dealer, and transfer legal title to the vehicles, at the earlier of the date the dealer found a buyer for the vehicles or 31 January 2013. The invoiced amount would be selling price at the date of delivery plus a display charge of 1% per month (or part month) the vehicles were displayed by the dealer before they assumed legal ownership. The dealer has the right to return the vehicles to Epsilon at any time in the six months immediately following transfer, provided the vehicles are in good condition. In these circumstances, the dealer would have to pay the appropriate display charge plus an early return penalty of 50% of the normal selling price of the returned vehicle at the date of original supply by Epsilon. The dealer is responsible for any loss of, or damage to, the vehicles during the display period. On 31 August 2012, the dealer sold 25% of the vehicles supplied by Epsilon and accordingly Epsilon invoiced an amount of $101,000. The dealer paid this amount on 30 September 2012. On 30 September 2012, the dealer sold a further 20% of the supplied vehicles and Epsilon invoiced an amount of $81,608. The dealer has an established record of settling invoices by the due date for payment. (7 marks)

(ii) Epsilon provides consultancy advice to other firms in the motor industry. On 1 April 2012, Epsilon signed a contract to supply 50 days of consultancy advice to a customer over the two-year period ending on 31 March 2014. The contract required Epsilon to submit to six-monthly audits to ensure that the performance conditions in the contract had been adhered to in the immediately preceding six months. The first six-monthly audit was carried out shortly after 30 September 2012, and this confirmed that Epsilon had satisfactorily supplied 15 days of advice in the six-month period ending on that date. The total contract price was $1·5 million payable on 31 March 2014. Epsilon has strong budgetary control systems in place and is able to accurately forecast the costs incurred in delivering the consultancy. The customer has a good record of making payments when they fall due. An appropriate rate of interest to impute to this project would be 15% **for an 18-month period**. (7 marks)

Required:

For both transactions compute:

The total amount of revenue Epsilon should recognise in the year ended 30 September 2012.
The amount and nature of any assets relating to the transaction at 30 September 2012.

Your answer should include appropriate explanations to support your figures.

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

(20 marks)

4 Omega prepares financial statements under International Financial Reporting Standards. In the year ended 30 September 2012, the following events occurred:

(a) On 1 July 2012, Omega decided to sell one of its divisions as a going concern following a recent change in its geographical focus. The proposed sale would involve the buyer acquiring the non-monetary assets (including goodwill) of the division, with Omega collecting any outstanding trade receivables relating to the division and settling any current liabilities.

On 1 July 2012, the carrying amounts of the relevant assets of the division were as follows:

– Purchased goodwill $600,000.
– Property, plant and equipment (average remaining estimated useful life two years) $2 million.
– Inventories $1 million.

From 1 July 2012, Omega began to actively market the division and has received a number of serious enquiries. On 1 July 2012, the directors estimated that they would receive $3·2 million from the sale of the division. Since 1 July 2012, market conditions have improved and on 31 October 2012 Omega received and accepted a firm offer to purchase the division for $3·3 million. The sale is expected to be completed on 31 December 2012. $3·3 million can be assumed to be a reasonable estimate of the value of the division on 30 September 2012. During the period from 1 July 2012 to 30 September 2012, inventories of the division costing $800,000 were sold for $1,200,000. At 30 September 2012, the total cost of the inventories of the division was $900,000. All of these inventories have an estimated net realisable value that is in excess of their cost.

Required:

Show how the proposed sale of the division will be reported in the financial statements of Omega for the year ended 30 September 2012, giving relevant explanations where appropriate. You should indicate the extent to which relevant transactions and balances need to be separately disclosed and when the separate disclosures can be made in the notes, rather than in the primary financial statements themselves.

(12 marks)

(b) On 1 January 2012, Omega entered into an operating lease for a piece of land on which it intended to construct a factory. The lease was for a 30-year period and was correctly assessed by Omega to be an operating lease. The lease rentals were $500,000 per half-year, payable in arrears. There was a surplus of supply of land for leasing on 1 January 2012 and so the lessor made a payment of $1·2 million to Omega on 1 January 2012 as an incentive to enter into the lease agreement.

On 1 January 2012, Omega began to construct a factory and borrowed $10 million to finance the construction. The effective rate of interest on the borrowing was 8% per annum, before tax. Omega actually spent $10·6 million on the construction materials but of this amount, $800,000 was on materials that were damaged before they were used and had to be destroyed.

The factory took six months to construct and the construction team were paid at a total amount of $750,000 per month throughout the construction period. The factory was ready for use on 1 July 2012 but production did not begin until 1 September 2012.

Required:

Show the effect of the lease of the land, and the subsequent construction of the factory, on the financial statements of Omega for the year ended 30 September 2012 (statement of financial position and statement of comprehensive income), giving relevant explanations where appropriate. (8 marks)

(20 marks)

End of Question Paper