Diploma in International Financial Reporting

MONDAY 8 DECEMBER 2003

QUESTION PAPER

Time allowed **3 hours**

This paper is divided into four sections

Section A	This ONE question is compulsory and MUST be answered
Section B	THREE questions ONLY to be answered

Section A – This ONE question is compulsory and MUST be attempted

1 Hoedown, a public company, acquired 80% of Sundown's $1 ordinary shares on 1 October 2001 paying $2·50 per share. The balance on Sundown's accumulated profits at that date was $600,000. On 1 April 2003, Hoedown acquired a 50% interest in Jennivere's $1 ordinary shares. This company had been a wholly owned subsidiary of Rumba, but will now be operated as a joint venture. Hoedown settled the consideration for Jennivere by a share exchange of 4 shares in Hoedown for 5 shares in Jennivere. At the date of the share exchange Hoedown's share price was $5. The exchange has not yet been recorded by Hoedown. The balance sheets of the three companies at 30 September 2003 are shown below:

	Hoedown		Sundown		Jennivere	
Non-current assets	$000	$000	$000	$000	$000	$000
Property, plant and equipment		8,400		2,630		2,000
Investments		4,000		350		nil
		12,400		2,980		2,000
Current assets						
Inventory	750		580		760	
Accounts receivable	370		440		300	
Bank	120	1,240	nil	1,020	240	1,300
Total assets		13,640		4,000		3,300
Equity and liabilities						
Capital and reserves:						
Ordinary shares of $1 each		2,000		1,500		1,000
Reserves:						
Share premium	1,200		500		700	
Accumulated profits b/f	8,100		900		500	
Profit (loss) period	1,500	10,800	(300)	1,100	600	1,800
		12,800		2,600		2,800
Non-current liabilities						
Deferred tax		400		200		100
Current liabilities						
Accounts payable	260		940		220	
Taxation	180		190		180	
Overdraft	nil	440	70	1,200	nil	400
Total equity and liabilities		13,640		4,000		3,300

The following information is relevant:

(i) Fair value adjustments:

On 1 October 2001 Sundown owned an investment property that had a fair value of $150,000 in excess of its carrying value. Sundown uses the cost model in IAS 40 'Investment Property', but the group policy is to use the fair value model. The fair value of this property at 30 September 2003 had increased by a further $40,000 since the acquisition of Sundown.

The fair value of Jennivere's property, plant and equipment at the date of acquisition was $500,000 in excess of its book value. Additional depreciation based on the fair value for the period from 1 April 2003 to 30 September 2003 is $100,000.

There were no other fair value differences.

(ii) In August 2003 Hoedown sold goods to Jennivere for $200,000. These were transferred at a mark up of 25% on cost. Half of these goods were still in the inventory of Jennivere at 30 September 2003.

(iii) The deferred tax of Sundown requires an adjustment for a reduction of $400,000 in the tax base of the company's assets over the carrying value of its net assets for the current year. The appropriate rate of income tax is 25%.

(iv) At 30 September 2003 there were no intra-group current account balances.

(v) The group accounting policy for goodwill is to write it off on a straight-line basis over a period of 5 years, with a proportionate charge where it arises part way through an accounting period.

(vi) Hoedown uses the **benchmark treatment** (proportional consolidation) in IAS 31 'Financial Reporting of Interest in Joint Ventures' to account for jointly controlled entities. It uses a combined line-by-line format to achieve this.

(vii) Hoedown uses the **allowed alternative treatment** in IAS 22 'Business Combinations' to allocate the cost of acquisition.

Required

Prepare the consolidated balance sheet of Hoedown as at 30 September 2003, showing all necessary workings.

(25 marks)

Section B – THREE questions ONLY to be attempted

2 The following figures have been extracted from the accounting records of Lavalamp on 30 September 2003:

	$000	$000
Sales revenue		112,500
Cost of sales (note (i))	78,300	
Operating expenses	11,400	
Lease rentals (note (iii))	2,000	
Loan interest paid	1,000	
Dividends paid	1,200	
Leasehold (20 years) factory at cost (note (ii))	25,000	
Plant and equipment at cost	34,800	
Depreciation 1 October 2002 – leasehold		6,250
– plant and equipment		12,400
Accounts receivable	25,550	
Inventory – 30 September 2003	21,800	
Cash and bank		4,000
Accounts payable		7,300
Ordinary shares of $1 each		20,000
Share premium		10,000
8% Loan note (issued in 2000)		25,000
Accumulated profits – 1 October 2002		3,600
	201,050	201,050

The following notes are relevant:

(i) Lavalamp has spent $6 million (included in the cost of sales) during the year developing and marketing a new brand of soft drink called Lavaflow. Of this amount $1 million is for advertising and the remainder is the development costs. A firm of consultants has been reviewing the sales of the new product and based on this, it has valued the brand name of Lavaflow at $10 million and expects the life of the brand to be 10 years. Lavalamp wishes to capitalise the maximum amount of intangible assets permitted under International Financial Reporting Standards.

(ii) Due to a sharp increase in the values of properties, Lavalamp had its leasehold property revalued on 1 October 2002 with the intention of restating its carrying value. A firm of surveyors contracted to value the property found that it had suffered some damage which will cost $1·5 million to rectify. They gave a valuation of $24 million for the property on the assumption that the repairs are carried out. Lavalamp has informed Capitalrent, the owner of the property, of the repairs needed. Capitalrent has since sent their own surveyors to inspect the property and have informed Lavalamp that they believe the damage is due to the type of machinery being used in the building and accordingly have requested that Lavalamp pay for the repairs. Lavalamp has taken professional advice on this matter which concluded that the property was not in good condition when it was originally leased, but the use of the plant is making the damage worse. Lavalamp has offered to share the cost of the repairs with Capitalrent, but it has not yet had a reply.

(iii) Included in the income statement charge of $2 million for lease rentals is a payment of $600,000 in respect of a five-year lease of an item of plant (requiring ten payments in total). The payment was made on 1 April 2003. The fair value of this plant at the date it was leased (1 April 2003) was $5 million. Information obtained from the finance department confirms that this is a finance lease with an implicit interest rate of 10% per annum. The company depreciates plant used under finance leases on a straight-line basis (with time apportionment) over the life of the lease. Other plant is depreciated at 20% per annum on cost. The remaining payments were confirmed as being for operating leases of office equipment.

(iv) A provision for income tax for the year to 30 September 2003 of $3,470,000 is required.

(v) Lavalamp made and accounted for a rights issue on 1 October 2002 of 1 new share for every 4 held at a price of $1·60 per share. The issue was fully subscribed.

Required:

Prepare the financial statements for the year to 30 September 2003 for Lavalamp in accordance with International Financial Reporting Standards as far as the information permits. They should include:

(a) An Income Statement; (10 marks)

(b) A Statement of Changes in Equity; and (4 marks)

(c) A Balance Sheet. (11 marks)

(25 marks)

Other than for item (ii) above, notes to the financial statements are NOT required, nor is a calculation of earnings per share. Ignore deferred tax.

3 **(a)** Hamlet, a publicly listed company, is preparing its financial statements to 30 September 2003. In previous years it has chosen to write off all of its development expenditure even where management have been confident that the related projects would be profitable. The company is aware that development expenditure meeting the definition of an intangible asset in IAS 38 'Intangible Assets' should be capitalised. In the near future Hamlet intends to prepare its financial statements under International Financial Reporting Standards and as a step towards this, the management of Hamlet are to change their accounting policy for development expenditure for the current year to comply with IAS 38. Reproduced below are details of Hamlet's development expenditure for the relevant years. For the purpose of implementing the new policy management consider four years to be an appropriate amortisation period for all development expenditure. Amortisation should commence in the year following initial capitalisation.

		$ million
Amounts written off in year to 30 September:	1999	500
	2000	400
	2001	900
	2002	640
	2003	720

No development expenditure occurred in any year prior to 30 September 1999. The accumulated profit of Hamlet at 1 October 2001 was $2,500 million. You may assume that the above development expenditure meets the definition of a recognisable intangible asset in IAS 38.

Required:

(i) **Describe the circumstances in which companies are permitted to change their accounting policies under International Financial Reporting Standards and discuss what constitutes a change of accounting policy;** (5 marks)

(ii) **Prepare extracts of Hamlet's income statement and balance sheet for the year to 30 September 2003 together with comparative figures to reflect the change in accounting policy in respect of development expenditure; and calculate the restated accumulated profits at 1 October 2001.** (8 marks)

Hamlet uses the benchmark treatment in IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies'. Ignore deferred tax.

(b) Hamlet is considering the acquisition of another company in order to expand its operations. It has obtained the published financial statements of two companies, Recall and Revival, for the year to 30 September 2003. By coincidence both companies reported the same operating profit before tax. Market expectations are that profits will increase (or losses will reduce) by an average of 8% in the year to 30 September 2004. Hamlet has extracted the following information from the company's income statements:

	Recall	Revival
Operating profit:	$ million	$ million
Continuing activities	175	200
Acquisitions	(25)	75
Discontinuing activities	100	(25)
	250	250

Notes to the financial statements of both companies referred to significant restructuring during the year. Recall's discontinuing operation represented the sale of its financial services division on 30 March 2003; Recall's acquisition occurred on 1 July 2003. Revival's acquisition occurred on 1 January 2003 and its discontinuing operation represented the closure of its loss making mining operations.

Required:

(i) Explain why information on discontinuing operations is important to users of financial statements;

(5 marks)

(ii) Calculate the expected operating profit for both companies for the year to 30 September 2004 (assuming the market forecast of increased profits and reduced losses is correct and applies to all sectors):

- **if the financial statements contained no information on discontinuing and acquired operations; and**
- **based on the information provided above;**

Briefly comment on your results. (7 marks)

(25 marks)

4 **(a)** IAS 36 'Impairment of Assets' was published in June 1998. Its primary objective is to ensure that an asset is not carried on the balance sheet at a value that is greater than its recoverable amount. The Standard does not apply to inventories (including construction contracts). It replaces guidance given in several other International Financial Reporting Standards.

Required:

(i) **Describe the circumstances where an impairment loss is deemed to have occurred and explain when companies should perform an impairment review of tangible and intangible assets;** (4 marks)

(ii) **Describe the matters to be considered in assessing whether an asset may be impaired.** (6 marks)

(b) Avendus is preparing its financial statements to 30 September 2003. It has identified the following issues:

(i) Avendus owns and operates an item of plant that had a carrying value of $400,000 and an estimated remaining life of 5 years. It has just been damaged due to incorrect operation by an employee. It is not economic to repair the plant but it still operates in a limited capacity although it is now no longer expected to last for 5 years. As the plant is damaged it could only be sold for $50,000. The cost of replacing the plant is $1 million. The plant does not generate cash flows independently and is part of a group of assets that have a carrying value of $5 million and an estimated recoverable amount of $7 million

Required:

Explain how the above item of plant should be treated in the financial statements of Avendus for the year to 30 September 2003. Your answer should consider the situations where the plant continues to be used and where it would be replaced. (6 marks)

(ii) Avendus owns an investment property which has a remaining useful economic life of five years. The property has a carrying value of $200,000 on 30 September 2003. It is currently let to Marchant at an annual rental of $50,000 per annum. A surveyor has estimated that Avendus could expect net proceeds of $165,000 from sale of the property. The lease and the rental are due for renegotiation on 1 October 2003. There is currently a surplus of rental properties and this has affected rental incomes and selling prices considerably. Aware of this, Marchant has offered to rent the property for a further five years, but for an annual rental, payable in advance, of only $40,000. The rental would be payable in full on 1 October each year. The current cost of capital of Avendus is 10% per annum, but current market assessments of a widely expected increase in interest rates means this will soon rise to 12% per annum. Avendus uses the cost method in IAS 40 'Investment Property'. The following information can be taken as correct:

Interest rate	10%	12%
Present value of 4 year annuity	3·2	3·0
Present value of 5 year annuity	3·8	3·6

Required:

Explain how the above investment property should be treated in the financial statements of Avendus for the year to 30 September 2003. (4 marks)

Your answer should be supported with numerical calculations.

(iii) Avendus recently acquired a company called Fishright, a small fishing and fish processing company for $2 million. Avendus allocated the purchase consideration as follows:

	$000
Goodwill	240
Fishing quotas	400
Fishing boats (2 of equal value)	1,000
Other fishing equipment	100
Fish processing plant	200
Net current assets	60
	2,000

Shortly after the acquisition, one of the fishing boats sank in a storm and this has halved the fishing capacity. Due to this reduction in capacity, the value in use of the fishing business as a going concern is estimated at only $1·2 million The fishing quotas now represent a greater volume than one boat can fish and it is not possible to replace the lost boat as it was rather old and no equivalent boats are available. However the fishing quotas are much in demand and could be sold for $600,000. Avendus has been offered $250,000 for the fish processing plant. The net current assets consist of accounts receivable and payable.

Required:

Calculate the amounts that would appear in the consolidated financial statements of Avendus in respect of Fishright's assets after accounting for the impairment loss. (5 marks)

(25 marks)

5 **(a)** Penchant is a company whose main activity is construction contracts. Details of the progress at 1 October 2002 of a contract to build a new road bridge at a fixed price of $200 million are:

	$ million
Contract revenue recognised to date	110
Contract expenses recognised to date	85
Profit to date	25

In January 2003 Penchant negotiated a variation to the contract with the client to include a footbridge alongside the road bridge. The agreed value of this variation was $40 million and Penchant estimated the additional cost would be $32 million.

The accounting records of Penchant at 30 September 2003 show that total progress billings received by 20 July 2003 were $161·5 million and the total contract costs incurred to 30 September 2003 were $140 million.

The receipt of progress billings is after a 5% retention by the customer. Since the date of the billing it is reliably estimated that a further $10 million (at selling value) of work has been completed. At 30 September 2003 an estimated further $40 million of additional costs will need to be incurred to complete the contract. These figures include the costs related to the contract variation.

Penchant calculates the percentage of completion of its contracts as the proportion of the contract revenues earned to date compared to the contract price.

Required:

Prepare extracts of the financial statements for Penchant for the above contract for the year to 30 September 2003. (10 marks)

(b) IAS 10 (revised) was issued in May 1999. It deals with the accounting treatment of events occurring after the balance sheet date.

Required:

(i) **In assessing the results of a company for the current year, explain why events occurring after the balance sheet date may be of importance; and describe the circumstances where the financial statements should and should not be adjusted.** (5 marks)

(ii) During a review of Penchant's draft financial statements (for the year ended 30 September 2003) in October 2003, the following matters came to light:

– The company's internal auditors discovered a fraud on one of the company's contracts. A senior employee had accepted an inducement of $200,000 for awarding the construction of roadways on one of the company's contracts to a particular sub-contractor. Investigations showed that the price of the sub-contracting was $1 million higher than another comparable tender offer. At 30 September 2003 the contract was approximately 50% complete. (3 marks)

– An earthquake occurred on 10 October 2003. It caused damage to an in progress contract that it is estimated will cost $500,000 to rectify. (2 marks)

– At 30 September 2003 the company's head office premises were included in the draft financial statements at a value of $12 million. A building surveyor's report showed that they had fallen in value by $2 million. This was due partly to the discovery of ground subsidence and partly to a general fall of 10% in property prices caused by a sharp unexpected rise in interest rates announced in October 2003. (3 marks)

– In October 2003 there was a sharp fall in the value of a foreign currency. Penchant was owed a substantial amount for the final instalment of a completed contract whose price was fixed in that currency. The estimated loss due to the fall in the exchange rate has been translated at $250,000. (2 marks)

Note: you may assume the above figures are material.

Required:

For each of the items above, explain how Penchant should treat them under International Financial Reporting Standards. (marks as indicated)

(25 marks)

End of Question Paper