Diploma in International Financial Reporting

MONDAY 12 DECEMBER 2005

QUESTION PAPER

Time allowed **3 hours**

This paper is divided into two sections

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

Do not open this paper until instructed by the supervisor

This question paper must not be removed from the examination hall

The Association of Chartered Certified Accountants

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

1 Alpha has owned 80% of the equity shares of Beta since the incorporation of Beta. Therefore Alpha has prepared consolidated financial statements for some years. On 1 June 2005 Alpha purchased 35% of the equity shares of Gamma. The income statements and summarised statements of changes in equity of the three entities for the year ended 30 September 2005 are given below:

Income statements

	Alpha $'000	Beta $'000	Gamma $'000
Revenue (Note 1)	150,000	100,000	96,000
Cost of sales	(110,000)	(78,000)	(66,000)
Gross profit	40,000	22,000	30,000
Distribution costs	(7,000)	(6,000)	(6,000)
Administrative expenses	(8,000)	(7,000)	(7,200)
Profit from operations	25,000	9,000	16,800
Investment income (Note 2)	6,280	Nil	Nil
Finance cost	(5,000)	(3,000)	(4,200)
Profit before tax	26,280	6,000	12,600
Income tax expense	(7,000)	(1,800)	(3,600)
Net profit for the period	19,280	4,200	9,000
Summarised statements of changes in equity			
Balance at 1 October 2004	122,000	91,000	82,000
Net profit for the period	19,280	4,200	9,000
Dividends paid on 30 June 2005	(6,500)	(2,500)	(4,800)
Balance at 30 September 2005	134,780	92,700	86,200

Notes to the financial statements

Note 1 – Inter-company sales

Alpha sells products to Beta, making a profit of 25% on the cost of the products sold. Details of the purchases of the products by Beta together with the amounts included in opening and closing inventories in respect of the products, are given below:

Purchased in year $'000	Included in opening inventory $'000	Included in closing inventory $'000
20,000	2,000	3,000

There were no other inter-company sales between Alpha, Beta or Gamma during the period.

Note 2 – Investment income

Alpha's investment income includes dividends received from Beta and Gamma and interest receivable from Beta. The dividend received from Gamma has been credited to the income statement of Alpha without time apportionment. The interest receivable is in respect of a loan of $20 million to Beta at a fixed rate of interest of 8% per annum. The loan has been outstanding for the whole of the year ended 30 September 2005.

Note 3 – Details of acquisitions by Alpha

Entity	Date of acquisition	Goodwill on acquisition $'000	Fair value adjustment at date of acquisition $'000
Beta	1 July 1994	Nil	Nil
Gamma	1 June 2005	8,400	7,200

The goodwill figure for Gamma is after taking account of the fair value adjustment. This goodwill has not suffered impairment since 1 June 2005.

The fair value adjustment has the effect of increasing the fair value of property, plant and equipment above the carrying value in the individual financial statements of Gamma. Group policy is to depreciate property, plant and equipment on a monthly basis over its estimated useful economic life. The estimated life of the property, plant and equipment of Gamma that was subject to the fair value adjustment is five years, with depreciation charged against cost of sales.

Note 4 – other information

- The purchase of shares in Gamma followed a contractual arrangement with two other investors to obtain joint control over Gamma from 1 June 2005. The contract requires that all three investors approve the key policy decisions of Gamma.
- All equity shares in Beta carry one vote at general meetings.
- The policy of Alpha regarding the treatment of equity investments in its consolidated financial statements is as follows:
  - Subsidiaries are fully consolidated.
  - Joint ventures are proportionally consolidated.
  - Associates are equity accounted.
  - Other investments are treated as available for sale financial assets.

Your assistant has been reading the working papers for the consolidated financial statements of Alpha for previous years. He has noticed that Beta has been consolidated as a subsidiary and has expressed the view that this must be because Alpha owns more than 50% of its shares. He has further stated that Gamma should be consolidated as an associate because Alpha owns more than 20% but less than 50% of its shares.

Required:

(a) Prepare the consolidated income statement and consolidated statement of changes in equity of Alpha for the year ended 30 September 2005. Notes to the consolidated income statement are not required. (20 marks)

(b) Assess the observations of your assistant regarding the appropriate method of consolidating Beta and Gamma. Your assessment need NOT include an explanation of the detailed mechanics of consolidation. You should refer to the provisions of international financial reporting standards where you consider they will assist your explanation. (5 marks)

(25 marks)

Section B – THREE questions ONLY to be attempted

2 Delta is an entity that prepares its financial statements to 30 September each year. The financial statements for the year ended 30 September 2005 are being prepared and you are provided with the following trial balance at that date.

	$'000	$'000
Revenue		130,000
Development costs (Note 1)	12,000	
Production costs	75,000	
Distribution costs	7,000	
Administrative expenses (Note 2)	26,000	
Inventories at 30 September 2004 (Note 3)	18,200	
Interest paid and payable on interest bearing borrowings	3,000	
Income tax (Note 4)		200
Dividends paid on equity shares	2,000	
Property, plant and equipment – at cost (Notes 5 and 6)	57,000	
Accumulated depreciation on property, plant and equipment at 30 September 2004 (Notes 5 and 6)		15,590
Suspense account (Note 6)		1,200
Trade receivables	44,000	
Cash and cash equivalents	33,790	
Trade payables		12,000
Provisions (Note 2)		4,000
Long term interest bearing borrowings		40,000
Lease rentals (Note 7)	8,000	
Deferred tax (Note 4)		6,000
Issued equity capital		50,000
Accumulated profits		27,000
	285,990	285,990

Notes to the Trial Balance

Note 1 – Development costs
The development costs relate to a project started on 1 January 2005 to develop a new product. Costs of $1 million per month were incurred for the six months to 30 June 2005. On this date the project was assessed as being technically feasible and commercially viable. Further costs totalling $6 million were incurred between 1 July 2005 and 30 September 2005 and at 30 September 2005 the development of the new product was substantially complete. Commercial production is due to begin on 1 January 2006 and the directors are confident that the new product will generate net cash flows that have a present value far in excess of the costs incurred on the project.

Note 2 – Administrative expenses
Administrative expenses include a provision of $4 million for the costs of a legal claim lodged against Delta by one of its customers before 30 September 2005. The customer is claiming $10 million and the directors of Delta consider that there is a 40% chance the claim will be successful and so have provided for 40% of the total claim.

Note 3 – Inventories at 30 September 2005
The carrying value of inventories at 30 September 2005 was $22 million. This figure was computed in accordance with the principles of IAS 2 – *Inventories*.

Note 4 – Tax
– The estimated income tax on the profits for the year to 30 September 2005 is $1·5 million.
– During the year $1·9 million was paid in full and final settlement of income tax on the profits for the year ended 30 September 2004. The balance sheet at 30 September 2004 had included $2·1 million in respect of this liability.
– At 30 September 2005 the carrying values of the net assets of Delta exceeded their tax base by $28 million.
– The rate of income tax in the jurisdiction in which Delta operates is 25%.

Note 5 – Property, plant and equipment
Details are as follows:

	Property		Plant and equipment
	Land	Buildings	
	$'000	$'000	$'000
Cost at 30 September 2005 (but see Note 6 below)	12,000	18,000	27,000
Estimate of useful economic life (at date of purchase)	Infinite	50 years	4 years
Accumulated depreciation **at 30 September 2004**	0	4,500	11,090

Depreciation of property, plant and equipment is allocated as follows:
– 80% to cost of sales.
– 10% to distribution costs.
– 10% to administrative expenses.

For all tangible non-current assets depreciation is charged in full in the year of purchase, with no depreciation being charged in the year of sale.

None of the non-current assets were fully depreciated at 30 September 2004. The above allocation excludes any depreciation charged on the leased asset (see note 7 below) which should be fully charged to cost of sales.

Note 6 – Suspense account
During the year plant and equipment costing $6 million and having been depreciated by a cumulative amount of $4·5 million at 30 September 2004 was disposed of and the proceeds credited to a suspense account. Any gain or loss on the sale of plant and equipment should be treated as an adjustment to the relevant depreciation expense.

Note 7 – Lease rentals
On 1 October 2004 Delta began to lease a group of machines that were used in the production process. The lease was for five years and the six-monthly rental (payable in arrears) was $4 million. The lessor paid $31 million for the machines on 30 September 2004. The lessor has advised Delta that the lease is a finance lease and that the rate of interest implicit in the lease can be taken as 5% per half year.

Note 8 – Share issue
On 1 November 2005 Delta issued a further 10 million ordinary shares for $30 million. The shares have no par value and the share issue has not been reflected in the trial balance that appears above.

Required:

(a) Prepare the income statement for Delta for the year ended 30 September 2005. (12 marks)

(b) Prepare the statement of changes in equity for Delta for the year ended 30 September 2005. (4 marks)

(c) Prepare the balance sheet for Delta as at 30 September 2005. (9 marks)

Notes to the income statement and balance sheet are not required. However, your workings should justify your treatment of items referred to in the trial balance and the notes with appropriate references to international financial reporting standards.

(25 marks)

3 You are the accountant of Epsilon, an entity that has business interests all around the world. The financial statements for the year ended 30 September 2005 are currently in the process of preparation. Where international financial reporting standards have been published before the year-end but mandatory compliance is deferred to a later period, the directors always follow the provisions of such standards from their date of publication. The directors have sought your advice on the financial reporting implications of the following issues:

1. On 31 August 2005 the directors decided to close down a business segment. The decision was taken out of a desire to refocus the strategic direction of the group and the segment being closed did not fit into the new strategy. The closure commenced on 15 October 2005 and was due to be completed on 31 December 2005. On 10 September 2005 letters were sent to employees offering voluntary redundancy or redeployment in other sectors of the business. On 13 September 2005 negotiations commenced with relevant parties with a view to terminating existing contracts of the business segment and arranging sales of its assets. Latest estimates of the financial implications of the closure are as follows:
   (a) Redundancy costs will total $20 million.
   (b) The pension plan will make a lump sum payment totalling $10 million to the employees who accept voluntary redundancy in termination of their rights under the plan. Epsilon will pay this amount into the plan on 31 January 2006.
   (c) The cost of redeploying and retraining staff who do not accept redundancy will total $6·5 million.
   (d) The costs of terminating existing contracts, including professional fees, will total $5 million.
   (e) Plant having a net book value of $12 million at 30 September 2005 will be sold for $1 million.
   (f) A freehold property having a net book value of $10 million at 30 September 2005 will be sold for $15 million. The potential purchaser is not interested in acquiring the plant.
   (g) The operating losses of the business segment for October, November and December 2005 will total $9 million. (12 marks)

2. In 2006 Epsilon is planning a major investment in Europe. Latest indications are that this investment will cost 40 million euros and that the funds will be required on 28 February 2006. In order to provide a measure of certainty regarding the cost of the investment the directors entered into a contract prior to the year end to purchase 40 million euros for $45 million, with a delivery date of 28 February 2006. On 30 September 2005 the forward rate of exchange was such that this contract had a fair value of $500,000 (a financial asset). (5 marks)

3. Epsilon has a subsidiary located in Farland. Farland has its own tax jurisdiction and no other group entity is located within it. The subsidiary regularly sells goods to Epsilon and the inventory of Epsilon at 30 September 2005 included goods purchased from its subsidiary on which its subsidiary had made a profit of $1 million [after translation at the appropriate rate]. The subsidiary had made a loss adjusted for tax purposes for the year ended 30 September 2005 that was equivalent to $4 million. Local tax legislation only allows tax losses to be carried forward for relief against future trading profits. The directors of Epsilon consider that the loss of the subsidiary is due to identifiable non-recurring causes and that the subsidiary will record a taxable profit for the foreseeable future. Both Epsilon and its subsidiary pay tax at 30%. (8 marks)

Required:

Advise the directors on the financial reporting implications of the three issues in the consolidated financial statements for the year ended 30 September 2005. For each issue you should indicate the amounts that would be included in the financial statements and the nature of any disclosures that might be appropriate in the notes. You should justify your conclusion with reference to appropriate international financial reporting standards and include any other explanations you consider relevant.

The allocation of marks to each individual issue is given above after the description of the issue.

(25 marks)

4 IAS 18 – *Revenue* – was issued with a view to standardising the recognition and measurement of revenue. The principles of the standard are based around the concept of income that was developed in the IASB's *Framework for the Preparation and Presentation of Financial Statements*.

Required:

(a) Explain how the IASB framework defines income and how this definition compares to the definition of revenue given in IAS 18. (4 marks)

(b) Outline the requirements of IAS 18 regarding the recognition and measurement of revenue from:

(i) The sale of goods;
(ii) The rendering of services;
(iii) The use of entity assets. (9 marks)

Iota prepares financial statements to 30 September each year. During the year ended 30 September 2005 Iota engaged in the following transactions:

1. On 1 October 2004 Iota sold a plot of land to a bank for \$10m. The land had a book value of \$5m and a market value of \$15m at the date of sale. Iota continued to develop the land and had a call option to buy the land back from the bank for \$12m on 30 September 2006. The bank had a put option to sell the land to Iota for \$12m on 30 September 2006.
2. On 30 September 2005 Iota sold some products under a two year warranty scheme. The total invoiced price was \$500,000. The scheme requires Iota to repair any defects found in the products for a two year period from the date of sale. The directors of Iota can reliably estimate that their warranty costs will average \$50,000 each year. A reasonable profit margin on the repair of such products is 20% of the normal invoiced price of such repairs.
3. On 1 October 2004 Iota sold some products for a total invoiced price of \$600,000. The consideration was receivable from the customer on 30 September 2006. Iota normally charges a finance cost of 8% per annum on transactions for which it provides finance.

Required:

(c) Explain how each of the transactions 1–3 should be recognised in the financial statements of Iota for the year ending 30 September 2005. You should quantify the amounts recognised and make reference to relevant provisions of IAS 18 wherever possible. (12 marks)

(25 marks)

5 Kappa is an entity that regularly purchases subsidiaries. Kappa prepares financial statements to 30 September each year. In its year ended 30 September 2003 Kappa purchased a new subsidiary, Omega, and began to amortise the goodwill on consolidation of Omega over an estimated useful economic life of 20 years.

On 30 June 2005 the entity acquired all the 100 million equity shares of Lambda by issuing one share in Kappa for every two shares acquired in Lambda. On 30 June 2005 the market value of a Kappa share was $5·40 and the market value of Lambda share $2·40.

The directors of Lambda prepared a balance sheet as at 30 June 2005 and the net assets of Lambda that were included were measured at $180 million (their fair values at that date). The directors of Kappa noted that the following assets of Lambda had not been included in the draft balance sheet prepared by the directors:

(i) Internally developed brands having an identifiable fair value of $10 million at 30 June 2005.
(ii) The value of future services of existing employees that was estimated to have a value of $15 million at 30 June 2005.

Required:

(a) Calculate the goodwill arising on initial consolidation of Lambda at 30 June 2005 and explain (without performing any calculations) how its carrying amount at 30 September 2005 would be measured. You should refer to relevant International Financial Reporting Standards to support your conclusions. (8 marks)

On 30 September 2005 Kappa carried out a review of the goodwill on consolidation of Lambda for evidence of impairment. The review was carried out despite the fact that there were no obvious indications of adverse trading conditions for Lambda. The review involved allocating the net assets of Lambda into three cash-generating units and computing the value in use of each unit. The carrying values of the individual units before any impairment adjustments are given below:

	Unit A	Unit B	Unit C
	$m	$m	$m
Patents	5	–	–
Property, plant and equipment	60	30	40
Net current assets	20	25	20
	85	55	60
Value in use of unit	72	68	65

It was not possible to meaningfully allocate the goodwill on consolidation to the individual cash generating units but all the other net assets of Lambda are allocated in the table shown above. The patents of Lambda have no ascertainable market value but all the current assets have a market value that is above carrying value. The value in use of Lambda as a single cash generating unit at 30 September 2005 is $205 million.

Required:

(b) Explain briefly the purpose of an impairment review and why the net assets of Lambda were allocated into cash generating units as part of a review of goodwill for impairment. (5 marks)

(c) Demonstrate how the impairment loss in unit A will affect the carrying value of the net assets of unit A in the consolidated financial statements of Kappa. (5 marks)

(d) Explain and calculate the effect of the impairment review on the carrying value of the goodwill on consolidation of Lambda at 30 September 2005. (7 marks)

(25 marks)

End of Question Paper