Diploma in International Financial Reporting

MONDAY 13 JUNE 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 The balance sheets of Alpha and its subsidiaries Beta and Gamma at 31 March 2005 (the accounting date for all three entities) are given below:

	Alpha		Beta		Gamma	
	$'000	$'000	$'000	$'000	$'000	$'000
ASSETS						
Non-current assets:						
Property, plant and equipment	28,000		25,000		20,000	
Financial assets (Notes 1-3)	49,000		nil		nil	
		77,000		25,000		20,000
Current assets:						
Inventories (Note 4)	18,000		12,000		11,000	
Trade and other receivables (Note 4)	15,000		10,000		9,000	
		33,000		22,000		20,000
Total assets		110,000		47,000		40,000
EQUITY AND LIABILITIES						
Capital and reserves:						
Issued capital ($1 shares)	25,000		15,000		10,000	
Share premium account	10,000		10,000		4,000	
Accumulated profits	36,000		8,000		9,300	
		71,000		33,000		23,300
Non-current liabilities						
Interest bearing borrowings	20,000		nil		4,000	
Deferred tax	2,000		1,000		1,500	
		22,000		1,000		5,500
Current liabilities						
Trade and other payables (Note 5)	12,000		9,000		7,000	
Short term borrowings	5,000		4,000		4,200	
		17,000		13,000		11,200
Total equity and liabilities		110,000		47,000		40,000

Notes to the balance sheets

Note 1
On 1 July 1990, the date of incorporation of Beta, Alpha purchased all the shares of Beta for $25 million.

Note 2
(i) On 1 April 2003 Alpha purchased eight million shares in Gamma for a cash payment of $2·80 per share. On 1 April 2003 the accumulated profits of Gamma stood at $12 million.
(ii) The fair value exercise that followed the acquisition of Gamma indicated that any fair value adjustments were not material in a group context.

Note 3
Prior to the publication of IFRS 3 – Business combinations – goodwill on consolidation was amortised over its estimated useful economic life of 20 years. Alpha adopted IFRS 3 in its financial statements for the first time in the current year. Accordingly the goodwill on consolidation of Gamma was reviewed for impairment at 31 March 2005. Gamma was viewed as a single cash-generating unit that at 31 March 2005 had a value in use of $24 million.

Note 4

The issued capital of all three entities comprises entirely ordinary shares.

Note 5

(i) Alpha supplies a component to Beta and Gamma at cost plus a mark up of 20%.

(ii) At 31 March 2005 the inventories of Beta included $1·5 million and the inventories of Gamma $1·2 million in respect of this component.

(iii) At 31 March 2005 the trade receivables of Alpha showed an amount receivable from Beta of $1·2 million, whilst the trade payables of Beta showed an amount payable to Alpha of $600,000. On 29 March 2005 Alpha sent a consignment of components to Beta at an invoiced price of $600,000. The consignment was received and recorded by Beta on 2 April 2005.

(iv) At 31 March 2005 the trade receivables of Alpha and the trade payables of Gamma showed an intra-group balance of $800,000.

Note 6

The directors of Alpha are concerned that Gamma has been making losses since acquisition. They would prefer not to include these losses in the consolidated financial statements and have heard that International Financial Reporting Standards allow the results of subsidiaries to be omitted in certain circumstances. They have indicated that Gamma supplies customers that operate mainly in the retail sector, whilst Alpha and Beta have customers that operate mainly in the manufacturing sector. Therefore they have suggested that consolidation of Gamma would be misleading in such circumstances.

Required:

(a) Prepare the consolidated balance sheet of Alpha as at 31 March 2005. (20 marks)

(b) Write a memorandum to the directors of Alpha that:

(i) Describes the circumstances in which non-consolidation of subsidiaries is appropriate under International Financial Reporting Standards.

(ii) Responds to the issues they have raised in Note 6 above. (5 marks)

(25 marks)

Section B – THREE questions ONLY to be attempted

2 Delta is an enterprise that prepares its financial statements to 31 March each year. The financial statements for the year ended 31 March 2005 are being prepared and you are provided with the following trial balance at that date.

	$'000	$'000
Revenue		132,000
Production costs	90,000	
Distribution costs	8,000	
Administrative expenses	12,000	
Inventories at 31 March 2004 (Note 1)	18,200	
Interest paid and payable on interest bearing borrowings (Note 2)	3,000	
Income tax (Note 3)	100	
Dividends paid on equity shares	2,000	
Land and buildings (Note 4)	50,000	
Plant and equipment (Note 4)	37,000	
Accumulated depreciation on property, plant and equipment:		
– Land and buildings (Note 4)		3,360
– Plant and equipment (Note 4)		10,500
Trade receivables	44,000	
Bank balances	28,560	
Trade payables		10,000
Long term interest bearing borrowings (Note 2)		30,000
Deferred tax (Note 3)		4,000
Issued preferred shares (Note 2)		20,000
Issued equity capital		40,000
Revaluation reserve at 31 March 2004 (Note 5)		4,000
Accumulated profits		39,000
	292,860	292,860

Notes to the Trial Balance

Note 1 – Inventories

(a) Inventories at 31 March 2005 had cost the entity $20 million. This figure included $960,000 in respect of a consignment of parts that had been purchased from a European supplier on 31 January 2005 for €800,000. These parts were unused at 31 March 2005. Payment (in Euros) was made to the supplier on 31 May 2005. Relevant exchange rates were as follows:

Date	Exchange rate ($s to 1 Euro)
31 January 2005	1·2
31 March 2005	1·3
31 May 2005	1·35

Delta credited $960,000 to trade payables on 31 January 2005 and has made no other entries regarding this transaction in the trial balance that appears above.

(b) On 15 April 2005 a water leak damaged some inventory that was included in the year end inventory figure at its cost of $500,000. As a result it had to be sold later in April 2005 for only $200,000. Apart from this inventory there was no other inventory held at 31 March 2005 that was likely to be disposed of for less than its cost.

Note 2 – Issue of preferred shares

On 1 April 2004 Delta issued 20 million $1 preferred shares at par. Issue costs of $200,000 were included as an administrative expense. The shares carry no dividend but are to be redeemed on 31 March 2009 at $1·60 per share. This represents an effective annual finance cost of 10%.

Note 3 – Tax

(i) The estimated income tax on the profits for the year to 31 March 2005 was $2·2 million.

(ii) During the year $2·1 million was paid in full and final settlement of income tax on the profits for the year ended 31 March 2004. Payables at 31 March 2004 had included $2 million in respect of this liability.

(iii) At 31 March 2005 the carrying value of the property, plant and equipment of Delta exceeded its tax base by $18 million. This does **not** include the taxable temporary difference caused by the revaluation of the property (see note 5 below). Delta had no other taxable or deductible temporary differences at 31 March 2005.

(iv) The rate of income tax in the jurisdiction in which Delta operates is 25%.

Note 4 – Property, plant and equipment

Details are as follows:

		Property	Plant and equipment	
	Land	**Buildings**	**Plant**	**Fixtures**
	$'000	**$'000**	**$'000**	**$'000**
Cost/Revalued amount at 31 March 2005 (see note 5)	22,000	28,000	28,000	9,000
Depreciation rate (%)	0	3	25	20
Depreciation method	None	Straight line	Straight line	Straight line
Accumulated depreciation **at 31 March 2004**	0	3,360	8,000	2,500

Depreciation of property, plant and equipment is allocated as follows:

(i) Plant and buildings to cost of sales.

(ii) Fixtures to administrative expenses

Note 5 – Property revaluation

(i) **On 31 March 2005** Delta revalued its property to its market value of $55 million. This figure is **not reflected** in note 4 above or in the current balance on the revaluation reserve.

(ii) The revaluation created a taxable temporary difference of $3 million.

Required:

(a) Prepare the income statement for Delta for the year ended 31 March 2005. (12 marks)

(b) Prepare the statement of changes in equity for Delta for the year ended 31 March 2005. (5 marks)

(c) Prepare the balance sheet for Delta as at 31 March 2005 (8 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 Lambda. Lambda operates in a jurisdiction that requires International Financial Reporting Standards to be used for local reporting purposes. Your assistant is responsible for preparing the financial statements for your review. He is in the process of preparing the first draft of the financial statements for the year ended 31 March 2005. Whilst he has a sound basic knowledge of accounting he is unsure about certain aspects of financial reporting. He has asked you a number of questions regarding the financial reporting practices of the group.

(a) As you know on 1 April 2004 our company granted 50 executives call options to purchase up to 5,000 shares each on 1 April 2006. This was partly a means of deferring them from leaving as the options only vest if the executives are still employed on 1 April 2006. Personnel tell me that they estimate 90% of the executives will remain with us for the two year period and exercise their options in full. I am very confused by some of the financial information I have been given regarding these options:

(i) The option price is $20 per share.

(ii) The market value of each share was $15 on 1 April 2004 and $18 on 31 March 2005. It is $19 today.

(iii) The market value of the share option was $2 on 1 April 2004 and $2·20 on 31 March 2005. It is $2·25 today.

I have made no accounting entries in the draft financial statements regarding these options. I base this on the fact that the option price is greater than the current market value so is unlikely to be exercised. Is my thinking correct on this? (8 marks)

(b) You will recall that on 1 March 2005 we entered into negotiations with employee representatives to restructure our operations and close down two of our five retail outlets. I understand that broad agreement was reached with the representatives on 25 March 2005 and the plans publicly announced on 27 March 2005. Relevant employees were sent letters on 28 March 2005 offering them redundancy or redeployment. The restructuring was completed on 31 May 2005. I have been advised that the financial effects of the closure were as follows:

(i) We incurred closure costs of $1 million, including redundancy payments of $400,000.

(ii) Costs of redeploying existing employees totalled $200,000.

(iii) Plant and equipment was scrapped at a loss of $150,000.

(iv) The properties of the two outlets were sold at a profit of $300,000.

(v) The operating losses of the two outlets from 1 April 2005 to 31 May 2005 totalled $100,000.

(vi) The net sum of all the above is a cost of $1,150,000.

I have made a provision of $1,150,000 in the draft financial statements and shown a closure cost of $1,150,000 in the income statement. I have also shown the results of the outlets for the year to March 2005 as discontinued operations since they are being closed down. However I have left the net assets of the retail outlets in their normal balance sheet captions because they were not sold until after 31 March 2005. Have I got this right? (9 marks)

(c) On 1 April 2004 we issued 1 million loan notes at $1 each. The loan notes carry an interest rate of 6% and are repayable on 31 March 2007. Alternatively the holders can elect to exchange a note for shares in Lambda on 31 March 2007. If this option were not available to them they would require an interest rate of 9%. I have shown this as a non-current liability of $1 million, with a finance cost of $60,000 in the income statement. Am I right to do this?

EXTRACTS FROM PRESENT VALUE TABLES:
Present value of $ received at the end of year 'N'

	6%	9%
N = 1	0·943	0·917
N = 2	0·890	0·842
N = 3	0·840	0·772

(8 marks)

Required:

Draft a reply to each of the queries raised by your assistant. You should make reference to International Financial Reporting Standards where relevant and explain the rationale behind your replies.

The mark allocation is shown against each of the three queries.

(25 marks)

4 Extracts from the financial statements of Omicron for the year ended 31 March 2005 are given below:

Income statements – year ended 31 March:

	2005	2004
	$'000	$'000
Revenue	600	500
Cost of sales	(300)	(240)
Gross profit	300	260
Other operating expenses	(156)	(145)
Profit from operations	144	115
Investment income	6	15
Finance cost	(50)	(45)
Profit on sale of property (note 1)	10	
Profit before tax	110	85
Income tax expense	(33)	(25)
Profit for the period	77	60

Statements of changes in equity – year ended 31 March

	2005	2004
	$'000	$'000
Equity at start of period	217	182
Profit for the period	77	60
Dividends paid	(25)	(25)
Equity at end of period	269	217

Balance sheets as at 31 March:

	2005		2004	
	$'000	$'000	$'000	$'000
ASSETS:				
Non-current assets:				
Property, plant and equipment (note 2)	240		280	
Development expenditure (note 3)	25		19	
		265		299
Current assets:				
Inventories	105		90	
Trade and other receivables	120		100	
Cash and cash equivalents	30		75	
		255		265
		520		564
EQUITY AND LIABILITIES				
Capital and reserves:				
Issued capital	100		100	
Revaluation reserve	Nil		20	
Accumulated profits	169		97	
		269		217
Non-current liabilities:				
Interest bearing borrowings	30		90	
Obligations under finance leases	80		70	
Deferred tax	29		24	
		139		184
Current liabilities:				
Trade and other payables (note 4)	75		63	
Short term borrowings (note 5)	12		80	
Obligations under finance leases	25		20	
		112		163
		520		564

Notes to the financial statements

Note 1 – profit on sale of property

A large freehold property was sold by Omicron on 1 October 2004 and leased back on an operating lease. The property was not depreciated in the current year. The property had been revalued in 2001 and the revaluation surplus credited to a revaluation reserve. No other entries had been made in the revaluation reserve prior to the sale of the property.

Note 2 – property, plant and equipment

	31 March 2005	31 March 2004
	$'000	$'000
Freehold land and buildings	Nil	90
Owned plant and equipment	150	120
Leased plant and equipment	90	70
	240	280

During the year Omicron entered into new finance lease agreements in respect of certain items of plant and equipment. The amounts debited to non-current assets in respect of such agreements during the year totalled $40,000. No disposals of plant and equipment (owned **or** leased) took place during the year. Depreciation of non-current assets for the year totalled $58,000.

Note 3 – development expenditure

This comprises the umamortised balance that is capitalised in accordance with the provisions of IAS 38 – *Intangible Assets*. Omicron charged amortisation of $10,000 to the income statement during the current period in accordance with the provisions of IAS 38.

Note 4 – trade and other payables

	31 March 200	31 March 2004
	$'000	$'000
Trade payables	57	50
Income taxes payable	10	8
Accrued interest	8	5
	75	63

Note 5 – cash and cash equivalents

In the jurisdiction in which Omicron reports short term borrowings are regarded as part of cash and cash equivalents.

Required:

(a) Prepare the cash flow statement of Omicron for the year ended 31 March 2005 in the form required by IAS 7 – Cash Flow Statements. You should use the indirect method to compute the operating cash flows. Notes to the cash flow statement are NOT required but your workings must be clearly shown. (20 marks)

(b) Explain, without reworking any figures:

(i) What would be reported in the cash flow statement if the direct method were used to compute the operating cash flows.

(ii) How the amounts that are reported under the direct method would be obtained.

(iii) Why the IASB encourages entities to use the direct method rather than the indirect method. (5 marks)

(25 marks)

5 Sigma is an entity that operates a defined benefit retirement benefits plan into which it makes contributions. On 31 March 2002 the balance sheet of Sigma showed a net liability relating to retirement benefit obligations as follows:

	$'000
Market value of plan assets	60,000
Present value of plan liabilities	(70,000)
Cumulative unrecognised actuarial losses	5,000
	(5,000)

Information relating to the plan for the next three years is as follows:

	Year ending 31 March		
	2003	2004	2005
	$'000	$'000	$'000
Market value of plan assets at the start of the year	60,000	62,000	64,000
Present value of plan liabilities at start of the year	70,000	84,000	96,000
Expected return on assets	3,000	3,200	3,500
Current service cost	6,000	6,400	6,500
Employer contributions to the plan	4,000	4,300	4,400
Benefits paid out	3,500	3,600	3,600
Market value of plan assets at the end of the year	62,000	64,000	66,000
Present value of plan liabilities at the end of the year	84,000	96,000	108,000
Discount rate at the start of the year	10%	9%	8%

Any actuarial gains and losses that fall outside the relevant corridor limits are to be recognised in the income statement as soon as the excess arises.

Required:

(a) Explain why IAS 19 – Employee Benefits – requires a method of accounting by the employer for retirement benefit plans that differs depending on the type of plan and outline the accounting requirements for defined contribution plans. (4 marks)

(b) Describe the accounting requirements of IAS 19 for defined benefit plans in the financial statements of the employer. (6 marks)

(c) Prepare appropriate extracts from the income statements and the balance sheets to show the effects of the retirement benefits plan covering each of the three years ending on 31 March 2003, 2004 and 2005 for Sigma. (15 marks)

(25 marks)

End of Question Paper