Diploma in International Financial Reporting

Friday 8 December 2017

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.

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Think Ahead ACCA

The Association of Chartered Certified Accountants

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The question paper begins on page 3.

ALL FOUR questions are compulsory and MUST be attempted

1 Alpha has two subsidiaries, Beta and Gamma. The draft statements of financial position of the three entities at 30 September 2017 are as follows:

	Alpha $'000	Beta $'000	Gamma $'000
Assets			
Non-current assets:			
Property, plant and equipment (Note 2)	610,000	310,000	160,000
Investments (Note 1)	370,700	Nil	Nil
	980,700	310,000	160,000
Current assets:			
Inventories (Note 3)	140,000	85,000	66,000
Trade receivables	95,000	70,000	59,000
Cash and cash equivalents	16,000	13,000	11,000
	251,000	168,000	136,000
Total assets	1,231,700	478,000	296,000
Equity and liabilities			
Equity:			
Share capital ($1 shares)	240,000	120,000	100,000
Retained earnings	550,700	168,000	59,000
Other components of equity (Notes 2, 6 and 7)	202,000	Nil	Nil
Total equity	992,700	288,000	159,000
Non-current liabilities:			
Long-term borrowings (Note 7)	100,000	70,000	60,000
Deferred tax	59,000	38,000	35,000
Total non-current liabilities	159,000	108,000	95,000
Current liabilities:			
Trade and other payables	60,000	52,000	32,000
Short-term borrowings	20,000	30,000	10,000
Total current liabilities	80,000	82,000	42,000
Total equity and liabilities	1,231,700	478,000	296,000

Note 1 – Summary of Alpha's investments

The investments figure in the individual financial statements of Alpha is made up as follows:

	$'000
Investment in Beta (Note 2)	236,500
Investment in Gamma (Note 3)	121,200
Other equity investments (Note 4)	13,000
	370,700

Note 2 – Alpha's investment in Beta

On 1 October 2012, Alpha acquired 90 million shares in Beta by means of a share exchange of two shares in Alpha for every three shares acquired in Beta. On 1 October 2012, the market value of an Alpha share was $3·90. Alpha incurred directly attributable costs of $2·5 million on acquisition of Beta relating to the cost of issuing its own shares.

On 1 October 2012, the individual financial statements of Beta showed retained earnings of $60 million.

The directors of Alpha carried out a fair value exercise to measure the identifiable assets and liabilities of Beta at 1 October 2012. The following matters emerged:

– Property which had a carrying amount of $150 million (land component $45 million) had an estimated fair value of $210 million (land component $66 million). The buildings component of the property had an estimated remaining useful life of 30 years at 1 October 2012.

– Plant and equipment which had a carrying amount of $122 million had an estimated fair value of $145 million. The estimated remaining useful life of the plant at 1 October 2012 was four years.

– On 1 October 2012, the directors of Alpha identified a brand name relating to Beta which had a fair value of $25 million. This brand name was not recognised in the individual financial statements of Beta as it was internally developed. The directors of Alpha considered that the useful life of the brand name was 25 years from 1 October 2012.

– 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 calculating deferred tax. The rate of deferred tax to apply to temporary differences is 20%.

No impairment of the goodwill on acquisition of Beta has been evident since 1 October 2012. On 1 October 2012, the directors of Alpha initially measured the non-controlling interest in Beta at its fair value on that date. On 1 October 2012, the fair value of an equity share in Beta (which can be used to measure the fair value of the non-controlling interest) was $2·35.

Note 3 – Alpha's investment in Gamma

On 1 October 2016, Alpha acquired 80 million shares in Gamma by means of a cash payment of $120 million. Alpha incurred due diligence costs of $1·2 million associated with this purchase. The purchase agreement provided for an additional cash payment of $56 million to the former holders of the 80 million acquired shares on 1 October 2018. An appropriate annual discount rate to use in any relevant discounting to measure the fair value of this additional cash payment is 8%.

On 1 October 2016, the individual financial statements of Gamma showed retained earnings of $50 million.

On 1 October 2016, the fair values of the net assets of Gamma were the same as their carrying amount with the exception of some inventory which was recognised in the individual financial statements of Gamma at a cost of $12 million. The directors of Alpha considered that this inventory had a fair value of $15 million on 1 October 2016. This inventory was all sold by Gamma prior to 30 September 2017. The fair value adjustment was not 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 calculating deferred tax. The rate of deferred tax to apply to temporary differences is 20%.

No impairment of the goodwill on acquisition of Gamma has been evident since 1 October 2016. On 1 October 2016, the directors of Alpha initially measured the non-controlling interest in Gamma at its fair value on that date. On 1 October 2016, the fair value of an equity share in Gamma was $1·75.

Note 4 – Other equity investments by Alpha

Alpha has a portfolio of equity investments which are classified in accordance with IFRS 9 – *Financial Instruments* – as 'fair value through profit or loss'. The carrying amount included in the financial statements of Alpha represents the fair value of the portfolio at 1 October 2016, which has been correctly adjusted for purchases and disposals in the year. The fair value of the portfolio at 30 September 2017 was $13·8 million.

Note 5 – Trade receivables and payables

On 29 September 2017, Gamma made a payment of $8 million to Beta to eliminate the intra-group balances at that date. This payment was received and recorded by Beta on 2 October 2017.

Note 6 – Share-based payment

On 1 October 2015, Alpha granted 200 senior managers options to buy 100,000 shares each between 30 September 2018 and 31 December 2018. The options are due to vest on 30 September 2018 provided the relevant managers remain employed over the three-year vesting period ending on that date. Since 1 October 2015 the expectation of the number of managers for whom the options would vest has varied as follows:

Date	Expected number of managers for whom the options will vest
1 October 2015	200
30 September 2016	180
30 September 2017	190

In preparing the financial statements of Alpha for the year ended 30 September 2016, the directors of Alpha debited retained earnings and credited other components of equity with the appropriate amount required by IFRS 2 – *Share-based payment*. The directors of Alpha have made no additional accounting entries in respect of the options in the draft financial statements for the year ended 30 September 2017.

On 1 October 2015, the fair value of one option was estimated to be \$1·20. The fair value of the same option at 30 September 2016 and 2017 was estimated to be \$1·25 and \$1·30 respectively.

Note 7 – Long-term borrowing

On 1 October 2016, Alpha issued 60 million \$1 loan notes at par. The annual rate of interest (payable in arrears) on the loan notes is 6%. The loan notes are repayable at par on 30 September 2026. As an alternative to repayment, the holders of the loan notes can elect to convert their loan notes into equity shares of Alpha on 30 September 2026. Had the conversion option not been available, the investors in the loan notes would have required an annual return of 9%.

Discount factors which may be relevant at 6% and 9% are as follows:

Discount rate	Present value of \$1 receivable in 10 years	Present value of \$1 receivable at the end of years 1–10
6%	55·8 cents	\$7·36
9%	42·2 cents	\$6·42

In preparing the draft financial statements for the year ended 30 September 2017, the directors of Alpha credited \$60 million to long-term borrowings and showed the interest paid to the investors as a finance cost.

Required:

Prepare the consolidated statement of financial position of Alpha at 30 September 2017. 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 prepares its financial statements to 30 September each year. The financial statements for the year ended 30 September 2017 are shortly to be authorised for issue. The following events are relevant to these financial statements:

(a) Delta operates a defined benefit retirement benefits plan on behalf of current and former employees. Delta receives advice from actuaries regarding contribution levels and overall liabilities of the plan to pay benefits. On 1 October 2016, the actuaries advised that the present value of the defined benefit obligation was $60 million. On the same date, the fair value of the assets of the defined benefit plan was $52 million. On 1 October 2016, the annual market yield on high quality corporate bonds was 5%.

During the year ended 30 September 2017, Delta made contributions of $7 million into the plan and the plan paid out benefits of $4·2 million to retired members. You can assume that both these payments were made on 30 September 2017.

The actuaries advised that the current service cost for the year ended 30 September 2017 was $6·2 million. On 31 August 2017, the rules of the plan were amended with retrospective effect. These amendments meant that the present value of the defined benefit obligation was increased by $1·5 million from that date.

During the year ended 30 September 2017, Delta was in negotiation with employee representatives regarding planned redundancies. The negotiations were completed shortly before the year end and redundancy packages were agreed. The impact of these redundancies was to reduce the present value of the defined benefit obligation by $8 million. Before 30 September 2017, Delta made payments of $7·5 million to the employees affected by the redundancies in compensation for the curtailment of their benefits. These payments were made out of the assets of the retirement benefits plan.

On 30 September 2017, the actuaries advised that the present value of the defined benefit obligation was $68 million. On the same date, the fair value of the assets of the defined benefit plan were $56 million.

(11 marks)

(b) On 1 April 2017, Delta completed the construction of a power generating facility. The total construction cost was $20 million. The facility was capable of being used from 1 April 2017 but Delta did not bring the facility into use until 1 July 2017. The estimated useful life of the facility at 1 April 2017 was 40 years.

Under legal regulations in the jurisdiction in which Delta operates, there are no requirements to restore the land on which power generating facilities stand to its original state at the end of the useful life of the facility. However, Delta has a reputation for conducting its business in an environmentally friendly way and has previously chosen to restore similar land even in the absence of such legal requirements. The directors of Delta estimated that the cost of restoring the land in 40 years' time (based on prices prevailing at that time) would be $10 million. A relevant annual discount rate to use in any discounting calculations is 5%. When the annual discount rate is 5%, the present value of $1 receivable in 40 years' time is approximately 14·2 cents. (9 marks)

Required:

Explain and show how the two events would be reported in the financial statements of Delta for the year ended 30 September 2017. When considering the reporting of events in the statement of comprehensive income, you should distinguish between events being reported in profit or loss from events being reported in other comprehensive income, where this is relevant. However, you do not need to comment on potential future reclassification issues.

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

(20 marks)

3 IFRS 16 – *Leases* – was issued in January 2016 and applies to accounting periods beginning on or after 1 January 2019. However, earlier application is permitted. IFRS 16 replaces IAS 17 – *Leases*. IFRS 16 makes substantial changes to the requirements for the recognition of rights and obligations under leasing arrangements for lessees.

Required:

(a) Explain:

(i) Why the International Accounting Standards Board considered it necessary to make significant changes to the requirements for the recognition of rights and obligations under leasing arrangements in the financial statements of lessees. (4 marks)

(ii) How IFRS 16 requires lessees to recognise and measure rights and obligations under leasing arrangements. (4 marks)

(iii) Any exceptions to the usual requirements you have outlined in (ii) above. Your answer should briefly describe the accounting treatment required in the case of such exceptions and, where appropriate, the types of assets which these exceptions might apply to. (4 marks)

Kappa prepares financial statements to 30 September each year. On 1 October 2016, Kappa began to lease a property on a 10-year lease. The annual lease payments were $500,000, payable in arrears – the first payment being made on 30 September 2017. Kappa incurred initial direct costs of $60,000 in arranging this lease. The annual rate of interest implicit in the lease is 10%. When the annual discount rate is 10%, the present value of $1 payable at the end of years 1–10 is 6·145 dollars.

Required:

(b) Explain and show how these transactions would be reported in the financial statements of Kappa for the year ended 30 September 2017 under IFRS 16 – *Leases*. (8 marks)

(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 prepared the financial statements for the year ended 30 September 2017 and these are due to be published shortly. The managing director has reviewed these financial statements and has prepared a list of queries arising out of the review.

Query One

I'm confused about our treatment of equity investments in listed entities that we don't control. There seem to be two different treatments in our financial statements. One of the notes to the financial statements says that the equity investments we hold to temporarily invest surplus cash balances are measured at fair value and that changes in fair value are recognised in profit or loss. Another note says that the equity investment we hold in a key supplier is measured at fair value and that changes in fair value are recognised in other comprehensive income (OCI). Earnings per share (EPS) is a key performance indicator for Omega, so please explain how it can be justified to use two different treatments for equity investments made by the same entity. Please also explain what the impact on EPS might be if a gain or loss is reported in OCI rather than profit or loss. (6 marks)

Query Two

I noticed that OCI includes a gain of $64 million relating to the revaluation of our portfolio of properties. I looked in the notes to check that a corresponding amount of $64 million had been added to property, plant and equipment. However, the note explaining movements in property, plant and equipment showed a revaluation increase of $80 million. There was a reference to tax in one of the notes I looked at but I don't see why this is relevant. I know our rate of tax is 20% and this would explain the difference but we won't pay any tax on this gain unless we sell the properties. We have no intention of selling any of them in the foreseeable future, so what relevance does tax have? Please explain the difference between the $64 million gain in OCI and the $80 million gain added to property, plant and equipment. (6 marks)

Query Three

I'm aware that on 31 December 2016 we acquired a new subsidiary and therefore its results and net assets are included in our consolidated financial statements for the year ended 30 September 2017. I seem to recall from the discussions we held at the time that the year end of this subsidiary is 31 May rather than 30 September. How do we deal with the fact that the year ends are different when we prepare the consolidated financial statements? Do we have to prepare additional special information for this subsidiary when we consolidate? (4 marks)

Query Four

As you know, my son owns a business that supplies us with a very small proportion of the components that we use in our production process. This business is one of a number that supply us with these components and the overall quantity is totally insignificant to us. I was very surprised to see that details of these transactions with my son's business have been disclosed in the notes to the draft financial statements. This seems ridiculous when transactions with far more significant suppliers are not disclosed at all. Please explain the rationale of this disclosure to me. (4 marks)

Required:

Provide answers to the queries raised by the managing director. You should justify your answers with reference to relevant International Financial Reporting Standards.

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

(20 marks)

End of Question Paper