

Fundamentals Level – Skills Module

Financial Reporting (Irish)

Tuesday 11 December 2007

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE 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.

The Association of Chartered Certified Accountants



Paper F7 (IRL)

ALL FIVE questions are compulsory and MUST be attempted

1 On 1 October 2006 Plateau acquired the following investments:

- 3 million equity shares in Savannah by an exchange of one share in Plateau for every two shares in Savannah plus €1 per acquired Savannah share in cash. The market price of each Plateau share at the date of acquisition was €6.
- 30% of the equity shares of Axle at a cost of €7.50 per share in cash.

Only the cash consideration of the above investments has been recorded by Plateau.

The summarised draft balance sheets of the three companies at 30 September 2007 are:

	Plateau €'000	Savannah €'000	Axle €'000
Tangible fixed assets	18,400	10,400	18,000
Investments in Savannah and Axle	12,000	nil	nil
Available-for-sale investments	6,500	nil	nil
	<u>36,900</u>	<u>10,400</u>	<u>18,000</u>
Current assets			
Stock	6,900	6,200	3,600
Debtors	3,200	1,500	2,400
	<u>10,100</u>	<u>7,700</u>	<u>6,000</u>
Creditors: amount falling due within one year	<u>(8,000)</u>	<u>(4,200)</u>	<u>(3,000)</u>
Creditors: amounts falling due after more than one year			
7% Loan notes	<u>(5,000)</u>	<u>(1,000)</u>	<u>(1,000)</u>
	<u>34,000</u>	<u>12,900</u>	<u>20,000</u>
Capital and reserves			
Equity shares of €1 each	10,000	4,000	4,000
Profit and loss account – at 30 September 2006	16,000	6,500	11,000
– for year ended 30 September 2007	<u>8,000</u>	<u>2,400</u>	<u>5,000</u>
	<u>34,000</u>	<u>12,900</u>	<u>20,000</u>

The following information is relevant:

- (i) At the date of acquisition the fair values of Savannah's assets were equal to their carrying amounts with the exception of Savannah's land which had a fair value of €500,000 **below** its carrying amount; it was written down by this amount shortly after acquisition and has not changed in value since then.
- (ii) On 1 October 2006, Plateau sold an item of plant to Savannah at its agreed fair value of €2.5 million. Its carrying amount prior to the sale was €2 million. The estimated remaining life of the plant at the date of sale was five years (straight-line depreciation).
- (iii) During the year ended 30 September 2007 Savannah sold goods to Plateau for €2.7 million. Savannah had marked up these goods by 50% on cost. Plateau had a third of the goods still in its stock at 30 September 2007. There were no intra-group debtors/creditors at 30 September 2007.
- (iv) The goodwill of Savannah is amortised over a five year life. The goodwill of Axle is deemed to have an indefinite life and was not impaired at 30 September 2007.
- (v) The available-for-sale investments are included in Plateau's balance sheet (above) at their fair value on 1 October 2006, but they have a fair value of €9 million at 30 September 2007
- (vi) No dividends were paid during the year by any of the companies.

Required:

(a) Prepare the consolidated balance sheet for Plateau as at 30 September 2007. (20 marks)

(b) A financial assistant has observed that the fair value exercise means that a subsidiary's net assets are included at acquisition at their fair (current) values in the consolidated balance sheet. The assistant believes that it is inconsistent to aggregate the subsidiary's net assets with those of the parent because most of the parent's assets are carried at historical cost.

Required:

Comment on the assistant's observation and explain why the net assets of acquired subsidiaries are consolidated at acquisition at their fair values. (5 marks)

(25 marks)

2 The following trial balance relates to Llama, a listed company, at 30 September 2007:

	€'000	€'000
Land and buildings – at valuation 1 October 2006 (note (i))	130,000	
Plant – at cost (note (i))	128,000	
Accumulated depreciation of plant at 1 October 2006		32,000
Investments – at fair value through profit and loss (note (i))	26,500	
Investment income		2,200
Cost of sales (note (i))	89,200	
Distribution costs	11,000	
Administrative expenses	12,500	
Loan interest paid	800	
Stock at 30 September 2007	37,900	
Corporation tax (note (ii))		400
Trade debtors	35,100	
Turnover		180,400
Equity shares of 50 cent each fully paid		60,000
Profit and loss account at 1 October 2006		25,500
2% loan note 2009 (note (iii))		80,000
Trade creditors		34,700
Revaluation reserve (arising from land and buildings)		14,000
Deferred tax		11,200
Suspense account (note (iv))		24,000
Bank		6,600
	471,000	471,000

The following notes are relevant:

- (i) Llama has a policy of revaluing its land and buildings at each year end. The valuation in the trial balance includes a land element of €30 million. The estimated remaining life of the buildings at that date (1 October 2006) was 20 years. On 30 September 2007, a professional valuer valued the buildings at €92 million with no change in the value of the land. Depreciation of buildings is charged 60% to cost of sales and 20% each to distribution costs and administrative expenses.

During the year Llama manufactured an item of plant that it is using as part of its own operating capacity. The details of its cost, which is included in cost of sales in the trial balance, are:

	€'000
Materials cost	6,000
Direct labour cost	4,000
Machine time cost	8,000
Directly attributable overheads	6,000

The manufacture of the plant was completed on 31 March 2007 and the plant was brought into immediate use, but its cost has not yet been capitalised.

All plant is depreciated at 12½% per annum (time apportioned where relevant) using the reducing balance method and charged to cost of sales. No fixed assets were sold during the year.

The fair value of the investments held at fair value through profit and loss at 30 September 2007 was €27.1 million.

- (ii) The balance of corporation tax in the trial balance represents the under/over provision of the previous year's estimate. The estimated corporation tax liability for the year ended 30 September 2007 is €18.7 million. At 30 September 2007 there were €40 million of net accelerated capital allowances. The corporation tax rate is 25%.
- (iii) The 2% loan note was issued on 1 April 2007 under terms that provide for a large premium on redemption in 2009. The finance department has calculated that the effect of this is that the loan note has an effective interest rate of 6% per annum.

(iv) The suspense account contains the corresponding credit entry for the proceeds of a rights issue of shares made on 1 July 2007. The terms of the issue were one share for every four held at 80 cent per share. Llama's share price immediately before the issue was €1. The issue was fully subscribed.

Required:

Prepare for Llama:

- (a) **A profit and loss account for the year ended 30 September 2007.** (9 marks)
- (b) **A balance sheet as at 30 September 2007.** (13 marks)
- (c) **A calculation of the earnings per share for the year ended 30 September 2007.** (3 marks)

Note: statements of total recognised gains and losses or movements on capital and reserves are not required.

(25 marks)

- 3 Shown below are the recently issued (summarised) financial statements of Harbin, a listed company, for the year ended 30 September 2007, together with comparatives for 2006 and extracts from the Chief Executive's report that accompanied their issue.

Profit and loss account	2007	2006
	€'000	€'000
Turnover	250,000	180,000
Cost of sales	(200,000)	(150,000)
Gross profit	50,000	30,000
Operating expenses	(26,000)	(22,000)
Finance costs	(8,000)	(nil)
Profit before tax	16,000	8,000
Corporation tax (at 25%)	(4,000)	(2,000)
Profit for the period	12,000	6,000
Balance sheet		
Fixed assets		
Goodwill	10,000	nil
Tangible fixed assets	210,000	90,000
	220,000	90,000
Current assets		
Stock	25,000	15,000
Debtors	13,000	8,000
Bank	nil	14,000
	38,000	37,000
Creditors: amounts falling due within one year		
Bank overdraft	17,000	nil
Trade creditors	23,000	13,000
Corporation tax payable	4,000	2,000
	(44,000)	(15,000)
Creditors: amounts falling due after more than one year		
8% loan notes	(100,000)	(nil)
	114,000	112,000
Capital and reserves		
Equity shares of €1 each	100,000	100,000
Profit and loss account	14,000	12,000
	114,000	112,000

Extracts from the Chief Executive's report:

'Highlights of Harbin's performance for the year ended 30 September 2007:

- an increase in turnover of 39%
- gross profit margin up from 16.7% to 20%
- a doubling of the profit for the period.

In response to the improved position the Board paid a dividend of 10 cent per share in September 2007 an increase of 25% on the previous year.'

You have also been provided with the following further information.

On 1 October 2006 Harbin purchased the whole of the net assets of Fatima (previously a privately owned entity) for €100 million. The contribution of the purchase to Harbin's results for the year ended 30 September 2007 was:

	€'000
Turnover	70,000
Cost of sales	(40,000)
Gross profit	<u>30,000</u>
Operating expenses	(8,000)
Profit before tax	<u>22,000</u>

There were no disposals of fixed assets during the year.

The following ratios have been calculated for Harbin for the year ended 30 September 2006:

Return on year-end capital employed (profit before interest and tax over total assets less current liabilities)	7.1%
Net asset (equal to capital employed) turnover	1.6
Net profit (before tax) margin	4.4%
Current ratio	2.5
Closing stock holding period (in days)	37
Debtors' collection period (in days)	16
Creditors' payment period (based on cost of sales) (in days)	32
Gearing (debt over debt plus equity)	nil

Required:

- (a) Calculate ratios for Harbin for the year ended 30 September 2007 equivalent to those calculated for the year ended 30 September 2006 (showing your workings). (8 marks)
- (b) Assess the financial performance and position of Harbin for the year ended 30 September 2007 compared to the previous year. Your answer should refer to the information in the Chief Executive's report and the impact of the purchase of the net assets of Fatima. (17 marks)

(25 marks)

- 4 (a) An important requirement of the ASB's Statement of Principles for Financial Reporting (Statement of principles) is that in order to be reliable, an entity's financial statements should represent faithfully the transactions and events that it has undertaken.

Required:

Explain what is meant by faithful representation and how it enhances reliability. (5 marks)

- (b) On 1 April 2007, Fino increased the operating capacity of its plant. Due to a lack of liquid funds it was unable to buy the required plant which had a cost of €350,000. On the recommendation of the finance director, Fino entered into an agreement to lease the plant from the manufacturer. The lease required four annual payments in advance of €100,000 each commencing on 1 April 2007. The plant would have a useful life of four years and would be scrapped at the end of this period. The finance director, believing the lease to be an operating lease, commented that the agreement would improve the company's return on capital employed (compared to outright purchase of the plant).

Required:

- (i) **Discuss the validity of the finance director's comment and describe how SSAP 21 *Accounting for Leases and Hire Purchase Contracts* ensures that leases such as the above are faithfully represented in an entity's financial statements.** (4 marks)
- (ii) **Prepare extracts of Fino's profit and loss account and balance sheet for the year ended 30 September 2007 in respect of the rental agreement assuming:**
- (1) **It is an operating lease;** (2 marks)
- (2) **It is a finance lease (use an implicit interest rate of 10% per annum).** (4 marks)

(15 marks)

- 5 Product development costs are a material cost for many companies. They are either written off as an expense or capitalised as an asset.

Required:

- (a) **Discuss the conceptual issues involved and the definition of an asset that may be applied in determining whether development expenditure should be treated as an expense or an asset.** (4 marks)

- (b) Emerald has had a policy of writing off development expenditure to the profit and loss account as it was incurred. In preparing its financial statements for the year ended 30 September 2007 it has decided to change its accounting policy to one of capitalising qualifying development expenditure. Below is the qualifying development expenditure for Emerald:

	€'000
Year ended 30 September 2004	300
Year ended 30 September 2005	240
Year ended 30 September 2006	800
Year ended 30 September 2007	400

All capitalised development expenditure is deemed to have a four year life. Assume amortisation commences at the beginning of the accounting period **following** capitalisation. Emerald had no development expenditure before that for the year ended 30 September 2004.

Required:

Calculate the amounts which should appear in the profit and loss account and balance sheet (including comparative figures), and statement of recognised gains and losses of Emerald in respect of the development expenditure for the year ended 30 September 2007.

Note: ignore taxation.

(6 marks)

(10 marks)

End of Question Paper