Fundamentals Level – Skills Module

Financial Reporting (United Kingdom)

Tuesday 9 December 2008

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 (UK)

ACCA

ALL FIVE questions are compulsory and MUST be attempted

1 On 1 April 2008, Pedantic acquired 60% of the equity share capital of Sophistic in a share exchange of two shares in Pedantic for three shares in Sophistic. The issue of shares has not yet been recorded by Pedantic. At the date of acquisition shares in Pedantic had a market value of £6 each. Pedantic also incurred directly related acquisition costs of £300,000 which are included in administrative expenses. Below are the summarised draft financial statements of both companies.

Profit and loss accounts for the year ended 30 September 2008

	Pedantic £'000	Sophistic £'000
Turnover	85,000	42,000
Cost of sales	(63,000)	(32,000)
Gross profit	22,000	10,000
Distribution costs	(2,000)	(2,000)
Administrative expenses	(6,000)	(3,200)
Operating profit	14,000	4,800
Finance costs	(300)	(400)
Profit before tax	13,700	4,400
Taxation	(4,700)	(1,400)
Profit for the year	9,000	3,000

Balance sheets as at 30 September 2008

	Pedantic £'000	Sophistic £'000
Fixed assets		
Tangible assets	40,600	12,600
Current assets	16,000	6,600
Creditors: amounts falling due within one year	(8,200)	(4,700)
Creditors: amounts falling due after more than one year		
10% loan notes	(3,000)	(4,000)
	45,400	10,500
Capital and reserves		
Equity shares of £1 each	10,000	4,000
Profit and loss account	35,400	6,500
	45,400	10,500

The following information is relevant:

(i) At the date of acquisition, the fair values of Sophistic's assets were equal to their carrying amounts with the exception of an item of plant, which had a fair value of £2 million in excess of its carrying amount. It had a remaining life of five years at that date [straight-line depreciation is used]. Sophistic has not adjusted the carrying amount of its plant as a result of the fair value exercise.

(ii) Sales from Sophistic to Pedantic in the post acquisition period were £8 million. Sophistic made a mark-up on cost of 40% on these sales. Pedantic had sold £5·2 million (at cost to Pedantic) of these goods by 30 September 2008.

(iii) Other than where indicated, profit and loss account items are deemed to accrue evenly on a time basis.

(iv) Sophistic's trade debtors at 30 September 2008 include £600,000 due from Pedantic which did not agree with Pedantic's corresponding trade creditor. This was due to cash in transit of £200,000 from Pedantic to Sophistic. Both companies have positive bank balances.

(v) Consolidated goodwill has an indefinite life and has not been impaired at 30 September 2008.

Required:

(a) Prepare the consolidated profit and loss account for Pedantic for the year ended 30 September 2008. (9 marks)

(b) Prepare the consolidated balance sheet for Pedantic as at 30 September 2008. (16 marks)

(25 marks)

2 The following trial balance relates to Candel at 30 September 2008:

	£'000	£'000
Leasehold property – at valuation 1 October 2007 (note (i))	50,000	
Plant and equipment – at cost (note (i))	76,600	
Plant and equipment – accumulated depreciation at 1 October 2007		24,600
Capitalised development expenditure – at 1 October 2007 (note (ii))	20,000	
Development expenditure – accumulated amortisation at 1 October 2007		6,000
Closing stock at 30 September 2008	20,000	
Trade debtors	43,100	
Bank		1,300
Trade creditors and provisions (note (iii))		23,800
Turnover (note (i))		300,000
Cost of sales	204,000	
Distribution costs	14,500	
Administrative expenses (note (iii))	22,200	
Preference dividend paid	800	
Interest on bank borrowings	200	
Equity dividend paid	6,000	
Research and development costs (note (ii))	8,600	
Equity shares of 25 pence each		50,000
8% redeemable preference shares of £1 each (note (iv))		20,000
Profit and loss account at 1 October 2007		24,500
Deferred tax (note (v))		5,800
Leasehold property revaluation reserve		10,000
	466,000	466,000

The following notes are relevant:

(i) Fixed assets – tangible:
The leasehold property had a remaining life of 20 years at 1 October 2007. The company's policy is to revalue its property at each year end and at 30 September 2008 it was valued at £43 million.

On 1 October 2007 an item of plant was disposed of for £2·5 million cash. The proceeds have been included in turnover by Candel. The plant is still included in the above trial balance figures at its cost of £8 million and depreciation of £4 million (to the date of disposal).

All plant is depreciated at 20% per annum using the reducing balance method.

Depreciation and amortisation of all fixed assets is charged to cost of sales.

(ii) Fixed assets – intangible:
In addition to the capitalised development expenditure (of £20 million), further research and development costs were incurred on a new project which commenced on 1 October 2007. The research period of the new project lasted until 31 December 2007 and incurred £1·4 million of costs. From that date the project incurred development costs of £800,000 per month. On 1 April 2008 the directors became confident that the project would be successful and yield a profit well in excess of its costs. The project is still in development at 30 September 2008.

Candel has a policy of capitalising development expenditure where permitted by accounting standards. Capitalised development expenditure is amortised at 20% per annum using the straight-line method. All expensed research and development is charged to cost of sales.

(iii) Candel is being sued by a customer for £2 million for breach of contract over a cancelled order. Candel has obtained legal opinion that there is a 20% chance that Candel will lose the case. Accordingly Candel has provided £400,000 (£2 million x 20%) included in administrative expenses in respect of the claim. The unrecoverable legal costs of defending the action are estimated at £100,000. These have not been provided for as the legal action will not go to court until next year.

(iv) The preference shares were issued on 1 April 2008 at par. They are redeemable at a large premium which gives them an effective finance cost of 12% per annum.

(v) The directors have estimated the provision for corporation tax for the year ended 30 September 2008 at £11·4 million. The required deferred tax provision at 30 September 2008 is £6 million.

Required:

(a) Prepare the profit and loss account for the year ended 30 September 2008. (11 marks)

(b) Prepare the statement of the movements in share capital and reserves for the year ended 30 September 2008. (4 marks)

(c) Prepare the balance sheet as at 30 September 2008. (10 marks)

Note: notes to the financial statements are not required.

(25 marks)

3 Victular is a public company that would like to acquire (100% of) a suitable private company. It has obtained the following draft financial statements for two companies, Grappa and Merlot. They operate in the same industry and their managements have indicated that they would be receptive to a takeover.

Profit and loss accounts for the year ended 30 September 2008

		Grappa		Merlot
	£'000	£'000	£'000	£'000
Turnover		12,000		20,500
Cost of sales		(10,500)		(18,000)
Gross profit		1,500		2,500
Operating expenses		(240)		(500)
Operating profit		1,260		2,000
Finance costs – loan		(210)		(300)
– overdraft		nil		(10)
– lease		nil		(290)
Profit before tax		1,050		1,400
Taxation		(150)		(400)
Profit for the year		900		1,000
Note: dividends paid during the year		250		700

Balance sheets as at 30 September 2008

Fixed assets				
Freehold factory (note (i))		4,400		nil
Owned plant (note (ii))		5,000		2,200
Leased plant (note (ii))		nil		5,300
		9,400		7,500
Current assets				
Stock	2,000		3,600	
Trade debtors	2,400		3,700	
Bank	600		nil	
	5,000		7,300	
Creditors: amounts falling due within one year				
Bank overdraft	nil		1,200	
Trade creditors	3,100		3,800	
Government grants	400		nil	
Finance lease obligations (note (iii))	nil		500	
Taxation	600		200	
	(4,100)		(5,700)	
Net current assets		900		1,600
Total assets less current liabilities		10,300		9,100
Creditors: amounts falling due after more than one year				
Finance lease obligations (note (iii))	nil		3,200	
7% loan notes	3,000		nil	
10% loan notes	nil		3,000	
Deferred tax	600		100	
Government grants	1,200	(4,800)	nil	(6,300)
		5,500		2,800

	£'000	Grappa £'000	£'000	Merlot £'000
Capital and reserves				
Equity shares of £1 each		2,000		2,000
Property revaluation reserve	900		nil	
Profit and loss account	2,600	3,500	800	800
		5,500		2,800

Notes

(i) Both companies operate from similar premises.

(ii) Additional details of the two companies' plant are:

	Grappa £'000	Merlot £'000
Owned plant – cost	8,000	10,000
Leased plant – original fair value	nil	7,500

There were no disposals of plant during the year by either company.

(iii) The interest rate implicit within Merlot's finance leases is 7·5% per annum. For the purpose of calculating ROCE and gearing, **all** finance lease obligations are treated as long-term interest bearing borrowings.

(iv) The following ratios have been calculated for Grappa and can be taken to be correct:

Return on year end capital employed (ROCE)	14·8%
(capital employed taken as shareholders' funds plus long-term interest bearing borrowings – see note (iii) above)	
Pre-tax return on equity (ROE)	19·1%
Net asset (total assets less current liabilities) turnover	1·2 times
Gross profit margin	12·5%
Operating profit margin	10·5%
Current ratio	1·2:1
Closing stock holding period	70 days
Trade debtors' collection period	73 days
Trade creditors' payment period (using cost of sales)	108 days
Gearing (see note (iii) above)	35·3%
Interest cover	6 times
Dividend cover	3·6 times

Required:

(a) Calculate for Merlot the ratios equivalent to all those given for Grappa above. (8 marks)

(b) Assess the relative performance and financial position of Grappa and Merlot for the year ended 30 September 2008 to inform the directors of Victular in their acquisition decision. (12 marks)

(c) Explain the limitations of ratio analysis and any further information that may be useful to the directors of Victular when making an acquisition decision. (5 marks)

(25 marks)

4 **(a)** The definition of a liability forms an important element of the Accounting Standards Board's *Statement of Principles for Financial Reporting* which, in turn, forms the basis for FRS 12 *Provisions, Contingent Liabilities and Contingent Assets*.

Required:

Define a liability and describe the circumstances under which provisions should be recognised. Give two examples of how the definition of liabilities enhances the reliability of financial statements. (5 marks)

(b) On 1 October 2007, Promoil acquired a newly constructed oil platform at a cost of £30 million together with the right to extract oil from an offshore oilfield under a government licence. The terms of the licence are that Promoil will have to remove the platform (which will then have no value) and restore the sea bed to an environmentally satisfactory condition in 10 years' time when the oil reserves have been exhausted. The estimated cost of this on 30 September 2017 will be £15 million. The present value of £1 receivable in 10 years at the appropriate discount rate for Promoil of 8% is £0·46.

Required:

(i) **Explain and quantify how the oil platform should be treated in the financial statements of Promoil for the year ended 30 September 2008;** (7 marks)

(ii) **Describe how your answer to (b)(i) would change if the government licence did not require an environmental clean up.** (3 marks)

(15 marks)

5 On 1 October 2005 Dearing acquired a machine under the following terms:

	Hours	£
Manufacturer's base price		1,050,000
Trade discount (applying to base price only)		20%
Early settlement discount taken (on the payable amount of the base cost only)		5%
Freight charges		30,000
Electrical installation cost		28,000
Staff training in use of machine		40,000
Pre-production testing		22,000
Purchase of a three-year maintenance contract		60,000
Estimated residual value		20,000
Estimated life in machine hours	6,000	
Hours used – year ended 30 September 2006	1,200	
– year ended 30 September 2007	1,800	
– year ended 30 September 2008 (see below)	850	

On 1 October 2007 Dearing decided to upgrade the machine by adding new components at a cost of £200,000. This upgrade led to a reduction in the production time per unit of the goods being manufactured using the machine. The upgrade also increased the estimated remaining life of the machine at 1 October 2007 to 4,500 machine hours and its estimated residual value was revised to £40,000.

Required:

Prepare extracts from the profit and loss account and balance sheet for the above machine for each of the three years to 30 September 2008.

(10 marks)

End of Question Paper