INTERNATIONAL STANDARDS INTERNATIONAL STANDARDS INTERNATIONAL

CIMA

Intermediate Level

Financial Accounting – International Accounting Standards

6b

IFAI

21 May 2003

Wednesday morning

INSTRUCTIONS TO CANDIDATES

Read this page before you look at the questions

You are allowed three hours to answer this question paper.
This question paper is based on INTERNATIONAL ACCOUNTING STANDARDS. If you require the paper based on UK Accounting Standards, please speak immediately to the invigilator.
Answer the ONE question in section A (this has 10 sub-questions). Answer the ONE question in section B. Answer TWO questions ONLY from section C.
Write your examination number in the boxes provided on the front of the answer book. Write IFAI on the line marked "Subject" on the front of the answer book. Write your examination number on the special answer sheet for section A which is on page 3 of this question paper booklet. Detach the sheet from the booklet and insert it into your answer book before you hand this in.
Do NOT write your name or your student registration number anywhere on your answer book.
Tick the appropriate boxes on the front of the answer book to indicate which questions you have answered.

SECTION A — 20 MARKS

ANSWER *ALL* TEN SUB-QUESTIONS – 2 MARKS EACH

Each of the sub-questions numbered from **1.1** to **1.10** inclusive, given below, has only ONE correct answer.

REQUIRED:

On the SPECIAL ANSWER SHEET opposite, place a circle "O" around the letter that gives the correct answer to each sub-question.

If you wish to change your mind about an answer, block out your first answer completely and then circle another letter. You will not receive marks if more than one letter is circled.

Please note that you will not receive marks for any workings to these sub-questions.

You must detach the special answer sheet from the question paper and attach it to the inside front cover of your answer book before you hand it to the invigilators at the end of the examination.

Question One

1.1 An investment property is defined by IAS 40 – *Investment Property* as

A an investment in land and / or buildings whether let to third parties or occupied by an enterprise within the group.

B a property owned and occupied by an enterprise for its own purposes.

C a property which is held to earn rentals or for capital appreciation.

D an investment in land and / or buildings other than leased property.

1.2 A capital grant received by an enterprise to offset the cost of purchasing a non-current asset should be accounted for as follows:

(i) Credit a deferred income account.

(ii) Credit the grant to a reserve account.

(iii) Release to the income statement over the life of the asset.

(iv) Release the grant to the statement of recognised gains and losses over the life of the asset.

(v) Credit the full amount to the income statement in year of receipt.

Which one of the following is correct?

A (i) and (iii) only

B (v) only

C (ii) and (iii) only

D (ii) and (iv) only

1.3 IAS 14 – *Segment Reporting* requires that segment revenue and result should be

A analysed by business segments and geographical segments.

B analysed by business segments.

C analysed by geographical segments.

D analysed by business segment and type of customer.

1.4 IAS 8 – *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* specifies the definition and treatment of a number of different items.

Which of the following is NOT specified by IAS 8?

A The effect of a change in an accounting estimate.

B Prior period adjustments.

C Extraordinary items.

D Provisions.

1.5 The gearing ratio of an enterprise is calculated as

(i) equity share capital and reserves;

(ii) equity share capital;

(iii) non-equity share capital and debt;

(iv) total gross assets;

(v) total debt.

Which one of the following is correct?

A (iii) divided by (ii) and (iii)

B (iii) divided by (i) and (iii)

C (v) divided by (iv)

D (v) divided by (ii)

1.6 Which one of the following descriptions most accurately describes "creative accounting"?

A Creating fictitious assets on the balance sheet to show a stronger financial position.

B Not applying International Accounting Standards' requirements so as to show a better year-end position.

C Deliberately falsifying the financial statements to show a stronger financial position.

D Using loop-holes in International Accounting Standards' requirements so that the financial statements are biased in the required direction.

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*The following data is to be used to answer questions **1.7 and 1.8** below*

B entered into a three-year contract to build a leisure centre for an enterprise. The contract value was $6 million. B recognises profit on the basis of certified work completed. At the end of the first year, the following figures were extracted from B's accounting records:

	$000
Certified value of work completed (progress payments billed)	2,000
Cost of work certified as complete	1,650
Cost of work-in-progress (not included in completed work)	550
Estimated cost of remaining work required to complete the contract	2,750
Progress payments received from enterprise	1,600
Cash paid to suppliers for work on the contract	1,300

1.7 How much profit should B recognise in its income statement at the end of the first year?

A $200,000 (loss)

B $300,000

C $350,000

D $400,000

1.8 What values should B record for this contract as "gross amounts due from customers" and "current liabilities – trade and other payables"?

	Gross amounts due from customers	*Current liabilities – trade and other payables*
A	$950,000	$350,000
B	$950,000	$900,000
C	$1,250,000	$600,000
D	$2,550,000	$900,000

1.9 The following balances were extracted from the books of A:

	31 March 2003
	$000
Sales	300
Cost of sales	200
Gross profit	100
Closing inventory	15
Trade receivables	36
Trade payables	28

A's average working capital cycle for the year ended 31 March 2003 is

A 11·0 days

B 20·1 days

C 34·7 days

D 37·1 days

1.10 R issued 500,000 new $1 equity shares on 1 April 2002. The issue price of the shares was $1·50 per share. Applicants paid $0·20 per share with their applications and a further $0.80 per share on allotment. All money was received on time.

A final call of $0·50 per share was made on 31 January 2003. One holder of 5,000 shares failed to pay the call by the due date and the shares were forfeited. The forfeited shares were reissued for $1 per share on 31 March 2003.

Which of the following is the correct set of accounting entries to record the reissue of the forfeited shares?

	Investment in own shares account	*Bank account*	*Investment in own shares account*	*Share premium account*
A	$5,000 credit	$5,000 debit	$2,500 debit	$2,500 credit
B	$5,000 credit	$5,000 debit	0	0
C	$5,000 credit	$5,000 debit	$2,500 credit	$2,500 debit
D	$5,000 debit	$5,000 credit	$2,500 credit	$2,500 debit

(Total = 20 marks)

SECTION B – 30 MARKS
ANSWER THIS QUESTION

Question Two

AZ is a quoted manufacturing enterprise. Its finished products are stored in a nearby warehouse until ordered by customers. AZ has performed very well in the past, but has been in financial difficulties in recent months and has been reorganising the business to improve performance.

The trial balance for AZ at 31 March 2003 was as follows:

	$000	*$000*
7% loan notes (redeemable 2007)		18,250
Accumulated profits at 31 March 2002		11,444
Administrative expenses	16,020	
Bank and cash	2,250	
Cost of goods manufactured in the year to 31 March 2003 (excluding depreciation)	94,000	
Distribution costs	9,060	
Dividends paid	1,000	
Dividends received		1,200
Interest paid	639	
Inventory at 31 March 2002	4,852	
Investments at market value	24,000	
Ordinary shares of $1 each, fully paid		20,000
Plant and equipment	30,315	
Provision for depreciation at 31 March 2002:		
Plant and equipment		6,060
Vehicles		1,670
Provision for deferred tax at 31 March 2002		138
Provision for doubtful debts at 31 March 2002		600
Restructuring costs	121	
Revaluation reserve		3,125
Sales revenue		124,900
Share issue expenses	70	
Share premium		500
Taxation	30	
Trade payables		8,120
Trade receivables	9,930	
Vehicles	3,720	
	196,007	196,007

Additional information provided:

(i) Non-current assets are being depreciated as follows:

Plant and equipment	20% per annum straight line
Vehicles	25% per annum reducing balance

Depreciation of plant and equipment is considered to be part of cost of sales while depreciation of vehicles should be included under distribution costs.

(ii) The balance on the taxation account is the previous year's income taxes underestimated in last year's financial statements by $30,000. Taxation due for the year to 31 March 2003 is estimated at $150,000.

(iii) A transfer to deferred tax for the year to 31 March 2003 of $11,000 is to be made.

(iv) The closing inventory at 31 March 2003 was $5,180,000. An inspection of finished goods inventory found that a production machine had been set up incorrectly and that several production batches, which had cost $50,000 to manufacture, had the wrong packaging. The goods cannot be sold in this condition but could be repacked at an additional cost of $20,000. They could then be sold for $55,000. The wrongly packaged goods were included in closing inventory at their cost of $50,000.

(v) A dividend of 5 cents per ordinary share was paid in February 2003.

(vi) The 7% loan notes are 10-year loans due for repayment by 31 March 2007. AZ incurred no other interest charges in the year to 31 March 2003.

(vii) The provision for doubtful debts is to be adjusted to 5% of the closing trade receivables' balance.

(viii) The restructuring costs in the trial balance represent the cost of a major fundamental restructuring of the enterprise to improve competitiveness and future profitability.

(ix) As at 31 March 2003, AZ was engaged in defending a legal action against the enterprise. Legal advisers have indicated that it is reasonably certain that the outcome of the case will be against the enterprise. The amount of compensation is currently estimated at $25,000.

(x) On 1 October 2002, AZ issued 1,000,000 ordinary shares at $1·50 each. All money had been received and correctly accounted for by the year end.

Required:

Prepare AZ's income statement for the year to 31 March 2003, a balance sheet at that date, and a statement of changes in equity for the year. These should be in a form suitable for presentation to the shareholders, in accordance with the requirements of International Accounting Standards.

Notes to the financial statements are not required, but all workings must be clearly shown. DO NOT prepare a statement of accounting policies or a statement of recognised gains and losses.

(30 marks)

SECTION C – 50 MARKS

ANSWER TWO QUESTIONS ONLY

Question Three

BY prepares its financial statements to 31 March each year. The following information relates to the year ended 31 March 2003; the financial statements for the year to 31 March 2003 have not yet been completed. There are some transactions regarding non-current assets that need to be clarified.

(a) Some of the cars used by BY's sales force needed replacing. Three new cars were acquired on 1 October 2002. The cars were leased from CarLease on the following terms:

- a non-cancellable 5-year lease;
- a total of 10 payments, made every six months in arrears;
- each instalment to be $7,200 ($2,400 per car);
- the interest rate implicit in the lease was 3·5% per six-month period;
- the fair value of each car was $20,000. The present value of the lease payments equals the fair value of the cars at the inception of the lease;
- the residual value of each car at the end of the lease is assumed to be zero;
- BY will pay for all insurance, repairs and maintenance costs.

Required:

(i) Explain the meaning of a "finance lease", using the above to illustrate your answer. Identify whether the lease on BY's cars should be treated as an operating lease or a finance lease.

(8 marks)

(ii) Assuming that the lease is to be treated as a finance lease, calculate the figures that will appear in respect of the lease in BY's income statement for the year ended 31 March 2003 and its balance sheet at that date.

(7 marks)

(b) A new type of delivery vehicle, when purchased on 1 April 2000 for $20,000, was expected to have a useful economic life of 4 years. It now appears that the original estimate of the useful economic life was too short, and the vehicle is now expected to have a useful economic life of 6 years, from the date of purchase.

All delivery vehicles are depreciated using the straight-line method and are assumed to have zero residual value.

Required:

State how BY should record the delivery vehicle in the income statement for the year ended 31 March 2003 and the balance sheet at that date. Justify your treatment by reference to appropriate International Accounting Standards.

(5 marks)

(c) A new machine was purchased from a German enterprise during the year to 31 March 2003. The purchase contract provided for payment to be made in dollars. The following payments were detailed in the contract:

	$
Basic cost of the machine	110,000
Upgrades and specific modifications to BY specifications	22,000
Shipping and transport charges payable in Europe ($ equivalent)	3,200
Total invoiced cost	135,200
Delivery, handling and installation charges	900
Total purchase price	136,100

The contract provided for 10% of the invoiced cost to be paid when the contract was signed, 40% when the machine was despatched, and the balance one month after installation. The delivery, handling and installation charges were to be paid as incurred. All delivery, handling and installation charges were paid by 31 March 2003.

The contract was signed on 1 January 2003 and the machine was despatched on 1 February 2003. BY made both payments on the due date. Delivery was made and installation completed on 25 March 2003.

Required:

State how BY should record the purchase of the machine in its income statement for the year ended 31 March 2003 and the balance sheet at that date. Justify your treatment by reference to appropriate International Accounting Standards.

(5 marks)

(Total = 25 marks)

Question Four

You are a trainee management accountant working for E. You have been co-opted onto a working group whose remit is to identify a suitable enterprise for acquisition.

The two enterprises under consideration are:

- X, which supplies 30% of E's purchases. Acquiring X as a subsidiary would give E considerable savings through discounts on purchases.
- Z, which operates in a related market. No immediate savings have been identified.

The summarised balance sheets and income statements for each enterprise at 31 March 2003 are given below.

Summarised balance sheets at 31 March 2003

	X	*Z*
	$000	*$000*
Non-current assets – tangible	8,439	7,326
Current assets	2,526	1,404
Total assets	10,965	8,730
Ordinary shares of 20 cents each	320	
Ordinary shares of $1 each		300
Share premium	2,290	1,800
Revaluation reserve	2,600	0
Accumulated profits	692	928
	5,902	3,028
10% loan notes	3,800	5,000
Current liabilities	1,263	702
Total equity and liabilities	10,965	8,730

Summarised income statements for the year to 31 March 2003

	X	*Z*
	$000	*$000*
Revenue	7,847	9,340
Cost of sales	(5,689)	(5,960)
Gross profit	2,158	3,380
Distribution costs	(354)	(836)
Administration expenses	(611)	(1,162)
Profit from operations	1,193	1,382
Finance cost	(380)	(600)
Profit before tax	813	782
Income tax expense	(220)	(210)
Net profit for the period	593	572

Summarised statements of changes in equity for the year to 31 March 2003

	X	*Z*
	$000	*$000*
Equity at 31 March 2002	5,629	2,956
Net profit for the year	593	572
Dividends paid	(320)	(500)
Equity at 31 March 2003	5,902	3,028
Average share price for the period	$5·00	$12·00

Required:

(a) Calculate the P/E ratio for each enterprise.

(3 marks)

(b) Using suitable accounting ratios to support your findings, draft a report to the acquisitions working group identifying the most suitable enterprise for further investigation, assuming:

- E would acquire 100% of the equity capital;
- the decision is based entirely on the profitability of each enterprise.

(16 marks)

(c) When analysing financial statements and interpreting accounting ratios, it is important to consider "non-financial factors" before making any decisions.

Required:

Explain briefly the main "non-financial factors" which should be considered when deciding whether to acquire an enterprise.

(6 marks)

(Total = 25 marks)

Question Five

The International Accounting Standards Committee (IASC), the predecessor of the International Accounting Standards Board (IASB), issued the Framework for the preparation and presentation of financial statements (Framework) in 1989.

Required:

(a) Explain the four principal characteristics that make financial information useful, as outlined in the Framework.

(9 marks)

(b) The introduction to the IASB's Framework states "The purpose of the Framework is to assist the Board in the development of future International Accounting Standards and in its review of existing International Accounting Standards".

Required:

Explain how the Framework can help with the development and review of Accounting Standards. Use IAS 1 – *Presentation of financial statements* to illustrate your answer.

(10 marks)

(c) IAS 1 states that financial statements should present fairly the financial position, financial performance and cash flows of an enterprise. It goes on to say that financial statements that comply with all relevant IASs almost always achieve this objective of fair presentation.

Required:

Explain what should be disclosed in the minority of cases where following a specific IAS requirement would not achieve fair presentation.

(6 marks)

(Total = 25 marks)

Question Six

(a) Published financial statements include all transactions that took place during the accounting period. Sometimes transactions or events that take place outside of the accounting period are included in the financial statements as well.

Required:

(i) Explain how IAS 10 – *Events after the balance sheet date* defines such events and what adjustments (if any) need to be made to the financial statements as a result of such events.

(6 marks)

(ii) Identify three other International Accounting Standards which might require transactions or events occurring in an accounting period to affect the financial statements of an earlier or later period. Give an example for each Standard identified.

(6 marks)

(b) During April 2003, excessive rain fell in the region where Z's main factory and warehouse facilities are situated. At the end of April 2003, the rainfall caused heavy flooding and Z's factory and warehouse were standing in two metres of water. The factory plant and equipment were damaged but can be fully repaired. However, all of Z's inventory was badly damaged and was written off. Z's equipment repairs and inventory write-offs were insured and the insurance underwriter has agreed to pay for the repairs and the replacement of the inventory. As it will be some time before the factory is able to operate normally again, Z has decided to purchase finished goods inventory from outside suppliers during the period that the factory will be closed for repairs. During the period when Z is buying in inventory instead of manufacturing its own products, its profits will be reduced by a material amount.

Required:

Explain how Z should treat this situation in its financial statements for the year to 31 March 2003.

(7 marks)

(c) N drilled a new oil well, which started production on 1 March 2003. The licence granting permission to drill the new oil well included a clause that requires N to "return the land to the state it was in before drilling commenced". N estimates that the oil well will have a 20-year production life. At the end of that time, the oil well will be decommissioned and work carried out to reinstate the land. The cost of this decommissioning work is estimated to be $20 million.

Required:

Explain how N should treat the decommissioning costs in its financial statements for the year to 31 March 2003.

(6 marks)

(Total = 25 marks)

End of paper