INTERNATIONAL STANDARDS INTERNATIONAL STANDARDS INTERNATIONAL

Intermediate Level

Financial Reporting – International Accounting Standards

7b IFRI

26 May 2004

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, and is on pages 2 – 9). Answer the ONE question in Section B (this is on pages 10 and 11). Answer TWO questions only from Section C (these questions are on pages 12 – 18)
Maths Tables and Formulae are provided on pages 21 – 23.
Write your full examination number, paper number and the examination subject title in the spaces provided on the front of the examination answer book. Also write your contact ID and name in the space provided in the right hand margin and seal to close.
Write your full 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 the examination answer book before you hand it to the invigilator.
Tick the appropriate boxes on the front of the answer book to indicate which questions you have answered.

TURN OVER

SECTION A — 20 MARKS

ANSWER *ALL* TEN SUB-QUESTIONS – TWO 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

A owns shares carrying 75% of the voting rights in B and 20% of the voting rights in C. B owns shares carrying 32% of the voting rights of C.

The following statements refer to the implications of these shareholdings for the consolidation of the A group.

(i) C is an associate of B because B owns shares carrying 32% of the voting rights and this holding would normally be sufficient to enable B to exercise a significant influence over the operating and financial policies of C.

(ii) C is an associate of A because the effective interest of A in C's profits is 20% + (75% x 32%) = 44%.

(iii) C is a subsidiary of A because A is able to control, either directly or indirectly, a majority of C's voting rights.

(iv) The consolidated reserves of the A group will include 44% of C's post-acquisition retained profits.

Which of the above statements are true?

A (i) and (ii) only.

B (i), (ii) and (iv) only.

C (iii) and (iv) only.

D (i), (iii) and (iv) only.

Financial Reporting – International Standards

MAY 2004 EXAMINATION

SPECIAL ANSWER SHEET FOR SECTION A

Write your full examination number below:

Centre Code:				
Venue Code:				
Desk Number:				

1.1	**A**	**B**	**C**	**D**
1.2	**A**	**B**	**C**	**D**
1.3	**A**	**B**	**C**	**D**
1.4	**A**	**B**	**C**	**D**
1.5	**A**	**B**	**C**	**D**
1.6	**A**	**B**	**C**	**D**
1.7	**A**	**B**	**C**	**D**
1.8	**A**	**B**	**C**	**D**
1.9	**A**	**B**	**C**	**D**
1.10	**A**	**B**	**C**	**D**

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 in to the invigilators at the end of the examination.

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1.2 X owns 80% of the issued ordinary shares of Y. Y sells goods to X at a mark up of 25% on cost. At the year end the inventories of X included $200,000 in respect of goods purchased from Y. There were no goods purchased from Y in the inventories of X at the start of the year

What is the consolidation adjustment that is required in respect of these intra-group sales at the year end?

A Credit inventory $40,000 and debit reserves $40,000.

B Credit inventory $40,000, debit reserves $32,000 and debit minority interest $8,000.

C Credit inventory $50,000 and debit reserves $50,000.

D Credit inventory $50,000, debit reserves $40,000 and debit minority interest $10,000.

1.3 P prepares financial statements to 31 December each year.

- On 1 January 2000, P purchased shares in R carrying 80% of the voting rights.
- On 1 January 2001, P purchased shares in Q carrying 40% of the voting rights.
- On 1 May 2003, P made a further purchase of shares in Q, so as to take its **total** shareholding to 70%.

Revenue of the three group enterprises for the year ended 31 December 2003 is:

- P – $800,000.
- Q – $600,000.
- R – $500,000.

There is no intra-group trading and transactions accrue evenly through the year.

What is the consolidated revenue of the P group for the year ended 31 December 2003?

A $1,480,000

B $1,620,000

C $1,700,000

D $1,900,000

Section A continues on the next page

TURN OVER

1.4 H is an enterprise that owns 80% of the ordinary shares of its foreign subsidiary, F. F prepares financial statements in groats. Both enterprises have an accounting reference date of 31 March. At 1 April 2003 the net assets of F were 20 million groats. The profit after tax of F for the year ended 31 March 2004 was 2·2 million groats. F does not pay dividends and goodwill on consolidation was fully amortised prior to 31 March 2003.

H uses the closing rate (or net investment) method to translate the financial statements of F into $s for consolidation purposes.

Relevant exchange rates (groats to $1) are:

Date	*Exchange rate (groats to $1)*
31 March 2003	2·5
31 March 2004	2·0
Weighted average for year to 31 March 2004	2·2

What is the exchange gain in respect of the translation of the net assets of F that will be included in the consolidated reserves of H for the year ended 31 March 2004?

A $1,600,000

B $1,680,000

C $2,000,000

D $2,100,000

1.5 A has a number of subsidiaries. On 31 March 2004, the consolidated balance sheet of the A group showed a minority interest of $9·2 million ($6·7 million on 31 March 2003). The minority interest in the profits for the year ended 31 March 2004 as shown in the consolidated income statement was $1·8 million.

On 1 October 2003, A acquired a 75% interest in a new subsidiary, N. The net assets of N on 1 October 2003 were $8 million and goodwill on acquisition amounted to $300,000. There were no other changes in the group structure during the year ended 31 March 2004. None of the subsidiaries had any proposed dividends at 31 March 2004 or 31 March 2003.

What cash outflow in respect of minority interests will be shown in the consolidated cash flow statement for the year ended 31 March 2004?

A $1·3 million

B $1·6 million

C $1·8 million

D $2·5 million

1.6 E pays contributions into a post-employment defined benefit plan on behalf of its employees. The balance sheet of the enterprise at 30 April 2003 showed a net pension liability of $60 million. During the year to 30 April 2004:

- The enterprise closed down a division and the curtailment of retirement benefits for employees made redundant resulted in a gain of $4 million.
- The estimated current service cost was $8 million.
- The expected return on assets was $6 million.
- The unwinding of the discount on the pension liability was $4 million.
- There was no recognition of actuarial gains or losses in the income statement.

The net pension liability at 30 April 2004 was $65 million [before incorporating the actuarial gain or loss for the year].

What is the actuarial gain or loss for the year ended 30 April 2004?

A A loss of $1 million

B A gain of $1 million

C A loss of $3 million

D A gain of $3 million

1.7 On 1 April 2003, IJK commenced construction of a supermarket. The following costs relating to the project were incurred in the nine-month period to 31 December 2003, the accounting reference date of the enterprise:

Cost of purchasing the site	$20 million
Cost of site preparation and clearance	$1 million
Direct construction costs	$2 million
Administrative overheads charged to the project in accordance with the enterprise's normal apportionment formula	$1·4 million

On 1 April 2003, the enterprise borrowed $25 million to finance the project. The borrowing carries an annual rate of interest of 8%. The enterprise capitalises finance costs whenever permitted by Accounting Standards.

What amount will be included in the property, plant and equipment of IJK in respect of the construction project at 31 December 2003?

A $23·5 million

B $24·5 million

C $25 million

D $25·9 million

TURN OVER

1.8 LMN prepares financial statements to 31 January each year. On 31 December 2003, the board of directors met and agreed a reorganisation of the enterprise. The reorganisation was due to commence on 1 March 2004 and was expected to take one month to complete. The following estimates were made of the total costs involved:

Voluntary redundancy	$4 million
Other direct reorganisation costs	$2·5 million
Apportioned fixed production costs for March 2004 [using the normal apportionment formula]	$1 million
Apportioned fixed administration costs for March 2004 [using the normal apportionment formula]	$1·5 million

The plan was made public on 10 January 2004 and offers of voluntary redundancy were despatched on this date. The financial statements of LMN for the year ended 31 January 2004 were approved by the directors on 15 April 2004. The reorganisation was completed on schedule and the cost estimates proved accurate.

What provision in respect of the reorganisation would be made in the financial statements at 31 January 2004?

A Nil.

B $6·5 million.

C $7·5 million.

D $9 million.

1.9 PQR prepares consolidated financial statements to 31 March each year. All the subsidiaries are wholly owned. The following information relates to timing differences at 31 March 2004:

- The carrying value of plant and equipment was $82 million and its tax base was $62 million.
- The consolidated inventory figure was after deducting $10 million in respect of unrealised profit on intra-group sales.
- During the year the group revalued its properties and a surplus of $50 million arose. No commitment had been made to sell any of these properties at 31 March 2004.

What is the correct provision for deferred tax that should be included in the consolidated balance sheet at 31 March 2004? Assume a rate of taxation of 25%.

A $2·5 million.

B $5 million.

C $7·5 million.

D $15 million.

1.10 N is an enterprise preparing financial statements in $s. N regularly purchases components from a foreign supplier who invoices N in "purets" [normally abbreviated to "Ps"]. On 1 October 2003, N signed a contract to take delivery of a consignment of components on 31 March 2004 at a pre-determined price of 10 million Ps. Payment is due on 30 June 2004. On 1 October 2003, N entered into a contract to purchase 10 million Ps on 30 June 2004 for $1 million. N prepares financial statements to 28/29 February each year.

The following statements refer to the treatment of the transaction in the financial statements of N for the year ended 29 February 2004:

(i) N should show a liability for the purchase of the components in payables at 29 February 2004 since it has already entered into an agreement to purchase them.

(ii) The contract to purchase 10 million Ps on 30 June 2004 should be recognised in the financial statements at fair value, since it has no meaningful historical cost.

(iii) IAS 39 – *Financial Instruments: Recognition and Measurement* – would require hedge accounting to be used for this type of transaction provided certain conditions regarding the relationship between the hedging instrument and the hedged item are satisfied.

Which of the statements are true?

A (i) and (ii) only.

B (i) and (iii) only.

C (ii) and (iii) only.

D All of them.

(Total = 20 marks)

End of Section A

Section B starts on the next page

TURN OVER

SECTION B – 30 MARKS

ANSWER THIS QUESTION

Question Two

You are the consolidation accountant of Chief. Chief has owned 80% of the equity shares of Indian since the incorporation of Indian. Therefore Chief has prepared consolidated financial statements for some years. On 1 September 2003 Chief purchased 35% of the equity shares of Squaw. The income statements and statements of changes in equity of the three enterprises for the year ended 31 December 2003 are given below:

Income Statements

	Chief	*Indian*	*Squaw*
	$000	*$000*	*$000*
Revenue *(Note 1)*	150,000	100,000	96,000
Cost of sales	(110,000)	(78,000)	(66,000)
Gross profit	40,000	22,000	30,000
Distribution costs	(7,000)	(6,000)	(6,000)
Administrative expenses	(8,000)	(7,000)	(7,200)
Profit from operations	25,000	9,000	16,800
Investment income *(Note 2)*	6,280	Nil	Nil
Finance cost	(5,000)	(3,000)	(4,200)
Profit before tax	26,280	6,000	12,600
Income tax expense	(7,000)	(1,800)	(3,600)
Net profit for the period	19,280	4,200	9,000
Statement of changes in equity			
Balance at 1 January 2003	122,000	91,000	82,000
Net profit for the period	19,280	4,200	9,000
Dividends paid on 30 September 2003	(6,500)	(2,500)	(4,800)
Balance at 31 December 2003	134,780	92,700	86,200

NOTES TO THE FINANCIAL STATEMENTS

Note 1 – Inter enterprise sales

Chief sells products to both Indian and Squaw, making a profit of one third on the cost of the products sold. In the case of Squaw, all sales took place after 1 September 2003. Details of sales of the products to Indian and Squaw, together with the amounts included in opening and closing inventories in respect of the products, are given below:

Name of enterprise	*Details of purchases from Chief in 2003*		
	Purchased in year	*Included in opening inventory*	*Included in closing inventory*
	$000	*$000*	*$000*
Indian	20,000	2,000	3,000
Squaw	10,000	Nil	4,000

Note 2 – Investment income

Chief's investment income includes dividends received from Indian and Squaw and interest receivable from Indian. The interest receivable is in respect of a loan of $20 million to Indian at a fixed rate of interest of 8% per annum. The loan has been outstanding for the whole of 2003.

Note 3 – Details of acquisitions by Chief

Enterprise	*Date of acquisition*	*Goodwill on acquisition $000*	*Fair value adjustment at date of acquisition $000*
Indian	1 July 1994	Nil	Nil
Squaw	1 September 2003	8,400	7,200

The goodwill figure for Squaw is after taking account of the fair value adjustment. The fair value adjustment has the effect of increasing the fair value of property, plant and equipment above the carrying value in the individual financial statements of Squaw. Group policy is to depreciate property, plant and equipment and goodwill on a monthly basis over their estimated useful economic lives. These estimates are:

- 5 years for property, plant and equipment (charged to cost of sales).
- 20 years for goodwill (charged to administrative expenses).

Note 4 – other information

- The purchase of shares in Squaw followed a contractual arrangement with two other investors to obtain joint control over Squaw from 1 September 2003. The contract requires that all three investors approve the key policy decisions of Squaw.
- All equity shares in Indian carry one vote at general meetings.
- Where International Accounting Standards permit more than one treatment of a particular transaction Chief always follows the benchmark treatment.

Your assistant has been reading the working papers for the consolidated financial statements of Chief for previous years. He has noticed that even though Chief owns only 80% of the equity shares of Indian it has included 100% of its profits in the consolidated income statement. He does not understand the logic for this treatment. He is also unsure of the treatment of Squaw in the consolidated income statement for 2003 and wonders whether it will be the same as the treatment of Indian.

Required:

(a) Explain:

(i) The reasoning for the stated treatment of Indian in the consolidated income statement.

(ii) The appropriate treatment for Squaw in the consolidated income statement for 2003.

You do not need to discuss the treatment of Indian and Squaw in the consolidated statement of changes in equity.

(7 marks)

Your explanation should NOT include the detailed mechanics of consolidation, but should focus on the principles underlying the treatment of Indian and Squaw. You should refer to the provisions of International Accounting Standards where you consider they will assist your explanation.

(b) Prepare the consolidated income statement and consolidated statement of changes in equity of Chief for the year ended 31 December 2003.
Notes to the consolidated income statement are NOT required.

(23 marks)

(Total = 30 marks)

End of Section B. Section C starts on page 12

TURN OVER

SECTION C – 50 MARKS

ANSWER TWO QUESTIONS ONLY

Question Three

You are a financial analyst whose clients include Ms A, a newly appointed non-executive director of TW. TW is located in a jurisdiction that permits enterprises to use international Accounting Standards for local reporting purposes. TW has numerous subsidiaries located throughout the world and raises finance on a number of different capital markets. The consolidated financial statements of TW for the year ended 30 April 2004 are due to be published in June 2004. The **first draft** of the 2004 financial statements has just been prepared and the board of directors is due to meet next week to discuss them. Ms A has a number of questions regarding these statements and wished to seek your advice prior to the board meeting. Extracts from these statements, together with the questions from Ms A, are set out below:

Income statement – year ended 30 April:

	2004 (draft)	*2003 (final)*
	$ million	*$ million*
Revenue	3,600	3,400
Cost of sales	(2,300)	(2,250)
Gross profit	1,300	1,150
Other operating expenses	(700)	(600)
Profit from operations	600	550
Profit on sale of subsidiaries	350	Nil
Finance cost	(250)	(120)
Profit before tax	700	430
Income tax expense	(200)	(140)
Profit after tax	500	290
Minority interests	(60)	(55)
Net profit for the period	440	235
Earnings per equity share	176 cents	94 cents

Balance sheet at 30 April:

	2004 (draft)		*2003 (final)*	
	$ million	*$ million*	*$ million*	*$ million*
ASSETS				
Non-current assets				
Property, plant and equipment	2,400		1,350	
Other financial assets	180		250	
		2,580		1,600
Current assets:				
Inventories	430		400	
Trade receivables	600		550	
Deferred marketing costs	100		Nil	
Cash and cash equivalents	940		Nil	
		2,070		950
		4,650		2,550
EQUITY AND LIABILITIES				
Capital and reserves:				
Issued share capital ($1 equity shares)	250		250	
Share premium account	150		150	
Revaluation reserve	800		Nil	
Accumulated profits	1,050		610	
		2,250		1,010

	2004 (draft)		2003 (final)	
	$ million	$ million	$ million	$ million
Non-current liabilities:				
Interest bearing borrowings	2,000		1,000	
Deferred tax	180		100	
		2,180		1,100
Current liabilities:				
Trade payables	220		200	
Short term borrowings	Nil		240	
		220		440
		4,650		2,550

NOTES TO THE DRAFT FINANCIAL STATEMENTS

(i) During the financial year, the group decided to change the nature and focus of its operations. Consequently, on 31 March 2004, the group disposed of two subsidiaries for total cash proceeds of $1,000 million. In the year to 30 April 2004, the two subsidiaries that were disposed of contributed $800 million to group revenue, $320 million to group gross profit and $175 million to group profit from operations.

(ii) During the last few months of the year ended 30 April 2004 the group embarked on an extensive marketing campaign to underpin the new operational focus. Marketing costs are normally charged to cost of sales but, in the draft financial statements, the directors of TW have included them in the balance sheet on the basis that the new operational focus is likely to generate future economic benefits for the group.

(iii) The revaluation reserve is caused by a group-wide revaluation of property, plant and equipment on 31 March 2004, immediately after the disposal of the two subsidiaries. Depreciation was charged on the revalued amounts from 1 April 2004. The average remaining useful economic lives of the revalued assets at 1 April 2004 was 8 years.

Questions from Ms A

(a) The papers I have been sent include some very complicated reconciliations of the financial statements to USA and Japanese accounting standards. I don't understand why these reconciliations are needed. I was sure I had read that only International Accounting Standards were being used throughout the world from now on. Please explain this for me.

(b) The papers contain an assertion from the Chief Executive that the financial statements show a very pleasing financial performance and position. The Chief Executive highlights the increase in revenue, profits, earnings per share and cash balances as evidence to support this assertion. I would like you to provide me with a short report evaluating this assertion and highlighting any relevant issues.

Required:

Prepare a reply to the questions Ms A has raised. The allocation of marks to the two questions is as follows:

Question (a) *(10 marks)*
Question (b) *(15 marks)*

(Total = 25 marks)

Section C continues on the next page

TURN OVER

Question Four

Motivate is an enterprise that prepares financial statements in accordance with international accounting standards. The consolidated income statement for the year ended 31 March 2004 has just been prepared in draft form in readiness for presentation to the board of directors.

This draft income statement appears below:

	$000
Revenue	120,000
Cost of sales	(55,000)
Gross profit	65,000
Other operating expenses	(30,000)
Profit from operations	35,000
Profit on sale of Redundant	5,000
Finance cost	(4,000)
Profit before tax	36,000
Income tax expense	(10,000)
Profit after tax	26,000
Minority interests	(3,500)
Net profit for the period	22,500

The issued ordinary share capital of Motivate at 1 April 2003 was 200 million $1 shares. On 1 February 2004, the enterprise made a rights issue to existing shareholders of 1 share for every 4 held. The offer price was $4 per share and all the ordinary shareholders subscribed for their rights. The quoted price of the ordinary shares at 1 February 2004 was $5 per share. The finance director has computed the earnings per share for the year as 11·25 cents. This was done by dividing the profit for the year ($22·5 million) by the number of shares in issue for the majority of the year (200 million).

You are provided with the following additional information regarding transactions during the period:

(i) On 30 September 2003, Motivate sold a wholly owned subsidiary (Redundant) to Newco, an enterprise that was a subsidiary of a bank. The proceeds of disposal were $15 million and the net assets of Redundant at 30 September 2003 were $10 million. Newco borrowed $15 million from its parent to finance the purchase at an annual interest cost of 10%. The loan is repayable on 30 September 2023. As part of the sale agreement Motivate continued to control the operating and financial policies of Redundant and is due to receive an operating fee from Newco payable annually in arrears on 30 September each year.

The fee is to be computed as:

- The operating profit of Redundant for each year to 30 September; less
- the interest payable by Newco on the borrowing to finance the purchase.
- if the interest payable exceeds the operating profit then Motivate is required to make a payment to Newco in respect of the difference.
- in the year to 30 September 2023 any fee payable by Newco will be reduced by the loan repayment to the bank and if necessary Motivate will make a payment to Newco to fund any shortfall.

The profit from operations of Redundant for the 6 months to 31 March 2004 was $200,000, but the directors of Motivate have made no entries in the financial statements for the year ended 31 March 2004 in respect of the operating fee.

(ii) On 1 April 2003, a 75% subsidiary of Motivate commenced operations from an oil rig. Motivate assessed the feasibility of this investment using discounted cash flow techniques with an annual cost of capital of 8%. The oil rig was estimated to have a useful economic life of 10 years. At the end of the 10 year period (31 March 2013) the oil rig will be shut down and relevant legislation will require the subsidiary to incur clean up costs of an estimated $40 million. The subsidiary has charged $4 million to its income statement for the year ended 31 March 2004, being 10% of the necessary expenditure.

(iii) During the year to 31 March 2004, Motivate employed a new software development engineer. This engineer was internationally respected and expected to secure considerable competitive advantage for the group. The directors of Motivate have estimated that the market value of the competitive advantage is $15 million and have created an intangible asset for this amount by debiting intangible assets and crediting other operating expenses.

Required:

Compute the earnings per share of Motivate for the year ended 31 March 2004 after fully taking account of the issues raised in this question. You should fully justify your calculation by referring to relevant International Accounting Standards.

Ignore the potential tax effects of any adjustments you make.

(Total = 25 marks)

Section C continues on the next page

TURN OVER

Question Five

The balance sheets of Large, Medium, and Small, three enterprises preparing financial statements in accordance with International Accounting Standards at 30 April 2004, the year end date for all three enterprises, are given below:

	Large		*Medium*		*Small*	
	$000	*$000*	*$000*	*$000*	*$000*	*$000*
ASSETS						
Non-current assets:						
Property, plant and equipment *(Note 1)*	40,000		32,000		25,000	
Other financial assets *(Note 2)*	29,500		11,000		Nil	
		69,500		43,000		25,000
Current assets:						
Inventories *(Note 3)*	22,000		18,000		14,000	
Receivables *(Note 4)*	25,000		20,000		15,000	
Cash and cash equivalents	1,500		Nil		1,000	
		48,500		38,000		30,000
		118,000		81,000		55,000
EQUITY AND LIABILITIES						
Capital and reserves:						
Issued capital (50c shares)	40,000		24,000		10,000	
Accumulated profits	38,200		23,600		17,500	
		78,200		47,600		27,500
Non-current liabilities:						
Interest bearing borrowings	20,000		16,000		15,000	
Deferred taxation	3,000		2,400		2,000	
		23,000		18,400		17,000
Current liabilities:						
Trade and other payables *(Note 4)*	16,800		13,500		10,500	
Short term borrowings	Nil		1,500		Nil	
		16,800		15,000		10,500
		118,000		81,000		55,000

NOTES TO THE BALANCE SHEETS

Note 1
On 1 May 2002, Large purchased an item of plant for $8 million. This plant was immediately transferred to Medium at an invoiced price of $10 million. Medium is depreciating this plant over its estimated useful economic life of 5 years.

Note 2

- On 1 May 1996, when the accumulated profits of Medium showed a balance of $10 million and the accumulated profits of Small showed a balance of $7 million, Large purchased 36 million shares in Medium for $29·5 million.
- On 1 May 1994, when the accumulated profits of Small showed a balance of $5 million, Medium purchased 12 million shares in Small Ltd for $11 million.
- On 1 May 1994 and 1 May 1996, the fair values of the identifiable net assets of Medium and Small were the same as their carrying values in the balance sheets of the individual enterprises.
- All shares in Medium and Small are equity shares and carry one vote per share at general meetings.
- Large amortises purchased goodwill over a 20 year period.

Note 3
Medium supplies a product to both Large and Small. The product is supplied at a special intra-group selling price. Medium adds 10% to its cost of production when invoicing the product. On 30 April 2004, the inventories of unsold products supplied by Medium at this price were as follows:

- $5·5 million included in the inventories of Large.
- $3·3 million included in the inventories of Small.

Note 4
Group policy is to suspend intra-group deliveries and payments for the last five days of each financial year in order to agree intra-group balances. On 25 April 2004, the agreed intra-group balances were as follows:

- $4 million included in the receivables of Medium and the payables of Large.
- $3 million included in the receivables of Medium and the payables of Small.

On 29 April 2004, contrary to the established policy, Small sent a payment of $2 million to Medium. Small debited payables and credited cash with $2 million, but Medium did not receive and record the payment until 2 May 2004 and so it is not reflected in the balance sheet of Medium.

You are the consolidation accountant of Large. Your assistant has read previous years' working papers and does not understand why Small has been treated as a subsidiary of Large. Your assistant thinks that subsidiaries are identified by the ability of the parent to exercise control and is unclear how this can be achieved when Large owns no shares in Small.

Required:

(a) Write a memorandum to your assistant that explains why it is appropriate to treat Small as a subsidiary of Large. You should refer to the provisions of International Accounting Standards where relevant.

(5 marks)

(b) Prepare the consolidated balance sheet of Large at 30 April 2004.

(20 marks)

(Total = 25 marks)

Section C continues on the next page

Question Six

You report to a manager who does not have a detailed knowledge of recent developments in financial reporting. However, the manager does have a reasonable basic knowledge of financial accounting. Your manager has recently attended a course at which a number of recent developments were discussed. He has sent you a note requiring clarification of a number of issues:

Issue (a) Share-based payment

We were told that when enterprises issue shares or share options to their employees, then they should make a charge to the income statement. It doesn't seem logical to me to make a charge to income when an enterprise issues shares – surely that's not what normally happens? When you extend this principle to share options this seems even less logical – the options may never be exercised. Please explain where my thinking falls down on this. Has a new Accounting Standard been issued that has escaped my notice?

Issue (b) Non-financial disclosures

We were told that more and more enterprises are voluntarily giving information about social and environmental policies in their annual reports. Surely annual reports should focus on financial matters. How can non-financial information such as social and environmental policies add value to corporate reports? I can't believe our shareholders need to know about this type of issue. The annual reports are for the shareholders aren't they, or have I got it wrong?

Issue (c) Off balance sheet finance

The course leader kept using this term. She stated that standard setters around the world are developing new standards to ensure that all financial obligations are reported on the balance sheet. I don't really understand what off balance sheet finance means. Please explain it to me. Surely the finance that an enterprise has is a matter of fact. Why would they want to keep finance off the balance sheet anyway? I would have thought that showing all the finance on the balance sheet would make the balance sheet stronger.

I would also be interested to know about current International Accounting Standards that deal with off balance sheet finance. If new standards are planned then what are the likely implications for our group? I overheard someone saying that current developments in this area have potentially wide ranging implications for enterprises that lease (rather than purchase) properties. As you know that describes our situation and this concerned me.

Required:

Draft an appropriate reply to the note sent by your manager that explains the issues that have been raised. The allocation of marks to the three issues is as follows:

Issue (a)	*(9 marks)*
Issue (b)	*(6 marks)*
Issue (c)	*(10 marks)*

(Total = 25 marks)

End of paper

Maths Tables and Formulae begin on page 21

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TABLES

Present value table

Present value of $1, that is $(1 + r)^{-n}$ where *r* = interest rate; *n* = number of periods until payment or receipt.

Periods (*n*)	Interest rates (*r*)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods (*n*)	Interest rates (*r*)									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.079	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Cumulative present value of $1 per annum, Receivable or Payable at the end of each year for *n* years

$$\frac{1-(1+r)^{-n}}{r}$$

Periods	Interest rates (*r*)									
(*n*)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods	Interest rates (*r*)									
(*n*)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	7.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

FORMULAE

Annuity

Present value of an annuity of $1 per annum, receivable or payable for *n* years, commencing in one year, discounted at *r*% per annum:

$$PV = \frac{1}{r}\left[1 - \frac{1}{[1+r]^n}\right]$$

Perpetuity

Present value of $1 per annum, payable or receivable in perpetuity, commencing in one year, discounted at *r*% per annum:

$$PV = \frac{1}{r}$$

Growing perpetuity

Present value of $1 per annum, receivable or payable, commencing in one year, growing in perpetuity at a constant rate of *g*% per annum, discounted at *r*% per annum:

$$PV = \frac{1}{r - g}$$

7b

IFRI

Financial Reporting – International Accounting Standards

Wednesday morning