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Intermediate Level

Financial Reporting – UK Accounting Standards

7a

IFRP

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 UK ACCOUNTING STANDARDS. **If you require the paper based upon International 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

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

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

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

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

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

(iv) The consolidated reserves of the A plc group will include 44% of C plc'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 – UK Standards

Write your full examination number below:

Centre Code:				

MAY 2004 EXAMINATION

Venue Code:			

SPECIAL ANSWER SHEET FOR SECTION A

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 plc owns 80% of the issued ordinary shares of Y Ltd. Y Ltd sells goods to X plc at a mark-up of 25% on cost. At the year end, the stocks of X plc included £200,000 in respect of goods purchased from Y Ltd. There were no goods purchased from Y Ltd in the stocks of X plc 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 stock £40,000 and debit reserves £40,000.

B Credit stock £40,000, debit reserves £32,000 and debit minority interest £8,000.

C Credit stock £50,000 and debit reserves £50,000.

D Credit stock £50,000, debit reserves £40,000 and debit minority interest £10,000.

1.3 P plc prepares financial statements to 31 December each year.

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

Turnover of the three group companies for the year ended 31 December 2003 is:

- P plc – £800,000
- Q plc – £600,000
- R plc – £500,000

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

What is the consolidated turnover of the P plc 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 plc is a UK company that owns 80% of the ordinary shares of its foreign subsidiary, F. F prepares financial statements in groats. Both companies have an accounting reference date of 31 March. At 1 April 2003, the net assets of F were 20 million groats. The profit after taxation 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 plc uses the closing rate (or net investment) method to translate the financial statements of F into £s for consolidation purposes, translating the profit and loss account at the weighted average rate for the year.

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 plc 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 plc has a number of subsidiaries located in the United Kingdom. On 31 March 2004, the consolidated balance sheet of the A plc 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 profit and loss account, was £1·8 million.

On 1 October 2003, A plc acquired a 75% interest in a new subsidiary, N Ltd. The net assets of N Ltd 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 During its year ended 30 April 2004, E plc has fully complied with FRS 17 – *Retirement Benefits*. The balance sheet of the company at 30 April 2003 showed a net pension liability of £60 million. During the year to 30 April 2004:

- The company 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.

The net pension liability at 30 April 2004 was £65 million.

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 plc 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 company:

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 company's normal apportionment formula	£1·4 million

On 1 April 2003, the company borrowed £25 million to finance the project. The borrowing carries an annual rate of interest of 8%. The company capitalises finance costs whenever permitted by accounting standards.

What amount will be included in the fixed assets of IJK plc 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 plc prepares financial statements to 31 January each year. On 31 December 2003, the board of directors met and agreed a reorganisation of the company. 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 plc 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 as at 31 January 2004?

A Nil

B £6·5 million

C £7·5 million

D £9 million

1.9 PQR plc 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 written down value was £62 million.
- The consolidated stock 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 taxation 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 plc is a company preparing financial statements in £s. N plc regularly purchases components from a foreign supplier who invoices N plc in "purets" [normally abbreviated to "Ps"]. On 1 October 2003, N plc 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 plc entered into a contract to purchase 10 million Ps on 30 June 2004 for £1 million. N plc 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 plc for the year ended 29 February 2004:

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

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

(iii) Current UK accounting practice would permit hedge accounting to be used for this type of transaction.

Which of the above 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 plc. Chief plc has owned 80% of the equity shares of Indian Ltd since the incorporation of Indian Ltd. Therefore, Chief plc has prepared consolidated financial statements for some years. On 1 September 2003, Chief plc purchased 35% of the equity shares of Squaw Ltd. The profit and loss accounts of the three companies for the year ended 31 December 2003 are given below:

	Chief plc	*Indian Ltd*	*Squaw Ltd*
	£000	*£000*	*£000*
Turnover *(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)
Operating profit	25,000	9,000	16,800
Investment income *(Note 2)*	6,280	Nil	Nil
Interest payable and similar charges	(5,000)	(3,000)	(4,200)
Profit before taxation	26,280	6,000	12,600
Taxation	(7,000)	(1,800)	(3,600)
Profit after taxation	19,280	4,200	9,000
Dividends paid on 30 September 2003	(6,500)	(2,500)	(4,800)
Retained profit for the period	12,780	1,700	4,200
Retained profit 1 January 2003	22,000	11,000	12,000
Retained profit 31 December 2003	34,780	12,700	16,200

NOTES TO THE FINANCIAL STATEMENTS

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

Name of company	*Details of purchases from Chief plc in 2003*		
	Purchased in year	*Included in opening stock*	*Included in closing stock*
	£000	*£000*	*£000*
Indian Ltd	20,000	2,000	3,000
Squaw Ltd	10,000	Nil	4,000

Note 2 – Investment income
Chief plc's investment income includes dividends received from Indian Ltd and Squaw Ltd and interest receivable from Indian Ltd. The interest receivable is in respect of a loan of £20 million to Indian Ltd at a fixed rate of interest of 8% per annum. The loan has been outstanding for the whole of 2003. None of the companies has proposed any dividends for 2003 prior to the 2003 accounts being approved.

Note 3 – Details of acquisitions by Chief plc

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

The goodwill figure for Squaw Ltd is after taking account of the fair value adjustment. The fair value adjustment has the effect of increasing the fair value of tangible fixed assets above the carrying value in the individual financial statements of Squaw Ltd. Group policy is to depreciate tangible fixed assets and goodwill on a monthly basis over their estimated useful economic lives.

These estimates are:

- 5 years for tangible fixed assets (charged to cost of sales).
- 20 years for goodwill (charged to administrative expenses).

Note 4 – other information

- The purchase of shares in Squaw Ltd followed a contractual arrangement with two other investors to obtain joint control over Squaw Ltd from 1 September 2003. The contract requires that all three investors approve the key policy decisions of Squaw Ltd.

- All equity shares in Indian Ltd carry one vote at general meetings.

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

Required:

(a) Explain:

(i) The reasoning for the stated treatment of Indian Ltd in the consolidated profit and loss account.

(ii) The appropriate treatment for Squaw Ltd in the consolidated profit and loss account for 2003.

(7 marks)

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

(b) Prepare the consolidated profit and loss account of Chief plc for the year ended 31 December 2003, starting with “turnover” and ending with “retained profit carried forward”.
Notes to the consolidated profit and loss account 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 plc, a company incorporated in the United Kingdom. TW plc has numerous subsidiaries located throughout the world and raises finance on a number of different capital markets. The consolidated financial statements of TW plc 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 is now seeking your advice prior to the board meeting. Extracts from these statements, together with the questions raised by Ms A, are set out below:

Profit and loss account – year ended 30 April:

	2004 (draft)	*2003 (final)*
	£ million	*£ million*
Turnover	3,600	3,400
Cost of sales	(2,300)	(2,250)
Gross profit	1,300	1,150
Other operating expenses	(700)	(600)
Operating profit	600	550
Profit on sale of subsidiaries	350	Nil
Interest payable and similar charges	(250)	(120)
Profit before taxation	700	430
Taxation	(200)	(140)
Profit after taxation	500	290
Minority interests	(60)	(55)
Group profit	440	235
Proposed dividends	Nil	(100)
Retained profit	440	135
Earnings per equity share	176 pence	94 pence

Balance sheet at 30 April

	2004 (draft)		*2003 (final)*	
	£ million	*£ million*	*£ million*	*£ million*
Fixed assets:				
Intangible assets	180		250	
Tangible assets	2,400		1,350	
		2,580		1,600
Current assets:				
Stocks	430		400	
Trade debtors	600		550	
Deferred marketing costs	100		Nil	
Bank balances	940		Nil	
	2,070		950	
Creditors: amounts due within one year:				
Trade creditors	(220)		(200)	
Proposed dividend	Nil		(100)	
Bank overdraft	Nil		(140)	
	(220)		(440)	
Net current assets		1,850		510

	2004 (draft) £ million	*2003 (final) £ million*
Creditors: amounts due after more than one year:		
Long term loans	(2,000)	(1,000)
Provisions for liabilities and charges		
Deferred tax	(180)	(100)
	(2,180)	(1,100)
	2,250	1,010
Capital and reserves:		
Called-up share capital (£1 equity shares)	250	250
Share premium account	150	150
Revaluation reserve	800	Nil
Profit and loss account	1,050	610
	2,250	1,010

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 turnover, £320 million to group gross profit and £175 million to group operating profit.

(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 plc 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 tangible fixed assets 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 state that the financial statements have been prepared in accordance with UK Accounting Standards. They include some very complicated reconciliations of the financial statements to USA and International Accounting Standards. I don't understand why these reconciliations are needed. Anyhow I was sure I had read that only International Accounting Standards were being used 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 turnover, 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 plc is a public company that prepares financial statements in accordance with UK Accounting Standards. The consolidated profit and loss account 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 profit and loss account appears below:

	£000
Turnover	120,000
Cost of sales	(55,000)
Gross profit	65,000
Other operating expenses	(30,000)
Operating profit	35,000
Profit on sale of Redundant Ltd	5,000
Interest payable and similar charges	(4,000)
Profit before taxation	36,000
Taxation	(10,000)
Profit after taxation	26,000
Minority interests	(3,500)
Group profit	22,500

The issued ordinary share capital of Motivate plc at 1 April 2003 was 200 million £1 shares. On 1 February 2004, the company 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 11·25p. 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).

The following additional information regarding transactions during the period is relevant:

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

The fee is to be computed as:

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

The operating profit of Redundant Ltd for the 6 months to 31 March 2004 was £200,000, but the directors of Motivate plc 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 plc commenced operations from an oil rig. Motivate plc 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 profit and loss account for the year ended 31 March 2004, being 10% of the necessary expenditure.

(iii) During the year to 31 March 2004, Motivate plc 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 plc 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 plc for the year ended 31 March 2004 after fully taking account of the issues raised in this question. You should fully justify your treatment of each issue by referring to relevant Accounting Standards.

Ignore the potential taxation 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 plc, Medium Ltd, and Small Ltd, three companies preparing financial statements in accordance with UK Accounting Standards at 30 April 2004, the year end date for all three companies, are given below:

	Large plc		*Medium Ltd*		*Small Ltd*	
	£000	*£000*	*£000*	*£000*	*£000*	*£000*
Fixed assets:						
Tangible assets *(Note 1)*	40,000		32,000		25,000	
Investments *(Note 2)*	29,500		11,000		Nil	
		69,500		43,000		25,000
Current assets:						
Stocks *(Note 3)*	22,000		18,000		14,000	
Debtors *(Note 4)*	25,000		20,000		15,000	
Bank balances	1,500		Nil		1,000	
	48,500		38,000		30,000	
Creditors: amounts due within one year:						
Trade creditors *(Note 4)*	14,400		11,500		9,000	
Taxation	2,400		2,000		1,500	
Bank overdrafts	Nil		1,500		Nil	
	16,800		15,000		10,500	
Net current assets		31,700		23,000		19,500
Creditors: amounts due after more than one year:						
Long term loans		(20,000)		(16,000)		(15,000)
Provision for liabilities and charges						
Deferred tax		(3,000)		(2,400)		(2,000)
		78,200		47,600		27,500
Capital and reserves:						
Called up share capital (50p shares)		40,000		24,000		10,000
Profit and loss account		38,200		23,600		17,500
		78,200		47,600		27,500

NOTES TO THE BALANCE SHEETS

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

Note 2

- On 1 May 1996, when the profit and loss account of Medium Ltd showed a balance of £10 million and the profit and loss account of Small Ltd showed a balance of £7 million, Large plc purchased 36 million shares in Medium Ltd for £29·5 million.
- On 1 May 1994, when the profit and loss account of Small Ltd showed a balance of £5 million, Medium Ltd 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 Ltd and Small Ltd were the same as their carrying values in the balance sheets of the individual companies.
- All shares in Medium Ltd and Small Ltd are ordinary shares and carry one vote per share at general meetings.
- Large plc amortises purchased goodwill over a 20 year period.

Note 3
Medium Ltd supplies a product to both Large plc and Small Ltd. 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 stocks of unsold products supplied by Medium Ltd at this price were as follows:

- £5·5 million included in the stocks of Large plc.
- £3·3 million included in the stocks of Small Ltd.

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 debtors of Medium Ltd and the creditors of Large plc.
- £3 million included in the debtors of Medium Ltd and the creditors of Small Ltd.

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

You are the consolidation accountant of Large plc. Your assistant has read previous years' working papers and does not understand why Small Ltd has been treated as a subsidiary of Large plc. 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 plc owns no shares in Small Ltd.

Required:

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

(5 marks)

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

(20 marks)

(Total = 25 marks)

Section C continues on the next page

TURN OVER

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 companies issue shares or share options to their employees, then they should make a charge to the profit and loss account. It doesn't seem logical to me to make a charge to profit when a company 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 companies 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 a company 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 UK 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 companies 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)

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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 (*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	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 (*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	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:

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

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IFRP

Financial Reporting – UK Accounting Standards

Wednesday morning