INTERNATIONAL STANDARDS INTERNATIONAL STANDARDS

CIMA

Intermediate Level

Financial Accounting – International Accounting Standards

6b

IFAI

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.
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.

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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 The International Accounting Standards Committee (IASC) Foundation's Trustees have a number of responsibilities.

Which of the following is a responsibility of the IASC trustees?

A To raise funds.

B To publish reports on International Accounting Standards.

C To enforce International Accounting Standards.

D To report to the International Organisation of Securities Commissions on financial reporting matters.

1.2 According to the International Accounting Standards Board's (IASB) *Framework for the preparation and presentation of financial statements* (Framework), "equity" is described as

A the amount paid into the enterprise by the owner.

B accumulated profits less amounts withdrawn.

C the residual interest in the assets less liabilities.

D owner's capital investment in the enterprise.

1.3 The IASB's Framework sets out the characteristics of useful information.

According to the Framework, which THREE of the following are NOT sub-characteristics of "reliability"?

(i)	Confirmatory value	(iv)	Consistency
(ii)	Completeness	(v)	Neutral
(iii)	Prudence	(vi)	Predictive value

A (i), (iii) and (vi)

B (i), (iv) and (vi)

C (ii), (iv) and (v)

D (ii), (iii) and (v)

1.4 The working capital cycle of an organisation is calculated by a formula; the elements of the formula are:

(i)	Inventories turnover	(iv)	Trade receivables turnover
(ii)	Trade payables turnover	(v)	Working capital
(iii)	Cash turnover	(vi)	Turnover

The working capital cycle formula is

A (i) + (iv) - (ii)

B (i) + (iii) + (iv) - (ii)

C $\frac{[(i)+(iii)+(iv)]}{(vi)}$

D $\frac{(v)}{(vi)}$

1.5 Extracts from G's balance sheet at 31 March 2004:

	$000
Loans due in more than one year	20
5% loan notes	15
Ordinary shares – $1 each fully paid	50
6% redeemable Preferred shares, $1 each fully paid	10
Retained profits	65
Revaluation reserve	25

The gearing ratio for G is (to one decimal place)

A 18·9%.

B 24·3%.

C 28·1%.

D 43·8%.

1.6 IAS 24 – *Related Party Disclosures* deals with related parties of an organisation.

Which of the following would be presumed to be a related party of an enterprise?

A A major customer whose purchases account for 30% of the enterprise's annual sales.

B A shareholder holding 25% of the enterprise's equity.

C A manager of the bank providing a loan to the enterprise.

D Employees of the enterprise.

1.7 IAS 1 – *Presentation of financial statements* sets out concepts to be followed when preparing accounting statements:

Which TWO of the following are NOT concepts discussed by IAS 1?

(i) going concern
(ii) prudence
(iii) accruals
(iv) consistency

A (i) and (iii)

B (i) and (iv)

C (ii) and (iii)

D (ii) and (iv)

1.8 An extract of tax related items from T's records were:

	$000
Under provision for year ended 31 March 2003	5
Net profit for the year ended 31 March 2004, before tax	144
Depreciation charge for the year included in the income statement	20
Capital allowances due for the year	28

T estimates 25% to be its rate of income tax due on profits for the year ended 31 March 2004.

T's taxation charge to the income statement for the year ended 31 March 2004 will be

A $31,000

B $35,250

C $39,000

D $41,000

1.9 A customer, C, has sued R for bad workmanship on a new roof it was contracted to install. R sub-contracted the work to F who used inferior quality products when installing the roof. The roof began leaking the first time it rained after installation. C has no difficulty proving that the installation is faulty, as the roof leaks every time it rains. C has sued R for the cost of repair, $22,000. R has been advised by its legal team that it is almost certainly going to lose the case and has to pay the full cost.

R has started legal proceedings against F for $28,000; $22,000 compensation for C plus $6,000 legal fees and expenses. F denies liability claiming that its quality standards ensure good workmanship. R's legal team has advised that R will probably win the case against F.

Neither case was settled at 31 March 2004.

The amounts that R should include in its balance sheet for the year ended 31 March 2004 should be

A a liability for $22,000.

B a liability for $22,000 and an asset for $28,000.

C a net asset of $6,000.

D no provision as neither amount is settled.

1.10 IAS 2 – *Inventories* specifies expenses that should be included in year-end inventory values. These could include:

(i) Marketing and selling overhead;

(ii) Variable production overhead;

(iii) General management overhead;

(iv) Accounting and finance overhead allocated to production;

(v) Cost of delivering raw materials to the factory;

(vi) Abnormal increase in overhead charges caused by unusually low production levels due to the exceptionally hot weather.

Which THREE of the above are allowable by IAS 2 as expenses that should be included in the cost of finished goods inventories?

A (i), (iii) and (v)

B (i), (ii) and (vi)

C (ii), (iv) and (v)

D (iii), (iv) and (vi)

(Total = 20 marks)

End of Section A

SECTION B – 30 MARKS

ANSWER THIS QUESTION [THE REQUIREMENT IS ON PAGE 11]

Question Two

The financial statements of C for the year to 31 March 2004 were as follows:

Balance Sheets at	*31 March 2004*		*31 March 2003*	
	$000	*$000*	*$000*	*$000*
Non-current assets:				
Intangible assets	111		90	
Property, plant and equipment	7,724	7,835	4,923	5,013
Current assets:				
Inventories	1,337		864	
Trade receivables	743		435	
Investment	0		730	
Bank	489		7	
Cash	27		22	
		2,596		2,058
Total assets		10,431		7,071
Capital and reserves:				
Ordinary shares $1 each	2,000		1,500	
Share premium account	1,500		500	
Revaluation reserve	1,080		630	
Accumulated profits	3,311		2,876	
		7,891		5,506
Non-current liabilities:				
Loans	1,006		410	
Deferred tax	254		291	
		1,260		701
Current liabilities:				
Trade payables	626		552	
Tax	234		188	
Interest payable	20		4	
Other provisions	400		120	
		1,280		864
Total equity and liabilities		10,431		7,071

Income statement for the year to 31 March 2004

	$000	*$000*
Revenue		14,780
Cost of sales		(9,607)
Gross profit		5,173
Distribution costs	(1,222)	
Administrative expenses (including provisions)	(2,924)	(4,146)
Profit from operations		1,027
Finance cost	(45)	
Income from investments	0	(45)
Profit before tax		982
Income tax expense		(197)
Net profit for the period		785

Additional information:

(i) Tangible non-current assets balances were as follows:

	31 March 2004	*31 March 2003*	
	Cost or valuation	*Cost or valuation*	*Accumulated depreciation/ amortisation*
	$000	*$000*	*$000*
Land	3,636	3,186	0
Buildings	3,063	1,663	416
Plant, machinery and equipment	2,188	1,108	671
Assets under construction	0	53	0

(ii) Intangible non-current assets comprise development expenditure incurred in previous years and in the current year, and being carried forward to future periods. Development expenditure amortised during the year was $18,000.

(iii) Tangible non-current assets include land which was revalued by $450,000 on 31 March 2004.

(iv) Machinery disposed of in the year had originally cost $400,000; accumulated depreciation at 31 March 2003 was $380,000. The agreed selling price of $31,000 had not been received by the year-end and is included in receivables.

(v) Assets under construction refer to a contract, started in February 2003, to build and supply C with new machinery. The machinery was installed and testing completed by 31 December 2003. Production began early January 2004. C had taken out a specific loan to finance the payments under the contract and in accordance with IAS 23 – *Borrowing costs*, has decided to capitalise the interest payments up to 31 December 2003. The interest paid was $24,000; this amount was transferred from the interest paid account to the assets under construction account. The balance on the assets under construction account was transferred to the plant and machinery account on 31 March 2004. The amount transferred was:

	$000
Balance at 31 March 2004	526
Interest	24
Total cost	550

In addition to this contract, other new plant and machinery had been purchased during the year.

(vi) Depreciation charged for the year was:

Buildings	2·5% straight line
Plant, machinery and equipment	20% reducing balance

C's accounting policy is to charge a full year's depreciation in the year of acquisition and no depreciation in the year of disposal.

(vii) Receivables consist of:

	31 March 2004	*31 March 2003*
	$000	*$000*
Trade receivables	712	401
Receivable arising from sale of non-current assets	31	0
Interest receivable on current asset investments	0	34

(viii) The current asset investment was a government bond, which matured on 31 March 2003 and was redeemed in April 2003 for $750,000.

(ix) C did not repurchase any of its shares during the year.

(x) An interim dividend of $350,000 was paid during the year.

Required:

(a) Prepare the following disclosure notes, for the year ended 31 March 2004, as required by International Accounting Standards:

(i) Property, plant and equipment;

(8 marks)

(ii) Finance cost.

(2 marks)

(b) Prepare the following for C for the year ended 31 March 2004, in the form prescribed by IAS 7 – *Cash Flow Statements:*

(i) A cash flow statement, using the indirect method;

(18 marks)

(ii) An analysis of cash and cash equivalents.

(2 marks)

(Total = 30 marks)

Note: DO NOT prepare a reconciliation of net cash flows to the movement in net debt or an analysis of changes in net debt. All workings must be clearly shown.

End of Section B

Question Three

The following trial balance was extracted from the books of U at 31 March 2004:

	$000	*$000*
5% loan notes		10,000
Administration expenses	5,900	
Bank	4,200	
Buildings at valuation (at 31 March 2003)	50,000	
Cost of goods sold	66,200	
Distribution expenses	1,600	
Dividend paid	1,500	
Inventories (at 31 March 2004)	6,100	
Land at valuation (at 31 March 2003)	6,000	
Loan note interest (six months to 30 September 2003)	250	
Ordinary shares $1 each		25,000
Payables		9,539
Plant & machinery at cost	30,000	
Provision for depreciation – buildings (at 31 March 2003)		5,000
Provision for depreciation – plant & machinery (at 31 March 2003)		10,000
Provision for doubtful receivables (at 31 March 2003)		400
Receivables	14,300	
Retained profit (at 31 March 2003)		4,411
Revaluation reserve – land & buildings		3,000
Revenue		101,050
Share premium account		17,650
	186,050	186,050

Additional information available was as follows:

(i) The directors had a valuation carried out on the land and buildings by an independent valuer and were informed that at 31 March 2004 the buildings value was $39,000,000. The directors decided to adjust the valuation of the buildings in the financial statements for the year ended 31 March 2004. The land was revalued at $6,000,000 at 31 March 2003 and had not changed at 31 March 2004. The land had originally cost $4,000,000. The buildings had originally cost $53,260,000 on 1 April 1994 and were revalued on 31 March 1998.

(ii) Depreciation on buildings is regarded as an administrative expense and is 2% of gross valuation per annum. Depreciation on plant and machinery is regarded as a "cost of sales" expense and is at 20% per annum on cost.

(iii) On 15 April 2004, U was advised that one of its major customers had gone into liquidation. The outstanding balance on their account at 31 March 2004 was $3,059,000. It is very unlikely that any money will be received from the liquidator.

(iv) Because of the recent increase in bankruptcies, the directors of U have decided that it would be prudent to increase the provision for doubtful receivables to 5% of the receivables balance.

(v) Income tax due for the year is estimated at $5,660,000.

(vi) During the year, the directors made a bonus issue; all existing shareholders received one new share free for every four shares held.

Required:

(a) Explain, with reference to appropriate International Accounting Standards, how item (i) above, the valuation of land and buildings, should be treated in U's income statement for the year ended 31 March 2004 and its balance sheet at that date.

(5 marks)

(b) Prepare U's income statement for the year ended 31 March 2004 and its balance sheet at that date, in a form suitable for presentation to the shareholders, in accordance with all current regulations.

(16 marks)

(c) Prepare U's disclosure note for movement on reserves.

(4 marks)

(Total = 25 marks)

Question Four

Q is a wholesale supplier to retail stores. The financial statements of Q for the year to 31 March 2004 were as follows:

Income statement for the year to 31 March 2004

	$000	$000
Revenue		2,600
Cost of sales		(1,200)
Gross profit		1,400
Distribution costs	(540)	
Administrative expenses	(434)	(974)
		426
Finance cost	(24)	
Income from investments	12	(12)
Profit before tax		414
Income tax expense		(108)
Net profit for the period		306

Balance sheet at 31 March 2004

	$000	$000
Tangible non-current assets		1,186
Current assets:		
Inventories	220	
Receivables	440	
Interest receivable	6	
Investments	80	
Bank and cash	122	
		868
Total assets		2,054
Capital and reserves:		
Ordinary shares $1 each	620	
Share premium account	84	
Revaluation reserve	90	
Accumulated profits	316	
		1,110
Payables: amounts falling due after more than one year:		
Loan notes		394
Payables: amounts falling due within one year:		
Trade payables	442	
Taxation	108	
		550
		2,054

Q paid dividends of $124,000 during the year ended 31 March 2004.

The industry average figures have been obtained from a trade association; these are for the calendar year ended 31 December 2003.

Industry averages

Return on capital employed	42%
Asset utilisation ratio	3·0 times
Net profit %	14%
Gross profit %	50%
Current ratio	1·9 : 1
Inventories turnover	25 days
Receivables turnover	40 days
Payables turnover	45 days

Q has a higher proportion of tangible non-current assets than the industry average as its business strategy is to own all of its land and buildings; the industry norm is to lease or rent land and buildings. If Q rented all the land and buildings it owns it would save $30,000 depreciation per annum and pay annual rents of $100,000. At 31 March 2004, the land and buildings net book value in the balance sheet was $300,000. Land and buildings depreciation is treated as a cost of sales; rent would be treated as an administrative expense.

Q’s financial statements for the year ended 31 March 2004 included an exceptional loss of $150,000 caused by the write-off of inventories damaged by a fire in a warehouse and not covered by insurance. This write-off was included in administrative expenses.

Required:

Q’s directors have decided to carry out a benchmarking exercise (comparison with industry averages to help identify possible areas for improvement.) They have requested you, a trainee management accountant, to prepare a report to assist them with their benchmarking exercise.

(i) Using the industry averages above, calculate the equivalent ratios for Q, based on its results for the year ended 31 March 2004.

(4 marks)

(ii) Make any adjustments to the financial statements you think necessary to make the results more comparable with the industry average. Explain the reasons for and the effect of any adjustments you make. Recalculate Q’s ratios where they have changed.

(10 marks)

(iii) Analyse the differences between the adjusted ratios you have calculated for Q and the industry average and suggest possible reasons for any differences. Propose a course of action to management that would help improve each of Q’s ratios falling below the industry average.

(11 marks)

(Total = 25 marks)

Question Five

S, a car dealer with a number of outlets, has expanded rapidly in recent years, but cash flow problems worsened in the year to March 2003. On 1 April 2003, the management of S decided to make three major changes to its activities.

A trainee management accountant has prepared a set of draft financial statements for the year ended 31 March 2004 but unfortunately did not appreciate the need to apply the concept of "substance over form" in the treatment of the various transactions involved.

Required:

(a) Explain the meaning of the accounting concept of substance over form. You should refer to relevant International Accounting Standards in your answer.

(4 marks)

(b)

Information for requirement (b)

The three major changes made by S on 1 April 2003, and the way in which they have been treated in the draft financial statements for the year ended 31 March 2004, are as follows:

Change 1
S sold all of its land and buildings on a sale and lease-back agreement to P on 1 April 2003. The terms were as follows:

- The annual rental was agreed at $7·5 million.
- The agreed selling price was $50 million with an option for S to repurchase the land and buildings at any time in the next ten years.
- The repurchase price was set at $50 million plus interest at bank rate plus 5% per annum from the date of the sale.

At the time of the sale, the land and buildings had a net book value (and current market value) of $80 million. The draft financial statements have treated the transaction as a disposal of the land and buildings and record a loss on disposal of $30 million in the draft income statement.

(8 marks)

Change 2
S decided to acquire new cars direct from the manufacturer on consignment. The terms of the trading are:

- On delivery of the cars to S they are invoiced at 50% of the purchase price;
- The balance of the purchase price is payable when the cars are sold;
- If a car remains unsold for three months, it must be paid for or returned to the manufacturer;
- When a car is returned, the manufacturer refunds the deposit less a 20% administration fee.

At 31 March 2004, S had 500 new cars in its inventories; all had been in inventories less than three months. The combined purchase price of the cars was $6 million. The draft financial statements omit the new cars from inventories, as they have been treated as the inventory belonging to the manufacturer. The 50% of the purchase price paid has been debited to prepayments in the draft balance sheet.

(5 marks)

Change 3
S replaced the computerised equipment used in its repair workshops. The previous equipment was purchased outright, and had no value on disposal. The new equipment was acquired on a lease, with the following terms:

- Lease term 6 years;
- Useful economic life of the equipment 5 to 7 years;
- Six equal payments of $1·5 million paid in advance commencing on 1 April 2003 and annually thereafter;
- The interest rate implicit in the lease is 7% per annum;
- The fair value of the equipment at the inception of the lease was $7,650,296;
- S will insure and maintain the equipment in good working order.

The draft financial statements record the lease payment of $1·5 million as an expense in the draft income statement.

(8 marks)

Required:

For each of the changes above, explain how S should treat each transaction in its income statement for the year ended 31 March 2004 and its balance sheet at that date. Justify your answer by reference to relevant International Accounting Standards. Prepare any journal entries that are required to adjust the draft financial statements.

Note: A descriptive narrative is not required for the journal entries.

(the breakdown of marks is shown against each change detailed above)

(Total for requirement (b) = 21 marks)

(Total = 25 marks)

Question Six

Bi specialises in property development. It carries out contract work for other organisations and also carries out work for its own investment property portfolio. Bi's accounting policy is to recognise profit on the basis of the percentage of contract completed.

At 1 April 2003, Bi had two building contracts in progress, one external and one internal, the details were:

External contract – Office complex and warehouse redevelopment
Contract price (fixed) $15 million
Duration: 24 months
Start date: 1 October 2002

1 October 2002 to 31 March 2003	*$000*
Expenditure incurred in the period	6,000
Estimated expenditure required to complete the contract at 31 March 2003	10,000
Amount received from the contract sponsor in the period	3,500
Amount paid to suppliers in the period	4,000
Percentage of contract completed at 31 March 2003	35%

1 April 2003 to 31 March 2004	*$000*
Expenditure incurred in the period	6,000
Estimated expenditure required to complete the contract at 31 March 2004	2,000
Amount received from the contract sponsor in the period	6,500
Amount paid to suppliers in the period	5,500
Percentage of contract completed at 31 March 2004	80%

Internal contract – Redevelopment of a commercial site owned by Bi
Duration: 15 months
Start date: 1 April 2002

1 April 2002 to 31 March 2003	*$000*
Expenditure incurred in the period	4,500
Estimated expenditure required to complete the contract at 31 March 2003	500
Amount paid to suppliers in the period	2,500
Percentage of contract completed at 31 March 2003	90%

1 April 2003 to 31 March 2004	*$000*
Expenditure incurred in the period	500
Amount paid to suppliers in the period	2,500

Bi had purchased the land several years earlier for $1 million; it is currently recorded, at this figure, in the balance sheet under tangible non-current assets – land. The contract was to clear the site and redevelop it, by building commercial properties that could be let to tenants. The market value of the property (land and buildings) at the date of completion was $12 million on 1 August 2003. At 31 March 2004, the market value had increased to $13 million.

The contract work was completed on time and the property was transferred at $12 million to investment properties account on 1 August 2003, for possible letting to tenants. Bi credited a gain of $6 million to income statement for the year ended 31 March 2004. Bi follows IAS 25 – *Accounting for investments* – as it accounts for investment properties as long-term investments.

Required:

(a) Calculate the figures that should appear in Bi's income statement for the years ended 31 March 2003 and 2004, and its balance sheet at those dates in respect of:

(i) the external contract.

(14 marks)

(ii) the internal contract.

(5 marks)

(b) After examining the financial statements for the year ended 31 March 2004, the external auditors issued an audit report which contained the following:

> "Included in profit for the year is $6,000,000 arising from the revaluation of work in progress (WIP). In our opinion this amount is not a realised profit and should be treated as a movement on reserves.
>
> Except for the profit arising on revaluation of WIP, in our opinion the financial statements give a true and fair view of the state of the enterprise's affairs at 31 March 2004 and of its profit for the year then ended and have been properly prepared in accordance with International Accounting Standards and relevant statutes."

Explain the type of audit report given by Bi's external auditors and suggest reasons why this report has been issued.

(6 marks)

(Total = 25 marks)

End of paper