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Intermediate Level

Financial Reporting – UK Accounting Standards

7a

IFRP

24 November 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.
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.

SECTION A – 20 MARKS

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

Question One

1.1 A plc owns 80% of the equity shares of its subsidiary, B Ltd. The year-ends of both companies are 30 September. On 25 September 2004, A plc sold goods to B Ltd at an invoiced price of £360,000. These goods were included in the stock of B Ltd at 30 September 2004. The goods were invoiced by A plc at cost plus $^{1}/_{3}$.

Assuming this is the first intra-group sale made by either company, what will be the required provision for unrealised profit in the consolidated balance sheet of the A plc group at 30 September 2004?

A £72,000

B £90,000

C £96,000

D £120,000

1.2 On 30 June 2004, C plc purchased 75% of the equity shares of D Ltd for £16 million. The balance sheet of D Ltd showed net assets of £14 million. This was before taking account of the following items:

- The market value of D Ltd's properties at 30 June 2004 [included in the balance sheet of D Ltd at a carrying value of £8 million] was £10 million.
- On 30 June 2004, D Ltd was in the process of negotiating an insurance claim in respect of stock that was damaged before that date. The claim was for £1 million and, although nothing has yet been received, the directors of D Ltd are confident that the claim will be successful.

What is the goodwill on consolidation that will appear in the consolidated balance sheet of C plc at 30 June 2004?

A £3·25 million

B £4 million

C £4·75 million

D £5·5 million

1.3 E plc has made share purchases in F Ltd as follows:

Date	*% of equity shares of F Ltd purchased*	*Balance on P&L reserve of F Ltd at date shares purchased £000*
30 June 1997	40	600
30 June 2000	30	800

On 31 March 2004, the profit and loss reserve balance of F Ltd stood at £1·1 million.

Ignoring amortisation of goodwill, what will be included in the consolidated profit and loss reserve of the E plc group in respect of F Ltd at 31 March 2004? All equity shares in F Ltd carry one vote per share.

A £200,000

B £210,000

C £290,000

D £410,000

1.4 The following data relates to the G plc group:

- The opening and closing balances on the minority interest account were £6·6 and £7·2 million respectively.
- The minority interest in the profits for the year was £2·5 million.
- During the year, the group disposed of a 75% owned subsidiary. The net assets of the subsidiary at the date of disposal were £4·4 million. Unamortised goodwill relating to the subsidiary at the date of disposal was £400,000. The subsidiaries of G plc had no dividends payable included in creditors at the start, or at the end, of the year.

What is the dividend paid to the minority shareholders during the year?

A £400,000

B £600,000

C £800,000

D £2,500,000

1.5 H plc owns 40% of the equity shares of its associate J Ltd. Both companies prepare financial statements to 30 September.

On 28 September 2004, H plc sold goods to J Ltd on which H plc recorded a profit of £40,000. All these goods were unsold by J Ltd at 30 September 2004.

What is the consolidation adjustment that will be made in the consolidated accounts of H plc at 30 September 2004 in respect of this inter-company sale?

A	Debit reserves	£16,000	Credit stock	£16,000
B	Debit reserves	£16,000	Credit investment in J Ltd	£16,000
C	Debit reserves	£40,000	Credit stock	£40,000
D	Debit reserves	£40,000	Credit investment in J Ltd	£40,000

1.6 The following statements allegedly refer to the conclusions to be drawn when using ratio analysis to interpret the financial statements of a company:

(i) A company can only increase its gross profit margin by increasing its sales prices or reducing its overall costs of production.

(ii) Revaluing fixed assets upwards would [other things being equal] lead to a reduction in the return on capital employed.

(iii) A company can increase its return on capital employed in the short term by postponing fixed asset replacement.

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.

1.7 A public company reported a profit after tax of £25 million for its year ended 30 September 2004. During the year, the following amounts were appropriated to the shareholders:

- £5 million to the non-equity shareholders.
- £12 million to the equity shareholders.

On 1 October 2003, the company had 50 million equity shares in issue. Then, on 1 April 2004, the company made a bonus issue to the equity shareholders of 3 equity shares for every 5 currently held. The company had 40 million non-equity shares in issue for the whole of the year ended 30 September 2004.

What is the earnings per share figure for the year ended 30 September 2004 that will need to be reported in the financial statements in order to comply with FRS 14 – *Earnings per Share* [ignoring comparatives and assuming that no calculations of the diluted earnings per share are needed]?

A 15 pence

B 25 pence

C 30·77 pence

D 31·25 pence

1.8 A parent company is reviewing goodwill arising on a prior acquisition for impairment. The goodwill is in respect of a business that is a single income generating unit. The net assets of the income generating unit immediately before the impairment review were as follows:

Item	*Carrying value prior to impairment review*
	£m
Goodwill on acquisition	20
Production licence	10
Specialist plant	25
Other tangible fixed assets	50
Net current assets	15
	120

The impairment review revealed that the unit had a value in use of £69 million. Further investigations revealed the following:

- The production licence could be assigned to a third party for £6 million.
- The specialist plant had been damaged by a water leak and cannot be used in the business. It can be sold for scrap for £5 million.
- The net current assets are already stated at the lower of cost and net realisable value.

Assuming none of the other tangible fixed assets have a net realisable value that is greater than their carrying value, what is the carrying value of the other tangible fixed assets immediately after the impairment review has been reflected in the financial statements?

A £32 million

B £43 million

C £49 million

D £50 million

1.9 A company prepares financial statements to 30 June each year. On 1 July 2003, the company issued 20 million £1 loan notes at 95 pence. The loan notes attract annual interest at 5% and are redeemable on 30 June 2008 at £1·20. Alternatively, the notes can be redeemed [at the option of the note-holder] on 30 June 2006 at £1·08. The company paid professional fees of £200,000 in connection with the issue and estimates that the cost of staff time in connection with the issue was £100,000.

Under the principles of FRS 4 – *Capital Instruments* – which of the following statements regarding the loan notes is true?

A The issue costs are £200,000 and the term of the loan is 3 years.

B The issue costs are £200,000 and the term of the loan is 5 years.

C The issue costs are £300,000 and the term of the loan is 3 years.

D The issue costs are £300,000 and the term of the loan is 5 years.

1.10 A company contributes to a defined benefit pension scheme and has fully complied with FRS 17 – *Retirement Benefits* – since its issue in 2000. On 1 July 2003, the net pension liability [before deferred tax] that was included in its balance sheet was £30 million. This liability was re-measured at 30 June 2004 at £35 million.

You are given the following information relevant to the pension scheme for the year ended 30 June 2004:

- The current service cost was £52 million.
- The expected return on assets was £25 million.
- The unwinding of discount on the pension liability was £10 million.
- The company closed down a division and the pension scheme paid a lump sum of £15 million in settlement of the accrued pension rights of employees affected by the closure. This figure was based on the actuarially determined liability to the relevant employees at the date of the closure.
- The company paid contributions of £30 million into the scheme.

What is the actuarial gain or loss that will be recognised in the Statement of Total Recognised Gains and Losses for the year ended 30 June 2004?

A A gain of £2 million

B A gain of £17 million

C A loss of £2 million

D A loss of £13 million

(Total = 20 marks)

End of Section A

SECTION B – 30 MARKS

ANSWER THIS QUESTION

Question Two

East plc is a company incorporated in the United Kingdom. East plc has a subsidiary, West Ltd that is located in Africa and prepares its financial statements under local accounting standards. West Ltd prepares its financial statements in African Francs (AFr). Financial information relating to the two companies for the financial year ended 30 September 2004 is given below:

Balance sheets at 30 September 2004	*East plc*		*West Ltd*	
	£m	*£m*	*AFrm*	*AFrm*
Fixed assets:				
Intangible assets [*Note 1*]	-		20	
Tangible assets [*Note 2*]	100		120	
Investments [*Note 3*]	27		-	
		127		140
Current assets:				
Stocks [*Note 4*]	40		50	
Debtors	45		60	
Cash and bank balances	15		-	
	100		110	
Creditors falling due within one year:				
Trade creditors	25		30	
Tax payable	10		15	
Bank overdraft	-		20	
	35		65	
Net current assets		65		45
Creditors falling due after more than one year:				
Long term loans		(50)		(60)
Provisions for liabilities and charges:				
Deferred tax		(15)		(12)
		127		113
Capital and reserves:				
Called-up share capital [£1/AFr1 shares]		75		60
Profit and loss account		52		53
		127		113

Profit and loss accounts for the year ended 30 September 2004	*East plc*	*West Ltd*
	£m	*AFrm*
Turnover	200	240
Cost of sales	(120)	(145)
Gross profit	80	95
Other operating expenses	(35)	(40)
Operating profit	45	55
Intra-group investment income	4·5	-
Interest payable	(7·5)	(10)
Profit before tax	42	45
Tax	(10)	(15)
Profit after tax	32	30
Dividends paid	(16)	(15)
Retained profit for the year	16	15
Retained profit – 1 October 2003	36	38
Retained profit – 30 September 2004	52	53

Notes to the financial statements

Note 1 The intangible assets of West Ltd comprise internally developed brands that have no ascertainable market value. At the date of acquisition of West Ltd by East plc (see *note 3* below) the carrying value of such brands was AFr12 million. The brands are not amortised and no change occurred in their carrying value during the year ended 30 September 2004.

Note 2 When East plc acquired West Ltd (see *note 3* below) the fair value of the tangible fixed assets of West Ltd was AFr20 million higher than their carrying value in West Ltd's balance sheet. These assets were being depreciated over their estimated useful economic lives and at the date of acquisition the directors estimated that the future useful lives of these assets was 4 years. This depreciation is recognised as part of cost of sales.

Note 3 On 1 October 2001, when the profit and loss reserve of West Ltd showed a credit balance of AFr25 million, East plc purchased 45 million shares in West Ltd for AFr1·80 each. East plc amortises purchased goodwill over 10 years, presenting the amortisation under other operating expenses. East plc has not provided West Ltd with any loan finance.

Note 4 On 1 September 2004, East plc sold a supply of components to West Ltd for £12 million. These components had cost East plc £10 million to manufacture. All of these components were included in the stock of West Ltd at 30 September 2004. West Ltd had paid for half of the consignment before the year-end and the balance of the liability was included in its creditors. Apart from this transaction, and the payment of a dividend by West Ltd on 30 June 2004, there were no other intra-group transactions.

Note 5 Exchange rates on relevant dates were:

Date	*Exchange rate AFr to £1*
1 October 2001	3·00
30 September 2003	2·70
30 June 2004	2·50
1 September 2004	2·45
30 September 2004	2·40

The weighted average exchange rate for the year ended 30 September 2004 was AFr2·5 = £1.

Note 6 In preparing the consolidated financial statements, the directors of East plc treat fair value adjustments and purchased goodwill as part of the net investment in West Ltd and so both are subject to exchange fluctuations. The closing rate [or net investment] method is appropriate for translating the financial statements of West Ltd for consolidation purposes, using the weighted average exchange rate for the year to translate the profit and loss account.

Required:

(a) Translate the balance sheet of West Ltd at 30 September 2004 into £ Sterling and prepare the consolidated balance sheet of East plc at 30 September 2004.

(18 marks)

(b) Translate the profit and loss account of West Ltd for the year ended 30 September 2004 into £ Sterling and prepare the consolidated profit and loss account of East plc for the year ended 30 September 2004. You should start with "Turnover" and end with "Retained profit for the year".

(12 marks)

(Total = 30 marks)

You should prepare all computations to the nearest £100,000.

End of Section B.

SECTION C – 50 MARKS
ANSWER TWO QUESTIONS ONLY

Question Three

Investor plc is a company that seeks to grow by acquisition. The company is cash rich and is therefore more concerned about the profitability of potential investments than their cash generating ability. Earnings per share is regarded as a key corporate performance indicator.

The directors have identified two possible targets for takeover – Alpha Ltd and Beta Ltd. Alpha Ltd is a subsidiary of another UK company, while the shares in Beta Ltd are held by its directors. The most recent audited accounts of Alpha Ltd and Beta Ltd have been obtained. Both companies disclose earnings per share on a voluntary basis. The directors of Investor plc have noted that the earnings per share of Alpha Ltd is higher than that of Beta Ltd and have concluded that the performance of Alpha Ltd must therefore be superior.

Profit and loss accounts of the two companies – year ended 31 March 2004

	Alpha Ltd	*Beta Ltd*
	£000	*£000*
Turnover	42,000	44,000
Cost of sales	(20,000)	(24,500)
Gross profit	22,000	19,500
Other operating expenses	(15,000)	(14,000)
Operating profit	7,000	5,500
Interest payable	(290)	(980)
Profit before tax	6,710	4,520
Tax	(2,000)	(1,300)
Profit for the year	4,710	3,220
Earnings per share	157 pence	107 pence

Other relevant information concerning the two companies:

1 – Interests in property
Alpha Ltd and Beta Ltd both acquired interests in very similar properties 20 years ago. Beta Ltd purchased its property for £15 million. The useful economic life of the property was estimated as 50 years at the date of purchase and Beta Ltd is charging depreciation of £150,000 each year to cost of sales on the depreciable amount. The purchase was funded with a long-term loan and £420,000 of the interest charge of Beta Ltd is in respect of this loan.

Alpha Ltd acquired a 50 year leasehold interest in a very similar property, paying a premium of £12 million and annual rentals of £160,000. This lease has been treated as an operating lease with the amortisation of the premium and annual rentals charged to cost of sales. However, the auditors have always been sceptical as to the classification of the lease as operating. If the directors of Alpha Ltd had classified the lease as a finance lease, then the charges to the profit and loss account in respect of depreciation and finance charges would have been very similar to the equivalent profit and loss account charges made by Beta Ltd.

2 – Alpha Ltd's terms of trade

- Alpha Ltd has loan capital of £7 million provided by a company that is part of the same group. Alpha Ltd pays interest at 3% per annum on these loans whereas the current market rate is 6% per annum.

- Included in the turnover of Alpha Ltd is £15 million representing sales to a fellow subsidiary, Gamma Ltd. Alpha Ltd earns a profit margin of 60% on these intra-group sales. The profit margin that Alpha Ltd earns on sales of similar products outside the group is 50%.

- Alpha Ltd receives administrative services from its parent, but no charge is made for the services. The directors of Alpha Ltd estimate that the market value of such services in the year ended 31 March 2004 was £1·5 million. Similar charges borne by Beta Ltd are presented in other operating expenses.

3 – Rates of tax
Both companies pay corporation tax at a rate of 30%. All adjustments made to profit (see requirement *(b)*) are subject to tax at this rate.

4 – Issued share capital
Both companies have an issued share capital of £3 million in £1 shares. This issued capital has not changed during the year ended 31 March 2004.

Required:

(a) Identify the factors that should be considered when comparing the financial statements of different companies when the acquisition of one of the companies is being considered.

(5 marks)

(b) Explain and compute any adjustments you consider should be made to the earnings per share of Alpha Ltd, so that the directors of Investor plc can validly compare this figure with that of Beta Ltd.

YOU SHOULD RECOMPUTE THE EARNINGS PER SHARE OF ALPHA LTD, BUT YOU DO NOT NEED TO WRITE OUT THE ADJUSTED PROFIT AND LOSS ACCOUNT OF ALPHA LTD.

(10 marks)

(c) Write a report to the directors of Investor plc identifying the underlying differences between the earnings per share of Alpha Ltd and Beta Ltd. You should clearly indicate any limitations in your conclusions based on the information available to you.

(10 marks)

(Total = 25 marks)

Question Four

You are the management accountant of Flexible plc, a UK company that has business interests all around the world. The financial statements for the year ended 31 October 2004 are currently in the course of preparation. The directors have sought your advice on the financial reporting implications of the following issues.

(1) On 30 September 2004, the directors decided to close down a business segment that had been making losses for a few years. The closure commenced on 15 November 2004 and was due to be completed on 31 December 2004. On 10 October 2004, letters were sent to employees offering voluntary redundancy or redeployment in other sectors of the business. On 13 October 2004, negotiations commenced with relevant parties with a view to terminating existing contracts of the business segment. Latest estimates of the financial implications of the closure are as follows:

- Redundancy costs will total £20 million.
- The pension scheme will make a lump sum payment totalling £10 million to the employees who accept voluntary redundancy in termination of their rights under the scheme. Flexible plc will pay this amount into the scheme on 31 January 2005.
- The cost of redeploying and retraining staff who do not accept redundancy will total £6 million.
- The costs of terminating existing contracts, including professional fees, will total £5 million.
- Plant having a net book value of £12 million at 31 October 2004 will be sold for £1 million.
- A freehold property having a net book value of £10 million at 31 October 2004 will be sold for £15 million.
- The operating losses of the business segment for November and December 2004 will total £8 million.

(12 marks)

(2) In 2005, Flexible plc is planning a major investment in Europe. Latest indications are that this investment will cost 50 million Euros and that the funds will be required on 28 February 2005. In order to provide a measure of certainty regarding the cost of the investment in £ Sterling on 31 August 2004, the directors entered into a contract to purchase 50 million Euros for £35 million, with a delivery date of 28 February 2005. On 31 October 2004, the rate of exchange was such that this contract had a fair value of £800,000.

(5 marks)

(3) Flexible plc has a subsidiary located in Taxland, which has its own tax jurisdiction. No other group company is located within it. The subsidiary regularly sells goods to Flexible plc and the stock of Flexible plc at 31 October 2004 included goods purchased from its subsidiary on which its subsidiary had made a profit of £1 million (after translation at the appropriate rate). The subsidiary had made a loss adjusted for tax purposes for the year ended 31 October 2004 that was equivalent to £4 million. Local tax legislation only allows tax losses to be carried forward for relief against future trading profits. The directors of Flexible plc consider that the loss of the subsidiary is due to identifiable non-recurring causes and that the subsidiary will record a taxable profit for the foreseeable future. Both Flexible plc and its subsidiary pay tax at 30%.

(8 marks)

Required:

Advise the directors on the financial reporting implications of the three issues for the year ended 31 October 2004. Where the primary financial statements are affected (excluding the cashflow statement), you should indicate the amounts that would be included where possible. In each case, you should indicate the nature of any disclosures that might be appropriate in the notes to the financial statements.

You should justify your conclusion with reference to appropriate Accounting Standards and include any other explanations you consider relevant.

The allocation of marks to the three issues is indicated after each issue.

(Total for Question Four = 25 marks)

Question Five

The profit and loss accounts of Hansen plc and its subsidiary companies Williams Ltd and Charvis Ltd for the year ended 30 September 2004 are given below:

	Hansen plc	*Williams Ltd*	*Charvis Ltd*
	£000	*£000*	*£000*
Turnover	60,000	45,000	35,000
Cost of sales	(30,000)	(25,000)	(19,000)
Gross profit	30,000	20,000	16,000
Other operating expenses	(15,000)	(10,000)	(8,000)
Operating profit	15,000	10,000	8,000
Investment income	2,800	-	-
Interest payable	(5,000)	(4,000)	(3,000)
Profit before tax	12,800	6,000	5,000
Tax	(3,500)	(2,000)	(1,800)
Profit after tax	9,300	4,000	3,200
Dividends paid 31 January 2004	(4,500)	(2,000)	(1,600)
Retained profit for the year	4,800	2,000	1,600
Retained profit 1 October 2003	20,000	12,000	10,000
Retained profit 30 September 2004	24,800	14,000	11,600

Note 1 – Investments by Hansen plc

- On 1 October 1996, when the profit and loss account of Williams Ltd showed a credit balance of £6 million, Hansen plc purchased 4 million of Williams plc's five million £1 issued equity shares. Hansen paid £10·8 million for these shares.
- On 1 October 1997, when the profit and loss account of Charvis Ltd showed a credit balance of £4 million, Hansen plc purchased 4·5 million of Charvis Ltd's six million £1 issued equity shares. Hansen paid £8·7 million for these shares.
- All shares in Williams Ltd and Charvis Ltd have equal voting rights. Neither company has any other reserves apart from its profit and loss reserve.
- No fair value adjustments were necessary in respect of either company when it was first consolidated by Hansen plc.
- Goodwill on both acquisitions is written off on a straight line basis over 240 months [20 years]. Hansen plc presents the amortisation of goodwill on acquisition of subsidiaries in other operating expenses.

Note 2 – Sale of shares in Charvis Ltd

On 1 April 2004, Hansen plc sold a total of three million shares in Charvis Ltd for £3·50 per share. The sale was made to help finance organic growth and Hansen plc retained a significant influence over the operating and financial policies of Charvis Ltd following the sale. Under UK tax legislation, no tax is payable on the disposal.

Note 3 – Intra-group trading
Hansen plc levies a management charge [included in its turnover] of £1 million per annum on each of its subsidiaries. The subsidiaries presented this charge under other operating expenses. In the case of Charvis Ltd, this charge ceased with effect from 1 April 2004. However, Charvis Ltd was obliged to incur equivalent costs from 1 April 2004 in order to replace the service formerly supplied by Hansen plc.

Note 4 – Profits of Charvis Ltd
All the profits of Charvis Ltd accrued evenly over the year ended 30 September 2004.

Required:

(a) Explain how the disposal of shares in Charvis Ltd will affect the method of consolidation of its profits by Hansen plc. You should make reference to appropriate Accounting Standards, but are NOT required to describe the consolidation method(s) in detail.

(5 marks)

(b) Prepare the consolidated profit and loss account of Hansen plc for the year ended 30 September 2004, starting with "Turnover" and ending with "Retained profit for the year".

(20 marks)

(Total = 25 marks)

Question Six

You are the assistant to the finance director of Rex plc. Rex plc is a UK parent company whose shares are listed on a number of different Stock Exchanges across the world. The finance director has had to take unexpected compassionate leave and before leaving he handed you a memorandum from the Chief Executive [who is not an accountant]. The Chief Executive has recently joined Rex plc from a similar position in the USA.

The memorandum contains three questions relating to three separate issues:

Issue One
I have recently heard that we should be preparing our financial statements in accordance with International Financial Reporting Standards. Surely this isn't right for a UK company! Aren't UK Standards more relevant to us? I vaguely remember someone saying that a change may occur in 2005 or 2007, but this is 2004. Please explain the latest position to me.

(9 marks)

Issue Two
You have probably read that we want to acquire a new subsidiary soon after our next year-end [31 December 2004]. I am worried about the impact this acquisition will have on our consolidated financial statements in the short term. Although the long-term prospects are good, the new subsidiary will almost certainly make losses in 2005 and maybe in 2006. Perhaps we can set up a provision for these losses when we first consolidate next year? I know this will increase the goodwill figure, but I know of companies who just leave their goodwill in the balance sheet and never write it off. Surely we could do the same? This would make the 2005 and 2006 earnings look much more acceptable to our shareholders.

(8 marks)

Issue Three
We are in the final stages of arranging the financing for the acquisition in 2004. It looks like we will have to use debt finance since shareholder confidence is low and share issues would be prohibitively expensive. However, I am concerned at the potential effect of the interest payments on cash flows and earnings. Therefore, I propose issuing debt that is repayable in 10 years' time at a substantial premium. As an alternative to repayment, we will offer the subscribers the option of converting their debt into equity shares – I am confident that shareholder confidence will have returned in 10 years' time. The dual effect of a large potential premium on repayment, together with the option to take shares instead, should mean that the investors will accept a very low coupon rate of interest. An additional benefit is that the convertible debt will be classified in the equity interests section of the balance sheet, with a consequential reduction in our borrowing ratios. Do you agree that this proposal will have the implications that I have predicted?

(8 marks)

Required:
Draft a reply to the memorandum sent by the Chief Executive. Where appropriate you should refer to Accounting Standards and any current developments to support your arguments.

The allocation of marks to the three issues is indicated after each issue.

(Total for Question Six = 25 marks)

End of paper