BEAM024

UNIVERSITY OF EXETER

SCHOOL OF BUSINESS AND ECONOMICS

January 2009

ADVANCED FINANCIAL ACCOUNTING

Module Convenor: Professor David Gwilliam

Duration: TWO HOURS – PLUS 15 minutes reading time

Answer THREE questions ONLY – all questions have equal marks

You should show all your workings

CLOSED NOTE = no material permitted

Approved calculators permitted

Statistical tables are provided at the end of the paper.

QUESTION 1. Investco Plc is a UK listed company which holds financial and property assets. As at 31.12.2007 these constituted:

A property portfolio which is expected to generate net cash rental income of £720,000 per annum into the foreseeable future. This is shown in the balance sheet at market value, currently £7,200,000, but is not considered to be a financial instrument coming under the ambit of IAS 39. The property portfolio was purchased four years ago for £6,000,000.

A deep discounted zero coupon corporate bond whereby Investco paid £3,756,574 on 1.1.2007 in return for repayment of £5,000,000 on 31.12.2009. This asset is accounted for on a 'held to maturity' basis.

An irredeemable government security paying 6% per annum on a nominal value of £10,000,000. This security cost £6,480,000 some years ago and is designated to be accounted for on a mark to market basis with valuation gains or losses passing through the income statement.

Investco is financed by £2,000,000 ordinary share capital and a £6,000,000 debenture on which interest is payable at 8% per annum. This loan was issued at par and is repayable at par in three years time.

The risk free rate of return in the economy is 10% and is expected to stay at this figure in the foreseeable future. Investco can borrow and invest at this rate of return. Investco has no other assets or liabilities as at 31.12.2007.

You may assume that all cash flows occur on the last day of the year to which they relate and that there is no taxation in the economy.

Part A **Required**:

a) Construct for Investco a summarised opening balance sheet as at 1.1.2008 in accordance with conventional accounting principles (treat the difference between net assets and share capital and revaluation reserve as distributable reserves).

8 marks

b) Calculate for Investco a measure of *ex ante* economic (Hicksian) income for the year ending 31.12.2008 which, on the assumption that this income is paid as a cash dividend at the end of the year, will allow both the maintenance of capital and an expectation of the same income in the year 2009.

6 marks

Part B **Required:**

Through much of the year 2008 the rented property market was stronger than had been anticipated and Investco's actual net rental receipts for the year amounted to £860,000. However a downturn in the market toward the end of the year means that Investco's expectation of the stream of future receipts into the foreseeable future falls to £680,000 per annum.

Furthermore, on 31.12.2008 the risk free rate of return in the economy falls to 8% and is expected to stay at this figure in the foreseeable future.

a) On the basis of this further information construct for Investco for the year ending 31.12.2008 a summarised income (profit and loss) statement and statement of financial position (balance sheet) as at 31.12.2008 in accordance with conventional accounting principles. You may assume that the property portfolio of Investco has a market value of £8,500,000 as at 31.12.2008 and that no depreciation is provided on this portfolio.

14 marks

b) Calculate measures of *ex post* economic (Hicksian) income which on the assumption of that income being distributed as at 31.12.2008 would result in

i) the net asset value of Investco reverting to the level at the start of the year given the state of knowledge holding as at 1.1.2008

ii) the net asset value of Investco reverting to the level at the start of the year, that level having being calculated taking into account revisions to knowledge occurring during the year.

iii) the *ex ante* income for 2009 being equal to the *ex post* income for 2008.

10 marks

Part C **Required**:

Discuss the extent to which conventional financial reporting under International Accounting conforms to Hicksian economic income ideals and in this context briefly consider whether the IASB should seek to move financial reporting forward in such a direction.

12 marks
(50 marks in total)

Turn over/…

QUESTION 2. At the start of its financial year Generous Plc sets up a non-contributory defined benefit scheme for a new employee based on one fiftieth of final salary for each year of service before anticipated retirement in twenty five years time. The employee's salary is expected to stay constant at £100,000 per annum throughout the period of employment. Investment returns are anticipated to be 8%. The individual is expected to live for seventeen years after retirement.

Required:

a) How much should the company plan to pay into the fund each year if the intention is to fund the scheme on a level basis throughout the twenty five years of remaining service life? (payments into the fund being made on the last day of the year).

5 marks

b) On the assumption that the scheme is funded in accordance with your calculation in a) above and that there are no changes to the assumptions underlying the scheme, how would the scheme be accounted for in the financial statements of Generous plc at the end of the first year and the second year of the scheme? Generous plc accounts for retirement benefits in accordance with the' FRS 17' option of IAS 19. You may assume that the return on a good quality corporate bond appropriately matched in duration to the liability is 5%.

15 marks

c) After five years (after making the funding payment for that year and immediately ahead of a new actuarial valuation) the scheme is in balance with assets equivalent to liabilities calculated on the basis of the assumptions set out above. However the revised actuarial assumptions at the end of the fifth year show that future investment returns are now anticipated to be 6%, the individual is now expected to live for twenty years after retirement and the return on an appropriately matched good quality corporate bond has fallen to 4%. Calculate the FRS 17/IAS 19 deficit on the scheme at the end of year five and briefly set out how this deficit would be reflected in the financial statements of Generous plc.

10 marks

d) Critically discuss the present requirements for accounting for retirement benefits under IAS 19. Your discussion should consider both theoretical and practical issues and briefly refer to the IASB's current proposals for change.

20 marks

(50 marks in total)

QUESTION 3. On 31 December 2008 Valuation Plc reported a profit figure for the twelve months just ended of £200m. Valuation Plc had reflected in its financial statements mark to market gains of £30m on its portfolio of designated financial securities. Furthermore an ‘available for sale’ asset which had cost £30m in June 2007 had been written down on 31 December 2008 from its value on 31 December 2007 of £60m to its current value of £40m and a property portfolio (not accounted for under IAS 39) which had previously been revalued upward from cost in June 2005 of £120m to a value of £150m on 31 December 2007 was written down on 31 December 2008 to a revised value of £100m. (No impairment or depreciation was provided on the property portfolio).

On 31 December 2008 Valuation Plc reported a book value of net assets of £1,000m after having paid on that day a cash dividend of £80m. A normal risk adjusted rate of return (i.e. the company’s cost of capital) for the company calculated on the basis of book value at the start of the year would be 10%. The company’s ability to maintain profits above the normal rate of return, ‘super profits’, can be modelled by a simple recursive process in which the ‘super profits’ for the next time period (one year) amount to 60% of those of the previous year.

Required:

a) In the context of financial valuation models set out what you understand by the term ‘clean surplus’ income and indicate the reasons why conventional financial profit and loss numbers may depart from clean surplus. Calculate, setting out clearly the basis and justification for your calculation and stating any assumptions that you make, the clean surplus income for Valuation plc for the year ending 31 December 2008.

16 marks

b) If the parameters of the recursive model were agreed by market participants calculate, setting out the basic assumptions that you make, what you consider would be the value of the company at the end of the day on 31 December 2008?

10 marks

c) What difference would it make to your calculation if it was anticipated ‘super profits’ could not be sustained at all into the next time period.

2 marks

d) What difference would it make to your calculation if it was anticipated that the ‘super profits’ could be sustained indefinitely.

3 marks

Turn over/…

e) Discuss the extent to which in the real economy patterns of reported income are likely to behave in the simple recursive manner modeled above. Your discussion should include reference to factors which are likely to impact the sustainability or otherwise of 'super profits' over periods of time.

8 marks

f) In the context of financial reporting identify what you consider to be the main contributions both theoretically and in practice of valuation models of the type set out above.

11 marks

(50 marks in total)

QUESTION 4. Part A

Mr Melmotte holds a security A and has the prospect of exchanging this security for either one of two other securities, security B and security C. The expected monetary outcome associated with holding each of these securities varies according to whether one of two possible states of the world exists, state 1 and state 2. (These states may be interpreted as referring to the possibility of interest rates being either high or low.) The probabilities of these states holding are respectively 0.7 and 0.3. The monetary outcomes consequent on the existence of either state of the world can be seen from the following table

Action	State 1 Probability 0.7	State 2 Probability 0.3
Hold security A	210	60
Exchange for security B	120	270
Exchange for security C	165	165

Mr Melmotte is offered the chance to purchase the output of a forecasting service which predicts whether interest rates will be high (state 1) or low (state 2). The accuracy of this service is known to have the following parameters:

On 60% of the occasions on which state 1 occurs the prediction will have been of state 1 and on 80% of the occasions on which state 2 occurs the prediction will have been of state 2.

Required:

a) If Mr Melmotte has a utility function U = W, i.e. he is completely risk neutral, what is the maximum amount that he would be prepared to pay for the information from this forecasting service for one time period?

17 marks

b) Discuss the implications for financial reporting of private information models of this nature.

8 marks

Part B

Within a highly stylised information economics setting Walker (1988) identifies five scenarios in which public information may improve economic welfare.

Required:

a) Briefly set out the basic assumptions of the Walker model identifying and explaining the five circumstances in which he considers public information may improve economic welfare

17 marks

b) Discuss the implications for financial reporting of the public information model set out by Walker.

8 marks

(50 marks in total)

5 a) Identify what you understand by the term ‘earnings management’ in relation to financial reporting

10 marks

e) Give examples of the manner in which earnings management has been practiced in recent years in the UK and North America

30 marks

f) Briefly discuss the manner in which researchers have sought to establish the extent of earnings management in large companies in the UK and North America

10 marks

(50 marks in total)

QUESTION 6. Set out the present requirements of IAS 39 with regard to the measurement of financial assets and liabilities and the manner in which they are reported in the financial statements. In this context identify what you consider to be the advantages and disadvantages of valuing all financial instruments at market value with valuation changes being reported in the income statement and proceed to briefly consider the political and institutional factors which have made the history of IAS 39 a turbulent one.

50 marks

End of Paper