SECTION A

This question is compulsory and MUST be answered

QUESTION 1 – LAHORE

The draft statements of financial position of Lahore, Barcelona and Kunming at 31 May 2011 (the reporting date for all three entities) are given below:

	Lahore		*Barcelona*		*Kunming*	
	$000	$000	$000	$000	$000	$000
Non-current assets						
Tangible assets	117,250		55,125		40,000	
Investments (Notes 1-2)	173,000		15,000		–	
		290,250		70,125		40,000
Current assets						
Inventories (Note 2)	65,342		51,136		31,000	
Trade receivables (Note 3)	33,297		39,288		23,000	
Cash	10,361		5,576		2,000	
		109,000		96,000		56,000
		399,250		166,125		96,000
Equity						
Share capital ($1 shares)		120,000		100,000		22,000
Retained earnings		99,500		36,000		18,000
		219,500		136,000		40,000
Non-current liabilities						
Long-term loans		100,000		–		26,000
Current liabilities						
Trade payables (Note 3)	25,100		18,100		13,000	
Income tax	9,150		5,025		3,000	
Bank overdraft	45,500		7,000		14,000	
		79,750		30,125		30,000
		399,250		166,125		96,000

Notes to the financial statements

(1) Lahore purchased 60 million shares in Barcelona on 1 February 2011, when the retained earnings of Barcelona were $23 million, paying cash of $142 million. At that date Barcelona had property with a carrying value of $13 million and a fair value of $16 million. The estimated remaining life of the property at 1 February 2011 was 20 years; with a full year's charge for depreciation made in the year to 31 May 2011. There were no other material differences between carrying value and fair value of the various net assets at 1 February 2011. Deferred tax can be ignored on the fair value adjustments. It is group accounting policy to account for goodwill using the full goodwill method for all subsidiaries. At 1 February 2011, the fair value of the non-controlling interest in Barcelona was $78 million.

Barcelona is regarded as a separate cash generating unit and following the annual impairment review at 31 May 2011 an impairment loss of $10 million in respect of the goodwill arose.

On 1 February 2011 Barcelona acquired 5.5 million of Kunming's shares for cash consideration of $12.5 million. Barcelona's other investments held at 31 May 2011 are financial assets recently acquired that are classified as held for trading purposes and still carried at a cost of $2.5 million. The fair value of these financial assets is now $6 million. The revaluation difference arising is to be accounted for as a temporary difference using the tax rate of 20%.

(2) On 1 February 2011, Lahore purchased 6.6 million of Kunming's $1 equity shares for a cash consideration of $31 million. A fair-value exercise was carried out and all of the net identifiable assets of Kunming at 1 February 2011 had a fair value that was equal to their carrying values in the statement of financial position of Kunming. During the year ended 31 May 2011, Kunming made a profit after taxation of $3 million and paid no dividends. This profit accrued evenly over the year. The fair value of the non-controlling interest at the date of acquisition in Kunming (both direct and indirect) was $31.125 million.

Kunming is regarded as a separate cash generating unit and following the annual impairment review at 31 May 2011 an impairment loss of $8 million in respect of the goodwill arose.

Kunming supplies a key component to both Barcelona and Lahore on a regular basis. It is supplied at a mark up of 20% and $3.9 million remained in inventory at 31 May 2011, all being purchased during March, April and May 2011:

(3) The trade payables of Lahore and Barcelona at 31 May 2011 include amounts of $11 million and $8 million respectively due to Kunming. Lahore's balance has been agreed with Kunming but Kunming's receivables include $9 million in relation to Barcelona. The difference is due to cash in transit. There was no other inter-group trading.

(4) Following the acquisitions, as a business and commercial priority, Lahore wants to rationalise the group operations and has estimated that this will cost $2 million. These costs are due to be incurred during the year to 31 May 2012, and Lahore has made a provision for this amount at 31 May 2011 which is included within trade payables.

(5) Included in the equity share capital of Lahore is $20 million of shares held by the directors of the company. These shares were issued to the directors on their appointment and will be held by the directors for the duration of their appointment. On leaving office the shares will be redeemed by the company.

(6) At the start of the current period Lahore commenced a defined benefit pension for its employees. Employees of the other group companies were not eligible to join. Just prior to the yearend Lahore made a single cash contribution to the pension scheme of $11 million which it has charged to the income statement. This is the only accounting entry that has been made to date in respect of accounting for the pension scheme. Investigations reveal that the current service cost is $9 million and expected returns and finance costs can be ignored as immaterial. At the year end the fair value of the pension fund assets is $11 million but the revaluation of the schemes liabilities the pension scheme has a deficit of $3million. Lahore has a policy of immediately recognising any actuarial gain or loss arising directly to the reserve "other components of equity".

Required:

(a) Prepare the consolidated statement of financial position for the Lahore group at 31 May 2011. (35 marks)

Following completion of the financial statements for the year ended 31 May 2011, it became apparent that there were three transactions which had not been properly addressed as follows:

- A payable due to an overseas supplier for Euro3,000 had been translated using the rate ruling at the date of the initial transaction on 30 April 2011, and was stated at this rate at this amount in the financial statements at 31 May 2011. The payable was then settled on 15 June 2011. Relevant exchange rates are as follows:

Date	Euro to $1
30 April 2011	1.6
31 May 2011	1.5
15 June 2011	1.7

- Borrowing costs amounting to $10,000 incurred on the purchase of a non-current asset had had been charged to income during the year to 31 May 2011.

- Lease payments amounting to $15,000 had been charged to income; upon subsequent review, the lease was considered to be a finance lease.

Required:

(b) Comment upon the accounting issues associated with each of these transactions (7 marks)

(c) Comment upon the professional and ethical issues associated with each of these transactions (6 marks)

NB there are two professional marks available for the quality of the discussion (2 marks)

(Total: 50 marks)

SECTION B

TWO questions ONLY to be attempted

QUESTION 2 – AZTEC

Aztec plc was incorporated as an importer of silver artefacts from South America which it customized for the UK market. The company had sold its products in the luxury market and traded profitably until five years ago. Since that date it has suffered continuous losses which have resulted in a negative balance on retained earnings.

The statement of financial position as at 31 December 20X3 showed the following:

ASSETS	$
Non-current assets	
Property, plant & equipment :	
Leasehold premises	397,000
Vehicles and equipment:	105,000
Machinery	250,000
	752,000
Current assets	
Inventory	295,000
Receivables	120,000
	1,167,000

EQUITY AND LIABILITIES	$
Equity shares of $1 each	675,000
Retained earnings	(573,000)
	102,000
Non- current liabilities	
Obligations under a finance lease	25,000
7% Debentures	135,000
11% Debentures (secured by a floating charge)	405,000
Current Liabilities	
Payables	288,000
Wages	80,000
Obligations under a finance lease	20,000
Bank Overdraft (secured by a fixed charge over the machinery)	112,000
	1,167,000

The company has been developing an export market for its products in Europe and the directors forecast that the company will return to profit in 20X4. They expect profits before tax and debenture interest to be in the range of $70,000 to $140,000 per annum over the next three years. As a result of developing the export market, they expect that the company will require warehouse premises on the continent in 20X6 at a forecast cost of $250,000.

However the directors are concerned that even if the company achieves a profit of $70,000 per year it will be a number of years before a dividend could be distributed to the equity shareholders and it would be difficult to raise fresh funds from the shareholders in 20X6 if there were to be little prospect of dividend for some time.

The directors are considering various courses of action and have had initial discussions with their auditors to ensure the legality of their proposals.

As a result of these discussions it was agreed that the finance director would produce a draft proposal for reorganisation; the auditors would let the finance director have their comments on the draft proposal: and the finance director would then submit a proposal to the board of directors for their consideration.

The following additional information was obtained by the finance director regarding the assets and liabilities at 31 December 20X3 together with the estimated costs of liquidating or reorganising:

(a) Fair values and liquidation values of assets were:

	Fair values on a going concern basis	*Liquidation values on a forced sale basis*
	$	$
Leasehold premises	360,000	100,000
Vehicles and equipment	85,000	35,000
Machinery	225,000	122,000
Current assets		
Inventory	285,000	150,000
Receivables	110,000	100,000

(b) Preference dividends are four years in arrears.

(c) Wages and related taxation would be preferential creditors upon liquidation.

(d) The costs of liquidating Aztec were estimated at $55,000.

(e) The costs of reorganisation were estimated at $40,000; these would be paid by Aztec (Europe) and treated as part of the purchase consideration.

The finance director prepared the following draft proposal:

(i) A new company was to be formed Aztec (Europe) with a share capital of $270,000 in 10 cent shares to acquire the assets and liabilities of Aztec as at 31 December 20X3.

(ii) The equity shareholders were to receive less than 25% of the equity shares in Aztec (Europe) so that each of the existing debenture holders had a significant interest and acting together had control of the new company.

(iii) The new company was to issue:

- 900,000 equity shares and $70,000 of 13% loan notes to the existing preference shareholders
- 1,200,000 equity shares and $200,000 of 13% loan notes to the existing 11% loan note holders
- 600,000 equity shares to the existing equity shareholders.

(iv) The variation of the rights of the shareholders and creditors was to be effected under legislation which requires that the scheme should be approved by a majority in number and 75% in value of each class of shareholders, by a majority in number and 75% in value of each class of creditor affected and by the court.

(v) Assume a company income tax rate of 35% on profits and ignore any other tax issues.

Required

(a) **Assuming that the necessary approvals have been obtained for assets and liabilities to be transferred on the proposed terms on 31 December 20X3:**

(i) **Prepare journal entries to close the books of Aztec; and**

(ii) **Prepare the statement of financial position of Aztec (Europe) after the transfer of the assets and liabilities.** **(10 marks)**

(b) **As advisor to Aztec, draft a memorandum to the finance director commenting on his draft proposals for a scheme of capital reduction and reorganisation.** **(15 marks)**

(Total 25 marks)

QUESTION 3 – FINANCIAL INSTRUMENTS

(a) Under IFRS9 Financial Instruments, financial assets have to be classified as either debt instruments, or equity instruments. There are in effect three classifications of financial assets; namely at fair value with gains and losses being recognised in income, at fair value with gains and losses being recognised in other comprehensive income or at amortised cost.

Required:

Describe the circumstances that determine how financial assets should be accounted for in accordance with IFRS 9 Financial Instruments. **(15 marks)**

(b) An entity, Barking, has entered into three derivative contracts during the year to 31 October 2010. All derivatives have to be initially recognised at fair value i.e. at the consideration given or received and this is often nil. However as derivatives are volatile (highly geared) in nature they have to be measured at their fair value on the statement of financial position. How the gains and losses that arise are accounted for depends on the purpose of the derivative contract.

- Barking regularly buys sugar beet as a raw ingredient in part of its manufacturing process. In response to concerns over fears of rising sugar beet prices due to climate change the entity has entered into futures contracts to fix the price that it will pay for the sugar beet in the future. The futures contracts were entered into without consideration passing. The fair value at the year end of the sugar beet futures was $50 million asset.
- Barking has a large exposure to the Dinar as it has invoiced customers in Dinars on extended credit terms. In response to concerns that fluctuating Dinar exchange rates may result in losses Barking has entered into future contracts to sell Dinars. The future contracts were entered into without consideration passing. The future contracts became a liability with the result that the fair value at the year end of the Dinar futures was $40 million, of which $30 million had been paid by Barking in a cash call.
- The finance director of Barking believes the price of gold will rise in the future and so has entered into some call options to buy gold. The premium paid to enter into the options was $2m. The price of gold has indeed risen with the effect that at the year end the value of the option was a $25 million asset.

Required:

Explain how each of the derivatives will be accounted for in the financial statements of Barking and provide extracts from the statement of comprehensive income for the year ended 31 October 2010, assuming that any hedge effectiveness has been 100%. **(10 marks)**

(Total: 25 marks)

QUESTION 4 – CURRENT ISSUE

Revenue is usually one of the largest numbers that appears in the financial statements of an entity. Therefore it is important to ensure that revenue is recognised and measured appropriately. IAS 18 – *Revenue* – was issued in order to provide standard accounting practice in this area.

Required:

(a) **Discuss the issues relating to current regulation of revenue recognition, and explain how the current developments for reform address these issues. (13 marks)**

Kappa is an entity that prepares financial statements to 31 March each year. During the year ended 31 March 2010 the following transactions occurred:

On 1 April 2009 Kappa sold a property it owned to a bank for $3,000,000. The carrying value of the property at that date was $2,000,000, of which $1,200,000 was depreciable. The remaining useful economic life of the depreciable element was 30 years from 1 April 2009. Kappa continued to occupy the property and be responsible for its security and maintenance. The market value of the property on 1 April 2009 was $5,000,000 and it is considered unlikely that this will fall significantly in the foreseeable future. Kappa measures all its property, plant and equipment under the cost model.

The terms of the sale allowed Kappa the option to repurchase the property as follows:

- On 31 March 2010 for $3,300,000.
- On 31 March 2011 for $3,630,000.
- On 31 March 2012 for $3,993,000.

Required:

(b) **Explain and compute, by applying the principles of IAS 18, how much revenue should be recognised in the statement of comprehensive income for the year ended 31 March 2010 and identify and compute any other amounts relating to the transaction that will be included in the statement of comprehensive income for the year ended 31 March 2010 and the statement of financial position at 31 March 2010. (5 marks)**

Weller is an entity that prepares financial statements to 31 December each year. On 1 November 2010 Weller signed a legally binding agreement to be responsible for the supply and erection of stage and lighting equipment for an outdoor music festival that will take place over a weekend in April 2011. Weller will not start work on the contract until March 2011. The contract has a value of $200,000 and, on agreeing the contract, $50,000 was immediately received. The balance of the monies is receivable in May 2011. Weller is very experienced in staging these types of events. It is confident that it will make a margin of 30% on this contract.

Required:

(c) **Explain how this contract should be accounted in the financial statements of Weller for the years ended 31 December 2010 and 2011 in accordance with current accounting regulations. (3 marks)**

(d) **Explain how an application of the Framework's definition of assets and liabilities can lead to alternative accounting treatment for this contract in the financial statements for the years ended 31 December 2010 and 2011. (4 marks)**

(Total: 25 marks)