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ACCA FINAL ASSESSMENT

Financial Reporting

December 2011

Paper F7 (INT)

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

All FIVE questions are compulsory and MUST be attempted.

Do NOT open this paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

This question paper must not be removed from the examination hall.

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All FIVE questions are compulsory and MUST be attempted

QUESTION 1

On 1 April 2007 Pierre purchased 56 million shares in Simone for an immediate cash payment of $90 million. The retained earnings of Simone at 1 April 2007 were $30 million. The terms of the business combination provide for the payment of an additional $12 million on 31 March 2009 if the performance of Simone reaches a specified level in the two year period ended 31 March 2009. The directors of Pierre estimated that the fair value of the contingent consideration at 1 April 2007 was $10 million. This estimate was unchanged at 30 September 2008 (ignore discounting). The statement of financial position of Pierre includes this investment at its original cash price of $90 million.

On 1 October 2006 Pierre paid $15 million (included in Pierre's cost of investment) for 25% of the equity shares of Alberta, a company that was incorporated on that date. The statements of financial position of the three entities at 30 September 2008 were as follows:

	Pierre	*Simone*	*Alberta*
Non-current assets:	$000	$000	$000
Property, plant and equipment	144,000	100,000	112,000
Investments	113,000	Nil	Nil
	257,000	100,000	112,000
Current assets:			
Inventories	40,000	32,000	28,000
Trade receivables	48,800	30,000	32,000
Bank	9,000	8,000	10,000
	97,800	70,000	70,000
Total assets	**354,800**	**170,000**	**182,000**
Equity			
Share capital	100,000	70,000	60,000
Retained earnings	158,800	39,000	56,000
Total equity	258,800	109,000	116,000
Non-current liabilities:			
Loan notes	60,000	36,000	42,000
Current liabilities:			
Trade payables	30,000	18,000	20,000
Taxation	6,000	7,000	4,000
Total current liabilities	36,000	25,000	24,000
Total equity and liabilities	**354,800**	**170,000**	**182,000**

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The following information is relevant:

(i) The directors of Pierre carried out a fair value exercise to measure the identifiable assets and liabilities of Simone at 1 April 2007. The following matters emerged:

Land having a carrying value of $10 million had an estimated market value of $15 million.

Plant and equipment having a carrying value of $40 million had an estimated market value of $44 million. The estimated future economic life of the plant at 1 April 2007 was four years.

The fair value adjustments have not been reflected in the individual financial statements of Simone.

(ii) The inventories of Simone and Alberta at 30 September 2008 included components purchased from Pierre during the year at a cost of $20 million to Simone and $16 million to Alberta. Pierre supplied these components at cost plus a mark up of one-third.

(iii) The trade receivables of Pierre included $5 million receivable from Simone and $4 million receivable from Alberta in respect of the purchase of components. The trade payables of Simone and Alberta include an equivalent amount payable to Pierre.

(iv) The directors of Pierre estimated that the fair value of the non-controlling interest in Simone on 1 April 2007 was $23 million. It is Pierre's policy to measure the non-controlling interest at the date of acquisition at its fair value in the consolidated financial statements.

(v) The goodwill arising on acquisition of Simone has not suffered any impairment since 1 April 2007.

Required:

(a) Prepare the consolidated statement of financial position of Pierre at 30 September 2008. (21 marks)

(b) Explain why there is a difference in the accounting treatment of Simone and Alberta in the consolidated financial statements. (4 marks)

(Total: 25 marks)

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QUESTION 2

Nemesis is a well known company manufacturing thrill rides. During the current economic climate, Nemesis has experienced some difficulties and unfortunately has had to close down its Merry Go Round division.

The company's trial balance at 31 October 2008 is as follows:

	$000	$000
Revenue		216,000
Cost of sales	91,080	
Distribution costs	21,180	
Administrative expenses	23,760	
Investment income		4,680
Investment property	45,000	
Interest paid	2,880	
Income tax		1,800
Property, plant and equipment carrying value at 1 November 2007	270,000	
Inventories – 31 October 2008	18,000	
Trade receivables	22,500	
Bank	10,800	
Payables		7,200
Deferred tax – 1 November 2007		12,600
8% Loan note		72,000
Ordinary $1 share capital		90,000
Retained earnings – 1 November 2007		100,920
	505,200	505,200

Note 1

Revenue includes cash sales of $12 million for goods sold in October 2008 to Abbeyfax Plc, a bank. The goods are marked up at 25% on cost, Abbeyfax has the option to require Nemesis to repurchase these goods within three months of the year end at their original selling price plus a one-off fee of $360,000.

Note 2

Included within property, plant and equipment is a building with a carrying value of $9 million. On 1 November 2007 it was revalued at $12 million. The building had an estimated life of twenty five years when it was purchased ten years prior to the revaluation date, this has not changed as a result of the revaluation. The directors of Nemesis wish to incorporate this value in the financial statements for the year ended 31 October 2008.

All other property, plant and equipment is to be depreciated at 20% per annum on the reducing balance basis. All depreciation is to be charged to cost of sales.

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Note 3

On 1 October 2008, Nemesis closed down its Merry Go Round division. The results of the division from 1 November 2007 to the date of closure are included in the above trial balance figures. These results are as follows:

	$000
Revenue	9,800
Cost of sales	6,450
Distribution costs	2,040
Admin expenses	1,980

The net assets of the division were sold at a loss of $3.2 million and are currently included within cost of sales.

Note 4

The investment property owned by Nemesis has risen in value during the year by 3%. This rise is to be incorporated into the financial statements. Nemesis uses the fair value model to value investment property, as allowed by IAS 40.

Note 5

The provision for income tax for the year ended 31 October 2008 has been estimated at $23,400,000. For the deferred tax provision, the only temporary differences are accelerated capital allowances. At 31 October, these were $21,600,000. Income tax is charged at 30%.

Required:

Prepare a statement of comprehensive income for the year ended 31 October 2008 for Nemesis along with a statement of changes in equity and a statement of financial position at that date.

(25 marks)

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QUESTION 3

The financial statements of Armstong Plc, a retailer of electronic products, are given below:

Statement of financial position	*20X9*		*20X8*	
	$000	$000	$000	$000
Non-current assets				
Property, plant & equipment	16,104		13,918	
Intangible assets	1,439		1,765	
		17,543		15,683
Current assets				
Inventories	10,931		9,480	
Receivables	4,429		3,892	
Cash at bank and in hand	3,658		7,518	
		19,018		20,890
		36,561		**36,573**
Equity				
Equity shares of $1 each	450		400	
Share premium	1,600		1,500	
Retained earnings	8,951		8,824	
		11,001		10,724
Non-current liabilities				
7% Loan notes	6,950		1,500	
Obligations under finance leases	993		356	
Deferred taxation	234		108	
		8,177		1,964
Current liabilities				
Trade payables	14,299		23,162	
Overdraft	2,123		–	
Taxation	300		250	
Warranty provision	511		428	
Obligations under finance leases	150		45	
		17,383		23,885
		36,561		**36,573**

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Income statement for the year ended 31 October 20X9

	$000
Revenue	83,430
Cost of sales	(70,876)
Gross profit	12,554
Operating expenses	(10,446)
Profit from operations	2,108
Finance costs	(809)
Profit before tax	1,299
Taxation	(672)
Profit for the year	627

Statement of changes in equity for the year ended 31 October 20X9

	Share capital	*Share premium*	*Retained earnings*	*Total*
	$000	$000	$000	$000
Opening balance	400	1,500	8,824	10,724
Profit for the year			627	627
Dividends paid			(500)	(500)
Issue of shares	50	100		150
Closing balance	450	1,600	8,951	11,001

Additional information:

(i) An item of plant with a carrying amount of $965,000 was sold at a loss of $50,000 during the year. Depreciation of $2,395,000 was charged (to operating expenses) for property, plant and equipment in the year ended 31 October 20X9.

(ii) New assets were acquired under finance leases in the year. The fair value of these assets at acquisition was $960,000.

(iii) There were no acquisitions or disposals of intangible assets during the year.

(iv) The company issued new shares at full market value.

(v) Armstrong gives a 12 month warranty on the majority of the products it sells. The amounts shown in current liabilities as warranty provision are an accurate assessment, based on past experience, of the amount of claims likely to be made in respect of warranties outstanding at each year end. Warranty costs are included in cost of sales.

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Required:

(a) Prepare a statement of cash flows for Armstrong plc for the year ended 31 October 20X9 in accordance with IAS 7 *Statement of Cash-flows* by the indirect method. (15 marks)

(b) The directors of Armstrong plc are looking to grow the business and are hoping to raise a mix of equity and debt to finance this growth. Armstrong's price earnings ratio at 31 October 20X9 is 4.6 and the industry average is 8.3.

(i) Explain how the price earnings ratio is calculated and what it represents. (2 marks)

(ii) Calculate gearing for 20X9 and 20X8. For the purpose of calculating debt all finance lease obligations should be treated as long-term interest bearing borrowings. (2 marks)

(iii) Briefly comment on Armstrong's cash flow position and their prospects of raising further long term equity and debt finance. (6 marks)

(Total: 25 marks)

QUESTION 4

(a) The principle of recording the substance of transactions rather than their legal form lies at the heart of the IASB's Framework for Preparation and Presentation of Financial Statements as well as numerous International Accounting Standards.

Required:

Explain why it is important to record the substance rather than the legal form of transactions and describe features that may indicate that the substance of a transaction is different from its legal form. (5 marks)

(b) (i) On 1 April 2009 Ramsden sold maturing inventory that had a carrying value of $4 million (at cost) to Funders plc, a finance house, for $6.5 million. The fair value of the inventory at 1 April 2009 was considered to be higher than $6.5 million. The inventory will not be ready for sale until 31 March 2013 and will remain on Ramsden's premises until this date.

The sale contract includes a clause allowing Ramsden to repurchase the inventory at any time up to 31 March 2013 at a price of $6.5 million plus interest at 10% per annum compounded from 1 April 2009.

The proceeds of the sale have been debited to the bank and the sale has been included in Ramsden's revenue. **(5 marks)**

(ii) Ramsden raised finance of $20 million on 1 April 2009 by issuing 20 million 8% redeemable preference shares of $1 each at par. They are redeemable at a large premium which gives them an effective finance cost of 12% per annum.

Ramsden has recorded the $20 million cash inflow as equity and has deducted the first year's dividend of $1.6 million from the retained earnings reserve. **(5 marks)**

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Required:

Describe how the above arrangements should be reflected in the financial statements of Ramsden Limited for the year ended 31 March 2010, explaining where relevant the difference between the legal form of the transactions and their substance.

Note: the mark allocation is shown against each of the scenarios.

(Total: 15 marks)

QUESTION 5

(a) The IASB's Framework for the preparation and presentation of financial statements (Framework) stresses that an entity's financial statements should be reliable.

Required:

Explain what is meant by reliability and discuss how IAS 17 Leases incorporates this qualitative characteristic. (4 marks)

(b) Peri Ltd entered into a lease agreement on 1 October 2009 with Finance Plc to lease a sauce making machine with a market price of $150,000. The machine was modified slightly for Peri Ltd's use, the cost of which was incorporated into the rentals. Peri Ltd is responsible for insuring the machine over the lease term and will undertake regular maintenance checks.

The lease requires five annual payments of $35,000 payable in advance, commencing on 1 October 2009. Peri Ltd is expected to return the machine at the end of the five year period. This type of lease has an implicit interest rate of 8.36%. The finance assistant is unsure if this is an operating lease or a finance lease.

Required:

Explain to the finance assistant what type of lease the Peri machine would be categorised as according to IAS 17 Leases and prepare extracts of the financial statements for the year ended 31 March 2010. (6 marks)

(Total: 10 marks)

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