

Fundamentals Level – Skills Module

Financial Reporting (International)

Tuesday 10 June 2008

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.

The Association of Chartered Certified Accountants

Paper F7 (INT)

ACCA

ALL FIVE questions are compulsory and MUST be attempted

1 On 1 August 2007 Patronic purchased 18 million of a total of 24 million equity shares in Sardonic. The acquisition was through a share exchange of two shares in Patronic for every three shares in Sardonic. Both companies have shares with a par value of \$1 each. The market price of Patronic's shares at 1 August 2007 was \$5.75 per share. Patronic will also pay in cash on 31 July 2009 (two years after acquisition) \$2.42 per acquired share of Sardonic. Patronic's cost of capital is 10% per annum. The reserves of Sardonic on 1 April 2007 were \$69 million.

Patronic has held an investment of 30% of the equity shares in Acerbic for many years.

The summarised income statements for the three companies for the year ended 31 March 2008 are:

	Patronic \$'000	Sardonic \$'000	Acerbic \$'000
Revenue	150,000	78,000	80,000
Cost of sales	(94,000)	(51,000)	(60,000)
Gross profit	56,000	27,000	20,000
Distribution costs	(7,400)	(3,000)	(3,500)
Administrative expenses	(12,500)	(6,000)	(6,500)
Finance costs (note (ii))	(2,000)	(900)	nil
Profit before tax	34,100	17,100	10,000
Income tax expense	(10,400)	(3,600)	(4,000)
Profit for the period	23,700	13,500	6,000

The following information is relevant:

(i) The fair values of the net assets of Sardonic at the date of acquisition were equal to their carrying amounts with the exception of property and plant. Property and plant had fair values of \$4.1 million and \$2.4 million respectively in excess of their carrying amounts. The increase in the fair value of the property would create additional depreciation of \$200,000 in the consolidated financial statements in the post acquisition period to 31 March 2008 and the plant had a remaining life of four years (straight-line depreciation) at the date of acquisition of Sardonic. All depreciation is treated as part of cost of sales.

The fair values have not been reflected in Sardonic's financial statements.

No fair value adjustments were required on the acquisition of Acerbic.

(ii) The finance costs of Patronic do not include the finance cost on the deferred consideration.

(iii) Prior to its acquisition, Sardonic had been a good customer of Patronic. In the year to 31 March 2008, Patronic sold goods at a selling price of \$1.25 million per month to Sardonic both before and after its acquisition. Patronic made a profit of 20% on the cost of these sales. At 31 March 2008 Sardonic still held inventory of \$3 million (at cost to Sardonic) of goods purchased in the post acquisition period from Patronic.

(iv) An impairment test on the goodwill of Sardonic conducted on 31 March 2008 concluded that it should be written down by \$2 million. The value of the investment in Acerbic was not impaired.

(v) All items in the above income statements are deemed to accrue evenly over the year.

(vi) Ignore deferred tax.

Required:

(a) Calculate the goodwill arising on the acquisition of Sardonic at 1 August 2007. (6 marks)

(b) Prepare the consolidated income statement for the Patronic Group for the year ended 31 March 2008.

Note: assume that the investment in Acerbic has been accounted for using the equity method since its acquisition. (15 marks)

(c) At 31 March 2008 the other equity shares (70%) in Acerbic were owned by many separate investors. Shortly after this date Spekulate (a company unrelated to Patronic) accumulated a 60% interest in Acerbic by buying shares from the other shareholders. In May 2008 a meeting of the board of directors of Acerbic was held at which Patronic lost its seat on Acerbic's board.

Required:

Explain, with reasons, the accounting treatment Patronic should adopt for its investment in Acerbic when it prepares its financial statements for the year ending 31 March 2009. (4 marks)

(25 marks)

- 2 Below is the summarised draft statement of financial position of Dexon, a publicly listed company, as at 31 March 2008.

	\$'000	\$'000	\$'000
Assets			
Non-current assets			
Property at valuation (land \$20,000; buildings \$165,000 (note (ii)))			185,000
Plant (note (ii))			180,500
Investments at fair value through profit and loss at 1 April 2007 (note (iii))			<u>12,500</u>
			378,000
Current assets			
Inventory		84,000	
Trade receivables (note (iv))		52,200	
Bank		<u>3,800</u>	<u>140,000</u>
Total assets			<u>518,000</u>
Equity and liabilities			
Equity			
Ordinary shares of \$1 each			250,000
Share premium		40,000	
Revaluation reserve		18,000	
Retained earnings – at 1 April 2007	12,300		
– for the year ended 31 March 2008	<u>96,700</u>	<u>109,000</u>	<u>167,000</u>
			417,000
Non-current liabilities			
Deferred tax – at 1 April 2007 (note (v))			19,200
Current liabilities			<u>81,800</u>
Total equity and liabilities			<u>518,000</u>

The following information is relevant:

- (i) Dexon's income statement includes \$8 million of revenue for credit sales made on a 'sale or return' basis. At 31 March 2008, customers who had not paid for the goods, had the right to return \$2.6 million of them. Dexon applied a mark up on cost of 30% on all these sales. In the past, Dexon's customers have sometimes returned goods under this type of agreement.
- (ii) The non-current assets have not been depreciated for the year ended 31 March 2008.
- Dexon has a policy of revaluing its land and buildings at the end of each accounting year. The values in the above statement of financial position are as at 1 April 2007 when the buildings had a remaining life of fifteen years. A qualified surveyor has valued the land and buildings at 31 March 2008 at \$180 million.
- Plant is depreciated at 20% on the reducing balance basis.
- (iii) The investments at fair value through profit and loss are held in a fund whose value changes directly in proportion to a specified market index. At 1 April 2007 the relevant index was 1,200 and at 31 March 2008 it was 1,296.
- (iv) In late March 2008 the directors of Dexon discovered a material fraud perpetrated by the company's credit controller that had been continuing for some time. Investigations revealed that a total of \$4 million of the trade receivables as shown in the statement of financial position at 31 March 2008 had in fact been paid and the money had been stolen by the credit controller. An analysis revealed that \$1.5 million had been stolen in the year to 31 March 2007 with the rest being stolen in the current year. Dexon is not insured for this loss and it cannot be recovered from the credit controller, nor is it deductible for tax purposes.
- (v) During the year the company's taxable temporary differences increased by \$10 million of which \$6 million related to the revaluation of the property. The deferred tax relating to the remainder of the increase in the temporary differences should be taken to the income statement. The applicable income tax rate is 20%.

- (vi) The above figures do not include the estimated provision for income tax on the profit for the year ended 31 March 2008. After allowing for any adjustments required in items (i) to (iv), the directors have estimated the provision at \$11.4 million (this is in addition to the deferred tax effects of item (v)).
- (vii) On 1 September 2007 there was a fully subscribed rights issue of one new share for every four held at a price of \$1.20 each. The proceeds of the issue have been received and the issue of the shares has been correctly accounted for in the above statement of financial position.
- (viii) In May 2007 a dividend of 4 cents per share was paid. In November 2007 (after the rights issue in item (vii) above) a further dividend of 3 cents per share was paid. Both dividends have been correctly accounted for in the above statement of financial position.

Required:

Taking into account any adjustments required by items (i) to (viii) above

- (a) **Prepare a statement showing the recalculation of Dexon's profit for the year ended 31 March 2008.** (8 marks)
- (b) **Prepare the statement of changes in equity of Dexon for the year ended 31 March 2008.** (8 marks)
- (c) **Redraft the statement of financial position of Dexon as at 31 March 2008.** (9 marks)

Note: notes to the financial statements are NOT required.

(25 marks)

3 Pinto is a publicly listed company. The following financial statements of Pinto are available:

Statement of comprehensive income for the year ended 31 March 2008		\$'000
Revenue		5,740
Cost of sales		(4,840)
Gross profit		<u>900</u>
Income from and gains on investment property		60
Distribution costs		(120)
Administrative expenses (note (ii))		(350)
Finance costs		(50)
Profit before tax		<u>440</u>
Income tax expense		(160)
Profit for the year		<u>280</u>
Other comprehensive income		
Gains on property revaluation		<u>100</u>
Total comprehensive income		<u>380</u>

Statements of financial position as at	31 March 2008		31 March 2007	
	\$'000	\$'000	\$'000	\$'000
Assets				
Non-current assets (note (i))				
Property, plant and equipment		2,880		1,860
Investment property		420		400
		<u>3,300</u>		<u>2,260</u>
Current assets				
Inventory	1,210		810	
Trade receivables	480		540	
Income tax asset	nil		50	
Bank	10	1,700	nil	1,400
Total assets		<u>5,000</u>		<u>3,660</u>
Equity and liabilities				
Equity shares of 20 cents each (note (iii))		1,000		600
Share premium	600		nil	
Revaluation reserve	150		50	
Retained earnings	1,440	2,190	1,310	1,360
		<u>3,190</u>		<u>1,960</u>
Non-current liabilities				
6% loan notes (note (ii))	nil		400	
Deferred tax	50	50	30	430
Current liabilities				
Trade payables	1,410		1,050	
Bank overdraft	nil		120	
Warranty provision (note (iv))	200		100	
Current tax payable	150	1,760	nil	1,270
Total equity and liabilities		<u>5,000</u>		<u>3,660</u>

The following supporting information is available:

- (i) An item of plant with a carrying amount of \$240,000 was sold at a loss of \$90,000 during the year. Depreciation of \$280,000 was charged (to cost of sales) for property, plant and equipment in the year ended 31 March 2008. Pinto uses the fair value model in IAS 40 *Investment Property*. There were no purchases or sales of investment property during the year.
- (ii) The 6% loan notes were redeemed early incurring a penalty payment of \$20,000 which has been charged as an administrative expense in the income statement.
- (iii) There was an issue of shares for cash on 1 October 2007. There were no bonus issues of shares during the year.
- (iv) Pinto gives a 12 month warranty on some 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.
- (v) A dividend of 3 cents per share was paid on 1 January 2008.

Required:

- (a) **Prepare a statement of cash flows for Pinto for the year to 31 March 2008 in accordance with IAS 7 *Statement of cash flows*.** (15 marks)
- (b) **Comment on the cash flow management of Pinto as revealed by the statement of cash flows and the information provided by the above financial statements.**

Note: ratio analysis is not required, and will not be awarded any marks. (10 marks)

(25 marks)

- 4 (a) The IASB's *Framework for the Preparation and Presentation of Financial Statements* requires financial statements to be prepared on the basis that they comply with certain accounting concepts, underlying assumptions and (qualitative) characteristics. Five of these are:

Matching/accruals
Substance over form
Prudence
Comparability
Materiality

Required:

Briefly explain the meaning of each of the above concepts/assumptions.

(5 marks)

- (b) For most entities, applying the appropriate concepts/assumptions in accounting for inventories is an important element in preparing their financial statements.

Required:

Illustrate with examples how each of the concepts/assumptions in (a) may be applied to accounting for inventory.

(10 marks)

(15 marks)

- 5 Pingway issued a \$10 million 3% convertible loan note at par on 1 April 2007 with interest payable annually in arrears. Three years later, on 31 March 2010, the loan note is convertible into equity shares on the basis of \$100 of loan note for 25 equity shares or it may be redeemed at par in cash at the option of the loan note holder. One of the company's financial assistants observed that the use of a convertible loan note was preferable to a non-convertible loan note as the latter would have required an interest rate of 8% in order to make it attractive to investors. The assistant has also commented that the use of a convertible loan note will improve the profit as a result of lower interest costs and, as it is likely that the loan note holders will choose the equity option, the loan note can be classified as equity which will improve the company's high gearing position.

The present value of \$1 receivable at the end of the year, based on discount rates of 3% and 8% can be taken as:

	3%	8%
	\$	\$
End of year 1	0.97	0.93
2	0.94	0.86
3	0.92	0.79

Required:

Comment on the financial assistant's observations and show how the convertible loan note should be accounted for in Pingway's income statement for the year ended 31 March 2008 and statement of financial position as at that date.

(10 marks)

End of Question Paper