Fundamentals Level – Skills Module

# Financial Reporting (Irish)

Wednesday 7 December 2011

**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 (IRL)

**ALL FIVE questions are compulsory and MUST be attempted**

**1** On 1 October 2010, Paladin secured a majority equity shareholding in Saracen on the following terms:

an immediate payment of $4 per share on 1 October 2010; and
a further amount deferred until 1 October 2011 of $5·4 million.

The immediate payment has been recorded in Paladin's financial statements, but the deferred payment has not been recorded. Paladin's cost of capital is 8% per annum.

On 1 February 2011, Paladin also acquired 25% of the equity shares of Augusta paying $10 million in cash.

The summarised statements of financial position of the three companies at 30 September 2011 are:

| | Paladin | Saracen | Augusta |
|---|---|---|---|
| Assets | $'000 | $'000 | $'000 |
| Non-current assets | | | |
| Property, plant and equipment | 40,000 | 31,000 | 30,000 |
| Intangible assets | 7,500 | nil | nil |
| Investments – Saracen (8 million shares at $4 each) | 32,000 | | |
| – Augusta | 10,000 | | |
| | 89,500 | 31,000 | 30,000 |
| Current assets | | | |
| Inventory | 11,200 | 8,400 | 10,000 |
| Trade receivables | 7,400 | 5,300 | 5,000 |
| Bank | 3,400 | nil | 2,000 |
| Total assets | 111,500 | 44,700 | 47,000 |
| Equity and liabilities | | | |
| Equity | | | |
| Equity shares of $1 each | 50,000 | 10,000 | 10,000 |
| Retained earnings – at 1 October 2010 | 25,700 | 12,000 | 31,800 |
| – for year ended 30 September 2011 | 9,200 | 6,000 | 1,200 |
| | 84,900 | 28,000 | 43,000 |
| Non-current liabilities | | | |
| Deferred tax | 15,000 | 8,000 | 1,000 |
| Current liabilities | | | |
| Bank | nil | 2,500 | nil |
| Trade payables | 11,600 | 6,200 | 3,000 |
| Total equity and liabilities | 111,500 | 44,700 | 47,000 |

The following information is relevant:

(i) Paladin's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose the directors of Paladin considered a share price for Saracen of $3·50 per share to be appropriate.

(ii) At the date of acquisition, the fair values of Saracen's property, plant and equipment was equal to its carrying amount with the exception of Saracen's plant which had a fair value of $4 million above its carrying amount. At that date the plant had a remaining life of four years. Saracen uses straight-line depreciation for plant assuming a nil residual value.

Also at the date of acquisition, Paladin valued Saracen's customer relationships as a customer-base intangible asset at fair value of $3 million. Saracen has not accounted for this asset. Trading relationships with Saracen's customers last on average for six years.

(iii) At 30 September 2011, Saracen's inventory included goods bought from Paladin (at cost to Saracen) of $2·6 million. Paladin had marked up these goods by 30% on cost. Paladin's agreed current account balance owed by Saracen at 30 September 2011 was $1·3 million.

(iv) Impairment tests were carried out on 30 September 2011 which concluded that consolidated goodwill was not impaired, but, due to disappointing earnings, the value of the investment in Augusta was impaired by $2·5 million.

(v) Assume all profits accrue evenly through the year.

**Required:**

**Prepare the consolidated statement of financial position for Paladin as at 30 September 2011.**

**(25 marks)**

**2** The following trial balance relates to Keystone at 30 September 2011:

| | $'000 | $'000 |
|---|---|---|
| Revenue (note (i)) | | 380,000 |
| Material purchases (note (ii)) | 64,000 | |
| Production labour (note (ii)) | 124,000 | |
| Factory overheads (note (ii)) | 80,000 | |
| Distribution costs | 14,200 | |
| Administrative expenses (note (iii)) | 46,400 | |
| Finance costs | 350 | |
| Investment income | | 800 |
| Leased property – at valuation on 1 October 2010 (note (ii)) | 48,000 | |
| Plant and equipment – at cost (note (ii)) | 44,500 | |
| Accumulated amortisation/depreciation at 1 October 2010 | | |
| – plant and equipment | | 14,500 |
| Financial asset: equity investments (note (v)) | 18,000 | |
| Inventory at 1 October 2010 | 46,700 | |
| Trade receivables | 33,550 | |
| Trade payables | | 27,800 |
| Bank | | 2,300 |
| Equity shares of 20 cents each | | 50,000 |
| Retained earnings at 1 October 2010 | | 33,600 |
| Revaluation reserve (note (ii)) | | 8,000 |
| Deferred tax (note (vi)) | | 2,700 |
| | 519,700 | 519,700 |

The following notes are relevant:

(i) Revenue includes goods sold and despatched in September 2011 on a 30-day right of return basis. Their selling price was $2·4 million and they were sold at a gross profit margin of 25%. Keystone is uncertain as to whether any of these goods will be returned within the 30-day period.

(ii) Non-current assets:

During the year Keystone manufactured an item of plant for its own use. The direct materials and labour were $3 million and $4 million respectively. Production overheads are 75% of direct labour cost and Keystone determines the final selling price for goods by adding a mark-up on total cost of 40%. These manufacturing costs are included in the relevant expense items in the trial balance. The plant was completed and put into immediate use on 1 April 2011.

All plant and equipment is depreciated at 20% per annum using the reducing balance method with time apportionment in the year of acquisition.

On 1 October 2010, the leased property was revalued at $48 million in line with recent increases in market values as confirmed by an independent surveyor. At that date the property had a remaining life of 16 years. Keystone does not make a transfer to retained earnings in respect of excess amortisation. The revaluation created a gain of $8 million (see note (vi)).

All depreciation and amortisation is charged to cost of sales. No depreciation or amortisation has yet been charged on any non-current asset for the year ended 30 September 2011.

(iii) On 15 August 2011, Keystone's share price stood at $2·40 per share. On this date Keystone paid a dividend (included in administrative expenses) that was calculated to give a dividend yield of 4%.

(iv) The inventory on Keystone's premises at 30 September 2011 was counted and valued at cost of $54·8 million.

(v) The equity investments had a fair value of $17·4 million on 30 September 2011. There were no purchases or disposals of any of these investments during the year. Keystone has not made the election in accordance with IFRS 9 *Financial Instruments*. Keystone adopts this standard when accounting for its financial assets.

(vi) A provision for income tax for the year ended 30 September 2011 of $24·3 million is required. At 30 September 2011 the tax base of Keystone's net assets was $15 million less than their carrying amounts. This excludes the effects of the revaluation gain on the leased property. The income tax rate of Keystone is 30%.

**Required:**

**(a) Prepare the statement of comprehensive income for Keystone for the year ended 30 September 2011.**

**(b) Prepare the statement of financial position for Keystone as at 30 September 2011.**

**(c) Describe and quantify how the revaluation of the leased property would have affected the revaluation reserve and deferred tax under RoI rules including any timing issues.**

Notes to the financial statements are not required.
A statement of changes in equity is not required.

The following mark allocation is provided as guidance for this question:

(a) 14 marks
(b) 9 marks
(c) 2 marks

**(25 marks)**

**3 (a)** The following information relates to the draft financial statements of Mocha.

**Summarised statements of financial position as at 30 September:**

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | $'000 | $'000 | $'000 | $'000 |
| Assets | | | | |
| Non-current assets | | | | |
| Property, plant and equipment (note (i)) | | 32,600 | | 24,100 |
| Financial asset: equity investments (note (ii)) | | 4,500 | | 7,000 |
| | | 37,100 | | 31,100 |
| Current assets | | | | |
| Inventory | | 10,200 | | 7,200 |
| Trade receivables | | 3,500 | | 3,700 |
| Bank | | nil | | 1,400 |
| | | 13,700 | | 12,300 |
| Total assets | | 50,800 | | 43,400 |
| Equity and liabilities | | | | |
| Equity | | | | |
| Equity shares of $1 each (note (iii)) | | 14,000 | | 8,000 |
| Share premium (note (iii)) | nil | | 2,000 | |
| Revaluation reserve (note (iii)) | 2,000 | | 3,600 | |
| Retained earnings | 13,000 | 15,000 | 10,100 | 15,700 |
| | | 29,000 | | 23,700 |
| Non-current liabilities | | | | |
| Finance lease obligations | 7,000 | | 6,900 | |
| Deferred tax | 1,300 | 8,300 | 900 | 7,800 |
| Current liabilities | | | | |
| Tax | 1,000 | | 1,200 | |
| Bank overdraft | 2,900 | | nil | |
| Provision for product warranties (note (iv)) | 1,600 | | 4,000 | |
| Finance lease obligations | 4,800 | | 2,100 | |
| Trade payables | 3,200 | 13,500 | 4,600 | 11,900 |
| Total equity and liabilities | | 50,800 | | 43,400 |

**Summarised income statements for the years ended 30 September:**

| | 2011 | 2010 |
|---|---|---|
| | $'000 | $'000 |
| Revenue | 58,500 | 41,000 |
| Cost of sales | (46,500) | (30,000) |
| Gross profit | 12,000 | 11,000 |
| Operating expenses | (8,700) | (4,500) |
| Investment income (note (ii)) | 1,100 | 700 |
| Finance costs | (500) | (400) |
| Profit before tax | 3,900 | 6,800 |
| Income tax expense | (1,000) | (1,800) |
| Profit for the year | 2,900 | 5,000 |

The following additional information is available:

(i) Property, plant and equipment:

| | Cost/ revaluation $'000 | Accumulated depreciation $'000 | Carrying amount $'000 |
|---|---|---|---|
| At 30 September 2010 | 33,600 | (9,500) | 24,100 |
| New finance lease additions | 6,700 | | 6,700 |
| Purchase of new plant | 8,300 | | 8,300 |
| Disposal of property | (5,000) | 1,000 | (4,000) |
| Depreciation for the year | | (2,500) | (2,500) |
| At 30 September 2011 | 43,600 | (11,000) | 32,600 |

The property disposed of was sold for $8·1 million. Plant, property and equipment was not revalued in the year.

(ii) Investments/investment income:

During the year an investment that had a carrying amount of $3 million was sold for $3·4 million. No investments were purchased during the year.

Investment income consists of:

| **Year to 30 September:** | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Dividends received | 200 | 250 |
| Profit on sale of investment | 400 | nil |
| Increases in fair value | 500 | 450 |
| | 1,100 | 700 |

(iii) On 1 April 2011 there was a bonus issue of shares that was funded from the share premium and some of the revaluation reserve. This was followed on 30 April 2011 by an issue of shares for cash at par.

(iv) The movement in the product warranty provision has been included in cost of sales.

**Required:**

**Prepare a statement of cash flows for Mocha for the year ended 30 September 2011, in accordance with IAS 7 *Statement of cash flows*, using the indirect method.** (19 marks)

**(b)** The format of the presentation of financial statements is designed to aid users' understanding. The format of a RoI cash flow statement has notable differences to those of a statement of cash flows prepared in accordance with IAS 7.

**Required:**

**Describe three areas where the format of the RoI cash flow statement differs to that of IAS 7 and how the RoI presentation may help users' understanding. Base your answers on the indirect method of presentation.** (6 marks)

**(25 marks)**

**4** **(a)** IAS 37 *Provisions, contingent liabilities and contingent assets* prescribes the accounting and disclosure for those items named in its title.

**Required:**

**Define provisions and contingent liabilities and briefly explain how IAS 37 improves consistency in financial reporting.** (6 marks)

**(b)** The following items have arisen during the preparation of Borough's draft financial statements for the year ended 30 September 2011:

**(i)** On 1 October 2010 Borough commenced the extraction of crude oil from a new well on the seabed. The cost of a 10-year licence to extract the oil was $50 million. At the end of the extraction, although not legally bound to do so, Borough intends to make good the damage the extraction has caused to the seabed environment. This intention has been communicated to parties external to Borough. The cost of this will be in two parts: a fixed amount of $20 million and a variable amount of 2 cents per barrel extracted. Both of these amounts are based on their present values as at 1 October 2010 (discounted at 8%) of the estimated costs in 10 years' time. In the year to 30 September 2011 Borough extracted 150 million barrels of oil.

**(ii)** Borough owns the whole of the equity share capital of its subsidiary Hamlet. Hamlet's statement of financial position includes a loan of $25 million that is repayable in five years' time. $15 million of this loan is secured on Hamlet's property and the remaining $10 million is guaranteed by Borough in the event of a default by Hamlet. The economy in which Hamlet operates is currently experiencing a deep recession, the effects of which are that the current value of its property is estimated at $12 million and there are concerns over whether Hamlet can survive the recession and therefore repay the loan.

**Required:**

**Describe, and quantify where possible, how items (i) and (ii) above should be treated in Borough's statement of financial position for the year ended 30 September 2011.**

**In the case of item (ii) only, distinguish between Borough's entity and consolidated financial statements and refer to any disclosure notes. Your answer should only refer to the treatment of the loan and should not consider any impairment of Hamlet's property or Borough's investment in Hamlet.**

Note: the treatment in the income statement is NOT required for any of the items.

The following mark allocation is provided as guidance for this requirement:

(i) 5 marks
(ii) 4 marks

(9 marks)

**(15 marks)**

**5** Bertrand issued $10 million convertible loan notes on 1 October 2010 that carry a nominal interest (coupon) rate of 5% per annum. They are redeemable on 30 September 2013 at par for cash or can be exchanged for equity shares in Bertrand on the basis of 20 shares for each $100 of loan. A similar loan note, without the conversion option, would have required Bertrand to pay an interest rate of 8%.

When preparing the draft financial statements for the year ended 30 September 2011, the directors are proposing to show the loan note within equity in the statement of financial position, as they believe all the loan note holders will choose the equity option when the loan note is due for redemption. They further intend to charge a finance cost of $500,000 ($10 million x 5%) in the income statement for each year up to the date of redemption.

The present value of $1 receivable at the end of each year, based on discount rates of 5% and 8%, can be taken as:

| | | 5% | 8% |
|---|---|---|---|
| End of year | 1 | 0·95 | 0·93 |
| | 2 | 0·91 | 0·86 |
| | 3 | 0·86 | 0·79 |

**Required:**

**(a) (i) Explain why the nominal interest rate on the convertible loan notes is 5%, but for non-convertible loan notes it would be 8%.** (2 marks)

**(ii) Briefly comment on the impact of the directors' proposed treatment of the loan notes on the financial statements and the acceptability of this treatment.** (3 marks)

**(b) Prepare extracts to show how the loan notes and the finance charge should be treated by Bertrand in its financial statements for the year ended 30 September 2011.** (5 marks)

**(10 marks)**

**End of Question Paper**