Fundamentals Level – Skills Module

Financial Reporting (International)

Tuesday 15 June 2010

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.

The Association of Chartered Certified Accountants

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1 On 1 April 2009 Picant acquired 75% of Sander's equity shares in a share exchange of three shares in Picant for every two shares in Sander. The market prices of Picant's and Sander's shares at the date of acquisition were $3·20 and $4·50 respectively.

In addition to this Picant agreed to pay a further amount on 1 April 2010 that was contingent upon the post-acquisition performance of Sander. At the date of acquisition Picant assessed the fair value of this contingent consideration at $4·2 million, but by 31 March 2010 it was clear that the actual amount to be paid would be only $2·7 million (ignore discounting). Picant has recorded the share exchange and provided for the initial estimate of $4·2 million for the contingent consideration.

On 1 October 2009 Picant also acquired 40% of the equity shares of Adler paying $4 in cash per acquired share and issuing at par one $100 7% loan note for every 50 shares acquired in Adler. This consideration has also been recorded by Picant.

Picant has no other investments.

The summarised statements of financial position of the three companies at 31 March 2010 are:

	Picant	Sander	Adler
Assets	$'000	$'000	$'000
Non-current assets			
Property, plant and equipment	37,500	24,500	21,000
Investments	45,000	nil	nil
	82,500	24,500	21,000
Current assets			
Inventory	10,000	9,000	5,000
Trade receivables	6,500	1,500	3,000
Total assets	99,000	35,000	29,000
Equity and liabilities			
Equity			
Equity shares of $1 each	25,000	8,000	5,000
Share premium	19,800	nil	nil
Retained earnings – at 1 April 2009	16,200	16,500	15,000
– for the year ended 31 March 2010	11,000	1,000	6,000
	72,000	25,500	26,000
Non-current liabilities			
7% loan notes	14,500	2,000	nil
Current liabilities			
Contingent consideration	4,200	nil	nil
Other current liabilities	8,300	7,500	3,000
Total equity and liabilities	99,000	35,000	29,000

The following information is relevant:

(i) At the date of acquisition the fair values of Sander's property, plant and equipment was equal to its carrying amount with the exception of Sander's factory which had a fair value of $2 million above its carrying amount. Sander has not adjusted the carrying amount of the factory as a result of the fair value exercise. This requires additional annual depreciation of $100,000 in the consolidated financial statements in the post-acquisition period.

Also at the date of acquisition, Sander had an intangible asset of $500,000 for software in its statement of financial position. Picant's directors believed the software to have no recoverable value at the date of acquisition and Sander wrote it off shortly after its acquisition.

(ii) At 31 March 2010 Picant's current account with Sander was \$3·4 million (debit). This did not agree with the equivalent balance in Sander's books due to some goods-in-transit invoiced at \$1·8 million that were sent by Picant on 28 March 2010, but had not been received by Sander until after the year end. Picant sold all these goods at cost plus 50%.

(iii) Picant's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose Sander's share price at that date can be deemed to be representative of the fair value of the shares held by the non-controlling interest.

(iv) Impairment tests were carried out on 31 March 2010 which concluded that the value of the investment in Adler was not impaired but, due to poor trading performance, consolidated goodwill was impaired by \$3·8 million.

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

Required:

(a) Prepare the consolidated statement of financial position for Picant as at 31 March 2010. (21 marks)

(b) Picant has been approached by a potential new customer, Trilby, to supply it with a substantial quantity of goods on three months credit terms. Picant is concerned at the risk that such a large order represents in the current difficult economic climate, especially as Picant's normal credit terms are only one month's credit. To support its application for credit, Trilby has sent Picant a copy of Tradhat's most recent audited consolidated financial statements. Trilby is a wholly-owned subsidiary within the Tradhat group. Tradhat's consolidated financial statements show a strong statement of financial position including healthy liquidity ratios.

Required:

Comment on the importance that Picant should attach to Tradhat's consolidated financial statements when deciding on whether to grant credit terms to Trilby. (4 marks)

(25 marks)

2 The following trial balance relates to Dune at 31 March 2010:

	$'000	$'000
Equity shares of $1 each		60,000
5% loan note (note (i))		20,000
Retained earnings at 1 April 2009		38,400
Leasehold (15 years) property – at cost (note (ii))	45,000	
Plant and equipment – at cost (note (ii))	67,500	
Accumulated depreciation – 1 April 2009 – leasehold property		6,000
– plant and equipment		23,500
Investments at fair value through profit or loss (note (iii))	26,500	
Inventory at 31 March 2010	48,000	
Trade receivables	40,700	
Bank		4,500
Deferred tax (note (v))		6,000
Trade payables		52,000
Revenue (note (iv))		400,000
Cost of sales	294,000	
Construction contract (note (vi))	20,000	
Distribution costs	26,400	
Administrative expenses (note (i))	34,200	
Dividend paid	10,000	
Loan note interest paid (six months)	500	
Bank interest	200	
Investment income		1,200
Current tax (note (v))		1,400
	613,000	613,000

The following notes are relevant:

(i) The 5% loan note was issued on 1 April 2009 at its nominal (face) value of $20 million. The direct costs of the issue were $500,000 and these have been charged to administrative expenses. The loan note will be redeemed on 31 March 2012 at a substantial premium. The effective finance cost of the loan note is 10% per annum.

(ii) Non-current assets:

In order to fund a new project, on 1 October 2009 the company decided to sell its leasehold property. From that date it commenced a short-term rental of an equivalent property. The leasehold property is being marketed by a property agent at a price of $40 million, which was considered a reasonably achievable price at that date. The expected costs to sell have been agreed at $500,000. Recent market transactions suggest that actual selling prices achieved for this type of property in the current market conditions are 15% less than the value at which they are marketed. At 31 March 2010 the property had not been sold.

Plant and equipment is depreciated at 15% per annum using the reducing balance method.

No depreciation/amortisation has yet been charged on any non-current asset for the year ended 31 March 2010. Depreciation, amortisation and impairment charges are all charged to cost of sales.

(iii) The investments at fair value through profit or loss had a fair value of $28 million on 31 March 2010. There were no purchases or disposals of any of these investments during the year.

(iv) It has been discovered that goods with a cost of $6 million, which had been correctly included in the count of the inventory at 31 March 2010, had been invoiced in April 2010 to customers at a gross profit of 25% on sales, but included in the revenue (and receivables) of the year ended 31 March 2010.

(v) A provision for income tax for the year ended 31 March 2010 of $12 million is required. The balance on current tax represents the under/over provision of the tax liability for the year ended 31 March 2009. At 31 March 2010 the tax base of Dune's net assets was $14 million less than their carrying amounts. The income tax rate of Dune is 30%.

(vi) The details of the construction contract are:

	costs to 31 March 2010 $'000	further costs to complete $'000
materials	5,000	8,000
labour and other direct costs	3,000	7,000
	8,000	15,000
plant acquired at cost	12,000	
per trial balance	20,000	

The contract commenced on 1 October 2009 and is scheduled to take 18 months to complete. The agreed contract price is fixed at $40 million. Specialised plant was purchased at the start of the contract for $12 million. It is expected to have a residual value of $3 million at the end of the contract and should be depreciated using the straight-line method on a monthly basis. An independent surveyor has assessed that the contract is 30% complete at 31 March 2010. The customer has not been invoiced for any progress payments. The outcome of the contract is deemed to be reasonably certain as at the year end.

Required:

(a) Prepare the income statement for Dune for the year ended 31 March 2010.

(b) Prepare the statement of financial position for Dune as at 31 March 2010.

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) 13 marks
(b) 12 marks

(25 marks)

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

Summarised statements of financial position as at:

	31 March 2010		31 March 2009	
	$'000	$'000	$'000	$'000
Assets				
Non-current assets				
Property, plant and equipment (note (i))		19,000		25,500
Current assets				
Inventory		12,500		4,600
Trade receivables		4,500		2,000
Tax refund due		500		nil
Bank		nil		1,500
Total assets		36,500		33,600
Equity and liabilities				
Equity				
Equity shares of $1 each (note (ii))		10,000		8,000
Share premium (note (ii))	3,200		4,000	
Retained earnings	4,500	7,700	6,300	10,300
		17,700		18,300
Non-current liabilities				
10% loan note (note (iii))	nil		5,000	
Finance lease obligations	4,800		2,000	
Deferred tax	1,200	6,000	800	7,800
Current liabilities				
10% loan note (note (iii))	5,000		nil	
Tax	nil		2,500	
Bank overdraft	1,400		nil	
Finance lease obligations	1,700		800	
Trade payables	4,700	12,800	4,200	7,500
Total equity and liabilities		36,500		33,600

Summarised income statements for the years ended:

	31 March 2010	31 March 2009
	$'000	$'000
Revenue	55,000	40,000
Cost of sales	(43,800)	(25,000)
Gross profit	11,200	15,000
Operating expenses	(12,000)	(6,000)
Finance costs (note (iv))	(1,000)	(600)
Profit (loss) before tax	(1,800)	8,400
Income tax relief (expense)	700	(2,800)
Profit (loss) for the year	(1,100)	5,600

The following additional information is available:

(i) Property, plant and equipment is made up of:

As at:	31 March 2010	31 March 2009
	$'000	$'000
Leasehold property	nil	8,800
Owned plant	12,500	14,200
Leased plant	6,500	2,500
	19,000	25,500

During the year Deltoid sold its leasehold property for $8·5 million and entered into an arrangement to rent it back from the purchaser. There were no additions to or disposals of owned plant during the year. The depreciation charges (to cost of sales) for the year ended 31 March 2010 were:

	$'000
Leasehold property	200
Owned plant	1,700
Leased plant	1,800
	3,700

(ii) On 1 July 2009 there was a bonus issue of shares from share premium of one new share for every 10 held. On 1 October 2009 there was a fully subscribed cash issue of shares at par.

(iii) The 10% loan note is due for repayment on 30 June 2010. Deltoid is in negotiations with the loan provider to refinance the same amount for another five years.

(iv) The finance costs are made up of:

For year ended:

	31 March 2010	31 March 2009
	$'000	$'000
Finance lease charges	300	100
Overdraft interest	200	nil
Loan note interest	500	500
	1,000	600

Required:

(i) Prepare a statement of cash flows for Deltoid for the year ended 31 March 2010 in accordance with IAS 7 *Statement of cash flows*, using the indirect method; (12 marks)

(ii) Based on the information available, advise the loan provider on the matters you would take into consideration when deciding whether to grant Deltoid a renewal of its maturing loan note. (8 marks)

(b) On a separate matter, you have been asked to advise on an application for a loan to build an extension to a sports club which is a not-for-profit organisation. You have been provided with the audited financial statements of the sports club for the last four years.

Required:

Identify and explain the ratios that you would calculate to assist in determining whether you would advise that the loan should be granted. (5 marks)

(25 marks)

4 **(a)** An important aspect of the International Accounting Standards Board's *Framework for the preparation and presentation of financial statements* is that transactions should be recorded on the basis of their substance over their form.

Required:

Explain why it is important that financial statements should reflect the substance of the underlying transactions and describe the features that may indicate that the substance of a transaction may be different from its legal form. (5 marks)

(b) Wardle's activities include the production of maturing products which take a long time before they are ready to retail. Details of one such product are that on 1 April 2009 it had a cost of $5 million and a fair value of $7 million. The product would not be ready for retail sale until 31 March 2012.

On 1 April 2009 Wardle entered into an agreement to sell the product to Easyfinance for $6 million. The agreement gave Wardle the right to repurchase the product at any time up to 31 March 2012 at a fixed price of $7,986,000, at which date Wardle expected the product to retail for $10 million. The compound interest Wardle would have to pay on a three-year loan of $6 million would be:

	$
Year 1	600,000
Year 2	660,000
Year 3	726,000

This interest is equivalent to the return required by Easyfinance.

Required:

Assuming the above figures prove to be accurate, prepare extracts from the income statement of Wardle for the three years to 31 March 2012 in respect of the above transaction:

(i) Reflecting the legal form of the transaction;

(ii) Reflecting the substance of the transaction.

Note: statement of financial position extracts are NOT required.

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

(i) 2 marks
(ii) 3 marks

(5 marks)

(c) **Comment on the effect the two treatments have on the income statements and the statements of financial position and how this may affect an assessment of Wardle's performance.** (5 marks)

(15 marks)

5 **(a)** Apex is a publicly listed supermarket chain. During the current year it started the building of a new store. The directors are aware that in accordance with IAS 23 *Borrowing costs* certain borrowing costs have to be capitalised.

Required:

Explain the circumstances when, and the amount at which, borrowing costs should be capitalised in accordance with IAS 23. (5 marks)

(b) Details relating to construction of Apex's new store:

Apex issued a $10 million unsecured loan with a coupon (nominal) interest rate of 6% on 1 April 2009. The loan is redeemable at a premium which means the loan has an effective finance cost of 7·5% per annum. The loan was specifically issued to finance the building of the new store which meets the definition of a qualifying asset in IAS 23. Construction of the store commenced on 1 May 2009 and it was completed and ready for use on 28 February 2010, but did not open for trading until 1 April 2010. During the year trading at Apex's other stores was below expectations so Apex suspended the construction of the new store for a two-month period during July and August 2009. The proceeds of the loan were temporarily invested for the month of April 2009 and earned interest of $40,000.

Required:

Calculate the net borrowing cost that should be capitalised as part of the cost of the new store and the finance cost that should be reported in the income statement for the year ended 31 March 2010. (5 marks)

(10 marks)

End of Question Paper