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UNIVERSITY OF LONDON **279 0091 ZA**

BSc degrees and Diplomas for Graduates in Economics, Management, Finance and the Social Sciences, the Diploma in Economics and Access Route for Students in the External Programme

Financial Reporting

Monday, 12 June 2006 : 2.30pm to 5.30pm

Candidates should answer **FOUR** of the following **SEVEN** questions. All questions carry equal marks.

Workings should be submitted for all questions requiring calculations. Any necessary assumptions introduced in answering a question are to be stated.

Extracts from compound interest tables are given at the end of the paper.

8 column accounting paper is provided. If used, it must be fastened securely inside the answer book.

A hand held calculator may be used when answering questions on this paper but it must not be pre-programmed or able to display graphics, text or algebraic equations. The make and type of machine must be stated clearly on the front cover of the answer book.

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UL06/121

Question 1

Hartley plc and James plc agreed to merge on 31 December 2004. The merger took place by means of an offer by Hartley of 8 £1 ordinary shares for every 10 ordinary shares in James plc. The market value of each £1 share in Hartley was £3 immediately before and after the merger.

Below are the summarised balance sheets as at 30 June 2005 (but not including the entries necessary to reflect the issue of shares by Hartley on 31 December 2004) and the summarised profit and loss accounts for the year ended 30 June 2005 for both companies:

Balance Sheets at 30 June 2005:

	Hartley	**James**
	£m	**£m**
Fixed Assets	1600	1800
Net Current Assets	400	650
	2000	2450
Long term liabilities	800	1200
Net assets	1200	1250
Share Capital: £1 ordinary shares	600	800
Reserves	600	450
	1200	1250

Profit and loss accounts for the year ended 30 June 2005:

	Hartley	**James**
	£m	**£m**
Turnover	2800	2200
Cost of Sales	1900	1200
Gross Profit	900	1000
Administration and Distribution costs	760	900
Operating Profit	140	100
Dividend Income	30	-
Profit before Taxation	170	100
Taxation	40	20
Profit after taxation	130	80
Dividends	100	30
Retained profit	30	50

The assets and liabilities of James were stated at fair values in its accounts at 31 December 2004, except that included in its fixed assets is land with a book value of £600m, the fair value of which throughout the year is estimated at £800m. The two companies have similar accounting policies. The income and expense items of James may be assumed to have accrued evenly through the year. James paid its dividend on 30 June 2005.

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Hartley's policy is to write off any goodwill on acquisitions over 20 years from the date of acquisition.

Required:

(a) Show the revised year-end company balance sheet of Hartley plc, taking into account the issue of shares on 31 December, on each of the following bases:

i. that Hartley will account for the transaction as an acquisition of James and does not take advantage of the merger relief provisions in the Companies Act 1985.

ii. that Hartley will account for the transaction as a merger, and does take account of the merger relief provisions in the Companies Act 1985. **(6 marks)**

(b) Prepare consolidated profit and loss accounts for the year ended 30 June 2005 and consolidated balance sheets at that date on each of the bases in (a) above. **(12 marks)**

(c) The ASB and IASB strictly limit the cases where merger accounting is to be used. Comment briefly both on why companies want to use merger accounting rather than acquisition accounting where possible, and on whether, in its conventional form, merger accounting should be allowed at all. **(7 marks)**

Question 2

The summarised historical cost balance sheet of Woodvile plc at 1 January 2005 was as follows:

	£	£
Plant and Machinery – cost		480,000
– depreciation		120,000
		360,000
Stock at cost	200,000	
Trade debtors	160,000	
Cash at bank	60,000	
	420,000	
Trade Creditors	240,000	180,000
		540,000
Debentures (10% redeemable 2023)		60,000
		480,000
Ordinary Shares of £1		300,000
Profit and loss account		180,000
		480,000

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The historical cost profit and loss account for the year ended 31 December 2005 was as follows:

	£	£
Sales		1,800,000
Cost of Sales:		
Stock at 1 January 2005	200,000	
Purchases	880,000	
	1,080,000	
Stock at 31 December 2005	280,000	800,000
		1,000,000
Sundry Expenses	526,000	
Depreciation	60,000	586,000
		414,000
Debenture Interest		6,000
		408,000

You have the following additional information:

(1) During 2005 sales, purchases of goods for resale and sundry expenses occurred evenly throughout the year. All of these transactions took place for cash, except for one sale on credit of £200,000, which took place on 30 September; this debt was still outstanding on 31 December 2005.

(2) The trade debtors at 1 January 2005 settled their accounts on 31 March 2005; the trade creditors outstanding at 1 January 2005 were paid on 30 June 2005.

(3) The plant and machinery is being depreciated on a straight line basis to zero residual value over 8 years. On 30 September 2005 the company purchased a piece of freehold land costing £124,000. A deposit of £24,000 was paid on that date; the balance of the amount due was still outstanding on 31 December 2005. No depreciation is provided on freehold land.

(4) The opening stock at 1 January 2005 had been purchased on average on 30 September 2004. The stock of goods for resale at 31 December 2005 had been purchased on average on 30 September 2005.

(5) Interest is payable on the debentures annually on 31 December.

(6) There had been no change in any relevant special price index or in the general index of prices from the date Woodvile plc was incorporated up until 2005. During 2005 the following index movements took place:

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	Stocks (Replacement Cost)	Plant and Machinery (Replacement Cost)	General Index of prices
1 January	150	100	200
31 March	160	104	210
30 June (=average for year)	175	110	220
30 September	190	116	230
31 December	200	121	242

There was no change in the replacement cost of the land between 30 September 2005 and 31 December 2005.

Required:

(a) Prepare a profit and loss account for Woodvile plc for the year ended 31 December 2005 and a Balance Sheet at that date under each of the following conventions:

i. Current value accounting incorporating replacement costs for assets sold, held and consumed, based on financial capital maintenance, measured in money terms. Base depreciation on the year-end value of fixed assets. **(10 marks)**

ii. Fully stabilised current value accounting, incorporating replacement costs for assets sold, held and consumed, based on financial capital maintenance, stabilised in £s of 31 December 2005 and including in the profit and loss account the real gain on long term borrowing and the total real gain or loss on short term net monetary items. Base depreciation on the year-end value of fixed assets. **(10 marks)**

(b) Discuss whether, under a system of current value accounting measured in money terms, holding gains and losses should be included in income. **(5 marks)**

Question 3

Cymri Investment Holdings owns three types of assets: rented properties, fixed interest bonds and variable rate deposits with financial institutions.

As at 1 January 2003, Cymri anticipated annual net cash receipts from property to be £500,000 per annum; held irredeemable government stock giving a fixed return of 5% on a nominal value of £3,000,000; and also had a bank deposit account of £600,000 which was earning the current market rate of interest on an annual basis.

During 2003, Cymri undertook a programme of refurbishment to renovate and improve its rented properties for a total of £750,000. £250,000 had to be paid on 31 December 2003 and the same amount at the end of each of the following two years. Cymri also undertook an advertising campaign to attract new tenants, at a cost of £40,000 which had to be paid on 31 December 2003.

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The rentals for 2003 were unaffected, but the anticipated net cash receipts from property for the forseeable future (apart from the payments in respect of improvements mentioned above) rose to £700,000 per annum.

The market rate of interest was 10% per annum throughout 2003 and at 1 January 2003 was expected to continue at this level in the foreseeable future. However, at 31 December 2003 the market rate of interest is now expected to move to 16% per annum as from 1 January 2004 and to remain at this level.

The general price level has remained constant and is expected to stay constant for the foreseeable future. All persons in the market have the same expectations. All cash receipts are received on 31 December of the year to which they relate.

Required:

(a) Outline the central concept of an **individual's** income and the No 1 and No 2 approximations to that concept as formulated by Hicks in *Value and Capital.* How may these approximations be expressed in relation to a **company's** income? **(6 marks)**

(b) Calculate Cymri's income for 2003 as follows:

i. Income No. 1 *ex ante.*
ii. Both variants of Income No. 1 *ex post.*
iii. Income No. 2 *ex ante.*
iv. Both variants of Income No. 2 *ex post.*

(Ignore rounding differences of less than £100.) **(10 marks)**

(c) In the light of your answer and Hicks's analysis of the concept of income, discuss how much of the gain or loss on revaluation of a property you consider should be regarded as part of a company's income for a year. **(9 marks)**

Question 4

Greetingcom plc owns a machine for the production of greeting cards which was purchased on 1 January 2003 at a cost of £400,000. When purchased it was expected to have a five year useful economic life. It has constant annual operating costs of £150,000 and required an overhaul costing £7,500 at the end of the third year of its life. It has a scrap value at the end of its useful economic life (or at any other time) of £12,500. It has no reliable value other than as scrap. It produces a constant annual output of 45,000 cards, all of which can be sold at the existing price of £7.50 each.

During 2003 a new model of the machine came on the market. It costs £600,000 and has a seven year useful economic life. It has operating costs of £95,000 per annum in each of the first two years of its useful life and £125,000 per annum in each of the remaining five years.

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It produces a constant annual output of 50,000 cards, all of which can be sold at the existing price. At the end of its useful life it is estimated that it would cost £5,000 (net of the proceeds of its sale as scrap) to dismantle and remove it. The arrival of the new model is not expected to affect the operating costs, output or scrap value of the existing machine.

The company's cost of capital is 10% per annum. A replacement machine would be paid for at the time of replacement; all other cash flows may be assumed to occur at the end of the years concerned.

Required:

(a) Prepare a schedule as at 1 January 2003 showing for each of the years ended 31 December 2003, 31 December 2004 and 31 December 2005 the forecast depreciation charge on the card-making machine, and its net book value at the end of each of those three years, using the annuity method of depreciation and assuming that there was no knowledge of the new model at that date. **(7 marks)**

(b) Calculate the deprival value of the card-making machine at 31 December 2005 assuming that the selling price of cards would continue at its present level of £7.50 each for the foreseeable future. **(7 marks)**

(c) 'For most companies, the deprival value of most assets will be replacement cost. Therefore corporate financial reports might just as well be based on replacement cost in all cases so as to avoid the subjectivity inherent in using deprival value.' Explain and comment on this statement. **(11 marks)**

Question 5

Phedora plc entered into the following transactions during the year ended 31 December 2001:

(1) On 1 March the company entered into a two year agreement to hire a chopping machine from Higherko. These machines have a useful economic life of eight years. Higherko provides service cover for repairs and maintenance as part of the annual rental of £6,000, payable in monthly instalments. To buy a new chopping machine now would cost £36,000.

(2) On 1 January 2001 the company signed a five year lease for the hire of a pounding plant. The plant has a useful economic life of five years from that date with no residual value, and Phedora plc is responsible for all repairs and maintenance. To buy a new pounding plant would cost £60,000. The lease provided for an initial payment of £10,000 on 1 January 2001 followed by ten half-yearly payments of £6,800, payable on 30 June and 31 December each year. The interest rate implicit in the lease is 6% per half year. For similar assets which it owns Phedora plc uses straight-line depreciation.

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(3) On 1 September the company sold goods to a customer in Amnesia (where the unit of currency is the \$Amn) for \$Amn 15,000. The customer paid in full on 31 October. On 1 September the exchange rate was £1 = \$Amn 2.5, and on 31 October it was £1 = \$Amn 3.

(4) On 1 September the company raised a loan of \$Amn 400,000 in Amnesia. The loan was used to purchase a piece of freehold land on 1 September. The land cost \$Amn 400,000. Phedora plc intends building a local sales office on the land during 2006. Interest is payable on 31 December each year at 10% per annum, and the loan is repayable on 31 December 2006. On 1 September the exchange rate was £1 = \$Amn 2.5 and on 31 December it was £1 = \$Amn 3.2.

(5) On 1 January 2001 the company issued 7% debentures with a nominal value of £300,000. The debentures were issued at a discount and the amount raised, net of issue costs, was £220,000. They are redeemable at a premium of 5% (i.e., at £315,000) on 31 December 2010. Interest is payable on 31 December each year. The effective rate of interest in the arrangement is 12% per annum.

Required:

(a) Show how each of the above transactions will be treated in the final accounts of Phedora plc for the year ended 31 December 2001 in accordance with standard accounting practice. Deal separately with each transaction. For (1) and (2), justify your treatment. **(20 marks)**

(b) Phedora plc has also made an investment in Ferrick plc. What factors would determine whether Ferrick plc should be treated as an associate? **(5 marks)**

Question 6

Either

'Current value accounting is at its most relevant when it reflects the loss that the entity would suffer if it were deprived of the asset involved'. Accounting Standards Board's *Statement of Principles*. Explain how deprival value reflects this loss and what problems might arise with the use of deprival value as the basis of asset valuation in corporate financial reports.

Or

In relation to an accounting issue of your choice, outline the major possible accounting treatments which (if no treatment were specified as standard practice or required by law) might be adopted and discuss the extent to which a conceptual framework for financial reporting, such as that developed by the Financial Accounting Standards Board in the United States, helps determine the most appropriate treatment. Include in your answer an outline of the objectives of financial reporting, and the qualitative characteristics of accounting information, in SFAC1 and SFAC2.

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Question 7

Either

It has been said that users of corporate financial reports need information both for legal (or quasi-legal) purposes and for purposes of economic decision-making. Distinguish between two types of need (with examples) and compare the strengths and weaknesses of historical cost accounting and a system of cash flow accounting and reporting (incorporating forecasts of future cash flows) in meeting these needs.

Or

'Accounting for goodwill and other intangibles is one of the most controversial aspects of financial reporting.'

Discuss this statement.

Extracts from compound interest tables

(1) Present value of £1

% / Period	1	2	3	4	5	6	7	8	9	10
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513

% / Period	11	12	13	14	15	16	17	18	19	20
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279

(2) Annuity of £1

% / Period	1	2	3	4	5	6	7	8	9	10
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868

% / Period	11	12	13	14	15	16	17	18	19	20
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605

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