PROFESSIONAL LEVEL EXAMINATION

MONDAY 6 JUNE 2016

(3 hours)

FINANCIAL ACCOUNTING AND REPORTING

This paper consists of **FOUR** questions (100 marks).

1. Ensure your candidate details are on the front of your answer booklet. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on this question paper. You may not write anything else until the exam starts.

2. Answer each question in black ballpoint pen only.

3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.

4. The examiner will take account of the way in which answers are presented.

5. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

Unless otherwise stated, make all calculations to the nearest month and the nearest £.

All references to IFRS are to International Financial Reporting Standards and International Accounting Standards.

IMPORTANT Question papers contain confidential information and must NOT be removed from the examination hall. **DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK**	You MUST enter your candidate number in this box.

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1. Guido, the financial controller of Pisa Ltd, has prepared draft financial statements for the year ended 31 December 2015. However, there are a number of outstanding issues. You have been provided with the following information and asked to complete the financial statements.

Draft statement of profit or loss for the year ended 31 December 2015

	£
Revenue	2,521,200
Cost of sales	(1,057,300)
Gross profit	1,463,900
Administrative expenses	(587,600)
Other operating costs	(245,500)
Operating profit	630,800
Income tax (Note 1)	(123,000)
Profit for the year	507,800

Draft statement of financial position as at 31 December 2015

	£	£
ASSETS		
Non-current assets		
Property, plant and equipment (Notes 2 and 3)		2,514,810
Current assets		
Inventories	849,300	
Trade and other receivables	478,230	
Cash and cash equivalents	13,600	
		1,341,130
Total assets		**3,855,940**
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital (£1 shares)		1,000,000
Preference share capital (Note 4)		500,000
Revaluation surplus		512,600
Retained earnings		1,327,840
		3,340,440
Current liabilities		
Trade and other payables	392,500	
Income tax (Note 1)	123,000	
		515,500
Total equity and liabilities		**3,855,940**

Additional information:

(1) The income tax charge of £123,000 is the appropriate estimate of the amount payable in respect of the year ended 31 December 2015. In October 2015 Pisa Ltd received a tax refund in relation to the year ended 31 December 2014 of £5,500. Guido debited this refund to cash at bank and credited it to other operating costs.

(2) Land and buildings are measured under the revaluation model, and plant and equipment under the cost model. The carrying amount for property, plant and equipment in the draft statement of financial position is made up as follows:

	Land and buildings £	Plant and equipment £
Valuation/cost at 31 December 2014	1,847,500	789,600
Accumulated depreciation at 31 December 2014	(53,900)	(315,840)
	1,793,600	473,760
Purchases on 1 November 2015	–	247,450
	1,793,600	721,210

On 1 January 2015 the directors commissioned an independent valuation of land and buildings, which attributed a total value of £2,300,000 to land and buildings, including £600,000 for the land. The surveyor estimated that the buildings had an estimated remaining useful life of 40 years at that date. If the buildings had been measured under the cost model they would have had a carrying amount of £750,000 on 1 January 2015. Pisa Ltd makes an annual transfer between the revaluation surplus and retained earnings in accordance with best practice. Guido has not made this transfer for the year ended 31 December 2015.

Depreciation on property, plant and equipment for the year ended 31 December 2015 has not yet been charged. Depreciation on buildings is charged on a straight-line basis and is recognised in administrative expenses. Depreciation on plant and equipment is charged on a reducing balance basis at 20% pa and is recognised in cost of sales.

Purchases of plant and equipment on 1 November 2015 included a specialised machine imported from Germany on that date. Pisa Ltd paid €106,000 for this machine. The purchase was initially recognised in property, plant and equipment and trade payables using the 1 November 2015 spot rate. The supplier gave Pisa Ltd 100 days' credit so the invoice was unpaid at 31 December 2015. On 31 December 2015 Guido retranslated the amount included in property, plant and equipment at the year-end exchange rate and included the translation difference in administrative expenses, whereas Pisa Ltd's policy is to recognise foreign exchange differences in cost of sales. Guido made no other adjustments in relation to this transaction.

The spot exchange rates were as follows:

1 November 2015	€1:£0.85
31 December 2015	€1:£0.80

(3) On 31 December 2015 the directors decided to sell a machine which had cost Pisa Ltd £20,000 on 1 January 2013. Guido did not adjust the draft financial statements to reflect this decision although the machine met the “held for sale” criteria of IFRS 5, Non-current Assets Held for Sale and Discontinued Operations. The machine is expected to sell for £9,000 with selling costs of £600.

(4) On 1 January 2015 Pisa Ltd issued 500,000 6% redeemable £1 preference shares at par. These shares are redeemable on 31 December 2018 at a premium. The preference dividend is paid annually in arrears on 31 December. Guido credited the dividend paid on 31 December 2015 to cash at bank and debited it to administrative expenses. The effective interest rate of the shares is 6.3% pa.

Requirements

1.1 Prepare the following for Pisa Ltd, in a form suitable for publication:

(a) a revised statement of profit or loss for the year ended 31 December 2015;

(b) a revised statement of financial position as at 31 December 2015; and

(c) a note to the financial statements showing the movements on property, plant and equipment for the year ended 31 December 2015. A total column is **not** required.

(25 marks)

1.2 The IASB’s Conceptual Framework refers to two fundamental qualitative characteristics: relevance and faithful representation. Explain these concepts and the conflict between them. You should illustrate your answer using the financial statements of Pisa Ltd.

(5 marks)

Total: 30 marks

2. Luigi, the finance director of Naples plc, a textile manufacturer and a listed company, has prepared draft financial statements for the year ended 31 December 2015. Shortly after completing the draft financial statements Luigi was taken ill. The managing director of Naples plc asked Roberto, the financial controller, to make any adjustments necessary to complete the financial statements. Both Luigi and Roberto are ICAEW Chartered Accountants. During Luigi’s absence, the managing director has become increasingly concerned about Luigi's treatment of certain matters within the draft financial statements, particularly given that the directors’ bonus is linked to the profit for the year.

On examining the draft financial statements prepared by Luigi, and supporting working papers, Roberto has identified the following issues:

(1) On 1 January 2015 Naples plc had in place £500,000 of 6.0% pa loan finance and £800,000 of 4.7% pa loan finance. Neither loan was taken out for a specific purpose. On 1 February 2015 the company began to construct a new office building, which was funded by this existing loan finance. The building was correctly assessed as a qualifying asset, was completed and available for use on 31 October 2015, and has an estimated total useful life of 50 years. The company moved its administrative function into this building on 31 December 2015. Luigi included the interest payable for the whole year on the total loan finance as part of the cost of the office building of £650,000 within property, plant and equipment. He did not recognise any depreciation on this building in the year ended 31 December 2015 because the staff did not move to the new building until the last day of the year.

(2) The draft financial statements include research and development expenditure of £390,500 within intangible assets. Luigi’s working papers show that this all related to the development of a new waterproof fabric, which was assessed as being commercially viable on 31 March 2015. The development of the fabric was completed on 31 August 2015, and the first fabric was delivered to customers on 1 September 2015. The amount capitalised is made up as follows:

	£
Research costs	100,000
Development costs incurred prior to 31 March 2015	55,500
Development costs incurred from 1 April 2015 to 31 August 2015	225,000
Marketing costs	10,000
	390,500

No amortisation has been charged on this amount. The fabric technology is estimated to have a three-year life before it is superseded by superior products.

(3) During the year ended 31 December 2015 the directors of Naples plc decided to change the company’s accounting policy in respect of consumable stores, such as dyes and threads used in the manufacturing process. In the year ended 31 December 2014, and all years prior to that, Naples plc’s stated accounting policy was to write off the costs of such consumable stores as incurred. The directors now wish to recognise consumable stores as inventory, on the grounds that this better matches purchases made to sales generated. As a result, Luigi included closing inventory of consumable stores of £22,600 in the draft financial statements for the year ended 31 December 2015, but made no other adjustments. Roberto has established that the equivalent figure at 31 December 2014 was £31,200, but it has not been possible to arrive at figures prior to that date.

(4) Luigi had calculated distributable profits at 31 December 2015, in readiness for a board meeting at which the annual dividend will be decided. Luigi has recently purchased a number of Naples plc's ordinary shares. His calculation, based on figures from the draft financial statements, is set out below:

	£
Share premium	150,000
Revaluation surplus	450,500
Retained earnings	101,300
Distributable profits	701,800

Naples plc has no reserves other than those listed above.

Requirements

2.1 Explain the required IFRS financial reporting treatment of Issues (1) to (3) above in the financial statements of Naples plc for the year ended 31 December 2015. Prepare all relevant calculations and set out the required adjustments in the form of journal entries. **(22 marks)**

2.2 Explain the errors that Luigi made in his calculation set out in Issue (4) above. Using your revised figures from Part 2.1, calculate whether or not Naples plc may legally pay a dividend for the year ended 31 December 2015. **(4 marks)**

2.3 Discuss the ethical issues arising for Luigi and Roberto from the scenario and the steps that Roberto should take to address them. **(5 marks)**

2.4 Describe the differences between IFRS and UK GAAP in respect of the financial reporting treatment of borrowing costs and development costs. **(3 marks)**

Total: 34 marks

3. On 1 January 2015 Genoa plc had a number of subsidiary companies, all acquired several years ago. Extracts from the group's consolidated financial statements for the year ended 31 December 2015 are set out below.

Consolidated statement of profit or loss for the year ended 31 December 2015 (extract)

	£
Profit from operations	2,000,500
Finance costs	(61,600)
Profit before tax	1,938,900
Income tax	(462,000)
Profit for the year	1,476,900
Attributable to:	
Owners of Genoa plc	1,218,300
Non-controlling interest	258,600
	1,476,900

Consolidated statement of financial position as at 31 December

	2015	2014
ASSETS	**£**	**£**
Non-current assets	3,457,400	2,973,600
Current assets		
Inventories	2,143,100	1,230,100
Trade and other receivables	870,200	839,800
Cash and cash equivalents	121,800	64,200
	3,135,100	2,134,100
Total assets	**6,592,500**	**5,107,700**
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital (£1 shares)	600,000	480,000
Share premium account	120,000	48,000
Retained earnings	3,271,200	2,145,400
Attributable to the equity holders of Genoa plc	3,991,200	2,673,400
Non-controlling interest	797,900	891,100
	4,789,100	3,564,500
Non-current liabilities		
Finance lease liabilities	420,200	324,000
Current liabilities		
Trade and other payables	699,000	587,800
Finance lease liabilities	180,200	177,800
Income tax payable	504,000	453,600
	1,383,200	1,219,200
Total equity and liabilities	**6,592,500**	**5,107,700**

Additional information:

(1) On 1 April 2015 Genoa plc sold all of its 70% holding in Venice Ltd's 100,000 £1 ordinary shares, for cash consideration of £1,200,000. Genoa plc paid £820,000 for the shares in Venice Ltd when the retained earnings of Venice Ltd were £271,000. Goodwill was calculated using the proportionate method, although £70,000 of this amount had been written off by 31 December 2014.

In the year ended 31 December 2015 Venice Ltd made a profit before tax of £110,000, with income tax on that amount of £20,000, both figures accruing evenly over the year. The correct amount of profit and income tax for the year up to disposal in respect of Venice Ltd has been included in the consolidated statement of profit or loss, although these figures have not been separately identified as being from discontinued operations. The profit on disposal was credited to revenue.

The net assets of Venice Ltd at the date of disposal were as follows:

	£
Property, plant and equipment	846,200
Trade and other receivables	69,500
Cash and cash equivalents	16,500
Trade and other payables	(51,200)
	881,000

(2) All finance costs in the consolidated statement of profit or loss relate to finance leases. In the year ended 31 December 2015 Genoa plc entered into finance leases for assets with a fair value of £600,000.

(3) Non-current assets comprise property, plant and equipment and goodwill which had arisen on business combinations. There were no disposals of non-current assets other than on the disposal of Venice Ltd. Depreciation of £673,800 was recognised during the year ended 31 December 2015 but there were no impairments of goodwill.

(4) The consolidated statement of changes in equity for the year ended 31 December 2015 showed that Genoa plc issued ordinary shares for cash, and paid ordinary dividends. Dividends were also paid to the non-controlling interest.

Requirements

3.1 Explain how the profit or loss from discontinued operations should have been calculated in accordance with IFRS 5, Non-current Assets Held for Sale and Discontinued Operations, and calculate the relevant figure. **(5 marks)**

3.2 Prepare a consolidated statement of cash flows for Genoa plc for the year ended 31 December 2015, including a note reconciling profit before tax to cash generated from operations, using the indirect method. A note showing the effects of the disposal of Venice Ltd is **not** required. **(13 marks)**

Total: 18 marks

4. Rome plc recognises goodwill and non-controlling interest using the fair value method. On 1 January 2015 Rome plc had one subsidiary, Turin Ltd.

The draft, summarised statements of financial position of the two companies at 31 December 2015 are shown below:

	Rome plc	**Turin Ltd**
	£	**£**
ASSETS		
Non-current assets		
Property, plant and equipment	2,958,500	2,874,500
Investments	1,700,000	–
Goodwill	–	40,000
	4,658,500	2,914,500
Current assets		
Inventories	879,300	453,700
Trade and other receivables	641,500	392,300
Cash and cash equivalents	21,800	17,600
	1,542,600	863,600
Total assets	6,201,100	3,778,100
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital (£1 shares)	3,000,000	800,000
Retained earnings	2,403,900	2,422,300
	5,403,900	3,222,300
Current liabilities		
Trade and other payables	547,200	380,800
Taxation	250,000	175,000
	797,200	555,800
Total equity and liabilities	6,201,100	3,778,100

Additional information:

(1) Rome plc acquired 80% of the 800,000 ordinary shares of Turin Ltd for cash of £1,600,000 on 1 January 2012 when the retained earnings of Turin Ltd were £856,500 and the fair value of the non-controlling interest was £380,000.

The fair values of the assets, liabilities and contingent liabilities of Turin Ltd at this date were equal to their carrying amounts, with the exception of a property which had a fair value £300,000 in excess of its carrying amount. The property had a remaining useful life of 25 years on the date that Rome plc acquired its shares in Turin Ltd.

On the date of acquisition, Turin Ltd’s statement of financial position included goodwill of £50,000 which had arisen on the acquisition of a sole trader. In the current year an impairment of £10,000 was recognised by Turin Ltd in relation to this goodwill.

(2) On 1 January 2015 Rome plc sold a machine to Turin Ltd for £35,000. The machine had a carrying amount in Rome plc's books at this date of £22,000. The estimated remaining useful life of the machine was reassessed on the date of sale at five years.

(3) In December 2015 Rome plc purchased goods from Turin Ltd for £100,000. At the year end Rome plc held half of these goods in its inventories. Turin Ltd makes all sales at cost plus a mark-up of 25%. On 30 December 2015 Rome plc sent a cheque for £25,000 of the amount due to Turin Ltd. Turin Ltd did not receive this cheque until 5 January 2016, therefore at the year end the intra-group balances in respect of this transaction did not agree.

(4) On 1 April 2015 Rome plc entered into a joint venture with three other companies, setting up a new company, Florence Ltd. Each of the four venturers subscribed for 100,000 £1 ordinary shares at par. In the nine months to 31 December 2015 Florence Ltd made a profit of £125,600.

Requirements

4.1 Prepare the consolidated statement of financial positon of Rome plc as at 31 December 2015. **(16 marks)**

4.2 Describe the differences between IFRS and UK GAAP in respect of the financial reporting treatment and disclosures of joint ventures. **(2 marks)**

Total: 18 marks