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OLLSCOIL NA hÉIREANN, GAILLIMH

NATIONAL UNIVERSITY OF IRELAND, GALWAY

Summer Examinations 2000

B. COMM. DEGREE EXAMINATION

Financial Accounting III (AY309)

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Time allowed: TWO AND A HALF HOURS

Candidates are required to attempt any THREE questions

All questions carry equal marks

Question 1:

On 1 October 1997 Cavan Ltd. issued 1,500,000 shares to acquire 1,950,000 shares of Leitrim Ltd. The shares issued had a value of £4 each, but the cost of the shares purchased was recorded in the balance sheet of Cavan Ltd. at the nominal value of shares issued since the directors of the two companies wished to use merger accounting for group reporting. At the time of the combination the balance on the profit and loss account in Leitrim's interim financial statements was £800,000; otherwise the figures for capital and reserves were as shown in the balance sheet below at 31 March 2000. At the time of the combination, the fair values of the tangible fixed assets of Cavan and Leitrim were £250,000 and £400,000 in excess of book values respectively. Incorporating those values in the financial statements of the two companies would have increased depreciation charges for the period between 1 October 1997 and 31 March 2000 by £35,000 and £70,000 for Cavan and Leitrim respectively. The accounting policy for calculating stock differs between the two companies. Using the Cavan method for group accounting purposes, the value of stocks for Leitrim at 31 March 2000 would have been £1,505,000, and at 1 October 1997 the value of stocks for Leitrim would have been £25,000 in excess of the amount recorded in Leitrim's books.

The balance sheets of the two companies at 31 March 2000 are shown below.

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	Cavan £000s		Leitrim £000s	
Tangible fixed assets (net)		2,800		3,150
Financial fixed assets		1,500		
		4,300		3,150
Current assets				
Stocks	1,630		1,475	
Dividends receivable from Leitrim	195			
Other debtors	1,870		1,720	
Cash at bank	325		15	
	4,020		3,210	
Creditors due within one year				
Bank overdraft	-		160	
Trade creditors	820		630	
Taxation	350		320	
Proposed dividends	250		200	
	1,420		1,310	
Net current assets		2,600		1,900
Total assets less current liabilities		6,900		5,050
Long-term loans		1,800		1,500
		5,100		3,550
Capital and reserves		2,750		2,000
Share capital (£1 shares)				
Share premium account		350		600
Revaluation reserve		150		50
Profit and loss account		1,850		900
		5,100		3,550

You are required to:

(a) prepare a consolidated balance sheet for Cavan Ltd. and Leitrim Ltd. at 31 March 2000 on a merger accounting basis;

(18 marks)

(b) explain how the consolidated balance sheet would differ it it were prepared on an acquisition accounting basis (you do not need to prepare a revised balance sheet);

(10 marks)

(c) explain briefly the major characteristics that distinguish a merger from an acquisition.

(5 1/3 marks)

Total 33 1/3 marks

Question 2:

Letterkenny Ltd. established a subsidiary, Derry Ltd., to market and distribute its products in Northern Ireland. Because of the relationship between Derry's operations and those of its parent, the temporal method of translation is considered appropriate for the translation of its financial statements for consolidation purposes. However, the directors of Letterkenny are discussing with the directors of Derry the possibility of that company developing independent commercial activities, which would mean that the net investment method of translation (with average rates used in the translation of the profit and loss account) would be appropriate in subsequent years.

The results of Derry for the year ended 30 April 2000 were as follows:

	£000s	£000s
Sales		3,600
Cost of sales		2,700
Gross profit		900
Wages and salaries	540	
Depreciation	144	
Other operating costs	90	
		774
Profit before interest		126
Interest		60
Net profit		66

The balance sheet of Derry at 30 April 2000 was as follows:

	£000s	£000s
Fixed assets, at cost		2,400
Accumulated depreciation		432
		1,968
Net current assets		1,110
		3,078
Long-term loan		900
		2,178
Share capital		2,000
Profit and loss account		178
		2,178

During the year ended 30 April 2000 the exchange rate averaged £0.80 sterling = IR£1. At the end of the year the rate was £0.75 sterling = IR£1, and at the beginning of the year it had been £0.85 sterling = IR£1. The share capital had been subscribed when the exchange rate was at parity (£1 sterling = IR£1); the fixed assets were purchased when the exchange rate was £0.96 sterling = IR£1, and the loan had been taken out at the same time as the purchase of the fixed assets.

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You are required to:

(a) translate the profit and loss account and balance sheet of Derry Ltd. into Irish pounds for consolidation with the financial statements of Letterkenny Ltd., using the temporal method of translation;

(18 marks)

(b) prepare a note for the directors explaining how the figures would differ if the net investment method of translation had been used (it is not necessary to prepare a revised profit and loss account and balance sheet);

(10 marks)

(c) state your opinion, briefly giving your reasons, as to which of the two translation methods is more appropriate for representing the contribution of Derry to the performance of the group.

(5 1/3 marks)

Total 33 1/3 marks

<u>Question 3</u>:

Monaghan Ltd. is in the process of negotiating a lease for the acquisition of machinery with the BMW Bank plc. Some members of the board of directors of Monaghan are concerned that if the lease is treated for accounting purposes as a finance lease the company's gearing ratio will appear unacceptably high, and have urged that the terms of the lease be carefully monitored to ensure that it can be treated as an operating lease. The basic terms of the lease are as follows:

(1) The lease will have a term of six years from 1 June 2000.

(2) Annual lease payment of £80,000 will be made commencing on 31 May 2001 and finishing on 31 May 2005.

(3) The fair value of the machinery at 1 June 2000 is £348,000.

The majority of the directors are of the belief that the machinery will be worthless after the expiry of the lease on 31 May 2005. The members of the board concerned about gearing, however, argue that the machinery could still have a value of £104,200 at that date, suggesting to them a useful economic life of at least eight years. The chairman of the board has suggested as a compromise that the useful economic life might be seen as seven years, and the residual value of the machinery at the expiry of the lease term as £40,000.

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Two possible additional terms of the lease are still under discussion with the bank. The first would give Monaghan the right to terminate the lease at any time after the first year, provided six months' notice has been given and a full payment of £80,000 made for each year or part of year for which the machinery is used or the period of notice applies. The second would give Monaghan the option to extend the lease for a secondary lease period on payment of a further nominal annual sum.

Present value factors for use in calculations are presented below:

	10%	12%	15%
After one year	0.91	0.89	0.87
After two years	0.83	0.80	0.76
After three years	0.75	0.71	0.66
After four years	0.68	0.63	0.57
After five years	0.62	0.57	0.50
After six years	0.56	0.51	0.43
After seven years	0.51	0.45	0.38
After eight years	0.47	0.40	0.33

You are required to:

(a) prepare calculations showing that using the basic terms of the lease and the opinion of the majority of directors that the machinery will be worthless after 31 May 2005 the implicit interest rate is 10%, but that substituting a residual value of £104,200 the implicit interest rate would be 15%;

(8 marks)

(b) explain why under the basic terms and assuming the machinery is worthless at 31 May 2005, the lease is a finance lease under SSAP 21 *Accounting for leases and hire purchase contracts*;

(6 marks)

(c) explain the impact on the status of the lease of each of the two alternative amounts suggested for residual value and each of the two possible additional terms for the lease;

(11 marks)

(d) summarise the accounting treatment and disclosure requirements for operating leases under SSAP 21.

(8 1/3 marks)

Total 33 1/3 marks

Question 4 is on the next page

Question 4:

(a) During the year ended 31 December 1999 Donegal Ltd. made an accounting profit of £250,000 after charging depreciation of £100,000 and after making a special provision for doubtful debts of £40,000. The amount charged for doubtful debts will not be allowable for tax purposes until the year ended 31 December 2000. Capital allowances for the year ended 31 December 1999 are £120,000. The rate of corporation tax is 28%, The balance on the deferred taxation account at 31 December 1998 was £64,000, based on cumulative capital allowances of £200,000 in excess of the corresponding depreciation figures and a tax rate of 32%.

Estimates of capital allowances and depreciation charges, together with the anticipated corporation tax rates, are given below for the years 2000 to 2003.

	2000	2001	2002	2003
Capital allowances	£60,000	£80,000	£120,000	£50,000
Depreciation	£110,000	£120,000	£120,000	£140,000
Corporation tax rate	24%	20%	16%	12.5%

The rate of corporation tax is expected to remain at 12.5% after 2003.

You are required to:

(i) calculate the tax payable on the profits for the year ended 31 December 1999;
(ii) calculate the full potential liability for deferred tax at 31 December 1999, using the liability method;
(iii) calculate the overall tax charge for the year ended 31 December 1999.

(17 marks)

(b) At 1 January 1998, Sligo Ltd. had 500,000 shares with a nominal value of 50 pence each. On 1 May 1999, the company had a rights issue of 1 share for 5 at a price of £6 compared to the market price per share of £8 at that date. Profits after taxation were £300,000 in the year ended 31 December 1998 and £450,000 in the year ended 31 December 1999; for the year ended 31 December 1999, the after tax profits included a gain of £75,000 after tax from the sale of surplus land and buildings on 1 December 1999.

You are required to calculate the earnings per share for Sligo Ltd. for inclusion in the financial statements for the year ended 31 December 1999, together with the corresponding figure for the year ended 31 December 1998.

(9 marks)

(c) Outline the main principles of FRS 12 in relation to provisions, and explain how the introduction of the standard confirms a trend of departure from ways in which the prudence concept was applied by companies in previous years.

(7 1/3 marks)

Total 33 1/3 marks