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OLLSCOIL NA hÉIREANN, GAILLIMH

NATIONAL UNIVERSITY OF IRELAND, GALWAY

Autumn Examinations 1999

B. COMM. DEGREE EXAMINATION

Financial Accounting III (AY 309)

Professor R. W. Scapens
Professor S. Collins
Mr K. Warnock
Ms E. Curtis

Time allowed: TWO AND A HALF HOURS

Candidates are required to attempt any THREE questions

All questions carry equal marks

Question 1:

Chenhall Ltd. have signed a lease agreement which is to take effect on 1 October 1999 for a fixed asset which could be purchased on that date for £186,000. There is a primary lease period of six years, during which the company will make payments of £20,000 each 1 October and 1 April, commencing on 1 October 1999. The asset is expected to have a useful economic life of ten years (after which its value will be negligible), and there is a clause in the lease agreement allowing Chenhall Ltd. to lease the asset for a further six years on the payment of a nominal annual amount.

You are required to:

(a) show how the lease will be reflected in the balance sheet, profit and loss account and notes of Chenhall Ltd. for the year ended 30 September 2000, on the assumption that it is a finance lease and that the sum-of-the-digits or "rule of 78" basis is to be adopted;

(16 marks)

(b) explain how the answer to part (a) would differ if the actuarial method were adopted, assuming that the implicit interest rate is 10%;

(10 marks)

(c) assuming that an alternative lease was available for a six year period only (i.e. with no provision for Chenhall to extend the lease beyond that time) and that the asset concerned was estimated to have a residual value (unguaranteed) in the region of £40,000, describe without performing calculations how a decision would be arrived at as to whether the lease should be classified as a finance lease or an operating lease.

(7 1/3 marks)

Total: 33 1/3 marks

Question 2:

On 30 September 1999 Berry Ltd. and its subsidiaries are expected to have the following consolidated balance sheet:-

	£000s	£000s
Net tangible fixed assets		836
Intangible fixed assets at cost		292
		1,128
Stocks	590	
Debtors	376	
Bank	24	
	990	
Trade creditors	410	
		580
		1,708
Warranty provisions		140
		1,568

[Question 2 continues on the next page]

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Share capital (£1 shares)	1,000
Share premium account	300
Profit and loss account	268
	1,568

The directors of Berry Ltd. are considering the merits of a business combination with Jarvis Ltd., whose balance sheet at the same date is forecast by the directors of the company to be as follows:

	£000s	£000s
Net tangible fixed assets		564
Intangible fixed assets at cost		184
		748
Stocks	216	
Debtors	224	
Bank	128	
	568	
Trade creditors	180	
		388
		1,136
Share capital (50p shares)		600
Share premium account		100
Revaluation reserve		56
Profit and loss account		380
		1,136

The directors of Berry Ltd. have two possible strategies for the business combination: either they will issue 800,000 shares in consideration for the whole of the share capital of Jarvis Ltd., or they will borrow £1,600,000 and use the entire proceeds of that loan to purchase the whole of Jarvis Ltd.'s share capital for cash. They are interested in examining the accounting consequences of these two options for the group balance sheet.

The following additional information has been assembled to determine the accounting impact of the combination:

(1) The tangible and intangible fixed assets of Jarvis are estimated to have fair values of £600,000 and £260,000 respectively (the corresponding figures for Berry are £880,000 and £340,000).

(2) The directors of Berry have noted that although Jarvis is in the same type of business it has not established appropriate warranty provisions; they believe that if the same policy used by Berry had been applied by Jarvis, that company would include warranty provisions of £60,000 in its balance sheet at 30 September 1999.

[Question 2 continues on the next page]

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You are required to:

(a) prepare a projected consolidated balance sheet for Berry Ltd, and its subsidiaries, including Jarvis Ltd., on the assumption that the consideration is paid in the form of shares and merger accounting used; (13 marks)

(b) prepare a revised consolidated balance sheet on the assumption that Berry Ltd. takes out the loan and pays the consideration in cash (any goodwill arising should be included under fixed assets); (14 marks)

(c) summarise briefly the difficulties which standard-setters have experienced in distinguishing between a merger and an acquisition.

(6 1/3 marks)

Total: 33 1/3 marks

Question 3:

Galway Ltd. established an English subsidiary, Reading Ltd., on 1 July 1998. IR£800,000 was transferred to England at a time when the exchange rate was IR£1 = 90 pence (sterling) and this was used to subscribe for shares in Reading Ltd. On the same date reading Ltd. borrowed £240,000 (sterling) from the Berkshire Bank and invested £600,000 (sterling) in fixed assets.

For the year ended 30 June 1999, Reading Ltd.'s profit and loss account was as follows:

	£ sterling	
Sales		1,800,000
Cost of goods sold	800,000	
Depreciation	120,000	
Other expenses, including interest	727,000	
		1,647,000
Net profit		153,000

A summarised balance sheet at 30 June 1999 showed:

	£ sterling
Fixed assets at cost	600,000
Accumulated depreciation	120,000
	480,000
Net current assets	633,000
	1,113,000
Share capital	720,000
Net profit for the year	153,000
	873,000
Long-term loan	240,000
	1,113,000

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During the year, the exchange rate averaged IR£1 = 82 pence sterling, and at the end of the year it was IR£1 = 80 pence sterling.

You are required to:

(a) translate the closing balance sheet of Reading Ltd. into IR£s for consolidation with the accounts of Galway Ltd., following the closing rate/net investment method and showing separately the amounts to be treated as profit for the year, any other movements on reserves, and how such other movements have arisen;

(16 marks)

(b) explain, without presenting further detailed calculations, how the balance sheet, the profit for the year, and the other movements on reserves would differ if the directors had decided that the translation of the financial statements of Reading Ltd. should be carried out using the temporal method.

(17 1/3 marks)

Total: 33 1/3 marks

Question 4:

You are required to advise the directors of Mott Ltd. on each of the following matters that have arisen in relation to the finalisation of the financial statements of the company for the year ended 31 July 1999, referring to any accounting or financial reporting standards that may be applicable:

(a) Two legal actions involving the company are not likely to be resolved until the year 2001 at the earliest. The company is owed £400,000 by a customer who claims that there are major deficiencies in the products sold by Mott Ltd. and is refusing to pay. Legal opinion suggests that the customer will be required to pay at least £240,000, but that the chances of the amount recoverable being as high as £320,000 are only 50/50. Mott itself is suing its former financial advisers for £700,000 in relation to a takeover bid on which it sought advice; legal opinion suggests that there is a 50% chance of success in the claim.

(9 marks)

(b) The company had previously been involved exclusively in the services area, where tax is payable at 40%, but has recently expanded into manufacturing, where there is a reduced rate of 10% applicable. Machinery purchased for the manufacturing operations has attracted capital allowances for tax purposes of £800,000, but depreciation is only £320,000. The company envisages a similar pattern of capital allowances and depreciation for the next three years, but thereafter it expects a pattern of reversing timing differences. During the year the company has had surplus funds for the first time, and these have been invested in short-term government securities. Accrued interest at 31 July 1999 was £60,000, but this will not be taxable until the year ended 31 July 2000. The directors seek advice on the appropriate provision, if any, for deferred taxation.

(9 marks)

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(c) The draft profit and loss account includes the following figures in thousands of pounds:

Profit before exceptional item	2,500
Exceptional item	
Loss on disposal of business	1,500
Profit before taxation	1,000
Taxation	300
Profit after taxation	700

The number of shares in issue at the beginning of the year was 2,500,000 but on 31 January 1999 there was a capitalisation issue: one new share was issued for every existing share, credited as fully paid by the capitalisation of the share premium account and part of the balance on the profit and loss account. The directors are unsure of how all this information should be reflected in the Earnings Per Share calculations of the company, given their wish to present the most positive view of the company consistent with the regulations.

(9 marks)

(d) On 15 July 1999, a customer suffered a major fire at its premises. On 10 August 1999, the customer contacted the management of Mott Ltd. and explained that as a result of the fire it would be going out of business, and therefore anticipated that of the total amount owed to Mott of £120,000, only £40,000 was likely to be paid.

(6 1/3 marks)

Total: 33 1/3 marks