

Professional Pilot Paper – Essentials module

Corporate Reporting (United Kingdom)

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

This paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – TWO questions ONLY to 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



Paper P2 (UK)

Section A – This ONE question is compulsory and MUST be attempted

1 The following draft financial statements relate to Zambeze, a public limited company:

Draft Group Balance Sheets at 30 June

	2006 £m	2005 £m
Fixed assets:		
Goodwill	30	25
Tangible assets	1,315	1,005
Investment in associate	270	290
	<u>1,615</u>	<u>1,320</u>
Current assets:		
Stock	650	580
Debtors	610	530
Cash at bank and in hand	50	140
	<u>1,310</u>	<u>1,250</u>
Creditors: amounts falling due within one year	(1,581)	(1,430)
Net current liabilities	(271)	(180)
Total assets less current liabilities	1,344	1,140
Creditors: amounts falling due after more than one year	(850)	(600)
Net assets	<u>494</u>	<u>540</u>
Capital and reserves:		
Called up share capital	100	85
Share premium account	30	15
Revaluation reserve	50	145
Profit and loss account	254	250
Minority interest – equity	60	45
Capital employed	<u>494</u>	<u>540</u>

Draft Group Profit and Loss for the year ended 30 June 2006

	£m
Turnover	4,700
Cost of sales	(3,400)
Gross profit	<u>1,300</u>
Distribution and administrative expenses	(600)
Finance costs (interest payable)	(40)
Share of profit in associate	30
Profit on ordinary activities before tax	<u>690</u>
Tax on profit on ordinary activities (including tax on income from associate £10 million)	(210)
Profit on ordinary activities after taxation	<u>480</u>
Minority interest	(25)
Profit attributable to members of parent company	<u>455</u>

Draft Group Statement of Total Recognised Gains and Losses for the year ended 30 June 2006

	£m
Profit for the financial year	455
Foreign exchange difference of associate	(5)
Impairment losses on tangible assets offset against revaluation surplus	(95)
Total recognised gains and losses for the period	<u>355</u>

Draft Reconciliation of Group Shareholders Funds for the year ended 30 June 2006

	£m
Total recognised gains and losses for the period	355
Dividends paid	(446)
New shares issued	30
Total movement during the year	<u>(61)</u>
Shareholders' funds at 1 July 2005	495
Shareholders' funds at 30 June 2006	<u>434</u>

The following relates to Zambeze:

- (i) Zambeze acquired a seventy per cent holding in Damp, a public limited company, on 1 July 2005. The fair values of the net assets acquired were as follows:

	£m
Tangible fixed assets	70
Stock and work in progress	90
	<u>160</u>

The purchase consideration was £100 million in cash and £25 million (discounted value) deferred consideration which is payable on 1 July 2006. The difference between the discounted value of the deferred consideration (£25 million) and the amount payable (£29 million) is included in "interest payable". Zambeze wants to set up a provision for reconstruction costs of £10 million retrospectively on the acquisition of Damp. This provision has not yet been set up.

- (ii) There had been no disposals of tangible fixed assets during the year. Depreciation for the period charged in cost of sales was £60 million.
- (iii) Creditors: amounts falling due within one year comprised the following items:

	2006	2005
	£m	£m
Trade creditors	1,341	1,200
Interest payable	50	45
Taxation	190	185
	<u>1,581</u>	<u>1,430</u>

- (iv) Creditors: amounts falling due more than one year comprised the following:

	2006	2005
	£m	£m
Deferred consideration – purchase of Damp	29	–
Liability for the purchase of tangible fixed assets	144	–
Loans repayable	621	555
Provision for deferred tax	30	25
Retirement benefit liability	26	20
	<u>850</u>	<u>600</u>

(v) The retirement benefit liability comprised the following:

	£m
Movement in year:	
Liability at 1 July 2005	20
Current and past service costs charged to profit and loss	13
Contributions paid to retirement benefit scheme	(7)
	<hr/>
Liability 30 June 2006	26
	<hr/>

There was no actuarial gain or loss in the year.

(vi) Goodwill was impairment tested on 30 June 2006 and any impairment was included in the financial statements for the year ended 30 June 2006. Group policy is to amortise goodwill over five years but because goodwill was impairment tested on 30 June 2006, no amortisation was charged in the year.

(vii) The Finance Director has set up a company, River, through which Zambeze conducts its investment activities. Zambeze has paid £400 million to River during the year and this has been included in dividends paid. The money was invested in a specified portfolio of investments. Ninety five per cent of the profits and one hundred per cent of the losses in the specified portfolio of investments are transferred to Zambeze. An investment manager has charge of the company's investments and owns all of the share capital of River. An agreement between the investment manager and Zambeze sets out the operating guidelines and prohibits the investment manager from obtaining access to the investments for the manager's benefit. An annual transfer of the profit/loss will occur on 30 June annually and the capital will be returned in four years time. The transfer of £400 million cash occurred on 1 January 2006 but no transfer of profit/loss has yet occurred. The balance sheet of River at 30 June 2006 is as follows:

River – Balance sheet at 30 June 2006

	£m
Investment at fair value through profit or loss	390
	<hr/>
	390
	<hr/>
Share capital	400
Retained earnings	(10)
	<hr/>
	390
	<hr/>

Required:

- (a) **Prepare a group cash flow statement for the Zambeze Group for the year ended 30 June 2006 using the indirect method.** (35 marks)
- (b) **Discuss the issues which would determine whether River should be consolidated by Zambeze in the group financial statements.** (9 marks)
- (c) **Discuss briefly the importance of ethical behaviour in the preparation of financial statements and whether the creation of River could constitute unethical practice by the finance director of Zambeze.** (6 marks)

Two marks are available for the quality of the discussion of the issues regarding the consolidation of River and the importance of ethical behaviour.

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Electron, a public limited company, operates in the energy sector. The company has grown significantly over the last few years and is currently preparing its financial statements for the year ended 30 June 2006.

Electron buys and sells oil and currently has a number of oil trading contracts. The contracts to purchase oil are treated as fixed assets and amortised over the contracts' durations. On acceptance of a contract to sell oil, fifty per cent of the contract price is recognised immediately with the balance being recognised over the remaining life of the contract. The contracts always result in the delivery of the commodity. (4 marks)

Electron has recently constructed an ecologically efficient power station. A condition of being granted the operating licence by the government is that the power station be dismantled at the end of its life which is estimated to be 20 years. The power station cost £100 million and began production on 1 July 2005. Depreciation is charged on the power station using the straight line method. Electron has estimated at 30 June 2006, it will cost £15 million (net present value) to restore the site to its original condition using a discount rate of five per cent. Ninety-five per cent of these costs relate to the removal of the power station and five per cent relates to the damage caused through generating energy. (7 marks)

Electron has leased another power station which was relatively inefficient, to a rival company on 30 June 2006. The beneficial and legal ownership remains with Electron and in the event of one of Electron's power stations being unable to produce energy, Electron can terminate the agreement. The leased power station is being treated as an operating lease with the net present value of the income of £40 million being recognised in the profit and loss account. The fair value of the power station is £70 million at 30 June 2006. A deposit of £10 million was received on 30 June 2006 and it is included in the net present value calculation. (5 marks)

The company has a good relationship with its shareholders and employees. It has adopted a strategy of gradually increasing its dividend payments over the years. On 1 August 2006, the board proposed a dividend of 5p per share for the year ended 30 June 2006. The shareholders will approve the dividend along with the financial statements at the general meeting on 1 September 2006 and the dividend will be paid on 14 September 2006. The directors feel that the dividend should be accrued in the financial statements for the year ended 30 June 2006 as a "valid expectation" has been created. (3 marks)

The company granted share options to its employees on 1 July 2005. The fair value of the options at that date was £3 million. The options vest on 30 June 2008. The employees have to be employed at the end of the three year period for the options to vest and the following estimates have been made:

Estimated percentage of employees leaving during vesting period

Grant date 1 July 2005	5%	
30 June 2006	6%	(4 marks)
Effective communication to the directors		(2 marks)

Required:

Draft a report suitable for presentation to the directors of Electron which discusses the accounting treatment of the above transactions in the financial statements for the year ended 30 June 2006, including relevant calculations.

(25 marks)

3 The following balance sheet relates to Kesare Group, a public limited company at 30 June 2006:

	£'000
Assets:	
Fixed assets:	
Tangible assets	10,000
Goodwill	6,000
Other intangible assets	5,000
Financial assets (cost)	9,000
	30,000
Debtors	7,000
Other receivables	4,600
Cash	6,700
Current assets	18,300
Trade creditors	(5,000)
Current tax liability	(3,070)
Creditors: amounts falling due within one year	(8,070)
Net current assets	10,230
Creditors: amounts falling due after more than one year:	
Long term borrowings	(10,000)
Deferred tax liability	(3,600)
Employee benefit liability	(4,000)
	(17,600)
Net assets	22,630
Capital and reserves	
Share capital	9,000
Profit and loss account	9,130
Other reserves	4,500
Capital employed	22,630

The following information is relevant to the above balance sheet:

- (i) The financial assets are valued at fair value through profit or loss but are shown in the above balance sheet at their cost on 1 July 2005. The market value of the assets is £10.5 million on 30 June 2006. Taxation is payable on the sale of the assets.
- (ii) Other tangible assets comprise an asset which was purchased on 1 July 2005 for £5 million and which qualifies for a government capital grant of £1 million. The asset has a useful life of five years. The grant has been credited to the profit and loss account and capital allowances are restricted by the amount of the grant. Assume a tax writing down allowance of 25% per annum.
- (iii) The defined benefit plan had a rule change on 1 July 2005. Kesare estimate that of the past service costs of £1 million, 40 per cent relates to vested benefits and 60 per cent relates to benefits that will vest over the next five years from that date. The past service costs have not been accounted for and the actuarial gain before accounting for the past service costs was £600,000.
- (iv) The company had purchased an investment property on 1 July 2005 at a cost of £3 million. This was included in tangible assets at this amount at 30 June 2006. The value of the property at 30 June 2006 was £5 million and the gain was included in the profit and loss account. The company had no intention of selling the property in the near future. The property qualifies for capital allowances at 4% per annum. No deferred taxation had been provided for on the investment property.
- (v) Assume taxation is payable at 30%.

Required:

- (a) **Discuss the main objectives of the recognition of deferred taxation and the conceptual principles upon which the timing difference approach to deferred taxation is based.** (7 marks)
- (b) **Show, with suitable explanations, any adjustments that would be required to the deferred tax provision and balance sheet amounts as a result of items (i) – (iv) above.** (18 marks)

Two marks will be awarded for the quality of the discussion of the objectives and conceptual principles in (a).

(25 marks)

- 4 A significant number of entities and countries around the world have adopted International Financial Reporting Standards (IFRS) as their basis for financial reporting, often regarding these as a means to improve the quality of information on corporate performance. However, while the advantages of a common set of global reporting standards are recognised, there are a number of implementation challenges at the international and national levels if the objective of an improved and harmonised reporting system is to be achieved.

Required:

- (a) **Discuss the implementation challenges faced by the International Accounting Standards Board (IASB) if there is to be a successful move to International Financial Reporting Standards.** (18 marks)
- (b) The Accounting Standards Board recently issued FRED36 *Business Combinations (IFRS3)* and amendments to FRS2 *Accounting for Subsidiary Undertakings*. The proposals radically change the basis of reporting business combinations and transactions with minority interests.

Discuss how the above exposure draft will fundamentally affect the existing accounting practices for business combinations. (7 marks)

Two marks will be awarded for the quality of the discussion of the ideas and information.

(25 marks)

End of Question Paper

Answers

1 (a) Zambeze Group
Group Statement of Cash Flows for the year ended 30 June 2006

	£m	£m
Net cash flows from operating activities (Note 1):		862
Cash contributions to pension scheme		(7)
Dividends received from associate (working 3)		35
Returns on investment and servicing of finance (Note 2)		(89)
Taxation (working 4)		(190)
Capital expenditure and financial investment (Note 2)		(651)
Acquisitions and disposals (Note 2)		(100)
Equity dividends paid (working 6)		(46)
		<u>(186)</u>
Cash outflow before use of liquid resources and financing		(186)
Financing:		
issues of shares	30	
increase in debt	66	96
		<u>96</u>
Decrease in cash in period		<u>(90)</u>
<i>Note 1</i>		
Reconciliation of operating profit to net cash inflow from operating activities		
Operating profit (690 + 40)		730
Depreciation		60
Impairment of goodwill (working 2)		8
Decrease in stock (650–580–90)	20	
Increase in debtors	(80)	
Increase in creditors	141	81
		<u>81</u>
Associate's profit		(30)
Current and past service costs		13
		<u>862</u>
<i>Note 2</i>		
Analysis of cash flows for headings netted in cash flow statement		
Returns on investment and servicing of finance		
Interest paid (working 5)		31
Minority interest – equity dividend		58
		<u>89</u>
Capital expenditure and financial investment		
Purchase of tangible fixed assets (working 1)		(251)
Investment in River		(400)
		<u>(651)</u>
Acquisitions		
Purchase of Damp		100
		<u>100</u>

Working 1

	£m
Tangible fixed assets	
Balance at 1 July 2005	1,005
Impairment losses	(95)
Depreciation	(60)
Purchases (by deduction)	395
Acquisition – Damp	70
	<u>1,315</u>
Closing balance	1,315

Cash flow is £395 million minus the liability for tangible fixed assets of £144 million, ie £251 million.

Working 2

	£m
Purchase of subsidiary:	
Net assets acquired	160
Group's share of net assets (70%)	112
Goodwill	13
Purchase consideration (100+25)	<u>125</u>
Goodwill:	
Balance at 30 June 2005	25
Goodwill on subsidiary	13
Impairment	(8)
Balance at 30 June 2006	<u>30</u>
Minority interest:	
Balance at 1 July 2005	45
Acquisition of Damp (160 x 30%)	48
Profit for year	25
Dividend	(58)
Balance at 30 June 2006	<u>60</u>

Working 3

	£m
Dividend from associate:	
Balance at 1 July 2005	290
Income (net of tax) (30-10)	20
Foreign exchange loss	(5)
Dividends received (difference)	(35)
Balance at 30 June 2006	<u>270</u>

Working 4

	£m	£m
Taxation:		
Balance at 1 July 2005		185
Income tax		25
Deferred tax		200
Income statements (210-10)		(190)
Tax paid (difference)		
Balance at 30 June 2006	190	<u>220</u>
Income tax	30	
Deferred tax	<u> </u>	

Working 5

	£m
Interest paid:	
Balance at 1 July 2005	45
Profit and loss	40
Unwinding of discount on purchase	(4)
Cash paid (difference)	(31)
Closing balance at 30 June 2006	<u>50</u>

Working 6

The cash payment to River should be shown as "financial investment" of £400 million and the dividend paid will then be £(446-400) million, ie £46 million.

- (b) FRS 2 *Accounting for subsidiary undertakings* essentially adopts the definitions of parent undertaking introduced by the Companies Act 1985. An undertaking is deemed to be a parent of another undertaking where:
- (i) over more than one half of the voting rights are owned by the parent; or
 - (ii) the parent has the right to exercise dominant influence over the undertaking or
 - (iii) the parent is a member and has the right to appoint or remove members of the board of directors who hold the majority of the voting rights at board meetings; or
 - (iv) the parent has a participating interest in the undertaking and exercises dominant influence.

Dominant influence is that which is exercised to achieve the operating and financial policies desired by the holder of the influence. The influence has to be exercised and is identified by its effect in practice.

FRS 2 *The definition* is based on the power of one entity to “control” another through the exercise of share holder control. FRS 5 *Reporting the substance of transactions* takes the view that the definitions above are not conclusive in determining what entities are to be consolidated. FRS 5 defines a quasi subsidiary and envisages situations where the need to give a true and fair view will require the consolidation of quasi subsidiaries. The key feature is control which means the ability to direct the financial and operating policies to gain economic benefit from its activities. Control is also indicated by the ability to prevent others from exercising those policies or enjoying the benefits of the subsidiary’s net assets. Control can be derived from a variety of sources and exercised in a number of ways. If the ‘owner’ has accepted real and severe constraints on the normal powers of ownership, then the real benefits of ownership must lie elsewhere. The ability to control decision making alone is not sufficient to establish control for accounting purposes but must be accompanied by the objective of obtaining benefits from the entity’s activities. If a company obtains the benefits of ownership, is exposed to the risks of ownership, and can exercise decision making powers to obtain those benefits, then the company must control the third party. The overall substance of the arrangement must be considered.

Zambeze should consolidate River as Zambeze controls it through the operating guidelines. Zambeze also receives 95% of the profits and suffers all the losses of River. The guidelines were set up when River was formed and, therefore, the company was set up as a vehicle with the objective of keeping certain transactions off the balance sheet of Zambeze. The investment manager manages the investments of River within the guidelines and incurs no risk and receives 5% of the profits for the management services.

- (c) Ethics in accounting is of utmost importance to accounting professionals and those who rely on their services. Accounting professionals know that people who use their services, especially decision makers using financial statements, expect them to be highly competent, reliable, and objective. Those who work in the field of accounting must not only be well qualified but must also possess a high degree of professional integrity. A professional’s good reputation is one of his or her most important assets.

There is a very fine line between acceptable accounting practice and management’s deliberate misrepresentation in the financial statements. The financial statements must meet the following criteria:

- (i) Technical compliance: A transaction must be recorded in accordance with generally accepted accounting principles (GAAP).
- (ii) Economic substance: The resulting financial statements must represent the economic substance of the event that has occurred.
- (iii) Full disclosure and transparency: Sufficient disclosure must be made so that the effects of transactions are transparent to the reader of the financial statements.

In the case of River, it could be argued that the first criterion may be met because the transaction is apparently recorded in technical compliance with FRS, but technical compliance alone is not sufficient. The second criterion is not met because the transaction as recorded does not reflect the economic substance of the event that has occurred.

Accounting plays a critical function in society. Accounting numbers affect human behaviour especially when it affects compensation, and to deliberately mask the nature of accounting transactions could be deemed to be unethical behaviour.

River was set up with the express purpose of keeping its activities off the balance sheet. The Finance Director has an ethical responsibility to the shareholders of Zambeze and society not to mask the true nature of the transactions with this entity. Further, if the transaction has been authorised by the Finance Director without the authority or knowledge of the Board of Directors, then a further ethical issue arises. Showing the transfer of funds as a dividend paid is unethical and possibly illegal in the jurisdiction. The transfer should not be hidden and River should be consolidated.

2 Report to directors of Electron

Terms of reference

This report sets out the nature of the accounting treatment and concerns regarding the following matters:

- Oil contracts
- Power station
- Operating leases
- Proposed dividends
- Share options

Oil Contracts

The accounting policy adopted for the agreements relating to the oil contracts raises a number of concerns. The revenue recognition policy currently used is inflating revenue in the first year of the contract with 50% of the revenue being recognised, but a smaller proportion of the costs are recognised in the form of depreciation. Over the life of the contract, costs and revenues are equally matched but in the short term there is a bias towards a more immediate recognition of revenue against a straight line cost deferral policy. Additionally oil sales result in revenue whilst purchases of oil result in a tangible fixed asset. Under FRS18 *Accounting Policies*, the question of whether revenue has arisen is judged independently from the matching concept according to whether an asset has been created. If it has, revenue is recognised. Similarly, if a liability has been created in the period, a related expense may have occurred and is recognised. The Statement of Principles adopts this “asset” and “liability” approach also. Similarly the Amendment to FRS5 *Reporting the substance of transactions – Revenue Recognition*, is based on the principles that a seller

generates revenue by performing contractual obligations and in exchange obtains the right to consideration. Thus when performance of a contract takes place over time the revenue should be recognised as performance takes place. The current accounting practice seems out of line with the basic principles of revenue recognition.

However, the election of the company to use some form of deferral policy for its agreements is to be commended as it attempts to bring its revenue recognition policy in line with the length of the agreements. The main problem is the lack of a detailed accounting standard on revenue recognition. The result is the current lack of consistency in accounting for long-term agreements. However, it may be advisable to adopt a deferral policy in terms of this type of revenue. The contracts always result in the delivery of the oil in the normal course of business and are not, therefore, accounted for as financial instruments as they qualify as normal sale and purchase contracts.

Power Station

Under FRS12 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be made at the balance sheet date for the discounted cost of the removal of the power station because of the following reasons:

- (i) the installation of the power station creates an obligating event
- (ii) the operating licence creates a legal obligation which is likely to occur
- (iii) the costs of removal will have to be incurred irrespective of the future operations of the company and cannot be avoided
- (iv) a transfer of economic benefits (ie the costs of removal) will be required to settle the obligation
- (v) a reasonable estimate of the obligation can be made although it is difficult to estimate a cost which will be incurred in twenty years time (FRS12 says that only in exceptional circumstances will it not be possible to make some estimate of the obligation)

The costs to be incurred will be treated as part of the cost of the facility to be depreciated over its production life. However, the costs relating to the damage caused by the generation of energy should not be included in the provision, until the power is generated which in this case would be 5% of the total discounted provision. The accounting for the provision is shown in Appendix 1.

Operating Leases

Under SSAP21 *Accounting for leases and hire purchase contracts* a lease is classified as a finance lease if it transfers substantially all the risks and rewards "incident" to ownership. All other leases are classified as operating leases. In this case, the beneficial and legal ownership remains with Electron and Electron can make use of the power station if it so wishes. Also for a lease asset to be a finance lease the present value of the minimum lease payments should be substantially all of the fair value of the leased asset (normally 90 per cent or more). In this case this amounts to 57.1% (£40 million ÷ £70 million) which does not constitute "substantially all". Thus there does not seem to be any issue over the classification of the lease as an operating lease. The immediate recognition as income of the future benefit at net present value is a little more problematical. SSAP21 says that lease income from operating leases should be recognised on a straight line basis over the lease term unless another systematic and rational basis is more representative. This applies even if the payments are not made on such a basis. If a fee is received as an "up front" cash payment then FRS18 and FRS5 should be applied. If there is future involvement required to earn the fee, or there are retained risks or risk of the repayment of the fee, or any restrictions on the lessor's use of the asset, then immediate recognition is inappropriate. The present policy of recognising the total lease income as if it were immediate income which it is not, would be difficult to justify. Similarly, as regards the deposit received, revenue should only be recognised when there is performance of the contract. Thus as there has been no performance under the contract, no revenue should be accrued in the period.

Proposed dividend

The dividend was proposed after the balance sheet date and the company, therefore, did not have a liability at the balance sheet date. No provision for the dividend should be recognised. The approval by the directors and the shareholders are enough to create a valid expectation that the payment will be made and give rise to an obligation. However, this occurred after the current year end and, therefore, will be charged against the profits for the year ending 30 June 2007.

The existence of a good record of dividend payments and an established dividend policy does not create a valid expectation or an obligation. However, the proposed dividend will be disclosed in the notes to the financial statements as the directors approved it prior to the authorisation of the financial statements.

Share options

Equity-settled transactions with employees would normally be expensed on the basis of their fair value at the grant date. Fair value should be based on market prices wherever possible. Many shares and share options will not be traded on an active market. In this case, valuation techniques, such as the option pricing model, would be used. FRS20's objective for equity-based transactions with employees is to determine and recognise compensation costs over the period in which the services are rendered. In this case, the company has granted to employees share options that vest in three years' time on the condition that they remain in the entity's employ for that period. These steps will be taken:

- (i) the fair value of the options will be determined at the date on which they were granted
- (ii) this fair value will be charged to the profit and loss account equally over the three year vesting period with adjustments made at each accounting date to reflect the best estimate of the number of options that eventually will vest

Shareholders' equity will be increased by an amount equal to the profit and loss account charge. The charge in the profit and loss account reflects the number of options that are likely to vest, not the number of options granted or the number of options exercised. If employees decide not to exercise their options because the share price is lower than the exercise price, then no adjustment is made to the profit and loss account. Many employee share option schemes contain conditions that must be met before the employee becomes entitled to the shares or options. These are called vesting conditions and could require, for example, an increase in profit or

growth in the entity's share price before the shares vest. In this case the vesting condition is the employment condition. £940,000 (£3 million x 94% x 1/3) will be charged in the profit and loss account and to equity at 30 June 2006.

Recommendations and conclusion

The above report sets out the recommendations regarding the accounting treatment of the items specified. It is imperative that the recommendations are followed as non-compliance with a single FRS constitutes a failure to follow UK GAAP for reporting purposes.

Appendix 1

	£m	£m
Present value of obligation at 1 July 2005 (15 ÷ 1.05)	14.3	
Provision for decommissioning (95% x 14.3)	13.6	
Provision for damage through extraction (5% x 14.3)		0.7

Balance Sheet at 30 June 2006

	£m	£m
Tangible fixed assets:		
Cost of power station	100	
Provision for decommissioning	13.6	
	113.6	
less depreciation (113.6 ÷ 20 years)	(5.7)	
Carrying value	107.9	
Other provisions:		
Provision for decommissioning 1 July 2005	13.6	
Unwinding of discount (13.6 x 5%)	0.7	
		14.3
Provision for damage (0.7 ÷ 20 years)		0.1
		14.4

Profit and Loss Account

	£m
Depreciation	5.7
Provision for damage	0.1
Unwinding of discount (finance cost)	0.7

A simple straight line basis has been used to calculate the required provision for damage. A more complex method could be used whereby the present value of the expected cost of the provision is provided for over 20 years and the discount thereon is unwound over its life.

- 3 (a) The objective of accounting for deferred tax is to ensure that the future tax consequences of past transactions and events are recognised as assets or liabilities in financial statements. The objective is based on the definition of a liability set out in the *Statement of Principles*. A liability for deferred tax should be recognised only for past transactions or events that give rise to an obligation to pay more tax in the future. Timing differences arise out of differences between an entity's taxable profits and its results as stated in the financial statements. Gains and losses are included in tax assessments in periods different from those in which they are recognised in the financial statements. Past transactions and events will have future tax consequences if they are recognised as timing differences that have originated but not reversed at the balance sheet date. An entity will have an obligation to pay more tax or a right to pay less tax where it has no discretion to avoid the future reversal of a timing difference. (An entity may originate a new timing difference which may postpone tax payable or recoverable.) This approach has been called the "incremental liability approach" and the Accounting Standards Board believes it is consistent with the *Statement of Principles*.
- (b) (i) Financial assets that are valued at fair value through profit and loss should be valued at fair value with any increase in value going to the profit and loss account. Thus the gain of £1.5 million should be included in the profit and loss account and the balance sheet value increased. Revaluation of non-monetary assets does not give rise to a timing difference because taxable profits are not affected and no future tax liability arises as a result of the revaluation (unless there is a binding sale agreement). However, FRS19 states that deferred tax should be recognised on timing differences arising when an asset is continuously revalued to fair value with changes being recognised in the profit and loss account. Thus deferred tax should be provided of (£10.5 million – £9 million) @ 30%, ie £450,000.
- (ii) Government grant

Government grants are dealt with in SSAP4 *Accounting for government grants*. Grants should be credited to revenue over the useful life of the related asset and not credited fully in the year of receipt. Grants can be deducted from the cost of the asset or treated as a deferred credit of which a proportion would be credited to revenue annually. SSAP4 warns that Counsel's opinion is that a deduction from cost method is unlawful. The timing difference arising on this item would be:

	£000
Cost of asset	5,000
Depreciation	(1,000)
Carrying value	4,000
Unamortised deferred income (1,000 – 200)	(800)
Net carrying value in financial statements	<u>3,200</u>
Cost of asset	5,000
less grant	(1,000)
	4,000
Capital allowance (25%)	(1,000)
Tax written down value	<u>3,000</u>
Timing difference	200
Deferred tax (3200–3000) @ 30%	<u>60</u>

(iii) Pension costs

The defined benefit plan should recognise (40% of £1 million + 60% of £1 million/5) ie £520,000 of the past service costs as an increase in the liability. Retained earnings will be charged with the same amount. This increase in the liability will reduce the actuarial gain to (£600–£520)K, £80,000. Therefore, deferred tax of £80,000 x 30%, ie £24,000 will be recognised in the STRGL as the actuarial gain will have been recognised there.

(iv) Investment property

Investment properties should not be depreciated (SSAP19) but should be included in the balance sheet at their open market value. Changes in the value of the investment properties should not be taken to the profit and loss account but should be taken to the investment revaluation reserve. Thus the gain on the investment property (£2 million) should be taken out of the profit and loss account and credited to investment revaluation reserve. Deferred tax is only provided on the gain arising on the revaluation if there was an intention to sell the investment property. As the company has no intention to sell, then no deferred taxation is provided on the gain. However, the company will have to provide deferred taxation on the difference between nil depreciation and the capital allowances £120,000 claimed at the tax rate of 30%, ie £36,000.

	Balance Sheet £000	Profit and Loss Account £000	Other reserves £000
Balance per balance sheet		9,130	4,500
(i) Financial assets	9,000		
Revaluation	1,500	1,500	
	<u>10,500</u>		
(ii) Grant	800	200	
Reversal of grant income		(1,000)	
Depreciation of fixed asset	(1,000)	(1,000)	
(iii) Pension costs – liability	(4,000)		
Past service costs	(520)	(520)	
	<u>(4,520)</u>		
(iv) Investment property		(2,000)	2,000
Increase in deferred tax (below)		(546)	(24)
		<u>5,764</u>	<u>6,476</u>
Deferred tax liability per balance sheet			3,600
Adjustment for			
Financial asset		450	
Government grant		60	
Pension costs (to STRGL)		24	
Investment property		36	570
Adjusted deferred tax liability			<u>4,170</u>

- 4 (a) International Financial Reporting Standards (IFRS) were initially developed for the preparation of group accounts of listed companies. The use of IFRS is growing such that in some countries that are building or improving their accounting regulatory framework, IFRS based corporate reports are deemed to be more reliable and relevant than local GAAP reports. In many of these countries IFRSs are the statutory requirement for legal entities and, therefore, an implementation issue that has arisen is that the national law has to be reconciled with the requirements of IFRS.

Another implementation issue relates to small and medium-sized enterprises (SMEs) in terms of whether a separate set of standards should be developed and what should be the underlying conceptual and methodological basis for such standards. Effective implementation requires continuous interaction between the International Accounting Standards Board (IASB) and national regulators. The IASB has issued a draft Memorandum of Understanding on the role of Accounting Standard Setters and their relationship with the IASB. It identifies responsibilities that the IASB and other standard setters should adopt to facilitate the ongoing adoption of or convergence with IFRS.

With the increase in the number of entities applying IFRS, the demand for implementation guidance is growing. The International Financial Reporting Interpretations Committee (IFRIC) has been given the task of meeting this demand but there may be a need for additional coping mechanisms as a limited number of interpretations have been issued since the inception of IFRIC.

Variations in translation of IFRS could introduce inconsistency. In some countries the capacity for highly technical translation is low and there may be a conflict with existing national terminology and legislation. Additionally, time lags in the local "endorsement" process and in translating new IFRS could mean that financial reports may not be consistent with the latest body of standards. Additionally the successful implementation of IFRS will depend upon the robustness of the local regulatory framework. Effective corporate governance practices, high quality auditing standards and practices, and effective enforcement or oversight mechanisms will be required to underpin the IFRS. Often endorsement of the standards is required as part of the implementation process. For example, in the European Union, after IFRSs have been issued by the IASB, they must go through an endorsement process before companies listed in the European Union are required to apply them. This process could create standards that differ from those of the IASB.

Implementation of IFRS can have implications for a number of legislative areas. The more complex the regulatory framework, the more problems will arise. There can be tax, price control and company law implications, and certain sectors, such as banking and insurance, may be subject to additional regulation that may require special reporting requirements. Entities may find that they are in breach of existing covenants with lenders where the provision of funding is based on national GAAP ratios. Similarly corporate law may set out the requirements on distribution of dividends and unless the necessary corporate law amendments are made then dividend distributions would be based on national GAAP which might create confusion.

An international mechanism for the co-ordination of enforcement of IFRS is required. IOSCO provides an infrastructure for enforcement with respect to publicly listed companies. IOSCO has put forward proposals for the regulatory interpretation and enforcement of IFRS. On a more local level, the European Union has established the Committee of European Securities Regulators whose role is to improve co-ordination among securities regulators and ensure implementation of legislation in the European Union.

The complex nature of IFRS and the sheer volume of standards make the task of implementation difficult. The standards are deemed to be "principles based" and this may lead to inconsistencies of application, particularly in countries without a critical mass of experienced accountants. Most accountants will have been trained to apply domestic accounting standards, and where there are options in IFRS, then it is likely that the accounting practice closest to their National GAAP will be chosen. Similarly IFRSs utilise fair value measurement extensively and market information is required to more accurately reflect the value. The nature of this market information will vary around the world. If market information is not available, an alternative source can be obtained by simulating a hypothetical market or by using mathematical modelling. Experience of such techniques will vary worldwide, and this experience will be variable in such areas as actuarial estimation, impairment testing, and valuing share based payments. The concepts set out in IFRS may be new to some accounting professionals and may be difficult to grasp.

- (b) Under current accounting practice the objective of acquisition accounting is to reflect the cost of the acquisition. To the extent to which it is not represented by identifiable assets and liabilities (measured at their fair value), goodwill arises and is reported in the financial statements. These exposure drafts adopt a different perspective and require the financial statements to reflect the fair value of the acquired business. The recognition of the acquired business at fair value will mean that any existing interest owned by the acquirer before it gained control will be remeasured at fair value at the date of acquisition with any gain or loss recognised in the profit and loss account.

The proposals treat the group as a single economic entity and any outside equity interest in a subsidiary is treated as part of the overall ownership interest in the group. As a consequence, transactions with minority shareholders are to be treated as equity transactions. No gain or loss will be recognised in the profit and loss account. Accounting for business combinations has to date been based on the "parent entity" concept where the extent of non-controlling interests and transactions with non-controlling interests are separately identified in the primary financial statements.

It is also proposed that goodwill is to be recognised in full even if control is less than 100%. FRS2 currently requires that goodwill arising on acquisition should only be recognised with respect to the part of the subsidiary undertaking that is attributable to the interest held by the parent entity.

Goodwill, after initial recognition, is to be measured at cost less impairment losses, and amortisation is not to be permitted. The ASB concluded that more useful information would be provided if goodwill was not amortised but subjected to a rigorous and operational impairment test. FRS10 "Goodwill and Intangible Assets" seeks to charge goodwill to the profit and loss account only to the extent that the carrying value of goodwill is not supported by the current value of goodwill within the acquired business.

Costs incurred in connection with an acquisition are not to be accounted for as part of the cost of the investment but will be charged in the profit and loss account. There will also be changes to the way in which some assets and liabilities acquired in a business combination are recognised and measured. The FRED requires assets and liabilities acquired to be measured and recognised at fair value at the acquisition date. Currently estimated fair values are used and guidance is given as to how to measure 'fair value' in the current standard. This guidance often results in the measurement of assets and liabilities in a manner which is inconsistent with fair value objectives.

1	(a)	Operating activities	6
		Retirement benefit	3
		Associate	3
		Subsidiary treatment	4
		Tangible fixed assets	3
		Goodwill	2
		Minority interest	3
		Taxation	3
		Dividend paid	3
		Interest	2
		River	2
		Issue of shares	1
			35
	(b)	Issues	9
	(c)	Ethical discussion	3
		River	3
			50
		AVAILABLE/MAXIMUM	50
2		Oil contracts	4
		Power station	7
		Operating leases	5
		Proposed dividend	3
		Share options	4
		Effective communication	2
			25
		AVAILABLE/MAXIMUM	25
3	(a)	Quality of discussion	2
		Statement of Principles	1
		Timing differences	1
		Gains and losses	1
		Tax consequences	1
		Incremental liability	1
			7
	(b)	Financial assets	4
		Grant	4
		Pension	4
		Investment property	4
		Adjustments	4
			20
		AVAILABLE	20
		MAXIMUM	18
			27
		AVAILABLE	27
		MAXIMUM	25
4	(a)	Subjective	18
	(b)	Subjective	7
			25
		AVAILABLE/MAXIMUM	25