May 2011 paper - Section A 20 marks

Section A – 20 marks

1.1 Answer is C

A earns $75,000 and pays more tax (17,000 / 75,000 = 23%)
B earns $44,000 and pays less tax (4,800 / 44,000 = 11%)

This is an example of progressive tax.

Progressive tax systems ó this a tax system which increases its rate of tax as the income of the taxable person increases. In the UK the income tax system is progressive as it has higher rates of tax when individuals earn more.

Regressive tax systems ó A **regressive tax** is a tax imposed in such a manner that the tax rate decreases as the amount subject to taxation increases. A tax that takes a larger percentage of the income of low-income people than of high-income people.

Proportional tax systems ó this is a tax system where the rate of tax is the same regardless of the amount it is applied to. An example of such a system is VAT in the UK.

Fixed rate tax
A tax that is set at a certain amount and does not vary according to the value of the item being taxed. For example, U.S. consumers pay a federal tax on gasoline at the pump that is levied on a per gallon basis.

1.2 Answer is B

Employers delaying payment of PAYE and being inefficient are not advantages of PAYE.

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1.3 Under the OECD model an entity will have residence **in the country of its effective management.**

The OECD Model Convention is an illustration of how to deal with double taxation and countries are encouraged to base their bilateral agreements on this. The main points are as follows:

- Specify which taxes should be included.
- **Residency** of company should be established in one of the two countries which should be based on where effective management decisions are made. **Resident of a Contracting State** means that the entity or person is liable for tax in that State in respect of income, profits or capital gains earned in that State.
- **Permanent establishment** ó õfixed place of business through which the business of an enterprise is wholly or partly carried onö.

1.4 Answer is D $11,400

Cost per unit	$15.00
Excise duty	$3.00
Total	$18.00
VAT at 15% (18 x 0.15)	$2.7
Total taxes per unit (3 + 2.7)	$5.70
Total taxes ($5.70 x 2000 units)	**$11,400**

Input VAT is calculated on cost plus excise duty.

1.5 Answer is C

Imprecise, vague tax laws and very high tax rates will encourage tax avoidance or tax evasion.

1.6 Answer is A

The depreciation reclassification from admin expenses to cost of sales requires a retrospective adjustment.

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Changing accounting policies doesnøt happen very often. IAS 8 only allows changes in accounting policies if:

- It is required by a standard, accounting setting body or statute.
- The change will result in the financial statements being more relevant and appropriate.

IAS 8 states that the following are not changes in accounting policies:

- The transaction is of a new type not encountered by the entity in the past, so a new policy is adopted.
- The accounting policy is new and relates to transactions not occurred in the past.

Retrospective application

This is when the new accounting policy is applied to all the affected transactions in the past (i.e. if the policy had always been in existence).

Retrospective application means adjusting the opening balance of equity which are affected by the change from the earliest prior period shown and the other comparative figures disclosed adjusted for the change in accounting policy as if the new accounting policy had always been applied.

The results are that:
- Opening balances are adjusted for the equity, retained earnings and other reserves.
- Comparative figures are adjusted.

B and C are changes in accounting estimates and under IAS 8 only require prospective changes (current and future periods only).

D is a new type of transaction not encountered by the entity in the past so a new policy is adopted (i.e. provisions)

1.7 Answer is D

These apply to IFRS 8 Operating Segments

(ii) A reportable segment is a component of the entity whose operating results are regularly reviewed by the entityøs chief operating decision maker in order to make decisions about resource allocations.

(iv) A reportable segment is every segment that accounts for 10% or more of the sales revenue.

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(i) The results of the segment must be prepared using the same accounting policies as are used for the financial statements.

This is incorrect, management accounts are used for the results of the segments.

(iii) Information for reportable segments is required to be prepared based on products and geographical areas.

This is incorrect; segments are determined by the internal management.

1.8 Answer is $32,000

Fair value (FV) adjustments

Property (115 ó 100) = $15,000
Plant and equipment (70-75) = ($5,000)

Total FV adjustment (15,000 ó 5,000) = $10,000

	$ø000	$ø000
Cost of investment		185
Less share of net assets acquired at fair value		
Shares	150	
Share premium	15	
Retained earnings	(22)	
Fair value adjustments	10	
Group share (x 100%)		153
Goodwill		32

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1.9 Answer is $25,900

Two ways this can be calculated

Method 1	
Group share of net assets at year end date	X
Plus goodwill (calculated as per IFRS 3)	X
Less impairment of goodwill	(X)
Investment in associate undertaking	X
Method 2	
Cost of investment in associate	X
Plus group share of post-acquisition retained reserves	X
Less impairment of goodwill	(X)
Investment in associate undertaking	X

Method 1– goodwill

Calculate the goodwill

	$ø000	$ø000
Cost of investment		25.0
Less share of net assets acquired at fair value		
Shares	50.0	
Share premium	12.5	
Retained earnings	10.0	
Group share (x 30%)	72.50	21.75
Goodwill		3.25

Net assets at year end = opening net assets + retained profit for the year
= 72,500 + 6,500 – 3,500 = 75,500

Group share of net assets at year end date (75,500 x 30%)	22,650
Plus goodwill (calculated as per IFRS 3)	3,250
Less impairment of goodwill	-
Investment in associate undertaking	25,900

Method 2	
Cost of investment in associate	25,000
Plus group share of post-acquisition retained reserves (*13,000 ó 10,000) x 30%	900
Less impairment of goodwill	-
Investment in associate undertaking	25,900

***Retained earning at year end = 10,000 + 6,500 – 3,500 = 13,000**

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1.10 Answer is $3,300

The unrealised profit on the year end inter company inventory (PUP)

Total inter-company sales $33,000
Half remain unsold at year end $16,500
PUP at 25% mark up = 16,500 x 25/125 = $3,300

Dr Consolidated cost of sales £3,300
Cr Consolidated inventory £3,300

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Section B – total 30 marks

Question 2a

(i) Corporate income tax due for ye 31/03/2011 = $57,375

Tax depreciation allowance for ye 31/03/2011

	Opening TWDV	Tax depreciation allowance rate	Tax depreciation allowance	Closing TWDV
1st year end 31/03/10	500,000	50%	250,000	250,000
2nd year end 31/03/11	250,000	25%	62,500	187,500

Depreciation = 500,000 / 5 yrs = $100,000 pa

FGøs income tax for ye 31/03/2011	$
Accounting profits	192,000
Add back depreciation	100,000
Less tax depreciation	(62,500)
Taxable profits	229,500
Tax at 25%	57,375

(ii) Deferred tax charge for ye 31/03/11 = $9,375

Year ending	TWDV	NBV	Timing difference	Tax at 25%
31/03/10	250,000	400,000	150,000	37,500
31/03/11	187,500	300,000	112,500	28,125

The deferred tax charge for year ending 31/03/11 = (37,500 ó 28,125) = $9,375

The deferred tax liability is reduced in the 2nd year
Cr Income statement tax expense $9,375
Dr Deferred taxation $9,375

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Question 2b

(i)

A **capital gain** is a profit that results from investments into a capital asset, such as stocks, bonds or non current assets, which exceeds the purchase price or carrying value. It is the difference between a higher selling price and a lower purchase price (or carrying value), resulting in a financial gain for the organisation. Conversely, a capital loss arises if the proceeds from the sale of a capital asset are less than the purchase price (or carrying value).

A **capital gains tax (CGT)** is a tax charged on capital gains, the profit realised on the sale of a non-inventory asset that was purchased at a lower price. The most common capital gains are realised from the sale of stocks, bonds, precious metals and property. Not all countries implement a capital gains tax and most have different rates of taxation for individuals and corporations.

(ii) Capital gains tax = $29,000

Net sales proceeds ó Carrying value = capital gains x tax rate = capital gains tax

	$ø000	$ø000
Sales proceeds		1,000
Tax allowable selling costs		(6)
Net sales proceeds		994
Carrying value of land		
Cost	850	
Surveyorsø fees	5	
Legal fees	8	
Site clearance	15	
Total cost	878	
Gain on disposal (994 ó 878)		116
Capital gains tax at 25%		**29**

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Question 2c

(i)

Underlying tax (ULT) is calculated on company profits used to pay a dividend. This calculation is used to work out foreign tax paid on foreign dividends received by a non-resident, which can then be used to give double taxation relief (DTR) in addition to the withholding tax (WHT) if tax laws allow, e.g. the non-resident will receive a tax credit in their own country, due to the fact that they are assessed and liable to pay tax twice on the same income received.

In the example given, SU pays a dividend out of its taxed profits; the underlying tax is the tax on its profit.

(ii) Underlying tax = $48,750

$$\text{ULT} = \frac{\text{(Dividend actually received + WHT)}}{\text{Financial profit after tax of the foreign company}} \times \text{tax paid on profits by foreign company}$$

WHT + dividends received = gross dividends

Net dividend = $156,000
Gross dividend = $156,000 / 0.8 = $195,000

ULT = $195,000 / (650,000 ó 130,000) x $130,000 = $48,750

Question 2d

Generally accepted accounting practice (GAAP)

This is the practice, which is used by countries, which incorporate their law, accounting standards and stock exchange requirements. Every country has its own GAAP. GAAP is also referred to as generally accepted accounting principles.

GAAP is changing all the time with the introduction and amendment of new accounting standards and law.

Prescriptive GAAP
This is where standards are detailed and the applications of these standards are very important as not to mislead. Less judgement is used as the guidelines are very clear. The USA has prescriptive system of GAAP

Principle-based GAAP
This system allows professional judgement to be used in cases where not enough detail is available. The spirit of the regulation is used due to the absence of exact detail. The IASBøs framework uses this system of GAAP.

Possible advantages of having principle based accounting standards:

- ✓ Principle based standard requires professional judgment to be used to ensure correct application of the standard. This will ensure the standard application cannot be avoided as it can with prescriptive based standards. Under prescriptive based, if a certain transaction or item is not included in the list, organisations can avoid showing that item in their financial statements.
- ✓ Principle based standards can be applied to all transactions, meaning the accounting standards do not require amendments, unlike prescriptive based accounting standards.
- ✓ The financial statements will be fair and accurate under principle based accounting as the spirit of the standard is followed rather than the letter of law.

Question 2e

(i)
The Framework states that the objective of financial statements is to provide information about the company to its users. Information in the financial statements shows the following:

- Financial position - shown in the balance sheet (statement of financial position)
- Financial performance - income statement (statement of comprehensive income)
- Financial adaptability - cash flow statement (statement of cash flows)

This information will be used by a wide range of users to help them with their economic decision making.

(ii)

Underlying assumptions

Accruals
Financial statements are prepared under the accrual basis. Accruals basis means that transactions are recorded in the period they occurred and not when the cash was paid or received.

The accruals concept also known as matching means that revenues and costs are matched in the period to which they relate. For example items sold (revenue) are matched with the cost of these items (cost of goods sold) to arrive at the gross profit. All businesses prepare financial statements on an accruals basis and not on a cash basis.

Going concern
Financial statements must also be prepared on the basis that the entity will continue to operate in the future and is not going to close down. This is known as the going concern basis.

Financial statements are produced on the basis that the business will continue to trade in the future and there is no sign of the business failing. Going into liquidation, or having major cutbacks indicates failure of business. The reason for going concern, is that the assets of the business are included in the balance sheet at their value to the business and not at their õbreak-up valueö

Consistency
Accounting standards are used to apply different rules to transactions. Most accounting standards give a choice as to which rule or policy to apply. The consistency concept means that whichever accounting policy is adopted it should be applied consistently.

This consistency concept is very important because it means that the financial statements over the years will be comparable and therefore more meaningful to the users.

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Question 2f

CIMA’s Code of Ethics for Professional Accountants

Qualified professional accountants must act ethically to ensure that they are not acting illegally; ensure that reporting and professional standards are being met, the professiononøs reputation is protected and that they serve the public interest.

CIMA have set out fundamental principles that members must abide by. These are:

- Integrity.
- Objectivity.
- Confidentiality.
- Professional behaviour.
- Professional competence and due care.
- Professional and technical standards.

Personal qualities of accountants

Members of the accountancy profession need to also meet certain personal qualities as well as the fundamental principles. These are outlined in the International Education Standard for Accountants published by IFAC *“Values, Ethics and Attitudes”*:

- Reliability.
- Responsibility.
- Timelines.
- Courtesy.
- Respect.

Professional qualities of an accountant

- Independence ó in mind and appearance.
- Scepticism ó question information given.
- Accountability ó for your own judgements and decisions.
- Social responsibility - to the public, employer or clients.

CX the accountant has to be objective and show integrity. This means she has to be honest in all her undertakings. If she is being asked to produce figures which are grossly overestimated, she is not being honest. She has produced figures using her own professional judgement and these figures are being ignored by the board to purely mislead the market. This is gross dishonesty.

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The possible options for CX

1. Try to persuade the board the implications of giving false information to the stock market and the impact it will have on the share price after the truth comes out.
2. Discuss the legal implications of giving false information to the stock market, as acting in this way can result in criminal proceedings.
3. Resign from her post and inform the relevant authorities if the board do not listen to her.

Section C
Question 3

Required:
Prepare MNøs statement of comprehensive income and statement of changes in equity for the year to 31 March 2011 AND a statement of financial position at that date, in a form suitable for presentation to the shareholders and in accordance with the requirements of International Financial Reporting Standards.

Notes to the financial statements are not required, but all workings must be clearly shown. Do not prepare a statement of accounting policies.
(Total for Question Three = 25 marks)

Revision - Exam technique for preparing financial statements	
Step 1	**Layout pro-forma's** For the statement of comprehensive income (income statement) and statement of financial position (balance sheet), allow for 2 whole A4 sides for each statement. For the statement of changes in equity allow 1 whole A4 side. For the statement of cash flows all 2 whole A4 sides. You can layout the pro-formaøs now or do them after you have done all the workings. The workings should start after the pro-forma. This method will ensure that all the workings are in one area of the answer book and it will be easy to add more workings as and when necessary. This will make it easier for the marker of the exam script to follow.
Step 2	**Work through the notes** On the workings page, start off by working through the additional information provided, systematically, note by note. In your answer script detail exactly what needs to be done. **It is imperative that you show all your workings!** This will involve: (i) **Identify** any relevant accounting standards / accounting principles, describing the accounting standards and explaining the treatment of the transaction. (ii) Write out the **journal entries** (iii) Show all **calculations** (iv) Detail the **destination** of transactions (i.e. income statement/balance sheet/ statement of changes in equity)

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Step 3	<u>**Additional calculations**</u> After the notes have been dealt with, do the following calculations before completing the financial statements: **(i) Depreciation** **(ii) Cost of sales** **(iii) Carrying value of tangible and intangible assets** **(iv) Taxation charge**
Step 4	<u>**Complete the financial statements**</u> Pick the figures from the trial balance and insert into the pro-forma financial statements (ensuring you tick and bash the trial balance and also incorporate the workings done during step 2 and step 3). Ensure the workings are cross referenced. Order of completion: 1 Statement of comprehensive income (income statement) 2 Statement of changes in equity 3 Statement of financial position (balance sheet)

Step 1 Layout pro-formas (see later)

Step 2 Work through the notes (all workings in $'000)

Note (i)

Opening book values of plant, property and equipment split between continuing and discontinuing operations.

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IFRS 5 revision

IFRS 5 details the treatment of assets held for sale. IFRS 5 is a new accounting standard issued by the IASB under the convergence project with US Financial Accounting Standards Board (FASB). IFRS 5 replaces the IAS 35 discontinued operations.

IFRS 5 states that assets that meet the criteria to be classified as held for sale to be measured at the **lower of carrying amount and fair value less costs to sell** Also depreciation on such assets to cease.

IFRS 5 also states that assets that meet the criteria to be classified as held for sale to be presented separately on the face of the statement of financial position and the results of discontinued operations to be presented separately in the income statement. This treatment allows users of the accounts to see the effects of the discontinued operations separately from the other activities of the organisation.

Carrying value of discontinued operations assets ($ø000)	= 250 ó 55	= 195
Carrying value of continued operations assets ($ø000)	= 2,160 ó 282	= 1,878

Note (ii)

Fair value less cost to sell of discontinued operations ($ø000) = $176

With discontinued operations, the depreciation ceases from date when trading ceased and the assets were classified as non current assets held for sale. Therefore a full yearøs depreciation will be charged on the discontinued assets. The carrying value of the discontinued assets at the year end will be compared with the fair value less costs to sell to see if there has been any impairment.

The results of the closed outlet can either be shown as a separate column in the statement of comprehensive income (meaning less information in the notes to the accounts) or as a one liner ó post tax for discontinued operations (the split of this figure will be detailed in the notes to the accounts).

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Note (iii)

Depreciation

$ø000	Continuing assets	Depreciation	Discontinued assets	Depreciation
Buildings (5% straight line)	700 x 5%	35	40 x 5%	2
Plant and equipment (20% reducing balance)	(240 ó 142) x 20%	20	(60 ó 35) x 20%	5
Total depreciation		55		7

Carrying value of continued operation assets (2,160 – 282 – 55) = 1,823

Discontinued operations

Carrying value of assets ($ø000) (250 ó 55 ó 7) = 188

Fair value less costs to sell ($'000) = 176

Impairment loss (188 ó 176) = 12

The impairment loss will go to discontinued results for the year. The discontinued assets will be shown under current assets as per IFRS 5 at the lower value of $176,000.

The net results of the discontinued operations can be established, this will be shown as a one liner (alternative method is show in columnar format).

	$ø000
Revenue	80
Cost of sales (130 + 7)	(137)
Gross loss	(57)
Admin expenses (40 + 12 ó impairment)	(52)
Distribution costs	(90)
Loss before tax	(199)
Tax credit	10
Loss for the period	**(189)**

This will be shown as a one liner in the statement of comprehensive income.

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Note (iv)

Current provision bought forward 31/03/10 ($ø000) = 76

Provision for year end ó calculated expected values.

Scenario $ø000	Probability	Cost	Expected cost
Worst	10%	190	19
Best case	15%	20	3
Most likely	75%	80	60
		Provision required	**82**
		Bal b/f	**76**
		Increase in provision	**6**

Dr Cost of sales $6,000 Cr Provision for warranty $6,000

(Show under current liabilities as the warranty is for one year).

Note (v) & (vi)

Tax charge for the income statement

	$ø000	
Tax estimate for the year (67 + 10)	77	Dr tax expense (IS), Cr tax liability (BS)
Under / over provision from previous year	0	
Less decrease in deferred tax (83-78)	(5)	Cr tax expense (IS), Dr deferred tax (BS)
Income statement charge for the year	**72**	

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Note (vii)

Accrue for interest ($ø000) ó 4% x 300 = 12

Dr Finance cost 12
Cr Interest payable (SOFP) 12

Additional workings

The items in the trial balance include the discontinued figures.

W1 Cost of good sold

	$ø000
As per trial balance	622
Less discontinued (note ii)	(130)
Add deprecation (note iii)	55
Add provision for warranty increase (note iv)	6
Total	553

All the notes have been dealt with, now prepare the financial statements

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MN: Statement of comprehensive income for year ended 31 March 2011	
Continuing operations	$ø000
Revenue (1,120 ó 80)	1,040
Cost of sales (W1)	(553)
Gross profit	487
Distribution costs (170 ó 90)	(80)
Administrative expenses (160 ó 40))	(120)
Finance costs (note vii)	(12)
Profit before tax	275
Income tax expense (note v)	(72)
Profit for the year from continuing operations	203
Loss for the period from discontinued operations (note iii)	(189)
Other comprehensive income	-
Total comprehensive income for the year	14

$ø000	Equity share capital	Share premium	Retained earnings	Total
Balances b/f	600	200	777	1,577
Total comprehensive income for the year			14	14
Dividends			(30)	(30)
Balances c/f	**600**	**200**	**761**	**1,561**

MN: Statement of comprehensive income for year ended 31 March 2011

	$ø000	$ø000
Assets		
Non-current assets		
Property, plant and equipment (note iii)		1,823
Current assets		
Inventories	65	
Trade receivables	101	
Held for sale non current asset (note ii)	176	
		342
Total assets		**2,165**
Equity and liabilities		
Share capital $1 ordinary shares	600	
Share premium account	200	
Retained earnings	761	
Total equity		1,561
Non- current liabilities		
Long term borrowings	300	
Deferred tax (note vi)	78	
		378
Current liabilities		
Trade payable	51	
Interest payable (note vii)	12	
Bank overdraft	14	
Provision for warranty (note iv)	82	
Income tax payable (note v)	67	
Total current liabilities		226
Total equity and liabilities		**2,165**

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Question 4
Required:
(a) Prepare a statement of cash flows, using the indirect method, for OP for the year ended 31 March 2011, in accordance with IAS 7 *Statement of Cash Flows*.
(19 marks)

(b) Calculate the amounts in respect of this finance lease that would be included in OPøs;

(i) Statement of comprehensive income for the year ended 31 March 2012
(ii) Statement of financial position as at 31 March 2012
(iii) Statement of cash flows for the year ended 31 March 2012

(6 marks)
(Total for Question Four = 25 marks)

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Statement of cash flows for OP for year ending 31st March 2011	**$'000**	**$'000**
Cash flow from operating activities		
Profit before taxation	1,089	
Add back Finance cost	15	
Operation profit	1,104	
Adjust for non cash and non operating		
+ Depreciation (note ii 25 + 17)	42	
+ Amortisation (note v)	15	
+ Impairment (note v)	10	
+ Loss on disposal of asset - note iv	6	
- Legal claim provisions	40	
	1,217	
Adjust for movement in working capital		
Increase in inventory (446 - 450)	4	
Increase in trade receivables (380 ó 10)	(70)	
Increase in trade payables (150 ó 95)	55	
Operating cash flow	**1,206**	
Tax paid (W1)	(280)	
Interest paid (W2)	(25)	
Dividends paid (W3)	(580)	
Net cash flow from operating activities		321
Cash flow from investing activities		
Purchase of PPE (W4)	(432)	
Sales proceeds from disposal of PPE (W4)	5	
Development expenditure (W5)	(10)	
Net cash outflow from investing activities		(437)
Cash flow from financing activities		
Issue of share capital (600 ó 300)	300	
Repayment of long term borrowings (100-250)	(150)	
Net cash inflow from financing activities		150
Net increase in cash and cash equivalents		**34**
Cash and cash equivalents at 01 September 2009		**35**
Cash and cash equivalents at 31st October 2010		**69**

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Working 1 Tax paid

Tax payable (both IT and DT)			
	$ǿ000		$ǿ000
Bal fig. = tax paid	**280**	Balance b/f (260 + 120)	380
Balance c/f (250 + 130)	380	Charge for year	280
	660		660

Working 2 Interest paid

Interest payable			
	$ǿ000		$ǿ000
Bal fig. = interest paid	**25**	Balance b/f	20
Balance c/f	10	Charge for year	15
	35		35

Working 3 Equity dividends paid

This can be established by looking at the movement in retained earnings

Retained earnings			
	$ǿ000		$ǿ000
Bal fig. = dividends paid	**580**	Balance b/f	423
Balance c/f	652	Profit for the year	809
	1,232		1,232

Working 4 PPE

PPE			
	$ǿ000		$ǿ000
Bal b/f	663	Bal c/f	977
Bal fig. additions	**432**	Depreciation (17 + 25)	42
		Revaluation loss (note iv)	65
	-	Disposal (NBV)	11
	1,095		1,095

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Disposed asset sales proceeds:

Loss on disposal = sales proceeds ó carrying value
6,000 = sales proceeds - $11,000

Therefore sales proceeds = (11,000 ó 6,000) = $5,000

Working 5 Development expenditure

Development expenditure			
	$ø000		$ø000
Bal b/f	65	Bal c/f	60
Bal fig. additions	**10**	Amortisation	15
	-		-
	75		75

(b) Finance lease

Year ending 31/03	Open. liability (1)	Interest at 12% (2)	Rental payments (3)	Capital repayment 3-2	Closing liability 1+2-3	Double entry
Year 1 (2012)	248,610	29,833	44,000	14,167	234,443	Dr Income statement 29,833 Dr SFP finance lease 14,167 Cr Cash 44,000
Year 2 (2013	234,443	28,133	44,000	15,867	218,576	Dr Income statement 28,133 Dr SFP finance lease 15,867 Cr Cash 44,000

Statement of comprehensive income for year ending 31/03/12 – extracts

Finance cost $29,833
Depreciation (248,610 / 10yrs) $24,861

Statement of financial position as at 31/03/12 – extracts

Current liability
Obligations under finance lease $15,867

Non current liability
Obligations under finance leas $218,756

Statement of cash flows for year ending 31/03/12 – extracts

Add back to cash flows from operating activities	
Depreciation	$29,833
Finance cost	$24,867
Cash flow from investing activities	
Finance lease payments	$44,000

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