SECTION A

A CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

A

1. Alternative models and practices

Most companies prepare their financial statements under the historical cost convention. In times of rising prices it has been said that without modification such financial statements can be misleading.

Required:

(a) Explain the problems that can be encountered when users rely on financial statements prepared under the historical cost convention for their information needs.

(4 marks)

Note:

Your answer should consider problems with the SOCI (income statement) and the SOFP (balance sheet).

Update has been considering the effect of alternative methods of preparing their financial statements. As an example they picked an item of plant that they acquired from Suppliers on 1 April 2003 at a cost of $250,000. The following details have been obtained:

- the company policy is to depreciate plant at 20% per annum on the reducing balance basis
- the movement in the retail price index has been:

1 April 2003	180
1 April 2004	202
1 April 2005	206
31 March 2006	216

- Suppliers' price catalogue at 31 March 2006 shows an item of similar plant at a cost of $320,000. On reading the specification it appears that the new model can produce 480 units per hour whereas the model owned by Update can only produce 420 units per hour.

The following additional information is available:

Non current assets as at 31 March 2006	Historical cost
	$
Non current assets	250,000
Less: accumulated depreciation	(122,000)
Add transfer to revaluation surplus	-
Carrying value	**128,000**

Required:

(b) Calculate for Update the depreciation charge for the plant for the year to 31 March 2006 (based on year end values) and its statement of financial position (SOFP) carrying value on that date using:

(i) a current purchasing power basis; and
(ii) a current cost basis.

(6 marks)
(10 marks)
(Adapted from June 2003)

2. Change of accounting policy and revenue recognition - Derringdo and Asifco

Derringdo sells carpets from several retail outlets. In previous years the company has undertaken responsibility for fitting the carpets in customers' premises. Customers pay for the carpets at the time they are ordered. The average length of time from a customer ordering a carpet to its fitting is 14 days. In previous years, Derringdo had not recognised a sale in income until the carpet had been successfully fitted as the rectification costs of any fitting error would be expensive. From 1 April 2002 Derringdo changed its method of trading by sub-contracting

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the fitting to approved contractors. Under this policy the sub-contractors are paid by Derringdo and they (the subcontractors) are liable for any errors made in the fitting. Because of this Derringdo is proposing to recognise sales when customers order and pay for the goods, rather than when they have been fitted.

Details of the relevant sales figures are:

	$'000
Sales made in retail outlets for the year to 31/03/2003	23,000
Sales value of carpets fitted in the 14 days to 14/04/2002	1,200
Sales value of carpets fitted in the 14 days to 14/04/2003	1,600

Note: the sales value of carpets fitted in the 14 days to 14 April 2002 are not included in the annual sales figure of $23 million, but those for the 14 days to 14 April 2003 are included.

Required:

(a) Discuss whether the above represents a change of accounting policy, and, based on your discussion, calculate the amount that you would include in sales revenue for carpets in the year to 31 March 2003

(5 marks)

(June 2003)

(b) Discuss whether the following represents a prior period error, and the correct accounting and presentation thereof.

Asifco recorded sales to Jameelco worth $50,000 on 31 December 20X6 whereas the goods were not delivered to Jameelco and were included in the inventory at 31 December 20X6. The error came to light in 20X7 after the 20X6 statements were authorised for issue. The normal gross profit rate is 20% on sales and the tax rate is 30%.

(3 marks)

(c) Would your answer be different if the statements for 20X6 were not authorised for issue?

(2 marks)

(10 marks)

3. Intangible assets and provisions - Worthright

Although it may come as a surprise to many non-accountants, the accounting profession internationally has encountered a great deal of problems in arriving at robust definitions for the 'elements' of financial statements. Defining assets, liabilities, and gains and losses (income and expenditure) has been particularly problematical. These definitions form the core of any conceptual framework that is to be used as a basis for preparing financial statements. It is also in this area that the International Accounting Standards Committee's 'Framework for the Preparation and Presentation of Financial Statements (Framework)' has come in for some criticism. It seems that the current accounting treatment of certain items does not (fully) agree with definitions in the Framework. A major objective of the Framework is to exclude from the SOFP (balance sheet) items that are neither assets nor liabilities; and to make 'off balance sheet' assets and liabilities more visible by putting them on the SOFP (balance sheet) whenever practicable.

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Required:

(a) Critically discuss the definition of assets and liabilities contained in the Framework. Your answer should explain the importance of the definitions and the relevance of each component of the definitions.

(9 marks)

(b) Below is a series of transactions or events that have arisen in relation to Worthright. The company's year-end is 31 March 2001.

(i) Worthright has entered into two contracts. The first contract entails Worthright installing and maintaining a telephone system in a building owned by Cranbourne. The installation will be completed by June 2001 and the contract will run for ten years. Worthright will receive a payment of $200,000 per annum. Worthright has installed many similar systems and it can reliably estimate that the annual cost of the contract will amount to $150,000 per annum.

In order to secure supplies, Worthright entered into a second contract agreeing to purchase 50,000 units of gas heating fuel per annum for the next five years at a price of $20 per unit. The contract, which is non-cancellable, was signed on 20 February 2001. The supply of gas will commence on 1 September 2001. Since the contract was signed there have been several large discoveries of this type of gas field and as a consequence the market price of the gas has fallen to $14 per unit. This market price is expected to prevail for the whole of the period of Worthright's contract.

(4 marks)

(ii) On 1 April 2000 Worthright purchased a new office building at a cost of $1 million. The building has an estimated life of 50 years, but it contains a sophisticated air conditioning and heating system (included in the price of the building), which will require replacement every ten years at a cost of $100,000. Worthright intends to depreciate the building at $20,000 per annum and provide a further $10,000 each year to facilitate the replacement of the heating system.

(4 marks)

(iii) Worthright is approximately half way through a three-year contract to build a sugar refinery for Sweetness. The contract contains a severe penalty clause which would require Worthright to pay Sweetness $1.5 million if the contract is not completed by its due date of 30 September 2002. Although the contract is currently on schedule, Worthright is not entirely confident that the penalty will be avoided. It therefore considers it prudent to provide for the penalty as a liability. The refinery is being constructed under local building regulations which require the builder of new properties to give a five-year warranty against defective materials and defective construction techniques. Worthright's past experience is that there are usually some warranty claims, but they are seldom of high value and in the past have been charged to the period in which they have arisen.

(4 marks)

(iv) Worthright undertakes a considerable amount of research and development work. Most of this work is done on its own behalf, but occasionally it undertakes this type of work for other companies. Before any of its own projects progress to the development stage they are assessed by an internal committee, which carefully analyses all information relating to the project. This process has led to a very good record of development projects delivering profitable results. Despite this, Worthright deems it prudent to write off immediately all research and development work, including that which it does for other companies.

(4 marks)

Required:

For the items (i) to (iv) above, discuss whether the transactions or events give rise to assets or liabilities; and describe how they should be recognised and measured under current International Accounting Standards and conventionally accepted practice.

(25 marks)
(June 2001)

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4. Qualitative characteristics of IASB's Framework - Gadget

The qualitative characteristics of relevance, reliability and comparability identified in the IASB's Framework for the preparation and presentation of financial statements (Framework) are some of the attributes that make financial information useful to the various users of financial statements.

Required:

(a) Explain what is meant by relevance, reliability and comparability and how they make financial information useful.

(9 marks)

The following transactions have taken place at Gadget during the year ended 31 March 2008:

(i) The company's accounting policy was to expense the finance costs on constructing a new manufacturing plant. The finance committee has decided to change this accounting policy to capitalise such costs.

(ii) It has rented a piece of machinery for the entire duration of its life.

(iii) Gadget's statement of comprehensive income is prepared using historical costs. It showed a loss on sales of electronic goods, but the company is aware that the value of its properties has increased far beyond the loss on sale of goods during the period.

Required:

(b) Explain how the above items should be treated in Gadget's financial statements and state on which of the framework's qualitative characteristics the treatments are based.

(6 marks)
(15 marks)
(Adapted from Pilot Paper)

5. Revenue recognition and measurement - Forest and Diamond Mines

(a) Revenue recognition - Forest

On 1 April 1997 Forest had an inventory of cut seasoning timber which had cost $12 million two years ago. Due to shortages of this quality of timber its value at 1 April 1997 had risen to $20 million. It will be a further three years before this timber is sold to a manufacturer of high-class furniture. On 1 April 1997 Forest entered into an arrangement to sell Barret Bank the timber for $15 million. Forest has an option to buy back the timber at any time within the next three years at a cost of $15 million plus accumulated interest at 2% per annum above base rate. This will be charged from the date of the original sale. The base rate for the period of the transactions is expected to be 8%. Forest intends to buy back the timber on 31 March 2000 and sell it the same day for an expected price of $25 million.

Note: ignore any storage costs and capitalisation of interest that may relate to inventories.

Required:

Assuming the above transactions take place as expected, prepare extracts to reflect the transactions in the SOCIs (income statements) for the years to 31 March 1998,1999 and 2000 and the SOFPs (balance sheets) (ignore cash) at those year ends:

(i) if Forest treated the transactions in their legal form; and
(ii) if the substance of the transactions is recorded.

Comment briefly on your answer to the above.

(11 marks)
(June 1998)

(b) Recognition and measurement - Diamond Mines

Goldmines Ltd was acquired by Diamond Mines Ltd. IFRS 3; *Business Combinations* requires that the assets and liabilities of the acquiree (Goldmines) shall be recorded at fair values in the books of the acquirer (Diamond mines).

Diamond mines management took a stand that it is only a change of identity and not an acquisition of business and hence it would not give a true and fair presentation if fair values are recorded. It has decided not to recognise the fair values but to account for the transaction as a merger (retaining the values of assets and liabilities that existed in the books of Goldmines)

Required:

Give your opinion on the stand taken by management of Diamond Mines.

(4 marks)
(15 marks)

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6. Revenue recognition - Derringdo

Derringdo sells goods supplied by Gungho. The goods are classed as A grade (perfect quality) or B grade, having slight faults. Derringdo sells the A grade goods acting as an agent for Gungho at a fixed price calculated to yield a gross profit margin of 50%. Derringdo receives a commission of 12·5% of the sales it achieves for these goods. The arrangement for B grade goods is that they are sold by Gungho to Derringdo and Derringdo sells them at a gross profit margin of 25%. The following information has been obtained from Derringdo's financial records:

	A grade $'000	B grade $'000
Inventory held on premises 01/04/2002	2,400	1,000
Goods from Gungho year to 31/03/2003	18,000	8,800
Inventory held on premises 31/03/2003	2,000	1,250

Required:

(a) Prepare the SOCI (income statement) extracts for Derringdo for the year to 31 March 2003 reflecting the above information.

(5 marks)

(b) Explain the implications that the IASB's Framework for the Preparation and Presentation of Financial Statements (Framework) and the application of substance over form have on the recognition of income. Give examples of how this may conflict with traditional practice and some accounting standards.

(5 marks)
(10 marks)
(Adapted from June 2003)