
Answers

Fundamentals Level – Skills Module, F7 (IRL)
Financial Reporting (Irish)

December 2007 Answers

1 (a) Consolidated balance sheet of Plateau as at 30 September 2007

	€'000	€'000
Fixed assets		
Goodwill (w (ii))		3,600
Tangible assets (18,400 + 10,400 – 400 (w (i)))		28,400
Investments – associate (w (iii))		10,500
– other available for sale		<u>9,000</u>
		51,500
Current assets		
Stock (6,900 + 6,200 – 300 URP (w (iv)))	12,800	
Debtors (3,200 + 1,500)	<u>4,700</u>	
	17,500	
Creditors: amounts falling due within one year (8,000 + 4,200)	<u>(12,200)</u>	5,300
Creditors: amounts falling due after more than one year		
7% Loan notes (5,000 + 1,000)		<u>(6,000)</u>
		50,800
Capital and reserves		
Equity shares of €1 each (w (v))		11,500
Reserves:		
Share premium (w (v))	7,500	
Profit and loss account (w (vi))	<u>28,650</u>	<u>36,150</u>
		47,650
Minority interest (w (vii))		<u>3,150</u>
		<u>50,800</u>

Workings (figures in brackets are in €'000)

(i) Tangible fixed assets

The transfer of the plant creates an initial unrealised profit (URP) of €500,000. This is reduced by €100,000 for each year (straight-line depreciation over five years) of depreciation in the post-acquisition period. Thus at 30 September 2007 the net unrealised profit is €400,000. This should be eliminated from Plateau's retained profits and from the carrying amount of the plant. The fall in the fair value of the land has already been taken into account in Savannah's balance sheet.

(ii) Goodwill in Savannah:

Investment at cost:	€'000	€'000
Shares issued (3,000/2 x €6)		9,000
Cash (3,000 x €1)		<u>3,000</u>
		12,000
Less – equity shares of Savannah	(3,000)	
– pre-acquisition reserves (6,000 x 75% (see below))	<u>(4,500)</u>	<u>(7,500)</u>
Goodwill on consolidation		<u>4,500</u>

Goodwill is amortised over a five year life giving a charge of €900,000 and a carrying amount at 30 September 2007 of €3.6 million.

Savannah's pre-acquisition reserves of €6.5 million require an adjustment for a write down of €500,000 in respect of the fair value of its land being below its carrying amount. Thus the adjusted pre-acquisition reserves of Savannah are €6 million. A consequent effect is that the post-acquisition reserves which are reported as €2.4 million in Savannah's balance sheet will become €2.9 million. This is because the fall in the value of the land has effectively been treated by Savannah as a post-acquisition loss.

(iii) Axle

Cost (4,000 x 30% x €7.50)	€'000	
		9,000
Share of net assets at acquisition (30% x (20,000 – 5,000))	<u>(4,500)</u>	
Goodwill (not amortised or impaired)		<u>4,500</u>
Carrying amount of Axle at 30 September 2007		
Cost		9,000
Share post-acquisition profit (5,000 x 30%)		<u>1,500</u>
		<u>10,500</u>

- (iv) The unrealised profit (URP) in stock is calculated as:
Intra-group sales are €2.7 million on which Savannah made a profit of €900,000 (2,700 x 50/150). One third of these are still in the stock of Plateau, thus there is an unrealised profit of €300,000.
- (v) The 1.5 million shares issued by Plateau in the share exchange at a value of €6 each would be recorded as €1 per share as capital and €5 per share as share premium giving an increase in share capital of €1.5 million and a share premium of €7.5 million.

(vi) Consolidated profit and loss:	€'000
Plateau's profit and loss	24,000
Savannah's post-acquisition ((2,900 – 300 URP) x 75%)	1,950
Axle's post-acquisition profits (5,000 x 30%)	1,500
URP in plant (see (i))	(400)
Gain on available-for-sale investment (9,000 – 6,500) see below	2,500
Goodwill amortisation – Savannah	(900)
	<u>28,650</u>

The gain on available-for-sale investments must be recognised directly in equity.

- (vii) Minority interest
Adjusted equity at 30 September 2007: (12,900 – 300 URP) = 12,600 x 25% 3,150

- (b) FRS 7 *Fair Values in Acquisition Accounting* requires the purchase consideration for an acquired entity to be allocated to the fair value of the net assets acquired with any residue being allocated to goodwill. This also means that those net assets will be recorded at fair value in the consolidated balance sheet. This is entirely consistent with the way other net assets are recorded when first transacted (i.e. the initial cost of an asset is normally its fair value). The purpose of this process is that it ensures that individual assets and liabilities are correctly classified (and valued) in the consolidated balance sheet. Whilst this may sound obvious, consider what would happen if say a property had a carrying amount of €5 million, but a fair value of €7 million at the date it was acquired. If the carrying amount rather than the fair value was used in the consolidation it would mean that tangible assets (property) would be understated by €2 million and intangible assets (goodwill) would be overstated by the same amount (note: in the consolidated balance sheet of Plateau the opposite effect would occur as the fair value of Savannah's land is below its carrying amount at the date of acquisition). There could also be a 'knock on' effect with incorrect depreciation/amortisation charges for both property and goodwill. Thus the use of carrying amounts rather than fair values would not give a 'true and fair view' as required by the *Statement of Principles for Financial Reporting*.

The assistant's comment regarding the inconsistency of value models in the consolidated balance sheet is a fair point, but it is really a deficiency of the historical cost concept rather than a flawed consolidation technique. Indeed the fair values of the subsidiary's net assets are the historical costs to the parent. To overcome much of the inconsistency, there would be nothing to prevent the parent company from applying the revaluation model to its tangible fixed assets.

2 (a) Llama – Profit and loss account – Year ended 30 September 2007

	€'000	€'000
Turnover		180,400
Cost of sales (w (i))		<u>(81,700)</u>
Gross profit		98,700
Distribution costs (11,000 + 1,000 depreciation)	(12,000)	
Administrative expenses (12,500 + 1,000 depreciation)	<u>(13,500)</u>	(25,500)
Investment income	2,200	
Gain on fair value of investments (27,100 – 26,500)	<u>600</u>	2,800
Finance costs (w (ii))		<u>(2,400)</u>
Profit before tax		73,600
Corporation tax expense (18,700 – 400 – (11,200 – 10,000) deferred tax)		<u>(17,100)</u>
Profit for the period		<u>56,500</u>

(b) Llama – Balance sheet as at 30 September 2007

	€'000	€'000
Fixed assets		
Land and buildings (w (iv))		122,000
Plant and equipment (w (iv))		106,500
Investments at fair value through profit and loss		<u>27,100</u>
		255,600
Current assets		
Stock	37,900	
Trade debtors	<u>35,100</u>	
	73,000	
Creditors: amounts falling due within one year		
Bank overdraft	6,600	
Trade creditors	34,700	
Corporation tax	<u>18,700</u>	
	(60,000)	
Net current assets		13,000
Creditors: amounts falling due after more than one year		
2% loan note (80,000 + 1,600 (w (ii)))		(81,600)
Provisions for liabilities		
Deferred tax (40,000 x 25%)		<u>(10,000)</u>
		<u>177,000</u>
Capital and reserves		
Equity shares of 50 cent each ((60,000 + 15,000) w (iii))		75,000
Reserves:		
Share premium (w (iii))	9,000	
Revaluation (14,000 – 3,000 (w (iv)))	11,000	
Profit and loss account (56,500 + 25,500)	<u>82,000</u>	102,000
		<u>177,000</u>

Workings (monetary figures in brackets are in €'000)

(i) Cost of sales:	€'000	
Per question	89,200	
Plant capitalised (w (iv))	(24,000)	
Depreciation (w (iv)) – buildings	3,000	
– plant	<u>13,500</u>	
	81,700	

(ii) The loan has been in issue for six months. The total finance charge should be based on the effective interest rate of 6%. This gives a charge of €2.4 million (80,000 x 6% x 6/12). As the actual interest paid is €800,000 an accrual (added to the carrying amount of the loan) of €1.6 million is required.

(iii) The rights issue was 30 million shares (60 million/50 cent is 120 million shares at 1 for 4) at a price of 80 cent this would increase share capital by €15 million (30 million x 50 cent) and share premium by €9 million (30 million x 30 cent).

(iv) Fixed assets/depreciation:

Land and buildings:

On 1 October 2006 the value of the buildings was €100 million (130,000 – 30,000 land). The remaining life at this date was 20 years, thus the annual depreciation charge will be €5 million (3,000 to cost of sales and 1,000 each to distribution and administration). Prior to the revaluation at 30 September 2007 the carrying amount of the building was €95 million (100,000 – 5,000). With a revalued amount of €92 million, this gives a revaluation deficit of €3 million which should be debited to the revaluation reserve. The carrying amount of land and buildings at 30 September 2007 will be €122 million (92,000 buildings + 30,000 land (unchanged)).

Plant

The existing plant will be depreciated by €12 million ((128,000 – 32,000) x 12¹/₂%) and have a carrying amount of €84 million at 30 September 2007.

The plant manufactured for internal use should be capitalised at €24 million (6,000 + 4,000 + 8,000 + 6,000).

Depreciation on this will be €1.5 million (24,000 x 12¹/₂% x 6/12). This will give a carrying amount of €22.5 million at 30 September 2007. Thus total depreciation for plant is €13.5 million with a carrying amount of €106.5 million (84,000 + 22,500).

(c) Earnings per share (eps) for the year ended 30 September 2007

Theoretical ex rights value			€
Holding (say)	100	at €1	100
Issue (1 for 4)	<u>25</u>	at 80 cent	<u>20</u>
New holding	<u>125</u>	ex rights price is 96 cent	<u>120</u>
Weighted average number of shares			
120,000,000	x 9/12 x 100/96		93,750,000
150,000,000 (120 x 5/4)	x 3/12		<u>37,500,000</u>
			<u>131,250,000</u>

Earnings per share (€56,500,000/131,250,000) 43 cent

3 (a) Note: figures in the calculations of the ratios are in €million

	2007	workings	2006	2007 re Fatima (b)
Return on year end capital employed	11.2 %	$24/(114 + 100) \times 100$	7.1%	18.9%
Net asset turnover	1.2 times	250/214	1.6	0.6
Gross profit margin (given in question)	20%		16.7%	42.9%
Net profit (before tax) margin	6.4%	16/250	4.4%	31.4%
Current ratio	0.9:1	38/44	2.5	
Closing stock holding period	46 days	$25/200 \times 365$	37	
Debtors' collection period	19 days	$13/250 \times 365$	16	
Creditors' payment period	42 days	$23/200 \times 365$	32	
Gearing	46.7%	$100/214 \times 100$	nil	

The gross profit margins and relevant ratios for 2006 are given in the question, and some additional ratios for Fatima are included above to enable a clearer analysis in answering part (b) (references to Fatima should be taken to mean Fatima's net assets).

(b) Analysis of the comparative financial performance and position of Harbin for the year ended 30 September 2007. Note: references to 2007 and 2006 should be taken as the years ended 30 September 2007 and 2006.

Introduction

The figures relating to the comparative performance of Harbin 'highlighted' in the Chief Executive's report may be factually correct, but they take a rather biased and one dimensional view. They focus entirely on the performance as reflected in the profit and loss account without reference to other measures of performance (notably the ROCE); nor is there any reference to the purchase of Fatima at the beginning of the year which has had a favourable effect on profit for 2007. Due to this purchase, it is not consistent to compare Harbin's profit and loss account results in 2007 directly with those of 2006 because it does not match like with like. Immediately before the €100 million purchase of Fatima, the carrying amount of the net assets of Harbin was €112 million. Thus the investment represented an increase of nearly 90% of Harbin's existing capital employed. The following analysis of performance will consider the position as shown in the reported financial statements (based on the ratios required by part (a) of the question) and then go on to consider the impact the purchase has had on this analysis.

Profitability

The ROCE is often considered to be the primary measure of operating performance, because it relates the profit made by an entity (return) to the capital (or net assets) invested in generating those profits. On this basis the ROCE in 2007 of 11.2% represents a 58% improvement (i.e. 4.1% on 7.1%) on the ROCE of 7.1% in 2006. Given there were no disposals of fixed assets, the ROCE on Fatima's net assets is 18.9% ($22\text{m}/100\text{m} + 16.5\text{m}$). Note: the net assets of Fatima at the year end would have increased by profit after tax of €16.5 million (i.e. $22\text{m} \times 75\%$ (at a tax rate of 25%)). Put another way, without the contribution of €22 million to profit before tax, Harbin's 'pre tax' profit would have been a **loss** of €6 million which would give a negative ROCE. The principal reasons for the beneficial impact of Fatima's purchase is that its profit margins at 42.9% gross and 31.4% net (before tax) are far superior to the profit margins of the combined business at 20% and 6.4% respectively. It should be observed that the other contributing factor to the ROCE is the net asset turnover and in this respect Fatima's is actually inferior at 0.6 times ($70\text{m}/116.5\text{m}$) to that of the combined business of 1.2 times.

It could be argued that the finance costs should be allocated against Fatima's results as the proceeds of the loan note appear to be the funding for the purchase of Fatima. Even if this is accepted, Fatima's results still far exceed those of the existing business.

Thus the Chief Executive's report, already criticised for focussing on the profit and loss account alone, is still highly misleading. Without the purchase of Fatima, underlying turnover would be flat at €180 million and the gross margin would be down to 11.1% ($20\text{m}/180\text{m}$) from 16.7% resulting in a loss before tax of €6 million. This sales performance is particularly poor given it is likely that there must have been an increase in spending on tangible fixed assets beyond that related to the purchase of Fatima's net assets as the increase in tangible fixed assets is €120 million (after depreciation).

Liquidity

The company's liquidity position as measured by the current ratio has deteriorated dramatically during the period. A relatively healthy 2.5:1 is now only 0.9:1 which is rather less than what one would expect from the quick ratio (which excludes stock) and is a matter of serious concern. A consideration of the component elements of the current ratio suggests that increases in the stock holding period and creditors' payment period have largely offset each other. There is a small increase in the collection period for debtors (up from 16 days to 19 days) which would actually improve the current ratio. This ratio appears unrealistically low, it is very difficult to collect credit sales so quickly and may be indicative of factoring some of the debtors or a proportion of the sales being cash sales. Factoring is sometimes seen as a consequence of declining liquidity, although if this assumption is correct it does also appear to have been present in the previous year. The changes in the above three ratios do not explain the dramatic deterioration in the current ratio, the real culprit is the cash position, Harbin has gone from having a bank balance of €14 million in 2006 to an overdraft of €17 million in 2007.

A cash flow statement would give a better appreciation of the movement in the cash position.

It is not possible to assess, in isolation, the impact of the purchase of Fatima on the liquidity of the company.

Dividends

A dividend of 10 cent per share in 2007 amounts to €10 million (100m x 10 cent), thus the dividend in 2006 would have been €8 million (the dividend in 2007 is 25% up on 2006). It may be that the increase in the reported profits led the Board to pay a 25% increased dividend, but the dividend cover is only 1.2 times (12m/10m) in 2007 which is very low. In 2006 the cover was only 0.75 times (6m/8m) meaning previous years' reserves were used to facilitate the dividend. The low profit and loss reserve indicates that Harbin has historically paid a high proportion of its profits as dividends, however in times of declining liquidity, it is difficult to justify such high dividends.

Gearing

The company has gone from a position of nil gearing (i.e. no long-term borrowings) in 2006 to a relatively high gearing of 46.7% in 2007. This has been caused by the issue of the €100 million 8% loan note which would appear to be the source of the funding for the €100 million purchase of Fatima's net assets. At the time the loan note was issued, Harbin's ROCE was 7.1%, slightly less than the finance cost of the loan note. In 2007 the ROCE has increased to 11.2%, thus the manner of the funding has had a beneficial effect on the returns to the equity holders of Harbin. However, it should be noted that high gearing does not come without risk; any future downturn in the results of Harbin would expose the equity holders to much lower proportionate returns and continued poor liquidity may mean payment of the loan interest could present a problem. Harbin's gearing and liquidity position would have looked far better had some of the acquisition been funded by an issue of equity shares.

Conclusion

There is no doubt that the purchase of Fatima has been a great success and appears to have been a wise move on the part of the management of Harbin. However, it has disguised a serious deterioration of the underlying performance and position of Harbin's existing activities which the Chief Executive's report may be trying to hide. It may be that the acquisition was part of an overall plan to diversify out of what has become existing loss making activities. If such a transition can continue, then the worrying aspects of poor liquidity and high gearing may be overcome.

4 (a) Faithful representation

The *Statement of Principles for Financial Reporting* (Statement) states that in order to be useful, information must be reliable and the two main components of reliability are freedom from material error and faithful representation. The Statement describes faithful representation as where the financial statements (or other information) have the characteristic that they faithfully represent the transactions and other events that have occurred. Thus a balance sheet should faithfully represent transactions that result in assets, liabilities and equity of an entity. This is a component part of showing a true and fair view. An essential element of faithful representation is the application of the concept of substance over form. There are many examples where recording the legal form of a transaction does not convey its real substance or commercial reality. For example an entity may sell some stock to a finance house and later buy it back at a price based on the original selling price plus a finance cost. Such a transaction is really a secured loan attracting interest costs. To portray it as a sale and subsequent repurchase of stock would not be a faithful representation of the transaction. The 'sale' would probably create a 'profit', there would be no finance cost in the profit and loss account and the balance sheet would not show the asset of stock or the liability to the finance house – all of which would not be representative of the economic reality. A further example is that an entity may issue loan notes that are (optionally) convertible to equity. In the past, sometimes management has argued that as they expect the loan note holders to take the equity option, the loan notes should be treated as equity (which of course would flatter the entity's gearing). In some cases transactions similar to the above, particularly off balance sheet finance schemes, have been deliberately entered into to manipulate the balance sheet and profit and loss account (so called creative accounting). Ratios such as return on capital employed (ROCE), asset turnover, interest cover and gearing are often used to assess the performance of an entity. If these ratios were calculated from financial statements that have been manipulated, they would be distorted (usually favourably) from the underlying substance. Clearly users cannot rely on such financial statements or any ratios calculated from them.

- (b) (i) The finance director's comment that the ROCE would improve, based on the agreement being classified as an operating lease is correct (but see below). Over the life of the lease the reported profit is not affected by the lease being designated as an operating or finance lease, but the balance sheet is. This is because the depreciation and finance costs charged

on a finance lease would equal (over the full life of the lease) what would be charged as lease rentals if it were classed as an operating lease instead. However, classed as an operating lease, there would not be a leased asset or lease obligation recorded in the balance sheet; whereas there would be if it were a finance lease or an outright purchase. Thus capital employed under an operating lease would be lower leading to a higher (more favourable) ROCE. SSAP 21 *Accounting for Leases and Hire Purchase Contracts* defines a finance lease as one which transfers to the lessee substantially all the risks and rewards incidental to ownership (an application of the principle of substance over form). In this case, as the asset will be used by Fino for four years (its entire useful life) and then be scrapped, it is almost certain to require classification as a finance lease. Thus the finance director's comments are unlikely to be valid.

Fino

(ii) (1)	Operating lease	€
	Profit and loss account – cost of sales (machine rental) (100,000 x 6/12)	50,000
	Balance sheet	
	Current assets	
	Prepayment (100,000 x 6/12)	50,000
(2)	Finance lease	
	Profit and loss account – cost of sales (depreciation) (350,000/4 x 6/12)	43,750
	– finance costs (see working)	12,500
	Balance sheet	
	Fixed assets	
	Leased plant at cost	350,000
	Depreciation (from above)	(43,750)
		<u>306,250</u>
	Creditors: amounts falling due within one year	
	Accrued interest (see working)	12,500
	Lease obligation (100,000 – 25,000 see below)	75,000
		<u>87,500</u>
	Creditors: amounts falling due after more than one year	
	Lease obligation (250,000 – 75,000)	175,000
	Working:	
	Cost	350,000
	Deposit	(100,000)
		<u>250,000</u>
	Interest to 30 September 2007 (6 months at 10%)	12,500
	Total obligation at 30 September 2007	<u>262,500</u>

The payment of €100,000 on 1 April 2008 will contain €25,000 of interest (€250,000 x 10%) and a capital repayment of €75,000.

- 5 (a)** The Statement of Principles defines assets as 'rights or other access to future economic benefits controlled by an entity as a result of past transactions or events'. However assets can only be recognised (on the balance sheet) when those expected benefits are probable and can be measured reliably. The Statement of Principles recognises that there is a close relationship between incurring expenditure and generating assets, but they do not necessarily coincide. Development expenditure, perhaps more than any other form of expenditure, is a classic example of the relationship between expenditure and creating an asset. Clearly entities commit to expenditure on both research and development in the hope that it will lead to a profitable product, process or service, but at the time that the expenditure is being incurred, entities cannot be certain (or it may not even be probable) that the project will be successful. Relating this to accounting concepts would mean that if there is doubt that a project will be successful the application of prudence would dictate that the expenditure is charged (expensed) to the profit and loss account. At the stage where management becomes confident that the project will be successful, it meets the definition of an asset and the accruals/matching concept would mean that it should be capitalised (treated as an asset) and amortised over the period of the expected benefits. Accounting Standards (SSAP 13 *Accounting for Research and Development*) interpret this as writing off all research expenditure and having the choice to capitalise development costs from the point in time where they meet strict conditions which effectively mean the expenditure meets the definition of an asset.

(b)	30 September 2007	30 September 2006
Emerald Profit and loss account:	€'000	€'000
Amortisation of development expenditure	335 (w (ii))	135 (w (i))
Balance sheet		
Development expenditure	1,195 (w (iv))	1,130 (w (iii))
Statement of total recognised gains and losses		
Prior period adjustment (credit)	1,130	

Workings (All figures in €'000. Note: references to 2004, 2005 etc should be taken as for the year ended 30 September 2004 and 2005 etc.)

Year	2004	2005	2006	cumulative 2006	2007	cumulative 2007
Expenditure	<u>300</u>	<u>240</u>	<u>800</u>	<u>1,340</u>	<u>400</u>	<u>1,740</u>
Amortisation (25%)	nil	(75)	(75)	(150)	(75)	(225)
	nil	nil	(60)	(60)	(60)	(120)
	nil	nil	nil	nil	(200)	(200)
Total amortisation	<u>nil</u>	<u>(75)</u>	(w (i)) <u>(135)</u>	<u>(210)</u>	(w (ii)) <u>(335)</u>	<u>(545)</u>
Carrying amount	<u>300</u>	<u>165</u>	<u>665</u>	(w (iii)) <u>1,130</u>	<u>65</u>	(w (iv)) <u>1,195</u>

This marking scheme is given as a guide in the context of the suggested answers. Scope is given to markers to award marks for alternative approaches to a question, including relevant comment, and where well-reasoned conclusions are provided. This is particularly the case for written answers where there may be more than one acceptable solution.

		<i>Marks</i>
1	(a) Balance sheet:	
	goodwill	4
	tangible fixed assets	2
	investments – associate	2
	– other	1
	current assets	2
	creditors due within one year	1
	7% loan notes	1
	equity shares	1
	share premium	1
	profit and loss account	4
	minority interest	1
		20
	(b) 1 mark per relevant point	5
	Total for question	25
2	(a) Profit and loss account	
	turnover	$\frac{1}{2}$
	cost of sales	$3\frac{1}{2}$
	distribution costs and administrative expenses	1
	investment income and gain on investment	$1\frac{1}{2}$
	finance costs	1
	tax	$1\frac{1}{2}$
		9
	(b) Balance sheet	
	land and buildings	$1\frac{1}{2}$
	plant and equipment	$1\frac{1}{2}$
	investments	1
	current assets	1
	overdraft and trade creditors	1
	corporation tax provision	$\frac{1}{2}$
	2% loan notes	$1\frac{1}{2}$
	deferred tax	1
	equity shares	1
	share premium	1
	revaluation reserve	1
	profit and loss account	1
		13
	(c) Earnings per share	
	calculation of theoretical ex rights value	1
	weighted average number of shares	1
	earnings and calculation of eps	1
		3
	Total for question	25
3	(a) one mark per required ratio	8
	(b) for consideration of Chief Executive’s report	3
	impact of purchase	6
	remaining issues 1 mark per valid point	8
		17
	Total for question	25

			<i>Marks</i>
4	(a) one mark per valid point to	maximum	5
	(b) (i) one mark per valid point to	maximum	4
	(ii) (1) operating lease – profit and loss account charge		1
	– prepayment		1
			2
	(2) finance lease – profit and loss account: depreciation and finance costs		1
	– balance sheet: fixed asset		1
	current liabilities interest and capital		1
	long-term liabilities		1
			4
		Total for question	15
5	(a) one mark per valid point to	maximum	4
	(b) profit and loss account amortisation		1½
	cost in balance sheets		1
	accumulated amortisation		1½
	prior year adjustment in STRGL		2
			6
		Total for question	10