Answers

1 (a) Cost of control in Sardonic:

	€'000	€'000
Consideration		
Shares (18,000 x 2/3 x €5.75)		69,000
Deferred payment (18,000 x 2.42/1.21 (see below))		36,000
		105,000
Less		
Equity shares	24,000	
Pre-acquisition reserves:		
At 1 April 2007	69,000	
To date of acquisition (13,500 x 4/12)	4,500	
Fair value adjustments (4,100 + 2,400)	6,500	
	104,000 x 75%	(78,000)
Goodwill		27,000

€1 compounded for two years at 10% would be worth €1·21.
The acquisition of 18 million out of a total of 24 million equity shares is a 75% interest.

(b) Patronic Group

Consolidated profit and loss account for the year ended 31 March 2008

	€'000	€'000
Turnover (150,000 + (78,000 x 8/12) – (1,250 x 8 months intra group))		192,000
Cost of sales (w (i))		(119,100)
Gross profit		72,900
Distribution costs (7,400 + (3,000 x 8/12))		(9,400)
Administrative expenses (12,500 + (6,000 x 8/12))		(16,500)
Amortisation of goodwill (27,000/9 years x 8/12)		(2,000)
Operating profit		45,000
Finance costs (w (ii))		(5,000)
Share of profit from associate (10,000 x 30%)		3,000
Profit before tax		43,000
Tax – group (10,400 + (3,600 x 8/12))	(12,800)	
– associate (4,000 x 30%)	(1,200)	(14,000)
Profit after tax		29,000
Minority interest (w (iii))		(2,100)
Profit for the year		26,900

(c) An associate is defined by FRS 9 *Associates and Joint Ventures* as an investment over which an investor has significant influence. There are several indicators of significant influence, but the most important are usually considered to be a holding of 20% or more of the voting shares and board representation. Therefore it was reasonable to assume that the investment in Acerbic (at 31 March 2008) represented an associate and was correctly accounted for under the equity accounting method.

The current position (from May 2008) is that although Patronic still owns 30% of Acerbic's shares, Acerbic has become a subsidiary of Spekulate as it has acquired 60% of Acerbic's shares. Acerbic is now under the **control** of Spekulate (part of the definition of being a subsidiary), therefore it is difficult to see how Patronic can now exert significant influence over Acerbic. The fact that Patronic has lost its seat on Acerbic's board seems to reinforce this point. In these circumstances the investment in Acerbic falls to be treated under FRS 26 *Financial Instruments: Recognition and Measurement*. It will cease to be equity accounted from the date of loss of significant influence. Its carrying amount at that date will be its initial recognition value under FRS 26 and thereafter it will be carried at fair value.

Workings

(i) Cost of sales

	€'000	€'000
Patronic		94,000
Sardonic (51,000 x 8/12)		34,000
Intra group purchases (1,250 x 8 months)		(10,000)
Additional depreciation: plant (2,400/ 4 years x 8/12)	400	
property (per question)	200	600
Unrealised profit in stock (3,000 x 20/120)		500
		119,100

Note: for both sales and cost of sales, only the post acquisition intra group trading should be eliminated.

(ii)	Finance costs	€'000
	Patronic per question	2,000
	Unwinding interest – deferred consideration (36,000 x 10% x 8/12)	2,400
	Sardonic (900 x 8/12)	600
		5,000
(iii)	Minority interest	
	Sardonic's post acquisition profit (13,500 x 8/12)	9,000
	Less post acquisition additional depreciation (w (i))	(600)
		8,400
		x 25% = 2,100

2 (a)

	€'000	€'000
Profit for period per question		96,700
Dividends paid (w (i))		15,500
Draft profit for year ended 31 March 2008		112,200
Discovery of fraud (w (ii))		(2,500)
Goods on sale or return (w (iii))		(600)
Depreciation (w (iv)) – buildings (165,000/15 years)	11,000	
– plant (180,500 x 20%)	36,100	(47,100)
Increase in investments ((12,500 x 1,296/1,200) – 12,500)		1,000
Provision for corporation tax		(11,400)
Increase in deferred tax (w (v))		(800)
Recalculated profit for year ended 31 March 2008		50,800

(b) Dexon – statement of the movement in share capital and reserves – Year ended 31 March 2008

	Ordinary shares €'000	Share premium €'000	Revaluation reserve €'000	Profit and loss account €'000	Total €'000
At 1 April 2007	200,000	30,000	18,000	12,300	260,300
Prior period adjustment (w (ii))				(1,500)	(1,500)
Restated earnings at 1 April 2007				10,800	
Revaluation of property (w (iv))			4,800		4,800
Rights issue (see below)	50,000	10,000			60,000
Profit for period (from (a))				50,800	50,800
Dividends paid (w (i))				(15,500)	(15,500)
At 31 March 2008	250,000	40,000	22,800	46,100	358,900

Rights issue: 250 million shares in issue **after** a rights issue of one for four would mean that 50 million shares were issued (250,000 x 1/5). As the issue price was €1·20, this would create €50 million of share capital and €10 million of share premium.

(c) Dexon – Balance sheet as at 31 March 2008:

	€'000	€'000
Fixed assets		
Property (w (iv))		180,000
Plant (180,500 – 36,100 depreciation see (a))		144,400
Investments at fair value through profit and loss (12,500 + 1,000 see (a))		13,500
		337,900
Current assets		
Stock (84,000 + 2,000 (w (iii)))	86,000	
Debtors (52,200 – 4,000 – 2,600 (w (ii) and (iii)))	45,600	
Bank	3,800	
	135,400	
Creditors: amounts falling due within one year (81,800 + 11,400 tax)	(93,200)	
Net current assets		42,200
Provision for liabilities		
Deferred tax (19,200 + 2,000 (w (v)))		(21,200)
		358,900
Share capital and reserves (from (b))		
Ordinary shares of €1each		250,000
Share premium	40,000	
Revaluation reserve	22,800	
Profit and loss account	46,100	108,900
		358,900

Workings (figures in brackets in €'000)

(i) Dividends paid
The dividend in May 2007 would be €8 million (200 million shares at 4 cent) and in November 2007 would be €7·5 million (250 million shares x 3 cent). Total dividends would therefore have been €15·5 million.

(ii) The discovery of the fraud means that €4 million should be written off debtors. €1·5 million is debited to the profit and loss account reserve as a prior period adjustment (in the statement of recognised gains and losses and shown here in the statement of the movements in share capital and reserves above) and €2·5 is written off in the profit and loss account for the year ended 31 March 2008.

(iii) Goods on sale or return
The sales over which customers still have the right of return should not be included in Dexon's turnover. The reversing effect is to reduce the relevant debtors by €2·6 million, increase stock by €2 million (the cost of the goods (2,600 x 100/130)) and reduce the profit and loss account for the year by the profit of €600,000.

(iv) Property
The carrying amount of the property (after the year's depreciation) is €174 million (185,000 – 11,000). A valuation of €180 million would create a revaluation surplus of €6 million of which €1·2 million (6,000 x 20%) would be transferred to deferred tax as the liability is likely to arise in the near future.

(v) Deferred tax
An increase in the timing differences of €10 million would create a transfer (credit) to deferred tax of €2 million (10,000 x 20%). Of this €1·2 million relates to the revaluation of the property and is debited to the revaluation reserve. The balance, €800,000, is charged to the profit and loss account.

3 (a) Cash flow statement of Pinto for the Year ended 31 March 2008:

Reconciliation of operating profit to net cash inflow from operating activities

	€'000	€'000
Operating profit		430
Adjustments for:		
Redemption penalty costs included in administrative expenses		20
Depreciation charges	280	
Loss on sale of tangible fixed assets	90	370
Working capital adjustments		
Increase in stock (1,210 – 810)	(400)	
Decrease in debtors (540 – 480)	60	
Increase in warranty provision (200 – 100)	100	
Increase in creditors (1,410 – 1,050)	360	120
Net cash inflow from operating activities		940

Cash Flow Statement

Net cash inflow from operating activities	940
Returns on investments and servicing of finance (note 1)	(10)
Tax refund (w (i))	60
Capital expenditure (note 1)	(1,290)
Equity dividends paid (1,000 x 5 x 3 cent)	(150)
Cash outflow before financing	(450)
Financing (note 1)	580
Increase in cash (120 + 10)	130

Note 1 Gross cash flows

Returns on investment and servicing of finance		
Investment income received (60 – 20 gain on investment property)	40	
Finance costs paid	(50)	(10)
Capital expenditure		
Purchase of tangible fixed assets (w (ii))	(1,440)	
Sale of tangible fixed assets (240 – 90)	150	(1,290)
Financing		
Proceeds from issue of equity shares (400 + 600)	1,000	
Redemption of loan notes (400 plus 20 penalty)	(420)	580

Workings (in €'000)

(i) Tax:

tax asset b/f	50
deferred tax b/f	(30)
profit and loss account charge	(160)
tax provision c/f	150
deferred tax c/f	50
difference is cash received	60

(ii) Tangible fixed assets:

carrying amount b/f	1,860
revaluation	100
depreciation for period	(280)
disposal	(240)
carrying amount c/f	(2,880)
difference is cash acquisitions	(1,440)

(b) Comments on the cash management of Pinto

Operating cash flows:

Pinto's operating cash inflows at €940,000 are considerably higher than operating profit of €430,000. This shows a satisfactory cash generating ability and is more than sufficient to cover finance costs, taxation (see later) and dividends. The major reasons for the cash flows being higher than the operating profit are due to the (non-cash) increases in the depreciation and warranty provisions. Working capital changes are relatively neutral; a large increase in stock appears to be being financed

by a substantial increase in creditors and a modest reduction in debtors. The reduction in debtors is perhaps surprising as other indicators point to an increase in operating capacity which has not been matched with an increase in debtors. This could be indicative of good control over the cash management of the debtors (or a disappointing sales performance).

An unusual feature of the cash flow is that Pinto has received a tax refund of €60,000 during the current year. This would indicate that in the previous year Pinto was making losses (hence obtaining tax relief). Whilst the current year's profit performance is an obvious improvement, it should be noted that next year's cash flows are likely to suffer a tax payment (estimated at €150,000 in the balance sheet at 31 March 2008) as a consequence. In any forward planning, Pinto should be aware that the tax reversal position will create an estimated total incremental outflow of €210,000 in the next period.

Capital expenditure:
There has been a dramatic investment/increase in tangible fixed assets. Their carrying amount at 31 March 2008 is substantially higher than a year earlier (admittedly €100,000 is due to revaluation rather than a purchase). It is difficult to be sure whether this represents an increase in operating capacity or is the replacement of assets disposed of. However, the net expenditure of €1,290,000 is much higher than the depreciation of the tangible fixed assets and, coupled with the (apparent) overall improvement in profit position, it seems likely that there has been a successful increase in capacity. It is not unusual for there to be a time lag before increased investment reaches its full beneficial effect and in this context it could be speculated that the investment occurred early in the accounting year (because its effect is already making an impact) and that future periods may show even greater improvements.

The investment property is showing a good return which is composed of rental income (presumably) of €40,000 and a valuation gain of €20,000.

Financing:
It would appear that Pinto's financial structure has changed during the year. Debt of €400,000 has been redeemed (for €420,000) and there has been a share issue raising €1 million. The company is now nil geared compared to modest gearing at the end of the previous year. The share issue has covered the cost of redemption and contributed to the investment in tangible fixed assets. The remainder of the finance has come from the very healthy operating cash flows. If ROCE is higher than the finance cost of the loan note at 6% (nominal) it may call into question the wisdom of the early redemption especially given the penalty cost (which has been classified within financing) of the redemption.

Cash position:
The overall effect of the year's cash flows is that they have improved the company's cash position dramatically. A sizeable overdraft of €120,000, which may have been a consequence of the (likely) losses in the previous year, has been reversed to a modest bank balance of €10,000 even after the payment of a €150,000 dividend.

Summary
The above analysis indicates that Pinto has invested substantially in renewing and/or increasing its tangible fixed assets. This has been financed largely by operating cash flows, and appears to have brought a dramatic turnaround in the company's fortunes. All the indications are that the future financial position and performance will continue to improve.

4 (a) The accruals basis requires transactions (or events) to be recognised when they occur (rather than on a cash flow basis). Revenue is recognised when it is earned (rather than when it is received) and expenses are recognised when they are incurred (i.e. when the entity has received the benefit from them), rather than when they are paid.

Recording the substance of transactions (and other events) requires them to be treated in accordance with economic reality or their commercial intent rather than in accordance with the way they may be legally constructed. This is an important element of faithful representation.

Prudence is used where there are elements of uncertainty surrounding transactions or events. Prudence requires the exercise of a degree of caution when making judgements or estimates under conditions of uncertainty. Thus when estimating the expected life of a newly acquired asset, if we have past experience of the use of similar assets and they had had lives of (say) between five and eight years, it would be prudent to use an estimated life of five years for the new asset.

Comparability is fundamental to assessing the performance of an entity by using its financial statements. Assessing the performance of an entity over time (trend analysis) requires that the financial statements used have been prepared on a comparable (consistent) basis. Generally this can be interpreted as using consistent accounting policies (unless a change is required to show a fairer presentation). A similar principle is relevant to comparing one entity with another; however it is more difficult to achieve consistent accounting policies across entities.

Information is material if its omission or misstatement could influence (economic) decisions of users based on the reported financial statements. Clearly an important aspect of materiality is the (monetary) size of a transaction, but in addition the nature of the item can also determine that it is material. For example the monetary results of a new activity may be small, but reporting them could be material to any assessment of what it may achieve in the future. Materiality is considered to be a threshold quality, meaning that information should only be reported if it is considered material. Too much detailed (and implicitly immaterial) reporting of (small) items may confuse or distract users.

(b) Accounting for stock, by adjusting purchases for opening and closing stocks is a classic example of the application of the accruals principle whereby revenues earned are matched with costs incurred. Closing stock is by definition an example of goods that have been purchased, but not yet consumed. In other words the entity has not yet had the 'benefit' (i.e. the sales revenue they will generate) from the closing stock; therefore the cost of the closing stock should not be charged to the current year's profit and loss account.

Consignment stock is where goods are supplied (usually by a manufacturer) to a retailer under terms which mean the legal title to the goods remains with the supplier until a specified event (say payment in three months time). Once the goods have been transferred to the retailer, normally the risks and rewards relating to those goods then lie with the retailer. Where this is the case then (in substance) the consignment stock meets the definition of an asset and the goods should appear as such (stock) on the retailer's balance sheet (along with the associated liability to pay for them) rather than on the balance sheet of the manufacturer.

At the year end, the value of an entity's closing stock is, by its nature, uncertain. In the next accounting period it may be sold at a profit or a loss. Accounting standards require stock to be valued at the lower of cost and net realisable value. This is the application of prudence. If the stock is expected to sell at a profit, the profit is deferred (by valuing stock at cost) until it is actually sold. However, if the goods are expected to sell for a (net) loss, then that loss must be recognised immediately by valuing the stock at its net realisable value.

There are many acceptable ways of valuing stock (e.g. average cost or FIFO). In order to meet the requirement of comparability, an entity should decide on the most appropriate valuation method for its stock and then be consistent in the use of that method. Any change in the method of valuing (or accounting for) stock would break the principle of comparability.

For most businesses stock is a material item. An error (omission or misstatement) in the value or treatment of stock has the potential to affect decisions users may make in relation to financial statements. Therefore (correctly) accounting for stock is a material event. Conversely there are occasions where, on the grounds of immateriality, certain 'stocks' are not (strictly) accounted for correctly. For example, at the year end a company may have an unused supply of stationery. Technically this is stock, but in most cases companies would charge this 'stock' of stationery to the profit and loss account of the year in which it was purchased rather than show it as an asset.

Note: other suitable examples would be acceptable.

5 Accounting correctly for the convertible loan note in accordance with FRS 25 *Financial Instruments: Disclosure and Presentation* and FRS 26 *Financial Instruments: Recognition and Measurement* would mean that virtually all the financial assistant's observations are incorrect. The convertible loan note is a compound financial instrument containing a (largely) debt component and an equity component – the value of the option to receive equity shares. These components must be calculated using the residual equity method and appropriately classified (as debt and equity) on the balance sheet. As some of the proceeds of the instrument will be equity, the gearing will not be quite as high as if a non-convertible loan was issued, but gearing will be increased. However, if the loan note is converted to equity in March 2010, gearing will be reduced. The interest rate that would be applicable to a non-convertible loan (8%) is representative of the true finance cost and should be applied to the carrying amount of the debt to calculate the finance cost to be charged to the profit and loss account thus giving a much higher charge than the assistant believes.

Accounting treatment: financial statements year ended 31 March 2008

Profit and loss account:	
Finance costs (see working)	€693,920
Balance sheet:	
Creditors: amount falling due after more than one year	
3% convertible loan note (8,674 + 393·92)	€9,067,920
Capital and reserves	
Option to convert	€1,326,000

Working (figures in brackets in €'000)

	cash flows	factor at 8%	present value €'000
year 1 interest	300	0·93	279
year 2 interest	300	0·86	258
year 3 interest and capital	10,300	0·79	8,137
total value of debt component			8,674
proceeds of the issue			10,000
equity component (residual amount)			1,326

The interest cost in the profit and loss account should be €693,920 (8,674 x 8%), requiring an accrual of €393,920 (693·92 – 300 i.e. 10,000 x 3%). This accrual should be added to the carrying value of the debt.

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.

			Marks
1	**(a)**	Goodwill of Sardonic:	
		consideration	2
		net assets acquired calculated as:	
		equity shares	1
		pre acquisition reserves	2
		fair value adjustments	1
			6
	(b)	Profit and loss account:	
		turnover	2
		cost of sales	5
		distribution costs and administrative expenses	1
		amortisation of goodwill	1
		finance costs	2
		share of associate's profit	$^1/_2$
		tax – group	1
		– associate	$^1/_2$
		minority interest	2
			15
	(c)	1 mark per relevant point to	4
		Total for question	**25**
2	**(a)**	Adjustments:	
		add back dividends	1
		balance of fraud loss	1
		goods on sale or return	1
		depreciation charges	2
		investment gain	1
		taxation provision	1
		deferred tax	1
			8
	(b)	Statement of movement in share capital and reserves	
		balances b/f	1
		restated earnings b/f	1
		gain on revaluation of property	2
		rights issue	2
		profit for period	1
		dividends paid	1
			8
	(c)	Balance sheet	
		property	1
		plant	1
		investment	1
		stock	1
		debtors	2
		current liabilities	1
		deferred tax	1
		capital and reserves from (b)	1
			9
		Total for question	**25**

			Marks
3	**(a)**	operating activities	
		operating profit	1
		adjustment for redemption penalty	1
		depreciation/loss on sale	1
		working capital items (including warranty provision)	2
		returns on investment and servicing of finance	2
		tax received	2
		capital expenditure	2
		dividend paid	1
		financing	2
		increase in cash	1
			15
	(b)	1 mark per relevant point	10
		Total for question	**25**
4	**(a)**	explanations 1 mark each	5
	(b)	examples 2 marks each	10
		Total for question	**15**
5		1 mark per valid comment up to	4
		use of 8%	1
		initial carrying amount of debt and equity	2
		finance cost	2
		carrying amount of debt at 31 March 2008	1
		Total for question	**10**