
Answers

1 (a) Consolidated balance sheet of Picant as at 31 March 2010

	€'000	€'000
Fixed Assets		
Goodwill (w (i))		9,600
Tangible fixed assets (37,500 + 24,500 + 2,000 – 100)		63,900
Investment in associate (w (ii))		12,920
		<u>86,420</u>
Current assets		
Stock (10,000 + 9,000 + 1,800 GIT – 600 URP (w (iii)))	20,200	
Debtors (6,500 + 1,500 – 3,400 intra-group (w (iii)))	<u>4,600</u>	24,800
Creditors: amounts falling due within one year		
Contingent consideration	2,700	
Other current liabilities (8,300 + 7,500 – 1,600 intra-group) (w (iii)))	<u>14,200</u>	(16,900)
Total assets less current liabilities		94,320
Creditors: amounts falling due after more than one year		
7% loan notes (14,500 + 2,000)		(16,500)
		<u>77,820</u>
Capital and reserves		
Equity shares of €1 each		25,000
Share premium	19,800	
Profit and loss account (w (iv))	<u>26,170</u>	45,970
		70,970
Minority interest (w (vi))		<u>6,850</u>
		<u>77,820</u>

Workings (figures in brackets are in €'000)

(i) Goodwill in Sander

	€'000	€'000
Share exchange (8,000 x 75% x 3/2 x €3.20)		28,800
Contingent consideration (revised amount)		<u>2,700</u>
Total consideration		31,500
Equity shares	8,000	
Pre-acquisition reserves:		
At 1 April 2009	16,500	
Fair value adjustments – factory	2,000	
– software (see below)	<u>(500)</u>	
	(26,000) x 75%	(19,500)
Goodwill arising on acquisition		12,000
Amortisation (over five years)		<u>(2,400)</u>
Carrying amount at 31 March 2010		<u>9,600</u>

The revision to the estimate of the contingent consideration adjusts the consideration paid and the subsequent goodwill calculation (FRS 7 paragraph 27).

The effect of the software having no recoverable amount is that its write-off in the post-acquisition period should be treated as a fair value adjustment at the date of acquisition for consolidation purposes. The consequent effect is that this will increase the post-acquisition profit for consolidation purposes by €500,000.

(ii) Associate

	€'000
Carrying amount at 31 March 2010:	
Cash consideration (5,000 x 40% x €4)	8,000
7% loan notes (5,000 x 40% x €100/50)	4,000
Total consideration	12,000
Post-acquisition profits (6,000 x 6/12 x 40%)	1,200
Amortisation of premium on acquisition (2,800/5 years x 6/12 see below)	(280)
	<u>12,920</u>
Cost (total consideration from above)	12,000
Share of net assets acquired:	
– equity at 31 March 2010	26,000
– less post-acquisition profits (6,000 x 6/12)	(3,000)
	<u>23,000 x 40%</u>
	(9,200)
Premium on acquisition	<u>2,800</u>

(iii) Goods in transit and unrealised profit (URP)

The intra-group current accounts differ by the goods-in-transit sales of €1.8 million on which Picant made a profit of €600,000 (1,800 x 50/150). Thus stock must be increased by €1.2 million (its cost), €600,000 is eliminated from Picant's profit, €3.4 million is deducted from debtors and €1.6 million (3,400 – 1,800) is deducted from trade creditors (other current liabilities).

(iv) Consolidated profit and loss account:

	€'000
Picant's profit and loss account	27,200
Sander's post-acquisition profit (1,400 x 75% see (v) below)	1,050
URP in stock (w (iii))	(600)
Adler's post-acquisition profits (6,000 x 6/12 x 40%)	1,200
Amortisation of consolidated goodwill (w (i))	(2,400)
Amortisation of premium on acquisition of associate (w (ii))	(280)
	<u>26,170</u>

(v) Post-acquisition adjusted profits of Sander are:

As reported	1,000
Add back write off software (treated as a pre-acquisition fair value adjustment)	500
Additional depreciation on factory	(100)
	<u>1,400</u>

(vi) Minority interest

Net assets at 31 March 2010	25,500
Fair value of factory	2,000
Additional depreciation	(100)
	<u>27,400 x 25%</u>
	<u>6,850</u>

- (b) Although the concept behind the preparation of consolidated financial statements is to treat all the companies within the group as if they were a single economic entity, it must be understood that the legal position is that each company is a separate legal entity and therefore the group itself does not exist as a separate legal entity. This focuses on a criticism of group financial statements in that they aggregate the assets and liabilities of all the companies within the group. This can give the impression that all of the group's assets would be available to discharge all of the group's liabilities. This is not the case.

Applying this to the situation in the question, it would mean that any liability of Trilby to Picant would not be a liability of any other member of the Tradhat group. Thus the fact that the consolidated balance sheet of Tradhat shows a strong position with healthy liquidity is not necessarily of any reassurance to Picant. Any decision on granting credit to Trilby must be based on Trilby's own (entity) financial statements (which Picant should obtain), not the group financial statements. The other possibility, which would take advantage of the strength of the group's balance sheet, is that Picant could ask Tradhat if it would act as a guarantor to Trilby's (potential) liability to Picant. In this case Tradhat would be liable for the debt to Picant in the event of a default by Trilby.

2 (a) Dune – Profit and loss account for the year ended 31 March 2010

	€'000
Turnover (400,000 – 8,000 + 12,000 (w (i) and (ii)))	404,000
Cost of sales (w (iii))	(315,700)
Gross profit	88,300
Distribution costs	(26,400)
Administrative expenses (34,200 – 500 loan note issue costs)	(33,700)
Investment income	1,200
Profit (gain) on investments at fair value through profit or loss (28,000 – 26,500)	1,500
Finance costs (200 + 1,950 (w (iv)))	(2,150)
Profit before tax	28,750
Corporation tax (12,000 – 1,400 – 1,800 (w (v)))	(8,800)
Profit for the year	19,950

(b) Dune – Balance sheet as at 31 March 2010

	€'000	€'000
Fixed assets		
Leasehold property (w (iii))		33,500
Plant and equipment (w (vi))		46,400
Investments at fair value through profit or loss		28,000
		107,900
Current assets		
Stock	48,000	
Stock re contract account (w (ii))	1,400	
Debtors (40,700 – 8,000 (w (i)))	32,700	
Debtors re contract account	12,000	
	94,100	
Creditors: amounts falling due within one year		
Trade creditors	52,000	
Bank overdraft	4,500	
Accrued loan note interest (w (iv))	500	
Corporation tax	12,000	
	(69,000)	
Net current assets		25,100
Creditors: amounts falling due after more than one year		
5% loan note (2012) (w (iv))		(20,450)
Total assets less current liabilities		112,550
Provisions for liabilities and charges		
Deferred tax (w (v))		(4,200)
		108,350
Capital and reserves		
Equity shares of €1 each		60,000
Profit and loss account (38,400 + 19,950 – 10,000 dividend paid)		48,350
		108,350

Workings (figures in brackets in €'000)

- (i) This appears to be a 'cut off' error in that Dune has invoiced goods that are still in stock. The required adjustment is to remove the sale of €8 million ($6,000 \times 100/75$) from turnover and debtors. No adjustment is required to cost of sales or closing stock.

- (ii) Contract account:

	€'000	€'000
Agreed selling price		40,000
Cost to date	8,000	
Cost to complete	15,000	
Plant ($12,000 - 3,000$)	9,000	(32,000)
Total estimated profit		<u>8,000</u>
Amounts for inclusion in the profit and loss account for the year ended 31 March 2010		
Turnover ($40,000 \times 30\%$)		12,000
Cost of sales (balance)		<u>(9,600)</u>
Gross profit ($8,000 \times 30\%$)		<u>2,400</u>
Amounts for inclusion in the balance sheet as at 31 March 2010		
Cost to date – materials, labour and other direct costs		8,000
Plant depreciation ($((12,000 - 3,000) \times 6/18)$)		<u>3,000</u>
		11,000
Charged to cost of sales		<u>(9,600)</u>
Included as stock		<u>1,400</u>
Turnover		12,000
Payments received		(nil)
Included as debtors		<u>12,000</u>

- (iii) Cost of sales

Per question	294,000
Contract account (w (ii))	9,600
Depreciation of leasehold property (see below)	3,000
Impairment of leasehold property (see below)	2,500
Depreciation of plant and equipment ($((67,500 - 23,500) \times 15\%)$)	<u>6,600</u>
	<u>315,700</u>

The leasehold property must be depreciated until it is sold. However, the information in relation to the expected realisable value is an indication of impairment.

Depreciation ($45,000/15$ years)	<u>3,000</u>
Impairment:	
Carrying amount ($45,000 - 6,000 - 3,000$)	36,000
Estimated recoverable amount ($((40,000 \times 85\%) - 500$ selling costs)	<u>(33,500)</u>
Impairment	<u>2,500</u>

- (iv) The finance cost of the loan note, at the effective rate of 10% applied to the correct carrying amount of the loan note of €19.5 million, is €1.95 million (the issue costs must be deducted from the proceeds of the loan note; they are not an administrative expense). The interest actually paid is €500,000 ($20,000 \times 5\% \times 6/12$); however a further €500,000 needs to be accrued as a current liability (as it will be paid soon). The difference between the total finance cost of €1.95 million and the €1 million interest payable is added to the carrying amount of the loan note to give €20.45 million ($19,500 + 950$) for inclusion as a liability in the balance sheet.

- (v) Deferred tax

Provision required at 31 March 2010 ($14,000 \times 30\%$)	4,200
Provision at 1 April 2009	<u>(6,000)</u>
Credit (reduction in provision) to profit and loss account	<u>1,800</u>

- (vi) Plant and equipment

Plant and equipment ($67,500 - 23,500 - 6,600$)	37,400
Contract plant ($12,000 - 3,000$)	<u>9,000</u>
	<u>46,400</u>

3 (a) (i) Deltoid – cash flow statement for the year ended 31 March 2010:

(Note: figures in brackets are in €'000)

Reconciliation of operating loss to net cash outflow from operating activities

	€'000	€'000
Operating loss (12,000 – 11,200)		(800)
Adjustments for:		
depreciation charges	3,700	
loss on sale of leasehold property (8,800 – 200 – 8,500)	100	3,800
Working capital adjustments		
increase in stocks (12,500 – 4,600)		(7,900)
increase in debtors (4,500 – 2,000)		(2,500)
increase in creditors (4,700 – 4,200)		500
Net cash outflow from operating activities		<u>(6,900)</u>

Cash flow statement

Net cash outflow from operating activities		(6,900)
Servicing of finance – interest paid		(1,000)
Tax paid (w (i))		(1,900)
Capital expenditure – disposal of leasehold property		8,500
Equity dividends paid (w (ii))		<u>(700)</u>
Cash outflow before financing		(2,000)
Financing (note 1)		<u>(900)</u>
Decrease in cash (1,500 + 1,400)		<u>(2,900)</u>
Note 1		
Financing		
Shares issued (10,000 – 8,000 – 800 bonus issue)	1,200	
Capital element of finance lease obligations (w (iii))	<u>(2,100)</u>	<u>(900)</u>

Workings

	€'000
(i) Tax paid:	
Provision b/f – current	(2,500)
– deferred	(800)
Profit and loss account – tax relief	700
Provision c/f – current	(500)
– deferred	1,200
Difference cash paid	<u>(1,900)</u>
(ii) Equity dividends paid	
Profit and loss account b/f	6,300
Loss for period	(1,100)
Dividends paid (balance)	<u>(700)</u>
Profit and loss account c/f	<u>4,500</u>
(iii) Leased plant:	
Balance b/f	2,500
Depreciation	(1,800)
Leased during year (balance)	<u>5,800</u>
Balance c/f	<u>6,500</u>
Lease obligations	
Balance b/f – current	(800)
– non-current	(2,000)
New leases (from above)	(5,800)
Balance c/f – current	1,700
– non-current	<u>4,800</u>
Difference – repayment during year	<u>(2,100)</u>

- (ii) The main concerns of a loan provider would be whether Deltoid would be able to pay the servicing costs (interest) of the loan and the eventual repayment of the principal amount. Another important aspect of granting the loan would be the availability of any security that Deltoid can offer.

Interest cover is a useful measure of the risk of non-payment of interest. Deltoid's interest cover has fallen from a healthy 15 times (9,000/600) to be negative in 2010. Although interest cover is useful, it is based on profit whereas interest is actually paid in cash. It is usual to expect interest payments to be covered by operating cash flows (it is a bad sign when interest has to be paid from long-term sources of funding such as from the sale of fixed assets or a share issue). Deltoid's position in this light is very worrying; there is a cash outflow from operating activities of €6.9 million and after interest and tax payments the outflow has risen to €9.8 million.

When looking at the prospect of the ability to repay the loan, Deltoid's position is deteriorating as measured by its gearing (debt including finance lease obligations/equity) which has increased to 65% (5,000 + 6,500/17,700) from 43% (5,000 + 2,800/18,300). What may also be indicative of a deteriorating liquidity position is that Deltoid has sold its leasehold property and rented it back. This has been treated as a disposal, but, depending on the length of the rental agreement and other conditions of the tenancy agreement (not specified in the question), it may be that the substance of the sale is a loan/finance leaseback (e.g. if the period of the rental agreement was substantially the same as the remaining life of the property). If this were the case the company's gearing would increase even further. Furthermore there is less value in terms of ownership of fixed assets which may be used as security (in the form of a charge on assets) for the loan. It is also noteworthy that, in a similar vein, the increase in other fixed assets is due to finance leased plant. Whilst it is correct to include finance leased plant on the balance sheet (applying substance over form), the legal position is that this plant is not owned by Deltoid and offers no security to any prospective lender to Deltoid.

Therefore, in view of Deltoid's deteriorating operating and cash generation performance, it may be advisable not to renew the loan for a further five years.

- (b) Although the sports club is a not-for-profit organisation, the request for a loan is a commercial activity that should be decided on according to similar criteria as would be used for other profit-orientated entities.

The main aspect of granting a loan is how secure the loan would be. To this extent a form of capital gearing ratio should be calculated; say existing long-term borrowings to net assets (i.e. total assets less current liabilities). Clearly if this ratio is high, further borrowing would be at an increased risk. The secondary aspect is to measure the sports club's ability to repay the interest (and ultimately the principal) on the loan. This may be determined from information in the profit and loss account. A form of interest cover should be calculated; say the excess of income over expenditure (broadly the equivalent of profit) compared to (the forecast) interest payments. The higher this ratio the less risk of interest default. The calculations would be made for all four years to ascertain any trends that may indicate a deterioration or improvement in these ratios. As with other profit-oriented entities the nature and trend of the income should be investigated: for example, are the club's sources of income increasing or decreasing, does the reported income contain 'one-off' donations (which may not be recurring) etc? Also matters such as the market value of, and existing prior charges against, any assets intended to be used as security for the loan would be relevant to the lender's decision-making process. It may also be possible that the sports club's governing body (perhaps the trustees) may be willing to give a personal guarantee for the loan.

- 4 (a) For financial statements to be of value to their users they must possess certain characteristics; reliability is one such important characteristic. In order for financial statements to be reliable, they must faithfully represent an entity's underlying transactions and other events. For financial statements to achieve faithful representation, transactions must be accounted for and presented in accordance with their substance and economic reality where this differs from their legal form. For example, if an entity 'sold' an asset to a third party, but continued to enjoy the future benefits embodied in that asset, then this transaction would not be represented faithfully by recording it as a sale (in all probability this would be a financing transaction).

The features that may indicate that the substance of a transaction is different from its legal form are:

- where the control of an asset differs from the ownership of the asset
- where assets are 'sold' at prices that are greater or less than their fair values
- the use of options as part of an agreement
- where there are a series of 'linked' transactions.

It should be noted that none of the above necessarily mean there is a difference between substance and legal form.

- (b) Extracts from the profit and loss account

- (i) reflecting the legal form:

Year ended:	31 March 2010	31 March 2011	31 March 2012	Total
	€'000	€'000	€'000	€'000
Turnover	6,000	nil	10,000	16,000
Cost of sales	(5,000)	nil	(7,986)	(12,986)
Gross profit	1,000	nil	2,014	3,014
Finance costs	nil	nil	nil	nil
Net profit	1,000	nil	2,014	3,014

(ii) reflecting the substance:

Year ended:	31 March 2010	31 March 2011	31 March 2012	Total
	€'000	€'000	€'000	€'000
Turnover	nil	nil	10,000	10,000
Cost of sales	(nil)	nil	(5,000)	(5,000)
Gross profit	nil	nil	5,000	5,000
Finance costs	(600)	(660)	(726)	(1,986)
Net profit	(600)	(660)	4,274	3,014

- (c) It can be seen from the above that the two treatments have no effect on the total net profit reported in the profit and loss accounts, however, the profit is reported in different periods and the classification of costs is different. In effect the legal form creates some element of profit smoothing and completely hides the financing cost. Although not shown, the effect on the balance sheets is that recording the legal form of the transaction does not show the stock, nor does it show the in-substance loan. Thus recording the legal form would be an example of off balance sheet financing. The effect on an assessment of Wardle using ratio analysis may be that recording the legal form rather than the substance of the transaction would be that interest cover and stock turnover would be higher and gearing lower. All of which may be considered as reporting a more favourable performance.

- 5 (a) Where a company adopts a policy of capitalising finance costs as part of the cost of the construction of a tangible fixed asset, only those finance costs directly attributable to the construction may be capitalised. The definition of finance cost is based on FRS 4 *Capital instruments* and means that all finance costs may be capitalised which include interest on overdrafts and short and long-term borrowings. It also includes amortisation of discounts, premiums and certain other expenses. This has the effect that the finance costs are based on the effective rate of interest. Finance costs may be based on specifically borrowed funds or on the weighted average cost of a pool of funds. Capitalised finance costs during a period cannot exceed the total amount of finance costs incurred in that period, effectively prohibiting the capitalisation of notional finance costs. Capitalisation is of the gross finance cost i.e. before the deduction of any tax relief.

Capitalisation can only commence when expenditure is being incurred on the asset, which is not necessarily from the date funds are borrowed. Capitalisation should cease when the asset is ready for its intended use, even though the funds used may still be incurring borrowing costs. Also capitalisation should be suspended if there is an interruption of active development of the asset.

Where a company adopts a policy of capitalisation it must be applied consistently and any finance costs that are not eligible for capitalisation must be expensed.

- (b) The finance cost of loan must be calculated using the effective rate of 7.5%, so the total finance cost for the year ended 31 March 2010 is €750,000 (€10 million x 7.5%). As the loan relates to the construction of a fixed asset, the finance cost (or part of it in this case) can be capitalised under FRS 15.

Essentially the Standard says that capitalisation commences from when expenditure is being incurred (1 May 2009) and must cease when the asset is ready for its intended use (28 February 2010); in this case a ten month period. However, interest cannot be capitalised during a period where development activity is suspended; in this case the two months of July and August 2009. Thus only eight months of the year's finance cost can be capitalised = €500,000 (€750,000 x 8/12). The remaining four months finance costs of €250,000 must be expensed. FRS 15 does not specifically address the issue of interest earned from the temporary investment of specific loans, however, in this case, the interest was earned during a period (April 2009) in which the finance costs were NOT being capitalised, thus the interest received of €40,000 would be credited to the profit and loss account and not to the capitalised finance costs.

In summary:

	€
Profit and loss account for the year ended 31 March 2010:	
Finance cost (debit)	(250,000)
Investment income (credit)	40,000
Balance sheet as at 31 March 2010:	
Property (finance cost element only)	500,000

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) Balance sheet:	
goodwill	5
tangible fixed assets	2
investment in associate	1½
stock	1½
debtors	1
contingent consideration	1
other current liabilities	1
7% loan notes	½
equity shares	½
share premium	½
profit and loss account account	4½
minority interest	2
	21
(b) 1 mark per relevant point	4
Total for question	25
2 (a) Profit and loss account	
turnover	2½
cost of sales	4½
distribution costs	½
administrative expense	1
investment income	½
gain on investments	½
finance costs	1½
corporation tax	2
	13
(b) Balance sheet	
leasehold property	1
plant and equipment	1½
investments	½
stock	½
stock re contract account	½
debtors	1
debtors re contract account	½
trade creditors	½
accrued loan note interest	½
bank overdraft	½
corporation tax	½
5% loan note	1
deferred tax	1
equity shares	½
profit and loss account (1 for dividend)	2
	12
Total for question	25

		Marks
3	(a) (i) operating loss	1
	depreciation	1
	loss on sale of leasehold	1
	working capital items	1½
	interest paid	½
	tax paid	1½
	sale proceeds of leasehold	1
	equity dividends paid	1
	share issue	1
	repayment of lease obligations	1½
	decrease in cash	1
		12
	(ii) 1 mark per valid point	8
	(b) 1 mark per valid point	5
	Total for question	25
4	(a) 1 mark per valid point	5
	(b) (i) and (ii) – 1 mark per reported profit figure	5
	(c) 1 mark per valid point	5
	Total for question	15
5	(a) 1 mark per valid point	5
	(b) use of effective rate of 7·5%	1
	capitalise for 8 months	2
	charge to profit and loss account	1
	interest received to profit and loss account	1
	Total for question	10