
Answers

Fundamentals Level – Skills Module, Paper F7 (MYS)
Financial Reporting (Malaysia)

June 2008 Answers

1 (a) Cost of control in Sardonic:	RM'000	RM'000
Consideration		
Shares (18,000 x 2/3 x RM5.75)		69,000
Deferred payment (18,000 x 2.42/1.21 (see below))		36,000
		<u>105,000</u>
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	
	<u>104,000</u> x 75%	<u>(78,000)</u>
Goodwill		<u>27,000</u>

RM1 compounded for two years at 10% would be worth RM1.21.

The acquisition of 18 million out of a total of 24 million equity shares is a 75% interest.

(b) Patronic Group

Consolidated income statement for the year ended 31 March 2008	RM'000
Revenue (150,000 + (78,000 x 8/12) – (1,250 x 8 months intra group))	192,000
Cost of sales (w (i))	<u>(119,100)</u>
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)
Finance costs (w (ii))	(5,000)
Impairment of goodwill	(2,000)
Share of profit from associate (6,000 x 30%)	<u>1,800</u>
Profit before tax	41,800
Income tax expense (10,400 + (3,600 x 8/12))	<u>(12,800)</u>
Profit for the year	<u>29,000</u>
Attributable to:	
Equity holders of the parent	26,900
Minority interest (w (iii))	<u>2,100</u>
	<u>29,000</u>

- (c)** An associate is defined by FRS 128 *Investments in Associates* 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 139 *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 139 and thereafter it will be carried at fair value.

Workings

(i) Cost of sales	RM'000	RM'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)	<u>200</u>	600
Unrealised profit in inventories (3,000 x 20/120)		<u>500</u>
		<u>119,100</u>

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

(ii) Finance costs	RM'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
	<u>5,000</u>
(iii) Minority interest	
Sardonic's post acquisition profit (13,500 x 8/12)	9,000
Less post acquisition additional depreciation (w (i))	(600)
	<u>8,400</u>
	x 25% = 2,100

2 (a)	RM'000	RM'000
Profit for period per question		96,700
Dividends paid (w (i))		<u>15,500</u>
Draft profit for the 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%)	<u>36,100</u>	(47,100)
Increase in investments ((12,500 x 1,296/1,200) – 12,500)		1,000
Provision for income tax		(11,400)
Increase in deferred tax (w (v))		<u>(800)</u>
Recalculated profit for the year ended 31 March 2008		<u>50,800</u>

(b) Dexon – Statement of Changes in Equity – Year ended 31 March 2008

	Ordinary shares RM'000	Share premium RM'000	Revaluation reserve RM'000	Retained earnings RM'000	Total RM'000
At 1 April 2007	200,000	30,000	18,000	12,300	260,300
Prior period adjustment (w (ii))				<u>(1,500)</u>	(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))				<u>(15,500)</u>	(15,500)
At 31 March 2008	<u>250,000</u>	<u>40,000</u>	<u>22,800</u>	<u>46,100</u>	<u>358,900</u>

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 RM1.20, this would create RM50 million of share capital and RM10 million of share premium.

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

	RM'000	RM'000
Non-current 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
		<u>337,900</u>
Current assets		
Inventory (84,000 + 2,000 (w (iii)))	86,000	
Trade receivables (52,200 – 4,000 – 2,600 (w (ii) and (iii)))	45,600	
Bank	3,800	135,400
		<u>473,300</u>
Total assets		
Equity and liabilities		
Equity (from (b))		
Ordinary shares of RM1 each		250,000
Share premium	40,000	
Revaluation reserve	22,800	
Retained earnings	46,100	108,900
		<u>358,900</u>
Non-current liabilities		
Deferred tax (19,200 + 2,000 (w (v)))		21,200
Current liabilities (81,800 + 11,400 income tax)		93,200
Total equity and liabilities		<u>473,300</u>

Workings (figures in brackets in RM'000)

- (i) Dividends paid
The dividend in May 2007 would be RM8 million (200 million shares at 4 sen) and in November 2007 would be RM7.5 million (250 million shares x 3 sen). Total dividends would therefore have been RM15.5 million.
- (ii) The discovery of the fraud means that RM4 million should be written off trade receivables. RM1.5 million debited to retained earnings as a prior period adjustment (in the statement of changes in equity) and RM2.5 written off in the income statement 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 recognised revenue. The reversing effect is to reduce the relevant trade receivables by RM2.6 million, increase inventory by RM2 million (the cost of the goods (2,600 x 100/130)) and reduce the profit for the year by RM600,000.
- (iv) Property
The carrying amount of the property (after the year's depreciation) is RM174 million (185,000 – 11,000). A valuation of RM180 million would create a revaluation surplus of RM6 million of which RM1.2 million (6,000 x 20%) would be transferred to deferred tax.
- (v) Deferred tax
An increase in the taxable temporary differences of RM10 million would create a transfer (credit) to deferred tax of RM2 million (10,000 x 20%). Of this RM1.2 million relates to the revaluation of the property and is debited to the revaluation reserve. The balance, RM800,000, is charged to the income statement.

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

	RM'000	RM'000
Cash flows from operating activities		
Profit before tax		440
Adjustments for:		
Depreciation of property, plant and equipment	280	
Loss on sale of property, plant and equipment	90	370
Increase in warranty provision (200 – 100)		100
Investment income		(60)
Finance costs		50
Redemption penalty costs included in administrative expenses		20
		<u>920</u>
Working capital adjustments		
Increase in inventories (1,210 – 810)	(400)	
Decrease in trade receivables (540 – 480)	60	
Increase in trade payables (1,410 – 1,050)	360	20
Cash generated from operations		<u>940</u>
Finance costs paid		(50)
Income tax refund (w (ii))		60
Net cash from operating activities		<u>950</u>
Cash flows from investing activities		
Purchase of property, plant and equipment (w (i))	(1,440)	
Sale of property, plant and equipment (240 – 90)	150	
Investment income received (60 – 20 gain on investment property)	40	
Net cash used in investing activities		<u>(1,250)</u>
Cash flows from financing activities		
Proceeds from issue of equity shares (400 + 600)	1,000	
Redemption of loan notes (400 plus 20 penalty)	(420)	
Dividends paid (1,000 x 5 x 3 sen)	(150)	
Net cash from financing activities		<u>430</u>
Net increase in cash and cash equivalents		<u>130</u>
Cash and cash equivalents at beginning of period		<u>(120)</u>
Cash and cash equivalents at end of period		<u>10</u>

Note: investment income received and dividends paid may alternatively be shown in operating activities.

Workings (in RM'000)

(i) Property, plant and equipment:	
carrying amount b/f	1,860
revaluation	100
depreciation for period	(280)
disposal	(240)
carrying amount c/f	<u>(2,880)</u>
difference is cash acquisitions	<u>(1,440)</u>
(ii) Income tax:	
tax asset b/f	50
deferred tax b/f	(30)
income statement charge	(160)
tax provision c/f	150
deferred tax c/f	50
difference is cash received	<u>60</u>

(b) Comments on the cash management of Pinto

Operating cash flows:

Pinto's operating cash inflows at RM940,000 (prior to investment income, finance costs and taxation) are considerably higher than the equivalent profit before investment income, finance costs and tax of RM430,000. 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 inventory appears to be being financed by a substantial increase in trade payables and a modest reduction in trade receivables. The reduction in trade receivables is

perhaps surprising as other indicators point to an increase in operating capacity which has not been matched with an increase in trade receivables. This could be indicative of good control over the cash management of the trade receivables (or a disappointing sales performance).

An unusual feature of the cash flow is that Pinto has received a tax refund of RM60,000 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 RM150,000 in current liabilities 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 RM210,000 in the next period.

Investing activities:

There has been a dramatic investment/increase in property, plant and equipment. The carrying value at 31 March 2008 is substantially higher than a year earlier (admittedly RM100,000 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 the plant disposed of (The voluntary disclosure encouraged by FRS 107 *Cash Flow Statements* would help to assess this issue more accurately). However, judging by the level of the increase and 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 RM40,000 and a valuation gain of RM20,000.

Financing activities:

It would appear that Pinto's financial structure has changed during the year. Debt of RM400,000 has been redeemed (for RM420,000) and there has been a share issue raising RM1 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 property, plant and equipment. The remainder of the finance for the property, plant and equipment 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 activities) 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 RM120,000, which may have been a consequence of the (likely) losses in the previous year, has been reversed to a modest bank balance of RM10,000 even after the payment of a RM150,000 dividend.

Summary

The above analysis indicates that Pinto has invested substantially in renewing and/or increasing its property, plant and equipment. 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 inventory, by adjusting purchases for opening and closing inventories is a classic example of the application

of the accruals principle whereby revenues earned are matched with costs incurred. Closing inventory 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 inventory; therefore the cost of the closing inventory should not be charged to the current year's income statement.

Consignment inventory 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 inventory meets the definition of an asset and the goods should appear as such (inventory) 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 inventory is, by its nature, uncertain. In the next accounting period it may be sold at a profit or a loss. Accounting standards require inventory to be valued at the lower of cost and net realisable value. This is the application of prudence. If the inventory is expected to sell at a profit, the profit is deferred (by valuing inventory 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 inventory at its net realisable value.

There are many acceptable ways of valuing inventory (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 inventory and then be consistent in the use of that method. Any change in the method of valuing (or accounting for) inventory would break the principle of comparability.

For most businesses inventories are a material item. An error (omission or misstatement) in the value or treatment of inventory has the potential to affect decisions users may make in relation to financial statements. Therefore (correctly) accounting for inventory is a material event. Conversely there are occasions where on the grounds of immateriality certain 'inventories' are not (strictly) accounted for correctly. For example, at the year end a company may have an unused supply of stationery. Technically this is inventory, but in most cases companies would charge this 'inventory' of stationery to the income statement 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 132 *Financial Instruments: Disclosure and Presentation* and FRS 139 *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 income statement thus giving a much higher charge than the assistant believes.

Accounting treatment: financial statements year ended 31 March 2008

Income statement:

Finance costs (see working)	RM693,920
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Balance sheet:

Non-current liabilities

3% convertible loan note (8,674 + 393·92)	RM9,067,920
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Equity

Option to convert	RM1,326,000
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Working (figures in brackets in RM'000)

	cash flows	factor at 8%	present value RM'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 income statement should be RM693,920 (8,674 x 8%), requiring an accrual of RM393,920 (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.

	<i>Marks</i>
1 (a) Goodwill of Sardonic:	
consideration	2
net assets acquired calculated as:	
equity shares	1
pre acquisition reserves	2
fair value adjustments	1
	<hr/>
	6
	<hr/>
(b) Income statement:	
revenue	2
cost of sales	5
distribution costs and administrative expenses	1
finance costs	2
impairment of goodwill	1
share of associate's profit	1
income tax	1
minority interest	2
	<hr/>
	15
	<hr/>
(c) 1 mark per relevant point to	4
	<hr/>
Total for question	25
	<hr/> <hr/>

	<i>Marks</i>
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
	<hr/>
	8
	<hr/>
(b) Statement of changes in equity	
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
	<hr/>
	8
	<hr/>
(c) Balance sheet	
property	1
plant	1
investment	1
inventory	1
trade receivables	2
equity from (b)	1
deferred tax	1
current liabilities	1
	<hr/>
	9
	<hr/>
Total for question	25
	<hr/>
	<hr/>
3 (a) operating activities	
profit before tax	1/2
depreciation/loss on sale	1
warranty adjustment	1/2
adjustments for investment income/finance costs	1/2
adjustment for redemption penalty	1
working capital items	1 1/2
finance costs	1
income tax received	2
investing activities (including 1 for investment income)	3
financing activities	
issue of equity shares	1
redemption of 6% loan note	1
dividend paid	1
cash and cash equivalents b/f and c/f	1
	<hr/>
	15
	<hr/>
(b) 1 mark per relevant point	10
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Total for question	25
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		<i>Marks</i>
4	(a) explanations 1 mark each	5
	(b) examples 2 marks each	10
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Total for question		15
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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
		<hr/>
Total for question		10
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