
Answers

1 (a) (i) Polestar

Consolidated statement of profit or loss for the year ended 30 September 2013

	\$'000
Revenue ($110,000 + (66,000 \times 6/12) - (4,000 + 9,000 \text{ intra-group sales})$)	130,000
Cost of sales (w (i))	(109,300)
Gross profit	20,700
Distribution costs ($3,000 + (2,000 \times 6/12)$)	(4,000)
Administrative expenses ($5,250 + (2,400 \times 6/12) - 3,400 \text{ negative goodwill (w (iii))}$)	(3,050)
Finance costs	(250)
Profit before tax	13,400
Income tax expense ($3,500 - (1,000 \times 6/12)$)	(3,000)
Profit for the year	10,400
Profit for year attributable to:	
Equity holders of the parent	11,150
Non-controlling interest losses (see below)	(750)
	10,400

Southstar's adjusted post-acquisition losses for the year ended 30 September 2013 are \$3 million ($4,600 \times 6/12 + (100 \text{ additional depreciation} + 600 \text{ URP})$). Therefore the non-controlling interest share of the losses is \$750,000 ($3,000 \times 25\%$).

Note: IFRS 3 Business Combinations says negative goodwill should be credited to the acquirer, thus none of it relates to the non-controlling interests.

(ii) Consolidated statement of financial position as at 30 September 2013

	\$'000
Assets	
Non-current assets	
Property, plant and equipment (w (ii))	64,600
Current assets ($16,500 + 4,800 - 600 \text{ URP}$)	20,700
Total assets	85,300
Equity and liabilities	
Equity attributable to owners of the parent	
Equity shares of 50 cents each	30,000
Retained earnings (w (iv))	29,650
	59,650
Non-controlling interest (w (v))	2,850
Total equity	62,500
Current liabilities	
Other ($15,000 + 7,800$)	22,800
Total equity and liabilities	85,300

Workings in \$'000

(i) Cost of sales

	\$'000
Polestar	88,000
Southstar ($67,200 \times 6/12$)	33,600
Intra-group purchases ($4,000 + 9,000$)	(13,000)
URP in inventory (see below)	600
Additional depreciation on leased property ($2,000/10 \text{ years} \times 6/12$)	100
	109,300

The profit on the sale of the goods back to Polestar is \$3.6 million ($9,000 - (4,000 + 1,400)$). Therefore the unrealised profit (URP) in the inventory of \$1.5 million at 30 September 2013 is \$600,000 ($3,600 \times 1,500/9,000$).

(ii) Property, plant and equipment		
		\$'000
Polestar		41,700
Southstar		21,000
Fair value adjustment		2,000
Additional depreciation		(100)
		<u>64,600</u>
(iii) Goodwill in Southstar		
	\$'000	\$'000
Investment at cost		
Cash consideration (6,000 x 2 (i.e. shares of 50 cents) x 75% x \$1.70)		15,300
Non-controlling interest (12,000 x 25% x \$1.20)		<u>3,600</u>
		18,900
Net assets (equity) of Southstar at 30 September 2013	18,000	
Add back: post-acquisition losses (4,600 x 6/12)	2,300	
Fair value adjustment for property	<u>2,000</u>	
Net assets at date of acquisition		(22,300)
Bargain purchase/negative goodwill – credited directly to profit or loss		<u>(3,400)</u>
(iv) Retained earnings		
		\$'000
Polestar		28,500
Southstar's post-acquisition adjusted losses (3,000 x 75%)		(2,250)
Negative goodwill		<u>3,400</u>
		<u>29,650</u>
(v) Non-controlling interest in statement of financial position		
		\$'000
At date of acquisition		3,600
Post-acquisition loss from statement of profit or loss		(750)
		<u>2,850</u>

- (b) After similar checks as required by international standards that the assets and liabilities of the subsidiary are correctly valued (thereby ensuring that negative goodwill is not the result of valuation errors), IAS 10 *Goodwill and Intangible Assets* requires the following treatment:

Negative goodwill is disclosed as a 'negative asset' in the statement of financial position as a sub-set of intangible assets directly under any positive goodwill (the IAS standard setters do not believe that negative goodwill meets the definition of a liability).

Negative goodwill is subsequently recognised in profit or loss in the periods when the non-monetary assets of the subsidiary are realised (by sale or by depreciation). The non-monetary assets are normally property, plant and equipment and inventory.

Applying the above normally means that the negative goodwill attributable to the inventory is recognised in profit or loss in the following accounting period (assuming the inventory has been sold) and the negative goodwill attributable to the other non-monetary assets (probably property, plant and equipment) is recognised systematically over the average remaining lives of those assets.

In the rare event where negative goodwill exceeds the fair value of the non-monetary assets acquired, this excess should be recognised in profit or loss in the periods which are expected to benefit. The IAS offers no advice on how this benefit should be measured.

2 (a) Moby – Statement of profit or loss and other comprehensive income for the year ended 30 September 2013

	\$'000
Revenue (227,800 + 10,000 construction contract (w (i)))	237,800
Cost of sales (w (ii))	(187,900)
Gross profit	49,900
Distribution costs	(13,500)
Administrative expenses (16,500 – 150 disallowed provision – see below)	(16,350)
Finance costs (900 + 4,000 loan + 2,930 lease (w (iv)))	(7,830)
Profit before tax	12,220
Income tax expense (3,400 – 1,050 – 2,000 (w (v)))	(350)
Profit for the year	11,870
Other comprehensive income	
Items which will not be reclassified to profit or loss:	
Gain on revaluation of land and buildings (w (iii))	4,400
Deferred tax on gain (4,400 x 25%)	(1,100)
Total other comprehensive income for the year	3,300
Total comprehensive income for the year	15,170

If a company chooses to 'self-insure', it cannot create a provision equal to a third party premium. Instead, it must charge the actual cost incurred of the previously insured claims.

(b) Moby – Statement of financial position as at 30 September 2013

	\$'000	\$'000
Assets		
Non-current assets		
Property, plant and equipment (w (iii))		115,000
Current assets		
Inventory	26,600	
Amount due from contract customer (w (i))	6,000	
Trade receivables	38,500	71,100
Total assets		186,100
Equity and liabilities		
Equity		
Equity shares of 20 cents each		45,000
Revaluation reserve	3,300	
Retained earnings (19,800 + 11,870)	31,670	34,970
		79,970
Non-current liabilities		
Lease obligation (w (iv))	16,133	
Deferred tax (w (v))	7,100	
Loan note (40,000 x 1.1)	44,000	67,233
Current liabilities		
Lease obligation (23,030 – 16,133 (w (iv)))	6,897	
Trade payables	21,300	
Bank overdraft	7,300	
Current tax payable	3,400	38,897
Total equity and liabilities		186,100

Workings (monetary figures in brackets in \$'000)

(i) Construction contract:

	\$'000	\$'000
Total contract revenue		25,000
Costs incurred to date	14,000	
Estimated costs to complete	<u>6,000</u>	<u>(20,000)</u>
Total contract profit		<u>5,000</u>

Percentage of completion is 40% (10,000/25,000)

Amounts to include in financial statements for the year ended 30 September 2013:

Revenue	10,000
Cost of sales (= balancing figure)	<u>(8,000)</u>
Profit for year (40% x 5,000)	<u>2,000</u>

Amount due from customer:

Contract costs to date	14,000
Profit for year	<u>2,000</u>
	<u>16,000</u>
Progress billings (work certified)	<u>(10,000)</u>
Amount due from customer	<u>6,000</u>

(ii) Cost of sales:

	\$'000
Per question	164,500
Construction contract costs	8,000
Depreciation of building (w (iii))	2,400
Depreciation of owned plant (w (iii))	6,000
Depreciation of leased plant (w (iii))	<u>7,000</u>
	<u>187,900</u>

(iii) Non-current assets:

	\$'000	\$'000
Land and buildings		
Carrying amount 1 October 2012 (60,000 – 10,000)		50,000
Revalued land	16,000	
Revalued buildings	<u>38,400</u>	<u>54,400</u>
Revaluation gain		<u>4,400</u>
Depreciation for year (38,400/16 years)		<u>(2,400)</u>
Carrying amount at 30 September 2013 (54,400 – 2,400)		<u>52,000</u>
Owned plant		
Carrying amount 1 October 2012 (65,700 – 17,700)		48,000
Depreciation for year (48,000 x 12.5%)		<u>(6,000)</u>
Carrying amount at 30 September 2013		<u>42,000</u>
Leased plant		
Carrying amount 1 October 2012 (35,000 – 7,000)		28,000
Depreciation for year (35,000/5 years)		<u>(7,000)</u>
Carrying amount at 30 September 2013		<u>21,000</u>
Carrying amount of property, plant and equipment at 30 September 2013: (52,000 + 42,000 + 21,000)		115,000

(iv) Lease obligation:

	\$'000
Liability at 1 October 2012	29,300
Interest at 10% for year ended 30 September 2013	2,930
Rental payment 30 September 2013	(9,200)
Liability at 30 September 2013	23,030
Interest at 10% for year ended 30 September 2014	2,303
Rental payment 30 September 2014	(9,200)
Liability at 30 September 2014	16,133

(v) Deferred tax:

	\$'000	\$'000
Provision b/f at 1 October 2012		(8,000)
Provision c/f required at 30 September 2013		
Taxable differences: per question	24,000	
on revaluation of land and buildings	4,400	
	28,400 x 25%	7,100
Net reduction in provision		(900)
Charged to other comprehensive income on revaluation gain (4,400 x 25%)		(1,100)
Credit to profit or loss		2,000

3 (a) Kingdom – Statement of cash flows for the year ended 30 September 2013:

(Note: figures in brackets are in \$'000)

	\$'000	\$'000
Cash flows from operating activities:		
Profit before tax		2,400
Adjustments for:		
depreciation of property, plant and equipment		1,500
loss on sale of plant (2,300 – 1,800)		500
finance costs		600
investment properties – rentals received		(350)
– fair value changes		700
		5,350
decrease in inventory (3,100 – 2,300)		800
decrease in receivables (3,400 – 3,000)		400
increase in payables (4,200 – 3,900)		300
Cash generated from operations		6,850
Interest paid (600 – 100 + 50)		(550)
Income tax paid (w (i))		(1,950)
Net cash from operating activities		4,350
Cash flows from investing activities:		
Purchase of property, plant and equipment (w (ii))	(5,000)	
Sale of property, plant and equipment	1,800	
Purchase of investment property (w (iv))	(1,400)	
Investment property rentals received	350	
Net cash used in investing activities		(4,250)
Cash flows from financing activities:		
Issue of equity shares (17,200 – 15,000)	2,200	
Equity dividends paid (w (iii))	(2,800)	
Net cash used in financing activities		(600)
Net decrease in cash and cash equivalents		(500)
Cash and cash equivalents at beginning of period		300
Cash and cash equivalents at end of period		(200)

Workings

	\$'000
(i) Income tax:	
Provision b/f	(1,850)
Profit or loss charge	(600)
Provision c/f	500
Tax paid (= balance)	<u>(1,950)</u>
(ii) Property, plant and equipment:	
Balance b/f	(25,200)
Depreciation	1,500
Revaluation (downwards)	1,300
Disposal (at carrying amount)	2,300
Transfer from investment properties	(1,600)
Balance c/f	<u>26,700</u>
Acquired during year (= balance)	<u>(5,000)</u>
(iii) Equity dividends:	
Retained earnings b/f	8,700
Profit for the year	1,800
Retained earnings c/f	<u>(7,700)</u>
Dividends paid (= balance)	<u>2,800</u>

Note: For tutorial purposes the reconciliation of the investment properties is:

	\$'000
Balance b/f	5,000
Acquired during the year (from question)	1,400
Loss in fair value	(700)
Transfer to property, plant and equipment	<u>(1,600)</u>
Balance c/f	<u>4,100</u>

- (b) (i) The fall in the company's profit before tax can be analysed in three elements: changes at the gross profit level; the effect of overheads; and the relative performance of the investment properties. The absolute effect on profit before tax of these elements are reductions of \$1.4 million (15,000 – 13,600), \$2.25 million (10,250 – 8,000) and \$1.25 million (900 + 350) respectively, amounting to \$4.9 million in total. Many companies would consider returns on investment properties as not being part of operating activities; however, these returns do impact on profit before tax.

Gross profit

Despite slightly higher revenue, gross profit fell by \$1.4 million. This is attributable to a fall in the gross profit margin (down from 34.1% to 30.3%). Applying the stated 8% rise in the cost of sales, last year's cost of sales of \$29 million would translate to an equivalent figure of \$31.32 million in the current year which is almost the same as the actual figure (\$31.3 million). This implies that the production activity/volume of sales has remained the same as last year. As the increase in revenue in the current year is only 2%, the decline in gross profitability has been caused by failing to pass on to customers the percentage increase in the cost of sales. This may be due to management's slow response to rising prices and/or to competitive pressures in the market.

Although there has been a purchase of new plant of \$5 million (from the statement of cash flows), it would seem that this is a replacement of the \$2.3 million of plant sold during the year. This is supported by the stagnation in the (apparent) volume of sales. The replacement of plant has probably led to slightly higher depreciation charges.

Operating costs/overheads

The administrative expenses and distribution costs are the main culprit of the fall in profit before tax as these are \$2.25 million (or 28%) higher than last year. Even if they too have increased 8%, due to rising prices, they are still much higher than would have been expected, which implies a lack of cost control of these overheads.

Performance of investment properties

The final element of the fall in profit before tax is due to declining returns on the investment properties. This has two elements. First, a reduction in rentals received which may be due to the change in properties under rental (one transferred to owner-occupation and one newly let property) and/or a measure of falling rentals generally. The second element is clearer: there has been a decrease in the fair values of the properties in the current year compared to a rise in their fair values in the previous year. The fall in investment properties mirrors a fall in the value of the company's other properties within property, plant and equipment (down \$1.3 million), which suggests problems in the commercial property market.

- (ii) The term rising prices may relate to specific goods/assets or to average prices (general inflation). Either way, they have two main effects on financial statements: an understatement of operating costs and a potentially greater understatement of asset values.

In the statement of profit or loss, input costs tend to be understated in terms of their real cost. The most commonly quoted examples of these are inventory, where the purchase at historical cost would be lower than the cost of replacing them (a form of current cost), and depreciation charges which understate the real value of the benefit consumed by the asset's use (as the fair value of the non-current assets will have increased).

In terms of interpreting financial performance, rising prices distort trend comparisons, meaning that previous years' results are not directly comparable with the current year's results. The most obvious example of this is with the return on capital employed (ROCE). When comparing previous years with the current year, using historical cost, the numerator (profit) would be relatively higher or overstated (due to lower operating costs) and the denominator (equal to net assets) would be relatively lower or understated (due to lower reported asset values). The differences between ROCEs which have not been adjusted for rising prices can be quite large with ROCEs from earlier years appearing much higher/better than the ROCE of the current year. It follows that the secondary ratios of profit margins and asset utilisation for earlier years are also flattering compared to current year measures.

The 'overstated' profit due to not adjusting for rising prices may also give rise to other problems, such as leading to higher wage demands, higher dividend payments and even higher taxes. A related issue is that over time the understatement of assets (in terms of their current values) can depress a company's share price and may make it vulnerable to a takeover bid.

In practice, however, many of the above potential problems are mitigated by companies revaluing their properties, which are usually the most understated assets. Also the increasing use of fair value accounting in IFRSs (e.g. for business combinations, investment properties and many financial assets) also reduces the distortion caused by rising prices.

- 4 (a) The *Conceptual Framework for Financial Reporting* implies that the two fundamental qualitative characteristics (relevance and faithful representation) are vital as, without them, financial statements would not be useful, in fact they may be misleading. As the name suggests, the four enhancing qualitative characteristics (comparability, verifiability, timeliness and understandability) improve the usefulness of the financial information. Thus financial information which is not relevant or does not give a faithful representation is not useful (and worse, it may possibly be misleading); however, financial information which does not possess the enhancing characteristics can still be useful, but not as useful as if it did possess them.

In order for financial statements to be useful to users (such as investors or loan providers), they must present financial information faithfully, i.e. financial information must faithfully represent the economic phenomena which it purports to represent (e.g. in some cases it may be necessary to treat a sale and repurchase agreement as an in-substance (secured) loan rather than as a sale and subsequent repurchase). Faithfully represented information should be complete, neutral and free from error. Substance is not identified as a separate characteristic because the IASB says it is implied in faithful representation such that faithful representation is only possible if transactions and economic phenomena are accounted for according to their substance and economic reality.

- (b) (i) When dealing with the factoring of receivables, probably the most important aspect of the transaction is which party bears the risk of any non-payment by the customer (irrecoverable receivables). In this case, that party is Laidlaw as it will have to 'buy back' any receivables not settled within four months of their 'sale'. Thus Finease is acting as an administrator (for a fee of \$10,000 per month) and as a provider of finance (charging 2% interest per month).

Laidlaw should not 'derecognise' the receivables as suggested in the question, but instead treat the \$1.8 million cash received from Finease as a current liability (a loan or financing arrangement secured on the receivables). Laidlaw should charge \$10,000 as an administration fee and \$36,000 (\$1.8 million x 2%) as interest (for the month of September 2013), to profit or loss as administrative expenses and finance costs respectively. Both these amounts should also be added to the current liability (the amount owed to Finease) which at 30 September 2013 would amount to \$1,846,000.

- (ii) The critical aspect of these transactions (the sale, the rental and the potential repurchase) is that they are (or will be) all carried out at commercial values. Thus Laidlaw has adopted the correct treatment by recording the disposal of the property as a 'true' sale and, presumably, charged \$400,000 to profit or loss under operating lease arrangements for the rental of the property for the year ended 30 September 2013. The fact that Laidlaw will be given the opportunity to repurchase the property in five years' time before it is put on the open market is not an asset and should not be recognised as such, nor does it affect the substance of the sale. This is because the price of the potential repurchase is at what is expected to be its fair value and is therefore not favourable to Laidlaw.

- 5 (a) The alterations to the leased property do not affect the lease itself and this should continue to be treated as an operating lease and charging profit or loss with the annual rental of \$2.3 million.

The initial cost of the alterations should be capitalised and depreciated over the remaining life of the lease. In addition to this, IAS 37 *Provisions, Contingent Assets and Contingent Liabilities* requires that the cost of restoring the property to its original condition should be provided for on 1 October 2012 as this is when the obligation to incur the restoration cost arises (as the time taken to do the alterations is negligible). The present value of the restoration costs, given as \$5 million, should be added

to the initial cost of the alterations and depreciated over the remaining life of the lease. A corresponding provision should be created and a finance cost of 8% per annum should be charged to profit or loss and accrued on this provision.

(b) Extracts from the financial statements of Fundo

	\$'000
Statement of profit or loss for the year ended 30 September 2013	
Cost of sales	
Operating lease rental	2,300
Depreciation of alterations to leased property (12,000/8 years)	1,500
Finance cost (5,000 x 8%)	400
Statement of financial position as at 30 September 2013	
Non-current assets	
Alterations to leased property (7,000 + 5,000)	12,000
Accumulated depreciation (above)	<u>(1,500)</u>
Carrying amount	<u>10,500</u>
Non-current liabilities	
Provision for property restoration costs (5,000 + 400 above)	<u>5,400</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) (i) Consolidated statement of profit or loss	
revenue	1½
cost of sales	3
distribution costs	½
administrative expenses	½
negative goodwill	4
finance costs	½
income tax expense	½
non-controlling interest	1½
	12
(ii) Consolidated statement of financial position	
property, plant and equipment	2
current assets	2
equity shares	½
retained earnings	2½
non-controlling interest	1½
other current liabilities	½
	9
(b) 1 mark per valid point	4
Total for question	25
2 (a) Statement of profit or loss and other comprehensive income	
revenue	1½
cost of sales	3
distribution costs	½
administrative expenses	1
finance costs	2
income tax expense	2
gain on revaluation of land and buildings	1
deferred tax on gain	1
	12
(b) Statement of financial position	
property, plant and equipment	2½
inventory	½
amount due on contract	1½
trade receivables	½
equity shares	½
revaluation reserve	1
retained earnings	1
non-current lease obligation	1
deferred tax	1
loan note	1
current lease obligation	½
bank overdraft	½
trade payables	½
current tax payable	1
	13
Total for question	25

		Marks
3	(a) Statement of cash flows	
	profit before tax	1/2
	depreciation	1/2
	loss on disposal of plant	1/2
	finance charges (added back)	1/2
	investment property income	1
	working capital items	1 1/2
	interest paid (cash outflow)	1
	income tax paid	1
	purchase of property, plant and equipment	3
	purchase of investment property	1/2
	sale of property, plant and equipment	1/2
	rental income received from investment properties	1
	issue of equity shares	1/2
	equity dividends paid	1
	cash b/f	1/2
	cash c/f	1/2
		14
	(b) (i) up to 2 marks each for gross profit, overheads and investment property returns	6
	(ii) comments – 1 mark per valid point, up to	5
	Total for question	25
4	(a) 1 mark per valid point	5
	(b) (i) 'buy back' means Laidlaw bears the risk of non-payment	1
	Finease earns administration and financing fees	1
	receivables are not derecognised (remain on statement of financial position)	1
	\$1.8 million is a loan secured on receivables	1
	\$10,000 and \$36,000 charged to profit or loss as administrative expenses and finance costs respectively	1
		5
	(ii) all transactions at commercial values	2
	thus accounting for as a disposal is correct	1
	rental correctly charged at \$400,000	1
	option is not an asset as a repurchase would apply at market values	1
		5
	Total for question	15
5	(a) 1 mark per valid point	4
	(b) statement of profit or loss	
	operating lease rental	1
	depreciation charge	1
	finance cost	1
	statement of financial position	
	alterations to leased property, at cost	1
	accumulated depreciation	1
	non-current liability (provision)	1
		6
	Total for question	10