

---

# Answers

---

**1 (a) Paradigm – Consolidated statement of financial position as at 31 March 2013**

	\$'000	\$'000
<b>Assets</b>		
Non-current assets:		
Property, plant and equipment (47,400 + 25,500 – 3,000 fair value + 500 depreciation)		70,400
Goodwill (w (i))		8,500
Financial asset: equity investments (7,100 + 3,900)		11,000
		<u>89,900</u>
Current assets		
Inventory (20,400 + 8,400 – 600 URP (w (ii)))	28,200	
Trade receivables (14,800 + 9,000 – 3,700 intra-group (w (iii)))	20,100	
Bank (2,100 + 900 CIT (w (iii)))	<u>3,000</u>	51,300
Total assets		<u>141,200</u>
<b>Equity and liabilities</b>		
Equity attributable to owners of the parent		
Equity shares of \$1 each (40,000 + 6,000 (w (i)))		46,000
Share premium (w (i))	6,000	
Retained earnings (w (iv))	<u>34,000</u>	40,000
		<u>86,000</u>
Non-controlling interest (w (v))		8,800
Total equity		<u>94,800</u>
Non-current liabilities		
10% loan notes (8,000 + 1,500 (w (i)))		9,500
Current liabilities		
Trade payables (17,600 + 13,000 – 2,800 intra-group (w (iii)))	27,800	
Bank overdraft	<u>9,100</u>	36,900
Total equity and liabilities		<u>141,200</u>

**Workings (figures in brackets are in \$'000)**

(i) Goodwill in Strata

	\$'000	\$'000
Controlling interest		
Share exchange ((20,000 x 75%) x 2/5 x \$2)		12,000
10% loan notes (15,000 x 100/1,000)		1,500
Non-controlling interest (20,000 x 25% x \$1.20)		<u>6,000</u>
		19,500
Equity shares	20,000	
Pre-acquisition retained losses:		
– at 1 April 2012	(4,000)	
– 1 April to 30 September 2012	<u>(2,000)</u>	
Fair value adjustment – plant	<u>(3,000)</u>	(11,000)
Goodwill arising on acquisition		<u>8,500</u>

The market value of the shares issued of \$12 million would be recorded: \$6 million share capital and \$6 million share premium as the shares have a nominal value of \$1 each and their issue value was \$2 each.

(ii) Unrealised profit (URP) in inventory

Strata's inventory (from Paradigm) at 31 March 2013 is \$4.6 million (one month's supply). At a mark-up on cost of 15%, there would be \$600,000 of URP (4,600 x 15/115) in the inventory.

(iii) Intra-group current accounts

	\$'000
Current account balance of Strata per question	2,800
Cash-in-transit (CIT) not yet received by Paradigm	<u>900</u>
Current account balance of Paradigm	<u>3,700</u>

(iv) Consolidated retained earnings

	\$'000
Paradigm's retained earnings (19,200 + 7,400)	26,600
Strata's post-acquisition profit (11,200 (see below) x 75%)	8,400
URP in inventory (w (ii))	(600)
Loss on equity investments (7,500 – 7,100)	(400)
	<u>34,000</u>

The adjusted post-acquisition profits of Strata are:

As reported for the year	8,000
Add pre-acquisition losses	2,000
Gain on equity investments (3,900 – 3,200)	700
Adjustment for over depreciation on fair value of plant (3,000 x 6/36 months)	500
	<u>11,200</u>

(v) Non-controlling interest

	\$'000
Fair value on acquisition (w (i))	6,000
Post-acquisition profit (11,200 (w (iv)) x 25%)	2,800
	<u>8,800</u>

- (b) The consolidated financial statements of Paradigm are of little value when trying to assess the performance and financial position of its subsidiary, Strata. Therefore the main source of information on which to base any investment decision would be Strata's own entity financial statements. However, where a company is part of a group, there is the potential for the financial statements (of a subsidiary) to have been subject to the influence of related party transactions. In the case of Strata, there has been a considerable amount of post-acquisition trading with Paradigm and, because of the related party relationship, there is the possibility that this trading is not at arm's length (i.e. not at commercial rates). Indeed from the information in the question, Paradigm sells goods to Strata at a much lower cost than it does to other third parties. This gives Strata a benefit which is likely to lead to higher profits (compared to what they would have been if it had paid the market value for the goods purchased from Paradigm). This seems to coincide with a remarkable turn around in the profitability of Strata; before the acquisition it was carrying accumulated losses of \$6 million, whereas in the six months since the acquisition it made a profit of \$10 million (see part (a)). The sales of \$4.6 million per month have a cost of \$4 million (4,600 x 100/115). Had these been priced at Paradigm's normal prices, they would have been sold to Strata for \$5.6 million (4,000 x 140%). For the six month post-acquisition period, this gives Strata a trading 'advantage' of \$6 million ((\$5.6 million – \$4.6 million) x 6 months) which is a large proportion of its post-acquisition profit. There may be other aspects of the relationship where Paradigm gives Strata a benefit that may not have happened had Strata not been part of the group, e.g. access to technology/research, cheap finance, etc.

The main concern is that any information about the 'benefits' Paradigm may have passed on to Strata through related party transactions is difficult to obtain from published sources. It may be that Paradigm has deliberately 'flattered' Strata's financial statements specifically in order to obtain a high sale price and a prospective purchaser would not necessarily be able to determine that this had happened from either the consolidated or entity financial statements.

2 (a) (i) Atlas – Statement of profit or loss and other comprehensive income for the year ended 31 March 2013

Monetary figures in brackets are in \$'000

	\$'000
Revenue (550,000 – 10,000 in substance loan)	540,000
Cost of sales (w (i))	(420,600)
Gross profit	119,400
Distribution costs	(21,500)
Administrative expenses (30,900 + 5,400 re directors' bonus of 1% of sales made)	(36,300)
Finance costs (700 + 500 (10,000 x 10% x 6/12 re in substance loan))	(1,200)
Profit before tax	60,400
Income tax expense (27,200 – 1,200 + (9,400 – 6,200) deferred tax)	(29,200)
Profit for the year	31,200
Other comprehensive income	
Revaluation gain on land and buildings (w (ii))	7,000
Total comprehensive income for the year	<u>38,200</u>

**(ii) Atlas – Statement of changes in equity for the year ended 31 March 2013**

	Share capital \$'000	Share premium \$'000	Revaluation reserve \$'000	Retained earnings \$'000	Total equity \$'000
Balances at 1 April 2012	40,000	6,000	nil	11,200	57,200
Share issue (see below)	10,000	14,000			24,000
Total comprehensive income (see (i) above)			7,000	31,200	38,200
Dividend paid				(20,000)	(20,000)
Balances at 31 March 2013	<u>50,000</u>	<u>20,000</u>	<u>7,000</u>	<u>22,400</u>	<u>99,400</u>

The rights issue of 20 million shares (50,000/50 cents each x 1/5) at \$1.20 has been recorded as \$10 million equity shares (20 million x \$0.50) and \$14 million share premium (20 million x (\$1.20 – \$0.50)).

**(iii) Atlas – Statement of financial position as at 31 March 2013**

	\$'000	\$'000
<b>Assets</b>		
Non-current assets		
Property, plant and equipment (44,500 + 52,800 (w (ii)))		97,300
Current assets		
Inventory (43,700 + 7,000 re in substance loan)	50,700	
Trade receivables	<u>42,200</u>	92,900
Plant held for sale (w (ii))		<u>3,600</u>
Total assets		<u>193,800</u>
<b>Equity and liabilities</b>		
Equity (see (ii) above)		
Equity shares of 50 cents each		50,000
Share premium	20,000	
Revaluation reserve	7,000	
Retained earnings	<u>22,400</u>	49,400
		<u>99,400</u>
Non-current liabilities		
In substance loan from Xpede (10,000 + 500 accrued interest)	10,500	
Deferred tax	<u>9,400</u>	19,900
Current liabilities		
Trade payables	35,100	
Income tax	27,200	
Accrued directors' bonus	5,400	
Bank overdraft	<u>6,800</u>	74,500
Total equity and liabilities		<u>193,800</u>

**(b) Atlas – Basic earnings per share for the year ended 31 March 2013**

Earnings per statement of comprehensive income	\$31.2 million
Weighted average number of shares (w (iii))	96.7 million
Earnings per share	32.3 cents

**Workings (figures in brackets are in \$'000)**

	\$'000
(i) Cost of sales	
Per question	411,500
Closing inventory re in substance loan	(7,000)
Depreciation of buildings (w (ii))	2,500
Depreciation of plant and equipment (w (ii))	<u>13,600</u>
	<u>420,600</u>

			\$'000
(ii)	Non-current assets		
	Land and buildings		
	The gain on revaluation and carrying amount of the land and buildings will be:		
	Carrying amount at 1 April 2012 (60,000 – 20,000)		40,000
	Revaluation at that date (12,000 + 35,000)		<u>47,000</u>
	Gain on revaluation		<u>7,000</u>
	Buildings depreciation (35,000/14 years)		<u>(2,500)</u>
	Carrying amount of land and buildings at 31 March 2013 (47,000 – 2,500)		<u>44,500</u>
	Plant		
	The plant held for sale should be shown separately and not be depreciated after 1 October 2012.		
	Other plant		
	Carrying amount at 1 April 2012 (94,500 – 24,500)		70,000
	Plant held for sale (9,000 – 5,000)		<u>(4,000)</u>
			<u>66,000</u>
	Depreciation for year ended 31 March 2013 (20% reducing balance)		<u>(13,200)</u>
	Carrying amount at 31 March 2013		<u>52,800</u>
	Plant held for sale:		
	At 1 April 2012 (from above)		4,000
	Depreciation to date of reclassification (4,000 x 20% x 6/12)		<u>(400)</u>
	Carrying amount at 1 October 2012		<u>3,600</u>
	Total depreciation of plant for year ended 31 March 2013 (13,200 + 400)		13,600
	As the fair value of the plant held for sale at 1 October 2012 is \$4.2 million, it should continue to be carried at its (lower) carrying amount (and no longer depreciated).		
(iii)	Earnings per share		
	Theoretical ex-rights value:		
		Shares	\$
	Holding (say)	100	2.00
	Rights taken up (1 for 4)	25	1.20
		<u>125</u>	<u>230</u>
	Theoretical ex-rights value		<u>1.84</u> (\$230/125 shares)
	Weighted average number of shares:		
	1 April 2012 to 30 June 2012	80 million x \$2.00/\$1.84 x 3/12 =	21.7 million
	1 July 2012 to 31 March 2013	100 million x 9/12 =	<u>75.0 million</u>
	Weighted average for the year		96.7 million

**3 (a) Monty – Statement of cash flows for the year ended 31 March 2013:**

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

	\$'000	\$'000
Cash flows from operating activities:		
Profit before tax		3,000
Adjustments for:		
depreciation of non-current assets		900
amortisation of non-current assets		200
finance costs		400
decrease in inventories (3,800 – 3,300)		500
increase in receivables (2,950 – 2,200)		(750)
increase in payables (2,650 – 2,100)		550
Cash generated from operations		4,800
Finance costs paid		(400)
Income tax paid (w (i))		(425)
Net cash from operating activities		3,975
Cash flows from investing activities:		
Purchase of property, plant and equipment (w (ii))	(700)	
Deferred development expenditure (1,000 + 200)	(1,200)	
Net cash used in investing activities		(1,900)
Cash flows from financing activities:		
Redemption of 8% loan notes (3,125 – 1,400)	(1,725)	
Repayment of finance lease obligations (w (iii))	(1,050)	
Equity dividend paid (w (iv))	(550)	
Net cash used in financing activities		(3,325)
Net decrease in cash and cash equivalents		(1,250)
Cash and cash equivalents at beginning of period		1,300
Cash and cash equivalents at end of period		50

**Workings**

	\$'000
(i) Income tax paid	
Provision b/f – current	(725)
– deferred	(800)
Tax charge	(1,000)
Transfer from revaluation reserve	(650)
Provision c/f – current	1,250
– deferred	1,500
Balance – cash paid	(425)
(ii) Property, plant and equipment	
Balance b/f	10,700
Revaluation	2,000
New finance lease	1,500
Depreciation	(900)
Balance c/f	(14,000)
Balance – cash purchases	(700)
(iii) Finance leases	
Balances b/f – current	(600)
– non-current	(900)
New finance lease	(1,500)
Balances c/f – current	750
– non-current	1,200
Balance cash repayment	(1,050)

(iv) Equity dividend

	\$'000
Retained earnings b/f	1,750
Profit for the year	2,000
Retained earnings c/f	(3,200)
Balance – dividend paid	(550)

- (b) (i) There are two aspects to the revaluation of the property that may be different under Rol Standards: first the actual valuation itself may require to be made on a different basis (e.g. existing use value), thus giving a different value for the property; and second the resulting transfer of part of the revaluation reserve to deferred tax would not be made (unless there was a binding agreement at the time of the revaluation to sell the property).

Whilst Rol and International Standards have similar principles for identifying when a lease should be classified as a finance lease, the Rol Standard contains guidance in the form of the '90% rule'. Strict adherence to this may mean that under Rol Standards, the lease may not be treated as a finance lease.

Again, although Rol and International Standards have similar principles for when development expenditure satisfies the criteria for capitalisation, the Rol Standard allows directors the option not to capitalise the expenditure, even if it meets the criteria to do so.

- (ii) In respect of the property revaluation, any different value (under Rol rules) would affect both ROCE and gearing. If the Rol method gave a higher property value, this would cause both the ROCE and gearing to be lower (because the revaluation reserve in equity would be higher). The opposite would be true for a Rol valuation lower than under International Standards (assuming it was still an upwards revaluation).

The effect of not making the transfer to deferred tax would also mean Rol ROCE (assuming deferred tax is not classed as debt) and gearing were lower because the increase in equity would be higher (by the amount of the transfer to deferred tax). The lowering effect on the ratios due to the different deferred tax treatment would be present, even if the gross valuation was lower under Rol rules.

If, under the Rol '90% rule', a lease were not capitalised, then both property, plant and equipment and debt (lease obligations) would be lower (by the same amount on initial recognition). This means that ROCE would be higher as the capital employed (measured in the form of debt or net assets) would be lower on a broadly similar profit. The gearing would be lower due to less debt.

Choosing to write off development expenditure under the Rol option would reduce profit for the period and non-current assets (and therefore equity). The reduction in the 'return' (of the ROCE) would be proportionately more than the reduction in equity, therefore ROCE would be lower. As there is no effect on debt, gearing would be higher.

- 4 (a) A discontinued operation is a component (see below) of an entity that has either already been disposed of or is classified as held for sale that represents a separate major line of business or geographical area of business operations (or is part of a co-ordinated plan to dispose of such). It also applies to a subsidiary that is acquired specifically with a view to resale.

A component of an entity has operations and cash flows that are clearly distinguished for reporting purposes from those of the rest of an entity. It would normally be a cash generating unit (or a group of cash generating units) or a subsidiary.

This information is important to users of financial statements when they are forming an assessment of the likely future performance of an entity. For example, if a group made a large profit from one of its subsidiaries that it has recently sold (or will soon sell), this will have a material effect on any forecast of the group's future profit. This is because the profits from the subsidiary disposed of will no longer contribute to future group profit (though the re-investment of any sale proceeds from the disposal could). Also, the converse would be true where the disposal or closure of a loss-making subsidiary could improve future profitability.

- (b) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* has been criticised for the use of the term 'a separate major line of business or geographical area of business operations' to identify a discontinued operation as it may mean different things to different people and lead to inconsistency (and thus a lack of comparability). Despite this, the disposal of hotels in country A would seem to represent a separate geographical location and should be treated as a discontinued operation, even though the group will continue to operate hotels in other countries. The example of country B is less conclusive. Some might argue that a change in the target market (to holiday and tourism) does represent a different 'line of business operations' that has a different pricing structure, operating costs (such as providing 'all-inclusive' holidays) and profit margins than that of business clients. Also, the refurbishment of the hotels would seem to indicate catering to a different market. Others may argue that this is simply adapting a product (as all companies have to do) and does not represent a change to a separate line of business.

- (c) On its own, a board decision to close the factory is not sufficient to justify the creation of a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, by formulating a plan and informing interested parties (employees, customers and suppliers), this is likely to constitute a constructive obligation for a restructuring provision by raising a valid expectation of the closure.

The amounts that should be provided for at 31 March 2013 are:

(workings in brackets are in \$'000)

	\$'000
– redundancy (200 employees x 5)	1,000
– impairment loss on plant (2,200 – (500 – 50))	1,750 (may be shown as a separate provision)
– onerous contract (lower amount)	850
– penalty payments	200
	<u>3,800</u>

The \$3.8 million should be charged to the statement of profit or loss for the year ended 31 March 2013 and the same amount reported in the statement of financial position as at 31 March 2013 as a current liability/plant impairment (assuming all parts of the factory closure will be completed within the next 12 months).

The factory and the plant would be disclosed in the statement of financial position as non-current assets held for sale at the lower of their carrying amount (factory) or fair value less cost to sell (the plant).

The \$125,000 retraining costs cannot be provided for as they are part of future activities and the anticipated \$1.2 million profit on the disposal of the factory cannot be recognised until it is realised.

- 5 (a) (i) An investment property is land or buildings (or a part thereof) held by the owner to generate rental income or for capital appreciation (or both) rather than for production or administrative use. It would also include property held under a finance lease and may include property under an operating lease, if used for the same purpose as other investment properties. Generally, non-investment properties generate cash flows in combination with other assets, whereas a property that meets the definition of an investment property means that it will generate cash flows that are largely independent of the other assets held by an entity and, in that sense, such properties do not form part of the entity's normal operations.
- (ii) Superficially, the revaluation model and fair value sound very similar; both require properties to be valued at their fair value which is usually a market-based assessment (often by an independent valuer). However, any gain (or loss) over a previous valuation is taken to profit or loss if it relates to an investment property, whereas for an owner-occupied property, any gain is taken to a revaluation reserve (via other comprehensive income and the statement of changes in equity). A loss on the revaluation of an owner-occupied property is charged to profit or loss unless it has a previous surplus in the revaluation reserve which can be used to offset the loss until it is exhausted. A further difference is that owner-occupied property continues to be depreciated after revaluation, whereas investment properties are not depreciated.

(b) Extracts from Speculate's financial statements for the year ended 31 March 2013

(workings in brackets in \$'000)

	\$'000
<b>Statement of profit or loss and other comprehensive income</b>	
Depreciation of office building (A) (2,000/20 years x 6/12)	(50)
Gain on investment properties: A (2,340 – 2,300)	40
B (1,650 – 1,500)	150
Other comprehensive income (A see below)	350
<b>Statement of financial position</b>	
Non-current assets	
Investment properties (A and B) (2,340 + 1,650)	3,990
Equity	
Revaluation reserve (A) (2,300 – (2,000 – 50))	350

In Speculate's consolidated financial statements property B would be accounted for under IAS 16 *Property, Plant and Equipment* and be classified as owner-occupied. Further information is required to determine the depreciation charge.



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>
<b>1 (a)</b> Statement of financial position:	
property, plant and equipment	1½
goodwill	5
equity investments	1
inventory	1
receivables	1
bank	1
equity shares	1½
share premium	½
retained earnings	3½
non-controlling interest	1½
10% loan notes	1
trade payables	1
bank overdraft	½
	<b>20</b>
<b>(b)</b> 1 mark per valid point	<b>5</b>
<b>Total for question</b>	<b>25</b>
<b>2 (a) (i)</b> Statement of profit or loss and other comprehensive income	
revenue	1
cost of sales	3
distribution costs	½
administrative expenses	1
finance costs	1
income tax	1½
other comprehensive income	1
	<b>9</b>
<b>(ii)</b> Statement of changes in equity	
balances b/f	1
rights issue	1
total comprehensive income	1
dividend paid	1
	<b>4</b>
<b>(iii)</b> Statement of financial position	
property, plant and equipment	2½
inventory	1
trade receivables	½
plant held for sale (at 3,600)	1
in substance loan	1
deferred tax	1
trade payables	½
current tax	½
directors' bonus	½
bank overdraft	½
	<b>9</b>
<b>(b)</b> Basic earnings per share	
earnings per statement of comprehensive income	½
theoretical ex-rights value	1
calculation of weighted average number of shares	1½
	<b>3</b>
<b>Total for question</b>	<b>25</b>

		<i>Marks</i>
<b>3</b>	<b>(a)</b>	
	profit before tax	$\frac{1}{2}$
	depreciation/amortisation	1
	finance costs added back	$\frac{1}{2}$
	working capital items ( $\frac{1}{2}$ mark each)	$1\frac{1}{2}$
	finance cost paid (outflow)	$\frac{1}{2}$
	income tax paid	$2\frac{1}{2}$
	purchase of property, plant and equipment	$2\frac{1}{2}$
	deferred development expenditure	1
	repayment of 8% loan notes	1
	repayment of finance lease obligations	2
	equity dividend paid	1
	cash b/f	$\frac{1}{2}$
	cash c/f	$\frac{1}{2}$
		<b>15</b>
	<b>(b)</b>	
	<b>(i)</b> 2 marks for each item: revaluation, finance lease and deferred development expenditure	<b>6</b>
	<b>(ii)</b> effect on ROCE	2
	effect on gearing	2
		<b>4</b>
	<b>Total for question</b>	<b>25</b>
<b>4</b>	<b>(a)</b> 1 mark per valid point	<b>5</b>
	<b>(b)</b> operations in country A is a discontinued operation	2
	discussion of issue for country B	2
		<b>4</b>
	<b>(c)</b> information points to a constructive obligation	1
	provide for redundancy	1
	but not for retraining	1
	impairment of plant 1,750 (cannot recognise/offset gain on property)	1
	onerous contract – lower amount provided for	1
	provide for penalty	1
		<b>6</b>
	<b>Total for question</b>	<b>15</b>
<b>5</b>	<b>(a)</b>	
	<b>(i)</b> 1 mark per valid point	3
	<b>(ii)</b> 1 mark per valid point	2
		<b>5</b>
	<b>(b)</b>	
	depreciation of property A for 6 months	1
	gain on investment properties A and B	1
	carrying amounts at 31 March 2013	1
	OCI/revaluation reserve at 31 March 2013	1
	property B classified as owner-occupied in consolidated financial statements	1
		<b>5</b>
	<b>Total for question</b>	<b>10</b>