

Fundamentals Level – Skills Module

# Financial Reporting

Specimen Exam applicable from  
September 2016



**Time allowed:** 3 hours 15 minutes

This question paper is divided into three sections:

Section A – ALL 15 questions are compulsory and **MUST** be attempted

Section B – ALL 15 questions are compulsory and **MUST** be attempted

Section C – BOTH questions are compulsory and **MUST** be attempted

**Do NOT open this question paper until instructed by the supervisor.**

**Do NOT record any of your answers on the question paper.**

**This question paper must not be removed from the examination hall.**

The Association of Chartered Certified Accountants

LEVEL  
7  
Paper

**ACCA**

**Section A – ALL 15 questions are compulsory and MUST be attempted**

Please use the grid provided on page two of the Candidate Answer Booklet to record your answers to each multiple choice question. Do not write out the answers to the MCQs on the lined pages of the answer booklet.

Each question is worth 2 marks.

**1 Which of the following should be capitalised in the initial carrying amount of an item of plant?**

- (1) Cost of transporting the plant to the factory
- (2) Cost of installing a new power supply required to operate the plant
- (3) Cost of a three-year plant maintenance agreement
- (4) Cost of a three-week training course for staff to operate the plant

- A** (1) and (3)
- B** (1) and (2)
- C** (2) and (4)
- D** (3) and (4)

**2** When a parent is evaluating the assets of a potential subsidiary, certain intangible assets can be recognised separately from goodwill, even though they have not been recognised in the subsidiary's own statement of financial position.

**Which of the following is an example of an intangible asset of the subsidiary which may be recognised separately from goodwill when preparing consolidated financial statements?**

- A** A new research project which the subsidiary has correctly expensed to profit or loss but the directors of the parent have reliably assessed to have a substantial fair value
- B** A global advertising campaign which was concluded in the previous financial year and from which benefits are expected to flow in the future
- C** A contingent asset of the subsidiary from which the parent believes a flow of future economic benefits is possible
- D** A customer list which the directors are unable to value reliably

**3** On 1 October 20X4, Flash Co acquired an item of plant under a five-year finance lease agreement. The plant had a cash purchase cost of \$25m. The agreement had an implicit finance cost of 10% per annum and required an immediate deposit of \$2m and annual rentals of \$6m paid on 30 September each year for five years.

**What is the current liability for the leased plant in Flash Co's statement of financial position as at 30 September 20X5?**

- A** \$19,300,000
- B** \$4,070,000
- C** \$5,000,000
- D** \$3,850,000

- 4 Financial statements represent transactions in words and numbers. To be useful, financial information must represent faithfully these transactions in terms of how they are reported.

**Which of the following accounting treatments would be an example of faithful representation?**

- A Charging the rental payments for an item of plant to the statement of profit or loss where the rental agreement meets the criteria for a finance lease
- B Including a convertible loan note in equity on the basis that the holders are likely to choose the equity option on conversion
- C Treating redeemable preference shares as part of equity in the statement of financial position
- D Derecognising factored trade receivables sold without recourse to the seller

- 5 On 1 October 20X4, Kalatra Co commenced drilling for oil from an undersea oilfield. Kalatra Co is required to dismantle the drilling equipment at the end of its five-year licence. This has an estimated cost of \$30m on 30 September 20X9. Kalatra Co's cost of capital is 8% per annum and \$1 in five years' time has a present value of 68 cents.

**What is the provision which Kalatra Co would report in its statement of financial position as at 30 September 20X5 in respect of its oil operations?**

- A \$32,400,000
- B \$22,032,000
- C \$20,400,000
- D \$1,632,000

- 6 When a single entity makes purchases or sales in a foreign currency, it will be necessary to translate the transactions into its functional currency before the transactions can be included in its financial records.

**In accordance with IAS 21 *The Effect of Changes in Foreign Currency Exchange Rates*, which of the following foreign currency exchange rates may be used to translate the foreign currency purchases and sales?**

- (1) The rate which existed on the day that the purchase or sale took place
- (2) The rate which existed at the beginning of the accounting period
- (3) An average rate for the year, provided there have been no significant fluctuations throughout the year
- (4) The rate which existed at the end of the accounting period

- A (2) and (4)
- B (1) only
- C (3) only
- D (1) and (3)

- 7 On 1 October 20X4, Hoy Co had \$2.5 million of equity share capital (shares of 50 cents each) in issue.

No new shares were issued during the year ended 30 September 20X5, but on that date there were outstanding share options which had a dilutive effect equivalent to issuing 1.2 million shares for no consideration.

Hoy's profit after tax for the year ended 30 September 20X5 was \$1,550,000.

**In accordance with IAS 33 *Earnings Per Share*, what is Hoy's diluted earnings per share for the year ended 30 September 20X5?**

- A \$0.25
- B \$0.41
- C \$0.31
- D \$0.42

- 8 Fork Co owns an 80% investment in Spoon Co which it purchased several years ago. The goodwill on acquisition was valued at \$1,674,000 and there has been no impairment of that goodwill since the date of acquisition.

On 30 September 20X4, Fork Co disposed of its entire investment in Spoon Co, details of which are as follows:

	\$'000
Sales proceeds of Fork Co's entire investment in Spoon Co	5,580
Cost of Fork Co's entire investment in Spoon Co	3,720

Immediately before the disposal, the consolidated financial statements of Fork Co included the following amounts in respect of Spoon Co:

	\$'000
Carrying amount of the net assets (excluding goodwill)	4,464
Carrying amount of the non-controlling interests	900

**What is the profit/loss on disposal (before tax) which will be recorded in Fork Co's CONSOLIDATED statement of profit or loss for the year ended 30 September 20X4?**

- A \$1,860,000 profit
  - B \$2,016,000 profit
  - C \$342,000 profit
  - D \$558,000 loss
- 9 Consolidated financial statements are presented on the basis that the companies within the group are treated as if they are a single economic entity.

**Which of the following are requirements of preparing consolidated financial statements?**

- (1) All subsidiaries must adopt the accounting policies of the parent in their individual financial statements
- (2) Subsidiaries with activities which are substantially different to the activities of other members of the group should not be consolidated
- (3) All entity financial statements within a group should normally be prepared to the same accounting year end prior to consolidation
- (4) Unrealised profits within the group must be eliminated from the consolidated financial statements

- A (1) and (3)
- B (2) and (4)
- C (3) and (4)
- D (1) and (2)

- 10 A parent company sells goods to its 80% owned subsidiary during the financial year, some of which remains in inventory at the year end.

**What is the adjustment required in the consolidated statement of financial position to eliminate any unrealised profit in inventory?**

- A DEBIT Group retained earnings  
CREDIT Inventory
- B DEBIT Group retained earnings  
DEBIT Non-controlling interest  
CREDIT Inventory
- C DEBIT Inventory  
CREDIT Group retained earnings
- D DEBIT Inventory  
CREDIT Group retained earnings  
CREDIT Non-controlling interest

- 11 Caddy Co acquired 240,000 of Ambel Co's 800,000 equity shares for \$6 per share on 1 October 20X4. Ambel Co's profit after tax for the year ended 30 September 20X5 was \$400,000 and it paid an equity dividend on 20 September 20X5 of \$150,000.

**On the assumption that Ambel Co is an associate of Caddy Co, what would be the carrying amount of the investment in Ambel Co in the consolidated statement of financial position of Caddy Co as at 30 September 20X5?**

- A \$1,560,000
- B \$1,395,000
- C \$1,515,000
- D \$1,690,000

- 12 Quartile Co is in the jewellery retail business which can be assumed to be highly seasonal. For the year ended 30 September 20X5, Quartile Co assessed its operating performance by comparing selected accounting ratios with those of its business sector average as provided by an agency. Assume that the business sector used by the agency is a meaningful representation of Quartile Co's business.

**Which of the following circumstances may invalidate the comparison of Quartile Co's ratios with those of the sector average?**

- (1) In the current year, Quartile Co has experienced significant rising costs for its purchases
- (2) The sector average figures are compiled from companies whose year ends are between 1 July 20X5 and 30 September 20X5
- (3) Quartile Co does not revalue its properties, but is aware that other entities in this sector do
- (4) During the year, Quartile Co discovered an error relating to the inventory count at 30 September 20X4. This error was correctly accounted for in the financial statements for the current year ended 30 September 20X5

- A (1) and (3)
- B (2) and (4)
- C (2) and (3)
- D (1) and (4)

- 13 **Which of the following criticisms does NOT apply to historical cost financial statements during a period of rising prices?**

- A They are difficult to verify because transactions could have happened many years ago
- B They contain mixed values; some items are at current values and some are at out of date values
- C They understate assets and overstate profit
- D They overstate gearing in the statement of financial position

- 14 The following information has been taken or calculated from Fowler's financial statements for the year ended 30 September 20X5:

Cash cycle at 30 September 20X5	70 days
Inventory turnover	six times
Year-end trade payables at 30 September 20X5	\$230,000
Credit purchases for the year ended 30 September 20X5	\$2 million
Cost of sales for the year ended 30 September 20X5	\$1.8 million

**What is Fowler's trade receivables collection period as at 30 September 20X5?**

- A 106 days
- B 89 days
- C 56 days
- D 51 days

- 15** On 1 October 20X4, Pyramid Co acquired 80% of Square Co's 9 million equity shares. At the date of acquisition, Square Co had an item of plant which had a fair value of \$3m in excess of its carrying amount. At the date of acquisition it had a useful life of five years. Pyramid Co's policy is to value non-controlling interests at fair value at the date of acquisition. For this purpose, Square Co's shares had a value of \$3.50 each at that date. In the year ended 30 September 20X5, Square Co reported a profit of \$8m.

**At what amount should the non-controlling interests in Square Co be valued in the consolidated statement of financial position of the Pyramid group as at 30 September 20X5?**

- A** \$26,680,000
- B** \$7,900,000
- C** \$7,780,000
- D** \$12,220,000

**(30 marks)**

**This is a blank page.  
Section B begins on page 8.**

**Section B – ALL 15 questions are compulsory and MUST be attempted**

Please use the grid provided on page two of the Candidate Answer Booklet to record your answers to each multiple choice question. Do not write out the answers to the MCQs on the lined pages of the answer booklet.

Each question is worth 2 marks.

The following scenario relates to questions 16–20.

Telepath Co has a year end of 30 September and owns an item of plant which it uses to produce and package pharmaceuticals. The plant cost \$750,000 on 1 October 20X0 and, at that date, had an estimated useful life of five years. A review of the plant on 1 April 20X3 concluded that the plant would last for a further three and a half years and that its fair value was \$560,000.

Telepath Co adopts the policy of revaluing its non-current assets to their fair value but does not make an annual transfer from the revaluation surplus to retained earnings to represent the additional depreciation charged due to the revaluation.

On 30 September 20X3, Telepath Co was informed by a major customer that it would no longer be placing orders with Telepath Co. As a result, Telepath revised its estimates that net cash inflows earned from the plant for the next three years would be:

Year ended 30 September:	\$
20X4	220,000
20X5	180,000
20X6	200,000

Telepath Co's cost of capital is 10% which results in the following discount factors:

Value of \$1 at 30 September:	
20X4	0.91
20X5	0.83
20X6	0.75

Telepath Co also owns Rilda Co, a 100% subsidiary, which is treated as a cash generating unit. On 30 September 20X3, there was an impairment to Rilda's assets of \$3,500,000. The carrying amount of the assets of Rilda Co immediately before the impairment were:

	\$
Goodwill	2,000,000
Factory building	4,000,000
Plant	3,500,000
Receivables and cash (at recoverable amount)	2,500,000
	<u>12,000,000</u>

**16 In accordance with IAS 36 *Impairment of Assets*, which of the following explains the impairment of an asset and how to calculate its recoverable amount?**

- A** An asset is impaired when the carrying amount exceeds its recoverable amount and the recoverable amount is the higher of its fair value less costs of disposal and its value in use
- B** An asset is impaired when the recoverable amount exceeds its carrying amount and the recoverable amount is the lower of its fair value less costs of disposal and its value in use
- C** An asset is impaired when the recoverable amount exceeds its carrying amount and the recoverable amount is the higher of its fair value less costs of disposal and its value in use
- D** An asset is impaired when the carrying amount exceeds its recoverable amount and the recoverable amount is the lower of its fair value less costs of disposal and its value in use



**17 Prior to considering any impairment, what is the carrying amount of Telepath Co's plant and the balance on the revaluation surplus at 30 September 20X3?**

	Plant carrying amount \$000	Revaluation surplus \$000
<b>A</b>	480	nil
<b>B</b>	300	185
<b>C</b>	480	185
<b>D</b>	300	nil

**18 What is the value in use of Telepath Co's plant as at 30 September 20X3?**

- A** \$600,000
- B** \$450,000
- C** \$499,600
- D** \$nil

**19 Which of the following are TRUE in accordance with IAS 36 *Impairment of Assets*?**

- (1) A cash generating unit is the smallest identifiable group of assets for which individual cash flows can be identified and measured
- (2) When considering the impairment of a cash generating unit, the calculation of the carrying amount and the recoverable amount does not need to be based on exactly the same group of net assets
- (3) When it is not possible to calculate the recoverable amount of a single asset, then that of its cash generating unit should be measured instead

- A** (1) only
- B** (2) and (3)
- C** (3) only
- D** (1) and (3)

**20 What is the carrying amount of Rilda Co's plant at 30 September 20X3 after the impairment loss has been correctly allocated to its assets?**

- A** \$2,479,000
- B** \$2,800,000
- C** \$2,211,000
- D** \$3,500,000

The following scenario relates to questions 21–25.

At a board meeting in June 20X3, Neutron Co's directors made the decision to close down one of its factories by 30 September 20X3 and market both the building and the plant for sale. The decision had been made public, was communicated to all affected parties and was fully implemented by 30 September 20X3.

The directors of Neutron Co have provided the following information relating to the closure:

Of the factory's 250 employees, 50 will be retrained and deployed to other subsidiaries within the Neutron group during the year ended 30 September 20X4 at a cost of \$125,000. The remainder accepted redundancy at an average cost of \$5,000 each.

The factory's plant had a carrying amount of \$2.2 million, but is only expected to sell for \$500,000, incurring \$50,000 of selling costs. The factory itself is expected to sell for a profit of \$1.2 million.

The company also rented a number of machines in the factory under operating leases which have an average of three years to run after 30 September 20X3. The present value of these future lease payments at 30 September 20X3 was \$1 million, however, the lessor has stated that they will accept \$850,000 if paid on 30 October 20X3 as a full settlement.

Penalty payments, due to the non-completion of supply contracts, are estimated to be \$200,000, 50% of which is expected to be recovered from Neutron Co's insurers.

**21 Which of the following must exist for an operation to be classified as a discontinued operation in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*?**

- (1) The operation represents a separate major line of business or geographical area
- (2) The operation is a subsidiary
- (3) The operation has been sold or is held for sale
- (4) The operation is considered not to be capable of making a future profit following a period of losses

- A** (2) and (4)  
**B** (3) and (4)  
**C** (1) and (3)  
**D** (1) and (2)

**22** IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* prescribes the recognition criteria for non-current assets held for sale. For an asset or a disposal group to be classified as held for sale, the sale must be highly probable.

**Which of the following must apply for the sale to be considered highly probable?**

- (1) A buyer must have been located
- (2) The asset must be marketed at a reasonable price
- (3) Management must be committed to a plan to sell the asset
- (4) The sale must be expected to take place within the next six months

- A** (2) and (3)  
**B** (3) and (4)  
**C** (1) and (4)  
**D** (1) and (2)

**23 What is the employee cost associated with the closure and sale of Neutron Co's factory which should be charged to profit or loss for the year ended 30 September 20X3?**

- A** \$125,000  
**B** \$1,250,000  
**C** \$1,125,000  
**D** \$1,000,000

- 24 What is the profit or loss on discontinued operations relating to property, plant and equipment for the year ended 30 September 20X3?**
- A** \$1.75 million loss
  - B** \$1.75 million profit
  - C** \$550,000 loss
  - D** \$550,000 profit
- 25 In respect of the operating leases and penalty payments, what provision is required in the statement of financial position of Neutron Co as at 30 September 20X3?**
- A** \$950,000
  - B** \$1,200,000
  - C** \$1,050,000
  - D** \$1,100,000

The following scenario relates to questions 26–30.

Speculate Co is preparing its financial statements for the year ended 30 September 20X3. The following issues are relevant:

**1. Financial assets**

Shareholding A – a long-term investment in 10,000 of the equity shares of another company. These shares were acquired on 1 October 20X2 at a cost of \$3·50 each. Transaction costs of 1% of the purchase price were incurred. On 30 September 20X3 the fair value of these shares is \$4·50 each.

Shareholding B – a short-term speculative investment in 2,000 of the equity shares of another company. These shares were acquired on 1 December 20X2 at a cost of \$2·50 each. Transaction costs of 1% of the purchase price were incurred. On 30 September 20X3 the fair value of these shares is \$3·00 each.

Where possible, Speculate Co makes an irrevocable election for the fair value movements on financial assets to be reported in other comprehensive income.

**2. Taxation**

The existing debit balance on the current tax account of \$2·4m represents the over/under provision of the tax liability for the year ended 30 September 20X2. A provision of \$28m is required for income tax for the year ended 30 September 20X3. The existing credit balance on the deferred tax account is \$2·5m and the provision required at 30 September 20X3 is \$4·4m.

**3. Revenue**

On 1 October 20X2, Speculate Co sold one of its products for \$10 million. As part of the sale agreement, Speculate Co is committed to the ongoing servicing of the product until 30 September 20X5 (i.e. three years after the sale). The sale value of this service has been included in the selling price of \$10 million. The estimated cost to Speculate Co of the servicing is \$600,000 per annum and Speculate Co's gross profit margin on this type of servicing is 25%. Ignore discounting.

**26 Which of the following meet the definition of a financial asset in accordance with IFRS 9 *Financial Instruments*?**

- (1) An equity instrument of another entity
- (2) A contract to exchange financial instruments with another entity under conditions which are potentially favourable
- (3) A contract to exchange financial instruments with another entity under conditions which are potentially unfavourable
- (4) Cash

- A** (1) and (2) only
- B** (1), (2) and (4)
- C** (1), (3) and (4)
- D** (4) only

**27 In respect of the financial assets of Speculate Co, what amount will be included in other comprehensive income for the year ended 30 September 20X3?**

- A** \$9,650
- B** \$10,650
- C** \$10,000
- D** \$nil

- 28 What is the total amount which will be charged to the statement of profit or loss for the year ended 30 September 20X3 in respect of taxation?**
- A** \$28,000,000
  - B** \$30,400,000
  - C** \$32,300,000
  - D** \$29,900,000
- 29 What is the amount of deferred income which Speculate Co should recognise in its statement of financial position as at 30 September 20X3 relating to the contract for the supply and servicing of products?**
- A** \$1.2 million
  - B** \$1.6 million
  - C** \$600,000
  - D** \$1.5 million
- 30 Which of the following are TRUE in respect of the income which Speculate Co has deferred at 30 September 20X3?**
- (1) The deferred income will be split evenly between the current and non-current liabilities in Speculate Co's statement of financial position as at 30 September 20X3
  - (2) The costs associated with the deferred income of Speculate Co should be recognised in the statement of profit or loss at the same time as the revenue is recognised
  - (3) The deferred income can only be recognised as revenue by Speculate Co when there is a signed written contract of service with its customer
  - (4) When recognising the revenue associated with the service contract of Speculate Co, the stage of its completion is irrelevant
- A** (1) and (2)
  - B** (3) and (4)
  - C** (2) and (3)
  - D** (1) and (4)

**(30 marks)**

**Section C – Both questions are compulsory and MUST be attempted**

Please write your answers to all parts of these questions on the lined pages within the Candidate Answer Booklet.

**31** After preparing a draft statement of profit or loss for the year ended 30 September 20X5 and adding the current year's draft profit (before any adjustments required by notes (i) to (iii) below) to retained earnings, the summarised trial balance of Kandy Co as at 30 September 20X5 is:

	\$'000	\$'000
Equity shares of \$1 each		20,000
Retained earnings as at 30 September 20X5		15,500
Proceeds of 6% loan note (note (i))		30,000
Investment properties at fair value (note (ii))	20,000	
Land (\$5 million) and buildings – at cost (note (ii))	35,000	
Plant and equipment – at cost (note (ii))	58,500	
Accumulated depreciation at 1 October 20X4: buildings		20,000
plant and equipment		34,500
Current assets	68,700	
Current liabilities		43,400
Deferred tax (notes (ii) and (iii))		2,500
Interest paid (note (i))	1,800	
Current tax (note (iii))		1,100
Suspense account (note (ii))		17,000
	184,000	184,000

The following notes are relevant:

(i) The loan note was issued on 1 October 20X4 and incurred issue costs of \$1 million which were charged to profit or loss. Interest of \$1.8 million (\$30 million at 6%) was paid on 30 September 20X5. The loan is redeemable on 30 September 20X9 at a substantial premium which gives an effective interest rate of 9% per annum. No other repayments are due until 30 September 20X9.

(ii) Non-current assets:

On 1 October 20X4, Kandy owned two investment properties. The first property had a carrying amount of \$15 million and was sold on 1 December 20X4 for \$17 million. The disposal proceeds have been credited to a suspense account in the trial balance above. On 31 December 20X4, the second property became owner occupied and so was transferred to land and buildings at its fair value of \$6 million. Its remaining useful life on 31 December 20X4 was considered to be 20 years. Ignore any deferred tax implications of this fair value.

The price of property has increased significantly in recent years and so the directors decided to revalue the land and buildings. The directors accepted the report of an independent surveyor who, on 1 October 20X4, valued the land at \$8 million and the buildings at \$39 million on that date. This revaluation specifically excludes the transferred investment property described above. The remaining life of these buildings at 1 October 20X4 was 15 years. Kandy does not make an annual transfer to retained profits to reflect the realisation of the revaluation gain; however, the revaluation will give rise to a deferred tax liability. The income tax rate applicable to Kandy is 20%.

Plant and equipment is depreciated at 12½% per annum using the reducing balance method.

No depreciation has yet been charged on any non-current asset for the year ended 30 September 20X5.

(iii) A provision of \$2.4 million is required for income tax on the profit for the year to 30 September 20X5. The balance on current tax in the trial balance is the under/over provision of tax for the previous year. In addition to the temporary differences relating to the information in note (ii), Kandy has further taxable temporary differences of \$10 million as at 30 September 20X5.

**Required:**

(a) Prepare a schedule of adjustments required to the retained earnings of Kandy Co as at 30 September 20X5 as a result of the information in notes (i) to (iii) above.

(b) Prepare the statement of financial position of Kandy Co as at 30 September 20X5.

Note: The notes to the statement of financial position are not required.

(c) Prepare the extracts from Kandy Co's statement of cash flows for operating and investing activities for the year ended 30 September 20X5 which relate to property, plant and equipment.

The following mark allocation is provided as guidance for this question:

(a) 8 marks

(b) 9 marks

(c) 3 marks

**(20 marks)**





**Required:**

- (a) **Comment on how the new contract and the purchase of Raremetal Co may have affected the comparability of the consolidated financial statements of Tangier Co for the years ended 30 September 20X4 and 20X5.**
- (b) **Calculate appropriate ratios and comment on Tangier Co's profitability and gearing. Your analysis should identify instances where the new contract and the purchase of Raremetal Co have limited the usefulness of the ratios and your analysis.**

Note: Your ratios should be based on the consolidated financial statements provided and you should not attempt to adjust for the effects of the new contract or the consolidation. Working capital and liquidity ratios are not required.

- (c) **Explain what further information you might require to make your analysis more meaningful.**

The following mark allocation is provided as guidance for this question:

- (a) 5 marks
- (b) 12 marks (up to 5 marks for the ratio calculations)
- (c) 3 marks

**(20 marks)**

**End of Question Paper**

---

# Answers

---

Section A

1 B

2 A

3 B

$25,000 - 2,000 = 23,000 + 2,300 (10\% \text{ int}) - 6,000 (\text{pmt}) = 19,300$   
 $19,300 + 1,930 (10\% \text{ int}) - 6,000 (\text{pmt}) = 15,230$   
 Current liability =  $19,300 - 15,230 = \$4,070$

4 D

5 B

Dismantling provision at 1 October 20X4 is \$20.4 million ( $30,000 \times 0.68$ ) discounted  
 This will increase by an 8% finance cost by 30 September 20X5 = \$22,032,000

6 D

7 A

$(1,550 / (2,500 \times 2 + 1,200)) = \$0.25$

8 C

		\$000
Sales proceeds		5,580
Net assets at disposal	4,464	
Goodwill at disposal	1,674	
Less: carrying value of NCI	(900)	(5,238)
		342

9 C

10 A

11 C

		\$'000
Cost ( $240,000 \times \$6$ )		1,440
Share of associate's profit ( $400 \times 240/800$ )		120
Less dividend received ( $150 \times 240/800$ )		(45)
		1,515

12 C

13 A

14 D

Inventory turnover is 61 days (365/6).  
Trade payables period is 42 days (230,000 x 365/2 million).  
Therefore, receivables collection period is 51 days (70 – 61 + 42).

15 C

	<b>\$000</b>
FV NCI at 1 October 14 (9000 x 20% x \$3.50)	6,300
Post-acquisition profit (8000 – (3000/5)) = 7,400 at 20%	1,480
	<u>7,780</u>

Section B

16 A

17 C

Annual depreciation prior to the revaluation is \$150,000 (750/5). At the date of revaluation (1 April 20X3), the carrying amount is \$375,000 (750-(150 x 2.5 yrs)). Revalued to \$560,000 with a remaining life of 3.5 years results in a depreciation charge of \$160,000 per annum which means \$80,000 for six months. The carrying amount at 30 September 20X3 is therefore \$480,000 (560 – 80). **Alternative calculation:** \$560,000 – (\$560,000/3.5 x 6/12) = \$480,000.

The revaluation surplus has a balance of \$185,000 (560,000 – 375,000).

18 C

	Cash flow \$'000	Discount factor at 10%	Present value \$'000
Year ended: 30 September 20X4	220	0.91	200.2
30 September 20X5	180	0.83	149.4
30 September 20X6	200	0.75	150.0
			<u>499.6</u>

19 D

20 B

	Carrying amount before \$'000	Impairment loss \$'000	Carrying amount after \$'000
Goodwill	2,000	2,000	Nil
Property	4,000	800	3,200
Plant	3,500	700	2,800
Cash and receivables	2,500	Nil	2,500
	<u>12,000</u>	<u>3,500</u>	<u>8,500</u>

21 C

22 A

23 D

200 employees at \$5,000 = \$1,000,000 redundancy costs. The retraining costs are a future cost.

**24 A**

Impairment loss on plant is \$1,750,000 (2,200,000 – (500,000 – 50,000)).

**25 C**

Onerous contract \$850,000 + penalty payments \$200,000 = \$1,050,000. The possible insurance receipt should be ignored as there is no certainty that it would be received and it would not be netted off against the provision anyway.

**26 B**

**27 A**

Shareholding A is not held for trading as an election made – FVTOCI.

Shareholding B is held for trading and so FVTPL (transaction costs are not included in carrying amount).

Cost of shareholding A is 10,000 x \$3.50 x 1.01 = \$35,350.

FV at 30 September 20X3 10,000 x \$4.50 = \$45,000.

Gain = 45,000 – 35,350 = \$9,650.

**28 C**

	<b>\$'000</b>
DT provision required at 30 September 20X3	4,400
DT Provision at 1 October 20X2	(2,500)
	<u>1,900</u>
Write off of the overprovision for the year ended 30 September 20X2	2,400
Income tax for the year ended 30 September 20X3	28,000
	<u>32,300</u>

**29 B**

At 30 September 20X3 there are two more years of servicing work, thus \$1.6 million ((600,000 x 2) x 100/75) must be treated as deferred income.

**30 A**

**Section C**

**31 (a) Kandy Co – Schedule of retained earnings of Kandy as at 30 September 20X5**

	<b>\$'000</b>
Retained earnings per trial balance	15,500
Adjustments re:	
Note (i)	
Add back issue costs of loan note (w (i))	1,000
Loan finance costs (29,000 x 9% (w (i)))	(2,610)
Note (ii)	
Gain on disposal of investment property (17,000 – 15,000)	2,000
Gain on revaluation of investment property prior to transfer (6,000 – 5,000)	1,000
Depreciation of buildings (w (ii))	(2,825)
Depreciation of plant and equipment (w (ii))	(3,000)
Note (iii)	
Income tax expense (w (iii))	(800)
Adjusted retained earnings	<u>10,265</u>

**(b) Kandy Co – Statement of financial position as at 30 September 20X5**

	\$'000	\$'000
Assets		
Non-current assets		
Property, plant and equipment (50,175 + 21,000 (w (ii)))		71,175
Current assets (per trial balance)		<u>68,700</u>
Total assets		<u>139,875</u>
Equity and liabilities		
Equity		
Equity shares of \$1 each		20,000
Revaluation surplus (32,000 – 6,400 (w (ii) and (iii)))	25,600	
Retained earnings (from (a))	<u>10,265</u>	<u>35,865</u>
		55,865
Non-current liabilities		
Deferred tax (w (iii))	8,400	
6% loan note (w (i))	<u>29,810</u>	38,210
Current liabilities		
Per trial balance	43,400	
Current tax payable	<u>2,400</u>	<u>45,800</u>
Total equity and liabilities		<u>139,875</u>

**Workings (monetary figures in brackets in \$'000)****(i) Loan note**

The issue costs should be deducted from the proceeds of the loan note and not charged as an expense. The finance cost of the loan note, at the effective rate of 9% applied to the carrying amount of the loan note of \$29 million (30,000 – 1,000), is \$2,610,000. The interest actually paid is \$1.8 million. The difference between these amounts of \$810,000 (2,610 – 1,800) is added to the carrying amount of the loan note to give \$29,810,000 (29,000 + 810) for inclusion as a non-current liability in the statement of financial position.

**(ii) Non-current assets****Land and buildings**

The gain on revaluation and carrying amount of the land and buildings will be:

	\$'000
Carrying amount at 1 October 20X4 (35,000 – 20,000)	15,000
Revaluation at that date (8,000 + 39,000)	<u>47,000</u>
Gain on revaluation	<u>32,000</u>
Buildings depreciation for the year ended 30 September 20X5:	
Land and buildings existing at 1 October 20X4 (39,000/15 years)	2,600
Transferred investment property (6,000/20 x 9/12)	<u>225</u>
	<u>2,825</u>
Carrying amount at 30 September 20X5 (47,000 + 6,000 – 2,825)	<u>50,175</u>
<b>Plant and equipment</b>	
Carrying amount at 1 October 20X4 (58,500 – 34,500)	24,000
Depreciation for year ended 30 September 20X5 (12½% reducing balance)	<u>(3,000)</u>
Carrying amount at 30 September 20X5	<u>21,000</u>

**(iii) Taxation****Income tax expense**

Provision for year ended 30 September 20X5	2,400
Less over provision in previous year	<u>(1,100)</u>
Deferred tax (see below)	<u>(500)</u>
	<u>800</u>

	\$'000
<b>Deferred tax</b>	
Provision required at 30 September 20X5 ((10,000 + 32,000) x 20%)	8,400
Provision at 1 October 20X4	<u>(2,500)</u>
Movement in provision	5,900
Charge to revaluation of land and buildings (32,000 x 20%)	<u>(6,400)</u>
Balance – credit to profit or loss	<u>(500)</u>

(c)	\$'000
<b>Cash flows from operating activities:</b>	
Add back depreciation	5,825
Deduct gain on revaluation of investment property	(1,000)
Deduct gain on disposal of investment property	(2,000)
<b>Cash flows from investing activities:</b>	
Investment property disposal proceeds	17,000

**32 (a) Note: References to '20X5' are in respect of the year ended 30 September 20X5 and '20X4' refers to the year ended 30 September 20X4.**

The key matter to note is that the ratios for 20X4 and 20X5 will not be directly comparable because two significant events, the acquisition of Raremetal Co and securing the new contract, have occurred between these dates. This means that the underlying financial statements are not directly comparable. For example, the 20X4 statement of profit or loss (SOPL) will not include the results of Raremetal Co or the effect of the new contract. However, the 20X5 SOPL will contain nine months of the results of Raremetal Co (although intra-group transactions will have been eliminated) and nine months of the effects of the new contract (which may have resulted in either a net profit or loss). Likewise, the 20X4 statement of financial position does not contain any of Raremetal Co's assets and liabilities, whereas that of 20X5 contains all of the net assets of Raremetal Co and the cost of the new licence. This does not mean that comparisons between the two years are not worthwhile, just that they need to be treated with caution. For some ratios, it may be necessary to exclude all of the subsidiaries from the analysis and use the single entity financial statements of Tangier Co as a basis for comparison with the performance of previous years. Similarly, it may still be possible to compare some of the ratios of the Tangier group with those of other groups in the same sector although not all groups will have experienced similar acquisitions.

Assuming there has been no impairment of goodwill, the investment in Raremetal Co has resulted in additional goodwill of \$30 million which means that the investment has cost more than the carrying amount of Raremetal Co's net assets. Although there is no indication of the precise cost, it is known to have been achieved by a combination of a share exchange (hence the \$180 million new issue of shares) and a cash element (funded from the proceeds of the loan issue and the decrease in the bank balance). Any intra-group sales have been eliminated on consolidation and it is not possible to determine in which individual company any profit on these intra-group sales will be reported; it is therefore difficult to measure any benefits of the investment. Indeed, the benefit of the investment might not be a financial one but merely to secure the supply of raw materials. It would be useful to establish the cost of the investment and the profit (if any) contributed by Raremetal Co so that an assessment of the benefit of the investment might be made.

(b) Relevant ratios:	20X5	20X4
Gross profit margin % (810/2,700 x 100)	30.0%	40.0%
Operating profit margin (235/2,700 x 100)	8.7%	21.9%
ROCE (235/(805 + 400))	19.5%	61.7%
Net asset turnover (2,700/(805 + 400))	2.24 times	2.82 times
Debt/equity (400/805)	49.7%	18.3%
Interest cover (235/40)	5.9 times	79.6 times

All of the issues identified in part (a) make a comparison of ratios difficult and, if more information was available, then some adjustments may be required. For example, if it is established that the investment is not generating any benefits, then it might be argued that the inclusion of the goodwill in the ROCE and asset turnover is unjustified (it may be impaired and should be written off). Goodwill has not been excluded from any of the following ratios.

The increase in revenues of 48.4% (880/1,820 x 100) in 20X5 will be partly due to the consolidation of Raremetal Co and the revenues associated with the new contract. Yet, despite these increased revenues, the company has suffered a dramatic fall in its profitability. This has been caused by a combination of a falling gross profit margin (from 40% in 20X4 to only 30% in 20X5) and markedly higher operating overheads (operating profit margin has fallen from 21.9% in 20X4 to 8.7% in 20X5). Again, it is important to note that some of these costs will be attributable to the consolidation of Raremetal Co and some to the new contract. It could be speculated that the 73% increase in administrative expenses may be due to one-off costs associated with the tendering process (consultancy fees, etc) and the acquisition of Raremetal Co and the 77% increase in higher distribution costs could be due to additional freight/packing/insurance cost of the engines, delivery distances may also be longer (even to foreign countries) (although some of the increase in distribution costs may also be due to consolidation).

This is all reflected in the ROCE falling from an impressive 61·7% in 20X4 to only 19·5% in 20X5 (though even this figure is respectable). The fall in the ROCE is attributable to a dramatic fall in profit margin at operating level (from 21·9% in 20X4 to only 8·7% in 20X5) which has been compounded by a reduction in the asset turnover, with only \$2·24 being generated from every \$1 invested in net assets in 20X5 (from \$2·82 in 20X4).

The information in the question points strongly to the possibility (even probability) that the new contract may be responsible for much of the deterioration in Tangier Co's operating performance. For example, it is likely that the new contract may account for some of the increased revenue; however, the bidding process was 'very competitive' which may imply that Tangier Co had to cut its prices (and therefore its profit margin) in order to win the contract.

The costs of fulfilling the contract have also been heavy: investment in property, plant and equipment has increased by \$370 million (at carrying amount), representing an increase of 61% (no doubt some of this increase will be due to the acquisition of Raremetal Co). The increase in licence costs to manufacture the new engines has cost \$200 million plus any amortisation and there is also the additional goodwill of \$30 million.

An eight-fold increase in finance cost caused by the increased borrowing at double the interest rate of the borrowing in 20X4 and (presumably) some overdraft interest has led to the dramatic fall in the company's interest cover (from 79·6 in 20X4 to only 5·9 in 20X5). The finance cost of the new \$300 million 10% loan notes to partly fund the investment in Raremetal Co and other non-current assets has also increased debt/equity (one form of gearing measure) from 18·3% in 20X4 to 49·7% in 20X5 despite also issuing \$180 million in new equity shares. At this level, particularly in view of its large increase from 20X4, it may give debt holders (and others) cause for concern as there is increased risk for all Tangier Co's lenders. If it could be demonstrated that the overdraft could not be cleared for some time, this would be an argument for including it in the calculation of debt/equity, making the 20X5 gearing level even worse. It is also apparent from the movement in the retained earnings that Tangier Co paid a dividend during 20X5 of \$55 million (295,000 + 135,000 – 375,000) which may be a questionable policy when the company is raising additional finance through borrowings and contributes substantially to Tangier Co's overdraft.

Overall, the acquisition of Raremetal Co to secure supplies appears to have been an expensive strategy, perhaps a less expensive one might have been to enter into a long-term supply contract with Raremetal Co.

**(c)** Further information which would be useful to obtain would therefore include:

- (i) The cost of the investment in Raremetal Co, the carrying amount of the assets acquired and whether Tangier Co has carried out a goodwill impairment test as required under IFRS.
- (ii) The benefits generated from the investment; for example, Raremetal Co's individual financial statements and details of sales to external customers (not all of these benefits will be measurable in financial terms).
- (iii) The above two pieces of information would demonstrate whether the investment in Raremetal Co had been worthwhile.
- (iv) The amount of intra-group sales made during the year and those expected to be made in the short to medium term.
- (v) The pricing strategy agreed with Raremetal Co so that the effects on the profits reported in the individual financial statements of Raremetal Co and Tangier Co can be more readily determined.
- (vi) More information is needed to establish if the new contract has been detrimental to Tangier Co's performance. The contract was won sometime between 1 October 20X4 and 1 January 20X5 and there is no information of when production/sales started, but clearly there has not been a full year's revenue from the contract. Also there is no information on the length or total value of the contract.



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.

<b>Section A</b>	<i>Marks</i>	
2 marks per question	<u><b>30</b></u>	
<b>Section B</b>		
3 cases (5 questions each) 2 marks per question	<u><b>30</b></u>	
<b>Section C</b>	<i>Maximum marks</i>	<i>Awarded</i>
<b>31 (a) Schedule of retained earnings as at 30 September 20X4</b>		
Retained earnings per trial balance	½	
Issue costs	1	
Loan finance costs	1	
Gains on investment properties	1	
Depreciation charges	3	
Income tax expense	1½	
	<u><b>8</b></u>	
<b>(b) Statement of financial position</b>		
Property, plant and equipment	2	
Current assets	½	
Equity shares	½	
Revaluation surplus	2	
Deferred tax	1	
6% loan note	1½	
Current liabilities (per trial balance)	½	
Current tax payable	1	
	<u><b>9</b></u>	
<b>(c) Extracts from the statement of cash flows</b>		
Cash flows from operating activities:		
Add back depreciation	1	
Less gain on revaluation of investment property	½	
Less gain on disposal of investment property	½	
Cash flows from investing activities:		
Investment property disposal proceeds	1	
	<u><b>3</b></u>	
	<u><b>20</b></u>	
<b>32 (a) Analysis of results</b>		
A like for like comparison taking account of the consolidation and the contract	<u><b>5</b></u>	
<b>(b) Up to 5 marks for ratio calculations</b>	5	
Profitability	4½	
Gearing and interest cover	2½	
	<u><b>12</b></u>	
<b>(c) Additional information</b>		
Any three of the six suggestions provided	<u><b>3</b></u>	
	<u><b>20</b></u>	