

Fundamentals Level – Skills Module

# Financial Reporting

Specimen Exam applicable from  
December 2014

**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

This paper is divided into two sections:

Section A – ALL TWENTY questions are compulsory and MUST be attempted

Section B – ALL THREE questions are compulsory and MUST be attempted

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

**During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.**

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

The Association of Chartered Certified Accountants

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

Please use the space provided on the inside cover of the Candidate Answer Booklet to indicate your chosen answer to each multiple choice question.

Each question is worth 2 marks.

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

- (i) Cost of transporting the plant to the factory
- (ii) Cost of installing a new power supply required to operate the plant
- (iii) A deduction to reflect the estimated realisable value
- (iv) Cost of a three-year maintenance agreement
- (v) Cost of a three-week training course for staff to operate the plant

- A** (i) and (ii) only
- B** (i), (ii) and (iii)
- C** (ii), (iii) and (iv)
- D** (i), (iv) and (v)

**2 Quartile is in the jewellery retail business which can be assumed to be highly seasonal. For the year ended 30 September 2014, Quartile assessed its operating performance by comparing selected accounting ratios with those of its business sector average as provided by an agency. You may assume that the business sector used by the agency is an accurate representation of Quartile's business.**

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

- (i) In the current year, Quartile has experienced significant rising costs for its purchases
- (ii) The sector average figures are compiled from companies whose year end is between 1 July 2014 and 30 September 2014
- (iii) Quartile does not revalue its properties, but is aware that other entities in this sector do
- (iv) During the year, Quartile discovered an error relating to the inventory count at 30 September 2013. This error was correctly accounted for in the financial statements for the current year ended 30 September 2014

- A** All four
- B** (i), (ii) and (iii)
- C** (ii) and (iii) only
- D** (ii), (iii) and (iv)

**3 Which of the following criticisms does NOT apply to historical cost accounts during a period of rising prices?**

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

- 4** Dempsey's year end is 30 September 2014. Dempsey commenced the development stage of a project to produce a new pharmaceutical drug on 1 January 2014. Expenditure of \$40,000 per month was incurred until the project was completed on 30 June 2014 when the drug went into immediate production. The directors became confident of the project's success on 1 March 2014. The drug has an estimated life span of five years; time apportionment is used by Dempsey where applicable.

**What amount will Dempsey charge to profit or loss for development costs, including any amortisation, for the year ended 30 September 2014?**

- A \$12,000
- B \$98,667
- C \$48,000
- D \$88,000

- 5** On 1 October 2013, Fresco acquired an item of plant under a five-year finance lease agreement. The plant had a cash purchase cost of \$25 million. The agreement had an implicit finance cost of 10% per annum and required an immediate deposit of \$2 million and annual rentals of \$6 million paid on 30 September each year for five years.

**What would be the current liability for the leased plant in Fresco's statement of financial position as at 30 September 2014?**

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

- 6** The following information has been taken or calculated from Fowler's financial statements for the year ended 30 September 2014.

Fowler's cash cycle at 30 September 2014 is 70 days.

Its inventory turnover is six times.

Year-end trade payables are \$230,000.

Purchases on credit for the year were \$2 million.

Cost of sales for the year was \$1.8 million.

**What is Fowler's trade receivables collection period as at 30 September 2014?**

All calculations should be made to the nearest full day. The trading year is 365 days.

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

- 7 Which of the following would be a change in accounting policy in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors?**

- A Adjusting the financial statements of a subsidiary prior to consolidation as its accounting policies differ from those of its parent
- B A change in reporting depreciation charges as cost of sales rather than as administrative expenses
- C Depreciation charged on reducing balance method rather than straight line
- D Reducing the value of inventory from cost to net realisable value due to a valid adjusting event after the reporting period

- 8** On 1 January 2014, Viagem acquired 80% of the equity share capital of Greca.

Extracts of their statements of profit or loss for the year ended 30 September 2014 are:

	Viagem	Greca
	\$'000	\$'000
Revenue	64,600	38,000
Cost of sales	(51,200)	(26,000)

Sales from Viagem to Greca throughout the year ended 30 September 2014 had consistently been \$800,000 per month. Viagem made a mark-up on cost of 25% on these sales. Greca had \$1.5 million of these goods in inventory as at 30 September 2014.

**What would be the cost of sales in Viagem's consolidated statement of profit or loss for the year ended 30 September 2014?**

- A** \$59.9 million
- B** \$61.4 million
- C** \$63.8 million
- D** \$67.9 million

- 9** The objective of IAS 17 *Leases* is to prescribe the appropriate accounting treatment and required disclosures in relation to leases.

**Which TWO of the following situations would normally lead to a lease being classified as a finance lease?**

- (i) The lease transfers ownership of the asset to the lessee by the end of the lease term
- (ii) The lease term is for approximately half of the economic life of the asset
- (iii) The lease assets are of a specialised nature such that only the lessee can use them without major modifications being made
- (iv) At the inception of the lease, the present value of the minimum lease payments is 60% of what the leased asset would cost to purchase

- A** (i) and (ii)
- B** (i) and (iii)
- C** (ii) and (iii)
- D** (iii) and (iv)

- 10 Which of the following is NOT a purpose of the IASB's Conceptual Framework?**

- A** To assist the IASB in the preparation and review of IFRS
- B** To assist auditors in forming an opinion on whether financial statements comply with IFRS
- C** To assist in determining the treatment of items not covered by an existing IFRS
- D** To be authoritative where a specific IFRS conflicts with the Conceptual Framework

- 11 An associate is an entity in which an investor has significant influence over the investee.**

**Which of the following indicate(s) the presence of significant influence?**

- (i) The investor owns 330,000 of the 1,500,000 equity voting shares of the investee
- (ii) The investor has representation on the board of directors of the investee
- (iii) The investor is able to insist that all of the sales of the investee are made to a subsidiary of the investor
- (iv) The investor controls the votes of a majority of the board members

- A** (i) and (ii) only
- B** (i), (ii) and (iii)
- C** (ii) and (iii) only
- D** All four

**12** 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 group accounts?**

- (i) All subsidiaries must adopt the accounting policies of the parent
- (ii) Subsidiaries with activities which are substantially different to the activities of other members of the group should not be consolidated
- (iii) All entity financial statements within a group should (normally) be prepared to the same accounting year end prior to consolidation
- (iv) Unrealised profits within the group must be eliminated from the consolidated financial statements

- A** All four
- B** (i) and (ii) only
- C** (i), (iii) and (iv)
- D** (iii) and (iv)

**13** The Caddy group acquired 240,000 of August's 800,000 equity shares for \$6 per share on 1 April 2014. August's profit after tax for the year ended 30 September 2014 was \$400,000 and it paid an equity dividend on 20 September 2014 of \$150,000.

**On the assumption that August is an associate of Caddy, what would be the carrying amount of the investment in August in the consolidated statement of financial position of Caddy as at 30 September 2014?**

- A** \$1,455,000
- B** \$1,500,000
- C** \$1,515,000
- D** \$1,395,000

**14** On 1 October 2013, Hoy had \$2·5 million of equity shares of 50 cents each in issue.

No new shares were issued during the year ended 30 September 2014, but on that date there were outstanding share options to purchase 2 million equity shares at \$1·20 each. The average market value of Hoy's equity shares during the year ended 30 September 2014 was \$3 per share.

Hoy's profit after tax for the year ended 30 September 2014 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 2014?**

- A** 25·0 cents
- B** 22·1 cents
- C** 31·0 cents
- D** 41·9 cents

**15** Although the objectives and purposes of not-for-profit entities are different from those of commercial entities, the accounting requirements of not-for-profit entities are moving closer to those entities to which IFRSs apply.

**Which of the following IFRS requirements would NOT be relevant to a not-for-profit entity?**

- A** Preparation of a statement of cash flows
- B** Requirement to capitalise a finance lease
- C** Disclosure of earnings per share
- D** Disclosure of non-adjusting events after the reporting date

- 16** Riley acquired a non-current asset on 1 October 2009 at a cost of \$100,000 which had a useful economic life of ten years and a nil residual value. The asset had been correctly depreciated up to 30 September 2014. At that date the asset was damaged and an impairment review was performed. On 30 September 2014, the fair value of the asset less costs to sell was \$30,000 and the expected future cash flows were \$8,500 per annum for the next five years. The current cost of capital is 10% and a five year annuity of \$1 per annum at 10% would have a present value of \$3.79

**What amount would be charged to profit or loss for the impairment of this asset for the year ended 30 September 2014?**

- A \$17,785
- B \$20,000
- C \$30,000
- D \$32,215

- 17** Trent uses the formula:

(trade receivables at its year end/revenue for the year) x 365

to calculate how long on average (in days) its customers take to pay.

**Which of the following would NOT affect the correctness of the above calculation of the average number of days a customer takes to pay?**

- A Trent experiences considerable seasonal trading
- B Trent makes a number of cash sales through retail outlets
- C Reported revenue does not include a 15% sales tax whereas the receivables do include the tax
- D Trent factors with recourse the receivable of its largest customer

- 18 Which TWO of the following events which occur after the reporting date of a company but before the financial statements are authorised for issue are classified as ADJUSTING events in accordance with IAS 10 Events after the Reporting Period?**

- (i) A change in tax rate announced after the reporting date, but affecting the current tax liability
- (ii) The discovery of a fraud which had occurred during the year
- (iii) The determination of the sale proceeds of an item of plant sold before the year end
- (iv) The destruction of a factory by fire

- A (i) and (ii)
- B (i) and (iii)
- C (ii) and (iii)
- D (iii) and (iv)

- 19 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 Derecognising factored trade receivables sold without recourse
- D Treating redeemable preference shares as part of equity in the statement of financial position

- 20** Isaac is a company which buys agricultural produce from wholesale suppliers for retail to the general public. It is preparing its financial statements for the year ending 30 September 2014 and is considering its closing inventory.

**In addition to IAS 2 *Inventories*, which of the following IFRSs may be relevant to determining the figure to be included in its financial statements for closing inventories?**

- A** IAS 10 *Events After the Reporting Period*
- B** IAS 11 *Construction Contracts*
- C** IAS 16 *Property, Plant and Equipment*
- D** IAS 41 *Agriculture*

**(40 marks)**

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

- 1 Tangier's summarised financial statements for the years ended 30 September 2014 and the comparative figures are shown below.

**Statements of profit or loss for the year ended 30 September:**

	2014 \$m	2013 \$m
Revenue	2,700	1,820
Cost of sales	<u>(1,890)</u>	<u>(1,092)</u>
Gross profit	810	728
Administrative expense	(345)	(200)
Distribution costs	(230)	(130)
Finance costs	<u>(40)</u>	<u>(5)</u>
Profit before taxation	195	393
Income tax expense	<u>(60)</u>	<u>(113)</u>
Profit for the year	<u>135</u>	<u>280</u>

**Statements of financial position as at 30 September:**

	2014 \$m	2013 \$m	2014 \$m	2013 \$m
Non-current assets				
Property, plant and equipment	680		410	
Intangible asset: manufacturing licence	300		200	
Investment at cost – Raremetal	<u>230</u>		nil	
	1,210		610	
Current assets				
Inventory	200		110	
Trade receivables	195		75	
Bank	nil		120	
Total assets	<u>1,605</u>		<u>915</u>	
Equity and liabilities				
Equity shares of \$1 each	430		250	
Retained earnings	<u>375</u>		<u>295</u>	
	805		545	
Non-current liabilities				
5% secured loan notes	100		100	
10% secured loan notes	<u>300</u>	400	nil	100
Current liabilities				
Bank overdraft	110		nil	
Trade payables	210		160	
Current tax payable	<u>80</u>	<u>400</u>	<u>110</u>	<u>270</u>
Total equity and liabilities	<u>1,605</u>		<u>915</u>	

The following additional information has been obtained in relation to the operations of Tangier for the year ended 30 September 2014:

- (i) On 1 January 2014, Tangier won a tender for a new contract to supply Jetside with aircraft engines which Tangier manufactures under a recently acquired licence. The bidding process had been very competitive and Tangier had to increase its manufacturing capacity to fulfil the contract.

- (ii) The company also decided to invest in Raremetal by buying 8% of its equity shares to secure supplies of specialised materials used in the manufacture of the engines. No dividends were received from Raremetal nor had the value of its shares increased.

On seeing the results for the first time, one of the company's non-executive directors is disappointed by the current year's performance.

**Required:**

**Explain how the new contract and its related costs may have affected Tangier's operating performance during the year ended 30 September 2014, identifying any further information regarding the contract which may be useful to your answer.**

Note: Your answer should be supported by appropriate ratios (up to 5 marks); however, ratios and analysis of working capital are not required.

**(15 marks)**

- 2** On 1 October 2013, Pyramid acquired 80% of Square's equity shares by means of a share exchange of two shares in Pyramid for every three acquired shares in Square. In addition, Pyramid would make a deferred cash payment of 88 cents per acquired share on 1 October 2014. Pyramid has not recorded any of the consideration. Pyramid's cost of capital is 10% per annum. The market value of Pyramid's shares at 1 October 2013 was \$6.

The following information is available for the two companies as at 30 September 2014:

	Pyramid \$'000	Square \$'000
<b>Assets</b>		
Non-current assets		
Property, plant and equipment	38,100	28,500
<b>Equity and liabilities</b>		
Equity		
Equity shares of \$1 each	50,000	9,000
Other components of equity	8,000	nil
Retained earnings – at 1 October 2013	16,200	19,000
– for the year ended 30 September 2014	14,000	8,000

The following information is relevant:

- (i) At the date of acquisition, Square's net assets were equal to their carrying amounts with the following exceptions:  
an item of plant which had a fair value of \$3 million above its carrying amount. At the date of acquisition it had a remaining life of five years (straight-line depreciation).
- Square had an unrecorded deferred tax liability of \$1million, which was unchanged as at 30 September 2014.
- (ii) Pyramid's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose a share price of \$3·50 each is representative of the fair value of the shares in Square held by the non-controlling interest at the acquisition date.
- (iii) Consolidated goodwill has not been impaired.

**Required:**

**Prepare extracts from Pyramid's consolidated statement of financial position as at 30 September 2014 for:**

- (a) **Consolidated goodwill;** (5 marks)
- (b) **Property, plant and equipment;** (2 marks)
- (c) **Equity (share capital and reserves);** (6 marks)
- (d) **Non-controlling interests.** (2 marks)

**(15 marks)**

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Question 3 begins on page 12.**

**3** The following trial balance relates to Quincy as at 30 September 2014:

The following notes are relevant:

- (i) On 1 October 2013, Quincy sold one of its products for \$10 million (included in revenue in the trial balance). As part of the sale agreement, Quincy is committed to the ongoing servicing of this product until 30 September 2016 (i.e. three years from the date of sale). The value of this service has been included in the selling price of \$10 million. The estimated cost to Quincy of the servicing is \$600,000 per annum and Quincy's normal gross profit margin on this type of servicing is 25%. Ignore discounting.
  - (ii) Quincy issued a \$25 million 6% loan on 1 October 2013. Issue costs were \$1 million and these have been charged to administrative expenses. Interest is paid annually on 30 September each year. The loan will be redeemed on 30 September 2016 at a premium which gives an effective interest rate on the loan of 8%.
  - (iii) Non-current assets:

Quincy had been carrying land and buildings at depreciated cost, but due to a recent rise in property prices, it decided to revalue its property on 1 October 2013 to market value. An independent valuer confirmed the value of the property at \$60 million (land element \$12 million) as at that date and the directors accepted this valuation. The property had a remaining life of 16 years at the date of its revaluation. Quincy will make a transfer from the revaluation reserve to retained earnings in respect of the realisation of the revaluation. Ignore deferred tax on the revaluation.

On 1 October 2013, Quincy had a processing plant installed at a cost of \$10 million which is included in the trial balance figure of plant and equipment at cost. The process the plant performs will cause immediate contamination of the nearby land. Quincy will have to decontaminate (clean up) this land at the end of the plant's ten-year life (straight-line depreciation). The present value (discounted at a cost of capital of 10% per annum) of the decontamination is \$6 million. Quincy has not made any accounting entries in respect of this cost.

All other 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 2014. All depreciation is charged to cost of sales.

Other than referred to above, there were no acquisitions or disposals of non-current assets.

- (iv) The investments had a fair value of \$15.7 million as at 30 September 2014. There were no acquisitions or disposals of these investments during the year ended 30 September 2014.

- (v) The balance on current tax represents the under/over provision of the tax liability for the year ended 30 September 2013. A provision for income tax for the year ended 30 September 2014 of \$7·4 million is required. At 30 September 2014, Quincy had taxable temporary differences of \$5 million requiring a provision for deferred tax. Any deferred tax adjustment should be reported in profit or loss. The income tax rate of Quincy is 20%.

**Required:**

- (a) **Prepare the statement of profit or loss and other comprehensive income for Quincy for the year ended 30 September 2014.**
- (b) **Prepare the statement of changes in equity for Quincy for the year ended 30 September 2014.**
- (c) **Prepare the statement of financial position of Quincy as at 30 September 2014.**
- (d) **Calculate the increase in the carrying amount of property, plant and equipment during the year ended 30 September 2014 from the perspective of:**
  - (i) **the change between the opening and closing statements of financial position and;**
  - (ii) **the statement of cash flows.**

**Comment on which perspective may be more useful to users of Quincy's financial statements.**

Notes to the financial statements are not required.

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

- (a) 12 marks
- (b) 3 marks
- (c) 12 marks
- (d) 3 marks

**(30 marks)**

**End of Question Paper**

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# **Answers**

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Section A

1 A

2 C

3 B

4 D

Write off to 1 January 2014 to 28 February 2014 (2 x \$40,000)  
 Amortisation  $160,000 \text{ (i.e. } 4 \times 40,000\text{)}/60 \text{ months} \times 3 \text{ (July to September)}$

\$
80,000
8,000
<u>88,000</u>

5 B

\$4,070,000 ( $19,300 - 15,230$ )

**Workings (in \$'000)**

	\$
Fair value 1 October 2013	25,000
Deposit	<u>(2,000)</u>
	23,000
Interest 10%	2,300
Payment 30 September 2014	<u>(6,000)</u>
Lease obligation 30 September 2014	19,300
Interest 10%	1,930
Payment 30 September 2015	<u>(6,000)</u>
Lease obligation 30 September 2015	15,230

6 D

Year end inventory of six times is 61 days ( $365/6$ ).  
 Trade payables period is 42 days ( $230,000 \times 365/2,000,000$ ).  
 Therefore receivables collection period is 51 days ( $70 - 61 + 42$ ).

7 B

8 C

	\$
Cost of sales	
Viagem	51,200
Greca ( $26,000 \times 9/12$ )	19,500
Intra-group purchases ( $800 \times 9$ months)	<u>(7,200)</u>
URP in inventory ( $1,500 \times 25/125$ )	300
	<u>63,800</u>

9 B

10 D

11 A

12 D

13 A

	\$'000
Cost (240,000 x \$6)	1,440
Share of associate's profit (400 x 6/12 x 240/800)	60
Less dividend received (150 x 240/800)	(45)
	<hr/>
	1,455

14 A

(1,550/((2,500 x 2 + 1,200 see below)  
2 million shares at \$1.20 = \$2.4 million which would buy 800,000 shares at full price of \$3.  
Therefore, dilution element (free shares) is 1,200,000 (2,000 – 800).

15 C

16 A

	\$
Cost 1 October 2009	100,000
Depreciation 1 October 2009 to 30 September 2014 (100,000 x 5/10)	<u>(50,000)</u>
Carrying amount	50,000

fair value less costs to sell	value in use
30,000	32,215 (8,500 x 3.79) (is higher)

the recoverable amount is therefore \$32,215

	\$
Carrying value	50,000
Recoverable amount	<u>(32,215)</u>
Impairment to income statement	17,785

17 D

Factoring with recourse means Trent still has the risk of an irrecoverable receivable and therefore would not derecognise the receivable.

18 C

19 C

20 A

IAS 10 defines adjusting events as those providing evidence of conditions existing at the end of the reporting period. In the case of inventories, it may be sales of inventory in this period indicate that the net realisable value of some items of inventory have fallen below their cost and require writing down to their net realisable value as at 30 September 2014.

## Section B

- 1 Note:** References to '2014' are in respect of the year ended 30 September 2014 and '2013' refers to the year ended 30 September 2013.

Despite an increase in revenues of 48·4% ( $880/1,820 \times 100$ ) in 2013, 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 2013 to only 30% in 2014) and markedly higher operating overheads. An eight-fold increase in finance cost caused by the increased borrowing at double the interest rate of existing borrowing and (presumably) some overdraft interest has led to the profit before tax more than halving. This is also borne out by the dramatic fall in the company's interest cover (from 79·6 in 2013 to only 5·9 in 2014).

This is all reflected in the ROCE falling from an impressive 61·7% in 2013 to only 19·5% in 2014 (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 2013 to only 8·7% in 2014) which has been compounded by a reduction in the non-current asset turnover, with only \$2·23 being generated from every \$1 invested in non-current assets in 2014 (from \$2·98 in 2013).

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's performance. It is likely that the new contract may account for the increased revenue; however, the bidding process was 'competitive' which implies that Tangier had to cut its price (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 \$270 million (at carrying amount), representing an increase of 66%.

The increase in licence costs to manufacture the new engines has cost \$100 million plus any amortisation (which is not identified in the question).

The investment in Raremetal to secure materials supplies has cost \$230 million. There has been no benefit in 2014 from this investment in terms of dividends or capital growth. It is impossible to quantify the benefit of securing material supplies which was the main reason for the investment, but it has come at a high cost. It is also questionable how the investment has 'secured' the provision of materials as an 8% equity investment does not normally give any meaningful influence over the investee. An alternative (less expensive) strategy might have been to enter into a long-term supply contract with Raremetal.

The finance cost of the new \$300 million 10% loan notes to partly fund the investment in non-current assets has also reduced reported profit and increased debt/equity (one form of gearing measure) from 18·3% in 2013 to 49·7% in 2014 despite issuing \$180 million in new equity shares. At this level, particularly in view of its large increase from 2013, it may give debt holders (and others) cause for concern. If it could be demonstrated that the overdraft was not able to be cleared for some time, this would be an argument for including it in the calculation of debt/equity, making the gearing level even worse. It is also apparent from the movement in the retained earnings that Tangier paid a dividend during the year of \$55 million ( $295,000 + 135,000 - 375,000$ ) which may be a questionable policy when the company is raising additional finance through borrowings.

It could be speculated that the 73% increase of administrative expenses may be due to one-off costs associated with the tendering process (consultancy fees, etc) and the 77% higher distribution costs could be due to additional freight/packing/insurance cost of the engines, delivery distances may also be longer (even abroad).

All of this seems to indicate that the new contract has been very detrimental to Tangier's performance, but more information is needed to be certain. The contract was not signed until January 2014 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. Unless the contract is for a considerable time, the increased investment in operating assets represents a considerable risk. There are no figures for the separate revenues and costs of the contract, but from 2014's declining performance it does not seem profitable, thus even if the contract does secure work for several years, it is of doubtful benefit if the work is loss-making. An alternative scenario could be that the early costs associated with the contract are part of a 'learning curve' and that future production will be more efficient and therefore the contract may become profitable as a result.

### Relevant ratios

	2014	2013
Gross profit % ( $810/2,700 \times 100$ )	30·0%	40·0%
Profit margin before interest % ( $235/2,700 \times 100$ )	8·7%	21·9%
ROCE ( $235/(805 + 400)$ )	19·5%	61·7%
Non-current asset turnover ( $2,700/1210$ )	2·23 times	2·98 times
Debt/equity ( $400/805$ )	49·7%	18·3%
Interest cover ( $235/40$ )	5·9 times	79·6 times

**2 Pyramid – as at 30 September 2014**

Figures in brackets are in \$'000

**(a) Consolidated goodwill**

**Controlling interest**

	\$'000	\$'000
Share exchange (4·8 million (w (i)) x \$6)		28,800
Deferred consideration (9,000 x 80% x 0·88/1·1)		5,760
Non-controlling interest (9,000 x 20% x \$3·50)		6,300
		<hr/>
Equity shares	9,000	
Pre-acquisition reserves	19,000	
Fair value plant	3,000	
Unrecorded deferred tax	(1,000)	<hr/>
Goodwill arising on acquisition		(30,000)
		<hr/>
		10,860

**(b) Property, plant and equipment**

	\$'000
Pyramid	38,100
Square	28,500
Gross fair adjustment to plant	3,000
Additional depreciation to 30 September 2014 (3,000/5 years)	(600)
	<hr/>
	69,000

**(c) Equity**

	\$'000
Equity shares of \$1 each (50,000 + 4,800)	54,800
Reserves	
Other components of equity (8,000 + 24,000)	32,000
Consolidated retained earnings (w (ii))	35,544

**(d) Non-controlling interest**

	\$'000
Fair value on acquisition (from answer (a) above)	6,300
Post-acquisition profit (7,400 x 20% (w (iii)))	1,480
	<hr/>
	7,780

**Workings**

- (i) Pyramid acquired 7·2 million (9 million x 80%) shares in Square. On the basis of a share exchange of two for three, Pyramid would issue 4·8 million (7·2 million/3 x 2) shares. At a value of \$6 each, this would amount to \$28·8 million and be recorded as \$4·8 million share capital and \$24 million (4·8 million x \$5) other components of equity.

**Note:** It would be acceptable to classify the \$24 million addition to other components of equity as share premium.

	\$
Pyramid's retained earnings	30,200
Square's post-acquisition profit (7,400 x 80% see below)	5,920
Interest on deferred consideration (5,760 x 10%)	(576)
	<hr/>
	35,544

- (iii) The adjusted post-acquisition profits of Square are:

	\$
As reported	8,000
Additional depreciation on plant (3,000/5 years)	(600)
	<hr/>
	7,400

**3 (a) Quincy – Statement of profit or loss and other comprehensive income for the year ended 30 September 2014**

	\$'000
Revenue (213,500 – 1,600 (w (i)))	211,900
Cost of sales (w (ii))	<u>(146,400)</u>
Gross profit	65,500
Distribution costs	(17,500)
Administrative expenses (19,000 – 1,000 loan issue costs (w (iv)))	(18,000)
Loss on fair value of equity investments (17,000 – 15,700)	(1,300)
Investment income	400
Finance costs (1,920 + 600 w (iv))	<u>(2,520)</u>
Profit before tax	26,580
Income tax expense (7,400 + 1,100 – 200 (w (v)))	<u>(8,300)</u>
Profit for the year	18,280
Other comprehensive income	
Gain on revaluation of land and buildings (w (iii))	<u>18,000</u>
Total comprehensive income	<u>36,280</u>

**(b) Quincy – Statement of changes in equity for the year ended 30 September 2014**

	Share capital \$'000	Revaluation reserve \$'000	Retained earnings \$'000	Total equity \$'000
Balance at 1 October 2013	60,000	nil	4,300	64,300
Total comprehensive income		18,000	18,280	36,280
Transfer to retained earnings (w (iii))		(1,000)	1,000	nil
Balance at 30 September 2014	<u>60,000</u>	<u>17,000</u>	<u>23,580</u>	<u>100,580</u>

**(c) Quincy – Statement of financial position as at 30 September 2014**

	\$'000	\$'000
<b>Assets</b>		
<b>Non-current assets</b>		
Property, plant and equipment (57,000 + 14,400 + 35,000 (w (iii)))	106,400	
Equity financial asset investments	<u>15,700</u>	
		122,100
<b>Current assets</b>		
Inventory	24,800	
Trade receivables	28,500	
Bank	<u>2,900</u>	56,200
Total assets		<u>178,300</u>
<b>Equity and liabilities</b>		
<b>Equity</b>		
Equity shares of 25 cents each		60,000
Revaluation reserve	17,000	
Retained earnings	<u>23,580</u>	40,580
		100,580
<b>Non-current liabilities</b>		
Deferred tax (w (v))	1,000	
Deferred revenue (w (i))	800	
Environmental provision (6,000 + 600 (w (iv)))	6,600	
6% loan note (2016) (w (iv))	<u>24,420</u>	32,820
<b>Current liabilities</b>		
Trade payables	36,700	
Deferred revenue (w (i))	800	
Current tax payable	<u>7,400</u>	44,900
Total equity and liabilities		<u>178,300</u>

- (d) (i) The carrying amount of property, plant and equipment at 30 September 2014 (from (b)) is \$106·4 million.

The carrying amount of property, plant and equipment at 1 October 2013 based on the trial balance figures less the acquisition of the new plant during the year is \$82 million (see below). Thus the increase in property, plant and equipment from the perspective of the statement of financial position is \$24·4 million.

	\$'000
Land and buildings (50,000 – 8,000)	42,000
Plant and equipment (83,700 – 10,000 – 33,700)	40,000
	<u>82,000</u>

- (ii) The increase in the carrying amount of property, plant and equipment from a cash flow perspective would be only \$10,000, being the cash cost of the processing plant; the revaluation, capitalisation of the clean up costs and depreciation are not cash flows.

Thus the statement of financial position shows an increase investment in property, plant and equipment of \$24·4 million whereas the cash investment is much less at \$10 million. Although both figures are meaningful (but do have different meanings), in this case, users are likely to find the cash investment figure a more intuitive measure of investment as the effects of the revaluation and, particularly, the capitalisation of environmental costs are more difficult to understand. They are also (subjective) estimates, whereas the cash payment is an objective test.

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

- (i) Sales made which include revenue for ongoing servicing work must have part of the revenue deferred. The deferred revenue must include the normal profit margin (25%) for the deferred work. At 30 September 2014, there are two more years of servicing work, thus \$1·6 million ((600 x 2) x 100/75) must be treated as deferred revenue, split equally between current and non-current liabilities.

(ii) Cost of sales

	\$
Per trial balance	136,800
Depreciation of building (w (iii))	3,000
Depreciation of plant (1,600 + 5,000 w (iii))	6,600
	<u>146,400</u>

(iii) Non-current assets

#### Land and buildings:

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

	Land	Building
Carrying amount as at 1 October 2013	10,000	(40,000 – 8,000) 32,000
Revalued amount as at this date	(12,000)	(60,000 – 12,000) (48,000)
Gain on revaluation	2,000	16,000
Building depreciation year to 30 September 2014 (48,000/16 years)		3,000

The transfer from the revaluation reserve to retained earnings in respect of 'excess' depreciation (as the revaluation is realised) is \$1 million (16,000/16 years).

The carrying amount at 30 September 2014 is \$57 million (60,000 – 3,000).

#### Plant and equipment:

	\$
Processing plant	10,000
Cash cost	6,000
Capitalise clean up costs (environmental provision)	<u>16,000</u>
Initial carrying amount	(1,600)
Depreciation 10-year life	<u>14,400</u>
Carrying amount as at 30 September 2014	40,000
Carrying amount as at 1 October 2013 (83,700 – 10,000 – 33,700)	(5,000)
Depreciation at 12½% per annum	<u>35,000</u>
Carrying amount as at 30 September 2014	35,000

(iv) **Loan note and environmental provision**

The finance cost of the loan note is charged at the effective rate of 8% applied to the carrying amount of the loan. The issue costs of the loan (\$1 million) should be deducted from the proceeds of the loan (\$25 million) and not treated as an administrative expense. This gives an initial carrying amount of \$24 million and a finance cost of \$1,920,000 ( $24,000 \times 8\%$ ). The interest actually paid is \$1·5 million ( $25,000 \times 6\%$ ) and the difference between these amounts, of \$420,000 ( $1,920 - 1,500$ ), is accrued and added to the carrying amount of the loan note. This gives \$24·42 million ( $24,000 + 420$ ) for inclusion as a non-current liability in the statement of financial position.

The unwinding of the environmental provision of \$6 million at 10% will cause a finance cost of \$600,000.

(v) **Deferred tax**

	\$
Provision required as at 30 September 2014 ( $5,000 \times 20\%$ )	1,000
Less provision b/f	<u>(1,200)</u>
Credit to statement of profit or loss	<u>200</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>
<b>Section A</b>	
<b>2 marks per question</b>	<b>40</b>
<b>Section B</b>	
<b>1</b> 1 mark per valid point (up to 5 marks for ratios)	15
	<b>Total for question</b>
	<b>15</b>
<b>2</b> (a) goodwill	5
(b) property, plant and equipment	2
(c) equity:	
equity shares	1½
other equity reserves	1½
retained earnings	3
	6
(d) non-controlling interest	2
	<b>Total for question</b>
	<b>15</b>
<b>3</b> (a) Statement of profit or loss and other comprehensive income	
revenue	1½
cost of sales	2½
distribution costs	½
administrative expenses	1
loss on investments	1
investment income	½
finance costs	2
income tax expense	2
gain on revaluation of land and buildings	1
	12
(b) Statement of changes in equity	
balances b/f	1
total comprehensive income	1
transfer of revaluation surplus to retained earnings	1
	3
(c) Statement of financial position	
property, plant and equipment	3
equity investments	1
inventory	½
trade receivables	½
bank	½
deferred tax	1
deferred revenue	1
environmental provision	1½
6% loan note	1½
trade payables	½
current tax payable	1
	12
(d) increase per statement of financial position	1
increase per cash flows	1
appropriate comment	1
	3
	<b>Total for question</b>
	<b>30</b>