# Answers

**1 (a) Consolidated statement of financial position of Picant as at 31 March 2010**

| | $'000 | $'000 |
|---|---|---|
| Assets | | |
| Non-current assets: | | |
| Property, plant and equipment (37,500 + 24,500 + 2,000 – 100) | | 63,900 |
| Goodwill (16,000 – 3,800 (w (i))) | | 12,200 |
| Investment in associate (w (ii)) | | 13,200 |
| | | 89,300 |
| Current assets | | |
| Inventory (10,000 + 9,000 + 1,800 GIT – 600 URP (w (iii))) | 20,200 | |
| Trade receivables (6,500 + 1,500 – 3,400 intra-group (w (iii))) | 4,600 | 24,800 |
| Total assets | | 114,100 |
| Equity and liabilities | | |
| Equity attributable to owners of the parent | | |
| Equity shares of $1 each | | 25,000 |
| Share premium | 19,800 | |
| Retained earnings (w (iv)) | 27,500 | 47,300 |
| | | 72,300 |
| Non-controlling interest (w (v)) | | 8,400 |
| Total equity | | 80,700 |
| Non-current liabilities | | |
| 7% loan notes (14,500 + 2,000) | | 16,500 |
| Current liabilities | | |
| Contingent consideration | 2,700 | |
| Other current liabilities (8,300 + 7,500 – 1,600 intra-group (w (iii))) | 14,200 | 16,900 |
| Total equity and liabilities | | 114,100 |

Workings (figures in brackets are in $'000)

(i) Goodwill in Sander

| | $'000 | $'000 |
|---|---|---|
| Controlling interest | | |
| Share exchange (8,000 x 75% x 3/2 x $3·20) | | 28,800 |
| Contingent consideration | | 4,200 |
| Non-controlling interest (8,000 x 25% x $4·50) | | 9,000 |
| | | 42,000 |
| Equity shares | 8,000 | |
| Pre-acquisition reserves: | | |
| At 1 April 2009 | 16,500 | |
| Fair value adjustments – factory | 2,000 | |
| – software (see below) | (500) | (26,000) |
| Goodwill arising on acquisition | | 16,000 |

Goodwill is impaired by $3·8 million and therefore has a carrying amount at 31 March 2010 of $12·2 million. The goodwill impairment is charged against Sander's retained earnings (see working (iv)), thus ensuring it is allocated between the controlling and non-controlling interests in proportion to their share ownership in Sander.

The effect of the software having no recoverable amount is that its write-off in the post-acquisition period should be treated as a fair value adjustment at the date of acquisition for consolidation purposes. The consequent effect is that this will increase the post-acquisition profit for consolidation purposes by $500,000.

(ii) Carrying amount of Adler at 31 March 2010

| | $'000 |
|---|---|
| Cash consideration (5,000 x 40% x $4) | 8,000 |
| 7% loan notes (5,000 x 40% x $100/50) | 4,000 |
| Share of post-acquisition profits (6,000 x 6/12 x 40%) | 1,200 |
| | 13,200 |

(iii) Goods in transit and unrealised profit (URP)

The intra-group current accounts differ by the goods-in-transit sales of $1·8 million on which Picant made a profit of $600,000 (1,800 x 50/150). Thus inventory must be increased by $1·2 million (its cost), $600,000 is eliminated from Picant's profit, $3·4 million is deducted from trade receivables and $1·6 million (3,400 – 1,800) is deducted from trade payables (other current liabilities).

(iv) Consolidated retained earnings

| | $'000 |
|---|---|
| Picant's retained earnings | 27,200 |
| Sander's post-acquisition losses (2,400 x 75% see below) | (1,800) |
| Gain from reduction of contingent consideration (4,200 – 2,700 see below) | 1,500 |
| URP in inventory (w (iii)) | (600) |
| Adler's post-acquisition profits (6,000 x 6/12 x 40%) | 1,200 |
| | 27,500 |

The adjustment to the provision for contingent consideration due to events occurring after the acquisition is reported in income (goodwill is not recalculated).

Post-acquisition adjusted losses of Sander are:

| | |
|---|---|
| Profit as reported | 1,000 |
| Add back write off software (treated as a pre-acquisition fair value adjustment) | 500 |
| Additional depreciation on factory | (100) |
| Goodwill written off (w (i)) | (3,800) |
| | (2,400) |

(v) Non-controlling interest

| | |
|---|---|
| Fair value on acquisition (w (i)) | 9,000 |
| Post-acquisition losses (2,400 x 25% (w (iv))) | (600) |
| | 8,400 |

**(b)** Although the concept behind the preparation of consolidated financial statements is to treat all the members of the group as if they were a single economic entity, it must be understood that the legal position is that each member is a separate legal entity and therefore the group itself does not exist as a separate legal entity. This focuses on a criticism of group financial statements in that they aggregate the assets and liabilities of all the members of the group. This can give the impression that all of the group's assets would be available to discharge all of the group's liabilities. This is not the case.

Applying this to the situation in the question, it would mean that any liability of Trilby to Picant would not be a liability of any other member of the Tradhat group. Thus the fact that the consolidated statement of financial position of Tradhat shows a strong position with healthy liquidity is not necessarily of any reassurance to Picant. Any decision on granting credit to Trilby must be based on Trilby's own (entity) financial statements (which Picant should obtain), not the group financial statements. The other possibility, which would take advantage of the strength of the group's statement of financial position, is that Picant could ask Tradhat if it would act as a guarantor to Trilby's (potential) liability to Picant. In this case Tradhat would be liable for the debt to Picant in the event of a default by Trilby.

**2 (a) Dune – Income statement for the year ended 31 March 2010**

| | $'000 |
|---|---|
| Revenue (400,000 – 8,000 + 12,000 (w (i) and (ii))) | 404,000 |
| Cost of sales (w (iii)) | (315,700) |
| Gross profit | 88,300 |
| Distribution costs | (26,400) |
| Administrative expenses (34,200 – 500 loan note issue costs) | (33,700) |
| Investment income | 1,200 |
| Profit (gain) on investments at fair value through profit or loss (28,000 – 26,500) | 1,500 |
| Finance costs (200 + 1,950 (w (iv))) | (2,150) |
| Profit before tax | 28,750 |
| Income tax expense (12,000 – 1,400 – 1,800 (w (v))) | (8,800) |
| Profit for the year | 19,950 |

**(b) Dune – Statement of financial position as at 31 March 2010**

| | $'000 | $'000 |
|---|---|---|
| Assets | | |
| Non-current assets | | |
| Property, plant and equipment (w (vi)) | | 46,400 |
| Investments at fair value through profit or loss | | 28,000 |
| | | 74,400 |
| Current assets | | |
| Inventory | 48,000 | |
| Construction contract – amounts due from customer (w (ii)) | 13,400 | |
| Trade receivables (40,700 – 8,000 (w (i))) | 32,700 | 94,100 |
| Non-current assets held for sale (w (iii)) | | 33,500 |
| Total assets | | 202,000 |
| Equity and liabilities | | |
| Equity | | |
| Equity shares of $1 each | | 60,000 |
| Retained earnings (38,400 + 19,950 – 10,000 dividend paid) | | 48,350 |
| | | 108,350 |
| Non-current liabilities | | |
| Deferred tax (w (v)) | 4,200 | |
| 5% loan notes (2012) (w (iv)) | 20,450 | 24,650 |
| Current liabilities | | |
| Trade payables | 52,000 | |
| Bank overdraft | 4,500 | |
| Accrued loan note interest (w (iv)) | 500 | |
| Current tax payable | 12,000 | 69,000 |
| Total equity and liabilities | | 202,000 |

Workings (figures in brackets in $'000)

(i) This appears to be a 'cut off' error in that Dune has invoiced goods that are still in inventory. The required adjustment is to remove the sale of $8 million (6,000 x 100/75) from revenue and trade receivables. No adjustment is required to cost of sales or closing inventory.

(ii) Construction contract:

| | $'000 | $'000 |
|---|---|---|
| Agreed selling price | | 40,000 |
| Costs to date | 8,000 | |
| Costs to complete | 15,000 | |
| Plant (12,000 – 3,000) | 9,000 | (32,000) |
| Total estimated profit | | 8,000 |
| Amounts for inclusion in the income statement for the year ended 31 March 2010 | | |
| Revenue (40,000 x 30%) | | 12,000 |
| Cost of sales (balance) | | (9,600) |
| Gross profit (8,000 x 30%) | | 2,400 |
| Amounts for inclusion in the statement of financial position as at 31 March 2010 | | |
| Cost to date – materials, labour and other direct costs | | 8,000 |
| Plant depreciation ((12,000 – 3,000) x 6/18) | | 3,000 |
| | | 11,000 |
| Profit to date | | 2,400 |
| | | 13,400 |
| Payments received | | (nil) |
| Amounts due from customer | | 13,400 |

(iii) Cost of sales

| | $'000 |
|---|---|
| Per question | 294,000 |
| Construction contract (w (ii)) | 9,600 |
| Depreciation of leasehold property (see below) | 1,500 |
| Impairment of leasehold property (see below) | 4,000 |
| Depreciation of plant and equipment ((67,500 – 23,500) x 15%) | 6,600 |
| | 315,700 |

The leasehold property must be classed as a non-current asset held for sale from 1 October 2009 at its fair value less costs to sell. It must be depreciated for six months up to this date (after which depreciation ceases). This is calculated at $1·5 million (45,000/15 years x 6/12). Its carrying amount at 1 October 2009 is therefore $37·5 million (45,000 – (6,000 + 1,500)).

Its fair value less cost to sell at this date is $33·5 million ((40,000 x 85%) – 500). It is therefore impaired by $4 million (37,500 – 33,500).

(iv) The finance cost of the loan note, at the effective rate of 10% applied to the correct carrying amount of the loan note of $19·5 million is, $1·95 million (the issue costs must be deducted from the proceeds of the loan note; they are not an administrative expense). The interest actually paid is $500,000 (20,000 x 5% x 6/12); however, a further $500,000 needs to be accrued as a current liability (as it will be paid soon). The difference between the total finance cost of $1·95 million and the $1 million interest payable is added to the carrying amount of the loan note to give $20·45 million (19,500 + 950) for inclusion as a non-current liability in the statement of financial position.

(v) Deferred tax

| | |
|---|---|
| Provision required at 31 March 2010 (14,000 x 30%) | 4,200 |
| Provision at 1 April 2009 | (6,000) |
| Credit (reduction in provision) to income statement | 1,800 |

(vi) Property, plant and equipment

| | |
|---|---|
| Property, plant and equipment (67,500 – 23,500 – 6,600) | 37,400 |
| Construction plant (12,000 – 3,000) | 9,000 |
| | 46,400 |

**3 (a) (i) Deltoid – Statement of cash flows for the year ended 31 March 2010:**

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

| | $'000 | $'000 |
|---|---|---|
| Cash flows from operating activities: | | |
| Loss before tax | | (1,800) |
| Adjustments for: | | |
| depreciation of non-current assets | | 3,700 |
| loss on sale of leasehold property (8,800 – 200 – 8,500) | | 100 |
| interest expense | | 1,000 |
| increase in inventory (12,500 – 4,600) | | (7,900) |
| increase in trade receivables (4,500 – 2,000) | | (2,500) |
| increase in trade payables (4,700 – 4,200) | | 500 |
| Cash deficit from operations | | (6,900) |
| Interest paid | | (1,000) |
| Income tax paid (w (i)) | | (1,900) |
| Net cash deficit from operating activities | | (9,800) |
| Cash flows from investing activities: | | |
| Disposal of leasehold property | | 8,500 |
| Cash flows from financing activities: | | |
| Shares issued (10,000 – 8,000 – 800 bonus issue) | 1,200 | |
| Payment of finance lease obligations (w (ii)) | (2,100) | |
| Equity dividends paid (w (iii)) | (700) | |
| Net cash from financing activities | | (1,600) |
| Net decrease in cash and cash equivalents | | (2,900) |
| Cash and cash equivalents at beginning of period | | 1,500 |
| Cash and cash equivalents at end of period | | (1,400) |

Workings

(i) Income tax paid:

| | | $'000 |
|---|---|---|
| Provision b/f | – current | (2,500) |
| | – deferred | (800) |
| Income statement tax relief | | 700 |
| Provision c/f | – current | (500) |
| | – deferred | 1,200 |
| Difference – cash paid | | (1,900) |

(ii) Leased plant:

| | |
|---|---|
| Balance b/f | 2,500 |
| Depreciation | (1,800) |
| Leased during year (balance) | 5,800 |
| Balance c/f | 6,500 |

Lease obligations:

| | | |
|---|---|---|
| Balance b/f | – current | (800) |
| | – non-current | (2,000) |
| New leases (from above) | | (5,800) |
| Balance c/f | – current | 1,700 |
| | – non-current | 4,800 |
| Difference – repayment during year | | (2,100) |

(iii) Equity dividends paid:

| | |
|---|---|
| Retained earnings b/f | 6,300 |
| Loss for period | (1,100) |
| Dividends paid (balance) | (700) |
| Retained earnings c/f | 4,500 |

**(ii)** The main concerns of a loan provider would be whether Deltoid would be able to pay the servicing costs (interest) of the loan and the eventual repayment of the principal amount. Another important aspect of granting the loan would be the availability of any security that Deltoid can offer.

Interest cover is a useful measure of the risk of non-payment of interest. Deltoid's interest cover has fallen from a healthy 15 times (9,000/600) to be negative in 2010. Although interest cover is useful, it is based on profit whereas interest is actually paid in cash. It is usual to expect interest payments to be covered by operating cash flows (it is a bad sign when interest has to be paid from long-term sources of funding such as from the sale of non-current assets or a share issue). Deltoid's position in this light is very worrying; there is a cash deficit from operations of $6·9 million and after interest and tax payments the deficit has risen to $9·8 million.

When looking at the prospect of the ability to repay the loan, Deltoid's position is deteriorating as measured by its gearing (debt including finance lease obligations/equity) which has increased to 65% (5,000 + 6,500/17,700) from 43% (5,000 + 2,800/18,300). What may also be indicative of a deteriorating liquidity position is that Deltoid has sold its leasehold property and rented it back. This has been treated as a disposal, but, depending on the length of the rental agreement and other conditions of the tenancy agreement (which are not specified in the question) it may be that the substance of the sale is a loan/finance leaseback (e.g. if the period of the rental agreement was substantially the same as the remaining life of the property). If this were the case the company's gearing would increase even further. Furthermore, there is less value in terms of ownership of non-current assets which may be used as security (in the form of a charge on assets) for the loan. It is also noteworthy that, in a similar vein, the increase in other non-current assets is due to finance leased plant. Whilst it is correct to include finance leased plant on the statement of financial position (applying substance over form), the legal position is that this plant is not owned by Deltoid and offers no security to any prospective lender to Deltoid.

Therefore, in view of Deltoid's deteriorating operating and cash generation performance, it may be advisable not to renew the loan for a further five years.

**(b)** Although the sports club is a not-for-profit organisation, the request for a loan is a commercial activity that should be decided on according to similar criteria as would be used for other profit-orientated entities.

The main aspect of granting a loan is how secure the loan would be. To this extent a form of capital gearing ratio should be calculated; say existing long-term borrowings to net assets (i.e. total assets less current liabilities). Clearly if this ratio is high, further borrowing would be at an increased risk. The secondary aspect is to measure the sports club's ability to repay the interest (and ultimately the principal) on the loan. This may be determined from information in the income statement. A form of interest cover should be calculated; say the excess of income over expenditure (broadly the equivalent of profit) compared

to (the forecast) interest payments. The higher this ratio the less risk of interest default. The calculations would be made for all four years to ascertain any trends that may indicate a deterioration or improvement in these ratios. As with other profit-oriented entities the nature and trend of the income should be investigated: for example, are the club's sources of income increasing or decreasing, does the reported income contain 'one-off' donations (which may not be recurring) etc? Also matters such as the market value of, and existing prior charges against, any assets intended to be used as security for the loan would be relevant to the lender's decision-making process. It may also be possible that the sports club's governing body (perhaps the trustees) may be willing to give a personal guarantee for the loan.

**4 (a)** For financial statements to be of value to their users they must possess certain characteristics; reliability is one such important characteristic. In order for financial statements to be reliable, they must faithfully represent an entity's underlying transactions and other events. For financial statements to achieve faithful representation, transactions must be accounted for and presented in accordance with their substance and economic reality where this differs from their legal form. For example, if an entity 'sold' an asset to a third party, but continued to enjoy the future benefits embodied in that asset, then this transaction would not be represented faithfully by recording it as a sale (in all probability this would be a financing transaction).

The features that may indicate that the substance of a transaction is different from its legal form are:

- where the control of an asset differs from the ownership of the asset
- where assets are 'sold' at prices that are greater or less than their fair values
- the use of options as part of an agreement
- where there are a series of 'linked' transactions.

It should be noted that none of the above necessarily mean there is a difference between substance and legal form.

**(b) Extracts from the income statements**

**(i) reflecting the legal form:**

| Year ended: | 31 March 2010 $'000 | 31 March 2011 $'000 | 31 March 2012 $'000 | Total $'000 |
|---|---|---|---|---|
| Revenue | 6,000 | nil | 10,000 | 16,000 |
| Cost of sales | (5,000) | nil | (7,986) | (12,986) |
| Gross profit | 1,000 | nil | 2,014 | 3,014 |
| Finance costs | nil | nil | nil | nil |
| Net profit | 1,000 | nil | 2,014 | 3,014 |

**(ii) reflecting the substance:**

| Year ended: | 31 March 2010 $'000 | 31 March 2011 $'000 | 31 March 2012 $'000 | Total $'000 |
|---|---|---|---|---|
| Revenue | nil | nil | 10,000 | 10,000 |
| Cost of sales | (nil) | nil | (5,000) | (5,000) |
| Gross profit | nil | nil | 5,000 | 5,000 |
| Finance costs | (600) | (660) | (726) | (1,986) |
| Net profit | (600) | (660) | 4,274 | 3,014 |

**(c)** It can be seen from the above that the two treatments have no effect on the total net profit reported in the income statements, however, the profit is reported in different periods and the classification of costs is different. In effect the legal form creates some element of profit smoothing and completely hides the financing cost. Although not shown, the effect on the statements of financial position is that recording the legal form of the transaction does not show the inventory, nor does it show the in-substance loan. Thus recording the legal form would be an example of off balance sheet (statement of financial position) financing. The effect on an assessment of Wardle using ratio analysis may be that recording the legal form rather than the substance of the transaction would be that interest cover and inventory turnover would be higher and gearing lower. All of which may be considered as reporting a more favourable performance.

**5 (a)** Where borrowing costs are directly incurred on a 'qualifying asset', they must be capitalised as part of the cost of that asset. A qualifying asset may be a tangible or an intangible asset that takes a substantial period of time to get ready for its intended use or eventual sale. Property construction would be a typical example, but it can also be applied to intangible assets during their development period. Borrowing costs include interest based on its effective rate (which incorporates the amortisation of discounts, premiums and certain expenses) on overdrafts, loans and (some) other financial instruments and finance charges on finance leased assets. They may be based on specifically borrowed funds or on the weighted average cost of a pool of funds. Any income earned from the temporary investment of specifically borrowed funds would normally be deducted from the amount to be capitalised.

Capitalisation should commence when expenditure is being incurred on the asset, which is not necessarily from the date funds are borrowed. Capitalisation should cease when the asset is ready for its intended use, even though the funds may still

be incurring borrowing costs. Also capitalisation should be suspended if there is a suspension of active development of the asset.

Any borrowing costs that are not eligible for capitalisation must be expensed. Borrowing costs cannot be capitalised for assets measured at fair value.

**(b)** The finance cost of the loan must be calculated using the effective rate of 7·5%, so the total finance cost for the year ended 31 March 2010 is $750,000 ($10 million x 7·5%). As the loan relates to a qualifying asset, the finance cost (or part of it in this case) can be capitalised under IAS 23.

The Standard says that capitalisation commences from when expenditure is being incurred (1 May 2009) and must cease when the asset is ready for its intended use (28 February 2010); in this case a 10-month period. However, interest cannot be capitalised during a period where development activity is suspended; in this case the two months of July and August 2009. Thus only eight months of the year's finance cost can be capitalised = $500,000 ($750,000 x 8/12). The remaining four-months finance costs of $250,000 must be expensed. IAS 23 also says that interest earned from the temporary investment of specific loans should be deducted from the amount of finance costs that can be capitalised. However, in this case, the interest was earned during a period in which the finance costs were NOT being capitalised, thus the interest received of $40,000 would be credited to the income statement and not to the capitalised finance costs.

In summary:

| | $ |
|---|---|
| **Income statement for the year ended 31 March 2010:** | |
| Finance cost (debit) | (250,000) |
| Investment income (credit) | 40,000 |
| **Statement of financial position as at 31 March 2010:** | |
| Property, plant and equipment (finance cost element only) | 500,000 |

**Fundamentals Level – Skills Module, Paper F7 (INT)**
**Financial Reporting (International)** **June 2010 Marking Scheme**

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.

| | | | Marks |
|---|---|---|---|
| **1** | **(a)** | **Statement of financial position:** | |
| | | property, plant and equipment | 2 |
| | | goodwill | 5 |
| | | investment in associate | $1\frac{1}{2}$ |
| | | inventory | $1\frac{1}{2}$ |
| | | receivables | 1 |
| | | equity shares | $\frac{1}{2}$ |
| | | share premium | $\frac{1}{2}$ |
| | | retained earnings | $4\frac{1}{2}$ |
| | | non-controlling interest | 2 |
| | | 7% loan notes | $\frac{1}{2}$ |
| | | contingent consideration | 1 |
| | | other current liabilities | 1 |
| | | | **21** |
| | **(b)** | 1 mark per relevant point | **4** |
| | | **Total for question** | **25** |
| **2** | **(a)** | **Income statement** | |
| | | revenue | $2\frac{1}{2}$ |
| | | cost of sales | $4\frac{1}{2}$ |
| | | distribution costs | $\frac{1}{2}$ |
| | | administrative expenses | 1 |
| | | investment income | $\frac{1}{2}$ |
| | | gain on investments | $\frac{1}{2}$ |
| | | finance costs | $1\frac{1}{2}$ |
| | | income tax expense | 2 |
| | | | **13** |
| | **(b)** | **Statement of financial position** | |
| | | property, plant and equipment | $1\frac{1}{2}$ |
| | | investments | $\frac{1}{2}$ |
| | | inventory | $\frac{1}{2}$ |
| | | construction contract | 1 |
| | | trade receivables | 1 |
| | | non-current asset held for sale | 1 |
| | | equity shares | $\frac{1}{2}$ |
| | | retained earnings (1 for dividend) | 2 |
| | | deferred tax | 1 |
| | | 5% loan note | 1 |
| | | trade payables | $\frac{1}{2}$ |
| | | accrued loan note interest | $\frac{1}{2}$ |
| | | bank overdraft | $\frac{1}{2}$ |
| | | current tax payable | $\frac{1}{2}$ |
| | | | **12** |
| | | **Total for question** | **25** |

| | | | | | Marks |
|---|---|---|---|---|---|
| **3** | **(a)** | **(i)** | loss before tax | | $^1/_2$ |
| | | | depreciation | | 1 |
| | | | loss on sale of leasehold | | 1 |
| | | | interest expense adjustment (added back) | | $^1/_2$ |
| | | | working capital items | | $1^1/_2$ |
| | | | interest paid (outflow) | | $^1/_2$ |
| | | | income tax paid | | $1^1/_2$ |
| | | | sale proceeds of leasehold | | 1 |
| | | | share issue | | 1 |
| | | | repayment of lease obligations | | $1^1/_2$ |
| | | | equity dividends paid | | 1 |
| | | | cash b/f | | $^1/_2$ |
| | | | cash c/f | | $^1/_2$ |
| | | | | | 12 |
| | | **(ii)** | 1 mark per valid point | | 8 |
| | **(b)** | | 1 mark per valid point | | 5 |
| | | | | **Total for question** | **25** |
| **4** | **(a)** | | 1 mark per valid point | | 5 |
| | **(b)** | | **(i)** and **(ii)** – 1 mark per reported profit figure | | 5 |
| | **(c)** | | 1 mark per valid point | | 5 |
| | | | | **Total for question** | **15** |
| **5** | **(a)** | | 1 mark per valid point | | 5 |
| | **(b)** | | use of effective rate of 7·5% | | 1 |
| | | | capitalise for eight months | | 2 |
| | | | charge to income statement | | 1 |
| | | | interest received to income statement | | 1 |
| | | | | | 5 |
| | | | | **Total for question** | **10** |