
Answers

Part 2 Examination – Paper 2.5 (INT)
Financial Reporting (International Stream)

June 2005 Answers

1 (a) (i)	Goodwill calculation	\$m	\$m
	Investments at cost		
	Cash consideration (80 x 75% x \$3.50)		210
	Deferred consideration (see below)		<u>100</u>
			310
	<i>Less</i>		
	Ordinary shares (75% x 80)	60	
	Share premium (75% x 40)	30	
	Pre acq profit (see working)	87	
	Fair value adjustments: brand (75% x 40)	30	
	land and buildings (75% x 20)	<u>15</u>	<u>(222)</u>
	Goodwill on acquisition		88
	Impairment at 31 March 2005 (from question)		<u>(22)</u>
	Goodwill at 31 March 2005		<u>66</u>

The deferred consideration of \$108 million must be discounted for one year at a cost of capital of 8% to \$100 million (108/1.08). The \$8 million difference is the finance charge in the year to 31 March 2005 (see (iii)).

Although the internally generated brand cannot be recognised in Samson's entity financial statements, it should be recognised in the consolidated balance sheet on the acquisition of Samson. This is because the method given in the question is an acceptable method of valuation and thus the brand can be 'reliably measured'.

The fair value adjustment for Samson's land and buildings on acquisition is \$20 million. The subsequent increase in value of \$4 million in the year to 31 March 2005 is treated as a revaluation.

The minority interest in the fair value adjustments and revaluation is \$16 million (25% of (24 + 40)) see below.

(ii)	Minority interest	\$m	\$m
	Ordinary shares (25% x 80)		20
	Share premium (25% x 40)		10
	Retained earnings (see working)		41
	Fair values (see (i) above)		<u>16</u>
			87
(iii)	Consolidated reserves:		
	Share premium: Highveldt only		80
	Revaluation reserve: (45 + (75% x 4))		48
	Retained earnings		
	Highveldt – from question		350
	Post acq profit of Samson (see working)		36
	Interest receivable (see below)		<u>6</u>
			392
	Finance cost on deferred consideration (see (i) above)	8	
	Impairment of goodwill	<u>22</u>	<u>(30)</u>
	Retained earnings in consolidated balance sheet		<u>362</u>

The intra group interest has not been recorded by Highveldt. To do so it would credit interest receivable (which increases the profit for the year) and debit cash (in transit).

Working (Note: all figures in \$million)

The pre and post acquisition profits of Samson are calculated as follows:

	Pre	Post	at 31 March 2005
Per question	134	76	
Apportionment of development costs	(18)	(22)	
URP in inventory (6/3)		(2)	
Amortisation of brand (40/10 years)		<u>(4)</u>	
	<u>116</u>	<u>48</u>	<u>164</u>

Therefore minority interest is 25% x 164 = 41

Pre acquisition earnings are 75% x 116 = 87

Post acquisition earnings are 75% x 48 = 36

(b) The objective of consolidated financial statements is to show the financial performance and position of the group as if it was a single economic entity. There is a view that, as the entity financial statements of the parent company contain the investments in subsidiaries as non-current assets, they reflect the assets of the group as a whole. The more traditional view is that entity financial statements do not provide users with sufficient information about subsidiaries for them to make a reliable assessment of the performance of the group as a whole. The following illustrates benefits of consolidated financial statements:

- they identify the nature and classification of the subsidiary's assets. For example, the investment in a subsidiary may be almost entirely in intangible assets or conversely they may be substantially land and buildings. Such a distinction is of obvious importance to users.
- the amount of the subsidiary's debt could not be assessed from the parent's entity financial statements. In effect the subsidiary's assets and liabilities are netted off when it is shown as an investment. This means group liquidity and gearing cannot be properly assessed.
- the cost of the investment does not reflect the size of a company. For example a parent company may show an investment in a subsidiary at a cost of \$10 million. This may represent the purchase of a subsidiary that has \$10 million of assets and no liabilities. Alternatively this could be a subsidiary that has \$100 million in assets and \$90 million of liabilities. Clearly the latter subsidiary would be a much larger company than the former.
- the cost of the investment may be a fair representation of its value at the date of purchase, but with the passage of time (assuming the subsidiary is profitable), its value will increase. This increase would not be reflected in the original cost, but it would be reflected in the consolidated net assets of the subsidiary (and the increase in group reserves).
- the cost of the investment might represent all of the ownership of the subsidiary or only just over half of it i.e. there would be no indication of the minority interest.

To summarise, in the absence of a consolidated balance sheet, users would have no information on the current value of a subsidiary, its size, the composition of its net assets and how much of it was owned by the group.

2 (a) Harrington:

Restated income statement – Year to 31 March 2005	\$000
Sales revenues (13,700 – 300 plant sale proceeds)	13,400
Cost of sales (w (i))	<u>(8,910)</u>
Gross profit	4,490
Operating expenses	(2,400)
Investment income (1,320 – 1,200)	120
Loan interest (25 + 25)	<u>(50)</u>
Profit before tax	2,160
Income tax expense (55 + 260 + (350 – 280) deferred tax)	<u>(385)</u>
Profit for the period	<u>1,775</u>

(b) Statement of Changes in Equity – Year to 31 March 2005

	Retained Profits	Revaluation reserve	Ordinary shares	Share premium	Total
	\$000	\$000	\$000	\$000	\$000
At 1 April 2004	2,990	nil	1,600	40	4,630
Rights issue (see below)			400	560	960
Profit for period (see (a))	1,775				1,775
Revaluation of property (w (ii))		1,800			1,800
Transfer to realised profit	80	(80)			nil
Ordinary dividends paid	<u>(500)</u>				<u>(500)</u>
At 31 March 2005	<u>4,345</u>	<u>1,720</u>	<u>2,000</u>	<u>600</u>	<u>8,665</u>

The number of 25c ordinary shares at the year end is 8 million (\$2 million x 4). This is after a rights issue of 1 for 4. Thus the number of shares prior to the issue would be 6.4 million (8 million x 4/5) and the rights issue would have been for 1.6 million shares. The rights issue price is 60c each which would be recorded as an increase in share capital of \$400,000 (1.6 million x 25c) and an increase in share premium of \$560,000 (1.6 million x 35c).

(c) Balance Sheet as at 31 March 2005

Non-current assets	\$000	\$000
Property, plant and equipment (6,710 + 1,350 (w (ii)))		8,060
Investments (1,200 x 110%)		1,320
		<u>9,380</u>
Current assets		
Inventory	1,750	
Trade receivables	2,450	
Bank	350	
		<u>4,550</u>
Total assets		<u>13,930</u>
Equity and liabilities:		
Ordinary shares of 25c each		2,000
Reserves (see (b)):		
Share premium	600	
Revaluation reserve (w (ii))	1,720	
Retained earnings (from (b))	4,345	
		<u>6,665</u>
		8,665
Non-current liabilities		
10% loan note (issued 2002)	500	
Deferred tax (1,400 x 25%)	350	
		<u>850</u>
Current liabilities		
Trade payables	4,130	
Accrued loan interest ((500 x 10%) – 25 paid)	25	
Current tax payable	260	
		<u>4,415</u>
Total equity and liabilities		<u>13,930</u>

Workings (all figures in \$000):

(i) Cost of sales:		
per question	9,200	
profit on sale of plant ((900 – 630) – 300)	(30)	
depreciation – plant (w (iii))	450	
– buildings (w (ii))	290	
capitalised expenses net of error (w (ii))	(1,000)	
	<u>8,910</u>	
(ii) Land and buildings:	cost/revaluation	depreciation
Self constructed (see below)	1,000	50 (20 year life)
Revalued	6,000	240 (see below)
	<u>7,000</u>	<u>290</u>

The carrying value of the land and buildings at 31 March 2005 is \$6,710,000 (7,000 – 290).

Depreciation on the building element will be \$240 (4,800/20 years). The revaluation of the land and buildings will create a revaluation reserve initially of \$1,800 (6,000 – (1,000 + (4,000 – 800))), however a transfer of \$80 (1,600/20 building element of the revaluation) to realised profit is required.

Self constructed asset:

purchased materials	150
direct labour	800
supervision	65
design and planning costs	20
error in construction (10 + 25)	(35)
	<u>1,000</u>

Note: the cost of the error cannot be capitalised; it must therefore be written off.

(iii) Plant	cost	depreciation 31 March 2004	carrying value
per balance sheet	5,200	3,130	
disposal	(900)	(630)	
	<u>4,300</u>	<u>2,500</u>	1,800

Depreciation for the current year will be \$450,000 (25% reducing balance), giving a net book value at 31 March 2005 of \$1,350,000.

- 3 (a) (i)** It is important to determine which financial statements constitute the first-time adoption of International Financial Reporting Standards (IFRSs) because IFRS 1 only applies to those financial statements. It does not apply to subsequent financial statements that are prepared under IFRSs as these must be prepared under the whole body of IFRSs (including IASs). A first time adopter is an entity that makes an explicit and unreserved statement that its financial statements comply with (all) IFRSs. Compliance with some, but not all, IFRSs is insufficient as is compliance with all IFRSs without the inclusion of an explicit statement of compliance.

The main issues to be addressed in the transition to IFRSs are:

- deciding the date of transition.
- selecting accounting policies that comply with IFRSs.
- preparing (but not presenting) an opening balance sheet at the date of transition to IFRSs as a basis for subsequent accounting. The date of transition to IFRSs is the beginning of the earliest comparative period. If the company's reporting date for its first IFRS financial statements is say 31 December 2005 and it intends to disclose one year's comparatives, then the date of transition is 1 January 2004.
- determining estimates of values for both the opening IFRS balance sheet and all other presented comparative balance sheets; and finally
- presenting IFRS financial statements (including the required disclosures relating to the transition).

Note: some credit would be given for references to practical issues such as required changes to information systems and the recruitment of personnel with IFRS experience.

- (ii)** When a company adopts IFRSs for the first time it must use the IFRSs that are in force at the reporting date. These IFRSs should be applied throughout all of the periods presented – normally two years. This means that comparative financial statements must comply with the IFRSs in force at the reporting date even if they were not in issue at the date of the comparatives (or different from those that were in issue).

The general principle is that the adoption of IFRSs should be applied retrospectively i.e. as if the entity had always applied each IFRS. This is contrary to the specific transitional requirements contained in some individual IFRSs (they often allow prospective application). More specifically an entity must:

- recognise all assets and liabilities that fall to be recognised by IFRSs (e.g. IFRSs require deferred tax to be recognised on a 'full' provision basis)
- not recognise assets and liabilities if IFRSs do not permit their recognition (e.g. IFRSs do not permit 'general' provisions to be made and some proposed dividends are not treated as liabilities)
- reclassify certain items under IFRSs (e.g. convertible debt must be split between its equity and debt components under IFRSs, but in some jurisdictions it may have been classed entirely as debt)
- apply IFRS rules to measure the value of all recognised assets and liabilities. This may mean for example using a non-discounted value to measure an item whereas under previous GAAP it may have been discounted
- give specified reconciliations for equity and reported profits between previous GAAP and IFRSs, together with details of any recognition or reversals of impairments when implementing first time reporting.

The resulting adjustments arising from the above must be recognised directly in equity at the date of transition.

The Standard contains some specific exemptions and exceptions to the above in the areas of values of property, plant and equipment, employee benefits, translation differences for net investments in foreign operations and derivative instruments. In essence the exemptions and exceptions allow the use of alternative value measures in limited circumstances and where the cost or effort required in determining the value measurements under IFRSs would be excessive.

The exemptions are permitted but not required and can be applied in full or individually, whereas exceptions (to retrospective application) are mandatory.

A particularly important exemption is that the IFRS rules governing business combinations are not applied retrospectively. However any intangible that was recognised under previous GAAP that cannot be recognised under IFRSs should be reclassified as goodwill and the entity must test for impairment of goodwill at the date of transition.

- (b) As Transit intends first-time adoption for the year ended 31 December 2005 and to disclose one year's comparatives, the date of transition to IFRSs is 1 January 2004.

Transit – summarised balance sheet at 1 January 2004

	\$000	\$000
Property, plant and equipment (w (i))		800
Goodwill (450 + 300 (w (ii)))		750
Development costs (w (ii))		nil
		<u>1,550</u>
Current assets		
Inventory (150 + 30 (w (i)))	180	
Receivables	250	
Bank	<u>20</u>	450
Total assets		<u>2,000</u>
Issued share capital		500
Retained earnings (w (v))		<u>820</u>
		1,320
Current liabilities		
Trade and other payables		320
Non-current liabilities		
Restructuring provision (w (iii))		nil
Deferred tax (w (iv))		<u>360</u>
Total equity and liabilities		<u>2,000</u>

In addition the goodwill will be tested for impairment and if there is any indication of impairment to the other identifiable assets, they too must be tested for impairment.

Workings (all figures in \$000)

- (i) Property, plant and equipment and inventory are restated to their IFRS base valuations of \$800,000 and \$180,000 respectively.
- (ii) Acquired intangible assets that do not qualify for recognition under IFRSs must be reclassified as goodwill after allowing for the effect of deferred tax. Thus an amount of \$300 (400 – 100 re deferred tax) is transferred to goodwill and \$100 debited to deferred tax.
- (iii) The restructuring provision does not qualify for recognition under IFRSs.
- (iv) Summarising the effect on deferred tax:
- | | |
|-----------------------------|--------------|
| per question | 300 |
| re development costs | <u>(100)</u> |
| | 200 |
| required balance | <u>(360)</u> |
| charge to retained earnings | <u>(160)</u> |
- (v) Summarising the effect on retained earnings:
- | | |
|--|--------------|
| per question | 900 |
| property, plant and equipment | (200) |
| inventory | 30 |
| elimination of restructuring provision | 250 |
| deferred tax | <u>(160)</u> |
| | <u>820</u> |

4 (a) Cash Flow Statement of Casino for the Year to 31 March 2005:

	\$m	\$m
Cash inflows from operating activities		
Operating loss		(32)
Adjustments for:		
Depreciation – buildings (w (i))	12	
– plant (w (ii))	81	
– intangibles (510 – 400)	110	
Loss on disposal of plant (from question)	12	
	<u>12</u>	<u>215</u>
Operating profit before working capital changes		183
Decrease in inventory (420 – 350)		70
Increase in trade receivables (808 – 372)		(436)
Increase in trade payables (530 – 515)		15
		<u>15</u>
Cash generated from operations		(168)
Interest paid		(16)
Income tax paid (w (iii))		(81)
		<u>(81)</u>
Net cash outflow from operating activities		(265)
Cash flows from investing activities		
Purchase of – land and buildings (w (i))	(110)	
– plant (w (ii))	(60)	
Sale of plant (w (ii))	15	
Interest received (12 – 5 + 3)	10	
	<u>10</u>	(145)
Cash flows from financing activities		
Issue of ordinary shares (100 + 60)	160	
Issue of 8% variable rate loan (160 – 2 issue costs)	158	
Repayments of 12% loan (150 + 6 penalty)	(156)	
Dividends paid	(25)	
	<u>(25)</u>	137
Net decrease in cash and cash equivalents		(273)
Cash and cash equivalents at beginning of period (120 + 75)		195
		<u>195</u>
Cash and cash equivalents at end of period (125 – (32 + 15))		(78)

Interest and dividends received and paid may be shown as operating cash flows or as investing or financing activities as appropriate.

Workings (in \$ million)

(i) Land and buildings		
net book value b/f		420
revaluation gains		70
depreciation for year		(12)
net book value c/f		<u>(588)</u>
difference is cash purchases		<u>(110)</u>
(ii) Plant:		
cost b/f		445
additions from question		60
balance c/f		<u>(440)</u>
difference is cost of disposal		65
loss on disposal		(12)
proceeds		<u>(15)</u>
difference accumulated depreciation of plant disposed of		<u>38</u>
depreciation b/f		105
less – disposal (above)		(38)
depreciation c/f		<u>(148)</u>
charge for year		<u>(81)</u>

(iii) Taxation:	
tax provision b/f	(110)
deferred tax b/f	(75)
income statement net charge	(1)
tax provision c/f	15
deferred tax c/f	90
	<hr/>
difference is cash paid	(81)
	<hr/>
(iv) Revaluation reserve:	
balance b/f	45
revaluation gains	70
transfer to retained earnings	(3)
	<hr/>
balance c/f	112
	<hr/>
(v) Retained earnings:	
balance b/f	1,165
loss for period	(45)
dividends paid	(25)
transfer from revaluation reserve	3
	<hr/>
balance c/f	1,098
	<hr/>

- (b) The accruals/matching concept applied in preparing an income statement has the effect of smoothing cash flows for reporting purposes. This practice arose because interpreting 'raw' cash flows can be very difficult and the accruals process has the advantage of helping users to understand the underlying performance of a company. For example if an item of plant with an estimated life of five years is purchased for \$100,000, then in the cash flow statement for the five year period there would be an outflow in year 1 of the full \$100,000 and no further outflows for the next four years. Contrast this with the income statement where by applying the accruals principle, depreciation of the plant would give a charge of \$20,000 per annum (assuming straight-line depreciation). Many would see this example as an advantage of an income statement, however it is important to realise that profit is affected by many subjective items. This has led to accusations of profit manipulation or creative accounting, hence the disillusionment of the usefulness of the income statement.
- Another example of the difficulty in interpreting cash flows is that counterintuitively a decrease in overall cash flows is not always a bad thing (it may represent an investment in increasing capacity which would bode well for the future), nor is an increase in cash flows necessarily a good thing (this may be from the sale of non-current assets because of the need to raise cash urgently).

The advantages of cash flows are:

- it is difficult to manipulate cash flows, they are real and possess the qualitative characteristic of objectivity (as opposed to subjective profits).
- cash flows are an easy concept for users to understand, indeed many users misinterpret income statement items as being cash flows.
- cash flows help to assess a company's liquidity, solvency and financial adaptability. Healthy liquidity is vital to a company's going concern.
- many business investment decisions and company valuations are based on projected cash flows.
- the 'quality' of a company's operating profit is said to be confirmed by closely correlated cash flows. Some analysts take the view that if a company shows a healthy operating profit, but has low or negative operating cash flows, there is a suspicion of profit manipulation or creative accounting.

- 5 (i) Future decontamination costs must be provided for in full at the time they become unavoidable. Where they are based on future values, they should be discounted to their present value (as has been done in this example). Rather than being immediately written off to the income statement, the decontamination costs are added to the cost of the related asset and amortised over the expected life of the asset. The current treatment of these costs by Triangle is incorrect. The depreciation charge must be based on the full cost of the plant which must include the decontamination costs. Also an imputed finance cost must be applied to the provision (often referred to as unwinding). Applying this, the extracts of the financial statements of Triangle at 31 March 2005 would be:

Non-current assets	\$million
Plant at cost (\$15 million + \$5 million)	20·0
Depreciation at 10% per annum	<u>(2·0)</u>
	18·0
Non-current liabilities	
Provision	5·0
Accrued finance costs	<u>0·4</u>
	5·4
Income statement	
Depreciation	2·0
Accrued finance costs (\$5 million x 8%)	0·4

- (ii) This is an example of an adjusting event after the balance sheet date. To some extent the figures in the draft financial statements already reflect the effects of the fraud (up to the amount at the year end i.e. \$210,000) in that presumably the cost of the materials paid for are included in cost of sales. However, the financial statements are incorrect in their presentation. As the fraud is considered material, \$210,000 should be removed from the cost of sales and included as an income statement operating expense (perhaps with separate disclosure). This will affect the gross profit and other ratios, though it will not affect the net profit. The further costs beyond the year end of \$30,000 should be noted as a non-adjusting event (if material in their own right).
- (iii) Triangle is of the opinion that the cost of the fraud may be covered by an insurance claim. However the insurance company is disputing the claim. This appears to be a contingent asset. If a contingent asset is probable it should be noted in the financial statements. However if it is only possible, it should be ignored. As this claim is at an early stage and the company has not yet sought a legal opinion, it would be premature to consider the claim probable. In these circumstances the contingent asset should be ignored and the financial statements will be unaffected.
- (iv) Although this transaction has been treated as a sale, this is probably not its substance. The clause allowing Triangle to repurchase the inventory makes this a sale and repurchase agreement. Assuming Triangle acts rationally it will repurchase the inventory if its retail value at 31 March 2008 is more than \$7,320,500 (\$5 million plus compound interest at 10% for four years) plus the accumulated storage costs (as these can be recovered from Factorall in the event that the inventory is not repurchased). There is no indication in the question as to what the inventory is likely to be worth on 31 March 2008. However it is unlikely that a finance company will really want to acquire this inventory (it is not its normal line of business) and thus it would not have entered into the contract unless it believed Triangle would repurchase the inventory. If the above is correct the substance of the transaction is that it is a secured loan rather than a sale. The required adjustments would therefore be:
- Remove \$5 million from sales (debit) and treat this as a long term (4 year) loan.
 - Remove \$3 million from cost of sales and treat this as inventory.
 - The receivable for the storage cost should be removed from trade receivables and added to the cost of the inventory.
 - Accrued interest of \$500,000 (\$5 million x 10%) should be charged to the income statement and added to the carrying value of the loan.

Part 2 Examination – Paper 2.5 (INT)
Financial Reporting (International Stream)

June 2005 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.

	<i>Marks</i>
1 (a) (i) goodwill	
– consideration given	2
– share capital and premium	1
– pre acq profit	2
– fair value adjustments	2
– goodwill impairment	1
	8
maximum	8
(ii) minority interest	
– share capital and premium	1
– retained earnings	2
– fair value adjustment	1
	4
maximum	4
(iii) consolidated reserves	
– share premium	1
– revaluation reserve	2
retained earnings	
– post acq profit	2
– interest receivable	1
– finance cost	1
– goodwill impairment	1
	8
maximum	8
(b) 1 mark per relevant point to	5
	Maximum for question 25
2 (a) Restated income statement	
sales revenue	1
cost of sales	5
operating expenses	1
investment income	1
loan interest	1
income tax	2
	11
available	11
maximum	9
(b) statement of changes in equity	
brought forward figures	1
rights issue	1
(restated) profit for the financial year	1
surplus on land and buildings	2
transfer to realised profits	1
dividend paid	1
	7
available	7
maximum	6

		<i>Marks</i>
(c)	Balance sheet	
	land and buildings	1
	plant	1
	investments	1
	inventory and trade receivables	1
	bank and trade payables	1
	accrued loan interest	1
	current tax	1
	10% loan note	1
	deferred tax	1
	share capital and premium	1
	revaluation reserve	1
	retained earnings	1
		available 12
		maximum 10
		Maximum for question 25
3	(a)	
	(i) one mark per valid point to max	7
	(ii) one mark per valid point to max	8
	(b)	
	Property, plant and equipment	1
	development costs/goodwill	3
	inventory	1
	retained earnings	3
	restructuring provision eliminated	1
	deferred tax	2
		available 11
		maximum 10
		Maximum for question 25
4	(a)	
	cash flows from operating activities	
	operating loss	1
	depreciation and loss on sale adjustments	4
	working capital items	3
	interest paid	1
	income tax	2
	investing activities	7
	financing 1 mark per item	4
	cash and cash equivalents b/f and c/f	1
		available 23
		maximum 20
	(b) 1 mark per relevant point to	5
		Maximum for question 25

		<i>Marks</i>
5	(i) explanation of treatment of provision	2
	cost of plant at \$20 million	1
	revised depreciation	1
	provision initially at \$5 million	1
	increase by finance cost	1
	income statement charges 1 each	2
	maximum	8
	(ii) an example of an adjusting event	1
	no overall effect on profit, but presentation incorrect	1
	remove from cost of sales and show as an expense	1
	\$30,000 is a non-adjusting event if material	1
	disclose as a note to the financial statements	1
	maximum	5
	(iii) due to the dispute this is an example of a contingent asset	1
	describe the treatment of contingent assets	1
not probable therefore ignore, financial statements unchanged	2	
maximum	4	
(iv) identify it as a sale and repurchase agreement (or financing arrangement)	1	
substance is not likely to be a sale	1	
will repurchase if value is more than \$7,320,500 plus storage costs	2	
business of Factorall is financing therefore terms likely to favour repurchase	1	
adjustments to – sales/loan; cost of sales/inventory;	2	
– trade receivables/inventory (re storage costs); accrued finance costs/loan	2	
available	9	
maximum	8	
Maximum for question	25	