Answers

1 (a) Premier

Consolidated statement of comprehensive income for the year ended 30 September 2010

	$'000
Revenue (92,500 + (45,000 x 4/12) – 4,000 intra-group sales)	103,500
Cost of sales (w (i))	(78,850)
Gross profit	24,650
Distribution costs (2,500 + (1,200 x 4/12))	(2,900)
Administrative expenses (5,500 + (2,400 x 4/12))	(6,300)
Finance costs	(100)
Profit before tax	15,350
Income tax expense (3,900 + (1,500 x 4/12))	(4,400)
Profit for the year	10,950
Other comprehensive income:	
Gain on available-for-sale investments	300
Gain on revaluation of property	500
Total other comprehensive income for the year	800
Total comprehensive income	11,750
Profit for year attributable to:	
Equity holders of the parent	10,760
Non-controlling interest ((1,300 see below – 400 URP + 50 reduced depreciation) x 20%)	190
	10,950
Total comprehensive income attributable to:	
Equity holders of the parent (10,760 + 300 + 500)	11,560
Non-controlling interest	190
	11,750

Sanford's profits for the year ended 30 September 2010 of $3·9 million are $2·6 million (3,900 x 8/12) pre-acquisition and $1·3 million (3,900 x 4/12) post-acquisition.

(b) Consolidated statement of financial position as at 30 September 2010.

	$'000
Assets	
Non-current assets	
Property, plant and equipment (w (ii))	38,250
Goodwill (w (iii))	9,300
Available-for-sale investments (1,800 – 800 consideration + 300 gain)	1,300
	48,850
Current assets (w (iv))	14,150
Total assets	63,000
Equity and liabilities	
Equity attributable to owners of the parent	
Equity shares of $1 each ((12,000 + 2,400) w (iii))	14,400
Share premium (w (iii))	9,600
Land revaluation reserve	2,000
Other equity reserve (500 + 300)	800
Retained earnings (w (v))	13,060
	39,860
Non-controlling interest (w (vi))	3,690
Total equity	43,550
Non-current liabilities	
6% loan notes	3,000
Current liabilities (10,000 + 6,800 – 350 intra group balance)	16,450
Total equity and liabilities	63,000

Workings in $'000

(i) Cost of sales

Premier		70,500
Sanford (36,000 x 4/12)		12,000
Intra-group purchases		(4,000)
URP in inventory		400
Reduction of depreciation charge		(50)
		78,850

The unrealised profit (URP) in inventory is calculated as $2 million x 25/125 = $400,000.

(ii) Non-current assets

Premier		25,500
Sanford		13,900
Fair value reduction at acquisition		(1,200)
Reduced depreciation		50
		38,250

(iii) Goodwill in Sanford

Investment at cost		
Shares (5,000 x 80% x 3/5 x $5)		12,000
6% loan notes (5,000 x 80% x 100/500)		800
Non-controlling interest (5,000 x 20% x $3·50)		3,500
		16,300
Net assets (equity) of Sanford at 30 September 2010	(9,500)	
Less: post-acquisition profits (see above)	1,300	
Less: fair value adjustment for property	1,200	
Net assets at date of acquisition		(7,000)
Goodwill		9,300

The 2·4 million shares (5,000 x 80% x 3/5) issued by Premier at $5 each would be recorded as share capital of $2·4 million and share premium of $9·6 million.

(iv) Current assets

Premier		12,500
Sanford		2,400
URP in inventory		(400)
Intra-group balance		(350)
		14,150

(v) Retained earnings

Premier		12,300
Sanford's post-acquisition adjusted profit ((1,300 – 400 URP + 50 reduced depreciation) x 80%)		760
		13,060

(vi) Non-controlling interest in statement of financial position

At date of acquisition		3,500
Post-acquisition profit from income statement		190
		3,690

2 (a) Cavern – Statement of comprehensive income for the year ended 30 September 2010

	$'000
Revenue	182,500
Cost of sales (w (i))	(137,400)
Gross profit	45,100
Distribution costs	(8,500)
Administrative expenses (25,000 – 18,500 dividends (w (iii)))	(6,500)
Investment income	700
Finance costs (300 + 400 (w (ii)) + 3,060 (w (iv)))	(3,760)
Profit before tax	27,040
Income tax expense (5,600 + 900 – 250 (w (v)))	(6,250)
Profit for the year	20,790
Other comprehensive income	
Loss on available-for-sale investments (15,800 – 13,500)	(2,300)
Gain on revaluation of land and buildings (w (ii))	800
Total other comprehensive losses for the year	(1,500)
Total comprehensive income	19,290

(b) Craven – Statement of changes in equity for the year ended 30 September 2010

	Share capital $'000	Share premium $'000	Other equity reserve $'000	Revaluation reserve $'000	Retained earnings $'000	Total equity $'000
Balance at 1 October 2009	40,000	nil	3,000	7,000	12,100	62,100
Rights issue (w (iii))	10,000	11,000				21,000
Dividends (w (iii))					(18,500)	(18,500)
Comprehensive income			(2,300)	800	20,790	19,290
Balance at 30 September 2010	50,000	11,000	700	7,800	14,390	83,890

(c) Cavern – Statement of financial position as at 30 September 2010

Assets	$'000	$'000
Non-current assets		
Property, plant and equipment (41,800 + 51,100 (w (ii)))		92,900
Available-for-sale investments		13,500
		106,400
Current assets		
Inventory	19,800	
Trade receivables	29,000	48,800
Total assets		155,200
Equity and liabilities		
Equity (see (b) above)		
Equity shares of 20 cents each		50,000
Share premium	11,000	
Other equity reserve	700	
Revaluation reserve	7,800	
Retained earnings	14,390	33,890
		83,890
Non-current liabilities		
Provision for decontamination costs (4,000 + 400 (w (ii)))	4,400	
8% loan note (w (iv))	31,260	
Deferred tax (w (v))	3,750	39,410
Current liabilities		
Trade payables	21,700	
Bank overdraft	4,600	
Current tax payable	5,600	31,900
Total equity and liabilities		155,200

Workings (monetary figures in brackets in $'000)

(i) Cost of sales

Per trial balance	128,500
Depreciation of building (36,000/18 years)	2,000
Depreciation of new plant (14,000/10 years)	1,400
Depreciation of existing plant and equipment ((67,400 – 10,000 – 13,400) x 12·5%)	5,500
	137,400

(ii) Property, plant and equipment

The new plant of $10 million should be grossed up by the provision for the present value of the estimated future decontamination costs of $4 million to give a gross cost of $14 million. The 'unwinding' of the provision will give rise to a finance cost in the current year of $400,000 (4,000 x 10%) to give a closing provision of $4·4 million.

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

Valuation – 30 September 2009	43,000
Building depreciation (w (i))	(2,000)
Carrying amount before revaluation	41,000
Revaluation – 30 September 2010	41,800
Gain on revaluation	800

The carrying amount of the plant and equipment will be:

New plant (14,000 – 1,400)	12,600
Existing plant and equipment (67,400 – 10,000 – 13,400 – 5,500)	38,500
	51,100

(iii) Rights issue/dividends paid

Based on 250 million (50 million x 5 – as shares are 20 cents each) shares in issue at 30 September 2010, a rights issue of 1 for 4 on 1 April 2010 would have resulted in the issue of 50 million new shares (250 million – (250 million x 4/5)). This would be recorded as share capital of $10 million (50,000 x 20 cents) and share premium of $11 million (50,000 x (42 cents – 20 cents)).

The dividend of 3 cents per share paid on 30 November 2009 would have been based on 200 million shares and been $6 million. The dividend of 5 cents per share paid on 31 May 2010 would have been based on 250 million shares and been $12·5 million. Therefore the total dividends paid, incorrectly included in administrative expenses, were $18·5 million.

(iv) Loan note

The finance cost of the loan note, at the effective rate of 10% applied to the carrying amount of the loan note of $30·6 million, is $3·06 million. The interest actually paid is $2·4 million. The difference between these amounts of $660,000 (3,060 – 2,400) is added to the carrying amount of the loan note to give $31·26 million (30,600 + 660) for inclusion as a non-current liability in the statement of financial position.

(v) Deferred tax

Provision required at 30 September 2010 (15,000 x 25%)	3,750
Provision at 1 October 2009	(4,000)
Credit (reduction in provision) to income statement	250

3 Note: references to 2009 and 2010 should be taken as being to the years ended 30 September 2009 and 2010 respectively.

Profitability:

Income statement performance:

Hardy's income statement results dramatically show the effects of the downturn in the global economy; revenues are down by 18% (6,500/36,000 x 100), gross profit has fallen by 60% and a healthy after tax profit of $3·5 million has reversed to a loss of $2·1 million. These are reflected in the profit (loss) margin ratios shown in the appendix (the 'as reported' figures for 2010). This in turn has led to a 15·2% return on equity being reversed to a negative return of 11·9%. However, a closer analysis shows that the results are not quite as bad as they seem. The downturn has directly caused several additional costs in 2010: employee severance, property impairments and losses on investments (as quantified in the appendix). These are probably all non-recurring costs and could therefore justifiably be excluded from the 2010 results to assess the company's 'underlying' performance. If this is done the results of Hardy for 2010 appear to be much better than on first sight, although still not as good as those reported for 2009. A gross margin of 27·8% in 2009 has fallen to only 23·1% (rather than the reported margin of 13·6%) and the profit for period has fallen from $3·5 million (9·7%) to only $2·3 million (7·8%). It should also be noted that as well as the fall in the value of the investments, the related investment income has also shown a sharp decline which has contributed to lower profits in 2010.

Given the economic climate in 2010 these are probably reasonably good results and may justify the Chairman's comments. It should be noted that the cost saving measures which have helped to mitigate the impact of the downturn could have some unwelcome effects should trading conditions improve; it may not be easy to re-hire employees and a lack of advertising may cause a loss of market share.

Statement of financial position:
Perhaps the most obvious aspect of the statement of financial position is the fall in value ($8·5 million) of the non-current assets, most of which is accounted for by losses of $6 million and $1·6 million respectively on the properties and investments. Ironically, because these falls are reflected in equity, this has mitigated the fall in the return of the equity (from 15·2% to 13·1% underlying) and contributed to a perhaps unexpected improvement in asset turnover from 1·6 times to 1·7 times.

Liquidity:
Despite the downturn, Hardy's liquidity ratios now seem at acceptable levels (though they should be compared to manufacturing industry norms) compared to the low ratios in 2009. The bank balance has improved by $1·1 million. This has been helped by a successful rights issue (this is in itself a sign of shareholder support and confidence in the future) raising $2 million and keeping customer's credit period under control. Some of the proceeds of the rights issue appear to have been used to reduce the bank loan which is sensible as its financing costs have increased considerably in 2010. Looking at the movement on retained earnings (6,500 – 2,100 – 3,600) it can be seen that the company paid a dividend of $800,000 during 2010. Although this is only half the dividend per share paid in 2009, it may seem unwise given the losses and the need for the rights issue. A counter view is that the payment of the dividend may be seen as a sign of confidence of a future recovery. It should also be mentioned that the worst of the costs caused by the downturn (specifically the property and investments losses) are not cash costs and have therefore not affected liquidity.

The increase in the inventory and work-in-progress holding period and the trade receivables collection period being almost unchanged appear to contradict the declining sales activity and should be investigated. Although there is insufficient information to calculate the trade payables credit period as there is no analysis of the cost of sales figures, it appears that Hardy has received extended credit which, unless it had been agreed with the suppliers, has the potential to lead to problems obtaining future supplies of goods on credit.

Gearing:
On the reported figures debt to equity shows a modest increase due to income statement losses and the reduction of the revaluation reserve, but this has been mitigated by the repayment of part of the loan and the rights issue.

Conclusion:
Although Hardy's results have been adversely affected by the global economic situation, its underlying performance is not as bad as first impressions might suggest and supports the Chairman's comments. The company still retains a relatively strong statement of financial position and liquidity position which will help significantly should market conditions improve. Indeed the impairment of property and investments may well reverse in future. It would be a useful exercise to compare Hardy's performance during this difficult time to that of its competitors – it may well be that its 2010 results were relatively very good by comparison.

Appendix:
An important aspect of assessing the performance of Hardy for 2010 (especially in comparison with 2009) is to identify the impact that several 'one off' charges have had on the results of 2010. These charges are $1·3 million redundancy costs and a $1·5 million (6,000 – 4,500 previous surplus) property impairment, both included in cost of sales and a $1·6 million loss on the market value of investments, included in administrative expenses. Thus in calculating the 'underlying' figures for 2010 (below) the adjusted cost of sales is $22·7 million (25,500 – 1,300 – 1,500) and the administrative expenses are $3·3 million (4,900 – 1,600). These adjustments feed through to give an underlying gross profit of $6·8 million (4,000 + 1,300 + 1,500) and an underlying profit for the year of $2·3 million (–2,100 + 1,300 + 1,500 + 1,600).

Note: it is not appropriate to revise Hardy's equity (upwards) for the one-off losses when calculating equity based underlying figures, as the losses will be a continuing part of equity (unless they reverse) even if/when future earnings recover.

	2010		2009
	underlying	**as reported**	
Gross profit % (6,800/29,500 x 100)	23·1%	13·6%	27·8%
Profit (loss) for period % (2,300/29,500 x 100)	7·8%	(7·1)%	9·7%
Return on equity (2,300/17,600 x 100)	13·1%	(11·9)%	15·2%
Net asset (taken as equity) turnover (29,500/17,600)	1·7 times	same	1·6 times
Debt to equity (4,000/17,600)	22·7%	same	21·7%
Current ratio (6,200:3,400)	1·8:1	same	1·0:1
Quick ratio (4,000:3,400)	1·2:1	same	0·6:1
Receivables collection (in days) (2,200/29,500 x 365)	27 days	same	28 days
Inventory and work-in-progress holding period (2,200/22,700 x 365)	35 days	31 days	27 days

Note: the figures for the calculation of the 2010 'underlying' ratios have been given; those of 2010 'as reported' and 2009 are based on equivalent figures from the summarised financial statements provided.

Alternative ratios/calculations are acceptable, for example net asset turnover could be calculated using total assets less current liabilities.

4 **(a)** Management's choices of which accounting policies they may adopt are not as wide as generally thought. Where an International Accounting Standard, IAS or IFRS (or an Interpretation) specifically applies to a transaction or event the accounting policy used must be as prescribed in that Standard (taking in to account any Implementation Guidance within the Standard). In the absence of a Standard, or where a Standard contains a choice of policies, management must use its judgement in applying accounting policies that result in information that is relevant and reliable given the circumstances of the transactions and events. In making such judgements, management should refer to guidance in the Standards related to similar issues and the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the IASB's *Framework for the preparation and presentation of financial statements*. Management may also consider pronouncements of other standard-setting bodies that use a similar conceptual framework to the IASB.

A change in an accounting policy usually relates to a change of principle, basis or rule being applied by an entity. Accounting estimates are used to measure the carrying amounts of assets and liabilities, or related expenses and income. A change in an accounting estimate is a reassessment of the expected future benefits and obligations associated with an asset or a liability. Thus, for example, a change from non-depreciation of a building to depreciating it over its estimated useful life would be a change of accounting policy. To change the estimate of its useful life would be a change in an accounting estimate.

(b) **(i)** The main issue here is the estimate of the useful life of a non-current asset. Such estimates form an important part of the accounting estimate of the depreciation charge. Like most estimates, an annual review of their appropriateness is required and it is not unusual, as in this case, to revise the estimate of the remaining useful life of plant. It appears, from the information in the question, that the increase in the estimated remaining useful life of the plant is based on a genuine reassessment by the production manager. This appears to be an acceptable reason for a revision of the plant's life, whereas it would be unacceptable to increase the estimate simply to improve the company's reported profit. That said, the assistant accountant's calculation of the financial effect of the revised life is incorrect. Where there is an increase (or decrease) in the estimated remaining life of a non-current asset, its carrying amount (at the time of the revision) is allocated over the new remaining life (after allowing for any estimated residual value). The carrying amount at 1 October 2009 is $12 million ($20 million – $8 million accumulated depreciation) and this should be written off over the estimated remaining life of six years (eight years in total less two already elapsed). Thus a charge for depreciation of $2 million would be required in the year ended 30 September 2010 leaving a carrying amount of $10 million ($12 million – $2 million) in the statement of financial position at that date. A depreciation charge for the current year cannot be avoided and there will be no credit to the income statement as suggested by the assistant accountant. It should be noted that the incremental effect of the revision to the estimated life of the plant would be to improve the reported profit by $2 million being the difference between the depreciation based on the old life ($4 million) and the new life ($2 million).

(ii) The appropriateness of the proposed change to the method of valuing inventory is more dubious than the previous example. Whilst both methods (FIFO and AVCO) are acceptable methods of valuing inventory under IAS 2 *Inventories*, changing an accounting policy to be consistent with that of competitors is not a convincing reason. Generally changes in accounting policies should be avoided unless a change is required by a new or revised accounting standard or the new policy provides more reliable and relevant information regarding the entity's position. In any event the assistant accountant's calculations are again incorrect and would not meet the intention of improving reported profit. The most obvious error is that changing from FIFO to AVCO will cause a reduction in the value of the closing inventory at 30 September 2010 effectively reducing, rather than increasing, both the valuation of inventory and reported profit. A change in accounting policy must be accounted for as if the new policy had always been in place (retrospective application). In this case, for the year ended 30 September 2010, both the opening and closing inventories would need to be measured at AVCO which would reduce reported profit by $400,000 (($20 million – $18 million) – ($15 million – $13·4 million) – i.e. the **movement** in the values of the opening and closing inventories). The other effect of the change will be on the retained earnings brought forward at 1 October 2009. These will be restated (reduced) by the effect of the reduced inventory value at 30 September 2009 i.e. $1·6 million ($15 million – $13·4 million). This adjustment would be shown in the statement of changes in equity.

5 From the information in the question, the closure of the furniture making operation is a restructuring as defined in IAS 37 *Provisions, contingent liabilities and contingent assets* and, due to the timing of the decision, a provision for the closure costs will be required in the year ended 30 September 2010. Although the Standard says that a Board of directors' decision to close an operation is alone not sufficient to trigger a provision the other actions of the management, informing employees, customers and a press announcement indicate that this is an irreversible decision and that therefore there is an obligating event.

Commenting on each element in turn for both years:

(i) Factory and plant
At 30 September 2010 – these assets cannot be classed as 'held-for-sale' as they are still in use (i.e. generating revenue) and therefore are not available for sale. Both assets will therefore continue to be depreciated.

Despite this, it does appear that the plant is impaired. Based on its carrying amount of $2·8 million an impairment charge of $2·3 million ($2·8 million – $0·5 million) would be required (subject to any further depreciation for the three months from July to September 2010). The expected gain on the sale of the factory cannot be recognised or used to offset the impairment charge on the plant. The impairment charge is not part of the restructuring provision, but should be reported with the depreciation charge for the year.

At 30 September 2011 – the realised profit on the disposal of the factory and any further loss on the disposal of the plant will both be reported in the income statement.

(ii) Redundancy and retraining costs
At 30 September 2010 – a provision for the redundancy costs of $750,000 should be made, but the retraining costs relate to the ongoing actives of Manco and cannot be provided for.

At 30 September 2011 – the redundancy costs incurred during the year will be offset against the provision created last year. Any under- or over-provision will be reported in the income statement. The retraining costs will be written off as they are incurred.

(iii) Trading losses
The losses to 30 September 2010 will be reported as part of the results for the year ended 30 September 2010. The expected losses from 1 October 2010 to the closure on 31 January 2011 cannot be provided in the year ended 30 September 2010 as they relate to ongoing activities and will therefore be reported as part of the results for the year ended 30 September 2011 as they are incurred.

It should also be considered whether the closure fulfils the definition of a discontinued operation in accordance with IFRS 5 *Non-current assets held for sale and discontinued operations*. As there is a co-ordinated plan to dispose of a separate major line of business (the furniture making operation is treated as an operating segment) this probably is a discontinued operation. However, the timing of the closure means that it is not a discontinued operation in the year ended 30 September 2010; rather it is likely that it will be such in the year ended 30 September 2011. Some commentators believe that this creates an anomalous situation in that most of the closure costs are reported in the year ended 30 September 2010 (as described above), but the closure itself is only identified and reported as a discontinued operation in the year ended 30 September 2011 (although the comparative figures for 2010 would then restate this as a discontinued operation).

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 comprehensive income:	
		revenue	1½
		cost of sales	3
		distribution costs	½
		administrative expenses	½
		finance costs	½
		income tax	½
		other comprehensive income – gain on investments	½
		other comprehensive income – gain on property	½
		non-controlling interest – profit for year	1
		split of total comprehensive income	½
			9
	(b)	statement of financial position:	
		property, plant and equipment	2
		goodwill	3½
		available-for-sale investments	1
		current assets	1½
		equity shares	1
		share premium	1
		revaluation reserve	½
		other equity reserve	1
		retained earnings	1½
		non-controlling interest	1½
		6% loan notes	½
		current liabilities	1
			16
		Total for question	**25**

				Marks
2	(a)	statement of comprehensive income		
		revenue		½
		cost of sales		3
		distribution costs		½
		administrative expenses		1
		investment income		½
		finance costs		2½
		income tax expense		2
		loss on available-for-sale investments		½
		gain on revaluation of land and buildings		½
				11
	(b)	statement of changes in equity		
		balances b/f		1
		rights issue		1
		dividends		1
		loss on available-for-sale investments		½
		revaluation gain		½
		profit for year		1
				5
	(c)	statement of financial position		
		property, plant and equipment		2½
		available-for-sale investments		½
		inventory		½
		trade receivables		½
		contamination provision		1
		8% loan note		1
		deferred tax		1
		trade payables		½
		bank overdraft		½
		current tax payable		1
				9
			Total for question	**25**
3	comments – 1 mark per valid point, up to			15
	a good answer must consider the effects of the ‘one off’ costs			
	ratios – up to			10
			Total for question	**25**
4	(a)	1 mark per valid point		**5**
	(b)	(i) recognise as a change in accounting estimate		1
		appears an acceptable basis for change		1
		correct method is to allocate carrying amount over new remaining life		1
		depreciation for current year should be $2 million		1
		carrying amount at 30 September 2010 is $10 million		1
				5
		(ii) proposed change is probably not for a valid reason		1
		change would cause a decrease (not an increase) in profit		1
		changes in policy should be applied retrospectively		1
		decrease in year to 30 September 2010 is $400,000		1
		retained earnings restated by $1.6 million		1
				5
			Total for question	**15**

		Marks
5	closure is a restructuring under IAS 37	1
	it is an obligating event in year ended 30 September 2010	1
	provide for impairment of plant	1
	cannot recognise gain on property until sold	1
	provide for redundancy in year ended 30 September 2010	1
	cannot provided for retraining costs in current year	1
	inclusion of trading losses in correct periods	2
	consider if and when closure should be treated as a discontinued operation	2
	Total for question	**10**