Answers

1 (a)

Cost of control in Sardonic:	**$'000**		**$'000**
Consideration			
Shares (18,000 x 2/3 x $5·75)			69,000
Deferred payment (18,000 x 2·42/1·21 (see below))			36,000
			105,000
Less			
Equity shares	24,000		
Pre-acquisition reserves:			
At 1 April 2007	69,000		
To date of acquisition (13,500 x 4/12)	4,500		
Fair value adjustments (4,100 + 2,400)	6,500		
	104,000	x 75%	(78,000)
Goodwill			27,000

$1 compounded for two years at 10% would be worth $1·21.
The acquisition of 18 million out of a total of 24 million equity shares is a 75% interest.

(b) Patronic Group

Consolidated income statement for the year ended 31 March 2008	**$'000**
Revenue (150,000 + (78,000 x 8/12) – (1,250 x 8 months intra group))	192,000
Cost of sales (w (i))	(119,100)
Gross profit	72,900
Distribution costs (7,400 + (3,000 x 8/12))	(9,400)
Administrative expenses (12,500 + (6,000 x 8/12))	(16,500)
Finance costs (w (ii))	(5,000)
Impairment of goodwill	(2,000)
Share of profit from associate (6,000 x 30%)	1,800
Profit before tax	41,800
Income tax expense (10,400 + (3,600 x 8/12))	(12,800)
Profit for the year	29,000
Attributable to:	
Equity holders of the parent	26,900
Minority interest (w (iii))	2,100
	29,000

(c) An associate is defined by IAS 28 *Investments in Associates* as an investment over which an investor has significant influence. There are several indicators of significant influence, but the most important are usually considered to be a holding of 20% or more of the voting shares and board representation. Therefore it was reasonable to assume that the investment in Acerbic (at 31 March 2008) represented an associate and was correctly accounted for under the equity accounting method.

The current position (from May 2008) is that although Patronic still owns 30% of Acerbic's shares, Acerbic has become a subsidiary of Spekulate as it has acquired 60% of Acerbic's shares. Acerbic is now under the **control** of Spekulate (part of the definition of being a subsidiary), therefore it is difficult to see how Patronic can now exert significant influence over Acerbic. The fact that Patronic has lost its seat on Acerbic's board seems to reinforce this point. In these circumstances the investment in Acerbic falls to be treated under IAS 39 *Financial Instruments: Recognition and Measurement*. It will cease to be equity accounted from the date of loss of significant influence. Its carrying amount at that date will be its initial recognition value under IAS 39 and thereafter it will be carried at fair value.

Workings

(i) Cost of sales	**$'000**	**$'000**
Patronic		94,000
Sardonic (51,000 x 8/12)		34,000
Intra group purchases (1,250 x 8 months)		(10,000)
Additional depreciation: plant (2,400/ 4 years x 8/12)	400	
property (per question)	200	600
Unrealised profit in inventories (3,000 x 20/120)		500
		119,100

Note: for both sales revenues and cost of sales, only the post acquisition intra group trading should be eliminated.

		$'000
(ii)	Finance costs	
	Patronic per question	2,000
	Unwinding interest – deferred consideration (36,000 x 10% x 8/12)	2,400
	Sardonic (900 x 8/12)	600
		5,000

(iii)	Minority interest		
	Sardonic's post acquisition profit (13,500 x 8/12)	9,000	
	Less post acquisition additional depreciation (w (i))	(600)	
		8,400	
		x 25%	= 2,100

2 (a)

	$'000	$'000
Retained profit for period per question		96,700
Dividends paid (w (i))		15,500
Draft profit for year ended 31 March 2008		112,200
Discovery of fraud (w (ii))		(2,500)
Goods on sale or return (w (iii))		(600)
Depreciation (w (iv)) – buildings (165,000/15 years)	11,000	
– plant (180,500 x 20%)	36,100	(47,100)
Increase in investments ((12,500 x 1,296/1,200) – 12,500)		1,000
Provision for income tax		(11,400)
Increase in deferred tax (w (v))		(800)
Recalculated profit for year ended 31 March 2008		50,800

(b) Dexon – Statement of Changes in Equity – Year ended 31 March 2008

	Ordinary shares $'000	**Share premium $'000**	**Revaluation reserve $'000**	**Retained earnings $'000**	**Total $'000**
At 1 April 2007	200,000	30,000	18,000	12,300	260,300
Prior period adjustment (w (ii))				(1,500)	(1,500)
Restated earnings at 1 April 2007				10,800	
Rights issue (see below)	50,000	10,000			60,000
Total comprehensive income (from (a) and (w (iv))			4,800	50,800	55,600
Dividends paid (w (i))				(15,500)	(15,500)
At 31 March 2008	250,000	40,000	22,800	46,100	358,900

Rights issue: 250 million shares in issue **after** a rights issue of one for four would mean that 50 million shares were issued (250,000 x 1/5). As the issue price was $1·20, this would create $50 million of share capital and $10 million of share premium.

(c) **Dexon – Statement of financial position as at 31 March 2008:**

	$'000	$'000
Non-current assets		
Property (w (iv))		180,000
Plant (180,500 – 36,100 depreciation see (a))		144,400
Investments at fair value through profit and loss (12,500 + 1,000 see (a))		13,500
		337,900
Current assets		
Inventory (84,000 + 2,000 (w (iii)))	86,000	
Trade receivables (52,200 – 4,000 – 2,600 (w (ii) and (iii)))	45,600	
Bank	3,800	135,400
Total assets		473,300
Equity and liabilities		
Equity (from (b))		
Ordinary shares of $1 each		250,000
Share premium	40,000	
Revaluation reserve	22,800	
Retained earnings	46,100	108,900
		358,900
Non-current liabilities		
Deferred tax (19,200 + 2,000 (w (v)))		21,200
Current liabilities (81,800 + 11,400 income tax)		93,200
Total equity and liabilities		473,300

Workings (figures in brackets in $'000)

(i) Dividends paid
The dividend in May 2007 would be $8 million (200 million shares at 4 cents) and in November 2007 would be $7·5 million (250 million shares x 3 cents). Total dividends would therefore have been $15·5 million.

(ii) The discovery of the fraud means that $4 million should be written off trade receivables. $1·5 million debited to retained earnings as a prior period adjustment (in the statement of changes in equity) and $2·5 written off in the income statement for the year ended 31 March 2008.

(iii) Goods on sale or return
The sales over which customers still have the right of return should not be included in Dexon's recognised revenue. The reversing effect is to reduce the relevant trade receivables by $2·6 million, increase inventory by $2 million (the cost of the goods (2,600 x 100/130)) and reduce the profit for the year by $600,000.

(iv) Property
The carrying amount of the property (after the year's depreciation) is $174 million (185,000 – 11,000). A valuation of $180 million would create a revaluation surplus of $6 million of which $1·2 million (6,000 x 20%) would be transferred to deferred tax.

(v) Deferred tax
An increase in the taxable temporary differences of $10 million would create a transfer (credit) to deferred tax of $2 million (10,000 x 20%). Of this $1·2 million relates to the revaluation of the property and is debited to the revaluation reserve. The balance, $800,000, is charged to the income statement.

3 (a) Statement of cash flows of Pinto for the Year to 31 March 2008:

	$'000	$'000
Cash flows from operating activities		
Profit before tax		440
Adjustments for:		
Depreciation of property, plant and equipment	280	
Loss on sale of property, plant and equipment	90	370
Increase in warranty provision (200 – 100)		100
Investment income		(60)
Finance costs		50
Redemption penalty costs included in administrative expenses		20
		920
Working capital adjustments		
Increase in inventories (1,210 – 810)	(400)	
Decrease in trade receivables (540 – 480)	60	
Increase in trade payables (1,410 – 1,050)	360	20
Cash generated from operations		940
Finance costs paid		(50)
Income tax refund (w (ii))		60
Net cash from operating activities		950
Cash flows from investing activities		
Purchase of property, plant and equipment (w (i))	(1,440)	
Sale of property, plant and equipment (240 – 90)	150	
Investment income received (60 – 20 gain on investment property)	40	
Net cash used in investing activities		(1,250)
Cash flows from financing activities		
Proceeds from issue of equity shares (400 + 600)	1,000	
Redemption of loan notes (400 plus 20 penalty)	(420)	
Dividends paid (1,000 x 5 x 3 cents)	(150)	
Net cash from financing activities		430
Net increase in cash and cash equivalents		130
Cash and cash equivalents at beginning of period		(120)
Cash and cash equivalents at end of period		10

Note: investment income received and dividends paid may alternatively be shown in operating activities.

Workings (in $'000)

(i) Property, plant and equipment:

carrying amount b/f	1,860
revaluation	100
depreciation for period	(280)
disposal	(240)
carrying amount c/f	(2,880)
difference is cash acquisitions	(1,440)

(ii) Income tax:

tax asset b/f	50
deferred tax b/f	(30)
income statement charge	(160)
tax provision c/f	150
deferred tax c/f	50
difference is cash received	60

(b) Comments on the cash management of Pinto

Operating cash flows:
Pinto's operating cash inflows at $940,000 (prior to investment income, finance costs and taxation) are considerably higher than the equivalent profit before investment income, finance costs and tax of $430,000. This shows a satisfactory cash generating ability and is more than sufficient to cover finance costs, taxation (see later) and dividends. The major reasons for the cash flows being higher than the operating profit are due to the (non-cash) increases in the depreciation and warranty provisions. Working capital changes are relatively neutral; a large increase in inventory appears to be being financed by a substantial increase in trade payables and a modest reduction in trade receivables. The reduction in trade receivables is

perhaps surprising as other indicators point to an increase in operating capacity which has not been matched with an increase in trade receivables. This could be indicative of good control over the cash management of the trade receivables (or a disappointing sales performance).

An unusual feature of the cash flow is that Pinto has received a tax refund of $60,000 during the current year. This would indicate that in the previous year Pinto was making losses (hence obtaining tax relief). Whilst the current year's profit performance is an obvious improvement, it should be noted that next year's cash flows are likely to suffer a tax payment (estimated at $150,000 in current liabilities at 31 March 2008) as a consequence. In any forward planning, Pinto should be aware that the tax reversal position will create an estimated total incremental outflow of $210,000 in the next period.

Investing activities:
There has been a dramatic investment/increase in property, plant and equipment. The carrying value at 31 March 2008 is substantially higher than a year earlier (admittedly $100,000 is due to revaluation rather than a purchase). It is difficult to be sure whether this represents an increase in operating capacity or is the replacement of the plant disposed of. (The voluntary disclosure encouraged by IAS 7 *Statement of cash flows* would help to assess this issue more accurately). However, judging by the level of the increase and the (apparent) overall improvement in profit position, it seems likely that there has been a successful increase in capacity. It is not unusual for there to be a time lag before increased investment reaches its full beneficial effect and in this context it could be speculated that the investment occurred early in the accounting year (because its effect is already making an impact) and that future periods may show even greater improvements.

The investment property is showing a good return which is composed of rental income (presumably) of $40,000 and a valuation gain of $20,000.

Financing activities:
It would appear that Pinto's financial structure has changed during the year. Debt of $400,000 has been redeemed (for $420,000) and there has been a share issue raising $1 million. The company is now nil geared compared to modest gearing at the end of the previous year. The share issue has covered the cost of redemption and contributed to the investment in property, plant and equipment. The remainder of the finance for the property, plant and equipment has come from the very healthy operating cash flows. If ROCE is higher than the finance cost of the loan note at 6% (nominal) it may call into question the wisdom of the early redemption especially given the penalty cost (which has been classified within financing activities) of the redemption.

Cash position:
The overall effect of the year's cash flows is that they have improved the company's cash position dramatically. A sizeable overdraft of $120,000, which may have been a consequence of the (likely) losses in the previous year, has been reversed to a modest bank balance of $10,000 even after the payment of a $150,000 dividend.

Summary
The above analysis indicates that Pinto has invested substantially in renewing and/or increasing its property, plant and equipment. This has been financed largely by operating cash flows, and appears to have brought a dramatic turnaround in the company's fortunes. All the indications are that the future financial position and performance will continue to improve.

4 **(a)** The accruals basis requires transactions (or events) to be recognised when they occur (rather than on a cash flow basis). Revenue is recognised when it is earned (rather than when it is received) and expenses are recognised when they are incurred (i.e. when the entity has received the benefit from them), rather than when they are paid.

Recording the substance of transactions (and other events) requires them to be treated in accordance with economic reality or their commercial intent rather than in accordance with the way they may be legally constructed. This is an important element of faithful representation.

Prudence is used where there are elements of uncertainty surrounding transactions or events. Prudence requires the exercise of a degree of caution when making judgements or estimates under conditions of uncertainty. Thus when estimating the expected life of a newly acquired asset, if we have past experience of the use of similar assets and they had had lives of (say) between five and eight years, it would be prudent to use an estimated life of five years for the new asset.

Comparability is fundamental to assessing the performance of an entity by using its financial statements. Assessing the performance of an entity over time (trend analysis) requires that the financial statements used have been prepared on a comparable (consistent) basis. Generally this can be interpreted as using consistent accounting policies (unless a change is required to show a fairer presentation). A similar principle is relevant to comparing one entity with another; however it is more difficult to achieve consistent accounting policies across entities.

Information is material if its omission or misstatement could influence (economic) decisions of users based on the reported financial statements. Clearly an important aspect of materiality is the (monetary) size of a transaction, but in addition the nature of the item can also determine that it is material. For example the monetary results of a new activity may be small, but reporting them could be material to any assessment of what it may achieve in the future. Materiality is considered to be a threshold quality, meaning that information should only be reported if it is considered material. Too much detailed (and implicitly immaterial) reporting of (small) items may confuse or distract users.

(b) Accounting for inventory, by adjusting purchases for opening and closing inventories is a classic example of the application of the accruals principle whereby revenues earned are matched with costs incurred. Closing inventory is by definition an example of goods that have been purchased, but not yet consumed. In other words the entity has not yet had the 'benefit' (i.e. the sales revenue they will generate) from the closing inventory; therefore the cost of the closing inventory should not be charged to the current year's income statement.

Consignment inventory is where goods are supplied (usually by a manufacturer) to a retailer under terms which mean the legal title to the goods remains with the supplier until a specified event (say payment in three months time). Once the goods have been transferred to the retailer, normally the risks and rewards relating to those goods then lie with the retailer. Where this is the case then (in substance) the consignment inventory meets the definition of an asset and the goods should appear as such (inventory) on the retailer's statement of financial position (along with the associated liability to pay for them) rather than on the statement of financial position of the manufacturer.

At the year end, the value of an entity's closing inventory is, by its nature, uncertain. In the next accounting period it may be sold at a profit or a loss. Accounting standards require inventory to be valued at the lower of cost and net realisable value. This is the application of prudence. If the inventory is expected to sell at a profit, the profit is deferred (by valuing inventory at cost) until it is actually sold. However, if the goods are expected to sell for a (net) loss, then that loss must be recognised immediately by valuing the inventory at its net realisable value.

There are many acceptable ways of valuing inventory (e.g. average cost or FIFO). In order to meet the requirement of comparability, an entity should decide on the most appropriate valuation method for its inventory and then be consistent in the use of that method. Any change in the method of valuing (or accounting for) inventory would break the principle of comparability.

For most businesses inventories are a material item. An error (omission or misstatement) in the value or treatment of inventory has the potential to affect decisions users may make in relation to financial statements. Therefore (correctly) accounting for inventory is a material event. Conversely there are occasions where on the grounds of immateriality certain 'inventories' are not (strictly) accounted for correctly. For example, at the year end a company may have an unused supply of stationery. Technically this is inventory, but in most cases companies would charge this 'inventory' of stationery to the income statement of the year in which it was purchased rather than show it as an asset.

Note: other suitable examples would be acceptable.

5 Accounting correctly for the convertible loan note in accordance with IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* would mean that virtually all the financial assistant's observations are incorrect. The convertible loan note is a compound financial instrument containing a (largely) debt component and an equity component – the value of the option to receive equity shares. These components must be calculated using the residual equity method and appropriately classified (as debt and equity) on the statement of financial position. As some of the proceeds of the instrument will be equity, the gearing will not be quite as high as if a non-convertible loan was issued, but gearing will be increased. However, if the loan note is converted to equity in March 2010, gearing will be reduced. The interest rate that would be applicable to a non-convertible loan (8%) is representative of the true finance cost and should be applied to the carrying amount of the debt to calculate the finance cost to be charged to the income statement thus giving a much higher charge than the assistant believes.

Accounting treatment: financial statements year ended 31 March 2008

Income statement:	
Finance costs (see working)	$693,920
Statement of financial position:	
Non-current liabilities	
3% convertible loan note (8,674 + 393·92)	$9,067,920
Equity	
Option to convert	$1,326,000

Working (figures in brackets in $'000)

	cash flows	**factor at 8%**	**present value $'000**
year 1 interest	300	0·93	279
year 2 interest	300	0·86	258
year 3 interest and capital	10,300	0·79	8,137
total value of debt component			8,674
proceeds of the issue			10,000
equity component (residual amount)			1,326

The interest cost in the income statement should be $693,920 (8,674 x 8%), requiring an accrual of $393,920 (693·92 – 300 i.e. 10,000 x 3%). This accrual should be added to the carrying value of the debt.

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)**	Goodwill of Sardonic:	
		consideration	2
		net assets acquired calculated as:	
		equity shares	1
		pre acquisition reserves	2
		fair value adjustments	1
			6
	(b)	Income statement:	
		revenue	2
		cost of sales	5
		distribution costs and administrative expenses	1
		finance costs	2
		impairment of goodwill	1
		share of associate's profit	1
		income tax	1
		minority interest	2
			15
	(c)	1 mark per relevant point to	4
		Total for question	**25**
2	**(a)**	Adjustments:	
		add back dividends	1
		balance of fraud loss	1
		goods on sale or return	1
		depreciation charges	2
		investment gain	1
		taxation provision	1
		deferred tax	1
			8
	(b)	Statement of changes in equity	
		balances b/f	1
		restated earnings b/f	1
		rights issue	2
		total comprehensive income	3
		dividends paid	1
			8
	(c)	Statement of financial position	
		property	1
		plant	1
		investment	1
		inventory	1
		trade receivables	2
		equity from (b)	1
		deferred tax	1
		current liabilities	1
			9
		Total for question	**25**

			Marks
3	**(a)**	operating activities	
		profit before tax	$^{1}/_{2}$
		depreciation/loss on sale	1
		warranty adjustment	$^{1}/_{2}$
		adjustments for investment income/finance costs	$^{1}/_{2}$
		adjustment for redemption penalty	1
		working capital items	$1^{1}/_{2}$
		finance costs	1
		income tax received	2
		investing activities (including 1 for investment income)	3
		financing activities	
		issue of equity shares	1
		redemption of 6% loan note	1
		dividend paid	1
		cash and cash equivalents b/f and c/f	1
			15
	(b)	1 mark per relevant point	10
		Total for question	**25**
4	**(a)**	explanations 1 mark each	**5**
	(b)	examples 2 marks each	10
		Total for question	**15**
5		1 mark per valid comment up to	4
		use of 8%	1
		initial carrying amount of debt and equity	2
		finance cost	2
		carrying amount of debt at 31 March 2008	1
		Total for question	**10**