Answers

1 (a) Paradigm – Consolidated statement of financial position as at 31 March 2013

	$'000	$'000
Assets		
Non-current assets:		
Property, plant and equipment (47,400 + 25,500 – 3,000 fair value + 500 depreciation)		70,400
Goodwill (w (i))		8,500
Financial asset: equity investments (7,100 + 3,900)		11,000
		89,900
Current assets		
Inventory (20,400 + 8,400 – 600 URP (w (ii)))	28,200	
Trade receivables (14,800 + 9,000 – 3,700 intra-group (w (iii)))	20,100	
Bank (2,100 + 900 CIT (w (iii)))	3,000	51,300
Total assets		141,200
Equity and liabilities		
Equity attributable to owners of the parent		
Equity shares of $1 each (40,000 + 6,000 (w (i)))		46,000
Share premium (w (i))	6,000	
Retained earnings (w (iv))	34,000	40,000
		86,000
Non-controlling interest (w (v))		8,800
Total equity		94,800
Non-current liabilities		
10% loan notes (8,000 + 1,500 (w (i)))		9,500
Current liabilities		
Trade payables (17,600 + 13,000 – 2,800 intra-group (w (iii)))	27,800	
Bank overdraft	9,100	36,900
Total equity and liabilities		141,200

Workings (figures in brackets are in $'000)

(i) Goodwill in Strata

	$'000	$'000
Controlling interest		
Share exchange ((20,000 x 75%) x 2/5 x $2)		12,000
10% loan notes (15,000 x 100/1,000)		1,500
Non-controlling interest (20,000 x 25% x $1·20)		6,000
		19,500
Equity shares	20,000	
Pre-acquisition retained losses:		
– at 1 April 2012	(4,000)	
– 1 April to 30 September 2012	(2,000)	
Fair value adjustment – plant	(3,000)	(11,000)
Goodwill arising on acquisition		8,500

The market value of the shares issued of $12 million would be recorded: $6 million share capital and $6 million share premium as the shares have a nominal value of $1 each and their issue value was $2 each.

(ii) Unrealised profit (URP) in inventory

Strata's inventory (from Paradigm) at 31 March 2013 is $4·6 million (one month's supply). At a mark-up on cost of 15%, there would be $600,000 of URP (4,600 x 15/115) in the inventory.

(iii) Intra-group current accounts

	$'000
Current account balance of Strata per question	2,800
Cash-in-transit (CIT) not yet received by Paradigm	900
Current account balance of Paradigm	3,700

(iv) Consolidated retained earnings

	$'000
Paradigm's retained earnings (19,200 + 7,400)	26,600
Strata's post-acquisition profit (11,200 (see below) x 75%)	8,400
URP in inventory (w (ii))	(600)
Loss on equity investments (7,500 – 7,100)	(400)
	34,000

The adjusted post-acquisition profits of Strata are:

As reported for the year	8,000
Add pre-acquisition losses	2,000
Gain on equity investments (3,900 – 3,200)	700
Adjustment for over depreciation on fair value of plant (3,000 x 6/36 months)	500
	11,200

(v) Non-controlling interest

	$'000
Fair value on acquisition (w (i))	6,000
Post-acquisition profit (11,200 (w (iv)) x 25%)	2,800
	8,800

(b) The consolidated financial statements of Paradigm are of little value when trying to assess the performance and financial position of its subsidiary, Strata. Therefore the main source of information on which to base any investment decision would be Strata's own entity financial statements. However, where a company is part of a group, there is the potential for the financial statements (of a subsidiary) to have been subject to the influence of related party transactions. In the case of Strata, there has been a considerable amount of post-acquisition trading with Paradigm and, because of the related party relationship, there is the possibility that this trading is not at arm's length (i.e. not at commercial rates). Indeed from the information in the question, Paradigm sells goods to Strata at a much lower cost than it does to other third parties. This gives Strata a benefit which is likely to lead to higher profits (compared to what they would have been if it had paid the market value for the goods purchased from Paradigm). This seems to coincide with a remarkable turn around in the profitability of Strata; before the acquisition it was carrying accumulated losses of $6 million, whereas in the six months since the acquisition it made a profit of $10 million (see part (a)). The sales of $4·6 million per month have a cost of $4 million (4,600 x 100/115). Had these been priced at Paradigm's normal prices, they would have been sold to Strata for $5·6 million (4,000 x 140%). For the six month post-acquisition period, this gives Strata a trading 'advantage' of $6 million (($5·6 million – $4·6 million) x 6 months) which is a large proportion of its post-acquisition profit. There may be other aspects of the relationship where Paradigm gives Strata a benefit that may not have happened had Strata not been part of the group, e.g. access to technology/research, cheap finance, etc.

The main concern is that any information about the 'benefits' Paradigm may have passed on to Strata through related party transactions is difficult to obtain from published sources. It may be that Paradigm has deliberately 'flattered' Strata's financial statements specifically in order to obtain a high sale price and a prospective purchaser would not necessarily be able to determine that this had happened from either the consolidated or entity financial statements.

2 (a) (i) Atlas – Statement of profit or loss and other comprehensive income for the year ended 31 March 2013

Monetary figures in brackets are in $'000

	$'000
Revenue (550,000 – 10,000 in substance loan)	540,000
Cost of sales (w (i))	(420,600)
Gross profit	119,400
Distribution costs	(21,500)
Administrative expenses (30,900 + 5,400 re directors' bonus of 1% of sales made)	(36,300)
Finance costs (700 + 500 (10,000 x 10% x 6/12 re in substance loan))	(1,200)
Profit before tax	60,400
Income tax expense (27,200 – 1,200 + (9,400 – 6,200) deferred tax)	(29,200)
Profit for the year	31,200
Other comprehensive income	
Revaluation gain on land and buildings (w (ii))	7,000
Total comprehensive income for the year	38,200

(ii) Atlas – Statement of changes in equity for the year ended 31 March 2013

	Share capital $'000	Share premium $'000	Revaluation reserve $'000	Retained earnings $'000	Total equity $'000
Balances at 1 April 2012	40,000	6,000	nil	11,200	57,200
Share issue (see below)	10,000	14,000			24,000
Total comprehensive income (see (i) above)			7,000	31,200	38,200
Dividend paid				(20,000)	(20,000)
Balances at 31 March 2013	50,000	20,000	7,000	22,400	99,400

The rights issue of 20 million shares (50,000/50 cents each x 1/5) at $1·20 has been recorded as $10 million equity shares (20 million x $0·50) and $14 million share premium (20 million x ($1·20 – $0·50)).

(iii) Atlas – Statement of financial position as at 31 March 2013

	$'000	$'000
Assets		
Non-current assets		
Property, plant and equipment (44,500 + 52,800 (w (ii)))		97,300
Current assets		
Inventory (43,700 + 7,000 re in substance loan)	50,700	
Trade receivables	42,200	92,900
Plant held for sale (w (ii))		3,600
Total assets		193,800
Equity and liabilities		
Equity (see (ii) above)		
Equity shares of 50 cents each		50,000
Share premium	20,000	
Revaluation reserve	7,000	
Retained earnings	22,400	49,400
		99,400
Non-current liabilities		
In substance loan from Xpede (10,000 + 500 accrued interest)	10,500	
Deferred tax	9,400	19,900
Current liabilities		
Trade payables	35,100	
Income tax	27,200	
Accrued directors' bonus	5,400	
Bank overdraft	6,800	74,500
Total equity and liabilities		193,800

(b) Atlas – Basic earnings per share for the year ended 31 March 2013

Earnings per statement of comprehensive income	$31·2 million
Weighted average number of shares (w (iii))	96·7 million
Earnings per share	32·3 cents

Workings (figures in brackets are in $'000)

	$'000
(i) Cost of sales	
Per question	411,500
Closing inventory re in substance loan	(7,000)
Depreciation of buildings (w (ii))	2,500
Depreciation of plant and equipment (w (ii))	13,600
	420,600

(ii) Non-current assets

	$'000
Land and buildings	
The gain on revaluation and carrying amount of the land and buildings will be:	
Carrying amount at 1 April 2012 (60,000 – 20,000)	40,000
Revaluation at that date (12,000 + 35,000)	47,000
Gain on revaluation	7,000
Buildings depreciation (35,000/14 years)	(2,500)
Carrying amount of land and buildings at 31 March 2013 (47,000 – 2,500)	44,500

Plant
The plant held for sale should be shown separately and not be depreciated after 1 October 2012.

	$'000
Other plant	
Carrying amount at 1 April 2012 (94,500 – 24,500)	70,000
Plant held for sale (9,000 – 5,000)	(4,000)
	66,000
Depreciation for year ended 31 March 2013 (20% reducing balance)	(13,200)
Carrying amount at 31 March 2013	52,800
Plant held for sale:	
At 1 April 2012 (from above)	4,000
Depreciation to date of reclassification (4,000 x 20% x 6/12)	(400)
Carrying amount at 1 October 2012	3,600
Total depreciation of plant for year ended 31 March 2013 (13,200 + 400)	13,600

As the fair value of the plant held for sale at 1 October 2012 is $4·2 million, it should continue to be carried at its (lower) carrying amount (and no longer depreciated).

(iii) Earnings per share

Theoretical ex-rights value:

	Shares	$	$
Holding (say)	100	2·00	200
Rights taken up (1 for 4)	25	1·20	30
	125		230
Theoretical ex-rights value		1·84 ($230/125 shares)	

Weighted average number of shares:

1 April 2012 to 30 June 2012	80 million x $2·00/$1·84 x 3/12 =	21·7 million
1 July 2012 to 31 March 2013	100 million x 9/12 =	75·0 million
Weighted average for the year		96·7 million

3 (a) Monty – Statement of cash flows for the year ended 31 March 2013:

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

	$'000	$'000
Cash flows from operating activities:		
Profit before tax		3,000
Adjustments for:		
depreciation of non-current assets		900
amortisation of non-current assets		200
finance costs		400
decrease in inventories (3,800 – 3,300)		500
increase in receivables (2,950 – 2,200)		(750)
increase in payables (2,650 – 2,100)		550
Cash generated from operations		4,800
Finance costs paid		(400)
Income tax paid (w (i))		(425)
Net cash from operating activities		3,975
Cash flows from investing activities:		
Purchase of property, plant and equipment (w (ii))	(700)	
Deferred development expenditure (1,000 + 200)	(1,200)	
Net cash used in investing activities		(1,900)
Cash flows from financing activities:		
Redemption of 8% loan notes (3,125 – 1,400)	(1,725)	
Repayment of finance lease obligations (w (iii))	(1,050)	
Equity dividend paid (w (iv))	(550)	
Net cash used in financing activities		(3,325)
Net decrease in cash and cash equivalents		(1,250)
Cash and cash equivalents at beginning of period		1,300
Cash and cash equivalents at end of period		50

Workings

		$'000
(i)	Income tax paid	
	Provision b/f – current	(725)
	– deferred	(800)
	Tax charge	(1,000)
	Transfer from revaluation reserve	(650)
	Provision c/f – current	1,250
	– deferred	1,500
	Balance – cash paid	(425)
(ii)	Property, plant and equipment	
	Balance b/f	10,700
	Revaluation	2,000
	New finance lease	1,500
	Depreciation	(900)
	Balance c/f	(14,000)
	Balance – cash purchases	(700)
(iii)	Finance leases	
	Balances b/f – current	(600)
	– non-current	(900)
	New finance lease	(1,500)
	Balances c/f – current	750
	– non-current	1,200
	Balance cash repayment	(1,050)

(iv) Equity dividend

	$'000
Retained earnings b/f	1,750
Profit for the year	2,000
Retained earnings c/f	(3,200)
Balance – dividend paid	(550)

(b) **Return on capital employed**

The most striking feature of Monty's performance is the increase in its ROCE; whilst this is 4·7% percentage points (21·4% – 16·7%), it represents an increase in return of 28·1% (4·7%/16·7% x 100) which is an excellent performance during a period of apparent expansion. Indeed, had Monty not revalued its property, the return would have been even higher. Looking at the component parts of the ROCE, it can be seen that most areas contributed to the improvement. Gross margins improved, meaning either selling prices increased or cost of sales were reduced, and although operating margins improved, this is mainly due to the follow through of the increased gross margins as operating overheads actually increased proportionally with revenue. There may be a correlation between the increase in operating cost and increase in sales, such as higher expenditure on advertising may have led to increased sales and higher gross margins. The other component of ROCE is asset utilisation; here again Monty has had some success increasing sales per $1 invested by 12·1% ((1·95 – 1·74)/1·74 x 100). Given the new investment in property, plant and equipment (including new finance leased assets that have not been operating for a full year), this is an excellent achievement and bodes well for future periods. Also, it seems likely that some of the improvement is due to the development project coming on stream (as it is being amortised) and generating revenues. These factors have more than overcome the comparatively suppressing effect on ROCE due to the revaluation of the property.

Gearing

The capital structure changes of repaying $1,725,000 of the 8% loan less a net increase in finance lease obligations of $450,000 (1,950 – 1,500) have reduced debt by $1,275,000. This, coupled with an increase in equity of $2·8 million (albeit that nearly half of this came from the revaluation reserve of $1·35 million), has acted to reduce gearing markedly from 47·4% in 2012 to only 26·7% in 2013. Many shareholders may be comforted by a reduction in debt, however, debt is not necessarily a bad thing. Monty is borrowing at 8% (on the loan notes, the interest rate of the lease is unknown) yet earning an overall ROCE of 21·4%; this means shareholders are benefiting from the relatively cheap debt.

Appendix

Note: References to 2013 should be taken as being to the year ended 31 March 2013 (similarly for references to 2012).

Calculation of ratios (figures in $'000):

	2013	2012
Return on capital employed (ROCE)		
((3,000 + 150 + 250)/(12,550 + 1,400 + 1,950) x 100)	21·4%	16·7%
Margins:		
Gross profit margin (9,200/31,000 x 100)	29·7%	25·6%
Operating margin (3,400/31,000 x 100)	11·0%	9·6%
Utilisation:		
Net asset turnover (31,000/15,900)	1·95 times	1·74 times
Gearing (debt/equity) (1,400 + 1,950/12,550)	26·7%	47·4%

The figures for the calculation of 2013's ratios are given in brackets; the figures for 2012 are derived from the equivalent figures. Capital employed taken as equity + loan notes + finance lease obligations (current and non-current).

4 **(a)** A discontinued operation is a component (see below) of an entity that has either already been disposed of or is classified as held for sale that represents a separate major line of business or geographical area of business operations (or is part of a co-ordinated plan to dispose of such). It also applies to a subsidiary that is acquired specifically with a view to resale.

A component of an entity has operations and cash flows that are clearly distinguished for reporting purposes from those of the rest of an entity. It would normally be a cash generating unit (or a group of cash generating units) or a subsidiary.

This information is important to users of financial statements when they are forming an assessment of the likely future performance of an entity. For example, if a group made a large profit from one of its subsidiaries that it has recently sold (or will soon sell), this will have a material effect on any forecast of the group's future profit. This is because the profits from the subsidiary disposed of will no longer contribute to future group profit (though the re-investment of any sale proceeds from the disposal could). Also, the converse would be true where the disposal or closure of a loss-making subsidiary could improve future profitability.

(b) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* has been criticised for the use of the term '*a separate major line of business or geographical area of business operations*' to identify a discontinued operation as it may mean different things to different people and lead to inconsistency (and thus a lack of comparability). Despite this, the disposal of hotels in country A would seem to represent a separate geographical location and should be treated as a discontinued operation, even though the group will continue to operate hotels in other countries. The example of country B is less conclusive. Some might argue that a change in the target market (to holiday and tourism) does represent a different 'line of business operations' that has a different pricing structure, operating costs (such as providing 'all-inclusive' holidays) and profit margins than that of business clients. Also, the refurbishment of the hotels would seem to indicate catering to a different market. Others may argue that this is simply adapting a product (as all companies have to do) and does not represent a change to a separate line of business.

(c) On its own, a board decision to close the factory is not sufficient to justify the creation of a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, by formulating a plan and informing interested parties (employees, customers and suppliers), this is likely to constitute a constructive obligation for a restructuring provision by raising a valid expectation of the closure.

The amounts that should be provided for at 31 March 2013 are:

(workings in brackets are in $'000)

	$'000	
– redundancy (200 employees x 5)	1,000	
– impairment loss on plant (2,200 – (500 – 50))	1,750	(may be shown as a separate provision)
– onerous contract (lower amount)	850	
– penalty payments	200	
	3,800	

The $3·8 million should be charged to the statement of profit or loss for the year ended 31 March 2013 and the same amount reported in the statement of financial position as at 31 March 2013 as a current liability/plant impairment (assuming all parts of the factory closure will be completed within the next 12 months).

The factory and the plant would be disclosed in the statement of financial position as non-current assets held for sale at the lower of their carrying amount (the factory) or fair value less cost to sell (the plant).

The $125,000 retraining costs cannot be provided for as they are part of future activities and the anticipated $1·2 million profit on the disposal of the factory cannot be recognised until it is realised.

5 (a) (i) An investment property is land or buildings (or a part thereof) held by the owner to generate rental income or for capital appreciation (or both) rather than for production or administrative use. It would also include property held under a finance lease and may include property under an operating lease, if used for the same purpose as other investment properties. Generally, non-investment properties generate cash flows in combination with other assets, whereas a property that meets the definition of an investment property means that it will generate cash flows that are largely independent of the other assets held by an entity and, in that sense, such properties do not form part of the entity's normal operations.

(ii) Superficially, the revaluation model and fair value sound very similar; both require properties to be valued at their fair value which is usually a market-based assessment (often by an independent valuer). However, any gain (or loss) over a previous valuation is taken to profit or loss if it relates to an investment property, whereas for an owner-occupied property, any gain is taken to a revaluation reserve (via other comprehensive income and the statement of changes in equity). A loss on the revaluation of an owner-occupied property is charged to profit or loss unless it has a previous surplus in the revaluation reserve which can be used to offset the loss until it is exhausted. A further difference is that owner-occupied property continues to be depreciated after revaluation, whereas investment properties are not depreciated.

(b) Extracts from Speculate's financial statements for the year ended 31 March 2013

(workings in brackets in $'000)

	$'000
Statement of profit or loss and other comprehensive income	
Depreciation of office building (A) (2,000/20 years x 6/12)	(50)
Gain on investment properties: A (2,340 – 2,300)	40
B (1,650 – 1,500)	150
Other comprehensive income (A see below)	350
Statement of financial position	
Non-current assets	
Investment properties (A and B) (2,340 + 1,650)	3,990
Equity	
Revaluation reserve (A) (2,300 – (2,000 – 50))	350

In Speculate's consolidated financial statements property B would be accounted for under IAS 16 *Property, Plant and Equipment* and be classified as owner-occupied. Further information is required to determine the depreciation charge.

Fundamentals Level – Skills Module, Paper F7 (INT)
Financial Reporting (International) **June 2013 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			1½
		goodwill			5
		equity investments			1
		inventory			1
		receivables			1
		bank			1
		equity shares			1½
		share premium			½
		retained earnings			3½
		non-controlling interest			1½
		10% loan notes			1
		trade payables			1
		bank overdraft			½
					20
	(b)	1 mark per valid point			**5**
				Total for question	**25**
2	**(a)**	**(i)**	Statement of profit or loss and other comprehensive income		
			revenue		1
			cost of sales		3
			distribution costs		½
			administrative expenses		1
			finance costs		1
			income tax		1½
			other comprehensive income		1
					9
		(ii)	Statement of changes in equity		
			balances b/f		1
			rights issue		1
			total comprehensive income		1
			dividend paid		1
					4
		(iii)	Statement of financial position		
			property, plant and equipment		2½
			inventory		1
			trade receivables		½
			plant held for sale (at 3,600)		1
			in substance loan		1
			deferred tax		1
			trade payables		½
			current tax		½
			directors' bonus		½
			bank overdraft		½
					9
	(b)	Basic earnings per share			
		earnings per statement of comprehensive income			½
		theoretical ex-rights value			1
		calculation of weighted average number of shares			1½
					3
				Total for question	**25**

			Marks
3	**(a)**	profit before tax	½
		depreciation/amortisation	1
		finance costs added back	½
		working capital items (½ mark each)	1½
		finance cost paid (outflow)	½
		income tax paid	2½
		purchase of property, plant and equipment	2½
		deferred development expenditure	1
		repayment of 8% loan notes	1
		repayment of finance lease obligations	2
		equity dividend paid	1
		cash b/f	½
		cash c/f	½
			15
	(b)	1 mark per valid point (up to 4 marks for ratios)	10
		Total for question	**25**
4	**(a)**	1 mark per valid point	5
	(b)	operations in country A is a discontinued operation	2
		discussion of issue for country B	2
			4
	(c)	information points to a constructive obligation	1
		provide for redundancy	1
		but not for retraining	1
		impairment of plant 1,750 (cannot recognise/offset gain on property)	1
		onerous contract – lower amount provided for	1
		provide for penalty	1
			6
		Total for question	**15**
5	**(a)**	**(i)** 1 mark per valid point	3
		(ii) 1 mark per valid point	2
			5
	(b)	depreciation of property A for 6 months	1
		gain on investment properties A and B	1
		carrying amounts at 31 March 2013	1
		OCI/revaluation reserve at 31 March 2013	1
		property B classified as owner-occupied in consolidated financial statements	1
			5
		Total for question	**10**