Answers

1 Consolidated statement of financial position of Paladin as at 30 September 2011

	$'000	$'000
Assets		
Non-current assets:		
Property, plant and equipment (40,000 + 31,000 + 4,000 – 1,000)		74,000
Intangible assets (w (i))		
– goodwill		15,000
– other intangibles (7,500 + 3,000 – 500)		10,000
Investment in associate (w (ii))		7,700
		106,700
Current assets		
Inventory (11,200 + 8,400 – 600 URP (w (iii)))	19,000	
Trade receivables (7,400 + 5,300 – 1,300 intra-group (w (iii)))	11,400	
Bank	3,400	33,800
Total assets		140,500
Equity and liabilities		
Equity attributable to owners of the parent		
Equity shares of $1 each		50,000
Retained earnings (w (iv))		35,200
		85,200
Non-controlling interest (w (vi))		7,900
Total equity		93,100
Non-current liabilities		
Deferred tax (15,000 + 8,000)		23,000
Current liabilities		
Bank overdraft	2,500	
Deferred consideration	5,400	
Trade payables (11,600 + 6,200 – 1,300 intra-group (w (iii)))	16,500	24,400
Total equity and liabilities		140,500

Workings (figures in brackets are in $'000)

(i) Goodwill in Saracen

	$'000	$'000
Controlling interest (see below)		
Immediate cash		32,000
Deferred consideration (5,400 x 100/108)		5,000
Non-controlling interest (10,000 x 20% (see below) x $3·50)		7,000
		44,000
Equity shares	10,000	
Pre-acquisition reserves:		
At 1 October 2010	12,000	
Fair value adjustments – plant	4,000	
– intangible	3,000	(29,000)
Goodwill arising on acquisition		15,000

The cost of the majority shareholding in Saracen was $32 million. Paladin acquired eight million shares and Saracen has 10 million $1 shares, this gives a controlling interest of 80% and a non-controlling interest of 20%.

The customer relationship asset is recognised as an intangible asset in the consolidated financial statements under IFRS 3 *Business combinations*.

(ii) Carrying amount of Augusta at 30 September 2011

	$'000
Cash consideration	10,000
Share of post-acquisition profits (1,200 x 8/12 x 25%)	200
Impairment loss	(2,500)
	7,700

(iii) Unrealised profit (URP) in inventory/intra-group current accounts

The URP in Saracen's inventory (supplied by Paladin) of $2·6 million is $600,000 (2,600 x 30/130). The current account balances of Paladin and Saracen should be eliminated from trade receivables and payables at the agreed amount of $1·3 million.

(iv) Consolidated retained earnings:

	$'000
Paladin's retained earnings (25,700 + 9,200)	34,900
Saracen's post-acquisition profits (4,500 (w (v)) x 80%)	3,600
Augusta's post-acquisition profits (w (ii))	200
Augusta's impairment loss	(2,500)
URP in inventory (w (iii))	(600)
Finance cost of deferred consideration (5,000 x 8%)	(400)
	35,200

(v) Post-acquisition adjusted profit of Saracen is:

	$'000
Profit as reported	6,000
Additional depreciation of plant (4,000/4 years)	(1,000)
Additional amortisation of customer relationship asset (3,000/6 years)	(500)
	4,500

(vi) Non-controlling interest

	$'000
Fair value on acquisition (w (i))	7,000
Post-acquisition profits (4,500 (w (v)) x 20%)	900
	7,900

2 (a) Keystone – Statement of comprehensive income for the year ended 30 September 2011

	$'000	$'000
Revenue (380,000 – 2,400 (w (i)))		377,600
Cost of sales (w (ii))		(258,100)
Gross profit		119,500
Distribution costs		(14,200)
Administrative expenses (46,400 – 24,000 dividend (50,000 x 5 x 2·40 x 4%))		(22,400)
Investment income		800
Loss on fair value of investments (18,000 – 17,400)		(600)
Finance costs		(350)
Profit before tax		82,750
Income tax expense (24,300 + 1,800 (w (v)))		(26,100)
Profit for the year		56,650
Other comprehensive income		
Revaluation of leased property	8,000	
Transfer to deferred tax (w (v))	(2,400)	5,600
Total comprehensive income for the year		62,250

(b) Keystone – Statement of financial position as at 30 September 2011

	$'000	$'000
Assets		
Non-current assets		
Property, plant and equipment (w (iv))		78,000
Financial asset: equity investments		17,400
		95,400
Current assets		
Inventory (w (iii))	56,600	
Trade receivables (33,550 – 2,400 (w (i)))	31,150	87,750
Total assets		183,150
Equity and liabilities		
Equity		
Equity shares of 20 cents each		50,000
Revaluation reserve (w (iv))	5,600	
Retained earnings (33,600 + 56,650 – 24,000 dividend paid)	66,250	71,850
		121,850
Non-current liabilities		
Deferred tax (w (v))		6,900
Current liabilities		
Trade payables	27,800	
Bank overdraft	2,300	
Current tax payable	24,300	54,400
Total equity and liabilities		183,150

Workings (figures in brackets in $'000)

(i) Where there is uncertainty over goods sold on a sale or return basis they should not be recognised as revenue until they have been formally accepted by the buyer. Thus $2·4 million should be removed from revenue and receivables. The goods should be added to the inventory at 30 September 2011 at their cost of $1·8 million (2·4 million x 75%).

(ii) Cost of sales

	$'000
opening inventory	46,700
materials (64,000 – 3,000)	61,000
production labour (124,000 – 4,000)	120,000
factory overheads (80,000 – (4,000 x 75%))	77,000
Amortisation of leased property (w (iv))	3,000
Depreciation of plant (1,000 + 6,000 (w (iv)))	7,000
Closing inventory (w (iii))	(56,600)
	258,100

The cost of the self-constructed plant is $10 million (3,000 + 4,000 + 3,000 for materials, labour and overheads respectively that have also been deducted from the above items in cost of sales). It is not permissible to add a profit margin to self-constructed assets.

(iii) Inventory at 30 September 2011:

	$'000
per count	54,800
goods on sale or return (w (i))	1,800
	56,600

(iv) Non-current assets:

The leased property has been amortised at $2·5 million per annum (50,000/20 years). The accumulated amortisation of $10 million therefore represents four years, thus its remaining life at the date of revaluation is 16 years.

	$'000
carrying amount at date of revaluation (50,000 – 10,000)	40,000
revalued amount	48,000
gross gain on revaluation	8,000
transfer to deferred tax (at 30%)	(2,400)
net gain to revaluation reserve	5,600

The revalued amount of $48 million will be amortised over its remaining life of 16 years at $3 million per annum.

The self-constructed plant will be depreciated for six months by $1 million (10,000 x 20% x 6/12) and have a carrying amount at 30 September 2011 of $9 million. The plant in the trial balance will be depreciated by $6 million ((44,500 – 14,500) x 20%) for the year and have a carrying amount at 30 September 2011 of $24 million.

In summary:

	$'000
Leased property (48,000 – 3,000)	45,000
Plant (9,000 + 24,000)	33,000
Property, plant and equipment	78,000

(v) Deferred tax

Provision required at 30 September 2011 ((15,000 + 8,000) x 30%)	6,900
Provision at 1 October 2010	(2,700)
Increase required	4,200
Transferred from revaluation reserve (w (iv))	(2,400)
Balance: charge to income statement	1,800

3 (a) Mocha – Statement of cash flows for the year ended 30 September 2011:

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

	$'000	$'000
Cash flows from operating activities:		
Profit before tax		3,900
Adjustments for		
depreciation of non-current assets		2,500
profit on the disposal of property, plant and equipment (8,100 – 4,000)		(4,100)
investment income		(1,100)
interest expense		500
increase in inventory (10,200 – 7,200)		(3,000)
decrease in receivables (3,700 – 3,500)		200
decrease in payables (4,600 – 3,200)		(1,400)
decrease in warranty provision (4,000 – 1,600)		(2,400)
Cash generated from operations		(4,900)
Interest paid		(500)
Income tax paid (w (i))		(800)
Net cash deficit from operating activities		(6,200)
Cash flows from investing activities:		
Purchase of property, plant and equipment	(8,300)	
Disposal of property, plant and equipment	8,100	
Disposal of investment	3,400	
Dividends received	200	
Net cash from investing activities		3,400
Cash flows from financing activities:		
Shares issued (w (ii))	2,400	
Payment of finance lease obligations (w (iii))	(3,900)	
Net cash from financing activities		(1,500)
Net decrease in cash and cash equivalents		(4,300)
Cash and cash equivalents at beginning of the year		1,400
Cash and cash equivalents at end of the year		(2,900)

Workings

(i) Income tax paid:

	$'000
Provision b/f – current	(1,200)
– deferred	(900)
Income statement tax charge	(1,000)
Provision c/f – current	1,000
– deferred	1,300
Difference – cash paid	(800)

(ii) Share issues

	$'000
Increase in share capital (14,000 – 8,000)	6,000
Bonus issue – share premium	(2,000)
– revaluation reserve (3,600 – 2,000)	(1,600)
Shares issued for cash at par	2,400

(iii) Finance lease

Balance b/f – current	(2,100)
– non-current	(6,900)
New leases in year	(6,700)
Balance c/f – current	4,800
– non-current	7,000
Principal repaid	(3,900)

Tutorial note:
Reconciliation of investments/investment income

	$'000
Investments	
Balance b/f	*7,000*
Carrying amount sold	*(3,000)*
Balance c/f	*(4,500)*
Difference: increase in fair value	*500*
Carrying amount sold	3,000
Proceeds	(3,400)
Profit on sale in income statement	400

Tutorial note: *as the retained earnings at 30 September 2010 (10,100) plus the profit for the period (2,900) equal the retained earnings at 30 September 2011 (13,000) there was no equity dividend paid.*

(b) (i) Mocha has reported an operating profit of $3·3 million (12,000 – 8,700) for the year ended 30 September 2011, which is likely to give a favourable impression to shareholders. However, its cash generated from operations is a deficit of $4·9 million. The reconciling items of these two figures appear in the statement of cash flows and it can be seen that operating profit has been boosted by the profit on the sale of a property and a large decrease in the product warranty provision. Some commentators argue that a profit on the sale of non-current assets is not really an 'operating' profit and it is misleading to be classed as such. Also, many items included in operating profit are subjective (for example the product warranty provision), and as such can be subject to manipulation. Cash flows are unaffected by such subjective estimates and from this perspective they are considered less susceptible to manipulation and therefore more reliable.

(ii) From the statement of financial position it can be seen that net investment in property, plant and equipment (after depreciation) has increased by $8·5 million (32,600 – 24,100). This may give the impression that the company is investing heavily in property, plant and equipment, and in one sense it is. However, the statement of cash flows shows that net cash investment in property, plant and equipment is only $200,000 (purchases of 8,300 less disposals of 8,100). Most of the difference is due to a (non-cash) acquisition of plant under finance leases (meaning further borrowing) and disposal proceeds of plant and equipment in excess of its carrying amounts. The cash flow information gives a somewhat different (and possibly more realistic) view of the company's investment in property, plant and equipment during the year.

4 (a) IAS 37 *Provisions, contingent liabilities and contingent assets* defines provisions as liabilities of uncertain timing or amount that should be recognised where there is a present obligation (as a result of past events), it is probable (assumed to be more than a 50% chance) that there will be an outflow of economic benefits (to settle the obligation) and the amounts can be estimated reliably. The obligation may be legal or constructive.

A contingent liability has more uncertainty in that it is a possible obligation (assumed to be less than a 50% chance) whose existence will be confirmed only by one or more future uncertain events that are not wholly within the control of the entity. An existing obligation where the amount cannot be reliably measured is also treated as a contingent liability.

The Standard seeks to improve consistency in the reporting of provisions. In the past some entities created 'general' (rather than specific) provisions for liabilities that did not really exist (known as 'big bath' provisions); equally many entities did not recognise provisions where there was a present obligation. The latter often related to deferred liabilities such as future environmental costs. The effect of such inconsistencies was that comparability was weakened and profit was frequently manipulated.

(b) (i) Although the information in the question says the environmental provision is not a legal obligation, it implies that it is a constructive obligation (Borough has created an expectation that it will pay the environmental costs) and therefore these costs should be provided for. The obligation for the fixed element of the cost arose as soon as the extraction commenced, whereas the variable element accrues in line with the extraction of oil. The present value of the environmental cost is shown as a non-current liability (credit) with the debit added to the cost of the licence and (effectively) charged to income as part of the annual amortisation charge.

The relevant extracts from Borough's statement of financial position as at 30 September 2011 are:

	$'000
Non-current asset	
Licence for oil extraction (50,000 + 20,000)	70,000
Amortisation (10 years)	(7,000)
Carrying amount	63,000
Non-current liability	
Environmental provision ((20,000 + (150,000 x 0·02 cents)) x 1·08 finance cost)	24,840

(ii) From Borough's perspective, as a separate entity, the guarantee for Hamlet's loan is a contingent liability of $10 million. As Hamlet is a separate entity, Borough has no liability for the secured amount of $15 million, not even for the potential shortfall for the security of $3 million. The $10 million contingent liability would normally be described and disclosed in the notes to Borough's entity financial statements.

In Borough's consolidated financial statements, the full liability of $25 million would be included in the statement of financial position as part of the group's consolidated non-current liabilities – there would be no contingent liability disclosed.

The concerns over the potential survival of Hamlet due to the effects of the recession may change the disclosure in Borough's entity financial statements. If Borough deems it probable that Hamlet is not a going concern the $10 million loan, which was previously a contingent liability, would become an actual liability and should be provided for on Borough's entity statement of financial position and disclosed as a current (not a non-current) liability.

5 (a) (i) The interest rate (5%) for the convertible loan notes is lower because of the potential value of the conversion option. The cost of equivalent loan notes without the option is 8%, the difference is mainly due to the market expectation of the higher worth of Bertrand's equity shares (compared to the cash alternative) when the loan notes are due for redemption. From the entity's viewpoint, the conversion option means lower payments of interest (to help cash flow), but it will eventually cause a dilution of earnings.

(ii) If the directors' treatment were acceptable, the use of the conversion option (compared to issuing non-convertible loans) would improve profit and earnings per share because of lower interest rates (and hence interest charges) and the company's gearing would be lower as the loan notes would not be shown as debt. However, this proposed treatment is not acceptable. A convertible loan note is a complex (hybrid) financial instrument and IFRS requires that the proceeds of the issue should be allocated between equity (the value of the option) and debt and the finance charge should be based on that of an equivalent non-convertible loan (8% in this case).

(b) Extracts from the financial statements of Bertrand

Income statement for the year ended 30 September 2011

	$'000
Finance costs (9,190 x 8%)	735 rounded

Statement of financial position as at 30 September 2011

Equity	
Equity option	810
Non-current liabilities	
8% convertible loan notes ((9,190 x 1·08) – 500)	9,425 rounded

Working

Year ended 30 September	Cash flow $'000	Discount rate at 8%	Discounted cash flows $'000
2011	500	0·93	465
2012	500	0·86	430
2013	10,500	0·79	8,295
value of debt component			9,190
value of equity option component (= balance)			810
total proceeds			10,000

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		property, plant and equipment		2½
		goodwill		5
		other intangibles		2½
		investment in associate		2
		inventory		1
		receivables		1
		bank		½
		equity shares		½
		retained earnings		5
		non-controlling interest		2
		deferred tax		½
		bank overdraft		½
		deferred consideration		1
		trade payables		1
			Total for question	**25**
2	**(a)**	Income statement		
		revenue		1
		cost of sales		7
		distribution costs		½
		administrative expenses		1½
		investment income		1
		loss on fair value of investment		1
		finance costs		½
		income tax expense		1½
		other comprehensive income		1
				15
	(b)	Statement of financial position		
		property, plant and equipment		2
		equity investments		½
		inventory		½
		trade receivables		1
		equity shares		½
		revaluation reserve		1½
		retained earnings		1½
		deferred tax		1
		trade payables		½
		bank overdraft		½
		current tax payable		½
				10
			Total for question	**25**

				Marks
3	**(a)**	profit before tax		½
		depreciation		1
		profit on disposal of property (deducted)		1
		investment income adjustment (deducted)		½
		interest expense adjustment (added back)		½
		working capital items		1½
		decrease in warranty provisions		1½
		interest paid (cash flow)		1
		income tax paid		2
		purchase of property, plant and equipment		1
		disposal of property, plant and equipment		1
		disposal of investment		1
		investment income (dividends received)		1
		share issue		2½
		payment of finance lease obligations		2
		cash b/f		½
		cash c/f		½
				19
	(b)	**(i)** and **(ii)** 3 marks each		**6**
			Total for question	**25**
4	**(a)**	definition of provisions		2
		definition of contingent liabilities		2
		how the Standard improves comparability		2
				6
	(b)	**(i)** it is a constructive obligation		1
		explanation of treatment		1
		non-current asset (including amortisation)		1½
		environmental provision (including unwinding of discount)		1½
		(ii) entity financial statements contingent liability of $10 million		1
		no obligation for secured $15 million		1
		consolidated statements show full $25 million as a liability		1
		if not a going concern, guarantee would be shown as an actual (current) liability in entity financial statements		1
				9
			Total for question	**15**
5	**(a)**	**(i)** 1 mark per valid point		**2**
		(ii) 1 mark per valid point		**3**
	(b)	finance cost		2
		value of equity option		1
		value of debt at 30 September 2011		2
				5
			Total for question	**10**