GROUP FINANCIAL STATEMENTS

QUESTIONS

COMPLEX AND MIX STRUCTURES

Q- 1

Alpha Co purchased 1,450,000 ordinary shares in Beta Co in 20X0, when the general reserve of Beta stood at$400,000 and there were no retained earnings.

The statements of financial position of the two companies as at 31 December 20X4 are set out below.

	Alpha $000	**Beta $000**
Assets		
Non current		
Property, plant and equipment	8,868	1,787
Investment in Beta at cost	1,45	
	10,318	1,787
Current assets		
Inventories	1,983	1,425
Receivables	1,462	1,307
Cash	25	16
	3,47	2,748
Total assets	13,788	4,535
Equity and liabilities		
Equity		
Share capital (50c ordinary shares)	5,500	1,000
General reserve	1,200	800
Retained earnings	485	100
Total equity	7,185	1,900
Non-current liabilities		
Borrowings 10%	4,000	
Borrowings 15%	-	500
Total non-current liabilities	4,000	500
Current liabilities		
Bank overdraft	1,176	840
Trade payables	887	1,077
Taxation	540	218
Total current liabilities	2,603	2,135
Total liabilities	6,603	2,635
Total equity and liabilities	13,788	4,535

At the end of the reporting period the current account of Alpha with Beta was agreed at $23,000 owed by Beta. This account is included in the appropriate receivable and trade payable balances shown above. There has been no impairment of goodwill since the date of acquisition.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's net assets.

Required

(a) Prepare a consolidated statement of financial position for the Alpha Beta Group.

(b) Show the alterations necessary to the group statement of financial position if the intragroup balance owed by Beta to Alpha represented an invoice for goods sold by Alpha to Beta at a mark-up of 15% on cost, and still unsold by Beta at 31 December 20X4.

Guidance notes

1. Lay out the pro-forma statement of financial position, leaving plenty of space.
2. Lay out workings for: goodwill calculation; general reserve; retained earnings; and non-controlling interest.
3. Fill in the easy numbers given in the question.
4. Work out the more complicated numbers using the workings and then add up the statement of financial position.
5. Keep all your work very neat and tidy to make it easy to follow. Cross reference all your workings.

Q-2

The statements of financial position of J Co and its investee companies, P Co and S Co, at 31 December 20X5 are shown below.

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	J CO. $000	P CO. $000	S CO. $000
Assets			
Non-current assets			
Freehold property	1,950	1,250	500
Plant and equipment	795	375	285
Investments	1,500	–	–
	4,245	1,625	785
Current assets			
Inventories	575	300	265
Trade receivables	330	290	370
Cash	50	120	2
	955	710	65
	5,200	2,335	1,440
Equity and liabilities			
Equity			
Share capital ($1 ordinary shares)	2,000	1,000	750
Retained earnings	1,460	885	39
	3,460	1,885	1,140
Non-current liabilities			
12% debentures	500	100	
Current liabilities			
Bank overdraft	560		300
Trade payables	680	350	300
	1240	350	300
	5200	2335	1440

Additional information

(a) J Co acquired 600,000 ordinary shares in P Co on 1 January 20X0 for $1,000,000 when the accumulated retained earnings of P Co were $200,000.

(b) At the date of acquisition of P Co, the fair value of its freehold property was considered to be $400,000 greater than its value in P Co's statement of financial position. P Co had acquired the property in January 20W0 and the buildings element (comprising 50% of the total value) is depreciated on cost over 50 years.

(c) J Co acquired 225,000 ordinary shares in S Co on 1 January 20X4 for $500,000 when the retained profits of S Co were $150,000.

d) P Co manufactures a component used by J Co only. Transfers are made by P Co at cost plus 25%. J Co held $100,000 of these components in inventories at 31 December 20X5.

(e) It is the policy of J Co to review goodwill for impairment annually. The goodwill in P Co was written off in full some years ago. An impairment test conducted at the year end revealed impairment losses on the investment in S Co of $92,000.

(f) It is the group's policy to value the non-controlling interest at acquisition at fair value. The market price of the shares of the non-controlling shareholders just before the acquisition was $1.65.

Required

Prepare, in a format suitable for inclusion in the annual report of the J Group, the consolidated statement of financial position at 31 December 20X5.

Q-3

(a) IAS 28 Investments in associates and IAS 31 Interests in joint ventures deal with associates and joint ventures respectively. The method of accounting for interests in joint ventures depends on whether they are interests in jointly controlled operations, jointly controlled assets or jointly controlled entities.

Required

(i) Explain the criteria which distinguish an associate from an ordinary non-current asset investment. (5 marks)
(ii) Explain the principal differences between a jointly controlled operation, a jointly controlled asset and a jointly controlled entity. (5 marks)

(b) The following financial statements relate to Baden, a public limited company.

INCOME STATEMENT
FOR YEAR ENDED 31 DECEMBER 20X8

	$m
Revenue	212
Cost of sales	178
Gross profit	34
Other income	12
Distribution costs	(17)
Administrative expenses	(8)
Finance costs	(4)
Profit before tax	17
Income tax expense	(5)
Profit for the year	12
Ordinary dividend – paid	4

STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X8

Property, plant and equipment	37
Current assets	31
	68
Equity	
Ordinary shares of $1	10
Share premium account	4
Retained earnings	32
	46
Non-current liabilities	10
Current liabilities	12
	68

(i) Cable, a public limited company, acquired 30% of the ordinary share capital of Baden at a cost of $14 million on 1 January 20X7. The share capital of Baden has not changed since acquisition when the retained earnings of Baden were $9 million.

(ii) At 1 January 20X7 the following fair values were attributed to the net assets of Baden but not incorporated in its accounting records. Fair values are to be taken into account when assessing any goodwill arising on acquisition.

Property, plant and equipment	**30**
(carrying value $20m) Current assets	31
Current liabilities	20
Non-current liabilities	8

(iii) Guy, an associate of Cable, also holds a 25% interest in the ordinary share capital of Baden. This was acquired on 1 January 20X8.

(iv) During the year to 31 December 20X8, Baden sold goods to Cable to the value of $35 million. The inventory of Cable at 31 December 20X8 included goods purchased from Baden on which the company made a profit of $10 million.

(v) The policy of all companies in the Cable Group is to depreciate property, plant and equipment at 20% per annum on the straight line basis.

Required

(i) Show how the investment in Baden would be stated in the consolidated statement of financial position and income statement of the Cable Group under IAS 28 Investments in associates, for the year ended 31 December 20X8 on the assumption that Baden is an associate.(8 marks)

(ii) Show and explain how the treatment of Baden would change if Baden was classified as an investment in a joint venture and it utilised the proportionate consolidation method in IAS 31 Interests in joint ventures. (7 marks)

(Total = 25 marks)

Q-4

Below are the statements of financial position of three companies as at 31 December 20X9.

	Bauble Co $'000	Jewel Co $'000	Gem Co $'000
Non-current assets			
Property, plant and equipment	720	60	70
Investments in group companies	185	100	–
	905	160	70
Current assets	175	95	90
	1,080	255	160
Equity			
Share capital – $1 ordinary shares	400	100	50
Retained earnings	560	90	65
	960	190	115
Current liabilities	120	65	45
	1,080	255	160

You are also given the following information:

(a) Bauble Co acquired 60% of the share capital of Jewel Co on 1 January 20X2 and 10% of Gem on 1 January 20X3. The cost of the combinations were $142,000 and $43,000 respectively. Jewel Co acquired 70% of the share capital of Gem Co on 1 January 20X3.

(b) The retained earnings balances of Jewel Co and Gem Co were:

	1 January 20X2	1 January 20X3
	$000	$000
Jewel Co	45	60
Gem Co	30	40

(c) No impairment loss adjustments have been necessary to date.

(d) It is the group's policy to value the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

(a) Prepare the consolidated statement of financial position for Bauble Co and its subsidiaries as at 31 December 20X9.

(b) Calculate the total goodwill arising on acquisition if Bauble Co had acquired its investments in Jewel and Gem on 1 January 20X3 at a cost of $142,000 and $43,000 respectively and Jewel Co had acquired its investment in Gem Co on 1 January 20X2.

Q-5

X, a public limited company, acquired 100 million ordinary shares of $1 in Y , a public limited company on 1 April 20X6 when the retained earnings were $120 million. Y acquired 45 million ordinary shares of $1 in Z, a public limited company, on 1 April 20X4 when the retained earnings were $10 million. On 1 April 20X4 there were no material differences between the book values and the fair values of Z. On 1 April 20X6, the retained earnings of Z were $20 million.

Y acquired 30% of the ordinary shares of W , a limited company, on 1 April 20X6 for $50 million when the retained earnings of W were $7 million. Y is in a position to exercise significant influence over W and there were no material differences between the book values and the fair values of W at that date.

There had been no share issues since 1 April 20X4 by any of the group companies. The following statements of financial position relate to the group companies as at 31 March 20X9.

	X	Y	Z	W
	$m	$m	$m	$m
Property, plant and equipment	900	100	30	40
Intangible assets		30		
Investment in Y	320			
Investment in Z		90		
Investment in W		50		
Net current assets	640	360	75	73
	1,860	630	105	113
Share capital	360	150	50	80
Share premium	250	120	10	6
Retained earnings	1,050	210	30	17
	1,660	480	90	103
Non-current liabilities	200	150	15	10
	1,860	630	105	113

Use tables to work out total values for X and Z at acquisition and at the end of the reporting period.

(i) The following fair value table sets out the book values of certain assets and liabilities of the group companies together with any accounting policy adjustments to ensure consistent group policiesat 1 April 20X6.

	Book value		Accounting policy adj.		Fair Value adj		Value after adjustment	
	$m	$m	$m	$m	$m	$m	$m	$m
	Y	Z	Y	Z	Y	Z	Y	Z
Property, plant and equipment	90	20			30	10	120	30
Intangible non-current assets	30		(30)					

Inventory	20	12	2	(8)	(5)	14	7
Allowance for receivables	(15)			(9)		(24)	

These values had not been incorporated into the financial records. The group companies have consistent accounting policies at 31 March 20X9, apart from the non-current intangible assets in Y's books.

(ii) During the year ended 31 March 20X9, Z had sold goods to X and Y . At 31 March 20X9, there were $44 million of these goods in the inventory of X and $16 million in the inventory of Y. Z had made a profit of 25% on selling price on the goods.

(iii) On 1 June 20X7, an amount of $36 million was received by Y from an arbitration award against Q. This receipt was secured as a result of an action against Q prior to Y's acquisition by X but was not included in the assets of Y at 1 April 20X6.

(iv) The group writes goodwill off immediately to reserves. However it has decided to bring its accounting policies into line with IFRSs and not local accounting policies. Thus goodwill will be capitalised under IFRS 3 Business combinations. At 31 March 20X6, property, plant and equipment had a remaining useful life of 10 years.

(v) It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

(a) Prepare a consolidated statement of financial position as at 31 March 20X9 for the X group. (25 marks)

(b) Explain how the change in accounting policy as regards goodwill should be dealt with in the financial statements of the X group under International Financial Reporting Standards.(5 marks)

All calculations should be rounded to the nearest million dollars. (Total = 30 marks)

Q-6

The following draft statements of financial position relate to Glove, Body and Fit, all public limited companies, as at 31 May 20X7.

	Glove $m	Body $m	Fit $m
Assets			
Non-current assets			
Property, plant and equipment	260	20	26
Investment in Body	60		
Investment in Fit		30	
Available for sale investments	10		
Current assets	65	29	20
Total assets	395	79	46
Ordinary shares	150	40	20
Other reserves	30	5	8
Retained earnings	135	25	10
Total equity	315	70	38
Non-current liabilities	45	2	3
Current liabilities	35	7	5
Total liabilities	80	9	8
Total equity and liabilities	395	79	46

The following information is relevant to the preparation of the group financial statements.

(a) Glove acquired 80% of the ordinary shares of Body on 1 June 20X5 when Body's other reserves were $4 million and retained earnings were $10 million. The fair value of the net assets of Body was $60 million at 1 June 20X5. Body acquired 70% of the ordinary shares of Fit on 1 June 20X5 when the other reserves of Fit were $8 million and retained earnings were $6 million. The fair value of the net assets of Fit at that date was $39 million. The excess of the fair value over the net assets of Body and Fit is due to an increase in the value of non-depreciable land of the companies. There have been no issues of ordinary shares in the group since 1 June 20X5.

(b) Body owns several trade names which are highly regarded in the market place. Body has invested a significant amount in marketing these trade names and has expensed the costs. None of the trade names has been acquired externally and, therefore, the costs have not been capitalised in the statement of financial position of Body. On the acquisition of Body by Glove, a firm of valuation experts valued the trade names at $5 million and this valuation had been taken into account by Glove when offering $60 million for the investment in Body. The valuation of the trade names is not included in the fair value of the net assets of Body above. Group policy is to amortise intangible assets over ten years.

(c) On 1 June 20X5, Glove introduced a new defined benefit retirement plan. At 1 June 20X5, there were no unrecognised actuarial gains and losses. The following information relates to the retirement plan.

	31 May 20X6	31 May 20X7
	$m	$m
Un-recognised actuarial losses to date	3	5
Present value of obligation	20	26
Fair value of plan assets	16	20

The expected average remaining working lives of the employees in the plan is ten years at 31 May 20X6 and 31 May 20X7. Glove wishes to defer actuarial gains and losses by using the 'corridor' approach. The defined benefit liability is included in non-current liabilities.

(d) Glove has issued 30,000 convertible bonds with a three year term repayable at par. The bonds were issued at par with a face value of $1,000 per bond. Interest is payable annually in arrears at a nominal interest rate of 6%. Each bond can be converted at any time up to maturity into 300 shares of Glove. The bonds were issued on 1 June 20X6 when the market interest rate for similar debt without the conversion option was 8% per annum. Glove does not wish to account for the bonds at fair value through profit or loss. The interest has been paid and accounted for in the financial statements. The bonds have been included in non-current liabilities at their face value of $30 million and no bonds were converted in the current financial year.

(e) On 31 May 20X7, Glove acquired plant with a fair value of $6 million. In exchange for the plant, the supplier received land, which was currently not in use, from Glove. The land had a carrying value of $4 million and an open market value of $7 million. In the financial statements at 31 May 20X7, Glove had made a transfer of$4 million from land to plant in respect of this transaction.

(f) Goodwill has been tested for impairment at 31 May 20X6 and 31 May 20X7 and no impairment loss occurred.

(g) It is the group's policy to value the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's identifiable net assets.

(h) Ignore any taxation effects.

Required

Prepare the consolidated statement of financial position of the Glove Group at 31 May 20X7 in accordance withInternational Financial Reporting Standards (IFRS).(25 marks)

Q-7

The following draft statements of financial position relate to Largo, a public limited company, Fusion, a public limited company and Spine, a public limited company, as at 30 November 20X4:

	Largo	Fusion	Spine
	$m	$m	$m
Non-current assets			
Property, plant and equipment	329	185	64
Investment in Spine		50	
Investment in Micro	11		
	340	235	64

Current assets	120	58	40
	460	293	104
Equity			
Called up ordinary share capital of $1	280	110	50
Share premium account	30	20	10
Retained earnings	120	138	35
	430	268	95
Non-current liabilities			
Deferred tax liability	20	20	5
Current liabilities	10	5	4
	460	293	104

The following information is relevant to the preparation of the group financial statements:

(a) Largo acquired ninety per cent of the ordinary share capital of Fusion and twenty-six per cent of the ordinary share capital of Spine on 1 December 20X3 in a share for share exchange when the retained earnings were Fusion $136 million and Spine $30 million. The fair value of the net assets at 1 December 20X3 was Largo $650 million, Fusion $330 million and Spine $128 million. Any increase in the consolidated fair value of the net assets over the carrying value is deemed to be attributable to property held by the companies.

The share for share exchange on the purchase of Fusion and Spine on 1 December 20X3 has not yet been recorded in Largo's books. Largo issued 150m of its own shares to purchase Fusion and 30m to purchase Spine. There have been no new issue of shares since 1 December 20X3. On 1 December 20X3, before the share for share exchange, the market capitalisation of the companies was $644 million: Largo; $310 million: Fusion; and $130 million: Spine.

(b) In arriving at the fair value of net assets acquired at 1 December 20X3, Largo has not accounted for the deferred tax arising on the increase in the value of the property of both Fusion and Spine. The deferred tax arising on the fair valuation of the property was Fusion $15 million and Spine $9 million.

(c) Fusion had acquired a sixty per cent holding in Spine on 1 December 20X0 for a consideration of $50 million when the retained earnings reserve of Spine was $10 million. The fair value of the net assets at that date was $80 million with the increase in fair value attributable to property held by the companies. Property is depreciated within the group at five per cent per annum.

(d) Largo purchased a forty per cent interest in Micro, a limited liability investment company on 1 December 20X3. The only asset of the company is a portfolio of investments which is held for trading purposes. The stake in Micro was purchased for cash for $11 million. The carrying value of the net assets of Micro on 1 December 20X3 was $18 million and their fair value was $20 million. On 30 November 20X4, the fair value of the net assets was $24 million. Largo exercises significant influence over Micro. Micro values the portfolio on a 'mark to market' basis.

(e) Fusion has included a brand name in its property, plant and equipment at the cost of $9 million. The brand earnings can be separately identified and could be sold separately from the rest of the business. The fair value of the brand at 30 November 20X4 was $7 million. The fair value of the brand at the time of Fusion's acquisition by Largo was $9 million.

(f) It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare the consolidated statement of financial position of the Largo Group at the year ended 30 November 20X4 in accordance with International Financial Reporting Standards. (30 marks)

Q-8

The following draft statements of financial position relate to Rod, a public limited company, Reel, a public limited company, and Line, a public limited company, as at 30 November 20X3.

	Rod	Reel	Line

	$m	$m	$m
Non-current assets			
Property, plant and equipment	1,230	505	256
Investment in Reel	640		
Investment in Line	160	100	
	2,030	605	256
Current assets			
Inventory	300	135	65
Trade receivables	240	105	49
Cash at bank and in hand	90	50	80
	630	290	194
Total assets	2,660	895	450
Equity			
Share capital	1,500	500	200
Share premium account	300	100	50
Revaluation surplus			70
Retained earnings	625	200	60
	2,425	800	380
Non-current liabilities	135	25	20
Current liabilities	100	70	50
Total equity and liabilities	2,660	895	450

The following information is relevant to the preparation of the group financial statements.

(a) Rod had acquired eighty per cent of the ordinary share capital of Reel on 1 December 20X0 when the retained earnings were $100 million. The fair value of the net assets of Reel was $710 million at 1 December 20X0. Any fair value adjustment related to net current assets and these net current assets had been realised by 30 November 20X3. There had been no new issues of shares in the group since the current group structure was created.

(b) Rod and Reel had acquired their holdings in Line on the same date as part of an attempt to mask the true ownership of Line. Rod acquired forty per cent and Reel acquired twenty-five per cent of the ordinary share capital of Line on 1 December 20X1. The retained earnings of Line on that date were $50 million and those of Reel were $150 million. There was no revaluation surplus in the books of Line on 1 December 20X1. The fair values of the net assets of Line at December 20X1 were not materially different from their carrying values.

(c) The group operates in the pharmaceutical industry and incurs a significant amount of expenditure on the development of products. These costs were formerly written off to the income statement as incurred but then reinstated when the related products were brought into commercial use. The reinstated costs are shown as 'development inventories'. The costs do not meet the criteria in IAS 38 Intangible assets for classification as intangibles and it is unlikely that the net cash inflows from these products will be in excess of the development costs. In the current year, Reel has included $20 million of these costs in inventory. Of these costs $5 million relates to expenditure on a product written off in periods prior to 1 December 20X0. Commercial sales of this product had commenced during the current period. The accountant now wishes to ensure that the financial statements comply strictly with IAS/IFRS as regards this matter.

(d) Reel had purchased a significant amount of new production equipment during the year. The cost before trade discount of this equipment was $50 million. The trade discount of $6 million was taken to the income statement. Depreciation is charged on the straight line basis over a six year period.

(e) The policy of the group is now to state property, plant and equipment at depreciated historical cost. The group changed from the revaluation model to the cost model under IAS 16 Property, plant and equipment in the year ended 30 November 20X3 and restated all of its assets to historical cost in that year except for the property, plant and equipment of Line which had been revalued by the directors of Line 1 December 20X2. The values were incorporated in the financial records creating revaluation surplus of $70 million. The property, plant and equipment of Line were originally purchased on December 20X1 at a cost of $300 million. The assets are depreciated over six years on the straight line basis. The group does not make an annual transfer from revaluation reserves to retained earnings in respect of the excess depreciation charged on revalued property, plant and equipment. There were no additions or disposals of the property, plant and equipment of Line for the two years ended 30 November 20X3.

(f) It is the group's policy to value the non-controlling interest at acquisition at its proportionate share of the subsidiary's identifiable net assets.

(g) During the year the directors of Rod decided to form a defined benefit pension scheme for the employees of the parent and contributed cash to it of $100 million. The following details relate to the scheme at 30 November 20X3

	$m
Present value of obligation	130
Fair value of plan assets	125
Current service cost	110
Interest cost – scheme liabilities	20
Expected return on pension scheme assets	10

The only entry in the financial statements made to date is in respect of the cash contribution which has been included in Rod's trade receivables. The directors have been uncertain as how to deal with the above

pension scheme in the consolidated financial statements because of the significance of the potential increase in the charge to the income statement relating to the pension scheme. They wish to recognise immediately any actuarial gain in profit or loss.

Required

(a) Show how the defined benefit pension scheme should be dealt with in the consolidated financial statements. (5 marks)

(b) Prepare a consolidated statement of financial position of the Rod Group for the year ended 30 November 20X3 in accordance with the standards of the International Accounting Standards Board. (22 marks)

(c) You are now advising the financial director of Rod about certain aspects of the financial statements for the year ended 30 November 20X4. The director has summarised these points as follows.

(i) Restructuring of the group. A formal announcement for a restructuring of the group was made after the year end on 5 December 20X4. A provision has not been made in the financial statements as a public issue of shares is being planned and the company does not wish to lower the reported profits. Prior to the year end, the company has sold certain plant and issued redundancy notices to some employees in anticipation of the formal commencement of the restructuring. The company prepared a formal plan for the restructuring which was approved by the board and communicated to the trade union representatives prior to the year end. The directors estimate the cost of the restructuring to be $60 million, and it could take up to two years to complete the restructuring. The estimated cost of restructuring includes $10 million for retraining and relocating existing employees, and the directors feel that costs of $20 million (of which $5 million is relocation expenses) will have been incurred by the time the financial statements are approved.(7 marks)

(ii) Fine for illegal receipt of a state subsidy. The company was fined on 10 October 20X4 for the receipt of state subsidies that were contrary to a supra-national trade agreement. The subsidies were used to offset trading losses in previous years. Rod has to repay to the government $300 million plus interest of $160 million. The total repayment has been treated as an intangible asset which is being amortised over twenty years with a full year's charge in the current year. (5 marks)

The financial director wishes to prepare a report for submission to the Board of Directors which discusses the above accounting treatment of the key points in the financial statements.

(d) Rod spends many millions of pounds on research in innovative areas. Often the research and development expenditure does not provide a revenue stream for many years. The company has gained a significant expertise in this field and is frustrated by the fact that the value which is being created is not shown in the statement of financial position, but the cost of the innovation is charged to profit or loss. The knowledge gained by the company is not reported in the financial statements.

Advise the directors on the current problems of reporting financial performance in the case of a 'knowledge led' company such as Rod. (8 marks)

(e) In many organisations, bonus payments related to annual profits form a significant part of the total remuneration of all senior managers, not just the top few managers. The directors of Rod feel that the chief internal auditor makes a significant contribution to the company's profitability, and should therefore receive a bonus based on profit.

Advise the directors as to whether this is appropriate. (3 marks)

(Total = 50 marks)

Q-9

The Exotic Group carries on business as a distributor of warehouse equipment and importer of fruit into the country. Exotic was incorporated in 20X1 to distribute warehouse equipment. It diversified its activities during 20X3 to include the import and distribution of fruit, and expanded its operations by the acquisition of shares in Melon in

20X5 and in Kiwi in 20X7.

Accounts for all companies are made up to 31 December.

The draft income statements for Exotic, Melon and Kiwi for the year ended 31 December 20X9 are as follows.

	Exotic $'000	Melon $'000	Kiwi $'000
Revenue	45,600	24,700	22,800
Cost of sales	18,050	5,463	5,320
Gross profit	27,550	19,237	17,480
Distribution costs	3,325	2,137	1,900
Administrative expenses	3,475	950	1,90
Finance costs	325	–	–
Profit before tax	20,425	16,150	13,680
Income tax expense	8,300	5,390	4,241
Profit for the year	12,125	10,760	9,439
Dividends paid and declared for the period	9500		-

The draft statements of financial position as at 31 December 20X9 are as follows.

	Exotic $'000	Melon $'000	Kiwi $'000
Non-current assets			
Property, plant and equipment (NBV)	35,483	24,273	13,063
Investments			
Shares in Melon	6,650		
Shares in Kiwi		3,800	
	42,133	28,073	13,063
Current assets	1,568	9,02	8,883
	43,701	37,098	21,946
Equity			
$1 ordinary shares	8,000	3,000	2,000
Retained earnings	22,638	24,075	19,898
	30,638	27,075	21,898
Current liabilities	13,063	10,023	48
	43,701	37,098	21,946

The following information is available relating to Exotic, Melon and Kiwi.

(a) On 1 January 20X5 Exotic acquired 2,700,000 $1 ordinary shares in Melon for $6,650,000 at which date there was a credit balance on the retained earnings of Melon of $1,425,000. No shares have been issued by Melon since Exotic acquired its interest.

(b) On 1 January 20X7 Melon acquired 1,600,000 $1 ordinary shares in Kiwi for $3,800,000 at which date there was a credit balance on the retained earnings of Kiwi of $950,000. No shares have been issued by Kiwi since Melon acquired its interest.

(c) During 20X9, Kiwi had made intragroup sales to Melon of $480,000 making a profit of 25% on cost and $75,000 of these goods were in inventories at 31 December 20X9.

(d) During 20X9, Melon had made intragroup sales to Exotic of $260,000 making a profit of 331/3% on cost and $60,000 of these goods were in inventories at 31 December 20X9.

(e) On 1 November 20X9 Exotic sold warehouse equipment to Melon for $240,000 from inventories. Melon has included this equipment in its property, plant and equipment. The equipment had been purchased on credit by Exotic for $200,000 in October 20X9 and this amount is included in its current liabilities as at 31 December 20X9.

(f) Melon charges depreciation on its warehouse equipment at 20% on cost. It is company policy to charge a full year's depreciation in the year of acquisition to be included in the cost of sales.

(g) An impairment test conducted at the year end did not reveal any impairment losses.

(h) It is the group's policy to value the non-controlling interest at fair value at the date of acquisition. The fair value of the non-controlling interests in Melon on 1 January 20X5 was $500,000. The fair value of the 28% non-controlling interest in Kiwi on 1 January 20X7 was $900,000.

Required

Prepare for the Exotic Group:

(a) A consolidated income statement for the year ended 31 December 20X9.(16 marks)

(b) A consolidated statement of financial position as at that date. (12 marks)

(c) The following year, Exotic acquired the whole of the share capital of Zest Software, a public limited company and merged Zest Software with its existing business. The directors feel that the goodwill ($10 million)arising on the purchase has an indefinite economic life. Additionally, Exotic acquired a 50% interest in a joint venture which gives rise to a net liability of $3 million. The reason for this liability is the fact that the negative goodwill ($6 million) arising on the acquisition of the interest in the joint venture was deducted from the interest in the net assets ($3 million). Exotic is proposing to net the liability of $3 million against a loan made to the joint venture by Exotic of $5 million, and show the resultant balance in property, plant and equipment. The equity method of accounting has been used to account for the interest in the joint venture. It isproposed to treat negative goodwill in the same manner as the goodwill on the purchase of Zest Software and leave it in the statement of financial position indefinitely.(11 marks)

(d) Advise the directors of Exotic on the issues relating to the reporting of environmental information in financial statements and the current reporting requirements in the UK.(11 marks)

(Total = 50 marks)

PIECEMEAL ACQUISITION AND DISPOSAL

Q-10

Angel Co bought 70% of the share capital of Shane Co for $120,000 on 1 January 20X6. At that date Shane Co's retained earnings stood at $10,000.

The statements of financial position at 31 December 20X8, summarized income statements to that date and movement on retained earnings are given below:

	Angle Co	**Shane Co**
	$'000	**$'000**
STATEMENTS OF FINANCIAL POSITION		
Non-current assets		
Property, plant and equipment	200	80
Investment in Shane Co	120	–
	320	80
Current assets	890	140
	1,210	220
Equity		
Share capital – $1 ordinary shares	500	100
Retained reserves	400	90
	900	190

Current liabilities	310	30
	1,210	220

SUMMARISED INCOME STATEMENTS

Profit before interest and tax	100	20
Income tax expense	(40)	(8)
Profit for the year	60	12
Other comprehensive income, net of tax	10	6
Total comprehensive income for the year	70	18

MOVEMENT IN RETAINED RESERVES

Balance at 31 December 20X7	330	72
Total comprehensive income for the year	70	18
Balance at 31 December 20X8	400	90

Angel Co sells one half of its holding in Shane Co for $120,000 on 30 June 20X8. At that date, the fair value of the 35% holding in Shane was slightly more at $130,000 due to a share price rise. The remaining holding is to be dealt with as an associate. This does not represent a discontinued operation.

No entries have been made in the accounts for the above transaction. Assume that profits accrue evenly throughout the year.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare the consolidated statement of financial position, statement of comprehensive income and a reconciliation of movement in retained reserves for the year ended 31 December 20X8.

Ignore income taxes on the disposal. No impairment losses have been necessary to date.

Q-11

X, a public limited company, owns 100 per cent of companies Y and Z which are both public limited companies. The X group operates in the telecommunications industry and the directors are considering two different plans to restructure the group. The directors feel that the current group structure is not serving the best interests of the shareholders and wish to explore possible alternative group structures.

The statements of financial position of X and its subsidiaries Y and Z at 31 May 20X1 are as follows:

	X	**Y**	**Z**
	$m	**$m**	**$m**
Property, plant and equipment	600	200	45
Cost of investment in Y	60		
Cost of investment in Z	70		
Net current assets	160	100	20
	890	300	65
Share capital – ordinary shares of $1	120	60	40
Retained earnings	770	240	25
	890	300	65

X acquired the investment in Z on 1 June 20W5 when the company retained earnings balance was $20 million. The fair value of the net assets of Z on 1 June 20W5 was $60 million. Company Y was incorporated by X and has always been a 100 per cent owned subsidiary. The fair value of the net assets of Y at 31 May 20X1 is $310 million and of Z is $80 million. The fair values of the net current assets of both Y and Z are approximately the same as their book values.

The directors are unsure as to the impact or implications that the following plans are likely to have on the individual accounts of the companies and the group accounts.

Local companies legislation requires that the amount at which share capital is recorded is dictated by the nominal value of the shares issued and if the value of the consideration received exceeds that amount, the excess is recorded in the share premium account. Shares cannot be issued at a discount. In the case of a share for share exchange, the value of the consideration can be deemed to be the book value of the investment exchanged.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

The two different plans to restructure the group are as follows.

Plan 1

Y is to purchase the whole of X's investment in Z. The directors are undecided as to whether the purchase consideration should be 50 million $1 ordinary shares of Y or a cash amount of $75 million.

Plan 2

The assets and trade of Z are to be transferred to Y. Company Z would initially become a non trading company. The assets and trade are to be transferred at their book value. The consideration for the transfer will be $60 million which will be left outstanding on the intercompany account between Y and Z.

Required

Discuss the key considerations and the accounting implications of the above plans for the X group. Your answer should show the potential impact on the individual accounts of X, Y and Z and the group accounts after each plan has been implemented.

Q-12

Ejoy, a public limited company, has acquired two subsidiaries. The details of the acquisitions are as follows:

Company	Date of acquisition	Ordinary share capita of $1 $m	Reserves at acquisitio n $m	Fair value of net value at acquisition $m	Cost of investment $m	Ordinary share capital of $1 acquired $m
Zbay	1 June 20X4	200	170	600	520	160
Tbay	1 December 20X5	120	80	310	216	72

The draft income statements for the year ended 31 May 20X6 are:

	Ejoy $m	Zbay $m	Tbay $m
Revenue	2,500	1,500	800
Cost of sales	(1,800)	(1,200)	(600)
Gross profit	700	300	200
Other income	70	10	–
Distribution costs	(130)	(120)	
(70) Administrative expenses	(100)	(90)	
(60) Finance costs	(50)	(40)	
(20) Profit before tax	490	60	50
Income tax expense	(200)	(26)	(20)
Profit for the year	290	34	30

Profit for year 31 May 20X5	190	20	15

The following information is relevant to the preparation of the group financial statements.

(a) Tbay was acquired exclusively with a view to sale and at 31 May 20X6 meets the criteria of being a disposal group. The fair value of Tbay at 31 May 20X6 is $300 million and the estimated selling costs of the shareholding in Tbay are $5 million.

(b) Ejoy entered into a joint venture with another company on 31 May 20X6. The joint venture is a limited company and Ejoy has contributed assets at fair value of $20 million (carrying value $14 million). Each party will hold five million ordinary shares of $1 in the joint venture. The gain on the disposal of the assets ($6 million) to the joint venture has been included in 'other income'.

(c) On acquisition, the financial statements of Tbay included a large cash balance. Immediately after acquisition Tbay paid a dividend of $40 million. The receipt of the dividend is included in other income in the income statement of Ejoy. Since the acquisition of Zbay and Tbay, there have been no further dividend payments by these companies.

(d) Zbay has a loan asset which was carried at $60 million at 1 June 20X5. The loan's effective interest rate is six per cent. On 1 June 20X5 the company felt that because of the borrower's financial problems, it would receive $20 million in approximately two years time, on 31 May 20X7. At 31 May 20X6, the company still expects to receive the same amount on the same date. The loan asset is classified as 'loans and receivables'.

(e) On 1 June 20X5, Ejoy purchased a five year bond with a principal amount of $50 million and a fixed interest rate of five per cent which was the current market rate. The bond is classified as an 'available for sale' financial asset. Because of the size of the investment, Ejoy has entered into a floating interest rate swap. Ejoy has designated the swap as a fair value hedge of the bond. At 31 May 20X6, market interest rates were six per cent. As a result, the fair value of the bond has decreased to $48·3 million. Ejoy has received $0·5 million in net interest payments on the swap at 31 May 20X6 and the fair value hedge has been 100% effective in the period, and you should assume any gain/loss on the hedge is the same as the loss/gain on the bond. No entries have been made in the income statement to account for the bond or the hedge.

(f) No impairment of the goodwill arising on the acquisition of Zbay had occurred at 1 June 20X5. The recoverable amount of Zbay was $630 million and that of Tbay was $290 million at 31 May 20X6. Impairment losses on goodwill are charged to cost of sales.

(g) Assume that profits accrue evenly throughout the year and ignore any taxation effects.

(h) It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare a consolidated income statement for the Ejoy Group for the year ended 31 May 20X6 in accordance with International Financial Reporting Standards.

(25 marks)

Q-13

(a) Base, a public limited company, acquired two subsidiaries, Zero and Black, both public limited companies, on 1 June 20X1. The details of the acquisitions at that date are as follows.

Subsidiary	**Ordinary share capita of $1** **$m**	**Reserves** **$m**	**Fair value of net value at acquisition** **$m**	**Cost of investment** **$m**	**Ordinary share capital acquired** **$m**
Zero	350	250	770	600	250
Black	200	150	400	270	120

The draft income statements for the year ended 31 May 20X3 are:

	Base **$m**	**Zero** **$m**	**Black** **$m**

Revenue	3,000	2,300	600
Cost of sales	(2,000)	(1,600)	(300)
Gross profit	1,000	700	300
Distribution costs	(240)	(230)	(120
Administrative expenses	(200)	(220)	(80)
Finance cost: interest expense	(20)	(10)	(12)
Investment income receivable			
(including intragroup dividends paid May 20X3)	100	–	–
Profit before tax	640	240	88
Income tax expense	(130)	(80)	(36)
Profit for the yea	510	160	52
Reserves 1 June 20X2	1,400	400	190

The following information is relevant to the preparation of the group financial statements.

(i) On 1 December 20X2, Base sold 50 million $1 ordinary shares in Zero for $155 million. The only accounting entry made by Base was to record the receipt of the cash consideration in the cash account and in a suspense account.

(ii) The fair value of Base's investment in Zero on 1 December 20X2 (just after the disposal) was $650m. The fair value of Base's investment in Black on 1 March 20X3 (just after the disposal) was $240m.

(iii) On 1 March 20X3, Base sold 40 million $1 ordinary shares in Black for $2.65 per share. Only the cash receipt has been recorded in the cash account and a suspense account.

(iv) Black had sold $150 million of goods to Base on 30 April 20X3. There was no opening inventory of intragroup goods but the closing inventories of these goods in Base's financial statements was $90 million. The profit on these goods was 30% on selling price.

(v) Base has implemented in full IAS 19 Employee benefits in its financial statements. The directors have included the following amounts in the figure for cost of sales.

	$m
Current service cost	5
Actuarial deficit on obligation	4
Interest cost	3
Actuarial gain on assets	(2)
Charged to cost of sales	10

The accounting policy in respect of these accounts is recognition in profit or loss using the 10% corridor approach. The fair value of the plan assets at 31 May 20X2 was $48 million and the present value of the defined benefit obligation was $54 million at that date. The net cumulative unrecognised actuarial loss at 31 May 20X2 was $3 million and the expected remaining working lives of the employees was ten years.

(vi) Base issued on 1 June 20X2 a redeemable debt instrument at a cost of $20 million. The debt is repayable in four years at $24.7 million. Base has included the redeemable debt in its statement of financial position at $20 million. The effective interest cost on the bond is 5.4%.

(vii) Base had carried out work for a group of companies (Drum Group) during the financial year to 31 May 20X2. Base had accepted one million share options of the Drum Group in full settlement of the debt owed to them. At 1 June 20X2 these share options were valued at $3 million which was the value of the outstanding debt. The following table gives the prices of these shares and the fair value of the option.

	Share price	Fair value of option
31 May 20X2	$13	$3
31 May 20X3	$10	$1

The options had not been exercised during the year and remained at $3 million in the statement of financial position of Base. The options can be exercised at any time after 31 May 20X5 for $8·50 per share.

(viii) Base had paid a dividend of $50 million in the year and Zero had paid a dividend of $70 million in May 20X3.

(ix) The post acquisition profit or loss effect of the fair value adjustments has been incorporated into the subsidiaries' records. Goodwill is reviewed for impairment annually. At 1 June 20X2 the group had recognised impairment losses of $10 million relating to Zero and $6 million relating to Black. No further impairment losses were necessary during the year ending 31 May 20X3.

(x) Ignore the tax implications of any capital gains made by the Group and assume profits accrue evenly throughout the year.

Required

Prepare a consolidated income statement for the Base Group for the year ended 31 May 20X3 in accordance with International Accounting Standards/International Financial Reporting Standards.

Show separately any required adjustment to the parent's equity in the group statement of financial position on the disposal of shares in subsidiaries.(30 marks)

(b) A small but material part of the revenue of the group results mainly from the sale of software under licences which provide customers with the right to use these products. Base has stated that it follows emerging best practice in terms of its revenue recognition policy which it regards as US GAAP. It has stated that the International Accounting Standards Board has been slow in revising its current standards and the company has therefore adopted the US standard SAB101 Revenue Recognition in Financial Statements. The group policy is as follows.

(i) If services are essential to the functioning of the software (for example setting up the software) and the payment terms are linked, the revenue for both software and services is recognised on acceptance of the contract.

(ii) Fees from the development of customised software, where service support is incidental to its functioning, are recognised at the completion of the contract.

Required

Discuss whether this policy is acceptable. (No knowledge of US GAAP is required.)

(5 marks)

(c) The directors of the Base group feel that their financial statements do not address a broad enough range of users' needs. They have reviewed the published financial statements and have realised that there is very little information about the corporate environmental governance. Base discloses the following environmental information in the financial statements.

(i) The highest radiation dosage to a member of the public

(ii) Total acid gas emissions and global warming potential

Contribution to clean air through emissions savings

Required

(i) Explain the factors which provide encouragement to companies to disclose social and environmental information in their financial statements, briefly discussing whether the content of such disclosure should be at the company's discretion. (9 marks)

(ii) Describe how the current disclosure by the Base Group of 'corporate environmental governance' could be extended and improved.(6 marks)

(Total = 50 marks)

Q-14

1 Bravado, a public limited company, has acquired two subsidiaries and an associate. The draft statements of financial position are as follows at 31 May 2009:

	Bravado	Message	Mixted
	$m	$m	$m
Assets			
Non-current assets			
Property, plant and equipment	265	230	161
Investments in subsidiaries			
Message	300		
Mixted	128		

Investment in associate – Clarity	20		
Available-for-sale financial assets	51	6	5
	764	236	166
Current assets:			
Inventories	135	55	73
Trade receivables	91	45	32
Cash and cash equivalents	102	100	8
	328	200	113
Total assets	1,092	436	279
Equity and liabilities:			
Share capital	520	220	100
Retained earnings	240	150	80
Other components of equity	12	4	7
Total equity	772	374	187
Non-current liabilities:			
Long-term borrowings	120	15	5
Deferred tax	25	9	3
Total non-current liabilities	145	24	8
Current liabilities			
Trade and other payables	115	30	60
Current tax payable	60	8	24
Total current liabilities	175	38	84
Total liabilities	320	62	92
Total equity and liabilities	1,092	436	279

The following information is relevant to the preparation of the group financial statements:

(i) On 1 June 2008, Bravado acquired 80% of the equity interests of Message, a private entity. The purchase consideration comprised cash of $300 million. The fair value of the identifiable net assets of Message was $400 million including any related deferred tax liability arising on acquisition. The owners of Message had to dispose of the entity for tax purposes by a specified date and, therefore, sold the entity to the first company to bid for it, which was Bravado. An independent valuer has stated that the fair value of the non-controlling interest in Message was $86 million on 1 June 2008. Bravado does not wish to measure the non-controlling interest in subsidiaries on the basis of the proportionate interest in the identifiable net assets but wishes to use the 'full goodwill' method. The retained earnings of Message were $136 million and other components of equity were $4 million at the date of acquisition. There had been no new issue of capital by Message since the date of acquisition and the excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

(ii) On 1 June 2007, Bravado acquired 6% of the ordinary shares of Mixted. Bravado had treated this investment as available-for-sale in the financial statements to 31 May 2008 but had restated the investment at cost on Mixted becoming a subsidiary. On 1 June 2008, Bravado acquired a further 64% of the ordinary shares of Mixted and gained control of the company. The consideration for the acquisitions was as follows:

	Holding	Consideration
	$m	**$m**
1 June 2007	6%	10
1 June 2008	64%	118
	70%	128

Under the purchase agreement of 1 June 2008, Bravado is required to pay the former shareholders 30% of the profits of Mixted on 31 May 2010 for each of the financial years to 31 May 2009 and 31 May 2010. The fair value of this arrangement was estimated at $12 million at 1 June 2008 and at 31 May 2009 this value had not changed. This amount has not been included in the financial statements.

At 1 June 2008, the fair value of the equity interest in Mixted held by Bravado before the business combination was $15 million and the fair value of the non-controlling interest in Mixted was $53 million.

The fair value of the identifiable net assets at 1 June 2008 of Mixted was $170 million (excluding deferred tax assets and liabilities),andtheretainedearningsandothercomponentsofequitywere$55millionand$7million respectively. There had been no new issue of share capital by Mixted since the date of acquisition and the excess of the fair value of the net assets is due to an increase in the value of property, plant and equipment (PPE). The fair value of the PPE was provisional pending receipt of the final valuations for these assets. These valuations were received on 1 December 2008 and they resulted in a further increase of $6 million in the fair value of the net assets at the date of acquisition. This increase does not affect the fair value of the non-controlling interest. PPE is depreciated on the straight-line basis over seven years. The tax base of the identifiable net assets of Mixted was $166 million at 1 June 2008. The tax rate of Mixted is 30%.

(iii) Bravado acquired a 10% interest in Clarity, a public limited company, on 1 June 2007 for $8 million. The investment was accounted for as an available-for-sale investment and at 31 May 2008, its value was $9 million. On 1 June 2008, Bravado acquired an additional 15% interest in Clarity for $11 million and achieved significant influence. Clarity made profits after dividends of $6 million and $10 million for the years to 31 May 2008 and 31 May 2009.

(iv) On 1 June 2007, Bravado purchased an equity instrument of 11 million dinars which was its fair value. The instrument was classified as available-for-sale. The relevant exchange rates and fair values were as follows:

	$ to dinars	**Fair value of instrument – dinars**
1 June 2007	4.5	11
31 May 2008	5.1	10
31 May 2009	4.8	7

Bravado has not recorded any change in the value of the instrument since 31 May 2008. The reduction in fair value as at 31 May 2009 is deemed to be as a result of impairment.

(v) Bravado manufactures equipment for the retail industry. The inventory is currently valued at cost. There is a market for the part completed product at each stage of production. The cost structure of the equipment is as follows:

	Cost per unit	**Selling price per unit**
	$	**$**
Production process – 1st stage	1,000	1,050
Conversion costs – 2nd stage	500	-
Finished product	1,500	1,700

The selling costs are $10 per unit and Bravado has 100,000 units at the first stage of production and 200,000 units of the finished product at 31 May 2009. Shortly before the year end, a competitor released a new model onto the market which caused the equipment manufactured by Bravado to become less attractive to customers. The result was a reduction in the selling price to $1,450 of the finished product and $950 for 1st stage product.

(vi) The directors have included a loan to a director of Bravado in cash and cash equivalents of $1 million. The loan has no specific repayment date on it but is repayable on demand. The directors feel that there is no problem with this accounting entry as there is a choice of accounting policy within International Financial Reporting Standards (IFRS) and that showing the loan as cash is their choice of accounting policy as there is no IFRS which says that this policy cannot be utilised.

(vii) There is no impairment of goodwill arising on the acquisitions.

Required:

(a) Prepare a consolidated statement of financial position as at 31 May 2009 for the Bravado Group. (35 marks)

(b) Calculate and explain the impact on the calculation of goodwill if the non-controlling interest was calculated on a proportionate basis for Message and Mixted. (8 marks)

(c) Discuss the view of the directors that there is no problem with showing a loan to a director as cash and cash equivalents, taking into account their ethical and other responsibilities as directors of the company. (5 marks)

Professional marks will be awarded in part (c) for clarity and expression of your discussion.(2 marks)

(50 marks)

Q-15

Grange, a public limited company, operates in the manufacturing sector. The draft statements of financial position of the group companies are as follows at 30 November 2009:

	Grange $m	Park $m	Fence $m
Assets:			
Non-current assets			
Property, plant and equipment	257	311	238
Investments in subsidiaries			
Park	340		
Fence	134		
Investment in Sitin	16		
	747	311	238
Current assets	475	304	141
Total assets	1,222	615	379
Equity and liabilities:			
Share capital	430	230	150
Retained earnings	410	170	65
Other components of equity	22	14	17
Total equity	862	414	232
Non-current liabilities	172	124	38
Current liabilities			
Trade and other payables	178	71	105
Provisions for liabilities	10	6	4
Total current liabilities	188	77	109
Total liabilities	360	201	147
Total equity and liabilities	1222	615	379

The following information is relevant to the preparation of the group financial statements:

(i) On 1 June 2008, Grange acquired 60% of the equity interests of Park, a public limited company. The purchase consideration comprised cash of $250 million. Excluding the franchise referred to below, the fair value of the identifiable net assets was $360 million. The excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

Park held a franchise right, which at 1 June 2008 had a fair value of $10 million. This had not been recognised in the financial statements of Park. The franchise agreement had a remaining term of five years to run at that date and is not renewable. Park still holds this franchise at the year-end.

Grange wishes to use the 'full goodwill' method for all acquisitions. The fair value of the non-controlling interest in Park was $150 million on 1 June 2008. The retained earnings of Park were $115 million and other components of equity were $10 million at the date of acquisition.

Grange acquired a further 20% interest from the non-controlling interests in Park on 30 November 2009 for a cash consideration of $90 million.

(ii) On 31 July 2008, Grange acquired a 100% of the equity interests of Fence for a cash consideration of $214 million. The identifiable net assets of Fence had a provisional fair value of $202 million, including any contingent liabilities. At the time of the business combination, Fence had a contingent liability with a fair value of $30 million. At 30 November 2009, the contingent liability met the recognition criteria of IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' and the revised estimate of this liability was $25 million. The accountant of Fence is yet to account for this revised liability.

However, Grange had not completed the valuation of an element of property, plant and equipment of Fence at 31 July 2008 and the valuation was not completed by 30 November 2008. The valuation was received on 30 June 2009 and the excess of the fair value over book value at the date of acquisition was estimated at $4 million. The asset had a useful economic life of 10 years at 31 July 2008.

The retained earnings of Fence were $73 million and other components of equity were $9 million at 31 July 2008 before any adjustment for the contingent liability.

On 30 November 2009, Grange disposed of 25% of its equity interest in Fence to the non-controlling interest for a consideration of $80 million. The disposal proceeds had been credited to the cost of the investment in the statement of financial position.

(iii) On 30 June 2008, Grange had acquired a 100% interest in Sitin, a public limited company, for a cash consideration of $39 million. Sitin's identifiable net assets were fair valued at $32 million.

On 30 November 2009, Grange disposed of 60% of the equity of Sitin when its identifiable net assets were $36 million. Of the increase in net assets, $3 million had been reported in profit or loss and $1 million had been reported in comprehensive income as profit on an available-for-sale asset. The sale proceeds were $23 million and the remaining equity interest was fair valued at $13 million. Grange could still exert significant influence after the disposal of the interest. The only accounting entry made in Grange's financial statements was to increase cash and reduce the cost of the investment in Sitin.

(iv) Grange acquired a plot of land on 1 December 2008 in an area where the land is expected to rise significantly in value if plans for regeneration go ahead in the area. The land is currently held at cost of $6 million in property, plant and equipment until Grange decides what should be done with the land. The market value of the land at 30 November 2009 was $8 million but as at 15 December 2009, this had reduced to $7 million as there was some uncertainty surrounding the viability of the regeneration plan.

(v) Grange anticipates that it will be fined $1 million by the local regulator for environmental pollution. It also anticipates that it will have to pay compensation to local residents of $6 million although this is only the best estimate of that liability. In addition, the regulator has requested that certain changes be made to the manufacturing process in order to make the process more environmentally friendly. This is anticipated to cost the company $4 million.

(vi) Grange has a property located in a foreign country, which was acquired at a cost of 8 million dinars on 30 November 2008 when the exchange rate was $1 = 2 dinars. At 30 November 2009, the property was revalued to 12 million dinars. The exchange rate at 30 November 2009 was $1 = 1·5 dinars. The property was being carried at its value as at 30 November 2008. The company policy is to revalue property, plant and equipment whenever material differences exist between book and fair value. Depreciation on the property can be assumed to be immaterial.

(vii) Grange has prepared a plan for reorganising the parent company's own operations. The board of directors has discussed the plan but further work has to be carried out before they can approve it. However, Grange has made a public announcement as regards the reorganisation and wishes to make a reorganisation provision at 30 November 2009 of $30 million. The plan will generate cost savings. The directors have calculated the value in use of the net assets (total equity) of the parent company as being $870 million if the reorganisation takes place and $830 million if the reorganisation does not take place. Grange is concerned that the parent company's property, plant and equipment have lost value during the period because of a decline in property prices in the region and feel that any impairment charge would relate to these assets. There is no reserve within other equity relating to prior revaluation of these non-current assets.

(viii) Grange uses accounting policies, which maximise its return on capital, employed. The directors of Grange feel that they are acting ethically in using this approach as they feel that as long as they follow 'professional rules', then there is no problem. They have adopted a similar philosophy in the way they conduct their business affairs. The finance director had recently received information that one of their key customers, Brook, a public limited company, was having serious liquidity problems. This information was received from a close friend who was employed by Brook. However, he also learned that Brook had approached a rival company Field, a public limited company, for credit and knew that if Field granted Brook credit then there was a high probability that the outstanding balance owed by Brook to Grange would be paid. Field had approached the director for an informal credit reference for Brook who until recently had always paid promptly. The director was intending to give Brook a good reference because of its recent prompt payment history as the director felt that there was no obligation or rule which required him to mention the company's liquidity problems. (There is no change required to the financial statements as a result of the above information.)

Required:

(a) Calculate the gain or loss arising on the disposal of the equity interest in Sitin.(6 marks)

(b) Prepare a consolidated statement of financial position of the Grange Group at 30 November 2009 in accordance with International Financial Reporting Standards. (35 marks)

(c) Discuss the view that ethical behaviour is simply a matter of compliance with professional rules and whether the finance director should simply consider 'rules' when determining whether to give Brook a good credit reference.(7 marks)

Professional marks will be awarded in part (c) for clarity and expression. (2 marks)

Q-16

The following financial statements relate to Ashanti, a public limited company.

Ashanti Group: Statements of comprehensive income for the year ended 30 April 2010.

	Ashanti $m	Bochem $m	Ceram $m
Revenue	810	235	142
Cost of sales	(686)	(137)	(84)
Gross profit	124	98	58
Other income	31	17	12
Distribution costs	(30)	(21)	(26)
Administrative expenses	(55)	(29)	(12)
Finance costs	(8)	(6)	(8)
Profit before tax	62	59	24
Income tax expense	(21	(23)	(10)
Profit for the year	41	36	14
Other comprehensive income for the year, net of tax:			
Available-for-sale financial assets (AFS)	20	9	6
Gains (net) on PPE revaluation	12	6	–
Actuarial losses on defined benefit plan	(14)	–	–
Other comprehensive income for the year, net of tax	18	15	6
Total comprehensive income and expense for year	59	51	20

The following information is relevant to the preparation of the group statement of comprehensive income:

1. On 1 May 2008, Ashanti acquired 70% of the equity interests of Bochem, a public limited company. The purchase consideration comprised cash of $150 million and the fair value of the identifiable net assets was $160 million at that date. The fair value of the non-controlling interest in Bochem was $54 million on 1 May 2008.Ashanti wishes to use the 'full goodwill' method for all acquisitions. The share capital and retained earnings of Bochem were $55 million and $85 million respectively and other components of equity were $10 million at the date of acquisition. The excess of the fair value of the identifiable net assets at acquisition is due to an increase in the value of plant, which is depreciated on the straight-line method and has a five year remaining life at the date of acquisition. Ashanti disposed of a 10% equity interest to the non-controlling interests (NCI) of Bochem on 30 April 2010 for a cash consideration of

$34 million. The carrying value of the net assets of Bochem at 30 April 2010 was $210 million before any adjustments on consolidation. Goodwill has been impairment tested annually and as at 30 April 2009 had reduced in value by 15% and at 30 April 2010 had lost a further 5% of its original value before the sale of the equity interest to the NCI. The goodwill impairment should be allocated between group and NCI on the basis of equity shareholding.

2. Bochem acquired 80% of the equity interests of Ceram, a public limited company, on 1 May 2008. The purchaseconsiderationwascashof$136million.Ceram'sidentifiablenetassetswerefairvaluedat $115 million and the NCI of Ceram attributable to Ashanti had a fair value of $26 million at that date. On 1 November 2009, Bochem disposed of 50% of the equity of Ceram for a consideration of $90 million. Ceram's identifiable net assets were $160 million and the fair value of the NCI of Ceram attributable to Bochem was $35 million at the date of disposal. The remaining equity interest of Ceram held by Bochem was fair valued at $45 million. After the disposal, Bochem can still exert significant influence. Goodwill had been impairment tested and no impairment had occurred. Ceram's profits are deemed to accrue evenly over the year.

3. Ashanti has sold inventory to both Bochem and Ceram in October 2009. The sale price of the inventory was $10 million and $5 million respectively. Ashanti sells goods at a gross profit margin of 20% to group companies and third parties. At the year-end, half of the inventory sold to Bochem remained unsold but the entire inventory sold to Ceram had been sold to third parties.

4. On 1 May 2007, Ashanti purchased a $20 million five-year bond with semi annual interest of 5% payable on 31 October and 30 April. The purchase price of the bond was $21·62 million. The effective annual interest rate is 8% or 4% on a semi annual basis. The bond is classified as available-for-sale. At 1 May 2009, the amortised cost of the bond was $21·05 million and the loss recognised in equity was $0·6 million, resulting in a carrying value of $20·45 million (no change to the effective annual interest rate). The issuer of the bond did not pay the interest due on 31 October 2009 and 30 April 2010. Ashanti feels that as at 30 April 2010, the bond is impaired and that the best estimates of total future cash receipts are $2·34 million on 30 April 2011 and $8 million on 30 April 2012. The current interest rate for discounting cash flows as at 30 April 2010 is 10%. No accounting entries have been made in the financial statements for the above bond since 30 April 2009.

5. Ashanti sold $5 million of goods to a customer who recently made an announcement that it is restructuring its debts with its suppliers including Ashanti. It is probable that Ashanti will not recover the amounts outstanding. The goods were sold after the announcement was made although the order was placed prior to the announcement. Ashanti wishes to make an additional allowance of $8 million against the total receivable balance at the year end, of which $5 million relates to this sale.

6. Ashanti owned a piece of property, plant and equipment (PPE) which cost $12 million and was purchased on 1 May 2008. It is being depreciated over 10 years on the straight-line basis with zero residual value. On 30 April 2009, it was revalued to $13 million and on 30 April 2010, the PPE was revalued to $8 million. The whole of the revaluation loss had been posted to the statement of comprehensive income and depreciation has been charged for the year. It is Ashanti's company policy to make all necessary transfers for excess depreciation following revaluation.

7. The salaried employees of Ashanti are entitled to 25 days paid leave each year. The entitlement accrues evenly over the year and unused leave may be carried forward for one year. The holiday year is the same as the financial year. At 30 April 2010, Ashanti has 900 salaried employees and the average unused holiday entitlement is three days per employee. 5% of employees leave without taking their entitlement and there is no cash payment when an employee leaves in respect of holiday entitlement. There are 255 working days in the year and the total annual salary cost is $19 million. No adjustment has been made in the financial statements for the above and there was no opening accrual required for holiday entitlement.

8. Ignore any taxation effects of the above adjustments and the disclosure requirements of IFRS 5 Non-current assets held for sale and discontinued operations.

Required:

(a) Prepare a consolidated statement of comprehensive income for the year ended 30 April 2010 for the Ashanti Group.(35 marks)

The directors of Ashanti have heard that the International Accounting Standards Board (IASB) has issued amendments to the rules regarding reclassification of financial instruments. The directors believe that the IASB has issued these amendments to reduce the difference between US GAAP and IFRS in respect of reclassification of financial assets. Reclassification, which was previously severely restricted under the IFRS, is now permitted in specific circumstances if the conditions and disclosure requirements are followed. They feel that this will give them the capability of managing their earnings, as they will be able to reclassify loss-making financial assets and smooth income. They feel that there is no problem with managing earnings as long as the shareholders do not find out and as long as the accounting practices are within the guidelines set out in International Financial Reporting Standards (IFRS).

Required:

(b) Describe the amendments to the rules regarding reclassification of financial assets issued in October 2008 by the IASB, discussing how these rules could lead to 'management of earnings'. (7 marks)

(c) Discuss the nature of and incentives for 'management of earnings' and whether such a process can be deemed to be ethically acceptable.(6 marks)

Professional marks will be awarded in question 1(c) for clarity and quality of discussion. (2 marks)

Q-17

(a) Jay, a public limited company, has acquired the following shareholdings in Gee and Hem, both public limited companies.

Date of Acquisition	Holding acquired	Fair value of net assets	Purchase Consideration
Gee		$m	$m
1 June 20X3	30%	40	15
1 June 20X4	50%	50	30
Hem			
1 June 20X4	25%	32	12

The following statements of financial position relate to Jay, Gee and Hem at 31 May 20X5.

	Jay	Gee	Hem
	$m	$m	$m
Property, plant and equipment	300	40	30
Investment in Gee	52		
Investment in Hem	22		
Current assets	100	20	15
Total assets	474	60	45
Share capital of $1	100	10	6
Share premium account	50	20	14
Revaluation surplus	15		
Retained earnings	139	16	10
Total equity	304	46	30
Non-current liabilities	60	4	3
Current liabilities	110	10	12
Total equity and liabilities	474	60	45

The following information is relevant to the preparation of the group financial statements of the Jay Group.

(i) Gee and Hem have not issued any new share capital since the acquisition of the shareholdings by Jay. The excess of the fair value of the net assets of Gee and Hem over their carrying amounts at the dates of acquisition is due to an increase in the value of Gee's non-depreciable land of $10 million at

1 June 20X3 and a further increase of $4 million at 1 June 20X4, and Hem's non-depreciable land of $6 million at 1 June 20X4. There has been no change in the value of non-depreciable land since 1 June 20X4. Before obtaining control of Gee, Jay did not have significant influence over Gee but has significant influence over Hem. Jay has accounted for the investment in Gee at market value with changes in value being recorded in profit or loss. The market price of the shares of Gee at 31 May 20X5 had risen to $6.50 per share as there was speculation regarding a takeover bid.

(ii) On 1 June 20X4, Jay sold goods costing $13 million to Gee for $19 million. Gee has used the goods in constructing a machine which began service on 1 December 20X4. Additionally, on 31 May 20X5, Jay purchased a portfolio of investments from Hem at a cost of $10 million on which Hem had made a profit of $2 million. These investments have been incorrectly included in Jay's statement of financial position under the heading 'Investment in Hem'.

(iii) Jay sold some machinery with a carrying value of $5 million on 28 February 20X5 for $8 million. The terms of the contract, which was legally binding from 28 February 20X5, was that the purchaser would pay a non-refundable initial deposit of $2 million followed by two instalments of $3·5 million (including total interest of $1 million) payable on 31 May 20X5 and 20X6. The purchaser was in financial difficulties at the year end and subsequently went into liquidation on 10 June 20X5. No payment is expected from the liquidator. The deposit had been received on 28 February 20X5 but the first instalment was not received. The terms of the agreement were such that Jay maintained title to the machinery until the first instalment was paid. The machinery was still physically held by Jay and the machinery had been treated as sold in the financial statements. The amount outstanding of $6 million is included in current assets and no interest has been accrued in the financial statements.

(iv) Group policy on depreciation of plant and equipment is that depreciation of 10% is charged on a reducing balance basis.

(v) There are no intra-group amounts outstanding at 31 May 20X5.

(vi) It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare the consolidated statement of financial position of the Jay Group as at 31 May 20X5 in accordance with International Financial Reporting Standards.

(Candidates should calculate figures to one decimal place of $ million.) (29 marks)

(b) In the year ended 31 May 20X6 Jay purchased goods from a foreign supplier for 8 million euros on 28 February 20X6. At 31 May 20X6, the trade payable was still outstanding and the goods were still held by Jay. Similarly Jay has sold goods to a foreign customer for 4 million euros on 28 February 20X6 and it received payment for the goods in euros on 31 May 20X6. additionally Jay had purchased an investment property on 1 June 20X5 for 28 million euros. At 31 May 20X6, the investment property had a fair value of 24 million euros. The company uses the fair value model in accounting for investment properties.

Jay would like advice on how to treat this transaction in the financial statements for the year ended 31 May 20X6. Its functional and presentation currency is the dollar.

Exchange rates	**Euro: $**	**Average rate (Euro:$)** for year to
1 June 20X5	1.4	
28 February 20X6	1.6	
31 May 20X6	1.3	1.5

(10 marks)

(c) Jay has a reputation for responsible corporate behaviour and sees the workforce as the key factor in the profitable growth of the business. The company is also keen to provide detailed disclosures relating to environmental matters and sustainability.

Discuss what matters should be disclosed in Jay's annual report in relation to the nature of corporate citizenship, in order that there might be a better assessment of the performance of the company. (11 marks)

(Total = 50 marks)

Q-18

Lateral, a public limited company, acquired two subsidiary companies, Think and Plank, both public limited companies. The details of the acquisitions are as follows:

Subsidiary	Date of acquisition	Retained net earnings at acquisition $m	Share capital acquired $1 shares $m	Fair value of assets at acquisition $m
Think	1 November 20X3	150	200	400
Plank	1 November 20X3	210	300	800

The draft statements of financial position as at 31 October 20X5 are:

	Lateral $m	**Think $m**	**Plank $m**
Property, plant and equipment	700	390	780
Investment in subsidiaries:			
Think	380		
Plank	340		
Held to maturity investments	30	–	–
	1,450	390	780
Current assets			
Inventories	200	185	90
Trade receivables	170	80	100
Cash and cash equivalents	40	30	50
	410	295	240
Non-current assets classified as held for sale		15	
		310	
Total assets	1,860	700	1,020
Equity and Liabilities:			
Share capital – shares of $1	400	250	500
Retained earnings	850	280	290
Total equity	1,250	530	790
Non-current liabilities	250	60	80
Current liabilities	360	110	150
Total liabilities	610	170	230
Total equity and liabilities	1,860	700	1,020

The following information is relevant to the preparation of the group financial statements.

(i) There have been no new issues of shares in the group since 1 November 20X3 and the fair value adjustments have not been included in the subsidiaries' financial records.

(ii) Any increase in the fair values of the net assets over their carrying values at acquisition is attributable to plant and equipment. Plant and equipment is depreciated at 20% per annum on the reducing balance basis.

(iii) Think sold plant and equipment to Lateral on 12 November 20X5. The transaction was completed at an agreed price of $15 million after selling costs. The transaction complies with the conditions in IFRS 5 Non- current assets held for sale and discontinued operations for disclosure as assets 'held for sale'. The plant and equipment had been valued at 'fair value less costs to sell' in the individual accounts of Think. At 1 November 20X4, this plant and equipment had a carrying value of $10 million and no depreciation on these assets has been charged for the year ended 31 October 20X5.

(iv) Lateral had purchased a debt instrument with five years remaining to maturity on 1 November 20X3. The purchase price and fair value was $30 million on that date. The instrument will be repaid in five years time at an amount of $37·5 million. The instrument carries fixed interest of 4·7% per annum on the principal of $37·5 million and has an effective interest rate of 10% per annum. The fixed interest has been received and accounted for but no accounting entry has been made other than the recognition of the original purchase price of the instrument.

(v) Goodwill arising on the acquisition of the subsidiaries was impairment tested on 31 October 20X4 and 31 October 20X5 in accordance with IAS 36 Impairment of assets. There was no impairment of goodwill on the acquisition of Think or Plank.

(vi) On 31 October 20X5, after accounting for the results of the impairment test, Lateral sold 100 million shares in Plank for $180 million. Lateral still maintains significant influence over Plank after the disposal of the shares. The fair value of the remaining investment was $400m at that date. The receipt of the sale proceeds has been recorded in the cash book and as a reduction in the carrying value of the cost of the investment in the subsidiary.

(vii) It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

(a) Calculate the gain or loss that would be recorded in the group financial statement on the sale of the shares in Plank. (4 marks)

(b) Prepare a consolidated statement of financial position as at 31 October 20X5 for the Lateral Group in accordance with International Financial Reporting Standards. (24 marks)

(c) In the year ended 31 October 20X6, Lateral entered into a contract to purchase plant and equipment from a foreign supplier on 30 June 20X7. The purchase price is 4 million euros. A non-refundable deposit of 1 million euros was paid on signing the contract on 31 July 20X6 with the balance of 3 million euros payable on 30 June 20X7. Lateral was uncertain as to whether to purchase a 3 million euro bond on 31 July 20X6 which will not mature until 30 June 20Y0, or to enter into a forward contract on the same date to purchase 3 million euros for a fixed price of $2 million on 30 June 20X7 and to designate the forward contract as a cash flow hedge of the purchase commitment. The bond carries interest at 4% per annum, payable on 30 June 20X7. Current market rates are 4% per annum. The company chose to purchase the bond with a view to selling it on 30 June 20X7 in order to purchase the plant and equipment. The bond is not to be classified as a cash flow hedge but at fair value through profit and loss.

Lateral would like advice as to whether it made the correct decision and as to the accounting treatment of the items for 20X6 and 20X7. The company's functional and presentational currency is the dollar.

Exchange rates	**Euro: $**	**Average rate (Euro:$)** for year to
31 July 20X6	1.6	
31 October 20X6	1.3	1.5

(d) Lateral discloses the following information relating to employees in its financial statements.

Its full commitment to equal opportunities

Its investment in the training of staff

The number of employees injured at work each year.

The company wishes to enhance disclosure in these areas, but is unsure as to what the benefits would be. The directors are particularly concerned that the disclosures on management of the workforce (human capital management) has no current value to the stakeholders of the company.

Discuss the general nature of the current information disclosed by companies concerning 'human capital management' and how the link between the company performance and its employees could be made more visible. (10 marks)

(Total = 50 marks)

Q-19

Beth, a public limited company, has produced the following draft statements of financial position as at 30 November 20X7. Lose and Gain are both public limited companies:

	Beth	Lose	Gain
	$m	**$m**	**$m**
Assets			
Non current assets			
Property, plant and equipment	1,700	200	300
Intangible assets	300		
Investment in Lose	200		
Investment in Gain	180		
	2,380	200	300
Current assets			
Inventories	800	100	150
Trade receivables	600	60	80
Cash	500	40	20
	1,900	200	250
Total assets	4,280	400	550
Share capital of $1	1,500	100	200
Other reserves	300		
Retained earnings	400	200	300
Total equity	2,200	300	500
Non-current liabilities	700		
Current liabilities	1,380	100	50
Total liabilities	2,080	100	50
Total equity and liabilities	4,280	400	550

The following information is relevant to the preparation of the group financial statements of the Beth Group.

(i)

	Date of acquisition	**Holding acquired**	**Retained earnings at acquisition**	**Purchase consideration**
		%	**$m**	**$m**
Lose:	**1 December 20X5**	20	80	40
	1 December 20X6	60	150	160
Gain:	**1 December 20X6**	30	260	180

Lose and Gain have not issued any share capital since the acquisition of the shareholdings by Beth. The fair values of the net assets of Lose and Gain were the same as their carrying amounts at the date of the acquisitions.

Beth did not have significant influence over Lose at any time before gaining control of Lose, but does have significant influence over Gain. There has been no impairment of goodwill on the acquisition of Lose since its acquisition, but the recoverable amount of the net assets of Gain has been deemed to be $610 million at

30 November 20X7.

It is the group's policy to value its non-controlling interests at its proportionate share of the fair value of the subsidiary's identifiable net assets.

The fair value of the 20% holding in Lose on 30th November 20X7 was $53.33m.

(ii) Lose entered into an operating lease for a building on 1 December 20X6. The building was converted into office space during the year at a cost to Lose of $10 million. The operating lease is for a period of six years, at the end of which the building must be returned to the lessor in its original condition. Lose thinks that it would cost $2 million to convert the building back to its original condition at prices at 30 November 20X7. The entries that had been made in the financial statements of Lose were the charge for operating lease rentals ($4 million per annum) and the improvements to the building. Both items had been charged to the income statement. The improvements were completed during the financial year.

(iii) On 1 October 20X7, Beth sold inventory costing $18 million to Gain for $28 million. At 30 November 20X7, the inventory was still held by Gain. The inventory was sold to a third party on 15 December 20X7 for $35 million.

(i) Beth had contracted to purchase an item of plant and equipment for 12 million euros on the following terms:

Payable on signing contract (1 September 20X7)	50%
Payable on delivery and installation (11 December 20X7)	50%

The amount payable on signing the contract (the deposit) was paid on the due date and is refundable. The following exchange rates are relevant:

20X7	**Euros to 1 dollar**
1 September	0·75
30 November	0·85
11 December	0·79

The deposit is included in trade receivables at the rate of exchange on 1 September 20X7. A full year's charge for depreciation of property, plant and equipment is made in the year of acquisition using the straight line method over six years.

(v) Beth sold some trade receivables which arose during November 20X7 to a factoring company on 30 November 20X7. The trade receivables sold are unlikely to default in payment based on past experience but they are long dated with payment not due until 1 June 20X8. Beth has given the factor a guarantee that it will reimburse any amounts not received by the factor. Beth received $45 million from the factor being 90% of the trade receivables sold. The trade receivables are not included in the statement of financial position of Beth and the balance not received from the factor (10% of the trade receivables factored) of $5 million has been written off against retained earnings.

(vi) Beth granted 200 share options to each of its 10,000 employees on 1 December 20X6. The shares vest if the employees work for the Group for the next two years. On 1 December 20X6, Beth estimated that there would be 1,000 eligible employees leaving in each year up to the vesting date. At 30 November 20X7, 600 eligible employees had left the company. The estimate of the number of employees leaving in the year to 30 November 20X8 was 500 at 30 November 20X7. The fair value of each share option at the grant date (1 December 20X6) was $10. The share options have not been accounted for in the financial statements.

(vii) The Beth Group operates in the oil industry and contamination of land occurs including the pollution of seas and rivers. The Group only cleans up the contamination if it is a legal requirement in the country where it operates. The following information has been produced for Beth by a group of environmental consultants for the year ended 30 November 20X7:

Cost of clean up contamination $m	**Law existing in country**
5	No
7	To come into force in December 20X7
4	Yes

The directors of Beth have a widely publicised environmental attitude which shows little regard for the effects on the environment of their business. The Group does not currently produce a separate environmental report and no provision for environmental costs has been made in the financial statements. Any provisions would be shown as non-current liabilities. Beth is likely to operate in these countries for several years.

Other information

Beth is currently suffering a degree of stagnation in its business development. Its domestic and international markets are being maintained but it is not attracting new customers. Its share price has not increased whilst that of its competitors has seen a rise of between 10% and 20%. Additionally it has recently received a significant amount of adverse publicity because of its poor environmental record and is to be investigated by regulators in several countries. Although Beth is a leading supplier of oil products, it has never felt the need to promote socially responsible policies and practices or make positive contributions to society because it has always maintained its market share. It is renowned for poor customer support, bearing little regard for the customs and cultures in the communities where it does business. It had recently made a decision not to pay the amounts owing to certain small and medium entities (SMEs) as the directors feel that SMEs do not have sufficient resources to challenge the non-payment in a court of law. The management of the company is quite authoritarian and tends not to value employees' ideas and contributions.

Required

(a) Prepare the consolidated statement of financial position of the Beth Group as at 30 November 20X7 in accordance with International Financial Reporting Standards. (35 marks)

(b) Describe to the Beth Group the possible advantages of producing a separate environmental report. (8 marks)

(c) Discuss the ethical and social responsibilities of the Beth Group and whether a change in the ethical and social attitudes of the management could improve business performance. (7 marks)

Note. Requirement (c) includes 2 professional marks for development of the discussion of the ethical and social responsibilities of the Beth Group. (Total = 50 marks)

Q-20

BPP Note. In this question the proformas are given to you to help you get used to setting out your answer. You may wish to transfer them to a separate sheet, or alternatively use a separate sheet for your workings only.

Standard Co acquired 80% of Odense SA for $520,000 on 1 January 20X4 when the retained earnings of Odense were 2,100,000 Danish Krone.

An impairment test conducted at the year end revealed impairment losses of 168,000 Danish Krone relating to Odense's recognised goodwill. No impairment losses had previously been recognised.

The translation differences in the consolidated financial statements at 31 December 20X5 relating to the translation of the financial statements of Odense (excluding goodwill) were $27,000.Retained earnings of Odense in Odense's separate financial statements in the post-acquisition period to 31 December 20X5 as translated amounted to $138,000.The dividends charged to retained earnings in 20X6 were paid on 31 December 20X6.

It is the group's policy to value the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's net assets.

Exchange rates were as follows:

	Kr to $1
1 January 20X4	9.4
31 December 20X5	8.8
31 December 20X6	8.1
Average 20X6	8.4

Required

Prepare the consolidated statement of financial position, statement of comprehensive income and statement of changes in equity extract for retained earnings of the Standard Group for the year ended 31 December 20X6. Set out your answer below, using a separate sheet for workings.

STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER 20X6

	Standard	**Odense**	**Rate**	**Odense**	**Consol**
	$'000	Kr'000	**$'000**	**$'000**	
Property, plant and equipment	1,285	4,400	8.1	543	
Investment in Odense	520	–		–	
Goodwill	–	–		–	
	1,805	4,400		543	
Current assets	410	2,000	8.1	247	
	2,215	6,400		790	
Share capital	500	1,000	9.4	106	
Retained earnings	1,115				

Pre-acquisition		2,100	9.4	224	
Post-acquisition			Bal	324	
	–	–			
	1,615	5,300		654	
Non-controlling interest					
Loans	200	300	8.1	37	
Current liabilities	400	800	8.1	99	
	600	1,100		136	
	2,215	6,400		790	

STATEMENT OF COMPREHENSIVE INCOME FOR YEAR ENDED 31 DECEMBER 20X6

	Standard	**Odense**	**Rate**	**Odense**	**Consol**
	$'000	Kr'000	**$'000**	**$'000**	
Revenue	1,125	5,200	8.4	619	
Cost of sales	(410	(2,300)	8.4	(274)	
Gross profit	715	2,900		345	
Other expenses	(180	(910)	8.4		
(108) Impairment loss	–	–		–	
Dividend from Odense	40				
Profit before tax	575	1,990		237	
Income tax expense	(180	(640)	8.4	(76)	
Profit for the year	395	1,350		161	
Other comprehensive income for the year					
Exchange differences on translation of foreign Operation	–	–			
Total comprehensive income for the year	395	1,350			
Profit attributable to:					
Owners of the parent					
Non-controlling interest					
Total comprehensive income attributable					
Owners of the parent					
Non-controlling interest					

STATEMENTS OF CHANGES IN EQUITY FOR THE YEAR (EXTRACT FOR RETAINED EARNINGS)

	Standard	**Odense**
	$'000	Kr'000
Balance at 1 January 20X6	915	3,355
Dividends paid	(195)	(405)
Total comprehensive income for the year	395	1,350
Balance at 1 January 20X6	1,115	4,300

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

FOR YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

	Retained Earnings $'000
Balance at 31 December 20X5	1,065
Dividends paid	
Total comprehensive income for the year	
Balance at 31 December 20X6	

Q-21

21 The effects of changes in foreign exchange rates states that where an entity has foreign operations, such as overseas subsidiaries, branches, joint ventures or associates, it should determine the functional currency of that foreign operation. The functional currency is the currency of the primary economic environment in which the entity operates. Where a foreign operation has a functional currency that is different from that of the reporting entity, it will be necessary to translate the financial statements of the foreign operation into the currency in which the reporting entity presents its financial statements.

However, where the foreign operation is located in a country with a high rate of inflation, the translation process may not be sufficient to present fairly the financial position of the foreign operation. Some adjustment for inflation should be undertaken to the local currency financial statements before translation. IAS 29 Financial reporting in hyper-inflationary economies deals with this issue.

Required

(a) Explain the factors which should be taken into account in determining whether or not the functional currency of a foreign operation is the same as that of its parent. (10 marks)

(b) Discuss the effects that hyper-inflation can have on the usefulness of financial statements, and explain how entities with subsidiaries that are located in hyper-inflationary economies should reflect this fact in their consolidated financial statements. You should restrict your discussion to financial statements that have been prepared under the historical cost convention. (7 marks)

(c) On 30 November 20X3 Gold Co set up a subsidiary in a foreign country where the local currency is effados. The principal assets of this subsidiary were a chain of hotels. The value of the hotels on this date was 20 million effados. The rate of inflation for the period 30 November 20X3 to 30 November 20X7 has been significantly high. The following inflation is relevant to the economy of the foreign country.

	Effados in exchange for	**Consumer price index in foreign country**
	$	
30 November 20X3	1.34	100
30 November 20X7	17.87	3,254

There is no depreciation charged in the financial statements as the hotels are maintained to a high standard.

Required

(i) Calculate the value at which the hotels would be included in the group financial statements of Gold Co on the following dates.

(1) At 30 November 20X3 and 30 November 20X7.

(2) At 30 November 20X7 after adjusting for current price levels. (4 marks)

(ii) Discuss the results of the valuations of the hotels, commenting on the validity of the different bases outlined above. (4 marks)

(Total = 25 marks)

Q-22

Zetec, a public limited company, owns 80% of the ordinary share capital of Aztec, a public limited company which is a foreign operation. Zetec acquired Aztec on 1 November 20X1 for $44 million when the retained earnings of Aztec were 98 million Krams (Kr). Aztec has not issued any share capital, nor revalued any assets since acquisition. The following financial statements relate to Zetec and Aztec.

STATEMENT OF FINANCIAL POSITION AT 31 OCTOBER 20X2

	Zetec	**Aztec**
	$m	**$m**
Non-current assets		

Tangible assets (including investments)	180	380
Investment in Aztec	44	
Intangible assets		12
Net current assets	146	116
	370	508
Equity		
Ordinary shares of $1/1Kr	65	48
Share premium	70	18
Revaluation surplus	–	12
Retained earnings	161	110
	296	188
Non-current liabilities	74	320
	370	508

INCOME STATEMENTS FOR THE YEAR ENDED 31 OCTOBER 20X2

	Zetec **$m**	**Aztec** **$m**
Revenue	325	250
Cost of sales	(189	(120)
Gross profit	136	130
Distribution and administrative expenses	(84)	(46)
Interest payable	(2)	(20)
Profit before taxation	50	64
Income tax expense	(15)	(30)
Profit on ordinary activities after taxation	35	34
Extraordinary items	–	(22)
Retained profit for the year	35	12

The directors of Zetec have not previously had the responsibility for the preparation of consolidated financial statements and are a little concerned as they understand that the financial statements of Aztec have been prepared under local accounting standards which are inconsistent in some respects with International Financial Reporting Standards (IFRS). They wish you to prepare the consolidated financial statements on their behalf and give you the following information about the financial statements of Aztec.

(a) Under local accounting standards, Aztec had capitalised 'market shares' under intangible assets. Aztec acquired a company in the year to 31 October 20X2 and merged its activities with its own. The acquisition allowed the company to obtain a significant share of a specific market and, therefore, the excess of the price paid over the fair value of assets is allocated to 'market shares'. The amount capitalised was Kr12 million and no amortisation is charged on 'market shares'.

Further, under local accounting standards, from 1 November 20X1 Aztec classified revaluation gains and losses and the effects of changes in accounting policies as extraordinary items. During the year, the amounts classified as extraordinary items were as follows:

Revaluation loss

A non-current asset was physically damaged during the year and an amount of Kr9 million was written off its carrying value as an impairment loss. This asset had been revalued on 31 October 20X0 and a credit of Kr6 million still remains in revaluation surplus in respect of this asset.

Changes in accounting policy

A change in the accounting policy for research expenditure has occurred during the period, in an attempt to bring Aztec's policies into line with IFRS. Prior to November 20X1, research expenditure was capitalised and amortised. The amount included in extraordinary items as a prior year adjustment was Kr13 million.

(b) The fair value of the net assets of Aztec at the date of acquisition was Kr240 million after taking into account any changes necessary to align the financial statements with IFRS. The directors do not know how to calculate the amount of goodwill. The increase in the fair value of Aztec over the net assets' carrying value relates to a stock market portfolio (included in tangible assets) held by Aztec. The value of these investments

(in Krs) has not changed materially since acquisition.

(c) Zetec sold $15 million of components to Aztec and these goods were shipped free on board (fob) on 31 May 20X2. The goods were received by Aztec on 30 June 20X2 as there had been a problem in the shipping of the goods. Zetec made a profit of 20% on selling price on the components. All of the goods had been utilised in the production process at 31 October 20X1 but none of the finished goods had been sold at that date. Aztec had paid for the goods on 31 July 20X2. This was the only intragroup transaction in the year. Foreign exchange gains/losses on such transactions are included in cost of sales by Aztec.

(d) The following exchange rates are relevant to the financial statements.

	Krams to the $
31 October 20X0	5
1 November 20X1	6
1 April 20X2	5.3
31 May 20X2	5.2
30 June 20X2	5.1
31 July 20X2	4.2
31 October 20X2	4
Weighted average for year to 31 October 20X2	5

(e) A dividend of $4 million has been paid by Zetec during the financial year.

(f) It is the group's policy to value the non-controlling interest at its proportionate share of the subsidiary's identifiable net assets.

Required

Prepare a consolidated income statement for the year ended 31 October 20X2 and a statement of financial position as at that date for the Zetec group.

(Candidates should show any exchange gains or losses arising in the consolidated financial statements. Astatement of comprehensive income is not required, but you should calculate the exchange differences arsing in the year that would be shown in the statement of comprehsive income.) (25 marks)

Helping hands

1. Learn our format for translation of the income statement and statement of financial position.
2. It is best to do workings for property, plant and equipment and net current assets on the face of the I/S and statement of financial position with reference to supporting workings where appropriate.
3. Remember that goodwill is translated at the closing rate, which means that there will be an exchange difference. The best and neatest way to calculate this difference is to set out your goodwill working as we have done.

Q-23

Memo, a public limited company, owns 75% of the ordinary share capital of Random, a public limited company which is situated in a foreign country. Memo acquired Random on 1 May 20X3 for 120 million crowns (CR) when the retained profits of Random were 80 million crowns. Random has not revalued its assets or issued any share capital since its acquisition by Memo. The following financial statements relate to Memo and Random:

STATEMENTS OF FINANCIAL POSITION AT 30 APRIL 20X4

	Memo	Random
	$m	$m
Property, plant and equipment	297	146
Investment in Random	48	–

Loan to Random	5	–
Current assets	355	
	102	
	705	248
Equity		
Ordinary shares of $1/1CR	60	32
Share premium account	50	20
Retained earnings	360	95
	470	147
Non current liabilities	30	41
Current liabilities	205	60
	705	248

INCOME STATEMENTS FOR YEAR ENDED 30 APRIL 20X4

	Memo	**Random**
	$m	**$m**
Revenue	200	142
Cost of sales	(120)	(96)
Gross profit	80	46
Distribution and administrative expenses	(30)	(20)
Profit from operations	50	26
Interest receivable	4	–
Interest payable	-	(2)
Profit before taxation	54	24
Income tax expense	(20)	(9)
Profit after taxation	34	15

The following information is relevant to the preparation of the consolidated financial statements of Memo.

(a) Goodwill is reviewed for impairment annually. At 30 April 20X4, the impairment loss on recognised goodwill was CR4.2m.

(b) During the financial year Random has purchased raw materials from Memo and denominated the purchase in crowns in its financial records. The details of the transaction are set out below:

	Date of transaction	**Purchase price**	**Profit percentage on selling price**
		$m	
Raw materials	1 February 20X4	6	20%

At the year end, half of the raw materials purchased were still in the inventory of Random. The intragroup transactions have not been eliminated from the financial statements and the goods were recorded by Random at the exchange rate ruling on 1 February 20X4. A payment of $6 million was made to Memo when the exchange rate was 2·2 crowns to $1. Any exchange gain or loss arising on the transaction is still held in the current liabilities of Random.

(c) Memo had made an interest free loan to Random of $5 million on 1 May 20X3. The loan was repaid on 30 May 20X4. Random had included the loan in non-current liabilities and had recorded it at the exchange rate at 1 May 20X3.

(d) The fair value of the net assets of Random at the date of acquisition is to be assumed to be the same as the carrying value.

(e) The functional currency of Random is the Crown.

(f) The following exchange rates are relevant to the financial statements:

	Crowns to $
30 April/1 May 20X3	2·5
1 November 20X3	2·6
1 February 20X4	2·5
30 April 20X4	2·1

Average rate for year to 30 April 20X4 2·5

(g) Memo has paid a dividend of $8 million during the financial year and this is not included in the income statement.

It is the group's policy to value the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare a consolidated statement of comprehensive income for the year ended 30 April 20X4 and a consolidated statement of financial position at that date in accordance with International Financial Reporting Standards.

(Candidates should round their calculations to the nearest $100,000.) (32 marks)

Q-24

Section A – This ONE question is compulsory and MUST be attempted

1 Rose, a public limited company, operates in the mining sector. The draft statements of financial position are as follows, at 30 April 2011:

	Rose	Petal	Stem
	$m	$m	Dinars m
Property, plant and equipment	370	110	380
Investments in subsidiaries			
Petal	113		
Stem	46		
Financial assets	15	7	50
	544	117	430
Current assets	118	100	330
Total assets	662	217	760
Equity and liabilities:			
Share capital	158	38	200
Retained earnings	256	56	300
Other components of equity	7	4	
Total equity	421	98	500
Non-current liabilities	56	42	160
Current liabilities	185	77	100
Total liabilities	241	119	260
Total equity and liabilities	662	217	760

The following information is relevant to the preparation of the group financial statements:

1 On 1 May 2010, Rose acquired 70% of the equity interests of Petal, a public limited company. The purchase consideration comprised cash of $94 million. The fair value of the identifiable net assets recognised by Petal was$120 million excluding the patent below. The identifiable net assets of Petal at 1 May 2010 included a patent which had a fair value of $4 million. This had not been recognised in the financial statements of Petal. The patent had a remaining term of four years to run at that date and is not renewable. The retained earnings of Petal were$49 million and other components of equity were $3 million at the date of acquisition. The remaining excess of the fair value of the net assets is due to an increase in the value of land.

Rose wishes to use the 'full goodwill' method. The fair value of the non-controlling interest in Petal was$46 million on 1 May 2010. There have been no issues of ordinary shares since acquisition and goodwill on acquisition is not impaired.

Rose acquired a further 10% interest from the non-controlling interest in Petal on 30 April 2011 for a cash consideration of $19 million.

2 Rose acquired 52% of the ordinary shares of Stem on 1 May 2010 when Stem's retained earnings were220 million dinars. The fair value of the identifiable net assets of Stem on 1 May 2010 was 495 million dinars. The excess of the fair value over the net assets of Stem is due to an increase in the value

of land. The fair value of the non-controlling interest in Stem at 1 May 2010 was 250 million dinars.

Stem is located in a foreign country and operates a mine. The income of Stem is denominated and settled in dinars. The output of the mine is routinely traded in dinars and its price is determined initially by local supply and demand. Stem pays 40% of its costs and expenses in dollars with the remainder being incurred locally and settled in dinars. Stem's management has a considerable degree of authority and autonomy in carrying out the operations of Stem and is not dependent upon group companies for finance.

Rose wishes to use the 'full goodwill' method to consolidate the financial statements of Stem. There have been no issues of ordinary shares and no impairment of goodwill since acquisition.

The following exchange rates are relevant to the preparation of the group financial statements:

	Dinars to $
1 May 2010	6
30 April 2011	5
Average for year to 30 April 2011	5.8

3 Rose has a property located in the same country as Stem. The property was acquired on 1 May 2010 and is carried at a cost of 30 million dinars. The property is depreciated over 20 years on the straight-line method. At

30 April 2011, the property was revalued to 35 million dinars. Depreciation has been charged for the year but the revaluation has not been taken into account in the preparation of the financial statements as at 30 April2011.

4 Rose commenced a long-term bonus scheme for employees at 1 May 2010. Under the scheme employees receive a cumulative bonus on the completion of five years service. The bonus is 2% of the total of the annual salary of the employees. The total salary of employees for the year to 30 April 2011 was $40 million and a discount rate of 8% is assumed. Additionally at 30 April 2011, it is assumed that all employees will receive the bonus and that salaries will rise by 5% per year.

5 Rose purchased plant for $20 million on 1 May 2007 with an estimated useful life of six years. Its estimated residual value at that date was $1·4 million. At 1 May 2010, the estimated residual value changed to$2·6 million. The change in the residual value has not been taken into account when preparing the financial statements as at 30 April 2011.

Required:

(a) (i) Discuss and apply the principles set out in IAS 21 The Effects of Changes in Foreign Exchange Rates in order to determine the functional currency of Stem.(7 marks)

(ii) Prepare a consolidated statement of financial position of the Rose Group at 30 April 2011, in accordance with International Financial Reporting Standards (IFRS), showing the exchange difference arising on the translation of Stem's net assets. Ignore deferred taxation.(35 marks)

(b) Rose was considering acquiring a service company. Rose stated that the acquisition may be made because of the value of the human capital and the opportunity for synergies and cross-selling opportunities. Rose estimated the fair value of the assets based on what it was prepared to pay for them. Rose further stated that what it was willing to pay was influenced by its future plans for the business.

The company to be acquired had contract-based customer relationships with well-known domestic and international companies and some mining companies. Rose estimated that the fair value of all of these customer relationships to be zero because Rose already enjoyed relationships with the majority of those customers.

Required:

Discuss the validity of the accounting treatment proposed by Rose and whether such a proposed treatment raises any ethical issues.(6 marks)

Professional marks will be awarded in part (b) for clarity and quality of the presentation and discussion. (2 marks)

Q-25

Traveler, a public limited company, operates in the manufacturing sector. The draft statements of financial position are as follows at 30 November 2011:

	Traveller $m	Data $m	Captive $m
Assets:			
Non-current assets			
Property, plant and equipment	439	810	620
Investments in subsidiaries			
Data	820		
Captive	541		
Financial assets	108	10	20
	1,908	820	640
Defined benefit asset	72		
Current assets	995	781	350
Total assets	2,975	1,601	990
Equity and liabilities:			
Share capital	1,120	600	390
Retained earnings	1,066	442	169
Other components of equity	60	37	45
Total equity	2,246	1,079	604
Non-current liabilities	455	323	73
Current liabilities	274	199	313
Total liabilities	729	522	386
Total equity and liabilities	2975	1,601	990

The following information is relevant to the preparation of the group financial statements:

1 On 1 December 2010, Traveler acquired 60% of the equity interests of Data, a public limited company. The purchase consideration comprised cash of $600 million. At acquisition, the fair value of the non-controlling interest in Data was $395 million. Traveler wishes to use the 'full goodwill' method. On 1 December 2010, the fair value of the identifiable net assets acquired was $935 million and retained earnings of Data were $299 million and other components of equity were $26 million. The excess in fair value is due to non-depreciable land.

On 30 November 2011, Traveler acquired a further 20% interest in Data for a cash consideration of $220 million.

2 On 1 December 2010, Traveler acquired 80% of the equity interests of Captive for a consideration of $541 million. The consideration comprised cash of $477 million and the transfer of non-depreciable land with a fair value of $64 million. The carrying amount of the land at the acquisition date was $56 million. At the year end, this asset was still included in the non-current assets of Traveler and the sale proceeds had been credited to profit or loss.

At the date of acquisition, the identifiable net assets of Captive had a fair value of $526 million, retained earnings were $90 million and other components of equity were $24 million. The excess in fair value is due to non-depreciable land. This acquisition was accounted for using the partial goodwill method in accordance with IFRS 3 (Revised) *Business Combinations.*

3 Goodwill was impairment tested after the additional acquisition in Data on 30 November 2011. The recoverable amount of Data was $1,099 million and that of Captive was $700 million.

4 Included in the financial assets of Traveler is a ten-year *7%* loan. At 30 November 2011, the borrower was in financial difficulties and its credit rating had been downgraded. Traveler has adopted IFRS 9 *Financial Instruments* and the loan asset is currently held at amortised cost of $29 million. Traveler now wishes to value

the loan at fair value using current market interest rates. Traveler has agreed for the loan to be restructured; there will only be three more annual payments of $8 million starting in one year's time. Current market interest rates are 8%, the original effective interest rate is 6-7% and the effective interest rate under the revised payment schedule is 6-3%.

5 Traveler acquired a new factory on 1 December 2010. The cost of the factory was $50 million and it has a residual value of $2 million. The factory has a flat roof, which needs replacing every five years. The cost of the roof was $5 million. The useful economic life of the factory is 25 years. No depreciation has been charged for the year. Traveler wishes to account for the factory and roof as a single asset and depreciate the whole factory over its economic life. Traveler uses straight-line depreciation.

6 The actuarial value of Traveler's pension plan showed a surplus at 1 December 2010 of $72 million, represented by the fair value of the assets of $250 million, the present value of the defined benefit obligation of $200 million and net un-recognised actuarial losses of $22 million. The average remaining working lives of the employees is 10 years. Traveler uses the corridor approach for recognising actuarial gains and losses. The aggregate of the current service cost, interest cost and expected return on assets amounted to a cost of $55 million for the year. After consulting with the actuaries, the company decided to reduce its contributions for the year to $45 million. The contributions were paid on 7 December 2011. No entries had been made in the financial statements for the above amounts. At the year end, the un-recognised actuarial losses were $20 million and the present value of available future refunds and reductions in future contributions was $18 million.

Required:
Prepare a consolidated statement of financial position for the Traveler Group for the year ended 30 November 2011.
(35 marks)

Q-26

The following draft statements of financial position relate to Robby, Hail and Zinc, all public limited companies, as at 31 May 2012:

	Robby $m	Hail $m	Zinc $m
Assets			
Non-current assets:			
Property, plant and equipment	112	60	26
Investment in Hail	55		
Investment in Zinc	19		
Financial assets	9	6	14
Jointly controlled operation	6		
Current assets	5	7	12
Total assets	206	73	52
Equity and Liabilities			
Ordinary shares	25	20	10
Other components of equity	11	-	-
Retained earnings	70	27	19
Total equity	106	47	29
Non-current liabilities	53	20	21
Current liabilities	47	6	2
Total equity and liabilities	206	73	52

The following information needs to be taken into account in the preparation of the group financial statements of Robby:

(i) On 1 June 2010, Robby acquired 80% of the equity interests of Hail. The purchase consideration comprised cash of $50 million. Robby has treated the investment in Hail at fair value through other comprehensive income (OCI).

A dividend received from Hail on 1 January 2012 of $2 million has similarly been credited to OCI.

It is Robby's policy to measure the non-controlling interest at fair value and this was $15 million on 1 June 2010.

On 1 June 2010, the fair value of the identifiable net assets of Hail were $60 million and the retained earnings of Hail were $16 million. The excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

(ii) On 1 June 2009, Robby acquired 5% of the ordinary shares of Zinc. Robby had treated this investment at fair value through profit or loss in the financial statements to 31 May 2011.

On 1 December 2011, Robby acquired a further 55% of the ordinary shares of Zinc and gained control of the company.

The consideration for the acquisitions was as follows:

	Shareholding	Consideration
1 June 2009	5%	2
1 December 2011	55%	16
	60%	18

At 1 December 2011, the fair value of the equity interest in Zinc held by Robby before the business combination was $5 million.

It is Robby's policy to measure the non-controlling interest at fair value and this was $9 million on 1 December 2011.

The fair value of the identifiable net assets at 1 December 2011 of Zinc was $26 million, and the retained earnings were $15 million. The excess of the fair value of the net assets is due to an increase in the value of property, plant and equipment (PPE), which was provisional pending receipt of the final valuations. These valuations were received on 1 March 2012 and resulted in an additional increase of $3 million in the fair value of PPE at the date of acquisition. This increase does not affect the fair value of the non-controlling interest at acquisition. PPE is to be depreciated on the straight-line basis over a remaining period of five years.

(iii) Robby has a 40% share of a joint operation, a natural gas station. Assets, liabilities, revenue and costs are apportioned on the basis of shareholding.

The following information relates to the joint arrangement activities:

– The natural gas station cost $15 million to construct and was completed on 1 June 2011 and is to be dismantled at the end of its life of 10 years. The present value of this dismantling cost to the joint arrangement at 1 June 2011, using a discount rate of 5%, was $2 million.
– In the year, gas with a direct cost of $16 million was sold for $20 million. Additionally, the joint arrangement incurred operating costs of $0·5 million during the year.

Robby has only contributed and accounted for its share of the construction cost, paying $6 million. The revenue and costs are receivable and payable by the other joint operator who settles amounts outstanding with Robby after the year end.

(iv) Robby purchased PPE for $10 million on 1 June 2009. It has an expected useful life of 20 years and is depreciated on the straight-line method. On 31 May 2011, the PPE was revalued to $11 million. At 31 May 2012, impairment indicators triggered an impairment review of the PPE. The recoverable amount of the PPE was $7·8 million. The only accounting entry posted for the year to 31 May 2012 was to account for the depreciation based on the revalued amount as at 31 May 2011. Robby's accounting policy is to make a transfer of the excess depreciation arising on the revaluation of PPE.

(v) Robby held a portfolio of trade receivables with a carrying amount of $4 million at 31 May 2012. At that date, the entity entered into a factoring agreement with a bank, whereby it transfers the receivables in exchange for $3·6 million in cash. Robby has agreed to reimburse the factor for any shortfall between the amount collected and $3·6 million. Once the receivables have been collected, any amounts above $3·6 million, less interest on this amount, will be repaid to Robby. Robby has derecognised the receivables and charged $0·4 million as a loss to profit or loss.

(vi) Immediately prior to the year end, Robby sold land to a third party at a price of $16 million with an option to purchase the land back on 1 July 2012 for $16 million plus a premium of 3%. The market value of the land is $25 million on 31 May 2012 and the carrying amount was $12 million. Robby accounted for the sale, consequently eliminating the bank overdraft at 31 May 2012.

Required:

Prepare a consolidated statement of financial position of the Robby Group at 31 May 2012 in accordance with International Financial Reporting Standards. (35 marks)

Q-27

Minny is a company which operates in the service sector. Minny has business relationships with Bower and Heeny. All three entities are public limited companies. The draft statements of financial position of these entities are as follows at 30 November 2012:

	Minny $m	Bower $m	Heeny $m
Assets:			
Non-current assets			
Property, plant and equipment	920	300	310
Investments in subsidiaries			
Bower	730		
Heeny		320	
Investment in Puttin	48		
Intangible assets	198	30	35
	1,896	650	345
Current assets	895	480	250
Total assets	2,791	1,130	595
Equity and liabilities:			
Share capital	920	400	200
Other components of equity	73	37	25
Retained earnings	895	442	139
Total equity	1,888	879	364
Non-current liabilities	495	123	93
Current liabilities	408	128	138
Total liabilities	903	251	231
Total equity and liabilities	2,791	1,130	595

The following information is relevant to the preparation of the group financial statements:

1. On 1 December 2010, Minny acquired 70% of the equity interests of Bower. The purchase consideration comprised cash of $730 million. At acquisition, the fair value of the non-controlling interest in Bower was $295 million. On 1 December 2010, the fair value of the identifiable net assets acquired was $835 million and retained earnings of Bower were $319 million and other components of equity were $27 million. The excess in fair value is due to non-depreciable land.
2. On 1 December 2011, Bower acquired 80% of the equity interests of Heeny for a cash consideration of $320 million. The fair value of a 20% holding of the non-controlling interest was $72 million; a 30% holding was $108 million and a 44% holding was $161 million. At the date of acquisition, the identifiable net assets of Heeny had a fair value of $362 million, retained earnings were $106 million and other components of equity were $20 million. The excess in fair value is due to non-depreciable land. It is the group's policy to measure the non-controlling interest at fair value at the date of acquisition.

3. Both Bower and Heeny were impairment tested at 30 November 2012. The recoverable amounts of both cash generating units as stated in the individual financial statements at 30 November 2012 were Bower, $1,425 million, and Heeny, $604 million, respectively. The directors of Minny felt that any impairment of assets was due to the poor performance of the intangible assets. The recoverable amount has been determined without consideration of liabilities which all relate to the financing of operations.
4. Minny acquired a 14% interest in Puttin, a public limited company, on 1 December 2010 for a cash consideration of $18 million. The investment was accounted for under IFRS 9 *Financial Instruments* and was designated as at fair value through other comprehensive income. On 1 June 2012, Minny acquired an additional 16% interest in Puttin for a cash consideration of $27 million and achieved significant influence. The value of the original 14% investment on 1 June 2012 was $21 million. Puttin made profits after tax of $20 million and $30 million for the years to 30 November 2011 and 30 November 2012 respectively. On 30 November 2012, Minny received a dividend from Puttin of $2 million, which has been credited to other components of equity.
5. Minny purchased patents of $10 million to use in a project to develop new products on 1 December 2011. Minny has completed the investigative phase of the project, incurring an additional cost of $7 million and has determined that the product can be developed profitably. An effective and working prototype was created at a cost of $4 million and in order to put the product into a condition for sale, a further $3 million was spent. Finally, marketing costs of $2 million were incurred. All of the above costs are included in the intangible assets of Minny.
6. Minny intends to dispose of a major line of the parent's business operations. At the date the held for sale criteria were met, the carrying amount of the assets and liabilities comprising the line of business were:

	$m
Property, plant and equipment (PPE)	49
Inventory	18
Current liabilities	3

It is anticipated that Minny will realise $30 million for the business. No adjustments have been made in the financial statements in relation to the above decision.

Required:

Prepare the consolidated statement of financial position for the Minny Group as at 30 November 2012.

(35 marks)

CONSOLIDATED CASHFLOWS

Q-28

The summarised financial statements of Charmer for the year to 30 September 20X1, together with a comparative statement of financial position, are as follows.

	$000
	7,482
Revenue	(4,284)
Cost of sales	3,198
Gross profit	(1,479)
Operating expenses	(260)
Investment income	120
Profit before tax	1,579
Income tax expense	(520)
Profit for the year	1,059

STATEMENT OF FINANCIAL POSITION AS AT:

	30 September 20X1			30 September 20X0		
	Cost / valuation	Depreciation	NBV	Cost / valuation	Depreciation	NBV
	$000	$000	$000	$000	$000	$000
Non-current assets						

Property, plant and	3,568	1,224	2,344	3,020	1,112	1,908
Equipment			690			nil
Investment			3,034			1,908
Current assets			1,046			785
Inventories			935			824
Trade receivables			120			50
Short term treasury bills			nil			122
Bank			2,101			1,781
Total assets			5,135			3,689

	30 September 20X1				**30 September 20X0**	
	Cost / valuation	Depreciation	Cost / valuation	Depreciation	Cost / valuation	Depreciation
	\$000	**\$000**	**\$000**	**\$000**	**\$000**	**\$000**
Equity and liabilities						
Equity						
Ordinary shares of \$1 each			1,400			1,000
Share premium			460			60
Revaluation surplus			90			40
Equity component of 10% convertible						
loan stock			nil			20
Retained earnings		192			177	
Retained earnings b/d		1,059			65	
Profit for period		(180)			(50)	
Dividends paid						
Retained earnings c/d			1,071			192
			3,021			1,312
Non-current liabilities						
Deferred tax liability			439			400
Government grants			275			200
10% convertible loan stock			nil			380
			714			980
Current liabilities						
Trade payables			644			760
Interest payable			40			25
Provision for negligence claim			nil			120
Current tax payable			480			367
Government grants			100			125
Overdraft			136			nil
			1,400			1,397
Total equity and liabilities			5,135			3,689

The following information is relevant.

(a) Non-current assets

Property, plant and equipment is analysed as follows.

	30 September 20X1				**30 September 20X0**	
	Cost / valuation	**Depreciation**	**Cost / valuation**	**Depreciation**	**Cost / valuation**	**Depreciation**
	\$000	**\$000**	**\$000**	**\$000**	**\$000**	**\$000**
Land and buildings	2,000	760	1,240	1,800	680	1,1
Plant	1,568	464	1,104	1,220	432	7

3,568	1,224	2,344	3,020	1,112	1,9

On 1 October 20X0 Charmer recorded an increase in the value of its land of $150,000.

During the year an item of plant that had cost $500,000 and had accumulated depreciation of $244,000 was sold at a loss (included in cost of sales) of $86,000 on its carrying value.

(b) Government grant

A credit of $125,000 for the current year's amortisation of government grants has been included in cost of sales.

(c) Share capital and loan stock

The increase in the share capital during the year was due to the following events.

(i) On 1 January 20X1 there was a bonus issue (out of the revaluation reserve) of one bonus share for every 10 shares held.

(ii) On 1 April 20X1 the 10% convertible loan stock holders exercised their right to convert to ordinary shares. The terms of conversion were 25 ordinary shares of $1 each for each $100 of 10% convertible loan stock.

(iii) The remaining increase in the ordinary shares was due to a stock market placement of shares for cash on 12 August 20X1.

(d) Dividends

The directors of Charmer always declare a final dividend (if the company has made a profit) in the week following the company's year end. It is paid after the annual general meeting of the shareholders.

(e) Provision for negligence claim

In June 20X1 Charmer made an out of court settlement of a negligence claim brought about by a former employee. The dispute had been in progress for two years and Charmer had made provisions for the potential liability in each of the two previous years. The unprovided amount of the claim at the time of settlement was $30,000 and this was charged to operating expenses.

(f) Short term treasury bills

The treasury bills mature on 31 July 20X2.

(g) It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare a statement of cash flows for Charmer for the year to 30 September 20X1 in accordance with IAS 7 Statement of cash flows using the indirect method.

Notes to the statement of cash flows are not required.

Q-29

On 1 September 20X5 Swing Co acquired 70% of Slide Co for $5,000,000 comprising $1,000,000 cash and 1,500,000 $1 shares.

The statement of financial position of Slide Co at acquisition was as follows:

	$'000
Property, plant and equipment	2,700
Inventories	1,600
Trade receivables	600
Cash	400
Trade payables	(300)
Income tax payable	(200)

4,800

The consolidated statement of financial position of Swing Co as at 31 December 20X5 was as follows:

	20X5	**20X4**
	$'000	**$'000**
Non-current assets	35,500	25,000
Property, plant and equipment	1,400	–
Goodwill	36,900	25,000
Current assets	16,000	10,000
Inventories	9,800	7,500
Trade receivables	2,400	1,500
Cash	28,200	19,000
	65,100	44,000
Equity attributable to owners of the parent	12,300	10,000
Share capital	5,800	2,000
Share premium	500	–
Revaluation surplus	32,100	21,900
Retained earnings	50,700	33,900
Non-controlling interest	1,600	–
	52300	
		33,900
Current liabilities	7,600	6,100
Trade payables	5,200	4,000
Income tax payable	12,800	10,100
	65,100	44,000

The consolidated income statement of Swing Co for the year ended 31 December 20X5 was as follows:

	20X5
	$'000
Profit before tax	16,500
Income tax expense	(5,200)
Profit for the year	11,300
Other comprehensive income	
Revaluation surplus	500
Total comprehensive income for the year	11,800
Profit attributable to:	
Owners of the parent	11,100
Non-controlling interest	200
	11,300
Total comprehensive income for the year attributable to	
Parent	11,450
Non-controlling interest 200 + (500 × 30%)	350
	11,800

Notes:

1 Depreciation charged for the year was $5,800,000. The group made no disposals of property, plant and equipment.

2 Dividends paid by Swing Co amounted to $900,000.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare the consolidated statement of cash flows of Swing Co for the year ended 31 December 20X5. No notes are required.

Q-30

Portal Group, a public limited company, has prepared the following group statement of cash flows for the year ended 31 December 20X0.

PORTAL GROUP

GROUP STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 20X0 (DRAFT)

	$m	$m
Cash generated from operations		875
Interest paid	(9)	
Income taxes paid	31	22
Net cash from operating activities		897
Cash flows from investing activities		
Disposal of subsidiary	(25)	
Disposal and transfer of property, plant and equipment at carrying value	(380)	
Disposal and transfer of property, plant	1,585	
Purchase of interest in joint venture	(225)	
Interest received	26	
Net cash used in investing activities		981
Cash flows from financing activities		
Increase in short term deposits	(143)	
Non-controlling interest	(40)	
Net cash used in financing activities		(183)
Net increase in cash and cash equivalents		1,695

The accountant has asked your advice on certain technical matters relating to the preparation of the group statement of cash flows. Additionally the accountant has asked you to prepare a presentation for the directors on the usefulness and meaning of statements of cash flows generally and specifically on the group statements of cash flows of Portal.

The accountant has informed you that the actual change in cash and cash equivalents for the period is $185 million, which does not reconcile with the figure in the draft group statement of cash flows above of $1,695 million. The figures for cash and cash equivalents were $600 million at 1 January 20X0 and $785 million at 31 December 20X0. The accountant feels that the reasons for the difference are the incorrect treatment of several elements of the statement of cash flows of which he has little technical knowledge. The following information relates to these elements:

(a) Portal has disposed of a subsidiary company, Web, during the year. At the date of disposal (1 June 20X0) the following statement of financial position was prepared for Web:

		$m	$m
Property, plant and equipment:	valuation		340
	Depreciation		(30)
			310
Inventory		60	
Trade receivables		50	
Cash		130	
			240
			550

Share capital	100
Retained earnings	320
	420
Current liabilities (including taxation $25 million)	130
	550

The loss on the sale of the subsidiary in the group accounts comprised:

		$m
Sale proceeds:	**ordinary shares**	300
	Cash	75
		375
Net assets sold (80% of 420)		(336)
Goodwill		(64)
Loss on sale		(25)

The accountant was unsure as to how to deal with the above disposal and has simply included the above loss in the statement of cash flows without any further adjustments.

(b) During the year, Portal has transferred several of its items of property, plant and equipment to a newly created company, Site, which is owned jointly with another company.

The following information related to the accounting for the investment in Site:

		$m
Purchase cost:	**property, plant and equipment transferred**	200
	Cash	25
		225
Dividend received		(10)
Profit for year on joint venture after tax		55
Revaluation of property, plant and equipment		30
Closing balance per statement of financial position – Site		300

The statement of cash flows showed the cost of purchasing a stake in Site of $225 million. Site is accounted for using the equity accounting approach rather than by proportional consolidation.

(c) The taxation amount in the statement of cash flows is the difference between the opening and closing balances on the taxation account. The charge for taxation in the income statement is $171.

(d) Included in the cash flow figure for the disposal of property, plant and equipment is the sale and leaseback, on an operating basis, of certain land and buildings. The sale proceeds of the land and buildings were $1,000 million in the form of an 8% loan note receivable by Portal in 20X2. The total profit on the sale of tangible non-current assets, including the land and buildings, was $120 million.

(e) The non-controlling interest figure in the statement comprised the difference between the opening and closing statement of financial position totals. The profit attributable to the non-controlling interest for the year was $75 million.

(f) The cash generated from operations is the profit before taxation adjusted for the statement of financial position movement in inventory, trade receivables and current liabilities and the depreciation charge for the year. The interest receivable credited to the income statement was $27 million and the interest payable was $19 million.

(g) It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

(a) Prepare a revised group statement of cash flows for Portal, taking into account notes (a) to (f) above, and using the format set out in the question (18 marks)

(b) Prepare a brief presentation on the usefulness and information content of group statements of cash flows generally and specifically on the group statement of cash flows of Portal. (7 marks)

(Total = 25 marks)

Q-31

(a) The following draft group financial statements relate to Andash, a public limited company.

ANDASH DRAFT GROUP STATEMENTS OF FINANCIAL POSITION AS AT

	20X6 $m	20X5 $m
Assets		
Non-current assets		
Property, plant and equipment	5,170	4,110
Goodwill	120	130
Investment in associate	60	–
	5,350	4,240
Current assets		
Inventories	2,650	2,300
Trade receivables	2,400	1,500
Cash and cash equivalents	140	300
	5,190	4,100
Total assets	10,540	8,340
Equity and liabilities		
Equity attributable to owners of parent		
Share capital	400	370
Other reserves	120	80
Retained earnings	1,250	1,100
	1,770	1,550
Non-controlling interest	200	180
Total equity	1,970	1,730
Non-current liabilities		
Long term borrowings	3,100	2,700
Deferred tax	400	300
Total non-current liabilities	3,500	3,000
Current liabilities		
Trade payables	4,700	2,800
Interest payable	70	40
Current tax payable	300	770
Total current liabilities	5,070	3,610
Total liabilities	8,570	6,610
Total equity and liabilities	10,540	8,340

ANDASH

DRAFT GROUP INCOME STATEMENT FOR THE YEAR ENDED 31 OCTOBER 20X6

	$m
Revenue	17,500
Cost of sales	(14,600)
Gross profit	2,900
Distribution costs	(1,870)
Administrative expenses	(490
Finance costs – interest payable	(148)
Gain on disposal of subsidiary	8
Profit before tax	400
Income tax expense	(160)

Profit for the year	240
Profit attributable to owners of parent	200
Profit attributable to non-controlling interest	40
	240

ANDASH

DRAFT STATEMENT OF CHANGES IN EQUITY OF THE PARENT FOR THE YEAR ENDED 31 OCTOBER 20X6

	Share capital $m	**Other reserves $m**	**Retained earnings $m**	**Total $m**
Balance at 31 October 20X5	370	80	1,100	1,550
Profit for period			200	200
Dividends		50)	(50)	
Issue of share capital	30	30		
Share options issued		10		10
Balance at 31 October 20X6	400	120	1,250	1,770

The following information relates to the draft group financial statements of Andash.

(i) There had been no disposal of property, plant and equipment during the year. The depreciation for the period included in cost of sales was $260 million. Andash had issued share options on 31 October 20X6 as consideration for the purchase of plant. The value of the plant purchased was $9 million at 31 October 20X6 and the share options issued had a market value of $10 million. The market value had been used to account for the plant and share options.

(ii) Andash had acquired 25 per cent of Joma on 1 November 20X5. The purchase consideration was 25 million ordinary shares of Andash valued at $50 million and cash of $10 million. Andash has significant influence over Joma. The investment is stated at cost in the draft group statement of financial position. The reserves of Joma at the date of acquisition were $20 million and at 31 October 20X6 were $32 million. Joma had sold inventory in the period to Andash at a selling price of $16 million. The cost of the inventory was $8 million and the inventory was still held by Andash at 31 October 20X6. there was no goodwill arising on the acquisition of Joma.

(iii) Andash owns 60% of a subsidiary Broiler, a public limited company. The goodwill arising on acquisition was $90 million. The carrying value of Broiler's identifiable net assets (excluding goodwill arising on acquisition) in the group consolidated financial statements is $240 million at 31 October 20X6. The recoverable amount of Broiler is expected to be $260 million and no impairment loss has been recorded up to 31 October 20X5.

(iv) On 30 April 20X6 a wholly owned subsidiary, Chang was disposed of Chang prepared interim financial statements on that date which are as follows:

	$m
Property, plant and equipment	10
Inventories	8
Trade receivables	4
Cash and cash equivalents	5
	27
Share capital	10
Retained earnings	4
Trade payables	6
Current tax payable	7
	27

The consolidated carrying values of the assets and liabilities at that date were the same as above. The group received cash proceeds of $32 million and the carrying amount of goodwill was $10 million.

(Ignore the taxation effects of any adjustments required to the group financial statements and round all calculations to the nearest **$m**illion.)

BPP note: Assume no dividend was paid by Joma during the period.

(v) It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare a group statement of cash flows using the indirect method for the Andash Group for the year ended 31 October 20X6 in accordance with IAS 7 Statement of cash flows after making any necessary adjustments required to the draft group financial statements of Andash as a result of the information above.

(Candidates are not required to produce the adjusted group financial statements of Andash.) (25 marks)

(b) Andash manufactures mining equipment and extracts natural gas. You are advising the directors on matters relating to the year ended 31 October 20X7.

The directors are uncertain about the role of the IASB's Framework for the Preparation and Presentation of Financial Statements (the Framework) in corporate reporting. Their view is that accounting is based on the transactions carried out by the company and these transactions are allocated to the company's accounting periods by using the matching and prudence concepts. The argument put forward by the directors is that the Framework does not take into account the business and legal constraints within which companies operate. Further they have given two situations which have arisen in the current financial statements where they feel that the current accounting practice is inconsistent with the Framework.

Situation 1

Andash has recently constructed a natural gas extraction facility and commenced production one year ago (1 November 20X6). There is an operating licence given to the company by the government which requires the removal of the facility and rectification of the damage caused by extraction of natural gas at the end of its life, which is estimated at 20 years. Depreciation is charged on the straight line basis. The cost of the construction of the facility was $200 million and the net present value at 1 November 20X6 of the future costs to be incurred in order to return the extraction site to its original condition are estimated at $50 million (using a discount rate of 5% per annum). 80 per cent of these costs relate to the removal of the facility and 20% relate to the rectification of the damage caused through the extraction of the natural gas. The auditors have told the company that a provision for decommissioning has to be set up.

Situation 2

Andash purchased a building on 1 November 20X6 for $10 million. The building qualified for a grant of $2 million which has been treated as a deferred credit in the financial statements. The tax allowances are reduced by the amount of the grant. There are additional temporary differences of $40 million in respect of deferred tax liabilities at the year end. Also the company has sold extraction equipment which carries a five year warranty. The directors have made a provision for the warranty of $4 million at 31 October 20X7 which is deductible for tax when costs are incurred under the warranty. In addition to the warranty provision the company has unused tax losses of $70 million. The directors of the company are unsure as to whether a deferred tax liability is required.

(Assume that the depreciation of the building is straight line over ten years, and tax allowances of 25% on the reducing balance basis can be claimed on the building. Tax is payable at 30%.)

Required

(i) Explain the importance of the Framework to the reporting of corporate performance and whether it takes into account the business and legal constraints placed upon companies. (6 marks)

(ii) Explain with reasons and suitable extracts/computations the accounting treatment of the above two situations in the financial statements for the year ended 31 October 20X7. (14 marks)

(iii) Discuss whether the treatment of the items in the situations above appears consistent with the Framework. (5 marks)

(Total = 50 marks)

Q-32

1 The following draft group financial statements relate to Warrburt, a public limited company:

Warrburt Group: Statement of financial position as at 30 November 2008

	30 Nov. 2008 $m	30 Nov. 2007 $m
Assets		
Non-current assets		
Property, plant and equipment	350	360
Goodwill	80	100
Other intangible assets	228	240
Investment in associate	100	–
Available-for-sale financial assets	142	150
	900	850
Current assets		
Inventories	135	198
Trade receivables	92	163
Cash and cash equivalents	312	323
	539	684
Total assets	1,439	1,534
Equity and Liabilities		
Equity attributable to owners of the parent:		
Share capital	650	595
Retained earnings	391	454
Other components of equity	25	20
	1,066	1,069
Non-controlling interest	70	53
Total equity	1,136	1,122
Non-current liabilities:		
Long-term borrowings	20	64
Deferred tax	28	26
Long-term provisions	100	96
Total non-current liabilities	148	186
Current liabilities:		
Trade payables	115	180
Current tax payable	35	42
Short term provisions	5	4
Total current liabilities	155	226
Total liabilities	303	412
Total equity and liabilities	1,439	1,534

Warrburt Group: Statement of comprehensive income for the year ended 30 November 2008

Revenue	**$m**
Cost of sales	910
	(886)
Gross profit	
Other income	24
Distribution costs	31
Administrative expenses	(40)
Finance costs	(35)
Share of profit of associate	(9)
	8
Loss before tax	(21)
Income tax expense	(31)
Loss for the year from continuing operations	(52)
Loss for the year	(52)

Other comprehensive income for the year (after tax):

Available-for-sale financial assets (AFS)	27
Gains on property revaluation	2
Actuarial losses on defined benefit plan	(4)
Other comprehensive income for the year (after tax)	25
Total comprehensive income for the year	(27)

Profit/loss attributable to:	
Owners of the parent	(74)
Non-controlling interest	22
	(52)

Total comprehensive income attributable to:	
Owners of the parent	(49)
Non-controlling interest	22
	(27)

Warrburt Group: Statement of changes in equity for the year ended 30 November 2008

	Share capital	**Retained earnings**	**ASF Financial Assets**	**Revalu ation Surplus**	**Total**	**Non-Controlling Interest**	**Total Equity**
	$m	**$m**	**$m**	**$m**	**$m**	**$m**	**$m**
Balance at 1 December 2007	595	454	16	4	1,069	53	1,122
Share capital issued	55						55
Dividends		(9)			(9)	(5)	(14)
Total comprehensive income for the year		(78)	27	2	(49)	22	(27)
Transfer to retained earnings		24	(24)				
Balance at 30 November 2008	650	391	19	6	1,066	70	1,136

Note to Statement of changes in equity:

	$m
Profit/Loss attributable to owners of parent	(74)
Actuarial losses on defined benefit plan	(4)
Total comprehensive income for year – retained earnings	(78)

The following information relates to the financial statements of Warrburt:

(i) Warrburt holds available-for-sale (AFS) financial assets which are owned by the holding company. The following schedule relates to those assets.

	$m
Balance 1 December 2007	150
Less sales of AFS financial assets at carrying value	(38)
Add gain on revaluation of AFS financial assets	30
	142

The sale proceeds of the AFS financial assets were $45 million. Profit on the sale of AFS financial assets is shown as 'other income' in the financial statements. Deferred tax of $3 million arising on the revaluation gain above has been taken into account in 'other comprehensive income' for the year. The profit held in equity on the AFS financial assets that were sold of $24 million, has been transferred to retained earnings.

(ii) The retirement benefit liability is shown as a long-term provision in the Statement of Financial Position and comprises the following:

	$m
Liability at 1 December 2007	96
Expense for period	10
Contributions to scheme (paid)	(10
Actuarial losses	4
Liability at 30 November 2008	100

Warrburt recognises actuarial gains and losses in the statement of comprehensive income in the period in which they occur. The benefits paid in the period by the trustees of the scheme were $3 million. There is no tax impact with regards to the retirement benefit liability.

(iii) The property, plant and equipment (PPE) in the Statement of Financial Position comprises the following:

	$m
Carrying value at 1 December 2007	360
Additions at cost	78
Gains on property revaluation	4
Disposals	(56
Depreciation	(36
Carrying value at 30 November 2008	350

Plant and machinery with a carrying value of $1 million had been destroyed by fire in the year. The asset was replaced by the insurance company with new plant and machinery which was valued at $3 million. The machines were acquired directly by the insurance company and no cash payment was made to Warrburt. The company included the net gain on this transaction in 'additions at cost' and 'other income'.

The disposal proceeds were $63 million. The gain on disposal is included in administrative expenses. Deferred tax of $2 million has been deducted in arriving at the 'gains on property revaluation' figure in 'other comprehensive income'.

The remaining additions of PPE comprised imported plant and equipment from an overseas supplier on 30 June 2008. The cost of the PPE was 380 million dinars with 280 million dinars being paid on 31 October 2008 and the balance to be paid on 31 December 2008.

The rates of exchange were as follows:

	Dinars to $1
30 June 2008	5
31 October 2008	4.9
30 November 2008	4.8

Exchange gains and losses are included in administrative expenses.

(iv) arrburt purchased a 25% interest in an associate for cash on 1 December 2007. The net assets of the associate at the date of acquisition were $300 million. The associate made a profit after tax of $24 million and paid a dividend of $8 million out of these profits in the year ended 30 November 2008. Assume a tax rate of 25%.

(v) An impairment test had been carried out at 30 November 2008, on goodwill and other intangible assets. The result showed that goodwill was impaired by $20 million and other intangible assets by $12 million.

(vi) The short term provisions relate to finance costs which are payable within six months.

Warrburt's directors are concerned about the results for the year in the statement of comprehensive income and the subsequent effect on the cash flow statement. They have suggested that the proceeds of the sale of property, plant and equipment and the sale of available-for-sale financial assets should be included in 'cash generated from operations'. The directors are afraid of an adverse market reaction to their results and of the importance of meeting targets in order to ensure job security, and feel that the adjustments for the proceeds would enhance the 'cash health' of the business.

Required:

(a) Prepare a group statement of cash flows for Warrburt for the year ended 30 November 2008 in accordance with IAS7, 'Statement of Cash Flows', using the indirect method. (35 marks)

(b) Discuss the key issues which the statement of cash flows highlights regarding the cash flow of the company.

(10 marks)

(c) Discuss the ethical responsibility of the company accountant in ensuring that manipulation of the statement of cash flows, such as that suggested by the directors, does not occur.(5 marks)

Note: requirements (b) and (c) include 2 professional marks in total for the quality of the discussion.

(50 marks)

Q-33

(a) The following draft financial statements relate to Squire, a public limited company.

SQUIRE DRAFT GROUP STATEMENT OF FINANCIAL POSITION AT 31 MAY 20X2

	20X1 $m	20X1 $m
Non-current assets		
Property, plant and equipment	2,630	2,010
Intangible assets	105	65
Investment in associate	535	550
	3,270	2,625
Retirement benefit asset	22	16
Current assets		
Inventories	1,300	1,160
Trade receivables	1,220	1,060
Cash at bank and in hand	90	280
	2,610	2,500
Total assets	5,902	5,141
Equity attributable to owners of the parent		
Share capital	200	170
Share premium account	60	30
Revaluation surplus	92	286
Retained earnings	533	505
	885	991
Non-controlling interest	522	345
Total equity	1,407	1,336
Non-current liabilities	1,675	1,320
Deferred tax liability	200	175
Current liabilities	2,620	2,310
Total liabilities	4,495	3,805
Total equity and liabilities	5,902	5,141

SQUIRE DRAFT GROUP STATEMENT OF COMPRREHENSIVE INCOME FOR THE YEAR ENDED 31 MAY 20X2

	$m
Revenue	8,774
Cost of sales	(7,310)
	1,464
Distribution and administrative expenses	(1,005)
Exchange difference on payment for purchase of non-current assets	(9)
Finance costs	(75)
Share of profit of associate	45
Profit before tax	420
Income tax expense	(205)
Profit for the year	215
Other comprehensive income	
Foreign exchange difference on associate	(10)

Impairment losses on non-current asset set off against revaluation surplus	(194)
Total comprehensive income for the year	11
	(204)

	$m
Profit attributable to	
Owners of the parent	123
Non-controlling interests	92
Total comprehensive income attributable to	215
Owners of the parent	(20)
Non-controlling interests	31
	11

SQUIRE

DRAFT GROUP STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 20X2

	$m
Balance at 1 June 20X1	1,336
Issue of share capital	60
Non-controlling interest acquired on acquisition of subsidiaries	90
Dividends (parent and non-controlling interest)	(90)
Total comprehensive income for the year	11
	1407

The following information relates to Squire.

(i) Squire acquired a seventy per cent holding in Hunsten Holdings, a public limited company, on 1 June 20X1. The fair values of the net assets acquired were as follows.

	$m
Property, plant and equipment	150
Inventories and work in progress	180
Provisions for onerous contracts	(30)
	300

The purchase consideration was $200 million in cash and $50 million (discounted value) deferred consideration which is payable on 1 June 20X3. The provision for the onerous contracts was no longer required at 31 May 20X2 as Squire had paid compensation of $30 million in order to terminate the contact on 1 December 20X1. The intangible asset in the group statement of financial position comprises goodwill only. The difference between the discounted value of the deferred consideration ($50m) and the amount payable ($54m) is included in 'finance costs'.

(ii) There had been no disposals of property, plant and equipment during the year. Depreciation for the period charged in cost of sales was $129 million.

(iii) Current liabilities comprised the following items.

	20X2	20X1
	$m	$m
Trade payables	2,355	2,105
Interest payable	65	45
Taxation	200	160
	2,355	2,105

(iv) Non-current liabilities comprised the following.

	20X2	20X1
	$m	$m
Deferred consideration – purchase of Hunsten	54	

Liability for the purchase of non-current assets	351	
Loans repayable	1,270	
	1,675	1,320

(v) The retirement benefit asset comprised the following.

	$m
Movement in year:	
Surplus at 1 June 20X1	16
Current and past service costs charged to income statement	(20)
Contributions paid to retirement benefit scheme	26
Surplus at 31 May 20X2	22

Required

Prepare a group statement of cash flows using the indirect method for Squire group for the year ended 31 May 20X2 in accordance with IAS 7 Statement of cash flows.

The note regarding the acquisition of the subsidiary is not required. (27 marks)

You have been asked to conduct an environmental audit for the Squire Group to assess how 'green' it is in terms of energy consumption, use of renewable resources, and employee awareness of these issues.

(b) Describe the information you would seek when planning the audit. (8 marks)

(c) Explain how would you test for employee awareness, and how would you involve all employees in the initiative. (6 marks)

(d) Discuss the reasons why companies wish to disclose environmental information in their financial statements. Discuss whether the content of such disclosure should be at the company's discretion. (9 marks)

(Total = 50 marks)

Q-34

The following draft financial statements relate to Zambeze, a public limited company:

ZAMBEZE DRAFT GROUP STATEMENTS OF FINANCIAL POSITION AT 30 JUNE

	20X6	**20X5**
Assets:	**$m**	**$m**
Non-current assets		
Property, plant and equipment	1,315	1,005
Goodwill	30	25
Investment in associate	270	290
	1,615	1,320
Current assets		
Inventories	650	580
Trade receivables	610	530
Cash at bank and cash equivalents	50	140
	1,310	1,250
Total assets	2,925	2,570
	20X6	20X5
	$m	**$m**
Equity and liabilities		
Equity		
Share capital	100	85
Share premium account	30	15
Revaluation reserve	50	145
Retained earnings	254	250
	434	495

Non-controlling interest	60	45
Total equity	494	540
Non-current liabilities	850	600
Current liabilities	1,581	1,430
Total liabilities	2,431	2,030
Total equity and liabilities	2,925	2,570

ZAMBEZE

DRAFT GROUP STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20X6

	$m
Revenue	4,700
Cost of sales	(3,400)
Gross profit	1,300
Distribution and administrative expenses	(600)
Finance costs	(40)
Share of profit in associate	20
Profit before tax	680
Income tax expense	(200)
Profit for the year	480
Other comprehensive income	
Foreign exchange difference of associate	(5)
Impairment losses on property, plant and equipment offset against revaluation surplus	(95)
Total comprehensive income for the year	380

	$m
Profit attributable to	
Ownersof the parent	455
Non-controlling interest	25
	480
Total comprehensive income attributable to	
Owners of the parent	355
Non-controlling interest	25
	380

ZAMBEZE

DRAFT STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 20X6

	$m
Balance at 1 July 20X5	540
Issue of share capital	30
Total comprehensive income for the year	380
Acquisition of non-controlling interest of Damp	48
Dividends paid (parent and non-controlling interest)	(504)
Balance at 30 June 20X6	494

The following relates to Zambeze:

(a) Zambeze acquired a seventy per cent holding in Damp, a public limited company, on 1 July 20X5. The fair values of the net assets acquired were as follows:

	$m
Property, plant and equipment	70
Inventories and work in progress	90
	160

The purchase consideration was $100 million in cash and $25 million (discounted value) deferred consideration which is payable on 1 July 20X6. The difference between the discounted value of the deferred consideration ($25 million) and the amount payable ($29 million) is included in 'finance costs'. Zambeze wants to set up a provision for reconstruction costs of $10 million retrospectively on the acquisition of Damp. This provision has not yet been set up.

(b) There had been no disposals of property, plant and equipment during the year. Depreciation for the period charged in cost of sales was $60 million.

(c) Current liabilities comprised the following items:

	20X6	20X5
	$m	$m
Trade payables	1,341	1,200
Interest payable	50	45
Taxation	190	185
	1,581	1,430

(d) Non-current liabilities comprised the following:

	20X6	20X5
	$m	$m
Deferred consideration – purchase of Damp	29	-
Liability for the purchase of property, plant and equipment	144	-
Loans repayable	621	555
Deferred tax liability	30	25
Retirement benefit liability	26	20
	850	600

(e) The retirement benefit liability comprised the following:

	$m
Movement in year	
Liability at 1 July 20X5	20
Current and past service costs charged to profit or loss	13
Contributions paid to retirement benefit scheme	(7)
Liability 30 June 20X6	26

There was no actuarial gain or loss in the year.

(f) Goodwill was impairment tested on 30 June 20X6 and any impairment was included in the financial statements for the year ended 30 June 20X6.

(g) The Finance Director has set up a company, River, through which Zambeze conducts its investment activities. Zambeze has paid $400 million to River during the year and this has been included in dividends paid. The money was invested in a specified portfolio of investments. Ninety five per cent of the profits and one hundred per cent of the losses in the specified portfolio of investments are transferred to Zambeze. An investment manager has charge of the company's investments and owns all of the share capital of River. An agreement between the investment manager and Zambeze sets out the operating guidelines and prohibits the investment manager from obtaining access to the investments for the manager's benefit. An annual transfer of the profit/loss will occur on 30 June annually and the capital will be returned in four years time. The transfer of $400 million cash occurred on 1 January 20X6 but no transfer of profit/loss has yet occurred. The statement of financial position of River at 30 June 20X6 is as follows:

RIVER: STATEMENT OF FINANCIAL POSITION AT 30 JUNE 20X6

	$m
Investment at fair value through profit or loss	390
	390
Share capital	400

Retained earnings	(10)
	390

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

(a) Prepare a group statement of cash flows for the Zambeze Group for the year ended 30 June 20X6 using the indirect method.(35 marks)

(b) Discuss the issues which would determine whether River should be consolidated by Zambeze in the group financial statements. (9 marks)

(c) Discuss briefly the importance of ethical behaviour in the preparation of financial statements and whether the creation of River could constitute unethical practice by the finance director of Zambeze.(6 marks)

(Total = 50 marks)

Two marks are available for the quality of the discussion of the issues regarding the consolidation of River and the importance of ethical behaviour.

Q-35

The following draft group financial statements relate to Jocatt, a public limited company:

Jocatt Group: Statement of financial position as at 30 November

	2010	2009
	$m	$m
Assets		
Non-current assets		
Property, plant and equipment	327	254
Investment property	8	6
Goodwill	48	68
Intangible assets	85	72
Investment in associate	54	
Available-for-sale financial assets	94	90
	616	490
Current assets		
Inventories	105	128
Trade receivables	62	113
Cash and cash equivalents	232	143
	399	384
Total assets	1,015	874
Equity and Liabilities		
Equity attributable to the owners of the parent		
Share capital	290	275
Retained earnings	351	324
Other components of equity	15	20
	656	619
Non-controlling interest	55	36
Total equity	711	655
Non-current liabilities:		
Long-term borrowings	67	71
Deferred tax	35	41
Long-term provisions-pension liability	25	22
Total non-current liabilities	127	134
Current liabilities:		
Trade payables	144	55

Current tax payable	33	30
Total current liabilities	177	85
Total liabilities	304	219
Total equity and liabilities	1,015	874

Jocatt Group: Statement of comprehensive income for the year ended 30 November 2010

	$m
Revenue	432
Cost of sales	(317
Gross profit	115
Other income	25
Distribution costs	(55.5)
Administrative expenses	(36)
Finance costs paid	(6)
Gains on property	10
Share of profit of associate	6
Profit before tax	59
Income tax expense	(11)
Profit for the year	48
Other comprehensive income after tax:	
Gain on available for sale financial assets (AFS)	2
Losses on property revaluation	(7)
Actuarial losses on defined benefit plan	(6)
Other comprehensive income for the year, net of tax	(11)
Total comprehensive income for the year	37
Profit attributable to:	
Owners of the parent	38
Non-controlling interest	10
	48
Total comprehensive income attributable to:	
	$m
Owners of the parent	27
Non-controlling interest	10
	37

Jocatt Group: Statement of changes in equity for the year ended 30 November 2010

	Share Capital	**Retained earnings**	**AFS financial assets**	**Revalu ation surplus (PPE)**	**Total**	**Non control ling interes t**	**Total equity**
	$m	**$m**	**$m**	**$m**	**$m**	**$m**	**$m**
Balance at 1 December 2009	275	324	4	16	619	36	655
Share capital issued	15				15		15
Dividends		(5)			(5)	(13)	(18)
Rights issue						2	2
Acquisitions						20	20
Total comprehensive income for the year		32	2	(7)	27	10	37
Balance at 30 November 2010	290	351	6	9	656	55	711

The following information relates to the financial statements of Jocatt:

(i) On 1 December 2008, Jocatt acquired 8% of the ordinary shares of Tigret. Jocatt had treated this investment as available-for-sale in the financial statements to 30 November 2009. On 1 December 2009, Jocatt acquired a further 52% of the ordinary shares of Tigret and gained control of the company. The consideration for the acquisitions was as follows:

	Holding	Consideration
		$m
1 December 2008	8%	4
1 December 2009	52%	30
	60%	34

At 1 December 2009, the fair value of the 8% holding in Tigret held by Jocatt at the time of the business combination was $5 million and the fair value of the non-controlling interest in Tigret was $20 million. No gain or loss on the 8% holding in Tigret had been reported in the financial statements at 1 December 2009. The purchase consideration at 1 December 2009 comprised cash of $15 million and shares of $15 million.

The fair value of the identifiable net assets of Tigret, excluding deferred tax assets and liabilities, at the date of acquisition comprised the following:

	$m
Property, plant and equipment	15
Intangible assets	18
Trade receivables	5
Cash	7

The tax base of the identifiable net assets of Tigret was $40 million at 1 December 2009. The tax rate of Tigret is 30%.

(ii) On 30 November 2010,Tigret made a rights issue on a 1 for 4 basis. The issue was fully subscribed and raised $5 million in cash.

(iii) Jocatt purchased a research project from a third party including certain patents on 1 December 2009 for$8 million and recognised it as an intangible asset. During the year, Jocatt incurred further costs, which included $2 million on completing the research phase, $4 million in developing the product for sale and$1 million for the initial marketing costs. There were no other additions to intangible assets in the period other than those on the acquisition of Tigret.

(iv) Jocatt operates a defined benefit scheme. The current service costs for the year ended 30 November 2010 are $10 million. Jocatt enhanced the benefits on 1 December 2009 however, these do not vest until 30 November 2012. The total cost of the enhancement is $6 million. The expected return on plan assets was $8 million for the year and Jocatt recognises actuarial gains and losses within other comprehensive income as they arise.

(v) Jocatt owns an investment property. During the year, part of the heating system of the property, which had a carrying value of $0·5 million, was replaced by a new system, which cost $1 million. Jocatt uses the fair value model for measuring investment property.

(vi) Jocatt had exchanged surplus land with a carrying value of $10 million for cash of $15 million and plant valued at $4 million. The transaction has commercial substance. Depreciation for the period for property, plant and equipment was $27 million.

(vii) Goodwill relating to all subsidiaries had been impairment tested in the year to 30 November 2010 and any impairment accounted for. The goodwill impairment related to those subsidiaries which were 100% owned.

(viii) Deferred tax of $1 million arose on the gains on available-for-sale investments in the year.

(ix) The associate did not pay any dividends in the year.

Required:

(a) Prepare a consolidated statement of cash flows for the Jocatt Group using the indirect method under IAS 7 ‘Statement of Cash Flows’.

Note: Ignore deferred taxation other than where it is mentioned in the question. (35 marks)

(b) Jocatt operates in the energy industry and undertakes complex natural gas trading arrangements, which involve exchanges in resources with other companies in the industry. Jocatt is entering into a long-term contract for the supply of gas and is raising a loan on the strength of this contract. The proceeds of the loan are to be received over the year to 30 November 2011 and are to be repaid over four years to 30 November 2015. Jocatt wishes to report the proceeds as operating cash flow because it is related to a long-term purchase contract. The directors of Jocatt receive extra income if the operating cash flow exceeds a predetermined target for the year and feel that the indirect method is more useful and informative to users of financial statements than the direct method.

(i) Comment on the directors' view that the indirect method of preparing statements of cash flow is more useful and informative to users than the direct method.(7 marks)

(ii) Discuss the reasons why the directors may wish to report the loan proceeds as an operating cash flow rather than a financing cash flow and whether there are any ethical implications of adopting this treatment.(6 marks)
Professional marks will be awarded in part (b) for the clarity and quality of discussion.(2 marks)

ANSWERS

A-1

(a) ALPHA

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Assets	
Non-current	
Property, plant and equipment	10,655.0
Goodwill (W1)	435.0
	11,090.0
Current assets	
Inventories	3,408.0
Receivables (1,462 + 1,307 – 23)	2,746.0
Cash	41.0
	6,195.0
Total assets	17,285.0
Equity and liabilities	
Equity attributable to owners of the parent	
Share capital (50c ordinary shares)	5,500.0
General reserve (W5)	1,490.0
Retained earnings (W4)	557.5
	7,547.5
Non-controlling interest (W3)	522.5
Total equity	8,070.0
Noncurrent liabilities	
Borrowings	4,500.0
Current liabilities	
Overdraft	2,016.0
Trade payables (887 + 1,077 – 23)	1,941.0
Taxation	758.0
Total current liabilities	4,715.0
Total liabilities	9,215.0
Total equity and liabilities	17,285.0

(b) Alpha has made a profit of 15/115 ⍰ $23,000 = $3,000 on its sale of goods to Beta. Beta has not yet sold goods to an outside party and the profit is therefore unrealised as far as the group is concerned. An adjustment is necessary to reduce the balance of retained earnings, and the value of inventory by $3,000.

Workings

Group structure

1 Alpha

$$\frac{\mathbf{1450,000}}{\mathbf{2,000,000}} = \mathbf{72.5\%}$$

Beta

2 Goodwill

	$'000	$'000
Cost of combination		1450
Fair value of identifiable net assets acquired		
Share capital	1000	
General reserve	400	
	1400	
Group share (72½%)		1015
		435

3 Non controlling interest

	$'000
Share capital	1000
Reserves (800 + 100)	900
	1900
Minority interest (27½%)	522.5

4 Retained earnings

	Alpha $'000	Beta $'000
Per question	485.0	100
At acquisition	-	-
	485	100
Share of post acquisition profits of Beta (72½ % 100)	72.5	
	557.5	

5 General reserve

	Alpha $'000	Beta $'000
Per question	1200	800
At acquisition	-	(400)
	1200	400
Share of post acquisition reserves of Beta (72½% 400)	290	
	1490	

A-2

J GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$'000
Assets	
Non-current assets	
Freehold property (1,950 + 1,250 + 370 (W2))	3,570
Plant and equipment (795 + 375)	1,170
Investment in associate (W5)	480
	5,220
Current assets	
Inventories (575 + 300 – 20 (W3))	855
Trade receivables (330 + 290))	620
Cash at bank and in hand (50 + 120)	170
	1645
	6865
Equity and liabilities	
Equity attributable to owners of the parent	
Issued share capital	2,000
Retained earnings	1,781
	3,781
Non-controlling interests (W6)	89
Total equity	4,675
Non-current liabilities	
12% debentures (500 + 100)	600
Current liabilities	
Bank overdraft	560
Trade payables (680 + 350)	1,030
	1,590
Total liabilities	2,190
	6865

Workings

1 Group structure

J

600/1,000 60% 30% 225/750

P S

Pre acquisition Profit	$200K	$15K

2. Fair value adjustment table

	At acquisition $'000	Movement $'000	date $'000	
Land	200		200	
Building	200	(30)	170	(200 x34/40)
	400	(30)	370	

3 unrealized profit on inventories

P Co $\longrightarrow$ J Co $100k X 25/125 = $20,000

4 Goodwill

	$'000	P Co $'000	NCI $'000
Consideration transferred/FV NCI (400 × $1.65)		1000	660
Net assets acquired:			
Share capital	1000		
Retained earnings at acquisition	200		
Fair value adjustment (W2)	400		
	1600		
Group/NCI share (× 60%/40%)		(960)	(640)
		40	20
Impairments to date		(40)	(20)
Year-end value		-	-

5 Investment in associate

	$'000
Cost of associate	500.0
Share of post acquisition retained reserves	
((390 – 150) × 30%)	72.0
Less impairment of investment in associate	(92.0)
	480.0

6 Non-controlling interest

	$'000	
Net assets per question	1,885	
Unrealised profit (W3)	(20)	
Fair value adjustment (W2)	370	
	2,235	X 40% = 894
Non-controlling interest in goodwill		-
		894

7 Retained earnings

	J Co $'000	P Co $'000	S Co $'000
Retained earnings per question	1,460	885	390
Unrealised profit (W3)		(20)	
Retained earnings profits at acquisition		(200)	(150)
Fair value adjustment movement (W2)		(30)	
		635	240
P Co: share of post acquisition profits 60%635	381		
S Co: share of post acquisition profits 30%240	72		
Goodwill impairments to date (40 + 92) (W4)	(132)		
	1,781		

A -3

(a)

(i) Associate v ordinary non-current asset investment

An investor will take a relatively passive role in an ordinary non current asset investment; whereas an associate is a vehicle for the conduct of business since the investor can exercise significant influence over the financial and operational policies of the investee company.

Under IAS 28, a holding of 20% or more of voting rights suggests the investor has significant influence. The attitude of the investor towards dividends, is important. For an investment, the investor will press for high dividends, but for an associate the investor will be keen to see profits reinvested.

IAS 28 indicates that board representation plus at least 20% voting rights will indicate associate status. Significant influence can also be exercised by intra company trading, exchange of key staff or providing technical support or information.

(ii) Principal differences: jointly controlled operation/asset/entity

Under IAS 31, jointly controlled operations utilise assets and resources from the venturers and are not separate entities. A venturer will recognise the assets it controls, the liabilities incurred, the expenses incurred and the share of income in its consolidated accounts.

A jointly controlled asset occurs when there is no separate entity. The venturer will recognise its share of the asset, any liabilities incurred and its share of any joint liabilities in its accounts.

A jointly controlled entity is a separate entity in which each venturer has an interest. Proportionate consolidation is used to account for these on an aggregate or line by line basis. IAS 31 permits the use of equity accounting in group accounts for jointly controlled entities as well.

(b) (i) At 1 January 20X7, goodwill is calculated as follows.

	$m	$m
Cost of investment		14.0
Property, plant and equipment	30.00	
Current assets	31.00	
Current liabilities	(20.00)	
Non-current liabilities	(8.00)	
Fair value of net assets	33.00	
30% thereof		9.9
Goodwill		4.1

Carrying value 31.12.20X8 in the statement of financial position

	$m
Investment cost	14.0
30% post acquisition profit (32 – 9)	6.9
Fair value adjustment for depreciation 220%(30 – 20)30%)	(1.2)
	19.7

The following would appear in the consolidated income statement.

	$m
Share of profit of associate ((30%12)– inter co profit 3.0* – depreciation 0.6)	-
***10 × 30%**	

Intragroup profit on the inventory will be treated as follows.

- Deducted from share of associate profit.
- Deduct from inventory as the asset subject to the transaction is held by the parent.

(ii) Change in treatment

Jointly controlled entities are accounted for using proportionate consolidation, as required by IAS 31 Interests in joint ventures. The venture can aggregate its share of joint assets, liabilities, income or expenses with similar items in the consolidated accounts on a line by line basis or include as separate items.

All the items (except the dividend) would be multiplied by 30% and consolidated in the income statement:

BADEN
CONSOLIDATED INCOME STATEMENT

	$m
Revenue (212 – 35) × 30 %	53.1
Cost of sales ((178 – 35) × 30%)+ 3 + 0.6))	
(46.5) Other income	3.6
Distribution costs	(5.1)
Administration expenses	(2.4)
Finance costs	(1.2)
Income tax expense	(1.5)
Profit for the year	0.0

The statement of financial position would include:

	$m
Non current assets	12.9
(30% x 37 + fair value adjustment (10 x 30% – depreciation 1.2))	
Goodwill	4.1
Current assets (30% x 31)	9.3
	26.3
Non current liabilities (30% 10)	(3.0)
Current liabilities (30%12)	(3.6)
	19.7

A-4

(a) BAUBLE GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	$'000
Non current assets	
Property, plant and equipment (720 + 60 + 70)	850
Goodwill (W2)	111
	961
Current assets (175 + 95 + 90)	360
	1,321
Equity attributable to owners of the parent	
Share capital – $1 ordinary shares	400
Retained earnings (W4)	600
	1,000
Non-controlling interest (W3)	91
	1,091
Current liabilities (120 + 65 + 45)	230
	1,321

Workings

1 Group structure

Bauble

60%

Jewel 10%

70%

Gem

Bauble interest in Gem

Direct	**10%**
Indirect (60% x 70%)	42%
	52%
Non controlling interest in Gem	48%

2 Goodwill

	B in J		B in G		J in G	
	$'000	**$'000**	**$'000**	**$'000**	**$'000**	**$'000**
Consideration transferred		142		43	60% x 100	60.0
Share of net assets acquired as represented By						
Share capital	100		50		50	
Ret'd earnings	45		40		40	
	145		90		90	
Group share	60%		10%		42%	
		87		9		37.8
Goodwill		55		34		22.2

Total goodwill = $111,200

3 Non controlling interest

	Jewel		Gem
	$'000		**$'000**
Net assets per question	190		110
Less: cost of investment in Gamma	(100)		
	90		115
Non-controlling share	X 40%		X 48%
	36		55.2
		91.2	

4 Consolidated retained earnings

	B	J	G
	$'000	**$'000**	**$'000**
Per Q	560	90	65
Less: pre-acquisition ret'd earnings		(45)	(40)
J – share of post acquisition ret'd earnings (45 ? 60%)	27		
G – share of post acquisition ret'd earnings (25 ? 52%)	13		
	600		

(b) Goodwill

		$'000		**$'000**
Consideration transferred				142.0
Fair value of identifiable net assets acquired:				
Jewel	**Share capital**	100		
	Retained earnings	60		
	Cost of investment – Gem	(100)		
		60.0	X60%	(36.0)
Gem	**Share capital**	50.0		
	Retained earnings (1 Jan. 20X3)	40.0		
		90.0	X42$	(37.8)
				68.2
Bauble in Gem (per part (a)				34.0
				102.2

A -5

			Marks
(a)	Property, plant and equipment		3
	Goodwill and investment in W		8
	Net current assets		2
	Non current liabilities		1
	Non-controlling interest		7
	Capital and reserves		5
		Available	26
		Maximum	25
(b)	Subjective		5
			30

(a) X GROUP

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X9

	$m
Property, plant and equipment (W3)	1,058
Goodwill (W5)	79
Investment in associate (W4)	53
Net current assets 640 + 360 + 75 – 15 (W6)	1,060
	2,250
Equity	360
Share premium	250
Retained earnings (W8)	1,114
Non-controlling interest (W7)	161
	1,885
Non current liabilities 200 + 150 + 15	365
	2,250

Workings

1 Group structure

X

Holding	Date acquired	Retained	Retained

						earnings	earnings
662/3%	Y		100m / 150m	=	1.4.X6	N/A	$120m
		90%	662/3%				
30%	Z		45m / 50m	= 90	1.4.X4	$10m	$20m
			30%		1.4X6	-	%7m
W							

2 Fair value adjustments and other adjustments to net assets

Y	**Acquisition $m**	**At reporting date $m**
Property, plant and equipment	30	30
Amortization (30 10% 3)		(9)
Non-current intangible assets	(30)	(30)
Inventory (2 – 8)	(6)	
Allowance for doubtful debts	(9)	
	15	(9)

Z	Acquisition **$m**	At reporting date **$m**
Property, plant and equipment	10	10
Amortization (10 10% 3)		(3)
Inventory	(5)	
	5	7

Note

The amount received as a result of the arbitration award was a contingent asset at the date of acquisition and is therefore not recognised as a fair value adjustment. IFRS 3 only requires recognition of contingent liabilities.

3 Property, plant and equipment

	X $m	**Y $m**	**Z $m**
Per question	900	100	30
Fair value adjustments (W2)	-	30	10
Amortisation (W2)	-	(9)	(3)
	900	121	37
Y	121		
Z	37		
	1,058		

4 Investment in W – associate

	$m
Cost	50
Add 30% post acquisition profit (17 – 7)	3
	53

5 Goodwill

X

2/3

Y

90%

Z

	Y	Z
Investment by X	2/3	60% (2/3 of 90%)
Non controlling interest	1/3	40%

	$m	$m
Consideration transferred (Y and Z)		320
Fair value of identifiable net assets acquired in Y:		
Share capital	150	
Share premium	120	
Reserves	120	
Fair value adjustments (W2)	(15)	
Investment in Z	(90)	
	285	
2/3		(190))
Fair value of identifiable net assets acquired in Z:		
Share capital	50	
Share premium	10	
Reserves	20	
Fair value adjustments (W2)	85	
60%		(51)
		79

6 Unrealized profit

	$m
On sales to X	44
On sales to Y	16
	60

Unrealised profit 25% × 60 = $15m

7 Non-controlling interests

	$m	$m
Net assets at reporting date per question	480	
Fair value adjustments (W2)		
(9) Cost of investment in Z	(90	
Cost of investment in associate	(50	
Investment in associate (W4)	53	
1/3	384	128
Z		
Net assets at reporting date per question	90	
Fair value adjustments (W2)	7	
Intragroup profit in inventories (44 + 16 × 25%)	(15)	
40	82	33
		161

8 Consolidated retained earnings

X	Y	Z	W
$m	$m	$m	$m

Per question	1,050	210	30	17
Intragroup profit in inventories (W8)			(15)	
Fair value adjustments (W2)	-	6	2	-
Retained earnings at acquisition (W5)	-	(120)	(20)	(7)
	1050	96	(3)	10
Post-acquisition profits of Y (2/3 ? 96)	64			
Post-acquisition profits of Z (60% ? (3))	2			
Post-acquisition profits of W (20% ? 10)	(2)			
	1114			

(b) Change of policy re goodwill

IFRS 1 First time adoption of International Financial Reporting Standards is relevant as the company appears to be adopting IFRSs for the first time.

IFRS 1 requires retrospective adoption of all IFRSs in force at the reporting date for the first IFRS financial statements (31 March 20X9). Assuming that the company presents comparative figures for one year only (the minimum required by IFRS 1), it will prepare an opening IFRS statement of financial position at 1 April 20X7, which will be the date of transition to IFRSs. As all its investments were acquired before this date, it must recognise the goodwill arising as an intangible asset.

Retrospective application means that X should adjust opening retained earnings for the effect of the change. X must also test the goodwill for impairment at the date of transition.

IFRS 1 contains an exemption from applying IFRS 3 retrospectively. However, the group wishes to account for the change in policy retrospectively and therefore is not claiming the exemption.

A -6

Marking scheme

		Marks
Equity		7
Reserves		6
Non-current liabilities		3
Defined benefit plan		4
Convertible bond		4
Plant		2
Trade name		3
	Available	29
	Maximum	25

GLOVE GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 20X7

	$m
Non-current assets	
Property, plant and equipment	
260 + 20 + 26 + 6 (W2) + 5(W2) + 3 (W5)	320.0
Goodwill (W6)	10.1
Other intangibles: trade name (W2)	4.0
Available for sale investments	10.0
Current assets: 65 + 29 + 20	344.1
	114.0
Total assets	458.1

Equity and liabilities

Equity attributable to owners of parent	
Ordinary shares	150.0
Other reserves (W8)	30.8
Retained earnings (W8)	150.8
Equity component of convertibledebt (W4)	1.6
	333.2
Non-controlling interests (W7)	28.9
	362.1
Non-current liabilities (W10)	
45 + 2 + 3 + 0.1 (W3) – 30 + 28.9 (W4)	49.0
Current liabilities: 35 + 7 + 5	47.0
	96.0
Total equity and liabilities	458.1

Workings

1 Group structure

	Glove			
1 June 20X5		80%	Retained earnings	$10m
			Other reserves	$4m
	Body			
1 June 20X5		70%	Retained earnings	$6m
			Other reserves	$8m
	Fit			%
Effective interest 80% x 70%				56
∴Non controlling assets				44
				100

Note. The acquisitions were on the same date. Our calculation of goodwill is done as if Body was acquired first, but either method would be acceptable.

2 Fair value adjustments

Y	**Acquisition $m**	**Movement (2 years) $m**	**At reporting date $m**
Body			
Land: 60 – (40+10+4)	6	-	6
Brand name (note)	5	(1)	4
	11	1	10
Fit			
Land: 39 – (20+8+6)	5	-	5

Note. The trade name is an internally generated intangible asset. While these are not normally recognised under IAS 38 Intangible assets, IFRS 3 Business combinations allows recognition if the fair value can be measured reliably. Thus this Glove should recognise an intangible asset on acquisition (at 1 June 20X5). This will reduce the value of goodwill.

The trade name is amortised over ten years, of which two have elapsed: $5m × 2/10 = $1m.

So the value is $(5 – 1)m = $4m in the consolidated statement of financial position.

3 Defined benefit pension scheme

	$m
Present value of obligation	26.0
Fair value of plan assets	(20.0)
Unrecognised actuarial losses (note) ($3m – $0.1m (note))	(2.9)
	3.1

Note. recognised actuarial losses

Corridor amounts:

10% of present value of obligation: 10% × $20m = $2m
10% of fair value of plan assets: 10% × $16m = $1.6m

∴ Use $2m

	$m
Unrecognised losses at 1 June 20X6	3
Less 10% of P.V. of obligation	(2)
Excess	1

Amortised over ten years ... $1m/10 = $0.1m

Accounting entries:

DEBIT	Retained earnings	$0.1m	
CREDIT	Unrecognised actuarial losses		$0.1m

4 Convertible bond

Under IAS 39, the bond must be split into a liability and an equity component:

	$'000	**$'000**
Proceeds: 30,000 × $1,000		30,000
Present value of principal in three years' time		
$\$30m\,\frac{1}{1.08^3}$	23,815	
Present value of interest annuity		
$30m × 6% = $1,800,000		
$\times\frac{1}{1.08}$	1,667	
$\times\frac{1}{(1.08)2}$	1,543	
$\times\frac{1}{(1.08)3}$	1,429	
Liability component		(28,454)
∴Equity component		1,546

Rounded to $1.6m
Balance of liability at 31 May 20X7

	$'000
Balance b/d at 1 June 20X6	28,454
Effective interest at 8%	2,276
Coupon interest paid at 6%	(1,800)
Balance c/d at 31 May 20X7	28930

5 Exchange of assets

The cost of the plant should be measured at the fair value of the asset given up, rather than the carrying value. An adjustment must be made to the value of the plant, and to retained earnings.

	$'000
Fair value of land	7
Carrying value of land	(4)

∴Adjustment required			3
DECIT	Plant	$3m	
CREDIT	Retained earnings		$3m

6 Goodwill

	Glove in Body		Body in Fit	
	$m	**$m**	**$m**	**$m**
Consideration transferred		60	80% x 30	2.00
Fair value of net assets acquired				
Per question	60		39	
Trade name (W2)	5		-	
	65		39	
Group share 80%/56%		(52)		(21.84)
		8		2.16

10.16

7 Non-controlling interest

	Body	Fit
Net assets per question	70.0	38
Cost of investment in Fit	(30.0)	-
Fair value adjustment (W2)	10.0	5
	50	43
	X 20%	X 44%
	10.00	18.92

$28.9m

8. Retained earnings

	Glove	Body	Fit
	$m	**$m**	**$m**
Per question	135.00	25	10
Fair value movement (W2)	-	(1)	-
Pension scheme (W3)	(0.10)		
Convertible bonds (W4) (2.3 – 1.8)			
	(0.50)		
Assets exchange:			
Adjustment to plant (W5)	3.00		
Less pre-acquisition		(10)	(6)
		14	4
Share of Body			
80% × 14	11.20		
Share of Fit			
56% x 4	2.24		
	150.84		

9. Other reserves

	Glove	Body	Fit
	$m	**$m**	**$m**
Per question	30.0	5	8
Less pre-acquisition		(4)	(8)
		1	-

Share of body	
80% × 1	0.8
Share of Fit	
56% × 0	0.0
	30.8

10 Non-current liabilities

Note. This working is for additional information. To save time, you should do yours on the face of the consolidated position statement

	Glove $m	Body $m
Non-current liabilities per question:		
Glove	45	
Body	2	
Fit	3	
		50.0
Unrecognised actuarial losses (W3)		0.1
Proceeds of convertible bond		(30.0)
Value of liability component		28.9
		49.0

A -7

Examiner's comment. This question was well answered in most cases. However, many candidates did not charge the additional depreciation on the fair value increase on the property of the subsidiaries, and failed to treat the brand name correctly on acquisition.

	Marks
Discussion of method of accounting for shareholdings	3
Equity of Fusion	6
Equity of Spine	5
Fair value calculation – assets	3
Fair value of consideration	3
Brand name	2
Property, plant and equipment	3
Group reserves	2
Micro	3
Available	30
Maximum	25

LARGO

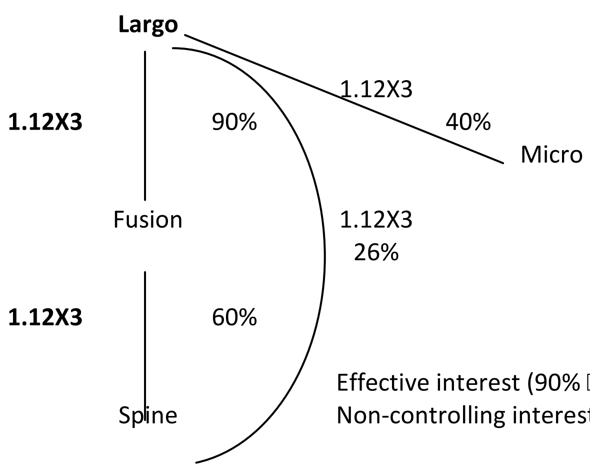
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 30 NOVEMBER 20X4

	$m
Assets	
Non current assets	
Property, plant and equipment (329 + 185 + (W2) + 60.8 + 64 + (W2) 36.1 – 9 brand)	665.9
Goodwill (W3)	80.3
Other intangible assets	7.0
Investment in associate (W4)	12.6
	765.8
Current assets (120 + 58 + 40)	218.0
	983.8
Equity and liabilities	
Equity attributable to owners of the parent	
Share capital (280 + 150 + 30)	460.0

Share premium [30 + (150 × $1.30) + (30 × $1.30)]	264.0
Retained earnings (W6)	122.2
	846.2
Non-controlling interest (W5)	50.8
	897.0
	$m
Non-current liabilities	
Deferred tax liability (20 + 20 + (W2) 14.25 + 5 + (W2) 8.55)	67.8
Current liabilities (10 + 5 + 4)	19.0
	983.8

Workings

1 Group structure



Effective interest (90% × 60%) + 26%	80%
Non-controlling interest	20%
	100%

2

	At acq'n	Movement	At reporting date
	1.12X3	(5%)	30.11X4
	$m	**$m**	**$m**
Fusion	64	(3.2)	60.8
Property (330 – 110 – 20 – 136)	(15)	0.75	(14.25)
Deferred tax liability	49	(2.45)	46.55
Spine	38	(1.9)	36.1
Property (128 – 50 – 10 – 30)	(9)	0.45	(8.55)
Deferred tax liability	29	(1.45)	27.55

3 Goodwill

	Largo in Fusion Group		**Largo in Spine**	
	$m	**$m**	**$m**	**$m**
Consideration transferred (150 × $2.30*)				
(30 x$2.30*)				
Fair value of net assets acquired:				
Fusion				
Share capital	110			
Share premium	20			
Retained earnings (1.12.X3)	136			
Fair value adjustments: Property (W2)	64			

Deferred tax liability		15)			
Cost of investment in Spine		50)			
		265			
Group share		90%	(238.5)		
Spine					
Share capital		50		50	
Share premium		10		10	
Retained earnings (1.12.X3)		30		30	
Fair value adjustments:	Property (W2)	38		38	
	Deferred tax liability	(9)		(9)	
		119		119	
Group share		54%	(64.26)	26%	(30.94)
			42.24		38.06
				80.30	

Note. IFRS 3 requires goodwill arising on a business combination to be tested annually for impairment. There is no information as to whether the goodwill is impaired hence no adjustment for impairment is necessary.

*The market price of the shares is calculated by reference to the market capitalisation of Largo: $644 million

÷ 280 million shares = $2.30 per share. Therefore the premium on each share is $1.30.

4 Investment in associate

	$m
Cost of associate	11.0
Share of post acquisition retained reserves ((24 – 20) ⍰ 40%)	1.6
	12.6

5 Non-controlling interest

	Fusion $m		Spine $m
Net assets at reporting date per question	268		95
Fair value adjustments (W2)	46.55		27.55
Cost of investment in Spine	(50)		
Impairment of brand (9 – 7)	(2)		–
	262.55		122.55
NCI share (10%/20% effective interest (W1))	26.26		24.51
		50.77	

6. Retailed Earning

	Largo	Fusion	Spine
Per question		138.00	35.00
Fair value change (W2)		(2.45)	(1.45)
Impairment loss		(2.00)	–
		133.55	33.55
At acquisition		(136.00)	(30.00)
		(2.45)	3.55
Group share of Fusion ((2.45) x 90%)	(2.21)		
Group share of Spine (3.55 x 80%)	2.84		
Share of profit of associate ((24 – 20) x 40%)	1.60		
	122.2		

A -8

Examiner's comment. Generally speaking, candidates performed quite well on this question but often struggled with the accounting for the defined benefit pension scheme. Many candidates treated one of the subsidiaries as an associate. In this situation, where the relationship between the companies has been incorrectly determined, marks are awarded for the methodology used in the question.

Marking scheme

				Marks
(a)	Defined benefit pension scheme			5
(b)	Shareholding			3
	Equity – Line			6
	Non current assets – Line			4
	Equity – Reel			8
	Fair value adjustment			2
	Group properties, plant and equipment			2
	Group retained earnings			3
	Trade receivables			1
	Inventory			1
(c)	(i)	Provision:	current practice	4
			Acceptability	2
	(ii)	Fine:	intangible asset	3
			Acceptability	2
(d)	1 mark per valid point			10
(e)	For			2
	Against			2
	Conclusion			1
			Available	61
			Maximum	50

(a) Defined benefit pension scheme

The defined benefit pension scheme is treated in accordance with IAS 19 Employee benefits. The pension scheme has a deficit of liabilities over assets:

Fair value of scheme assets	125
Less present value of obligation	(130
	(5)

The deficit is reported as a liability in the statement of financial position. The income statement for the year includes:

	$m
Current service cost	110
Interest cost	20
Expected return on plan assets	(10)
Actuarial gain (see note)	(15)
	105

The balance sheet includes:	**$m**
Present value of pension obligation	(130)
Fair value of plan assets	125
Liability	(5)
	120

Changes in present value of the defined benefit obligation

	$m
Opening defined benefit obligation	Nil
Interest cost	20
Current service cost	110

Closing defined benefit obligation	130

Changes in fair value of plan assets

	$m
Opening fair value of plan assets	Nil
Expected return on plan assets	10
Contributions	100
Actuarial gain (balancing figure)	15
Closing fair value of plan assets	125

There is an actuarial gain of $15 million on the defined benefit pension scheme assets (W). Under IAS 19 the unrecognised gains and losses at the end of the previous reporting period can be recognised in profit or loss for the year using the '10% corridor' approach or any other systematic approach including immediate recognition, either in retained earnings or in profit or loss for the year. Here, the directors have chosen to recognise the gain immediately in profit or loss for the year.

Adjustment to the group accounts:

	$m	$m
DEBIT Retained earnings	105	
CREDIT Trade receivables		100
CREDIT Defined benefit pension scheme		5

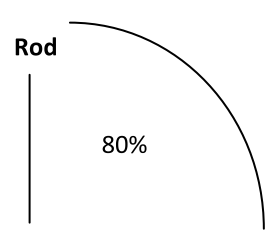
(b) ROD

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 30 NOVEMBER 20X2

	$m
Non-current assets	
Property, plant and equipment (W5)	1,930
Goodwill (W2)	132
	2,062
Current assets	
Inventories (300 + 135 + 65 – 20)	480
Receivables (240 + 105 + 49 – 100)	294
Cash at bank and in hand	220
	994
	3,056
Equity attributable to owners of the parent	
Share capital	1,500
Share premium	300
Retained earnings (W4)	586
	2,386
Non-controlling interest (W3)	265
	2,651
Non-current liabilities	
Pension scheme	5
Other	180
Current liabilities	20
	3,056

Workings

1 Group structure



Reed 40%

25%

Line

Rod's total holding in Line is 60% (40% direct + 80% × 25% indirect).

2 Goodwill

	Rod in Reel		**Reel in Line**		**Rod in Line**	
	$m	**$m**	**$m**	**$m**	**$m**	**$m**
Consideration transferred		640	80% × 100	80		160
Net assets acquired						
Share capital	500		200		200	
Share premium	100		50		50	
Retained earnings	100		50		50	
Fair value adjustment	10		–		–	
	710		300		300	
Group share	80%		20%		40%	
		(568)		(60)		(120)
		72		20		40

Total goodwill: $72m + $20m + $40m = $132m

3 Non controlling interests

	Reel	**Line**
	$m	**$m**
Net assets per question	800	380
Investment in Line	(100)	-
Development costs written off	(20)	-
Trade discount on PPE less depreciation	(5)	-
Elimination of revaluation reserve (W6)–	-	(70)
Adjustment for excess depreciation (W6)	-	14
	675	324
	X 20%	X 40%

264.6

4 Retained earnings

	Rod	**Reel**	**Line**
	$m	**$m**	**$m**
Per question	625.0	200	60
Fair value adjustment realized		(10)	
Development costs written off		(20)	
Trade discount on tangible assets less depreciation		(5)	
Adjustment for excess depreciation (W6)			14
At acquisition		(100)	(50)
	625.0	65	24
Group share of Reel (80% x 65)	52.0		
Group share of Line (60% x 24)	14.4		

Less defined benefit pension scheme (part (a))	(105.0)
	586.4

Note. The development costs do not meet the recognition criteria in IAS 38 and they cannot be treated as inventory because they have previously been written off as incurred. They were reinstated after acquisition, so they must be written off post-acquisition reserves.

5 Property, plant and equipment

	$m
Rod	1,230
Reel	505
Line	256
	1,991
Less adjustment to PPE of Line (W6)	(56)
Reel: trade discount net of depreciation (6 ⍰ 5/6)	(5)
	1,930

Note. IAS 16 states that the cost of a item of PPE should be measured net of trade discounts. The trade discount must be deducted from Reel's tangible assets.

6 Adjustment to property, plant and equipment of Line

An adjustment must be made to re-state the PPE of Line from their revalued amount to depreciated historical cost, in line with group accounting policies.

The revaluation took place after acquisition, so the adjustment does not affect goodwill.

	Valuation $m	Depreciation historic cost $m
Cost at 1 December 20X1 (date of acquisition by Rod)	300	300
Depreciation (300/6)	(50)	(50)
NBV at 30 November 20X2	250	250
Revaluation	70	
Revalued amount	320	
Depreciation (320/5)	(64)	50)
NBV at 30 November 20X3	256	200
Adjustment required to the group accounts:	**$m**	**$m**
DEBIT Revaluation surplus	70	
CREDIT Retained earnings (64 – 50)		14
CREDIT Property, plant and equipment (256 – 200)		56

(c) (i) Restructuring of the group

IAS 37 Provisions, contingent liabilities and contingent assets contains specific requirements relating to restructuring provisions. The general recognition criteria apply and IAS 37 also states that a provision should be recognised if an entity has a constructive obligation to carry out a restructuring. A constructive obligation exists where management has a detailed formal plan for the restructuring and has also raised a valid expectation in those affected that it will carry out the restructuring. In this case, the company made a public announcement of the restructuring after the year end, but it had actually drawn up the formal plan and started to implement it before the year end, by communicating the plan to trade union representatives. Although the plan is expected to take two years to complete, it appears that the company had a constructive obligation to restructure at the year end. Therefore a provision should be recognised.

IAS 37 states that a restructuring provision should include only the direct expenditure arising from the restructuring. Costs that relate to the future conduct of the business, such as training and relocation costs, should not be included. Measuring the provision is likely to be difficult in practice, given that the restructuring will take place over two years. IAS 37 requires the provision to be the best estimate of the expenditure required to settle the present obligation at the reporting date, taking all known risks and uncertainties into account. There may be a case for providing $50 million (total costs of $60 million less relocation costs of $10 million) and the company should certainly provide at least $15 million ($20 million incurred by the time the financial statements are approved less $5 million relocation expenses). IAS 37 requires extensive disclosures and these should include an indication of the uncertainties about the amount or timing of the cash outflows.

(ii) Fine for illegal receipt of a state subsidy

IAS 38 Intangible assets defines an intangible asset as a resource controlled by the company as a result of past events and from which economic benefits are expected to flow. The fine does not meet this definition. The subsidy was used to offset trading losses, not to generate future income. The fine should be charged as an expense in the income statement for the year ended 30 November 20X4. As it is material it should be separately disclosed.

(d) Rod spends considerable amounts of money on research that ultimately creates economic benefits and enhances shareholder value. However, this research does not meet the criteria for deferral under IAS 38 Intangible assets because of the time lag between the expenditure and the revenue that it generates. Therefore the company's activities appear to reduce profits, rather than increase them. The company's expertise is part of its inherent goodwill and cannot be valued reliably at a monetary amount. Therefore it is not recognised on the statement of financial position.

There is a strong argument that traditional financial reporting is inadequate to deal with 'knowledge led' companies such as Rod. It is possible that the capital markets will undervalue the company because the financial statements do not reflect the 'true' effect of the company's research activities. The economy is becoming more 'knowledge based' and many companies find themselves in this situation.

The market value of a company is based on the market's assessment of its future prospects, based on available information. Analysts have developed alternative measures of performance such as Economic Value Added (EVA). These take factors such as expenditure on research and development expenditure into account, so that they attempt to assess estimated future cash flows. There is a growing interest in ways of measuring shareholder value as opposed to earnings.

Analysts and other users of the financial statements now recognise the importance of non-financial information about a company. Many Stock Exchanges require companies to present an Operating and Financial Review (sometimes called Management Discussion and Analysis) and some large companies do so voluntarily. This normally includes a description of the business, its objectives and its strategy. It is current best practice to analyse the main factors and influences that may have an effect on future performance and to comment on how the directors have sought to maintain and improve future performance. In this way the directors of Rod can make the markets aware of its research activities and the way in which they give rise to future income streams and enhance shareholder value.

(e) Internal auditor bonusFor

The chief internal auditor is an employee of Rod, which pays a salary to him or her. As part of the internal control function, he or she is helping to keep down costs and increase profitability. It could therefore be argued that the chief internal auditor should have a reward for adding to the profit of the business. Against Conversely, the problem remains that, if the chief internal auditor receives a bonus based on results, he or she may be tempted to allow certain actions, practices or transactions which should be stopped, but which are increasing the profit of the business, and therefore the bonus.

Conclusion

On balance, it is not advisable for the chief internal auditor to receive a bonus based on the company's profit.

A -9

(a) EXOTIC GROUP

CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20X9

	$'000
Revenue (W4)	92,120
Cost of sales (W5)	(27,915)
Gross profit	64,205
Distribution costs (3,325 + 2,137 + 1,900)	(7,362)
Administrative expenses (3,475 + 950 + 1,900)	(6,325)
Finance costs	(325)
Profit before tax	50,193
Income tax expense (8,300 + 5,390 + 4,241)	(17,931)
Profit for the year	32,262
Profit attributable to:	
Owners of the parent	28,549
Non-controlling interest (W6)	3,713
	32,262
Dividends paid and declared for the period	92,120

(b) EXOTIC GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	$'000
Property, plant and equipment (35,483 + 24,273 + 13,063 – (W3) 40 + (W3) 8)	72,787
Goodwill (W7)	4,094
	76,881
Current assets (1,568 + 9,025 + 8,883 – (W2) 15 – (W2) 15)	19,446
	96,327
Equity attributable to owners of the parent	
Share capital	8,000
Retained earnings (W9)	56,609
	64,609
Non-controlling interest (W8)	8,584
	73,193
Current liabilities (13,063 + 10,023 + 48)	23,134
	96,327

Workings

1 Group structure

Exotic
| 90%
Melon
| 80%
Kiwi

Effective interest (90% × 80%)	72%
∴Non-controlling interest	28%
	100

2. Intragroup trading

(i) **Cancel**

DEBIT group revenue (260 + 480)	$74,000	
CREDIT group cost of sales		$74,000

(ii)	Melon (60 x331/3/1331/3)		15
	Kiwi (75 x 25/125)		15
	Adjust in books of seller:		
	DEBIT Cost of sales/retained earnings		

3 Intragroup transfer of equipment

(i)			
	Cancel intragroup sale/purchase:		
	DEBIT group revenue	$240,000	
	CREDIT group cost of sales		$240,000
(ii)	Unrealised profit on intragroup sale of equipment		
			$'000
	Adjust in books of seller (Exotic):		
	DEBIT Cost of sales/retained earnings	$40,000	
	CREDIT Group property, plant and equipment		$40,000
(iii)	Excess depreciation		
			$'000
	240,000 – 200,000) x 20%		8
	Adjust in books of seller (Exotic):		
	DEBIT Property, plant and equipment	$8,000	
	CREDIT Cost of sales/retained earnings		$8,000

4 Revenue

	$'000
Exotic	45,600
Melon	24,700
Kiwi	22,800
Less intragroup sales (W2)	(740)
Less intragroup transfer of equipment (W3)	(240)
	92,120

5 Cost of sales

	$'000
Exotic	18,050
Melon	5,463
Kiwi	5,320
Less intragroup purchases (W2)	(740)
Less intragroup transfer of equipment (at transfer price) (W3)	(240)
Add unrealised profit on transfer of equipment (W3)	40
Less excess depreciation (240 – 200) x 20%	(8)
Add PUP (W2): Melon	15
Kiwi	15
	27,915

6 non controlling interest (income statement)

	$'000
Melon ((10,760 – (W2) 15) x 10%)	1,074
Kiwi ((9,439 – (W2) 15) x (W1) 28%)	2,639
	3,713

7

	Exotic in Melon			Melon in Kiwi		
	Group		NCI	Group		NCI
	$'000	**$'000**	**$'000**	**$'000**	**$'000**	**$'000**
Consideration transferred/FV NCI		6,650	500.0	90% × 3,800	3,420	900
Share of net assets acquired:						
Share capital	3,000			2,000		
Retained earnings at acquisition	1,425			950		
	4,425			2,950		
Group/NCI share	90%		10%	72%		28%
		(3,983)	(442.5)		(2,124)	(826)
		2,667	57.5		1,296	74
				4,094.5		

8 non controlling interest (statement of financial position)

	Melon	Kiwi
	$'000	**$'000**
Net assets per question	27,075	21,898
Less: PUP (W2)	(15)	(15)
Less: Cost of investment in Kiwi	3,800)	
	23,260	21,883
	x10%	x 28%
Non-controlling interest share	2,326.0	6,127
Non-controlling interests in goodwill (W7)	57.5	74
	2,383.5	6,201

9 Retained earnings

		Exotic	Melon	Kiwi
		$'000	**$'000**	**$'000**
Retained earnings per question		22,638	24,075	19,898
Less: PUP (W2)			(15)	
		(15)		
Transfer of equipment (W3):	**PUP**	(40)		
	excess dep'n	8		
Pre-acquisition retained earnings			(1,425	(950)
			22,635	18,933
Share of Melon (22,635 × 90%)		20,372		
Share of Kiwi (18,933 × (W1) 72%)		13,631		
		56,609		

(c) Goodwill arising on acquisition of Zest Software

The company believes that this goodwill has an indefinite economic life and therefore it will be retained in the statement of financial position indefinitely. IFRS 3 Business combinations states that goodwill arising on a business combination should be recognised as an intangible asset and is not amortised. However, goodwill must be reviewed for impairment annually and impairment losses charged to the income statement where necessary. It should be noted that software products generally have short lives and the sector is not noted for stability. This suggests that in practice the goodwill is likely to suffer impairment within a reasonably short time.

Interest in joint venture

Although the main standard dealing with joint ventures is IAS 31 Interests in joint ventures, the company uses the equity method to account for its interest. IAS 31 allows the use of the equity method and IAS 28

Investments in associates deals with its application.

IAS 28 states that if an investor's share of the losses of an associate equals its interest in the associate, it discontinues recognising its share of further losses. The investment is reported at nil value. In theory, IAS

28 does not prevent the company from including the loan to the joint venture as part of its investment, particularly if it is a long-term loan. Therefore the net liability in the joint venture should not be offset against the loan. (However, IAS 1 Presentation of financial statements prohibits offsetting unless required or permitted by a standard.)

This leaves a net liability of $3 million (the company's share of the net assets of the joint venture of $3 million less negative goodwill of $6 million). In this case the net liability arises from negative goodwill, rather than net liabilities in the joint venture itself. IAS 28 states that where there is negative goodwill this should be excluded from the carrying amount of the investment and should be immediately recognised in profit or loss (as a gain). This treatment of negative goodwill is also required by IFRS 3.

Therefore the net interest in the joint venture should be reported in the statement of financial position as a non-current asset investment (the usual treatment for an investment in a joint venture accounted for using the equity method at a value of $3 million and the negative goodwill of $6 million recognised in profit or loss).

(d) Environmental reporting

At present, most companies are not specifically required to report any information about the way in which their activities affect the environment.

Some accounting standards require disclosure of specific environmental information:

- IAS 1 Presentation of financial statements requires details of material items recognised in profit or loss; these may include environmental costs.
- IAS 37 Provisions, contingent liabilities and contingent assets requires disclosure of information about provisions and contingent liabilities relating to environmental matters.

In addition, many companies, particularly listed companies, may present an Operating and Financial Review or Management Discussion and Analysis. It is best practice to describe business risks related to environmental issues, and to disclose details of potential environmental liabilities and environmental protection costs.

Apart from this, companies can disclose as much or as little information as they wish in whatever way that they wish.

In practice companies often present information selectively or in such a general way that it is meaningless. This means that it is difficult to compare the performance of different companies. However, many large companies publish extensive and extremely informative 'environmental reports' that are completely separate from the financial statements themselves. Because most environmental disclosures do not have to be audited, users cannot yet rely on the environmental information included in the financial statements. Progas's operations clearly do have an impact on the environment and the company should seriously consider disclosing environmental information in its financial statements. By acknowledging its responsibility for the environment, a company can enhance its reputation and distinguish itself from competitors. Information that would be useful to users of the financial statements might include the following.

(i) Details of emissions, including reductions/increases from the previous year;
(ii) The impact of gas emissions on the environment and action taken to minimise this impact;
(iii) Expenditure on restoring the countryside after pipelines have been laid;
(iv) Details of any infringement of environmental laws/guidelines including details of any fines.

There are a number of codes of practice which companies may follow, for example, the Sustainability Reporting Guidelines published by the Global Reporting Initiative (GRI). The company may also consider signing up to the Eco Management and Audit Scheme (EMAS). This would involve agreeing to a specific code of practice with the environmental report being validated by an accredited independent verifier.

A -10

ANGEL GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X8

Non-current assets	
	$'000
Property, plant and equipment	200.00

Investment in Shane (W3)	133.15
	333.15
Current assets (890 + 120)	1,010.00
	1,343.15
Equity attributable to owners of the parent	
Share capital	500.00
Retained earnings (W5)	533.15
	1,033.15
Current liabilities	310.00
	1,343.15

ANGEL GROUP

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X8

	$'000
Profit before interest and tax [100 + (20 x 6/12)]	110.00
Profit on disposal of shares in subsidiary (W4)	80.3
Share of profit of associate (12 ? 35% ? 6/12)	2.10
Profit before tax	192.40
Income tax expense [40 + (8 ? 6/12)]	(44.00
Profit for the year	148.40
Other comprehensive income net of tax [10 + (6 × 6/12)]	13.00
Share of other comprehensive income of associate (6 × 35% × 6/12)	1.05
Other comprehensive income for the year	14.05
Total comprehensive income for the year	162.45
Profit attributable to:	
Owners of the parent	146.60
Non-controlling interests (12 ? 6/12 ? 30%)	1.80
	148.40
Total comprehensive income attributable to:	
Owners of the parents	159.75
Non controlling interests (18 × 6/12 × 30%)	2.70
	162.45

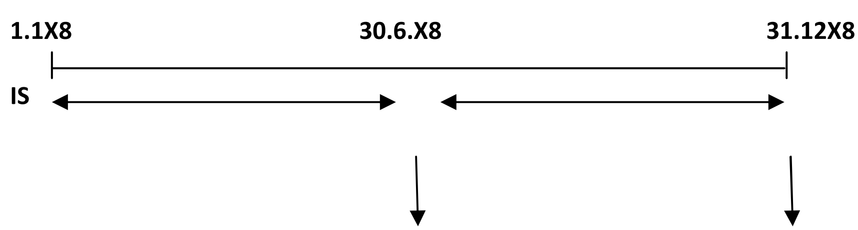
ANGEL GROUP

CONSOLIDATED RECONCILIATION OF MOVEMENT IN RETAINED RESERVES

	$'000
Balance at 31 December 20X7 (W6)	373.40
Profit for the year	159.75
Balance at 31 December 20X8 (W5)	533.15

Workings

1 Timeline



Subsidiary – 6/12	Associate – 6/12

Group gain
on disposal

2 Goodwill - Shane

	$'000	$'000
Consideration transferred		100
Less:		
Share capital	100	
Retained earnings	10	
	110	
Group share (110 x 70%)		(77)
		43

3 Investment in associate

	$'000
Fair value at date control lost	130.00
Share of post 'acquisition' retained reserves: 18 × 6/12 × 35%	3.15
	133.15

4 Group profit on disposal of Shane

	$'000	$'000
Fair value of consideration received		120.0
Fair value of 35% investment retained		130.0
Less share of carrying value when control lost		
Net assets (190 – (18 × 6/12)) × 70%	126.7	
Goodwill belonging to owners of the parent (W2)	43.0	
		(169.7)
		80.3

5 Group retained reserves

	Angel	Shane 35%	Shane 35% sold
Per qu/dates of disposal (90 – (18 × 6/12))	400.00	90	81
Group profit on disposal (W4)	80.30		
Less pre-acquisition		(10)	(10)
		80	71
Shane: 35% retained × 80	28.00		
Shane: 35% sold × 71	24.85		

6 Retained reserves b/f

	Angel $'000	Shane $'000
Per Q	330.0	72
Less: Pre-acquisition retained reserves		(10)
	330.0	62
Shane – Share of post acquisition ret'd reserves (62 ? 70%)	43.4	
	373.4	

A -11

Key considerations and accounting impacts

There are a number of reasons why a group may re-organise.

- To reduce gearing by floating a business
- Companies may be transferred to another business during a divisionalisation process
- To create efficiencies of group structure for tax purposes The impact of each of the proposed structures is discussed below. Plan 1

The implications of this plan will be different, depending on the choice of purchase consideration.

Share for share exchange

If the purchase consideration is in the form of shares, then a share premium account will need to be set up in the books of Y. This share premium account must comprise the minimum premium value, which is the excess of the book value of the investment over the nominal value of the shares issued: $70m − $50m = $20m.

The impact on the individual company accounts and on the group accounts is as follows.

	Note	**X**	**Y**	**Z**	**Group**
		$m	**$m**	**$m**	**$m**
Property, plant and equipment		600	200	45	845
Intangible assets: goodwill					10
Cost of investment in Y	1	130			
Cost of investment in Z	2		70		
Net current assets		160	100	20	280
		890	370	65	1,135
	Note	X	Y	Z	Group
Share capital	3	120	110	40	120
Share premium	4		20		
Retained earnings	5	770	240	25	1,015
		890	370	65	1,135

Notes

1 Cost of investment in Y

This is increased by the total value of the shares issued: $50m + $20m = $70m.

2 Cost of investment in Z

Transferred to Y. The book value of the investment is preserved.

3 Share capital

Y's share capital is increased by the nominal value of the shares issued, $50m.

4 Share premium

This is as discussed above.

5 Retained earnings

Goodwill arising on the purchase of Z is $10m ($70m − ($40m + $20m)). The group retained earnings are calculated as follows.

	X	**Y**	**Z**
	$m	**$m**	**$m**
Per question	770	240	25
Retained earnings at acquisition		-	(20)

	770	240	5
Share of post-acquisition profits of Y (100%)	240		
Share of post-acquisition profits of Z (100%)	5		
	1,015		

Cash purchase

The group accounts are not affected by the change as the reorganisation is internal. It has no impact on the group as a single entity.

If the purchase consideration is in the form of cash, a gain or loss on the sale of Z will arise in the books of X. This does not count as a distribution as the cash price of $75m is not in excess of the fair value of the net assets of Z, $80m. The effect on the accounts would be as follows.

	Note	X	Y	Z	Group
		$m	$m	$m	$m
Property, plant and equipment		600	200	45	845
Goodwill					10
Cost of investment in Y		60			
Cost of investment in Z	1		75		
Net current assets	2	235	25	20	280
		895	300	65	1,135
Share capital		120	60	40	120
Retained earnings	3	775	240	25	1,015
		895	300	65	1,135

Notes

1 Cost of investment in Z

This is the cash consideration of $75m.

2 Net current assets

X's cash increases by $75m and Y's cash decreases by $75m.

3 Retained earnings

X's retained earnings have been increased by $5m, being the profit on the sale of the investment in Z. This is eliminated on consolidation as it is an intra-group transaction. The consolidated retained earnings are calculated in exactly the same way as in the share for share exchange.

Plan 2

This restructuring plan is a rationalisation, aimed at simplifying the group structure. An important point to take into account is that the investment in Z in the books of X may be impaired. Z was originally purchased for $70m, with goodwill of $10m arising, but the assets have been transferred to Y at book value of $60m. Z will be a shell company with a net asset value of $60m and this will be shown as an intercompany account with Y. The cost of X's investment in Z should be reduced to $60m, with a corresponding charge to the retained earnings. The accounts would appear as follows.

	Note	X	Y	Z	Group
		$m	$m	$m	$m
Goodwill					10
Property, plant and equipment		600	245		
Cost of investment in Y		60			845
Cost of investment in Z	1	60			
Net current assets	2	160	60	60	280
		880	305	60	1,135

Share capital		120	60	40	120
Revaluation surplus	3		5		
Retained earnings	4	760	240	20	1,015
		880	305	60	1,135

Notes

1 Cost of investment in Z

	$m
Per question	70
Less impairment	(10)
	60

2 Net current assets

Y's net current assets are $100m + $20m less intragroup payable $60m.

Note that this calculation is based on the assumption that the $10m loss in X's books, the revaluation gain in Y's books and the loss on the transfer of assets to Y in Z's books are intragroup items and can be ignored.

3 Revaluation surplus

This is the gain on the purchase of the assets from Z: $65m − $60m.

4 Retained earnings

X's individual retained earnings are $770m less the impairment of $10m, which gives $760m. The group retained earnings are calculated as follows.

	X $m	Y $m	Z $m	Group $m
Per question	770	240		25
Retained earnings at acquisition	–	–		(20)
	770	240		5
Share of post-acquisition profits of Y (100%)	240			
Share of post-acquisition profits of Z (100%)	5			
	1,015			

Z's retained earnings are $20m, ie $25m less $5m loss on transfer of assets.

Summary and conclusion

There are advantages and disadvantages to each of the three plans. Before we could make a recommendation we would need more information about why the group wishes to restructure.

Plan 1 does not change the group financial statements. From an internal point of view it results in a closer relationship between Y and Z. This may be advantageous if Y and Z are close geographically or in terms of similarity of business activities. Alternatively, it might be advantageous for tax reasons.

Plan 2 is an example of divisionalisation: the assets and trade of Z are transferred to Y and Z becomes a shell company. This could result in cost savings overall. Furthermore, Z becomes a non-trading company and this could be used for some other purpose.

A -12

	Marks
Goodwill	7
Joint venture	2
Financial assets	7
Dividend	2

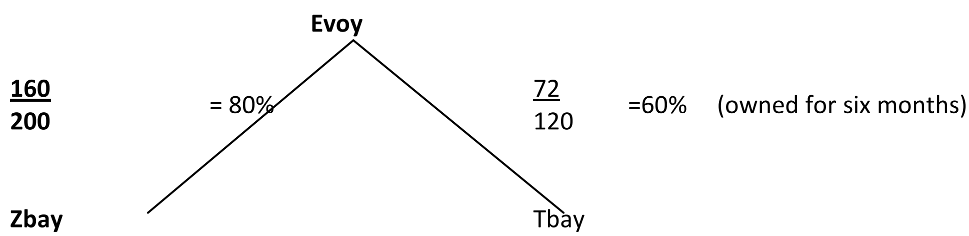
Income statement	7
Tbay	4
Non-controlling interest	2
Available	31
Maximum	25

EJOY: CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 MAY 20X6

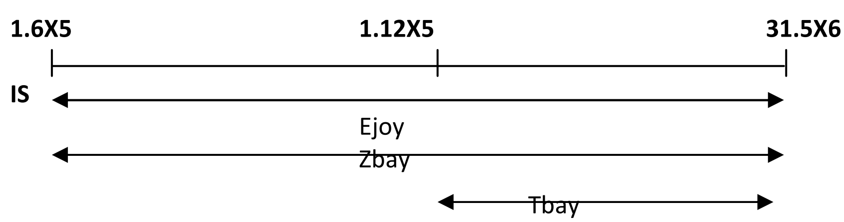
	$m
Continuing operations	
Revenue (2,500 + 1,500)	4,000
Cost of sales (1,800 + 1,200 + 26 (W8))	(3,026)
Gross profit	974
Other income (70 + 10 – 3 (W11) – 24 (W2))	53
Distribution costs (130 + 120)	
(250) Administrative expenses (100 + 90)	(190)
Finance income (W5)	6
Finance costs (W6)	(134)
Profit before tax	459
Income tax expense (200 + 26)	(226)
Profit for period from continuing operations	233
Discontinued operations	
Profit for the year from discontinued operations ((30 × 6/12) – 2 (W8))	13
Profit for the year	246
Profit attributable to:	
Owners of the parent	241
Non-controlling interest (W12)	5
	246

Workings

1. Group structure



Timeline



2 Pre-acquisition dividend income

Pre-acquisition dividend income (Tbay)

	$m	$m
Dividend treated as a reduction in cost of investment (60% × 40)		24

DEBIT Dividend income	24	
CREDIT Cost of investment in Tbay (W7)		24

3 Loan asset held by Zbay

	$m
Carrying value of loan at 1.6.X5 (a financial asset)	60.0
Impairment loss (balancing figure)	(42.2)
Present value of expected future cash flows (20 x $\frac{1}{1.06^2}$ at 1.6.X5 (note)	17.8
Interest income (6% × 17.8)	1.1
At 31.5.X6	18.9

Note. The $20 million is expected to be received on 31 May 20X7, ie. in two years' time.

4 Hedged bond (Ejoy)

	$m
1.6.X5	50.0
Interest income (5% × 50)	2.5
Fair value loss (balancing figure)	(1.7)
Fair value at 31.5.X6 (per question)	48.3

Because the interest rate swap is 100% effective as a fair value hedge, it exactly offsets the loss in value of$1.7 million on the bond. The bond is an 'available for sale' item (per IAS 39) and therefore the loss would normally be taken to equity, but because hedge accounting is adopted both the gain on the swap and the loss on the bond are recognised in profit or loss as income and expense. The net effect on profit or loss is nil.

5 Finance income

	$m
Interest income on loan asset held by Zbay (W3)	1.1
Interest receivable on bond held by Ejoy (W4)	2.5
Interest received on interest rate swap held by Ejoy	0.5
Fair value gain on interest rate swap	1.7
	5.8

6 Finance costs

	$m
Per draft income statements (50 + 40)	90
Impairment loss (loan asset held by Zbay) (W3)	42.2
Fair value loss on hedged bond (W4)	1.7
	133.9

7 Goodwill

	Zbay		Tbay	
	$m	$m	$m	$m
Consideration transferred		520		216
Less pre-acquisition dividend (W2)				(24)
Fair value of net assets at Acquisition	600		310	
Group share (W1)	80%		60%	
		(480)		(186)
		40		6

8 Impairment Loss

	Zbay	Tbay
	$m	$m

Notional goodwill (40 × 100/80) (6 × 100%) (W7)	50.0	10.0
Carrying amount of net assets (W9)/(W10)	612.9	285.0
	662.9	295.0
Recoverable amount 630/(300 – (5 × 100/60))	(630.0)	291.7)
Impairment loss: gross	32.9	3.3
Impairment loss recognised: all allocated to goodwill		
(80% x 32.9)/(60% × 3.3)	26.3	2.0

9 Carrying amount of net assets at 31 May 20X6 (Zbay)

	$m
Fair value of identifiable assets and liabilities acquired (1 June 20X4)	600.0
Profit for year to 31 May 20X5	20.0
Profit for year to 31 May 20X6 per draft income statement	34.0
Less impairment loss (loan asset) (W3)	(42.2)
Interest income (loan asset) (W3)	1.1
	612.9

10 Carrying amount of net assets (Tbay)

	$m
Carrying value of investment in Tbay at 31 May 20X6:	
Fair value of net assets at acquisition (1 December 20X5)	310
Post acquisition profit (30 × 6/12)	15
Less dividend	(40)
	285

11 Joint venture

	$m	**$m**
Elimination of other venturer's share of gain on disposal (50% x 6)		3
DEBIT Other income	3	
CREDIT Investment in joint venture		3

12 Non controlling assets

	Zbay	**Tbay**
	$m	**$m**
Profit for period per question	34.0	
x 6/12		15
Less impairment loss on loan asset (W3)	(42.2)	
Interest income on loan asset (W3)	1.1	-
	(7.1)	15
	X20%	X 40%
	(1.4)	6

$$\underbrace{(1.4) \quad 6}_{4.6}$$

A -13

Examiner's comment. In general this question was well answered. However, some candidates used proportional consolidation for the subsidiary, and few treated the share options correctly.

		Marks
(a)	Revenue	1
	Cost of sales	3
	Distribution/administration	1

	Interest expense		2
	Investment income		1
	Taxation		1
	Goodwill		3
	Inter-company profit		2
	Retirement benefit – explanation		2
	Debt – explanation		2
	Share options – explanation		2
	Associate		4
	Non-controlling interest		2
	Gain on disposal/adjustment to parent equity		4
(b)	Revenue recognition		5
(c)	(i)	Strategic issue	1
		Sustainable performance	1
		Transparency	1
		Best practice	1
		Responsible ownership	1
		Reduction of risks	1
		Reputation	1
		Governments	1
		Cultural/social pressures	1
	(ii)	1 mark per point up to a maximum	6
	Maximum		50

(a) BASE GROUP

CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 MAY 20X3

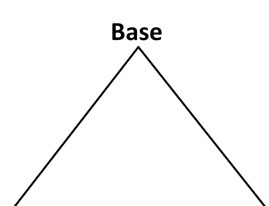
	$m
Revenue (3,000 + 2,300 + (600 x 9/12))	5,750
Cost of sales (W2) (2,000 + 1,600 + 225 – 5 – (3 – 1)	3,822
Gross profit	1,928
Distribution costs (240 + 230 + (120 x 9/12))	(560)
Administrative expenses (200 + 220 + (80 x 9/12))	(480)
Profit on disposal of shares in subsidiary (W8)	35
Finance costs (W3) (20 + 10 + 9 + 1.1 + 3)	(43)
Investment income receivable (100 – (200/350 x 70))	60
Share of loss of associate (W6)	(6)
Profit before tax	934
Income tax expense (130 + 80 + 27)	(237)
Profit for the year	697
Profit attributable to	
Owners of the parent	624
Non-controlling interests (W7)	73
	697

Because Base retained control of Zero, the gain on the sale of the 50 million shares in Zero is treated as an adjustment to the parent's equity in the consolidated statement of financial position. It is calculated as $12m

(W9) n the SOFP, goodwill on the acquisition of Zero will remain at $8m. Non-controlling interests will increase.

Workings

1 Group structure



250/350 for 6 months	60% for 9 months
200/350 for 6 months	40% for 3 months

Zero	Black

Zero was a subsidiary throughout the year.

Black became an associate on 1 March 20X3.

2 Cost of sales

	$m
Base	2,000
Zero	1,600
Black (300 × 9/12)	225
	3,825
Retirement benefit (W4)	(5)
Share options (3 – 1)	2
	3,822

Note. The loss in the value of the share options is included in cost of sales because the options were received in exchange for trade receivables.

3 Finance costs

	$m
Base	20
Zero	10
Black (12 × 9/12)	9
	39
Redeemable debt (20 × 5.4%)	1.1
Retirement benefit plan	3
	43.1

4 Retirement benefits

	$m
Amount originally included in cost of sales	10
Amount that should be included (current service cost only)	(5)
Adjustment (reduction)	5

10% 'corridor' (based on amounts at 31 May 20X2)	
10% of present value of defined benefit obligation ($54m)	$5.4m
10% of fair value of plan assets ($48 m)	$48m

The unrecognised actuarial loss is only $3 million and therefore no loss is recognised during the year.

5 Goodwill

	Zero	Black
	$m	**$m**
Consideration transferred	600	270
Less: fair value of net assets acquired:		
(250/350 x 770)	(550)	
(60% x 400)		(240)
	50	30
Impairment losses to 1 June 20X2	(10)	(6)
Goodwill not yet written off at date of disposal	40	24

6 Share of loss of associate

	$m
Profit for the year (52 ? 3/12 ? 40%)	5.2
Provision for unrealised profit (90 (W10))	(10.8)
	(5.6)

7 Non-controlling interests

	$m
Zero to 1 December 20X2 (160 x 6/12 x 100/350)	23
Zero to 31 May 20X3 (160 x 6/12 x 150/350)	34
Black to 1 March 20X3 (52 x 9/12x 40%)	16
	73

8 Profit on disposal of shares in Black

	$m	$m	$m
Fair value of consideration received			106.0
Fair value of 40% investment retained (40m × $2.65)			240.0
Base's share of consolidated carrying value when control lost			
Share capital	200		
Retained earnings at start of year	190		
Profit for current year (52 ? 9/12)	39		
Fair value adjustment ((400 – (200 + 150))	50		
	479	x 60%	(287.4)
Goodwill not yet written off attributable to owners of parent(W5)			(24.0)
			34.6

9 Adjustment to parent's equity on disposal of Zero

	$m	$m
Fair value of consideration received		155
Increase in NCI in net assets at disposal		
Share capital	350	
Retained earnings at start of year	400	
Profit for current year (160 × 6/12)	80	
Fair value adjustment (770 – 350 – 250)	170	
	1,000	
Increase in NCI 50/350		(143)
		12

Note: No adjustment is made to the non-controlling interests in goodwill as they are not recognised as a group policy is to hold non-controlling interests at their proportionate share of the fair because value of the identifiable net assets not at fair value.

10 Provision for unrealised profit

$90 x 30% = $25m

Group share: 40% = $10.8m

(b) Revenue from the sale of software under licences

At present the company must comply with IAS 18 Revenue, although this standard only sets out general principles. There have recently been several high profile cases in which companies have been criticised for adopting questionable revenue recognition policies. As a result, many companies have turned to US GAAP where this provides further guidance on reporting specific types of transaction. In itself, this does not contravene IAS 18.

However, IAS 18 does require that where a transaction consists of more than one distinct element, each element should be accounted for separately. An Appendix to IAS 18 states that where the selling price of the product includes an identifiable amount for subsequent servicing, that amount, including a profit element, should be deferred and recognised as revenue over the period during which the service is performed. Alternatively, it could be argued that the provision of the software and the services are linked and should be treated as one transaction. The correct accounting treatment depends on the economic substance of the transactions.

The Appendix to IAS 18 also states that fees from the development of customised software should be recognised by reference to the stage of completion of the development. At present the company only recognises revenue at the completion of the contract and therefore this accounting policy should be changed.

(c) (i) There are a number of factors which encourage companies to disclose social and environmental information in their financial statements.

Public interest in corporate social responsibility is steadily increasing. Although financial statements are primarily intended for investors and their advisers, there is growing recognition that companies actually have a number of different stakeholders. These include customers, employees and the general public, all of whom are potentially interested in the way in which a company's operations affect the natural environment and the wider community. These stakeholders can have a considerable effect on a company's performance. As a result many companies now deliberately attempt to build a reputation for social and environmental responsibility. Therefore the disclosure of environmental and social information is essential. There is also growing recognition that corporate social responsibility is actually an important part of an entity's overall performance. Responsible practice in areas such as reduction of damage to the environment and recruitment increases shareholder value. Companies that act responsibly and make social and environmental disclosures are perceived as better investments than those that do not.

Another factor is growing interest by governments and professional bodies. Although there are no IFRSs that specifically require environmental and social reporting, it may be required by company legislation. There are now a number of awards for environmental and social reports and high quality disclosure in financial statements. These provide further encouragement to disclose information.

At present companies are normally able to disclose as much or as little information as they wish in whatever manner that they wish. This causes a number of problems. Companies tend to disclose information selectively and it is difficult for users of the financial statements to compare the performance of different companies. However, there are good arguments for continuing to allow companies a certain amount of freedom to determine the information that they disclose. If detailed rules are imposed, companies are likely to adopt a 'checklist' approach and will present information in a very general and standardised way, so that it is of very little use to stakeholders.

(ii) The Base Group could improve its disclosure of 'Corporate Environmental Governance' by including the following information in its financial statements:

(1) a general description of its policies relating to the environment

(2) descriptions of the ways in which the company seeks to manage and minimise environmental risks

(3) details of any serious pollution incidents that have occurred during the year and details of any fines imposed for environmental offences

(4) a report on the company's environmental performance including details of acid gas and other emissions and details of how the company's activities affect the natural environment in other ways. The report should include narrative information (descriptions of how the risks are reduced) and numerical information if this is verifiable

(5) details of the company's targets (key performance indicators) for reducing emissions and other forms of pollution and whether these have been met; historical data should be included here if this is practicable

There exist a number of guidelines that set out the information that should be disclosed in an environmental report (for example, the Global Reporting Initiative (GRI) framework of performance indicators). The guidance is non-mandatory, but represents best practice. Ideally, the environmental information should be audited.

A -14

Consolidated Statement of Financial Position at 31 May 2009

	$m
Assets:	
Non-current assets:	
Property, plant and equipment W9	708
Goodwill W2	25
Investment in associate W3	22·5
Available for sale financial assets W10	44·6
	800·1
Current assets:	
Inventories W10	245
Trade receivables W11	168
Loans to directors	1
Cash and cash equivalents	209
	623
Total assets	1,423·1
Equity and liabilities	
Equity attributable to owners of parent	
Share capital	520
Retained earnings W5	256·32
Other components of equity W5	9·5
	785·82
Non-controlling interest W7	148·88
	934·7
Non-current liabilities	
Long-term borrowings	140
Deferred tax W10	39·4
Total non-current liabilities	179·4
Current liabilities	
Trade and other payables W6	217
Current tax payable	92
Total current liabilities	309
Total liabilities	488·4
Total equity and liabilities	1,423·1

Working 1
Message

	$m
Fair value of consideration for 80% interest	300
Fair value of non-controlling interest	86
	386
Amount of identifiable net assets acquired	(400)
Gain on bargain purchase	(14)

Essentially the entries would be:

DR	**Net identifiable assets**	400	
CR	**Cash**		300
CR	**Gain on bargain purchase**		14
CR	**Equity – non-controlling interest**		86
		400	400

Working 2

Mixted

	$m
1 June 2008 (128 – 10)	118
Contingent consideration	12
Total consideration transferred	130
Fair value of equity interest held before business combination	15
Fair value of consideration	145
Fair value of non-controlling interest	53
	198
Identifiable net assets	(170)
Increase in value	(6)
Deferred tax (176 – 166) x 30%	3
Goodwill	25

Working 3
Clarity
The gain of 1 recorded within other equity should now be deemed realised once the shareholding has been increased to 25%. An adjustment is required to reclassify this gain.

DR	**Other components of equity (9 – 8)**	1
CR	**Profit or Loss (Retained Earnings)**	1

The amount included in the consolidated statement of financial position would be:

	$m
Cost ($9 million + $11 million)	20
Share of post acquisition profits ($10 million x 25%)	2.5
	22.5

(There is an alternative way of dealing with Clarity which is reduce the value of the original investment to cost as it has been classified as available for sale.

DR	**Other components of equity (9 – 8)**	1
CR	**Investment in associate**	1

The amount included in the consolidated statement of financial position would be:

	$m
Cost ($8 million + $11 million)	19
Share of post acquisition profits ($6 million x 10% + $10 million x 25%)	3.1
	22.1

This would affect the statement of financial position.)

Working 4
Available for sale instrument

Date	**Exchange rate**	**Value**		**Change in fair value**
		Dinars m	**$m**	
1 June 2007	4·5	11	49·5	
31 May 2008	5·1	10	51	1·5
31 May 2009	4·8	7	33·6	(17·4)

The asset's fair value in the overseas currency has declined for successive periods. However, no impairment loss is recognised in the year ended 31 May 2008 as there is no loss in the reporting currency ($). The gain of $1·5 million would be recorded in equity. However, in the year to 31 May 2009 an impairment loss of $17·4 million will be recorded as follows:

$m

DR Other components of equity	1·5
DR Profit or loss	15·9
CRAFS investments	17·4

Working 5

Retained earnings

	$m
Bravado:	
Balance at 31 May 2009	240
Associate profits W3	2·5
AFS impairment W4	(15·9)
Increase in fair value of Clarity now realized	1
Write down of inventory W8	(18)
Increase in fair value of equity interest – Mixted (15 – 1	5
Gain on bargain purchase	14
Post acquisition reserves: Message	11·2
Mixted	16·52
	256·32
Message:	
Post acquisition reserves (150 – 136) i.e. $14m	
Group reserves – 80%	11·2
NCI – 20%	2·8
	14
Mixted:	
Post acquisition reserves:	
at 31 May 2009 (80 – 55)	25
Less increase in depreciation	(2)
Add deferred tax movement	0·6
	23·6
Group reserves – 70%	16·52
NCI – 30%	7·08
	23·6

Bravado: other components of equity	**$m**
Balance at 31 May 2009	12
Investment in associate W3	(1)
Impairment loss – AFS W4	(1·5)
	9·5

Working 6

Current liabilities – trade payables	**$m**
Balance at 31 May 2009	
Bravado	115
Message	30
Mixted	60
	205
Contingent consideration	12
	217

Working 7

Non-controlling interest	**$m**
Message	86
Post acquisition reserves	2·8
	88·8
Mixted	53
Post acquisition reserves	7·08
	60·08

Total	148·88

Working 8

Inventories

IAS2 'Inventories' states that estimates of net realisable value should take into account fluctuations in price occurring after the end of the period to the extent that it confirms conditions at the year end. The new model would have been developed over a period of time and, therefore, would have existed at the year end. The loss in value should be adjusted for. Additionally, although the selling price per stage can be determined, net realisable value (NRV) is based on the selling price of the finished product, and this should be used to calculate NRV.

	$m
Selling price of units	1,450
Less selling costs	(10)
NRV	1,440
Less conversion costs	(500)
NRV at 1st stage	940

Write down	**$m**
200,000 units x (1,500 – 1,440)	12
100,000 units x (1,000 – 940)	6
	18

There will have to be an investigation of the difference between the total value of the above inventory and the amount in the financial statements.

Working 9
Property, plant and equipment

	$m	$m
Bravado	265	
Message	230	
Mixted	161	
Increase in value of land – Message (400 – 220 – 136 – 4)		656
Increase in value of PPE – Mixted (176 – 100 – 55 – 7)		40
Less: increased depreciation (14 ÷ 7)		14
		(2)
		708

Working 10

Available for sale financial assets	**$m**	
Bravado	51	**$m**
Message	6	
Mixted	5	
Less: impairment loss		62
		(17·4)
		44·6
Inventories	**$m**	**$m**
Bravado	135	
Message	55	
Mixted	73	
		263
Less: write down to NRV		(18)
		245

Deferred tax	$m	$m
Bravado	25	
Message	9	
Mixted	3	
		37
Arising on acquisition		3
Movement to year end		(0.6)
		39.4

Working 11

Trade receivables

	$m	
Bravado	91	
Message	45	
Mixted	32	
		168

(b) Message:
Gain on bargain purchase if proportionate interest method is used.

	$m
Consideration	300
Identifiable net assets	400)
Non-controlling interest (20% x 400)	80
Gain on bargain purchase	(20)

	$m
Mixted:	
Purchase consideration	145
Identifiable net assets less deferred tax	
(170 initial fair value + 6 additional fair value – 3 deferred tax)	173)
Non-controlling interest (30% x 173)	51·9
Goodwill	23·9

Thus in the case of Mixted, the proportionate interest method results in lower net assets in the statement of financial position where goodwill is created with the result that impairment of goodwill may be less. Additionally in the case of Message, it results in a higher gain on the bargain purchase which increases the reported income.

(c) Showing a loan as cash and cash equivalents is misleading. The Framework says that financial statements should have certain characteristics:

(a) understandability

(b) relevance

(c) reliability

(d) comparability

These concepts would preclude the showing of directors' loans in cash. Such information needs separate disclosure as it is relevant to users as it shows the nature of the practices carried out by the company. Reliability requires information to be free from bias and faithfully represent transactions. Comparability is not possible if transactions are not correctly classified. Directors are responsible for the statutory financial statements and if they believe that they are not complying with IFRS, they should take all steps to ensure that the error or irregularity is rectified. Every director will be deemed to have knowledge of the content of the financial statements. In some countries loans to directors are illegal and directors can be personally liable. Directors have a responsibility to act honestly and ethically and not be motivated by personal interest and gain. If the ethical conduct of the directors is questionable then other areas of the financial statements may need scrutiny. A loan of this nature could create a conflict of interest as the directors' personal interests may interfere or conflict with those of the company's. The accurate and full recording of business activities is essential to fulfil the financial and legal obligations of a director as is the efficient use of corporate assets. The loan to a director conflicts with the latter principle.

A-15

(a) Disposal of equity interest in Sitin

The gain recognised in profit or loss would be as follows:

	$m
Fair value of consideration	23
Fair value of residual interest	13
Gain reported in comprehensive income	1
	37
less net assets and goodwill derecognized	
net assets	(36)
goodwill ($39 – $32 million)	(7)
Loss on disposal	(6)

(b) Grange plc

Consolidated Statement of Financial Position at 30 November 2009

	$m
Assets:	
Non-current assets	
Property, plant and equipment (W6)	784·47
Investment property (W7)	8
Goodwill (30 + 8)	38
Intangible assets (10 – 3)	7
Investment in Associate (Part a)	13
	850·47
Current assets	920
Total assets	1,770·47
Equity and liabilities:	
Share capital	430
Retained earnings (W3)	401·67
Other components of equity (W3)	57·98
	889·65
Non-controlling interest (W5)	140·82
Total equity	1,030·47
Non-current liabilities	334
Current liabilities	
Trade and other payables	354
Provisions for liabilities (W4)	52
Total current liabilities	406
Total liabilities	740
– Total equity and liabilities	1,770·47

Working 1 Park goodwill and subsequent acquisition

	$m	
Fair value of consideration for 60% interest	250	
Fair value of non-controlling interest	150	400
Fair value of identifiable net assets acquired		(360
Franchise right		(10)

Goodwill	30

Amortisation of Franchise right

1 June 2008 to 30 November 2009 – $10m divided by five years multiplied by 1·5 years is $3 million

Dr Profit or loss $3 million

Cr Franchise right $3 million

Acquisition of further interest

The net assets of Park have increased from $370 million to $(414 + 5 + 10 – 3) i.e. $426 million at 30 November 2009. They have increased by $56 million and therefore the NCI has increased by 40% of $56 million i.e. $22·4 million.

	$m
Park – NCI 1 June 2008	150
Increase in net assets – NCI to 30 November 2009	22·4
NCI – 30 November 2009	172·4
Transfer to equity 20/40	(86·2
Balance at 30 November 2009	86·2
Fair value of consideration	90
Transfer from NCI	(86·2
Negative movement in equity	3·8

Alternatively the acquisition could have been calculated as consideration of $90m less 20% of net assets at second acquisition (20% x (net assets per question 414 + land fair value 5 + franchise fair value 10 less franchise amortisation 3)), resulting in a negative movement in equity of $4·8m. The NCI would therefore be $85·2 million.

Working 2 Fence goodwill and disposal

	$m
Fair value of consideration	214
Fair value of net assets held	(202)
Increase in value of PPE	(4)
Goodwill	8
Sale of equity interest in Fence	
Fair value of consideration received	80
Amount recognised as non-controlling interest (Net Assets per question at year end 232 – provision created 25 + Fair value of PPE at acquisition 4 – depreciation of fair value adjustment 0·53 (4 x 16/12 x 1/10) + goodwill 8) x 25%	(54·62)
Positive movement in parent equity	25·38

Because a provisional fair value had been recognised for the non-current asset and the valuation was received within 12 months of the date of the acquisition, the fair value of the net assets at acquisition is adjusted thus affecting goodwill. Contingent liability – Fence

IFRS 3 (2004) required the contingent liabilities of the acquiree to be recognised and measured in a business combination at acquisition-date fair value. IFRS 3 (2008) effectively reapplies the requirement of IFRS 3 (2004) to measure at acquisition- date fair value regardless of probability, but retains a fi lter based on whether fair value can be measured reliably. This may result in the recognition of contingent liabilities that would not qualify for recognition under IAS 37 Provisions, Contingent Liabilities and Contingent Assets. The following consolidation adjustment would have been made:

Dr Retained earnings $30 million

Cr Contingent liability $30 million

IFRS 3(2008) requires the acquirer to measure contingent liabilities subsequent to the date of acquisition at the higher of the amount that would be recognised in accordance with IAS 37, and the amount initially recognised, less any appropriate cumulative amortisation. These requirements should be applied only for the period in which the item is considered to be a contingent liability, and usually will result in the contingent liability being carried at the value attributed to it in the initial business combination.

In this case, the contingent liability has subsequently met the requirements to be classified as a provision and has been measured in accordance with IAS 37. As a result the provisions for liabilities of Fence will be reduced by $5 million as the contingent liability consolidation adjustment is no longer required and the provision is created as an entry in the financial statements of Fence. No adjustment will be made to goodwill arising on acquisition.

Dr Contingent Liability/Provisions $5 million

Cr Profit or loss $5 million

Working 3 Retained earnings and other components of equity

	$m	$m	$m
Grange:			
Balance at 30 November 2009			410
Associate profits Sitin (post acquisition profit 3 x 100%)			3
Loss on disposal of Sitin			(6)
Impairment			(28)
Investment property – gain			
Provision for legal claims			(7)
Post acquisition reserves: Park (60% x (year end retained earnings 170 – acquisition profit 115 – franchise amortisation 3)			31·2
Fence (100% x (year end retained earnings 65 – acquisition retained earnings 73 + conversion of contingent liability to provision and reduction 5 – FV PPE depreciation 0·53))			(3·53)
			401·67

		$m
Other components of equity		
Balance at 30 November 2009		22
Post acqn reserves	**– Park (60% x (14 – 10))**	2·4
	– Fence (17 – 9)	8
	– Sitin (post acquisition 1 – recycled on disposal 1)	(nil)
Revaluation surplus – foreign property		4
Park – negative movement in equity		(3·8
Fence – positive movement in equity		25·38
		57.98

Working 4 Provisions

	$m
Balance at 30 November 2009	
Grange	10
Park	6
Fence	4
	20
Contingency	30
Cancellation of contingency and introduction of provision	(5)
Provision for environmental claims	7
	52

Working 5 Non-controlling interest

	$m
Park (W1)	86.2
Fence (W2)	54.62
Total	140.82

Working 6 Property, plant and equipment

	$m	$m
Grange	257	

Park	311	
Fence	238	
		806
Increase in value of land – Park (360 – 230 – 115 – 10)		5
Investment property – reclassified		(6)
Impairment – Grange (W9)		(28)
Increase in value of PPE – Fence		4
Less: increased depreciation (4 x 16/12 ÷ 10)		(0.53)
Revaluation surplus foreign property		4
		784.47

Working 7

The land should be classified as an investment property. Although Grange has not decided what to do with the land, it is being held for capital appreciation. IAS 40 'Investment Property' states that land held for indeterminate future use is an investment property where the entity has not decided that it will use the land as owner occupied or for short-term sale. The land will be measured at fair value as Grange has a policy of maximising its return on capital employed. The fall in value of the investment property after the year-end will not affect its year-end valuation as the uncertainty relating to the regeneration occurred after the year-end.

Dr Investment property	$6 million
Cr PPE	$6 million
Dr Investment property	$2 million
Cr Profit or loss	$2 million

No depreciation will be charged

Working 8 Provision for environmental claims

The environmental obligations of $1 million and $6 million (total $7 million) arise from past events but the costs of $4 million relating to the improvement of the manufacturing process relate to the company's future operations and should not be provided for.

Dr Profit or loss	$7 million
Cr Provision	$7 million

Working 9 Restructuring

A provision for restructuring should not be recognised, as a constructive obligation does not exist. A constructive obligation arises when an entity both has a detailed formal plan and makes an announcement of the plan to those affected. The events to date do not provide sufficient detail that would permit recognition of a constructive obligation. Therefore no provision for reorganisation should be made and the costs and benefits of the plan should not be taken into account when determining the impairment loss. Any impairment loss can be allocated to non-current assets, as this is the area in which the directors feel that loss has occurred.

	$m
Carrying value of Grange's net assets	862
Revaluation surplus	4
Provision for legal claims	(7)
Investment property	2
Impairment of investment in Sitin (16 – 13)	(3)
	858
Value-in-use (pre-restructuring)	830
Impairment to PPE	(28)

Working 10 Foreign property

	$m
Value at 30 November 2009 (12m dinars/1·5)	8
Value at acquisition 30 November 2008	4
Revaluation surplus to equity	4
Change in fair value (4m dinars at 1·5)	2·67

Exchange rate change	1·33
(8m dinars at 2 minus 12 million dinars at 1·5)	4

(c) Rules are a very important element of ethics. Usually this means focusing upon the rules contained in the accounting profession's code of professional conduct and references to legislation and corporate codes of conduct. They are an efficient means by which the accounting profession can communicate its expectations as to what behaviour is expected.

A view that equates ethical behaviour with compliance to professional rules could create a narrow perception of what ethical behaviour constitutes. Compliance with rules is not necessarily the same as ethical behaviour. Ethics and rules can be different. Ethical principles and values are used to judge the appropriateness of any rule.

Accountants should have the ability to conclude that a particular rule is inappropriate, unfair, or possibly unethical in any given circumstance. Rules are the starting point for any ethical question and rules are objective measures of ethical standards. In fact, rules are the value judgments as to what is right for accountants and reflect the profession's view about what constitutes good behaviour. Accountants who view ethical issues within this rigid framework are likely to suffer a moral crisis when encountering problems for which there is no readily apparent rule.

An overemphasis on ethical codes of behaviour tends to reinforce a perception of ethics as being punitive and does not promote the positive aspects of ethics that are designed to promote the reputation of an accounting firm and its clients, as well as standards within the profession. The resolution of ethical problems depends on the application of commonly shared ethical principles with appropriate skill and judgment. Ethical behaviour is based on universal principles and reasoned public debate and is difficult to capture in 'rules'.

Accountants have to make accounting policy choices on a regular basis. Stakeholders rely on the information reported by accountants to make informed decisions about the entity at hand. All decisions require judgment, and judgment depends on personal values with the decision needing to be made on some basis such as following rules, obeying authority, caring for others, justice, or whether the choice is right. These values and several others compete as the criterion for making a choice. Such personal values incorporate ethical values that dictate whether any accounting value chosen is a good or poor surrogate for economic value. To maintain the faith of the public, accountants must be highly ethical in their work. The focus on independence (conflict of interest) and associated compliance requirements may absorb considerable resources and conceptual space in relation to ethics in practice. This response is driven by a strong commitment within the firms to meet their statutory and regulatory obligations. The primary focus on independence may have narrowed some firms' appreciation of what constitutes broader ethical performance. As a result it may be that the increasing codification and compliance focus on one or two key aspects of ethical behaviour may be in fact eroding or preventing a more holistic approach to enabling ethics in practice.

If the director tells Field about the liquidity problems of Brook, then a confidence has been betrayed but there is a question of honesty if the true situation is not divulged. Another issue is whether the financial director has a duty to several stakeholders including the shareholders and employees of Grange, as if the information is disclosed about the poor liquidity position of Brook, then the amounts owing to Grange may not be paid. However, there is or may be a duty to disclose all the information to Field but if the information is deemed to be insider information then it should not be disclosed.

The finance director's reputation and career may suffer if Brook goes into liquidation especially as he will be responsible for the amounts owing by Brook. Another issue is whether the friend of the director has the right to expect him to keep the information private and if the shareholders of Grange stand to lose as a result of not divulging the information there may be an expectation that such information should be disclosed. Finally, should Field expect any credit information to be accurate or simply be a note of Brook's credit history? Thus it can be seen that the ethical and moral dilemma's facing the director of Grange are not simply a matter of following rules but are a complex mix of issues concerning trust, duty of care, insider information, confidentiality and morality.

A -16

(a) Ashanti Group: Statement of comprehensive income for the year ended 30 April 2010 (see working 1)

	$m
Revenue	1,096
Cost of sales	(851)
Gross profit	245
Other income	57·8
Distribution costs	(64)
Administrative expenses	(96·01)
Investment income	1·67
Finance costs	(31·98)
Share of profit of associate	2·1
Profit before tax	114·58
Income tax expense	(49)
Profit for the year	65·58
Other comprehensive income for the year, net of tax:	
Available-for-sale financial assets (AFS)	29·6
Gains on property revaluation	19·6
Actuarial losses on defined benefit plan	(14)
Share of other comprehensive income of associates	0·9
Other comprehensive income for the year, net of tax	36·1
Total comprehensive income and expense for year	101·68
Profit/loss attributable to: (W8)	
Owners of the parent	51·19
Non-controlling interest (W8)	14·39
	65·58
Total comprehensive income attributable to:	
	$m
Owners of the parent	81·20
Non-controlling interest (W8) (14·39 + 6·09)	20·48
	101.68

Workings

	Ashanti	Bochem	Ceram	Adjustment	Total
	$m	$m	$m	$m	$m
Revenue	810	235	71	(15)	
Revenue from illiquid customer (W5)	(5)				1,096
Intercompany profit ($5m x 20%)	(1)				
Cost of sales	(686)	(137)	(42)	15	(851)
Gross profit	118	98	29		245
Gain on sale of Ceram (W3)		3·8			
Other income	31	17	6		57·8
Distribution costs	(30)	(21)	(13)		(64)
Administrative expenses	(55)	(29)	(6)		
Holiday pay accrual (W7)	(0·21)				
Depreciation (W2)		(2)			
Loss on revaluation of PPE (W6)	(1·6)				
Impairment of goodwill (W2)		(2·2)			(96·01)
Accrual of bond interest (W4)	1·67				1·67
Impairment of bond (W4)	(13·98)				
Impairment of trade receivable (W5)	(3)				
Available-for-sale financial asset			3		

Finance costs	(8)	(6)	(4)		(31·98)
Share of profits of associate (W3)		2·1			2·10
Profit before tax	38·88	60·7	15		114·58
Income tax expense	(21)	(23)	(5)		(49)
Profit for the year	17·88	37·7	10		65·58
Other comprehensive income for the year, net of tax:					
Available-for-sale financial assets	20	9			
Loss on bond now recognized	0·6				29·6
Gains on property revaluation	12		–		
Revaluation adjustment (W6)	1·6				19·6
Actuarial losses on defined benefit plan	(14)	–	–		(14)
Share of associate available-for-sale financial assets (W3)		0·9			0·9
Other comprehensive income for the year, net of tax	20·2	15·9			36·1
Total comprehensive income and expense for year	38·08	53·6	10		101·68

Working 2 Bochem

	$m	**$m**
Fair value of consideration for 70% interest	150	
Fair value of non-controlling interest	54	
		204
Fair value of identifiable net assets acquired		(160)
Goodwill		44
Depreciation of plant		
Fair value of identifiable net assets		160
Book value ($55m + $85m + $10m)		(150)
Plant revaluation		10

Dr	**Profit or loss ($10 x 1/5)**	2
Dr	**Retained earnings**	2
Cr	**Accumulated depreciation**	4

Goodwill impairment	
Up to 30 April 2009, $44m x 15%	$6·6 million
Further impairment up to 30 April 2010, $44 x 5%	$2·2 million
Total impairment	$8·8 million

Sale of equity interest in Bochem	34
Fair value of consideration received	
Amount recognised as non-controlling interest (Net assets per question at year end $210m + Fair value of PPE at acquisition $10m – depreciation of fair value adjustment $4m + goodwill (44 – 8·8)) x 10%	(25.12)
Positive movement in parent equity (Shown as movement in equity not in OCI)	8.88

Working 3 Ceram

	$m	**$m**
Fair value of consideration for 80% interest	136	
Indirect holding in Ceram – NCI (30% of 136)	(40·8)	
Fair value of non-controlling interest	26	121·2
Fair value of identifiable net assets acquired		(115)
Goodwill		6.2

The fair value of the consideration held in Ceram represents the 80% shareholding purchased by Bochem. The 30% element that belongs to the NCI of Bochem needs to be deducted thereby giving the net balance representing the effective 56%

(70% of 80%) shareholding from the group viewpoint. However, goodwill could be calculated from the entity's perspective

($47 million) which would give a significantly different goodwill and gain/loss on disposal figure.

As Bochem has sold a controlling interest in Ceram, a gain or loss on disposal should be calculated. Additionally, the results of Ceram should only be consolidated in the statement of comprehensive income for the six months to 1 November 2009. Thereafter Ceram should be equity accounted.

The gain recognised in profit or loss would be as follows:

	$m
Fair value of consideration	90
Fair value of residual interest to be recognised as an associate	45
Value of NCI	35
	170
Less: net assets and goodwill derecognised	
net assets	(160)
Goodwill	(6·2)
Gain on disposal to profit or loss	3·8

The gain above has been calculated from Bochem's viewpoint and therefore a portion of this gain belongs to the NCI of

Bochem.

The share of the profits of the associate would be 30% of a half year's profit ($7m) i.e. $2·1 million and 30% of half of the gain on the AFS investments i.e. $0·9million.

Working 4 Bond

	$m
Carrying value at 1 May 2009	20·45
Accrual of half year interest (4%) to 31 October 2009	0·82
	21·27
Accrual of half year interest (4%) to 30 April 2010	0·85
Carrying value at 30 April 2010	22·12
Interest accrual (0·82 + 0·85)	1·67
Fair value of bond at 30 April 2010	
($2·34m discounted at 10% + $8m discounted at 10% for two years)	8·74
Impairment of bond (22·12 – 8·74)	13·38
Reclassification of loss in equity	0·6
Impairment recognised in profit or loss	13·98

Note: the accrual of interest could also be based on the amortised cost at 1 May 2009 as an alternative to the carrying value.

Working 5

Ashanti should not record the revenue of $5 million, as it is not probable that economic benefit relating to the sale will flow to Ashanti. The revenue will be recorded when the customer pays for the goods. The cost of the goods will remain in the financial statements and the allowance for doubtful debts will be reduced to $3 million.

Working 6

At 30 April 2009, a revaluation gain of ($13m – $12m – depreciation $1·2m) $2·2 million would be recorded in equity for the PPE. At 30 April 2010, the carrying value of the PPE would be $13m – depreciation of $1·44m i.e. $11·56m. Thus there will be a revaluation loss of $11·56m – $8m i.e. $3·56m. Of this amount $1·96m ($2·2m less $0·24m transfer for excess depreciation) will be charged against revaluation surplus in reserves and $1·6 million will be charged to profit or loss.

Working 7

An accrual should be made under IAS 19 Employee Benefits for the holiday entitlement carried forward to next year.

900 x 3 days x 95% = 2,565 days

Number of working days = 900 x 255 = 229,500

Accrual is 2,565/229,500 x $19m = $0·21m

Working 8

Non-controlling interest (NCI)

NCI in profits for year is (30% of $37·7m + 44% of $7 million) =	**$14·39m**
NCI in other recognised income is (30% x $15·9m + 44% of $3m) =	$6·09m
	$20·48

(b) The International Accounting Standards Board (IASB) has published amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures. The amendments are an attempt to create a 'level playing field' with US GAAP regarding the ability to reclassify financial assets. The changes to IAS 39 permit an entity to reclassify non-derivative financial assets out of the 'fair value through profit or loss' (FVTPL) and 'available-for-sale' (AFS) categories in limited circumstances. Such reclassifications will create additional disclosures. The amendments will only permit reclassification of certain non-derivative financial assets. Financial liabilities, derivatives and financial assets that are designated as at FVTPL on initial recognition under the 'fair value option' cannot be reclassified. The amendments therefore only permit reclassification of debt and equity financial assets subject to meeting specified criteria. The amendments do not permit reclassification into FVTPL or AFS at initial recognition.

A debt instrument that would have met the definition of loans and receivables, if it had not been required to be classified as held for trading at initial recognition, may be reclassified to loans and receivables if the entity has the intention and ability to hold the asset for the foreseeable future or until maturity. A debt instrument classified as AFS that would have met the definition of loans and receivables may be reclassified to the category if the entity has the same intention and ability as above. Any other debt instrument, or any equity instrument, may be reclassified from FVTPL to AFS, or from FVTPL to Held to Maturity (HTM) (in the case of debt instruments only), if the financial asset is no longer held for the purpose of selling in the near term – but only in 'rare' circumstances. The IASB acknowledged that volatile and illiquid market conditions are a possible example of a 'rare' circumstance.

All reclassifi cations must be made at the fair value of the fi nancial asset at the date of reclassifi cation. Any previously recognised gains or losses cannot be reversed. The fair value at the date of reclassification becomes the new cost or amortised cost of the financial asset, as applicable.

For reclassifications out of AFS, IAS 39 requires the amounts previously recognised in other comprehensive income (OCI) to be reclassified to profit or loss either through the effective interest rate or at disposal. Amounts deferred in equity may also need to be reclassified to profit or loss if there is impairment.

Allowing reclassification, even in limited circumstances, will allow an entity to manage its reported profit or loss by avoiding future fair value gains or losses on the reclassified assets. The intention of this is to ensure that previously impaired cash flows are reflected in the income statement over the life of the asset rather than as immediate income effectively deferring the loss in the hope that economic conditions will improve. The IASB normally publishes an exposure draft of any proposed amendments to standards to invite comments from interested parties. However, the IASB decided to proceed directly to issuing the amendments without any due process. This exceptional step could lead to management of earnings by some entities as the amendments relax the existing requirements to provide 'short-term relief' for some entities. This relief effectively means that anticipated losses could be avoided by entitles. It could be argued that the amendments are a short-term response to a current crisis, which because of the lack of exposure could lead to longer-term issues.

(c) 'Earnings management' has been defined in various ways. It can be described as the purposeful intervention in the external fi nancial reporting process with the intent of obtaining some private gain. Alternatively it can be the use of judgment in fi nancial reporting and in structuring transactions to alter financial reports to either mislead stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting judgments.

Incentives lie at the heart of earnings management. Managers should make accounting judgments and decisions solely with the intention of fairly reporting operating performance. However, there are often economic incentives for managers to engage in earnings management, because the value of the firm and the wealth of its managers or owners are normally linked to reported earnings. Contractual incentives to manage earnings arise when contracts between a company and other parties rely upon financial statements to determine financial exchanges between them. By managing the results of operations, managers can alter the amount and timing of those exchanges. Contractual situations could stimulate earnings management. These would include debt covenants, management compensation agreements, job security, and trade union negotiations. Market incentives to manage earnings arise when managers perceive a connection between reported earnings and the company's market value. Regulatory incentives to manage earnings arise when reported earnings are thought to influence the actions of regulators or government officials. By managing the results of operations, managers may influence the actions of regulators or government officials, thereby minimising political scrutiny and the effects of regulation.

One way in which directors can manage earnings is by manipulation of accruals with no direct cash flow consequences. Examples of accrual manipulation include under-provisioning for irrecoverable debt expenses, delaying of asset write-offs and opportunistic selection of accounting methods. Accrual manipulation is a convenient form of earnings management because it has no direct cash flow implications and can be done after the year-end when managers are better informed about earnings. However, managers also have incentives to manipulate real activities during the year with the specific objective of meeting certain earnings targets. Real activity manipulation affects both cash flows and earnings.

Where management does not try to manipulate earnings, there is a positive effect on earnings quality. The earnings data is more reliable because management is not influencing or manipulating earnings by changing accounting methods, or deferring expenses or accelerating revenues to bring about desired short-term earnings results. The absence of earnings management does not, however, guarantee high earnings quality. Some information or events that may affect future earnings may not be disclosed in the financial statements. Thus, the concept of earnings management is related to the concept of earnings quality. One major objective of the IASB Framework is to assist investors and creditors in making investing and lending decisions. The Framework refers not only to the reliability of financial statements, but also to the relevance and predictive value of information presented in financial statements.

Entities have a social and ethical responsibility not to mislead stakeholders. Ethics can and should be part of a corporate strategy, but a company's first priority often is its survival and optimising its profits in a sustainable way. Management of earnings may therefore appear to have a degree of legitimacy in this regard but there is an obvious conflict. An ethical position that leads to substantial and long-term disadvantages in the market place will not be acceptable to an entity.

It is reasonable and realistic not to rely exclusively on personal morality. A suitable economic, ethical and legal framework attempts to ensure that the behaviour of directors conforms to moral standards. Stakeholders depend on the moral integrity of the entity's directors. Stakeholders rely upon core values such as trustworthiness, truthfulness, honesty, and independence although these cannot be established exclusively by regulation and professional codes of ethics. Thus there is a moral dilemma for directors in terms of managing earnings for the benefit of the entity, which might directly benefit stakeholders and themselves whilst at the same time possibly misleading the same stakeholders.

A-17

Examiner's comment. The step-by-step acquisition was not well-answered, with candidates unsure how to calculate the goodwill arising on the acquisition. Many candidates could not account for the associate, and actually used acquisition techniques instead of equity accounting to consolidate it, giving a non-controlling interest of 75%. The elimination of the inter-company profit was quite well done but some candidates did not allocate part of the revaluation surplus arising on the fair value of the net assets at acquisition to the non-controlling interest. Overall, the question was not particularly well-answered, mainly because of a lack of understanding of the basic technique of step-by-step acquisitions.

		Marks
(a)	Property, plant and equipment	4
	Goodwill	5
	Associate	4
	Investment	1

	Current assets	1
	Share capital	1
	Revaluation surplus	1
	Retained earnings	7
	Non-controlling interest	
	Non-current liabilities	4
	Current liabilities	
(b)	Inventory, goods sold	10
(c)	Corporate citizenship:	3
	Corporate governance	3
	Ethics	3
	Employee reports	3
	Environment	3
	Maximum	50

(a) JAY GROUP

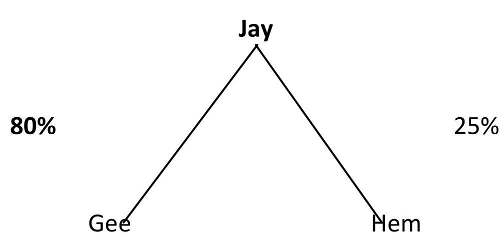
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31 MAY 20X5

	$m
Assets	
Property, plant and equipment (W6) 300 + 40 + 14 + (5 – 0.1) – 5.7 (W9)	353.2
Goodwill (W4)	8.0
Investment in associate (W3)	13.0
Investment (10 – 0.5) (W2)	9.5
Current assets (120 – 6) (W3)	114.0
	497.7

	$m
Equity and liabilities	
Share capital	100.0
Share premium	50.0
Revaluation surplus (W8)	15.0
Retained earnings (W7)	136.7
	301.7
Non-controlling interest (W6)	12.0
	313.7
Non-current liabilities	64.0
Current liabilities	120.0
	497.7

Working

1 Group structure



2 Provision for unrealised profit
Sales from Jay to Gee

$m

Profit (19 – 13)	6.0
Less depreciation on machine constructed with goods: (6 x 10% x 6/12)	(0.3)
	5.7

Sale of investments from Hem to Jay

	$m
Group share of profit (25% × 2)	0.5

3 Impairment of receivable

	$m
Cost of machinery	8.0
Less deposit received	(2.0)
Bad debt written off	6.0
Less net book value of machine (included in tangible assets)	(4.9)
Impairment loss deducted from retained earnings	1.1

4 Goodwill: Gee (on acquiring control)

	$m
Consideration transferred	30
Fair value of previously held equity interest **$6* × 30% × 10**	18
Fair value of identifiable assets acquired and **liabilities assumed: 80% × 50**	(40)
	8

* At 1 June 20X4, the share price of Gee was $\frac{\$30m}{50\% \times \$10m}$ = $6

5 Investment in associate

	$m
Cost of investment	12
Profit for year ended 31 May 20X5 (25% × 36 – 32)	2
	13

6 Non-controlling interests

	$m
Net assets at reporting date	46.00
Plus fair value adjustment (W10)	14.00
	60.00
NCI share (20%)	12.00

7 Retained earnings

	Jay	Gee	Hem
	$m	**$m**	**$m**
Per question	139.00	16	10
Profit on de-recognition of investment *	3.00		
PUP on machinery (W2)	(5.70)		
PUP on inventories (associate)			(2)
Impairment loss on receivable	(1.10)		
Pre-acquisition (NA excl FV adjustments, SC and SP			
50 – 14 – 10 – 20		(6)	
32 – 6 – 6 – 14			(6)
		10	2
Group share			
Gee: 80% × 10	8.0		

Hem: 25% × 2	0.5	
Less fair value gain recognised in Jay's separate FS: 52 – 30 – 15	(7.0)	
	136.7	

*** Profit on derecognition of 30% investment:**	
Fair value at date control obtained (W4)	18
Cost	(15)
	3

8 Revaluation surplus

	$m
Jay	15.00
Gee: at date control acquired (80% ▯ 14 – 14)	0.00
	15.00

9 Property, plant and equipment

	$m	$m
Jay		300.0
Gee		40.0
Fair value adjustment (land)		14.0
Machine		
Cost	5.0	
Less depreciation (3/12 x 10% x 5	(0.1)	
		4.9
Provision for unrealised profit (W2)		(5.7)
		353.2

Note that Jay has retained title to the machinery because the first instalment has not been paid.

(b) The initial transaction of the purchase of goods from the foreign supplier would be recorded in the ledger accounts at $5 million (€8/1.6). Therefore both the purchase and the payables balance would be recorded at this amount. At the year end the payables balance is restated to the closing rate but the inventories remain at $5 million. Therefore the payable is restated to $6.2 million (€8m/1.3) and an exchange loss is taken to the income statement of $1.2 million ($6.2 – 5m).

On the sale, the original transaction is recorded at $2.5 million (€4m/1.6) as both a sale and a receivable. When payment is made the amount actually received is $3.1 million (€4m/1.3) and an exchange gain is recognised in profit or loss of $0.6 million ($3.1 – 2.5m).

When the investment property was first purchased it should have been recognised in the statement of financial position at $20 million (€28m/1.4). At the year end the investment property has fallen in value to €24 million and the exchange rate has changed to 1.3. Therefore at 31 May 20X6 the property would be valued at $18.5 million (€24m/1.3).

The fall in value of $1.5 million ($20 – 18.5m) is recognised in profit or loss. The loss is a mixture of a fall in value of the property and a gain due to the exchange rate movement. However, as the investment property is a non-monetary asset the foreign currency element is not recognised separately.

(c) Nature of corporate citizenship

Increasingly businesses are expected to be socially responsible as well as profitable. Strategic decisions by businesses, particularly global businesses nearly always have wider social consequences. It could be argued, as Henry Mintzburg does, that a company produces two outputs: goods and services, and the social consequences of its activities, such as pollution.

One major development in the area of corporate citizenship is the environmental report. While this is not a legal requirement, a large number of major companies produce them. Worldwide there are around 20 award schemes for environmental reporting, notably the ACCA's.

Jay might be advised to adopt the guidelines on sustainability given in the Global Reporting Initiative. These guidelines cover a number of areas (economic, environmental and social). The GRI specifies key performance indicators for each area. For environmental reporting, the indicators are:

(ii) Energy
(iii) Water

(iii) Biodiversity

(iv) Emissions

(v) Energy and waste

(vi) Products and services

(iii) Compliance
(iv) Transport

Another environmental issue which the company could consider is emission levels from factories. Many companies now include details of this in their environmental report.

The other main aspect of corporate citizenship where Jay scores highly is in its treatment of its workforce. The company sees the workforce as the key factor in the growth of its business. The car industry had a reputation in the past for restrictive practices, and the annual report could usefully discuss the extent to which these have been eliminated.

Employees of a businesses are stakeholders in that business, along with shareholders and customers. A company wishing to demonstrate good corporate citizenship will therefore be concerned with employee welfare. Accordingly, the annual report might usefully contain information on details of working hours, industrial accidents and sickness of employees.

In conclusion, it can be seen that the annual report can, and should go far beyond the financial statements and traditional ratio analysis.

A -18

Examiner's comment. Generally speaking the performance on this question was quite good. The main problem areas (part (a) only) were:

- Not adding back the sale proceeds of the shares to the cost of the investment in Plank. Candidates lost very few marks for this minor error. The only problem was that this error created 'negative goodwill' instead of positive goodwill.
- Candidates thought that, because Lateral still had significant influence over Plank after the disposal of shares, that Plank was still a subsidiary. Plank was in fact an associate. This error caused candidates many problems, not least the fact that they spent time consolidating an additional subsidiary.
- Candidates dealt quite well with the debt instrument. However many calculated the interest received based on the fair value and not on the principal amount. Again candidates only lost one mark for this error.
- The calculation of the group reserves was quite poor. The main reason was that this figure was dependent upon other calculations. That is the debt instrument, the post acquisition profit of the associate, the profit on the sale of shares and other adjustments. Thus errors earlier in the question would be compounded in this figure. Credit was given for the correct methodology even if the figures were inaccurate.
- The non-controlling interest was normally calculated incorrectly as the profit and the depreciation on 'held for sale' assets was often not taken into account. Again marks were given if the principle used was sound.

		Marks
(a)	Gain/loss on sale of shares	4
(b)	Plant and equipment	4
	Associate	3
	Investment	4
	Goodwill	7
	Sundry assets and liabilities	2
	Retained earnings	6
	Non-controlling interests	2

(c)	Plant and machinery		
	Deposit		3
	Cash flow hedge		3
	Bond		3
	Forward contract		3
(d)	Nature of current information		5
	Visibility		5
		Available	54
		Maximum	50

(a) Gain on the sale of shares in Plank

	$m	$m
Fair value of consideration transferred		180.0
Fair value of 40% investment retained 600 × 40%/60%		400.0
Less: Lateral's share of consolidated carrying value when control lost		
Per question	790.0	
Fair value adjustments (W3)	57.6	
	847.6	
Lateral's share: 60%		(508.6)
Goodwill in Plank		(40.0)
		31.4

(b) LATERAL GROUP

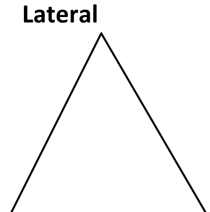
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31 OCTOBER 20X5

	$m	$m
Assets		
Non-current assets		
Property, plant and equipment (W7)		1,098
Investment in associate (W4)		400
Held to maturity investments (W8)		33
Intangible assets: goodwill (W2)		60
		1591
Current assets		
Inventories	385	
Trade receivables	250	
Cash and cash equivalents	70	705
Total assets		2,296
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital		400
Retained earnings (W6)		1,011
		1,411
Non-controlling interest (W5)		105
Total equity		1,516
Non-current liabilities		310
Current liabilities		470
Total equity and liabilities		2,296

Workings

1 Group structure

Lateral



80%	60% to 31/10/X5 40% from 31/10/X5

Think Plank

2 Goodwill

		Think	Think	Plank	Plank
		$m	$m	$m	$m
Cost of investment per individual statements of financial position			380		340
Sale proceeds added back to cost of Investment					180
Consideration transferred			380		520
Less net assets acquired					
Share capital		250		500	
Retained earnings		150		210	
Fair value adjustments (800 – 710)		-		90	
		400		800	
Group share:	**80%**		(320)		
	60%				(480)
Goodwill			60		40

3 Fair value adjustments

	At acq'n 1.11.X3		Movement	At reporting date 31.10.X15
	$m		**$m**	**$m**
Plant and equipment	90	(20% x 90)	(18.0)	
		(20% x 90)	(14.4)	
	90		(32.4)	57.6

4 Investment in associate: Plank

	$m
Fair value at date control lost	400
Share of post acquisition retained reserves*	-
	400

*Note. There are no PARR as control was lost at the year end.

5 Non-controlling interests

	$m
Net asset at reporting date: Think	
Share capital	250
Retained earnings	280
Unrealised profit on 'held for sale' assets	(5)
Depreciation on 'held for sale' assets (10% x 20%)	(2)
	523

Non-controlling share: 20% x 523 = $104.6m

6 Consolidated retained earnings

	Lateral	Think	Plank	Plank
	$m	**$m**	**$m**	**$m**
At 31 October 20X5/at date of disposal Re20% Sold	850	280	290.0	290.0
At acquisition		(150)	(210.0)	210.0
		130	80.0	80.0
Additional depreciation on fair value adjustment (W3)			(32.4)	32.4
Group profit on sale of shares in Plank (Part (a))	314			
Unrealised profit on 'held for sale' assets (15 – 10)		(5)		
Depreciation on 'held for sale' assets (10 ⍰ 20%)		(2)		
Gain on debt instrument (W8)	2.6			
	884.0	123	47.6	47.6
Share of Think (80% x 123)	98.4			
Share of Plank (40% x 47.6) + (20% × 47.6)	28.6			
1	1011.0			

Note. Because the 20% of Plank was sold at the year end, the post acquisition profits are the same as those of the 40% retained. Often this will not be the case as the disposal is often made part way through the year.

7 Property, plant and equipment

The 'held for sale' assets reported in the statement of financial position of Think are not 'held for sale' in the group as a whole and should therefore be included in the consolidated statement of financial position at their carrying value less depreciation for the year ended 31 October 20X5.

	$m
Lateral	700
Think	390
Held for sale assets at carrying value	10
Less depreciation for year (20% x 10)	(2)
	1,098

8 Held to maturity investment

	20X3/4	**20X4/5**
	$m	**$m**
At beginning of year	30.00	31.24
Interest (10%)	3.00	3.12
Interest received (4.7%)	(1.76)	(1.76)
At end of year	31.24	32.60

Therefore the investment is carried at $32.6 million and there is a gain of $2.6 million in consolidated retained earnings

(c) The first part of this transaction involves a non-refundable deposit of €1 million paid on 31 July 20X6. As this is a non-refundable deposit it is not a monetary item and therefore should be translated and included in the statement of financial position as an asset as part of property, plant and equipment at $625,000

(€1m/1.6). This will not be retranslated at the year end.

The company then had to make a decision about how to deal with the risk surrounding the fact that it would be required to pay €3 million on 30 June 20X7. The option that was chosen was to invest in the €3 million bond on 31 July 20X6 and to sell it on 30 June 20X7 in order to fund the purchase of the property, plant and equipment. Initially the bond will be recognised on 31 July 20X6 at $1.9 million (€3m/1.6). This bond is classified as at fair value through profit or loss*, but as the bond has a coupon rate of 4% which is the same as the market rate then its fair value will be the same as its carrying value, ie €3 million. However as a monetary item the bond must be retranslated at the

closing rate of exchange at 31 October 20X6 to $2.3 million (€3 m/1.3) and the exchange gain of $0.4 million ($2.3m – 1.9m) must be taken to the income statement. There will also be accrued interest on the bond of €30,000 (€3m 4% 3/12) which will be translated at the average rate in the income statement at $20,000 and at the closing rate as accrued income in the balance at $23,000.
In the year to 31 October 20X7 the effect of the bond will depend upon the movement in interest rates. As the bond is a fixed interest rate investment, its value will be dependent upon the movement in interest rates. If interest rates increase then the bond will reduce in value. Therefore by purchasing the bond the company has exposed itself to interest rate risk. To eliminate this interest rate risk then the company could enter into an interest rate swap agreement to exchange its fixed rate interest receipts for floating rate interest receipts. If this were to happen then the interest rate swap would be designated as a hedging instrument of the bond.

If the company had alternatively entered into a forward contract to purchase the €3 million for $2 million then initially (at 31 July 20X6) this contract would have a fair value of zero. At the year end (31 October 20X6) the forward contract should be revalued to its fair value:

On the open market	€3m would cost	
	€3m/1.3 =	$2.3
Under the forward contract,€3m costs=		$2m
Gain on forward contract		$0.3m

Under IAS 39, for hedge accounting to be applied, the hedge must be between 80% and 120% effective. Therefore we need to calculate the gain/loss on the hedged item (the purchase of the fixed asset) to test the effectiveness.

Amount expected to pay as at 31 October 20X6 : €3m/1.3 =	**$2.3m**
Amount expected to pay out at year end 31.10.X6 : €3m/1.6 =	$1.9m
Loss	$0.4m

Therefore effectiveness is $0.3m/$0.4m = 75%.

This falls outside the required effectiveness, which must be between 80% and 120%. Therefore the contract cannot be treated as a cash flow hedge, and should be treated as a normal financial asset at fair value through profit and loss. The gain on the forward contract should be posted to the income statement.

DEBITFinancial asset $0.3m

CREDITIncome statement £0.3m

*BPP note: The fair value option has been restricted and the bond could only be treated this way if it met the definition of 'held for trading'.

(d) Although many large companies disclose information about 'Human Capital Management' the type and level of disclosure varies. In some countries, such as the UK, there are legal requirements to disclose information such as employee numbers, policies relating to equal opportunities, information on disabled employees and staff remuneration. Companies often adopt a 'checklist' approach, often disclosing only the minimum amount of information required. Other companies may be more proactive. In practice, publishing information about human capital management can enhance the reputation of a company and help it to recruit and retain high quality staff.

The company wishes to help stakeholders to understand the link between its performance and the way that it manages its employees. As well as information on equal opportunities and health and safety at work it could disclose the following:

(i) A description of the company's policies relating to the recruitment, retention and motivation of employees
(ii) Employee numbers and other appropriate information about the composition of the workforce
(iii) Details of staff remuneration
(iv) Details of amounts invested in training and developing employees and also descriptions of the company's policies and practices in this area
(v) A description of the way in which the company ensures management succession. Information should be provided consistently from period to period and should be comparable with previous periods. This means that the company will need to develop key performance indicators.

The most obvious vehicle for these disclosures is the Operating and Financial Review (Management Discussion and Analysis) as this is management's analysis of the key factors and risks affecting the company's performance. Many companies also publish separate social or employee reports, which can be targeted at particular stakeholder groups, such as investors or current and potential employees and the general public.

A -19

		Marks
(a)	Goodwill – Lose	5
	Non-controlling interest	1
	Group reserves	2
	Associate and impairment	5
	Intra-group profit	2
	Foreign currency	4
	Debt factoring	4
	Share options	4
	Provision	3
	Operative lease	3
	Other statement of financial position items	2
	Maximum	35
(b)	Benefits of environmental report – Maximum	8
(c)	Discussion of ethical and social responsibility – subjective	5
	Professional marks	2
	Maximum	7
	Minimum	50

(a) BETH GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 NOVEMBER 20X7

	$m
Non-current assets	1,910
Property, plant and equipment: 1,700 + 200 + (W2) 10 + 2 – 2	13
Goodwill (W8)	300
Other intangible assets	183
Investment in associate (W9)	2,406

MOCK EXAM 3 (DECEMBER 2007): ANSWER 1

	$m
Current assets	900
Inventories: 800 + 100	709
Trade receivables: 600 + 60 – 1 (W4) + 50 (W5)	540
Cash: 500 + 40	2,149
Total assets	4,555

	$m
Equity and liabilities	
Equity attributable to owners of the parent	
Share capital	1,500
Retained earnings (W11)	447
Other reserves: 300 + 9 (W6)	309
	2,256
Non-controlling interests (W10)	61
	2,317
Non-current liabilities: 700 + 2 (W3) + 11 (W7)	713
Current liabilities: 1,380 + 100 + 45 (W5)	1,525

Total equity and liabilities	4,555

Working

1 Group structure

	1 Dec 20x5		1 Dec 20x6	Beth		1 Dec 20x6
	20%	+	60% = 80%			30%
Pre-acquisitionretained earnings	%80m		$150m		Pre-acquisitionretained earnings	$26m
			Lose		Gain	

2 Unrealised profit on intra-group trading with associate (Gain)

	$m
Inventories: selling price	28
Cost	(18)
Profit	10

IAS 28 requires that Beth's share of this profit should be eliminated. Beth's share is 30% x $10m =$3m.

DEBIT	**Cost of sales/retained earnings (Beth)**	**$3m**	
CREDIT	Inventories (Gain)		$3m

Note. The unrealised profit is eliminated from retained earnings in the books of the seller (Beth) and from inventories in the books of the holder (Gain).

3 Lease

IAS 16 Property, plant and equipment requires that Lose should capitalise the leasehold improvements of $10m and depreciate them over the term of the lease. The requirement in the lease to return the building in its original condition is an obligation arising from past events, so a provision of $2m should be made for the estimated costs

Capitalise leasehold improvements

DEBIT	Property, plant and equipment	$10m
CREDIT	Cost of sales /retained earnings	$10m

Provide for conversion costs

DEBIT	Property, plant and equipment	$2m
CREDIT	Non-current liability	$2m

Adjust for depreciation

DEBIT	Cost of sales/retained earnings	$2m
	(10 + 2) x6	
CREDIT	Property, plant and equipment	$2m

Note. The PPE adjustment will affect non-controlling interest in Lose.

4 Foreign currency contract

The payment to the supplier is a refundable deposit. It is deemed to be a monetary amount and is re-translated at the year end.

At 1 September 20X7 **$m**

€12m x 50% x 0.75 = 8.00

At y/e (30 November 20X7)

€12m x 50% ÷ 0.85 = 7.06

Loss = 0.94 (rounded to $1m)

DEBIT	Retained earnings$1m	$1m	
CREDIT	Receivables		$1m

5 Debt factoring

Under IAS 39 Financial instruments: recognition and measurement, a financial asset must be de- recognised:

(i) If the contractual rights to the cash flows have expired

(ii) If the financial asset has been transferred, together with the risks and rewards

Condition (ii) has not been met. Beth still bears the risks and rewards of ownership . Accordingly, the receivable must be reinstated.

DEBIT Receivables	$50m	
CREDIT Retained earnings		$5m
CREDIT Loan (current liabilities)		$45m

6 Share options

Following IFRS 2, a charge must be made to profit or loss and a corresponding credit to equity, as follows.

200 options x (10,000 – (600+500)) x ½ x $10

= $8.9m, rounded to $9m

DEBIT	Retained earnings	$9m
CREDIT	Equity (Share-based payment reserve/other reserves) $9m	

7 Provision for contamination clear up Following IAS 37, a provision must be recognised if and only if:

(i) A present obligation (legal or constructive) has arisen as a result of a past event

(ii) Payment is probable

(iii) The amount can be measured reliably

In this case, a provision must be made for the costs of contamination only where there is a legal obligation to clean it up. A moral obligation does not justify a provision. $4m relates to costs where there is an existing law. $7m relates to a law that will come in December 20X7, but it is assumed that the law will apply retrospectively. The total provision that must be made is $(7+4)m = $11m.

DEBIT	Profit and loss/retained earnings	$11m	
CREDIT	Non-current liability		$11m

8 Goodwill: Lose (at date control obtained)

	$m	$m
Consideration transferred		160.00
Fair value of previously held equity interest		53.33
Fair value of identifiable assets acquired and liabilities assumed		
Share capital	100	
Retained earnings	150	
	250	
× 80%		(200.00)

13.33

9 Investment in associate

	$m
Cost	180
Share of post acquisition retained earnings: (300 – 260) x 30%	12
Unrealised profit in inventories (W2)	(3
Impairment loss (to profit or loss/retained earnings) (bal.fig.)	(6)
Recoverable amount: $610 ⍰ 30%	183

10 Non-controlling interest: Lose

	$m
Net assets per question	300
Operating lease corrections (W3): 10 – 2	8
	308

Non-controlling interest: $308m ⍰ 20% = $61.6m rounded down to $61m

11 Retained earnings

	Beth	Lose	Gain
	$m	**$m**	**$m**
Per question	400.00	200	300
Profit on derecognition of investment	13.33		
Unrealised profit (W2)	(3.00)		
Operating lease (W3): 10 - 2		8	
Foreign currency (W4)	(1.00)		
Debt factoring reversal (W5)	5.00		
Share-based payment (W6)	9.00		
Provision (W7)	(11.00)		
Pre-acquisition		(150)	(260)
		58	40
Group share			
Lose: 58 x 80%	46.40		
Gain: 40 x 30%	12.00		
Impairment (W9)	(6.00)		
	446.73	Round up to 447	

***Profit on derecognition of investment:**	
	$m
Fair value at date control obtained	53.33
Cost	(40.00)
	13.33

(b) Advantages of a separate environmental report

Most countries do not have any legal requirements to produce an environmental report, and until fairly recently, environmental reporting was not seen as important. However, there would be a number of advantages for Beth in producing an environmental report.

(i) Producing a separate report will force Beth to improve its practices on environmental matters, an area the group has neglected.

(ii) Customers will see the efforts the group is making, and this will increase customer confidence in the group and its products.

(iii) The oil industry has a negative image when it comes to environmental matters. If Beth can be shown to be making an effort, and giving a detailed report on the changes made, this will give the group an edge over its competitors.

(iv) Beth has a poor reputation as a good corporate citizen. This needs to be put right and be seen to be put right.

(v) The group is facing potential litigation. If it takes steps to improving environmental performance and reporting on this, it can improve relationships with regulators, and therefore reduce the potential threat.

(vi) Beth operates in a number of different countries, and so needs to improve its international reputation. The international trend is towards improving environmental performance and increased provision of environmental information. Sustained efforts in this area will enhance the group's standing in the international arena.

(vii) Environmental performance covers areas such as waste management, resources and costs. Improvements in these areas will bring economies and efficiencies which will improve the group's profitability.

(v) Management information systems will be enhanced in order to provide environmental information.

(ix) A good quality environmental report will make Beth attractive to investors and financial analysts, who are keen to see evidence of sustainability.

(x) Companies Beth supplies and contracts with may have to demonstrate to their own investors that they are dealing with reputable suppliers and contractors. Good environmental practices and reporting will make Beth a more attractive supplier and contractor to deal with.

A separate environmental report on its own is clearly not enough to give these benefits – the report must be underpinned by sustained action.

(c) Ethical and social responsibilities

Ethics and corporate social responsibility are important in themselves, but also because they can improve business performance. At present the company is stagnating, because it has focused on maintaining market share and on its own shareholders at the expense of other stakeholders. Corporate social responsibility is concerned with a company's accountability to a wide range of stakeholders, not just shareholders. For Beth, the most significant of these include:

(i) Regulators
(ii) Customers
(iii) Creditors
(iv) Employees

Regulators

The relationship with regulators is not good, mainly because of a poor reputation on environmental matters. Beth just does the bare minimum, for example cleaning up contamination only when legally obliged to do so. Adopting environmentally friendly policies and reporting in detail on these in an environmental report will go some way towards mending the relationship. Litigation costs, which have a direct impact on profit, can be avoided.

Customers

Currently Beth provides poor customer support, and makes no effort to understand the customs and cultures of the countries in which it operates. Moreover, it makes no positive contributions and does not promote socially responsible policies. This attitude could easily alienate its present customers and deter new ones. A competitor who does make positive contributions to the community, for example in sponsoring education or environmental programmes, will be seen as having the edge and could take customers away from Beth. Corporate social responsibility involves thinking long-term about the community rather than about short-term profits, but in the long term, profits could suffer if socially responsible attitudes are not adopted.

Creditors

Suppliers are key stakeholders, who must be handled responsibly if a reputation in the wider business community is not to suffer. Beth's policy of not paying small and medium-sized companies is very short- sighted. While such companies may not be in a position to sue for payment, the effect on goodwill and reputation will be very damaging in the long term. Suppliers may be put off doing business with Beth. Perhaps a key component can only be sourced from a small supplier, who will not sell to Beth if word gets around that it does not pay. This unethical and damaging policy must be discontinued and relationships with all suppliers fostered.

Employees

Employees are very important stakeholders. Beth's authoritarian approach to management and its refusal to value employees or listen to their ideas, is potentially damaging to business performance. High staff turnover is costly as new staff must be recruited and trained. Employees who do not feel valued will not work as hard as those who do. In addition, employees may have some good ideas to contribute that would benefit performance; at the moment Beth is missing out on these ideas.

Acting responsibly and ethically is not just right; it is also profitable.

A -20

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Standard	***Odense***	***Rate***	***Odense***	***Consol***
	$'000	Kr'000	**$'000**	**$'000**	
Property, plant and equipment	1,285	4,400	8.1	543	1,828
Inv in Odense	520	–		–	–
Goodwill (W2)	–	–		–	277
	1,805	4,400		543	2,105
Current assets	410	2,000	8.1	247	657
	2,215	6,400		790	2,762
Share capital	500	1,000	9.4	106	500
Retained earnings (W3)	1,115				1,395
Pre-acq'n		2,100	9.4	224	
Post acq'n	–	2,200	Bal fig.	324	
	1,615	5,300		654	1,895
Non-controlling interest (654 x 20%)					131
					2,026
Loans	200	300	8.1	37	237
Current liabilities	400	800	8.1	99	499
	600	1,100		136	736
	2,215	6,400		790	2,762

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Standard	***Odense***	***Rate***	***Odense***	***Consol***
	$'000	Kr'000	**$'000**	**$'000**	
Revenue	1,125	5,200	8.4	619	1,744
Cost of sales	(410)	(2,300)	8.4	(274)	(684)
Gross profit	715	2,900		345	1,060
Other expenses	(180)	(910)	8.4	(108)	(288)
Impairment loss (W2)					(21)
Dividend from Odense	40				-
Profit before tax	575	1,990	237	751	
Income tax expense	(180)	(640)	8.4	(76)	(256)
Profit for the year	395	1,350		161	495
OTHER COMPREHENSIVE INCOME Exchange difference on translating foreign operations (W4)	-	-	-		72
	395	1,350		161	567

TOTAL COMPREHENSIVE INCOME FOR THE YEAR Profit attributable to:	
Owners of the parent	463
Non-controlling interest (161× 20%)	32

	495
Total comprehensive income for the year attributable to:	
Owners of the parent	525
Non-controlling interest (161 + 48) × 20%	42
	567

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (EXTRACT)	Retained earnings **$000**
Balance at 20X5	1,065
Dividends paid	(195)
Total comprehensive income for the year (per SOCI)	525
Balance at 31/12/X6 (W3)/(W4)	1,395

Workings

1 Group structure

Standard

1.1.X4 80%

Pre-acquisition ret'd earnings 2,100,000 Krone

Odense

2 Goodwill

	Kr'000	Kr'000	Rate	$'000
Consideration transferred		4888		
Share capital	1,000			
Retained earnings	2,100			
	3,100			
Group share (80%)		(2,480)		
		2,408	9.4	256
Exchange differences 20X4-20X	-		β	18
At 31.12.X5		2,408	8.8	271
Impairment losses 20X6		(168)	8.1	(21)
Exchange differences 20X6			β	24
		2,240	8.1	277

3 Consolidated retained earnings carried forward

	Standard **$'000**
Standard	1,115
Group share of post acquisition reserves at Odense (324 x 80%)	259
	1,374
Less goodwill impairment losses (W2)	(21)
Exchange on differences on goodwill (18 + 24)	42
Group share of post acquisition reserves at Odense (324 x 80%)	1395

4 Exchange differences

	$'000	**$'000**
On translation of net assets:		

Closing NA @ CR	654	
Opening NA @ OR (5,300 – 1,350 + 405 = 4,355 @ 8.8)	(495)	
Less retained profit as translated (161 (SOCI) – 405 @ 8.1)	(111)	
Exchange gain		48
On goodwill (W2)		24
		72

5 Consolidated retained earnings b/f proof

	$'000
Standard	915
Add post-acquisition retained earnings of Odense	
(4,355 @ 8.8 – 3,100 @ 9.4) x80%	132
Less goodwill impairment losses (W2)	0
Exchange differences on goodwill (W2)	18
	1,065

A -21

(a) A foreign operation normally has the same functional currency of its parent when:

(i) The foreign company is merely an extension of the investing company operations overseas.

(ii) The foreign company is dependent upon the investing company for financing.

(iii) The foreign company cash flows have a material impact on those of the investing company.

(v) The majority of the transactions are denominated in the investing company currency.

A foreign operation normally has a different functional currency from is parent when:

(i) The foreign operation is separate or independent.

(ii) The normal operations are denominated in the local currency.

(vi) The normal operations are (at least partially) financed locally.
(vii) The foreign operation has a management team committed to maximisation of the local currency profits.
(viii) The financial statements of the foreign operation are be expressed in the local currency as the best indicator of the performance locally.

Factors which may be taken into account in determining the functional currency include the following.

(i) Pricing and market conditions. Are they determined locally or by the investing company?

(ii) Does the foreign operation buy goods and services locally or rely on imports?

(iii) How is the foreign operation financed? Locally or by the investing company?

(iv) What is the extent of intra-group trading?

(b) The effects of hyper-inflation on the financial statements

Hyper-inflation can reduce the usefulness of financial statements in the following ways:

- The amounts at which assets are stated in the statement of financial position are unlikely to reflect their current values.
- The level of profit for the year may be misleading. Income appears to increase rapidly, while expenses such as depreciation may be based on out of date costs and are artificially low.
- It is therefore difficult to make any meaningful assessment of an entity's performance as assets are understated and profits are overstated.

These are well known disadvantages of basing financial statements on historic cost and they affect most entities. However, where there is hyper-inflation these problems are exacerbated. In addition, where an entity's financial statements are translated into dollars, hyper-inflation often gives rise to significant exchange differences which may absorb reserves.

How hyper-inflation should be dealt with in the financial statements

IAS 29 does not provide a definition of hyper-inflation. However, it does include guidance as to characteristics of an economic environment of a country in which hyper-inflation may be present. These include, but are not limited to, the following.

- The general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency
- Interest rates, wages and prices are linked to a price index
- The cumulative inflation rate over three years is approaching, or exceeds, 100%

IAS 29 states that the financial statements of an entity that reports in the currency of a hyper-inflationary economy should be restated in terms of the measuring unit current at the reporting date. This involves remeasuring assets and liabilities by applying a general price index. The gain or loss on the net monetary position is included in net income and separately disclosed. The fact that the financial statements have been restated should also be disclosed, together with details of the index used.

IAS 21 The effects of changes in foreign exchange rates states that where there is hyper-inflation, the financial statements of a foreign operation should be restated in accordance with the requirements of IAS29 before they are translated into the currency of the reporting entity. In this way users are made aware of the effect of hyper-inflation on the results and net assets of the entity.

(c) (i)

(1)	**Value (E million)**	**Exchange rate**	**$m**
30 November 20X3	20	1.34	14.93
30 November 20X7	20	17.87	1.12

(A material reduction in value)

	Value (E million)	**Index**	**Exchange Rate**	**$m**
30 November 20X7	20 x	3,254/100	17.87	36.42

(ii) In example (1) the tremendous reduction is due to severe exchange rate movements and has nothing at all to do with trading performance from the assets.

In example (2) a paper gain emerges simply as a result of revaluation locally, again this has little to do with trading performance and reflects an unrealised holding gain measured locally. However, this method does eliminate the 'disappearing assets' problem and IAS 29 requires restatement using this method where there is hyperinflation.

A -22

Examiner's comment. Candidates generally made good attempts at the translation of the foreign subsidiary and the calculation of goodwill, inter company profit in inventory, and the gain in translation. At the same time, there were problems with the 'extraordinary' items and surprisingly with the rates of exchange to be used in translating the income statement and statement of financial position of the subsidiary. However, generally the performance on this question was good.

	Marks
Consolidated income statement	13
Consolidated statement of financial position	12
Maximum	25

ZETEC GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 OCTOBER 20X2

$m

Non-current assets: 180 + 95 (W1) + 19.3 (W3)	294
Goodwill: (3 + 18) (W1, W7)	21
Net current assets: 146 + 29 (W1) – 3 (W4)	172
	487
Equity attributable to the owners of the parent	
Ordinary shares of $1	65
Share premium	70
Retained earnings (W9)	185
	320
Non-controlling interest (W8)	13
	333
Non-current liabilities: 74 + 80 (W1)	154
	487

ZETEC GROUP

CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 OCTOBER 20X2

	$m
Revenue: 325 + 50 (W2) – 15 (W4)	360
Cost of sales: 189 + 24.6 (W2) – 15 (W4) + 3 (W4)	(202)
Gross profit	158
Distribution and administrative expenses: 84 + 9 (W2)	(93
Finance costs: 2 + 4 (W2)	(6)
Profit before tax	59
Income tax expense: 15 + 6 (W2)	(21)
Profit for the year	38
Profit attributable to:	
Owners of the parent	37
Non-controlling interest: 6.2 (W2) x 20%	1
	38

Workings

1 Translation of subsidiary's statement of financial position/adjustment to IFRS

	Per qu Kr'm	**Adjustments**	**Note/ Working**	**Total**	**Rate Note 1**	**$m**
Non-current assets	380			380	4	95.0
Goodwill	12		2	12	4	3.0
Net current assets	116			116	4	29.0
	508			508		127.0
Equity						
Ordinary shares: 1 kr	48			48	6	8.0
Share premium	18			18	6	3.0
Pre-acq'n reserves:						
Revaluation surplus	12			12	6	2.0
Retained earnings	98	(13)	(W6)	85	6	14.2
	176			163		27.2
Post-acq'n reserves:						
Profit (Note 3)	34	(3)		31	ß	21.0
'Extraordinary' item	(22)	3+6+13	(W6)	-		-
Revaluation surplus		(6)	(W6)	(6)	5	(1.2)
	188			188		
Long-term liabilities	320			320	4	80.0

508		508	127.0

Notes

1 Translate assets and liabilities at the rate ruling at the reporting date, and share capital and pre- acquisition reserves at the historic rate. Post-acquisition reserves are as calculated above. The translation reserve is the balancing figure.

2 Aztec has allocated the excess of the price paid for its acquisition of a company over the fair value of the company's net assets to 'market share'. However, this should be re-classified as goodwill.

3 Profit excludes the extraordinary item but includes exchange differences arising on retransaltion of the subsidiary.

2 Translation of Aztec income statement

	Kr'm	Rate	$m
Revenue	250	5	50.0
Cost of sales (120 – 3 (W6))	(123)	5	24.6
Gross profit	127		25.4
Distribution and administrative expenses	(46)	5	(9.2)
Interest payable	(20	5	(4.0)
Profit before tax	61		12.2
Income tax expense	(30	5	6.0
Profit for the year	31		6.2

3 Fair value adjustment

	Acquisition	Movement	Exchange differences	Reporting date
	Kr'm	Kr'm	Kr'm	Kr'm
Stock market portfolio (240 – (W1) 163)	77	–	–	77
Exchange rate	6	5	–	4
Translated	12.8	–	6.5	19.3

4 Unrealised profit in inventories

Although the goods sold by Zetec to Aztec have been consumed in the manufacturing process, they have not been sold and are included in closing finished goods inventories. Hence, the unrealised profit must be eliminated on consolidation. The profit sits in Zetec's (the parent) books and must therefore be adjusted in full against its profits.

Goods transferred from Zetec at selling price	**$15m**
Percentage profit on selling price	20%
Goods transferred from Zetec at selling price	$3m

5 Settlement of debt from inventory transfer

A gain would be made by Aztec, calculated as follows:

	Kr'm
Liability arising on transfer of the goods at 31 May 20X2: 15m x 5.2	78
Settlement on 31 July 20X2: 15m x 4.2	63
Gain	15

This would have already been included in Aztec's income statement (in cost of sales) and is therefore recorded in Aztec's income statement in the amount of Kr 15 million in cost of sales and included in the group accounts accordingly.

6 Elimination of extraordinary item

The extraordinary items figure of Kr 22m in the income statement of Aztec has been eliminated in Working 1 as follows.

	Kr'm
Accounting policy adjustment to opening reserves *	13
Impairment of non-current asset charged to revaluation surplus **	6
Impairment of non-current asset charged to cost of sales (9 – 6)	3

	22

*Aztec has written the prior year adjustment of Kr 13m off to the current period's income statement. Under IAS 8, it should be treated as a prior year adjustment and charged against opening retained earnings, ie deducted from pre-acquisition profits and added back to post-acquisition profits.

**This would result in a debit balance on the post acquisition revaluation surplus. Consequently, on consolidation the translated figure of 1.2 (6 ÷ 5 from Working 1) will have to be offset against group retained earnings (see Working 9 below).

7 Goodwill arising on acquisition of Aztec

	Kr'm	Kr'm	Kr'm	Kr'm
Consideration transferred		264		
Less fair value of net assets acquired	240			
Group share: 80%		192		
		72	6	12
FX gain		-	β	6
		72	4	18

8 Non-controlling interest

	$m
Net assets at reporting date [47.0 (W1) + 19.3 (W3)]	66.3
Minority share	x 20%
	13.3

9 Retained earnings

	$m
Zetec per question	161.0
Aztec post-acquisition (21 (W1) – 1.2 (W1, W6 note)) x 80%	15.8
Difference on fair value adjustments (6.5 (W3)) ⍰ 80%]	5.2
On goodwill (W7)	6.0
Unrealised profit	(3.0)
	185.0

10 Proof of movement on retained earnings

	$m
Retained earnings at 1 November 20X1 [161 – 35 + 4]	30
Profit for the year	37
Dividends paid	(4)
Impairment of non-current asset charged to rev'n surplus (1.2 (W1, W6 note) x 80%)	(1)
Retained earnings as at as at 31 October 20X2	62

Analysis of exchange gain (specifically asked for in the requirement)

	$m
Closing net assets at closing rate (W1)	47.0
Opening net assets at opening rate (W1)	(27.2)
Increase in net assets	19.8
Less: profit for year (W1)	(6.2)
Add back: charge to revaluation surplus in the year (W1)	1.2
Translation differences arising in the year	14.8

A -23

Examiner's comment. This question was well answered. Candidates generally made good attempts at the translation of the foreign subsidiary, the calculation of goodwill, intragroup profit in inventory, and the gain on translation. At the same time, there were problems with the treatment of goodwill as a foreign currency asset, and the exchange gain on the intra group loan.

		Marks
Consolidated statement of financial position		7
Translation of sub- statement of financial position		5
Goodwill		1
Non-controlling interest		2
Post acquisition reserves		5
Consolidated income statement		5
Unrealised profit		4
Loan		3
	Available	32
	Maximum	32

(Movement on reserves and exchange gain analysis not asked for)

MEMO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 30 APRIL 20X4

	$m
Assets	
Property, plant and equipment	367
Goodwill (W4)	8
Current assets (355 + 48.6 – 0.6) (W8)	403
	778
Equity and liabilities	
Equity attributable to owners of the parent:	
Share capital	60
Share premium	50
Retained earnings (W7)	372
	482
Non-controlling interest (W6)	18
	500
Non-current liabilities (30 + 18.6 – 5)	44
Current liabilities	234
	778

MEMO

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 APRIL 20X4

	$m
Revenue (200 + 71 – 6)	265
Cost of sales (120 + 48 – 6 + 0.6 (W8)	(163)
Gross profit	102
Distribution costs and administrative expenses	(40
Impairment of goodwill (W5)	(2)
Finance costs	(1)
Interest receivable	4
Exchange gains (W8)	1
Profit before tax	64
Income tax expense	(24)
Profit for the year	40
Other comprehensive income	
Exchange differences on foreign operations (W9) (9.7 + 1.6)	11
Total comprehensive income for the year	51
Profit attributable to	
Owners of the parent	38
Non-controlling interest (25% ▯ 7.9) (W6)	2
	40

Total comprehensive income for the year attributable to	
Owners of the parent	47
Non-controlling interest (7.9 + 9.7) x 25%	4
	51

Workings

1 Group structure

Memo

1 May 20x3 75%

Random

Cost = 120m crowns
PAR = 80m crowns

2 Translation of statement of financial position

	CRm	Rate	$m
Property, plant and equipment	146.0	2.1	69.5
Current assets	102.0	2.1	48.6
	248.0		18.1
Share capital	32.0	2.5	12.8
Share premium	20.0	2.5	8.0
Retained earnings:			
Pre-acquisition	80.0	2.5	32.0
	132.0		52.8
Post– acquisition: 15 + (2 – 1.2) (W8)	15.8	β	17.6
	147.8		70.4
Non-current liabilities (41 – 2 (W8))	39.0	2.1	18.6
Current liabilities (60 + 1.2 (W8))	61.2	2.1	29.1
	248.0		69.5

3 Translation of income statement

	CRm	Rate	$m
Revenue	142	2	71
Cost of sales	(96)	2	(48)
Gross profit	46		23
Distribution and administrative expenses	(20)	2	(10)
Interest payable	(2)	2	(1)
Exchange gain (2 – 1.2) (W8)	0.8	2	0.4
0.4			
Profit before tax	24.8		12.4
Income tax expense	(9)	2	
	(4.5)		
Profit for the year	15.8		7.9

4 Provision for unrealised profit

	$m
Sale by parent to subsidiary (6 million x 20% x ½)	0.6

5 Goodwill

	CRm	CRm	Rate	$m
Consideration transferred				
Less fair value of net assets acquired				
Share capital	32			

Share premium	20			
Retained earnings	80			
Group share (75%)		(99.0)		
		21.0		
Impairment losses		(4.2)	2.5	8.4
		(2.0)	2.1	(2.0)
FX gain		–	B	1.6
At 30.4.X4		16.8	2.1	8.0

6 Non-controlling interest

	$m
Non-controlling interest share of net assets (25% x 70.4 (W2))	17.6

7 Retained earnings

	$m
Memo	360.0
Random (75% x 17.6 (W3))	13.2
Provision for unrealised profit (W4)	(0.6)
Impairment of goodwill (W5)	(2.0)
Exchange differences on goodwill (W5)	1.6
	372.2

8 Exchange gains and losses in the accounts of Random

	CRm
At 1 May 20X3 ($5 million x 2.5)	12.5
At 30 April 20X4 ($5 million x 2.1)	(10.5)
Gain	2.0

Intro-group purchases (current liabilities)

	CRm
Purchase of goods from Memo ($6 million x 2)	12
Payment made ($6 million x 2.2)	(13.2)
Loss	(1.2)

Exchange differences in income statement (retranslated to dollars)

	$m
Gain on loan (2 ÷ 2)	1.0
Loss on current liability/purchases (1.2 ÷ 2)	(0.6)
	0.4

(Note. This has been rounded up to $1 million.)

9 Exchange differences arising during the year

	$m	$m
Closing net assets at closing rate (W2)	70.4	
Less opening net assets at opening rate (W2)	(52.8)	
		17.6
Less retained profit as translated (W3)		(7.9)
		9.7
Exchange gain on retranslation of goodwill (W4)		1.6
		11.3

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(a) (i) The functional currency is a matter of fact and is the currency of the primary economic environment in which the entity operates (IAS 21). It should be determined at the entity level. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. The following factors should be considered in determining Stem's functional currency (IAS 21):

(i) the currency that mainly influences the determination of the sales prices; and

(ii) the currency of the country whose competitive forces and regulations mainly influences operating costs

The currency that dominates the determination of sales prices will normally be the currency in which the sales prices for goods and services are denominated and settled. IAS 21 requires entities to consider primary and secondary factors when determining the functional currency. These factors include the degree of autonomy and the independence of financing.

In Stem's case, sale prices are influenced by local demand and supply, and are traded in dinars. Analysis of the revenue stream points to the dinar as being the functional currency. The cost analysis is variable as the expenses are influenced by the dinar and the dollar. Additional factors to be taken into account include consideration of the autonomy of a foreign operation from the reporting entity and the level of transactions between the two. Stem operates with a considerable degree of autonomy both financially and in terms of its management. Consideration is given to whether the foreign operation generates sufficient functional cash flows to meet its cash needs, which in this case Stem does, as it does not depend on the group for finance. Therefore, the functional currency of Stem will be the dinar as the revenue is clearly influenced by the dinar, and although the expenses are mixed, secondary factors point to the fact that the functional currency is different to that of Rose.

(ii) Rose plc

Consolidated Statement of Financial Position at 30 April 2011

	$m
Assets:	
Non-current assets	
Property, plant and equipment (W6)	603·65
Goodwill (16 + 6·2) (W1 & W2)	22·2
Intangible assets (4 – 1) (W1)	3
Financial assets (W7)	32
	660·85
Current assets (118 + 100 + 66)	284
Total assets	944·85
Equity and liabilities:	
Share capital	158
Retained earnings (W3)	267·12
Exchange reserve (W3)	10·27
Other components of equity (W3)	6·98
Non-controlling interest (W5)	89·83
Total equity	532·20
Non-current liabilities (W8)	130·65
Current liabilities (W4)	282
Total liabilities	412·65
Total equity and liabilities	944·85

Working

Petal

	$m	**$m**
Fair value of consideration for 70% interest	94	
Fair value of non-controlling interest	46	
		140
Fair value of identifiable net assets		(120)
Total premium		20

Comprising	
Patent	4
Goodwill	16

Amortisation of patent

1 May 2010 to 30 April 2011 – $4m divided by 4 years, i.e. $1 million

Dr	Profit or loss	$1 million
Cr	Patent	$1 million

Acquisition of further interest

The net assets of Petal have increased from $124m (38 + 49 + 3 + 4 patent + 30 land (W6)) million to 131 million(98 + 3 patent + 30 land (W6)) at 30 April 2011. They have increased by $7 million and therefore the NCI has increased by 30% of $7 million, i.e. $2·1 million.

	$m
Petal NCI 1 May 2010	46
Increase in net assets	2·1
Net assets 30 April 2011	48·1
Transfer to equity 10/30	(16·03)
Balance at 30 April 2011	32·07
Fair value of consideration	19
Transfer to equity	(16·03)
Negative movement (debit) in equity	2·97

Working 2

Stem – translation and calculation of goodwill

	Dinars m	Dinars m fair value adjust	Rate	$m
Property, plant and equipment	380	75	5	91
Financial assets	50		5	10
Current assets	330		5	66
	760	75		167
Share capital	200		6	33·33
Retained earnings – pre-acquisition	220		6	36·67
post acquisition	80		5·8	13·79
Exchange difference			Bal.	18·71
Other equity		75	6	12·5
				115
Non-current liabilities	160		5	32
Current liabilities	100		5	20
	760	75		167

The fair value adjustment at acquisition is (495 – 200 – 220) million dinars, i.e. 75 million dinars. Goodwill is measured using the full goodwill method.

	Dinars m	Rate	$m
Cost of acquisition	276	6	46
NCI	250	6	41·67
Total	526	6	87·67
Less net assets acquired	495	6	82·5
Goodwill	31	6	5·17

Goodwill is treated as a foreign currency asset, which is retranslated at the closing rate. Goodwill in the consolidated statement of financial position at 30 April 2011 will be 31 million dinars divided by 5, i.e.

$6·2 million. Therefore an exchange gain of $1·03m will be recorded in retained earnings ($0·54m) and NCI ($0·49m).

Exchange difference on Stem's net assets

	$m
Net assets at 1 May 2010 $(33·33 + 36·67 + 12·5)m	82·5
Exchange difference arising on Stem's net assets	18·71
Profit for year (80m dinars/5·8)	13·79
Net assets at 30 April 2011 (575m dinars/5)	115

The exchange difference is allocated between group and NCI according to shareholding, group ($9·73m) (W3) and NCI($8·98m) (W5).

Working 3

Tutorial note: The exchange reserve has been shown separately. It is acceptable to have combined this with retained earnings.

Retained earnings

	$m
Rose: balance at 30 April 2011	256
Current service cost – bonus scheme (W9)	(0·65)
Depreciation overcharged	0·4
Post acquisition reserves: Petal (70% x (56 – 49	4·2
Stem (52% x 13·79)	7·17
	267·12
Exchange reserve	
Exchange gain on goodwill (W2)	0·54
Exchange gain on net assets	9·73
Total	10·27

Other components of equity

	$m
Rose: balance at 30 April 2011	7
Post acqn reserves – Petal (70% x (4 – 3))	0·7
Petal – negative movement in equity (W1)	(2·97)
Revaluation surplus – overseas property (W6)	2·25
	6.98

Working 4

	$m
Rose	185
Petal	77
Stem	20
	282

Working 5

Non-controlling interest

	$m
Petal (W1)	32·07
Stem at acquisition (W2)	41·67
Exchange gain – goodwill (W2)	0·49
Profit for year (13·79 x 48%)	6·62
Exchange gain on net assets (W2)	8·98
Total	89·83

Working 6

Property, plant and equipment

	$m	$m
Rose	370	
Petal	110	
Stem	91	
		571
Increase in value of land – Petal (120 – (38 + 49 + 3))		30
Change in residual value		
Cost $20 – residual value $1·4 = $18·6m		
New depreciable amount at 1 May 2010	$17·4m	
Less depreciation to date (18·6 x 3/6)	$9·3m	
Amount to be depreciated	$8·1m	
Depreciation over remaining three years p.a	$2·7m	
Amount charged in year (18·6 x 1/6)	$3·1m	
Depreciation overcharged		0.4
Overseas property		
cost (30m/6 dinars)	$5m	
Depreciation (5m/20)	($0·25m)	
Revalued amount (35/5)	$7m	
Revaluation surplus to equity	($7m – 4·75m)	2.25
		603.65

Working 7

Financial assets

		$m
Rose	15	
Petal	7	
Stem	10	
		32

Working 8

Non-current liabilities

		$m
Rose	56	
Petal	42	
Stem	32	
		130
Bonus scheme (W9)		0.65
		130.65

Working 9

Employee bonus scheme

The cumulative bonus payable will be $4·42 million.

The benefit allocated to each year will be this figure divided by five years. That is $884,000 per year. The current service cost is the present value of this amount at 30 April 2011. That is $884,000 divided by 1·08 for four years, i.e $0·65m

	30 April 2011 $m	**30 April 2012 $m**	**30 April 2013 $m**	**30 April 2014 $m**	**30 April 2015 $m**

Benefit 2% of salary which increases at 5%		0·8	0·84	0·882	0·926
Bonus cumulative	0·8	1·64	2·522	3·448	4·42

(b) Rose's allocation of the cost of acquisition of companies is not based on 'fair value' as defined in IAS 38 or IFRS 3. Further the application of fair value in accordance with IFRS may result in the identification and allocation of the cost of the business combination to other types of intangible assets in addition to those recognised by Rose.

IFRS 3 requires an acquirer to allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria at their fair values at the date of acquisition. The fair value of intangible assets that are not traded in an active market is determined at the amount that would be paid for the assetsin an arm's length transaction between knowledgeable and willing parties, based on the best information available. The fair value is not an amount that is specific to the acquirer, nor should it take into account the acquirer's intentions for the future of the acquired business.

If Rose plans to allocate the cost of business combination to assets based on the value that they have for Rose, this is not in compliance with IFRS.

The contract-based customer relationships are identifiable in accordance with IAS 38 and would probably have value. In order to be recognised separately, the identifiable assets, liabilities and contingent liabilities have to satisfy the probability and reliable measurement criteria of IFRS 3. For intangible assets acquired in business combinations the probability recognition criterion is always considered to be satisfied. Furthermore, IAS 38 states that the fair value of intangible assets acquired in business combinations can normally be measured sufficiently reliably to be recognised separately from goodwill. Part of the cost of the business combination of the company should be allocated to customer relationships, assuming there to be a positive value at the date of acquisition and notwithstanding the fact that many of the customers were already known to Rose. The fair value of the customer relationships could not be based on the lack of Rose's willingness to pay but, rather, should reflect what a well-informed buyer without previous customer relationships with these customers would be willing to pay for those assets.

Management often seeks loopholes in financial reporting standards that allow them to adjust the financial statements as far as is practicable to achieve their desired aim. These adjustments amount to unethical practices when they fall outside the bounds of acceptable accounting practice. Reasons for such behaviour often include market expectations, personal realisation of a bonus, and maintenance of position within a market sector. In most cases conformance to acceptable accounting practices is a matter of personal integrity. It is often a matter of intent and therefore if the management of Rose is pursuing such policies with the intention of misleading users, then there is an ethical issue.

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Traveler plc
Consolidated Statement of Financial Position at 30 November 2011

	$m
Assets:	
Non-current assets:	
Property, plant and equipment (W9)	1,842·28
Goodwill (W3)	69·2
Financial assets (W4)	130·12
Defined benefit asset (W8)	38
Current assets (W10)	2,126
Total assets	4,205·6
Equity and liabilities	
Equity attributable to owners of parent	
Share capital	1,120
Retained earnings (W5)	968·4
Other components of equity (W5)	91·7
	2,180·1

Non-controlling interest (W7)	343·5
	2523.6
Total non-current liabilities (W10)	851
Current liabilities (W6)	831
Total liabilities	1,682
Total equity and liabilities	4,205.6

Working 1
Data

	$m	$m
Fair value of consideration for 60% interest		600
Fair value of non-controlling interest		395
Fair value of identifiable net assets acquired:		
Share capital	600	
Retained earnings	299	
OCE	26	
FV adjustment – land (balance)	10	(935)
Goodwill		60

Further acquisition of 20%

	$m	$m
Fair value of consideration		200
NCI at 1 December 2010	395	
Increase in net assets to 30 November 2011:		
((1,079 + 10) – 935) x 40%	61.1	
NCI 30 November 2011	456.6	
Transfer to equity 20/40		228.3
Positive movement in equity		8.3

The net assets of Data have increased from $935 to $1,089 million $(1,079 + fair value adjustment 10), i.e. $154 million.

The NCI proportion is 40% of $154 million, i.e. $61·6 million.

Working 2
Captive

	$m		$m
Purchase consideration			541
Less fair value of identifiable net assets:			
Share capital	390		
Retained earnings	90		
OCE	24		
FV adjustment – land (balance)	22		
	526	X 80%	420.8
Goodwill			120.2

The assets transferred as part of the consideration need to be removed from non-current assets, and the gain on disposal needs to be calculated. The proceeds of $64m credited to profit needs to be removed. The sale consideration is $64 million and the carrying amount is $56 million, giving a gain on disposal of $8 million. The adjustment required to arrive at the gain is:

Dr Retained earnings $56m
Cr Non-current assets $56m

Working 3
Impairment of goodwill
Data

	$m	$m
Goodwill		60
Identifiable net assets		
Net assets	1,079	
FV adjustment – land	10	1,089
Total		1,149
Recoverable amount		(1,099)
Goodwill impairment		50

The goodwill impairment relating to Data will be split 80/20 between the group and the NCI. Thus retained earnings will be debited with $40 million and NCI with $10 million.

Note: IAS 36 Appendix C, paragraphs C5 to C9 states that when NCI is valued at fair value, any goodwill impairment should be allocated on the basis of the allocation used for profit or loss. Given that the impairment review arose at the year end when Traveler's shareholding was 80%, this is now the basis of profit allocation and hence has been used in determining the split between group and NCI. It could be argued that a 60:40 allocation between group and NCI is also appropriate as this was how profits that arose in the year have been apportioned and the impairment is a loss that arose in the year, albeit at the year end.

Captive

	$m	$m
Goodwill		120.2
Unrecognised non-controlling interest (20%)		30.05
Identifiable net assets		
Net assets	604	
FV adjustment – land	22	626
Total		776.25
Recoverable amount		(700)
Goodwill impairment on grossed up amount		76.25
Goodwill impairment on Traveler's share (80% x 76·25)		61

Goodwill is therefore $(60 + 120·2 – 50 – 61) million, i.e. $69·2 million.

Financial asset

Under IFRS 9, debt instruments are subsequently measured at amortised cost if:

(a) The asset is held within a business model whose objective is to hold the assets to collect the contractual cash flows; and

(b) The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding.

All other debt instruments are subsequently measured at fair value. The classification of an instrument is determined on initial recognition and reclassifications are only permitted on the change of an entity's business model and are expected to occur only infrequently. Traveler cannot measure the instrument at fair value as the objective for holding the financial asset has not changed.

The impairment loss is calculated by discounting the annual payments using the original effective interest rate of 6·7% as follows:

	$m	$m
Carrying value		29.00
PV of future cash flows:		
Year 1 8m x 1/1·067	7.50	
Year 2 8m x 1/1·0672	7.03	

Year 3 8m x 1/1·0673	6.59	
		(21.12)
Impairment to profit or loss		7.88

The carrying value will be $(108 + 10 + 20 – 7·88)m, i.e. $130·12m

Working 5
Retained earnings

	$m
Traveler – Balance at 30 November 2011	1,066
Sale of non-current asset (W2)	(56)
Impairment of goodwill (W3) $(40 + 61)m	(101)
Impairment of financial instrument (W4)	(7·88)
Defined benefit cost (W8)	(55)
Write off of defined benefit asset	(24)
Depreciation for year factory (W9)	(2·72)
Post acquisition reserves: Data (60% of $(442 – 299)m)	85·8
Captive (80% of $(169 – 90)m)	63·2
	968.4

Other components of equity

	$m
Traveler – Balance at 30 November 2011	60
Data post acqn (60% of $(37 – 26)m)	6·6
Captive (80% x $(45 – 24)m)	16·8
Positive movement in equity	8·3
	91.7

Working 6
Current liabilities

	$m
Traveler	274
Data	199
Captive	313
Defined benefit contributions (W8)	45
	831

Working 7
Non-controlling interest

	$m
Data (W1)	228·3
Impairment of Data goodwill (W3)	(10)
Captive (20% x $(604 + 22)m)	125·2
	343.5

Working 8
Defined benefit pension fund

The entries for the pension scheme would be as follows:

Dr profit or loss	**$55m**	
Cr defined benefit asset	**$55m**	
Pension cost		
Dr defined benefit asset	**$45m**	
Cr current liabilities		**$45m**
Accrual of contributions		

The defined benefit asset would be as follows:

PV of obligation at 1 December 2010	200
Fair value of assets at 1 December 2010	(250)
Actuarial losses	(22)
Pension surplus at 1 December 2010	(72)
Pension costs	55
Contributions accrued	(45)
Pension surplus at 30 November 2011	(62)
Restriction of amount recognised as asset (see below)	24
Pension surplus at 30 November 2011	38

There would not be any recognition of actuarial losses as the limits of the corridor (10% of the fair value of the assets, i.e. $25 million) are greater than the unrecognised losses. However, there will be a ceiling placed on the amount to be recognized as an asset. This will be the total of the unrecognised actuarial losses of $20 million and the present value of available future refunds and reductions in future contributions of $18 million. That is $38 million. Therefore the defined benefit asset will be reduced by $(62 – 38) million, i.e. $24 million.

Working 9

Property, plant and equipment

Traveler cannot treat the roof and the building as a single asset. They must be treated separately. The roof will be depreciated over five years at $1 million per annum and the remainder will be depreciated over 25 years taking into account the residual value. ($45m – 2m)/25 years, i.e. $1·72million per annum. The total depreciation for the year is $2·72 million.

	$m	**$m**
Traveler	439	
Data	810	
Captive	620	
		1,869
Increase in value of land – Data (W1)		10
Increase in value of land – Captive (W2)		22
Less depreciation		(2.72)
Less disposal of asset (W2)		(56)
		1,842.28

Working 10

Non-current liabilities

	$m	**$m**
Traveler	455	
Data	323	
Captive	73	
		851
Current assets		
Traveler	995	
Data	781	
Captive	350	
		2,126

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Robby Consolidated Statement of Financial Position at 31 May 2012

	$m
Assets	
Non-current assets:	
Property, plant and equipment (W8)	241.13

Goodwill (5 + 1) (W1 and W2)	6.00
Financial assets	29.00
Current assets (W9)	36.00
Total assets	312.13
Equity and Liabilities	
Ordinary shares	25.00
Other components of equity (W3)	2.00
Retained earnings (W3)	81.45
Total equity	108.45
Non-controlling interest (W4)	27.64
Total equity	136.09
Non-current liabilities including provision (W11)	94.84
Current liabilities (W10)	81.20
Total equity and liabilities	312.13

Working 1

Hail

Fair value of consideration for 80% interest	50.00
Fair value of non-controlling interest	15.00
	65.00
Fair value of identifiable net assets acquired	(60.00)
Goodwill	5.00

On consolidation, there will be a reversal of the fair value adjustments to the investment held at fair value through profit and loss. Further, the dividend income on investment should be taken to profit or loss and not other comprehensive income.

Therefore the adjustments required are:

Dr Other comprehensive income	5.00	
Cr Investment in Hail		5.00
Dr Other comprehensive income	2.00	
Cr Retained earnings		2.00

Working 2

Zinc

	$m
Consideration: at 1 June 2009	2.00
at 1 June 20	16.00
Increase in fair value to 31 May 2011	1.00
Investment in Zinc in Robby's financial statements	19.00
Increase in fair value of equity interest (5-00 1 2-00 1 1-00)	2.00
Fair value of consideration	21.00
Fair value of non-controlling interest	9.00
	30.00
Fair value of identifiable net assets	(26.00)
Increase in value	(3.00)
Goodwill	1.00

Working 3

Retained earnings

	$m
Robby:	
Balance at 31 May 2012	70·00
Dividend from Hail	2·00

Increase in fair value of equity interest – Zinc	2·00
Post-acquisition reserves: Hail	8·80
Zinc	2·16
Joint operation	0·68
Impairment loss	(0·70)
Transfer from OCE	0·11
Factoring trade receivables	0·40
Reversal of disposal profit on land under option	(4.00)
	81.45

Hail:	
Group reserves – 80% of 11	8.80
NCI – 20% of 11	2.20
Post-acquisition reserves (27 – 16)	11.00

Zinc:	
Post-acquisition reserves (19 – 15)	4.00
***Less* increase in depreciation (W2)**	(0.40)
	3.60
Group reserves – 60% of 3·60	2.16
NCI – 40% of 3·60	1.44
	3.60

Other components of equity

Robby:	
Balance at 31 May 2012	11·00
Dividend to retained earnings	(2·00)
Profit on revaluation of investment in Hail	(5·00)
Impairment loss	(1·89)
Transfer to retained earnings	(0·11)
	2.00

Working 4

Non-controlling interest

	$m
Hail:	
At acquisition	15.00
Post-acquisition share	2.20
	17.20
Zinc:	
At acquisition	9.00
Post-acquisition share	1.44
	10.44
Total	27.64

Working 5

Trade receivables

The correcting double entry is:

	$m
DR Trade receivables	4.00
CR Secured borrowings	3.60
CR Retained earnings	0.40

Working 6

Impairment of PPE

Any impairment loss on a revalued asset is charged to other comprehensive income to the extent of the amount relating to that asset in the revaluation surplus and thereafter in profit or loss.

PPE	Depreciated historical cost	Revalued carrying amount
	$m	$m
31 May 2011	9.00	9.00
Revaluation		2.00
Total		11.00
Depreciation to 31 May 2012	(0.50)	(0..61)
Balance 31 May 2012	8.50	10.39
Impairment loss	(0.70)	(2.59)
31 May 2012 after impairment loss	7.80	7.80

There will have been a transfer of $0·11 (0·61 – 0·50) million from the revaluation surplus to retained earnings for the excess depreciation charged in the year so the remaining amount in the revaluation surplus is $1·89m (2·00 – 0·11). $1·89m of the impairment will be recognised in other comprehensive income and the remaining $0·7m in profit or loss.

Working 7

Joint operation

	1 June 2011	Dismantling cost	Depreciation	Unwinding of discount	31 May 2012
PPE	6	2 x 40%	(6.8 x 1/10)		6.12
Trade receivables					8
Trade payables (0·2 + 6·4)					6.6
Provision		0.8		0.04	0.84
Income statement					
Revenue (20·00 x 40%)					4
Cost of sales (16·00 x 40%)					(6.4)
Operating cost (0·50 x 40%)					(0.2)
Depreciation					(0.68)
Finance expense					(0.04)
Net profit					0.68

Working 8

Property, plant and equipment

	$m	$m
Robby	112.00	
Hail	60.00	
Zinc	26.00	
		198.00
Increase in value of land – Hail (60 – 20 – 16)		24.00
Increase in value of PPE – Zinc (26 – 10 – 15)		1.00
Further increase in value of PPE at acquisition		3.00
Less: increased depreciation (1 + 3)/5 x 6/12		(0.40)
Impairment loss		(2.59)
Joint operation (W7)		6.12
Land – option to repurchase		12.00
		241.13

The sale of land should not be recognised in the financial statements as the risks and rewards of ownership have not been transferred. The land can be repurchased at the sale price plus a premium, which represents effectively an interest payment. It is effectively manipulating the financial statements in order to show a better cash position. The land should be reinstated at its carrying amount before the transaction, so $12 million, a current liability recognised of $16 million and the profit on disposal of $4 million that was recorded reversed.

Working 9
Current assets

	$m	$m
Robby	5.00	
Hail	7.00	
Zinc	12.00	
		24.00
Factoring trade receivables		4.00
Joint operation (W7)		8.00
		36.00

Working 10
Current liabilities

	$m
Robby	47·00
Hail	6·00
Zinc	2·00
Secured borrowings	3·60
Joint operation (W7) (6·40 trade payable + 0·20 operating costs)	6·60
Land sale	16.00
	81.20

Working 11
Non-current liabilities

	$m
Robby	53.00
Hail	20.00
Zinc	21.00
Joint operation (0·80 provision + unwinding of discount 0·04) (W7)	0.84
	94.84

Minny Group
Consolidated Statement of Financial Position at 30 November 2012

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Assets:	
Non-current assets:	
Property, plant and equipment (W9)	1,606.00
Goodwill (W2)	190.00
Intangible assets (W8)	227.00
Investment in Puttin (W3)	50.50
	2,073·50
Current assets (W10)	1,607·00
Disposal group (W11)	33.00
Total assets	3,713.50

Equity and liabilities

Equity attributable to owners of parent		
Share capital		920.00
Retained earnings (W5)		936.08
Other components of equity (W5)		77.80
		1,933.88
Non-controlling interest (W7)		394.62
		2,328.50
Total non-current liabilities (W10)		711.00
Disposal group (W11)		3.00
Current liabilities (W6)		671.00
Total liabilities		1,385.00
Total equity and liabilities		3713.50

Working 1

Bower

	$m	**$m**
Purchase consideration		730
Fair value of non-controlling interest		295
Fair value of identifiable net assets acquired:		
Share capital	400	
Retained earnings	319	
OCE	27	
FV adjustment – land	89	(835)
Goodwill		190

Working 2

Heeny

	$m	**$m**
Purchase consideration –		320
***Less* consideration belonging to NCI – (30% of $320)**		(96)
NCI fair value of 44% holding		161
Fair value of identifiable net assets:		
Share capital	200	
Retained earnings	106	
OCE	20	
FV adjustment – land	36	(362)
Goodwill		23

Impairment test of Bower and Heeny

	Bower **$m**	Heeny **$m**
Goodwill	190	23
Assets	1130	595
Fair value adjustment	89	36
Total asset value	1409	654
Recoverable amount	(1425)	(604)
Impairment	n/a	50

There is no impairment in the case of Bower but Heeny's assets are impaired. Goodwill of $23 million plus $27 million of the intangible assets will be written off. The reason for the latter write down is because the directors feel that the reason for the reduction in the recoverable amount is due to the intangible assets' poor performance.

Group reserves will be debited with $28 million and NCI with $22 million, being the loss in value of the assets split according to the profit sharing ratio.

Total goodwill is therefore ($190m + $23m – $23m impairment), i.e. $190 million

Working 3
Puttin

The gain of $3 million ($21m – $18m) recorded within OCE up to 1 June 2012 would not be transferred to profit or loss for the year but can be transferred within equity and hence to retained earnings under IFRS 9 *Financial Instruments*.

The amount included in the consolidated statement of financial position would be:

Cost ($21 million + $27 million)	48
Share of post-acquisition profits ($30 million x 0·5 x 30%)	4.5
Less dividend received	(2.0)
	50.5

The dividend should have been credited to Minny's profit or loss and not OCI. Dividend income as an investment and as an associate is treated in the same way as a credit to profit or loss. There is no impairment as the carrying amount of the investment in the separate financial statements does not exceed the carrying amount in the consolidated financial statements nor does the dividend exceed the total comprehensive income of the associate in the period in which the dividend is declared.

Working 4
Intangible assets

Minny should recognise the $10 million as an intangible asset plus the cost of the prototype of $4 million and the $3 million to get it into condition for sale. The remainder of the costs should be expensed including the marketing costs. This totals $9 million, which should be taken out of intangibles and expensed.

Dr Retained earnings	$9 million
Cr Intangible assets	$9 million

Working 5
Retained earnings

	$m
Balance at 30 November 2012: Minny	895·00
Post-acquisition reserves: Bower (70% of (442 – 319))	86·10
Heeny (56% of (139 – 106))	18·48
Puttin: fair value of investment at acquisition from OCE	3·00
Puttin: share of post-acquisition retained profits (W3) (4·5 – 2)	2·50
Dividend income from OCE	2·00
Intangible assets	(9·00)
Impairment loss on goodwill of Heeny (W2)	(28·00)
Impairment loss on disposal group (W11)	(34·00)
Total	936.08

Other components of equity	
Balance at 30 November 2012: Minny	73
Post-acquisition reserves: Bower (70% of (37 – 27))	7
Heeny (56% of (25 – 20))	2·8
Dividend income to retained earnings	(2)

Transfer to retained earnings		(3)
		77.8

Working 6
Current liabilities
Balance at 30 November 2012

Minny	408
Bower	128
Heeny	138
	674
Disposal group	(3)
	671

Working 7
Non-controlling interest

Bower (W1)	295
Heeny (W2) – purchase consideration	(96)
Fair value	161
Post-acquisition reserves – Bower	
Retained earnings (30% of (442 – 319))	36·9
OCE (30% of (37 – 27))	3
Heeny	
Retained earnings (44% of (139 – 106))	14·52
OCE (44% of (25 – 20))	2·2
Impairment loss (W2)	(22)
	394·62

Working 8
Intangibles

	$m	**$m**
Minny	198	
Bower	30	
Heeny	35	
Intangible expensed	(9)	
Impairment of intangible	(27)	
		227

Working 9
Property, plant and equipment

	$m	**$m**
Minny	920	
Bower	300	
Heeny	310	
		1,530
Increase in value of land – Bower (W1)		89
Increase in value of land – Heeny (W2)		36
		1,655
Disposal group		(49)
		1,606

Working 10
Non-current liabilities

	$m	**$m**
Minny	495	
Bower	123	
Heeny	93	

		711
Current assets		
Minny	895	
Bower	480	
Heeny	250	
		1,625
		(18)
Disposal group		1,607

Working 11

Disposal group

	$m
PPE	49
Inventory	18
Current liabilities	(3)
Proceeds	30)
Impairment loss	34

The assets and liabilities will be shown as single line items in the statement of financial position. Assets at ($67 – 34 m), i.e. $33 million and liabilities at $3 million. A plan to dispose of net assets is an impairment indicator.

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CHARMER

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 30 SEPTEMBER 20X1

Cash flows from operating activities	**$m**	**$m**
Profit before taxation	1,579	
Adjustments for		
Depreciation ((W1) 80 + 276)	356	
Loss on disposal of plant	86	
Amortisation of government grant	(125)	
Negligence claim previously provided	120)	
Investment income	(120)	
Interest expense	260	
	1,916	
Increase in trade receivables (935 – 824)	(111)	
Increase in inventories (1,046 – 785)	(261)	
Decrease in trade payables (760 – 644)	(116)	
Cash generated from operations	1,428	
Interest paid (W5)	(245)	
Income taxes paid (W3)	(368)	
Net cash from operating activities		815
Cash flows from investing activities		
Purchase of property, plant and equipment ((W1) 50 + 848)	(898)	
Purchase of non-current investments	(690)	
Purchase of treasury bills (120 – 50)	(70)	
Proceeds from sale of plant (W1)	170	
Government grant received (W4)	175	
Investment income received	120	
Net cash used in investing activities		(1,193)
Cash flows from financing activities		

Proceeds from issue of share capital (W2)	300	
Dividends paid	(180)	
Net cash from financing activities		120
Net decrease in cash and cash equivalents		(258)
Cash and cash equivalents at beginning of period		122
Cash and cash equivalents at end of period		(136)

Workings

1 Non-current assets and depreciation

LAND AND BUILDINGS – COST/VALUATION

	$'000		$'000
Balance b/f	1800		
Revaluation	150		
Cash purchase (bal fig)	50	Balance c/f	2,000
	2000		2,000

PLANT – COST

	$'000		$'000
Balance b/f	1220	Disposal	500
Cash purchases (bal fig)	848	Balance c/f	1568
	2068		2068

Disposal proceeds:

	$'000
Cost	500
Accumulated depreciation	(244)
NBV	256
Loss on sale	(86)
∴Disposal proceeds	170

LAND AND BUILDINGS – ACC'D DEPRECIATION

	$'000		$'000
		Balance b/f	680
Balance c/f	760	Depreciation (bal fig.)	80
	760		760

LAND AND BUILDINGS – ACC'D DEPRECIATION

	$'000		$'000
Disposal	244	Balance b/f	432
Balance c/f	464	Depreciation (bal fig.)	276
	708		708

2 Issue of share capital

SHARE CAPITAL

	$'000		$'000
		Balance b/f	1,000
		Bonus issue 1 for 10	100
		Conversion of loan stock	100
Balance c/f	1,400	Issued for cash (bal fig)	200
	1,400		1,400

SHARE PREMIUM

	$'000		$'000

		Balance b/f	60
		Conversion of loan stock	300
Balance c/f	460	Issued for cash (bal fig)	100
	460		460

∴ Total for cash = $200,000 + $100,000 = $300,000

* Conversion of loan stock:

Carrying value of loan stock = $20,000 + $380,000 = $400,000

∴ No of shares = $400,000 × 25 = 100,000

Shares must be at a premium of $400,000 – $100,000 = $300,000

3 Income tax paid

INCOME TAX CAPITAL

	$'000		**$'000**
Income taxes paid (bal fig)	368	Deferred tax b/f	400
Deferred tax c/f	439	Current tax b/f	367
Current tax c/f	480	Income tax charged to I/S	520
	1,287		1287

4 Government grant received

GOVERNMENT GRANT

		$'000			**$'000**
Amortisation credited to			Balance b/f:	non-current	200
cost of sales		125		current	125
Balance c/f:	**non-current**	275	Cash receipt (bal fig)		175
	current	100			
		500			500

5 Interest paid

INTEREST PAYABLE

	$'000		**$'000**
Interest paid (bal fig)	245	Balance b/f	25
Balance c/f	40	Charged to I/S	260
	285		285

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STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X5

Cash flows from operating activities

Cash flows from operating activities

	$'000	**$'000**
Profit before tax	16,500	
Adjustments for:		
Depreciation	5,800	
Impairment losses (W2)	240	
	22,540	
Increase in trade receivables (9,800 – 7,500 – 600)	(1,700)	
Increase in inventories (16,000 – 10,000 – 1,600)	(4,400)	
Increase in trade payables (7,600 – 6,100 – 300)	1,200	
Cash generated from operations	17,640	
Income taxes paid (W1)	(4,200)	

Net cash from operating activities		13,440
Cash flows from investing activities		
Acquisition of subsidiary net of cash acquired	(600)	
Purchase of property, plant and equipment (W2)	(13,100)	
Net cash used in investing activities		(13,700)
Cash flows from financing activities		
Proceeds from issue of share capital		
(12,300 + 5,800 – 10,000 – 2,000 – (5,000 – 1,000))	2,100	
Dividends paid	(900)	
Dividends paid to non-controlling interest (W3)	(40)	
Net cash from financing activities		1,160
Net increase in cash and cash equivalents		900
Cash and cash equivalents at the beginning of the period		1,500
Cash and cash equivalents at the end of the period		2,400

Workings

1 Additions to property, plant and equipment

GOVERNMENT GRANT

	$'000		$'000
b/d	25,000		
Revaluation surplus	500		
On acquisition	2,700	Depreciation	5,800
∴ Additions	13,100	c/d	35,500
	41,300		41,300

2 Goodwill impairment loss

GOODWILL

	$'000		$'000
b/d	0	∴ Impairment loss	240
On acquisition			
(5,000 – (4,800 X 70%))	1,640	c/d	1,400
	1,640		1640

3 Dividends paid to non-controlling interest

NON-CONTROLLING INTEREST

	$'000		$'000
		b/d	0
∴ Dividends paid	40	Acquisition (4,800 x 30%)	1440
c/d	1,600	I/S	200
	1,640		1640

4 Income taxes paid

INCOME TAX PAYABLE

	$'000		$'000
		b/d	4,000
∴ Income taxes paid	4,200	Acquisition	200
c/d	5,200	I/S	5,200
	9,400		9,400

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Top tips. The examiner for this paper has stated that the emphasis is on advising management and on realistic scenarios. Part (b) could come under the heading of advice and Part (a), which involves using your knowledge to correct the accountant's work, could come under both headings.

			Marks
(a)	Net cash inflow		8
	Taxation		3
	Sale of property, plant and equipment		4
	Non-controlling interest		2
	Joint venture		2
	Disposal of subsidiary and cash disposed of		2
		Available	21
		Maximum	18
(b)	Subjective		7
		Available	28
		Maximum	25

(a) PORTAL GROUP

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X0

	Working	$m	$m
Cash generated from operations	1		712
Interest paid		(9)	
Income taxes paid	2	(115)	
			124
Net cash from operating activities			588
Cash flows from investing activities			
Disposal of subsidiary		75	
Subsidiary's cash disposed of		(130)	
Purchase ofproperty, plant and equipment		(380)	
Sale of property, plant and equipment	3	195	
Purchase of interest in joint venture		(25)	
Interest received		26	
Dividend received from joint venture		10	
Net cash used in investing activities			(229)
Cash flows from financing activities			
Increase in short term deposits		(143)	
Dividend paid to non-controlling interest	4	(31)	
Net cash used in financing activities			(174)
Net increase in cash and cash equivalents			185
Cash and cash equivalents at 1 January 20X0			600
Cash and cash equivalents at 31 December 20X0			785

Workings

1 Cash generated from operations

	$m
Per question	875
Add back loss on disposal	25
Adjustments for current assets/liabilities of subsidiary *	
Inventory	(60)
Trade receivables	(50)
Current liabilities (130 – 25)	105
Deduct post-tax profit on joint venture	(55)
Interest receivable	(27)

Interest payable	19	
Deduct profit on sale of non current assets	(120)	
	712	

*Note. The movements in current assets used by the accountant to calculate net cash inflow from operating activities incorrectly include amounts relating to the subsidiary disposed of.

2 Income taxes paid

	$m
Per question (position statement movement)	31
Tax on subsidiary disposed of	25
Tax on profit	(171)
Cash outflow	(115)

3 Sale of property, plant and equipment

	$m
Per question (carrying value)	1,585
Transferred to joint venture	(200)
Subsidiary disposed of	(310)
Sale and leaseback	1,000)
Profit on sale	120
Cash inflow	195

4 Dividend paid to non-controlling interests

	$m
Difference per question (position statement movement)	40
Profit for year	75
Sale of subsidiary (20% x 420)	(84)
	31

Notes

1 An investment normally qualifies as a cash equivalent only when it has a short maturity, of say three months or less from date of acquisition. It is assumed that the short term investments do not fall into this category because they have a maturity profile in excess of the suggested three months.

2 The joint venture has been accounted for, as per IAS 31, using the equity method rather than proportionate consolidation.

(b) Statements of cash flows: presentation to directors of Portal plc

General purpose

The purpose of statements of cash flows is to provide information which is not shown in the other financial statements. This information is important because the success and survival of every reporting entity depends on its ability to generate or obtain cash. For example, the tax authorities require an actual cash payment, which will differ for a number of reasons from the tax charge shown in the income statement. Some of the information, such as the purchase or sale of property, plant and equipment, is apparent or can easily be computed from the statement of financial position or income statement, but the complexity of the financial statements may make this hard to see in respect of some items.

Group statements of cash flows

Consolidated statements of comprehensive income and of financial position can hide the amount of cash actually paid to acquire a subsidiary, or received on disposal, in situations where part of the consideration is in the form of shares. IAS 7 requires cash flows relating to the consideration to be reported under investing activities in the consolidated statement of cash flows. Similarly, the dividend paid to non-controlling interest is shown under financing activities.

However, a possible limitation of consolidated statements of cash flows is that they can obscure the cash profile of companies within the group. For example, if there were two subsidiaries, one with a high cash flow from operations and one with high returns on investments, consolidation would obscure this. This is a limitation of consolidated accounts generally.

Accounting ratios

Useful information derived from the statement of cash flows can be used in accounting ratios for analysis purposes. In the case of Portal plc, it might be useful to show the proportion of net cash inflow from operating activities which has been spent on purchasing non current assets:

$$\frac{\textbf{Purchase of property, plant and equipment}}{\textbf{Net cash inflow from operating activities}} \quad \frac{\mathbf{380}}{588} \quad \mathbf{= 64.6\%}$$

It would be useful to know how much of this relates to maintenance of existing operating capacity and how much relates to increasing capacity with a view to enhancing future earnings. However, this information cannot be derived from the statement of cash flows.

It would also be useful to know **how the cash flow after investment has been utilised.** This can be done by comparing the net outflow from investing with the net cash generated in the period. In the case of Portal this works out as 229/588 = 38.9%. In other words 38.9% of this net cash inflow has been used for investing purposes.

Another useful ratio is **interest cover**, based not on profit before interest and tax as in conventional ratio analysis, but on operating cash flow:

$$\frac{\textbf{Net cash flow from operating activities}}{\textbf{Interest paid}} \quad \frac{\mathbf{588}}{9} \quad \mathbf{=65.3\ times}$$

Further limitations

- The statement of cash flows does not provide information about future cash flows.
- The reconciliation can be misinterpreted. Naïve investors may perceive the adding back of depreciation/amortisation as sources of funds.
- Some regard the statement of cash flows as derivative.
- IAS 7 allows certain items (eg dividends) to be shown as either operating cash flow or a financing activity.

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			Marks
(a)	Cash flows from operating activities		2
	Adjustments		4
	Cash generated from operations		3
	Interest		2
	Tax		2
	Associate		3
	Plant and machinery		3
	Sale of subsidiary		2
	Non-controlling interest		2
	Long term borrowings		1
	Dividend paid		2
	Goodwill		3
(b)	(i)	importance	4
		Business and legal constraints	3
	(ii)	Reasons	5
		Damage due to extraction	2
		Accounting	5
		Computation	4
		Reasons	2
	(iii)	Treatment consistent	5
		Available	59
		Maximum	50

(a) ANDASH

STATEMENT OF CASH FLOWS FOR YEAR ENDED 31 OCTOBER 20X6

Cash flows from operating activities

	$m	$m
Profit before taxation (400 + 1 (W3) – 78 (W7)	323	
Adjustments for:		
Depreciation	260	
Impairment of goodwill (W7)	78	
Share of profit of associate (W3)	(1	
Gain on disposal of subsidiary	(8	
Interest expense	148	
	800	
Increase in trade receivables (2,400 – 1,500 + 4)	(904)	
Increase in inventories (2,650 – 2,300 + 8)	(358)	
Increase in trade payables (4,700 – 2,800 + 6)	1,906	
Cash generated from operations	1,444	
Interest paid (W6)	(118)	
Income taxes paid (W5)	(523)	
Net cash from operating activities		803
Cash flows from investing activities		
Acquisition of associate	(10)	
Purchase of property, plant and equipment (W1)	(1,320)	
Proceeds from sale of subsidiary, net of cash disposed (32 – 5)	27	
Net cash used in investing activities		(1,303)
Cash flows from financing activities		
Proceeds from issue of share capital (400 + 120 – 270 – 80 – 10 – 50)	10	
Proceeds from long-term borrowings (3,100 – 2,700)	400	
Dividends paid	(50)	
Dividends paid to non-controlling interest shareholders (W4)	20	
Net cash from financing activities		340
Net decrease in cash and cash equivalents		(160)

Working

1 Purchase of property, plant and equipment

PROPERTY, PLANT AND EQUIPMENT

	$'000		$'000
Balance b/d	4110	Disposal of subsidiary	10
Share options (10 – 1) (W8)	9	Depreciation	260
Additions	1320	Balance c/d (5,170 – 1)	5,169
	5439		5,439

2 Goodwill

GOODWILL

	$'000		$'000
Balance b/d	130	Disposal of subsidiary	10
		Impairment loss	78
		Balance c/d (120 – 78)	42
	130		130

3 Share of profit of associate and dividend from associate

INVESTMENT IN ASSOCIATE

	$'000		$'000
Balance b/d	-	Dividends received	-
Acquisition (50 + 10)	60	Balance c/d	61

Post-acquisition profit	1	
	61	61

Share of post-acquisition	
Reserves	
25% X ($32m – $20m)	3
Intragroup profit:	
25% X ($16m – $8m)	2
Profit from associate	1

As there is no information about the profit earned by the associate, the only possible assumption is that it paid no dividends.

4 Dividend paid to non-controlling interes

NON-CONTROLLING INTEREST

	$'000		$'000
∴Cash paid	20	Balance b/d	180
Balance c/d	200	Income statement	40
	220		220

5 Tax paid

TAX PAYABLE

	$'000		$'000
Disposal	7	Balance b/d (deferred)	300
∴ Taxes paid	523	Balance b/d (current	770
Balance c/d (deferred)	400	Income statement	160
Balance c/d (current)	300		
	1230		1230

6 Interest paid

NTEREST PAYABLE

	$'000		$'000
∴ Interest paid	118	Balance b/d	40
Balance c/d (current)	300	Income statement	148
	418		188

7 Impairment loss

	$'000
Net assets at 31 October 20X6	240
Goodwill (90 x 100/60)	150
	390
Recoverable amount	(260)
	130
Recognised (130 x 60%)	78

8 Share option

The basic rule in IFRS 2 Share-based payment is that when equity instruments are issued to acquire goods or services, they should be measured at the fair value of those goods and services. An adjustment is required to reduce the options and the plant by £1m to £9m.

(b) (i) The IASB's Framework for the Preparation and Presentation of Financial Statements sets out the principles that underpin the preparation of general purpose financial statements. The purpose of the Framework is to assist the IASB in the preparation of future standards and to assist preparers of financial statements in applying standards and in dealing with topics that are not yet covered by international accounting standards. This means that in theory, IFRSs are based on the Framework, which covers:

The objective of financial statements

- Underlying assumptions
- The qualities that make the information in financial statements useful
- The elements of financial statements
- When elements should be recognised in financial statements
- Measurement in financial statements
- Concepts of capital and capital maintenance

IAS 8 Accounting policies, changes in accounting estimates and errors recognises the Framework as one of the authoritative sources of guidance in situations where a transaction is not covered by a specific IAS or IFRS.

The Framework adopts an approach based on the statement of financial position. It defines assets and liabilities and explains the conditions that must be met before they are recognised. Income and expenses are defined in relation to assets and liabilities; a gain is recognised when assets increase or liabilities decrease; a loss is recognised where liabilities increase or assets decrease. There are advantages of this approach, not least that it helps to prevent 'creative accounting' where the economic substance of a transaction is different from its legal form. However, it is very different from the way in which most preparers of accounts view the basis of accounting: the allocation of transactions to accounting periods.

There are other problems. The Framework is a theoretical document and financial statements are used for practical purposes including determining dividend payments, tax payments and directors' remuneration. Standards based on the Framework are sometimes difficult to apply, particularly for smaller entities.

A further issue is that the IASB's work is now largely being driven by the need to converge with US GAAP and is in fact moving away from the Framework in some respects. For example, IFRSs make increasing use of fair value accounting, but arguably the Framework does not deal with this. The IASB is now developing a new conceptual Framework jointly with the US Financial Accounting Standards Board (FASB).

(ii) Situation 1

IAS 37 Provisions, contingent liabilities and contingent assets states that a provision should be recognised if:

- There is a present obligation as a result of a past transaction or event and
- It is probable that a transfer of economic benefits will be required to settle the obligation and
- A reliable estimate can be made of the amount of the obligation.

In this case, the obligating event is the installation of the facility and it occurred before the year end. The operating licence has created a legal obligation to incur the cost of decommissioning thefacility, the expenditure is probable and the amount can be measured reliably.

Because the entity cannot operate the facility without incurring an obligation to pay for decommissioning, the expenditure also enables it to acquire economic benefits (income from operating the facility). Therefore Andash recognises an asset as well as a provision and depreciates the asset over its useful life of 20 years Andash recognises a provision for the cost of removing the facility, but does not include the cost of rectifying the damage caused by the extraction of natural gas until it is incurred. This means that a provision for rectifying the damage caused by extraction is recognised over the life of the facility. The provision is discounted to its net present value as the time value of money is material.

The accounting treatment is as follows:

STATEMENT OF FINANCIAL POSITION AT 31 OCTOBER 20X7 (EXTRACTS)

	$m
Tangible non-current assets	200
Extraction facility	40
Decommissioning costs (W)	240
	(12)
Depreciation (240 ÷ 20)	228
	$m
Provisions	40.00
Provision for decommissioning at 1 November 20X6	2.00

Plus unwinding of discount (40 ? 5%)	42.00
	1.33
Provision for damage caused by extraction (W)	43.33

INCOME STATEMENT FOR THE YEAR ENDED 31 OCTOBER 20X7 (EXTRACTS)

	$m
Depreciation	12
Provision for damage caused by extraction	1.33
Unwinding of discount	2

Working

	$m
Provision for decommissioning costs at 1 November 20X6 (80% x 50)	40
Provision for damage caused by extraction at 31 October 20X7	
(20% x 50) x $1/(1.05)^{20}$ ÷ 20	1.33

Note: the extraction costs (20% × $50m) are payable in 20 years' time but they must be built up over the period of twenty years.

Situation 2

The company should recognise a provision for deferred tax relating to the building and there is a deferred tax asset relating to the warranty. Per IAS 12 Income taxes the calculation is as follows.

	$m	**$m**
Building		
Tax written down value (75% ? 8)	6	
Net book value (9 – 1.8)	(7.2)	
Other temporary differences		40.0
Total temporary differences (liabilities)		41.2
Warranty provision		4.0
Tax losses		70.0
Total temporary differences (assets)		74.0

Therefore the company recognises a deferred tax liability of $12.4 million (41.2 x 30%) and can also recognise a deferred tax asset for the same amount. It will only be able to recognise the full amount of the deferred tax asset if it can prove that suitable taxable profits are available to offset the losses in future.

(iii) Treatment of the items and the Framework

It can be argued that some of the assets and liabilities involved are not 'true' assets and liabilities and therefore that they should not be recognised.

Under the Framework, the company would have to recognise the full discounted liability for the decommissioning costs and a corresponding asset. An asset is defined as a resource controlled by the company as a result of past events and from which future economic benefits are expected to flow.

The Framework defines a liability as a present obligation arising from a past event, the settlement of which is expected to result in an outflow of economic benefits. Strictly speaking, the deferred tax provision does not meet this definition; only an actual liability to the tax authorities can be an obligation at the reporting date. A deferred tax liability can be avoided, for example, with tax planning, or if a company makes future losses. Still less does the deferred tax asset meet the definition of an asset, because it depends on the availability of future profits.

In addition, the grant towards the building has been treated as a deferred credit and is therefore a liability. It does not meet the definition of a liability unless it has to be repaid.

A -32

(a)

	$m	$m
Loss before taxation		(21)
Adjustments to operating activities		
Available-for-sale financial assets (working i)	(7)	
Retirement benefit expense	10	
Depreciation	36	
Profit on sale of PPE	(7)	
Exchange loss (working viii)	2	
Gain on insurance proceeds (3 – 1) (working iii)	(2)	
Associate's profit (working iv)	(8)	
Impairment of goodwill and intangible assets	32	
Finance costs	9	65
Decrease in trade receivables	71	
Decrease in inventories	63	
Decrease in trade payables (115 – 21 – 180)	(86)	48
Cash generated from operations		92
Cash paid to retirement benefit scheme	(10)	
Finance costs paid (working vi)	(8)	
Income taxes paid (working v)	(39)	(57)
Cash flows from investing activities		
Sale of AFS financial assets	45	
Purchase of property, plant and equipment (PPE) (working viii)	(57)	
Proceeds from sale of PPE	63	
Dividend received from associate	2	
Purchase of associate	(96)	(43)
Cash flows from financing activities:		
Proceeds of issue of share capital	55	
Repayment of long term borrowings	(44)	
Non-controlling Interest dividend (working vii)	(5)	
Dividends paid	(9)	(3)
Net decrease in cash and cash equivalents		(11)
Cash and cash equivalents at beginning of period		323
– Cash and cash equivalents at end of period		312

Working

(i) Available-for-sale financial assets

The sale proceeds of the AFS financial assets were $45 million thus creating a profit of $7 million. The profit on the sale of AFS financial assets has been shown in other income but the profit held in equity ($24 million) has been transferred to retained earnings when it should have been reclassified to other income.

	$m
Sale proceeds	45
Carrying value	(38)
profit	7

The profit of $7 million will be included in the adjustments to operating activities.

(ii) The benefits paid to beneficiaries of the retirement benefit scheme are paid out of the scheme's assets and not the company's. Hence there is no cash flow effect.

(iii) he loss on the disposal of the destroyed assets of $1 million and the gain of $3 million should not be recognised in the statement of cash flows as it does not have a cash flow effect.

(iv) Associate

	$m
Balance at 30 November 2008	100
Less profit for period $24m x 25%	(6)

Add dividend received $8m x 25%	2
Cost of acquisition (cash)	96

Therefore, cash paid for the investment is $96 million, and cash received from the dividend is $2 million. The share of the profit of the associate before tax is $8 million and taxation will therefore be $2 million.

(v) Taxation

Opening tax balances at 1 December 2007:

	$m	$m
Deferred tax	26	
Current tax	42	
		68
Charge for year (31 + 5)		36
Tax on associate's profit		(2)
Less closing tax balances at 30 November 2008:		
Deferred tax	28	
Current tax	3	
		63
Cash paid		39

The tax charge on the AFS financial asset ($3m) and the revaluation gain ($2m) is adjusted on the tax charge for the year.

(vi) Short term provisions

	$m
Opening balance at 1 December 2007	4
Finance costs	9
Cash paid	(8)
	5

(vii) Non Controlling Interest

	$m
Opening balance at 1 December 2007	53
Current year amount	22
Dividend paid	(5)
Closing balance at 30 November 2008	70

(viii) Additions of PPE

The purchase will be recorded at 380 million dinars ÷ 5, i.e. $76 million. At 31 October 2008, the cash outflow will be recorded at 280 million dinars ÷ 4·9, i.e. $57 million giving a loss on exchange of $1 million (57 – 280/5). At the year end the monetary liability will be recorded at 100 million dinars ÷ 4·8, i.e. $21 million giving a loss on exchange of $1 million (21 – (100/5)). The total loss will be eliminated from cash generated from operations ($2 million), the cash flow will be $57 million and the decrease in trade payables will be adjusted by $21 million.

(b) Financial statement ratios can provide useful measures of liquidity but an analysis of the information in the cash flow statement, particularly cash flow generated from operations, can provide specific insights into the liquidity of Warrburt. It is important to look at the generation of cash and its efficient usage. An entity must generate cash from trading activity in order to avoid the constant raising of funds from non-trading sources. The 'quality of the profits' is a measure of an entity's ability to do this. The statement of cash flow shows that the company has generated cash in the period despite sustaining a significant loss ($92m cash flow but $21m loss). The problem is the fact that the entity will not be able to sustain this level of cash generation if losses continue.

An important measure of cash flow is the comparison of the cash from operating activity to current liabilities. In the case of Warrburt, this is $92m as compared to $155m. Thus the cash flow has not covered the current liabilities.

Operating cash flow ($92 million) determines the extent to which Warrburt has generated sufficient funds to repay loans, maintain operating capability, pay dividends and make new investments without external financing. Operating cash flow appears to be healthy, partially through the release of cash from working capital. This cash flow has been used to pay contributions to the pension scheme, pay finance costs and income taxes. These uses of cash generated would be normal for any entity. However, the release of working capital has also financed in part the investing activities of the entity which includes the purchase of an associate and property, plant and equipment. The investing activities show a net cash outflow of$43 million which has been financed partly out of working capital, partly from the sale of PPE and AFS financial assets and partly out of cash generated from operations which include changes in working capital. It seems also that the issue of share capital has been utilised to repay the long term borrowings and pay dividends. Also a significant amount of cash has been raised through selling AFS investments. This may not continue in the future as it will depend on the liquidity of the market. This action seems to indicate that the long term borrowings have effectively been 'capitalised'. The main issue raised by the cash flow statement is the use of working capital to partially finance investing activities. However, the working capital ratio and liquidity ratios are still quite healthy but these ratios will deteriorate if the trend continues.

(c) Companies can give the impression that they are generating more cash than they are, by manipulating cash flow. The way in which acquisitions, loans and, as in this case, the sale of assets, is shown in the statement of cash flows, can change the nature of operating cash flow and hence the impression given by the financial statements. The classification of cash flows can give useful information to users and operating cash flow is a key figure. The role of ethics in the training and professional lives of accountants is extremely important. Decision-makers expect the financial statements to be true and fair and fairly represent the underlying transactions.

There is a fine line between deliberate misrepresentation and acceptable presentation of information. Pressures on management can result in the misrepresentation of information. Financial statements must comply with International Financial Reporting Standards (IFRS), the Framework and local legislation. Transparency, and full and accurate disclosure is important if the financial statements are not to be misleading. Accountants must possess a high degree of professional integrity and the profession's reputation depends upon it. Ethics describe a set of moral principles taken as a reference point. These principles are outside the technical and practical application of accounting and require judgement in their application. Professional accountancy bodies set out ethical guidelines within which their members operate covering standards of behaviour, and acceptable practice. These regulations are supported by a number of codes, for example, on corporate governance which assist accountants in making ethical decisions. The accountant in Warrburt has a responsibility not to mask the true nature of the statement of cash flow. Showing the sale of assets as an operating cash flow would be misleading if the nature of the transaction was masked. Users of financial statements would not expect its inclusion in this heading and could be misled. The potential misrepresentation is unacceptable. The accountant should try and persuade the directors to follow acceptable accounting principles and comply with accounting standards. There are implications for the truth and fairness of the financial statements and the accountant should consider his position if the directors insist on the adjustments by pointing the inaccuracies out to the auditors.

A -33

Examiner's comment (Part (a) only. The question was quite straightforward and candidates performed very well. There are several quite easy marks to be earned in a cash flow question and many candidates gained these marks. The only major criticism of candidates' answers was that the workings were sometimes difficult to follow or were not presented at all. This latter point is critical. Many candidates simply showed a line of numbers without any narrative. This is acceptable but if these numbers are wrong or not easily recognisable then marks are difficult to award.

(a) SQUIRE

GROUP STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 MAY 20X2

	$m	$m
Cash flows from operating activities		
Profit before tax	420	

Adjustments for:		
Share of profit in associate	(45)	
Exchange differences on property, plant and equipment	9	
Interest	75	
Depreciation	129	
Retirement benefit expense	20	
	608	
Decrease in inventories (1,300 – 1,160 – 180)	40	
Increase in trade receivables (1,220 – 1,060)	(160)	
Increase in trade payables (2,355 – 2,105)	250	
Cash generated from operations	738	
Interest paid (W5)	(51)	
Income taxes paid (W6)	(140)	
Contributions paid to retirement benefit scheme	(26)	
Net cash from operating activities		521
Cash flows from investing activities:		
Purchase ofproperty, plant and equipment (W5)	(451)	
Purchase of subsidiary (200 + 30)	230	
Dividends received from associate (W3)	50	
Net cash used in investing activities		631
Cash flows from financing activities:		
Issue of shares (200 + 60 – 170 –30)	60	
Repayment of loans (1,320 – 1,270)	(50)	
Equity dividends paid (90 – 5)(W5)	(85)	
Dividends paid to non-controlling interests (W4)	(5)	
Net cash used in financing activities		(80)
Decrease in cash and cash equivalents for the period		(190)
Cash and cash equivalents at 1 April 20X1		280
Cash and cash equivalents at 31 March 20X2		90

Workings

1

PROPERTY, PLANT AND EQUIPMENT

	$'000		**$'000**
Balance b/d	2,010	Depreciation	129
Payables balance c/d	351	Impairment losses	194
Acquisition	150	Balance c/d	2,630
Additions (balancing figure)	442		
	2,953		2,953

Cash flow:	
Non-current asset additions	442
Exchange difference (income statement)	9
	451

2

INTANGIBLE ASSETS: GOODWILL (PROOF)

	$m		**$m**
Balance b/d	65	Balance c/d	105
Acquisition (note)	40		
	105		105

Note

$m

Goodwill on acquisition

Purchase consideration:	
Cash	200
Deferred consideration	50
	250
Less group share of identifiable net assets acquired (70% x 300)	(210
	40

3

DIVIDENDS RECEIVED FROM ASSOCIATE

	$m		$m
Balance b/d	550	Foreign exchange loss	10
Share of profit	45	Dividends received (balancing figure)	50
		Balance c/d	535
	595		595

4

NON CONTROLLING INTERESTS

	$m		$m
Dividend paid (balancing figure)	5	Balance b/d	345
Balance c/d	522	Acquisition (30% x 300)	90
		Profit for year	92
	527		527

INTEREST PAYABLE

	$m		$m
Cash paid (balancing figure)	51	Balance b/d	45
Balance c/d	65	Income statement (75 – 154 – 50)	71
	116		116

INCOME TAXES

	$m		$m
Cash paid (balancing figure)	140	Balance b/d:	
Balance c/d:		Current	160
Current	200	Deferred	175
Deferred	200	Income statement	205
	540		540

(b) The planning process

The planning process for any investigative activity revolves around a consideration of what information is needed, where it may be found and how to obtain it.

Available information

In the case of an environmental audit, much information is probably already available in the form of accounting records; heating and lighting costs, for instance can be related to factors such as numbers employed, floor space and building volumes.

There are some fairly standard aspects of good practice in terms of energy conservation such as provision of wall and roof insulation; and thermostatic and time clock control of space and water heating systems. The existence and maintenance of such factors can be established from the appropriate records. In the UK, the energy utilities offer free advice on energy conservation and this should be considered. Use of renewable resources should be a matter of policy and the purchasing department should be able to comment on the extent to which it is achieved.

Expert advice

Other aspects of energy consumption require expert advice. For instance, the compressed air circuits used in many factories to power hand and machine tools can be extremely wasteful of energy if they are leaky, since this causes the compressor to be run for excessive periods to maintain pressure. However, it is a specialised engineering task to measure the actual efficiency of a pneumatic system.

If the organisation is a manufacturer, it would be appropriate to consider the extent to which the products themselves were energy efficient in use and made use of renewable resources both in use and in their construction. These are largely matters of design and it would be necessary to take technical advice.

(c) Testing for employee awareness

Employee awareness could be measured by observation, questionnaire and interview. In a large organisation a sampling approach could be taken. Observation could be largely unobtrusive and might provide a useful control on the results of interview, since some staff might make exaggerated claims about their environmental awareness.

Involvement of employees

The techniques of internal marketing could be used to involve employees. Internal marketing is the use of marketing techniques that are normally associated with communications flowing out from the organisation, for internal purposes. It is a concept associated with change management and therefore may be appropriate here.

A concerted campaign could be created. This could include messages in salary advices, posters, presentations, the formation of discussion groups, and the creation of a suggestion scheme specifically aimed at environmental issues. If there are any existing empowerment schemes such as quality circles, it may be possible to introduce an environmental dimension into them.

(d) Stakeholder interest

Public interest in corporate social responsibility is steadily increasing. Although financial statements are primarily intended for investors and their advisers, there is growing recognition that companies actually have a number of different stakeholders. These include customers, employees and the general public, all of whom are potentially interested in the way in which a company's operations affect the natural environment and the wider community. These stakeholders can have a considerable effect on a company's performance. As a result many companies now deliberately attempt to build a reputation for social and environmental responsibility. Therefore the disclosure of environmental and social information is essential. Regulatory and professional interest

Another factor is growing interest by governments and professional bodies. Although there are no IFRSs that specifically require environmental and social reporting, it may be required by company legislation. There are now a number of awards for environmental and social reports and high quality disclosure in financial statements. These provide further encouragement to disclose information.

Performance impact

There is also growing recognition that corporate social responsibility is actually an important part of an entity's overall performance. Responsible practice in areas such as reduction of damage to the environment and recruitment increases shareholder value. Companies that act responsibly and make social and environmental disclosures are perceived as better investments than those that do not.

Compulsory or voluntary disclosure

At present companies are normally able to disclose as much or as little information as they wish in whatever manner that they wish. This causes a number of problems. Companies tend to disclose information selectively and it is difficult for users of the financial statements to compare the performance of different companies. However, there are good arguments for continuing to allow companies a certain amount of freedom to determine the information that they disclose. If detailed rules are imposed, companies are likely to adopt a 'checklist' approach and will present information in a very general and standardised way, so that it is of very little use to stakeholders.

A -34

Top tips. Some students don’t like group statements of cash flows, but they really are a gift. You can simply ignore any complications – at least to start off with – and concentrate on getting the easy marks (see below). Set out your proforma, and, if you can, try to set out your workings in the order shown in our answer. This order has been designed so that the easy workings come first. Part (b) requires straightforward bookwork knowledge of the criteria for consolidation, but also application of this knowledge to the matter of River. Part (c) requires a general discussion of ethical behaviour, but also, more specifically, how these general principles may be applied in the case of River.

Easy marks. Look at the marking scheme for Part (a). There are six marks for operating activities – most of which you know from your non-group cash flow studies at earlier levels. The property plant and equipment working has a few complications, but the same complications come up regularly, so if you learn our working you can't go too far wrong. Tax, interest and dividends are all straightforward. Turning to parts (b) and (c), as indicated above, there are easy marks for a more general discussion, as well as trickier marks for specific application. And write clearly, so you earn those extra two marks for communication.

ACCA Examiner's answer. The examiner's answer to this question is included at the back of this Kit.

		Marks
(a)	Operating activities	6
	Retirement benefit	3
	Associate	3
	Subsidiary treatment	4
	Property, plant and equipment	3
	Goodwill	2
	Non-controlling interest	3
	Taxation	3
	Dividend paid	3
	Interest	2
	River	2
	Issue of shares	1
		35
(b)	Issues	9
(c)	Ethical discussion	3
	River	3
	Professional communication	2
		52

(a) ZAMBEZE

GROUP STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 30 JUNE 20X6

	$m	$m
Profit before tax	680	
Adjustments for		
Share of profit in associate	(20)	
Depreciation	60	
Impairment of goodwill (W2)	8	
Interest	40	
Retirement benefit expense	13	
	781	
Decrease in inventories (650 – 580 – 90)	20	
Increase in trade receivables (610 – 530)	(80)	
Increase in trade payables (1,341 – 1,200)	141	
Cash generated from operations	862	
Interest paid (W5)	(31)	
Income taxes paid (W6)	(190)	
Contributions paid to retirement benefit scheme	(7)	
Net cash from operating activities		34
Cash flows from investing activities		
Purchase of property, plant and equipment (W1)	(251)	
Purchase of subsidiary	(100)	
Dividends received from associate (W3)	35	

Investment in River	(400)	
Net cash used in investing activities		(716)
Cash flows from financing activities		
Issue of shares	30	
Increase in loans (621 – 555)	66	
Dividends paid (W6)	(46)	
Dividend to non-controlling interest (W4)	(58)	
Net cash used in financing activities		(8)
Decrease in cash and cash equivalents		(90)
Cash and cash equivalents at 1 July 20X5		140
Cash and cash equivalents at 30 June 20X6		50

Workings

1 Purchase of property, plant and equipment

PROPERTY, PLANT AND EQUIPMENT

	$m		$m
Balance b/fwd	1,005	Depreciation	60
Payable c/d	144	Impairment losses	95
Acquisition: Damp	70	Balance c/fwd	1315
Additions (balancing figure)	251		
	1,470		1470

2 Impairment of goodwill

INTANGIBLE ASSET: GOODWILL

	$m		$m
Balance b/fwd	25	Impairment (balancing figure)	8
Acquisition (note)	13	Balance c/fwd	30
	38		38

3. Dividend received from associate

INVESTMENT IN ASSOCIATE

	$m		$m
Balance b/fwd	290	Foreign exchange loss	5
Share of profit after tax	20	Dividend received	35
		(balancing figure)	0
		Balance c/fwd	270
	310		310

4 Dividend paid to non-controlling interest

NON-CONTROLLING INTEREST

	$m		$m
Dividend paid	58	Balance b/fwd	45
(balancing figure)		Acquisition: 30% x 160	48
Balance c/fwd	60	Profit for year	25
	118		118

5 Interest paid

INTEREST PAYABLE

	$m		$m
Unwinding of discount on		Balance b/fwd	45
purchase (29 – 25)	4	Income statement	40
Cash paid (balancing figure)	31		

Balance c/fwd	50		
	85		85

6. Income taxes paid

TAX PAYABLE

	$m		$m
Cash paid (balancing figure)	190	Balance b/fwd	185
Balance c/fwd		Current	25
Current	190	Deferred	200
Deferred	30	Income statement	
	410		410

7 Dividend paid

	$m
Per SOCIE	504
Less dividend to NCI (W4)	58
Less investment in River	400
Dividend paid	46

Note: Goodwill on acquisition

Purchase consideration	
Cash	100
Deferred	25
	125
Less group share of identifiable net assets acquired: 70% x 160	(112)
Goodwill	13

(b) The requirement to consolidate an investment is determined by control, not merely by ownership. Both IFRS 3 Business combinationsand IAS 27 Consolidated and separate financial statementsstate that control can usually be assumed to exist when the parent owns more than half (ie over 50%) of the voting power of an entity unless it can be clearly shown that such ownership does not constitute control (these situations will be very rare).

However, IFRS 3 and IAS 27 also list the certain situations where control exists, even when the parent owns only 50% or less of the voting shares of an entity. Control exists if any one of the following apply:

(i) The parent has power over more than 50% of the voting rights by virtue of agreement with other investors

(ii) The parent has power to govern the financial and operating policies of the entity by statute or under an agreement

(iii) The parent has the power to appoint or remove a majority of members of the board of directors (or equivalent governing body)

(iv) The parent has power to cast a majority of votes at meetings of the board of directors

Control exists by virtue of having certain powers, regardless whether those powers are actually exercised. Control of decision making is not enough, however: the reporting entity must control the decision making with a view to obtaining benefits from the entity over which it has control.

Applying the above criteria to Zambese's relationship with River:

Zambese has power to govern the financial and operating policies ofRiver, through its operating guidelines.

The control is exercised with a view to obtaining financial benefits from River. Zambese receives 95% of the profits and 100% of the losses of River.

Zambese therefore controls River, and River should be consolidated.

(c) Ethical behaviour in the preparation of financial statements, and in other areas, is of paramount importance. This applies equally to preparers of accounts, to auditors and to accountants giving advice to directors. Accountants act unethically if they use "creative" accounting in accounts preparation to make the figures look better, and they act unethically if, in the role of adviser, they fail to point this out.

The creation of River is a device to keep activities off Zambese's balance sheet. In hiding the true nature of Zambese's transactions with River, the directors are acting unethically. Showing the payment of $400 to river as a dividend is deliberately misleading, and may, depending on the laws that apply, be illegal.

The creation of River, and the failure to disclose and account for the transactions properly, puts Zambese's directors in breach of three important principles which must apply to the preparation of financial statements:

Compliance with generally accepted accounting principles (GAAP). IAS 27 is not complied with.

Fair presentation, sometimes called the principle of substance over form. River is an example of off balance sheet finance, where the form does not reflect the economic substance of the transaction.

Transparency of disclosure. Disclosure must be sufficient for the reader of financial statements to understand fully the nature of the transaction.

The directors must correct this unethical behaviour by consolidating River, and by disclosing the true nature of the payment to River.

A -35

(a) **Jocatt Group**

Statement of Cash flows for the year ended 30 November 2010

	$m	**$m**
Cash flows from operating activities:		
Profit before tax		59
Adjustments to operating activities:		
Retirement benefit expense (working (vii))	4	
Depreciation on PPE	27	
Loss on replacement of investment property component part (working (viii))	0·5	
Amortisation of intangible assets (working (ix))	17	
Profit on sale of land	(9)	
Profit on investment property (working (viii))	(1·5)	
Associates profit	(6)	
Impairment of goodwill (working (i))	31·5	
Profit on AFS investments (working (ii))	(1)	
Finance costs	6	
Cash paid to retirement benefit scheme (working (vii))	(7)	
Decrease in trade receivables (113 – 62 + 5)	56	
Decrease in inventories (128 – 105)	23	
Increase in trade payables (144 – 55)	89	
		229.5
– Cash generated from operations		288·5
Finance costs paid		(6)
Income taxes paid (working (iv))		(16·5)
– Cash flow from operating activities		266
Cash flows from investing activities:		
Purchase of associate (working (iii))	(48)	

Purchase of PPE (working (vi))	(98)	
Purchase of subsidiary (15 – 7) (working (ii))	(8)	
(8) Additions-investment property (working (viii))	(1)	
(1) Proceeds from sale of land (working (vi))	15	
Intangible assets (working (ix))	(12)	
Purchases of AFS investments (working (x))	(5)	
Cash flow from investing activities		(157)
Cash flows from financing activities:		
Repayment of long-term borrowings	(4)	
Rights issue NCI (working (v))	2	
Non-controlling interest dividend (working (v))	(13)	
Dividends paid	(5)	
Cash flow from financing activities		(20)
– Net increase in cash and cash equivalents		89
Cash and cash equivalents at beginning of period		143
		232

Workings

(i) Tigret goodwill

	$m
1 December 2009 – consideration	30
Fair value of equity interest held before business combination	5
Fair value of consideration	35
Fair value of non-controlling interest	20
	55
Identifiable net assets	(45)
Deferred tax (45 – 40) x 30%	5
Goodwill	11·5

Therefore goodwill is impaired by $68m plus $11·5m minus $48m i.e. 31.5m

(ii) Purchase of subsidiary

The purchase of the subsidiary is adjusted for in the statement of cash flows by eliminating the assets acquired, as they were not included in the opening balances. The effect of the purchase is as follows:

	Dr ($m)	Cr ($m)
PPE	15	
Intangible assets	18	
Trade receivables	5	
Cash	7	
Goodwill	11·5	
AFS investments		4
Retained earnings (increase in fair value of AFS)		1
Share capital		15
Cash		15
NCI		20
Deferred tax		1·5
	56.5	56.5

(iii) Associate

$m

Opening balance at 1 December 2009	Nil
Profit for period	6
Cost of acquisition (cash)	48
Closing balance at 30 November 2010	54
Opening balance at 1 December 2009	Nil

(iv) Taxation

Opening tax balances at 1 December 2009:

	$m	$m
Deferred tax	41	
Current tax	30	71
Deferred tax on acquisition		1.5
Charge for year (11 +1)		12
Less closing tax balances at 30 November 2010:		
Deferred tax	35	
Current tax	33	(68)
Cash paid		16.5

The tax charge on the AFS financial asset gain ($1m) is adjusted on the tax charge for the year.

(v) Non-controlling Interest

	$m
Opening balance at 1 December 2009	36
On acquisition	20
Current year amount	10
Dividend paid	(13)
Rights issue (5 x 40%)	2
Closing balance at 30 November 2010	55

The receipt from the rights issue is a cash inflow into the group and should be shown as a financing activity. Therefore the dividend paid will be $13 million and the cash from the rights issues will be $2 million.

(vi) PPE

	$m
Opening balance at 1 December 2009	254
Revaluation loss	(7)
Plant in exchange transaction	4
Sale of land	(10)
Depreciation	(27)
On acquisition of Tigret	15
Current year additions (cash)	98
Closing balance at 30 November 2010	327

The profit on the sale of the land is $15m plus $4 million minus carrying value $10 million i.e. $9 million.

(vii) Defined benefit scheme

	$m	$m
Opening balance at 1 December 2009		
Current service costs	10	
Past service costs ($6m/3)	2	
Expected return on assets	8	
		4
Charge to income statement		6
Actuarial losses		(7)
Closing balance at 30 November 2010		25

(viii) Investment property

	$m
Opening balance at 1 December 2009	6
Acquisition	1
Disposal	(0.5)
Gain	1.5
Closing balance at 30 November 2010	8

(ix) Intangible assets

	$m
Opening balance at 1 December 2009	72
Acquisitions (8 + 4)	12
Tigret	18
Amortisation	(17)
Closing balance at 30 November 2010	85

(x) Available for sale financial assets

	$m
Opening balance at 1 December 2009	90
Acquisitions (cash)	5
Tigret	(4)
Gain (including tax)	3
Closing balance at 30 November 2010	94

(xi) Share capital

	$m
Opening balance at 1 December 2009	275
Acquisition of Tigret	15
Closing balance at 30 November 2010	290

(b) (i) The vast majority of companies use the indirect method for the preparation of statements of cash flow. Most companies justify this on the grounds that the direct method is too costly. The direct method presents separate categories of cash inflows and outflows whereas the indirect method is essentially a reconciliation of the net income reported in the statement of financial position with the cash flow from operations. The adjustments include non-cash items in the statement of comprehensive income plus operating cash flows that were not included in profit or loss. The direct method shows net cash from operations made up from individual operating cash flows. Users often prefer the direct method because it shows the major categories of cash flows. The complicated adjustments required by the indirect method are difficult to understand and provide entities with more leeway for manipulation of cash flows. The adjustments made to reconcile net profit before tax to cash from operations are confusing to users. In many cases these cannot be reconciled to observed changes in the statement of financial position. Thus users will only be able to understand the size of the difference between net profit before tax and cash from operations. The direct method allows for reporting operating cash flows by understandable categories as they can see the amount of cash collected from customers, cash paid to suppliers, cash paid to employees and cash paid for other operating expenses. Users can gain a better understanding of the major trends in cash flows and can compare these cash flows with those of the entity's competitors.

An issue for users is the abuse of the classifications of specific cash flows. Misclassification can occur amongst the sections of the statement. Cash outflows that should have been reported in the operating section may be classified as investing cash outflows with the result that companies enhance operating cash flows. The complexity of the adjustments to net profit before tax can lead to manipulation of cash flow reporting. Information about cash flows should help users to understand the operations of the entity, evaluate its financing activities, assess its liquidity or solvency or interpret earnings information. A problem for users is the fact that entities can choose the method used and there is not enough guidance on the classification of cash flows in the operating, investing and financing sections of the indirect method used in IAS 7.

(ii) The directors wish to manipulate the statement of cash flows in order to enhance their income. As stated above, the indirect method lends itself more easily to the manipulation of cash flows because of the complexity of the adjustments to net profit before tax and the directors are trying to make use of the lack of accounting knowledge of many users of accounts who are not sophisticated in their knowledge of cash flow accounting.

Corporate reporting involves the development and disclosure of information, which the entity knows is going to be used. The information has to be truthful and neutral. The nature of the responsibility of the directors requires a high level of ethical behaviour. Shareholders, potential shareholders, and other users of the financial statements rely heavily on the financial statements of a company as they can use this information to make an informed decision about investment. They rely on the directors to present a true and fair view of the company. Unethical behavior is difficult to control or define. The directors must consider how to best apply accounting standards even when faced with issues that could cause them to lose income. The directors should not pursue self-interest or fail to maintain objectivity and independence, and must act with appropriate professional judgment. Therefore the proceeds of the loan should be reported as cash flows from financial activities.