May 2010 paper - Section A 50 marks

Section A

Question One

Required:

(a) **Explain the basis on which each of the investments should be accounted for in the consolidated financial statements of the DF Group for the year ended 31 December 2009 (calculations are not required).**

(8 marks)

(b) **Briefly explain the impact of the investment in AB, in the consolidated income statement for the year ended 31 December 2009.**

(2 marks)

(Total for Question One = 10 marks)

Tutor Note: Part a of the question is purely discursive. Full explanations of the accounting standards and accounting treatment are required to ensure maximum marks. Firstly determine the relationships and then the accounting treatment.

Answer to part (a)

Investment in AB

The investment in AB is 90% of the equity shares. This gives DF the majority of the shareholdings and voting rights. Therefore AB is able to exert control through dominant influence and participating interest.

Dominant influence is influence over the financial and operating policies of the company. **Participating interest** is an interest in shares held for the long-term for the purpose of gaining economic benefits in future.

The relationship therefore is that AB is a subsidiary of DF. Under IAS 27 - *Consolidated and separate financial statements* DF will be consolidated 100% line by line in the group financial statements. As the acquisition was part way through the year, the consolidated income statement will show DF on a pro-rata basis. Any consolidation adjustments will be shown in the consolidated accounts relating to the fair value and additional depreciation.

Investment in GH

The investment in GH is 40% of the equity shares. This gives DF a significant amount of voting rights but not the majority. Assuming that there is no dominant shareholder (i.e.

the remaining 60% of the equity shares are held by many investors), DF is able to exert significant influence over GH and has a participating interest.

Significant influence - This involves participating in the financial and operating policy decisions, including dividend policies and strategic issues. There is no control (or joint control) over these activities, just influence. **Participating interest** is an interest in shares held for the long-term for the purpose of gaining economic benefits in future.

The relationship therefore is that GH is an associate of DF. Under IAS 28 *Investments in associates* the equity method of accounting will be used to show GH in the group accounts. In the consolidated statement of financial position, GH will be shown as a one liner investment in associate undertaking under non current assets. This amount will be the initial cost plus share of any post acquisition gains or losses. In the consolidated income statement, the group share of the associates profit after tax will be shown.

Investment in JK

The equity investment is 65% which would make JK a subsidiary of DF. However as DF have plans to sell JK and are actively marketing to sell, the accounting standard IFRS 5 *Non current assets held for sale and discontinued operations* is applicable here.

Subsidiary held for resale
Under the revised IAS 27 and IFRS 5 there is an exemption for a subsidiary for which **control is intended to be temporary** because the **subsidiary was acquired and is held exclusively with a view to its subsequent disposal in the near future**. For such a subsidiary, if it is highly probable that the sale will be completed within 12 months then the parent should account for its investment in the subsidiary under IFRS 5 as an asset held for sale, rather than consolidate it under IAS 27. The parent company will show this type of subsidiary as a **single item** on the face of the consolidated statement of financial position, rather than consolidating line by line.

Under IFRS 5 subsidiaries acquired exclusively with a view to resale are measured on both acquisition and at subsequent reporting dates, at fair value less costs to sell. Any movement in fair value from these 2 points is taken to the consolidated income statement and shown under discontinued activities.

Investment in LM

The second investment of 40% of the equity shares in LM takes the total equity stake to 55%. This is an example of step acquisition where control is gained.

Step acquisitions (piecemeal acquisitions)
It is quite common for parent companies to make investments in other companies at different dates. The parent company may acquire shares, which change the status of its investment. The acquisition of equity shares over time, changes the investment from a

ACORN PROFESSIONAL TUTORS

simple investment to associate and then finally subsidiary when greater than 50% of shares are acquired, giving ultimate control.

IFRS 3 business combinations (revised 2008) gives details on how to account for step acquisitions (piecemeal acquisitions) in the consolidated financial statements. The revised IFRS 3 alongside the revised IAS 27 now state that acquisition accounting is only applied when **control** is achieved.

All investments before control is achieved are treated in accordance with their relevant accounting standards:
(i) Less than significant equity investments (i.e. 5%) treat under IAS 39
(ii) Significant investments treat as associate under IAS 28
(iii) Joint control investments treat as joint venture under IAS 31

When the parent company acquires further equity shares and it changes the status of the investment to subsidiary, that is control has been achieved, then acquisition accounting is used but the following must also be done:

- **Re-measure** the previously held investment (any of the 3 above) to **fair value** on the date control is achieved.
- Recognise any resulting **gain or loss** in the consolidated income statement
- Calculate **goodwill**.

The initial investment of 15% will be de-recognised on 1st October 2009 and the 55% equity investment will be recognised as a subsidiary and consolidated 100% line by line.

Answer to part (b)

Impact of investment AB to the consolidated income statement

All of the revenue and expenses of AB will be consolidated 100% line by line but pro-rated for 6 months.

Positive purchased goodwill is capitalised but negative purchased goodwill is written off to the consolidated income statement immediately.

The goodwill for AB is:

Cost of investment	$6 million
Less share of fair value of net assets	
($6.8m x 90%)	($6.12) million

Negative purchased goodwill (6 ó 6.12) = $120,000. The consolidated earnings will increase by $120,000.

The additional depreciation on the fair value asset will be charged to the consolidated income statement ó (6.8 ó 5.8) = $1 million / 40 years = $25,000 additional depreciation.

ACORN PROFESSIONAL TUTORS

Therefore the affect of AB consolidation adjustments would be a credit of $120,000 and a debit of $25,000.

ACORN PROFESSIONAL TUTORS

Question Two

Part (a)

Required:
Briefly discuss the economic substance of JKøs contractual agreement with SB and explain which entity should recognise the vehicles in inventory during the period that they were held at JKøs premises.

(5 marks)

Reporting substance over form

Substance over form requires that transactions must be accounted for in accordance with their economic substance, rather than its true legal form.

When a transaction has taken place, the question to ask is whether the transaction changes the existing assets/liabilities of the company either by creating new ones or altering existing ones.

Assets
Resources controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

Liabilities
Present obligation of the enterprise arising from past events the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits

The risk and rewards are a good indication as to whom the asset and liability belongs to. Risk is the uncertainty of the expected outcome. In this case it is the uncertainty of future economic benefits and potential exposure to loss.

Recognition in the statement of financial position will occur once the assets and liabilities have been identified (by looking at risk and rewards) and can be measured with sufficient reliability.

Consignment goods

This is an arrangement where goods are held by one party (distributor), but are owned by another (a manufacturer or a finance company). Consignment goods are common in the motor trade or goods sold on a ÷sale or returnø basis. The question is whose statement of financial position do the goods appear and who bears the risk of slow moving goods.

To identify the correct treatment, it is necessary to identify the point at which the distributor acquired the benefits of the asset, rather than the point at which legal title was

ACORN
PROFESSIONAL TUTORS

acquired. If the manufacturer has the right to require the return of the goods and is likely to do so, then the stock is not an asset of the distributor.

The agreement that JK and SB have is a follows:

- JK can hold 100 vehicles on its premises but the legal title of the vehicles remains with SB until they are sold to a third part.

This part of the agreement suggest that SB should show the inventory in their financial statements because have legal title. Any disputes that JK and SB might have, SB can recover the vehicles because they have legal title.

- SB the manufacturer only raises the invoices for the cars once JK the distributor sells to a third party. The price agreed at the original delivery date.

This part of the agreement means JK is protected from any price increases from the date of delivery to date of sale. It also means SB only generates revenue when JK sells the cards to the public. Therefore suggesting that SB should show the inventory in its financial statements.

- JK as the right to return any vehicle at any time without incurring a penalty.

This part of the agreement means that SB bears all the risk of slow moving inventory which can be returned without any costs to JK. Therefore SB has the risk of the inventory being unsold, which means they should show the inventory in their financial statements.

- JK is responsible for insuring the vehicles on its property.

This part of the agreement suggests that JK is responsible for the vehicles whilst they are on their premises, meaning they have control over the assets. Therefore this suggests JK should show the inventory in their financial statements.

In such circumstances where both parties have risks associated with the arrangement, reporting substance over legal form principles looks at what the major significant risks are for the items in question. For car inventory the major risks are slow moving stock and obsolescence. As the cars can be returned to SB without any penalty, itøs SB who should show the inventory held at JKøs premises in their financial statements.

Question Two part (b)

Required:

Prepare the accounting entries to record, for the year to 30 November 2009, the expense associated with the SARs. ***(5 marks)***

IFRS 2 share based payments was introduced by the IASB, which states that when the company offers share options or warrants, it must treat this as a **financial instrument** and recognise them in the financial statements at fair value, the charge going to the income statement and the credit going either to equity or liabilities.

Cash – settled share based payment transactions

This is where the employee is offered cash in the future for their services, but the cash is based on the value of the companyøs share price or other equity instrument.

Debit	Expense in the income statement
Credit	Liability in the statement of financial position

The amounts must be re-measured at each accounting period end (to fair value) and the difference taken to the income statement.

For JK SARs is an example of cash settled share based transactions. They will initially be measured at fair value and then subsequent measurement will be at fair value at each year end.

Year 1 – year ending 30th November 2008

1,000 SARs x (120 ó 12 ó 15) eligible employees x $15 fair value = $1,395,000
Amount to be recognised is $1,395,000 over the 3 year vesting period = $1,395,000 / 3 yrs = $465,000

Debit	Income statement ó remuneration costs	$465,000	
	Credit Liability (SOFP)		$465,000

Year 2 – year ending 30th November 2009

1,000 SARs x (120 ó 12 ó 8 ó 10) eligible employees x $17 fair value = $1,530,000

Amount to be recognised to date	= $1,530,000 x 2/3	= $1,020,000
Amount already recognised		= ($465,000)
Amount to be recognised in the year		= **$555,000**

Debit	Income statement ó remuneration costs	$555,000	
	Credit Liability (SOFP)		$555,000

ACORN PROFESSIONAL TUTORS

Question Three

Required:
(a) Calculate the basic earnings per share to be reported in the financial statements of CSA for the year ended 31 December 2009, including comparative, in accordance with the requirements of IAS 33 Earnings Per Share.

(4 marks)

(b) Calculate the diluted earnings per share for the year ended 31 December 2009, in accordance with the requirements of IAS 33 Earnings Per Share.

(3 marks)

(c) Briefly explain why the bonus issue and issue at full market value are treated differently in arriving at basic earnings per share.

(3 marks)
(Total for Question Three = 10 marks)

Revision

Change in capital structure	Earnings	WANS
Issue at full market price New capital is introduced therefore earnings would be expected to rise from date of new Issue.	Remain the same as basic	The numbers of shares are time apportioned. There is no affect to prior years EPS as the issue is a full price.
Bonus issue Free shares are issued to existing shareholders. The earnings of the company will not rise as there are no extra funds generated.	Remain the same as basic	No time apportioning. The bonus shares are treated as if they were already in issue at the beginning of the year and for prior years. The reciprocal (1/x) of the bonus fraction is applied to prior years EPS. Bonus fraction is calculated as : New share holding / old share holding (i.e. one bonus share for every four = 5/4)

ACORN PROFESSIONAL TUTORS

Basic calculation

$$\frac{\text{Net profit/loss attributable to ordinary shareholders (earnings for the year)}}{\text{Weighted average no. of shares (WANS)}}$$

Answer to part (a)

Basic earnings = $1,040,000 - $270,000 = $770,000

1st May 2009 – Bonus issue

Bonus fraction = 4/3

Number of shares after the bonus issue = 3 million x 4/3 = 4 million

1st September 2009 – Issue at full market price

2 million new shares issued ó pro ó rata

Date	Proportion	Shares in issue	Weighted average
01/01 ó 30/8	8/12	4,000,000	2,666,667
01/09 ó 31/12	4/12	6,000,000	2,000,000
			4,666,667

2009 - Basic EPs = $770,000 / 4,666,667 = 16.5 cents per share

Re-state prior years EPS due to bonus issue by multiplying with the reciprocal of the bonus fraction:

2008 - 15.4 cents x 3/4 = 11.6 cents per share

ACORN PROFESSIONAL TUTORS

Answer to part (b)

Revision

Diluted EPS

Equity share capital may change in the future due to the company have õinstrumentsö now which means holders of these instruments can convert them to shares at some point in the future. Examples are convertible loan stock, preference shares, options and warrants.

Diluted EPS (DEPS) is calculated to show the impact of these future equity shares and give shareholders and users of accounts more information. The DEPS shows the effect of the worst possible dilution. It is helpful for investors to see the full impact of dilution on the earnings for the company in the future.

IAS 33 requires the DEPS to be disclosed along with the basic EPS where the company has such issues.

Convertible loan stock or preference shares

Earnings

Net basis earnings	X
Add back interest or dividends saved	X
Less taxation lost on interest saved	(X)
Diluted earnings	X

No of shares

Basic weighted average	X
Add additional shares on conversion (use terms giving max dilution available)	X
Diluted number	X

Revised earnings

	$ø000
Basic earnings	770
Add back interest ($4m x 7%)	280
Less tax forgone (280 x 30%)	(84)
Revised earnings	**966**

Revised WANS	
Basic WANS (as per part a)	4,666,667 shares
Additional shares upon conversion	2,400,000 shares
Total shares	**7,066,667 shares**

Diluted EPS = $966,000 / 7,066,667 = 13.7 cents per share

Answer to part (c)

With a bonus issue, free shares are given to existing shareholders. No new finance is raised and hence there will be no impact of this bonus issue to the ability of generating more revenue in the future. Therefore essentially the bonus issue is deemed to have always existed with the shares since their birth. Hence IAS 33 treatment of bonus issue is to assume the bonus element has always been there. The shares are not pro-rated and prior years EPS is re-stated for better comparisons.

With a full market issue, new shares are issued at full market price, which means additional finance is raised. This additional finance will help to organisation to increase their earnings in the future. The shares are pro-rated to arrive at the weighted average number of share for the denominator of the EPS ratio.

ACORN PROFESSIONAL TUTORS

Question Four

Required:
Calculate the amounts that will appear in the consolidated statement of financial position of the MX Group as at 31 December 2009 for:
(i) Goodwill;
(ii) Consolidated retained earnings; and
(iii) Non-controlling interest.

(Total for Question Four = 10 marks)

Revision - IFRS 3: Business combinations (January 2008)

Goodwill and non controlling interest (NCI)

IFRS 3 (Jan 2008) replaced IFRS 3 (2004) effective for business combinations on or after 1 July 2009. However earlier application is permitted, but not for periods beginning before 1 July 2007.

It has been argued in the past that the old method of calculating goodwill only recognises the goodwill acquired by the parent. This old method shows the parentøs **ownership** interest only rather than the goodwill **controlled** by the parent. This old method doesnøt recognise the goodwill attributable to the NCI. The NCI when purchasing their shares in the subsidiary would also purchase goodwill and the traditional method of consolidating does not include this NCI share of goodwill.

The new revised IFRS 3 method of calculating goodwill now gives the parent company a choice between 2 methods of calculating goodwill and dealing with NCI:

(i) **NCI's share of net assets** - this is the old method (also known as the **partial goodwill**). Here the goodwill is calculated in the traditional way. The NCI are basically ignored in the goodwill calculation and just the parentøs share is shown.

(ii) **Fair value** ó this is the new method (also known as the f**ull goodwill**). Both the parentøs and the NCIøs goodwill are established and shown in the consolidated financial statements.

Tutor note: Adopting the step by step approach will ensure that you cover all the adjustments for calculating goodwill (step 4), consolidated retained earnings (step 7) and non controlling interest (step 6)

Step 1 Group structure

MX is the parent company owning 80% of FZ which is the subsidiary. NCI is 20%. Date of acquisition is 1st May 2009 (subsidiary for only 8 months of the year). Under IAS 27 consolidate 100% line by line.

Step 2 Layout pro-forma ó N/A
Step 3 Consider the adjustments

- Fair value of property, plant and equipment ó required in the goodwill calculation (FV adjustment = $745,000 - $680,000 = $65,000).
- Additional depreciation - $65,000 x 8 months / (5 years x 12 months) = $8,667. Dr Retained earnings (affects NCI as relates to subsidiary), Cr Consolidated non current assets.
- Contingent liability include in goodwill and financial statements (IFRS 3 overrides IAS 37).
- IFRS 3 specifically doesnøt allow re-organising costs as part of goodwill.
- FZ (subs) sells to MX (parent). PUP on unsold year end intercompany inventory = $300,000 x 20/100 = $60,000 ó Dr Consolidated earnings (affects NCI as subs made profit), Cr Consolidated inventory

Step 4 Goodwill

Answer to (i) - Goodwill

Goodwill calculation under the fair value (new) method Full goodwill	$ø000	$ø000
Cost of investment at fair value		1,750
Less share of net identifiable assets acquired at fair value at date of acquisition		
Share capital	1,000	
Reserves	920	
Fair value adjustments (745 ó 680)	65	
*Contingent liability	(100)	
	1,885	
Group share x 80%		(1,508)
Goodwill parent's share		**242**
Fair value of NCI at date of acquisition	320	
Less: share of NCI net identifiable assets at fair value at date of acquisition (1,885 x 20%)	(377)	
Goodwill – NCI share		**(57)**
Total goodwill (parent + NCI)		**185**

* **Recognition of contingent liabilities**
In applying the acquisition method, a contingent liability must be recognised in the business combination, if its fair value is reliably measurable. A contingent liability recognised under IFRS 3 continues to be recognised in subsequent periods even though it does not qualify for recognition under IAS 37 provisions, contingent liabilities and

ACORN PROFESSIONAL TUTORS

contingent assets. Contingent liabilities and contingent assets are not shown in the individual financial statements under IAS 37 provisions contingent assets and contingent liabilities. However IFRS 3 overrides IAS 37.

Future re-organising costs of $200,000 are specifically disallowed for goodwill calculation purposes un IFRS 3.

Alternative method of establishing goodwill

	$ø000
Consideration paid by parent	1,750
+ Non controlling interest (*fair value given*)	320
- Fair value of subsidiaryøs net identifiable assets at date of acquisition (total)	(1,885)
Goodwill at date of acquisition	**185**
Impairment	(-)
Goodwill at current period end	**185**

Step 5 Combine financial statements ó N/A

Step 6 NCI

Answer to part (iii) -NCI

S Ltd – NCI calculation	**£'000**
Ordinary share capital	1,000
Reserves	1,100
Adjustment ó PUP on year end intercompany inventory	(60)
Adjustment ó Additional depreciation on fair value	(8.7)
Total adjusted net assets at year end	2,031.3
NCI share at 20%	406.3
Goodwill on NCI (step 4)	(57)
Total NCI	349.3

ACORN PROFESSIONAL TUTORS

Step 7 Consolidated reserves

Answer to part (ii) – Consolidated retained earnings

$'000	**MX**	**FZ**
Reserves as per question	3,200	1,100
Adjustment ó PUP on year end intercompany inventory		(60)
Adjustment ó Additional depreciation on fair value	-	(8.7)
Adjusted reserves	3,200	1,013.3
Group share of post acquisition retained reserves (PARR)		
FZ ó (1,013.3 ó 920) x 80%	89	
Less goodwill impairment	(-)	
Consolidated reserves	**3,289**	

ACORN PROFESSIONAL TUTORS

Question Five

Required:
Prepare the report, explaining the progress to date of the convergence project. Include four examples of areas of accounting where convergence has been achieved.

(Total for Question Five = 10 marks)

To:	**Accountancy Firm**
From:	**Trainee Accountant**
Date:	**May 2010**
Subject:	**Report on convergence project**

This report details the convergence project to date.

1.1 Convergence with US GAAP

The largest capital market remaining with its own standards is the US. The United States Securities and Exchange Commission (SEC) requires all overseas companies listed in the US to prepare their financial statements using either US GAAP or their local GAAP but doing a reconciliation between their local GAAP and US GAAP.

In 2002 at a meeting at Norwalk, Connecticut, the IASB and the US Financial Accounting Standards Board (FASB) agreed to a convergence program and working towards reducing differences between the two sets of standards. This is known as the Norwalk Agreement. In February 2006 FASB and IASB issued a Memorandum of Understanding including a program of topics on which the two bodies will seek to achieve convergence by 2008.

The SEC has said it will remove the reconciliation requirement once it is satisfied that IFRS are of a sufficient standard

1.2 Developments – FASB and IASB

In October 2002, the Financial Accounting Standards Board (FASB ó USA) and the International Accounting Standards Board (IASB) agreed under the Norwalk Agreement, their commitment to the convergence of U.S. and international accounting standards.

In February 2006 the IASB and FASB agreed setting out their plans for convergence of their standards by 2008.

1.3 Short-term convergence

The Boards identified areas for short-term convergence, whereby they determined by 2008 whether major differences in these areas can be resolved through short-term standard setting projects, and if so, to complete or substantially complete the needed

ACORN PROFESSIONAL TUTORS

work. The agreement recognises that limiting the number of short-term projects enables more effort to be devoted to major convergence topics.

The short-term convergence standards include:

(i) Government grants
(ii) Joint ventures
(iii) Impairment
(iv) Income tax
(v) Investment properties
(vi) Research and development
(vii) Subsequent events

The effective date of IFRSs resulting from the short-term convergence work plan will be no earlier than financial periods beginning 1 January 2009 and in some cases early adoption of new standards will be allowed.

1.4 Major convergence topics

The agreement lists other topics that are either already on one or both of the Boardsø agendas or are in the research stage.

- Business combinations
- Consolidations
- Fair-value measurement
- Liabilities and equity distinctions
- Performance reporting
- Post-retirement benefits (including pensions)
- Revenue recognition
- De-recognition
- Financial instruments
- Intangible assets
- Leases

1.5 Areas where convergence has been achieved

Joint projects undertaken have resulted in the following:

- IFRS 8 Operating Segments
- IAS 1 revised to standardise the format and terminology of the financial statements.
- IAS 27 and IFRS 3 revised. This affects the consolidated financial statements, the treatment of non controlling interest and goodwill.
- IFRS 5 Non current assets held for sale and discontinued operations. This affects the valuations of the assets held for sale.

ACORN PROFESSIONAL TUTORS

Conclusion

A lot of progress has been made towards international harmonisation and the IASB is the main goal-setter. But there are questions about how much the US is prepared to adopt international standards in practice. The IASB cannot enforce compliance and requires support from the national standard setters.

The IASB is working very closely with national standard setters including UK ASB and US FASB. The US FASB has agreed to reduce differences between the IAS's and US accounting standards (e.g. IFRS 5). The United Nations is involved with accounting regulations for developing countries via its conference on trade and development.

ACORN PROFESSIONAL TUTORS

Section B

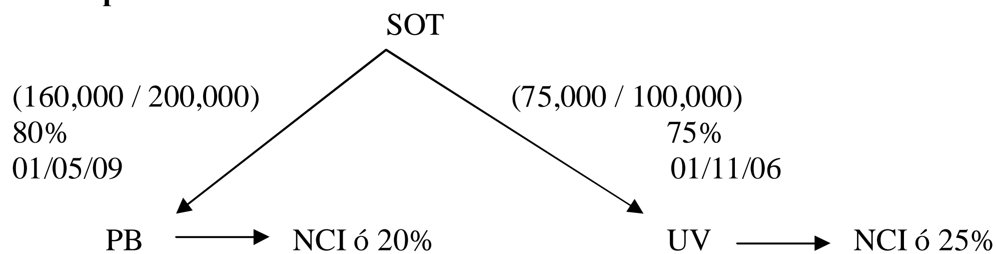
Question Six

Required:
Prepare the consolidated statement of comprehensive income for the SOT group for the year ended 30 September 2009.

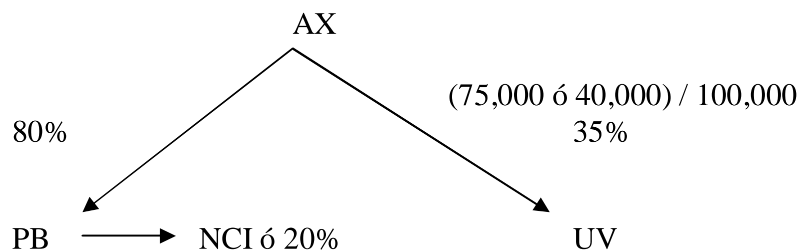
(Total for Question Six = 25 marks)

Step 1 - Group structure – equity investments

Before the disposal



After the disposal – 1st July 2009



Disposal fraction = (75 - 35)/75 = 40/75
Therefore remaining shareholding = 35/75

<u>Relationship & accounting treatment</u>

PB is a subsidiary of SOT, therefore will be consolidated 100% line by line under IAS 27. PB was acquired part-way through the year on 1st May 2009 so was a subsidiary for only 5 months out of the 12 months. All items for PB will be added 100% line by line but pro-rated for 5/12.

ACORN PROFESSIONAL TUTORS

UV was a subsidiary before the disposal. After the disposal the remaining shareholder is significant but not controlling. Therefore for the 9 months of the accounting period, UV was a subsidiary and for the remaining 3 months it was an associate.

Therefore UV will be pro-rated for 9 months as a subsidiary where all the items will be added 100% line by line under IAS 27. For the remaining 3 months it will be treated as an associate under IAS 28 where the share of the profit after tax will be shown pro-rated for 3 months.

Revision - Group disposals

Disposals means the parent company selling (i.e. disposing) of some or all of its equity shares in its investment company which it consolidates.

Disposals where **control is lost** and disposals where **control is retained** are treated completely differently under IFRS 3 and IAS 27 (revised 2008).

Where **control is retained**, the event is treated as a **transaction between owners** (the non controlling interest has increased and parentøs share has decreased). Itøs shown as a **reallocation of ownership between parent and non controlling interes**t. The revised IFRS 3 (2008) states, that the group is one **economic entity** and views all providers of equity (parent and non controlling interest) as owners of the group. The revised IFRS 3 views the non controlling shareholders as owners of the group and not outsiders.

Where control is lost, acquisition method of accounting ceases and the remaining equity investment is treating accordingly.

ACORN PROFESSIONAL TUTORS

Revision - Group disposals

Control is retained	Control is lost
Subsidiary to subsidiary (i.e. 75% to 60%)	Full disposal (i.e. 75% to zero)
	Partial disposal (i.e. 75% to 40%) ó subsidiary to associate
	Partial disposal (i.e. 75% to 10%) ó subsidiary to trade investment
Accounting treatment	**Accounting treatment**
Parentøs individual financial statements - calculate gain or loss plus tax charge (pro-forma working)	Parentøs individual financial statements - calculate gain or loss plus tax charge (pro-forma working)
Group accounts ó consolidate as normal, show disposal of shares as adjustment to parentøs equity (pro-forma working)	Group accounts ó do not consolidate and treat as per status after the disposal (i.e. associate, trade investment or nothing). Calculate group gain or loss on disposal (pro-forma)

Disposals – control is lost

When control is lost either though full disposal or partial disposal of equity shares, the consolidated accounts must be prepared in accordance with the status of the remaining investment if any.

(i) The consideration received is recognised
(ii) Any remaining investment is recognised at fair value on the date of disposal
(ii) The former subsidiary will no longer be consolidated line by line as control is lost.

ACORN PROFESSIONAL TUTORS

Step 2 – Layout pro-forma (consolidated statement of comprehensive income)

Leave 2 whole A4 sides blank in the exam. This will ensure that all the workings follow through on the next 3rd page. This makes it easier for the marker to follow the workings.

Step 3 – Consider adjustments

Go through the additional information given in the exam and work through systematically note by note, detailing exactly what needs to be done. The disposal calculation needs to be done, but need goodwill figure first.

Note 1 – PB investment details

The goodwill is impaired by 10% during the year. So once step 4 goodwill is done, the impairment value will be calculated and charged to the consolidated statement of comprehensive income.

Groupøs policy is to show goodwill under the traditional method (No NCI goodwill).

Fair value adjustment of $960,000 will affect the goodwill calculation. The additional depreciation will need to be charged to the consolidated income statement as a consolidation adjustment.

Fair value adjustment $960,000
Remaining useful life after acquisition 40 years
Annual additional depreciation charge ($960,000 / 40 years) = $24,000
Total monthly charge since date of acquisition - $24,000 x 5/12 = $10,000

Journal entry

Dr Consolidated admin expenses $10,000
Cr Consolidated property, plant and equipment $10,000

Note 2 – UV acquisition and disposal details

The disposal of shares resulted in control being lost. Hence the consolidated group gain or loss will be calculated and shown in the consolidated statement of comprehensive income. This will be done after the goodwill calculation during step 4. UV will be shown as a subsidiary for 9 months, then as an associate for 3 months.

Note 3 – Dividend from PB

Dividend income from subsidiaries is never shown in the consolidated statement of comprehensive income. Therefore the $80,000 will be eliminated upon consolidation.

ACORN PROFESSIONAL TUTORS

Note 4 – Available for sale investments

Revision - IAS 39 – financial assets

IAS 39 requires financial assets to be classified in one of the following categories:

- Financial assets at fair value through profit or loss.
- Loans and receivables.
- Held-to-maturity investments
- Available-for-sale financial assets

The financial asset must initially be recognised at **FAIR VALUE** less direct transaction costs. Subsequent measurement depends on the initial classification.

IAS 39 now states that subsequent measurement can either be fair value and/or the following:

Classification of financial instrument	**Subsequent measurement**	**Change taken to**
Financial assets at fair value through profit or loss	Fair value	Gains and losses taken to the income statement at each re-measurement
Loans and receivables	Amortised cost, using the effective interest rate method, or fair value	Gains and losses taken to the income statement at each re-measurement
Held to maturity investments	Amortised cost, using the effective interest rate method, or fair value	Gains and losses taken to the income statement at each re-measurement
Available for sale financial assets	Fair value	Gains and losses shown under **other comprehensive income** and recognised in equity (reserves). When the item is sold or removed, the cumulative gains or losses are reclassified as part of the retained profit in the statement of changes in equity.

ACORN PROFESSIONAL TUTORS

The gain on subsequent measurement for the available for sale investments will be shown under other comprehensive income.

Cr Gain on available for sale investment (other comprehensive income) $46,000

Dr Available for sale investment (statement of financial position) $46,000

Note 5 – Available for sale investments disposed

Under IAS 39, when available for sale investments are disposed of, the gain or loss is calculated in relation to the original value of the investment not its last valuation. Hence the previous gain of $40,000 needs to be taken out of the reserves and recycled to the profit for the year. This then forms part of the retained profit.

Cr	Consolidated admin expenses	$40,000	
	Dr Reserves		$40,000

Hence the consolidated admin expenses will be reduced by $40,000 (as itøs a credit). Other comprehensive income will show a debit of $40,000, which will also be shown in the statement of changes in equity under the relevant reserve column.

ACORN PROFESSIONAL TUTORS

Step 4 Goodwill

Normally when preparing the consolidated statement of comprehensive income, goodwill calculation is not required. If impairment occurred during the year and you are not given the actual amount, goodwill needs to be calculated. Also if there has been a disposal, goodwill is also required.

Group policy is calculate the goodwill using the traditional method (proportionate share of the (fair value of the) subsidiaryøs net assets).

Traditional method - proportionate share of the (fair value of the) subsidiaryøs net assets	SOT in PB		SOT in UV	
	$ø000	$ø000	$ø000	$ø000
Cost of investment at fair value		2,800		980
Less share of net identifiable assets acquired at fair value at date of acquisition				
Share capital	200		100	
Reserves	2,050		1,020	
Fair value adjustments	960		-	
Other adjustments	-		-	
	3,210		1,120	
Group share at (x 80%) (x 75%)		(2,568)		(840)
Goodwill at date of acquisition		232		140
Impairment (10%)		(23)		-
Goodwill at year end		**209**		**140**

The impairment of $23,000 will go to admin expenses
Dr Consolidated admin expenses Cr Goodwill

ACORN PROFESSIONAL TUTORS

Now calculate the gain or loss on disposal of UV shares ó control is lost

Disposal calculation	
In holding company ***(not required but useful to do)***	$ø000
Sales proceed	960
Less cost of investment x % sold 980 x 40/75	(523)
Profit on disposal	437
Tax	-
Net profit	437

The journal entries in the **parent's individual financial statements**

Banking sales proceeds, de-recognise investment and recognise gain

Debit	$960,000 bank ó with sales proceeds (statement of financial position)
Credit	$523,000 Investment ó with cost of investment x % sold (statement of financial position)
Credit	$437,000 Gain on disposal (statement of comprehensive income)

Group gain or loss on disposal of shares – control lost	$ø000	$ø000
Fair value of proceeds / consideration received		960
Plus fair value of 35% investment retained		792
		1,752
Less		
Net assets x share % at date of disposal		
Share capital	100	
Reserves at date of disposal (1,300 + 709 x 9/12)	1,832	
	1,932	
Group share x 75%	1,449	
Remaining goodwill (step 4)	140	
Less remaining goodwill of NCI share (if full method used)	-	
		(1,589)
Gain on disposal of shares		163
Less tax (as per holding company)		-
Net gain		163

Shown in consolidated income statement

ACORN PROFESSIONAL TUTORS

Step 5 Combine financial statements

SOT Group: Consolidated statement of comprehensive income for the year ending 30th September 2009	**$’000**
Revenue (6,720 + 6,240 x 5/12 + 5,280 x 9/12)	13,280
Cost of sales (3,600 + 3,360 x 5/12 + 2,880 x 9/12)	(7,160)
Gross profit	6,120
Administrative expenses (760 + 740 x 5/12 + 650 x 9/12 +10 + 23 ó 40)	(1,549)
Distribution costs (800 + 700 x 5/12 + 550 x 9/12)	(1,504)
Gain on disposal of shares in UV (W4)	163
Finance costs (360 + 240 x 5/12 + 216 x 9/12)	(622)
Profit before tax ó group	2,608
Share of associates profit after tax (684 x 3/12 x 35%)	60
	2,668
Income tax (400 + 360 x 5/12 + 300 x 9/12)	(775)
Profit for the year	**1,893**
Other comprehensive income:	
Actuarial gains on defined pension plan (110 + 40 x 9/12)	140
Tax affect of other comprehensive income (30 + 15 x 9/12)	(41)
Gain on available for sale investment (W3)	46
Gain on disposal of available for sale investment recycled	(40)
Share of associates other comprehensive income (25 x 3/12 x 35%)	2
Other comprehensive income for the year, net of tax	107
Total comprehensive income for the year (1,893 + 107)	**2,000**
Profit for the year attributable to:	
Equity owners of the parent (1,893 ó 196)	1,697
Non controlling interest (68 + 128) (W6)	196
	1,893
Total comprehensive income attributable to:	
Equity owners of the parent (2,000 ó 201)	1,799
Non controlling interest (68 + 133) (W6)	201
	2,000

Step 6 NCI -minority interest

Profit for the year NCI

$ø000	PB	UV
Profit for the year	840	684
Adjustments ó Additional depreciation on FV assets	(24)	-
Adjusted profit	816	684
NCI % (20%) (25%)	163	171
Pro rata (x 5/12 x 9/12)	**68**	**128**

ACORN PROFESSIONAL TUTORS

Total comprehensive income NCI

$ø000	PB	UV
Total comprehensive income	840	709
Adjustments ó Additional depreciation on FV assets	(24)	-
Adjusted profit	816	709
NCI % (20%) (25%)	163	177
Pro rata (x 5/12 x 9/12)	**68**	**133**

ACORN PROFESSIONAL TUTORS

Question 7

Required:

(a) Analyse the financial performance and financial position of KER for the year to 31 December 2009 and comment on the Chairmanøs claims on expansion (8 marks are available for the calculation of relevant ratios).

(20 marks)

(b) Differences in accounting policies and estimates can affect the comparison of financial statements of two or more entities. Discuss three examples of where such differences could affect comparability between entities.

(5 marks) (Total for Question Seven = 25 marks)

Answer to part (a)

Analysis of the financial performance and position of KER

From the income statement, the revenue has increased from $1,022 million to $1,430 million in 2009. This is an increase of 40%, which shows the strategy of expanding into new markets with existing products has worked. The Chairmanøs comments are correct in this respect.

The cost of sales and distribution cots seems to have increased significantly which is something you would expect during an expansion program. The profit for the year for 2009 is $120 million compared to 2008øs $92 million which is an increase of 30%. However in 2009, share of associates profit amounted to $80 million, there was no associate in 2008.

From the statement of financial position, non current assets have increased significantly to $807 million which is an increase of 48%. This will hopefully generate more revenue and profits in the future. Working capital has also increased by 77% which is very significant and could be signs of bad management of working capital. The increases in revaluation gains and retained earnings have pushed the equity up by 36% (although there has been no increase in the share capital). There has been a significant increase in long term borrowings, which is how the company has used to finance its expansion program, alongside a huge overdraft of $37m. The expansion has been financed by debt, which increases the financial risk of the organisation and makes it less attractive to shareholders.

Letøs now analyse the ratios which have been calculated in appendix 1.

Performance

The return on capital employed has reduced by 6.8%, which means the ability to generate profits from the capital has been reduced. The capital employed has increased for KER resulting in the ratio reduction. However some of the increase in capital employed is due to revaluations of non current assets ($45 million for property, plant and equipment, and $16 million from available for sale investments).

ACORN PROFESSIONAL TUTORS

This is worrying as these revaluations will not necessarily generate future profits as they are existing assets. Future reduction in ROCE could deter investors.

The operating profit margin has reduced significantly by 35.5% from 15.2% to 9.8%. So although revenues have increased, the costs have increased by a higher rate. The gross profit margin has come down from 31% to 26%. This means cost of sales have been higher than before, perhaps the expansion has resulted in sourcing goods from other suppliers or other costs which were not budgeted. Distribution cost margin is 12.2% higher in 2009. An expansion program into different locations would increase the distribution costs, but they are much higher than before. Perhaps the cost of fuel rose during the year? Cost of sales, distribution costs and administrative expenses should ideally move in line with previous years, however perhaps due to the expansion, there are fixed costs incurred which may not occur in subsequent years (i.e. set up costs).

The profit for the year is only higher because of the $80 million coming in from the share of the associate. In fact if this is taken out the profit for the year will only be $40 million (which is 57% lower than 2008). The Chairmanøs assertion that increase in revenue and profits are due to the expansion is misleading. A significant part of the increase in profits is due to the associate. The expansion has resulted in increase in revenues but the costs have increased by a higher % resulting in lower underlying profits. KER needs to ensure that costs are kept low in order for the expansion plan to be a success.

Position

From the statement of financial position, the working capital has declined. Although the current ratio has reduced from 3.3 in 2008 to 2.9 in 2009, inventory levels and trade receivables have increased. Although increases in these current assets are expected during expansion, the trade receivables days is now 63 days compared 47.9 days in 2008. This increase in trade receivable days increases risk of bad debt and will have a negative impact on cash flows for KER (especially has trade payables days remains at the similar levels). Inventory days are now 50 days compared to 33.7 days in 2008. KER is holding high levels of inventory which has an opportunity cost associated with it (holding costs, insurance costs etc). Both trade receivables and inventory are unproductive assets and organisations should aim to minimise these levels to increase profitability.

KER has a huge overdraft of $37m which is normally repayable on demand. Effective management of the working capital can help to reduce the overdraft and risk of cash flow problems (collect debts in quicker, delay payments to suppliers and reduce inventory levels).

As KER has financed the expansion through debt, the gearing level has increased to 60.3% from 43.1%. If the overdraft is included in this, the gearing stands at 65.9%. Gearing increases the financial risk to the shareholders as more of the profits are consumed up with obligatory interest payments. Interest cover has reduced from 5.2 times to 3.7 times and this would be much lower if the associateøs profits are taken out. Any increases in interest rate will cause huge problems for KER as they may not be able to finance their debt, resulting in insolvency problems.

ACORN PROFESSIONAL TUTORS

The Chairmanøs comments on the expansion resulting in increases in revenues and profits are very misleading. Although KER has increased revenues, the financial statements show concern over the management of working capital, the increasing level of debt, high costs of sales and distribution costs. KER needs to effectively manage these areas or face cash flow problems and declining profitability.

Answer to part (b)

Differences in accounting policies and estimates affecting comparisons between entities

Different accounting policies that can be adopted will have an impact on the ratios calculated and therefore make comparisons more difficult. The different accounting policies affect the income statement and the statement of financial position and these impacts on all the major ratios like ROCE and gearing.

1. **Non current assets** can be valued using the cost model or revaluation model. This will have an impact on the statement of financial position and income statement, with higher or lower depreciation charges.
2. **Capitalisation of borrowing costs** is optional, resulting in the statement of financial position and income statement being affected. Capitalisation reports higher profits (as less interest expense) and higher capital employed (high non current assets).
3. **Inventory valuation** at the year end will result in higher or lower cost of sales and therefore different profit figures. FIFO and weighted average method are allowed.
4. **Finance leases** are capitalised with the obligation being set up as well. This will have an impact on both gearing and ROCE. Operating leases are not capitalised.
5. **Defined benefit pension plan** has different methods of dealing with actuarial gains and losses which go through the income statement and therefore affect profitability.
6. **Goodwill** on acquisition used to be amortised through the income statement. It is not now and only impairment losses go through the income statement. This will make profitability more volatile. The statement of financial position will show the goodwill indefinitely and therefore ROCE will be lower.
7. **International company** comparisons adds another layer of problems, where different accounting policies are used.

(Tutor note: only 3 examples were required)

ACORN
PROFESSIONAL TUTORS

Appendix 1 – Ratio calculations

PERFORMANCE				
		2009	**2008**	**% Change**
ROCE PBIT x 100% CE	(160 + 60) / (663 + 400) (125 + 30) / (487 + 210)	20.7%	22.2%	-6.8% (20.7 ó 22.2) 22.2
Operating profit margin PBIT / turnover (excluding associate)	(372 ó 74 - 158) / 1430 (317 ó 62 ó 100) / 1022	9.8%	15.2%	-35.5% 9.8 ó 15.2 15.2
Non current asset turnover Turnover / non current assets	1430 /480 1022 / 404	3.0 times	2.5 times	+20.0% (3.0 ó 2.5) 2.5
Gross profit margin GP / Turnover x 100%	372 / 1430 317 / 1022	26.0%	31.0%	-16.1% (26 - 31) 31
Cost of sales margin COS / turnover	1058 / 1430 705 / 1022	74.0%	69.0%	+7.2% (74 - 69) 69
Admin expenses margin Admin exp / Turnover x 100%	74 / 1430 62 / 1022	5.2%	6.1%	-14.8% (5.2 ó 6.1) 6.1
Distribution cost margin Dist. cost / Turnover x 100%	158 / 1430 100 / 1022	11.0%	9.8%	+12.2% (11 ó 9.8) 9.8
Profit for the year margin Profit for the year / turnover x 100%	120 / 1430 92 / 1022	8.4%	9.0%	-6.7% (8.4 ó 9.0) 9.0
Profit for the year margin excluding associate	(120 ó 80)/ 1430 92 / 1022	2.8%	9.0%	-68.9% (2.8 ó 9.0) 9.0

ACORN PROFESSIONAL TUTORS

Profit for the year / turnover x 100%				
		POSITION		
		2009	**2008**	**% Change**
Current ratio CA / CL	392 / 136 221 / 68	2.9:1	3.3:1	-12.1%
Quick ratio (CA ó inventory) / CL	(392 - 145) / 136 (221 - 65) / 68	1.8:1	2.3:1	-21.7%
Inventory days Inventory / COS x 365 days	145 / 1058 x 365 65 / 705 x 365	50.0 days	33.7 days	+48.4%
Trade receivables (TR) days TR / sales x 365 days	247 / 1430 x 365 134 / 1022 x 365	63.0 days	47.9 days	+31.5%
Trade payable (TP) days TP / COS x 365 days	99 / 1058 x 365 68 / 705 x 365	34.2 days	35.2 days	-2.8%
Working capital cycle Inventory days + trade receivable days ó trade payable days	50.0 + 63.0 ó 34.2 33.7 + 47.9 - 35.2	75.8 days	46.4 days	+63.4%
Interest cover PBIT / Interest	(160 + 60) / 60 (125 + 30) / 30	3.7 times	5.2 times	-28.8%
Gearing Debt / Equity	400 / 663 210 / 487	60.3%	43.1%	+39.9%
Gearing with overdraft	(400 + 37) / 663 210 / 487	65.9%	43.1%	+52.9%

ACORN PROFESSIONAL TUTORS