



ACCA

Paper F7

Financial Reporting
December 2017

Revision Mock B – Answers



To gain maximum benefit, do not refer to these answers until you have completed the revision mock questions and submitted them for marking.

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SECTION A

1 A

Basic Earnings per Share: $565,000 / (6,000,000 + 750,000) = 8.4\text{¢}$

Comparative: $11\text{¢} \times \frac{8}{9} = 9.8\text{¢}$

Bonus issues are treated as if the shares had always been in issue. The bonus issue would have increased the number of shares in issue by $6\text{m} \times \frac{1}{8} = 750,000$ shares.

The bonus fraction is the number of shares after the bonus issue/number of shares before the bonus issue = $\frac{9}{8}$. Comparatives are restated by multiplying the prior year EPS figure by the inverse of the Bonus Fraction, i.e. $\frac{8}{9}$.

2 B

	\$
Cost of investment:	
Share exchange $((1,000,000 \times 80\%) \times \frac{2}{5}) \times \5.40	1,728,000
Fair value of NCI	850,000
	2,578,000
Less: net assets at acquisition	(2,000,000)
	578,000

3 B

	\$000
Cost of investment	6,000
Net assets at acquisition	(7,300)
	1,300
Bargain purchase (negative goodwill)	1,300

Negative goodwill is taken as a gain to the statement of profit or loss.

4 B

Significant influence is assumed with a shareholding of between 20 and 50% and is confirmed as Prima is involved in Akasma’s decision-making with a seat on the board of directors. Akasma should be equity accounted in the consolidated financial statements.

In relation to Artim, Prima holds 40% of the shares so significant influence would be assumed, but the other 60% are owned by one company which in turn will control Artim, therefore Prima has no significant influence.

For Adora, Prima holds less than 20% of the shares, so would be assumed to have no significant influence over Adora so there is no need to equity account or consolidate. This investment would be held as a financial instrument.

For Ajax, 35% of the preference shares gives no influence or control over Ajax so there is no need to equity account or consolidate. This investment would be held as a financial instrument.

5 D

The figure under operating activities will represent the adjustment to profit before tax, and is therefore the non-cash grant amortisation, calculated below. The figure under investing activities will represent the actual cash received during the year, given in the question as \$500,000.

	\$000		\$000
(β) Grant amortisation	150	b/f NCL government grants	1,100
		b/f CL government grants	650
		Grant received	500
c/f NCL government grants	1,250		
c/f CL government grants	850		
	_____		_____
	2,250		2,250
	_____		_____

6 D

The current ratio would not be affected as it considers current assets and liabilities. The revaluation would increase the equity section of the statement of financial position, and affect any ratios that include equity or capital employed.

7 B

Restating the earnings per share will enable a like-for-like comparison.

8 D

Information is relevant if it has predictive or confirmatory value. Disclosing discontinued operations enables users to identify those transactions/events that will not continue in subsequent accounting periods, so has predictive value.

9 A

Inventory should be valued at the lower of cost and net realisable value (NRV). In this case the damaged items have a NRV below cost, and this reduction in value needs to be reflected within the final total inventory value.

	\$
Cost of damaged goods	390,000
Plus normal mark-up 20%	78,000

Normal selling price	468,000
Less discount 30%	(140,400)

Net realisable value	327,600

Inventory needs to be written down by the difference between cost and NRV, \$62,400.

Final value of inventory is therefore 5,000,000 – 62,400 = **\$4,937,600**.

10 C

1 Depreciation – 200,000/5 years = **\$40,000**

2 Lease interest:

Year	b/f	Interest 10%	c/f
20X9	155,000	15,500	170,500

Therefore total charge = \$40,000 + \$15,500 = **\$55,500**.

11 A

\$19,500,000 / 15 years = **\$1,300,000**

The original cost of the property is irrelevant to the calculation, which should be based on the latest valuation of the **building** and the latest estimate of remaining life.

12 C

Damage/obsolescence and a change in the way an asset is used are **internal** indicators that an entity's assets may have become impaired. Market values and economic environment changes are **external** factors.

13 C

Borrowing costs should be capitalised during the period of construction of a qualifying asset. If construction is halted, either temporarily or permanently, the capitalisation also ceases. Any income arising from temporary investment of surplus funds during the period of construction is deducted from the borrowing costs capitalised.

14 B

		\$000
Carrying amount b/f	(\$20m – \$4m)	16,000
Amortisation to 31 March 20X9	(\$20m/5 years)	(4,000)
		—————
Carrying amount at 31 March 20X9		12,000
Fair value at 31 March 20X9		(9,000)
		—————
Impairment		3,000
		—————

15 D

Adjusting events are those events that arise between the reporting date and the date on which the financial statements are authorised for issue, and which provide additional evidence of conditions that existed at the reporting date. The fraud was committed before the reporting date, so the financial statements will be adjusted.

SECTION B

16 A \$29 million

Cost of investment		\$m
Cash		70
Deferred consideration	$8.47 \times 1/1.1^2$	7
Non-controlling interest	Per question	24
Net assets		
Share capital	20	
Retained earnings	48	
Fair value adjustment	4	
(\$12m – \$8m)	—	
		(72)
		29
		29

17 A

The gain on bargain purchase reflects the fact that net assets have been acquired at a price below their fair value. As such, this represents a realised gain and is included within the profit or loss for the year.

18 B \$46.8M

		\$m
Cost of investment	$50m \times 30\% \times \$3$	45.0
Post-acquisition profit	$24 \times \frac{3}{12} \times 30\%$	1.8
		46.8
		46.8

The investment in Aaron is measured at initial cost plus the parent’s share of post-acquisition profit. Retained earnings at the year-end are irrelevant here because we are told the profit earned during the year.

19 C

		\$m
Payne		180
Scannell		60
Fair value adjustment	(\$12m – \$8m)	4
Fair value depreciation	$4 \times \frac{1}{20}$	(0.2)
		243.8
		243.8

20 B

Professional fees incurred should be written off as an expense in the statement of profit or loss.

21 C

		Plant carrying amount \$000	Revaluation surplus \$000
1 December 20X5 Cost		150	
Depreciation to 1 June 20X8	$\$150,000 \times 2\frac{1}{2}/5$	(75)	
		<hr/>	
Carrying amount 1 June 20X8		75	
Revaluation gain	(balancing figure)	30	30
		<hr/>	
Fair value 1 June 20X8		105	
Depreciation to 30 November 20X8	$\$105,000 \times 6 \text{ months}/3\frac{1}{2} \text{ years}$	(15)	
		<hr/>	
Carrying amount 30 November 20X8		90	30
		<hr/>	<hr/>

22 A

Year ended	Cash flow \$000	Discount factor at 8%	Present value \$
30 November 20X9	44,000	0.93	40,920
30 November 20Y0	36,000	0.86	30,960
30 November 20Y1	40,000	0.79	31,600
			<hr/>
			103,480
			<hr/>

23 B

	Carrying amount before impairment	Impairment	Carrying amount after impairment
	\$000	\$000	\$000
Goodwill	200	200	–
Factory building	400	80	320
Plant	350	70	280
Receivables and cash	250	–	250
	1,200	350	850

Impairment is first allocated against goodwill, then pro-rata against the remaining assets, excluding cash and receivables which are outside the scope of IAS 36. The goodwill impairment accounts for \$200,000 of the total impairment of \$350,000, leaving \$150,000 to be apportioned between the factory building and plant, based on their carrying amounts before the impairment.

The impairment charged against the plant is calculated:

$$\$150,000 \times 350 / (350 + 400) = \$70,000$$

24 D

Statement 1 is the definition of a cash generating unit. Cash generating units are considered when the recoverable amount of an individual asset cannot be determined. The assets comprising a cash generating unit must be considered consistently when comparing carrying amount and recoverable amount, so Statement 2 is untrue.

25 B

An asset is impaired when its carrying amount is overstated. The recoverable amount represents the cashflow from the most advantageous use of the asset, hence the higher of fair value less costs of disposal and value in use.

26 B

A contract to exchange financial instruments with another entity under conditions which are potentially unfavourable is an example of a financial liability.

27 A

The investment is speculative, so the election to measure at Fair Value through Other Comprehensive Income is not available, and the investment would be carried at Fair Value through Profit or Loss. Transaction costs are therefore not included within the initial recognition value, but instead are taken to profit or loss as an expense of **\$350**.

Cost of shareholding is $10,000 \times \$3.50 = \$35,000$

Fair value at 31 December 20X5 $10,000 \times \$4.50 = \$45,000$

Gain = $\$45,000 - \$35,000 = \$10,000$

Net impact in the statement of profit or loss = \$10,000 gain less \$350 expense = \$9,650.

28 C

The finance cost would be calculated using the effective rate of interest for six months.

$\$40 \text{ million} \times 7 \times \frac{6}{12} = \1.4 million

29 B

The standard selling price for the machine is \$20.5 million and for the maintenance \$1.5 million per annum, a total standard sales value of \$25 million. The agreed selling price for the package is \$20 million, a discount of 20% against the standard price. This discount is apportioned between the performance obligations (delivery and maintenance) on the basis of standard price.

	\$000	
Machine: \$20.5m less 20%	16,400	
Maintenance: \$1.5m × 3 years less 20%	3,600	(\$1.2m per annum)
	20,000	
Agreed selling price	20,000	

Revenue is recognised on the basis of satisfaction of performance obligations. By 31 December 20X5 Stankovic has delivered the machine and provided one year of maintenance. The total revenue to be recognised in the year is \$16.4m goods + \$1.2m maintenance = **\$17.6m**.

30 C

The five stages of revenue recognition under IFRS 15 are to:

- i. Identify the contract
- ii. Identify the performance obligations under the contract
- iii. Identify the contract price
- iv. Allocate the price to the performance obligations
- v. Recognise revenue as the performance obligations are satisfied

SECTION C

(a) Ratios for Heywood for the year ended 31 December 20X7

Return on capital employed	3.0%	$((30 - 28) / (23 + 32 + 12)) \times 100$
Gross profit margin	10%	$(30 / 300) \times 100$
Operating profit margin	0.7%	$((30 - 28) / 300) \times 100$
Asset turnover	4.5 times	$(300 / (23 + 32 + 12))$
Current ratio	0.9 : 1	$(118 / 126)$
Gearing (debt to debt + equity)	65.7%	$(32 + 12) / (23 + 32 + 12)$

(b) Report

To The Directors, Heywood

Subject Company performance for the year to 31 December 20X7

Introduction

This report is in response to your request to assess the financial performance of Heywood for the year to 31 December 20X7, in the light of the strategic action implemented following the board meeting in January 20X7. The strategy was designed to increase sales and market share, and, to the extent that sales have increased from \$120m to \$300m, this has been successful. However, profitability has suffered and this report attempts to identify the main reasons for this.

Profitability

The primary profitability ratio is the return on capital employed (ROCE). Unfortunately this has declined in the period from 32% to a poor 3%. The actions taken by the Board to reduce prices to beat the competition, including the 'price promise' and winning the competitive tender, would be expected to have squeezed margins and thus stimulate greater sales and more efficient use of assets.

The ROCE comprises two elements, profitability (operating margin) and efficiency (asset turnover). The board's plan was to sacrifice profitability in order to stimulate efficiency, the intention being to increase efficiency to such a degree that overall ROCE would be improved.

The anticipated effects occurred, but unfortunately the increase in sales of 150% (\$120m to \$300m) and the related net asset turnover increase from 1.9 to 4.5 times, was insufficient to compensate for an operating margin that declined to only 0.7%. The board appear to have been overenthusiastic in their price-cutting strategy, a strategy that is not sustainable in the long term. Although they may seek alternative remedies, such as cost-cutting or negotiating bulk discount with suppliers, the board need to re-visit their pricing strategy, and consider re-negotiating some contracts.

The deferral of the marketing costs is controversial and difficult to justify. The directors have attempted to justify the deferral by referring to the 'expected long-term benefits', but, even though there may be some future benefit, this would be extremely difficult to measure, and would therefore not appear to be adequate justification for the deferral. It would have perhaps been possible to defer recognition of the expenditure if this was simply a prepayment of expenditure, with the journals containing the marketing campaign not published until after 31 December 20X7, but this does not seem to be the case. The impact of the deferral has been to reduce costs and thus reduce the loss in the current year by \$6 million. Had the marketing costs been written off as incurred, a more prudent approach, the loss for the year before tax would have risen to \$14 million.

Liquidity and working capital

The liquidity position of the company also gives cause for concern with the current ratio deteriorating from an acceptable figure of 1.8 in 20X6 to a much less secure 0.9 in 20X7. A current ratio below 1 indicates that the entity has insufficient assets to pay its liabilities as they fall due. Although these ratios will have been calculated based on year-end figures, and may be distorted by movements around the year-end, such a sharp drop is worrying.

The cause of this deterioration seems to lie principally in the new credit policy. Revenue rose by 150%, whereas receivables have increased by 276% (\$25m to \$94m). An increase in the level of receivables days is to be expected, given the new policy, but this huge increase seems to indicate extremely poor credit management, extremely powerful customers, or some combination of the two. The decision to offer increased periods of credit to this degree is very questionable.

The increased receivables appear to have been funded by delaying payments to suppliers and a decline in the bank balance from \$8 million in hand to a \$34 million overdraft.

Payables have increased dramatically from \$15 million in 20X6 to \$80 million in 20X7. This increased "free" credit is being taken to cushion the impact of the considerable rise in receivables. Heywood must ensure that it is adhering to credit terms agreed to avoid damaging its relationship with suppliers.

Inventory-holding efficiency has improved, with the value of inventory only rising by 50% (\$12m to \$18m), compared to a 200% increase (\$90m to \$270m) in cost of sales. On the surface this is indicative of efficient low inventory levels but it may be that suppliers are becoming unwilling to supply goods on credit due to the time Heywood is taking to pay them. Heywood is then being forced to buy goods for cash, and therefore only buying inventory when it needs it immediately.

Solvency

Gearing also gives cause for concern, with a substantial increase from 39.7% in 20X6 to 65.7% in 20X7, indicating significant increase in levels of risk. The gearing level would be even higher if the overdraft was considered as part of long-term borrowing, a realistic suggestion as there seems little prospect of it being paid off in the near future. If the deferred expenditure had been written off during the year this would also have increased gearing due to lower equity.

Increased production has led to a requirement for greater investment in non-current assets. From the information provided, the overdraft has exceeded its agreed limit and therefore it may be assumed that this is the main reason for some of the assets having been acquired under leases.

The more worrying aspect of this is that due to poor profitability, interest payments which were covered by a factor of 10 (20/2) in 20X6, are not covered in 20X7. This position is not sustainable for very long, especially when one considers that it is cash that pays interest rather than profit, and Heywood has no cash.

From analysis of the retained earnings balance we can calculate that Heywood paid a dividend of \$14 million during the year. Although there may have been good reason for this, it seems at best imprudent given the cash situation. A smaller dividend would have gone some way to easing the current cash situation.

Conclusion

There is little point in increasing turnover and market share if this cannot be done profitably. It is advisable to reverse the marketing strategy as soon as possible, but the company will find it much more difficult to increase prices and keep customers than it was to attract customers with loss-making prices. Other methods of developing sales and customer loyalty should be implemented.

The present trading position cannot continue. A change of strategy is needed, possibly a rights issue could be considered, coupled with an injection of long term debt finance. Although shareholders may be tempted by a rights issue, given the recent dividend, it seems unlikely that many debt investors will be keen to lend to a company with such a poor interest cover. Without some sort of capital injection, the company is likely to fail in the very near future, and the current performance and position is unlikely to tempt many investors. The actions implemented by the Board in 20X7 have turned out to be disastrous.

Marking scheme		<i>Marks</i>
(a)	1 mark per ratio	6 —
(b)	1 mark per relevant comment	
	Profitability, max	5
	Liquidity, max	5
	Solvency, max	4 —
		14 —
Total		20 —

32 CHESTNUT**(a) Statement of profit or loss and other comprehensive income for the year ended 31 March 20X5**

	\$000
Revenue	387,500
Cost of sales (W4)	(305,630)
	<hr/>
Gross profit	81,870
Distribution costs	(24,375)
Admin expenses	(34,370)
	<hr/>
Profit from operations	23,125
Investment income	4,500
Finance costs (400 + 298 (W2) + 5,200 (W3))	(5,898)
	<hr/>
Profit before tax	21,727
Income tax (W5)	(3,075)
	<hr/>
Profit for the year	18,652
Other comprehensive income:	
Revaluation gain (W1)	5,000
	<hr/>
Total comprehensive income	23,652
	<hr/>

(b) Statement of financial position as at 31 March 20X5

	\$000	\$000
Non-current assets		
Leasehold property (W1)		62,000
Current assets		
Inventory	35,250	
Trade receivables	41,375	
Bank	34,350	
	<hr/>	
	110,975	
Asset held for sale (W1)	28,500	
	<hr/>	
		139,475
		<hr/>
		201,475
		<hr/>

Equity		
Ordinary share capital		50,000
Convertible option (W2)		1,272
Revaluation reserve (9,000 + 5,000 (W1))		14,000
Retained earnings (12,125 + 18,652 – 12,500)		18,277
	b/f profit dividend	
		<hr/>
		83,549
Non-current liabilities		
6% preference shares (W3)	54,200	
Convertible loan (W2)	9,026	
Deferred tax (W6)	7,000	
	<hr/>	
		70,226
Current liabilities		
Income tax payable (W5)	5,700	
Trade payables	42,000	
	<hr/>	
		47,700
		<hr/>
		201,475
		<hr/>

Workings

(W1) Non-current assets



Tutorial note:

The property is to be revalued at the year-end, so depreciate first and then revalue.

	Property	Plant and equipment
	\$000	\$000
Cost/valuation 1 April 20X4	60,000	60,000
Accumulated depreciation 1 April 20X4		(22,000)
		—————
		38,000
Depreciation: $\$60,000 \times \frac{1}{20}$	(3,000)	
$\$38,000 \times 25\%$		(9,500)
	—————	—————
	57,000	28,500
		—————
Revaluation gain: other comprehensive income	5,000	
	—————	
Valuation 31 March 20X5	62,000	
	—————	

As plant is held for sale, transfer to current assets and measure at the lower of carrying amount (\$28,500) and fair value less costs to sell (\$32,000). Therefore carry in current assets at \$28,500.

(W2) Convertible loan note



Tutorial note

The convertible loan note needs to be split into its liability and equity components.

The liability component is calculated by taking the present value of the payments to be made, discounted at the market rate of a similar loan note without conversion options.

The payments will therefore be discounted at 8%.

Year ended 31 March	Cash flows	Factor at 8%	Present value \$000
	\$000		\$000
20X5 interest (10,000 × 4%)	400	0.93	372
20X6 interest	400	0.86	344
20X7 interest	400	0.79	316
20X8 interest + capital redemption	400 + 10,000	0.74	7,696
Total value of liability component			8,728
Equity component (balancing figure)			1,272
Proceeds of issue			10,000

The initial double entry is:

	\$000
Dr Cash	10,000
Cr Liability	8,728
Cr Equity	1,272

The liability element is then carried at amortised cost as shown below.

Year	b/f \$000	Interest 8% \$000	Interest paid 4% \$000	c/f \$000
20X5	8,728	698	(400)	9,026
		(finance costs – in SPLOCI)		(non-current liability in SFP)

As only \$400,000 had been included within finance costs, an additional amount of \$298,000 must be charged and added to the carrying value of the liability.

(W3) Preference shares

Year	b/f	Interest @ 10%	Payment	c/f
	\$000	\$000	\$000	\$000
31 March 20X4	52,000	5,200	(3,000)	54,200
		To finance costs	Per trial balance	To NCL

(W4) Cost of sales

		\$000
Per trial balance		293,130
Depreciation	– Leasehold property (W1)	3,000
	– Plant (W1)	9,500
		<hr/>
		305,630
		<hr/>

(W5) Income tax

	\$000
Year-end estimate, per note (iv)	5,700
Under provision, per trial balance	875
Decrease in deferred tax (W6)	(3,500)
	<hr/>
	3,075
	<hr/>

(W6) Deferred tax

	\$000
Deferred tax c/fwd (Non-current liability on SFP)	7,000
Deferred tax b/fwd	(10,500)
	<hr/>
Decrease in deferred tax	(3,500)
	<hr/>

ACCA marking scheme		<i>Marks</i>
(a)	Statement of profit or loss and other comprehensive income	
	Revenue	½
	Cost of sales (½ per TB, ½ property depn, ½ plant depn)	1½
	Distribution costs	½
	Administrative expenses	½
	Investment income	½
	Finance costs (½ pref div, ½ convertible interest paid, ½ convertible adj, ½ pref adj)	2
	Income tax (½ under provision, ½ current year, ½ deferred tax)	1½
	Other comprehensive income – revaluation gain	1
		<hr style="width: 100%; border: 0.5px solid black;"/>
		8
		<hr style="width: 100%; border: 0.5px solid black;"/>
(b)	Statement of financial position	
	Leasehold property	1
	Inventory	½
	Receivables	½
	Bank	½
	Asset held for sale (0 if in PPE, 0 if \$32,000)	1
	Share capital	½
	Conversion option	½
	Revaluation reserve	1
	Retained earnings	1
	Convertible loan (1 for initial liability, ½ for adjustment)	1½
	Redeemable preference shares	1½
	Deferred tax	1
	Trade payables	½
	Taxation	1
		<hr style="width: 100%; border: 0.5px solid black;"/>
		12
		<hr style="width: 100%; border: 0.5px solid black;"/>
Total		20
		<hr style="width: 100%; border: 0.5px solid black;"/>

