The Examiner's Answers
F1 - Financial Operations
May 2013

Some of the answers that follow are fuller and more comprehensive than would be expected from a well-prepared candidate. They have been written in this way to aid teaching, study and revision for tutors and candidates alike.

SECTION A

Answers to Question One

Rationale
Question One consists of 10 objective test sub-questions. These are drawn from all sections of the syllabus. They are designed to examine breadth across the syllabus and thus cover many learning outcomes.

1.1 A

1.2 D

1.3 Two from:

- Exemption
- Tax credit
- Deduction

1.4

Cost	$650,000
Duties	$25,000
	$675,000
Indexation	$337,500
	$1,012,500
Sales price	$1,200,000
Less charges	$17,000
	$1,183,000

Profit $1,183,000 - $1,012,500 = $170,500
Tax @ 25% = $42,625

Answer: $42,625

1.5 D

1.6 C

1.7 Any two from:

- Multinational entities could benefit from access to a wider range of international finance opportunities. This could have the effect of reducing financing costs;
- Multinational entities could benefit from improved management control as all parts of the entity would be reporting using one consistent basis;
- Multinational entities could benefit from greater efficiency in accounting departments as they would not have to spend time converting data from one accounting basis to another;
- Multinational entities could benefit from easier consolidation of overseas subsidiaries' results when preparing group accounts.

1.8 Any two from:

- To give advice to the IASB on agenda decisions;
- To give advice to the IASB on the priorities in its work;
- In relation to major standard setting projects to inform the IASB of the views of organisations and individuals on the Council;
- To give any other advice to the IASB or the Trustees.

1.9 Relevance and faithful representation

1.10 Opinion

SECTION B

Answers to Question Two

(a)

Rationale
To test candidates' knowledge of the statement of cash flows. Tests learning outcome C1a.
Suggested Approach
Prepare workings to calculate property, plant and equipment purchased during the year. Prepare workings to calculate non-current asset investments purchased during the year. Prepare workings to calculate the amount spent on deferred development expenditure during the year. Prepare the extract from the statement of cash flows.

Workings:

	$million
Property, plant and equipment	
Balance at 31 March 2012	645
Sold in year	(60)
Annual depreciation	(120)
	465
Balance at 31 March 2013	635
Purchased	170
Non-current asset investments	
Balance at 31 March 2012	107
Revaluation loss	(21)
	86
Balance at 31 March 2013	93
Purchased	7
Deferred development expenditure	
Balance at 31 March 2012	24
Amortisation	(8)
	16
Balance at 31 March 2013	29
Purchased	13

CFQ Statement of Cash Flows for year ended 31 March 2013 (Extract)

	$million
Cash flows from Investing Activities:	
Purchase of Property, plant and equipment	(170)
Purchase of Non-current asset investments	(7)
Purchase of Deferred development expenditure	(13)
Proceeds from disposal of property, plant and equipment	45
Net cash outflow from investing activities	(145)

(b)

Rationale
To test the candidates' understanding of the process of resolving an ethical dilemma. Tests learning outcome B2c.
Suggested Approach
Identify the sequence of events that Ace could use to raise awareness of the possible ethical problem.

He should start by gathering all relevant information so that he can be sure of the facts and decide if there really is an ethical problem. All steps taken should be fully documented.

Initially he should raise his concern internally, possibly with the team's manager or a trusted colleague.

If this is not a realistic option, for example because of the relationship of the manager and the team member that Ace is concerned about, he may have to consider escalating the issue and speak to the manager's boss, a board member or a non-executive director. If there is an internal whistle blowing procedure or internal grievance procedure he should use that.

If after raising the matter internally nothing is done and he still has concerns he should take it further, for example if the other team member is an accountant Ace could consider reporting the team member to his professional body.

Ace could also distance himself from the problem and ask to be moved to a different department or to a different team.

(c)

Rationale
To test candidates' understanding of the application of IAS 32 and IAS 39 to redeemable preference shares. Tests learning outcome C2b.
Suggested Approach
Explain the definition of equity and debt given by IAS 32. Explain why the preference shares are classified as debt and the dividend treated as interest paid. Explain how the initial value of the preference shares is calculated. Explain how the cost of the preference shares is charged to profit or loss.

(i)

IAS 32 *Financial Instruments: Presentation* requires shares to be classified as debt (financial liability) or equity according to their substance rather than legal form.

A financial liability is defined as a contractual obligation to deliver cash or other financial asset to another entity.

Cumulative redeemable preferred shares meet the definition of financial liability and therefore must be classified as debt and included in the statement of financial position under non-current liabilities.

(ii)
IAS 39 Financial Instruments: Recognition and Measurement: The cumulative redeemable preferred shares will initially be measured at the fair value of the consideration received. That is issue price less issue costs, ($500,000-$20,000 = $480,000).

The charge to profit or loss will be based on the effective interest rate which includes any issue costs, dividends paid and redemption costs.

(d)

Rationale

To test candidates' knowledge of tax base and the calculation of deferred tax.

Tests learning outcome A4a.

Suggested Approach

Define the meaning of the tax base of an asset.
Explain the importance of the assets tax base when calculating deferred tax.
Calculate the accounting carrying value of plant and equipment.
Calculate the tax base of the plant and equipment.
Calculate the difference between the two amounts calculated and multiply by the tax rate.

(i)
The tax base of an asset is the tax written down value of the asset. i.e. its cost less accumulated tax depreciation. Deferred tax arises as a result of temporary differences caused by a difference between an asset's tax base and its accounting carrying value.

(ii)
Accounting carrying value:

	$000
Cost	260
Less residual value	(26)
	234
Annual depreciation 1/6	(39)
Cost	260
Depreciation 2011/12	(39)
Depreciation 2012/13	(39)
Carrying value 31 March 2013	182

Tax Base:

Cost	260
First year allowance (50%)	(130)
Second year allowance (25%)	(32.5)
	97.5

Difference 182 – 97.5 = 84.5
Deferred tax = $84,500 x 25% = $21,125

(e)

Rationale

To test candidates' understanding of corporate income tax calculations.

Tests learning outcome A3a.

Suggested Approach

Calculate MT's taxable profits for the year to 31 March 2013. Then deduct the loss brought forward to calculate the taxable amount for the year. Multiply by the tax rate to give the tax due for the year ended 31 March 2013.

MT Taxable profits:

	$
Profit before tax	37,000
Add back donations	5,000
Add back depreciation	39,000
	81,000
Less tax depreciation allowances:	
First year allowance (30000x50%)	(15,000)
Annual writing down allowance (120000x25%)	(30,000)
Taxable profits for year	36,000
Less loss b/f	(12,000)
Taxable profit	24,000
Tax due @ 25%	6,000

(f)

Rationale

To test candidates' knowledge of different types of sales tax and their calculation.

Tests learning outcome A1e.

Suggested Approach

Explain how a cascade tax and VAT work to highlight the difference between them.
Calculate the profit, excluding tax that AV should recognise.

(i)

Cascade tax – tax is taken at each stage of production and is treated as a business cost. No refunds are provided by local government.
VAT – charged each time a component or product is sold but government allows businesses to claim back all the tax they have paid. The entire tax burden is passed to the final consumer.

(ii)

	$000	$000
Sales at standard rate	828	VAT
Less VAT (828x15/115)	(108)	108
	720	
Zero rated sales	150	
	870	
Purchases	(620)	(60)
	250	48

Profit for period $250,000

VAT due for period $48,000

SECTION C

Question Three

Rationale

To test the candidates' understanding of the criteria that have to be met in order to classify assets as "held for sale" in accordance with IFRS 5 *Non-current assets held for sale and discontinued operations*.
To test candidates' ability to prepare a set of financial statements for a single entity, including the application of a number of IFRS/IAS.

Tests learning outcome C1a.

Suggested Approach

Explain the criteria that have to be met in order to classify division B as "held for sale" in accordance with IFRS 5 *Non-current assets held for sale and discontinued operations*.
Prepare the non-current asset depreciation calculations.
Prepare workings to calculate the loss on discontinued operations for the year.
Prepare workings for cost of sales, administration and distribution.
Prepare all other required workings.
Prepare the statement of profit or loss.
Prepare the statement of financial position.
Prepare the statement of changes in equity.

(a)

The criteria that must be met before an operation can be classified as "held for sale" under IFRS 5 *Non-current assets held for sale and discontinued operations* are:

- It must be available for immediate sale in its present condition
- The sale must be highly probable, management must be committed to selling the assets and have an active programme to locate a buyer
- It must be being offered at a reasonable price
- The sale is expected within the next year

(b)

SA – Statement of profit or loss for the year ended 31 March 2013

Continuing Operations		$000	$000
Revenue			2,784
Cost of sales			(1,900)
Gross Profit			884
Administrative expenses	W3	(368)	
Distribution costs	W3	(20)	(388)
Profit from operations			496
Finance cost	W4		(27)
Profit before tax			469
Income tax	W5		(87)
Profit for the period from Continuing operations			382
Discontinued Operations			
Loss from discontinued operations	W6		(284)
Profit for the period			98

SA Statement of financial position as at 31 March 2013

	$000	$000
Non-current assets		
Property, plant and equipment		983
Current Assets		
Inventory	68	
Trade receivables	56	
Cash and cash equivalents	202	
		326
Non-current assets held for sale		431
Total Assets		1,740
Equity and liabilities		
Equity		
Share capital	800	
Revaluation reserve	80	
Retained earnings	226	
Total equity		1,106
Non-current Liabilities		
Long term borrowings	450	
Deferred tax (W5)	69	
Total non-current liabilities		519
Current liabilities		
Trade payables	51	
Interest payable (W4)	14	
Tax payable (W5)	50	
Total current liabilities		115
Total equity and liabilities		1,740

SA Statement of changes in equity for the year ended 31 March 2013

	Equity Shares	Revaluation reserve	Retained earnings	Total
	$000	$000	$000	$000
Balance at 1 April 2012	800	80	183	1,063
Profit for period			98	98
Dividend paid			(55)	(55)
Balance at 31 March 2013	800	80	226	1,106

Workings - All figures in $000

(W1) – Tangible Non-current Assets (continuing operations)

Plant & Equipment	$000	
Cost balance 1/4/12	1,010	
Less discontinued operations	(180)	
	830	
Depreciation balance 1/4/12	360	
Less discontinued operations	(140)	
	220	
Charge for year ([830-220]x20%)	122	
	342	
Net book value at 31/3/13		488
Buildings		
Cost 1/4/12	995	
Less discontinued operations	(460)	
	535	
Depreciation balance 1/4/12	50	
Less discontinued operations	(23)	
Depreciation balance 1/4/12	27	
Charge for year (535x2.5%)	13	
	40	
Net book value at 31/3/13		495
		983

(W2) Non-current Assets - Discontinued Operations

Buildings		
Cost	460	
Depreciation b/f	(23)	
Depreciation – year (460x2.5%)	(12)	
		425
Plant and equipment		
Cost	180	
Depreciation b/f	(140)	
Depreciation – year (40x20%)	(8)	
		32
		457
Fair Value		431
Loss on adjustment in value to fair value		(26)

(W3)

	Administration	**Distribution**
Per trial balance	263	145
Less discontinued	(30)	(125)
Depreciation (W1) (122+13)	135	
	368	20

(W4) Finance charge

Years loan interest	(450 x 6%)	27
Paid		(13)
Accrued		14

(W5) Tax

Continuing Operations		
Current year	(50+40)	90
Decrease in deferred tax		(3)
Charge for year		87

Deferred tax

Per trial balance	72
Decrease in year	(3)
	69

(W6)

Discontinued Operations		
Revenue		185
Cost of sales		(230)
		(45)
Administration (W3+W2)(30+20)	(50)	
Distribution (W3)	(125)	(175)
		(220)
Closure costs		(78)
		(298)
Tax refund		40
		(258)
Loss on adjustment in value to fair value (W2)		(26)
		(284)

Question Four

Rationale

To test candidates' understanding of the treatment of a post acquisition increase in goodwill.
To test candidates' ability to prepare a set of financial statements for a group of entities.
Tests learning outcome C1c.

Suggested Approach

Explain how a post acquisition increase in goodwill should be treated in consolidated financial statements.
Prepare workings:

- Calculate the fair value of Green's net assets at acquisition.
- Calculate goodwill arising on acquisition of Green.
- Calculate investment in associated entity Tee.
- Prepare workings for intra-group activities.
- Prepare workings for consolidated property, plant and equipment
- Prepare workings for all other consolidated items required for the answer.
- Calculate consolidated retained earnings balance at 31 March 2013.

Prepare consolidated statement of financial position.

(a)

If an impairment review indicates that goodwill has increased in value, the increase is deemed to be internally generated goodwill. Internally generated goodwill is not allowed to be recognised in the financial statements. Club will therefore not recognise the increase in goodwill and will include goodwill in its statement of financial position at its original value.

(b) **Workings (All workings in $000)**

(i) Fair value of net assets of Green at acquisition	
Equity Shares	17,370
Share premium	3,470
Retained earnings	3,000
Fair value adjustment	1,200
	25,040

(ii) Goodwill -	
Cost	35,610
Fair value of net assets acquired:	(25,040)
Goodwill	10,570

(iii) Investment in associate –
Acquired 3,980,000 shares out of 15,920,000 shares = 25%

Cost	8,000
Add group share of post acquisition profits (2290 x 25%)	573
Investment at 31 March 2013	8,573

(iv) Intra-group trading
Mark up on cost $33^{1}/_{3}$ = 25% margin on selling price.
Selling price 960; unrealised profit = 960 x 25% = 240
20% of goods sold; 80% in inventory
Unrealised profit = 240 x 80% = 192

	Dr.	Cr.
Consolidated retained earnings	192	
Consolidated current assets - inventory		192

(v) Intra-group asset transfers

Transfer value	115
Carrying value	(90)
Unrealised profit	25

Excess depreciation, to add back:
(115-90)/5 = 5

(vi) Consolidated Inventory

Club	34,910
Green	9,310
Less intra-group unrealised profit	(192)
	44,028

(vii) Consolidated Trade Receivables

Club	38,790
Green	16,530
Less intra-group sales	(960)
Less cash transfer	(115)
	54,245

(viii) Consolidated Cash and cash equivalents

Club	5,010
Green	1,480
Cash transfer	115
	6,605

(ix) Consolidated Trade Payables

Club	11,320
Green	10,830
Less intra-group sales	(960)
	21,190

(x) Excess depreciation
Fair value adjustment – 1,200
Economic life 12 years, straight line basis
Excess depreciation = 100 per year
Two years since acquisition = 100 x 2 = 200

(xi) Consolidated Property, plant and equipment

Club	50,050
Green	30,450
Fair value adjustment (i)	1,200
Excess depreciation (ix)	(200)
Machinery transfer – profit (v)	(25)
Machinery transfer – excess depreciation (v)	5
	81,480

(xii) Consolidated Retained Earnings

Club	15,630
Green (10,650 – 3,000)	7,650
Tee (2,290 x 25%)	573
Unrealised profit – inventory (iv)	(192)
Unrealised profit – machinery (v)	(25)
Excess depreciation – fair value adjustment (ix)	(200)
Excess depreciation – machinery (v)	5
Balance 31 March 2013	23,441

Club - Consolidated Statement of Financial Position as at 31 March 2013

	$000	*$000*
Non-Current Assets		
Property, plant and equipment (xi)		81,480
Goodwill (ii)		10,570
Investment in associate (iii)		8,573
Current Assets		
Inventory (vi)	44,028	
Trade receivables (vii)	54,245	
Cash and cash equivalents (viii)	6,605	104,878
Total assets		205,501
Equity and Liabilities		
Equity Shares	112,620	
Share premium	0	
Retained Earnings (xii)	23,441	136,061
Non-current liabilities		
Long term borrowings (32,000 + 15,000)		47,000
Current Liabilities		
Trade payables (ix)	21,190	
Loan interest payable (800 + 450)	1,250	22,440
		205,501