Exam in Advanced Financial Reporting and Analysis

**Time allowed: 3 hours**

**ALL the questions are compulsory and MUST be attempted.**

**Open-ended questions**

**Question 1**

1. Andros develops and manufactures desktop and laptop computers. Profit after tax for the year-ended 31 December 20X1 is 5% lower than the prior period. Andros discloses the following non-financial performance measures in its Integrated Report for the year ended 31 December 20X1.

20X1 20X0

Faults per 1,000 sales 2.1 3.2

Customer service helpline waiting time (minutes) 1.5 4.2

Staff turnover\* (%) 6.5 13.2

\*(leavers/average number of employees × 100)

Required:

*Discuss how the above information might be interpreted by Andros ’s current and potential investors. (15 marks)*

1. Lechko discloses an additional performance measure (APM) in its financial statements. The following is an extract from one of Lechko ’s financial statement disclosure notes for the year ended 31 December 20X1:

GEL/m

Loss before tax (8)

Finance cost 4

Depreciation 10

Amortisation 8

Impairment of brand 7

Foreign exchange loss on monetary items 3

Gains on FVPL financial assets (5)

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Underlying profit 19

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Lechko presents comparable information for the prior period.

*Required:*

*Discuss why this APM may not be useful to Lechko ’s stakeholders. (10 marks)*

*(Total 25 marks)*

**Question 2**

On 1 July 20X4 Azzy purchased 1,600,000 of the 2,000,000 GEL 1 equity shares of Windsor for GEL 10,280,000. At the date of acquisition the retained earnings of Windsor were GEL 6,150,000.

The statements of profit or loss for each entity for the year ended 31 March 20X5 were as follows.

Azzy Windsor

GEL 000 GEL 000

Revenue 60,000 24,000

Cost of sales (42,000) (20,000)

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Gross profit 18,000 4,000

Distribution costs (2,500) (50)

Administrative expenses (3,500) (150)

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Profit from operations 12,000 3,800

Investment income 75 –

Finance costs – (200)

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Profit before tax 12,075 3,600

Tax (3,000) (600)

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Profit for the year 9,075 3,000

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Retained earnings bfd 16,525 5,400

There were no items of other comprehensive income in the year.

The following information is relevant:

1 The fair values of Windsor’s net assets at the date of acquisition were equal to their carrying values with the exception of plant and equipment, which had a carrying value of GEL 2,000,000 but a fair value of GEL 5,200,000. The remaining useful life of this plant and equipment was four years at the date of acquisition. Depreciation is charged to cost of sales and is time apportioned on a monthly basis.

2 During the post-acquisition period Azzy sold goods to Windsor for GEL 12 million. The goods had originally cost GEL 9 million. During the remaining months of the year Windsor sold GEL 10 million (at cost to Windsor) of these goods to third parties for GEL 13 million.

3 Incomes and expenses accrued evenly throughout the year.

4 Azzy has a policy of valuing non-controlling interests using the full goodwill method. The fair value of non-controlling interest at the date of acquisition was GEL 2,520,000.

5 The recoverable amount of the net assets of Windsor at the reporting date was GEL 14,150,000. Any goodwill impairment should be charged to administrative expenses.

*Required:*

*Prepare a consolidated statement of profit or loss for Azzy group for the year ended 31 March 20X5 (25 marks).*

**Question 3**

An entity, Nio, established a share option scheme for its four directors. This scheme commenced on 1 July 20X2. Each director will be entitled to 25,000 share options on condition that they remain with

Nio for four years, from the date the scheme was introduced. Information regarding the share options is provided below:

Fair value of option at grant date GEL 10

Exercise price of option GEL 5

The fair value of the shares at 30 June 20X3 was GEL 17 per share.

A tax deduction is only given for the share options when they are exercised. The allowable deduction will be based on the intrinsic value of the options. Assume a tax rate of 30%.

*Required:*

*Calculate and explain the amounts to be included in the financial statements of Nio for the year ended 30 June 20X9, including explanation and calculation of any deferred tax implications. (25 marks)*

**Question 4**

On 1 January 20X1, Napa purchased a bond for $1 m which is measured at amortised cost. Interest of 10% is payable in arrears.

Repayment is due on 31 December 20X3. The effective rate of interest is 10%.

On 31 December 20X1, Napa received interest of $100,000. It estimated that the probability of default on the bond within the next 12 months would be 0.5%. If default occurs within the next 12 months then

Napa estimated that no further interest will be received and that only 50% of the capital will be repaid on 31 December 20X3.

The asset’s credit risk at 31 December 20X1 is low.

*Required:*

*Discuss the accounting treatment of the financial asset at 31 December 20X1.*

**Answer 1**

1. Profits

Andros ’s profit decline year-on-year will be concerning to investors. However, the non-financial information presented in the integrated report paints a more optimistic picture of the entity’s future prospects.

Faults

A decline in the number of faults in Andros ’s products will reduce future repair costs, increasing profits. Fewer faults will improve customer satisfaction. This may generate stronger brand loyalty, making it more likely that customers will make repeat purchases.

Helpline

The reduction in helpline waiting times may be due to the reduction in the number of product faults or, potentially, to investment in the customer services department. Whatever the reason, this is likely to have a positive impact on customer perception which may, once again, improve brand loyalty.

Staff turnover

Reduced staff turnover means that staff experience is being retained in the business. This might help to reduce recruitment and training costs in the future. Moreover, experienced staff will probably perform at a higher level than inexperienced staff. In fact, this may partly explain the improvement in fault levels and customer helpline waiting times. Reduced staff turnover could also have other benefits – more experienced staff might develop more innovative products.

Summary and further information

In conclusion, the non-financial information in the Integrated Report provides an important insight into Andros ’s future prospects. Nonetheless, it would be useful to compare these performance measures to other entities in the same sector. Furthermore, some investors may question the reliability of these disclosures unless assurance is provided by an assurance practitioner.

b. Depreciation and amortisation are judgemental, non-cash expenses.

However, excluding them from underlying profit ignores the fact that the entity’s non-current assets will need to be replaced or enhanced in the future.

The impairment of a brand suggests that the business outlook may be weaker than expected. It also indicates that management over-paid for the brand. Adding back this expense when calculating underlying profit diminishes its significance when assessing the past decisions of management and also when predicting Lechko 's future performance. Foreign exchange differences on monetary items can be volatile, and potentially distort an entity’s performance profile. However, many monetary items, such as receivables and payables, are short-term in nature and so represent gains and losses that will be realised in the near future. It would seem that Lechko will be receiving less units of its functional currency (or paying more units) than originally expected when the overseas transactions are settled and so it seems odd to exclude these losses from underlying profit.

Fair value gains on financial assets measured at fair value through profit or loss are volatile and may make it difficult to compare an entity’s performance year-on-year. However, these financial assets are likely to be sold in the short-term and so the gains (or losses) will be realized shortly. They are also unlikely to be one-off items – entities that trade material quantities of financial assets will probably enter into similar transactions on a regular basis.

Overall, it looks like Lechko is trying to disguise a weak performance – particularly as the APM has turned a loss before tax into a profit. This could be misleading, particularly if the APM is presented with prominence. However, to Lechko ’s credit, it discloses the calculation behind the APM, thus allowing users to reconcile it to the figures in the financial statements. This will enable them to draw their own conclusions about the adequacy and usefulness of this APM.

**Answer 2**

Azzy group statement of profit or loss for the year ended 31 March 20X5

Revenue (GEL 60,000 + (9/12 × GEL 24,000) – GEL 12,000) 66,000

Cost of sales

(GEL 42,000 + (9/12 × GEL 20,000) – GEL 12,000 + GEL 600 (W6) +

GEL 500 (W5))

(46,100)

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Gross profit 19,900

Distribution costs (GEL 2,500 + (9/12 × GEL 50)) (2,538)

Administrative expenses

(GEL 3,500 + (9/12 × GEL 150) + GEL 300 (W2)) (3,912)

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Profit from operations 13,450

Investment income (GEL 75 + nil) 75

Finance costs (nil + (9/12 × GEL 200)) (150)

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Profit before tax 13,375

Tax (GEL 3,000 + (9/12 × GEL 600)) (3,450)

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Profit after tax for the year 9,925

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Profit attributable to:

Owners of the parent (bal. fig) 9,655

Non-controlling interest (W7) 270

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9,925

(W1) Group structure – Azzy owns 80% of Windsor

– the acquisition took place three months into the year

– nine months is post-acquisition.

(W2) Goodwill impairment

GEL 000

Net assets of the subsidiary (W3) 13,000

Goodwill (W4) 1,450

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14,450

Recoverable amount (14,150)

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Impairment 300

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The impairment will be allocated against goodwill and charged to the statement of profit or loss.

Goodwill has been calculated using the fair value method so the impairment needs to be factored in when calculating the profit attributable to the NCI (W7).

(W3) Net assets

Acq'n date Rep. date

GEL 000 GEL 000

Equity capital 2,000 2,000

Retained earnings 6,150 8,400

(Rep date = GEL 5,400 bfd + GEL 3,000)

Fair value adjustment – PPE

(GEL 5.2m – GEL 2.0m)

3,200 3,200

Depreciation on FVA (W6) – (600)

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11,350 13,000

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(W4) Goodwill

GEL 000

Consideration 10,280

FV of NCI at acquisition 2,520

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12,800

FV of net assets at acquisition (W3) (11,350)

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Goodwill pre-impairment review (W2) 1,450

(W5) PURP

GEL 2 million (GEL 12m – GEL 10m) of the GEL 12 million intra-group sale remains in inventory.

The profit that remains in inventory is GEL 500,000 ((GEL 12m – GEL 9m) × 2/12).

(W6) Excess depreciation

Per W3, there has been a fair value uplift in respect of PPE of GEL 3,200,000.

This uplift will be depreciated over the four year remaining life.

The depreciation charge in respect of this uplift in the current year statement of profit or loss is GEL 600,000 ((GEL 3,200,000/4 years) × 9/12).

(W7) Profit attributable to the NCI

GEL 000 GEL 000

Profit of Windsor (9/12 × GEL 3,000) 2,250

Excess depreciation (W6) (600)

Goodwill impairment (W2) (300)

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1,350

× 20% –––––

Profit attributable to the NCI 270

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**Answer 3**

The expense recognised for an equity-settled share-based payment scheme is calculated based on the fair value of the options at the grant date. This expense is spread over the vesting period. At each reporting date, the entity should reassess the number of options expected to vest.

The expense for the scheme in the year ended 30 June 20X9 is GEL 250,000 (4 × 25,000 × GEL 10 × 1/4).

For tax purposes, tax relief is allowed based on the intrinsic value of the options at the date they are exercised.

At the reporting date, the shares have a market value of GEL 17 but the options allow the holders to purchase these shares for GEL 5. The options therefore have an intrinsic value of GEL 12 (GEL 17 – GEL 5).

The deferred tax asset is calculated as follows:

GEL GEL

Carrying value of share-based payment Nil

Tax base of the share-based payment

(4 × 25,000 × (GEL 17 – GEL 5) × 1/4)

(300,000)

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× Tax rate 30% (300,000)

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Deferred tax asset 90,000

Where the amount of the estimated future tax deduction exceeds the accumulated remuneration expense, this indicates that the tax deduction relates partly to the remuneration expense and partly to equity. In this case, the estimated future tax deduction is GEL 300,000 whereas the accumulated remuneration expense is GEL 250,000. Therefore, GEL 50,000 of the temporary difference is deemed to relate to an equity item, and the deferred tax relating to this should be credited to equity.

The following entry is required:

Dr Deferred tax asset GEL 90,000

Cr Equity (GEL 50,000 × 30%) GEL 15,000

Cr Profit or loss (GEL 250,000 × 30%) GEL 75,000

If the deferred tax asset is to be recognised, it must be regarded as recoverable.

**Answer 4**

The credit risk on the financial asset has not significantly increased.

Therefore, a loss allowance should be made equal to 12-month expected credit losses. The loss allowance should factor in a range of possible outcomes, as well as the time value of money.

The credit loss on the asset is $586,777 (W1). This represents the present value of the difference between the contractual cash flows and the expected receipts if a default occurs.

The expected credit loss is GEL2,934 (GEL586,777 credit loss × 0.5% probability of occurrence). A loss allowance of GEL2,934 will be created and an impairment loss of GEL2,934 will be charged to profit or loss in the year ended 31 December 20X1.

The net carrying amount of the financial asset on the statement of financial position is GEL997,066 (GEL1,000,000 – GEL2,934).

Note: Interest in future periods will continue to be charged on the asset’s gross carrying amount of GEL1,000,000.

Date Expected cash shortfall Discount rate PV

GEL GEL

31/12/X2 100,000 1/1.1 9 0,909

31/12/X3 100,000 1/1.12 82,645

31/12/X3 500,000 1/1.12 413,223

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586,777