Exam in Financial Reporting and IFRS

**Time allowed: 3 hours**

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

**Open-ended questions**

**Question 1**

Mina Co is considering the acquisition of a subsidiary in the catering industry. Two companies have been identified as potential acquisitions and extracts from the financial statements of Isa Co and Rao Co have been reproduced below:

**Statements of profit or loss for the year ended 30 September 20X3:**

|  |  |  |
| --- | --- | --- |
|  | **Isa Co‘000 GEL**  | **Rao Co‘000 GEL**  |
| Revenue | 21,500 | 16,300 |
| Cost of sales | (14,545) | (8,350) |
| Gross profit | **6,955** | **7,950** |
| Operating expenses | (1,940) | (4,725) |
| Finance costs | (650) | (200) |
| Profit before tax | **4,365** | **3,025** |
| Income tax | (1,320) | (780) |
| Profit for the year | **3,045** | **2,245** |

**Extracts from the statements of financial position as at 30 September 20X3:**

|  |  |  |
| --- | --- | --- |
|  | **Isa Co‘000 GEL**  | **Rao Co‘000 GEL**  |
| **Non-current assets** |  |  |
| Property | 22,250 | 68,500 |
| **Equity** |  |  |
| Equity shares of GEL 1 each | 1,000 | 1,000 |
| Revaluation surplus | - | 30,000 |
| Retained earnings | 18,310 | 2,600 |
| **Non-current liabilities** |  |  |
| Loan notes | 7,300 | 5,200 |

|  |  |
| --- | --- |
| (1) | Both companies are owner-managed. Rao Co operates from expensive city centre premises, selling to local businesses and the public. Isa Co is a large wholesaler, selling to chains of coffee shops. Isa Co operates from a number of low-cost production facilities. |
|  |   |
| (2) | On 1 October 20X2, Rao Co revalued its properties for the first time, resulting in a gain of GEL 30m. The properties had a remaining useful life of 30 years at 1 October 20X2. Rao Co does not make a transfer from the revaluation surplus in respect of excess depreciation. Isa Co uses the cost model to account for its properties. Rao Co and Isa Co charge all depreciation expenses to operating expenses. |
|  |   |
| (3) | Isa Co charges the amortisation of its research and development to cost of sales, whereas Rao Co charges the same costs to operating expenses. These costs amounted to GEL 1.2m for Isa Co and GEL 2.5m for Rao Co. |
|  |   |
| (4) | The notes to the financial statements show that Isa Co paid its directors total salaries of GEL 110,000 whereas Rao Co paid its directors total salaries of GEL 560,000. |
|  |   |
| (5) | The following ratios have been correctly calculated in respect of Isa Co and Rao Co for the year ended 30 September 20X3: |

 **Isa Rao**

Gross profit margin 32.3% 48.8%

Operating margin 23.3% 19.8%

Return on capital employed 18.8% 8.3%

*(a) Adjust the relevant extracts from Rao Co's financial statements to apply the same accounting policies as Isa Co and re-calculate Rao Co's ratios provided in note (5).*

*(7 marks)*

*(b) Based on these adjusted accounting ratios, compare the performance of the two companies. Your answer should comment on the difficulties of making a purchase decision based solely on the extracts of the financial statements and the information provided in notes (1) to (5).*

*(18 marks)*

*(25 marks)*

**Question 2**

On 1 January 20X2, Mina Co acquired 90% of the 16 million GEL 1 equity share capital of Irao Co. Mina Co issued three new shares in exchange for every five shares it acquired in Irao Co. Additionally Mina Co will pay further consideration on 31 December 20X2 of GEL 2.42 per share acquired. Mina Co's cost of capital is 10% per annum and the discount factor at 10% for one year is 0.9091. At the date of acquisition, shares in Mina Co and Irao Co had fair values of GEL 8.00 and GEL 3.50 respectively.

Statement of profit or loss for the year ended 30 September 20X2:

|  |  |  |
| --- | --- | --- |
|  | **Mina Co****GEL '000** | **Irao Co****GEL '000** |
| Revenue | 103,360 | 60,800 |
| Cost of sales | (81,920) | (41,600) |
| Gross profit | **21,440** | **19,200** |
| Distribution costs | (2,560) | (2,980) |
| Administrative expenses | (6,080) | (3,740) |
| Investment income | 800 | - |
| Finance costs | (672) | - |
| Profit before tax | **12,928** | **12,480** |
| Income tax expense | (4,480) | (2,560) |
| Profit for the year | **8,448** | **9,92** |

1. At 1 October 20X1, the retained earnings of Irao Co were GEL 56m.
2. At the date of acquisition, the fair value of Irao Co's assets were equal to their carrying amounts with the exception of two items:

- An item of plant had a fair value of GEL 2.6m above its carrying amount. The remaining life of the plant at the date of acquisition was three years. Depreciation is charged to cost of sales.

- Irao Co had a contingent liability which Mina Co estimated to have a fair value of GEL 850,000. This has not changed as at 30 September 20X2.

Irao Co has not incorporated these fair value changes into its financial statements.

1. Mina Co's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose, Irao Co's share price at that date can be deemed to be representative of the fair value of the shares held by the non-controlling interest.
2. Sales from Mina Co to Irao Co in the post-acquisition period had consistently been GEL 600,000 per month. Mina Co made a mark-up on cost of 25% on these sales. Irao Co had GEL 1.2m of these goods in inventory as at 30 September 20X2.
3. Mina Co's investment income is a dividend received from its investment in a 40% owned associate which it has held for several years. The associate made a profit of GEL 3m for the year ended 30 September 20X2.
4. On 1 October 20X1 Mina Co issued 100,000 GEL 100 6% convertible loan notes at par value, with interest payable annually in arrears over a five-year term. The equivalent rate for non-convertible loan notes was 8%. Mina Co has recorded the loan notes as a liability at par value and charged the annual 6% interest to finance costs.

|  |  |
| --- | --- |
| **Discount factors in year 5:** | **Annuity factors for 5 years:** |
| 6% 0.747 | 6% 4.212 |
| 8% 0.681 | 8% 3.993 |

1. At 30 September 20X2 no impairment to goodwill is required.
2. Profits accrue evenly throughout the year unless otherwise stated.

*(a) Calculate the goodwill arising on the acquisition of Irao Co.*

*(7 marks)*

*(b) Prepare the consolidated statement of profit or loss for Mina Co for the year ended 30 September 20X2.*

*Note: All workings should be done to the nearest GEL '000.*

*(18 marks)*

*(25 marks)*

**Question 3**

1. Wise PLC had two loans in existence in the year it commenced construction of a qualifying asset.

The details of the loans are:

 1 January 2023 31 December 2023

 GEL’million GEL’million

12% bank loan repayable in 2026 500 500

9% bank loan repayable in 2027 750 750

The two loan notes were originally generally obtained but partly applied to the construction of a qualifying asset. Construction works began on 1 April 2023 with expenditure of GEL180 million and GEL70 million drawn down for the construction on 1 April 2023 and 1 November 2013 respectively, from existing loans. Construction works were completed on 31 December 2023.

*Required:*

*Explain and quantify how the borrowing costs on the loans and the qualifying asset ought to be accounted for by Wise PLC for the year ended 31 December 2013 in accordance with IAS 23 ‘Borrowing costs’ (9 marks)*

(b) NOON Ltd is a construction company that prepares its financial statements to 31 March each year. During the year ended 31 March 2023, the company commenced two construction contracts that are expected to take more than one year to complete.

*Required:*

*Describe the issues of revenue and profit recognition relating to construction contracts. (6 marks)*

(c) Wise Ltd acquired an item of plant on 1 July 2023 with the following costs:

 GEL’ million

 List price 240

Trade discount (5% of list price)

Modification cost to enable use 30

Delivery and installation costs 15

1 year warranty cost 2

Wise Ltd qualified for a government grant of 25% of acquisition cost of the plant qualifying for capitalization before the end of the current accounting period. The grant had not been received by 30

 June 2024 though the government had indicated to Wise that the grant would be disbursed two weeks after 30 June 2024.The plant is to be depreciated on straight line basis over three years with a nil estimated residual value. It is Wise’s practice to recognize grant as deferred income.

*Required*

*Explain and quantify how the above transaction should be accounted for when finalizing financial statements of* Wise *for the year ended 30 June 2024. (10 marks)*

 *[Total: 25 marks]*

**Question 4**

The following are the financial statements of Oleo Limited:

Statement of profit or loss for the year ended 31 August 2024.

 GEL’million

 Revenue 148.80

Cost of sales (104.64)

Gross profit 44.16

Distribution costs (17.28)

Administrative expenses (10.56)

Finance cost (1.92)

Profit before tax 14.40

Income tax (4.80)

Profit for the year 9.60

Other comprehensive income:

Revaluation surplus 6.48

**Total comprehensive income 16.08**

**Statements of financial position as at: 31 st. August 2024 31 st. August 2013**

 GEL’million GEL’million

Assets

Non-current

Property, plant & equipment (i) 52.20 36.36

Investments (iii) 15.00 15.00

Development costs (ii) 4.80 6.00

 **72.00 57.36**

**Current**

 Inventory 15.84 18.24

Receivables (i) 14.16 10.56

Bank 0.24 0.24

 **30.24 29.04**

**Total assets**

 **102.24 86.4**

**Equity and liabilities**

**Equity**

Equity shares @ K2.00 each 41.40 30.00

Share premium 1.40 nil

Revaluation reserve 6.48 nil

Retained earnings 21.00 12.60

**Total equity**

 **70.28 42.60**

**Liabilities**

**Non –current**

16% loan note 12.00 8.04

Deferred tax 8.16 12.96

 **20.16 21.00**

**Current**

Trade payables 5.80 18.96

Current tax 6.00 3.84

 **11.80 22.80**

**Total liabilities**

 **31.96 43.80**

**Total equity and liabilities**

 **102.24 86.40**

The following information is relevant:

(i) An item of plant with a carrying value of GEL 2 million was sold for GEL 2.4 million to Beka Enterprises on 31 st July 2024. Beka Enterprises paid 75% of the sales value. The balance is included in receivables’ figure. Depreciation of GEL 13.44 million was charged to cost of sales for property, plant and equipment in the year ended 31 st August 2014.

(ii) This relates to development expenditure that met capitalisation criteria in accordance with IAS 38’ Intangible assets’. During the year to 31 st August 2024, the company incurred and paid for development expenditure amounting to GEL 0.20 million.The amount shown in the statement of financial position is after deducting amortisation for the period to 31 st August 2024. Amortisation was charged to cost of sales.

(iii) This r elates to shares classified as ‘financial assets through profit or loss’. During the year to 31 st August 2024, Oleo limited acquired additional shares for cash consideration of GEL6 million. Further, the company disposed of shares with a carrying value of GEL4 million for GEL 5.8 million cash. There were no other acquisitions and disposals of shares. Any variance on investments’ account is attributable to changes in fair value taken to cost of sales.

(iv) Oleo Limited issued additional equity shares for cash on 1 st July 2024.

(v) The dividends paid on 1 st August 2024 for the year to 3 St August 2024 have been taken into account correctly in the above financial statements.

**Required**

***Prepare a statement of cash flow of Oleo*** ***Limited using the indirect method for the year ending 31***

***St August 2024.***

***Total: 25 marks***

**Answer 1**

**Mina Co**

(a) Adjusted financial statement extracts and ratios for Rao Co

 As per question Adjustment Adjusted

 GEL ’000 GEL ’000 GEL ’000

 **SOPL:**

 Revenue 16,300 16,300

 Cost of sales 8,350 +2,500 10,850

 Gross profit 7,950 5,450

 Operating expenses 4,725 –1,000 1,225

 –2,500

 Profit from operation 3,225 4,225

**SOFP**:

 Property 68,500 –30,000 39,500

 +1,000

 Equity shares 1,000 1,000

 Revaluation surplus 30,000 –30,000 nil

 Retained earnings 2,600 +1,000 3,600

 Loan notes 5,200 5,200

 Isa Co Rao Co Workings Rao Co

 (original) (restated)

 Gross profit margin 32·3% 48·8% 5,450/16,300 x 100 33·4%

 Operating profit margin 23·3% 19·8% 4,225/16,300 x 100 25·9%

 ROCE 18·8% 8·3% 4,225/(4,600 + 5,200) x 100 43·1%

 If Rao Co accounted for properties under the cost model:

 – Depreciation would reduce by GEL 1,000,000 (GEL 30 million/30 years) making operating expenses GEL 3,725,000, and profit from operations GEL 4,225,000.

 – Retained earnings would increase by GEL 1,000,000 to GEL 3,600,000.

 – Revaluation surplus of GEL 30 million would be removed.

 – Property would decrease by GEL 29 million (GEL 30 million less extra depreciation).

 If Rao Co accounted for amortisation in cost of sales:

 – Cost of sales would increase by GEL 2·5 million, making gross profit GEL 5,450,000.

 – Operating expenses would decrease by GEL 2·5 million, but profit from operations would remain at GEL 4,225,000

(b) **Margins**

Isa Co may be a slightly larger company, having made more sales and profits during the year. Initially, it appears that Rao Co makes a significantly higher margin than Isa Co (48·8% compared to 32·3%), which suggests that it is much more profitable to sell as a retailer rather than wholesale.

 However, this is misleading as the higher gross profit margin is larGEL y due to the accounting policy of where amortisation is charged. Once the figures are adjusted to make the two companies comparable, the two gross profit margins are much closer (33·4% and 32·3%).

 Even with this adjustment, Rao Co still makes a higher gross profit margin, suggesting that the relatively high cost properties are still producing a good return.

 Looking at the operating profit margin, it appears that Isa Co makes a significantly higher margin, suggesting a greater cost control (23·3% compared to 19·8%). Once the adjustments for the different accounting policies are taken into account, it can be seen that the margins are much more comparable (23·3% and 25·9%).

 Without further information on the operating expenses, it is difficult to draw too many conclusions about the cost management of the two companies.

 The one thing which can be noted is the higher payment of salaries in Rao Co compared to Isa Co. As both companies are owner managed, it may be that Isa Co’s management are taking a lower level of salaries in order to show increased profits.

Alternatively, it could be that the Rao Co management are taking salaries which are too high, at the expense of the growth of the business. The low level of retained earnings suggests that Rao Co’s owners may not leave much money in the business for growing the company.

ROCE

When looking at the return on capital employed, the initial calculations show that Isa Co is making a much more impressive return from its long-term funding (18·8% compared to 8·3%). This is completely reversed when the revaluation surplus is removed from Rao Co’s figures, as Rao Co makes a return of almost twice that of Isa Co (18·8% and 43·1%). This return is not due to high operating profits, as the margins of the two companies are similar, with Rao Co actually making lower profits from operations. The reason for the high return on capital employed is that Rao Co has a much better asset turnover than Isa Co. This is not because Rao Co is generating more sales, as these are lower than Isa Co. The reason is that Rao Co has a significantly lower equity balance, due to having extremely low retained earnings relative to Isa Co.

Difficulties

Without examining the market value of Isa Co’s properties, it will be difficult to assess which company is likely to cost more to purchase. Basing any investment decision on a single year’s financial statements is difficult, as the impact of different accounting policies is difficult to assess. From the information provided, it is unclear whether Isa Co’s directors are taking an unrealistically low salary, or whether Rao Co’s directors are taking vastly greater salaries than average.

Conclusion: Overall, both companies appear to be profitable and have performed well. Looking at previous years’ financial statements of both entities will enable us to make a much clearer investment decision, as will looking at the notes to the accounts to assess the accounting policies applied by each company

**Answer 2**

(a) Goodwill

 GEL ’000 GEL ’000 GEL ’000

 Consideration:

 Deferred cash (90% x 16,000 x GEL 2·42 x 0·9091) 31,680

 Shares (90% x 16,000 x 3/5 x GEL 8·40) 69,120

 100,800

 Non-controlling interest (NCI) (10% x 16,000 x GEL 3·50) 5,600

 106,400

 Less: FV of net assets at acquisition

 Equity shares 16,000

 Retained earnings:

 At 1 October 20X1 56,000

 1 October 20X1–1 January 20X2 (9,920 x 3/12) 2,480 58,480

 Fair value adjustments:

 Plant 2,600

 Contingent liability (850)

 (76,230)

 Goodwill 30,170

(b) Consolidated statement of profit or loss for the year ended 30 September 20X2

 GEL’000

 Revenue (103,360 + (60,800 x 9/12) – 5,400 (W1)) 143,560

 Cost of sales (81,920 + (41,600 x 9/12) – 5,400 (W1) + 240 (W1) + 650 (W2)) (108,610)

 Gross profit 34,950

 Distribution costs (2,560 + (2,980 x 9/12)) (4,795)

 Administrative expenses (6,080 + (3,740 x 9/12)) (8,885)

 Share of profit from associate (3,000 x 40%) 1,200

 Finance costs (672 + 136 (W3) + 2,376 (W4)) (3,184)

 Profit before tax 19,284

 Income tax expense (4,480 + (2,560 x 9/12)) (6,400)

 Profit for the year 12,886

 Profit attributable to:

 Owners of the parent 12,207

 NCI (W5) 679

 12,886

 Workings

 W1 – Intercompany and PUP

 Post-acquisition sales = ($600 x 9) = $5,400

 PUP = (1,200 x 25/125) = $240

 W2 – FV depreciation on plant = ($2,600/3 x 9/12) = $650

 W3 – Convertible loan – calculate liability component

 GEL’000 DF 8% GEL’000

 Liability:

 Interest (10,000 x 6%) = 600 3·993 2,396

 Principal 10,000 0·681 6,810

 Liability 9,206

 GEL’000

 Interest charge to PL:

 ($9,206 x 8%) = 736

 Interest already charged (600)

 136

 W4 – Deferred cash consideration

 Unwinding of discount on deferred consideration (see goodwill calculation): $31,680 x 10% x 9/12 = $2,376

 W5 – NCI

 GEL’000

Silver’s profit for the year ($9,920 x 9/12) 7,440

 FV Depreciation (W2) (650)

 6,790

 NCI share 10% 679

**Answer 3**

a)IAS 23 Borrowing costs requires that borrowing costs incurred for the acquisition or construction of qualifying asset be capitalized commencing when expenditure and borrowing costs on qualifying asset are being incurred, and activities in progress to prepare the asset for intended use.

In XYZ’s case, where entity used existing borrowing on construction of asset, a weighted average capitalization rate is used to calculate borrowing costs for capitalisation. The balance of the finance costs are to be expensed as shown by the workings below.

Statement of profit or loss extracts

GEL’ million

Finance costs (w1) 112.54

Statement of financial position Extract

Property, plant and equipment (w2&w3) 264.96

WORKINGS

1. Total borrowing costs on the loans:

 GEL’million

 12% x 500,000 60.00

9% x 750,000 67.50

Total 127.50

Amount to be capitalized (w2) (14.96)

Total to be expensed 112.542.

Weighted average rate=[12%x500/500 +750] + [9%x 750/500 +750]= 0.048 + 0.054 = 0.102= 10.2%

Borrowing costs for capitalization: GEL 180m x 10.2 x 9/12 months=GEL 13.77m

GEL70m x 10.2 x 2/12 = GEL1.19m

14.963.

Total cost of PPE Drawn expenditure on PPE (GEL180m +70m) 250.00

Capitalized borrowing costs (w2) 14.96

 264.96

Note: Expenditure of GEL 180million was drawn 3 months into the current accounting period hence borrowing cost prorated for 9 months and that of GEL 70million drawn 10 months into the accounting period hence prorated for 2 months.

1. Since construction contracts can span several accounting periods, if no revenue were recognized until the end of the contract, it would be against the accruals concept which states that incomes earned to be recognized in the same period as associated expense in order to calculate profit for the year Outcome of contract not reasonably certain Revenue recognized should be equal to costs incurred. Thus nil profit is recognized. Outcome reasonably certain Profit is recognized based on percentage of completion while a loss is recognized in full.
2. Outcome of contract not reasonably certain. Revenue recognized should be equal to costs incurred. Thus nil profit is recognized. Outcome reasonably certain

Profit is recognized based on percentage of completion while a loss is recognized in full.

c) IAS 20 Accounting for government grants and disclosure of government assistance requires that a grant be recognized when the following criteria are met; The entity will comply with any conditions attached to the grant

The entity will actually receive the grant. The fact that it qualified for grant is evident of compliance with conditions and the government has disbursed money there by confirming second criterion. The company therefore needs to recognize the grant as deferred income in the statement of financial position and make an equal transfer to profit or loss per annum for three years, the estimated life of granted asset. The figures for the extracts are as follows:

GEL’million

Cost of plant (95% x GEL240m) 228.00

Modification costs 30.00

Delivery and installation 15.00

Total cost for capitalization 273.00

Annual depreciation over three years for the plant will be: GEL273million/3years =GEL91million.

Government grant will be (25% x 273m) = 68.25million

Statement of profit or loss extract

Grant 22.75

Depreciation charge 91.00

Statement of financial position extract

GEL’million

Non-current assets

Plant (273m–91m) 182

Non-current liabilities

Deferred grant income 22.75

Current liabilities

Deferred grant income 22.75

**Answer 4.**

Statement of cash flow for the year ended 31 st August 2024.

 GEL’million GEL’million

Cash flow from operating activities

 Profit before tax 14.40

Adjustments for:

Interest expense 1.92

Depreciation charge 13.44

Decrease in fair value of financial assets W4 2.00

Amortisation 6+0.2–4.8 1.40

Profit on sale of plant 2.4 – 2 (0.40)

Profit on sale of financial assets 5.8 –4 (1.80)

 16.56

 **30.96**

**Changes in working capital**

Decrease in inventory 18.24 –15.84 2.40

Increase in receivables 14.16 –10.56 –0.6(25% x 2.40) (3.00)

Decrease in trade payables 18.96 –5.8 (13.16)

Cash generated from operations 17.20

Interest paid (1.92)

Tax paid W1 (7.44)

Net cash inflow from operating activities 7.84

Cash flow from investing activities

 Proceeds from disposal of plant 75% x 2.4 1.80

Proceeds from the disposal of financial asset 5.80

Cash paid for development expenditure (0.20)

Cash paid to acquire financial assets (6.00)

Cash paid to acquire property, plant and equipment W2 (24.80)

Net cash outflow from investing activities (23.40)

Cash flow from financing activities

 Proceeds from issue of shares 41.4+1.4–30 12.80

Proceeds from loan issue 12–8.04 3.96

Dividends paid W3 (1.20)

Net cash inflow from financing activities 15.56

Increase/decrease in cash and cash equivalents

 Opening cash and cash equivalents 0.24

Closing cash and cash equivalent 0.24

Workings

W1 Taxation

 Opening balance 3.84+12.96 16.80

Statement of profit or loss 4.80

Cash paid (bal.fig) (7.44)

Closing balance 6+8.16 14.16

W2 Property, plant and equipment

 Opening balance 36.36

Revaluation surplus 6.48

 Disposal (2.00)

Depreciation charge (13.44)

Cash acquisition (bal.fig) 24.80 C

closing balance 52.20

W3 Retained earnings

 Opening balance 12.60

Profit for the period 9.60

Dividends paid (bal. fig) (1.20)

Closing balance 21.00