Fundamentals Level – Skills Module

Paper F7

Financial Reporting

March/June 2016 – Sample Questions

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This question paper is divided into two sections:

Section A – ALL 20 questions are compulsory and MUST be attempted

Section B – ALL THREE questions are compulsory and MUST be attempted

Do NOT open this question paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

Do NOT record any of your answers on the question paper.

This question paper must not be removed from the examination hall.

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Section B – ALL THREE questions are compulsory and MUST be attempted

Please write your answers to all parts of these questions on the lined pages within the Candidate Answer Booklet.

1 On 1 October 2015, Zanda Co acquired 60% of Medda Co's equity shares by means of a share exchange of one new share in Zanda Co for every two acquired shares in Medda Co. In addition, Zanda Co will pay a further $0·54 per acquired share on 30 September 2016.

Zanda Co has not recorded any of the purchase consideration and its cost of capital is 8% per annum.

The market value of Zanda Co's shares at 1 October 2015 was $3·00 each.

The summarised statements of financial position of the two companies as at 31 March 2016 are:

	Zanda Co $'000	Medda Co $'000
Assets		
Non-current assets		
Property, plant and equipment (note (i))	25,400	13,500
Financial asset: equity investments (note (iv))	5,500	2,000
	30,900	15,500
Current assets		
Inventory (note (iii))	12,700	5,300
Other current assets	9,700	4,000
	22,400	9,300
Total assets	53,300	24,800
Equity and liabilities		
Equity		
Equity shares of $1 each	20,000	9,000
Retained earnings:		
Brought forward at 1 April 2015	12,200	8,600
Profit/(loss) for the year ended 31 March 2016	5,000	(3,000)
	37,200	14,600
Non-current liabilities		
Deferred tax (note (i))	5,000	nil
Current liabilities	11,100	10,200
Total equity and liabilities	53,300	24,800

The following information is relevant:

(i) At the date of acquisition, Zanda Co conducted a fair value exercise on Medda Co's net assets which were equal to their carrying amounts (including Medda Co's financial asset equity investments) with the exception of an item of plant which had a fair value of $2·5 million **below** its carrying amount. The plant had a remaining useful life of 30 months at 1 October 2015.

The directors of Zanda Co are of the opinion that an unrecorded deferred tax asset of $1·2 million at 1 October 2015, relating to Medda Co's losses, can be relieved in the near future as a result of the acquisition. At 31 March 2016, the directors' opinion has not changed, nor has the value of the deferred tax asset.

(ii) Zanda Co's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose, a share price for Medda Co of $1·50 each is representative of the fair value of the shares held by the non-controlling interest.

(iii) At 31 March 2016, Medda Co held goods in inventory which had been supplied by Zanda Co at a mark-up on cost of 35%. These goods had cost Medda Co $2·43 million.

(iv) The financial asset equity investments of Zanda Co and Medda Co are carried at their fair values at 1 April 2015. At 31 March 2016, these had fair values of \$6·1 million and \$1·8 million respectively, with the change in Medda Co's investments all occurring since the acquisition on 1 October 2015.

(v) There is no impairment to goodwill at 31 March 2016.

Required:

Prepare the following extracts from the consolidated statement of financial position of Zanda Co as at 31 March 2016:

(i) Goodwill;
(ii) Retained earnings;
(iii) Non-controlling interest.

The following mark allocation is provided as guidance for this question:

(i) 6 marks
(ii) 7 marks
(iii) 2 marks

(15 marks)

2 Nonat Co is a manufacturer of domestic appliances. Its chairman is pleased with the results for the year ended 31 December 2015 as they show a continuing improvement over recent past performance. However, the finance director says that a better assessment of the company's performance would be made by a comparison to other companies in the same sector. The finance director has obtained some ratios for Nonat Co's business sector, based on a year end of 31 December 2015, which are:

Return on capital employed (ROCE)	18·5%
Net asset (total assets less current liabilities) turnover	1·8 times
Gross profit margin	21%
Operating profit margin	10·3%
Current ratio	1·6:1
Gearing (debt/equity)	36%

The summarised financial statements of Nonat Co are:

Statement of profit or loss for the year ended 31 December 2015

	$'000
Revenue	62,500
Cost of sales	(51,800)
Gross profit	10,700
Operating costs	(5,800)
Finance costs	(1,800)
Profit before tax	3,100
Income tax expense	(1,000)
Profit for the year	2,100

Statement of financial position as at 31 December 2015

	$'000	$'000
Assets		
Non-current assets		
Property		8,100
Owned plant		12,600
Leased plant		12,200
		32,900
Current assets		16,400
Total assets		49,300
Equity and liabilities		
Equity		
Equity shares of $1 each		9,000
Property revaluation surplus		4,000
Retained earnings		10,600
		23,600
Non-current liabilities		
10% loan notes	10,000	
Finance lease obligations	6,400	16,400
Current liabilities		
Finance lease obligations	2,100	
Other current liabilities	7,200	9,300
Total equity and liabilities		49,300

Required:

(a) Prepare for Nonat Co the equivalent ratios to those of its sector.

Note: The finance lease obligations should be treated as debt in the ROCE and gearing calculations.

(6 marks)

(b) Analyse the financial performance and position of Nonat Co for the year to 31 December 2015 in comparison to the sector averages. (9 marks)

(15 marks)

3 The following trial balance relates to Downing Co as at 31 March 2016:

	$'000	$'000
Equity shares of $1 each		25,000
Other equity		11,800
Retained earnings at 1 April 2015		8,000
5% convertible loan notes (note (iii))		30,000
Land and buildings at cost (land element $14 million) (note (iv))	64,000	
Plant and equipment at cost (note (iv))	82,700	
Patent at cost (ten-year life) (note (iv))	7,500	
Accumulated depreciation/amortisation at 1 April 2015:		
buildings		5,000
plant and equipment		36,700
patent		3,000
Inventory at 31 March 2016	32,100	
Trade receivables	38,500	
Bank		2,700
Current tax (note (v))	1,550	
Deferred tax (note (v))		4,800
Revenue (note (i))		267,900
Cost of sales	166,600	
Distribution costs	20,000	
Administrative expenses	22,000	
Contract asset (note (ii))	5,000	
Loan note interest paid (note (iii))	1,500	
Bank interest	150	
Other operating income from royalties		300
Trade payables		46,400
	441,600	441,600

The following notes are relevant:

(i) Revenue includes an amount of $16 million for a sale made on 1 April 2015. The sale relates to a single product and includes ongoing servicing from Downing Co for four years. The normal selling price of the product and the servicing would be $18 million and $500,000 per annum ($2 million in total) respectively.

(ii) The contract asset is comprised of contract costs incurred at 31 March 2016 of $15 million less a payment of $10 million from the customer. The agreed transaction price for the total contract is $30 million and the total expected costs are $24 million. Downing Co uses an input method based on costs incurred to date relative to the total expected costs to determine the progress towards completion of its contracts.

(iii) Downing Co issued 300,000 $100 5% convertible loan notes on 1 April 2015. The loan notes can be converted to equity shares on the basis of 25 shares for each $100 loan note on 31 March 2018 or redeemed at par for cash on the same date. An equivalent loan note without the conversion rights would have required an interest rate of 8%.

The present value of $1 receivable at the end of each year, based on discount rates of 5% and 8%, are:

	5%	8%
End of year 1	0·95	0·93
2	0·91	0·86
3	0·86	0·79

(iv) Non-current assets:

Due to rising property prices, Downing Co decided to revalue its land and buildings on 1 April 2015 to their market value. The values were confirmed at that date as land $16 million and buildings $52·2 million with the buildings having an estimated remaining life of 18 years at the date of revaluation. Downing Co intends to make a transfer from the revaluation surplus to retained earnings in respect of the annual realisation of the revaluation surplus. Ignore deferred tax on the revaluation.

Plant and equipment is depreciated at 15% per annum using the reducing balance method.

During the current year, the income from royalties relating to the patent had declined considerably and the directors are concerned that the value of the patent may be impaired. A study at the year end concluded that the present value of the future estimated net cash flows from the patent at 31 March 2016 is $3·25 million; however, Downing Co also has a confirmed offer of $3·4 million to sell the patent immediately at that date.

No depreciation/amortisation has yet been charged on any non-current asset for the year ended 31 March 2016. All depreciation/amortisation is charged to cost of sales.

There were no acquisitions or disposals of non-current assets during the year.

(v) The directors estimate a provision for income tax for the year ended 31 March 2016 of $11·4 million is required. The balance on current tax in the trial balance represents the under/over provision of the tax liability for the year ended 31 March 2015. At 31 March 2016, Downing Co had taxable temporary differences of $18·5 million requiring a provision for deferred tax. Any deferred tax movement should be reported in profit or loss. The income tax rate applicable to Downing Co is 20%.

Required:

(a) Prepare the statement of profit or loss and other comprehensive income for Downing Co for the year ended 31 March 2016.

(b) Prepare the statement of changes in equity for Downing Co for the year ended 31 March 2016.

(c) Prepare the statement of financial position of Downing Co as at 31 March 2016.

Notes to the financial statements are not required. Work to the nearest $1,000.

The following mark allocation is provided as guidance for these requirements:

(a) 11 marks
(b) 4 marks
(c) 10 marks

(25 marks)

(d) The finance director of Downing Co has correctly calculated the company's basic and diluted earnings per share (EPS) to be disclosed in the financial statements for the year ended 31 March 2016 at 148·2 cents and 119·4 cents respectively.

On seeing these figures, the chief executive officer (CEO) is concerned that the market will react badly knowing that the company's EPS in the near future will be only 119·4 cents, a fall of over 19% on the current year's basic EPS.

Required:

Explain why and what aspect of Downing Co's capital structure is causing the basic EPS to be diluted and comment on the validity of the CEO's concerns. (5 marks)

(30 marks)

End of Question Paper