Answers

Section B

16 A The correct answer is $18·4m. This is calculated as $10m + $0·5m + $1m + $6·6m less unused materials of $0·5m plus borrowing costs of $0·8m.

17 B

18 C

19 D The impairment loss for the CGU is $2·2m ($11·8m – $9·6m). The impairment loss is initially allocated to the goodwill balance of $1·4m. The unallocated impairment loss is $0·8m. This is allocated to the brand and PPE based on their carrying amounts:

Brand	2
PPE	6
Total	8

2/8 x 0·8 = 0·2 loss to be allocated to brand so new carrying amount = $2m – $0·2m = $1·8m

20 C

21 C

22 A The correct answer is $8·95m. This is the $8·6m plus the $0·4m missing items ($0·6m x 100/150) less the write down of $0·05m ($200,000 – $150,000 – would normally be sold for $300,000 but actually being sold at $150,000).

23 D

24 B

25 D The correct answer is $0·34m. The loan notes should initially be recorded at the net proceeds of $8·5m. The effective interest rate of 8% would then be expensed in relation to this, being $0·68m. As the loan notes were only issued on 1 July 20X8, the expense for the year would be $0·34m ($0·68m x 6/12).

26 D

27 A

28 C The provision should be recorded at the most likely outcome. This will be $5·2m discounted at 10% for one year which is $4·7m.

29 A

30 B

Section C

31 (a) Gain/loss on disposal

(i) **Individual financial statements of Pirlo Co**

	$000
Sales proceeds	300,000
Cost of investment	(210,000)
Gain on disposal	90,000

(ii) **Consolidated financial statements of the Pirlo group**

	$000
Sales proceeds	300,000
Less: goodwill	(70,000)
Less: net assets ($260m + $50m FV)	(310,000)
Add: NCI	66,000
Loss on disposal	(14,000)

(b) Key ratios

	20X9	20X8
Gross profit margin	45·8%	44·9%
	(97,860/213,480) x 100%	(97,310/216,820) x 100%
Operating margin	11·9%	13·5%
	(25,500/213,480) x 100%	(29,170/216,820) x 100%
Interest cover	1·43	1·8
	(25,500/17,800)	(29,170/16,200)

(c) Comment on the performance

The revenue for the group for the year has actually declined in the year. The scenario states that the Samba Co revenue has remained the same in both years, so this decrease appears to represent a *decline from the remaining companies in the group*.

Whilst there has been an overall decline in revenue, the gross profit margin has improved in 20X9 (44·9% increased to 45·8%). Samba Co has a significantly higher gross profit margin (81%) in relation to the rest of the group, *suggesting that the rest of the Pirlo group operates at a lower gross profit margin*.

The operating profit margin of the group has deteriorated in 20X9 (13·5% has decreased to 11·9%). This is initially surprising due to the significant increase in the operating profit margin of Samba Co (41% has increased to 66%). However, the increase in Samba Co's operating profit margin *may not represent a true increase in performance in Samba Co* due to the following:

- Samba Co has recorded a $2m profit on disposal of its properties, which will inflate its profit from operations in 20X9.
- In addition to this, Samba Co has been charged a lower rate of rent by Pirlo Co, which may also have the impact of making the profit from operations in 20X9 higher than the previous period if the rent is lower than the depreciation Samba Co would have recorded.

This concern is further enhanced when the share of the profit of the associate is considered. This has contributed $4·6m to the profit for the year, which is nearly 40% of the overall profit of the group.

The combination of these factors raises concerns over the profitability of Pirlo Co and any other subsidiaries in the group, as it appears to be loss making. *Some of these losses will have been made through the loss of rental income through the new arrangement*.

The joining fee paid to Samba Co's previous directors is a one-off cost paid by Pirlo Co. Consequently, it is included in the consolidated statement of profit or loss for the year ended 31 December 20X9. A similar amount was paid by Samba Co in the form of an annual bonus in the year ended 20X8. Therefore, 20X8 and 20X9 are comparable but the joining fee represents a cost saving for Pirlo Co in future years.

The decline in interest cover appears to be driven by both the decrease in profit from operations and an increase in finance costs. As Samba Co has a large amount of debt, and much lower interest cover than the group, this should increase in future periods.

The disposal of Samba Co appears to be surprising, given that it generates the high margins compared to the rest of the group.

The loss on disposal of Samba Co should be brought into the consolidated statement of profit or loss. This would reduce profit from operations by a further $14m and would reduce the operating profit margin further to 5·4%.

The sale of Samba Co at a loss is very surprising given that it appears to contribute good results and has a history of strong performance.

Whilst selling Samba Co at a loss may be a strange move, Pirlo Co may believe that the real value of the Samba Co business has been secured by employing the two founding directors.

Conclusion

The disposal of Samba Co does not appear to be a good move, as the Pirlo group seem to be losing its most profitable element. The Pirlo Co directors seem to have made a risky decision to move into the software development industry as a competitor of Samba Co.

32 (a) Statement of profit or loss and other comprehensive income

		$000
Revenue	75,350 + 3,407 (w1) + 1,875 (w2)	80,632
Cost of sales		(46,410)
Gross profit		34,222
Operating expenses	20,640 – 125 (w2) – 400 (w3)	(20,115)
Profit from operations		14,107
Finance costs		(4,050)
Investment income	1,520 + 296 (w1) + 302 (w3) + 4,000 (w4)	6,118
Profit before tax		16,175
Tax expense	130 + 3,200 (w5)	(3,330)
Profit for the year		12,845
Other comprehensive income		
Gain on revaluation	12,000 – 3,000 (w4)	9,000
Total comprehensive income		21,845

Workings:

(w1) Sale with significant financing component

As the sale has a significant financing component, the initial revenue should be recorded at present value, with the discount unwound and recorded as finance income.

Therefore, the initial revenue should be $7·407m ($8m/1·08), which is taken to revenue and receivables. As $4m has been already taken, a further $3·407m must be added to revenue and receivables.

The receivable of $7·407m is then increased by 8% over the year to get to the $8m in June 20X9. As Vernon Co has a reporting date of 31 December 20X8, six months' interest should be added.

$7·407m x 8% x 6/12 = $296k, which is added to receivables and finance income.

(w2) Overseas sale

The sale should initially be recorded at the historic rate at the date of the transaction, which is $1·875m (12m Kr/6·4). This should be recorded in revenue and receivables.

At 31 December 20X8, the unsettled receivable must be retranslated at the closing rate.

12m Kr/6 = $2m. Therefore the receivable must be increased by $125k, with the increase going through the profit or loss (although not through revenue).

(w3) Bonds

The professional fees on the bonds must be added to the bond asset, and not expensed, resulting in a $0·4m decrease to operating expenses.

If the bonds are held at amortised cost, the following calculation will take place:

b/f	Int 8%	Payment	c/f
$000	$000	$000	$000
9,400	752	(450)	10,602

Vernon Co should record $752k in investment income. As only $450k has been recorded, a further $302k must be added into investment income.

(w4) Revaluations

The $12m gain on the property used by Vernon Co must be shown in other comprehensive income, net of the $3m deferred tax liability applicable to it.

The $4m gain on investment properties must go through the statement of profit or loss, not other comprehensive income.

(w5) Tax

The tax of $130k in the trial balance will represent an under-provision, as it is a debit balance. The $3·2m tax estimate for the year should be added to this in order to calculate the tax expense for the year.

(b) Earnings per share

12,845,000/41,870,689 (w1) = $0·307, or 30·7c

(w1) Weighted average number of shares

Date	Number	Rights fraction	Period	Weighted average
1 January	30,000,000	3·10/2·9 (w2)	3/12	8,017,241
1 April	35,000,000	3·10/2·9 (w2)	3/12	9,353,448
1 July	49,000,000	–	6/12	24,500,000
				41,870,689

(w2) Theoretical ex-rights price

5	at $3·10	$15·50
2	at $2·40	$4·80
7		$20·30

TERP = $20·30/7 = $2·90

The rights fraction is market value before issue/TERP (3·10/2·9 OF) and should be applied to all periods **up to** the date of the rights issue.

This marking scheme is given as a guide in the context of the suggested answers. Scope is given to markers to award marks for alternative approaches to a question, including relevant comment, and where well-reasoned conclusions are provided. This is particularly the case for written answers where there may be more than one acceptable solution.

Section B			*Marks*
3 cases (5 questions each) 2 marks per question			30
Section C			
31	**(a)**	Disposal	5
	(b)	Ratios	3
	(c)	Revenue/margins	6
		Other and conclusion	6
			12
			20
32	**(a)**	Revenue/cost of sales	3·5
		Operating expenses	3
		Finance cost/investment income	5
		Tax/other comprehensive income	3·5
			15
	(b)	Earnings per share	5
			20

FR Examiner's commentary on March/June 2019 sample questions

This commentary has been written to accompany the published sample FR questions and answers based on observations of the marking team. The aim of this commentary is to provide constructive guidance for future candidates and their tutors by giving insight into what markers are looking for and identifying issues encountered by candidates who sat these questions.

Q31 PIRLO
This question required candidates to complete three tasks. The majority of the marks available were for the calculation of some standard ratios and an analysis of financial statement extracts for a group company following a disposal of a subsidiary holding during the year.

Part (a) required a calculation of a gain/loss on disposal to be included in both the parent's individual financial statements and the group financial statements following the disposal of Samba Co. This is an area which was added to the financial reporting syllabus in recent years and has been tested on several occasions. On the whole, candidates demonstrated a sound knowledge of calculating a disposal gain/loss for a group but often struggled with the relatively straightforward calculation for the parent company gain.

The most common mistake made by candidates was the inclusion of goodwill in the disposal calculation at its closing value. This was disappointing to see as per IFRS 3 *Business Combinations* goodwill should be valued at the date of acquisition and reviewed annually for impairment. Any increases in goodwill are not to be accounted for in the group financial statements.

Part (b) required candidates to calculate three relatively straightforward ratios for a two-year period with many candidates scoring full marks. For those candidates who did not score full marks, this was often due to the question instruction not being followed. Candidates were specifically told not to adjust for the disposal calculation in part (a), yet many still attempted to adjust the profit figures. This resulted in incorrect ratio calculations.

If the same error was made to profit more than once, then candidates were given the benefit of the own figure marking rule provided that the calculation was visible. This continues to be a problem with many candidates continuing not to provide the marking team with supportive workings. Marks cannot be awarded to incorrect calculations if your workings cannot be seen.

Other errors noted by the marking team on the calculation of ratios included some candidates using profit before tax when calculating operating profit margin and the inverse of the fraction was often used for interest cover. It is likely that you will be required to perform some ratio calculations in every financial reporting exam and therefore you must ensure that you are familiar with the formula.

Finally, part (c) asked candidates to comment on the performance and interest cover of the Pirlo group for the comparative two-year period. The requirement specifically asked candidates to consider three specific areas including how the disposal of the subsidiary would impact your current analysis and what implications this may have for the future.

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Those candidates who used the requirements to give their analysis structure generally tended to score well. Some candidates used the requirements as headings in their analysis which was pleasing to see, as this often led to sensible comments being made. However, many candidates overlooked this prompt in the requirement and as a result provided some superficial analysis. This was disappointing to see as previous examiner's commentary has expressed the importance of using the requirement to structure an answer.

The marking team noted that, unfortunately, many candidates continue to provide a weak analysis of the performance of an entity by simply stating that one ratio is bigger or smaller than another. These types of comments are likely to score relatively few marks as there is no actual analysis of the company being provided. Candidates are encouraged to use the scenario to add substance (and therefore marks) to an answer.

For example, at first glance, the Pirlo group appears to be disposing of a company which is performing particularly well when looking at the increase in their operating profit margin. However, the scenario indicated that property was being rented to Samba Co at a reduced rent, which would in part be a reason for Samba's superior profit margins. In addition to this, the profit on disposal of Samba's properties in the year will have artificially inflated the profit from operations this year. In following accounting periods, these one-off gains on disposal would not be included and Samba's individual margins are likely to fall.

The marking team commented on an increase in the number of candidates attempting to provide a conclusion to their analysis which was particularly pleasing to see. This is something that candidates should be encouraged to continue to do.

Q32 VERNON

Part (a) to this question required candidates to prepare a statement of profit or loss and other comprehensive income. Overall, the performance on this part of the question was good with many candidates making a good attempt at dealing with the adjustments in the question. The marking team noted that there were some common errors and weaknesses, however, and these will be discussed below.

Note (i) to the question indicated that Vernon Co had incorrectly accounted for a sale which included a significant financing component. Per IFRS 15 *Revenue from Contacts with Customers*, the revenue should be recognised in full when the five steps are met, which in this case they were. As a result candidates were expected to record the full $8 million but at present value to take into account the time value of money. To do this correctly candidates were required to take the difference between the discounted total revenue and the amount recorded so far to date.

There were several variations noted by the marking team including adjustments which ignored discounting all together, some candidates added on the remaining $4 million to ultimately show a total of $8 million revenue, and some only discounted the $4 million recorded so far and adjusted revenue in various ways. For those candidates who attempted to discount the revenue to present value, only a few then proceeded to unwind the discount for the first 12

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months. Many who did attempt to unwind incorrectly recorded the unwinding within finance costs rather than in finance income.

It was pleasing to see that the initial adjustment to record the goods sold to an overseas customer was well attempted with many candidates completing this adjustment correctly. Some candidates, however, made errors by recording the sale either in the foreign currency, or by translating it at an incorrect exchange rate.

Following on from the initial recording of the sale, many candidates failed to recognise that the receivable is a monetary item and in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*, the receivable should be retranslated at the closing rate with any gain or loss being recognised immediately in profit or loss.

Generally, the investment in bonds was dealt with reasonably well, although a significant number of candidates recorded the adjustment to bonds as if they were financial liabilities rather than financial assets. Many candidates were able to correctly reverse the initial direct cost of acquiring the bonds from administrative expenses but did not then go on to capitalise as part of the bond total at acquisition. Another common error for this adjustment arose when candidates included the full 8% interest in the statement of profit or loss rather than recognising the difference between this amount and the cash received so far to date.

It was pleasing to see that the revaluation, which has been examined many times before, was dealt with well by the majority of candidates with the gain often being recorded correctly within other comprehensive income. In addition to this, compared to previous examination diets, more candidates were able to correctly deal with the deferred tax implication.

The marking team noted, however, that there are still a significant number of candidates who are not able to deal with the deferred tax on a revaluation, with many including it within the profit or loss tax expense. This is an adjustment which has been dealt with many times now within the financial reporting examination and candidates are advised to cover this as part of their revision.

On the whole investment properties were dealt with well, however, a minority of candidates failed to deal with this adjustment at all which was surprising as it is a relatively straightforward adjustment. The gain on investment properties was included in investment income within the model answer but markers were able to award marks if included elsewhere within the statement of profit or loss. Many candidates, however, took the gain and recorded this incorrectly within other comprehensive income which was disappointing to see.

Part (b) to this question required candidates to calculate the earnings per share following a rights issue of shares made during the year. The marking team were pleased to note that there were many, well prepared candidates able to score very well on this part of the question. Some candidates, however, made some basic mistakes by not using profit after tax in their calculation or by time apportioning the shares incorrectly.

Some candidates made more significant errors such as not being able to deal correctly with the weighted average of shares following a rights issue and omitted the rights issue bonus

fraction altogether. Others incorrectly calculated the theoretical ex-rights price by using the nominal value of the share capital rather than the market value and issue price.