National University of Science and Technology

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING

SECOND SEMESTER EXAMINATION: 2014

DATE:	**MAY 2014**
SUBJECT:	**FINANCIAL ACCOUNTING 2B: CAC 2201**
TIME ALLOWED:	**THREE (3) HOURS**
MARKS:	**100**

INSTRUCTION TO THE CANDIDATES

1. Answer **all** questions
2. Begin each Full question on a new page

INFORMATION FOR CANDIDATES

1. All workings should be shown
2. All answers should be presented in good style

Question one [25 Marks]

On 1 April 2013, ABC acquired 75% of the equity share capital of DEF. DEF had been experiencing difficult trading conditions and making significant losses. In allowing for DEF's difficulties, ABC made an immediate cash payment of only $1·50 per share. In addition, ABC will pay a further amount in cash on 30 September 2014 if DEF returns to profitability by that date. The value of this contingent consideration at the date of acquisition was estimated to be $1·8 million, but at 30 September 2013 in the light of continuing losses, its value was estimated at only $1·5 million. The contingent consideration has not been recorded by ABC Overall; the directors of ABC expect the acquisition to be a bargain purchase leading to negative goodwill.

At the date of acquisition shares in DEF had a listed market price of $1·20 each. Below are the summarised draft financial statements of both companies

Statements of profit or loss for the year ended 30 September 2013

	ABC	**DEF**
	$'000	**$'000**
Revenue	110,000	66,000
Cost of sales	(88,000)	(67,200)
Gross profit (loss)	22,000	(1,200)
Distribution costs	(3,000)	(2,000)
Administrative expenses	(5,250)	(2,400)
Finance costs	(250)	nil
Profit (loss) before tax	13,500	(5,600)
Income tax (expense)/relief	(3,500)	1,000
Profit (loss) for the year	10,000	(4,600)

Statements of financial position as at 30 September 2013

Assets		
Non-current assets		
Property, plant and equipment	41,000	21,000
Financial asset: equity investments (note (iii))	16,000	nil
	57,000	21,000
Current assets	16,500	4,800
Total assets	73,500	25,800

Equity and liabilities		
Equity		
Equity shares of 50 cents each	30,000	6,000
Retained earnings	28,500	12,000
	58,500	18,000
Current liabilities	15,000	7,800
Total equity and liabilities	73,500	25,800

The following information is relevant:

(i) At the date of acquisition, the fair values of DEF's assets were equal to their carrying amounts with the exception of a leased property. This had a fair value of $2 million above its carrying amount and a remaining lease term of 10 years at that date. All depreciation is included in cost of sales.

(ii) ABC transferred raw materials at their cost of $4 million to DEF in June 2013. DEF processed all of these materials incurring additional direct costs of $1·4 million and sold them back to ABC in August 2013 for $9 million. At 30 September 2013 ABC had $1·5 million of these goods still in inventory. There were no other intra-group sales.

(iii) ABC has recorded its investment in DEF at the cost of the immediate cash payment; other equity investments are carried at fair value through profit or loss as at 1 October 2012. The other equity investments have fallen in value by $200,000 during the year ended 30 September 2013

(iv) ABC's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose, DEF'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.

(v) All items in the above statements of profit or loss are deemed to accrue evenly over the year unless otherwise indicated.

Required:

(a) Prepare the consolidated statement of profit or loss for ABC for the year ended 30 September 2013. **[12]**

(b)Prepare the consolidated statement of financial position for ABC as at 30 September 2013. **[13]**

<u>Question two [25 Marks]</u>

Transaction one

Bertrand issued $10 million convertible loan notes on 1 October 2013 that carry a nominal interest (coupon) rate of 5% per annum. They are redeemable on 30 September 2016 at par for cash or can be exchanged for equity shares in Bertrand on the basis of 20 shares for each $100 of loan. A similar loan note, without the conversion option, would have required Bertrand to pay an interest rate of 8%.

When preparing the draft financial statements for the year ended 30 September 2014, the directors are proposing to show the loan note within equity in the statement of financial position, as they believe all the loan note holders will choose the equity option when the loan note is due for redemption. They further intend to charge a finance cost of $500,000 ($10 million x 5%) in the income statement for each year up to the date of redemption.

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

Required:

(**a**) (i) Explain why the nominal interest rate on the convertible loan notes is 5%, but for non-convertible loan notes it would be 8%. [**2]**

(ii) Briefly comment on the impact of the directors' proposed treatment of the loan notes on the financial statements and the acceptability of this treatment. **[3]**

(b) Prepare extracts to show how the loan notes and the finance charge should be treated by Bertrand in its financial statements for the year ended 30 September 2014. [**5]**

Transaction two

Bertrand issued 5 million 6% redeemable $1 preference shares 2018 at their nominal value on 1 January 2012. The issue costs associated with the share issue is $200,000**.**

Required*:*

(a) In accordance with IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement:*

(i) Explain how this instrument should be classified and prepare the journal for the year ended 31 December 2012; and

(ii) Explain how the preference dividend should be treated in the financial statements of

Bertrand. **[7]**

Transaction three

Bertrand made an investment in a financial instrument on 1 January 2012 at its nominal value of $2,000,000. The instrument carries a fixed coupon interest rate of 7%, which is receivable annually in arrears. The instrument will be redeemed for $2,265,000 on 31 December 2015. Transaction costs of $100,000 were paid on acquisition. Bertrand intends to hold this investment until its redemption date.

Required:

(i) Explain how this investment should be classified; and

(ii) Prepare journal entries for the four years up to 31 December 2015 **[8]**

<u>Question three [25 Marks]</u>

BN acquired 75% of the 1 million issued $1 ordinary shares of AB on 1 January 2012 for $1,850,000 when AB's retained earnings were $885,000.

The carrying value of AB's net assets was considered to be the same as their fair value at the date of acquisition with the exception of AB's property, plant and equipment. The book value of these assets was $945,000 and their market value was $1,100,000. The property, plant and equipment of AB had an estimated useful life of 5 years from the date of acquisition. BN depreciates all assets on a straight line basis.

AB sold goods to BN with a sales value of $400,000 during the year ended 31 December 2013. All of these goods remain in BN's inventories at the year end. AB makes a 20% gross profit margin on all sales.

The retained earnings reported in the financial statements of BN and AB as at 31 December 2013 are $4,200,000 and $1,300,000 respectively.

The group policy is to measure non-controlling interest at fair value at the acquisition date. The fair value of the non-controlling interest was $570,000 on 1 January 2012.

An impairment review performed on 31 December 2013 indicated that goodwill on the acquisition of AB had been impaired by 20%. No impairment was recognised in the year ended 31 December 2012.

Required:

Calculate the amounts that will appear in the consolidated statement of financial position of the BN group as at 31 December 2013 for:

(i) Goodwill;

(ii*)* Consolidated retained earnings; and

(iii) Non-controlling interest. **[10]**

(b)Define the term control in accordance with IFRS 10: *Consolidated Financial Statements* and state instances when control can be achieved. **[7]**

(c)Outline the audit procedures that need to carried out when you determine that you have a gain from a bargain purchase **[8]**

Question four [25 Marks]

On 1 October 2012, Leopard Ltd acquired 75% of Tiger's equity shares by means of a share exchange of two new shares in Leopard for every five acquired shares in Tiger. In addition, Leopard issued to the shareholders of Tiger a $100 10% loan note for every 1,000 shares it acquired in Tiger. Leopard has not recorded any of the purchase consideration, although it does have other 10% loan notes already in issue.

The market value of Leopard's shares at 1 October 2012 was $2 each

The summarrised Statement of Financial Position of the two companies at 31 March 2013 were as follows:

	Leopard	**Tiger**
	$'000	**$'000**
Assets		
Non-current assets		
Property, plant and equipment	47,400	25,500
Financial asset: equity investment notes (i) and (iv)	7500	3,200
Current assets		
Inventory (note ii)	20,400	8,400
Trade receivables (note iii)	14,800	9,000
Bank	2,100	nil
Total assets	92,200	46,100

Equity and liabilities		
Equity		
Equity shares of $1 each	40,000	8,400
Retained earnings/ (losses) 1 April 2012	19,200	(4000)
For year ended 31 March 2013	7,400	8,000
Non- current liabilities		
10% loan notes	8,000	nil
Current liabilities		
Trade payables note iii	17,600	13,000
Bank overdraft	nil	9,100
Total equity and liabilities	92,200	46,100

The following information is relevant:

(i) At the date of acquisition, Tiger's produced a draft statement of profit or loss which showed it had made a net loss after tax of $2 million at that date. Leopard accepted this figure as the basis for calculating the pre- and post-acquisition split of Tiger's profit for the year ended 31 March 2013.

Also at the date of acquisition, Leopard conducted a fair value exercise on Tiger's net assets which were equal to their carrying amounts (including Tiger's financial asset equity investments) with the exception of an item of plant which had a fair value of $3 million below its carrying amount. The plant had a remaining economic life of three years at 1 October 2012.

Leopard's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose, a share price for Tiger of $1·20 each is representative of the fair value of the shares held by the non-controlling interest.

(ii) Each month since acquisition, Leopard's sales to Tiger were consistently $4·6 million. Leopard had marked these up by 15% on cost. Tiger had one month's supply ($4·6 million) of these goods in inventory at 31 March 2013. Leopard's normal mark-up (to third party customers) is 40%.

(iii) Tiger's current account balance with Leopard at 31 March 2013 was $2·8 million, which did not agree with Leopard's equivalent receivable due to a payment of $900,000 made by Tiger on 28 March 2013, which was not received by Leopard until 3 April 2013.

(iv) The financial asset equity investments of Leopard and Tiger are carried at their fair values as at 1 April 2012. As at 31 March 2013, these had fair values of $7·1 million and $3·9 million respectively.

(v) There was no impairment losses within the group during the year ended 31 March 2013.

Required

Prepare the consolidated Statement of Financial Position as at 31 March 2013 **[20]**

(b) Discuss how an asset can be recognised in the annual financial statements. **[5]**

End of examination paper