Fundamentals Pilot Paper – Skills module

Financial Reporting (International)

Paper F7 (INT)

Time allowed

Reading and planning:	15 minutes
Writing:	3 hours

ALL FIVE questions are compulsory and MUST be attempted.

Do NOT open this 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.

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

The Association of Chartered Certified Accountants

ALL FIVE questions are compulsory and MUST be attempted

1 On 1 October 2005 Pumice acquired the following non-current investments:

- 80% of the equity share capital of Silverton at a cost of $13.6 million
- 50% of Silverton's 10% loan notes at par
- 1.6 million equity shares in Amok at a cost of $6.25 each.

The summarised draft balance sheets of the three companies at 31 March 2006 are:

	Pumice $'000	Silverton $'000	Amok $'000
Non-current assets			
Property, plant and equipment	20,000	8,500	16,500
Investments	26,000	nil	1,500
	46,000	8,500	18,000
Current assets	15,000	8,000	11,000
Total assets	61,000	16,500	29,000
Equity and liabilities			
Equity			
Equity shares of $1 each	10,000	3,000	4,000
Retained earnings	37,000	8,000	20,000
	47,000	11,000	24,000
Non-current liabilities			
8% loan note	4,000	nil	nil
10% loan note	nil	2,000	nil
Current liabilities	10,000	3,500	5,000
Total equity and liabilities	61,000	16,500	29,000

The following information is relevant:

(i) The fair values of Silverton's assets were equal to their carrying amounts with the exception of land and plant. Silverton's land had a fair value of $400,000 in excess of its carrying amount and plant had a fair value of $1.6 million in excess of its carrying amount. The plant had a remaining life of four years (straight-line depreciation) at the date of acquisition.

(ii) In the post acquisition period Pumice sold goods to Silverton at a price of $6 million. These goods had cost Pumice $4 million. Half of these goods were still in the inventory of Silverton at 31 March 2006. Silverton had a balance of $1.5 million owing to Pumice at 31 March 2006 which agreed with Pumice's records.

(iii) The net profit after tax for the year ended 31 March 2006 was $2 million for Silverton and $8 million for Amok. Assume profits accrued evenly throughout the year.

(iv) An impairment test at 31 March 2006 concluded that consolidated goodwill was impaired by $400,000 and the investment in Amok was impaired by $200,000.

(v) No dividends were paid during the year by any of the companies.

Required:

(a) Discuss how the investments purchased by Pumice on 1 October 2005 should be treated in its consolidated financial statements. (5 marks)

(b) Prepare the consolidated balance sheet for Pumice as at 31 March 2006. (20 marks)

(25 marks)

2 The following trial balance relates to Kala, a publicly listed company, at 31 March 2006:

	$'000	$'000
Land and buildings at cost (note (i))	270,000	
Plant – at cost (note (i))	156,000	
Investment properties – valuation at 1 April 2005 (note (i))	90,000	
Purchases	78,200	
Operating expenses	15,500	
Loan interest paid	2,000	
Rental of leased plant (note (ii))	22,000	
Dividends paid	15,000	
Inventory at 1 April 2005	37,800	
Trade receivables	53,200	
Revenue		278,400
Income from investment property		4,500
Equity shares of $1 each fully paid		150,000
Retained earnings at 1 April 2005		119,500
8% (actual and effective) loan note (note (iii))		50,000
Accumulated depreciation at 1 April 2005 – buildings		60,000
– plant		26,000
Trade payables		33,400
Deferred tax		12,500
Bank		5,400
	739,700	739,700

The following notes are relevant:

(i) The land and buildings were purchased on 1 April 1990. The cost of the land was $70 million. No land and buildings have been purchased by Kala since that date. On 1 April 2005 Kala had its land and buildings professionally valued at $80 million and $175 million respectively. The directors wish to incorporate these values into the financial statements. The estimated life of the buildings was originally 50 years and the remaining life has not changed as a result of the valuation.

Later, the valuers informed Kala that investment properties of the type Kala owned had increased in value by 7% in the year to 31 March 2006.

Plant, other than leased plant (see below), is depreciated at 15% per annum using the reducing balance method. Depreciation of buildings and plant is charged to cost of sales.

(ii) On 1 April 2005 Kala entered into a lease for an item of plant which had an estimated life of five years. The lease period is also five years with annual rentals of $22 million payable in advance from 1 April 2005. The plant is expected to have a nil residual value at the end of its life. If purchased this plant would have a cost of $92 million and be depreciated on a straight-line basis. The lessor includes a finance cost of 10% per annum when calculating annual rentals. (Note: you are not required to calculate the present value of the minimum lease payments.)

(iii) The loan note was issued on 1 July 2005 with interest payable six monthly in arrears.

(iv) The provision for income tax for the year to 31 March 2006 has been estimated at $28.3 million. The deferred tax provision at 31 March 2006 is to be adjusted to a credit balance of $14.1 million.

(v) The inventory at 31 March 2006 was valued at $43.2 million.

Required, prepare for Kala:

(a) An income statement for the year ended 31 March 2006. (10 marks)

(b) A statement of changes in equity for the year ended 31 March 2006. (4 marks)

(c) A balance sheet as at 31 March 2006. (11 marks)

(25 marks)

3 Reactive is a publicly listed company that assembles domestic electrical goods which it then sells to both wholesale and retail customers. Reactive's management were disappointed in the company's results for the year ended 31 March 2005. In an attempt to improve performance the following measures were taken early in the year ended 31 March 2006:

– a national advertising campaign was undertaken,
– rebates to all wholesale customers purchasing goods above set quantity levels were introduced,
– the assembly of certain lines ceased and was replaced by bought in completed products. This allowed Reactive to dispose of surplus plant.

Reactive's summarised financial statements for the year ended 31 March 2006 are set out below:

Income statement	$million
Revenue (25% cash sales)	4,000
Cost of sales	(3,450)
Gross profit	550
Operating expenses	(370)
	180
Profit on disposal of plant (note (i))	40
Finance charges	(20)
Profit before tax	200
Income tax expense	(50)
Profit for the period	150

Balance sheet	$million	$million
Non-current assets		
Property, plant and equipment (note (i))		550
Current assets		
Inventory	250	
Trade receivables	360	
Bank	nil	610
Total assets		1,160
Equity and liabilities		
Equity shares of 25 cents each		100
Retained earnings		380
		480
Non-current liabilities		
8% loan notes		200
Current liabilities		
Bank overdraft	10	
Trade payables	430	
Current tax payable	40	480
Total equity and liabilities		1,160

Below are ratios calculated for the year ended 31 March 2005.

Return on year end capital employed (profit before interest and tax over total assets less current liabilities)	28.1%
Net asset (equal to capital employed) turnover	4 times
Gross profit margin	17%
Net profit (before tax) margin	6.3%
Current ratio	1.6:1
Closing inventory holding period	46 days
Trade receivables' collection period	45 days
Trade payables' payment period	55 days
Dividend yield	3.75%
Dividend cover	2 times

Notes:

(i) Reactive received $120 million from the sale of plant that had a carrying amount of $80 million at the date of its sale.

(ii) the market price of Reactive's shares throughout the year averaged $3.75 each.

(iii) there were no issues or redemption of shares or loans during the year.

(iv) dividends paid during the year ended 31 March 2006 amounted to $90 million, maintaining the same dividend paid in the year ended 31 March 2005.

Required:

(a) Calculate ratios for the year ended 31 March 2006 (showing your workings) for Reactive, equivalent to those provided above. (10 marks)

(b) Analyse the financial performance and position of Reactive for the year ended 31 March 2006 compared to the previous year. (10 marks)

(c) Explain in what ways your approach to performance appraisal would differ if you were asked to assess the performance of a not-for-profit organisation. (5 marks)

(25 marks)

4 **(a)** The qualitative characteristics of relevance, reliability and comparability identified in the IASB's *Framework for the preparation and presentation of financial statements* (Framework) are some of the attributes that make financial information useful to the various users of financial statements.

Required:

Explain what is meant by relevance, reliability and comparability and how they make financial information useful. (9 marks)

(b) During the year ended 31 March 2006, Porto experienced the following transactions or events:

(i) entered into a finance lease to rent an asset for substantially the whole of its useful economic life.

(ii) a decision was made by the Board to change the company's accounting policy from one of expensing the finance costs on building new retail outlets to one of capitalising such costs.

(iii) the company's income statement prepared using historical costs showed a loss from operating its hotels, but the company is aware that the increase in the value of its properties during the period far outweighed the operating loss.

Required:

Explain how you would treat the items in (i) to (iii) above in Porto's financial statements and indicate on which of the Framework's qualitative characteristics your treatment is based. (6 marks)

(15 marks)

5 IAS 11 *Construction contracts* deals with accounting requirements for construction contracts whose durations usually span at least two accounting periods.

Required:

(a) Describe the issues of revenue and profit recognition relating to construction contracts. (4 marks)

(b) Beetie is a construction company that prepares its financial statements to 31 March each year. During the year ended 31 March 2006 the company commenced two construction contracts that are expected to take more than one year to complete. The position of each contract at 31 March 2006 is as follows:

Contract	1	2
	$'000	$'000
Agreed contract price	5,500	1,200
Estimated total cost of contract at commencement	4,000	900
Estimated total cost at 31 March 2006	4,000	1,250
Agreed value of work completed at 31 March 2006	3,300	840
Progress billings invoiced and received at 31 March 2006	3,000	880
Contract costs incurred to 31 March 2006	3,900	720

The agreed value of the work completed at 31 March 2006 is considered to be equal to the revenue earned in the year ended 31 March 2006. The percentage of completion is calculated as the agreed value of work completed to the agreed contract price.

Required:

Calculate the amounts which should appear in the income statement and balance sheet of Beetie at 31 March 2006 in respect of the above contracts. (6 marks)

(10 marks)

End of Question Paper

Answers

1 (a) As the investment in shares represents 80% of Silverton's equity, it is likely to give Pumice control of that company. Control is the ability to direct the operating and financial policies of an entity. This would make Silverton a subsidiary of Pumice and require Pumice to prepare group financial statements which would require the consolidation of the results of Silverton from the date of acquisition (1 October 2005). Consolidated financial statements are prepared on the basis that the group is a single economic entity.

The investment of 50% ($1 million) of the 10% loan note in Silverton is effectively a loan from a parent to a subsidiary. On consolidation Pumice's asset of the loan ($1 million) is cancelled out with $1 million of Silverton's total loan note liability of $2 million. This would leave a net liability of $1 million in the consolidated balance sheet.

The investment in Amok of 1.6 million shares represents 40% of that company's equity shares. This is generally regarded as not being sufficient to give Pumice control of Amok, but is likely to give it significant influence over Amok's policy decisions (eg determining the level of dividends paid by Amok). Such investments are generally classified as associates and IAS 28 *Investments in associates* requires the investment to be included in the consolidated financial statements using equity accounting.

(b) Consolidated balance sheet of Pumice at 31 March 2006

		$'000
Non-current assets:		
Plant, property and equipment (w (i))		30,300
Goodwill (4,000 (w (ii)) – 400 impairment)		3,600
Investments – associate (w (iii))		11,400
– other ((26,000 – 13,600 – 10,000 – 1,000 intra-group loan note))		1,400
		46,700
Current assets (15,000 + 8,000 – 1,000 (w (iv)) – 1,500 current account)		20,500
Total assets		67,200
Equity and liabilities		
Equity attributable to equity holders of the parent		
Equity shares of $1 each		10,000
Reserves:		
Retained earnings (w (v))		37,640
		47,640
Minority interest (w (vi))		2,560
Total equity		50,200
Non-current liabilities		
8% Loan note	4,000	
10% Loan note (2,000 – 1,000 intra-group)	1,000	5,000
Current liabilities (10,000 + 3,500 – 1,500 current account)		12,000
		67,200

Workings in $'000

(i) Property, plant and equipment

Pumice		20,000
Silverton		8,500
Fair value – land	400	
– plant	1,600	2,000
Additional depreciation (see below)		(200)
		30,300

The fair value adjustment to plant will create additional depreciation of $400,000 per annum (1,600/4 years) and in the post acquisition period of six months this will be $200,000.

(ii) Goodwill in Silverton:

Investment at cost		13,600
Less – equity shares of Silverton (3,000 x 80%)	(2,400)	
– pre-acquisition reserves (7,000 x 80% (see below))	(5,600)	
– fair value adjustments (2,000 (w (i)) x 80%)	(1,600)	(9,600)
Goodwill on consolidation		4,000

The pre-acquisition reserves are:

At 31 March 2006	8,000
Post acquisition (2,000 x 6/12)	(1,000)
	7,000

(iii) Carrying amount of Amok at 31 March 2006

Cost (1,600 x $6.25)	10,000
Share post acquisition profit (8,000 x 6/12 x 40%)	1,600
	11,600
Impairment loss per question	(200)
	11,400

(iv) The unrealised profit (URP) in inventory is calculated as:
Intra-group sales are $6 million of which Pumice made a profit of $2 million. Half of these are still in inventory, thus there is an unrealised profit of $1 million.

(v) Consolidated reserves:

Pumice's reserves	37,000
Silverton's post acquisition (((2,000 x 6/12) - 200 depreciation) x 80%)	640
Amok's post acquisition profits (8,000 x 6/12 x 40%)	1,600
URP in inventory (see (iv))	(1,000)
Impairment of goodwill – Silverton	(400)
– Amok	(200)
	37,640

(vi) Minority interest

Equity shares of Silverton (3,000 x 20%)	600
Retained earnings ((8,000 – 200 depreciation) x 20%)	1,560
Fair value adjustments (2,000 x 20%)	400
	2,560

2 (a) Kala – Income statement – Year ended 31 March 2006

	$'000	$'000
Revenue		278,400
Cost of sales (w (i))		(115,700)
Gross profit		162,700
Operating expenses		(15,500)
		147,200
Investment income – property rental	4,500	
– valuation gain (90,000 x 7%)	6,300	10,800
Finance costs – loan (w (ii))	(3,000)	
– lease (w (iii))	(7,000)	(10,000)
Profit before tax		148,000
Income tax expense (28,300 + (14,100 – 12,500))		(29,900)
Profit for the period		118,100

(b) Kala – Statement of changes in equity – Year ended 31 March 2006

	Equity shares $'000	Revaluation reservr $'000	Retained earnings $'000	Total $'000
At 1 April 2005	150,000	nil	119,500	269,500
Profit for period (see (a))			118,100	118,100
Revaluation of property (w (iv))		45,000		45,000
Equity dividends paid			(15,000)	(15,000)
At 31 March 2006	150,000	45,000	222,600	417,600

(c) Kala – Balance sheet as at 31 March 2006

Non-current assets	**$'000**	**$'000**
Property, plant and equipment (w (iv))		434,100
Investment property (90,000 + 6,300)		96,300
		530,400
Current assets		
Inventory	43,200	
Trade receivables	53,200	96,400
Total assets		626,800
Equity and liabilities		
Equity (see (b) above)		
Equity shares of $1 each		150,000
Reserves:		
Revaluation	45,000	
Retained earnings	222,600	267,600
		417,600
Non-current liabilities		
8% loan note	50,000	
Deferred tax	14,100	
Lease obligation (w (iii))	55,000	119,100
Current liabilities		
Trade payables	33,400	
Accrued loan interest (w (ii))	1,000	
Bank overdraft	5,400	
Lease obligation (w (iii)) – accrued interest	7,000	
– capital	15,000	
Current tax payable	28,300	90,100
Total equity and liabilities		626,800

Workings in brackets in $'000

(i) Cost of sales:

Opening inventory	37,800
Purchases	78,200
Depreciation (w (iv)) – buildings	5,000
– plant: owned	19,500
leased	18,400
Closing inventory	(43,200)
	115,700

(ii) The loan has been in issue for nine months. The total finance cost for this period will be $3 million (50,000 x 8% x 9/12). Kala has paid six months interest of $2 million, thus accrued interest of $1 million should be provided for.

(iii) Finance lease:

	$'000
Net obligation at inception of lease (92,000 – 22,000)	70,000
Accrued interest 10% (current liability)	7,000
Total outstanding at 31 March 2006	77,000

The second payment in the year to 31 March 2007 (made on 1 April 2006) of $22 million will be $7 million for the accrued interest (at 31 March 2006) and $15 million paid of the capital outstanding. Thus the amount outstanding as an obligation over one year is $55 million (77,000 – 22,000).

(iv) Non-current assets/depreciation:

Land and buildings:

At the date of the revaluation the land and buildings have a carrying amount of $210 million (270,000 – 60,000). With a valuation of $255 million this gives a revaluation surplus (to reserves) of $45 million. The accumulated depreciation of $60 million represents 15 years at $4 million per annum (200,000/50 years) and means the remaining life at the date of the revaluation is 35 years. The amount of the revalued building is $175 million, thus depreciation for the year to 31 March 2006 will be $5 million (175,000/35 years). The carrying amount of the land and buildings at 31 March 2006 is $250 million (255,000 – 5,000).

Plant: owned

The carrying amount prior to the current year's depreciation is $130 million (156,000 – 26,000). Depreciation at 15% on the reducing balance basis gives an annual charge of $19.5 million. This gives a carrying amount at 31 March 2006 of $110.5 million (130,000 – 19,500).

Plant: leased
The fair value of the leased plant is $92 million. Depreciation on a straight-line basis over five years would give a depreciation charge of $18.4 million and a carrying amount of $73.6 million.

Summarising the carrying amounts:

Land and buildings	250,000
Plant (110,500 + 73,600)	184,100
Property, plant and equipment	434,100

3 **(a)** Note: figures in the calculations are in $million

Return on year end capital employed	32.3 %	220/(1,160 – 480) x 100
Net asset turnover	5.9 times	4,000/680
Gross profit margin	13.8 %	(550/4,000) x 100
Net profit (before tax) margin	5.0 %	(200/4,000) x 100
Current ratio	1.3 :1	610:480
Closing inventory holding period	26 days	250/3,450 x 365
Trade receivables' collection period	44 days	360/(4,000 – 1,000) x 365
Trade payables' payment period (based on cost of sales)	45 days	(430/3,450) x 365
Dividend yield	6.0%	(see below)
Dividend cover	1.67 times	150/90

The dividend per share is 22.5 cents (90,000/(100,000 x 4 ie 25 cents shares). This is a yield of 6.0% on a share price of $3.75.

(b) Analysis of the comparative financial performance and position of Reactive for the year ended 31 March 2006

Profitability
The measures taken by management appear to have been successful as the overall ROCE (considered as a primary measure of performance) has improved by 15% (32.3 -28.1)/28.1). Looking in more detail at the composition of the ROCE, the reason for the improved profitability is due to increased efficiency in the use of the company's assets (asset turnover), increasing from 4 to 5.9 times (an improvement of 48%). The improvement in the asset turnover has been offset by lower profit margins at both the gross and net level. On the surface, this performance appears to be due both to the company's strategy of offering rebates to wholesale customers if they achieve a set level of orders and also the beneficial impact on sales revenue of the advertising campaign. The rebate would explain the lower gross profit margin, and the cost of the advertising has reduced the net profit margin (presumably management expected an increase in sales volume as a compensating factor). The decision to buy complete products rather than assemble them in house has enabled the disposal of some plant which has reduced the asset base. Thus possible increased sales and a lower asset base are the cause of the improvement in the asset turnover which in turn, as stated above, is responsible for the improvement in the ROCE.

The effect of the disposal needs careful consideration. The profit (before tax) includes a profit of $40 million from the disposal. As this is a 'one-off' profit, recalculating the ROCE without its inclusion gives a figure of only 23.7% (180m/(1,160 - 480m + 80m (the 80m is the carrying amount of plant)) and the fall in the net profit percentage (before tax) would be down even more to only 4.0% (160m/4,000m). On this basis the current year performance is worse than that of the previous year and the reported figures tend to flatter the company's underlying performance.

Liquidity
The company's liquidity position has deteriorated during the period. An acceptable current ratio of 1.6 has fallen to a worrying 1.3 (1.5 is usually considered as a safe minimum). With the trade receivables period at virtually a constant (45/44 days), the change in liquidity appears to be due to the levels of inventory and trade payables. These give a contradictory picture. The closing inventory holding period has decreased markedly (from 46 to 26 days) indicating more efficient inventory holding. This is perhaps due to short lead times when ordering bought in products. The change in this ratio has reduced the current ratio, however the trade payables payment period has decreased from 55 to 45 days which has increased the current ratio. This may be due to different terms offered by suppliers of bought in products.

Importantly, the effect of the plant disposal has generated a cash inflow of $120 million, and without this the company's liquidity would look far worse.

Investment ratios
The current year's dividend yield of 6.0% looks impressive when compared with that of the previous year's yield of 3.75%, but as the company has maintained the same dividend (and dividend per share as there is no change in share capital) , the 'improvement' in the yield is due to a falling share price. Last year the share price must have been $6.00 to give a yield of 3.75% on a dividend per share of 22.5 cents. It is worth noting that maintaining the dividend at $90 million from profits of $150 million gives a cover of only 1.67 times whereas on the same dividend last year the cover was 2 times (meaning last year's profit (after tax) was $180 million).

Conclusion
Although superficially the company's profitability seems to have improved as a result of the directors' actions at the start of the current year, much, if not all, of the apparent improvement is due to the change in supply policy and the consequent beneficial effects of the disposal of plant. The company's liquidity is now below acceptable levels and would have been even worse had the disposal not occurred. It appears that investors have understood the underlying deterioration in performance as there has been a marked fall in the company's share price.

(c) It is generally assumed that the objective of stock market listed companies is to maximise the wealth of their shareholders. This in turn places an emphasis on profitability and other factors that influence a company's share price. It is true that some companies have other (secondary) aims such as only engaging in ethical activities (eg not producing armaments) or have strong environmental considerations. Clearly by definition not-for-profit organisations are not motivated by the need to produce profits for shareholders, but that does not mean that they should be inefficient. Many areas of assessment of profit oriented companies are perfectly valid for not-for-profit organisations; efficient inventory holdings, tight budgetary constraints, use of key performance indicators, prevention of fraud etc.

There are a great variety of not-for-profit organisations; eg public sector health, education, policing and charities. It is difficult to be specific about how to assess the performance of a not-for-profit organisation without knowing what type of organisation it is. In general terms an assessment of performance must be made in the light of the stated objectives of the organisation. Thus for example in a public health service one could look at measures such as treatment waiting times, increasing life expectancy etc, and although such organisations don't have a profit motive requiring efficient operation, they should nonetheless be accountable for the resources they use. Techniques such as 'value for money' and the three Es (economy, efficiency and effectiveness) have been developed and can help to assess the performance of such organisations.

4 (a) Relevance
Information has the quality of relevance when it can influence, on a timely basis, users' economic decisions. It helps to evaluate past, present and future events by confirming or perhaps correcting past evaluations of economic events. There are many ways of interpreting and applying the concept of relevance, for example, only material information is considered relevant as, by definition, information is material only if its omission or misstatement could influence users. Another common debate regarding relevance is whether current value information is more relevant than that based on historical cost. An interesting emphasis placed on relevance within the Framework is that relevant information assists in the predictive ability of financial statements. That is not to say the financial statements should be predictive in the sense of forecasts, but that (past) information should be presented in a manner that assists users to assess an entity's ability to take advantage of opportunities and react to adverse situations. A good example of this is the separate presentation of discontinued operations in the income statement. From this users will be better able to assess the parts of the entity that will produce future profits (continuing operations) and users can judge the merits of the discontinuation ie has the entity sold a profitable part of the business (which would lead users to question why), or has the entity acted to curtail the adverse affect of a loss making operation.

Reliability
The Framework states that for information to be useful it must be reliable. The quality of reliability is described as being free from material error (accurate) and a faithful representation of that which it purports to portray (i.e. the financial statements are a faithful representation of the entity's underlying transactions). There can be occasions where the legal form of a transaction can be engineered to disguise the economic reality of the transaction. A cornerstone of faithful representation is that transactions must be accounted for according to their substance (i.e. commercial intent or economic reality) rather than their legal or contrived form. To be reliable, information must be neutral (free from bias). Biased information attempts to influence users (perhaps to come to a predetermined decision) by the manner in which it is presented. It is recognised that financial statements cannot be absolutely accurate due to inevitable uncertainties surrounding their preparation. A typical example would be estimating the useful economic lives of non-current assets. This is addressed by the use of prudence which is the exercise of a degree of caution in matters of uncertainty. However prudence cannot be used to deliberately understate profit or create excessive provisions (this would break the neutrality principle). Reliable information must also be complete, omitted information (that should be reported) will obviously mislead users.

Comparability
Comparability is fundamental to assessing an entity's performance. Users will compare an entity's results over time and also with other similar entities. This is the principal reason why financial statements contain corresponding amounts for previous period(s). Comparability is enhanced by the use (and disclosure) of consistent accounting policies such that users can confirm that comparative information (for calculating trends) is comparable and the disclosure of accounting policies at least informs users if different entities use different policies. That said, comparability should not stand in the way of improved accounting practices (usually through new Standards); it is recognised that there are occasions where it is necessary to adopt new accounting policies if they would enhance relevance and reliability.

(b) (i) This item involves the characteristic of reliability and specifically reporting the substance of transactions. As the lease agreement is for substantially the whole of the asset's useful economic life, Porto will experience the same risks and rewards as if it owned the asset. Although the legal form of this transaction is a rental, its substance is the equivalent to acquiring the asset and raising a loan. Thus, in order for the financial statements to be reliable (and comparable to those where an asset is bought from the proceeds of a loan), the transaction should be shown as an asset on Porto's balance sheet with a corresponding liability for the future lease rental payments. The income statement should be charged with depreciation on the asset and a finance charge on the 'loan'.

(ii) This item involves the characteristic of comparability. Changes in accounting policies should generally be avoided in order to preserve comparability. Presumably the directors have good reason to be believe the new policy presents a more reliable and relevant view. In order to minimise the adverse effect a change in accounting policy has on comparability, the financial statements (including the corresponding amounts) should be prepared on the basis that the new policy had always been in place (retrospective application). Thus the assets (retail outlets) should include the previously expensed finance costs and income statements will no longer show a finance cost (in relation to these assets whilst under construction). Any finance costs relating to periods prior to the policy change (i.e. for two or more years ago) should be adjusted for by increasing retained earnings brought forward in the statement of changes in equity.

(iii) This item involves the characteristic of relevance. This situation questions whether historical cost accounting is more relevant to users than current value information. Porto's current method of reporting these events using purely historical cost based information (i.e. showing an operating loss, but not reporting the increases in property values) is perfectly acceptable. However, the company could choose to revalue its hotel properties (which would subject it to other requirements). This option would still report an operating loss (probably an even larger loss than under historical cost if there are increased depreciation charges on the hotels), but the increases in value would also be reported (in equity) arguably giving a more complete picture of performance.

5 **(a)** The correct timing of when revenue (and profit) should be recognised is an important aspect of an income statement showing a faithful presentation. It is generally accepted that only realised profits should be included in the income statement. For most types of supply and sale of goods it is generally understood that a profit is realised when the goods have been manufactured (or obtained) by the supplier and satisfactorily delivered to the customer. The issue with construction contracts is that the process of completing the project takes a relatively long time and, in particular, will spread across at least one accounting period-end. If such contracts are treated like most sales of goods, it would mean that revenue and profit would not be recognised until the contract is completed (the "completed contracts" basis). This is often described as following the prudence concept. The problem with this approach is that it may not show a faithful presentation as all the profit on a contract is included in the period of completion, whereas in reality (a faithful representation), it is being earned, but not reported, throughout the duration of the contract. IAS 11 remedies this by recognising profit on uncompleted contracts in proportion to some measure of the percentage of completion applied to the estimated total contract profit. This is sometimes said to reflect the accruals concept, but it should only be applied where the outcome of the contract is reasonably foreseeable. In the event that a loss on a contract is foreseen, the whole of the loss must be recognised immediately, thereby ensuring the continuing application of prudence.

(b) Beetie

Income statement	Contract 1	Contract 2	Total
	$'000	$'000	$'000
Revenue recognised	3,300	840	4,140
Contract expenses recognised (balancing figure contract 1)	(2,400)	(720)	(3,120)
Expected loss recognised (contract 2)		(170)	(170)
Attributable profit/(loss) (see working)	900	(50)	850

Balance sheet			
Contact costs incurred	3,900	720	4,620
Recognised profit/(losses)	900	(50)	850
	4,800	670	5,470
Progress billings	(3,000)	(880)	(3,880)
Amounts due from customers	1,800		1,800
Amounts due to customers		(210)	(210)

Workings (in $'000)

Estimated total profit:		
Agreed contract price	5,500	1,200
Estimated contract cost	(4,000)	(1,250)
Estimated total profit/(loss)	1,500	(50)

Percentage complete:	
Agreed value of work completed at 31 March 2006	3,300
Contract price	5,500
Percentage complete at 31 March 2006 (3,300/5,500 x 100)	60%
Profit to 31 March 2006 (60% x 1,500)	900

At 31 March 2006 the increase in the expected total costs of contract 2 mean that a loss of $50,000 is expected on this contract. In these circumstances, regardless of the percentage completed, the whole of this loss should be recognised immediately.

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.

1	**(a)**	1 mark per relevant point	**5**
	(b)	Balance sheet:	
		property, plant and equipment	2½
		goodwill	3½
		investments – associate	3
		– other	1
		current assets	2
		equity shares	1
		retained earnings	3
		minority interest	1½
		8% loan notes	½
		10% loan notes	1
		profit and loss account	1
			20
		Total for question	**25**
2	**(a)**	Income statement	
		revenue	½
		cost of sales	4½
		operating expenses	½
		investment income	1½
		finance costs	1½
		taxation	1½
			10
	(b)	Movement in share capital and reserves	
		brought forward figures	1
		revaluation	1
		profit for period	1
		dividends paid	1
			4
	(c)	Balance sheet	
		land and buildings	2
		plant and equipment	2
		investment property	1
		inventory and trade receivables	1
		8% loan	½
		deferred tax	½
		lease obligation: interest and capital one year	1
		capital over one year	1
		trade payables and overdraft	1
		accrued interest	½
		income tax provision	½
			11
		Total for question	**25**

3	**(a)**	one mark per ratio		**10**
	(b)	1 mark per valid point	**maximum**	**10**
	(c)	1 mark per valid point	**maximum**	**5**
			Total for question	**25**
4	**(a)**	3 marks each for relevance, reliability and comparability		9
	(b)	2 marks for each transaction ((i) to (iii)) or event		6
			Total for question	**15**
5	**(a)**	one mark per valid point to	**maximum**	**4**
	(b)	revenue (½ mark for each contract)		1
		profit/loss (½ mark for each contract)		1
		amounts due from customers (contract 1)		2
		amounts due to customers (contract 2)		2
				6
			Total for question	**10**