POLITECHNIKA WARSZAWSKA SZKOŁA BIZNESU

DIPLOMA in ACCA

Accounting & Finance

FINANCIAL ACCOUNTING

2017/2018 Exam

Time allowed: 3 hours 15 minutes

This question paper is divided into three sections:

Section A – ALL 15 questions are compulsory and MUST be attempted

Section B – ALL 15 questions are compulsory and MUST be attempted

Section C – BOTH questions are compulsory and MUST be attempted

Do NOT open this question paper 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.

ACCA

Section A – ALL 15 questions are compulsory and MUST be attempted

Please use the grid provided on page two of the Candidate Answer Booklet to record your answers to each multiple choice question (MCQ). Do not write out the answers to the MCQ on the lined pages of the answer booklet.

1. An item of equipment cost PLN 85,000 on 1 January 2015. This equipment is depreciated at 10% per annum on cost and tax depreciation is calculated at 25% on a reducing balance basis. Corporate income tax is charged at 20%.

The amount of deferred tax asset/liability that should be recognised in the statement of financial position as at 31 December 2017? (to the nearest integer)

- **A.** PLN 2072 deferred tax asset
- **B.** PLN 2590 deferred tax liability
- **C.** PLN 2590 deferred tax asset
- **D.** PLN 2072 deferred tax liability

2. The following financial information relates to a calculation of a goodwill arising on an acquisition of 80% of a subsidiary's net assets:

	PLN '000
Fair value of a purchase consideration	125,000
Fair value of NCI as of date of acquisition	45,000
Total	*170,000*
Fair value of subsidiary's identifiable net assets at the date of acquisition	210,000
Bargain purchase	(40,000)

What is a proper way to account for the result of such a bargain purchase?

- **A.** Do nothing as IFRS 3 'Business combinations' forbids recognition of negative assets
- **B.** Write it off to profit/loss as a loss immediately
- **C.** Recognise it fully in profit/loss as a gain
- **D.** Amortise it to profit/loss over a period not exceeding 5 years.

3. IFRS *5 'Non current Assets Held for Sale and Discontinuing Operations'* states conditions which must be satisfied in order to classify an asset as held for sale.

Which of the following is NOT the condition required for the latter?

A. An asset must be ready for an immediate sale in its current condition
B. Sale of an asset must be highly probable
C. An asset must not be depreciated anymore
D. Sale must be take place within 12 months from the classification moment.

4. IAS 10 'Events after the Reporting Period' defines both adjusting and non-adjusting events. Due to these specific definitions mentioned in the standard which of the following will give rise to an adjusting event

A. Three weeks after the year end company's management decided to commence a restructuring process
B. One month after the year end unexpected earthquake has destroyed company's warehouse in full and most of its inventory.
C. A dividend for the current year was properly proposed for before the year and formally authorized within a required period of 3 months after the year end
D. Two months after the year end the company lost the case against one of its ex directors and it is required to pay a compensation of PLN 40,000. At the year end the provision for PLN 25,000 was recognised.

5. On 1 July 2017 Roman Ltd. Issued PLN 5m convertible debentures at par with a coupon (nominal interest rate) of 4% per annum. These debentures are redeemable on 30 June 2020 at par or its holder can opt to have his/her cash converted to Roman's Ltd. shares. At the date of debenture's issue there are similar instruments traded on a market but with no conversion option. Such instrument carries a coupon of 7%.

The present value of 1 PLN receivable at the end of each year using % rates mentioned above is:

		4%	7%
End of year	1	0,96	0,93
	2	0,92	0,87
	3	0,89	0,82
	4	0,85	0,76

Which of the following correctly illustrates an initial recognition of the above convertible debenture in company's statement of financial position at 1 July 2017 ?

	Equity **PLN 000**	**Non-current Liability** **PLN 000**
A.	376	4,624
B.	Nil	5,000
C.	5,000	nil
D.	156	4,844

6. There are three levels of input which IFRS 13 *'Fair value measurement'* defines introducing a hierarchy for fair value measurement.

Which of the following inputs represents Level 2 in fair value hierarchy?

A. Market related inputs
B. Prices of instruments quoted in active markets at a date of measurement
C. Directly or indirectly observable inputs other than quoted prices
D. Unobservable inputs obtained from the use of an appropriate model

7. Sometimes an entity faces a need to change in accounting policy. A 'change in accounting policy' requires its retrospective application as described in IAS 8 *'Accounting Policies, Changes in Accounting Estimates and Errors'*

Which of the following would require a retrospective application per IAS 8 *'Accounting Policies, Changes in Accounting Estimates and Errors'*?

A. An entity decreased an allowance for trade receivables from 10% to 4% of outstanding balances receivable
B. Asset's useful life has been extended from four to eight years due to favourable estimate of expected future cash flows the asset is to generate for the entity
C. Entity decided to adopt a revaluation model for its intangible assets measured so far at cost model
D. There was a change in valuation of inventory from weighted average to first-in first-out.

8. Agromark SA has obtained an element of plant costing PLN 280,000. Asset's life has been estimated as 10 years and its residual value of PLN 25,000. In an eight year of its use a management decided to extend its remaining useful life to 16 years and change its residual value to PLN 5,000.

What would be the annual depreciation charge in year 9?

A. PLN 8,875
B. PLN 9,500
C. PLN 6,375
D. PLN 17,187

9. At 1 January 2017 Popiel Ltd. acquired 100% of Mysza Ltd. for PLN 2,000,000. At the date of acquisition share capital of Mysza Ltd. was represented by 400,000 ordinary shares of PLN 0.25 each and its retained profits amounted PLN 350,000. Amongst net assets of Mysza Ltd. there were some assets whose carrying amount was PLN 250,000 but their fair value was PLN 310,000.

What was goodwill at the date of acquisition?

A. PLN 1,550,000
B. PLN (10,000)
C. PLN 1,490,000
D. PLN 50,000

10. The following items were extracted from the consolidated statement of financial position of Biebrza SA for the year ended 31 December 2017:.

	PLN '000
Share capita	100
Share Premium	250
Other Components of Equity	85
Accumulated Profits	350
Total	**785**
Non-controlling interest	45
Total	**830**
Non current Liabilities	
Lease liability	225
Deferred tax liability	35
10% debentures	185
Total non - current liabilities	**445**
Current Liabilities	
Lease liability	75
Trade payables	165
Overdraft	56
Total current liabilities	**296**
Total equity and liabilities	**1,571**

What is a gearing ratio of Biebrza SA assuming the gearing ratio is to be taken as debt/equity and that Biebrza SA considers an overdraft facility as a permanent source of its financing?

A. 68.92%
B. 53.61%
C. 73.38%
D. 60.36%

11. Which of the following may be classified as non-monetary item in accordance with IAS 21 *'The Effects of Changes in Foreign Exchange Rates'*?

(1) A receivable denominated in foreign currency
(2) Property located in a foreign country acquired for specified amount of foreign currency some years ago
(3) A dividend receivable from entity' foreign equity investment
(4) Inventory sold before the year end to entity's foreign related party on sale or return basis.

A. 1 and 3
B. All
C. 2 and 4
A. 4 only

12. The following items were taken from the statement of cash flows of Polonez SA for the year ended 31 December 2017:

	PLN
Loss on disposal of non –current assets	5,000
Cash on disposal of non –current assets	50,000
Depreciation charge for the year	40,000
Carrying amount of non –current assets (opening)	250,000
Carrying amount of non –current assets (closing)	400,000

What amount represents a cash spend to acquire new non – current assets?

A. PLN 235,000
B. PLN 245,000
C. PLN 205,000
D. PLN 190,000

13. In the year ended 31 December 2017 company Morwa SA, having 800,000 ordinary shares in issue (no changes of share capital during the year) achieved basic EPS of PLN 0.52. Additionally in the statement of financial position of Morwa SA shows PLN 200,00 6% convertible debentures in issue. The conversion rights attached to this convertible debentures allow their holder to obtain 4 shares for each PLN 10 of debt.

Income tax payable by Morwa SA is 20%.

In accordance with IAS 33 *'Earnings Per Share'* what is diluted earnings per share for the year ended 31 December 2017?

A. PLN 0.486
B. PLN 0.484
C. PLN 0.475
D. PLN 0.479

14. **Which of the following statements are true in relation to preparation of consolidated statement of financial position?**

(1) Unrealised profits must be eliminated to the extent of parent's interest in subsidiary's net assets
(2) Cost of acquisition is replaced by parent's share in subsidiary's nets assets and goodwill arising on the date of acquisition. It is therefore eliminated from the consolidated statement of financial position.
(3) All intercompany balances must be eliminated on consolidation
(4) All dividends declared by group members must be fully cancelled when preparing consolidated statement of financial position.

A. 1 and 3
B. All
C. 2 and 3
D. 1 only

15. Over last three years Bolek Sp. z o.o. (Ltd) has 25% of ordinary shares and exerts a significant influence over Lolek Sp. z o.o (Ltd.). Sometime during the current year Bolek Sp. z o.o. sold goods worth PLN 40,000 to Lolek Sp. z o.o. The investor uses 25% mark-up. Lolek Sp. z o.o. still had 30% of these goods in inventory at the year end.

What is the amount of unrealised profit which will be reflected in consolidated financial statements prepared for the current year?

A. PLN 600
B. PLN 750
C. PLN 1,400
D. PLN 1,750

(30 marks)

Section B – ALL 15 questions are compulsory and MUST be attempted

Please use the grid provided on page two of the Candidate Answer Booklet to record your answers to each multiple choice question (MCQ). Do not write out the answers to the MCQ on the lined pages of the answer booklet.

Each question is worth 2 marks.

The following scenario relates to questions 16-20.

The extract from Miedzianka Sp. z o.o. draft trial balance:

Trial Balance PLN 000	**Dr.**	**Cr.**
10% Bonds		40,000
Equity shares PLN 0.25 each		31,500
Under/over provision for tax		400
Deferred tax		1,200

10% bonds (financial instrument)

Miedzianka Sp. z o.o. issued 10% bonds on 1 January 2016 at its par value of PLN 40,000. At the same date some legal expenses, directly attributable to bonds issue were incurred in the amount PLN 1,000. An accountant processing this information was not sure of how to account for these expenses. These bonds are to be redeemed in 4 years time at some premium which requires the effective interest rate of 14%. Annual interest was paid in two semi-annual instalments.

Taxation

Apart from settlement of an under/over provision of current tax for the year ended 31 December 2015, it is required to recognise a provision for the current year tax at the amount of PLN 1,800,000. Additionally it was estimated that the carrying value of entities net assets was PLN 2,500,000 higher than their tax base. Miedzianka Sp. z o.o. has effective tax rate of 25%.

Earnings per share

The value of equity share capital (at nominal value PLN 0.25) as of 1 January 2016 was PLN 20 million. On 1 May 2016 Miedzianka Sp. z o.o. issued new 25 million fully paid up equity shares at PLN 2.20 per share. Sometime later on 1 October there has been a rights issue of 1 for 5 shares at PLN 1.90 when the market price of these shares was PLN 2.50 per share.

Dividends

The Board of Directors decided to pay some interim dividend during the year. As of 12 July 2016 the interim dividend of PLN 0.45 per share, which were in issue at date, was paid.

16. What is the amount of the finance costs related to 10% bond to be recognised in Miedzianka Sp. z o.o. statement of comprehensive income for the year ended 31 December 2016?

A. 5,460 PLN
B. 4,000 PLN
C. 3,900 PLN
D. 5,600 PLN

17. How much will be tax expenses recognised in the company's statement of comprehensive income for the year ended 31 December 2016%?

A. Dr 2,775 PLN
B. Dr 1,625 PLN
C. Cr 425 PLN
D. Dr 825 PLN

18. According to IAS 33 'Earnings per share' what will be weighted average number of ordinary shares to be used to compute basic earnings per share for the year ended 31 December 2016?

A. 99,083
B. 38,917
C. 104,851
D. 75,667

19. Which of the following methods represent a proper accounting treatment of a direct issue costs of a financial instrument classified as 'amortised cost' per IFRS 9 'Financial Instruments'?

- **A.** Recognise them as an adjustment to the initial amount of an 'amortised cost' instrument
- **B.** Recognise them as period expense when incurred
- **C.** Ignore them as not relevant to the issue of an 'amortised cost' instrument
- **D.** Defer them in company's equity through the other comprehensive income.

20. How much was the amount of interim dividend paid at 12 July 2016?

- **A.** 56,700 PLN
- **B.** 11,250 PLN
- **C.** 47,250 PLN
- **D.** 31,688 PLN

The following scenario relates to questions 21-25

Statement of cash flows

At 1 January 2017 Kolejorz SA owned some machines with the carrying amount of PLN 350,000. During the year some machines were disposed off. Cash received from their disposal was PLN 65,000 which resulted in the loss on disposal of PLN 20,000. Additionally Kolejorz SA revalued assets recognising a revaluation gain of PLN 120,000. Depreciation charged for the year ended 31 December 2017 was PLN 55,000. The carrying amount of remaining machines at 31 December 2017 was PLN 420,000.

Effects of changes in foreign exchange rates

Kolejorz SA is trading internationally with some EU partners (Euro). On 15 October 2016 Kolejorz SA sold on credit goods worth Euro 23,500. As of 25 of December 2016 debtor repaid Euro 15,500 and the outstanding balance is due by the end of January 2017. Additionally on 28 October some goods were purchased on credit for Euro 38,500, for which Kolejorz SA paid on 29 December 2016. Only half of the inventory purchased once remained in company's warehouse at 31 December 2016.

Financial instruments

Kolejorz SA issued few years ago 5% PLN 2,000,000 convertible bond (where for each PLN 100 of debt a bond holder can obtain 25 ordinary shares of Kolejorz SA). Per IAS 32 'Financial Instruments: Presentation' such instruments constitutes a compound instrument and as such it should be split into debt and equity components and such elements must be presented separately in the statement of financial position.

Events after the reporting period.

Kolejorz SA as a public entity is required to organise an Annual General Meeting of its shareholders within a period of maximum six months from the year end. They are very much aware that a certain materials events taking place between their year end and a moment when their financial statements are authorised for issue should be reviewed and decided which ones, in accordance with IAS 10 'Events after the Reporting Period', should be accounted for as adjusting events and non -adjusting events.

21. How much will be an amount presented in the statement of cash flows of Kolejorz SA for the year ended 31 December 2017 under the heading of 'cash from investing activities'?

A. PLN 15,000 inflow
B. PLN 25,000 outflow
C. PLN 30,000 inflow
D. PLN 145,000 outflow

22. What was a value of the inventory remained at the year end?

A. PLN 83,545
B. PLN 85,470
C. PLN 79,310
D. PLN 81,813

23. What was a total foreign exchange gain or loss recognised in Kolejorz's SA profit or loss for the current year?

A. PLN 2,610 loss
B. PLN 4,935 gain
C. PLN 2,610 gain
D. PLN 4,935 loss

24. Which of the following methods of compound's instrument separation is allowed by IAS 32?

A. Both components should be separately measured using Level 1 inputs as defined by IFRS 13 'Fair Value Measurement'
B. Debt component should be reliably measured based on the present value of principal and interest repayable in the future and the equity component to be found as a balancing figure
C. Equity component should be measured first using option valuation model as Black Scholes and the debt component to be found as a balancing figure
D. Debt component to be measured independently using the effective rate based on company's WACC and equity element found and recognised as a balancing figure assuming its amount will exceed company's materiality level.

25. Which of the following events taking place after the end reporting period should be accounted for as adjusting events?

- **A.** The year end inventory of Kolejorz SA included 50 items of goods at total cost of PLN 20,000. All of them were not older than 3 years. After long negotiations process they were all sold within 3 months after the year
- **B.** Two weeks after the year end company's warehouse was hit by meteorite and all inventories (not insured) stored there were destroyed. Loss incurred will not jeopardize going concern
- **C.** Two months after the year end the Board of Kolejorz SA has publicly announced company's major restructuring process which will take 3 years to complete.
- **D.** Sixteen days after the end of reporting period a Government of a country where Kolejorz SA operates announced unexpectedly a change in corporate income tax.

The following scenario relates to questions 26-30

Impairment of assets

Bocian Sp. z o.o. has decided to adopt a fair value model to measure its property, plant and equipment. The carrying amount of some asset before its revaluation was PLN 2,500 and it is now stated in the statement of financial position at PLN 3,850. Before the year end due to some technical failure of this asset it was necessary to perform the impairment test. Recoverable amount of this asset has been determined as PLN 2,150.

Intangible assets

Bocian Sp. z o.o. a well-known pharmaceutical enterprise some time ago has undertaken a major project leading to a development of a new medicine for Parkinson disease. In the current year a following expenses related to the latter project were incurred. IAS 38 'Intangible Assets' provides some guidance on the accounting treatment of both research and development expenditure.

A list of expenses incurred:

Title of expense	PLN
Wages of scientific personnel engaged in the project	50,000
Acquisition of specific know how necessary to proceed with a testing of raw chemical formula of a potential medicine	180,000
An incentive payment to attract a famous scientist who got involved in the project	250,000
Cost of hiring a special cyclotron necessary to test some interactions of the raw formula with other substance	45,000
Cost of hiring a market research consultant to verify the market for the new medicine	35,000

Leases IFRS 16

Bocian Sp. z o.o. has decided to acquire some assets using long term lease. Some lease contract has been entered into before the year end and the Chief Accountant of Bocian Sp. z o.o. became concerned with a proper recognition of components of the lease contract as he realised that there has been a new standard - IFRS 16 'Leases' issued recently.

Government grants

In a recent times a natural environment in Poland became severely polluted by production related fumes caused by companies from a manufacturing sector where Bocian Sp. z o.o. operates. The Government, aiming to reduce the pollution has announced a program of governmental grants which eligible companies (those which pollute the environment) could obtain subject to satisfaction of some criteria. It is possible to obtain such grant amounting to a maximum of 40% of the cost of filtering system which the company will first install and then apply for such grant.

Property, plant and equipment

Bocian Sp. z o.o. owns large number of property, plant and equipment. Due to the use of modern technologies many assets are not deteriorating over their use so quickly as it was earlier anticipated. It results with many cases where assets useful lives have been revised - usually extended as compared to previous estimates. One of such machines purchased four years ago for PLN 400,000 is now subject to such review. Its initially estimated useful life was eight years and its residual value was PLN 35,000. It is now estimated that due to relatively good condition of this asset its life can be now extended for another ten years but its residual value should be reduced to PLN 15,000.

26. How much of the impairment loss should be charged to profit or loss in accordance to IAS 36 'Impairment of Assets'?

A. PLN 350 loss
B. PLN nil
C. PLN 1,700 loss
D. PLN 1,350 loss

27. What is a total cost of intangible asset which should be recognised in the statement of financial position of Bocian Sp. z o.o. at the year-end in accordance with IAS 38 'Intangible Assets'?

A. PLN 260,000
B. PLN 475,000
C. PLN 510,000
D. PLN 225,000
k

28. Which of the following represents a proper initial recognition of a lease in lessee's books per IFRS 16 'Leases'?

A. At the commencement of the lease, a lessee shall recognise the right-of-use asset and a lease liability
B. At the commencement of the lease, a lessee recognises both asset and lease liability at the lower of present value of minimum lease payment and fair value of the asset
C. At the commencement of the lease, a lessee recognises an expense and a lease liability at the lower of present value of minimum lease payment and fair value of the implicit asset
D. At the commencement of the lease, a lessee recognises both an asset and a lease liability at the higher of present value of minimum lease payment and fair value of the asset.

29. According to IAS 20 'Accounting for Government Grants and Disclosure of Government Assistance' which TWO of the following accounting treatments of grants related to depreciable assets, in the statement of financial position are correct?

(1) Grant related to assets should be deducted from the initial cost of the asset and recovered through decreased depreciation charges over asset's life.
(2) Grant must be recognised as integral part of equity as in most cases it becomes forgivable loan so it will never be repaid back to the Government
(3) Grant must be recognised as a provision (non - current liability) and recognised as a gain in the statement of comprehensive income over asset's remaining life
(4) Grant must be deferred in the statement of financial position as a deferred income (liability) and then amortised to profit/loss over remaining asset's life.

A. 1 and 3,
B. 1 and 4,
C. 2 and 4
D. 2 and 3

30. What shall be the carrying amount of this asset at the end of year 5?

A. PLN 195,750
B. PLN 181,500
C. PLN 197,250
D. PLN 203,036

Section C – BOTH questions are compulsory and MUST be attempted

Harmonia SA decided to expand their business activities and as result of this plan they have acquired their so far competitor Basetla Sp. z o.o. An effective date when Harmonia SA obtained a control over net assets of Basetla Sp. z o.o. was 1 April 2017. Harmonia SA acquired 80% of the ordinary share capital of Basetla at a cost of PLN 15,420,000. On the same date it also acquired 50% of Basetla's 15% loan notes at par. The draft financial statements of both companies are reproduced below:

Statements of comprehensive income: Year to 31 December 2017

	Harmonia	Basetla
	PLN 000	PLN 000
Sales revenue	90,000	36,000
Cost of sales	(63,000)	(30,000)
Gross profit	27,000	6,000
Operating expenses	(9,000)	(300)
Loan interest received (paid)	225	(450)
Operating profit	18,225	5,250
Taxation	(4,500)	(900)
Profit after tax for the year	13,725	4,350
Extract from SOCIE		
Profit for year	13,725	4,350
Opening retained earnings	24,788	8,100
Closing retained earnings	38,513	12,450

Statements of financial position: as at 31 December 2017 (PLN 000)

Tangible non-current Assets	29,890	12,000
Investments	16,920	500
	45,900	12,500
Current Assets		
Inventory	9,450	3,600
Receivables	8,400	4,800
Cash	4,650	3,600
Total assets	68,400	24,500
Equity and liabilities		
Ordinary shares of PLN 1 each	15,000	3,000
Retained earnings	38,400	12,600
	53,400	15,600
Non-current liabilities		
15% Loan notes	nil	3,000
Current liabilities	15,000	5,900
Total equity and liabilities	68,400	24,500

The following information is relevant:

(i) The fair values of Basetla 's assets were equal to their book values with the exception of its plant, which had a fair value of PLN 4,8 million in excess of its book value at the date of acquisition. The remaining life of all of Basetla's plant at the date of its acquisition was five years and this period has not changed as a result of the acquisition. Depreciation is charged on a straight-line basis and it is presented as part of cost of sales. Harmonia did not adjust carrying amounts of these assets for the impact of the above fair value difference yet.

(ii) Sometime during the post-acquisition period Harmonia SA sold goods to Basetla at a price of PLN 18 million. The original cost of these goods in Harmonia SA records was PLN 13,5 million. During the year Basetla had sold PLN 15 million (at cost to Basetla) of these goods for PLN 18,5 million.

(iii) Revenues and profits are assumed to accrue evenly throughout the year.

(iv) Non-controlling interest is valued at their proportionate share of the subsidiary's identifiable net assets and they are not credited with their share of goodwill. On 31 December 2017 Harmonia SA performed an impairment test on the value of goodwill. The test revealed that goodwill must be impaired by 30%.

Required:

(a) Prepare a consolidated statement of comprehensive income for Harmonia SA for the year to 31 December 2017 (8 marks)

(b) Prepare a statement of financial position for Harmonia SA for the year to 31 December 2017 (9 marks)

(b) If Harmonia SA decides to measure NCI at the date of acquisition at its fair value what will be the value of goodwill recalculated in such way both at the date of acquisition and the remaining balance which will be recognised in the consolidated statement of financial position as at 31 December 2017. The fair value of both Harmonia SA and Basetla's Sp. z o.o. shares at the date of acquisition were PLN 8.5 and PLN 6.5 respectively. . (3 marks)

(20 marks)

32.

You are a financial analyst with fifteen years of experience. You have been approached by your client who look for some advice regarding one of his investments, Ernon SA., the company manufacturing mineral fertilizers.

Last year Ernon SA has appointed three out of five new members of the Board of Directors including Kenneth Maj being very ambitious, dynamic and visionary businessman. He is trying to put forward very ambitious business expansion strategy aiming to enter some new markets with Ernon SA current product base. Management Report issued in the current year mentions increase in revenues and resultant profits and significant investment in non – current assets necessary to maintain a growth in company's revenues. Ernon SA management is very excited to have invested in an equity of one of its long standing raw materials suppliers (20% share of their equity) which is believed to improve the quality of their finished goods and improve results of Ernon SA performance in the future.

The client is keen to retain the investment in Ernon SA based on such positive impression made by the Management Report mentioned above but still would like to obtain some independent opinion of a specialist before final decision will be made. The client asked you therefore to perform the analysis of Ernon SA financial statements to verify Management opinions formulated in their annual report.

Statements of comprehensive income for the year ended 31 December 2017

	2017	2016
	PLN m	PLN m
Revenue	2,145	1,533
Cost of sales	(1,587)	(1,058)
Gross profit	558	476
Administrative expenses	(111)	(93)
Distribution costs	(237)	(150)
Finance costs	(90)	(45)
Share of associate's profits	120	0
Profit before tax	240	188
Income tax expense	(60)	(50)
Profit for the year	180	138
Other comprehensive income:		
Revaluation gain on property, plant	68	15
FV gains on FVTOCI assets	3	1
Other comprehensive income for the year	71	16
Total comprehensive income for the year	251	154

Statements of financial position as at 31 December 2017

Assets		**2017**		**2016**
Non-current assets		**PLN m**		**PLN m**
Property, plant and equipment		720		606
Investment in Associate		266		0
Financial assets - FVTPL		225		210
		1,211		816
Current assets				
Inventory	218		98	
Trade receivables	371		201	
Bank/Cash	0	588	33	332
Total assets		1,799		1,148
Equity and liabilities				
Equity shares of PLN1 each	150		150	
Revaluation reserve	111		48	
Other components of equity	48		33	
Retained earnings	686	995	500	731
		995		731
Non-current liabilities				
Loans	600		315	
		600		315
Current liabilities				
Bank overdraft	56		0	
Trade payables	149		102	
		204		102
Total equity and liabilities		1,799		1,148

Required:

Based on relevant financial ratios of your choice pls analyse and comment upon the financial performance and financial position (short and long term horizon) of Ernon SA for the year to 31 December 2017, commenting also on management's plan of business expansion. (there are 8 marks available for calculation of relevant ratios – please state clearly a formula used and present all chosen ratios in some appendix).

(20 marks)

End of question paper.

POLITECHNIKA WARSZAWSKA SZKOŁA BIZNESU

FINANCIAL REPORTING

2017/2018 Exam

Answers

Section A	
1.	**D** Carrying amount of the equipment at 31/12/17 – cost 85.000 – (85.000*0.1* 3yrs) = **59.500** Tax base of the equipment (85.000 – (21.500+15,937+11,953)) = **49.141** Deferred tax liability **59.500 – 49.141 = 10.359 * 20% = 2071,80 = 2072**
2.	**C**
3.	**C** Depreciation of the asset classified as held for sale ceases when the asset has been classified as held for sale.
4.	**D** A provision existed at the year end already suggesting the obligating event to have taken place. Loss of the course case simply confirms that provision was necessary at the year end so financial statements for the year just ended must be adjusted for the outcome of this adjusting event.
5.	**A** Total value of debt component = PV of interest payable at 4% over 3 yrs. (PLN 200.000 * AF3yrs,7% (2.62)= PV PLN 524,000 and PV of principle repaid at maturity (5m * DF3yrs, 7% (0,82)= PLN 4,100,000. Total value of the debt component = PLN 4,624,000 and it gives equity element of PLN 376,000.
6.	**C**
7.	**D** Other items except D are changes in accounting estimates while D represents a change of an accounting policy which is dealt with however by IAS 38 *'Intangible assets'* rather than IAS 8.
8.	**A** Original annual depreciation (280,000-25,000)/10 = PLN 25,500. Carrying amount in 8yr (280,000 – (25,500*8)) = PLN 76,000. New depreciation charge after revision of both remaining useful life and residual value (76,000-5,000)/8 = PLN 8,875.

9.	**C** Cost of acquisition PLN 2,000,000. Net assets of Mysza Ltd. (Share capital PLN 100,00 (400,000 *PLN 0.25), retained earnings PLN 350,000 and the fair value adjustment PLN 60,000 (PLN 310k – PLN 250k) = PLN 510,000. Total goodwill = PLN 2,000,000 less PLN 510,000 = PLN 1,490,000.
10.	**A** Gearing ratio – total debt = lease liability (both current and non – current element PLN 225+75), 10% debentures (PLN 185), overdraft (PLN 56) = PLN 541. Total equity PLN 785 i.e. ignoring NCI (PLN 45) = PLN 785. Gearing ratio = 541/785 = 68.92%
11.	**C**
12.	**B** (PLN 55,000 NBV on disposal + PLN 40,000 depreciation + PLN 400,000 c/d of PPE) = PLN 495,000 less PLN 250,000 (b/d PPE) = PLN 245,000 – cash spent to acquire new PPE
13.	**B** New shares assumed to be issued under conversion of debentures – 80,000 (PLN 200,000/10*4) and additional profit savings – PLN 9,600 (PLN 200,000*6%*(1-0.2)). The overall impact of new shares and new savings on basic EPS = (PLN 416,000+PLN 9.600)/ 880.000 = PLN 0.4836 (rounded to PLN 0.484).
14.	**C** Per IFRS all intercompany balances arising in a business combination must be fully eliminated when preparing consolidated financial statements and the cost of acquisition of subsidiary's net assets disappears from the consolidated statement of financial position.
15.	**A** Unrealised profit in inventory sold to Associate – PLN 40,000 *25/125*30% (goods retained) = PLN 2,400 and inventor's share in such unrealised profit – PLN 2,400*25% = PLN 600

Section B

16.	**A.** PLN 40,000 less 1,000 = 39,000 * 14% (effective interest rate) = PLN 5,460 [10% being a coupon rate on this bond should be ignored as it is used to calculate the interest payable on this bond only).
17.	**D.** Dr PL 1,800 (current tax charge required) less 400 being over-provision of current tax from the last year = 1,400 Dr less 575 Cr being a change in the deferred tax liability for the period = net Dr 825 [NB. opening Dtax liability – 1,200 Cr less new closing Dtax liability 625 Cr (taxable temporary difference – 2,500 * 25%) = PLN 575.
18.	**C**. 1.1-30.4 – 80,000 shares *4/12 * 2.50/2.40 = 27,778 shares, 1.5-30.9 – 105,000 shares * 5/12 * 2.50/2.40 = 45,573 shares (1:5 rights issue) 1.10 – 31.12 – 126,000 shares * 3/12 = 31,500 shares Total weighted average number of shares = **104,851** Bonus fraction on rights 5 shares before rights @ PLN 2.5 = PLN 12.5 1 shares at rights @ PLN 1.9 = PLN 1.9 6 shares ex-rights has value of PLN 14.4 so therefore TERP (theoretical ex-rights price = 14.4/6 = PLN 2.40. Bonus fraction on rights therefore **2.50/2.40**
19.	**A.**
20.	**C.** Shares in issue as at 12 July 2016 were: 80,000 brought down and a new 25,000 shares issued at full issue as of 1 May = 105,000 shares * PLN 0.45 = PLN 47,250.
21.	**B.** There are two cash flows which make a solution i.e. total cash spent to acquire new assets – PLN 90,000 (outflow) (c/d 420,000 +55,000 depreciation + 85,000 carrying amount of disposed assets [PLN 65,000 cash on disposal + (20,000) loss on disposal] less b/d 350,000 less 120,000 revaluation. Total net

	cash flow = (90,000) + 65,000 cash in on disposal = (25,000) outflow
22.	**A.** Inventories purchased as of 28.10 – Euro 38,500 * 4,34 = PLN 167,090. As half of the inventory is remained at the year end it is therefore PLN 83,545 (PLN 167,090/2).
23.	**C.** 2,610 gain. Cash of Euro 15,500 collected as of 25/12 is restated at spot rate (4.29) – PLN 66,495 and as compared to its value at the date of transaction (PLN 65,565 = 15,500 Euro * 4.23) gives a foreign exchange gain of PLN 930. Balance of Euro 8,000 outstanding at the year end makes PLN 35,520 (PLN 33,840 as of 15.10) gives another gain of PLN 1,680. Total gain therefore is PLN 2,610.
24.	**B**.
25.	**A.** The net impact of the revaluation loss write down is PLN 350 loss. B/d carrying amount of PPE PLN 3,850 less PLN 2,150 recoverable amount = PLN 1,700 revaluation loss. Its write off will consume the whole revaluation surplus – PLN 1,350 and the difference of PLN 350 is taken to profit/loss.
26.	**B.** All would result from greater protection against foreign competition
27.	**D.** PLN 225,000 = know **–** how PLN 180,000 + the hire of cyclotron PLN 45,000.
28.	**A.**
29.	**B.**
30.	**C.** Original annual depreciation of the asset – PLN 45,625 [(400,000 – 35,000)/8 yrs.]. Carrying amount at the end of 4th year (400,000 – 182,500) was 217,500) and due to the change in estimates (remaining life now – 10 yrs. and new estimate of the residual value – 15,000) a new annual depreciation charge will be PLN 20,250 [(217,500 – 15,000)/10 yrs.]. It results with the carrying amount of this asset to be PLN 197,250 at the end of 5th year (217,500 less 20,250).

Section C

31.

(a) **<u>Harmonia SA– Consolidated Statement of Comprehensive Income</u>**

Consolidated statement of comprehensive income for the year to 31 December 2017

	PLN 000
Sales revenue	
(90,000 + (36,000 × 9/12) – 18,000 intra-group sales)	99,000
Cost of sales (W5)	(68,970)
Gross profit	30,030
Operating expenses	
(9,000 + (300 × 9/12) + 549 goodwill (W2)	(9,774)
Loan interest ((450 × 9/12) – 169 intra-group))	(169)
	20,088
Taxation (4,500 + (900 × 9/12))	(5,175)
Profit after tax	14,913
Attributable to Non-controlling interest	
(((4,350 × 9/12) – 720 depreciation adjustment) × 20%)	509
Attributable to shareholders of Harmonia SA	14,404

(b) **Harmonia SA – Consolidated Statement of Financial Position**

Consolidated statement of financial position at 31 December 2017

Non-current assets	
Goodwill (W2)	1,281
Investments	500
Tangible non-current Assets	
(28,980 + 12,000 + 4,080 (W1))	45,060
	46,841
Current Assets	
Inventory (9,450+3,600-750 PUPR (W6)	12,300
Receivables (8,400+4,800)	13,200
Cash (4,650+3,600)	8,250
Total assets	80,591
Equity and liabilities	
Ordinary shares of PLN 1 each	15,000
Reserves:	
Retained earnings (W4)	39,255
	54,255
Non-controlling interest (W3)	3,936
	58,191
Non-current liabilities	
15% Loan notes (3,000 – 1,500 intra-group)	1,500
Current liabilities (15,000+5,900)	20,900
Total equity and liabilities	80,591

WORKINGS in PLN 000

(1) **Net assets summary**

	Reporting date PLN 000	Acquisition date PLN 000	Post PLN 000
Ordinary share capital	3,000	3,000	
Retained earnings			
(8,100 + (4,350 × 3/12))	12,600	9,188	3,412
Fair value difference	4,800	4,800	0
Additional deprec.(4,800*0.2*9/12)	(720)		(720)
Net assets	19,680	16,988	2,692

Depreciation in respect of FV difference = (4,800 / 5yrs) × 9/12 = 720

(2) **Goodwill**

	PLN 000
Cost	15,420
NCI at date of acquisition (16,988*20%)	3,398
Less 100% of Basetla net assets from date of acqn	(16,988)
	1,830
CRE (W4) & CSOCI (30%)	549
CSOFP (remaining)	1,281

(3) **Non-controlling interest**

	PLN 000
NCI from the date of acquisition (W2)	3,398
NCI share of Basetla's post-acquisition profits (2,692 × 20%)	539
	3,936 (round)

(4) **Consolidated retained earnings**

	PLN 000
All of Harmonia SA	38,400
Unrealised profit (4,500 × 3/18)	(750)
Share of Basetla (post acquisition retained earnings)	
(80% × 2,692 – W1)	2,154
Goodwill impaired (100%) (W2)	(549)
	39,255

(5) **Cost of sales**

Harmonia SA	63,000
Basetla Sp. z o.o. (30,000 × 9/12)	22,500
Intra-group sales	(18,000)
URP in inventory	750
Additional depreciation	720
	68,970

The unrealised profit (PURP) in inventory is calculated as:

Intra-group sales are PLN 18 million of which Basetla has sold outside the group PLN 15 million leaving PLN 3 million (3/18) still in inventory at the year-end. The cost of goods sold by Harmonia SA to Basetla Sp. z o.o. was PLN 13,5 million giving Harmonia SA a profit of PLN 4,5 million (18m – 13,5m). The unrealised element of this is PLN 750,000 (PLN 4,5 million × 3/18).

The fair value adjustment applicable to tangible non-current assets is PLN 4,8 million. At the date of acquisition they have a remaining life of five years, which requires a calculation of some additional depreciation of PLN 960,000 per annum which requires apportioning by 9/12 = PLN 720,000.

(6) **<u>Current assets and liabilities</u>**

Current assets:	
Inventory (9,450+3,600 less 750 PURP)	12,300
Receivable (8,400 + 4,800)	13,200
Cash (4,650+3,600)	8,250
	33,750
Current liabilities	
Harmonia SA	15,000
Basetla Sp. z o.o.	5,900
	20,900

(c) <u>Harmonia SA – Goodwill recalculated at the fair value of NCI from the date of acquisition</u>

Goodwill

	PLN 000
Cost	15,420
FV of NCI at date of acquisition (W1)	3,900
Less 100% of Basetla net assets from date of acqn	(16,988)
	2,332
CRE (W4) & CSOCI (30%)	700
CSOFP (remaining)	**1,632**

(W1) Calculation of a fair value of NCI at the date of acquisition:

Number of Basetla's Sp. z o.o. shares acquired by non-controlling shareholders
Share capital of Basetla – 3,000 shares (PLN 1 nominal value) * 20% = 600 shares

Fair value of NCI at the date of acquisition = 600 shares * PLN 6.50 = **PLN 3,900**

32.

Financial performance of Ernon SA.

In both years Ernon SA maintain its profitability both on a gross profit and profit for the year levels. It seems that company's expansion to some new markets resulted in an improved performance in 2017 when sales grew by 40% while cost of sales increased disproportionately (50%) which suggests this expansion has been achieved at the expense profit margins (gross profit margin falls from 31% last year to 26% in 2017). Some competition existing on these markets must have caused a need for Ernon SA to decrease their sale prices in order to enter these markets.

Further analysis of other items of Ernon's SA performance shows that there has been very significant increase in distribution expenses (58% since last year) which suggest new markets enter into may be geographically dispersed. One could expect entering new markets would usually result with the increase of such expenses but such growth should remain in some relationship with main performance driver which is revenue (here revenue grows only by 40%).

Administrative expenses seems under control during such business expansion. It is worth to note that Ernon SA has invested acquiring some shares of another entity which became its associate (PLN 266m asset). It is possible that such associate is some local entity operation on a new market which Ernon SA entered, making a whole expansion little easier and more effective. As a result of such investment there is quite significant (PLN 120m) financial income being a share of the associate's profits. The overall profit for the year falls insignificantly since last year (8.4% in 2017 and 9.0% in 2016), however should there has not been such acquisition of the associate while expanding the business, the overall annual profit would fall to a very low level of 2.8% (see appendix). In fact the existence of the associate's profits share saved the annual profit (now growing by 30% from the last year) from massive decrease by 57% .

ROCE remains fairly stable from the last year (21% in 2017 and 22% in 2016) which for potential investor of Ernon SA seems a good news but it should be noticed that ROCE would be much higher as it was affected (depressing it) by significant increase in both non current assets revaluation (revaluation surplus grows by 131% from last year) and significant increase in borrowings (91% growth). While borrowings will remain over some future years (assuming financial resource borrowed will be successfully invested in Ernon's operations bringing some future benefits) then revaluation gains will not necessarily generate for Ernon SA economic benefits in the future. On a positive side it is worth to note that increased revenue in 2017 has helped to improve an efficiency in utilization of Ernon's non-current assets (they increased in 2017 by 19%) from 2.5 to 3 times.

Financial position of Ernon SA.

Even some quick overview of Ernon's SA financial statements bring some worrying observations which I shall summarise below:

1. Ernon SA moves from a positive cash balance in 2016 (PLN 33) to a significant overdraft in 2017 (PLN 56).
2. External financing represented by loans grows significantly by 91% from 2016 creating comparable growth in finance expenses, affecting drastically the annual profit in 2017
3. A general impression about the working management leaves some concerns – an evident deterioration from 2016.

As regards a long term financial position of Ernon SA it is worth to note that this company may be facing some financial stress in the future years as the massive increase in external financing in 2017 lifts company's gearing to 60% (it was 43% in 2016), its interest cover falls from 5.2 times (2016) to 3.7 times - all these impairs Ernon's ability to raise additional external finance should there be some need for it in the future. Additionally a significant finance costs (interest on loan which grows in 2017 by 100% (!) will continue to affect annual profits for some years to come (pls be reminded that thanks to share of associate's profits – PLN 120m – Ernon's overall profit for 2017 was saved but no one can tell how will this look in the future), what combined with decreasing interest cover may cause financial providers to increase cost of finance for existing Ernon's borrowings due to increasing financial risk related to Ernon.

The expansion has certainly put a pressure on working capital which unfortunately resulted in its management's deterioration. Some further analysis of the working capital management reveals that Ernon SA has significantly invested in their inventories in 2017 (growth by 123%) which caused inventory days to increase from 34 to 50 days in 2017. Not mentioning a risk of developing some obsolete inventories should this trend continue, there is quite a lot of financial resources invested in such extensive level of inventories. It seems that such growth in inventories is not supported by business expansion – see the analysis of performance above.

Receivables increased in 2017 by 84% (sales grow by 40% only) causing an average period of their collection to grow from 48 days (2016) to 63 days (2017) while at the same time balance of payables grew only by 46% in 2017 resulting in no change in number of days it takes Ernon to pay for their supplies (34 days in 2016 and 35 days in 2017). Significant financial investment in massive level of inventories and huge growth in credit sales with the overdraft at the year end, seems not to be properly supported by trader's credit which could be obtained from company's suppliers or other short term financing instruments. Combining the above it looks as if the company is experiencing currently financial difficulties which may soon develop into a serious liquidity problem (there is PLN 56m overdraft at the end of the year already). Such quick expansion of Ernon SA resembles some overtrading which is quite common when business try to grow too quickly having not adequate financial resources to do it.

Appendix

Ratio formulae	**2017**	**2016**
Gross profit margin = gross profit/sales revenue	558/2145 = 26%	476/1533 = 31%
Profit for year margin = profit for the year/sales	180/2145 = 8.4%	138/1533 = 9.0%
Profit for year margin excl. income from associate = profit for the year less income from associate/sales	180-120/2145 = 2.8%	
Gearing ratio = debt/equity	600/995 = 60%	315/731 = 43%
ROCE = profit before interest and tax/ equity and debt	(240+90)/(995+600) = 21%	(188+45)/(315+731) = 22%
Interest cover = profit before tax plus interest/interest	(240+90)/90 = 3.7 times	(188+45)/45 = 5.2 times
Non current assets turnover = sales/non current assets	2145/720 = 3 times	1533/606 = 2.5 times
Inventory days = closing inventory/cost of sales * 365	218/1587 * 365 = 50 days	98/1058 * 365 = 34 days
Receivables days = closing receivables/sales * 365	371/2145 * 365 = 63 days	201/1533 * 365 = 48 days
Payables days = closing payables/cost of sales * 365	149/1587 * 365 = 34 days	102/1058 * 365 = 35 days