Answers

Section C

Fit Co

a) Ratio calculations

Ratios		**Fit Co**		**Sporty Co**
Gross Profit	60,000/250,000*100%	24.0%	70,000/220,000*100%	31.8%
Operating profit	25,000/250,000*100%	10.0%	32,000/220,000*100%	14.5%
Trade payables days	35,000/190,000*365	67 days	12,000/150,000* 365	29 days
Return on Capital Employed	25,000/(90,000+45,000)*100%	18.5%	32,000/(60,000+15,000)*100%	42.7%
Gearing	45,000/90,000*100%	50%	15,000/60,000*100%	25%

b) Performance and position

Performance

As can be seen from the ratio calculations, Sporty Co has a higher gross profit margin than Fit Co, even though it has lower revenue overall. The reason for this could be that Sporty Co sources its items direct from the manufacturer, and so does not incur manufacturing costs.

Indeed, it is surprising that Fit Co has a lower GPM than Sporty Co given that it is selling premium branded goods – it would be expected that such goods would be sold at a higher margin.

The difference could also be a result of the competition suffered by Fit Co in the year, which may have led Fit Co to decrease its selling prices.

The gross profit margin of Fit Co may also fall further, as the gross profit margin of the Active division is 40%, which is much higher than Fit Co overall. Therefore, the underlying gross profit margin of the remaining Fit Co business would be expected to be lower than that shown for the current year.

The operating profit for Sporty Co is 4% higher than Fit Co. This is not surprising given that Sporty Co's GPM is higher than that of Fit Co. On closer inspection, Fit Co's OPM is inflated because of the non-recurring $5m gain on disposal. In addition to this, Fit Co profit for 31 December 20X0 includes central services income of $1.2m which will not recur following the disposal of the Active division. It is also worth noting that Fit Co will have a higher cost base, which would be expected as it operates its own stores, whereas Sporty Co uses department stores.

Sporty Co has a much higher return on capital employed than Fit Co, as it has a higher operating profit, and lower long-term debt and equity

Position

Fit Co has a gearing ratio twice that of Sporty Co, as it has much higher long-term debt. This makes Fit Co a riskier business than Sporty Co, as it must meet these debt repayments or would face insolvency.

As the gearing for Sporty Co is much lower than that of Fit Co, Sporty Co should be able to secure debt finance if needed for its planned international expansion.

Fit Co will incur much higher finance costs on its debt than Sporty Co, which is equity financed. Both companies can currently cover interest payments from operating profits however the cash balance for Fit Co is much lower than Sporty Co, which applies further

pressure to Fit Co as it must meet high interest payments. The current year interest payments for Fit Co exceed the cash balance at year-end, therefore Fit Co must ensure that its cash interest payments are sustainable in the long term.

Trade payables days are 67 for Fit Co and 29 for Sporty Co. This is consistent with the fact that Fit Co has a much lower cash balance than Sporty Co and shows that Fit Co are unable to pay suppliers quickly. This could lead to future problems with suppliers and shows that Fit Co needs to monitor its cash balance to ensure it can continue to trade in the long term.

Conclusion

Overall, it would appear that Sporty Co is in a better financial position than Fit Co, as it is more profitable, has lower debt, and should be able to access additional resources for its planned expansion.

Plank Co

(a)

Consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X8

			$000
Revenue		705,000 + (9/12 x 218,000) - 39,000	829,500
Cost of sales		Working 1	(346,000)
Gross profit			483,500
Distribution costs		58,000 + (9/12 x 16,000)	(70,000)
Administrative expenses		92,000 + (9/12 x 28,000)	(113,000)
Investment income	Share of profit of associate		30,300
	Other income	46,000 + (9/12 x 2,000) -5,000 - 12,250 - 15,300	14,950
Finance costs		12,000 + (9/12 x 14,000) - 5,000	(17,500)
Profit before tax			328,250
Income tax expense		51,500 + (9/12 x 15,000)	(62,750)
Profit for the year			265,500
Other comprehensive income:			
Gain on revaluation of land		2,800 + 3,000	5,800

Total comprehensive income for the year			271,300
Profit attributable to Parent			258,375
Profit attributable to NCI			7,125
			265,500
Total comprehensive income attributable to Parent			263,725
Total comprehensive income attributable to NCI			7,575
			271,300

Workings

W1) Cost of sales

Plank Co			320,000
Strip Co		81,000 x 9/12	60,750
Intercompany purchases			(39,000)
Additional depreciation on plant		$8 million / 3 years x 9/12	2,000
Unrealised profit adjustment	Plank to Strip	$39million x 1/4 x 30/130	2,250
			346,000

W2) Income from associate

Share of profit after tax	$92.57m x 35%	32,400

Unrealised profit	Plank to Arch	\$26m x 35% x 30/130	2,100
			30,300

W3) Share of profit/total comprehensive income to parent and NCI

Strip post acquisition profit	9/12 x 66,000	49,500
Less: Additional depreciation on machinery		(2,000)
		47,500
	x 15%	7,125
Profit as above		7,125
Other comprehensive income	3000 x 15%	450
		7,575

(b)

Investment in Associate		\$000
Carrying amount of investment at 31 December 20X7		145,000
Share of post-acquisition profits	\$92.57 million x 35% (W2)	32,400
Dividends paid	\$35 million x 35% (SOPL)	(12,250)
Unrealised profit adjustment	\$26 million x 30/130 x 35% (W2)	(2,100)

Carrying amount at 31 December 20X8	163,050

Marking Scheme

Fit Co

		Marks	*Marks*
(a)	Ratio calculations		**6**
(b)	Performance	9	
	Position & conclude	5	
			14
Total marks			**20**

		Marks	Marks
Plank Co			
(a)	Revenue to admin exp	6	
	Inv inc/associate	6	
	Fin tax OCI split	6	
			18
(b)	Inv in associate		**2**
Total marks			**20**