Answers

Section B

1 Zanda Co – Extracts from the consolidated statement of financial position as at 31 March 2016

		$'000
(i)	Goodwill (w (i))	1,400
(ii)	Retained earnings (w (ii))	16,342
(iii)	Non-controlling interest (w (iii))	4,920

Workings (figures in brackets are in $'000)

(i) Goodwill in Medda Co

	$'000	$'000
Controlling interest		
Share exchange (9,000 x 60% x 1/2 x $3·00)		8,100
Deferred consideration (9,000 x 60% x 0·54 x 1/1·08)		2,700
Non-controlling interest (9,000 x 40% x $1·50)		5,400
		16,200
Equity shares	9,000	
Pre-acquisition retained profits/losses:		
profit at 1 April 2015	8,600	
loss 1 April to 30 September 2015 (3,000 x 6/12)	(1,500)	
Fair value adjustments: plant	(2,500)	
deferred tax asset	1,200	14,800
Goodwill arising on acquisition		1,400

(ii) Consolidated retained earnings

	$'000
Zanda Co's retained earnings (12,200 + 5,000)	17,200
Medda Co's post-acquisition losses (1,200 (see below) x 60%)	(720)
URP in inventory (see below)	(630)
Finance cost of deferred consideration (2,700 (w (i)) x 8% x 6/12)	(108)
Profit on equity investments (6,100 – 5,500)	600
	16,342

The adjusted post-acquisition profits of Medda Co are:

Apportioned losses 1 October 2015 to 31 March 2016 (3,000 x 6/12)	(1,500)
Loss on equity investments (2,000 – 1,800)	(200)
Adjustment for over-depreciation on fair value of plant (2,500 x 6/30 months)	500
	(1,200)

Medda Co's inventory at 31 March 2016 is $2·43 million, at a mark-up on cost of 35% there would be $630,000 of unrealised profit (URP) (2,430 x 35/135) in inventory.

(iii) Non-controlling interest

	$'000
Fair value on acquisition (w (i))	5,400
Post-acquisition losses (1,200 (w (ii) x 40%)	(480)
	4,920

2 (a) Equivalent ratios for Nonat Co

		Nonat Co	Sector average
Return on capital employed	((3,100 + 1,800)/(23,600 + 16,400 + 2,100) x 100)	11·6%	18·5%
Net asset turnover	(62,500/40,000)	1·6 times	1·8 times
Gross profit margin	(10,700/62,500 x 100)	17·1%	21%
Operating profit margin	(4,900/62,500 x 100)	7·8%	10·3%
Current ratio	(16,400:9,300)	1·8:1	1·6:1
Gearing (debt/equity)	((16,400 + 2,100)/23,600)	78%	36%

(b) Analysis of comparative financial performance and position

Financial performance

As measured by the return on capital employed (ROCE), Nonat Co's overall profitability does not compare well with its competitors, underperforming the sector average profitability by over 37% ((18·5% – 11·6%)18·5%). The component parts of overall profitability are asset turnover and profit margins and, on both of these, Nonat Co considerably underperforms the sector average. The underperformance is worse for profit margins than for asset utilisation and indeed it is the gross margin which is the main cause of the unfavourable comparison. This may be due to a deliberate policy of underpricing competitors (to increase sales) or it may be due to inefficient manufacturing. Nonat Co's control of operating expenses, as shown by the difference between gross and operating profit margins, is relatively good (at 9·3% of revenue compared to 10·7% for the sector) which confirms that it is gross profit margin which is the problem area, assuming there are no differences in cost classification.

Nonat Co is generating approximately 11% ((1·8 – 1·6)/1·8) less revenue from its assets compared to the sector average which (as already noted) is also contributing to overall lower profitability (ROCE). Apart from the obvious implication that Nonat Co may be a less efficient manufacturer, there could also be a number of other reasons for the lower asset utilisation. Nonat Co has revalued its property, whereas it is not known if its competitors have (without the revaluation Nonat Co's ROCE would be 12·9% ignoring additional depreciation). Some of Nonat Co's plant may have been recently acquired and therefore may not be up to full production capacity, meaning the current year's revenue does not contain sales for a full year in respect of production from this plant. The leasing of plant is usually more expensive than outright purchase (although the finance costs would not affect ROCE). Of course other competitors may also experience some of these issues, the effects of which would be included in the sector average figures.

Financial position

The current ratio shows that the liquidity of Nonat Co is within expected norms and compares well with its competitors. There may be an argument to exclude the current finance lease liability from the current ratio which would then put it at 2·3:1 (16,400:7,200) which is perhaps a little higher than expected norms (usually an upper limit of 2).

Nonat Co's gearing is quite high at more than double that of its competitors. This obviously increases finance costs and with an interest cover of only 2·7 times (4,900/1,800), any downturn in profit may place Nonat Co in a difficult position. That said, a finance cost of 10% on the loan notes (plus the finance costs of the lease obligations) is a lower percentage than the ROCE so shareholders are getting a (slight) benefit from the debt, but this is at considerable risk.

It is tempting to say that if Nonat Co had not leased some of its plant its gearing would be more in line with the sector average, but this begs the question of how else would it have financed the plant. Issuing a further loan note would leave Nonat Co in a similar debt position as now; only a cash injection from a new share issue would reduce the gearing. Another possibility is that Nonat Co could structure its plant leases such that they qualified as operating rather than finance leases. Indeed, it may be that Nonat Co already has some operating leased plant, but this cannot be determined from the information provided.

Conclusion

Nonat Co is considerably underperforming its sector averages and the finance director is correct to say that a comparison with its competitors is a better indication of Nonat Co's current performance than looking at the past trend of its own performance, subject to the definitions and accounting policies used by other companies in the sector.

The analysis indicates Nonat Co may need to look at its pricing policy or manufacturing efficiency and also needs to investigate a strategy of reducing its gearing.

3 (a) Downing Co – Statement of profit or loss and other comprehensive income for the year ended 31 March 2016

	$'000
Revenue (267,900 – 1,200 (w (i)) + 18,750 (w (ii)))	285,450
Cost of sales (w (iii))	(192,500)
Gross profit	92,950
Distribution costs	(20,000)
Administrative expenses	(22,000)
Other operating income from royalties	300
Finance costs (150 + 2,206 (w (v)))	(2,356)
Profit before tax	48,894
Income tax expense (11,400 + 1,550 – 1,100 (w (vi)))	(11,850)
Profit for the year	37,044
Other comprehensive income	
Items that will not be reclassified to profit or loss	
Gain on revaluation of land and buildings (2,000 + 7,200) (w (iv))	9,200
Total comprehensive income for the year	46,244

(b) Downing Co – Statement of changes in equity for the year ended 31 March 2016

	Share capital $'000	Other equity $'000	Revaluation surplus $'000	Retained earnings $'000	Total equity $'000
Balance at 1 April 2015	25,000	11,800	nil	8,000	44,800
Equity option (w (v))		2,430			2,430
Total comprehensive income for the year			9,200	37,044	46,244
Transfer to retained earnings (w (iv))			(400)	400	nil
Balance at 31 March 2016	25,000	14,230	8,800	45,444	93,474

(c) Downing Co – Statement of financial position as at 31 March 2016

	$'000	$'000
Assets		
Non-current assets (w (iv))		
Property, plant and equipment (65,300 (w (iv)) + 39,100)		104,400
Patent		3,400
		107,800
Current assets		
Inventory	32,100	
Contract asset (w (ii))	8,750	
Trade receivables	38,500	79,350
Total assets		187,150
Equity and liabilities		
Equity		
Equity shares of $1 each		25,000
Other components of equity	14,230	
Revaluation surplus	8,800	
Retained earnings	45,444	68,474
		93,474
Non-current liabilities		
Deferred tax (w (vi))	3,700	
Deferred revenue (w (i))	800	
5% convertible loan note (2018) (w (v))	28,276	32,776
Current liabilities		
Trade payables	46,400	
Deferred revenue (w (i))	400	
Bank overdraft	2,700	
Current tax payable	11,400	60,900
Total equity and liabilities		187,150

Workings (figures in brackets in $'000)

(i) Product and servicing sale

Under IFRS 15 *Revenue from Contracts with Customers*, sales made which include revenue for on-going servicing work must have part of the revenue deferred and any discount offered to stand-alone selling prices must (normally) be allocated to each component pro rata to the stand-alone selling prices.

The stand-alone selling price of the product and the servicing work would be $20 million ($18 million and $2 million (500 x 4 years) respectively). The actual combined selling price of $16 million represents a 20% discount on the stand-alone selling prices ((20,000 – 16,000)/(18,000 + 2,000)). Thus the sales revenue of $16 million would be allocated $14·4 million (18,000 x 80%) to the product and $1·6 million (2,000 x 80%) to the servicing. At 31 March 2016 there are three more years of servicing work, thus $1·2 million ((1,600 x 3 years/4 years) must be treated as deferred revenue, split $400,000 as a current liability and $800,000 as a non-current liability.

(ii) Contract with customer

	$'000
Total transaction price	30,000
Total estimated costs	24,000
Estimated total profit	6,000

Based on an input method (cost) basis to determine the completion of the contract, it is 62·5% complete (15,000/24,000 x 100). Thus the profit for the year to 31 March 2016 is $3·75 million (6,000 x 62·5%); $18·75 million (15,000 + 3,750) will be recognised as revenue; and $15 million as cost of sales.

The contract asset will be $8·75 million (18,750 – 10,000) received.

(iii) Cost of sales

	$'000
Per trial balance	166,600
Contract costs (w (ii))	15,000
Depreciation of building (w (iv))	2,900
Depreciation of plant and equipment ((82,700 – 36,700) x 15%)	6,900
Amortisation of patent (7,500/10 years)	750
Impairment of patent (w (iv))	350
	192,500

(iv) Non-current assets

Land and buildings:
The gain on revaluation and carrying amount of the land and buildings is:

	Land $'000		Building $'000
Carrying amount as at 1 April 2015	14,000	(50,000 – 5,000)	45,000
Revalued amount as at this date	(16,000)		(52,200)
Gain on revaluation	2,000		7,200
Building depreciation year to 31 March 2016 (52,200/18 years)			2,900

The carrying amount of land and buildings at 31 March 2016 is $65·3 million (16,000 + (52,200 – 2,900).

The transfer from the revaluation surplus to retained earnings in respect of the annual realisation of the surplus is $400,000 (7,200/18 years).

The carrying amount of plant and equipment at 31 March 2016 is $39·1 million (82,700 – (36,700 + 6,900)).

The carrying amount of the patent at the date of the impairment (31 March 2016) is $3·75 million (7,500 – (3,000 + 750)), the higher of its fair value (3,400) and its value in use (3,250) is $3·4 million, thus the patent is impaired by $350,000 (3,750 – 3,400).

(v) 5% convertible loan note

The convertible loan notes are a compound financial instrument having a debt and an equity component which must both be quantified and accounted for separately:

Year ended 31 March	Outflow $'000	8%	Present value $'000
2016	1,500	0.93	1,395
2017	1,500	0.86	1,290
2018	31,500	0.79	24,885
Debt component			27,570
Equity component (= balance)			2,430
Proceeds of issue			30,000

The finance cost for the year will be $2,206,000 (27,570 x 8%) and the carrying amount of the loan at 31 March 2016 will be $28,276,000 (27,570 + (2,206 – 1,500)).

(vi) Deferred tax

	$'000
Provision required as at 31 March 2016 (18,500 x 20%)	3,700
Less provision b/f	(4,800)
Credit to statement of profit or loss	1,100

(d) The issue of the 5% convertible loan notes is the reason why Downing Co has to disclose a figure for diluted EPS in addition to its basic EPS. When the convertible loan notes are due for redemption on 31 March 2018, there is the potential that they will be converted into equity shares which would increase the number of equity shares in issue. At the same time there will also be a saving in the after tax interest which will no longer be paid to the loan note holders, however, this will be proportionately less per share than is currently generated from earnings per share (otherwise there would not be a dilution) and thus the EPS will be diluted or 'watered down'. In reality, it is possible that the convertible loan notes, or a proportion of them, will be redeemed for cash which would not cause a dilution, however, IAS 33 *Earnings per Share* requires that maximum possible dilution has to be assumed when calculating the diluted EPS.

Despite this, the CEO seems mistaken as to what the diluted EPS figure actually means; it does **not** mean that this will be the EPS in the near future (or at the time of redemption). The future EPS will be based on future earnings and the (weighted average) number of shares actually in issue in that future year. Rather, the diluted EPS figure should be seen as a sort of warning. It is saying that, based on existing circumstances, if the dilution had already taken place, i.e. that the convertible shares had already been redeemed for equity (at the maximum possible number of new shares), the diluted EPS as disclosed would have been the figure reported as the actual (basic) EPS.

So, although the CEO does not fully understand what the diluted EPS figure means, it does indicate to investors the possibility of a future dilution of EPS; and with the dilution being a sizable 19% lower than the basic EPS, it may well cause an adverse reaction in the market price of the Downing Co's shares.

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.

				Marks
Section B				
1		Extracts from Zanda Co's statement of financial position		
	(i)	Goodwill		**6**
	(ii)	Retained earnings		**7**
	(iii)	Non-controlling interest		**2**
			Total for question	**15**
2	**(a)**	1 mark per ratio		**6**
	(b)	1 mark per valid comment		**9**
			Total for question	**15**
3	**(a)**	Statement of profit or loss and other comprehensive income		
		revenue		2½
		cost of sales		3
		distribution costs		½
		administrative expenses		½
		other operating income from royalties		½
		finance costs		1½
		income tax expense		1½
		gain on revaluation of land and buildings		1
				11
	(b)	Statement of changes in equity		
		balances b/f		1
		equity option		1
		total comprehensive income		1
		transfer of revaluation surplus to retained earnings		1
				4
	(c)	Statement of financial position		
		property, plant and equipment		1½
		patent		1
		inventory		½
		contract asset		1
		trade receivables		½
		deferred tax		1
		deferred revenue: non-current		½
		5% convertible loan note		1½
		trade payables		½
		current tax payable		1
		deferred revenue: current		½
		bank overdraft		½
				10
	(d)	1 mark per valid point to maximum		**5**
			Total for question	**30**