
Answers

Section C

31 (a) Restated financial information

Statement of profit or loss

	20X4 \$'000
Revenue (54,200 – 2,100 (note (i)))	52,100
Cost of sales (21,500 – 1,200 (note (i)))	(20,300)
Gross profit	31,800
Operating expenses (W1)	(12,212)
Profit before tax	<u>19,588</u>

W1: Restatement of operating expenses

	20X4 \$'000
As per question	11,700
Less: expenses relating to non-core division	(700)
Less: loss on disposal of non-core division	(1,500)
Less: Gamilton management charge (54,200 x 1%)	(542)
Add: Funject management charge (31,800 x 10%)	3,180
Less: rent charged by Gamilton	(46)
Add: commercial rent	120
Restated operating expenses	<u>12,212</u>

- (b) Profit has decreased from \$21,000,000 to \$19,588,000 and the resulting journal entry will be (\$'000s):

Dr Retained earnings (21,000 – 19,588)	\$1,412	
Cr Cash		\$1,412

Ratio calculations

	Workings	20X4
Gross profit margin	31,800/52,100 x 100	61%
Operating profit margin	19,588/52,100 x 100	38%
Receivables collection period (days)	(5,700/52,100) x 365	40
Current ratio	<u>(12,900 – 1,412)</u> (11600)	1:1
Acid test (quick)ratio	(12,900 – 4,900 – 1,412)/(11,600)	0.57:1
Gearing (debt/equity)	<u>16,700</u> (9,000 – 1,412)	220%

(c) Commentary on performance

Profitability

The discontinued operation had a gross profit % (GP%) of 43% (900/2,100 x 100) and an operating profit % (OP%) of 10% (200/2,100 x 100). Before adjusting for the disposal, Aspect Co has a GP% of 60%. After an adjustment has been made to reflect the disposal, Aspect Co's GP% is 61% which is higher than the industry average of 45%. Thus, it would appear that the disposal of the non-core division has had a positive impact on the GP% of Aspect Co. Such a positive comparison of the GP% to the industry average would suggest that Aspect Co has negotiated a very good deal with its suppliers for the cost of goods in comparison to its competitors; the GP% is 16% (61 – 45) higher than the industry average. However, when considering the OP%, the financial statements have been adjusted to reflect: (i) the disposal of the discontinued operation; (ii) a new management charge which would be imposed by Funject Co; and (iii) commercial rent charges. These adjustments result in an OP% of 38%. So, although the OP% is still 10% (38 – 28) higher than the industry average, it would appear that some of the advantage of having such a good deal with its suppliers is lost when operating costs are incurred. The OP% does not outperform the industry average to the same extent that GP% did. Although the management charge will be eliminated as an intra-group transaction on consolidation, it will still have an impact in the individual financial statements of Aspect Co. However, there is no indication of what this charge is for and whether or not it represents a market value for these costs. The rent of \$120,000 is deemed to be a fair market value which would indicate that the previous rent charge of \$46,000 was artificially low. If Funject Co acquires Aspect Co, it may wish to capitalise on the relationship which Aspect Co has with its supplier of goods but it might also need to investigate the composition of operating costs other than those described above to see if any of these can be avoided/reduced.

Liquidity

Aspect Co's receivables collection period appears to be comparable with the KPIs provided (40 days in comparison to 41 days). Terms of trade of 30 days are quite reasonable (though this usually depends on the type of business) and so there are no causes for concern here.

Given that Aspect Co's receivables collection period is comparable to the industry average, the difference in the current ratio (1.1:1 in comparison to 1.6:1) can only be explained by either lower current assets other than receivables (for example, cash) or higher current liabilities. As Aspect Co's cash balance does not appear to be low (\$2.3m), this suggests that its liabilities might be higher than average. Perhaps Aspect Co's favourable relationship with its suppliers also extends to longer than average credit terms. As Aspect Co's acid (quick) ratio (0.57:1) is much less than the industry average (1.4:1), this would also suggest that Aspect Co is holding a higher than average level of inventory. This may raise a concern about Aspect Co's ability to sell its inventory. There is also a current tax bill to consider. Indeed, if Aspect Co were asked to settle its current liabilities from merely its receivables and bank, it would be unable to do so. Perhaps Funject Co may wish to further investigate the procedures associated with the purchase and holding of Aspect Co's inventory prior to a takeover. As a parent company, Funject Co should be able to influence these procedures and have more control over the levels of inventory held.

Gearing

Aspect Co appears to be highly geared but perhaps this is not a huge cause for concern because it appears to be a highly geared industry (220% compared to 240%). It may be that the proceeds from the sale of the non-core division can be/were used to pay down loans. As the gearing for the industry is higher than that of Aspect Co, it may be that Aspect Co could still increase borrowings in future. If so, Aspect Co may need to increase working capital efficiency and reduce costs in order to generate enough cash to service higher borrowings.

Conclusion

Overall, Aspect's statement of financial position gives little cause for concern; the profitability margins appear to be healthy although further investigations of operating costs and working capital efficiency may be required. More information also needs to be obtained about the nature of the business and perhaps the financial statements of several years (as opposed to one) might also be beneficial.

32 Dargent Co – Consolidated statement of financial position as at 31 March 20X6

	\$'000	\$'000
Assets		
Non-current assets:		
Property, plant and equipment (75,200 + 31,500 + 4,000 re mine – 200 depreciation)		110,500
Goodwill (w (i))		11,000
Investment in associate (4,500 + 1,200 (w (iii)))		5,700
		<u>127,200</u>
Current assets		
Inventory (19,400 + 18,800 + 700 GIT – 800 URP (w (ii)))	38,100	
Trade receivables (14,700 + 12,500 – 3,000 intra group)	24,200	
Bank (1,200 + 600)	<u>1,800</u>	64,100
Total assets		<u>191,300</u>
Equity and liabilities		
Equity attributable to owners of the parent		
Equity shares of \$1 each (50,000 + 10,000 ((w (i)))		60,000
Other equity reserves (share premium) (w (i))	22,000	
Retained earnings (w (iii))	<u>37,390</u>	59,390
		<u>119,390</u>
Non-controlling interest (w (iv))		9,430
Total equity		<u>128,820</u>
Non-current liabilities		
8% loan notes (5,000 + 15,000 consideration)	20,000	
Accrued loan interest (w (iii))	300	
Environmental provision (4,000 + 80 interest (w (iii)))	<u>4,080</u>	24,380
Current liabilities (24,000 + 16,400 – (3,000 – 700 GIT) intra group (w (ii)))		<u>38,100</u>
Total equity and liabilities		<u>191,300</u>

Workings (figures in brackets are in \$'000)

(i) Goodwill in Latree Co

	\$'000	\$'000
Controlling interest		
Share exchange (20,000 x 75% x 2/3 = 10,000 x \$3.20)		32,000
8% loan notes (20,000 x 75% x \$1000/1,000)		15,000
Non-controlling interest (20,000 x 25% x \$1.80)		<u>9,000</u>
		56,000
Equity shares	20,000	
Retained earnings at 1 April 2015	19,000	
Earnings 1 April 2015 to acquisition (8,000 x 9/12)	6,000	
Fair value adjustments – asset re mine	4,000	
– provision re mine	<u>(4,000)</u>	<u>(45,000)</u>
Goodwill arising on acquisition		<u>11,000</u>

The share exchange of \$32 million would be recorded as share capital of \$10 million (10,000 x \$1) and share premium of \$22 million (10,000 x (\$3.20 – \$1.00)).

Applying the group policy to the environmental provision would mean adding \$4 million to the carrying amount of the mine and the same amount recorded as a provision at the date of acquisition. This has no overall effect on goodwill, but it does affect the consolidated statement of financial position and post-acquisition profit.

(ii) The inventory of Latree Co includes unrealised profit (URP) of \$600,000 (2,100 x 40/140). Similarly, the goods-in-transit sale of \$700,000 million includes URP of \$200,000 (700 x 40/140).

(iii) Consolidated retained earnings:

	\$'000
Dargent Co's retained earnings	36,000
Latree Co's post-acquisition profit (1,720 x 75% see below)	1,290
Unrecorded share of Amery's retained profit ((6,000 – 2,000) x 30%)	1,200
Outstanding loan interest at 31 March 2016 (15,000 x 8% x 3/12)	(300)
URP in inventory (w (ii))	<u>(800)</u>
	<u>37,390</u>

The adjusted post-acquisition profits of Latree Co are:

As reported and time apportioned (8,000 x 3/12)	2,000
Interest on environmental provision (4,000 x 8% x 3/12)	(80)
Additional depreciation re mine (4,000/5 years x 3/12)	<u>(200)</u>
	<u>1,720</u>

(iv) Non-controlling interest

	\$'000
Fair value on acquisition (w (i))	9,000
Post-acquisition profit (1,720 x 25% (w (iv)))	<u>430</u>
	<u>9,430</u>

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.

Section C	<i>Maximum marks</i>	<i>Awarded</i>
31 (a) Adjustment to revenue and cost of sales	1	
Disposal of non-core division	1	
Management charge (remove old, add new)	2	
Rent expense (remove current, add commercial)	1	
	<u>5</u>	
(b) Calculation of ratios	<u>5</u>	
(c) Profitability comments	5	
Liquidity comments	3	
Gearing comments	1	
Conclusion	1	
	<u>10</u>	
	<u>20</u>	
32 Property, plant and equipment	2	
Goodwill: consideration	2.5	
Goodwill: fair value net assets	2	
Investments in associate	1	
Inventory	1.5	
Receivables	1	
Bank	0.5	
Equity shares and share premium	1	
Retained earnings: post-acquisition sub	2	
Retained earnings: other	2	
Non-controlling interests	1.5	
8% loan notes	0.5	
Environmental provision	1.5	
Current liabilities	1	
	<u>20</u>	



F7 Examiner's commentary on March/June 2017 sample questions

This commentary has been written to accompany the published sample questions and answers and is written based on the observations of markers. The aim is to provide constructive guidance for future candidates and their tutors, giving insight into what the marking team is looking for, and flagging pitfalls encountered by candidates who sat these questions.

Question 31

This question initially required candidates to make a number of adjustments to profit for the effect of the disposal of a division and to revised management and rent charges for a company noted as a possible acquisition within the same industry. The second part required the calculation of six ratios equivalent to those given as comparable industry averages. The third part required an analysis of the company's performance and position comparing it to the industry averages taking into account the effect of the disposal.

Most of the profit adjustments were dealt with correctly although it was not always clear whether the adjustments increased or decreased profit. In this type of requirement, full credit can only be given if the answer clearly distinguishes between increases or decreases. Showing decreases in brackets is an effective convention here.

For the ratio calculations it was expected the revised figures from the first part would be used and, in line with the "own figure rule" used throughout marking, credit was given for candidates' own adjusted figures. The question clearly stated that the "duality" effect of the net adjustment should be a corresponding increase or decrease to cash which would impact on financial position ratios. Many candidates did not make any such adjustment which meant they calculated incorrect current and acid test ratios.

A number of candidates calculated the receivables collection period (days) as $\text{trade receivables}/\text{cost of sales} \times 365$. There is no underlying logic to this calculation; the use of credit sales gives the most logical denominator, but total revenue is an acceptable substitute.

A significant minority of candidates did not show their workings for the ratios; as these calculations were based on the revised figures markers expected to see the underlying figures on which they were based. Without background figures to support the ratio, an incorrect result gained no marks.

In many cases, the analysis showed little if any insight into the scenario. Most answers confined themselves to giving a textbook based explanation of what the ratio told users and whether the company's ratio was higher or lower than the industry average. Some answers went on to suggest whether the company ratios were better or worse than the industry averages, but very few provided any further analysis. Better answers referred to the differing performance of the division disposed of and its impact on the company's results. The difference in performance at the gross profit level between the company and the industry averages was not reflected at the operating margin level which therefore required comment regarding the company's control of its operating expenses compared to the industry. Few answers referred to the likely implications if the company was acquired, particularly in relation to the revised rent and management charges. With respect to working capital management there were issues regarding inventory management and cash resources in relation to current liabilities that would be important for an acquirer.

Although a report format was not specifically required, many candidates did provide a short conclusion to their analysis and this is encouraged.

It was encouraging that the majority of candidates on this diet managed their time sufficiently well to make an attempt at the analysis/written part of this question. However, candidates are expected to provide reasons or

changes or (as in this case) differences in ratios, using the given scenario, to secure good marks on this type of question.

Question 32

This question required the preparation of a consolidated statement of financial position including many adjustments similar to those seen in recent past exams.

Most candidates prepared good consolidation workings, including the time-apportioned retained earnings at the date of acquisition, and few made any errors with the calculation of the purchase consideration on the acquisition of the subsidiary. The intra-group balances, goods in transit and the principles behind the investment in the associate were generally dealt with to allow candidates to earn high or maximum marks.

The main problems candidates encountered with this question were:

- there was an asset that required decommissioning as part of the fair value adjustment exercise. What very few candidates realised (another example of "duality") is that this required the recognition of both an asset **and** a liability, for the same amount, at the date of acquisition.
- although neutral with regards to goodwill, this did require a depreciation charge on the asset and a finance cost (unwinding the discount) on the liability, both as part of the subsidiary's post-acquisition profits and to determine the correct amounts for the asset and the liability/provision in the consolidated statement of financial position
- the associate had paid a dividend and the investor had already accounted for this. Under equity accounting principles the carrying value of the investment in the associate should be increased by the investor's share of the associate's **retained** profit for the year rather than its profit for the year.
- the unrealised profit on inventories should have been in respect of the inventory held by the buying company **and** the goods in transit; the latter adjustment was frequently omitted.
- accounting for the shares issued as part of the purchase consideration was often forgotten in the parent's share capital and share premium balances
- accounting for the loan issued as part of the purchase consideration was also often forgotten in the consolidated non-current liabilities; the accrued interest on the loan was also omitted by most candidates
- some candidates time apportioned the subsidiary's assets and liabilities for which there is no underlying logic in a statement of financial position.