Answers

Section C

31 (a) Inventory adjustment

The disposal of the inventory at a discounted price would be classified as an adjusting event in accordance with IAS® 10 *Events After the Reporting Period*.

Retail price of the inventory	\$1·5 million; GP margin 20% = \$0·3 million
Closing inventory (currently credited to SOPL)	\$1·2 million

A write down to NRV would require a \$0·6m charge to cost of sales thereby increasing it to \$70·6 million and reducing profit from operations to \$12·56 million. In the statement of financial position, inventory is written down to \$3·36 million and retained earnings will be adjusted to \$32·28 million.

	Buns Co	Sector average
Return on year-end capital employed (12,560/(32,280 + 14,400) x 100)	26·9%	18·6%
Operating profit margin (12,560/100,800 x 100%)	12·5%	8·6%
Inventory holding period (days) (3,360/70,600 x 365)	17·4 days	4 days
Debt to equity (debt/equity) (14,400/32,280 x 100)	44·6%	80%
Asset turnover (100,800/46,680)	2·16	2·01

(b) Analysis of financial performance

Profitability

The primary measure of profitability is the return on capital employed (ROCE) and this shows that Buns Co (26·9%) is outperforming the sector (18·6%). The ROCE measures the operating profit relative to the equity employed in the business. As a percentage, it would appear that Buns Co is 31% ((26·9 – 18·6)/26·9) more efficient that its competitors. However, this ratio should be treated with caution because Bun Co's capital employed includes its revaluation surplus associated with the property. If Buns Co's competitors did not revalue their property, then the ratio is not directly comparable; for example, if Buns Co's revaluation surplus were to be excluded from capital employed, it would increase ROCE to be even higher than the sector average.

As there is little difference between the asset turnover of Buns Co and that of the sector, it would appear that the main cause of ROCE over-performance is due to a significantly higher operating profit margin (12·5% compared to 8·6%). Offering meal deals is advisable, as the company can still afford to reduce its prices and still make a high operating profit margin compared to the industry sector average. By offering meal deals at reduced prices, Buns Co would look to increase their sales volume and therefore this may help them to control and reduce inventory days.

Alternatively, it may be that Buns Co has better control over its costs (either direct or indirect costs or both) than its competitors; for example, Buns Co may have lower operating costs. As Buns Co owns 80% of its non-current assets in the form of property, this means that it is not paying any rent, whereas its competitors may be. Buns Co's competitors may prefer to lease premises which could be a more flexible basis on which to run a business, but often more costly.

Financial position (limited to inventory and gearing)

In a company like Buns Co, it is expected that inventory would be turned into cash in a relatively short period of time. Buns Co is taking significantly longer than its competitors to sell its inventory which is being held on average for 17 days instead of four days as per the sector average. The main worry is that the inventory is largely perishable. It may be that, since the acquisition of the brand, Buns Co pursued a higher pricing strategy but this may be having a detrimental impact on the company's ability to move its inventory.

Buns Co's debt to equity at 44·6% is lower than the sector average of 80%. This could be because Buns Co acquired its property which has no associate finance. This also means that there will be smaller amounts of interest charged to the statement of profit or loss but this is difficult to confirm as the extract provided is only to profit from operations. There is a bank loan of \$14·4m and, although the bank loan interest rate of 10% might appear quite high, it is lower than the ROCE of 26·9% (which means shareholders are benefiting from the borrowings). Finally, Buns Co also has sufficient tangible non-current assets to give more than adequate security on any future borrowings. Therefore there appears to be no adverse issues in relation to gearing.

Conclusion

Buns Co is right to be concerned about its declining profitability compared to previous years, but from the analysis compared to the industry sector averages, it seems that Buns Co may be in a strong position. The information shows that Buns Co has a much better profitability compared to the industry, but the worrying issue which could become a long-term problem is the length of time Buns Co is holding inventory. Buns Co should seriously consider the strategy of reducing their prices to enable them to sell more inventory and reduce wastage. Should Buns Co wish to raise finance in the future, it seems to be in a strong position to do so.

(c) Factors which may limit the usefulness of the comparison with business sector averages

It is unlikely that all the companies which have been included in the sector averages will use the same accounting policies. In the example of Buns Co, it is apparent that it has revalued its property; this will increase its capital employed and (probably) lower its gearing (compared to if it did not revalue). Other companies in the sector may carry their property at historical cost.

There could also be differences as Buns Co owns the shop, and yet other companies in the sector may not own the freehold and may just rent the shop space. Dependent on how the depreciation compares to the equivalent rate would lead to differences in the margins experienced by each company.

The accounting dates may not be the same for all the companies. In this example the sector averages are for the year ended 30 June 20X7, whereas Buns Co's are for the year ended 30 December 20X7. If the sector is exposed to seasonal trading (which could be likely if there are cakes made for Christmas orders, large bread orders for Christmas and New Year parties), this could have a significant impact on many ratios, in particular working capital based ratios. To allow for this, perhaps Buns Co could prepare a form of adjusted financial statements to 30 June 20X7.

It may be that the definitions of the ratios have not been consistent across all the companies included in the sector averages (and for Buns Co). This may be a particular problem with ratios like gearing as there are alternative methods used to calculate it (inventory days used costs of sales in the calculation, but industry could use purchases). Often agencies issue guidance on how the ratios should be calculated to minimise these possible inconsistencies. Of particular relevance in this example is that it is unlikely that other bakery stores will have a purchased trademark.

Sector averages are just that: averages. Many of the companies included in the sector may not be a good match to the type of business and strategy of Buns Co. This company not only has bakery stores but cafés too and this may cause distortions if comparing to companies within the sector who do not have the same facilities. Also, some companies may adopt a strategy of high-end specialist loaves, cakes and patisserie goods which have high mark-ups, but usually lower inventory turnover, whereas other companies may adopt a strategy of selling more affordable bread and cakes with lower margins in the expectation of higher volumes.

32 (a) Runner Co consolidated statement of financial position as at 31 March 20X5

	$'000	$'000
Assets		
Non-current assets		
Property plant and equipment (455,800 + 44,700+ 9,000 (w1))		509,500
Investment		12,500
Goodwill (w2)		20,446
		542,446
Current assets		
Inventory (22,000 + 16,000 – 720 (w4))	37,280	
Trade receivables (35,300 + 9,000 – 3,000 – 3,400)	37,900	
Bank (2,800 + 1,500 + 3,000)	7,300	82,480
Total assets		624,926
Equity and liabilities		
Equity attributable to the owners of the parent		
Equity shares of $1 each		202,500
Retained earnings (w5)		290,950
		493,450
Non-controlling interest (w3)		14,476
Total equity		507,926
Current liabilities (81,800 + 17,600 – 3,400)	96,000	
Deferred consideration (19,446 + 1,554)		
	21,000	117,000
Total equity and liabilities		624,926

Workings

(1) Net assets of Jogger Co

	Year-end $'000	**Aquisition $'000**	**Post-aquisition $'000**
Share capital	25,000	25,000	0
Retained earnings	28,600	19,500	9,100
Fair value adjustment	9,000	10,000	(1,000)
Unrealised profit	(720)	0	(720)
	61,880	54,500	7,380

(2) **Goodwill in Jogger Co**

	$'000	$'000
Cost of investment: Cash	42,500	
Deferred consideration (21,000 x 0·926)	19,446	61,946
Non-controlling interest		13,000
		74,946
Less: Net assets acquired (w1)		(54,500)
Goodwill		20,446

(3) **Non-controlling interest**

	$'000
NCI at acquisition	13,000
NCI share of post-acquisition reserves (7,380 x 20%)	1,476
	14,476

(4) **Intercompany transaction**

	$'000
Inventory held at year end	4,800
Unrealised profit (4,800 x 15%)	720

(5) **Retained earnings**

	$'000
Runner Co	286,600
Runner Co's share of Jogger Co's post-acquisition RE (7,380 (w1) x 80%)	5,904
Unwinding discount on deferred consideration (21,000 – 19,446 (w1))	(1,554)
	290,950

(b) Runner Co has significant influence over Walker Co, therefore Walker Co should be treated as an associate in the consolidated financial statements, using the equity method.

In the consolidated statement of financial position, the interest in the associate should be presented as 'investment in associate' as a single line under non-current assets. The associate should initially be recognised at cost and subsequently adjusted each period for the parent's share of the post-acquisition change in net assets (retained earnings). This figure should be reviewed for impairment at each year end which given the fall in value of the investment due to the loss would be most likely.

Calculation:

	$'000
Cost of investment	13,000
Share of post-acquisition change in net assets ((30,000 x 30%) = 9,000)	(9,000)
	4,000

Section C

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32	**(a)**	PPE and investments	2
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		Current assets	3·5
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FR Examiner's commentary on September/December 2019 sample questions

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

BUN

This question required candidates to complete three tasks, with the majority of the marks available for an analysis of the financial performance and position of Bun Co, a single entity in comparison to the industry average.

There were two aspects to part (a). Candidates were first required to adjust the financial statements in respect of an adjusting event relating to inventory in accordance with IAS 10 *Events After the Reporting Period*. After the reporting date, further information about the selling price of inventory became known and, therefore, inventory was required to be restated to its net realisable value in accordance with IAS 2 *Inventories*. Many candidates correctly identified the adjustment of $0·6 million, however, the marking team commented on numerous incorrect calculations being demonstrated. The calculation of the adjustment was only a small part of the question, as subsequent use of this amount to adjust the financial statements was awarded marks under the own figure rule. Some candidates did attempt to adjust cost of sales but many incorrectly deducted the inventory write down, which would further increase the inventory value in profit or loss. It was very disappointing to note that most candidates did not attempt to adjust retained earnings for the inventory write down despite there being a clear impact on the profit reported for the period.

Once the adjustment to the financial statements was complete, candidates were required to calculate five ratios using the adjusted financial statements. Candidates were able to score full marks here using their own balances following the inventory adjustment. Despite having attempted the adjustments, many candidates continued to calculate the ratios using the unadjusted financial statement figures and therefore were unable to score the full marks available. The marking team noted that despite numerous, past examiner reports, candidates continue to provide ratio calculations without the supporting workings. Markers are unable to award own figure marks for incorrect calculations if the workings are not provided.

Interestingly, many candidates calculated 'gearing' using the debt to debt plus equity formula, even though the question specifically stated debt to equity. This resulted in a relatively easy mark being lost. It is vital that you read the information in the question carefully and provide your answers accordingly.

Part (b) required candidates to assess the financial performance and position of Bun Co in comparison to the industry average. Performance on this question was disappointing compared to previous analysis questions. The marking team noted a significant increase in the number of responses which gave a superficial analysis. Typical comments simply cited the movements in the ratios, some then provided 'textbook responses' as a reason for the change and ignored the scenario to aid the analysis. Such responses continue to attract relatively few, if any, marks and candidates are once again reminded that the scenario given in the question MUST be used to earn the marks available.

The marking team were pleased to note that many candidates continued to attempt a conclusion to their analysis. This is something that candidates should be encouraged to continue to do.

ACCA

Finally, part (c) required candidates to explain three possible limitations of the comparison between Bun Co and the industry average. Many candidates were able to identify some limitations such as different accounting policies, but often, these were presented as a list rather than explained as per the requirement. In some instances, candidates gave generic limitations of ratio analysis rather than relating to industry specific limitations and markers were unable to award marks. Responses must relate to the question asked.

RUNNER

Part (a) to this question required candidates to prepare a consolidated statement of financial position. Overall, the performance on this part of the question was very good with many candidates achieving close to full marks. However, there were some common errors noted by the marking team and these will be discussed below.

A pleasing observation made by the marking team was that there appeared to be an increase in the number of candidates who were showing their workings when compared to previous diets. However, not all candidates provided workings and it continues to be the case that where no workings are shown and a candidate response is incorrect, then the marking team are unable to award any marks. For example, current liabilities in this question were $96m (calculated as $81·8m + $17·6m – $3·4m). If a candidate successfully calculated $96m and did not show a calculation, then, as the amount is correct, markers were able to award the marks in full. However, if a candidate had calculated this as $65·4m and not provided a working, then this is incorrect and there would be no marks allocated to current liabilities. In reality, however, the $65·4m may have been calculated by ignoring a decimal place in the working such as $81·8m + $17·6m – $34m. If the candidate had shown this working, then the marker would continue to allocate the marks accordingly. It is therefore vital that candidates show all workings for calculations made in the exam.

Candidates were required to discount the deferred cash payment to present value at acquisition using the discount factor provided in the question. This is a common adjustment associated with consolidated financial statements. Some candidates did not attempt to discount the future consideration at all, however, it was pleasing to see that a significant majority discounted to present value correctly. For those candidates who did discount successfully, a proportion of these responses did not subsequently unwind the discount at the reporting date. The marking team noted that where the unwinding of the discount had been calculated, some candidates did not fully account for this. For example, the $1·554m was calculated but not included in liabilities on the statement of financial position, nor as an adjustment in retained earnings, also there were candidates who only completed one side of the adjustment rather than the complete double entry.

The fair value adjustment for specialised plant was generally well done, however, there were still errors made by some candidates. For example, the fair value depreciation was often adjusted in the subsidiary net assets at the acquisition date. Fair value depreciation will affect post-acquisition profit and therefore should not be adjusted at the date of acquisition. Some candidates failed to update property, plant and equipment for the fair value depreciation which had been calculated whereas others often incorrectly added the depreciation onto property, plant and equipment rather than deducting it.

An adjustment for unrealised profit was required because of trading between Jogger Co and Runner Co. Some candidates calculated the adjustment incorrectly by using mark-up instead of margin to find the unrealised profit whereas others calculated profit on the original sale rather than the amount left in inventory at the reporting date. Other errors noted by the marking team included incorrectly adding the adjustment onto inventory in current assets and mistaking the selling company as the parent company so only adjusting group retained earnings.

ACCA

Unrealised profit is a common adjustment which is present in many consolidation questions and therefore is something that should be practised by candidates.

The intra-group receivables and payables attracted many variations in candidate responses. This type of intra-group adjustment has been tested on numerous occasions. Candidates were required to adjust the cash in-transit before removing the reconciled receivable and payable balances. The more common errors included candidates deducting the incorrect amounts, not adjusting cash and adding the $3m in-transit item to inventory.

It is surprising to note that there continues to be a number of candidates who use proportionate consolidation in their answer, i.e. they add 100% of the parent's assets and liabilities to the group share of the subsidiary's assets and liabilities. The use of this method (which is not shown in any of the approved learning materials) is considered a fundamental error and the basic consolidation marks cannot be awarded when used.

Part (b) to this question required candidates to demonstrate their knowledge of associates in accordance with IAS 28 *Investments in Associates and Joint Ventures*. Many candidates calculated the carrying amount of the investment in the associate only and ignored the requirement to explain how Walker Co should be accounted for. Candidates who achieved full marks on this question were those who were also able to explain that a 30% investment in the equity shares of another entity should be treated as an associate if significant influence exists and, where this is the case, the equity method of accounting should be applied.

Disappointingly, a large number of candidates failed to attempt this part of the question at all.