Answers

Section C

Loudon Co

a) Schedule of adjusted retained earnings of Loudon as at 30 September 20X8

Workings

	$'000
Retained earnings per trial balance	4,122
Adjustments:	
Add back issue costs of loan	125
Loan finance costs (W1)	(390)
Building depreciation (W2)	(900)
Impairment (W2)	(3,600)
Factory depreciation (W2)	(3,885)
Disposal gain on factory (W2)	500
Unwinding of discount on environmental provision ($1,228 x 5%)	(61)
Deferred tax adjustment (W3)	(203)
Adjusted retained earnings	(4,292)

b) Statement of financial position as at 30 September 20X8

	$'000
Assets	
Non-current assets	
Property, plant and equipment ($11,500 + $22,015) (W2)	33,515
Current assets (per TB)	14,700
Total assets	48,215
Equity and liabilities	
Equity	
Equity shares $1 each (per TB)	10,000
Retained earnings (part (a))	(4,292)
	5,708
Non-current liabilities	
5% loan note (W1)	5,015
Environmental provision ($1,228 + $61 (part(a))	1,289
Deferred Taxation (W3)	1,703
	8,007
Current liabilities (per TB)	34,500
Total equity and liabilities	48,215

Workings

W1) Loan note

The issue costs should be deducted from the proceeds of the loan note and not charged as an expense. This gives the loan note an opening carrying amount of $4,875,000 ($5,000,000 - $125,000). The finance cost of the loan note, at the effective interest rate of 8% applied to the carrying amount of the loan is $390,000. The actual interest paid is $250,000 (see TB) which leaves a closing carrying amount of $5,015,000 for inclusion as a non-current liability in the statement of financial position.

Opening balance 1 October 20X7	Finance costs 8% x opening balance	Interest paid 5% x principal	Closing balance 30 September 20X8
$'000	**$'000**	**$'000**	**$'000**
4,875	390	(250)	5,015

W2) Non-current assets

Office Building	**$'000**
Carrying amount at 1 September 20X7 ($20,000 - $4,000)	16,000
Depreciation to 1 April 20X8 ($20,000/25 years x 6/12 months)	(400)
Carrying amount at 1 April 20X8	15,600
Impairment	(3,600)
Fair value at 1 April 20X8	12,000
Depreciation to 30 September 20X8 ($12,000/12 years x 6/12 months)	(500)
	11,500

Factories	
Carrying amount at 1 September 20X7 ($40,000 - $11,100)	28,900
Disposal at carrying amount	(3,000)

Carrying amount at 1 September 20X8	25,900
Depreciation for the year to 30 September 20X8 ($25,900 x 15%)	(3,885)
	22,015

Disposal of factory

Proceeds	3,500
Carrying amount	(3,000)
Gain in disposal	500

W3) Deferred Tax

	$'000
Tax written down value of PPE at 30 September 20X8	25,000
Carrying amount of PPE at 30 September 20X8 per SOFP	(33,515)
	8,515
Deferred tax provision required at 30 September 20X8 ($8,515 x 20%)	1,703
Deferred tax provision at 30 September 20X7 (per TB)	(1,500)
Deferred tax charge for year ended 30 September 20X8	203

Karl Co

a) Loss on disposal

The loss on disposal in the consolidated financial statements is:

	$m
Proceeds	20
Less: net assets	(29)
Less: carrying amount of goodwill (W1)	(2.1)
Loss on disposal	(11.1)

W1) Goodwill

	$m
FV/cost of investment	35
Less net assets at acquisition	(28)
Goodwill at acquisition	7
Goodwill impairment (70%)	(4.9)
Carrying amount of goodwill	2.1

b) Ratios and commentary

	20X8	20X7
Profitability ratios		
Gross profit margin	**42.9%** ($124m / $289m x 100)	**48.5%** ($132m / $272m x 100)
Operating profit margin	**22.1%** ($64m / $289m x 100)	**35.3%** ($96m / $272m x 100)
ROCE (operating profit / equity + NCL)	**8.9%** ($64m / ($621m + $100m)	**13.2%** ($96m / ($578m + $150m)
Liquidity ratios		
Current ratio	**3.1:1** $112m / $36m	**0.8:1** $125m/$161m
Gearing (debt/ debt + equity)	**13.9%** 100/100+621	**20.6%** 150/150+578

Financial performance

Consolidated revenue has increased from 20X7 to 20X8, despite the loss of Sinker Co's significant customer contract three months into the financial year. This might suggest that an increase in the revenue of Karl (or its other subsidiary, or both) has more than compensated for Sinker Co's lost revenue. However, even though the group revenue has increased, the gross profit margin has fallen by 5.6% and the group cost of sales is higher than 20X7. This is likely to have been impacted by the poor financial performance of Sinker Co. Alternatively, it may be that the sales mix of the group has changed.

As sales of Sinker Co represent 14% of the total group sales, this poor performance will also have impacted on the group operating margin. Operating profit margin has dropped significantly from 35.3% to 22.1%. Administrative expenses have almost doubled from $23m for the year ended 31 December 20X7 to $45m for the year ended 31 December 20X8. Part of this increase will be due to the $11.1m loss on disposal of Sinker Co. The administrative expenses will also have increased as a result of the $15m staff redundancy costs and impairment of goodwill.

ROCE has fallen from 13.2% to 8.9%, but this figure is hard to interpret, as the return includes the results of Sinker Co (including the loss on disposal and impairment of goodwill) but the capital employed does not include the capital of Sinker Co due to the disposal at the year end. The operating loss made by Sinker Co of $17m, plus the loss on disposal of $11.1m and impairment of $4.9m will have reduced operating profit. Although it is a simplification, removing these balances would result in a group ROCE of 12.9% ($64m + ($17m + $11m + $4.9m)) / (($621m + $17m + $11.1m + $4.9m) + $100m) which is more in line with the 20X7 figure.

Financial position

The current ratio shows considerable improvement for the year ended 20X8, following the disposal of Sinker Co. The group was in a net current liability position at the end of 20X7. This would suggest that Sinker Co may have had a large bank overdraft balance or high levels of payables at 31 December 20X8. It would appear that the sale of Sinker Co has improved the liquidity of the group.

It should be noted that 20X8 group current assets of $112m will include the $20m consideration for Sinker Co. This could be used to settle some of the long-term debt. Bank loans have already decreased by at least $50m. There is no information about the longterm loans of Sinker Co.

Gearing has been reduced during the year from 20.6% to 13.9% but, without further information on Sinker Co's non-current liabilities, it is very difficult to tell if this is a result of the disposal or whether Karl Co has simply repaid debt during the year.

Conclusion

The inclusion of Sinker Co in the consolidated statement of profit or loss does not appear to have had an adverse impact on revenue generation but, now that Karl Co has disposed of the poorly performing subsidiary, it might be able to better control costs, thereby improving gross and operating profit margins. Sinker Co appears to have been a drain on the liquidity of the group, and the position of the group appears to be much healthier following the disposal of Sinker Co.

c) Comparability of the consolidated financial statements

The results of Karl Co and its two subsidiaries, including Sinker Co, will have been consolidated in the group financial statements for the year ended 31 December 20X7 but only in the consolidated statement of profit or loss for the year ended 31 December 20X8. So, 20X8 will not be directly comparable to 20X7 because Karl Co sold its holding in Sinker Co on the last day of the year ended 31 December 20X8. This means that the consolidated statement of financial position at 31 December 20X8 will have been prepared on a different basis to that of 20X7.

The results of Sinker Co for the year ended 31 December 20X8 will be included in the 20X8 consolidated statement of profit or loss (SOPL). Because Sinker Co was disposed on the last day of the financial year, its results for the full year will be included, and therefore, with the exception of the loss on disposal, the figures in the consolidated SOPL will be comparable to those of the previous year. The loss on disposal is included within administrative expenses in the consolidated SOPL for the year ended 31 December 20X8 which explains why this balance is significantly higher than in the previous year. Operating profit of the group for the year ended 31 December 20X8 will be distorted by this loss.

The consolidated statement of financial position as at 31 December 20X8 will not include the assets and liabilities of Sinker Co as the net assets are no longer controlled by Karl at that date. Therefore, the consolidated assets and liabilities will not be directly comparable year-on-year.

Marking Scheme

Loudon Co	***Marks***	**Marks**
(a) Adjust profit		**8**
(b) SFP		**12**
Total marks		**20**

Karl Co	***Marks***	**Marks**
(a) Disposal loss		**4**
(b) Ratio calculations	5	
Analysis	8	**13**
(c) Comparability		**3**
Total marks		**20**