Answers

Section B

1 (a) Moston – Statement of profit or loss and other comprehensive income for the year ended 30 June 2015

	$'000
Revenue (113,500 – 3,000 see below)	110,500
Cost of sales (w (i))	(95,700)
Gross profit	14,800
Distribution costs	(3,600)
Administrative expenses (6,800 – 500 loan note issue costs)	(6,300)
Investment income	300
Gain on financial asset equity investments (9,600 – 8,800)	800
Finance costs (w (ii))	(1,710)
Profit before tax	4,290
Income tax expense (1,200 + 800)	(2,000)
Profit for the year	2,290
Other comprehensive income	
Items that will not be reclassified to profit or loss	
Gain on revaluation of property (29,000 – (28,500 – 1,900) w (i))	2,400
Total comprehensive income for the year	4,690

The 'sale' of the maturing goods is an in-substance loan of $3 million carrying interest at 10% per annum. This is because the option is almost certain to be exercised because the expected value of the goods of $5 million is considerably higher than the cost of buying them back.

(b) Moston – Statement of changes in equity for the year ended 30 June 2015

	Share capital	Other components of equity	Revaluation surplus	Retained earnings	Total equity
	$'000	$'000	$'000	$'000	$'000
Balance at 1 July 2014	20,000	2,300	3,000	6,200	31,500
Share issue	10,000	7,000			17,000
Total comprehensive income for the year			2,400	2,290	4,690
Dividends paid (20,000 x 20 cents)				(4,000)	(4,000)
Balance at 30 June 2015	30,000	9,300	5,400	4,490	49,190

Workings (monetary figures in brackets in $'000)

(i) Cost of sales

	$'000
Per trial balance	88,500
Goods re in-substance loan	(2,000)
Depreciation of property (28,500/15 years)	1,900
Depreciation of plant and equipment ((27,100 – 9,100) x 15%)	2,700
Research and development expenses (see below)	4,600
	95,700

Research and development costs can only be capitalised from the date the directors became confident that the new product would be commercially successful; 1 May 2015 in this case. Thus, research of $3 million (1,000 x 3 months) and April's development costs of $1·6 million should be written off, total $4·6 million. This would leave $3·2 million (1,600 x 2 months) to be capitalised at the year end (though not required by the question).

(ii) Loan interest

5% loan note ((20,000 – 500) x 8% see below)	1,560
In-substance loan (3,000 x 10% x 6/12)	150
	1,710

The 5% loan note issue costs should not be charged to administrative expenses, but deducted from the proceeds of the loan.

2 (a) Assessment of the comparative performance and financial position of Kandid and Kovert for the year ended 30 September 2015

Introduction

This assessment of the two companies will look at the areas of profitability, liquidity and gearing with reference to some differences which may make the comparison of the reported figures potentially invalid.

Profitability

ROCE is usually considered as the most important measure of profitability and is often described as a measure of management's overall efficiency in the use of the assets at its disposal. The ROCE of 62·5% of Kandid is far superior (more than double) to the 31·0% return achieved by Kovert. This superior return of Kandid can be analysed into its component parts of profit margin and asset turnover and in both of these areas Kandid's performance is better than that of Kovert. Kandid is generating $3·30 for every dollar invested, compared to only $2·50 per dollar invested in Kovert and earning a profit margin of 19·0% compared to just 12·3% by Kovert. Additionally, Kandid's gross profit margin at 24% is a third (6%/18%) higher than the 18% of Kovert. This may be (at least in part) due to marketing policy; Kovert may be deliberately charging lower selling prices in order to generate greater revenue. This is evidenced by Kovert's turnover of $40 million compared to only $25 million for Kandid. The superior gross margin of Kandid continues into the operating profit level indicating that Kandid has better control of its overheads.

There are, however, a number of areas relating to the capital employed which may bring this superiority into question. Kandid has deducted the receipt of a government grant directly from the carrying amount of the related plant (this is allowed but is rather unusual). Normally, plant is shown gross (less accumulated depreciation) and related government grants are shown as a (separate) deferred credit. It also appears that Kandid rents its property whereas Kovert has purchased its property (and indeed revalued it which has increased its capital employed). Kandid also holds proportionately less inventory and receivables than Kovert. Whilst these factors may not necessarily result in a higher profit for Kandid (e.g. property rental may be higher than the equivalent depreciation of property), they would act to give Kandid lower net assets (and thus lower capital employed) and, in turn, a higher ROCE than Kovert.

Bearing in mind these differences, it may be more helpful if Xpand were to calculate a return on its potential equity investment (ROE) of $12 million as this would be more relevant should it acquire either of the companies. Using profit after tax, Kandid's ROE would be 30% (3,600/12,000 x 100) whereas Kovert's ROE would be 25% (3,000/12,000). This still supports Kandid's superior return, but this introduces further differences. Both companies have $5 million in loan notes; however, the interest rate on Kandid's loan is only 5% compared to 10% for Kovert, presumably this reflects the difference in the credit worthiness of the two companies which is something that Xpand should take note of. There also appears to be a favourable tax discrepancy with Kandid paying a nominal rate of tax on its profit of 20% compared with 25% paid by Kovert. This may be due to be adjustments relating to previous years' profits or other tax issues. If Kandid had a comparable (to Kovert) finance cost and tax rate, its ROE would be nearer that of Kovert.

Liquidity

The given ratios show that both companies have healthy liquidity positions. Kandid's current ratio is slightly higher (perhaps too high) than Kovert's. This seems to be down to holding more cash (than Kovert) as it has better inventory and receivables control (their payable periods are very similar); though arguably the current finance lease obligation of Kovert should not be included in this ratio for comparative purposes. The individual components of the current ratio could suggest that Kovert holds a greater range of inventory (perhaps this helps it to achieve more sales) and the relatively high receivables collection period could be indicative of an uncollectible customer balance which should have been written off or may just be due to poor credit control.

Gearing

At around 65%, both companies are highly geared. The relatively low equity, particularly retained earnings, may be due to the companies having a policy of paying most of their earnings as dividends. Kovert's high gearing is in part due to its policy of using finance leases to acquire its plant. Xpand should be aware that, for both companies, the $5 million loans are due for repayment in the near future which will represent a substantial further cash outlay on top of the purchase price it may pay.

Summary

Although both companies operate in a same industry sector and have a similar level of after-tax profits, and indeed have the same indicative valuation, they would represent very different investments. Kovert's revenue is over 60% (15,000/25,000 x 100) higher than that of Kandid, it is financed by high levels of debt (loans and finance leases), and it also owns, rather than rents, its property. Another point of note is that Kovert's plant is 80% depreciated and will need replacement in the near future (with consequent financing implications). Ultimately, the investment decision may be determined by Xpand's attitude to risk and how well each investment would fit in with existing activities and management structure.

(b) Basing an investment decision solely on one year's summarised financial statements is fraught with danger. Below are a number of issues/items of information which Xpand may wish to seek answers to before making an offer.

General:

– in addition to using different strategies (e.g. buying property or renting it, targeting low mark-up/high volume sales), the two companies may use different accounting policies
– the availability of non-published forward looking information such as profit forecasts, capital commitments and the size of orders on the books (providing this information should not be unreasonable if the shareholders are receptive to a takeover)

– is either company established (mature) or a relatively young and growing company (more risk, but potentially more reward)?

Specific:

– as noted above, the owned assets of Kovert are nearing the end of their useful life; will these need replacing soon, or have they already been replaced by the leased assets?
– how much of the profit is due to the reputation or contacts of the current management and would they continue in their role after a takeover (and indeed would Xpand want this or would it prefer to use its own managers)?
– the fair value of the assets, compared to their carrying amounts, which will impact on the calculation of goodwill.

3 (a) Palistar – Consolidated statement of financial position as at 30 June 2015

	$'000
Assets	
Non-current assets:	
Property, plant and equipment (w (i))	82,100
Goodwill (w (ii))	5,000
Game rights (12,000 – 1,200 (w (iv)))	10,800
Financial asset equity investments (13,200 + 7,900)	21,100
	119,000
Current assets	
Inventory (17,000 + 15,400 + 800 GIT – 600 URP (w (iii)))	32,600
Trade receivables (14,300 + 10,500 – 2,400 intra-group)	22,400
Bank (2,200 + 1,600)	3,800
	58,800
Total assets	177,800
Equity and liabilities	
Equity attributable to owners of the parent	
Equity shares of $1 each (20,000 + 6,000 (w (ii)))	26,000
Other component of equity (share premium) (4,000 + 18,000 (w (ii)))	22,000
Retained earnings (w (iv))	52,800
	100,800
Non-controlling interest (w (v))	15,800
Total equity	116,600
Current liabilities	
Deferred consideration (18,000 + 900 finance cost (w (iv)))	18,900
Other current liabilities (25,800 + 18,100 – (2,400 intra-group – 800 GIT))	42,300
	61,200
Total equity and liabilities	177,800

Workings (figures in brackets are in $'000)

(i) Property, plant and equipment

	$'000
Palistar	55,000
Stretcher	28,600
Fair value reduction in plant	(2,000)
Fair value reduced depreciation (2,000/2 x 6/12)	500
	82,100

(ii) Goodwill in Stretcher

	$'000	$'000
Controlling interest		
Share exchange (20,000 x 75% x 2/5) = (6,000 x $4·00)		24,000
Deferred consideration (20,000 x 75% x $1·32/1·1)		18,000
Non-controlling interest (20,000 x 25% x $3·00)		15,000
		57,000
Equity shares	20,000	
Pre-acquisition retained earnings:		
at 30 June 2014	14,000	
from 1 July to 31 December 2014 (10,000 x 40%)	4,000	
Fair value adjustments – plant	(2,000)	
– game rights	12,000	
– investments	1,000	(49,000)
Goodwill on acquisition		8,000
Impairment		(3,000)
Goodwill at 30 June 2015		5,000

The shares issued by Palistar (6 million at $4 – see above) would be recorded as share capital of $6 million (6,000 x $1·00) and share premium in other components of equity of $18 million (6,000 x $3·00).

(iii) The inventory of Stretcher at 30 June 2015 (adjusted for goods-in-transit (GIT) sale of $800,000) is $2·6 million (1,800 + 800). The unrealised profit (URP) on this will be $600,000 (2,600 x 30/130).

(iv) Consolidated retained earnings:

	$'000
Palistar's retained earnings (26,200 + 24,000)	50,200
Stretcher's adjusted post-acquisition profit (3,200 x 75% see below)	2,400
Finance cost on deferred consideration (18,000 x 10% x 6/12)	(900)
URP in inventory (w (iii))	(600)
Gain on equity investments (13,200 – 11,500)	1,700
	52,800

The adjusted post-acquisition profit of Stretcher is:

$10 million x 60%	6,000
Gain on investments (7,900 – 7,000)	900
Reduced depreciation of plant (2,000 x 6/24)	500
Amortisation of game rights (12,000/5 years x 6/12)	(1,200)
Goodwill impairment (w (i))	(3,000)
	3,200

(v) Non-controlling interest

Fair value on acquisition (w (i))	15,000
Post-acquisition profit (3,200 x 25% (w (iii))	800
	15,800

(b) To be treated as an associate (i.e. equity accounted) an investor must have significant influence over the investee company. Significant influence is the power to participate in (but not control) the affairs of the investee. There are several ways in which significant influence is determined, the most important of which is that a holding of 20% or more of voting shares leads to 'presumed' influence. Another indicator of influence is a seat on the board of the investee. Prior to Agresso's offer, Dilemma could demonstrate both of these influences and correctly treated Myno as an associate. IAS 28 *Investments in Associates and Joint Ventures* says the 20% holding criteria gives presumed influence unless it can be clearly shown that this is not the case.

After the successful offer by Agresso, Dilemma still holds 35% of Myno (it did not sell its shares); however, there is strong evidence that this no longer gives Dilemma any level of influence over Myno. From 1 April 2015, Myno became a subsidiary of Agresso which means it can exert control over Myno. It is difficult to see how Dilemma can have any influence over Myno when Agresso is exerting active control as is evidenced by Dilemma immediately losing its seat on the board of Myno.

Thus from 1 July 2014 to 31 March 2015, Myno should (continue to) be equity accounted in the consolidated financial statements of Dilemma. At that date equity accounting should cease and instead Myno should be treated as a (simple) financial asset equity investment. Its initial carrying amount at 1 April 2015 would be its carrying amount immediately before reclassification; subsequently it would (probably) be accounted for at fair value through profit or loss with any dividends received being treated as investment income.

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	**(a)**	Statement of profit or loss and other comprehensive income		
		revenue		1
		cost of sales		3½
		distribution costs		½
		administrative expenses		1
		finance costs		2
		investment income		½
		gain on investments		½
		income tax expense		1
		other comprehensive income		1
				11
	(b)	Statement of changes in equity		
		balances b/f		1
		share issue		1
		dividends paid		1
		total comprehensive income		1
				4
			Total for question	**15**
2	**(a)**	1 mark per valid point up to		**11**
	(b)	1 mark per valid point up to		**4**
			Total for question	**15**
3	**(a)**	Consolidated statement of financial position:		
		property, plant and equipment		2
		goodwill		6½
		game rights		1
		financial asset investments		1
		inventory		2
		receivables		1
		bank		½
		equity shares		1
		other component of equity		1
		retained earnings		5
		non-controlling interest		2
		deferred consideration		1
		other current liabilities		1
				25
	(b)	1 mark per valid point up to		**5**
			Total for question	**30**