Answers

Section C

Pastry Co

(a) **Adjusted financial statement extracts and ratios for Dough Co**

	As per question $'000	Adjustment $'000	Adjusted $'000
SOPL:			
Revenue	16,300		16,300
Cost of sales	8,350	+2,500	10,850
Gross profit	7,950		5,450
Operating expenses	4,725	–1,000 –2,500	1,225
Profit from operation	3,225		4,225
SOFP:			
Property	68,500	–30,000 +1,000	39,500
Equity shares	1,000		1,000
Revaluation surplus	30,000	–30,000	nil
Retained earnings	2,600	+1,000	3,600
Loan notes	5,200		5,200

	Cook Co	Dough Co (original)	Workings	Dough Co (restated)
Gross profit margin	32·3%	48·8%	5,450/16,300 x 100	33·4%
Operating profit margin	23·3%	19·8%	4,225/16,300 x 100	25·9%
ROCE	18·8%	8·3%	4,225/(4,600 + 5,200) x 100	43·1%

Tutorial note: *The explanations below were not part of the requirement but are included to assist candidates in understanding how the adjustments were determined.*

If Dough Co accounted for properties under the cost model:

– Depreciation would reduce by $1,000,000 ($30 million/30 years) making operating expenses $3,725,000, and profit from operations $4,225,000.
– Retained earnings would increase by $1,000,000 to $3,600,000.
– Revaluation surplus of $30 million would be removed.
– Property would decrease by $29 million ($30 million less extra depreciation).

If Dough Co accounted for amortisation in cost of sales:

– Cost of sales would increase by $2·5 million, making gross profit $5,450,000.
– Operating expenses would decrease by $2·5 million, but profit from operations would remain at $4,225,000.

(b) Margins

Cook Co may be a slightly larger company, having made more sales and profits during the year. Initially, it appears that Dough Co makes a significantly higher margin than Cook Co (48·8% compared to 32·3%), which suggests that it is much more profitable to sell as a retailer rather than wholesale.

However, this is misleading as the higher gross profit margin is largely due to the accounting policy of where amortisation is charged. Once the figures are adjusted to make the two companies comparable, the two gross profit margins are much closer (33·4% and 32·3%).

Even with this adjustment, Dough Co still makes a higher gross profit margin, suggesting that the relatively high cost properties are still producing a good return.

Looking at the operating profit margin, it appears that Cook Co makes a significantly higher margin, suggesting a greater cost control (23·3% compared to 19·8%). Once the adjustments for the different accounting policies are taken into account, it can be seen that the margins are much more comparable (23·3% and 25·9%).

Without further information on the operating expenses, it is difficult to draw too many conclusions about the cost management of the two companies.

The one thing which can be noted is the higher payment of salaries in Dough Co compared to Cook Co. As both companies are owner managed, it may be that Cook Co's management are taking a lower level of salaries in order to show increased profits.

Alternatively, it could be that the Dough Co management are taking salaries which are too high, at the expense of the growth of the business. The low level of retained earnings suggests that Dough Co's owners may not leave much money in the business for growing the company.

ROCE

When looking at the return on capital employed, the initial calculations show that Cook Co is making a much more impressive return from its long-term funding (18·8% compared to 8·3%). This is completely reversed when the revaluation surplus is removed from Dough Co's figures, as Dough Co makes a return of almost twice that of Cook Co (18·8% and 43·1%).

This return is not due to high operating profits, as the margins of the two companies are similar, with Dough Co actually making lower profits from operations.

The reason for the high return on capital employed is that Dough Co has a much better asset turnover than Cook Co. This is not because Dough Co is generating more sales, as these are lower than Cook Co. The reason is that Dough Co has a significantly lower equity balance, due to having extremely low retained earnings relative to Cook Co.

Difficulties

Without examining the market value of Cook Co's properties, it will be difficult to assess which company is likely to cost more to purchase.

Basing any investment decision on a single year's financial statements is difficult, as the impact of different accounting policies is difficult to assess.

From the information provided, it is unclear whether Cook Co's directors are taking an unrealistically low salary, or whether Dough Co's directors are taking vastly greater salaries than average.

Conclusion *(marks awarded for sensible conclusion)*:

Overall, both companies appear to be profitable and have performed well. Looking at previous years' financial statements of both entities will enable us to make a much clearer investment decision, as will looking at the notes to the accounts to assess the accounting policies applied by each company.

Other comments which candidates may produce which could be given credit

Comments that Cook Co's operating profit margin would be lower if equivalent salaries to Dough Co were paid.
Comment on the relative size or cost of premises of the two companies.
Discussion of potential reasons for low retained earnings in Dough Co.
Discussion of the relative level of debt and relative interest charges.
Dough Co being highly geared but owning property.
Dough Co having much lower rate of interest with sensible suggestion of why this may be the case (e.g. possibly due to loan being new or from parent).
Lack of prior year financial statements included as a difficulty.

Gold Co

(a) Goodwill

	$'000	$'000	$'000
Consideration:			
Deferred cash (90% x 16,000 x $2·42 x 0·9091)			31,680
Shares (90% x 16,000 x 3/5 x $8·40)			69,120
			100,800
Non-controlling interest (NCI) (10% x 16,000 x $3·50)			5,600
			106,400
Less: FV of net assets at acquisition			
Equity shares		16,000	
Retained earnings:			
At 1 October 20X1	56,000		
1 October 20X1–1 January 20X2 (9,920 x 3/12)	2,480	58,480	
Fair value adjustments:			
Plant		2,600	
Contingent liability		(850)	
			(76,230)
Goodwill			30,170

(b) Consolidated statement of profit or loss for the year ended 30 September 20X2

		$'000
Revenue	(103,360 + (60,800 x 9/12) – 5,400 (W1))	143,560
Cost of sales	(81,920 + (41,600 x 9/12) – 5,400 (W1) + 240 (W1) + 650 (W2))	(108,610)
Gross profit		34,950
Distribution costs	(2,560 + (2,980 x 9/12))	(4,795)
Administrative expenses	(6,080 + (3,740 x 9/12))	(8,885)
Share of profit from associate	(3,000 x 40%)	1,200
Finance costs	(672 + 136 (W3) + 2,376 (W4))	(3,184)
Profit before tax		19,284
Income tax expense	(4,480 + (2,560 x 9/12))	(6,400)
Profit for the year		12,886
Profit attributable to:		
Owners of the parent		12,207
NCI (W5)		679
		12,886

Workings

W1 – Intercompany and PUP

Post-acquisition sales = ($600 x 9) = $5,400

PUP = (1,200 x 25/125) = $240

W2 – FV depreciation on plant = ($2,600/3 x 9/12) = $650

W3 – Convertible loan – calculate liability component

			$'000	DF 8%	$'000
Liability:					
	Interest	(10,000 x 6%) =	600	3·993	2,396
	Principal		10,000	0·681	6,810
	Liability				9,206

	$'000
Interest charge to PL:	
($9,206 x 8%) =	736
Interest already charged	(600)
	136

W4 – Deferred cash consideration

Unwinding of discount on deferred consideration (see goodwill calculation): $31,680 x 10% x 9/12 = $2,376

W5 – NCI

		$'000
Silver's profit for the year	($9,920 x 9/12)	7,440
FV Depreciation (W2)		(650)
		6,790
NCI share 10%		679

Section C

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Gold Co		
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(b)	Revenue/COS	5·5
	Other including NCI	8·5
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