Answers

Section C

31 Perkins Co

(a) **Gain on disposal in Perkins group consolidated statement of profit or loss**

	$000
Proceeds	28,640
Less: Goodwill (w1)	(4,300)
Less: Net assets at disposal	(26,100)
Add: NCI at disposal (w2)	6,160
	4,400

(w1) Goodwill

	$000
Consideration	19,200
NCI at acquisition	4,900
Less: Net assets at acquisition	(19,800)
	4,300

(w2) NCI at disposal

	$000
NCI at acquisition	4,900
NCI% x S post acquisition	
20% x (26,100 – 19,800)	1,260
	6,160

(b) **Adjusted P/L extracts:**

	$000
Revenue (46,220 – 9,000 (S x 8/12) + 1,000 (intra-group))	38,220
Cost of sales (23,980 – 4,400 (S x 8/12)) [see note]	(19,580)
Gross profit	18,640
Operating expenses (3,300 – 1,673 (S x 8/12) + 9,440 profit on disposal)	(11,067)
Profit from operations	7,573
Finance costs (960 – 800 (S x 8/12))	(160)

Note: Originally, the intra-group sale resulted in $1m turnover and $0·7m costs of sales. These amounts were recorded in the individual financial statements of Perkins Co. On consolidation, the $1m turnover was eliminated – this needs to be added back. The corresponding $1m COS consolidation adjustment is technically made to Swanson Co's financial statements and so can be ignored here.

(c) **Ratios of Perkins Co, eliminating impact of Swanson Co and the disposal during the year**

	20X7 recalculated	Working (see P/L above)	20X7 original	20X6
Gross profit margin	48·8%	18,640/38,220	48·1%	44·8%
Operating margin	19·8%	7,573/38,220	41%	16·8%
Interest cover	47·3 times	7,573/160	19·7 times	3·5 times

(d) **Analysis of Perkins Co**

Gross profit margin

In looking at the gross margin of Perkins Co, the underlying margin made by Perkins Co is higher than in 20X6.

After the removal of Swanson Co's results, this continues to increase, despite Swanson Co having a gross margin of over 50%.

It is possible that Swanson Co's gross profit margin was artificially inflated by obtaining cheap supplies from Perkins Co. Perkins Co makes a margin of 48·8%, but only sold goods to Swanson at 30%.

Operating margin

The operating margin appears to have increased significantly on the prior year. It must be noted that this contains the profit on disposal of Swanson Co, which increases this significantly.

Removing the impact of the Swanson Co disposal still shows that the margin is improved on the prior year, but it is much more in line.

Swanson Co's operating margin is 32·6%, significantly higher than the margin earned by Perkins Co, again suggesting that a profitable business has been sold. This is likely to be due to the fact that Swanson Co was able to use Perkins Co's facilities with no charge, meaning its operating expenses were understated compared to the market prices.

It is likely that the rental income earned from the new tenant has helped to improve the operating margin, and this should increase further once the tenant has been in for a full year.

Interest cover

Initially, the interest cover has shown good improvement in 20X7 compared to 20X6, as there has been a significant increase in profits. Even with the profit on disposal stripped out, the interest cover would still be very healthy.

Following the removal of Swanson Co, the interest cover is improved further. This may be because the disposal of Swanson Co has allowed Perkins Co to repay debt and reduce the interest expense incurred.

Conclusion

Swanson Co seems to have been a profitable company, which raises questions over the disposal. However, some of these profits may have been derived from favourable terms with Perkins Co, such as cheap supplies and free rental. It is worth noting that Perkins Co now has rental income in the year. This should grow in future periods, as this is likely to be a full year's income in future periods.

32 (a) Adjustments to Harverford Co's profit for the year ended 31 December 20X7

	$000
Draft profit	2,250
Convertible loan notes (w1)	(135)
Contract revenue (w2)	5,600
Contract cost of sales (w2)	(3,600)
Depreciation (w4)	(720)
Property impairment (w4)	(480)
Closing inventories (w5)	390
Revised profit	3,305

(b) Statement of changes in equity for the year ended 31 December 20X7

	Share capital $000	OCE $000	Retained earnings $000	Revaluation surplus $000	Option $000
Balance as at 1 January 20X7	20,000	3,000	6,270	800	–
Profit – from (a)			3,305		
Revaluation loss (w4)				(800)	
Bonus issue (w3)	4,000	(3,000)	(1,000)		
Convertible loan notes issued (w1)					424
Dividend paid			(3,620)		
Balance as at 31 December 20X7	24,000	–	4,955	–	424

(c) **Statement of financial position for Haverford Co as at 31 December 20X7**

	$000
Assets	
Non-current assets:	
Property (w3)	16,000
Current assets:	
Inventory (w5)	4,700
Trade receivables	5,510
Contract asset (w2)	2,500
Cash	10,320
Total assets	39,030
Equity and liabilities	
Equity:	
Share capital	24,000
Retained earnings	4,955
Convertible option	424
Total equity	29,379
Non-current liabilities:	
Convertible loan notes (w1)	7,711
Current liabilities:	1,940
Total equity and liabilities	39,030

Working 1 – Convertible loan notes

	Payment $000	Discount rate $000	Present value $000
20X7	320	0·943	302
20X8	320	0·890	285
20X9	8,320	0·840	6,989
			7,576

As the full amount of $8m has been taken to liabilities, adjustment required is:

Dr Liability	$424k
Cr Equity	$424k

The liability should then be held at amortised cost, using the effective interest rate.

Balance b/f $000	Interest 6% $000	Payment Payment $000	Balance c/f $000
7,576	455	(320)	7,711

As only $320k has been recorded in finance costs:

Dr Finance costs	$135k
Cr Liability	$135k

Working 2 – Contract with customer

Overall contract:

	$000
Price	14,000
Costs to date	(1,900)
Costs to complete	(7,100)
	5,000

Progress: 40%

Statement of profit or loss:

	$000
Revenue ($14,000 x 40%)	5,600
Cost of sales ($9,000 x 40%)	(3,600)
	2,000

Statement of financial position:

	$000
Costs to date	1,900
Profit to date	2,000
Amount billed to date	(1,400)
	2,500

$5·6m should be recorded in revenue, and $3·6m in cost of sales, giving an overall increase to the draft profit of $2m. $2·5m should then be recorded in the statement of financial position as a current asset.

Working 3 – Bonus issue

The 1 for 5 bonus issue will lead to an increase in share capital of $4m ($20m x 1/5). Of this, $3m will be debited to other components of equity to take it to zero. The remaining $1m will be deducted from retained earnings.

Adjustment:

Dr Share premium	$3m
Dr Retained earnings	$1m
Cr Share capital	$4m

Working 4 – Property

The asset should first be depreciated. $18m/25 = $720k. This should be deducted from the draft profit and the asset, giving a carrying amount of $17,280k.

Dr Draft profit	$720k
Cr Property	$720k

Then the asset should be revalued from $17,280k to $16,000k, giving a revaluation loss of $1,280k. As the revaluation surplus is only $800k, only $800k can be debited to this, with the remaining $480k being debited from the draft profit for the year.

Dr Revaluation surplus	$800k
Dr Draft profit	$480k
Cr Property	$1,280k

Working 5 – Inventories

Closing inventories should be adjusted from $4,310k to $4,700k.

Dr Inventories	$390k
Cr Draft profit	$390k

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

31	**(a)**	Proceeds	0·5
		Goodwill	2·5
		Net assets	0·5
		NCI	1·5
			5
	(b)	Revenue and COS	2
		Other costs	2
			4
	(c)	Ratios	2
	(d)	Gross profit margin	2
		Operating profit margin	5
		Interest cover	1
		Conclusion	1
			9
			20
32	**(a)**	Convertible loan notes	1
		Contract	2
		Depreciation/impairment	2
		Inventory	1
			6
	(b)	Opening balances	1
		Convertible loan notes	1
		Bonus issue	2
		Profit/dividend/revaluation	2
			6
	(c)	PPE	1
		Contract	2
		Other current assets	2
		Equity	0·5
		Convertible loan notes	2
		Current liabilities	0·5
			8
			20