CIMA

The Examiner's Answers –
F2 - Financial Management

Some of the answers that follow are fuller and more comprehensive than would be expected from a well-prepared candidate. They have been written in this way to aid teaching, study and revision for tutors and candidates alike.

SECTION A

Answer to Question One

(a) **Consolidated statement of financial position of BG group as at 31 March 2011**

All workings in $000	**BG**
Non-current assets	**$000**
Property, plant and equipment (322 + (25% x 280))	392
Goodwill **(W1)**	10
	402
Current assets	
Inventories (111 + (25% x 120) – 5 **(W2)**)	136
Receivables(115 + (25% x 132) – 6 **(W3)**)	142
Held for trading (35+7**(W4))**	42
Cash and cash equivalents (21 + (25% x 40))	31
	351
Total assets	753
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent	
Share capital ($1 shares)	120
Revaluation reserve	18
Retained earnings **(W5)**	235
Total equity	373
Non-current liabilities	
Long term borrowings	90
Current liabilities	
Payables (185 + (25% x 160) - 6 **(W3)**)	219
Income tax payable (48 + (25% x 92))	71
	290
Total liabilities	380
Total equity and liabilities	753

Workings

W1 Goodwill	**$000**	**$000**
Consideration transferred		70
Net assets acquired:		
25% of share capital of JV (25% x 200)	50	
Retained earnings at acquisition (25% x 40)	10	(60)
Goodwill		10

W2 Unrealised profit on intra-group trading

	$000
Sales	200
Held by BG at year end – 50%	100
20% profit margin	20
25% group share	5

Dr RE 5
Cr Inventories 5

W3 Intra-group balance

	$000
Outstanding balance	24
Group share 25%	6

Dr Payables 6
Cr Receivables 6

W4 Held for trading

	$000
FV at 31 March 2011	42
Carrying value brought forward	35
Gain on HFT transferred to profit or loss (thru RE in SOFP)	7

Dr HFT asset 7
Cr RE 7

W5 Retained earnings

	$000
RE of BG	213
25% group share of post-acquisition RE of JV (25% x (120 – 40))	20
Less group share of unrealised profit on inventories (W2)	(5)
Increase in fair value of HFT asset (W4)	7
Consolidated retained earnings	235

(b) IAS 31 permits equity accounting to be used as an alternative to proportionate consolidation when consolidating investments in joint venture entities. Equity accounting initially measures the interest at cost and then subsequently at cost plus the group share of post-acquisition profits and gains. Adopting equity accounting would have a significant effect on the consolidated financial statements of the BG group as the investment would be included as a one-line entry, Investment in Joint Venture, rather than the group share of all assets and liabilities being included on a line by line basis. Each element within the group statement of financial position would therefore be reduced and instead there would be an “Investment in Joint Venture” within non-current assets which would be measured at cost plus BG’s share of post-acquisition reserves.

Answer to Question Two

(a) Sale of land

This is a form of sale and repurchase agreement and therefore under IAS 18 and the Framework we need to consider the substance of the transaction and ultimately who holds the majority of the risks and rewards of the ownership of the land.

The substance of this transaction would appear to be a financing arrangement, especially as NKL is already a provider of long term finance to DRT, with the land acting as security. The risks and rewards associated with the land have not actually been transferred to NKL. DRT continues to be subject to the principal risk of the asset, which is a fall in its value, as it would be forced to repurchase the land in 4 years' time at $1.8 million. DRT could, however, gain from the agreement if the value of the land increased beyond the agreed repurchase terms. In addition, DRT continues to determine how the land can be used.

The asset should not be derecognised by DRT and the gain on sale should be eliminated. The proceeds received represent finance and therefore a corresponding liability should be recognised in DRT's financial statements at 31 May 2011. In subsequent years the liability will be adjusted to include interest (which arises because the repurchase price is higher than the original "sale" price). However, no interest on this financing is recognised in the year to 31 May 2011 as the transaction occurred at the year-end date.

The correcting entry being:

Dr Property, plant and equipment		$1,310,000	
Dr Gain on sale	$290,000		
Cr Liability			$1,600,000

(b) Set-up of payroll services entity, GHJ

The key question here is whether DRT has control of GHJ and hence it should be consolidated as part of the DRT group. In accordance with IAS 27 *Consolidated and Separate Financial Statements* and IFRS 3 *Business Combinations,* ownership of the majority of the equity share capital of an entity is normally sufficient to presume control, unless there is evidence to the contrary. The sales director holds all of the equity shares of GHJ which would normally infer control. However, he has no voting power, instead DRT effectively exercises control by way of the signed agreement. Other factors which would indicate that DRT effectively controls GHJ are as follows:

- The control over the financial and operating policies of GHJ enables DRT to ensure that the economic benefits flow from GHJ to DRT.
- GHJ is undertaking activities that DRT would be conducting itself if GHJ did not exist.
- DRT is acting as guarantor for the loan.

Taking all of this into account we can conclude that DRT controls GHJ, which is actually a special purpose entity and should be consolidated by DRT. The assets transferred are group assets and would be included in the consolidated statement of financial position. In addition the loan of $1 million should also be consolidated.

Answer to Question Three

(a) **Basic eps:**

Profit attributable to ordinary shareholders		$3,800,000
Weighted average number of issued ordinary shares during the year ended 30 June 2011:		
(5,000,000 x 7/12) + (8,000,000 x 5/12) + 2,500,000 (bonus)		8,750,000
Basic eps		**43.4 cents**
Basic eps for y/e 30 June 2010 (restated) 48.2 cents x 2/3		**32.1 cents**

(b) **Diluted eps:**

Profit attributable to ordinary shareholders		$3,800,000
Weighted average number of issued ordinary shares during the year ended 30 June 2011 from part a:		8,750,000
Shares held under option	1,000,000	
Shares that would have been issued at average market price (1,000,000 x 3.10/4.00)	(775,000)	
Shares effectively issued for no consideration and therefore dilutive		225,000
Weighted average number of issued ordinary shares and potential ordinary shares during the year ended 30 June 2011		8,975,000
		42.3 cents

(c) The diluted earnings per share measure includes the dilutive impact of any potential ordinary shares that a company has. Potential ordinary shares (such as the options in this scenario), when they are eventually issued, will increase the weighted average number of shares, the denominator of the basic eps calculation. This will have a negative impact on the reported eps. The diluted eps is presented alongside the basic calculation with equal prominence and shows investors the effect on eps if these dilutive shares were issued.

Answer to Question Four

(a) Financial instrument

(i) This debt instrument will be initially measured at fair value less transaction costs, being the net proceeds of issue. It is subsequently measured at amortised cost using the effective interest rate.

(ii)

Year end 30 June	Opening balance $000	Effective interest 7.06% $000	Interest received $000	Closing balance $000
2010	5,800	409	(360)	5,849
2011	5,849	413	(360)	5,902

The carrying value of the liability as at 30 June 2011 is $5,902,000.

(b) Pension plan

Income statement expense	**$000**
Service cost	300
Interest cost (7% x $1,400,000)	98
Expected return (4% x $1,200,000)	(48)
Net expense	350

The net expense in profit or loss will be $350,000.

Actuarial gains and losses	**FV of plan assets $000**	**PV of plan liabilities $000**
Opening balance	1,200	1,400
Service cost		300
Interest cost (7% x $1,400,000)		98
Expected return (4% x $1,200,000)	48	
Benefits paid	(220)	(220)
Contributions	400	
	1,428	1,578
Actuarial loss on plan assets	**(28)**	
Actuarial loss on plan liabilities		**22**
Closing balance	1,400	1,600

Within other comprehensive income there will be an actuarial loss on plan assets of $28,000 and an actuarial loss on plan liabilities of $22,000.

Answer to Question Five

(a) Progress towards convergence

The FASB and the IASB at their Norwalk meeting agreed to work towards convergence using two main strategies:

- To eliminate minor differences between a list of target standards
- To develop new accounting standards jointly to ensure common approach and wording.

The work schedule towards convergence was entitled the Roadmap and included a list of the standards to be revised or amended to align their approaches and wording. This target was achieved and resulted in the revision of IAS 23 Borrowing costs and IAS 1 Presentation of Financial statements.

New standards, including IFRS 5, IFRS 8 and IFRS 9 have been developed jointly and incorporate new agreed definitions and wording. The FASB has agreed that its approach needs to switch from a rules-based system of reporting to a principles-based approach like that adopted by the IASB. This is the reason that the two bodies are jointly reviewing and revising the Framework for Preparation and Presentation of Financial Statements as the underlying basis for all future jointly developed accounting standards.

The progress of the convergence project has achieved objectives faster than expected and as a result the SEC in the US no longer requires entities to provide a reconciliation from IAS to US GAAP for entities adopting IAS and listed on the US stock exchange.

(b) Possible benefits to investors and accounting students

Financial statements prepared using accounting standards that follow the same principles can easily be compared. Prior to convergence, it would have been necessary to adjust certain figures in the accounts that would have been recognised or measured on different bases. Increased comparability and transparency should result in greater liquidity in investment markets and promote cross-border investment. This is all positive for investors, as it is easier to trade investments and realise capital gains.

Accounting students can also benefit from accounting across the world being based on similar and jointly developed accounting standards. This means there is one set of principles to be learned – increasing the chance of understanding and creating less confusion. One set of principles also increases the relevance of an accounting qualification – as an accounting qualification based on these principles is relevant across the world enabling an easy transfer of skills abroad.

SECTION B

Answer to Question Six

(a) Consolidated statement of comprehensive income for the BH Group for the year ended 31 March 2011.

All workings in $000	**$000**
Revenue (3,360 + (3/12 x 3,240) – 200**(W1)**)	3,970
Cost of sales (1,800 + (3/12 x 1,860) - 200 **(W1)** + 20 **(W1)**)	(2,085)
Gross profit	1,885
Administrative expenses (380 + (3/12 x 340) + 16**(W2)** + 41**(W3)**)	(522)
Distribution costs (400 + (3/12 x 300))	(475)
Gain on derecognition of AFS Investment **(W4)**	125
Investment income (80 – (40% x 80))	48
Finance costs (180 + (3/12 x 140))	(215)
Share of profit of associate (40% x 350 x 6/12)	70
Profit before tax	916
Income tax expense (200 + (3/12 x 160))	(240)
Profit for the year	676
Other comprehensive income:	
Revaluation of property, plant and equipment (70 + (3/12 x 40))	80
Gain on AFS investments – eliminated on consolidation **(W5)**	-
Tax effect of other comprehensive income (50 + (3/12 x 16))	(54)
Recycling of previously recognised gains on AFS investment **(W6)**	(100)
Share of other comprehensive income of associate, net of tax (40% x 20 x 6/12)	4
Other comprehensive income for the year, net of tax	(70)
Total comprehensive income for the year	606
Profit for the year attributable to:	
Equity holders of the parent (676 - 26)	650
Non-controlling interest **(W7)**	26
	676
Total comprehensive income attributable to:	
Equity holders of the parent (606 – 28)	578
Non-controlling interest **(W7)**	28
	606

Workings

W1 Elimination of intra-group trading	**$000**
Adjustment to revenue and cost of sales to eliminate intra-group trading	200
Total items remaining in inventories	100
Profit margin earned on these items 20% - adjustment to cost of sales	20

W2 Goodwill impairment - NJ	**$000**	**$000**
Consideration transferred (for 40% purchased on 1 Jan 2011)		680
Previously held interest at fair value on 1 Jan 2011		425
Non-controlling interest at fair value at date control gained		581
Net assets at acquisition:		
Share capital	1,000	
Reserves at date control gained	526	
		(1,526)
Goodwill		160
10% impairment to be charged to administrative expenses		16

W3 Impairment of investment in associate	**$000**
Investment at cost	334
Plus 40% share of post-acquisition TCI of associate (6/12 x 370) x 40%	74
	408
Impairment 10%	41

W4 Gain on derecognition of AFS investment in NJ	**$000**
FV at date control is gained	425
Original cost of 25% investment	(300)
Gain on derecognition	125

W5 Gain on AFS investments	**$000**
OCI gain in year reported in BH's accounts	96
Reverse post acquisition gain recognised on investment in MK(340,000-334,000)	(6)
Reverse post-acquisition gain recognised on investment in NJ $(90,000 – 25,000)	(65)
Recycling of pre-acquisition gain recognised in the year $(425,000 – 400,000)	(25)
	-

W6 Gains previously recognised in OCI (up to y/e 31/3/10)	**$000**
FV of AFS Investment (25% holding in NJ) at 31 March 2010	400
Original cost of investment	(300)
Gains previously recognised in OCI to be recycled on de-recognition	100

W7 Non-controlling interest	**PFY $000**	**TCI $000**
As per NJ accounts	440	464
Pro-rata for 3 months	110	116
Less adjustment for unrealised profit on inventories	(20)	(20)
Less goodwill	(16)	(16)
	74	80
NCI share 35%	**26**	**28**

(b) Functional currency

The functional currency of a foreign enterprise is the currency of the primary economic environment in which the entity operates. The key considerations would be:

- The currency which principally influences selling prices for goods and services;
- The country that most influences the selling prices of the entity's goods and services through its competitive forces and regulation;
- The currency that mainly influences labour, material and other costs.

If it is still unclear which currency should be the functional currency then consider the currency in which funding is primarily raised and in which operating receipts are retained. Where the subsidiary operates relatively autonomously, rather than as an extension of the parent, this provides evidence that the functional currency of this subsidiary should be the local currency in which it operates.

Based on the information provided it is likely that NJ would adopt the currency of the country in which it operates. If the move went ahead, NJ would be impacted by the local currency as it would be sourcing goods locally and recruiting local workforce. In addition, it would be subject to local corporate rules and regulations. Furthermore since NJ is expected to operate autonomously its local currency is most likely to be its functional currency. Therefore the KRON is likely to be the currency in which NJ will prepare its financial statements.

Answer to Question Seven

(a) Report on ABC's financial performance and position

To: Mr X
From: Member of Investment Team

ABC's revenue has grown by a considerable 62% from 2010 as a result of the new on-line store and the hotel contract. If these two new lines of business are stripped out revenues have actually increased in the core business by 8%, which is encouraging.

ABC is generating a healthy gross profit margin of 32%, up from 30% in 2010. The segments generating this overall profit, however, are generating different margins.
Both the retail operations and online store have generated the same gross margin, which you would expect as both are selling own-brand products. The online store however is benefiting from lower operating costs and generating a net profit margin (based on PBT) of 12.6% as opposed to the equivalent retail operations margin of 8%. Fewer sales staff and shop overheads are likely to be causing this difference. The hotel contract has achieved a 43% gross margin. The PBT margin is 9.1%, which is again more lucrative than the retail operations but lower than you would perhaps expect with such a high GP margin. It may be reasonable to assume that expenses related to setting up the hotel contract have been incurred and charged to profit (such as new labelling etc) and these expenses are unlikely to recur in future years, resulting in a higher profit before tax margin from this segment in the future. It would, however be necessary to investigate how expenses have been allocated to the segments to ensure the margin fairly reflects the economic reality. There is also an opportunity for ABC to capitalise on this development and approach other hotels about a similar deal.

Finance costs have increased as a result of ABC requiring short-term funding in the year, however the increased profitability has resulted in interest cover increasing in the year from 10 to 13.6 times. It appears that ABC's profits provide adequate cover for additional finance costs on debt, and so this is unlikely to be the cause of the bank's refusal to extend borrowing facilities. The lack of assets available for security appears to be the main issue.

The working capital is as you would expect for a principally retail based business with high levels of inventory and low receivables. Receivables of approximately 30 days seems high for a retail based business, however it must be noted that a significant part of the retail operations revenue comes from selling to other larger retailers, who will have negotiated favourable credit terms. There is no breakdown between the segments but clearly the terms of the hotel contract have no negative impact on the receivables of ABC as it hasn't changed. It is surprising to see that payables days have reduced from 53 days to 32 days from last year. This could result from a new supplier for the hotel own-label products negotiating faster payment or that a large payment to suppliers was made shortly before the year-end, causing payables to reduce and short-term borrowing to increase. It is difficult to determine accurately from just the year-end statement of financial position, however gaining the maximum credit possible from your suppliers could avoid the need for interest-bearing borrowings being required to fund working capital.

Inventories are the main asset of the business and investment in them dominates ABC's working capital. When inventories are removed in the calculation of the quick ratio, we see an increase from 0.9 to 1.1 in the period. The inventories days are high but have reduced from 166 days to 113 days. A reduction in the holding period of more than 50 days is a positive result for ABC and may be a result of the online business being set up. To conclude on working capital, it does appear that the working capital position is a result of changes in trading conditions rather than poor management controls which is a positive sign when considering investment.

ABC has improved efficiency in the year, increasing turnover with very little investment in non-current assets. Non-current asset turnover has increased from 9.0 to 15.0 in the year, which again reflects well on the management of the business.

The gearing has moved slightly as a result of the short-term borrowings, increasing from 34.8% to 37.7%. The gearing level itself is not a major issue but it is clear from the bank's refusal that lack of security is an issue and the bank was obviously not interested in utilising the inventories. ABC appears to be a well-managed, ambitious, profitable enterprise and additional investment is likely to provide the funds required to continue the expansion and bring additional returns.

There is sufficient interest cover for additional debt and coming from the technologies sector, Mr X has experience of entities that have a low non-current asset base and may be able to suggest alternative means of security. Alternatively, this analysis of ABC would suggest that an equity investment would also be viable, although perhaps less attractive to the existing owners. If an equity investment was sought then Mr X would need to agree terms of return with ABC.

One note of caution is that a dividend of $293,000 appears to have been paid which is 72% of the profit for the year. Given that ABC is looking for investment and is short of cash, such a large dividend pay-out appears on the face of it to be a poor management decision. However, I would recommend that the investment be considered further and in particular reasons for the large dividend be established.

(b) **Benefits and limitations of ratio analysis**

The benefits to Mr X of using traditional ratio analysis for investment decisions include the ability to delegate the preliminary analysis to other members of his team. It can act as a first screening of investments by creating benchmarks and minimum targets that have to be achieved for investments to be considered further. It therefore can cut down time and costs associated with investment appraisal.

Traditional ratio analysis does not account for the different business sectors, and so using thresholds and target percentages may not work when comparing entities from different sectors or from different ends of the same sector. In the case of the investment in ABC, it does not take account of his personal interest in research and development activities and if ABC were to continue to expand it may invest more resources in developing new perfume recipes or formulae for cosmetic creams, etc. This may be an area of particular interest to Mr X and ratio analysis does not account for personal bias towards certain types of entity. Also coming from a technology background he may have an interest in web/online development. The ratios do not distinguish between different sources of revenue.
