May 2011 paper - Section A 50 marks

Section A

Question One

(a) **Calculate** the actuarial gains or losses on pension plan assets and liabilities that will be included in other comprehensive income for the year ended 31 December 2010. (Round all figures to the nearest $000).

(5 marks)

$'000	**Fair value of pension assets**	**Fair value of pension liabilities**	**Net pension**
Bal b/f (01 Jan 2010)	2,600	2,900	(300)
Current service costs		450	(450)
Past service costs		90	(90)
Interest costs (8% x $2.9m)		232	(232)
Expected returns (5% x $2.6m)	130		130
*Pension paid to members	(240)	(240)	0
Contributions made	730		730
Sub total	**3,220**	**3,432**	**(212)**
Actuarial gains on pension assets	*180*		*180*
Actuarial losses on pension liabilities		*68*	*(68)*
			112
Bal c/f (31 Dec 2010)	**3,400**	**3,500**	**(100)**

* Pension paid reduces cash and pension liability.

The net actuarial gain is $112,000 which will be taken to other comprehensive income.

b) Prepare the accounting entry to record the expense associated with the SARs, for the year to 31 December 2010, in accordance with IFRS 2 *Share-based Payments*.

(5 marks)
(Total for Question One = 10 marks)

IFRS 2 share based payments was introduced by the IASB, which states that when the company offers share options or warrants, it must treat this as a **financial instrument** and recognise them in the financial statements at fair value, the charge going to the income statement and the credit going either to equity or liabilities.

Cash – settled share based payment transactions

This is where the employee is offered cash in the future for their services, but the cash is based on the value of the companyôs share price or other equity instrument.

Debit	Expense in the income statement
Credit	Liability in the statement of financial position

The amounts must be re-measured at each accounting period end (to fair value) and the difference taken to the income statement.

For EAU SARs is an example of cash settled share based transactions. They will initially be measured at fair value and then subsequent measurement will be at fair value at each year end, the differences being taken to the income statement as an expense.

Year 1 – year ending 31st December 2009

1,000 SARs x (300 ï 32 ï 35) eligible employees x $8 fair value = $1,864,000
Amount to be recognised is $1,864,000 over the 3 year vesting period = $1,864,000 / 3 yrs = $621,333

Debit	Income statement ï remuneration costs	$621,333	
	Credit Liability (SOFP)		$621,333

Year 2 – year ending 31st December 2010

1,000 SARs x (300 ï 32 ï 28 - 10) eligible employees x $12 fair value = $2,760,000

Amount to be recognised to date	= $2,760,000 x 2/3	= $1,840,000
Amount already recognised		= ($621,333)
Amount to be recognised in the year		= **$1,218,667**

Debit	Income statement ï remuneration costs	$1,218,667	
	Credit Liability (SOFP)		$1,218,667

Question 2

a)
(a) Explain the impact of the additional 20% purchase of DCAôs ordinary share capital by RBE on the equity of the RBE Group.

(3 marks)

(b) Prepare the consolidated statement of changes in equity for the year ended 31 December 2010 for the RBE Group, showing the total equity attributable to the parent and to the non-controlling interest.

(7 marks)
(Total for Question 2 = 10 marks)

Revision

Step acquisitions (piecemeal acquisitions)
It is quite common for parent companies to make investments in other companies at different dates. The parent company may acquire shares, which change the status of its investment. The acquisition of equity shares over time, changes the investment from a simple investment to associate and then finally subsidiary when greater than 50% of shares are acquired, giving ultimate control.

IFRS 3 business combinations (revised 2008) gives details on how to account for step acquisitions (piecemeal acquisitions) in the consolidated financial statements. The revised IFRS 3 alongside the revised IAS 27 now state that acquisition accounting is only applied when **control** is achieved.

All investments before control is achieved are treated in accordance with their relevant accounting standards:
(i) Less than significant equity investments (i.e. 5%) treat under IAS 39
(ii) Significant investments treat as associate under IAS 28
(iii) Joint control investments treat as joint venture under IAS 31

When the parent company acquires further equity shares and it changes the status of the investment to subsidiary, that is **control has been achieved,** then acquisition accounting is used but the following must also be done:
- **Re-measure** the previously held investment (any of the 3 above) to **fair value** on the date control is achieved.
- Recognise any resulting **gain or loss** in the consolidated income statement
- Calculate **goodwill**.

Before IFRS 3 was revised, goodwill was established separately for each ñsignificantò acquisition, so therefore there was a portion of goodwill at each stage of the acquisition.

Now under the revised IFRS 3 goodwill is measured as the difference at acquisition date between the fair value of any investment in the business held before the acquisition, the consideration transferred and the net assets acquired.

Essentially with piecemeal acquisitions, when control is achieved, the investment is revalued, any gain or loss is reported in the consolidated income statement. If control is not achieved, no gain or loss is reported, but an adjustment to the parentôs equity is made.

The parent company may acquire additional equity shares in its existing subsidiary (i.e. for RBE had 70%, now they have 90%). The revised IFRS 3 states that this is a transaction between owners and the ownership has been re-allocated between parent and non controlling shareholders.

Here the parentôs equity is adjusted. The parentôs share has increased and the non controlling interest has decreased. Gain or loss is not recognised and goodwill is not re-measured. The difference between the change in the non controlling interest and fair value of consideration paid is recognised directly in equity and attributed to the parent.

The pro-forma for the adjustment in parentôs equity is:

Fair value of consideration paid	(X)
Decrease in non controlling interest at date of transaction	X
Decrease in non controlling interest in goodwill at date of transaction (if full goodwill method used only)	X
Adjustment to parentôs equity (reduce)	(X)

RBE owned 70% of DCA and then purchased a further 20% on 1st October 2010. DCA was a subsidiary during the entire accounting period; this is an example of piecemeal acquisition where the status of the investment remains a subsidiary (i.e. subsidiary to subsidiary).

b)

Group structure

1st Jan to 30 Sep (9 months)

RBE

↓ **70%**

DCA (NCI = 30%)

1st Oct to 31st Dec (3 months)

RBE

↓ **90%**

DCA (NCI = 10%)

RBE group: statement of changes in equity for year ending 31st December 2010

$'000	Equity attributable to parent shareholders	Non controlling interest	Total equity
Bal b/f (1st Jan 2010)	**3,350**	**650**	**4,000**
Total comprehensive income (W1)	**1,350**	**150**	**1,500**
Shares issued (W2)	**2,600**		**2,600**
Dividends paid (W3)	**(200)**	**(30)**	**(230)**
Non controlling interest transferred with additional purchase (W4)	**503**	**(503)**	
Adjustment to parent's equity (W5)	**(37)**		**(37)**
Bal c/f (31st Dec 2010)	**7,566**	**267**	**7,833**

W1

Total comprehensive income – NCI share

DCAôs total comprehensive income for the year	=	$600,000
NCI share - First 9 months - $600,000 x 30% x 9/12	=	$135,000
NCI share - First 9 months - $600,000 x 10% x 3/12	=	$ 15,000
Total comprehensive income ï NCIôs share	=	$150,000

Parents total comprehensive income

RBE ï total comprehensive income for the year	=	$ 900,000
Parentôs share of DCA ($600,000 - $150,000)	=	$ 450,000
Total	=	$1,350,000

W2
Share issued = 2 million x $1.30 = $2.6 million

W3

RBE dividends = $200,000

DCA dividends = $100,000
30% NCI = $30,000

W4

The fair value of the NCI on date of transfer needs to be established. This can be done by taking the opening NCI value and increasing by the retained profit attributable to the NCI

Opening NCI	=	$650,000
+ NCI profit up to 30/09/10 (W1)	=	$135,000
ï Dividends paid NCI share (W3)	=	($ 30,000)
Fair value of NCI as at 30/09/10	=	$755,000

NCI was 30% before the additional purchase of shares and then 10% after the purchase. Therefore the amount of NCI transferred = (30 ï 10)/30 = 20/30 = 2/3

Therefore the fair value of the NCI transferred with additional purchase of shares = 2/3 x $755,000 = $503,333.

$503,333 is transferred from NCI to parentôs equity.

W5
The difference in actual amount paid and value transferred is the adjustment that will also go the parentôs equity

Consideration paid by parent for additional shares	=	$540,000
Fair value of NCI transferred (W4)	=	($503,333)
Adjustment to parents equity - loss	=	$ 37,000

Essentially the parent company has made a loss as they paid $540,000 for the additional 20% shares which had a fair value of $503,333. This loss or adjustment to parentôs equity is shown in the statement of changes in equity only.

Question 3

(a) **Discuss** whether the managing directorôs comment is accurate in respect of the operating segment analysis that is required in accordance with IFRS 8.

(4 marks)

(b)

(i) **Explain** why the information that is presented for operating segments is likely to be highly relevant to investors

(ii) **Discuss** the potential limitations of operating segment analysis as a tool for comparing different entities.

(6 marks)

(Total for Question Three = 10 marks)

(a)

Many organisations now do business in lots of different geographical areas and carry on with different classes of business. These different sections will have different levels of profitability, growth and risk. Analysing the different business ñsegmentsò will give users of accounts more information for their decision-making purposes.

Segmented accounts give the users information relating to the different areas of business or location for the enterprise.

IFRS 8 requires an organisation to adopt the **management approach** to reporting on the financial performance of its operating segments. The general idea is that:

- Information that would be reported would be what **management uses internally for decision** making of the segments (management accounts).
- This therefore means that information may be **different** from what is used to prepare the income statement and statement of financial position.
- The IFRS therefore requires **explanations** of the basis on which the segment information is prepared and **reconciliations** to the amounts recognised in the income statement and statement of financial position.
- Management approach to segmental reporting will allow users of financial statements to **review the operations from the management's point of view** and see how the organisation is controlled by the senior decision makers.
- As this information is produced internally by the management it will **incur few costs**.
- This will also allow **interim reporting of the segment information**, as internally this is produced anyway for management accounts purposes.

All listed companies have to produce segmented accounts. FGH is looking to float on the local stock exchange. Once it is listed it will have to comply with IFRS 8 and produce segmented accounts.

The managing director is correct about the regulation being time consuming and costly. However IFRS 8 requires organisations to choose business segments according to how the organisation segments its business and also to use information from their internal management accounts. Therefore most of information required to comply with IFRS 8 will already be produced by the organisation.

b (i)

The information presented for operating segments are going to benefit the investors as it will give them more information about the organisationôs business activities.

Under IFRS 8 operating segments, the organisation gives information about their business units which they use themselves for decision making purposes. Profitable areas of the business will be highlighted, alongside loss making operations and risky operations. All this information will be highly relevant to investors as they can use this for their own decision making purposes.

Investors will be able to assess whether the organisation they have invested in is making the right decisions and producing them high returns.

IFRS 8 discloses useful information for investors to help them with their decision making:

IFRS 8 disclosure requirements

- General information about how the **operating segments were identified** and the types of products and services from which each operating segment derives its revenues;
- Information about the reported segment profit or loss, segment assets and segment liabilities and the basis of measurement.
- **Reconciliations** of the totals of segment revenues, segments profit or loss, segment assets, segment liabilities and other material items to corresponding items in the organisationôs financial statements. Remember the segmented information is derived from the management accounts which may differ from financial statements, hence reconciliation is required.
- Information about each product and service or groups of products and services.
- Analyses of revenues and certain non-current assets by geographical area.
- Foreign country disclosures of revenues and assets (if material), regardless of whether there is an operating segment identified.
- Details about transactions with major customers.

- Issuing considerable segment information at interim reporting dates.

b (ii) Limitations of IFRS 8 for comparison purposes

As each organisation can decide on how they choose the segments, it makes comparisons of segments more difficult. Similar entities (i.e. Tesco and Asda) may use different criteria to choose their segments as usually internal management accounting criteria are selected for segments.

This makes comparisons less meaningful and not useful to investors and users of accounts for decision making purposes.

Like with all financial statements and financial data, organisations can deliberately mislead the users by manipulating the data to suit their needs. This again makes comparisons difficult.

Question 4

(a)

Explain AND **demonstrate** how this convertible instrument would be initially measured in accordance with IAS 32 *Financial Instruments: Presentation* AND subsequently measured in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* in the financial statements for the year ended 31 December 2010.

(7 marks)

IAS 32

This accounting standard states that companies must classify financial instruments as either a financial liability or as equity. The classification is important because it has an impact on the appearance of the statement of financial position and therefore major ratios like gearing. Gearing measures the companyôs debt capital to its equity capital and shows how risky or stable the company is. The correct classification will enhance the financial statements for userôs of these accounts in helping them assess the organisationôs financial position, performance and cash flows according to IAS 32.

Some financial instruments have both equity and liability elements. IAS 32 requires that liability element and equity element be identified and classified separately. An example is convertible debt which is debt that can be converted into equity shares at some point in the future. Another example is debt issued with detachable share purchase warrants

IAS 32 requires the liability component be calculated. This amount is then deducted from the whole value (or fair value) of the instrument, which leaves the equity element.

The liability is calculated first. This is the present value (PV) of the redeemable capital plus the present value of the interest payments. The bonds will be redeemed in 5 years time.

	$ô000
PV of redeemable $10m x 0.713 (DF @ 7% 5yrs)	7,130
PV of interest payments (5% x $10m x 4.100 (CDF @ 7% 5yrs)	2,050
Total present value (fair value of bond)	9,180
Proceeds	10,000
Equity component (10,300 ï 9,180)	820

Debit Non current liability $820,000
Credit Equity $820,000

The equity component will remain the same for the duration of the convertible bond.

The liability component of $9.18 million will be treated as per IAS 39, using amortised cost method.

Year	Open liability $'000 (1)	Finance cost x 7% $'000 (2)	Interest payment (10m x 5%) $'000 (3)	Closing liability $'000 1 + 2 - 3
1	9,180	642.6	(500)	9,322.6

For year one the journal entry would be:

		$ó000	$ó000
Dr Finance charge ï income statement		642,600	
Cr	Bond		142,600
Cr	Cash		500,000

(b)
Explain how the preference shares would be classified in accordance with IAS 32 *Financial Instruments: Presentation,* AND the impact that this issue will have on the gearing of QWE.

(3 marks)
(Total for Question Four = 10 marks)

Under IAS 32 the **substance** of the instrument is considered when assessing what the classification is. If there is an **obligation to transfer economic benefit**, then this meets the definition of a **liability** and therefore must be classified as such.

Redeemable preference shares
The issuer has the obligation to pay preference dividends and redeem the shares. This gives the characteristic of a liability and therefore should be classified as such. QWE is obligated to pay each year the preference dividends (if profits are made) ï 6% x $5m = $300,000 of preference dividends each year.

These preference shares will be classified as a liability and therefore increase the gearing of QWE.

With equity shares, there is no obligation to pay dividends; hence they are classified as equity.

Question 5

***(a)* Discuss the potential advantages that could be *gained by BNM* if it included voluntary narrative disclosures within the annual report.**

(6 marks)

***(b)* Discuss the potential drawbacks of voluntary disclosures being included in annual reports.**

(4 marks)
(Total for Question Five = 10 marks)

Financial statements are prepared on a mainly historic basis and show transactions that have already occurred. Users of the accounts need additional information to make informed economic decisions.

The ways in which this can be achieved are as follows:

Forecast information
Annual financial statements can include forecast data. But this is difficult as estimates have to be made, and if the organisation does not achieve those targets it will reflect badly on them.

Environment and social reporting
Details of the way the organisation is dealing with its environmental responsibilities as this affects the public. Human resource issues like redundancies and the type of labour being used.

Non financial information
More information on non financial aspects of the organisation can be given, like future product development, local community information and how the organisation interacts with it. Information of the organisationôs ethical policies.

The more information users have, the better their economic decision made.

In the UK the operating and financial review is guidance for organisations to add to their financial accounts.

The **potential advantages** to BNM to include voluntary narrative disclosures within their annual report include:

- ✓ Gives more detail, and therefore more information for users. BNM will be able to communicate the potential of their intellectual property and key customer relationships in this report, thereby assisting decision making for the users of the accounts. Currently most forms of intellectual capital are not measurable for accounting purposes and therefore do not appear in the financial statements. But

because of their future potential, intellectual capital is a key economic source for organisations.

- ✓ As a result of this additional information, the future of the business can be assessed and this is better for decision making, especially for investors and lenders.
- ✓ The additional information is more likely to be read by users of the accounts as there is no accounting jargon or complex calculations to deal with. This will also improve the image of the company especially if they include social, environmental and ethical issues

(b)

Drawbacks of voluntary disclosures

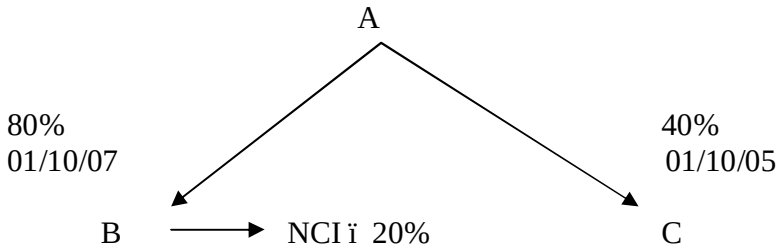
- X Organisations may not give out all relevant information. Good news may only be reported and bad news hidden away. This will make the report misleading.
- X Difficult to compare with other organisations as no set format. With these voluntary reports there are no set formats, which make comparisons with other organisations more difficult and hence difficult for investors and other users of accounts for their decision making.
- X Voluntary information is currently not audited so there is no independent review of this information, which reduces its usefulness
- X All the work will incur additional costs which will reduce the profits of the organisation, especially when there is no guarantee that it will benefit the company.

Question 6

Prepare the consolidated statement of comprehensive income for the A Group for the year ended 30 September 2010 and the consolidated statement of financial position as at that date.

(Total for Question Six = 25 marks)

Step 1 Group structure



B is a foreign subsidiary of A. B will be consolidated 100% line by line (IAS 27) after the financial statements of B are translated to Aôs currency. The translation method will be the closing rate method (presentation currency method) as per IAS 21. Bôs functional currency is different from its parent company.

C is an associate of A and will be shown in the consolidated financial statements using the equity method (IAS 28).

Step 2 – Layout pro-forma (consolidated statement of comprehensive income and the consolidated statement of financial position)

Leave 3 whole A4 sides blank in the exam. This will ensure that all the workings follow through on the next 4th page. This makes it easier for the marker to follow the workings.

Step 3 – Consider adjustments

Go through the additional information given in the exam and work through systematically note by note, detailing exactly what needs to be done. The translation of Bôs financial statements will also be done here.

Note 1

Information about the functional currencies. Bôs is different hence the need to translate their financial statements using the presentation currency (closing rate method).

Note 2

Investment information regarding B, the foreign subsidiary. This will be used in step 4 for goodwill calculation.

Note 3

Investment information regarding C, the associate. This will be used in step 4 for goodwill calculation.

Note 4

No impairment of goodwill information.

Note 5

Fair of NCI given, the goodwill method will be the full method, which includes goodwill for NCI ï this information will be used in step 4.

Note 6

Relevant exchange rates for translation of Bôs financial statements.

The income statement will be translated using the average rate of B$0.65.

The statement of financial positionôs net assets will be translated using closing rate of exchange B$0.63

The share capital and pre-acquisition reserves will be translated using the historical rate B$0.50.

The opening exchange rate of B$0.7 is given for the calculation of exchange differences.

Translation of B's financial statements

Note: the foreign currency will be divided by the exchange rates given are value of B$ for every one A$.

Statement of comprehensive income

Details	B$'000	Exchange rate	A$'000
Revenue	2,200	0.65	3,385
Cost of sales and operating expenses	(1,600)	0.65	(2,462)
Profit before tax	600		923
Income tax	(150)	0.65	(231)
Profit for the year	450		692
Other comprehensive income			
Revaluation of PPE	120	0.65	185
Total comprehensive income	570		877

Statement of financial position

Details	B$'000	Exchange rate	A$'000
Non current assets			
PPE	4,000	0.63	6,349
Current assets	2,000	0.63	3,175
Total assets	6,000		9,524
Equity and liabilities			
Share capital	1,000	HR ï 0.50	2,000
Pre-acquisition reserves	1,800	HR - 0.50	3,600
Post acquisition reserves (3,500 – 1,800)	***1,700***	***Bal. fig.***	***1,543***
	4,500		7,143
Current liabilities	1,500	0.63	2,381
Total equity and liabilities	6,000		9,524

Step 4 Goodwill calculation

The goodwill in the foreign subsidiary will be established in foreign currency and then re-translated each year end. The exchange differences go through the reserves.

	A in B	
Goodwill calculation under the fair value (new) method Full goodwill	B$'000	B$'000
Cost of investment at fair value (A$5,200 x B$0.50)		2,600
Less share of net identifiable assets acquired at fair value at date of acquisition		
Share capital	1,000	
Reserves	1,800	
	2,800	
Group share x 80%		(2,240)
Goodwill parent's share		**360**
	600	
Fair value of NCI at date of acquisition		
Less: share of NCI net identifiable assets at fair value at date of acquisition (2,800 x 20%)	(560)	
Goodwill – NCI share		**40**
Total goodwill (parent + NCI)		**400**

The exchange difference on the re-translation of goodwill needs to be calculated. There will be 2 calculations

1 From date of acquisition to year end ï this will be part of the consolidated reserves reconciliation.

2 From last year to this year end -this will be shown under other comprehensive income statement

Working 1 Translation of goodwill

	B$'000	Ex rate	A$'000
30/09/10 ï year end	400	0.63	635
01/10/07 ï date of acquisition	400	0.50	800
30/09/09 ï last year end	400	0.71	563

1 Exchange difference from date of acquisition in re-translation of goodwill (800 ï 635) = A$165,000 exchange loss

2 Exchange difference for the year in re-translation of goodwill (635 ï 563) = A$72,000 exchange gain

Working 2 Exchange differences on the re-translation of net assets

Calculation of exchange differences on re-translation of net assets relating to subsidiary	A$'000
Closing net assets at closing rate	7,143
Less opening net assets at opening rate *(B$4,500 ï 570) / 0.71	(5,535)
Movement in net assets	1,608
Less total comprehensive income per translated statement	(877)
Exchange differences - gain	731
Group share (80%)	585
NCI share (20%)	146

***Opening net assets can be established by taking the closing net assets and deducting the total comprehensive income for the year.**

Total exchange differences between parent and NCI share

Exchange differences	Net assets	Goodwill (for the year)
Total	731	72
Parents share (80%)	585	58
NCI share (20%)	146	14
Total Parent	643	
Total NCI	160	

Exchange differences	Goodwill (total)
Total	(165)
Parents share (80%)	(132)
NCI share (20%)	(33)

Working 3 Goodwill for associate

	A in C
Goodwill calculation under the fair value (new) method Full goodwill	A$ð000 A$ð000
Cost of investment at fair value	900
Less share of net identifiable assets acquired at fair value at date of acquisition	
Share capital	1,000
Reserves	700
	1,700
Group share x 40%	(680)
Goodwill	**220**

Working 4 Investment in associate undertaking

	A$ð000
Group share of net assets at year end (2,500 x 40%)	1,000
Add goodwill (net of impairment)	220
Investment in associate undertaking	1,220

Step 5 Combine financial statements

A group: consolidated statement of comprehensive income for year ending 30/09/10	**A$'000**
Revenue (4,600 + 3,385)	7,985
Cost of sales and operating expenses (3,700 + 2,462)	(6,162)
Share of associateôs profit (400 x 40%)	160
Profit before tax	1,983
Income tax (200 + 231)	(431)
Profit for the year	**1,552**
Other comprehensive income	
Revaluations of PPE (200 + 185)	385
Share of associatesôrevaluation gains (70 x 40%)	28
Exchange gain on re-translation of foreign operations (731 + 72)	803
Total other comprehensive income	1.216
Total comprehensive income	**2,768**
Profit for the year attributable to:	
Owners of the parent (1,552 ï 138)	1,414
Non controlling interest (692 x 20%)	138
	1,552
Total comprehensive income attributable to:	
Owners of the parent (2,768 ï 335)	2,433
Non controlling interest (877 x 20% + 160)	335
	2,768

A group: consolidated statement of financial position as at 30 September 2010	A$ô000
Assets	
Non current assets	
Goodwill (step 4 ï W1)	635
PPE (7,000 + 6,349)	13,349
Investment in associate undertaking (step 4 ï W4)	1,220
	15,204
Current assets (3,000 + 3,175)	6,175
	21,379
Equity and Liabilities	
Share capital (parents only)	2,000
Consolidated reserves (step 7)	13,522
Non controlling interest (step 6)	1,476
	16,998
Current liabilities (2,000 + 2,381)	4,381
Total equity and liabilities	**21,379**

Step 6 NCI

	A$'000
Translated net assets at year end of B x NCI % (7,143 x 20%)	1,429
Add translated goodwill (B$40 / 0.63)	64
Less exchange loss on re-translation of goodwill	(33)
*****Tutor note - correcting item***	***16***
NCI	1,476

*****The traditional method of calculating NCI in this question results in an error:***

The examiners solution for NCI:

	A$'000
NCI on acquisition at fair value (B$600 / 0.50)	*1,200*
ADD share of NCI PARR (1,543 x 20%)	*309*
Less exchange loss on re-translation of goodwill	*(33)*
NCI	*1476*

Step 7 Consolidated reserves

As B is a foreign entity, the post acquisition reserves were established from the translation of the statement of financial position

	A Group
Reserves of A	12,100
Share of PARR of B (1,543 x 80%)	1,234
Share of PARR for C (1,500 ï 700) x 40%	320
Exchange loss on re-translation of goodwill	(132)
	13,522

Question 7

(a) Analyse and prepare a report on the financial performance and financial position of CVB. *(8 marks are available for the calculation of relevant ratios.)*

(20 marks)

(b) Explain what further financial information may assist your friend in deciding whether or not to invest in CVB.

(5 marks)

(Total for Question Seven = 25 marks)

(a)

Report

To: **Friend**
From: **Management accountant**
Date: **May 2011**
Subject: **Financial analysis of CVB**

Introduction

This report will analyse the financial performance and financial position of CVB.

1.1 Overview of the financial statements

Income statement

From the consolidated income statement, the revenue has increased by $41m from 2009 (increase of 10%); this is very good considering that CVB was trading in very harsh economic conditions. However gross profit has only increased by $4m, suggesting the cost of sales were higher than last year. This could be due to the fact that CVB has introduced a new line of fair trade clothing. This could well have worked out expensive for CVB, however there is always costs when social and economic policies are implemented. The image of CVB will be greatly enhanced with fair trade clothing, but unfortunately it does impact profitability. The rise in cost of sales could also be due to the global increase in commodity prices like cotton.

Segmented accounts would be useful here to see how the fair trade line has performed in relation to the other fashion lines.

Although sales and marketing costs have increased in line with sales increase, admin expenses have reduced by $2m from last year. Further investigation is required on this, perhaps this is due to accounting journals rather than actual cost cutting strategy.

Finance cost for 2010 is $3 million higher than 2009, although long term borrowings have reduced, there has been a significant increase in short term borrowings, resulting in higher interest costs. CVB will need to address this high cost of borrowing urgently.

Profit for the year is $5 million less than 2009 due to the higher cost of sales and higher finance costs. Revaluation gains of £14 million has resulted in the total comprehensive income being higher than 2009 by $9 million. This is deceptive as 2010 was a poor performing year than 2009.

Statement of financial position

Plant, property and equipment has increased in 2010 by $27 million, however $14 million is due to the revaluation gain. So CVB hasnôt really invested much in its long term assets, it would be useful to know how many new stores have been opened and in which geographical location.

Current assets are significantly higher in 2010, with inventory levels increasing by 61%. The reason for this increase in stock needs investigating as this represents cash tied up in clothing lines, which can go out of fashion very quickly resulting in losses. CVB also has no cash in 2010, instead relying on overdraft which has increased to $18 million. With no increase in capital from either shares or long term debt, this is a very risky strategy for CVB as they could face severe liquidation problems.

1.2 Financial performance

From the ratios which are in appendix 1, the ROCE has decreased by nearly 5%. This means that CVBôs profitability has declined as they are generating fewer profits for every $1 of capital invested, the cost of sales are higher in 2010. The decrease is also due to the revaluation of $14 million which has resulted in higher capital employed and therefore reducing the ROCE.

The gross profit margin has reduced to 32.7%, a fall of 6.6%. This could be due to higher costs of material, higher costs of fair trade or poor purchasing. This needs to improve significantly; otherwise CVB will see reducing profit margins in the future also.

Overall the financial performance of CVB has declined even though sales have increased, further information on costs is required and also information on their sales strategy. Perhaps CVB has been deliberately selling lines of clothes at reduced price to compete.

1.3 Financial position

The current ratio has reduced by 23.5%, although inventory and trade receivables are up in 2010, the overdraft and increase in trade payables has resulted in a decline in the current ratio. CVB has to carefully manage its working capital to ensure that it doesnôt face liquidity problems. The seriousness of this problem can be seen in the quick ratio which is only 0.5 compared to 0.8 in 2009. CVB will face severe cash flow problems if

the overdraft is withdrawn. CVB needs more capital and as itôs relatively low geared; it could take on more long term financing. However the current economic conditions may mean CVB is unable to borrow from banks or from other investors.

CVBôs inventory days have increased by 48% to 50 days. Their inventory is slow moving and this could result in fashion lines becoming out of fashion in the next season. The reason for the high inventory needs investigation. Maybe CVB will be opening more stores? This is good from an investment opportunity point of view as it means the company is expanding.

Trade receivable days have increased by 8%, as most of retail sales are in cash; the amount of outstanding debtors should be low. The figures in the statement of financial position also include other receivables; further information is required on these.

Trade payable days have increased by 33% to 172 days. This is significantly high and CVB may not be acting in good faith with their suppliers, especially if they are buying fair trade. The fair trade suppliers need to have their cash on time to survive. CVB is clearly using trade payables as a way of managing their shortage of cash, and although this is good for profitability as trade payables represent a free source of finance, itôs not good for the suppliers and this will impact on their image of being socially and ethically responsible.

The high trade payable days has resulted in a negative working capital cycle. CVB needs to address the issue of the short term borrowings urgently and also to consider reducing the trade payable days in order to be fair to its suppliers.

The decline in interest cover to 2.5 times (2009 4 times) is also a grave concern. As an investor, higher finance costs means less profits for dividends, and therefore this could impact shareholder returns. Any further decline in profits will result in fewer profits being available to distribute to shareholders, this could then impact the share price and ultimately the value of the firm. This would therefore mean itôs not a good company to invest in.

Earnings per share have declined as has the PE ratio. The share price is already down by 40% from last year. CVB needs to turn this around by increasing its profits, reducing its overdraft by taking on more long term capital. Itôs clear the market is losing faith in the company with the decline the share price.

Conclusion

Although CVB is trying to improve its image with regards to social issues, unfortunately the financial statements for 2010 are worse than 2009. The higher costs and poor working capital means for an investor this would be a poor company to invest in.

Signed
Management accountant

(b) **Further financial information**

To help with the investment decision the following information would be useful

- **Forecast financial information.** The financial statements are out of date and forecast data would be useful to assist in the decision making process. Forecast sales, new stores opening, new fashion lines etc would greatly assist.
- **Analysis of the costs** to see if fair trade has resulted in higher cost of sales.
- **Segmented accounts** to assist in different locations, different clothes line etc and their profitability.
- The **dividend policy** of the CVB, do they regularly pay dividends to their shareholders (stable policy) or do they withhold dividends in periods of poor performance. The majority shareholders would be useful to know to see how much impact they have on the directors.
- **Information on the industry** and other organisations in similar trading to CVB. This would help to compare CVBôs performance against their competitors.
- Information on **sources of funds available** to CVB, can they raise debt capital or equity capital with ease?

Appendix 1 – Ratio calculations

PERFORMANCE				
		2010	**2009**	**% Change**
ROCE PBIT x 100% CE	(10+2+8) / (273 + 55) (18-3+5) / (256 + 58)	6.1%	6.4%	-4.7% (6.1 ï 6.4) 6.4
Operating profit margin PBIT / turnover (excluding associate)	(10+2+8) / 453 (18-3+5) / 412	4.4%	4.9%	-10.2% 4.4 ï 4.9 4.9
Non current asset turnover Turnover / non current assets	453 /276 412 / 251	1.64 times	1.64 times	No change
Gross profit margin GP / Turnover x 100%	148 / 453 144 / 412	32.7%	35.0%	-6.6% (32.7 - 35) 35
Cost of sales margin COS / turnover	305 / 453 268 / 412	67.3%	65.0%	+3.5% (67.3 - 65) 65
Profit for the year margin Profit for the year / turnover x 100%	8 / 453 13 / 412	1.8%	3.2%	-43.8% (1.8 ï 3.2) 3.2

POSITION				
		2010	**2009**	**% Change**
Current ratio CA / CL	215 / 162 159 / 95	1.3:1	1.7:1	-23.5%
Quick ratio (CA ï inventory) / CL	(215 - 140) / 162 (159 - 87) / 95	0.5:1	0.8:1	-37.5%
Inventory days Inventory / COS x 365 days	145 / 1058 x 365 65 / 705 x 365	50.0 days	33.7 days	+48.4%
Trade receivables (TR) days TR / sales x 365 days	75 / 453 x 365 63 / 412 x 365	60.4 days	55.8 days	+8.2%
Trade payable (TP) days TP / COS x 365 days	144 / 305 x 365 95 / 268 x 365	172.3 days	129.4 days	+33.2%
Working capital cycle Inventory days + trade receivable days ï trade payable days	50 + 60.4 -172.3 33.7 + 55.8 ï 129.4	-61.9 days	-39.9 days	-55.1%
Interest cover PBIT / Interest	(10+2+8) / 8 (18-3+5) / 5	2.5 times	4.0 times	-37.5%
Gearing Debt / Equity	55 / 273 58 / 256	20.1%	22.7%	-11.5%
Gearing with short term borrowings	(55 +18)/ 273 58 / 256	26.7%	22.7%	+17.6%

Potential / investor ratios				
EPS (profit attributable to equity shareholders / number of shares)	7 / 30 11 / 30	23.3p	36.7p	
PE ratip (share price / EPS)	$1.25 / $0.233 (*$1.25 / 0.6) / $0.367	5.4 times	5.7 times	

*** share price is 40% lower this year.**