Answers

Section C

31 (a)

	20X7	Workings	20X6	Workings
Operating profit margin	8·0%	12,300/154,000	11·7%	18,600/159,000
Return on capital employed	3·6%	12,300/(192,100 + 130,960 +19,440)	8·7%	18,600/(44,800 + 150,400 +19,440)
Net asset turnover	0·45 times	154,000/(192,100 + 130,960 +19,440)	0·74 times	159,000/(44,800 + 150,400 +19,440)
Current ratio	0·53:1	15,980/29,920	1·22:1	28,890/23,690
Interest cover	1·3 times	12,300/9200	1·8 times	18,600/10,200
Gearing (Debt/Equity)	78·3%	(130,960+19,440)/192,100	379·1%	(150,400 + 19,440)/44,800

(b) Performance

Mowair Co's revenue has declined in the year. As Mowair Co has had exactly the same number of flights in the year, the decline must be due to either lower numbers of passengers or from Mowair Co reducing the price on certain flights. To substantiate this, it would be helpful to see the number of passengers who have flown on Mowair Co flights during the year.

In addition to the decline in revenue, there has been a decline in the operating profit margin in the year. As the number of flights operated by Mowair Co has remained the same, it would appear that a number of the costs incurred by Mowair Co on operating the airline will be relatively fixed and may not have changed significantly during the year. It has been noted that there has been an increase in cost of licences charged by airports during the year, which would again cause the operating profit margin to fall as amortisation would be higher. This only occurred in April 20X7, so the full impact will not actually be felt until next year.

In addition to this, it important to note that there are numerous contracts up for renewal in the next year. This could lead to higher prices for using the airports, and may even result in Mowair Co being unable to use those airports in future. If this was the case, it may have a significant impact on the revenue for the business, as these are described as major airports, which will have the higher levels of demand.

Return on capital employed has declined significantly in the year. There are two major reasons for this. First, there has been a decline in the profit from operations, as discussed above. In addition to this, Mowair Co has revalued its non-current assets in the year. This means that there is a large revaluation surplus in 20X7 which was not present in 20X6. This will have the effect of reducing the return on capital employed due to there being a much larger total balance in equity. If the return on capital employed is calculated without this, it would be 6·2%, which still represents a decline in performance.

Looking at the net asset turnover, this has declined dramatically from 0·74 times to 0·45 times. This will again be affected by the revaluation surplus, making the two years incomparable. If this is removed from the calculation, the net asset turnover increases to 0·78 times. This is a slight increase in performance. This increase has not come from increased revenue, as it can be seen that revenue has fallen by $5 million. Rather, this increase has come from the decrease in capital employed. This arises from the reduction in the loan notes, which appear to have a significant amount repaid annually.

Position

The value of non-current assets has risen sharply in the year, by $147 million. A large proportion of that will be due to the revaluation which has taken place, leading to an increase of $145 million. This suggests that Mowair Co has acquired some new assets in the year, but it is unclear what these are. They may be replacement components on aircraft, as it is unlikely to be significant enough to be an actual new aircraft itself.

The level of debt in the business is a concern, as this makes up a significant portion of the entity's financing, and appears to incur a large annual repayment. The reduction in the current ratio can be attributed to the large decrease in cash, which is likely to be due to the debt repayments made.

It is worth noting that Mowair Co is almost completely funded by debt, with a relatively small amount held in share capital. Therefore, there is an opportunity for a new investor to consider putting more money into the business in the form of shares and the company then repaying some of the loans held by Mowair Co. As Mowair Co is currently repaying $19 million a year on the loans, it may be more sensible to repay these if possible, freeing up a lot more cash for growing the business or to be returned annually in the form of dividends, also saving $9 million a year in interest.

Areas of concern for the future

There are a number of things to consider regarding the future performance of Mowair Co. The first of these is the ten major licences which are due for renegotiation with airports. If the price is raised on these, then this will lead to reduced profits being made by Mowair Co in future periods.

The debt appears to be being repaid in annual instalments of $19 million, meaning that Mowair Co needs to generate sufficient cash to repay that each year, before returning any profit to the owner. In addition to this, the $9 million interest means that the business appears currently unable to return any cash to investors.

Finally, Mowair Co's business model is heavily dependent on large, expensive items of non-current assets. It has been noted that there has been criticism of under-investment in these, so this could lead to large potential outlays in the near future to replace assets.

Conclusion

Mowair Co has not shown a weakened performance in the current year, but appears to be a profitable business at its core. The major issue with the business is the level of debt, which is resulting in $19 million annual repayments and $9 million annual interest. Any new investor who was able to reduce these amounts as part of any future purchase, would put the business in a much stronger cash position.

32 (a) Consolidated statement of financial position for Party Co as at 30 September 20X5

		$'000
Assets		
Non-current assets:		
Property, plant and equipment	(392,000 + 84,000)	476,000
Investments	(120,000 – 92,000 – 28,000)	0
Goodwill	(w3)	32,396
		508,396
Current assets:	(94,700 + 44,650 + 60 FV – 250 URP)	139,160
Total assets		647,556
Equity and liabilities		
Equity:		
Share capital		190,000
Retained earnings	(w5)	209,398
Revaluation surplus		41,400
		440,798
Non-controlling interest	(w4)	15,392
Total equity		456,190
Non-current liabilities:		
Deferred consideration	(23,996 + 1,920)	25,916
Current liabilities:	(137,300 + 28,150)	165,450
Total equity and liabilities		647,556

Working 1 – Group structure

Party Co owns 80% of Streamer Co.
Party Co has owned Streamer Co for one year.

Working 2 – Net assets

	Acquisition $'000	SOFP date $'000	Post acq $'000
Share capital	60,000	60,000	0
Retained earnings	34,000	36,500	2,500
Revaluation surplus	4,000	4,000	0
Fair value adj inventory	600	60	(540)
	98,600	100,560	1,960

Working 3 – Goodwill

	$'000
Cash	92,000
Deferred cash (28m x 0·857)	23,996
NCI at acquisition	15,000
Less: Net assets at acquisition	(98,600)
Goodwill at acquisition	32,396

Working 4 – Non-controlling interest

	$'000
NCI at acquisition	15,000
NCI % of Streamer post acquisition (1,960 x 20%)	392
	15,392

Working 5 – Retained earnings

	$'000
Party Co	210,000
P's % of Streamer post acquisition RE (1,960 x 80%)	1,568
Unwinding discount on deferred consideration (23,996 x 8%)	(1,920)
Unrealised profit (1,000 x 25%)	(250)
	209,398

(b) The consolidated financial statements of the Party Group are of little value when trying to assess the performance and financial position of its subsidiary, Streamer Co. Therefore the main source of information on which to base any investment decision would be Streamer Co's individual financial statements. However, where a company is part of a group, there is the potential for the financial statements (of a subsidiary) to have been subject to the influence of related party transactions. In the case of Streamer Co, there has been a considerable amount of post-acquisition trading with Party Co and, because of the related party relationship, there is the possibility that this trading is not at arm's length (i.e. not at commercial rates). Indeed from the information in the question, Party Co sells goods to Streamer Co at a much lower margin than it does to other third parties. This gives Streamer Co a benefit which is likely to lead to higher profits (compared to what they would have been if it had paid the market value for the goods purchased from Party Co). Had the sales of $8m been priced at Party Co's normal prices, they would have been sold to Streamer Co for $10·9 million (at a margin of 25% these goods cost $6m; if sold at a normal margin of 45% they would have been sold at $6m/55% x 100). This gives Streamer Co a trading 'advantage' of $4·9 million ($10·9 million – $6 million).

There may also be other aspects of the relationship where Party Co gives Streamer Co a benefit which may not have happened had Streamer Co not been part of the group, e.g. access to technology/research, cheap finance, etc.

The main concern is that any information about the 'benefits' Party Co may have passed on to Streamer Co through related party transactions is difficult to obtain from published sources. It may be that Party Co has deliberately 'flattered' Streamer Co's financial statements specifically in order to obtain a high sale price and a prospective purchaser would not necessarily be able to determine that this had happened from either the consolidated or entity financial statements.

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			*Maximum marks*	*Awarded*
31	**(a)**	Ratio calculations	6	
	(b)	Performance	6	
		Position	4	
		Future issues of concern	3	
		Conclusion	1	
			14	
			20	
32	**(a)**	Property, plant and equipment	0·5	
		Goodwill	4	
		Current assets	2·5	
		Share capital	0·5	
		Retained earnings	3·5	
		Revaluation surplus	0·5	
		NCI	1·5	
		Deferred consideration	1·5	
		Current liabilities	0·5	
			15	
	(b)	Limitations of interpretation using consolidated financial statements	5	
			20	

F7 Examiner's commentary on September/December 2017 sample questions

This commentary has been written to accompany the published sample F7 questions and answers based on the observations of the marking team. The aim of this commentary is to provide constructive guidance for future candidates and their tutors by giving insight into what markers are looking for and identifying issues encountered by candidates who sat these questions.

Question 31 – Mowair Co

This was a standard ratios and analysis question built around summary financial statements and a brief scenario for an airline. As in many previous diets, the majority of answers provided for the interpretation were superficial and lacked depth. This commentary shows how these answers might have been improved.

For part (a), to support the subsequent analysis, candidates were asked to calculate six ratios for both years (20X7 and 20X6). The operating profit margin and the current ratio caused few problems as no adjustments to the given figures were needed. The question clearly stated that all loan notes (i.e. current and non-current) should be treated as debt which meant that capital employed should include all loan notes. Many candidates ignored this adjustment for the return on capital employed (ROCE) and net asset turnover calculations. Net asset turnover (Revenue/capital employed) continues to be a ratio that candidates struggle to calculate; the two items were often inverted or totally inappropriate items were used. Although the question clearly stated that gearing was to be calculated as debt/equity, some candidates used debt/capital employed. Interest cover (Profit from operations/finance costs) was often inverted or other figures were used; for example, adding finance costs back to profit from operations was seen several times.

Candidates are reminded to provide workings to support all ratio calculations as these are helpful to markers. Appropriate workings allow markers to see what adjustments have been made, and to ensure that any obvious arithmetic errors are not penalised. This approach also allows markers to easily apply the "own figure" rule where candidates have interpreted ratios that have been calculated incorrectly.

For part (b), the structure of candidates' responses could have been improved had they been presented in three (headed) sections: performance, position and conclusion. This approach was consistent with the requirements of the question and the marking grid. Additionally, there was a specific requirement to highlight issues that the company should consider in the near future. Few candidates gave any separate consideration to these issues at all; very good scripts identified this as a separate heading and reflected on their analysis of the company's recent past and looked forward.

Candidates were expected to use the information provided in the scenario which gave useful clues as to why the company's performance in 20X7 was weaker than in 20X6. (A few candidates got the years the wrong way round, however, markers continued to give due credit in such circumstances)

Many candidates noted if the ratios in part (a) were higher or lower, the percentage increase or decrease from the past year and whether they represented an improvement or a worsening of the financial performance or position. Whilst this approach is acceptable as an introductory sentence, it does not answer the question and does not comment on the company's performance or position using of all the information available.

A key criticism of the company was its under-investment in its non-current assets. However, there was a substantial increase in the carrying amount of its property, plant and equipment (PPE) which led many candidates to say that such investment had taken place without appreciating that these assets had been revalued, for the first time, by almost the same amount as the increase in carrying amount. Removing the effect of the revaluation from the 20X7 carrying amount shows a small reduction in PPE, thus confirming (subject to depreciation charges) that no substantial investment had taken place. Well-prepared candidates pointed out that this distorted comparison between the two years (particularly for key ratios such as ROCE, net asset turnover and gearing).

Revenue and operating profit margin had both declined (one is not an inevitable consequence of the other) although the number of flights and destinations remained the same. This invited comments as to the company's pricing policies, number of passengers carried, cost control, the incidence of fixed costs (for an airline these would be significant) and the part-year effect of increased licence costs.

ROCE declined significantly but was, as noted above, materially influenced by the impact of the PPE revaluation and the decline in profit from operations in both absolute and relative terms. Candidates were given credit if their answer included a revised 20X7 ROCE calculation, excluding the effect of the revaluation, for a better comparison between the two years. In this case, this showed a decline but not as significant as the initial calculations. A similar approach could have been taken to net asset turnover which showed a very slight increase in 20X7. This was caused by a combination of the decline in revenue and a decrease in capital employed evidenced by the decrease in cash and cash equivalents and/or non-current liabilities.

The cost of the licences acquired late in the financial year was responsible for the increase in intangible assets. It was not possible for candidates to assess the impact of increased depreciation charges caused by the revaluation of PPE or amortisation of the intangible assets, but a good answer referred to these charges having a further impact on 20X7 margins and thereby limiting a valid comparison between the two years.

With respect to the current ratio, many candidates insisted that as this ratio was below 2:1, this was a significant financial problem. There are no "ideal" ratios and no sector averages were provided on this occasion so answers should have concentrated on the reasons for the decline which were a combination of the increase in trade payables and the decrease in cash and cash equivalents (influenced by the repayment of loan notes).

Interest cover had declined, even though finance costs had decreased (because of the repayment of some loan notes). This was primarily because of the decline in the profit from operations noted earlier. The decline in cash flow from operations provided further evidence of potential liquidity problems for the company.

Unless the revaluation surplus was excluded from the 20X7 equity, the decrease in gearing was not a valid comparison or evidence of a stronger financial position. The main reason for the decrease was the impact of the revaluation. If this was removed it shows that gearing was still worryingly high – especially for a company that will need to invest in new non-current assets in the near future (to address the issue of recent under-investment).

The above commentary on performance and position is intended to offer those working through the question an insight into the sort of issues that should be taken from the question (especially the written narrative and candidate's own ratios) and applied to support analysis of the company's (in this case) financial weaknesses.

The question asked candidates to "highlight any issues that Mowair Co should be considering in the near future". As this was specifically asked, markers were looking for responses – ideally as a separately headed section in answers. Very few candidates made any reasonable attempt at this although observations from the question were repeated in different parts of answers. Good answers could have mentioned, under one heading, such impending issues as: the impact of the negotiations with airports for more new licences which will put further strain on profitability and cash flow and may even prevent the company from using those airports if renewal costs are prohibitive; the high levels of existing debt and the company's limited ability to continue to pay this off; the possible difficulties of paying dividends with little available profit and cash; the need to invest in non-current assets and how this investment will be financed.

A conclusion, drawing together key issues (present and future in this case) in a short final paragraph was expected.

Question 32 – Party Co

Part (a) required the preparation of a consolidated statement of financial position with a series of routine adjustments supporting the consolidation process. The overall performance on this question, from a well-tried part of the syllabus, was very good. That said there were a number of common errors and weaknesses and this commentary addresses these.

Candidates needed to identify that this was an 80% acquisition by Party Co at the start of the year (there was therefore a 20% non-controlling interest (NCI) and no time apportionment of Streamer Co's results).

The provision of the three-column analysis of the subsidiary's net assets (at acquisition date, since acquisition, at consolidation date and cross-balanced) is a good example of a working which markers can easily follow and attribute marks accordingly. Alternative approaches can be used, providing that appropriate workings are provided. In this instance, a fair value adjustment was required to inventory. The fair value adjustment required at consolidation was $600,000 but this needed to be split by recognising that 90% of this had been sold since acquisition ($540,000 of this profit has been realised) and only 10% ($60,000) should be adjusted for at the date of consolidation by increasing the value of current assets.

Many candidates scored full marks for the goodwill calculation. Other than the fair value adjustment, the deferred consideration was the most common problem. The $28 million (payable on 1 July 20X8 – in two years' time) needed to be discounted at 8% to its present value at 1 July 20X6, for which the discount rate was given. Candidates who correctly made their own factor calculations and/or rounded the sum to $24 million were not penalised. A few candidates omitted the NCI (or tried to calculate the amount at acquisition for themselves) or tried to calculate the parent's share of goodwill only.

Some candidates incorrectly included the pre-acquisition amount of the revaluation surplus in the consolidated revaluation surplus – it should of course have been included in the goodwill calculation.

Although many candidates suggested otherwise, there were no other investments by Party Co other than the two reported elements of investment in Streamer Co.

Several candidates confused mark-up with margin for the unrealised profit element of the intra-group trading. In this question, 25% was a margin so the unrealised profit was 25% x $1 million ($250,000 rather than 25/125 x $1 million or $200,000). Candidates also tried to incorrectly base their adjustment on the $8 million which, as this question wasn't asking for profit or loss items, was irrelevant. Many candidates deducted $8 million from current assets and/or current liabilities but, as the question gave no indication of any amounts still owing from such trading, this was an incorrect approach. It should also be noted that, in this question, the parent sold to the subsidiary so the unrealised profit adjustment was to the parent's retained earnings and no adjustment needed to be made to the NCI.

There was no share exchange on the acquisition by Party Co of a controlling interest in Streamer Co so the only share capital that should be reported in the consolidated statement of financial position was that given in the question for Party Co. There are no exceptions to the rule that the share capital is only ever that of the parent company – candidates who suggest otherwise are quickly betraying a lack of understanding of the consolidation process.

Most candidates, using the "own figure" rule, gained full marks for the NCI as this was the value at the date of acquisition plus 20% of post-acquisition profits (including the revaluation surplus).

The deferred consideration was also an issue for retained earnings and liabilities. As noted above, the amount needed to be discounted for the goodwill calculation as it was payable in two years' time. For the consolidated statement of financial position one year later the discount (at 8%) needed to be "unwound" for a year with a deduction from the parent's retained earnings and an increase in the discounted non-current liability. The majority of candidates who recognised this amount only adjusted retained earnings.

The above paragraphs identify the common errors that were noted during marking. Very few candidates made all of the errors noted above. A very small number of candidates used proportional consolidation in their answer by taking 80% of the carrying amounts of the assets and liabilities of Streamer Co. This is a fundamental error of principle and will not attract marks for any item to which it is applied.

Although many candidates provided full and clear workings, the importance of explaining where all numbers not already given in the question have come from cannot be over-emphasised. This allows markers to determine whether an incorrect figure has been used in a calculation or whether the final total is wrong but the supporting figures are correct.

In part (b) of the question, most candidates were able to identify that the individual financial statements of Streamer Co would be a better source of information on which to base any investment decisions. However, the main point to be made was that the subsidiary's post-acquisition results had been improved due to favourable pricing of the intra-group trading originated by the parent based on the terms stated in the question. This is an example of the possible effect of related party transactions but very little of this was mentioned by the vast majority of candidates. Only a very small proportion of answers made reference to any numbers in this part of the question.