Answers

1 (a) (i)

Adnett Ltd
Profit and loss account for the year ended 31 May 2005

	£000	Marks	Workings £000
(Heading)		1·0	
Turnover	3,485	1·0	(3,500 – 15)
Cost of sales (W1)	(2,715)	5·0	
Gross profit	770		
Distribution costs (W1)	(153)	1·5	
Administrative expenses (W1)	(331)	4·5	
Operating profit	286		
Interest payable	(58)	0·5	(580 x 10%)
Profit on ordinary activities before taxation	228		
Tax on profit on ordinary activities	(70)	0·5	
Retained profit for the year	158	1·0	
Transfer to general reserve	(35)		
Transferred to retained profits	123		
Retained profit at 1 June 2004	115		
Retained profits at 31 May 2005	238		
		15·0	

(ii)

Adnett Ltd
Balance sheet as at 31 May 2005

	£000	£000	Marks	Workings £000
(Heading)			1	
Fixed Assets (W2)				
Intangible:				
Goodwill		68	1·0	(85 – 17)
Tangible:				
Land		345	1·0	
Buildings		828	1·5	
Plant		600	1·5	
		1,841		
Current assets				
Stock	560		0·5	
Trade debtors	660		1·0	(700 – 40)
Bank	147		0·5	
	1,367			
Creditors: amounts falling due within one year	(1,200)		2·5	W3
Net current assets		167		
Creditors: amounts falling due after more than one year				
10% Debentures		(580)	0·5	
		1,428		
Capital and reserves				
£1 Ordinary shares (W4)		1,080	1·5	
Share premium account (W4)		40	1·5	
General reserve		70	1·0	(35 + 35)
Profit and loss account		238	2·0	(115 + 123)
		1,428		
			17	

Workings

1

	Cost of Sales £000	Distribution Cost £000	Administrative Expenses £000
Opening stock	515		
Discounts allowed			70
Discounts received			(80)
Heating and lighting (40:20:40)	108	54	108
Administrative expenses			60
Wages and salaries (£250 + £42) (50:25:25)	146	73	73
Purchases (£2,170 + £35 – £17) *($1^1/_2$ marks)*	2,188		
Carriage inwards	105		
Closing stock *($^1/_2$ mark)*	(560)		
Increase in provision for doubtful debts			10
Goodwill amortised			17
Depreciation – buildings (25:50:25)	13	26	13
Depreciation – plant	200		
Director's remuneration			60
	2,715	153	331
	(5 marks)	*(1·5 marks)*	*(4·5 marks)*

2 **Fixed Assets**

	Goodwill £000	Land £000	Buildings £000	Plant £000
Cost	85	345	1,040	1,200
Depreciation b/f	–	–	(160)	(400)
Current year's depreciation/amortisation:				
Goodwill (£85,000/5)	(17)			
Buildings £1,040 x 5%			(52)	
Plant (£1,200 – £400) x 25%				(200)
	68	345	828	600

3 **Creditors within one year**

	£000	
Trade creditors	1,030	*(0·5 marks)*
Corporation tax	70	*(0·5 marks)*
Wages accrual	42	*(1 mark)*
Debenture interest	58	*(0·5 marks)*
	1,200	

4 **Share Capital Reconciliation**

	Share Capital £000	Share Premium £000
Opening balance	800	200
Issued on purchase of business	100	20
Shares ranking for dividend	900	220
Bonus issue 900 x 1/5	180	(180)
Closing balance	1,080	40

(b) Accounting treatment of goodwill

As Adnett Ltd is a private limited company then the accounting treatment for goodwill is specified by FRS10.

If the life of the goodwill is expected to be limited and annual impairment reviews are not feasible; and the value of the goodwill is not significant the goodwill should be amortised on a systematic basis. There is a rebuttable presumption that the life of goodwill is limited and will not exceed 20 years unless there are valid and disclosed grounds based on the nature of the underlying investment, or believing the life to be longer.

Purchased goodwill should be capitalised and classified as an intangible asset on the balance sheet. If the goodwill is significant and it is expected to be maintained indefinitely; and it is readily measurable in future then it should not be written down, unless an annual impairment review shows a diminution in its value.

3 marks

			Marks
2 (a) Prepared in accordance with FRS1 (as revised)			
Snowdrop Ltd			
Cash flow statement for the year ended 31 May 2005			1
	£000	**£000**	
Net cash inflow from operating activities (Note 1)		1,637	1
Returns on investments and servicing of finance			
Interest paid		(10)	1
Taxation			
Corporation tax paid		(145)	2
Capital Expenditure			
Payments for tangible fixed assets		(2,800)	2·5
Proceeds from disposals		180	1
Equity dividends paid		(270)	1
		(1,408)	
Financing			
Issue of ordinary share capital	1,280		1
Repayment of long term loans	(100)		1·5
Net cash inflows from financing		1,180	1
Decrease in cash		(228)	1

Notes to the cash flow statement

1 Reconciliation of operating profit to net cash flow from operating activities

	£000	**£000**	Marks
Operating profit		1,042	1
Depreciation	700		1
Loss on disposal	20		1
Increase in stock	(80)		1
Increase in debtors	(130)		1
Increase in creditors	85		1
		595	
Net cash inflow from operating activities		1,637	20

The following notes are shown for completeness, but are not required by the question.

2 Reconciliation of net cash flow to movement in debt

	£000
Net cash flow for the period	(228)
Repayment of long term loans	100
Change in net debt	(128)
Net funds/debt at 31 May 2004	70
Net funds/debt at 31 May 2005	(58)

3 Analysis of changes in net funds/(debts)

	At 31 May 2004 £000	**Cash flows £000**	**At 31 May 2005 £000**
Cash at bank	170	(228)	(58)
Debt due after 1 year	100	(100)	0
	270	(328)	(58)

Workings

Fixed Assets

	£000		**£000**
Balance b/f	2,700	Depreciation	700
New fixed assets (bal)	2,800	Disposals	200
		Balance c/f	4,600
	5,500		5,500

	Tax £000		£000
Tax paid (balancing figure)	145	Balance b/f	145
Balance c/f	180	Profit and loss	180
	325		325

(b) Comment on the financial position of Snowdrop Ltd as shown by the cash flow statement

There has been a net outflow of cash £228,000 which has left the company with an overdraft of £58,000.
There was significant expenditure on fixed assets of £2,800,000 during the year. This should help improve operational efficiency and future profitability.
Additional ordinary shares were issued which resulted in a cash inflow of £1,280,000. This will result in future cash outflows in the form of dividends.
Long term loans of £100,000 were repaid which will reduce interest payments in future.
There has been an increase in debtors of £130,000 which may mean customers are taking longer to pay and consequently having an adverse impact on cash flows.

1·5 marks for each relevant comment which is adequately explained up to a maximum of 6 marks.

(c) Briefly state some of the ways in which a company could manipulate the year end cash position.

(i) Offering short term incentives to customers to increase sales.
(ii) Reducing the selling price to increase sales.
(iii) Cutting expenses.
(iv) Disposing of assets.
(v) Delaying payments to creditors.
(vi) Encouraging debtors to pay early by offering discounts.
(vii) Resourcing effective debt collection procedures.

1 mark for each relevant comment up to a maximum of 4 marks.

Marks

3 (a) (i) Capital accounts immediately before sole traders merge

A. Little's Capital Account

	£000		£000	Marks
Balance c/f	205	Balance b/f	160	
		Revaluation	10	
		Goodwill	35	
	205		205	
				2

B. Sutton's Capital Account

	£000		£000	Marks
Revaluation (70 – 55)	15	Balance b/f	79	2
Balance c/f	89	Goodwill	25	
	104		104	

(ii) **Little Sutton's Capital Accounts**

	A. Little £000	B. Sutton £000		A. Little £000	B. Sutton £000	Marks
Goodwill w/off (2:1)	40	20	Transfer: Sole traders	205	89	3
Balances c/f	165	69				
	205	89		205	89	

Marks

(iii) Little Sutton
Balance sheet as at 1 June 2005

	£000	£000	Marks
Fixed assets			
Freehold property		120	0·5
Plant and equipment		80	0·5
		200	
Current assets			
Stock	27		0·5
Trade debtors	18		0·5
Bank and cash	23	68	0·5
		268	
Current liabilities			
Trade creditors		(34)	0·5
		234	
Capital Accounts			
A. Little		165	0·5
B. Sutton		69	0·5
		234	4

(b) Briefly state two advantages and two disadvantages of A. Little and B. Sutton becoming partners rather than continuing as sole traders.

Advantages
- Risks are spread between the partners
- They may be able to specialise in a particular activity within the business.
- They may find it easier to raise finance for the business.
- They can pool their network of contacts

Disadvantages
- They may find working together a problem.
- Their individual freedom for decision making might be limited.
- They now have to share any profits.

1 mark for each advantage or disadvantage up to a maximum of 4 marks.

4 (a)

		Formula		Workings		Result	Marks
(i)	Return on capital employed*	$\frac{\text{Net Profit before Interest \& Tax}}{\text{Capital Employed}}$	x 100	$\frac{25}{180}$	x 100	=13·9%	1·5
(ii)	Gross profit percentage	$\frac{\text{Gross Profit}}{\text{Sales}}$	x 100	$\frac{60}{160}$	x 100	=37·5%	1·5
(iii)	Net profit percentage*	$\frac{\text{Net Profit before interest and tax}}{\text{Sales}}$	x 100	$\frac{25}{160}$	x 100	=15·6%	1·5
(iv)	Quick/Acid test ratio	$\frac{\text{Current Assets – Stock}}{\text{Current liabilities}}$	:1	$\frac{75 - 45}{45}$	:1	= 0·67 :1	1·5
(v)	Debtors collection period	$\frac{\text{Debtors}}{\text{Sales}}$	x 365	$\frac{25}{160}$	x 365	= 57 days	1·5
(vi)	Earnings per share	$\frac{\text{Profits on ordinary activities after tax}}{\text{No. of ordinary shares in issue}}$		$\frac{10}{100}$		= 10 pence	1·5

* Alternative definitions are also acceptable

9·0

(b) Brief Report

To:
From: A CAT Student

Date June 2005

Subject: Financial Appraisal of F. Raser Ltd Using Accounting Ratios

Introduction

The purpose of this report is to analyse the financial performance of F. Raser Ltd over the last three years using accounting ratios. The report specifically comments on the following ratios:

- Return on capital employed;
- Gross profit percentage;
- Net profit percentage;
- Quick/acid test ratio;
- Debtors collection period; and
- Earnings per share

The report also highlights what other information would be useful to help interpret the ratios.

Return on capital employed

The return on capital employed has declined over the last three years from 16·2% to 13·9% and is now well below the industry average (16·2%). This should be a cause for concern to the board of directors because if investors can obtain a higher return elsewhere then they may withdraw their investment. Alternatively they may seek to change the management board. It would be helpful to have more information on the market in which F. Raser Ltd operates e.g. is the market growing or declining, are there many buyers and sellers or just a few?

Gross profit percentage

The gross profit percentage has risen over the period from 30·4% to 37·5%. Clearly the company has either:

(i) increased the selling price of its goods, e.g. perhaps it is able to sell at a premium because of perceptions regarding the quality of the goods sold.

(ii) reduced the cost of its supplies. Possibly changing suppliers or obtaining greater discounts as sales volume has increased.

It would be useful to know what the company is selling and the volume of sales analysed by product and year.

Net profit percentage

The net profit percentage has declined over the period from 19·3% to 15·6% and is below the industry average of 17·3%. This is worrying, considering the increase in the gross profit percentage over the same period. The decline in the net profit percentage suggests that the costs may not be tightly controlled within the company. More detailed information on expenditure during the period would be helpful in identifying the reasons for the decline in profitability.

Quick (or acid test) ratio

The quick ratio has also declined significantly during the period from 1·5 to 0·67 suggesting the company may be experiencing liquidity problems. This view is also supported when the ratio is compared to the industry average which is over double that of F. Raser Ltd. The level of stock may be a concern as it is tying up cash. More information on the type of stock and the level of stock turnover would be useful.

Debtors collection period

The time taken to collect debts has increased over the period from 32 days to 57 days. This seems very high when compared to the industry average debt collection period of just 35 days. The ratio suggests that there is little control over debt collection. In addition, the lengthening of the collection period means it is more likely that some debts will not be paid by customers. The poor control over debt collection will be a factor contributing to the adverse liquidity situation of the company.

Earnings per share

The earnings per share deteriorated over the period from 18p per share to 10p per share. This level of EPS is also significantly below the industry average and it likely to discourage potential investors from investing in the company and may not be sufficient to keep existing shareholders.

Conclusion

Although the company has managed to increase its gross profit over the period, this has not resulted in a similar increase in net profit. In summary the ratios indicate poor internal control of costs and poor management of working capital. The return on capital employed and the EPS ratios are unlikely to be sufficiently attractive to potential investors or to existing shareholders.

Marking scheme

1 mark for each relevant comment up to a maximum of 10 marks. 1 mark for report format