Answers

1 (a) (i) Adnett
Income statement for the year ended 31 May 2005

	$000	Marks	Workings $000
		1·0	
Revenue	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	
Profit from operations	286		
Finance cost	(58)	0·5	(580 x 10%)
Profit before tax	228		
Tax	(70)	0·5	
Net profit for the period	158	1·0	
		15·0	

(ii) Adnett
Balance sheet as at 31 May 2005

	$000	$000	Marks	Workings
			1	
Assets				
Non-current assets (W2)				
Property, plant and equipment		1,773	4	
Goodwill		68	1·0	
		1,841		
Current assets				
Inventory	560		0·5	
Trade receivables	660		1·0	(700 – 40)
Bank	147	1,367	0·5	
Total assets		3,208		
Equity and liabilities				
Capital and reserves				
$1 Ordinary shares (W3)		1,080	1·5	
Share premium account (W3)		40	1·5	
General reserve		70	1·0	(35 + 35)
Retained earnings		238	2·0	(115 + 158 – 35)
		1,428		
Non-current liabilities				
10% Loan notes		580	0·5	
Current liabilities				
Trade payables	1,030		0·5	
Income tax	70		0·5	
Wages accrual	42		0·5	
Loan notes interest accrual	58	1,200	1·0	
Total equity and liabilities		3,208		
			17·0	

Workings

1

	Cost of Sales $000	Distribution Cost $000	Administrative Expenses $000
Opening inventory	515		
Discounts allowed			70
Discounts received			(80)
Electricty expenses (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 mark)*	2,188		
Freight inwards	105		
Closing inventory *(1 mark)*	(560)		
Increase in allowance for doubtful debts			10
Goodwill impairment			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 Non-current assets

	Goodwill $000	Land $000	Buildings $000	Plant $000	Total Property, Plant & Equipment $000
Cost	85	345	1,040	1,200	2,585
Depreciation b/f	–	–	(160)	(400)	(560)
Current year's depreciation/amortisation:					
Goodwill write-down	(17)				
Buildings \$1,040 x 5%			(52)		(52)
Plant (\$1,200 – \$400) x 25%				(200)	(200)
	68	345	828	600	1,773
	(1 mark)		*(4 marks)*		

3 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
	(1·5 marks)	*(1·5 marks)*

(b) The accounting treatment for goodwill as required by FRS 103:

At the date of acquisition the acquirer recognises goodwill as an intangible asset. On an ongoing basis goodwill is measured at cost and is assessed for impairment in accordance with FRS 36 at least annually. When a recoverable amount write-down is required, that write-down is taken through the income statement in the period in which it is identified.

3 marks

			Marks
2 (a) Prepared in accordance with FRS7			

Snowdrop
Cash flow statement for the year ended 31 May 2005 — 1

	$'000s	$'000s	Marks
Cash flows from operating activities			
Net profit before tax	1,032		1
Adjustments for:			
Depreciation	700		1
Loss on sale of tangible non-current assets	20		1
Interest expense	10		0·5
Operating profit before working capital changes	1,762		
Increase in inventory	(80)		1
Increase in receivables	(130)		1
Increase in payables	85		1
Cash generated from operations	1,637		
Interest paid	(10)		0·5
Tax paid	(145)		2
Dividends paid	(270)		1
Net cash from operating activities		1,212	
Cash flow from investing activities			
Purchase of non-current assets	(2,800)		2·5
Receipts from sales of tangible non-current assets	180		1
Net cash used by investing activities		(2,620)	
Cash flows from financing activities			
Proceeds from issue of share capital	1,280		1
Repayment of long term borrowing	(100)		1
Net cash from financing activities		1,180	1
Net decrease in cash and cash equivalents		(228)	1
Cash and cash equivalents at the beginning of period		170	0·5
Cash and cash equivalents at end of period		(58)	1

Note

Dividends paid and interest paid may be shown in either operating activities or financing activities. — 20

Workings

Non-current assets

	$000		$000
Balance b/f	2,700	Depreciation	700
New non-current 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	Income statement	180
	325		325

(b) Comment on the financial position of Snowdrop 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 non-current 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 receivables 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 credit suppliers.
(vi) Encouraging customers 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.

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	2
		Goodwill	35	
	205		205	

B. Sutton's Capital Account

	$000		$000	Marks
Revaluation (70 – 55)	15	Balance b/f	79	
Balance c/f	89	Goodwill	25	2
	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	
Balance c/f	165	69				3
	205	89		205	89	

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

	$000	$000	Marks
Assets			
Non-current assets			
Freehold property		120	0·5
Plant and equipment		80	0·5
		200	
Current assets			
Inventory	27		0·5
Trade receivables	18		0·5
Bank and cash	23	68	0·5
Total assets		268	
Capital and liabilities			
Capital Accounts			
A. Little		165	0·5
B. Sutton		69	0·5
		234	
Current liabilities			
Trade payables		34	0·5
Total capital and liabilities		268	
			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		Calculation		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	$\frac{\text{Gross Profit}}{\text{Revenue}}$	x 100	$\frac{60}{160}$	x 100	=37·5%	1·5
(iii)	Net profit percentage*	$\frac{\text{Net Profit before interest and tax}}{\text{Revenue}}$	x 100	$\frac{25}{160}$	x 100	=15·6%	1·5
(iv)	Quick/Acid test ratio	$\frac{\text{Current Assets – Inventory}}{\text{Current liabilities}}$	:1	$\frac{75 - 45}{45}$	:1	= 0·67 :1	1·5
(v)	Receivables collection period	$\frac{\text{Receivables}}{\text{Revenue}}$	x 365	$\frac{25}{160}$	x 365	= 57 days	1·5
(vi)	Earnings per share	$\frac{\text{Profit after tax}}{\text{No of ordinary shares in issue}}$		$\frac{10}{100}$		= 10 cents	1·5
							9·0

* Alternative definitions are also acceptable

(b) Brief Report

To:
From: A CAT Student

Date June 2005

Subject: Financial Appraisal of F. Raser Using Accounting Ratios

Introduction

The purpose of this report is to analyse the financial performance of F. Raser 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;
- Receivables 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 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 significantly 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. The level of inventory may be a concern as it is tying up cash. More information on the type of inventory and the level of inventory turnover would be useful.

Receivables 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 18c per share to 10c per share. This level of EPS is also significantly below the industry average and it is 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.