Answers

1 (a) Calculation of Operating Profit

Profit and loss account

	£000		£000	*Marks*
Taxation	80	Bal. at 1 June 2005	130	1
Dividends	100	Operating Profit (Bal. fig)	370	1
Debenture Interest	6			0·5
Bal. at 31 May 2006	314			0·5
	500		500	3

(b) Prepared in accordance with FRS1 (as revised)

Hadrian Ltd
Cash flow statement for the year ended 31 May 2006 0·5

	£000	£000	
Net cash inflow from operating activities (Note 1)		390	1
Returns on investments and servicing of finance			
Interest paid		(6)	1
Taxation			
Corporation tax paid		(60)	1·5
Capital expenditure			
Payments for tangible fixed assets	(880)		2·5
Proceeds from disposals	100		1·5
Total for capital expenditure		(780)	
Equity dividends paid		(100)	1
Cash flow before financing		(556)	
Financing			
Issue of ordinary share capital	550		1·5
Repayment of long term loans	(60)		1·5
Net cash inflows from financing		490	1
Decrease in cash		(66)	1

Notes to the cash flow statement

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

	£000	£000	
Operating profit		370	1
Depreciation	300		1
Profit on disposal	(20)		1
Increase in stock	(110)		1
Increase in debtors	(120)		1
Decrease in creditors	(30)		1
		20	
Net cash inflow from operating activities		390	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	(66)
Repayment of long term loans	60
Change in net funds	(6)
Net funds/(debt) at 31 May 2005	10
Net funds/(debt) at 31 May 2006	4

3 Analysis of changes in net funds/(debts)

	At 31 May 2005 £000	Cash flows £000	At 31 May 2006 £000
Cash at bank	70	(66)	4
Debt due after 1 year	(60)	60	0
	10	(6)	4

Workings

	£000		£000
Fixed Assets			
Balance b/f	1,500	Depreciation	300
New fixed assets (bal)	880	Disposals	80
		Balance c/f	2,000
	2,380		2,380

(c) **(i)** Return on capital employed* $\frac{\text{Profit before int. \& tax}}{\text{Capital employed}} \times 100$ $\frac{370}{2{,}414} \times 100 = 15\%$

(ii) Quick ratio $\frac{\text{Current Assets – Stock}}{\text{Current liabilities}} :1$ $\frac{274}{200} :1 = 1{\cdot}4 : 1$

(iii) Debtors collection period# $\frac{\text{Debtors}}{\text{Sales}} \times 365$ $\frac{270}{800} \times 365 = 123$ Days

(iv) Earnings per share $\frac{\text{Profits on ordinary act. after tax}}{\text{No. of ordinary shares}}$ $\frac{284}{2{,}000} = 14$ p

* Alternative ratio definitions and calculations may be acceptable.
# Average debtors may be used in ratio definition and calculation.

Marking scheme: 0·5 for each correct formula and 1 mark for each correct ratio.

(d) **Comments on the cash flow statement**

Cash in the business has decreased by £66,000 and the changes in working capital suggest a squeeze on liquidity i.e. debtors and stock have increased over the period and at the same time creditors have decreased. However, cash from operations is positive and Hadrian Ltd is able to pay interest and tax which are key items.

During the year Hadrian Ltd has:

- repaid £60,000 of long term loans which will reduce future year's interest payments
- purchased assets worth £880,000 which may improve future efficiency and therefore profitability
- issued 500,000 shares at a 10% premium

Comments on ratios

Return on capital employed
The return on capital employed appears to be good when compared with the industry average. However, this may be misleading if the company's fixed assets are under valued.

Quick ratio
The low quick ratio in comparison with the industry average confirms the analysis from the cash flow statement that liquidity may be a problem for this company.

Debtors collection period
The long debtors collection period suggests the company may be having problems collecting its debts. This long debt collection period will be having an adverse impact on the company's liquidity. In addition, the longer the collection period, the less likely the debts will be recovered.

Earnings per share
The earnings per share is just slightly lower than the industry average. This may not necessarily be a cause for concern, as the company issued shares in 2006 which will have reduced the EPS. The success of the share issue suggests that investors find this company an attractive investment. The investment by the company, in new assets, is likely to result in a higher EPS in the future.

Marking Scheme: 1 mark for each relevant comment up to a maximum of 11 marks.

				Marks	Workings
2	**(a)**	Paul and Barry Trading and Profit and Loss Account and Appropriation Account for the year ended 31 May 2006		0·5	

	£	£	Marks	Workings
Sales		568,000	0·5	
Less returns inwards		(5,100)	0·5	
		562,900		
Opening stock	39,200		0·5	
Add Purchases	375,150		1·0	(£375,600 – £450)
	414,350			
Less closing stock	(32,000)		0·5	
Cost of goods sold		(382,350)	0·5	
Gross Profit		180,550	0·5	
Expenses				
Rent	18,760		0·5	
Selling expenses	55,600		0·5	
General expenses	4,280		1·0	(£3,680 + £600)
Wages	18,000		0·5	
Depreciation				
– Motor vehicles	4,200		1·5	((£30,000 – £9,000) x 20%)
– Fixtures and fittings	2,100		1·0	(£14,000 x 15%)
Insurance	640		1·0	(£1,540 – £900)
Motor vehicle expenses	9,300		0·5	
Discounts allowed	8,900		0·5	
Bad debts	1,100		0·5	
Increase in allowance for debtors	220	(123,100)	1·5	((£47,500 – £1,100) x 5%) – £2,100
Net profit before appropriation		57,450		
Interest on drawings: Paul	420		0·5	
Barry	180	600	0·5	
		58,050		
Salary: Paul		(15,000)	0·5	
		43,050		
Share of profit: Paul 2/3	28,700		0·5	
Barry 1/3	14,350		0·5	
		43,050		
			16·0	

(b)

Current Accounts

Paul

	£		£	Marks
Drawings	16,000	Bal b/f	3,570	0·5 + 0
Interest on drawings	420	Salary	15,000	0·5 + 0·5
Balance c/f	30,850	Share of profit	28,700	0 + 0·5
	47,270		47,270	

Barry

	£		£	Marks
Drawings	11,000	Bal b/f	2,190	0·5 + 0
Goods	450	Share of profit	14,350	0·5 + 0·5
Interest on drawings	180			0·5
Balance c/f	4,910			
	16,540		16,540	
				4

(c)

Paul and Barry
Balance sheet as at 31 May 2006

		Cost	Accumulated Depreciation	Net Book Value	*Marks*	*Workings*
					0·5	
		£	£	£		
Fixed assets						
Motor vehicles		30,000	13,200	16,800	1·0	
Fixtures and fittings		14,000	9,100	4,900	1·0	
		44,000	22,300	21,700	0·5	
Current assets						
Stock			32,000		0·5	
Debtors		46,400			1·0	(£47,500 – £1,100)
Allowance for debtors		(2,320)	44,080		1·0	(£46,400 x 5%)
Prepayment (insurance)			900		0·5	
Bank			13,980		0·5	
			90,960			
Current liabilities						
Creditors		(41,300)			0·5	
Accruals (general expenses)		(600)	(41,900)		0·5	
Net current assets				49,060	0·5	
				70,760		
Partners' capital accounts						
Paul			20,000		0·5	
Barry			15,000	35,000	0·5	
Partners' current accounts						
Paul			30,850		0·5	
Barry			4,910	35,760	0·5	
				70,760		
					10·0	

3 (a)

Goodwill on acquisition of				*Workings (£000)*
Everpool Ltd	**£000**	**£000**		
Cost of investment		3,500	0·5	
Share capital (75% of £4,000,000)	(3,000)		1	
Accumulated profits (75% of £200,000)	(150)	(3,150)	1	
Goodwill on acquisition		350	0·5	
			3	

(b)

Liverton Ltd
Consolidated profit and loss account for the year ended 31 May 2006

	£000		
Turnover	8,800	1·5	(6,400 + 2,600 – 200)
Cost of sales	(5,004)	2·5	(3,700 + 1,450 – 200 + (60% x 90))
Gross profit	3,796		
Distribution costs	(1,590)	0·5	
Administrative expenses	(1,020)	0·5	
Goodwill amortisation	(70)	1	(350 ÷ 5)
Profit before tax	1,116		
Tax	(480)	0·5	
Profit after tax	636		
Minority interest	(65)	1	(260 x 25%)
Group net profit for the year	571	0·5	
		8	

(c) Associates

An associate is defined as an entity other than a subsidiary in which another entity (the investor) has a participating interest and over whose operating and financial policies the investor exercises significant influence. Significant influence can be determined by the holding of voting rights (usually represented by holding shares) in the enterprise. If an investor holds between 20% and 50% of the voting power of the investee then the investor will usually have significant influence over the investee unless it can be clearly demonstrated this is not the case.

The existence of significant influence might also be demonstrated in one or more of the following ways:
(a) Representative of the investor on the board of directors.
(b) Participation in the policy making process.
(c) Material transactions between investee and investor.
(d) Interchange of management personnel.
(e) Provision of essential technical information.

Marking scheme: 1 mark for each point up to a maximum of 4 marks for a good answer.

4 **(a)** Adjusting events – These are events that provide evidence of a condition that existed at the balance sheet.

FRS 21 requires that the amounts recognised in the financial statements be adjusted to take account of an adjusting event. The standard also requires that disclosures be up-dated in the light of new information that relate to a condition that existed at the balance sheet date.

Non-adjusting event – These are events that are indicative of conditions that arose after the balance sheet date.

FRS 21 prohibits the adjustment of amounts recognised in the financial statements to reflect non-adjusting events after the balance sheet date. However, if a non-adjusting event is material and its non-disclosure could influence the decisions of users then an entity should disclose the following:

(a) the nature of the event

(b) an estimate of its financial effect, or a statement that such an estimate cannot be made.

Marking scheme: up to 2 marks for defining each type of event and how they should be treated (maximum 4 marks).

(b) (i) Debts that were thought to be good at the balance sheet date will not now be paid. – Adjusting event

(ii) Jilton Newl Ltd has announced a bid to take over another company. – Non adjusting event

(iii) Some material errors have been discovered which show the financial statements are incorrect. – Adjusting event

(iv) The factory workforce at Jilton Newl Ltd has started strike action for an indefinite length of time. – Non adjusting event

Marking scheme: 1 mark for each correct answer (maximum 4 marks)

(c) Contingent liability

FRS 12 defines a contingent liability as:

A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity; or

A present obligation that arises from past events but is not recognised because:

– It is not probable that a transfer of economic benefits will be required to settle the obligation; or

– The amount of the obligation cannot be measured with sufficient reliability

Contingent liabilities should not be recognised in the financial statements but they should be disclosed, unless the possibility of any liability is remote. The required disclosures are:

– A brief description of the nature of the contingent liability

– An estimate of its financial effect

– An indication of the uncertainties that exist

– The possibility of any reimbursement

Marking scheme: up to 1·5 marks for defining a contingent liability and up to 2 marks for the accounting treatment.

Contingent asset

FRS 12 defines a contingent asset as:

A possible asset that arises from past events and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control.

A contingent asset must not be recognised. Only when the realisation of the related economic benefit is virtually certain should recognition take place. At that point the asset is no longer a contingent asset.

A contingent asset is disclosed where an inflow of economic benefit is probable.

Marking scheme: up to 1·5 marks for defining a contingent asset and up to 2 marks for the accounting treatment.