Answers

1 (a) Calculation of profit before interest and tax.

Retained Earnings

	$000		$000	*Marks*
Taxation	80	Bal. at 1 June 2005	130	1
Dividends	100	Profit before interest and tax (Bal. fig)	370	1
Loan note interest	6			0·5
Bal. at 31 May 2006	314			0·5
	500		500	3

(b) Prepared in accordance with IAS 7

Hadrian
Cash flow statement for the year ended 31 May 2006

	$000	$000	Marks
Hadrian Cash flow statement for the year ended 31 May 2006			0·5
Cash flows from operating activities			
Net profit before tax	364		1
Adjustments for:			
Depreciation	300		1
Profit on sale of tangible non-current assets	(20)		1
Interest	6		0·5
Operating profit before working capital changes	650		
Increase in inventory	(110)		1
Increase in receivables	(120)		1
Decrease in payables	(30)		1
Cash generated from operations		390	
Interest paid	(6)		0·5
Tax paid	(60)		1·5
Dividends paid	(100)	(166)	1
Net cash from operating activities		224	
Cash flow from investing activities			
Purchase of non-current assets	(880)		2·5
Receipts from sale of tangible non-current assets	100		1·5
Net cash used in investing activities		(780)	
Cash flows from financing activities			
Proceeds from issue of share capital	550		1·5
Repayment of long term borrowing	(60)		1·5
Net cash from financing activities		490	1
Net decrease in cash and cash equivalents		(66)	1
Cash and cash equivalents at the beginning of period		70	0·5
Cash and cash equivalents at end of period		4	0·5
			20

Note

Interest paid and dividends paid may be shown in either operating activities or financing activities.

Workings

Non-current assets

	$000		$000
Balance b/f	1,500	Depreciation	300
New non-current assets (bal)	880	Disposals	80
		Balance c/f	2,000
	2,380		2,380

(c) (i) Return on capital employed*

$$\frac{\text{Profit before int. \& tax}}{\text{Capital employed}} \times 100 \quad \frac{370}{2{,}414} \times 100 = 15\%$$

(ii) Quick ratio

$$\frac{\text{Current Assets – Inventory}}{\text{Current liabilities}} :1 \quad \frac{274}{200} :1 = 1{\cdot}4 : 1$$

(iii) Receivables collection period#

$$\frac{\text{Receivables}}{\text{Sales revenue}} \times 365 \quad \frac{270}{800} \times 365 = 123 \text{ Days}$$

(iv) Earnings per share

$$\frac{\text{Profits on ordinary act. after tax}}{\text{No. of ordinary shares}} \quad \frac{284}{2{,}000} = 14 \text{ cents}$$

* Alternative ratio definitions and calculations may be acceptable.
\# Average receivables 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. receivables and inventory have increased over the period and at the same time payables have decreased. However, cash from operations is positive and Hadrian is able to pay interest and tax which are key items.

During the year Hadrian has:

– repaid $60,000 of long term loans which will reduce future year's interest payments
– purchased non-current 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 non-current 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.

Receivables collection period
The long receivables 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.

2 (a)

Paul and Barry
Income statement and appropriation account
for the year ended 31 May 2006

	$	$	*Marks*	*Workings*
			0·5	
Sales revenue		568,000	0·5	
Less returns inwards		(5,100)	0·5	
		562,900		
Opening inventory	39,200		0·5	
Add Purchases	375,150		1·0	($375,600 – $450)
	414,350			
Less closing inventory	(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 receivables	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

	$		$	
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

	$		$	
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) *Marks Workings*

Paul and Barry
Balance sheet as at 31 May 2006

	Cost	Accumulated Depreciation	Net Book Value	Marks	Workings
	$	$	$	0·5	
Non-current 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					
Inventory		32,000		0·5	
Trade receivables	46,400			1·0	($47,500 – $1,100)
Allowance for receivables	(2,320)	44,080		1·0	($46,400 x 5%)
Prepayment (insurance)		900		0·5	
Bank		13,980	90,960	0·5	
			112,660		
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		
Current Liabilities					
Trade payables		41,300		0·5	
Accruals (general expenses)		600	41,900	0·5	
			112,660	0·5	
				10·0	

3 (a) Goodwill on acquisition of Everpool *Workings ($000)*

	$000	$000	Marks
Cost of investment		3,500	0·5
Share capital (75% of $4,000,000)	(3,000)		1
Pre-acquisition reserves (75% of $200,000)	(150)	(3,150)	1
Goodwill on acquisition		350	0·5
			3

(b) **Liverton**
Consolidated income statement for the year ended 31 May 2006

	$000	Marks	Workings
Sales revenue	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 impairment	(70)	1	(200 – 130)
Profit before tax	1,116		
Income tax expense	(480)	0·5	
Profit for the period	636		
Attributable to:			
Equity holders of the parent	571	0·5	
Minority interest	65	1	(260 x 25%)
	636		
		8	

(c) Associates

An associate is defined as an entity over which an investor has significant influence and that is neither a subsidiary nor a joint venture of the investor. Significant influence is the power to participate in the financial and operating policy decisions of the investee. 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.

IAS 10 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.

IAS 10 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) Receivables that were thought to be good at the balance sheet date will not now be paid. – Adjusting event

(ii) Jilton Newl 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 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

IAS 37 defines a contingent liability as:

A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-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

IAS 37 defines a contingent asset as:

A possible asset that arises from past events and whose existence will be confirmed by the occurrence, or non-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.