Answers

1 (a) Goodwill on acquisition of Tricepts Ltd

	£000	£000	Marks
Cost of investment		24,000	1
Share capital (£25 million x 80%)	20,000		1
Profit and loss account (£2 million x 80%)	1,600	(21,600)	1
Goodwill		2,400	
		Total	3

(b) (i) Bicepts Ltd

Consolidated profit and loss account for the year ended 31 May 2007 0·5

	£000	Marks	Workings (£000)
Turnover	197,000	1·5	135,000 + 74,000 – 12,000
Cost of sales	(89,000)	2·5	70,000 + 30,000 – 12,000 + 1,000*
Gross Profit	108,000		
Distribution costs	(13,700)	0·5	
Administrative expenses	(26,784)	0·5	
Goodwill amortised	(600)	1·5	2,400/4
Operating profit	66,916		
Interest payable	(12)	1·0	16 – 4
Profit on ordinary activities before taxation	66,904		
Tax on profit on ordinary activities	(19,000)	0·5	
Profit on ordinary activities after taxation	47,904		
Minority interests	(4,200)	1·5	20% x 21,000
Group profit for the year	43,704		
Total		10·0	

(ii) Bicepts Ltd

Consolidated Balance Sheet as at 31 May 2007 0·5

	£000	£000	Marks	Workings
Fixed assets				
Intangible – goodwill		1,800	1·0	(2,400 – 600)
Tangible, net book value		119,050	0·5	(80,000 + 39,050)
		120,850		
Current assets				
Stock	14,128		1·5	(10,630 + 4,498 – 1,000*)
Debtors	22,486		3·5	(18,460 + 12,230 – 6,400** – 1,800*** – 4****)
Bank	4,744		0·5	(3,400 + 1,344)
	41,358			
Creditors amounts falling due within one year				
Creditors	6,118		2·5	(6,000 + 1,922 – 1,800*** – 4****)
Tax	18,000		0·5	
Dividends payable to Minority Interests	1,600		1·0	
Dividends	12,000		0·5	
	37,718			
Net current assets		3,640		
		124,490		
Creditors amounts falling due after more than one year				
8% Debenture		(150)	1·0	(200 – 50)
		124,340		
Capital and Reserves				
£1 Ordinary shares		70,000	0·5	
Profit and loss account (W1)		46,340	4·0	W1
Minority interest		8,000	1·5	(20% x 40,000)
		124,340		
		Total	19·0	

Marks

Notes:
* Exclusion of unrealised profit held in stock (£1,000,000)
** Exclusion of the intragroup dividends from debtors (£6,400,000)
*** Intragroup indebtedness (£1,800,000)
**** Exclusion of intragroup interest (£4,000)

Workings

W1 Profit and loss account as at 31 May 2007

	£000	£000	Marks
Bicepts Ltd Balance Sheet		37,540	0·5
Less unrealised profit		(1,000)	1
Tricepts Ltd:			
Profit and loss account	15,000		
Pre-acquisition reserves	(2,000)		
	13,000		
Group share (80% x £13,000,000)		10,400	2
Less goodwill amortised as at 31 May 2007		(600)	0·5
		46,340	
			4

(c) When one company sells goods to another company within the same group an identical amount is shown in the sales figure of the first company and in the cost of sales of the second. However, as far as the group is concerned there has not been an external sale. Therefore, on consolidation the amount of the inter-company trade must be eliminated from sales and purchases (cost of sales).

If there are unrealised profits on inter-company trading these also need to be excluded from the figures for the group profits. This is achieved by calculating and then deducting the amount of unrealised profit from unsold stock at the year end.

Similarly, if fixed assets have been sold at profit between companies in a group then the profit element has to be eliminated.

Any debtor/creditor balances outstanding between the two companies at the year end are cancelled on consolidation to avoid producing a misleading balance sheet.

Up to 3 marks

2 (a) J Moor's accounts **Marks**

(i) Revaluation account

	£		£	Marks
Stock loss	500	Goodwill	12,000	1·0 + 0·5
Capital account	16,500	Property – profit	5,000	0·5 + 1·0
	17,000		17,000	

(ii) Capital account

	£		£	Marks
Balance c/f to new business	56,000	Balance b/f	35,000	0·5 + 0·5
		Dodd's loan	4,500	1·0
		Profit on revaluation	16,500	0·5
	56,000		56,000	

P Croft's accounts

(i) Revaluation account

	£		£	Marks
Plant and machinery – loss	1,500	Goodwill	9,000	1·0 + 0·5
Capital account	7,500			0·5
	9,000		9,000	

(ii) Capital account

	£		£	Marks
Motor vehicle	7,000	Balance b/f	23,300	1·0 + 0·5
Balance c/f to new business	23,800	Profit on revaluation	7,500	0·5 + 0·5
	30,800		30,800	
			Total	10

(b)

Moorcroft
Balance sheet as at 31 May 2007

	£	£	Marks	Workings
Fixed assets				
Property		30,000	1	
Plant and machinery		28,500	1	(£14,000 + £14,500)
		58,500		
Current assets				
Stock	8,500		1	(£4,500 + £4,000)
Trade debtors	2,800		1	
Cash at bank	4,000		1	
	15,300			
Current liabilities				
Trade creditors	(15,000)	300	1	
		58,800		
Capital accounts				
J Moor		42,000	2	W1
P Croft		16,800	2	W1
		58,800		
		Total	10	

Working 1

Partners' Capital accounts

	Moor £	Croft £		Moor £	Croft £	Marks
Goodwill written off 2:1 x £21,000	14,000	7,000	Balance b/f from old business	56,000	23,800	1·0 + 1·0 + 0·5 + 0·5
Balance c/f	42,000	16,800				0·5 + 0·5
	56,000	23,800		56,000	23,800	

(c) Goodwill is calculated as the difference between the value of the whole business as a going concern and the value of the tangible and other identifiable intangible assets less any liabilities. Therefore, goodwill is a balancing item rather than an item that is objectively valued. (up to 2 marks)

Goodwill needs to be recalculated when a partner joins a partnership business for the following reasons.
A new partner that joins a business is entitled to share in the future growth of all the partnership assets. Their entitlement arises because they make a payment to enter the partnership, or the existing partners consider they will enhance the future profitability of the firm. However, the new partner's entitlement is to share in the future growth of the business not its past growth.
Any goodwill which has already been built up by the existing partners needs to be credited to them. (up to 3 marks)

Total 5 marks

									Marks
3	**(a)**	**(i)**	Gross profit percentage	$\frac{\text{Gross profit}}{\text{Sales}}$ x 100	$\frac{95}{375}$	x 100	=	25·3%	1
		(ii)	Net profit percentage*	$\frac{\text{Net profit (before interest and tax)}}{\text{Sales}}$ x 100	$\frac{50}{375}$	x 100	=	13·3%	1
		(iii)	Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$:1	$\frac{133}{103}$	:1	=	1·3:1	1
		(iv)	Acid test (Quick) ratio	$\frac{\text{Current assets – stock}}{\text{Current liabilities}}$:1	$\frac{133 - 96}{103}$	:1	=	0·4:1	1
		(v)	Debtors collection period	$\frac{\text{Debtors}}{\text{Sales}}$ x 365	$\frac{34}{375}$	x 365	=	33·1 days	1
			* Could also be after interest and tax.					**Total**	5

(b) **Comments on the performance of Acoms Ltd**

Gross Profit
Gross profit percentage has reduced from the previous year by 27%. This might indicate increased competition in the market and that selling prices have been discounted. Alternatively the cost of purchases may have increased significantly. The situation is particularly worrying because this ratio is now below the industry average.

Net Profit
The net profit percentage has also deteriorated on the previous year and is below the industry average. This suggests that the control of costs needs to be improved if the company is to remain competitive.

Current Ratio
The current ratio has deteriorated slightly on the previous year but is similar to the industry average. The business has sufficient current assets to cover its current liabilities. However, the composition of the current assets is heavily weighted with stock. The company may have problems converting stock to cash if it is required quickly.

Acid Test
The acid test ratio gives a better indication of liquidity than the current ratio. This ratio is 0·4:1 and has fallen significantly below the industry average. This ratio suggests the company may be experiencing some liquidity problems. The current stock levels might also indicate the business is having some trading problems.

Debtors collection period
The debtors collection period has more than doubled since the previous year and is 13 days longer than the industry average. The business may be giving customers more credit in order to sell more stock. Alternatively the debtors collection procedures may need to be tightened up, which would help to improve the business' liquidity situation.

Marking scheme: Maximum of 10 marks.

(c) **Main limitations of ratio analysis**

– Inflation may distort comparisons of ratios over time.
– Different accounting policies may distort intercompany comparisons.
– The ratios are only as good as the financial information on which they are based.
– The accounting information used to prepare the ratios may be out of date.
– Changes in accounting policies from year to year may produce misleading ratios.
– Usually the information presented in the published accounts is summarised, making a detailed analysis impossible.
– Using industry averages as a basis for comparison can be misleading as they are the average of the ratios from a number of companies.

Marking scheme 1 mark for each relevant comment up to a maximum of 5 marks

4 **(a)** **(i)** The role of the FRC is to act as an independent regulator for corporate reporting and governance in the UK.

(ii) The role of the ASB is to develop and then issue accounting standards.

(iii) The role of the UITF is to assist the ASB where unsatisfactory or conflicting interpretations have developed about a requirement of an accounting standard or the Companies Act.

(iv) The role of the FRRP is to ensure that the annual accounts of public companies and large private companies comply with the requirements of applicable accounting standards.

Marking scheme: 1 mark for briefly explaining each role up to a maximum of 4 marks.

(b) The qualitative characteristics of financial information are the characteristics that make the information useful and determine whether, when and how it is presented in financial statements so that the information they give is useful to users for assessing the financial position, performance and financial adaptability of the business.

(1) Relevance

Information is considered to be relevant if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions.

(2) Reliability

Information is reliable if:

(a) it can be depended upon by users to represent faithfully what it either purports to represent or is reasonably expected to represent and therefore reflects the substance of the transactions and other events that have taken place.

(b) it is free from deliberate or systematic bias and material error, and is complete; and

(c) in its preparation under conditions of uncertainty, a degree of caution has been applied in exercising the necessary judgements.

(3) Comparability

Information is comparable if it enables users to determine and evaluate similarities in, and differences between, the nature and effects of transactions and other events over time and across different businesses.

(4) Understandability

Information is understandable if its significance can be appreciated by users that have a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided.

Marking scheme: $^1/_2$ a mark for identifying and 2 marks for explaining the characteristic. Maximum of 10 marks.

(c) The main problems with historical cost accounting are:

(i) Fixed asset values are unrealistic

The value of fixed assets shown on the balance sheet may be unrealistic if presented at their historical cost. For example, property assets have a tendency to appreciate over time, hence the value on the balance sheet becomes understated.

To overcome this problem a business may periodically revalue its assets.

(ii) Potential capital reduction

Distributions made out of profit based on the historical cost basis may result in a reduction of capital in real terms. Depreciation is regarded as a proxy for the contribution fixed assets have made to the business over the accounting period. A criticism of depreciation based on historical cost is that it may not adequately reflect the value of the asset's contribution during the year. This inadequacy is partly overcome by periodically revaluing the assets.

(iii) Holding gains on stock are included in profit

Closing stocks, during a period of rising prices, will tend to have a higher value than goods purchased in earlier periods (i.e. stock appreciation). Therefore, the gross profit will be overstated because the closing stock is deducted from the opening stock plus purchases. However, when the stock is eventually sold it will probably cost more to replace.

(iv) Comparisons over time are unrealistic

Measuring the growth or the success of a business over time can be difficult during periods of inflation. For example, comparing the current profitability of a company with its performance ten years later would be meaningless without attempting to adjust the figures for inflation.

Examiner's note: reference to Current Purchasing Power Accounting (CPP) and Current Cost Accounting (CCA) should be given due credit.

Marking Scheme: 1 mark per relevant point up to a maximum of 6 marks.