

# **FINANCIAL REPORTING**

**December 2004  
Certificate stage**

## **MARKING SCHEME**



(Copyright)

<b>Question 1</b>
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(a)

<b>Parmelo plc</b>				½
<b>Profit and loss account</b>				
<b>for the year ended 31 October 2004</b>				½
	<i>Continuing Operations</i>	<i>Discontinued Operations</i>	<i>Total</i>	
	£	£	£	
Turnover	12,915,000	5,535,000	18,450,000	1
Cost of sales	<u>(9,573,850)</u>	<u>(5,314,000)</u>	<u>(14,887,850)</u>	1 ½
Gross profit	3,341,150	221,000	3,562,150	½
Distribution costs	(331,200)	(108,000)	(439,200)	1 ½
Administrative expenses	<u>(1,097,150)</u>	<u>(194,000)</u>	<u>(1,291,150)</u>	3 ½
Operating profit/(loss)	<u>1,912,800</u>	<u>(81,000)</u>	1,831,800	½
Loss on sale of operation			(195,600)	1
Income from fixed asset investments			14,800	1
Interest payable and similar charges			<u>(53,600)</u>	1
Profit on ordinary activities			1,597,400	½
Tax on profit on ordinary activities			<u>(472,200)</u>	1
Profit on ordinary activities after taxation			1,125,200	½
Dividends paid and proposed			<u>(342,500)</u>	2
Amount set aside to reserves			<u>782,700</u>	½
Basic earnings per share (in pence) (Note 1)			<u>27.6</u>	1 ½

**Note 1: Earnings per share**

Earnings per share is calculated by dividing the profit after taxation and preference dividend for the year of £1,102,700 by the number of ordinary shares, 4,000,000, in issue and ranking for dividend during the year.

*Marks as above 18 ½*  
*Disclosure note on eps 1 ½*  
*Appropriate disclosure of discontinued operations*  
*Analysis of turnover ½*  
*Analysis of cost of sales ½*  
*Analysis of gross profit ½*  
*Analysis of distribution costs ½*  
*Analysis of administrative expenses ½*  
*Analysis of operating profit ½*  
*Style and presentation 2*  
 (25)

**Workings**

<b>Cost of sales</b>	£	
Per trial balance	14,760,000	½
Production director's remuneration	54,450	½
Depreciation	73,400	½
	<u>14,887,850</u>	
 <b>Distribution costs</b>	 £	
Per trial balance	358,900	½
Sales director's remuneration	36,300	½
Depreciation	44,000	½
	<u>439,200</u>	
 <b>Administrative expenses</b>	 £	
Per trial balance	968,100	½
Exclude overdraft interest	(5,600)	½
Bad debts	203,000	½
Directors' remuneration (£54,450 + £36,300)	90,750	1
Depreciation	29,400	½
Audit and accountancy fees	5,500	½
	<u>1,291,150</u>	
 <b>Interest payable and similar charges</b>	 £	
Debenture interest	48,000	½
Bank overdraft interest	5,600	½
	<u>53,600</u>	
 <b>Tax on profit on ordinary activities</b>	 £	
Corporation tax	488,700	½
Transfer from deferred taxation	(16,500)	½
	<u>472,200</u>	
 <b>Dividends paid and proposed</b>	 £	
Preference paid	11,250	½
Preference proposed	11,250	½
Ordinary paid	120,000	½
Ordinary proposed	200,000	½
	<u>342,500</u>	

**(b)**

**Parmelo plc**  
**Statement of total recognised gains and losses for the**  
**year ended 31 October 2004**

	£	
Profit on ordinary activities after taxation	1,125,200	½
Unrealised loss following reduction in value of investment property	(160,000)	1
Unrealised surplus following revaluation of premises	200,000	1
Total recognised gains and losses for the year	<u>1,165,200</u>	½

*Marks as above 3*  
*Not including share issue premium 1*  
*Layout/style 1*  
*(5)*  
  
**(30)**

**Question 2**

(a) The direct method calculates the cash generated from operations by analysing total operating cash flows into:

- Cash received from customers
- Cash payments to suppliers
- Cash paid to and on behalf of employees
- Other cash payments

The indirect method takes the figure for operating profit (ie profit before interest and tax) and adjusts it to convert it into the cash flow from operations. Adjustments are made for non-cash expenses such as depreciation and for changes in current assets and liabilities associated with operating profit eg changes in stock, trade debtors, prepaid expenses, trade creditors and accrued expenses.

The direct method has been used in the cash flow statement given.

*Explanation of direct method 2*  
*Explanation of indirect method 2*  
*Method used identified 1*  
*(5)*

**(b) Report**

Subject: Performance of Angelo  
To: Treasury Manager  
From:  
Date:

The cash flow statement is easy to understand because every figure represents an actual cash flow into or out of the business. It provides a bridge between the information in the Profit and Loss Account and that in the Balance Sheet. The cash flow statement can provide useful information about the financial and liquidity management of the company.

Many aspects of the cash flow of Angelo Ltd over the past three years give cause for concern.

The net cash flow from operations has fallen by almost 94% over the past three years. This seems due to a combination of falling cash receipts from customers, and increasing cash payments to suppliers and employees.

The falling receipts from customers may be evidence of falling sales, an increasing period of credit being taken by customers, or even perhaps increasing discounts being given to customers to make early payment in order to improve cash flow.

The cash payments to suppliers seem to be increasing relative to the cash collected from customers. This may be evidence of increasing purchase costs (which appear

not to be being passed on to customers), or tighter credit control by suppliers (which is perhaps not being matched by tighter control on credit customers).

The above is evidence of there being some pressure on profit margins. Further evidence of this is the increasing payments to employees. Other cash payments have been falling. However, it should be checked whether this is due to effective cost control or delays in paying invoices.

The falling amounts of interest received may be due to falling interest rates and or a reduction in deposits and other loan investments. There is some evidence to support the latter since there seem to be significant receipts from the sale of government bonds. It is not clear how much scope there is for further receipts from the sale of short term investments. There would appear to be no sales of government bonds in 2004 – but the significant amount raised from the sale of fixed asset investments may be a sign of desperation.

Despite the falling interest receipts interest payments are increasing significantly. This could be due to increasing interest rates (although this would be inconsistent with the fall in interest received), or, as may be more likely, increasing borrowing.

The changes in the cash flows associated with investing activities are revealing. Investment in fixed assets decreased significantly between 2002 and 2003 and had all but ceased in 2004. There have been significant disposals of fixed assets and short-term investments over the past three years.

There were issues of both debentures and shares in 2003. Given the circumstances, it would be interesting to know whether or not the shares were issued at a premium and to whom these issues were made. The £175,000 raised from the share issue would not appear to be associated with any increased long-term investment in the company. The £300,000 raised from the issue of the debentures would appear merely to replace some of loans repaid over the three years. The issue of ordinary shares would appear to be necessary to finance increasing working capital requirements. This plus the fact that the dividend paid (on an increased capital base) has plummeted in 2004 give real cause for concern.

It should be borne in mind that the cash flow statement provides limited evidence as to the past performance of the company. Also, it is the future performance of the company which matters – not its past. Nevertheless, Angelo Ltd's cash flow statement reveals a number of items which are of concern and which should be investigated further.

Please do not hesitate to get back to me if you have any further queries.

*Report format 2*  
*Each substantive point, if supported by evidence: 2 marks to a maximum of 18*  
*Conclusions and style 5*

(25)

(30)

**Question 3****(a) Lessee – Sum-of-the-digits/Rule of 78****Barello Ltd  
Profit and Loss accounts**

Year	1	2
	£	£
Finance charge	20,000	13,333
Depreciation	20,000	20,000
Net costs	40,000	33,333
Taxation		
Corporation tax	9,000	9,000
Net cost after taxation	31,000	24,333

*Finance charge: correct figure for each year, 1 mark each = 2 marks*

*Depreciation: ½ mark for each correct figure = 1 mark*

*Taxation: ½ mark for each correct figure = 1 mark*

**(4)**

**Supportive workings:****Allocation of profit on lease****Rule of '78**

Year	Number of Instalments not yet due	Interest £	Rental paid £	Capital Repayment £
1	3	20,000	30,000	10,000
2	2	13,333	30,000	16,667
3	1	6,667	30,000	23,333
4	0	-	30,000	30,000
	6	40,000	120,000	80,000

**Calculation of corporation tax**

Each year corporation tax is 30% of the rental paid i.e. 30% of £30,000 = £9,000

**(b) Lessee – Actuarial method,  $r = 36.31\%$** **Barello Ltd****Profit and Loss accounts**

Year	1	2
	£	£
Finance charge	18,155	13,854
Depreciation	<u>20,000</u>	<u>20,000</u>
Net costs	38,155	33,854
Taxation		
Corporation tax	<u>9,000</u>	<u>9,000</u>
Net cost after taxation	<u><u>29,155</u></u>	<u><u>24,854</u></u>

*Finance charge: 1 mark for each correct figure = 2 marks*

*Depreciation: 0.5 mark for correct figure = 1 mark*

*Corporation tax 0.5 mark for correct figure = 1 mark*

*(4)*

**Supportive workings****Calculation of finance charge (ie interest):**

	£
Fair value of asset	80,000
Initial rental	<u>(30,000)</u>
Outstanding for year 1	50,000
Interest year 1 @ 36.31%	<b>18,155</b>
Rental year 2	<u>(30,000)</u>
Outstanding for year 2	38,155
Interest year 2 @ 36.31%	<b>13,854</b>
Rental year 3	<u>(30,000)</u>
Outstanding for year 3	22,009

**Calculation of corporation tax**

Each year corporation tax is 30% of the rental paid i.e. 30% of £30,000 = £9,000



**(c) Balance sheet – actuarial method**

## LEASED ASSETS

End of Year	Cost £	Accumulated Depreciation £	Net Book Value £
1	80,000	20,000	60,000
2	80,000	40,000	40,000

## LEASING OBLIGATIONS

Year	Obligations under finance leases o/s at start of year £	Capital repayment £	Obligations under finance leases o/s at end of year £
1	80,000	30,000	50,000
2	50,000	11,845	38,155

*Reporting of asset 2 x 1 = 2  
Reporting of leasing obligations 2 x 2  
(Capped at 4)*

**(d) Operating lease – Profit and loss account**

Cash flows associated with the operating lease would be reported on a straight line basis over the life of the lease. The cash flows are:

Cash incentive = £2,400  
Cash rentals = 3 x £3,600 = £10,800  
So net cash flow = £10,800 - £2,400 = £8,400

The rental reported in the profit and loss account will be £8,400 / 3 = £2,800 each year.

The balance sheet will show an accrual (or deferred income) of £1,600 at the end of the first year and £800 at the end of the second year.

*Profit and loss account figures 2  
Balance sheet figures 2  
(4)*

**(e) At the moment the ASB's SSAP 21 Accounting for leases and hire purchase contracts requires finance leases to be capitalised but operating leases are charged to revenue on a straight line basis over the life of the lease.**

However, current thinking on recognition and derecognition suggests that this may be unsatisfactory. There are now proposals for an accounting standard that would require a single method of accounting for both finance and operating leases so that assets and liabilities (reflecting rights to use and obligations to pay) would be reported for all leases in lessees' balance sheets.

Candidates may also mention the current problems in distinguishing between a finance lease and an operating lease – in particular the use and abuse of the '90% rule' ie a lease is a finance lease if the present value of the minimum lease

payments is at least 90% of the fair value of the asset. Although widely applied the 'rule' is in SSAP 21 as guidance only.

Candidates may refer to the following:

- A G4+1 Special Report, *Accounting for Leases: A New Approach— Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts* (1996)
- ASB Discussion Paper 'Leases: Implementation of a New Approach' (1999)

*Awareness of current practice = 1 mark*

*Awareness of current debate = 1 mark*

*Quality of argument either for or against = 4 marks*

*Total capped at 4 marks*

**(20)**

**Question 4****(1) Treatment of brand**

FRS 10 Goodwill and intangible assets.

The brand name should be shown as an intangible asset and amortised over its estimated economic life. If the economic life is greater than 20 years the company will need to undertake an impairment review each year. Given the difficulties in accurately estimating the economic lives of some intangible assets the company might wish to consider writing the brand name off over 20 years. This would avoid having to incur the expenses of an impairment review every year. The difference in the charge against profits would be £17,500 (87,500 – 70,000). Either way there would need to be an impairment review at the end of the first full financial year following the initial recognition of the brand.

*FRS 10 – 1 mark*

*Requirement to amortise over economic life – 1 mark*

*Requirement to have annual impairment reviews – 1 mark*

*Suggestion to write off over 20 years – 1 mark*

*Need for first impairment review – 1 mark*

*Total capped at 5 marks (4 marks if the FRS is not correctly identified)*

**(2) Treatment of government capital grant**

This is dealt with in SSAP 4 Accounting for government grants.

The government grant should be treated as a deferred credit and not deducted from the cost of the asset (as this is a depreciable asset). The deferred credit will be shown in the balance sheet – but not as part of shareholders' funds. One possibility is to include it in 'accruals and deferred income'.

The asset will be written off over 15 years so depreciation will be £5,000 a year. The deferred income will be written off to profit and loss account as deferred income of £2,500 a year.

The annual depreciation charge and the annual transfer from deferred income should not be offset.

Candidates will also get credit if they discuss the disclosure requirements.

*SSAP 4 Accounting for government grants – 1 mark*

*Government grant as a deferred credit – 1 mark*

*Balance sheet treatment of deferred credit – 1 mark*

*Depreciation of asset £5,000 a year – 1 mark*

*Deferred income written off to P & L as deferred income, £2,500 a year – 1 mark*

*No offset – 1 mark*

*Disclosure requirements – 1 mark*

*Total capped at 5 marks (4 marks if the SSAP is not correctly identified)*

**(3) Revaluation of fixed asset.**

FRS 15 Tangible fixed assets.

1

Basis of valuation would be existing use value.

1

Asset should be shown at its current value which is the lower of replacement cost and recoverable amount (ie the higher of net realisable value and value in use).	2
It would not be possible to leave the other assets in this class at depreciated historic cost.	1
They would all need to be revalued ie a full revaluation every 5 years, and an interim valuation in year 3.	2

*Total capped at 5 marks (4 marks if the FRS is not correctly identified)*

**(4) Consignment stock**

FRS 5 – Reporting the substance of transactions.

This is consignment stock and substantially all the risks and rewards are passed to Vuelo plc.

Vuelo plc enjoys the following benefits:

- The cash flows from selling the product to third parties and the right to keep items in order to achieve a sale.
- Protection from increases in the price charged by the dealer because payments are based on the original invoice price.
- The right to display and use the stock.

Vuelo plc also bears significant risks.

- Although Vuelo plc has the right to return unsold stock to its supplier it is restricted as to when it can do this and bears a penalty payment. Vuelo plc therefore bears the risk of obsolescence.

The 100 items should be included in stock as at the end of the year at their cost of £6,000 and a short term creditor should be set up for the £3,900 owing to the supplier.

However, this treatment should be reviewed in the light of experience, in particular the likelihood that items will be returned to the supplier.

*1 mark for each valid point  
Capped at 5 (4 marks if the FRS is not correctly identified)*

**(20)**

<b>Question 5</b>
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**(a)** Historical cost accounting**Profit and Loss Account for the year ended 31 October**

	£	
Sales	56,400	ie 6 fire engines at £9,400 each
less Cost of sales	44,400	ie 6 fire engines at their original cost, £7,400 each
Profit	12,000	

**Balance Sheet as at 31 October**

	£	
<b>Assets</b>		
Stock, at cost	7,400	ie the 1 fire engine left in stock, original cost £7,400 each
Cash	56,400	ie the cash received for the fire engines sold
	63,800	
<b>Financed by</b>		
Opening capital	51,800	The original capital introduced to finance purchases
Profit for the year	12,000	
	63,800	

*Sales, cost of sales, stock, cash, opening capital, profit – ½ marks each = 6 X ½ = 3*

- (b) (i)** The figures reported for sales and cost of sales represent the historical amounts updated using a general price index to their end of year purchasing power equivalents. The general price index is used as a surrogate measure of inflation.

The historical cost figures would be multiplied by a conversion factor. The conversion factor is a fraction; the numerator of the fraction is the index number as at the end of the year; the denominator would be the value of the index number as at the date of the transaction. Where a series of similar transactions have taken place the average index number for the period may be used as the denominator.

3

- (ii)** The figure for monetary items is the difference between monetary assets and monetary liabilities. Monetary items are reported in the current purchasing power [cpp] balance sheet at the actual amount receivable or payable. Monetary assets include debtors and cash balances. Monetary liabilities comprise all liabilities other than capital.

Monetary items are not restated in cpp accounts. However, monetary assets are associated with purchasing power losses during a period of inflation and monetary liabilities are associated with purchasing power profits. In cpp accounts these losses and profits are calculated and the net profit or loss would be reported in the cpp profit and loss account.

This business operates on a cash basis and has no loans or other sources of finance other than the owner's capital. The only monetary item is therefore

cash. During a period of inflation holding cash is associated with purchasing power losses – hence the reporting of a loss in the cpp profit and loss account.

There would have been a monetary profit if the business's monetary liabilities been greater over the year than its monetary assets eg if the opening capital had been borrowed as a loan rather than being contributed by the owner.

3 marks  
Profit 1 mark  
(4)

- (c) (i) The cost of sales adjustment is the difference between the historical cost of sales and the current cost of sales. The current cost of sales would normally be calculated using the replacement values for stock. The replacement values would usually be calculated using specific price index numbers for the particular type of stock. 2

(ii) Other current cost adjustments

***Depreciation adjustment***

The depreciation adjustment is the extra depreciation which would need to be charged to calculate profit on a current cost basis. It is the difference between depreciation calculated on the replacement cost of fixed assets and depreciation calculated on the historical cost of those fixed assets.

***Monetary working capital adjustment***

This adjustment allows for the extra net cost of providing credit to customers after allowing for the credit received from suppliers. Monetary working capital [mwc] is the difference between trade debtors and trade creditors. The adjustment is the difference between the increase in mwc using current costs and the increase in mwc based on historical costs. Current costs would be calculated using the same specific price index number used to calculate the cost of sales adjustment.

***Gearing adjustment***

This adjustment uses the gearing proportion. The gearing proportion is a measure of gearing calculated using values from the current cost balance sheet. For example, if the current cost balance sheet shows that 30% of assets are financed by borrowing and 70% by equity the gearing proportion is 30%.

The gearing adjustment is the gearing proportion applied to the total of the current cost operating adjustments (i.e. cost of sales adjustment + monetary working capital adjustment + depreciation adjustment) and is added back to profits.

The idea is that ordinary shareholders should not bear the full cost of maintaining the operating capability of the business when specific prices are rising if the business is partly financed through borrowings. This assumes that lenders will increase the amount of finance they are prepared to lend in order to maintain the operating capability of the business.

Whether there should be a gearing adjustment and how it should be calculated remain controversial areas. The cynical view is that the main attraction of making a gearing adjustment is that it increases current cost profit rather than any theoretical arguments in its favour.

*1 ½ marks for each ie  
Identification ½ mark  
Explanation 1 mark  
(3)*

**(d)** There is no single correct answer to this part of the question.

Each measurement system is based on a particular capital maintenance concept – and arguments in favour of any particular system will, inter alia, depend on the extent to which the writer is of the opinion that its underlying capital maintenance is the most appropriate.

The capital maintenance concept implicit in the historical cost accounts is the maintenance of Jenny's money capital of £51,800. Thus no account will be taken of depreciation in the unit of currency (inflation) or of specific price changes in the resources used in the business.

The replacement cost accounts take an entity viewpoint and report a profit only after maintaining the 'operating capability' of Jenny's business. In this case the operating capability is 7 fire engines of the type traded in by Jenny. This may take a rather static view of Jenny's business assuming that Jenny will continue to trade in this particular type of asset.

The current purchasing power accounts adopt an equity viewpoint and report a profit only after the 'real' value of Jenny's capital i.e. its generalised purchasing power. However, it could be argued that while this is perhaps an improvement on historical cost accounting Jenny's capital is committed within a specific sector of the economy and should therefore take specific price changes within that sector into account.

Marks will be awarded on the basis of candidate's knowledge of the underlying assumptions and their ability to support their arguments with evidence.

*1 mark per valid point to a maximum of 5*

**(20)**