FINANCIAL REPORTING

December 2005
Certificate stage

MARKING SCHEME

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Question 1

(a)

Tangible fixed assets	Land £m	Buildings £m	Equipment £m	Total £m	
Cost or valuation					
As at 1 November 2004	71	104	180	355	*½*
Additions	20	30	40	90	*1*
Disposals		(23)	(34)	(57)	*1*
As at 31 October 2005	91	111	186	388	*½*
Accumulated depreciation					
As at 1 November 2004	0	17	99	116	*½*
Charge for the year	0	6	29	35	*1*
Withdrawn on disposals		(7)	(29)	(36)	*1*
As at 31 October 2005	0	16	99	115	*½*
Net book value					
As at 1 November 2004	71	87	81	239	*½*
As at 31 October 2005	91	95	87	273	*½*
					(7)

(b)

Beniox plc
Profit and loss account for the year ended 31 October 2005 *1*

	£m	
Turnover	1,160	*½*
Cost of sales	(930)	*3*
Gross profit	230	
Administrative expenses	(166)	*1½*
Other operating income	14	*½*
Operating profit	78	
Income from fixed asset investments	4	*½*
Interest payable	(14)	*½*
Profit on ordinary activities before taxation	68	
Tax on profit on ordinary activities	(11)	*1*
Profit for the financial year	57	
Dividends paid and proposed	(19)	*1*
Amount set aside to reserves	38	*½*
		(10)

Beniox plc
Balance sheet as at 31 October 2005 ½

Fixed assets		£m	
Intangible			
Unamortised goodwill		9	*1*
Tangible		273	*½*
Investments		51	*1*
		333	
Current assets	£m		
Stock	19		*1*
Debtors	124		*1*
Cash at bank and in hand	33		*½*
	176		
Creditors: amounts falling due within one year			
Trade creditors	48		*½*
Taxation	8		*½*
Proposed dividend	11		*½*
Bank loan, repayable 31 October 2006	25		*½*
	92		
Net current liabilities		84	
Total assets less current liabilities		417	
Creditors: amounts falling due after more than one year			
Bank loans	(20)		*½*
9% Debentures 2015	(60)	(80)	*½*
Net assets		337	
Capital and reserves			
Issued ordinary share capital		150	*½*
Share premium		20	*½*
Revaluation reserve		40	*1*
Profit and loss account		127	*1*
		337	
			11½
		Presentation	*1½*

Total for part (b) (23)

Workings

Gain/(loss) on fixed assets disposals

		£m
Proceeds from sale		9
Book value of assets sold		
Buildings	16	
Equipment	5	
		21
		(12)

Allocation of expenses

	Cost of sales £m	Administrative expenses £m	Distribution costs £m
Per trial balance	858	163	0
Reduction in closing stock	24		
Increase in opening stock	5		
Loss on disposal of assets	12		
Depreciation for the year			
Buildings	5	1	
Equipment	23	6	
Amortisation of goodwill	3		
Provision for bad debts		(4)	
	930	166	0

Allowance for bad debts	£m
Old provision for bad debts	9
New provision for bad debts	5
Decrease	(4)

Debtors	£m
Trade debtors	129
Allowance for bad debts	(5)
	124

Dividends paid and proposed	£m
Interim dividend	8
Proposed dividend	11
	19

Profit and loss account	£m
Balance b/f	84
Increase in opening stock	5
Retained profit for the year	38
	127

Fixed asset investments	£m
Carrying value	30
New valuation	26
Diminution in value	4
Written off Revaluation Reserve	4
Charged to profit and loss account	0

Revaluation reserve	£m
per trial balance	44
Written off	(4)
	40

Closing stock	£m
per trial balance	43
Write off (41 - 17)	24
	19

Goodwill	£m	
Carrying value	12	
Estimated life	6	years
Years old as at start of year	2	
So, years still to write off	4	
So, annual amortisation	3	
And cost of goodwill	18	

Corporation tax	
Provision for the current year	8
Previous underprovision	3
Charge for the year	11

Calculation of depreciation

Buildings	£m	
Cost as at end of year	111	
Depreciation rate	5%	
	6	
Equipment		
Cost as at end of year	186	
Accumulated depreciation	70	(99 - 29)
	116	
Depreciation rate	25%	
	29	

Question 2

(a) REPORT

The performance of Robovert plc compared with three competitors

From:
To:
Date:

General

The following report is based on a number of performance ratios calculated from the most recent financial statements of Robovert plc and three of its competitors which, for the purposes of this report, are named companies A, B and C respectively. These ratios are available as an appendix to this report.

Profitability

Return on capital employed is perhaps the best single overall measure of the efficiency of a profit making entity. Here this has been measured by comparing net profit to total assets employed (ratio 1). The higher this ratio is the better. However, the performance of Robovert plc is the lowest of the group, and significantly so when compared with companies B and C. The most profitable companies are achieving a return on capital employed which is three to three and a half times that of Robovert plc. This suggests that there may be opportunities for efficiency gains in Robovert plc.

Robovert plc's poor overall performance seems attributable to its comparatively low profitability on trading (ratio 2). Robovert plc is earning only £5 profit for every £100 of sales which is the lowest of the four companies. Robovert plc's competitors are all earning significantly more than this and, again, companies B and C are by far the best performers here.

In terms of assets utilisation Robovert plc occupies a middle position (ratio 3) – better than companies A and B, but not quite as productive as company C. This will be analysed in greater detail later.

Robovert plc's poor profitability on trading seems mostly attributable to high overheads (ratios 5 and 6). Robovert plc's administrative expenses and selling and distribution costs relative to sales are the highest of the four companies. Together these are absorbing 15% of sales revenue in Robovert plc, but only 9 to 10% of sales in the other companies.

Robovert plc's profitability disadvantage is not so pronounced when it comes to gross margins (ratio 4). However, there may still be some scope for improvement here because Robovert plc's figures are not as good as the best of its competitors.

Assets utilisation and liquidity

It has already been noted that Robovert plc's assets utilisation does not appear to be significantly different from its competitors. However, when this is analysed between fixed and current assets (ratios 7 and 8) it may be that Robovert plc is

more efficient at using its fixed assets to generate sales than its current assets. This suggests that Robovert plc's working capital management may not be as efficient as its competitors. To some extent this is supported by Robovert plc's current and acid test ratios (ratios 9 and 10) which may be a bit on the high side compared with its competitors.

However, it should be noted that Robovert plc's liquidity ratios are lower than those of Company C which is the best overall performer here. The analysis of the current ratio (ratios 11, 12 and 13) suggests that Robovert plc's stock holdings and debtors may be higher than necessary and this has resulted in relatively low cash levels.

Recommendations

The above analysis suggests certain areas where there may be scope for improvement. It is suggested that Robovert plc should seek:

- Better control of its overheads – particularly administrative expenses,
- To improve its gross profit margins; and
- Better control of working capital – in particular, better stock control and credit control.

Reservations

- It has been assumed that all the data is comparable, eg similar accounting policies have been used in the four companies, that the financial years are coterminous, etc.
- The data is available for one year only. Accordingly, it has not been possible to consider trends within each company and the industry sector. Also, although the information used was from the most recent financial statements it may now be out of date.
- We know nothing about the status of the three comparator companies. Are these the three 'best' companies, or are they representative of the whole sector?
- The available information is limited. Other financial indicators might be useful, eg investors ratios. It would also be useful to have additional information about the quality of each company's current management, its risk exposure and the prospects for the industry sector.

Discussion of ratios – 1 mark per valid point up to a maximum of 16
Recommendations – 4 marks
Reservations – 4 marks

(b) Ratio analysis is unreliable if the data used is not comparable. Comparability is an issue in at least two areas.

Firstly, a valid ratio is one in which the numerator is 'comparable' with the denominator. That is to say, we would expect the numerator to be connected in some way with the denominator, eg profit and sales. This allows a ratio for one year or one business to be validly compared with another. Sometimes this can be problematic, eg return on capital employed, where there are problems of defining the ratio so that the numerator is consistent with the denominator. In the ratios supplied, net profit to total assets may not the be best measure of return on capital employed, and operating profit to sales might have been a better indicator of profitability on trading than net profit to sales.

Secondly, the problem of comparability is also an issue where ratios are being compared between businesses (as here) or over time, eg is the data prepared using consistent accounting policies?

If the data is not comparable, conclusions may not be valid. If the data has been prepared using different accounting policies it may be possible to restate the data with more consistent accounting policies and this should result in more valid conclusions.

The following factors should be considered in deciding whether or not ratios are comparable between businesses and over time.

(a) Have identical definitions been used for the ratios?
(b) Have identical accounting policies been used to produce the data?
(c) Are the businesses similar? eg

- In the same industry—except for some non-industry specific ratios. There may be problems in defining what the industry is - especially where firms have diversified.
- Of similar size—except for some size independent ratios. Once again there may be problems in choosing a suitable measure of size, eg number of employees, sales, profits.
- Similar legal structure—in a limited company top management receive directors' remuneration which is charged as an expense in the profit and loss account; in a sole trader's business or in a partnership amounts paid to the sole trader or the partners are classified as 'drawings' and deducted directly from Capital Account(s). Also, in a private company (and especially a close company) an element of dividends may be paid as directors' remuneration (or vice versa).

1 mark per valid point up to a maximum of 6

(30)

Question 3

Suggested solution

(a)

Indirect method

	£	
Operating profit	673,850	*656,250 + 17,000 + 600*
Depreciation	349,550	
Profit on sale of tangible fixed assets	(5,000)	
Increase in stocks	(10,000)	
Decrease in debtors and prepaid expenses	23,070	*22,300 + 770*
Increase in creditors and accrued expenses	61,450	*60,000 + 2050 - 600*
	1,092,920	

1 mark per figure (6)

(b) Operating profit

Operating profit should be used as a starting point rather than net profit because we are concerned with *operations*. Other items included in net profit but not operating profit (eg interest paid, interest received and investment income received) are dealt with under separate headings in the cash flow statement.

Depreciation

This is excluded by adding the depreciation charge back. Depreciation is a non cash allocation and should therefore not be included. The cash flows associated with fixed assets are the cost of purchasing the asset and the proceeds when the asset is sold. Both items are reported elsewhere in the cash flow statement. Not excluding the depreciation charge would mean double counting the depreciable amount of fixed assets.

Profit on sale of tangible fixed asset

This is excluded by deducting the amount of the profit from operating profit. The profit is included in the proceeds from the sales of the assets which will be reported in the cash flow statement under the heading ‘Capital expenditure and financial investment’.

Increase in stocks

This converts ‘cost of sales’ into purchases. The adjustment is negative because increasing stock holdings reduces the amount of cash available for other uses.

Decrease in debtors and prepaid expenses

This removes the non-cash element from sales and expenses. The adjustment here is positive because a decrease in debtors would increase the amount of cash available to the entity.

Increase in creditors and accrued expenses
This removes the non-cash element from purchases and expenses. The adjustment here is positive because an increase in creditors would increase the amount of cash available to the entity.

Maximum of 1 mark per heading (6)

(c)

Direct method

	£
Cash from customers	12,004,900
Cash to suppliers	(8,927,000)
Cash paid to and on behalf of employees	(1,158,550)
Other cash payments	(826,430)
	1,092,920

Workings

Cash from customers	
Sales	12,000,000
Discounts allowed	(17,400)
Increase in debtors	22,300
	12,004,900

Cash to suppliers	
Purchases	9,010,000
Discounts received	(23,000)
Decrease in creditors	(60,000)
	8,927,000

Cash paid to and on behalf of employees	
Wages and salaries	1,160,000
Increase in accrued expenses	(2,050)
Exclude accrued interest	600
	1,158,550

Other cash payments	
Other expenses	827,200
Decrease in prepaid expenses	(770)
	826,430

Marks: 2 per figure = 4 x 2 = 8 marks

(**20)**

Question 4

(a) A finance lease is one in which substantially all the risks and rewards of ownership of an asset 'pass' to the lessee. Several factors in the data given suggest that this lease is a finance lease:

1. The minimum lease period of 5 years is the same as the economic life of the asset.
2. The total of the minimum lease payments (£18,000 X 5 = £90,000) more than covers the fair value of the asset (£75,000). It is almost certain that the present value of the minimum lease payments would be at least 90% of the fair value of the asset.
3. The substance of the transaction seems to be the provision of finance to enable the lessee to acquire and use the asset.

1 mark per valid point up to a maximum of 3

(b)

Allocation of finance charge

Year	Straight line	Rule of 78	Actuarial method
	£	£	£
1	3,000	6,000	5,727
2	3,000	4,500	4,494
3	3,000	3,000	3,137
4	3,000	1,500	1,642
5	3,000	0	0
	15,000	15,000	15,000

Straight line – 1 mark
Rule of 78 – 2 marks
Actuarial method – 3 marks

Workings

Rule of 78

Year	Number of Instalments not yet due	Interest	Rental paid	Capital Repayment
		£	£	£
1	4	6,000	18,000	12,000
2	3	4,500	18,000	13,500
3	2	3,000	18,000	15,000
4	1	1,500	18,000	16,500
5	0	-	18,000	18,000
	10	15,000	90,000	75,000

Actuarial method

	£
Fair value of asset	75,000
Initial rental	(18,000)
O/s for year 1	57,000
Interest year 1	**5,727**
Rental year 2	(18,000)
O/s for year 2	44,727
Interest year 2	**4,494**
Rental year 3	(18,000)
O/s for year 3	31,221
Interest year 3	**3,137**
Rental year 4	(18,000)
O/s for year 4	16,358
Interest year 4	**1,642**
Rental year 5	(18,000)
O/s for year 5	0
Interest for year 5	**0**
	0
Total interest	**15,000**
Total rentals	90,000

(c) SSAP 21 requires finance leases to be capitalised in the balance sheet of the lessee and the rentals split into capital repayment and interest (ie finance charge) elements. The finance charge is allocated to successive accounting periods.

SSAP 21 requires the finance charge to give a constant periodic rate of charge on the remaining balance of the obligation for each accounting period, or a reasonable approximation to this.

The actuarial method achieves this objective. The rule of 78 may give a reasonable approximation to achieving the objective. The straight line method does not achieve the objective – but in certain circumstances eg if the amounts involved are not material – may be acceptable.

1 mark per valid point up to a maximum of 3

(d)

PROFIT AND LOSS ACCOUNT - Actuarial method

Year	1	2
	£	£
Finance charge	5,727	4,494
Depreciation	15,000	15,000
Net costs	20,727	19,494
Taxation		
Corporation tax	5,400	5,400
Net cost after taxation	15,327	14,094

Finance charge – 2 marks
Depreciation – 1 mark
Taxation – 1 mark
(4)

(e)

Balance sheet extracts
as at end of year

	1	2
Fixed assets	£	£
Leased asset, at cost	75,000	75,000
less Accumulated depreciation	15,000	30,000
	60,000	45,000
Creditors: amounts falling due within one year		
Obligations under finance leases	12,273	13,506
Accrued interest	5,727	4,494
	18,000	18,000
Creditors: amounts falling due after more than one year		
Obligations under finance leases	44,727	31,220

Leased assets – maximum of 2 marks
Leasing obligation – maximum of 4 marks
Capped at a maximum of 4 marks

(20)

Question 5

(a) Nursing homes

SSAP 19 *Accounting for investment properties* defines an investment property as an interest in land and/or buildings in respect of which construction work and development is completed and which is held for its investment potential, any rental income being negotiated at arm's length.

At first sight these properties may appear to meet the SSAP 19 definition; the investment potential of each property is a consideration and it could be argued that the rent paid for each property seems to be fixed at arm's length. However, SSAP 19 states that a property let to and occupied by another group company – as is the case here – is not an investment property either in Satirac plc's own accounts or its group accounts.

Thus, these properties cannot be treated as investment properties in the accounts of Satirac plc.

Definition – 2 marks
Discussion – 1 mark per valid point up to a maximum of 3 marks
(5)

(b) Investment properties

Property A

At the time of sale this property will be valued in the accounts at £7m and the investment revaluation reserve will include the surplus of £2m. SSAP 19 does not deal with the sale of investment properties. However, FRS 3 suggests that the profit on sale should be based on the properties' carrying value of £7m. The profit is therefore £0.5m (£7.5 m – £7 m).

After the sale the surplus of £2m in the investment revaluation reserve is no longer needed and can be released to profit and loss account.

The treatment in the accounts is therefore:

- Investment properties – reduce by £7m.
- Investment revaluation reserve – reduce by £2m, which should be transferred to profit and loss account reserve.
- Profit and loss account – include a profit on disposal of fixed assets of £0.5m.

Property B

After the disposal of property A but before the revaluation of property B as at 31 October 2005 the balance on the investment property reserve is £1m – all relating to the previous revaluation of property B. This is insufficient to absorb fully the revaluation loss of £1.2m now required. A deficit in the investment revaluation reserve will be permitted if the diminution in value is expected to be temporary. If it is considered to be permanent it should be written off to profit and loss account.

1 mark per valid point up to a maximum of 6 marks

(c) Coffee shop

Franchise

This is an intangible asset and should be recorded at cost and written off over its estimated economic life of 10 years.

Goodwill

The problem here is that goodwill is negative. The purchase consideration is £250,000 and the net assets taken over total £270,000 (150,000 + 50,000 + 70,000). So there is negative goodwill of £20,000.

The guidance of FRS 10 is to first of all question whether or not a mistake might have been made in identifying and valuing the net assets taken over. So, first of all Satirac plc should review whether all the assets and liabilities taken over have been correctly identified and valued. In this case Satirac plc should look for possible impairment of the assets taken over. If this does not get rid of the negative goodwill the amount should be separately reported as a negative asset and deducted from any existing positive goodwill in the balance sheet. The amount should then be written off to profit and loss account over the periods in which the non-monetary assets are written off.

If Satirac plc does not have any positive goodwill to write off it may have no choice other than to write the full amount as a gain to the profit and loss account.

Franchise – 1 mark per valid point up to a maximum of 2 marks
Valuation of goodwill - 1
Treatment – up to 4 marks
(7)

(d) Provision

The provision is no longer needed and should be transferred to the profit and loss account for the year ended 31 October 2005. The reason for the movement in the provision should be disclosed in the financial statements for the year. As there is no current obligation the provision is unnecessary. The directors' proposal is therefore unacceptable.

1 mark per valid point up to a maximum of 2 marks.

(20)