CIPFA

FINANCIAL REPORTING

Certificate stage examination

8 December 2006

MARKING SCHEME

AT THE HEART OF YOUR CAREER

Question 1

(a)

Stock valuation		£m	
Valuation at 5 November 2006		92	
add back cost of net sales			
Sales	38		
Returns inwards	2		
Net sales at selling price	36		
Average markup	9		
		27	*2*
		119	
exclude purchases		19	*1*
Cost of stock as at 31 October 2006		100	
			(3)

(b)

Tangible fixed assets	Property, Plant and Equipment	Investment property	Total	
	£m	£m	£m	
Cost or valuation				
As at 1 November 2005	386	60	446	½
Additions	104		104	½
Disposals	(64)		(64)	½
Revaluation adjustment		8	8	½
As at 31 October 2006	426	68	494	½
Accumulated depreciation				
As at 1 November 2005	126		126	½
Charge for the year	48		48	½
Withdrawn on disposals	(34)		(34)	½
As at 31 October 2006	140		140	½
Net book value				
As at 1 November 2005	260	60	290	
As at 31 October 2006	286	68	354	½
				(5)

(c)

DeVoux plc

Profit and loss account for the year ended 31 October 2006 *1*

	£m	½
Turnover	1,840	½
Cost of sales	(1,245)	½
Gross profit	595	½
Administrative expenses	(375)	½
Other operating income	41	½
Operating profit	261	½
Income from fixed asset investments	22	½
Interest payable	(14)	½
Profit on ordinary activities before taxation	269	½
Tax on profit on ordinary activities	(41)	*1*
Profit for the financial year	228	½

Workings 6 ½

(14)

Workings

Gain / (loss) on fixed assets disposals

	£m
Proceeds from sale	36
Book value of assets sold	30
Gain	6

Allocation of expenses

	Cost of sales	Administrative expenses	
	£m	£m	
Per trial balance		363	½
Opening stock	84		½
Purchases	1,240		½
	1,324		
Closing stock	(100)		*1*
	1,224		
Gain on disposal of assets	(3)	(3)	*2*
Depreciation for the year	24	24	*1*
Allowance for doubtful debts		(9)	*1*
	1,245	375	*(6 ½)*

Allowance for doubtful debts	£m
Old allowance for doubtful debts	16
New allowance for doubtful debts	7
Decrease	(9)

Debtors	£m
Trade debtors	230
Provision for doubtful debts	(7)
	223

Profit and loss account	£m
Balance b/f	67
Profit for the year	227
Dividends paid	(40)
	254

Fixed asset investments	£m
Carrying value	27
New valuation	21
Diminution in value	6
Written off Revaluation Reserve	6
Charged to profit and loss account	0

Revaluation reserve	£m
per trial balance	42
Written off fixed asset investments	(6)
Surplus on investment property	8
	44

Corporation tax	
Provision for the current year	50
Previous overprovision	(9)
Charge for the year	41

(d)

Movements in share capital and reserves	Share Capital	Share Premium	Revaluation Reserve	Profit and Loss Account	
	£m	£m	£m	£m	
Balance as at 1 November 2005	150	15	42	66	*2*
Issue of shares	50	20			*2*
Surplus on revaluation of investment property			8		*1*
Written off fixed asset investments			(6)		*1*
Profit for the financial year				228	*1*
Dividends paid				(40)	*1*
Balance as at 31 October 2006	200	35	44	254	

(8)

(30)

Question 2

(a) (i) Dividend cover

Dividend cover is a measure of the number of times that the profit attributable to a particular class of shareholders covers the dividends paid to those shareholders during the financial year. It is a ratio of particular interest to the shareholders in a company.

For example, if profit after taxation (and any preference dividend if applicable) is £9m and the dividends paid to the ordinary shareholders during the year were £3m the dividend cover would be 9/3 = 3 times. This means that for every £1 distributed to shareholders the company reinvests £2.

The dividend cover is a measure of the ‘safety’ or ‘security’ of the amounts distributed to the shareholders. The higher the dividend cover the more secure the distribution. If the dividend cover is low then the risk attaching to the dividend may be higher, because profits would only need to fall by a relatively small amount for the company to find it difficult to cover the dividend.

However, things may not be as simple as this. A high dividend cover may be associated with a low distribution policy and high reinvestment within the business. Similarly a low dividend cover may be associated with a high distribution policy.

The dividend cover takes a narrow and rather simple view of things. It only looks at profit and ignores the availability or otherwise of cash. Other ratios such as dividend yield, earnings per share and the PE ratio may be more useful.

1 mark per valid point to a maximum of 3

(ii) Earnings per share

Earnings per share (eps) is the profit attributable to the ordinary shareholders divided by the number of ordinary shares in issue.

For example, if profit after tax and preference dividends is £10m and there are 100m ordinary shares issued earnings per share is £10m/ 100m = 10 pence per share.

Earnings per share is used widely by investors to assess the performance of a company over time and to compare its performance with that of competitors. Generally, the higher the figure for earnings per share the better the performance of the company from the viewpoint of the shareholder. However, some authorities feel that investors attach too high an importance to earnings per share and neglect other aspects of a company’s performance. Company managements know this and may be tempted to place too much emphasis on the effect of a decision on its eps in decision making.

Given the importance of eps, its calculation and disclosure is regulated – in the UK that is FRS 22. FRS 22, which applies to companies with publicly traded shares, governs both the calculation of eps and its disclosure in the financial statements. Its objective is to achieve transparency and comparability over time and between companies.

The calculation and interpretation of basic earnings per share is straightforward, but things can get quite complex where there have been bonus issues or rights issues of shares, or where there are convertible bonds or options which potentially would dilute earnings per share.

Earnings per share is a key component of the Price Earnings (PE) ratio.

1 mark per valid point to a maximum of 3

(6)

(b) **(i)** Ordinary shareholders are generally interested in the return they get on their investment relative to the risk of the investment. Basically shareholders entrust their funds to the management of the company with a view to maximising the dividends received on their shares and the capital growth of their shares.

Profitability can be maximised by maximising sales revenue, minimising costs and maximising the efficient use of assets.

The financial information provided shows that dividends paid to shareholders have increased steadily over the five year period. In 2002 the company was paying a dividend of 30 pence per share and this grew to 51 pence in 2006.

The dividend cover seems adequate and, although variable, seems to be on average about 3 times. However, the dividend cover has fallen over the past three years while dividends per share have increased. This suggests that the amount being reinvested in the company may have fallen over the past three years. This seems to be supported by the fall in capital expenditure over the past three years. Capital expenditure in 2006 was half of what it was in 2004. However, retained profit has remained unchanged over the past two years at £3.8m (profit after tax less dividends paid).

Earnings per share has shown significant and consistent growth over the past five years and has more than doubled. However, operating profit has not followed a similar pattern over the past three years. Operating profit seems to be stagnant and actually fell in 2006. However, profit before (and after) tax has shown a growth pattern similar to dividends and earnings per share. This suggests that the growth in profits is coming from non-operating sources.

The liquidity of the company seems to have improved over the five years with cash resources doubling from a significant overdraft in 2002 to what seems to be a much healthier positive bank balance in 2006. To some extent this improvement is offset by an increase in long term borrowing.

At first sight shareholders might be pleased with the constant growth in dividends, earnings per share and profit after tax over the past five years. However, the falling capital investment, and the reliance on non-operating sources of income for profit growth may give more concern about the future development of the company.

Some shareholders may also be concerned about the increasing reliance on imported electricity. Almost all the electricity sold by the company now seems to be imported. The cost of this to the company seems to have been increasing and the company has announced a significant increase in its prices to customers. It remains to be seen what effect this will have. Prices have barely increased over the past five years. It may well be that not all of the increase in the cost of electricity can be passed on to consumers and this may put profitability under pressure.

Shareholders may also be concerned at the relatively small number of customers. Customer numbers have increased – but not by much, particularly in the past two years. The total number of units sold follows a similar pattern. It might be interesting to know the company's plans for increasing revenue from its existing customer base e.g. by diversifying into associated products and services.

1 mark per valid point to a maximum of 12

(ii) Employees will be interested in

- The security of their jobs.
- Their employer's ability to pay and deliver the agreed remuneration package (including, increasingly, pension arrangements).
- Promotion prospects.
- The prospects for increases in the remuneration package.

To some extent employees will have the same interests as shareholders. A strongly profitable and liquid business should have good survival and growth prospects and hence good employment prospects. However, this convergence of interests is limited. The main concern of a capitalist business will be to maximise returns to shareholders and employees are a cost which must be minimised if shareholder returns are to be maximised.

In this respect the financial data supplied may not be particularly encouraging for an employee. There is some evidence that operating profits are under pressure so the company will be seeking to lower costs.

The information about employee numbers may also not be encouraging. The total number of employees in the company has fallen by a third over the past five years. This reduction is not confined to any one particular type of employee, but the reduction in the workforce seems largest in trainees and non-production staff – presumably administrative and selling staff. What seems to be a very significant reduction in the training opportunities offered by the company may be a particular concern.

The reduction in the workforce is accompanied by a increase in the productivity of the remaining production employees as evidenced by the statistics for units sold and customers per energy employee. There are no statistics about wages and salaries so it is not possible to comment on the extent to which this significant increase in productivity has been reflected in higher remuneration for staff.

1 mark per valid point to a maximum of 6

(iii) Customers of Electra plc will be interested in:

- The ability of Electra to meet and maintain their demand for electricity.
- Competitive prices for electricity.
- Minimal price increases which avoid large or erratic price increases.
- Good service and support from the company.

Like employees, customers will have an interest in the profitability and liquidity of the company in so far as these enhance the survival prospects and financial viability of the company. But again customers will be aware that maximising profits will imply maximising revenue and hence increasing selling prices.

The customers of Electra have benefited from a pretty constant charge for their electricity over the past five years – 7.3 pence per unit. That seems to have ended with the announcement of a 7% increase in prices as from 1 November 2006. Customers may be concerned about whether this increase is a once-off increase in price or whether it will herald a period of significant consecutive price increases.

Customers may also be concerned at the increasing reliance of their company on imported energy which now accounts for 98% of units sold. They may feel that this reduces the flexibility of the company and exposes them to further price increases on the world markets.

Customers may also be concerned about the reduction in the workforce and what this might imply for service and support from the company.

1 mark per valid point to a maximum of 6

(24)

(30)

Question 3

(a)

	GlenKogan plc		½
	Cash flow statement for the year ended 31 October 2006		
Net cash inflow from operating activities		£	½
Cash received from customers		16,829,450	*2*
Cash payments to suppliers		(13,339,600)	*2*
Cash paid to and on behalf of employees		(949,600)	*1*
Other cash payments		(698,700)	*2*
		1,841,550	
Returns on investments and servicing of finance			
Interest paid		(18,512)	½
Taxation			
Corporation tax paid		(187,600)	*2*
Capital expenditure			
Payments to acquire tangible fixed assets	(536,600)		*2*
Receipts from sales of tangible fixed assets	45,500		*1*
		(491,100)	
Equity dividends paid			
Ordinary dividends paid		(525,000)	½
		619,338	
Financing			
Issue of ordinary share capital	800,000		*1*
Repayment of debentures	(60,000)		*1*
		740,000	
Increase in cash		1,359,338	
			(16)

(b)

Reconciliation of operating profit to net cash inflow from operating activities

	£	
Operating profit	1,035,005	*1*
Depreciation charges	659,795	*½*
Profit on sale of tangible fixed assets	(6,400)	*1*
Decrease in stocks	37,000	*½*
Decrease in debtors and prepaid expenses	101,850	*½*
Increase in creditors and accrued expenses	14,300	*½*
Net cash inflow from operating activities	1,841,550	
		(4)

Workings

Cash received from customers	£
Opening trade debtors	344,700
Sales	16,750,000
Discounts allowed	(20,400)
Closing debtors	(244,850)
Cash received from customers	16,829,450

Cash payments to suppliers	£
Opening trade creditors	306,100
Purchases	13,363,000
Discounts received	(14,500)
Closing creditors	(315,000)
	13,339,600

Cash paid to and on behalf of employees	£
Wages and salaries	955,000
Accrued at start of year	11,100
Accrued at end of year	(16,500)
	949,600

Other cash payments	£
Rent, rates and insurance	210,400
Selling expenses	385,600
Accountancy	74,200
Miscellaneous	30,500
	700,700
Prepaid at start of year	(5,000)
Prepaid at end of year	3,000
	698,700

	£
Cash payments to suppliers	13,339,600
Cash paid to and on behalf of employees	949,600
Other cash payments	698,700
Cash paid to suppliers and employees	14,987,900

Calculation of purchases	£
Cost of sales	13,400,000
Opening stock	(103,500)
Closing stock	66,500
	13,363,000

Calculation of Operating Profit	£
Net profit	1,016,493
add Interest paid	18,512
Operating profit	1,035,005

Taxation

Taxation

	£		£
Balance c/f	199,500	Balance b/f	133,000
Bank (amount paid)	187,600	Profit and loss	254,100
	387,100		387,100

(20)

Question 4

Issue 1 – Legal claims

(a) FRS 12 states that a provision for a liability should be made if:

1. an entity has a present obligation as a result of a past event. The obligation may be legal or constructive.
2. It is probable that a transfer of economic benefits will be necessary to settle the obligation.
3. A reliable estimate can be made of the amount of the obligation.

3

(b) Employee claiming damages

Expert opinion here is that it is probable that the company will lose the case. The company should therefore make a provision for a liability of £15,000 in the financial statements.

Damages claim against contractor

This is a contingent asset and should not be recognised until the outcome of the case is known.

4

(7)

Issue 2 – Possible impairment

Carrying value = Cost £24,000,000
Net realisable value = £14,000,000.
Economic value = £20,500,000

There is clear evidence of impairment here. The recoverable amount of the factory (it's value in use here of £20,500,000) has fallen below what would be its carrying value (cost of £24,000,000 less depreciation of £2,400,000 = £21,600,000). The factory should therefore be written down to £20,500,000 as at 30 November 2006 and written off over the following nine years. In the circumstances, however, the company should perhaps be sensitive to further possible impairment of this asset in the future.

(4)

Issue 3 – treatment of debentures

(a)

- Initial recognition of the liability should be the fair value of the consideration (here £750,000) less direct issue costs incurred (here £87,987).
- The total finance cost is the difference between the total payments made over the life of the instrument less the initial carrying value.
- The finance charge should be charged to profit and loss account over the term of the debt so as to give a constant rate of interest on the amount outstanding on the debt.

- The carrying value of the debt should be increased each year by the finance cost for the year and reduced by the payments made on the debt over the year. *(4)*

(b) (i)

	£
Nominal value	750,000
Issue costs	87,987
Liability initially recognised	662,013

1

(ii) Workings

Cost of debenture over life

		£
Issue costs		87,987
Redemption costs		105,000
Annual interest	75,000	
Years	4	
		300,000
		492,987

Year	Opening balance	Charge to Profit and Loss	Interest	Closing balance
	£	£	£	£
1	662,013	112,542	(75,000)	699,555
2	699,555	118,925	(75,000)	743,480
3	743,480	126,392	(75,000)	794,871
4	794,871	135,128	(75,000)	854,999

(a) Charge to profit and loss for the year ended 30 November 2007 = £112,542

(b) Charge to profit and loss for the year ended 30 November 2007 = £118,925

2

(iii) (a) Carrying value as at 30 November 2007 = £699,555

(b) Carrying value as at 30 November 2008 = £743,480

See workings above

2

(5)

(20)

Question 5

(a)

	Tyne	Tees	Wear	
	£m	£m	£m	
Contract value	19.80	24.83	15.50	*1*
Costs to date	7.52	1.33	12.93	*½*
Estimated future costs	6.56	9.45	5.27	*1 ½*
Estimated profit/(loss)	5.72	14.05	(2.70)	*1*
				(4)

(b)

	Tyne	Tees	Wear	
Percentage complete:	10.3/19.8	1.25/24.83	n/a due to losses	
	= 52%	= 5%	64.5%	*1 ½*
Attributable profit (£m)	2.98	nil	(2.7)	*1 ½*
				(3)

(c)

	Tyne	Tees	Wear	**Total**	
	£m	£m	£m	**£m**	
Turnover	5.05	1.25	10.00	**16.30**	*1 ½*
Cost of Sales (balance)	3.47	1.25	12.70	**17.42**	*1 ½*
Profit	1.58	0.00	(2.70)	**(1.12)**	*1*
					(4)

(d)

	Tyne	Tees	Wear	**Total**	
	£m	£m	£m	**£m**	
Work in progress:					
Costs to date	7.52	1.33	12.93		*1 ½*
Transferred to Cost of Sales	7.32	1.25	12.70		*1 ½*
	0.20	0.08	0.23	**0.51**	

Amounts recoverable on contracts:

Turnover	10.30	1.25	10.00		*1 ½*
Value of work invoiced	8.30	1.00	10.00		*1 ½*
	2.00	0.25	0.00	**2.25**	

Trade debtors:

Value of work invoiced	8.30	1.00	10.00		*1 ½*
Payments received	6.50	1.00	9.00		*1 ½*
	1.80	0.00	1.00	**2.80**	
					(9)
					(20)