CIPFA

FINANCIAL REPORTING

Certificate stage examination

7 December 2007

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

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Question 1

Masfin plc
Income Statement
For the year ended 31 October 2007 ½

	£000		
	£000	½	
Revenue	1,789	*1 ½*	
Cost of sales	(1,370)	*2*	W
Gross profit	419	*½*	
Distribution costs	(52)	*1*	
Administrative expenses	(314)	*2*	W
Operating profit	53		
Reorganisation costs incurred	(86)	*1*	
Provision for reorganisation used	90	*1*	
	57		
Income from non-current investments	47	*½*	
Finance cost	(3)	*1*	
Profit before tax	101		
Taxation	(17)	*1 ½*	
Profit for the year	84	*½*	
		(13 ½)	

Masfin plc
Balance sheet as at 31 October 2007 ½

ASSETS

Non-current assets	Cost	Depreciation	Net Book Value	
	£000	£000	£000	
Property, plant and equipment	400	(121)	279	*2 ½*
Investments			92	*1*
			371	
Current assets				
Inventory			102	*1*
Trade receivables			185	*1 ½*
Cash and cash equivalents			266	*½*
			553	
Total assets			924	

EQUITY AND LIABILITIES

Equity		
Issued ordinary shares of £1	200	½
Share premium	80	½
Revaluation reserve	81	*1*
Retained earnings	133	*2*
Total equity	494	
Non-current liabilities		
8% Preference Shares, redeemable 2012	40	*1*
Deferred taxation	77	*1*
Other provisions	190	*1*
Total non-current liabilities	307	
Current liabilities		
Trade payables	45	½
Current taxation payable	52	*1*
Other payables	26	*1*
Total current liabilities	123	
Total liabilities	430	
Total equity and liabilities	924	
		(16 ½)

Workings

Calculation of depreciation		**£000**
Property		
Cost		100
Depreciation		2
Plant and equipment		425
less disposal		125
		300
Depreciation		60
Total depreciation (2 + 60)		62
Allocated to:		
Cost of sales	50%	31
Administration	30%	19
Distribution	20%	12
		62

Taxation	£000
Provision for corporation tax	52
Previous overprovision	(13)
	39
Decrease in deferred taxation	(22)
	17

Revenue	**£000**
Turnover	1,795
less Goods on sale or return	(6)
	1,789

Operating expenses	**Cost of sales £000**	**Admin. £000**	**Dist. £000**
per trial balance	1,364	72	40
Increase in closing inventory	(4)		
Depreciation	31	19	12
Surplus on disposal of non-current asset	(21)		
Bad debt		33	
Provision for legal claim		190	
	1,370	314	52

Trade receivables	£000
per trial balance	224
Goods on sale or return	(6)
Bad debt	(33)
	185

Revaluation reserve	£000
per trial balance	69
Increase in value of non-current investments	12
	81

Retained earnings	£000
per trial balance	129
Profit for the year	84
Equity diivdends paid	(80)
	133

(30)

Question 2

(a) The annual accounts of large limited companies must be audited by a suitably qualified independent auditor. The auditor is required to give an opinion as to whether or not the financial statements show a true and fair view. This is contained in the auditors report which explains the work done by the auditor, whether or not the accounts conform with (in the UK) the requirements of the Companies Act 1985 and applicable accounting standards (either international or UK), and whether they present a true and fair view of the company's results and financial position. If everything is satisfactory the auditor's report will be unqualified. The auditor will qualify the report if there is any disagreement with the company's directors which cannot be reconciled.

The cash flow statement falls within the scope of the auditor's report. Hence the full year's figures here are from the audited accounts for the previous year. However, the interim (or half year) results need not be audited – and here that fact is highlighted. The main reason for this is the need for the interim figures to be produced as quickly as possible in order to be useful to the capital markets. This does not necessarily mean that the figures are wrong or suspect – but they may be subject to change during the auditing process.

The fact that the football club produces interim financial statements suggests that it is a listed company. Listed companies are currently required (in the UK) to produce six monthly financial statements. In the USA the requirement is to produce quarterly results and UK practice may follow USA practice in due course.

1 mark per valid point up to a maximum of (3)

(b) The profit/loss for the financial period is the figure reported in the club's income statement. This is not necessarily the same as the cash flow from operations. There are three main areas of difference:

(i) The profit for the period is adjusted to the operating profit for the period. Operating profit is profit before tax and interest. This means adding back charges for interest (finance expenses) and taxation (income tax expense) and excluding investment income and interest received (finance income).

(ii) Non-cash items are then excluded. These include depreciation, impairment and amortization charges. These are allocated costs and do not represent actual cash flows. Actual cash flows arising from the purchase and sale of non-current assets appear later in the cash flow statement.

Non-cash items also include profits/losses on the disposal of non-current assets and player registrations. These are excluded because the actual amounts of cash received will be reported later on in the cash flow statement.

(iii) Finally, there are adjustments for movements in the working capital of the club, for example changes in inventories, receivables and payables. This adjustment is necessary to convert the performance measure of 'profit' to the equivalent cash flow.

The cash flow statements provided show all the above adjustments clearly and account for the difference between profit and the movement in cash. For example, the most recent figures show an overall loss of £6,330,000 for the six months – but the cash generated from operating activities is a positive cash flow of £1,769,000.

1 mark per valid point up to a maximum of (6)

(c) Wages paid to players are not separately disclosed in the cash flow statement. These would be classified as an operating expense, so the amount of cash generated from operations [£1,769,000 for the first six months of the current financial year] is after the deduction of the amounts paid as wages.

This football club has adopted international accounting standards, which it is now required to do as a listed company with subsidiaries. Had the cash flow statement been prepared according to UK standards *and* the direct method had been used, the total paid as wages and salaries would have been separately disclosed - but it would have been *all* wages and salaries and not just the payments made to players.

(1)

(d) The following points are valid:

- A variety of comparisons is possible for the data given eg last six months with the equivalent six months in the previous year, last year's six months with the previous full twelve months. This could be useful in identifying possible seasonal effects, and possible estimates of amounts for the whole of the current year.

- In each of the three periods the amount of money spent by the club is greater than the amount of money received by the club.

- At the end of the previous financial year and the previous first six months the club had positive cash resources. At the end of the first six months of the current year that has changed significantly and the club has negative cash resources of just under £15 million, mainly in the form of what seems to be a large bank overdraft.

- The main reason for the negative cash flow is the very large amount spent on acquiring players. The amount spent in the first six months of the current year is more than double the equivalent for the first six months of the previous year. There may be a seasonal effect here; the previous year's figures suggest that most of the amount spent on acquiring new players occurs in the first six months of the financial year.

- While expenditure on new players seems to have increased significantly, proceeds from the sale of player registrations seems to have fallen significantly – less than 60% of the amount raised in the equivalent six months of the previous year.

- Investments in non-current assets (ie property, plant and equipment) have fallen significantly in the last six months – just about 25% of the equivalent figure for the previous year.

- There is a significant increase in the amount raised from the sale of non-current assets, although this is small relative to the other cash flows.

- The amounts paid as interest seem to be falling and this is consistent with the amounts being repaid on borrowings – although the amount of borrowings repaid in the most recent six months is less than half the amount for the equivalent six months for the previous year. It might be that the amounts of interest being saved because borrowings are repaid is being offset by increased interest payments on overdrafts.

- Apart from bank financing through overdrafts there has been no additional borrowing during the first six months of the current financial year.

- Dividends paid seem to be very low compared with the previous periods. This may be due to reduced dividends or to the delay in the payment of dividends. If control is in the hands of one or a few shareholders, this may also be evidence of optimizing cash flows in the short term.

- There seem to be significant changes in the management of working capital in the first six months of the year, with significant decreases in receivables and payables.

- There is a cash outflow for share issue expenses – but no evidence of an issue of shares in the last 18 months. This might be a forthcoming issue of shares, or a bonus issue of shares – but there is insufficient information here.

- It would be simplistic to say that there is a possibly worrying deterioration in the cash flow management of the club. Nevertheless, there is evidence of significant changes which could usefully be investigated by seeking out information from elsewhere in the financial statements and from other sources – and the full year results should be interesting.

- Finally, it should be noted that the biggest cash outflow is in respect of investing activities. If these are well chosen investing activities they should result in enhanced cash flows in future years.

2 marks per developed substantive point up to a maximum of (20)

(30)

Question 3

(a) **Castrani plc**
Statement of changes in equity
for the year ended 31 October 2007

	Share Capital	Share premium	Revaluation reserve	Retained earnings	Total	
	£m	£m	£m	£m	£m	
as at 31 October 2006	100	25	32	153	310	*2*
Surplus on investments following the adoption of IAS39			18		18	*1*
as at 1 November 2006	100	25	50	153	328	*2*
Issue of share capital	10	15			25	*2*
Gain on sale of investments			(10)	10		*1*
Investments marked to market			4		4	*1*
Gain on property revaluation			15		15	*1*
Profit for the year				88	88	*2*
Dividends paid				(50)	(50)	*1*
as at 31 October 2007	110	40	59	201	410	*1*

Not including liabilities 1

(15)

(b) Usefulness of the statement of changes in equity

- All conceptual frameworks identify ‘owners’ as primary users of financial statements and ‘relevance’ as an important characteristic of useful information. The statement of changes in equity is directly relevant to owners as it shows how the various components of owners’ interest have changed over the financial year.

- All conceptual frameworks identify usefulness as a primary objective of financial statement. Providing a statement of changes in equity enhances the usefulness of the financial statements to primary users.

The following are some of the ways in which usefulness is enhanced:

- The statement of changes in equity collects together in one statement all the recognised changes in equity over the year. This is useful in emphasising that there are significant types of gain and loss which are not reported in the income statement – but which are carried directly to reserves. This encourages shareholders not to take a narrow view of how their wealth can change.

- The statement of changes in equity shows (usually next to each other) the profit for the year and dividends paid during the year. This gives shareholders a very good insight into the dividend cover (the number of times profit covers dividends) and hence the safety or ‘risk’ attaching to their dividends.

- The statement of changes in equity shows movements in issued share capital during the year. This can be useful to shareholders in signalling potential dilution of their voting rights in the company.

- However, the main drawback is that the statement of changes in equity can be substantial and complex. The whole concept of ‘reserves’ and a knowledge of the kinds of things which can cause increases and decreases in reserves is peculiar to trained accountants and finance specialists. Many shareholders will not have this knowledge and this will limit the usefulness of the statement to them.

(5)

(20)

Question 4

(a) (i) A related party is a person or entity with which the reporting entity cannot have an independent arm's length relationship in a transaction because of the nature of the relationship between the entity and the related party. IAS24 gives a number of examples.

1 ½

Transactions with related parties should be disclosed because transactions between the parties may not be at arm's length and this could have a significant effect on the financial position and operating results of the entity.

1 ½

(ii) (1) an employee of the company

An employee would not be presumed to be a related party just because they are employed by the company.

(2) a shareholder with 30% of the equity shares

Significant influence would be presumed because of the participating interest of 30%, and hence the shareholder would be presumed to be a related party.

(3) a director of the company

This is identified as a related party relationship by IAS24 (member of the key management personnel of the entity).

(4) the brother of a director of the company.

The brother is connected to a related party, and hence presumed to be a related party.

(5) Orter plc

According to IAS24 the fact that Orter plc is economically dependent on Prebnez plc does not necessarily by itself create a related party relationship.

1 mark per valid point up to a maximum of 5

(8)

(b) (i) *Research* is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use. *3*

(ii) (1) is research expenditure and should be written off as it is incurred. *2*

(2) is potentially development expenditure – but the project does not seem technically feasible at the moment. Accordingly, this expenditure should be written off. *2*

(7)

(c) Fidget Factoring Finance is offering with recourse factoring. The receivables should remain in the balance sheet of Prebnez plc and a loan secured on them recognised. Charges should be debited to income statement as finance charges.

Fidget Factoring Finance is compensated for the time delay in receivables collection and the factor has recourse to Prebnez plc for uncollectable debts.

(5)

(20)

Question 5

(a) Ruslan plc

Weighted average number of shares in issue during the year

21 times 3/4	=	15.75		*1*
30 times 1/4	=	7.50		*1*
		23.25		*½*
Earnings		6.9	million	*1*
So, earnings per share		29.7	pence	*1*
Earnings per share for previous year		25	pence	
Restated		21.43	pence (25 times 18 / 21)	*1 ½*

Lyudmila plc

Shares issued as rights issue	3	(18 times 1/6)	*½*
And, total shares in issue after rights issue	21		*½*
Market value of shares before rights issue	2.36		
Value of 6 shares before rights issue	14.16		*1*
Value of 1 share as part of rights issue	2.1		*1*
	16.26		
Theoretical price after rights issue	2.32	(16.26/7)	*1*

Weighted average number of shares

18	times	1/4	times	2.36 / 2.32	=	4.58	*2*
21	times	3/4			=	15.75	*1*
						20.33	

So, eps for year 33.9 pence (6.9/20.33) *1*

Eps for previous year (restated) 25 times 2.32 / 2.36 *1*
= 24.6 pence

(15)

(b) Earnings per share

Basic and fully diluted earnings per share of 29.7 pence (2006 21.4 pence) are based on earnings attributable to ordinary shareholders of £6.9m (2006 £XXm) divided by the weighted average number of shares of 23.25 million (2006 21 million) issued and ranking for dividends.

Disclosure of earnings 1 mark
Disclosure of number of shares 1 mark
Disclosure of any other relevant piece of information 1 mark
(3)

(c) Cash flow statement of Ruslan plc

Financing activities
Issue of shares £19.8 million

(9 million shares at £2.20 each)

Cash flow statement of Lyudmila plc

Financing activities
Issue of shares £6.3 million

(3 million shares at £2.10 each)

1 mark for each figure up to a maximum of (2)

(30)