FINANCIAL REPORTING

Certificate stage examination
10 December 2004

From 2.00 pm to 5.00 pm
plus ten minutes reading time from 1.50 pm to 2.00 pm

Instructions to candidates

*Answer **four** questions in total: **both** questions in **Section A** and **two** of the three questions in **Section B**. The marks available for each question are shown in italics in the right hand margin.*

All workings should be shown. Where calculations are required using formulae, calculators may be used but steps in the workings must be shown. Calculations with no evidence of this (for example, using the scientific functions of calculators) will receive no credit. Programmable calculators are not permitted in the examination room.

Formula sheets, statistical tables, graph paper and cash analysis paper are available from the invigilator, where applicable.

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.

Candidates may use the proforma sheets provided in the separate booklet and submit them as part of their answer.

CIPFA

SECTION A (Answer both questions)

1 The following list of balances has been extracted from the records of Parmelo plc as at 31 October 2004, the end of Parmelo plc's most recent financial year.

Parmelo plc
List of balances as at 31 October 2004

	Note	£
Sales		18,450,000
Cost of sales		14,760,000
Investment income		14,800
Distribution costs		358,900
Administrative expenses	*4*	968,100
Debtors		2,306,000
Creditors		984,000
Provision for doubtful debts, as at 31 October 2004		46,100
Bad debts		203,000
Directors' remuneration	*3*	181,500
Debenture interest		48,000
Interim preference dividend paid	*1*	11,250
Interim ordinary dividend paid	*1*	120,000
Loss on sale of operation	*5*	195,600
Premises, at valuation	*7*	1,750,000
Investment property, at valuation	*1*	450,000
Equipment, at cost		1,223,000
Provisions for depreciation, as at 31 October 2004		
- on premises		98,000
- on equipment		611,500
Long term investments, at cost		185,000
Stock, at cost		606,600
Depreciation	*2*	146,800
Bank overdraft		112,100
Deferred taxation	*1*	56,500
Ordinary shares of 25 pence each	*6*	1,000,000
9% preference shares of £1 each		250,000
12% Debentures		400,000
Share premium		375,000
Revaluation reserve		330,000
Profit and loss account, as at 1 November 2003		785,750

The following additional information is available:

1 The following have still to be provided for in the accounts for the year ended 31 October 2004:

- Audit and accountancy fees of £5,500.
- Corporation tax of £488,700 on the profits for 2003/2004.
- The transfer of £16,500 from deferred taxation.
- A revaluation downwards of the investment property by £160,000. The investment property had been revalued upwards by £80,000 during the year ended 31 October 2002 and upwards by £120,000 during the year ended 31 October 2003.
- The preference dividend for the second half of the year.
- The proposed final ordinary dividend of £0.05 per share.

2 The depreciation charge for the year of £146,800 can be analysed as follows:

Depreciation by class of asset	£
- Buildings	24,500
- Equipment	122,300
	146,800

Depreciation by function	£
- Production	73,400
- Sales	44,000
- Administration	29,400
	146,800

3 Directors' remuneration for the year comprises the following:

	£
Managing director	54,450
Production director	54,450
Sales director	36,300
Finance director	36,300
	181,500

4 Administrative expenses include bank overdraft interest of £5,600.

5 During the year ended 31 October 2004 Parmelo plc disposed of a loss making activity. The activity was sold at a loss of £195,600 which is included in the list of balances as at 31 October 2004. The contribution of the discontinued activity to the results for the year ended 31 October 2004 was:

	£
Turnover	5,535,000
Cost of sales	5,314,000
Distribution costs	108,000
Administrative expenses	194,000

These figures are included in the totals for these items in the list of balances as at 31 October 2004.

6 On 1 November 2003 Parmelo plc issued 400,000 ordinary shares for £0.97 per share, their full market value as at the date of issue. This has been recorded in the accounts.

7 Certain premises were revalued upwards by £200,000 on 31 October 2004. The revaluation surplus has been recorded in the accounts.

- **Requirement for question 1**

(a) Prepare the profit and loss account of Parmelo plc for the year ended 31 October 2004. In so far as the information permits this should comply with Format 1 of the Companies Act 1985 and with the requirements of FRS 3.

Please note:

- Your profit and loss account should disclose basic earnings per share for the year calculated and disclosed in accordance with FRS 14.
- You need not provide the additional disclosures of expenses required by the Companies Act or a statement of accounting policies.
- Provide clear workings showing how you have derived your figures.
- You are NOT required to prepare a balance sheet as at 31 October 2004. *25*

(b) Prepare the Statement of Total Recognised Gains and Losses for Parmelo plc for the year ended 31 October 2004. *5*

(30)

---

2 A manager in the Treasury Department of the organisation you work for has asked for your help in interpreting the cash flow statement of Angelo Ltd, a private company. He has supplied you with the cash flow statements for Angelo Ltd for the last three years as follows:

Angelo Ltd
Cash flow statement for the year ended 31 October

	2002	2003	2004
	£	£	£
Operating activities (see Note)	1,130,500	398,200	68,500
Returns on investments and servicing of finance			
Interest received	4,450	1,340	430
Interest paid	(8,500)	(10,600)	(20,700)
	(4,050)	(9,260)	(20,270)
Taxation			
Corporation tax paid	(185,000)	(120,760)	(87,500)
Capital expenditure and financial investment			
Payments to acquire tangible fixed assets	(440,300)	(310,500)	(15,400)
Receipts from sales of fixed asset investments	0	0	156,870
Receipts from sales of tangible fixed assets	258,410	310,200	100,300
	(181,890)	(300)	241,770
Equity dividends paid			
Dividends paid on equity shares	(200,000)	(200,000)	(100,000)
Management of liquid resources			
Sale of government bonds	20,700	35,960	0
Net cash inflow before financing	580,260	103,840	102,500
Financing			
Issue of ordinary share capital	0	175,000	0
Issue of debentures	0	300,000	0
Redemption of debentures	(150,000)	(150,000)	(150,000)
Net cash inflow from financing	(150,000)	325,000	(150,000)
Increase/(decrease) in cash	430,260	428,840	(47,500)

Note

Net cash inflow from operating activities	**2002**	**2003**	**2004**
	£	£	£
Cash received from customers	3,450,710	2,998,700	2,635,600
Cash payments to suppliers	(1,456,600)	(1,677,540)	(1,589,600)
Cash paid to and on behalf of employees	(580,000)	(645,300)	(797,540)
Other cash payments	(283,610)	(277,660)	(179,960)
	1,130,500	398,200	68,500

- **Requirement for question 2**

(a) Explain the differences between the direct and indirect methods of analysing operating cash flows indicating which method has been used in the above cash flow statement. *5*

(b) Prepare a report for the manager in which you:

- assess the performance of Angelo Ltd over the past three years; and
- highlight areas in which you feel Angelo Ltd should seek to improve its performance, suggesting ways in which this might be achieved.

Your report should be about 450 words long. *25*

(30)

SECTION B (Answer two questions from this section)

3

Barello Ltd is about to enter into two lease agreements.

Finance lease
Under the first agreement Barello Ltd will lease printing equipment on a finance lease. Under the terms of the lease Barello Ltd will make 4 rental payments of £30,000 payable annually in advance. The fair value of the printing equipment is £80,000 and its economic life is 4 years with no residual value. The rate of corporation tax is 30% and the rate of interest implicit in the lease is 36.31%.

Operating lease
Under the second agreement Barello Ltd will lease an internet server. This lease will be classified as an operating lease. Barello Ltd will receive a cash incentive payment of £2,400 as soon as it signs the lease agreement and will make 3 annual rental payments of £3,600 in advance.

- **Requirement for question 3**

(a) Show how the finance lease would be reported in the profit and loss account of Barello Ltd for each of *the first two years* of the lease using the sum-of-the-digits method (also known as the Rule of 78 method). Include corporation tax. *4*

(b) Show how the finance lease would be reported in the profit and loss account of Barello Ltd for each of the *first two years* of the lease using the actuarial method. Include corporation tax. *4*

(c) Show how the finance lease would be reported in the balance sheet of Barello Ltd as at the end of the first and second years of the lease using the actuarial method. *4*

(d) Applying UITF 28 *Operating lease incentives* describe with illustrative figures how the operating lease would be reported in the profit and loss accounts and balance sheets of Barello Ltd for each of the 3 years of the lease. *4*

(e) Comment on the current proposals that finance leases and operating leases should be reported on the same basis. *4*

(20)

4

The financial year of Vuelo plc ended on 31 October 2004 and the company accountant is seeking your advice as to how the following four items should be dealt with in the financial statements for the year.

1 Vuelo plc purchased another business during the year and acquired a brand name valued at £1,750,000. The company considers that the economic life of the brand name is 'about 25 years'.

2 Vuelo plc received a government grant of 50% towards the cost of installing a new energy saving heating system. The new system cost £75,000 (before the grant) and is to be written off over its estimated economic life of 15 years.

3 Vuelo plc reports all its fixed assets at cost less accumulated depreciation. The company knows that one of its property assets is currently worth considerably more than its net book value. It would like to include the property in its balance sheet at its current value but is not sure what the basis of valuation should be or what the implications are for the company's other property assets which the company would like to continue reporting at depreciated historical cost. All Vuelo plc's properties are non-specialised.

4 During the year ended 31 October 2004 Vuelo plc entered into a special agreement with a new supplier to sell a new product. Under the agreement Vuelo plc pays the supplier 35% of the invoice price as a deposit. The balance of the invoice price becomes payable when Vuelo plc sells the product. Vuelo plc has an option to return to the supplier any of the products unsold after 12 months of delivery and receive a refund of 20% of their original invoice price. By the end of the financial year Vuelo plc had sold 4,200 units of this product and has a further 100 units with a total invoice value of £6,000 unsold.

- **Requirement for question 4**

Prepare notes for a meeting with the company accountant which:

- Identify the accounting standard which is relevant for each of the four items.

- Make a clear recommendation, with reasons, on how each item should be treated in the financial statements for the year ended 31 October 2004.

4 x 5 marks

(20)

5

Jenny Firelo set up a part time business on 1 November 2003 buying and selling second hand fire engines. On 1 November 2003 she commenced business with £51,800 which she immediately used to purchase 7 identical fire engines costing £7,400 each, paying in cash. On 1 May 2004 she sold 6 of the fire engines for £9,400 each receiving the cash immediately. Jenny estimates that the net realisable value of the fire engine remaining unsold was £10,100 as at 31 October 2004.

The replacement cost of similar fire engines was £7,600 as at 1 May 2004 and £7,800 as at 31 October 2004, and the value of a relevant general price index was 100 as at 1 November 2003, 104 as at 1 May 2004 and 108 as at 31 October 2004.

Jenny paid the proceeds from the sales on 1 May 2004 into a special bank account for the business and made no drawings and incurred no expenses over the year ending 31 October 2004.

A friend of Jenny's has told her that there are different ways of calculating profit and financial position and has produced the following figures

Current purchasing power accounting

Profit and Loss Account
for the year ended 31 October 2004

	£
Sales	58,569
less Cost of sales	47,952
	10,617
Loss on monetary item	(2,169)
CPP net profit	8,448

Balance Sheet
as at 31 October 2004

	£
Assets	
Stock	7,992
Cash	56,400
	64,392
financed by	
Opening capital	55,944
Profit for the year	8,448
	64,392

Current cost accounting

Profit and Loss Account
for the year ended 31 October 2004

	£
Historical cost profit	12,000
less Cost of sales adjustment	1,200
Current cost profit	10,800

Balance Sheet
as at 31 October 2004

	£
Assets	
Stock	7,800
Cash	56,400
	64,200
financed by	
Opening capital	51,800
Current cost reserve	1,600
Profit for the year	10,800
	64,200

- **Requirement for question 5**

(a) Prepare Jenny's historical cost profit and loss account for the year ended 31 October 2004 and her balance sheet as at 31 October 2004. *3*

(b) (i) Explain, in general terms, how the figures for Sales and Cost of sales were calculated for the current purchasing power profit and loss account. You need not provide detailed calculations. *3*

(ii) Explain what the 'loss on monetary item' means. In what circumstances would there be a profit on monetary items? *4*

(c) (i) Explain, in general terms, how the 'cost of sales adjustment' was calculated for the current cost profit and loss account. You need not provide detailed calculations. *2*

(ii) Identify and explain the purpose of any two other adjustments which you might expect to see in a current cost profit and loss account prepared in this way. *3*

(d) State, giving your reasons, which of the three bases gives the best measure of Jenny's financial performance and financial position. *5*

(20)
