CIPFA

FINANCIAL REPORTING

Certificate stage examination

9 June 2006

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

Question 1

(a)

Poletex plc *1*
Profit and loss account
for the year ended 31 May 2006 *½*

	Continuing Operations	Discontinued Operations	Total		
	£000	£000	£000	*½*	
Turnover	14,256	5,544	19,800	*1*	*1*
Cost of sales	(10,679)	(5,386)	(16,065)	*2½*	*½*
Gross profit	3,577	158	3,735	*½*	*½*
Distribution costs	(417)	(150)	(567)	*2½*	*½*
Administrative expenses	(999)	(167)	(1,166)	*5½*	*½*
Operating profit/(loss)	2,161	(159)	2,002	*½*	*½*
Loss on sale of operation			(145)	*½*	
Income from fixed asset investments			13	*½*	
Interest payable and similar charges			(35)	*1*	
Profit on ordinary activities			1,835	*½*	
Tax on profit on ordinary activities			(497)	*2*	
Profit on ordinary activities after taxation			1,338	*1*	
Basic and fully diluted earnings per share (in pence)			41.3	*1½*	
				Style 1	
				22.5	*3.5*
				(26)	

Workings

Cost of sales	£000	
Per list of balances	15,840	*½*
Production director's remuneration	42	*1*
Depreciation	183	*1*
	16,065	*(2½)*

Distribution costs	£000	
Per list of balances	468	*½*
Sales director's remuneration	38	*1*
Depreciation	61	*1*
	567	*(2½)*

Administrative expenses	£000	
Per list of balances	759	*½*
Exclude overdraft interest	(5)	*1*
Bad debts	218	*1*
Directors' remuneration	100	*1*
Depreciation	61	*1*
Audit and accountancy fees	33	*1*
	1,166	*(5 ½)*

Interest payable and similar charges	£000	
Debenture interest	30	*½*
Bank overdraft interest	5	*½*
	35	*(1)*

Tax on profit on ordinary activities	£000	
Corporation tax	515	*1*
Transfer from deferred taxation	(18)	*1*
	497	*(2)*

Calculation of earnings per share	£000	
Profit after tax	1,338	*½*
Preference dividend	16	*½*
Available for ordinary shareholders	1,322	
Number of shares	3,200	*½*
Earnings per share	41.3	*(1 ½)*

(b)

Calculation of balance on profit and loss	£000	
Balance b/f	918	*½*
Profit after taxation	1,338	*½*
	2,256	
Dividends paid	(400)	*1*
Balance c/f	1,856	*(2)*

(c) A transfer from deferred taxation account back to profit and loss account will occur when reversing timing differences are greater than originating timing differences. This would happen, for example, when the amount charged as depreciation in the accounts (which is not allowable for corporation tax purposes) is greater than the amount of capital allowances for the year.

1 mark per valid point to a maximum of 2

(30)

Question 2

(a)

Prelyn Ltd
Cash flow statement for the year ended 31 May 2006

		£000	
Net cash inflow from operating activities		1,513	*7*
Returns on investments and servicing of finance			
Interest paid		(103)	*2*
Taxation			
Corporation tax paid		(110)	*2*
Capital expenditure	£000		
Payments to acquire tangible fixed assets	(184)		*1*
Receipts from sales of tangible fixed assets	75		*1*
		(109)	
Equity dividends paid			
Ordinary dividends paid		(300)	*1*
		891	
Financing			
Issue of ordinary share capital	325		*1*
Repayment of debentures	(300)		*1*
		25	
Increase in cash		916	*(16)*

RECONCILIATION OF OPERATING PROFIT to NET CASH INFLOW FROM OPERATING ACTIVITIES

		£000	
Operating profit		1,030	*1*
Loss on sales of fixed assets		25	*1*
		1,055	
Depreciation			
on Equipment	296		*1*
on Motor vehicles	88		*1*
Amortisation of goodwill	66		*1*
		450	
Increase in stock		(110)	*1*
Decrease in trade debtors		40	*½*
Increase in trade creditors		78	*½*
Net cash inflow from operating activities		1,513	*(7)*

Workings:

Interest paid = 18 (accrued b/f) + 100 (for year) – 15 (accrued b/f) = 103 paid
Taxation = 123 (b/f) – 13 (overprovision) = 110

(b)

Prelyn Ltd
Balance Sheet as at 31 May 2006

Fixed assets		£000	
Intangible assets		99	*1*
Tangible, net book value		610	*2*
		709	
Current assets	£000		
Stock, at cost	750		*½*
Trade debtors	450		*½*
Cash and bank	748		*½*
	1,948		
Creditors: amounts falling due within one year			
Trade creditors	515		*½*
Taxation	233		*½*
Accrued interest	15		*½*
	763		
		1,185	
Total assets less current liabilities		1,894	
Provisions for liabilities			
Deferred taxation		(250)	*1*
		1,644	
Share capital and reserves			
Ordinary shares of £1 each		750	*1*
Share premium account		275	*1*
Profit and loss account		619	*1*
		1,644	
			(10)

Workings:

Fixed assets, at cost = 1,690 (b/f) – 250 (disposals) + 184 (purchased) = 1,624
Accumulated depreciation = 780 (b/f) – 150 (withdrawn on disposals) + 384 (charge for the year)
Cash and bank = 30 (b/f) + 916 (increase from cash flow statement) – 198 (repaid) = 748
Ordinary share capital = 500 (b/f) + 250 (issued) = 750
Share premium = 200 (b/f) + 75 (premium on share issued) = 275
Profit and loss account = 302 (b/f) + 615 (profit after tax) – 300 (dividends paid) = 617

(c) The liquidity of Prelyn plc has improved significantly over the year, viz:

- At the beginning of the year there was a small positive bank balance which was exceeded by significant bank loans and overdrafts. By the end of the year the bank loans and overdrafts had been repaid and the balance sheet shows a healthy bank balance.
- The gearing of the company has been reduced over the year. The 12% debentures have been repaid by the proceeds of an issue of shares at a premium.

- Significant funds generated from operations have been retained within the company. The cash generated from operations is five times the amount paid to ordinary shareholders as dividends.

- Funds have also been used to invest in new fixed assets and a significant contribution towards the cost of the new assets has come from the proceeds from the sales of assets no longer required.

- Liquidity has also been improved by reducing the amounts owed to the company by customers while increasing the amount of credit taken from suppliers. The only possible concern about the management of working capital might be the significant increase in stocks over the year.

1 mark per valid point to a maximum of 4

(30)

Question 3

(a) This is a post balance sheet event as it has occurred between the end of the financial year and the date on which the accounts are signed off. The use of the word 'significant' suggests that this is a material event. However, it does not relate to the company's financial position as at 30 April 2006. It is therefore a non-adjusting post balance sheet event. Kortine plc should disclose this transaction as a note to the financial statements if it considers that knowledge of this transaction would affect the economic decisions of users. The note should disclose the nature of the transaction and its financial effect.

1 mark per valid point to a maximum of 4

(b) This is a change in estimation technique. There is no change in the way motor vehicles are being recognised, nor is there any change in the measurement basis. Therefore, according to FRS 18 Accounting policies, there is no change in accounting policy. The net book value of the motor vehicles as at 1 May 2005 should be written off using the new method of depreciation. There is no need to restate figures for previous years, nor is there any need to disclose a change in accounting policy.

1 mark per valid point to a maximum of 3

(c) Kortine plc should make a provision for the cost of warranty repairs in its financial statements for the year ended 30 April 2006. The provision should be made only in respect of sales made during the year ended 30 April 2006 and will comprise:

- The cost of repairing or replacing goods for which defects have been notified but where the work has not yet been undertaken, plus
- An estimate of costs of repairing other items sold where there is sufficient evidence that defects will occur during the remaining period of warranty cover.

1 mark per valid point to a maximum of 3

(d) Kortine plc has the option of reporting the leasehold property either at cost or at a revalued amount. Either way depreciation should be provided to write the cost or revalued amount of the leasehold property off over the duration of the lease (or useful life if lower than the length of the lease).

1 mark per valid point to a maximum of 2

(e) The goodwill paid for is the amount paid for the investment (£600,000) less the fair value of the net assets acquired (£1,000,000) ie negative goodwill of £400,000.

2

Where negative goodwill arises the valuation used for net assets acquired and the amount paid should be reviewed to confirm that no errors have been made in identifying and valuing the assets acquired (including intangible assets) and in calculating the amount of the purchase consideration. If the figures are confirmed and negative goodwill remains, it should be reported in the balance sheet as a negative asset and deducted from any positive goodwill reported.

Negative goodwill should be written off to profit and loss account over the same period/periods as the non-monetary assets purchased. The stock will be written off in the year ended 31 May 2005 (150,000) as well as 1/6th of the fair value of the fixed assets (100,000) – a total of £250,000. The total non-monetary assets as at the start of the year were £750,000. So 1/3rd of goodwill will be written off in the current year i.e. 400,000/3 = 133,333. The balance of goodwill (£266,667) should be written off equally over the remaining life of the fixed assets acquired ie 5 years.

Description – 3 marks
Numerical illustration – 3 marks

(20)

Question 4

Statement of Total Recognised Gains and Losses (STRGL)

The STRGL is a primary statement which, according to FRS 3, should have equal prominence in the accounts as the profit and loss account, balance sheet and cash flow statement. It collects into one statement all value changes recorded (ie recognised) in the accounts during the financial period. It will include the value changes recognised in the profit and loss account and also those recognised in the balance sheet either because company law precludes recognising them in the profit and loss account or because they are regarded as unrealised. The STRGL is a measure of comprehensive income.

The usefulness of the STRGL may be limited for a number of reasons:

- Research appears to show that very few users understand its purpose or content.
- The statement contains very little in the way of new information not already contained in the Profit and Loss account. This is because very few companies engage in fair value accounting and so the real purpose of the STRGL is not fulfilled.

This STRGL shows that comprehensive income is different from the profit reported in the Profit and Loss account. Profit after tax of £9,156,000 falls to an overall gain of £8,999,000. This is due to

- A revaluation downwards of an investment property by £260,000 which had previously been revalued upwards by more than £260,000.
- A revaluation upwards of a tangible fixed asset (perhaps property) by £450,000.
- A prior year loss of £347,000. It is not possible to tell what the prior year adjustment is for – although information would be disclosed elsewhere in the accounts. It could be the correction of a fundamental error, or it could be a retrospective adjustment for a change of accounting policy.

1 mark for each valid point to a maximum of 8

Reconciliation of Movement in Shareholders' Funds

The STRGL shows the total increase or decrease in shareholders' funds attributable to value changes over the reporting period. However there can be other increases and decreases in shareholders' funds which are not value changes ie they are not profits or losses. Examples would include the issue of shares, the redemption of shares, and the payment of dividends.

The purpose of this reconciliation is to collect all these items together so that the total change in shareholders' funds is analysed into its various components of which comprehensive income may be just one.

This statement is useful to shareholders because it explains how their collective investment in the company has increased or decrease over the reporting period.

In this example shareholders' funds have increased significantly. This is mostly due to a significant retained profit for the year and a significant issue of share capital during the year.

1 mark for each valid point up to a maximum of 6

Note on historical cost profits and losses

In the past the practice of revaluing assets has been an ad hoc affair. However, more recently an element of order has been introduced by FRS 15. If a fixed asset is revalued, all assets in the same class must also be revalued – and there are requirements to keep those valuations up to date. However, there is still a diversity of practice between companies as to whether or not fixed assets are revalued, which classes are revalued, and how recent the revaluations are. Where assets are revalued upwards the depreciation charge in the profit and loss account is likely to be higher (thus reducing reported profits) while capital employed increases to reflect the net increase in carrying value.

The purpose of the note on historical profits and losses is to take profit on ordinary activities before taxation and make adjustments (eg by adding back the increase in the depreciation charge attributable to the revaluation surplus) to take it back to what it would have been had unmodified historical cost accounting been used. The intention is to give a historical cost profit figure which is more comparable between different companies. However;

(a) There still remain lots of possible differences in accounting policies which mean that pure historical cost profit figures are just not comparable anyway.

(b) There is no equivalent note for net assets employed which would enable a consistent calculation of return on capital employed. The information about the historical cost of revalued assets will be reported in the financial statements – but the user will have to locate it and make the appropriate adjustments.

(c) There may be a problem in users understanding the nature and purpose of the statement and the limitations in using pure historical cost profit figures.

In the note on historical cost profits and losses provided there are two adjustments.

- The first is an adjustment of £100,000 relating to the sale of a revalued property. This suggests that the profit reported on the basis of the excess of the proceeds over the carrying value of the property would have been £100,000 higher had the property not been revalued.

- The second is an adjustment of £40,000 which relates to depreciation charged on revalued fixed assets. This suggests that the depreciation on the historical cost of the revalued assets was £40,000 lower than the equivalent depreciation charge on the revalued amount.

1 mark for each valid point to a maximum of 6

Purpose = 3 + 3 + 2 = 8
Usefulness = 2 + 2 + 2 = 6
Interpretation = 2 + 2 + 2 = 6

(20)

Question 5

(a) Possible reasons for the increase in the gross profit percentage include:

(1) More efficient purchasing so that purchase prices have become lower.
(2) Increases in selling prices without adversely affecting the quantity of sales.
(3) Change in sales mix, so that an increasing proportion of sales are made up of higher margin goods.
(4) Reduction in the quantity of goods lost, stolen or pilfered.
(5) Error in the counting or valuation of closing stock in the second year ie closing stock has been overstated.

1 mark for each point, up to a maximum of 5

(b) **(i)**

Interest element for first year	£2,731	
Annual instalment	£15,000	
So, capital repayment is (15,000 – 2,731)	12,269	*1*
Fair value of asset	68,000	
First instalment (paid in advance)	15,000	*1*
So, capital value outstanding at start of lease	53,000	*1*
Capital repayment first year	12,269	
Balance outstanding at start of second year	40,731	*1*
Rate of interest (2,731/53,000)	5.15%	*1*
So for year 2, finance charge is (5.15% of 40,731)	2,098	*1*

(ii) An alternative method would be to use the rule of 78 method. This operates similarly to the sum of the years digits method of providing for depreciation and would allocate a decreasing finance charge to each successive accounting period. This would not achieve the objective of SSAP 21 which is that the finance charge should be allocated to accounting periods so as to give a constant periodic rate of return on the amount invested in the lease. However, the method is simple to use and would be an acceptable compromise where the finance lease is not significant relative to the other assets of the company.

Method identified – 1 mark
Acceptable – 1 mark

(c) (i)

Basic eps is	30.0	pence	
Number of ordinary shares in issue	7,000,000		
So, profit attributable to ordinary shareholders (after interest and tax)	£2,100,000		*1*
Number of additional shares if convertible bonds converted	1,600,000		
This would give a total number of ordinary shares in issue of	8,600,000		*1*
Profit attributable to ordinary shareholders (after interest and tax)	£2,100,000		
Add interest expense saved if bonds converted	120,000		*1*
Corporate tax on interest (30%)	(36,000)		*1*
Giving revised earnings of	£2,184,000		
So diluted eps is (2,184,000/8,600,000)	25.4	pence	*1*

(ii) Disclosure requirements for diluted earnings per share include:

1) Diluted earnings per share from continuing operations attributable to the ordinary equity holders should be presented on the face of the profit and loss account – along with basic earnings per share.

2) Diluted earnings per share should be presented with the same prominence as basic earnings per share.

3) Diluted earnings per share should be presented for every period for which a profit and loss account is presented.

4) If basic and diluted earnings per share are equal dual presentation on one line can be adopted.

5) If there are discontinued operations, basic and diluted earnings per share should be presented for the discontinued operation either on the face of the profit and loss account or in the notes to the financial statements.

6) Basic and diluted earnings per share should be presented even if the amounts are negative.

7) The figures used as the numerator (along with a reconciliation to profit or loss for the period) and the denominator should be disclosed in the notes to the financial statements.

1 mark each to a maximum of 2

(20)