FINANCIAL REPORTING

Certificate stage examination

9 June 2006

From 10.00am to 1.00pm
plus ten minutes reading time from 9.50am to 10.00am

Instructions to candidates

*Answer **four** questions in total: **Two** questions from **Section A** and **two** questions from **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.

A Proforma booklet, graph paper and cash analysis paper are available from the invigilator.

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.

The Proforma booklet provided may be submitted as part of an answer.

AT THE HEART OF
YOUR CAREER

SECTION A (Compulsory)

1 The following list of balances has been extracted from the records of Poletex plc as at 31 May 2006, the end of Poletex plc's most recent financial year.

Poletex plc
List of Balances as at 31 May 2006

	Note	£000
Sales		19,800
Cost of sales		15,840
Investment income		13
Distribution costs		468
Administrative expenses	*2*	759
Debtors		2,475
Creditors		1,056
Allowance for doubtful debts		50
Bad debts		218
Directors' remuneration	*3*	180
Debenture interest		30
Preference dividends paid		16
Ordinary dividends paid		384
Loss on sale of operation	*4*	145
Property, at valuation		2,100
Investment property, at valuation		360
Equipment, at cost		1,157
Provisions for depreciation, as at 31 May 2006		
- on property		296
- on equipment		1,155
Long term investments, at cost		164
Stock, at cost		651
Depreciation	*5*	305
Bank overdraft		98
Deferred taxation		116
Ordinary shares of 25 pence each		800
8% preference shares of £1		200
10% Debentures		300
Share premium		170
Revaluation reserve		280
Profit and loss account, as at 1 June 2005		918

The following additional information is available:

1 The following have still to be provided for in the accounts for the year ended 31 May 2006:

- Accrued audit and accountancy fees of £33,000.
- Corporation tax of £515,000 on the profits for 2005/2006.
- A reduction of £18,000 in deferred taxation.

2 Administrative expenses include bank overdraft interest of £5,000.

3 The company has four directors whose remuneration was as follows:

	£
A J Polson – managing director	63,000
A Patel – production director	42,000
G Meier – sales director	38,000
E McKendrick – finance director	37,000
	180,000

4 During the year ended 31 May 2006 Poletex plc sold a loss making activity at a loss of £145,000 which is included in the list of balances as at 31 May 2006. The contribution of the discontinued activity to the results for the year ended 31 May 2006 was:

	£
Sales	5,544,000
Cost of sales	5,386,000
Distribution costs	150,000
Administrative expenses	167,000

These figures are included in the relevant totals in the list of balances as at 31 May 2006.

5 The depreciation charge for the year of £305,000 can be analysed as follows:

Depreciation by functional area:	£
- Production	183,000
- Sales	61,000
- Administration	61,000
	305,000

Depreciation by type of asset:	£
- Property	25,000
- Equipment	280,000
	305,000

6 The preference dividend was paid in full during the year ended 31 May 2006. The directors will be proposing a final ordinary dividend of 8 pence per share.

- **Requirement for question 1**

(a) Prepare the profit and loss account of Poletex plc for the year ended 31 May 2006. In so far as the information provided 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 22.
- You need NOT provide the additional disclosures of expenses required by the Companies Act or a statement of accounting policies.
- Please provide clear workings showing how you have worked out your figures.
- You are NOT required to prepare a balance sheet as at 31 May 2006.

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(b) Calculate the balance on Profit and Loss Account which will be reported in the balance sheet as at 31 May 2006. *2*

(c) Explain the circumstances that might have caused the reduction of £18,000 in the balance on the deferred taxation account. *2*

(30)

2 The following is the summarised balance sheet of Prelyn Ltd as at 31 May 2005, the *start* of its most recent financial year.

Prelyn Ltd

Balance sheet as at 31 May 2005

Fixed assets	Cost	Accumulated depreciation	Net book value
	£000	£000	£000
Intangible: goodwill	330	165	165
Tangible:			
Equipment	1,250	550	700
Motor vehicles	440	230	210
	1,690	780	910
			1,075
Current assets			
Stock		640	
Trade debtors		490	
Bank		30	
		1,160	
Creditors: amounts falling due within one year			
Trade creditors		437	
Taxation		123	
Accrued interest		18	
Bank loans and overdrafts		198	
		776	
Net current assets			384
Total assets less current liabilities			1,459
Creditors: amounts falling due after more than one year			
12% Debentures			(300)
Provisions for liabilities			
Deferred taxation			(155)
			1,004
Share capital and reserves			
Ordinary shares of £1 each			500
Share premium account			200
Profit and loss account			304
			1,004

The following is the summarised profit and loss account of Prelyn Ltd for the year ended 31 May 2006:

Prelyn Ltd
Profit and loss account
for the year ended 31 May 2006

		£000
Sales		6,030
Cost of sales		
Opening stock	640	
Purchases	4,240	
	4,880	
Closing stock	(750)	
		4,130
Gross profit		1,900
Operating expenses		(870)
Interest payable		(100)
Profit before tax		930
Taxation		
Corporation tax	(233)	
Overprovision for previous year	13	
Deferred taxation	(95)	
		(315)
Profit after tax		615

The following additional information is available:

1. During the year ended 31 May 2006 equipment costing £250,000, which had a carrying value of £100,000, was sold for £75,000. Equipment costing £184,000 was purchased during the year.

2. The company's policies for providing depreciation are as follows:

   - Equipment: 25% straight line method.
   - Motor vehicles: 20% straight line method.
   - Goodwill: amortised equally over 5 years.

   A full year's depreciation is charged in the year of purchase and no depreciation is charged in the year of disposal. All residual values are assumed to be zero.

3. During the year ended 31 May 2006:

   - 250,000 ordinary shares were issued at £1.30 each. All cash has been received.
   - Dividends of £300,000 were paid.
   - The 12% debentures were repaid.
   - All bank loans and overdrafts were repaid.

4. At 31 May 2006 trade debtors were £450,000, trade creditors were £515,000 and accrued interest was £15,000.

- **Requirement for question 2**

(a) Prepare Prelyn Ltd's cash flow statement for the year ended 31 May 2006 using the indirect method.

Your cash flow statement should include a reconciliation of operating profit to net cash inflow from operating activities but the other notes and reconciliations required by FRS 1 *Cash Flow Statements* are not required. *16*

(b) Prepare Prelyn Ltd's balance sheet as at 31 May 2006. The note giving details of fixed asset movements during the year is not required. *10*

(c) Comment on how the liquidity of Prelyn Ltd has changed during the year ended 31 May 2006. *4*

(30)

SECTION B (Answer two questions from this section)

3

Kortine plc has prepared its draft financial statements for the financial year ended 30 April 2006. However, the following issues remain unresolved.

(a) Shortly after 30 April 2006 Kortine plc took out a significant loan secured on the company's freehold property.

- **Requirement for question 3 (a)**

  With reference to FRS 21, discuss whether or not this transaction should be disclosed in the financial statements for the year ended 30 April 2006. *4*

(b) Kortine plc has been depreciating its motor vehicles at 20% on cost using the straight line method. However, as from the financial year ended 30 April 2006 the company decided to depreciate its motor vehicles at 30% using the diminishing balance method because the company feels that this method better reflects the way in which the economic benefits are used up by the company.

- **Requirement for question 3 (b)**

  Discuss whether or not this is a change in accounting policy and how this should be presented in the financial statements for the year ended 30 April 2006. *3*

(c) During the year ended 30 April 2006 Kortine plc started selling a new product with an extended warranty. Under the warranty Kortine plc will repair or replace any faulty products free of charge if a defect occurs within three years from the date of sale. Warranty costs actually incurred during the year have been recorded and charged in the profit and loss account.

- **Requirement for question 3 (c)**

  How should Kortine plc account for the warranty in its financial statements for the year ended 30 April 2006? *3*

(d) No depreciation has been provided for on a leasehold property purchased by Kortine plc on 1 May 2005 for £2,800,000 because the property is estimated to be worth £3,100,000 at 30 April 2006.

- **Requirement for question 3 (d)**

  What is the appropriate treatment of the leasehold property in the financial statements? *2*

(e) Kortine plc purchased a 100% holding in another business on 1 May 2005. The assets acquired comprised:

	£000
Fixed assets (remaining useful life 6 years), at fair value	600
Stock	150
Net monetary assets	250

The amount paid for the investment was £600,000.

- **Requirement for question 3 (e)**

  Calculate the goodwill arising on the transaction and explain how it should be treated in the financial statements of Kortine plc. Illustrate the treatment of goodwill with appropriate figures. *8*

(20)

4

The following three statements have been taken from the published financial statements of Torrance plc:

Torrance plc
Statement of Total Recognised Gains and Losses
for the year ended 31 May 2006

	£000
Profit on ordinary activities after taxation	9,156
Unrealised loss on reduction in value of investment property	(260)
Unrealised surplus on revaluation of tangible fixed asset	450
Total recognised gains and losses for the year	9,346
Prior year adjustment	(347)
Total gains and losses recognised since last annual report	8,999

Torrance plc
Reconciliation of Movements in Shareholders' Funds
for the year ended 31 May 2006

		£000
Profit on ordinary activities after taxation		9,156
Dividends paid		(3,500)
Amount set aside to reserves		5,656
Other recognised gains and losses relating to the year (net)		190
Share capital issued		2,000
Net addition to shareholders' funds		7,846
Opening shareholders' funds	8,562	
Less Prior year adjustments	(347)	
		8,215
Closing shareholders' funds		16,061

Torrance plc
Note of Historical Cost Profits and Losses
for the year ended 31 May 2006

	£000
Reported profit on ordinary activities before taxation	11,540
Realisation of property gain of previous years	100
Difference between historical cost depreciation and the actual depreciation charge for the year calculated on revalued amounts	40
Historical cost profit on ordinary activities before taxation	11,680

- **Requirement for question 4**

For **each** statement:

- Explain the purpose of each of the three statements. *8*
- Evaluate the usefulness of each statement in assessing financial performance. *6*
- Interpret the information given in each statement. *6*

(20)

5

You are reviewing the draft financial statements of Omeka plc for the financial year ended 31 May 2006 with the managing director. The following issues have arisen.

(a) The gross profit to sales percentage of Omeka plc has risen over the past two years from 29% to 35% and the managing director would like to know what could have caused this.

- **Requirement for question 5 (a)**

  Identify five possible reasons for the gross profit percentage increasing. *5*

(b) On 1 June 2005 Omeka plc acquired a fixed asset with a fair value of £68,000 under a finance lease. The annual rental is £15,000 payable in advance each year. The financial statements show that the finance charge for the year ended 31 May 2006 was £2,731. Omeka plc is allocating the total finance charge on the lease using the actuarial method. The managing director would like to know what the finance charge will be for the following year and whether or not there are other ways of accounting for it.

- **Requirement for question 5 (b)**

  (i) Calculate the finance charge on the lease for the year ended 31 May 2007 ie the second year of the lease. *6*

  (ii) Identify one other method of allocating the finance charge that Omeka plc could have used and discuss whether or not the method would be acceptable under SSAP 21 Accounting for leases and hire purchase transactions. *2*

(c) Omeka plc's draft profit and loss account shows basic earnings per share of 30.0 pence. Omeka plc has 7,000,000 ordinary shares of 50 pence each in issue. There is also a 12% convertible loan of £1,000,000 which is convertible into 1,600,000 ordinary shares of 50 pence each. Omeka plc's marginal rate of corporation tax is 30%. The managing director knows that some companies disclose a diluted earnings per share figure while others do not.

- **Requirement for question 5 (c)**

  (i) Calculate Omeka plc's diluted earnings per share figure for the year ended 31 May 2006. *5*

  (ii) Identify **two** of the disclosure requirements of FRS 22 Earnings per share for the presentation of diluted earnings per share in the financial statements. *2*

(20)
