FINANCIAL AND PERFORMANCE REPORTING

Diploma stage examination

5 June 2007

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

Question 1

(a) The Energy Research Agency Income and Expenditure Account for year ended 31 March 2007

	£'000	
Income (w4)	10,944	
Staff costs	(4,920)	
Other operating costs (w3)	(2,975)	
Depreciation	(559)	
Operating surplus/(deficit)	2,490	
Interest receivable	0	
Interest payable	(34)	½
Public dividend capital dividends	(93)	½
Retained surplus/deficit for the year	2,363	

The Energy Research Agency Balance Sheet as at 31 March 2007

Fixed assets:		
- Land and buildings (5,092 + 2,885 + 490)	8,467	
- Plant and machinery	348	
- Information technology	90	
	8,905	
Current assets:		
Stock	198	
Debtors	1,616	
Cash	204	
	2,018	
Creditors: amounts falling due within one year (550+93)	(643)	½
Net current assets	1,375	
Total assets less current liabilities	10,280	

Financed by:

Deferred revenue (2,521 - 1,300)	1,221	½
Capital and reserves:		
Public dividend capital	1,764	
Long term loans	500	
Revaluation reserve (w5)	2,934	
Retained surplus (w5)	3,371	
Donated Asset Reserve (w5)	490	
	10,280	

Presentation of both statements ½

Working 1 - Fixed Assets

	Land	Buildings Bought	Buildings Donated	Computer	Equip.	
Cost						
Opening balance	4,792	3,460	-	764	1,658	
Revaluation	300	-	-	-	-	½
	5,092	3,460	-	764	1,658	
Indexation	-	415	-	-56	-	1
	5,092	3,875	-	708	1,658	
Additions	-	356	500	-	-	1
Disposals (w2)	-	(504)	-	-	-	½
Closing balance	5,092	3,727	500	708	1,658	
Depreciation						
Opening balance	-	712	-	514	978	
Backlog	-	85	-	-38	-	1
Disposals (w2)	-	(30)	-	-	-	½
Charge for year	-	75	10	142	332	2
Closing balance	-	842	10	618	1,310	
Closing Net Book Value	**5,092**	**2,885**	**490**	**90**	**348**	

Working 2 - Buildings Disposal

Gross cost at 1 April 2006	450	
Plus 06/07 indexation	54	
Cost at date of disposal	504	*1*
Depreciation: 3 years x (504 / 50 years)	30	*1*
NBV of building sold	474	
Disposal proceeds	505	
Profit on disposal	31	½

Revaluation reserve balance to be transferred to I&E reserve:

Balance relating to building at 31 March 2006	104	
Plus 06/07 indexation	54	
Less 06/07 backlog:		
Opening depreciation on asset: 3 years x (450 / 50 years) = 27		
Therefore backlog for 06/07	(3)	
Amount transferred from revaluation reserve to I&E reserve	155	*1*

Working 3 - Expenses

Depreciation:		
- Purchased buildings	75	
- Donated buildings	10	
- Computers	142	
- Scientific equipment	332	
	559	½
Other operating expenses:		
Per trial balance	2,460	
Impairment of computers (56-38 (w1))	18	*1*
Interest paid	(34)	½
Opening stock	729	½
Closing stock	(198)	½
	2,975	

Working 4 - Income

Sale of solar energy technology (TB)	4,360	
Secondment income (TB)	5,243	
Profit on disposal (w2)	31	½
Donated asset depreciation transfer (w1)	10	½
EU Grant (06/07 element)	1,300	½
	10,944	

Working 5 - Reserves

	I&E	Reval'n	Don. Asset	
TB	853	2,459	-	
Asset donation	-	-	500	½
Depreciation on donated asset transferred to income	-	-	(10)	½
Transfer of balance on disposed asset (w2)	155	(155)	-	½
Revaluation - land	-	300	-	½
Indexation - buildings	-	415	-	½
Backlog - buildings	-	(85)	-	
Retained surplus for year (I&E)	2,363	-	-	½
	3,371	2,934	490	

(20)

Question 2

(a) Reconciliation from net deficit to cash inflow

	£000	
General fund deficit for the year	3,108	*1*
Depreciation charged in year	(6,383)	½
MRP Adjustment *((6,004-17)-6,383))*	396	*1*
Direct revenue financing	(3,800)	½
Stock movement	(758)	½
Debtors movement	178	½
Creditors movement *((1,908-345)-1,772)*	209	*1*
External interest paid	(517)	*1*
Net cash (inflow)/outflow from revenue activities	(7,567)	

(6)

(b) Gannymeade City Council Cash flow statement for the year ended 31 March 2004

	£000	£000	
Cash outflows			
Cash paid to and on behalf of employees	361,752		
Other operating cash payments	78,581		
Payments to NNDR Pool	74,123		
Cash inflows			
Fees and charges	(51,508)		
Council tax receipts	(159,314)		
NNDR receipts from pool	(138,507)		
Revenue support grant	(172,694)		
Net cash (inflow) / outflow from revenue activities		(7,567)	½
Returns on investments and servicing of finance			
Interest paid	500		
Interest element of finance lease rentals	17		
		517	½
Capital activities			
Purchase of fixed assets *(w2)*	6,325		*(w2)*
Sale of fixed assets *(w3)*	(120)		*(w3)*
		6,205	
Net cash (inflow)/outflow before financing		**(845)**	
Financing			
Capital element of finance lease payments	33		½
New loans raised *(95,965 - 90,465)*	(5,500)		½
		(5,467)	
Net (increase) / decrease in cash		**(6,312)**	

Presentation 1

Workings **£'000**

Working 1 – Finance Lease

Fair value of vehicles	200	
Total lease payments (5 years x 50,000)	250	
Total finance charge	50	½
Using sum of digits method, year 1 finance cost = 5/15 * £50,000	17	1
Year one principal repayment is therefore £50,000 - £17,000 =	33	1

Working 2 - Fixed asset purchases

Fixed assets

b/f	130,002			
		Depreciation	6,383	½
Revaluation / disposal (FARA)	411			½
Purchases	$\boxed{6,870}$			½
		c/f	130,900	
	137,283		137,283	

Total purchases	6,870	
Less finance leases (non-cash)	(200)	½
Less capital creditor	(345)	½
Total fixed asset purchases	**6,325**	

Fixed asset restatement account

		b/f	19,660	
c/f	20,071	**Revaluation / disposal**	$\boxed{\mathbf{411}}$	1
	20,071		20,071	

Working 3 – Disposal proceeds

Useable Capital Receipts

From CFA - purchase	2,870	b/f	3,861	½
		Bank	$\boxed{\textbf{120}}$	½
c/f	1,111			
	3,981		3,981	

Capital Financing Account

		b/f	5,241	
		DRF	3,800	½
Lease interest (w1)	17			½
MRP adjustment *(6,383 – 6,004)*	379	**To UCR –** *reserved capital receipts and acquisitions funded through capital receipts*	$\boxed{\textbf{2,870}}$	½ ½
c/f	11,515			
	11,911		11,911	

(12)

(c) Analysis of net debt

	Opening £000	Cash flow £000	Non-cash flow £000	Closing £000	
Bank overdraft	(11,548)	6,312	0	(5,236)	
Borrowings	(90,465)	(5,500)	0	(95,965)	
Deferred liabilities - lease	0	33	(200)	(167)	*1*
Current asset investments	1,038	0	0	1,038	
	(100,975)	845	(200)	(100,330)	

(2)

If bank overdraft, borrowings and investments correct then 1 mark, if two out of three correct then ½ mark, if one out of three correct then no marks

(20)

Question 3

(a) 1 Performance against the Capital resource Limit

Capital Resource Limit set by DoH		850	
Capital Resource Requirement:			
Gross Capital Expenditure		1,382	½
Less net book value of disposals:			
Disposal proceeds per cash flow statement	811		½
Less profit on disposal	-103		½
		-708	½
Less capital grants		-367	½
Capital Resource Requirement		307	½
Under spend against CRL		543	½

The PCT has under spent against its capital resource limit by £543,000. This means that it has spend less on fixed asset purchases in the year than it originally budgeted for and agreed with the Department of Health (DoH). Under spending is permitted by the DoH, but the PCT needs to assess why it has under spent (e.g. delays to capital projects) and apply to the DoH to carry forward this under spend to next year.

Max 1 ½ marks for interpretation

2 Performance against the resource limit

Unadjusted resource limit set by DoH	133,133	
Impairments charge to OCS	79	½
Provisions charged to OCS	365	½
Non-cash limited GMS payments	3,200	½
Adjusted resource limit	136,777	½
Net operating cost	138,078	½
Overspend against resource limit	1,301	½

The PCT has spent £1.3m more during the year than it was allocated by the DoH. PCTs are not allowed to have a net operating cost that exceeds their resource limit. The DoH will require the PCT to examine the reason for overshooting the target (e.g. poor cost control) and may reduce its resource limit for the following year in order to claw back the overspend.

Max 1 ½ marks for interpretation

3 Performance against the cash limit

Cash limit set by DoH	136,995	
Parliamentary funding drawn down	138,205	½
Overshoot	1,210	½

The cash limit exists to control the amount of cash that a PCT can draw down from the DoH. Linhey PCT has spent £1.2m more than its limit and hence has overshot the limit, which is not permitted. As with the accruals based resource limit, the DoH would require the PCT to report on the reasons for overshooting the limit and might reduce next year's cash limit.

Max 1 ½ marks for interpretation

4 Provider Arm Break Even

Provider arm net operating cost	7,353	½
Income received from commissioning arm	7,650	½
Surplus on provider arm	297	½

The provider arm has generated a surplus of £297,000. The PCT should break even on its provider arm and this surplus represents resources that could have been used commissioning healthcare services externally (e.g. from NHS Trusts or private providers).

Max 1 ½ marks for interpretation

(15)

(b) PCTs have to report performance against the public sector payment policy. They must report the percentage of invoices by volume and value that are paid within 30 days. Although there is no statutory target, PCTs are supposed to pay 95% within 30 days and so this target can be used by users of the accounts to assess how well the PCT manages its working capital and how solvent it is. *1*

PCTs also have to report the amount spend on managing services. This is reported as the cost per head of the population in the PCT's local area. Each PCT has a target set for the year and a national definition of what should be classed as management costs is published to ensure consistency. This target indicates to users of the accounts how much the PCT invests directly in service delivery. *1*

(2)

(c) NHS organisations such as PCTs have strict statutory financial targets because they are subject to central control (by the DoH). The DoH needs to be able to assess all trusts using the same rules and to compare performance across the NHS. *1*

Local government organisations have more flexibility as there is less centralised control with each authority being accountable to its local electorate rather than a government department. *1*

Local authorities are required to set a balanced budget, i.e. to ensure that each year council tax and grants received equals total budgeted expenditure. This helps to ensure accountability for the services delivered in the year to the local taxpayers. *1*

As part of its best value plan, a local authority will also need to disclose the percentage of invoices paid within 30 days. This target has been established from the Late Payment of Commercial Debt Act 1998 and is similar to a PCT's reporting of its payment policy. The target not only tells users of the accounts if the local authority has acted as a responsible corporate debtor but can also indicate how well the authority manages its working capital and the extent to which it is solvent. *1*

Unlike PCTs, there are no other statutory targets to report. However, specific grants received may require separate reporting of both financial and non-financial performance but this would not be included within the published financial statements of the authority. *1*

1 mark per comment up to a maximum of (3)

(20)

Question 4

MEMORANDUM

To: Adam Okaro, Finance Director
From: Gina Gold, Finance Assistant
Subject: Analysis of 2006/07 Financial Statements

1 Introduction

The purpose of this memo is to analyse the financial performance and position of Sunhill Housing Association (SHA) for the year-ended 31 March 2007.

Please refer to Appendix I for all ratio calculations referred to in this memo.

2 Analysis of financial performance and position

SHA' s performance and position has deteriorated significantly during the 2006/07 financial year. It has failed to meet all 4 of its key financial targets.

a) *Earn a return on capital employed of at least 5%*

SHA has made an operating deficit this year due largely to increases in debt write-offs and other expenses, which means that it has failed to meet is ROCE target of 5%, as its ROCE is –16%.

b) *Maintain revenue reserves at a minimum level of 50% of the year's cash operating expenditure*

The increases in operating expenses also mean that it has failed to meet the target of maintaining revenue reserves of at least 50% of cash operating expenditure, as its reserves as at 31 March 2007 only cover 38.5% of cash operating expenditure, a significant decrease from 115.2% last year. Failing to meet this target indicates that the level of expenditure this year is not sustainable in the long term.

c) *Minimise bad debt write-offs by collecting 95% of rental income invoiced to tenants.*

SHA aims to minimise bad debt write-offs by collecting 95% of rental income invoiced. The calculation in Appendix I show that only 73.5% has been collected this year, a significant decline since last year. Since debtor days have risen from 59 last year to 122 this year, it is possible that there will be further amounts of uncollectible debt that will need to be written off, decreasing the percentage collected even further.

The large bad debt expense in 2006/7 is one of the main contributors to the deficit for the year, and the lack of cash flows from debtors is putting pressure on our working capital.

d) *Pay trade suppliers within 30 days of invoice*

SHA aims to pay its trade suppliers within 30 days of invoice, and the calculation of creditor days of 144 indicates that SHA is far from meeting this target. This is probably because the debt collection problems mean that SHA has no cash to pay its suppliers. SHA risks the good relationships that it has built up with its suppliers of maintenance and other services, and these suppliers could claim interest for late paid invoices from us or even stop doing work for us in the future.

Up to 1½ marks per target explained up to a maximum of 6

3 Application for bank loan

SHA currently has significant financial problems. The failure to control operating expenses means that it has no surplus to be able to afford the additional expense of interest payments, and the working capital pressures caused by debt collection problems means that it has no cash available to make interest and principal repayments on the loan.

I recommend that SHA defer applying for the loan until the financial position has been brought under control and we have prepared adequate long-term forecasts to assess the affordability of the loan. I also recommend that SHA investigate grants available from the Housing Corporation and other bodies to assist with building the key worker homes, as this would reduce the amount of money that SHA need to borrow, as £3.2m is probably too much for us when our total capital employed is only £5.4m at the moment.

Up to a maximum of 2

4 Recommendations

The following steps must be taken as soon as possible:

- Proper budgeting procedures must be put in place to control operating expenditure, and expenditure must be analysed and questioned each month to ensure that it is kept under control.

- Strong credit control procedures need to be put in place by the new credit control staff in order to collect as much of the outstanding rent as possible and to minimise future problems. Looking at best practice among other London Housing Associations will help us to develop good procedures for collecting rent on a timely basis.

- The overdraft of £355,000 as at 31 March 2007 needs to be investigated to ensure that this is at a competitive rate of interest and that we have not exceeded our limit.

- We need to perform a review of all outstanding trade creditors and ensure that we communicate to all our suppliers when we will pay them in order to ensure continuity of service from them.

- Income from donations has fallen from £354,000 last year to £301,000 this year. We should ensure that we are maximising donations income and may need to consider appointing a dedicated fundraising team.

Up to 1 mark per point explained up to a maximum of 3

5 Further information required

This memo has been prepared using only the 2006/07 published financial statements as its basis, and the following further information is required in order to draw conclusions:

- Financial statements and key ratios for comparable housing associations. For example, we could determine what are normal bad debt write-off levels for other housing associations operating in similarly deprived areas.

- Analysis of the other operating expenses balance to determine if this includes any one-off items (such as legal costs relating to the staff problems in the year).

- Non-financial information such as tenant satisfaction levels and the percentage of properties meeting the government's Decent Homes Standard to determine whether the financial problems have also led to failures in service provision.

- The reason for the resignation of key financial and credit control staff during the year. Proper financial control cannot be maintained if staff are constantly being replaced, and we should ask the Human Resources department to investigate the reasons for the problems.

Up to 1 mark per point explained up to a maximum of 3

6 Conclusion

SHA has failed to meet all of its key financial targets this year, probably due to a breakdown in control as a result of staffing problems. SHA needs to put effective credit control procedures in place in order to collect outstanding rent quicker and minimise bad debt write-offs, and bring operating expenditure under control.

½ mark for conclusion and ½ mark for Presentation / Memo format

Appendix 1 – Ratio Calculations

	31 March 2007 £'000	31 March 2006 £'000
1 Return on Capital Employed		
Surplus before interest payable:		
Retained surplus / (deficit)	(901)	402
Plus interest payable	58	-
	(843)	402
Capital employed	5,436	5,729
	-16%	**7%**

2 Revenue reserve as a percentage of cash operating expenses

Closing revenue reserve	1,082	1,983
Total operating expenses for year	3,791	2,622
Less depreciation	(980)	(901)
Cash operating expenses	2,811	1,721
	38.5%	**115.2%**

3 Creditor days

Trade creditors	397	57
As a proxy for purchases:		
Maintenance expenses	273	234
Other operating expenses	735	351
	1,008	585
x 365 =	**144 days**	**36 days**

4 Percentage of rental income collected

Gross social housing lettings income	2,647	2,667
Bad debt expense	(701)	(152)
Net income after write-offs	1,946	2,515
	73.5%	**94.3%**

5 Debtor days

Debtors	883	431
Social housing income	2,647	2,667
x 365 =	**122 days**	**59 days**

1 mark per correct pair of ratios up to a maximum of 5

(20)

Question 5

Finance Department
Hockley Dogs Home
London SE1 0SX

Dear Mrs Cray

Thank you for your telephone message that you left for me this morning. Please find below my responses to your questions.

a) Cash and accruals accounting

Cash accounting systems are used by many of the world's central governments, including the UK until recently. Cash based financial statements are easy to prepare and simple to understand because they are simply a list of all payments and receipts – in effect, a summarised cashbook. *1*

However, there are several disadvantages of cash accounting. Cash accounting does not distinguish between payments of day-to-day expenses, such as salaries, and payments to acquire long lasting fixed asses. As a result, cash accounting systems take no account of outstanding items at year-end and so users of the accounts cannot determine what assets and liabilities the organisation has. It also means that an organisation could manipulate its accounts by holding off payments until after the year-end so that they aren't recognised in the accounts. *1*

Because of the disadvantages of cash-based accounting, all UK public and private sector organisations used accruals based accounting. Under accruals accounting, income is recognised when it is earned and expenditure when resources are used. So for example, we recognise an annual depreciation charge on our dogs home building rather than recognising the entire cost of building it the first year of its life. This gives a much fairer presentation and means that the cost of buying a fixed asset is matched to the benefit received from using it. *1*

The other advantage of accruals accounting is that a year-end balance sheet is prepared, showing users of the accounts the assets and liabilities the organisation has, and a surplus or deficit can be calculated, meaning that performance can be evaluated and compared to earlier years and to other organisations. *1*

b) Consolidation of Hockley Canine Trading Limited

Hockley Canine Trading Limited (HCT) has to be consolidated under the rules prescribed by the Accounting Standards Board's *Financial Reporting Standard* (*FRS) 2 Accounting for Subsidiary Undertakings* and the *Statement of Recommended Practice (SORP) for Charities*, published by the Charities Commission. *1*

FRS 2 requires that consolidation occurs whenever an organisation controls another organisation. *1*

As the charity owns 100% of HCT, it clearly controls the company, regardless of whether it is supposed to operate at arms length. *1*

The reason for preparing consolidated accounts for the charity and HCT is in order to show a true and fair view of the whole group, i.e. to reflect the performance of the group as a whole and not just one part of it. *1*

c) Fund accounting

Fund accounting underpins accounting in many public sector organisations. Public sector organisations such as charities use fund accounting to maintain accountability for identified resources. For example, Hockley Dogs Home may have a fundraising campaign to raise funds to build a new vetinary surgery for sick dogs and would be required to keep a separate fund for these funds to show users of the accounts that it has used the funds raised only for this project. *1*

This is in contrast to private sector companies, where there is less need to focus on individual funds because their accounts are not primarily focused on showing the stewardship of funds. *1*

d) Legacies received after the year-end

The rules relating to recognising legacies come from the Statement of Recommended Practice (SORP) for charities, published by the Charities Commission. The SORP interprets the rules provided by *FRS 21 Events after the Balance Sheet Date.* *1*

The SORP requires that charities recognise legacies income received after the year-end but before adoption of the accounts even if they were not aware that it would receive the legacy until after the balance sheet date. *1*

e) International Accounting Standards

From 2005 onwards, all large EU companies have to prepare accounts following International Accounting Standards (IAS) instead of their country's own standards. *1*

International Public Sector Accounting Standards (IPSAS) have been developed which take the principals of IAS and apply them to the situation of public sector. *1*

The UK public sector has not yet agreed to adopt these, and the SOPRS and accounting manuals for all public sector organisations including charities are still based on UK accounting standards. *1*

However, the UK Accounting Standards Board is currently implementing a convergence project, which means that UK accounting standards are gradually being brought into line with IAS. Hence eventually all the UK standards which the Charities SORP is based on will be the same as IAS anyway. *1*

f) Corporate Governance

The public sector has responded to developments in corporate governance in the private sector by adapting the private sector principles to the public sector. *½*

For example, when the Cadbury Committee focused its report on the issue of corporate governance in listed private sector companies, CIPFA published a discussion paper "Corporate Governance in the Public Services" which concluded that the recommendations of the Cadbury Report were equally relevant to the public services but identified a number of distinctive characteristics which have to be taken into account when considering corporate governance issues, such as the many objectives of public sector organisations and the wider remit of auditors in the public sector. *1*

Each sector within the public sector has adopted its own corporate governance rules and best practice. The level of mandatory reporting for charities is less than that for other public sector organisations but in recent years the Charity Commission in its role as regulator has produced several reports as part of its annual review process covering governance issues. These reports have included trustee recruitment and selection, and charities and commercial partners. *1*

The Charity Commission has also undertaken reviews of the effectiveness of boards and the remuneration of trustees. Discussion is ongoing as to the best way in which large charities can be regulated to ensure that the public trusts them. *1*

Letter format ½

(20)

Question 6

(a) Endowments are accounted for following the principles of *SSAP 4 Acccounting for Government Grants*, as interpreted in the *Further and Higher Education SORP*. *1*

The university's endowments are restricted endowments, meaning that the income received of £380,000 can only be used for expenditure stipulated in the terms of the endowment.

As only £235,000 of it has been used for eligible expenditure, the remaining £145,000 has the be removed from the income and expenditure account and reserved in the balance sheet until it is used for eligible expenditure in subsequent years.

Up to 2 marks for explanation

In order to reverse out the remaining income, the following additional accounting entry is required:

Dr I&E – Appropriations £145,000
Cr Balance Sheet – Specific Endowments Reserve £145,000 *1*

(4)

(b) The obsolete equipment should be dealt with in accordance with *FRS 11 impairment of Fixed Assets and Goodwill.* *1*

The obsolete equipment must be subject to an impairment review. As the realisable value of the equipment is nil, it should be written down to nil in the accounts. As it is unlikely that the equipment was previously revalued, all the impairment loss should be charged to expenses.

Up to 2 marks for explanation

Dr I+E Operating expenditure - £106,000
Cr Fixed assets - £106,000 *1*

(4)

(c) The development costs should be accounted for in accordance with *SSAP 13 Research and Development.* *1*

SSAP 13 permits the capitalisation of development costs providing that they relate to a product that will generate profits in the future. As the university expects to sell the product next year at a substantial profit, it is permitted to capitalise its costs. *1*

As management wish to capitalise the costs, the following journal entry is required:

Dr Balance Sheet – intangible fixed assets – deferred development expenditure £98,000
Cr I&E – Operating Expenditure £98,000 *1*

(3)

(d) The treatment of the transaction in the consolidated accounts should follow the rules from *FRS 2 Accounting for Subsidiary Undertakings.* *1*

The purpose of the consolidated accounts is to show the performance and position of the University as a whole. If these accounts include transactions which are within the university group, then turnover, expenses, debtors and creditors will all be overstated.

Up to 2 marks for explanation

In order to eliminate these intra-group transactions, the following journals are required:

Dr I&E – Income £120,000
Cr I&E – Expenditure £120,000

Dr Balance Sheet – Creditors £65,000
Cr Balance Sheet – Debtors £65,000 *2*

(5)

(e) The Russian language programme should be accounted for in accordance with *FRS 9 Associates and Joint Ventures.* *1*

The Russian language programme should be accounted for as a joint arrangement that is not an entity (JANE). It is a JANE because no separate organisation has been set up and the programme is merely an extension of the university's existing activities, i.e. teaching. Therefore, consolidation of the programme is not required. FRS 9 requires that the income, expenditure, assets and liabilities that the organisation has put into the JANE are simply included as part of the organisations own transactions.

Up to 2 marks for explanation

Therefore, no further adjustments are required to the accounts as the cost of providing the staff is already included within the total staff costs for the university.

1 mark for accounting treatment

(4)

(20)