FINANCIAL REPORTING AND ACCOUNTABILITY

Professional 2
June 2004

MARKING SCHEME

Question 1

(a) Consolidated balance sheet as at 31 December 2003:

	£000	
Goodwill	640	*3*
Fixed assets	9,190	*2*
Investment in A Ltd	1,820	*1*
Net current assets	1,640	*1*
Less: Proposed dividends	(140)	*½*
	13,150	
Creditors due in > 1 year	(2,080)	
Debentures	(1,400)	*½*
	9,670	
Ordinary share capital	8,000	*½*
General reserve	500	
Profit and loss account	818	*5*
	9,318	
Minority interest	352	*1½*
	9,670	

1 mark for aggregation and cancellation

(16)

Working 1: Goodwill (Cost of Control)

A	Proportion of equity owned by H Ltd	80%
	Proportion of equity owned by minority interest	20%
B	Years as subsidiary	4
		£000
C	Investment at cost	2,960
D	Nominal value of share capital	(800)
E	Pre-acquisition profits (1,500 x 80%)	(1,200)
F	Fair value of assets	(160)
G	Goodwill [C - (D+E+F)]	800
H	Annual amortisation (over 20 years)	40
I	Amortisation charges against group profits [B x H]	160
J	Total [G - I]	640

Working 2: Tangible fixed assets

		H Ltd £000	B Ltd £000	Total £000
Balances		7,270	1,800	9,070
Revaluation to fair value	Group		160	160
	Minority Interest		40	40
Increase in depreciation	Group		(64)	(64)
	Minority Interest		(16)	(16)
Total		7,270	1,920	9,190

Working 3: Net current assets

	H Ltd £000	B Ltd £000	Total £000
Balances	355	1,355	1,710
Unrealised profit on goods in stock		(10)	(10)
Cancellation of intra-group dividend	(60)		(60)
Total	295	1,345	1,640

Working 4:

	H Ltd £000	B Ltd £000	Total £000
Creditors due in > 1 year	(1,250)	(830)	(2,080)

Working 5: Proposed Dividend

	H Ltd £000	B Ltd £000	Total £000
Balances	125	75	200
Cancellation of intra-group dividend		(60)	(60)
Total	125	15	140

Working 6: Profit and loss a/c

	H Ltd £000	B Ltd £000	Total £000
Balances	1,710	650	2,360
Pre-acquisition profits		(1,200)	(1,200)
Unrealised profit on goods in stock		(8)	(8)
Amortisation of goodwill		(160)	(160)
Increased depreciation on fair value of assets		(64)	(64)
Share of A Ltd's post acqn. profit (40% x 100)	40		40
Amortisation of goodwill in A Ltd	(20)		(20)
Attributable to minority interest		(130)	(130)
Total	1,730	(912)	818

Working 7: Minority interest

	B Ltd £000	Total £000
Nominal value of ordinary share capital	200	200
Share of profit and loss a/c	130	130
Increase in fair value of fixed assets	40	40
Increased depreciation on fair value of assets	(16)	(16)
Unrealised profit on goods in stock	(2)	(2)
Total	352	352

Treatment of A Ltd:

Shareholding of 40% (2,000 of the 5,000 50 pence shares), hence use equity method to incorporate into group balance sheet:

Working 1: Calculation of implicit goodwill

A	Proportion of equity owned by H Ltd	40%
B	Years as subsidiary	1
		£000
C	Investment at cost	1,800
D	Nominal value of share capital	(1,000)
E	Pre-acquisition profits [40% x (1,100 – 100)]	(400)
F	Implicit goodwill [C - (D+E)]	400
H	Annual amortisation (over 20 years)	20
I	Amortisation charges against group profits [B x H]	20

Working 2: Value of investment in A Ltd on group balance sheet

	Total £000
Investment at cost	1,800
Share of post-acquisition profit (40% x 100)	40
Amortisation of implicit goodwill	(20)
Total	1,820

(b) Included in the consolidated profit and loss account:

(A Ltd's post acquisition profit x 40%) – (goodwill amortised)

= 40 – 20 = 20.

Shown as net of two entries on the consolidated P&L A/c after operating profit:

Share of A Ltd's operating profit: (240 x 40%) – 20 = 76

Taxation to include: (A Ltd's taxation x 40%) = (65 x 40%) = 26

Plus:

Elimination of dividend receivable by H Ltd from A Ltd:
(75 x 40%) = 30 *(4)*

(20)

Question 2

(a) Somewhere County Council

Note 1: Reconciliation of revenue surplus to net cash inflow from operating activities.

	£000	£000	
General fund surplus (25,250 - 14,700)		10,550	*1*
Add: Depreciation	17,500		*½*
MRP adjustment (17,500 - 9,000)	(8,500)		*1*
DRF	1,350	10,350	*½*
		20,900	
Add/less: Movements in working capital			
Less: Increase in stock	(400)		*½*
Less: Increase in debtors	(5,250)		*½*
Add: Increase in creditors	3,750	(1,900)	*½*
		19,000	
Add: Revenue costs of financing			
Add: External interest paid	16,650		*1*
Less: Investment income	(1,405)	15,245	*½*
		34,245	

(6)

(b)

Somewhere County Council
Cash flow statement for the year ended 31 March 2003.

	£000	£000	
Revenue activities:			
Cash outflows:			
Cash paid on behalf of employees		(393,115)	
Other operating costs		(73,125)	
		(466,240)	
Cash inflows:			
Precept	203,985		
RSG	175,000		
NNDR	83,500		
Specific grants	29,250		
Fees and charges	8,750	500,485	
Revenue Activities: Net cash flow		34,245	*4*
Returns on investments and servicing of finance			
Interest paid	(16,650)		*2*
Interest received	1,405	(15,245)	*½*
		19,000	
Capital activities:			
Purchase of fixed assets	(62,150)		*2*
Purchase of investments	(2,350)		*1*
Sale of fixed assets	24,000	(40,500)	*2½*
Net cash flow before financing		(21,500)	
Financing:			
Repayments of borrowing	(32,550)		*1½*
New loans raised	58,050	25,500	*1½*
Increase in cash		4,000	

1 mark for presentation

(16)

Workings:

Asset management revenue account

Depreciation	17,500	Asset rentals	83,500
Transfer CRA	49,350		
External interest	*16,650*		
	83,500		83,500

Fixed assets

Balance b/f	635,000	Depreciation	17,500
FARR (B/S mvt)	47,850		
Acquisitions	*62,150*	Balance c/f	727,500
	745,000		745,000

New loans raised:

	£000
Capital expenditure (FA A/c)	62,150
Less: UCR	(2,750)
Less: DRF	(1,350)
New loans raised	58,050

Long term borrowing

Loans repaid	*32,550*	Balance b/f	223,000
Balance c/f	248,500	New loans raised	58,050
	281,050		281,050

Usable capital receipts

Capital expenditure	2,750	Balance b/f	12,100
Balance c/f	21,350	*Sales (usable 50%)*	*12,000*
	24,100		24,100

Hence cash inflow from sales = £24,000,000

(c) Capital financing reserve:

Capital financing reserve

MRP adjustment	8,500	Balance b/f	16,750
(Depn-MRP= 17.5-9)		RCR	12,000
		DRF FA acquisition	1,350
		UCR FA acquisition	2,750
Bal c/f	24,350		
	32,850		32,850

(3)

(25)

Question 3

(a) Calculation of notional charges:

ROCE: = 6% x average capital employed

= 6% x ((2,750 + 575) + (2,925 + 580))/2

= 6% x (3,325 + 3,305)/2

= 6% x 3,415K = 205,000 *3*

Insurance: 1% x FA excl. land @ 31/03/03 = 1% x 1,500K	=	15,000	
0.1% x Staff costs = 0.1% x 8,950K	=	9,000	
0.5% x Average stock (810 + 750)/2 = 0.5% x 780K	=	4,000	
Total insurance	=	28,000	*3*
Audit fee:	=	45,000	*1*
Total notional charges:	=	278,000	

(7)

(b) Note 1: Reconciliation of operating deficit to net cash outflow from operating activities

	£000	£000	
Operating deficit		(8,550)	*½*
Add: Charges not involving cash movements:			
Notional items	278		*1*
Depreciation	65		*5*
Less: Profit on disposal FA (225-200)	(25)		*1*
		318	
Add/less: Movements in working capital			
Add: Decrease in stock	60		*½*
Less: Increase in debtors	(5)		*½*
Less: Decrease in creditors	(60)	(5)	*½*
Net cash outflow from operating activities		(8,237)	

1 mark for presentation

(10)

Workings:

Derivation of depreciation charge for the year:

	Land £000	Other £000	Total £000
Bal b/f 1/4/02	1,250	1,500	2,750
Disposals	-	(200)	(200)
Indexation	175	170	345
Depreciation for year	-	*(65)*	*(65)*
Backlog depn	-	(10)	(10)
Acquisitions		105	105
	1,425	1,500	2,925

(c) Cash flow statement for the year ended 31 March 2003

	£000	
Net cash outflow from operating activities	(8,237)	*1*
Capital expenditure and financial investment	120	*2*
Financing	8,830	*4*
Increase in cash	713	

1 mark for presentation

(8)

Workings:

Capital expenditure and financial investment:

	£000
Purchase of fixed assets	105
Less: Receipt from sale of fixed assets	(225)
Net cash inflow from investing activities	**120**

Financing:

	£000
Net parliamentary grant voted	9,850
Less: Surplus of parliamentary grant over expend.	(1,270)
Add: Deficit on appropriations in aid	250
Financing	**8,830**

(25)

Question 4

(a) Gooding income and expenditure account for year ended 31 March 2003.

	£000	
Turnover (42,500 + 25)	42,525	½
Operating costs (31,450 + 75 + 3,074 – 50 – 25)	(34,524)	2
Operating surplus	8,001	
Profit on sale of fixed assets (490 + 2,378)	2,868	2
Interest receivable	420	
Interest payable (7,250 + 25)	(7,275)	1
Surplus for the year	4,014	
Transfers to the designated reserves (490 + 2,378)	(2,868)	2
Surplus for the year after transfers to reserves	1,146	
Surplus b/f	58,880	½
Revenue reserves C/F	60,026	

1 mark for presentation
(9)

Workings:

Depreciation calculation:

	Land £000	Housing Prop. £000	Offices £000	Furn./Equip. £000
Trial balance	100,000	228,400	4,800	1,750
Less: SHG		(106,400)		
Office disposal			(400)	
Leased asset				300
Additions		210		
	100,000	122,210	4,400	2,050
Depn years	-	50 yrs	20 yrs	5 yrs
Depreciation	0	2,444	220	410

Total depreciation = 2,444 + 220 + 410 = 3,074K

(b) Gooding balance sheet as at 31 March 2003.

	£000	
Fixed assets:		
Land and housing property (100,000 + 228,400 – 2,820 + 31,865 + 210 – 2,444 – 3,300 + 440 + 38)	352,389	*4*
Less: Social housing grant (106,400 + 16,000 – 1,100)	(121,300)	*1*
	231,089	
Non-housing fixed assets (4,800 – 1,200 + 1,750 – 700 – 220 – 410 – 400 + 160 + 300)	4,080	*3½*
	235,169	
Current assets / liabilities:		
Debtors (2,150 + 25)	2,175	*1*
Cash	870	
Less: Creditors due in < 1 year (3,650 + 1,100 + 55)	(4,805)	*1*
Total assets less current liabilities	233,409	
Creditors due in > 1 year:		
Loans	112,500	
Finance lease (300 – 50 – 55)	195	*2½*
Provisions	300	
Capital and reserves		
Designated reserves (14,920 + 490 + 2,378)	17,788	*1*
Restricted reserves	42,600	
Revenue reserves (58,880 + 1,146)	60,026	*1*
	233,409	

1 mark for presentation
(16)

Workings:

Finance Lease:

	£000
Fair value of asset	300,000
Total lease payments	375,000
	75,000

Sum of digits = 1 + 2 + 3 + 4 + 5 = 15

Interest for 2002/03 = 75,000 x 5/15 = 25,000
Hence: Principal repayment for 2002/03 = 75k – 25k = 50,000

Interest for 2003/04 = 75,000 x 4/15 = 20,000
Hence: Principal repayment for 2003/04 = 75k – 20k = 55,000

Double entries:

	£000	£000
Dr furniture and equipment	300,000	
Cr creditors > 1 year: finance lease		300,000
Dr interest payable	25,000	
Cr operating costs		25,000
Dr creditors > 1 year: finance lease	50,000	
Cr operating costs		50,000
Dr creditors > 1 year: finance lease	55,000	
Cr creditors < 1 year		55,000

Calculation of profit on sale of fixed assets

Office building:	NBV = 400 – 160	= 240K
	Proceeds	= 730K
	Profit on disposal	= 490K

Housing Property:

Depreciation for 02/03 $= \frac{(3{,}300 - 300 - 1{,}100)}{50\text{yrs}}$ = 38

NBV = 3,300 – 440 – 38	= 2,822K
Proceeds	= 5,200K
Profit on disposal	= 2,378K

(25)

Question 5

(a)

Saint Sebastian NHS Trust
Income and expenditure account for year ended 31 March 2003.

	£000	
Income from activities (68,300 + 4,200 + 350)	72,850	
Other operating income	343	*1*
Operating expenses (42,750+15,950+485+970+1,279+2,464+343)	(64,241)	*2*
Profit / loss on disposal of fixed assets (110 – (303-61))	(132)	*2*
Surplus / deficit before interest	8,820	
Interest receivable	245	
Other financing costs – unwinding the discount	(18)	*2*
Surplus / deficit for financial year	9,047	
PDC Dividends	(2,860)	
Retained surplus for the year	6,187	

1 mark for presentation
(8)

Workings:

Unwinding the discount:

Provision required = (300/0.84) x 0.89 = 318; adj. by 18

(b)

Saint Sebastian NHS Trust
Balance sheet as at 31 March 2003.

	£000	£000	
Fixed assets:			
Land		7,839	
Buildings		49,877	
NHS equipment		6,568	
Donated equipment		1,257	
		65,541	*7*
Current assets / liabilities:			
Stock	240		
Debtors	1,900		*½*
Cash	160		
Creditors due in < I year	(2,790)	(490)	
Creditors due > 1 year:			
Provisions for charges and liabilities		(318)	*1*
Total assets employed		64,733	
Taxpayers' Equity:			
Public dividend capital		49,080	
Rev. Res. (5,740-125+1,450+39+756-463+122-33)		7,486	*3½*
Donations reserve (1,500-343+17+85-2)		1,257	*2½*
Income and expenditure a/c (260+463+6,187)		6,910	*1½*
		64,733	

1 mark for presentation

(17)

Workings:

Calculation of depreciation and FA balance sheet entries:

Land and buildings:

	Land £000	Buildings £000
Opening balance	7,925	48,950
Revaluation	(125)	1,450
Indexation	39	756
Depreciation	-	(1,279)
	7,839	49,877

	NHS £000	Donated £000
Opening balance	12,200	1,700
Revaluation	-	-
Indexation	122	17
Addition	285	85
Disposal	(303)	
	12,304	1,802

	NHS £000	Donated £000
Opening balance	3,300	200
Indexation	33	2
Depreciation for year	2,464	343
Disposal	(61)	-
	5,736	545

Historic cost depreciation adjustments:

NHS: (1,279-1,160) + (2,464 – 2,120) = 119k + 344k = 463,000

(25)

Question 6

(a) Specific sources needed, examples of which might be as follows:

Central Government: Public sector borrowing, taxation, parliamentary vote on account, appropriations in aid.

Local Government: Revenue support grant, council tax, NNDR, housing rents.

NHS Trust: PCT funding for procedures, private patient income, endowment fund investment income.

Housing Associations/Registered Social Landlords: Housing rents, social housing grant, property sale surpluses.

Further and Higher Education: FEFC grants, tuition fees, corporate sponsorship, research grants/contracts, other services eg: accommodation/catering/conference fees.

(½ mark per example, up to 1 mark per sector; maximum of 5 marks)

(b) Governed by SSAP 4 Accounting Treatment for Government Grant. *1*

Private Sector: Revenue grants to P&L a/c when conditions of grant have been maintained – if over more than one year, the grant should be split and included as other Income in proportion to the element of qualifying expenditure that has been incurred in each year.

Capital grants are released to the P&L a/c over the useful life of the asset purchased / funded. Balance of grant is held on the balance sheet as Deferred Income. Effectively offsets depreciation within the P&L a/c.

Local Government: Revenue grants to I&E A/c when conditions of grant have been met.

Capital grants use the deferred credit method – grants credited to a government grants deferred account on the consolidated balance sheet.

Released over the useful life of the asset to offset depreciation, hence through the asset management revenue account. Amounts released to AMRA reversed via appropriations section of I&E a/c to the capital financing reserve.

Further and Higher Education: Very similar to private sector. Revenue grants to I&E A/c when conditions of grant have been met.

Capital grants credited to deferred capital grants on the balance sheet. Released to Other Income in the I&E a/c in proportion to the depreciation charge on the capitalised asset.

(Up to 3 marks per sector; maximum of 9 marks)
(10)
(15)

Question 7

Specific measures of financial performance required, examples of which may include:

(a) Private sector:

1. Principally profit from P&L a/c – measures primary objective of private company.
2. Uni-variate ratio analysis, eg: ROCE, profit margin, EPS – measures ability to generate profit.
3. Investors ratios, eg: return on equity, earnings per share, price earnings ratio – ability to satisfy providers of finance, and hence generate capital for investment.
4. Multivariate ratio analysis eg: Altman's Z-score – combines measures of profitability, performance for investors etc. to give an overview of financial performance.

(b) Local Government:

1. Limiting expenditure to budget – measures primary objective of stewardship of public funds.
2. Performance Indicators – comparing against similar organisations to demonstrate vfm in service delivery.
3. Minimising increases in Council Tax – achieving local accountability in use of public money to deliver services.

(c) NHS:

1. External Financing Limit – maximum Trusts can spend on a cash basis. Set nationally for each Trust. Performance measured by comparison to the external financing requirement.
2. Capital Resource Limit – maximum Trust can spend on capital net of internally generated funds on an accruals basis. Performance measured as a comparison of CRL with the actual capital financing requirement of the Trust for the year.
3. Capital Absorption Duty – similar to ROCE; requirement to generate a 6% return on average relevant net assets, which is then paid from the I&E A/c as PDC dividend. (Required return of 6% in 02/03, 3.5% in 03/04: accept either in answers.)

4. Break Even – Trusts must break even taking one year with another over a three year period. A surplus/deficit equal to or less than 0.5% of turnover is deemed break even.

(½ mark per measure identified, plus up to 2 marks for clear explanation of purpose; maximum of 5 marks per sector)

(15)

Question 8

(a) Central Government:

Tangible fixed assets at lower of replacement cost and recoverable amount.

Heritage assets preserved in trust for future generations. If operational, then treated as tangible fixed assets.

Infrastructure assets: Roads at current replacement cost, depreciated according to renewals expenditure in response to annual condition survey.

Water depreciated at normalised maintenance charge required to keep asset indefinitely in existing condition.

Depreciation charged in accordance with FRS 15 on all fixed assets with finite life (except freehold land) , using appropriate depreciation methods.

Values reviewed annually, with independent revaluation at least every five years.

Notional charge for the cost of capital based on Treasury rate (6% for 02/03, 3.5% for 03/04). Charged to operating cost statement, but not a cash payment (transferred to general fund).

(1 mark per valid point; up to 5 marks)

(b) NHS Trusts:

Complies with FRS 15 in the treatment of fixed assets, but specific rules are laid out in the capital accounting manual.

Annual revaluation and indexation of all fixed assets, with corresponding entries in the revaluation reserve for NHS funded assets (or donation reserve for donated assets). Assets valued at current replacement cost.

Depreciation charged evenly over the useful life of assets (other than land). Useful lives separately identified for buildings, and appropriate categories of equipment. Depreciation charged quarterly.

Donated assets strictly separated from NHS-funded assets, with depreciation charges offset by income released from the donation reserve to remove impact on NHS Trust I&E account.

Capital charges made up of depreciation and dividends paid on 6%/3.5% of average relevant net assets.

(1 mark per valid point; up to 5 marks)

(c) Local Government:

Assets included in the balance sheet according to different bases of valuation:

Infrastructure held at historic cost, depreciated where appropriate.

Community assets, held in perpetuity, at original value, rarely depreciated.

Operational assets held at lower of net replacement cost or net realisable value in existing use. Depreciated over useful life.

Non-operational assets, held at net replacement or realisable cost. Not consumed.

Complies fully with FRS 15 rules of depreciation (ie: except where land, fully maintained to infinite useful life or depreciation immaterial). Authorities determine method and period of depreciation appropriate to asset.

Depreciation charged to revenue as part of asset rentals (together with notional interest on capital tied up in asset), via asset management revenue account.

Assets held in the balance sheet at current cost re-valued at intervals of no less than five years.

(1 mark per valid point; up to 5 marks)

(15)