FINANCIAL REPORTING

June 2004
Certificate stage

MARKING SCHEME

Question 1

(a) Tangible fixed assets

	Land	Buildings	Plant and Machinery	Total	
	£m	£m	£m	£m	
Cost or valuation					
As at 1 April 2003	650	8,100	2,230	10,980	*1*
Additions	250	300	1,282	1,832	*1*
Disposals		(150)	(450)	(600)	*1*
As at 31 March 2004	900	8,250	3,062	12,212	*1*
Accumulated depreciation					
As at 1 April 2003	0	730	1,570	2,300	*1*
Charge for the year	0	206	562	768	*1*
Withdrawn on disposals		(40)	(380)	(420)	*1*
As at 31 March 2004	0	896	1,752	2,648	*1*
Net book value					
As at 1 April 2003	650	7,370	660	8,680	*1*
As at 31 March 2004	900	7,354	1,310	9,564	*1*
					(10)

(b)

Rarablat plc
Profit and loss account for the year ended 31 March 2004

	£m	
Turnover	25,400	½
Cost of sales	(18,934)	*4*
Gross profit	6,466	½
Distribution costs	(1,910)	½
Administrative expenses	(2,747)	*1*
Other operating income	510	½
Operating profit	2,319	½
Income from fixed asset investments	115	½
Interest payable	(250)	½
Profit on ordinary activities before taxation	2,184	½
Tax on profit on ordinary activities	(841)	½
Profit for the financial year	1,343	½
Dividends paid and proposed	(720)	*1*
Amount set aside to reserves	623	½

Rarablat plc
Balance sheet as at 31 March 2004

Fixed assets		£m	
Tangible		9,564	*(O/F OK) ½*
Investments		1,195	*½*
		10,759	
Current assets	£m		
Stock	1,240		*½*
Debtors	2,344		*1*
Cash at bank and in hand	324		*½*
	3,908		
Creditors: amounts falling due within one year			
Trade creditors	1,950		*½*
Taxation	960		*½*
Proposed dividend	400		*½*
Bank loan, repayable 1 September 2004	280		*½*
	3,590		
Net current assets		318	
Total assets less current liabilities		11,077	
Creditors: amounts falling due after more than one year			
Bank loan, repayable 2008	(1,880)		*½*
10% Debentures 2010/15	(1,000)	(2,880)	*½*
		8,197	
Capital and reserves			
Issued ordinary share capital		4,000	*½*
Share premium		800	*½*
Revaluation reserve		450	*½*
Profit and loss account		2,947	*(O/F OK) 1*
		8,197	
			(20)
			(30)

Workings

Gain/(loss) on fixed assets disposals

		£m
Proceeds from sale		230
Book value of assets sold		
Buildings	110	
Plant and machinery	70	
		180
Gain on disposal		50

Allocation of expenses

	Cost of sales £m		Administrative expenses £m		Distribution costs £m	
Per trial balance	18,500		2,440		1,910	*(½)*
Gain on disposal of assets	(50)	*(1)*				
Depreciation for the year						
Buildings	124	*(½)*	82	*(½)*		
Plant and machinery	337	*(½)*	225	*(½)*		
Written off fixed asset investments	15	*(1)*				
Website costs written off	8	*(1)*				
	18,934	*(4)*	2,747	*(1)*	1,910	*(½)*

Debtors	**£m**
Trade debtors	2,400
Provision for doubtful debts	(56)
	2,344

Dividends paid and proposed	**£m**
Interim dividend	320
Proposed dividend	400
	720

Profit and loss account	**£m**
Balance b/f	2,324
Retained profit for the year	623
	2,947

Fixed asset investments	**£m**
Carrying value	300
New valuation	185
Diminution in value	115
Written off Revaluation Reserve	100
Charged to profit and loss account (cost of sales)	15

Question 2

(a)

Number of shares issued in rights issue	10,000,000	
So, total shares issued	90,000,000	*1*

Calculation of theoretical ex-rights value per share

$$\frac{\text{Fair value of all outstanding shares + total amount received from exercise of rights}}{\text{Number of shares before exercise + number of shares issued in the exercise}}$$

$$\frac{(£6.20 \times 80{,}000{,}000 \text{ shares}) + (£4.20 \times 10{,}000{,}000 \text{ shares})}{80{,}000{,}000 \text{ shares} + 10{,}000{,}000 \text{ shares}} \qquad \textit{2} \; \textit{2}$$

= 538,000,000 / 90,000,000

= £5.98 per share *1*

Computation of adjustment factor

Fair value per share before exercise of rights	£6.20	
Theoretical ex-rights value per share	£5.98	
Adjustment factor	1.03717472	*2*

Calculation of earnings

Earnings attributable to ordinary shares	£	
Retained profit	5,260,000	
Interim ordinary dividend	4,500,000	
Final ordinary dividend	6,750,000	
	16,510,000	*2*

Weighted average number of shares issued

First three months		
80,000,000 x 1.03717 x 3/12	20,743,494	
Last nine months		
90,000,000 x 9/12	67,500,000	
	88,243,494	*3*

Earnings per share	18.7	pence	*1*
			(14)

(b) Price per share as at 31 March 2004 = £5.00

Earnings per share = 18.7 pence

So, PE ratio = 5 / 0.187 = 27 *(2)*

(c) The PE ratio is the price/earnings ratio. It is the market value (per share) divided by earnings (per share). The PE ratio gives some idea of the number of years' purchase of the latest known earnings that investors are willing to pay to acquire an interest in the company. A high ratio means that the market is bidding up the price beyond what the latest reported earnings would appear to justify; presumably, then, investors are expecting future earnings to rise enabling larger dividends to be paid.

The PE ratio reflects the market's confidence in a quoted company. It depends not only on the company's perceived future prospects but also on the industry within which the company operates and economic confidence generally. 'The Financial Times' publishes PE ratios for each industry group and subsection. Individual company PE ratios can therefore be compared with the average PE ratio for companies in similar lines of business. If a company has a PE ratio significantly higher than the average for its sector the company is a leader in its sector. Unfortunately, it could also mean that the company's shares are merely overvalued — it is important not to read more into these ratios than is justified.

An important constituent of the PE ratio is the earnings per share figure. Despite the standardisation of FRS14 the figures used to calculate EPS should still be looked at carefully. Investors should also beware using a single indicator of performance. EPS and the PE ratio are insufficient in themselves to form valid conclusions about the past performance and future prospects for a company.

(1 mark per valid point to a maximum of 4)

(d) **(i)** FRED 26 proposes that basic and diluted earnings per share should be disclosed on the face of the profit and loss account for the net profit/loss for the period (as with FRS 14) *and also for the profit/loss from continuing operations.* *2*

Basic and diluted earnings per share for discontinued operations, if reported, should be reported either on the face of the profit and loss account or as a note to the accounts. *2*

Additional per share amounts can be presented – but only in the notes to the accounts. *1*

The disclosure requirements are reduced where additional per share amounts are published. *1*

(2 + 2 + 1 + 1 to a maximum of 3 marks)

(ii) The reason for proposing the change to FRS 14 is that the change is part of the ASB's convergence programme to align UK domestic accounting standards with International Financial Reporting Standards [or IAS] issued by the IASB – in this case to achieve convergence with the IASB's proposed changes to IAS 33 'Earnings per Share'.

(1 mark per valid point to a maximum of 2 marks)

(e) **(i)** FRED 27 proposes that if dividends on equity instruments *(1 mark)* are declared after the balance sheet date *(1 mark)* they should not be recognised as a liability at the balance sheet date *(1 mark)*, but disclosed as a note to the accounts *(1 mark)*.

This will create a conflict with the 4th Schedule of the Companies Act *(1 mark)* – but the ASB has asked the DTI to consider changing the law to permit the proposed change *(1 mark).*

(6 x 1 to a maximum of 3 marks)

(ii) The rationale for the change is again the ASB's convergence programme. In International Accounting Standards dividends declared after the balance sheet date but before the date of approval of the financial statements are post balance sheet events but do not meet the criteria in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. These dividends are disclosed as a note in accordance with IAS 1 *Presentation of Financial Statements*.

(1 mark per valid point to a maximum of 2 marks)

(30)

Question 3

REPORT

From:
To:
Date:
Subject: **Recent performance of Stimlat Ltd**

The following is a report on the performance of Stimulat Ltd over the three years from 2001 to 2003 as evidenced by a number of performance indicators for the company and the industry.

Profitability
Simulat Ltd's overall profitability as evidenced by its return on capital employed (ratio 1) has fallen consistently and markedly from over 30% in 2001 to just under 4% in 2003. The main reason for this deterioration was a decline in profit margins (ratio 2) rather than the overall efficiency in the use of assets (ratio 3).

The main reason for the decline in profitability is significantly increasing production costs (ratio 4). This seems attributable to increasing materials costs (ratio 8) and factory overheads (ratio 10). Distribution costs, administrative expenses and factory direct labour costs have shown small increases – but seem well in control when compared with industry averages.

Liquidity
The level of working capital (ratio 13) has increased significantly but holdings of liquid cash balances relative to activity (ratio 16) have fallen. Liquid cash holdings seem to be now significantly lower than the industry average. It is not possible to judge whether or not this is likely to cause liquidity problems but there is evidence that the components of working capital may need better management.

Assets utilisation
Overall assets utilisation (ratios 3 and 11) seems relatively stable – but within this there are concerns about the management of working capital. Working capital relative to the level of activity (ratio 13) has increased significantly. This seems attributable to increasing levels of debtors. Liquid cash holdings (ratio 16) have fallen and the level of credit taken from suppliers (ratio 17) seems to have increased. These changes may be linked with pressure caused by the increasing credit being taken by customers. Stock control seems fine.

Comparison with the industry sector
The areas of concern noted above continue to cause concern when compared with industry averages. Stimulat Ltd's overall efficiency (ratio 1) now seems very low in comparison with industry averages. This is almost entirely attributable to low profit margins because of high materials costs and factory overheads. Working capital (ratio 13) seems efficient when compared with the industry average. However, this is mainly due to efficient stock control (ratio 14) and the level of credit given to customers and taken from suppliers seem to be significantly in excess of industry averages.

Recommendations for improving the performance of Stimulat Ltd.
The overall performance of Stimulat Ltd could be transformed if:

- The high level of materials costs was investigated with a view to identifying ways in which these could be reduced;

- Factory overheads were investigated with a view to introducing better cost control; and

- Credit control policies and procedures were investigated with a view to tightening up credit control.

Caveats
- It has been assumed that all the data is comparable ie that similar accounting policies have been used over the three years and within the industry sector.

- The data is somewhat out of date. Given the marked and sharp decline in the performance of Stimulat Ltd it would be useful to have interim figures for 2004 or information about significant management or strategic changes introduced since the period covered by the 2003 financial statements.

- Comparing Stimulat Ltd's results with the industry medians is of limited use. It would be useful to know how variable the statistics are for the industry. Furthermore, it might be more useful to compare Stimulat Ltd's performance with the industry sector leaders particularly with a view to knowing what is achievable.

- The available information is very limited. It would be useful to have additional information about the quality of Stimulat Ltd's management, its risk exposure and the prospects for the industry sector.

Maximum of 4 marks for each section – ie 6 x 4 marks = 24 marks
Capped at a maximum of 18
Report format = maximum of 1 mark
Overall style and presentation = maximum of 1 mark

(20)

Question 4

(a)

Declat plc
Profit calculation for the year ended 31 March 2005

	£000		Workings
Sales	2,041		(1,100 + 300 x 12/5) x 1.15 x 0.975
Cost of sales	1,517		(880 + 200 x 12/5) x 1.15 x 0.97
Gross profit	524	**26%**	
Operating expenses	287		(160 + 40 x 12/5) x 1.12
Operating profit	237	**12%**	

Sales, cost of sales: 2 marks each operating expenses and ratios 1 mark each, gross profit and opening profit ½ mark each, up to a maximum of 8

(b) FRS 3 requires the figures in the profit and loss account to be analysed into 'continuing activities', 'acquisitions' and 'disposals'. The level of analysis extends from turnover down to operating profit – although the analysis may be split between the profit and loss account (eg turnover) and the notes to the financial statements (cost of sales, etc).

Separate ratios can therefore be calculated for gross profit to sales and operating profit to sales for each of 'continuing activities', 'acquisitions' and 'disposals'. The contribution to overall profitability on trading from each class of activity can thus be assessed.

This can enhance the prediction of future profitability. Other things being equal, the profitability on continuing activities can be expected to continue while the profitability on discontinued activities can be excluded. It is also possible to assess whether any acquisitions are likely to increase or decrease overall profitability on trading. This can be made more sophisticated by taking into consideration (a) the size of acquisitions relative to continuing activities and (b) the dates of acquisition, if known.

The following ratios have been calculated from Declat plc's results for 2004 and 2003:

Ratios	**2004**	**2003**
Gross profit to sales	26%	42%
Continuing	20%	29%
Acquisitions	33%	
Discontinued	45%	34%
Operating profit to sales	8%	12%
Continuing	5%	14%
Acquisitions	20%	
Discontinued	6%	6%

The above figures show that overall gross margin has fallen in 2004. The gross margin on discontinued activities was particularly high (and, indeed, *increased* in 2004) so we would expect that, other things being equal, the company's gross margin will fall in 2005. The situation will be helped to some extent by the fact that the gross margin on acquisitions is higher than on continuing activities.

The net margin on sales has also fallen significantly in 2004. However, this seems entirely attributable to continuing activities and the overall impact of losing the contribution from the net margin earned on discontinued activities may be minimal. The net margin on acquisitions seems very high and this should enhance the overall net margin in 2005 – other things being equal.

Of course, other things may not be equal – but we may be able to adjust predictions for expected or anticipated changes. A number of these have been taken into account in the profit estimation for 2005. This shows that the decline in gross margins may be minimal (2005 gross margin estimated at 26%) and that the net margin may actually increase – mainly due to the expected impact of acquisitions.

Awareness of continuing, discontinued and acquisitions as FRS 3 requirements, up to a maximum of 3 marks

Awareness of possibility of assessing profitability on trading on each type, up to a maximum of 2 marks

Awareness of predicting continuing and acquisitions into the future, up to a maximum of 2 marks

Appropriate illustrations from figures for 2003 and 2004, up to a maximum of 4 marks

Appropriate comparisons with estimated figures for 2005 (use of O/Fs OK), up to a maximum of 4 marks

Overall mark for this section limited to a maximum of 12

(20)

Question 5

(a) Direct method

	£
Cash received from customers	15,207,000
Cash payments to suppliers	(11,549,000)
Cash paid to and on behalf of employees	(1,617,000)
Other cash payments	(988,850)
Net cash inflow from operating activities	1,052,150

Marks 4 x 1½ marks = 6

Workings

Cash received from customers	£
Opening trade debtors	380,000
Sales	15,500,000
Discounts allowed	(23,000)
Closing debtors	(650,000)
Cash received from customers	15,207,000

Cash payments to suppliers	£
Opening trade creditors	220,000
Purchases	11,665,000
Discounts received	(36,000)
Closing creditors	(300,000)
	11,549,000

Cash paid to and on behalf of employees	£
Wages and salaries	1,616,000
Accrued at start of year	3,000
Accrued at end of year	(2,000)
	1,617,000

Other cash payments	£
Rent, rates and insurance	304,000
Selling expenses	555,800
Accountancy	85,250
Sundries	44,200
	989,250
Prepaid at start of year	(1,500)
Prepaid at end of year	1,100
	988,850

(b) Indirect method

	£	
Operating profit	799,250	*1*
Depreciation charges	464,500	*1*
Loss on sale of tangible fixed assets	19,000	*1*
Increase in stocks	(40,000)	*1*
Increase in debtors and prepaid expenses	(269,600)	*1*
Increase in creditors and accrued expenses	79,000	*1*
Net cash inflow from operating activities	1,052,150	*(6)*

(c) Capital expenditure

	£	
Payments to acquire tangible fixed assets	(917,000)	*2*
Receipts from sales of tangible fixed assets	41,000	*2*
	(876,000)	*(4)*

(d) Financing

	£	
Issue of ordinary share capital	600,000	*1*
Repayment of debentures	(280,000)	*1*
	320,000	*(2)*

(e) Reconciliation of Net Cash Flow to Movement In Net Debt

	£	
Increase/(decrease) in cash for the period	103,550	½
add back Cash used to repay debentures	280,000	½
Change in net debt resulting from cash flows	176,450	
Net debt at the start of the year	345,000	½
Net debt at the end of the year	168,550	½
		(2)

(20)