FINANCIAL REPORTING

June 2005
Certificate stage

MARKING SCHEME

CIPFA

Question 1

(a)

<div align="center">

Claudel Ltd
Balance Sheet as at 31 March 2005
</div>

			½
Fixed assets		£000	½
Intangible			
Goodwill, net book value		171	1
Development expenditure		44	1
		215	
Tangible			
Land, at valuation	1,270		1
Freehold buildings, net book value	2,222		3
Equipment, net book value	292		2
		3,784	
Investment properties		540	½
		4,539	
Current assets			
Stock, at cost	626		½
Debtors	943		1
Investments	101		½
Cash at bank and in hand	27		½
	1,697		
Creditors: amounts falling due within one year			
Trade creditors	603		½
Taxation	102		½
Loans	50		½
Proposed dividends	216		½
Other creditors	220		1
	1,191		
Net current assets		506	
Total assets less current liabilities		5,045	
Creditors amounts falling due after one year			
Loans		650	1
Provisions for liabilities and charges			
Deferred tax	150		1
Provision	57		1
		207	
		4,188	
Capital and reserves			
Issued share capital		1,200	1
Share premium		200	1
Investment property revaluation reserve		248	1
Retained profits		2,540	1
		4,188	

<div align="right">(22)</div>

Workings

Intangible assets   £000
Goodwill   at cost   180
            amortisation   9
            Net book value   171

Development expenditure
            Per list of balances   187
            Written off   143
                                                           44

Tangible assets
            Land
            Per list of balances   1,400
            Impairment   (130)
                                                         1,270

Buildings	Cost	Depreciation	Net
Per list of balances	3,120	468	
Disposals	(400)	(38)	
	2,720	430	2,290
Depreciation		68	
	2,720	498	2,222

Equipment			
Per list of balances	1,660	996	
Disposals	(355)	(108)	
	1,305	888	417
Depreciation		125	
	1,305	1,013	292

Investment properties
            Value at end of year   540
            Per list of balances   450
            Add to Investment Properties   90
            Revaluation Reserve

Provision for doubtful debts
            Existing provision   17
            New provision   29
            Increase in provision   12

Debtors
            Per list of balances   972
            Provision for doubtful debts   29
                                                          943

Share premium
            Per list of balances   400
            Bonus issues (400,000 x 0.50p)   200
                                                          200

(b)

Calculation of net profit before tax

		£000	
Increase in retained profit (2,540 – 858)		1,682	*1*
Add: Dividends paid during the year	160		*½*
Dividends proposed	216	376	*½*
Net profit after taxation		2,058	
Tax provision	102		*1*
Over provision for previous year	(28)		*1*
Transfer to deferred taxation	41	115	*1*
Net profit before tax		2,173	*(5)*

(c) The partial provision method provides for deferred taxation only on those material timing differences which are expected to reverse in the foreseeable future, ie where an actual tax liability is expected to arise.

The full provision method provides for deferred taxation on all material timing differences irrespective of whether or not they are expected to reverse in the foreseeable future, ie irrespective of an actual tax liability arising.

The appropriate method to use is the full provision method because this is the method which is required in the UK under FRS 19 *Deferred Taxation* (or under IAS 12 *Income Taxes* for UK listed companies applying international accounting standards).

(1 mark for each, up to a maximum of 3 marks)

(30)

Question 2

(a) **(i)**

- The overall performance of the two companies as measured by return on capital employed is the same over the two years for both companies.
- Both companies have achieved relatively high returns on capital suggesting good profitability and efficiency.
- However, performance has fallen significantly in 2004 for each company.
- The ratios indicate that the decline in Company A's overall efficiency was due to falling profitability on trading.
- The ratios indicate that the decline in Company B's overall efficiency was due to falling efficiency in use of capital employed for Company B.

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

(ii) Company A needs to improve its profitability on trading. This could be achieved by

- increasing selling prices – although the number of units sold would need to be maintained
- improving the sales mix so that a greater proportion of sales is made up of more profitable items
- reducing purchase prices, perhaps by changing suppliers or negotiating better terms with existing suppliers
- tighter control of overheads ie reducing selling, distribution and administrative expenses relative to turnover.

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

Company B needs to improve the efficiency with which it utilises its capital employed. This could be achieved by

- More intensive use of fixed assets or disposing of redundant or underused fixed assets
- Better stock control with a view to minimising the investment in stocks
- Better credit control with a view to reducing the period of credit taken by credit customers, reducing bad debts by better vetting of prospective credit customers and more efficient billing and collection procedures.
- Better treasury management with a view to minimising holdings of liquid assets such as cash and bank and better investment of temporary excess liquid funds
- Better use of the credit facilities provided by suppliers or negotiating improved credit terms.

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

(b)   Some of the limitations in reliably using return on capital employed ratios are:

- Definition & consistency

    There are various measures that could be used for 'return' (eg operating profit, profit before tax, or profit after tax) and various measures for 'capital employed' (eg total assets, net assets, shareholders' funds, ordinary shareholders' funds). The various combinations that are possible will all give different results! The important thing is that whatever measure is used as 'return' should be consistent with the definition used for 'capital employed'.

- Valuation problems with valuing net assets

    Despite the efforts of the ASB there are still inconsistencies in the ways companies identify and value assets, particularly fixed assets. In pure historical cost accounting there is a systematic overstatement of return on capital employed figures because in periods of rising prices profit will have been calculated using more up to date prices than capital employed.

- Historical data

    Investors make decisions which need to be based on how a company is going to perform in the future. However, financial statements attempt to describe and quantify past performance. Return on capital employed figures attempt to achieve objectivity by using past audited data. Investors need to subjectively adjust and project these figures into the future.

- Problems of comparability

    There may be pitfalls in comparing return on capital employed figures between different businesses and over time. These partly result from the limitations identified above. However, there may be in addition a lack of comparability because different accounting policies have been used either from year to year or between different businesses.

    (1 mark per valid limitation plus 1 mark for further development, to a maximum of 6)

(c)   (i)   Interest cover

    This is a profit and loss account ratio which is calculated by taking profit before tax and interest and dividing it by interest charges for the year. For example, if profit before interest and tax is £500,000 and annual interest charges are £50,000 the interest cover is 10 times.

    The interest cover is a measure of financial risk. It tells us the number of times that interest commitments could have been covered by operating profit. It enables lenders to assess the margin of safety attaching to interest payments due to them by the business.

    An investor would generally prefer this ratio to be higher rather than lower. If this ratio falls then the income gearing of the business is increasing and the risk attaching to the lending is increasing. If it falls to near 1 to 1 lenders

might become worried that future interest payments (and ultimately the repayment of their loans) might be in jeopardy.

(ii) Dividend yield

The dividend yield is the dividend paid on a share expressed as a percentage of the middle market price of the share. The middle market price is the average of the bid and offer price of the shares. For example, if a company paid dividends totaling 20 pence per share in its last financial year and the market value of the share is £1.60 the dividend yield is 12.5%.

The dividend yield enables the investor to look at how dividend yields have changed over time and how dividend yields compare between different companies.

Generally, speaking the higher the dividend yield is the better and, other things being equal, an investment in a company with a higher dividend yield would be more attractive than an investment in an equivalent company with a lower yield. However, it should be borne in mind that the motivations of investors may vary. For example, some investors might be happy to forego a high dividend yield in the short term in return for long term growth prospects. Nevertheless, the dividend yield might be a useful comparator for an investor interested in the cash flow returns from investments.

It is worthwhile noting two important limitations in using dividend yields. Firstly, they are based on past dividend levels and the investment decision should be based on expected future dividend levels. Secondly, dividends represent distributed profits only. The dividend yield does not allow for the retention policy of the company. So a company may have a relatively low dividend yield not because profits are low but because it is ploughing back a high proportion of profits into the business. This could auger well for future profits and distributions.

(iii) PE ratio

The PE ratio is the ratio of the current market price of a share to its last reported earnings per share. For example, if the last reported earnings per share for a company were 15 pence and the current share price was £1.50 the PE ratio would be 10.

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, so generally speaking, the higher the ratio the better. 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.

(Definition of each ratio = 1, what it measures = 1, use and interpretation = 2 marks, total 4 per ratio = 4 x 3 = 12)

(d)   Multivariate analysis involves considering several ratios simultaneously to calculate a single number which purports to describe the overall 'health' of a business.   Almost all the work that has been done in this area has been concerned with the prediction of financial distress ie bankruptcy.

The best known of these ratios is the Z score which is now used in the prediction of company insolvency and the evaluation of corporate creditworthiness by banks, investment houses, and others. Z scores use data taken from the published financial statements of companies and combine a number of conventional accounting ratios to derive a single, numeric solvency index. The result lies on a scale which shows whether the company is healthy, indifferent or a potential failure.

There are several Z scores available. All are derived using a technique known as multiple discriminant analysis. The work of Altman and Taffler and Tisshaw is noteworthy in this area.

The Z score seeks to discriminate between companies which will not fail and those which might. If a company has a bad Z score it does not necessarily mean that it will fail, merely that it has financial characteristics similar to those of previous bankrupts.   What eventually happens depends on the actions of management, creditors, debenture holders, banks, etc. A poor Z score is an indicator that something is wrong. It does not reveal what is wrong and it may be possible for the company to rectify matters.

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

(30)

Question 3

(a)   Rezia plc

Calculation of basic EPS	£		
Profit after taxation	4,284,000		½
less Preference dividend	90,000		½
Profit attributable to the ordinary shareholders	4,194,000		
Number of ordinary shares issued	16,000,000		1
So, basic earnings per share	26.2	pence	1
			(3)

(b)   Huon plc

Earnings per share for year ended 31 May 2005	**16.3**	pence	1
ie £980,000 divided by 6,000,000			
Earnings per share for previous year	15.7	pence	
Restated (15.7 x 5,000,000 / 6,000,000)	**13.1**	pence	2
			(3)

(c)   Fatima plc

Number of shares under option	1,500,000	
This would give a total number of ordinary shares in issue of	9,000,000	1
Estimate of the average share price during the financial year	10.60	1
However, the number that would have been issued at fair value is (1,500,000 x £5.60 / £10.60)	(792,453)	2
Number of shares (9,000,000 – 792,453)	8,207,547	1
Profit attributable to ordinary shareholders	2,170,000	1
So, diluted eps	26.4 pence	1
		(7)

(d)

- *Convertible preference shares*
  The holders of these have the right to convert their preference shares into ordinary shares. If they were to exercise this right the company would no longer have to pay the preference dividend on these shares – but there would be more ordinary shareholders to share in residual profits.

- *Convertible bonds*
  The holders of these have a right to convert their bonds into ordinary shares. If the bond holders were to exercise their right to convert the company would not have to pay interest (and this would probably increase the company's corporation tax liability) – but, again, there would be more ordinary shareholders to share in residual profits.

(2 x 2 marks = 4)

(e)   FRS 14 requires:
- The disclosure of *both* basic earnings per share and diluted earnings per share.
- These should be disclosed on the face of the profit and loss account.
- These should be disclosed even if they are negative figures.
- Comparative figures for the previous period are required.
- A note to the accounts should explain how the figures have been calculated – in particular the figure used as the numerator and the figure used as the denominator.
- All dilutive effects should be included irrespective of materiality.
- A basic and diluted earnings per share figure should be disclosed for every set of ordinary shares with different rights.

(1 mark per valid point, up to a maximum of 3)

(20)

Question 4

(a)

	Sherasmin £m	Mermaid £m	Puck £m		
Contract value	40.0	50.0	31.5	*	*1*
Costs to date	17.0	3.1	25.5		*½*
Estimated future costs	13.0	33.9	12.5		*1 ½*
Estimated profit/(loss)	10.0	13.0	(6.5)		*1*
					(4)

* Includes increase of 12.5% due to foundation problems.

(b)

	Sherasmin	Mermaid	Puck	
Percentage complete:	21 / 40	2.5 / 50	n/a due to	
	52.5%	5%	losses	*1 ½*
Attributable profit (£m):	5.25	nil	6.5 loss	*1 ½*
				(3)

(c)

	Sherasmin £m	Mermaid £m	Puck £m	**Total £m**	
Turnover	21.00	2.50	19.00	**42.50**	*1 ½*
Cost of Sales (balance)	15.75	2.50	25.50	**43.75**	*1 ½*
Profit	5.25	0.00	(6.50)	**(1.25)**	*1*
					(4)

If it is considered that this is not a material figure in respect of economic activity then turnover and cost of sales for the Mermaid contract could be omitted from the profit and loss account.

(d)

	Sherasmin £m	Mermaid £m	Puck £m	**Total £m**	
Work in progress:					
Costs to date	17.00	3.10	25.50		*1 ½*
Transferred to Cost of Sales	15.75	2.50	25.50		*1 ½*
	1.25	0.60	0.00	**1.85**	
Amounts recoverable on contracts:					
Turnover	21.00	2.50	19.00		*1 ½*
Value of work invoiced	18.00	2.50	16.00		*1 ½*
	3.00	0.00	3.00	**6.00**	
Trade debtors:					
Value of work invoiced	18.00	2.50	16.00		*1 ½*
Payments received	16.00	1.50	10.00		*1 ½*
	2.00	1.00	6.00	**9.00**	
					(9)
					(20)

Question 5

(a)

Oberon plc
Statement of Total Recognised Gains and Losses
for the year ended 31 March 2005

	£000	
Profit on ordinary activities after taxation	9,300	*1*
Unrealised loss following reduction in value of investment property	(210)	*1*
Unrealised surplus on revaluation of tangible fixed asset	280	*1*
Total recognised gains and losses for the year	9,370	*1*
Prior year adjustment	(300)	*1*
Total gains and losses recognised since last annual report	9,070	*1*
Not including stock write down		*1*
		(7)

(b)

Oberon plc
Reconciliation of Movements in Shareholders' Funds
For the year ended 31 March 2005

		£000		
Profit on ordinary activities after taxation		9,300		*1*
Dividends paid		(2,750)		*1*
		6,550		*1*
Other recognised gains and losses relating to the year (net)		70	(-210 + 280)	*1*
Share capital issued		3,000		*1*
Net addition to shareholders' funds		9,620		*1*
Opening shareholders' funds	14,889			*1*
Prior year adjustment	(300)			*1*
		14,589		
Closing shareholders' funds		24,209		*1*
				(9)

(c)

Oberon plc
Note of Historical Cost Profits and Losses for the year ended
31 March 2005

	£000	
Reported profit on ordinary activities before taxation	12,800	*1*
Realisation of property gain of previous years	150	*1 ½*
Difference between historical cost depreciation and the actual depreciation charge for the year calculated on revalued amounts	40	*1 ½*
Historical cost profit on ordinary activities before taxation	12,990	*(4)*
		(20)