CIPFA

FINANCIAL REPORTING

Certificate stage examination

8 June 2007

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

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Question 1

(a)

Mestoplan plc
Balance sheet
as at 31 May 2007 ½

ASSETS		
Non-current assets	£000	
Property, plant and equipment	9,600	*1 + W4*
Investments	1,100	*1*
	10,700	
Current assets		
Inventories	1,339	*1*
Trade receivables	4,320	*1*
Cash and cash equivalents	98	*½*
	5,757	
Total assets	16,457	
EQUITY AND LIABILITIES		
Equity		
Share capital	5,000	*½*
Share premium	1,000	*½*
Revaluation reserve	510	*½*
Retained earnings	4,097	*½*
Total equity	10,607	
Non-current liabilities		
Bank loan, repayable 2008	1,500	*½*
10% Loan notes	1,250	*½*
Total non-current liabilities	2,750	
Current liabilities		
Trade payables	1,840	*½*
Short-term borrowings	300	*½*
Current tax payable	960	*1*
Total current liabilities	3,100	
Total liabilities	5,850	
Total equity and liabilities	16,457	

Layout Good 1
Layout Very good 2

(16)

Workings

	Land	Buildings	Plant & Machinery	
Cost	£000	£000	£000	
per trial balance	800	8,000	4,200	
Less cost withdrawn on assets sold			(200)	*1*
So, corrected cost as at end of year	800	8,000	4,000	

	Buildings	Plant & Machinery	
Accumulated depreciation	£000	£000	
per trial balance	640	2,140	
Less depreciation withdrawn on assets sold		(140)	*1*
	640	2,000	
Charge for the year (see below)	160	400	*2*
	800	2,400	

Calculation of depreciation for the year	Buildings	Plant & Machinery
Rate	2%	20%
Method	Str. Line	Dim. Bal.
Charged on	8,000	2,000 *
Charge for the year	160	400

* (4,000 less 2,000)

Allowance for doubtful debts	£000
Old allowance	85
New allowance	180
Increase	95

Trade receivables	£000
Trade receivables	4,500
Allowance for doubtful debts	(180)
	4,320

Net-current asset investments	£000
Carrying value	500
New valuation	350
Diminution in value	150
Written off Revaluation Reserve	90
Charged to income statement	60

Inventory	£000
Per list of balances	1,350
Less stock write down	11
	1,339

(b)

**Statement of changes in equity
for the year ended 31 May 2007**

	Issued ordinary share capital	Share premium	Revaluation reserve	Retained earnings	Total	
	£000	£000	£000	£000	£000	
Balance at 31 May 2006	4,000	1,250	600	3,047	8,897	*4*
Prior year adjustment				(627)	(627)	*1*
Balance at 1 June 2006	4,000	1,250	600	2,420	8,270	
Rights issue	500	250			750	*2*
Write down of revalued asset			(90)		(90)	*1*
Profit for the year after tax				2,627	2,000	*1*
Dividends paid				(950)	(950)	*1*
Bonus issue	500	(500)				*2*
Balance at 31 May 2007	5,000	1,000	510	4,097	9,980	*2*

(14)

(30)

Question 2

Report

Subject: The performance of Kelpdon plc, 2002 to 2006
To: Shareholder
From:
Date:

(a) EPS and diluted EPS

Earnings per share is earnings attributable to equity shareholders divided by the number of equity shares issued and ranking for dividends. The diluted EPS figure shows the earnings per share if all stock options, warrants, convertibles, etc. were invoked, thereby increasing the total shares issued.

For example, a company may have convertible preference shares in issue. The holders of these have the right to convert their preference shares into ordinary shares. If they were to exercise this right there would be more ordinary shareholders to share in profits.

Similarly, if the company had issued convertible bonds the bond holders could exercise their right to convert to ordinary shares. The company would not have to pay interest – but, again, there would be more ordinary shares to share in residual profits.

(4)

(b) Market capitalisation

The market capitalisation of a company can be calculated by taking the number of shares traded on the stock exchange and multiplying it by the market price per share. Here the market capitalisation of Kelpdon plc as at the end of financial year 2006 is:

3,850,000 shares times £12 = £46,200,000

This a rough estimate of the value of the company. However, it could cost considerably more than this amount to acquire a controlling interest in a company.

(3)

(c) PE ratio for 2006

The PE ratio measures the ratio between the market price of the shares and the earnings per share. Here the price of the shares as at the end of financial year 2006 was £12 and the earnings per share were £0.4. So the PE ratio is £12 / £0.4 = 30.

(3)

(d) Estimate of revenue for 2006

It is not possible to estimate revenue accurately from the data given. Earnings per share are £0.4 and the number of shares is given as 3,850,000. This suggests that earnings are about £1,540,000. The operating margin is given as 20% so this suggests revenue of at least £7,700,000. However, this ignores the tax and net finance charges for the year. These should both be added to the £7,700,000 to get a more accurate figure. The figure for revenue will be reported in the financial statements – so it should not normally be necessary to estimate revenue in this way.

(4)

(e) Performance of Kelpdon plc

The return on equity earned by Kelpdon plc has more than halved from a very respectable 18% in 2002 to 7% in 2006. Apart from a small recovery in 2005, the return on equity has fallen consistently over the five years.

This decline in profitability has been mirrored in the decline in the company's operating margin, which has also fallen more or less consistently from 44% to 20% in 2006. This might be due to falling sales and/or increasing operating costs.

Given that the number of shares in issue has remained more or less constant over the five year period, earnings per share (eps) has also mirrored the decline in profitability with eps more than halving over the period. There is no difference between eps and diluted eps suggesting that the company has not issued any financial instruments convertible into equity shares.

The net asset value per share increased in 2003, suggesting, perhaps, increased investment in non-current assets. However, this ratio has fallen since then. It is difficult to take this ratio much further without access to the company's balance sheet – but it may be that investment in non-current assets has recently been low.

Operating cash flow per share is operating cash flows less any preferred dividends divided by the number of equity shares in issue. Like many of the performance indicators here that has halved over the five year period. This may be connected with the erratic pattern of dividends to shareholders, and no dividends were paid to shareholders in financial year 2006.

The estimate of revenue and the number of staff employed suggest that this is a small company which has been experiencing performance difficulties over the past few years.

However, shareholder confidence in the confidence seems to have remained buoyant. The share price is considerably in excess of the face value of 50 pence, suggesting significant past growth financed from internally generated funds. Perhaps this is also a factor in understanding the dividend policy of the company.

The company also seems low geared with shareholders consistently financing at least 90% of assets, suggesting a low financial risk.

The market price of the shares has been maintained over the past four years which may be surprising given the apparent decline in performance of the company. The market price also seems immune to the decline in recent earnings, and

consequently the price earnings ratio actually increased significantly in 2006. This suggests shareholder optimism for the future.

It is always difficult to understand the performance and prospects for a company from a few ratios. It would be useful to know what this company does, what markets it operates in, what the prospects are in those markets, and what strategic changes the company has recently made.

I hope this report is useful.

Layout and report style 2
Content of f): 1 mark per valid point to maximum of 14

(16)

(30)

Question 3

(a) Business segments are groupings of products and services. Geographical segments are groupings of markets. In both cases, each segment should be subject to risks and returns which are different from those of other segments. For reporting purposes business and geographical segments will often be based on those used internally by management.

(3)

(b) An entity must choose either its business segments or geographical segments as its primary segment for reporting purposes. This should be determined by looking at the dominant source and nature of the entity's risks and returns. IAS 14 requires information to be reported for both business segments and geographical segments – but the disclosure requirements are more extensive for primary segments.

(3)

(c)

Floothair plc
Segment information
Business segments
For the year ended 31 May 2007

	International airline business	Domestic airline business	Non-airline business	Un-allocated	Total	½
	£m	*£m*	*£m*	*£m*	*£m*	*½*
Revenue	8,104	388	260		8,752	*1*
Inter-segment sales	103	14	7		124	*1*
Segment revenue	8,207	402	267		8,876	*1*
Segment result	803	(30)	16		789	*1*
Profit on sale of assets			32	4	36	*1*
Unallocated income				22	22	*1*
Profit/(loss) before tax and finance costs	803	(30)	48	26	847	
Net finance costs					(149)	*½*
Income tax expense					(170)	*½*
Net profit for the year					528	*½*
Segment assets	12,050	240	140		12,430	*1*
Segment liabilities	4,566	84	350		5,000	*1*
Unallocated liabilities				5,420	5,420	*½*
	4,566	84	350	5,420	10,420	

(11)

(d) Valid points include:

- Most revenue, by far, comes from international airline business.
- The domestic airline business is operating at a loss.
- Although the smallest segment, non-airline business is the most profitable in terms of return on segment assets.
- Liabilities exceed assets in the non-airline business segment.

(3)

(20)

Question 4

(a) (i) Financial statements for the year ended 30 April 2006

The available evidence suggests that there was no obligation as a result of past events as at the date the financial statements were approved. There is therefore no need to recognise a provision. This matter should be disclosed as a contingent liability unless the probability of an outflow is regarded as being remote. [IAS 37]

(3)

(ii) Financial statements for the year ended 30 April 2007

On the basis of the evidence available, there is an obligation as at the date of the balance sheet. It is also probable that there will be an outflow of resources. A provision should therefore be recognised for the best estimate of the amount to settle the obligation. It is an expense for the year ended 30 April 2007 and not a prior year adjustment. [IAS 37]

(3)

(b) The depreciation schedule for this asset will be revised as from the year ended 30 April 2007 to reflect the revised expectations for the video cameras.

The original depreciable amount was £86,400 [£96,000 less £9,600] giving an annual depreciation charge of £14,400 [£86,400 / 6]. This depreciation charge would have been made for the years ended 30 April 2005 and 2006.

The depreciable amount was £67,200 [£96,000 less £28,800] as at 1 May 2006. This will be written off equally over the three years ending on 30 April 2007, 2008 and 2009. The machine will continue to be reported in the balance sheet at cost of £96,000 less accumulated depreciation.

The depreciation schedule for this asset is as follows:

	£
Cost of video cameras	96,000
Residual value	9,600
Depreciable amount	86,400
Depreciation charged on 30 April 2005	14,400
Depreciation charged on 30 April 2006	14,400
Current carrying value	67,200
New residual value	(10,950)
New depreciable amount	56,250
New estimated life (in years)	3
So, depreciation for the year ended 30 April 2007	18,750
and, for the year ended 30 April 2008	18,750
and, for the year ended 30 April 2009	18,750
	56,250

The depreciation charge in the income statement for the year ended 30 April 2007 will be £18,750.

In the balance sheet as at 30 April 2007 this asset will be included as a non-current asset in property, plant and equipment at cost, £96,000, less accumulated depreciation of £47,550 [£14,400 + £14,400 + £18,750] giving a carrying value of £48,450. [IAS 16]

Explanation 2
New depreciable amount 2
New annual depreciation charge 2

(6)

(c) The provision of the service gives rise to a constructive obligation because the company's literature creates a valid expectation of a refund if customers are unhappy with the service. On the basis that a proportion of customers will want a refund it is probable that there will be an outflow of resources. The company should therefore make a provision for the best estimate of the costs of refunds. [IAS 37]

(3)

(d) This a non-adjusting post balance sheet event. The diminution in value of the non-current investments is attributable to factors which have arisen after the date of the balance sheet. The figure reported in the balance sheet for non-current investments as at 30 April 2007 should not be adjusted. If the diminution in value is material it should be disclosed as a note to the financial statements. [IAS 10]

(2)

(e) As far as having to scrap the digital video tapes is concerned this is an adjusting post balance sheet event. The inventory was impaired as at the date of the balance sheet and should be written off in the financial statements for the year ended 30 April 2007. Inventory as at 30 April 2007 should be written down by £5,000. [IAS 10]

There was no liability for the cleaning and redecoration of the store room as at 30 April 2007. Also the amount may not be material. No adjustment to or disclosure in the financial statements for the year ended 30 April 2007 is necessary. [IAS 37]

(3)

(20)

Question 5

Argentox plc
Cash flow statement for the year ended 31 May 2007

		£	
Cash flow from operating activities			
Cash receipts from customers		24,707,200	*2*
Cash paid to suppliers and employees		(20,549,150)	*5*
Cash generated from operations		4,158,050	
Interest paid		(299,000)	*1*
Income taxes paid		(741,850)	*2*
Net cash from operating activities		3,117,200	
Cash flows from investing activities			
Purchase of non-current assets	(8,277,000)		*2*
Proceeds from sales of plant and machinery	110,000		*2*
Net cash used in investing activities		(8,167,000)	
Cash flows from financing activities			
Proceeds from issuance of share capital	3,200,000		*1*
Increase in long-term borrowings	2,200,000		*1*
Dividends paid	(350,000)		*1*
Net cash used in financing activities		5,050,000	
Net increase in cash and cash equivalents		200	*½*
Cash and cash equivalents at beginning of period		100,800	*1*
Cash and cash equivalents at end of period		101,000	*1*

(20)

Workings

Cash received from customers	£
Opening trade receivables	814,200
Sales	24,796,000
Discounts allowed	(22,500)
Closing trade receivables	(880,500)
Cash received from customers	24,707,200

Calculation of purchases	£
Cost of sales	14,877,600
add closing inventory	464,500
less opening inventory	(424,400)
	14,917,700

Cash payments to suppliers	£
Opening trade payables	408,400
Purchases	14,917,700
Discounts received	(34,800)
Closing trade payables	(517,740)
Purchases	14,773,560

Cash paid to and on behalf of employees	£
Wages and salaries	4,276,400
Accrued at start of year	4,320
Accrued at end of year	(5,700)
	4,275,020

Other cash payments	£
Rent, rates and insurance	546,870
Selling expenses	601,800
Accountancy	99,000
Sundries	254,300
	1,501,970
Prepaid at start of year	(2,450)
Prepaid at end of year	1,050
	1,500,570

Cash payments to suppliers	14,773,560
Cash paid to and on behalf of employees	4,275,020
Other cash payments	1,500,570
Cash paid to suppliers and employees	20,549,150

Taxation paid	
b/f at start of year	843,500
Charge in income statement	334,490
Transferred to deferred taxation	(100,000)
c/f at end of year	(336,140)
Paid during the year	741,850

Property, plant and equipment	
Cost/valuation	
At end of year	26,196,900
At start of year	18,264,800
Increase	7,932,100
Disposals	344,900
Purchases	8,277,000