CIPFA

FINANCIAL REPORTING

Certificate stage examination

6 June 2008

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

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Question 1

(a) **Troklanz plc**
Balance sheet as at 31 May 2008 *0.5*

	£000		
ASSETS			
Non-current assets			
Property, plant and equipment	91,620		*4*
Intangible	16,000		*1*
Investments	14,750		*0.5*
	122,370		
Current assets			
Inventories	62,980		*1*
Trade receivables	62,565		*1.5*
Cash and cash equivalents	13,400		*0.5*
	138,945		
Total assets	261,315		
EQUITY AND LIABILITIES			
Equity			
Share capital	132,000		*0.5*
Share premium	104,000		*0.5*
Revaluation reserve	12,720		*1*
Retained earnings	(93,965)	*	*0.5*
Total equity	154,755		
Non-current liabilities			
Bank loan, repayable 2010	14,500		*0.5*
11% Debentures	12,500		*1*
Total non-current liabilities	27,000		
Current liabilities			
Trade payables	74,600		*0.5*
Short-term borrowings	4,000		*0.5*
Current tax payable	960		*1*
Total current liabilities	79,560		
Total liabilities	106,560		
Total equity and liabilities	261,315		*15*

Presentation 1

* *balancing figure*

(16)

Workings

Property, plant and equipment

	Land	Buildings	Plant & Machinery	Total	
Cost	£000	£000	£000	£000	
per trial balance	12,000	48,000	135,980	195,980	*0.5*
Less cost withdrawn on assets sold			(19,850)	(19,850)	*1*
So, corrected cost as at end of year	12,000	48,000	116,130	176,130	
Accumulated depreciation					
per trial balance		10,800	73,400	84,200	*0.5*
Less depreciation withdrawn on assets sold			(15,430)	(15,430)	*1*
		10,800	57,970	68,770	
Charge for the year		1,200	14,540	15,740	*1*
		12,000	72,510	84,510	
Net book value				91,620	

Calculation of depreciation for the year	**Buildings**	**Plant & Machinery**
Rate	2.50%	25.00%
Method	Str. Line	Dim. Bal.
Depreciable amount	48,000	58,160 *
Charge for the year	1,200	14,540

* (116,130 less 57,970)

Non-current investments	£000
Carrying value	15,460
Diminution in value	710
	14,750
Written off Revaluation Reserve	380
Charged to income statement	330
	710

Inventory	£000
per valuation	65,300
exclude cost of inventory written down	2,455
	62,845
add scrap value	135
	62,980

Allowance for doubtful debts	£000
Old allowance	1,300
New allowance	1,935
Increase	635

Trade Receivables	£000
Trade receivables	64,500
Allowance for doubtful debts	(1,935)
	62,565

(b) **Statement of changes in equity for the year ended 31 May 2008**

	Share capital	**Share premium**	**Revaluation reserve**	**Retained earnings**	**Total**	
	£000	£000	£000	£000	£000	
Balance at 1 June 2007	80,000	117,600	11,400	(78,945)	130,055	*4*
Bonus issue	40,000	(40,000)			0	*2*
Rights issue	12,000	26,400			38,400	*2*
Increase in fair value of patents and trademarks			1,700		1,700	*1*
Write down of revalued asset			(380)		(380)	*1*
Profit for the year after tax				5,580	5,580	*1*
Dividends paid				(20,600)	(20,600)	*1*
Balance at 31 May 2008	132,000	104,000	12,720	(93,965)	154,755	*2*

(14)

(30)

Question 2

(a) IAS 38 *Intangible Assets* requires all intangible assets to be recognised initially at cost. After initial recognition intangible assets may be measured either using the cost model or a revaluation model.

Using the cost model, intangible assets will be carried at cost less accumulated amortisation and impairment losses.

Under the revaluation model, intangible assets will be carried at fair value less subsequent accumulated amortisation and impairment losses.

The problems in using the revaluation model include:

- Fair values are to be determined from an active market. This means that the items traded are homogeneous in a market consisting of willing buyers and sellers with market prices available to the public. It is unlikely that there will be an active market for most intangibles which tend to be unique in nature (e.g. brands, trademarks, copyrights) and fail the homogeneity test. This probably rules out the use of the revaluation model for most intangibles.
- Even if the homogeneity test is passed, there is additional work involved because fair values are to be reassessed regularly to ensure that the carrying value does not differ materially from fair value.
- If the revaluation model is adopted, all intangible assets in the same class must also be reported using the revaluation model in order to avoid a mixture of costs and fair values.
- Associated with the difficulties in implementing the above, using the revaluation model is clearly going to involve additional costs and reporting entities may doubt whether or not using the revaluation model passes the cost-benefit test.
- Neither the cost model nor the revaluation model is available for internally generated intangible assets which are therefore not recognised in the financial statements.

1 mark per valid point to a maximum of (5)

(b) **REPORT**

Financial performance of a retail company

From:
To:
Date:

Introduction

The company under review is a UK retail company. Few indicators of its size or significance have been provided. However, the company makes earnings of just over £40m from operations in 670 stores. This suggests an average profit of about £1,150 per store per week. Based on the net profit to sales ratio of 5% this gives a weekly turnover of approximately £23,000 per store. This suggests that the company operates a large number of relatively small outlets.

Scope of report

The following report analyses the financial performance of the company on the basis of a number of key performance indicators taken from the most recent financial statements of the company. These performance indicators are available for the past five financial years. A number of additional financial ratios are available for the past two years.

Key indicators

- Significant decline in sales growth;
- Sales in key core stores stagnant;
- Fewer new stores being opened;
- Declining capital expenditure;
- Declining earnings and earnings per share;
- Significant decline in liquidity ratios and cash holdings.

Analysis

2007 seems to have been a difficult year for this company, with almost all the performance indicators available showing either stagnation or significant declines.

Sales growth has declined consistently and significantly over the past three years. The growth in sales in 2007 was almost half of what it had been in 2006 and showed the lowest increase for the past five years. In particular, sales in the company's key stores were stagnant in 2007. This suggests that the small increase in overall turnover in 2007 was due to sales from new stores.

A total of 111 new stores were opened over the past five years, an increase of 20%. However, this tailed off in 2007 with only 9 new stores being opened.

This is partly reflected in a decline in capital expenditure in 2007. There is little information available about capital expenditure (significantly more information would be available in the published financial statements), but there may be evidence of a three year cycle with peaks in 2003 and 2006 and decreases in subsequent years.

Earnings before interest and tax were increasing each year, but there was a significant decline in 2007. Basic earnings per share seem to mirror earnings and this may suggest that there have not been significant changes in issued capital. However, there is insufficient information to be sure about this.

In terms of profitability gross margins, at 62% of sales, and administration costs, at 6.7% of sales, have remained constant over the past two years. However, a small but significant increase in distribution costs has reduced operating profit relative to sales in 2007. In 2007 every £100 of sales yielded an operating profit of £7 and this may (or may not) compare favourably with competitors.

Finance costs seem constant relative to sales, but finance income has halved relative to sales in 2007. Given the small increase in sales in 2007 this suggests that either investments have been sold or the return on investments has fallen. Either way the ratio of profit after tax to sales has fallen by about 1.5% in 2007.

Return on equity has barely changed in the past two years, but may be relatively healthy at just under 19%. However, gearing has increased because the percentage of total assets financed by equity has fallen. Given that finance costs seem to have been fairly constant, this may be evidence that the company reduced its capital in 2007. This can only be confirmed by looking at the financial statements.

Liquidity has fallen in 2007. Both the current ratio and the liquidity ratios fell in 2007. Although both were significantly below 1 to 1 in 2007, this may not be as dangerous as some textbooks suggest, given the nature of the business. However, cash and cash equivalents have fallen significantly from over £65m at the start of 2007 to less than £20m by the end of 2007. This may or may not be a cause for concern. The reasons for the fall can be analysed by looking at the cash flow statement in the financial statements.

The fact that the liquidity ratio is only marginally smaller than the current ratio suggests that the company holds relatively small inventories. Inventory control may be efficient, but many types of store need to hold significant levels of inventory as a minimum. The company's merchandise may therefore be perishable, e.g. food.

Summary

The small number of performance indicators available suggests that 2007 was a difficult and challenging year for this company. Further information is needed to investigate this further. It is not clear whether this company is repositioning itself for a secure and profitable future or entering a period of continued decline.

Caveats

This report has been limited to a study of a small number of performance indicators. It has been assumed that the data is comparable and has not been distorted by significant changes in accounting policies. It would have been useful to know more about the company, e.g. what sector it operates in, and to compare the results of the company with those of its competitors and the sector as a whole.

Report format: 2
Style and presentation: 5
Content: 1 mark per valid point up to a maximum of 18

(25)

(30)

Question 3

(a) **Marie plc** *0.5*
Consolidated Income Statement *1*
for the year ended 31 May 2008

	£m		*0.5*
Revenue	535.0	*H + S - intragroup sales*	*3*
Cost of goods sold	(253.3)	*see calculation*	*4*
Gross Profit	281.7		
Distribution costs	(50.5)	*H + S*	*1*
Administrative expenses	(83.3)	*H + S*	*1*
Operating profit	147.9		
Income from investments	11.0		*2*
Net profit	158.9		
Income tax expense	(60.0)	*H + S*	*1*
Profit for the period	98.9		
attributable to			
Equity shareholders	80.0		
Minority interest	18.9	*30% of S's profit after tax*	*3*
Profit for the period	98.9		

(17)

Workings

Revenue	£m
Marie plc	355.0
Blanche plc	300.0
Intragroup sales	(120.0)
	535.0

Unrealised profit	£m
Transfer price	120.0
Original cost	68.0
	52.0
Proportion unsold	25%
Unrealised profit	13.0
Cost of sales to be increased by	**Marie plc**

Cost of Sales	£m
Marie plc	195.3
Blanche plc	165.0
Intragroup sales	(120.0)
Provision for unrealised profit	13.0
	253.3

Minority interest	£m
Blanche plc's profit after tax	63.0
Minority interest	30%
	18.9

(b) Statement of changes in equity

	Ordinary shares	Retained earnings	Minority interest	Total	
	£m	£m	£m	£m	
At the start of the year	*xx*	*xx*	*xx*	*xx*	
Profit for the year		80.0	18.9	98.9	*1 ½*
Dividends		(30.0)	(12.0)	(42.0)	*1 ½*
		50.0	6.9	56.9	
At the end of the year	*xx*	*xx*	*xx*	*xx*	
	xx	*xx*	*xx*	*xx*	

(3)

(20)

Question 4

(a) (i)

Number of shares issued in rights issue	4,000,000	
So, total shares issued	24,000,000	

Calculation of theoretical ex-rights value per share

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

$$\frac{(£4.05 \times 20{,}000{,}000 \text{ shares}) + (£3.50 \times 4{,}000{,}000 \text{ shares})}{20{,}000{,}000 \text{ shares} + 4{,}000{,}000 \text{ shares}}$$ *2* *2*

95,000,000 divided by 24,000,000

= £ 3.96 per share *1*

Computation of adjustment factor

Fair value per share before exercise of rights	£ 4.05	
Theoretical ex-rights value per share	£ 3.96	
Adjustment factor	1.023157895	*2*

Calculation of earnings per share

Earnings attributable to ordinary shares	£	
Profit before tax	13,397,000	
Less tax	5,320,000	
	8,077,000	*1*
Weighted average number of shares issued		
First four months		
20,000,000 x 1.02316 x 4/12	6,821,053	
Last eight months		
24,000,000 x 8/12	16,000,000	
	22,821,053	*2*
Basic earnings per share	35.4 pence	*2*

(12)

(ii)

Bonus element on take up of potential ordinary shares 642,534
(2,000,000 x (£4.42 - £3.00)/£4.42)

Calculation of dilutive effect

Net profit from continuing operations	8,077,000	22,821,053	35.4	
Options	nil	642,534		*2*
	8,077,000	23,463,587	34.4	*2*

So, fully diluted earnings per share = 34.4 pence

(4)

(b) (i) In a defined contribution scheme the employer pays a regular contribution, usually a percentage of employees' pay, into a scheme. The money is invested and pensions are then paid to employees based on the contributions made.

In a defined benefit scheme the employer undertakes to provide employees with a pension based on remuneration at the time of retirement, for example, a pension of 1/80th of final salary for each year of service, up to a maximum of 40/80ths. *2*

(ii) This is the method advocated for a defined benefit scheme by IAS 19 which adopts a balance sheet approach. With this method, it is assumed that each period of service by an employee gives rise to an additional unit of future benefits. The present value of that unit of future benefits can be calculated, and attributed to the period in which the service is given. The units, each measured separately, build up to give the overall obligation. *2*

(4)

(20)

Question 5

Sipfalor plc
Cash flow statement for the year ended 31 May 2008 ½

Cash flow from operating activities		£	½
Cash receipts from customers		43,290,156	2
Cash paid to suppliers and employees		(36,529,992)	5
Cash generated from operations		6,760,164	
Interest paid		(812,500)	1
Income taxes paid		(261,440)	2
Net cash from operating activities		5,686,224	
Cash flows from investing activities			
Purchase of non-current assets	(23,913,660)		2
Proceeds from sales of plant and machinery	45,000		2
Net cash used in investing activities		(23,868,660)	
Cash flows from financing activities			
Proceeds from issuance of share capital	19,000,000		1
Issue of long-term borrowings	2,500,000		1
Dividends paid	(680,000)		1
Net cash used in financing activities		20,820,000	
Net increase in cash and cash equivalents		2,637,564	
Cash and cash equivalents at beginning of period		64,640	1
Cash and cash equivalents at end of period		2,702,204	1

(20)

Workings

Cash received from customers	£
Opening trade receivables	467,800
Sales	43,380,756
Closing trade receivables	(558,400)
Cash received from customers	43,290,156

Calculation of purchases	£
Cost of sales	25,050,812
add opening inventory	412,350
less closing inventory	(389,500)
	25,073,662

Cash payments to suppliers	£
Opening trade payables	309,800
Purchases	25,073,662
Closing trade payables	(409,800)
	24,973,662

Calculation of depreciation

Increase in provision	3,990,491
Withdrawn on disposals	276,160
Charge for the year	4,266,651

Profit/loss on sale of non-current assets

Carrying value	55,940
Proceeds	45,000
Loss	(10,940)

Purchases of non current assets

Increase in cost	23,781,560
Withdrawn on disposal	332,100
Revaluation surplus	(200,000)
	23,913,660

Cash paid to suppliers and employees

Cash payments to suppliers	24,973,662
Operating expenses	15,833,481
	40,807,143
Accrued at start of year	4,560
Accrued at the end of the year	(5,140)
Prepaid at the start of the year	(1,540)
Prepaid at the end of the year	2,560
	40,807,583
Exclude depreciation	(4,266,651)
Exclude profit on sale of non current assets	(10,940)
	36,529,992

Taxation paid

b/f at start of year	389,740
Income statement	278,793
Transferred to deferred taxation	(70,300)
c/f at end of year	(336,793)
Paid during the year	261,440