FINANCIAL REPORTING

Certificate stage examination
8 June 2004

From 2.00 pm to 5.00 pm
plus ten minutes reading time from 1.50 pm to 2.00 pm.

Instructions to candidates

Answer ***four*** *questions in total:* ***both*** *questions in* ***Section A*** *and* ***two*** *of the three questions in* ***Section B****. The marks available for each question are shown in italics in the right hand margin.*

All workings should be shown. Where calculations are required using formulae, calculators may be used but steps in the workings must be shown. Calculations with no evidence of this (for example, using the scientific functions of calculators) will receive no credit. Programmable calculators are not permitted in the examination room.

Formula sheets, statistical tables, graph paper and cash analysis paper are available from the invigilator, where applicable.

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.

Proforma profit and loss account, balance sheet, cash flow statement and statement of total recognised gains and losses are appended to this paper and may be submitted as part of an answer.

CIPFA

SECTION A (Answer all questions)

1 The following trial balance has been extracted from the records of Rarablat plc as at 31 March 2004, the end of its most recent financial year.

	Notes	Dr £m	Cr £m
Sales			25,400
Cost of sales		18,500	
Stock, 31 March 2004		1,240	
Administrative expenses		2,440	
Distribution costs		1,910	
Interim dividend		320	
Other operating income			510
Overprovision for corporation tax for 2002/2003			119
Fixed asset investments	*5*	1,310	
Investment income			115
Interest payable		250	
Freehold properties at valuation			
Land		900	
Buildings		8,400	
Plant and machinery at cost	*1, 2, 3, 4*	3,520	
Accumulated depreciation as at 1 April 2003			
Buildings			730
Plant and machinery			1,570
Proceeds on sale of assets	*2*		230
Trade debtors and creditors		2,400	1,950
Provision for doubtful debts, 31 March 2004			56
Cash at bank and in hand		324	
Bank loans			
Due for repayment 1 September 2004			280
Due for repayment in 2008			1,880
10% Debentures 2010/15			1,000
Issued share capital (all ordinary shares of £1 each)			4,000
Share premium account			800
Revaluation reserve			550
Profit and loss account, 1 April 2003			2,324
		41,514	41,514

The following additional information is available:

1 The costs or valuations of tangible fixed assets as at 1 April 2003 were:

	£m
Land	650
Buildings	8,100
Plant and machinery	2,230

2 During the year ended 31 March 2004 buildings costing £150m (carrying value £110m) and plant and machinery costing £450m (carrying value £70m) were sold for £230m. The proceeds from the sales were debited to bank and credited to proceeds on sale of assets account. No other entries were made in the accounts. Any gain or loss on the disposal of fixed assets is to be included in cost of sales.

3 Included in plant and machinery are the following website costs:

	£m
Planning costs	5
Infrastructure costs	10
Design and content costs	4
Maintenance costs	3
	22

These costs relate to a website project which was set up during the year ended 31 March 2004. The website will be used to generate sales and the directors feel that it is commercially viable and will generate a significant contribution to revenue without adversely affecting current sales.

4 Rarablat plc's depreciation policies are:

- Land: no depreciation charged.
- Buildings: 2.5% per year using the straight line method.
- Plant and machinery: 30% per year using the diminishing balance method.

Depreciation is charged for a full year in the year of acquisition; no depreciation is charged in the year of disposal.

Depreciation is to be allocated between cost of sales and administrative expenses in the ratio 3:2.

5 Fixed asset investments include certain equity investments which cost £200m. These were revalued upwards to £300m during the year ended 31 March 2001. The directors have now decided to recognise a permanent diminution in the value of these investments and write them down to £185m as at 31 March 2004. None of these holdings of equity shares gives rise to a participating interest.

6 Provide the following for the year ended 31 March 2004:

- Corporation tax of £960m on the profits for 2003/2004.
- A proposed ordinary dividend of £0.10 per share.

- **Requirement for question 1**

(a) Prepare the disclosure note showing movements in tangible fixed assets for the year ended 31 March 2004 in so far as the above information permits. Round all figures to the nearest £m. *10*

(b) Prepare Rarablat plc's profit and loss account for the year ended 31 March 2004 and its balance sheet as at 31 March 2004 in so far as the above information permits. Additional notes and disclosures are not required. Round all figures to the nearest £m. *20*

(30)

2

The last financial year of Orolat plc, whose shares are publicly traded, ended on 31 March 2004. On 1 April 2003 the share capital of Orolat was as follows:

	Authorised	Issued
	£	£
Ordinary shares of £0.50	100,000,000	40,000,000
9% Preference shares of £1	25,000,000	20,000,000

On 1 July 2003 Orolat plc made a rights issue of 1 for 8 at an exercise price of £4.20. The market value of each ordinary share on 1 July 2003 before the issue was £6.20 per share. The new shares were eligible for all subsequent dividends.

Orolat plc's retained profit for the year ended 31 March 2004 was £5,260,000. Orolat plc paid an interim dividend of £4,500,000 on the ordinary shares and proposed a final ordinary dividend of £6,750,000. The total taxation charge for the year ended 31 March 2004 was £6,400,000.

The market value of each ordinary share on 31 March 2004 was £5.00.

- **Requirement for question 2**

(a) Calculate Orolat plc's basic earnings per share for the year ended 31 March 2004 in accordance with the provisions of FRS 14 *Earnings per share*. *14*

(b) Calculate Orolat plc's PE ratio as at 31 March 2004. *2*

(c) Explain clearly what the PE ratio measures and its usefulness as a performance indicator for an investor. *4*

(d) FRED 26 *Earnings per share* proposes a number of changes to FRS 14 *Earnings per share*.

(i) Summarise the main changes proposed by FRED 26. *3*

(ii) Explain briefly the ASB's rationale for revising FRS 14. *2*

(e) FRED 27 *Events after the Balance Sheet date* proposes changes to the current treatment of proposed dividends in UK financial statements.

(i) Explain the proposed change in the treatment of proposed dividends. 3

(ii) Explain briefly the ASB's rationale for changing the treatment of proposed dividends. *2*

(30)

SECTION B (Answer two questions from this section)

3

You have been asked to prepare a report for your supervisor on the recent performance of Stimlat Ltd, a UK private company. Your supervisor has told you that she is not interested in reading a lengthy report and that she needs 'about a page and a half' identifying clearly the main issues.

You have obtained the company's financial statements for the past three years and have calculated a number of performance indicators for the past three financial years ending on 31 December. You have also obtained average (ie median) values for quoted companies in the same sector from an online financial database. The information available to you is summarised below:

		Stimlat Ltd			*Industry average*
		2001	**2002**	**2003**	***2003***
1	Profit to capital employed (%)	31.2%	14.9%	3.9%	21.0%
2	Profit to sales (%)	29.9%	15.0%	4.1%	21.0%
3	Sales to capital employed (times)	1.0	1.0	1.0	1.0
4	Production costs to sales (%)	42.0%	51.6%	60.3%	42.4%
5	Distribution costs to sales (%)	12.0%	12.4%	12.6%	15.0%
6	Administrative expenses to sales (%)	10.0%	11.0%	12.0%	13.0%
7	Interest payable to sales (%)	6.1%	10.0%	11.0%	8.6%
8	Materials cost to sales (%)	20.0%	24.0%	28.0%	18.0%
9	Direct labour costs to sales (%)	12.0%	12.6%	12.3%	12.4%
10	Factory overheads to sales (%)	10.0%	15.0%	20.0%	12.0%
11	Capital employed per £000 sales	958.0	1,004.0	1,050.5	1,000.2
12	Fixed assets per £000 sales	840.0	860.0	875.0	805.2
13	Net current assets per £000 sales	118.0	144.0	175.5	195.0
14	Stocks per £000 sales	100.0	103.0	102.0	160.0
15	Debtors per £000 sales	170.0	200.0	240.0	160.0
16	Bank and cash per £000 sales	14.0	11.0	8.5	15.0
17	Short-term creditors per £000 sales	166.0	170.0	175.0	140.0

- **Requirement for question 3**

Prepare a suitable report for your supervisor on the performance of Stimlat Ltd which:

- Analyses Stimlat Ltd's profitability.
- Analyses Stimlat Ltd's liquidity.
- Analyses Stimlat Ltd's assets utilisation (including working capital management).
- Compares Stimlat Ltd's performance with that of its industry sector.
- Makes recommendations as to how the performance of Stimlat Ltd could be improved.
- Indicates any reservations you have about your analysis. ***(20)***

4

The following information has been extracted from the most recent profit and loss account of Declat plc:

Declat plc
Profit and Loss account for the year ended 31 March

		2004		**2003**
		£000		**£000**
Turnover		1,100		900
Acquisitions (Note 1)		300		
		1,400		900
Discontinued		200		350
		1,600		1,250
Cost of sales		(1,190)		(870)
Gross profit		410		380
Operating expenses		(279)		(230)
Operating profit				
Continuing operations	60		130	
Acquisitions	60			
	120		130	
Discontinued	11		20	
		131		150
Profit on sale of activity		125		
		256		150

Note 1

The acquisition was made 7 months into the financial year.

Note 2

	2004				**2003**		
	Continuing		*Discontinued*	*Total*	*Continuing*	*Discontinued*	*Total*
	£000	*£000*	*£000*	*£000*	*£000*	*£000*	*£000*
	Acquisitions						
Cost of sales	200	880	110	1,190	640	230	870
Operating expenses	40	160	79	279	130	100	230

Note 3

During the year ended 31 March 2005 Declat plc expects that:

- there will be no acquisitions or disposals;
- selling prices will be reduced by 2.5%;
- purchase prices will fall by 3%;
- stock levels will remain unchanged;
- the volume of sales and purchases will increase by 15%; and
- operating expenses will increase by 12%.

- **Requirement for question 4**

(a) Estimate the following for the year ended 31 March 2005:

(i) Turnover
(ii) Cost of sales
(iii) Gross profit
(iv) Operating expenses
(v) Operating profit
(vi) Gross margin
(vii) Operating profit percentage *8*

(b) Explain the disclosure requirements of FRS 3 and comment on how they improve the predictive quality of the profit and loss account. Illustrate your answer using the recent and projected figures for Declat Ltd. *12*

(20)

5 The accountant of Tarblat Ltd has prepared the following draft internal accounts for the financial year ended 31 May 2004. Comparative figures for the previous financial year are shown in italics.

Tarblat Ltd
Profit and Loss Accounts for the years ended 31 May

			2004		***2003***
			£		*£*
Sales			15,500,000		*13,950,000*
less	Cost of goods sold	£		*£*	
	Stock at 1 June	90,000		*80,000*	
	Purchases	11,665,000		*9,775,000*	
		11,755,000		*9,855,000*	
	Stock at 31 May	(130,000)		*(90,000)*	
			11,625,000		*9,765,000*
Gross profit			3,875,000		*4,185,000*
Add	Other income				
	Discounts received		36,000		*39,600*
			3,911,000		*4,224,600*
less	Operating expenses				
	Wages and salaries	1,616,000		*1,702,000*	
	Selling expenses	555,800		*484,000*	
	Rent, rates and insurance	304,000		*296,000*	
	Depreciation	483,500		*373,000*	
	Discounts allowed	23,000		*40,000*	
	Accountancy and audit	85,250		*75,250*	
	Interest payable	26,000		*20,000*	
	Other expenses	44,200		*47,600*	
			3,137,750		*3,037,850*
Net profit			773,250		*1,186,750*
Taxation			235,700		*160,000*
Net profit after taxation			537,550		*1,026,750*
Dividends paid and proposed			440,000		*400,000*
Retained profit			97,550		*626,750*

Tarblat Ltd
Balance Sheets as at 31 May

	2004		2003	
Fixed Assets	**£**	**£**	**£**	**£**
Freehold property, at cost/valuation	5,700,000		*4,000,000*	
Accumulated depreciation	(642,500)		*(500,000)*	
		5,057,500		*3,500,000*
Plant and machinery, at cost	1,200,000		*900,000*	
Accumulated depreciation	(345,000)		*(225,000)*	
		855,000		*675,000*
Motor vehicles, at cost	300,000		*300,000*	
Accumulated depreciation	(165,000)		*(120,000)*	
		135,000		*180,000*
		6,047,500		*4,355,000*
Current Assets				
Stock	130,000		*90,000*	
Trade debtors	650,000		*380,000*	
Prepaid expenses	1,100		*1,500*	
Cash at bank	85,750		*55,000*	
	866,850		*526,500*	
Creditors: amounts falling due within one year				
Trade Creditors	300,000		*220,000*	
Accrued expenses	2,000		*3,000*	
Bank overdraft	134,300		*0*	
Corporation tax payable	232,000		*160,000*	
Proposed dividends	230,000		*200,000*	
	898,300		*583,000*	
Net Current Assets		(31,450)		*(56,500)*
		6,016,050		*4,298,500*
Creditors: amounts falling due after more than one year				
Debentures		(120,000)		*(400,000)*
		5,896,050		*3,898,500*
Share Capital and Reserves				
Issued share capital		2,500,000		*2,000,000*
Share premium		300,000		*200,000*
Revaluation reserve		1,300,000		*0*
Profit and loss account		1,796,050		*1,698,500*
		5,896,050		*3,898,500*

The following additional information is available:

1 During the year ended 31 May 2004 plant and machinery which cost £217,000 and which had a book value of £60,000 was sold for £41,000. The loss on disposal has been included in the depreciation charge for the year.

2 During the year ended 31 May 2004 Tarblat Ltd paid an interim dividend of £210,000 to its shareholders.

3 The figures for accrued expenses in the balance sheets are for wages and salaries. The figures for prepaid expenses in the balance sheets are for rates and insurance.

- **Requirement for question 5**

Prepare clear calculations of the following amounts to be included in Tarblat Ltd's Cash Flow Statement, prepared in accordance with FRS 1, for the year ended 31 May 2004:

(a) The net cash flow from operating activities using the direct method. *6*

(b) The net cash flow from operating activities using the indirect method. *6*

(c) The amounts to be disclosed under the heading 'Capital expenditure'. *4*

(d) The amounts to be disclosed under the heading 'Financing'. *2*

(e) The reconciliation of net cash flow to movement in net debt for the year ended 31 May 2004. *2*

Note: you do not need to prepare the full cash flow statement.

(20)

PROFORMA PROFIT AND LOSS ACCOUNT

	Continuing operations	acquisitions	discontinued	total
	£	£	£	£
Turnover				
Cost of sales				
Gross profit or loss				
Distribution costs				
Administration costs				
Other operating income				
Operating profit or loss				
Exceptional items				
Profit or loss on ordinary activities before interest				
Interest receivable				
Interest payable				
Profit or loss on ordinary activities before tax				
Taxation				
Profit or loss for the financial year				
Dividends				
Retained profit for the financial year				

PROFORMA BALANCE SHEET

Fixed assets
- intangible assets
- tangible assets
- investments

Current assets
- stock
- debtors
- investments
- cash at bank and in hand

Prepayments and accrued income

Creditors: amounts falling due within one year
- trade creditors
- tax
- loans
- dividends
- other creditors
- accruals and deferred income

NET CURRENT ASSETS

TOTAL ASSETS LESS CURRENT LIABILITIES

Creditors: amounts falling due after more than one year

Provisions for liabilities and charges

CAPITAL AND RESERVES
Called up share capital

Share premium account

Revaluation reserve

Other reserves

Retained profits

PROFORMA CASH FLOW STATEMENT

Net cash inflow from operating activities

Returns on investments and servicing of finance

Taxation

Capital expenditure and financial investment

Equity dividends paid

Management of liquid resources

Financing

Increase in cash

PROFORMA STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

Profit for the financial year

Revaluation reserve arising during the year

Exchange adjustments

TOTAL RECOGNISED GAINS AND LOSSES FOR THE FINANCIAL YEAR

Prior year adjustments

TOTAL GAINS AND LOSSES RECOGNISED SINCE LAST ANNUAL REPORT