FINANCIAL REPORTING

Certificate stage examination
9 December 2005

From 10.00am to 1.00pm
plus ten minutes reading time from 9.50am to 10.00am

Instructions to candidates

Answer ***four*** *questions in total:* ***Two*** *questions from* ***Section A*** *and* ***two*** *questions from* ***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 (Compulsory)

1

The following trial balance has been extracted from the records of Beniox plc as at 31 October 2005, the end of its most recent financial year.

	Notes	*Dr* £m	*Cr* £m
Sales			1,160
Cost of sales		858	
Stock, 31 October 2005	*1*	43	
Administrative expenses		163	
Other operating income			14
Fixed asset investments	*2*	55	
Investment income			4
Interest payable		14	
Freehold properties at valuation	*3, 4, 5*		
Land		91	
Buildings		134	
Equipment, at cost	*3, 4, 5*	220	
Accumulated depreciation			
Buildings			17
Equipment			99
Proceeds from sales of fixed assets	*4*		9
Goodwill, written down value	*6*	12	
Trade debtors		129	
Trade creditors			48
Allowance for doubtful debts, 1 November 2004	*7*		9
Cash at bank and in hand		33	
Bank loans	*8*		45
9% Debentures 2015			60
Issued ordinary share capital	*10*		150
Share premium account			20
Revaluation reserve			44
Profit and loss account, 1 November 2004			84
Underprovision for corporation tax for 2003/2004		3	
Interim dividend paid		8	
		1,763	1,763

The following additional information is available:

1 Included in stock as at 31 October 2005 are items valued at their cost of £41m. The directors now feel that these items were obsolete as at 31 October 2005 and had a net realisable value of £17m.

It has also recently been discovered that stock as at 1 November 2004 was understated by £5m because of an error.

2 Fixed asset investments include equity investments which cost £20m. The directors have decided to adjust the carrying value of these investments to £26m. These investments had been previously revalued to £30m but the directors feel that there was a permanent diminution in the recoverable amount of these investments during the year ended 31 October 2005. None of the holdings of equity shares gives rise to a participating interest.

3 The costs or valuations of tangible fixed assets as at 1 November 2004 were:

	£m
Land	71
Buildings	104
Equipment	180

4 During the year ended 31 October 2005 land costing £20m, buildings costing £30m and equipment costing £40m were purchased. There were no revaluations or impairments of tangible fixed assets during the year. However, buildings with a carrying value of £16m (cost £23m) and equipment with a carrying value of £5m (cost £34m) were sold. The proceeds from the sales were debited to bank and credited to proceeds from sales of assets account. Any gain or loss on the sales of fixed assets is to be included in cost of sales.

5 Beniox plc's depreciation policies are:

- Land: no depreciation charged
- Buildings: 5% per year using the straight line method
- Equipment: 25% per year using the diminishing balance method

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

Depreciation is to be allocated 80% to cost of sales and 20% to administrative expenses.

6 The goodwill arose on the acquisition of an unincorporated business on 1 November 2002. The goodwill is being written off equally over its total estimated economic life of 6 years. Goodwill has not yet been amortised for the year ended 31 October 2005.

7 The allowance for doubtful debts is to be adjusted to 4% of trade debtors.

8 Bank loans comprise the following:

- Bank loan of £25m due for repayment on 31 October 2006
- Bank loan of £10m due for repayment on 1 December 2006
- Bank loan of £10m due for repayment on 1 July 2008

9 The following are to be included in the financial statements for the year ended 31 October 2005:

- Corporation tax of £8m on the profits for 2004/2005
- A proposed ordinary dividend of 7 pence per share

10 The issued share capital of Beniox plc consists of ordinary shares of £1 each.

- **Requirement for question 1**

(a) Prepare the disclosure note showing movements in tangible fixed assets for the year ended 31 October 2005 in so far as the above information permits. *7*

Note
- Round all figures to the nearest £m.

(b) Prepare Beniox plc's profit and loss account for the year ended 31 October 2005 *and* its balance sheet as at 31 October 2005 in so far as the above information permits. *23*

Note
- Additional notes and disclosures are not required.
- Disclosure of earnings per share is not required.
- Round all figures to the nearest £m.

(30)

2

You work for Robovert plc. You have been asked to prepare a report for your supervisor on how the performance of Robovert plc compares with other similar companies. Your supervisor does not wish to read a lengthy report and has indicated that 'about a couple of pages identifying clearly the main issues' are required.

You obtain the most recent financial statements of Robovert plc and three of its competitors. Using these you calculate the following ratio values:

		Robovert Plc	Competitor A	Competitor B	Competitor C
1	Net profit to total assets	6.3%	9.8%	22.6%	19.3%
2	Net profit to turnover	5.0%	8.0%	18.5%	13.5%
3	Turnover to total assets (times)	1.25	1.22	1.22	1.43
4	Gross profit to turnover	20.0%	17.0%	28.5%	22.5%
5	Administrative expenses to turnover	12.0%	7.5%	8.0%	7.5%
6	Distribution costs to turnover	3.0%	1.5%	2.0%	1.5%
7	Turnover to fixed assets (times)	1.67	1.61	1.57	1.75
8	Turnover to current assets (times)	5.00	5.00	5.41	7.69
9	Current ratio	1.33	1.25	1.37	0.93
10	Acid test ratio	0.90	0.81	1.07	0.71
11	Stock to sales	6.5%	7.0%	4.0%	3.0%
12	Debtors to sales	11.5%	9.5%	7.0%	5.0%
13	Cash to sales	2.0%	3.5%	7.5%	5.0%

- **Requirement for question 2**

(a) Prepare a report analysing the performance of Robovert plc for your supervisor. Your report should:

- Compare Robovert plc's profitability, assets utilisation and liquidity with its competitors *16*
- Make clear recommendations on how the performance of Robovert plc could be improved *4*
- Indicate any limitations of your analysis. *4*

(b) Discuss the issue of comparability within the context of ratio analysis. Why is comparability important and how can comparability be enhanced? *6*

(30)

SECTION B (Answer two questions from this section)

3

You have been asked to help an accounting trainee who is preparing the cash flow statement for an entity. The trainee has been asked to calculate the cash flow from operating activities using the indirect method – but is having difficulties.

The trainee has provided you with the following draft (but incorrect) calculation of the cash flow from operating activities:

	£
Net profit before tax	656,250
Interest paid	17,000
Depreciation charges	349,550
Profit on sale of tangible fixed assets	5,000
Increase in stocks	10,000
Decrease in debtors	22,300
Decrease in prepaid expenses	770
Increase in creditors	60,000
Increase in accrued expenses	2,050
	1,120,870

You examine the draft financial statements and discover the following:

(a) The trainee's figures are arithmetically correct and the trainee has correctly identified whether items have increased or decreased over the year.

(b) The interest paid figure of £17,000 is the actual amount paid during the financial year and does not take into account accrued interest of £600 at the end of the financial year. All other accruals are for wages and salaries.

(c) All prepayments are for property occupancy costs.

(d) The following totals are available for the financial year:

	£
Sales (cash and credit)	12,000,000
Purchases (all on credit)	9,010,000
Discounts received	23,000
Discounts allowed	17,400
Wages and salaries	1,160,000
Other expenses excluding interest and depreciation	827,200

- **Requirement for question 3**

(a) Prepare a corrected calculation of the cash flow from operating activities using the indirect method. *6*

(b) Prepare notes for a meeting with the trainee which will explain clearly the treatment of each of the items in the *corrected* calculation of cash flow. *6*

(c) Prepare a calculation of the cash flow from operating activities using the direct method. *8*

(20)

4

Lees Ltd is about to lease an assembly machine on a finance lease. The terms of the lease require Lees Ltd to make 5 rental payments of £18,000 annually in advance. The fair value of the assembly machine is £75,000 and its economic life is 5 years with no residual value. The rate of corporation tax is 30% and the rate of interest implicit in the lease is 10.05%.

- **Requirement for question 4**

(a) Explain why this lease is a finance lease and not an operating lease. *3*

(b) Prepare a table showing how the finance charge in this lease would be allocated to each of the five years using each of the following methods:

(i) straight line method
(ii) rule of 78 method
(iii) actuarial method *6*

(c) State with reasons which of the methods in (b) above best achieves the objectives of SSAP 21 *Accounting for leases and hire purchase transactions*. *3*

(d) Show how the finance lease would be reported in the profit and loss account of Lees Ltd for each of the first two years of the lease using the actuarial method. *4*

(e) Show how the finance lease would be reported in the balance sheet of Lees Ltd as at the end of the first and second years of the lease using the actuarial method. *4*

(20)

5

Satirac plc is preparing its financial statements for the financial year ended 31 October 2005 and has asked you for guidance on a number of issues.

(a) **Nursing homes**

Satirac plc purchases properties throughout the country and redevelops them as residential nursing homes. An important consideration in deciding which properties to purchase is the property's potential for capital growth and alternative use potential. Each nursing home is run by a subsidiary company of Satirac plc which recruits its staff locally and pays a rental to Satirac plc. The rental is fixed independently by a local property consultant.

(b) **Investment properties**

Satirac plc has specific problems with two investment properties, property A and property B.

Property A was purchased in 2003 for £5m. It was valued at £6m as at 31 October 2003 and at £7m at 31 October 2004. During the year ended 31 October 2005 this property was sold for £7.5m.

Property B was purchased in 2004 for £4m and was valued at £5m at 31 October 2004 and at £3.8m as at 31 October 2005.

(c) **Coffee shop**

Satirac plc is diversifying and, in September 2005, purchased, as a going concern, an established coffee shop which is run under a well known national franchise. The purchase price was £250,000 and Satirac plc took over the premises, fixtures, fittings and equipment, and the franchise at the following agreed values:

	£
Premises (10 year lease)	150,000
Fixtures, fittings and equipment (5 years remaining economic life)	50,000
Franchise (10 year franchise)	70,000

(d) **Provision**

Satirac plc made a provision in its financial statements for the year ended 31 October 2004 in anticipation of damages and legal fees in connection with a legal action brought against it by a supplier. The case was heard in July 2005 and was decided in Satirac plc's favour and no damages were awarded and no costs were incurred. Although there are no claims currently against the company the directors wish to carry forward the provision in the accounts to cushion it against possible future claims.

- **Requirement for question 5**

(a) Define an investment property and discuss whether or not Satirac plc can treat its nursing homes (see (a) above) as investment properties in its financial statements. *5*

(b) Explain how each of the investment properties (see (b) above) would be treated in the financial statements for the year ended 31 October 2005. *6*

(c) Explain, giving your reasons, how the franchise and goodwill in connection with the purchase of the coffee shop (see (c) above) should be treated in the financial statements for the year ended 31 October 2005. *7*

(d) Advise the directors on their proposed treatment of the provision (see (d) above) in the accounts for the year ended 31 October 2005. *2*

(20)