

Financial Reporting and Analysis

Sample paper

Suggested answers

Important notice

When reading these answers, please note that they are not intended to be viewed as a definitive 'model' answer, as in many instances there are several possible answers/approaches to a question. These answers indicate a range of appropriate content that could have been provided in answer to the questions. They may be a different length or format to the answers expected from candidates in the examination.

Section A

1. You are the company secretary of Highbury plc ('Highbury') and the summarised draft accounts prepared for the year to 31 March 2010 contained the following information:

Statement of comprehensive income for the year ended 31 March		
	2010	2009
	£000	£000
Revenue	12,296	10,260
Profit on sale of investments surplus to requirements	602	-
	12,898	10,260
Cost of goods sold	7,376	6,182
Depreciation	556	440
Distribution, selling and marketing costs	3,307	2,761
Directors' emoluments	400	357
Finance charge	72	-
Profit on ordinary activities before tax	1,187	520
Taxation	350	200
Profit for the year	837	320
Dividends paid	180	180
Retained profit for the year	657	140

Statement of financial position at 31 March		
	2010	2009
	£000	£000
Non-current assets		
Land, buildings, plant and machinery at cost less depreciation	2,647	1,756
Goodwill at cost	340	-
Quoted investments at cost	-	400
	2,987	2,156
Current assets		
Inventories	2,490	1,951
Trade receivables	2,280	1,701
Cash at bank and in hand	-	26
	4,770	3,678
	7,757	5,834
Equity and liabilities		
Called up share capital (£1 shares)	1,800	1,800
Retained earnings	2,226	1,569
	4,026	3,369
Non-current liabilities		
Provision for deferred taxation	1,452	1,272
	1,452	1,272
Current liabilities		
Bank overdraft	564	-
Trade payables	1,545	983
Corporation tax	170	210
	2,279	1,193
	7,757	5,834

In April 2009, Highbury added to its existing operations by acquiring the business assets of Wheatsheaf Ltd, a local competitor trading with a turnover of £2,000,000 per annum. The purchase price of £1,400,000 included acquisition of plant and machinery worth £700,000 and inventories worth £360,000.

Required

Prepare a report for the board of directors of Highbury on the company's financial progress during the year to 31 March 2010 and on its financial position at that date based on the information provided above. You should support your analysis with relevant accounting ratios covering: profit margins; return on investment; asset utilisation; and short-term liquidity.

(25 marks)

Suggested answer

Date: 30 April 2010

To: The board of directors of Highbury

From: Company secretary

Subject: Report on financial progress and position of Highbury for the year to 31 March 2010

A study of the company's performance indicates the developments and trends discussed below. This is based on comparison of accounting ratios (set out in the Appendix to this report) for the current year compared with those of the preceding year.

Acquisition of W heatsheaf Ltd

The turnover of the company has increased during the year by £2,036,000. This is almost entirely attributable to the acquisition of W heatsheaf Ltd at the beginning of the year, as we were told that the annual turnover of this company was £2 million.

The sale of the quoted investments has provided a total cash injection of £1,002,000, meeting nearly three-quarters of the cost of the acquisition of W heatsheaf Ltd.

Profit margins

The gross profit percentage has remained almost unchanged at 40%, reflecting the fact that the cost of goods sold has increased in line with turnover. The small increase is welcome.

The operating profit percentage has fallen by 0.2%. This is surprising in view of the substantial increase in sales and the fact that costs of sales have remained stable at about 60%. The explanation is the more than proportionate increase in the depreciation charge. This suggests that non-current assets purchased during the year are not yet being fully utilised.

Return on investment

The return on gross assets has shown a marginal decline, indicating that the management is using the total assets at its disposal a little less efficiently than in the preceding year.

The earnings per share which, in order to comply with the provisions of IAS 33 must include the exceptional item (profit on sale of investment), shows a significant increase from 17.8p to 46.5p. This is good news for the shareholders in the current year but, as indicated above, is due to a non-recurring event which cannot be repeated.

Asset utilisation

The total asset turnover has declined from 1.76:1 to 1.59:1.

Applying the Du Pont formula, the decline in the total asset turnover more than outweighs the small rise in the operating profit percentage, explaining the overall decline in return on gross assets.

Further interrogation of asset utilisation is provided by the rates of inventories turnover and trade receivables turnover. Each of these have declined over the year, respectively by 8 days and 7.2 days. This matter is discussed further below.

Short-term liquidity

The short-term liquidity ratios of Highbury each show a significant reduction due principally to the substantial bank overdraft raised to part finance the acquisition of W heatsheaf Ltd.

However, each of these ratios remains fairly healthy by comparison with conventional 'norms'.

The level of reliance on external funding has increased during the year with the shareholders' proportion of total finance declining from 57.7% to 51.9%. The shareholders' equity has in fact increased during the year but external finance has increased more than proportionately. This is principally represented by the bank overdraft and the significant increase in trade payables; an increase disproportionate to the increased level of activity.

No interest was payable in the year to 31 March 2009, whereas £72,000 was payable in the most recent accounting period. However, the interest cover calculation of 9.1x indicates no cause for concern in this area.

Further issue

Further matters which require the attention of Highbury's management include the accounting treatment of goodwill.

The goodwill arising on the acquisition of Wheatsheaf Ltd amounts to £340,000. It is a requirement of IAS 38 'Intangible Assets' that this item should be the subject of an annual impairment charge. Management should take steps to ensure that effect is given to this requirement for the purpose of the published accounts.

Appendix

	Calculation	2010	Ratio
Profit margins			
Gross profit percentage*	$12,296-7,376/12,296 \times 100$	40%	
	$10,260-6,182/10,260 \times 100$		39.7%
Operating profit percentage*	$1,187-602+72=657/12,296 \times 100$	5.3%	
	$520/10,260 \times 100$		5.1%
Return on investment			
Return on capital employed/shareholders' equity*	$585/4,026 \times 100$	14.5%	
	$520/3,369 \times 100$		15.4%
Earnings per share	$837/1,800 \times 100$	46.5p	
	$320/1,800 \times 100$		17.8p
Return on gross assets*	$657/7,757 \times 100$	8.5%	
	$520/5,834 \times 100$		8.9%
Asset utilisation			
Asset turnover ratio	$12,296:7,757$	1.59:1	
	$10,260:5,834$		1.76:1
Inventory turnover ratio	$2,490/7,376 \times 365$	123 days	
	$1,951/6,182 \times 365$		115 days
Trade receivables turnover	$2,280/12,296 \times 365$	67.7 days	
	$1,701/10,260 \times 365$		60.5 days
Short-term liquidity			
Current ratio	$4,770:2,279$	2.1:1	
	$3,678:1,193$		3.1:1
Liquidity (acid test) ratio	$2,280:2,279$	1:1	
	$1,727:1,193$		1.4:1
Leverage effect			
Shareholders' gearing ratio	$4,026/7,757 \times 100$	51.9%	
	$3,369/5,834 \times 100$		57.7%
Interest cover*	$657:72$	9.1x	
			n/a

* Excluding profit on the sale of investments.

Credit will be given for any reasonable alternative calculations of ratios.

Section B

2. The summarised statements of comprehensive income and financial position of the Sturton group of companies ('the Sturton group') for 2009 were as follows:

Statement of comprehensive income for the year ending 31 December 2009	
	2009
	£000
Revenue	61,345
Cost of sales	- 45,890
Gross profit	15,455
Net operating expenses	-10,190
Share of operating profits of associated company	780
Operating profit	6,045
Finance costs	-666
Profit before tax	5,379
Taxation	-3,100
Profit after tax	2,279
Attributable to:	
Equity holders of the parent company	1,593
Minority interest	686

(continued)

Statement of financial position at 31 March 2009		
	2009	2008
	£000	£000
Assets		
<i>Non-current assets</i>		
Property, plant and equipment	5,400	3,250
Goodwill at cost	1,250	800
Investments in associated company	940	575
	<u>7,590</u>	<u>4,625</u>
<i>Current assets</i>		
Inventories	3,344	4,020
Trade receivables	4,009	3,955
Cash and cash equivalents	1,111	888
	<u>8,464</u>	<u>8,863</u>
	<u>16,054</u>	<u>13,488</u>
Equity		
<i>Parent company shareholders' equity</i>		
Share capital	1,396	1,346
Other reserves	556	345
Retained earnings	2,893	1,300
	<u>4,845</u>	<u>2,991</u>
Minority interest	666	540
Total equity	<u>5,511</u>	<u>3,531</u>
<i>Non-current liabilities</i>		
Long-term borrowings	3,006	2,708
Deferred taxation	825	746
	<u>3,831</u>	<u>3,454</u>
<i>Current liabilities</i>		
Trade and other payables	4,443	3,896
Short-term borrowings	1,555	2,040
Taxation	714	567
	<u>6,712</u>	<u>6,503</u>
	<u>16,054</u>	<u>13,488</u>

You are provided with the following additional information:

(i)	Property, plant and equipment	Cost	Depreciation
	Balance at 1 January 2009	6,290	3,040
	Additions	3,562	
	Charge for the year		1,295
	Surplus on revaluation	211	
	Disposals	-1,796	-1,468
	Balance at 31 December 2009	<u>8,267</u>	<u>2,867</u>
	Carrying value at 31 December 2009	<u>5,400</u>	

Property, plant and equipment was disposed of at carrying value.

(ii)	Taxation	
	Corporation tax charge for the year	2,688
	Provision for deferred taxation	79
	Associated company	333
		<u>3,100</u>

Required

- (a) Prepare a consolidated statement of cash flows of the Sturton group for the year ended 31 December 2009 using the 'indirect method' in accordance with IAS 7 'Statement of Cash Flows'.

(18 marks)

Suggested answer

Consolidated statement of cash flows of the Sturton group for the year ending 31 December 2009		
	£000	£000
Cash flows from operating activities		
Profit before tax	5,379	
Adjustment for:		
Depreciation	1,295	
Interest payable	666	
Share of profit of associated company	-780	
Operating profit before working capital changes	6,560	
Decrease in inventories	676	
Increase in receivables	-54	
Increase in payables	547	
Cash generated from operations	7,729	
Interest paid	-666	
Income taxes paid	-2,541	
<i>Net cash from operating activities</i>		4,522
Cash flows from investing activities		
Purchase of intangible fixed assets	-450	
Payments to acquire tangible fixed assets	-3,562	
Receipts from sale of tangible fixed assets	328	
Dividends received from associated company	82	
<i>Net cash flow from investing activities</i>		-3,602
Cash flow from financing activities		
Issue of share capital	50	
Issue long term loan	298	
Dividends paid to minority interest	-560	
<i>Net cash used in financing activities</i>		-212
Net increase in cash and cash equivalents		708
Cash and cash equivalents at the beginning of the year		-1,152
Cash and cash equivalents at the end of the year		-444

Workings

		2009	2008
		£000	£000
W1	Minority interest		
	Balance brought forward	540	
	Profit and loss account	686	
		1,226	
	Dividend: balancing item	-560	
	666		
W2	Taxation		
	Balances brought forward	567	
	Charge for the year	2,688	
		3,255	
	Balances carried forward	714	
	2,541		
W3	Purchase of goodwill: 1,250 - 800	450	
W4	Sale of fixed assets: 1,796 - 1,468	328	
W5	Associate		
	Balance brought forward	575	
	Profit before tax	780	
	Taxation	-333	
		1,022	
	-82		
	940		
W6	Issue of shares: 1,396 - 1,346	50	
W7	Loan: 3,006 - 2,708	298	
W8	Cash and cash equivalents		
	Cash	1,111	888
	Overdraft	- 1,555	-2,040
	-444	-1,152	

(b) Based on the content of the cash flow statement prepared under (a), above, prepare a memorandum explaining to the board the main financial developments at the Sturton group during 2009.

(7 marks)

Suggested answer

Subject: An explanation of the main financial developments at the Sturton group during 2009.

To: Board of directors of the Sturton group
 From: Company secretary
 Date: Saturday 26 June 2010

Based on the content of the consolidated statement of cash flows of the Sturton group for the year ending 31 December 2009, the main financial developments are as follows:

- During the year the company expanded its activities significantly by spending £3,992,000 on the acquisition of tangible and intangible fixed assets.
- Part of this cost was met from the sale of tangible fixed assets (£328,000) and the company also benefited from a dividend of £82,000 received from Sturton's associated company.

- Applying this form of analysis, the remainder of the acquisition cost (£3,602,000) was met from cash generated from operating activities.
- The surplus of £4,522,000 generated from operating activities left a balance of £920,000 which, after funding the deficit from financing activities of £212,000, enabled the Sturton group to improve its cash and cash equivalent position by £708,000.
- Overall, there has been a significant expansion which has not undermined the financial stability of the enterprise.

Please do not hesitate to get in touch if you require further clarification of any of the above points.

3. The following draft accounts have been prepared in respect of Priory plc ('Priory') for the year to 31 March 2010.

Statement of comprehensive income for the year ending 31 March 2010			
	Notes	£000	£000
Revenue			50,600
Cost of sales		31,400	
Provision for closure costs	(i)	5,130	
Distribution, selling and marketing costs		8,511	45,041
Operating profit			5,559
Dividend from Woodman Ltd	(ii)		200
Profit for the period			5,759

Statement of financial position at 31 March 2010			
	Notes	£000	£000
Assets			
<i>Tangible non-current assets</i>			
Freehold property	(iii)		15,000
Plant and equipment at cost		9,000	
Less: Accumulated depreciation		6,200	2,800
			17,800
<i>Intangible non-current assets</i>			
Goodwill	(iv)		1,100
Research and development	(v)		1,720
<i>Current assets</i>			
Inventories	(vi)		3,250
Other current assets less liabilities			1,929
			25,799
Equity			
Ordinary share capital (£1 ordinary shares)			17,000
Retained earnings at 1 April 2009			3,040
Retained earnings for the year to 31 March 2010			5,759
			25,799

The following further information is provided in respect of the items indicated by Notes (i) – (vi) above.

- (i) On 2 March 2010, the directors of Priory made the decision to close down a loss-making division with effect from 30 September 2010. The figure contained in the accounts is the provision for expected losses between 1 April 2010 and 30 September 2010 together with the estimated costs associated with the closure. At 31 March 2010, the closure decision remained confidential.
- (ii) Priory acquired 25% of the ordinary share capital of Woodman Ltd on 1 April 2009 and, through representation on the board of directors, is able to exercise a significant influence over the financial and operating policies of that company. The profit made by Woodman Ltd in the year to 31 March 2010 amounted to £1,400,000.

The purchase consideration was £9,000,000 and was satisfied by the issue of 3 million ordinary shares of £1 each in Priory. No entry has been made in the above accounts of Priory in respect of the acquisition.

- (iii) Priory's freehold property was professionally revalued on 31 March 2010 at £22,000,000. It has been decided to use this figure in the accounts in order to show a fairer view of the financial position of the company.
- (iv) This amount represents goodwill arising on the acquisition of the tangible and intangible assets of a local business, Trinity Ltd, on 1 April 2009. The goodwill is estimated to be worth £1,010,000 on 31 March 2010.
- (v) The balance is made up of the following:
- Development expenditure brought forward on 1 April 2009 of £1,350,000. This was incurred to develop a new product which came on to the market on 1 April 2009. It is estimated that the new product will prove highly profitable for a period of nine years from that date.
 - Research expenditure of £370,000 incurred during the year to 31 March 2010 in the endeavour to invent a new design for one of Priory's leading products. The directors are convinced that this will result in the creation of an improved design in due course.
- (vi) The cost and net realisable value of the company's inventories, analysed in categories of similar items, are as follows:

Category	Cost	Net selling price
	£000	£000
A	800	660
B	1,170	2,100
C	1,280	1,970

Required

- (a) Explain the required treatment of items (i), (ii) and (iv), above, in order to comply with the relevant accounting standards.

(9 marks)

Suggested answer

The closure decision is covered by IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'. The purpose of this standard is to prevent what is known as the 'big bath'; this is a process whereby companies make excessive provisions for future losses in order to depress the current profit figure and provide scope for smoothing reported profits in future years.

In this case, the company does not have a **present** obligation (legal or constructive, for example, a decision has not been communicated to groups who, therefore, might reasonably expect the decision to be carried out) as the result of a past event. Consequently, it is not appropriate for any provision to be recognised in the accounts.

The acquisition of shares in Woodman Ltd is covered by IAS 28 'Investments in Associates'. Woodman Ltd is an associated company both because of the level of the shareholding and because of the existence of representation on the board of directors.

In such circumstances, the equity method should be used with Priory's share (25%) of the post acquisition profits reported in the statement of comprehensive income, and added to the value of the initial investment plus its share of post-acquisition profit reported in the statement of financial position.

The accounting treatment of goodwill is governed by IAS 38 'Intangible Assets'. Goodwill must be the subject of an annual impairment review and, if impairment has been found to occur, goodwill must be restated at its new figure and the difference between that and prior carrying value must be debited to the income statement.

(b) Prepare the accounts of Priory for the year ended 31 March 2010 revised, as appropriate, to comply with standard accounting practice so far as the available information permits.

(16 marks)

Notes:

- Ignore taxation.
- Calculations to the nearest £000.
- Assume there were no differences between the purchase price and fair value of the net assets of Woodman Ltd at the acquisition date.
- Assume all figures to be material.

Suggested answer

Statement of comprehensive income for the year ending 31 March 2010			
	£000	£000	
Revenue		50,600	
Cost of sales	31,400		
Impairment of goodwill	90		W1
Inventories write off	140		W2
Research and development	520		W3
Administration, selling and distribution expenses	8,511	-40,661	
Share of operating profits of associated company		350	W4
Operating profit		10,289	

Statement of financial position at 31 March 2010

Assets	£000	£000	
<i>Tangible non-current assets</i>			
Freehold property at revaluation		22,000	W5
Plant and equipment at cost	9,000		
Less: Accumulated depreciation	6,200	2,800	
		<u>24,800</u>	
Investment in Woodman Ltd		9,150	W4
<i>Intangible non-current assets</i>			
Goodwill		1,010	
Research and development		1,200	W3
<i>Current assets</i>			
Inventories		3,110	W2
Other current assets less liabilities		7,059	W6
		<u>46,329</u>	
Equity			
Ordinary share capital		20,000	W4
Share premium account		6,000	W4
Revaluation reserve		7,000	W5
Retained earnings at 1 April 2009		3,040	
Retained earnings for the year to 31 March 2010		10,289	
		<u>46,329</u>	

Workings		
W1	Impairment of goodwill: £1,100,000 - £1,010,000	90
W2	Inventories write off: £800,000 - £660,000	140
W3	Research and development	£000
	Research expenditure	370
	Development expenditure: £1,350,000 / 9	150
	Total write off	<u>520</u>
W4	Associated company	£000
	Purchase price	9,000
	Add: Profit share: £1,400 / 4	350
		<u>9,350</u>
	Less: Dividend received	200
	Book value at 31 March 2010	<u>9,150</u>
	Value of shares issued	9,000
	Nominal value of shares issues	3,000
	Share premium account	<u>6,000</u>
W5	Revaluation of freehold property: £22,000,000 - £15,000,000	7,000
	Other current assets less liabilities	1,929
W6	Write back of provision for closure costs	5,130
		<u>7,059</u>

4. The following issues have arisen in relation to the accounts of Dundee plc ('Dundee') for the year ending 31 December 2009:
- (i) Dundee received from a customer, during December 2009, an advance payment of £3 million for the supply of services over the next three years. The directors plan to include this amount as sales revenue for 2009.
 - (ii) An action has been brought against Dundee for negligence during 2009. Dundee's lawyers have been instructed to vigorously defend the action, but tell the directors that they should expect to lose the case, which would cost up to £1.5 million. A court decision is not expected for at least a year.
 - (iii) Dundee's Chief Accountant believes that the company should always take the most prudent approach when valuing assets for inclusion in the accounts.
 - (iv) A property was purchased at the beginning of 2009 for £10 million. On 31 December 2009 the property is expected to be worth £16 million, and the finance director of Dundee is not sure which figure should be used when preparing the accounts.
 - (v) Dundee owns a machine with a carrying value of £50,000 at 31 December 2009 which is now obsolete. The directors have discovered that the machine could be sold to a South American company, in January 2010, for £50,000. It would cost Dundee £62,000 to transport the machine to South America. The directors are unsure whether the machine should be treated as an asset in the accounts.

Required

Advise the directors of Dundee how to deal with the above five issues in the accounts for the year ended 31 December 2009. You should base your advice on the underlying assumptions and qualitative characteristics contained in the IASB's 'Framework for the preparation and presentation of financial statements'.

(25 marks)

Suggested answer

Date: March 2010
To: Directors of Dundee
From: Company secretary
Subject: Dundee – accounts for the year ended 31 December 2009.

The board has requested further information about the following areas of judgement in this year's annual accounts:

Transaction (i)

The underlying assumption, 'accruals', requires revenues and expenses to be included in the income statement as earned and incurred rather than when received and paid.

The assumption also points to the need to match revenue with related costs. The cash has been received in 2009 but the revenue is earned in 2010 – 12.

The £3 million should be treated as revenue received in advance (a prepayment/liability) in 2009, and should be released to the income statement over the next three years.

Transaction (ii)

The underlying assumption, 'accruals', requires expenses to be recognised in the income statement on the basis of direct association between costs incurred and the earning of specific items of income (matching).

The qualitative characteristic 'prudence' does not permit the deliberate overstatement of liabilities or expenses. Therefore, prudence does not automatically justify a provision being made.

Consideration needs to be given to whether a liability exists in accordance with the provisions of standard accounting practice.

Given the lawyers' expectation that Dundee will lose, it would seem that a provision of £1.5 million is required.

Transaction (iii)

Prudence is the relevant qualitative characteristic. Uncertainty requires prudent measurement.

However, the characteristic of prudence does not permit the deliberate understatement of assets or revenue, or deliberate overstatements of liabilities or expenses. The chief accountant's bias should be resisted when preparing the accounts of Dundee.

Transaction (iv)

The going concern concept allows the liquidation value of assets and liabilities to be ignored unless the enterprise intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so.

However, companies may restate assets at fair value if this produces financial reports which are more relevant.

Relevance depends on whether an item's disclosure could influence the economic decisions of users.

A problem with revaluation is the need not to contravene the qualitative characteristic of neutrality. This requires that published information should be neutral and free from bias. The company should choose the valuation best equipped to help the accounts reveal a true and fair view.

Transaction (v)

The machine fails to meet the definition of an asset as it is not expected to generate net future economic benefits for the enterprise based on the information provided.

The machine's net realisable value is a negative figure of £12,000.

If the directors of Dundee decide to pursue the course described, a liability of £12,000 (£62,000 cash outflow minus £50,000 cash inflow) should be recognised in the accounts.

Dundee should explore alternative ways of disposing of the obsolete machine.

These matters will be discussed with the company's auditors and proposals brought to the next board meeting so that the directors can debate and agree the appropriate approach before approving the final accounts.

5. (a) Trace the evolution of stand-alone environmental reports and explain why this development has occurred.

(12 marks)

Suggested answer

There has been a steady growth in the rate at which environmental reports are being produced.

Activity is greater in sectors where there is a high risk to the environment, such as forestry, chemicals, oil and gas, and pharmaceuticals.

Such reporting activity has been a response to consumer pressure (agency effect) and to the public relations value of obtaining an award from one of the award schemes.

At the European-wide level, there are the European Environmental Reporting Awards which commenced in 1997, in which entries are selected from the winners of national schemes.

There are also the ACCA environmental reporting awards which have been running since the early 1990s.

These awards have contributed towards the high profile currently enjoyed by environmental reporting and to the high quality of many of the reports published by companies.

- (b) Outline the activities involved in an environmental audit.

(13 marks)

Suggested answer

The activities involved in an environmental audit can be classified into those concerned with assessing the current position and those which focus on evaluating decisions affecting the future.

Assessing the current position:

- Physical appraisal carried out by means of site inspections, scientific testing to sample and test substances including air samples, and off-site testing to examine organisational impact on the immediate surroundings.
- Systems appraisal carried out by means of systems inspections to review the stated systems of management and control in respect of environmental issues, operational reviews to review actual practice compared with stated systems and compliance audits for certification schemes.
- Staff appraisal carried out to test staff awareness and basic knowledge, which might be done through questionnaires.

Assessing the future by:

- Carrying out planning and design appraisal by way of review of planning procedures, to ensure that environmental factors are considered in the planning processes adopted by the organisation.
- Undertaking design reviews to examine the basic processes which aim to ensure that environmental issues are addressed at the design stage, to help an organisation avoid problems rather than be forced to address them when they arise.
- Assessing preparedness for emergencies by reviewing relevant arrangements to deal with predictable emergencies.

- Reviewing the organisation's general approach to crisis management with the audit covering such matters as the formulation of crisis management teams and assessing resource availability.

6. Tracey Ltd ('Tracey') and Park Ltd ('Park') are companies which trade in a similar range of products on the cash basis. Their statements of financial position at 31 December 2009 were identical and contained the following information:

Statement of financial position as at 31 December 2009	
Assets	£000
Non-current assets	2,800
Inventories	840
Cash	350
	3,990
Equity	
Ordinary share capital	2,000
Retained profit	1,990
	3,990

To put into effect plans for expansion, each company needs to acquire a fleet of new lorries which will cost £998,600. Each lorry is expected to have a useful life of five years and, in total, their residual value is estimated to be £198,600.

The directors of each company have entered into an arrangement with a London city-based financial institution to lease the lorries. The lease contract provides for an initial payment of £200,000, on 1 January 2010, and five further annual payments of the same amount commencing 31 December 2010. The interest rate implicit in the lease arrangement is 8% per annum.

The forecast operating profits of Tracey and Park for 2010 are £594,000. This amount is before lease rental charges (if any) and depreciation of £400,000 on the non-current assets owned at 31 December 2009. The level of inventories is expected to remain unchanged during 2010.

The directors of Tracey intend to account for the lease arrangement as an operating lease, whereas the directors of Park have decided to account for it as a finance lease.

Required

- (a) Prepare the forecast statements of financial position of Tracey and Park as at 31 December 2010. These statements should show the appropriate adjustments to cash and retained profit as the result of transactions undertaken during 2010.

(13 marks)

Suggested answer

Forecast statements of financial position at 31 December 2010				
		Tracey £000		Park £000
Assets				
Non-current assets [2,800 – 400]		2,400		2,400
Leased asset [998 – 160]				838
Inventories		840		840
Prepaid lease rental		200		
Cash	350		350	
Profit before rental charges and depreciation	594		594	
Rental	-400	544	-400	544
Due to financial inst. [798 + 64 – 200]				-662
Total assets less current liabilities		3,984		3,960
Equity				
Ordinary share capital		2,000		2,000
Retained profit	1,990		1,990	
Profit before rental charges and depreciation	594		594	
Rental	-200			
Depreciation	-400		-560	
Interest		1,984	-64	1,960
		3,984		3,960

- (b) Identify and discuss three arguments in support of the imposition of compulsory accounting standards for financial reporting. Where appropriate, you should illustrate your answer by reference to the content of the accounts prepared under part (a), above.

(12 marks)

Note: All calculations to the nearest £1,000.

Suggested answer

Comparability

The performance of companies is assessed partly by reference to the achievements of similar entities. To make valid inter-company comparisons of performance, users must be supplied with relevant and reliable data that has been standardised. Such comparisons will be distorted and valueless if companies are permitted to select accounting policies at random and, even worse, with the intention of misleading users.

The legal form of the transaction entered into by the two companies is a lease agreement and, if accounted for in accordance with the contractual arrangement, the transaction would be reported as an operating lease and the financing arrangement would remain off-balance sheet – see Tracey's statement of financial position.

The effect of different treatments on the statement of financial position is material. Treated as an operating lease, the statement of financial position of Tracey at 31 December 2010 shows a zero level of gearing. However, in compliance with the requirements of IAS 17 'Leases', when Park accounts for the arrangement as a finance lease, the ratio of loan to equity finance becomes 0.2:1 (662:3960).

Professional credibility

The accounting profession would lose credibility if companies were permitted to produce financial reports which disclosed markedly different results simply because they were permitted to select different accounting policies. Uniformity is essential if users are to be convinced that published financial reports represent a true and fair view of financial performance and position.

Accounting policy appraisal

The process of formulating standards has encouraged a constructive appraisal, by the business community, of the policies employed to tackle individual financial reporting practices. This appraisal has led to the adoption of more rational policies and has helped in the formulation of a meaningful conceptual framework. For example, IAS 17 gave practical effect to the idea that transactions should be accounted for in accordance with their commercial substance rather than simply their legal form.

The scenarios included here are entirely fictional. Any resemblance of the information in the scenarios to real persons or organisations, actual or perceived, is purely coincidental.