



DIPLOMA SUMMER 2008 EXAMINATION

INTERPRETATION OF FINANCIAL STATEMENTS

DATE OF EXAM	Wednesday 25 June 2008
3 HOURS	2.00 pm – 5.00 pm
RUBRIC	SECTION A – ALL parts of the question in this section are to be answered SECTION B – Question 2 AND EITHER Question 3 OR Question 4 are to be answered SECTION C – ALL questions in this section is to be answered

Candidates are reminded that no marks will be awarded for illegible work

NOTES TO CANDIDATES

1. Please insert your Candidate Number on the cover of your Answer Book. *Do not insert your name.*
2. Show *all* workings in your Answer Book.
3. Candidates may attempt the sections in any order. Please indicate clearly in your Answer Book which questions you are answering.
4. Please insert in the box provided on the cover of your Answer Book the numbers of the questions you have attempted in the order in which they appear in the Answer Book.
5. You may use the calculator provided or one approved by the Securities & Investment Institute.
6. You must hand your Answer Book to an invigilator before you leave the Examination Hall. *Failure to do so will result in disqualification.*
7. The decision of the panel is final and no correspondence will be entered into concerning the grade awarded.
8. Once submitted, the examination scripts become the property of the Securities & Investment Institute and will not be returned to candidates.

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PLEASE TURN OVER WHEN INSTRUCTED

Answer ALL parts of this question

Question 1

This question relates to the annual report and accounts for Lavendon Group for the year ending 31 December 2007. Assume you work for a competitor of Lavendon and are writing a report for your manager, the commercial director.

- a) Present a numeric and discursive overview of Lavendon and its development over the last year. *(6 marks)*

- b) Carry out a ratio analysis of Lavendon Group, discussing the meaning and interpretation of the ratios calculated. Focus on the following ratio categories:
 - i) Performance; *(12 marks)*
 - ii) Liquidity and solvency. *(8 marks)*

- c) Analyse the performance of Lavendon's three largest geographic segments (see pages 51 and 52) *(10 marks)*

- d) Discuss the advantages and disadvantages of Lavendon's "five financial key performance indicators, and ... employee turnover" (see the *operating and financial review*, pages 9 to 12). *(5 marks)*

- e) On page 7, the chairman refers to "... mild winter conditions did not suppress activity levels to the extent traditionally experienced." How might such seasonality have affected the current balance sheet working capital figures as compared to the previous balance sheet inventory, trade receivables and trade payables in the year? *(4 marks)*

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PROCEED TO SECTION B OVERLEAF

SECTION B**TOTAL 35 MARKS****Answer question 2 AND EITHER question 3 OR question 4****Question 2**

A Z score is a composite ratio designed to assess the likelihood of company failure. One such score is derived by Altman (1983) and is calculated as follows:

$$Z = 0.717A + 0.847B + 3.11C + 0.420D + 0.998E$$

Where

- A is net working capital / total assets
- B is retained earnings / total assets
- C is earnings before interest and tax / total assets
- D is shareholders' equity / total liabilities
- E is sales / total assets

If Z is less than 1.20 then bankruptcy is predicted for the company being assessed. If it is over 2.90, the company is thought to be safe and if the statistic falls between 1.20 and 2.90, then the expectation is unclear (the grey area).

- a) Comment on the relevance of each of the elements of Altman's Z score for assessing solvency. *(5 marks)*
- b) Below is information extracted from Morton plc's accounts for 2006 and 2007:

	<i>£m</i>	2006	2007
Sales		250	350
Profit before interest and tax		23	40
Working Capital		60	80
Total Assets		200	210
Total Liabilities		120	110
Retained Earnings		10	20
Shareholders Equity		80	100

Calculate and interpret Altman's Z score for Morton plc for 2006 and 2007. *(13 marks)*

- c) Recommend two further ratios that would assist in the evaluation of a company's financial position. *(2 marks)*

Question 3

A work colleague sends you an email stating:

“Balance sheets clearly state “as at xx/xx/xx”, so I assume everything in the financial statement is valued at that date”.

You are concerned about your colleagues understanding of financial statements.

Write him an email addressing the following points:

- a) The role and meaning of the balance sheet, comparing it to the income statement. *(3 marks)*
- b) The meaning of historic cost, giving the valuation of tangible non-current assets as an example *(3 marks)*
- c) The meaning and application of fair value accounting, using financial assets and liabilities as examples *(3 marks)*
- d) The meaning of realisable value, using inventories as an example *(3 marks)*
- e) Briefly state the perceived problem with using fair value when compiling the accounts of financial services companies. *(3 marks)*

(15 marks total)

Question 4

A sceptical fund manager was recently heard to say:

“Analysts tend to focus on the reported income statement when assessing company performance and potential.”

Debate the strengths and limitations of relying on the reported income statement for assessing past results and for forecasting future performance. *(15 marks)*

Answer ALL questions in this section

Question 5

When looking through the report and accounts of a manufacturing company you notice a large deferred tax provision. How would this particular provision have arisen? *(3 marks)*

Question 6

In most published reports and accounts of quoted companies, the directors include both a Company Balance Sheet and the Group Balance Sheet. Explain the difference between these balance sheets. *(3 marks)*

Question 7

The shareholders' funds of a company at the start of a period are £400,000. During the period the following three transactions occur:

- Cash received from debtors of £35,000
- Debtors of £10,000 are deemed bad and written off.
- Sale of stock for £80,000 on credit (stock cost £55,000)
- A short-term bank loan of £70,000 is received

Work out the new figure for shareholders' funds. *(3 marks)*

Question 8

A company is considering making a one for two bonus issue of shares. What impact would there be on:

- a) total shareholders' funds?
- b) total market value?
- c) earnings per share?

(3 marks)

Question 9

For the forthcoming year, Myrtle plc has guided the market to expect an EBIT of £20 million and interest of £10 million. The directors have just decided to spend £20 million building a new factory, starting at the beginning of the new financial year. This project will require a loan of £20 million specifically for this investment at an interest rate of 8%. It will take two years to complete the factory.

- a) Using the above information, what interest charge do you expect Myrtle to report in its statutory income statement for the coming year? Calculate expected interest cover. *(3 marks)*
- b) Myrtle uses straight line depreciation. Assuming a ten year life for the factory and a residual value of £5 million at the end of the tenth year, what will be the depreciation charge for the factory's first year of operation? *(2 marks)*

Question 10

The nominal value of a share in Lavendon is 1 penny. In the last financial year 3,339,189 shares were issued and the share premium account increased from £79,787,000 at the beginning of the year to £95,347,000 at the end of the year.

What was the average issue price, net of issuing costs, of a share in the financial year?
(3 marks)