



DIPLOMA WINTER 2008 EXAMINATION

INTERPRETATION OF FINANCIAL STATEMENTS

DATE OF EXAM	Wednesday 3 December
3 HOURS	2.00 pm – 5.00 pm
RUBRIC	SECTION A – <i>ALL</i> parts of the question in this section are to be answered SECTION B – Question 2 <i>AND EITHER</i> Question 3 <i>OR</i> Question 4 are to be answered SECTION C – <i>ALL</i> questions in this section are 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 Securities and Investment Institute 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 is based on the Annual Report and Accounts of Associated British Foods (ABF) for the year ending 15 September 2007.

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

- b) Carry out a ratio analysis of ABF, discussing the meaning and interpretation of the ratios calculated. Focus on the following ratio categories:
 - i) Performance *(12 marks)*

 - ii) Liquidity and solvency *(6 marks)*

- c) Analyse the performance of ABF's grocery, sugar and retail segments in 2006 and 2007. Comment on the changing structure of the group and the implications for future prospects. *(12 marks)*

- d) Calculate and interpret the dividend cover for 2006 and 2007 using the figures on page 48. Discuss whether the adjusted earnings per share on page 01 should be used in the calculation. *(5 marks)*

- e) On page 43 a performance review graph is included as part of the remuneration report. Explain the calculation and meaning of total shareholder return. How has ABF performed compared to the FTSE 100 over the last two years? *(4 marks)*

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PROCEED TO SECTION B OVERLEAF

Answer question 2 AND EITHER question 3 OR question 4

Question 2

Below are the abbreviated accounts for Dolphin plc.

Income Statement for the year ending	31/12/2007 £	31/12/2006 £
Turnover	64000	53000
Costs	-56800	-49000
Operating profit	7200	4000
Net interest payable	-2000	-150
Profit before tax	5200	3850
Tax	-1404	-527
Profit after tax	3796	3323
Minorities	-300	-275
Profit for group equity holders	3496	3048

Balance Sheet as at	31/12/2007 £	31/12/2006 £
Non-current assets		
Intangible	46750	26750
Tangible	47235	41200
Total	93985	67950
Current assets		
Inventory	1250	1050
Debtors	2450	1800
Cash	100	100
Total	3800	2950
less Current liabilities		
overdraft	750	300
Trade creditors	3162	2100
Others	400	270
Total	4312	2670
less Long term liabilities		
Debt	25500	2300
Provisions	3701	2470
	72896	68800
Called up share capital	8600	8600
Share premium reserve	32000	32000
Retained earnings	28496	25000
Shareholders' funds	69096	65600
Minorities	3800	3200
	72896	68800

- a) Calculate and interpret the change from 2006 to 2007 of the following ratios:
- i) Sales margin
 - ii) Return on net assets
 - iii) Interest cover
 - iv) Long-term gearing
 - v) Return on shareholders' funds (10 marks)
- b) Explain why return on net assets has not improved as dramatically as sales margin. (2 marks)
- c) Explain why return on shareholders' funds has not improved as much as return on net assets. (3 marks)
- d) Calculate and interpret the change in the current ratio and the acid test. Give one reason why the change in liquidity of Dolphin might be good and one reason why it might be detrimental. (5 marks)

Question 3

Research and development is a crucial activity for a pharmaceutical company such as GSK. The following is GSK's research and development accounting policy:

Research and development

Research and development expenditure is charged to the income statement in the period in which it is incurred. Development expenditure is capitalised when the criteria for recognising an asset are met, usually when a regulatory filing has been made in a major market and approval is considered highly probable. Property, plant and equipment used for research and development is depreciated in accordance with the Group's policy. (GSK Annual Report, 2007, page 95)

In the 2007 financial year GSK had turnover of £22,716 million and recognised a research and development cost of £3,327 million before posting an operating profit of £7,593 million and earnings of £5,214 million. On 9th September 2008, GSK had a market capitalisation of £65 billion. A client is considering investing in GSK and has emailed you asking for the implications of the research and development policy.

Write an email in reply to the client, including the following:

- a) An outline of the distinction between research costs expensed to the income statement and development costs that are capitalised in the balance sheet.
- b) An explanation of why accountants are averse to capitalising research expenditure.
- c) The implications for the Price Earnings ratio of this accounting policy for GSK and research-intensive companies generally compared to writing off all research and development as it is incurred or capitalising all research and development.
- d) A discussion of the subjectivity introduced into the accounts by these approaches and how an analyst might adjust the published information in order to improve the assessment of the prospects for the company. (15 marks)

Question 4

IAS7 mandates the publishing of a cash flow statement alongside the income statement and the balance sheet. A client has sent you an email questioning the value of this additional statement and its related notes.

Write an email replying to the client, including:

- a) A discussion of the importance in distinguishing between cash and profit.
- b) The common reasons for differences between profit for the period and net cash from operating activities (you may refer to Associated British Foods annual report if you wish).
- c) An explanation of the attractiveness of using cash based ratios to assess a company rather than profit based ones.
- d) A discussion of the relative merits of cash flow and earnings in the valuing of a company or share.
- e) A discussion of other key information that the cash flow statement and related notes provide.

(15 marks)

Answer ALL SEVEN questions in this section

Question 5

A company purchased a non-current asset for £20m five years ago with no expected residual value. It has been depreciated on a straight line basis and is thought to have a ten year life. The asset is then sold for £21m. What would be the profit or loss on sale disclosed in the income statement? *(2 marks)*

Question 6

Who is responsible for preparing the report and the accounts for a company? *(2 marks)*

Question 7

If an audit report questions the use of the “Going Concern” principle in the drawing up of a set of accounts, what is that likely to imply? *(2 marks)*

Question 8

If the current ratio is calculated from the face of a published balance sheet, highlight three potential problems with interpreting this number. What does a current ratio of less than one imply about the company’s working capital? *(3 marks)*

Question 9

What are the effects of capitalising interest costs during the construction of a non-current asset on the income statement and the balance sheet? Specifically give the effect on interest cover and profit in the first year this accounting policy is introduced. *(4 marks)*

Question 10

BR plc is a quoted company with several substantial trading subsidiaries. The consolidated balance sheet of BR shows “minority interests”. Explain the meaning of the balance sheet entry for minority interest. Should it be included in shareholders’ funds when calculating return on equity? *(4 marks)*

Question 11

The board of JM plc is considering its accounts for the 2008 financial year. Return on net assets has fallen from 17% to 13%. The following reasons for the decline are put forward:

- i) Profit margin declined
- ii) Stock levels increased
- iii) Asset turnover rose
- iv) Depreciation policy for the expected life of the JM's assets was changed from 10 to 12 years.

Which of the above are possible explanations of the decline? *(3 marks)*