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Intermediate Level

Financial Accounting – UK Accounting Standards

6a

IFNA

26 May 2004
Wednesday morning

INSTRUCTIONS TO CANDIDATES

Read this page before you look at the questions

You are allowed three hours to answer this question paper.
This question paper is based on UK ACCOUNTING STANDARDS.
Answer the ONE question in Section A (this has 10 sub-questions). Answer the ONE question in Section B. Answer TWO questions ONLY from Section C.

SECTION A – 20 MARKS

ANSWER *ALL* TEN SUB-QUESTIONS – 2 MARKS EACH

Each of the sub-questions numbered from **1.1** to **1.10** inclusive, given below, has only ONE correct answer.

REQUIRED:

On the SPECIAL ANSWER SHEET opposite, place a circle "O" around the letter that gives the correct answer to each sub-question.

If you wish to change your mind about an answer, block out your first answer completely and then circle another letter. You will not receive marks if more than one letter is circled.

Please note that you will not receive marks for any workings to these sub-questions. You must detach the special answer sheet from the question paper and attach it to the inside front cover of your answer book before you hand it to the invigilators at the end of the examination.

Question One

1.1 The Financial Reporting Council (FRC) has a number of responsibilities.

Which of the following is a responsibility of the FRC?

A To raise finance to run the FRC, the ASB and the FRRP.

B To publish reports on Accounting Standards.

C To enforce Accounting Standards.

D To report to the stock exchange on financial reporting matters.

1.2 According to the Accounting Standards Board's (ASB) *Statement of Principles for Financial Reporting* (SoP) chapter 4, "ownership interest" is described as

A the amount paid into the business by the owner.

B accumulated profits less amounts withdrawn.

C the residual amount of assets less liabilities.

D owner's capital investment in the business.

1.3 Chapter 3 of the ASB's SoP sets out the characteristics of useful information.

According to chapter 3, which THREE of the following are NOT sub-characteristics of "reliability"?

(i)	Confirmatory value	(iv)	Consistency
(ii)	Complete	(v)	Neutral
(iii)	Prudence	(vi)	Predictive value

A (i), (iii) and (vi)

B (i), (iv) and (vi)

C (ii), (iv) and (v)

D (ii), (iii) and (v)

1.4 The working capital cycle of an organisation is calculated by a formula; the elements of the formula are:

(i)	Stock turnover	(iv)	Debtors turnover
(ii)	Creditors turnover	(v)	Working capital
(iii)	Cash turnover	(vi)	Sales

The working capital cycle formula is

A (i) + (iv) – (ii)

B (i) + (iii) + (iv) – (ii)

C $\frac{[(\text{i})+(\text{iii})+(\text{iv})]}{(\text{vi})}$

D $\frac{(\text{v})}{(\text{vi})}$

1.5 Extracts from G Ltd's balance sheet at 31 March 2004:

	£000
Loans due in more than one year	20
5% Debentures	15
Ordinary shares – £1 each fully paid	50
6% redeemable Preference shares, £1 each fully paid	10
Retained profits	65
Revaluation reserve	25

The gearing ratio for G Ltd is (to one decimal place)

A 18·9%.

B 24·3%.

C 28·1%.

D 43·8%.

1.6 FRS 8 – *Related Party Disclosures* deals with related parties of an organisation.

Which of the following would be presumed to be a related party of a company?

A A major customer whose purchases account for 30% of the company's annual sales.

B A shareholder holding 25% of the company's equity.

C A manager of the bank providing a loan to the company.

D Employees of the company.

1.7 FRS 18 – *Accounting policies* sets out pervasive concepts which are presumed to be followed when preparing financial statements.

Which TWO of the following are NOT pervasive concepts according to FRS 18?

(i) going concern
(ii) prudence
(iii) accruals
(iv) consistency

A (i) and (iii)

B (i) and (iv)

C (ii) and (iii)

D (ii) and (iv)

1.8 An extract of tax related items from T Ltd's records were:

	£000
Under provision for year ended 31 March 2003	5
Net profit for the year ended 31 March 2004, before tax	144
Depreciation charge for the year included in the profit and loss account	20
Capital allowances due for the year	28

T Ltd estimates 25% to be its rate of corporation tax due on profits for the year ended 31 March 2004.

T Ltd's taxation charge to the profit and loss account for the year ended 31 March 2004 will be

A £31,000

B £35,250

C £39,000

D £41,000

1.9 A customer, C, has sued R Ltd for bad workmanship on a new roof it was contracted to install. R Ltd sub-contracted the work to F Ltd who used inferior quality products when installing the roof. The roof began leaking the first time it rained after installation. C has no difficulty proving that the installation is faulty, as the roof leaks every time it rains. C has sued R Ltd for the cost of repair, £22,000. R Ltd has been advised by its legal team that it is almost certainly going to lose the case and has to pay the full cost.

R Ltd has started legal proceedings against F Ltd for £28,000; £22,000 compensation for C plus £6,000 legal fees and expenses. F Ltd denies liability claiming that its quality standards ensure good workmanship. R Ltd's legal team has advised that R Ltd will probably win the case against F Ltd.

Neither case was settled at 31 March 2004.

The amounts that R Ltd should include in its balance sheet for the year ended 31 March 2004 should be

A a liability for £22,000.

B a liability for £22,000 and an asset for £28,000.

C a net asset of £6,000.

D no provision as neither amount is settled.

1.10 SSAP 9 – *Stock and long term contracts* specifies expenses that should be included in year-end stock values. These could include:

(i) Marketing and selling overhead;

(ii) Production overhead;

(iii) General management overhead;

(iv) Accounting and finance overhead allocated to production;

(v) Cost of delivering raw materials to the factory;

(vi) Abnormal increase in overhead charges caused by unusually low production levels due to the exceptionally hot weather.

Which THREE of the above are allowable by SSAP 9 as expenses that should be included in the cost of finished goods stock?

A (i), (iii) and (v)

B (i), (ii) and (vi)

C (ii), (iv) and (v)

D (iii), (iv) and (vi)

(Total = 20 marks)

End of Section A

SECTION B – 30 MARKS

ANSWER THIS QUESTION

Question Two

The financial statements of C plc for the year to 31 March 2004 were as follows:

Balance Sheets at	*31 March 2004*		*31 March 2003*	
	£000	*£000*	*£000*	*£000*
Fixed assets:				
Intangible	111		90	
Tangible	7,724	7,835	4,923	5,013
Current assets:				
Stock	1,337		864	
Debtors	743		435	
Investment	0		730	
Bank and cash	516		29	
	2,596		2,058	
Creditors: amounts falling due within one year:				
Trade creditors	(626)		(552)	
Corporation tax	(234)		(188)	
Dividends	(200)		(150)	
Interest payable	(20)		(4)	
	(1,080)		(894)	
Net current assets		1,516		1,164
Total assets less current liabilities		9,351		6,177
Creditors: amounts falling due after more than one year:				
Loans		(1,006)		(410)
Provisions for liabilities and charges				
Deferred tax	(254)		(291)	
Other provisions	(400)		(120)	
		(654)		(411)
		7,691		5,356
Capital and reserves				
Ordinary shares £1 each		2,000		1,500
Share premium account		1,500		500
Revaluation reserve		1,080		630
Profit & loss account		3,111		2,726
		7,691		5,356

Profit & loss account for the year to 31 March 2004

	£000	*£000*
Turnover		14,780
Cost of sales		(9,607)
Gross profit		5,173
Distribution costs	(1,222)	
Administrative expenses (including provisions)	(2,924)	(4,146)
Operating profit		1,027
Interest payable	(45)	
Interest receivable	0	(45)
Profit before tax		982
Tax		(197)
Profit after tax		785
Dividends		(400)
Retained profit for the year		385

Additional information:

(i) Tangible fixed assets balances were as follows:

	31 March 2004	*31 March 2003*	
	Cost or valuation	*Cost or valuation*	*Accumulated depreciation/ amortisation*
	£000	*£000*	*£000*
Land	3,636	3,186	0
Buildings	3,063	1,663	416
Plant, machinery & equipment	2,188	1,108	671
Assets under construction	0	53	0

(ii) Intangible fixed assets comprise development expenditure incurred in previous years and in the current year, and being carried forward to future periods. Development expenditure amortised during the year was £18,000.

(iii) Tangible fixed assets include land which was revalued by £450,000 on 31 March 2004.

(iv) Machinery disposed of in the year had originally cost £400,000; accumulated depreciation at 31 March 2003 was £380,000. The agreed selling price of £31,000 had not been received by the year-end and is included in debtors.

(v) Assets under construction refer to a contract, started in February 2003, to build and supply C plc with new machinery. The machinery was installed and testing completed by 31 December 2003. Production began early January 2004. C plc had taken out a specific loan to finance the payments under the contract and in accordance with FRS 15 – *Tangible fixed assets*, has decided to capitalise the interest payments up to 31 December 2003. The interest paid was £24,000; this amount was transferred from the interest paid account to the assets under construction account. The balance on the assets under construction account was transferred to the plant and machinery account on 31 March 2004. The amount transferred was:

	£000
Balance at 31 March 2004	526
Interest	24
Total cost	550

In addition to this contract, other new plant and machinery had been purchased during the year.

(vi) Depreciation charged for the year was:

Buildings	2·5% straight line
Plant, machinery and equipment	20% reducing balance

C plc's accounting policy is to charge a full year's depreciation in the year of acquisition and no depreciation in the year of disposal.

(vii) Debtors consist of:

	31 March 2004	*31 March 2003*
	£000	*£000*
Trade debtors	712	401
Debtor arising from sale of fixed assets	31	0
Interest receivable on current asset investments	0	34

(viii) The current asset investment was a government bond, which matured on 31 March 2003 and was redeemed in April 2003 for £750,000.

(ix) C plc did not repurchase any of its shares during the year.

Required:

(a) Prepare the following disclosure notes, for the year ended 31 March 2004, as required by the Companies Act 1985 and/or Accounting Standards:

(i) Tangible fixed assets;

(8 marks)

(ii) Interest payable.

(2 marks)

(b) Prepare the following for C plc for the year ended 31 March 2004, in the form prescribed by FRS 1 – *Cash Flow Statements*:

(i) a reconciliation of operating profit to net cash inflow from operating activities;

(7 marks)

(ii) a cash flow statement.

(13 marks)

(Total = 30 marks)

Note: DO NOT prepare a reconciliation of net cash flows to the movement in net debt or an analysis of changes in net debt. All workings must be clearly shown.

End of Section B

SECTION C – 50 MARKS
ANSWER TWO QUESTIONS ONLY

Question Three

The following trial balance was extracted from the books of U Ltd at 31 March 2004:

	£000	*£000*
5% Debentures		10,000
Administrative expenses	5,900	
Bank	4,200	
Buildings at valuation (at 31 March 2003)	50,000	
Cost of goods sold	66,200	
Creditors		9,539
Debenture interest (six months to 30 September 2003)	250	
Debtors	14,300	
Distribution expenses	1,600	
Dividend paid	1,500	
Land at valuation (at 31 March 2003)	6,000	
Ordinary shares £1 each		25,000
Plant & machinery at cost	30,000	
Provision for depreciation – buildings (at 31 March 2003)		5,000
Provision for depreciation – plant & machinery (at 31 March 2003)		10,000
Provision for doubtful debts (at 31 March 2003)		400
Retained profit (at 31 March 2003)		4,411
Revaluation reserve – land & buildings		3,000
Sales		101,050
Share premium account		17,650
Stock (at 31 March 2004)	6,100	
	186,050	186,050

Additional information available was as follows:

(i) The directors had a valuation carried out on the land and buildings by an independent valuer and were informed that at 31 March 2004 the buildings value was £39,000,000. The directors decided to adjust the valuation of the buildings in the financial statements for the year ended 31 March 2004. The land was revalued at £6,000,000 at 31 March 2003 and had not changed at 31 March 2004. The land had originally cost £4,000,000. The buildings had originally cost £53,260,000 on 1 April 1994 and were revalued on 31 March 1998.

(ii) Depreciation on buildings is regarded as an administrative expense and is 2% of gross valuation per annum. Depreciation on plant and machinery is regarded as a "cost of sales" expense and is at 20% per annum on cost.

(iii) On 15 April 2004, U Ltd was advised that one of its major customers had gone into liquidation. The outstanding balance on their account at 31 March 2004 was £3,059,000. It is very unlikely that any money will be received from the liquidator.

(iv) Because of the recent increase in bad debts, the directors of U Ltd have decided that it would be prudent to increase the provision for doubtful debts to 5% of the debtors balance.

(v) Corporation tax for the year is estimated at £5,660,000.

(vi) During the year, the directors made a bonus issue; all existing shareholders received one new share free for every four shares held.

(vii) The directors wish to provide for a final ordinary dividend of 10p per share.

Required:

(a) Explain, with reference to appropriate Accounting Standards, how item (i) above, the valuation of land and buildings, should be treated in U Ltd's profit and loss account for the year ended 31 March 2004 and its balance sheet at that date.

(5 marks)

(b) Prepare U Ltd's profit and loss account for the year ended 31 March 2004 and a balance sheet at that date in a form suitable for publication and in accordance with all current regulations.

(16 marks)

(c) Prepare U Ltd's disclosure note for movement on reserves.

(4 marks)

(Total = 25 marks)

Question Four

Q Ltd is a wholesale supplier to retail stores. The financial statements of Q Ltd for the year to 31 March 2004 were as follows:

Profit & loss account for the year to 31 March 2004

	£000	£000
Turnover		2,600
Cost of sales		(1,200)
Gross profit		1,400
Distribution costs	(540)	
Administrative expenses	(434)	(974)
		426
Interest payable	(24)	
Interest receivable	12	(12)
Profit before tax		414
Tax		(108)
Profit after tax		306
Dividends		(124)
Retained profit for the year		182

Balance sheet at 31 March 2004

	£000	£000
Tangible fixed assets		1,186
Current assets:		
Stock	220	
Debtors	440	
Interest receivable	6	
Investments	80	
Bank and cash	122	
	868	
Creditors: amounts falling due within one year:	(674)	
Net current assets		194
Total assets less current liabilities		1,380
Creditors: amounts falling due after more than one year:		
Debentures		(394)
Net assets		986
Capital and reserves:		
Ordinary shares £1 each		620
Share premium account		84
Revaluation reserve		90
Profit & loss account		192
		986

Creditors: amounts falling due within one year include:

	£000
Trade creditors	442
Taxation	108
Proposed dividends	124
	674

The industry average figures have been obtained from a trade association; these are for the calendar year ended 31 December 2003.

Industry averages

Return on capital employed	42%
Asset utilisation ratio	3·0 times
Net profit %	14%
Gross profit %	50%
Current ratio	1·9 : 1
Stock turnover	25 days
Debtors turnover	40 days
Creditors turnover	45 days

Q Ltd has a higher proportion of tangible fixed assets than the industry average as its business strategy is to own all of its land and buildings; the industry norm is to lease or rent land and buildings. If Q Ltd rented all the land and buildings it owns it would save £30,000 depreciation per annum and pay annual rents of £100,000. At 31 March 2004, the land and buildings net book value in the balance sheet was £300,000. Land and buildings depreciation is treated as a cost of sales; rent would be treated as an administrative expense.

Q Ltd's financial statements for the year ended 31 March 2004 disclosed an exceptional loss of £150,000 caused by the write-off of stock damaged by a fire in a warehouse and not covered by insurance. This write-off was included in administrative expenses.

Required:

Q Ltd's directors have decided to carry out a benchmarking exercise (comparison with industry averages to help identify possible areas for improvement). They have requested you, a trainee management accountant, to prepare a report to assist them with their benchmarking exercise.

(i) Using the industry averages listed above, calculate the equivalent ratios for Q Ltd, based on its results for the year ended 31 March 2004.

(4 marks)

(ii) Make any adjustments to the financial statements you think necessary to make the results more comparable with the industry average. Explain the reasons for and the effect of any adjustments you make. Recalculate Q Ltd's ratios where they have changed.

(10 marks)

(iii) Analyse the differences between the adjusted ratios you have calculated for Q Ltd and the industry average and suggest possible reasons for any differences. Propose a course of action to the directors that would help improve each of the company's ratios falling below the industry average.

(11 marks)

(Total = 25 marks)

Question Five

S plc, a car dealer with a number of outlets, has expanded rapidly in recent years, but cash flow problems worsened in the year to March 2003. On 1 April 2003, the Board of S plc decided to make three major changes to its activities.

A trainee management accountant has prepared a set of draft financial statements for the year ended 31 March 2004 but, unfortunately, did not appreciate the need to apply the concept of "substance over form" in the treatment of the various transactions involved.

Required:

(a) Explain the meaning of the accounting concept of substance over form. You should refer to relevant Accounting Standards in your answer.

(4 marks)

(b)

Information for requirement (b)

The three major changes made by S plc on 1 April 2003, and the way in which they have been treated in the draft financial statements for the year ended 31 March 2004, are as follows:

Change 1

S plc sold all of its land and buildings on a sale and lease-back agreement to P plc on 1 April 2003. The terms were as follows:

- The annual rental was agreed at £7·5 million.
- The agreed selling price was £50 million with an option for S plc to repurchase the land and buildings at any time in the next ten years.
- The repurchase price was set at £50 million plus interest at bank rate plus 5% per annum from the date of the sale.

At the time of the sale the land and buildings had a net book value (and current market value) of £80 million. The draft financial statements have treated the transaction as a disposal of the land and buildings and record a loss on disposal of £30 million in the draft profit and loss account.

(8 marks)

Change 2

S plc decided to acquire new cars direct from the manufacturer on consignment. The terms of the trading are:

- On delivery of the cars to S plc, they are invoiced at 50% of the purchase price;
- The balance of the purchase price is payable when the cars are sold;
- If a car remains unsold for three months it must be paid for, or returned to the manufacturer;
- When a car is returned, the manufacturer refunds the deposit less a 20% administration fee.

At 31 March 2004, S plc had 500 new cars in stock; all had been in stock less than three months. The combined purchase price of the cars was £6 million. The draft financial statements omit the new cars from stock, as they have been treated as the stock belonging to the manufacturer. The 50% of the purchase price paid has been debited to prepayments in the draft balance sheet.

(5 marks)

Change 3
S plc replaced the computerised equipment used in its repair workshops. The previous equipment was purchased outright, and had no value on disposal. The new equipment was acquired on a lease, with the following terms:

- Lease term 6 years;
- Useful economic life of the equipment 5 to 7 years;
- Six equal payments of £1·5 million paid in advance commencing on 1 April 2003 and annually thereafter;
- The interest rate implicit in the lease is 7% per annum;
- The fair value of the equipment at the inception of the lease was £7,650,296;
- S plc will insure and maintain the equipment in good working order.

The draft financial statements record the lease payment of £1·5 million as an expense in the draft profit and loss account.

(8 marks)

Required:

For each of the changes above, explain how S plc should treat each transaction in its profit and loss account for the year ended 31 March 2004 and its balance sheet at that date. Justify your answer by reference to relevant Accounting Standards. Prepare any journal entries that are required to adjust the draft financial statements.

Note: A descriptive narrative is not required for the journal entries.

(the breakdown of marks is shown against each change detailed above)

(Total for requirement (b) = 21 marks)

(Total = 25 marks)

Question Six

Bi plc specialises in property development. It carries out contract work for other organisations and also carries out work for its own investment property portfolio. Bi plc's accounting policy is to recognise profit on the basis of the percentage of contract completed.

At 1 April 2003, it had two building contracts in progress, one external and one internal, the details were:

External contract – Office complex and warehouse redevelopment
Contract price (fixed) £15 million
Duration: 24 months
Start date: 1 October 2002

1 October 2002 to 31 March 2003	*£000*
Expenditure incurred in the period	6,000
Estimated expenditure required to complete the contract at 31 March 2003	10,000
Amount received from the contract sponsor in the period	3,500
Amount paid to creditors in the period	4,000
Percentage of contract completed at 31 March 2003	35%

1 April 2003 to 31 March 2004	*£000*
Expenditure incurred in the period	6,000
Estimated expenditure required to complete the contract at 31 March 2004	2,000
Amount received from the contract sponsor in the period	6,500
Amount paid to creditors in the period	5,500
Percentage of contract completed at 31 March 2004	80%

Internal contract – Redevelopment of a commercial site owned by Bi plc
Duration: 15 months
Start date: 1 April 2002

1 April 2002 to 31 March 2003	*£000*
Expenditure incurred in the period	4,500
Estimated expenditure required to complete the contract at 31 March 2003	500
Amount paid to creditors in the period	2,500
Percentage of contract completed at 31 March 2003	90%

1 April 2003 to 31 March 2004	*£000*
Expenditure incurred in the period	500
Amount paid to creditors in the period	2,500

Bi plc had purchased the land several years earlier for £1 million; it is currently recorded, at this figure, in the balance sheet under tangible fixed assets – land. The contract was to clear the site and redevelop it, by building commercial properties that could be let to tenants. The market value of the property (land and buildings) at the date of completion was £12 million on 1 August 2003. At 31 March 2004, the market value had increased to £13 million.

The contract work was completed on time and the property was transferred at £12 million to investment properties account on 1 August 2003, for possible letting to tenants. Bi plc credited a gain of £6 million to profit and loss account for the year ended 31 March 2004. Bi plc follow SSAP 19 – *Accounting for investment properties* – as their accounting policy for investment properties.

Required:

(a) Calculate the figures that should appear in Bi plc's profit and loss account for the years ended 31 March 2003 and 2004, and its balance sheet at those dates in respect of:

(i) the external contract.

(14 marks)

(ii) the internal contract.

(5 marks)

(b) After examining the financial statements for the year ended 31 March 2004, the external auditors issued an audit report which contained the following:

> "Included in profit for the year is £6,000,000 arising from the revaluation of work in progress (WIP). In our opinion this amount is not a realised profit and should be treated as a movement on reserves.
>
> Except for the profit arising on revaluation of WIP, in our opinion the financial statements give a true and fair view of the state of the company's affairs at 31 March 2004 and of its profit for the year then ended and have been properly prepared in accordance with the Companies Act 1985."

Explain the type of audit report given by Bi plc's external auditors and suggest reasons why this report has been issued.

(6 marks)

(Total = 25 marks)

End of paper