ACCOUNTING THEORY AND PRACTICE

Professional 1
December 2002

MARKING SCHEME

CIPFA

Question 1

(a) **C Plc**

Profit & Loss Account for year ended 30 June 2002

	£000	
Turnover	4,090	*1*
Cost of sales (see working (ii))	(3,325)	
Gross profit	765	
Administration and distribution costs	(62)	*½*
Profit or loss on ordinary activities before interest	703	
Loan finance charges (see working (viii))	(170)	
Profit or loss on ordinary activities before tax	533	
Taxation (see working (iv))	(220)	
Profit or loss for the financial year	313	
Dividends	(125)	*½*
Retained profit for the financial year	188	

C plc
Balance Sheet as at 30 June 2002

	£000	£000	£000	
Fixed assets				
Intangible assets				
Goodwill (see working v)	100	80	20	
Tangible assets				
Leased equipment	765	459	306	
Leased vehicles	1,750	1,000	750	
	2,515	1,459	1,076	
Current assets				
Stock		35		*½*
Debtors		740		
Investments		500		*1*
Cash at bank and in hand		222		*½*
		1,497		
Creditors: amounts falling due within one year*		(509)		
Net current assets			988	
Total assets less current liabilities			2,064	
Creditors: amounts falling due after more than one year				
Amounts due under finance leases			(1,126)	*½*
Provisions for liabilities and charges				
Provision for legal claim			(100)	*1*
			838	
Capital and reserves				
Called up share capital				
Ordinary shares			500	*½*

Retained profits	338
	838

	£000	
*Creditors: amounts falling due within one year		
Trade creditors	79	
Tax	230	
Dividends	125	½
Amounts due on leases	75	
	509	

Workings

(i) Debtors	£000	
B/F	660	
Sales	4,090	½
Less received	(3,990)	½
Less written off	(20)	½
Balance C/F Balance sheet	740	

(ii) Cost of sales	£000	
Direct operational costs incurred	2,682	*1*
Goodwill amortisation	20	½
Bad debt written off	20	½
Tangible asset depreciation:		
Equipment	153	*1*
Vehicles	350	*1*
Provision for legal claim	100	*1*
	3,325	

(iii) Creditors	£000	
B/F	92	
Incurred	2,682	½
Paid	(2,695)	½
Balance C/F balance sheet	79	

(iv) Tax	£000	
B/F	(200)	½
Paid	190	½
	(10)	
Year charge to P & L	(220)	½
	(230)	

(v) Goodwill	£000	
Amortised in year 100/5=	20	½
Amortisation B/F	60	
Amortisation C/F	80	½

(vi)

	Equipment		Vehicles		
	Cost	Deprec	Cost	Deprec	
	£000	£000	£000	£000	
B/F	765	306	1,625	650	½
Add purchases			125		½
Depreciation		153		350	½
Total	765	459	1,750	1,000	

(vi) Retained Profit	£000	
B/F	150	½
P&L	188	½
	338	

(vii) Amounts due on leases

Existing leases brought forward 1/7/01

	Less than one year	More than one year	
	£000	£000	
Balance 1/7/01	473	1,096	½
Reclassified	52	(52)	½
New leases	23	82	½
Repaid existing	(473)	_	½
	75	1,126	

New Leases

Year	B/F	Interest @ 10%	Payments	Balance C/F	
1	125,000	12,500	-32,976	104,524	*1 Interest*
2	104,524	10,452	-32,976	82,000	*1 Payments*
3	85,000	8,200	-32,976	57,224	*1 Splitting balance*
4	57,224	5,722	-32,976	29,970	
5	29,970	2,997	-32,976	-9	

(viii) Interest paid	£000	
Existing leases	157	½
New leases	13	½
	170	

(25)

(b) Univariate analysis considers each ratio in turn. The different ratios then need to be looked at together, this needs skill and judgement as each ratio is equal. *2*

Multivariate ratio analysis is often used in predicting corporate failure, eg Altman's Z score. ½
Multivariate analysis uses a limited number of specified ratios which each have a predetermined weighting. The ratios are calculated and then weighted. The weighted figures are then summed to give a score. The score is used to determine how secure a company might be. ½ 1 1

(5)

(c) Report format. *2*

(i) ROCE has increased slightly from 2001 and it is nearly double the industry average. As the finance leases are excluded from long term debts, the assets employed by C plc will be share holders funds only. This will give a much higher ROCE. *2*

Asset turnover has decreased in the year; this is probably due to the increase in the finance leases in the year. Turnover is still more than double the average.
Although profit margin has increased it is still below the average. As finance leases are not counted as long term debt, the interest on finance leases should be deducted from operating profit; this would give a lower profit margin than would be achieved if profit before interest was used. *2*

The very high asset turnover and lower profit margin could be an indication that C plc is setting prices competitively to obtain a higher turnover. This strategy seems to be working as ROCE is well above average. C plc has expanded recently; they may have been giving special deals to customers to increase turnover. *2*

Liquidity has improved in the year, but is still below the industry average. C plc may be happy with a lower liquidity as they have a high turnover and can generate cash quickly. *2*

Debtors collection has increased by 2 days over the year and now stands at more than two months. C plc needs to try and improve their debt collection, at least reducing to the industry average. C plc may not have been chasing debtors so vigorously as they have been trying to expand sales. *2*

C plc has no gearing as finance leases are excluded. If finance leases were to be included the gearing ratio would be 2001 - 63% and 2002 – 43%. New leases were acquired in the year the amount of finance leases due in more than one year has hardly moved in the period. Shareholders funds have increased along with retained profits, so gearing would have been reduced if finance leases were included as debt. As the five-year leases near completion the gearing would continue to reduce. Gearing will then increase dramatically as all the leases are renewed. The 35% average gearing implies that most other companies either fund the business partly through debt or they include finance leases as long term debt. *5*

(Marks total 17)
(Maximum marks awarded 12)

(ii) Reasons why C plc is different from the industry average:

- C plc rents all premises and uses finance leases for all its equipment and vehicles – this may not be the norm in the industry. If property was owned there would be higher asset values and a reduction in asset turnover. *2*
- Other companies may include finance leases as long term debt – this will increase capital employed and reduce ROCE. *1*
- Gearing may be different because other companies may use loans to purchase assets – these could have a different repayment profile to C plc's leases. *1*
- Liquidity is reduced by the inclusion of lease payments due in less than one year under current liabilities. If other companies used long term loans, such as debentures, these would remain as debt and not be moved to current liabilities. Liquidity without including lease payments is 2.8:1. *2*
- C plc does not revalue leased assets. If other companies revalued fixed assets they would increase shareholders funds and reduce gearing. *1*
- The other companies may use different accounting policies to C plc, so their results may not be comparable. *1*
- The other companies are probably not identical to C plc – some may only cover one city; others may also include other services. *1*
- The industry average has a different year-end – if the business is at all cyclical this may have an effect on the different results. *1*

(Marks total 10)

(Maximum awarded 7)

(49)

Question 2

(a) Reconciliation of Operating Profit to net cash inflow from operating activities.

	£m	
Operating profit	77	½
Add depreciation – land and buildings	19	½
Plant, equipment etc	31	½
Less gain on disposal of investments	(13)	½
Increase in stock	(17)	½
Increase in creditors	28	½
	125	½

Cash Flow Statement for year ended 30 June 2002

		£m
Net cash inflow from operating activity		125
Returns on investment and servicing of finance	(See working 1)	(9)
Corporation tax paid (see working 3)		(12)
Capital expenditure (see working 2)		(210)
Equity dividends paid (see working 4)		(27)
Net cash flow before financing		(133)
Management of liquid resources		
Sale of investments		103 ½
Reduction in cash		(30)

Workings:
Returns on investment and servicing of finance

	£m	
(1) Interest received	6	
Interest paid	(15)	½
	(9)	½

(2)

	Land & Buildings	Plant, equipment etc	W I P	
	£m	£m	£m	
Balance B/F	696	116	33	
Completed/transferred	29		(29)	*1*
Revalued	70			*1*
Depreciation – year	(19)	(31)		*2*
Balance C/F	(924)	(126)	(25)	*1½*
Purchases/New works (bal)	148	41	21	

(3)	£m	
Tax		
Balances B/F:		
Corporation tax	20	
Deferred tax	40	
Charge to P & L	25	
	85	
Balances C/F		
Corporation tax	(23)	
Deferred tax	(50)	
Paid	12	*2*

(4)		
Dividends		
Balance B/F	12	
P & L	30	
	42	
Balance C/F	(15)	
Paid	27	*1 ½*

(14)

(b) Reconciliation of net cashflow to movement in net funds *Format 1*

	£m	£m	
Decrease in cash in period		(30)	
Cash inflow from current asset investments	(103)		*½*
Less gain on disposal	13	(90)	*½*
Change in net funds resulting from cashflows		(120)	*½*
Net debt at 30 June 2001		(40)	*½*
Net debt at 30 June 2002		(160)	

(17)

Question 3

	£000
Site 1	
Contract value	800
Total cost	
Payments made	(400)
Cost to completion	(300)
Total profit	100
Sales in year 800 * 50% =	400
Cash received	500
Excess cash received	100
Expenses paid	400
Cost of sales 700* 50% =	350
	50
Less part excess cash received	(50)
	0
Creditors – Balance excess cash received	50

4

Site 2

Contract value 5,000

Costs unknown

- therefore not prudent to recognise any profits. As contract is profitable recognise turnover and cost of sales.

Sales in year 5,000 * 10% =	500
Cash received	420
Outstanding debtors	80
Expenses paid	600
Cost of sales (equal to turnover)	500
WIP	100

5

Site 3

Sales value	1,500
Total cost -	
Payments made	(1,275)
Cost to completion	(305)
Expected loss	(80)
Sales in year 1,500 * 80% =	1,200
Cash received	1,050

Outstanding debtors	150

	£000
Expenses paid	1,275
Cost of sales 1,580 * 80%	1,264
WIP	11
Less provision for loss	(11)
	0

Turnover	1,200
Cost of sales	1,264
Loss in year	(64)
Provision for future losses	(16)
Total loss	(80)

Provision for future losses	(16)
Less utilised against WIP	11
	(5)

6

	Site 1	**Site 2**	**Site 3**	**Total**
	£000	**£000**	**£000**	**£000**
Profit & Loss Account				
Turnover	400	500	1,200	2,100
Cost of sales	350	500	1,280	2,130
Profit/(loss)	50	0	(80)	(30)
Balance Sheet				
Debtors – amounts due on contracts	0	80	150	230
Stock – Contract WIP	0	100	0	100
Creditors – receipts in excess of amounts due on contracts	(50)	0	0	(50)
Provision for future losses on contracts	0	0	(5)	(5)

Totals and Summary 2

(17)

Question 4

(a) Deferred tax and pensions costs often cover fairly long time periods, sometimes in excess of ten years. *1*

Inflation tends to increase prices year on year; as prices increase the real value of money decreases. Therefore £1 in hand now is worth more than £1 in two years time. *1*

When estimating expenses we need to include the fair value of the expected costs. If the costs are expected to be incurred in the future then the real value of those items at today's prices is less. We therefore need to discount future expenses to fair value at today's prices. *2*

If the future expenses were not discounted their effect would be overstated in the accounts. *1*

(5)

(b) **Current purchasing power (CPP) accounting**
The current purchasing power of an asset is its original cost adjusted for inflation since its acquisition. *2*

CPP accounting makes adjustments to income and capital values to allow for the general rate of price inflation. Non-monetary assets are restated using the RPI. Monetary items are not restated. *2*

Profit in CPP accounting is measured after allowing for maintenance of equity capital – profit is only recognised after non-monetary assets have been restated. *2*

(6)

(c) Discounting uses an estimate of the time value of money, the discount rate, to reduce future payments or receipts to their present value. *2*

Indexing takes a recognised index of actual price movements, such as the retail price index, and uses it to increase items such as non-monetary asset costs to present day prices. *2*

In other words discounting takes estimates and applies estimated discount rates to arrive at a present value figure. Indexing, as used in CPP for example, takes actual expenses and increases them by the average of actual past increases in prices. *2*

(6)

(17)

Question 5

(a) One mark each for explaining the meaning of relevance, reliability, comparability and understandability. *4*

(b) "Pervasive role" means that their role is all-encompassing, they underlie all aspects of financial statements. *1*

(c) The six headings should be applied to a public sector organisation and an example given to illustrate each heading's application.

One mark for each explanation one mark for each example; 6 x 2 = 12

(17)