ACCOUNTING THEORY AND PRACTICE

Professional 1
June 2003

MARKING SCHEME

CIPFA

Question 1

(a)

ABC plc

Profit and Loss Account for the Year ended 31 March 2003

	Continuing Operations £000	**Acquistions £000**	**Total £000**	
Turnover	13,050	1,780	14,830	½
Cost of sales (W8)	(4,700)	(280)	(4,980)	See workings
Gross profit	8,350	1,500	9,850	
Distribution costs (W8)	(1,088)	(157)	(1,245)	See workings
Administration costs (W8)	(751)	(82)	(833)	See workings
Profit on ordinary activities before interest	6,511	1,261	7,772	
Interest payable (W9)			(168)	See workings
Profit before tax			7,604	
Tax (W10)			(1,872)	See workings
Profit after tax			5,732	
Dividends (W11)			(261)	See workings
Retained profit for the year			5,471	

ABC plc

Balance Sheet as at 31 March 2003

	£000	**£000**	**£000**	
Intangible fixed assets	Cost	Amortisation		
Goodwill (W1)	150	105	45	See workings
Development expenditure (W2)	200	40	160	See workings
			205	
Tangible fixed assets				
Land (W5)			2,500	See workings
Buildings (W6)			7,000	See workings
Plant and equipment (W7)			2,992	See workings
Vehicles (W4)			1,200	See workings
Fixed asset investments			450	
			14,347	
Current assets				
Stock	716			
Debtors (W3)	1,672			See workings
Cash & bank	392	2,780		
Liabilities due in less than one year				
7.2% Debentures	(250)			½
Debenture interest	(9)			½
Tax	(1,830)			½
Dividends	(121)			½
Creditors	(970)			½
Amounts due on lease (W4)	(270)	(3,450)	(670)	½
			13,677	
Liabilities due in more than one year				
Amounts due on lease (W4)			(990)	½
			12,687	
Provisions				
Deferred tax			(140)	½
			12,547	
Share Capital & Reserves				
Ordinary shares			4,000	
Preference shares			450	
Share premium			475	½
Revaluation reserve (W11)			1,131	See workings
Profit & loss account (W13)			6,491	See workings
			12,547	

Workings

W1 Note (i)

Assets acquired				
Land		400		
Buildings		590		
Equipment		315		
Debtors		60		
Stock		35		
		1,400		
Cost		1,450		
Goodwill		50		*1*
Amortisation 1/10		5	P&L	*½*
		45	B/S	

Goodwill				
Balance B/F		100	90	
Acquired		50		*½*
Amortised in yr			15	*½*
		150	105	

W2 Note (iii)

Research & development		321		
Less research		121		
		200		*½*
Amortisation 1/5		(40)		*½*
		160		

W3 Note (v)

Debtors		1,800		
Acquired		60		*½*
		1,860		
Bad debt	30			
Specific provision	70	(100)	P&L	*½*
		1,760		
5% Provision		(88)	P&L (105 – 88) = 17	*½*
		1,672	B/S	

W4 Note (vi)

Payments (5 x 390)		1,950		
Fair value		(1,500)		
Finance charge		450		*1*
Sum of digits is 15				
Years finance charge (5/15 x 450)		150	P&L	*1*

Vehicles				
Fair value		1,500		*½*

Depreciation 1/5)	(300)			½
	1,200	B/S		

Lease creditor		
Current liability	1500 – 390 + 150 = 1260 – 990 = 270	*1*
Creditor > 1 year	1260 – 390 +120 = 990	*1*

W5 Note (vii)

Land				
Per trial balance	2,030			
Acquired	400			½
	2,430			
Revalued to	2,500			½
Revaluation reserve	70	B/S		

W6 Note (viii)

Buildings				
Per trial balance	5,750			½
Acquired	590			
	6,340	P & L		
Depreciation 1/35	(181)	109	Cost of sales	½
	6,159	36	Distribution	
Revaluation	7,000	36	Admin	½
Revaluation reserve	841	B/S		

W7 Note (ix)

Plant & equipment			
Per trial balance	3,176		
Acquired	315		½
	3,491		
Depreciation 1/7	(499)	P&L	½
	2,992	B/S	

W8	Cost of Sales	Administration	Distribution	
Opening stock	648			
Stock acquired	35			½
Purchases	2,319			½
Closing stock	(716)			½
Admin wages		418		½
Delivery costs			873	½
Factory supervisors	305			½
General non-productive overhead		281		½
Production wages	1,620			½
Warehousing			426	½
	4,211	699	1,299	
Goodwill amortised - new acquisition		5		½
Research	121			½
Development amortised	40			½
Bad debt and specific provision		100		½
General provision for bad debts		(17)		½
Lease payment			(390)	½
Depreciation buildings	109	36	36	½
Depreciation plant & equip	499			½
Depreciation vehicles			300	½
Goodwill amortised		10		½
Total	4,980	833	1,245	
New acquisition	280	82	157	½
Continuing activities	4,700	751	1,088	

W9				
Interest payable				
7.2% Debentures	18			½
Paid		9		
Due		9	B/S	
Finance charges lease	150			½
	168	P&L		

W10 Note (iii)			
Tax			
Current year estimate	1,830		½
Deferred tax	42		½
	1,872	P&L	
Deferred tax			
Full provision	140		
Less trial balance	(98)		
	42		*1*

W11
Dividends

Ordinary shares			
Interim	120		
Final	100	220	½
Preference shares			
Interim	20		
Final	21	41	*1*
		261	

W12
Revaluation reserve

Per trial balance	220	
Land	70	½
Buildings	841	½
	1,131	

W13
Profit and loss account

Per trial balance	1,020	½
Profit for year	5,471	½
	6,491	

(35)

(b)

Earnings per share:		
Number of ordinary share per trials balance	4,000	½
Less public issue	(1,000)	½
	3,000	
Less bonus issue one for five	500	½
Shares in issue at 1 April 2002	2,500	
Weighted average number of shares:		
At start of year	2,500	
Bonus issue	500	
	3,000	
Plus public issue 4/12 x 1,000 =	333	*1*
	3,333	
EPS = 5,691/3,333 = 171p		½
Diluted EPS		
Options value = £200,000 x £1.25 =	250	½
Shares at full value (250/1.45)	172	½
Bonus element	28	½
Weighted average shares	3,333	
Bonus element of options	28	*1*
	3,361	

Diluted EPS = 5,691/3,361 = 169p *½*

(6)

(c) Statement of Total Recognised Gains and Losses
For the year ended 31 March 2003

	£000	
Profit for the year (after tax)	5,732	*1*
Unrealised surplus on revaluation of:		
Land	70	*½*
Buildings	841	*½*
Total gains relating to the year	6,643	
		(2)

(d) Reconciliation of Movements in Shareholders Funds
For the year ended 31 March 2003

	£000	
Profit for the year	5,691	*½*
Dividends	220	*½*
	5,471	
Other gains and losses	911	*1*
New share capital subscribed	1,400	*1*
Net additions to shareholders funds	7,782	
Opening shareholders funds	4,315	*see below*
Closing shareholders funds	12,097	

Opening shareholder funds		
Ordinary shares	2,500	*½*
Share premium (475 – 400)	75	*1*
Revaluation reserve	220	*½*
Profit and loss (1,020 + 500)	1,520	*1*
	4,315	
		(6)

(49)

Question 2

(a) An impairment review is required when events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. *1*

XYZ plc carried out an impairment review because the new legislation led to higher costs making the products less economic. *1*

The legislation is the event that led to changed circumstances requiring a review. *1*

(3)

(b) According to FRS 10 if intangible fixed assets give control of future benefits and can be separately identified their cost can be carried on the balance sheet and amortised over their useful economic life. *1*

If the intangible fixed asset has a readily ascertainable market value it can be revalued. *1*

Purchased goodwill can be carried on the balance sheet at cost and amortised over its useful economic life. *1*

Internally generated goodwill cannot be recognised. *1*

Goodwill cannot be revalued although if it becomes impaired it can be written down. *1*

(5)

(c)

Production machines	£000
Book value	640
Estimated present value	510
NRV	315

The value in use has reduced to £510,000 therefore the production machinery should be reduced to a net book value of £510,000. *1*

This requires £130,000 to be written off. The machines have previously been revalued:

	£000
Valuation	800
Net book value	(700)
	100

1

Write off £100,000 to revaluation reserve and the balance, £30,000 to the profit and loss account. *1*

Goodwill has no value as the change in legislation has affected XYZ plc's market. Write off the £32,000 to profit and loss account. *1*

The cost of brand names should be included as an intangible fixed asset at £1,200,000 and then be amortised over 10 years. *½*

Amortisation for the year will be £120,000 and will be charged to the profit and loss account. *1*

Patents will initially be recognised at cost of £600,000 and then amortised over 10 years. The charge to the profit and loss account for the year will be £60,000. *1*

The patents meet the requirement for a readily ascertainable market value as they have been valued. Revalue the net book value to £900,000. *1*

Credit the revaluation reserve with £360,000 *1*

	£000	
Cost	600	
Year's amortisation	(60)	
Net book value	540	*½*
Revalued to	900	
	360	*1*

Only purchased goodwill can be recognised, therefore the new internally generated goodwill cannot be recognised in the accounts. *1*

(Up to a maximum of 9 marks)

(17)

Question 3

(a) FRS 12 defines a provision as "a present obligation arising as a result of a past event and it is probable that a transfer of economic benefits will be required to settle the obligation and a reliable estimate can be made". *2*

A contingent liability is defined "where the obligation only arises on the occurrence of uncertain future events which are outside the control of the company or where the transfer of benefit is not probable". *2*

(4)

(b) (i) There is a present obligation to pay the rentals; a past event, the signing of the lease and transfer of benefits, cash payments. The unavoidable *1*
costs of meeting the obligation exceeds the economic benefits expected to be received under the lease. PR plc do not expect to receive any benefit yet they are unable to cancel the lease, so they must continue to *1*
pay the annual lease payment of £15 million and yet get no benefit. This can be defined as an onerous contract under FRS 12, the full amount *1*
payable (2 years at £15 million) should be provided for in full, possibly discounted if the difference is material. *1*

(b) (ii) As the tanker captain at fault cannot be established PR plc may not have a legal obligation to pay for the clean up. However due to their stated *1*
environmental policies there is almost certainly a constructive obligation *1*
to pay for the clean up. A provision should be made for the full cost of £50 million. *1*

(b) (iii) No provision is allowed by FRS 12. Although the Board of Directors has *1*
made a decision, they have not informed anyone, therefore they could *1*
change their minds. There is therefore no obligation either contractual or constructive, so there is no requirement to make any provision. *1*

(b) (iv) The expense will have to be incurred, once the oil rig is put in place and drilling starts the legal obligation exists to remove it at the end. Therefore *1*
the full cost of the £150 million should be provided for in the year to 31 *1*
March 2003. The £150 million should be discounted if it is material, which it probably will be over a 20 year period. *1*

(13)

(17)

Question 4

(a) Charities use fund accounting to enable them to report on each type of fund that they operate. Income and expenditure and assets and liabilities are recorded separately for each fund and separate accounts are prepared for each fund. This is known as fund accounting. *2*

The main objective of fund accounting is to maintain accountability for each separate identifiable set of resources. *1*

(3)

(b) The main differences between fund accounting and entity accounting are:

- Entity accounting accounts for the whole entity, in fund accounting the accounts are concerned with each fund which is only part of the entity. *1*
- Entity accounting is used by companies and is usually focused on profit or loss. Fund accounting is more concerned with accountability and does not focus on profitability. *1*
- Fund accounts emphasise the stewardship aspect of accounting, entity accounting has less emphasis on stewardship. *1*
- Fund accounting requires the source and purpose of all income and expenditure to be identified and recorded. Entity accounting simply needs to record the income and expenditure. *1*

(4)

(c) In a charity money donated for a specific purpose must be used for that purpose, each purpose is designated as a fund and money received and paid is recorded separately for each fund. Income and expenditure has to be accounted for according to its source and purpose. *(2)*

(d) The profit and loss account format is inappropriate because it emphasises profit, a charity is not concerned with profit and therefore sees a profit and loss account as inappropriate. *1*

The profit and loss account has inappropriate or no relevant headings, for example receipts are all assumed to be sales turnover. Whereas a charity has several different types of income and needs to identify income by source, for example from donors or investments. Some income to a charity could be capital that has to be invested to provide an endowment. *2*

Expenditure needs to be identified to its income source rather than just type of expenditure. *1*

The main differences are:

Profit and loss account	Statement of financial activities	
No income analysis	Income analysed by source and purpose.	*1*
analyses expenditure by type of expenditure	Expenditure analysed by source of funding and then into objects of charity; fund raising and administration.	*1*
Shows total for the entity only	Shows totals for each fund and transfers between funds.	*1*
Shows net profit Fixed format specified by CA85.	Shows net movement in funds Analyses income and expenditure in the way most appropriate to a particular charity, no fixed format.	*1* *1*
Contents and headings standard for all companies	Contents recommended but not mandatory.	*1*

(Maximum of 8 marks)

Question 5

(a) Report format *1*

A discussion of the bases of valuation and a comparison of the results of the calculations. *3*

Conclusion

As the offer is below the earnings based valuations it is not a fair offer *1*

If current profit levels can be maintained it is reasonable to use the last five months profits as a basis for projecting future profits. On this basis the minimum value of the shares should be £2.87. As Z plc have a particular objective in mind they should be willing to pay more than this minimum price, Z plc should be willing to pay at least £3 a share to achieve their objective. *2*

Appendix – Alternative Valuations
(All figures in £000s or 000s except final value per share)

		Valuation	*Value per share*	
Net assets – book value				
Book value		7,789		
Number of shares		5,000		
Value per share			£1.56	*1*
Net replacement cost of assets				
Buildings	5,750			
Other fixed assets	3,225			
Current assets	4,703			
Current liabilities	(4,219)			
		9,459		
Number of shares		5,000		
Value per share			£1.89	*2*

Earnings	*Earnings*	*P/E*	*Valuation*	*Value per share*	
Current year profit	1,385	9	12,465	£2.49	*1*
Average two years profit	1,283	9	11,547	£2.31	*1*
Forecast profit based on last 5 months	1,596	9	14,364	£2.87	*2*

(14)

(b) P/E is share price divided by earnings per share. The P/E ratio indicates how long an investor would take to get their money back. A high P/E indicates that the market has confidence in a particular company and is willing to wait for a return. *(3)*

(17)