ACCOUNTING THEORY AND PRACTICE

Professional 1 examination
3 June 2003

From 2.00 to 5.00 pm,
plus ten minutes reading time from 1.50 pm to 2.00 pm.

Instructions to candidates

*Answer **four** questions in total. Question **1** in Section **A** and **three** questions from Section **B**. The marks available for each question are shown in italics in the right hand margin.*

All workings should be shown. Where calculations are required using formulae, calculators may be used but steps in the workings must be shown. Calculations with no evidence of this (for example, using the scientific functions of calculators) will receive no credit. Programmable calculators are not permitted in the examination room.

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.

Formula sheets, statistical tables, graph paper and cash analysis paper are available from the invigilator, where applicable.

A proforma Profit & Loss Account, Balance Sheet, Cash Flow Statement and Statement of Total Recognised Gains & Losses are appended to this paper and can be submitted as part of an answer.

SECTION A (Compulsory)

Use may be made of the proformas attached to this question paper.

1

The trial balance of ABC plc as at 31 March 2003 is as follows:

	£000	£000
7.2% Debentures September 2003		250
9% Preference shares		450
Administration wages	418	
Buildings	5,750	
Business purchase	1,450	
Cash and bank	392	
Creditors		970
Debenture interest paid	9	
Debtors	1,800	
Deferred tax provision		98
Delivery costs	873	
Factory supervisors' salaries	305	
General non-production overheads	281	
Goodwill	10	
Interim dividends paid		
• Ordinary	120	
• Preference	20	
Investment properties	450	
Land	2,030	
Ordinary shares £1 each		4,000
Plant and equipment	3,176	
Production wages	1,620	
Profit and loss reserve		1,020
Provision for doubtful debts		105
Purchases of raw materials and finished goods	2,319	
Research and development costs	321	
Revaluation reserve		220
Share premium account		475
Stock (raw materials, WIP & finished goods) 1 April 2002	648	
Turnover		14,830
Warehousing costs	426	
	22,418	22,418

The following information relates to the year ended 31 March 2003:

(i) ABC plc bought a retail business for £1,450,000 on 1 April 2002; the market value of the assets acquired were:

- Land £400,000;
- Buildings £590,000;
- Equipment £315,000;
- Debtors £60,000;
- Stock £35,000.

The transaction has been recorded in the accounts by crediting the bank account and debiting the Business Purchase account with the cost of £1,450,000.

The income and expenses for the period that relate to the new acquisition were as follows:

	£000
Turnover	1,780
Cost of sales	280
Delivery costs	105
General non-production overheads	32
Administration wages	50
Warehousing costs	52

Note: These are the only income and expense figures that should be shown in relation to the acquired business. All income and expenses are included in the trial balance figures.

(ii) The closing stock-take identified stocks with a total value of £716,000 at 31 March 2003.

(iii) Research and development costs include research expenditure of £121,000; the remaining costs relate to a product that went into production on 1 April 2002 and is expected to be profitable for a minimum of 5 years.

(iv) Full provision for deferred tax amounts to £140,000 at 31 March 2003. The estimated corporation tax due for 2002/3 is £1,830,000.

(v) Bad debts amounting to £30,000 should be written off. A specific provision for doubtful debts should be made for £70,000 and a general provision for doubtful debts at the year end should be provided at 5%.

(vi) A new finance lease was entered into on 15 March 2002 to acquire delivery vans to be delivered on 1 April 2002. The fair value of the vans was £1,500,000; the annual rental is £390,000 for 5 years, payable on 31 March each year starting in 2003; interest is allocated using the sum of digits method. The only entry made in the accounts was to debit the annual rental to delivery costs.

(vii) Land and buildings were revalued on 28 March 2003; buildings were valued at £7,000,000 and land at £2,500,000. The valuations are to be entered in the accounts for the year ended 31 March 2003.

(viii) The average remaining life of buildings was assessed as 35 years from 1 April 2002; buildings are split 60% factory, 20% warehouse and 20% office.

(ix) The plant and equipment is depreciated over 7 years on the straight line basis.

(x) Goodwill of £100,000 arose when ABC plc bought a business 9 years ago. ABC plc's policy is to amortise purchased goodwill over a ten-year period, charging a full year in the year of acquisition.

(xi) The share capital and reserve figures on the trial balance include a one-for-five bonus issue of ordinary shares on 1 October 2002 and a public issue of 1 million shares at a price of £1.40 per share on 1 December 2002. All shares in issue at the end of the year rank for the final proposed dividend of 2.5p per share.

(xii) At 31 March 2003 there were outstanding share options that had been granted to the directors during the year. No options were exercised during the year ended 31 March 2003.

- Options at 31 March 2003, 200,000 ordinary £1 shares @ £1.25.
- Average share price for the period was £1.45.

- **Requirement for question 1**

(a) Prepare the Profit and Loss Account for the year ended 31 March 2003 and a Balance Sheet at that date. Notes to the accounts are not required, but all workings must be shown. *35*

(b) Calculate the earnings per share and fully diluted earnings per share for the year ended 31 March 2003. *6*

(c) Prepare the Statement of Total Recognised Gains and Losses for the year ended 31 March 2003. *2*

(d) Prepare the Reconciliation of Movements in Shareholders Funds for the year ended 31 March 2003. *6*

(49)

SECTION B (Answer three questions)

2

New government legislation was recently introduced requiring a redesign of most of XYZ plc's products. The change required a complete redesign to meet the new regulations on safety. The new design led to longer production times and significantly increased the cost price of all the products, making it less economical for XYZ plc to continue to manufacture and sell.

XYZ plc carried out an impairment review on 31 December 2002. The review identified the following:

- carrying value of production machines at 31 December 2002, £640,000
- estimated present value of future cash flows from the production machines, £510,000
- net realisable value of production machines, £315,000
- carrying value of purchased goodwill relating to the product is £32,000, but estimated present value of future cash flows from this goodwill is zero as a result of the new legislation
- all other tangible fixed assets, including land and buildings, had a carrying value similar to the value in use which totalled £5,230,000
- production machines had been revalued two years ago when the valuation was £800,000 and the net book value was £700,000
- revaluation reserve balance at 31 December 2001 was £100,000.

XYZ plc has a financial year end of 31 December. The directors want the valuations recorded in the accounts for the year ended 31 December 2002.

To counter the changes caused by the legislation XYZ plc decided to acquire a brand name and relevant patents from W Ltd. XYZ plc paid W Ltd, on 1 February 2002, £1.2 million for the brand name and £0.6 million for the patents. The new products launched using the patents have proved so successful that the directors of XYZ plc have had the patents revalued at 31 December 2002. The current value of the patents is £0.9 million. The new products have helped XYZ plc establish a new improved image in the market and the directors are firmly of the opinion that new goodwill has been generated. They estimate the goodwill generated to be £100,000. The directors want the patents and goodwill revalued at 31 December 2002.
Goodwill is amortised over 20 years and intangible fixed assets over 10 years. A full year's amortisation is charged in the year of acquisition.

- **Requirement for question 2**

(a) Explain why XYZ plc carried out an impairment review on 31 December 2002. *3*

(b) Explain the FRS 10 – Goodwill and Intangible Fixed Assets requirements relating to the revaluation of goodwill and intangible fixed assets. *5*

(c) Explain how the items above should be treated in XYZ plc's accounts for the year ended 31 December 2002. Specify any amounts required to be taken to the profit and loss account or revaluation reserve. *9*

(17)

3

PR plc is a company that carries out many different activities. It is proud of its reputation as a 'caring' organisation and has adopted various ethical policies towards its employees and the wider community in which it operates. In addition to its annual report, PR plc publishes a separate environmental report which states that PR plc "will do everything in its power to protect the environment" and details its environmental policies. The policies of PR plc include setting performance targets for activities such as recycling, controlling emissions of noxious substances and limiting use of non-renewable resources.

The chief accountant of PR plc is reviewing the draft financial reports for the year ended 31 March 2003, checking the accounting treatment of various items prior to submitting them to the finance director. The chief accountant is concerned about the treatment of the following:

(i) PR plc occupied their London offices on an operating lease that runs for a further 2 years to 31 March 2005. During October 2002 the headquarters of PR plc moved from London to Newcastle in order to take advantage of various government grants and reduced property costs. Annual rentals under the lease are £15 million. PR plc is unable to cancel the lease and is having significant problems re-letting the offices. The directors have been advised that the chances of re-letting are very low, less than 30%, due to the short time left on the lease. The annual rental payments up to October 2002 have been included in the accounts.

(ii) PR plc operates a number of oil wells and oil tankers in the North Sea. In February 2003, during heavy seas, one of PR plc's tankers collided with another tanker in the approach to the oil terminal. The collision resulted in a very large oil slick that caused a lot of pollution and damage to wildlife. PR's legal advisers are of the opinion that t is very unlikely that the enquiry into the collision will be able to prove who was at fault. As a result PR plc would not be legally liable for the cost of the clean up operation. The clean up cost of £50 million has therefore been completely excluded from PR plc's final accounts.

(iii) PR plc plans to spend £350 million to upgrade their fleet of tankers to reduce the risk of pollution in any future collisions. The chief accountant is wondering whether this should be included as a provision in the accounts.

(iv) When PR plc received their licence to drill for oil, the conditions of the licence included the requirement to remove the oil rig and restore the sea bed at the end of the life of each oil well. The oil wells are estimated to have economic lives of at least 20 years each. The total cost of removing the oil rigs and restoring the sea bed is estimated to be £150 million in 20 years' time. No entries have been made in the accounts to 31 March 2003 as it is thought that 20 years' time is too remote.

- **Requirement for question 3**

(a) Define the meaning of "provision" and "contingent liability" as defined by FRS 12 – Provisions, contingent liabilities and contingent assets. *4*

(b) Explain how each of the items in notes (i) – (iv) above should be treated in the financial statements of PR plc for the year ended 31 March 2003. *13*

(17)

4

Fund accounting is widely used by charities and has some significant differences from entity accounting.

One of the objectives of published accounts is to present information that is useful to the user. The use of fund accounting by most charities means that the traditional profit and loss account format is inappropriate for those charities' activities, so a Statement of Financial Activities is published instead.

- **Requirement for question 4**

(a)	Explain the meaning and main objectives of fund accounting.	*3*
(b)	Explain the main differences between fund and entity accounting.	*4*
(c)	Explain why charities usually operate a system of fund accounting.	*2*
(d)	Explain why the profit and loss account format is inappropriate for charities and briefly outline the main differences between the Profit and Loss account and the Statement of Financial Activities.	*8*
		(17)

5

A Ltd is an unquoted company and prepares accounts to 31 December each year. A Ltd has received a cash offer to acquire all of its ordinary shares on 30 June 2003 at £2.25 per share. The offer has been received from Z plc, one of A Ltd's main competitors, who are seeking to reduce their competition by acquisition.

Extracts from A Ltd's Profit and Loss accounts for the year ended:

	31 Dec 2001	31 Dec 2002
	£000	£000
Profit for the year after tax	1,180	1,385
Dividends	500	500
Retained profit for the year	680	885

Summarised Historic Cost Balance Sheet as at 31 December 2002:

	£000	£000
Buildings		4,200
Other tangible fixed assets		3,025
		7,225
Current assets	4,783	
Current liabilities	4,219	
		564
		7,789
Ordinary share capital, £1 ordinary shares fully paid		5,000
Retained profits		2,789
		7,789

Additional information:

(i) A Ltd's sales and profits accrue evenly over the year.

(ii) The five months' profits to 31 May 2003 were £665,000 after tax. The directors are confident that the trend can be maintained or even increased further.

(iii) The net replacement cost (current use) of the assets at 31 December 2002 was:

	£000
Buildings	5,750
Other fixed assets	3,225
Current assets	4,703

(iv) Shares of quoted companies in the same industry have an average P/E ratio of 12.

(v) The extra risk factor for unquoted companies is 25% in this industry.

- **Requirement for question 5**

(a) Draft a brief report to the shareholders of A Ltd evaluating whether the offer from Z plc is a fair one. Calculations should be shown as an appendix to the report. *14*

(b) Note (iv) above states that the average P/E ratio is 12. Explain the meaning of the term P/E ratio and its significance to investors. *3*

(17)

PROFORMA PROFIT AND LOSS ACCOUNT

	continuing operations	acquisitions	discontinued	total
	£	£	£	£
Turnover				
Cost of sales				
Gross profit or loss				
Distribution costs				
Administration costs				
Other operating income				
Operating profit or loss				
Exceptional items				
Profit or loss on ordinary activities before interest				
Interest receivable				
Interest payable				
Profit or loss on ordinary activities before tax				
Taxation				
Profit or loss for the financial year				
Dividends				
Retained profit for the financial year				

PROFORMA BALANCE SHEET

Fixed assets
    intangible assets

    tangible assets

    investments

Current assets
    stock
    debtors
    investments
    cash at bank and in hand

Prepayments and accrued income

Creditors: amounts falling due within one year
    trade creditors
    tax
    loans
    dividends
    other creditors
    accruals and deferred income

NET CURRENT ASSETS

TOTAL ASSETS LESS CURRENT LIABILITIES

Creditors: amounts falling due after more than one year

Provisions for liabilities and charges

CAPITAL AND RESERVES
Called up share capital

Share premium account

Revaluation reserve

Other reserves

Retained profits

PROFORMA CASH FLOW STATEMENT

Net cash inflow from operating activities

Returns on investments and servicing of finance

Taxation

Capital expenditure

Equity dividends paid

Management of liquid resources

Financing

Increase in cash

PROFORMA STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

Profit for the financial year

Revaluation reserve arising during the year

Exchange adjustments

TOTAL RECOGNISED GAINS AND LOSSES FOR THE FINANCIAL YEAR

Prior year adjustments

TOTAL GAINS AND LOSSES RECOGNISED SINCE LAST ANNUAL REPORT