ACCOUNTING THEORY AND PRACTICE

Professional 1 examination
2 December 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.

CIPFA

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

SECTION A (Compulsory)

1 The following are summarised financial statements of NetWise plc.

Balance sheet as at 30 September 2002

	£000	£000	£000 Net book value
Fixed assets			
Intangible assets			296
Tangible assets			2,753
			3,049
Current assets:			
Stock		1,360	
Bank		22	
		1,382	
Less creditors due in less than one year:			
Trade creditors	790		
Taxation	10		
Proposed dividend	0		
Bank loans and overdrafts	761		
Accrued interest	30		
		1,591	
Current assets less current liabilities			(209)
Total assets less current liabilities			2,840
Creditors due in more than one year:			
10% Debentures			(422)
Provisions for liabilities and charges:			
Deferred tax			(816)
			1,602
Ordinary shares of £1 each			900
Share premium			345
Profit and loss account			357
			1,602

Profit and loss account for the year to 30 September 2003

	£000	£000
Turnover		4,810
Cost of sales:		
Opening stock	1,360	
Purchases	3,745	
	5,105	
Closing stock	1,200	
		3,905
Gross profit		905
Expenses:		
Distribution	(240)	
Administration	(626)	(866)
Operating profit		39
Interest payable		(95)
Loss before tax		(56)
Taxation:		
Corporation tax payable	(12)	
Deferred tax credits	89	77
Profit after tax		21
Ordinary dividend proposed		(18)
Retained profit		3

Notes:

(i) During 2003 £1,000,000 5% debentures were issued at par. Costs associated with the issue were £20,000. NetWise plc used the cash raised from the debenture issue to redeem the 10% debentures at a premium of 5% and to reduce the overdraft. The issue costs and premium on redemption have been charged to administration expenses.

(ii) The bank overdraft was further reduced by a new issue of 240,000 £1 ordinary shares at a price of £1.25 per share.

(iii) The tangible fixed assets at 30 September 2002 comprised:

	Cost	Depreciation to date	Net book value
	£000	£000	£000
Equipment, furniture & fittings	555	222	333
Computer hardware	1,890	270	1,620
Website development costs	933	133	800
			2,753

(iv) During the year ended 30 September 2003, furniture and equipment costing £40,000 and written down to £8,000 at 30 September 2002 was sold for £9,000.

(v) Equipment, furniture and fittings purchased during the year ended 30 September 2003 cost £25,000. Furniture and equipment are depreciated over 10 years on a straight-line basis calculated on the cost balance at the year-end.

(vi) All sales are paid by credit card in advance. The debtor's balance at 30 September 2003 was nil.

(vii) Computer hardware and web development costs are depreciated over 7 years on a straight-line basis.

(viii) The intangible fixed assets relate to goodwill, original cost £370,000, arising on the acquisition of a smaller Internet company on 1 October 2000. Goodwill is amortised over 10 years.

(ix) The tax charge for the year ended 30 September 2003 is £12,000. Deferred tax balance at 30 September 2003 was reduced to £727,000. NetWise plc directors expect to continue making profits in 2004 and beyond.

(x) Balances at 30 September 2003 included:

• Accrued interest payable	£26,000
• Creditors	£827,000
• Bank	£743,000
• Taxation	£12,000

(xi) Cost of sales for the year ended 30 September 2002 was £3,700,000.

- **Requirement for question 1**

(a) Prepare NetWise plc's Cash Flow Statement for the year ended 30 September 2003, along with all notes to the cash flow as required by FRS 1 - Cash Flow Statements (Revised). *20*

(b) Prepare NetWise plc's balance sheet as at 30 September 2003. *10*

(c) The directors had the "NetWise" brand name valued, by a firm of specialist valuers, at £150,000 on 30 September 2003. NetWise has built up a strong brand loyalty with a large number of registered users on the NetWise websites. The NetWise directors want to recognise the value of this loyalty and the creation of the brand name value by revaluing goodwill upwards by £150,000.

Draft a reply to the NetWise plc directors, advising them of the requirements of FRS 10 – Goodwill and intangible assets regarding revaluation of goodwill. *7*

(d) Assess the changes in liquidity of NetWise plc during the year ended 30 September 2003. *12*

(49)

All calculations should be to the nearest £000.

SECTION B (Answer three questions)

2 The following trial balance was extracted from the books of the GHI plc as at 31 March 2003

	Dr	Cr
	£000	£000
£1 ordinary shares		30,000
5% Debentures		20,000
Undistributed profit at 1 April 2002		7,600
Share premium account		4,500
Creditors		7,950
Provision for depreciation – Buildings (as at 1 April 2002)		5,000
Provision for depreciation – Plant & Machinery (as at 1 April 2002)		12,010
Provision for doubtful debts		417
Sales		74,841
Cost of goods sold	47,280	
Stock at 31 March 2003	5,490	
Land and building at cost	38,650	
Plant & machinery at cost	32,600	
Bank	17,122	
Administration expenses	4,330	
Debenture interest	500	
Directors' fees	2,140	
Interim ordinary dividend paid	600	
Distribution expenses	1,320	
Debtors	10,300	
Long term contract work in progress	1,927	
Lease payments	59	
	162,318	162,318

Additional information available was as follows:

(i) Corporation tax for the year is estimated at £4,100,000.

(ii) Depreciation on plant and machinery is regarded as a "cost of sales" expense and is at 10% per annum on cost.

(iii) On 5 May 2003 GHI was advised that one of its major customers had gone into liquidation. The outstanding balance on their account at 31 March 2003 was £330,000. It is very unlikely that any money will be received from the liquidator.

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

(v) In addition to its normal product sales, GHI plc has a three-year contract to build a leisure facility for the local council. The total contract value is £7.5 million; at 31 March 2003 the work certified as complete was 30% of the contract. The estimated cost of the additional work to complete the contract was £3,696,000. No payments on account have yet been received from the council.

(vi) The directors, on the advice of an independent valuer, wish to revalue the land and buildings at £35,000,000 on 1 April 2002. (This comprises £25,000,000 for buildings, £10,000,000 for land.) At 1 April 2002 the buildings were 25 years old and were deemed to have a useful life overall of 50 years. Depreciation on buildings is regarded as an administration expense.

(vii) The lease payments relate to a lease for equipment, commencing 10 October 2002. The lease term is 12 months, and the useful economic life of the equipment is 7 years. The fair value of the equipment at the inception of the lease was £350,000.

(viii) The directors wish to provide for a final ordinary dividend of 2p per share

- **Requirement for question 2**

Prepare GHI plc's Profit and Loss account for the year ended 31 March 2003 and a Balance Sheet at that date. ***(17)***

3

(a) The Accounting Standards Board's (ASB) Statement of Principles for financial reporting (SoP), chapter 4 defines elements of financial statements.

- **Requirement for question 3(a)**

Explain how the SoP defines:

(i) An asset.
(ii) A gain.
(iii) A distribution to owners. *3*

(b) FRS 19 Deferred Tax requires that deferred tax is provided in full on all timing differences. In situations where the tax paid is higher than the charge to the profit and loss account due to timing differences, for example where depreciation is more than capital allowances, a deferred tax asset may be recorded in the balance sheet.

- **Requirement for question 3(b)**

Using the ASB's SoP, justify the treatment of deferred tax as an asset in these situations. *5*

(c) X Ltd contracted B Ltd, a building contractor, to remove and replace an old leaky roof on one of their buildings at a cost of £20,000. B Ltd carried out the work which was completed on 31 July 2003. Very soon after the roof was completed it became clear that the new roof had not been correctly installed and that there were several leaks in it.

X Ltd complained to B Ltd, who claimed that they are not at fault as they sub-contracted the work to D Ltd.

X Ltd started legal action against B Ltd on 31 August 2003. B Ltd's legal advisers are of the opinion that the claim for £20,000 compensation from X Ltd is very likely to be successful. B Ltd has made a counter claim against D Ltd for £20,000 plus expenses. B Ltd's legal advisers are confident that B Ltd has a very strong case against D Ltd. On further investigation it was found that D Ltd has several outstanding legal claims against it and that D Ltd has recently gone into liquidation.

You work for B Ltd as a trainee accountant. The assistant accountant of B Ltd proposes to offset the claim and counter claim in the financial statements for the period ended 30 September 2003.

- **Requirement for question 3(c)**

Advise the assistant accountant whether the proposed treatment in the financial statements for the year ended 30 September 2003 is acceptable. *9*

(17)

4

D Ltd had cash flow problems and needed to raise cash to enable it to continue trading.

(i) D Ltd decided to factor its debts to F plc, a debt factoring company. D Ltd agreed the following terms with F plc:

1. F plc will pay the full value of debts transferred less 15%. All amounts paid will be non-returnable.

2. F plc will keep 5% of the amounts transferred as a factoring fee.

3. Any amounts collected above 90% of the amount transferred will be repaid to D Ltd.

4. During the year to 31 October 2003 the book value of debts transferred were £10million. No repayments had been received from F plc before the year-end.

(ii) D Ltd raised cash by selling its HQ building to I plc, a property investment company, on 30 June 2003. The building was sold for £5 million when the current market value was £9 million. D Ltd can repurchase the building at any time between one and five years after the sale. The repurchase price will be calculated as £5 million plus interest at 2.5% above bank base rate for the period between the sale and the repurchase.

(iii) D Ltd gives a two year warranty to all purchasers of its products. Under the warranty D Ltd undertakes to make good, by repair or replacement, manufacturing defects that show up during the period of two years from the date of sale. Based on past experience, D Ltd's expectations of claims on the warranty are:

% Probability	Defects	Cost of repair £000
80	None	0
17	Minor	90
3	Major	120

Due to the uncertainty of claims, D Ltd's accountant is proposing that nothing is recognised in the financial statements for the year to 31 October 2003.

- **Requirement for question 4**

(a) Define the term "Off balance sheet finance" and explain why users of accounting statements may see it as a problem. *5*

(b) Explain how D Ltd should show the above transactions in their financial statements for the year ended 31 October 2003. *12*

(17)

5

You are a trainee accountant working for A plc. A plc acquired a 15% holding in Z Ltd's ordinary share capital 5 years ago at a price of £2.20 per share. A plc are now reconsidering their investment in Z Ltd, and are trying to decide whether to acquire more shares in Z Ltd or to sell the current holding.

Z Ltd Summary Profit and Loss accounts

for the year ended:	31 March 2002	31 March 2003
	£000	£000
Sales	1,100	1,075
Cost of sales	572	516
Gross profit	528	559
Administrative and other expenses	280	292
	248	267
Interest payable	27	27
	221	240
Taxation	87	92
	134	148
Dividends	34	48
	100	100

Z Ltd Summary Balance Sheets at:

	31 March 2002		31 March 2003	
	£000	£000	£000	£000
Tangible fixed assets		790		1,415
Current assets	230		210	
Current liabilities	(170)	60	(160)	50
		850		1,465
Creditors greater than one year:				
9% Convertible loan stock		(300)		(300)
		550		1,165
Ordinary Share Capital; £1 each		450		600
Share premium		-		365
Reserves		100		200
		550		1,165
Market price per share as at 31 March		£3.50		£3.60

During the year to 31 March 2003 the following occurred:

(i) Z Ltd made a rights issue of 1 new share for every 3 shares held on 30 September 2002. The rights issue was at £3.43 per share. The relevant market price on 30 September 2002 was £3.75 per share.

(ii) The convertible loan stock can be converted to ordinary shares on the basis of 1 share for each £2 of loan stock at anytime after 1 January 2005.

(iii) Assume Z Ltd's marginal corporation tax rate is 30%.

(iv) There were no share movements during the year ended 31 March 2002.

- **Requirement for question 5**

(a) Calculate Z Ltd's basic and fully diluted earnings per share for the year ended 31 March 2003, as required by FRS 14 Earnings Per Share. *7*

Note: Restating last years EPS is not required.

(b) As the first stage in A plc's decision regarding their investment in Z Ltd, you have been asked to draft a report to the Finance Director analysing A plc's return on its investment in Z Ltd, referring to any changes in the level of risk in their investment. *10*

(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