ACCOUNTING THEORY AND PRACTICE

Professional 1 examination
3 December 2002

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.

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.

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.

SECTION A (Compulsory)

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

1 C plc provides office cleaning services to a wide range of organisations nation-wide. C plc operates through a network of depots situated in most UK cities. The depots are generally rented spaces situated in out of town industrial developments. C plc has a policy to lease all major equipment and vehicles.

C plc
Balance Sheet as at 30 June 2001

Fixed assets	**Cost/Valuation £000**	**Depreciation £000**	**Net Book Value £000**
Intangible fixed assets:			
Goodwill	100	60	40
Tangible fixed assets:			
Leased equipment	765	306	459
Leased vehicles	1,625	650	975
	2,390	956	1,434
Total fixed assets	2,490	1,016	1,474
Current assets			
Stock		34	
Debtors		660	
Short term investments		170	
Bank and cash		291	
		1,155	
Creditors			
Amounts due within one year*		(883)	
Net current assets			272
Total assets less current liabilities			1,746
Creditors payable in more than one year:			
Amounts due on leases			(1,096)
Total net assets			650
Capital and reserves			
Issued share capital:			
Ordinary shares of £1 each fully paid			500
Retained profits			150
			650

***Creditors:** Amounts due within one year

Creditors	92
Proposed dividends	118

Corporation tax	200
Amounts due on leases	473
	883

During the year 1 July 2001 to 30 June 2002 the following transactions were recorded:

	£000
Debtors – invoiced for services rendered	4,090
Debtors – payments received	3,990
Debtors – bad debts written off in the year	20
Direct operating expenses paid (see (i) below)	2,695
Direct operating expenses incurred	2,682
Administration and distribution costs, incurred and paid	62
Lease payments made in year (excluding new lease) (see (ii) below)	630
New vans – lease payments made	33
Tax paid in year	190
Dividends paid in year	118
Investments purchased	330

Further information is available as follows:

(i) Direct operating expenses are regarded as cost of sales.

(ii) The lease finance payments are made up of the finance charge for the year of £157,000 and the lease principal repayments of £473,000.

(iii) An amount of £52,000 classified as "creditors payable in more than one year, amounts due on leases" at 30 June 2001 became due in less than one year at 30 June 2002.

(iv) Five new delivery vans were leased on 1 July 2001 to support the provision of services to an expanding number of clients. The terms of the finance lease are:

(1) Non-cancellable five-year lease.
(2) Fair value of all five delivery vans was regarded as £125,000.
(3) The interest rate implicit in the lease was 10%.
(4) The lease payments were £2,748 per month, paid monthly in arrears.

(v) Equipment and vehicles are depreciated on the straight line basis over five years.

(vi) At the year-end, C plc was defending a court case. A client claimed that C plc's employees had used the wrong cleaning solvent on their carpets and as a result they had changed colour. The client is claiming £100,000 compensation. Current legal advice is that the amount will probably have to be paid.

(vii) The goodwill relates to the purchase of various sole trader cleaning firms in previous years. C plc regards goodwill as relatively short lived and has a policy to write off purchased goodwill over five years, using the straight line method.

(viii) The final proposed dividend for the year is £125,000 and the estimated corporation tax charge for the year is £220,000.

(ix) Closing balances at 30 June 2002 included:
(1) Closing stock £35,000
(2) Bank and cash in hand £222,000

(x) Finance leases have been excluded from the definition of long term loans when calculating the ratios for C plc.

(xi) The management of C plc monitor their performance by an annual comparison of accounting ratios. The year's ratios are compared with the previous year's ratios and the industry average. The ratios for the current period are:

	C plc Year to June 2002	C plc Year to June 2001	Industry average (Calendar year 2001)
ROCE (Profit on ordinary activities before tax and interest on long term loans / Share holders funds plus long term loans)	64%	60%	35%
Asset turnover (sales / total assets)	4.8 times	5.4 times	2 times
Profit margin (return / sales)	14%	11%	17%
Liquidity – current ratio (current assets / current liabilities)	1.45:1	1.3:1	1.9:1
Debtors collection period (average debtors / sales per day)	63 days	65 days	59 days
Gearing (total long term debt / share holders funds plus long term debt)	0%	0%	35%

- **Requirement for question 1**

(a) Prepare C plc's Profit and Loss account for the year ended 30 June 2002 and the Balance Sheet at that date. *25*

(b) Explain the difference between univariate and multivariate ratio analysis. *5*

(c) Draft a report:

(i) Analysing C plc's recent performance. *12*

(ii) Indicating possible reasons for differences between C plc and the industry averages. *7*

Note: Base your answers on the data given in the question, ignoring your answer to part (a).

(49)

SECTION B (Answer three questions)

2

F plc operates a chain of retail stores. The directors of F plc have been expanding the business in recent years. The directors viewed the results for the year to 30 September 2002 as a good year. They are keen to continue expansion of the company by continuing to use all surplus cash to build or purchase new stores. Summary financial statements for F plc are given below.

F plc
Balance Sheet as at 30 September:

	2002		**2001**	
	£m	**£m**	**£m**	**£m**
Fixed assets				
Tangible fixed assets, net book values:				
Land and buildings		924		696
Plant, equipment, fixtures, fittings and vehicles		126		116
Buildings work in progress		25		33
		1,075		845
Current assets				
Stock	91		74	
Investments	30		120	
Bank and cash	10		40	
	131		234	
Creditors				
Amounts due within one year*	(219)		(185)	
Net current liabilities		(88)		49
Total assets less current liabilities		987		894
Creditors payable in more than one year:				
7.5% Debentures		(200)		(200)
		787		694
Provisions				
Deferred Tax		(50)		(40)
Total net assets		737		654
Capital and reserves				
Issued share capital:				
Ordinary shares of £1 each fully paid		34		34
Share premium		166		166
Revaluation reserve		100		30
Retained profits		437		424
		737		654

***Creditors:** Amounts due within one year

	30 Sept 2002	30 Sept 2001
	£m	**£m**
Creditors	181	153
Proposed dividends	15	12
Corporation tax	23	20
	219	185

Summary Profit and Loss Account for year ended 30 September 2002

	£m	**£m**
Turnover		1,880
Cost of sales		(1,763)
		117
Expenses		(40)
		77
Interest received	6	
Interest paid	(15)	(9)
		68
Taxation		(25)
		43
Dividends paid and proposed		(30)
Retained profit		13

(i) The cost of sales includes depreciation of £19m on land and buildings and £31m on plant, equipment, fixtures, fittings and vehicles.

(ii) During the year, F plc disposed of short-term investments. The gain of £13m on disposal is included under cost of sales.

(iii) During the year existing land and buildings were revalued. Additional land and buildings and plant, equipment, fixtures, fittings and vehicles were acquired.

(iv) Part of the building work in progress at 30 September 2001 was completed during the year and transferred to land and buildings at cost, £29m.

- **Requirement for question 2**

(a) Prepare F plc's cash flow statement for the year ended 30 September 2002, in accordance with FRS 1 Cash Flow Statements. *14*

(b) Prepare F plc's reconciliation of net cashflow to movement in net debt. (Note: other notes required by FRS 1 are not required in your answer). *3*

(17)

3 T plc is a small building contractor. At 30 September 2002 T plc had three housing developments under construction.

Site 1 was a small development of 10 homes for a sheltered homes charity. The work started on 1 March 2002 and is expected to be completed by August 2003.

Site 2 was a larger development of 60 houses for a housing association. The work started on 1 April 2002 and was due to take five years to complete.

The contracts for sites 1 and 2 provide for regular payments to be made by the principal throughout the contract.

Site 3 was a small development of 6 luxury homes for sale to the public by T plc. As at 30 September 2002 all six properties had been sold although work on two properties is still to be completed. The development was started in October 2001 and was scheduled for completion in January 2003.

Contract information available as at 30 September 2002

	Site 1	Site 2	Site 3
	£000	**£000**	**£000**
Total selling price of homes			1,500
Fixed price contract value	800	5,000	
Percentage completed in the year	50%	10%	80%
Cash received	500	420	1,050
Payments made in the year	400	600	1,275
Future estimated cost to completion	300	? (see below)	305

? the final outcome of this contract is not able to be estimated with sufficient reliability, but it is expected to be profitable.

- **Requirement for question 3**

Calculate the profit and loss account and balance sheet entries required to record the contracts in T plc's financial statements for the year ended 30 September 2002. *17*

4

Several recent accounting standards issued by the ASB either allow or require estimated cash flows for future periods to be discounted to present value, for example FRS 17 Retirement Benefits and FRS 19 Deferred Tax.

- **Requirement for question 4**

(a) Explain why future cash flows, such as deferred tax and pension costs, should be discounted. *5*

Alternative methods of accounting, such as current purchasing power (CPP), attempt to counter the effects of inflation by the use of indices.

(b) Explain the meaning of current purchasing power (CPP). *6*

(c) Explain the differences and similarities between discounting and indexing. *6*

(17)

5

FRS 18 replaces SSAP 2, Disclosure of accounting policies. FRS 18 applies to all financial statements that are intended to give a true and fair view except those complying with the FRSSE, which are exempt. FRS 18 states that the concepts of going concern and accruals play a 'pervasive role' in financial statements.

FRS 18 removes matching, prudence and realisation as primary considerations when selecting accounting policies and replaces them with relevance, reliability, comparability and understandability.

- **Requirement for question 5**

(a) Explain the meaning of relevance, reliability, comparability and understandability. *4*

(b) Explain what FRS 18 means by a 'pervasive role'. *1*

(c) FRS 18 is stated as applying to "all financial statements that are intended to give a true and fair view"; this will include public sector organisations. With reference to a public sector organisation with which you are familiar, explain the relevance of each of the following headings to the organisation, using examples to illustrate your answer:

(i) Relevance
(ii) Reliability
(iii) Comparability
(iv) Understandability
(v) Going concern

(vi)	Accruals	*12*
		(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