FINANCIAL REPORTING AND ACCOUNTABILITY

Professional 2

MARKING SCHEME

CIPFA

Question 1

H & S retail group
Balance sheet as at 30/9/03

	£000	£000	£000	Workings	
Fixed assets	Cost	Dep	NBV		
Goodwill	8	(3.2)	4.8	See W1	*4½*
Land and buildings	540	(85)	455	See W2	*1*
Plant and machinery	225	(95)	130		
Vehicles	119	(49)	70	See W3	*1½*
			659.8		
Current assets					
Stock	92			See W4	*1½*
Debtors	112			See W5	*½*
Cash	22			See W5	*½*
		226			
Current liabilities					
Creditors	(74)			(45 + 29)	*½*
Dividends H	(63)				
Dividends S	(3)			(9 – 6 intra group)	*½*
		(140)			
			86		
			745.8		
Long term liabilities					
Debentures 8%			(150)		
Debentures 10%			(40)	(80 – 40 intra group)	*½*
			555.8		
Financed by					
Ordinary £1 shares			200	Parent only	*½*
5% preference shares			60	Parent only	
Share premium			30		
Revaluation reserve			63.6	See W6	*1*
Profit and loss			153.2	See W8	*5*
			506.8		
Minority interest			49	See W7	*2½*
			555.8		
					(20)

Workings

1 Goodwill:

	£000	£000	
Cost of investment in ordinary shares		90	
Share capital	50		½
Revaluation reserve	8		½
Profit and loss	23		½
Fair value adjustment (land)	30		½
Fair value adjustment (vehicles)	(6)		½
	105		
% Acquired	80%		½
		(84)	
		6	
Cost of investment preference shares	22		
Less 50% Acquired	(20)	2	½
Total goodwill		8	
Depreciation to date (4 years x 8/10)		(3.2)	*1*
		4.8	*(4½)*

2 Land and buildings

	Cost £000	Dep^n £000	NBV £000	
H Ltd	320	(50)		½
S Ltd	190	(35)		
Fair value adjustment	30	-		½
	540	(85)	455	

3 Vehicles

	Cost £000	Dep^n £000	NBV £000	
H Ltd	85	(30)		½
S Ltd	40	(25)		
Fair value adjustment	(6)			½
Depreciation adjustment		6		½
	119	(49)	70	

4 Stock

	£000		
H Ltd	62		½
S Ltd	45		
Unrealised profit on stock	(15)	(150 – 100 = 50 x 45/150 = 15)	*1*
	92		

5 Debtors/Current Accounts/Cash

	Debtors	Current a/c	Cash	
	£000	£000	£000	
H Ltd	92	20	10	
S Ltd	26	(16)	8	
Cash in transit		(4)	4	½
Intra group dividends	(6)*			½
	112	0	22	

* Ordinary dividend 5 x 80% = 4
Preference dividend 4 x 50% = 2
6

6 Revaluation reserve

	£000	
H Ltd	62	
S Ltd	10	
Minority interest (10 x 20%)	(2)	½
Group share of pre-acquisition (8 x 80%)	(6.4)	½
	63.6	

7 Minority Interest

	£000	£000	
OSC	50		
Revaluation reserve	10		½
Profit and loss	55		
FV adjustment (land)	30		½
FV adjustment (vehicles)	(6)		½
Dep^{n} adjustment (vehicles)	6		
		145	
		x 20%	½
		29	
Preference shares (40 x 50%)		20	½
		49	

8 Profit and Loss account

	£000	£000	
Profit & loss account H		141	½
Post acquisition profit S			
Balance per accounts	55		
Less balance at acquisition	23		½
	32		
H Ltd's group share 80%		25.6	½
<u>Adjustments</u>			
Stock provision (W4)		(15)	*1*
Goodwill written off (W1)		(3.2)	½
Dep^{n} adjustment (vehicles)*		4.8	*2*
		153.2	

* Fair value adjustment of 6 x 3/3 = 6 x 80%

Question 2

(a) Calculation of the operating surplus or deficit.

	£000	
Opening income and expenditure	8,450	
Closing income and expenditure	7,470	
Net movement	(980)	*½*
Taxation (-800 + 700 + 526)	426	*1½*
Surplus on disposal of fixed assets (working 1)	(150)	*1*
Operating deficit	(704)	

Reconciliation of operating deficit to net cash flow

	£000	
Operating deficit	(704)	*½*
Depreciation (working 1 (400 + 2,430))	2,830	*2*
Investment income	(254)	
Interest payable	396	*½*
Decrease in stock	198	*½*
Increase in debtors	(224)	*½*
Increase in creditors (1,724 – 100 – 1,500)	124	*1*
Net cash flow from operations	2,366	
		(8)

Working 1

Surplus on disposal of fixed assets

Plant & Machinery

		Cost	Depn	NBV	Proceeds	Surplus
		£000	£000	£000	£000	£000
Bfwd		(4,800)	3,000			
Disposal		**1,500**	**(500)**	**1,000**	**1,050**	**50**
Cfwd		4,000	(2,900)			
Balancing figures	additions	700				
	depn in yr		(400)			

Buildings

		Valuation	Depn	NBV	Proceeds	Surplus
		£000	£000	£000	£000	£000
Bfwd		(9,200)	2,300			
Disposal		**800**	**(230)**	**570**	**670**	**100**
Cfwd		12,800	(4,500)			
Balancing figures	additions	4,400				
	depn in yr		(2,430)			
					1,720	**150**

Note: new assets cost £4,400 + £700 = £5,100. £5,000 has been paid with £100 creditor.

(b) Groanham University
Cash Flow statement for the year ended 31 July 2003

		£000	
Net cash flow from operating activities (part a)		2,366	½ *Own figure*
Returns on investment and servicing of debt			
Interest paid	(396)		½
Interest received	254		½
Net cash outflow		(142)	
Taxation		(700)	½
Capital expenditure and financial investment			
Payments to acquire assets (working 1)	(5,000)		*4½*
Acquisition of endowment investments	(2,500)		½
Receipts from assets disposals (working 1)	1,720		*1*
Endowment received	2,500		½
		(3,280)	
Management of liquid resources (500 – 500)		0	
Financing			
Loans raised		2,300	½
Increase in cash (1,551 – 1,007)		544	

(9)

(c) A wide range of points may be raised by students; examples of these points are:

- Reconciliation between income and expenditure and the cash flow statement is essential in understanding the two statements. The reconciliation permits the reader the opportunity to evaluate the impact of non–cash transactions.
- Cash Flow statements show an objective view of the financial position of the University, that is the receipt, payment and cash balances are factual.
- Income and Expenditure statements are prepared in accordance with accounting standards and reflect the underlying financial strength or weakness of the University (true and fair view).
- Both cash flow and income & expenditure statements are underpinned by the organisational controls therefore both are integrated and supportive of good governance.
- Controls over cash/bank transactions are viewed as higher risk so the soundness of controls and segregation of duties should be rigorously enforced. The statements do not, per se, evidence good governance but directors will have data to evaluate and challenge.
- All organisations must ensure sufficiency of cash to meet contractual payments including staff salaries.
- The University has different sources of income (grants, fees, rent etc) so by evaluating both types of statements directors will gain an appreciation of changes/issues. By seeking explanations to such issues directors are enhancing corporate governance practice.
- The cash flow fails to show all required analysis such as the reason for the increase in debtors. Governors must use the cash flow reconciliation and a source of questions for officers in order to fully understand the implications of the published reports.

Up to 2 marks per point raised, up to a maximum of 8
Marks will be awarded for relevant points

(25)

Question 3

(a)

Calculation of operating surplus:

	£000	
Retained surplus for the year (8,680 – 7,495)	1,185	½
Public dividend capital dividends paid	2,000	½
Interest received	(540)	½
Loss on disposal of equipment	120	½
Surplus on disposal on building	(1,220)	½
Operating surplus	1,545	

Reconciliation of operating surplus to net cash flow from operating activities

	£000	
Operating surplus (calculated above)	1,545	
Depreciation charged for the year (note 1 below)	3,030	*3*
Stock decreases (2,200 – 2,168)	32	½
Debtor increase (3,245 – 2,665)	(580)	½
Creditor decreases (1,880 – 2,105)	(225)	½
Net cash flow from operating activities	**3,802**	

(7)

Note 1
Workings for buildings

	£000		
Opening balance	29,350	50,350 – 21,000 (note 1)	
Disposals	(7,300)	Note 2	Sale proceeds = 7,300 + 1,220 = 8,520 (note 2)
Depreciation for year	(1,640)	Note 5	
Revaluation	800	Note 6	
Acquisitions (balance)	10,530		
Closing balance	31,740	52,740 – 21,000 (note 1)	

Workings for equipment

	Gross £000	**Dep'n £000**	**Net £000**		
Opening balance	8,100	2,105	5,995	Note 5	
Disposals	(1,240)	(590)	(650)	Note 3	Sale proceeds = 650 - 120 = 530 (note 3)
Depreciation for year (balance)		1,390	(1,390)	Note 5	
Revaluation	200		200	Note 6	
Donated asset	2,583		2,583	Note 9	
Acquisitions (balance)	607		607		
Closing balance	10,250	2,905	7,345	Note 5	

Total depreciation	1,640 + 1,390 = 3,030
New assets	10,530 + 607 = 11,137 – 120 creditor = 11,017
Proceeds	8,520 + 530 = 9,050

(b) Denby NHS Trust
Cash flow statement for the year ended 31 March 2003

	£000	**£000**	
Net cash flow from operating activities		3,802	½
Returns on investment and servicing of finance			
Interest received		540	½
Capital expenditure			
Payments to acquire fixed assets (note 1)	(11,017)		4
Receipts from the sale of fixed assets	9,050		2
Net cash flow from capital expenditure		(1,967)	
Dividends paid		(2,000)	½
Financing			
New PDC	1,000		½
Net cash flow from Financing		1,000	
Increase in cash (1,885 –(900 – 390))		1,375	
			(8)

(c) **1** **Break-even target**: The Trust is required to break-even on a three year basis. The Trust has returned a surplus of £1,185K. This will add to existing surpluses and should be used to off-set future planned deficits. *2*

2 **Capital cost absorption duty:** This requires NHS Trusts to earn a return (currently 6%) on their average relevant net assets. The actual absorption rate for the Trust is found by stating the PDC dividends as a proportion of its actual average relevant net assets for the year. Based on the information available Denby has only achieved an absorption rate of 3.3%.

	£000	
PDC dividends	2,000	= 3.3%
Average relevant net assets	60,893	

Calculation of average relevant net assets

	2003	2002	
	£000	£000	
Total capital and reserves	65,263	59,495	
Less:			
Donation reserve	(2,583)	0	
Plus:			
Loans and overdrafts	0	(390)	
	62,680 +	59,105	= 121,785/2
			= 60,893

2

3 External financing limit (EFL): This sets the amount of expenditure on operating costs and capital schemes on a cash basis that a Trust can have in year. Measurement of performance: The EFL is compared to the external financing requirement of the Trust.

The EFL of Denby can be calculated as:

	£000
Net cashflow before financing and management of liquid resources	2,375
Add: finance leases taken out in year	Nil
Less: Other capital receipts	Nil
EFL:	2,500
Undershoot	(125)

As the Trust is permitted to undershoot its EFL target, the target can be judged to have been met. *3*

4 Capital resource limit (CRL): This sets the amount of capital expenditure that the Trust can have in year on an accruals basis. Measurement of performance: The charge made against the CRL is measured against the limit set. Trust's may underspend against the limit but are not permitted to overspend.

The charge against the CRL for Denby can be calculated as:

	£000
Gross capital expenditure	13,720
Less: NBV of assets disposed of	(7,950)
Less: Donated assets received in year	(2,583)
Charge against the CRL:	3,187
CRL:	3,200
Undershoot	13

Denby has met its CRL. *3*

(10)

(25)

Question 4

(a) AMRA

	Debit		Credit	
	£000		£000	
Depreciation	26,837	Asset rents	101,600	
External interest	23,977			
Balance to CRA	50,786			
	101,600		101,600	*1 mark per entry*

Up to a maximum of 4

	Depreciation	Notional interest	Asset rent
	£000	£000	£000
Education	11,699	29,821	41,520
Social services	6,600	19,854	26,454
Cultural, Environment and Planning	2,873	12,753	15,626
Highways, Roads and Transport	2,444	9,334	11,778
Central services	3,221	3,001	6,222
	26,837	74,763	101,600

(b)

Sheen County Council consolidated revenue account for the year ended 31 March 2003

	Expenditure	Income	Net	
	£000	£000	£000	
Central services	14,561	(523)	14,038	*1*
CEP	128,078	(10,379)	117,699	*1½*
Education	668,063	(98,722)	569,341	*1*
Highways	29,333	(623)	28,710	*1*
Social services	250,464	(26,524)	223,940	*1*
Net cost of service	1,090,499	(136,771)	953,728	
AMRA			(50,786)	*½*
Interest received			(9,333)	
Net operating expenditure			893,609	
MRP (40,000 – 26,837 depreciation)			13,163	*1*
Direct revenue financing			4,000	*½*
Amount to be met from govt grant and local tax payers			910,772	
General govt grants			(650,487)	
NNDR			(107,662)	
Council tax			(174,008)	
Net general fund (surplus)/deficit			(21,385)	
General fund brought forward			(12,863)	
General fund carried forward			(34,248)	

(7½)

Workings

Central services 8,339 + 6,222 = 14,561

CEP 109,952 + 15,626 +2,500 write off = 128,078

Education 626,543 + 41,520 = 668,063

Highways 17,555 + 11,778 = 29,333

Social Services 224,010 + 26,454 = 250,464

Journal entries to clear the suspense account:

Dr suspense account	28,000		
Cr long term loans		16,000	*1½*
Cr grants deferred		12,000	
Being the fund received			
Dr net tangible asset	32,000		
Cr suspense account		32,000	*1*
Being the purchase of the asset			
			(2½)

Sheen County Council
Balance Sheet as at 31 March 2003

	£000	£000	
Net tangible assets (893,161 + 32,000 – 26,837)		898,324	*1*
Stock	867		
Debtors (31,098 – 3,000 – 2,500)	25,598		*1*
Short term investments	123		
Cash in hand	6,124		
Creditors due within one year (95,238 – 3,000)	(92,238)	(59,526)	*½*
Total assets less current liabilities		838,798	
Long term borrowing		(283,000)	*½*
Government grant deferred		(12,000)	*1*
Provisions for liabilities and charges		(12,000)	
		531,798	
Fixed assets restatement reserve		326,888	
Capital financing reserve (123,499 + 4,000 + 13,163)		140,662	*1*
Useable capital receipts		30,000	
General fund		34,248	
		531,798	
			(5)
			(15)

(c) Contrary to the view expressed by the Council, general fund balances have risen in the last year however, with a £32,500,000 reduction in grant less a maximum increase in Council Tax of £17,400,000 (net £15,100,000) the current position cannot be maintained.

The last annual surplus was £21,400,000 so the Council will only have £6,300,000 to fund inflation and operational developments. The balance represents only 0.66% of the current net costs of service, even with low inflation of 2% the Council is facing a substantial deficit.

Additionally the new Integrated Regional Transport Centre will increase operational cost with asset rentals. Interest becomes payable on the £16,000,000, all of which will place further pressure on the Council's net revenue position. The release of grant will not help the revenue position as the grant will be reversed into the CFR.

The Council may use retained balances in the first instance but cannot rely upon this source for long; cuts in service provision will need to be investigated. Also with cash balances too close to zero very careful treasury management practices are needed.

In conclusion the Council must face very difficult spending decisions to stay within funding limits.

Up to 1 ½ marks per relevant point, up to a maximum of 6

(25)

Question 5

(a) **Definition of GAAP** – all embracing term used to cover all accounting regulations relating to companies. *1*

Companies Act

- Not relevant to central government since specific to companies. *½*
- Formats used for I&E and balance sheet are amended versions of Companies Act formats. *1*

Stock Exchange

- Not relevant to central government since no shares or shareholders. *1*

Accounting standards

- Adopted where they are relevant to central government. *1*
- Examples of relevant standards are SSAPs 4 Grants, 5 VAT, 9 Stocks, 13 R&D, 17 PBSE, 19 Inv Props, 20 FX, 21 Leases, FRSs 1 Cash Flow 2 Subs, 3 Reporting performance, 5 Substance, 11 Impairments, 15 TFAs, 12 Provisions and 18 Policies.

½ per example plus ½ mark per explanation, up to a maximum of 2
(If FRS 18 or SSAP 9 used do not give identification ½ mark since give in later question)

- Non relevant (or of limited relevance) standards FRSs 4 Cap inst 6, 7, 9, 10 Group accounts 13 Derivatives 14 EPS 16 and 19 Tax.

½ per example plus ½ mark per explanation, up to a maximum of 2

UITF

- Where appropriate should be applied (no examples need be given). *1*

Other sources of guidance

- Legislation including Central Government Resource and Accounting Act 2000 and Central Government Trading Fund Act 1973, Exchequer and Audit Act 1866 and National Audit Act 1983. *½*
  (plus ½ mark for one example)
- Treasury guidance including Resource Accounting Manual, DAO letters, Accounts Direction. *1½*
- FRAB guidance to Treasury on application of new standards. *1*

Trading funds

- Trading Funds compile accounts on a commercial basis therefore should apply UK GAAP in full. *1*

(14)

(b) **Going Concern** – assumes that an enterprise will continue its activities for the foreseeable future; in practice a company facing liquidation will value the company at realisable value however, central government functions are usually transferred elsewhere therefore this is unlikely to happen even where a department is reorganised. *½* *1*

Accruals – revenue and costs are recorded for the period to which they relate not when the cash transaction takes place; this principle is applied in agencies and now with departments reporting resource accounts; cash remains as the control of government spending and therefore reporting to Parliament. *½* *1*

(3)

(c) **Accounting entries** –
Capital grant Dr Cash Cr Government Grant Reserve.
Depreciation Dr Operating account Cr Depn Provn.
Def grant Dr Government Grant Reserve Cr Operating account.
Revenue grant Dr Cash Cr operating account. *2*

Accounting standards – SSAP 4 Accounting for capital grants has been applied to determine the above entries. *½*

Operating cost statement –

- **capital** – credited to depreciation each year at £4 million per annum; *1*
- **revenue** - £200 million credited to Operating Cost Statement but £1 million allowance for own administration should be shown as a reduction in cost to exchequer and the balance shown as amounts received on behalf of third parties (since it is then distributed to businesses). *½* *1*

(5)

(d) **Accounting entries –**
Admin Dr Administration Cr Stock. *½*
This entry would only be made if £2,500 were material to the defence department administration budget. As one of the largest departments then this is unlikely to be the case however, we do not currently have sufficient information to judge. *1*

Equipment – no entry required
SSAP 9 requires stock to be held at lower of cost and realisable value; the stock is not for resale by the department therefore the 10% fall in purchase price is not relevant and it should remain in stock at cost. *½* *1*

(3)

(25)

Question 6

(a) Critical Evaluation of the financial position of the Association.

	2003		2002	
Current ratio	4,916/2,997	1.64	6,154/2,331	2.64
Fixed asset turnover	27,553/166,494	0.17	28,300/168,176	0.17
Operating surplus: turnover	1,886/27,553	0.07	4,007/28,300	0.14
Interest cover	1,886/1,967	0.96	4,007/1,200	3.34
Interest cost	1,967/145,899	0.013	1,200/149,797	0.008

1 mark per pair of valid ratios
½ mark for any single year ratio
Maximum mark for calculations 3

To the Board of Deanhill Housing Association (DHA).

The evaluation undertaken of the results presented of DHA is significantly limited due to the summary nature of the published statements, the lack of supporting notes and the absence of the cash flow statement. However, it is possible to make the following observations:

- Weaker liquidity is evident. Although the significant drop in cash is tempered by a small increase in debtors, there is a larger increase in creditors. The Board should review their treasury procedures and policies as liquidity will become a crucial issue if the 2002/2003 results become a trend. The key current ratio of 1.64:1 should be monitored on a regular basis.

- Turnover has fallen slightly and the operating costs have risen by nearly £1,400,000 with a resulting negative impact upon the surplus to turnover ratio which has fallen from 14% to 7%. Again careful monitoring and review of budgets during 2003/2004 is needed to ensure the fall does not become a trend.

- From a period where interest receivable may be seen as a minor item the association now relies upon this figure to create a retained surplus for the year. The recurrence of this income is dependent upon cash flow management of grant and other housing income. Should these change, the potential for earning interest on short term deposit may be diminished.

- Following from the forgoing bullet points the association now has a problem with interest cover falling from 3.39 times to 0.95 times in a year. Interest rates paid have significantly increased. This may be due to the end of a deferred interest period or the replacement of existing debt with new debts at higher rates. The Board should look at the source of finance and seek alternative cheaper options.

- Utilisation of assets remains static as illustrated by the fixed asset turnover ratio. The future investment in Council Housing stock may affect this position. The figure of 17%, however is only static: there is no evidence as to the relative strengths or weaknesses of these results.

- There seems little opportunity for the association to finance an additional £6,000,000 investment as the liquidity is weak and the ability to cover additional debt is uncertain.

1 mark per relevant item discussed, up to a maximum of 6
(9)

(b) Examples of questions to be raised:

Who are the debtors? How quickly will they pay? Are they commercial, governmental or other specialist debts? This will indicate the potential repayment periods and risks of non-payment. Within Housing Associations the debtors and creditors may be with the same source and if significant the traditional views of liquidity performance become invalid.

Who are the creditors? When will payment be enforced? Is this a permanent increase in liability? In the same vein as debtors some creditors may never (for political or social reasons) enforce payment to the ultimate detriment of the Association and tenants.

What has caused the increase in operating costs? Is the increase recurring and is it possible to analyse performance in greater detail? Did Board budget reports show a trend of increased expenditure. The difference represents 50% of the required funding. Increased costs have effectively created most of the Association's problems. The Board must evaluate whether the increased costs are controllable or influenced by the Association and staff. For example, it is excellent news if the housing repairs backlog has been cut, but can the Association afford it? On the other hand the increase may be due to increased ground rent as part of a periodic hurdle within a land contract and therefore outside of the control of the Association (although such an increase should have been planned for).

What sources of finance are available? This is to seek cheaper finance for existing debt and an economic way of financing the £6,000,000 required. Who are the loan providers? It may be assumed from the analysis that they are preferential loans and not commercially issued debt. Is there scope to borrow the £6 million?

What is the opportunity cost of not proceeding with the new housing? If we cannot find the £6,000,000 what will happen to the grant? Will it be lost? Will another provider step in? What will the tenant reaction be? Simply the Board must understand the ramifications of not being able to complete the housing transfer including residual costs impacting upon the Association.

What support may be sought from the Council and Housing Association? Are other organisations in a position to support the transfer of housing stock?

Do bench mark figures exist to compare with other associations? For example, asset utilisation figures and liquidity trends; perhaps we are part of a national problem and are in fact fairing slightly better than others.

1 mark for identifying a question, 1 mark for explaining why the question is needed
Up to a maximum of 6

(15)

Question 7

(a) The role of accounting standards is to ensure that financial information is useful to external users. Information is useful if it is relevant, reliable, comparable and understandable. *2*

There is no overt link to governance within the UK public sector. However, accounting statements that are published following approved practices should allow the reader and users of the statements to place a high degree of reliance on the figures. It should ensure that there are no material differences in the construction of statements between years or between similar public sector organisations. *2*

Accounting standards and governance have co-terminus aims, that is to present a realistic or fair view of the organisation, to ensure sound controls exist and to provide sufficient detail for the reader to understand the statements (transparency). *1*

There is an implication that directors have acted *reasonably* in deciding the accounting policies and standards used in the production of the annual accounts. *1*

Accounting standards do not ensure good governance nor does governance ensure appropriate application of standards. They are supportive of each other. (Although some may validly argue that conflict may still arise). *1*

Up to a maximum of 6

(b) Answers may include any **two** standards. What is essential is that the relevant point of the chosen standard is explained and clearly linked to an element of governance.

FRS 5 (Reporting the substance of transactions) makes it clear that assets and liabilities which qualify for recognition should be accounted for individually. It further states that transactions must be disclosed in sufficient detail to enable the reader to understand their effect. The essence of the standard is to stop the masking of transactions by making them clearer for following the accounting statements.

FRS 5 applies to all entities whose particular accounts are intended to show a true and fair view, with no exemptions. The fundamental principle is that the economic substance, which may be different from the legal form, of an entity's transactions should be reflected in the accounts.

The standard covers the topics of: consignment stock, sale and repurchase agreements, factoring of debts, securitised assets, and loan transfers. Additionally the standard covers the topic of non recourse finance and the resultant netting of finance and asset values. Such netting is only permitted where debit and credit balances are not really separate assets and liabilities. An overriding requirement is to disclose transactions in sufficient detail to enable an average reader to understand the commercial effect of the transaction.

FRS 5 has full applicability to the public services as the treatment of transactions may influence the interpretation of revenue accounts and balance sheets. The application notes to the standard have partial application to public services, for example, it is rare to find consignment stocks in the sector and use of factoring is not a widespread practice as inappropriate use of a factor may not be deemed value for money. A topic of concern to public services is that of PFI schemes. When, for example, a county council passes ownership of land to a road contractor and pays a subsequent usage charge for the road, with the road returning in 20–25 years time to council ownership, does the county still have, in substance, the land value, the road value or no value? Does the position change as the contract nears completion?

A fundamental element of good governance is the need for directors to create structures where all decisions are subject to validation and are understandable. To that extent FRS 5 has similar aims of transparency and providing sufficient data to allow users to understand the transaction.

FRS 11 (Impairment of fixed assets and goodwill) ensures that fixed assets are valued at no more than their recoverable amount and that any impairment loss is fully disclosed and measured and recognised on a consistent basis. The rationale of the standard is to prevent assets being overvalued in the balance sheet. If the value has been permanently diminished then it is inappropriate to show the asset at an enhanced value and the accumulated income and expenditure balance prior to accounting for the loss in value.

Impairment happens as a result of an event affecting the asset or the environment, such as:

- Continued losses (or loss of key employees) with the implication that the assets used in the loss making activity may have no long term earnings potential and therefore value.
- The market value of the asset has diminished.
- The asset has become obsolete or damaged.
- Change in the statutory or regulatory environment.

The impairment review involves the comparison of the carrying amount of the asset with its recoverable amount. The recoverable amount is the higher of net realisable value (ie net disposal proceeds) or the value in use (the present value of future cash flows generated by the asset).

Notwithstanding the public service ethic and structures all of the forgoing points have full applicability to the sector.

Assets such as leisure centres make an interesting study; some may be required to run on a fully commercial basis; others may offer preferential rates to achieve equality of access to facilities. If the latter applies then the notion of loss applies and an impairment exercise must be undertaken. Certain public service assets have poor disposal values due to their location, restrictions on use and the target markets they serve, where the assets also have weak future cash flows the impairment loss may be substantial.

Impairment losses for companies may provide a negative impact to investment markets and will affect profit figures. In public services the impact of accounting entries are similar but will directly impact upon the entity's ability to meet statutory targets and brings with that political ramifications. The NHS for example transferred non recurring income to NHS Trusts to compensate the impairment losses but then required Trusts to repay public dividend capital to restrict the accumulation of cash in the Trust. An overly complex and administratively burdensome arrangement?

Clearly policy structures are required by good governance and all decisions should be taken on a fair and (as far as possible) open basis. Such a view may be derived from Cadbury and his views on the role of directors and the practical application of Turnbull's views on segregation and policies. Reference may be also made to Nolan and the principles of public life. Therefore the change in value is made to reflect the equitableness of the asset value which in turn is required by good governance which supports control systems that produce a fair and reasonable result.

Governance requires directors to undertake a fair and balanced view of the financial position, which it may be argued is made simpler by the adoption of relevant accounting standards.

Up to 2 ½ marks per standard will be awarded for explaining the chosen standard plus a further mark for making the link to governance
2 marks per standard are for discussing the application of the standard to a chosen element of the public sector, up to a maximum of 9

(15)

Question 8

(a) The question seeks a discussion of the concepts introduced in the question. Although the content may significantly differ between answers some form of standardisation in structure is expected. The structure should include a clear statement of points supporting the view that accountants have enhanced freedom in the production of the accounts and equally clear contra views. A conclusion should be drawn from the discussion.

Examples of discussion points are:

For - freedom as an accountant

- Accountants may select from a range of valuation methods in preparing accounts, (Housing & Further Education).
- Assets lives and depreciation methods are subject to selection, (Local Government, Housing).
- Financial statements may be produced using accounting estimations to ensure a true and fair view. (Present fairly – Local Government).
- There is flexibility such as the recognition of income and liabilities (testing feasibility of transactions arising in the future etc).

Against - freedom as an accountant

- Statutory regulation and targets such as minimum revenue provision/grant utilisation/reserved receipts (local government), external finance limit (NHS, Central Government), notional income (central government) all heavily constrain how transactions are valued and presented.
- Asset valuation methods are prescribed (NHS, Central Government, Local Government).
- The public service has a narrower form of regulation than the private sector, accounting code of practice (statement of recommended practice for Local Government), NHS manual of accounts/RAM (Central Government/Housing Association/HEFC (Further Education).
- Importance of consistency – fear of criticism and the strength of public service audit.
- Measurement of cash and cash based targets have a higher profile in public services: cash measures have greater objectivity than subjective application of accounting standards.
- Multiple objectives reduce focus on pure finance based measures.

1 mark is available for identifying a relevant issue and a further 1 mark for critically comparing the issue with a second sector
*4 marks available for **'for'** arguments and 4 for **'against'***
Up to a maximum of 8

(b) Issues relating to the entity theory. The theory assumes all the entity's activities follow clear and common objectives and the entity is distinct from any group or individual associated with it. The reporting unit is the entity and is addressed to all interested parties, although the Statement of Principles requires the accounting statements to be addressed to the predominant stakeholder.

NHS – is the objective to operate an NHS Trust or is the Trust a group of semi autonomous specialties? Would the commander theory be more appropriate?

Local Government – transactions relating to the activities of 'owners', councillors etc are excluded so entity theory is applied. Fund theory may be more crucial however, for example, Collection Fund, Housing Revenue Account, Pension Fund.

Central Government – all internal transactions are excluded consistent with entity theory. Concept of entity theory also extended now to whole of government accounts (WGA). All government departments will be consolidated to provide an entity view of the whole of the UK Government.

Housing & FHE – all external transactions with other public sector bodies, private sector companies, charities and the general public are included in the accounts. Activities of governors, non-executive directors and internal transactions between parts of the entity are excluded. All consistent with entity theory.

1 mark per relevant point raised
Up to a maximum of 3

(c) Accounting policies impact upon the recording of all costs and revenues but are primarily designed to demonstrate a true and fair view. Performance management relates to measurement of inputs, processes and outputs but at a more detailed level than the published statements.

Users of performance measures should be aware of the potential materiality and alternative accounting treatments of policies. Comparisons across entities or over time should be adjusted for differences in the application of accounting policies.

1 mark per valid point raised, up to a maximum of 2

Examples that may be given in sector, valuation of assets will impact upon the cost of capital and depreciation and therefore the cost of a service.

The identification & treatment of potential litigation will impact upon total costs and the indirect costs of service.

Central service apportionments (for example in NHS speciality costs and local authority published statements) will impact upon the cost of service.

1 mark per valid point raised, maximum 2
Up to a maximum of 4

(15)