FINANCIAL REPORTING AND ACCOUNTABILITY

Professional 2 examination
5 June 2003

From 10.00 am to 1.00 pm,
plus twenty minutes reading time from 9.40 am to 10.00 am.

Instructions to candidates

*Answer **five questions** in total;*
***One** question from **Section A**;*
***One** question from **Section B**;*
***One** question from **Section C**;*
***One** question from **Section D**; and*
One** question from **Section E

Candidates have a free choice in each of Sections A, B and C as to which sector (Central Government; Further and Higher Education; Health Service; Housing Associations; Local Government) they choose to base their answer on. For the question in Section C, candidates must state the sector that their answer relates to.

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 examinations room.

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

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 (Answer one question)

(Central Government)

1

Red Mountain Education (RME) is an on-Vote Agency that sells training courses and provides advice regarding fire and rescue services.

RME prepares its financial statements to 31 March each year. The balance sheets as at 31 March 2001 and 31 March 2002 are presented below.

Red Mountain Education
Balance sheet as at 31 March

	2001		2002	
	£000	**£000**	**£000**	**£000**
Tangible fixed assets:				
Buildings	9,000		8,000	
Accumulated depreciation	(3,000)	6,000	(2,000)	6,000
Plant and equipment	4,000		5,000	
Accumulated depreciation	(2,500)	1,500	(2,900)	2,100
		7,500		8,100
Current assets:				
Stocks	800		300	
Trade debtors	700		800	
Bank and cash	225		0	
	1,725		1,100	
Creditors – amounts falling due within one year:				
Trade creditors	(850)		(280)	
Other creditors	(100)		0	
	(950)		(280)	
		775		820
		8,275		8,920
Financed by:				
Revaluation reserve		1,000		1,500
General fund		7,275		7,420
		8,275		8,920

Additional information:

1. Other creditors relate to amounts owed in relation to acquisition of plant and machinery.

2. Asset sales during the year were as follows:

	Book value £000	Profit/(loss) £000
Buildings	1,000	200
Plant and equipment	200	(60)

Note: both assets disposed of were 60% depreciated.

3. The Gross Parliamentary Grant voted by Parliament for the Red Mountain Education agency for 2001/2002 was £11,200,000. Appropriations in aid of £1,000,000 were approved but only £900,000 was collected. The surplus to be surrendered to the Consolidated Fund for the year amounted to £200,000.

4. The operating account deficit was £10,379,000.

5. Notional charges of interest at 6% of average net assets and 0.1% insurance on average fixed assets were charged to the operating account.

6. The movement on the revaluation reserve relates to revaluation of buildings during the year.

7. Backlog depreciation for the year amounted to £100,000.

- **Requirement for question 1**

(a) Prepare the following for the year ended 31 March 2002:

- Reconciliation of operating surplus/deficit to net cash flow from operating activities.
- Reconciliation of Parliamentary Grant received to the appropriation account for the vote.
- Cash Flow Statement. *21*

(Note: no additional notes to the Cash Flow Statement are required).

(b) The agency has been set a target of recovering 10% of full costs from turnover. Comment on its performance against this target. *4*

(N.B: Show workings to nearest £000)

(25)

(Further and Higher Education)

2

Red Mountain College prepares its financial statements to 31 July each year. The balance sheets as at 31 July 2001 and 31 July 2002 are presented below:

Red Mountain College
Balance sheet as at 31 July

	2001		2002	
	£000	**£000**	**£000**	**£000**
Tangible fixed assets:				
Land (valuation)		1,000		1,300
Buildings (valuation)	8,000		6,700	
Accumulated depreciation	(3,000)	5,000	(2,000)	4,700
Plant and equipment (cost)	4,000		5,000	
Accumulated depreciation	(2,500)	1,500	(2,900)	2,100
		7,500		8,100
Investments		650		1,100
Current assets:				
Stocks	800		300	
Trade debtors	800		900	
Investments	50		200	
Bank and cash	75		0	
	1,725		1,400	
Creditors – amounts falling due within one year:				
Bank overdraft	0		(240)	
Trade creditors	(850)		(280)	
Other creditors	(100)		(60)	
	(950)		(580)	
		775		820
		8,925		10,020
Creditors – amounts falling due after more than one year:				
Long term loan		(500)		(600)
		8,425		9,420
Financed by:				
Endowments – specific		450		500
Endowments – general		200		600
Revaluation reserve		500		900
Income and expenditure account		7,275		7,420
		8,425		9,420

Additional information:

1. Red Mountain College received an average return on their short term investments of 3% during the year ended 31 July 2002, and paid average loan interest of 6% during the same period. Long term investments represent endowment funds invested. The average return on these investments was 5%.

2. Other creditors relates to amounts owed to the Inland Revenue in relation to corporation tax on profits of a small research company owned by the college.

3. Asset sales during the year were as follows:

	Book value	**Profit/(loss)**
	£000	**£000**
Buildings	1,000	200
Plant and equipment	200	(60)

Note: both assets disposed of were 60% depreciated.

4. The college treats its short term investments as liquid funds.

5. The long-term loan is with a commercial bank and £500,000 is repayable in 2004.

6. No land was purchased or sold during the year.

7. Endowment investments of £100,000 were realised during the year at cost.

- **Requirement for question 2**

(a) Prepare the following for the year ended 31 July 2002:

- Reconciliation of operating surplus/deficit to net cash flow from operating activities.
- Cash Flow Statement.
- Reconciliation of net cash flow to movement in net debt and an analysis of changes in net debt. *20*

(b) Outline any observations you have about the cash position of the college and suggest solutions to any problems you identify. *5*

(N.B: Show workings to nearest £000)

(25)

(Health Service)

3

Red Mountain NHS Trust prepares its financial statements to 31 March each year. The balance sheets as at 31 March 2001 and 31 March 2002 are presented below:

Red Mountain NHS Trust
Balance sheet as at 31 March

	2001		2002	
	£000	£000	£000	£000
Tangible fixed assets:				
Land		1,000		1,000
Buildings	8,000		7,000	
Accumulated depreciation	(3,000)	5,000	(2,000)	5,000
Plant and equipment	4,000		5,000	
Accumulated depreciation	(2,500)	1,500	(2,900)	2,100
		7,500		8,100
Current assets:				
Stocks	800		300	
NHS debtors	850		1,100	
Bank and cash	75		0	
	1,725		1,400	
Creditors – amounts falling due within one year:				
Bank overdraft	0		(300)	
NHS creditors	(850)		(280)	
Other creditors	(100)		0	
	(950)		(580)	
		775		820
		8,275		8,920
Creditors – amounts falling due after more than one year:				
Provisions for liabilities and charges		(500)		(600)
		7,775		8,320
Financed by:				
Public dividend capital		5,000		5,500
Revaluation reserve		1,500		1,695
Donations reserve		750		695
Income and expenditure account		525		430
		7,775		8,320

Additional information:

1. Donations for the year amounted to £200,000. Half of this was a cash donation to support the running of the children's ward. The remainder was the purchase of a new piece of equipment which was made available on 31 December 2001. The asset has a 5 year useful life.

2. Other creditors relates to amounts owed in relation to acquisition of plant and machinery.

3. Asset sales during the year were as follows:

	Book value	**Profit/(loss)**
	£000	**£000**
Building	1,000	200
Plant and equipment	200	(60)

Note: both assets disposed of were 60% depreciated and were not donated

4. The trust received bank interest of £80,000 during the year and paid dividends on PDC of £468,000. PDC of £50,000 was repaid at the end of the year.

5. Indexation for the year was 3% for buildings and plant however land valuations remain unchanged.

- **Requirement for question 3**

(a) Prepare the following for the year ended 31 March 2002:

- Reconciliation of operating surplus/deficit to net cash flow from operating activities.
- Cash Flow Statement.
- Reconciliation of net cash flow to movement in net debt and an analysis of changes in net debt. *20*

(b) Outline any observations you have about the cash position of the Trust and suggest solutions to any problems you identify. *5*

(N.B: Show workings to nearest £000)

(25)

(Housing Associations)

4

Red Mountain Housing Association prepares its financial statements to 31 March each year. The balance sheets as at 31 March 2001 and 31 March 2002 are presented below.

Red Mountain Housing Association
Balance sheet as at 31 March

	2001		**2002**	
	£000	**£000**	**£000**	**£000**
Tangible fixed assets:				
Land		5,000		5,000
Housing properties	16,000		16,500	
Accumulated depreciation	(6,500)	9,500	(6,800)	9,700
Social Housing Grant (SHG)		(4,500)		(4,700)
Plant and equipment	4,000		5,000	
Accumulated depreciation	(2,500)	1,500	(2,900)	2,100
		11,500		12,100
Current assets:				
Stocks	800		300	
Trade debtors	800		900	
Investments	50		200	
Bank and cash	75		0	
	1,725		1,400	
Creditors – amounts falling due within one year:				
Bank overdraft	0		(300)	
Trade creditors	(950)		(280)	
	(950)		(580)	
		775		820
		12,275		12,920
Creditors – amounts falling due after more than one year:				
Long-term loan		(6,000)		(6,500)
		6,275		6,420
Financed by:				
Share capital		1		1
Designated reserves		300		500
Restricted reserves		700		800
Revenue reserve		5,274		5,119
		6,275		6,420

Additional information:

1. Red Mountain Housing Association received an average return on their short term investments of 3% during the year ended 31 March 2002, and paid average loan interest of 6% during the same period.

2. Asset sales during the year were as follows:

	Book value £000	**Profit/(loss) £000**
Land and properties	1,000	200
Plant and equipment	200	(60)

Note: both assets disposed of were 60% depreciated on cost.

SHG of £600,000 was repaid as a result of these disposals.

3. Red Mountain Housing Association treats its short term investments as liquid funds.

4. 25% of the long-term loans are repayable in 2004.

- **Requirement for question 4**

(a) Prepare the following for the year ended 31 March 2002:

- Reconciliation of operating surplus/deficit to net cash flow from operating activities.
- Cash Flow Statement.
- Reconciliation of net cash flow to movement in net debt and an analysis of changes in net debt. *20*

(b) Outline any observations you have about the cash position of the Association and suggest solutions to any problems you identify. *5*

(N.B: Show workings to nearest £000)

(25)

(Local Government)

5

Red Mountain Council prepares its financial statements to 31 March each year. The balance sheets for the last two years are presented below.

Red Mountain Council
Balance Sheet as at 31 March

	2001		2002	
	£000	**£000**	**£000**	**£000**
Net Fixed Assets		7,500		8,100
Current assets:				
Stocks	800		300	
Debtors	800		900	
Investments	50		200	
Bank and cash	75		0	
	1,725		1,400	
Creditors:	(950)		(580)	
		775		820
Long term borrowing		(3,850)		(3,670)
		4,425		5,250
Fund balances and reserves:				
Fixed asset restatement reserve		1,900		1,800
Usable capital receipts		400		600
Capital financing reserve		1,400		1,950
General fund		725		900
		4,425		5,250

Additional information

1. During the year ended 31 March 2002 Red Mountain Council received and made the following cash payments:

Receipts:	Precepts	£5,000,000
	Grants	£4,000,000
	Fees	£1,000,000
Payments:	To and on behalf of employees	£5,692,000
	Other costs	£3,481,000

2. Red Mountain Council received an average return on their short term investments of 3% during the year ended 31 March 2002, and paid average loan interest of 6% during the same period.

3. Internal financing consisted of £50,000 from usable capital receipts and £250,000 from revenue.

4. The Minimum Revenue Provision (MRP) for the year has been calculated as £150,000.

5. The only entry in the Fixed Asset Restatement Reserve for the year relates to an asset sale during the year. Part of the resulting receipt was reserved in the Capital Financing Reserve.

6. The amount of loans raised during the year were equivalent to the amount of credit approval used by the Council to finance capital expenditure.

7. Asset rentals of £2,000,000 were charged to services whilst the credit to the Consolidated Revenue Account from the Asset Management Revenue Account was £1,644,000.

- **Requirement for question 5**

(a) Prepare the following for the year ended 31 March 2002:

- Reconciliation of surplus/deficit to net cash flow from revenue activities.
- Cash Flow Statement.
- Reconciliation of net cash flow to movement in net debt and an analysis of changes in net debt. *20*

(b) Outline any observations you have about the cash position of the Council and suggest solutions to any problems you identify. *5*

(N.B: Show workings to nearest £000)

(25)

SECTION B (Answer one question)

(Central Government)

6

The Whitemog Centre is a research arm of the defence department that operates as an agency. The draft accounts for the year ended 31 March 2002 have been presented to the auditors, however the senior auditor has come back with a number of queries as follows:

- Capital funding amounting to £120,000 in respect of the whole cost of an asset has been credited to the asset account in the ledger; the asset acquired on 30 June 2001 has an asset life of 6 years.
- A piece of equipment has been financed by lease, however the auditor believes that it has been incorrectly treated as a finance lease; the lease is for 3 years and comprises annual rental payments of £24,000 in arrear. It is in respect of an asset which has a market value of £70,000 and a useful life of at least 5 years (sum of digits method was used); the lease rental includes an element for maintenance of the asset and the lease company will replace it if it becomes irreparable. The asset will be returned to the leasing company at the end of the lease.
- The Centre has made a decision to relocate certain research activities which will lead to confirmed restructuring costs of £50,000 in 2004; staff have been informed but no costs have as yet been recognised, although the auditors believe that some charge should be made.
- The year end debtors of £600,000 were debited to the Consolidated Fund Extra Receipts ledger account.
- Insurance charges amounting to £500 per annum have been omitted from the accounts since the Centre was separated from the department in 1996; the auditors are concerned that no prior year adjustment has been made for this.
- An asset was revalued for the first time during the year by increasing its value by 5%; its original value was £800,000 and depreciation has been charged for the year based on the revalued net book value over the remaining life of 5 years (original estimated life was 8 years); although the asset value was increased no backlog depreciation was charged.

N.B. The current cost of capital used by the treasu ry is 6%.

- **Requirement for question 6**

Explain the appropriate treatment of each of the above with reference to relevant accounting standards and sector guidance and show the journal entries for any adjustments that may need to be made. ***20***

(Further and Higher Education)

7

The Whitemog College draft accounts for the year ended 31 July 2002 have been presented to the auditors, however the senior auditor has come back with a number of queries as follows:

- A capital grant has been received and credited to the asset account; the grant was to fund 60% of an asset acquired on 31 July 2002 that cost £120,000.

- A piece of equipment has been financed by lease, however the auditor believes that it has been incorrectly treated as a finance lease; the lease is for 3 years and comprises annual rental payments of £24,000 in arrear. It is in respect of an asset which has a market value of £70,000 and a useful life of at least 5 years (sum of digits method was used); the lease rental includes an element for maintenance of the asset and the lease company will replace it if it becomes irreparable. The asset will be returned to the leasing company at the end of the lease.

- The College has made a decision to create a company to deal with certain research activities which will lead to confirmed restructuring costs of £50,000 in 2003; staff have been informed but no costs have as yet been recognised, although the auditors believe that some charge should be made.

- A VAT inspection in October 2002 identified a number of discrepancies in documentation and has disallowed £30,000 of input VAT in the previous VAT return (July – September 2002); the auditors are concerned that no adjustment has been made for this.

- A piece of land valued at £150,000 has been donated to the college with the stipulation that it is to be used as playing fields for students and staff; it was omitted from the accounts on the grounds that it is free.

- A cash sum of £500,000 was received by the college on 1 August 2001 from a legacy; the capital must be kept intact but income generated from it can be used for the general running of the college; the income was credited to other income and included in the income and expenditure account.

- **Requirement for question 7**

Explain the appropriate treatment of each of the above with reference to relevant accounting standards and sector guidance and show the journal entries for any adjustments that may need to be made. ***20***

(Health Service)

8

Whitemog NHS Trust draft accounts for the year ended 31 March 2002 have been presented to the auditors, however the senior auditor has come back with a number of queries as follows:

- A piece of equipment has been financed by lease, however the auditor believes that it has been incorrectly treated as a finance lease; the lease is for 3 years and comprises annual rental payments of £24,000 in arrear. It is in respect of an asset which has a market value of £70,000 and a useful life of at least 5 years (sum of digits method was used); the lease rental includes an element for maintenance of the asset and the lease company will replace it if it becomes irreparable. The asset will be returned to the leasing company at the end of the lease.

- The Trust has made a decision to merge Accident and Emergency facilities at two hospitals which will lead to confirmed restructuring costs of £50,000 in 2003; staff have been informed but no costs have as yet been recognised, although the auditors believe that some charge should be made.

- A VAT inspection in May 2002 identified a number of discrepancies in documentation and has disallowed £40,000 of input VAT since the start of the previous return period (ie January to April 2002); the auditors are concerned that no adjustment has been made for this.

- A cash sum of £500,000 was received by the Trust on 1 August 2001 from a legacy; the capital must be kept intact but income generated from it can be used for the general running of the Trust; the income was credited to other income and included in the income and expenditure account.

- An asset was indexed fo r the first time during the year by increasing its value by 5%; its original book value was £600,000 and depreciation has been charged for the year based on the new revalued net book value over the remaining life of 5 years (original estimated life was 6 years); although the asset value was increased no backlog depreciation was charged.

- **Requirement for question 8**

Explain the appropriate treatment of each of the above with reference to relevant accounting standards and sector guidance and show the journal entries for any adjustments that may need to be made. ***20***

(Housing Associations)

9

Whitemog Housing Association draft accounts for the year ended 31 March 2002 have been presented to the auditors, however the senior auditor has come back with a number of queries as follows:

- Social Housing Grant (SHG) has been received and credited to the revenue account; the grant was to fund 60% of a property that cost £120,000.

- A piece of equipment has been financed by lease, however the auditor believes that it has been incorrectly treated as a finance lease; the lease is for 3 years and comprises annual rental payments of £24,000 in arrear. It is in respect of an asset which has a market value of £70,000 and a useful life of at least 5 years (sum of digits method was used); the lease rental includes an element for maintenance of the asset and the lease company will replace it if it becomes irreparable. The asset will be returned to the leasing company at the end of the lease.

- A VAT inspection in May 2002 identified a number of discrepancies in documentation and has disallowed £40,000 of input VAT since the start of the previous return period (ie January – April 2002); the auditors are concerned that no adjustment has been made for this.

- A property which originally cost £500,000 was disposed of for £800,000; it was 80% funded from Social Housing Grant (SHG). The asset at cost has been charged to operating costs and the total sale proceeds have been credited to miscellaneous income; the balance on the SHG account was credited to the income and expenditure account under miscellaneous income; capital surpluses after SHG should be set aside in a capital reserve to fund future capital expenditure.

- An amount of £400,000 has been charged to operating expenditure and set aside in a provision for future repairs; the programme of repairs has still to be planned in detail.

- **Requirement for question 9**

Explain the appropriate treatment of each of the above with reference to relevant accounting standards and sector guidance and show the journal entries for any adjustments that may need to be made. ***20***

(Local Government)

10

Whitemog District Council draft accounts for the year ended 31 March 2002 have been presented to the auditors, however the senior auditor has come back with a number of queries as follows:

- A capital grant has been received and credited to the revenue account; the grant was to fund 60% of a property that cost £120,000 and has a useful life of 36 years.

- A piece of equipment has been financed by lease, however the auditor believes that it has been incorrectly treated as a finance lease; the lease is for 3 years and comprises annual rental payments of £24,000 in arrear. It is in respect of an asset which has a market value of £70,000 and a useful life of at least 5 years (sum of digits method was used); the lease rental includes an element for maintenance of the asset and the lease company will replace it if it becomes irreparable; asset rentals of £28,000 were also charged to services on the asset. The asset will be returned to the leasing company at the end of the lease.

- A VAT inspection in May 2002 identified a number of discrepancies in documentation and has disallowed £40,000 of input VAT since the start of the previous return period (ie January – April 2002); the auditors are concerned that no adjustment has been made for this.

- The Principal Accountant post has been vacant for some time; the Accounting Technician has calculated and accounted for the depreciation charge for the year (£390,000); she has also calculated the Minimum Revenue Provision (£450,000) and Direct Revenue Financing (£350,000) for the General Fund for the year but no entries have as yet been made due to uncertainty about how to account for them.

- Some investments undertaken by the Pension Fund run by the Council have been revalued by £1,000,000; the entries were posted to the Fixed Asset Restatement Reserve and the Council's own invested funds.

- **Requirement for question 10**

Explain the appropriate treatment of each of the above with reference to relevant accounting standards and sector guidance and show the journal entries for any adjustments that may need to be made. ***20***

SECTION C (Compulsory)

11

- **Requirement for question 11**

(a) Explain the concept of capital maintenance and discuss the extent to which it is relevant to the public sector. *7*

(b) Explain why inflation can be a problem for financial and management accounting in public sector organisations. *5*

(c) Explain how inflation is dealt with in the financial accounts of organisations from your sector. *3*

(15)

Note:

You must state the specific sector (Central Government, Further and Higher Education, Health Service, Housing Associations, Local Government) that your answer relates to at the beginning of your answer to this question.

SECTION D (Compulsory)

12

(a) Pamper plc acquired 80% of the ordinary share capital of Huggle plc on 1 March 2002 paying £19,200,000. An extract of Huggle plc's balance sheet at 28 February 2003 is shown below:

Balance sheet as at 28 February 2003	**£000**
Net assets	25,000
£1 Ordinary shares	2,500
Share premium account	5,800
Revaluation reserve	3,000
Profit and loss account	13,700
	25,000

During the year land and buildings valuations were increased in the balance sheet by £500,000. Post tax profits for the year were £1,500,000 and the dividend for the year was £600,000.

In July 2002 Pamper plc acquired a further 400,000 shares in Huggle plc as part of a one for four rights issue that was fully subscribed. Pamper plc took up all of their shares at the rights issue price of £11 per share.

The fair values of the subsidiary were assessed on 1 March 2002 and were adjusted for the purposes of consolidation as follows:

Asset	**Adjustment £000**
Land	+500
Buildings	+100
Other fixed assets	-50
Stock	-20

- **Requirement for question 12 part (a)**

Calculate the Goodwill on acquisition and explain how the Goodwill should be treated in the accounts of the group. *8*

(b) Mater & Pater plc acquired 100% of the ordinary share capital of MC plc on 1 April 2002. The following balance sheets of the two companies existed at 31 March 2002:

	M&P plc	MC plc
	£000	**£000**
Tangible fixed assets	7,000	8,000
Working capital	20,000	3,000
	27,000	11,000
M&P plc share capital (£1 shares)	3,000	-
MC plc share capital (£2 shares)	-	2,000
Share premium	1,000	4,000
P&L account	23,000	5,000
	27,000	11,000

Additional information:

1. Fair values of tangible fixed assets for MC plc were £1,000,000 greater than shown in the balance sheet at acquisition.

2. The market price of M&P plc shares was £4 at the time of the acquisition. The acquisition was achieved through a cash offer of £16,000,000.

3. The above balance sheets for the two companies are stated immediately prior to the acquisition.

- **Requirement for question 12 part (b)**

(i) Prepare the consolidated balance sheet of the group after the acquisition and provide a brief explanation of any adjustments that you have made. *8*

(ii) Explain how the consolidated balance sheet would differ if the acquisition was achieved through a share swap of four M&P plc shares for one MC plc share (calculations are not required). *4*

(20)

SECTION E (Answer one question only)

13

- **Requirement for question 13**

(a) Outline the development of corporate governance for private sector companies. *8*

(b) Explain why good corporate governance is relevant to the public services and why it has not been possible to just apply private sector principles of corporate governance directly to public service organisations. *6*

(c) Explain how the corporate governance and accountability issues differ for elective and non-elective public service bodies. *6*

(20)

14

- **Requirement for question 14**

(a) Explain the concept of Value for Money. *5*

(b) Identify TWO appropriate performance measures for each of the '3 E's' and explain how they can be used to improve the performance of the relevant public sector organisation (*Note: examples do NOT need to come from the same sector).* *9*

(c) Explain the role of benchmarking in performance management of public services. *6*

(20)