ACCOUNTING THEORY AND PRACTICE

Professional 1 examination
5 December 2000

From 2.00 pm 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 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.

CIPFA

SECTION A (Compulsory)

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

1

The following trial balance has been extracted from the books of ABC plc for the year ended 30 September 2000.

	£m	£m
Buildings valuation 1 October 1995	849	
Land at cost	489	
Plant, fixtures and fittings	1,772	
Vehicles	240	
Accumulated depreciation 1 October 1999:		
Buildings		159
Plant, fixtures and fittings		415
Vehicles		84
Sales excluding VAT		5,231
Purchases excluding VAT	1,912	
Other production costs	2,000	
Opening stock 1 October 1999	192	
Administration costs	424	
Distribution costs	333	
Other operating income		22
Interest receivable		34
Interest payable (full year due on bank loans)	9	
Cash received on disposal of machine		1
Gain on disposal of confectionery business (see note (i))		62
Investment properties	61	
Debtors	437	
Creditors		267
Cash at bank and in hand	15	
Bank loans due 1 June 2001		80
Convertible Bond 2005		185
Lease rentals	29	
Ordinary 25p shares		600
Share premium		332
Investment properties revaluation reserve		37
Revaluation reserve		189
Retained profits 1 October 1999		900
VAT on inputs	540	
VAT on outputs		622
Deferred tax provision		72
Provision for bad debts		10

	9,302	9,302

The accountant had partially completed the year-end adjustments, but then became seriously ill and was admitted to hospital. He is unlikely to return to work for several months. As his assistant, you have been asked to complete the accounts in his absence. You have managed to find his working file with partially completed accounts and the following information, which had been collected by the accountant ready for adjustments to be made.

(i) ABC plc are manufacturers of a range of carbonated soft drinks, confectionery and snacks. During the year ABC decided to dispose of the confectionery business, to allow them to concentrate on the soft drinks and snacks market. A buyer was found and the confectionery business was sold on 31 August 2000. Most of the confectionery business staff transferred with the business and became employees of the new owner, the rest of the staff were offered enhanced severance payments. Included in the trial balance figures are the following balances which relate to the confectionery business in the year 1 October 1999 to 30 September 2000.

	£m
• Turnover	1,610
• Cost of sales	1,010
• Administration costs	400
• Distribution costs	320

(ii) At 30 September 2000 some of the severance payments were still in dispute and had not been paid. The estimated cost of the unsettled payments was £11m. The selling price of the confectionery business was £250m and the net assets disposed of were £188m. The trial balance assets and liabilities exclude the assets and liabilities sold as part of the confectionery business.

(iii) The VAT accounts consist of the transfer of VAT on inputs and outputs for the last quarter of the year.

(iv) Investment properties had been revalued as at 30 September 2000 at £70m by Valuations Ltd. No entries had been made in the accounts.

(v) Buildings, excluding those referred to in item (i) above are considered to have suffered a fall in value of £150m due to a general decline in market values of manufacturing premises. Net book value as at 1 October 1999 was £540m. This has not yet been adjusted.

(vi) The accountant had discovered that the purchases figure included vehicles purchased on 1 April 2000 for £4m, but he had not made any adjustments.

(vii) Deferred tax of £72m is the balance on this account as at 1 October 1999. The tax accountant for ABC plc informed the accountant that he has calculated the deferred tax full provision requirement as at 30 September 2000 as £120m and the partial provision requirement at that date as £86m, but no entries have been made yet.

(viii) During the year ABC leased two new machines. One replaced an old machine while the second was to help with production while several other machines were being renovated. The old machine was disposed of for £1m, its original cost was £43m and accumulated depreciation to 1 October 1999 was £38m.

- Lease 1 – fair value of machine A £68m, financed by a lease agreement commencing 1 April 2000, involving rentals of £8.8m per half year, payable in arrears over five years. Expected economic life of machine is five years. ABC plc pays for all repair, maintenance and insurance costs.

- Lease 2 – fair value of machine B £80m, leased for one year from 1 October 1999, lease payments of £10m per half year in advance. Expected economic life of the machine is ten years. The lessor provides all maintenance, insurance and repairs.

- The effective interest rate can be assumed to be 10.25% per annum or 5% per half year.

- Only the lease payments have been entered in the accounts.

(ix) A £200m convertible bond was issued on 1 October 1999 raising £185m cash and is to be redeemed at its nominal value in 5 years time. The bond carries a 7% rate of interest.

(x) In October 2000 ABC were notified by the liquidator of one of their customers, Z Ltd, that there was unlikely to be any payments from the liquidator in relation to the debt due to ABC plc. The amount outstanding at 30 September 2000 was £20m.

(xi) There are several legal cases against ABC plc outstanding at 30 September 2000. These cases all allege that foreign objects found in a food item manufactured by ABC plc caused them injury. The company's legal advisers have advised that it is highly probable that ABC plc will lose all of the cases, and have to pay damages which are estimated at £19m.

(xii) The current depreciation policy of the company is:

- To charge a full year's depreciation in the year of acquisition and no depreciation in the year of disposal.
- Buildings straight line on revalued amount over remaining life. The buildings' remaining life as at 1 October 1999 was 27 years.
- Plant, fixtures and fittings 25% reducing balance.
- Vehicles 20% reducing balance.

Depreciation for the year has not yet been posted.

(xiii) Other information as at 30 September 2000 not yet accounted for is:

- Closing stock 30 September 2000 £216m.
- Taxation charge for the year £75m.
- A dividend for the year of 1.5p per share has been proposed.
- Provision for bad debts is to be provided for at the rate of 6% of debtors balance as at 30 September 2000 after deducting any bad debts.

- **Requirement for question 1**

(a) For all items (i)-(xi) explain how they should be accounted for in the year end accounts, identifying clearly the relevant rationale underlying your treatment as given in the ASB's Statement of Principles and/or relevant SSAPs/FRSs. *28*

(b) Prepare the profit and loss account for the year ended 30 September 2000 and the balance sheet as at that date, for publication, for ABC plc taking account of all information known and current accounting guidance. (Round all figures to the nearest £m). Notes to the accounts are not required. *21*

(49)

SECTION B (Answer three questions)

2

The following are summarised financial statements of ATP plc for the period 1 April 1998 to 31 March 2000

Balance Sheets as at 31 March:

	2000		1999		1998	
	£m	£m	£m	£m	£m	£m
Fixed assets		6,760		4,556		3,088
Current assets:						
Stock	1,216		632		712	
Debtors	2,268		1,740		1,980	
Bank	1,236		612		280	
	4,720		2,984		2,972	
Less creditors due less than one year:						
Trade creditors	(1,204)		(1,536)		(1,256)	
Taxation	(224)		(136)		(128)	
Proposed dividend	(240)		(108)		(120)	
Bank loans and overdrafts	(1,916)		(912)		(480)	
	(3,584)		(2,692)		(1,984)	
Current assets less current liabilities:		1,136		292		988
Total assets less current liabilities:		7,896		4,848		4,076
Creditors due in more than one year:						
Debentures		(3,732)		(2,740)		(2,740)
		4,164		2,108		1,336
Financed by:						
Ordinary shares of 50p each		1,752		1,380		1,380
Revaluation reserve		1,840		600		0
Profit and loss account		572		128		(44)
		4,164		2,108		1,336

Profit and Loss Accounts for the year to 31 March:

	2000		1999	
	£m	**£m**	**£m**	**£m**
Turnover		5,736		4,760
Cost of sales		(4,276)		(3,804)
Gross profit		1,460		956
Expenses:				
Distribution and Marketing	(232)		(208)	
Administration	(544)	(776)	(496)	(704)
		684		252
Interest received		392		384
Operating profit		1,076		636
Interest paid		(272)		(200)
Profit before tax		804		436
Taxation		(120)		(64)
Profit after tax		684		372
Ordinary dividend		(240)		(200)
Balance carried forward		444		172

Reconciliation of operating profit to net cash inflow from operating activities

	2000	1999
	£m	**£m**
Operating profit	1,076	636
Add depreciation charges	148	120
Decrease/(Increase) in stocks	(584)	80
Decrease/(Increase) in debtors	(528)	240
Increase/(Decrease) in creditors	(332)	280
Net cash inflow from operating activities	(220)	1,356

Cash Flow Statement for year ended 31 March

	2000	**1999**
	£m	**£m**
Net cash inflow from operating activities	(220)	1,356
Returns on investment and servicing of finance:		
Interest paid	(272)	(200)
Taxation	(32)	(56)
Capital expenditure:		
Payments to acquire fixed assets	(1,112)	(988)
	(1,636)	112
Equity dividends paid	(108)	(212)
	(1,744)	(100)
Financing:		
Issue of ordinary share capital	372	0
Issue of debentures	992	0
	1,364	0
Decrease in cash	(380)	(100)

- **Requirement for question 2**

You are the Chief Accountant of ATP plc and you are required to draft a report to the board of ATP plc assessing the performance of ATP plc over the period 1 April 1998 to 31 March 2000. *17*

3

(a)

"Charities have to operate a complex system of 'fund accounting' where the income and expenditure has to be accounted for according to its source and purpose." CIPFA ATP Open Learning Material session 20 page 20.14.

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

Explain the rationale underpinning 'fund accounting' and identify why charities have to use a fund accounting system. *6*

(b)

Charities have different sources of funds and incur different types of expenses to limited companies. The Charities SORP requires charities to publish a 'comprehensive statement of financial activities' instead of a profit and loss account.

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

Explain the main differences between a 'comprehensive statement of financial activities' and a profit and loss account. *5*

(c)

Certain SSAPs and FRSs do not apply to charity accounting because of the different nature of their activities. In addition, small and medium size companies do not have to follow all the requirements of SSAPs and FRSs because the Financial Reporting Standard for Smaller Entities (FRSSE) sets out a range of exemptions for them.

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

Explain how accounts prepared under the FRSSE exemptions can show a true and fair view if they have not followed the requirements of all of the FRSs. *6*

(17)

4

With the rapid developments in e-commerce and more companies developing in high-tech industries the content of many company balance sheets has changed in recent years. The more traditional forms of tangible fixed assets have reduced and intangible fixed assets related to patents, copyrights, research and development and intellectual rights have increased. This can cause problems for accountants trying to decide how to treat the intangible assets in the financial statements.

All fixed assets, tangible and intangible, may be subject to a reduction in their value - when this occurs an impairment review is required.

- **Requirement for question 4**

(a) Explain the accounting treatment of intangible fixed assets as required by FRS10. *6*

(b) Identify the conditions that need to be satisfied to carry research and development expenditure forward as an asset on the balance sheet. *3*

(c) Explain the purpose of an impairment review and briefly describe how an impairment review could be carried out. *8*

(17)

5

The following balances were extracted from the books of a company, year end 30 November 2000, for contract number 993 which started in January 2000 and is due for completion in October 2001. The total contract price is £2,112,000 and the total cost is expected to be £1,472,000.

Costs incurred to 30 November 2000	£680,000
Payments received from client re contract 993	£646,000
Value of work completed to 30 November 2000	£960,000
Cost relating to work completed at 30 November 2000	£640,000

- **Requirement for question 5**

(a) Explain the Accounting Standards Board's definition of assets and liabilities contained in their Statement of Principles Chapter 3. *6*

(b) Prepare the journal entries to record contract 993 in the financial statements for the year ended 30 November 2000 and show the balance sheet extracts as at that date for contract 993. *5*

(c) Justify your treatment of the long term contract, making reference to relevant accounting concepts, SSAPs and FRSs. *6*

(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