ACCOUNTING THEORY AND PRACTICE

Professional 1
December 2000

MARKING SCHEME

Question 1

(a)

(i) Confectionery business disposed of in the year, FRS 3 requires this to be shown separately under discontinued activities. The turnover to operating profit figures need to be split between continuing and discontinued activities and shown on the face of the profit and loss account (minimum of turnover and operating profit) or in the notes to the accounts (all other headings). Previous year's comparatives would also be required to be shown under discontinued activities. *1* *1* *1*

(ii) Severance payments still in dispute are going to be paid, but the timing is unknown. The estimated cost should be a provision as required by FRS 12. The provision forms part of the gain/loss on disposal of the segment reducing the gain of £62m to £51m. The net amount should be included under exceptional items. *1* *1* *1*

(iii) The input tax should be deducted from the output tax and the net amount shown under creditors less than 1 year. *1*

(iv) Revalue the properties to £70m, add the increase (£9m) to Investment Properties Revaluation Reserve. SSAP 19 requires investments to be carried at market value, but not depreciated. *2*

(v) A fall in value such as this would be an impairment as defined by FRS 11. The impairment should be written off the carrying value at the date of the impairment arising. The impairment is charged to revaluation reserve if the asset has previously been revalued upwards or to the profit and loss account if the asset concerned has not previously been revalued or there is insufficient balance left in the revaluation reserve. The £150m is deducted from the balance on the revaluation reserve leaving £39m. The new valuation is then written off over the remaining useful life, £540m divided by 27 years gives £20m per year. *½* *½* *1* *½* *½*

(vi) The £4m should be transferred to fixed assets and the cost of purchases reduced. *1*

(vii) The current requirement under SSAP 15 is to use the partial provision method of providing for deferred tax. The balance carried forward should be £86m giving the charge to profit and loss account of £14m, shown under the tax heading on the profit and loss account. *2*

(viii)

- Lease 1 is a finance lease as defined by SSAP 21 and FRS 5. The risks and rewards of ownership have passed to ABC plc and the asset is being used for its entire economic life. Create an asset value £68m and depreciate using the company policy for machinery. Also create a liability for the same amount, £68m - this is then reduced by the rental payment and increased by the interest charges at 5% per half-year compound. *½ ½ ½ ½*

- Lease 2 is an operating lease, the risks and rewards of ownership have not transferred and ABC plc are only using the asset for one year out of ten. Charge the rentals to administration costs in profit and loss account. *2*

- The old machine needs to be removed from asset balances. Deduct £43m from cost and £38m from depreciation provision. The £5m balance less £1m proceeds shown in profit and loss as loss on disposal. *1*

(ix) The bond nominal value is £200m but only £185m was raised. Therefore the issue costs of £15m have been deducted from the nominal value to show the cash actually received. FRS 4 requires the issue costs to be charged to profit and loss account over the life of the instrument. £15m spread over 5 years is £3m a year. The bond carries interest at 7% which gives annual interest of £14m plus the issue cost recovery means an annual charge to profit and loss of £17m. The value of the bond shown under liabilities at the end of the year is £185 plus the issue costs recovered £3m giving a balance of £188m. *4*

(x) This is treated as a post balance sheet adjusting event, which gives additional information on the situation prevailing at the balance sheet date. Write off the balance of £20m as a bad debt. *2*

(xi) FRS 12 applies here. The high probability that the cases will be lost means that these cases should be set up as a provision. FRS 12 requires the most likely amount to be used as the basis of the provision. Create a provision for £19m, show in the profit and loss account under administration and on the balance sheet under provisions. *2*

(28)

(b)

ABC plc

Profit & Loss account for year ended 30 September 2000

	Continuing £m	**Discontinued £m**	**Total £m**	
				1 for principle
Turnover	3,621	1,610	5,231	
Cost of sales W1	(2,874)	(1,010)	(3,884)	*1 for split of figures*
Gross profit	747	600	1,347	
Administration W2	(473)	(400)	(873)	
Distribution W3	(45)	(320)	(365)	
	229	(120)	106	
Other operating income	22	0	22	
	251	(120)	131	
Exceptional items:				
Loss on disposal fixed assets	(4)		(4)	½
Gain on disposal of business segment		51	51	½
	247	(69)	178	
Interest receivable			34	½
Interest payable (9+14+3+4)			(30)	*1*
			182	
Tax (75+14)			(89)	½
			93	
Dividends			(36)	½
Retained profit			57	

Workings:

	£m	
W1 Cost of sales		
Opening stock	192	
Net purchases	1,908	
	2,100	
Less closing stock	-216	
	1,884	½
Other production costs	2,000	½
	3,884	
W2 Administration		
Trial balance	424	
Lease rental	20	½
Depreciation buildings	20	½
Depreciation plant f & f	338	½

Depreciation finance lease machine A	17	½
	£m	
Bad debts	20	½
Provision bad debts	15	½
Provision legal cases	19	½
	873	
W3 Distribution costs		
Trial balance	333	
Vehicle depreciation	32	½
	365	

Depreciation:

Buildings	Cost/Valuation	Depreciation	Net	
	£m	£m	£m	
Trial balance	849	-159	690	
Reduction in value	-309	159	-150	
	540	0	540	½
Depreciation 1/27		-20	-20	½
	540	-20	520	

Plant F&F				
Trial balance	1,772	-415	1,357	
Disposal	-43	38	-5	½
	1,729	-377	1,352	
Years depreciation @ 25%		-338	-338	½
	1,729	-715	1,014	
Finance lease	68	-17	51	½
	1,797	-732	1,065	

Vehicles				
Trial balance	240	-84	156	
Purchases	4		4	½
	244	-84	160	
Years depreciation @ 20%		-32	-32	½
	244	-116	128	

Alternative treatment of leased asset:
The leased plant could be depreciated over the life of the lease, ie five years instead of 25% applied to other plant.

Balance Sheet as at 30 September 2000

Tangible fixed assets	Cost/Valuation	Depreciation	Net	
	£m	£m	£m	
Land	489	0	489	
Buildings	540	(20)	520	
Plant, fixtures & fittings	1,797	(732)	1,065	
Vehicles	244	(116)	128	
			2,202	
Investment property			70	½
Current assets				
Stock	216			
Debtors	392			
Cash	15	623		½
Creditors < 1 year *		(566)	57	
			2,329	
Creditors > 1 year				
Finance lease		(51)		½
Bonds		(188)	(239)	½
			2,090	
Provisions for liabilities and charges				
Deferred tax		(86)		½
Provision legal charges		(19)		½
Provision severance payments		(11)	(116)	½
			1,974	
Financed by:				
Share capital			600	
Share premium			332	
Revaluation reserve			39	½
Investment property revaluation reserve			46	½
Retained profits (900+57)			957	
			1,974	
* Creditors < 1 year:				
Creditors	(267)			
Bank loan	(80)			
Dividends	(36)			½
VAT	(82)			½
Tax	(75)			½
Finance lease	(12)			½
Bond interest	(14)			½
	(566)			

(21)

Question 2

Report *Report format 1*

To: The Board of Directors of ATP plc

From: The Chief Accountant

Date: 1 December 2000

Report on Performance of ATP plc April 1998 to March 2000

Introduction
The financial statements of ATP plc were analysed and ratios calculated to assess the performance of ATP plc for the two-year period 1 April 1998 to 31 March 2000. The ratios calculated are attached as an appendix.

Performance
ROCE has slightly increased from 13.1 to 13.6 using the figures in the closing balance sheets. The closing balance sheets include an asset revaluation during the year 1999/2000. If the asset revaluation is excluded the true increase in ROCE is 16.4% - a 25% increase on 1998/99. The turnover increased from £4,760m to £5,736m or just over 20% between 1998/99 and 1999/2000. The net profit margin over the same period increased 40% from 13.4% to 18.8% while the gross margin increased from 20.15% to 25.5%. Expenses reduced as a proportion of sales from 14.8% to 13.3%, probably due to some expenses being fixed relative to sales volume, in the short term. The increase in the gross margin was the main reason for the improvement in the ROCE.

Asset utilisation
The asset turnover, which was already low at 0.98, reduced to 0.73 partly because of the asset revaluation and partly because of the fixed asset purchases. There was a very large investment in fixed assets over the two years. The cash flow statement shows asset purchases of £988m and £1,112m over the two years. The new assets are probably not fully contributing to activities. The outlook for 2000/2001 should be good as the assets come fully on line and the improvements in gross margins and net margins continue.

Management of working capital
As profitability has increased liquidity has fallen. In 1998 the current ratio was 1.5 to 1, this fell to 1.11 to 1 in 1999 and then recovered to 1.32 to 1 in 2000. A similar pattern was repeated for the quick ratio, starting at 1.14 to 1, falling to 0.87 to 1 and recovering to 0.98:1. This is supported by the cash flow statement which shows decreases in stock, debtors and creditors in 1998/99 and then increases in all three in 1999/2000.

The debtors days outstanding fell from 143 to 128, while the stock turnover increased from 65 to 79 days and creditors payments fell from 134 days to 117 days. The debtors payment period and creditors payment period are both too long and need to be reduced further.

Capital structure
The gearing has improved from 1998/99 to 1999/2000, from 57% to 47%. This reduction has occurred despite an increase in debentures of 36% from £2,740m to £3,732m. The share capital was also slightly increased during the period, but the increase in revaluation reserve was the main reason for the reduction in gearing. If the revaluation reserve had remained the same the gearing would have been 56%.

1 mark for each comment on a ratio up to a maximum of 7

Summary
ATP plc has generated significant cash flows during the period, but cash has been reduced overall due to large investments in fixed assets and increases in working capital. ATP has undergone rapid expansion and has managed to increase its profitability. The liquidity position temporarily fell but has partially recovered. The expansion has been funded by long term loans and increases in equity funding, without an increase in gearing. The current position of ATP seems to be very sound.

2 marks for conclusion

Appendix

	2000	**1999**
ROCE	1076 / (4164 + 3732) = 13.6%	636 / (2108 + 2740) = 13.1%
ROCE (excluding revaluation of assets)		
	1076 / (4164 – 1240 + 3732) = 16.4%	
Net profit margin	1076 / 5736 = 18.8%	636 / 4760 = 13.4%
Asset turnover	5736 / 7896 = 0.73 times	4760 / 4848 = 0.98 times
Gross margin	1460 / 5736 = 25.5%	956 / 4760 = 20.1%

Liquidity:	**2000**	**1999**	**1998**
Current ratio	4720:3584 = 1.32:1	2984:2692 = 1.11:1	2972:1984 = 1.5:1
Quick ratio	3504:3584 = 0.98:1	2352:2692 = 0.87:1	2260:1984 = 1.14:1

Management control:
Debtor turnover (assume all sales are on credit and using average debtors)

$\frac{(2268+1740)/2}{5736} * 365 = 128$ $\frac{(1740+1980)/2}{4760} * 365 = 143$

Stock Turnover (using cost of sales and average closing stock)

$\frac{(1216+632)/2}{4276} * 365 = 79$ $\frac{(632+712)/2}{3804} * 365 = 65$

Creditor turnover

$\frac{(1204+1536)/2}{4276} * 365 = 117$ $\frac{(1536+1256)/2}{3804} * 365 = 134$

Gearing (excluding bank loans and overdraft):
3732 / (3732+4164) = 47% 2740 / (2740+2108) = 57%

EPS:
684/3504 = 19.5 372/2760 = 13.5

1 mark for calculation of each ratio up to a maximum of 7
Alternative ratios, correctly calculated, are also acceptable

(17)

Question 3

(a)

The major strength of fund accounting is that it provides information on the use of resources in meeting specific objectives. It is a powerful tool for assessing accountability for particular resources. *1*

Fund accounting means that the activities of an entity, such as a charity, are separated and each separate activity is designated as a fund. Each fund is then represented by a set of self-balancing accounts which separate specific activities in accordance with agreed rules. *1*

A separate revenue account and balance sheet is produced for each fund. *½*

Separate funds are identified to maintain accountability for identified resources. The records must identify which net assets are associated with the balance on each fund. *1*

It should be appreciated that funds will only be created where specific pools of resources are earmarked for particular purposes. Funds received could be: *½*

1. Endowments; that is capital which has to be retained and the income from which is used for specific purposes. Each endowment must be accounted for separately. *½*

2. Donations which may be for generalpurposes or for a particular appeal. Donations for a particular appeal will have to be kept separate from the general purpose ones. *½*

3. Grants either for specific projects or for the general work of the charity. Specific grants will have to be accounted for separately. *½*

The accounts should show clearly the source of the income and how it was applied.

A consolidated balance sheet and a consolidated statement of financial activities are also produced to show the total resources available to the charity. *½*

(6)

(b) Statement Of Financial Activities (SOFA)

This statement analyses income and expenditure in a way that is most appropriate to charity operations, by type of fund and, in the case of expenditure, by type of transaction. The contents of a SOFA include:

(i) All incoming resources showing the amounts from the different sources.
(ii) All resources expended showing the amounts spent on activities directly relating to the objects of the charity, on fund raising and publicity and on the cost of managing and administering the charity.
(iii) Gross transfers between the funds of the charity.

(iv) Gains or losses on disposal of fixed assets intended for investment or on revaluation of fixed assets intended for use or investment.
(v) Total of funds brought forward from previous year.
(vi) The total of funds carried forward to next financial year.

The incoming resources also need to be analysed by type of fund:
(i) unrestricted income funds;
(ii) income funds which are restricted;
(iii) capital funds; and
(iv) the total for all funds.

Up to 2 marks for description of SOFA

A company profit and loss account is simpler, in that income and expenditure are shown for the year, analysed according to standard formats. If the company is large they may have to show an analysis of the turnover and expenses by product segment and geographical location. This could be regarded as similar to the analysis required for the SOFA. The expenditure analysis is different in a profit and loss account as there is no distinction between income generated by activities, from investments and from donations. There are not usually any donations to companies! *1* *1*

The net profit of a company is seen as an important item, one that is usually assumed to be maximised. The net funds figure for the year is not a good measure of the performance of the charity. In fact if the charity has a large surplus of funds left at the year end they may not be performing at all well. A large surplus at the year end means resources received but not distributed for the charitable cause. *1*

(5)

(c) The Financial Reporting Standard for Smaller Entities (FRSSE) has maintained the same measurement criteria for small companies as is used for larger enterprises. The requirements of the various standards have not been removed altogether; they have only been relaxed and simplified. *1½*

The FRSSE has removed a lot of the detailed disclosure requirements from small companies which will make their reports shorter and easier to produce. It has also simplified some of the more complex accounting treatments, such as allowing lease financing charges to be accounted for on the straight line basis. *1½*

The FRSSE specifically says that the resulting financial statements should present a true and fair view of the results for the period and of the state of affairs at the end of the period. *1½*

As the measurement and recognition principles are the same, and the FRSSE requires a true and fair view, then the fact that there is some simplification in accounting treatments and less disclosure should not detract from the accounts showing a true and fair view. *1½*

(6)

(17)

Question 4

(a)

Intangible assets under FRS 10 are treated as follows:

- Internally generated and purchased assets can be included on the balance sheet if they meet the criteria set out - that is that they have a readily ascertainable market value in their own right. They can be sold separately from the business as a whole.
- All intangible assets must be separately identifiable - if not separately identifiable they are included in goodwill.
- Intangible assets must give control of future economic benefits.
- Only intangible assets with a readily ascertainable market value can be revalued. Goodwill cannot be revalued.
- Intangible assets and goodwill can be amortised over their useful economic life up to 20 years, more than 20 years or treated as having an indefinite life. If the economic life is deemed to be over 20 years an annual impairment review must be carried out - this implies that the asset is capable of continued measurement.
- Amortisation will usually be on straight line basis.

1 mark per point made up to a maximum of 6

(b)

• Clearly defined project;	½
• Expenditure must be separately identifiable;	½
• Outcome must be reasonably certain as to technical feasibility and commercial viability;	½
• Future revenues expected to future costs plus deferred development costs; and	*1*
• Adequate resources are available to exploit project.	½
	(3)

(c)

The impairment review is a recoverable amount check, which is required every year if the useful life of a fixed asset is greater than 20 years. An impairment review follows the long established principle that an asset's balance sheet carrying value should not exceed its recoverable amount, which is measured by reference to the future cash flows that can be generated from its continued use or disposal. Impairment is defined in FRS 10 as "a reduction in the recoverable amount of a fixed asset or goodwill below its carrying value". *4*

In general or summary terms the annual detailed impairment review has a number of steps as follows:

- Identifying separate income-generating units;
- Establishing balance sheets for each income-generating unit, comprising the net tangible and intangible assets plus allocated purchased goodwill;
- Forecasting the future cash flows of the income-generating unit and discounting them to present value;
- Comparing the present value of the cash flows with the net assets of the income-generating unit and recognising any shortfall as an impairment loss; and
- Allocating any impairment loss to write down the assets of the income-generating unit. *4*

(8)

(17)

Question 5

(a) The ASB statement of principles, chapter 3, Elements defines assets as follows:

"Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events." *1*

and liabilities are defined as follows:

"Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events." *1*

The definitions are also repeated in FRS 5. *½*

Therefore to be an asset a transaction must give rise to a future economic benefit that is controlled by the entity. Past expenditure that convey no future benefits cannot be carried as assets in the balance sheet. *1* *1*

Liabilities only exist where there is already an obligation to transfer future economic benefit. Future commitments are not included in liabilities. *1½*

(6)

(b) Contract 993 is expected to be profitable and we can therefore recognise the profit earned to date. The entries for contract 993 are: *1*

	Dr £	Cr £	
Turnover		960,000	
Debtors – Amounts due under contracts	960,000		
To record the value of work carried out under contract 993			*1*
Cost of sales	640,000		
Work in progress		640,000	
To record the cost of work done on contract 993			*1*
Balance sheet extracts:			
Debtors – amounts due under contract 993	314,000		
(960,000 – 646,000)			*1*
Work in progress – contract 993	40,000		
(680,000 – 640,000)			*1*

(5)

(c) The long term contract is recognised under turnover and cost of sales to give a true and fair view. If the income from long term contracts and the cost of work done on them was only recognised at the end of the contract the profit and loss account would not reflect the amount of activity during the period. The results recognised would be very unbalanced, depending on how many contracts were completed in a year. SSAP 9 applies the matching concept to match revenues and costs for the contract during the period. Prudence is also observed in that a profit can only be recognised when the contract is sufficiently complete to allow a reasonable estimate of the outcome to be made and the contact as a whole is estimated to be profitable. If the contract is expected to make a loss the whole loss is recognised immediately. The stock-work in progress must be at cost or net realisable value (Companies Act '85) therefore the turnover is recognised in the profit and loss account and debited to debtors. The net amount of debtors on the balance sheet is after taking account of any payments received. *6*

(17)