

ACCOUNTING THEORY AND PRACTICE

**Professional 1 examination
December 1999**

MARKING SCHEME

The logo for CIPFA, featuring the letters 'CIPFA' in a serif font. The letter 'I' is stylized with a decorative flourish that loops over the top of the 'P'.

Question 1

(a) **THREE LIONS PLC**
PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 OCTOBER 1999

| | £000 | £000 | |
|--|-------------|----------------------|-----|
| Turnover | | 369,650 | |
| Cost of sales | | (248,782) | |
| | | <u>120,868</u> | |
| Admin expenses | (40,616) | | |
| Contingent liability | (250) | | 1/2 |
| Debtor write off | (90) | | 1/2 |
| Distribution expenses | (36,882) | (77,838) | |
| | | <u>43,030</u> | |
| Other income | | | |
| Investment Income | | 4,375 | |
| Profit on ordinary activities before tax | | <u>47,405</u> | |
| Taxation | | | |
| Corporation tax for year | (500) | | |
| Last year underestimation | (100) | | 1/2 |
| Deferred tax provision | (100) | | |
| Tax credit on dividend received | (875) | (1,575) | 1/2 |
| | | <u>45,830</u> | |
| Dividends proposed | | (585) | |
| Retained profit for year | | <u><u>45,245</u></u> | |

BALANCE SHEET AS AT 31 OCTOBER 1999

| | £000 | £000 | £000 | |
|------------------------|------------|---------------|----------------|---|
| | cost | depcn | total | |
| Fixed assets | | | | |
| Equipment | 174,820 | 84,214 | 90,606 | ½ |
| Vehicles | 8,900 | 5,526 | 3,374 | ½ |
| Investments | | | 54,400 | |
| | | | <u>148,380</u> | |
| Current assets | | | | |
| Stock | | 11,730 | | |
| Debtors (22,270-90) | | 22,180 | | 1 |
| Bank | | 6,708 | | |
| Cash | | 2,320 | | |
| | | <u>42,938</u> | | |
| Current liabilities | | | | |
| Creditors | (25,930) | | | |
| Taxation | (500) | | | 1 |
| Proposed dividends | (585) | | | |
| Legal action | (250) | (27,265) | 15,673 | 1 |
| | | <u>15,673</u> | | |
| Deferred tax provision | | | (328) | |
| | | | <u>163,725</u> | |
| Ordinary share capital | | | 43,870 | |
| Retained profit | | | 119,855 | ½ |
| | | | <u>163,725</u> | |
| Workings | | | | |
| w1 proposed dividend | | | | |
| No of shares | 43,870,000 | *100/75 = | 58,493,333 | |
| 10p dividend | 58,493,333 | *1p = | 585,000 | 1 |

(½ mark for entry on P&L account, and ½ mark for entry in balance sheet)

w2 depreciation

| | Equipment £000 | Clothing £000 | Books £000 | Total £000 | |
|------------------|---------------------------|--------------------------|-----------------------|-----------------------------------|----|
| Equipment | 17,482 | 13,986 | 3,496 | | |
| Cost of sales | 8,741 | 6,993 | 1,748 | 17,482 | |
| Distribution | 6,993 | 5,594 | 1,399 | 13,986 | |
| Admin | 1,748 | 1,399 | 349 | 3,496 | |
| | | | | 34,964 (17,482,000 x 20%) | |
| Bal b/f | | | | 49,250 | |
| | | | | <u>84,214</u> | 2½ |
| Vehicles | | | | | |
| Distribution | 361 | 940 | 145 | 1,446 (8,900,000-4,080,000 x 38%) | |
| Bal B/f | | | | 4,080 | |
| | | | | <u>5,526</u> | 1½ |

w3 cost of sales

| | Equipment £000 | Clothing £000 | Books £000 | Total £000 | |
|---------------|---------------------------|--------------------------|-----------------------|-----------------------|---|
| Trial balance | 146,730 | 76,070 | 8,500 | 231,300 | |
| Depcn- equip | 8,741 | 6,993 | 1,748 | 17,482 | |
| | <u>155,471</u> | <u>83,063</u> | <u>10,248</u> | <u>248,782</u> | ½ |

w4 admin expenses

| | Equipment £000 | Clothing £000 | Books £000 | Total £000 | |
|---------------|---------------------------|--------------------------|-----------------------|-----------------------|---|
| Trial balance | 24,650 | 11,690 | 680 | 37,020 | |
| Depcn-equip | 1,748 | 1,399 | 349 | 3,496 | |
| Accountancy | | | | 100 | |
| | <u>26,398</u> | <u>13,089</u> | <u>1,029</u> | <u>40,616</u> | ½ |

w5 distribution expenses

| | Equipment | Clothing | Books | Total | |
|----------------|------------------|-----------------|--------------|---------------|----------|
| | £000 | £000 | £000 | £000 | |
| Trial balance | 12,350 | 8,180 | 920 | 21,450 | |
| Depcn- equip | 6,993 | 5,594 | 1,399 | 13,986 | |
| Depcn- vehicle | 361 | 940 | 145 | 1,446 | |
| | <u>19,704</u> | <u>14,714</u> | <u>2,464</u> | <u>36,882</u> | <i>½</i> |

w6 investment income

3500*100/80 =4,375 *1*

w7 deferred tax

| | | |
|-------------|------------|----------|
| | £000 | |
| Balance | 228 | |
| P&L account | <u>100</u> | |
| | <u>328</u> | <i>1</i> |

(15)

(b) **SEGMENTAL INFORMATION**

| | Equipment | Clothing | Books | Total | |
|-------------------|------------------|-----------------|--------------|---------------|------------|
| | £000 | £000 | £000 | £000 | |
| Turnover | 255,410 | 94,370 | 19,870 | 369,650 | <i>1</i> |
| Segmental result | 53,837 | -16,496 | 6,129 | 43,470 | <i>2</i> |
| | | | | (440) | |
| less common costs | | | | <u>43,030</u> | <i>1</i> |
| Other income | | | | <u>4,375</u> | <i>1</i> |
| | | | | <u>47,405</u> | <i>(5)</i> |

(c)

| | |
|----------------------|------------|
| Class of business | <i>1</i> |
| Geographical segment | <i>1</i> |
| | <i>(2)</i> |

(d)

Legal action accounting for provisions / contingencies

probable provide as legal obligation FRS 12 *1½*

Post balance sheet event SSAP 17 adjusting/non adjusting *1½*

(3)

Question 2

Given below is one version of arriving at the figures for cost of control, minority interest and profit & loss.

w1 revaluation of assets

| | | | | | |
|-----------|------|-----------------|------|--|---|
| buildings | +120 | | | | |
| vehicles | -50 | | | | |
| | +70 | mi =70*.315 =22 | | | |
| | | group =70*.685 | = 48 | | 1 |

w2 depreciation on revalued assets

| | | | | | |
|----------|--------------|--|--|--|-----|
| building | 120/50*6 =14 | | | | |
| vehicles | -50/5*5 =-50 | | | | 1/2 |

w3 cost of control

| | | | | | | |
|-------------------|---------|--------------|-------------------|----------|--------------|---------|
| cost | | 960 | Ord shares | | 685 | |
| Profit & loss | 20*.685 | 14 | 1/2 Share premium | 100*.685 | 69 | 1/2 |
| Negative Goodwill | bal | 68 | General | 300*.685 | 206 | 1/2 |
| | | | Revaluation | 50*.685 | 34 | 1/2 |
| | | | Fair value | w1 | 48 | 1/2 |
| | | <u>1,042</u> | | | <u>1,042</u> | (2 1/2) |

w4 stock

| | | | | |
|-------------------|---------------|-------------|--|-----|
| sold | 60,000 | | | |
| unrealised profit | (17,000) | (60*40/140) | | |
| cost | <u>43,000</u> | | | 1/2 |

w5 Minority interest

| | | | |
|-----------------|--------------|-------------|-----|
| | | £000 | |
| Ordinary shares | 1000*.315 | 315 | 1/2 |
| Share premium | 100*.315 | 31 | 1/2 |
| General | 500*.315 | 158 | 1/2 |
| Revaluation | 150*.315 | 47 | 1/2 |
| Fair value | 22+(36*.315) | 33 | 1/2 |
| P&L account | 727*.315 | 229 | 1/2 |
| | | <u>813</u> | |

Consolidated profit and loss account

| | | | | | | |
|-------------------|----|-------------|---|--------------|---------|-------------|
| Unrealised profit | w4 | 17 | ½ | Balance | | |
| | | | | 30/9/99 | | |
| Minority intrst | w5 | 229 | ½ | UM | 1083 | |
| Group balance | | 1616 | | Bongo | 727 | |
| | | | | Pre acq loss | w3 | 14 |
| | | | | Dividend | 20*.685 | 14 |
| | | | | Excess depcn | w2*.685 | 24 |
| | | <u>1862</u> | | | | <u>1862</u> |

Consolidated balance sheet

| | | | | | | |
|-------------------------------------|----|----------------|--|--|-------------|---|
| Fixed assets | | | | | | |
| Negative Goodwill | w3 | | | | (68) | ½ |
| Land & buildings | | 820+300+120-14 | | | 1226 | ½ |
| Plant & machinery | | 900+1200 | | | 2100 | |
| Vehicles | | 500+830-50+50 | | | 1330 | ½ |
| Current assets | | | | | | |
| Stock | | 166+140-17 | | | 289 | ½ |
| Debtors | | 310+160-60 | | | 410 | ½ |
| Cash | | 77+25 | | | 102 | |
| Current Liabilities | | | | | | |
| Creditors | | 250+178-60-14 | | | (354) | ½ |
| Long term liabilities | | | | | | |
| Debentures | | | | | (200) | |
| | | | | | <u>4903</u> | |
| Share capital & reserves | | | | | | |
| Ordinary shares | | | | | 1700 | ½ |
| Share premium | | 500+100-69-31 | | | 500 | ½ |
| General reserve | | | | | 137 | |
| Asset revaluation | | | | | 69 | |
| Profit & loss | w6 | | | | 1616 | ½ |
| Minority interest | w5 | | | | 813 | ½ |
| | | | | | <u>4903</u> | |

(15)

Credit was given for rounding differences

No goodwill policy was given in question students should be given for:

Either

(a) Leaving on balance sheet as negative goodwill

Or

(b) Amortising over a suitable period

| | |
|--------------------------------------|-----|
| Definition of acquisition accounting | 1 |
| Definition of fair value | 2 |
| Rationale of the treatment | 2 |
| | (5) |

Question 3

The question asked students to explain the rationale behind the following entries.

| | | |
|-------|---|------------|
| (i) | Government grant SSAP 14 | |
| | £275,000 deferred income on the balance sheet | <i>1/2</i> |
| | dr suspense account £275,000 | |
| | cr deferred income £275,000 | <i>1</i> |
| | Release to P&L a/c over 5 years | <i>1/2</i> |
| | dr deferred income £55,000 | |
| | cr P&L account £55,000 | <i>1</i> |
| | £75,000 revenue grant | <i>1/2</i> |
| | dr suspense account £75,000 | |
| | cr P&L a/c £75,000 | <i>1</i> |
| (ii) | Investment properties SSAP 19 | |
| | Can be shown at valuation without depreciation therefore no action required | <i>1</i> |
| (iii) | Research and development SSAP 13 | |
| | Pure and applied research to be charged to P&L | |
| | Development may be capitalised if following criteria met | |
| | - clearly defined project | |
| | - expenditure separately identifiable | |
| | - technically feasible and commercially viable | |
| | - expected revenue greater than cost | |
| | - resources are available | <i>3</i> |
| | £70,000 capitalise | |
| | cr suspense account £70,000 | |
| | dr intangible assets £70,000 | <i>1</i> |
| | Amortise from year end 30 September 2000 | |
| | cr intangible assets £14,000 | |
| | dr P&L account £14,000 | <i>1</i> |
| | £80,000 scheme not viable | |
| | cr suspense | |
| | dr P&L a/c | <i>1</i> |
| (iv) | leasing SSAP 21 | |
| | what is a finance lease | <i>2</i> |
| | dr asset a/c £300,000 | |
| | cr Creditor lessor account £300,000 | <i>1</i> |

| | |
|--|-------------|
| charge finance charge to P&L account over the lease life by sum of the digits method, in year ending 30 September will amount to £21,143 | <i>1½</i> |
| dr P&L account | |
| cr suspense account | <i>1</i> |
| balance ie £72,000- £21,143 | <i>1</i> |
| dr creditor lessor account | |
| cr suspense account | <i>1</i> |
| (v) Stock merely an error £75,000 | |
| dr P&L purchases | |
| cr creditors | <i>1</i> |
| | <i>(20)</i> |

Question 4

Report should have following headings

- to whom report addressed/ heading/date 1
- background
- to analyse the effect of the decision to reduce price and extend credit terms 1
- ratio analysis description/interpretation
 - profitability
 - gross profit/sales fallen 60%>40% reasons
 - Net profit/sales fallen 34%>11% reasons
 - ROCE fallen 29%>16% reasons
 - solvency
 - Current ratio increased 3.44>4.41 reasons
 - Quick ratio increased 2.61>3.13 reasons
 - capital structure
 - Capital gearing increased 10%>56% reasons
 - net profit up 20,000
 - gross profit up 1,450,000

*Analysis of other ratios should be credited 1 mark for each appropriate interpretation
Up to a maximum of 7*

- conclusions
 - Although profit margins profitability has reduced, the solvency of the company has improved reasons 3
 - recommendations
 - To continue, but monitor 2
 - appendix ratio calculation
- calculation of ratios
 - Gross profit/sales 1350/2250&2800/7000
 - net profit/sales 755/2250&775/7000
 - ROCE 785/2660&1255/7630
 - Current ratio 310/90&2050/465
 - Quick ratio 235/90&1455/465
 - Capital gearing 250/2570&4000/7165

*Other appropriate ratios correctly calculated should be credited
(maximum 6 ratios, 1 mark per ratio)
(20)*

Other correct calculations of the above ratios should be credited

Question 5

| | |
|--|------|
| The economic benefit of using the asset is not represented by the capital required to finance it, finance provided by another entity | 1 |
| Examples | |
| lease | 1 |
| sale and repurchasing of assets describe | 2 |
| factoring describe | 2 |
| Main areas covered by FRS | |
| determination of the substance of a transaction | 3 |
| whether any resulting assets & liabilities should appear in balance sheet | 2 |
| disclosure requirements | 2 |
| when quasi subsidiaries should be included in a consolidation | 2 |
| | (15) |
| <i>See open learning book section 3.4.16 and technical update.</i> | |

Question 6

| | |
|---|--|
| (a) Reasons | |
| - sale | |
| - new partner | <i>See open learning book section 5.4</i> |
| - partner dies | |
| - another business bids | |
| - shareholder in company dies | 2 |
| | <i>½ mark for each reason up to a maximum of 2 marks</i> |
| (b) Valuation depends on the circumstances and intention of buyer | 1 |
| Quoted companies stock exchange price ? limitations | 2 |
| <i>See open learning section 5.4</i> | |
| Valuation based on underlying assets & liabilities | 5 |
| Valuation based on earnings | 5 |
| <i>See technical update</i> | |
| | (15) |