ACCOUNTING THEORY AND PRACTICE

Professional 1 examination
5 June 2001

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 italics 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.

SECTION A (Compulsory)

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

1

The following trial balance was extracted from the books of the OP plc as at 31 March 2001.

	Dr £000	Cr £000
£1 Ordinary shares		500,000
6% Preference shares		200,000
5% Debentures		300,000
Revaluation reserve		52,000
Undistributed profit at 1 April 2000		95,000
Share premium account		100,000
Discounts received		11,500
Creditors		99,500
Provision for depreciation – Buildings (as at 1 April 2000)		200,000
Provision for depreciation – Plant & Machinery (as at 1 April 2000)		280,100
Proceeds from sale of machinery		5,000
Provision for doubtful debts		6,170
Sales		1,248,250
Cost of goods sold	752,800	
Stock at 31 March 2001	114,900	
Land and Buildings at cost	476,500	
Plant & Machinery at cost	576,000	
Brand names at cost	380,000	
Bank and cash	371,220	
Administration expenses	97,300	
Debenture interest	7,500	
Directors' fees	41,400	
Interim dividend paid:		
Ordinary	25,000	
Preference	6,000	
Distribution expenses	27,200	
Debtors	213,000	
Closure expenses	8,700	
	3,097,520	3,097,520

Additional information available was as follows:

1. The authorised share capital of the company is £700,000,000 £1 Ordinary shares and £200,000,000 6% £1 Preference shares.
2. On 31 March 2001, the company issued bonus shares to ordinary shareholders on a one for ten basis. The bonus shares did not rank for dividends until 2001/2002 financial year. No entry relating to this has yet been made in the books.
3. OP decided to completely withdraw from one of its less productive market segments. During the year one of OP's factories, the only one producing the products now discontinued, was closed. The premises had been rented, the agreement was terminated and the machinery sold. The proceeds of the sale of the machinery from the closed factory were £5,000,000. The machines had cost £45,000,000 and the depreciation to date amounted to £31,750,000. Other closure costs amounted to £8,700,000. The only entry made in the books so far has been to record the receipt from the disposal of the machinery and the payment of closure costs.
4. The discontinued activities accounted for:

- Turnover £50,000,000
- Cost of sales £48,000,000
- Administration £7,000,000
- Distribution £4,000,000

  During the year to 31 March 2001

These figures are included in the trial balance figures.

5 OP acquired its brand names ten years ago and has a policy of not amortising brand names as they are deemed to have an infinite life due to the annual expenditure to support them. Although the directors still believe the brands have an infinite life, they have decided to amortise the brands for the first time in the 2000/2001 accounts, as they are unwilling to carry out the very expensive annual impairment review required by FRS 10. The brands are estimated, for the amortisation purpose, to have an economic life of 20 years from the date they were acquired.

6 Wages owing at 31 March 2001 amounted to £487,000. These wages are regarded as part of administrative expenses.

7 Corporation tax for the year is estimated at £41,000,000.

8 Depreciation on plant and machinery is regarded as a "cost of sales" expense and is at 10% per annum on cost.

9 On 5 May 2001 OP was advised that one of its major customers had gone into liquidation. The outstanding balance on their account at 31 March 2001 was £33,000,000. It is very unlikely that any money will be received from the liquidator.

10 Due to the recent increase in bad debts, the directors of OP have decided that it would be prudent to increase the provision for doubtful debts to 5% of the final debtors balance as at 31 March 2001.

11 The directors, on the advice of an independent valuer, wish to revalue the land and buildings to £320,000,000 as at 1 April 2000. The land originally cost £76,500,000 and is to be revalued to £100,000,000. At 1 April 2000 the buildings were 25 years old and were deemed to have a useful life from their date of purchase of 50 years. The buildings are occupied by staff from each section as follows:

- production 50%
- administration 25%
- sales and distribution 25%

12 The directors wish to provide for:

- The final preference dividend
- A final ordinary dividend of 2p per share

13 OP plc had surplus cash at the year-end and decided to use it to redeem 50% of the debentures that became available on the open market. The debentures were originally issued at par. £150,000,000 debentures were redeemed on 31 March 2001 at a premium of 5%. No entries have been made in the books to record the purchase.

• Requirement for question 1

(a) "FRS 3 – Reporting Financial Performance, is an important accounting standard that made several changes to financial reporting when it was introduced". CIPFA ATP Study Guide.

Identify and explain the reasons for the changes made by FRS 3. *12*

(b) Prepare a Profit and Loss account for the year ended 31 March 2001 and a Balance Sheet at that date for OP plc. *23*

(c) Prepare the following statements for OP plc for the year ended 31 March 2001:

(i) Statement of total recognised gains and losses.
(ii) Reconciliation of movements in shareholder funds.
(iii) Note on historical cost profit. *11*

(d) Prepare the note to the balance sheet showing the Movement on Reserves. *3*

(49)

SECTION B (Answer three questions)

2

The Accounting Standards Board (ASB) published its Statement of Principles for Financial Reporting in 1999. The Statement of Principles is intended to be the ASB's conceptual framework. According to the Statement of Principles *"the objective of financial statements is to provide information about the performance, financial position and cash flows which is useful to a wide range of users…"*.

- **Requirement for question 2**

(a) Define the phrase "conceptual framework". *3*

(b) Identify the benefits of having a conceptual framework for financial reporting. *7*

(c) Explain who the "*wide range of users*" of financial statements could be and identify their information needs. *7*

(17)

3

Mr A invested in a small business, renting out computer games and videos for home use. Mr A wants to maintain his capital so that he can retire in ten years' time and be able to sell his business and realise the same value as his original investment.

- **Requirement for question 3**

(a) Explain what Mr A means when he says he wants to "maintain his capital" and "realise the same value as his original investment". *9*

(b) Current cost accounting (CCA) uses four adjustments to adjust historical cost profits. Explain these four adjustments. *8*

(17)

4

"Economic substance over legal form" is a relatively new concept in UK accounting, introduced by FRS 5.

(i) C Ltd needed more working capital to invest in new stock, and raised the required amount by signing a debt factoring agreement with F plc. The agreement provides for F plc to purchase the debts at sales invoice value less 20% – this amount is non-returnable. F plc then collects the amounts due and any amounts collected in excess of the invoice value less 20% are returned to C Ltd, less the factoring fee. The sales invoice value transferred to F plc and outstanding at the year-end was £500,000.

(ii) B Ltd needed to raise cash for expansion. B Ltd decided to sell its HQ building for £25 million. It immediately took out a 99-year lease on the building with an annual rental payable of £3 million. There was no change in the use of the building.

(iii) M Ltd is a dealer in mobile homes. A manufacturer supplies the mobile homes on consignment. The terms are:

- On delivery 50% deposit is payable based on the invoice price.
- When the homes are sold M Ltd pays the balance due, based on the original invoice price.
- At the end of the summer season M Ltd can return all unsold homes and receive a refund of the deposit paid less a 10% administration fee.

At the end of the financial year M Ltd had three mobile homes on consignment from the manufacturer.

(iv) A special adviser to the managing director of Z Ltd has recently been appointed on a fixed term one year contract. The conditions of employment include the provision of a company car. Z Ltd takes out a one year lease on a new vehicle supplied by Cars Ltd. The lease payments are £500 per month in advance. The lessor will pay all repairs and servicing during the year.

- **Requirement for question 4**

(a) Explain the meaning of "Economic substance over legal form". *5*

(b) Explain how each of the scenarios in (i) to (iv) above should be treated in the financial statements of C Ltd, B Ltd, M Ltd and Z Ltd. (Reference to accounting entries will aid your explanation). *12*

(17)

5

Mr X has a majority shareholding in X Ltd. Mr X is about to resign his appointment as Chairman and also wants to dispose of his shares in X Ltd.

Below are extracts from recent financial statements. X Ltd is an unquoted company and prepares its accounts to 30 September each year.

Extracts from Profit and Loss accounts for the year ended:

	1997/98	1998/99	1999/2000
	£000	£000	£000
Profit for the year after tax	700	850	1,000
Dividends	200	350	500
Retained profit for the year	500	500	500

Summarised Historic Cost Balance Sheet as at 30 September 2000

	£000	£000
Buildings		2,400
Other tangible fixed assets		2,100
		4,500
Current assets	3,000	
Current liabilities	2,500	
		500
		5,000
Ordinary share capital, £1 ordinary shares fully paid		3,000
Retained profits		2,000
		5,000

Additional information:

(i) X Ltd's sales and profits accrue evenly over the year. The half year profits to 31 March 2001 were £685,000. The directors are confident that the trend can be maintained.

(ii) The net replacement cost (current use) value of the assets at 30 September 2000 was:

	£000
Buildings	2,750
Other fixed assets	2,600
Current assets	3,300

(iii) Shares in similar quoted companies in the industry have an average P/E ratio of 10. The extra risk factor for unquoted companies is 25% in this industry.

- **Requirement for question 5**

(a) Explain the main methods that can be used to value shares in an unquoted company, such as X Ltd. *8*

(b) What price could Mr X reasonably expect to receive for his shares? *9*

(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