ACCOUNTING THEORY AND PRACTICE

Professional 1
June 2001

MARKING SCHEME

Question 1

(a) FRS 3 – Reporting Financial Performance deals with several aspects of financial reporting. It changes the format of the profit & loss account, adds additional primary statements to the accounts, replaces SSAP 6 changing some of its definitions and updates EPS in SSAP 3.

The changes brought about by FRS were:

- Analysis between continuing operations, acquisitions in the year and discontinued operations should be disclosed to the level of operating profit. The turnover and operating profit analysis must appear on the face of the profit and loss account. The analysis of other headings can appear in the notes. The reason for this is to enable users of accounts to assess future profits with more certainty. *2*
- FRS 3 sets out strict criteria for distinguishing between continuing and discontinued operations. To be classified as discontinued all of the following conditions must be satisfied:
  1. Activities must be ceased permanently.
  2. Sale or termination must be completed during the year or before signing of accounts/three months after year end, whichever is sooner.
  3. Must have a material effect on nature and focus of the operations of the entity.

Must have clearly distinguishable assets, expenses and revenues. If expenses need to be apportioned they are not clearly distinguishable.
The reason is to provide a standard classification for discontinued, to make the accounts more comparable. *2*

- FRS 3 revised SSAP 6, reclassified exceptional and extraordinary items, so that extraordinary items are effectively eliminated. It created new exceptional item headings on the profit and loss account but left prior year adjustments unchanged.
- Extraordinary items: Material items outside ordinary activities. Not expected to recur. Are extremely rare.
- Exceptional items: Material items within ordinary activities that need to be disclosed to give true and fair view. Three shown on P & L a/c:
  - Profit/loss on sale or termination of an operation
  - Costs of a fundamental reorganisation or restructuring
  - Profit/loss on sale of fixed assets

All other exceptional items included in normal P & L a/c headings and disclosed. The reason that these headings were reclassified is because they were being abused under the old definitions. Losses were often treated as extraordinary, and gains as exceptions. The new definitions will cause the items to be categorised by type of item rather than the effect they have on the profit. *3*

- SSAP 3 was updated, EPS was to be calculated after extraordinary items if any occur. This has been continued under FRS 14. The reason was also due to the manipulation of the EPS figure, caused by inconsistent allocation of items to exceptional and extraordinary. *1*

The FRS 3 introduced a number of additional statements. These were part of the ASB objectives for FRS 3, which were to require reporting entities to highlight a range of important components of financial performance to aid users in understanding the performance achieved in a period and assist then in assessing future results and cash flows. The ASB's views were that a range of components was required to assess companies, not just one number (P/E) as often used by investors. *1*

- A new primary financial statement, the "Statement of Total Recognised Gains and Losses". This statement shows the total gains/losses from all sources in the year, and aims at showing changes in wealth rather than just profit. *2*
- The memorandum "note of historical cost profits and losses" to immediately follow the "Statement of Total Recognised Gains and Losses". This shows the restatement of profit based on historical costs, excluding the effects of revaluations. It aims to show profits/losses on a basis that is more comparable with companies that have not revalued their assets. *2*

- A "Reconciliation of movements in shareholders funds". This statement reconciles the difference between the opening and closing balances on the shareholders funds. 2

(Maximum of 12)

(b)

(i) All figures in £000.

Workings

(No additional marks are available for details of accounting standards or explanation of accounting treatment)

(2)

Bonus issue, 10% of 500,000 = 50,000

Paid for by transfer from share premium account to share capital.

(3)

Permanently closed; change in direction and focus; separate assets would appear to be able to be classified as discontinued by FRS 3.

Machinery	Cost		45,000
	Depreciation		31,750
	Net book value	13,250	
	Proceeds		5,000
Exceptional - Loss on disposal		8,250	
Exceptional closure costs		8,700	

(4)

The figures quoted need to be deducted from the totals to leave continuing activities.

(5)

Brand names must be amortised over not more than 20 years unless an annual impairment review is carried out. Annual amortisation will be 380,000 / 20 = 19,000.

Ten years have already elapsed therefore as this is a change in accounting policy the backlog amortisation will be adjusted as a prior year adjustment, ten years out of 20 years, 380,000 * 10/20 = 190,000 the write off treated as a prior year adjustment.

(Give marks for alternative interpretation of question, 9 years prior year adjustment plus current year is £19,000, giving a total carry forward of £190,000. The balance sheet assets and retained profits; STRGL; Reconciliation of movements in shareholders funds and Note – Movements on Reserves will all be altered by this change).

(6)

Add the wages outstanding to the administrative expenses and to creditors.

(7)

Accrue corporation tax and charge to profit for the year.

(8)

Depreciation - Plant and Machinery	Cost	Depreciation
Trial balance	576,000	280,100
Disposals	(45,000)	(31,750)
	531,000	248,350
Depreciation for year @ 10%		53,100
		301,450

(9)

This is a post balance sheet adjusting event as it provides better evidence on the likelihood of the debtors paying or not paying. Write off as a bad debt the full amount due and disclose as material.

(10)

Provision for doubtful debts:

Debtors - trial balance	213,000	
Bad debt written off		33,000
		180,000
Provision @ 5%	9,000	
Provision on trial balance	6,170	
Increase in provision		2,830

Balance sheet Debtors 180,000 – 9,000 = 171,000

(11)

Land and Buildings

Per trial balance - Cost	476,500
- Depreciation	200,000

		276,500
Revaluation to	320,000	
Revaluation reserve increase		43,500

Depreciation at present:
Cost 476,500 less 76,500 = 400,000 life 50 years annual depreciation = 8,000
After revaluation:
Revalued to 320,000 less 100,000 = 220,000 life 25 years, annual depreciation = 8,800
Increase in depreciation 8,800 – 8,000 = 800
Years depreciation, 8,800 split

Cost of sales (50%)	4,400
Admin (25%)	2,200
Distribution (25%)	2,200

(12)
Dividends:

Preference -	interim	6,000		
	final	6,000		12,000
Ordinary -	interim	25,000		
	final	10,000		35,000
P&L a/c			47,000	

Balance sheet (creditor) 6,000 + 10,000 = 16,000

(13)
Debentures repurchased on open market at 5% premium.
Not issued at premium therefore cannot debit to share premium account. Premium on redemption 150,000*5% = 7,500
Purchase took place at year end, full years interest payable, 300,000 *5% = 15,000. P&L a/c. paid (on TB) 7,500, Balance sheet accrue 7,500.
Charge to P&L a/c = interest and redemption premium, 15,000 + 7,500 = 22,500
Reduce cash by 150,000 +7,500 = 157,500; Cash 371,220 – 157,500 = 213,720
Reduce debentures 300,000 – 150,000 = 150,000

(14)
Working schedules for P&L account:

	Cost of Sales	Administration	Distribution	
Trial balance	752,800	97,300	27,200	
Directors fees		41,400		½
Accrued wages (6)		487		½
Depreciation -				
Plant & machinery (8)	53,100			*1*
Buildings (11)	4,400	2,200	2,200	*1*
Amortisation-Brands (5)	19,000			*1*
Bad debt w/o (9)		33,000		½
Increased bad debt provision (10)		2,830		*1*
Discount received	(11,500)			½
Total	817,800	177,217	29,400	
Discontinued activities (4)	(48,000)	(7,000)	(4,000)	*1*
Continuing Activities	769,800	170,217	25,400	*7 (see P & L)*

(Marking note: allow for the following items, even if they are included under one of the other headings: accrued wages; amortisation of brands, bad debt write-off and provision and discount received)

OP plc
Profit and Loss Account for the year ended 31 March 2001

	Continuing	Discontinued	Total	
Turnover	1,198,250	50,000	1,248,250	
Cost of sales (14)	(769,800)	(48,000)	(817,800)	
Gross profit	428,450	2,000	430,450	
Distribution costs (14)	(25,400)	(4,000)	(29,400)	
Administrative expenses (14)	(170,217)	(7,000)	(177,217)	
Operating profit	232,833	(9,000)	223,833	*7 (see above)*
Interest payable & similar charges (13)	(22,500)		(22,500)	*1½*
Exceptional items, discontinuing operations:				
Loss on disposal of fixed asset (3)		(8,250)	(8,250)	*1*
Loss on sale and termination of operations (3)	(8,700)	(8,700)		*1*
Profit on ordinary activities before tax	210,333	(25,950)	184,383	
Tax on ordinary activities			(41,000)	½
Profit on ordinary activities after tax			143,383	
Dividends (12)			(47,000)	*1*
Retained profit for the year			96,383	

OP plc
Balance Sheet as at 31 March 2001

Fixed Assets	Cost/Valuation	Depreciation	Net Book Value	
Brands (5)	380,000	209,000	171,000	*1*
Land and buildings (11)	320,000	8,800	311,200	*1*
Plant & Machinery (8)	531,000	301,450	229,550	*1*
	1,231,000	519,250	711,750	
Current assets				
Stock	114,900			
Debtors (10)	171,000			*1*
Bank and cash (13)	213,720			*1*
	499,620			
Creditors				
Amounts due within one year:				
Net current liabilities (see below)	(164,487)		335,133	*2½*
			1,046,883	*(see below)*
Creditors payable in more than one year:				
5% Debentures (13)			(150,000)	*1*
Total assets less current liabilities			896,883	
Capital and Reserves				
Issued share capital:				
Ordinary shares of £1 each fully paid (2)		550,000		*1*
6% Preference shares of £1 each fully paid			200,000	
Share premium (see D)		50,000		½
Revaluation reserve (see D)		95,500		½
Retained profits (see D)		1,383	146,883	½
			896,883	
				(23)

Creditors: Amounts due within one year		
Creditors T/B	99,500	
Accrual (6)	487	½
Accrued interest (13)	7,500	½
Proposed dividends-ordinary (12)	10,000	½
Proposed dividends-preference (12)	6,000	½
Corporation tax (7)	41,000	½
	164,487	*(2½) see balance sheet*

(c)

OP plc

Statement of Total Recognised Gains and Losses
for the year ended 31 March 2001 *(format & title)* *1*

Profit for the year after tax	143,383	*1*
Unrealised surplus on revaluation of land and buildings (11)	43,500	*1*
	186,883	
Prior year adjustment;		
Change in accounting policy on amortisation of brands (5)	(190,000)	*1*
	(3,117)	*(4)*

(Marking note: award marks where students uses their figures from part (a)).

OP plc

Reconciliation of Movements in Share Holders Funds
for the year ended 31 March 2001 *(format & title)1*

Profit for the year after tax		143,383	½
Dividends		47,000	½
		96,383	
Other recognised gains and losses		43,500	½
Net additions		139,883	
Opening Shareholders funds B/F	947,000		½
Less Prior Year adjustment	(190,000)		*1*
		757,000	
Closing shareholders funds		896,883	*(4)*

(Marking note: award marks for students using their figures from part (a)).

OP plc

Note on Historical Cost Profit
for the year ended 31 March 2001 *(format & title)1*

Profit on ordinary activities before tax	184,383	½
Difference between the historical cost depreciation charge		
and the actual depreciation charge for buildings (11)	800	*1*
Historical cost profits before tax	185,183	
Historical cost profit for the year retained after tax and dividends	97,183	½
		(3)
		(11)

(Marking note: award marks for students using their figures from part (a)).

(d)

OP plc

Note - Movements on Reserves

	Bal. B/F	Reval.	PYA	Bonus Is.	Yr Profit	Balance C/F	
Share premium	100,000			(50,000)		50,000	*½*
Revaluation reserve	52,000	43,500				95,500	*½*
Profit & Loss a/c	95,000		(190,000)		96,383	1,383	*1*
							Format 1

(3)

(Marking note: award marks for students using their figures from part (a)).

(49)

Question 2

(a) A conceptual framework is a statement of the theoretical principles which underpin the study of a subject. It is a basic structure for determining objectives and how they can be achieved. A conceptual framework should be able to provide reasoning that allows abstract objectives to be traced to practical applications or vice versa. *3*

(b) A conceptual framework should provide the following benefits:

1. A source of reference

   - Standard setters setting standards in the future
   - Preparers of financial accounts who need guidance on new topics
   - Auditors who need support for their reasoning on a particular item
   - Users to help interpret financial statements *2*

2. Where there is a new accounting issue and no FRS or UITF the conceptual framework could help identify how the ASB might deal with the topic when they develop an FRS. *1*
3. It helps keep the number of standards down. There is no need to produce a standard for every situation as the framework can be used with a standard to identify the treatment of related items. *1*
4. The framework can be used to reduce alternative accounting policies. By applying the conceptual framework only one acceptable policy may be identified. *1*
5. It is argued that future accounting standards will be more consistent as they will all be based on the same framework, rather than developed piecemeal as was previously the case. *1*
6. New standards should be able to be set and agreed more quickly because the basic foundations are already there. *1*

1 mark for any other valid point, up to a maximum of 7

(c) The users and their needs identified by the statement of principles are:

- Investors — who need information to help asses their risk and return on their investment;
- Lenders — to asses the likelihood of the payment of interest and repayment of their loan;
- Suppliers — to asses the chances of getting paid;
- Employees — to asses whether the company can provide stable employment. The ability to pay wages, or wage increases and pensions;
- Customers — to asses the probability of the company's continued existence, for warranty claims and future supplies;

- Government for tax purposes and statistical returns;
- Public varied examples include pollution of the environment and the impact on the local community.

1 mark each up to maximum of 7

(17)

Question 3

(a)

When Mr A says he wants to "maintain his capital" what does he mean?

If capital maintenance is viewed from an owner's perspective, then income will be the amount which can be distributed by the business whilst maintaining the value of the owner's capital. This is usually referred to as financial capital maintenance. Traditionally accounts have adopted this approach in terms of maintaining the money value of the owner's capital, through the application of the historic cost principle. *2*

If inflation is allowed for, then it becomes a matter of maintaining the "real" value of the owner's capital. The only practical way of dealing with this is to use a general indicator of inflation such as the retail price index. The owner's capital is assumed to be part of their general wealth which is used for general consumption, therefore it is maintained if it will purchase the same amount of goods as it did before. If the price of goods generally increases by the retail price index then the capital will be maintained if it increases by the same proportion. The profit recognised is after the purchasing power of the shareholders funds are maintained in real terms. *2*

If capital is viewed from the business's perspective then income will be the amount that can be distributed whilst maintaining the operating capability or physical capacity of the business. In other words it is the amount that can be distributed as dividends without adversely affecting the capacity of the company in terms of its underlying resources and ability to maintain its scale of operations. Such a view defines capital in terms of assets and liabilities of the business and values each on the basis of the value to the business. The profit recognised is only after a sufficient amount has been charged to ensure that the physical capital is maintained. *2*

If inflation affects consumers and businesses similarly then there will be little difference in the income calculated under the two capital maintenance approaches. If price changes differ between the consumer and business markets there could be major differences. *1*

What does Mr A mean when he says he wants to "realise the same value as his original investment"?

Mr A could literally mean the same amount invested, so he realises the same cash amount as previously invested, if inflation has occurred the cash may not have the same purchasing power. *1*

If Mr A wants to realise the same purchasing power as he invested he will need to allow for an annual adjustment for inflation so that he realises the same value in 'real terms' as he invested. *1*

(9)

(b) The current cost adjustments are:

- The depreciation adjustment;
- The cost of sales adjustment (COSA);
- The monetary working capital adjustment (MWCA);
- The gearing adjustment.

2 marks for each adjustment, correctly named and explained
(8)

(17)

Question 4

(a)

'Economic substance over legal form' means that the economic substance of a transaction should be examined and the transaction or group of linked transactions recorded in the accounts so as to reflect their economic substance rather than their legal form. *1*

To determine substance all aspects of the transaction should be identified and greater weight given to those likely to have a commercial effect. A group or series of transactions designed to have an overall commercial effect must be viewed as a whole. *1*

To determine the substance of a transaction FRS 5 requires that the impact of the transaction on assets and liabilities be examined. If a new asset or liability has arisen or an existing asset or liability has changed then the transaction should be recognised. If there is no change in the asset or liability then the transaction is treated as a refinancing. *2*

Examples include finance leases; sale and lease-back; stock on sale or return and debt factoring. *1*
(5)

(b)

(i) C Ltd - The cash received for the debtors was 500 less 20% = 400 which is non-returnable. This amount can be shown using the linked presentation as it is non-returnable. But debtors have not been entirely removed as there is still some risk involved with the 20% deducted, some of it may be paid. *1*

Show as follows:

Debtors subject to financing arrangements	500		
Less non-returnable advance		(400)	
		100	*2*

(ii) B Ltd - There has been no change of use. B Ltd still uses the building as its HQ. The asset still exists and B Ltd still enjoys the risks and rewards of its use. *1*
Treat as a refinancing arrangement. *1*
Leave the building on the balance sheet and include the amount raised as a liability for £25 million. *1*

(iii) M Ltd - The risk and reward of ownership has been transferred to the dealer. *1*
There is a penalty for returning the goods. The price paid is the price quoted at the time the deposit was paid.
Therefore the risk and reward of price changes while the mobile home is held as stock are borne by the dealer. *1*

The asset therefore exists and should be recorded in the balance sheet at cost and a creditor set up for the balance outstanding on the stock. *1*

(iv) Z Ltd - This is an operating lease. The lessor keeps the risks and rewards by paying for maintenance. *1*
One year is not a substantial part of the life of a vehicle. Show the lease payments as an expense. *2*

(12)

(17)

Question 5

(a) The main methods that can be used to value shares in an unquoted company are:

I. Based on underlying assets and liabilities. Tangible fixed asset bases of valuation:
   i. Depreciated historical cost
   ii. Open market values, existing use
   iii. Net current replacement cost
   iv. Value to the business

1 mark for listing valuation bases
1 for mentioning the validity of asset valuation bases
(2)

II. Based on tangible fixed asset valuation plus goodwill valuation using excess profit basis.

1 m ark for identifying goodwill
1 mark for method of valuing goodwill
(2)

III. Based on Yield.

1 mark for identifying yield
I mark for explaining when yield method is valid
(2)

IV. Based on Earnings.

1 mark for identifying earnings basis
I mark for explaining when earnings basis is appropriate
(2)

(8)

(b) Valuation based on underlying assets and liabilities:

Historical cost	5,000/3,000 = £1.66	*1*
Net replacement cost		
Buildings	2,750	
Other fixed assets	2,600	
Current assets	<u>3,300</u>	
	8,650	
Less current liabilities	<u>(2,500)</u>	
	<u>6,150</u>	
	6,150/3,000 = £2.05	*2*

As Mr X has a majority shareholding yield would not be appropriate.

Earnings

Other companies P/E of 10, less additional risk factor 25% = 7.5 *1*

EPS on historical cost profits of previous year 1,000/3,000 = 0.33
0.33 * 7.5 = £2.48
EPS based on the average 3 years profits gives:
(700+850+1000)/3 = 850 / 3,000 = 0.28
0.28 * 7.5 = £2.12
EPS based on first half of current year projected without further inflation gives (685*2) = 1,370 for the year. 1,370/3,000 = 0.46; 0.46 * 7.5 = £3.45

2 marks each for any two calculations relating to earnings, maximum of 4

Comment about expectations or most likely price. *1*

(9)

(17)