ACCOUNTING THEORY AND PRACTICE

Professional 1 examination
11 June 2002

From 2.00 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.

CIPFA

SECTION A (Compulsory)

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

1 ABZ plc has one manufacturing and distribution centre based in Birmingham. The production systems produce two products, product DD and product YY, which ABZ plc sells throughout the UK.

The following trial balance has been extracted from the books of ABZ plc for the year ended 31 December 2001.

	£m	£m
Sales of product DD		6,486
Sales of product YY		5,120
Cost of sales of product DD	4,247	
Cost of sales of product YY	3,825	
Stock (as at 31 December 2001)	582	
Employee and other administration expenses	1,005	
Distribution expenses	877	
Other operating income (unallocated)		119
Goodwill	170	
Investment income (full amount due for year)		33
Interest payable (full year due on all loans)	88	
Freehold properties at valuation	3,845	
Land at cost	857	
Plant, fixtures and fittings	1,114	
Accumulated depreciation 1 January 2001:		
properties		330
plant, fixtures and fittings		661
Cash received sale of assets (see item (2))		90
Investment properties	77	
Investment properties revaluation reserve		40
Debtors	116	
Creditors		442
Short term investments	75	
Cash at bank and in hand	38	
Bank loans due 1 June 2002		50
Bank loans due 2004		340
Bonds due 2009		550
Ordinary 50p shares		1,200
Share premium		720
Revaluation reserve		320
Retained profits 1 January 2001		495
Research and development	80	
	16,996	16,996

The following information is available:

1. Asset values as at 1 January 2001 were:

	£m
• Land	857
• Freehold properties	3,700
• Plant, fixtures & fittings	990

2. Assets disposed of were:
   - Buildings, revalued cost 1 January 2001 £65m and accumulated depreciation £60m and;
   - Plant, fixtures and fittings cost 1 January 2001 £131m and accumulated depreciation £122m.

3. Investment properties have been revalued, as at 31 December 2001, at £90m by DTX Ltd. This information has not been incorporated into the above trial balance figures.

4. The current depreciation policy of the company is:
   - Freehold property: straight line on revalued amount over remaining life. The properties' remaining life as at 1 January 2001 was 30 years.
   - Plant, fixtures and fittings: 25% reducing balance.

   No depreciation has been provided for the current year.

5. Goodwill arose on the acquisition of the business of a sole trader three years ago on 1 January 1998. The balance in the trial balance, of £170m, is the difference between the original cost and amortisation to 31 December 2000. The goodwill had an expected useful life of 20 years at the date of acquisition.

6. Research and development of £80m consists of:
   - £20m on a project which is to be discontinued, as it is not viable.
   - £10m was paid to UK University for research to try and discover a new material that would reduce overall production costs.
   - £50m was on a product development for a project which is going to go into production from 1 March 2002. The product is expected to be very profitable, covering all development costs in two years.

   ABZ directors want all research and development carried forward.

7. Other information as at 31 December 2001 not yet accounted for is:
   - Taxation charge for the year of £148m.
   - A dividend for the year of 5p per share has been proposed.
   - Provision for bad debts is to be provided for at the rate of 5% of debtors balance as at 31 December 2001.

8. Assets and liabilities relate to the two product groups as follows:

	Product DD	Product YY
• Intangible and tangible fixed assets (amortisation and depreciation are apportioned on the same basis as the fixed assets).	75%	25%
• Current assets and creditors less than one year.	80%	20%
• Creditors over one year.	70%	30%

- Investments and investment income are regarded as unallocated assets/income.

Administration costs and distribution costs are equally divided between the two products. There were no inter-segment sales in 2001.

- **Requirement for question 1**

(a) Prepare the profit and loss account for the year ended 31 December 2001 and the balance sheet as at that date, for publication, for ABZ 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, except as in part (b). *20*

(b) Prepare the following detailed notes to the accounts (as far as the information given will allow), as required by the Companies Act and/or accounting standards:
(i) Fixed assets (tangible and intangible). *8*
(ii) Segmental analysis by product. *9*

(c) Explain the arguments for and against segmental reporting. *12*

(49)

SECTION B (Answer three questions)

2

The Companies Act 1985 requires purchased fixed assets to be stated at cost and assets produced by the company for its own use to be stated at production cost. The Alternative Accounting rules in part C of Schedule 4 of the Companies Act 1985 allows fixed assets to be carried at a valuation. As a result, some companies have stated part of their fixed assets at cost less depreciation and others at valuation less depreciation. FRS 15 – Tangible Fixed Assets, introduced new requirements relating to the treatment of revalued tangible fixed assets.

R plc have produced the following data relating to their tangible fixed assets as at 31 March 2002.

Tangible Fixed Assets	Original cost	Last valuation at 1 March 1999.	Book value at 31 March 2002, before adjustment	New valuation at 1 March 2002 (not yet recorded in accounts)
	£000	**£000**	**£000**	**£000**
Land	200	400	400	500
Buildings	150	210	180	230
Vehicles	60	68	27	10

There were no purchases or disposals in the period 1 March 1999 to 31 March 2002. Vehicles were purchased on 1 January 1999 and are depreciated over five years. Depreciation is calculated on a monthly basis.

- **Requirement for question 2**

(a) Explain the difference between an "asset" and a "contingent asset". *3*

(b) Explain the meaning of "cost" and "production cost" in the above paragraph. Use suitable examples to illustrate your answer. *4*

(c) Explain the requirements of FRS 15 – Tangible Fixed Assets, for the treatment of revalued fixed assets in financial statements. Use the data for R plc to illustrate your answer. *10*

(17)

3

A lessee leases an asset on a non-cancellable lease contract of five years. The rental is £20,962 per annum payable at the end of each year. The lessee also has to pay all maintenance and insurance costs. The fair value of the asset was agreed as £88,300. The interest rate implicit in the lease is 6%.

· **Requirement for question 3**

(a) What is "off balance sheet finance", and why have accounting standards tried to prevent it? *3*

(b) FRS 5 considers a number of off balance financing situations, and sets out detailed application notes for five categories of off balance sheet financing. What are these five categories? *5*

(c) Calculate the annual finance charges for each of the five years. *4*

(d) State the profit and loss account and balance sheet entries for years one and two of the lease. *5*

(17)

4 The financial statements of H plc for the year to 31 March 2002 were as follows:

Profit & Loss Account for the year to 31 March 2002

	£m	£m
Turnover		1,300
Cost of sales		(600)
Gross profit		700
Distribution costs	(320)	
Administrative costs	(142)	(462)
Operating profit		238
Interest payable	(12)	
Interest receivable	6	(6)
Profit before tax		232
Tax		(54)
Profit after tax		178
Dividends		(33)
Retained profit for the year		145

Balance Sheets at:	**31 March 2002**		**31 March 2001**	
	£m	**£m**	**£m**	**£m**
Tangible fixed assets		493		320
Current assets:				
Stock	260		290	
Debtors	220		175	
Interest receivable	3		6	
Investments	40		0	
Cash	61		20	
	584		491	
Creditors: amounts falling due within one year:	(537)		(430)	
Net current assets		47		61
Total assets less current liabilities		540		381
Creditors: amounts falling due after more than one year:				
Debentures		(146)		(174)
Net assets		394		207
Capital and reserves				
Ordinary shares 50p each		209		160
10% £1 preference shares		0		40
Share premium account		65		62
Revaluation reserve		30		0
Retained profits		90		(55)
		394		207

Additional information:

1. On 1 March 2002 H plc issued 60 million £0.50 ordinary shares at a premium of 100%. The proceeds were used to finance the purchase and cancellation of all its preference shares at a premium of 20p per share. A bonus issue of one for ten shares held was then made.

2. The current asset investment was a 30-day Government bond.

3. Tangible fixed assets include certain properties which were revalued in the year.

4. Assets disposed of in the year had a net book value of £42 million. Cash received was £50 million.

5. Depreciation charged for the year ended 31 March 2002 was £56 million.

6. Some of the debentures were redeemed at par on 31 March 2002.

7. Analysis of creditors payable within one year at:

	31 March 2002	**31 March 2001**
	£m	**£m**
Bank overdraft	0	50
Trade creditors	440	300
Corporation tax	78	60
Dividends	10	15
Interest payable	9	5
	537	430

- **Requirement for question 4**

Prepare a cash flow statement for H plc for the year ended 31 March 2002, in accordance with FRS 1. Notes to the cash flow statement are not required. *(17)*

5

The Accounting Standards Board's Statement of Principles sets out eight chapters which include:

- Chapter 5 – Recognition in Financial Statements.
- Chapter 6 – Measurement in Financial Statements.

- **Requirement for question 5**

Referring to the Statement of Principles in your answer, explain:

(a) When transactions should be recognised and derecognised in financial statements. Illustrate your answers by the use of suitable examples. *9*

(b) How a value can be attributed to transactions, ie how they can be measured for inclusion in the financial statements. Illustrate your answers by the use of suitable examples. *8*

(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