

CIMA

Intermediate Level

Financial Accounting –
UK Accounting Standards

6a

IFNA

21 May 2003

Wednesday morning

INSTRUCTIONS TO CANDIDATES

Read this page before you look at the questions

You are allowed three hours to answer this question paper.

This question paper is based on UK ACCOUNTING STANDARDS.

If you require the paper based on International Accounting Standards, please speak immediately to the invigilator.

Answer the ONE question in section A (this has 10 sub-questions).

Answer the ONE question in section B.

Answer TWO questions ONLY from section C.

Write your examination number in the boxes provided on the front of the answer book.

Write IFNA on the line marked "Subject" on the front of the answer book.

Write your examination number on the special answer sheet for section A which is on page 3 of this question paper booklet.

Detach the sheet from the booklet and insert it into your answer book before you hand this in.

Do NOT write your name or your student registration number anywhere on your answer book.

Tick the appropriate boxes on the front of the answer book to indicate which questions you have answered.

SECTION A — 20 MARKS

ANSWER ALL TEN SUB-QUESTIONS – 2 MARKS EACH

Each of the sub-questions numbered from **1.1** to **1.10** inclusive, given below, has only ONE correct answer.

REQUIRED:

On the SPECIAL ANSWER SHEET opposite, place a circle "O" around the letter that gives the correct answer to each sub-question.

If you wish to change your mind about an answer, block out your first answer completely and then circle another letter. You will not receive marks if more than one letter is circled.

Please note that you will not receive marks for any workings to these sub-questions.

You must detach the special answer sheet from the question paper and attach it to the inside front cover of your answer book before you hand it to the invigilators at the end of the examination.

Question One

1.1 An investment property is defined by SSAP 19 – *Accounting for Investment Properties* as

- A** an investment in land and / or buildings whether let to third parties or occupied by a company within the group.
 - B** a property owned and occupied by a company for its own purposes.
 - C** an interest in land and / or buildings which is held for its investment potential.
 - D** an investment in land and / or buildings other than leased property.
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1.2 A capital grant received by a company to offset the cost of purchasing a fixed asset should be accounted for as follows:

- (i) Credit a deferred income account.
- (ii) Credit the grant to a reserve account.
- (iii) Release to the profit and loss account over the life of the asset.
- (iv) Credit the grant to the fixed asset account to show net cost.
- (v) Credit the full amount to profit and loss account in year of receipt.

Which one of the following is correct?

- A** (i) and (iii) only
 - B** (v) only
 - C** (ii) and (iii) only
 - D** (iii) and (iv) only
-

- 1.3** SSAP 25 – *Segmental Reporting* requires that turnover and operating profit should be
- A** analysed by class of business and geographic area of sales origin and destination.
 - B** analysed by class of business.
 - C** analysed by geographic area of sales origin and destination.
 - D** analysed by class of business and type of customer.
-

- 1.4** FRS 3 – *Reporting Financial Performance* specifies the definition and treatment of a number of different items.

Which of the following is NOT specified by FRS 3?

- A** Discontinued activities.
 - B** Prior period adjustments.
 - C** Exceptional items.
 - D** Provisions.
-

- 1.5** The gearing ratio of a company is calculated as

- (i) equity share capital and reserves;
- (ii) equity share capital;
- (iii) non-equity share capital and debt;
- (iv) total gross assets;
- (v) total debt.

Which one of the following is correct?

- A** (iii) divided by (ii) and (iii)
 - B** (iii) divided by (i) and (iii)
 - C** (v) divided by (iv)
 - D** (v) divided by (ii)
-

- 1.6** Which one of the following descriptions most accurately describes "creative accounting"?

- A** Creating fictitious assets on the balance sheet to show a stronger financial position.
 - B** Not applying Companies Act 1985 or Accounting Standards' requirements so as to show a better year-end position.
 - C** Deliberately falsifying the financial statements to show a stronger financial position.
 - D** Using loop-holes in the Companies Act 1985 and Accounting Standards' requirements so that the financial statements are biased in the required direction.
-

The following data is to be used to answer questions 1.7 and 1.8 below

B Ltd entered into a three-year contract to build a leisure centre for a local authority. The contract value was £6 million. B Ltd recognises profit on the basis of certified work completed. At the end of the first year, the following figures were extracted from B Ltd's accounting records:

	£000
Certified value of work completed	2,000
Cost of work certified as complete	1,650
Cost of work-in-progress (not included in completed work)	550
Estimated cost of remaining work required to complete the contract	2,750
Cash received from local authority	1,600
Cash paid to creditors for work on the contract	1,300

1.7 How much profit should B Ltd recognise in its profit and loss account at the end of the first year?

- A** £200,000 (loss)
- B** £300,000
- C** £350,000
- D** £400,000

1.8 What values should B Ltd record for this contract as "debtors" and "creditors, amounts falling due within one year"?

	<i>Debtors</i>	<i>Creditors, amounts falling due within one year</i>
A	£400,000	£350,000
B	£400,000	£900,000
C	£600,000	£900,000
D	£700,000	£600,000

1.9 The following balances were extracted from the books of A Ltd:

	31 March 2003
	£000
Sales	300
Cost of sales	<u>200</u>
Gross profit	<u>100</u>
Closing stock	15
Trade debtors	36
Trade creditors	28

A Ltd's average working capital cycle for the year ended 31 March 2003 is

- A** 11.0 days
- B** 20.1 days
- C** 34.7 days
- D** 37.1 days

1.10 R plc redeems 10,000 £1 redeemable preference shares at a premium of 10%. No fresh issue of shares is made to finance the redemption.

Which of the following is the correct set of accounting entries to record this transaction?

	<i>Debit share capital account</i>	<i>Credit capital redemption reserve account</i>	<i>Debit profit and loss account</i>	<i>Credit bank account</i>
A	£10,000	£10,000	£11,000	£11,000
B	£10,000	£11,000	£10,000	£11,000
C	£11,000	£10,000	£10,000	£11,000
D	£10,000	£11,000	£11,000	£10,000

(Total = 20 marks)

SECTION B – 30 MARKS

ANSWER THIS QUESTION

Question Two

AZ plc is a quoted manufacturing company. Its finished products are stored in a nearby warehouse until ordered by customers. AZ plc has performed very well in the past, but has been in financial difficulties in recent months and has been reorganising the business to improve performance.

The trial balance for AZ plc at 31 March 2003 was as follows:

	£000	£000
6% preference shares of £1 each		1,000
7% debentures 2007		18,250
Administration expenses	16,020	
Bank and cash	2,250	
Corporation tax	30	
Cost of goods manufactured in the year to 31 March 2003 (excluding depreciation)	94,000	
Creditors		8,120
Debenture interest paid	639	
Debtors	9,930	
Distribution costs	9,060	
Interest received		1,200
Investments at market value	24,000	
Ordinary shares of £1 each, fully paid		20,000
Plant and equipment	30,315	
Profit and loss account at 31 March 2002		9,444
Provision for deferred tax at 31 March 2002		138
Provision for depreciation at 31 March 2002:		
Plant and equipment		6,060
Vehicles		1,670
Provision for doubtful debts at 31 March 2002		600
Restructuring costs	121	
Revaluation reserve		3,125
Sales		124,900
Share issue expenses	70	
Share premium		500
Stock at 31 March 2002	4,852	
Vehicles	3,720	
	<u>195,007</u>	<u>195,007</u>

Additional information provided:

- (i) The fixed assets are being depreciated as follows:
- | | |
|---------------------|--------------------------------|
| Plant and equipment | 20% per annum straight line |
| Vehicles | 25% per annum reducing balance |
- Depreciation of plant and equipment is considered to be part of cost of sales while vehicle depreciation should be included under distribution costs.
- (ii) The balance on the corporation tax account is the previous year's corporation tax, underestimated in last year's accounts by £30,000. Corporation tax for the year to 31 March 2003 is estimated at £150,000.
- (iii) A transfer to deferred tax for the year to 31 March 2003 of £11,000 is to be made.
- (iv) The closing stock at 31 March 2003 was £5,180,000. An inspection of finished goods found that a production machine had been set up incorrectly and that several production batches, which had cost £50,000 to manufacture, had the wrong packaging. The goods cannot be sold in this condition but could be repacked at an additional cost of £20,000. They could then be sold for £55,000. The wrongly packaged goods were included in closing stock at their cost of £50,000.
- (v) AZ plc's directors are proposing the payment of the preference dividend and a final ordinary dividend of 5p per share. No interim dividends were declared.
- (vi) The 7% debentures are 10-year loans due for repayment by 31 March 2007. AZ plc incurred no other interest charges in the year to 31 March 2003.
- (vii) The provision for doubtful debts is to be adjusted to 5% of the closing debtors' balance.
- (viii) The restructuring costs in the trial balance represent the cost of a major fundamental restructuring of the company to improve competitiveness and future profitability.
- (ix) As at 31 March 2003, AZ plc was engaged in defending a legal action against the company. Legal advisers have indicated that it is reasonably certain that the outcome of the case will be against the company. The amount of compensation is currently estimated at £25,000.
- (x) On 1 October 2002, AZ plc issued 1,000,000 ordinary shares at £1.50 each. All money had been received and correctly accounted for by the year end.

Required:

Prepare the profit and loss account for AZ plc for the year to 31 March 2003 and a balance sheet at that date, in a form suitable for publication and in accordance with all current regulations.

Notes to the financial statements are not required, but all workings must be clearly shown. DO NOT prepare a statement of accounting policies, a statement of total recognised gains and losses or a reconciliation of movements in shareholders' funds.

(30 marks)

SECTION C – 50 MARKS

ANSWER TWO QUESTIONS ONLY

Question Three

BY Ltd prepares its financial statements to 31 March each year. The following information relates to the year ended 31 March 2003; the financial statements for the year to 31 March 2003 have not yet been completed. There are some transactions regarding tangible fixed assets that need to be clarified.

- (a) Some of the cars used by BY Ltd's sales force needed replacing. Three new cars were acquired on 1 October 2002. The cars were leased from CarLease plc on the following terms:
- a non-cancellable 5-year lease;
 - a total of 10 payments, made every six months in arrears;
 - each instalment to be £7,200 (£2,400 per car);
 - the interest rate implicit in the lease was 3.5% per six-month period;
 - the fair value of each car was £20,000. The present value of the lease payments equals the fair value of the cars at the inception of the lease;
 - the residual value of each car at the end of the lease is assumed to be zero;
 - BY Ltd will pay for all insurance, repairs and maintenance costs.

Required:

- (i) Explain the meaning of a "finance lease", using the above to illustrate your answer. Identify whether the lease on BY Ltd's cars should be treated as an operating lease or a finance lease.

(8 marks)

- (ii) Assuming that the lease is to be treated as a finance lease, calculate the figures that will appear in respect of the lease in BY Ltd's profit and loss account for the year ended 31 March 2003 and its balance sheet at that date.

(7 marks)

- (b) A new type of delivery vehicle, purchased on 1 April 2000 for £20,000, was expected to have a useful economic life of 4 years. It now appears that the original estimate of the useful economic life was too short, and the vehicle is now expected to have a useful economic life of 6 years, from the date of purchase.

All delivery vehicles are depreciated using the straight-line method and are assumed to have zero residual value.

Required:

State how BY Ltd should record the delivery vehicle in the profit and loss account for the year ended 31 March 2003 and the balance sheet at that date. Justify your treatment by reference to appropriate Accounting Standards.

(5 marks)

- (c) A new machine was purchased from a German company during the year to 31 March 2003. The purchase contract provided for payment to be made in UK Pounds. The following payments were detailed in the contract:

	£
Basic cost of the machine	110,000
Upgrades and specific modifications to BY Ltd specifications	22,000
Shipping and transport charges payable in Europe (£ equivalent)	<u>3,200</u>
Total invoiced cost	135,200
Delivery, handling and installation charges in the UK	<u>900</u>
Total purchase price	<u>136,100</u>

The contract provided for 10% of the invoiced cost to be paid when the contract was signed, 40% when the machine was despatched, and the balance one month after installation. The UK delivery, handling and installation charges were to be paid as incurred in the UK. All UK expenses were paid by 31 March 2003.

The contract was signed on 1 January 2003 and the machine was despatched on 1 February 2003. BY Ltd made both payments on the due date. Delivery was made and installation completed on 25 March 2003.

Required:

State how BY Ltd should record the purchase of the machine in the profit and loss account for the year ended 31 March 2003 and the balance sheet at that date. Justify your treatment by reference to appropriate Accounting Standards.

(5 marks)

(Total = 25 marks)

Question Four

Your company, E plc, is considering expansion by acquiring an established business. You, a trainee management accountant, have been co-opted onto a working group whose remit is to identify a suitable company for acquisition.

The two companies under consideration are:

- X plc, which supplies 30% of E plc's purchases. Acquiring X plc as a subsidiary would give E plc considerable savings through discounts on purchases.
- Z plc, a company that operates in a related market. No immediate savings have been identified.

The summarised balance sheets and profit and loss accounts for each company at 31 March 2003 are given below.

Summarised balance sheets at 31 March 2003

	<i>X plc</i>	<i>Z plc</i>
	<i>£000</i>	<i>£000</i>
Tangible fixed assets	8,439	7,326
Net current assets	<u>1,263</u>	<u>702</u>
Total assets less current liabilities	9,702	8,028
Creditors due in more than one year:		
10% debentures	(3,800)	(5,000)
	<u>5,902</u>	<u>3,028</u>
Ordinary shares of 20p each	320	
Ordinary shares of £1 each		300
Share premium	2,290	1,800
Revaluation reserve	2,600	0
Profit and loss account	<u>692</u>	<u>928</u>
	<u>5,902</u>	<u>3,028</u>

Summarised profit and loss accounts for the year to 31 March 2003

	<i>X plc</i>	<i>Z plc</i>
	<i>£000</i>	<i>£000</i>
Turnover	7,847	9,340
Cost of sales	(5,689)	(5,960)
Gross profit	2,158	3,380
Expenses:		
Distribution	(354)	(836)
Administration	<u>(611)</u>	<u>(1,162)</u>
Operating profit	1,193	1,382
Interest paid	(380)	(600)
Profit before taxation	813	782
Taxation	<u>(220)</u>	<u>(210)</u>
Profit after taxation	593	572
Ordinary dividend	<u>(320)</u>	<u>(500)</u>
Retained profit	<u>273</u>	<u>72</u>
Average share price for the period was	£5.00	£12.00

Required:

(a) Calculate the P/E ratio for each company.

(3 marks)

(b) Using suitable accounting ratios to support your findings, draft a report to the acquisitions working group identifying the most suitable company for further investigation, assuming:

- E plc would acquire 100% of the equity capital;
- the decision is based entirely on the profitability of each company.

(16 marks)

(c) When analysing financial statements and interpreting accounting ratios, it is important to consider "non-financial factors" before making any decisions.

Required:

Explain briefly the main "non-financial factors" which should be considered when deciding whether to acquire a company.

(6 marks)

(Total = 25 marks)

Question Five

The Accounting Standards Committee, the predecessor of the Accounting Standards Board (ASB), was often criticised for not having developed a conceptual framework of accounting. When the ASB took over, it set about developing a conceptual framework of accounting. In December 1999, the ASB published the Statement of Principles for financial reporting (SoP).

Required:

- (a) Explain the four main characteristics that make financial information useful, as outlined in the SoP.

(9 marks)

- (b) The ASB's Foreword to Accounting Standards states "The objective of [the] SoP is to provide a framework for the consistent and logical formulation of individual Accounting Standards".

Required:

Explain how a framework such as the SoP can help with the "consistent and logical formulation of individual Accounting Standards". Use FRS 18 – *Accounting Policies* to illustrate your answer.

(10 marks)

- (c) UK financial reporting is based on the principle that financial statements must give a true and fair view. The Companies Act 1985 and the Foreword to Accounting Standards both provide an override clause, which permits companies to use alternative accounting treatments in exceptional circumstances.

Required:

Explain the meaning of "true and fair view override" and explain the accounting and / or disclosure requirements that are required when a company uses the override clause.

(6 marks)

(Total = 25 marks)

Question Six

- (a) Published financial statements include all transactions that took place during the accounting period. Sometimes transactions or events that take place outside of the accounting period are included in the financial statements as well.

Required:

- (i) Explain how SSAP 17 – *Accounting for Post Balance Sheet Events* defines such events and what adjustments (if any) need to be made to the financial statements as a result of such events.

(6 marks)

- (ii) Identify three other Accounting Standards which might require transactions or events occurring in an accounting period to affect the financial statements of an earlier or later period. Give an example for each Standard identified.

(6 marks)

- (b) During April 2003, excessive rain fell in the region where Z plc's main factory and warehouse facilities are situated. At the end of April 2003, the rainfall caused heavy flooding and Z plc's factory and warehouse were standing in two metres of water. The factory plant and equipment were damaged, but can be fully repaired. However, all of Z plc's stock was badly damaged and was written off. Z plc's equipment repairs and stock write-offs were insured and the insurance underwriter has agreed to pay for the repairs and the replacement of the stock. As it will be some time before the factory is able to operate normally again, Z plc has decided to purchase finished goods from outside suppliers during the period that the factory will be closed for repairs. During the period when Z plc is buying in goods instead of manufacturing its own products, its profits will be reduced by a material amount.

Required:

Explain how Z plc should treat this situation in its financial statements for the year to 31 March 2003.

(7 marks)

- (c) N plc drilled a new oil well, which started production on 1 March 2003. The licence granting permission to drill the new oil well included a clause that requires N plc to "return the land to the state it was in before drilling commenced". N plc estimates that the oil well will have a 20-year production life. At the end of that time, the oil well will be decommissioned and work carried out to reinstate the land. The cost of this decommissioning work is estimated to be £20 million.

Required:

Explain how N plc should treat the decommissioning costs in its financial statements for the year ended 31 March 2003.

(6 marks)

(Total = 25 marks)

End of paper