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CIMA

Intermediate Level

Financial Accounting – UK Accounting Standards

6a

IFNA

24 November 2004

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.
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.

SECTION A – 20 MARKS

ANSWER *ALL* TEN SUB-QUESTIONS – 2 MARKS EACH

Question One

1.1 When an external auditor is unable to agree the accounting treatment of a material item with the directors of a company, but the financial statements are not seriously misleading, he will issue

A an unqualified audit report.

B an adverse opinion.

C a qualified audit report using “except for”.

D an unqualified audit report using “except for”.

1.2 According to SSAP 19 – *Accounting for investment properties*, an investment property has to meet some of the following criteria:

(i) Completely let to a third party
(ii) Completely let to a subsidiary
(iii) Partly occupied by the company and partly let to a third party
(iv) Let at a commercial rent
(v) Let at a discounted rent
(vi) Held for investment
(vii) Held for use in the business

An investment property is a property owned by the company that meets the following SSAP 19 criteria:

A (i), (v) and (vi)

B (ii), (v) and (vii)

C (iii), (iv) and (vi)

D (i), (iv) and (vi)

1.3 X plc, a quoted company, had the following results for the year ended 30 September 2004:

	£m
Profit before tax	2,400
Tax	700
Profit after tax	1,700

X plc also had the following balances at 30 September 2004:

Share capital of 680 million shares at a nominal value of £0·50 each

Closing stock market price per share at 30 September 2004 was £10

X plc's P/E ratio is:

A 0·25

B 2·0

C 2·9

D 4·0

1.4 In some circumstances, company directors set aside the detailed provisions contained in the Companies Act 1985 and Accounting Standards and use their own accounting methods.

This setting aside of detailed regulations could be:

(i) Creative accounting

(ii) Applying the "true and fair view override"

(iii) Illegal manipulation of accounting data

A (i) only

B (ii) only

C (iii) only

D (i) or (iii)

1.5 Z Ltd entered into a finance lease agreement on 1 November 2002. The lease was for five years, the fair value of the asset acquired was £45,000 and the interest rate implicit in the lease was 7%. The annual payment was £10,975 in arrears.

The total amount due to creditors (less than one year plus more than one year) under the lease at 31 October 2004 was

A £27,212.

B £28,802.

C £29,350.

D £40,108.

1.6 W Ltd owns two properties, property 1 and property 2. As economic circumstances have worsened recently, W Ltd has carried out an impairment review of its properties. The values calculated during the review are as follows:

All values are at 31 October 2004:

	Book value	*Net realisable value*	*Value in use*
	£000	*£000*	*£000*
Property 1	1,650	1,500	1,400
Property 2	2,500	2,300	2,600

According to FRS 11 – *Impairment of fixed assets and goodwill*, the values that W Ltd should use in its balance sheet at 31 October 2004 are

	Property 1	*Property 2*
	£000	*£000*
A	1,400	2,300
B	1,400	2,600
C	1,500	2,300
D	1,500	2,500

1.7 Using the requirements set out in SSAP 17 – *Accounting for Post Balance Sheet Events*, which of the following would be classified as an adjusting post balance sheet event in financial statements ended 31 March 2004 that were approved by the directors on 31 August 2004?

A A reorganisation of the company, proposed by a director on 31 January 2004 and agreed by the Board on 10 July 2004.

B A strike by the workforce which started on 1 May 2004 and stopped all production for 10 weeks before being settled.

C A claim on an insurance policy for damage caused by a fire in a warehouse on 1 January 2004. No provision had been made for the receipt of insurance money at 31 March 2004 as it was uncertain that any money would be paid. The insurance company settled with a payment of £1·5 million on 1 June 2004.

D The company had made large export sales to the USA during the year. The year end debtors included £2 million for amounts outstanding that were due to be paid in US dollars between 1 April 2004 and 1 July 2004. By the time these amounts were received, the exchange rate had moved in favour of the company and the equivalent of £2·5 million was actually received.

1.8 N Ltd started business on 1 September 2003. The following balances were extracted from the books of N Ltd on 31 August 2004:

	£000	*£000*
Sales		161
Cost of sales:		
Purchases	151	
Closing stock	26	
		125
Gross profit		36
Trade debtors		25
Trade creditors		16

Assume a 365 day trading year.

Using the information above, N Ltd's average working capital cycle for the year ended 31 August 2004 (to the nearest day) was

A 81 days.

B 94 days.

C 113 days.

D 171 days.

1.9 R plc redeemed its redeemable preference shares with a cash payment, paying a premium of 25%. The shares redeemed were as follows:

	£
Nominal value of preference shares redeemed	95,000
Cash paid on redemption	118,750

How much should be debited to distributable profits and how much should be credited to the capital redemption reserve?

	Distributable profits	*Capital redemption reserve*
	£	£
A	23,750	95,000
B	95,000	118,750
C	118,750	118,750
D	118,750	95,000

1.10 S Ltd revalues its properties to current value each year. One of S Ltd's warehouses, in its balance sheet at its September 2003 current value of £1,200,000, was sold on 29 September 2004 for £900,000 with an option to repurchase after four years at £1,093,956 (£900,000 plus compound interest for four years at 5% per annum).

The warehouse's current value at 29 September 2004 was £1,380,000.

How should S Ltd treat this transaction in its financial statements for the year ended 30 September 2004?

A As a sale of the warehouse recording a loss on disposal of £300,000.

B Revalue the warehouse to £1,380,000 and record £900,000 as a loan received.

C Revalue the warehouse to £1,380,000 and record a loss on disposal of £480,000.

D Leave the warehouse in its balance sheet at £1,200,000 and record £900,000 as a loan received.

(Total = 20 marks)

End of Section A

SECTION B – 30 MARKS
ANSWER THIS QUESTION

Question Two

ZZ Ltd produces two different ranges of products, range A and range B. The range A brand was developed in-house, but the range B brand name was purchased seven years ago.

The B product range has been losing popularity and sales have been in sharp decline for the last two years. By the end of the third quarter of 2002, the level of sales had declined to a point where the directors decided it was no longer viable to produce the B product range. A provision of £100,000 for closure costs was set up in the accounts for the year ended 30 September 2003. The closure was delayed until 1 January 2004 when the production lines ceased production and all the assets relating to the B product range were put up for sale.

ZZ Ltd's trial balance at 30 September 2004 is shown below:

	£000	*£000*
10% Debentures 2010		2,600
Administration expenses – A product range	96	
Administration expenses – B product range	34	
Bank & Cash	3,192	
Brand name – B product range	197	
Buildings at cost	2,500	
Cash received on disposal of factory		2,000
Cash received on disposal of machinery		50
Closure costs	125	
Corporation tax	20	
Cost of goods sold – A product range	513	
Cost of goods sold – B product range	127	
Creditors		90
Debenture interest paid – half year	130	
Debtors	140	
Distribution costs – A product range	92	
Distribution costs – B product range	12	
Land at valuation at 30 September 2003	1,500	
Machinery and equipment at cost	1,706	
Ordinary shares £1 each, fully paid		1,500
Profit & loss account at 30 September 2003		436
Provision for amortisation of brand name – B product range at 30 September 2003		138
Provision for closure costs at 30 September 2003		100
Provision for deferred tax at 30 September 2003		203
Provision for depreciation at 30 September 2003:		
Buildings		860
Machinery and equipment		415
Revaluation reserve		900
Sales – A product range		1,260
Sales – B product range		42
Stock at 30 September 2004 – A product range	210	
	10,594	10,594

Further information:

(i) The assets relating to the B product range were disposed of as follows:

- The land and the factory buildings were sold on 1 March 2004 for £2,000,000.
- The machinery was sold for £50,000 on the same date.
- All the cash received is included in the trial balance.
- The purchased brand name was deemed to have no value and should be written off. The book values of the assets sold were:

Asset type	*Cost*	*Valuation*	*Accumulated depreciation*
	£000	*£000*	*£000*
Land	300	750	0
Buildings	400		220
Machinery and equipment	462		195

(ii) Buildings are depreciated at 5% per annum on the straight-line basis. Machinery is depreciated at 25% per annum using the reducing balance method. Depreciation is treated as a cost of sales.

(iii) There were no purchases of tangible fixed assets during the year.

(iv) ZZ Ltd's accounting policy for amortisation and depreciation is to charge a full year in the year of acquisition and make no charge in the year of disposal.

(v) The directors decided to downsize the company and used the cash received to repay loans rather than invest in new production facilities. The debentures were redeemed on 30 September 2004. A payment equal to the nominal value outstanding, plus accrued interest to date, was made from the bank account on 30 September 2004. This transaction has not been recorded in the trial balance.

(vi) The directors estimate the corporation tax charge on the year's profits at £113,000. The balance on the corporation tax account is the amount remaining after settling the amount due for the year ended 30 September 2003.

(vii) The deferred tax provision needs to be reduced to £170,000.

(viii) The directors have proposed a final dividend of £200,000, no interim dividend was paid during the year.

Required:

(a) Prepare the tangible fixed assets note to the accounts for the year ended 30 September 2004.

(6 marks)

(b) Prepare the profit and loss account for ZZ Ltd for the year ended 30 September 2004 and its balance sheet at that date. These should be in a form suitable for publication and in accordance with all current regulations.

(24 marks)

> Notes to the financial statements are not required (except as specified in requirement (a)) 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.

(Total for Question Two = 30 marks)

End of Section B

SECTION C – 50 MARKS

ANSWER TWO QUESTIONS ONLY

Question Three

Requirement (a)

FRS 18 – *Accounting policies*, distinguishes between accounting policies and estimation techniques.

Required:

Explain the difference between accounting policies and estimation techniques; give an example of each.

(4 marks)

Requirement (b)

The directors of U plc have recently made four changes to their accounting treatment of certain items for the year ended 30 September 2004:

Change 1

U plc has been depreciating its factory machines on the straight-line basis over six years, assuming no residual value. U plc replaced all of its machines at the same time on 1 October 2000 at a cost of £1,300,000.

The directors of U plc have decided to change the method of machinery depreciation to the reducing balance method, as they think that it will more accurately reflect usage of the machines and will give a true and fair view. Effective from 1 October 2003, all machinery will be depreciated at 25% per annum using the reducing balance method.

(5 marks)

Change 2

U plc manufactures refrigerators and freezers and sells them with a one-year warranty. It applies the requirements of FRS 12 – *Provisions, contingent liabilities and contingent assets* to its financial accounts. U plc has made a provision for future warranty claims each year.

U plc did not keep accurate records of previous warranty claims, so when FRS 12 became effective, it estimated future warranty claims based on an estimated 10% of sales turnover. It also started keeping accurate records of warranty claims.

U plc has decided to change its method of calculating the provision for warranty claims to the weighted average of the last three years' actual claims paid.

A warranty claim provision of £900,000, calculated on the old basis, has already been entered in the accounts for the year ended 30 September 2004.

Year to 30 September	*2002*	*2003*	*2004*
	£000	*£000*	*£000*
Sales	7,500	8,000	9,000
Actual warranty claims paid	375	400	325

(6 marks)

Change 3
U plc did not previously capitalise interest incurred in connection with the construction of tangible fixed assets. All interest was charged to the profit and loss account each year. The directors have now decided that, in future, interest incurred on construction contracts will be added to the cost of construction. U plc's trial balance shows that construction costs of tangible fixed assets completed in the year ended 30 September 2004 were £1,400,000. Interest directly attributable to the construction was £56,000 during the year; this has been included in the trial balance under interest paid.

(5 marks)

Change 4
U plc owns an office building, which it purchased for £250,000 ten years ago (1 October 1993) for use by its employees. U plc has charged depreciation on the office building at 2% per annum on the straight line basis.

All of U plc's employees have now moved to other premises and U plc has let the office building to a third party on an operating lease. Effective from 1 October 2003, the directors have decided to reclassify the office building as an investment property and to carry it in its balance sheet at valuation without any depreciation, as required by SSAP 19 – *Accounting for investment properties*. The office building was valued at £450,000 on 1 October 2003.

(5 marks)

Required:

For each of the four changes above:

(i) Identify the accounting policy and estimation technique involved and explain whether U plc is making a change in accounting policy or a change in estimation technique or neither.

(ii) Prepare the accounting entries required in U plc's profit and loss account and balance sheet to implement changes 1 to 4 above for the year ended 30 September 2004 and explain the need for such entries.

(The breakdown of marks is shown against each change detailed above)

(Total for Requirement (b) = 21 marks)

(Total for Question Three = 25 marks)

Question Four

JK plc is considering entering a long-term business arrangement with another organisation to provide a full range of contract services for the construction industry.

The selected organisation must be in a strong financial position and be able to survive and prosper in both the immediate future and the medium term.

JK plc has two possible candidates for the business arrangement, CDE Ltd and VWX Ltd. Both candidates have a high reputation for the provision of their services. Neither company carries any significant stocks.

Summarised profit and loss account for the year ended 31 October 2004

	CDE Ltd	*VWX Ltd*
	£000	*£000*
Turnover	11,200	9,800
Operating profit	990	966
Interest payable	(202)	(70)
Profit before tax	788	896
Tax	(190)	(240)
Profit after tax	598	656
Dividends	(320)	(400)
Retained profit for the year	278	256
Retained profit b/fwd	22	739
Retained profit c/fwd	300	995

Balance sheets at 31 October 2004

	CDE Ltd		*VWX Ltd*	
	£000	*£000*	*£000*	*£000*
Tangible fixed assets		2,000		2,500
Current assets	1,950		1,995	
Creditors: amounts falling due within one year				
Bank loan 2005	(1,110)		0	
Creditors	(630)		(990)	
	(1,740)		(990)	
		210		1,005
		2,210		3,505
Creditors: amounts falling due after more than one year				
Loans 2010-2015		(1,410)		(1,010)
		800		2,495
Capital and reserves:				
Ordinary share capital		400		1,000
Share premium		100		500
Retained profits		300		995
		800		2,495

Requirement (a)

As the trainee management accountant you have been asked to prepare a draft report to the Finance Director, based on the information given above, analysing the financial strengths and weaknesses of each of the candidate organisations and their suitability for a long-term business arrangement with JK plc.

(*Note:* You should ignore the further information given in requirement (b) for this draft report.)

(19 marks)

Requirement (b)

VWX Ltd regularly revalues all its tangible fixed assets which are carried in its balance sheet at current value. CDE Ltd has not revalued any assets and carries all its assets at depreciated historical cost. If CDE Ltd were to revalue its assets at 31 October 2004, its tangible fixed assets would increase by £2,750,000.

All other accounting policies of the two organisations are substantially the same.

Required:

Explain, with supporting calculations, how the revaluation of CDE Ltd's fixed assets will affect its financial ratios and whether this would have any effect on your conclusions regarding CDE Ltd's suitability for a long-term business arrangement with JK plc.

(6 marks)

(Total for Question Four = 25 marks)

Question Five

Requirement (a)

A general manager in your organisation has recently enrolled on a management course at the local college. She is studying a module on finance and accounting and is having some difficulty understanding the theory. She has asked you, the trainee management accountant, if you could explain the consultative process used to produce a new Financial Reporting Standard (FRS).

(5 marks)

Requirement (b)

E Ltd, a food retailer, decided to start a home delivery service from 1 November 2002. As E Ltd had no vehicles suitable for use by the new service, it purchased three small delivery vehicles to enable them to provide the service.

The invoice for the vehicles included the following details:

	£
Cost price - per vehicle	12,000
Less: Trade discount	(2,400)
	9,600
Delivery charge	250
One vehicle	9,850
Three vehicles	29,550
1 year's insurance for the three vehicles	2,100
Total cost of three vehicles	31,650

By 31 October 2003, there had been a general price increase in all new delivery vehicles of 25%. The directors of E Ltd decided to revalue all three of their delivery vehicles to 125% of their net book value at 31 October 2003.

During the next year, it became apparent that the delivery service was so successful that the delivery vehicles were now too small. On 1 April 2004, E Ltd traded in the three delivery vehicles for three new larger vehicles. The new larger delivery vehicles cost £18,000 each and the vendor allowed a trade-in value of £9,000 for each of the old vehicles. E Ltd paid the balance of £9,000 per vehicle on 1 May 2004.

All vehicles are depreciated using the reducing balance method at 25% per annum, charged on a time basis.

E Ltd purchased new computer equipment, costing £5,000, to assist in running the delivery service. The software required to provide the service was also purchased at the same time. The initial cost of the delivery scheduling software was £950 plus the cost of adapting the software to E Ltd's detailed specifications £2,600. The computer equipment and the adapted software were delivered on 1 November 2002, and brought into use at once. During December 2002, the software developed reliability problems, often crashing for no apparent reason. E Ltd's in-house programmer spent time resolving these problems at an estimated cost of £2,000 in December 2002 and £1,000 in January 2003. E Ltd depreciates all computer equipment and software on a straight line basis over four years, assuming no residual value.

The Accounting Standards Board's (ASB) *Statement of Principles for Financial Reporting* (SoP) describes the asset recognition process as:

- Initial recognition
- Subsequent remeasurement
- Derecognition

Required:

(i) Apply the ASB's SoP asset recognition process to the above situations and explain the relevance of each stage of the process to each of the situations.

(6 marks)

(ii) Prepare profit and loss account and balance sheet extracts for the years ended 31 October 2003 and 31 October 2004 to show how the above transactions would be recorded. Explain your treatment with reference to appropriate Accounting Standards.

(14 marks)

(Total for Requirement (b) = 20 marks)

(Total for Question Five = 25 marks)

Question Six

Requirement (a)

M plc operates a copper mine in a remote part of a country which is designated a national park. To obtain the licence to operate the mine, M plc had to agree to a number of conditions. One condition is that at the end of the useful economic life of the mine, M plc will remove all above ground buildings and equipment and will reinstate the land on which they were situated. They also agreed to landscape all the waste tips and to plant them with trees normally found in the area. The estimated cost of all of this work is £3 million.

The initial costs of building the required premises, preparing the mine for operation and other set-up costs were £5 million and have been charged to tangible fixed assets – assets under construction.

M plc paid the government £10 million for a licence to operate the mine for 25 years. This has been debited to tangible fixed assets. The mine commenced operations on 1 October 2003.

Required:

Calculate the value of the amounts that M plc should show in its profit and loss account for the year ended 30 September 2004 and its balance sheet at that date. Justify your treatment of each item by reference to appropriate Accounting Standards.

(9 marks)

Requirement (b)

N plc manufactures a range of electrical products for home and portable personal entertainment. Demand for products can fall drastically at very short notice, often due to a product having been superseded by a new product.

At 30 September 2004, N plc's stock balance included the following:

	Total cost	*Total normal sales value*
	£000	*£000*
20,000 personal cassette tape players	18	27
5,000 basic CD players	45	90
Damaged DVD players	10	20

At 30 September 2004, the 20,000 personal cassette tape players had been in stock an average of 18 months. These cassette tape players are no longer manufactured. During November 2004, N plc found a buyer for its whole stock of cassette tape players; the total agreed price was £10,000.

The market for the basic CD players has contracted as higher specification models and DVD players have entered the market. N plc's sales director estimates that the basic CD players will only sell for £10 each.

A quantity of DVD players were found to be damaged and were unable to be sold in their current condition. The DVD players had a zero scrap value. These units could be repaired at a total cost of £5,000; they could then be sold for a total of £12,000.

Required:

Advise N plc how it should treat the above stock items in its profit and loss account for the year ended 30 September 2004 and how it should value the stock in its balance sheet at that date. Your answer should refer to appropriate Accounting Standards.

(7 marks)

Requirement (c)

D Ltd purchased all its tangible fixed assets new three years ago on 1 October 2001. The tangible fixed assets cost £720,000 and all qualified for capital allowances at 25% per annum on the reducing balance method. D Ltd's depreciation policy is to depreciate tangible fixed assets at 20% per annum using the straight-line method and assuming no residual value. D Ltd pays corporation tax at 30%.

Required:

(i) Calculate D Ltd's deferred tax balance at the end of each of the years ended 30 September 2002, 2003 and 2004.

(5 marks)

(ii) Using the Accounting Standards Board's (ASB) *Statement of Principles for Financial Reporting* (SoP) definitions of assets and liabilities, justify the deferred tax balances at 30 September 2002, 2003 and 2004.

(4 marks)

(Total for requirement (c) = 9 marks)

(Total for Question Six = 25 marks)

End of paper