ACCOUNTING THEORY & PRACTICE

Professional 1
June 2002

MARKING SCHEME

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Question 1

(a)

ABZ plc
Profit and Loss Account for the Year ended 31 December 2001

	£m	
Turnover	11,606	½
Cost of sales	(8,072)	½
Gross profit	3,534	
Distribution costs	(877)	½
Administration costs	(1,288)	*3 (see note 1)*
Other operating income	119	½
Operating profit/loss	1,488	
Exceptional items; gain on disposal of fixed assets	76	*1*
Profit on ordinary activities before interest	1,564	
Interest receivable	33	½
Interest payable	(88)	½
Profit before tax	1,509	
Tax	(148)	½
Profit after tax	1,361	
Dividends	(120)	*1*
Retained profit for the year	1,241	
Retained profit B/F	495	½
Retained profit C/F	1,736	
		(9)

ABZ plc
Balance Sheet as at 31 December 2001

	£m	£m	
Intangible fixed assets			
Goodwill	160		½
Development expenditure	50		½
		210	
Tangible fixed assets			
Land	857		½
Freehold property	3,384		½
Plan, fixtures and fittings	333		½
		4,574	
Fixed asset investments		90	½
		4,874	
Current assets			
Stock	582		½
Debtors	110		*1*
Current asset investments	75		½
Cash & bank	38		½
	805		
Current liabilities			
Bank loans 2002	(50)		½
Tax	(148)		½
Dividends	(120)		½
Creditors	(442)		½
		45	
Current liabilities > one year			
Loans 2004	(340)		½
Bonds 2009	(550)		½
		(890)	
		4,029	
Share capital		1,200	½
Share premium		720	½
Revaluation reserve		320	½
Investment properties-revaluation reserve		53	*1*
Retained profits		1,736	
		4,029	*(11)*
			(20)

Note 1

	£m	
Employee & admin costs	1,005	½
Research & development (see below)	30	½
Bad debt provision (see below)	6	½
Depreciation – Freehold property (see below)	126	½
Depreciation – Plant, furniture & fittings (see below)	111	½
Amortisation – goodwill (see below)	10	½

1,288

Research & development-
Projects not viable and pure research is charged to P&L account in the year – 20 + 10 = 30.
Projects capable of profitable marketing that meet the requirements of SSAP 13 can be carried forward, as an intangible asset. Assume that this meets SSAP 13 requirements and carry as an intangible asset to be amortised from next year – 50.

Depreciation-

Freehold property
3,780/30 = 126

Plant, furniture & fittings
983-539 = 444 x 25% = 111

Goodwill–
Purchased three years ago, useful life 20 years. Currently 170/17 = 10 pa
Three years = 10x3= 30
Therefore – Cost (170+30) = 200

Bad debt provision = 5% of 116 = 5.8 round to 6.

Profit on disposal.

Cash	90
NBV – Buildings (65 – 60)	(5)
PFF (131 – 122)	(9)
	76

(b)

(i) Fixed assets note

	Tangible fixed assets			Fixed asset investments	Intangible fixed assets		
Cost or revaluation	Land	Freehold property	Plant, fixtures & fittings	Investment properties	Goodwill	Development	
	£m	£m	£m	£m	£m	£m	
Balance 1 Jan 2001	857	3,700	990	77	200	0	*1*
Additions in year (Balancing figure)	0	145	124	0	0	50	*½*
Balance before disposals (* given in TB)	*857	*3,845	*1,114	*77	200	50	*½*
Revaluation	0	0	0	13	0	0	*½*
Disposals in year	0	(65)	(131)	0	0	0	*1*
Balance 31 Dec 2001	857	3,780	983	90	200	50	*½*
Depreciation/ amortisation							
Balance 1 Jan 2001	0	330	661	0	30	0	*½*
Less disposals in year	0	(60)	(122)	0	0	0	*1*
Charge for the year	0	126	111	0	10	0	*1½*
Balance 31 Dec 2001	0	396	650	0	40	0	*½*
Net Book Value 31 Dec 2001	857	3,384	333	90	160	50	*½*
Net Book Value 1 Jan 2001	857	3,370	329	77	170	0	*(8)*

Segmental Information by Product

	Product DD	Product YY	Total	
	£m	**£m**	**£m**	
Turnover	6,486	5,120	11,606	½
Cost of sales	4,247	3,825	8,072	½
Gross profit	2,239	1,295	3,534	
Distribution costs	(438)	(439)	(877)	½
Administration costs (excl depreciation & amortisation)	(521)	(520)	(1,041)	*1½*
Depreciation & amortisation	(185)	(62)	(247)	*1*
Sub totals	1,095	274	1,369	
Unallocated:				
Other operating income			119	½
Total operating profit			1,488	
Total assets used	3,001	938	3,939	*1½ see below*
Unallocated assets:				*1*
Investment properties			90	
Total			4,029	½

Presentation and format 1½

Total Assets Used

Total fixed assets	(75%)	3,588	(25%)	1,196	4,784	½
Working capital	(80%)	36	(20%)	9	45	½
Creditors over one year	(70%)	(623)	(30%)	(267)	(890)	½
Subtotal		3,001		938	3,939	

(9)

(c) The arguments for segmental information include:

- Shareholders and analysts need segmental information to make valid judgements on the future prospects of a company.
- Segmental information is essential to correctly assess the company's risks and market exposures.
- Consolidated financial statements include results, assets and liabilities of dissimilar businesses, segmental information can help understand the different parts of the group.

The arguments against segmental information include:

- The costs of producing the information may outweigh the benefits.
- Commercial damage could be incurred as a result of disclosing too much information.
- There can be practical difficulties identifying segments and separating out their information.

2 marks per point up to a maximum of 12 marks

(49)

Question 2

(a) "Asset" a right or other access to future economic benefits controlled by an entity as a result of past transactions or events. *½*

"Contingent asset" is a possible asset that arises from past events and whose existence will be confirmed by the occurrence of one or more future events not wholly within the entity's control. A contingent is not recognised in the accounts until the benefits are virtually certain, then it ceases to be contingent. *1 ½*

The difference is that an asset has a future economic benefit whereas a contingent asset may have a future benefit if a certain condition arises. *1*

(3)

(b) "Cost" includes the purchase price plus all directly attributable expenses. These can include:

- Stamp duty
- Import duties
- Any irrecoverable VAT
- Delivery costs
- Professional fees
- Insurance during transit
- Installation and testing expenses.
- An estimate of the costs of dismantling and removing the asset at the end of its useful life as required by FRS 1

Example: a machine imported from Germany, cost would include: purchase price plus import duties and taxes; delivery charges; insurance; gains/losses on foreign exchange conversion; installation and setup costs. *2*

"Production cost" must include all attributable cost incurred in getting the asset into a condition where it can be used. This will include:

- The cost of raw materials used
- Cost of any consumables used
- Labour and any other direct costs
- A reasonable proportion of indirect costs
- Interest on capital borrowed specifically to finance the production of the asset.

Example: the production cost of drilling an oil well would include the exploration costs, construction costs and drilling and other work required to get the well to the stage where it can produce oil. The cost would also include decommissioning costs, to remove the structures and return the land to, as near as possible, its original state. *2*

(4)

(c) FRS 15 requirements include:

- May adopt a policy of revaluing tangible fixed assets; must be applied consistently to all assets in the same class. *½*
- Carrying amount of a revalued fixed asset should be its current value. *½*
- Current value is lower of replacement cost and recoverable amount. *½*
- Full valuation required every five years; Interim valuation in year 3. *½*
- If likely been a material change interim valuation in any of the other years. *½*
- Bases of valuation set out by FRS 15:
  - Specialised properties – depreciated replacement cost.
  - Non-specialised properties – existing use value.
  - Properties surplus to requirements – open market value.
  - Tangible fixed assets other than property – valued at market value or depreciated replacement cost. *1*
- Where indication of impairment an impairment review required. *½*
- Revaluation gains reported in STRGL except where they reverse previous losses then recognised in P&L a/c. *1*
- Revaluation losses recognised in P&L a/c unless previously revalued then recognised in STRGL until previous revaluations have been reversed then recognised in P&L a/c. *1*

Maximum of 5 marks for explanation

R plc:

Land

Increase carrying amount to current value, the valuation on 1 March 2002. Add £100,000 to Land and increase revaluation reserve by £100,000. *1*

Buildings

Last valuation has had depreciation applied since revaluation. The difference between the current book value and the new valuation, £230,000 - £180,000 = £50,000 should be added to Buildings account and added to Revaluation reserve. The depreciation charge for 2002/3 will then be based on £230,000. *1*

Vehicles

Current value is £17,000 less than carrying value, this needs to be written off of the vehicles account, the carrying value being reduced to £10,000. Depreciation for 2002/3 will then be based on £10,000. *1*

The difference between £10,000 and the current book value £27,000, £17,000 will be charged partly to the profit and loss account, and part to the revaluation reserve as follows:

Depreciated historical cost would have been £60,000 – (£60,000*38/60) = £22,000. *1*

Actual book value based on previous revaluation £27,000.

Reduction to depreciated historical cost regarded as reversal of previous revaluation, £27,000-£22,000 = £5,000 will therefore be deducted from revaluation reserve. *1*

The difference between depreciated cost and current valuation will be debited to the profit and loss account, £22,000- £10,000 = £12,000) unless the vehicles recoverable amount is greater than its relevant amount. In this case the loss can be recognised in the STRGL. The effect in practice is that any remaining surplus on revaluation will be reversed before charging P & L a/c.

STRGL	(10)
P & L	(7)
	(17)

1

Maximum of 5 marks for application

(10)

(17)

Question 3

(a) Off balance sheet finance is “the funding or refinancing of a company’s operations in such a way that, under legal requirements and existing accounting conventions, some or all of the finance may not be shown on its balance sheet.” CIPFA ATP Textbook *1*

The reason for not allowing off balance sheet finance is that the true extent of assets and liabilities are not shown in the balance sheet. The true substance of the transactions should be shown, not merely their legal form. *2*

(3)

(b) The categories that are discussed in detail in FRS 5 application notes are:

1. Consignment stock.
2. Sale and repurchase agreements.
3. Factoring of debts.
4. Securitised assets.
5. Loan transfers.

(5)

(c)

Year	Capital sum at start	Finance charge at 6%	Rental paid	Capital sum at end	Due < 1 year	Due > 1 year
1	88,300.00	5,298.00	20,962.00	72,636.00	16,603.84	56,032.16
2	72,636.00	4,358.16	20,962.00	56,032.16	17,600.07	38,432.09
3	56,032.16	3,361.93	20,962.00	38,432.09	18,656.07	19,776.01
4	38,432.09	2,305.93	20,962.00	19,776.01	19,776.02	-0.00
5	19,776.01	1,186.56	20,962.58	-0.00	-0.00	0.00

(4)

(Note: Sum of digits method also accepted as correct answers).

(d) The Profit and Loss account entries are:

	Year 1	Year 2
Interest charge for year	£5,298	£4,358
Depreciation, straight line (five years, no residual value)	£17,660	£17,660

2

The Balance Sheet entries are:

	Year 1	Year 2
Fixed assets at cost – leased	£88,300	£88,300
Depreciation provision	£17,660	£35,320

1

	Year 1	Year 2
Liabilities – amounts due on lease		
Less than one year	£16,604	£56,032
Two to five years	£17,600	£38,432

2

(5)

(17)

Question 4

Reconciliation of Operating Profit to Net Cash Inflow from Operating Activities

	£m	
Operating profit	238	*1*
Add depreciation	56	*½*
Less profit on disposal of fixed asset	(8)	*1*
Add reduction in stock	30	*½*
Less increase in debtors	(45)	*½*
Add increase in creditors	140	*½*
Net cash inflow	411	

H plc
Cash flow statement

Net cash inflow from operations		411	
Returns on investments & servicing of finance			
Interest paid (W1)	(8)		*1*
Interest received (W2)	9	1	*1*
Taxation (W4)		(36)	*1*
Capital expenditure & financial investment			
Purchase tangible fixed assets (W6)	(241)		*2 ½*
Sale of tangible fixed assets	50		*½*
		(191)	
Equity dividends paid (W3)		(38)	*1*
Net cash flow before financing		147	
Management of liquid resources			
Purchases of Government Bond		(40)	*1*
Financing			
Issue of ordinary shares	60		*1 ½*
Redemption of debentures	(28)		*1*
Redemption of preference shares	(48)	(16)	*1 ½*
Net inflow of cash & cash equivalents		91	

Format and correct headings 1

(17)

Workings

W1

Interest paid

B/F	5
P&L	12
	17
C/F	9
Paid	8

W2

Interest received

B/F	6
P&L	6
	12
C/F	3
	9

W3

Dividends

B/F	15
P&L	33
	48
C/F	(10)
	38

W4

Tax

B/F	60
P&L	54
	114
C/F	(78)
	36

W5

Ordinary shares

B/F	160
Cash issue	30
	190
Bonus issue	19
C/F	209

W6

Tangible fixed assets

B/F	320
Revalued	30
	350
Disposal	(42)
	308
Depreciation for year	(56)
	252
C/F	493
Purchases	241

W7

Share premium

B/F	62
Share issue	30
	92
Redemption preference shares	(8)
	84
Bonus issue	19
C/F	65

Question 5

Ch 5 Recognition in financial statements

There are 3 stages in the recognition of assets and liabilities.

- Initial recognition. *1 ½*
- Subsequent re-measurement.
- Derecognition.

Uncertainty sometimes makes it necessary to delay the recognition process.

- Element uncertainty - does the item exist and meet the definition of elements? *1 ½*
- Measurement uncertainty - at what monetary amount should it be recognised?
- *Matching* is still important, but does not *drive* the recognition process.

Examples illustrating above. *6*

(9)

Ch 6 Measurement in financial statements

- *Initially*: record asset/liability at transaction cost = historical cost = current replacement cost. *1*
- *Re-measure:* in historical cost system.
  - Write down *asset* to recoverable amount.
  - Amend *liability* to monetary amount to be paid. *1*
- *Current value system* recommended.
  - *Asset* current value = value to the business.
    Liability current value = market value = value to business. *1*

Examples illustrating above points *5*

(8)

(17)