ACCOUNTING THEORY AND PRACTICE

Professional 1
December 2003

MARKING SCHEME

CIPFA

Question 1

(a) NetWise plc
Reconciliation of operating profit to net cash inflow from operating activities

		£000	
Operating profit		39	*1*
Debenture issue costs		20	*1*
Premium on redemption		21	*1*
Less profit on disposal		(1)	*1*
		79	
Add:			
Depreciation equipment, F&F		54	*½*
Depreciation computer hardware		270	*½*
Depreciation computer software		133	*½*
Amortisation goodwill		37	*½*
Reduction in stock		160	*½*
Increase in creditors		37	*½*
		770	

NetWise Plc
Cash flow statement for the year ended 30 September 2003

Net cash inflow from operating activities		770	
Return on investments and servicing of finance			
Interest paid		(99)	*1*
Taxation paid		(10)	*2*
Capital expenditure (Note 1)		(16)	*1*
		645	
Dividends		0	
		645	
Financing (Note 1)		837	
		1,482	

Note 1 – Gross Cash flows

Capital expenditure:			
Payments to acquire tangible fixed assets		(25)	
Receipts from disposal of tangible fixed assets		9	
		(16)	
Financing:			
Issue of shares		300	*½*
Issue of debentures		1,000	*½*
Cost of issue		(20)	*1*
Redemption of 10% debenture		(443)	*1*
Increase in cash		837	

Reconciliation of net cash flow to movement in net debt

Increase in cash		1,482	*½*
Less issue of debentures	(980)		*½*
Add redemption of debentures	422	(558)	*½*
Change in net debt		924	
Net debt at 30/9/02		(1,161)	*½*
Net debt at 30/9/03		(237)	

Format 1

Analysis of Change in Net Debt

	Balance at 30/9/02	Cash flow	Balance at 30/9/03	
Cash & bank	22	721	743	½
Bank loans & overdrafts	(761)	761	0	½
10% debentures	(422)	422	0	½
5% debentures	0	(980)	(980)	½
Totals	(1,161)	(924)	(237)	
				Format 1

Workings:

Interest paid

B/f	30	
P&L	95	
	125	
C/f	(26)	
	99	

Taxation

B/f		
Current tax	10	
Deferred tax	816	826
P & L		77
		749
C/f		
Current tax	12	
Deferred tax	727	(739)
		10

Total for part (a) 20

(b) Workings

Tangible fixed assets:

Equipment furniture & fittings

	Cost	Depreciation		
Bal b/f	555	222		½
Disposal	(40)	(32)		½
Purchased	25	0		½
Depreciation	0	54		½
	540	244	296	
Computer hardware				
Bal b/f	1,890	270		
Depreciation		270		
	1,890	540	1,350	½
Website				
Bal b/f	933	133		
Depreciation		133		
	933	266	667	½
Total tangible fixed assets			2,313	

Goodwill				
Bal b/f	370	74		
Amortisation		37		½
	370	111	259	

Profit and loss account:		
Balance b/f	357	½
Profit for year in question	3	½
Add back	20	½
	380	

(b)

NetWise Plc

Balance Sheet at 30 September 2003

Intangible fixed assets		259		
Tangible fixed assets		2,313	2,572	
Current assets				
Stock		1,200		½
Bank		743		½
		1,943		
Creditors due in less than one year:				
Trade creditors	827			½
Taxation	12			½
Proposed dividend	18			½
Interest accrued	26	883	1,060	½
			3,632	
Creditors due in more than one year:				
5% debentures			(980)	½
Provisions:				
Deferred tax			(727)	½
			1,925	
Ordinary shares (900 + 240)			1,140	½
Share premium (346 + 60)			405	½
Profit and loss account			380	½
			1,925	

Total marks (b) 10

(c) Goodwill can be recognised in the financial statements if it is purchased goodwill, which is the difference between the price paid for a business and the *1* value of the net assets acquired. Goodwill is recognised at cost and amortised *1* over its useful economic life, normally 20 years or less. Goodwill may become *1* impaired and can be written down in value but FRS 10 does not allow goodwill to be revalued upwards. *1*

All intangible assets must be able to be sold separately, it is doubtful if the brand name ‘Netwise’ could be sold separately from the rest of the business. *1*

FRS 10 allows self generated intangible assets to be recognised and revalued to market value as long as they meet the FRS 10 criteria. The FRS 10 criteria *1* are:

- The asset must be a member of a group of homogeneous assets which are equivalent in all material respects *1*
- There is an active market for that group of assets. *1*

Brand names are all unique and therefore self-generated brand names cannot be recognised as they fail to meet the criteria. *1*
NetWise plc is not able to recognise the brand name in its accounts and cannot achieve the directors' objective of recognising the loyalty of customers in the financial statements. *1*

(Up to a maximum of 7)

(d) Liquidity has drastically improved during the year. The attached appendix shows the calculations for the ratios in this report. *1*

The current ratio has improved from 0.9:1 to 2.2:1. The original 0.9 was very low and needed to be improved. The current figure is a very acceptable 2.2:1. *1* It is even in danger of moving too high, which would indicate that too many assets were being kept idle. The cash flow statement shows that this *1* improvement was due to new issues of shares and debentures. *1*

The quick ratio shows even more drastic an improvement. From almost zero (0.01:1) to 0.84: 1. The 2002 figure was too low and in danger of causing a *1* cash flow problem. The new issues in 2003 have enabled the cash position to *1* be dramatically improved.

The stock turnover has improved a little from 134 to 112 days due to lower stock holding along with increased sales. *1*

Creditors payment has remained stable throughout the period. The increase in cash has not been used to pay creditors more quickly. 77 days is a little slow *1* being more than two months to pay suppliers. NetWise should consider more use of their technologies to pay creditors more quickly. *1*

Appendix

Liquidity:	At 30/9/02	At 30/9/03	
CA/CL	1382:1591 = 0.9:1	1943:883 = 2.2:1	*1*
Quick ratio	22/1591 = 0.01:1	743:883 = 0.84:1	*1*
Stock turn	1360/3700*365 = 134 days	1200/3905*365 =112 days	*1*
Creditors payment	790/3700*365=77.9 days	827/3905*365 = 77.3 days	*1*

Up to a maximum of 12 marks

(49)

Question 2

GHI Plc
Profit and Loss account for the year ended 31 March 2003

		£000	
Turnover	74,841		½
Long term contract turnover (W6)	2,250	77,091	½
Cost of sales (W4)	50,540		*See workings*
Long term contract cost (W6)	1,687	52,227	½
Gross profit		24,864	
Distribution expenses	1,320		½
Administrative expenses (W4)	7,941	9,261	*See workings*
Profit on ordinary activities before interest		15,603	
Interest payable		1,000	½
Profit before tax		14,603	
Tax		4,100	½
Profit after tax		10,503	
Dividends		1,200	*1*
Retained profit for the year		9,303	
			(4)

GHI Plc
Balance sheet as at 31 March 2003

	£000	£000	£000	
Tangible fixed assets				
Land & buildings (W1)		34,000		*See workings*
Plant and machinery (W2)		17,330		*See workings*
			51,330	
Current assets				
Stock	5,490			½
WIP long term contract (W6)	240			½
Debtors (W3)	9,471			*See workings*
Debtors – LTC (W6)	2,250			½
Cash & bank	17,122	34,573		½
Liabilities due in less than one year				
Interest payable	(500)			½
Tax	(4,100)			½
Dividends	(600)			½
Creditors	(7,950)			½
		(13,150)	21,423	½
			72,753	
Liabilities due in more than one year				
5% debentures			(20,000)	½
			52,753	
Share Capital & Reserves				
Ordinary shares			30,000	½
Share premium			4,500	½
Revaluation reserve			1,350	½
Profit & loss account (W5)			16,903	*See workings*
			52,753	
				6½

Workings

W1				
Land & buildings cost	38,650			½
Less provision depreciation	5,000			½
	33,650			
Revalued to	35,000			
Revluation reserve	1,350			½
Buildings	35,000			
Land element	10,000			
	25,000			
New depreciation	25,000/25=	1,000 p.a		*1*

W2	Cost	Depreciation		
Plant and machinery	32,600	12,010		½
Years deprecation		3,260		½
	32,600	15,270	17,330	

W3			
Debtors	10,300		
Bad debt	(330)	P & L	½
	9,970		
5% provision	(499)		½
	9,471	B/S	
P & L Increase in provision	499 – 417 =	82	½

W4	**Administration**	**Cost of sales**	
Trial balance	4,330	47,280	
Directors fees	2,140		½
Bad debt	330		½
General provision for bad debts	82		½
Lease payment	59		½
Depreciation buildings	1,000		½
Depreciation plant and machinery		3,260	½
Total	7,941	50,540	

W5		
Profit and loss account		
Per trial balance	7,600	½
Profit for year	9,303	½
	16,903	

W6

Contract value			7,500	
Contract costs:				
Trial balance		1,927		
Cost to complete		3,696		
			5,623	
Profit			1,877	*Profitable contract recognised % to date*
Turnover	7,500 x 30% =		2,250	
Cost of sales	5,623 x 30% =		1,687	
Stock WIP	1,927 – 1,687 =		240	
LTC Debtors			2,250	

(9)

(Maximum 17)

Question 3

(a) **(i)** An asset is a right or other access to future economic benefits controlled by an entity as a result of past transactions *1*

(ii) A gain is an increase in ownership interest, other than those relating to contributions from owners *1*

(iii) A distribution to owners is a decrease in ownership interest resulting from transfers made to owners in their capacity as owners. *1*

(3)

(b) Deferred tax meets the requirements to be treated as an asset if it conveys future economic benefit. *1*

The event has happened so it is a past event, if this gives rise to a future benefit it can be treated as an asset. Future benefit will be received if tax in a *1*
future period is reduced as a result of the deferred tax asset being reversed. *1*
In the example given the depreciation has been charged to profits but the capital allowances have not yet been given to the same extent. This will *1*
balance out over the life of the asset, so in future years the capital allowances will be greater than the depreciation charge. The temporary timing difference *1*
is therefore an asset with future benefit. *1*

(Up to a maximum 5)

(c) The companies Act 1985 requires that assets and liabilities should not be offset in financial statements. B Ltd must consider the asset and liability *1*
separately, rather than together as one may succeed while the other fails. *1*

There is a possible obligation arising out of a past event, the roof repair. The *1*
outflow of economic benefit is more than probable and the amount is known. *1*
The claim against B Ltd is “virtually certain” to succeed, this should be *1*
regarded as a provision under FRS 12 and the £20,000 accrued and charged *1*
to profit and loss account. *1*

The income would be regarded as a contingent asset under FRS 12. The income is contingent on the decision of the court and is outside the control of X Ltd. As B Ltd has a very strong case it may be reasonable to assume that the *1*
case will succeed. However as D Ltd is in liquidation with few assets, even if *1*
the court finds in B Ltd’s favour B Ltd may not get any compensation from D Ltd as there may not be sufficient assets to make a payment. *1*

To be able to recognise the debtor the income must be virtually certain. As D *1*
Ltd is in liquidation the income is far from certain, even with a very strong case. *1*
B Ltd should not accrue any income from the counter claim. *1*

(Up to a maximum 9)

(17)

Question 4

(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. *2*

Off balance sheet financing is seen as a problem because the users of the financial statements do not have a proper view of the state of the company's affairs. Company law and accounting standards do not provide sufficient *1* disclosure rules to ensure that the true nature of the transactions are shown. *1*

The main argument for disallowing off balance sheet financing is that the true substance of transactions should be shown, not merely its legal form. *1*

(5)

(b) (i) When applying FRS 5 substance over form, the main question is "has the asset been sold or refinanced?" D Ltd's debts have been factored *1* but not completely sold. *1*
The £8,500,000 initial payment is non-returnable so this part of the debt has been removed as there is no recourse. *1*

F plc charges a factoring fee and returns amounts collected over 90%.
So there is potential for D Ltd to receive a further £1,000,000. D Ltd *1*
therefore still has an interest in the balance and still has the benefits of ownership of the debts as the risks and rewards have not been fully passed to F plc. *1*
The debts should be shown on D Ltd's balance sheet using linked presentation as follows:

Debtors	£10,000,000	
Less amounts transferred to factor	<u>£9,000,000</u>	
Balance outstanding	<u>£1,000,000</u>	*1*

£500,000 should be charged to the profit and loss account as a factoring fee. *1*

(ii) The building was sold for approximately 50% of its value, which implies that it was not a true arms length transaction. D can repurchase the *1* building for the selling price plus interest at 2.5% above bank base rate. The substance of this transaction is a financing deal as D Ltd is very *1* unlikely to not repurchase the building as the price will be only approximately 50% of its market value. D Ltd should continue to carry *1* the building on its balance sheet and should recognise a long term creditor for the £5,000,000 cash received. Interest will be accrued at *1* the appropriate rate.

(iii) Each individual warranty has a very low probability of becoming a claim. FRS 5 requires warranties to be considered as a group. When *1* the group is considered together it is almost certain that claims will arise. The warranties need to be recognised as an expense in the period when the goods were sold, the best estimate of the amount payable should be used. The best estimate can be calculated for D Ltd *1* using the expected value approach. *1*

% probability	Cost £000	Expected cost £000	
80	0	0	
17	90	15.3	½
3	120	3.6	½
		18.9	

D Ltd should charge the warranty expense of £18,900 to its profit and loss account for the year ended 31 October 2003. *1*

(Up to a maximum 12 marks)

(17)

Question 5

(a) Basic Earnings per share:

Earnings £148,000

Number of shares:
Rights issue

3	@ £3.75	=	11.25	
1	@ £3.43	=	3.43	
4			14.68	
14.68/4 = 3.67				*1½*

Bonus element 3.75/3.67 = 1.0218 *½*
450*1.0218 = 460 *½*

1 April 2002 to 30 September 2003 (460/2) = 230 *½*
1 October 2002 to 31 March 2003 (600/2) = 300 *½*
Weighted average number of shares = 530

EPS = 148 / 530 = 27.9 pence per share *½*

Diluted EPS;
Convertible stock
Convertible stock – interest saved 9%x300 = 27 *1*
Less tax 27*30% = (8.1) *½*
18.9
Shares
One share for £2 Convertible stock = 300 / 2 = 150 *½*

	Earnings	Shares	Fully diluted EPS
Basic	148	530	
Convertible shares	+ 18.9	+ 150	
	166.9	680	24.5p

1

(7)

(b)

Report

To: Finance Director

From: Trainee Accountant

Analysis of our investment in Z Ltd

*Report format **1 mark***

As requested I have prepared a report analysing our return from our investment in Z Ltd and the changes in risk over the last 12 months.

The attached appendix shows the calculation of the ratios quoted in this report.

The profitability of Z Ltd as shown by its return on capital employed (ROCE) reduced from 29.2% to 18.2% in the year to 31 March 2003. This was due to the new share issue increasing the capital employed and the new investment of funds in fixed assets not coming fully on stream until the following year. *1* *1*

The reduction in ROCE directly affected the earnings per share, which also fell from 29.7pence to 27.9 pence. This should increase in 2003/4 as the new assets become fully operational. The P/E ratio indicates the markets perception of the company, a higher P/E indicating more confidence in the company. As EPS fell the P/E increased, this could be interpreted as the market anticipating a turn-round in 2003/4. *1* *1*

In terms of the direct return to A plc, the original investment plus rights issue gives an average cost of £2.51 per share; this gives an overall yield of just 3.2% on the cost of the shares. *1*

The dividend yield on the year-end market price was unchanged between the two-year ends, 2.1% in 2001/2 and 2.2% in 2002/3. *1*

Risk as measured by the gearing of the company markedly reduced with the rights issue. Z Ltd looks much stronger at 31 March 2003 than it did at 31 March 2002 with gearing down to 20.5% from a relatively high 35.3%. *1* *1*

Up to a maximum for discussion 6

	31 March 02	31 March 03	
ROCE	248/850 = 29.2%	267/1,465 = 18.2%	*1*
Basic EPS	134/450 = 29.7p	27.9 p	*½*
P/E	3.5/29.7 = 11.8	3.60 / 27.9 = 12.9	*1*
Gearing	300 / 850 = 35.3%	300 / 1,465 = 20.5%	*1*
Dividend cover	134 / 34 = 3.94	148 / 48 = 3.08	*1*
Dividend yield (on purchase cost)		Cost (3x2.2)+(3.43) = 10.03 average cost 10.03/4 = 2.51 .08/2.51 = 3.2%	*1*
Dividend on market price	.075/3.50 = 2.1%	.08/3.60 = 2.2%	*1*

Maximum for calculations 5
Maximum for part (b) 10

(17)