FINANCIAL ACCOUNTING

June 2004
Certificate Stage

MARKING SCHEME

Question 1

(a)

Hazel
Trading and Profit and Loss Account for the year to 31 October 2003

	Working	£	£	
Sales (£100,740 - £610 + £550)	W2		100,680	*3*
Cost of sales:				
Stock as at 1 November 2002		9,430		*½*
Purchases	W3	62,250		*1*
		71,680		
Own consumption		490		*½*
		71,190		
Stock at 31 October 2003 (£10,160 - £40)		10,120	61,070	*1*
Gross profit			39,610	
Profit on disposal of shop equipment			50	*½*
			39,660	
Less: Wages		5,840		*½*
Shop rent		8,400		*½*
Business rates (£1,250 + £400 - £490)		1,160		*½*
Insurance		1,570		*½*
Electricity (£1,090 - £210 + £180)		1,060		*½*
Sundry expenses (£1,170 + £880)		2,050		*½*
Bank charges and interest (£340 + £30)		370		*½*
Increase in doubtful debt provision		170		*½*
Depreciation (25% x £3,600)		900	21,520	*½*
Net profit for the year			18,140	
				(11)

(b)

Hazel
Balance Sheet as at 31 October 2003

	Working		£	£	
Fixed assets					
Shop equipment (£3,600 - £900)				2,700	*1*
Current assets					
Stock			10,120		½
Trade debtors (£550 + £170)		720			
Less: Provision for doubtful debts		170	550		*1*
Prepayments			490		½
Cash at bank (£4,160 - £200)			3,960		½
Cash in hand			270		½
			15,390		
Current liabilities					
Trade creditors		5,280			½
Accruals		180	5,460		½
Net current assets				9,930	
				12,630	
Capital					
As at 1 November 2002	W1			7,030	*2*
Capital introduced				1,000	½
Net profit for the year				18,140	½
				26,170	
Drawings (£13,000 + £50 + £490)				13,540	*1*
				12,630	
					(9)

(20)

Workings

W1 Opening capital

	Assets	*Liabilities*
	£	**£**
Bank balance	1,470	
Stock of goods	9,430	
Debtors	610	
Creditors		4,920
Cash	250	
Accrual		210
Prepayment	400	
	12,160	5,130
	5,130	
	7,030	

W2 Cash account

	£	**£**
Opening balance	250	
Received from customers (balancing figure)	100,740	
Wages		5,840
Drawings		13,000
Sundry expenses		1,170
Paid into bank account		80,710
Closing balance		270
	100,990	100,990

W3 Suppliers

	£	**£**
Opening creditor		4,920
Purchases (balancing figure)		62,250
Bank	61,890	
Closing creditor	5,280	
	67,170	67,170

Question 2

(a) The purpose of the Statement of Principles is to provide a conceptual framework for financial accounting. Even though it is an ASB product it is not an accounting standard and will not become one. Rather, the main intention of the Statement of Principles is to offer: *1*

- a coherent frame of reference (including a set of definitions) to be used by the ASB in the development and review of accounting standards *1*
- assistance to preparers and auditors analysing new or emerging issues in the absence of applicable accounting standards. *1*

The Statement of Principles was devised by the ASB because previously there was no coherent set of principles providing a theoretical foundation for financial accounting. Instead, there was only a set of traditional accounting concepts (or conventions) which had grown up out of accounting experience but which sometimes offered contradictory guidance. The Statement uses many of these conventions but attempts to organise them into a logically consistent set of rules which can guide accountants in their work and improve the quality of financial accounting. *2*

(5)

(b) The Statement of Principles states that the main objective of financial statements is:

- "*to provide information*
- *about the reporting entity's financial performance*
- *and financial position,*
- *that is useful to a wide range of users*
- *for assessing the stewardship of management and*
- *for making economic decisions*".

(3)

(c) The main users of financial statements are listed in the Statement as:

- investors
- lenders
- suppliers and other trade creditors
- employees
- customers
- governments and their agencies
- the public.

As stated above, financial statements provide information about an entity's financial performance and financial position and this information helps users to make important economic decisions. For example:

- Potential investors must decide whether or not to invest in a business in the first place. Those that do invest must then decide whether to maintain, increase or reduce the size of their investment.

- Lenders approached for a loan must assess whether the business is likely to be able to make the necessary repayments and must then make a loan decision.

- Similarly, suppliers and other trade creditors must decide whether to offer credit to a business and (if so) how much credit to offer.

- Employees are interested in job security and fair pay. Information about their employer's financial performance and position will help employees (or their representatives) to decide whether the employer is likely to continue in business and whether the remuneration offered is fair.

- Before placing a long-term contract, customers who need a secure source of supply will need to be sure that a potential supplier is financially stable and not likely to cease trading in the foreseeable future.

- One obvious purpose for which the Government uses accounting information is the assessment of taxes. Other purposes include the regulation of business and the production of national economic statistics.

- The activities of some businesses (especially big, powerful businesses) are of interest to the general public. For example, the accounting information published by a business may help the public to decide whether or not that business is charging excessive prices.

½ mark for identifying user + 1 mark for explanation, up to a maximum of (9)

(d) According to the Statement of Principles, the main limitations of financial statements are as follows:

- The information contained in financial statements is restricted to information which can be expressed in quantitative terms. Non-financial information is largely neglected.

- The statements are historical in nature and may not provide reliable guidance with regard to future events.

- The need to allocate the effects of business transactions to discrete accounting periods often involves the exercise of judgement (eg judging the degree to which an asset has depreciated or the likelihood of a bad debt) so that the financial statements can never be entirely reliable.

(3)

(20)

Question 3

(a) The duality (or dual aspect) principle states that every business transaction has two effects on the financial position of the business concerned. For example, if a business buys a motor vehicle and pays by cheque, this transaction results in an increase in the value of the vehicles owned by the business and a decrease in its bank balance. The purpose of a double-entry book-keeping system is to record both aspects of each business transaction, in accordance with the duality principle. *(2)*

(b)

Purchase ledger control account

	£		£	
		Balance b/d	24,791	*½*
		Purchases (1)	2,755	*1*
Casting error (3)	1,000			*1*
		Bank (5)	180	*1*
Contras (7)	340			*1*
Balance c/d	26,386			
	27,726		27,726	
		Balance b/d	26,386	

	£	£	
Total balances per list (£24,312 - £185)		24,127	*½*
Add:			
Omitted purchase invoices (1)	2,755		*1*
Cheque incorrectly posted (5)	180	2,935	*1*
		27,062	
Less:			
Casting error (2)	100		*1*
Debit balance listed as credit balance (4)	114		*1*
Discount received recorded incorrectly (6)	462	676	*1*
		26,386	

(10)

(c) It is certainly true that many types of book-keeping error could not occur in a computer-based system but it would be wrong to say that all errors would be eliminated. With reference to the errors listed in the question, the following errors would not occur in a computer-based accounting system (so long as the hardware and software functioned correctly):

- errors 2 and 3 (casting)
- error 4 (debit balance listed as credit balance)
- error 6 (entry on wrong side of account)
- error 7 (items omitted from control account).

However, errors 1 and 5 (transactions omitted altogether or recorded for the wrong amount) could occur in a computer system just as easily as in a manual system. The main types of error that would not be eliminated on the introduction of a computer-based system are:

- completely failing to record a transaction (error of omission)
- recording a transaction at the wrong amount (error of original entry)

- mis-coding a transaction so that entries are made in the wrong accounts (error of commission).

Although computer-based systems offer many advantages (see below) they are not a panacea and demand strict control of input data to ensure that errors such as these are avoided. *(4)*

(d) The main *advantages* of computer-based accounting systems include:

- rapid processing of financial transactions
- accurate processing
- relatively cheap processing
- automatic generation of a variety of reports based upon the information stored in the system (eg trial balance, draft financial statements, VAT returns, aged debtor report etc).

The main *disadvantages* of computer-based accounting systems include:

- the need for strict controls to ensure the accuracy of input data
- initial costs (eg acquiring hardware and software, conversion from the manual system, staff training etc.)
- the fact that systems are generally developed and maintained by technical IT staff who may not fully appreciate the information needs of accountants. *(4)*

(20)

Question 4

(a)

Operating profit or loss for the year to 31 March 2004

	£000
Decrease in profit and loss reserve (30 – 40)	(10)
+ Debenture interest (6 + 3)	9
+ Bank overdraft interest	4
+ Corporation tax for the year to 31 March 2003	2
	5
- Transfer from general reserve	40
Operating loss	(35)

(4)

(b)

Hartington Ltd
Cash flow statement for the year to 31 March 2004

Reconciliation of operating loss to net cash inflow from operating activities	**Working**	**£000**	
Operating loss		(35)	*½*
Depreciation charge	W1	90	*1*
Profit on disposal of tangible fixed assets (30 - 25)		(5)	*1*
Decrease in stocks (175 - 140)		35	*½*
Decrease in trade debtors (250 - 210)		40	*½*
Decrease in trade creditors (80 - 70)		(10)	*½*
Net cash inflow from operating activities		115	

	Working	**£000**	**£000**	
Cash flow statement				
Net cash inflow from operating activities			115	*½*
Returns on investments and servicing of finance				
Interest paid			(13)	*½*
Taxation (75 + 2)			(77)	*1*
Capital expenditure				
Purchase of tangible fixed assets	W1	(70)		*1*
Sale of tangible fixed assets		30	(40)	*½*
Equity dividends paid			(50)	*1*
			(65)	
Financing				
Issue of ordinary share capital (285 - 120)		165		*1*
Issue of debentures		100	265	*½*
Increase in cash during the year (130 + 70)			200	

(10)

Workings

W1 Tangible fixed assets	**£000**
Cost at 31/3/03	430
Cost of disposals	(100)
	330
Acquisitions year to 31/3/04 (derived figure)	70
Cost or valuation at 31/3/04	400
Accumulated depreciation at 31/3/03	160
Depreciation on disposals	(75)
	85
Depreciation year to 31/3/04 (derived figure)	90
Accumulated depreciation at 31/3/04	175

(c) The company's cash position has improved by £200,000 during the year to 31 March 2004 (ie an overdraft of £130,000 has been turned into a positive bank balance of £70,000). However, this apparently encouraging result looks rather less satisfactory if the cash flow statement for the year is scrutinised.

It is apparent from the cash flow statement that the company raised cash of £115,000 during the year from its operating activities. Much of this was obtained by reducing stocks and debtors, but without further information it is impossible to say whether these reductions were caused by increased efficiency or by a downturn in the company's trade. However, all of the cash raised from the company's operations was spent on paying the previous year's dividends and tax. The £40,000 investment in fixed assets and the need to service the company's debts left a cash deficit of £65,000.

The deficit of £65,000 has been turned into a surplus of £200,000 by means of extra financing. £165,000 was raised by means of a share issue and a further £100,000 was raised from debenture loans. *(4)*

(d) The Statement of Principles states that one of the functions of accounting is to provide information about an entity's "financial adaptability", which is defined as "*its ability to take effective action to alter the amount and timing of its cash flows so that it can respond to unexpected needs or opportunities*". The cash flow statement provides this information. *(2)*

(20)

Question 5

(a) The Companies Acts 1985 and 1989 requires companies to disclose certain specified information in their financial statements and to present those statements in a prescribed format. However, compliance with company law does not prevent companies from employing a wide variety of accounting treatments in relation to many of the items shown in their financial statements.

The purpose of accounting standards is to provide guidance as to how companies should treat various items in their financial statements. Some standards are prescriptive, requiring all relevant companies to adopt a specified accounting treatment. Others provide a range of acceptable treatments and require companies to disclose the chosen approach. Accounting standards are in effect an attempt to "standardise" accounting so that comparability is achieved and the deliberate distortion of financial information becomes impossible.

Company law requires that financial statements should show a "true and fair" view and that any material departures from accounting standards should be explained. Furthermore, it is generally agreed that financial statements which do not comply with accounting standards cannot (by virtue of that fact) show a true and fair view. Therefore, although the standards are not actually enshrined in law, they have a quasi-legal impact on financial reporting. *(3)*

(b) The main bodies involved in the standard-setting process are:

- the Financial Reporting Council (FRC) *1*
- the Accounting Standards Board (ASB) *2*
- the sub-committees of the ASB, including the Committee on Accounting for Smaller Entities (CASE) and the Urgent Issues Task Force (UITF) *2*
- the Financial Reporting Review Panel (FRRP). *2*

(marks awarded for identifying each body and outlining the functions of each)
(7)

(c) Accounting concepts (or conventions) which might be regarded as especially important include:

(i) The FRS18 "pervasive concepts"

- going concern
- accruals (or matching)

(ii) Concepts required by the Companies Act 1985

- going concern
- accruals (or matching)
- separate determination
- consistency } now regarded by the ASB as subsidiary to the
- prudence } characteristics of comparability and reliability

(iii) Other concepts referred to in the Statement of Principles

- materiality

- substance over form
- neutrality or objectivity

(iv) Other concepts traditionally adopted by accountants:

- historical cost
- realisation
- business entity
- money measurement
- stable monetary unit

2 marks per concept including a valid explanation and example (10)

(20)

Question 6

Even though accounting ratios are not mentioned in the question, the obvious approach is to conduct a ratio analysis insofar as the information permits. The list of ratios given below is fairly comprehensive although marks would be awarded for alternative ratios if relevant.

		ABC plc	
ROCE	1,020 ÷ 6,460 x 100	*15.8%*	½
GPP	1,570 ÷ 7,250 x 100	*21.7%*	½
NPP	610 ÷ 7,250 x 100	*8.4%*	½
Current ratio	2,370 ÷ 1,180	*2.0*	½
Quick assets ratio	1,220 ÷ 1,180	*1.0*	½
Fixed asset turnover	7,250 ÷ 5,270	*1.4*	½
Stock holding period	1,150 ÷ 5,680 x 365	*74 days*	½
Debtor collection period	1,190 ÷ 7,250 x 365	*60 days*	½
Creditor payment period	940 ÷ 5,680 x 365	*60 days*	½
Gearing ratio	2,000 ÷ 6,460 x 100	*31.0%*	½

		XYZ plc	
ROCE	1,050 ÷ 8,490 x 100	*12.4%*	½
GPP	1,700 ÷ 8,470 x 100	*20.1%*	½
NPP	580 ÷ 8,470 x 100	*6.8%*	½
Current ratio	4,140 ÷ 2,090	*2.0*	½
Quick assets ratio	1,730 ÷ 2,090	*0.8*	½
Fixed asset turnover	8,470 ÷ 6,440	*1.3*	½
Stock holding period	2,410 ÷ 6,770 x 365	*130 days*	½
Debtor collection period	1,720 ÷ 8,490 x 365	*74 days*	½
Creditor payment period	1,690 ÷ 6,770 x 365	*91 days*	½
Gearing ratio	2,500 ÷ 8,490 x 100	*29.4%*	½

(10)

Report structure

The report should provide information on the relative profitability, liquidity, efficiency and gearing of the two companies, ideally referring to an index containing the calculations given above. There should also be a section highlighting the limitations of the analysis and indicating any further information required. Marks will be awarded for presentation as well as content. *2*

Comparison of the two companies

- On all measures, ABC plc is significantly more profitable than XYZ plc.

- Even though each company has the same current ratio, the quick assets ratios show that XYZ plc is more likely to be experiencing liquidity problems than ABC plc. The creditor payment period of XYZ plc may also indicate this, assuming that the figure is reliable (see below).

- ABC plc seems to be the more efficient company, certainly in terms of stock control and credit control. The creditor payment period has had to be computed with reference to cost of sales (rather than purchases) and so may not be entirely reliable.

- Both companies have roughly the same level of gearing. However, if XYZ plc is experiencing liquidity problems, the company may need to obtain further loan finance and so become higher-geared.

- On the basis of this extremely brief analysis, ABC plc would seem to be the better investment. However, one point in favour of XYZ plc is that the company is paying a dividend to its shareholders, whereas ABC plc is not. Dividend policy could be important to a retired investor who may be seeking an income from his investment. *4*

Limitations and further information

- The accounts are highly summarised. More detailed accounts would provide a basis for a more thorough analysis.

- It is unwise to place too much reliance on a single year's figures. It is far better to review several year's figures and look for trends. Accounts for (say) the last 5 years would be useful, together with business plans/projections for the future.

- The effect of differing accounting policies on the figures shown in the financial statements may invalidate the results of the ratio analysis. A statement of accounting policies for each company would be useful.

- Balance sheet figures might not be typical or representative and this could lead to distorted ratios. Yearly average figures (eg for items such as stock) would provide a better basis for the analysis.

- Industry average figures would be helpful and might indicate that there are other companies in the same sector which would prove a better investment. *4*

(10)

(20)