FINANCIAL ACCOUNTING

December 2004
Certificate Stage

MARKING SCHEME

Question 1

(a)

Jefferson Ltd
Profit and Loss Account for the year to 30 June 2004

	Working	£	£	
Turnover:				
Continuing operations		826,600		
Acquisitions		233,650		
		1,060,250		
Discontinued operations		102,000	1,162,250	*1*
Cost of sales (164,220 + 412,280 - 187,340)			389,160	*½*
Gross profit			773,090	
Distribution costs	W1	202,160		*1*
Administrative expenses	W2	339,470	541,630	*3*
Operating profit				
Continuing operations	W3	176,910		
Acquisitions	W3	64,250		
		241,160		
Discontinued operations	W3	(9,700)	231,460	*1*
Loss on disposal of discontinued operation			52,500	*½*
			178,960	
Income from fixed asset investments			2,640	*½*
			181,600	
Interest payable			2,460	*½*
Profit before taxation			179,140	
Taxation (35,000 - 2,330)			32,670	*1*
Profit for the financial year			146,470	
Dividends (12,500 + 20,000)			32,500	*1*
Retained profit for the year			113,970	

Jefferson Ltd
Balance Sheet as at 30 June 2004

	Working	£	£	£	
Fixed assets					
Tangible assets					
Freehold property			500,000		*½*
Motor vehicles	W4		33,390		*1*
Office equipment	W4		20,770	554,160	*1*
Investments				35,000	*½*
				589,160	
Current assets					
Stock			187,340		*½*
Debtors					
Trade debtors		135,670			
Prepayments		3,000	138,670		*½*
			326,010		
Creditors due within one year					
Bank overdraft		27,440			
Trade creditors		83,290			
Other creditors	W5	55,000			
Accruals		5,100	170,830		*2*
Net current assets				155,180	
Total assets less current liabilities				744,340	
Capital and reserves					
Called-up share capital				250,000	*½*
Revaluation reserve				150,000	*½*
Profit and loss account	W6			344,340	*1*
				744,340	

(18)

(b)

Jefferson Ltd
Statement of total recognised gains and losses
for the year to 30 June 2004

	£	
Profit for the financial year	146,470	*1*
Unrealised surplus on revaluation of freehold property	150,000	*1*
Total gains and losses recognised since last annual report	296,470	

(2)

(20)

Workings

W1 Distribution costs	£
Per trial balance	192,050
Motor vehicles depreciation (W4)	10,110
	202,160

W2 Administrative expenses	£
Per trial balance	257,550
Directors' fees	120,000
Motor vehicles depreciation (W4)	4,200
Office equipment depreciation (W4)	12,680
Interest payable	(2,460)
Loss on sale of discontinued operation	(52,500)
	339,470

W3 Operating profit	Continuing	Acquisitions	Discontinued
	£	£	£
Turnover	826,600	233,650	102,000
Cost of sales	(226,260)	(85,400)	(77,500)
Distribution costs	(142,160)	(46,800)	(13,200)
Administrative expenses	(281,270)	(37,200)	(21,000)
Operating profit	176,910	64,250	(9,700)

W4 Fixed assets	£	£
Motor vehicles at cost		85,800
Depreciation to 30/6/03	38,100	
Depreciation for year (30% x (85,800 - 38,100))	14,310	52,410
Net book value		33,390

Note:
Depreciation on the MD's car is 30% x 70% x 20,000 = £4,200.

Office equipment at cost		63,400
Depreciation to 30/6/03	29,950	
Depreciation for year (20% x 63,400)	12,680	42,630
		20,770

W5 Other creditors	£
Corporation tax	35,000
Proposed dividends	20,000
	55,000

W6 Profit and loss account	£
Per trial balance	230,370
Retained profit for the year	113,970
	344,340

Question 2

(a)

Plant and machinery at cost

		£			£	
1/10/03	Balance b/d	66,000				½
1/7/04	Bank	11,250				½
			1/7/04	Disposal	9,750	½
			30/9/04	Balance c/d	67,500	
		77,250			77,250	
1/10/04	Balance b/d	67,500				

Provision for depreciation of plant and machinery

		£			£	
			1/10/03	Balance b/d	29,720	½
1/7/04	Disposal	5,460				*1*
			30/9/04	P & L a/c	10,620	
30/9/04	Balance c/d	34,880				
		40,340			40,340	
			1/10/04	Balance b/d	34,880	

Disposal of plant and machinery

		£			£	
1/7/04	Office equipment	9,750				
			1/7/04	Prov'n for dep'n	5,460	
			1/7/04	Bank	4,000	
			30/9/04	P & L a/c	290	½
		9,750			9,750	

Notes:

(i) In effect, the depreciation policy is 16% pa straight line.
(ii) Accumulated depreciation on the sold plant is £9,750 x 16% x 3.5 = £5,460.
(iii) The depreciation charge for the year is as follows:

		£	
Plant owned all year	16% x (66,000 - 9,750)	9,000	½
Plant bought in year	16% x 11,250 x 3/12	450	½
Plant sold in year	16% x 9,750 x 9/12	1,170	½
		10,620	

(5)

(b)

Telephone

		£			£	
1/10/03	Prepayment b/d	400	1/10/03	Accrual b/d	1,730	*1*
30/9/04	Bank	7,490				½
			30/9/04	P & L a/c	7,370	
	Accrual c/d	1,660		Prepayment c/d	450	*1*
		9,550			9,550	
1/10/04	Prepayment b/d	450	1/10/04	Accrual b/d	1,660	

Bank interest receivable

		£			£	
1/10/03	Accrual b/d	2,850				½
			30/9/04	Bank	16,940	½
				Accrual c/d	3,420	½
30/9/04	P & L a/c	17,510				
		20,360			20,360	
1/10/04	Accrual b/d	3,420				

(4)

(c)

Journal

	Dr £	Cr £	
1 October 2003			
Bank	210,000		*1*
Share capital		150,000	*1*
Share premium account		60,000	*1*
An issue of 150,000 ordinary shares at a premium of 40p per share			½
1 August 2004			
Share premium account	70,000		*1*
Share capital		70,000	*1*
A bonus issue of 70,000 ordinary shares financed out of the share premium account.			½

(6)

(d)

Journal

	Dr £	Cr £	
Suspense	6,820		*1*
Sales returns		3,410	½
Purchase returns		3,410	½
Suspense	100		½
Debtors		100	½
Purchases	1,270		½
Suspense		1,270	½

The suspense account has been debited with £6,920 and credited with £1,270, reducing the opening credit balance of £5,650 to nil. *1*

(5)

(20)

Question 3

(a)

Jones, Kumar and Lee
Appropriation account for the year to 31 October 2004

		£	£	
Net profit for the year:			81,970	
Add: Interest on drawings				
Jones	7% x £40,000 x 6/12	1,400		
Kumar	7% x £32,000 x 6/12	1,120		
Lee	7% x £6,000 x 6/12	210	2,730	*1*
			84,700	
Less: Interest on capital				
Jones	5% x £50,000	2,500		
Kumar	5% x £30,000	1,500		
Lee	5% x £10,000	500	4,500	*1*
			80,200	
Less: Partners' salaries				
Kumar		5,000		
Lee		12,000	17,000	*1*
			63,200	
Less: Profit shares				
Jones	50%	31,600		
Kumar	40%	25,280		
Lee	10%	6,320	63,200	*1*

(4)

(b)

Partners' capital accounts

	Jones	*Kumar*	*Lee*		*Jones*	*Kumar*	*Lee*	
	£	**£**	**£**		**£**	**£**	**£**	
				Balance b/d	50,000	30,000	10,000	*1*

Partners' current accounts

	Jones	*Kumar*	*Lee*		*Jones*	*Kumar*	*Lee*	
	£	**£**	**£**		**£**	**£**	**£**	
Balance b/d			590	Balance b/d	16,320	1,110		*1*
				Int capital	2,500	1,500	500	*1*
				Salaries		5,000	12,000	*1*
				Profit share	31,600	25,280	6,320	*1*
Drawings	40,000	32,000	6,000					*1*
Int drawings	1,400	1,120	210					*1*
Balance c/d	9,020		12,020	Balance c/d		230		
	50,420	33,120	18,820		50,420	33,120	18,820	
Balance b/d		230		Balance b/d	9,020		12,020	

(7)

(c) If each partner has a fixed capital account (showing the amount of capital which was introduced by that partner) plus a current account (showing profit allocations and drawings made against those profits) it becomes easier to see whether a partner has drawn out more than his or her share of the partnership's profits. If so, that partner's current account will show a debit balance. *(2)*

(d) In the absence of a partnership agreement (express or implied) the Partnership Act 1890 states that:

- profits and losses are to be shared equally between the partners *1*
- there will be no interest on capital *½*
- there will be no interest on drawings *½*
- there will be no partners' salaries *½*
- partners who lend money to the partnership in excess of their agreed capital are entitled to interest on the loan at 5% per annum. *½*

(3)

(e) Advantages of forming a partnership rather than operating as a sole trader:

- An increased amount of capital is available, so it becomes possible to establish larger businesses. *1*
- The risks and responsibilities of business ownership are shared rather than being borne by one person. *½*
- Partners may bring complementary skills or qualities to the partnership. *½*

Disadvantages of forming a partnership:

- In general, a partnership may have no more than 20 partners. *½*
- Partners may disagree on business policy. *½*
- Each partner is legally bound by the acts of all of the other partners and can be held individually responsible for all of the partnership's debts. In general there is no limit to a partner's liability, but certain partners may be limited partners (under the Limited Partnership Act 1907) and the Limited Liability Partnership Act 2000 now allows partners to enjoy limited liability. *1*

(4)

(20)

Question 4

(a) The main purpose of accounting standards is to introduce a degree of uniformity into financial statements. Some of the standards prescribe a standard accounting treatment of the relevant items, so ensuring that all companies deal with these items in the same way. Others allow companies a choice of accounting treatments but require disclosure of the treatment adopted.

Accounting standards improve the comparability of financial statements and make it more likely that financial statements will show a true and fair view. *(2)*

(b) *Item 1*

Accounting standard FRS15 (Tangible fixed assets) requires that the estimated useful life and residual value of tangible fixed assets should be reviewed at the end of each accounting period. If expectations are significantly different from previous estimates, the change should be accounted for over the remainder of the asset's useful life. *1*

Depreciation of £30,000 will have been charged in each of the years to 31 August 2002 and 2003, giving a written-down value of £190,000 on 1 September 2003. This amount (less a residual value of £50,000) must now be written off over the next two years, giving an annual depreciation charge of £70,000. Therefore the profit and loss account for the year to 31 August 2004 should show depreciation of £70,000. *2*

The effect of this change should be disclosed in the notes to the accounts. *1*

Item 2

If a tangible fixed asset with a finite useful life is revalued, accounting standard FRS15 requires that the revalued amount should be depreciated over the remainder of the asset's useful life. *1*

The land (which is not depreciable) should be shown at its valuation of £650,000 and the surplus on revaluation (£250,000) should be credited to a revaluation reserve. *1*

The buildings cost £350,000 and depreciation of £7,000 will have been charged in each of the ten years to 31 August 2003, giving a written-down value on 1 September 2003 of £280,000. The buildings are revalued at £300,000, giving a surplus on revaluation of £20,000, which should be credited to a revaluation reserve. The revalued amount should then be depreciated over the remaining 40 years of the buildings' useful life. Therefore the profit and loss account for the year to 31 August 2004 will show depreciation of £7,500. *2*

Item 3

Accounting standard SSAP13 (Accounting for research and development) requires that expenditure on pure or applied research should be written off to the profit and loss account. Therefore the expenditure of £160,000 must be shown as an expense in the company's profit and loss account for the year to 31 August 2004. *1*

However, subject to certain conditions, development expenditure may be capitalised and then amortised over its useful life. These conditions are:

(i) There is a clearly defined development project.
(ii) The expenditure concerned is separately identifiable.
(iii) There is reasonable certainty that the project is technically feasible and commercially viable.
(iv) Adequate resources are available to complete the project (or there is a reasonable expectation that such resources will become available).
(v) There is a reasonable expectation that future revenues from the project will be sufficient to cover the total development costs to date, plus any further development costs, plus the costs of production, selling and administration. *2*

If these conditions are satisfied (and if it is the company's policy to capitalise development expenditure whenever possible) the expenditure of £360,000 may be capitalised and then amortised over the expected useful life of the new product. *1*

Item 4

Accounting standard SSAP9 (Stocks and long-term contracts) requires that stock is valued at the lower of cost and net realisable value. *1*

The cost of this stock is £172,400. Its net realisable value is £198,000 (£260,000 - £50,000 - £12,000). The lower of cost and NRV is £172,400 so the stock should be shown at this figure in the balance sheet at 31 August 2004. *1*

(14)

(c) Accounting standard FRS15 allows companies to revalue tangible fixed assets rather than showing the assets at historical cost. However, if such a policy is adopted it must be applied consistently to all assets of the same class and the valuations must be kept up-to-date. *1*

This is generally achieved by a five-yearly full valuation by a qualified external valuer, with an interim valuation in year 3 (and further interim valuations in the other intervening years if it is likely that there has been a material change in value). The interim valuations may be performed by a qualified internal or external valuer. *1*

(2)

(d) With the exception of non-depreciable land, tangible fixed assets should be depreciated over their useful economic lives. However, if the useful economic life of an asset is very long (or its residual value is very high) the depreciation charge for a period may be immaterial. In this case, it is permissible not to charge depreciation. However, impairment reviews must be carried out at the end of each period for such assets and for all assets with a remaining useful life exceeding 50 years. *(2)*

(20)

Question 5

(a)

		31/3/03	
Profitability:			
Gross profit percentage	1,630 ÷ 4,640 x 100	*35.1%*	½
Operating profit to sales	780 ÷ 4,640 x 100	*16.8%*	½
ROCE	780 ÷ 3,920 x 100	*19.9%*	½
Liquidity:			
Current ratio	1,450 ÷ 980	*1.5*	½
Quick assets ratio	940 ÷ 980	*0.96*	½
Efficiency:			
Stock holding period	510 ÷ 3,010 x 365	*62 days*	½
Debtor collection period	630 ÷ 3,480 x 365	*66 days*	½
Creditor payment period	600 ÷ 3,010 x 365	*73 days*	½

		31/3/04	
Profitability:			
Gross profit percentage	2,040 ÷ 6,420 x 100	*31.8%*	½
Operating profit to sales	740 ÷ 6,420 x 100	*11.5%*	½
ROCE	740 ÷ 5,910 x 100	*12.5%*	½
Liquidity:			
Current ratio	2,160 ÷ 1,440	*1.5*	½
Quick assets ratio	1,270 ÷ 1,440	*0.88*	½
Efficiency:			
Stock holding period	890 ÷ 4,380 x 365	*74 days*	½
Debtor collection period	1,120 ÷ 4,815 x 365	*85 days*	½
Creditor payment period	1,090 ÷ 4,380 x 365	*91 days*	½

<u>Note</u>: Other valid ratios and/or means of calculation will be given credit.

(8)

(b) Profitability:

- The GPP has decreased by 3.3% (nearly one-tenth). This is likely to be caused by a deliberate price-cutting policy, hence the large increase in turnover. If this is not the reason, then other possibilities include understatement of the closing stock at 31 March 2004 or misappropriation of sale proceeds. *1*

- The ratio of operating profit to sales has fallen by 5.3% (nearly one-third). Part of this fall is caused by the fall in GPP. The remainder is caused by a disproportionate rise in administrative expenses, which do not seem to be under control. *1*

- ROCE has fallen by 7.4% (over one-third). This is caused by a large rise in capital employed which is not matched by a rise in operating profit. Even if the effect of the revaluation is removed from the calculation, ROCE has still fallen to 14.5% (a fall of over one-quarter). It would appear that the extra £1 million of loan capital raised at the start of the year has not (yet) yielded extra profits. *1*

Liquidity:

- The current ratio is unchanged and the quick assets ratio has decreased by 0.08% (about one-tenth). Whilst the liquidity ratios for 2004 are not much different from their 2003 equivalents, it is noticeable that the company now has far less cash than it had a year ago, despite borrowing £1 million during the year. It seems that all of the extra borrowings have been spent (mainly on fixed assets). The ratio of cash to trade creditors is far worse than in 2003 and the company may be experiencing liquidity problems, hence the rise in creditor payment period (see below). *2*

Efficiency:

- The stock holding period (which had to be computed using closing stocks, since the opening stock figure at 1 April 2002 was not given) has increased by 12 days. This may be the result of a deliberate policy of holding larger stocks so as to improve customer satisfaction. On the other hand, it may be the result of poor stock control. *1*

- The debtor collection period has increased by 19 days. This may be the result of a deliberate policy of offering customers longer credit. On the other hand, it may be the result of poor credit control. *1*

- The creditor payment period (which had to be computed using cost of sales figures, since purchases figures were not given) has increased by 18 days. This is likely to be caused by the company's inability to pay its creditors more quickly, given the adverse effect on cash flow caused by the increases in stock holding and debtor collection periods. *1*

This analysis is restricted for the following main reasons:

- Only two years' data is available. Trends are more likely to emerge if several years' accounts are analysed.

- Accounting policies have not been disclosed (other than the policy of revaluing one class of fixed assets). For example, if the stock valuation policy has changed between the two years, this could account for some of the changes noted above.

- Annual average figures are not available, so that several of the ratio calculations have had to be calculated using year-end figures, which might not be representative.

- Industry average figures are not available, so it is not possible to compare the company with similar companies in the same sector of industry. *2*

(10)

(c) The gearing ratio at 31 March 2003 is 25.5% (1,000/3,920 x 100). The equivalent figure at 31 March 2004 is 33.8% (2,000/5,910 x 100). Therefore the company is more highly geared than it was previously. *1*

<u>Note</u>: Other valid definitions of the capital gearing ratio will be given credit.

Higher gearing means that a greater proportion of the company's long-term funds is now supplied by lenders rather than shareholders. From the shareholders' point of view, higher gearing means a riskier investment. If profits decrease, the need to pay loan interest will result in a disproportionately large decrease in the profits available for shareholders.

In a very high-geared company (which Jupiter Ltd is not) the need to service debt may become paramount and the welfare of shareholders may become secondary. *1*

(2)

(20)

Question 6

(a) The main function of accounting is to provide economic information to the users of that information. In general terms, this involves the following activities:

- collecting, measuring and recording economic data relating to an organisation (this is often referred to as book-keeping). *1*
- processing this data so as to produce useful economic information which meets users' needs. *1*
- communicating this information to users and (if necessary) interpreting or analysing the information and explaining its meaning. *1*

Financial accounting is concerned with providing information to owners, investors and other external users (eg lenders, the tax authorities). This information takes the form of a set of financial statements, usually prepared annually, providing information mainly about the organisation's financial performance and financial position. The objective of the financial statements to help users assess the stewardship of management and make better economic decisions. *2*

(5)

(b) Some of the main influences on the development of accounting in the next few years seem likely to include:

- the ever-increasing use of computer systems for collecting, storing, processing and communicating information *1*
- use of the Internet as a tool for the dissemination of information *1*
- the breaking down of international barriers (especially in Europe), the development of a common currency and the move towards the adoption of international accounting standards for EU listed companies in 2005 *1*
- recognition that large powerful corporations may have a significant impact on the environment and on society as a whole, possibly requiring accounting to report on environmental and social matters as well as financial matters *1*
- the development of new methods of accounting for public sector bodies. *1*

1 mark per valid point up to a maximum of (5)

(c) The qualitative characteristics which should be possessed by financial information are identified in the Statement of Principles as:

(i) materiality *1*

(ii) relevance: *1*

- predictive
- confirmatory *½*

(iii) reliability: *1*

- faithful representation *½*
- neutrality *½*
- freedom from material error *½*
- completeness *½*
- exercise of prudence *½*

(iv) comparability: *1*

- consistency *½*
- disclosure *½*

(v) understandability: *1*

- aggregation and classification *½*
- capabilities of users. *½*

Marks given for identification and explanation of each characteristic (10)

(20)