FINANCIAL ACCOUNTING

December 2005
Certificate Stage

MARKING SCHEME

CIPFA

Question 1

(a)

Saturn Ltd
Profit and Loss Account for the year to 30 September 2005

	Working	£	£	
Turnover (875,440 - 31,490)			843,950	*½*
Cost of sales	W1		499,240	*1*
Gross profit			344,710	
Distribution costs	W2	141,360		*2*
Administrative expenses	W3	292,370	433,730	*3*
			(89,020)	
Other operating income			20,000	*½*
Operating loss			(69,020)	
Interest payable			9,420	*½*
Loss before taxation			(78,440)	
Taxation			880	*½*
Loss for the financial year			(77,560)	
Dividends			5,000	*½*
Retained loss for the year			(82,560)	

Saturn Ltd
Balance Sheet as at 30 September 2005

	Working	£	£	£	
Fixed assets					
Freehold land				150,000	*½*
Freehold buildings	W4			210,000	*1*
Motor vehicles	W4			31,520	*1*
Office equipment	W4			27,000	*1*
				418,520	
Current assets					
Stock	W1		89,120		*1*
Trade debtors (85,500 x 96%)			82,080		*½*
Prepayments			3,920		*½*
			175,120		
Creditors due within one year					
Trade creditors		121,660			*½*
Bank overdraft		15,330			*½*
Accruals		12,400	149,390		*½*
Net current assets				25,730	
Total assets less current liabilities				444,250	
Creditors due after more than one year					
Debenture loans				100,000	*½*
				344,250	
Capital and reserves					
Called-up share capital				50,000	*½*
Revaluation reserve				50,000	*½*
Profit and loss account	W6			244,250	*1*
				344,250	

(18)

(b)

Journal

	Dr	Cr
	£	**£**
Bank	30,000	
Share capital		25,000
Share premium account		5,000

A fully subscribed rights issue of 25,000 ordinary shares at a premium of 20p per share

(2)

(20)

Workings

W1 Cost of sales	**£**
Opening stock	95,580
Purchases	510,110
Returns outwards	(17,330)
Closing stock (89,370 - 250)	(89,120)
	499,240

W2 Distribution costs	**£**
Per trial balance	95,200
Buildings depreciation (W4)	1,250
Motor vehicles depreciation (W4)	12,600
Wages and salaries (1/3 x 96,930)	32,310
	141,360

W3 Administrative expenses	**£**
Per trial balance	152,060
Directors' remuneration	45,000
Buildings depreciation (W4)	3,750
Motor vehicles depreciation (W4)	8,400
Office equipment depreciation (W4)	18,000
Loss on disposal of office equipment (W4)	1,080
Wages and salaries (2/3 x 96,930)	64,620
Reduction in provision for doubtful debts (W5)	(540)
	292,370

W4 Fixed assets

	£	£
Buildings at cost		250,000
Depreciation to 30/9/04	35,000	
Depreciation for year (2% x 250,000)	5,000	40,000
Net book value		210,000
Motor vehicles at cost		105,000
Depreciation to 30/9/04	52,480	
Depreciation for year (20% x 105,000)	21,000	73,480
		31,520
Office equipment at cost (77,380 - 5,000)		72,380
Depreciation to 30/9/04 (31,300 - 3,920)	27,380	
Depreciation for year (40% x 45,000)	18,000	45,380
		27,000

Note: WDV of scrapped item = 60% x 60% x 60% x £5,000 = £1,080, so accumulated depreciation is £3,920.

W5 Provision for doubtful debts

	£
Per trial balance	3,960
4% x 85,500	3,420
Reduction for the year	540

W6 Profit and loss account

	£
Per trial balance	326,810
Retained loss for the year	82,560
	244,250

Question 2

(a)

Sales ledger control account

	£		£
Balance b/d	7,450	Sales returns (2,310 + 129)	2,439
Sales	70,099	Cash received (66,151 - 27)	66,124
(69,228 + 1,000 - 129)		Discounts allowed	1,754
		Bad debts (520 + 235)	755
		Purchase ledger contras	227
		Balance c/d	6,250
	77,549		77,549
Balance b/d	6,250		

1 mark for each error corrected. Maximum mark of 6

Reconciliation to list of ledger balances	*Subtract* £	*Add* £	
Total of original list		7,287	*½*
Sales return posted to wrong side of a/c	258		*1*
Sale posted to wrong side of a/c		100	*1*
Further bad debt written off	235		*½*
Credit balance treated as debit balance	680		*1*
Discount incorrectly posted		9	*½*
Cash received incorrectly recorded		27	*½*
	1,173	7,423	
		1,173	
		6,250	

(11)

(b) Three ways in which a credit balance might arise on a customer's ledger account are:

- the customer makes a payment which exceeds the balance which is outstanding on the account
- the customer pays the account in full and then receives a credit note
- the customer pays in advance, before an invoice is issued.

1 mark per valid point up to a maximum of 3

(c) The main purposes of maintaining a sales ledger control account include:

- to check the accuracy of the underlying sales ledger
- to ensure that errors in the sales ledger do not cause the trial balance totals to disagree
- to allow a total debtors figure to be extracted rapidly if required.

1 mark per valid point up to a maximum of 3

(d) The opening provision is 2% x £7,450 = £149. The closing provision is 2% x £6,250 = £125, so the provision needs to be reduced by £24. The provision for doubtful debts account for the year is as follows:

Provision for doubtful debts

		£			**£**
			1/11/04	Balance b/d	149
31/10/05	P & L a/c	24			
	Balance c/d	125			
		149			149
			1/11/05	Balance b/d	125

(3)

(20)

Question 3

(a)

		30/11/04	
Profitability:			
ROCE	375 ÷ 2,065 x 100	*18.2%*	½
Gross profit percentage	840 ÷ 2,350 x 100	*35.7%*	½
Net profit percentage	270 ÷ 2,350 x 100	*11.5%*	½
Liquidity:			
Current ratio	725 ÷ 430	*1.7*	½
Quick assets ratio	315 ÷ 430	*0.7*	½
Efficiency:			
Stock holding period	410 ÷ 1,510 x 365	*99 days*	½
Debtor collection period	190 ÷ 1,175 x 365	*59 days*	½
Capital structure:			
Gearing ratio	50 ÷ 2,065 x 100	*2.4%*	½

		30/11/05	
Profitability:			
ROCE	345 ÷ 2,840 x 100	*12.1%*	½
Gross profit percentage	830 ÷ 2,940 x 100	*28.2%*	½
Net profit percentage	225 ÷ 2,940 x 100	*7.7%*	½
Liquidity:			
Current ratio	1,060 ÷ 720	*1.5*	½
Quick assets ratio	330 ÷ 720	*0.5*	½
Efficiency:			
Stock holding period	730 ÷ 2,110 x 365	*126 days*	½
Debtor collection period	330 ÷ 1,470 x 365	*82 days*	½
Capital structure:			
Gearing ratio	600 ÷ 2,840 x 100	*21.1%*	½

Note: These marks will also be awarded for acceptable alternative answers

(8)

(b) Each of the three profitability ratios shows a clear deterioration during the year to 30 November 2005:

- A substantial increase in capital employed (largely obtained by means of long-term loans) has not been matched by a corresponding increase in profit. In fact, profit after tax has actually fallen during the year. *1*

- Turnover has increased by about one-quarter but the gross profit has remained virtually unchanged and the gross profit percentage has fallen by approximately one-fifth. It may be that the company has attempted to stimulate turnover by reducing the prices charged to customers. If so, this policy has failed to improve profits. Alternatively, the company may have been charged higher prices by its suppliers and may have been unable or unwilling to pass these price increases on to its customers. *2*

- The net profit percentage has also fallen substantially (by about one-third). In part, this fall has been caused by the six-fold increase in interest payable. *1*

- Both of the liquidity ratios have deteriorated. Despite borrowing over half a million pounds during the year, the company has ended the year with an empty bank account and increased current liabilities. It would seem that most (if not all) of the amount borrowed has been used to fund a major investment in fixed assets. These assets may generate improved cash flows in the future but for now the company's liquidity position is noticeably worse than it was a year ago. *1*

- The stock-holding and debtor collection periods have also worsened during 2005. The company may be deliberately holding larger stocks and offering longer credit in the hope of attracting more customers. If so, this policy may have contributed to the rise in turnover during the year. On the other hand, the worsening of these ratios may be the result of declining efficiency in the areas of stock control and debtor control. In either case, the company is now taking substantially longer to turn stocks into cash, and this is a root cause of the deterioration in liquidity which is mentioned above. *2*

- The gearing ratio was extremely low in 2004 but has increased ten-fold in 2005. If further loans are needed in the future (to fund expansion or to cope with liquidity problems) the company may become high-geared, increasing the level of risk borne by the shareholders. *1*

(8)

(c) It is important that the results of a simple ratio analysis (like the one above) should not be relied upon until further information has been gathered. Such information might invalidate (or support) the initial conclusions drawn from the ratio analysis. In this instance, useful further information would include:

- a statement of accounting policies for each of the two years (Has the increase in fixed assets been caused by a revaluation? Has the increase in stocks been caused by a change in stock valuation method?) *1*

- year-average figures for balance sheet items (Did the increase in fixed assets occur only towards the end of the year, so that these assets have not yet had chance to contribute towards greater profits?) *1*

- detailed financial statements, so that a more thorough analysis can be made (Were there any exceptional items in the P & L account?) *1*

- corresponding figures for each of the last five years (so that trends can be identified) and industry-average figures. *1*

(4)

(20)

Question 4

(a)

Simone
Trading and Profit and Loss Account for the year to 30 June 2005

	Working	£	£	
Sales (£147,270 - £720 + £650)	W2		147,200	*1*
Cost of sales:				
Stock at 1 July 2004		15,330		*½*
Purchases (£99,990 - £7,410 + £7,510)		100,090		*1*
		115,420		
Stock at 30 June 2005 (balancing figure)		12,380	103,040	*½*
Gross profit (30% x £147,200)			44,160	*1*
Wages		9,220		*½*
Rent and rates (£12,430 + £1,840 - £1,930)		12,340		*1*
Insurance (£1,950 + £780 - £870)		1,860		*1*
Heat, light, telephone (£1,770 - £290 + £320)		1,800		*1*
Sundry expenses (£1,580 + £2,940)		4,520		*½*
Bank overdraft interest		160		*½*
Loan interest (£10,000 x 7% x 6/12 + £6,000 x 7% x 6/12)		560		*1*
Loss on disposal (£720 - £650)	W4	70		*½*
Depreciation	W4	1,720	32,250	*1*
Net profit for the year			11,910	
				(11)

(b)

Simone
Balance Sheet as at 30 June 2005

	Working		£	£	
Fixed assets					
Equipment (£8,600 - £5,440)	W4			3,160	*1*
Current assets					
Stock			12,380		*½*
Trade debtors			650		*½*
Prepayments			2,800		*½*
Cash in hand			300		*½*
			16,130		
Current liabilities					
Bank overdraft	W3	2,280			*1*
Trade creditors		7,510			*½*
Accruals		320	10,110		*½*
Net current assets				6,020	
				9,180	
Long-term loan				6,000	*½*
				3,180	
Capital					
As at 1 July 2004	W1			2,710	*2*
Net profit for the year				11,910	*½*
				14,620	
Drawings (£12,000 - £560)				11,440	*1*
				3,180	
					(9)
					(20)

Workings

W1 Opening capital	*Assets*	*Liabilities*
	£	**£**
Loan from mother		10,000
Cash float	300	
Bank balance		1,760
Equipment (8,000 x 40%)	3,200	
Stock of goods	15,330	
Debtors	720	
Creditors		7,410
Accruals		290
Prepayments	2,620	
	22,170	19,460
	19,460	
	2,710	

W2 Cash account

	£	£
Opening balance	300	
Received from customers (balancing figure)	147,270	
Wages		9,220
Drawings		12,000
Sundry expenses		1,580
Paid into bank account		124,470
Closing balance		300
	147,570	147,570

W3 Bank account

	£	£
Opening overdraft		1,760
Total receipts	125,120	
Total payments		125,640
Closing overdraft (balancing figure)	2,280	
	127,400	127,400

W4 Equipment

	£	£
Cost at 30 June 2004		8,000
Disposal		1,800
		6,200
Acquisition		2,400
Cost at 30 June 2005		8,600
Depreciation to 30 June 2004 (£8,000 x 60%)	4,800	
Disposal (£1,800 x 60%)	1,080	
	3,720	
Depreciation for year (20% x £8,600)	1,720	5,440
Net book value at 30 June 2005		3,160

Question 5

(a) **(i)** Initial measurement

A tangible fixed asset should initially be measured at its cost. This comprises the purchase price of the asset together with any further costs incurred so as to bring the asset into working condition for its intended use. Capitalisation of the finance costs (eg interest) associated with the acquisition of a tangible fixed asset is permitted, so long as this policy is applied consistently.

Subsequent expenditure on the asset should be capitalised if the expenditure provides an enhancement of the economic benefits to be derived from the asset. *(3)*

(ii) Depreciation

FRS15 defines depreciation as "*the measure of the cost or revalued amount of the economic benefits of a tangible fixed asset that have been consumed during the period*". The main requirements of the standard in relation to depreciation are: *1*

- All tangible fixed assets (apart from land) should be depreciated over their useful economic lives. *1*
- The depreciation method used should reflect as fairly as possible the usage pattern of the asset concerned. *1*
- If an asset is revalued, the revalued amount should be depreciated over the remainder of the asset's useful life. *1*
- The useful economic life and residual value of a tangible fixed asset should be reviewed at the end of each accounting period. If expectations are significantly different from previous estimates, the change should be accounted for prospectively over the remainder of the asset's useful life. *1*
- For each class of tangible fixed asset, the financial statements should disclose the depreciation method and rates used and the amount of depreciation charged for the period. The cost (or revalued amount), accumulated depreciation and written down value at the beginning and end of the period should also be disclosed. *1*

(6)

(iii) Valuation

FRS15 allows companies to revalue tangible fixed assets rather than showing the assets at historic 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. This is generally achieved by a five-yearly full valuation by a qualified external valuer, with an interim valuation in year 3. *(3)*

(b) UK standards are set by the Accounting Standards Board (ASB). When a new standard is being considered, the ASB may circulate a Discussion Draft (DD) to interested parties and invite comment on the matter concerned. A draft standard known as a Financial Reporting Exposure Draft (FRED) may then be published and further comment invited before the final Financial Reporting Standard (FRS) is issued. *(3)*

(c) The main role of the International Accounting Standards Board is to work towards international harmonisation of accounting standards. Standards issued by the IASB used to be referred to as International Accounting Standards (IAS). Recent standards are referred to as International Financial Reporting Standards (IFRS).

With increasing globalisation of the economy, the aim of the IASB is to work towards the situation in which all companies adopt the same set of accounting rules, no matter where in the world those companies are located.

Some countries (mainly those without their own national standards) have adopted IAS/IFRS, whilst other countries allow companies to use the international standards rather than domestic ones. All EU listed companies (including UK listed companies) must now use IAS/IFRS and all UK unlisted companies are now permitted to use international standards if they wish.

A process of convergence between UK national standards and international standards is underway and it seems inevitable that this process will eventually lead to the point where UK standards are identical to international ones. *(5)*

(20)

Question 6

(a)

Cashbook

	£		£	
		Balance b/d	6,476	½
		Interest and charges (1)	129	½
Capital account (3)	815			½
Debtors (5)	1,000			½
		Debtors (6)	230	½
Casting error (7)	10			½
Balance c/d	5,010			
	6,835		6,835	
		Balance b/d	5,010	

Bank reconciliation

	£	
Cash at bank per statement (derived)	3,243	*1*
Unpresented cheques (2)	17,693	½
	(14,450)	
Outstanding lodgements (4)	9,440	½
Overdraft per cashbook	(5,010)	

(5)

(b)

FIFO

	No. of litres			*Cost (£)*	
Sold 10 April	600	600 @ £1.50			
Sold 25 May	1,100	400 @ £1.50			
		700 @ £1.60			
Sold 9 August	1,300	300 @ £1.60			
		1,000 @ £1.70			
Stock 31 August	500	500 @ £1.70		**£850**	*3*

LIFO

	No. of litres			*Cost (£)*	
Sold 10 April	600	600 @ £1.50			
Sold 25 May	1,100	1,000 @ £1.60			
		100 @ £1.50			
Sold 9 August	1,300	1,300 @ £1.70			
Stock 31 August	500	300 @ £1.50	450		
		200 @ £1.70	340	**£790**	*3*

AVCO

	No. of litres		*Cost (£)*	*Weighted average cost per unit*	
Bought 8 March	1,000	@ £1.50	1,500	£1.50	
Sold 10 April	600		900		
	400		600		
Bought 11 May	1,000	@ £1.60	1,600		
	1,400		2,200	£1.57	
Sold 25 May	1,100		1,729		
	300		471		
Bought 4 July	1,500	@ £1.70	2,550		
	1,800		3,021	£1.68	
Sold 9 August	1,300		2,182		
Stock 31 August	500		**£839**		*4*

(10)

(c) Accounting standard SSAP9 states that stocks should normally be valued at the lower of cost and net realisable value. Ideally, the cost of each individual stock item should be ascertained and then these individual costs should be aggregated to give a total cost figure.

However, the standard accepts that it is sometimes impossible to relate expenditure to specific units of stock (eg if a number of identical items have been purchased at different times) and that it will be necessary in these cases to select an appropriate method for calculating the cost of stock. The method chosen should provide the fairest practicable approximation to cost.

Allowable methods include FIFO and AVCO. However, the standard states that LIFO is "not usually appropriate" because it often results in stocks being valued at amounts which bear little relationship to recent cost levels (so giving a misleading presentation of current assets). The LIFO method may be used only if the circumstances of the company require the adoption of this method in order for the accounts to show a true and fair view. *(5)*

(20)