FINANCIAL ACCOUNTING

Certificate stage examination

5 June 2007

MARKING SCHEME

AT THE HEART OF YOUR CAREER

Question 1

(a)

Walrus plc
Income statement for the year to 31 March 2007

	Working	£000	
Sales revenue		1,432	½
Cost of sales	W1	476	½
Gross profit		956	
Other income		30	½
Distribution costs	W2	(229)	*2*
Administrative expenses	W3	(601)	*4*
Finance costs		(9)	½
Profit before taxation		147	
Taxation (30 - 6)		24	*1*
Profit for the period		123	

(9)

(b)

Walrus plc
Balance Sheet as at 31 March 2007

	Working	£000	£000	
Non-current assets				
Property, plant and equipment	W4		603	*4*
Goodwill			300	½
			903	
Current assets				
Inventory		119		½
Trade receivables (183 - 8 - 7)		168	287	*1*
Total assets			1,190	
Equity				
Share capital		200		
Other reserves		180		
Retained earnings		606	986	½
Current liabilities				
Trade and other payables		117		½
Short-term borrowings		57		½
Current tax payable		30	204	½
Total equity and liabilities			1,190	

(8)

(c) **Walrus plc**

Statement of changes in equity for the year to 31 March 2007

	Share capital £000	Other reserves £000	Retained earnings £000	Total equity £000	
Balance at 31 March 2006	200	-	503	703	
Valuation gain		180		180	
Profit for the period			123	123	
Dividend paid			(20)	(20)	
Balance at 31 March 2007	200	180	606	986	*(3)*

(20)

Workings

W1 Cost of sales	**£000**
Opening inventory	107
Purchases	488
Closing inventory	(119)
	476

W2 Distribution costs	**£000**
Per trial balance	101
Wages and salaries (25%)	69
Buildings depreciation (W4)	5
Equipment depreciation (W4)	12
Vehicles depreciation (W4)	42
	229

W3 Administrative expenses	**£000**
Per trial balance	186
Bank overdraft interest	(9)
Directors' fees	150
Wages and salaries (75%)	207
Buildings depreciation (W4)	5
Equipment depreciation (W4)	36
Vehicles depreciation (W4)	18
Loss on disposal (44 - 33 - 10)	1
Bad debt	8
Reduction in allowance for receivables	(1)
	601

W4 Property, plant and equipment	**£000**	**£000**	**£000**
Land at valuation			300
Buildings at cost		250	
Depreciation to 31/3/06	90		
Depreciation for year (4% x 250)	10	100	150
Equipment at cost		196	
Depreciation to 31/3/06	76		
Depreciation for year (40% x 120)	48	124	72
Motor vehicles at cost (284 - 44)		240	
Depreciation to 31/3/06 (132 - 33)	99		
Depreciation for year (25% x 240)	60	159	81
			603

Question 2

(a)

Journal

		£	£	
1	Suspense account	270		
	Trade payables		270	*1 ½*
2	Receivables control account	900		
	Sales		900	*1 ½*
3	Suspense account	17		
	Bank interest receivable		17	*1 ½*
4	Receivables control account	466		
	Sales		466	*1 ½*
5	*No entries required*			*1*
6	Trade payables	238		
	Suspense account		238	*1 ½*
7	Suspense account	5,428		
	Receivables control account		5,428	*2*
8	Suspense account	100		
	Trade payables		100	*1 ½*

(12)

(b)

Suspense account

	£		£	
		Balance b/d	5,577	½
Trade payables (1)	270			½
Bank interest rec. (3)	17			½
Receivables control (7)	5,428			½
		Trade payables (6)	238	½
Trade payables (8)	100			½
	5,815		5,815	

(3)

(c)

Receivables control account

	£		£	
Balance b/d	26,212			½
Sales (2)	900			½
Sales (4)	466			½
		Suspense a/c (7)	5,428	1
		Balance c/d	22,150	
	27,578		27,578	

Reconciliation to list of ledger balances	*Subtract* £	*Add* £	
Total of original list (£23,693 - £861)		22,832	1
Sales invoices omitted (4)		466	½
Cr. balance treated as dr. balance (5)	1,148		1
	1,148	23,298	
		1,148	
		22,150	

(5)

(20)

Question 3

(a)

			X Ltd	
Profitability:				
ROCE		1,120 ÷ 5,320 x 100	*21.1%*	½
Gross profit percentage		1,880 ÷ 5,720 x 100	*32.9%*	½
Net profit percentage	*either*	1,120 ÷ 5,720 x 100	*19.6%*	½
	or	1,070 ÷ 5,720 x 100	*18.7%*	
	or	750 ÷ 5,720 x 100	*13.1%*	
Liquidity:				
Current ratio		1,520 ÷ 770	*1.97*	½
Quick assets ratio		1,010 ÷ 770	*1.31*	½
Efficiency:				
Inventory holding period		510 ÷ 3,840 x 365	*48 days*	½
Trade receivables collection period		670 ÷ 5,720 x 365	*43 days*	½
Trade payables payment period		450 ÷ 3,840 x 365	*43 days*	½
Capital structure:				
Capital gearing ratio		500 ÷ 5,320 x 100	*9.4%*	½
			Y Ltd	
Profitability:				
ROCE		990 ÷ 6,530 x 100	*15.2%*	½
Gross profit percentage		2,070 ÷ 6,310 x 100	*32.8%*	½
Net profit percentage	*either*	990 ÷ 6,310 x 100	*15.7%*	½
	or	640 ÷ 6,310 x 100	*10.1%*	
	or	430 ÷ 6,310 x 100	*6.8%*	
Liquidity:				
Current ratio		1,980 ÷ 1,780	*1.1*	½
Quick assets ratio		1,090 ÷ 1,780	*0.6*	½
Efficiency:				
Inventory holding period		890 ÷ 4,240 x 365	*77 days*	½
Trade receivables collection period		1,090 ÷ 6,310 x 365	*63 days*	½
Trade payables payment period		1,130 ÷ 4,240 x 365	*97 days*	½
Capital structure:				
Capital gearing ratio		3,500 ÷ 6,530 x 100	*53.6%*	½

Note:

The trade payables payment period has been calculated with reference to cost of sales, since the figures for purchases are not available.

(9)

Credit will be given for other acceptable ratios that may be offered

(b) The main points which should be made are as follows:

Profitability

- X is making a better return on capital.
- Both companies have a similar GPP, perhaps indicating that similar prices are charged to customers.
- X has a better NPP (whichever method of calculation is used). This suggests that X has better control over its overheads. *2*

Liquidity

- X has better liquidity (as measured by both liquidity ratios).
- Y's quick assets ratio is especially worrying.
- Y has no cash at all and borrowings, whilst X has cash in the bank and comparatively low borrowings. *2*

Efficiency

- X takes a total of 91 days to turn inventories into cash.
- Y takes much longer to turn inventories into cash (140 days) and is therefore less efficient. However, the company might be deliberately holding larger stocks and offering longer credit so as to attract customers. This is beneficial from Western's point of view, so long as it is sustainable in the long term.
- Y pays its suppliers much later than X. This may be a sign of efficiency but may also be a sign that Y is struggling to pay its debts and could find it difficult to obtain credit in future. *2*

Gearing

- X is very low-geared.
- Y is comparatively high-geared and may find it difficult to service its high level of debt and/or to obtain further long-term finance. *1*

Conclusion

X is the sounder company. Y might offer larger stocks and more generous credit terms but X would seem to be the better choice if Western is seeking a long-term, reliable source of supply. *1*

(8)

(c) *Further information required*

- financial statements for several previous years (to detect trends)
- year-average figures for balance sheet items
- statement of accounting policies for each company
- industry-average ratios
- projections for the future

(3)

(20)

Question 4

(a) The main objectives of the IASB are:

- to develop a single set of high-quality global accounting standards
- to promote the use and rigorous application of those standards
- to bring about the convergence of national accounting standards and international accounting standards (IASs/IFRSs).

(*3*)

(b) The *Framework* document sets out the fundamental principles on which accounting should be based. Some of the main purposes of the *Framework* are:

- to assist the IASB in the development and review of IASs/IFRSs
- to assist preparers of financial statements in applying IASs/IFRSs and in dealing with matters which are not covered by accounting standards
- to assist users in interpreting financial statements.

(*3*)

(c) The objective of financial statements is "to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions".

(*1*)

(d) The underlying assumptions identified in the *Framework* are:

(i) **Accruals basis**. The effects of transactions and other events are recognised when they occur (not when cash is received or paid) and are reported in the financial statements of the periods to which they relate.

(ii) **Going concern**. Financial statements are generally prepared on the assumption that the entity will continue in operation for the foreseeable future. If this is not the case, the financial statements should be prepared on a different basis and the basis used should be disclosed.

(*2*)

(e) The qualitative characteristics which should be possessed by useful information are identified in the *Framework* as:

(i) **Relevance**:
- influences the economic decisions of users
- predictive relevance
- confirmatory relevance
- *contributory factors*: disclosure, materiality

(ii) **Reliability**:
- free from material error and can be depended upon by users to represent faithfully transactions, events etc.
- *contributory factors*: substance over form, neutrality, prudence, completeness

(iii) **Comparability**:

- users are able to compare financial statements of an entity through time (to identify trends) and with other entities' statements (to evaluate relative financial position, performance etc.)
- *contributory factors*: consistency, disclosure

(iv) **Understandability**:

- information should be readily understandable by users
- it is assumed that users have reasonable business/accounting knowledge and are willing to study the information with reasonable diligence
- *contributory factors*: users' abilities, aggregation and classification

½ mark for each valid characteristic, up to a maximum of 2
½ mark for each valid explanation of the characteristics, up to a maximum of 2
1 mark for identifying the contributory factors for each characteristic, up to a maximum of 4

(8)

(f) The main uses of IASs and IFRSs are:

- to be adopted as national requirements
- to be used as the basis for some or all national requirements
- to be used as a benchmark for those countries which develop their own accounting standards.

(*3*)

(20)

Question 5

(a)

	Assets	*Liabilities*	*Capital*
	£	**£**	**£**
Equipment (£2,000 x 20% x 1.75)	700		
Inventory - deduced	22,420		
Cash	250		
Bank	2,640		
Trade accounts payable		7,240	
Accrued expenses		330	
Prepaid expenses	2,190		
Capital accounts			20,000
Current accounts (£1,520 - £890)			630
	28,200	7,570	
	7,570		
	20,630		20,630

(3)

(b)

Wendy and Yvonne
Income statement for the year to 30 April 2007

		£	**£**	
Sales (£93,270 - £90 + £18,530 + £100)			111,810	*2*
Cost of sales:				
Inventory as at 1 May 2006		22,420		
Purchases (£76,830 - £7,240 + £7,610)		77,200		*1*
		99,620		
Inventory at 30 April 2007 (deduced)		25,080	74,540	
Gross profit (£111,810 x 50/150)			37,270	*1*
Less:	Rent, rates & ins. (£12,680 + £2,190 - £2,680)	12,190		*1*
	Heat, light & phone (£2,170 - £330 + £350)	2,190		*1*
	Miscellaneous expenses (£2,270 + £4,130)	6,400		*½*
	Bank charges and interest (£410 + £50)	460		*½*
	Depreciation:			
	£2,000 x 20% x 6/12	200		*½*
	£2,900 x 20% x 6/12	290		*½*
	Loss on disposal (£700 - £200 - £350)	150	21,880	*½*
Net profit for the year			15,390	
Appropriation of net profit:				
Interest on capital:				
Wendy £10,000 x 4%		400		
Yvonne (£10,000 x 4%) + (£3,000 x 4% x 9/12)		490	890	*1*
Profit shares:				
Wendy 60%		8,700		
Yvonne 40%		5,800	14,500	*½*
			15,390	

(10)

(c)

Wendy and Yvonne
Balance Sheet as at 30 April 2007

		£	£	
Non-current assets				
Equipment (£2,900 - £290)			2,610	*1*
Current assets				
Inventory		25,080		
Prepayments		2,680		
Cash at bank (£2,000 - £90 - £50)		1,860		
Cash in hand		350		
		29,970		*2*
Current liabilities				
Trade accounts payable	7,610			
Accruals	350	7,960		*1*
Net current assets			22,010	
			24,620	
Partners' capital accounts				
Wendy		10,000		
Yvonne		13,000	23,000	*1*
Partners' current accounts				
Wendy (£1,520 + £9,100 - £6,400)		4,220		
Yvonne (£6,290 - £890 - £8,000)		(2,600)	1,620	*2*
			24,620	

(7)

(20)

Question 6

(a) IAS2 states that inventories are assets:

- held for sale in the ordinary course of business;
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

The main items covered by this definition are goods purchased and held for resale, finished goods produced, work in progress and raw materials held for use in the production process.

(3)

(b) The cost of inventories comprises:

- *costs of purchase*, comprising the purchase price plus any irrecoverable duties or taxes, plus transport etc. costs directly attributable to the acquisition of the items concerned, less any trade discounts obtained;
- *costs of conversion*, including all costs directly related to units of production (e.g. direct labour) and a systematic allocation of fixed and variable production overheads (eg factory management costs and indirect materials and labour);
- *other costs* incurred in bringing the inventories to their present location and condition.

Costs excluded from the cost of inventories include the cost of abnormal wastage, general administrative overheads and selling costs.

(5)

(c) Net realisable value is the estimated selling price of inventory in the ordinary course of business, less estimated costs of completion and less estimated selling costs.

(2)

(d)

	Product A	Product B
	£	**£**
Cost per unit	25	30
NRV per unit:		
Product A (£50 - £12 - £7)	31	
Product B (£55 - £21 - £5)		29
Lower of cost and NRV	25	29

WIP should be shown at £33,380 ((500 x £25) + (720 x £29)).

(3)

(e) In general, the cost of inventories should be measured by assigning specific costs to individual items of inventory. However, a cost formula such as FIFO or AVCO may be used in the case of large numbers of inventory items which are interchangeable (ie the items are indistinguishable from each other).

(2)

(f) FIFO

	No. of units		*Cost (£)*	
Issued 3 March	1,800	1,800 @ £12.50		
Issued 11 March	1,900	700 @ £12.50		
		1,200 @ £11.90		
Issued 16 March	400	400 @ £11.90		
Issued 30 March	2,200	400 @ £11.90		
		1,800 @ £11.30		
Inventory 31 March	1,200	1,200 @ £11.30	**£13,560**	*1*

AVCO

	No. of units		*Cost (£)*	*Weighted average cost per unit*	
Opening inventory	2,500	@ £12.50	31,250	£12.50	
Issued 3 March	1,800		22,500		
	700		8,750		
Received 8 March	2,000	@ £11.90	23,800		
	2,700		32,550	£12.06	
Issued 11 March	1,900		22,906		
	800		9,644		
Issued 16 March	400		4,822		
	400		4,822		
Received 24 March	3,000	@ £11.30	33,900		
	3,400		38,722	£11.39	
Issued 30 March	2,200		25,055		
Inventory 31 March	1,200		**£13,667**		*4*

(5)

(20)