CIPFA

FINANCIAL ACCOUNTING

Certificate stage examination

4 December 2007

MARKING SCHEME

AT THE HEART OF YOUR CAREER

Question 1

(a)

Anne, Emily and Charlotte
Income statement for the year to 31 October 2007

	£	£	
Sales		153,670	
Less: Returns inwards		3,330	
		150,340	*1*
Cost of sales:			
Inventory as at 1 November 2006	12,710		
Purchases	64,440		
	77,150		
Less: Returns outwards	4,920		
	72,230		
Inventory at 31 October 2007	13,190	59,040	*2*
Gross profit		91,300	
Less: Operating expenses	10,740		*½*
Loan interest	1,600		*1*
Depreciation:			
£27,200 x 18.75%	5,100	17,440	*1 ½*
Net profit for the year		73,860	

(6)

(b)

Anne, Emily and Charlotte
Appropriation account for the year to 31 October 2007

	£	£	
1 November 2006 to 31 July 2007:			
Interest on capital: Anne £60,000 x 5% x 9/12	2,250		
Emily £40,000 x 5% x 9/12	1,500		
Salaries: Anne £10,000 x 9/12	7,500		
Emily £8,000 x 9/12	6,000		
Profit shares: Anne 50%	7,660		
Emily 50%	7,660	32,570	*3*
1 August 2007 to 31 October 2007:			
Interest on capital: Anne £54,000 x 6% x 3/12	810		
Emily £40,000 x 6% x 3/12	600		
Charlotte £12,000 x 6% x 3/12	180		
Salaries: Anne £15,000 x 3/12	3,750		
Emily £10,000 x 3/12	2,500		
Charlotte £5,000 x 3/12	1,250		
Profit shares: Anne 50%	16,100		
Emily 30%	9,660		
Charlotte 20%	6,440	41,290	*3*
		73,860	

(6)

Notes:

(i) Net profit for the period 1 November 2006 to 31 July 2007 is (£91,300 x 50%) - (£17,440 x 9/12) = £32,570.

(ii) Net profit for the period 1 August 2007 to 31 October 2007 is (£91,300 x 50%) - (£17,440 x 3/12) = £41,290.

(c)

Partners' current accounts

	A	*E*	*C*		*A*	*E*	*C*
	£	**£**	**£**		**£**	**£**	**£**
Blce b/d		360		Blce b/d	2,880		
				Loan int.	1,600		
				Int. cap.	2,250	1,500	
				Salaries	7,500	6,000	
				Profits	7,660	7,660	
				Int. cap.	810	600	180
				Salaries	3,750	2,500	1,250
				Profits	16,100	9,660	6,440
Drawings	37,400	24,370	8,450				
Blce c/d	5,150	3,190		Blce c/d			580
	42,550	27,920	8,450		42,550	27,920	8,450
Blce b/d			580	Blce b/d	5,150	3,190	

(3)

(d)

Anne, Emily and Charlotte
Balance Sheet as at 31 October 2007

		£	£	
Non-current assets				
Freehold property		90,000		
Equipment (£27,200 - £16,020)		11,180	101,180	*1*
Current assets				
Inventory		13,190		
Trade receivables		28,550		
		41,740		*1*
Current liabilities				
Trade payables	6,890			
Bank overdraft	2,270	9,160		*1*
Net current assets			32,580	
			133,760	
Loan from Anne			20,000	*1*
			113,760	
Partners' capital accounts:				
Anne		54,000		
Emily		40,000		
Charlotte		12,000	106,000	*½*
Partners' current accounts:				
Anne		5,150		
Emily		3,190		
Charlotte		(580)	7,760	*½*
			113,760	

(5)

(20)

Question 2

(a)

Cashbook

	£		£	
		Balance b/d	1,412	*1*
Trade receivables	90			*1*
		Trade receivables	170	*1*
		Bank charges & interest	63	*1*
Suspense a/c	10			*1*
		Drawings	1,000	*1*
Balance c/d	2,545			
	2,645		2,645	
		Balance b/d	2,545	

Bank reconciliation

	£	
Cash at bank per statement	874	
Unpresented cheques	(5,769)	*1*
	(4,895)	
Outstanding lodgements	2,350	*1*
Overdraft per cashbook	2,545	

(8)

(b)

Journal

	£	£	
Bad debts written off	230		*1*
Trade receivables		230	*1*
Allowance for doubtful receivables	26		*1*
Decrease in allowance for doubtful receivables		26	*1*

Notes:

(i) The draft figure for trade receivables was £4,950 (£4,732 + £218). As a result of the adjustments made during the bank reconciliation, this has increased to £5,030 (£4,950 - £90 + £170). Bad debts of £230 written off reduce this figure to £4,800.

(ii) The required allowance for doubtful receivables is £192 (4% x £4,800). This is £26 less than the allowance brought forward at 1 October 2006. *3*

(7)

(c)

Statement of corrected net loss

	£	£	
Net loss per draft accounts		1,738	
Less:			
Decrease in allowance for doubtful receivables	26		*1*
TB difference removed from expenses	10	36	*1*
		1,702	
Add:			
Increase in bank charges & interest		63	*1*
Increase in bad debts written off		230	*1*
Corrected net loss		1,995	*1*

(5)

(20)

Question 3

(a)

Aadvaark Trading Ltd
Cash flow statement for the year to 30 November 2007

	Working	£000	£000	
Cash flows from operating activities:				
Net loss before tax ((480 + 20) - 800)			(300)	*1*
Depreciation charge	W1		300	*1*
Loss on disposal of tangible non-current assets (40 - 30)			10	½
Profit on disposal of investments (70-50)			(20)	½
Investment income			(5)	½
Interest expense for the year			70	½
Increase in inventories (740 - 510)			(230)	½
Increase in trade receivables (1,010 - 640)			(370)	½
Increase in trade payables (660 - 530)			130	½
Cash generated from operations			(415)	
Interest paid			(70)	½
Taxation paid			(130)	*1*
Net cash outflow from operating activities			(615)	
Cash flows from investing activities:				
Payments to acquire tangible non-current assets	W1	(550)		*2*
Receipts from sale of tangible non-current assets		30		½
Proceeds of sale of investment		70		½
Investment income		5		½
Net cash outflow from investing activities			(445)	
Cash flows from financing activities:				
Issue of share capital		140		*1*
Increase in long-term loans		400		½
Net cash inflow from financing activities			540	
Net decrease in cash and cash equivalents			(520)	
Cash and cash equivalents at 1/12/2006			330	½
Cash and cash equivalents at 30/11/2007			(190)	½

Note*: Analysis of cash and cash equivalents*

	30/11/06 £000	30/11/07 £000	Change in year £000	
Cash at bank	180	-	(180)	
Short-term investments	150	-	(150)	
Bank overdraft	-	(190)	(190)	
	330	(190)	(520)	*1*

(14)

Workings

W1 Non-current assets	**£000**
Cost/valuation at 30/11/06	1,790
Less: Cost of disposals	120
	1,670
Revaluation surplus	250
Cost of acquisitions (derived figure)	550
	2,470
Accumulated depreciation at 30/11/06	630
Less: Disposals	80
	550
Depreciation year to 30/11/07 (derived)	300
Accumulated depreciation at 30/11/07	850

(b)

If a cash flow statement is prepared using the direct method, major classes of receipts and payments arising from operating activities are disclosed individually and then aggregated to give the total amount of cash generated from operations. A cash flow statement prepared using the direct method will usually disclose:

(i) cash receipts from customers
(ii) cash paid to suppliers of goods and services
(iii) cash paid to employees.

These figures could be obtained by conducting an analysis of the cashbook for the period. Alternatively, if the information provided in the income statement and in the opening and closing balance sheets is sufficiently detailed, it might be possible to derive the required figures without conducting such an analysis. For instance, the amount of cash received from customers during the period could be derived by taking the sales figure shown in the income statement and then making an adjustment for opening and closing trade receivables.

(3)

(c)

A company's capital gearing ratio shows the extent to which the company's long-term finance has been obtained by means of borrowing (rather than being obtained from the shareholders in the form of share capital and reserves). The capital gearing ratios of Aadvaark Trading Ltd as at 30 November 2006 and 2007 are as follows:

30 November 2006	500/2,100	= 23.8%	*1*
30 November 2007	900/2,570	= 35.0%	*1*

The increase in the ratio shows an increased reliance on borrowing. The company is more "high-geared" than it was a year previously and if this ratio were to continue to increase in future years, the need to make sizeable interest payments and capital repayments could prejudice shareholders' interests. *1*

(3)

(20)

Question 4

(a) A "non-current asset" is an asset which is acquired for long-term use within a business. Such an asset is not acquired for sale to a customer (though it may be sold at the end of its useful life) but for use in the business over a number of accounting periods. *1*

Typical examples of non-current assets are property, plant and equipment, intangible assets (such as patents and trademarks) and long-term investments. *1*

Current assets consist of cash, cash at bank and other short-term assets which the business intends to turn into cash in the fairly near future (usually within a year or less). These assets continually flow through the business and are constantly being realised. *1*

Typical examples of current assets are inventories, trade receivables, short-term investments and cash. *1*

(4)

(b) Capital expenditure is expenditure which results in the acquisition of a non-current asset or in an improvement to the earning capacity of an existing non-current asset. For example, expenditure on acquiring business premises (or building an extension to existing premises) would be classed as capital expenditure. *2*

Revenue expenditure is expenditure which results in the acquisition of a current asset (eg inventory) or expenditure on items such as selling and distribution expenses, administrative expenses and finance charges. The cost of repairs or maintenance to a non-current asset (but not the cost of improvements) would be classed as revenue expenditure. *2*

(4)

(c) Capital expenditure is shown initially in the balance sheet and is then charged to the income statement over a period of years by means of depreciation charges. In contrast, revenue expenditure is wholly written off to the income statement in the year to which it relates.

Therefore, if an item of capital expenditure was incorrectly classified as revenue expenditure, this would reduce the reported profit of the company for the year in which the expenditure was incurred (and would also reduce the amount of non-current assets shown on the balance sheet). However, if the non-current asset is depreciable the absence of depreciation charges in future years would increase the reported profit of those years so that the company's total profits over the entire useful life of the asset would in fact be unaffected by the error.

(3)

(d) The cost of the machine (and therefore the amount which should be treated as capital expenditure) is £378,400 (£342,000 + £6,800 + £29,600). *1*

One-half of the maintenance charge (ie £13,500) should be shown as an expense in the company's income statement for the year to 31 December 2007. The other half should be treated as a prepayment and should be shown as a current asset in the balance sheet at 31 December 2007. This £13,500 will then be shown as an expense in the company's income statement for the year to 31 December 2008. *1*

The cost of the spare parts (£14,600) should be treated as the acquisition of a current asset (inventory) and should be shown as such in the balance sheet. As the spares are used, their cost should be removed from inventory and shown as an expense in the income statement. *1*

(3)

(e)

Journal

	£000	**£000**	
Freehold land	100		
Revaluation reserve		100	*1*
Allowance for depreciation of buildings	125		
Freehold buildings		50	
Revaluation reserve		75	*2*

Depreciation of buildings for the year to 31 December 2007 is £15,000 (£450,000 ÷ 30). *1*

(4)

(f) If the price paid for a business exceeds the fair market value of the net assets acquired, the excess is the cost of "goodwill". Goodwill may arise (for example) because a business has an established reputation for providing a high standard of customer service. *1*

The £75,000 of "purchased goodwill" should be shown as an intangible non-current asset on the balance sheet of Gamma Ltd and then written down in future years if there is evidence of impairment (ie a fall in its value). *1*

(2)

(20)

Question 5

(a) It is generally agreed that the main function of accounting is to provide useful economic information to a wide range of user groups. This involves the following activities:

- collecting and recording economic data relating to a business entity (this is often referred to as book-keeping)
- processing this data so as to produce useful economic information
- communicating this information to users and explaining its meaning. *2*

Financial accounting provides information to owners, investors and other external users (eg the tax authorities). This information generally takes the form of a set of financial statements which provide information about the entity's financial performance and position. These statements help external users to make better economic decisions in relation to the entity. *2*

Management accounting provides information for internal use and helps managers to make better management decisions. *1*

(5)

(b) 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. *(3)*

(c) The SAC has approximately 50 members and provides a forum for participation in the standard-setting process by interested organisations and individuals. The SAC advises the IASB on its agenda and priorities and also passes on Council members' views with regard to standard-setting projects. *1*

IFRIC interprets the application of international standards and provides advice on matters not specifically addressed in the standards. *1*

(2)

(d) The term "GAAP" refers to the complete set of accounting regulations from all sources (eg legislation, standards, stock exchange regulations) which apply in a given jurisdiction, together with any general accounting conventions which are usually applied in that jurisdiction.

(2)

(e) The historical cost convention is that items should be stated in the accounts at their original cost or at a figure which is based on original cost. In particular, this convention requires that non-current assets should be shown at cost (or cost less accumulated depreciation) and that the current market values of such assets should be ignored. *2*

The main advantage of the historical cost convention is objectivity. The cost of an item is generally a matter of fact rather than opinion, so the need to make subjective judgements is reduced when the historical cost convention is applied. *1*

Further advantages include the fact that the historical cost convention is well understood and that it has been found impossible to reach agreement on a better approach. *1*

The main disadvantages of the historical cost convention are as follows:

- non-current asset values shown in the balance sheet may be unrealistic
- depreciation charges may be inadequate
- holding gains on inventories are not separately identified
- gains or losses on monetary items are not separately identified
- inflation is ignored and so comparisons over time may be misleading.

1 mark per disadvantage to a maximum of 4

(8)

(20)

Question 6

(a) Preference shares

- Preference shareholders are entitled to a fixed rate of dividend each year, before any dividends are paid to the ordinary shareholders. ½
- Preference shares may be "cumulative" or "non-cumulative". The holders of cumulative preference shares are entitled to receive any arrears of dividends before dividends are paid to the ordinary shareholders. The holders of non-cumulative preference shares are not entitled to receive arrears of dividends. ½
- Preference shareholders usually cannot vote at shareholders' meetings. ½
- On a winding up, preference shareholders are entitled to repayment of their share capital in priority to ordinary shareholders. ½
- Preference shareholders are not entitled to any of the company's profits apart from their fixed dividend. Nor are they entitled to any of the company's assets when the company is wound up, apart from the amount required to repay the nominal value of their shares. *1*

Ordinary shares

- Ordinary shareholders own the remainder of the company's profits after any preference dividend has been paid. ½
- Ordinary shareholders are entitled to vote at shareholders' meetings. ½
- On a winding up, the ordinary shareholders are entitled to the whole of the company's assets, after all of the liabilities and the preference shares (if any) have been repaid. *1*

(5)

(b)

Interest cover = $\dfrac{\text{Profit before interest and tax}}{\text{Interest charges}}$ = 5,620 / 430 = 13.07 *1*

Earnings per share = $\dfrac{\text{Profit after tax and preference dividends}}{\text{Number of equity shares in issue}}$ = 3,600/24,000 = 15p per share *1*

Dividend cover = $\dfrac{\text{Earnings per share}}{\text{Dividend per ordinary share}}$ = $\dfrac{15p}{7p}$ = 2.14 *1*

Dividend yield = $\dfrac{\text{Dividend per ordinary share}}{\text{Market value per share}}$ = $\dfrac{7p}{112p}$ = 6.25% *1*

Price earnings ratio = $\dfrac{\text{Market value per share}}{\text{Earnings per share}}$ = $\dfrac{112p}{15p}$ = 7.47 *1*

(5)

(c) A high P/E ratio occurs if the market price per share is high in comparison to recent earnings per share. This suggests that the market is confident about the company's future prospects and is therefore seen as an encouraging sign. *(2)*

(d)

	Original	**After rights issue**	**After bonus issue**
	£000	**£000**	**£000**
Non-current assets	8,500	8,500	8,500
Net current assets	3,800	4,300	4,300
	12,300	12,800	12,800
Share capital	4,000	4,200	8,400
Share premium account	900	1,200	-
Retained earnings	7,400	7,400	4,400
	12,300	12,800	12,800

(4)

(e)

		£000	
Authorised	100m shares of 20p	20,000	*1*
Issued	33m shares of 20p	6,600	*1*
Called-up	£5m + £800,000	5,800	*1*
Paid-up	£5m + £720,000	5,720	*1*

(4)

(20)