CIPFA

FINANCIAL ACCOUNTING

Certificate stage examination

June 2008

MARKING SCHEME

AT THE HEART OF YOUR CAREER

Question 1

(a)

Buffalo Ltd
Income statement for the year to 31 May 2008

	Working	£000	
Sales revenue		1,540	½
Cost of sales	W1	795	*1*
Gross profit		745	
Distribution costs	W2	(365)	*1*
Administrative expenses	W3	(420)	*1*
Finance charges		(45)	½
Loss before taxation		(85)	
Taxation		10	*1*
Loss for the year		(75)	
			(5)

(b)

Buffalo Ltd
Balance Sheet as at 31 May 2008

	Working	£000	£000	
Non-current assets				
Property, plant and equipment	W4		420	*1*
Current assets				
Inventory		375		
Trade receivables		480	855	*1*
Total assets			1,275	
Equity				
Share capital		250		½
Share premium account		75		½
Retained earnings		480	805	*1*
Non-current liabilities				
Long-term borrowings			110	½
Current liabilities				
Trade payables		315		
Bank balance		45	360	½
Total equity and liabilities			1,275	
				(5)

(c)

Buffalo Ltd
Statement of changes in equity for the year to 31 May 2008

	Share capital £000	Other reserves £000	Retained earnings £000	Total equity £000	
Balance at 31 May 2007	200	-	605	805	*1*
Loss for the year			(75)	(75)	*½*
Dividend paid			(50)	(50)	*½*
Share issue	50	75		125	*1*
Balance at 31 May 2008	250	75	480	805	

(3)

(d)

Buffalo Ltd
Cash flow statement for the year to 31 May 2008

	£000	£000	
Cash flows from operating activities:			
Net loss before tax		(85)	½
Depreciation charge		190	½
Interest expense for the year		45	½
Decrease in inventories (375 - 410)		35	½
Increase in trade receivables (480 - 370)		(110)	½
Decrease in trade payables (315 - 330)		(15)	½
Cash generated from operations		60	
Interest paid		(45)	½
Taxation paid		(170)	½
Dividend paid		(50)	½
Net cash outflow from operating activities		(205)	
Cash flows from investing activities:			
Payments to acquire non-current assets	(90)		½
Net cash outflow from investing activities		(90)	
Cash flows from financing activities:			
Issue of share capital	125		½
Decrease in long-term loans	(70)		½
Net cash inflow from financing activities		55	
Net decrease in cash and cash equivalents		(240)	
Cash and cash equivalents at 31/5/07		195	½
Cash and cash equivalents at 31/5/08		(45)	½

Note: The dividend paid could instead be shown as a cash outflow from financing activities.

(7)

(20)

Workings

W1 Cost of sales	**£000**
Opening inventory	410
Purchases	760
Closing inventory	(375)
	795

W2 Distribution costs	**£000**
Per trial balance	270
PPE depreciation (W4)	95
	365

W3 Administrative expenses	**£000**
Per trial balance	325
PPE depreciation (W4)	95
	420

W4 Property, plant and equipment	**£000**	**£000**
At cost		950
Depreciation to 31/5/07	340	
Depreciation for year (20% x 950)	190	530
		420

Note: The cost of PPE acquired in the year is £90,000 (£610,000 - £520,000).

Question 2

(a) The duality principle states that every business transaction has two effects on the financial position of the business concerned. For example, if a business buys a machine and pays by cheque, this transaction results in an increase in the value of the machines 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)

Journal

	£	£	
Purchases	123,850		½
Trade payables control account		123,850	½
Trade payables control account	2,370		½
Purchase returns		2,370	½
Trade payables control account	3,790		½
Discounts received		3,790	½

(3)

(c)

Insurances

		£			£	
1/5/07	Prepayment b/d	10,050	30/4/08	Inc. statement	23,600	
30/4/08	Bank	24,920	30/4/08	Prepayment c/d	11,370	
		34,970			34,970	
1/5/08	Prepayment b/d	11,370				*2*

Electricity charges

		£			£	
30/4/08	Bank	55,650	1/5/07	Accrual b/d	6,730	
30/4/08	Accrual c/d	7,440	30/4/08	Inc. statement	56,360	
		63,090			63,090	
			1/5/08	Accrual b/d	7,440	*2*

(4)

(d)

Allowance for doubtful receivables

		£			£
30/4/08	Inc. statement	660	1/5/07	Balance b/d	8,600
30/4/08	Balance c/d	7,940			
		8,600			8,600
			1/5/08	Balance b/d	7,940

(2)

(e)

Plant and equipment

		£			£	
1/5/07	Balance b/d	208,000	31/1/08	Disposal	20,000	
31/1/08	Bank	26,000	30/4/08	Balance c/d	214,000	
		234,000			234,000	
1/5/08	Balance b/d	214,000				*2*

Allowance for depreciation of plant and equipment

		£			£	
31/1/08	Disposal	13,140	1/5/07	Balance b/d	91,740	
30/4/08	Balance c/d	119,220	30/4/08	Inc. statement	40,620	
		132,360			132,360	
			1/5/08	Balance b/d	119,220	*3*

WDV of the equipment disposed of is £6,860 (70% x 70% x 70% x £20,000). Therefore the accumulated depreciation on this item is £13,140.

The depreciation charge for the year is 30% x (£214,000 - £78,600) = £40,620.

Disposal of plant and equipment

		£			£	
31/1/08	Plant & Equip't	20,000	31/1/08	Allce. for dep'n	13,140	
			31/1/08	Bank	6,250	
			30/4/08	Inc. statement	610	
		20,000			20,000	*2*
						(7)

(f)

Journal

	£	£
Bank	175,000	
Share capital		50,000
Share premium account		125,000

(2)

(20)

Question 3

(a)

		Baker plc	
ROCE	2,280 ÷ 13,380 x 100	*17.0%*	*½*
EPS	1,320 ÷ 6,000 x 100	*22p*	*½*
PE ratio	165p ÷ 22p	*7.5*	*1*
Current ratio	3,300 ÷ 3,040	*1.09*	*½*
Quick ratio	1,720 ÷ 3,040	*0.57*	*½*
Trade payables payment period	1,920 ÷ 10,720 x 365	*65 days*	*½*
Capital gearing ratio	3,500 ÷ 13,380 x 100	*26.2%*	*½*
Dividend yield	3p ÷ 165p x 100	*1.8%*	*1*

		Grant plc	
ROCE	1,960 ÷ 9,940 x 100	*19.7%*	*½*
EPS	1,440 ÷ 6,000 x 100	*24p*	*½*
PE ratio	240p ÷ 24p	*10*	*1*
Current ratio	2,900 ÷ 1,440	*2.01*	*½*
Quick ratio	1,640 ÷ 1,440	*1.14*	*½*
Trade payables payment period	960 ÷ 8,680 x 365	*40 days*	*½*
Capital gearing ratio	500 ÷ 9,940 x 100	*5.0%*	*½*
Dividend yield	10p ÷ 240p x 100	*4.2%*	*1*

(10)

(b) The main points to be made are:

- Grant's ROCE and EPS are both better than Baker's and these ratios have improved since last year, whilst Baker's have declined. Grant seems to be the more profitable company. *1*

- Grant's PE ratio has risen since last year and is higher than Baker's (which has declined). This may indicate greater investor confidence in Grant's future prospects than Baker's. *1*

- Grant's liquidity ratios are roughly the same as in the previous year and appear to be much better than Baker's (which have declined). Coupled with Baker's lack of cash, high borrowings and lengthening payables payment period, this suggests that Baker may be experiencing liquidity problems. *1*

- On the other hand, it is possible that Baker's liquidity problems are caused by a large and recent investment in non-current assets (which are substantially higher than Grant's). If this is the case, the use of these assets may feed through to greater prosperity in future years. *1*

- Neither company is high-geared, but Baker has a substantially higher gearing ratio than Grant and this ratio has more than doubled since last year. This indicates that Baker has borrowed during the year. This may have been done as a means of investing in non-current assets, but further substantial borrowing could turn Baker into a high-geared company and prejudice shareholders' interests. *1*

- Grant's dividend yield has been maintained since last year and is higher than Baker's (which has declined). This could be further evidence of Baker's liquidity problems and could indicate that Baker's shares may not be a wise choice for an investor seeking dividend income. *1*

- On the whole, the ratio analysis suggests that Grant plc is more profitable than Baker plc, has better liquidity and is lower-geared. This may indicate that an investment in the shares of Grant plc should be recommended, but further information should be obtained before a final decision is made (see below). *1*

(7)

(c) Further information which should be obtained includes:

- more recent financial information (half-year results? is it worth waiting until the September 2008 accounts are available?);
- forecasts for the future performance of each company (if possible);
- accounts for the last five years, including cash flow statements;
- industry average ratios;
- statement of accounting policies for each company.

1 mark per valid point up to a maximum of (3)

(20)

Question 4

(a)

Subscriptions account

	£		£	
		Subs in advance b/d	760	
		Receipts	11,520	
I & E a/c	11,450			
Subs in advance c/d	830			
	12,280		12,280	
		Subs in advance b/d	830	*2*

Life membership fees account

	£		£	
		Balances b/d	3,050	½
		Receipts	1,500	½
I & E a/c	550			½
Balances c/d				
£300 x 5	1,500			
£350 x 1	350			
£400 x 2	800			
£450 x 3	1,350			½
	4,550		4,550	
		Balances b/d	4,000	

(4)

(b)

Bar trading account
Year to 31 March 2008

	£	£	
Sales		29,240	½
Less: Cost of sales			
Inventory at 1 April 2007	3,480		½
Purchases (£20,870 - £1,740 + £2,930)	22,060		*1*
	25,540		
Inventory at 31 March 2008 (deduced)	3,610	21,930	*1*
Gross profit (1/4 x £29,240)		7,310	

(3)

(c)

West Barton Tennis Club
Income and expenditure account for the year to 31 March 2008

	£	£	
Income			
Subscriptions		11,450	
Life membership fees		550	
Gross profit on bar		7,310	
Donations		340	
Surplus on dinner dance (£1,670 - £1,320)		350	
		20,000	*2*
Expenditure			
Wages	10,760		
Insurance (£840 + £570 - £630)	780		*1*
Electricity (£1,660 - £310 + £280)	1,630		*1*
Rates and water	1,700		
Repairs and maintenance	430		
Charitable donations	1,500		
Bank interest and charges	260		
Miscellaneous expenses	1,010		
Clubhouse depreciation (2% x £30,000)	600		*1*
Equipment depreciation (25% x £14,400)	3,600	22,270	*1*
Excess of expenditure over income		2,270	

Wages, rates, repairs, donations, bank charges and miscellaneous expenses *1*

(7)

Note: Clubhouse depreciation to 31 March 2007 amounts to 46% of cost. This has accumulated over 23 years, giving a depreciation rate of 2% per annum on cost.

(d)

West Barton Tennis Club
Balance sheet as at 31 March 2008

	£	£	
Non-current assets			
Freehold land at cost		20,000	
Clubhouse at cost	30,000		
Less: Depreciation to date	14,400	15,600	
Equipment at cost	22,600		
Less: Depreciation to date	11,800	10,800	
		46,400	*1 1/2*
Current assets			
Bar inventory	3,610		
Prepaid insurance	630		
Cash	300	4,540	*1*
Total assets		50,940	
Accumulated fund			
Balance as at 31 March 2007	44,880		*1/2*
Excess of expenditure over income for the year	2,270	42,610	*1*
Non-current liabilities			
Life membership fees		4,000	*1/2*
Current liabilities			
Subscriptions in advance	830		
Trade payables (brewery)	2,930		
Bank (£1,090 + £44,270 - £45,550 - £100)	290		
Accrued electricity charges	280	4,330	*1 1/2*
		50,940	
			(6)
			(20)

Question 5

(a) The main purpose of accounting standards is to standardise financial reporting as far as possible and so introduce a degree of uniformity into the way that financial statements are prepared and presented. Some accounting standards require all reporting entities to deal with certain items in a standard way. Other standards allow a choice of accounting treatment, but then require that entities should disclose the treatment they have chosen.

Accounting standards improve the comparability of financial statements (an important qualitative characteristic) and help to eliminate dubious accounting practices. This makes it more likely that financial statements will provide a fair representation of an entity's financial performance and financial position.

(2)

(b) The term 'Generally Accepted Accounting Practice' (GAAP) refers to the complete set of accounting regulations from all sources which apply in a given jurisdiction, together with any general accounting principles or conventions that are usually applied in that jurisdiction. GAAP therefore includes:

- Accounting legislation
- Accounting standards
- Accounting concepts or conventions.

(3)

(c) Partly-completed products

	Cost to date	*Net realisable value (NRV)*	*Lower of cost and NRV*
	£	**£**	**£**
Item 1	4,750	(95% x £7,200) – £500 = 6,340	4,750
Item 2	3,190	(95% x £4,800) – £800 = 3,760	3,190
Item 3	730	(95% x £1,000) – £300 = 650	650
Item 4	8,420	(95% x £12,600) – £1,000 = 10,970	8,420
Item 5	5,550	(95% x £6,000) – £400 = 5,300	5,300
			22,310

IAS2 (Inventories) requires that items should (in general) be valued individually at the lower of cost and net realisable value. As shown above, this gives a total of £22,310. Since the items have been included in the draft accounts at a value of £22,640, this means that inventory should be reduced by £330. *4*

Special product

IAS2 (Inventories) excludes abnormal wastage costs from the cost of inventory. Storage costs of a finished product are also excluded. Fixed production overheads are included.

Application of these rules gives a cost of £16,340 for the special product, derived as follows:

	£
Raw materials (3/4 x £14,400)	10,800
Direct labour costs	2,780
Allocation of fixed production overheads	2,760
Total cost	16,340

Assuming that NRV exceeds £16,340, the special item should be included in inventory at £16,340. This means that inventory should be reduced by £4,050. *4*

Computer system

IAS16 (Property, plant and equipment) requires that depreciation charges should be adjusted for the current and future periods if the expected useful life or residual value of an item of PPE differs from previous estimates.

Based on the original estimates, the depreciation charge made in the years to 31 March 2006 and 2007 would have been £35,000 per annum. Therefore the computer system had a WDV on 1 April 2007 of £150,000. The residual value is now estimated to be £8,000, giving a depreciable amount of £142,000 over the remaining two years of the system's useful life.

Assuming that the straight-line method is still considered appropriate (see below) depreciation charges for the years to 31 March 2008 and 2009 should be £71,000 per annum. *3*

(11)

(d) IAS16 (Property, plant and equipment) requires that depreciation methods should be reviewed periodically. If there has been a significant change in the expected pattern of economic benefits to be derived from an item of PPE, the depreciation method should be changed to reflect the changed pattern. *(2)*

(e) IAS16 (Property, plant and equipment) requires that the depreciable amount of an item of PPE should be allocated on a systematic basis over its useful life. But if that useful life is unlimited (as is usually true in the case of land) the item is not depreciated. *(2)*

(20)

Question 6

(a) The IFAC Code of Ethics was developed as a response to a number of widely publicised accounting scandals, in which the actions of accountants and auditors were criticised. Examples of such scandals include Enron and WorldCom.

The IFAC Code attempts to address the perceived causes of failure on the part of accountants and is intended to apply to all accountants, all over the world and in all work environments.

Accountants perform an extremely important task and it is vital that their work should be trusted by shareholders, lenders and other stakeholders. To some extent, accountants earn this trust by submitting themselves to a rigorous programme of training and assessment. Agreeing to be bound by a strict code of ethics should earn further trust - hence the IFAC Code.

(2)

(b) The five ethical principles are:

- *Integrity*
  A professional accountant should be straightforward and honest in all professional and business relationships.

- *Objectivity*
  A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

- *Professional Competence and Due Care*
  A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

- *Confidentiality*
  A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties.

- *Professional Behaviour*
  A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Up to 2 marks per principle explained up to a maximum of (8)

(c) The six threats to the ethical principles are:

- *Self-interest*
  This threat can arise in any situation in which an accountant (or someone close to that accountant) has a vested interest in an outcome over which the accountant has some degree of influence or control.

- *Intimidation*
  This involves the exercise of disproportionate pressure by someone in a position of power and influence. At worst this could involve threats of violence, but it is more likely to take the form of a hint at damage to the accountant's career or some withdrawal of co-operation that will make the accountant's life difficult.

- *Self-review*
  This threat arises when an accountant is called upon to check, audit or approve a piece of work that he or she was involved in originating.

- *Familiarity*
  This threat arises through long association with individuals, whether in the accountant's own organisation, a client, a supplier or a customer. Objective critique of the work of someone the accountant knows well becomes harder because it impacts on the relationship.

- *Advocacy*
  This is a threat to independence affecting accountants who take on a role representing a client. The threat is that in taking the client's part the accountant is compromised if an issue arises where the facts do not suit the case.

- *Political Bias*
  This threat may arise in any public body where the leadership is democratically elected. It is unethical knowingly to mis-state or falsify a case, or deliberately to suppress relevant information, in furtherance of a party-political position.

Up to 2 marks per threat explained up to a maximum of (6)

(d) The two main categories of safeguards are:

- institutional safeguards
  eg statute and regulation, various internal procedures

- personal safeguards
  eg disposing of financial interests, reporting the offer of a gift.

(4)

(20)