FINANCIAL ACCOUNTING

Certificate stage examination

9 June 2008

From 10.00am to 1.00pm
plus ten minutes reading time from 9.50am to 10.00am

Instructions to candidates

*There are **six** questions on this question paper*

*Answer **five** questions in total*

Three compulsory** questions in **Section A
Two** of the three questions in **Section B

*The questions in Section A carry, in total, **60** marks*
*The questions in Section B each carry **20** marks*

All workings should be shown. Where calculations are required using formulae, calculators may be used but steps in the workings must be shown. Calculations with no evidence of this (for example, using the scientific functions of calculators) will receive no credit. Programmable calculators are not permitted in the examinations room.

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.

Proforma income statement, balance sheet, cash flow statement and statement of changes in equity are appended to this paper and may be submitted as part of an answer.

AT THE HEART OF
YOUR CAREER

SECTION A (Compulsory)

1 Buffalo Ltd prepares accounts to 31 May each year. A trial balance which has been extracted from the company's books at 31 May 2008 shows the following balances:

	£000	£000
Property, plant and equipment, at cost	950	
Accumulated depreciation at 31 May 2007		340
Inventory at 31 May 2007	410	
Trade receivables and payables	480	315
Bank balance		45
Taxation		10
Long-term loans		110
Share capital		200
Retained earnings at 31 May 2007		605
Purchases and sales	760	1,540
General distribution costs	270	
General administrative expenses	325	
Interest paid	45	
Dividend paid	50	
Suspense account		125
	3,290	3,290

The following information is also available:

1. Property, plant and equipment is depreciated on the straight-line basis at 20% per annum of cost, with a full year's charge in the year of acquisition. Depreciation is to be split equally between distribution costs and administrative expenses. There were no disposals of property, plant and equipment during the year to 31 May 2008. None of the company's property, plant and equipment has yet been fully depreciated.

2. Inventory at 31 May 2008 was £375,000.

3. The taxation liability for the year to 31 May 2007 was over-estimated by £10,000. The taxation liability for the year to 31 May 2008 is £nil.

4. All interest due for the year to 31 May 2008 was paid during the year.

5. On 31 May 2008, the company issued 50,000 £1 shares at £2.50 per share. The proceeds of this share issue were banked and credited to a suspense account.

- **Requirements (a) to (c) for question 1**

Prepare the following financial statements for Buffalo Ltd in accordance with the requirements of International Accounting Standards:

(a) an income statement for the year to 31 May 2008; *5*

(b) a balance sheet as at 31 May 2008; *5*

(c) a statement of changes in equity for the year to 31 May 2008. *3*

Formal notes to the accounts are not required, but all workings should be shown.

The company's balance sheet at 31 May 2007 (i.e. the end of the previous accounting year) was as follows:

Buffalo Ltd
Balance Sheet as at 31 May 2007

	£000	**£000**
Non-current assets		
Property, plant and equipment		520
Current assets		
Inventory	410	
Trade receivables	370	
Bank balance	195	975
Total assets		1,495
Equity		
Share capital	200	
Retained earnings	605	805
Non-current liabilities		
Long-term borrowings		180
Current liabilities		
Trade payables	330	
Taxation	180	510
Total equity and liabilities		1,495

- **Requirement (d) for question 1**

(d) Prepare a cash flow statement for Buffalo Ltd for the year to 31 May 2008 in accordance with the requirements of International Accounting Standards.

7
(20)

2

Barstow Ltd prepares accounts to 30 April each year. The company maintains a trade payables control account which forms part of its double-entry book-keeping system. The personal accounts of individual suppliers do not form part of the double-entry system and are held as memorandum records only. You are provided with the following information:

1. The purchases daybook for the month of April 2008 totalled £123,850. The purchase returns daybook for that month totalled £2,370. The cashbook for April 2008 showed that cash discounts received from suppliers during the month amounted to £3,790.

2. Insurance premiums of £24,920 were paid during the year to 30 April 2008. Prepaid insurances at 30 April 2007 and 2008 were £10,050 and £11,370 respectively.

   Electricity bills totalling £55,650 were paid during the year to 30 April 2008. Accrued electricity charges at 30 April 2007 and 2008 were £6,730 and £7,440 respectively.

3. Trade receivables at 30 April 2007, *after* deducting a 4% allowance for doubtful receivables, were £206,400.

   Trade receivables at 30 April 2008, *before* deducting the allowance for doubtful receivables, were £198,500. The allowance for doubtful receivables is to be adjusted to 4% of this figure.

4. Plant and equipment is depreciated on the reducing balance basis at 30% per annum, with a full year's charge in the year of acquisition and no charge in the year of disposal. The company's ledger showed the following balances at 30 April 2007:

	£
Plant and equipment at cost	208,000
Allowance for depreciation	91,740

   An item of equipment which had cost £20,000 on 30 November 2004 was sold on 31 January 2008 for £6,250. On the same date, a new item was acquired at a cost of £26,000.

5. The company's issued share capital at 30 April 2007 consisted of 100,000 £1 ordinary shares. There were no further share issues until 30 April 2008, when a 1 for 2 rights issue was made at £3.50 per share. This rights issue was fully subscribed.

- **Requirement for question 2**

(a) Explain briefly the principle of duality on which double-entry book-keeping systems are based. *2*

(b) Write journal entries to record the purchases, purchase returns and discounts received for the month of April 2008 (narratives are not required). *3*

(c) Prepare ledger accounts for insurances and electricity charges for the year to 30 April 2008. *4*

(d) Write up the allowance for doubtful receivables account for the year to 30 April 2008. *2*

(e) Prepare ledger accounts for plant and equipment, allowance for depreciation of plant and equipment, and disposal of plant and equipment for the year to 30 April 2008. *7*

(f) Write journal entries to record the share issue made on 30 April 2008 (narratives are not required). *2*

(20)

3

Brenda is considering an investment in the ordinary shares of either Baker plc or Grant plc. These companies both operate in the same sector of industry and both prepare accounts to 30 September each year. Financial statements for the year to 30 September 2007 are shown below.

Income statements for the year to 30 September 2007

	Baker plc	Grant plc
	£000	£000
Sales revenue	15,160	12,260
Cost of sales	10,720	8,680
Gross profit	4,440	3,580
Operating expenses	2,160	1,620
Operating profit	2,280	1,960
Interest payable	520	40
Profit before taxation	1,760	1,920
Taxation	440	480
Profit after taxation	1,320	1,440

Balance sheets as at 30 September 2007

	Baker plc		Grant plc	
	£000	£000	£000	£000
Non-current assets		13,120		8,480
Current assets				
Inventories	1,580		1,260	
Trade receivables	1,720		1,360	
Bank balance	-	3,300	280	2,900
Total assets		16,420		11,380
Equity				
Share capital	6,000		6,000	
Retained earnings	3,880	9,880	3,440	9,440
Non-current liabilities				
Long-term loans		3,500		500
Current liabilities				
Trade payables	1,920		960	
Taxation	440		480	
Bank balance	680	3,040	-	1,440
Total equity and liabilities		16,420		11,380

The following information is also available:

1. For both companies, all purchases and sales are made on credit terms.

2. During the year to 30 September 2007, Baker plc paid dividends of £180,000 and Grant plc paid dividends of £600,000.

3. Each company's issued share capital consists of 6 million ordinary shares of £1 each. At the close of business on 30 September 2007, the market price of an ordinary share in Baker plc was £1.65 and the market price of an ordinary share in Grant plc was £2.40.

Having examined the financial statements of the two companies, Brenda is inclined to invest in the shares of Baker plc. Her reasons for this view are that Baker plc has higher turnover, higher operating profit and greater assets than Grant plc. The shares of Baker plc are also cheaper.

- **Requirement for question 3**

(a) In so far as the information given permits, compute the following ratios for Baker plc and Grant plc:

- return on capital employed
- earnings per share
- price earnings ratio
- current ratio
- quick ratio (acid test)
- trade payables payment period
- capital gearing ratio
- dividend yield. *10*

(b) Ratios for Baker plc and Grant plc based upon the financial statements for the **previous** year (i.e. the year to 30 September 2006) were as follows:

	Baker plc	**Grant plc**
Return on capital employed	18.5%	18.9%
Earnings per share	23p	23p
Price earnings ratio	8.5	9.5
Current ratio	1.2	2.1
Quick ratio (acid test)	0.7	1.1
Trade payables payment period	49 days	39 days
Capital gearing ratio	11%	5%
Dividend yield	3%	4%

Taking into account these ratios and those which you have calculated for the year to 30 September 2007, advise Brenda which of the two companies seems to be the better investment. Give reasons for your advice. *7*

(c) Identify **three** types of further information which should be obtained before a final investment decision is made. *3*

(20)

SECTION B (Answer two from three questions)

4 The West Barton Tennis Club prepares accounts to 31 March each year. The club's balance sheet at 31 March 2007 is shown below:

West Barton Tennis Club
Balance sheet as at 31 March 2007

	£	£
Non-current assets		
Freehold land at cost		20,000
Clubhouse at cost	30,000	
Less: Depreciation to date	13,800	16,200
Equipment at cost	17,400	
Less: Depreciation to date	8,200	9,200
		45,400
Current assets		
Bar inventory	3,480	
Prepaid insurance	570	
Bank	1,090	
Cash	200	5,340
		50,740
Accumulated fund		
As at 31 March 2007		44,880
Non-current liabilities		
Life membership fees		3,050
Current liabilities		
Subscriptions in advance	760	
Trade payables (brewery)	1,740	
Accrued electricity charges	310	2,810
		50,740

The following information is also available:

1. Receipts during the year to 31 March 2008 were:

	£
Subscriptions for year to 31 March 2008	10,690
Subscriptions for year to 31 March 2009	830
Life membership fees	1,500
Donations	340
Bar takings	29,240
Sale of dinner dance tickets	1,670
	44,270

2. Payments made during the year to 31 March 2008 were:

	£
Wages	10,760
Payments to brewery	20,870
Purchase of new equipment	5,200
Insurance for year to 31 December 2008	840
Electricity charges	1,660
Rates and water for year to 31 March 2008	1,700
Repairs and maintenance	430
Dinner dance costs	1,320
Charitable donations	1,500
Bank interest and charges	260
Miscellaneous expenses	1,010
	45,550

3. The clubhouse was acquired on 1 April 1984 and is being depreciated on the straight line basis assuming a residual value of £nil.

4. Equipment is depreciated on the reducing balance basis at 25% per annum with a full year's charge in the year of acquisition.

5. Bar inventory is always sold at a mark-up of one-third on cost.

6. The cash balance at 31 March 2008 was £300.

7. The club owed £2,930 to the brewery on 31 March 2008.

8. An electricity bill of £420 for the three months to 30 April 2008 was received in May 2008.

9. Life membership of the club costs £500 and life membership fees are written off over 10 years. As at 31 March 2007, the club had eight life members. Five of these had become life members on 1 April 2004, one on 1 April 2005 and two on 1 April 2006.

- **Requirement for question 4**

(a) Prepare ledger accounts for subscriptions and for life membership fees for the year to 31 March 2008. *4*

(b) Prepare a bar trading account for the year to 31 March 2008. *3*

(c) Prepare an income and expenditure account for the year to 31 March 2008. *7*

(d) Prepare a balance sheet as at 31 March 2008. *6*

(20)

5

Beech plc is a manufacturing company which prepares accounts to 31 March each year and complies with international accounting standards. The company's financial statements for the year to 31 March 2008 cannot be finalised until a number of outstanding matters have been resolved. These are as follows:

1. **Inventory: Partly-completed products**

The company's inventory at 31 March 2008 includes the following partly-completed items of production:

	Production costs incurred to date	Further costs required to complete	Expected selling price
	£	£	£
Item 1	4,750	500	7,200
Item 2	3,190	800	4,800
Item 3	730	300	1,000
Item 4	8,420	1,000	12,600
Item 5	5,550	400	6,000
Totals	22,640	3,000	31,600
Less: 5% expected selling expenses			1,580
			30,020

In the draft financial statements for the year to 31 March 2008, these items have been included in inventory at their total cost to date of £22,640.

2. **Inventory: Special product**

The company's inventory at 31 March 2008 also includes a special product which was completed in February but which had not been sold by the end of March. Costs incurred in relation to this product up to 31 March 2008 were as follows:

	£
Purchase price of raw materials	14,200
Less: 10% trade discount	1,420
	12,780
Carriage inwards	390
Import duties	1,230
Total cost of raw materials	14,400
Direct labour costs	2,780
Allocation of fixed production overheads	2,760
Storage costs since product completed	450
Total cost	20,390

Notes:
One-quarter of the raw materials included above were wasted because of an abnormal machine fault.

In the draft financial statements for the year to 31 March 2008, this item has been included in inventory at its total cost of £20,390.

3. **Property, plant and equipment**

The company's property, plant and equipment at 31 March 2008 includes a computer system bought for £220,000 on 1 April 2005. The useful life of this system was estimated at that time to be six years (with a residual value of £10,000 at the end of the six-year period) and the straight-line method of depreciation was chosen.

However, on 1 April 2007, the company determined that the remaining useful life of the computer system would be only two years, with a residual value of £8,000 at the end of the two-year period.

- **Requirement for question 5**

(a) Explain the purposes of accounting standards. *2*

(b) Explain what is meant by the term 'Generally Accepted Accounting Practice' (GAAP). *3*

(c) With reference to relevant international accounting standards, explain how each of the outstanding matters referred to above should be dealt with in the financial statements of Beech plc for the year to 31 March 2008. *11*

(d) Identify the circumstances in which a company should change the depreciation method being used in relation to an item of property, plant and equipment. *2*

(e) Identify the circumstances in which companies are allowed not to depreciate an item of property, plant and equipment. *2*

(20)

6

In June 2006, CIPFA issued a Standard of Professional Practice (SOPP) on Ethics. This SOPP consists of the International Federation of Accountants (IFAC) Code of Ethics together with a CIPFA foreword. CIPFA is a member of IFAC.

The SOPP establishes some fundamental *ethical principles* for accountants, identifies certain *threats* that might cause an accountant to breach these principles and suggests *safeguards* which may be used to prevent a threat from causing a breach of the ethical principles.

- **Requirement for question 6**

(a) Explain briefly why IFAC felt it necessary in 2005 to draw up a Code of Ethics for accountants and to make adoption of this Code (or a materially similar code) a condition of IFAC membership. *2*

(b) Identify and explain **four** of the fundamental ethical principles which are established in the CIPFA SOPP on Ethics. *8*

(c) Identify and explain **three** of the threats to the fundamental ethical principles which are described in the SOPP. *6*

(d) Identify and explain the **two** main categories of safeguards which are described in the SOPP. *4*

(20)