FINANCIAL ACCOUNTING

Foundation stage
December 2000

MARKING SCHEME

CIPFA

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Question 1

(a)

Alpha Ltd
Profit and Loss Account for the year to 30 June 2000

	Working	£	£	
Turnover			479,290	
Cost of sales (73,700 + 170,630 – 81,700)			162,630	*1*
Gross profit			316,660	
Distribution costs	W1	91,450		*1*
Administrative expenses	W2	135,340	226,790	*2 ½*
			89,870	
Income from fixed asset investments			620	*½*
			90,490	
Interest payable and similar charges			820	*½*
Profit before taxation			89,670	
Taxation (1,170 + 18,000)			19,170	*1*
Profit after taxation			70,500	
Transfer to reserves		40,000		*½*
Dividends paid and proposed (5,000 + 6,000)		11,000	51,000	*1*
Retained profit for the year			19,500	
			Presentation	*2*

Alpha Ltd
Balance Sheet as at 30 June 2000

	Working	£	£	£	
Fixed assets					
Tangible assets					
Land and buildings			200,000		½
Motor vehicles	W3		15,900		*1*
Equipment	W3		11,340	227,240	*1*
Investments				15,000	½
				242,240	
Current assets					
Stock			81,700		
Debtors					
Trade debtors	W4	73,990			*1*
Prepayments		1,870	75,860		
			157,560		
Creditors due within one year					
Bank overdraft		12,680			½
Trade creditors		36,620			
Other creditors	W5	24,000			*1*
Accruals		2,650	75,950		
Net current assets				81,610	
				323,850	
Capital and reserves					
Called-up share capital				100,000	
Revaluation reserve				50,000	*1*
Other reserves				120,000	½
Profit and loss account	W6			53,850	*1*
				323,850	
				Presentation	*2*
					(20)

Workings

W1 Distribution costs	**£**
Per trial balance	83,500
Accrual	2,650
Depreciation of delivery van (W3)	5,300
	91,450

W2 Administrative expenses	**£**
Per trial balance	94,530
Less : bank interest	820
	93,710
Prepayment	(1,870)
Depreciation of equipment (W3)	2,680
Directors' fees	40,000
Bad debt	900
Decrease in doubtful debt provision	(80)
	135,340

W3 Fixed assets	**£**	**£**
Motor vehicles at cost		37,400
Depreciation to 30 June 1999	16,200	
Depreciation for year (25% x (37,400 – 16,200))	5,300	21,500
Net book value		15,900
Equipment at cost		26,800
Depreciation to 30 June 1999	12,780	
Depreciation for year (10% x 26,800)	2,680	15,460
		11,340

W4 Trade debtors	**£**
Per trial balance	76,400
Less : Bad debt written off	900
	75,500
Provision for doubtful debts (2%)	1,510
	73,990

W5 Other creditors	**£**
Corporation tax	18,000
Proposed dividend	6,000
	24,000

W6 Profit and loss account	**£**
Per trial balance	34,350
Retained profit for the year	19,500
	53,850

(b)

The *reserves* of a company consist of profits and gains which have been retained within the company and not as yet distributed to the shareholders. Reserves are part of the capital of a company and represent a claim on the company's assets by the ordinary shareholders. *1*

Revenue reserves consist mainly of undistributed trading profits. These profits could legally have been paid out to the shareholders as dividends and might indeed be distributed at some time in the future. For now, the company has decided to retain these profits, perhaps to finance the acquisition of new fixed assets or to increase the amount of working capital at the company's disposal. If a company distributed all of its profits every year (and had no revenue reserves) it would have difficulty in expanding its operations. This would stifle business growth. *1*

Two examples of a revenue reserve are the "general reserve" to which many companies transfer part of their profits each year and the retained profits shown as a balance on the profit and loss account. Alpha Ltd (see above) has both of these types of revenue reserve. *1*

Capital reserves consist mainly of profits and gains which cannot legally be distributed to the shareholders. The two most common examples of a capital reserve are share premium accounts and revaluation reserves. The latter of these occurs in the case of Alpha Ltd. *1*

A share premium account arises when a company issues shares at more than their nominal value. Companies' legislation prevents a share premium account from being distributed in the form of dividends, though it may be used to fund an issue of bonus shares. A revaluation reserve arises when a company revalues a fixed asset at more than historical cost. This has the effect of recognising that a gain has occurred. However, such a gain will not be realised until the asset is sold (perhaps at some time in the distant future) and therefore a revaluation reserve cannot be distributed in the form of dividends. *1*

(5)

(25)

Question 2

(a)

Sales ledger control account

	£		£	
Balance b/d	27,657			
Casting error (1)	100			½
Omitted invoice (5)	78			½
		Discounts allowed (3)	738	*1*
		Bad debts (4)	300	½
		Daybook casting error (6)	10	½
		Bank (8)	20	*1*
		Contras (10)	825	*1*
		Balance c/d	25,942	
	27,835		27,835	
Balance b/d	25,942			

	£	£	
Total balances per list (26,077 – 375)		25,702	*1*
Add:			
Omitted sales invoice (5)	78		*1*
Omitted debit balance (7)	500	578	½
		26,280	
Less:			
Omitted credit balance (2)	153		*1*
Non-existent debit balance (2)	135		*1*
Payment under-recorded (8)	20		*1*
Casting error (9)	30	338	½
		25,942	

(11)

(b) A credit balance might arise on a customer's account in the sales ledger if (for example):

- the customer mistakenly pays more than the amount owing on the account
- the customer pays the full amount outstanding and then receives credit for a sales return
- a sales invoice is omitted from the customer's account
- an amount of money received from another customer is mistakenly credited to this customer's account.

1 mark per point up to a maximum of 3

(c) The main purposes of preparing control accounts in a manual book-keeping system are:

- to test the accuracy of the underlying sales or purchase ledger *1*
- to cut down the amount of detailed checking required if the trial balance totals do not agree (by making the sales and purchase ledgers self-checking) *1*
- to enable the rapid extraction of a figure for total debtors or total creditors if this is required (eg if interim accounts are needed unexpectedly). *1*

(3)

(d) The role of control accounts in a computer-based system is primarily to provide total figures for debtors and creditors, for inclusion in the trial balance and the balance sheet. *1*

Control accounts perform an important error detection role in manual systems but this is not necessary in computer-based systems, where clerical book-keeping errors cannot occur. The emphasis in computer-based systems is on input controls. Once data has been correctly input to the system, it can be assumed that it will be processed correctly. *2*

(3)

(20)

Question 3

Alison
Profit and Loss Account for the year to 31 July 2000

	Working	£	£	
Sales	W3		88,760	*2 ½*
Cost of sales:				
Stock as at 1 August 1999		8,470		
Purchases	W4	42,090		*1*
		50,560		
Less: Own consumption		600		*1 ½*
		49,960		
Stock at 31 July 2000		8,930	41,030	
Gross profit			47,730	
Less: Wages		13,000		*1*
Rent and rates	W5	7,150		*1*
Insurances	W5	1,370		*1*
Heat, light and power	W5	1,670		*1*
Van expenses		3,270		
Sundry expenses (1,300 + 940)		2,240		
Loan interest (5,000 @ 8% x 6/12)		200		*1*
Bank interest		180		
Depreciation (11,200 @ 20%)		2,240		*1*
Loss on disposal of van	W6	1,260	32,580	*2*
Net profit for the year			15,150	
				(12)

Alison
Balance Sheet as at 31 July 2000

	Working	£	£	£	
Fixed assets					
Motor van at cost			11,200		
Less: Depreciation to date			2,240	8,960	*1*
Current assets					
Stock			8,930		
Trade debtors			390		
Prepayments (1,460 + 410)			1,870		*1*
Cash at bank			1,310		
Cash in hand			300		
			12,800		
Current liabilities					
Trade creditors		3,510			
Accruals (230 + 200)		430	3,940		*1*
Net current assets				8,860	
				17,820	
Long-term liabilities					
Loan				5,000	*1*
				12,820	
Capital					
As at 1 August 1999	W1			8,670	*2*
Net profit for the year				15,150	
				23,820	
Less: Drawings			10,400		*1*
Own consumption			600	11,000	*1*
				12,820	
					(8)
					(20)

Workings

W1 Opening capital	**Assets**	**Liabilities**
	£	**£**
Motor van (9,400 - 60% depreciation)	3,760	
Stock	8,470	
Debtors	350	
Creditors		3,750
Cash	200	
Bank overdraft		2,250
Accruals		210
Prepayments (1,720 + 380)	2,100	
	14,880	6,210
	6,210	
	8,670	

W2 Cash account	**£**	**£**
Opening balance	200	
Cash from customers (balancing figure)	88,720	
Sundry expenses (25 x 52)		1,300
Drawings (200 x 52)		10,400
Wages (250 x 52)		13,000
Paid into bank account		63,920
Closing balance		300
	88,920	88,920

W3 Sales	**£**
Opening debtors	350
Sales (balancing figure)	88,760
	89,110
Cash from customers (W2)	88,720
Closing debtors	390

W4 Purchases	**£**
Opening creditors	3,750
Purchases (balancing figure)	42,090
	45,840
Bank	42,330
Closing creditors	3,510

W5 Expenses	**R and R**	**Insurances**	**H, L and P**
	£	**£**	**£**
Opening prepayment/(accrual)	1,720	380	(210)
Bank	6,890	1,400	1,650
Closing (prepayment)/accrual	(1,460)	(410)	230
Profit and loss account	7,150	1,370	1,670

W6 Loss on sale of van	**£**
WDV 1 August 1999 (W1)	3,760
Sale proceeds	2,500
Loss on sale	1,260

Question 4

(a)

		1999	
ROCE	760 ÷ 5,355 x 100	*14.2%*	½
GPP	1,270 ÷ 4,150 x 100	*30.6%*	½
NPP	575 ÷ 4,150 x 100	*13.9%*	½
Current ratio	1,890 ÷ 1,135	*1.7*	½
Quick assets ratio	1,185 ÷ 1,135	*1.0*	½
Stock holding period	705 ÷ 2,880 x 365	*89 days*	½
Debtor collection period	670 ÷ 4,150 x 365	*59 days*	½
Gearing ratio	0 ÷ 5,355 x 100	*0%*	½

		2000	
ROCE	725 ÷ (5,565 + 800) x 100	*11.4%*	½
GPP	1,520 ÷ 6,370 x 100	*23.9%*	½
NPP	510 ÷ 6,370 x 100	*8.0%*	½
Current ratio	2,660 ÷ 1,995	*1.3*	½
Quick assets ratio	1,210 ÷ 1,995	*0.6*	½
Stock holding period	1,450 ÷ 4,850 x 365	*109 days*	½
Debtor collection period	1,210 ÷ 6,370 x 365	*69 days*	½
Gearing ratio	800 ÷ (5,565 + 800) x 100	*12.6%*	½

(8)

(b)

The first three ratios all indicate that the *profitability* of the company has declined in year 2000. The gross profit percentage has fallen by approximately 7% which may indicate that the company has engaged in a deliberate price-cutting policy. Alternatively, the company may have suffered price increases in relation to its own supplies and chosen not to pass these on to customers. In absolute terms, the company's profits have fallen despite big increases in both turnover and capital employed. *2*

Both of the *liquidity* ratios have fallen considerably. It is especially worrying that the company has no cash at all at the end of the second year, despite having borrowed £800,000 during the year. Presumably much of this has been spent on the acquisition of new fixed assets. *2*

The stock holding period and the debtor collection period have both increased in 2000, and therefore the company is operating with less *efficiency* in these areas than in 1999. Once again, this could be a deliberate policy aimed at winning increased turnover. *1*

The company was as *low-geared* as could be at the end of 1999 and is still fairly low-geared at the end of 2000. However, a few consecutive years of 10%+ increases in the gearing ratio would soon convert Ace Manufacturing Ltd into a high-geared company, with the attendant risks for the shareholders. *1*

Without further information, it is impossible to state with any certainty why these various changes have occurred in 2000. However, one possibility is that the company has embarked upon an all-out attempt to increase its market share by offering an attractive combination of lower prices, a wider range of stocks and longer credit. If this is so, the policy appears to have stimulated sales dramatically but not sufficiently to prevent a fall in profits and a potential liquidity problem. The dividend has been cut in 2000. If the company is forced to keep on borrowing to provide working capital, it is possible that increasing interest payments will eat further into the company's profits and that the dividend will continue to be under threat. *2*

Some of the main reservations about the use of ratio analysis are:

– The lack of standard definitions for some ratios (eg ROCE), making comparisons difficult and perhaps invalid.

– The fact that a company's accounting policies have an important effect on various figures in the financial statements (eg stock, depreciation) so that it is necessary to know something about these policies before drawing any conclusions from a ratio analysis. Ace Manufacturing Ltd may have changed one or more of its accounting policies between 1999 and 2000, so casting doubt upon the results of the ratio analysis.

– The fact that year-end figures from the balance sheet are not necessarily representative of the year as a whole and so may give misleading ratios. For instance, Ace Manufacturing Ltd may have issued its £800,000 of debentures at the very end of 2000, so that the average figure for capital employed during the year would actually be significantly lower than the year-end figure.

– The need to be aware of and take into account a whole host of background factors (eg the economic climate, rate of inflation, industry average performance etc) before placing too much reliance on the results of a ratio analysis.

1 mark per reservation up to a maximum of *3*
Memorandum headings *1*

(12)

(20)

Question 5

(a) According to Chapter 1 of the Statement of Principles, the main objective of financial statements is:

- *"to provide information* ½
- *about the reporting entity's financial performance* ½
- *and financial position,* ½
- *that is useful to a wide range of users* ½
- *for assessing the stewardship of management and* ½
- *for making economic decisions".* ½

(3)

(b) The main users of financial statements are listed as:

- investors *1*
- lenders *1*
- suppliers and other trade creditors *1*
- employees *1*
- customers *1*
- governments and their agencies *1*
- the public. *1*

(½ mark for each + ½ mark for suggesting types of information each user needs) *(7)*

(c) The most important qualitative characteristics which should be possessed by financial information are identified as:

- materiality *1*
- relevance *1*
- reliability *1*
- comparability *1*
- understandability *1*

(½ mark for each + further ½ mark for explanation of each) *(5)*

(15)

Question 6

(a) 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 (e.g. interest) associated with the acquisition of a tangible fixed asset is permitted, so long as this policy is applied consistently. *4*

(b) Valuation

FRS15 allows companies to revalue tangible fixed assets rather than showing the assets at historical 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*

(c) 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*". *2*

The main requirements of the standard in relation to depreciation are:

– 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. *2*

(8)

(15)