FINANCIAL ACCOUNTING

Certificate Stage Examination

6 June 2006

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

Question 1

(a)

Giles, Jones and Vaughan
Trading and Profit and Loss Account for the year to 31 December 2005

	£	£	£	
Sales			226,560	
Less: Returns inwards			5,920	
			220,640	*1*
Cost of sales:				
Stock at 1 January 2005		34,250		
Purchases	112,670			
Carriage inwards	2,110			
	114,780			
Less: Returns outwards	1,440	113,340		
		147,590		
Stock at 31 December 2005		39,270	108,320	*2*
Gross profit			112,320	
Discounts received			820	*½*
			113,140	
Less:				
Staff wages		31,400		
Rent, rates and insurance (£11,330 - £2,400)		8,930		*1*
Heating and lighting (£2,880 + £350)		3,230		*1*
Postage, stationery and telephone:				
(£2,130 - £270 + £100)		1,960		*1*
Carriage outwards		7,930		
Discounts allowed		4,720		
Bad debts written off		1,270		
Increase in provision for doubtful debts		500		*½*
Bank charges and interest		670		
Sundry expenses		710		
Loss on disposal of machine		500		*1*
Depreciation		4,520	66,340	*1*
Net profit for the year			46,800	
				(9)

Note:

The depreciation policy amounts to 16% per annum on cost. The machine which was disposed of during the year was acquired in 2001 and had therefore been depreciated in 2001, 2002, 2003 and 2004. This gives a total of 64% depreciation, leaving a WDV of £2,250 (36% of £6,250). The machine was sold for £1,750 so there is a loss on disposal of £500.

The cost of the remaining plant and machinery is £28,250 (£34,500 - £6,250) and so depreciation for the year is £4,520 (16% of £28,250). Accumulated depreciation is £14,710 (£14,190 - £4,000 + £4,520).

(b)

Giles, Jones and Vaughan
Appropriation Account for the year to 31 December 2005

	£	£	
Net profit for the year		46,800	
1 January 2005 to 30 June 2005:			
Giles	5,200		
Jones	5,200		
Vaughan	5,200	15,600	½
		31,200	
1 July 2005 to 31 December 2005:			
Interest on capital:			
Giles 4% x £15,000 x 6/12	300		
Jones 4% x £10,000 x 6/12	200		
Vaughan 4% x £30,000 x 6/12	600	1,100	*1*
		30,100	
Partners' salaries:			
Giles £10,000 x 6/12	5,000		
Jones £8,000 x 6/12	4,000		
Vaughan £13,000 x 6/12	6,500	15,500	*1*
		14,600	
Remaining profits:			
Giles (50%)	7,300		
Jones (40%)	5,840		
Vaughan (10%)	1,460	14,600	½

(3)

(c)

Partners' current accounts

	Giles	*Jones*	*Vaughan*		*Giles*	*Jones*	*Vaughan*
	£	**£**	**£**		**£**	**£**	**£**
Balance b/d	160			Balance b/d		1,090	1,840
				Int. capital	300	200	600
				Salaries	5,000	4,000	6,500
				Profits (1)	5,200	5,200	5,200
				Profits (2)	7,300	5,840	1,460
Drawings	12,440	7,390	18,610				
Balance c/d	5,200	8,940		Balance c/d			3,010
	17,800	16,330	18,610		17,800	16,330	18,610
Balance b/d			3,010	Balance b/d	5,200	8,940	

(3)

(d)

Giles, Jones and Vaughan
Balance Sheet as at 31 December 2005

	£	£	£	
Fixed assets				
Plant and machinery at cost			28,250	
Less: Accumulated depreciation			14,710	
			13,540	*1*
Current assets				
Stock		39,270		
Trade debtors	26,490			
Less: Provision for doubtful debts	1,500	24,990		
Prepayments		2,670		
		66,930		*1*
Current liabilities				
Bank overdraft	3,590			
Trade creditors	10,300			
Accruals	450	14,340		*1*
Net current assets			52,590	
			66,130	
Capital accounts				
Giles		15,000		
Jones		10,000		
Vaughan		30,000	55,000	*1*
Current accounts				
Giles		5,200		
Jones		8,940		
Vaughan		(3,010)	11,130	*1*
			66,130	
				(5)

(20)

Question 2

(a)/(b)

Freehold premises

		£			£
1/4/05	Balance b/d	75,000			

Equipment

		£			£
1/4/05	Balance b/d	27,420	31/3/06	Balance c/d	29,920
31/3/06	Bank	2,500			
		29,920			29,920

Provision for depreciation of equipment

		£			£
			1/4/05	Balance b/d	12,620

Stock

		£			£
1/4/05	Balance b/d	9,820			

Sales ledger control

		£			£
1/4/05	Balance b/d	6,550			
31/3/06	Sales	73,650	31/3/06	Bank	69,440
			31/3/06	Sales returns	1,130
			31/3/06	Balance c/d	9,630
		80,200			80,200

Provision for doubtful debts

		£			£
			1/4/05	Balance b/d	370

Cash

		£			£
1/4/05	Balance b/d	400	31/3/06	Bank	8,340
31/3/06	Sales	23,940	31/3/06	Capital	15,600
			31/3/06	Balance c/d	400
		24,340			24,340

Bank

		£			£
31/3/06	SL control	69,440	1/4/05	Balance b/d	6,770
31/3/06	Cash	8,340	31/3/06	PL control	62,350
31/3/06	Rent receivable	3,330	31/3/06	Heat and light	3,180
31/3/06	Capital	3,000	31/3/06	Insurance	1,600
31/3/06	Balance c/d	2,100	31/3/06	Business rates	3,640
			31/3/06	General expenses	5,170
			31/3/06	Equipment	2,500
			31/3/06	Loan	1,000
		86,210			86,210

Purchase ledger control

		£			£
			1/4/05	Balance b/d	5,410
31/3/06	Bank	62,350	31/3/06	Purchases	64,440
31/3/06	Purchase returns	670			
31/3/06	Balance c/d	6,830			
		69,850			69,850

Insurances

		£			£
1/4/05	Balance b/d	330	31/3/06	Balance c/d	1,930
31/3/06	Bank	1,600			
		1,930			1,930

Heat and light

		£			£
31/3/06	Bank	3,180	1/4/05	Balance b/d	290
			31/3/06	Balance c/d	2,890
		3,180			3,180

Rent receivable

		£			£
31/3/06	Balance c/d	3,600	1/4/05	Balance b/d	270
			31/3/06	Bank	3,330
		3,600			3,600

Loan from mother

		£			£
31/3/06	Bank	1,000	1/4/05	Balance b/d	5,000
31/3/06	Balance c/d	4,000			
		5,000			5,000

Capital

		£			£
31/3/06	Cash	15,600	1/4/05	Balance b/d	88,790
			31/3/06	Bank	3,000
31/3/06	Balance c/d	76,190			
		91,790			91,790

Sales

		£			£
31/3/06	Balance c/d	97,590	31/3/06	SL control	73,650
			31/3/06	Cash	23,940
		97,590			97,590

Sales returns

		£			£
31/3/06	SL control	1,130			

Purchases

		£			£
31/3/06	PL control	64,440			

Purchase returns

	£		£
		31/3/06 PL control	670

Business rates

	£		£
31/3/06 Bank	3,640		

General expenses

	£		£
31/3/06 Bank	5,170		

Part (a), ¼ mark for each opening balance up to a maximum of 3.
Part (b), ½ mark for each double entry and ¼ mark for each closing balance up to a maximum of 11

(c)

Trial balance at 31 March 2006

	£	£
Freehold premises	75,000	
Equipment	29,920	
Provision for dep'n of equip't at 1 April 2005		12,620
Stock at 1 April 2005	9,820	
Trade debtors	9,630	
Provision for doubtful debts at 1 April 2005		370
Cash	400	
Bank		2,100
Trade creditors		6,830
Insurances	1,930	
Heat and light	2,890	
Rent receivable		3,600
Loan from mother		4,000
Capital		76,190
Sales		97,590
Sales returns	1,130	
Purchases	64,440	
Purchase returns		670
Business rates	3,640	
General expenses	5,170	
	203,970	203,970

(3)

(d)

Journal

		£	**£**	
(i)	Bad debts written off	370		
	Sales ledger control		370	½
	Provision for doubtful debts	370		
	Reduction in prov'n for doubtful debts		370	½
(ii)	Prepayments	400		
	Insurances		400	½
	Heating and lighting	350		
	Accruals		350	½
	Rent receivable	300		
	Prepaid income		300	*1*
				(3)
				(20)

Question 3

(a)

		2005	
Current ratio	359 ÷ 244	*1.47*	½
Quick assets ratio	193 ÷ 244	*0.79*	½
Stock holding period	159 ÷ 844 x 365	*69 days*	½
Debtor collection period	193 ÷ 1,220 x 365	*58 days*	½
Creditor payment period	147 ÷ 858 x 365	*63 days*	½

		2006	
Current ratio	285 ÷ 141	*2.02*	½
Quick assets ratio	189 ÷ 141	*1.34*	½
Stock holding period	131 ÷ 819 x 365	*58 days*	½
Debtor collection period	115 ÷ 1,030 x 365	*41 days*	½
Creditor payment period	141 ÷ 749 x 365	*69 days*	½

Notes:

(i) Average stock for y/e 30 April 2005 is (£152,000 + £166,000)/2 = £159,000.
Average stock for y/e 30 April 2006 is (£166,000 + £96,000)/2 = £131,000.

(ii) Purchases for y/e 30 April 2005 are £858,000 (£844,000 - £152,000 + £166,000).
Purchases for y/e 30 April 2006 are £749,000 (£819,000 - £166,000 + £96,000).

(5)

(b)

Trent Ltd
Cash flow statement for the year to 30 April 2006

		£000	
Reconciliation of operating profit to cash flow from operating activities			
Operating loss (211 - 315)		(104)	*1*
Depreciation charge (137 - 37)		100	*1*
Profit on disposal of fixed asset		(4)	*1*
Decrease in stocks (166 - 96)		70	½
Decrease in trade debtors (193 - 115)		78	½
Decrease in trade creditors (147 - 141)		(6)	½
Net cash inflow from operating activities		134	
Cash flow statement			
Net cash inflow from operating activities		134	
Returns on investments and servicing of finance:			
Interest paid		(4)	½
Taxation		(35)	*1*
Capital expenditure:			
Sale of fixed assets		41	½
		136	
Financing:			
Issue of ordinary share capital (250 - 200)	50		*1*
Redemption of debentures	(50)	0	½
Increase in cash during the year (62 + 74)		136	

(8)

(c) The accounting ratios confirm that the company's liquidity has improved during the year to 30 April 2006. The ratios also reveal that (to some extent) this has been achieved by holding lower stocks, better credit control and by taking longer credit from suppliers. In each case, this may be the result of a deliberate policy of improving efficiency. So long as customers are not deterred by the fact that the company holds lower stocks and collects payment earlier, and so long as creditors are willing to accept later payment, this policy should deliver a permanent improvement in the company's cash position.

The cash flow statement sheds further light on the situation, showing that nearly all of the operating loss was caused by depreciation (which does not trigger a flow of cash out of the business) and that no new fixed assets were acquired during the year. Indeed, £41,000 was raised by selling fixed assets. If the company's fixed assets are becoming elderly and are overdue for replacement, it may be difficult to repeat this saving in future years.

The cash flow statement also shows that the company was able to fund the loan repayment by issuing further ordinary shares (at a premium). If the company continues to suffer operating losses and to pay zero dividends, it may not be possible to issue shares at a premium in future and this may cause difficulties when it is time to redeem the remaining debentures.

Overall, the company seems to have improved its cash situation (despite the poor operating result) by making efficiency gains in the areas of stock holding, debtor collection and creditor payment, by delaying the replacement of fixed assets and by making a share issue. It remains to be seen whether this improvement can be sustained in future years, especially if the company continues to incur losses.

(5)

(d) The term 'gearing' refers to the relationship between:

(i) the amount of long-term finance that a company has obtained by means of borrowing (or by issuing preference shares) and;

(ii) the total amount of the company's long-term finance (including equity capital). *1*

For Trent Ltd, the capital gearing ratio is as follows:

30 April 2005	100/687	= 14.6%	
30 April 2006	50/579	= 8.6%	*1*

(2)

(20)

Question 4

(a)

Tower Trading plc
Profit and Loss Account (extract)
Year to 31 January 2006

	£000	**£000**	
Turnover			
Continuing operations	854		
Acquisitions	205		
	1,059		
Discontinued operations	109	1,168	
Cost of sales		427	
Gross profit		741	*1*
Distribution costs	239		
Administrative expenses	270	509	½
		232	
Other operating income		17	½
Operating profit			
Continuing operations	213		
Acquisitions	49		
	262		
Discontinued operations	(13)	249	*3*
Loss on termination of discontinued operation		(57)	*1*
		192	

Workings	Continuing **£000**	Acquisitions **£000**	Discontinued **£000**
Turnover	854	205	109
Cost of sales	(277)	(73)	(77)
Distribution costs	(192)	(44)	(3)
Administrative expenses	(189)	(39)	(42)
Other operating income	17		
Operating profit	213	49	(13)

(6)

(b) A post balance sheet event is an event (whether favourable or unfavourable) which occurs between the balance sheet date and the date when the financial statements are authorised for issue. FRS21 distinguishes between two types of post balance sheet event: *1*

(i) Adjusting events. These events provide new or additional evidence of conditions existing at the balance sheet date. Typical examples of adjusting events include: *1*

- the subsequent determination of the purchase price or sale proceeds of a fixed asset purchased or sold before the year-end
- the insolvency of a customer who was a debtor at the year-end
- events providing evidence of the net realisable value of closing stocks
- the announcement of tax rates applicable to the accounting year. *1*

FRS21 requires that the financial statements should be changed so as to take into account the effects of material adjusting events. *1*

(ii) Non-adjusting events. These are concerned with conditions which did not exist at the balance sheet date. Typical examples are: *1*

- a fire, flood or other catastrophe which destroys company assets
- an industrial dispute
- mergers and acquisitions
- issues of shares or debentures. *1*

FRS21 requires that the financial statements should *not* be changed to reflect non-adjusting events but that material non-adjusting events should be disclosed in the notes to the accounts. *1*

(7)

(c) SSAP13 classifies R & D expenditure into three types. These are:

(i) Pure research. This is experimental or theoretical work which is undertaken primarily to acquire new scientific or technical knowledge and is not directed towards any specific application. ½

(ii) Applied research. This is work undertaken to gain new scientific or technical knowledge, directed towards a specific practical aim. ½

(iii) Development. This is the use of existing scientific/technical knowledge to produce new or substantially improved products or services. ½

The standard requires that expenditure on pure or applied research should be written off immediately. As regards development expenditure, companies may choose between writing off the expenditure immediately or (subject to certain conditions) capitalising the expenditure and writing it off over its useful life. The same accounting policy must be applied to *all* development expenditure. The conditions which must be satisfied before development expenditure may be capitalised (or "deferred") are as follows:

- There is a clearly defined development project.
- The expenditure concerned is separately identifiable.
- There is reasonable certainty that the project is technically feasible and commercially viable.

- Adequate resources are available to complete the project (or there is a reasonable expectation that such resources will become available).

- There is a reasonable expectation that future revenues from the project will be sufficient to cover the total development costs to date, plus any further development costs, plus the costs of production, selling and administration. *4 ½*

All deferred development expenditure must be reviewed each year to ensure that the above conditions are still satisfied and should be written off immediately if this is not the case. *1*

(7)

(20)

Question 5

(a)

Journal

	£000	£000	
Suspense account	12		
Ordinary share capital		5	
Share premium account		7	*1*
Freehold land	80		
Revaluation reserve		80	*1*
			(2)

(b)

Turnbull plc
Balance Sheet as at 31 May 2006

	£000	£000	£000	
Fixed assets				
Intangible assets				
Goodwill			50	
Tangible assets				
Land and buildings (290 - 22)		268		
Plant and machinery (45 - 25)		20		
Fixtures, fittings, tools and equipment (44 - 19)		25	313	
			363	*1*
Current assets				
Stock		133		
Trade debtors (117 - 3)		114		
Prepayments		4		
Cash in hand		2		
		253		*1*
Creditors due within one year				
Bank overdraft	107			
Trade creditors	60			
Other creditors	56			
Accruals	5	228		*1*
Net current assets			25	
Total assets less current liabilities			388	
Creditors due after more than one year				
Debenture loans			40	½
			348	
Capital and reserves				
Called-up share capital (55 + 25)			80	*1*
Share premium account			7	½
Revaluation reserve			80	½
Profit and loss account			181	½
			348	
				(6)

(c)

	£000	**£000**	
Profit before taxation (deduced)		200	
Taxation (56 + 7)		63	*1*
Profit for the financial year		137	
Dividends - preference	2		*1*
- ordinary	6	8	*1*
Retained profit for the year (181 - 52)		129	*1*

(4)

(d) *Revenue reserves* consist of undistributed trading profits. These profits could have been paid out to the shareholders as dividends but, for now at least, they have been retained within the company. An example of a revenue reserve is the profit and loss account balance shown on a company's balance sheet. *2*

Capital reserves consist of profits and gains which cannot legally be distributed as dividends. An example of a capital reserve is a share premium account. Another example is a revaluation reserve. *2*

(4)

(e)

Preference dividend cover	£137,000 ÷ £2,000	*68.5*	*1*
Ordinary dividend cover	£135,000 ÷ £6,000	*22.5*	*1*
Earnings per share	£135,000 ÷ 100,000	*£1.35*	*1*
Price/earnings ratio	£5.40 ÷ £1.35	*4*	*1*

(4)

Note: Full marks will be awarded to a candidate who uses a denominator of 110,000 in the EPS calculation. In this case, EPS is £1.23 per share and the P/E ratio is 4.4.

(20)

Question 6

(a) The *going concern* concept states that financial statements should be prepared on the assumption that the company in question will continue to trade for the foreseeable future, unless there is a reason to believe otherwise. One consequence of this concept is that the cost (or revalued amount) of fixed assets may be spread over their expected useful lives. Another consequence is that stock may be valued on the assumption that it will be sold in the normal course of trade.

The *consistency* concept states that similar items should be treated in similar ways, both within an accounting period and across different periods. This concept is required because (despite the guidance provided by accounting standards) there is often more than one way of accounting for an item. For example, the accountant must choose between depreciation methods, stock valuation methods etc.

The *prudence* concept recognises that accountants have to form judgments and make estimates when preparing financial statements. Although the concept does not require accountants to be pessimistic, it does require accountants (in conditions of uncertainty) to make sure that assets and revenues are not overstated and that liabilities and expenses are not understated.

The *accruals* (or matching) concept is concerned with the timing of expenses into the profit and loss account. The concept states that expenses should be matched against the revenue to which they relate, regardless of the date on which the expenses are paid. This means that the expenses incurred in order to generate certain revenue will be recognised in the same accounting period as the revenue itself. Examples of the application of the accruals concept include accounting for accruals, prepayments and depreciation.

The *separate determination* concept states that each component of any category of assets or liabilities should be valued separately when arriving at a total to be shown in the accounts for that category. For example, the value of each stock item should be calculated individually (at the lower of cost and net realisable value) and these values should then be totalled to give the stock figure which will appear in the accounts. Stock should not be valued at the lower of total cost and total NRV.

2 marks each for any three concepts, including an example of their application up to a maximum of 6

(b) Further accounting concepts include:

- the historical cost concept
- the realisation concept
- the materiality concept
- the substance over form concept
- the objectivity concept
- the stable monetary unit concept
- the duality concept
- the money measurement concept
- the business entity concept.

1 mark per concept including a valid explanation up to a maximum of 5

(c) The qualitative characteristics which should be possessed by financial information are identified in the Statement of Principles as:

(i) materiality

(ii) relevance

(iii) reliability

(iv) comparability

(v) understandability

1 mark per characteristic, including a brief explanation up to a maximum of 5

(d) The accruals concept requires that the cost of a fixed asset should be spread over its useful life. Assuming that the business is a going concern, this will normally entail charging depreciation over a period of several years.

However, the prudence concept might suggest that the entire cost of a fixed asset should be written off immediately, especially if the asset concerned is one whose useful life could be abruptly cut short. A footballer's registration (acquired by payment of a transfer fee) is an example of such an asset, since it may become valueless if the player concerned suffers serious injury.

Clashes of this nature might be resolved by reference to a relevant accounting standard (if one exists). Failing this, the general guidance provided by the Statement of Principles might help. In the final analysis, accountants must sometimes use their professional judgment and experience when choosing between alternative accounting treatments suggested by different accounting concepts.

(4)

(20)