CIPFA

FINANCIAL ACCOUNTING

Certificate stage examination

6 June 2006

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

Instructions to candidates

*Answer **five** questions in total: **Three** questions from **Section A**, and **two** questions from **Section B**. The marks available for each question are shown in italics in the right hand margin.*

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.

A Proforma booklet, graph paper and cash analysis paper are available from the invigilator.

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.

The Proforma booklet provided may be submitted as part of an answer.

AT THE HEART OF
YOUR CAREER

(Copyright)

SECTION A (Compulsory)

1

Giles, Jones and Vaughan have been in partnership for several years, preparing accounts to 31 December each year and sharing profits equally. As from 1 July 2005, the partners agreed to adopt the following profit-sharing agreement:

(i) Partners would be entitled to 4% pa interest on their fixed capital accounts.

(ii) Partners' annual salaries would be Giles £10,000, Jones £8,000 and Vaughan £13,000.

(iii) Remaining profits or losses would be shared between Giles, Jones and Vaughan in the ratio 5:4:1.

The trial balance of the partnership as at 31 December 2005 was as follows:

	£	**£**
Bad debts written off	1,270	
Bank balance		3,590
Bank charges and interest	670	
Carriage inwards	2,110	
Carriage outwards	7,930	
Current accounts at 1 January 2005 - Giles	160	
- Jones		1,090
- Vaughan		1,840
Discounts allowed and received	4,720	820
Disposal of plant and machinery		1,750
Drawings - Giles	12,440	
- Jones	7,390	
- Vaughan	18,610	
Fixed capital accounts - Giles		15,000
- Jones		10,000
- Vaughan		30,000
Heating and lighting	2,880	
Plant and machinery, at cost	34,500	
Postage, stationery and telephone	2,130	
Provision for depreciation at 1 January 2005:		
Plant and machinery		14,190
Provision for doubtful debts at 1 January 2005		1,000
Purchases and sales	112,670	226,560
Rent, rates and insurance	11,330	
Returns inwards and outwards	5,920	1,440
Staff wages	31,400	
Stock at 1 January 2005	34,250	
Sundry expenses	710	
Trade debtors and creditors	26,490	10,300
	317,580	317,580

The following information is also available:

1 Plant and machinery is depreciated over five years on the straight line basis, assuming a residual value equal to 20% of cost. A full depreciation charge is made in the year of acquisition and none is made in the year of disposal. All of the plant and machinery held on 31 December 2004 was less than five years old.

Machinery which had cost £6,250 on 1 April 2001 was sold for £1,750 on 1 May 2005. The sale proceeds were debited to the bank account and credited to a disposal account, but no other entries have yet been made in relation to this disposal. There were no acquisitions of plant and machinery during the year to 31 December 2005.

2 Closing stock at 31 December 2005 was valued at £39,270.

3 Prepayments and accruals at 31 December 2005 were as follows:

	£
Prepaid rent, rates and insurance	2,400
Prepaid telephone rental	270
Accrued telephone call charges	100
Accrued heating and lighting	350

4 It has been decided that the provision for doubtful debts should be increased to £1,500.

5 The partners have agreed that, for profit sharing purposes, one-third of the net profit for the year to 31 December 2005 should be allocated to the first half of the year and the other two-thirds of the net profit should be allocated to the second half of the year.

- **Requirement for question 1**

(a) Prepare a trading and profit and loss account for the year to 31 December 2005. *9*

(b) Prepare an appropriation account for the year to 31 December 2005. *3*

(c) Write up the partners' current accounts for the year to 31 December 2005. *3*

(d) Prepare a balance sheet as at 31 December 2005. *5*

(20)

2

Tariq is a sole trader who prepares accounts to 31 March each year. His sales are mainly credit sales, but he also has some cash sales. All purchases of stock are made on credit. Tariq's balance sheet as at 31 March 2005 was as follows:

Tariq
Balance Sheet as at 31 March 2005

	£	£	£
Fixed assets			
Freehold premises at cost			75,000
Equipment at cost		27,420	
Less: Depreciation to date		12,620	14,800
			89,800
Current assets			
Stock		9,820	
Trade debtors	6,550		
Less: Provision for doubtful debts	370	6,180	
Prepaid insurance		330	
Cash		400	
		16,730	
Current liabilities			
Bank overdraft	6,770		
Trade creditors	5,410		
Accrued heat and light	290		
Rent received in advance	270	12,740	
Net current assets			3,990
			93,790
Long-term liabilities			
Loan from mother (interest-free)			5,000
			88,790
Capital account			
As at 31 March 2005			88,790
			88,790

The following information is available for the year to 31 March 2006:

1 All credit sales, purchases and returns are recorded in daybooks. The daybook totals for the year to 31 March 2006 were as follows:

	£
Sales daybook	73,650
Sales returns daybook	1,130
Purchases daybook	64,440
Purchase returns daybook	670

2 Cash sales are always banked intact, after Tariq has taken £300 per week to cover his personal living expenses. A cash float of £400 is maintained and this did not change during the year to 31 March 2006.

3 A summary of the business bank account for the year to 31 March 2006 is as follows:

Amounts paid in:	**£**
Cheques received from trade debtors	69,440
Cash sales paid into the bank account	8,340
Rent received	3,330
Capital introduced by Tariq	3,000

Amounts paid out:	**£**
Cheques to trade creditors	62,350
Heating and lighting	3,180
Insurance	1,600
Business rates	3,640
General expenses	5,170
Purchase of equipment	2,500
Loan repayment	1,000

- **Requirement for question 2**

(a) Open ledger accounts for each of the items shown in Tariq's balance sheet at 31 March 2005 and record opening balances in these accounts as at 1 April 2005. (Leave enough space between these ledger accounts to allow the recording of the entries required for part (b) of this question). *3*

(b) Record Tariq's transactions for the year to 31 March 2006, opening additional ledger accounts as necessary. Where there is more than one entry in an account, calculate and show the balance on the account as at 31 March 2006. *11*

(c) Extract a trial balance as at 31 March 2006. *3*

(d) Write journal entries for the following year-end adjustments (narratives are **not** required):

(i) Bad debts of £370 are to be written off and the provision for doubtful debts is to be reduced to zero.

(ii) Prepaid insurance at 31 March 2006 was £400 and accrued heating and lighting was £350. Rent of £300 had been received in advance. *3*

(20)

3

The summarised financial statements of Trent Ltd for the years to 30 April 2005 and 2006 are as follows:

Profit and loss accounts

	y/e 30/4/05		y/e 30/4/06	
	£000	**£000**	**£000**	**£000**
Sales		1,220		1,030
Cost of sales		844		819
Gross profit		376		211
Net operating expenses	251		315	
Interest payable	8	259	4	319
Profit/(loss) before tax		117		(108)
Taxation		35		0
Profit/(loss) after tax		82		(108)
Dividends paid		20		0
Retained profit/(loss)		62		(108)

Balance sheets

	as at 30/4/05		as at 30/4/06	
	£000	**£000**	**£000**	**£000**
Fixed assets		572		435
Current assets:				
Stock	166		96	
Trade debtors	193		115	
Cash at bank	-		74	
	359		285	
Current liabilities:				
Trade creditors	147		141	
Corporation tax	35		-	
Bank overdraft	62		-	
	244		141	
Net current assets		115		144
		687		579
8% Debenture loans		100		50
		587		529
Ordinary £1 shares		200		220
Share premium account		-		30
Profit and loss account		387		279
		587		529

The company suffered fierce competition during the year to 30 April 2006 and was obliged to advertise heavily in order to avoid losing too much of its custom. These factors account for the reduction in turnover during the year and the large increase in operating expenses.

Although there was a loss of £108,000 for the year to 30 April 2006, the directors were pleased (and surprised) to discover that the company's cash position had actually improved. A bank overdraft of £62,000 at the start of the year had turned into a positive bank balance of £74,000 by the end of the year. The directors would like an explanation of how this apparently contradictory situation has arisen.

The following information is also available:

1. All of the company's sales and purchases are on credit.

2. The closing stock at 30 April 2004 was £152,000.

3. £50,000 of debenture loans was repaid on 1 May 2005.

4. There were no acquisitions of fixed assets during the year to 30 April 2006. A fixed asset which had originally cost £60,000 was disposed of during the year for £41,000. The accumulated depreciation on this asset on the date of disposal was £23,000.

- **Requirement for question 3**

(a) Calculate TWO liquidity ratios and THREE efficiency (management of working capital) ratios for the year to 30 April 2005 and the year to 30 April 2006. *5*

(b) Prepare a cash flow statement for Trent Ltd for the year to 30 April 2006 in accordance with the requirements of accounting standard FRS1. The reconciliation to movement in net debt is not required. *8*

(c) Use the information provided by the ratios and by the cash flow statement to explain why (despite poor operating results) the company's cash position has improved during the year to 30 April 2006. *5*

(d) Briefly explain what is meant by the accounting term 'gearing' and calculate the company's capital gearing ratio as at 30 April 2005 and 30 April 2006. *2*

(20)

SECTION B (Answer two from three questions)

4 Tower Trading plc prepares accounts to 31 January each year. The following is an extract from the draft profit and loss account which has been prepared for the year to 31 January 2006:

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

	£000	**£000**
Turnover		1,168
Cost of sales		427
Gross profit		741
Distribution costs	239	
Administrative expenses	327	566
		175
Other operating income		17
Operating profit		192

The following information is also available:

1 On 31 May 2005, the company closed down one of its business operations, incurring a loss on termination of £57,000. In the draft profit and loss account, this loss has been included in administrative expenses. Between 1 February 2005 and 31 May 2005, the terminated operation yielded turnover of £109,000. Related costs were:

	£000
Cost of sales	77
Distribution costs	3
Administrative expenses	42

None of the "other operating income" in the draft profit and loss account relates to the terminated operation.

2 On 1 September 2005, the company began a new business operation. This operation yielded turnover of £205,000 between 1 September 2005 and 31 January 2006. Related costs were:

	£000
Cost of sales	73
Distribution costs	44
Administrative expenses	39

None of the "other operating income" in the draft profit and loss account relates to this new operation.

3 In the draft profit and loss account, administrative expenses include an unusually large bad debt of £30,000. This bad debt did not arise from the operation which was closed down at 31 May 2005 or from the new operation which began on 1 September 2005.

4 It has been decided that the company will establish a research and development department as from August 2006. This will be the first time that the company has ever engaged in research and development activity.

- **Requirement for question 4**

(a) Insofar as the above information permits, prepare a profit and loss account for the year to 31 January 2006 which complies with the requirements of accounting standard FRS3 (Reporting Financial Performance). Accompanying notes are **not** required but all workings must be shown. Assume that all amounts are material. *6*

(b) Explain the term "post balance sheet event" and outline the treatment of such events which is required by accounting standard FRS21 (Events after the Balance Sheet Date) which replaces SSAP17 (Accounting for Post Balance Sheet Events). *7*

(c) Explain the main requirements of accounting standard SSAP13 (Accounting for Research and Development) in connection with the accounting treatment of research and development expenditure. *7*

(20)

5

Turnbull plc prepares accounts to 31 May each year. The following trial balance shows the balances remaining in the company's books at 31 May 2006 *after* the profit and loss account for that year has been prepared:

	£000	**£000**
Bank balance		107
Cash	2	
Corporation tax		56
7.5% Debentures 2010		40
Freehold buildings, at cost	110	
Freehold land, at cost	100	
Goodwill	50	
Motor vehicles, at cost	45	
Office furniture and equipment, at cost	44	
Ordinary shares of 50p each, fully paid		50
8% Preference shares of £1 each, fully paid		25
Prepayments and accruals	4	5
Profit and loss account at 31 May 2006		181
Provisions for depreciation at 31 May 2006:		
Freehold buildings		22
Motor vehicles		25
Office furniture and equipment		19
Provision for doubtful debts at 31 May 2006		3
Stock at 31 May 2006	133	
Suspense account		12
Trade debtors and creditors	117	60
	605	605

The following information is also available:

1 On 31 May 2006, the company made a fully subscribed 1 for 10 rights issue of ordinary shares at £1.20 per share. The proceeds of this issue were temporarily credited to a suspense account. There were no other share issues during the year.

2 On 1 January 2006, the company's freehold land was revalued at £180,000. It is intended that this revaluation should be incorporated into the accounts for the year to 31 May 2006.

3 The preference dividend for the year was paid on 31 May 2006. An interim ordinary dividend of 6p per share was paid on 1 March 2006. No final ordinary dividend is proposed.

4 In the accounts for the year to 31 May 2005, the company's corporation tax liability for that year was underestimated by £7,000. This sum was paid in the year to 31 May 2006.

5 Retained profits brought forward on 1 June 2005 were £52,000.

6 The company's ordinary shares had a market value of £5.40 per share as at 31 May 2006.

- **Requirement for question 5**

(a) Write journal entries to reflect the rights issue and the revaluation of freehold land. Narratives are **not** required. *2*

(b) Prepare a balance sheet as at 31 May 2006 in a form which is suitable for publication. *6*

(c) Compute the company's pre-tax profit for the year to 31 May 2006. *4*

(d) Briefly distinguish between a revenue reserve and a capital reserve, giving an example of each type of reserve. *4*

(e) Compute the following ratios for the year to 31 May 2006:

- preference dividend cover
- ordinary dividend cover
- earnings per share
- price/earnings ratio. *4*

(20)

6

For many years, accountants seeking guidance on the most appropriate treatment of an item in the accounts of a company have relied upon a set of accounting concepts or conventions. Five of these concepts are enforced by company law. They are:

- going concern
- consistency
- prudence
- accruals (or matching)
- separate determination.

Furthermore, accounting standard FRS18 (Accounting Policies) states that the going concern concept and the accruals concept both play a "pervasive role" in financial statements and in the selection of accounting policies.

The ASB *Statement of Principles for Financial Reporting* also refers to some of the accounting concepts when describing the "qualitative characteristics" which make financial information useful.

- **Requirement for question 6**

(a) Explain THREE of the accounting concepts listed above and give an example of the application of each of these three concepts. *6*

(b) Identify a further FIVE key accounting concepts and briefly explain the guidance provided by each of them. *5*

(c) List and explain the qualitative characteristics which make financial information useful. *5*

(d) Give an example of a situation in which the guidance offered by one of the accounting concepts might contradict the guidance offered by another concept. Explain how such clashes might be resolved. *4*

(20)
