Answers

1 (a)

Wisaron
Trading and Profit and Loss and Appropriation Account
for the year ended 31 October 2005

		£	£	Marks	Workings
for the year ended 31 October 2005				0·5	
Sales			302,200	0·5	
Less Returns inwards			(3,600)	0·5	
			298,600		
Opening stock		23,500		0·5	
Add Purchases		214,400		1·0	(£215,300 – £900)
Carriage inwards		1,150		0·5	
		239,050			
Less closing stock		19,000		0·5	
Cost of goods sold			(220,050)	0·5	
Gross Profit			78,550	0·5	
Expenses					
Selling expenses		17,500		0·5	
Rent		12,000		1·0	(£13,000 – £1,000)
General expenses		1,900		0·5	
Insurance		800		0·5	
Motor vehicle expenses		6,000		0·5	
Discounts allowed		1,340		0·5	
Wages		9,490		1·0	(£9,090 + £400)
Depreciation					
– Motor vehicles		2,500		1·5	((£16,000 – £6,000) x 25%)
– Fixtures and fittings		800		1·0	(£8,000 x 10%)
Loan interest		200		1·0	((£5,000 x 8%) x 0·5)
Bank charges		75		0·5	
Irrecoverable debts		400		0·5	
Increase in allowance for debtors		565	(53,570)	1·5	((£25,700 – £400) x 5%) – £700
Net profit			24,980	0·5	
Interest on drawings:	Lewis	270		0·5	
	Aaron	210	480	0·5	
			25,460		
Salary: Aaron			(8,500)	1·0	
			16,960		
Share of profit:	Lewis 3/5	10,176		0·5	
	Aaron 2/5	6,784		0·5	
			16,960		
				19·0	

				Marks	Workings

(b)

Current Accounts

Lewis

	£		£	Marks
Drawings	6,500	Balance b/f	2,560	0·5 + 0·5
Goods	900	Loan interest	200	1 + 1
Interest on drawings	270	Share of profit	10,176	0·5 + 0·5
Balance c/f	5,266			
	12,936		12,936	

Aaron

	£		£	Marks
Drawings	5,600	Balance b/f	1,370	0·5 + 0·5
Interest on drawings	210	Salary	8,500	0·5 + 1
Balance c/f	10,844	Share of profit	6,784	0 + 0·5
	16,654		16,654	
				7

(c)

Wisaron

Balance sheet as at 31 October 2005 — 0·5

	Cost	Accumulated Depreciation	Net Book Value	Marks	Workings
	£	£	£		
Fixed Assets					
Motor vehicles	16,000	8,500	7,500	1·0	
Fixtures and fittings	8,000	3,800	4,200	1·0	
	24,000	12,300	11,700	1·0	
Current assets					
Stock		19,000		0·5	
Debtors	25,300			1·0	(£25,700 – £400)
Allowance for debtors	(1,265)	24,035		1·0	(£25,300 x 5%)
Prepayment (rent)		1,000		1·0	
Bank		1,375		1·0	(£1,450 – £75)
		45,410			
Current Liabilities					
Creditors	22,600			0·5	
Accruals (wages)	400	(23,000)		1·0	
Net current assets			22,410	0·5	
			34,110		
Loan from Lewis			(5,000)	1·0	
Net assets			29,110	0·5	
Capital accounts					
Lewis		7,000		1·0	(£12,000 – £5,000)
Aaron		6,000	13,000	0·5	
Current accounts					
Lewis		5,266		0·5	
Aaron		10,844	16,110	0·5	
			29,110		
				14	

2 (a) Goodwill on acquisition

	£000	£000	Workings £m	Marks
Cost of investment		660,000		1
Share Capital	480,000		(80% x 600)	1
Reserves	76,000		(80% x 95)	1
Revaluation of land	56,000		(80% x 70)	1
		(612,000)		
Goodwill		48,000		4

(b) **Spyder Ltd**
Consolidated Balance Sheet as at 31 October 2005

	£000	£000		
Fixed assets				
Land and buildings		663,000	(W1)	2
Plant		505,000	(285 + 220)	0·5
		1,168,000		
Current assets				
Stock	597,000		(357 + 252 – 12)	1·5
Debtors	626,000		(525 + 126 – 25)	1·5
Bank	188,000		(158 + 30)	0·5
	1,411,000			
Creditors: amounts falling due within one year	289,000		(220 + 94 – 25)	1·5
Net current assets		1,122,000		
		2,290,000		
Capital and reserves				
£1 Ordinary shares		1,500,000		1
Reserves		613,600	(W2)	3·5
Minority Interest		176,400	(W3)	3
		2,290,000		
				15

Workings

W1 Land and Buildings	**£000**	**£000**	**Analysis of marks**
Spyder Ltd		315,000	0·5
Phly Ltd: Book value	278,000		0·5
: Revaluation of land on acquisition	70,000		1
		348,000	2
		663,000	

W2 Reserves			
Spyder Ltd balance		580,000	0·5
Reserves of Phly Ltd (80% x £212 million)		169,600	1
Pre acquisition reserves (80% x £95 million)	(76,000)		1
Less Goodwill	(48,000)		0·5
Profit on purchases from Spyder Ltd	(12,000)		0·5
		(136,000)	
Reserves		613,600	3·5

W3 Minority Interest			
Share Capital (20% x £600 million)		120,000	1
Revaluation (20% x £70 million)		14,000	1
Reserves (20% x £212 million)		42,400	1
Minority Interest		176,400	3

(c) Inter-company trading and consolidation

The companies within a group are separate legal entities and therefore may treat other companies within the group the same as any other customer. For example, in this question, Phly Ltd has purchased goods from Spyder Ltd.

The accounts of Spyder Ltd will show a profit earned on sales to Phly Ltd and similarly Phly Ltd's balance sheet will include stock at the cost purchased from Spyder Ltd. There are two accounting issues that need to be addressed when preparing the group accounts:

(i) Although Spyder Ltd has made a profit on the goods it has sold to Phly Ltd, the group has not made a sale, or any profit, until an outside customer buys the goods from Phly Ltd.
(ii) Any purchases that remain unsold by Phly Ltd at the end of the year will be included in Phly Ltd's stock. Their balance sheet value will be their cost to Phly Ltd, which is not the same as to the group.

The only profits to be recognised should be those made by the group in providing goods to third parties. Stock in the consolidated balance sheet should also be valued at the cost to the group. Thus, the £12 million of Spyder's profit in Phly's closing stock is unrealised from the group's perspective and is eliminated in full upon consolidation.

There may also be debtors and creditors within a group. In these circumstances these internal balances are cancelled. For example in this question Phly Ltd is indebted to Spyder Ltd for £25 million. Therefore, Phly Ltd has a creditor on its balance sheet of £25 million and Spyder Ltd has a debtor of £25 million on its balance sheet. When the accounts are consolidated the two balances are cancelled.

Marking scheme
Up to 3 marks for identifying the issue of unrealised profit on stock, explaining how they are treated on consolidation and using an example from the question.
Up to 3 marks for identifying the issue of internal debtors and creditors, explaining how they are treated on consolidation and using an example from the question.

3 (a)

Ratio	Formulae	Aber Ltd	Cromby Ltd
Gross profit percentage	$\frac{\text{Gross profit}}{\text{Sales}} \times 100$	$\frac{1,100}{5,500} \times 100 = 20{\cdot}0\%$	$\frac{2,160}{7,200} \times 100 = 30{\cdot}0\%$
Return on capital employed*	$\frac{\text{Profit before int. \& tax}}{\text{Capital employed}} \times 100$	$\frac{490}{4,155} \times 100 = 11{\cdot}8\%$	$\frac{475}{7,520} \times 100 = 6{\cdot}3\%$
Earnings per share	$\frac{\text{Net profit after tax}}{\text{No. of ordinary shares}}$	$\frac{275}{3,000} = 9{\cdot}2\text{p}$	$\frac{280}{7,000} = 4{\cdot}0\text{p}$

Marking scheme
1 mark for each ratio (6 marks)
* Alternative ratio definitions and calculations may be acceptable.

(b)

Ratio	Aber Ltd	Cromby Ltd	Comment
Gross profit percentage	20%	30%	Cromby Ltd has been able to achieve a significantly higher gross profit percentage than Aber Ltd. This may be due to a number of factors; for example, Cromby Ltd may be operating at the luxury (branded) end of the leisurewear market, consequently it may be able to charge its customers a premium price for its goods. Cromby Ltd may also be able to obtain good discounts from its suppliers for bulk purchases. Alternatively, Aber Ltd may have expensive suppliers, with high costs associated with carriage inwards.
Return on capital employed	11·8%	6·3%	Aber Ltd's return on capital employed is nearly double that of Cromby Ltd. This might suggest that Aber Ltd is managed more efficiently than Cromby Ltd. Certainly Aber Ltd's returns represents a reasonable return when compared to current market borrowing rates. However, more information is needed; for example are the property assets of both businesses correctly valued?
Earnings per share	9·2p	4·0p	Aber Ltd has a higher EPS than Cromby Ltd and from a shareholder's perspective, Aber Ltd would be considered a better investment. It would be useful to have the previous year's EPS figures so that any trends could be identified.

There should be some evidence of trying to interpret the ratios, while acknowledging the limitations of the information available. Other comments, if appropriate, will also be given credit.
1 mark for each relevant comment up to 9 marks.

(c) **Limitations of ratio analysis:**

1 The accounting information used to prepare the ratios may be out of date.
2 Usually the information presented in the published accounts is summarised, making a detailed analysis impossible.
3 Price changes over time make year on year comparisons difficult.
4 Changes in accounting policies from year to year may produce misleading ratios.
5 Different businesses use different accounting policies. This may make direct comparisons difficult.

Marking scheme
1 mark for each limitation that is explained up to 5 marks (other examples may be given).

4 **(a)** **(i)** **Going Concern Concept**

The going concern concept implies that the business will continue in operational existence for the foreseeable future, and that there is no intention to put the company into liquidation or make drastic cutbacks to the scale of operation. This concept has a major influence on the assumptions made when evaluating particular items in the balance sheet. For example assets are not normally shown at net realisable value because they are expected to be kept in the business for future use.

2 marks

(ii) **Accruals Concept**

The accruals concept requires that revenue and costs are recognised as they are earned or incurred, not when the money is received or paid. They must be matched with one another so far as their relationship can be established or justifiably assumed and dealt with in the profit and loss account of the period to which they relate.

2 marks

(iii) **Reliablity**

Accounting information must be reliable if it is to be useful. In accounting terms this means the information should be free from material error and bias. The user must be able to depend on it being a faithful representation.

2 marks

(iv) **Understandability**

Users of financial statements must be able to understand them. However, it is assumed they have some business, economic and accounting knowledge and they are able to apply themselves to study the information provided properly. The complex matters of financial statements should not be left out simply because of their difficulty, if it is relevant information.

2 marks

(b) **The arguments for having accounting standards**

– Accounting standards restrict the number of choices in the methods used to prepare financial statements and therefore reduce the risk of creative accounting. This should help the users of accounts to compare the financial performance of different organisations.

– Companies are obliged to disclose the accounting policies they have used in the preparation of accounts. This should help the users of accounts better understand the information presented.

– Accounting standards should increase the credibility of accounts by increasing uniformity of accounting treatment between companies.

– Accounting standards require companies to disclose information which they might not want to disclose if the standards did not exist.

– Accounting standards provide a focal point for discussion about accounting practice.

The arguments against having accounting standards

– Sometimes the accounting method advocated may not be appropriate in some particular circumstances or for certain types of organisation.

– Accounting standards may be overly prescriptive, reducing flexibility and the opportunity for accountants to use their professional judgement.

– Standards may be too general, resulting in a lack of clear guidance in some situations.

– If standards contain too many detailed rules, there is a danger that preparers will develop creative accounting techniques that technically adhere to the rules but conflict with the overall aims and principles behind financial statements.

– Accounting standards may have been drafted as a consequence of a particular pressure group.

– Some accounting standards can be expensive to comply with.

Marking scheme: 1 mark for each relevant point up to 7 marks.