Answers

1 (a)

Wisaron
Income Statement and Appropriation Account
for the year ended 31 October 2005

		$	$	Marks	Workings
				0·5	
Sales revenue			302,200	0·5	
Less Returns inwards			(3,600)	0·5	
			298,600		
Opening inventory		23,500		0·5	
Add Purchases		214,400		1·0	($215,300 – $900)
Freight inwards		1,150		0·5	
		239,050			
Less closing inventory		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 receivables		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
Assets	$	$	$		
Non-current 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					
Inventory		19,000		0·5	
Trade receivables, net	25,300			1·0	($25,700 – $400)
Allowance for receivables	(1,265)	24,035		1·0	($25,300 x 5%)
Prepayment (rent)		1,000		1·0	
Bank		1,375	45,410	1·0	($1,450 – $75)
Total assets			57,110	0·5	
Partners' capital accounts					
Lewis		7,000		1·0	($12,000 – $5,000)
Aaron		6,000	13,000	0·5	
Partners' current accounts					
Lewis		5,266		0·5	
Aaron		10,844	16,110	0·5	
Non-current liabilities					
Loan from Lewis			5,000	1·0	
Current Liabilities					
Payables		22,600		0·5	
Accruals (wages)		400	23,000	1·0	
Total capital and liabilities			57,110	0·5	
				14	

			$000	$000	Workings $m	Marks
2	(a)	Goodwill on acquisition				
		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
Consolidated Balance Sheet as at 31 October 2005

Assets	$000	$000		
Non-current assets				
Land and buildings		663,000	(W1)	2
Plant		505,000	(285 + 220)	0·5
		1,168,000		
Current assets				
Inventory	597,000		(357 + 252 – 12)	1·5
Trade receivables	626,000		(525 + 126 – 25)	1·5
Bank	188,000	1,411,000	(158 + 30)	0·5
Total assets		2,579,000		
Equity and liabilities				
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		
Current liabilities				
Payables		289,000	(220 + 94 – 25)	1·5
Total equity and liabilities		2,579,000		
				15

Workings

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

W2 Reserves			
Spyder balance		580,000	0·5
Reserves of Phly (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	(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 customers. For example, in this question, Phly has purchased goods from Spyder.

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

(i) Although Spyder has made a profit on the goods it has sold to Phly, the group has not made a sale, or any profit, until an outside customer buys the goods from Phly.
(ii) Any purchases that remain unsold by Phly at the end of the year will be included in Phly's inventory. Their balance sheet value will be their cost to Phly, 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. Inventory 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 inventory is unrealised from the group's perspective and is eliminated in full upon consolidation.

There may also be receivables and payables within a group. In these circumstances these internal balances are cancelled. For example in this question Phly is indebted to Spyder for $25 million. Therefore Phly has a payable on its balance sheet of $25 million and Spyder has a receivable 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 inventory, explaining how they are treated on consolidation and using an example from the question.
Up to 3 marks for identifying the issue of internal receivables and payables, explaining how they are treated on consolidation and using an example from the question.

3 (a)

Ratio	**Formulae**	**Aber**	**Cromby**
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	$\frac{\text{Net Profit after tax}}{\text{No. of ordinary shares}}$	$\frac{275}{3,000} = 9{\cdot}2$ cents	$\frac{280}{7,000} = 4{\cdot}0$ cents

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

(b)

Ratio	**Aber**	**Cromby**	**Comment**
Gross profit percentage	20%	30%	Cromby has been able to achieve a significantly higher gross profit percentage than Aber. This may be due to a number of factors; for example, Cromby 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 may also be able to obtain good discounts from its suppliers for bulk purchases. Alternatively, Aber may have expensive suppliers, with high costs associated with freight inwards.
Return on capital employed	11·8%	6·3%	Aber's return on capital employed is nearly double that of Cromby. This might suggest that Aber is managed more efficiently than Cromby. Certainly Aber's return 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	9·2c	4·0c	Aber has a higher EPS than Cromby and from a shareholder's perspective, Aber would be considered a better investment. It would be useful to have the previous years' 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 income statement 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.