# FINANCIAL ACCOUNTING

**Foundation Stage**
**June 2002**

# MARKING SCHEME

 

## Question 1

(a)

**Drummond Ltd**
**Profit and Loss Account for the year to 31 March 2002**

| | Working | £ | £ | |
|---|---|---|---|---|
| Turnover | | | 1,351,810 | |
| Cost of sales (156,620 + 701,110 – 141,500) | | | 716,230 | *½* |
| Gross profit | | | 635,580 | |
| Distribution costs | W1 | 227,330 | | *2* |
| Administrative expenses | W2 | 298,620 | 525,950 | *2* |
| | | | 109,630 | |
| Other operating income | | | 10,000 | *½* |
| Operating profit | | | 119,630 | |
| Cost of fundamental reorganisation | | | 37,200 | *1* |
| | | | 82,430 | |
| Income from fixed asset investments | | | 2,400 | *½* |
| Interest receivable | | | 5,850 | *½* |
| | | | 90,680 | |
| Interest payable | | | 14,000 | *½* |
| Profit before taxation | | | 76,680 | |
| Taxation (2,870 + 17,500) | | | 20,370 | *1* |
| Profit after taxation | | | 56,310 | |
| Dividends paid and proposed (32,000 + 35,600) | | | 67,600 | *1* |
| Retained loss for the year | | | 11,290 | |

*Presentation* *1 ½*

## Drummond Ltd
## Balance Sheet as at 31 March 2002

| | Working | £ | £ | £ | |
|---|---|---|---|---|---|
| **Fixed assets** | | | | | |
| Tangible assets | | | | | |
| Land and buildings | | | 330,000 | | *½* |
| Motor vehicles | W3 | | 35,330 | | *1* |
| Equipment | W3 | | 41,510 | 406,840 | *1* |
| Investments | | | | 50,000 | *½* |
| | | | | 456,840 | |
| **Current assets** | | | | | |
| Stock | | | 141,500 | | |
| Debtors | | | | | |
| Trade debtors | | 110,270 | | | |
| Prepayments | | 5,770 | 116,040 | | |
| Cash at bank | | | 47,510 | | |
| | | | 305,050 | | *1* |
| **Creditors due within one year** | | | | | |
| Trade creditors | | 159,970 | | | |
| Other creditors | W4 | 53,100 | | | *1* |
| Accruals | | 16,890 | 229,960 | | |
| **Net current assets** | | | | 75,090 | |
| **Total assets less current liabilities** | | | | 531,930 | |
| **Creditors due after more than one year** | | | | | |
| Debenture loans | | | | 200,000 | *½* |
| | | | | 331,930 | |
| **Capital and reserves** | | | | | |
| Called-up share capital (80,000 + 31,250) | | | | 111,250 | *1* |
| Share premium account | | | | 18,750 | *1* |
| Revaluation reserve | | | | 80,000 | *½* |
| Other reserves (130,000 – 10,000) | | | | 120,000 | *½* |
| Profit and loss account | W5 | | | 1,930 | *½* |
| | | | | 331,930 | |
| | | | | *Presentation* | *1* |
| | | | | | *(21)* |

**Workings**

| **W1 Distribution costs** | **£** |
|---|---|
| Per trial balance | 120,940 |
| Profit on sale of vehicle | (830) |
| Distribution equipment dep'n (W3) | 17,790 |
| 50% of motor vehicle dep'n (W3) | 16,210 |
| 40% of wages and salaries | 73,220 |
| | 227,330 |

| **W2 Administrative expenses** | **£** |
|---|---|
| Per trial balance (209,780 – 37,200) | 172,580 |
| 50% of motor vehicle dep'n (W3) | 16,210 |
| 60% of wages and salaries | 109,830 |
| | 298,620 |

| **W3 Fixed assets** | **£** | **£** |
|---|---|---|
| Motor vehicles at cost | | 129,680 |
| Depreciation to 31/3/01 | 61,930 | |
| Depreciation for year (25% x 129,680) | 32,420 | 94,350 |
| Net book value | | 35,330 |
| | | |
| Distribution equipment at cost | | 96,500 |
| Depreciation to 31/3/01 | 37,200 | |
| Depreciation for year (30% x 59,300) | 17,790 | 54,990 |
| | | 41,510 |

| **W4 Other creditors** | **£** |
|---|---|
| Corporation tax | 17,500 |
| Proposed dividend | 35,600 |
| | 53,100 |

| **W5 Profit and loss account** | **£** |
|---|---|
| Per trial balance | 3,220 |
| Retained loss for the year | (11,290) |
| | |
| Transfer from general reserve | 10,000 |
| | 1,930 |

(b)

**Journal**

| | £ | £ | |
|---|---|---|---|
| Share premium account | 18,750 | | ½ |
| Revaluation reserve | 80,000 | | ½ |
| General reserve | 12,500 | | ½ |
| Share capital | | 111,250 | ½ |

A one-for-one bonus issue of ordinary shares financed from capital reserves with a shortfall of £12,500 financed from the general reserve. ½

A company might make a bonus issue for the following reasons:

- To eliminate capital reserves, which have very restricted uses. ½
- To indicate to shareholders that revenue reserves used for this purpose are no longer available for the payment of dividends (probably because they are now represented by assets which are needed by the company) ½
- To increase the marketability of the shares, since shares with a lower market value per share are thought to be easier to buy/sell than shares with a higher market value per share. ½

*(4)*

*(25)*

**Question 2**

(a)

**Journal**

| | | £ | £ | |
|---|---|---|---|---|
| 1 | Sales | 5,000 | | |
| | Capital | | 5,000 | *1* |
| 2 | PL Control | 3,476 | | |
| | Suspense account | | 3,476 | *1* |
| 3 | Purchases | 322 | | |
| | PL Control | | 322 | *1* |
| 4 | Suspense account | 75 | | |
| | Interest received | | 75 | *1* |
| 5 | *No entries required* | | | |
| 6 | PL Control | 1,000 | | |
| | Suspense account | | 1,000 | *1* |
| 7 | Discounts allowed | 482 | | |
| | Discounts received | 482 | | |
| | Suspense account | | 964 | *1* |
| 8 | Sales returns | 310 | | |
| | SL Control | | 310 | *1* |
| 9 | Rates | 400 | | |
| | Suspense account | | 400 | *1* |
| 10 | Bank | 180 | | |
| | PL Control | | 180 | *1* |

**Suspense account**

| | £ | | £ | |
|---|---|---|---|---|
| Balance b/d | 5,765 | | | |
| Interest received (4) | 75 | | | |
| | | PL Control (2) | 3,476 | |
| | | PL Control (6) | 1,000 | |
| | | Discounts allowed (7) | 482 | |
| | | Discounts received (7) | 482 | |
| | | Rates (9) | 400 | |
| | 5,840 | | 5,840 | *2* |

*(11)*

(b)

**Purchase ledger control account**

| | £ | | £ | |
|---|---|---|---|---|
| | | Balance b/d | 23,274 | ½ |
| Suspense account (2) | 3,476 | | | ½ |
| Suspense account (6) | 1,000 | | | ½ |
| | | Purchases (3) | 322 | ½ |
| | | Bank (10) | 180 | ½ |
| Balance c/d | 19,300 | | | ½ |
| | 23,776 | | 23,776 | |
| | | Balance b/d | 19,300 | |

| | £ | £ | |
|---|---|---|---|
| Total balances per list | | 18,998 | ½ |
| *Add*: | | | |
| Omitted purchase invoice (3) | 322 | | ½ |
| Overstated payment (10) | 180 | 502 | ½ |
| | | 19,500 | |
| *Less*: | | | |
| Casting error (5) | | 200 | ½ |
| | | 19,300 | |

*(5)*

(c)

**Statement of corrected net loss**

| | £ | £ | |
|---|---|---|---|
| Net loss per draft accounts | | 6,190 | |
| *Add*: | | | |
| Reduction in sales (1) | | 5,000 | ½ |
| Increase in purchases (3) | | 322 | ½ |
| Increase in discounts allowed (7) | | 482 | ½ |
| Decrease in discounts received (7) | | 482 | ½ |
| Increase in sales returns (8) | | 310 | ½ |
| Increase in rates (9) | | 400 | ½ |
| | | 13,186 | |
| *Less*: | | | |
| Increase in interest received (4) | 75 | | ½ |
| Suspense account removed from expenses | 5,765 | 5,840 | ½ |
| Corrected net loss | | 7,346 | |

*(4)*

*(20)*

**Question 3**

(a)

| *Date bought* | *Cost* | *Period owned to 1 May 2001* | *Depreciation to 1 May 2001* | *NBV at 1 May 2001* |
|---|---|---|---|---|
| | £ | | £ | £ |
| 1 May 1995 | 12,750 | 6 yrs | 12,750 | nil |
| 1 November 1997 | 8,400 | 3 yrs 6 mths | 5,880 | 2,520 |
| 1 February 1999 | 7,600 | 2 yrs 3 mths | 3,420 | 4,180 |
| | 28,750 | | 22,050 | 6,700 |

The accumulated depreciation at 1 May 2001 is £22,050. *(3)*

(b)

| *Date bought* | *Cost* | *Period for which depreciated in y/e 30/4/02* | *Depreciation y/e 30/4/02* |
|---|---|---|---|
| | £ | | £ |
| 1 May 1995 | 12,750 | none | nil |
| 1 November 1997 | 2,400 | 3 mths | 120 |
| 1 November 1997 | 6,000 | full year | 1,200 |
| 1 February 1999 | 7,600 | full year | 1,520 |
| 1 August 2001 | 9,600 | 9 mths | 1,440 |
| | | | 4,280 |

*3*

**Office equipment at cost**

| | £ | | £ | |
|---|---|---|---|---|
| Balance b/d | 28,750 | | | ½ |
| Bank | 9,600 | | | ½ |
| | | Disposal a/c | 7,400 | ½ |
| | | Balance c/d | 30,950 | ½ |
| | 38,350 | | 38,350 | |
| Balance b/d | 30,950 | | | |

**Provision for depreciation of office equipment**

| | £ | | £ | |
|---|---|---|---|---|
| | | Balance b/d | 22,050 | ½ |
| | | Depreciation expenses | 4,280 | ½ |
| Disposal (see note) | 6,800 | | | ½ |
| Balance c/d | 19,530 | | | ½ |
| | 26,330 | | 26,330 | |
| | | Balance b/d | 19,530 | |

**Disposal of office equipment**

| | £ | | £ | |
|---|---|---|---|---|
| Office equipment | 7,400 | | | ½ |
| | | Provision for dep'n | 6,800 | ½ |
| | | Bank | 700 | ½ |
| Profit and loss a/c | 100 | | | ½ |
| | 7,500 | | 7,500 | |

*Note:*
The amount of depreciation transferred to the disposal account is £5,000 for the fully depreciated equipment, plus £1,800 (£2,400 @ 20% for 3 yrs 9 mths) for the partly depreciated equipment, giving a total of £6,800.

**Depreciation expenses (office equipment)**

| | | | | |
|---|---|---|---|---|
| Provision for depreciation | 4,280 | Profit and loss a/c | 4,280 | *1* |

*(10)*

(c) Depreciation is a measure of the cost of the economic benefits of a fixed asset that have been consumed during an accounting period. *2*

Most fixed assets other than land (in general) are subject to depreciation and the purpose of charging depreciation in the profit and loss account of a business is to spread the net cost of a fixed asset over the accounting periods in which the asset is used. This is in line with the matching (or accruals) convention which requires the revenue for a period to be matched against all of the expenses incurred so as to earn that revenue. *2*

The net book value of a fixed asset which has been partly depreciated represents the cost of the unexpired economic benefits which the asset still has to offer. NBV does *not* (other than coincidentally) represent the current market value of the asset concerned. *2*

In principle, a business should choose the depreciation method (straight line, reducing balance etc) which most closely matches the usage pattern of the asset concerned. For instance, if the benefits to be obtained from an asset are spread fairly evenly over its useful life, the straight line method (which charges equal amounts of depreciation each year) would seem to be the more appropriate. *1*

*(7)*

*(20)*

**Question 4**

(a) *Calculation of ratios*

The list of ratios given below is fairly comprehensive but not exhaustive. Other relevant ratios are also acceptable.

| | | **X plc** | |
|---|---|---|---|
| ROCE | 270 ÷ 1,860 x 100 | *14.5%* | ½ |
| GPP | 410 ÷ 1,620 x 100 | *25.3%* | ½ |
| NPP | 150 ÷ 1,620 x 100 | *9.3%* | ½ |
| Current ratio | 1,670 ÷ 1,060 | *1.6* | ½ |
| Quick assets ratio | 390 ÷ 1,060 | *0.4* | ½ |
| Stock holding period | 1,280 ÷ 1,210 x 365 | *386 days* | ½ |
| Debtor collection period | 390 ÷ 1,620 x 365 | *88 days* | ½ |
| Creditor payment period | 1,060 ÷ 1,210 x 365 | *319 days* | ½ |
| Gearing ratio | 570 ÷ 1,860 x 100 | *30.6%* | ½ |

| | | **Y plc** | |
|---|---|---|---|
| ROCE | 400 ÷ 1,520 x 100 | *26.3%* | ½ |
| GPP | 590 ÷ 1,860 x 100 | *31.7%* | ½ |
| NPP | 215 ÷ 1,860 x 100 | *11.6%* | ½ |
| Current ratio | 740 ÷ 650 | *1.1* | ½ |
| Quick assets ratio | 410 ÷ 650 | *0.6* | ½ |
| Stock holding period | 330 ÷ 1,270 x 365 | *95 days* | ½ |
| Debtor collection period | 290 ÷ 1,860 x 365 | *57 days* | ½ |
| Creditor payment period | 650 ÷ 1,270 x 365 | *187 days* | ½ |
| Gearing ratio | 450 ÷ 1,520 x 100 | *29.6%* | ½ |

*(9)*

(b) *Report structure*

The report should provide information on the relative profitability, liquidity, efficiency and gearing of the two companies, ideally referring to an index containing the calculations given above. There should also be a section highlighting the limitations of the analysis and indicating any further information required. Marks will be awarded for presentation as well as content.

*Comparison of the two companies*

(i) On all measures, Y plc is significantly more profitable than X plc. *2*

(ii) Even though X plc seems at first sight to have the better current ratio, this is almost entirely caused by huge stocks (over a year's worth!). The quick assets ratio shows that X plc is more likely to be experiencing liquidity problems than Y plc. The creditor payment period of X plc may also indicate this, assuming that the figure is reliable (see below). *2*

(iii) Y plc seems to be the more efficient company, certainly in terms of stock control and credit control. The creditor payment period has had to be computed with reference to cost of sales (rather than purchases) and so may not be entirely reliable. *2*

(iv) Both companies have about the same level of gearing, though X's lack of cash and possible liquidity problems may force the company to seek further loan finance and so become higher-geared. *1*

(v) On the basis of this very brief analysis, Y plc would seem to be the more attractive investment. *1*

*Limitations and further information*

(i) The accounts provided are highly summarised. More detailed accounts would provide a basis for a more thorough analysis.

(ii) It is unwise to place too much reliance on a single year's figures. It is far better to review several years' figures and look for trends. Accounts for (say) the last 5 years would be useful, together with business plans/projections for the future.

(iii) The effect of differing accounting policies on the figures shown in the financial statements may invalidate the results of the ratio analysis. A statement of accounting policies for each company would help.

(iv) Balance sheet figures might not be typical or representative and this could lead to distorted ratios. Yearly average figures (eg for items such as stock) would provide a better basis for the analysis.

(v) It might be that neither company is the best repository for Mrs Danvers' money, even if she is determined to invest in the specific sector of industry in which both of the companies are engaged. Industry average figures might indicate that there are other companies in the same sector which would prove a better investment.

*1 mark per point up to a maximum of (3)*

*(11)*

*(20)*

**Question 5**

(a) The main bodies involved are:

- the Financial Reporting Council (FRC) *2*
- the Accounting Standards Board (ASB) *3*
- the sub-committees of the ASB, especially the Committee on Accounting for Smaller Entities (CASE) and the Urgent Issues Task Force (UITF) *2*
- the Financial Reporting Review Panel (FRRP). *2*

*(marks awarded for identifying each body and outlining functions of each)*

*(9)*

(b) Company law requires that companies disclose certain specified information in their financial statements and that this information is disclosed in a specified format. However, compliance with company law does not prevent companies from employing a wide variety of accounting treatments in relation to many of the items shown in the financial statements. If companies were entirely free:

- to choose any accounting treatments that they wished, and
- to change these at will, and
- to conceal the treatments adopted

it would be difficult (if not impossible) to compare the accounts of different companies or to compare the accounts of the same company in different periods. This degree of freedom would also facilitate “creative accounting”. *2*

The role of accounting standards is to provide guidance as to how companies should treat various matters in their financial statements. Some standards are prescriptive, requiring all affected companies to adopt a specified accounting treatment. Others provide a range of acceptable treatments and require companies to disclose the chosen approach. Accounting standards are in effect an attempt to “standardise” accounting so that comparability is achieved and the deliberate distortion of financial information becomes impossible. *2*

Company law requires that financial statements should show a “true and fair” view and that any material departures from accounting standards should be explained. Furthermore, it is generally agreed that financial statements which do not comply with accounting standards cannot (by virtue of that fact) show a true and fair view. Therefore, although the standards are not actually enshrined in law, they have a quasi-legal impact on financial reporting. *2*

*(6)*

*(15)*

**Question 6**

(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 and an example of the reasons for needing the statements are:

- investors/how effectively are managers performing their stewardship function? *1*
- lenders/can the business afford interest payments and eventual capital repayment? *1*
- suppliers and other trade creditors/will the business be able to pay for goods or services supplied on credit? *1*
- employees/are wages and salaries fair? *1*
- customers/is the business a secure source of supply? *1*
- governments and their agencies/how much tax should the business pay? *1*
- the public/is the business abusing its economic power? *1*

*(½ mark for each + ½ mark for giving an example of the reasons for needing the statements)*
*(Other relevant answers acceptable)*

The economic decisions for which users need financial information differ from one class of user to another. Different decisions usually require different information, but the ASB asserts that there is "*some overlap in the information required: all potential users are interested ... in the financial performance and financial position of the entity*". Therefore financial statements which focus on the entity's financial performance and position will focus on "*the common interest that all users have*". *2*

*(9)*

(c) Financial statements are subject to various inherent limitations. Some of the main limitations are as follows:

– The information contained in financial statements is restricted to information which can be expressed in quantitative terms. Non-financial information is largely neglected. *1*

– The statements are historical in nature and may not provide reliable guidance with regard to future events. *1*

– The need to allocate the effects of business transactions to discrete accounting periods often involves the exercise of judgement (eg judging the degree to which an asset has depreciated or the likelihood of a bad debt) so that the financial statements can never be entirely reliable. *1*

*(3)*

*(15)*