FINANCIAL ACCOUNTING

Certificate stage examination

5 December 2006

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

Question 1

(a)

Calculation of operating profit	**£**	
Operating profit (deduced)	185,610	
Income from FA investments	1,200	*½*
Interest receivable	390	*½*
	187,200	
Interest payable (£3,600 + £2,700 + £1,050)	7,350	*1*
Profit before taxation	179,850	
Taxation (£56,600 + £3,700)	60,300	*1*
Profit for the financial year	119,550	
Dividends (£10,000 + £25,000)	35,000	*1*
Retained profit for the year	84,550	*1*
Retained profit brought forward	38,920	
Retained profit carried forward	123,470	
		(5)

(b)

Vixen Ltd
Cash flow statement for the year to 30 June 2006

Reconciliation of operating profit to net cash inflow from operating activities	**Working**	**£**	
Operating profit		185,610	
Depreciation charge	W1	67,410	*2*
Loss on disposal of TFAs (£17,150 - £15,000)		2,150	*½*
Profit on disposal of FA investments (£45,000 - £7,500)		(37,500)	*½*
Increase in stocks (£139,440 - £123,220)		(16,220)	*½*
Increase in debtors/prep'ts (£96,780 - £82,100)		(14,680)	*½*
Increase in creditors/accruals (£89,730 - £65,310)		24,420	*½*
Net cash inflow from operating activities		211,190	

	Working	**£**	**£**	
Cash flow statement				
Net cash inflow from operating activities			211,190	
Returns on investments and servicing of finance				
Dividends received		1,200		*½*
Interest received		390		*½*
Interest paid		(7,350)	(5,760)	*½*
Taxation (£38,400 + £3,700)			(42,100)	*1*
Capital expenditure				
Purchase of tangible fixed assets	W1	(63,490)		*1*
Sale of tangible fixed assets		15,000		*½*
Purchase of fixed asset investments	W2	(22,400)		*½*
Sale of fixed asset investments		45,000	(25,890)	*½*
Equity dividends paid (£30,000 + £10,000)			(40,000)	*1*
Management of liquid resources				
Purchase of Treasury Bills			(50,000)	*½*
			47,440	
Financing				
Issue of shares (£150,000 - £130,000)		20,000		*½*
Repayment of loan		(20,000)	-	*½*
Increase in cash (£21,050 + £26,390)			47,440	
				(12)

Workings

W1 Tangible fixed assets	**£**
WDV at 30/6/05	178,360
WDV of disposals (£50,000 x 70% x 70% x 70%)	(17,150)
	161,210
Acquisitions y/e 30/6/06 (derived figure)	63,490
	224,700
Depreciation year to 30/6/06 (£157,290 x 30/70)	67,410
WDV at 30/6/06	157,290

W2 Fixed asset investments	**£**
Cost at 30/6/05	20,000
Cost of disposals	(7,500)
	12,500
Acquisitions y/e 30/6/06 (derived figure)	22,400
Cost at 30/6/06	34,900

(c) One of the objectives of accounting standard FRS1 is that companies should "*provide information that assists in the assessment of their liquidity, solvency and financial adaptability*". A company's financial adaptability is defined by the Statement of Principles as "*its ability to take effective action to alter the amount and timing of its cash flows so that it can respond to unexpected needs or opportunities*".

The cash flow statement provides such information, giving much more detail about the sources and uses of cash during an accounting period than can be found in either:

(i) the profit and loss account for the period, which is prepared in accordance with the accruals concept, or

(ii) the balance sheet, which shows only a snapshot of the company's financial position at the end of the period.

(3)

(20)

Question 2

(a)

Cashbook

	£		£	
		Balance b/d	1,428	½
		Bank charges	102	½
		Trade debtors	500	½
		Trade debtors	198	½
Casting error	1,000			½
Balance c/d	1,228			
	2,228		2,228	
		Balance b/d	1,228	

Bank reconciliation

	£	
Cash at bank per statement	1,960	½
Unpresented cheques	(5,637)	½
	(3,677)	
Outstanding lodgements	2,449	½
Overdraft per cashbook	(1,228)	

(4)

(b)

Journal

	£	£	
Heating and lighting	110		½
Accruals		110	½
Prepayments (£156 x 2/3)	104		½
Accruals		65	½
Telephone charges		39	*1*
Prepayments (£744 x 4/12)	248		½
Insurances		248	½
Bad debts written off	217		½
Trade debtors		217	½
Profit & Loss (increase in provision)	283		½
Provision for doubtful debts		283	½
Depreciation expenses (18% x £4,600)	828		½
Provision for depreciation of P & M		828	½

(7)

(c)

Statement of corrected net profit

	£	£	
Net loss per draft accounts		8,375	
Less:			
Decrease in telephone charges	39		½
Decrease in insurances	248		½
TB difference removed from expenses	1,000	1,287	½
		7,088	
Add:			
Increase in bank charges		102	½
Increase in heating and lighting		110	½
Increase in bad debts written off		217	½
Increase in provision for doubtful debts		283	½
Depreciation for the year		828	½
Corrected net loss		8,628	

(4)

(d)

Schedule of changes to balance sheet items

	Assets	*Liabilities*	*Capital*	
	£	**£**	**£**	
Trade debtors (£698 - £217)	481			½
Bank overdraft		(200)		½
Accruals		175		½
Prepayments	352			½
Provision for doubtful debts	(283)			½
Provision for depreciation	(828)			½
Increase in net loss (£8,628 - £8,375)			(253)	1
	(278)	(25)	(253)	

Assets fall by £278 but liabilities fall by £25 so net assets fall by £253. This is equal to the reduction in capital and so the balance sheet remains in balance. *1*

(5)

(20)

Question 3

(a)

		Alpha plc	
ROCE	1,630 ÷ 7,340 x 100	*22.2%*	½
Gross profit percentage	3,860 ÷ 12,750 x 100	*30.3%*	½
Current ratio	3,260 ÷ 2,150	*1.52*	½
Quick assets ratio	1,620 ÷ 2,150	*0.75*	½
Stock holding period	1,640 ÷ 8,890 x 365	*67 days*	½
Capital gearing ratio	1,000 ÷ 7,340 x 100	*13.6%*	½
Earnings per share	1,030 ÷ 2,000	*51.5p*	½

		Beta plc	
ROCE	2,360 ÷ 7,080 x 100	*33.3%*	½
Gross profit percentage	4,110 ÷ 13,660 x 100	*30.1%*	½
Current ratio	3,510 ÷ 1,600	*2.19*	½
Quick assets ratio	1,980 ÷ 1,600	*1.24*	½
Stock holding period	1,530 ÷ 9,550 x 365	*58 days*	½
Capital gearing ratio	600 ÷ 7,080 x 100	*8.5%*	½
Earnings per share	1,610 ÷ 2,000	*80.5p*	½

Alternative ratio definitions accepted
(7)

(b) Based on the above analysis, Beta plc appears to be the better investment. In comparison with Alpha plc, Beta plc seems:

- to be more profitable
- to have better liquidity
- to handle stocks more efficiently
- to be lower-geared
- to generate higher earnings per share.

(2)

(c) The restated figures for Alpha plc are as follows:

	£'000	
Profit and loss account items:		
Turnover	12,750	
Cost of sales	8,890	
Operating profit (1,630 + 630 + 380)	2,640	*1*
Interest payable	170	
Taxation charge	430	
Profit after tax (1,030 + 630 + 380)	2,040	½
Balance sheet items:		
Net book value of fixed assets (6,230 + 630 + 380 - 500 - 900)	5,840	*2*
Stock (1,640 - 220)	1,420	½
Trade debtors	1,620	
Cash at bank (900 - 670)	230	½
Trade creditors	1,480	
Bank overdraft	nil	½
Long-term loans	1,000	
Share capital and reserves (6,340 + 630 - 220 + 380 - 500)	6,630	

Based on these revised figures, the accounting ratios for Alpha plc are:

		Alpha plc	
ROCE	2,640 ÷ 7,630 x 100	*34.6%*	½
Gross profit percentage	3,860 ÷ 12,750 x 100	*30.3%*	
Current ratio	3,270 ÷ 1,480	*2.21*	½
Quick assets ratio	1,850 ÷ 1,480	*1.25*	½
Stock holding period	1,420 ÷ 8,890 x 365	*58 days*	½
Capital gearing ratio	1,000 ÷ 7,630 x 100	*13.1%*	½
Earnings per share	2,040 ÷ 2,000	*102p*	½

These ratios indicate that the previous ratio analysis was distorted by the differing accounting policies of the two companies and by the purchase of fixed assets by Alpha plc on the last day of the accounting period.

The adjusted figures suggest that there is little to choose between the two companies. Alpha plc has generated higher earnings per share than Beta plc and therefore might now be seen as the better investment. Admittedly, Alpha plc is the higher-geared company but the gearing ratio is sufficiently low for this not to be a concern. *1*

(9)

(d) The notes accompanying the financial statements of the two companies would have outlined each company's accounting policies but would almost certainly have provided insufficient detail to facilitate the above comparison. The fact that Alpha plc had purchased fixed assets on the last day of the accounting period is unlikely to have been disclosed.

(2)

(20)

Question 4

(a)

Opening accumulated fund

	Assets	*Liabilities*
	£	£
Ground and changing rooms	10,000	
Cash	96	
Bank overdraft		120
Subscriptions	230	370
Life memberships ((2/5 x £250) + (3/5 x £500))		400
Motor mower (1/5 x £440)	88	
Prepayments and accruals	665	110
	11,079	1,000
	1,000	
	10,079	

(4)

(b)

Subscriptions account

	£		£	
Subs in arrears b/d	230	Subs in advance b/d	370	*1*
		Receipts & Payments a/c	5,970	*½*
Income & Expenditure a/c	5,990			
Subs in advance c/d	410	Subs in arrears c/d	290	*1*
	6,630		6,630	
Subs in arrears b/d	290	Subs in advance b/d	410	

Life membership fees account

	£		£	
		Balances b/d		*1*
		£50 x 2	100	
		£100 x 3	300	
		Receipts & Payments a/c	900	*½*
Income & Expenditure a/c	330			
Balances c/d				*1*
£50 x 1	50			
£100 x 2	200			
£180 x 4	720			
	1,300		1,300	
		Balances b/d	970	

(5)

(c)

Valley AFC
Income and expenditure account for the year to 31 May 2006

	£	£	
Income			
Subscriptions		5,990	½
Life membership fees		330	½
Donations		386	
Sale of match tickets		3,695	
Profit on disposal of roller		20	½
		10,421	
Expenditure			
Ground staff wages	2,600		
Electricity & water (£926 + £15 - £25)	916		*1*
Insurance (£360 - £20)	340		½
Repairs	1,263		
Fee to Football Association	150		
Treasurer's fee	100		
Charitable donations	344		
Loss on annual dinner (£965 - £640)	325		½
Bank charges	64		
Sundry expenses	1,137		
New football kit for 1st team	480		½
Loss on disposal of motor mower	18		½
Depreciation (£650 x 20% + £320 x 10%)	162	7,899	*1*
Excess of income over expenditure		2,522	

Balance sheet as at 31 May 2006

	£	£	£	
Fixed assets				
Ground and changing rooms at cost			10,000	
Equipment at cost (£1,820 + £970)		2,790		½
Less: Dep'n to date (£1,820 + £162)		1,982	808	½
			10,808	
Current assets				
Subscriptions in arrears		290		½
Prepayments		710		½
Bank current account (W1)		2,211		*1*
Cash in hand		87		½
		3,298		
Current liabilities				
Subscriptions in advance	410			½
Accruals	125	535	2,763	½
			13,571	
Long term liabilities				
Life membership fees			970	½
			12,601	
Accumulated fund				
As at 1 June 2005			10,079	
Excess of income over expenditure			2,522	
			12,601	½

(11)

Workings

W1 Cash and bank current account	**£**
Balances at 1 June 2005 (£96 - £120)	(24)
Total receipts	11,681
	11,657
Total payments	(9,359)
Balances at 31 May 2006 (£87 + £2,211 (derived))	2,298

(20)

Question 5

(a) According to the ASB Statement of Principles for Financial Reporting, the main users of the information produced by financial accountants are:

- investors, who use financial statements to help them to make investment decisions and (in the case of a company) to assess how well their investment has been managed by the company's directors

- lenders, who use financial statements to judge the ability of the business to repay a loan and to maintain interest payments on that loan

- suppliers and other trade creditors, who use the information provided in financial statements to determine whether or not to offer credit to the business

- employees, who may use financial statements to help them to decide whether their jobs are secure and whether their remuneration is fair

- customers, who may inspect the financial statements of a potential supplier to ensure that the supplier is financially stable before placing long-term contracts with that supplier

- governments and their agencies, who use financial statements to help determine tax liabilities and to collect national statistics

- the public, who may inspect the financial statements of a large company to determine whether the company is charging excessive prices or to assess the company's ethical and environmental policies.

1/2 mark for each + 1/2 mark for explanation up to a maximum of (7)

(b) The main *advantages* of computer-based accounting systems include:

- extremely rapid processing of financial data
- highly accurate processing (so long as input data is correct)
- much cheaper processing than with manual systems
- the automatic generation of reports based upon the accounting data stored in the system (e.g. trial balance, draft financial statements)
- the ease of access to (and dissemination of) financial information by means of the Internet.

The main *disadvantages* of computer-based accounting systems include:

- results will be inaccurate if input data is incorrect, so there must be strict controls over the input process to ensure that input data is absolutely accurate
- the initial costs of acquiring computer hardware and software (though these costs are now far lower than they were) plus further implementation costs such as the conversion of paper-based files, staff training etc.
- the potential lack of an audit trail unless the system is programmed to provide one and the danger of system failure, data corruption (e.g. if a virus enters the system) and breaches of security
- the fact that computer-based systems are developed and maintained by technical IT staff who may not appreciate the information needs of accountants.

½ marks for each valid point up to a maximum of (4)

(c) Some of the main influences which are currently affecting the development of financial accounting include:

- the breaking down of international barriers (especially within the rapidly expanding European Union), leading to the development of a common currency and the move towards the adoption of international accounting standards for EU listed companies as from 1 January 2005
- the growing realisation that large powerful corporations may make a significant impact on the environment (usually negative) and may also have a profound effect on society as a whole, leading to the view that accounting should report on environmental impact and social policies as well as on financial matters
- the development of new methods of accounting for public sector bodies.

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

(d) A qualified accountant is expected to maintain a high standard of ethical behaviour and each of the accountancy bodies issues ethical guidelines to its members. In general, ethical requirements for an accountant cover the following areas:

(i) *Conflicts of interest*. A qualified accountant should try to avoid conflicts of interest wherever possible and should openly declare such conflicts if they arise. For example, a bank may ask an accountant to carry out an independent review of a company's finances with a view to granting the company a major loan (for which the company is desperate). The bank may be totally unaware that the accountant is married to one of the company's directors. A conflict of interest could arise in such circumstances and the accountant should either decline the work or (at least) explain the situation to the bank and offer to withdraw. *1 ½*

(ii) *Gifts*. Gifts and/or hospitality offered to an accountant could be viewed as a bribe and should generally be refused. For example, an accountant who is performing the audit of a company's financial statements would be expected to refuse any gifts etc. which are offered by the company's directors. *1 ½*

(iii) *Confidentiality*. Accountants are expected at all times to maintain confidentiality in relation to the financial affairs of their clients or employers. For example, an accountant who discussed a client's financial position with friends or relatives would be in breach of ethical guidelines. *1 ½*

(iv) *Professional updating*. All qualified accountants are expected to keep their technical knowledge up-to-date as a matter of course. For example, a financial accountant should absorb changes to the law relating to accounting and should also become familiar with new or amended financial reporting standards. Some professional bodies require their members to undergo an annual programme of professional development in order to ensure that this requirement is satisfied. *1 ½*

(6)

(20)

Question 6

(a) The main purpose of accounting standards is to "standardise" financial reporting to some extent and introduce a degree of uniformity into the way that financial statements are prepared and presented. Some of the standards prescribe a standard accounting treatment for the items concerned, requiring all companies to deal with these items in the same way. Other standards allow a choice of accounting treatment but require that companies disclose the treatment they have adopted.

Accounting standards improve the comparability of financial statements and also help to stamp out "creative accounting", so making it more likely that financial statements will show a true and fair view.

(3)

(b) In general, UK sole traders and partnerships (other than Limited Liability Partnerships) are under no legal obligation to prepare any financial statements at all. Such entities will usually prepare financial statements for their own internal purposes and must of course supply financial information to the tax authorities, but there is no requirement to produce a set of financial statements which comply with UK accounting standards.

On the other hand, UK limited companies (and Limited Liability Partnerships) are not only obliged to produce financial statements but are also obliged to produce financial statements which show a true and fair view. The ASB Foreword to Accounting Standards states that the standards "*are applicable to financial statements of a reporting entity that are intended to give a true and fair view*" and therefore the standards do generally apply to UK companies and LLPs. However:

(i) some of the UK accounting standards apply only to larger entities

(ii) as from 1 January 2005, listed companies are obliged to comply with international accounting standards, rather than UK standards

(iii) as from 1 January 2005, unlisted UK companies may choose to use international standards, if they so wish.

(5)

(c)

Freehold land

	£		£	
Balance b/d	140,000			
Revaluation reserve	60,000			
		Balance c/d	200,000	
	200,000		200,000	
Balance b/d	200,000			*1*

Freehold buildings

	£		£	
Balance b/d	180,000	Transfer from dep'n a/c	19,800	
Revaluation reserve	14,800			
		Balance c/d	175,000	
	194,800		194,800	
Balance b/d	175,000			*2*

Provision for depreciation of freehold buildings

	£		£	
Transfer to buildings a/c	19,800	Balance b/d (£3,600 x 5.5)	19,800	
Balance c/d	3,500	Profit & Loss a/c	3,500	
	23,300		23,300	
		Balance b/d	3,500	*2*

Motor vehicles

	£		£	
Balance b/d	70,000			
Bank	11,200			
Disposal a/c (part-ex allce)	6,000			
		Disposal a/c (A)	14,400	
		Balance c/d	72,800	
	87,200		87,200	
Balance b/d	72,800			*2*

Provision for depreciation of motor vehicles

	£		£	
		Balance b/d:		
		A £14,400 x 36 x 1.25%	6,480	
		B £19,200 x 32 x 1.25%	7,680	
		C £14,800 x 18 x 1.25%	3,330	
		D £21,600 x 4 x 1.25%	1,080	
			18,570	
		Profit and loss a/c:		
		A £14,400 x 7 x 1.25%	1,260	
		B £19,200 x 12 x 1.25%	2,880	
		C £14,800 x 12 x 1.25%	2,220	
		D £21,600 x 12 x 1.25%	3,240	
		E £17,200 x 5 x 1.25%	1,075	
Disposal a/c (A)	7,740			
Balance c/d	21,505			
	29,245		29,245	
		Balance b/d	21,505	*4*

Disposal of motor vehicle

	£		£	
Motor vehicles	14,400	Motor vehicles (part-ex allce)	6,000	
		Provision for dep'n	7,740	
		P & L (loss on disposal)	660	
	14,400		14,400	*1*

(12)

(20)