FINANCIAL ACCOUNTING

Certificate stage examination

4 December 2007

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

Instructions to candidates

*There are **six** questions on this question paper*

*Answer **five** questions in total*

***Three compulsory** questions in Section A*
***Two** of the three questions in Section B*

*The questions in Section A carry, in total, **60** marks*
*The questions in Section B each carry **20** marks*

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.

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.

Proforma income statement, balance sheet, cash flow statement and statement of changes in equity are appended to this paper and may be submitted as part of an answer.

AT THE HEART OF
YOUR CAREER

SECTION A (Compulsory – answer all three questions)

1 Anne and Emily are in partnership. They prepare accounts to 31 October each year. Their partnership agreement provides that profits should be shared equally between them after accounting for interest on capital at 5% per annum and partners' annual salaries of £10,000 for Anne and £8,000 for Emily. No interest is charged on partners' drawings.

On 1 August 2007, they decide to admit Charlotte as a partner. The revised partnership agreement provides that profits should in future be shared between Anne, Emily and Charlotte in the ratio 5:3:2, after accounting for interest on capital at 6% per annum and partners' annual salaries of £15,000 for Anne, £10,000 for Emily and £5,000 for Charlotte. As before, no interest is charged on partners' drawings.

The partnership's trial balance at 31 October 2007 is as follows:

	£	£
Capital accounts - Anne		54,000
- Emily		40,000
- Charlotte		12,000
Current accounts at 01/11/2006 - Anne		2,880
- Emily	360	
8% Loan from Anne		20,000
Drawings - Anne	37,400	
- Emily	24,370	
- Charlotte	8,450	
Purchases and sales	64,440	153,670
Returns inwards and outwards	3,330	4,920
Inventory at 1 November 2006	12,710	
Operating expenses	10,740	
Freehold property, at cost	90,000	
Equipment, at cost	27,200	
Allowance for depreciation at 1/11/2006:		
- Equipment		10,920
Trade receivables and payables	28,550	6,890
Bank balance		2,270
	307,550	307,550

The following information is also available:

1. Anne withdrew £6,000 of her capital on 31 July 2007 and Charlotte introduced capital of £12,000 on 1 August 2007. Otherwise, there were no changes to the partners' capital accounts during the year.

2. On 1 November 2006, Anne lent £20,000 to the partnership at an interest rate of 8% per annum. No interest has yet been accounted for in relation to this loan.

3. For profit sharing purposes, the partners have agreed that 50% of the gross profit for the year to 31 October 2007 should be deemed to have occurred in the last three months of the accounting year. All of the expenses deducted from gross profit are spread evenly over the year.

4 Closing inventory at 31 October 2007 was £13,190.

5 No account has yet been made for depreciation. Freehold property is not depreciated at all but equipment is depreciated on the straight line basis, assuming a useful life of 4 years and a residual value equal to 25% of cost. A full year's depreciation charge is made in the year of acquisition but no depreciation is charged in the year of disposal. All of the equipment held on 31 October 2006 was less than three years old. There were no disposals in the year to 31 October 2007.

- **Requirement for question 1**

(a) Prepare the partnership's income statement for the year to 31 October 2007. *6*

(b) Prepare an appropriation account for the year to 31 October 2007. *6*

(c) Write up the partners' current accounts (in columnar form) for the year to 31 October 2007. *3*

(d) Prepare a balance sheet as at 31 October 2007. *5*

(20)

2

Amjad has been trading for many years, preparing accounts to 30 September each year. His draft accounts for the year to 30 September 2007 show a net loss of £1,738. However, these draft accounts have been prepared before performing a bank reconciliation for the month of September 2007 and before adjusting for bad debts and doubtful receivables.

Amjad's cashbook shows a bank overdraft of £1,412 at 30 September 2007, but his bank statements show a positive bank balance of £874 on that date. A comparison of the cashbook and bank statements reveals the following:

1 A cheque for £870 received from a customer on 12 September 2007 has been recorded in both the cashbook and the receivables ledger as £780.

2 The bank statement for September 2007 shows a dishonoured customer cheque of £170. The fact that this cheque was dishonoured has not been recorded in the cashbook.

3 Cheques totalling £2,350 received from customers and paid into the bank on 30 September 2007 are recorded in the cashbook but do not appear on the bank statements.

4 Bank charges and interest of £63 are shown on the bank statements but have not been recorded in the cashbook or in the draft accounts.

5 The debit side of the cashbook has been undercast by £10. This explains why Amjad's trial balance totals at 30 September 2007 disagree by £10. In Amjad's draft accounts, this £10 difference has been shown as one of the items in the draft income statement.

6 Cheques to suppliers totalling £5,769 which are recorded in the cashbook in late September do not appear on the bank statements.

7 Amjad's drawings of £1,000 for the month of September 2007 (paid by direct debit) have not been recorded in the cashbook.

The draft balance sheet at 30 September 2007 shows trade receivables of £4,732. This is after deducting an allowance for doubtful receivables brought forward from 1 October 2006 of £218. Amjad needs to write off bad debts of £230 and then adjust the allowance for doubtful receivables to 4% of the remaining trade receivables.

- **Requirement for question 2**

(a) Write up the cashbook as necessary to reflect the discrepancies listed above and prepare a bank reconciliation as at 30 September 2007. *8*

(b) Write journal entries for the required adjustments relating to the bad debts written off and the allowance for doubtful receivables. (Narratives are not required). *7*

(c) Calculate Amjad's amended net profit or loss for the year to 30 September 2007. *5*

(20)

3

The balance sheets of Aadvaark Trading Ltd as at 30 November 2006 and 2007 are as follows:

	30 November 2006		30 November 2007	
	£000	**£000**	**£000**	**£000**
Non-current assets:				
Tangible assets				
At cost or revaluation	1,790		2,470	
Less: depreciation to date	630	1,160	850	1,620
Investments at cost		100		50
		1,260		1,670
Current assets:				
Inventories	510		740	
Trade receivables	640		1,010	
Short-term investments	150		-	
Bank balance	180	1,480	-	1,750
		2,740		3,420
Equity:				
Share capital	400		500	
Share premium account	100		140	
Revaluation reserve	300		550	
Retained earnings	800	1,600	480	1,670
Non-current liabilities:				
Long-term loans		500		900
Current liabilities:				
Trade payables	530		660	
Current tax payable	110		-	
Bank overdraft	-	640	190	850
		2,740		3,420

The following information is also available:

1 Freehold property which was valued at £500,000 on 30 November 2006 was revalued at £750,000 on 30 November 2007.

2 Plant and equipment with an original cost of £120,000 and accumulated depreciation of £80,000 was sold in February 2007 for £30,000.

3 One half of the non-current asset investments were sold for £70,000 in June 2007. Dividends received from non-current asset investments during the year to 30 November 2007 were £5,000.

4 Interest paid and payable in the year totalled £70,000.

5 There is no tax liability for the year to 30 November 2007. The tax liability for the year to 30 November 2006 was underestimated by £20,000.

6 No dividends were paid or proposed in either year.

7 The short-term investments were sold for £150,000 in June 2007. These investments ranked as cash equivalents as defined by IAS7.

- **Requirement for question 3**

(a) Prepare a cash flow statement for Aadvaark Trading Ltd for the year to 30 November 2007, in accordance with the requirements of accounting standard IAS7 and using the indirect method. Also provide an analysis of cash and cash equivalents, showing the balance at 30 November 2006 and 2007 and the amount by which each component of cash and cash equivalents has changed during the year to 30 November 2007. *14*

(b) Explain briefly how a cash flow statement is produced if the direct method is used. *3*

(c) Calculate the capital gearing ratio of Aadvaark Trading Ltd as at 30 November 2006 and 2007. Comment on your results. *3*

(20)

SECTION B (Answer two from three questions)

4

Accounting standard IAS16 *Property, Plant and Equipment* makes a number of recognition, measurement and disclosure requirements with regard to tangible non-current assets. The term "non-current asset" is defined in accounting standard IAS1 *Presentation of Financial Statements*. The information given below relates to three companies, each of which prepares accounts to 31 December.

Alpha Ltd

Alpha Ltd bought a factory machine on 30 June 2007 and paid a total of £420,000. The supplier's invoice showed that this sum was made up of the following items:

	£
Manufacturer's list price	380,000
Less: Trade discount	38,000
	342,000
Delivery charge	6,800
Installation costs	29,600
Maintenance charge for year to 30 June 2008	27,000
Spare parts	14,600
	420,000

Beta Ltd

On 1 January 1997, Beta Ltd bought freehold property for £800,000. This figure was made up of land £300,000 and buildings £500,000. The land was non-depreciable but it was decided to depreciate the buildings on the straight-line basis, assuming a useful life of 40 years and a residual value of £nil.

On 1 January 2007, the land was revalued at £400,000 and the buildings were revalued at £450,000. The company decided to incorporate these valuations into its accounts. The previous estimates of the building's useful life and residual value remain unchanged.

Gamma Ltd

In August 2007, Gamma Ltd paid £250,000 to acquire the business of a local sole trader. The fair value of the net assets acquired was £175,000.

- **Requirement for question 4**

(a) Distinguish between current assets and non-current assets, giving TWO examples of each type of asset. *4*

(b) Explain, with appropriate examples, the difference between capital expenditure and revenue expenditure. *4*

(c) If a company incorrectly classified an item of capital expenditure as revenue expenditure, what effect would this have on the company's accounts in the year of the expenditure and in subsequent years? *3*

(continued)

(d) In accordance with the rules of IAS16, calculate the cost figure at which the machine bought by Alpha Ltd should initially be measured. Also explain the correct accounting treatment of any component of the £420,000 expenditure which cannot be treated as part of the machine's cost. *3*

(e) Write journal entries for the revaluation of Beta Ltd's freehold property on 1 January 2007. (Narratives are not required). Also calculate the amount of depreciation which should be charged in relation to the building for the year to 31 December 2007. *4*

(f) Explain why (probably) Gamma Ltd was willing to pay £250,000 for net assets worth only £175,000, and explain how the difference of £75,000 should be shown in the accounts. *2*

(20)

5

The term "regulatory framework" refers to the body of rules and regulations which apply to the financial statements of limited companies. This framework includes company law, accounting standards and (for listed companies) stock exchange regulations.

The term "conceptual framework" refers to the theoretical basis of financial accounting. This framework includes a number of accounting "concepts" or "conventions". Some of these are referred to in company law or in the *Framework for the Preparation and Presentation of Financial Statements* published by the International Accounting Standards Board (IASB).

One of the accounting conventions which has been accepted for many years (but is now subject to criticism) is the "historical cost" convention.

- **Requirement for question 5**

(a) Explain the main functions of accounting, distinguishing between financial accounting and management accounting. *5*

(b) State the objectives of the International Accounting Standards Board. *3*

(c) Explain briefly the role of the Standards Advisory Council (SAC) and the International Financial Reporting Interpretations Committee (IFRIC). *2*

(d) Explain the term "Generally Accepted Accounting Practice" (GAAP). *2*

(e) Explain the historical cost convention. Also explain the main advantages and disadvantages of applying this convention when preparing financial statements. *8*

(20)

6

The information given below relates to three public limited companies:

A1 plc

The issued and fully paid share capital of A1 plc on 31 August 2007 consisted of 24 million ordinary shares of 50p each. The following is an extract from the company's income statement for the year to 31 August 2007:

	£000
Profit before interest and tax	5,620
Interest payable	430
Profit before tax	5,190
Taxation	1,590
Profit after tax	3,600

Dividends for the year totalled £1,680,000. There were no share issues during the year to 31 August 2007 and the market value of the company's shares on that date was £1.12 per share.

A2 plc

The issued and fully paid share capital of A2 plc on 30 June 2007 consisted of four million ordinary shares of £1 each. The company's summarised balance sheet at 30 June 2007 was as follows:

	£000
Non-current assets	8,500
Net current assets	3,800
	12,300
Share capital	4,000
Share premium account	900
Retained earnings	7,400
	12,300

On 1 July 2007, the company made a 1 for 20 rights issue at £2.50 per share. All of the shareholders took up their rights. The company then made an immediate 1 for 1 bonus issue, financed as far as possible from the share premium account and then out of retained earnings.

A3 plc

The authorised share capital of A3 plc consists of 100 million ordinary shares of 20p each. When the company was formed in 1999, 15 million of these shares were issued at par. In 2002, another 10 million shares were issued at 25p per share. Both of these issues are now fully paid.

On 31 October 2007, the company issued a further 8 million shares at par. 10p per share was payable on issue and the remaining 10p per share was to be paid a year later. As at 10 November 2007, the company had received a total of £720,000 in relation to this share issue.

- **Requirement for question 6**

(a) List the main characteristics of ordinary shares and preference shares. *5*

(b) Compute the following ratios in relation to A1 plc:

- interest cover
- earnings per share
- dividend cover
- dividend yield
- price earnings ratio *5*

(c) Explain why a high price earnings ratio is thought to be preferable to a low price earnings ratio. *2*

(d) Prepare the summarised balance sheet of A2 plc as it would appear at close of business on 1 July 2007, assuming that no further transactions took place on that date. *4*

(e) In relation to A3 plc, compute the amount of each of the following as at 10 November 2007:

- authorised share capital
- issued share capital
- called-up share capital
- paid-up share capital. *4*

(20)