LCCI International Qualifications from EDI

Series 2 Examination 2009

CERTIFICATE IN ACCOUNTING (IAS)

Level 3

Thursday 2 April

Subject Code: 3902

Time allowed: **3 hours**

INSTRUCTIONS FOR CANDIDATES

- Answer **any 4** questions. There are no compulsory questions.
- All questions carry equal marks.
- Study the "**REQUIRED**" section of each question carefully and extract from the information supplied the data required for your answers.
- Write your answers in blue or black ink/ballpoint. Pencil may be used only for graphs, charts, diagrams etc.
- Begin your answer to each question on a new page.
- All answers must be correctly numbered, but need not be in numerical order.
- Workings must be shown.
- You may use a calculator, provided the calculator gives no printout, has no word display facilities, is silent and cordless. The provision of batteries and their condition is your responsibility.

QUESTION 1

Lille has prepared the following details, in respect of the year ended 30 September 2008:

		$000	$000
Revenue			120
Less Cost of goods sold –	Opening inventory	12	
	Purchases	77	
		89	
	Closing inventory	6	83
Gross profit			37

In previous years, the gross profit to revenue ratio was 33⅓%. Lille suspects his assistant may be stealing goods from inventory.

REQUIRED

(a) Calculate the value of goods the assistant may have stolen, in the year to 30 September 2008:

(i) at cost price
(ii) at selling price.

(6 marks)

(b) Give **four other** possible reasons for the fall in gross profit to revenue ratio, in the year to 30 September 2008.

(8 marks)

Sedan's non-current assets at 1 January 2008 were shown in her Balance Sheet as follows:

	Cost	Accumulated Depreciation	NBV
	$000	$000	$000
Buildings	720	260	460
Plant and machinery	400	200	200

During the year ended 31 December 2008, the following transactions took place in relation to non-current assets:

(1) Buildings (cost $40,000, accumulated depreciation $10,000) were sold for $8,000
(2) New buildings were purchased for $120,000
(3) Plant and machinery (cost $30,000, net book value $10,000) was sold for $17,000
(4) New plant and machinery was purchased for $70,000.

Buildings are depreciated at 2% on a straight line basis, assuming zero residual value. Plant and machinery is depreciated at 20% on a reducing balance basis. A full year's depreciation is charged in the year of purchase and none in the year of sale.

REQUIRED

(c) Calculate for Sedan, the cost, accumulated depreciation, and net book value at 31 December 2008 of:

(i) Buildings
(ii) Plant and machinery.

(11 marks)

(Total 25 marks)

QUESTION 2

The Purchases Ledger Control Account of York, a private company, had a credit balance of $65,331 on 31 January 2009. On that date, the list of balances extracted from the Purchases Ledger had a net credit total of $64,594. Neither the individual purchases ledger accounts, nor the individual sales ledger accounts are treated as part of York's double entry records. The following errors were discovered:

(1) an invoice for $60, correctly recorded in the Purchases Day Book, had not been posted to the supplier's account in the Purchases Ledger

(2) a purchase invoice for $826 had been completely omitted from the books

(3) a credit balance of $270 in the list of purchases ledger balances had been wrongly listed as a debit balance

(4) the discount received column in the Cash Book had been over-added by $80

(5) contras of $207 had been correctly entered in the purchases ledger accounts and in the sales ledger accounts, but no entry had been made in either control account

(6) a cheque for $875, paid to a supplier, had been entered into the supplier's account as $785

(7) a page in the Purchases Day Book had been over-added by $100.

REQUIRED

(a) Prepare Journal entries (without narratives) showing the corrections necessary to the **double entry** records.

(8 marks)

(b) Calculate:

(i) the corrected balance on the Purchases Ledger Control Account
(ii) the corrected net total of the balances extracted from the Purchases Ledger
(iii) the change to York's net profit as a result of the errors that had been discovered.

(13 marks)

(c) Explain what is meant by a 'contra' and give **one** advantage and **one** disadvantage of using contras.

(4 marks)

(Total 25 marks)

QUESTION 3

Glimt, a private company, has to choose between projects P and Q, details of which are as follows:

	Year	Project P	Project Q
		$	$
Initial cash investment	1 (beginning)	(80,000)	(130,000)
Trading cash inflows:	1	30,000	20,000
	2	40,000	70,000
	3	20,000	30,000
	4	10,000	60,000
Residual cash inflow	4 (end)	60,000	100,000

Discounting factors	Year	Factor
	1	0.909
	2	0.826
	3	0.751
	4	0.683

REQUIRED

For each of the two projects, calculate the following:

(a) the net present value (assuming trading cash inflows occur at the end of each year) (6 marks)

(b) the payback period (assuming trading cash inflows accrue evenly over each year) (6 marks)

(c) the accounting rate of return. (8 marks)

Methods of investment appraisal each have their advantages and disadvantages.

REQUIRED

(d) State which of the above methods of investment appraisal:

- (i) is best for the initial screening of projects and why
- (ii) do not take into account the time value of money
- (iii) uses profits rather than cash flows.

(5 marks)

(Total 25 marks)

QUESTION 4

The summarised Balance Sheet of Aston, a private company, at 31 December 2008 was as follows:

	$000
Net assets	3,000
	$000
Ordinary shares of $1 each	1,800
Share premium	400
Accumulated profits	800
	3,000

Villa, a public company, is considering acquiring Aston and believes that Aston will make a net profit of $600,000 for the year ended 31 December 2009, accruing evenly over the year. Villa's policy is to write off goodwill at 10% per year, on a monthly basis.

REQUIRED

(a) Calculate the amounts to be included in the budgeted Consolidated Balance Sheet of Villa, at 31 December 2009, in respect of Aston for **Goodwill, Minority Interest and Accumulated Profits**, on each of the **alternative** assumptions that:

- (i) all the shares in Aston were acquired by Villa on 1 January 2009 for $3,500,000 cash
- (ii) 75% of the shares in Aston will be acquired by Villa on 1 July 2009 for $2,675,000 cash.

(16 marks)

(b) Assuming all the shares in Aston were acquired by Villa on 1 January 2009 show the Journal entry necessary to record this transaction in the books of Villa. A narrative is required.

(3 marks)

The Managing Director of Aston is not concerned about whether or not the takeover goes ahead, and makes the following observations:

- (i) no entries will be necessary in the books of Aston, in respect of the acquisition
- (ii) no changes will be necessary to Aston's accounting policies
- (iii) the existing directors of Aston will continue to run the business.

REQUIRED

(c) Discuss each of the Managing Director's observations, concluding in each case as to whether or not he is correct.

(6 marks)

(Total 25 marks)

QUESTION 5

The summarised financial statements of Roma, a public company and a manufacturer, are as follows:

Income Statement for the year ended 31 December

	2007	2008
	$000	$000
Revenue	1,900	3,400
Cost of goods sold	900	1,850
Gross profit	1,000	1,550
Expenses	380	1,200
Net operating profit	620	350
Debenture interest	-	150
Net profit	620	200
Dividends	160	160
Retained profit	460	40

Balance Sheet at 31 December

	2007		2008	
	$000	$000	$000	$000
ASSETS				
Non-current Assets				
Plant and equipment		800		5,000
Motor vehicle		300		270
		1,100		5,270
Current Assets				
Inventory	100		308	
Receivables	190		981	
Bank	360		26	
		650		1,315
Total Assets		1,750		6,585
EQUITY AND LIABILITIES				
Capital and reserves				
Ordinary shares of $1 each		1,000		2,000
Accumulated profits		485		525
Equity		1,485		2,525
Non-current Liabilities				
10% Debentures		-		3,000
Current Liabilities				
Payables	105		900	
Dividends	160		160	
		265		1,060
		1,750		6,585

QUESTION 5 CONTINUED

Roma issued 1,000,000 $1 shares on 1 January 2008. Its share price was $1.80 on 31 December 2007 and $0.30 on 31 December 2008.

REQUIRED

(a) Calculate the following ratios, correct to two decimal places, for **each** of the years 2007 **and** 2008:

(i) Revenue to (closing) non-current assets
(ii) Net profit to total (closing) capital employed
(iii) Earnings per share
(iv) Price/earnings
(v) Dividend yield
(vi) Dividend cover
(vii) Earnings yield
(viii) Interest cover (2008 only)

(16 marks)

(b) Calculate when the 10% Debentures were issued and state (without calculations) the effect of this issue on Roma's gearing.

(3 marks)

The Managing Director of Roma has stated that:

(1) 2008 was a year of great change and the full benefits of that change are not expected until 2009 and beyond
(2) increased revenues have been achieved, whilst keeping costs under control.

REQUIRED

(c) Using the figures in the financial statements, discuss whether or not you agree with **each** of the Managing Director's statements.

(6 marks)

(Total 25 marks)

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Hong Kong School of Commerce
香港商業專科學校

ACCOUNTING(IAS)

LEVEL 3

SERIES 2 EXAMINATION 2009

Suggested Answers

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LONDON CHAMBER OF COMMERCE AND INDUSTRY
SERIES 2 EXAMINATION 2009
ACCOUNTING (IAS)
(LEVEL 3)

ANSWER 1

LILLE

(a)

(i) Inventory stolen at cost price

	$000
Opening inventory	12
Add : Purchases	77
	89
Less : Cost of goods sold (120 × 2/3)	80
Closing inventory	9
Less : Recorded inventory	6
Inventory stolen	3

(ii) Inventory stolen at selling price = Cost price × 3/2
= $3,000 × 3/2
= $4,500

(b) Four other possible reasons for the fall in gross profit to revenue ratio

- Reduce in selling price per unit
- Decrease in sales volume
- Increase in purchase cost
- Decrease in net realizable value of inventory
- Lower trade discounts received from suppliers

(any four of the above)

ANSWER 1 (CONTINUED)

SEDAN

(c) **Calculation at 31 December 2008**

(i)

	Cost	Accumulated depreciation	Net book value
	$000	$000	$000
Buildings	720	260	
Additions	120	(W1) 16	
	840	276	
Less : Disposal	40	10	
	800	266	534

(ii)

	Cost	Accumulated depreciation	Net book value
	$000	$000	$000
Plant and machinery	400	200	
Additions	70	(W2) 52	
	470	252	
Less : Disposal	30	20	
	440	232	208

Workings

(1) Depreciation on buildings
= $800,000 × 2%
= $16,000

(2) Depreciation on plant and machinery
= $(370,000 – 180,000) × 20% + $70,000 × 20%
= $52,000

ANSWER 2

YORK

(a) Journal

Item	Particulars	Debit	Credit
		$	$
(1)	No entries are required		
(2)	Purchases	826	
	Purchases ledger control		826
(3)	No entries are required		
(4)	Discounts received	80	
	Purchases ledger control		80
(5)	Purchases ledger control	207	
	Sales ledger control		207
(6)	No entries are required		
(7)	Purchases ledger control	100	
	Purchases		100

(b) (i) Purchases Ledger Control

2009			$	2009			$
Jan	31	(5) Sales ledger control - contra	207	Jan	31	Balance per question	65,331
	31	(7) Purchases	100		31	(2) Purchases	826
	31	Corrected balance c/d	65,930		31	(4) Discounts received	80
			66,237				66,237
				Feb	1	Corrected balance b/d	65,930

ANSWER 2 (CONTINUED)

(ii) Calculation of the corrected net total extracted from Purchases Ledger

	$	$
Net credit total extracted from Purchases Ledger		64,594
Add : (1) Credit balance omitted	60	
(2) Purchases omitted	826	
(3) Credit balance recorded on the wrong side (270 × 2)	540	1,426
		66,020
Less : (6) Incorrect amount of payment recorded (875 – 785)		90
Corrected net total of the balances		65,930

(iii) Statement to calculate the change in net profit

	Add	Deduct	
	$	$	$
(1) Credit balance of supplier's account omitted	No	effect	
(2) Purchases omitted	-	(826)	
(3) Credit balance of a purchases ledger listed as debit balance	No	effect	
(4) Discounts received over-added		(80)	
(5) Contras omitted in control accounts	No	effect	
(6) Incorrect amount of payment on supplier's account	No	effect	
(7) Purchases over-added	100	-	
	100	(906)	
Net adjustment			(806)

(c) **Contra** means the transferring of lesser balance from one ledger control account to another. It usually transfers the balance from sales ledger control account to purchases ledger control account for set-off purpose.

Advantage : It facilitates the settlement of trade debts in net amount.

Disadvantage : It requires much time to locate the amounts from trade receivables and trade payables for contra purpose.

ANSWER 3

GLIMT

(a) Calculation of the net present value

Project P

Year	Cash flows	Discount Factor	Present Value
	$		$
0	(80,000)	1	(80,000)
1	30,000	0.909	27,270
2	40,000	0.826	33,040
3	20,000	0.751	15,020
4	70,000	0.683	47,810
		Net present value	43,140

Project Q

Year	Cash flows	Discount Factor	Present Value
	$		$
0	(130,000)	1	(130,000)
1	20,000	0.909	18,180
2	70,000	0.826	57,820
3	30,000	0.751	22,530
4	160,000	0.683	109,280
		Net present value	77,810

(b) Calculation of the payback period

Project P

= 2 years + [(80,000 – 30,000 – 40,000) / 20,000 × 12] months

= 2 years + (10,000 / 20,000 × 12) months

= 2 years 6 months

Project Q

= 3 years + [(130,000 – 20,000 – 70,000 – 30,000) / 60,000 × 12] months

= 3 years + (10,000 / 60,000 × 12) months

= 3 years 2 months

ANSWER 3 (CONTINUED)

(c) Calculation of the accounting rate of return

Project P

Year	1	2	3	4	Total
	$	$	$	$	$
Trading cash inflow	30,000	40,000	20,000	10,000	
Less : Depreciation $\frac{(80,000 - 60,000)}{4}$	5,000	5,000	5,000	5,000	
Profit	25,000	35,000	15,000	5,000	80,000

Average annual profit = $80,000 / 4 = $20,000

Initial investment cost = $80,000

Average rate of return = $20,000 / $80,000 × 100% = 25%

Project Q

Year	1	2	3	4	Total
	$	$	$	$	$
Trading cash inflow	20,000	70,000	30,000	60,000	
Less : Depreciation $\frac{(130,000 - 100,000)}{4}$	7,500	7,500	7,500	7,500	
Profits	12,500	62,500	22,500	52,500	150,000

Average annual profit = $150,000 / 4 = $37,500

Initial investment cost = $130,000

Average rate of return = $37,500 / $130,000 × 100% = 28.85%

(d)

(i) Net present value. It is because it takes into account the time value of money and considers all cashflows.

(ii) Payback period.

(iii) Accounting rate of return.

ANSWER 4

VILLA AND ASTON

(a) Calculation of the amounts to be included in the budgeted Consolidated Balance Sheet at 31 December 2009

(i)

	$000	$000
Investment in Aston		3,500
Less: Capital and reserves		
Ordinary share capital	1,800	
Share premium	400	
Accumulated profits	800	3,000
Goodwill		500

Goodwill at 31 December 2009 = $500,000 × 9/10 = $450,000

Minority interest = NIL

Accumulated profits	$000
Post-acquisition profit 1 Jan – 31 Dec 2009	600
Less: Goodwill written off (500 × 10%)	50
	550

(ii)

	$000	$000
Investment in Aston		2,675
Less: Capital and reserves		
Ordinary share capital (1,800 × 75%)	1,350	
Share premium (400 × 75%)	300	
Accumulated profits (800 + 300) × 75%	825	2,475
Goodwill		200

Goodwill at 31 December 2009 = $200,000 – $200,000 × 1/10 × 1/2 = $190,000

Minority interest	$000
Ordinary share capital (1,800 × 25%)	450
Share premium (400 × 25%)	100
Accumulated profits (800 + 600) × 25%	350
	900

ANSWER 4 (CONTINUED)

Accumulated profits	$000
Post-acquisition profit 1 Jul – 31 Dec 2009 (600 × 6/12 × 75%)	225
Less: Goodwill written off (200 × 10% × 6/12)	10
	215

VILLA

(b)

Journal

Date	**Particulars**	**Debit**	**Credit**
2009		$	$
Jan 1	Investment in Aston	3,500	
	Cash		3,500
	Being acquisition of 100% in Aston for $3,500,000 and settled by cash		

(c)

(i) Correct. The shareholders of Aston will only sell all the shares and receive cash from Villa and therefore no entries will be necessary in the books of Aston, in respect of the acquisition.

(ii) Incorrect. In order to achieve consistency in accounting policies, no change in accounting policies is allowed unless the requirements in IAS 8 are satisfied. Company can change an accounting policy only if one of the following circumstances is fulfilled:

1. Change is required by an accounting standard or an interpretation.
2. The change results in the financial statements providing reliable and more relevant information of the company.

Hence, Aston's accounting policies can be changed.

(iii) Incorrect. Villa has majority shareholdings of Aston, and has the right to appoint other directors by voting in the shareholders' meeting.

ANSWER 5

ROMA

(a) Calculation of ratios — **2007** / **2008**

(i) Revenue to (closing) non-current assets — **\$000** / **\$000**

$$= \frac{\text{Revenue}}{\text{Non-current assets}}$$

2007: $\frac{\$1,900}{\$1,100}$ = 1.73 times

2008: $\frac{\$3,400}{\$5,270}$ = 0.65 time

(ii) Net profit to total (closing) capital employed

$$= \frac{\text{Net profit}}{\text{Total capital employed}} \times 100\%$$

2007: $\frac{\$620}{\$1,485} \times 100\%$ = 41.75%

2008: $\frac{\$200}{\$2,525 + \$3,000} \times 100\%$ = 3.62%

(iii) Earnings per share

$$= \frac{\text{Net profit}}{\text{No. of ordinary shares}}$$

2007: $\frac{\$620}{1,000}$ = \$0.62 per share

2008: $\frac{\$200}{2,000}$ = \$0.1 per share

(iv) Price/earnings

$$= \frac{\text{Price per share}}{\text{Earnings per share}}$$

2007: $\frac{\$1.8}{\$0.62}$ = 2.9 times

2008: $\frac{\$0.3}{\$0.1}$ = 3 times

(v) Dividend yield

$$= \frac{\text{Dividend per share}}{\text{Price per share}} \times 100\%$$

2007: $\frac{\$0.16}{\$1.80} \times 100\%$ = 8.89%

2008: $\frac{\$0.08}{\$0.3} \times 100\%$ = 26.67%

(vi) Dividend cover

$$= \frac{\text{Earnings}}{\text{Dividends}}$$

2007: $\frac{\$620}{\$160}$ = 3.88 times

2008: $\frac{\$200}{\$160}$ = 1.25 times

(vii) Earnings yield

$$= \frac{\text{Earnings per share}}{\text{Price per share}} \times 100\%$$

2007: $\frac{\$0.62}{\$1.8} \times 100\%$ = 34.44%

2008: $\frac{\$0.1}{\$0.3} \times 100\%$ = 33.33%

(viii) Interest cover (2008 only)

$$= \frac{\text{Net profit before interest}}{\text{Interest}}$$

2007: Nil

2008: $\frac{\$200 + \$150}{\$150}$ = 2.33 times

ANSWER 5 (CONTINUED)

(b) Gearing ratio focuses on the extent to which the firm has borrowed money to finance its operation. Gearing is measured in the ways of debts to total capital or debts to equity. When the 10% debentures were issued, the gearing ratio would be higher. An increase in gearing may be a dangerous sign for a highly geared company. It may be more difficult for it to obtain further financing.

In 2008, when 10% debentures were issued on 1 July 2008 (with half-yearly interest) paid, the effect of gearing would be adjusted to 54.3%.

Working

$$\text{Gearing ratio} = \frac{\text{Prior charge capital}}{\text{Total capital employed}} \times 100\%$$

$$= \frac{3{,}000{,}000}{2{,}525{,}000 + 3{,}000{,}000} \times 100\%$$

$$= 54.3\ \%$$

(c)

(1) Purchase of plant and equipment will generate benefits in long term and will be reflected in the financial statements in a later period. However, the purchase of plant and equipment was financed by issuing shares and debentures. There will be an interest burden in the years afterwards.

(2) It shows that revenue has increased by 78.9% in 2008. However, gross profit margin of 2007 drops from 52.6% (= 1,000,000/1,900,000 × 100%) to 45.6% (= 1,550,000/ 3,400,000 × 100%) in 2008. It reflects that there was an increase in the amount of cost of goods sold.

In addition, the net profit is not satisfactory. This is because the amount of expenses is too large. This may due to poor cost control in administration, operation, selling and other expenses.

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