LCCI International Qualifications from EDI

Series 4 Examination 2009

CERTIFICATE IN ACCOUNTING (IAS)

Level 3

Friday 13 November

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. You can only use pencil 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.
- Marks may be lost through lack of neatness and poor presentation.

QUESTION 1

Every month the accountant of Viking Ltd, a private company, reconciles the bank balance appearing in the cash book with the balance appearing in the company's bank statement at the end of that month.

At 31 October 2008 the cash book showed a bank balance in hand of $10,932 whilst the bank statement showed a balance in hand of $8,133.

A Suspense Account had been set up as the Trial Balance did not balance.

The accountant discovered the following:

(1) A receipt from a receivable of $360 was received and banked on 30 October but no entry had been made in the books. This deposit appeared on the bank statement on 2 November.
(2) Cheques totalling $996 were entered in the books on 29 October and sent out to suppliers on that date. They did not appear in the bank statement until 4 November.
(3) No entries had been made in the books for bank charges of $1,206 which appeared on the bank statement on 28 October.
(4) Takings of $5,259 were entered in the cash book and banked on 31 October, but did not appear in the bank statement until 1 November.
(5) A standing order for a subscription payable of $165 had been paid twice, in error, by the bank. No entry had been made in the cash book in respect of either payment.
(6) The debit side of the cash book for October had been under added by $3,000.

REQUIRED

(a) Prepare journal entries, excluding narratives, but including entries relating to bank, to record the necessary adjustments.

(8 marks)

(b) Calculate the corrected bank balance in the cash book at 31 October 2008.

(5 marks)

(c) Prepare a bank reconciliation statement at 31 October 2008 starting with the balance on the company's bank statement on that date.

(5 marks)

A trainee accountant has asked the following questions relating to the bank reconciliation process:

(i) "Why is the company paying bank charges when it has a sizeable balance in hand? Surely the bank should be paying Viking interest and not the other way round?"
(ii) "Why are deposits entered in the bank statement within a day whilst cheques take many days to appear in the bank statement?"

REQUIRED

(d) Reply to the trainee accountant's questions.

(7 marks)

(Total 25 marks)

QUESTION 2

In 2008 Clyst, a private company, constructed a new workshop. The following expenditure was incurred in relation to the workshop during 2008:

	$	$
Purchase of land		120,000
Legal fees in respect of:		
Purchase of land	11,000	
A dispute with a supplier over the quality of the building materials	5,000	16,000
Architect's fees		6,000
Clearance of site		12,000
Building materials		21,000
Labour: Clyst's own employees charged at cost plus 50% to cover the associated administrative expenses		75,000
Electrical installation		13,000
Cost of electricity		2,000
Decoration:		
Initial		500
Redecoration in more pleasing colours		600
Annual insurance		900
		267,000

REQUIRED

(a) Prepare a schedule showing the total amount to be:
  (i) Treated as part of the capital cost of the workshop
  (ii) Written off as expenses.

(7 marks)

Hayle, a public company, purchased a new machine on 1 January 2009 for $120,000. It is expected to be used for five years and then have a residual value of $8,000.

REQUIRED

(b) For each of the years 2009, 2010 and 2011, calculate, for Hayle, the amount to be charged to the Income Statement, in respect of depreciation on the new machine, using **each** of the following methods:

  (i) Straight line
  (ii) Reducing balance at 40%
  (iii) Sum of the years' digits

(8 marks)

(c) Explain what is meant by 'residual value' in relation to non-current assets.

(3 marks)

QUESTION 2 CONTINUED

Truro, a private company, imports model aircraft, paints them, packages them in attractive boxes and then sells them to retail shops. Details are as follows:

	$ Per aircraft
Purchase price before discounts	7.40
Import taxes	0.80
Settlement discount received	0.37
Trade discount received	0.74
Painting	2.10
Box	0.80
Carriage outwards	0.40
Carriage inwards	0.30
Selling price	11.80
Other selling costs	0.50

There were 380 model aircraft, painted, boxed and ready for despatch, in inventory at 30 June 2009.

REQUIRED

(d) Calculate the cost of inventory and the net realisable value of inventory, at 30 June 2009, and show the amount that should appear in Truro's Balance Sheet at that date.

(7 marks)

(Total 25 marks)

QUESTION 3

Brann, a retailer, has the following budgeted Balance Sheets at 31 December:

	Cost $000	2009 Acc.Dep. $000	Nbv $000	Cost $000	2010 Acc.Dep. $000	Nbv $000
Non-current assets	500	140	360	570	190	380
Current assets						
Inventory		71			82	
Trade receivables		25			59	
Bank		10			-	
		106			141	
Current liabilities						
Trade payables	14			11		
Accrued expenses	6			7		
Bank overdraft	-	20		9	27	
Net current assets			86			114
			446			494
			$000			**$000**
Capital						
Opening balance			420			446
Net Profit			40			60
			460			506
Drawings			14			12
			446			494

Notes:

(1) The profit to revenue ratios for 2010 are budgeted to be:

Gross profit 25%
Net profit 10%

(2) No non-current asset disposals are budgeted for 2010.

REQUIRED

(a) Prepare an annual cash budget for Brann for 2010.

(13 marks)

Brann is concerned that the budgeted figures show that a bank balance in hand of $10,000 has become a bank overdraft of $9,000 by the end of 2010.

REQUIRED

State:

(b) **Three** reasons for the overdraft

(6 marks)

(c) **Six** actions Brann might take to avoid having to request overdraft facilities.

(6 marks)

(Total 25 marks)

QUESTION 4

The following information has been extracted from the accounting records of Wick, a private company, for the year ended 31 December 2008:

(1) Motor vehicles (cost $80,000, net book value $32,000) were sold for $24,000. These were the only non-current assets disposed of during the year.

(2) Plant and machinery, costing $84,000, was acquired.

(3) Accumulated depreciation of non-current assets was $78,000 on 1 January and $56,000 on 31 December.

(4) Dividends received from investments of $3,000 was $4,000 less than loan interest paid.

(5) A five year bank loan of $40,000 was received.

(6) Issued share capital increased from 200,000 $1 ordinary shares to 400,000 $1 ordinary shares. A bonus (capitalisation) issue of one share for every two shares held had been followed by a fully subscribed rights issue at $1.25 per share.

(7) Wick made a net profit of $50,000.

(8) Receivables at 31 December were 20% higher than the $70,000 receivables at 1 January.

(9) Payables at 31 December were $40,000, a decrease of 20% on payables at 1 January.

(10) Inventory at 31 December was $5,000 higher than the $25,000 inventory at 1 January.

REQUIRED

(a) Show the following items as they would appear in the Cash Flow Statement of Wick for the year ended 31 December 2008 in accordance with IAS 7:

(i) Reconciliation of net profit to net cash inflow from operating activities.
(ii) Net cash outflow from investing activities.
(iii) Net cash inflow from financing activities.

(17 marks)

The Managing Director is concerned about the company's cash position. One suggestion that he has received is to reduce the amount of inventory held.

REQUIRED

(b) State **three** advantages and **one** disadvantage of this suggestion.

(8 marks)

(Total 25 marks)

QUESTION 5

Extracts from the financial statements of Lazio, a food and clothing retailer, are as follows:

Income Statements for the year ended 31 December:

	2007	2008
	$000	**$000**
Revenue	225	250
Gross profit	105	100
Selling and administrative expenses	40	45
Loan interest	10	7

Balance Sheets at 31 December:

	2007	2008
	$000	**$000**
Non-current assets at net book value	333	300
Inventory	4	7
Trade receivables	10	30
Bank	(25)	10
Trade payables	10	20
Loans to Lazio	150	100
Ordinary shares of $1 each	100	150

Notes:

(1) Lazio's share price was $2.50 on 31 December 2007 and $1.50 on 31 December 2008.
(2) Lazio paid dividends of $15,000 during the year ended 31 December 2008. The same amount was paid in the previous year.

REQUIRED

(a) Calculate, for Lazio, the following ratios (correct to 2 decimal places), for **each** of 2007 and 2008:

(i) Gross profit to revenue
(ii) Inventory turnover (using closing inventory and expressed in days)
(iii) Receivables' collection period (expressed in days)
(iv) Earnings per share
(v) Price earnings
(vi) Dividend cover
(vii) Interest cover

(16 marks)

Further information about Lazio, in respect of 2008, was obtained from the company website as follows:

(1) The company introduced 'Lazio Loyalty Credit Cards'. These allow customers to purchase goods on credit with no interest if paid within 60 days.
(2) Ten poorly performing stores were sold off and the rest refurbished, resulting in a one-off expense of $5,000. No new stores were acquired.

REQUIRED

(b) Assess the possible success, or otherwise, of the above changes using the Income Statement and Balance Sheet extracts that have been provided.

(6 marks)

QUESTION 5 CONTINUED

The increase in ordinary share capital between the Balance Sheet dates resulted from a bonus issue of one for two.

REQUIRED

(c) Explain what is meant by:

(i) bonus issue
(ii) one for two.

(3 marks)

(Total 25 marks)

HKSC
(Founded 1959)

Hong Kong
School of Commerce
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ACCOUNTING(IAS)

LEVEL 3

SERIES 4 EXAMINATION 2009

Suggested Answers

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LONDON CHAMBER OF COMMERCE AND INDUSTRY
SERIES 4 EXAMINATION 2009
ACCOUNTING (IAS)
(LEVEL 3)

ANSWER 1

(a) **VIKING LTD**

Journal

Item	Particulars	Dr	Cr
		$	$
(1)	Bank	360	
	Receivables		360
(2)	No entries are required		
(3)	Bank charges	1,206	
	Bank		1,206
(4)	No entries are required		
(5)	Subscription	165	
	Bank		165
(6)	Bank	3,000	
	Suspense		3,000

(b) Statement to calculate correct bank balance in cash book at 31 October 2008

		$	$
Balance before correction			10,932
Add:	(1) Receipts from receivables omitted	360	
	(6) Debit balance under added	3,000	3,360
			14,292
Less:	(3) Bank charges omitted	1,206	
	(5) Subscription payables omitted	165	1,371
Balance after correction			12,921

ANSWER 1 (Continued)

(c) Bank reconciliation statement at 31 October 2008

		$	$
Balance as per bank statement			8,133
Add:	(1) Uncredited receipt from receivables	360	
	(4) Uncredited takings	5,259	
	(5) Bank error - Subscription paid twice	165	5,784
			13,917
Less:	(2) Unpresented cheque		996
Balance as per updated cash book			12,921

(d)

(i) Bank charges are expenses charged by the bank in providing services to the holders of bank accounts, e.g. charges for standing order and direct debit. For a current account, the bank will not provide interest to the account holder.

(ii) Cash deposits are easier to be verified by the bank. However, clearing of cheques takes time. That means the transmission and settlement of cheque payments between payer and payee accounts held at different banks. Also, they need to check the correctness of details on cheques and whether the drawer has enough money in the account to be debited.

ANSWER 2

(a) **CLYST**

(i) **Schedule showing the capital cost of the workshop**

	$
Purchase of land	120,000
Legal fees in respect of purchase of land	11,000
Architect's fees	6,000
Clearance of site	12,000
Building materials	21,000
Labour : own employees ($75,000 × 100/150)	50,000
Electrical installation	13,000
Decoration: Initial	500
Capital cost of the workshop	**233,500**

(ii) **Schedule showing the total amount to be written off as expenses**

	$
Legal fees in respect of a dispute with a supplier*	5,000
Labour: Administrative expenses ($75,000 × 50/150)	25,000
Cost of electricity	2,000
Decoration: Redecoration in more pleasing colours	600
Annual insurance	900
Expenses to be written off	**33,500**

* As it is an abnormal expense, it is regarded as revenue expenditure.

(b) **HAYLE**

Calculation showing the depreciation amounts to be charged to Income Statement

			2009	**2010**	**2011**
			$	$	$
Depreciation	- (i)	Straight line (W1)	22,400	22,400	22,400
	- (ii)	Reducing balance (W2)	48,000	28,800	17,280
	- (iii)	Sum of digits (W3)	37,333	29,867	22,400

Working

(1) Straight line method

Year		**Depreciation**
2009	$(120,000 – 8,000) / 5	$22,400
2010	$(120,000 – 8,000) / 5	$22,400
2011	$(120,000 – 8,000) / 5	$22,400

ANSWER 2 (Continued)

(2) Reducing balance method

Year		Depreciation
2009	$120,000 × 40%	$48,000
2010	$(120,000 – 48,000) × 40%	$28,800
2011	$(120,000 – 48,000 – 28,800) × 40%	$17,280

(3) Sum of the years' digits method

Total sum of digits for 5 years = [5(5 + 1)] / 2 = 15

Year		Depreciation
2009	$(120,000 – 8,000) × 5/15	$37,333
2010	$(120,000 – 8,000) × 4/15	$29,867
2011	$(120,000 – 8,000) × 3/15	$22,400

(c) Residual value of non-current assets is the net amount which the enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of depreciation.

(d) **TRURO**

Calculation showing the cost and net realizable value of inventory at 30 June 2009

	Cost	NRV
	$	$
Purchase price before discounts	7.40	-
Trade discount	(0.74)	-
Import taxes	0.80	-
Painting	2.10	-
Box	0.80	-
Carriage inwards	0.30	-
Selling price	-	11.80
Carriage outwards	-	(0.40)
Other selling costs	-	(0.50)
Cost / Net realizable value of inventory at 30 June 2009	**10.66**	**10.90**

Balance Sheet (Extract) at 30 June 2009

Current Assets	$
Inventory ($10.66 × 380)	4,051*

*Calculated to the nearest dollar

ANSWER 3

(a) **BRANN**

Annual Cash Budget for 2010

Receipts	$000
Trade Receivables (W1)	566
Payments	
Trade Payables (W2)	464
Non-current assets $(570 – 500)	70
Expenses (W4)	39
Drawings	12
	585
Payments exceed receipts	(19)
Opening balance	10
Closing balance	(9)

Workings

(1) **Trade Receivables**

	$000		$000
Balance b/f	25	**Bank (balancing figure)**	**566**
Sales*	600	Balance c/d	59
	625		625
Balance b/d	59		

*($60 / Sales) × 100% = 10%

Sales = $60 / 10%

Sales = $600

(2) **Trade Payables**

	$000		$000
Bank (balancing figure)	**464**	Balance b/f	14
Balance c/d	11	Purchases (W3)	461
	475		475
		Balance b/d	11

ANSWER 3 (Continued)

(3)

		$000	$000
Sales			600
Less Cost of sales			
	Opening inventory	71	
	Purchases (balancing figure)	**461**	
		532	
	Less Closing inventory	82	450
Gross profit ($600 × 25%)			150

(4) **Expenses**

	$000		$000
Bank (balancing figure)	**39**	Balance b/f	6
Balance c/d	7	Income Statement (W5)	40
	46		46
		Balance b/d	7

(5)

	$000
Gross profit	150
Less: Expenses	
Expenses (balancing figure)	**40**
Depreciation $(190 – 140)	50
Net profit	60

(b) Three reasons for the overdraft

- The amount of acquisition of non-current assets ($70,000) in 2010 is huge.
- Amounts owed by trade receivables for $59,000 in 2010 are high in comparison with $25,000 in 2009. Increase in trade receivable would reduce the cash inflows.
- Increase in inventory from $71,000 to $82,000 would be a possible cause of the increase in cash outflows.

(c) Six actions Brann might take to avoid having to request overdraft facilities:

- Cash introduced by owner as an increase of capital.
- Sales proceeds from disposal of non-current assets.
- New capital expenditures may be deferred.
- Longer trade payables settlement period taken from suppliers.
- Shorter trade receivables collection period allowed to customers.
- Arrangement with banks for long-term borrowings.

ANSWER 4

(a) **WICK**

(i) Reconciliation of net profit to net cash inflow from operating activities

	$	$
Profit before interest $(50,000 + 3,000 + 4,000)		57,000
Adjustment for		
Dividend received	(3,000)	
Depreciation [$56,000 – $(78,000 – 48,000)]	26,000	
Loss on sale of motor vehicles ($32,000 – $24,000)	8,000	31,000
Operating cash flows before working capital changes		88,000
Increase in inventories	(5,000)	
Increase in receivables ($70,000 × 20%)	(14,000)	
Decrease in payables [$40,000 / (1 – 20%) – $40,000]	(10,000)	(29,000)
Cash generated from operation		59,000
Interest paid ($3,000 + $4,000)		(7,000)
Net cash flow from operating activities		**52,000**

(ii) Net cash outflow from investing activities

Cash flow from Investing activities	$
Plant and machinery acquired	(84,000)
Dividend received	3,000
Sale of motor vehicles	24,000
Net cash outflow from investing activities	**(57,000)**

(iii) Net cash inflow from financing activities

Cash flow from financing activities	$
Bank loan	40,000
Ordinary shares issued (Working)	125,000
Net cash inflow from financing activities	**165,000**

Working

Ordinary shares increased (400,000 – 200,000)	200,000	shares
Less: Bonus issue (200,000 × 1/2)	100,000	shares
Balance shares to be issued	100,000	shares
Right issues (100,000 × $1.25)		**$125,000**

ANSWER 4 (Continued)

(b) Advantages of reducing inventory held:

- Reduce the handling cost of inventory e.g. insurance
- Reduce the storage cost of inventory
- Reduce the risk of inventory loss

Disadvantages of reducing inventory held:

- Loss of revenue caused by shortage of inventory.

ANSWER 5

LAZIO

		2007	2008
(a)	**Calculation of ratios**		
(i)	**Gross profit to revenue**	**\$000**	**\$000**
	$= \dfrac{\text{Gross profit}}{\text{Revenue}} \times 100\%$	$\dfrac{105}{225} \times 100\%$	$\dfrac{100}{250} \times 100\%$
		= 46.67%	= 40%
(ii)	**Inventory turnover**		
	$= \dfrac{\text{Closing inventory}}{\text{Cost of sales}} \times 365 \text{ days}$	$\dfrac{4}{(225-105)} \times 365$	$\dfrac{7}{(250-100)} \times 365$
		= 12.17 days	= 17.03 days
(iii)	**Receivables collection period**		
	$= \dfrac{\text{Receivables}}{\text{Revenue}} \times 365 \text{ days}$	$\dfrac{10}{225} \times 365$	$\dfrac{30}{250} \times 365$
		= 16.22 days	=43.8 days
(iv)	**Earnings per share**		
	$= \dfrac{\text{Net profit}}{\text{No. of ordinary shares issued}}$	$\dfrac{(105-40-10)}{100}$	$\dfrac{(100-45-7)}{150}$
		= \$0.55 per share	= \$0.32 per share
(v)	**Price earnings**		
	$= \dfrac{\text{Market price per ordinary share}}{\text{Earnings per share}}$	$\dfrac{\$2.50}{\$0.55}$	$\dfrac{\$1.5}{\$0.32}$
		= 4.55 times	= 4.69 times
(vi)	**Dividend cover**		
	$= \dfrac{\text{Earnings per share}}{\text{Ordinary dividends per share}}$	$\dfrac{\$0.55}{(15 / 10)}$	$\dfrac{\$0.32}{\$0.1}$
		= 3.67 times	= 3.20 times

ANSWER 5 (Continued)

(a) Calculation of ratios	**2007**	**2008**
	$000	**$000**
(vii) Interest cover		
= Profit before interest / Loan interest	(105 – 40) / 10	(100 – 45) / 7
	= 6.50 times	= 7.86 times

(b) Introduction of credit cards may contribute to the increase in revenue and trade receivables, but revenues [11% = (250 – 225) / 225 × 100%] increased without corresponding increase in trade receivables [200% = (30 – 10) / 10 × 100%]. Moreover, the amount of trade receivables increased by twice and the collection period lengthened from 16.22 days to 43.8 days, hence there is higher risk of bad debts.

The main reason for the closure of poorly performing stores was to increase company's profitability. However, the gross profit margin reduced from 47% [= (105 / 225) × 100% in 2007 to 40% [= (100 / 250) × 100%] in 2008. Hence, the restructuring cannot increase profitability.

According to the above analysis, the introduction of credit cards and selling off the poorly performing stores are unsuccessful.

(c)

(i) **Bonus issue** is the issue of ordinary shares to existing shareholders out of the company's reserves. No cash is paid to acquire bonus issue.

(ii) **One for two** means every two shares hold, a shareholder is entitled to one share from the company, maybe on bonus issue or right issue approach.

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