LCCI International Qualifications

Series 3 Examination 2008

CERTIFICATE IN ACCOUNTING (IAS)

Level 3

Wednesday 4 June

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 the data required for your answers from the information supplied.
- 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

Wool and Looe are in partnership sharing profits in the ratio 4:3 respectively after allowing for a salary of $3,000 per year for Wool. The following Trial Balance has been extracted at the end of the six month period ended on 31 March 2008:

	$	$
Non-current assets – cost	37,000	
accumulated depreciation		15,000
Inventory at 1 October 2007	12,300	
Receivables	9,750	
Provision for doubtful debts		1,200
Bank		2,100
Cash	800	
Payables		4,750
Prepayments	425	
Accruals		380
Revenue		112,300
Purchases	78,100	
Distribution costs	12,100	
Administrative expenses	9,200	
Partners' accounts – Wool		14,175
Looe		9,770
	159,675	159,675

The following additional information is available:

(1) Inventory at 31 March 2008 cost $14,100
(2) Bad debts (to be charged to administrative expenses) of $150 are to be written off and the provision for doubtful debts adjusted to 6% of receivables
(3) Depreciation is to be charged at 20% per year, on a straight-line basis, on non-current assets costing $25,000. Depreciation is to be charged at 30% per year, on a reducing balance basis, on the remaining non-current assets which have accumulated depreciation of $4,800. All depreciation is to be charged to administrative expenses
(4) Prepaid distribution costs have been overstated by $140 and accrued administrative expenses have been understated by $180
(5) Cheques totalling $520 were sent out before 31 March 2008, but not recorded. Of this amount $300 is for distribution costs and the remainder for administrative expenses. These expenses have not been included in accruals.

REQUIRED

(a) Prepare the Income Statement and Appropriation Account of the partnership for the six months ended 31 March 2008 and a Balance Sheet at that date.

(21 marks)

Wool and Looe are unhappy with the net profit calculated in (a) above. Wool suggests that the easiest way to improve it would be to increase the value placed on inventory at 31 March 2008. Looe is not convinced, suggesting that this change would reduce profit as well as not being acceptable accounting practice.

REQUIRED

(b) Briefly discuss whether or not Looe is correct. (4 marks)

(Total 25 marks)

QUESTION 2

Hull is trying to decide between two investment projects. Each would require the immediate purchase of machinery costing $100,000 and lasting 5 years, with a disposal value of $20,000 at the end of 5 years.

Project A will require, immediately, additional working capital of $10,000, which will be released at the end of Year 5. Each unit of output will make a contribution of $50 and production and sales are expected to be as follows:

Year	Units
1	200
2	300
3	500
4	2,000
5	800

Project B will require, immediately, additional working capital of $30,000, which will be released at the end of year 5. Project B will also require immediate expenditure of $20,000 on an advertising campaign. Each unit of output will make a contribution of $5 and production and sales are expected to be as follows:

Year	Units
1	16,000
2	8,000
3	6,000
4	6,000
5	4,000

All cash flows are assumed to occur at the end of each year, "immediately" being Year 0.

REQUIRED

Calculate the following for **each** project:

(a) The cash flows occurring in each of the years 0,1,2,3,4,5. (10 marks)

(b) The payback period. (3 marks)

(c) The net present value using a discount rate of 10%. Relevant discount factors are as follows:

Year	Factor
1	0.909
2	0.826
3	0.751
4	0.683
5	0.621

(7 marks)

"Payback period emphasises cash flows, but ignores cash received beyond the payback period and is therefore useless for project appraisal".

REQUIRED

(d) Briefly discuss the above statement. (5 marks)

(Total 25 marks)

QUESTION 3

Deal, a private company, acquired 75% of the 400,000 $1 Ordinary Shares of Dover, a private company, on 1 January 2002. The credit balance on Dover's Accumulated Profits was then $26,000. The Income Statements of each company, for the year ended 31 December 2007, were as follows:

	Deal	Dover
	$000	$000
Revenue	740	320
Cost of sales	(280)	(130)
Gross profit	460	190
Distribution costs	(40)	(30)
Administrative expenses	(28)	(13)
Dividends received	132	-
Interest expense	(5)	(3)
Net profit	519	144
Dividends paid	(80)	(100)
Profit for the year	439	44
Accumulated profits brought forward	173	98
Accumulated profits carried forward	612	142

The following additional information is available:

(1) Goodwill on the acquisition of Dover was $140,000. It is being written off evenly over 10 years and is to be charged to administrative expenses in the Consolidated Income Statement.
(2) Deal's share of Dover's dividends has been recorded in Deal's books
(3) In the year ended 31 December 2007 Deal sold goods to Dover for $120,000, representing cost to Deal plus a mark-up of 20%. Dover resold all these goods before 31 December 2007, realising $160,000.

REQUIRED

(a) Prepare the Consolidated Income Statement of Deal and its subsidiary Dover for the year ended 31 December 2007.

(20 marks)

(b) Calculate the goodwill figure which will appear in the Consolidated Balance Sheet of Deal at 31 December 2007.

(2 marks)

Goodwill is an example of an intangible fixed asset.

REQUIRED

(c) Give **one** other example of an intangible fixed asset and **two** examples of tangible fixed assets.

(3 marks)

(Total 25 marks)

QUESTION 4

Frome, a public company, has for many years been a manufacturing company producing below average results. On 1 January 2003 a new Managing Director was appointed whose aims were as follows:

A. Increase the company's gross profit percentage
B. Develop services like maintenance and repair work in addition to manufacturing
C. Improve the standing of the company in the financial community
D. Minimise risks for the company shareholders.

The following information for Frome relates to the financial year before the new Managing Director was appointed and to the most recent financial year:

	2002	2007
	$000	$000
Revenue	21,500	43,750
Net profit	1,700	3.500
Cost of goods sold	8,400	11,200
Closing inventory	3,200	3,700
Current assets (excluding inventory)	3,500	4,100
Current liabilities	2,100	2,400
Price/earnings ratio	10	14
Share price	$0.75	$1.10
Average wage per employee	$14,175	17,400
Gearing	25%	40%

REQUIRED

(a) Calculate, correct to 2 decimal places, the following ratios for **each of the years 2002 and 2007**:

(i) Gross profit percentage
(ii) Inventory turnover based on closing inventory and expressed in days
(iii) Earnings per share
(iv) Acid test
(v) Current.

(12 marks)

(b) Based on the information given and your calculations in (a) above, assess whether or not each of the aims of the new Managing Director, A to D above, have been achieved. Ignore inflation.

(10 marks)

A public company, Rugby's current ratio at 31 December 2007 was 3:1, its acid test ratio at that date was 1.2:1 and current liabilities were $74,000.

REQUIRED

(c) Calculate Rugby's current assets, current assets excluding inventory and inventory at 31 December 2007.

(3 marks)

(Total 25 marks)

QUESTION 5

Epsom and Ewell have been in partnership for many years, sharing profits in the ratio 3:1 respectively, after allowing for a salary of $6,000 per year to Epsom. On 1 July 2007 they admitted Worle to the partnership. Profits were then shared between Epsom, Ewell and Worle in the ratio 2:2:1 after allowing for salaries of $2,000 per year to each partner. Worle paid $30,000 for his share of the partnership goodwill at 1 July 2007.

The following information relates to the revenues and expenses of the partnership for the year ended 31 December 2007:

(1) Total revenue was $180,000
(2) 40% of revenue value occurred in the six months ended 30 June
(3) Gross profit percentage was 30% in the six months ended 30 June and 40% subsequently
(4) Salaries (including those of the partners) were $12,000 in the six months ended 30 June and $20,000 in the six months to 31 December
(5) All other expenses totalled $12,000 in the six months to 31 December and 25% less in the six months ended 30 June.

REQUIRED

(a) Prepare, in columnar form, the Income Statements and Appropriation Accounts of the partnership for the six months ended 30 June 2007 and for the six months to 31 December 2007.

(13 marks)

(b) Calculate the total goodwill of the partnership at 30 June 2007. (2 marks)

(c) It has been agreed between the partners that goodwill is to remain unrecorded and that adjustments should be made directly between the partners' capital accounts. Prepare a journal entry, without narratives, to record the necessary adjustments in respect of goodwill at 30 June 2007.

(6 marks)

(d) Give **two** differences between a partnership and a private company. (4 marks)

(Total 25 marks)

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LCCI International Qualifications from EDI

ACCOUNTING (IAS)

LEVEL 3

SERIES 3 EXAMINATION 2008

Suggested Answers

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LONDON CHAMBER OF COMMERCE AND INDUSTRY
SERIES 3 EXAMINATION 2008
ACCOUNTING (IAS)
(LEVEL 3)

ANSWER 1

(a) (i)

WOOL & LOOE

Income Statement and Appropriation Account for half year ended 31 March 2008

	$	$
Revenue		112,300
Less: Cost of sales		
Opening inventory	12,300	
Purchases	78,100	
	90,400	
Less: Closing inventory	14,100	76,300
Gross profit		36,000
Less: Expenses		
Distribution costs (12,100 + 140 + 300)	12,540	
Administrative expenses (W1)	12,706	25,246
Net profit		10,754
Appropriation:		
Partner's salary - Wool (3,000 x 1/2)		(1,500)
		9,254
Share of profit		
Wool (9,254 x 4/7)	5,288	
Looe (9,254 x 3/7)	3,966	9,254

ANSWER 1 (CONTINUED)

Workings:

W1.	Administrative expenses	$
	Balance b/f	9,200
	Bad debts	150
	Provision for doubtful debts	(624)
	[(9,750 - 150) x 6% - 1,200]	
	Accrued administrative expenses	180
	Administrative expenses not recorded	220
	Depreciation on non-current assets	3,580
	(25,000 x 20% x 1/2) + (12,000 - 4,800) x 30% x 1/2	
	Total administrative expenses	12,706

(a) (ii)

WOOL & LOOE

Balance Sheet at 31 March 2008

	$	$	$
Non-current Asset			
Cost			37,000
Accumulated depreciation (15,000 + 2,500 + 1,080)			18,580
			18,420
Current Assets			
Inventory		14,100	
Receivables (9,750 - 150)	9,600		
Less: Provision for doubtful debt (1,200 - 624)	576	9,024	
Prepayments (425 - 140)		285	
Cash		800	24,209
			42,629
Partners' Capital Accounts			
Wool (14,175 + 1,500 + 5,288)			20,963
Looe (9,770 + 3,966)			13,736
			34,699
Current Liabilities			
Payables		4,750	
Accruals (380 + 180)		560	
Bank overdraft (2,100 + 520)		2,620	7,930
			42,629

ANSWER 1 (CONTINUED)

(b) According to IAS 2, inventory is valued at the lower of cost and net realizable value, but not at partner's valuation. Looe is correct that Wool's suggestion is not an acceptable accounting practice. However, Looe is wrong that increasing closing inventory will reduce profit. On the contrary, this will increase profit.

ANSWER 2

(a) Cash flows

Project A

Year	Calculations $	Total $	Cumulative total $
0	(100,000) + (10,000)	(110,000)	(110,000)
1	200 x 50	10,000	(100,000)
2	300 x 50	15,000	(85,000)
3	500 x 50	25,000	(60,000)
4	2,000 x 50	100,000	40,000
5	800 x 50 + 20,000 + 10,000	70,000	110,000

Project B

Year	Calculations $	Total $	Cumulative total $
0	(100,000) + (30,000) + (20,000)	(150,000)	(150,000)
1	16,000 x 5	80,000	(70,000)
2	8,000 x 5	40,000	(30,000)
3	6,000 x 5	30,000	0
4	6,000 x 5	30,000	30,000
5	4,000 x 5 + 20,000 + 30,000	70,000	100,000

ANSWER 2 (CONTINUED)

(b) Payback period

Project A
In year 4, there is positive net cash flow. Therefore, payback period is 3 plus 60,000/100,000 years i.e 3.6 years

Project B
In year 3, total cash inflow equals cash outflow, therefore, payback period is 3 years.

(c) Net present value

Project A

Year	Cash flow	Discount factor	$
0	(110,000)	1	(110,000)
1	10,000	0.909	9,090
2	15,000	0.826	12,390
3	25,000	0.751	18,775
4	100,000	0.683	68,300
5	70,000	0.621	43,470
		NPV	**42,025**

Project B

Year	Cash flow	Discount factor	$
0	(150,000)	1	(150,000)
1	80,000	0.909	72,720
2	40,000	0.826	33,040
3	30,000	0.751	22,530
4	30,000	0.683	20,490
5	70,000	0.621	43,470
		NPV	**42,250**

(d) Payback period is useful in eliminating projects which exceed the company's target payback period. Besides, this method is easy and simple to use and understand.

ANSWER 3

(a) **DEAL**

Consolidated Income Statement for the year ended 31 December 2008

	$000
Revenue (740 + 320 - 120)	940
Cost of sales (280 + 130 - 120)	(290)
Gross profit	650
Distribution costs (40 + 30)	(70)
Administrative expenses (28 + 13 + 140 x 1/10)	(55)
Dividend received (132 – 100 x 75%)	57
Interest expenses (5 + 3)	(8)
Net profit	574
Minority interest (144 x 25%)	(36)
Profit before dividend	538
Dividends	(80)
Profit after dividend	458
Accumulated profits b/f [173 + (98 - 26) x 75% - 140 x 1/10 x 5]	157
Accumulated profits c/f	615

(b)

	$000
Goodwill on acquisition	140
Less: Amortization (140,000 x 1/10 x 6)	(84)
	56

(c) Patent is an example of intangible fixed asset.

Motor vehicles, land, buildings, etc. are examples of tangible fixed assets.

ANSWER 4

(a)

	2002	2007
(i) Gross profit percentage	(21,500 - 8,400) x 100%	(43,750 - 11,200) x 100%
Gross profit x 100%	21,500	43,750
Sales	= 60.93%	= 74.40%
(ii) Inventory turnover (days)	3,200 x 365	3,700 x 365
Closing inventory x 365	8,400	11,200
Cost of goods sold	= 139.05 days	= 120.58 days
(iii) Earnings per share	\$0.75	\$1.1
Price	10	14
Price/Earning ratio	= \$0.075	= \$0.08
(iv) Acid test ratio	3,500	4,100
Current assets – Inventory	2,100	2,400
Current liabilities	= 1.67 : 1	= 1.71 : 1
(v) Current ratio	3,200 + 3,500	4,100 + 3,700
Current assets	2,100	2,400
Current liabilities	= 3.19 : 1	= 3.25 : 1

b)

(i) The aim is achieved as the gross profit is increased from 60.93% to 74.4%.

(ii) It seems the aim is achieved. Higher profit percentage implies better quality of work, lower manufacturing cost due to the addition of maintenance and repair work to manufacturing. Moreover, more revenue may be generated from the additional services. Besides, the increase in average wage per employee implies the new employment of skillful worker for the development of new services.

(iii) The aim is achieved. The increase in share price, earning per share, average wage per employee suggested the standing of the company in the financial sector has been enhanced.

(iv) The aim achieved in short run, with both current and acid test ratio increase in 2007 shows that the company's liquidity position is strong. However, the gearing ratio increases from 25% to 40% in 2007, indicates the situation is worsen for the long term stability of the company.

ANSWER 4 (CONTINUED)

(c) Rugby

(i) Current ratio = Current assets / Current liabilities

Current asset = Current ratio x Current liabilities

= 3 x $74,000

= $222,000

(ii) Acid test ratio = (Current assets – Inventory) / Current liabilities

Current assets excluding inventory = Acid test ratio x Current liabilities

= 1.2 x $74,000

= $88,800

(iii) Closing Inventory = Current assets – Current assets excluding Inventory

= $(222,000 - 88,800)

= $133,200

ANSWER 5

(a)

EPSOM, EWELL & WORLE

Income Statement and Appropriation Account for six months ended

	30 June 2007		31 December 2007	
	$	$	$	$
Sales (180,000 x 40% ; 180,000 x 60%)		72,000		108,000
Cost of sales		(50,400)		(64,800)
Gross profit (72,000 x 30% ; 108,000 x 40%)		21,600		43,200
Salaries (12,000 - 3,000 ; 20,000 - 3,000)	(9,000)		(17,000)	
Other expenses (12,000 x 75%)	(9,000)	(18,000)	(12,000)	(29,000)
Net profit before appropriation		3,600		14,200
Appropriation				
Salary				
-Epsom (6,000 x 1/2 ; 2,000 x 1/2)	(3,000)		(1,000)	
-Ewell (2,000 x 1/2)	-		(1,000)	
-Worle (2,000 x 1/2)	-	(3,000)	(1,000)	(3,000)
		600		11,200
Share of profit				
-Epsom (600 x 3/4 ; 11,200 x 2/5)	(450)		(4,480)	
-Ewell (600 x 1/4 ; 11,200 x 2/5)	(150)		(4,480)	
-Worle (11,200 x 1/5)	-	(600)	(2,240)	(11,200)

ANSWER 5 (CONTINUED)

(b)

Worle paid $30,000 for sharing 1/5 of goodwill. Therefore, total goodwill is $30,000 x 5 i.e. $150,000.

(c) **Journal**

	Particulars	Dr	Cr
		$	$
(1)	Goodwill	150,000	
	Capital - Epsom (150,000 x 3/4)		112,500
	- Edwell (150,000 x 1/4)		37,500
(2)	Capital - Epsom (150,000 x 2/5)	60,000	
	- Edwell (150,000 x 2/5)	60,000	
	- Worle (150,000 x 1/5)	30,000	
	Goodwill		150,000

(d) (i) Private company shareholders enjoy limited liability while partners do not.

(ii) Private company is a separate legal entity. A change of shareholders do not affect the company. However, partnership will be affected when there is partners change.

[END OF SUGGESTED ANSWERS]