Series 2 Examination 2011

CERTIFICATE IN ACCOUNTING (IAS)

Level 3

Friday 8 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.
- Marks may be lost through lack of neatness and poor presentation.

QUESTION 1

Trym and Frome are partners in a hairdressing business and share profits in the ratio 2:1 respectively. Apart from keeping the records, neither partner is active in the business. Their shop manager, Avon, manages the business, with help from part time staff.

The business makes a profit of around $30,000 per year, after allowing for Avon's salary of $20,000 and $15,000 paid to part time staff. The Balance Sheet of the partnership at 31 December 2010 is as follows:

	$	$
Tangible non current assets (book value)		4,800
Current assets		
Inventory	2,000	
Receivables	900	
Bank	14,000	
		16,900
		21,700
Capital		**$**
Trym		7,900
Frome		5,800
		13,700
Current liabilities		8,000
Payables		21,700

Trym and Frome have realised that they have become dependent upon Avon, and on 1 January 2011, make two alternative proposals to him, as follows:

Proposal (1):
Avon would buy the business for $130,000. All existing assets and liabilities would be taken over at their book values.

Proposal (2):
Avon would join the partnership on the following terms -

- Avon, Trym and Frome to share profits in the ratio 7:2:1 respectively, with no partners' salaries
- Avon to introduce $100,000 into the business in payment for his capital and goodwill
- Non current assets to be revalued at $8,100, receivables written down to $600, with inventory and payables to remain unchanged
- Goodwill to be valued at $120,000, but remain unrecorded.

REQUIRED

Prepare:

(a) Avon's Balance Sheet on 1 January 2011 assuming that Proposal (1) is accepted.

(4 marks)

(b) The Capital Accounts of Avon, Trym and Frome in columnar form, showing the changes as a result of Proposal (2) being accepted.

(6 marks)

The profits of the business for the next three years, before charging Avon's salary or the payments to the part time staff, are budgeted as follows:

	$
2011	62,000
2012	65,000
2013	68,000

If Proposal (1) was accepted, Avon would be able to borrow the necessary funds at 12% per year, but the cost of the part time staff would increase to $24,000 per year, as Avon would require the services of a book keeper.

If Proposal (2) was accepted, Avon would be able to borrow the necessary funds at 8% per annum, as the bank regards Proposal (2) to be less risky than Proposal (1).

REQUIRED

(c) Calculate Avon's budgeted total profit for the three year period assuming:
  (i) Proposal (1) is accepted
  (ii) Proposal (2) is accepted.

(8 marks)

(d) Based on your answer to (c) above, advise Avon which offer to accept, stating any reservation you might have.

(2 marks)

Avon's wife, who is an accountant, suggests Avon should negotiate lower payments to the existing partners, as he must be largely responsible for the goodwill.

REQUIRED

(e) Discuss whether or not:
  (i) his wife's suggestion is a valid reason for making lower payments
  (ii) Avon should negotiate with Trym and Frome, even if his wife's suggestion is not valid.

(5 marks)

(Total 25 marks)

QUESTION 2

Tamer is a retailer selling ladies' shoes at the rate of 30,000 pairs per year. Accounting data relating to this level of sales is as follows:

	$
Selling price per pair	30
Purchase price per pair	8
Annual wages (including commission of $2 per pair)	80,000
Annual selling costs (including delivery of $1.50 per pair)	60,000
Administrative costs (all fixed)	335,000

REQUIRED

(a) Calculate:
   (i) the profit made each year by Tamer from selling 30,000 pairs of shoes
   (ii) the number of pairs of shoes Tamer would have to sell each year in order to break even
   (iii) the number of pairs of shoes Tamer would have to sell each year in order to make a profit of $203,500.

(13 marks)

Tamer is considering selling men's shoes as well as ladies' shoes. Accounting data relating to the men's shoes, per pair, would be as follows:

	$
Selling price	25.00
Purchase price	7.00
Commission	1.50
Delivery	1.00

Tamer expects to be able to sell 10,000 pairs of men's shoes each year, which is the minimum order his supplier will accept.

Due to limited space Tamer would then only be able to sell 26,000 pairs of ladies' shoes each year. The selling price and variable cost per pair of ladies' shoes would remain the same.

All the fixed costs would remain the same per year, except an additional $10,000 would be spent on advertising.

REQUIRED

(b) Calculate the change in annual profit resulting from selling both men's and ladies' shoes.

(6 marks)

Tamer has sought advice from a marketing consultant, who has made the following suggestions:

(1) sell expensive boxes of chocolates, to attract people into the shop in search of presents for friends and relatives, in the hope that some of them may decide to purchase shoes as gifts as well

(2) have regular sales at bargain prices, so as to increase inventory turnover and increase the space available for more fashionable products.

REQUIRED

(c) Discuss **each** of the above suggestions and conclude whether or not they are likely to increase Tamer's profits.

(6 marks)

(Total 25 marks)

QUESTION 3

Trent, a public company, operates a chain of supermarkets and owns 150 large lorries and 500 small vans. All vehicles are depreciated at 25% per year on a straight line basis, assuming a zero residual value. A full year's depreciation is charged in the year of purchase, no depreciation is charged in the year of sale.

Trent keeps double entry accounts for Vehicles at Cost and Accumulated Depreciation on vehicles, which show separately the total cost of vehicles owned and the accumulated depreciation on them.

Trent also keeps a memorandum (i.e. not part of the double entry system) vehicles register showing the cost of, and accumulated depreciation on, each vehicle owned.

At the end of every financial year, Trent reconciles the balances shown in the double entry records with the totals of the individual balances shown in the vehicles register. However, at 31 December 2010 the balances did not reconcile. On investigation the following errors were discovered:

(1) a lorry costing $50,000 had been recorded twice in the double entry records and not entered in the memorandum records

(2) no entry had been made in the memorandum records for the purchase of a van for $8,000

(3) depreciation on ten lorries, costing $400,000 in total, had not been entered in the memorandum records

(4) a computer system, costing $80,000, had been wrongly included in the double entry vehicle accounts. Trent depreciates computer systems at 20% on a straight line basis, assuming a zero residual value

(5) five lorries costing $180,000 in total, and fully depreciated before 2010, had been sold for $2,000 each, but no entry had been made in the double entry records.

REQUIRED

(a) Calculate the total change, resulting from the correction of the above errors in the double entry records, to each of the balances on the following accounts:

(i) Vehicles at Cost
(ii) Accumulated Depreciation on Vehicles.

(8 marks)

(b) Calculate the total change, resulting from the correction of the above errors in the memorandum records, to the total of the list of balances for each of the following accounts:

(i) Vehicles at Cost
(ii) Accumulated Depreciation on Vehicles.

(7 marks)

(c) Calculate the change in Trent's net profit for 2010, as a result of the correction of the above errors.

(5 marks)

The Managing Director of Trent believes that the existing depreciation policy is incorrect, because the vans have a longer useful life than lorries.

The Transport Director argues that, as every vehicle is different, there should be a different depreciation policy for each vehicle.

REQUIRED

(d) Briefly discuss the views of the Managing Director and the Transport Director, stating whether or not you agree.

(5 marks)

(Total 25 marks)

QUESTION 4

The following information relates to Ouse, a public company:

(1) **Extracts from the Financial Records for the year ended 31 December 2010:**

	$000
Profit before interest	10,800
Interest expense	100
Dividend	2,700

(2) **Extracts from the Balance Sheet at 31 December 2010:**

	$000
10% Debentures (the only amount due after more than one year)	1,000
Ordinary shares of $0.50 each (the only class of share capital)	25,000
Reserves	9,400

(3) The market value of one ordinary share in Ouse at 31 December 2010 was $1.50.

REQUIRED

(a) Calculate, to two decimal places, the following:
   (i) Dividend per share
   (ii) Earnings per share
   (iii) Gearing (using loan capital over total capital).

(6 marks)

(b) Based on the information given, name and calculate, **four** other ratios which would assist in assessing the performance of Ouse (to two decimal places).

(10 marks)

The following ratios have been calculated from the accounts of Yare, a private company:

	2009	**2010**
Gross profit to sales	30%	32%
Net profit to sales	10%	8%

The following information has been provided in order to try and explain the increase in gross profit percentage and decrease in net profit percentage:

(i) sales increased
(ii) bad debts were higher
(iii) obsolete inventory was higher
(iv) the directors took a voluntary decrease in their salaries
(v) a change in the sales mix resulted in a bigger proportion of high margin goods being sold
(vi) ten members of the administrative staff were made redundant and not replaced.

REQUIRED

(c) Discuss whether or not **each** of (i) to (vi) above, provide a reason for the change in the gross profit percentage and/or the change in the net profit percentage.

(9 marks)

(Total 25 marks)

QUESTION 5

The following information relates to Test, a public company, in respect of the year ended 31 December 2010:

(1) Inventory increased by 25% in value from 31 December 2009, when it was valued at $400,000. The company wishes to make a provision for obsolete inventory equal to 1% of the value of closing inventory. There was no provision at 31 December 2009.

(2) Receivables decreased by 20% in value from 31 December 2009 to the current value of $160,000. The company wishes to make a provision for bad debts equal to 10% of the value of closing receivables. There was no provision at 31 December 2009.

(3) Interest paid was $12,000 and interest received was $6,000.

(4) Test's accumulated profits at 31 December 2010, before making the provisions for obsolete inventory and bad debts, were $358,000. Accumulated profits at 31 December 2009 were $277,000.

(5) Dividends for the year were $72,000 and on 1 July 2010 a transfer was made to general reserve of $20,000.

(6) Trade payables were $87,000 at 31 December 2010 and $64,000 at 31 December 2009.

(7) Depreciation, excluding profits or losses on disposal of non current assets was $48,000.

(8) A motor vehicle (cost $17,000, net book value $8,000) was sold for $6,000.

(9) Plant and machinery (cost $9,000, accumulated depreciation $7,000) was sold for $2,400.

REQUIRED

(a) Calculate the net operating profit of Test for the year ended 31 December 2010.

(6 marks)

(b) Using your answer to (a) calculate the cash generated from operations to be included in Test's Cash Flow Statement for the year ended 31 December 2010.

(9 marks)

Stour, a public company, purchased 75% of the ordinary shares of Arun, a private company, on 30 June 2010. The summarised Income Statements of the two companies at 31 December 2010 are as follows:

	Stour	**Arun**
	$	**$**
Sales	47,000	32,000
Cost of sales	(31,000)	(19,000)
Gross profit	16,000	13,000
Operating expenses	(2,000)	(1,000)
Operating profit	14,000	12,000
Interest expense	(1,200)	(2,000)
Net profit for the year	12,800	10,000

Further information is as follows:

(1) All the revenues and expenses of Arun accrued evenly over the year

(2) In the six months ended 31 December 2010, Stour invoiced goods to Arun for $3,000 (giving a profit to Stour of 10% of the invoice price). Arun had only resold half these goods by 31 December 2010.

(3) Goodwill arising on the acquisition of Arun was $4,000. 10% of the goodwill is impaired and should be written off.

REQUIRED

(c) Calculate, for the year ended 31 December 2010 the following amounts:

(i) operating profit of the Stour group
(ii) minority interest in the profit of the Stour group.

(10 marks)

(Total 25 marks)

