

Accounting Level 3



International
Qualifications from EDI

Model Answers Series 2 2011 (3012)

Accounting Level 3

Series 2 2011

How to use this booklet

Model Answers have been developed by EDI to offer additional information and guidance to Centres, teachers and candidates as they prepare for LCCI International Qualifications. The contents of this booklet are divided into 3 elements:

- (1) Questions – reproduced from the printed examination paper
- (2) Model Answers – summary of the main points that the Chief Examiner expected to see in the answers to each question in the examination paper, plus a fully worked example or sample answer (where applicable)
- (3) Helpful Hints – where appropriate, additional guidance relating to individual questions or to examination technique

Teachers and candidates should find this booklet an invaluable teaching tool and an aid to success.

EDI provides Model Answers to help candidates gain a general understanding of the standard required. The general standard of model answers is one that would achieve a Distinction grade. EDI accepts that candidates may offer other answers that could be equally valid.

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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 fixed assets (book value)		4,800
Current assets		
Stock	2,000	
Debtors	900	
Bank	<u>14,000</u>	
	16,900	
Current liabilities		
Creditors	<u>8,000</u>	<u>8,900</u>
		<u>13,700</u>
Capital		£
Trym		7,900
Frome		<u>5,800</u>
		<u>13,700</u>

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
- Fixed assets to be revalued at £8,100, debtors written down to £600, with stock and creditors 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)

MODEL ANSWER TO QUESTION 1

Syllabus Topic 4: Partnerships
Syllabus Topic 9: Budgetary Control

(a) **Avon**
Balance Sheet at 1 January 2011

	£		£	
Fixed assets				
Tangible 1 1			4,800	½
Goodwill (130,000 - 13,700)			<u>116,300</u>	
			121,100	
Current assets				
Stock	2,000			
Debtors	900			
Bank	<u>14,000</u>			
	16,900			
Current liabilities				
Creditors	<u>8,000</u>	½	<u>8,900</u>	
			<u>130,000</u>	
Capital account			£	
			<u>130,000</u>	1

(4 marks)

(b) **Capital Accounts**

	Avon £	Trym £	Frome £		Avon £	Trym £	Frome £
Debtors (2:1)	-	200	100	Opening balance	-	7,900	5,800
	½	½	½		-	½	½
Goodwill (7:2:1)	84,000	24,000	12,000	Fixed assets (2:1)	½	2,200	1,100
					-	-	
Closing balance	<u>16,000</u>	<u>65,900</u>	<u>34,800</u>	Bank	100,000	½	½
	<u>100,000</u>	<u>90,100</u>	<u>46,900</u>	Goodwill (2:1)	-	<u>80,000</u>	<u>40,000</u>
					<u>100,000</u>	<u>90,100</u>	<u>46,900</u>

(6 marks)

QUESTION 1 CONTINUED

(c) (i) **Proposal (1)**

	£	
Total profit before part time staff costs (62,000 + 65,000 + 68,000)	195,000	1½
Less part time staff costs (3 x 24,000)	<u>72,000</u>	1
	123,000	
Less interest (3 x .12 x 130,000)	<u>46,800</u>	1½
Total profit	<u>76,200</u>	

(ii) **Proposal (2)**

	£		£	
Total profit before part time staff costs	195,000	½		
Less part time staff costs (3 x 15,000)	<u>45,000</u>	1		
Avon's share of profit	.7 x <u>150,000</u>		105,000	1
Less interest (3 x .08 x 100,000)			<u>24,000</u>	1½
Total profit			<u>81,000</u>	

(8 marks)

- (d) Proposal (2) would appear to be the best, but Avon would not have full control of the business.
(1 mark for proposal recommendation, 1 mark for stating reservation)

(2 marks)

- (e) (i) The suggestion seems sensible. Hairdressing is a service industry and customers are likely to remain because of the reputation and performance of Avon and his staff. As such, goodwill will derive from Avon and his staff.

(1 mark for agreeing with wife, 2 marks for depth of reasoning)

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- (ii) Avon should certainly negotiate, as he has had no preliminary discussions with the partners. His success may depend on whether or not he is replaceable.

(1 mark for stating yes, 1 mark for giving a reason)

2

(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:
- the profit made each year by Tamer from selling 30,000 pairs of shoes
 - the number of pairs of shoes Tamer would have to sell each year in order to break even
 - 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:

- 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
- have regular sales at bargain prices, so as to increase stock 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)

MODEL ANSWER TO QUESTION 2

Syllabus Topic 10.1 Breakeven

(a) (i) **Annual profit on 30,000 pairs of ladies' shoes**

	£
Gross profit [30,000 x (30-8)]	660,000
Less other costs (80,000 + 60,000 + 335,000)	<u>475,000</u>
Net profit	<u>185,000</u>

(ii) **Number of pairs of ladies' shoes to be sold annually in order to breakeven**

$$\frac{\text{Fixed costs}}{\text{Contribution per pair}} = \frac{370,000 \text{ (W1)}}{18.5 \text{ (W2)}} = \underline{20,000 \text{ pairs}} \quad \text{1 of}$$

W1 Fixed costs:

	£
Wages [80,000 - (30,000 x 2)]	20,000
Selling costs [60,000 - (30,000 x 1.5)]	15,000
Administrative costs	<u>335,000</u> 1
	<u>370,000</u>

W2 Contribution per pair:

	£	£
Selling price		30.0 1/2
Less: purchase price	8.0 1/2	
commission	2.0 1/2	
delivery	<u>1.5</u>	<u>11.5</u> 1/2
		<u>18.5</u>

(iii) **Number of pairs of ladies' shoes to be sold annually in order to make a profit of £203,500**

$$\frac{\text{Fixed costs} + \text{desired profit}}{\text{Contribution per pair}} = \frac{370,000 + 203,500}{18.5} = \underline{31,000 \text{ pairs}} \quad \text{1 of}$$

(13 marks)

(b) **Change in profit resulting from selling both men's shoes and ladies' shoes.**

	£
Annual contribution from ladies' shoes (26,000 x 18.5)	481,000 1 1/2
Annual contribution from men's shoes [10,000 (25.0-7.0-1.5-1.0)]	<u>155,000</u> 2 1/2
Less fixed costs (10,000 + 370,000)	<u>636,000</u> 1/2 of
Less original profit	<u>380,000</u> 1
	256,000
Less original profit	<u>185,000</u> 1/2
Increase	<u>71,000</u>

(6 marks)

QUESTION 2 CONTINUED

(c) Suggestions from marketing consultant

- (i) Shoes are not normally purchased as gifts, as most people would wish to try them on before purchase and tastes are difficult to predict. Furthermore, as space is limited, selling chocolates would mean having less room to sell shoes. Unless chocolates have a higher margin than shoes this suggestion could lead to a decrease in profits.

1 mark for saying 'no', depth of discussion 2 marks. Accept yes if depth of argument is strong 3

- (ii) Shoes are a fashion item, with a clear risk of obsolescence if fashion changes. Therefore holding regular sales at bargain prices is a sensible idea. This might increase profits, provided the bargain prices are not too low.

1 mark for saying 'yes', depth of discussion 2 marks. Accept no if depth of argument is strong 3

(6 marks)

(Total 25 marks)

QUESTION 3

Trent Plc 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 Plc 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 Plc 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 Plc reconciles the balances shown in the double entry records with the totals of the individual balances shown in the vehicle 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 Plc 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 Plc's net profit for 2010, as a result of the correction of the above errors.

(5 marks)

The Managing Director of Trent Plc 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)

MODEL ANSWER TO QUESTION 3

Syllabus Topic 3: Valuation of fixed assets

(a) Corrections to balances in double entry records

(i)	Vehicles at cost	£	
(1)	Lorry entered twice	(50,000)	1
(4)	Computer incorrectly included	(80,000)	1
(5)	Lorry disposal omitted	<u>(180,000)</u>	1
		<u>(310,000)</u>	1F
(ii)	Accumulated depreciation on vehicles	£	
(1)	Lorry entered twice (.25 x 50,000)	(12,500)	1
(4)	Computer incorrectly included (.25 x 80,000)	(20,000)	1
(5)	Lorry disposal omitted	<u>(180,000)</u>	1
		<u>(212,500)</u>	1F

(8 marks)

(b) Corrections to lists of balances from memorandum records

(i)	Vehicles at cost	£	
(1)	Lorry omitted	50,000	1
(2)	Van omitted	<u>8,000</u>	1
		<u>58,000</u>	1F
(ii)	Accumulated depreciation on vehicles	£	
(1)	Lorry omitted (.25 x 50,000)	12,500	1
(2)	Van omitted (.25 x 8,000)	2,000	1
(3)	Lorry depreciation omitted (.25 x 400,000)	<u>100,000</u>	1
		<u>114,500</u>	1F

(7 marks)

(c) Change in net profit

		£	
(1)	Depreciation on lorry entered twice	12,500	1of
(4)	Depreciation on computer wrongly charged	20,000	1of
(4)	Depreciation on computer (.20 x 80,000)	(16,000)	1
(5)	Profit on disposal of five lorries (5 x 2,000)	<u>10,000</u>	1
	Increase	<u>26,500</u>	1of

(5 marks)

(d) Views of Directors

Depreciation must take into consideration the useful economic life of fixed assets. If they differ between vans and lorries this should affect the rate used under straight line depreciation. The Managing Director is therefore correct.

Up to 1½ marks for depth of discussion 1 mark for conclusion

Theoretically each individual vehicle could be given a different depreciation rate reflecting its "individual" circumstances. However, when dealing with a large number of vehicles, as is the case here, this would be over-complicated. Assets with similar characteristics are normally depreciated in the same way. Therefore, although the Transport Director has a point, it is not practical to follow his suggestion.

Up to 1½ marks for depth of discussion 1 mark for conclusion

(5 marks)

(Total 25 marks)

QUESTION 4

The following information relates to Ouse Plc:

(1) **Extracts from the Profit and Loss Account 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 owing beyond 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 Plc 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 Plc (to two decimal places).

(10 marks)

The following ratios have been calculated from the accounts of Yare Ltd:

	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 stock 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 Plc in respect of the year ended 31 December 2010:

- (1) Stock 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 stock equal to 1% of the value of closing stock. There was no provision at 31 December 2009.
- (2) Debtors 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 debtors. There was no provision at 31 December 2009.
- (3) Interest paid was £12,000 and interest received was £6,000.
- (4) Test Plc's retained earnings at 31 December 2010, before making the provisions for obsolete stock and bad debts, were £358,000. Retained earnings 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 creditors were £87,000 at 31 December 2010 and £64,000 at 31 December 2009.
- (7) Depreciation, excluding profits or losses on disposal of fixed 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 Plc for the year ended 31 December 2010. (6 marks)
- (b) Using your answer to (a) calculate the net cash inflow from operating activities to be included in Test Plc's Cash Flow Statement for the year ended 31 December 2010. (9 marks)

Stour Plc purchased 75% of the ordinary shares of Arun Ltd on 30 June 2010. The summarised Profit and Loss Accounts of the two companies at 31 December 2010 are as follows:

	Stour Plc	Arun Ltd
	£	£
Sales	47,000	32,000
Cost of sales	<u>(31,000)</u>	<u>(19,000)</u>
Gross profit	16,000	13,000
Operating expenses	<u>(2,000)</u>	<u>(1,000)</u>
Operating profit	14,000	12,000
Interest expense	<u>(1,200)</u>	<u>(2,000)</u>
Net profit for the year	<u>12,800</u>	<u>10,000</u>

Further information is as follows:

- (1) All the revenues and expenses of Arun Ltd accrued evenly over the year
- (2) In the six months ended 31 December 2010, Stour Plc invoiced goods to Arun Ltd for £3,000 (giving a profit to Stour Plc of 10% of the invoice price). Arun Ltd had only resold half these goods by 31 December 2010.

QUESTION 5 CONTINUED

- (3) Goodwill arising on the acquisition of Arun Ltd was £4,000. This is being written off at 20% per year.

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)

MODEL ANSWER TO QUESTION 5

Syllabus Topic 7: Cash flow statements

Syllabus Topic 6: Accounting for groups of companies

(a)	Net operating profit	$\frac{1}{2}$	$\frac{1}{2}$		£	
	Increase in retained earnings (358,000 - 277,000)				81,000	
	Provision for obsolete stock (.01 x 400,000 x 1.25)				(5,000)	1½
	Provision for bad debts (.10 x 160,000)				(16,000)	1
	Transfer to general reserve				20,000	1
	Dividends paid				72,000	$\frac{1}{2}$
	interest paid				12,000	$\frac{1}{2}$
	Interest received				<u>(6,000)</u>	$\frac{1}{2}$
					<u>158,000</u>	

(6 marks)

(b)	Net cash inflow from operating activities				£	
	Net operating profit (from (a) above)				158,000	1 of
	Depreciation				48,000	$\frac{1}{2}$
	Loss on disposal of motor vehicle (6,000 - 8,000)				2,000	1
	Profit on disposal of plant and machinery (2,400 - 9,000 + 7,000)				(400)	1½
	Increase in stock (500,000 - 400,000 - 5,000)				(95,000)	2
	Decrease in debtors (200,000 - 160,000 + 16,000)				56,000	2
	Increase in creditors (87,000 - 64,000)				<u>23,000</u>	1
					<u>191,600</u>	

(9 marks)

(c)	(i)	Group operating profit				£	
		Sales [47,000 + (.5 x 32,000) - 3000]	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$	60,000
		Cost of sales [31,000 + (.5 x 19,000) - 3,000 + (3,000 x .1 x .5)]	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$	<u>37,650</u>
		Gross profit					22,350
		Operating expenses [2,000 + (.5 x 1,000) + (4,000 x .1)]	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$	<u>2,900</u>
							<u>19,450</u>
	(ii)	Minority interest in group profit				£	
		25 x .50 x 10,000	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$		<u>1,250</u>

(10 marks)

(Total 25 marks)

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