LCCI International Qualifications

# Accounting
# Level 3

International
Qualifications from EDI

## Model Answers
Series 3 2011 (3012)

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# Accounting Level 3
## Series 3 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.

**QUESTION 1**

Towe is the manager of Nesco superstore in Brigg. Nesco has two hundred superstores in the country and expects managers to achieve results on its two main product lines as follows:

| | | |
|---|---|---|
| Electrical goods | - | 50% mark up on cost |
| Food | - | 12% gross profit on sales |

Sales of electrical goods at the Brigg superstore for the six months ended 31 December 2010 were 20% above the budget of £140,000. However, on 31 December 2010, there was a burglary and all the electrical goods were stolen.

Towe was able to provide the following information in respect of electrical goods:

(1) 1 July 2010, stock at cost was £20,700 and creditors were owed £17,200

(2) during the six months to 31 December 2010, creditors were paid £105,400

(3) 31 December 2010 creditors were owed £21,700.

**REQUIRED**

(a) Calculate the cost of the electrical goods stolen, assuming that the 50% mark up on cost had been achieved.

(9 marks)

Figures for the sale of food at the Brigg superstore, for the six months ended 31 December 2010, were as follows:

(1) 1 July, stock at cost was £18,000 and at 31 December, stock at cost was 25% higher in value than it had been at 1 July

(2) stock turnover ratio, based on the average cost of the opening stock and the closing stock, was 26 times

(3) actual gross profit on sales was 10%, as opposed to the expected 12%.

**REQUIRED**

(b) Prepare the Trading Account, for food, in respect of the six months ended 31 December 2010.

(6 marks)

(c) Calculate the difference between the actual gross profit on food and the expected gross profit on food, based on the sales figure from (b) above, for the six months ended 31 December 2010.

(2 marks)

On 1 January 2011 Towe was dismissed. She intends to claim compensation from Nesco for unfair dismissal, and provides the following information to her lawyer:

(i) Because of the burglary it was not possible to accurately assess the performance of the electrical goods department

(ii) The burglary took place while she was on annual leave. Closed circuit television showed that the security guards, recruited by her, were asleep when the burglary took place

(iii) Bad weather, and fear that supplies would run out, had led to the panic buying of food in December. Towe had reduced the prices in order to reassure buyers

(iv) Head office, without consulting Towe, had sent 5,000 frozen carp (a fish which they had imported) to be sold at the Brigg superstore. Local fishermen, who are not allowed to catch carp, organised a boycott of food sales at the superstore until the carp were withdrawn from sale.

**QUESTION 1 CONTINUED**

**REQUIRED**

(d) Discuss, whether or not, **each** of the four pieces of information provided by Towe will assist her compensation claim.

(8 marks)

**(Total 25 marks)**

**MODEL ANSWER TO QUESTION 1**

**Syllabus Topic 2: Valuation of stocks**
**Syllabus Topic 8: Accounting ratios**

(a) **Cost of electrical goods stolen**

| | | £ |
|---|---|---|
| Opening stock at cost | 1 | 20,700 |
| Purchases (105, 400 + 21,700 - 17,200) | 3 | 109,900 |
| | | 130,600 |
| **Less** sales at cost (140,000 x 1.2 x 100/150) | 3 | 112,000 |
| | 1+1 of | 18,600 |

(9 marks)

(b) **Food: Trading Account**

| | | £ | | £ |
|---|---|---|---|---|
| Sales | (526,500 x 100/90) | | 1 of | 585,000 |
| **Less**: | Opening stock | 18,000 | ½ | |
| | Purchases (R) | 531,000 | ½ of | |
| | | 549,000 | | |
| | Closing stock (18,000 x 1.25) | ( 22,500) | 1 | |
| Cost of sales | [(18,000 + 22,500) x .5 x 26] | | 2 | 526,500 |
| Gross profit | (526,500 x 10/90) | | 1 of | 58,500 |

(6 marks)

(c)

**Difference in gross profit**

| | £ | |
|---|---|---|
| Expected gross profit (585,000 x .12) | 70,200 | 1 of |
| Actual gross profit | 58,500 | 1 of |
| Reduction | 11,700 | |

(2 marks)

(d) **Information relating to claim for damages**

(i) Sales of electrical goods have increased by 20%, which helps Towe's claim. However, the stock is an estimate based on achieving a 50% mark up on cost, which may have been achieved, so evidence for dismissal is lacking. 2

(ii) Towe is entitled to annual leave, but as she recruited the security guards, she must bear some indirect responsibility for their falling asleep. 2

(iii) Towe would probably have been better off increasing prices (rather than reducing them) to discourage panic buying. This would not help her compensation claim. 2

(iv) Towe was not responsible for buying the fish and selling them, so the boycott was not her fault. This will help her compensation claim. 2

(8 marks)

**(Total 25 marks)**

## QUESTION 2

The following information has been extracted from Volga Ltd's Balance Sheet at 31 December 2010:

| | £ |
|---|---|
| Ordinary shares of £0.50 each | 400,000 |
| 10% Preference shares of £1.00 each | 50,000 |
| Share premium | 70,000 |
| Retained earnings | 130,000 |

Volga Ltd has a substantial bank balance at 31 December 2010, and the directors are uncertain as to how it should be used.

Two suggestions have been put forward:

A - Purchase 160,000 of Volga Ltd's own £0.50 ordinary shares, at a premium of £0.20 per share

B - Purchase a new machine for £112,000. This would increase profits by £25,000 in 2011, and by £28,000 in 2012, both calculated before deducting depreciation on the machine, to be provided on a reducing balance basis at 30%, per year.

Volga Ltd's accountant, had budgeted that profits, after providing for depreciation but excluding profit from the new machine, will be £90,000 for 2011 and £100,000 for 2012. It is company policy to pay total dividends equal to 40% of net profit each year.

**REQUIRED**

(a) Prepare Journal entries (without narratives) to record the necessary transactions if Suggestion A is adopted.

(7 marks)

(b) Calculate, to **three** decimal places, the earnings per ordinary share for **each** of 2011 and 2012, assuming **alternatively**:

(i) Suggestion A is adopted
(ii) Suggestion B is adopted.

(8 marks)

(c) Calculate to **three** decimal places, the dividend payable per ordinary share for **each** of 2011 and 2012, assuming **alternatively**:

(i) Suggestion A is adopted
(ii) Suggestion B is adopted.

(6 marks)

Volga Ltd's accountant has argued that, instead of either of Suggestions A and B, the company should pay a one-off (special) dividend to the ordinary shareholders. The directors have two objections to this:

(i) if this dividend is paid, it will raise the expectations of ordinary shareholders in respect of dividends in future years
(ii) the preference shareholders will not receive any benefit.

**REQUIRED**

(d) Briefly discuss whether or not either objection of the directors is valid.

(4 marks)

**(Total 25 marks)**

**MODEL ANSWER TO QUESTION 2**

**Syllabus Topic 5: Companies**
**Syllabus Topic 8: Accounting ratios**

(a) **Journal entries**

| | DR £000 | CR £000 | |
|---|---|---|---|
| Ordinary share capital (160,000 x 0.5) | 80 | | 1 |
| Share purchase | | 80 | ½ |
| Retained earnings | 80 | | 1 |
| Capital redemption reserve | | 80 | 1 |
| Retained earnings (160,000 x 0.2) | 32 | | 1 |
| Share purchase | | 32 | 1 |
| Share purchase | 112 | | ½ |
| Bank | | 112 | 1 |

(7 marks)

(b) **Earnings per ordinary share**

Suggestion A (i) 2011 $\frac{90,000 - (.10 \times 50,000)}{800,000 - 160,000}$ ½ ½ = 85,000 / 640,000 ½ £0.133

(ii) 2012 $\frac{100,000 - (.10 \times 50,000)}{800,000 - 160,000}$ ½ ½ = 95,000 / 640,000 ½ £0.148

Suggestion B (i) 2011 $\frac{90,000 - 5,000 + 25,000 - (.30 \times 112,000)}{800,000}$ ½ ½ ½ ½ ½

= 76,400/800,000 £0.096

(ii) 2012 $\frac{100,000 - 5,000 + 28,000 - (.30 \times 0.70 \times 112,000)}{800,000}$ ½ ½ ½ ½ ½

= 99,480/800,000 £0.124

(8 marks)

(c) **Dividend per ordinary share**

Suggestion A (i) 2011 [(.40 x 90,000) - 5,000 ] / 640,000 ½ ½ ½ £0.048

(ii) 2012 [(.40 x 100,000) - 5,000 ] / 640,000 ½ ½ ½ £0.055

Suggestion B (i) 2011 [.40 (90,000 + 25,000 - 33,600) - 5,000] / 800,000 ½ ½ ½
= 27,560/800,000 £0.034

(ii) 2012 [.40 (100,000 + 28,000 - 23,520) - 5,000] / 800,000 ½ ½ ½
= 36,792/800,000 £0.046

(6 marks)

**QUESTION 2 CONTINUED**

(d) **Paying a one-off dividend**

(i) There is certainly a possibility that shareholders will anticipate receiving large dividends in future years. This might be reduced by stressing the one-off nature of this dividend. 2

(ii) Preference shareholders are only entitled to a fixed dividend, though they must receive this before ordinary shareholders receive anything. Therefore, they are not entitled to anything further. Unless future preference dividends are prejudiced by the one-off dividend to ordinary shareholders, then preference shareholders can have no complaints.

2

(4 marks)

**(Total 25 marks)**

**QUESTION 3**

Three techniques used for evaluating investment projects are:

(1) payback period
(2) accounting rate of return
(3) net present value

**REQUIRED**

(a) State which technique takes into consideration the time value of money.

(1 mark)

(b) State which two techniques use cash flows in their calculation.

(2 marks)

Swale, who runs a small supermarket, is considering buying a delivery van for £26,000. The running costs of the van are estimated to be £6,000 per year (excluding depreciation) but Swale would save £10,000 per year in distribution costs. The van would be sold for £8,000 after 5 years' use and be depreciated on a straight line basis.

Discount factors at 12% (Swales cost of capital) are as follows:

| | |
|---|---|
| Year 1 | 0.893 |
| Year 2 | 0.797 |
| Year 3 | 0.712 |
| Year 4 | 0.636 |
| Year 5 | 0.567 |

**REQUIRED**

(c) Calculate the following in respect of Swale's van:

(i) payback period
(ii) accounting rate of return
(iii) net present value.

(16 marks)

Swale's manager believes that the payback period should be used when deciding whether or not to buy the van. If the van doesn't pay back it shouldn't be purchased, if it does pay back it should be purchased.

Swale's chief salesman believes that additional data should be included in the decision making process, like the sales value of the goods delivered. Swale's accountant agrees to some extent but believes that the additional data should be the profit made on the goods delivered.

**REQUIRED**

(d) Assess the argument put forward by Swale's manager.

(3 marks)

(e) Discuss the views of Swale's chief salesman and Swale's accountant, and give a conclusion.

(3 marks)

**(Total 25 marks)**

## MODEL ANSWER TO QUESTION 3

**Syllabus Topic 10: Introduction to decision making**

(a) Net present value

(1 mark)

(b) Payback period; Net present value

(2 marks)

(c) (i) **Payback period**

½ ½ ½ ½ ½

(26,000) - 5 x (10,000 – 6,000) = (6,000) + 8,000 = 2,000
So the payback is only completed when the van is sold = 5 years 1½

(ii) **Accounting rate of return**

½ ½ 2 ½

$$\frac{10{,}000 - 6{,}000 - [(26{,}000 - 8{,}000) / 5] \times 100}{26{,}000 \ ½} = (400/26{,}000) \times 100 = 1.54\%$$

(iii) **Net present value**

| Year | Cash Flow | Discount Factor | | Discounted cash flow |
|---|---|---|---|---|
| | £ | | | £ |
| 0 | (26,000) | 1.000 | 2 | (26,000) |
| 1 | *4,000 | 0.893 | 2 | 3,572 |
| 2 | 4,000 | 0.797 | ½ | 3,188 |
| 3 | 4,000 | 0.712 | ½ | 2,848 |
| 4 | 4,000 | 0.636 | ½ | 2,544 |
| 5 | 4,000 | 0.567 | ½ | 2,268 |
| 5 | 8,000 | 0.567 | 1 | 4,536 |
| | | | 1 of | (7,044) |

* 10,000 - 6,000

(16 marks)

(d) **Argument put forward by Swale's manager**

It is correct to say that any project which doesn't payback shouldn't be accepted. However, if it does payback acceptance is not necessarily a correct decision. In this case the van project has a negative net present value and should be rejected.

(3 marks)

(e) **Views of Swale's chief salesman and the accountant**

The calculations in (c) above assume that sales are not affected by the purchase of the van. If, for example, there are increased sales, then those should be taken into consideration. However also to be taken into consideration, would be the cost of purchasing the additional goods being sold. So, although the view of the accountant is better than that of the chief salesman, neither is correct.

(3 marks)

**(Total 25 marks)**

**QUESTION 4**

Ruhr Plc was formed on 1 January 2008. It decided on the following depreciation policies:

| | |
|---|---|
| Buildings | 2% per year on cost |
| Plant and machinery | 30% per year on cost |
| Fixtures and fittings | 20% per year on a reducing balance basis |
| Motor vehicles | sum of the years digits basis over 5 years assuming a zero residual value |

Ruhr Plc did not purchase or sell any fixed assets during the two years ended 31 December 2009 at which date the net book values of the final assets, purchased on 1 January 2008, were as follows:

| | £ |
|---|---|
| Land and buildings (including land £300,000) | 588,000 |
| Plant and machinery | 120,000 |
| Fixtures and fittings | 80,000 |
| Motor vehicles | 240,000 |

**REQUIRED**

(a) Calculate for Ruhr Plc, the total depreciation charge for **each** of the years 2008 and 2009.
(14 marks)

On 30 June 2010, Ruhr Ltd's land and buildings were valued at £700,000, of this figure £360,000 related to buildings. It was decided to incorporate the new value in the accounts, on 1 July 2010. The total life of the buildings from 1 January 2008 (implied by the depreciation policy) remained unchanged. The revalued amount was to be written off evenly over the remaining life.

**REQUIRED**

(b) Calculate, to the nearest £, the depreciation charge for Ruhr Plc's buildings for 2010.
(3 marks)

(c) Calculate, the surplus on revaluation of land and buildings on 1 July 2010, and explain how this surplus should be treated in Ruhr Plc's accounts.
(3 marks)

Two directors are concerned about the revaluation and its effects:

(1) the Marketing Director argues that if one class of assets is revalued then all the other fixed assets must be revalued

(2) the Production Director is concerned that the increase in depreciation expense each year will reduce profits and distributable reserves.

**REQUIRED**

(d) Comment briefly on the views of **each** of the two directors.
(5 marks)

**(Total 25 marks)**

**MODEL ANSWER TO QUESTION 4**

**Syllabus Topic 3: Valuation of fixed assets**

(a) **Total depreciation charge**

| | | | | £ |
|---|---|---|---|---|
| **2008** | Buildings | [(588,000-300,000) x 100/96 x .02] | 2 | 6,000 |
| | Plant and machinery | (120,000 x 100/40 x .30) | 2 | 90,000 |
| | Fixtures and fittings | (80,000 x 1.25 x 1.25 x .20) | 2 | 25,000 |
| | Motor vehicles | (240,000 x 15/6 x 5/15) | 2 | 200,000 |
| | | | ½ of | 321,000 |

| | | | | £ |
|---|---|---|---|---|
| **2009** | Buildings | (as 2008) | ½ of | 6,000 |
| | Plant and machinery | (as 2008) | ½ of | 90,000 |
| | Fixtures and fittings | (25,000 x .8) | 1+1 of | 20,000 |
| | Motor vehicles | (200,000 x 4/5) | 1+1 of | 160,000 |
| | | | ½ of | 276,000 |

(14 marks)

(b) **Depreciation charge on buildings for 2010**

| | | | £ |
|---|---|---|---|
| 6 months to 30 June 2010 | (6,000 x .5) | 1 | 3,000 |
| 6 months to 31 December 2010 | (360,000 x 0.5/47.5) | 1½ | 3,789 |
| | | ½ of | 6,789 |

(c) **Surplus on revaluation and its treatment** (3 marks)

| | | | £ |
|---|---|---|---|
| Revalued amount | | ½ | 700,000 |
| Book value at 30 June 2010 | (588,000 - 3,000) | 1 | 585,000 |
| | | ½ of | 115,000 |

This revaluation surplus must be transferred to a non-distributable (capital)` reserve. 1

(3 marks)

(d) **Views of the Directors**

(i) The Marketing Director is incorrect, only assets in the same class have to be revalued and not **all** fixed assets. For a continuing business, land and buildings are the only assets likely to increase in value. Revaluing other fixed assets will produce deficits which have to be written off and this is unnecessary.

2

(2) The Production Director is partly correct, profits will certainly be reduced. However distributable profits need not be reduced as transfers can be made, equal to the additional depreciation, from the revaluation reserve to retained earnings.

3

(5 marks)

**(Total 25 marks)**

## QUESTION 5

Nile Plc has two subsidiaries; Blue Ltd and White Ltd, both of which were acquired several years ago. Details of the acquisitions are as follows:

(1) Nile Plc paid £700,000 to acquire 80% of the 100,000 £1 ordinary shares in Blue Ltd. At the date of acquisition Blue Ltd had a share premium of £60,000 and retained earnings of £80,000. At that date the fair value of Blue Ltd's assets and liabilities were equal to their book values, except for property which originally cost £80,000 (book value £30,000), which had a fair value of £100,000.

(2) Nile Plc paid £800,000 to acquire 70% of the 300,000 £0.50 ordinary shares in White Ltd. At the date of acquisition White Ltd had a revaluation reserve of £40,000 and retained earnings of £70,000. At that date the fair values of White Ltd's assets and liabilities were equal to their book values in all cases.

Blue Ltd depreciated property at 2% per year on cost. It is Nile Plc group policy to depreciate all property at 5% per year on cost.

**REQUIRED**

Calculate the following amounts:

(a) the total of the goodwill arising on the acquisitions of Blue Ltd and White Ltd.

(7 marks)

(b) the increase in the annual depreciation charge on Blue Ltd's property since the acquisition by Nile Plc.

(2 marks)

(c) the amount of extra annual depreciation charged to the minority interest in Blue Ltd.

(1 mark)

In most acquisitions of subsidiaries, fair value adjustments are likely to be necessary in respect of fixed assets. Adjustments are less likely in respect of current assets, and even less likely in respect of liabilities.

**REQUIRED**

(d) Discuss the validity or otherwise of the above statement.

(6 marks)

At 31 December 2010, the group's year end, the current accounts in which the intercompany debts are recorded did not agree. On investigation the following matters were discovered:

(1) Nile Plc sold goods costing £20,000 to Blue Ltd, on 15 December 2010, for £60,000. Half the value of these goods had been included in Blue Ltd's stock at 31 December 2010 (as they remained unsold) valued at their cost to Blue Ltd. However, although the sale had been recorded in Nile Plc's books, the purchase had not been recorded in Blue Ltd's books.

(2) White Ltd sold goods costing £50,000 to Nile Plc, on 18 December, at a mark up of 30%. A quarter of the value of these goods had been included in Nile Plc's stock at 31 December 2010 (as they remained unsold) valued at their cost to Nile Plc. However, although the sale was correctly recorded in White Ltd's books, the purchase had not been recorded in Nile Plc's books.

**REQUIRED**

(e) Prepare Journal entries (**with narratives**) to account for the unrecorded purchases in the books of:

(i) Blue Ltd
(ii) Nile Plc.

(5 marks)

**QUESTION 5 CONTINUED**

(f) Calculate the decrease, caused by the need to provide for unrealised profit, in:

(i) consolidated retained earnings
(ii) minority interest.

(4 marks)

**(Total 25 marks)**

**MODEL ANSWER TO QUESTION 5**

**Syllabus Topic 6: Accounting for groups of companies**

(a) **Goodwill on consolidation**

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | £ | | £ |
| Blue Ltd - | Cost of investment | | | | ½ | 700,000 |
| | Less: Ordinary share capital | | | 100,000 | ½ | |
| | Share premium | | | 60,000 | ½ | |
| | Retained earnings | | | 80,000 | ½ | |
| | Fair value (100,000 - 30,000) | | | 70,000 | 1 | |
| | | | . 80 x | 310,000 | | 248,000 |
| | | | ½ | | | 452,000 |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | £ | | £ |
| White Ltd - | Cost of investment | | | | ½ | 800,000 |
| | Less: Ordinary Share capital (300,000 x .5) | | | 150,000 | 1 | |
| | Revaluation reserve | | | 40,000 | ½ | |
| | Retained earnings | | | 70,000 | ½ | |
| | | | . 70 x | 260,000 | | 182,000 |
| | | | ½ | | | 618,000 |

Total (452,000 + 618,000) ½ of £1,070,000

(7 marks)

(b) **Increase in annual depreciation**

| | | | |
|---|---|---|---|
| | | | £ |
| New amount | (.05 x 100,000) | 1 | 5,000 |
| Old amount | (.02 x 80,000) | 1 | 1,600 |
| Increase | | | 3,400 |

(2 marks)

(c) **Depreciation charged to minority interest**

| | | |
|---|---|---|
| | | £ |
| (. 20 x 3,400) | 1 of | 680 |

(1 mark)

(d) **Fair value adjustments**

Fair value adjustments in respect of fixed assets are likely, because book values do not often represent their saleable value. This is especially true of property, which can appreciate in value. 2

Current assets are less likely to require fair value adjustment as they are usually recorded at relatively up to date values. However adjustments may be necessary in respect of obsolete stock and bad debts. 2

Liabilities usually represent actual amounts owed and are likely to be stated at fair value. 1

The statement therefore, is largely correct. 1

(6 marks)

**QUESTION 5 CONTINUED**

**REQUIRED**

(e) (i)

| | £ | | £ |
|---|---|---|---|
| Purchases | 60,000 | 1 | |
| Current account with Nile Plc | | 1 | 60,000 |
| Purchases from Nile Plc unrecorded | | ½ | |

(ii)

| | | | |
|---|---|---|---|
| Purchases (50,000 x 1.3) | 65,000 | 1 | |
| Current account with White Ltd | | 1 | 65,000 |
| Purchases from White Plc unrecorded | | ½ | |

(5 marks)

(f) **Decreases caused by unrealised profit**

| | | £ |
|---|---|---|
| (i) To consolidated retained earnings: | | |
| Stock in Blue Ltd [(60,000 - 20,000) x 0.50] | 1 | 20,000 |
| Stock in Nile Plc [(65,000 - 50,000) x 0.25 x .70] | 1½ | 2,625 |
| | | 22,625 |

| | | £ |
|---|---|---|
| (ii) To minority interest: | | |
| Stock in Nile Plc [(65,000 - 50,000) x 0.25 x .30] | 1½ | 1,125 |

(4 marks)

**(Total 25 marks)**

 

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