Chartered Institute of Credit Management

Accounting Principles

Question Paper, Answers and Examiner's Comments

Level 3 Diploma **June 2018**

ADVICE TO CICM LEARNER CANDIDATES

HOW TO TACKLE YOUR ACCOUNTING PRINCIPLES EXAMINATION

1. **Be prepared.**
   Read the Accounting Principles unit syllabus contained in the Level 2 and Level 3 Diploma in Credit Management Syllabus booklet, free to download from the CICM website if you do not already have an up-to-date copy. It contains all the learning objectives that might be tested in the examination, along with indicative content of what the unit is about. You can use it to help plan your learning and to check you are adequately prepared.

2. **Examination structure and rubric.**
   Remember that the unit syllabus and examination rubric changed in Summer 2016. Some features of the examination are now fixed, so you know that:

   a) It is a three-hour, handwritten examination and a writing booklet for your answers is supplied.

   b) There will be five (5) questions each worth an overall 20 marks.

   c) There are no optional questions or elements in the exam, so you will need to attempt them all. This is consistent with CICM's other core units.

   d) Each question contains parts a), b) and c) which are worth different mark values up to the 20 available for the entire question. In each question, part a) will be a straight-forward task worth 4 marks, part b) will be some form of substantive task for between 10 and 12 marks, and part c) will be for remaining marks up to 20 and may have some connection with or develop the part b) task.

   e) A certain amount of account ledger paper is included in the supplied writing booklet, so you do not have to draw account grids if you need to tackle a book-keeping task.

   f) The pass mark for a Level 2 exam is 40% and marks of 50% and above will receive a Level 3 pass. Unfortunately, marks below 40% are not pass marks.

   g) The language and terminology of the examination is based upon International Accounting Standards as used in CICM's own learning materials for this unit.

3. **General approach**.
   More exams are failed through poor technique during the examination than from poor knowledge and understanding. The key things to do are:

   a) Read the detail within each question task very carefully, so you are sure what the examiner is asking you to do.

   b) Allocate your examination time carefully. Remember that you should spend roughly the same time on each question overall, but that each question part will need a different amount of time to be spent within that.

   c) Remember to attempt all parts of all questions. It is always worth giving a response, even if you are unsure of it.

4. **Giving an effective response**.
As with any examination, preparation is the key and practising an effective response to an Accounting Principles task is a worthwhile exam room skill, so it is worth a reminder of what this unit and its exam is about.

a) The unit and examination is written with the credit industry in mind, so often carries a viewpoint of a customer relationship or credit control situation.

b) The exam will require skills in description/explanation, application of the practical principles of accounting, and commentary/narrative to convey the meaning of the principles, and the results of applying those principles.

c) It is not, in itself, an assessment of mathematical ability, although accurate calculations are important and unavoidable in this type of subject.

d) There is plenty to write about too! It is not just about identifying what a number is, but showing you understand what it means, and why or what its relevance is.

e) The unit's learning objectives also ask that you construct recognised financial and management statements, undertake accurate tasks, and give explanations. Use the published exam materials to practice this.

f) It is worthwhile practising in advance not just the subject matter, but also how to use your non-programmable calculator if you choose to bring one to your exam.

The following will help you give an effective response:

a) Ensure you fully address the tasks set for you. They are not tripwires, but simply to ensure that everyone sits same tasks and that marks are awarded fairly.

b) Stick to the task and avoid drifting from the set task onto a tangent. Frequently check with the task to ensure you are central to it, as that is where marks are available. Responses not on the set task, or which provide surplus-to-task material, waste exam time and are unlikely to score marks, even if accurate.

c) Use clear, well-constructed, labelled and accurate layouts to help you get good marks. Where commentary or written explanation is required, it should be clearly expressed and relevant to the task. Whilst not needing a 'beginning, middle, and end' essay, remember these are opportunities for you to show your knowledge and understanding of the syllabus topics under question. A response which is easy to follow is easy to mark.

d) Take great care to ensure responses are not too brief for purpose. If the task was to 'explain what steps might be needed?' there is a huge difference in response quality (and therefore numbers of marks awarded) between stating that, e.g. more care should be taken, and explaining *why* more care should be taken. Use linking words, such as 'because', or 'meaning that', or 'such as' to prompt a developed on-task response.

e) Whilst bullet points can be carefully used in responses, ensure you develop each point you make, rather than simply leave a bullet list absent of meaning and understanding, and absent of marks. Go back over bullet points and make sure their meaning is clear. Note that whilst suggested response areas in unit past question papers may be in the form of bullet point responses, you will see that each bullet simply separates one discrete idea from another and that each bullet is extended and developed. This is a safe style if you choose to use bullet points.

f) Show workings and calculations to support your figures even if you used a calculator to produce or check your response. Even if your 'number' is incorrect, it may still be possible to obtain marks from the methods you used where that was deemed part of the task.

g) Practise extended writing by hand using a ball-point pen or similar – firstly, if you are accustomed to using a keyboard of whatever size to produce written text for work and study, you might find handwriting at length may be quite tiring; secondly, it is an ideal opportunity to practice accurate recall of frameworks, and the extended and developed writing techniques discussed on these pages! Keep handwriting as legible as you can and help the examiner to read your response.

Good luck!

Chartered Institute of Credit Management

Accounting Principles

Level 3 Diploma in Credit Management questions, answers and examiners' comments

JUNE 2018

Instructions to Candidates

Answer **all** questions. All questions carry equal marks. Time allowed 3 hours

Candidates are reminded there are no optional elements in this examination

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Ledger accounts must be prepared in continuous running account balance format.

Financial statements must be prepared in vertical format.

FRS terminology should be used in responses wherever possible.

Credit balances should be clearly shown in brackets ( ) for clarity.

Where required by a task, VAT is to be calculated at 20%.

The examination paper structure of five compulsory multi-part questions is now firmly established and most candidates handled it satisfactorily well this time. Many could show a sufficient level of knowledge and understanding of accounting principles, practices, concepts and methodology to record a pass mark at one of the two levels available. Candidates' preparation has also improved generally with some very sound responses offered with continuing improvement especially in narratives (those written responses which explain, justify or shed light on associated numerical calculations or given data). There were some issues though which seemed to suggest a lack of readiness for their examination by some candidates, especially in the unorthodox nature of some responses to the double-entry task. Whilst the need for a continuous running account balance (not T-accounts) is specific to the CICM syllabus, it is also a rubric instruction. The principles of bookkeeping itself are many centuries old. Consequently, in neither case, is there an acceptable alternative strategy to obtain the available marks. A reminder for all that bookkeeping is also a communications exercise, not solely a numerical one. Indeed, the same is true for this whole unit. A positive development though is that the vast majority of candidates are now using the accounting terminology adopted by the syllabus and this is to be welcomed.

Sadly, again, marks were not available to some candidates simply through poor examination technique and it is always worthwhile for candidates to ensure that they address the set question directly. Simply listing ideas without regard for the question requirements will never attract marks as readily as focussed responses. Remember that every question set must now be addressed by every candidate sitting the examination, so responses that do not tackle the question as set are therefore readily identifiable, do stand out, and will not score well.

1) a) Briefly explain the main differences between the Trial Balance, the Income Statement and the Statement of Financial Position. (4 marks)

b) Mr Johnson runs an electrical wholesale SME business operating from rented premises on a small industrial estate. The following balances were extracted from his books on 31 May 2018:

	£
Bank	?
Capital	24,800
Drawings	8,500
Electricity	1,800
General Expenses	3,600
Inventory 1.6.2017	9,200
Non-current assets	13,700
Purchases	35,200
Rent	5,000
Sales Revenue	51,900
Trade Payables	4,000
Trade Receivables	3,100
Wages	3,200

TASKS for part b)

i) Prepare a Trial Balance for Mr Johnson's business incorporating its Bank account balance. (8 marks)

ii) Explain why arithmetically correct trial balances might not necessarily confirm the accuracy of the balances on the individual ledger accounts, illustrating your response with **three** varied examples of your own choice. (4 marks)

c) Distinguish between:

i) Capital expenditure and revenue expenditure (2 marks)

ii) Cash and profit. (2 marks)

Total 20 marks

1. **Question aims**

To test candidates' knowledge and understanding of:

- differences between the various accounting and financial statements.
- how a Trial Balance is compiled from account balances in the ledger.
- why 'balancing' trial balances do not guarantee ledger account accuracy.
- the differences between capital and revenue expenditure, and profit and cash.

Suggested grounds for response include:

a) A trial balance is a statement on a certain date of the balance of every individual ledger account, distinguishing between debit balances and credit balances, and which checks the arithmetical accuracy of the double entry in the ledger by ensuring that total debits equal total credits.

It allows an opportunity for errors that disturb debits equalling credits overall to be identified and corrected before the trial balance content is used to compile the other main financial statements of a business.

An Income Statement shows the financial performance of a business over a period of time, using the revenues and expenses to calculate its Gross Profit from trading activities and the overall Net/Operating Profit or Loss after the business's general non-trading income and expenses are taken into account.

A Statement of Financial Position shows, on a specified date, what the business owns (that is, its assets), what the business owes (its liabilities), and its capital (the owner's investment). Assets and liabilities are also identified as to whether they are determined to be long- or short-term (non-current or current).

b) i) Trial balance of Mr Johnson's Business as at 31 May 2018:

	Dr	Cr
	£	£
Capital		24,800
Drawings	8,500	
Electricity	1,800	
General expenses	3,600	
Inventory as at 1 June 2017	9,200	
Non-current assets	13,700	
Purchases	35,200	
Rent	5,000	
Sales revenue		51,900
Trade payables		4,000
Trade receivables	3,100	
Wages	3,200	
Bank		2,600
	83,300	83,300

ii) When a trial balance balances, it simply indicates that the total of the debit balances is equal to the total of the credit balances. One cannot assume that the double-entries within individual accounts are completely error free also. There are a number of errors which might not be picked up from an otherwise arithmetically accurate trial balance and in addition, candidates must make reference by illustration to any **three** of the following errors.

- **Error of Commission** – this occurs when a transaction is entered using the correct amount on the correct side of the double-entry, but in the wrong account of the same class
- **Error of Omission** – when an accounting transaction has been completely omitted from the records
- **Reversal of Entries –** the correct amount is entered in the correct account but the entry has been made in the wrong side of each account
- **Error of Original Entry** – this is when a wrong figure is used when the double-entry transaction is first entered in the accounts
- **Error of Principle** – this happens when an account transaction is entered using the correct amount and on the correct side, but in the wrong class of account
- **Compensation Error** – where two or more errors cancel each other out, but where debits still equal credits.

c) i) **Capital Expenditure** relates to the purchase of a non-current asset e.g., premises, plant, equipment, vehicles, fixtures and fittings. Those assets that will be kept and used for more than one year.

Revenue Expenditure is the costs involved in the day-to-day running of the organisation e.g., purchase of inventory, rent, wages, insurance etc. The benefit for this expenditure will be less than one accounting year. Each is treated as an expense and impacts upon the profit for each year.

ii) **Profit** is the monetary surplus a business has made once all expenses/overheads have been accounted for. In essence, it is a mathematical calculation universally agreed by accountants.

Cash is the amount of money on hand to immediate payment of due bills. In essence it is a current asset, liquid, and an actual resource for use by the organisation.

Total 20 marks

Responses to this question were handled well overall, but there were common mistakes in approach worthy of comment here. Everybody secured some marks for part a) with many full mark responses identified also.

Full marks were not given though where responses merely detailed the expected content of the three documents, rather than laying out the key differences in nature and construct between them, which is what the task required.

Whilst handled well by most, part b) i) did create a challenge for some. Many secured full or near to full marks by inserting each account balance into the appropriate debit or credit column, drafting a hash total for each, and deducing the balancing figure as the unknown Bank balance - in this case a credit balance denoting an overdraft - there were some common errors. These included incorrect postings of capital, drawings, trade payables and trade receivables and some failed to appropriately title the trial balance along with the name of the business and extract date. All accounting statements must be appropriately titled for accounting and bookkeeping to fulfil its role as a communications medium, and there will always be a marks reward for correctly doing so.

In part b)ii) candidates made a bold attempt, but a common response was to merely list the different types of errors that might not be highlighted by a trial balance, such as error of commission, principle, omission, etc. Many failed to show why this would mean that the trial balance would continue to balance, despite the incorrect handling of the transaction(s) causing the error in the first place and therefore missed full marks. More commonly than anticipated, the different errors were confused with each other, so identification of the error, and the illustration of it, were mismatched.

For part c), most candidates secured some marks especially with regard to i). The difference between cash and profit in ii) created problems for a number who merely indicated what each was, without highlighting how the two differed.

2) a) Describe **four** key features of the Director's Report, with regard to the financial statements of an incorporated business. (4 marks)

b) After the preparation of the year-end Income Statement on 31 March 2018, the following account balances of ETC Ltd remain:

	£
Prepaid Receivables	3,000
Accrued Payables	5,000
Bank (in overdraft)	8,000
Trade Payables	40,000
5% £1 preference shares	50,000
Share premium account	80,000
Trade Receivables	80,000
Motor Vehicles	100,000
Office Equipment	100,000
Profit before tax 31.3.2018	103,500
Retained Earnings 1.4.2017	125,500
Plant and Equipment	140.000
Premises	150,000
£1 ordinary shares – fully paid	200,000

The following information is also available:

- Corporation tax has been assessed at £37,500.
- Closing inventory has been valued at £45,000 following a stocktake.
- Year-end depreciation has already been fully included in these figures.
- An allowance of £6,000 for doubtful debt has been approved by the Board.
- The preference share dividend was paid in May 2018.
- An unpaid ordinary share dividend of 10% was declared before year-end.

TASK for part b)

i) Prepare a Retained Earnings Reconciliation Statement showing all workings. (4 marks)

ii) Present a year-end Statement of Financial Position for ETC Ltd using the ledger account balances and additional information given above. (10 marks)

c) Briefly explain the significance of a 'clean' auditor's report to an incorporated business. (2 marks)

Total 20 marks

2) **Question aims**

To test the candidates' knowledge and understanding of the nature, form and structure of the financial statements of an incorporated business.

To examine the learners' appreciation of the importance of the Director's Report and Auditor's Report in assessing the financial performance of an incorporated business.

Suggested grounds for response include:

a) The Director's Report can provide a plethora of information on the overall performance of a company in addition to that found in the audited accounts. The report will make reference to:

- the year's activities and the major developments of the company and its subsidiaries during the last financial year
- a general overview of trading performance, taxation liabilities and any alterations to the capital structure
- any substantial shareholders and their shareholding
- proposed dividends and transfers to general and other reserves
- any developments arising during the year which have impacted on results
- any principal activities and changes in those activities which will affect future performance
- post balance sheet events
- any research and development embarked upon by the company during the last trading year
- changes to non-current assets during the year and the difference between the carrying value and market value of these assets
- any charitable donations in excess of £2,000
- an overview of the employee structure and the organisation's employment policies
- details of directors, their shareholding and any changes in personnel
- information on any acquisitions by the company of its own shares
- an overview of supplier payment policy
- the auditors appointed/reappointed by the Board.

b) i) Retained earnings reconciliation statement:

	£
Retained earnings as at 1 April 2017	125,500
Profit for the year (W1)	66,000
Preference dividend (W2)	(2,500)
Ordinary share dividend (W3)	(20,000)
Retained earnings as at 31 March 2018	169,000

W1 Profit for the year calculation:	£
Profit before tax	103,500
Corporation tax	(37,500)
Profit for the year	66,000

W2 Preference dividend calculation	£
50,000 x 5/100	2,500

W3 Ordinary share dividend calculation	£
200,000 x 10%	20,000

b) ii)

Statement of Financial Position for ETC Ltd as at 31 March 2018

	£	£	£
Non-current assets			
Motor Vehicles			100,000
Office Equipment			100,000
Premises			150,000
Plant and equipment			140,000
			490,000
Current assets			
Inventory		45,000	
Trade receivables	80,000		
Less: Allowance for doubtful debts	6,000	74,000	
Prepaid receivables		3,000	
		122,000	
Less current liabilities			
Trade payables	40,000		
Bank overdraft	8,000		
Accrued payables	5,000		
Corporation tax	37,500		
Declared dividends	22,500	113,000	
			9,000
			499,000

Equity and reserves	
Ordinary share capital	200,000
5% preference shares	50,000
Share premium account	80,000
Retained earnings	169,000
	499,000

c) It is important that the financial statements of an incorporated business are given a 'clean bill of health' by the external auditor, as it shows for the organisation:

- that proper accounting records have been kept and that their financial statements agree with these.
- that all necessary and required information has been obtained during the audit to support the auditor's opinion.
- that there is consistency between the Director's Report, the accounting records and financial statements.
- that the financial statements have been compiled in accordance with all relevant statutes, regulations and accounting frameworks (concepts and conventions).

Total 20 marks

Part a) posed few fundamental problems for candidates who secured at least some marks concerning the content of the Directors' Report, with a few achieving full marks. All addressed at least one key component concerning either the previous year's trading performance, investment transactions, share issues or dividends, however those highlighting issues such as research and development, post balance sheet activities, charitable donations and changes to the Board, were much less frequent. Some candidates did refer too much to the importance of the document to stakeholders; this was not needed by the task.

The construction and treatment of the financial statements of incorporated businesses, especially with regard to the additional documents which accompany them such as the Directors' and Auditor's Reports, is improving as is recognising the significance of these from both an accounting and credit management perspective. This is certainly a positive development and candidates are to be applauded.

However, there were still some issues with regard to the nature and form of corporate retained earnings reconciliation statements and the "Equity and Reserves" section on the Statement of Financial Position where crucial marks were unclaimed. In Part b) i), some still failed to correctly compute the retained earnings for the year by taking into account, as is needed, dividends from all classes of shares and the corporation tax liability. In b) ii) we still see problems with the structure, format and presentation of the Statement of Financial Position for an incorporated business. The appropriate heading was noticeably incorrect more frequently than anticipated where it was given, some still confuse current with non-current liabilities and where the respective components in each 'current' section of the statement were correctly stated, the individual balances were in the wrong order with no respect for increasing liquidity. More often than liked, the bank overdraft appeared as a negative current asset, the *allowance for doubtful debts appeared as a current liability and the corporation tax and dividend liabilities were completely omitted. All said, there were some very good responses scoring well.*

The importance of the Auditor's report in part c) was in the main handled well by the vast majority with often full or near full marks awarded. There were a few though that, as in part a), talked about the importance of the document for stakeholders, which was not needed. Reference to the facts that a 'clean' report shows the Auditor is for instance happy that proper accounting records were kept, and that there is consistency with the accounts, financial statements and the Directors' Report, was more relevant and mark-worthy.

3) a) Detail the dual aspect of the following transactions showing how they impact upon the individual elements of the Accounting Equation:

i) The owner takes £3,500 worth of inventory out of the business for her own personal consumption. (1 mark)

ii) The owner takes a cash loan of £10,000 from a friend to expand her business. (1 mark)

iii) The owner makes a payment of £6,000 by business cheque to HMRC for Value Added Tax owing. (1 mark)

iv) The owner makes a cash repayment of £500 towards the loan in ii) above. (1 mark)

b) On 1 June 2018, Raj Patel, a VAT-registered entrepreneur, started a new business selling computer software. The following transactions are for his first week of trading:

1 June	Raj opened a business bank account and deposited £25,000 of his own money into it.
1 June	Raj purchased Fixtures and Fittings for £7,500 and a till for £3,500 by a single cheque at an insolvency sale. *NOTE: ignore any VAT implications with these transactions.*
2 June	Raj bought software for resale for £6,500 plus VAT on 30-day terms from IT Solutions (Rutland) Ltd.
2 June	Rent of £500 was paid by cheque.
3 June	Sold software to Jayess Games for £960 cash, including VAT.
3 June	Gave Dalia Digital credit terms and sold software to her for £1,800, plus VAT.
4 June	Raj returned faulty software to IT Solutions (Rutland) Ltd for £1,200 inclusive of VAT.
5 June	He paid wages to assistant of £400 by cheque.
6 June	Dalia Digital returned £450 of unsuitable goods, including VAT

TASK for part b)

Correctly enter each of the above transactions into Raj's books, opening and naming accounts and giving each their ledger names, as appropriate. (12 marks)

c) Explain **four** main reasons for gathering accounting information. (4 marks)

Total 20 marks

3) **Question aims**

To assess the learners' knowledge and understanding of the accounting equation.

To identify the candidates' knowledge and understanding of double-entry bookkeeping

To test the candidates' understanding of the reasons why accounting information is collected.

Suggested grounds for response include:

a) Dual aspects of the transactions impact include:

- The asset of **inventory** would be reduced by £3,500. The withdrawal of **capital** by way of **drawings** would increase by £3,500.
- The asset of **cash** would be increased by £10,000 and a liability of the **loan** (a long-term liability) would be increased by £10,000.
- The asset of **bank** would be reduced by £6,000. The liability of **HMRC** owed VAT (a short-term liability) would also be reduced by £6,000.
- The asset of **cash** would be reduced by £500 whilst the long-term liability of the **loan** would also be reduced by £500.

b) Account, ledgers and transactions for Raj Patel's shop:

Account: Bank CB				
Date	Detail	Dr	Cr	Balance
1 June	Capital NL	25,000		25,000
1 June	Fixtures and Fittings NL / Till NL *		11,000	14,000
2 June	Rent NL		500	13,500
5 June	Wages NL		400	13,100

* Task determines one cheque used, so one Bank CB entry anticipated; Split entries X = 0

Account: Capital NL				
Date	Detail	Dr	Cr	Balance
1 June	Bank CB		25,000	(25,000)

Account: Fixtures & Fittings NL				
Date	Detail	Dr	Cr	Balance
1 June	Bank CB	7,500		7,500

Account: Till NL				
Date	Detail	Dr	Cr	Balance
1 June	Bank CB	3,500		3,500

Account: Sales Revenue NL				
Date	Detail	Dr	Cr	Balance
3 June	Cash CB		800	(800)
3 June	Dalia Digital SL		1,800	(2,600)

Account: Cash CB				
Date	Detail	Dr	Cr	Balance
3 June	Sales Revenue NL	960		960

Account: Dalia Digital SL				
Date	Detail	Dr	Cr	Balance
3 June	Sales Revenue NL	2,160		2,160
6 June	Sales Returns NL		450	1,710

Account: Wages NL				
Date	Detail	Dr	Cr	Balance
5 June	Bank CB	400		400

Account: IT Solutions (Rutland) Ltd PL				
Date	Detail	Dr	Cr	Balance
2 June	Purchases NL		7,800	(7,800)
4 June	Purchases Returns NL	1,200		(6,600)

Account: Purchases NL				
Date	Detail	Dr	Cr	Balance
2 June	IT Solutions (Rutland) Ltd PL	6,500		6,500

Account: VAT NL				
Date	Detail	Dr	Cr	Balance
2 June	IT Solutions (Rutland) Ltd PL	1,300		1,300
3 June	Sales Revenue NL		160	1,140
3 June	Dalia Digital SL		360	780
4 June	IT Solutions (Rutland) Ltd PL		200	580
6 June	Dalia Digital SL	75		655

Account: Rent NL				
Date	Detail	Dr	Cr	Balance
2 June	Bank CB	500		500

Account: Purchases Returns NL				
Date	Detail	Dr	Cr	Balance
4 June	IT Solutions (Rutland) Ltd PL		1,000	(1,000)

Account: Sales Returns NL				
Date	Detail	Dr	Cr	Balance
6 June	Dalia Digital SL	375		375

c) Any appropriate reason will be given credit, such as:

- Accounts are required to provide businesses with a record of all the financial matters of a business
- Once this information has been collated it can assist in the decision making process for the business in question
- Accounting information facilitates planning with regard to likely future sales levels and costs incurred in running the business

- Once a plan is put in place, a degree of control can be exercised as actual results are compared against projects, so corrective action can be taken

- They provide intelligence that can be used by the business to calculate whether a profit or loss is to be made.

- Levels of profit and overall performance will be of interest to all stakeholders in the business such as shareholders, suppliers, customers, and employees, providers of finance, the local community, HMRC and potential investors.

Total 20 marks

Part a) surprisingly caused more problems for candidates than anticipated. The task was to show how the cited transactions would impact upon the key components in the accounting equation, that is, assets, capital and liabilities. For instance, in a) i), the owner taking the business's goods for her own personal use would not only reduce the asset of inventory by £3,500 (it is no longer available to be sold in the course of business), but also withdrawal capital by way of drawings (the accepted CICM syllabus methodology to show capital reductions in sole trader businesses) and this would increase by the same amount. Many recorded the perceived double entry transactions only with no reference to assets, liabilities or capital outside of that context, therefore no reference to the accounting equation. Indeed, for many so doing, an appropriate double-entry treatment of withdrawing inventory by the owner in a) i) is not on the syllabus in any event.

The content of part b) concerning the double-entry posting of transactions to the individual ledger accounts seemed attractive to many candidates with some scoring very heavily indeed. Unfortunately there is still the temptation for a few to ignore the need for good accuracy and adherence to examination rubric instructions in bookkeeping exercises, so a number of issues still need to be highlighted. Firstly, not all candidates correctly employ the ledger account templates included at the rear of their examination answer booklet. Whilst acknowledged as a matter of free choice, for some, effectively utilising this resource saves valuable examination time. There is no advantage in drawing sufficient grids elsewhere in the booklet if they offer less support than the pre-printed templates (e.g. by not including a continuous running account balance column), or if they are more time-consuming to construct. It is mentioned again that their use is intended for exercises that involve laying out double-entry transactions only. Whilst naturally any response written on or in these templates will be marked unless deleted (nothing crossed out is marked), their use is not directly suited to any purpose other than ledger accounts and double-entry transactions. It is also worth repeating that the structure of each template gives room for the Account Name and its Resident Ledger, e.g. Bank (Cash Book) [or (CB) is perfectly acceptable], and the columns hold the Transaction Date, Details narrative, Debit Entry, Credit Entry and Continuous Running Account Balance respectively. Further reminders are given that the Details narrative should be the name of the other major account involved in the double-entry (not a description of the transaction), it is not correct to present the Dr and Cr columns reversed, and any continuous running account balance which is a credit balance should be shown in brackets. The requirement to show a continuous running account balance means that each successive transaction should visually update the account balance, however 3% of candidates did not follow that rubric instruction and gave a final balance only for the accounts they presented.

As always, account postings featured common errors which, in the main part, were avoidable with sufficient practice whilst studying. Occasionally, given balances or double-entry transactions were posted wrong way round and individual account names and/or resident ledger names was wrong. Using 'stock' or 'inventory' accounts in double-entry bookkeeping transactions is beyond the CICM syllabus, so must be incorrect in a response. Also, agreed to be confusing, but the Sales Revenue account is not in the Sales Ledger and the Purchases account is not in the Purchase Ledger; both are in Nominal Ledger, as in Sales Revenue (NL) and Purchases (NL). The issue of one cheque suggests just one entry to Bank (CB), although two different asset accounts were needed for the different types of non-current asset acquired. There were various responses given to the cash sale transaction with Jayess Games, but the only fully correct response required opening a Cash (CB) account to accept the incoming cash (as a debit) and a Sales Revenue (NL) account to accept the VAT-exclusive sale value as a credit, with the VAT element credited to the already existing VAT (NL) account. With no requirement to bank the cash or to give credit facilities, debiting Bank (CB) at any stage, or opening a trade receivables (i.e. SL) account for Jayess Games in the Sales Ledger was incorrect. Accounting for VAT in transactions still causes problems for a few and avoiding the VAT element in the set transactions is counter-productive.

In part c) however many candidates were able to cite at least a couple of reasons as to why businesses keep and record accounting information and secured marks. Most could make reference in one way or another to planning, decision-making and control, although a common error was to concentrate too much on the importance of accounting information to stakeholders.

4) Explain what is meant by the 'Cash Operating Cycle', giving the formula for its calculation in your response. (4 marks)

b) The 2017 financial statements for Ceetee Ltd revealed the following data:

	£
Prepaid Expenses	100
Cash and Cash Equivalents	100
Closing Inventory	600
Opening Inventory	600
Office, Distribution and General Expenses	800
Trade Payables	1,000
Trade Receivables	1,100
Cost of Sales	3,000
Sales Revenue	6,000
Net Assets	20,000

TASKS for part b)

i) Calculate Ceetee Ltd.'s cash operating cycle, showing your workings and mentioning any assumptions you make. (4 marks)

ii) Apart from those you cited in b) i) above, describe how any **three** other named financial ratios can assist the credit manager in the decision making process. (6 marks)

iii) Calculate the three ratios you discussed in b) ii) above, showing your workings and mentioning any assumptions you make. (3 marks)

c) Briefly assess the significance of the results of your calculations in b) above from a credit management perspective. (3 marks)

Total 20 marks

4) **Question aims**

To assess the candidates' appreciation of the importance of the cash operating cycle in identifying the liquidity of a business

To test the candidates' knowledge and understanding of the importance of other accounting ratios to measure organisational performance with regard to liquidity and profitability.

Suggested grounds for response include:

a) ● The Cash Operating Cycle for a business is the period of time between the firm's actual expenditure (that is, when the payment is made to the supplier) on new inventory and/or raw materials

<u>and</u>

● the receipt of the payment for the goods/finished goods sold from the customer.

It is therefore the length of time that the firm, in principle, finances the inventory and resultant transaction, so an appropriately short cash operating cycle is an indicator of efficient working capital management.

The COC calculation formula is:		Inventory Turnover Rate
	+	Receivables Collection Period
	–	Payables Settlement Period
	=	Cash Operating Cycle (days).

b) i) The cash operating cycle for Ceetee Ltd is calculated as follows:

Inventory Turnover Rate (in days), calculated by:

$\frac{\text{Average Inventory}}{\text{Cost of Sales}} \times 365$ so, $\frac{(600+600)/2}{3{,}000} \times 365$ = 73.0 days

Receivables Collection Period (in days), calculated by:

$\frac{\text{Trade Receivables}}{\text{Sales Revenue}} \times 365$ so, $\frac{1{,}100}{6{,}000} \times 365$ = 66.9 days

Payables Settlement Period (in days), calculated by:

$\frac{\text{Trade Payables}}{\text{Purchases}} \times 365$ so, $\frac{1{,}000}{3{,}000} \times 365$ = 121.7 days

Cash Operating Cycle (in days), calculated by:

	Inventory Turnover Rate	73.0
+	Receivables Collection Period	+ 66.9
–	Payables Settlement Period	- 121.7
=	Cash Operating Cycle	= 18.2 days

Use of the Sales Revenue figure is assumed since the volume of credit sales was not ascertainable from the data given. The Purchases figure can be derived from the calculation of Cost of Sales, i.e. Opening Inventory + Purchases – Closing Inventory = Cost of Sales, so 600 + Purchases – 600 = 3,000, so Purchases = 3,000.

ii) Candidates can choose **three** from (but not COC elements):

- **Current ratio** [current assets ÷ current liabilities] is an indication of the general liquidity of a business, which will be of interest to the credit manager as it is an indicator of whether it is able to pay its debts as and when they fall due from its cash or cash equivalent assets. A business with net current liabilities will need to raise cash from non-current asset sales, or from further borrowings or incoming investment.

- **Acid test** or quick ratio [current assets excluding inventory ÷ current liabilities] is a narrower measurement of liquidity, but in this case omits the current asset of inventory from the calculation as it is the hardest one to realise in the form of cash. This is a more critical measurement of liquidity as it shows whether debts can be paid independently from sales funds and is an important consideration to the credit manager as to whether to grant credit to a potential or new customer.

- **Gross profit margin** [sales revenue minus cost of sales] measures the margin of profit between the cost price and selling price of goods sold. A change in the figure could indicate a change in the selling price, or in the cost of sales without a corresponding change in the selling price. A credit manager would seek clarification as to why such changes have taken place in their review of a customer’s credit terms/limits or the granting of credit in the first place.

- **Operating margin profit** [gross profit minus expenses] measures the margin of profit made after overheads and other expenses have been accounted for in relation to sales. Changes in the ratio could be due to a rise in an organisation’s expenses and overheads without a corresponding rise in selling price. It might also be an indication of poor budgeting control in relation to expenses and overheads. Credit managers would want clarification on the issues in granting or extending terms or limits to customers.

- **Return on capital employed** [operating or net profit ÷ net assets or capital employed, as appropriate to the nature of the organisation and data available] shows how capable an organisation is in generating profit from the funds invested in it and shows how efficiently the owners or directors of the business have managed the organisation’s assets. It alters when profit decreases in relation to the capital invested in the business, or where there is an increase in capital employed in relation to profit, or if there is a change in capital employed without a corresponding change in profit.

iii)

- **Current ratio** = 1.9:1

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{100+100+600+1{,}100}{1{,}000} = \frac{1{,}900}{1{,}000} = 1.9:1$$

- **Acid Test** = 1.3:1

$$\frac{\text{Current Assets - Inventory}}{\text{Current Liabilities}} = \frac{1{,}900-600}{1{,}000} = \frac{1{,}300}{1{,}000} = 1.3:1$$

- **Gross Profit Margin** = 50.0%

$$\frac{\text{Gross Profit}}{\text{Sales Revenue}} \times 100 = \frac{6{,}000-3{,}000}{6{,}000} = \frac{3{,}000}{6{,}000} \times 100 = 50.0\%$$

- **Operating Profit Margin** = 36.7%

$$\frac{\text{Operating Profit}}{\text{Sales Revenue}} \times 100 = \frac{6{,}000-3{,}000-800}{6{,}000} = \frac{2{,}200}{6{,}000} \times 100 = 36.7\%$$

- **Return on Capital Employed** = 11.0%

$$\frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100 = \frac{6{,}000-3{,}000-800}{20{,}000} = \frac{2{,}200}{20{,}000} \times 100 = 11.0\%$$

c) The suggested responses below are by no means the definitive interpretation of the ratios calculated, nor do they represent a model response for the marks available. Marks can be awarded for any relevant or reasonable observation of the metrics calculated, made in a brief, but salient, narrative comparison of liquidity, profitability and/or asset efficiency.

- The **cash operating cycle** is the length of time between the organisation’s cash outflow on inventory and raw materials and other expenditure and the inflow of cash from customers. A short cash operating cycle, in this case **18 days**, is an indication of a business’ efficiency in its control of working capital.

- The **inventory turnover rate** indicates how quickly it is being sold. Obviously the period is dependent on the type of product and the sector in which the business is operating. In this case, turnover is on average **5 times a year** which would seem to be a positive observation, but inventory levels are not large.

- The **receivables collection period** suggests the average time taken to collect money from customers and when taken in conjunction with the terms of trade, is a measure of efficiency of the credit control department. If credit terms were 60 days, then **67 days** average collection period is fine. If terms of trading were 30 days, 67 days would be an indication of poor credit management.

- The **payment settlement period** shows the average number of days to pay suppliers and other creditors and should be looked at with the credit terms given to the business by suppliers in mind. Good practice would be to settle with suppliers after the business has received its money from credit customers, which at **121 days** is the case here. However businesses should be wary of taking too long to settle their short-term indebtedness or being slow in making payments, since this could lead to suppliers removing credit, requesting cash payments, ceasing supply of inventory or raw materials, or even litigation.

- Whilst the **current ratio** at **1.9:1** would suggest that £2 of near-cash asset is available for every £1 of liability, a satisfactory number on the face of it, the reality is a heavy dependence upon incoming cash flow from trade receivables to pay its way, and a credit manager would be able to deduce that. This is reinforced by the **acid test** of **1.3:1** suggesting that inventory levels are not particularly influential, if removed from the calculations.

- The firm is profitable in relative terms with the **gross profit margin** of **50%** suggesting half of every £1 of sales is profit, whilst the **operating profit margin** at **37%** is very healthy indeed. It would be interesting if that is repeated within a much larger organisation. The opportunity for investment would be somewhat attractive since the **return on capital employed** suggests an **11%** profit returned for every £1 of capital invested, so a credit manager would concentrate more upon the business's ability to generate cash as the greater concern.

Total 20 marks

T*his part of the syllabus is crucial in putting emphasis upon the importance of interpreting available financial information as opposed to collection, compilation and presentation in itself.*

Most could define, even partially, the cash operating cycle (COC), its importance and its constituent parts as required in the part a) task. Where marks were not claimed, candidates typically offered insufficient detail to show how it is actually calculated, or insufficiently explained what it shows or indicates.

Part b) i) expected candidates to calculate the cash operating cycle using the formula required by part a) by extracting the appropriate detail from the given data and calculating the relevant ratios accordingly. Most scored some marks, with many candidates awarded the maximum. Some missed marks by not offering a ratio calculation despite their theoretical knowledge of Receivables Collection Period, Inventory Turnover Rate and Payables Settlement Period, in not offering an acceptable substitute for Credit Sales or Credit Purchases, or in suggesting that the Purchases figure was not available at all.

Using Sales Revenue or Purchases figures in lieu are perfectly acceptable techniques where the credit-based element of either is not given data, or cannot be deduced. The figure for Purchases here however is readily deduced from the data given using the Cost of Sales calculation which all candidates are expected to know.

Part b ii) expected candidates to select any three appropriate ratios outside of those used to compute the cash operating cycle. A few merely replicated their observations in part b) i) above, but there were some very pertinent selections and observations made here, and it was good to see that display of knowledge and understanding. The current ratio, acid test ratio and the gross profit margin were the most popular selections with some very good responses recorded. Those who selected the operating profit margin and the return on capital employed risked making heavy weather of it, but there were some very acceptable responses. Rubric errors can occur in a number of different situations, and candidates submitting four or more selections here only had material relating to their first three selections marked.

In b) iii), many scripts scored some marks whilst maximum marks regularly featured. The most accurate calculation of current assets in the liquidity ratios included the prepaid expenses.

Generally, there is always likely to be some opportunity in the current syllabus for the interpretation of financial statements which requires candidates to first compute, apply and then comment on financial accounting ratios. Although certainly the general quality of responses in this area is on the up, there are still some who make this type of question difficult for themselves by not being able to calculate the full range of ratios required, with conjecture and guess work then needed to offer a later narrative.

Part c) afforded students the opportunity to offer their observations as a narrative concerning the calculations made in all of part b). Some sound answers resulted, which made claims on the marks available for the task, but many just described the ratio in question without any commentary with regard to its significance in the context of the scenario given in the task. This misses the point of the task and misses the points available for the task.

5) a) Briefly explain the benefits to larger businesses of budget preparation.

(4 marks)

b) Mitre Trading plc buys and sells specialist electronic equipment used exclusively in the retail sector.

The cash budget for Mitre Trading plc for the three months ending September 2018 needs to be compiled. The following information is available:

- A 2-year bank loan of £50,000 plus £10,000 interest has been arranged with the company's bankers. This will be paid into the business bank account in August. The loan will be paid in 24 equal instalments, the first of which is due on the 1 September 2018.

- The pattern of sales (in units) is budgeted to be:

June	July	August	September
550	600	680	700

  Units will be sold for £280 each. One quarter of the sales are for cash, the other three-quarters are on one month credit terms. Credit customers are therefore expected to pay their accounts in the month following that in which they bought/received their goods.

- The company has budgeted to buy-in the following units:

May	June	July	August	September
600	650	680	700	750

  The units cost £150 each and it is the policy of the company to pay trade payables as follows:

  - 20% in the month of purchase,
  - 60% in the following month and,
  - 20% in the month after that.

- The company will also pay:
  - £35,000 per month in salaries
  - general expenses of £20,000 per month, and
  - £50,000 quarterly rent from 1 January 2018 payable in advance.

- A vehicle is to be purchased in June and delivered in July. A deposit of £15,000 is to be paid on delivery and the balance of £10,000 is to be paid one month later.

- The company plans to issue 120,000 shares at a paid-up issue price of £1.50 per share. This is due to take place in September.

- The bank balance at the end of June 2018 is budgeted to be £25,975 (in funds). The bank charges 10% interest on overdrafts (cash deficits) at month-end, to the nearest whole £. This is paid in the following month.

TASK for part b)

Prepare Mitre Trading plc's cash budget for the three months July to September 2018.

(12 marks)

c) Discuss **one** cause and recommend a course of action that might be implemented to resolve **each** of the following variances:

i) Receipts are less than the budgeted figure. (2 marks)

ii) Payments are more than the budgeted figure. (2 marks)

Total 20 marks

5) **Question aims**

To test the candidates' understanding of the nature, structure and importance of budgets in general and cash budgets specifically.

To assess the candidates' ability to construct a cash budget and calculate running balances after taking into consideration cash inflows and outflows.

Suggested grounds for response include:

a) Budgeting in all its forms has numerous business benefits.

- It enhances the business planning process by setting out objectives for the coming year and provides a means of control and decision-making by management if the planned objectives are in danger of not being achieved.

- The sales budget for instance estimates unit sales and revenue prospects for the coming year, and will assume market trends or established business objectives, as well as sales aspirations. It is therefore a planning tool.

- Similarly departmental expenditure budgets anticipate overheads including currently known costs as well as foreseeable events such as pay rises. A level of control can be exercised to ensure that the costs do not escalate.

- Properly prepared budgets facilitates the monitoring process as they compare what is actually happening compared to what was forecast in the original budget (variance analysis).

- Since many people are involved in the process, it facilitates collaboration between departments. For instance, production budgets utilise data gleaned from the sales budget to ensure output is available to meet those sales.

- The departmental budget establishes clear goals and targets and can act as a motivator to all concerned. In addition, it may become the basis for personal appraisal and/or team targets.

- Cash budgets identify cash surpluses and deficits. Management can better employ the forecast cash surpluses, and arrange overdrafts, etc., in advance, saving the additional costs of those taken without prior arrangement.

- Budgets facilitate the leverage to efficiently use assets (e.g. inventory, cash, plant, machinery, asset maintenance, etc.).

Cash Budget for Mitre Trading plc July to September 2018 (in £)

Receipts	**July**	**August**	**September**
From cash sales	42,000	47,600	49,000
From receivables	115,500	126,000	142,800
Bank loan	0	50,000	0
Share issue	0	0	180,000
Total Receipts (A)	**157,500**	**223,600**	**371,800**

Payments	**July**	**August**	**September**
Purchases	96,900	101,700	105,900
Loan repayment	0	0	2,500
Salaries	35,000	35,000	35,000
Vehicle	15,000	10,000	0
General expenses	20,000	20,000	20,000
Rent	50,000	0	[50,000]
Overdraft interest	0	3,343	0
Total Payments (B)	**216,900**	**170,043**	**163,400**
Opening balance	25,975		20,132
Net cash flow (A-B)	**(59,400)**	**53,557**	**208,400**
Closing balance	(33,425)	20,132	228,532

Workings

Cash sales £				
July	600 x 280	=168,000	x25%	= 42,000
August	680 x 280	=190,400	x25%	= 47,600
September	700 x 280	=196,000	x25%	= 49,000

Receivables £	**July**	**August**	**September**
June 154,000 x75%	115,500		
July 168,000 x75%		126,000	
August 190,400 x75%			142,800

Purchases		**July**	**August**	**September**
May	90,000	£18,000	0	0
June	97,500	£58,500	£19,500	0
July	102,000	£20,400	£61,200	£20,400
August	105,000	0	£21,000	£63,000
September	112,500	0	0	£22,500
		£96,900	£101,700	£105,900

Loan repayment

(£50,000 + £10,000) / 24 = £2,500 per month

Share issue

£120,000 x 1.50 = £180,000

Overdraft Interest: July, paid August

£33,425 x 10% = £3,342.50 = £3,343 rounded

c) One cause and courses of action that might be implemented to solve the stated variances might include:

i) Receipts are less than those budgeted for:

Reason	Course of action
Lower sales volume than anticipated	• Reduce prices • Increase marketing • Offer deals • Improve the product
Receipts taking longer to be collected	• Improve credit control processes and procedures • Offer settlement discount • Change terms and conditions of sales

ii) Payments are higher than the budgeted figure:

Reason	Course of action
Higher prices for inventory and raw materials	• Negotiate early payment discount • Negotiation a trade or bulk discount • Change supplier
More materials required	• Change supplier • Look at production processes
Suppliers impose shorter credit terms than industry standard	• Equivalent terms to customers of those goods/services
Unexpected asset purchase	• Negotiate best terms possible to reduce impact

Total 20 marks

The quality of Management Accounting tasks concerning budgets have certainly improved, though some still have had problems with accurately calculating staged payments and the computation, application and timing of consequential payments such as overdraft interest.

This question aimed to encourage identification of the importance of management accounting in relation to budget preparation. In part a) though, most only made reference to cash budgets in their response, whereas the requirement was to examine the importance of all forms of budgeting to larger businesses. Reference therefore to how having a system of budgetary control brings specific business benefits brought the greatest rewards within that available. Unfortunately, this reference was lacking in the many cases repeating effectively a 'forecasting, planning, monitoring and control' mantra, without really being able to say what the benefits actually are.

Part b) expected candidates to be able to create the definitive cash budget showing receipts, payments, net monthly cash flow and balances brought and carried down for each month of the budget – and as stated several times previously, an adequate heading.

The unit Study Text offers one ideal layout for a completed document and an alternative, but since the structure of the cash (or indeed any) budget is not regulated by company law, any reasonable format was recognised. Please note though that inefficient formats are more likely to introduce errors and omissions to the end product. Over and above format, most candidates scored well. There were some commonly seen errors around when to combine numbers and when not. The distinction between receipts from cash sales and receipts from credit sales/trade receivables, and payments for cash purchases and to credit suppliers (that is, to trade payables) was often confused. These numbers should be stated separately. However, a notable number of candidates combined both to give only one monthly figure which, although often arithmetically correct, disguised the source of the receipts or payments, negating the benefits of the budget as a communications tool. Conversely, whilst it is useful to see in workings the breakdown of staged receipts and payments (e.g. 20% in month 1, 60% in month 2, 20% in month 3), the correct solution will bring the components received/paid in any one month together as one combined figure. Please refer to the suggested grounds for response if in any doubt.

There was in some cases significant confusion regarding the incoming funds from the bank loan and the incoming funds from the share issue. Both were incoming investment but both notably cited as a payment rather than a receipt. This led to some identifying the first loan repayment (where it was mentioned by candidates at all) as incoming cash which is more difficult to understand and might have prompted doubts about the accuracy of the earlier errors. Few took the time to calculate the relevant overdraft interest.

Part c) did attract some imaginative responses. Many identified how cash flows in and out could be incorrectly anticipated and came up with some creditable responses as to how these could be addressed. It is worth mentioning though that suggestions of the original budget being wrong contradicts some of the syllabus-stated purposes of budgeting and of budgetary control methodology, so is not a credible response to this type of task.

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