Chartered Institute of Credit Management

Accounting Principles

Question Paper, Answers and Examiner's Comments

Level 3 Diploma **January 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!

Accounting Principles

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

JANUARY 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

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%.

This is the third examination of the reformed Accounting Principles unit with its new syllabus and test structure of five multi-part questions which must be attempted by all candidates and it was handled well in the main by most entering it. Those candidates displayed a sufficient level of knowledge and understanding of basic accounting principles, practices, concepts and conventions to achieve one of the two pass levels available and showed better preparation for an examination of this nature, which is pleasing to note.

However, it is also clear that many of the candidates not achieving a pass mark on this occasion are missing out for reasons which, given a sharper focus, attention to detail and more effective use of tutorial support, would have been easily remedied. Some of these issues featured under the previous syllabus also, therefore the comments made then, as well as those more recently with the new syllabus materials, still hold good. These are reiterated with the individual question commentaries below, where appropriate, and the attention of future candidates, tutors, and those who are disappointed by their mark this time, is drawn to those comments.

All candidates achieving a pass mark on this occasion are warmly congratulated and the examining team hope that your mark helps you to achieve your CICM qualification aspirations. If your mark this time is not what you would have wanted, we hope that the comments and feedback here will help you to achieve your future ambitions and you are wished well in this respect.

Questions start overleaf

1) a) Explain why **four** different stakeholder groups of your own choosing would be interested in the published accounts of an incorporated business. (4 marks)

b) The following information relates to a pop-up designer gifts business opened by successful entrepreneur Doug Deape under his existing VAT number, and its first few transactions that took place in December 2017:

4 December	Doug puts £5,000 of his own money into the new business bank account.
5 December	He buys inventory from EZPZ Products on credit for £3,500 before VAT.
6 December	Gifts UK becomes his first customer and buys £3,120 of goods including VAT.
7 December	Doug buys office equipment from Posh Pad Designs on credit and agrees to pay back the £3,000 before VAT over three weeks.
8 December	He banks his first week's cash sales of £1,440 plus VAT.
11 December	He buys goods for resale from Cash 4 Gifts and pays the £1,440 including VAT by cheque.
12 December	Doug uses £500 from the bank to pay for his own food shopping.
13 December	He buys business stationery for £200 plus VAT by cheque.
14 December	Finally, he sends a £1,200 cheque to Posh Pad Designs for the first payment he promised.

TASK for part b)

Doug has asked you to draw up the double-entry bookkeeping accounts for the above business activity by opening appropriate ledger accounts and accurately recording the stated transactions. (12 marks)

c) Using **four** varied examples of your own choosing, explain how every business transaction can impact on the various sections of the Statement of Financial Position. (4 marks)

Total 20 marks

Question aims

To test candidates' ability to recognise the justifiable users of financial and accounting information and their requirements.

To assess candidates' knowledge and understanding of the conceptual underpinning and rules of double-entry bookkeeping, the accurate recording of transactions, the maintenance of continuous running account balances and the setting up of appropriate accounts in the ledgers to record the transactions.

To test candidates' appreciation of the importance of the accounting equation and how it conceptually underpins accounting processes.

Suggested grounds for response include:

a) Candidates may choose and justify **four** stakeholders from the following list:

- Employees – wage levels/employment prospects
- Trade unions – wage levels/employment prospects
- Trade and other suppliers - continuity of business/creditworthiness
- Investors - profit/survival/market share/repayment
- Local community – employment opportunities/environmental concerns
- Customers – supply of good quality goods and services
- Government departments and other agencies – corporation tax/VAT/national insurance
- Shareholders/owners - profit levels
- Competitors – establish and review market position
- Banks and other providers of finance – liquidity/profitability/creditworthiness.

b) The required ledger accounts and double entry transactions for Doug Deape's designer gifts business are as follows:

Account: Bank CB				
Date	Detail	Dr	Cr	Balance
4 December	Capital NL	5,000		5,000
8 December	Sales Revenue NL	1,728		6,728
11 December	Purchases NL		1,440	5,288
12 December	Drawings NL		500	4,788
13 December	Stationery NL		240	4,548
14 December	Posh Pad Designs PL		1,200	3,348

Account: Capital NL				
Date	Detail	Dr	Cr	Balance
4 December	Bank CB		5,000	(5,000)

Account: Purchases NL				
Date	Detail	Dr	Cr	Balance
5 December	EZPZ Products PL	3,500		3,500
11 December	Bank CB	1,200		4,700

Account: VAT NL				
Date	Detail	Dr	Cr	Balance
5 December	EZPZ Products PL	700		700
6 December	Gifts UK SL		520	180
7 December	Posh Pad Designs PL	600		780
8 December	Sales Revenue NL		288	492
11 December	Purchases NL	240		732
13 December	Stationery NL	40		772

Account: Sales Revenue NL				
Date	Detail	Dr	Cr	Balance
6 December	Gifts UK SL		2,600	(2,600)
8 December	Bank CB		1,440	(4,040)

Account: Gifts UK SL				
Date	Detail	Dr	Cr	Balance
6 December	Sales Revenue SL	3,120		3,120

Account: Office Equipment NL				
Date	Detail	Dr	Cr	Balance
7 December	Posh Pad Designs PL	3,000		3,000

Account: EZPZ Products PL				
Date	Detail	Dr	Cr	Balance
5 December	Purchases NL		4,200	(4,200)

Account: Posh Pad Designs PL				
Date	Detail	Dr	Cr	Balance
7 December	Office Equipment NL		3,600	(3,600)
14 December	Bank CB	1,200		(2,400)

Account: Stationery NL				
Date	Detail	Dr	Cr	Balance
13 December	Bank CB	200		200

Account: Drawings NL				
Date	Detail	Dr	Cr	Balance
12 December	Bank CB	500		500

c) This task looks at the accounting equation with particular reference to the Statement of Financial Position. The accounting equation underpins the whole double-entry accounting system. Each transaction changes the individual sections within the Statement of Financial Position as each has a dual effect on the individual ledger accounts. For instance, the **owner introduces new capital** by paying a personal cheque into the business's bank account. This will increase the current asset of Bank and increases the Capital, a special type of liability which represents the owner's financial investment, and is the money owed by the business to the owner. Other examples could be used to explain the idea, for example:

- The **purchase of non-current assets** – this will increase the non-current asset section of the Statement of Financial Position and reduce the funds at the Bank, and therefore the value of current assets.

- The **purchase of goods for resale on credit** – this increases the current asset of Inventory and also increases the current liability of Trade Payables.

- The **settlement of a supplier's account by bank transfer** - this will reduce the value of current liabilities as the amount of Trade Payables is reduced, and the current asset of Bank will also reduce as payment is made when the transfer takes place.

There are many other variations that could be cited so long as each represents a 'business transaction' and shows a simultaneous double-impact on the SFP and, if applicable, will be awarded marks accordingly for a varied selection.

Total 20 marks

*The overall quality of response to this question suggested good preparation and study practice by many candidates for this examination. All secured at least some marks for **part a)** concerning the stakeholders' interest in the published accounts of an incorporated business, with full marks frequently awarded. In **part b)**, testing learners' knowledge of setting up appropriate accounts and double entry bookkeeping transactions related to specified activities, candidates either fared well, or were held back by common errors or general inaccuracy. It is of continuing concern that there is still confusion (although rarer thankfully) between debit and credit entries (and sometimes Dr and Cr columns), that ledger accounts are being presented by some without a continuous running account balance (an examination requirement), and that credit balances are not being highlighted in brackets (another examination requirement) therefore appear identical to debit balances. Rubric errors, as they are known, cannot be rewarded at all and a response must be to the task, as set, for it to be open to receiving marks.*

A notable number of candidates still draw their own ledger account frameworks in the exam room. Future candidates and CICM tutors are reminded that 'pre-ruled' ledger account templates are supplied within CICM answer booklets, and that account names should also identify the ledger division within which the account appears. Inaccurate bookkeeping postings are very difficult to reward. This reflects the fact that accounting and bookkeeping activities are fundamentally a communications exercise.

Following the CICM syllabus by computation of VAT and posting to a VAT account created difficulties for some. Where VAT was ignored altogether, it should be said that there is nothing to merit this or any other approach which cuts through the set exercise and its associated tasks, and the marks available for showing this knowledge cannot be achieved in other ways. Better care is also needed where candidates open a Cash account where this is consistent with task scenario. Whilst a number did so for this task, none successfully fully reproduced the necessary entries that supported the scenario-based activity, although credit would have been given if this was done.

As has always been the case with past cohorts, some candidates still open a 'Stock' account to record a credit purchase of goods for resale. Stock accounts do not appear in the CICM syllabus and this accounting treatment in incorrect anyway. Also a number of candidates recorded Drawings in a Capital account which is not appropriate at this stage of the bookkeeping process. The identification of credit sales and credit purchases was often overlooked and recorded as a sale/purchase through the Bank which is unfortunately wrong where payment was not concurrent.

***Part c)** though proved particularly troublesome, with many responses including one-sided discussions not based upon recognised dual effect business transactions, and only a small minority citing specific appropriate examples to support their arguments. The question required reference to the extended accounting equation ('A-L=C' alone will not normally be sufficiently comprehensive enough to underpin a well-scoring response) in so far as any transaction could alter the constituent parts of the Statement of Financial Position from the perspective of the firm's assets and liabilities by its dual aspect. For instance: if the owner injected more money into their business the asset of Bank and the special liability of Capital would both increase; or the acquisition of, say, a vehicle on long-term finance would increase the firm's non-current assets and by virtue of the increase in the amount owed to third-party lenders, its non-current liability of, say, Loans. Many could define the term 'accounting equation' and describe its basic constituent parts, but only a very small minority could show how each part would be affected by any given business transaction.*

2) a) Outline the **four** main purposes of the Sales Ledger Control Account. (4 marks)

b) Johnson has extracted the following ledger balances from his business accounts on 30 November 2017:

	£
Sales Revenue	31,726
Premises	19,500
Purchases	15,180
Trade Receivables	7,476
Trade Payables	4,190
Drawings	2,840
General Expenses	2,788
Purchase Returns	1,348
Sales Returns	852
Bank (in overdraft)	744
Discount Allowed	480
Bad Debts	300
Discount Received	245

Later on, the following errors were discovered:

i) An unpaid sales invoice for £900 had not been entered in the books.

ii) Johnson had taken £450 of goods from the business for his own personal use, but no accounting entries were made.

iii) An invoice for £750 received from a supplier was entered into the accounts twice.

iv) A cheque for £895 received from a customer had not been entered into the accounts at all.

v) The figure for Capital had not been extracted and listed, so needs to be calculated.

TASK for part b)

Prepare a trial balance for Johnson's business using the 30 November 2017 balances taking into account the information about errors given above. (11 marks)

c) i) Explain the difference between an expense and a liability, using examples of your own choosing to illustrate your response. (3 marks)

ii) Apply your response in c) i) above to the context of the accounting equation. (2 marks)

Total 20 marks

Question aims

To test candidates' knowledge and understanding of the importance of control accounts in error detection and correction.

To assess candidates' knowledge and understanding of the construction of a trial balance and the underpinning duality concept to resolve TB construct issues.

To test candidates' knowledge and understanding of the components of the accounting equation and their impact upon financial statements.

Suggested grounds for response include:

a) **Four main purposes** of the Sales Ledger Control Account include:

- Sales Ledger Control Account checks the **arithmetical accuracy** of the individual personal accounts of customers
- It will **identify errors** earlier which will reduce time in encountering errors later and correcting them
- It **saves time** when extracting the trial balance. Without the sales ledger control account, all the individual balances on the accounts of customers would become part of the trial balance which would prove very complicated and protracted
- If the trial balance does not agree, the **receivables figure can be excluded** from the investigations as they have already been verified.

b)

Trial Balance for Johnson's business as at 30 November 2017

	DR £	CR £
Premises	19,500	
General Expenses	2,788	
Sales Revenue		32,626
Capital		11,163
Bank	151	
Trade Receivables	7,481	
Trade Payables		3,440
Sales Returns	852	
Purchase Returns		1,348
Purchases	13,980	
Drawings	3,290	
Discount Received		245
Discount Allowed	480	
Bad Debts	300	
	48,822	48,822

Workings and adjusted balances *[NB: neither a suspense account, nor journals, was required by the task, nor was a 'before' and 'after' approach]*:

i)	£900	DR. Trade Receivables	CR. Sales Revenue
ii)	£450	DR. Drawings	CR. Purchases
iii)	£750	DR. Trade Payables	CR. Purchases
iv)	£895	DR. Bank	CR. Trade Receivables

v) Deduced from the accurate Trial Balance as a balancing figure by following the Accounting Equation [that is, (A+E)-(L+I)=C], so (£11,163).

Leading to the following adjusted balances:

Bank CB: (£744) + £895 = £151

Purchases NL: £15,180 – £450 – £750 = £13,980

Drawings NL: £2,840 + £450 = £3,290

Sales Revenue NL: (£31,726) - £900 = (£32,626)

Trade Receivables SL: £7,476 + £900 - £895 = £7,481

Trade Payables PL: (£4,190) + £750 = (£3,440).

c) i) A **liability** is any amount owed by the business to a third-party. Examples include amounts owed to suppliers (trade payables), the outstanding elements of multi-accounting period loans, bank overdrafts, and unpaid elements of business rates, taxation, VAT and so on at accounting period end (accrued payables), etc. A liability can be viewed in the short-term (a current liability, which is planned to be settled within the next accounting period) and the longer-term (a non-current liability, which is due to be paid over several accounting periods).

An **expense** is any cost to the business for goods, services or assets from which a useable benefit to the business derives. Examples include the costs of running the business (e.g. for energy and utilities, wages, business rates, rent, etc.), the costs of trading (generally goods for resale, raw materials for manufacture, etc.), and the costs that are determined by accepted accounting conventions but where only the current year's proportion of cost is allocated to the relevant accounting period (such as the current year's depreciation for non-current assets).

Exemplified reference must be correctly made to both elements for the maximum marks available in this section.

ii) In standard expressions of the accounting equation such as 'Assets + Expenses = Capital + Liabilities + Income', Liabilities and Expenses appear on different and opposing sides. This is because the conceptual accounting system separately recognises the usefulness and benefits received from […assets and…] expenses as being of value to the organisation, but looks on amounts owing to third-parties (even in relation to that same expense category) as independent claims upon the overall worth of the organisation.

Total 20 marks

Part a) *posed few significant problems for candidates with most securing at least one mark and others being awarded the maximum. Some candidates made reference to the content of the sales ledger control account, but without talking about its purposes such as checking the overall arithmetical accuracy of the individual personal accounts of the customer and the fact it can often identify errors earlier in the processing of the individual accounts and in the compilation of the trial balance.*

Part b) *did create a challenge for many candidates, and although most could secure some marks here, there were only a few instances of close to full marks. This part of the question required construction of a Trial Balance after taking into consideration some scenario-based errors identified after the ledger account balances were originally extracted. Some of the adjustments required were computed incorrectly and, in a notable number of instances, ignored altogether (for no benefit). A number of candidates prepared 'before' and 'after' trial balances, which was not time-efficient, and several did not offer either the missing total of the Capital account, or the hash totals of the Dr and Cr columns, which should have been the same if the exercise was to be resolved satisfactorily.*

Candidates should have firstly identified the impact of the errors and then made the relevant adjustments to the extracted balances of the individual accounts involved. For instance, the first error required the candidate to adjust the Trade Receivables on the debit side and then credit the Sales Revenue account with the figure of £900. For the second error, some credited the Bank with the £450 (suggesting an outflow of cash?) as part of the double entry to record Johnson taking goods for personal use out of the business, rather than credit Purchases as required by the syllabus, and which would have gained the marks.

The majority of candidates underperformed in this exercise, which was unfortunate. Errors were incorrectly adjusted, Dr and Cr hash totals were missing as previously stated, and no appropriate missing Capital figure was deduced. Consequently, Trial Balances were inaccurately configured. In some instances, attempts were made to set up a suspense account which was not required by the task and in a couple of cases, journals were raised and this is not required by the syllabus. All that said, whilst not full or near full in terms of marks awarded, there were a good number of mark-worthy responses seen, which correctly determined whether Trade Payables and Trade Receivables were debit or credit and showed the revised Bank debit balance as it was no longer in overdraft.

In ***part c) i)*** *most could correctly define an expense and a liability supported by appropriate examples, but* ***part c) ii)*** *proved more problematic as only a few could correctly apply these two accounting classifications to an expression of the accounting equation.*

3) a) Explain **four** reasons why non-current assets lose their value over time. (4 marks)

b) Parvati Patil started trading on 1 January 2017 selling designer clothes. With a starting capital of £45,000, she purchased during the first month of trading:

- a delivery van for £13,500
- fixtures and fittings for £12,500
- a computer for £11,500.

At the end of the year on 31 December 2017, Parvati was able to identify from the records that she had made £32,500 in sales, although clothes totalling £5,500 had been returned to her as being unsuitable. The sales had cost £25,000 to purchase and there was £12,000 of inventory remaining at year end. During the year, Parvati had also sent inventory back to her suppliers to the value of £5,000 and had recorded the following overheads:

	£
Rent and Rates	£3,000
Electricity	£1,950
Motor expenses	£1,000
Insurance	£850
Advertising	£750

All non-current assets are to be depreciated at 15% at year end. At the end of the year, Parvati's business was also £1,800 overdrawn at the bank, it owed £14,500 to suppliers and was owed £13,800 from customers.

TASK for part b)

You are required to draw up an Income Statement for Parvati Patil's business at 31 December 2017. (12 marks)

c) i) Explain the difference between operating profit margin and net profit margin in relation to an incorporated business. (2 marks)

ii) It has been reported that the operating profit margin for a company has fallen from 8% last year to 4% in the current year. Suggest and explain **two** possible causes of this adverse trend. (2 marks)

Total 20 marks

Question aims

To test candidates' knowledge and understanding of how non-current assets lose their value over time.

To examine candidates' understanding of the nature, form and content of, and an ability to construct, an Income Statement for a non-incorporated organisation.

To assess candidates' understanding of the content and influencing factors of different corporate profit levels, and differences with non-corporate profit statements.

Suggested grounds for response include:

a) There are numerous reasons why non-current assets lose their value over the years and examples include:

- **Wear and tear** through use - specifically with reference to vehicles and machinery in this context
- **Obsolescence -** a new specification of a non-current asset such as a machine, which does the job faster, cheaper and better renders the old machine obsolete
- **Depletion** – where the asset is in the form of natural resources, e.g., coal, iron ore, oil etc. The volume of output declines as more units are extracted
- **Passage of time** – where assets are being used up over a fixed and specific period of time, e.g., a lease on a building or machine.

b) Income Statement for Parvati Patil

Income Statement for Parvati Patil for the year ending 31 December 2017

	£	£
Sales Revenue		32,500
less Sales Returns		5,500
Net Sales		27,000
Less Cost of Sales		
Opening Inventory	0	
Purchases	25,000	
less Purchases Returns	5,000	
	20,000	
Less Closing Inventory	12,000	8,000
Gross Profit		19,000
Less Expenses		
Rent and Rates	3,000	
Electricity	1,950	
Motor Expenses	1,000	
Insurance	850	
Advertising	750	

Depreciation:		
- Delivery Van	2,025	
- Fixtures and Fittings	1,875	
- Computer	1,725	13,175
Net Profit		5,825

c) i) **Operating Margin** is profit before finance costs and taxation. It shows the amount of profit made by the business including its overheads and expenses made on sales as a %. It measures the margin of profit between the actual operating activity of the firm and the selling price of the goods. **Net Profit Margin** on the other hand is the measure of profit for the year and includes the finance costs not accounted for in above.

ii) The adverse trend could be caused by

- A rise in expenses and/or overheads without a corresponding increase in the selling price
- Higher day-to-day expenses on things like utilities, labour, rent or rates etc.
- A conscious decision to absorb financial pressures caused by external factors which have impacted upon Gross Profit
- Poor budgetary control in relation to expenses and overheads resulting in significant overspend.

Total 20 marks

Part a) *was well-answered in the main with most candidates securing some marks. Wear and tear, obsolescence and resource depletion were often happily mentioned, although only a few could identify that for an asset with a time-constrained limitation (e.g. a 50-year lease), the passage of that time is also a valid reason why the non-current asset would lose its value.*

Part b) *caused problems for some candidates who appeared entirely unpractised in using given data unless it was in the form of a listed balance, or in being able to determine what was needed for the set task from what was not. Additionally, the structure, format and presentation offered for an Income Statement varied considerably, with some very good and well scoring, but others extremely poor. The Heading of the Income Statement was often surprisingly tardy with the statement name, business name, date and period covered variously missing or poorly expressed. Some candidates used the phrase "as at (date)" when it required "for the year ending (date)" in the heading (these are not interchangeable) and some just gave the name of the person; others omitted the heading entirely (a lack of communication). This lack of attention to detail is most disappointing and affected the marks awarded.*

It was apparent that for a number of candidates, there was no clear notion of the typical framework of the Income Statement on this syllabus. There were instances of candidates calculating the purchases and sales, then less the returns, and then presenting this as the final figure on the statement. The majority failed to identify Opening Inventory as '£0' [zero] (NB: NOT a 'dash' in a numerical statement, please…) as it was a new business with no inventory at the beginning of the accounting period. They either omitted the category completely, or attributed it with the Purchases figure, which was incorrect treatment.

In most cases, though, a credible figure for gross profit was computed so long as the Cost of Sales was accurately calculated.

When it came to Expenses, most could identify some or all of them correctly, although a notable number of candidates included current and non-current assets as expenses, which was worrying. Fortunately, away from these errors, there were scripts where candidates had obviously practised compiling an Income Statement from given data at sufficient length and therefore obtained full or close to full marks reward.

*In **part c) i)** the majority of students could clearly define the terms "operating profit margin" and "net profit margin", but not all could clearly differentiate between the two by making reference to the fact that the latter metric includes the finance costs not included in the former. For **part c) ii)**, most candidates offered an appropriate response and full marks were given here.*

4) a) Explain the business benefits of having sufficient working capital. (4 marks)

b) Below are highlights from the published accounts of Company X and Company Y for the end of their reporting period on 30 September 2017. You will be asked to use the data given along with any other relevant information to compare and contrast the Liquidity and the Business Efficiency of Company X and Company Y.

		Company X £	Company Y £
1 October 2016			
Inventory		8,500	6,100
For the year to 30 September 2017			
<u>Sales Revenue</u>		140,000	110,000
of which:	Credit sales	120,000	110,000
	Cash sales	20,000	0
<u>Purchases</u>		107,000	96,000
of which:	Credit purchases	107,000	60,000
	Cash purchases	0	36,000
Cost of Sales		34,000	14,600
Other Expenses		10,000	14,500
30 September 2017			
Inventory		9,500	6,700
Equity and Reserves		144,000	125,000
Bank		13,250 in funds	7,600 overdrawn
Trade Payables		12,500	5,000
Trade Receivables		11,500	11,900
5 year Bank Loan		10,000	15,000

TASKS for part b)

Calculate **three** liquidity ratios and **three** efficiency ratios **for both companies** (to one decimal place).

i) Company X: Liquidity and Efficiency – 3 ratios for each category. (5 marks)

ii) Company Y: Liquidity and Efficiency – 3 ratios for each category. (5 marks)

c) Based on your calculations in b)i) and b)ii) above and any other relevant information, analyse the respective performance of Company X and Company Y. (6 marks)

Total 20 marks

Question aims

To test candidates' knowledge and understanding of the importance of working capital to an organisation.

To assess candidates' understanding of liquidity and efficiency of asset management in an organisation.

To assess candidates' knowledge and understanding of business performance using ratio analysis.

Suggested grounds for response include:

a) In that working capital is often expressed as 'Current Assets minus Current Liabilities', it is the amount of liquid (cash or near cash) funds a business needs to operate on a day to day basis.

The volume of working capital required is specific to each business and the particular demands for cash that its own operations require.

It is therefore a measure of financial comfort that a business can meet its immediate needs from its own cash resources, or it is able to transfer other current assets such as trade receivables into cash for that purpose.

A shortage of adequate working capital is a frequent reason for financial difficulties and business failure.

b) Analysis of (i) Company X and (ii) Company Y for Liquidity and Efficiency in Reporting Year 2017 using the most likely ratios:

Liquidity

Ratios:	**Company X**	**Company Y**
Current Ratio		
<u>Current Assets</u>	<u>34,250</u>	<u>18,600</u>
Current Liabilities	12,500 = 2.7:1	12,600 = 1.5:1
Acid Test Ratio		
<u>Current Assets – Closing Inventory</u>	<u>34,250 – 9,500</u>	<u>18,600 – 6,700</u>
Current Liabilities	12,500 = 2.0:1	12,600 = 0.9:1
Financial Gearing		
<u>Non-Current Liabilities</u>	<u>10,000</u>	<u>15,000</u>
Capital Employed x 100	[144,000 + 10,000] x 100 = 6.5%	[125,000 + 15,000] x 100 = 10.7%

Efficiency

Ratios:	**Company X**	**Company Y**
Inventory Turnover Rate		
<u>Average inventory</u>	<u>[8,500 + 9,500] ÷2</u>	<u>[6.100 + 6,700] ÷2</u>
Cost of sales x 365	34,000 x 365 = 96.6 days	14,600 x 365 = 160.0 days
Payables Settlement Period		
<u>Trade Payables</u>	<u>12,500</u>	<u>5,000</u>
Credit Purchases x 365	107,000 x 365 = 42.6 days	60,000 x 365 = 30.4 days
Receivables Collection Period		
<u>Trade Receivables</u>	<u>11,500</u>	<u>11,900</u>
Credit Sales x 365	120,000 x 365 = 35.0 days	110,000 x 365 = 39.5 days

Profit ratios/discussions were not required by the task

c) **Commentary on ratios.**

The suggested responses below are by no means the definitive interpretation of the ratios calculated. Marks can be awarded for any relevant or reasonable observation of the metrics calculated in a balanced narrative comparison of liquidity and asset efficiency.

Liquidity

Company X's **current ratio** is quite satisfactory as its Current Assets are over two and a half times its Current Liabilities, meaning that every £1 of current liability can be covered by £2.70 of current assets. Company Y's position might be regarded as being too low as its Current Assets are only 1.5 times great than its Current Liabilities, so depending on how easily it can convert its current assets into cash, it may find it difficult to pay its current liabilities as and when they fall due or take advantage of any cash discounts that might become available.

The **acid test** or **quick ratio** takes inventory out of the equation as it is the most illiquid Current Asset, having to be sold, turned into a Trade Receivable and the cash then collected. The ratio provides a comparison between receivables, cash and bank, and short-term liability. A figure below 1.0:1 indicates that a firm would have difficulty in meeting an immediate demand from suppliers and short-term lenders. Company X's ratio far exceeds this and at 2.0:1 arguably might be considered as too high. Perhaps there is too much cash in the bank and not doing anything, or the needs of Company X's industry suggest a higher ratio is wise. Company Y's acid test figure is just below the benchmark which is probably fine so long as an immediate and substantial demand for settlement e.g. from the bank for the overdraft, is not made, but Company Y's only asset is Trade Receivables so they are entirely dependent on them to pay to terms to ensure they can pay their own debts as and when they fall due.

With regard to **financial gearing**, both Company X and Y are using very little borrowed money in relation to each business's own capital and so is not a cause for concern.

Efficiency

Inventory Turnover Rate measures the number of days an average level of inventory has been held through the year. The figure depends on the type of business in question with, for instance, a supermarket being a typically low figure and a heavy engineering firm typically experiencing a much higher figure.

From the available data, Company X is holding its inventory for less time on average than Company Y and, without knowledge of any other variables cited above, no further comment can be drawn. However, a higher figure might indicate that a company is taking longer to sell their products due to, for instance, an unexpected fall in demand or because obsolete or naturally slow moving stock items are being held.

Payables Settlement Period measures the speed in which an organisation pays its suppliers on average. Ideally, a business will receive money from its Receivables before it pays its suppliers. This seems the case for Company X, but not for Company Y. Although Company Y's Trade Payable figure is lower than Company X, the fact that Company Y has a significant overdraft as a means of short-term finance might have a bearing on this.

Also some purchases have not been made on a credit basis, so unless in response to a financially attractive deal, represents a further drain on resources, especially if credit facilities were not, or are no longer, available.

Receivables Collection Period measures, on average, how many days credit customers take to pay invoices. In the case study, Company X is receiving the money in quicker than Company Y, though only by a few days. It could be said therefore that Company X's credit control processes and procedures are marginally superior to Company Y, or their credit terms are shorter, or perhaps they are offering discounts to secure early payment.

The above comments are general observations. Credit would also be available for appropriate reference to and interpretation of the **Cash Operating Cycle** in this context, for the credit/cash difference between the two companies in relation to Purchases and Sales Revenue, or to the size of Company Y's bank overdraft.

Total 20 marks

Part a) *was generally well-addressed with all candidates securing some marks. Most had a broad understanding of "working capital" and could detail its constituent parts. Weaker candidates however did not apply the concept as beneficial in facilitating the business to pay its bills as and when they fall due dependent upon its own needs, allowing the business to operate efficiently without any recourse to the bank and to its trade payables as a finance stream.*

Part b) *expected calculation of three liquidity and three efficiency ratios from the extracts of the financial statements given. Most secured some marks concerning the liquidity measurements, although a number did fail to calculate the liquidity values correctly. For candidates involved in the credit industry, it proved surprisingly troublesome. The same can also be said for the three measurements assessing the efficiency of the two organisations cited in the scenario. There was confusion between Cost of Sales and Sales Revenue, and some did not use an average Inventory calculation to establish the Inventory Turnover Rate. More worrying is that some candidates failed to distinguish between Trade Receivables and Trade Payables. That said, some candidates scored heavily here in attracting most or all of the available marks and these tended to be the better papers overall.*

Part c) *required the candidates to take the ratio figures calculated in b) from the financial statement extracts of the two organisations and evaluate their performance from a liquidity and efficiency perspective. The vast majority could put some or all of the ratios into some sort of context and assess their performance from the most recent financial year. Even where calculations of current ratio and the acid test in b) above did not cause too many problems, their application however could have been more effective. Reference to how the current ratio assesses the organisation's ability to pay its short term commitments out of credit sales receipts was needed, and once taking inventory (the hardest current asset to be turned into cash) out of the mix, it shows how effectively a business can maintain liquidity. Often students did not compare the two business's performance in this vein, nor compare the results with any form of generic ratio-based expectations. Gearing, unfortunately, was often misinterpreted with only a few detailing how it is a measure of an organisation's reliance on funds borrowed long term, and whilst for both organisations in question, this was not an issue, candidates failed to point this out. With regard to the inventory turnover, payables settlement period and receivables collection period, the major issue once again was applying these figures into some coherent evaluation of each organisation's performance from the perspectives of liquidity and general efficiency.*

Again, however, there were some very creditable answers, with the better ones also making appropriate reference to the cash operating cycle in their evaluation. As indicated in previous reports, the interpretation of given data and/or calculated figures is just as important as the calculation and compilation of bookkeeping and accounting documents and statements.

Candidates are therefore reminded that questions of this nature expecting a predominantly or entirely narrative response will always be asked, so it is important that candidates practise the skills of presenting a written response to interpret the data calculated or given in a question task.

5) a) Describe what depreciation is, and explain why depreciation does not normally feature within a cash budget. (4 marks)

b) Dai Jones runs a small business selling specialist electrical equipment on credit terms only. The following information is available to you from his sales forecasts and other projections:

	Forecast – 1st Quarter 2018			Forecast – 2nd Quarter 2018		
	Jan	Feb	March	April	May	June
Credit Sales (£000s)	120	140	160	180	190	200
Credit Purchases (£000s)	80	94	108	100	110	140

In order to get the best possible prices from suppliers, credit purchases are paid for, in practical terms, within the same month as supply. That pattern will continue as the advantages to Dai's firm far outweigh the disadvantages. However, Dai's current credit terms to customers are 60 days from invoice date and the **current payment pattern** is that:

- 20% of credit sales is paid in the month following sale,
- 70% of credit sales pay two months after sale, and,
- the final 10% is settled three months after sale.

Dai cannot change the credit terms since '60 days' is his industry's norm, but he is contemplating introducing a settlement discount of 2% if payment is made within 30 days of sale. This, Dai believes, would result in a **changed payment pattern** as follows:

- 80% of credit sales after discount in the month following sale,
- 10% after discount two months after sale, and,
- the final 10% paid after discount three months following sale.

Dai anticipates that the business will have a bank overdraft of £20,000 at the end of March 2018 and he is keen to learn whether his idea will bring any meaningful benefit to his business.

TASKS for part b)

For the 2nd Quarter 2018 and using rounded pounds throughout:

i) Construct a cash budget for the months of April to June 2018, using only the data given above along with the **current payment pattern** of credit sales. (6 marks)

ii) Construct a cash budget for the months of April to June 2018, using only the data given above along with the **changed payment pattern** of credit sales, taking into account a 2% settlement discount in all the amounts received. (6 marks)

c) Using the two cash budgets you have prepared in b)i) and b)ii) above, explain to Dai whether his idea is likely to bring any meaningful benefits to his business and whether or not his idea has any potential drawbacks. (4 marks)

Total 20 marks

Question aims
To test candidates' knowledge and understanding of the structure, form and content of a cash budget.

To assess candidates' ability to indicate the usefulness of cash budgets from a credit management perspective.

To test candidates' understanding of what depreciation is, and why as a non-cash item it will not feature in the cash budget.

To assess candidates' understanding of the factors that might restrict the flow of cash to an organisation.

Suggested grounds for response include:

a) i) Depreciation is an adjustment made at accounting year-end and is the way in which a business recognises that assets held long-term within the organisation (its non-current assets) will lose value over time. It replicates, in a controlled and systematic way, that loss to the organisation by reducing profits accordingly.

However, whilst the current year's depreciation of a non-current asset is treated as an expense on the Income Statement, there is no impact on the business' cash balance. No transfer of cash is involved and depreciation neither sets up a 'fund' for eventual replacement, nor is accumulated depreciation in the Statement of Financial Position an accumulation of money.

The forecast purchase of a non-current asset is only recorded in a cash budget once, when it is initially proposed to acquire and pay for it. Only then, when it belongs to the firm, is it recorded as an asset at cost – in other words, at the price that was paid for it.

Therefore, depreciation is not a cash flow unlike most of the other expenses in the Income Statement, so the amount charged should be excluded from the cash budget as it is not a flow of cash.

b) i) Current Cash Budget for Dai Jones

Dai Jones – 2nd Quarter 2018 - Current Payment Pattern Cash Budget

Receipts	April	May	June
	£	£	£
Receivables +1 month 20%	32,000	36.000	38,000
Receivables +2 months 70%	98,000	112,000	126,000
Receivables +3 months 10%	12,000	14,000	16,000
Total receipts	142,000	162,000	180,000

Payments	April	May	June
	£	£	£
Payables	100,000	110,000	140,000
Total payments	100,000	110,000	140,000

	April	May	June
	£	£	£
Net cash flow	42,000	52,000	40,000
Opening cash balance	(20,000)	22,000	74,000
Closing cash balance	22,000	74,000	114,000

ii) Changed Payment Pattern Cash Budget for Dai Jones

Dai Jones – 2nd Quarter 2018 – Changed Payment Pattern Cash Budget

<u>Receipts</u> <u>@ 98% of Credit Sales</u>	April	May	June
	£	£	£
Receivables +1 month 80%	125,440	141,120	148,960
Receivables +2 months 10%	13,720	15,680	17,640
Receivables +3 months 10%	11,760	13,720	15,680
Total receipts	150,920	170,520	182,280

<u>Payments</u>	April	May	June
	£	£	£
Payables	100,000	110,000	140,000
Total payments	100,000	110,000	140,000

	April	May	June
	£	£	£
Net cash flow	50,920	60,520	42,280
Opening cash balance	(20,000)	30,920	91,440
Closing cash balance	30,920	91,440	133,720

Workings:

Workings – current pattern 20%, 70% and 10%	April	May	June
	£	£	£
January £120,000	12,000		
February £140,000	98,000	14,000	
March £160,000	32,000	112,000	16,000
April £180,000		36,000	126,000
May £190,000			38,000
	142,000	162,000	180,000

Workings -
Anticipated credit sales receivables net of 2% early settlement discount:

January	£120,000 x 98% = £117,600
February	£140,000 x 98% = £137,200
March	£160,000 x 98% = £156,800
April	£180,000 x 98% = £175,400
May	£190,000 x 98% = £186,200

Workings – changed pattern 80%, 10% and 10%	April	May	June
	£	£	£
January £117,600	11,760		
February £137,200	13,720	13,720	
March £156,800	125,440	15,680	15,680
April £176,400		141,120	17,640
May £186,200			148,960
	150,920	170,520	182,280

c) If the cash budget projections come about in reality, observations may include:

- There would seem to be benefits for Dai in cash flow terms since offering the discount not only overcomes the lengthy credit terms usual in his industry, but appears to speed up receipts from credit sales

- This will have a material effect on late payment in that better attention may be given to the lower number of overdue accounts; this may also have a knock-on effect in the potential volumes of bad debts

- In the period under scrutiny, April to June 2018, net cash overall has improved by approximately £20,000; improved and earlier cash flow will have a positive effect on lowering and avoiding overdrafts along with attendant finance costs, and creating better opportunities for investment and benefits from investment income

- However, allowing the settlement discount in itself is a significant cost along with the possibility that clients paying later than the 60 day terms may still deduct the discount unreasonably, meaning Dai will have to recover it from them, potentially damaging customer goodwill.

Total 20 marks

Part a) *required candidates to show what depreciation is and why it does not appear on a cash budget as an outflow. Whilst many could define the notion of depreciation and how it impacts upon profit, some could not additionally show that whilst it is a recognised expense, it is an accounting adjustment rather than a non-cash item, so it does not reduce cash flow as other expenses would.*

Part b) *expected candidates to produce two short cash budget statements – one showing the current payment pattern before the discount offered and one after the concession was made showing an altered expectation of the timing and volume of cash receipts from cash and credit sales. The structure, content and design of these documents varied considerably, which did not in itself affect the marks awarded, but whilst there were some very good presentations which scored well, others were piecemeal, sketchy and resembled rough work. Consequently these poorer statements tended not to communicate a response which matched the given data, or therefore a particularly mark-worthy response.*

The need to construct a cash budget in ***b) i)*** *required showing the current payment pattern with regard to varying credit terms over the three months. Outflows to payables in the current pattern would then be incorporated into the budget to show the anticipated positive cash position of £114,000 at the end of June, even though the starting figure was an overdraft at the beginning of the quarter. Most candidates offered a good attempt at this and marks - in some cases at or near maximum - were recorded.*

Different issues emerged however in ***b) ii)*** *with some having difficulty not only establishing the new cash flows and timings, but also incorporating the reduction in receipts because of the incentive discount which applied to all receipts anticipated. Others failed to identify the new cash positions at the end of each month by suggesting a limited version of the impact of the discount, or omitting the discount entirely. Only a minority could offer the correct, or near correct, figures for both phases.*

Part c) *did attract some noteworthy responses however and many identified that the volume of cash flow would improve under the new policy, so were awarded marks accordingly; a lesser number of these, though, could actually back up their conclusion from their own budget constructs.*

There was some good commentary nevertheless suggesting candidates were not only well-prepared for narrative responses, but were also able to support their findings with narrative from the appropriate perspective; that said, only a limited number of candidates could highlight that along with the desirable benefits of an improved cash flow, moving forward, the new discount policy would also have cost implications.

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