Accounting Technicians Ireland

Advanced Financial Accounting

2nd Year Examination

August 2013

Exam Paper, Solutions & Examiner's Report

Professional. Practical. Proven.

NOTES TO USERS ABOUT THESE SOLUTIONS

The solutions in this document are published by Accounting Technicians Ireland. They are intended to provide guidance to students and their teachers regarding possible answers to questions in our examinations.

Although they are published by us, we do not necessarily endorse these solutions or agree with the views expressed by their authors.

There are often many possible approaches to the solution of questions in professional examinations. It should not be assumed that the approach adopted in these solutions is the ideal or the one preferred by us. Alternative answers will be marked on their own merits.

This publication is intended to serve as an educational aid. For this reason, the published solutions will often be significantly longer than would be expected of a candidate in an examination. This will be particularly the case where discursive answers are involved.

Accounting Technicians Ireland

2nd Year Examination: Autumn 2013

Paper : Advanced Financial Accounting

Monday 19th August 2013 - 2.30 p.m. to 5.30 p.m.

INSTRUCTIONS TO CANDIDATES

PLEASE READ CAREFULLY

Candidates must indicate clearly whether they are answering the paper in accordance with the law and practice of Northern Ireland or the Republic of Ireland.

In this examination paper the €/£ symbol may be understood and used by candidates in Northern Ireland to indicate the UK pound sterling and the €/£ symbol may be understood by candidates in the Republic of Ireland to indicate the Euro.

Answer ALL THREE questions in Section A and TWO of the THREE questions in Section B. If more than TWO questions are answered in Section B, then only the first TWO questions, in the order filed, will be corrected.

Candidates should allocate their time carefully.

All workings should be shown.

All figures should be labelled, as appropriate, e.g. €'s, £'s, units etc.

Answers should be illustrated with examples, where appropriate.

Question 1 begins on Page 2 overleaf.

SECTION A

Answer ALL THREE Questions in this Section

QUESTION 1 *(Compulsory)*

A friend of your fathers has been made redundant from a manufacturing plant in which he worked as a junior accounts clerk. Following some basic retraining he has decided to seek employment in the accounts department of a local pharmaceutical company. However, while preparing for an upcoming interview he has decided that he should improve his understanding of corporate governance.

Your father knows that you have studied this area and has asked you to prepare a note for his friend explaining the following:

i. What 'good corporate governance' actually means.

4 Marks

ii. The role of the internal auditor.

7 Marks

iii. The role of the external auditor.

7 Marks

Presentation <u>2</u> Marks

Total <u>20</u> Marks

QUESTION 2 *(Compulsory)*

The following multiple choice question consists of TEN parts, each of which is followed by FOUR possible answers. There is ONLY ONE right answer in each part.

Each part carries 1 ½ marks.

Requirement

Indicate the right answer to each of the following ten parts.

Total <u>15</u> Marks

Candidates should answer this question by ticking the appropriate boxes on the special answer sheet which is contained within the answer booklet.

[1] Under the terms of IAS 8 *Accounting Policies, Change in Accounting Estimates and Errors* where the effect of a change in estimate is material to the financial statements:

[a] the nature and monetary effect of the change on the financial statements must be disclosed.

[b] the change in estimate should be applied retrospectively.

[c] the change in estimate should only be applied retrospectively where it is deemed necessary to provide more reliable information.

[d] the nature and monetary effect of the change on the financial statements must be disclosed only where it is deemed necessary to provide more reliable information.

QUESTION 2 *(Cont'd)*

[2] In accordance with IAS 2 *Inventories,* which of the following costs cannot be included as part of th of inventory?

- **[a]** variable overheads.
- **[b]** import duties.
- **[c]** selling costs.
- **[d]** fixed overheads.

[3] Which of the following is shown on the debit side of a trial balance?

- **[a]** liabilities and expenses.
- **[b]** liabilities and gains.
- **[c]** assets and gains.
- **[d]** assets and expenses.

[4] Which of the following is not recognised as equity in the Statement of Financial Position of a limited company?

- **[a]** ordinary capital.
- **[b]** debentures.
- **[c]** retained earnings.
- **[d]** share premium account.

[5] Which of the following critical attributes must be met for an item to be considered an intangible asset?

- **[a]** Asset must be identifiable, within entity's control and reasonably assured to deliver future economic benefits.
- **[b]** Asset must be identifiable and capable of being readily converted into cash.
- **[c]** Asset must be relevant, material and identifiable.
- **[d]** Asset must be an identifiable monetary asset without physical substance.

[6] A statement of cash flows prepared in accordance with IAS 7 *Statement of Cash Flows* can be best described as:

- **[a]** a statement showing the movement in working capital.
- **[b]** a statement showing the effects of profit on cash resources.
- **[c]** a statement of cash inflows and outflows from operating activities.
- **[d]** a statement showing the inflows and outflows of cash.

QUESTION 2 *(Cont'd)*

[7] In accordance with IAS 10 *Events after the Reporting Period* the loss of inventory, which was included in inventory at year end, as a result of a fire which occurred after the reporting period is an example of:

[a] an immaterial event.

[b] an adjusting event.

[c] a non-adjusting event.

[d] a material event.

[8] With regard to IAS 16 *Property, Plant and Equipment*, which of these statements is true?

[a] If an item of plant and equipment is re-valued, the entire class of plant and equipment to which it belongs must be re-valued.

[b] If an item of plant and equipment is re-valued, there is no obligation to re-value other assets within the same class of plant and equipment.

[c] If an item of plant and equipment is re-valued, the same item must be re-valued annually thereafter to ensure that the carrying value of the asset does not differ materially from the fair value at the balance sheet date.

[d] If an item of plant and equipment is re-valued depreciation continues to be calculated on the original cost price as the revaluation surplus/deficit is not a realised gain/loss.

[9] Partner A, B and C are in partnership sharing profits in the ratio 3:2:2. Partner C has a guaranteed minimum profit of €/£ 36,000. The net profit for the year to 31 December 2012 was €/£ 91,000. How will the net profit be distributed between the partners?

[a] A €/£ 39,000 ; B €/£ 26,000 ; C €/£ 26,000

[b] A €/£ 33,000 ; B €/£ 22,000 ; C €/£ 36,000

[c] A €/£ 34,000 ; B €/£ 21,000 ; C €/£ 36,000

[d] A €/£ 35,000 ; B €/£ 20,000 ; C €/£ 36,000

[10] A machine cost €/£ 22,100 on 1 July 2008 and is to be depreciated 20% per annum using the reducing balance method. It has an expected useful life of 6 years and an expected residual value of €/£ 5,800. A full years depreciation is charged in the year of purchase and none in the year of disposal. The machine was sold in 2012 for €/£7,300.

The profit or loss on disposal is?

[a] a loss of €/£ 1,752

[b] a profit of €/£ 58

[c] a loss of €/£ 1,500

[d] a profit of €/£ 2,880

QUESTION 3 *(Compulsory)*

FARMHAND Limited is a manufacturing company with an authorised share capital of €/£3,000,000 comprise... of ordinary shares only.

The following trial balance was extracted from the books and records of the company as at 31 December 2012.

Farmhand Limited
Trial balance as at 31 December 2012

	DR €/£'000	CR €/£'000
Ordinary shares (of €/£0.50 ea)		1,220
10% debentures (repayable in 2020)		2,090
Retained earnings at 1 January 2012		550
Freehold premises	1,330	
Freehold premises accumulated depreciation		425
Plant and equipment	1,080	
Plant and equipment accumulated depreciation		420
Motor vehicles	375	
Motor vehicles accumulated depreciation		125
Long term investments	160	
Goodwill	390	
Inventory @ 31 December 2012	1,240	
Trade receivables	1,180	
Trade payables		675
Prepayments	235	
Allowance for receivables @ 1 January 2012		94
Deferred income		120
Corporation tax		210
Accruals		275
Retained profit for year		130
Cash at bank	164	
Short term investments	180	
	6,334	**6,334**

Additional information:

1. The above trial balance has been arrived at after charging depreciation for the year.

2. On the last day of the financial year, after inventory was valued, a fire broke out in the warehouse and destroyed 80 units of inventory. These goods were valued at €/£500 each and were under-insured by 50%.

QUESTION 3 *(Cont'd)*

3. The company received a capital grant of €/£60,000 in December 2012 in respect of new plant w was acquired. Plant and equipment is depreciated 10% per year on cost with a full years depreciatio charged in the year of acquisition and no depreciation charged in the year of disposal. The Finance Director was not sure how to treat deferred income and therefore no entries were made to record this receipt.

4. The company entered into a five year lease for new machinery on 1 January 2012. The company has to make five annual payments of €/£25,000, payable in advance, on the first day of the year. The present value of the minimum lease payments is €/£104,247. The interest rate implicit in the lease is 10%. No part of this transaction has been included in the trial balance.

5. Following the preparation of the trial balance the Finance Director learned that a customer, owing a balance of €/£40,000 at year end, went into liquidation and no dividend will be paid to creditors. The Finance Director has subsequently reviewed the receivables listing and believes that the general allowance for receivables should be set at 10% of the final receivables figure.

6. During the year the company disposed of a machine which had cost €/£120,000 and had a net book value of €/£32,000 at the date of sale. The proceeds of sale were agreed at €/£40,000 of which €/£20,000 was received on the final day of the accounting period and the remaining proceeds will be received on 31 January 2013. This disposal was omitted from the books and records in error.

Requirement

Prepare, in a form suitable for publication, the Statement of Financial Position for Farmhand Limited for the year ended 31 December 2012.

23 Marks
Presentation 2 Marks
Total 25 Marks

SECTION B

Answer TWO of the THREE questions in this Section

QUESTION 4

The following financial information relates to FENWICK Limited, a manufacturing company, for the year ended 31 December 2012 (with comparative figures for the year ended 31 December 2011 where relevant).

Fenwick limited

Statement of Financial Position as at 31 December 2012

	2012	2012	2011	2011
	€/£'000	€/£'000	€/£'000	€/£'000
ASSETS				
Non-current assets		11,420		8,160
Current assets				
Inventory	5,110		4,210	
Receivables	6,150		6,810	
Cash in hand	560		1,305	
		11,820		12,325
Total assets		**23,240**		**20,485**
EQUITY & LIABILITIES				
Share capital and reserves				
Ordinary share capital		4,240		4,240
Retained earnings		3,640		2,785
		7,880		7,025
Non-current liabilities				
10% debentures		6,910		5,900
Current liabilities				
Payables	7,310		6,620	
Other accruals	1,140		940	
		8,450		7,560
Total equity and liabilities		**23,240**		**20,485**

QUESTION 4 CONTINUED OVERLEAF

QUESTION 4 *(Cont'd)*

Other information:

		2012	2011
	Turnover (€/£'000)	58,620	42,510
Ratios:			
	ROCE	19%	12%
	Gross profit	23%	16%
	Receivable days	38	55
	Payable days	79	62
	Inventory turnover period (days)	73	47
	Gearing	47%	46%

Requirement

(a) Provide the formula for calculating <u>each</u> of the six ratios listed above.

6 Marks

(b) Select any <u>four</u> of the six ratios listed above and briefly outline what information each ratio provides to the user of financial information, commenting specifically on the financial results of Fenwick Limited.

8 Marks

(c) Calculate <u>two</u> additional ratios, for both 2011 and 2012, which would provide further evidence of the liquidity of the company.

4 Marks

Presentation <u>2</u> Marks

Total <u>20</u> Marks

QUESTION 5

FELIX Limited is a technology company that has produced the following financial statements for the year ended 31 December 2012.

Felix Limited
Statement of Profit or Loss for the year ended 31 December 2012

	€/£'000
Revenue	351
Cost of sales	(232)
Gross profit	119
Other income	16
Administration	(46)
Distribution	(27)
Operating profit	62
Interest payable	(18)
Profit before taxation	44
Taxation	(17)
Profit after tax	**27**

Statement of Changes in Equity

	Ordinary share capital €/£'000	Share premium €/£'000	Retained profits €/£'000	Total equity €/£'000
As at 1 January 2012	970	55	421	1,446
Net profit for year ended 31 Dec 2012			27	27
Share issue	45	5		50
Ordinary dividends			(21)	(21)
As at 31 December 2012	1,015	60	427	1,502

QUESTION 5 CONTINUED OVERLEAF

QUESTION 5 *(Cont'd)*

Felix Limited
Statement of Financial Position as at 31 December 2012

	2012		2011	
	€/£'000	**€/£'000**	**€/£'000**	**€/£'000**
ASSETS				
Non-current assets				
Property, plant & equipment		1,995		1,680
Investments		145		290
		2,140		1,970
Current assets				
Inventories	89		67	
Receivables	72		98	
Prepayments	21		14	
Bank	38	220	35	214
		2,360		2,184
EQUITY & LIABILITIES				
Share capital and reserves				
Share capital (€/£1 shares)		1,015		970
Share premium		60		55
Profit and loss		427		421
		1,502		1,446
Non-current liabilities				
Long term loans		630		510
Deferred income		60		0
Current liabilities				
Payables	110		141	
Accruals	23		31	
Corporation tax	35	168	56	228
		2,360		2,184

The following additional information is also available:

1. The net book value of non-current assets is arrived at as follows:

	2012	**2011**
	€/£'000	**€/£'000**
Property, plant & equipment at cost	2,445	2,180
Acc depreciation	(450)	(500)
	1,995	1,680

QUESTION 5 *(Cont'd)*

2. Accruals include the following amounts in relation to interest charges at year end:

	2012	**2011**
	€/£'000	**€/£'000**
Amount owing at year end	12	17

3. During the year an asset which cost €/£92,000 was sold for €/£31,000. The asset was depreciated by €/£77,000 at the date of sale.

4. During the year a capital grant of €/£60,000 was received as a contribution towards the cost of plant acquired during the year. The plant acquired will be depreciated evenly over a ten year period. This grant was not amortised in error.

5. Investments sold during the year were sold for par value. No new investments were acquired.

6. The ordinary dividend declared and paid during the year was €/£29,000, not €/£21,000 which was recorded in error.

7. Insurance of €/£12,000, paid for the quarter ending 31 March 2013, was included in administration costs.

Requirement

Prepare, in a form suitable for publication, the Statement of Cash Flows for Felix Limited for the year to 31 December 2012.

N.B. *You are NOT required to prepare notes to the Statement of Cash Flows. You are required to submit your workings.*

18 Marks

Presentation 2 Marks

Total 20 Marks

QUESTION 6

The records of FANFARE Limited include the following balances at 1 January 2012:

	Cost	Accumulated Depreciation	Depreciation policy
	€/£	**€/£**	**€/£**
Property	1,450,000	348,000	4% p.a. Straight line
Plant and machinery	980,000	422,000	5% p.a. Reducing balance
Fixtures and fittings	1,340,000	389,000	7.5% p.a. Straight line

During the year ended 31 December 2012 the following events occurred:

1 March 2012

A new piece of machinery costing €/£116,500 was purchased. The new machine is expected to have a residual value of €/£20,000 and a shorter useful life than the existing plant and machinery and accordingly should be depreciated at a rate of 8% p.a. reducing balance.

1 July 2012

Fixtures and fittings, that cost €/£360,000, and had a net book value of €/£115,000 at 1 January 2012, were sold for €/£130,000.

1 October 2012

An extension to the company's property was completed. The following costs were incurred:

	€/£
Site preparation	67,500
Materials	234,700
Labour	421,300
Architect fees	22,680
General administration	26,450
Re-design costs	17,800
Cost of borrowing funds to finance extension	27,980

It is the company's policy to charge a full year's depreciation in the year of acquisition and no depreciation in the year of disposal. Depreciation has not yet been provided for and no entries have been made to record the above events.

QUESTION 6 CONTINUED OVERLEAF

QUESTION 6 *(Cont'd)*

Requirement

(a) Prepare the following ledger accounts for Fanfare Limited, as at 31 December 2012, to record the above events for both *plant and machinery* and *fixtures and fittings*:

i. Cost
ii. Accumulated depreciation
iii. Disposal (only relevant for *fixtures and fittings*)

9 Marks

(b) Use your understanding of IAS 16 *Property, Plant and Equipment* to answer the following questions:

i. Define the cost of an asset.

ii. What conditions must be met before the cost of an asset can be recognised in the financial statements of a business?

iii. How should costs which are disallowed under IAS 16 be treated in the financial statements of a business?

iv. Which costs incurred during the construction of the company's property extension, completed on 1 October 2012 and noted above, can be capitalised?

9 Marks
Presentation 2 Marks
Total 20 Marks

2nd Year Examination: August 2013

Advanced Financial Accounting

Suggested Solutions

Marks Allocated

Students please note: These are suggested solutions only; alternative answers may also be deemed to be correct and will be marked on their own merits.

Solution 1

To : Mr X
From : Accounting Technician
Subject : Corporate Governance
Date : May 2012

Following a conversation with my father I have prepared a note below discussing the issues in relation to which you have requested further explanation:

What 'good corporate governance' actually means
Corporate governance is 'the system by which companies are managed and controlled'. Put simply, corporate governance is the system of management within a company. Good corporate governance will ensure that the company is well managed and that the directors act in the best interest of the company. One corporate governance tool used to prevent and detect fraud is the establishment of a set of internal controls and by having an internal audit function that continually examines and assesses the internal controls in place. The UK Corporate Governance Code 2010 deals with ethical and corporate governance issues within public limited companies and incorporates the Turnbull Report which deals with internal controls within public limited companies. Currently in Ireland there is no legal requirement to have an internal audit function however it is considered best practice for public limited companies to establish such a function. **4 marks**

Role of the internal auditor
The internal audit function normally exists within large public limited companies and plays an important role in helping directors discharge their responsibility for the prevention and detection of fraud and error.

The following outlines the role of the internal audit department:

i. The internal audit department examines the internal controls within an organisation to determine if they are operating efficiently and effectively.

ii. The internal audit department has a wide focus and is concerned with the operations of the entire business and must ensure that breaches of legislation do not occur. This avoids not only the financial impact of such breaches but also the effect on the reputation of the company.

iii. This department identifies weaknesses within the internal control environment and ensure such weaknesses are addressed and the controls strengthened. By identifying weaknesses in the internal controls of an organisation and undertaking regular reviews

Solution 1 *(Cont'd)*

[partly hidden: "…ks …ted"]

the internal audit department assists in the establishment of a robust internal control environment and reduces the risk of fraud and/or error not being identified.

iv. The internal audit department is staffed by company employees who are familiar with every aspect of the internal operations of the company, both financial and operational.

v. Internal auditors usually report to the board of directors or the audit committee, which in turn reports to the board of directors, on the efficiency and effectiveness of the internal control systems in place. The reporting structure implemented can have a significant impact on the effectiveness of the internal audit departments.

While an internal audit function may represent best practice there remains no legal requirement to have one in either Ireland or the UK.

7 marks

The role of the external auditor

Company law requires the directors of a company to prepare a set of financial statements at the end of each financial year. These financial statements provide information on the profitability and financial position of the company. It is therefore important that the users of such financial information know that the information can be relied upon. In this regard it is the fundamental role of the external auditor to *provide assurance that the information contained within the financial statements is reliable and presents a true and fair view of the financial affairs of the company*.
The external auditor is independent of the company he/she audits and is responsible *for forming an opinion* as to the truth and fairness of the financial statements. In forming this opinion the auditor will examine whether:

i. The books and records of the company are properly maintained
ii. The provisions of company law have been followed
iii. Relevant accounting standards have been applied
iv. Any judgements made by the company directors and whether these judgements appear reasonable.

As stated above the external auditor forms and expresses an opinion on the financial statements. The auditor does not make a statement of fact that the financial statements are 100% accurate. Once the external auditor has concluded his/her review an audit report is issued. Where the auditor believes that the financial statements show a true and fair view of the financial affairs of the company an unqualified audit report is issued. This report is not saying with certainty that the financial statements are 100% accurate, it is however saying that in the opinion of the auditor the financial statements reflect a true and fair view of the company's financial affairs. Thus it is this level of assurance that the external auditor gives to the users of financial statements in order that they may rely on the financial statements.

I hope you find the information set out above helpful. Please contact me should you wish to discuss these, or any other, matters in greater detail.

An Accounting Technician

7 marks

Presentation: 2 marks

Total: 20 marks

Solution 2:

Question Number	Answer	Marks Allocated
1	**a**	**1 ½ marks**
2	**c**	**1 ½ marks**
3	**d**	**1 ½ marks**
4	**b**	**1 ½ marks**
5	**a**	**1 ½ marks**
6	**d**	**1 ½ marks**
7	**c**	**1 ½ marks**
8	**a**	**1 ½ marks**
9	**b**	**1 ½ marks**
10	**a**	**1 ½ marks**

Workings

9. 91,000 / (3 + 2 + 2) = 13,000
A: 13,000 x 3 = 39,000
B: 13,000 x 2 = 26,000
C: 13,000 x 2 = 26,000

Guaranteed min profit 36,000
36,000 – 26,000 = 10,000

A: 39,000 – [(10,000 x 3/(3+2))] = 33,000
B: 26,000 – [(10,000 x 2/(3+2))] = 22,000
C: 26,000 + 10,000 = 36,000 **Solution (b)**

10. Yr 1 22100 x 20% = 4420
Yr 2 (22100 – 4420) = 17680 x 20% = 3536
Yr3 (17680 – 3536) = 14144 x 20% = 2829
Yr4 (14144 – 2829) = 11315 x 20% = 2263
2012 NBV is 11315 – 2263 = 9052
NBV 9052 – proceeds 7300 = loss 1,752 **Solution (a)**

Solution 3:

Farmhand Limited
Statement of Financial Position as at 31 December 2012

	£/€'000	£/€'000	A...
Non-current assets			
Property, plant & equipment (w8)		1,866	
Intangible assets		390	**¼ mark**
Other financial assets		160	**¼ mark**
		2,416	
Current assets			
Inventories (w1)	1200		
Receivables (w4)	1026		
Prepayments	235		**¼ mark**
Cash and cash equivalents (w7)	399		
Other receivables (w9)	40		
		2,900	
Total assets		***5,316***	**½ mark**
Equity and liabilities			
Ordinary share capital	1220		**¼ mark**
Retained profits (w5)	585	1,805	
Non-current liabilities			
Debentures	2090		**¼ mark**
Lease liability* (w3)	87		
Deferred income* (w2)	174	2351	
Current liabilities			
Payables	675		**¼ mark**
Corporation tax	210		**¼ mark**
Accruals	275	1160	**¼ mark**
		5,316	**½ mark**
			3 marks
		Workings	**20 marks**
		Presentation	**2 marks**
		Total	**25 marks**

'* In practice lease liability and deferred income should be divided up and shown in both current liabilities and non-current liabilities. However as the manual does not show students how to split these amounts between short and longer term liabilities they are being shown as one amount in non-current liabilities. No marks were lost where students attempted to split the liabilities in line with practice guidelines.

Question 3 (cont'd)

Workings

					Alloca
1	**Inventory**			**£/€'000**	
	No. Units destroyed		80		
	Value per unit (£/€)		500		
	Value of inventory destroyed		40000	40	**½ mark**
	Closing inventory			1240	
	Less goods destroyed			(40)	
	Revised closing inventory			1,200	**½ mark**
	Other receivables:				
	Insurance funds receivable	50%		20	**1 mark**

2	**Deferred income**		**£/€'000**	
	Balance per trial balance		120	**¼ mark**
	Capital grant received		60	**½ mark**
			180	
	Less 1 yrs amortisation of new capital grant	10%	(6)	**¾ mark**
	Revised deferred income		174	

3	**Finance lease**		**£/€**	**£/€'000**	
	PV of lease		104,247	104	
	No. Yrs in lease	5			
	Annual depreciation charge		**20,849**	**21**	**¾ mark**
	NBV of leased asset			**83**	**½ mark**
	First yr interest charge				
	PV of lease		104,247		
	1st payment due 1 January 2012		(25,000)		
			79,247		
	1st yrs interest charge	**10%**	**7,925**	**8**	**¾ mark**

Lease liability

PV of lease	104,247		
Lease payment	(25,000)		
Interest charge	7,925		
	87,172	87	1 ½ mar

4 Receivables

Per trial balance		1,180	¼ mark
Additional bad debts		(40)	½ mark
		1,140	
Provision for doubtful debts (10%)	10%	(114)	½ mark
Revised receivables		1,026	
Allowance for doubtful debts per trial balance		94	
Revised allowance		114	
Increase in allowance		**20**	¾ mark

5 Retained profits

	£/€'000	
Opening balance	550	¼ mark
Profit for year	130	¼ mark
Less inventory destroyed by fire	(40)	½ mark
Add insurance funds receivable	20	½ mark
Capital grant amortisation	6	½ mark
Finance lease depreciation	(21)	½ mark
Finance lease interest charge	(8)	½ mark
Additional bad debt	(40)	½ mark
Increase in bad debt provision	(20)	½ mark
Profit on disposal	8	½ mark
	585	

6 Non-current asset disposal

	£/€'000	
NBV	32	
Sales proceeds	(40)	
Profit on sale	(8)	½ mark
Proceeds received	20	
Proceeds receivable	20	

			Marks allocated
7	**Cash and cash equivalents**	**£/€'000**	
	Cash at bank	164	**¼ mark**
	Lease payment made	(25)	**½ mark**
	Capital grant	60	**½ mark**
	Sale proceeds	20	**½ mark**
	Revised cash balance	219	
	Short term investments	180	**¼ mark**
		399	

8	**Non-current assets**				
		Cost	**Acc depr**	**NBV**	
	Freehold premises	1330	(425)	905	**½ mark**
	Plant and equipment	1080	(420)	660	**½ mark**
	Motor vehicles	375	(125)	250	**½ mark**
		2785	(970)	1815	
	Add lease machinery			83	**½ mark**
	Less asset disposed			(32)	**½ mark**
				1866	

9	**Other receivables**		
	Insurance funds	20	**¾ mark**
	Proceeds of sale not yet received	20	**¾ mark**
		40	
			Total 20

Solution 4:

(a) Provide the formula for calculating each of the six ratios listed above.

Ratio	**Formula**
ROCE	$\frac{\text{Net profit (bef int \& tax)}}{\text{Capital + reserves + non-current liabilities}} \times \frac{100}{1}$
Gross profit	$\frac{\text{Gross profit}}{\text{Sales / Revenue}} \times \frac{100}{1}$
Receivable days	$\frac{\text{Receivables}}{\text{Credit sales}} \times 365$
Payable days	$\frac{\text{Payables}}{\text{Credit purchases}} \times 365$
Inventory turnover	$\frac{\text{Average inventory}}{\text{Cost of sales}} \times 365$
Gearing	$\frac{\text{Non-current liabilities}}{\text{Capital + reserves + non-current liabilities}} \times \frac{100}{1}$

6 marks

(b) In relation to four of the six ratios listed above outline briefly what information each ratio provides to the user of financial information.

Note: students only required to discuss four ratios.

ROCE
This ratio is often considered the most important measure of profitability. This ratio calculates the profitability of the business as a percentage of capital employed. Capital employed is the capital used to finance the business, i.e. funds provided by shareholders (share capital plus reserves) and funds advanced by financial institutions (non-current liabilities).
The ROCE for Fenwick Limited states that the return for every £/€1 invested in the business profits for 2011 were 12 pence/cent increasing to 19 pence/cent in 2012. This is the return earned on the funds invested in the business, it is not however a measure of how much is paid out in the form of interest and/or dividends.

Gross profit
This ratio is a measure of profitability and shows how much gross profit is earned for every £/€1 in sales. A business with a high level of cost of sales will have a low gross profit margin. The gross profit margin for Fenwick Limited is increasing and is quite a healthy margin for a manufacturing company which usually have a high level of direct costs, that is cost of goods sold, and therefore a lower gross profit margin. In this particular scenario both turnover and gross profit have increased, which shows that the company has managed to reduce its direct cost base at the same time as increasing turnover. To achieve such a dramatic increase in gross profit the company has probably benefited from economies of scale and/or undertaken a cost saving programme which has delivered positive results.

Receivables days
Receivables days ratio is one of the common ratios used to measure the efficiency of a business. If a business has healthy efficiency ratios it will tend to have good liquidity. Efficiency ratios examine how many days it takes the business to sell inventories, collect receivables and pay payables. The three efficiency ratios are the inventory turnover period, the receivables days ratio and the payables days ratio.
In relation to Fenwick Limited as can be seen from the Statement of Financial Position receivables have decreased despite an increasing turnover. This is evident from the reducing receivables days from 55 days in 2011 to 38 days in 2012. The receivable days in 2011 of 55 appear to be reasonable however the ratio of 38 days shows that the company has engaged in stricter credit control procedures and is enforcing credit terms. This isn't always a sensible approach and may result in having to offer incentives such as discounts to receive early payment, but it may also be indicative of an over reliance on debtor receipts to fund activities such as capital expenditure.

Payable days
As discussed above payables days ratio is one of the three efficiency ratios. A payable days ratio of 79 days means that on average it takes Fenwick Limited 79 days to pay its payables and this has increased from 62 days in 2011. While it is true that credit represents an interest free loan to a business and should be exploited to its full potential, the ratio can in fact be too high and may be detrimental to the business, that is, suppliers may withdraw credit altogether if payment is not made quicker or they may tighten credit terms on offer. As noted above the company is shortening its receivables days at the same time that it is squeezing its creditors, together providing further credit.
While the payable days ratio may not be at a critically high level management should determine why it has increased and be clear of the potential implications should they decide to continue to squeeze creditors in this way.

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Inventory turnover

As discussed above inventory turnover period is one of the three efficiency ratios. This ratio measures how long it takes a business to sell inventories. Like all efficiency ratios, the ratio is an average as some items of inventory may sell quicker than the average inventory days and some will take longer. ‘Average inventory’ is usually taken as the average of the opening and closing inventory. A business normally wants the inventory turnover period to be as low as possible. When the period is high a significant amount of cash is tied up in inventory, these funds could potentially be put to better use elsewhere. Also the company incurs additional warehousing and storage costs when holding higher than required levels of inventory.

In this scenario inventory has increased as seen in the Statement of Financial Position and accordingly inventory days have increased from 47 days (2011) to 73 days (2012). This is quite a significant jump and management should determine the reasons for such an increase. Perhaps management reacted to increasing turnover by buying additional inventory which it believed it would sell but didn’t, it could be indicative of higher levels of obsolete stock, it could relate to inventory which was purchased in advance for 2013 orders. Whatever the reason management must review inventory particularly in light of stricter credit control procedures and lengthening payables days. Needlessly high levels of inventory can be very costly for a business.

Gearing

The term gearing is used to describe the capital structure of a company which is usually made up of a combination of debt and equity. Equity refers to the monies owners (shareholders) have invested in the business and debt refers to the funds which have been borrowed.

A company that is highly geared has a lot of debt relative to equity and a company that does not have a lot of debt relative to equity is said to have low gearing. For Fenwick Limited the gearing ratio means that for every £/€1 invested in the company, 47 pence/cent (46 pence/cent in 2011) of it has come from borrowed funds. A gearing ratio of 47% would generally be considered as high however it should not be examined in isolation and should be reviewed in light of the company’s ability to service the debt and the industry norm. However, in this situation the company only borrowed an additional £/€1 million to finance capital expenditure of approx. £/€3 million. While it is not clear perhaps the company was unable to avail of additional long term finance due to its high gearing ratio and this could explain why the company is putting so much pressure on its working capital and why the bank balance has reduced so significantly despite increasing turnover.

4 x 2 marks each

(Max 8 marks)

(c) ***Calculate two additional ratios which would provide further evidence of the liquidity of the company.***

Ratio	**Formula**	**2012** £/€'000		**2011** £/€'000	
Current ratio	Current assets / Current liabilities	11,820 / 8,450	1.4 : 1	12325 / 7560	1.6 : 1
Acid test ratio	Current assets – closing inventory / Current liabilities	11820 – 5110 / 8,450	0.8 : 1	12325 – 4210 / 7560	1.1 : 1

4 marks

Presentation: 2 marks

Total: 20 marks

Solution 5:

Statement of Cash Flows for Felix Limited for year to 31 December 2012

	£/€ '000	**£/€ '000**	
Cash flows from operating activities			
Net profit before interest (W1)		80	
Adjustments for:			
Depreciation (W5)	27		
Grant amortisation (W10)	(6)		
Profit on disposal (W7)	(16)		
Changes in working capital			
Increase in inventory (W2)	(22)		
Increase in prepayments (W2)	(19)		
Decrease in receivables (W2)	26		
Decrease in payables (W2)	(31)		
Decrease in accruals (W2)	(3)		
		(44)	
Cash generated from operations		**36**	
Interest paid (W3)	(23)		
Tax paid (W4)	(38)		
		(61)	
Net cash from operating activities		**(25)**	
Cash flows from investing activities			
Payment to acquire non-current assets (W6)	(357)		
Capital grants received (W10)	60		
Receipt from sale of non-current assets (W7)	31		**¾ mark**
Receipt from sale of investments (W13)	145		
Net cash flow from investing activities		(121)	
Cash flows from financing			
Proceeds from share issue (incl share prem) (W12)	50		
Debenture loans issued (W8)	120		
Dividends paid (W9)	(29)		
Net cash flow from financing activities		141	
Increase in cash and cash equivalents		**(5)**	**1 ¼ marks**
Cash and cash equivalents at start of year		35	**¼ mark**
Cash and cash equivalents at end of year		**30**	**¼ mark**
			2 ½ marks
	Workings		**15 ½ marks**
	Presentation		**2 marks**
			Total: 20 marks

Solution 5 *(Cont'd)*

Workings

			£/€'000		**Allo**
1	**Net profit before interest**				
	Operating profit		62		**¼ mark**
	Prepaid insurance costs		12		**½ mark**
	Amortisation omitted in error		6		**½ mark**
			80		
2	**Changes in working capital**		**£/€'000**		
	Inventory	(89 - 67)	(22)	increase	**½ mark**
	Receivables	(72 - 98)	26	decrease	**½ mark**
	Prepayments	(33 - 14)	(19)	increase	**¾ mark**
	Payables	(110 - 141)	(31)	decrease	**½ mark**
	Accruals (excl interest)	(23 - 12) - (31 - 17)	(3)	decrease	**¾ mark**
3	**Interest paid**		**£/€'000**		
	Opening balance		17		**¼ mark**
	Annual charge as per P&L		18		**¼ mark**
			35		
	Less closing balance		(12)		**¼ mark**
	Amount paid		**23**		
4	**Tax paid**				
	Opening balance		56		**¼ mark**
	Annual charge		17		**¼ mark**
	Closing balance		(35)		**¼ mark**
	Amount paid		38		
5	**Depreciation**				
	Opening balance		(500)		**¼ mark**
	Less disposals		77		**½ mark**
	Closing balance		450		**¼ mark**
	Depreciation charge for the year		27		
6	**Non-current asset acquisition**				
	Opening balance		(2,180)		**¼ mark**
	Less disposals		92		**½ mark**
	Closing balance		2,445		**¼ mark**
	Acquisitions		357		**1 ¼ marks**

Solution 5 *(Cont'd)*

7 Non-current asset disposal

Cost		92	
Acc depreciation		(77)	
NBV		15	**½ mark**
Sale proceeds		31	
Profit on sale		16	**½ mark**

8 Long term loans

Opening balance		510	
Closing balance		630	
New loans received		120	**¾ mark**

9 Ordinary dividend

Amount as per SOCIE		21	
Actual amount paid		29	**½ mark**
Understatement		(8)	**½ mark**
Closing bank balance		38	**¼ mark**
Less understatement		(8)	**¼ mark**
		30	
Retained profit as at 31 December 2012		427	
Less understatement		(8)	
		419	

10 Deferred income

Capital grant received		60	**½ mark**
Amortisation	10%	6	**½ mark**

11 Prepayments

As per SOFP		21	
Insurance costs omitted in error		12	
Revised prepayments		33	**¾ mark**

12 Share issue

Share issue proceeds		45	**½ mark**
Share premium		5	**½ mark**
		50	

13 Investments

Opening value		290	
Closing value		(145)	
Sale proceeds		145	**½ mark**
			15 ½ marks

Solution 6:

(a)

Plant and machinery

Cost a/c

01/01/2012	Balance b/d	980,000			
01/03/2012	Bank	116,500	31/12/2012	Balance c/d	1,096,500
		1,096,500			1,096,500
01/01/2013	Balance b/d	1,096,500			

1 ¼ marks

Accumulated depreciation a/c

			01/01/2012	Balance b/d	422,000
31/12/2012	Balance c/d	457,620	31/12/2012	Statement of P&L	35,620
		457,620			457,620
			01/01/2013	Balance b/d	457,620

Fixtures and fittings

1 ¾ marks

Cost a/c

01/01/2012	Balance b/d	1,340,000	01/07/2012	Disposal	360,000
			31/12/2012	Balance c/d	980,000
		1,340,000			1,340,000
01/01/2013	Balance b/d	980,000			

1 ¼ marks

Accumulated depreciation a/c

01/07/2012	Disposal	245,000	01/01/2012	Balance b/d	389,000
31/12/2012	Balance c/d	217,500	31/12/2012	Statement of P&L	73,500
		462,500			462,500
			01/01/2013	Balance b/d	217,500

2 ¼ marks

Disposal a/c

01/07/2012	Cost	360,000	01/07/2012	Acc deprec	245,000
01/07/2012	Statement of P&L	15,000	01/07/2012	Bank	130,000
		375,000			375,000

2 ½ marks

Presentation 2 marks

Solution 6 *(Cont'd)*

Workings
Depreciation

Plant and machinery

Existing:	Cost	(a)	980000	
	Acc depre	(b)	422000	
	Depreciation	(c)	5%	reducing bal
	Depre charge	(a-b)xc	**27900**	
New:	Cost	(a)	116500	
	Residual value	(b)	20000	
	Depreciation	(c)	8%	reducing bal
	Depre charge	(a-b)xc	**7720**	
	Total depreciation		**35620**	

Fixtures & fittings

Cost	(a)	1340000	
Disposal	(b)	360000	
Depreciation	(c)	7.50%	straight line
Depre charge	(a-b)xc	**73500**	

Solution 6 *(Cont'd)*

(b)

i. Define the cost of an asset.

The standard defines the cost of an asset as all costs necessary to bring the asset into working condition for its intended use. The standard includes the following costs as being part of the initial cost of the asset:

- purchase price,
- any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended,
- the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located,
- borrowing costs that are directly attributable to the acquisition, construction or production of an asset.

2 marks

ii. What conditions must be met before the cost of an asset can be recognised in the financial statements of a business?

The cost of an asset should only be recognised in the financial statements of a business when the following two conditions are met:

- It is probable that future economic benefits associated with the item will flow to the business, and
- The cost of the item can be measured reliably.

2 marks

iii. How should costs which are dis-allowed under IAS 16 be treated in the financial statements of a business?

Costs dis-allowed under IAS 16 must be expensed to the Statement or Profit and Loss, an example of such costs includes costs incurred when an asset, capable of being used as intended is left idle, or initial operating losses incurred while demand for the assets output builds up.

1 ½ marks

iv. Which costs incurred during the construction of the company's property extension, and noted above, can be capitalised?

	£/€	
Site preparation	67,500	Capitalised
Materials	234,700	Capitalised
Labour	421,300	Capitalised
Architect fees	22,680	Capitalised
General administration	26,450	Disallowed
Re-design costs	17,800	Disallowed
Cost of borrowing funds to finance extension	27,980	Capitalised

3 ½ marks

Total: 20 marks

2nd Year Examination: August 2013

Advanced Financial Accounting

Examiner's Report

Statistical Analysis – By Question						
Question No.	1	2	3	4	5	6
Average Mark (%)	43%	61%	46.%	65%	48%	58.5%
Nos. Attempting	204	209	209	185	168	57

Statistical Analysis - Overall	
Pass Rate	65%
Average Mark	52%
Range of Marks	**Nos. of Students**
0-39	27
40-49	45
50-59	72
60-69	57
70 and over	8
Total No. Sitting Exam	**209**
Total Absent	45
Total Approved Absent	10
Total No. Applied for Exam	264

General comment:

Despite a mixed bag of average marks per question the overall results were in line with previous years. The average mark was 52% (summer 2013: 53%) and the pass rate was 65% (summer 2013: 66%). Three questions scored below 50% while the remaining three questions scored a relatively high average mark of circa 60%.

Question 1

This question tested the student's knowledge of accounting theory and the average mark was 43%. Although the average mark was lower than the pass mark it was a very welcome turnaround when compared with results from previous exam sittings. This increase was perhaps due to the allocation of 2 marks to presentation and unfortunately not to an improvement in the students understanding of the theory examined. For those students who knew the topics examined they answered this question quickly, briefly and scored highly but for those who were not familiar with the topics they lost valuable time and struggled to meet the requirements.

Question 2

Overall a great result with no obvious areas of difficulty. Well done!

Question 3

This compulsory question is awarded the highest marks out of all the questions on the exam paper (25 marks) and accordingly is commonly the most challenging. The average mark achieved for this question was 46%, the second lowest score on the paper.

This question tested the student's ability to make a number of adjustments, correct errors and prepare a Statement of Financial Position ('SOFP') from a trial balance provided. Students were comfortable with the layout of the SOFP however the treatment of the following matters proved to be the most challenging:

i. Under-insured inventory
ii. Finance lease
iii. Increase in provision for doubtful debts

While many students made good attempts at calculating the revised retained earnings very few included all the relevant items. For these reasons this question proved to be too cumbersome and fragmented for many students and this of course is reflected in the overall average marks.

Question 4

This question examined the student's knowledge, and understanding, of ratio analysis and was the most popular optional question on the paper, scoring the highest average mark of 65%. Part (a) and (c) of the question tested the student's knowledge of ratio formulae and was answered quite comfortably by students. The two formula which caused the most confusion were, perhaps unsurprisingly, ROCE and gearing.

Part (b) of the question required students to discuss four of the six ratios listed. This was met with a very mixed response and is clearly an area where students are less comfortable. Nevertheless the overall performance was good and this is reflected in the high average mark awarded.

Question 5

This question required students to make various adjustments and prepare a Statement of Cash Flow ('SOCF'). Again, a popular question however the average mark of 48% highlights that popularity does not always translate into high scores. Students should bear this in mind when selecting the questions to attempt.

In a similar way to question 3 discussed above this question was quite fragmented and required students to tackle the question as a whole unit rather than individual parts. Many students were well able for this aspect of the question and made very successful attempts at pulling all the pieces together into the final SOCF. However weaker students fell down in this area and thus struggled to gain the marks that perhaps their efforts warranted. This was by far the biggest challenge presented by this question.

Question 6

This question was made up of two parts, part (a) which tested the student's ability to prepare ledger accounts and part (b) which tested their understanding of IAS 16 *Property, Plant and Equipment*. While this question was undoubtedly the least favoured optional question those who attempted it were pleasantly surprised and were rewarded by scoring the second highest average mark of 59%. This was a great result for a question which included two parts, ledger accounts and narrative, not commonly preferred by students. While the presentation of the ledger accounts was somewhat sloppy at times overall students did particularly well in this part. Part (b) also highlighted an ability of the students to be clear and concise and identified a move away from the meandering style of discussion that has been presented in the past.