Accounting Technicians Ireland

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Advanced Financial Accounting

2nd Year Examination

May 2012

Exam Paper, Solutions & Examiner's Report

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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.

There are often many possible approaches to the solution of questions in professional examinations. The examiner will accept alternatives to the suggested solution shown herein as long as that alternative is appropriate.

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.

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Accounting Technicians Ireland

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2nd Year Examination: Summer 2012

Paper : ADVANCED FINANCIAL ACCOUNTING

Monday 14th May 2012 - 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.

Note:
This paper uses both the language of International Accounting Standards (I.A.S's) and Financial Reporting Standards (F.R.S's) where appropriate (e.g. Receivables/Debtors). Examinees are permitted to use <u>either terminology</u> when preparing financial statements but the use of the language of the International Accounting Standards (e.g. Receivables rather than Debtors) is preferred.

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SECTION A

Answer ALL THREE Questions in this Section

QUESTION 1 *(Compulsory)*

(a) The primary objective of accounting and auditing regulatory bodies is to ensure that financial statements present a true and fair view of the financial performance, position and cash flows of an entity.

i. Define the term 'true and fair view'.

ii. Describe the role played by each of the following regulatory bodies:

a. The International Accounting Standards Board ('IASB');
b. The IFRS Interpretation Committee;
c. The IFRS Advisory Council.

15 marks

(b) Following a number of corporate scandals in the US, the US government published the Sarbanes-Oxley Act 2002 ('the Act').

Prepare a note outlining the objective and main provisions of the Act.

5 marks
Total 20 marks

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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 15 Marks

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

[1] Which of the following combinations makes up the regulatory framework in Ireland and the UK?

[a] Professional Regulation, EU Directives and Stock Exchange Regulations.

[b] Domestic Regulation, International Regulations and Company Law.

[c] Accounting Standards, Stock Exchange Regulations and Company Law.

[d] Professional Regulation, Company Law, EU Directives and Stock Exchange Regulations.

[2] In the absence of a partnership agreement the Partnership Act 1890, as amended, applies. Which of the following is *not* a provision of the 1890 Partnership Act?

[a] Partners have a right to receive interest at 5% on current account balances.

[b] Partners have a right to receive interest at 5% pa on loans advanced to the partnership.

[c] No interest is paid on the capital advanced by each partner.

[d] No remuneration is paid to partners for acting within the business.

[3] Which of the following must be corrected retrospectively under the provisions of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*?

[a] changes in accounting policies and all prior period errors.

[b] changes in accounting policies and material prior period errors.

[c] prior period errors and changes in accounting estimates.

[d] changes in accounting policies, changes in accounting estimates and material prior period errors.

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QUESTION 2 *(Cont'd)*

[4] IAS 17 *Leases* defines two types of leases, a finance lease and an operating lease. Which of the following characteristics would imply that the associated lease is an operating lease as per the provisions of IAS 17?

[a] the lessee has the option to purchase the asset at a price which is lower than the expected fair value of the asset at the date the purchase option is exercisable.

[b] the leased asset is specialised in nature and can be used by other businesses but only after modifications have been made.

[c] the lease term is for the major part of the useful economic life of the asset.

[d] the present value of the minimum lease payments is less than 90% of the fair value of the leased asset.

[5] Which of the following is not an example of an intangible asset?

[a] Customer lists.

[b] Computer software.

[c] Leased assets.

[d] Goodwill.

[6] What journal entries are required to record the receipt of a capital grant that relates to the purchase of a non-current asset?

[a] Debit receivables, Credit bank.

[b] Debit bank, Credit deferred income.

[c] Debit payables, Credit deferred income.

[d] Debit other income, Credit receivables.

[7] Which of the following is normally excluded from the definition of 'cash and cash equivalents' as per IAS 7 *Statement of Cash flow*?

[a] Short term highly liquid investments.

[b] Bank overdrafts, repayable on demand.

[c] Equity investments.

[d] Cash on hand.

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QUESTION 2 *(Cont'd)*

[8] Company A has an authorised ordinary share capital of £/€ 2.4 million and an issued ordinary share capital of £/€ 1.5 million. The par value of the ordinary shares is £/€ 0.75. A dividend of £/€ 0.05 was paid at year end. What is the total value of the dividend paid?

[a] £/€ 160,000

[b] £/€ 75,000

[c] £/€ 120,000

[d] £/€ 100,000

BACKGROUND INFORMATION TO PARTS [9] AND [10]

The extract below is from the Statement of Financial Position of AB Limited:

	31 Dec 2011	31 Dec 2010
	£/€	£/€
Inventory	58,000	32,000
Trade receivables	197,000	216,000
Accruals	12,000	40,000
Trade payables	170,000	150,000
Prepayments	42,000	12,000

[9] What is the cash flow from 'Changes in Working Capital' for the year ended 31 December 2011 for inclusion in the Statement of Cash Flows in accordance with IAS 7 *Statement of Cash Flow*?

[a] £/€ 45,000

[b] £/€ (45,000)

[c] £/€ (15,000)

[d] £/€ 13,000

[10] What is the current ratio for the financial year 2011?

[a] 1.63 : 1

[b] 1.40 : 1

[c] 1.31 : 1

[d] 1.50 : 1

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QUESTION 3 *(Compulsory)*

The following trial balance was extracted from the books and records of EDGEWARE Limited. However, the financial accountant failed to include the closing balances for the following accounts:

- Trade receivables;
- Trade payables;
- Administration expenses;
- Distribution expenses;
- Ordinary dividend paid;
- Closing inventory.

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QUESTION 3 *(Cont'd)*

Trial balance as at 31 December 2011

	DR	**CR**
	£/€	**£/€**
Ordinary shares (of £/€0.50 ea)		440,000
10% debentures		230,000
Share premium		36,000
Retained earnings at 1 January 2011		208,610
Premises	528,600	
Premises accumulated depreciation		267,392
Plant and equipment	526,830	
Plant and equipment accumulated depreciation		237,100
Motor vehicles	112,000	
Motor vehicles accumulated depreciation		46,700
Goodwill	95,000	
Inventory at 1 January 2011	302,800	
Trade receivables		
Trade payables		
Deferred income		44,200
Sales revenue		832,860
Sales returns	19,300	
Purchases	362,750	
Purchase returns		21,670
Administration expenses		
Distribution expenses		
Debenture interest	23,000	
Taxation	6,187	
Short term investments	48,600	
Cash at bank	68,749	
Accrued expenses		42,990
Ordinary dividend		
	2,497,231	**2,497,231**

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QUESTION 3 *(Cont'd)*

The following additional information is also available:

1. Average gross margin is 30%.
2. Average receivables days is 70.
3. Average trade payables days is 96.
4. The expenses percentage is 25%. Expenses include distribution and administration expenses which are of equal value.
5. An ordinary dividend of £/€0.05 per share was paid on 31 December 2011.

Requirement

(a) Calculate the value of closing inventory as at 31 December 2011.

3 marks

(b) Calculate the following balances that were not included in the trial balance:

i. Trade receivables
ii. Trade payables
iii. Administration expenses
iv. Distribution expenses
v. Ordinary dividend paid

N.B. *Round up amounts to nearest £/€*

10 marks

(c) Prepare EDGEWARE Limited's Statement of Comprehensive Income and Statement of Changes in Equity for the year ended 31 December 2011 in a form suitable for publication.

N.B. *You are required to submit your workings to show the make-up of the figures included in the Statement of Comprehensive Income and Statement of Changes in Equity.*

10 marks
Presentation: 2 marks
Total 25 marks

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SECTION B

Answer TWO of the THREE questions in this Section

QUESTION 4

ELWOOD Limited is a manufacturing company with an authorised share capital of £/€2,000,000 comprised of ordinary shares only.

The following trial balance was extracted from the books and records of the company as at 31 December 2011.

	DR £/€'000	CR £/€'000
Ordinary shares (of £/€0.50 ea)		950
10% debentures (repayable in 2020)		2,590
Retained earnings at 1 January 2011		860
Revaluation reserve		240
Land	800	
Freehold premises	1,575	
Freehold premises accumulated depreciation		345
Plant and equipment	980	
Plant and equipment accumulated depreciation		420
Motor vehicles	375	
Motor vehicles accumulated depreciation		145
Investments (not for re-sale)	660	
Goodwill	520	
Inventory at 31 December 2011	900	
Trade receivables	960	
Trade payables		565
Prepayments	185	
Allowance for receivables @ 1 January 2011		110
Corporation tax		360
Accruals		290
Retained profit for year		440
Cash at bank	130	
Short term investments	230	
	7,315	**7,315**

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The following additional information was also available:

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

2. The land was revalued downwards by £/€60,000 however this has not yet been provided for in the above trial balance. The land had previously been revalued upwards giving rise to the revaluation reserve as shown in the Trial Balance.

3. Expenses for the year include irrecoverable debts of £/€25,000. Following a review of the receivables listing, the Finance Director has recommended that a further £/€20,000 of specific receivables should be written off. The general allowance for receivables should be set at 10% of the final receivables figure.

4. During the year the company disposed of a machine which had cost £/€160,000 and had a net book value of £/€80,000 at the date of sale. The sale proceeds of £/€65,000 were received on the final day of the accounting period. No entries have been made to record this sale.

Requirement

(a) Prepare, in a form suitable for publication, the Statement of Financial Position for Elwood Limited for the year ended 31 December 2011.

N.B. *You are **NOT** required to prepare an income statement or notes to the accounts. You are required to submit your workings to show the make-up of the figures in the Statement of Financial Position.*

11 marks

(b) Elwood Limited recently approached the bank in which you work seeking further finance. Your manager has asked you to review the loan application. While researching the company you found a recent newspaper article in which Elwood was described as a 'highly geared' company.

i. Explain what is meant by 'highly geared'.

3 marks

ii. Discuss the implications of a high gearing ratio on the loan application submitted.

4 marks

Presentation: 2 marks

Total 20 marks

QUESTION 5

(a) While studying for your accountancy qualification you are also working for a small retail business that is preparing its year end accounts. The bookkeeper does not understand the statement of cash flow and has asked for your help. You have photocopied the following Statement of Cash Flow from your course material and are preparing a note to assist the bookkeeper.

Statement of Cash Flow for the year ended 31 December 2011

	£/€'000	£/€'000
Cash flows from operating activities		
Net profit before interest		65,000
Adjustments for:		
Depreciation	4,310	
Profit on sale of non-current assets	(1,200)	
Amortisation of capital grant	(5,000)	
Changes in working capital:		
Inventory	(19,780)	
Receivables	13,450	
Prepayments	(4,730)	
Payables	(17,820)	
		(30,770)
Cash generated from operations		34,230
Interest paid	0	
Tax paid	(9,230)	
		(9,230)
Net cash from operating activities		25,000
Cash flows from investing activities		
Payment to acquire non-current assets	(21,200)	
Receipt from sale of non-current assets	9,780	
Net cash used in investing activities		(11,420)
Cash flows from financing activities		
New bank loans	8,300	
Proceeds of share issue, incl premium	4,200	
Dividends paid	(2,450)	
Proceeds from capital grant	3,100	
Net cash used in financing activities		13,150
Increase in cash and cash equivalents		26,730
Cash and cash equivalents at start of year		(2,300)
Cash and cash equivalents at end of year		24,430

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QUESTION 5 *(Cont'd)*

Requirement

Draft a report to the bookkeeper and in this report you should explain the following:

i. the adjustments made to 'net profit before interest' for non-cash items.

ii. the movements in the following working capital items, identifying in each situation whether the item has increased or decreased:

1. Receivables
2. Payables

3. non-current asset activities during the year, including how these activities may have been financed.

11 Marks

(b)

IAS 1 *Presentation of Financial Statements* states that with the exception of the Statement of Cash Flow financial statements must be prepared on an accruals basis.

i. Define the accruals concept as discussed in IAS 1.

2 Marks

ii. Identify the journal entries required to account for a credit sales transaction (£/€15,000) and the corresponding revenue receipt (£/€12,000) at a later date, the balance to be written off.

5 Marks

Presentation: 2 Marks

Total 20 Marks

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QUESTION 6

Management at ECCLES Limited have completed the draft accounts for the year ended 31 December 2011 and have asked you to review the books and records to identify any errors or omissions. You have identified the following transactions that must be provided for before finalising the accounts for the year.

1. The company gives warranties at the time of sale to all customers who purchase their product. Under the terms of sale the company undertakes to make good, by repair or replacement, manufacturing defects that occur within one year from the date of sale. Based on past experience, 10% of sales resulted in goods being returned due to manufacturing defects. A new quality control manager has been employed and is confident that the 10% rate of returns can be reduced to 5%. No entries were made to record the provision in the books and records of the company. Sales revenue for the year is £/€450,000.

2. The company constructed a new factory during the year and incurred the following costs, none of which have been accounted for:

	£/€
Site preparation	134,500
Materials	372,000
Labour	642,000
Architect fees	128,000
General administration	83,000
Industrial dispute	23,000
Re-design costs	46,000

   During the project it was discovered that the original design needed to be amended with the associated costs amounting to 8% of material costs and 5% of labour. The cost of an industrial dispute that arose during construction amounted to 3% of labour costs after the deduction of re-design costs. The factory should be depreciated at a rate of 5% per year on cost. No entries were made to record the above costs. The Company charges a full year's depreciation in the year of acquisition.

3. A capital grant of £/€250,000 was received prior to year end in respect of the newly constructed factory.

4. Inventory at year end includes both slow moving and obsolete goods. The slow moving goods are included at a value of £/€52,000, however it is expected that they can only be sold at a discount warehouse for 75% of their value. Commission costs of 5% will be incurred. The obsolete goods are made up of 500 identical units which cost £/€75 each. These goods have been included in inventory at cost price. On the last day of the financial year, 50 units of this stock were sold for £/€56 each however the sales manager believes that he can achieve a higher price of £/€81 per unit in the coming year. No entries were made to record the sale or the necessary changes to the value of closing inventory.

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QUESTION 6 *(Cont'd)*

Requirement

Prepare the journal entries to show how the above items should be dealt with in the final accounts for the year ended 31 December 2011. You should use your understanding of the relevant IAS's in dealing with each item.

N.B. *Notes to journals are required. You are **NOT** required to prepare T accounts.*

18 marks
Presentation: 2 marks
Total 20 marks

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2nd Year Examination: May 2012

Advanced Financial Accounting

Suggested Solutions

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

(a)

Marks Allocated

i. True and fair view

The term true and fair has never been defined by the courts however it would appear that in order for a set of accounts to give a true and fair view of the financial performance, position and cash flows of an entity they must comply with both International Financial Reporting Standards (IFRS's) and Company Law. **3**

In very rare circumstances entities may chose not to comply with the provisions of accounting standards. This occurs where compliance with the standard together with additional disclosure would not result in a fair presentation and is referred to as the true and fair override.

Financial reporting standards tend to deal with how the various figures in the financial statements should be calculated while the Company Law tends to focus on how the information should be presented to users. This is how both the standards and law work together to ensure that the information presented in financial statements is true and fair and therefore can be relied upon by users of financial information as the basis for making decisions regarding the company.

ii. Describe the role played by each of the following regulatory bodies:

1. The International Accounting Standards Board (IASB)
2. The IFRS Interpretation Committee
3. The IFRS Advisory Council

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Solution 1 *(Cont'd)*

IASB

The IASB has responsibility in two main areas:

- Issuing new International Financial Reporting Standards (IFRS). An IFRS will sometimes contain more than one permitted accounting treatment for a transaction or event. One of the permitted accounting treatments will usually be designated the most appropriate treatment. The other permitted treatments are classified as allowed alternative treatments.

- Approving interpretations developed by the IFRS Interpretations Committee.

The IASB has 16 members drawn from around the world. The IASB has full control over developing and setting its own agenda, the IFRS Foundation considers this agenda but does not have the power of determination.

The IFRS Interpretation Committee 4

The IFRS Interpretation Committee is comprised of 14 members and is responsible for the following:

- Interpreting the application of IFRSs and providing timely guidance on financial reporting issues not specifically addressed in IFRSs or IASs.
- Undertaking other tasks as requested by the IASB.
- Publishing Draft Interpretations for public comment and considering comments made within a reasonable period before finalising an Interpretation.
- Reporting to the IASB and obtaining IASB approval for final Interpretations.

4

IFRS Advisory Council

The IFRS Advisory Council ('the Council') provides a forum for participation by organisations and individuals interested in international financial reporting. There are between 30 and 40 members of the Council including representatives from national standard setters. The role envisaged for national standard setters in the future is for them to become part of the Council that will feed into the setting of new standards. The main objectives of the Council are as follows:

- To advise the IASB on the technical agenda and to prioritise the IASBs work
- To inform the IASB of the views of the organisations and individuals on the Council on major standard setting projects
- To give other advice to the IASB

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Solution 1 *(Cont'd)*

(b)

The Sarbanes-Oxley Act

Corporate failures in the US in 2001/2002, which had far reaching implications across both the business world and accounting profession, resulted in the issues of corporate governance and corporate ethical behaviour coming under close scrutiny. The US government addressed the concerns raised and problems identified by enacting the Sarbanes-Oxley Act 2002 ('the Act'). This Act is very prescriptive and lays down a number of rules and regulations which companies must follow to ensure that they behave in an ethical manner. Under this rules based approach a minimum standard of ethical behaviour is established.

5

This Act therefore forms the basis of the US's rules based approach to ethical behaviour and good corporate governance.

The main provisions of the Act are as follows:

1. The Chief Executive Officer ('CEO') and the Chief Financial Officer ('CFO') are required to take personal responsibility for the accuracy of the company accounts.
2. If the financial statements need to be re-stated due to non-compliance with accounting standards then the CEO and CFO have to repay any bonuses which they received in the previous twelve months.
3. Companies (other than banks) cannot lend monies to company directors or executives under any circumstances.
4. The consulting work that can be performed by the company's auditors is significantly reduced/eliminated.
5. Directors and senior executives cannot trade shares in the company during blackout periods. These blackout periods run from 15 days prior to the announcement of quarterly results to two days after the announcement of the results.
6. Public companies must review the internal controls around their financial reporting function every year and maintain evidence that this review has taken place.

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Solution 2

MCQ

1.	d	**1 ½**
2.	a	**1 ½**
3.	b	**1 ½**
4.	d	**1 ½**
5.	c	**1 ½**
6.	b	**1 ½**
7.	c	**1 ½**
8.	d	**1 ½**
9.	b	**1 ½**
10.	a	**1 ½**

Workings:

(8)

1,500,000 / 0.75 = 2,000,000
2,000,000 x 0.05 = €100,000 (d)

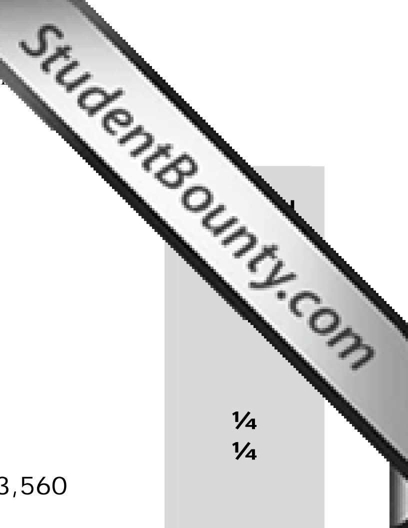
(9)

Inventory	58,000 – 32,000	= (26,000)
Receivables	197,000 – 216,000	= 19,000
Accruals	12,000 – 40,000	= (28,000)
Payables	170,000 – 150,000	= 20,000
Prepayments	42,000 – 12,000	= (30,000)

Changes in working capital **(45,000)** (b)

(10)

$$\frac{(58{,}000 + 197{,}000 + 42{,}000)}{(12{,}000 + 170{,}000)} = \frac{297}{182} = \mathbf{1.63 : 1} \text{ (a)}$$



Solution 3

EDGEWARE Limited

(a) Closing inventory

Avg gross margin	30%			
	£/€			¼
Sales	832,860			¼
sales returns	(19,300)	813,560		
Opening inventory	302,800			¼
Purchases	362,750			¼
Purchases returns	(21,670)			¼
Cost of goods avail for sale	643,880			
Closing inventory	**(74,388)**		(3)	1
		569,492	(2)	¼
Gross profit	30%	244,068	(1)	½

(b) Receivables

Receivables / Credit sales x 365 = 70 — ½

Receivables = (832,860 – 19,300) x 70 / 365 — ½

156,025 — 1 ½

Payables

Payables / Credit purchases x 365 = 96 — ½

Payables = (362,750 – 21,670) x 96 / 365 — ½

89,709 — 1 ½

Expenses

Sales		813,560	
Expenses as % sales		25%	
Total expenses		203,390	1
Distribution	50%	101,695	1
Administration	50%	101,695	1

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Solution 3 *(Cont'd)*

Ordinary dividend

	£/€	Marks Allocated
Share capital	440,000	
Par value of ea share	0.50	
Number of shares	880,000	½
Dividend per share	£/€0.05	
Ordinary dividend	44,000	**1 ½**

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Solution 3 *(Cont'd)*

EDGEWARE Limited
Statement of Comprehensive Income for the year ended 31 December 2011

	£/€	Marks allocated
Sales revenue	813,560	1
Cost of sales (w.3)	(569,492)	See working
Gross profit	244,068	
Administration costs (w.5)	(101,695)	½
Distribution costs (w.6)	(101,695)	½
	40,678	
Interest	(23,000)	½
Profit on ordinary activities before tax	17,678	
Taxation	(6,187)	½
Profits on ordinary activities after taxation	11,491	1 ½
	Presentation	1

Statement of Changes in Equity

	Ordinary share capital £/€	Share premium £/€	Retained earnings £/€	Total equity £/€	
As at 1 January 2011	440,000	36,000	208,610	684,610	1 ½
Profit for the year			11,491	11,491	½
Ordinary dividends			(44,000)	(44,000)	½
Balance as at 31 Dec 2010	440,000	36,000	176,101	652,101	1
				Presentation	1

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Solution 3 *(Cont'd)*

Workings

1 Cost of sales	**£/€**	**£/€**	**Al**
Opening inventory		302,800	½
Purchases	362,750		½
Less: purchase returns	(21,670)	341,080	½
Closing inventory		(74,388)	½
		569,492	

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Solution 4

ELWOOD Limited

Statement of Financial Position as at 31 December 2011

	£/€'000	£/€'000	Al
Non-current assets			
Property, plant & equipment		2,680	2 ¼
Intangible assets		520	¼
Other financial assets		660	¼
Current assets			
Inventories	900		¼
Receivables	846		1 ¼
Prepayments	185		¼
Cash and cash equivalents	425		1
		2,356	
Total assets		***6,216***	
Equity and liabilities			
Capital and reserves			
Ordinary share capital	950		¼
Revaluation reserve	180		¾
Retained profits	1281	2,411	2 ½
Non-current liabilities			
Debentures		2590	¼
Current liabilities			
Payables	565		¼
Corporation tax	360		¼
Accruals	290	1215	¼
Total equity and liabilities		***6,216***	
		Presentation	*2*

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Solution 4 *(Cont'd*

Workings

1 Non-current assets

	Cost	Acc dep	NBV
Land (w2)	740		740
Freehold premises	1,575	345	1,230
Plant and equipment (w5)	820	340	480
Motor vehicles	375	145	230
	3,510	830	2,680

2 Land

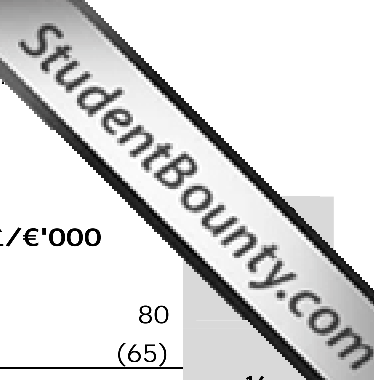
	£/€'000
Balance per trial balance	800
Revaluation	(60)
	740
Revaluation reserve	240
Land revaluation	(60)
	180

3 Receivables

		£/€'000	
Per trial balance		960	
Additional bad debts		(20)	
		940	
Provision for doubtful debts (10%)	10%	(94)	
Revised receivables		846	
Allowance for doubtful debts per trial balance		110	
Revised allowance		94	
Decrease in allowance		(16)	½

4 Retained profits

	£/€'000
Opening balance	860
Profit for year	440
Add decrease in allowance for doubtful debts	16
Additional bad debts	(20)
Loss on disposal	(15)
	1,281



Solution 4
(Cont'd)

5	**Non-current asset disposal**	**£/€'000**	
	NBV	80	
	Sales proceeds	(65)	
	Loss on sale	15	½
	Plant and equipment per Trial Balance	980	
	Less machine sold	(160)	
	Revised plant and equip at cost	820	
	Plant and equip acc depr	420	
	Machine sold	(80)	
	Revised acc depr	340	

6	**Cash and cash equivalents**	**£/€'000**
	Cash at bank	130
	Sale proceeds	65
	Revised cash balance	195
	Short term investments	230
		425

(b)
(i)

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. **3**

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.

The gearing ratio of a company is calculated as follows:

Non-current liabilities x 100
Share capital + reserves + non-current liabilities

(ii)

Elwood's gearing ratio is 52%* which means that for every £/€1 invested in the business 52 pence/cent of it came from borrowed funds, that is more than half the funds invested came from debt. While this is not a negligible level of debt it is not at a critically high level unless of course the company was unable to service this debt. In this situation the annual interest charge on debentures is £/€259,000 and after tax profits for the year under review were £/€440,000. This means that after servicing the debt and providing for the annual tax charge the company had £/€440,000 profits remaining which shows that the company can comfortably service existing debt with sufficient profits to service higher levels of debt. **4**

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Solution 4 *(Cont'd)*

Some of the disadvantages of a highly geared company are as follows:

1. Companies with high levels of gearing normally find it more difficult to borrow than companies with low gearing.
2. Interest on debt must be paid every year regardless of profits whereas there is no such obligation to pay dividends on ordinary shares.
3. Higher levels of debt results in higher interest charges and less funds available for the ordinary shareholders.

However there are some advantages to having higher gearing levels:

1. Interest is tax deductible whereas dividends are not.
2. When debt is used to finance the business instead of equity the ownership of the business is less diluted that businesses with low levels of gearing.

In conclusion, while Elwoods Limited has a relatively high level of gearing it is generating sufficient profits to service the debt and still has profits available to make a dividend distribution to shareholders. Therefore I would not consider the current gearing levels to be too high and would like to review profit forecasts to determine whether the company can continue to service current and possibly higher debt levels.

**** Gearing ratio***

Non-current liabilities	2,590
Share capital	950
Revaluation reserves	180
Retained profits	1,281
Total	5,001

2590 / 5001 x 100 = 51.8%

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Marks Allocated

Solution 5

(a)

TO : A. Bookkeeper

FROM : An Assistant

DATE : 20 March 2012

RE : Cash flow statement

Following our recent conversations I have prepared the following note based on a sample cash flow statement (see attached). In my notes below I have addressed the areas identified by you as those areas which you find most confusing.

Adjustments made to 'net profit before interest' for non-cash items:

The Statement of Comprehensive Income usually contains transactions which have no effect on the cash flow of the business, these items are referred to as non-cash items. As the cash flow statement is only concerned with items that affect the cash flow of the business the impact of these items on profits must be reversed. The most common non-cash item is depreciation which reduces profits but does not result in any cash leaving the business.

In the attached example the net profit before interest is adjusted for the following three non-cash items:

i. **Depreciation** : the company has purchased, in the past, non-current assets which must be depreciated on an annual basis in order to assign the cost of the asset to profit over the useful life of the assets. The Statement of Comprehensive Income ('SOCI') includes a depreciation charge of £/€4.3 million which must be added back to profit as no cash actually left the business. **1 ½**

ii. **Profit on sale of non-current asset**: The Company sold a non-current asset during the year for an amount which was greater than the net book value of the asset. This resulted in a profit on the sale which was included in 'Other Income' in the SOCI. The sale of a non-current asset does have a cash impact however this affects the Statement of Financial Position ('SOFP') and not the SOCI which records the realised gain on the sale not the actual proceeds received. Accordingly the profit on sale must be deducted from the profit. **1 ½**

iii. **Capital grant**: Capital grants are often received from the Government to contribute towards the cost of capital expenditure. Such grants are recorded as deferred income in the SOFP and amortised on an annual basis in order to allocate the grant income over the useful life of the non-current asset to which it relates. In effect the amortisation of capital grants is very similar to the depreciation of non-current assets and has no effect on the cash flow of the business. However, unlike depreciation grant amortisation increases profits and therefore should be deducted from profits. **1 ½**

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Solution 5 *(Cont'd)*

Movements in working capital items

i. Receivables 2

Receivables have *decreased* in the current accounting period.

The decrease in receivables between accounting periods is added because when receivables decrease it means that customers are paying the company and this has a positive effect on the cash flow of the business. Similarly an increase in receivables must be subtracted from profits. This affects the cash position of the company but not profits and therefore to move from profit to cash an adjustment must be made for the change in receivables.

ii. Payables 2

Payables have *decreased* in the current accounting period.

The decrease in payables between accounting periods is subtracted because when payables decrease it means that the company is paying its suppliers. Accordingly a decrease in payables has a negative impact on cash as more cash is flowing out of the company. This affects the cash position of the company but not the profit figure and therefore to move from profit to cash an adjustment must be made for the change in payables.

Non-current asset activities during the year

'Payments to acquire non-current assets' refers to the cash used to purchase non-current assets during the accounting period. In this situation the Company spent £/€21.2 million purchasing non-current assets during the year and these assets were financed through a range of financing activities including new bank loans (£/€8.3 million), new shares issued (£/€4.2 million) and a capital grant (£/€3.1 million). Further finance was also raised through the sale of non-current assets (£/€9.78 million) which generated a profit on sale of £/€1.2 million. Using this information we know that the net book value of non-current assets disposed of was £/€8,58 million. 2 ½

Accordingly during the accounting period non-current assets increased by £/€12.6 million (21.2 – 8.58) before depreciation.

I hope the above is helpful. Please contact me should you wish to discuss further.

Kind regards

An. Assistant

Presentation **2**

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Solution 5 *(Cont'd)*

Marks Allocation

(b)

i. Accruals concept

Financial statements, with the exception of the cash flow statement, are prepared on the accruals basis of accounting where transactions are recognised in the period in which they take place irrespective of the when the cash flow arising from these transactions occurs. **2**

ii. Journals

		£/€	£/€	Marks
Dr	Receivables (SOFP)	15,000		2
CR	Sales (SOCI)		15,000	
	[Accounting for credit sales transaction]			
DR	Bank (SOFP)	12,000		1 ½
CR	Receivables (SOFP)		12,000	
	[Being receipt of amount owing by debtor]			
DR	Bad debt expenses (SOCI)	3,000		1 ½
CR	Receivables		3,000	
	[Being bad debt written off]			

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Solution 6

Eccles Limited

			DR	CR	A
1.	Dr	Product repairs (SOCI)	22,500		2
	Cr	Provisions (SOFP)		22,500	
		[Customer warranty provision]			

As there is still a possibility that the actual volume of repairs necessary will be 10% a contingent liability should be disclosed for the additional 5% that has not been provided for.

			DR	CR	
2.	DR	Non-current assets (SOFP)	1,196,343		3
	CR	Bank/trade payables (SOFP)		1,196,343	
		[Capitalising construction costs of new factory]			
	DR	Factory expenses (SOCI)	232,157		2
	CR	Bank/trade payables (SOFP)		232,157	
		[Costs associated with construction of new factory which cannot be capitalised]			
	DR	Depreciation (SOCI)	59,817		2
	CR	Accumulated depreciation (SOFP)		59,817	
		[Depreciation of new factory]			
3.	DR	Bank (SOFP)	250,000		2
	CR	Deferred income (SOFP)		250,000	
		[Receipt of capital grant]			
	DR	Deferred income (SOFP)	12,500		2
	CR	Other income (SOCI)		12,500	
		[Annual amortisation of capital grant]			
4.	DR	Inventory (SOCI)	14,950		2
	CR	Inventory (SOFP)		14,950	
		[Write down of slow moving goods to NRV]			
	DR	Inventory (SOCI)	12,300		3
	CR	Inventory (SOFP)		12,300	
		[Write down of obsolete inventory to NRV]			
		Presentation			2

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Solution 6 *(Cont'd)*

Workings

(2)

Material 372,000 – 29,760 (8%) = 342,240

Labour 642,000 – 32,100 (5%) = 609,900 – 18,297 (3%) = 591,603

Costs to be capitalised:

Materials	342,240
Labour	591,603
Site preparation	134,500
Architect fees	128,000
Total	**1,196,343**

Costs to be charged to Statement of Comprehensive Income

Materials	29,760
Labour	50,397 (32,100 + 18,297)
General admin	83,000
Industrial dispute	23,000
Re-design	46,000
TOTAL	**232,157**

(4)

Slow moving stock:

52,000 x 75% = 39,000
39,000 x 5% commission = 1,950

Amount to be realised is:

39,000 – 1,950 = 37,050

Therefore, inventory needs to reduced by:
52,000 – 37,050 = **14,950**

Obsolete goods:

50 units x 75 = 3,750

Revised NRV is 56 per unit, write down per unit is (75 – 56) 19

450 units x 19 = 8,550

3,750 + 8,550 = **12,300** Reduction in inventory valuation

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2nd Year Examination: May 2012

Advanced Financial Accounting

Examiner's Report

Statistical Analysis – By Question						
Question No.	1	2	3	4	5	6
Average Mark (%)	33%	64%	61%	53%	60%	47%
Nos. Attempting	866	894	881	772	601	397

Statistical Analysis - Overall	
Pass Rate	64.5%
Average Mark	53%
Range of Marks	**Nos. of Students**
0-39	176
40-49	144
50-59	234
60-69	220
70 and over	122
Total No. Sitting Exam	**896**
Total Absent	121
Total Approved Absent	33
Total No. Applied for Exam	1050

General comment

Overall students performed very well in this exam resulting in an increase in the average pass rate from 2011. However the theory question, Q1, continues to cause difficulties for many students and as a result has a significant impact on the overall performance for many students. This was certainly the question on the paper that made the difference between an overall pass and a fail or a pass and a credit. Apart from this question students performed particularly well in this exam with no obvious black spots.

It is worth emphasising at this stage the importance of workings. Many students continue to submit their exam scripts without workings. Whilst those correcting exam scripts can go so far to determine the student's intention they cannot always re-create and therefore students lose valuable marks that they otherwise should be awarded.

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Note: Following the exam, a substantial amount of feedback was received about th difficulty of this paper from both students and lecturers, particularly in respect of Q3 & Q5. An independent review of the standard of these questions and a sample of scripts indicated that the questions were fair and appropriate to the level of the course. It also indicated that no unusual trend was observed. Furthermore, the statistics for both Q3 and Q5 did not indicate any general difficulty with either question and the overall subject pass rate shows an improvement on 2011.

Further to a review of this information, the Board of Examiners was satisfied that the paper was fair and that the standard required was appropriate.

Question 1

As shown in previous years, students perform poorly in theory questions and this year is no exception, students either knew the theory or they didn't and therefore struggled to piece together an answer. The question, which covered three distinct topics, was designed to give students the opportunity to pick up marks for even limited knowledge of each area. However the wider scope still failed to deliver high results. Students must gain a better understanding of the theory elements of the syllabus and an appreciation of the impact it has on their overall exam performance.

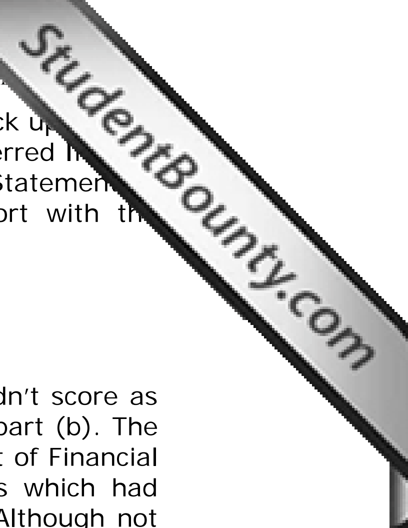
A disappointing high number of students still failed to describe adequately what is meant by 'True and fair view'. Very few correctly identified the need for financial statements to comply with both International Financial Reporting Standards and Company Law in order to give a true and fair view of an entity's financial performance. Students made reasonable attempts at discussing the three regulatory bodies identified in part (a ii) however there was an obvious lack of clarity in the solutions presented. Part (b) of the question asked students to prepare a note in relation to the Sarbanes-Oxley Act 2002. When examined in 2011, this topic was met with a poor response and unfortunately no greater understanding of the area was shown this year. Students either got it right or struggled, with many discussing practices such as profit smoothing and/or the importance of internal controls instead of discussing corporate governance and ethical behaviour.

Question 2

This question brought out the best in students delivering the highest average mark. Students were a lot more comfortable and capable in relation to parts 6 to 10 however less comfortable in parts 2 to 5, perhaps due to the fact that the latter parts were less computational and more theoretical in nature. A surprising trend that became obvious was one that showed the majority of students answering part 6 correctly (identifying the journal entries required to record the receipt of a capital grant) yet many of these students struggled when asked to prepare the same journal in Q6.

Question 3

This was the second best answered question on the exam. While many students calculated closing inventory correctly they did so in quite a roundabout way. Students who struggled with part (b) did so as a result of not knowing the correct ratio formula. It was disappointing to see a significant number of students determining that receivables and payables were equal to net credit sales and net credit purchases respectively. Most students correctly calculated the dividend paid.



Part (c) of the question was less taxing and therefore allowed students to pick up marks with relative ease. The most common error was the inclusion of 'Deferred In €44,200' as other income in the SOCI, this should only appear in the Statement of Financial Position. It was good to see a much greater level of comfort with the Statement of Changes in Equity than in previous years.

Question 4

This question was the most popular optional question however students didn't score as highly as perhaps they had expected to largely due to the requirements of part (b). The most common errors involved including non-current assets in the Statement of Financial Position at cost instead of net book value, deducting irrecoverable debts which had already been deducted and incorrectly accounting for the asset disposal. Although not required many students calculated debenture interest and included it in current liabilities.

Part (b) of the question tested the students understanding of gearing and the results were very mixed with only a few students scoring highly in this part. Many students confused gearing with the working capital ratio and therefore resorted to discussing the ratio between current assets and current liabilities and not the relationship between debt and equity.

Question 5

This question delivered the best result in the optional questions. The main focus of this question was the Statement of Cash Flows however 7 of the 20 marks available tested the students understanding of the accruals concept and journal entries.

Most students presented a reasonably good report discussing the sample Statement of Cash Flows. The weakest area was part (i), which required students to discuss the adjustments made for non-cash items with the most common incorrect answer discussing interest and tax charges in the Statement of Comprehensive Income and not depreciation, profit on sale of asset and the amortisation of capital grants. It was disappointing to see students correctly identifying the cash inflow from receivables as a decrease yet incorrectly identifying the cash outflow from payables as an increase. Students showed a very good understanding of the cash flows from investing and financing activities and had little difficulty discussing each.

Part (b) of the question asked students to define the accruals concept. It was disappointing to see students who performed well in other questions struggle with what was quite a basic journal entry requirement. Students should note that unless specifically requested students should not attempt to calculate and account for the VAT implications of transactions presented.

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Question 6

This question tested the student's ability to prepare journals and was the least favoure[d] optional question. The overall average mark for this question was 48% (2011: 50%).

As stated previously this is a difficult question to score well in if the student is weak at journal entry and therefore should be avoided. Part (4) of the question caused the most difficulty, with very few students gaining full marks for this part. Students need to break the requirement down into its individual parts and carefully identify what has already been accounted for and what has yet to be accounted for. Rather than accounting for the reduction in value most students accounted for the revised value ignoring the fact that the goods were already included in inventory at year end.

The most common error in part (2), which related to capitalising costs, was the addition instead of subtraction of redesign costs from materials and labour costs. It was disappointing to see a high percentage of students capitalise general administration costs, these costs are disallowed under IAS 16. However overall students made good attempts at calculating the costs to be capitalised and accordingly were awarded some marks for their efforts.