Accounting Technicians Ireland



# Advanced Financial Accounting

2nd Year Examination

**August 2012**

**Exam Paper, Solutions & Examiner's Report**

Professional. Practical. Proven.

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Accounting Technicians Ireland

# Accounting Technicians Ireland

## 2nd Year Examination: Autumn 2012

## Paper : ADVANCED FINANCIAL ACCOUNTING

Monday 20th August 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 either terminology when preparing financial statements but the use of the language of the International Accounting Standards (e.g. Receivables rather than Debtors) is preferred.

**SECTION A**

**Answer ALL THREE Questions in this Section**

**QUESTION 1** *(Compulsory)*

(a) The IASB is responsible for issuing new international financial reporting standards (IFRS).

i. What are 'accounting standards'?

**3 Marks**

ii. List the six steps involved in the standard setting process and describe any four of these steps.

**12 Marks**

(b) IAS1 *Presentation of Financial Statements* describes how the financial statements of an entity should be presented and sets down a number of provisions with respect to the preparation of financial statements.

Briefly describe any two of the following provisions:

- Accruals concept;
- Going concern;
- Offsetting;
- Materiality and aggregation.

**5 Marks**

**Total 20 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.***

**Requirement**
Indicate the right answer to each of the following TEN parts.

**Total 15 Marks**

**N. B.** ***Each part carries 1.5 marks.***
*Candidates should answer this question by ticking the appropriate boxes on the special answer sheet which is obtained in the Answer booklet.*

**[1]** Chapter three of *The Framework for the Preparation and Presentation of Financial Statements* lists four qualitative characteristics of financial information, what are they?

**[a]** Understandability, relevance, reliability and materiality.
**[b]** Consistency, relevance, reliability and comparability.
**[c]** Understandability, relevance, reliability and comparability.
**[d]** Understandability, relevance, comparability and objectivity.

**[2]** A change in the estimated useful economic life of a non-current asset, due to improvements in technology that will render the asset obsolete in a shorter time frame, will require an adjustment being made to the annual depreciation charge. Under the terms of IAS 8 *Accounting Policies, Change in Accounting Estimates and Errors* this change is an example of:

**[a]** a change in accounting estimate and a change in accounting policy.
**[b]** a change in accounting policy.
**[c]** a prior period error.
**[d]** a change in accounting estimate.

**[3]** Which of the following is **not** a provision of the Sarbanes-Oxley Act 2002?

**[a]** The CEO and CFO are required to take personal responsibility for the accuracy of company accounts.
**[b]** Public companies must review the internal controls around their financial function every five years.
**[c]** 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 that they received in the previous 12 months.
**[d]** Companies, other than banks, cannot lend monies to company directors or executives under any circumstances.

**QUESTION 2** *(Cont'd)*

**[4]** Company A has an authorised ordinary share capital of £/€2,400,000 and an issued ordinary capital of £/€1,200,000. Each share has a par value of £/€0.75. An ordinary dividend of £/€0.0 was paid at year end. What is the total value of the dividend paid?

- **[a]** £/€80,000
- **[b]** £/€60,000
- **[c]** £/€160,000
- **[d]** £/€120,000

**[5]** Which of the following statements is true?

- **[a]** When a company liquidates the ordinary shareholders are entitled to receive their capital back before preference shareholders.
- **[b]** A preference shareholder has a vote at the AGM of the issuing company.
- **[c]** When a company liquidates the preference shareholders are entitled to receive their capital back before trade creditors.
- **[d]** A preference shareholder does not have a vote at the AGM of the issuing company.

**[6]** Which of the following is the correct treatment for an upward asset revaluation?

- **[a]** Debit non-current asset account, credit Statement of Comprehensive Income.
- **[b]** Debit revaluation reserve, credit non-current asset account and no disclosure in Statement of Comprehensive Income.
- **[c]** Debit non-current asset account, credit revaluation reserve and amount to be shown on face of Statement of Comprehensive Income.
- **[d]** Debit revaluation reserve and credit Statement of Comprehensive Income.

**[7]** IAS 16 *Property, Plant and Equipment* defines the cost of an asset as all costs necessary to bring the asset to working condition for its intended use. Which of the following best describes the costs that may be included as part of the initial cost of an asset?

- **[a]** purchase price including import duties, borrowing costs, professional fees, delivery costs.
- **[b]** purchase price before import duties and rebates, borrowing costs, delivery costs.
- **[c]** purchase price including import duties, borrowing costs, delivery costs.
- **[d]** purchase price before import duties and after rebates, borrowing costs, professional fees, delivery costs.

**QUESTION 2** *(Cont'd)*

**[8]** Drawings made during the year by a partner in a partnership should be:

- **[a]** included as a revenue in the partnership statement of comprehensive income.
- **[b]** included as an expense in the partnership statement of comprehensive income.
- **[c]** debited to the partner's current account.
- **[d]** credited to the partner's current account.

**[9]** In the year ended 31 December 2011 Company A received £/€50,000 in the form of a grant towards the purchase of plant and equipment which is to be depreciated evenly over a four year period. Company A also received £/€15,000 in the form of a grant towards the cost of training staff to use the new equipment. What amount should recorded in the Statement of Comprehensive Income for the year ended 31 December 2011 in respect of grant income?

- **[a]** a debit of £/€65,000
- **[b]** a credit of £/€65,000
- **[c]** a debit of £/€27,500
- **[d]** a credit of £/€27,500

**[10]** Finished goods inventory is valued at £/€220,000 and is made up of 4,000 identical units. Inventory has been valued at cost, which includes variable manufacturing overheads of £/€12.50 per unit, administration overheads of £/€6.00 per unit and selling costs of £/€3.50 per unit. Sales price per unit at year end was £/€52.00. What is the correct inventory valuation?

- **[a]** £/€ 182,000
- **[b]** £/€ 196,000
- **[c]** £/€ 208,000
- **[d]** £/€ 206,000

**QUESTION 3** *(Compulsory)*

EXCELLENCE Limited runs a health and fitness business in Ireland. Due to an upturn in demand for gymnasiums it acquired two buildings that it fit out to a high standard. The buildings cost a total of £/€850,000 and the plant and equipment cost a total of £/€370,000. All costs were incurred during the year ending 31 December 2011. EXCELLENCE Limited depreciates its buildings at 5% pa on a straight line basis and its plant and equipment at 15% on a reducing balance basis. A full year's depreciation is charged in the year of acquisition.

During the year ending 31 December 2011 the company applied for, and received, a Government grant for 30% of the building costs and 25% of the plant and equipment costs. The company also received £/€25,000 towards the cost of training staff to use the new equipment. Training costs incurred amounted to £/€55,000.

The Company has not yet accounted for any of the above transactions.

**Requirement**

(a) Prepare the journal entries to show how all the above items will be dealt with in the accounts for the year ended 31 December 2011. You should use your understanding of the relevant IASs when dealing with each item.

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

**10 Marks**

(b) Prepare an extract from the Statement of Cashflows of EXCELLENCE Limited for the year ended 31 December 2011 to show how the information above affects this statement.

**4 Marks**

(c) Prepare an extract from the Statement of Financial Position of EXCELLENCE Limited to show how the information above affects this statement.

**5 Marks**

(d) Explain the circumstances that must exist before a government grant can be recognised in the Statement of Comprehensive Income as set out in IAS 20 *Accounting for Government Grants*.

**4 Marks**
**Presentation: 2 Marks**
**Total 25 Marks**

## SECTION B

**Answer TWO of the THREE questions in this Section**

## QUESTION 4

**(a)**

Alpha, Beta and Gamma are in partnership sharing profits in the ratio 4:3:2. Beta has a guaranteed minimum profit of £/€30,000. The following information is available for the partnership for the year ended 31 December 2011.

| | | | |
|---|---|---|---|
| Profit for the year | **£/€**83,600 | | |
| | **Alpha** | **Beta** | **Gamma** |
| | **£/€** | **£/€** | **£/€** |
| Drawings | 12,000 | 8,200 | 4,100 |
| Salary | 3,200 | 12,000 | 3,200 |
| Balance on capital accounts 31 December 2010 | 7,500 | 22,300 | 17,200 |
| Balance on current accounts 31 December 2010 | 1,750 | 2,150 | 1,900 |

Interest on drawings is charged at 10% per annum.

Interest on capital is paid at 5% per annum.

**Requirement**

(a) Prepare the appropriation account for the year ended 31 December 2011.

**3 Marks**

(b) Prepare the partners' current accounts for the year ended 31 December 2011.

**3 Marks**

(c) A client of yours is hoping to be appointed a partner in an existing partnership however he has no experience in this area and has asked you to advise him.

Prepare an explanatory note for your client to explain the following:

i) Partnership agreement.
ii) Partnership Act 1890.
iii) Capital account.
iv) Current account.

**8 Marks**

**(b)**

Define each of the following terms providing an example for each:

i. Intangible assets
ii. Goodwill

**4 Marks**
**Presentation: <u>2</u> Marks**
**Total <u>20</u> Marks**

**QUESTION 5**

The following are the Summary Income Statement, Statement of Financial Position and Summary Cash Flow Statement of EDMONSTOWN Limited for the year ended 31 December 2011 (with comparative figures for the year ended 31 December 2010 where relevant).

**Summary Income Statement for the year ended 31 December 2011**

| | 2011 | 2010 |
|---|---|---|
| | £/€'000 | £/€'000 |
| Revenue (credit sales) | 59,500 | 48,670 |
| Cost of sales* | (44,100) | (39,240) |
| Gross profit | 15,400 | 9,430 |
| Less expenses | (10,600) | (6,340) |
| Net profit before interest & tax | 4,800 | 3,090 |
| *Purchases for each year | 43,707 | 32,850 |

**Summary Statement of Cash Flow as at 31 December 2011**

| | £/€'000 |
|---|---|
| Net cash flow from operating activities | 7,270 |
| Net cash flow from investing activities | (6,100) |
| Net cash flow from financing activities | (7,200) |
| Net movement in cash and equivalents | (6,030) |
| Cash and equivalents at beginning of period | 7,980 |
| **Cash and equivalents at end of period** | **1,950** |

**QUESTION 5 CONTINUED OVERLEAF**

**QUESTION 5** *(Cont'd)*

**Statement of Financial Position as at 31 December 2011**

| | 2011 £/€'000 | 2011 £/€'000 | 2010 £/€'000 | 2010 £/€'000 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Non-current assets | | 13,870 | | 8,340 |
| Current assets | | | | |
| Inventory | 6,980 | | 4,130 | |
| Receivables | 6,220 | | 7,560 | |
| Cash in hand | 1,950 | | 7,980 | |
| | | 15,150 | | 19,670 |
| **Total assets** | | **29,020** | | **28,010** |
| **EQUITY & LIABILITIES** | | | | |
| Share capital and reserves | | | | |
| Ordinary share capital | | 8,120 | | 8,120 |
| Retained earnings | | 6,920 | | 4,230 |
| | | 15,040 | | 12,350 |
| Noncurrent liabilities | | | | |
| 10% debentures | | 1,000 | | 8,200 |
| Current liabilities | | | | |
| Payables | 9,960 | | 5,850 | |
| Other accruals | 3,020 | | 1,610 | |
| | | 12,980 | | 7,460 |
| **Total equity and liabilities** | | **29,020** | | **28,010** |

**Requirement**

(a) Calculate two ratios for the two years ended 31 December 2011 and 2010 in respect of each of the following categories of ratios:

i. Profitability
ii. Liquidity
iii. Efficiency

**12 Marks**

(b) Based on the ratios calculated above and the financial information available, prepare a note explaining the reasons why the bank balance as at 31 December 2011 has decreased so significantly at the same time that turnover and profitability have increased.

**6 Marks**
**Presentation: 2 Marks**
**Total 20 Marks**

**QUESTION 6**

EDWARDS Limited is a manufacturing company producing sports equipment. The company produced the following trial balance for the year ended 31 December 2011:

**Trial balance as at 31 December 2011**

| | **DR £/€'000** | **CR £/€'000** |
|---|---|---|
| Ordinary shares (of £/€0.50 ea) | | 24,000 |
| Share premium | | 9,600 |
| Retained earnings at 1 January 2011 | | 8,420 |
| Premises | 37,200 | |
| Premises accumulated depreciation | | 120 |
| Plant and equipment | 22,200 | |
| Plant and equipment accumulated depreciation | | 7,680 |
| Motor vehicles | 1,800 | |
| Motor vehicles accumulated depreciation | | 380 |
| Goodwill | 4,200 | |
| Inventory at 1 January 2011 | 4,900 | |
| Trade receivables | 6,200 | |
| Trade payables | | 4,500 |
| Sales revenue | | 35,600 |
| Sales returns | 500 | |
| Purchases | 23,800 | |
| Purchase returns | | 110 |
| Administration expenses | 880 | |
| Distribution expenses | 1,030 | |
| Bank term loan | | 18,000 |
| Loan interest | 780 | |
| Short term investments | 1,300 | |
| Cash at bank | 2,370 | |
| Tax | 1,230 | |
| Bad debt provision | | 260 |
| Ordinary dividend paid | 280 | |
| | **108,670** | **108,670** |

***The following additional information was also available:***

1. Depreciation is to be provided for as follows:

| | |
|---|---|
| Premises | 2% per year on cost |
| Plant & equipment | 5% per year on cost |
| Motor vehicles | 15% reducing balance |

25% of depreciation on premises to be charged to both administration and distribution.

**QUESTION 6** *(Cont'd)*

2. Inventory at the year end was valued at £/€4,680,000. Included in inventory at year end are goods which cost £/€500,000. Due to a downturn in demand these goods were sold at auction on 15th January 2012 for £/€300,000. Auctioneer's fees were 3% of sales proceeds.

3. On 6th January 2012 goods that had been ordered from a supplier on 20th December 2011, costing £/120,000, were received. These goods are not included in the trial balance above.

4. The company entered into a five year lease for new office furniture equipment on 1 January 2011. The company has to make five annual payments of £/€30,000, payable in advance, on the first day of the year. The present value of the minimum lease payments is £/€125,096. The interest rate implicit in the lease is 10%. No aspect of this transaction has been included in the Trial Balance.

5. Included in receivables is a balance of £/€90,000 that is considered a bad debt. The directors have decided that the provision for bad debts should be 8% of receivables at year end. The bad debt must be written off and the relevant adjustment made to the bad debt provision.

6. Prepaid insurance costs of £/€125,000 were incorrectly debited to distribution expenses.

**Requirement**

(a) Prepare ECCLES Limited's Statement of Comprehensive Income for the year ended 31 December 2011 in a form suitable for publication.

**N.B.** *You must submit your workings to show the make-up of the figures in the Statement of Comprehensive Income.*

**16 Marks**

(b) Briefly explain the reasons for your treatment of the goods received in January 2012 as per note 3 above.

**2 Marks**

**Presentation: 2 Marks**

**Total 20 Marks**

# 2nd Year Examination: August 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.

**Marks Allocated**

## Solution 1

**(a)**
**What are accounting standards?**

Accounting standards are a set of rules that describe how an item in financial accounting is treated and calculated and how accounts should be prepared and presented. The objective of accounting standards is to regulate the accounting profession and to provide guidance to both accounting practitioners and users of financial information about how contentious and difficult areas should be treated. **3**

Accounting standards are issued by a national or international body of the accounting profession and are intended to apply to all financial accounts which are intended to give a true and fair view of the financial position and profit/loss of an entity. Standards are detailed working regulations within the framework of government legislation and they cover areas in which the law is silent.

**Standard setting process**

The standard setting process involves six steps and a consultation process which involves interested parties and organisations from around the world. **2 (for listing six steps)**

The six steps are discussed below:

**2 ½**

1. Setting the agenda

This step in the process involves deciding what area in financial accounting needs to be addressed through a standard. When deciding if an item should be added to the agenda the IASB considers the following factors:

i. the relevance of the information to users
ii. the reliability of the information which would be provided
iii. existing guidance in the area
iv. whether the new item increases the possibility of convergence and resource constraints.

**2 ½**

2. Planning the project

Once an item has been added to the agenda the next decision to be made is whether the IASB should undertake the project alone or in conjunction with another body such as the ASB in Ireland or the UK. Once this has been determined a project team is assembled.

3. Developing and publishing the discussion paper

The purpose of a discussion paper is to solicit early comment from interested parties in an effort to ensure all issues are identified and discussed. A discussion paper will usually contain the following elements: **2 ½**

i. a detailed overview of the issue stating why a standard is required in this area
ii. different potential approaches for dealing with the issue
iii. preliminary views of the IASB on dealing with the issue, and
iv. an invitation to comment on the issue.

4. Developing and publishing the exposure draft **2 ½**

Once the IASB has received and discussed all comments received a draft standard is prepared detailing a specific proposal for dealing with the issue. The draft standard is then issued to interest parties for consideration and comment.

**(students required to discuss any four of six steps)**

5. Developing and publishing the standard

Once the exposure draft has been issued comments will be received by the IASB on the proposed treatment. The IASB may then decide that it is satisfied with the proposed treatment and a draft IFRS is drawn up. This draft IFRS is referred to as a pre-ballot draft. The pre-ballot draft is normally subjected to external review which is usually undertaken by IFRIC. IASB members are then balloted and if the ballot is in favour of the publication of the standard then the IFRS is issued.
Where the IASB is not satisfied that it is in a position to agree on the proposed treatment then a second exposure draft may be issued suggesting a revised treatment of the item in question.

6. After the standard is issued

The process is not complete once the standard is issued. At this stage the IASB hold further meetings with interested parties in order to understand any unanticipated issues relating to the practical application of the standard.

**(b)**

**a. 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 ½**

**b. Going concern**

Financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Foreseeable future is considered to be twelve months from the date the financial statements are signed. In the event that management decide that it is no longer appropriate to prepare the financial statements on a going concern basis this must be disclosed. **2 ½**

**(students required to discuss two of four parts (a) to (d) )**

**c. Offsetting**

Under IAS 1 assets and liabilities and income and expenditure may not be offset against one another unless required or permitted by a financial reporting standard. This is one reason why current assets and current liabilities are shown separately on the Statement of Financial Position and not offset against one another. If items in the financial statements were offset this would compromise the understandability and comparability of accounts both between accounting periods and between entities. It would also make it more difficult for users to make reliable and informed economic decisions based on the financial information made available.

**d. Materiality and aggregation**

Information is material to a set of financial statements if its omission or misstatement could influence the economic decisions of users. However some transactions are deemed to be material by their very nature for example, all transactions involving a company and a director of that company are deemed to be material regardless of the value of the transaction. With respect to aggregation, each material class of similar items must be presented separately in the financial statements. Items of dissimilar nature should be presented separately unless they are immaterial.

**Solution 2** **A**

**MCQ**

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

**(Note: No marks are allocated to workings in a multi-choice question)**

**Workings**

(4)

| | |
|---|---|
| Issued shares | 1,200,000 |
| Par value of shares | £/€0.75 |
| No. shares | 1,600,000 (1,200,000 / 0.75) |
| Dividend per share | £/€0.05 |
| Total dividend | £/€80,000 (1,600,000 x 0.05) **(a)** |

(9)

| | |
|---|---|
| Capital grant | £/€50,000 |
| No. yrs amortization | 4 yrs |
| Annual amortization | £/€12,500 (50,000 / 4) |
| Revenue grant | £/€15,000 |

Grant recognized in income statement £/€27,500 (12,500 + 15000) **(d)**

(10)

| | |
|---|---|
| Finished goods inventory | £/€220,000 |
| No. units | 4,000 |

Inventory to be valued at lower of cost or NRV

| | |
|---|---|
| Cost per unit | £/€55.00 (220,000 / 4,000) |
| Deduct costs incorrectly incl in costs: | |
| Admin overheads | (£/€6.00) |
| Selling costs | (£/€3.50) |
| Corrected costs price | **£/€45.50** |
| NRV | |
| Selling price | £/€52.00 |
| Less selling costs | (£/€3.50) |
| Corrected selling price | **£/€48.50** |

Inventory valuation

4,000 units x 45.50 £/€182,000 **(a)**

## Solution 3 - EXCELLENCE Limited

**(a)**

| | | **DR** | **CR** | **Marks allocated** |
|---|---|---|---|---|
| DR | Non-current assets at cost a/c (SOFP) (w1) | 1,220,000 | | |
| CR | Bank (or payables) a/c (SOFP) | | 1,220,000 | |
| [Being purchase of buildings and plant and equipment] | | | | |
| DR | Depreciation (SOCI) (w2) | 98,000 | | **2** |
| CR | Accumulated depreciation account (SOFP) | | 98,000 | |
| [Being annual depreciation charge on new noncurrent asset] | | | | |
| DR | Bank (SOFP) (w3) | 347,500 | | **2** |
| CR | Deferred income | | 347,500 | |
| [Being receipt of capital grants] | | | | |
| DR | Deferred income (SOFP) (w4) | 26,625 | | **2** |
| CR | Other income (SOCI) | | 26,625 | |
| [Being release of capital grant to income statement] | | | | |
| DR | Training expenses (SOCI) | 55,000 | | **1** |
| CR | Bank/payables (SOFP) | | 55,000 | |
| [Being payment of training costs incurred] | | | | |
| DR | Bank (SOFP) | 25,000 | | **1 ½** |
| CR | Training costs (or other income) | | 25,000 | |
| [Being receipt of grant in respect of employee training costs incurred] | | | | |

**Workings:**

1. Noncurrent account purchases

Buildings 850,000 + plant and equipment 370,000 = 1,220,000

2. Depreciation

| | |
|---|---|
| Buildings | 850,000 x 5% = 42,500 |
| Plant and equipment | 370,000 x 15% = 55,500 |
| **Total** | **98,000** |

3. Grant income

| | |
|---|---|
| Buildings | 850,000 x 30% = 255,000 |
| Plant and equipment | 370,000 x 25% = 92,500 |
| **Total** | **347,500** |

4. Grant amortisation

| | |
|---|---|
| Buildings | 255,000 x 5% = 12,750 |
| Plant and equipment | 92,500 x 15% = 13,875 |
| **Total** | **26,625** |

**Solution 3** *(Cont'd)*

Marks
located

**(b)**
Prepare an extract from the Statement of Cashflows of EXCELLENCE Limited for the year ended 31 Decem
2011 to show how the information above affects this statement

**EXCELLENCE Limited**
**Statement of Cashflows (extract)**

| | | £/€ | £/€ | |
|---|---|---|---|---|
| **Cash flows from operating activities** | | | | |
| Net profit before interest | | | X | |
| Adjustments for: | | | | |
| | Depreciation | 98,000 | | 1 |
| | Grant amortisation | (26,625) | | 1 |
| Changes in working capital | | | | |
| | Increase in inventory | (X) | | |
| | Increase in receivables | (X) | | |
| | Increase in payables | X | | |
| Interest paid | | (X) | | |
| Tax paid | | (X) | | |
| | | | X | |
| **Net cash flow from operating activities** | | | **X** | |
| **Cash flows from investing activities** | | | | |
| Payment to acquire non-current assets | | (1,220,000) | | 1 |
| Receipt from sale of non-current assets | | X | | |
| Capital grants received | | 347,500 | | 1 |
| Receipt from sale of non-current assets | | X | | |
| **Net cash flow from investing activities** | | | **(872,500)** | |
| | | | **Presentation** | 1 |

**Solution 3** *(Cont'd)*

| | Marks Allocated |
|---|---|

**(c)**
Prepare an extract from the Statement of Financial Position of EXCELLENCE Limited to show how the information above affects this statement.

**EXCELLENCE Limited**
**Statement of Financial Position (extract)**

| | £/€ | Marks |
|---|---|---|
| **Assets** | | |
| ***Non current assets*** | | |
| Property, plant and equipment (w.1) | 1,122,000 | 1 ½ |
| Intangible assets | X | |
| Other financial assets | X | |
| | | |
| ***Current assets*** | | |
| Bank (w2) | (902,500) | 2 |
| | | |
| **Equity and liabilities** | | |
| ***Non current liabilities*** | | |
| Deferred income | (320,875) | 1 ½ |

**Workings**

1 Noncurrent assets

| | |
|---|---|
| Assets purchased | 1,220,000 |
| Acc depreciation | (98,000) |
| | 1,122,000 |

2 Bank

| | |
|---|---|
| Non current asset costs | (1,220,000) |
| Training costs | (55,000) |
| Capital grants received | 347,500 |
| Revenue grants received | 25,000 |
| | (902,500) |

3 Non current liabilities

| | |
|---|---|
| Deferred income | 347,500 |
| Amortisation | (26,625) |
| | 320,875 |

**Presentation** **1**

Marks Allocated

**Solution 3** *(Cont'd)*

**(d)**

Explain the circumstances which must exist before a government grant can be recognised in the Statement of Comprehensive Income as set out in IAS 20 *Accounting for Government Grants*.

Government grants transfer economic benefit from the government to the recipient business and as such they can be seen as a form of income. The key issue to be determined is when should a government grant be recognised in the Statement of Comprehensive Income:

A grant should not be recognised until:

I. The conditions for its receipt have been complied with.

Most government grants will have some conditions attached, for example a business must employ a certain number of employees or be in operation in the country for a certain period of time. Until such time as the conditions are met the grant cannot be credited to the Statement of Comprehensive income.

II There is reasonable assurance that the grant will be received
This is consistent with one of the basic accounting concepts of prudence, which applies in situations of uncertainty, to ensure that assets are not overstated and liabilities are not understated.

When these conditions have been met all grants should be recognised in the Statement of Comprehensive Income to correspond with the expenditure to which they relate.

4

## Solution 4

Marks Allocated

### (a) Alpha, Beta, Gamma

**Appropriation account**

| | | | £/€ | £/€ | | Marks |
|---|---|---|---|---|---|---|
| Profit for the year | | | | 83,600 | | |
| Salaries | | | | | | |
| | Alpha | | (3,200) | | | |
| | Beta | | (12,000) | | | |
| | Gamma | | (3,200) | (18,400) | | ½ |
| Interest on drawings | | | | | | |
| | Alpha | | 1,200 | | | |
| | Beta | | 820 | | | |
| | Gamma | | 410 | 2,430 | | ½ |
| Interest on capital accounts | | | | | | |
| | Alpha | | (375) | | | |
| | Beta | | (1,115) | | | |
| | Gamma | | (860) | (2,350) | | ½ |
| | | | | 65,280 | | |
| Share of profit | | | | | | |
| | Alpha | 4 | 29,013 | (5,493) | **23,520** | ½ |
| | Beta | 3 | 21,760 | 8,240 | **30,000** | ½ |
| | Gamma | 2 | 14,507 | (2,747) | **11,760** | ½ |
| | | | **65,280** | | **65,280** | |
| | | | | | **Presentation** | 1 |

### (b)

| | A | B | G | | A | B | G | |
|---|---|---|---|---|---|---|---|---|
| | **£/€** | **£/€** | **£/€** | | **£/€** | **£/€** | **£/€** | |
| Drawings | 12,000 | 8,200 | 4,100 | Balance b/f | 1,750 | 2,150 | 1,900 | |
| Interest on drawings | 1,200 | 820 | 410 | Salaries | 3,200 | 12,000 | 3,200 | ½ |
| | | | | Interest on capital | 375 | 1,115 | 860 | ½ |
| Balance c/f | 15,645 | 36,245 | 13,210 | Share of profit | 23,520 | 30,000 | 11,760 | ½ |
| | 28,845 | 45,265 | 17,720 | | 28,845 | 45,265 | 17,720 | |

**Drawings** ½
**Interest on drawings** ½
**Closing balances** ½

**Presentation** 1

**Solution 4 (*Cont'd)***

**TO** : A Friend

**From** : Your Friend

**Date** : 30 March 2012

**RE** : Partnership

Following our recent discussions during which you explained that you hope to join an existing partnership I have prepared this note to explain some of the relevant terms in the context of partnerships.

***Partnership agreement***
When a partnership business is set up it is standard practice for a partnership agreement to be drawn up by the partners. This agreement sets out the rules governing how the partnership will operate eg profit sharing ratio between partners, the role each partner will play in the business, how much capital each partner must invest in the business. However there is no legal requirement for partners to draw up such an agreement and in the absence of such an agreement the Partnership Act 1890 applies. **2**

***Partnership Act 1890***
The main provisions of the Partnership Act are as follows: **2**

1. All profits and losses must be shared equally
2. All partners have the right to take part in the business
3. All partners have the right to prevent the entry of another partner
4. All partners have the right to examine the books of the partnership
5. No interest is paid on the capital advanced by each partner
6. No remuneration is paid to partners for acting in the business
7. All partners have the right to receive interest at 5% pa on loans and advances made to the partnership in excess of their capital subscription
8. Differences of opinion shall be settled by the majority of the partners but the nature of the business cannot be changed without the consent of all partners

***Capital account***
The capital account records the original capital invested into the partnership. There is a capital account set up for each individual partner and the account will generally remain fixed unless more capital is introduced, non-current assets are revalued or the goodwill of the partnership is crystallised and recognised. Thus the capital account records the long term element of each partner's capital and will always have a credit balance. **2**

***Current account***
The current account records the following: **2**

i. partner's share of profits/losses
ii. partner's drawings
iii. interest on any loans extended to the partnership
iv. interest on credit capital balances

The current account represents the short-term element of each partner's capital. Due to the nature of the elements of the current account, transactions will be posted on a regular basis. The current account will usually have a credit balance (ie partner has not withdrawn all of profits he/she was entitled to withdraw) but may have a debit balance (ie partner has withdrawn more profits than he/she was entitled to). The corresponding entry for all transactions posted to the current account is the appropriation section of the Statement of Comprehensive Income.

**Solution 4** *(Cont'd)*

**(b)**

*i.* *Intangible asset*

An intangible asset is an identifiable non-monetary asset without physical substance. An asset is a resource that is controlled by the entity as a result of past events and from which future economic benefits are expected to flow. For an asset to be considered as an intangible asset three critical features must exist: **1 ½**

1. Identifiable: the asset must be capable of being separated from other assets.
2. Control: an entity must have control of the asset, that is, the power to obtain benefits from the asset and prevent others from benefitting from the asset without an exchange of economic value between the parties.
3. Future economic benefits: the owner entity must be capable of deriving future economic benefits from the asset in the form of revenues or reduced costs.

**Example**: computer software, patents, copyrights. **½**

*ii.* *Goodwill*

Goodwill arises where the value of a business is greater than the total value of net assets as shown in the statement of financial position. Purchased goodwill arises when one company acquires another and the amount paid on acquisition is greater than the total value of net assets acquired. **1 ½**

The following examples can lead to the recognition of goodwill:

i. The expertise of employees **½**
ii. The reputation of a business and its products

## Solution 5

**EDMONSTOWN Limited**

**Ratio analysis**

| | | 2011 | 2010 | Marks allocated |
|---|---|---|---|---|
| **Profitability ratios** | | | | |
| Gross profit | (15400/59500)*100 | 25.9% | | 1 |
| | (9430/48670)*100 | | 19.4% | 1 |
| Net profit | (4800/59500)*100 | 8.1% | | 1 |
| | (3090/48670)*100 | | 6.3% | 1 |
| Expenses | (10600/59500)*100 | 17.8% | | (marks awarded to correct two ratios) |
| | (6340/48670)*100 | | 13.0% | |
| ROCE | (4800/(15040+1000))*100 | 29.9% | | |
| | (3090/(12350+8200)*100 | | 15.0% | |
| **Liquidity ratios** | | | | |
| Current ratio | (15150/12980) | 1.17 : 1 | | 1 |
| | (19670/7460) | | 2.64 : 1 | 1 |
| Acid test ratio | (15150 - 6980/12980) | 0.63 : 1 | | 1 |
| | (19670 - 4130/7460) | | 2.08 : 1 | 1 |
| **Efficiency ratios** | | | | |
| Receivable days | (6220/59500)*365 | 38.2 days | | 1 |
| | (7560/48670)*365 | | 56.7 days | 1 |
| Payable days | (9960/43707)*365 | 83.2 days | | 1 |
| | (5850/32850)*365 | | 65 days | 1 |
| | | | **Presentation** | 1 |

Marks Allocated

**Solution 5** *(Cont'd)*

**(b)**

**TO** : AB Bankers
**FROM** : Finance Director, Edmonstown Limited
**RE** : Profitability versus cash flows

As discussed during our recent telephone conversation the turnover and profitability of the company improved significantly during the year ending 2011, however, there was a deterioration in the liquidity position and the bank balance decreased from £/€8 m to £/€2 m.
I have set out below the reasons why the improved profitability did not result in a corresponding improvement in the bank position:

***Cash flow statement***
As can be seen from the financial statements the company was very profitable in 2011 and this in turn generated a high level of cash flow from operating activities (£/€8.3 m) which the company used to finance investment in noncurrent assets. Whilst this investment should generate significant additional cash flow in future years for now it has had a negative impact on current cash flows.
The company also used current cash flow and the opening bank balance to repay debenture loans leaving a balance on long term debt of only £/€1 m at the end of the year.
The combined effect of the cash inflow from operations and cash outflow in relation to noncurrent assets and repayment of debenture loans was a net cash outflow for the year of £/€5 m.

***Liquidity***
As can be seen from the Statement of Financial Position the receivables balance has decreased despite the increase in turnover. This can also be seen in the receivables days ratio which has fallen from 57 to 38 days. This would imply that the company has tightened its credit terms and/or put pressure on debtors to pay early. This strategy was probably undertaken to ensure cash levels did not fall below a certain level and that the company could finance the purchase of long term assets and repayment of long term loans out of working capital.
Payables days have increased from 65 to 83 days and therefore it would appear that while the company is shortening its receivables days it is squeezing the current liabilities to avail of additional credit. The combined effect of these changes can be seen by looking at the liquidity ratios which show a worsening liquidity position.

***Comments***
It is concerning that the company is putting so much pressure on its working capital and that it is financing long term investments and repaying long term debt out of cash flow generated from operations. Although the financial information is only available for two years it appears that the company is well placed to avail of long term finance which it should use to finance long term investments. This would then leave the company with sufficient cash to finance operations and eliminate the need to put such significant strain on the receivables, payables and accruals.

6

**Presentation** 1

## Solution 6

...ks
...ed

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

| | £/€ |
|---|---|
| Sales revenue (w.8) | 35,100 |
| Cost of sales (w.1) | (25,601) |
| Gross profit | 9,499 |
| Administration costs (w.6) | (1,410) |
| Distribution costs (w.7) | (1,304) |
| | 6,785 |
| Interest | (790) |
| Profit on ordinary activities before tax | 4,566 |
| Taxation | (1,230) |
| Profits on ordinary activities after taxation | 4,766 |

**Solution 6** *(Cont'd)*

Marks Allocated

*****Included for completeness purposes only****

**EDWARDS LIMITED**

**Statement of Financial Position as at 31 December 2011**

| | | |
|---|---|---|
| | | £/€ |
| ***Non-current assets*** | | |
| premises | | 36,336 |
| plant and equipment | | 13,410 |
| motor vehicles | | 1,207 |
| leased assets | | 100 |
| goodwill | | 4,200 |
| | | 55,253 |
| ***Current assets*** | | |
| inventory | 4,471 | |
| receivables | 5,621 | |
| short term invest | 1,300 | |
| prepayments | 125 | |
| cash at bank | 2,340 | |
| | | 13,857 |
| **Total assets** | | **69,110** |
| **Equity and liabilities** | | |
| **Equity and reserves** | | |
| ordinary share capital | | 24,000 |
| Share premium | | 9,600 |
| retained profit* | | 12,906 |
| | | 46,506 |
| **Non-current liabilities** | | |
| term loan | | 18,000 |
| **Current liabilities** | | |
| payables | 4,500 | |
| fin lease | 105 | |
| | | 4,605 |
| **Total equity and liabilities** | | **69,110** |

***Retained earnings**

| | |
|---|---|
| Op retained earnings | 8,420 |
| Add profit | 4,766 |
| Less dividend | (280) |
| | 12,906 |

**Solution 6** *(Cont'd)*

**Workings**

**1 Cost of sales**

| | £/€ | £/€ | Marks Allocated |
|---|---|---|---|
| Opening inventory | | 4,900 | |
| Purchases | 23,800 | | ¼ |
| Less: purchase returns | (110) | 23,690 | ¼ |
| Depreciation | | 1,482 | ¼ |
| Closing inventory | | (4,471) | ¼ |
| | | **25,601** | |

**2 Leased asset**

| | | | |
|---|---|---|---|
| PV of lease | | 125,096 | |
| No. Yrs in lease | | 5 | |
| **Annual depreciation charge** | | **25,019** | ½ |
| First yr interest charge | | | |
| PV of lease | | 125,096 | |
| 1st payment due 1 January 2011 | | (30,000) | |
| | | 95,096 | ½ |
| **1st yrs interest charge** | 10% | **9,510** | 1 |

**3 Closing inventory**

| | | | |
|---|---|---|---|
| Inventory at year end | 4,680 | | |
| Auctioned goods at cost | 500 | | |
| Sales value | | 300 | |
| Less auctioneer fees | 3% | (9 ) | |
| NRV | | 291 | ½ |
| Closing inventory | 4,680 | | |
| Less inventory overvaluation (500 - 291) | (209) | | 1 |
| Adjusted closing inventory | **4,471** | | ½ |

Goods arrived in January:

No adjustment as non-adjusting event as per IAS 10 ½

## Solution 6 *(Cont'd)*

| | | | Marks Allocated |
|---|---|---|---|
| **4 Provision for bad debts** | | | |
| Receivables | | 6,200 | |
| Less bad debt | | (90) | |
| | | 6,110 | |
| Yr end provision | 8% | 489 | ½ |
| Existing provision | | 260 | |
| Increase in bad debt provision | | **229** | ¾ |

**5 Depreciation**

| | Total | COGS | Admin | Distrib | Marks Allocated |
|---|---|---|---|---|---|
| Premises (2% pa on cost) | 744 | 372 | 186 | 186 | 1 |
| Plant & equip (5% pa on cost) | 1,110 | 1,110 | | | ¾ |
| Motor vehicles (15% pa red bal) | 213 | | | 213 | ¾ |
| | **2,067** | **1,482** | **186** | **399** | |

| | | Marks Allocated |
|---|---|---|
| **6 Administration expenses** | | |
| per trial balance | 880 | ¼ |
| bad debt | 90 | ½ |
| leased asset depreciation | 25 | ½ |
| increase in bad debt provision | 229 | ½ |
| depreciation | 186 | ½ |
| | **1,410** | |
| **7 Distribution** | | |
| per trial balance | 1,030 | ¼ |
| prepaid insurance | (125) | ½ |
| depreciation | 399 | ½ |
| | **1,304** | |
| **8 Sales revenue** | | |
| Sales per trial balance | 35,600 | ¼ |
| Less returns | (500) | ¼ |
| | **35,100** | |
| **9 Finance costs** | | |
| lease interest | 10 | ¾ |
| loan interest | 780 | ¼ |
| | **790** | |

**Solution 6** *(Cont'd)*

Marks Allocated

**(b)**

IAS 10 Events after the Reporting Period defines two types of events, adjusting and non adjusting events and sets down the appropriate accounting treatment for each. An adjusting event is an event after the reporting period that provides further evidence of conditions that existed at the end of the reporting period. A non adjusting event is an event after the reporting period that is indicative of a condition that arose after the end of the reporting period. The purchase and sale of goods in the ordinary course of business is a non adjusting event and therefore should not be provided for in the accounts for the year in which they were ordered. These goods will be included in purchases and payables in the year in which they were received. Once paid, the amount is transferred out of payables and the amount paid is credited to the bank accounts. **2**

# 2nd Year Examination: August 2012

# Advanced Financial Accounting

# Examiner's Report

| Statistical Analysis – By Question | | | | | | |
|---|---|---|---|---|---|---|
| **Question No.** | 1 | 2 | 3 | 4 | 5 | 6 |
| **Average Mark (%)** | 52% | 58% | 50% | 60% | 67% | 47% |
| **Nos. Attempting** | 227 | 229 | 229 | 151 | 151 | 155 |

| Statistical Analysis - Overall | |
|---|---|
| **Pass Rate** | 75% |
| **Average Mark** | 55% |
| **Range of Marks** | **Nos. of Students** |
| 0-39 | 23 |
| 40-49 | 34 |
| 50-59 | 80 |
| 60-69 | 63 |
| 70 and over | 29 |
| **Total No. Sitting Exam** | **229** |
| **Total Absent** | 32 |
| **Total Approved Absent** | 11 |
| **Total No. Applied for Exam** | 272 |

Once again there has been an improvement in the overall performance and in this particular case the improvement is significant. The average mark achieved was 55%, higher than the average mark of 45% for the Autumn sitting in 2011. There was also a considerable increase in the pass rate achieved which was 75%, again comparing favourably with the pass rate achieved at the Summer 2012 sitting (64%) and Autumn 2011 (40%).

The exam covered a large part of the syllabus with perhaps a higher than usual emphasis on narrative solutions. In terms of performance for individual questions the average mark was at least a pass in all cases with the exception of Q6. Overall students performed quite well with no obvious difficulties.

**Question 1 - Theory**

In previous reports it has been noted that it was the continuing poor performance in theory question that made the difference between a pass and a fail and a fail and credit for many students. It is no surprise, therefore, that the much improved performance in this question has had a significant impact on the overall pass rate.

This main focus of this question was on accounting standards and the standard setting process. Students who had studied this topic delivered a competent solution in a relatively short format and therefore gave themselves a positive start to the exam. It was relatively easy to score well in this question if the student was familiar with the topic, it was straight forward and required very little other than to restate the material as set out in the course manual.

Part (b) of this question asked students to describe two of four provisions relating to the preparation of financial statements. As expected most students discussed the first two provisions presented, accruals concept and going concern. These concepts have appeared on exams on numerous occasions in the past and therefore there is very little excuse at this stage for not being able to explain either in a coherent manner. Students should not resort to examples to explain definitions.

**Question 2 - MCQ**

Although the average mark for this question was a very respectable 58% (Autumn 2011: 62%) it was nonetheless slightly lower than achieved in recent sittings. The main difficulties identified in this question were very clearly part (9) and (10) both of which were computational style questions. Students may have been confused by the combination of computational and journal elements in part (9). However the confusion in part (10) was much clearer as the majority of students who answered this part incorrectly selected (c) as the correct answer. By doing so students ignored the fact that the inventory cost had been calculated incorrectly and needed to be adjusted before comparing it with the NRV.

Students need to be more comfortable with computational style questions appearing within the MCQ as they will continue to appear going forward.

**Question 3**

This question presented the students with a capital expenditure scenario and asked students to prepare the required journals and extracts from both the Statement of Cashflows and Statement of Financial Position. Overall students performed surprisingly well in the preparation of journals which a notable decline in the numbers preparing T accounts instead of journals. The journal entries for grant income continue to confuse and it is very clear that many students do not know where to include the credit entry for capital grants.

Students continued to make great effortsin respect of the topics in part (b) and many scoring well in these parts. However, again it was the capital and revenue income which caused the most difficulties.

Part (c) of the question required students to discuss when a grant can be recognised in the financial statements. For those who knew the answer it was an easy 4 marks, however for those who were less sure they wasted valuable time providing sometimes lengthy discussions on capital versus revenue grants.

**Question 4**

This question delivered the most mixed performance with students recording either very high scores or very low scores. Students struggled with the basic appropriation account and allocation of profit, with very few correctly accounting for beta's minimum profit share. The current account showed a less varied performance and overall students made reasonable attempts. In an effort to save time students should consider combining the current accounts into one account rather than showing three separate accounts. No marks are lost or won for showing three separate accounts, however valuable time may be lost.

Part (b) of the question asked students to prepare an explanatory note explaining some terms common to partnerships. This part did not appear to present any problem to students with some providing the correct information in a very concise format, which of course saved them some time for other questions.

Part (c) asked students to define *intangible assets* and *goodwill*. The definitions provided were quite mixed with very few clearly defining both correctly. The most common misconception in relation to goodwill is that it is an act of kindness undertaken by a corporate entity.

**Question 5**

This question delivered the best result in the optional questions, with students gaining an overall average mark of 67%. The main focus of this question was ratio analysis and the preparation of a note explaining the entity's financial performance.

13 of the 20 marks available were awarded for the calculation of ratios and where students knew the ratio formulas they obtained these marks quite easily. This is the main reason why students scored so well in this question. Marks were awarded where relevant ratios, other than those presented in the suggested solution, were correctly calculated.

In contrast Part (b) of the question saw a dramatic drop in performance with many students struggling to address the issue of improving profits and decreasing cash. Most students chose to discuss overall trading performance and paid very little attention to the decreasing bank balance and as a result very few students correctly identified the mismatch between uses and sources of finance. This was by far the weakest area of the exam.

**Question 6**

This question was more traditional in nature and examined the students ability to make necessary adjustments and prepare a Statement of Comprehensive Income. Unfortunately students scored the lowest average mark in this question (47%), which was disappointing given that this style of question appears quite frequently in exams.

The two areas that were most problematic for students were the accounting requirements for the leased equipment and the inventory sold at below cost. In relation to the leased asset very few students correctly calculated the interest charge and even fewer, if any, correctly calculated the annual depreciation charge. Where students correctly calculated either or both of the aforementioned charges very few knew how or where to account for them.

An additional requirement for 2 marks asked students to explain their treatment of goods ordered prior to year end but not received. A disappointing number of students included the goods at year end and relied on the accruals concept to support their treatment. However some students did correctly identify the purchase of goods in the ordinary course of business as a non-adjusting event and accordingly did not adjust for the inventory.