Accounting Technicians Ireland

Financial Accounting II

2nd Year Examination

August 2011

Paper, Solutions & Examiner's Report

Professional, Practical, Proven

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Accounting Technicians Ireland

2nd Year Examination: Autumn 2011
Paper : FINANCIAL ACCOUNTING II

Monday 15th August 2010 - 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 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.

Candidates may ignore any VAT implications to transactions throughout this paper unless the question specifically instructs them to do otherwise.

Question 1 begins on Page 2 overleaf.

The following insert is enclosed with this paper:

- **Multiple choice question answer sheet [QUESTION 2]**

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)*

Both companies and company directors have a number of duties and responsibilities, both internal and external, that have been the subject of much study and discussion following market developments and corporate scandals.

(a) Company directors use internal controls to discharge their duties in order to prevent and detect fraud and error. Describe the guidance provided by the Turnbull Report in relation to internal controls.

9 Marks

(b) Describe the role played by the internal audit department in assisting directors in their duty to prevent and detect fraud and error.

5 Marks

(c) Companies have a duty to the communities in which they operate to ensure that they operate in an ethical manner. Discuss the differences between the rules based approach to ethical behaviour and the principles based approach.

6 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.

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 specified green answer sheet which is supplied with the examination paper.

[1] The following definition from *The Framework for the Preparation and Presentation of Financial Statements* relates to which element in financial statements?

‘A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits’

[a] Income.

[b] Asset.

[c] Liability.

[d] Expense.

[2] Chapter two of *The Framework for the Preparation and Presentation of Financial Statements* lists two underlying assumptions upon which financial statements should be prepared, what are they?

[a] Going concern and accruals basis.

[b] Relevance and reliability.

[c] Understandability and comparability.

[d] Consistency and materiality.

QUESTION 2 *(Cont'd)*

[3] Which of the following is true in relation to a company's gearing ratio?

[a] It is useful because it measures the financial and operating risk of a company.
[b] It is useful because it measures the financial risk of a company.
[c] It is useful because it measures the operating risk of a company.
[d] A company with a high level of gearing has a low financial risk.

[4] Which of the following would give a valid calculation of a dividend yield ratio?

[a] (Earnings available to shareholders / number of shares issued) x 100
[b] (Earnings available to shareholders / market value of a share) x 100
[c] (Dividend per share / earnings available to shareholders) x 100
[d] (Dividend per share / market value of a share) x 100

[5] Which of the following is not included in the appropriation account of a partnership?

[a] partnership drawings.
[b] interest on capital accounts.
[c] interest on current accounts.
[d] partnership salaries.

[6] In the event that partners do not draw up a partnership agreement the Partnership Act 1890 applies and states that:

[a] All partners have the right to receive interest at 5% p.a. on capital advanced.
[b] Interest paid on capital advanced by each partner must be deducted before profits are appropriated between partners.
[c] No interest is paid on the capital advanced by each partner.
[d] All partners have the right to receive interest at 2% p.a. on capital advanced.

QUESTION 2 *(Cont'd)*

BACKGROUND INFORMATION TO PARTS [7] AND [8]

The extract below is from the Statement of Financial Position of Company B:

	31 Dec 2010	**31 Dec 2009**
	£/€	**£/€**
Inventory	88,000	64,000
Trade receivables	212,000	195,000
Bank	33,000	40,000
Trade payables	170,000	150,000
Bank overdraft	5,000	15,000

[7] What is the cash flow from 'Changes in Working Capital' for the year ended 31 December 2010 for inclusion in the Statement of Cash Flows in accordance with IAS 7?

[a] £/€21,000

[b] £/€(21,000)

[c] £/€(18,000)

[d] £/€18,000

[8] What is the movement in cash and cash equivalents for the year ended 31 December 2010?

[a] £/€ (24,000)

[b] £/€ (3,000)

[c] £/€ 3,000

[d] £/€ 24,000

QUESTION 2 *(Cont'd)*

[9] IAS 1 'Presentation of Financial Statements' states that a business should prepare its financial statements on the basis that the business is a going concern:

[a] if it is being liquidated.

[b] if it cannot continue in business for the foreseeable future.

[c] if the directors have no realistic alternative but to liquidate the entity.

[d] only if none of the above situations exist.

[10] The books and records of Company A show that during the year ended 31 December 2010 the following transactions took place:

	£/€
Cash purchase of inventory	108,000
Cash purchase of machinery	450,000
Profit on sale of machinery	23,000
Proceeds from sale of machinery	95,000

What is the 'Cash Flow from Investing Activities' for the year ended 31 December 2010 for inclusion in the Statement of Cash Flows in accordance with IAS 7?

[a] £/€ (355,000)

[b] £/€ (378,000)

[c] £/€ (487,000)

[d] £/€ (595,000)

QUESTION 3 *(Compulsory)*

Management at DUNHILL Limited (a VAT registered manufacturing company) have completed the draft year end accounts for the year ended 31 December 2010 but have asked you to review the books and records to identify any errors or omissions. You have identified the following issues that must be rectified before finalising the accounts for the year end 31 December 2010:

1. During the year the company bought, and paid for, a new machine which cost £/€300,000 plus VAT at 21%. The company received a grant of £/€75,000 towards the cost of the machine and £/€18,000 towards the cost of training staff how to use it. Plant and machinery is depreciated on a straight line basis over a ten year period with a full year's depreciation charged in the year of acquisition. No entries were made to record these transactions.

2. In early January 2011 management received correspondence from the liquidator of a substantial debtor that there would be no funds available for trade creditors. The Company was owed £/€35,700 from this debtor at year end, however it had made a specific provision against this debt for £/€15,000 which was provided for in the accounts. The Company's exposure to this debtor had increased by a further £/€12,000 at the time of this review.

3. Finished goods inventory, which is included in the financial statements, is made up of 5,000 units with a total value of £/€345,000. Management have confirmed that inventory has been valued at cost and cost price includes the following:

	£/€ per unit
General administration costs	3.50
Storage costs	3.10
Fixed manufacturing overheads	13.80

   Management have confirmed that the sales price for finished goods at year end was £/€61.00 per unit. You should ensure that inventory is valued correctly.

4. Prepaid insurance costs of £/€21,000 were incorrectly included in administration costs. This error was not identified by management as it was assumed to be rent of equal value which was outstanding at year end but omitted from the books and records in error.

Requirement

Prepare the journal entries to show how each of the above items should be dealt with in the final accounts for the year ended 31 December 2010. You should use your understanding of the relevant IAS's in dealing with each item.

23 Marks
Presentation: 2 Marks
Total 25 Marks

SECTION B

Answer TWO of the THREE questions in this Section

QUESTION 4

(a) What are the two types of lease defined by IAS 17 and describe how you would identify which category a lease falls into?

6 Marks

(b) IAS 2 provides clarity in relation to the accounting treatment of inventories. What is 'inventory' as defined by IAS 2 and how should it be valued?

6 Marks

(c) IAS 20 sets out how government grants should be treated in financial statements. What are the two types of grant discussed in IAS 20 and what is the recommended accounting treatment for each?

6 Marks
Presentation: 2 Marks
Total 20 Marks

QUESTION 5

DAGWOOD Limited is a construction company with an authorised share capital of £/€2,200,000 comprised of ordinary shares only.

The following trial balance was extracted as at 31 December 2010.

	DR £/€'000	CR £/€'000
Ordinary shares (of £/€0.50 ea)		1,500
10% debentures (repayable in 2020)		1,850
Share premium		250
Retained earnings at 1 January 2010		1,380
Freehold premises @ 31 December 2010	1,980	
Freehold premises accumulated depreciation		675
Furniture and fittings @ 31 December 2010	1,230	
Furniture and fittings accumulated depreciation		545
Motor vehicles @ 31 December 2010	520	
Motor vehicles accumulated depreciation		230
Long term investments	2,500	
Inventory at 31 December 2010	1,000	
Trade receivables	1,900	
Trade payables		250
Prepayments	200	
Deferred income		200
Corporation tax		400
Director's loan (repayable in 2015)		450
Debenture interest		230
Retained profit for year		1,780
Cash at bank	410	
	9,740	**9,740**

QUESTION 5 *(Cont'd)*

The following additional information is also available:

1. The above Trial Balance has been arrived at after charging depreciation for the year.

2. As a result of the changing economic climate management have decided that it would be prudent to make a provision for doubtful debts. Accordingly a provision of 10% of receivables should be provided for.

3. A final ordinary dividend of £/€0.075 per share should be provided for.

4. Deferred income is made up of grant income received in 2008 in relation to non-current asset acquisitions. This income should be released to income evenly over a 10 year period however, in error, no amount was released to income in the current year.

Requirement

(a) Prepare, in a form suitable for publication, the Statement of Financial Position for DAGWOOD Limited for the year ended 31 December 2010 in as far as the information permits.

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.*

13 Marks

(b) Prepare a note outlining your understanding of what the Statement of Financial Position tells you about DAGWOOD Limited and identify any areas requiring further investigation.

Note: Students are not required to prepare ratios to support their findings.

5 Marks
Presentation: 2 Marks
Total 20 Marks

QUESTION 6

The Statement of Comprehensive Income, Statement of Changes in Equity, Statement of Financial Position and other relevant information of DENBY Limited, for the year ended 31 December 2010, are as follows:

STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR END 31 DECEMBER 2010

	£/€'000
Revenue	2,625
Cost of sales	(1,721)
Gross profit	904
Other income	50
Administration	(355)
Distribution	(230)
Operating profit	369
Interest payable	(18)
Profit before taxation	351
Taxation	(172)
Profit after tax	**179**

STATEMENT OF CHANGES IN EQUITY

	Ordinary share capital £/€'000	Share premium £/€'000	Revaluation reserve £/€'000	Retained profits £/€'000	Total equity £/€'000
As at 1 January 2010	1,000	65	60	313	1,438
Net profit for year end 31/12/10				179	179
Share issue	24	6			30
Land revaluation			80		80
Ordinary dividend				(73)	(73)
As at 31 December 2010	1,024	71	140	419	1,654

QUESTION 6 *(Cont'd)*

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2010

	2010		**2009**	
	£/€'000	**£/€'000**	**£/€'000**	**£/€'000**
Non-current assets				
Tangible assets		1,585		1,407
Current assets				
Inventories	365		332	
Receivables	153		320	
Bank	24	542	35	687
		2,127		2,094
Equity and liabilities				
Share capital (£/€1 shares)		1,024		1,000
Share premium		71		65
Profit and loss		419		313
Revaluation reserve		140		60
		1,654		1,438
Non-current liabilities				
Long term loans		157		129
Current liabilities				
Payables	166		241	
Bank overdraft	115		230	
Corporation tax	35	316	56	527
		2,127		2,094

QUESTION 6 *(Cont'd)*

The following additional information was also available:

1. The depreciation charge for the year as per the financial statements was £/€27,000.

2. During the year, land that cost £/€140,000 was sold for £/€155,000. Following the sale of the land management re-valued the remaining land.

3. Following a review of the books and records it was noted that the financial statements contained the following errors:

   i. Distribution expenses include prepayments of £/€23,000.
   ii. The tax charge in the Income Statement includes depreciation of £/€7,000 that was included in error. This amount was not included in the depreciation charge in income statement, however it was included in accumulated depreciation account.

Requirement

Prepare a cash flow statement for DENBY Limited for the year ended 31 December 2010 in accordance with the requirements of IAS 7 Cash Flow Statement. Notes to the cash flow statement are not required.

18 Marks

Presentation: 2 Marks

Total 20 Marks

2nd Year Examination: August 2011

Financial Accounting II

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.

Suggested Solution 1

(a)
Describe the guidance provided by the Turnbull Report in relation to internal controls.

Internal control systems serve a critical role in the prevention and detection of fraud and error within companies of all sizes. In the UK the Turnbull Report ('Report'), which was first issued in 1999, deals with the importance of internal controls within public limited companies. This report has since been updated and now forms part of the Combined Code of Corporate Governance which deals with corporate governance and ethical issues within public companies.

The Report defines three types of internal controls and it is worth noting that the Report does not confine internal controls to just financial accounting. The three types of internal controls are discussed below:

Operational controls

> Operational controls are processes, tasks, policies, and actions that, combined together, help an organisation to operate effectively and efficiently to safeguard the assets of the company from inappropriate use and loss. Operational controls also help to ensure that all the assets and liabilities of the company are identified, recorded, and managed appropriately. Eg. Internal control system which records and monitors use of company cars and safeguards the assets from unauthorised use or theft.

Compliance controls

> Compliance controls are processes, tasks, policies and actions that, combined together, help an organization to ensure that it is aware of and complies with relevant external laws and regulations. These controls also help to ensure that the activities of the company comply with internal policies. Eg. Documented process and checking procedure to ensure that a company disposes of hazardous waste in accordance with legal requirements.

Suggested Solution 1 *(Cont'd)*

Financial controls

Financial controls are processes, tasks, policies and actions that, combined together, help to ensure the quality and integrity of the financial information which is produced both for internal and external reporting. Eg. Monthly bank reconciliations prepared by one person and approved by another.

(b)

Describe the role played by the internal audit department in assisting directors in their duty to prevent and detect fraud and error.

The role of the internal audit department is to help directors discharge their responsibility for the prevention and detection of fraud and error. The primary function of the internal audit department is to act as a monitor and appraiser of the processes, tasks, policies and actions that combined together contribute to the operational, compliance and financial internal control environment within a company.

The internal audit department, where one exists within a company, will examine the internal controls within an organisation to help determine if they are operating efficiently and effectively. Audit methods employed by the internal control department to gain comfort on the reliability of controls usually include spot checks on group companies or departments within companies to ensure that the controls that should be in place are actually in place and are working effectively.

The internal auditor has a much wider focus than that of the external audit which is to look at the internal operations of the entire business. The internal auditor must make sure that the operational, compliance and financial controls within a company are operating effectively.

Although the primary function of the internal audit department is to assist Company Directors to discharge their duties in respect of fraud and error the head of the internal audit department, known as the internal auditor, is employed by the company and therefore is not independent. However, the independence of the internal auditor can be improved by deciding to whom the internal auditor reports. If the internal auditor reports directly to an audit committee this is considered to be more independent and therefore objective than if it were to report to the head of the finance function on which it is reporting.

Accordingly the reporting line of the internal audit department is also an important factor when determining how effective the department is.

Suggested Solution 1 *(Cont'd)*

(c)

Company Directors also have an obligation to the communities in which they operate to ensure that the Company operates in an ethical manner. Discuss the differences between the rules based approach to ethical behaviour and the principles based approach.

Increasingly over time companies are seen to have a much greater role to play in society and accordingly companies have to look beyond the narrow goal of profit maximisation. Companies must now recognise that they have an obligation to the communities in which they operate to behave in an ethical manner.

Currently there are two competing schools of thought in relation to ensuring that companies behave in an ethical manner, the rules based approach and the principle based approach.

The rules based approach

This approach is based upon the idea that if we want companies to behave in an ethical manner rules must be set up and enforced to achieve this. The USA is a good example of a jurisdiction with a rules based approach. Here the rules, which companies must follow, are laid out in the Sarbanes-Oxley Act 2002 ('the Act') which was introduced following corporate failures in the USA. It is believed that by following these rules and regulations good corporate governance and ethical behaviour will follow.

The following are some of the main provisions of the Act:

i. The Chief Executive Officer ('CEO') and the Chief Financial Officer ('CFO') are required to take personal responsibility for the accuracy of the company accounts.
ii. 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 during the previous twelve months.
iii. Companies, other than banks, can not lend monies to company directors or executives under any circumstances.
iv. The consulting work that can be performed by the company's auditors is significantly reduced/eliminated.
v. Directors and senior executives cannot trade shares in the company during black out periods. These periods run from 15 days prior to the announcement of quarterly results to two days after days the announcement of the results.
vi. Public companies must review the internal controls around their financial reporting function every year and maintain evidence that this review has taken place.

The advantages of a rules based approach is that the decision as to whether or not to adopt ethical behaviour is taken out of the companies control and it establishes a minimum standard of ethical behaviour. Companies are free of course to implement more stringent ethical policies and procedures where they see fit.

Suggested Solution 1 *(Cont'd)*

The principles based approach

This approach takes the precision out of the process and prefers instead a code which should apply to all companies and the code should be made up of a set of principles rather than a set of exact rules. This principles based approach is the approach favoured in the UK and Ireland both of which have implemented The Combined Code of Corporate Governance ('Code'). This Code sets out a standard of good practice and ethical behaviour in relation to the following areas; board of directors composition, executive remunerations, accountability of directors, audits and relationships with shareholders.

Whilst it may be seen to deal with the same issues and the Sarbanes-Oxley Act the main difference is that the Code is a set of principles and not rules. While companies are expected to comply with guidelines they are not required to do so, companies are however required to comply with rules. In Ireland and the UK a 'comply or explain' approach has developed. Where companies decide not to comply with provisions of the Code they must notify shareholders and explain the reasons for not doing so. All public companies in Ireland and the UK are required to report on how they have applied provisions of the Code.

Note for students:

Solutions to parts (b) and (c) are longer than what would be required in the exam having regard to the marks allocated for each part. The solution is provided in such detail to act as a comprehensive study aid.

Suggested Solution 2

1. c
2. a
3. b
4. d
5. a
6. c
7.

Increase in inventory	(24,000)	
Increase in trade receivables	(17,000)	
Increase in payables	20,000	
Changes in working capital	(21,000)	(b)

8.

Movement in cash and cash equivalents

Opening position	(40,000 – 15,000)	25,000	
Closing position	(33,000 – 5,000)	28,000	
Movement in cash and cash equivalents		+3,000	(c)

9. d

10.

Purchase of machinery	(450,000)	
Proceeds from sale of machinery	95,000	
Net cash outflow	(355,000)	(a)

Suggested Solution 3

(1)

		DR	CR
DR	Plant & machinery	300,000	
DR	VAT recoverable	63,000	
CR	Bank		363,000

[Being purchase of new machine]

		DR	CR
DR	Depreciation (income statement)	30,000	
CR	Accumulated depreciation (B/S)		30,000

[Being calculation of depreciation on new machine]

		DR	CR
DR	Bank	75,000	
Cr	Deferred income/Government grants (B/S)		75,000

[Being receipt of government grant for capital costs incurred]

		DR	CR
DR	Bank	18,000	
Cr	Staff training costs/other income (income statement)		18,000

[Being receipt of government grant for training costs incurred]

		DR	CR
DR	Deferred income (B/S)	7,500	
CR	Grant released (income statement)		7,500

[Being release of capital grant to income statement]

(2)

		DR	CR
DR	Provision for doubtful debts (BS)	15,000	
CR	Bad debt provision (income statement)		15,000

[Being reversal of specific bad debt provision]

		DR	CR
DR	Bad debt (income statement)	35,700	
CR	Receivables (BS)		35,700

[Being write off of year end debtor balance]

No adjustment should be made in respect of the £/€ 12,000 arising after the date of the Statement of Financial Position as this is a non-adjusting event in accordance with IAS 10 'Events after the Reporting period'.

(3)

		DR	CR
DR	Inventory (income statement)	40,000	
CR	Inventory (B/S)		40,000

[Being write-down of inventory to NRV]

Suggested Solution 3 *(Cont'd)*

(4)	DR	Prepayments (BS)	21,000	
	CR	Administration (income statement)		21,000

[Being correction of prepayments included in administration in error]

DR	Administration (income statement)	21,000	
CR	Trade payables		21,000

[Being rent due at year end omitted from accounts in error]

Workings

(3)

Cost price per accounts 345,000 / 5000 = £/€69.00 per unit
Adjustments to cost price for disallowable costs

Cost per unit	69.00	
Less:		
Storage costs	(3.10)	
General admin costs	(3.50)	
Correct cost per unit		**£/€ 62.40**
NRV	**£/€ 61.00**	

Finished goods inventory should be valued at NRV (ie £/€ 61.00 per unit)

Revised inventory valuation (5,000 x 61) £/€ 305,000

Inventory write down £/€ 40,000

Suggested Solution 4

(a)

What are the two types of lease defined by IAS 17 and describe how you would identify which category a lease falls into?

IAS 17 defines two types of leases, a finance lease and an operating lease.

A finance lease is a lease that transfers substantially all the risks and rewards of ownership of an asset from the lessor to the lessee. Legal title of the asset may or may not eventually be transferred.

An operating lease is a lease other than a finance lease. IAS 17 states that it is the substance of the transaction rather than the legal form of the transaction which is the key to determining whether a lease is an operating or a finance lease.

IAS 17 identifies the following characteristics which would indicate that a lease is a finance lease and not an operating lease:

1. The lease transfers ownership of the asset from the lessor to the lessee by the end of the lease term.
2. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value of the asset at the date the option becomes exercisable.
3. The lease term is for a major part of the useful economic life of the asset, thus the lessee will hold the leased asset for the majority of its useful economic life.
4. On commencement of the lease, the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset. The threshold here is often taken as 90%.
5. The leased assets are of a specialised nature, such that, only the lessee can use them without major modifications being made.
6. If the lessee is entitled to cancel the lease, any losses suffered by the lessor as a result of the cancellation are borne by the lessee.
7. Gains or losses from the fluctuations in the residual fair value of the asset fall to the lessee.
8. The lessee has the ability to continue to lease the asset for a secondary period at a rent that is substantially lower than the market rent.

In summary, whilst not all of the above characteristics must be present in order for a lease to be classified as a finance lease, any of the above would suggest it is such. Where none of these characteristics are present then the lease is an operating lease.

Suggested Solution 4
(b)

IAS 2 provides clarity in relation to the accounting treatment of inventories. What is 'inventory' as defined by IAS 2 and how should it be valued?

Inventories, as defined by IAS 2, are assets:

(i) held for sale in the ordinary course of business (finished goods).
(ii) In the process of production for such sale (work in progress)
(iii) In the form of materials or supplies to be consumed in the production process or in the rendering of services (raw materials)

Inventory valuation

The fundamental principle of IAS 2 is that inventory should be valued at the lower of cost and net realisable value ('NRV').

NRV is the estimated selling price in the ordinary course of business, less all further costs that must be incurred to complete the production of the inventory item and all costs to be incurred to sell and distribute the good.

While NRV has been defined quite clearly, the determination of cost however is not as straightforward. IAS 2 provides guidance as to what can be classified and incorporated within the cost of inventory items. IAS 2 states that the cost of inventory should include the following:

(i) All costs of purchase (incl taxes, import duties, transport and handling) net of trade discounts.
(ii) Costs of conversion (incl fixed and variable overheads).
(iii) Other costs incurred in bringing the inventories to their present location and condition.

The following items are specifically excluded from inclusion as part of the cost of inventory items:

(i) Abnormal waste or spoilage
(ii) Factory idle time
(iii) Storage costs – except where storage costs are necessary in the production process before a further stage of production.
(iv) General administrative overheads
(v) Marketing and other selling costs

Suggested Solution 4
(c)

IAS 20 sets out how government grants should be treated in financial statements. What are the two types of grant discussed in IAS 20 and what is the recommended accounting treatment for each?

IAS 20 deals with two types of grants, revenue based grants and capital based grants.

Revenue based grants

These grants are in respect of short term expenditure incurred by a company. The related expenditure is short term in nature and is accounted for in the Statement of Comprehensive Income. An example of such expenditure is staff training costs.

IAS 20 allows for two possible treatments of such revenue based grants:

(i) The grant receivable can be shown in the Statement of Comprehensive Income as 'other income' or if material in nature can be shown as a separate line item, or
(ii) The grant receivable can be deducted from the related expenditure in the Statement of Comprehensive Income.

Capital based grants

Capital based grants are normally contributions towards the cost of acquiring non-current assets and are longer term in nature. The benefit received from capital grants is recognised in the Statement of Comprehensive Income over the life of the related non-current asset. By doing this the grant is matched to the expenditure to which it relates as capital expenditure is recognised over the useful life of the asset and not just the accounting period in which the cost was incurred. An example of such expenditure includes the purchase of a new factory or manufacturing plant.

IAS 20 allows for two possible treatments of capital based grants:

(i) The grant is recognised as deferred income on the Statement of Financial Position. Every year thereafter, over the useful life of the asset, a portion of deferred income is transferred to the Statement of Comprehensive Income, or
(ii) The value of the grant is deducted from the carrying value of the associated asset thereby reducing the annual depreciation charge provided for in the Statement of Comprehensive Income.

Although IAS 20 allows for two possible treatments the provisions of the Companies Acts in both Ireland and the UK guide the user away from treatment two above in favour of treatment one which shows non-current assets at cost price and does not provide for netting income (grant) and expenditure (depreciation) off against each other.

Suggested Solution 5

(a)

DAGWOOD Limited
Statement of Financial Position as at 31 December 2010

	£/€'000	£/€'000
Non-current assets		
Property, plant & equipment (W1)		2,280
Other financial assets		2,500
Current assets		
Inventories	1000	
Receivables (W3)	1710	
Prepayments	200	
Cash and cash equivalents	410	3,320
Total assets		***8,100***
Equity and liabilities		
Capital and reserves	1500	
Share premium	250	
Accumulated profits (W4)	2770	4,520
Non-current liabilities		
Debentures	1850	
Directors loan	450	
Deferred income (W5)	150	2,450
Current liabilities		
Payables	250	
Corporation tax	400	
Debenture interest	230	
Deferred income (W5)	25	
Dividend (W2)	225	1130
		8,100

Suggested Solution 5 *(Cont'd)*

Workings

1 Non-current assets

	Cost	**Acc dep**	**NBV**
Freehold premises	1,980	675	1,305
Furniture and fittings	1,230	545	685
Motor vehicles	520	230	290
	3,730	1,450	2,280

2 Dividend

	£/€
Share capital	1,500,000
Number of shares	3,000,000
Dividend per share	£/€0 075
Total dividend	225,000

3 Receivables

	£/€'000
Per trial balance	1,900
Provision for doubtful debts (10%)	190
Receivables	1,710

4 Retained profits

	£/€'000
Opening balance	1380
Profit for year	1,780
Less bad debts provision	(190)
Dividend payable	(225)
Grant income	25
	2,770

Suggested Solution 5
(Cont'd)

5 Deferred income

Per trial balance		200
No. yrs remaining		8 yrs
Annual amortisation		25
balance at yr end		175
< 1 yr	25	
> 1 yr	150	

(b)

The balance sheet, as the statement of financial position is more commonly known, provides information on the financial position of DAGWOOD Limited ('the Company'). Essentially the balance sheet is a list of the entities assets and liabilities and provides information on how the Company is financed.

Assets are resources owned by the Company from which future benefits accrue to the Company. The Company owns long term assets which are more permanent in nature and include premises, plant and machinery and motor vehicles. These assets are used by the company to undertake its construction business and generate profit, they are less liquid assets and accordingly are not easily converted into cash. The Company also owns a significant amount of long term investments which actually exceed its tangible non-current assets. Perhaps the business has decided to invest funds in 'safer' financial assets rather than business expansion due to the downturn in the construction market. It would be interesting to know what these financial assets comprise of, how recently they were invested in and on whose advice, internal or external.

The Company's current assets include more liquid assets which are easier to convert into cash within a short time frame. Inventories include the materials used by the company in its building activities. It is somewhat unusual that a construction company would have such a high level of inventory. Perhaps the company has purchased inventory for ongoing or upcoming projects. It would be important that the company do not invest too heavily in inventory which may be project specific and may be of little or no value if the specific projects to which it relates is postponed or even cancelled. A review of inventory should be undertaken to determine if it includes obsolete stock.

Receivables are amounts owing by debtors (customers) in respect of ongoing or completed building projects. Whilst we do not know if the receivables have increased or decreased since 2009 it would be worth investigating the make up and age of the individual receivable accounts. The 10% provision for doubtful debts may turn out to be very light and may need to be increased to allow for debts which have already gone 'bad' or are very likely to go this way.

Suggested Solution 5 *(Cont'd)*

Prepayments are amounts prepaid by the Company, it may include items such as insurance for 2011 which will be expensed in the next years financial statements. Cash and cash equivalents relate to the cash available to the Company and in this particular case is very healthy and reassuring. Management should ensure that where funds are higher than required on a day to day basis they are invested in some form of interest earning bank account, albeit one where funds are available on demand.

Liabilities are amounts owing by the Company as a result of past events. Liabilities include current liabilities which are short term in nature and include amounts which must be paid within the next twelve months. Non-current liabilities include amounts owing over a longer term such as debenture loans and in this case loans made to the Company by its directors. Deferred income is grant income already received by the company and invested in non-current assets. This income is released to income on an annual basis over an agreed number of years. The release of this income on an annual basis has no affect on the cash flow of the business.

Equity is made up of the funds the owners (shareholders) have invested in the business. In this particular situation the Company is financed by both debt (debenture and directors loans) and share capital however it is not highly geared and has no difficult meeting its annual interest charges. The issued share capital of the company is also lower than the authorized share capital and therefore in the event that the company decided to restructure its financing I would not expect that it would have any difficulty raising funds from share capital given its high level of profits and its dividend payments.

Current liabilities are made up of short term debts which fall due for payment within a twelve month period. Payables are particularly low and accordingly management should review their credit terms to make sure they are availing of all available credit and not paying creditors in advance of agreed payment terms. Having regard to the current assets and liabilities the working capital ratio of the company is just short of 3:1. While it is recommended that the working ratio of 2:1 is prudent, a ratio of 3:1 is not a particularly good sign. As discussed above a ratio of higher than 2:1 may indicate excess levels of inventory and receivables.

Note:
Solution (b) is longer than that which would be expected in an exam situation. The solution is provided in such detail to act as a study aid and to highlight the information available from a Statement of Financial Position.

Question 6

DENBY LIMITED
STATEMENT OF CASH FLOW FOR THE YEAR ENDED 31 DECEMBER 2010

	£/€ '000	£/€ '000
Cash flows from operating activities		
Net profit before interest (W1)		385
Adjustments for:		
Depreciation (W5)	34	
Profit on disposal (W7)	(15)	
Changes in working capital		
Increase in inventory (W2)	(33)	
Increase in prepayments(W2)	(23)	
Decrease in receivables (W2)	167	
Decrease in payables (W2)	(75)	
		55
Cash generated from operations		
Interest paid (W3)	(18)	
Tax paid (W4)	(186)	
		(204)
Net cash from operating activities		**236**
Cash flows from investing activities		
Payment to acquire non-current assets (W5)	(272)	
Receipt from sale of non-current assets (W3)	155	
		(117)
Cash flows from financing		
Proceeds from share issue (incl share prem)	30	
New bank loans (W6)	28	
Dividends paid	(73)	
		(15)
Increase in cash and cash equivalents		**104**
Cash and cash equivalents at start of year		(195)
Cash and cash equivalents at end of year		**(91)**

Question 6 *(Cont'd)*

Workings

1 Net profit before interest

	£/€'000
Operating profit	369
Prepaid distribution expenses	23
Depreciation omitted in error	(7)
	385

2 Changes in working capital

Inventory	(365 - 332)	(33)	increase
Receivables	(153 - 320)	167	decrease
Prepayments		(23)	increase
Payables	(166 - 241)	(75)	decrease

3 Interest paid

No opening or closing liabilities therefore amount paid equals P&L charge

4 Tax paid

Opening balance	56
Annual charge	172
Amount included in error	(7)
Closing balance	(35)
Amount paid	186

5 Depreciation

Charge for year	27
Amount omitted in error	7
	34

6 Non-current asset acquisition

Opening balance	1,407
Less disposals	(140)
Add increase in revaluation reserve	80
Less depreciation	(34)
Closing balance	(1,585)
Acquisitions	(272)

Question 6 *(Cont'd)*

7 Non-current asset disposal

Book value	140
Sale proceeds	155
Profit on sale	15

8 Long term loans

Opening balance	129
Closing balance	(157)
New loans received	(28)

9 Cash and cash equivalents

Cash at start of year	(35-230)	(195)
Cash at end of year	(24-115)	(91)
Change during the year		(104)

2nd Year Examination: August 2011

Financial Accounting II

Examiner's Report

General comment

Overall this exam does not appear to have caused any undue upset for students and the pass rate, albeit low at 39%, is on par with previous years.

Question 1

Once again this question highlights the lack of familiarity students have with the theory section of the syllabus. It appears from the current, and recent, exam papers that many students have prepared answers for some theory topics and they provide these answers irrespective of the question asked. Students should be reminded that it is not a case that one answer fits all. In this regard it is surprising how many students answered part (a) without mentioning the Turnbull report. In relation to part (c) only a very small minority of students mentioned Sarbanes-Oxley or The Code of Corporate Governance with the majority of students providing a discussion on 'profits versus ethics'. Students must answer the question asked as no matter how correct their discussion is if it's not what is asked marks cannot be awarded.

Question 2

It was great to see how well this question was answered with many students scoring very high marks. Despite the pressures to answer all parts as quickly as possible students did particularly well in those parts which required them to perform calculations.

Question 3

This question tested the student's ability to prepare journals and whilst it is clearly an area that students are less comfortable with the standard of solutions provided was higher than expected. Students had difficulty determining how much should be provided for in Part (2) with very few identifying the £/€12,000 as a non-adjusting event. While many students identified the correct inventory valuation in Part (3) a significant number did not know how to prepare the required journal entries. In addition to losing marks as a result of not knowing what journals were required students also lost valuable marks by not reading the question, eg Part (1) clearly said the machine cost £/€300,000 plus VAT *not* inclusive of VAT, Part (3) said cost price includes elements listed, it did not state that they were the only elements of cost price. Surprisingly some students continue to provide ledger accounts instead of journals. Students must provide journals in the correct journal format when asked, ledger accounts are not a valid replacement.

Question 4

This question tested the students knowledge of three IAS's (IAS 17 Leases, IAS 2 Inventory and IAS 20 Grants) which when combined with 2 presentation marks provided students with the opportunity to pick up easy marks relatively quickly. Whilst students understand what inventory is many tripped up on the second part of the question which asked students to discuss how it is valued. However students are much more familiar with grants and leases and picked up most of their marks here.

Question 5

Once again this question was the most popular on the paper and it's where students picked up valuable marks making up for poor scores elsewhere. It was disappointing to see that a significant number of students correctly calculated the NBV of non-current assets yet proceeded to include the cost value in the Statement of Financial Position. The next most common difficulty was in relation to deferred income with very few students recognising that there were only 8 years, and not 10, of amortisation left. However, overall this question was well answered.

Question 6

As discussed previously there was and continues to be an obvious bias away from the cash flow statement however those who did attempt the question generally scored well. It was disappointing to see that many students failed to adjust the net profit before interest for prepaid distribution expenses and depreciation omitted in error. Payments to acquire non-current assets also presented students with difficulties with very few including the land revaluation in their calculations. Students should also take greater care in relation to changes in working capital as valuable marks are lost by incorrectly adding or subtracting correct amounts. However students do appear to be getting more familiar with the layout of the statement.

Other

It is worth emphasising at this stage the importance both workings and presentation. Many students continue to submit their exam scripts without workings. Whilst those correcting exam scripts can go so far to determine the students intention they cannot always re-create and therefore students lose valuable marks that they otherwise should be awarded. This also applies to presentation, poorly laid out scripts are difficult to correct and as a result students may lose out on presentation and other marks.