
Financial Accounting II

2nd Year Examination

May 2011

Paper, Solutions & Examiner's Report



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Accounting Technicians Ireland

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

Monday 16th May 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)**

It is important that financial reporting be subject to rules and regulations. The rules and regulations which apply are commonly referred to as the 'regulatory framework' or Generally Accepted Accounting Practices ('GAAP').

- (a) Explain the need for regulation in the context of financial reporting and explain why it is important.

8 Marks

- (b) Describe briefly the four main sources of regulation that represents Irish GAAP.

12 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]** Under the terms of IAS 8 where the effect of a change in estimate is material to the financial statements:
- [a]** the nature and monetary effect of the change on the financial statements must be disclosed.
 - [b]** the change in estimate should be applied retrospectively.
 - [c]** the change in estimate should only be applied retrospectively where it is deemed necessary to provide more reliable information.
 - [d]** the nature and monetary effect of the change on the financial statements must be disclosed only where it is deemed necessary to provide more reliable information.

QUESTION 2 (*Cont'd*)

- [2] If a partner lends the partnership funds in the form of start-up finance, how should the annual interest charge be treated?
- [a] debited to partners current account.
 - [b] credited to partners current account.
 - [c] deducted from business profits before the profits are apportioned.
 - [d] credited to partners capital account.
- [3] Drawings, by a partner in a partnership, made during the year should be:
- [a] included as an expense in the partnership Statement of Comprehensive Income.
 - [b] included as a revenue in the partnership Statement of Comprehensive Income.
 - [c] credited in the partners current account.
 - [d] debited in the partner's current account.
- [4] The provision for discounts allowed on debtors balances outstanding should be calculated, at the appropriate rate on:
- [a] the debtors outstanding, after deducting the provision for doubtful debts but before taking into account bad debts written off.
 - [b] the debtors outstanding, after taking into account bad debts written off and after deducting the provision for doubtful debts.
 - [c] the debtors outstanding after taking into account bad debts written off but before taking into account the provision for doubtful debts.
 - [d] the debtors outstanding.
- [5] Coral Limited's mark-up on cost is 20%. The closing inventory at 31 December 2010 has been counted and valued at cost which amounts to £/€102,000. This amount includes damaged items which cost £/€8,800. It is expected that once repaired, at a cost of £/€500, the goods will then be in a condition to be sold at a discount of 25% on full price. At what value should inventory be stated at 31 December 2010?
- [a] £/€ 101,500.
 - [b] £/€ 99,300.
 - [c] £/€ 100,620.
 - [d] £/€ 101,120.

QUESTION 2 (*Cont'd*)

[6] If a capital grant is recognised as deferred income in the balance sheet what are the entries to be made each year over the useful life of the associated asset:

- [a]** credit deferred income, debit income statement.
- [b]** debit deferred income, credit income statement.
- [c]** debit deferred income, credit bank.
- [d]** credit deferred income, debit bank.

[7] The following information relates to Considine Limited:

	£/€
Trade payables @ 1 Jan 2010	96,000
<u>Transactions for the year ended 31 Dec 2010</u>	
Payments to suppliers	468,000
Discount allowed	7,500
Discount received	5,940
Payables @ 31 Dec 2010	97,500

What is the credit purchase figure for the year ended 31 December 2010?

- [a]** £/€ 475,440.
- [b]** £/€ 467,940.
- [c]** £/€ 473,880.
- [d]** £/€ 472,440.

QUESTION 2 (*Cont'd*)

[8] The following information relates to Georgia Limited:

	£/€
Sales	32,800
Opening inventory	5,200
Closing inventory	3,600
Returns in	4,200
Returns out	1,100
Purchases	25,600
Carriage in	900
Carriage out	800

What is the cost of goods sold figure for the year ended 31 December 2010?

- [a]** £/€ 30,600.
[b] £/€ 26,900.
[c] £/€ 23,900.
[d] £/€ 27,000.
- [9]** What journal entries are required to record the receipt of a bad debt at year end which was written off during the year?
- [a]** debit bad debt expense, credit bank.
[b] debit bank, credit bad debt expense.
[c] debit bad debts, credit debtors.
[d] debit debtors, credit bad debts.
- [10]** In accordance with I.A.S. 16 'Property, Plant and Equipment' assets may be recognised at cost less accumulated depreciation or at a revalued amount. Where an asset is revalued upwards, there is a debit entry to the asset at cost account. Where is the corresponding credit entry recorded?
- [a]** In the Bank account in the Statement of Financial Position.
[b] In 'Other Income' in the Statement of Comprehensive Income.
[c] In the Revaluation reserve account in the 'Capital and Reserves' section of the Statement of Financial Position.

[d] In the appropriate 'Accumulated depreciation' account in the Statement of Financial Position.

QUESTION 3 (Compulsory)

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

Statement of Financial Position as at 31 December 2010

	£/€'000	£/€'000	2009 £/€'000	2009 £/€'000
ASSETS				
<i>Non-current assets</i>		1,520		1,220
<i>Current assets</i>				
Inventory	1,440		1,530	
Receivables	2,630		2,040	
Prepayments	280		160	
Cash & cash equivalents	20		30	
		<u>4,370</u>	<u>3,760</u>	
Total assets		5,890		4,980
EQUITY and LIABILITIES				
<i>Capital and reserves</i>				
£/€1 ordinary shares	310		250	
Preference shares	110		110	
Share premium account	30		-	
Retained earnings	160		280	
		610	280	640
<i>Non-current liabilities</i>				
Bank loans	2,040		1,740	
10% debentures	900		900	
		2,940	900	2,640
<i>Current liabilities</i>				
Trade payables	1,210		970	
Current instalments due on loans	540		540	
10% debentures	300		-	
Bank overdraft	50		-	
Taxation	210		160	
Preference dividends	30		30	
		<u>2,340</u>	<u>1,700</u>	
Total equity and liabilities		5,890		4,980

QUESTION 3 (Cont'd)**STATEMENT OF CHANGES IN EQUITY**

	Pref share capital £/€'000	Ord Share capital £/€'000	Share premium £/€'000	Retained profits £/€'000	Total equity £/€'000
As at 1 January 2010	110	250	0	280	640
Net profit for year ended 31 Dec 2010				(90)	(90)
Share issue		60	30		90
Preference dividends				(30)	(30)
As at 31 December 2010	<u>110</u>	<u>310</u>	<u>30</u>	<u>160</u>	<u>610</u>

Additional information:

- (1) On 1 July 2010 CARSWELL issued £/€ 1 ordinary shares at £/€ 1.50 per share.
- (2) During the year the company acquired new plant and equipment which was part financed by the total funds raised from the issue of debentures. The balance owing is included in trade payables. No depreciation is charged in the year of acquisition.
- (3) The company also disposed of older equipment which was no longer in use and had a net book value of £/€60,000. Proceeds from the sale of equipment amounted to £/€80,000.
- (4) Prepayments of £/€ 15,000 were incorrectly recorded as expenses. This error should be rectified.
- (5) The income statement includes the following charges for the year:

	31 Dec 2010	31 Dec 2009
(i) Depreciation	£/€ 180,000	£/€ 150,000
(ii) Interest	£/€ 210,000	£/€ 170,000
(iii) Tax	£/€ 50,000	£/€40,000

Requirement

- (a) Prepare a statement of cash flows for CARSWELL Limited for the year ended 31 December 2010 in accordance with IAS 7 *Statement of Cash Flows*.

N. B. You are **NOT** required to prepare notes to the statement of cash flows.

QUESTION 3 (*Cont'd*)

- (b)** You are a creditor of CARSWELL Limited who is owed a significant, but not overdue, amount at year end. You have been asked by your managing director to prepare a note outlining the cash performance of CARSWELL during the year.

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

5 Marks

Presentation 2 Marks

Total 25 Marks

Answer TWO of the THREE questions in this Section**QUESTION 4****[a]**

Prior to the introduction of IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', there were no clear guidelines outlining when and why a provision could be set up. This lack of clarity resulted in a situation whereby companies engaged in 'profit smoothing' to disguise fluctuations in profitability.

The Finance director has been asked by the Board of Directors to prepare a presentation for the next Board meeting to explain the concept of profit smoothing and how this has been dealt with by IAS 37.

Requirement

You are required to draft a report to the Finance Director and in this report you should:

- (a) Briefly explain the concept of 'profit smoothing'. **3 Marks**
- (b) Define a 'provision' and explain under what circumstances it can be recognised in the financial statements. **3 Marks**
- (c) Explain how a 'contingent liability' differs from a 'provision' and whether it should be recognised in the financial statements. **3 Marks**
- (d) Explain the term 'contingent asset'. **2 Marks**

[b]

Subsequent to initial recognition IAS 16 'Property, Plant and Equipment' allows for two methods of asset valuation, the cost model and the revaluation model.

Requirement

- (a) Explain the 'revaluation model' and the provisions contained within IAS 16 with respect to revaluations. **3 Marks**
- (b) Company A owns a building which originally cost £/€650,000 and has a net book value of £/€475,000. The Finance Director has had the building valued by professional valuers who have assigned a fair value of £/€ 725,000 to the building.

Outline the journal entries required to record the upward revaluation.

4 Marks**Presentation: 2 Marks****Total 20 Marks**

The following trial balance has been extracted from the books and records of CORAL Limited as at 31 December 2010.

CORAL Limited
Trial balance as at 31 December 2010

	DR	CR
	£/€	£/€
Ordinary shares (£/€0.50 ea)		325,000
10% debentures (repayable in 2020)		270,000
Share premium		25,000
Retained earnings at 1 January 2010		120,700
Freehold premises	675,000	
Freehold premises accumulated depreciation		157,000
Furniture and fittings	271,500	
Furniture and fittings accumulated depreciation		93,500
Motor vehicles	23,500	
Motor vehicles accumulated depreciation		8,000
Inventory at 1 January 2010	90,580	
Trade receivables	41,300	
Trade payables		30,340
Deferred income		35,000
Sales revenue		567,500
Purchases	325,120	
Purchase returns		17,110
Administration expenses	58,500	
Distribution expenses	23,700	
Debenture interest	13,500	
Taxation	58,600	
Cash at bank	67,850	
	1,649,150	1,649,150
	1,649,150	1,649,150

Additional information:

1. Depreciation is to be provided for as follows:

Premises	2% per year on cost	
Furniture and fittings	5% per year on cost	
Motor vehicles	20% reducing balance	

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

2. A final ordinary dividend of £/€0.025 per share should be provided for in the year end accounts.

QUESTION 5 (*Cont'd*)

3. A significant account holder has gone into liquidation and management do not believe that there will be any funds available for creditors. Accordingly a bad debt of £/€19,000 should be provided for.
4. Management wish to make a provision for doubtful debts of 10% of recoverable debtors.
5. Deferred income includes a grant of £/€25,000 which was received during the year. This grant should be realised to income evenly over a 5 year period.
6. The trial balance only provides for half year debenture interest.
7. Closing inventory at 31 December 2010 was valued at £/€82,000.

Requirement

- (a) Prepare CORAL Limited's Statement of Comprehensive Income for the year ended 31 December 2010 in a form suitable for publication.

15 Marks

- (b) Prepare a Statement of Changes in Equity for the year ended 31 December 2010.

3 Marks**Presentation: 2 Marks****Total 20 Marks**

During the year CONSIDINE Limited, a VAT registered company, undertook a long overdue overhaul of both its buildings and plant and equipment used in its manufacturing process. However a review of the year end books and records revealed that the following transactions have not yet been recorded.

1. During the year the company purchased a piece of machinery on credit with a list price of £/€190,000 (excl VAT). The invoice also included delivery costs of £/€8,000 (excl VAT) and a one year maintenance contract for £/€7,000 (excl VAT). If VAT is charged at 15% write the required journals for this transaction.
2. The Company entered into an 8 year finance lease for a new machine on 1st January 2010. The lease agreement requires 8 annual payments of £/€ 25,000, with the first annual payment due on 31st December 2010 and subsequent payments due annually thereafter. The present value of minimum lease payments is £/€133,373 and the interest rate implicit in the lease is 10%. The asset must be depreciated evenly over the life of the lease.
3. The Company received the following two grants during 2010; a training grant of £/€ 18,000 in respect of salary costs incurred in training graduates and a capital grant of £/€ 90,000 in respect of building renovation costs which have been capitalised. The Company does not know the appropriate treatment for such grants and accordingly has not yet recorded either grant in the books and records. Buildings are depreciated on a straight line basis at the rate of 5% per annum.
4. Additional architects fees incurred of £/€22,000 have not yet been paid or recorded. These fees were in addition to the original fees quoted and arose as a result of management's decision to re-design original plans.

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.

18 Marks

Presentation: 2 Marks

Total 20 marks

2nd Year Examination: May 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.

Question 1

[a] Explain the need for regulation in the context of financial reporting and explain why it is important.

Companies are owned by shareholders, the number of which vary depending on whether the company is private or public. Whilst private companies may have very few shareholders public companies on the other hand may have thousands of shareholders. Although some shareholders may also act as directors the majority of shareholders will have no direct involvement with the company's day to day activities. Such shareholders are almost entirely reliant on the information contained in the annual financial statements to determine the company's performance and financial position and to help them make informed decisions in relation to the company and/or their share ownership. Financial statements also act as the sole source of information in relation to the company sought by other users of financial statements such as lending institutions, tax authorities, suppliers, customers, employees etc. Therefore financial statements need to be reliable and consistent and it is for this reason that the need for regulation arose.

Having described above the need for regulation in the context of financial reporting I have outlined below why such regulation is important:

1. Reliability

Users of financial statements are a wide and diverse audience who do not work in the business on a day to day basis. Therefore the information contained in the financial statements is more than likely the only information they receive about the performance and financial position of the company. Accounting rules and regulations allow for better understanding of this financial information as it gives the users knowledge of the accounting policies and procedures which have been used when financial statements are being prepared.

2. Decision making

The various user groups need to be able to rely upon and understand the information contained in financial statements. In this regard regulation has been put in place and strengthened over time to ensure users of the reliability of financial statements. If the form and content of financial statements were not regulated it would be possible for incompetent or unscrupulous directors to provide users with false or misleading information which would result in users making poor economic decisions and undermine the whole purpose of preparing financial statements.

All companies, with very few exceptions, must comply with financial accounting rules and regulations. Therefore this aids comparability between financial statements produced by different companies. The users know that if these all comply with Irish GAAP for example then they have all been prepared using similar policies and procedures and are therefore comparable.

Limited companies have limited liability and therefore the debts of the entity will only be discharged from the assets of the entity. For this reason, when deciding whether to interact with a limited company, a supplier will often assess the creditworthiness of the company by examining its financial statements. Suppliers thus rely on financial statements to be true and fair and users in general rely on accounting rules and regulation to enhance the reliability of financial statements.

[b] Describe briefly the four main sources of Irish GAAP.

The four main sources of Irish GAAP:

1. Professional regulation (domestic and international)

Prior to and during the 1970s a significant amount of criticism was levied against the accounting profession for lack of regulation and the concerns which this gave rise to. Therefore in the 1970s the Accounting Standards Committee ('ASC') was set up in an attempt to self regulate and address the criticisms the profession had attracted. The ASC, which was later replaced by the ASB, issued accounting standards. The function of accounting standards, both SSAPs and FRSs, is to describe and provide guidance to the accounting profession and users of accounting information about how difficult matters should be treated,

The need for international regulation arose due to the increasing number of companies operating in more than one jurisdiction. The aim of international regulation is to promote international comparability and consistency between the financial statements prepared by companies worldwide.

2. Company law (Republic of Ireland and UK)

Company law deals with many aspects of companies including the manner in which financial information must be presented and disclosed to users and filing requirements for companies. Company law also details what information must be presented in a set of financial statements and what a set of financial statements must include depending on the size of the company.

3. EU Directives

Several EU Directives were issued with the aim of achieving harmonisation in financial accounting across member states. At a later date the European Commission decided to support the accounting standards issued by the IASB rather than to issue further Directives and this made the goal of harmonisation a more achievable target. To date all publicly quoted companies must comply with IFRSs when preparing consolidated accounts.

4. Stock exchange regulation

These regulations only apply to public limited companies. Although the stock exchange was one of the first publishers of rules and regulations governing financial statements many of these rules and regulation have been included, and in some instances expanded upon, in either statutory or professional regulation. However this does not reduce the importance of stock exchange regulation which still contains important regulation not contained in other areas.

1. a
2. c
3. d
4. b
- 5.

NRV of damaged inventory	8,800 x 1.2	10,560
Less discount	10,560 x 25%	<u>(2,640)</u>
		7,920
Less cost of repair		<u>(500)</u>
NRV		<u>7,420</u>

As NRV < cost must use NRV

$$102,000 - 8,800 + 7,420 = \mathbf{100,620 (c)}$$

6. b
- 7.

Opening balance	96,000
Less:	
Bank	(468,000)
Discount received	(5,940)
Closing balance	<u>(97,500)</u>
Purchases	<u>475,440 (a)</u>

- 8.

Opening inventory	5,200
Purchases	25,600
Returns out	(1,100)
Carriage in	<u>900</u>
Goods available	30,600
Less closing inventory	<u>(3,600)</u>
Cost of goods sold	<u>27,000 (d)</u>

9. b
10. c

[a]

CARSWELL Limited

Statement of Cash Flows for the year ended 31 December 2010

	£/€ '000	£/€ '000
Cash flows from operating activities		
Net profit before interest (W1)		185
Adjustments for:		
Depreciation	180	
Profit on disposal (W3)	(20)	
Changes in working capital		
Decrease in inventory (W2)	90	
Increase in receivables (W2)	(590)	
Increase in prepayments (W2)	(135)	
Decrease in payables (W2)	0	
	<u>0</u>	(475)
Cash generated from operations		(290)
Interest paid (W3)	(210)	
Tax paid (W4)	0	
	<u>0</u>	(210)
Net cash from operating activities		(500)
Cash flows from investing activities		
Payment to acquire non-current assets (W6)	(300)	
Receipt from sale of non-current assets (W7)	80	
	<u>80</u>	(220)
Cash flows from financing		
Proceeds from share issue (incl share prem) (W9)	90	
New bank loans	300	
Issue of new debentures (W6)	300	
Dividends paid (W8)	(30)	
	<u>(30)</u>	660
Decrease in cash and cash equivalents		(60)
Cash and cash equivalents at start of year		30
Cash and cash equivalents at end of year		(30)

(1) Net profit before interest

	£/€'000
Net loss for year	(90)
Add: tax	50
Add : interest	<u>210</u>
	170
Adjustment for error in prepayment	<u>15</u>
Net profit before interest	<u>185</u>

(2) Changes in working capital

	£/€'000
Inventory (1440 - 1530)	90 decrease
Receivables (2630 - 2040)	(590) increase
Prepayments (295 - 160) (W5)	(135) increase
Trade payables (1210 - 240 - 970)	0 no change

(3) Interest

	£/€'000
Opening balance	0
Charge for year	210
Closing balance	<u>0</u>
Amount paid	210

(4) Taxation

	£/€'000
Opening balance	160
Charge for year	50
Closing balance	<u>(210)</u>
Amount paid	<u>0</u>

(5) Prepayments

	£/€'000
Closing balance	280
Add error	<u>15</u>
Revised balance	<u>295</u>

£/€'000

Opening balance	1,220
Less depreciation	(180)
Less disposal	<u>(60)</u>
	980
Closing balance	<u>1,520</u>
Acquisition	<u>540</u>
Financed by: debenture	300
Trade payables	240

(7) Non-current asset disposal

£/€'000

NBV	60
Sale proceeds	<u>80</u>
Profit on sale	<u>20</u>

(8) Preference dividend

£/€'000

Opening balance	30
Profit and loss	30
Closing balance	<u>(30)</u>
Paid	<u>30</u>

(9) Share issue

£/€'000

Share issue	60
Share premium	<u>30</u>
Total funds received	<u>90</u>

(b) Financial Performance of CARSWELL Limited

A Statement of Cash flow is an extremely useful tool when assessing the financial and operating performance of a company. It is the only financial statement which is prepared on a cash basis, not an accruals basis, and it shows not only where cash was generated but also where it was spent. It is a very useful tool which identifies the overall change in cash position during period under review and also the individual components which affect this change in overall cash position.

From an initial review the financial performance of Carswell Limited has deteriorated during the financial year under review, largely due to the trading loss and worsening bank position. However the cash flow needs to be reviewed in further detail to identify individual areas of concern and areas in which the company performed well.

The changes in working capital highlight a concerning increase in receivables and, whilst smaller in value, an equally concerning increase in prepayments. If this problem is not rectified and receivables brought back to a more manageable level the company could experience a higher than forecast level of bad debts and thus add to an already worsening cash position. Management should also investigate why prepayments have increased so much, has the company lost its credit rating and is now being forced to pay for services in advance? Again, this could cause further cash flow difficulties which could in turn affect the company's ability to pay suppliers, including our company.

Although the Company did record a tax charge in the Statement of Comprehensive Income it did not make any payments to the tax authorities. Was the decision not to pay its tax liability due to cash flow difficulties?

The Company also increased its long term financing during the year, with both the long term loan and the debentures increasing by £/€300,000 each. While the funds received from the issue of debentures has been used to finance an investment in non-current assets the increase in long term loans seems to have been used to finance increasing working capital requirements. It seems unlikely that the Company sought to increase its long term financing for this purpose. This could also indicate that the Company was unable to avail of a more suitable short term credit facility.

On a more positive note it should be stated that the working capital ratio is within recommended levels, 2.21 : 1 in 2009 and 1.87 : 1 in 2010. The Company has also continued to pay amounts owing to our company within the agreed credit terms.

In summary, I believe that I have identified a sufficient number of concerns above to justify requesting a meeting with Carswell Limited to investigate further how the company intends to manage its cash flow going forward and to determine if the company will be able to pay its debts as they fall due. Following this meeting we should decide on the appropriate course of action which may involve insisting on tighter payment terms or even reducing the level of credit extended. In the meantime I suggest we do not increase our current exposure any further.

[A] IAS 37

To : The Directors
From : An. Accountant
Date : XX/MM/YY
Subject : IAS 37 and its main provisions

As requested I have outlined below the main provisions contained within IAS 37 Provisions, Contingent Liabilities and Contingent Assets in addition to briefly explaining the concept of 'profit smoothing':

A. Profit smoothing

Profit smoothing was introduced to present steadily increasing profits in situations where profits were actually fluctuating. This was believed to present a less risky form of results which shareholders would be more satisfied with.

Profit smoothing was actually achieved by transferring profits out of the Statement of Comprehensive Income to a provision account in years where the business was profitable. This had the effect of reducing profits in those years. Then in later years when profitability was poor profits were transferred out of the provision accounts back into the Statement of Comprehensive Income thereby increasing profits in those periods.

IAS 37 was introduced to reduce abuses in this area.

B. What is a 'provision'?

IAS 37 defines a provision as a liability of uncertain timing or amount. A provision can only be recognised in the financial statements when all three of the following conditions have been met:

- (i) A business has a present obligation as a result of a past event (the obligating event).
- (ii) It is probable that a transfer of economic benefits will be required to settle the obligation.
- (iii) A reliable estimate can be made of the amount of the obligation.

C. What is a 'contingent liability'?

A 'contingent liability' is an item which has failed one of the recognition criteria of a provision. IAS 37 defines a 'contingent liability' as:

- (i) A present obligation that arises from past events but it is not recognised because it is not probable that a transfer of economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.
- (ii) A possible obligation that arises from past events and whose existence will only be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control.

Contingent liabilities should not be recognised in financial statements but they should be disclosed by way of a note.

D. *What is a 'contingent asset'?*

IAS 37 defines a 'contingent asset' as a possible asset that arises from past events, the existence of which will be confirmed only by the occurrence of one or more uncertain future events not wholly within the business's control.

A contingent asset should not be recognised. It should only be recognised when the realisation of the related economic benefit is virtually certain. At that point the asset is no longer a contingent asset.

I hope the above is helpful. Should you require any further information in this regard please feel free to contact me.

An Accountant.

[B] IAS 16

(a) The revaluation model is where an asset is recorded in the books and records at a revalued amount and not the original cost amount. The revalued amount is the asset's fair value at the date of revaluation less subsequent depreciation, provided that fair value can be measured reliably. An asset may be revalued upwards or downwards.

The provisions contained within IAS 16 with respect to revaluations are as follows:

- (i) The fair value of the asset is usually the market value of the asset as determined by a professionally qualified valuer.
- (ii) If an asset is revalued the entire class of asset to which the item belongs must also be revalued. This ensures that the company does not cherry pick assets to revalue and suit their needs.
- (iii) Revaluations should be carried out regularly so that the carrying amount of an asset does not differ materially from its fair value at the date the Statement of Financial Position has been prepared. This ensures that asset valuations do not become out of date.

(b)

		DR	CR
		£/€	£/€
DR	Building at cost account	75,000	
CR	Revaluation reserve account (BS)		75,000

[Being asset revalued upwards]

DR	Accumulated Depreciation account	175,000	
CR	Revaluation reserve account (BS)		175,000

[Being transfer of depreciation to revaluation account]

CORAL Limited
Income Statement for the year ended 31 December 2010

	£/€
Sales revenue	567,500
Cost of sales (w.3)	<u>(323,340)</u>
Gross profit	244,160
Other income (w.8)	5,000
Administration costs (w.5)	(96,680)
Distribution costs (w.6)	<u>(30,175)</u>
	122,305
Interest payable (w.7)	<u>(27,000)</u>
Profit on ordinary activities before tax	95,305
Taxation	<u>(58,600)</u>
Profits on ordinary activities after taxation	<u>36,705</u>

CORAL Limited
Statement on changes in equity for the year ended 31 December 2010

	Share premium	Share capital	Retained earnings	Total
	£/€	£/€	£/€	£/€
Bal as at 1 Jan 2010	25,000	325,000	120,700	470,700
Profit for the year			36,705	36,705
Ordinary dividends (w.2)			(16,250)	(16,250)
Balance as at 31 Dec 2010	<u>25,000</u>	<u>325,000</u>	<u>141,155</u>	<u>491,155</u>

1	Depreciation	Total	Cost of sales	Admin	Distrib
		£/€	£/€	£/€	£/€
	Premises* (2% on cost)	13500	6750	3375	3375
	Furniture & fittings (5% on cost)	13575		13575	
	Motor vehicles (20% on reducing bal)	3100			3100
		30175	6750	16950	6475
<hr/>					
2	Dividend			£/€	
	Share capital			325,000	
	Number of shares			650,000	
	Dividend per share			£/€0 025	
	Total dividend			16,250	
3	Cost of sales		£/€	£/€	
	Opening inventory			90,580	
	Purchases		325,120		
	Less: purchase returns		<u>(17,110)</u>	308,010	
	Depreciation (per 1 above)			6,750	
				<hr/>	
				405,340	
	Closing inventory			(82,000)	
				<hr/>	
				323,340	
				<hr/>	

4	Bad debt	£/€
	Receivables	41,300
	Less bad debts	<u>(19,000)</u>
	Recoverable receivables	22,300
	provision for bad debts 10%	<u>2,230</u>
	Revised receivables	20,070
5	Administration costs	£/€
	Cost per trial balance	58,500
	Add bad debt	19,000
	Provision for bad debt	2,230
	Depreciation	16,950
		<u>96,680</u>
6	Distribution	£/€
	Cost per trial balance	23,700
	Depreciation (per 1 above)	6,475
		<u>30,175</u>
7	Debenture interest	£/€
	Per trial balance	13,500
	To be provided for (£/€270,000*10%*6/12)	13,500
		<u>27,000</u>
8	Grant income	£/€
	Grant received	25,000
	Annual amortisation*	5,000
	* to be included in 'Other Income'	

Question 6**CONSIDINE Limited**

		DR	CR
		£/€	£/€
(1)			
	DR Non-current assets	198,000	
	DR VAT recoverable	29,700	
	CR Payables		227,700
	[Being purchase of plant and machinery including delivery costs]		
	DR Maintenance (Income statement)	7,000	
	DR VAT recoverable	1,050	
	Cr Payables		8,050
	[Being purchase of annual maintenance contract for new plant]		
(2)			
	DR Lease machinery	133,373	
	CR Finance lease		133,373
	[Being purchase of leased machinery]		
	DR Income statement	16,672	
	CR Accumulated depreciation account		16,672
	[Being annual depreciation charge on lease asset]		
	DR Finance lease	25,000	
	CR Bank		25,000
	[Being payment of first year lease payment]		
	DR Income statement	13,337	
	CR Finance lease		13,337
	[Being calculation of first year's lease interest charge]		
(3)			
	DR Bank	18,000	
	CR Training costs		18,000
	[Being grant received in respect of employee training costs incurred]		
	DR Bank	90,000	
	CR Deferred income		90,000
	[Being receipt of grant in respect of building renovation costs]		
	DR Deferred income	4,500	
	CR Income statement		4,500
	[Being transfer of deferred income to income]		

(4)

DR	Administration	22,000	
CR	Trade payables		22,000
[Being architect fees payable at year end]			

2nd Year Examination: May 2011

Financial Accounting II

Examiner's Report

General comment

Students appear to have found this exam paper difficult particularly in relation to Question 1 in respect of which most students performed very poorly. The disappointing performance in Question 1, combined with a compulsory cash flow question and a journal question, resulted in an overall lower pass rate which again highlights a high level of discomfort in these two latter areas. However students who prepared well for the exam scored highly.

Question 1

This was by far the worst answered question on the paper with many students providing an answer to what they thought was being asked and not what was asked. This question was made up of two parts, both based on the regulatory environment which governs financial reporting. Part (a) asked students to explain the need for regulation and to discuss why it is important. The most popular answer given was one which discussed 'The Framework for the Preparation of Financial Statements' and the chapters within. Part (b) asked students to describe the four main sources of regulation however many students did not discuss sources but instead discussed qualitative characteristics of financial information or the underlying assumptions. The answers to part (a) and (b) are clearly discussed in chapter two of the manual and should have been met with a more positive response. Many students clearly did not prepare well, if at all, for the theory part of the exam. Where students did prepare well and were able to answer this question it was easy to score high marks.

Question 2

Students made reasonable attempts at the multiple choice question however a surprising number of students failed to answer at least one part. Even if the student does not know the correct answer it is always worth selecting one of the possible answers as opposed to leaving it blank.

Question 3

Although the cash flow question has shown once again that it is an area that students are less comfortable with it did not seem to present as big a problem as in 2010 which is encouraging. Students appear to be more comfortable with the layout and calculating the basic components but the trickier areas, such as those included in the 'additional information' in the question, continue to confuse and this is why students failed to score highly. A surprising number of students did not attempt part (b) which was a less challenging way to gain marks.

Question 4

This question tested the students knowledge of IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' and IAS 16 'Property, Plant and Equipment'. Students made good attempts at answering most parts of this question but it is probably no surprise that students are less comfortable with the theory elements of the syllabus. In relation to IAS 37 many students provided examples of each of the terms examined instead of explaining each. In relation to IAS 16 most students were able to answer part (a) however students provided a wide range of answers to part (b), both in terms of numbers and formats.

Question 5

The Income Statement question was attempted by the majority of students and is certainly the area where students performed well and scored highly. Calculation of depreciation and its allocation across cost centres continues to present problems. Also, students continue to be sloppy in their presentation of both the Income Statement and Statement of Changes in Equity and this is where they fail to earn the easier presentation marks. This was all the more surprising in relation to the Statement of Changes in Equity as one of these statements was laid out in Question 3 on the exam paper. However, overall this question was well answered.

Question 6

This question tested the student's ability to prepare journals specifically in relation to capitalising costs, finance leases and grant income. This is a difficult question to score well in if the student is weak at journal entry and therefore should be avoided. The answers provided to this question were quite mixed, ranging from full marks to very low marks. Part 4 of the question, which was the most straight forward part, caused a surprising level of confusion with many students incorrectly deciding that no journal was required as it was a 'non-adjusting' cost. The cost in question could not be capitalised but it still had to be recorded in the books and records as an expense. Once again this question highlights the need for students to improve their proficiency in the area of journal entry.

Other

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