Accounting Technicians Ireland

Advanced Financial Accounting

Sample Paper 1

Questions & Suggested Solutions

Professional, Practical, Proven

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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 is 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 pilot paper and solution have been prepared in recognition that public companies are now required to prepare accounts implementing the language of International Accounting Standards (I.A.S.'s) but that other companies and non corporate entities are not required to do so.

Examinees would be at liberty to use the language of either (i) I.A.S.'s or (ii) the Companies (Amendment) Act 1986 and F.R.S.'s/S.S.A.P's in answering questions relating to non-public companies

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SECTION A

Answer ALL THREE Questions in this Section

(The total marks for section A will be 60, made up of a theory question of 20 marks, a multiple choice question of 15 marks and a further question of 25 marks)

QUESTION 1

(i) The Turnbull Report attempts to define internal controls and in doing so describes three types of controls:

(a) Operational controls
(b) Compliance controls
(c) Financial controls

Outline the purpose of each of the above internal controls and provide one example of each.

9 marks

(ii) The Board of Directors of your company has asked you, as Financial Accountant, to advise them on the need for a robust internal control system and to describe five commonly found internal financial controls, giving an example of each.

11 marks

Total 20 marks

QUESTION 2

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 1½ marks.

Requirement

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

Total 15 Marks

N.B. *Candidates should answer this question by ticking the appropriate boxes on the special green answer sheet which is supplied with the examination paper.*

[1] Under the terms of IAS 2 the net realisable value of an inventory item is the:

(a) estimated selling price in the ordinary course of business, less the estimated costs of completion and estimated costs necessary to make the sale
(b) estimated selling price in the ordinary course of business
(c) actual selling price in the ordinary course of business less selling costs
(d) estimated selling price in the ordinary course of business less the estimated costs of completion

QUESTION 2 (cont'd)

[2] An unqualified audit report is saying:

(**a)** with certainty that the financial statements are 100% accurate
(b) that in the opinion of the auditor the financial statements do not reflect a true and fair view of the company's financial affairs
(c) that in the opinion of the auditor the financial statements reflect a true and fair view of the company's financial affairs
(d) with certainty that the financial statements reflect a true and fair view of the company's financial affairs

[3] Under the terms of IAS 1 assets and liabilities and income and expenses may not be offset against one another unless:

(a) the elements to be offset are immaterial in nature
(b) the reason for doing so is detailed in the notes to the accounts
(c) the external auditor approves
(d) required or permitted by a standard

[4] Overvaluing closing inventory in the Statement of Profit & Loss results in:

(a) the understatement of Cost of Sales and overstatement of operating profit
(b) the overstatement of Cost of Sales and understatement of operating profit
(c) the understatement of Cost of Sales and understatement of operating profit
(d) the overstatement of Cost of Sales and overstatement of operating profit

[5] What is the ratio for *Acid test*?

(a) Current assets –closing inventory / non-current liabilities
(b) Current assets – closing inventory / current liabilities
(c) Current assets – average inventory / current liabilities
(d) Current assets – average inventory / non-current liabilities

[6] 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 affect 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)*

[7] Under the terms of IAS 37 contingent liabilities should:

(a) only be disclosed by way of note to the financial statements if material in nature
(b) be recognised in financial statements as it is probable that a cost will be incurred
(c) only be recognised in the financial statements if material in nature
(d) not be recognised in financial statements or disclosed by way of note

[8] A fire which broke out at the shop premises of Sole Trader X resulted in damage being caused to the accounting records. However the following information is available:

		€/£
Bank balance	1 Jan 2010	2,000
	31 Dec 2010	2,700 (overdrawn)
Cheque payments		57,000
Trade receivables	1 Jan 2010	6,200
	31 Dec 2010	7,800

There are no cash sales. Calculate turnover for the year.

(a) €/£ 60,100
(b) €/£ 59,300
(c) €/£ 53,900
(d) €/£ 63,300

[9] A government grant of €/£45,000 to help meet the cost of wages and salaries incurred during the year to train staff was treated as deferred income in error. What journal entries are required to correct this error?

(a) debit deferred income, credit wages and salaries
(b) debit wages and salaries, credit deferred income
(c) debit bank, credit deferred income
(d) debit bank, credit wages and salaries

[10] If the balance sheets at 1 January 2006 and 31 December 2006 show a liability for tax of €/£21,000 and €/£28,000 respectively and the charge for the year is 35% of operating profit. What figure for tax will appear in the cash flow statement for the year ended 31 December 2009 if operating profit is €/£110,000.

(a) €/£38,500
(b) €/£45,500
(c) €/£28,000
(d) €/£31,500

QUESTION 3

Shoebox Ltd., is a shoe manufacturer with an authorised share capital of €/£2,400,000, comprised of 8,000,000 ordinary shares of 25 cent/pence each and €/£400,000 of 8% preference shares of €/£1 each.

The following trial balance was extracted as at 31st December 2009

	€/£'000	€/£'000
Ordinary share capital		1,200
8% preference share capital		200
Retained profits at 1 January 2009		90
10% debenture stock		120
Land at cost	200	
Land accumulated depreciation		60
Premises at cost	980	
Premises accumulated depreciation		80
Plant and machinery at cost	420	
Plant and machinery accumulated depreciation		180
Motor vehicles at cost	120	
Motor vehicles accumulated depreciation		40
Inventory at 31 December 2009	290	
Goodwill	160	
Investments (not for re-sale)	160	
Short term investments	40	
Bank deposit account	80	
Bank balance		260
Trade receivables	372	
Provision for doubtful debts at 31 December 2009		16
Trade payables		88
Corporation tax owing		88
Valued added tax owing		28
Accrued expenses		56
Deferred government grants at 1 January 2009		48
Loan from director (repayable in 2015)		128
Retained profit for the year ended 31 December 2009		140
	2,822	2,822

ADDITIONAL INFORMATION

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

(2) A final ordinary dividend of €/£0.025 per share has been approved by the shareholders. The dividend should be provided for in the year end accounts.

(3) Prepaid expenses valued at €/£24,000 were incorrectly included in operating costs.

(4) Full year debenture interest to be provided for.

(5) Government grants received of €/£40,000 have not been included in the trial balance. These grants and the grants already provided for in the trial balance should be released to the profit and loss account over a four year period starting with the current year.

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QUESTION 3 *(Cont'd)*

Requirement

(a) Prepare, in a form suitable for publication, the statement of financial position for SHOEBOX Ltd., for the year ended 31st December 2009 in as far as the information provided permits.

N. B. *You are* ***NOT*** *required to prepare an Statement of Profit & Loss or notes to the accounts. You are required to submit workings to show the make-up of the figures in the statement of financial position.*

18 Marks

(b) You have been asked by a friend, who does not have a financial background, to explain the statement of financial position as per (a) above. Prepare a note outlining your understanding of what the statement of financial position tells you about Shoebox Limited.

5 Marks

Presentation 2 marks
Total 25 Marks

SECTION B
Answer TWO of the THREE questions in this Section

QUESTION 4

During a review of the draft accounts of CARTER Limited the financial accountant brought the following issues to your attention:

i) The company entered into a 5 year finance lease for a new machine on 1st January 2009. The lease agreement requires 5 annual payments of €/£ 30,000 to be made on 1st day of each year. The present value of the minimum lease payments is €/£ 125,096. The interest rate implicit in the lease is 10%. The asset must be depreciated evenly over the life of the lease.

ii) On the last day of the financial year a fire broke out in the warehouse and destroyed 50 units of stock. On the same day 40 units of the same stock were sold for €/£ 95 each. The inventory valuation at year end was based on the stock count which was performed on the second last day of the year and included 450 units of stock at a cost of €/£ 105 each. Goods sold were recorded in both sales and receivables.

iii) €/£ 20,000 relating to the purchase of fixtures and fittings was incorrectly included in administration costs at year end. Fixtures and fittings should be depreciated 10% per year on cost.

iv) Distribution expenses incorrectly include prepaid expenses of €/£ 15,000.

QUESTION 4 *(Cont'd)*

Requirement

You are required to prepare the journal entries to show the financial accountant how each of the above items should be dealt with in the final accounts for the year ended 31 December 2009. You should use your understanding of the relevant IAS's in dealing with each item.

Note: Journal narratives are required.

18 Marks

Presentation 2 marks
Total 20 Marks

QUESTION 5

IAS 37 provides definitions of a provision and a contingent liability and describes how each should be treated in financial statements.

[a] Define both a *'provision'* and a '*contingent liability*' as set out in IAS 37 and describe under what circumstances, if any, they should be recognised in the financial statements.

6 marks

[b] Review the following scenarios and confirm whether or not a provision should be recognised in the financial statements as at 31 December 2009. Provide reasons for your answer.

(i) On 12 December 2009 the board of Company A decided to close down a division making a particular product. On 20 December 2009 a detailed closure plan was agreed by the board and, on the same day, letters were sent to both customers and employees informing them of the intended closure.

(ii) Company B gives warranties at the time of sale to purchasers of its products. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale.

(iii) Company C operates profitably from a factory that it has leased under an operating lease. During December 2009 the entity relocates its operations to a new factory. The lease on the old factory has four years remaining and it cannot be cancelled. The entity hopes to re-let the premises to a tenant however no tenant has been found by year end.

(iv) Under new legislation Company D is required to fit smoke alarms to its factories by 30 December 2011. The company has not yet fitted the smoke alarms.

8 marks

QUESTION 5 CONTINUED OVERLEAF

QUESTION 5 *(Cont'd)*

[c] The following information relates to BARNS Limited, a widget manufacturer, for the year ended 31 December 2009:

	€/£
Direct materials cost per unit	2.00
Direct labour cost per unit	3.00
Direct expenses per unit	2.50
Administration overheads per annum	600,000
Production overheads per annum	900,000
Selling overheads per annum	200,000
Interest payments per annum	100,000

There were no finished goods at the start of the year and no work in progress. There were 250,000 units in finished goods at the year end. The normal annual level of production is 750,000 widgets however due to an industrial dispute only 450,000 widgets were produced in the year to 31 December 2009. The company uses a standard costing system to value its inventory.

These widgets have an expected selling price of €/£9 per unit if a further €/£1.20 is spent in advertising costs.

Requirement

You are required to value the inventory at year end in accordance with IAS 2 'Inventories'.

4 marks

Presentation 2 marks
Total 20 Marks

QUESTION 6

The following trial balance has been extracted from the records of CORNWALL Limited at 31 December 2009.

	€/£'000	€/£'000
Revenue		30,780
Purchases	17,180	
Inventory at 1st January 2009	2,890	
Distribution costs	3,040	
Administration expenses	2,240	
Land at valuation 1 January 2009	21,840	
Building at revalued amount	16,000	
Building accumulated depreciation at 1 January 2009		4,430
Factory plant & equipment at cost	26,640	
Factory plant & equip acc depreciation at 1 January 2009		5,140
Warehouse plant & equipment at cost	2,400	
Warehouse plant & equip acc depreciation at 1 January 2009		1,040
Trade receivables and payables	8,520	4,660
Cash at bank	800	
Ordinary shares of €/£1 each		28,000
Debenture interest	120	
Dividends	300	
Share premium account		6,000
Retained earnings		9,320
Revaluation reserve		6,700
Bank interest	60	
Long term bank loan		2,000
3% debentures		4,000
Corporation tax	40	
	102,070	102,070

The following items are to be adjusted for in preparing financial statements for the year ended 31st December 2009:

(1) Depreciation is to be provided as follows:

Buildings	2% per year on revalued amount
Plant & equipment	20% reducing balance

Depreciation on buildings is to be charged fully to factory costs (cost of sales).

(2) Closing inventory at 31 December 2009 is valued at cost of €/£3,250,000. Included in inventory at 31 December 2009 are goods which had cost €/£500,000. Due to a downturn in demand, these goods were sold at auction on 15th January 2010 for €/£300,000. Auctioneers fees were 3% of sales proceeds.

(3) The taxation charge of €/£40,000 included in the above trial balance is in respect of an under provision in the previous year. The estimated tax charge for the current year is estimated to be €/£940,000.

QUESTION 6*(Cont'd)*

(4) Included in trade receivables is a balance of €/£120,000 which is considered a bad debt and is to be written off. The directors have decided to make an allowance for doubtful debts of 3% of outstanding trade receivables.

Requirement

(a) Prepare, in a form suitable for publication, the company's Statement of Profit & Loss for the year ended 31 December 2009

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N. B. *You are **NOT** required to prepare a statement of financial position or notes to the accounts. You are required to submit workings to show the make-up of the figures in the statement of financial position.*

14 Marks

(b) You are required to calculate two ratios in respect of each of the following categories of ratios based on the information provided above:

(i) Profitability
(ii) Liquidity

4 Marks
Presentation 2 marks
Total 20 Marks

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Sample Paper 1 - Solutions

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Examinees would be at liberty to use the language of either (i) I.A.S.'s, (ii) the Companies (Amendment) Act 1986 and F.R.S.'s/S.S.A.P's in answering questions relating to non-public companies.

Solution to question 1

(a)

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.

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)

To : Board of Directors
From : A. Accountant
Date : 10 August 2010
Subject : Internal control system

I refer to our recent meeting during which the need for an internal control system was discussed. In this regard I have prepared this note to outline to you, as the Board of Directors, why it is important that a robust internal control system be designed and implemented in order to protect your company from fraud and/or error.

As previously discussed it is the company's directors who are responsible for the prevention and detection of fraud and error. One of the means by which directors discharge this responsibility is to establish an internal control system which is implemented and enforced and reviewed regularly to ensure its effectiveness.

As directors of many companies are removed from the day to day operations and running of the company they need to know that the risk of fraud or error is managed and this therefore is one of the primary functions of an internal control system. Accordingly a robust internal control system provides comfort to the directors that the risk of fraud or error is minimised and that the assets are safeguarded and liabilities recorded.

The Turnbull Report concentrates on the importance of internal control processes within public limited companies and defines three types of internal controls; financial controls, compliance controls and operational controls. I have discussed below five commonly found internal financial controls and provided an example of each:

Physical controls

> These are measures designed to protect company assets from loss, misuse, theft or damage. Eg. Employees required to use swipe cards to access company premises. Access should be restricted to those areas individual employees need access to. This helps to reduce the risk of company assets being stolen.

Approval and authorization controls

> These controls relate to spending and entering into a transaction on behalf of the company. Eg. The person who approves purchase orders only approves orders submitted by approved personnel. This helps to reduce the risk of unapproved purchase orders being processed and the company being bound by unauthorized purchase transactions.

Segregation of duties

> This control relates to the division of duties so that the work carried out by one individual is automatically checked by another before being finalised. Eg. The person who prepares monthly bank reconciliations is not responsible for reviewing and signing off the same reconciliations. This helps to reduce the risk of funds being misappropriated and increases the chance of any such transactions being identified.

Personnel controls

> These controls relate to the selection and training of employees to ensure that only personnel who are suitably skilled undertake work for the company. Eg. Individuals dispensing medical advice for a private hospital have the appropriate medical qualifications. This helps to reduce the risk of incorrect advice being given to patients which could cause harm.

Accounting controls

> These controls relate to the integrity of the accounting system and help to ensure the accuracy of the information contained within. Eg. Access to the accounting system restricted to authorised personnel each of whom only have access to the sections of the accounting

system relevant to their work area. This helps to reduce the risk of input errors, deliberate or otherwise.

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<u>Solution to question 2</u>

(1) A

(2) C

(3) D

(4) A

(5) B

(6) A

(7) D

(8) C (see workings)

(9) A

(10) D (see workings)

Workings:

(8) Bank : 57,000 – 2,000 – 2,700 = 52,300
Debtors : 52,300 + 7,800 – 6,200 = $\boxed{\textbf{53,900 (c)}}$

(10) 110,000 x 35% = 38,500
21,000 + 38,500 – 28,000 = $\boxed{\text{31,500 (d)}}$

Solution to question 3

(a)

Shoebox Ltd.

Statement of financial position as at 31 December 2009

	£/€'000	£/€'000
Non-current assets		
Property, plant & equipment (W1)		1,360
Goodwill		160
Other financial assets		160
		1,680
Current assets		
Inventories	290	
Trade receivables (W6)	356	
Prepayments (W9)	24	
Cash and cash equivalents (W8)	160	
		830
Total assets		**2,510**
Equity and liabilities		
Capital	1,400	
Accumulated profits (W3)	144	
		1,544
Non-current liabilities		
Interest-bearing borrowings	120	
Deferred income (W5)	66	
Directors loan	128	
		314
Current liabilities		
Trade and other payables (W7)	380	
Bank overdraft	260	
Interest payable (W4)	12	
		652
		2,510

Solution to question 3(cont'd)

(b)

The balance sheet, as the statement of financial position is more commonly known, provides information on the financial position of Shoebox 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 land, premises, plant and machinery and motor vehicles. These assets are used by the company to undertake its shoe manufacturing activities and generate profit, they are less liquid assets and accordingly are not easily converted into cash. The Company's current assets include more liquid assets which are easier converted into cash. Inventories include the Company's stock of shoes manufactured but not yet sold. It will also include materials to be used in the manufacturing process. Trade receivables are amounts owing by debtors (customers) in respect of sales, most likely shoe retailers.

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 bank debt and in this case loans made to the Company by its directors.

Equity is made up the funds the owners (shareholders) have invested in the business and in the case of Shoebox limited it includes both ordinary shares and preference shares. In this particular situation the Company is financed by both debt and share capital however the proportion of debt versus equity is quite low and therefore the company has a low gearing. A highly geared company is one which has a high proportion of debt relative to equity.

Based on the statement of financial position prepared and the discussion above the Company appears to be quite healthy. The Company made a profit in 2009 and declared a dividend which is a distribution of profits to ordinary shareholders. Although the Company has a positive working capital at year end (current assets (€/£830k) exceed current liabilities (€/£ 652k)) the current ratio of 1.27:1 is less than the recommended ratio of 2:1. It is also worth noting that even though current assets include cash and cash equivalents of €/£ 160k this is less than the bank overdraft of €/£ 260k. The Company should concentrate on reducing the overdraft during the coming year or consider converting part of it into cheaper longer term debt.

Workings

(1) Property, plant & equipment

	Land	Premises	Plant & machinery	Motor vehicles	Total
	£/€'000	£/€'000	£/€'000	£/€'000	£/€'000
Cost	200	980	420	120	1,720
Accumulated depreciation	(60)	(80)	(180)	(40)	(360)
NBV	140	900	240	80	1,360

(2) Dividend

Share capital	£/€ 1,200,000	
Share value	25 pence/cent per share	
No. shares issued	4,800,000	
Dividend	4,800,000 x £/€0.025	£/€120,000

(3) Accumulated profits

	£/€'000
Retained profit for year per trial balance	140
Prepaid expenses	24
Dividend (W3)	(120)
Interest (W4)	(12)
Government grants released (W.5)	22
	54
Retained Profit brought forward 1 Jan 2009	90
Accumulated profits	144

(4) Interest

Debenture 10%	£/€ 120,000
Interest	£/€ 12,000

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Solution to question 3(cont'd)

(5) Grants

	£/€'000
Grants as at 1 Jan 2009	48
Grants received during the year	40
	88
Grants released during year (88/4)	22
Deferred government grants	66

(6) Trade receivables

	£/€'000
Receivables per trial balance	372
Less provision for doubtful debts	(16)
	356

(7) Trade and other payables

	£/€'000
Trade payables per Trial Balance	88
Corporation tax	88
VAT	28
Accrued expenses	56
Dividend payable (W2)	120
	380

(8) Cash and cash equivalents

	£/€'000
Short term investments	40
Bank deposit	80
Government grant received	40
	160

(9) Prepayments

Prepaid expenses of €/£24,000 included in operating costs in error to be in current assets.

Solution to question 4

			DR	CR
(i)				
	DR	Lease machinery	125,096	
	CR	Finance lease		125,096
	[Being purchase of leased machinery]			
	DR	Statement of Profit & Loss	25,019	
	CR	Accumulated depreciation		25,019
	[Being calculation of annual depreciation charge]			
	DR	Finance lease	30,000	
	CR	Bank		30,000
	[Being payment of first year lease payment]			
	DR	Statement of Profit & Loss	9,510	
	CR	Finance lease		9,510
	[Being calculation of first year's lease interest]			
(ii)				
	DR	Inventory (Statement of Profit & Loss)	5,250	
	Cr	Inventory (balance sheet)		5,250
	[Being correction of inventory due to stock destroyed in fire]			
	DR	Inventory (Statement of Profit & Loss)	4,200	
	CR	Inventory (balance sheet)		4,200
	[Being correction of inventory due to stock sold but not yet recorded]			
	DR	Inventory (Statement of Profit & Loss)	3,600	
	CR	Inventory (balance sheet)		3,600
	[Being write down of inventory to NRV as per IAS 2]			
(iii)				
	DR	Fixtures & fittings	20,000	
	CR	Administration costs		20,000
	[Being correction of acquisition of fixtures and fittings incorrectly recorded as administration expenses]			

Solution to question 4 (cont'd)

			DR	CR
	DR	Statement of Profit & Loss	2,000	
	CR	Accumulated depreciation		2,000
		[Being calculation of annual depreciation charge]		
(iv)				
	DR	Prepayments	15,000	
	CR	Distribution expenses		15,000
		[Being correction of prepayments incorrectly treated as distribution expenses]		

Solution to question 5

[a]

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.

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.

[b]

(i) There is a present obligation (to close the division) as a result of a past obligating event (decision to close division and communication of this decision to suppliers and employees). It is more probable that a transfer of economic benefits will arise as the entity will incur closure costs.

Therefore a provision should be recognised in the accounts.

(ii) There is a present obligation (to repair or replace defective products) as a result of a past obligating event (sale of goods to customers which includes a three year warranty). A transfer of economic benefits will result as the company must meet the cost of repair or replacement and this can be reliably measured based on sales information and costs incurred in prior years.

Therefore a provision should be recognised in the accounts.

(iii) There is a present obligation (to pay lease payments as they arise and become due) as a result of a past obligating event (signing of the lease). Until such time as the entity finds a new tenant the entity must pay the unavoidable lease payments and this can be reliably measured.

Therefore a provision should be recognised in the accounts.

(iv) There is no present obligation as there is no past obligating event (the cost of fitting of smoke alarms or for fines under the new legislation).

Therefore no provision should be recognised in the accounts.

[c]

IAS 2 states that inventories should be measured at the lower of cost or net realisable value.

Inventory valuation:

Cost	**€/£ per unit**
Materials	2.00
Labour	3.00
Expenses	2.50
Production (900,000 / 750,000)	1.20
Cost per unit	**8.70**
NRV	
Selling price	9.00
Marketing costs	(1.20)
NRV per unit	**7.80**

Therefore stock will be valued at the lower of cost of NRV, which is NRV:

250,000 units x €/£7.80 per unit = **€/£1,950,000**

Solution to question 6

[a]

Cornwall Ltd.

Statement of comprehensive income for the year ended 31 December 2009

	£/€'000
Sales Revenue	30,780
Cost of sales (W.7)	(21,649)
Gross profit	9,131
Distribution costs (W.3)	(3,312)
Administrative expenses (W.4)	(2,612)
	3,207
Interest (W.8)	(180)
Profit before tax	3,027
Tax expense (W.5)	(980)
Profit on ordinary activities after tax	2,047

[b]

Profitability ratios

Gross profit	(9,131/30,780)*100	29.7%
Net profit	(3,027/30,780)*100	9.8%

Liquidity ratios

Current ratio (W.9 & W.10)	(11,989/5,600)	2.14 : 1
Acid test ratio (W.9 & W.10)	(11,989 – 3,041)/5,600	1.60 : 1

Workings

(1) Depreciation

	£/€'000	£/€'000	£/€'000
	Buildings	Factory Plant & equip	Warehouse Plant & equip
Cost	16,000	26,640	2,400
Acc deprec	(4,430)	(5,140)	(1,040)
	11,570	21,500	1,360
Depreciation			
2% revalued	320		
20% red bal		4,300	272

(2) Closing inventory

	£/€'000
Auctioned goods at cost	500
Sales value	300
Less : auctioneer fees (3%)	(9)
NRV	291

Auctioned goods to be valued at lower of cost of NRV as per IAS 2.

Closing inventory	3,250
Less inventory over valuation (500-291)	(209)
Adjusted closing inventory	3,041

(3) Distribution expenses

	£/€'000
Per T/B	3,040
Depreciation : Warehouse plant & equip.	272
	3,312

(4) Administrative expenses

	£/€'000
Per T/B	2,240
Bad debt	120
Bad debt provision (W6)	252
	2,612

(5) Taxation

	£/€'000
Per trial balance	40
Charge for current year	940
Total taxation charge	980

(6) Bad debt provision

	£/€'000
Debtors	8,520
Bad debt	(120)
	8,400
Bad debt provision (3%)	252

(7) Cost of sales

	£/€'000
Opening inventory	2,890
Add: purchases	17,180
Buildings depreciation	320
Factory plant & equipment depreciation	4,300
Less: closing inventory	(3,041)
Cost of goods sold	21,649

(8)Interest

	£/€'000
Debenture interest	120
Bank interest	60
Total interest	180

(9)Current assets

	£/€'000
Receivables	8,520
Less: bad debt (W.6)	(120)
Bad debt provision (W.6)	(252)
Inventory (W.2)	3,041
Cash at bank	800
Total current assets	11,989

(10)Current liabilities

	£/€'000
Payables	4,660
Tax	940
Total current liabilities	5,600