SUGGESTED SOLUTIONS

KE1 – Financial Accounting & Reporting Fundamentals

September 2015

SECTION 1

Answer 01

1.1.

Learning Outcome: 1.1.5 State the differences between financial accounting and management accounting.
Correct answer: B

1.2.

Learning Outcome: 1.2.1. Explain the objective of financial reporting
Correct answer: B

1.3.

Learning Outcome: 1.2.5. Explain the underlying assumption (going concern) in accounting and accounting concepts (accrual, materiality, consistency, entity, matching, prudence, periodic),
Correct answer: C

1.4.

Learning Outcome: 1.2.6. Explain qualitative characteristics of financial information.
Correct answer: C

1.5.

Learning Outcome: 2.1.1. Identify source documents and their records used in accounting.
Correct answer: D

1.6.

Learning Outcome: 2.1.4. Explain the objective of primary books used in accounting.
Correct answer: D

1.7.

Learning Outcome: 2.3.2
Correct answer: C

1.8

Learning Outcome: 2.3.2. Record transaction based on source document.	
Correct answer: B	

1.9.

Learning Outcome: 4.9.4 Explain the difference between taxable temporary differences and deductible temporary differences	
Correct answer: B	

110

Learning Outcome: 4.11.1 Identify basic financial assets and financial liabilities.	
Correct answer: C	

(Total: 20 marks)

Answer 02

2.1.

Learning Outcome: 1.2.7 Explain the need for accounting standards.

Correct answer:
To deal with subjectivity arising from application of judgment in preparing financial statements and to achieve comparability between different organisations.

2.2..

Learning Outcome: 1.2.8 Identify the role of CA Sri Lanka in financial reporting.

Correct answer:

(i) The main responsibility is to issue Sri Lanka Accounting Standards.

(ii) To adopt IFRS as issued by IASB and issue them as LKAS/SLFRS.

2.3.

Learning Outcome:

1.2.9 Discuss the fundamentals of both accrual basis and cash basis of accounting.

1.2.10 Explain the difference between a set of financial statements prepared using accrual basis versus cash basis.

Correct answer:

(a)

		Rs.
Accrual basis		
Sales 8*120,000	=	960,000
Cost of TV sold 8*95,000	=	(760,000)
Profit	**=**	**200,000**
Cash Basis		
Sales 8*120,000	=	960,000
Purchase 10*95,000	=	950,000
Profit	**=**	**10,000**

(b) Under cash basis, the figure shows cash received and paid. There is no matching of income with the cost of earning that income. Therefore there is no recognition of closing inventory under cash basis. Under accrual basis income and expenses are matched.

2.4.

Learning Outcome: 2.4.2 Prepare the year-end financial statements for accruals, pre-payments, depreciation, bad debts and closing stocks
Correct answer:

	Rs.	Rent income	Rs.
P/L	560,000	Rent advance	25,000
		Cash	500,000
		Rent arrears	3 5,000
	560,000		560,000

Rent income= Rs. 560, 000

2.5.

Learning Outcome: 4.2.4. Explain the different methods of PPE depreciation
Correct answer:

(1) Straight line method.
(2) Reducing balance method.

2.6.

Learning Outcome: 4.5.2 Explain different methods used in inventory valuation.
Correct answer:

Under FIFO method, it is assumed that the items of inventory that were purchased or produced first are sold first. When items are purchased at different prices, the items remaining in inventory at the end of the period will be at the latest purchase price.

Under weighted average cost method the cost of each item is determined from the weighted average of the cost of similar items purchased or produced. Every time a purchase is made the weighted cost will be recomputed. The balance of inventory remaining would have the same unit valuation.

Accordingly, different valuation methods produce different values for inventory.

2.7.

Learning Outcome: 4.2.4. Explain the different methods of PPE depreciation. 4.6.1 Identify the purpose of lKAS 8.
Correct answer: (i) (100-40)=60/5 = 12 (ii) Change in useful life of machinery is a <u>change in accounting estimate</u>. It affects both the current year and future periods. It should be <u>accounted prospectively</u>. i.e. recognize carrying amount as at 31 March 2014 (Rs.60 m) over remaining 5 years on straight line basis.

2.8.

Learning Outcome: 4.8.2 Explain the difference between finance lease and operating lease
Correct answer: (a) Building – lease period is not a major part of the useful life. Therefore risks and rewards of ownership are with the lessor. It's <u>an operating lease</u> (b) Motor Vehicle – since Beta owns the vehicle at the end of the lease period, risks and rewards of ownership are passed to Beta. It's a <u>finance lease</u>. (c) Plant – Since the plant is specialized and only Beta can use it without major modification, risks and rewards are with Beta and it's <u>a finance lease</u>.

2.9.

Learning Outcome: 4.10.1. Define employee benefits.
Correct answer: (a) Short-term employee benefits are employee benefits other than termination benefits that are <u>expected to be settled wholly before 12 months after the annual reporting</u> period in <u>which the employees render the related</u> services (b) Post-employee benefits are employee benefits that are payable <u>after the completion of employment.</u> (c) Termination benefits are employee benefits provided <u>in exchange for the termination of employee's employment</u>

2.10.

Learning Outcome: 4.12.3 Explain the criteria to be satisfied when recognsing provision in financial statements.
Correct answer: * An entity has a <u>present obligation</u> as a result of a past event. * It is <u>probable that transfer of economic benefits will be required to settle the obligation</u>. * <u>Reliable estimate</u> can be made <u>of the obligation</u>.

(Total: 30 marks)

SECTION 2

Answer 03

Learning Outcome:
2.5.2 Prepare journal entries for correction of errors. 2..7.2 Prepare a reconciliation statement reconciling the cash book balance with the bank statement balance.

Correct answer:

(a) Sales Dr. Rs. 12,850
Trade Receivables Cr. Rs. 12,850
(being reversal of sales recorded incorrectly)

Repair Expenses Dr. Rs. 5,000
Machinery Cr. Rs. 5,000
(being correction of repair expenses incorrectly debited to the machinery account)

Purchases Dr.Rs. 70,000
Trade Payables Cr. Rs. 70,000
(being correction of purchases understated due to a casting error)

(3 marks)

(b)

	Rs.	Rs.
(i) cash book balance as at 28 February 2015		35,000
<u>Adjustments</u>		
Mobile bill paid	(3,650)	
Bank charges	(1,120)	
Direct deposit by a customer	1,000	
Cheque cancelled	<u>1,000</u>	<u>-2,770</u>
Corrected balance in the cash book		<u>32,230</u>

(4 marks)

(ii) Bank Reconciliation Statement as at 28 February 2015

Balance as per bank statement		21,730
Add:		
Unrealised cheques	<u>15,000</u>	36,730
Less:		
Unpresented cheques	5,500	
Cancelled cheque	<u>-1,000</u>	<u>(4,500)</u>
Balance as per Cash book		<u>32,230</u>

(3 marks)
(Total 10 marks)

Answer 04

Learning Outcome: 3.3.2. Prepare the financial statements for a partnership including appropriation accounts (simple financial statements for a partnership without change in the ownership during the period).

Correct answer:

	Rs.
Net profit for the year as given	1,020,000
Profit on motor vehicle transfer	130,000
Adjustment for trading stock withdrawal	180,000
Partners' loan interest	(60,000)
Net profit available for appropriation	1,270,000

(a) **Appropriation account**

Net profit available for appropriation			1,270,000
Partners' salary - Aruna			240,000
Interest on capital	- Aruna	150,000	
	- Bala	100,000	
	- Chaminda	50,000	300,000
Share of profit	- Aruna	365,000	
	- Bala	243,333	
	- Chaminda	121,667	730,000
			1,270,000

(6 marks)

(b) **Partners' current account**

	Aruna	**Bala**	**Chamin**		**Aruna**	**Bala**	**Chamin**
	(Rs.)	**(Rs.)**	**(Rs.)**		**(Rs.)**	**(Rs.)**	**(Rs.)**
Balance 1/4/2014	**150,000**	**-**	**-**	**Balance 1/4/2014**	**-**	**250,000**	**450,000**
M. vehicle taken	-	-	750,000	Loan interest	60,000	-	-
Stock withdrawal	180,000	-	-	Partners' salary	240,000	-	-
Drawings	400,000	-	360,000	Interest on Capital	150,000	100,000	50,000
Profit share - shortfall	107,000	71,333	-	Share of profit	365,000	243,333	121,667
Trade receivable	-	80,000		Profit share - shortfall	-	-	178,333
Balance c/d	**-**	**442,000**		**Balance c/d**	**22,000**	**-**	**310,000**
	837,000	593,333	1,110,000		837,000	593,333	1110,000

(4 marks)
(Total: 10 marks)

Answer 05

Learning Outcome: 2.6.2 Prepare a reconciliation of control account balances with the total of individual accounts.
Correct answer:

(a) **Journal entries to correct the errors:**

			Rs.	Rs.
(i)	Discount allowed account/suspense	Dr	15,000	
	Trade receivable account	Cr		15,000
(ii)	Trade receivable account	Dr	36,000	
	Sales account	Cr		36,000
(iii)	Trade payable account	Dr	40,000	
	Sales account	Cr		40,000
(iv)	Sales account	Dr	110,000	
	Trade receivable account	Cr		110,000
(v)	Suspense account	Dr	52,000	
	Discount allowed	Cr		26,000
	Discount received	Cr		26,000

(4 marks)

(b)

Receivable control account

	Rs.		Rs.
Balance b/d	580,000	Error correction – discount allowed	15,000
Error correction –Sales	36,000	Error correction – Sales	110,000
		Cash received	4,260,000
Credit Sales account	4,429,000	Balance c/d	660,000
	5,045,000		**5,045,000**

Payable Control account

	Rs.		Rs.
		Balance b/d	360,000
Cash paid	3,440,000		
Sales	40,000	Credit purchases	3,640,000
Balance c/d	520,000		
	4,000,000		**4,000,000**

(4 marks)

(c) **Mayura Ltd – Trading account:** **(in Rs.000's)**

Cash sales (1,280-110)			1,170
Credit sales			4,429
			5,599
Less: Cost of sales:			
Opening inventory		870	
Add:	Cash purchases	940	
	Credit purchases	3,640	
		5,450	
Less: Closing inventory		990	4,460
Gross profit			1,139

(2 marks)

(Total: 10 marks)

Answer 06

Learning Outcome: 3.6.2 Compute basic accounting ratios (profitability ratios, liquidity ratios, gearing ratios excluding investor ratios).
Correct answer:

(a) **Possible reasons for variations in following ratios:**

(i) Gross profit ratio

Possible reasons are:

- Change in average prices due to external factors (like market conditions) or internal factors such as higher level of discounts.
- Change in cost of sales due to external factors (such as increased costs) or internal factors (such as high level of wastages and high direct costs).

(ii) ROCE

- Changes in share capital (new share issues, bonus issues etc.)
- Changes in long term borrowings (new borrowings, repayments etc.)
- Increase/decrease in gross profit margin
- Changes in utilization of assets in making profits.
- Cost control measures.

(4 marks)

(b)			**2014/15**	**2013/14**
(i)	Gross profit ratio = G. Profit/Sales	=	6,770/20,900	5,760/15,980
		=	32.39%	36.05%
(ii)	ROCE = PBIT / Capital employed	=	3,670 / 15,840	2,620/14,910
		=	23.17%	17.57%
(iii)	Assets turnover = Sales / Capital emp	=	20,900/15,840	15,980/14,910
		=	1.32 times	1.07 times
(iv)	Inventory holding period = (Average inventory/ Cost of sales) * 365 days			
		=	(1,070/14,130)*365	(860/10,220) *365
		=	27.64 days	30.71 days

Average inventory taken for 2014/15, marks may be given even if the yearend inventory is taken.

(v)	Average receivable collection period	=	(Average debtors/Sales) * 365	
		=	(880/20,900) * 365	(780/15,980) * 365
		=	15.37 days	17.82 days
(vi)	Quick assets ratio = (Current assets – inventory) / Current liabilities			
		=	1,500 / 1200	1200 / 990
		=	1.25 : 1	1,21 : 1

(6 marks)

(Total: 10 marks)

SECTION 3

Answer 07

Learning Outcome: 3.2.3	Prepare financial statements for the purpose of management and publication.
Correct answer:	

(a)

Manik Furniture (Pvt) Limited **Statement of Comprehensive Income for the Y/E 31 March 2015**	
	Rs. '000
Revenue(2367-22.5)	2,344.50
Cost of sales (w1)	(799)
Gross Profit	1,545.50
Profit from Disposal of Equipment	4.00
Insurance Claim	132.00
Admin Expenses (405+162 - (180/12*3)+ 6.25+11) + 4.4	(543.65)
Distribution Expenses	(234.00)
Finance Cost	(6.00)
Profit Before Tax	897.85
Income Tax (11.2+2.5)	(13.70)
Profit after tax	**884.15**
Other comprehensive income Revaluation of Land	220.00
Total comprehensive income for the year	1,104.15

Cost of sales – **W1**		
Opening stock	87	
Purchases	956	
	1,043	
Closing stock	(244)	799.00

(7 marks)

(b)

Manik Furniture (Pvt) Limited **Statement of Changes in Equity for the Y/E 31 March 2015**				
	Stated Capital	Revaluation Reserve	Refined earning	Total
	(Rs.'000)	**(Rs.'000)**	**(Rs.'000)**	**(Rs.'000)**
Balance as at 1.4.14	1,440.00	-	1,353.00	2,793.00
Profit for the year			884.15	884.15
Revaluation		220.0 0		220.00
Dividend paid			(80.00)	(80.00)
Balance as at 31.3.15	1,440.00	220.00	2,157.15	3,817.15

Note: (1) NRV adjustment on stock may be shown as an expense as alternate treatment.
(2) Amount paid by insurance co. Rs. 132,000. If treated as a receipt for damages to stocks due to fire this value should be adjusted to cost of sales.

(3 marks)

(c)

Manik Furniture (Pvt) Limited Statement of Financial Position as at 31 March 2015	
Non-Current Assets	
	Rs. '000
Property, Plant & Equipment	2,910.35
Current Assets	
Inventory	244.0
Trade receivables (540-22.5)	517.5
Prepaid rent	45.0
Cash at bank	678.0
	1,484.5
Total Assets	**4,394.85**
Equity & Liabilities	
Stated capital (1540-100)	1,440.0
Revaluation reserve	220.0
Retained earnings (1353+884.15-80)	2,157.15
	3,817.15
Non-Current Liabilities	
12% loan stock	100.0
Current Liabilities	
Trade payables	459.0
Income tax payables	1.7
Interest payable	6.0
Accrued expenses	11.0
	477.7
Total Liabilities	**4,394.85**

(10 marks)

Working 2

Property, Plant and Equipment					
	Cost	Disposal	Revaluation	A/Dep	WDV
	Rs.'000	**Rs.'000**	**Rs.'000**	**Rs.'000**	**Rs.'000**
Land	1,300.0		220.0		1,520.0
Machinery	1,625.0			548.25	1,076.75
Furniture and Fittings	320.0			193.0	127.0
Equipment 435 + 44	479.0	(50.0)		242.4	186.6
					2,910.35

(Total: 20 marks)

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