Practice Assessment: - ANSWERS

Task 1:
Issue of shares=£625,000 & Share premium= £125,000

Dr- Closing Inventory (Current Assets)	£4,280,000
Cr- Closing Inventory (Cost of Sales)	£4,280,000
Dr- Administrative expenses	£500,000
Cr- Land	£500,000
Dr- Administrative expenses	£633,000
Cr- Trade & other receivables	£633,000
Dr- Tax expense	£50,000
Cr- Tax liability	£50,000

Depreciation- PM: 15% x (£12,000 – 3,500) = £1,275
Building: 2.5% x £10,000 = £250
COS & Distribution = 40% x £(1,275 + 250) = £610
Admin expenses = 20% x £(1,275 + 250) = £305

Baljow Limited
Statement of profit or loss and other comprehensive income for the year ended 31 May 20X1

Continuing operations:	**£'000**
Revenue	36,824
Cost of sales	(17,940)
Gross profit	18,884
Distribution costs	(8,716)
Administrative expenses	(8,678)
Profit from operations	1,490
Finance costs	(975)
Profit before tax	515
Tax	(50)
Profit for the year from continuing operations	465
Other comprehensive income:	
Gain/loss on revaluation	(0)
Total comprehensive income for the year	**465**

Workings:

Cost of sales	**£'000**
Opening Inventory	5,064
Purchases	16,546
Depreciation	610
Closing Inventory	(4,280)
	17,940

Administrative expenses	**£'000**
Administrative expenses	7,240
Revaluation of land	500
Irrecoverable debt	633
Depreciation	305
	8,678

Distribution costs	**£'000**
Distribution costs	8,106
Depreciation	610
	8,716

Finance costs	**£'000**
Interest	550
Accrual	425
	975

Baljow Limited
Statement of changes in equity for the year ended 31 May 20X1

	Share capital	Other reserves	Retained earnings	Total equity
	£'000	£'000	£'000	£'000
Balance at 1 June 20X0	10,375	6,075	6,059	22,509
Changes in equity for the year:				
Total comprehensive income for the year			465	465
Dividends paid			(1,600)	(1,600)
Issue of shares at a premium	625	125		750
Balance at 31 May 20X1	**11,000**	**6,200**	**4,924**	**22,124**

Task 2:
Baljow Limited Statement of financial position as at 31 May 20X1

ASSETS		£'000
Non – current assets		
Land and buildings		17,750
Plant and machinery		7,225
		24,975
Current assets		
Inventory		4,280
Trade & other receivables		8,770
Cash & cash equivalents		3,980
		17,030
Total assets		**42,005**
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital		11,000
Share premium		4,000
Revaluation reserves		2,200
Retained earnings		4,924
Total equity		22,124
Non - current liabilities		
6.5% loan stock		15,000
Current liabilities		
Trade & other payables		4,831
Tax liability		50
		4,881
Total liabilities		19,881
Total equity and liabilities		**42,005**

Workings:

Land and buildings	**£'000**
Land and buildings at cost	20,000
Accumulated depreciation	(1,500)
Depreciation for the year	(250)
Revaluation	(500)
	17,750

Plant and machinery	**£'000**
Plant and machinery at cost	12,000
Accumulated depreciation	(3,500)
Depreciation for the year	(1,275)
	7,225

Trade & other receivables	**£'000**
Trade receivables	7,335
Prepayments	2,068
Irrecoverable debt	(633)
	8,770

Trade & other payables	**£'000**
Trade payables	4,406
Finance cost accrual	425
	4,831

Task 3:
Fundamental qualitative characteristics
Relevance
Financial information must be relevant to the decision making process and should have the ability to influence the economic decision of the users by helping them evaluate past, present and future events. For information to be relevant, it must also have predictable and confirmatory values in addition to being capable of influencing decisions.

Faithful representation
Financial information must be reliable in reflecting the substance and economic reliability of the transactions and other events that occurred and not merely the legal form of the events-i.e. substance over form. The information must be complete and free from material error and bias –i.e. neutral- and it must be dependable upon by its users to represent faithfully what it claims to represent as at the date of the financial statements.

Financial information produced under uncertainty, where decisions have to be made on estimates e.g. allowance for doubtful debts, must exhibit a level of caution and prudence in order to be reliable and show a faithful representation.

Materiality
As a quality threshold, financial information must be material for it to be useful and possess any of the other qualities discussed above and below. Information in the financial statements must be complete within the bounds of materiality and cost, for it to be relied upon by its users.

An item is deemed to be material if its omission or misstatement will influence the economic decisions of the users of the accounts. The materiality concept concerns the accounting treatment for “small” or non-material items in the financial statements. If an item is non-material, that is, its omission from compliance with the underlying rules in accounts preparation doesn’t affect the economic decisions of the users of the accounts, then it can be exempt from such compliance.

Enhancing qualitative characteristics
Comparability
Financial information must be comparable and consistently applied over time to enable its users be able to compare similar information on the business for other periods. Financial statements must include corresponding information for the preceding periods and any changes in accounting policies used, must be notified to the users of the financial statements.

Verifiability
Financial information must be verifiable and independent observers should be able to reach a possible broad agreement or consensus on the way items in the financial statements have been dealt with and presented and this ought to depict a faithful representation. Verifiability helps to assure users of the financial information that the financial statements faithfully represent the economic data that it purports to represent.

Timeliness
Financial information must be presented in a timely manner to be capable of influencing the decisions of the users of the financial statements. The older the information, the less reliable and less useful such information will be to the users of the financial statements.

(b) Give two examples of user groups identified in the Conceptual Framework for Financial Reporting and explain their need for the information in the financial statements.

Existing and potential investors
The investors need to make investments decisions like buying or selling shares, so they will need financial information which will enable them make such informed decisions. Information such as the profitability, liquidity, management’s ability to use and utilise resources, earnings per share, financial position of the company will be needed to be able to make the relevant investment decisions.

Existing and potential lenders
The lenders need to make decisions on offering or redeeming loans and credit facilities, so they will need financial information which will enable them decide on whether to lend resources or withdraw resources and funds from such company.

Task 4:
(a) A provision is a liability of uncertain timing or amount and a liability is a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. For example, where a claim is made against an entity, the management may know they will be liable to paying out damages, but may not know the exact amount or time this will be done, as it will depend on the outcome of the court case.

Provisions should be recognised as a liability in the financial statements. Hence,

Dr- Expense (Relevant expense)
Cr- Liability (Trade and other payables)

(b) A contingent liability is <u>either</u>:

- A <u>possible obligation</u> which arises from past events whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control.

OR

- A <u>present obligation</u> which arises from past events but is not recognised because:
  -It is not probable that an outflow of economic benefits will be required to settle the obligation,
  or
  -The amount of obligation cannot be measured with sufficient reliability.

A contingent liability does not meet the recognition criteria, so it should not be recognised in the financial statements, however it should be disclosed as a note in the accounts.

(c) A contingent asset is a possible asset which arises from past events whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control.

A company should not recognise a contingent asset in its financial statements because it could result in the recognition of an income that may never be realised. However, if the possibility of an inflow of economic benefits is probable, it should be disclosed and if the asset is virtually certain to be realised, it should be recognised.

Task 5:
(a) An asset is impaired when the recoverable amount is higher than the carrying amount?
True or <u>**False**</u>

(b) Inventory is valued at the lower of Cost or Recoverable amount? True or <u>**False**</u>

(c) (i) FIFO inventory valuation methods? £32.50 (ii) AVCO inventory valuation methods? £31.80

(d) (i) £24,226 (ii) £25,906

(e) Reconciliation of profit from operations to net cash flow from operating activities

	£
Profit from operations	13,600
Adjustments:	
Add back: Depreciation	2,564
Operating profit before working capital changes	16,164
Gain on disposal of non-current assets	(1,260)
Increase in trade and other receivables	(5,460)
Decrease in inventories	1,617
Increase in trade and other payables	2,919
Cash generated from operations	**13,980**

Task 6:

Jabi Ltd Consolidated statement of financial position as at 31 December 20X5

ASSETS	**£**
Non-current Assets	
Goodwill [(99000-{63000+70%x26000})x80%]	14,240
Property, plant and equipment (190000+128000)	318,000
	332,240
Current assets (101000+69000-6000-5000)	159,000
Total Assets	**491,240**
EQUITY & LIABILITIES	
Equity	
Share capital	196,000
Retained earnings	88,640
Non-controlling interest (30%x152000)	45,600
Total equity	330,240
Current liabilities (121000+45000-5000)	161,000
Total equity and liabilities	**491,240**

Workings:

Goodwill	**£**
Cost	99,000
Shares	(63000)
Retained Earnings (70%x£26000)	(18,200)
	17,800
Impairment	(3,560)
Goodwill at end of year	**14,240**

Retained earnings	**£**
Jabi Ltd	73,000
Bantel Ld (70%x{62000-26000})	25,200
Impairment of goodwill	(3,560)
Unrealised profit	(6,000)
	88,640

(b)

Consolidated statement of profit or loss for the year ended 31 December 20X5

Continuing operations:	**£'000**
Revenue (4900+2450-220)	7,130
Cost of sales (2660+1400-220+40)	(3,880)
Gross profit	3,250
Other income	0
Distribution costs (578+349)	(927)
Administrative expenses (439+530)	(969)
Profit from operations	5,146
Tax (462+33)	(495)
Profit after tax	**4,651**

Task 7:

Ratio	Formula	Computation of ratio (to one decimal place)	
		20X0	20X1
Gross profit percentage	Gross profit x 100 / Revenue	41.3%	45.7%
Operating expense/ revenue percentage	Operating expense x 100 / Revenue	15.8%	23.5%
Interest cover	Profit from operations / Finance cost	13.3 times	11.9 times
Return on capital employed	Profit from operations / Total equity + Non-current liabilities x 100	37.1%	25.8%
Return on shareholders funds	Profit after tax x 100 / Total equity	37.7%	24.1%

Task 8:

(a) Gross profit percentage is better in 20X1 than 20X0

Possible reasons would include:

- More gross profit is being generated by sales/ more gross profit margins on sales.
- Selling prices may have increased.
- Sales volume may have increased.
- Cost of sales / purchase costs may have decreased, hence better gross profits.
- The mix of products sold may have changed and improved in 20X1.
- The annual budget anticipated an increase in gross profit but the increase is greater than expected.

(ii) Operating profit percentage is worse in 20X1 than 20X0

Possible reasons would include:

- As the gross profit ratio has improved, the reduction would be due to increased overhead costs.
- Less operating profit is being generated from sales.
- A lower level of efficiency is being maintained in the operating expenses.
- Sales may have increased and the operating expenses may have increased at a faster level.
- The operating profit achieved can be said to be in line with the budget as there is a slight reduction.

(iii) Inventory holding days is better in 20X1 than 20X0

Possible reasons would include:

- An increase in sales has enhanced the reduction in holding days.
- Less volume of inventory are being purchased in each order.
- An efficient economic order quantity (EOQ) is being maintained.
- Inventory levels are being monitored closely.
- As gross profit percentage has increased, cost of sales may have reduced.
- The improvement in inventory holding days may have been anticipated by the budget, but is better than expected.

(iv) Current ratio is worse in 20X1 than 20X0

Possible reasons would include:

- As inventory holding days has reduced, there may be less inventory being held in stock.
- Less volume of inventory are being purchased in each order.
- Less current assets are being maintained.
- More current liabilities are being maintained
- Less cash resources available to the company
- The decline in current ratio may have been anticipated by the budget, but is greater than expected.

(b) Johnny Fisher should maintain his investment in the company as the company shows signs of profitability and the operating profit percentage has only reduced by 1% between 20X0 and 20X1.

Having said that, there is very limited information to apply in making this decision, as there is no industry comparison to ascertain how well the company is doing in comparison to other companies in the same industry of the same size and there are no other previous years data to ascertain the trend being developed by the company.

There will also need to be a review of the company's liquidity and its ability to pay its short term debts into the future.