

Examination Paper, Solutions and Examiner's Report

**Paper:
Financial and Management
Accounting**

**Certificate in Financial
Fundamentals for Business**

October 2011

QUESTION 1

The financial accountant of KM Ltd ('KM') is preparing the financial statements of the company for the year to 31 March 2011. Accounting for each of the following three areas has still to be completed.

Leases

On 1 April 2010 KM entered into a four-year lease of a machine. The machine would have cost £200,000 to acquire at that date. The terms of the lease require KM to pay £65,000 per annum on 31 March 2011 to 31 March 2014 inclusive. The machine has an estimated useful life of 4 years with an estimated residual value of £10,000, wholly attributable to KM. The lease payment due on 31 March 2011 was paid on the due date.

KM uses the sum-of-digits method to allocate interest on finance leases.

Loan

KM borrowed £6 million from a bank on 1 April 2010. Under the terms of the loan KM must pay 4% interest per annum on the amount borrowed on 31 March each year and repay £6.5 million on 31 March 2016. This equates to an effective interest rate of approximately 5.22%.

KM accounts for borrowings using the amortised cost method.

Foreign currency

The company sold goods to an American customer for \$8 million on 1 February 2011 when the spot rate of exchange was £1=\$1.92. The customer paid the full amount on 9 April 2011 when the rate of exchange was £1=\$1.88. At 31 March 2011 the rate of exchange was £1=\$1.89.

On 5 March 2011 KM received €7million which it deposited in a bank account that day. The amount was uplifted on 10 March 2011, exchanged into sterling and placed on short-term sterling deposit that day. Exchange rates were £1=€1.13 on 5 March 2011 and £1=€1.15 on 10 March 2011.

Required:

For each of the three areas above:

(a) Explain, with reasons, how each should be treated in the financial statements of KM for the year ended 31 March 2011.

(8 marks)

(b) Calculate the amounts, if any, to be included in KM's:

(i) income statement

(ii) balance sheet.

(17 marks)

(Total 25 marks)

QUESTION 2

The accountant of Bristo Ltd ('Bristo') has started the preparation of the cash flow statement of the company for the year to 30 September 2010. The investing and financing sections of the statement have still to be completed. The following information is available.

Bristo Ltd

Balance sheet extracts

As at 30 September

	2010 £'000	2009 £'000
Property, plant and equipment	11,760	10,990
Equity		
Share capital (25p ordinary shares)	1,000	800
Share premium	200	-
Revaluation reserve	200	50
Non-current liabilities		
Bank loan	1,500	1,750
Bonds	3,550	2,100
Finance lease obligations	890	760
Current liabilities		
Bank loan	250	250
Finance lease obligations	110	130

Income statement extracts

Depreciation of property, plant and equipment	(1,254)	(1,096)
Dividends received	55	30
Gain on disposal of property, plant and equipment	175	-

Notes

1. On 30 September 2010 Bristo revalued land from £400,000 to £550,000.
2. The asset on which the gain on disposal of £175,000 was made had a carrying amount of £438,000 at the date of sale.
3. Machinery with a fair value of £200,000 was acquired under finance leases in the year.
4. Bristo issued new shares for cash in January 2010.
5. Bristo paid a dividend of 15p per share in June 2010 to all shareholders at that date.
6. The policy of Bristo is not to include dividends paid and received in the operating activities section of the cash flow statement.

Required:

Prepare the investing and financing sections of the cash flow statement of Bristo for the year to 30 September 2010.

(15 marks)

QUESTION 3

A business was set up with the introduction of £75,000 cash. Fixed assets were bought for £20,000 cash and inventory of £8,500 was acquired on credit. Some of the goods in inventory were sold on credit for £6,800 and the remainder for £5,350 cash. Wages of £1,400 were paid in cash and expenses of £450 were accrued. £6,000 was paid to the creditor arising from the purchase of inventory.

Required:

Explain the effect of these transactions in terms of the accounting equation.

(6 marks)

QUESTION 4

Shareholders in large public companies expect companies they invest in to have good corporate governance. It is believed that audit, nomination and remuneration committees can each help achieve good corporate governance.

Required:

(a) Explain what is meant by, and identify the four main parties involved in 'corporate governance'.

(5 marks)

(b) Describe the appropriate membership and responsibilities of each of the three committees mentioned above.

(5 marks)

(Total 10 marks)

QUESTION 5

Consolidated financial statements include a parent and its subsidiaries. In preparing consolidated financial statements a number of accounting adjustments are required to be made.

Required:

(a) Explain the purpose of preparing consolidated financial statements and how these differ from the financial statements of the parent itself.

(3 marks)

(b) Describe how goodwill on consolidation is calculated and what it represents.

(5 marks)

(Total 8 marks)

QUESTION 6

Q Ltd has a 31 March 2011 year end. In February 2011 the Board of Directors decided to close one of the divisions of Q Ltd. A plan was drawn up to close the division by the end of December 2011 and an announcement was made to affected parties in late March 2011. The plan detailed the following costs:

	£
Retraining retained staff	180,000
Cancellation of lease	230,000
Operating losses of division to date of closure	400,000

In addition there will be redundancy payments. The company has estimated that there is a 50% chance that redundancy payments will be £500,000 and a 50% chance they will amount to £800,000. The exact amount will not be known until negotiations are completed after the year end.

The cancellation of the lease relates to a property used by the division to be closed. Under the terms of the lease it must be cancelled if Q Ltd no longer operates from the property.

Required:

Explain the appropriate treatment of the closure of the division in the financial statements of Q Ltd for the year to 31 March 2011 and calculate the amount of any provision required.

(6 marks)

QUESTION 7

Banner Ltd manufactures two products, A and B. Information for the next period is as follows:

	A	B
Forecast sales (units)	1,200	4,200
Selling price per unit	£460	£300
Requirements per unit:		
Material X (£10 per kg)	12kg	14kg
Material Y (£12 per kg)	16kg	9kg
Skilled labour (£14 per hour)	4 hours	2 hours
Unskilled labour (£8 per hour)	6 hours	5 hours

There are no other costs relating to production of A and B.

Actual and budgeted stock figures are as follows:

	Material X	Material Y	Product A	Product B
Opening stock	400kg	750kg	130 units	200 units
Closing stock – budgeted	860kg	650kg	400 units	350 units

Required:

Prepare the following budgets of Banner Ltd for:

- (a) Sales**
- (b) Production**
- (c) Labour**
- (d) Materials usage**
- (e) Materials purchases**

(14 marks)

QUESTION 8

Mupple plc bought 500,000 shares in Everre plc for £2.60 per share in October 2010. Costs of acquiring the shares were £3,000. At 31 December 2010, the year-end of Mupple plc, the shares in Everre plc were trading at £2.82 per share.

Mupple plc also acquired 100,000 shares in Petron Ltd for £3.00 per share in November 2010. Acquisition costs were £1,200. As the shares in Petron Ltd are not listed the directors of Mupple plc are unable to determine a reliable fair value for the shares.

Mupple plc classifies the above investments as available for sale financial assets.

Required:

Explain, showing appropriate amounts, how each of the investments should be treated in the financial statements of Mupple plc for the year to 31 December 2010.

(6 marks)

QUESTION 9

Briefly explain the following accounting concepts:

- periodicity
- going concern
- realisation

(6 marks)

QUESTION 10

Briefly explain the following in relation to a company accounting for its defined benefit pension plan, indicating how each should be calculated:

- interest cost
- expected return on assets

(4 marks)

Suggested Solutions for October 2011

QUESTION 1

Explanation and income statement and balance sheet amounts

Lease

Lease of machine

This is a finance lease as the lease is for the full useful life of the asset and the lease payments cover the full fair value of the asset. The asset should be recorded at fair value and lease payments allocated over the period of the lease using the sum-of-digits method. The amount due to the lessor at the end of each year should be split into current and non-current liabilities. The leased asset should be depreciated over the shorter of the lease term and the useful life of the asset.

Income statement

Finance cost	£ 24,000
Depreciation	47,500

Balance sheet

Property, plant and equipment	152,500
Non-current liability	
Finance lease creditor	112,000
Current liability	
Finance lease creditor	47,000

Workings

Depreciation = $(£200,000 - 10,000)/4 = £47,500$

Carrying value = $£200,000 - 47,500 = £152,500$

Allocation of interest

Interest = payments less fair value = $4 \times £65,000 - 200,000 = £60,000$

Sum of digits = $(4 \times 5)/2 = 10$. Payments are in arrears therefore $n = 4$

Interest allocated to:

Year 1 = $4/10 \times £60,000 = £24,000$, therefore capital = $£65,000 - 24,000 = £41,000$

Year 2 = $3/10 \times £60,000 = £18,000$, therefore capital = $£65,000 - 18,000 = £47,000$

Lease creditor

Year 1 = $£200,000 - \text{capital repayment} = £200,000 - 41,000 = £159,000$.

Year 2 = $£159,000 - 47,000 = £112,000$

Loan from bank

The loan is a financial liability and should be accounted for using the amortised cost method in accordance with the policy of the company.

Finance expense on the loan should be calculated using the effective interest rate and be added to the original balance or balance brought forward each period. Payments made to the lender should be deducted from the loan balance.

Income statement

Finance cost	313,200
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Balance sheet

Non-current liabilities	
Loan	6,073,200

Workings

Expense = loan x effective interest rate = 5.22% x £6m = £313,200

Loan = amount borrowed + interest expense – payments made

= £6,000,000 + 313,200 – 240,000 = £6,073,200.

The full amount is a non-current liability as none of the principal is repayable until 2016.

Foreign currency transaction

The transaction should be recorded at the spot rate at the date of the transaction.

At the year-end the debtor (a monetary item) should be retranslated at the rate at the balance sheet date with any gain or loss going to profit or loss.

The receipt of euro should be recorded at spot. When uplifted and exchanged the rate at that date should be used with any gain or loss taken to profit or loss.

As the deposit is short-term it should be included in current assets.

Income statement

Foreign exchange loss	41,596
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Balance sheet

Current assets	
Receivable	£4,232,804
Deposit	£6,086,957

Workings

Sale of goods

Gain = $\$8\text{m}/1.92 - \$8\text{m}/1.89 = \text{£}66,137$

Receivable = $\$8\text{m}/1.89 = \text{£}4,232,804$

Euro funds

On receipt = $\text{€}7\text{m}/1.13 = \text{£}6,194,690$

On uplift = $\text{€}7\text{m}/1.15 = \text{£}6,086,957$

Loss on exchange = $\text{£}107,733$

Overall loss = $\text{£}107,733 - 66,137 = \text{£}41,596$

QUESTION 2

Bristo Ltd

Cash flow statement

Year to 30 September 2010

Cash flows from investing activities

Purchase of property, plant and equipment (W1)	(2,112)
Proceeds from sale of property, plant and equipment (W2)	613
Dividends received	<u>55</u>
Net cash used in investing activities	<u>(1,444)</u>

Cash flows from financing activities

Issue of shares	400
Payment of finance lease liabilities (W3)	(90)
Repayment of bank loan	(250)
Issue of bonds	1,450
Dividends paid (W4)	<u>(600)</u>
Net cash from financing activities	<u>910</u>

Workings

Purchase of property, plant and equipment

At 1 October 2009	10,990
Less: depreciation	(1,254)
Disposal of asset (NBV)	(438)
Add: revaluation	150
Assets acquired under finance leases	<u>200</u>
	9,648
At 30 September 2010	<u>11,760</u>
Purchases	<u>2,112</u>

Proceeds of disposal of property, plant and equipment

Carrying amount at date of sale	438
Gain made on disposal	<u>175</u>
Proceeds	<u>613</u>

Finance lease payments

At 1 October 2009 (£760,000 + £130,000)	890
Add: new finance leases in the year	<u>200</u>
	1,090
At 30 September 2010 (890,000 + £110,000)	<u>1,000</u>
Repayments in year	<u>90</u>

Dividends paid

Number of shares in June 2010 (after share issue)
= 1,000,000 x 4 = 4,000,000 (as the shares are 25p each).

Dividend = 4m x 15p = £600,000.

QUESTION 3

Capital	Assets	Liabilities
75,000	75,000	
75,000	75,000 + 20,000 - 20,000	
75,000 - 8,500	75,000	8,500
66,500 + 6,800 + 5,350	75,000 + 6,800 + 5,350	8,500
78,650 - 1,400	87,150 - 1,400	8,500
77,250 - 450	85,750	8,500 + 450
76,800	85,750 - 6,000	8,950 - 6,000
76,800 =	79,750 -	2,950

QUESTION 4

a) Corporate governance

Corporate governance can be described as the process by which companies are directed and controlled. It is primarily concerned with the behaviour and actions of the board. Good corporate governance should reduce the agency risk that exists between directors and stakeholders ensuring that:

- A company's dealings with shareholders are fair and transparent
- The board of directors is held accountable
- The company deals responsibly with stakeholders

The four main parties that have a role to play in corporate governance are:

- Shareholders
- Directors

- External auditors
- Internal auditors

b) Audit committee

This should be made up of independent non-executive directors (NEDs). Its main responsibilities relate to the financial reporting process, internal control review, internal audit and relations with the external auditor.

Nomination committee

This should be made up with a majority of NEDs. Its main responsibility relates to the nomination of new members of the board of directors.

Remuneration committee

This should be made up of NEDs. Its main responsibilities relate to the setting of the remuneration of directors.

QUESTION 5

a) Purposes of preparing consolidated financial statements

The purpose of preparing consolidated financial statements is to show the total assets and liabilities under the control of the parent company and its directors and the results arising from this control. This is achieved by effectively combining the accounts of the parent and its various subsidiaries. In the balance sheet of the parent itself all that is shown is the investment in the subsidiaries (usually at cost) with no indication of the actual assets and liabilities of the companies it controls. The income statement would include the dividends received and receivable from the subsidiaries but not the results.

b) Goodwill

Goodwill is defined as the difference between the fair value (normally market value) of the consideration given for a stake in a subsidiary and the fair value of the net assets acquired in return. If the parent does not own all of the shares in the subsidiary the non-controlling interest should be valued either at their share of the net assets or at fair value.

Goodwill represents the amount that a buyer is willing to pay over and above the value of the net assets recognised on the balance sheet of the subsidiary. This in effect recognises the value of such things as reputation, research, skills of the workforce etc. Although less common it is possible for the opposite to arise – where the price paid is less than the fair value of the net assets of the subsidiary. This is referred to as a bargain purchase and could arise, for example, where the seller is desperate to sell or the business is trading at a loss.

QUESTION 6

As the decision has been made and communicated to affected parties by 31 March 2011 an obligation exists.

Therefore redundancy payments and cancellation of the lease (an onerous contract) should be provided for. The lease is onerous as it cannot be assigned and Q Ltd has no option but to pay the cancellation charge once it has decided to close the division.

Retraining and future losses are not obligations at 31 March 2011.

Therefore retraining costs and future losses should not be provided for.

The amount of the provision will be:

Redundancy*	£650,000
Cancellation of lease	<u>£230,000</u>
Provision	<u>£880,000</u>

* $50\% \times £500,000 + £800,000 \times 50\%$

QUESTION 7

Sales

Product	Volume	Price (£)	Revenue (£)
A	1,200	460.00	552,000
B	4,200	300.00	<u>1,260,000</u>
			<u>1,812,000</u>

Production budget

	A	B
Planned closing stock	400	350
Opening stock	130	200
Inc/Dec in stock	270	150
Sales volume	<u>1,200</u>	<u>4,200</u>
Production volume	<u>1,470</u>	<u>4,350</u>

Labour budget

	Skilled		Unskilled		
	Hours	£14.00/hr	Hours	£8.00/hr	£
A	$1,470 \times 4 = 5,880$	82,320	$1,470 \times 6 = 8,820$	70,560	152,880
B	$4,350 \times 2 = 8,700$	121,800	$4,350 \times 5 = 1,750$	174,000	<u>295,800</u>
					<u>448,680</u>

Materials usage budget

		Material X	Material Y
To produce			
A	1,470	17,640	23,520
B	4,350	<u>60,900</u>	<u>39,150</u>
		78,540	62,670
Planned closing stock		860	650
Opening stock		<u>(400)</u>	<u>(750)</u>
Requiring purchase		<u>79,000</u>	<u>62,570</u>

Materials purchases budget

	Material X	Material Y
Required purchase (units)	79,000	62,570
Cost per unit	£10	£12
Purchase total	<u>£790,000</u>	<u>£750,840</u>

QUESTION 8

Available for sale assets

The shares in Everre plc have a known value at the year-end. As they are in the available for sale category they should be initially recorded at cost plus transaction costs and restated to fair value at the year end with any change in fair value being taken to reserves and reported in other comprehensive income (unless there is a fall in value and objective evidence of impairment in which case the loss should be written-off to profit or loss).

Cost (500,000 x £2.60 + £3,000)	£1,303,000
Fair value at year end (500,000 x £2.82)	<u>1,410,000</u>
Gain to reserves	<u>107,000</u>

As there is no reliable fair value for the shares in Petron Ltd they should remain at cost (unless there is objective evidence of impairment). They will therefore be recorded at £301,200 (100,000 x £3.00 + £1,200) at the date of acquisition and at the year-end.

QUESTION 9

Periodicity

The financial statements of an entity have to be prepared regularly to be of benefit to users. The normal period for the production of full financial statements is 12 months although listed companies also have to prepare interim reports for the first 6 months of the year. In order for accounts to be produced a cut-off date has to be established (the year-end of the company) and incomplete transactions have to be accounted for at that date. These transactions are dealt with by applying other accounting concepts eg accruals.

Going concern

Financial statements are normally produced on the assumption that the entity will continue in existence for at least another 12 months. On this basis it is assumed that assets will be realised in the normal course of business and are accounted for as such eg fixed assets will be used over their estimated useful lives and are therefore depreciated over this period. The alternative is to assume that the assets will be realised as quickly as possible and to state them at liquidation value.

Realisation

Periodicity requires accounts to be prepared before some transactions are complete. The realisation concept requires that certain key events should have taken place before sales and purchases are recognised in the financial statements at the cut-off date. Cash does not have to have been received or paid by the year end but risks and rewards of ownership have been transferred. For example, if goods have been ordered but not received by the year-end they would not be recognised in the accounts at that date and as a result no creditor would be recognised either. This is because the entity does not have control of the goods it has ordered – this will not normally be achieved until the goods are received. The same approach is adopted for sales.

QUESTION 10

Interest cost

This is the increase in the liability to pay pensions as the retirement of the members of the plan (and therefore the payment of their pension) gets closer. As the liability is increasing it represents a cost to the company.

It is calculated as: opening liability x discount rate.

Expected return on assets

A funded pension plan will have assets. These will be invested. The expected return is the actuary's expectation of this return. It is calculated as:

opening assets x expected return.

Examiner's Report

Financial and Management Accounting October 2011

General

The overall pass rate was 64% (April 2011 54%) with 52 of the 81 candidates passing. The average mark for the paper was 51% but the standard deviation of 18 indicates that there was a wide range of marks. Of the 81 candidates who sat the paper 20 scored 65 or above but 15 scored below 35.

QUESTION 1 (25 marks)

This question required an explanation of the accounting treatment of a lease, a loan taken out by the company and two foreign currency items. Amounts to appear in the income statement and balance sheet had also to be calculated.

Almost all students correctly identified that the lease was a finance lease and most gave an adequate explanation of the accounting treatment although the fact that the asset should be depreciated over the shorter of the useful life and lease term was often missing. Calculations were generally accurate although a number of candidates calculated interest as a fraction of the lease payments rather than the total interest payable under the lease. It was pleasing to see that the majority of candidates appreciated that the lease creditor had to be analysed between current and non-current liabilities.

The loan was also well attempted by the majority with accurate figures calculated for the income statement and the balance sheet. A number of candidates stated that the loan would be classified under 'loans and receivables'. This category is for financial assets and does not apply to liabilities.

The foreign exchange items were also quite well attempted although a number omitted the second item. Weaker candidates based the final amount of the American customer on the settlement date exchange rate rather than that at the year end. As settlement was after the year end the settlement rate was irrelevant.

The average mark was 57%.

QUESTION 2 (15 marks)

Candidates had to complete the investing and financing sections of a cash flow statement.

There were several candidates who scored full marks.

Common errors were:

- Including only the gain on disposal of the asset rather than the proceeds
- Including the dividends received in the financing section rather than the investing section
- Omitting one or more of the movements in property, plant and equipment when calculating purchases
- Not including both current and non-current finance lease obligations when calculating the payment of finance lease payments
- Forgetting that the nominal value of the company's shares was 25p and that there were therefore four shares for every £1 of capital. This affected the calculation of the dividend paid.

The average mark for this question was 54%.

QUESTION 3 (6 marks)

This question required an explanation of the effect of transactions in terms of the accounting equation.

While the detail provided in answers tended to vary most candidates correctly dealt with all items except for the purchase and sale on inventory. There are basically two ways of dealing with this – either through capital (writing-off, or debiting, inventory as purchased and including, crediting sales revenue) or through assets (in which case the net profit has to be transferred to capital). Quite often there was a mixture of the two e.g. inventory added to assets but revenue to capital with no subsequent adjustments made. This demonstrated an overall lack of understanding of the effect on the accounting equation.

The average mark was 62%.

QUESTION 4 (10 marks)

The question required an explanation of corporate governance, the main parties involved and a description of the membership and responsibilities of the audit, nomination and remuneration committees.

The question was not well answered with **an average mark of 34%**.

Corporate governance was often too briefly and not clearly explained and although directors and shareholders were often identified as parties external and internal auditors were not always differentiated and employees were frequently incorrectly included.

Descriptions of the responsibilities of the remuneration and nomination committees were generally good although membership was sometimes unclear. Many thought that one of the main purposes of the audit committee was to appoint the external auditors. External auditors are appointed by shareholders. Some candidates described the role of external auditors rather than the committee.

QUESTION 5 (8 marks)

The question required an explanation of the purpose of consolidated financial statements, how these differ from the financial statements of the parent and a description of the calculation of goodwill and what it represents.

The explanation of the purpose of consolidated financial statements was reasonable but many omitted how parent company accounts' differed or just gave a description of what parent company accounts contained.

The description of goodwill was better although very few mentioned the alternative ways of valuing non-controlling interest. Many did mention the possibility of a bargain purchase (negative goodwill).

The average mark for this question was 37%.

QUESTION 6 (6 marks)

Candidates had to explain appropriate accounting treatment of the closure of a division and calculate the amount of any provision required.

Most candidates correctly identified that the training costs and operating losses should not be provided for as there was no obligation to incur these costs as at the year end. Most also correctly identified that provision should be made for the lease and redundancy payments as an obligation existed at the balance sheet. Some, however, did not adequately explain that the announcement prior to the year end created a constructive obligation.

A number of candidates based the redundancy provision on either the lower or higher of the two amounts mentioned in the question. The correct treatment is to take the relevant probability of each i.e. $50\% \times £500,000$ plus $50\% \times £800,000$. A number stated that no reliable estimate could be made. Only in extremely rare situations is it not possible to make a reliable estimate. In exam questions you should always presume it is possible unless the question clearly indicates to the contrary.

Although many correctly provided for the lease very few clearly explained why it was onerous (unavoidable loss through requirement to cancel).

The average mark was 43%.

QUESTION 7 (14 marks)

The question required the preparation of a number of budgets. This question was very well attempted with many scoring full marks.

The average mark was 86%.

QUESTION 8 (6 marks)

Candidates were required to explain, showing appropriate amounts, how two investments classified as available for sale assets should be accounted for.

Calculations were generally good although a number of students subtracted rather than added transaction costs. Weaker candidates stated that the gain on the first investment should be included in the income statement rather than taken to reserves and reported in other comprehensive income.

Most candidates correctly identified that the second investment should be carried at cost as no reliable fair value was available.

The average mark for this question was 59%.

QUESTION 9 (6 marks)

Candidates had to explain the accounting concepts, periodicity, going concern and realisation.

This question was not well answered. Although going concern was quite well explained many did not fully explain periodicity and few had a clear understanding of the realisation concept.

The average mark for this question was 33%.

QUESTION 10 (4 marks)

This question asked students to explain, in the context of a defined benefit pension plan, interest cost and expected return on assets indicating how each should be calculated.

This question was omitted by a number of students, perhaps due to time pressure.

Those that did attempt the question usually explained how the amounts should be calculated (although many did not clearly state that the amounts should be based on opening balances) but most did not explain what they represented.

The average mark was 27%.