THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KE1 – Financial Accounting & Reporting Fundamentals

March 2019

SECTION 1

Answer 01

1.1

Learning outcome/s: 1.1.2 Identify the role of accounting.
Study text reference: Page 5
Correct answer: C

1.2

Learning outcome/s: 1.2.4 Explain the elements of financial statements; assets, liabilities, equity, income, expenses and cash flows.
Study text reference: Pages 28 and 29
Correct answer: D

1.3

Learning outcome/s: 2.1.1 Identify source documents and other records used in accounting.
Study text reference: Page 65
Correct answer: B

1.4

Learning outcome/s: 4.1.2 Discuss items to be presented on the face of the statement of comprehensive income (SOCI), statement of financial position (SOFP), statement of cash flows (SOCF) and statement of changes in equity (SOCIE).
Study text reference: Pages 434 and 435
Correct answer: A

1.5

Learning outcome/s: 2.1.3 Identify the primary books used in accounting.
Study text reference: Pages 71 – 80
Correct answer: D

1.6

Learning outcome/s: 2.7.1 State the purpose and need for preparation of bank reconciliation statements.
Study text reference: Page 247
Correct answer: A

1.7

Learning outcome/s: 4.2.6 List the disclosure requirements with regard to PPE as per LKAS 16.
Study text reference: Pages 519 and 520
Correct answer: D

1.8

Learning outcome/s: 4.4.2 Prepare a cash flow statement under both direct method and indirect method.
Study text reference: Page 631
Correct answer: C

1.9

Learning outcome/s: 4.9.6 Compute deferred tax.
Study text reference: Pages 554 – 567
Correct answer: D

1.10

Learning outcome/s: 4.13.2 Identify entities that can follow SLFRS for SMEs.
Study text reference: Pages 657 and 658
Correct answer: B

(Total: 20 marks)

Answer 02

2.1

Learning outcome/s: 1.1.1
Identify the governance structure of business organisations.
Study text reference: Page 5 (additional study support material)
• Decide the remuneration policy especially for the CEO and others in the management team. • Decide on targets for the board of directors and the CEO. • Evaluate the achievements of the CEO.

2.2

Learning outcome/s: 1.1.3
Identify external environmental factors that affect the process of accounting (including economical, technological and regulatory requirements).
Study text reference: Pages 7 and 8 (additional study support material)
- Economic environment (e.g. inflation, interest rates, currency depreciation) - Political and legal environment (e.g. change of the governing party, new legislation, changes to existing laws) - Technological environment (e.g. innovations, obsolescence of existing technology, new machinery) - Social environment (e.g. changes in the age of the population, changes in lifestyles)

2.3

Learning outcome/s: 1.1.6 Identify the ethical requirements of financial reporting and the consequences of unethical behaviour.
Study text reference: Page 10 (additional study support material)
Integrity – be straightforward and honest in his/her professional and business relationships. Integrity also implies dealing fairly with other people and being truthful. **Objectivity** – make all professional and business judgments fairly on the basis of an independent and intellectually honest appraisal of information. **Professional competence and due care** – maintain professional knowledge and skills at the level required to ensure that clients or employers receive a competent professional service, and act diligently in accordance with applicable, technical and professional standards when providing professional services. **Confidentiality** – refrain from disclosing confidential information and using confidential information to their personal advantage or the advantage of a third party. **Professional behavior –** comply with relevant laws and regulations and avoid any action that may bring disrepute to the profession.

2.4

Learning outcome/s: 1.2.6 Explain qualitative characteristics of financial statements/financial information.
Study text reference: Page 42
Relevant financial information is information that is capable of making a difference in the decisions made by users. Financial information is capable of making a difference if it is has a <u>predictive value and/or confirmatory value.</u> Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information has confirmatory value if it provides feedback about previous evaluations.

2.5

Learning outcome/s: 1.2.9 Discuss the fundamentals of both accrual basis and cash basis of accounting.
Study text reference: Pages 55 – 57

Under the accrual basis, the effects of transactions and other events are recognised when they occur.

Under the cash basis, the effects of transactions and other events are recognised and recorded when cash or its equivalent is received or paid.

Accordingly under the accrual basis, transactions that are recorded as revenue and expenses are incurred in the accounting period, which they relate to, whereas under the cash basis, transactions are recorded on the basis of cash received or paid. Therefore, no matching takes place under the cash basis.

2.6

Learning outcome/s: 2.3.2 Record transactions based on source documents.
Study text reference: Pages 102 – 112

(i)	Sales returns/return inwards	**Dr.** Rs. 5,000	
	Trade receivables/Customer X		**Cr.** Rs. 5,000
(ii)	Bad debts/provision for impairment of debtors	**Dr.** Rs. 3,500	
	Trade receivables		**Cr.** Rs. 3,500
(iii)	Stationery expense	**Dr.** Rs. 10,000	
	Cash book		**Cr.** Rs. 10,000

2.7

Learning outcome/s: 2.6.2 Prepare a reconciliation of control account balances with a total of individual accounts.
Study text reference: Pages 274 – 290

Impact on trade receivables control account and trade receivables ledger account

		Trade receivables control account	Trade receivables ledger account
(i)	Settlement	**Cr.** Rs. 15,000	**Cr.** Rs. 15,000
(ii)	Undercast sales day book	**Dr.** Rs. 34,000	No impact

2.8

Learning outcome/s: 4.1.3 Explain the criteria to be used in the classification of assets and liabilities as current and non-current.
Study text reference: Page 432

Conditions to be fulfilled to classify an asset as a current asset

- Expected to be realised or is held for sale or consumption in the normal operating cycle of the entity.
- Held primarily for the purpose of being traded.
- Expected to be realised within 12 months from the reporting date.
- Cash and cash equivalents that are not restricted in their use.

2.9

Learning outcome/s: 4.13.1 Identify the need to adopt SLFRS for SMEs.
Study text reference: Page 659

Simplifications of SLFRS for SMEs

(i)	Financial instruments	Financial instruments meeting specified criteria are measured at cost or amortised cost. All others are measured at fair value through profit or loss (FVTPL).
(ii)	Research and development costs	Treated as an expense.
(iii)	Borrowing costs	Treated as an expense.

2.10

Learning outcome/s: 4.10.3 Explain the difference between short-term employee benefits, post-employment benefits and other long-term employee benefits.
Study text reference: Pages 574 and 575

(i) Short-term employee benefit
(ii) Post-employee benefit
(iii) Short-term employee benefit

(Total: 30 marks)

SECTION 2

Answer 03

Learning outcome/s: 2.6.2 Prepare a reconciliation of control account balances with a total of individual accounts.
Study text reference: Pages 274 – 283

(a) **Original balance in the receivables control account as at 31 December 2018**

	Rs.
Receivables ledger balance	2,725,560
Add:	
Customer returns not considered	536,440
Free sample issue considered as sales	150,000
Deposited but dishonoured cheque	57,000
	3,469,000
Less:	
Discount given to customer	(25,665)
Overcast value in the receivables ledger	(5,500)
	3,437,835

OR

		Rs.
Corrected total balance of the receivables ledger		
Total balance		3,526,395
Add: Sales returns	536,440	
Free sample of goods	150,000	686,440
		4,212,835
Less: Credit sales		(775,000)
		3,437,835

(b) **Journal entries to correct the errors**

Sales returns	**Dr.** Rs. 536,440	
Receivables control account		**Cr.** Rs. 536,440

(Recording the sales return made by a customer)

Receivables control account	**Dr.** Rs. 775,000	
Sales		**Cr.** Rs. 775,000

(Recording the credit sales not recorded)

Sales	**Dr.** Rs. 150,000	
Receivables control account		**Cr.** Rs. 150,000

(Correcting the error made by recording the free sample issued as a credit sale)

(c) **Corrected receivables ledger balance**

	Rs.
Receivables ledger balance	2,725,560
Add:	
Credit sales	775,000
Deposited but dishonoured cheque	57,000
	3,557,560
Less:	
Discount given to customer	(25,665)
Overcast value in the receivables ledger	(5,500)
	3,526,395

OR

	Rs.
Original balance of the receivables control account	3,437,835
Add:	
Credit sales	775,000
	4,212,835
Less:	
Sales returns	(536,440)
Free sample of goods	(150,000)
Corrected balance	3,526,395

(Total: 10 marks)

Answer 04

Learning outcome/s: 3.4.2 Prepare financial statements for non-profit entities.
Study text reference: Pages 389 – 418

(a)

Maharagama Sports Club Income and expenditure account for the year ended 31 December 2018	
	Rs.
Income	
Subscriptions **(W1)**	2,000,000
Admission fees	40,000
Receipts from the annual sports meet	76,000
Gross profit from the cafeteria **(W2)**	580,000
Donations	125,000
Rent income	11,700
	2,832,700
Expenses	
Salaries	643,000
Rates and taxes	21,000
Depreciation **(W3)**	199,500
Stationery	3,400
Annual sports meet expenses	72,300
Sundry expenses	4,600
	943,800
Excess of income over expenditure	**1,888,900**

(b)

Maharagama Sports Club Statement of financial position as at 31 December 2018	
	Rs.
Non-current assets	
Land	500,000
Buildings	185,200
Motor vehicles	405,900
	1,091,100
Current assets	
Subscription receivables **(W1)**	80,000
Cafeteria stock	342,000
Receivables of the cafeteria	5,000
Cash	1,702,500
	2,129,500
Total assets	**3,220,600**
Equity	
Accumulated funds as at 1 January 2018	1,324,600
Add: Excess of income over expenditure	1,888,900
	3,213,500
Current liabilities	
Cafeteria payables	3,200
Rent received in advance	3,900
	7,100
Total equity and liabilities	**3,220,600**

W1 – Subscriptions

Subscriptions account			
	Rs.		**Rs.**
Balance b/f	40,000	Balance b/f	20,000
Income and expenditure account	2,000,000	Receipts	1,940,000
		Balance c/f (4*20,000)	80,000
	2,040,000		**2,040,000**

W2 – Cafeteria profit

	Rs.
Sales (received)	671,200
Sales (receivable)	5,000
	676,200
Purchases (paid)	435,000
Purchases (payable)	3,200
Stock as at 31 December 2018	(342,000)
Cost of sales	96,200
Gross profit from the cafeteria	**580,000**

W3 – Depreciation

	Rs.
Building	39,500
Motor vehicles	160,000
	199,500

(Total: 10 marks)

Answer 05

Learning outcome/s: 3.5.2
Prepare financial statements from incomplete records.
Study text reference: Pages 316 – 348

(a)

Statement of profit or loss For the year ended 31 December 2018	
	Rs.
Revenue **(W1)**	2,563,700
Opening inventory	450,300
Purchases **(W2)**	1,179,600
Less: Closing inventory	500,800
Cost of sales	1,129,100
Gross profit	**1,434,600**
Profit from sale of motorbike **(W3)**	95,000
Electricity	13,200
Water	5,200
Telephone	7,000
Cleaning expenses	7,300
Cash stolen	8,000
Insurance	25,000
Depreciation	30,000
	95,700
Profit for the year	**1,433,900**

(b)

Statement of financial position As at 31 December 2018	
	Rs.
Assets	
Non-current assets	
Three-wheeler	**1,400,000**
Current assets	
Inventory	500,800
Trade receivables	23,500
Cash at bank	2,137,200
	2,661,500
Total assets	**4,061,500**
Capital and liabilities	
Capital	
Balance as at 1 January 2018 **(W4)**	620,700
Additional capital	2,000,000
Profit for the year	1,433,900
Less: Drawings	12,000
Balance as at 31 December 2018	**4,042,600**
Current liabilities	
Trade payables	**18,900**
Total capital and liabilities	**4,061,500**

W1 – Revenue

	Rs.
Credit sales	
Cash received from customers	323,000
Add: Trade receivables as at 31 December 2018	23,500
	346,500
Less: Trade receivables as at 1 January 2018	32,100
Credit sales	314,400
Cash sales	
Receipts from sales	2,234,000
Add: Expenses paid	7,300
Add: Cash stolen	8,000
Cash sales	2,249,300
Revenue for the year	2,563,700

W2 – Purchases

	Rs.
Payments to suppliers	1,178,000
Add: Trade payables as at 31 December 2018	18,900
Less: Trade payables as at 1 January 2018	17,300
	1,179,600

W3 – Sale of motorbike

	Rs.
Cash proceeds	215,000
Cost	150,000
Less: Accumulated depreciation (150,000/5)	30,000
	120,000
Profit from disposal	95,000

W4 – Opening capital

	Rs.
Trade receivables	32,100
Cash at bank	5,600
Motorbike (cost)	150,000
Inventory	450,300
Trade payables	(17,300)
	620,700

(Total: 10 marks)

Answer 06

Learning outcome/s: 3.6.2 and 2.7.2 3.6.2 Compute basic accounting ratios (profitability ratios, liquidity ratios, gearing ratios excluding investor ratios). 2.7.2 Prepare a reconciliation statement reconciling the cash book balance with the bank statement balance.
Study text reference: Pages 245 – 260, 667 – 700

(a)

	Rs.
Balance per cash book	4,000
Items on the bank statement but not in the cash book	
- Bank charges	(1,300)
- Direct deposits by customers	12,000
- Transfer to savings account	(10,000)
- Incorrectly recorded cheque	1,800
Corrected balance per cash book	6,500
Items in the cash book but not on the bank statement	
- Cheques deposited	(27,000)
- Cheques issued	30,000
Balance on the bank statement	9,500

(b)

ROCE = $\frac{\text{Profit before interest and tax}}{\text{Capital employed}} * 100$

= $\frac{1,672}{78,750} * 100$

= 2.12%

ROE = $\frac{\text{Profit after tax}}{\text{Equity holders' fund}} * 100$

= $\frac{1,510}{68,750} * 100$

= 2%

Current ratio = $\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{12,100}{13,400}$

=0.9

= 0.9:1

Gearing ratio = $\frac{\text{Total long-term debt}}{\text{Shareholders' equity + total long-term debt}} * 100$

= $\frac{10,000}{(68,750 + 10,000)} *100$

= 12.7%

(Total: 10 marks)

SECTION 3

Answer 07

Learning outcome/s: 3.2.3 and 4.5.4
3.2.3 Prepare financial statements for the purpose of management and publication. 4.5.4 List the disclosure requirement with regard to inventories as per LKAS 2.
Study text reference: Pages 427 – 448, 501

(a)

Rumega PLC Statement of comprehensive income For the year ended 31 December 2018		
		Rs. '000
Sales		829,070
Cost of sales	**W1**	(425,725)
Gross profit		**403,345**
Other income	**W9**	3,000
Administrative expenses	**W7**	(185,105)
Distribution expenses	**W8**	(207,145)
Finance expenses		(6,575)
Profit before tax		**7,520**
Tax expense	**W6**	(13,272)
Profit after tax		**(5,752)**
Other comprehensive income		**-**
Revaluation gain		152,500
Total comprehensive income		**146,748**

(b)

Rumega PLC Statement of financial position As at 31 December 2018		
		Rs. '000
ASSETS		
Non-current assets		
Property, plant and equipment	**W3**	502,470
Investment		53,000
Total non-current assets		**555,470**
Current assets		
Inventory	**W2**	31,570
Trade receivables	**W4**	261,240
Allowance for doubtful debts	**W4**	(13,062)
Cash and cash equivalents		21,280
Total current assets		**301,028**
Total assets		**856,498**
EQUITY AND LIABILITIES		
Equity		
Stated capital (40,000 shares)		400,000
Revaluation gain		152,500
Retained earnings (142,936 – 5,752)		137,184
Total equity		**689,684**
Non-current liabilities		
Interest bearing loans and borrowings		**5,778**
Current liabilities		
Trade payables		147,389
Interest bearing loans and borrowings		772
Accrued expenses	**W10**	353
Tax payable	**W6**	12,522
Total current liabilities		**161,036**
Total equity and liabilities		**856,498**

W1 – Cost of sales

	Rs. '000
Opening stock	44,500
Add: Purchases	412,795
	457,295
Less: Closing stock **(W2)**	(31,570)
	425,725

W2 – Closing inventory

	Rs. '000
Cost	31,570
Net realisable value	32,498

[Expected selling price – related expenses = 32,525 – 27]

According to LKAS 2, inventory should be valued at lower of cost or NRV.

Accordingly, closing inventory would be Rs. 31,570,000.

W3 – Property, plant and equipment

	At cost/valuation Rs'000	Accumulated depreciation Rs'000	Revaluation Rs'000	NBV Rs'000
Land and buildings (Land = Rs. 250 million)	375,000	87,500	152,500	440,000
Furniture and equipment	85,800	65,080		20,720
Motor vehicles	82,150	40,400		41,750
				502,470

Depreciation

	Rs. '000
Building (125,000/50)	2,500
Motor vehicles (75,600/6)	12,600
Furniture and equipment (85,800/10)	8,580
	23,680

Value of MV

	Rs. '000
TB	75,600
Lease arrangement (W 11)	6,550
	82,150

Revaluation

	Land Rs. '000	Buildings Rs. '000
Cost	250	125
Accumulated depreciation	-	(87.5)
NBV	250	37.5
Revalued amount	264	176
Revaluation gain	14	138.5

Total revaluation gain = 14,000 + 138,500 = 152,500

W4 – Allowance for doubtful debts

	Rs. '000
Trade debtors	261,240
Allowance	13,062
Already provided for	(5,020)
Provision for the year	8,042

W5 – Short-term accumulating paid absences

No. of days of unused leave = 40 days
Estimated number of utilisation based on past experience = 40 days * 80% = 32 days
Average daily pay per executive employee = 3,000
Therefore expense of accumulated paid absences = 32 days * Rs. 3, 000 = Rs. 96,000

W6 – Income tax payable

	Rs. '000
Current year provision	12,522
Last year under provision	750
Tax expense	13,272

W7 – Administrative expenses

	Rs. '000
Per trial balance	173,672
Accruals: Utilities	257
Depreciation (W3) (2,500 + 8,580)	11,080
Accumulating paid absences (W5)	96
Total expense	185,105

W8 – Distribution expenses

	Rs. '000
Per trial balance	186,503
Depreciation of MV (W3)	12,600
Provision for doubtful debts (W4)	8,042
Total expense	207,145

W9 – Other income (Rs. '000)

Interest income from FD = 50,000 * 12% * 6/12 = 3,000

W10 – Accrued expenses

	Rs. '000
Accrued	257
Accumulating paid absences	96
	353

W11 – Lease arrangement

Fair value: Rs. 6,552,000
PVMLP: 6,550,000 (1,672,866 * PVIFA 13.75%, 7 years)
Fair value of the lease is approximately equal to PVMLP, assets will be owned by the company after the lease period and the lease period is a major part of the useful life. Therefore this arrangement should be classified as a finance lease.

Lower of FV or PVMLP
Lease period: 6 years
Useful life: 7 years

Dr. PPE (MV)	6,550,000	
Cr. Interest bearing loans and borrowings (current)		772,241
(non-current)	5,777,759	

Opening balance (Rs.)	Interest expense @ 13.75% (Rs.)	Installment payment (Rs.)	Closing balance (Rs.)
6,550,000	900,625	1,672,866	5,777,759
5,777,759	794,442	1,672,866	4,899,335
4,899,335	673,659	1,672,866	3,900,128
3,900,128	536,268	1,672,866	2,763,530
2,763,530	379,985	1,672,866	1,470,649
1,470,649	202,214	1,672,866	-

(b) The financial statements should disclose the following.

- Accounting policies adopted in measuring inventories including the cost formulae used.
- The total carrying amount of inventories and the carrying amount of classifications appropriate to the entity.
- Carrying amount of inventories carried at fair value less cost to sell.
- The amount of inventories recognised as an expense during the period.
- The amount of any write down of inventories recognised as an expense in the period, in accordance with paragraph 34.
- The amount of reversal of any write down.
- The circumstances or events that led to the reversal of a write down of inventory per paragraph 34.
- The carrying amount of inventories pledged as security for liabilities.

(Total: 20 marks)

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