KE 1 - FINANCIAL ACCOUNTING AND REPORTING FUNDAMENTALS

Suggested Answers and Marking Grid

SECTION 1

Question 01
1(a)
1.1.

Learning Outcome:
1.2.6 Explain qualitative characteristics of financial statements/financial information.

Correct answer: C
This is the correct classification as per the conceptual framework. Options A, B and D have mixed up these characteristics.

1.2.

Learning Outcome:
1.1.1 Identify the governance structure of business organisations.

Correct answer: A
Option A allows the board to maintain majority who does not represent the management; so that a proper balance can be maintained in the board to assure good governance.
Option B: Whether CEO holds shares or not does not create any barrier to give her/his expertise. On the other hand holding shares by CEO influence her/him to work better for the company. Then the option B is not a good governance.
Option C: Major shareholder is unlikely to protect the interest of minority shareholders instead she/he thinks of her/his own interest. So it is not a good governance principle
Option D: Though it appears to help improve the decision making, such a situation might give an upper hand to CEO to do whatever she/he wants at the expense of shareholder. So it is not a good governance principle

1.3.

Learning Outcome:
4.13.2 Identify entities that can follow SLFRS for SMEs.

Correct answer: A
An entity listed on a Stock Exchange listed under the Securities and Exchange commission Act No. 36 of 1987 and any entity in which the equity instruments are traded in the public market and a Fund Management Company has to follow full set of Accounting Standards.
SME will be applicable the Entities that does not have public Accountability

1.4.

Learning Outcome:
4.10.2 Explain the difference between defined contribution plan and defined benefit plans.

Correct answer: C

Payment of Gratuity is not a short term benefit. Any person has to complete five (05) years of service to be entitled to gratuity. It is a long term benefit plan.

1.5.

Learning Outcome:
4.11.1 Identify basic financial assets and financial liabilities.

Correct answer: C

Shares issued by a company is an equity instruments which does not come under the purview of Financial Assets.

1.6.

Learning Outcome:
4.4.1 Identify the different types of cash flows associated with an organisation.

Correct answer: C

Conversion of debt into equity and Issue of bonus shares does not generate any Cash Flows. Those are only book entries. Therefore, does not generate any Cash Flows.

1.7.

Learning Outcome:
4.6.6 Record transactions involving a change in accounting estimates.

Correct answer: B

Recognizing a change in accounting estimate in the current and future periods affected by the change and applying a new accounting policy to transactions occurring after the date at which the policy changed, are applicable for the current year and future years. Therefore, such applications are known as prospective applications.

However, correcting the financial statements as if a prior period error had never occurred and applying a new accounting policy to transactions as if that policy had always been applied are known as retrospective applications.

1.8.

Learning Outcome:
2.7.2 Prepare a reconciliation statement reconciling the cash book balance with the bank statement balance.

Correct answer: B

Balance as per the bank statement Rs. 25,000(overdraft) less unpresented cheques of Rs. 21,000 (i.e. Rs.10,000+ Rs.11,000) comes to an overdraft balance of Rs. 46,000. This becomes an overdraft balance of 42,000 once the unrealized cheques of Rs. 4,000 is added back.

Since the bank charges of Rs. 2,000 is a relevant expenditure and it has been already deducted in arriving to the balance as per bank statement and carrying amount has been derived by using the balance as per bank statement, there is no need to adjust that amount again. Therefore the answer is an overdraft of Rs. 42,000.

1.9.

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

Correct answer: D

GP margin minus other expenses and tax gives the net margin of 9%.(=30% - 12% - 9%) ROE can be indirectly calculated by multiplying the profit margin by asset turnover ratio. So that it comes to 9%x3= 27%.

1.10.

Learning Outcome:
1.2.5 Explain the underlying assumption (going concern) in accounting and accounting concepts (accrual, materiality, consistency, entity, matching, prudence, periodic, realisable, relevance, reliability and comparability).

Correct answer: B

Going Concern assumes that the entity will continue for a foreseeable future time when the financial statements are prepared so that the option 2 gives that meaning. Therefore, other options do not highlight that fact instead they talk about other aspect of continuity of business.

Marking Guide
Each question carries 2 marks. Total 20 marks.

1(b)

1.11

Learning Outcome
4.4.2 Prepare a cash flow statement under both direct method and indirect method.

	Rs.	**Marks Allocation**
Depreciation charged for the year	988,400	0.5
Profit on sale of PPE	543,000	0.5
Proceeds from Sale of PPE	975,000	1.0
Acquisition of PPE	4,684,400	1.0

1.12

Learning Outcome:
4.2.2 Explain the treatment for initial and subsequent measurement of PPE.

	Rs.	**Marks Allocation**
Amount paid through bank represent Cost, Freight & Insurance	9,453,500	
Taxes & Clearing Charges	2,176,200	0.5
Transportation cost to propose Factory	345,000	
Installation, including site preparation	245,000	
Cost incurred on the test run prior to use	117,600	0.5
Sale proceed of output of test production	(19,000)	
Estimated cost of Dismantling	154,000	
Estimated residual value	(172,300)	
Cost of the Machinery	**12,300,000**	
The depreciation for the year is Rs. 12,300,000 x 6.67% x 7.5/12 = Rs.512,500		**2.0**

1.13

Learning Outcome:
4.7.2 Explain adjusting events and non-adjusting events.

Adjusting events are those that provide evidence of conditions that existed at the end of the reporting period.

Marks Allocation
1 Mark

Example:

- The bankruptcy of a customer that occurs after the reporting period existed at the end of the reporting period

Non adjusting events are those that are indicative of conditions that arose after the reporting period

Marks Allocation
1 Mark

Example:

- A decline in market value of investments between the end of the reporting period and date of authorization

Marks Allocation
1 Mark

1.14

Learning Outcome:
2.3.4 Identify the characteristics of computerised accounting packages.

Payroll, Debtors, Inventory, Fixed Assets

Marks Allocation
1 x 3 Marks

1.15

Learning Outcome:
2.1.3 Identify the primary books used in accounting. 2.2.2 Relate the connection between “dual aspect” of accounting and the accounting equation. 2.3.1 Identify the process of accounting 2.5.1 Identify omissions and errors in accounting. 2.5.2 Prepare journal entries for correction of errors. 2.6.1 State the purpose of control accounts. 2.6.2 Prepare a reconciliation of control account balances with a total of individual accounts.

	DR	CR
Discount allowed	5,000	
Debtors Control Account		5,000
Sales	25,000	
Debtors Control Account		25,000

Marks Allocation
1 x 3 Marks

1.16

Learning Outcome:
3.2.5 State the regulatory requirement to prepare consolidated financial statements for a group of companies.

1. When the entity has more than ½ of voting rights of another entity.
2. When the entity has the power to govern financial and operating policies of another entity under statute or an agreement.
3. When the entity has the power to appoint or remove the majority of the board of directors of another entity.
4. When the entity has the power to cast the majority of voting rights at meeting of the boards even ½ voting rights is not available.

Marks Allocation
1 x 3 Marks

1.17

Learning Outcome:
4.3.1 Explain criteria to be satisfied to recognise revenue from sale of goods and rendering of services. 4.3.2 Explain the accounting treatment with regard to recognition of revenue arising from interest, dividend and royalties.

Item	**Recognized? (Yes) / (No)**	**Reason**
Money Received from a client	No	There is no evidence whether the risks and rewards of the ownership of goods have been transferred to the buyer
Dividend	No	The entities right to receive this amount dividend did not exist at 31st March 2014
Interest	Up to the year end - Yes The rest - No	What is accrued at effective interest rate is only Rs. 9000 as at 31st March 2014. The rest will accrue in the following year.

Marks Allocation
0.5 x 6 Marks

1.18

Learning Outcome:
4.5.1 Identify different types of inventories. 4.5.2 Explain different methods used in inventory valuation.

Inventory Type	**Carrying Amount (Rs.)**
Raw Material	1,500,000
Work in Process	430,000
Finished Goods	1,500,000

Marks Allocation
0.5 x 6 Marks

1.19

Learning Outcome:
Understanding of the ethical factors to be affected to accounting

(i) Enhancing the stock to adjust the profit is ethically incorrect.
(ii) It is ethically incorrect to prepare the Financial Statements to safeguard the personal interest of employees.
(iii) It is ethically incorrect to prepare the Financial Statements to safeguard the personal interest of Employees or Directors.

1.20

Learning Outcome:
4.9.1 Define tax expense. 4.9.2 Explain the difference between accounting profit and tax profit. 4.9.6 Compute deferred tax.

<u>Tax Expense</u>	**Rs.**
Tax for the year / Current tax 8,250,000x 28% =	2,310,000
Deferred tax provision (3,500,000-2,100,000) x 28% -265,000 =	127,000
	<u>2,437,000</u>

Marking Scheme
Each question carries 3 marks. Total 30 marks.

SECTION 2

Question 02

Learning Outcome:
3.3.1 Explain the nature of partnerships and special accounts relating to partnership. 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).

2.1.

1.

Kamal, Lalith and Maali Partners
Partners Current Accounts

	Kamal	**Lalith**	**Maali**
Balance	120,000	80,000	(20,000)
Reversal of Profit	(110,000)	(110,000)	(110,000)
Drawings- Goods	(30,000)	-	-
Interest on Capital	20,000	15,000	15,000
Salaries	-	-	100,000
Profit Share	60,000	60,000	30,000
Adjusted Balance	**60,000**	**45,000**	**15,000**

Marking Scheme	Marks
Reversal of Profit	1
Interest on Capital	1
Salaries	1
Profit Share	1
	Total 4 marks

2.

Kamal, Lalith and Maali Partners
Statement of Financial Position as at 31st March 2014

		Rs.
Property Plant and Equipment		455,000
Current Assets		
Inventory	125,000	
Accounts Receivable	80,000	
Rent Advance	40,000	
Cash	25,000	
Total Current Asset		**270,000**
Total Assets		**725,000**
Equity		
Partners' Capital Accounts		
Kamal	80,000	
Lalith	60,000	
Maali	60,000	200,000
Partners Current Accounts		
Kamal	60,000	
Lalith	45,000	
Maali	15,000	120,000
		320,000
Non-Current Liabilities		
Loan		300,000
Current Liabilities		
Accounts Payables		12,000
Accruals		93,000
Total Equity and Liabilities		**725,000**

Marking Scheme	Marks
Property Plant and Equipment	1
Inventory	0.5
Accounts Receivable	0.5
Rent Advance	0.5
Cash	0.5
Loan	0.5
Accruals	0.5
	Total 4marks

<u>Working</u>

Correction of the Profit

		Rs.'000
Profit for the year		330
Drawings not accounted for	30	
Finance Cost	(30)	
Utility Bills	(55)	
Depreciation	(15)	
Building Rent Advance	40	(30)
Corrected Net Profit		300
Partner Salaries		(100)
Interest on Capital		(50)
Divisible Profit		150

<u>Profit Share</u>

Kamal	60	
Lalith	60	
Maali	30	(150)
		-

2.2

The methods adopted in the preparation of financial statements of facilitate comparability are as follows;

I. To prepare and present financial statement in accordance with the generally accepted accounting principles and Sri Lanka Accounting Standards.

II. To prepare and present financial statements in accordance with the norms applicable to the particular industry.

III. Users to be informed of the accounting policies employed in the preparation of the financial statements.

IV. To adopt accounting policies consistently and when there is a Change of Accounting policy those changes to be disclosed in the financial statements.

V. Comparative information to be stated against each line item of the financial statements.

VI. Information of last 5 or 10 years to be disclosed in the financial statement of elsewhere in the annual report.

Marking Scheme
Any point is entitled to 1 Mark. Only for two points in total.

Question 03

Learning Outcome:
3.1.1 Prepare financial statements for sole proprietorships.

1.

"PQR Manufacturers"

Manufacturing Account for the year ended 31st March 2013

	Rs. '000	**Rs. '000**
Raw Material Stock at 1.4.2012		500
Purchases	2,100	
Returns Outward	(60)	
Damaged Stock	(40)	
Closing RM	(200)	1,800
RM used in the production		2,300
Direct Labour cost		590
Royalty Payments		110
Prime Cost		3,000
Production Overheads		
Depreciation - Machinery	260	
Depreciation - Building	60	
Insurance	42	
Electricity	117	
Water	72	
Telephone Charges	15	
Salaries	1,000	
EPF	150	
Production Accessories	244	1,960
WIP at 1.4.2012		200
WP at 31.3.2103		(160)
Total Production cost		5,000
10 % Margin		500
Value of goods transferred to trading account		**5,500**

Marking Scheme	Marks
Damaged Stock	0.5
Closing RM	0.5
Direct Labour cost	0.5
Depreciation - Machinery	0.5
Depreciation - Building	0.5
Insurance	0.5
Electricity	0.5
EPF	0.5
10% Margin	1
	Total 5marks

2.

"PQR Manufacturers"

Calculation of Gross Profit

	Rs. '000	Rs. '000
Sales		7,950
Returns Inward		(20)
Inventory 1/4/2012	330	
Value of Goods Transferred from manufacturing	5,500	
Inventory 31/3/2013	(440)	5,390
Gross Profit		2,540
Provision for unrealized Profit(40-30)		(10)
Gross Profit after the provision		2,530

Marking Scheme	Marks
Inventory 1.4.2012	1
Cost of Production	1
Provision for unrealized Profit(40-30)	1
	Total 3marks

3.

Although the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset. In return the obligation to pay and amount to the lessor in future. Therefore, lease should be recognized as an asset in the books of lessee even though the lessee does not have any legal ownership of the asset.

Marking Scheme
Total 2 marks

Question 04

Learning Outcome:
2.5.1 Identify omissions and errors in accounting. 2.5.2 Prepare journal entries for correction of errors. 2.5.3 Solve omissions and errors embedded in accounting records and financial statements, using suspense accounts. 3.4.2 Prepare financial statements for non-profit entities. 2.1.2 Explain the purpose of source documents used in accounting. 2.3.3 Define the term "double entry system" and explain its role in accounting.

4.1

1. Suspense Account (Rs.)

	Dr.	Cr.
Difference		380,000
Debtors		50,000
Debtors	150,000	
Creditors	150,000	
Discount Allowed	20,000	
Discount Received	20,000	
Creditors	90,000	
	430,000	430,000

Marking Scheme	Marks
Difference	0.5
Debtors	0.5
Debtors	0.5
Creditors	0.5
Discount allowed	0.5
Discount received	0.5
Creditors	0.5
Balance	0.5
	Total 4 marks

2. Computation of Correct profit (Rs.)

Draft Profit		400,000
Omission of credit notes	(16,500)	
Discount received	20,000	
Overstatement of Discount allowed	20,000	
Omission of bad debts	(25,000)	(1,500)
Corrected Profit		398,500

Marking Scheme	Marks
Omission of credit notes	0.5
Discount received	0.5
Overstatement of Discount allowed	0.5
Omission of bad debts	0.5
	Total 2 marks

4.2 Subscription account (Rs.)

	Dr	Cr
Cash		520,000
Arrears at 1.4.2012	105,000	
Advance Ac at 1.4.2012		40,000
Arrears account at 31.3.2013		161,500
Advance account at 31.3.2013	20,000	
Write off of arrears		1,000
Balance CF	597,500	
	722,500	722,500

Marking Scheme	Marks
Cash	0.5

Arrears at 1.4.2012	0.5
Advance Ac at 1.4.2012	0.5
Arrears account at 31.3.2013	0.5
Advance account at 31.3.2013	0.5
Write off of arrears	0.5
Balance CF	1.0
	Total 4 marks

Question 05

Learning Outcome:
3.5.1 Identify the different circumstances under which incomplete records are acceptable. 3.5.2 Prepare financial statements from incomplete records. 2.6.1 State the purpose of control accounts. 2.6.2 Prepare a reconciliation of control account balances with a total of individual accounts. 2.7.1State the purpose and need for preparation of bank reconciliation statements.

1.

SQ Brothers

Income Statement for the Year Ended 31st March 2014

	Rs. '000	Rs. '000
Sales		1,300
Cost of Sales		(780)
Gross profit		520
Discount Received		5
		525
Discount allowed	14	
Depreciation of Equipment	60	
Other expenses	321	395
Profit For the year		130

Marking Scheme	Marks
Sales	0.5
Cost of sales	1.0
Gross profit	0.5
Discount received	0.5
Discount allowed	0.5

Depreciation of equipment	0.5
Other expenses	1.0
Profit for the year	0.5
	Total 5 marks

2.

SQ Brothers

Statement of financial position as at 31st March 2014

	Rs. '000
Equipment	305
Inventory	100
Debtors	151
Cash in Hand	37
Cash at Bank	15
Total Assets	**608**
Equity	
Capital	400
Retained Earnings BF	65
Profit for the year	130
Drawings	(70)
	525
Creditors	45
Accruals	38
Total Equity and Liabilities	**608**

Workings

- Statement of affairs as at 01/04/2012

Initial capital	400	Equipment	240
		Cash in hand	20
		Cash at Bank	50
		Debtors	110
Retained Profit	65	Inventories	45
	465		**465**

- Cash Book

O/B - Cash	20	Equipment	125
O/B - Bank	50	Purchases	500

Cash Sales	500		
From debtors	745	Creditors	285
		Drawings	70
		Expenses	283
		C/B - Cash	15
		C/B - Bank	37
	1315		**1315**

- Debtors

O/Balance	110	Purchases	745
Cash	800	Discount	14
		Balance	151
	910		**910**

- Creditors

Cash	285	O/Balance	-
Discount	5		
		Purchases	335
Balance	45		
	335		**335**

- Computation of Purchases

Cost of sales	780
C/Stock	100
	880
opening Stock	(45)
	835
Marking Scheme	Marks
Equipment	0.5
Inventory	0.5
Debtors	0.5
Cash in hand	0.5
Cash at bank	0.5
Capital	0.5
Retained earnings B/F	0.5
Drawings	0.5
Total equity	0.5
Creditors	0.5
	Total 5 marks

SECTION 3

Question 06

Learning Outcome:
3.2.3 Prepare financial statements for the purpose of management and publication.
4.2.2 Explain the treatment for initial and subsequent measurement of PPE.
4.2.4 Explain the different methods of PPE depreciation.
4.2.6 List the disclosure requirements with regard to PPE as per LKAS 16.
2.4.2 Prepare the year-end financial statements for accruals, pre-payments, depreciation, bad debts and closing stocks.
1.2.5 Explain the underlying assumption (going concern) in accounting and accounting concepts (accrual, materiality, consistency, entity, matching, prudence, periodic, realisable, relevance, reliability and comparability).
2.4.1 Identify the need for year-end adjustments on financial statements, such as accruals, closing stock, pre-payments, depreciation and bad debts.
4.5.3 Explain the methods of inventory measurement.
4.12.3 Explain the criteria to be satisfied when recognising provisions in financial statements.
4.8.4 Explain the accounting of finance lease in lessees' books.
4.9.2 Explain the difference between accounting profit and tax profit.

1.

ABC LIMITED

Statement of Comprehensive Income for the Year ended 31st March 2014

	Rs.	Rs.
Revenue		16,150
Cost of Sales		(7,032)
Gross Profit		9,118
Other Income		130
		9,248
EXPENSES		
Distribution Cost	3,980	
Administration Cost	2,406	
Other Cost	1,004	

Finance Charges	690	(8,080)
Net Profit Before Taxation		1,168
INCOME TAX EXPENSE		
Tax for the year	384	
Previous period over provision	(34)	(350)
Net Profit For the Period		818
Other Comprehensive Income		
Change in revaluation gain of Property, Plant &Equipment		2,000
Total Comprehensive Income		**2,818**

Marking Scheme	Marks
Revenue	0.5
Cost of Sales	1.0
Other Income	0.5
Distribution Cost	1.0
Administration Cost	1.0
Other Cost	1.0
Finance Charges	1.0
Previous period over provision	1.0
Change in revaluation gain of Property, Plant &Equipment	1.0
	Total 8 marks

2.

ABC LIMITED

Statement of Changes in Equity for the year ended 31st March 2014 (Rs.'000)

	Stated Capital	Revaluation Reserve	Retained Earnings	Total
Balance as at 01/04/2013	2,000	-	1,295	3,295
Profit for the year	-	-	818	818
Revaluation Increase –Land	-	2,000	-	2,000
Dividends Paid	-	-	(200)	(200)
Balance at 31/03/2014	2,000	2,000	1,913	5,913

Marking Scheme	Marks
Balance as at 01/04/2013	0.5
Profit for the year	0.5
Revaluation Increase –Land	0.5
Dividends Paid	0.5
	Total 2 marks

3.

ABC LIMITED

Statement of Financial Position as at 31st March 2014

ASSETS	Rs'000	Rs'000
Non Current Assets		
Property, Plant & Equipment		6,185
Current Assets		
Inventories	350	
Trade Receivables	392	
Other Receivables	60	
Cash & Cash Equivalents	156	958
Total Assets		**7,143**
EQUITY AND LIABILITIES		
Stated Capital & Reserves		
Stated Capital		2,000
Reserves		
Revaluation Reserve	2,000	
Retained Earnings	1,913	3,913
Total Equity		5,913
Non Current Liabilities		
12% Debentures	300	300
Current Liabilities		
Trade Payables	150	
Other Payables	530	
Income Tax Payable	250	930
Total Equity & Liabilities		**7,143**

Marking Scheme	Marks
Property, plant & equipment (6,185+1,100)	02
Inventories	0.5
Trade receivables	1.0
Other receivables	0.5
Cash & cash equivalents	0.5
Stated capital	0.5
Revaluation reserve	0.5

Retained earnings	0.5
Total equity	0.5
12% debentures	0.5
Lease creditors	0.5
Trade payables	0.5
Other payables	0.5
Lease creditors	1.0
Income tax payable	0.5
	Total 10 marks

Workings

- Cost of sales

Balance given	7,432
Closing stocks adjustment	(400)
	7,032

- Distribution Cost

Amount given	3,696
Depreciation on M/V	260
Bad debts	28
Over provision of doubtful debts	(4)
	3,980

- Administration Costs

Balance given	2,451
Depreciation on building	35
Reversal of depreciation	(44)
EPF	25
ETF	3
Adjustment for accruals	(60)
Adjustment for prepayments	(4)
	2,406

- Other Costs

Balance given	354
Loss on revaluation of PPE	600
Inventory written off	50
	1004

- Finance Charges

Balance given	672
Debenture interest	18
	690

- Sales

Balance given	16,250
Advanced received	(100)
	16,150

- Income Tax 2013/14

Amount given	260
Amount paid for 2012/13	(126)
Tax for the period.	(384)
Balance payable	**250**

- Income Tax 2012/13

Balance payable 01/04/13	160
Full settlement	(126)
Over provision	**34**