



Hong Kong Institute of
Accredited Accounting Technicians
香港財務會計協會

Accredited Accounting Technician Examination

Pilot Examination Paper

Paper 7 Financial Accounting

Questions & Answers Booklet

The Suggested Answers given in this booklet are purposely made to give more details for educational purpose.

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Paper 7 Financial Accounting

Time allowed – 3 hours

Section A: Multiple-choice Questions – Attempt all 15 Questions

Section B: Compulsory Question – Attempt the Question

Section C: Optional Questions – Attempt any 2 out of 3 Questions

**DO NOT OPEN THIS QUESTION PAPER UNTIL
INSTRUCTED TO DO SO BY THE SUPERVISOR**

SECTION A (MULTIPLE-CHOICE QUESTIONS) (20 marks)

Answer **ALL** questions in this section. Choose the best answer for each question.
Marks will not be deducted for incorrect answers.

(Questions A1 to A10 carry 1 mark each. Total: 10 marks)

A1. Financial statements are a structured representation of the financial position and performance of an entity. The objectives of financial statements, as given in HKAS 1 *Presentation of Financial Statements* are the following, **EXCEPT**:

- A Providing information about the financial position and financial performance of an entity that is useful to a wide range of users.
- B Showing the results of management's stewardship of the resources entrusted to it.
- C Serving as guidelines for the structure and minimum requirements for the content of financial statements.
- D Providing information about an entity's cash flows, financial viability and financial adaptability that is useful for making economic decisions.

A2. Which of the following is correct about related party relationship under HKAS 24 *Related Party Disclosures*?

- A A relationship between key management personnel of an entity and the employees of such management.
- B A relationship in which one entity has interest in another entity.
- C A relationship between key management personnel of the entity and its parent.
- D A relationship between the family members of a director of an associate and the associate.

A3. Which of the following is correct under the definition of an investment property under HKAS 40 *Investment Property*?

- A It is a land or a building, or part of a building, or both held to earn rental revenues or capital appreciation.
- B It is property that is being constructed or developed for future use as investment property.
- C It is a land or a building, or part of a building, or both held by the owner used for administrative purposes.
- D It is a property held for sale in the ordinary course of business.

- A4.** In respect of its interests in the jointly controlled assets, according to HKAS 31 *Interests in Joint Ventures*, a venturer shall recognise the following items in its financial statements **EXCEPT**:
- A Its share of the jointly controlled assets, classified according to the nature of the assets.
 - B Its share of liabilities that it has incurred or incurred jointly with other venturers and any expenses that it has incurred in respect of its interest in the joint venture.
 - C Its income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture.
 - D Its expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture.
- A5.** In accordance with the requirements of HKAS 10 *Events After the Balance Sheet Date*, which of the following event occurred after the end of reporting period is **NOT** an adjusting event?
- A The determination of the cost of assets purchased before the end of the reporting period.
 - B The determination of the amount of bonus payments and the obligation of the entity concerned to pay at the end of the reporting period.
 - C The discovery of frauds in the financial statements at the end of the reporting period.
 - D The bankruptcy of a customer that had an outstanding balance with the company at the end of the reporting period.
- A6.** When an enterprise has a present obligation as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the enterprise should:
- A Include this item under equity in the financial statements.
 - B Make a provision in the statement of financial position if it can make a reliable estimate of the amount of the obligation.
 - C Categorise the obligation as non-current liabilities in the statement of financial position.
 - D Disclose the indication of the uncertainties relating to the amount or timing of any outflow, an estimate of its financial effect and the possibility of any reimbursement only.
- A7.** According to HKAS 16 *Property, Plant and Equipment*, which of the following should **NOT** be included as part of the cost of an item of property, plant and equipment:
- A Costs of site preparation.
 - B Costs of testing whether the asset is functioning properly.
 - C The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.
 - D Costs of opening a new facility.

- A8.** Which of the following is correct about the accounting treatment of government grants related to income under HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*?
- A The government grant shall be included in the financial statements as a deferred income.
 - B The government grant shall be deducted from value of related assets in arriving at the carrying amount of the asset.
 - C The government grant shall be credited directly to shareholders' interests on a systematic basis.
 - D The government grant shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate on a systematic basis.
- A9.** HKAS 23 *Borrowing Costs* states that "an entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date". The borrowing costs shall be capitalised when all the following conditions are met **EXCEPT**:
- A The entity incurs expenditure for the asset.
 - B The entity incurs borrowing costs.
 - C The entity involves in planning activities that are necessary to prepare the asset for its intended use.
 - D The entity undertakes activities that are necessary to prepare the asset for its intended use or sale.
- A10.** In accordance with HKAS 7 *Statement of Cash Flows*, which of the following is **NOT** a financing activity?
- A Cash proceeds from issuing equity or debt instruments.
 - B Cash payments to acquire equity or debt instruments of other entities.
 - C Cash payments to redeem the entity's equity shares.
 - D Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

(Questions A11 to A15 carry 2 marks each. Total: 10 marks)

A11. HKAS 27 *Consolidated and Separate Financial Statements* states that “control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity”. However, control also exists when the parent owns half or less of the voting power of an entity **EXCEPT**:

- (1) When there is power over more than half of the voting rights by virtue of an agreement with other investors;
- (2) When there is power to govern the financial and operating policies of the entity under a statute or an agreement;
- (3) When there is power to appoint or remove one-third of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- (4) When there is power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

- A (1), (2) and (4).
B (1) and (4).
C (2) and (3).
D (2) and (4).

A12. In accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which of the following is categorised as changes in accounting estimates?

- (1) A change in the measurement basis applied in inventory.
- (2) A change in the expected pattern of consumption of economic benefits of depreciable assets.
- (3) Loss recognised on the outcome of a contingency which previously could not be estimated reliably.
- (4) An impairment of non-current assets charged to profit and loss in the current year.
- (5) A judgement made on the fair value of financial assets or financial liabilities.

- A (1) and (2).
B (2) and (5).
C (3) and (4).
D (1), (3) and (4).

A13. According to HKAS 28 *Investments in Associates*, the existence of significant influence by an investor is usually evidenced by the following, **EXCEPT**:

- (1) The power to cast the majority of votes at meetings of board of directors or equivalent governing body where control of the entity is by that board or body.
- (2) The provision of essential technical information and interchange of managerial personnel.
- (3) The participation in financial and operating policy making processes.
- (4) The power to govern an enterprise's financial and operating policies.
- (5) The representation on the board of directors or equivalent governing body of the investee.

- A (1) and (5).
B (2) and (3).
C (1) and (4).
D (1), (3) and (5).

A14. On 1 January 2007, Willen Limited entered into a fixed price contract of \$27 million to build a bridge. It will take three years to build the bridge. Willen Limited's estimate of contract costs, at the commencement of the contract, was \$24 million. At 31 December 2007, the actual total costs incurred and the estimated further costs to complete the project were \$6.28 million and \$17.87 million, respectively. The stage of completion of the construction contract at 31 December 2007 should be:

- A 23%.
B 35%.
C 11%.
D 26%.

A15. Following the information in question A14, the amount of profit from the construction contract to be recognised should be:

- A \$741,000.
B \$538,720.
C \$702,000.
D \$624,000.

(Total: 20 marks)

[END OF SECTION A]

SECTION B (COMPULSORY QUESTION) (30 marks)

Answer **THE** question in this section. Marks are indicated at the end of the question.

B1. The ledger balances at 31 March 2008 extracted from the books of Kylie Limited are as follows:

	Debit	Credit
	\$'000	\$'000
Property, plant and equipment	51,500	
Accumulated depreciation		16,250
Available-for-sale financial assets	9,300	
Trade receivables	17,000	
Inventory at 1 April 2007	6,200	
Cash and cash equivalents	2,180	
Trade payables		16,600
Ordinary shares at \$1 each		10,000
6% preference shares at \$1 each		6,000
8% debentures (payable in 2014)		5,000
Bank loans		5,000
Retained earnings at 1 April 2007		7,080
Revenue		126,780
Profit on sale of plant		800
Purchases	73,600	
Distribution costs	10,100	
Administrative expenses	18,250	
Other expenses	5,400	
Debenture interest	400	
Dividend income		420

Additional information:

(1) The breakdown of item of property, plant and equipment at 31 March 2008 are as follows:

	Cost/ revaluation \$'000	Accumulated depreciation \$'000	Carrying value \$'000
Factory building	24,000	8,000	16,000
Plant and equipment	<u>27,500</u>	<u>8,250</u>	<u>19,250</u>
	<u>51,500</u>	<u>16,250</u>	<u>35,250</u>

- (a) On 1 April 2007, the factory building was revalued at \$21,000,000 and this transaction has not been recorded in the books of Kylie Limited. This factory building was acquired on 1 April 2004. Management had revised the useful life of this factory building and it was estimated that it had a remaining useful life of 15 years from 1 April 2007.
- (b) The plant and equipment was acquired on 1 April 2005.
- (c) The annual depreciation for property, plant and equipment for the year to 31 March 2008 had been grouped under “administrative expenses”.
- (d) There is no disposal of property, plant and equipment during the year to 31 March 2008.
- (2) Kylie Limited has raised a bank loan of \$5,000,000, at 7% annual interest, for the purpose of financing the establishment of a new production line. Interest has been charged for the full year and included in “other expenses” account of the company.
- (3) Kylie Limited gives warranties to customers at the time of sale of its product. Under the terms of the contract for sale, the company undertakes to make good the manufacturing defects within three years from the date of sale. Based on the past experience, it is probable that the amount of claims under the warranties is about 5% of sales value. The balance of provisions for warranties at 1 April 2007 was zero.
- (4) The company conducted a physical inventory count on 10 April 2008. The value of the inventory on that date was \$6,000,000 at cost. The following transactions have occurred during the period from 1 April 2008 to 10 April 2008:
- | | | |
|-----|-----------|-------------|
| (a) | Sales | \$4,550,000 |
| (b) | Purchases | \$710,000 |

The sale price of the product is usually at a 30% mark-up on costs.

- (5) The estimated income tax expense for the year to 31 March 2008 is \$4,000,000 and this has not been included in the books of Kylie Limited.
- (6) The market value of the available for sale financial assets at 31 March 2008 is close to its book value.
- (7) The accounting policies of Kylie Limited are extracted as follows:
- (a) The item of property, plant and equipment is depreciated on a straight-line basis, with full year depreciation in the year of acquisition and none in the year of disposal.
- (b) Depreciation on plant and equipment is grouped under “cost of sales”.
- (c) Depreciation on factory building is grouped under “administrative expenses” in the statement of comprehensive income.
- (d) Provisions for warranties are included in “administrative expenses”.

REQUIRED:

Prepare the statement of comprehensive income for the year ended 31 March 2008 and the statement of financial position as at 31 March 2008 of Kylie Limited.

(You are required to present the financial statements in accordance with the format required by HKAS 1 (Revised) *Presentation of Financial Statements*, issued in December 2007.)

(Total: 30 marks)

[END OF SECTION B]

SECTION C (OPTIONAL QUESTIONS) (50 marks)

Answer any **TWO** questions only in this section. Each question carries 25 marks.

C1. Lessor Limited entered into a lease agreement with Lessee Limited on 1 January 2007 to lease office machinery. The terms of the lease are as follows:

- (1) Lessee Limited was required to make an initial deposit of \$5,550 with the balance being settled in three equal instalments of \$5,300 payable on the last day of each year, starting from year 2007.
- (2) Upon the expiry of two years after the inception of the lease, Lessee Limited has the options to:
 - (a) purchase the office machinery at an amount of \$5,500; or
 - (b) continue the lease for a period of two years at a rent of \$500 per month.

The following information is also available:

- (1) The imputed interest rate of the lease was 15% per annum.
- (2) The useful economic life of the machinery was estimated to be four years.
- (3) The cash price for the machinery is \$20,000 on 1 January 2007.
- (4) The market rent for the office machinery at 1 January 2007 is \$1,000 per month.
- (5) The director of Lessee Limited indicates that he will take either one of the options upon the expiry of two years after the inception of the lease.
- (6) It is estimated that the residual value of the office machinery at 31 December 2008 will be \$10,000.
- (7) It is the policy of Lessee Limited to depreciate the office machinery on a straight-line basis and full year depreciation is charged in the year of acquisition and none in the year of disposal.

REQUIRED:

- (a) **Describe the basic principles, under HKAS 17 Leases, for classifying the lease into finance lease or operating lease.**
(3 marks)
- (b) **Discuss whether the lease between Lessor Limited and Lessee Limited is a finance lease or an operating lease.**
(7 marks)
- (c) **Assume that the lease between Lessor Limited and Lessee Limited is a finance lease, show the breakdown between interest and capital throughout the lease period, using actuarial method.**
(6 marks)
- (d) **Prepare the journal entries in Lessee Limited's book for the year to 31 December 2007. (Narration is required.)**
(9 marks)

(Your calculation should be rounded up to the nearest dollar.)

(Total: 25 marks)

- C2.** Fit Limited, which is engaged in manufacturing and selling of office equipments, has an accounting year-end of 31 December. On 1 January 2007, Fit Limited sold goods to a customer in four equal instalments of \$150,000, payable in advance. The market borrowing rate, at time of the sale, was 15% per annum.

REQUIRED:

- (a) In accordance with HKAS 18 *Revenue*, explain when and how to recognise the revenue from sale of goods. (7 marks)
- (b) HKAS 18 states that “if the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised.” Provide two examples of situations in which the entity may retain significant risks and rewards of ownership in the context of sale of goods. (2 marks)
- (c) Prepare journal entries to record the transactions of instalment sales from years to 31 December 2007 to 2010. Show all your workings.

(Your calculation should be rounded up to the nearest dollar.)

(16 marks)

(Total: 25 marks)

- C3.** Supreme Limited, a listed company, is a retailer that sells clothing. The managing director of the company is an aggressive person. Supreme Limited expanded in its operations and employed a famous designer to design new stylish clothing and to restyle its clothing products. Sales increased significantly during the year to 30 April 2008; however, the profitability of the company was disappointing. You are asked by the managing director to write a report to analyse the financial position of Supreme Limited for the year to 30 April 2008. The ratios of Supreme Limited for the years to 30 April 2007 and 2008 have been calculated as follows:

	<u>2008</u>	<u>2007</u>
Return on capital employed	10%	35%
Asset turnover	2 times	3 times
Gross profit margin	9%	19%
Net profit margin	2%	7%
Current ratio	0.7	0.7
Gearing ratio	30%	15%
Dividend cover	4 times	25 times
Inventory holding period	60 days	30 days
Accounts payable period	60 days	45 days

REQUIRED:

- (a) What are the problems of using ratio analysis in evaluating the performance of a company? (9 marks)
- (b) Evaluate the financial performance of Supreme Limited for the two years ended 30 April 2007 and 2008.

Your evaluation should include areas of:

- (i) management efficiency; (6 marks)
- (ii) liquidity and gearing; (3 marks)
- (iii) returns to shareholders; and (3 marks)
- (iv) working capital management. (4 marks)

(Total: 25 marks)

[END OF EXAMINATION PAPER]

Suggested Answers

Pilot Examination Paper

Paper 7

Financial Accounting

SECTION A (MULTIPLE-CHOICE QUESTIONS) (20 marks)

(Questions A1 to A10 carry 1 mark each. Total: 10 marks)

- A1. C
- A2. C
- A3. A
- A4. D
- A5. D
- A6. B
- A7. D
- A8. D
- A9. C
- A10. B

(Questions A11 to A15 carry 2 marks each. Total: 10 marks)

- A11. C
- A12. B
- A13. C
- A14. D
- A15. A

(Total: 20 marks)

SECTION B (COMPULSORY QUESTION) (30 marks)

B1.

Marks

Kylie Limited

Statement of comprehensive income

For the year ended 31 March 2008

	\$'000	
Revenue	126,780	[0.5]
Cost of sales (Working 1)	(73,760)	[4]
Gross profit	<u>53,020</u>	
Other income - investment income	420	[0.5]
Other income - profit on sale of plant	800	[0.5]
Distribution costs	(10,100)	[0.5]
Administrative expenses (Working 3)	(21,239)	[4.5]
Other expenses (\$5,400 – loan interests \$5,000 x 7%)	(5,050)	[1.5]
Finance costs (\$400 + loan interests \$5,000 x 7%)	(750)	[1.5]
Profit before tax	<u>17,101</u>	
Income tax expense	(4,000)	[0.5]
PROFIT FOR THE YEAR	<u>13,101</u>	
Other comprehensive income:		
Gains on property revaluation	3,000	[2]
[Revalued amount \$21,000 – carrying amount (\$16,000 + \$8,000/4)]		
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u><u>16,101</u></u>	[0.5]

Working 1: Cost of sales	\$'000
Beginning inventory	6,200
Add: Production during the year	76,350
[\$73,600 + depreciation of plant and equipment \$8,250/3]	
Less: Closing inventory (Working 2)	(8,790)
	<u>73,760</u>

Working 2: Closing Inventory	
Inventory count at 10 April 2008	6,000
Add: Sales during the period 1/4/08 -10/4/08 {\$4,550 x [1/(1 + 30%)]]	3,500
Less: Purchases during the period 1/4/08 -10/4/08	(710)
	<u>8,790</u>

Working 3: Administrative expenses	
Balance per ledger	18,250
Provision for warrants (\$126,780 x 5%)	6,339
Depreciation of factory building overstated (\$21,000/15 – \$8,000/4)	(600)
Depreciation of plant and equipment transferred to cost of sales (\$8,250/3)	(2,750)
	<u>21,239</u>

		Marks
Kylie Limited		
Statement of financial position		
As at 31 March 2008		
	\$'000	
ASSETS		
Non-current assets		
Property, plant and equipment $[(\$21,000 - \$21,000/15) + \$19,250]$	38,850	[2]
Available-for-sale financial assets	9,300	[0.5]
	<u>48,150</u>	
Current assets		
Inventories $[\$6,000 + (\$4,550 \times 100/130) - \$710]$	8,790	[2.5]
Trade receivables	17,000	[0.5]
Cash and cash equivalents	2,180	[0.5]
	<u>27,970</u>	
Total assets	<u><u>76,120</u></u>	
EQUITY AND LIABILITIES		
Equity		
6% preference shares at \$1 each	6,000	[0.5]
Ordinary shares at \$1 each	10,000	[0.5]
Retained earnings $(\$7,080 + \$13,101)$	20,181	[1]
Revaluation surplus $[\$21,000 - (\$16,000 + \$8,000/4)]$	3,000	[2]
Total equity	<u>39,181</u>	
Non-current liabilities		
Long-term borrowings – Bank loans	5,000	[0.5]
Long-term borrowings – 8% debentures	5,000	[0.5]
Total non-current liabilities	<u>10,000</u>	
Current liabilities		
Trade and other payables	16,600	[0.5]
Current tax payable	4,000	[0.5]
Short-term provisions $(\$126,780 \times 5\%)$	6,339	[1]
Total current liabilities	<u>26,939</u>	
Total liabilities	<u>36,939</u>	
Total equity and liabilities	<u><u>76,120</u></u>	[0.5]

(Total: 30 marks)

SECTION C (OPTIONAL QUESTIONS) (50 marks)

- C1. (a)** The determination of whether a lease is a finance lease or an operating lease lies with the doctrine of “substance over form”. Substance over form refers to the substance of the transaction rather than the legal form of the lease contract. **[1 mark]**

The classification of leases adopted in HKAS 17 is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee: **[1 mark]**

- Risks include technological obsolescence and decline in return or value of assets due to changing economic conditions. **[1 mark]**
- Rewards include the future return from using the asset and of gain from appreciation in value. **[1 mark]**

(Maximum 3 marks)

- (b)** The lease between Lessor Limited and Lessee Limited is a finance lease because of the following reasons:

- Ownership of the office machinery will be transferred to the lessee by the end of the lease term, since the director of Lessee Limited indicates his intention to take the option. **[1.5 marks]**
- Lessee Limited has the option to purchase the office machinery at a price (that is, \$5,500) which is expected to be sufficiently lower than the fair value at the date the option (that is, \$10,000) becomes exercisable. **[1.5 marks]**
- The lease term (that is, 3 years, 75% of the machinery’s economic life) is the major part of the economic life of the asset (that is, 4 years). **[1.5 marks]**
- The present value of the minimum lease payments (that is, $\$17,655 = \$5,550 + \$5,300/(1 + 15\%) + \$5,300/(1 + 15\%)^2 + \$5,300/(1 + 15\%)^3$) amounts to at least substantially all of the fair value (that is, \$20,000) of the leased asset at the inception of the lease. **[2 marks]**
- Lessee Limited has the ability to continue the lease for a secondary period of 2 years after 31 December 2008 at a rent (that is, \$500 per month) which is substantially lower than market rent (that is, \$1,000 per month). **[1.5 marks]**

(Maximum 7 marks)

(c) Breakdown between interest and capital elements of the lease:

<u>Year</u>	<u>Principal (opening)</u>	<u>Repayment</u>	<u>Finance charge (15%)</u>	<u>Principal (closing)</u>	Marks
	\$	\$	\$	\$	
1-Jan-07	17,655	5,550	0	12,105	[1.5]
31-Dec-07	12,105	5,300	1,816	8,621	[1.5]
31-Dec-08	8,621	5,300	1,293	4,614	[1.5]
31-Dec-09	4,614	5,300	686	0	[1.5]

(6 marks)

(d) Journal entries in Lessee Limited's book:

		<u>Dr</u>	<u>Cr</u>	Marks
		\$	\$	
1 Jan 2007	Leased machinery	17,655		[1]
	Bank		5,550	[1]
	Lease obligation		12,105	[1]
	To record lease capitalisation at the effective date of lease contract and to record the lease payment.			[0.5]
31 Dec 2007	Lease obligation	3,484		[1]
	Interest expenses	1,816		[1]
	Bank		5,300	[1]
	To record the lease payment.			[0.5]
31 Dec 2007	Depreciation expenses (\$17,655/ 4 years)	4,414		[1]
	Accumulated depreciation		4,414	[1]
	To record year-end depreciation on leased machinery.			[0.5]

(Maximum 9 marks)

(Total: 25 marks)

- C2. (a)** Revenue is recognised when, according to HKAS 18, it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably and it is usually applied separately to each transaction. **[1 mark]**

In accordance with HKAS 18, revenue from the sale of goods should be recognised when all the criteria below, as specified in HKAS 18, have been met:

- the entity has transferred to the buyer the significant risks and rewards of ownership of the goods; **[1 mark]**
- the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold; **[1 mark]**
- it is probable that the economic benefits associated with the transaction will flow to the entity; **[1 mark]**
- the amount of revenue can be measured reliably; **[1 mark]** and
- the costs incurred or to be incurred in respect of the transaction can be measured reliably. **[1 mark]**

[Any 4 out of the 5 points above, maximum 4 marks]

Therefore, revenue arising out of the transaction should be recognised by reference to the terms included in the sales contract between the seller and the buyer **[1 mark]** and determined when the seller has transferred the significant risks and rewards of ownership to the buyer by the transfer of legal title or the passing of possession. **[1 mark]**

(7 marks)

- (b)** Examples of situations in which the entity may retain the significant risks and rewards of ownership in the context of sale of goods are:

- The seller retains an obligation for unsatisfactory performance not covered by normal warranty provisions.
- The receipt of the revenue from the sale is contingent upon the amount of revenue derived by the buyer from its sale of the goods.
- The goods are shipped subject to installation and such a condition is included as a significant part of the contract which has not yet been completed by the entity.
- The buyer has the right to rescind the purchase based on a specific term in the sales contract and the seller is uncertain about the return of goods.

(1 mark for each example, maximum 2 marks)

(c) The journal entries to record the instalment sales transaction are:

		Dr	Cr	Marks
		\$	\$	
1 Jan 2007	Bank	150,000		[1]
	Accounts receivable	342,484		[1]
	Sales		492,484	[2]
31 Dec 2007	Accounts receivable	51,373		[1]
	Interest income		51,373	[1]
1 Jan 2008	Bank	150,000		[1]
	Accounts receivable		150,000	[1]
31 Dec 2008	Accounts receivable	36,578		[1]
	Interest income		36,578	[1]
1 Jan 2009	Bank	150,000		[1]
	Accounts receivable		150,000	[1]
31 Dec 2009	Accounts receivable	19,565		[1]
	Interest income		19,565	[1]
1 Jan 2010	Bank	150,000		[1]
	Accounts receivable		150,000	[1]

(16 marks)

Working:

<u>Date</u>	<u>Instalment</u>	<u>Discount Factor</u>	<u>Present Value</u>
	\$		\$
1 Jan 2007	150,000	1.000000	150,000
1 Jan 2008	150,000	0.8695652	130,435
1 Jan 2009	150,000	0.7561437	113,422
1 Jan 2010	150,000	0.6575162	<u>98,627</u>
			<u>492,484</u>

<u>Year</u>	<u>Balance @ 1 Jan</u>	<u>Instalment</u>	<u>Interest</u>	<u>Balance @ 31 Dec</u>
	\$	\$	\$	\$
2007	492,484	150,000	51,373	393,857
2008	393,857	150,000	36,578	280,435
2009	280,435	150,000	19,565	150,000
2010	150,000	150,000	0	0

(Total: 25 marks)

- C3. (a)** Problems of using ratio analysis in evaluating the performance of a company are:
- Comparisons of performance among different periods need to consider the changes in economic climate and its impact on business or industry engaged by the entity. **[1.5 marks]**
 - Since different types of industry will have different operations and environment, they should have different sets of performance indicators or yardsticks. **[1.5 marks]**
 - The accounting policies and financing policies may vary widely among companies. Thus, the variations of the accounting and financing policies selected by companies may add difficulties to the comparison among different companies. **[1.5 marks]**
 - Conglomerates, which have multiple lines of business, are often difficult to categorise into industry segments for the purpose of performing cross-sectional comparison. **[1.5 marks]**
 - A single ratio provides only limited information for comparison. An overall picture of the performance of a company can only be obtained through analysing a group of related ratios. **[1.5 marks]**
 - The result of ratio analysis lies with the quality of its underlying financial information. In this connection, unreliable financial information can only lead to misleading or poor quality analysis and evaluation of financial performance of a company. **[1.5 marks]**
 - The reliance on ratios exclusively for evaluating the financial performance of a company may lose sight of information in the underlying financial statements. Certain information reported in the financial statements is also essential in assessing a company's financial performance. **[1.5 marks]**

(Any 6 points, maximum 9 marks)

- (b)** Based on the information given in question, the performance of Supreme Limited can be analysed in the following aspects:

- (i) Management efficiency

Supreme Limited's overall performance can be measured by the ROCE (10% for 2008; 35% for 2007), which indicates that it has deteriorated significantly. ROCE can be analyzed into:

- Net profit margin, which has fallen from 7% in 2007 to 2% in 2008, may indicate that the expansion has caused a significant increase in operating expenses without a corresponding increase in sales level.
- Asset turnover, which has declined from three times in 2007 to two times in 2008, may indicate that it takes time for the investment in new operations to generate additional sales and, thus, this situation can be improved in future years.

The significant decline in gross profit margin from 19% to 9% when compared with 2007 may indicate decline in economic climate, increasing market competition, and changes in customer preferences, etc. The expansion of operations may not be a suitable action because the decline in gross profit margin may be an indication of economic recession.

(6 marks)

(ii) Liquidity and gearing

Supreme Limited's liquidity position has not changed from year 2007 to 2008 and the current ratio for both years are 0.7. It is not easy to evaluate retail business using current ratio because liquidity ratio will be affected by the proportion of sales on cash and on credit.

The gearing ratio of Supreme Limited has increased from 15% in 2007 to 30% in 2008. This indicates that the expansion of its operations is financed by increasing the amount of long-term loans. Nevertheless, the level of 30% gearing ratio is financially healthy in terms of the solvency of a company.

(3 marks)

(iii) Returns to shareholders

The returns to shareholders can be reflected in the dividend cover and ROCE. The ROCE, which indicates the overall performance of a company, has declined significantly (by 25%) from 2007 to 2008. Shareholders may feel that the performance of management is not satisfactory.

Moreover, the dividend cover has significantly decreased from 25 times in 2007 to 4 times in 2008. The existing dividend policy may not be maintained and this may be a signal to stock market that the profitability of the company may decline in future.

(3 marks)

(iv) Working capital management

The inventory holding period has increased significantly from 30 days in 2007 to 60 days in the current year. This may indicate that Supreme Limited would like to increase the inventory level, since the company expects an increase in sales. But, this may also indicate that there are slow-moving and obsolete inventory.

The accounts payable period has increased from 45 days in 2007 to 60 days in the current year. This may indicate that the company is unable to pay the debts when they fall due because of the tight liquidity position.

It is noted that the current ratio is 0.7 for both 2007 and 2008. Despite the fact that current ratio remains the same, there are negative trends in gross profit ratio, net profit ratio and inventory turnover. It is unlikely that the current ratio can be improved in the near future.

(4 marks)

(Total: 25 marks)

[END OF SUGGESTED ANSWERS]