

# EXAMPLE QUESTIONS AND ANSWERS FOR TUITION PURPOSES

## COMPULSORY SECTION C P7 FINANCIAL ACCOUNTING & TAX PRINCIPLES EFFECTIVE MAY 2007

### **IMPORTANT NOTE:**

The examples that follow are **NOT** specifically written pilot questions to reflect the revised format and content of Section C of the P7 question paper.

They do, however, reflect the potential **STYLE** of question likely to be set and have been recommended by the P7 Examiner as good examples of them. The answers provided are fuller than would be expected from a candidate under exam conditions.

The examples have been adapted from questions set in the previous CIMA syllabus question paper *Financial Accounting – International Standards*.

## EXAMPLES A AND B

***This scenario is common to both the Example A and the Example B question.***

J is a large entity which is listed on its national stock exchange. It has been going through a period of rapid change in response to shareholder pressures and also adverse comment in the financial press.

The entity's latest trial balance at 31 March 2007 is as follows:

### *J – Trial balance at 31 March 2007*

	<i>\$m</i>	<i>\$m</i>
Accumulated profits		39
Administrative expenses	60	
Bank	9	
Cost of sales – clothing	140	
Cost of sales – confectionery	40	
Cost of sales – games software	60	
Distribution costs	45	
Finance charges on leases	6	
Finance leases		40
Income tax expense	5	
Interest	31	
Interest-bearing borrowings (repayable 2015)		300
Inventories at 31 March 2007	30	
Property, plant and equipment	1,170	
Reorganisation costs	30	
Revaluation reserve		35
Revenue – clothing		250
Revenue – confectionery		100
Revenue – games software		300
Share capital		400
Share premium		200
Trade payables		16
Trade receivables	54	
	<u>1,680</u>	<u>1,680</u>

(i) J stopped manufacturing clothing during the year. The closure of this operation was completed during the year and so no further reorganisation costs are expected to arise in respect of this.

(ii) J expanded the games software operation during the year. Substantial amounts were spent on the recruitment of new staff, the organisation of a new factory for manufacturing games discs and cartridges and the conversion of the entity's old clothing shops into games shops. Prior to this expansion, the entity's games software operation was very much smaller and did not have any of its own manufacturing capacity.

(iii) Reorganisation costs are made up as follows:

	<i>\$m</i>
Loss on disposal of clothing factory	11
Redundancy and other costs of closure	9
Reorganisation of games software	<u>10</u>
	<u>30</u>

(iv) During the year ended 31 March 2007, J sold its clothing factories, which had a book value of \$205m, for \$194m. This loss on disposal was included in the total for reorganisation costs.

(v) Administrative expenses and distribution costs can be allocated as follows:

	<i>Administration</i>	<i>Distribution</i>
Clothing	20%	20%
Confectionery	50%	40%
Games software	30%	40%

- (vi) During the year ended 31 March 2007, J acquired \$821m of new property, plant and equipment, primarily the factory and equipment for the manufacture of games software. Some of this was financed by borrowing. Finance leases worth \$48m and \$200m of long-term loans were taken out.
- (vii) The finance leases outstanding at 31 March 2007 include \$10m that will be payable within twelve months. The remainder will be repaid within five years.
- (viii) During the year ended 31 March 2007, J charged a total of \$90m depreciation on its property, plant and equipment.
- (ix) The balance on the revaluation reserve represents the effects of the revaluation in previous years of the property used in the entity's confectionery interests. A revaluation of these properties on 31 March 2007 increased their values by a further \$100m. The adjustments required to incorporate this revaluation in the accounting records have not yet been made.
- (x) The figure in the trial balance for interest includes \$4m spent on finance for the construction of the new factory. The directors have decided to capitalise these finance charges.
- (xi) On 30 June 2006, the entity issued 100 million shares for \$1.60 each by means of a rights issue. The market price of the shares immediately before the rights issue was \$1.80.
- (xii) The balance on the income tax expense account represents the balance remaining after settling the tax charge for the year ended 31 March 2006. The directors have estimated the tax charge for the year ended 31 March 2007 at \$42m.
- (xiii) J has not paid a dividend for several years and the directors do not intend to pay one in the immediate future.

## EXAMPLE A QUESTION

Prepare J's income statement for the year ended 31 March 2007 and its balance sheet at that date. These should be in a form suitable for publication and should be accompanied by a statement of changes in equity and notes as far as you are able to prepare these from the information provided.

Do NOT prepare a statement of accounting policies or the segmental analysis required by IAS 14 – *Reporting Financial Performance by Segment*. There is insufficient information in the question to provide the disclosures required by IAS 16 – *Property, Plant and Equipment* in respect of property, plant and equipment.

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**Additional information for the Example B Question which should be used in conjunction with information in the Scenario**

J's balance sheet at the end of the previous year was as follows:

*Balance sheet at 31 March 2006*

	\$m	\$m
<b>ASSETS</b>		
<b>Non-current assets</b>		
Property, plant and equipment		644
<b>Current assets</b>		
Inventories	19	
Trade receivables	37	
Bank	<u>12</u>	
		<u>68</u>
		<u>712</u>
<b>EQUITY AND LIABILITIES</b>		
<b>Capital and reserves</b>		
Share capital	300	
Share premium	140	
Revaluation reserve	35	
Accumulated profits	<u>39</u>	
		514
<b>Non-current liabilities</b>		
Interest-bearing borrowings	150	
Finance leases	<u>6</u>	
		156
<b>Current liabilities</b>		
Trade payables	9	
Finance leases	2	
Income tax expense	<u>31</u>	
		<u>42</u>
		<u>712</u>

**EXAMPLE B QUESTION**

Prepare J's cash flow statement for the year ended 31 March 2007. Produce this statement from the information provided in the scenario and opening balance sheet. These should be in the form prescribed by IAS 7 – *Cash Flow Statements*.

*Notes to the cash flow statement are not required*

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## EXAMPLE C

### Scenario

M is an entity which manufactures components for sale to the electronics industry. The following trial balance has been extracted from the entity's financial records:

#### M – Trial balance at 30 September 2007

	\$m	\$m
Administrative expenses	64	
Cash and cash equivalents	98	
Cost of sales	1,142	
Deferred tax		291
Disposal of plant and equipment	11	
Distribution costs	148	
Dividend – interim paid	300	
Income tax expense		37
Interest	72	
Interest-bearing borrowings (repayable 2018)		1,618
Inventories at 30 September 2007	45	
Plant and equipment – cost	794	
Plant and equipment – depreciation to date		324
Property – cost	4,456	
Property – depreciation to date		811
Provision for cost of sales		300
Retained earnings brought forward		1,132
Revenue		2,970
Issued capital		600
Trade payables		27
Trade receivables	<u>980</u>	
	<u>8,110</u>	<u>8,110</u>

- (i) Seller is an entity which is one of M's largest suppliers. G, one of M's Directors, owns 98% of Seller. M purchased \$43m of goods from Seller during the year ended 30 September 2007, all under Seller's normal terms and conditions. M owed Seller \$3m at 30 September 2007.
- (ii) Plant and equipment which had cost \$125m and had been depreciated by \$78m was sold during the year. New plant and equipment was purchased for \$160m. These transactions have been included in the above figures. There were no other transactions involving non-current assets.
- (iii) Depreciation for the year has still to be charged as follows:
- |                     |                      |
|---------------------|----------------------|
| Property            | 2% of cost           |
| Plant and equipment | 25% reducing balance |

A whole year's depreciation is charged in the year of acquisition and none in the year of disposal.

- (iv) The trial balance figure for inventories is calculated on the following basis:

	Purchase price	Attributable manufacturing overheads	Attributable non-manufacturing overheads	Total cost	Net realisable value
	\$m	\$m	\$m	\$m	\$m
Current inventory	26	7	3	36	51
Obsolete inventory	6	2	1	<u>9</u>	<u>5</u>
Total				<u>45</u>	<u>56</u>

Total cost is lower than total net realisable value and so the Directors have valued the inventory at \$45m. The external auditors have refused to accept this valuation, arguing that it is inconsistent with the requirements of IAS 2 *Inventories*. M's Directors have agreed to correct the inventory figure to bring it into line with IAS 2.

- (v) The Directors have estimated the tax charge for the year at \$120m. The balance on the income tax expense account is the amount remaining after settling the liability for the year ended 30 September 2006.
- (vi) The provision for deferred tax has arisen from the timing differences arising from accelerated capital allowances on the entity's non-current assets. The tax written-down value of non-current assets at 30 September 2007 was \$2,985m. It is estimated that tax will be paid at a rate of 30% when these timing differences reverse.
- (vii) The Directors declared a final dividend of \$150m before the balance sheet date.
- (viii) M is a quoted entity. Authorised share capital is 800 million shares of \$1.00. Issued share capital is 600 million shares of \$1.00, fully paid.
- (ix) M's largest customer placed an order during September 2007 for all of the goods that it is likely to require during the year ending 30 September 2008. M invoiced this customer for these goods during September 2007. A total of \$800m was debited to trade receivables and credited to revenue in respect of this invoice. A provision for \$300m was created in respect of the estimated cost of manufacturing the invoiced goods.
- (x) M's customer agreed to place the order referred to in *note (ix)* above only after receiving a number of written assurances from M's Directors. The goods themselves will be delivered at times and in quantities decided by the customer. The customer will pay for the goods in accordance with M's normal credit terms after delivery. The customer can cancel the order without penalty at any time and any remaining balance on the invoice will be cancelled immediately.
- (xi) M's external auditors have examined the documentation referred to in *notes (ix)* and *(x)* above and disagree with the Directors' decision to treat this as a sale.

### Example C Questions

- (a) Prepare M's income statement for the year ended 30 September 2007 and its balance sheet at that date. These should be in a form suitable for publication and should be accompanied by notes as far as you are able to prepare these from the information provided.

Do NOT adjust any figures in the financial statements in respect of the information provided in *notes (ix)* to *(xi)* in the scenario. Do NOT prepare a statement of accounting policies, a statement of recognised gains and losses or a statement of changes in equity.

- (b) M's Directors congratulated the Finance Director for the increase in recorded revenue for the year to 30 September 2007 as compared to that for the year to 30 September 2006. The Finance Director is, however, unhappy because she believes that the arrangements described in *notes (ix)* and *(x)* of the scenario will be easy for an expert reader to identify.

Explain briefly how an external reader could identify adjustments such as those described in *notes (ix)* and *(x)*, assuming that they are not described directly in the financial statements.

**ANSWERS FOR EXAMPLES A, B AND C FOLLOW**

## ANSWER TO EXAMPLE A

### J – Income Statement for the year ended 31 March 2007

	Notes	Continuing operations	Discontinued operations	Total
		\$m	\$m	\$m
Revenue		400	250	650
Cost of sales		(100)	(140)	(240)
Gross profit		300	110	410
Distribution costs		(36)	(9)	(45)
Administrative expenses		(48)	(12)	(60)
Profit from operations	1	216	89	305
Reorganisation costs		(10)		(10)
Loss on disposal of property			(11)	(11)
Closure costs			(9)	(9)
		206	69	275
Finance costs	3			(33)
Profit before tax				242
Income tax expense	4			(47)
Profit after tax				<u>195</u>

### J – Statement of changes in equity for the year ended 31 March 2007

	Issued capital	Share premium	Revaluation Reserve	Retained profit	Total
	\$m	\$m	\$m	\$m	\$m
Balance at 31 March 2006	300	140	35	39	514
Unrealised surplus on revaluation of properties			100		100
Net profit for the period				195	195
Shares issued in year	100	60			160
Total recognised gains and losses	400	<u>200</u>	<u>130</u>	<u>234</u>	<u>969</u>

### J – Balance sheet at 31 March 2007

	Notes	\$m	\$m
<i>Assets</i>			
<i>Non-current assets</i>			
Property, plant and equipment			1,274
<i>Current assets</i>			
Inventories		30	
Trade receivables		54	
Bank		<u>9</u>	
			<u>93</u>
			<u>1,367</u>
<b>Equity and liabilities</b>			
<i>Capital and reserves</i>			
Issued capital		400	
Share premium		200	
Revaluation reserve		135	
Retained earnings		<u>234</u>	

969

*Non-current liabilities*

Interest bearing borrowings		300	
Finance leases	5	<u>30</u>	330

*Current liabilities*

Trade payables		16	
Taxation		42	
Finance leases	5	<u>10</u>	
			<u>68</u>
			<u>1,367</u>

**Notes**

**1 Profit from operations**

Profit from operations was arrived at after charging depreciation of \$90m.

**2 Discontinued operations**

The clothing operation was discontinued during the year.

**3 Finance costs**

	<i>\$m</i>
Loan interest	31
Capitalised	(4)
Finance charges on leases	<u>6</u>
	<u>33</u>

**4 Income tax expense**

	<i>\$m</i>
Charge for year	42
Underprovision brought forward	<u>5</u>
	<u>47</u>

**5 Finance leases**

	<i>\$m</i>
Payable within one year	10
Payable between one and five years	<u>30</u>
	<u>40</u>

**Workings**

**Revenue – continuing operations**

	<i>\$m</i>
Confectionery	100
Software	<u>300</u>
	<u>400</u>

**Cost of sales – continuing operations**

	<i>\$m</i>
Confectionery	40
Software	<u>60</u>
	<u>100</u>

**Administration**

	<i>\$m</i>	
Clothing	12	
Confectionery	30	} 48

Software	<u>18</u>	
	<u>60</u>	
<b>Distribution</b>	<i>\$m</i>	
Clothing	9	
Confectionery	18	} 36
Software	<u>18</u>	
	<u>45</u>	

<b>Property, plant and equipment</b>	<i>\$m</i>
Trial balance	1,170
Capitalised interest	4
Revaluation	<u>100</u>
	<u>1,274</u>

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## ANSWER TO EXAMPLE B

*J – Cash flow statement for the year ended 31 March 2007*

	\$m	\$m
<i>Cash flows from operating activities</i>		
Cash receipts from customers	633	
Cash paid to suppliers and employees	<u>(278)</u>	
Cash generated from operations	355	
Interest paid	(37)	
Income taxes paid	<u>(36)</u>	
Net cash from operating activities		282
<i>Cash flows from investing activities</i>		
Purchase of property, plant and equipment	(773)	
Proceeds from sale of equipment	<u>194</u>	
Net cash used in investing activities		(579)
<i>Cash flows from financing activities</i>		
Proceeds from issuance of share capital	160	
Proceeds of long-term borrowings	150	
Repayment of finance leases	<u>(16)</u>	
Net cash from financing activities		<u>294</u>
Net decrease in cash and cash equivalents		(3)
Cash and cash equivalents at beginning of period		<u>12</u>
Cash and cash equivalents at end of period		<u><u>9</u></u>

### Workings

#### **Cash receipts from customers**

		\$m			\$m
Trade receivables			Bank		633 (b. figure)
	Balance b/d	37	Balance c/d		<u>54</u>
	Revenue	<u>650</u>			<u>687</u>
		<u>687</u>			

Cost of sales includes depreciation of \$90m. Cash items in cost of sales = 240 - 90 = \$150m

#### **Cash paid to suppliers and employees**

		\$m			\$m
<b>Cost of sales</b>			Income statement		150
(op. Inventory)	Balance b/d	19	Balance c/d		<u>30</u>
(b. figure)	Purchases	<u>161</u>			<u>180</u>
		<u>180</u>			
<b>Trade payables</b>					
(b. figure)	Bank	154	Balance b/d		9
	Balance c/d	<u>16</u>	Purchases		<u>161</u>
		<u>170</u>			<u>170</u>

	<i>\$m</i>
Payment to suppliers	154
Administration	60
Distribution	45
Reorganisation (30 - 11 loss)	<u>19</u>
	<u>278</u>

	<i>\$m</i>
<b>Interest paid</b>	
On loans	31
Finance charge on leases	<u>6</u>
	<u>37</u>

**Taxation**

	<i>\$m</i>		<i>\$m</i>
(b. figure) Bank	36	Balance b/d	31
Balance c/d	<u>42</u>	Income statement	<u>47</u> (42 + 5)
	<u>78</u>		<u>78</u>

*\$m*

**Non-current assets acquired for cash**

New tangible assets	821
Assets acquired by lease	<u>(48)</u>
	<u>773</u>

**Issued capital**

	<i>\$m</i>
Increase in issued capital	100
Increase in share premium	<u>60</u>
	<u>160</u>

**Repayments on finance leases**

Finance leases			<i>\$m</i>
	<i>\$m</i>		<i>\$m</i>
(b. figure) Bank	16	Balance b/d	8 (6 + 2)
Bank (finance charge)	6	Non-current assets	48
Balance c/d	<u>40</u>	Income statement	<u>6</u>
	<u>62</u>		<u>62</u>

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## ANSWERS TO EXAMPLE C

### Answer to (a)

#### M – Income Statement for the year ended 30 September 2007

	Notes	\$m	\$m
Revenue			2,970
Cost of sales			<u>(1,367)</u>
Gross profit			1,603
Distribution costs		(148)	
Administrative expenses		<u>(64)</u>	
			<u>(212)</u>
Profit from operations	<b>1</b>		1,391
Finance cost			<u>(72)</u>
Profit before taxation			1,319
Income tax expense	<b>3</b>		<u>(69)</u>
Profit after taxation			<u>1,250</u>

#### M – Balance Sheet at 30 September 2007

	Notes	\$m	\$m
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment	<b>5</b>		3,908
<b>Current assets</b>			
Inventories		38	
Trade receivables		980	
Cash and cash equivalents		<u>98</u>	
			<u>1,116</u>
Total assets			<u>5,024</u>
<b>Equity and liabilities</b>			
<b>Capital and reserves</b>			
Issued capital	<b>7</b>		600
Retained earnings			<u>1,932</u>
			2,532
<b>Non-current liabilities</b>			
Interest bearing borrowings		1,618	
Deferred tax	<b>6</b>	277	
Cost of sales provision		<u>300</u>	
			2,195
<b>Current liabilities</b>			
Trade payables		27	
Taxation		120	
Proposed dividend		<u>150</u>	
			<u>297</u>
Total equity and liabilities			<u>5,024</u>

## Notes

### 1 Profits from operations

Profits from operations was arrived at after charging depreciation of \$207m.

### 2 Related party

During the year ended 30 September 2007, \$43m of goods were purchased from Seller. \$3m was owed to Seller at 30 September 2007. Seller is owned by G, a member of M's board.

### 3 Income tax expense

	<i>\$m</i>
Charge for year	120
Overprovision brought forward	<u>(37)</u>
	83
Decrease in deferred tax	<u>(14)</u>
	<u>69</u>

### 4 Dividends

	<i>\$m</i>
Interim paid	300
Final proposed	<u>150</u>
	<u>450</u>

### 5 Property, plant and equipment

	<i>Property</i>	<i>Plant and equipment</i>	<i>Total</i>
	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>
Cost or valuation			
At 30 September 2006	4,456	759	5,215
Additions	0	160	160
Disposals	<u>0</u>	<u>(125)</u>	<u>(125)</u>
At 30 September 2007	<u>4,456</u>	<u>794</u>	<u>5,250</u>
Depreciation			
At 30 September 2006	811	402	1,213
Disposals	0	(78)	(78)
Charge for year	<u>89</u>	<u>118</u>	<u>207</u>
At 30 September 2007	<u>900</u>	<u>442</u>	<u>1,342</u>
Net book value			
At 30 September 2007	<u>3,556</u>	<u>352</u>	<u>3,908</u>
At 30 September 2006	<u>3,645</u>	<u>357</u>	<u>4,002</u>

### 6 Deferred tax

	<i>\$m</i>
Balance at 30 September 2006	291
Decrease for year	<u>(14)</u>
Balance at 30 September 2007	<u>277</u>

### 7 Issued capital

	<i>Number</i>	<i>\$m</i>
Authorised Ordinary shares of \$1	<u>800 million</u>	<u>800</u>
Issued and fully paid Ordinary shares of \$1	<u>600 million</u>	<u>600</u>

**Workings**

<b>Closing inventory</b>	<i>Purchase price</i>	<i>Attributable production overheads</i>	<i>Total relevant cost</i>	<i>Net realisable value</i>	<i>Lower of cost and net realisable value</i>
	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>
Current inventory	26	7	33	51	33
Obsolete inventory	6	2	8	5	<u>5</u>
Total					<u>38</u>
Adjustment (45 - 38)					7

**Cost of sales**

Trial balance	1,142
Inventory adjustment (45 - 38)	7
Loss on disposal	11
Depreciation – plant	118
Depreciation – property	<u>89</u>
	<u>1,367</u>

**Deferred tax**

NBV of assets	3,908
Tax wdv	<u>2,985</u>
Timing difference	<u>923</u>
x 30%	277
Decrease (291 - 277)	14

**Answer to (b)**

A reader might be alerted by the substantial increase in the receivables turnover ratio from 2006 to 2007. The financial statements for the year ended 30 September 2006 will show a ratio of  $180/1,845 \times 365 = 36$  days. For the year ended 30 September 2007, the ratio will be  $980/2,970 \times 365 = 120$  days. This increase would be noticeable in itself, even if the reader did not suspect this specific type of transaction had been recorded.

A reader would also look at any figures that were subject to any discretion on the part of the entity. Provisions always attract attention because there is scope for disagreement over the amounts involved. The directors are likely to be quizzed at the AGM if the provision for the cost of this sale was not described in sufficient detail.

A reader might also relate the recorded profit to cash flows. It is always worth comparing cash flows from operations with operating profits, even though these are likely to be different. Cash flows always represent “real” transactions that are relatively untouched by accounting estimates or adjustments. Reconciling items in the cash flow statement might identify a major anomaly in the accounting policies.