THE INSTITUTE OF CHARTERED ACCOUNTANTS (GHANA)

INTEGRITY

MAY 2007 EXAMINATIONS
(PROFESSIONAL)

PART 2

FINANCIAL ACCOUNTING PRACTICE
(Paper 2.1)

Attempt ALL Questions

TIME ALLOWED: 3 HOURS

QEUSTION 1

Aseidu and Ayitey were trading in partnership sharing profits in the ratio of 2:1. Andy was trading as a sole trader in the same class of business. Both businesses made up their accounts to 31st December each year.

It was agreed that with effect from 1st January 2007, the two businesses should be merged with Ayitey and Andy sharing profits equally and Asiedu retiring.

For the purpose of the merger and retirement, goodwill was to be valued at two years' purchase of the average adjusted profits of the last three years but was not to be brought in as an asset in the new firm.

The summarized balance sheets of the businesses at 31st December, 2006 were as follows:

	Asiedu & Ayitey	Andy
	¢000	¢000
Capital Accounts		
Aseidu	10,000	
Ayitey	5,000	
Andy		8,500
Current Accounts		
Aseidu	1,500	
Ayitey	3,200	
Creditors	14,000	12,000
	33,700	20,500
Freehold land at cost	12,000	3,000
Fixtures & fittings (NBV)	3,500	1,200
Stocks at cost	9,000	6,000
Debtors	3,200	2,800
Balance at bank	6,000	7,500
	33,700	20,500

Additional information:

i. In valuing goodwill, the profits were to be adjusted for the following:

- The surplus or deficiency arising on the revaluation of the freehold premises and fixtures and fittings.

- The salary of ¢500,000 per annum to Andy's wife was to be added back. Andy's wife has been working in the husband's business for the past three years.

- Obsolete stocks and bad debts were to be eliminated

ii. Premises and fixtures and fittings were to be taken into the new firm at the values placed on them by an Independent Valuer.

iii. Stocks were to be taken in at cost less ¢300,000 in respect of obsolete stock held by Asiedu and Ayitey.

iv. Creditors, debtors and bank balances were to be taken in at book values less bad debts amounting to ¢150,000 in the case of Asiedu and Ayitey and ¢100,000 in the case of Andy.

v. The new firm was to take over the liabilities to Asiedu for his share in Asiedu and Ayitey

vi. The valuations by the Independent Valuer were:

	Asiedu & Ayitey	Andy
	¢	¢
Freehold premises	18,000,000	10,000,000
Fixture and fittings	3,800,000	1,000,000

Ignore depreciation adjustment relating to the revaluation.

vii. The unadjusted profits of the business for the last three years were:

	Asiedu & Ayitey	Andy
	¢	¢
Year to 31/12/03	7,300,000	3,300,000
Year to 31/12/04	6,100,000	3,800,000
Year to 31/12/05	7,510,000	3,900,000

Required:

Prepare in Columnar form:

a) The partners Capital Accounts.

b) The balance sheet of the new firm of Ayitey and Andy on January 1st 2007.

(**Total 20 marks)**

QUESTION 2

The following trial balance relates to Kack Ltd at 31st March 2006:

	¢'000	¢'000
Turnover (note 1)		1,075,350
Cost of sales	555,150	
Distribution cost	86,100	
Administration expenses	45,000	
Lease rentals (note 2)	60,000	
Debenture interest paid	6,000	
Interim dividends (note 6)	36,000	
Land and buildings at cost (note 3)	600,000	
Plant and equipment at cost	464,400	
Depreciation, 1 April 2005 – plant and equipment		104,400
Development expenditure (note 4)	90,000	
Profit on disposal of fixed assets (note 3)		135,000
Trade debtors	165,000	
Stocks – 31 March, 2006	84,720	
Cash and bank	31,980	
Trade creditors		88,200
Taxation – over provision 31 March, 2005		6,600
Stated capital (note 6)		450,000
8% Debenture (issued in 2003)		150,000
Income surplus, 1 April 2005		214,800
	2,312,550	2,312,500

The following notes are relevant:

(1) Included in the turnover is ¢81million, which relates to sales made to customers under sale or return agreements. The expiry date for the return of these goods is 30th June 2006. Kack Ltd has charged a mark-up of 20% on cost for these sales.

(2) A lease rental of ¢60 million was paid on 1st April 2005. It is the first of five annual payments in advance for the rental of an item of equipment that has a cash purchase price of ¢240 million. The auditors have advised that this is a finance lease and have computed the interest rate implicit in the lease as 12% per annum. Leased assets should be depreciated on a straight-line basis over the life of the lease.

(3) On 1st April, 2005 Kack Ltd acquired new land and building at a cost of ¢600 million. For the purpose of calculating depreciation only, the asset has been separated into the following elements:

	¢'000	Life
Land	100,000	Freehold
Building	450,000	50 years
Fittings	50,000	10 years

The depreciation of the elements of the building should be calculated on a straight-line basis. The new building replaced an existing building that was sold on the same date for ¢285 million. It had cost ¢150 million and had a carrying value of ¢240 million at the date of sale. The profit on this building has been calculated on the original cost. It had not been depreciated on the basis that the depreciation charge would not be material.

Plant and machinery is depreciated at 20% on the reducing balance basis. Depreciation expenses should be charged to cost of sales.

(4) The development expenditure in the trial balance represents the amounts capitalized in previous years in respect of the development of a new product. Unfortunately, during the current year, the Government has introduced legislation which effectively bans this type of product. As a consequence of this the project has been abandoned.

(5) A provision for corporation tax for the year to 31st March, 2000 of ¢45 million is required.

(6) The stated capital is made up of ordinary shares which were issued at ¢300 per share. The company has paid an interim dividend on ordinary shares and half of the annual debenture interest. The average annual dividend yield (interim and final) for companies in Kack Ltd's market sector is 12%. The current market price of Kack Ltd's equity shares is ¢500. The directors are to propose a final dividend which will give Kack Ltd's equity shareholders a return equal to the average gross yield for the sector.

Required:

(a) Prepare the profit and loss account of Kack Ltd for the year to 31st March 2006.
(***8 marks)***

(b) A balance sheet as at 31st March 2006.
(***8 marks)***

(c) State any **five (5)** relevant accounting policies followed in the preparation of the financial statements. (***5 marks)***

(d) Provide the accompanying fixed assets schedule.
(***4 marks)***
(**Total: 25 marks)**

QUESTION 3

a) List **five (5)** situations where a lease transaction would normally be classified as a finance lease. (***5 marks)***

b) Workhard Company (WC) entered into a lease agreement with Excellent Engineering Company (EEC) for a new factory plant on 1st January 2003.

The cost of the plant to EEC (the lessor) is GHC 80,000 and it sells at a cash selling price of GHC 94,912. The lease agreement provides for the following:

- The primary lease period is 4 years after which WC (the lessee) has the right to extend the lease indefinitely on the payment of a nominal annual rental.

- Annual rental payment of GHC 27,220 payable in advance starting from 1 January 2003.

- The implicit rate of interest is 10% per annum.

WC depreciates plant of the type at the rate of 25% per annum on straight line basis assuming a nil residual value. WC's accounting year end is 31 December.

Required:

From the view point of WC (the lessee),

(i) Show the charges to the Income Statement in respect of the lease for the years ended 31 December 2003, 2004, 2005 and 2006.

(ii) Show the relevant balance Sheet extracts as at 31 December 2003, 2004, 2005 and 2006. (***10 marks)***

(**Total: 15 marks*)***

QUESTION 4

(a) Alvin Ltd is a medium-sized manufacturing company that plans to increase its capacity. The following are the most recent financial statements of the company:

Profit and Loss Accounts for years ending 31 December

	2006	2005
	¢'m	¢'m
Sales	5,000	5,000
Cost of sales	(3,100)	(3,000
Gross profit	1,900	2,000
Administration and distribution expenses	(400)	(250)
Profit before interest and tax	1,500	1,750
Interest	(400)	(380)
Profit before tax	1,100	1,370
Tax	(330)	(400)
Profit after tax	770	970
Dividends	(390)	(390)
Profit after taxation transferred to Income Surplus Account	380	580

Balance sheet as at 31 December

	2006		2005	
	¢'m	¢'m	¢'m	¢'m
Fixed Assets		6,500		6,400
Current Assets				
Stock	1,170		1,000	
Debtors	850		900	
Cash	130		100	
	2,150		2,000	
Current Liabilities	1,150		1,280	
		1,000		720
		7,500		7,120
10% Debentures 2007		3,500		3,500
		4,000		3,620
Capital and Surplus		4,000		3,620

Average data for the business sector in which Alvin Ltd. operates is as follows:

Gearing (book value of debt/book value of equity	60%
Interest cover	4 times
Current ratio	2:1
Stock Days	90 days
Return before Interest and Tax/Capital Employed	25%

Required:

Analyse and comment on the performance of the company based on the above sector average data. (***15 marks***)

(b) Oda Manufacturing Company Ltd is preparing accounts for the year ended 31/12/06. Included in its balance sheet as at 31/12/2005 was a balance in VAT/NHIS recoverable account as ¢15,000 million.

Its summary profit and loss account for the year is as follows:

	¢'m
Sales (all standard rated)	500,000
Purchases (all standard rated)	120,000
Gross profit	380,000
Expenses	280,000
Operating profit	100,000
Interest receivable	20,000
Profit before tax	120,000

Note: Expenses

Wages and salaries	200,000
Entertainment	10,000
Others (all standard rated)	70,000
	280,000

Payments of ¢5,000 million, ¢15,000 million and ¢20,000 million have been made in the year and a repayment of ¢12,000 million was received.

Required

What is the balance for VAT/NHIS in the balance sheet as at 31st December 2006? Assume a standard rate of 15%. (***5 marks)***

(Total: 20 marks)

QUESTION 5

a) State and explain any **four (4)** sources of financing public sector organizations.

(***10 marks)***

b) The idea that inventory should be included in accounts at the lower of **historical cost** and **net realizable value** follows the **prudence convention** but not the **consistency convention**.

Required:

(i) Explain clearly what is meant by:

- Historic cost
- Net realisable value
- Prudence convention
- Consistency convention

(ii) State with brief reasons whether or not you agree with the quotation.

(***10 marks)***

(Total: 20 marks)