**H2PAA 2021 Prelim Paper 1 Answer guide**

**Qn 1**

| **(a) Street Wear Pte Ltd** | | |
|---|---|---|
| **Statement to correct the net loss for the year ended 31 July 2020** | **$** | |
| Unadjusted net loss for the year | (32,000) | |
| (1) Impairment loss for specialised equipment **(700-200)-(350>290)** | (150,000) | **(1m)** |
| (2) Impairment loss for inventory **(3000-2300)** | (7,000) | **(1m)** |
| (3) Unpresented cheques & direct transfer | NIL | |
| (4) Impairment loss for trade receivables **(710000-10000-128000)x5%)+10000** | (38,600) | **(2m)** |
| (5) Overstatement of repairs and maintenance **(45000 – 2500 - (5/12 x 2100)** | 41,625 | **(2m)** |
| (6) Depreciation of plant and equipment **(40400x0.25)** | (10,100) | **(1m)** |
| Adjusted net loss for the year | (196,075) | |

**(b)**

| **Street Wear Pte Ltd** | | | | |
|---|---|---|---|---|
| **Balance sheet as at 31 July 2020** | | | | |
| | $ | $ | $ | |
| **Non-current assets** | Cost | Accumulated Depreciation | Net book Value | **(1m)** |
| Property and plant at cost **(5000k+40.4k)** | 5,040,400 | (1,710,100) | 3,330,300 | **(1m)** |
| Specialised equipment at cost | 700,000 | (350,000) | 350,000 | |
| | | | 3,680,300 | |
| | | | | |
| **Current assets** | | | | |
| Inventory **(1,476,000-7000)** | | | 1,469,000 | **(1m)** |
| Trade receivables **(710,000-10,000-128,000)** | | 572,000 | | |
| Less : Allowance for impairment of trade receivables **(700kx5%)** | | (28,600) | 543,400 | **(1m)** |
| Prepaid insurance | | | 1,225 | **(1m)** |
| Cash at bank **(-88,000+128,000)** | | | 40,000 | **(1m)** |
| Total current assets | | | 2,053,625 | |
| Total assets | | | **5,733,925** | |

**(c)**

Based on the information presented, the specialised equipment are considered "impaired" because its net book value of $500, 000 **($700k - $200k)** is greater its current recoverable amount. Recoverable amount is the higher of (fair value less cost to sell of $$350,000) and (value-in-use of $290,000). **(1m)**

Impairment loss of $150,000 **($500k-$350k)** is recognised in the income statement as an expense and a corresponding increase in the asset's accumulated depreciation to lower its net book value in the Balance sheet. **(2m)**

This is consistent with prudence / conservatism concept, which acknowledges all possible losses which should be recognised sooner rather than later, to ensure all ensure assets and income are not overstated and prevent understatement of liabilities and expenses. **(1m)**

**(d)**

The company should not proceed with the proposal to change depreciation methods, because there are no strong reasons justifying a change of method. **(1m)**

This would go against the accounting concept of consistency, which states that similar accounting procedures/methods should be used for items of similar nature from period to period, to facilitate meaningful comparison and informed decision-making. **(1m)**

However, a change in accounting methods is acceptable if it results in a more relevant and faithful representation of an underlying economic phenomenon. Here, the doctrine of disclosure is needed to acknowledge such changes in the notes to the accounts to allow users to take it into consideration when making decisions. **(1m)**

**Answers to Qn 2**

| | | | |
|---|---|---|---|
| **(a) Strategic Marine Ltd** | | | |
| **Income statement as at 30 Apr 2020** | | | |
| | $ | $ | |
| Cash sales **(76+84+78+38)** | | 276,000 | **(1m)** |
| Credit sales **[(276000 / 25) x 75]** | | 828,000 | |
| Total Sales | | 1,104,000 | |
| Less : Cost of Sales | | | |
| Opening inventory **(given)** | 45,000 | | |
| Add : Purchases **(350+210+85+130)** | 775,000 | | **(1m)** |
| Less : Closing inventory **(given)** | (90,000) | 730,000 | |
| Gross Profit | | 374,000 | |
| | | | |
| Add : Other income | | | |
| Gain on disposal **($15000 - ($75k-$65k)** | | 5,000 | **(1m)** |
| | | | |
| Less : Other Expenses | | | |
| General expenses **(10+29+45+30)** | | 114,000 | **(1m)** |
| Depreciation expenses | | 30,500 | **(1m)** |
| Interest expenses **($110,000 x 0.08 x 3/12)** | | 2,200 | **(1m)** |
| | | | |
| Net Profit | | **232,300** | |

| | | |
|---|---|---|
| **(b) Strategic Marine Ltd** | | |
| **Balance sheet as at 30 Apr 2020 (extract)** | | |
| **Current assets** | | |
| Cash at bank **(given)** | 320,000 | **(1m)** |
| Inventory **(Given info # 7)** | 90,000 | **(1m)** |
| Trade receivables **(38000/25) x75) or (66k+828k-780k)** | 114,000 | **(2m)** |
| Total current assets | **524,000** | |
| | | |
| **Current liabilities** | | |
| Trade creditors **(Given info # 2)** | 130,000 | **(1m)** |
| Interest payable **($110,000 x 0.08 x 3/12)** | 2,200 | **(1m)** |
| Total current liabilities | **132,200** | |
| Working Capital | **391,800** | |

**(c)**
Current ratio = **3.96 : 1** **($524,000 / $132,200)** **(1m) OF**
For every $1.00 of current liabilities, Strategic Marine Ltd has $3.96 of current assets to pay of its short term debts/obligations. **(1m)**

**(d)**

Given that the current ratio of 3.96 : 1 is considerably higher than what is reflected in the industry standards of 2.80 : 1, it means that the company has $1.16 more of current assets to finance it short-term debts. **(1m)**

Though a high current ratio may be an indicator of lowered risk, excessive working capital may not be good as it reflects poor optimising of resources. The company should be making more effective use of its current assets. **(1m)**

Excess working resources (eg cash at bank) could be diverted to more productive use or revenue generating activities. **(1m)** (Eg : Short term investments - fixed deposits or any other revenue generating activity that is acceptable).**(1m)**

**(e)**

<u>Varying efficiencies of managing working capital</u> : Companies with stringent/stricter collection policies will have lower levels of trade receivables and those with better negotiation skills are offered longer credit periods from credit suppliers. Companies will alter their credit policies to better match their working capital needs and no 2 companies will have similar working capital requirements.

<u>Varying company size could mean varying capital structures</u> : Bigger firms with more resources, have access to larger short-term loans or bank overdraft facilities or have the ability to raise capital via sale of shares, thus have greater CA as compared to smaller firms, hence impacting their current ratios. (impact CA – cash & CL – Bank overdraft, interest payable)

<u>Different mode of business</u> : Companies with varying modes of operations (Eg. Physical stores vs online or e-commerce platforms), could have varying amounts of inventory. Most online businesses have low levels of inventory or adopt Just-in-time inventory mgmt, given limited space. Physical stores which keep inventories also incur additional costs owed. (Eg Storage, pallets etc) as compared to those with lower inventory levels. (impact CA - inventory)

<u>Different level of experience</u> : Varying levels of experience in the market could result in some companies being offered lower prices for inventory, given established working relationships built. Smaller companies with lesser experience pay retail prices without discounts offered to those with a longer working relationship with vendors. (impact CA - inventory)

**(Accept any 2 x 1m)**

**Answers to Qn 3**

**(a)**

- Bonus issue of share is done to distribute excess reserves to shareholders but rights issue is done to raise funds.
- Cash/ net assets increases with a rights issue but not bonus issue.
- Share equity is increased with a rights issue but there is no change to equity in a bonus issue.
- Any other points

**(Accept any 2 x 1m)**

**(b) AB Limited - Statement of changes in equity for the year ended 31 March 2021**

| | **Pref Share Capital** | **Ordinary Share Capital** | **Retained earnings** | **Asset Rev. Reserve** | **Total** | |
|---|---|---|---|---|---|---|
| | $000 | $000 | $000 | $000 | $$000 | |
| Beginning balance | 200 | 400 | (165) | 0 | | |
| /Changes in equity for the year | | | | | | |
| Revaluation of assets | | | | 900 | | **(1m)** |
| Bonus issue of share capital ($400 x 2) | | 800 | | (800) | | **(1m)** |
| Rights Issue of share capital [(800 + (800 x 2)) 3/2 x $0.40] | | 1 440 | | | | **(1m)** |
| Net profit [318- (10%x600x9/12 +10%x200x3/12] | | | 268 | | | **(1m)** |
| Preference dividends (8% x 200) | | | (16) | | | **(1m)** |
| Ordinary Dividends [$0.02 x (orig 800 + bonus (800 x 2) + rights (800 + (800 x 2) 3/2 ] | | | (120) | | | **(2m)** |
| Ending balance | 200 | 2 640 | (33) | 100 | 2907 | **(1m)** |

| O/S | No '000 | $'000 |
|---|---|---|
| Beginning | 800 | 400 |
| 1 Sep: 2 for 1 BI | 1600 | 800 |
| | 2400 | 1200 |
| 1 Oct: 3 for 2 RI at $0.40 | 3600 | 1440 |
| | 6000 | 2640 |

**(c)** Dividend per ordinary share = (268 000-16 000)/ 6 000 000 = $0.042 **(2m)**

**(d)**
No **(1m)**

It has **just started to make profits** and there is still **retained losses** at year end **(1m)**

Funds needed for **operations and expansion** purposes **(1m)**

May lead to **unreasonable expectations of shareholders** to pay out all profits as dividends in future **(1m)**

Any other relevant points

**(e)**
No **(1m)**

Including the revaluation gains as profit will overstate the profit and the accounts will not be objective, which in turn affects users of the financial statements. **(2m)**

Revaluation gains cannot be distributed as dividends as there is no actual cash flow from the revaluation Only profit from operations can be distributed as cash dividends. **(1m)**

**Answers to Qn 4**

**Answers**

| **(a) Verizon Medical Pte Ltd** | | | |
|---|---|---|---|
| **Cash Flow Statement for the year ended 31 December 2020** | | | |
| **<u>Cash flow from Operating Activities</u>** | | | |
| Net profit before interest **(44.6 (given)+1+1.6)** | 47 200 | | **(1m)** |
| Adjustment for : | | | |
| Add : Depreciation – motor vehicle | 29 000 | | **(1m)** |
| Less : Gain on disposal of motor vehicle | (4 000) | | |
| **Operating cash flows before movement in wc** | | 72 200 | |
| Decrease in inventory **(47 - 41)** | 6 000 | | |
| Decrease in trade receivables **(52.2 - 48)** | 4 200 | | **(1m)** |
| Increase in trade payables **(31.4-34)** | 2 600 | 12 800 | |
| **Net inflow of cash from operations** | | **85 000** | |
| **<u>Cash flow from Investing Activities</u>** | | | |
| Purchase of motor vehicles | (108 000) | | **(1m)** |
| Payment for building extension | (60 000) | | |
| Proceeds from sale of motor vehicles **(given)** | 39 200 | | |
| **Net inflow of cash from investing activities** | | **(128 800)** | |
| **<u>Cash flow from Financing Activities</u>** | | | |
| Issue of shares | 20 000 | | **(1m)** |
| Proceeds from long term loan | 50 000 | | **(1m)** |
| Repayment of mortgage loan | (40 000) | | |
| Interest paid **(8%x40Kx9/12) + (5%X50kX3/12)** | (2 600) | | **(1m)** |
| Dividends **(5 600+8000)** | (13 600) | | **(1m)** |
| **Net inflow of cash from financing activities** | | **13 800** | |
| **Net increase / decrease in cash and cash equivalents** | | **(30 000)** | |
| Balances as at 1 January 2020 | | 21 000 | |
| Net decrease in cash and cash equivalents | | **(30 000)** | **(1m)** |
| Balances as at 31 December 2020 | | (9 000) | |

**(b)**
Positive cash flow generated from operations of $85, 000 indicative of healthy cash flow from trading activities. **(1m)**
However overall cash flow from all activities combined is negative, largely due to the purchases of non - current assets of $168, 000 **($108,000 + $60,000)**, possibly indicating that the company is expanding. **(1m)**

Acquisition of non-current assets were partly funded by bank loans and issue of ordinary shares, totaling to **$70,000 ($50,000 + $20,000).** **(1m)** The repayment of mortgage loan, resulted in a huge outflow of cash with interest cost charged for the year as well. **(1m)**

The company's liberal views about cash dividends, of which $13,600 worth of dividends declared this year **($5,600 interim + proposed $12,600)** and payment of last year's proposed dividends, has contributed to negative bank balance of $30,000. **(1m)**

Working capital has deteriorated from $40,800 **(120,200 – 79,400)** in 2019 to $33,400 **($89,000 – 55,600)** in 2020, due to funds used to partly pay for investments in non-current assets and having just enough to cover its short-term expenses. **(1m)**

**(c)**
The explanation to the director should include the following justification as to why net profit does not necessarily equate to a positive change in cash resources

The company has substantial non-cash expenses of $29,000 of depreciation, which lowered net profits but not cash. It has also earned $4,000 of other income but received $39,200 from such disposal. These have resulted in differences between net profit and cash. **(1m)**

Changes to working capital of $12,800 collectively, all have negatively impacted net profit but not cash of equivalent amount. Hence all 3 working capital items required adding differences back to the net profit to reconcile net profit and cash. **(1m)**

The company engaged in cash expenditure of non-current assets amounting to $168,000, which has not brought in returns yet. These have lowered cash but have no impact on net profits. **(1m)**

The company has facilitated the repayment of debts owed of $40,000 and interest/dividends amounting to $16,200. These have lowered cash but have no impact on net profits. **(1m)**

| **(d)** Name of ratio | Year ended 31 December 2020 | | **Industry standards** | |
|---|---|---|---|---|
| AR collection period (days) | Avg Net TR / Net Credit SR x 365 days | [(52,200+48,000) / 2] / 356,000 x 365 = **51 days** | **38 days** | **(1m)** |
| Invt T/o (days) | Avg inventory / Cost of sales x 365 days | [(47,000 + 41,000) / 2] / 280,400 x 365 = **57 days** | **65 days** | **(1m)** |
| AP payment period (days) | Avg Net TP / COS x 365 days | [(31,400+34,000)/2] / 280,400 x 365 = **42 days** | **35 days** | **(1m)** |
| Debt-equity ratio | Total Liabilities / Total Equity x 100% | (105,600) / 237,400 x 100% = **44%** | **39%** | **(1m)** |
| Net Profit Margin | NP after int exp / Net SR x 100% | 44,600 / 356,000 x 100% = **12.52%** | **10%** | **(1m)** |

**(Each answer x 1m)**

**(e)**

Accounts receivable collection period (days)

- The company's trade receivables collection period is higher/longer, thus worse than industry averages by **(51 – 38 = 13 days)**, taking 13 more days to collect payment from debtors.
- Possible indicator of inefficient credit collection policies, possibly due to increased credit period offered to customers during this difficult pandemic period. **(2m)**

Inventory turnover (days)

The company's inventory turnover in days is shorter, thus better than industry standards by 8 days.

- Possible indicator that inventory is moving or being purchased and sold more quickly thus indicative of more efficient inventory management or ;
- could be due to lower prices, better credit terms or ;
- greater demand for medical and health care products due to the current pandemic situation. **(3m)**

Accounts payable payment period (days)

The company's accounts payable payment period is higher by 7 days, means the company is taking a longer period to pay its suppliers.

- Possibly due to better negotiation to extend credit period with suppliers.
- Greater reliance on short term finance (↑ in trade payables and bank overdraft).
- Company could be taking advantage of this credit period, even though at the expense of cash discounts, to cope with cash needs given heavy investment in non-current assets and interest payments. **(3m)**

Debt-equity ratio

The company's debt to equity ratio is higher that industry by 5%, meaning gearing or reliance on debt is slightly greater unfavourable,

- thus representing a higher risk for shareholders given the higher claims by all lenders. Eg mandatory interest and loan principal payments. **(2m)**

Net profit Margin

The company's net profit margin is better than those reflected in the industry by 2.52%.

- Indicative that the company is efficient in its operations and is effective in controlling its expenses. **(2m)**

**(Each ratio, (1m is for interpretation/explanation)(1m/2m is for its reasoning or implication)**

**(f)** The company should not lend money to staff.

Reasons include the risk of bad debts, it's not a revenue producing activity and such financial risk could incur more future costs (eg recovery of such debts when such employees resign). **(1m)**

The issue of accountability is a concern here, given such loans equate to forgoing potential income (eg. Interest earned from simply keeping money in the bank or fixed deposit etc) and this is clearly not in the interest of the owners / shareholders of the company. **(1m)**

Such loans could threaten the ethical principle of objectivity, where parties ascertaining creditworthiness when approving loans are subjected to conflict of interest, undue influence or bias towards fellow staff. **(1m)**

- Lack of safeguards to ensure prompt payment, unlike banks who can impose penalties or increased rates for delayed payments). **(1m)**