

1. (a) An effective internal control system should contain the following internal control principles:
- Segregation of duties
  - Independent internal verification
  - Physical safeguard of assets
  - Proper authorization
  - Adequate documents and procedures
  - Competent personnel with clear responsibilities.
- (i) Explain any THREE of the internal control principles listed above. [ 9 marks]
- (ii) Show how the internal control principles of **physical safeguard of assets** and **proper authorization** apply to controls over inventory. [ 6 marks]
- (b) The third level of the conceptual framework of accounting is made up of assumptions, principles and constraints. The principles incorporated in this level are (i) **going concern**, (ii) **historical cost**, (iii) **materiality** and (iv) **revenue recognition**. Briefly explain any THREE principles incorporated in this level. [ 6 marks]
- (c) Accounting standards have been developed by a number of bodies. Explain why standards are important for the preparation of financial statements. [14 marks]

2. The accounting firm of Lois and Kent Associates has been contracted to perform accounting services for Nylon Corporation, a public company, and Velcro Inc. a private company. Nylon Corporation has provided Lois and Kent with the following information pertaining to its financial affairs at December 31, 2003.

Sales	\$1 200 000
Purchase discounts	18 000
Purchases	720 000
Earthquake loss (net of tax) (extraordinary item)	42 000
Selling expenses	128 000
Share capital	200 000
Accumulated depreciation	180 000
Dividend revenue	8 000
Inventory, January 1, 2003	152 000
Inventory, December 31, 2003	125 000
Unearned service revenue	4 400
Accrued interest payable	1 000
Retained earnings, January 1, 2003	270 000
Interest expense	17 000
General and administrative expenses	160 000
Dividends declared	29 000
Allowance for doubtful accounts	5 000
Materials and supplies	40 000

The capital structure of Nylon Corporation consists of 20 000 ordinary shares with NO par value and the corporation tax rate is 30 per cent.

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- (a) Prepare an income statement for Nylon Corporation for the year ended December 31, 2003. Your statement should comply with the requirements of International Accounting Standards 1. [19 marks]

Velcro Inc. presented Lois and Kent Associates with the following balance sheet prepared by the part-time bookkeeper:

**VELCRO INC.**  
**Balance Sheet**  
**as of December 31, 2003.**

Cash	\$ 90 000	Accounts payable	\$ 75 000
Accounts receivable (net)	52 200	Long-term liabilities	110 000
Inventories	57 000	Stockholders' equity	208 500
Investments	76 300		
Equipment (net)	86 000		
Patents	32 000		
	<u>\$ 393 500</u>		<u>\$ 393 500</u>

During an interview with the bookkeeper the following additional information was revealed:

- (i) Cash includes the cash surrender value of a life insurance policy of \$9 400 and a bank overdraft of \$1 500 which has been deducted.
  - (ii) The net accounts receivable balance includes:
    - (a) Accounts receivable ——— debit balances \$60 000;
    - (b) Accounts receivable ——— credit balances \$3 000;
    - (c) Allowance for doubtful accounts \$4 800.
  - (iii) Inventories **do not** include goods costing \$5 000 shipped out on consignment. Receivables of \$5 000 were recorded on these goods.
  - (iv) Investments include marketable securities of \$24 000 and long-term investments valued at \$52 300.
  - (v) Equipment costing \$8 000 with an accumulated depreciation of \$6 000 is no longer used and is held for sale. Accumulated depreciation on the other equipment is \$40 000.
- (b) Prepare the corrected balance sheet for Velcro Inc. for the year ended December 31, 2003, in accordance with International Accounting Standards. [16 marks]

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3. Spice Isle Inc. has been operating successfully in the Isle of Child for the past five years. The company is considering expanding its operations to the country of Sabre. The manager of Spice Isle Inc. has approached the First National Bank for a loan in the amount of \$500 000 to finance the proposed operations in Sabre. The loans officer of the bank has requested the financial statements of Spice Isle Inc. to perform an analysis of the liquidity, solvency and profitability of the entity. The recent financial statements of Spice Isle Inc. appear below.

**SPICE ISLE INC.**  
**Balance Sheets**  
**May 31, 2003 and 2002**

	<u>2003</u>	<u>2002</u>
Cash	\$ 27 875	\$ 30 000
Accounts receivable	\$ 8 000	\$ 9 375
Inventories	\$ 49 875	\$ 37 625
Long-term investments		\$ 10 000
Plant and equipment	\$165 625	\$150 000
Less accumulated depreciation	( <u>\$ 63 500</u> )	( <u>\$ 58 500</u> )
Total assets	<u>\$187 875</u>	<u>\$178 500</u>
Accounts payable	\$ 2 000	\$ 3 000
Accrued liabilities	\$ 2 625	\$ 2 250
Mortgage	\$100 000	\$100 000
Ordinary shares at \$5 each	\$ 35 000	\$ 25 000
Retained earnings	<u>\$ 48 250</u>	<u>\$ 48 250</u>
Total liabilities and stockholders' equity	<u>\$187 875</u>	<u>\$178 500</u>

**SPICE ISLE INC.**  
**Income statement**  
**For the Year Ended May 31, 2003**

Sales	\$127 500
Less cost of goods sold	<u>\$ 91 250</u>
Gross margin	\$ 36 250
Less operating expenses	<u>\$ 17 500</u>
Income before taxes	\$ 18 750
Less income taxes	<u>\$ 5 625</u>
Net income	<u>\$ 13 125</u>

Additional information:

- (i) Shares in Bowen Co., held as a long-term investment, were sold for \$10 000 cash.
- (ii) Dividends of \$13 125 were declared and paid during the year.
- (iii) Interest payments in the amount of \$2 500 have been included in the operating expenses.
- (iv) The market value of Spice Isle shares was \$6.50 EACH.

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- (a) Using the **indirect method**, prepare a statement of cash flows for Spice Isle Co. for the year ended May 31, 2003. **[15 marks]**
- (b) Calculate the following for the year ended May 31, 2003:
- (i) Current ratio
  - (ii) Quick ratio
  - (iii) Debt to equity ratio
  - (iv) Debt to total asset ratio
  - (v) Times interest earned
  - (vi) Earnings per share
  - (vii) Price earnings ratio
  - (viii) Return on investment **[14 marks]**
- (c) Discuss the liquidity and solvency position of Spice Isle Inc. **[ 6 marks]**

**END OF TEST**