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AQ2013 Level 4

FINANCIAL STATEMENTS

FOCUS NOTES

KAPLAN PUBLISHING

CONTENTS

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Introduction

Purpose of this unit:

- Follows on from ACPR and FSTP
- Purpose – to develop competence in drafting and interpreting financial statements of limited companies
- Relates to individual companies and corporate groups
- Requires knowledge and application of International Financial Reporting Standards
- Includes analysis and interpretation of financial statements to assist in the decision-making of external user groups

Core topics within FSTM:

- The regulatory framework
- Key features of published financial statements
- Draft financial statements for a limited company
- Draft consolidated financial statements
- Interpretation of financial statements using ratio analysis

Assessment of FSTM:

- Tasks 1 & 2 – Draft statutory financial statements for a limited company
- Task 3 – Conceptual and regulatory framework
- Tasks 4 & 5 – International financial reporting standards
- Task 6 – Consolidated financial statements
- Tasks 7 & 8 – Analysis and interpretation

Regulatory frameworks

1

Learning objectives:

At the end of this chapter you will be able to:

- Demonstrate knowledge of the legislation and regulation that must be complied with when preparing financial statements.

Contents:

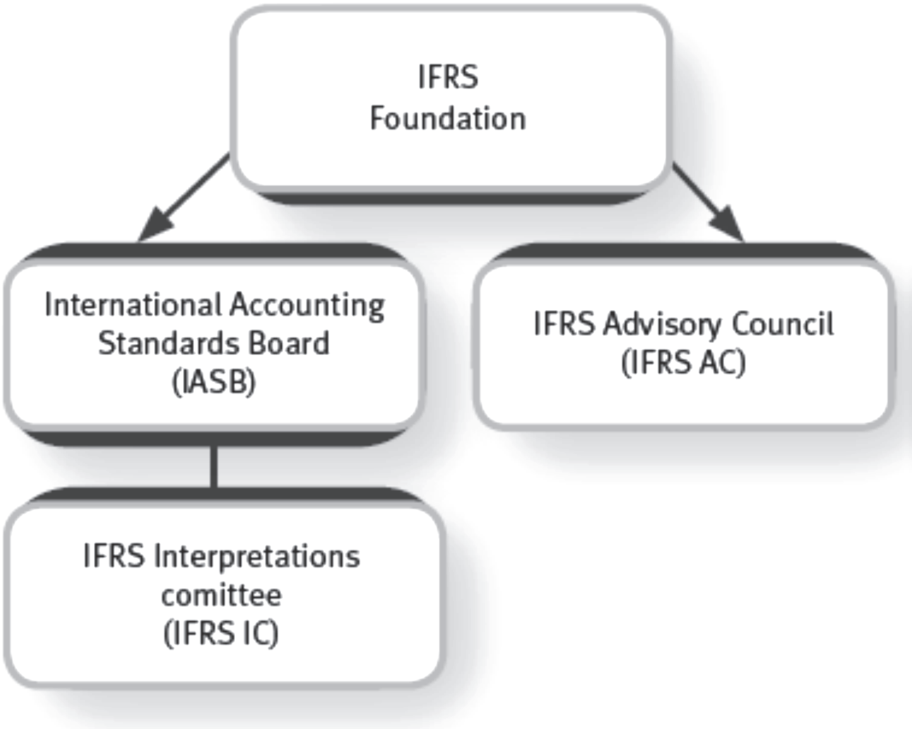
1 The legal framework

The legal framework in the UK

- Companies Act 2006
- Additional law may apply to other companies – e.g. banks

2 The regulatory framework

All UK companies may use International Financial Reporting Standards (IFRS) when preparing their financial statements. It is mandatory for listed UK companies to use IFRS.



3 Summary

Legal regulation

The Companies Act 2006

The regulatory framework

The IFRS Foundation

4 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 1 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 1 of the Financial Statements pocket notes.

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q1-2 are simpler questions for students who may be struggling
- Q36-37 are trickier questions to challenge more able students.

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

- Regulatory frameworks – (Chapter 1): activity 1

The conceptual framework

2

Learning objectives:

At the end of this chapter you will be able to:

- Demonstrate a knowledge and understanding of the International Accounting Standards Board's Conceptual Framework for Financial Reporting.

Contents:

1 What is the framework?

Conceptual Framework for Financial Reporting 2010

- It provides a context, structure and principles for the development and application of IFRS

2 The objective of financial statements

Objective of financial statements

- To provide information on the financial position and performance of a company that is useful to a range of users

Principal users of financial statements

Users	Purpose
Investors	To assess risks and returns of relevant investments
Lenders	To decide whether to offer loans and what rates of interest to charge
Suppliers	To decide whether to supply goods on credit and the terms of the credit

Principal users of financial statements

Government	To use figures to calculate the correct tax payable
Employees	To assess the position of the business with regard to job stability and opportunities
Customers	To ensure they have a stable supplier of goods and services
Public	To obtain information about companies of interest

3 The qualitative characteristics of useful information

The Framework identifies two **fundamental** qualitative characteristics of useful financial information and four **enhancing** characteristics. Preparers of financial information should attempt to maximise these characteristics to benefit the users.

Fundamental characteristics

Relevance	Capable of influencing decision-making
Faithful representation	Complete, neutral and free from error

Enhancing qualitative characteristics

Comparability	Between entities and also for one entity between different time periods
Verifiability	This provides assurance regarding reliability of information
Timeliness	Information available within appropriate timescale for decision-making
Understandability	Information should be understandable to those who use it

Principal users of financial statements

Government	To use figures to calculate the correct tax payable
Employees	To assess the position of the business with regard to job stability and opportunities
Customers	To ensure they have a stable supplier of goods and services
Public	To obtain information about companies of interest

4 The underlying assumption

Going concern

Definition: The business will continue in operational existence for the foreseeable future without the need or intention to cease trading

5 Elements of the financial statements

Elements of the financial statements

Asset	A resource controlled by an entity as a result of past transactions or events, from which future economic benefits are expected to flow to the entity
Liability	A present obligation arising from past transactions or events, the settlement of which is expected to result in an outflow of economic benefits from the entity
Equity	The residual interest of the business when it ceases to trade (and all the assets are sold and liabilities paid)

The statement of financial position presents the assets, equity and liabilities of the company as at the end of a reporting period.

Statement of financial position as at 30 June 20X6

	£	£
Non-current assets		
Property, plant and equipment		X
Intangible assets		X
Current assets		X
Inventories	X	
Trade and other receivables	X	
Cash and cash equivalents	X	
		X
Total assets		**X**
Equity		
Share capital		X
Share premium account		X
Retained earnings		X
Revaluation reserve		X
Total equity		X

Non-current liabilities		
Long-term loans or debentures		X
Current liabilities		
Trade and other payables	X	
Bank overdrafts	X	
Tax payable	X	
		X
Total liabilities		X
Total equity and liabilities		**X**

Elements of the financial statements

Income	The increase in economic benefits during an accounting period
Expense	The decreases in economic benefits during an accounting period

The statement of profit or loss and other comprehensive income shows the performance of the company over the period. It includes items of other comprehensive income, such as revaluation gains, which are not recognised in profit or loss.

Statement of profit or loss and other comprehensive income for year ended 30 June 20X6

	£
Revenue	X
Cost of sales	(X)
Gross profit	X
Distribution costs	(X)
Administrative expenses	(X)
Profit from operations	X
Finance costs	(X)
Profit before tax	X
Income tax expense	(X)
Profit for the period	**X**
Other comprehensive income	
Revaluation gain	X
Total comprehensive income for year	X

Note that there is more formalised terminology and only certain headings and amounts are required to be disclosed in the annual financial statements.

Note also that the capital structure of a limited company is different to that of a sole trader or a partnership.

6 Measuring the elements

Measuring the elements

Historical cost: Assets would be recorded at the price paid to acquire them. Liabilities would be recognised at the proceeds received

Current cost: Assets would be carried at the current purchase price. Liabilities would be carried at the amount required to settle them.

Measuring the elements

Realisable value: Assets would be carried at the amount that would be obtained from their sale. Liabilities would be carried at the amount required to settle them

Present value: Assets would be carried at the discounted value of the future cash inflows that the item will generate. Liabilities would be carried at the discounted value of the cash flows required to settle them

7 Summary

The objective of financial statements

- To provide information
- About position, performance and changes
- That is useful to a range of users

Qualitative characteristics

- Relevance
- Faithful representation
- Comparability
- Verifiability
- Timeliness
- Understandability

The elements:

- Assets
- Liabilities
- Equity
- Income
- Expenses

Possible measure bases are:

- Historical cost
- Current cost
- Realisable value
- Present value

8 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 2 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 1 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 10 (Recognition)
- Question 11 (Objectives)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 2 of the Financial Statements text book

- Workbook Activities 5 – 9

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q3-4 are simpler questions for students who may be struggling
- Q38-39 are trickier questions to challenge more able students.

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

The conceptual framework – (Chapter 2): activities 1, 2 3 and 4

Revision kit (for recapping and revising the chapter)

Questions 12 and 13

Property, plant and equipment 3

Learning objectives:

At the end of this chapter you will be able to:

- Account for the purchase, depreciation and disposal of property, plant and equipment
- Account for revaluation gains and losses
- Explain the disclosures required for property, plant and equipment

Contents:

1 Recording property, plant and equipment

IAS 16 – Property, plant and equipment

Contents:

Definitions

Accounting treatments

Disclosure requirements

Definitions

Non-current assets – assets that are purchased with the intention of long term use within the business

Tangible non-current assets – assets that have a tangible, physical form, such as land and, buildings, machinery and cars

Intangible non-current assets – are assets for long-term use in the business that have no physical form, e.g. patents and licences

Definitions

Capital expenditure – expenditure on non-current assets or on the improvement of non-current assets. Capital purchases are recorded as assets on the statement of financial position

Revenue expenditure – all other expenditure within the business that is not of a capital nature. This may include expenditure that maintains but does not improve non-current assets, such as money spent on repairs and renewals

2 Depreciation of property, plant and equipment

Definitions

Depreciation: The consumption or usage of a non-current asset in the accounting period which is spread over its estimated useful life to the business

Useful economic life – the period over which economic benefits are expected to be derived from the asset.

Residual value – the amount that the asset is expected to be sold for at the end of its useful economic life.

Methods of depreciation

Straight-line – this assumes that the asset is used consistently throughout its life. The depreciation charge is the same each year

Diminishing balance – this assumes that an asset is used less and less the older that it gets. The depreciation charge falls each year

Straight-line depreciation – method

EITHER: **(Cost – residual value)/Useful life**

OR: **(Cost – residual value) × %**

Diminishing balance depreciation – method

Carrying value of non-current asset × %

Carrying value – the cost of the asset less the accumulated depreciation charged to date

Accounting entries for the annual depreciation charge

DR:	Depreciation expense (P&L)
CR:	Accumulated depreciation (SOFP)

3 Disposal

Accounting treatment upon disposal of a non-current asset

1 – Remove the cost of the asset and transfer to a disposal account

DR:	Disposal of NCA
CR:	Non-current asset

Accounting treatment upon disposal of a non-current asset

2 – Remove the accumulated depreciation and transfer to disposal account

DR:	Accumulated depreciation
CR:	Disposal of NCA

Accounting treatment upon disposal of a non-current asset

3 – Record disposal proceeds received in disposal account

DR:	Cash / Bank
CR:	Disposal of NCA

Accounting treatment upon disposal of a non-current asset

4 – Transfer remaining balance on disposal account to P&L

DR:	Disposal of NCA
CR:	P&L (if a profit on disposal)
OR:	
DR:	P&L (if a loss on disposal)
CR:	Disposal of NCA

Calculation of profit or loss upon disposal of a NCA

		£
Proceeds		X
Less carrying value:		
Cost	X	
Accumulated dep'n	(X)	
		(X)
Profit/(Loss)		X/(X)

4 Example 1 – Disposal

Vintage Ltd bought a machine on 1 January 2010 for £10,000. It depreciates machines on a straight line basis over 5 years with no estimated residual value.

On 31 December 2012, Vintage Ltd sold the machine for £7,000

Task:

Calculate the profit or loss on disposal?

Solution:

The profit or loss on disposal can be calculated as follows:

		£
Proceeds:		7,000
Carrying value:		
Cost:	10,000	
Accumulated Depreciation		
((£10,000/5 years) × 3 years)	(6,000)	
		(4,000)
Profit on disposal		3,000

The answer to the above example can be found in Chapter 19.

5 Revaluation

Revaluation rules

- IAS 16 permits revaluation of PPE – it is not compulsory
- The company must revalue all assets within the class or category – there cannot be selective revaluation of assets
- Revalued assets should be depreciated over their remaining estimated useful lives
- Revalue at regular intervals to keep valuation up to date

Revaluation – accounting treatment

- An increase in the CV of PPE creates an unrealised gain – recognise in other comprehensive income and in revaluation reserve within equity

Dr PPE – asset account	(to increase the cost to valuation amount value)
Dr Accumulated depreciation	(to remove accumulated depreciation to date)
Cr Revaluation reserve	(to record the gain in the value of the asset)

Revaluation – accounting treatment

- A decrease in the CV of PPE creates an unrealised loss – recognise first against revaluation reserve (if possible), and then in P&L

Dr Revaluation reserve / profit or loss	(to recognise fall in value)
Dr Accumulated depreciation	(to remove all accumulated depreciation)
Cr PPE – asset account	(to record the loss in the value of the asset)

Revaluation – excess depreciation annual transfer within SOCIE

- Transfer is not compulsory, but if done, must be applied consistently every year
- Effect is to regard part of revaluation reserve as being realised

Dr Revaluation reserve

Cr Retained earnings

Disposal of a revalued asset

- A gain or loss on disposal is included in profit or loss for the year
- Transfer balance on revaluation reserve to retained earnings within SOCIE

Dr Revaluation reserve

Dr Retained earnings

6 Example 2 – Revaluation

On 31 December 20X2, Earlgrey plc revalued a building. The building originally cost £5,000,000 and had an estimated useful life of fifty years with no residual value. Accumulated depreciation at the date of revaluation was £1,000,000. The estimated market value of the building was £5,500,000.

Several years ago, Lapsong Ltd re-valued a building to £3,000,000 recording a gain of £100,000 which is held within a revaluation reserve. On 31 December 20X2, the accumulated depreciation on the building was £400,000. At that date, a surveyor advises that the building was now worth only £2,000,000 with a remaining estimated useful life of twenty years.

Required:

State the double entry required to record each revaluation and calculate the new annual deprecation charge for each building.

Solution:

The double entry required to record each revaluation

Earlgrey plc:

The building has a carrying value of £4,000,000 (5,000,000 – £1,000,000). It needs to be re-valued to £5,500,000. This will create a gain of £1,500,000 (£5,500,000 – £4,000,000) that will be held within a revaluation reserve.

Dr	Building – asset account	£500,000 (£5,500,000 – £5,000,000)
Dr	Accumulated depreciation	£1,000,000 (to remove acc dep'n)
Cr	Revaluation reserve	£1,500,000

Revised depreciation charge: £5,500,000 / 40 years = £137,500

Lapsong Ltd

The asset currently has a carrying value of £2,600,000 (£3,000,000 – £400,000). It needs to be re-valued to £2,000,000. This is a revaluation loss of £600,000.

This will first of all be allocated to the revaluation reserve, reducing it from £100,000 to nil. The remaining loss of £500,000 (£600,000 – £100,000) will be expensed to profit or loss.

Dr	Revaluation reserve	£100,000 (reduced to nil by the revaluation loss)
Dr	Profit or loss	£500,000 (balancing figure)
Dr	Accumulated depreciation	£400,000 (to remove acc dep'n)
Cr	Building – asset account	£1,000,000 (£3,000,000 – £2,000,000)

Revised depreciation charge: £2,000,000 / 20 years = £100,000

The answer to the above example can be found in Chapter 19.

7 Disclosures

In the financial statements, a disclosure note is required that details the changes in the cost and accumulated depreciation account balances of each class of property, plant and equipment since the last reporting date.

	Land and buildings	*Plant and machinery*	*Motor vehicles*	*Total*
Cost or valuation				
At 1 January 20X2	X	X	X	X
Additions	X	X	X	X
Disposals	(X)	(X)	(X)	(X)
Revaluations	X	X	X	X
At 31 December 20X2	X	X	X	X
Accumulated depreciation				
At 1 January 20X2	X	X	X	X
Revaluations	(X)	(X)	(X)	(X)
Charge for year	X	X	X	X
Disposals	(X)	(X)	(X)	(X)
At 31 December 20X2	X	X	X	X
Carrying value				
At 31 December 20X2	X	X	X	X
At 1 January 20X2	X	X	X	X

Note that the PPE asset accounts may now include some items measured at cost whilst others are stated on a valuation basis. Strictly, the term ‘cost account’ should no longer be used – ‘assets at cost or valuation’ is a more accurate description.

Accounting policies disclosures

- Depreciation methods and rate(s) used for each major class of asset
- Measurement basis (cost or valuation) for each major class of asset

8 Summary

Recognition

Record PPE at total of capital expenditure

Depreciation

- Straight line
- Diminishing balance

Revaluations

- Gains are recorded in reserves
- Losses are recorded in profit or loss

9 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 3 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 6 of the Financial Statement pocket notes

Real assessment standard question practice

Revision kit:

- Question 32 (Larch plc)
- Question 33 (Revaluation)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 3 of the Financial Statements text book

- Workbook activities 2, 3 and 4

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q5-7 are simpler questions for students who may be struggling
- Q40-41 are trickier questions to challenge more able students.

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

Valuation gains – (Chapter 3): activities 1

Revision kit (for recapping and revising the chapter)

Questions 14 and 34

Intangible assets

4

Learning objectives:

At the end of this chapter you will be able to:

- Distinguish between tangible and intangible assets
- Record entries for the acquisition of intangible assets
- Distinguish between research and development activities
- Explain the accounting treatment of research and development activities
- Record entries for the amortisation of intangible assets

Contents:

1 Recognition and measurement of intangible assets

IAS 38 – Intangible assets

Contents:

Definition

Recognition requirement

Accounting treatments

Disclosure requirements

IAS 38 – Intangible assets

Definition – an identifiable, non-monetary asset without physical substance

Recognition

- Identifiable – capable of being separated from other assets
- Controlled – able to use or determine who can use the assets
- Reliable measurement of cost – otherwise cannot recognise
- Future economic benefits – applied to every asset
- Internally generated assets – not normally recognised

IAS 38 – Intangible assets

Measurement

- Initially recognise at cost
- Amortise if reliable estimate of EUL
- If no EUL – permanent asset, subject to annual impairment review
- Future economic benefits
- Permitted to revalue intangible assets, but requires active market for identical assets – very rare

2 Research and development

IAS 38 – Intangible assets

Research – is original investigation which is undertaken in order to obtain new knowledge

- Write off to P&L as incurred

IAS 38 – Intangible assets

Development – is the application of research findings to produce new or improved materials, products or processes

- Capitalise and amortise if meeting specific criteria – otherwise write off to P&L

Development costs criteria for compulsory capitalisation

Remember SECTOR

- **S**ufficient resources to complete
- **E**ntity will complete development of product
- **C**omplete the project
- **T**echnically feasible
- **O**verall profitable
- **R**eliably measured

3 Example 1 – Research and development

Salmon Ltd, a manufacturer of food packaging, has undertaken a number of research and development activities in the year ended 31 December 2013. It can be assumed that expenditure occurred evenly over the course of the year.

(i) £500,000 has been spent testing a new type of plastic to see if it is harmful to humans.

(ii) In the prior year, Salmon Ltd performed tests on a new type of plastic and found that it decomposes much more quickly than traditional plastics. During the year ended 31 December 2013, £120,000 has been spent designing a milk bottle that incorporates the new plastic. On 1 August, the directors received the results of market research that demonstrated a massive demand for this new milk bottle. Salmon Ltd has sufficient resources to bring the product to market.

Required:

What is the correct accounting treatment for the research and development activities in the year ended 31 December 2013?

Solution:

(i) This project is still in the research phase. Therefore, all £500,000 must be recognised as an expense in the statement of profit or loss.

(ii) This project is in the development stage. An intangible asset must be recognised when the IAS 38 criteria are met.

The profitability of the project was confirmed on 1 August 2013 so expenditure from this date is capitalised.

Therefore an intangible should be recognised at £50,000 (5/12 × £120,000).

The remaining £70,000 (£120,000 – £50,000) must be charged to the statement of profit or loss.

The answer to the above example can be found in Chapter 19.

4 Amortisation

IAS 38 – Intangible assets

Amortisation of intangible fixed assets

Similar to accounting for depreciation on tangible fixed assets

- Dr: Amortisation expense (P&L)
- Cr: Accumulated amortisation (SOFP)

IAS 38 – Intangible assets

Amortisation of intangible fixed assets

- If no reliable estimate of EUL, then cannot amortise, but must have annual impairment review

5 Example 2 – Amortisation

Chardonnay Ltd purchased two brands on 30 June 2013. Details of these brands are given below:

Brand Name	Cost (£)	Useful Life (years)
A	100,000	10
B	500,000	Indefinite

In addition, Chardonnay Ltd has internally generated a new brand (Brand C). It estimates that this cost £400,000 in staff costs.

Required:

What is the correct accounting treatment of the brands in the year ended 31 December 2013?

Solution:

Brand A: This brand will be recognised in the statement of financial position at its cost of £100,000.

This will be amortised over the useful life of 10 years from the date the brand is available to use (30 June 2013).

The amortisation expense in the statement of profit or loss is therefore £5,000 ((£100,000/10 years) × 6/12)). This will reduce the value of the brand in the statement of financial position to £95,000 (£100,000 – £5,000).

Brand B: The brand will be recognised in the statement of financial position at its cost of £500,000.

This brand has an indefinite useful life and is therefore not amortised. Instead, it will be subject to an annual impairment review.

Brand C: This is an internally generated intangible asset. Internally generated intangible assets can only be recognised if they result from development activities and strict criteria are met.

Therefore, Brand C will not be held on the statement of financial position.

The answer to the above example can be found in Chapter 19.

6 Summary

Intangible assets

- Recognise if purchased
- Do not recognise if internally generated (except R&D)

Research and development

- Research costs are expensed
- Development costs are capitalised if all criteria are fulfilled.

Intangible assets are amortised over their useful economic life

If they have an indefinite life, they are subject to an annual impairment review.

7 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 4 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 6 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 15 (Victoria plc)
- Question 48 (Research and Development)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 4 of the Financial Statements text book.

- Workbook activities 2 and 3

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q8-9 are simpler questions for students who may be struggling
- Q42-43 are trickier questions to challenge more able students.

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

Capitalising research and development – (Chapter 4): activity 1

Revision kit (for recapping and revising the chapter)

Questions 18 and 47

Impairments

5

Learning objectives:

At the end of this chapter you will be able to:

- Assess when an impairment review is required
- Calculate if an asset is impaired
- Account for the impairment of an asset

Contents:

1 Impairment of assets

IAS 36 – Impairment of assets

Contents:

Definition

Recognition requirement

Accounting treatment

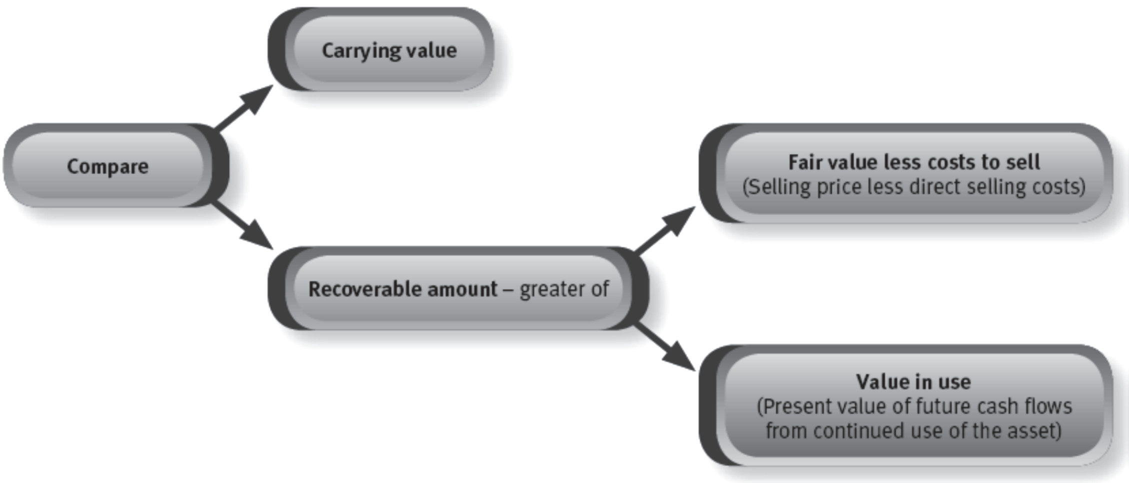
IAS 36 – Impairment of assets – definitions

Impairment – a reduction in the recoverable amount of an asset below its carrying amount

Recoverable amount – the higher of either fair value less costs to sell or value in use

Fair value less costs to sell – the amount an asset could be sold for, less direct selling costs

Value in use – the present value of future cash flows arising from continued use of the asset



2 Impairment reviews

IAS 36 – Impairment of assets

Annual impairment reviews required:

- Intangible assets which have been assessed as having an indefinite useful life
- Goodwill arising from a business combination
- Otherwise – only need impairment review when there is an indication of possible impairment

IAS 36 – Impairment of assets

Indicators of impairment (not exhaustive):

- Decreases in the market value of an asset
- A reduction in the usage of an asset
- Evidence that an asset has performed worse than expected

IAS 36 – Impairment of assets

Impairment review calculation

		£
Carrying value of asset		X
Less recoverable amount – the higher of		
(a) FV less costs to sell	X	
(b) Value in use	X	(X)
		(X)

IAS 36 – Impairment of assets

Outcome of impairment review:

- If recoverable amount exceeds CV of asset, then no impairment
- If recoverable amounts is less than CV of asset – impairment loss is written off against revaluation reserve if a revalued asset, otherwise to P&L
- Disclose impairment losses in notes to P&L
- Depreciate reduced asset CV over remaining EUL

3 Example 1 – Impairment review

The following information relates to three assets held by a company.

	A	B	C
Carrying value (£)	200	200	200
Net selling price (£)	250	175	160
Value in use (£)	180	150	180

Required:

Calculate the impairment losses, if any, in respect of the three assets.

Solution:

Recoverable amount is the higher of the net selling price (fair value less costs to sell) and value in use.

	A	B	C
Recoverable amount (£)	250	175	180
Carrying value (£)	200	200	200
Impairment (£)	No	(25)	(20)

The answer to the above example can be found in Chapter 19.

4 Summary

Perform an impairment review on:

- Intangibles with indefinite lives
- Goodwill
- Assets with indicators of impairment

An asset is impaired if:

Carrying value > Recoverable amount

Recoverable amount is the higher of:

- Fair value less costs to sell
- Value in use

Impairment losses

Dr	Profit or loss	X
Cr	Asset (SOFP)	X

5 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 5 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 6 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 38 (Frank Ltd)
- Question 39 (Bovey Ltd)

Additional, more challenging questions

The following question can be found at the rear of Chapter 5 of the Financial Statements text book.

- Workbook Activity 2

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q10-11 are simpler questions for students who may be struggling
- Q44-45 are trickier questions to challenge more able students.

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

Impairment review – (Chapter 5): activity 1

Revision kit (for recapping and revising the chapter)

Questions 40, 41 and 42

Inventories

6

Learning objectives:

At the end of this chapter you will be able to:

- Account for closing inventory at the lower of its cost and net realisable value

Contents:

1 Recording inventories

IAS 2 – Inventories

Contents:

Definitions

Accounting treatment

IAS 2 – Inventories –

Definitions:

Cost – comprises all costs of purchase, conversion and finishing to bring items to their current location and condition: e.g. purchase cost of raw materials

Net realisable value – the estimated selling price in the ordinary course of business, less the estimated costs required to complete and sell the item

IAS 2 – Inventories

Methods of identifying cost per unit for identical items:

- Unit cost – purchase cost
- Weighted average cost – average cost for items purchased
- First-in-first-out (FIFO) – inventory held consists of the most recent purchases

IAS 2 – Inventories

Accounting requirement:

- Inventory is measured (i.e. valued) at the lower of cost or net realisable value for each separate item or product

IAS 2 Inventories –

Accounting entries for closing inventories:

- Dr: Closing inventory (SOFP)
- Cr: Closing inventory (Cost of sales – P&L)

2 Example 1 – Recording inventories

A company starts trading in January. It makes the following inventory purchases:

	Units	£/unit
1 January	5	10
15 January	10	12
29 January	8	15

On 31 January, the company sells 10 units of inventory.

Task:

Calculate the cost of closing inventory on 31 January using:

(i) First-in, first-out (FIFO)

(ii) Average cost

Solution:

Total unit purchases were 23 (5 + 10 + 8). Therefore, there are 13 units (23 – 10) of closing inventory

(i) Under FIFO, these will be valued at the latest purchase prices:

8 units	×	£15	=	£120
5 units	×	£12	=	£60
13 units				£180

(ii) (The total purchase cost is £290 ((5 units × £10) + (10 units × £12) + (8 units × £15))

The average purchase cost is therefore £12.61 (£290/23 units)

Closing inventory will be valued at £163.93 (13 units × £12.61)

The answer to the above example can be found in Chapter 19.

3 Example 2 – Net realisable value

Tracey Ltd sells three products – A, B and C. The following information was available at the year-end:

	A	*B*	*C*
	£ per unit	£ per unit	£ per unit
Original cost	7	10	19
Estimated selling price	15	13	20
Selling and distribution costs	2	5	6
Units of inventory	20	25	15

Task:

What is the correct value of closing inventories?

Solution:

All items should be valued at the lower of cost and NRV.

Unit A: Cost = £7

NRV = £13 (£15 – £2)

Therefore each of the 20 units should be valued at £7

Unit B: Cost = £10

NRV = £8 (£13 – £5)

Therefore each of the 25 units should be valued at £8

Unit C: Cost = £19

NRV = £14 (£20 – £6)

Therefore each of the 15 units should be valued at £14

Closing inventory is therefore £550 ((20 × £7) + (25 × £8) + (15 × £14))

The answer to the above example can be found in Chapter 19.

4 Summary

Closing inventory

Dr	Inventory (SOFP)	X
Cr	Cost of sales (P/L)	X

The cost of inventory

- Unit cost
- FIFO
- Average cost

Inventory is measured at the lower of:

- Cost
- NRV

5 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 6 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 7 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 20 (Chestnut plc)
- Question 21 (FIFO)

Additional, more challenging questions

The following question can be found at the rear of Chapter 6 of the Financial Statements text book

- Workbook Activity 4

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q12-13 are simpler questions for students who may be struggling
- Q46-47 are trickier questions to challenge more able students.

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

Application of IAS 2 – (Chapter 6): activities 1, 2 and 3

Revision kit (for recapping and revising the chapter)

Questions 22 and 23

Taxation

7

Learning objectives:

At the end of this chapter you will be able to:

- Identify the amount of tax to be recognised in the statement of financial position and the statement of profit or loss
- Account for adjustments in respect of over or under-estimated tax in prior periods

Contents:

1 Tax in the financial statements

IAS 12 – Income taxes

Contents:

Definitions – note that IAS 12 refers to Income taxes – this is tax charged on the income of a company which would normally be referred to as corporation tax in the UK. Reference to income taxes in this context should not be confused with tax paid by individuals.

When the provision for a company's income tax is made in the accounts, it is an estimate. The final amount will be agreed with the tax authorities at a later date. The basic accounting treatment is very similar to accounting for an expense on an accruals basis. Any difference between the original estimate and the actual amount paid at a later date will be adjusted in the following year.

IAS 12 – Income taxes

Accounting treatment:

Dr: Tax expense (P&L)

Cr: Tax payable (SOFP)

IAS 12 – Income taxes

Tax in the financial statements

	£
Tax charge estimated for the year (To SOFP)	X
Less: overprovision in earlier year	(X)
Add: underprovision in earlier year	X
Tax charge in P&L	(X)

IAS 12 Income taxes

Definitions:

- Underprovision – is an under-estimate of the tax expense in the previous year. This must be added to the current year tax charge.
- Overprovision – is an overestimate of the tax expense in the previous year. This must be deducted from the current year tax charge.

2 Example 1 – Tax

CalcsRus Ltd estimated that the tax due on its profits for the year ended 31 December 2012 was £90,000.

On 1 October 2013, it settled its prior year tax bill for £88,000.

CalcsRus Ltd estimate that the tax due on its profits for the year-ended 31 December 2013 is £110,000.

Task:

What is the accounting treatment of the above for the year-ended 31 December 2013?

Solution:

The 2012 tax bill has been paid. CalcsRus Ltd's liability for the year-ended 31 December 2013 is the current year tax bill only. Therefore the liability on the statement of financial position is £110,000.

The statement of profit or loss and other comprehensive income will include the current year tax expense but also an adjustment for the prior year. CalcsRus estimated that their tax on the 2012 profits would be £90,000 but they only paid £88,000. They therefore over-estimated the prior year expense by £2,000.

The expense in 2013 can be calculated as follows:

	£
Current year tax expense	110,000
Prior year over-estimate	(2,000)
Prior year under-estimate	–
	108,000

Alternatively, this can be presented in a T account:

Tax payable

Cash	88,000	Bfd	90,000
Cfd (c/y estimate)	110,000	Profit or loss (bal. fig)	108,000
	198,000		198,000

The answer to the above example can be found in Chapter 19.

3 Summary

Tax in the statement of financial position:

The liability is always the estimate of the current year's tax bill

Tax in the statement of profit or loss and other comprehensive income:

The expense is calculated as:

Current year estimate – prior year over-estimate + prior year under-estimate

4 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 7 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 7 of the Financial Statements pocket notes.

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q14-15 are simpler questions for students who may be struggling
- Q48-49 are trickier questions to challenge more able students.

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

Tax in the financial statements – (Chapter 7): activity 1

Revision kit (for recapping and revising the chapter)

Questions 19 (part e)

Leases

8

Learning objectives:

At the end of this chapter you will be able to:

- Classify a lease as either a finance lease or an operating lease
- Understand the accounting treatment of finance leases and operating leases

Contents:

1 What is a lease?

IAS 17 – Leases

Contents:

Definitions

Accounting treatment

IAS 17 – Leases – definitions

Lease – a lease is a contract to hire out an asset between the lessor (owner of the asset) and the lessee (who uses the asset).

In effect, a lease agreement is a form of rental agreement.

IAS 17 – Leases – definitions

Finance lease – a lease that transfers substantially all of the risks and rewards of ownership of the asset to the lessee.

Operating lease – any lease that does not meet the definition of a finance lease is regarded as an operating lease.

IAS 17 – Leases – definitions

Lessee – the lessee is the company or business that uses the leased asset in its business

Lessor – the lessor is the owner of the asset who allows the lessee to use the asset for an agreed period of time in exchange for payment

IAS 17 – Leases

Indicators of a finance lease:

- Transfer of legal ownership at end of lease term
- The lessee has the option to purchase the asset at the end of the lease term at less than fair value
- The lease term is for substantially most of the economic useful life of the asset
- At the start of the lease, the present value of the minimum lease payments amounts to substantially all of the fair value of the asset
- The lessee will compensate the lessor if the lease is cancelled

2 Accounting treatment – operating leases

If a lessee enters into an operating lease, it does not recognise an asset. Instead, the lessee simply recognises an annual leasing expense in the statement of profit or loss.

IAS 17 – Leases

Operating leases:

Annual lease rental charge is calculated as:

- Total lease payments / Total lease term
- Dr: Operating lease expense (to P&L)
- Cr: Bank

3 Accounting treatment – finance leases

The lessee controls the asset and, in accordance with the Framework, the substance of the transaction should be recorded in the financial statements.

IAS 17 – Leases

Finance leases:

Recognise or record a finance lease asset and finance lease liability:

- Dr: Finance lease asset (NCA in SOFP)
- Cr: Finance lease liability (in SOFP)

IAS 17 – Leases

Finance leases:

Depreciate the asset over the shorter of either the lease term or the useful economic life of the asset:

- Dr: Depreciation expense (P&L)
- Cr: Accumulated depreciation (SOFP)

IAS 17 – Leases

Finance leases:

The liability or obligation is a form of loan finance – a finance cost is incurred:

- Dr: Finance costs (P&L)
- Cr: Finance lease liability (SOFP)

IAS 17 – Leases

Finance leases:

Lease (or loan) repayments are made to reduce the total liability:

- Dr: Finance lease liability (SOFP)
- Cr: Bank (SOFP)

4 Illustration 1

Two companies entered into lease agreements on 1 January 2013.

(i) Borrow Ltd has signed an agreement to lease a photocopier for 2 years. This will cost £10,000 per annum as well as an upfront, non-refundable deposit of £5,000. The photocopier has an estimated total useful life of 10 years. Borrow Ltd is not responsible for insuring and maintaining the photocopier.

(ii) Buy Ltd has signed an agreement to lease a machine for four years. This will cost £2,000 per annum, with payments being made at the end of each year. The asset, which has an expected useful life of four years, could have been bought outright for £5,800 and the present value of the minimum lease payments is £5,710. The interest rate implicit in the lease is 15%.

Required:

What is the accounting treatment of the above for each company for the year ended 31 December 2013?

Solution:

(i) The risks and rewards of ownership have not passed to Borrow Ltd:

- Borrow Ltd will not be using the asset for most of its life (the lease term is 2 years while the asset has a useful life of 10 years).
- Borrow Ltd is not responsible for fixing the asset if it breaks down.

This lease is therefore an operating lease:

- The photocopier is not recognised as an asset.
- The total cost of the lease is spread straight line over the lease term in the statement of profit or loss.

Total payments	= £5,000 deposit + (2 × £10,000)
	= £25,000
Spread over 2 years	= £12,500 per year.

An expense of £12,500 will therefore be recognised in the year ending 31 December 2013.

£15,000 has been paid this year, so a prepayment of £2,500 will be presented on the statement of financial position.

Financial statement extracts

	£
Extract from statement of profit or loss	
Operating lease rentals	12,500
Extract from statement of financial position	
Prepayment	2,500

(ii) The risks and rewards of ownership have passed to Buy Ltd:

- Buy Ltd will be using the asset throughout its useful life (the lease term is 4 years, which is the same as the asset's useful life).
- The present value of the minimum lease payments (£5,710) is almost the same as the asset's fair value (£5,800).

This lease is therefore a finance lease.

Recognise the asset

The machine will be recognised as an asset in the statement of financial position at £5,710 (the lower of the present value of the minimum lease payments and the fair value). A corresponding finance lease liability will be recognised at £5,710.

Depreciate the asset

The asset will be depreciated over the lower of the lease term and the useful life of the asset. These are both 4 years.

Therefore, depreciation will be £1,428 (£5,710/4 years).

Record interest on the liability

Interest will be charged on the liability at 15%:

£5,710 × 15% = £857

Record the cash payments

Buy Ltd pays £2,000 to the lessor and this will reduce the liability.

Extracts from statement of profit or loss	£
Depreciation	1,428
Finance costs	857
Extract from statement of financial position	
Non-current assets (£5,710 – 1,428)	4,282
Total finance lease liability	4,567
(£5,710 + £857 interest – £2,000 payment)	
Liability due after more than one year	
(£4,567 + £456 interest – £2,000 payment)	3,023
Liability due within one year	1,544

5 Summary

Finance lease

A lease where the risks and rewards of ownership transfer from the lessor to the lessee.

Accounting for a finance lease

Recognise the leased asset and a finance lease liability on the statement of financial position.

Operating lease

A lease which is not a finance lease.

Accounting for an operating lease

The total lease payments are expensed to the statement of profit or loss over the lease term.

6 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 8 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 7 of the Financial Statements pocket notes.

Real assessment question practice

Revision kit:

- Question 16 (Poppy plc)
- Question 35 (Ash plc)

Additional, more challenging questions

The following question can be found at the rear of Chapter 8 of the Financial Statements text book.

- Workbook Activity 3

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q16-17 are simpler questions for students who may be struggling
- Q50-51 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

- Finance lease – (Chapter 8): activity 1
- Operating lease – (Chapter 8): activity 2

Revision kit (for recapping and revising the chapter)

Questions 36 and 37

Provisions and events after the reporting period

9

Learning objectives:

At the end of this chapter you will be able to:

- Explain what is meant by a provision, contingent liability and contingent asset
- Identify the correct accounting treatment for provisions and contingencies
- Prepare the accounting entries to recognise and adjust for provisions
- Distinguish between adjusting and non-adjusting events

Contents:

1 What is a provision?

IAS 37 – Provisions, contingent liabilities and contingent assets

Contents:

Definitions

Accounting treatment

IAS 37 –Provisions, contingent liabilities and contingent assets

Definition – a provision is a form of liability

Liability – an obligation that arises from a past transaction or event that will lead to an outflow of economic resources

Provision – a liability where there is uncertainty regarding either the exact amount and/or the timing of any payment

Provisions involve uncertainty and therefore need to be estimated. IAS 37 says that they should be measured at a **best estimate.** This might be based on past experience or on expert advice.

2 Recognising a provision

IAS 37 – Provisions, contingent liabilities and contingent assets:

A provision should be recognised in the financial statements only if:

- there is an obligation (legal or constructive) , and
- it is probable that there will be an outflow of economic benefits, and
- the outflow of economic benefits can be reliably measured.

Note: A provision cannot be made for future operating losses – they are avoidable.

3 Illustration 1

During the year ended 31 December 20X3, a company made an employee redundant. The employee started legal proceedings against the company for wrongful dismissal as they believed that the redundancy selection process was unfair.

Legal advisers believe that the company will lose the case and, based on similar legal cases the past, will have to pay £300,000 in compensation to lease agreements on 1 January 2013.

Task:

Determine whether or not a provision needs to be recognised in the financial statements or the year ended 31 December 20X3.

Solution:

- Is there an obliging event at the year end?

  Yes – the employee has been made redundant

- Is it probable that there will be an outflow of economic benefits as a result?

  Yes – the company will probably lose the case as it has not complied with relevant law or regulation when selecting employees for redundancy.

- Can the probable outflow of economic benefits be reliably measured?

  Yes – legal advisors have estimated that a payment of approximately £300,000 may be required if the case is lost.

Conclusion: A provision should be recognised in the financial statements for the year ended 31 December 20X3 for £300,000.

4 Accounting for a provision

IAS 37 – Provisions, contingent liabilities and contingent assets

Double entry for accounting for a provision:

- Dr: Expense (P&L)
- Cr: Provisions (SOFP)

When the provision is fully or partly settled:

- Dr: Provision (SOFP)
- Cr: Bank (SOFP)

IAS 37 – Provisions, contingent liabilities and contingent assets

At the year-end, re-estimate provision and adjust if required.

Increase the provision:

- Dr: Expense (P&L)
- Cr: Provisions (SOFP)

Decrease the provision:

- Dr: Provision (SOFP)
- Cr: Expense (P&L)

As a provision is an estimate, the original estimate may not match the amount that is actually paid. Any under-provision or over-provision is cleared to P&L when it is established that no obligation remains outstanding.

5 Example 1 – Provisions

Gaga Ltd started business on 1 January 20X2 and has a year end of 31 December.

They sell computer equipment with a one year warranty. If the item breaks within one year of the sale, then Gaga Ltd will fix it at no extra cost to the customer.

At 31 December 20X2, Gaga Ltd estimates that they will have to spend £500,000 fixing items which are still under warranty.

During the year ended 31 December 20X3, Gaga Ltd spends £450,000 on repairing products returned under warranty.

At 31 December 20X3, Gaga Ltd estimates they will have to spend £600,000 fixing items which have been sold and are still covered by a warranty.

Task:

What is the accounting treatment of the above for the year-ended 31 December 20X3?

Solution:

Gaga Ltd should recognise a provision for the cost of repairing goods sold under warranty because:

- There is an obligation
  - The sale of goods under warranty has occurred
- An outflow of resources is probable
  - It is likely that some products will break and therefore that Gaga Ltd will spend money on repairing these
- The outflow can be measured reliably
  - Gaga Ltd will be able to estimate the cost of repairs through its knowledge of the percentage of products that typically develop faults and the actual cost of fixing these

There would have been a provision on 31 December 20X2 for £500,000. Some of this has been utilised in 20X3, because Gaga Ltd has repaired computers and therefore fulfilled its obligation. The entry for this is:

Dr	Provisions	£450,000
Cr	Cash	£450,000

The provision has therefore been reduced to £50,000 (£500,000 – £50,000).

At 31 December 20X3, Gaga Ltd estimates that it needs a provision of £600,000. Therefore the provision needs to be increased by £550,000 (£600,000 – £50,000):

Dr	Profit or loss	£550,000
Cr	Provisions	£550,000

This can be summarised in a T account as follows:

Provisions

Cash	450,000	Bfd	500,000
Cfd	600,000	Profit or loss	550,000
	————		————
	1,050,000		1,050,000
	————		————

Therefore, there will be a provision in the statement of financial position for £600,000 and a charge to the statement of profit or loss for £550,000.

The answer to the above example can be found in Chapter 19.

6 Provisions – summary of accounting treatment

IAS 37 – Provisions, contingent liabilities and contingent assets

Summary of accounting requirements

Probability of Inflow / outflow	**Liabilities**	**Assets**
Virtually certain	Provide	Recognise
Probable	Provide	Disclose
Possible	Disclose	Ignore
Remote	Ignore	Ignore

7 Contingent liabilities and contingent assets

IAS 37 – Provisions, contingent liabilities and contingent assets

Definition – contingent liability

- This is a possible obligation, the outcome of which will only be determined by one or more future events outside of the control of the entity.
- An obligation which cannot be measured reliably will also be treated as a contingent liability.

IAS 37 – Provisions, contingent liabilities and contingent assets

Definition – contingent asset

- This is a possible asset, the outcome of which will only be determined by one or more future events outside the control of the company.

This can be related to the earlier illustration of the employee bringing legal proceedings for wrongful dismissal.

It may be that the legal advisors cannot reliably predict the outcome of the case and/or the amount of compensation that would be payable if the company lost the case. It cannot therefore be regarded as a probable obligation – only a possible obligation. This could happen, for example, if the case is based upon new law which has not yet been tested in courts and there are no previous cases to refer to for guidance.

In this situation, it would be regarded as a contingent liability and would be disclosed only in the financial statements.

8 What are events after the reporting period?

IAS 10 –Events after the reporting period

Definition:

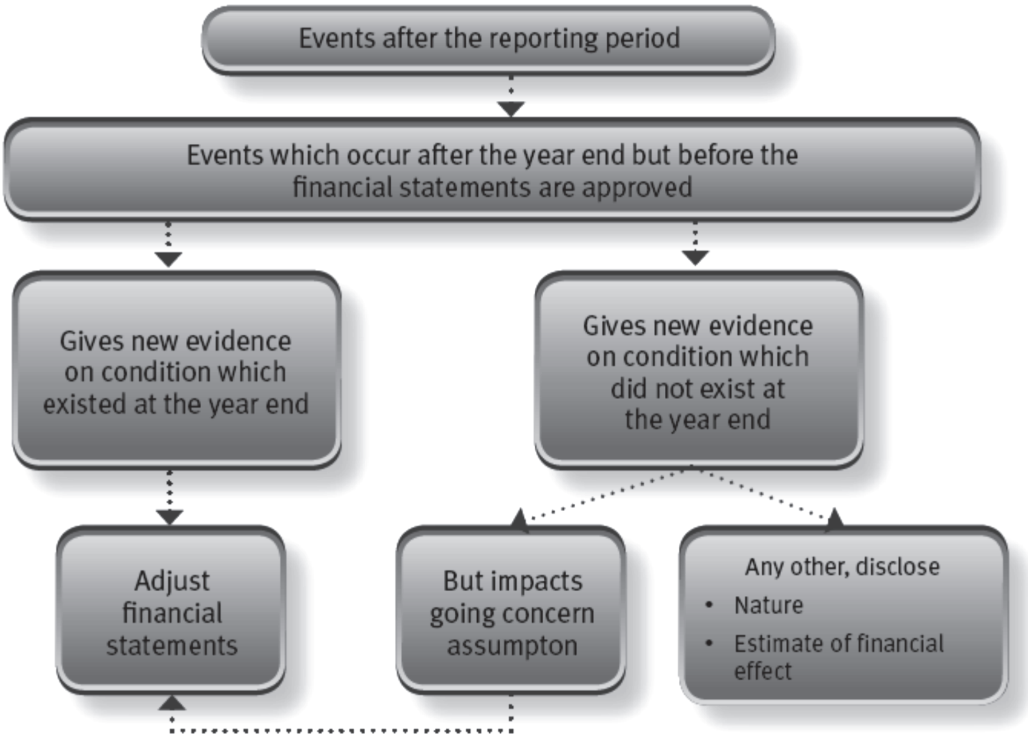
Those events, both favourable and unfavourable, which occur between the statement of financial position date and the date on which the financial statements are authorised for issue.

IAS 10 –Events after the reporting period

Definitions:

Adjusting events – provide further evidence of conditions existing at the reporting date. The financial statements must be adjusted to reflect these events.

Non-adjusting events – provide no additional evidence about the conditions that existed at the reporting date. If material, these events are merely disclosed by a note in the financial statements.



IAS 10 – Events after the reporting period

Examples of adjusting events:

- Settlement post year-end of court case
- Bankruptcy post year-end of a credit customer
- Sale of inventory post year-end at less than cost
- Discovery of fraud/error that confirm the financial statements were incorrect

IAS 10 – Events after the reporting period

Examples of non-adjusting events:

- Mergers and acquisitions
- Reconstructions
- The issue of shares or debentures
- Purchase or sale of non-current assets or investments
- Loss of assets as a result of a catastrophe after the year end
- Dividends proposed after the reporting date

9 Summary

Provisions

Recognise at best estimate if:

- An obligation exists
- Payment is probable
- It can be measured reliably

Recognising a provision

Dr	Profit or loss	x
Cr	Provisions	x

The level of provision is then reviewed at the year end

Contingent liabilities and assets

- Possible liabilities and assets
- Existence is confirmed by a future event

Events after the reporting period

- Adjusting events
- Non-adjusting events

10 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 9 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 7 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 17 (Toddy plc)
- Question 31 (Events)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 9 of the Financial Statements text book.

- Workbook Activities 4 and 5

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q18-19 are simpler questions for students who may be struggling
- Q52-53 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

- Events after the reporting period – (Chapter 9): activities 1, and 3
- Provisions (Chapter 9): activities 2 and 3

Revision kit (for recapping and revising the chapter)

Questions 45 and 46

10 Revenue

Learning objectives:

At the end of this chapter you will be able to:

- Understand the definition of revenue
- Understand when to recognise revenue from the sale of a good, the rendering of services and the receipt of a dividend

Contents:

1 What is revenue?

IAS 18 – Revenue

Contents:

Definition

Accounting treatment

IAS 18 – Revenue

Definition:

Revenue is the gross inflow of economic benefits during the period arising from the ordinary activities of the entity

2 Recognising revenue

IAS 18 – Revenue

Revenue recognition criteria for the sale of goods:

- The amount of revenue can be recognised reliably
- The costs incurred or to be incurred can be measured reliably
- Receipt of future economic benefits is probable.
- The seller transfers the risks and rewards of ownership
- The seller does not retain management or control over the goods

IAS 18 – Revenue

Revenue recognition criteria for the rendering of services:

- The amount of revenue can be recognised reliably
- The costs incurred or to be incurred can be measured reliably
- Receipt of future economic benefits is probable.
- The stage of completion can be reliably measured.

IAS 18 – Revenue

Measurement of revenue to include in the financial statements:

- Fair value of consideration received /receivable
- Exclude VAT/ sales tax

3 Example 1 – Revenue

Paperback Ltd is a publisher of books and magazines. They have a number of different products and need to know how to account for revenue for each one for the year ending 31 December 2013.

(i) Paperback Ltd has announced a new title in the Freddy Hopper series. By 31 December 2013, they had taken £300,000 in deposits from customers. The book will be finished and despatched on 1 April 2014.

(ii) Paperback Ltd started publishing a new monthly magazine on 1 July 2013. On this date, they sold annual subscriptions totalling £200,000 covering the 12 months up to 30 June 2014. The monies have been received and are non-refundable.

Required:

What is the accounting treatment of the above for the year-ended 31 December 2013?

Solution:

(i) Revenue from the sale of goods can only be recognised if the risks and rewards of ownership have transferred. The book has yet to be published and therefore there has been no transfer of risks and rewards.

Revenue cannot be recognised. The £300,000 received should be recognised as deferred income on the statement of financial position.

(ii) Revenue should be recognised as each magazine is published. Half of the magazines have been published so half of the revenue (£100,000) can be recognised.

The answer to the above example can be found in Chapter 19.

4 Summary

Revenue

The gross inflow of benefits arising from the ordinary activities of an entity. This may include:

- The sale of goods
- The rendering of services
- The receipt of dividends

Revenue from the sale of a good

- The risks and rewards of ownership must have transferred

Revenue from rendering services

- The stage of completion must be measurable

Revenue should be recognised:

- At fair value
- Net of value-added taxes

5 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 10 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 7 of the Financial Statements pocket notes.

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q20-21 are simpler questions for students who may be struggling
- Q54-55 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

Revenue recognition – (Chapter 10): activities 1 and 2

Revision kit (for recapping and revising the chapter)

Questions 19 (part f)

Company finance

11

Learning objectives:

At the end of this chapter you will be able to:

- Explain the sources of company finance
- Account for the issue of shares and loan notes
- Account for the payment of dividends

Contents:

1 Types of finance

Companies need to raise finance in order to purchase the resources they require to operate. The two main forms of finance are debt and equity:

Types of company finance

Debt – The company receives money and must make mandatory repayments in return – it is a loan to the company. The company must pay interest on this loan.

Equity – The company receives money but does not have to make mandatory repayments. The equity holder is instead entitled to a residual interest in the company's assets when it ceases to trade

2 Debt

Types of company finance

Loan notes – A loan note is a written acknowledgement of a loan to a company by either one other person or perhaps by a large number of individuals

Accounting for raising debt finance

Dr: Cash received

Cr: Loan liability

Accounting for interest payments on the loan

Dr: Interest payable (P&L a/c)

Cr: Cash paid or accruals

3 Equity

Ordinary shares

Voting rights – Ordinary shareholders have the right to attend and vote at the company's Annual General Meeting (AGM)

Dividends – If a company makes a profit or has accumulated retained profits shareholders may receive a dividend from the company. A dividend is not an expense charged in profit or loss.

Retained earnings – They represent accumulated profits less accumulated losses from trading year by year. They are classified as equity on the company SOFP .

Ordinary shares

Nominal value – The monetary units that share capital is divided into for issue by the company to shareholders. It represents the minimum amount that shareholders must pay to the company when the shares are first issued.

Share premium – This is the amount received by the company in excess of nominal value per share when ordinary shares are first issued. It is part of the equity or capital structure of the company.

Accounting for raising equity finance

Dr: Cash received

Cr: Share capital (NV per share)

Cr: Share premium (excess over NV per share received)

Accounting for dividend payments

Dr: Retained earnings

Cr: Cash paid

Dividends are accounted for on a cash basis, not an accruals basis

Preference shares:

- No right to vote at AGM
- No residual interest in the company

Types of preference share:

- **Redeemable preference shares –** These shares entitle the holder to repayment at some later date i.e. they are a liability and should be classified as debt
- **Irredeemable** – These shares do not entitle the holder to repayment of capital and should be classified as equity.

4 Example 1 – Ordinary shares

At 1 January 20X1, a company has 10,000 £1 ordinary shares in issue. To raise further finance, they issue another 2,000 £1 ordinary shares for £3 each.

On 30 June 20X1, they pay a dividend to their ordinary shareholders of 20p per share.

Required:

What are the double entries to account for the share issue and the dividend paid?

Solution:

The company has issued 2,000 new shares for £3 each. It has therefore received an extra £6,000. The double entry required is:

Dr	Cash	£6,000
Cr	Share capital	£2,000 (2,000 shares × £1 nominal value)
Cr	Share premium	£4,000 (2,000 shares × (£3 issue – £1 nominal))

The company now has 12,000 ordinary shares in issue (10,000 + 2,000). A dividend of 20p per share is paid. The total dividend payout is therefore £2,400 (12,000 shares × £0.2). The double entry required is:

Dr	Retained earnings	£2,400
Cr	Cash	£2,400

The answer to the above example can be found in Chapter 19.

5 Summary

Company finance

- Debt
- Equity

Share issue

- Dr Cash
- Cr Share capital
- Cr Share premium

Dividend payments

- Dr Retained earnings
- Cr Cash

6 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 11 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 2 of the Financial Statements pocket notes.

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q22-23 are simpler questions for students who may be struggling
- Q56-57 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

Issue of share capital – (Chapter 11): activity 1

Company financial statements

12

Learning objectives:

At the end of this chapter you will be able to:

- Identify the components needed to produce a complete set of financial statements
- Describe the purpose, including key components, of a statement of financial position, statement of profit or loss and other comprehensive income, and a statement of changes in equity

Contents:

1 Limited company financial statements

IAS 1 requirements for company annual financial statements

- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of changers inequity
- Statement of cash flows
- Notes to the financial statements

2 Statement of financial position

The statement of financial position presents the assets, equity and liabilities of the company as at the end of a reporting period.

Statement of financial position as at 31 December 20X2

	£	£
Non-current assets		
Property, plant and equipment		X
Intangible assets		X
		——
Current assets		X
Inventories	X	
Trade and other receivables	X	
Cash and cash equivalents	X	
	——	
		X
		——
Total assets		**X**
		——
Equity		
Share capital		X
Share premium account		X
Retained earnings		X
Revaluation reserve		X
		——
Total equity		X
		——

Non-current liabilities		
Loans or debentures		X
Current liabilities		
Trade and other payables	X	
Bank overdrafts	X	
Tax payable	X	
		X
Total liabilities		X
Total equity and liabilities		**X**

The statement of financial position is a summary or list of all assets and liabilities of the sole trader at the end of the accounting period.

Non-current assets are those assets that will be used in the business over a number of years: examples include land and buildings and plant and machinery.

Current assets are those assets that are expected to be realised in the business in the normal course of trading (usually a period of less than one year): examples include inventories and prepayments.

Non-current liabilities are those liabilities which will be paid off over a period exceeding one year from the reporting date: an example would be a long-term bank loan.

Current liabilities are the short-term payables of the business which are due to be paid within one year of the reporting date: examples include trade payables and bank overdrafts.

3 Statement of profit or loss and other comprehensive income

The statement of profit or loss and other comprehensive income shows the performance of the company over the period. It includes items of other comprehensive income, such as revaluation gains, which are not recognised in profit or loss.

Statement of profit or loss and other comprehensive income for year ended 31 December 20X2

	£
Revenue	X
Cost of sales	(X)
Gross profit	X
Distribution costs	(X)
Administrative expenses	(X)
Profit from operations	X
Finance costs	(X)
Profit before tax	X
Income tax expense	(X)
Profit for the period	**X**
Other comprehensive income	
Revaluation gain	X
Total comprehensive income for year	X

Statement of profit or loss is a summary of income and expenses for a period, usually one year to calculate the profit or loss made.

The trading account calculates the gross profit or loss that has been made from trading activities – the buying and selling of goods or the provision of services.

The net profit or loss is arrived at by deducting all expenses of the business from the gross profit.

4 Statement of changes in equity

The statement of changes in equity shows the shareholders where the increases and decreases in their funds over the reporting period have come from.

Statement of changes in equity for the year ended 31 December 20X2

	Share capital	*Share premium*	*Revaluation reserve*	*Retained earnings*	*Total*
At 1 January 20X2	X	X	X	X	X
Total comprehensive income			X	X	X
Dividends				(X)	(X)
Share issue	X	X			X
At 31 December 20X2	**X**	**X**	**X**	**X**	**X**

Total comprehensive income is made up of two amounts:

- Profit for the year – this is added to retained earnings
- Other comprehensive income – in the Financial Statements exam, this will be attributable to revaluation gains and should therefore be added to the revaluation reserve.

5 Summary

Limited company financial statements:

- Statement of financial position
- Statement of profit or loss
- Statement of changes in equity
- Statement of cash flows
- Notes

6 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 12 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 2 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 1 (ABC Ltd)
- Question 2 (Willow Ltd)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 12 of the Financial Statements text book.

- Workbook Activities 5 – 7

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q24-25 are simpler questions for students who may be struggling
- Q58-59 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

- Public and private companies – (Chapter 12): activity 1
- Tax in financial statements – (Chapter 12): activity 2
- IAS 1 – (Chapter 12): activity 3
- Accounts preparation (Chapter 12): activity 4

Revision kit (for recapping and revising the chapter)

Questions 4 and 5

13 Statement of cash flows

Learning objectives:

At the end of this chapter you will be able to:

- Describe the key components and purpose of the statement of cash flows as presented in IAS 7
- Identify international financial reporting standards relevant to cash flow reporting in the financial statements
- Accurately draft a statement of cash flows in accordance with IAS 7

Contents:

1 IAS 7 – Statement of cash flows

IAS 7 Statement of Cash Flows

All entities are required to present a statement of cash flows (SCF)

The SCF analyses changes in cash and cash equivalents during a period

Cash and cash equivalents = cash in hand/in the bank and current asset investments less overdrafts repayable on demand.

Presentation

The SCF must be analysed between operating, investing and financing activities.

Operating activities

are the main revenue-generating activities of the entity.

Investing activities

are the acquisitions and disposals of long-term assets and other investments.

Financing activities

are activities that alter the equity and long-term borrowing of the entity.

Interest paid and dividends paid may be classified as either operating or financing cash flows

Interest received and dividends received may be classified as either operating or investing cash flows

Taxes on income are normally classified as operating activities

IAS 7 permitted formats:

- **Direct method:** Shows direct operating cash flows e.g. receipts from customers, payments to suppliers, payments for employment costs etc to arrive at operating cash flow for the year
- **Indirect method:** Shows movements in working capital etc to arrive at operating cash flow for the year

Guidance notes

For the purpose of this unit learners will only be required to report cash flows from operating activities using the indirect method, although you do need to be aware that there are two possible methods of presentation.

2 The reconciliation of profit to net cash flow from operating activities (indirect method)

Cash flow from operating activities (indirect method):	
	£
Profit from operations	X
Adjustments for:	
Depreciation	X
(Gain)/loss on disposal of PPE	(X)/X
	X
(Increase)/decrease in inventories	(X)/X
(Increase)/decrease in trade and other receivables	(X)/X
Increase/(decrease) in trade payables	X/(X)
Cash generated by operations	X
Tax paid	(X)
Interest paid	(X)
Net cash from operating activities	**X**

Guidance notes

For the purposes of this unit:

- In the assessment the reconciliation of profit or loss to the net cash from operating activities will always begin with profit from operations.
- Interest paid is to be classified as an operating activity.

3 The statement of cash flows

Statement of cash flows for the year ended XX/XX/XXXX		
	£	£
Net cash flow from operating activities		X/(X)
Cash flows from investing activities		
Purchases of PPE	(X)	
Proceeds from sale of PPE	X	
Interest received	X	
Dividends received	X	
Net cash flow from investing activities		X/(X)
Cash flows from financing activities		
Proceeds from issue of shares	X	
Proceeds from long term borrowing	X	
Dividends paid	(X)	
Net cash flow from financing activities		X/(X)
Net increase/(decrease) in cash and cash equivalents		X/(X)
Cash and cash equivalents at beginning of year		X
Cash and cash equivalents at end of year		X

Guidance notes

For the purposes of this unit:

- Interest and dividends received are to be classified as investing activities
- Dividends paid are to be classified as a financing activity

4 Example 1 – Cash flow

You have been asked to assist in the preparation of financial statements for Batty Ltd for the year ended 30 September 20X9.

The draft statement of profit or loss and statement of financial position of Batty Ltd are set out below.

Statement of profit or loss for the year ended 30 September 20X9

	£000
Revenue	60,000
Cost of sales	(31,100)
Gross profit	28,900
Distribution costs	(1,000)
Administrative expenses	(1,900)
Profit from operations	26,000
Finance costs	(500)
Profit before taxation	25,500
Tax	(1,000)
Profit for the financial year	24,500

Statement of financial position as at 30 September

	20X9		*20X8*	
	£000	£000	£000	£000
ASSETS				
Non-current assets				
Property, plant and equipment		164,000		125,500
Investment		5,000		–
Current assets				
Inventories	40,000		38,000	
Trade receivables	27,000		26,500	
Cash and cash equivalents	3,500		4,700	
		70,500		69,200
Total assets		**239,500**		**194,700**

EQUITY AND LIABILITIES				
Called up share capital		100,000		90,000
Share premium		40,000		30,000
Retained earnings		63,000		40,000
		203,000		160,000
Non-current liabilities				
Loan		13,500		12,000
Current liabilities				
Trade payables	22,000		21,900	
Taxation	1,000		800	
		23,000		22,700
Total equity and liabilities		**239,500**		**194,700**

Notes:

You have been given the following further information:

- A non-current asset that originally cost £100,000,000 with accumulated depreciation of £50,500,000 was sold in the year for a profit of £100,000
- The total depreciation charge for the year was £17,000,000
- All sales and purchases were on credit. Other expenses were paid for in cash
- Dividends of £1,500,000 were declared and paid during the year

Required:

Produce a reconciliation of profit from operations to net cash flow from operating activities and a statement of cash flows for Batty Ltd for the year ended 30 September 20X9.

Solution:

Reconciliation of profit from operations to net cash flow from operating activities for Batty

The purpose of this process is to remove the non-cash incomes and expenses recorded in the income statement from the profit for the year. Once these have been removed the remaining figures should reflect the cash flow of the organisation.

	£000	Study notes
Profit from operations	26,000	Taken directly from the P/L
Adjustments for non-cash items:		
Depreciation charge	17,000	This is a non-cash expense adjustment that needs to be reversed. This is taken directly from the notes.
Profit on disposal of PPE	(100)	This is a non-cash income that needs to be reversed. This is taken directly from the notes.
	42,900	
Increase in inventories	(2,000)	These adjustments reflect the fact that the sales and purchases are performed on a credit basis and do not reflect cash flows. The figures are calculated as the difference between this year's and last year's balances on the SOFP.
Increase in receivables	(500)	
Increase in payables	100	
Cash from operation	40,500	
Interest paid	(500)	There are no unpaid interest liabilities on the SOFP so the full P/L finance charge must have been paid.
Tax paid	(800)	See working 1
Net cash flow from operating activities	**39,200**	

Working 1:

The total tax charge for the year is £1,000,000, taken from the income statement. This is the amount of tax the business should have paid based on their reported profits. It is, however, unlikely that this is the amount actually paid because businesses rarely pay their exact tax liability in the year it relates to. They often pay the tax liability in the following financial year. In order to work out the tax actually paid you need to use the following 'fill in the blanks' method:

Step 1: Draw up a proforma tax liability T account

Tax liability

	£000		£000
		Balance b/d	
Cash paid		Tax charge in the IS	
Balance c/d			
	_____		_____
Total		Total	
	_____		_____

Step 2: Fill in the balances b/d and c/d as they appear on last year's and this year's statement of financial position, respectively

Step 3: Fill in the tax charge that appears in this year's income statement

Step 4: Balance off the T account

Step 5: Calculate the missing cash paid figure that balances the debit side of the T account

Tax liability

	£000		£000
		Balance b/d **(2)**	800
Cash (balancing figure) **(5)**	800	Tax charge in the IS **(3)**	1,000
Balance c/d **(2)**	1,000		
	_____		_____
Total **(4)**	1,800	Total **(4)**	1,800
	_____		_____

Note: Exactly the same method can be used to calculate interest paid when there is an interest liability on the statement of financial position.

Statement of cash flows for Batty Ltd for the year ending 30 September 20X9

	£000	Study notes
Net cash flow from operating activities	**39,200**	
	_______	
Cash flow from investing activities		
Purchases of PPE	(105,000)	See working 2
Proceeds from sale of PPE	49,600	See working 3
Purchases of investments	(5,000)	A
	_______	
Net cash flow from investing activities	**(60,400)**	
	_______	

	£000	Study notes
Cash flow from financing activities		
Loan	1,500	A
Share issue	20,000	A
Dividends paid	(1,500)	Given in the notes
Net cash from financing activities	**20,000**	
Decrease in cash and cash equivalents	(1,200)	Cash from OA + IA + FA
Cash/cash equivalents at beginning of year	4,700	B
Cash/cash equivalents at the end of year	3,500	B

A: these figures are all calculated as the differences between the amounts on this year's and last year's statement of financial position.

Don't forget that share issues affect both share capital and share premium.

B: these figures are calculated as the total cash and cash equivalents on this year's and last year's statements of financial position.

Do not forget that cash and cash equivalents include: cash at bank and in hand, current asset investments and overdrafts.

Working 2:

This question requires us to identify the cash spent on purchases of new PPE during the year. Once again we can use a 'fill in the blanks' approach that reconciles the opening and closing PPE figures to reveal the one missing piece of information.

Note that the missing piece of information may not be purchases of PPE every time, it may, for example, be that the depreciation charge is missing. This technique will always work as long as there is only one piece of missing information and all other figures can be identified from the information given.

Step 1: Draw up a proforma PPE T account

CV of PPE

	£000		£000
Balance b/d		Depreciation charge	
Purchases		CV of disposals	
Revaluation		Balance c/d	
Total		Total	

Step 2: Fill in the balances b/d and c/d as they appear on last year's and this year's statement of financial position, respectively

Step 3: Fill in the depreciation charge given in the notes

Step 4: Fill in the carrying value of disposals, figures for which are given in the notes

Step 5: Calculate the value of revaluations in the year (this is the difference between the revaluation reserve on this year's and last year's statement of financial position)

Step 6: Balance off the T accounts

Step 7: Calculate the missing purchases figure required to balance the debit side.

CV of PPE

	£000		£000
Balance b/d **(2)**	125,500	Depreciation charge **(3)**	17,000
Purchase **(7)** (balancing figure)	105,000	CV of disposal **(4)** (100,000 – 50,500)	49,500
Revaluation **(5)**	0	Balance c/d **(2)**	164,000
Total **(6)**	230,500	Total **(6)**	230,500

Working 3:

To calculate anything relating to the disposal of assets use the following working:

	£000
Proceeds	
Carrying value of assets sold	
Profit/(loss) on disposal	

Once more you can fill in the information you have to identify the one missing figure, which in this case is the proceeds from disposal.

	£000	
Proceeds (balancing figure)	49,600	
Carrying value of assets sold	(49,500)	Cost less accumulated depreciation: given in notes to question and used in W2
Profit/(loss) on disposal	100	Given in notes to question

5 Summary

IAS 7 Statement of Cash Flows

IAS 7 requires the analysis of changes in cash and cash equivalents during a period under three headings:

- Operating activities.
- Investing activities.
- Financing activities.

Reconciliation of profit to net cash flow from operating activities

This amends the profit from operations, as reported in the income statement, taking into account all forms of non-cash income and expense.

The adjusted figure represents the cash flow from core trading activities during the year.

The statement of cash flows

This summarises the cash flows from the three core areas. It reconciles the movement in cash and cash equivalents as reported on the current and prior year's statements of financial position.

Most of the figures represent the movement between the current and previous year's financial statements. For example; share issues and movements in loans.

Watch out for the trickier areas, such as tax paid and purchases of PPE.

6 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 13 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 3 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 5 (Magnolia Ltd)
- Question 6 (Thorngumbald Ltd)
- Question 24 (Cash flow)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 13 of the Financial Statements text book.

- Workbook Activities 4 – 6

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q26-27 are simpler questions for students who may be struggling
- Q60-61 are trickier questions to challenge more able students.

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

- Financing activities – (Chapter 13): activity 1
- Operating activities – (Chapter 13): activity 2
- Statement of cash flows (Chapter 13): activity 3

Revision kit (for recapping and revising the chapter)

Questions 7, 8, 25 and 26

Interpreting financial statements

14

Learning objectives:

At the end of this chapter you will be able to:

- Explain the importance of ratio analysis
- Identify the correct formula for a ratio
- Calculate ratios when provided with relevant data
- Analyse and interpret ratios

Contents:

1 Interpretation

Accounting ratios are a means of presenting information in a form which facilitates comparisons.

For example, you have a choice to make: should you invest your life savings in Company A or company B? This requires a comparison of the two companies. Simply comparing their profits is of limited use.

Interpretation – Types of ratios

- **Profitability ratios** measure how profitable a business is
- **Liquidity ratios** assess whether a business can meet its short-term obligations
- **Efficiency ratios** measure how well a business uses its assets and liabilities
- **Financial position ratios** assess the capital structure of the business. Capital structure refers to the extent that a business is funded by equity and/or debt.

2 Profitability ratios

Types of ratios – Profitability ratios

- **Return on capital employed**

$$\frac{\text{Operating profit}}{\text{Total equity + Non-current liabilities}} \times 100\%$$

- **Return on shareholders' funds**

$$\frac{\text{Profit after tax}}{\text{Total equity}} \times 100\%$$

Types of ratios – Profitability ratios

- **Gross profit percentage**

$$\frac{\text{Profit after tax}}{\text{Total equity}} \times 100\%$$

- **Expense/revenue percentage**

$$\frac{\text{Specified expense}}{\text{Revenue}} \times 100\%$$

Types of ratios – Profitability ratios

- **Operating profit percentage**

$$\frac{\text{Profit from operations}}{\text{Revenue}} \times 100\%$$

3 Liquidity ratios

Types of ratios – Liquidity ratios

- **Current ratio**

Current ratio: $\frac{\text{Current assets}}{\text{Current liabilities}}$

- **Quick ratio or 'acid test' ratio**

- $\frac{\text{Current assets – inventories}}{\text{Current liabilities}}$

4 Efficiency ratios

Types of ratios – Efficiency ratios

- **Inventory turnover**

$$\frac{\text{Cost of sales}}{\text{Inventories}} = \text{X times}$$

- **Inventory turnover (days)**

$$\frac{\text{Inventories}}{\text{Cost of sales}} \times 365 \text{ days}$$

Types of ratios – Efficiency ratios

- **Receivables collection period**

$$\frac{\text{Trade receivables}}{\text{Revenue}} \times 365 \text{ days}$$

- **Payables payment period**

$$\frac{\text{Trade payables}}{\text{Cost of sales}} \times 365 \text{ days}$$

Working capital cycle (days)

Inventory days + receivables days – payables days

Types of ratios – Efficiency ratios

- **Asset turnover (net assets)**

$$\frac{\text{Revenue}}{\text{Total assets – current liabilities}} = \text{X times}$$

- **Asset turnover (non-current assets)**

$$\frac{\text{Revenue}}{\text{Non-current assets}} = \text{X times}$$

5 Financial position ratios

Types of ratios – Financial position ratios

- **Interest cover**

$$\frac{\text{Profit from operations}}{\text{Finance costs}} = \text{X times}$$

- **Gearing**

$$\frac{\text{Non-current liabilities}}{\text{Equity + Non-current liabilities}} \times 100\%$$

6 Interpretation of ratios – points to consider

Interpretation – points to consider

- You need two ratios to compare
- One company compared over two time periods
- Budget or forecast results compared with actual results
- Financial performance and position of two companies

Interpretation – points to consider

- Has financial performance or position has improved or deteriorated? (e.g. from the earlier year to the later year, or which company has the better ratio)
- Try to consider why a specific ratio has improved or deteriorated
- Perhaps use the ratio formula to give you guidance – think about the top part (numerator) and bottom part (denominator) of the ratio separately – why may each figure have increased or decreased?
- Does the task data give any clues? (e.g. does it tell you what has happened to the company or what it is doing? This may help to explain the ratios

7 Example 1 – Ratio and interpretation

Cherry Ltd makes and sells sandwiches to convenience stores. The statements of financial position as at 31 December 20X3 and 31 December 20X2 are presented below:

	20X3	*20X2*
	£	£
Assets		
Non-current assets		
Property, plant and equipment	382,000	279,000
Current assets		
Inventories	135,000	60,000
Trade and other receivables	140,000	109,000
Cash and cash equivalents	2,000	75,000
Total assets	659,000	523,000
Equity and liabilities		
Equity		
Share capital	100,000	100,000
Retained earnings	159,000	213,000
Non-current liabilities		
Loans	200,000	60,000
Current liabilities		
Trade and other payables	200,000	150,000
Total equity and liabilities	659,000	523,000

Required:

For both 20X3 and 20X2, calculate:

- **Gearing**
- **The current ratio**
- **The quick ratio**

Comment on whether these ratios have improved or deteriorated year on year, giving possible reasons.

Solution:

Gearing

20X3 $\frac{200{,}000}{100{,}000+159{,}000+200{,}000} \times 100\% = 43.6\%$

20X2 $\frac{60{,}000}{100{,}000+213{,}000+60{,}000} \times 100\% = 16.1\%$

Gearing has deteriorated year on year.

More of Cherry Ltd's funding now comes from loans. This makes it a riskier company because regular interest payments must be made.

This increased risk may hinder Cherry Ltd's ability to obtain funding in the future.

Current ratio

20X3 $\frac{135{,}000+140{,}000+2{,}000}{200{,}000} = 1.4:1$

20X2 $\frac{60{,}000+109{,}000+75{,}000}{150{,}000} = 1.6:1$

The current ratio has deteriorated year on year.

Cherry Ltd has more short-term debts in 20X3 compared to 20X2.

There is a chance that Cherry Ltd's inventory and receivables may not be converted into cash quickly enough to pay off the debts as they fall due.

Quick ratio

20X3 $\frac{140{,}000+2{,}000}{200{,}000} = 0.7:1$

20X2 $\frac{109{,}000+75{,}000}{150{,}000} = 1.2:1$

The quick ratio has deteriorated year on year.

This is largely due to lower levels of cash. It may be that the company has over-spent on inventory. This is a problem in the food industry because fresh produce may perish.

The ratio has also worsened due to higher levels of payables. It may be that Cherry Ltd is delaying payments because of a lack of cash.

As it stands, the company does not have enough liquid assets (assets readily convertible into cash) to meet its short term debts.

The answer to the above example can be found in Chapter 19.

8 Summary

Profitability ratios

- Return on capital employed
- Return on shareholders' funds
- Gross profit percentage
- Expense/revenue percentage
- Operating profit percentage

Liquidity

- Current ratio
- Quick ratio

Efficiency

- Inventory turnover
- Inventory holding period
- Receivables collection period
- Payables payment period
- Working capital cycle
- Asset turnover

Financial position

- Interest cover
- Gearing

9 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 14 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 8 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 60 (Parek Ltd) (formula)
- Question 61 (Regency Ltd) (formula)
- Question 66 (Chilled Ltd) (written)
- Question 67 (Westella Ltd) (written)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 14 of the Financial Statements text book.

- Workbook Activities 3 – 8

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q28-29 are simpler questions for students who may be struggling
- Q62-63 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

- Ratio formula – (Chapter 14): activities 1 and 2
- Explanation of ratios: (Chapter 14): activities 1 and 2

Revision kit (for recapping and revising the chapter)

Questions 62 (formula), 63 (formula), 68 (written), 69 (written)

15 Consolidated statement of financial position

Learning objectives:

At the end of this chapter you will be able to:

- Describe the key components of a consolidated statement of financial position
- Explain the basic consolidation process for a parent and subsidiary in relation to the preparation of a consolidated statement of financial position
- Draft a consolidated statement of financial position

Contents:

1 The basics of consolidation

IFRS 10 definitions

Parent – A parent entity is one that controls one or more other entities

Subsidiary – A subsidiary is an entity that is controlled by another entity

IFRS 10 – Elements required demonstrate the exercise of control

- Power over the investee (subsidiary)
- Exposure or rights to receive variable returns (i.e. equity dividends)
- The ability to use power to influence variable returns

Normally demonstrated by owning more than 50% of the equity share capital of the subsidiary

IFRS 10 requirements

If one entity controls another:

- Prepare consolidated or group accounts for the combined entities from the perspective of parent entity
- Reflects application of 'substance over form' principle

The basic consolidation process for the statement of financial position is as follows:

1. The assets and liabilities of the parent and the subsidiary are added together in full on a line-by-line basis.
2. The investment shown in the parent's financial statements is cancelled against the subsidiary's equity balances (share capital, share premium, retained earnings) at the date of acquisition.
3. A **goodwill** asset is calculated and included within non-current assets.
4. The net assets of the subsidiary attributable to **non-controlling interests** are calculated and shown within equity.
5. The group share of the subsidiary's post acquisition profits is calculated and added to **group retained earnings** within equity.

2 Goodwill

IFRS 3 – Definition

Goodwill – represents the difference between the price paid for the subsidiary less the fair value of the net assets acquired.

- An intangible non-current asset
- Subject to annual impairment review

Goodwill at acquisition

	£
Purchase consideration	X
Share capital acquired (Note 1)	(X)
Retained earnings acquired (Note 2)	X
Other reserves acquired (Note 3)	X
Revaluation adjusts attributable to the Parent (Note 4)	X
Goodwill at acquisition	(X)

Goodwill in Group SOFP

	£
Goodwill at acquisition	X
Impairment w/off to group retained earnings	(X)
Goodwill in Group SOFP	(X)

Notes:

(1) Parent's percentage ownership (P%) × subsidiary's (S's) share capital at the date of acquisition

(2) P% × S's retained earnings at the date of acquisition

(3) P% × S's other reserves (e.g. revaluation) at the date of acquisition

(4) P% × the difference between the fair value and book value of S's net assets at the acquisition date.

3 Non-controlling interest

IFRS 3 – Definition

Non-controlling interest – represents the equity interest in a subsidiary not attributable to the controlling interest (i.e. parent)

The mechanics of consolidation require that 100% of the subsidiary's assets and liabilities are added to the parent's. This is performed regardless of the parent's actual shareholding.

An amount is then calculated and disclosed within equity showing the non-controlling interest's holding in the subsidiary company.

Non-controlling interest

	£
Share capital attributable to NCI (Note 1)	X
Retained earnings attributable to NCI (Note 2)	(X)
Revaluation attributable to NCI (Note 3)	X
Revaluation adjustments attributable to NCI (Note 4)	X
NCI in Group SOFP	(X)

Notes:

(1) NCI percentage ownership (NCI%) × subsidiary's (S's) share capital at the period-end

(2) NCI% × S's retained earnings at the period-end

(3) NCI% × S's other reserves (e.g. revaluation) at the period-end

(4) NCI% × the difference between the fair value and book value of S's net assets at the acquisition date.

4 Retained earnings

As part of the consolidation process, the investment in the subsidiary which is held within the parent's financial statements is cancelled against the subsidiary's acquisition equity. Therefore, only the subsidiary's **post-acquisition reserves** are consolidated.

Retained earnings shows the profits attributable to the shareholders of the group. Therefore, it should only include the parent's share of the subsidiary's post-acquisition retained earnings.

Retained earnings

	£
100% of Parent's retained earnings	X
Parent's share of sub post acquisition retained earnings (Note 1)	(X)
Impairment of goodwill (as per goodwill working)	X
Retained earnings in Group SOFP	(X)

Note:

(1) P% × (S's retained earnings at the period-end – S's retained earnings at the date of acquisition).

5 Example 1 – Simple consolidated financial statements

Polar Ltd bought 75% of the ordinary share capital of Squirrel for a consideration of £150,000 on 1 January 20X9, when the retained earnings of Squirrel were £40,000.

The book value of Squirrel Ltd's net assets approximates their fair value with the exception of some land. The fair value of this land exceeded its carrying value by £20,000.

At 31 December 20X9, goodwill has been impaired by £10,000.

The draft statements of financial position of Polar and Squirrel on 31 December 20X9 were as follows:

	Polar Ltd	*Squirrel Ltd*
	£000	£000
Non-current assets		
Property, plant and equipment	50	110
Investment in Squirrel at cost	150	–
	200	110
Current assets		
Inventories	25	25
Trade receivables	15	20
Cash	10	5
Total assets	250	160
Equity and reserves		
Share capital	80	100
Share premium	20	–
Retained earnings	120	50
	220	150
Current liabilities		
Trade payables	20	5
Other payables	10	5
	30	10
Total equity and liabilities	250	160

Required:

Prepare a consolidated statement of financial position as at 31 December 20X9.

Solution:

Polar Group consolidated statement of financial position as at 31 December 20X9

	£000
Non-current assets	
Goodwill (W1)	20
Property, plant and equipment (50 + 110 + 20)	180
	200
Current assets	
Inventory (25 + 25)	50
Trade receivables (15 + 20)	35
Cash (10 + 5)	15
Total assets	300
Equity	
Share capital (P only)	80
Share premium (P only)	20
Retained earnings (W3)	117.5
	217.5
Non-controlling interests (W2)	42.5
Current liabilities	
Trade payables (20 + 5)	25
Other payables (10 + 5)	15
Total equity and liabilities	300

Workings:

(W1) **Goodwill**

	£000
Purchase consideration	150
Share capital acquired (75% × 100)	(75)
Retained earnings acquired (75% × 40)	(30)
P% of revaluation adjustment (75% × 20)	(15)
Goodwill at acquisition	30
Impairment	(10)
	20

(W2) **Non-controlling Interests**

	£000
Share capital attributable to NCI (25% × 100)	25
Retained earnings attributable to NCIs (25% × 50)	12.5
NCI % of revaluation adjustment (25% × 20)	5
	42.5

(W3) **Retained earnings**

	£000
100% Polar	120
P's share of S's retained earnings (75% × [50 – 40])	7.5
Impairment of goodwill	(10)
	117.5

The answer to the above example can be found in Chapter 19.

6 Other adjustments

Transactions between parent and subsidiary

- Cancel receivables and payables balances between parent and subsidiary in the consolidated statement of financial position
- Reflects commercial substance of one combined business

Unrealised profits (PUPs)

- If the parent and subsidiary trade with each other, goods may be sold which include a profit element
- To the extent that the goods have not yet been sold on outside of the group, that profit is regarded as unrealised
- Unrealised profit must be removed from the consolidated accounts

Unrealised profits (PUPs) adjustment if parent sells to subsidiary

- Dr: Retained earnings (W3)
- Cr: Inventory

Unrealised profits (PUPs) adjustment if subsidiary sells to parent

- Dr: Subsidiary's closing retained earnings
- Cr: Inventory

This will affect both non-controlling interests (W2) and retained earnings (W3)

7 Example 2

Statement of financial position at 30 September 20X9

	Kit Ltd	*Kat Ltd*
	£000	£000
ASSETS		
Non-current assets		
Property plant & equipment	15,910	2,095
Investment in Kat Ltd	2,502	–
	18,412	2,095
Current assets		
Inventories	4,521	642
Trade receivables	2,815	361
Cash	29	264
	7,365	1,267
Total assets	25,777	3,362
EQUITY AND LIABILITIES		
Equity		
Share capital	1,700	1,200
Share premium	500	150
Retained earnings	19,605	920
	21,805	2,270
Non-current liabilities		
Loan	48	586
Current liabilities		
Trade payables	2,998	350
Taxation	926	156
Total equity and liabilities	25,777	3,362

Further information:

- The share capital of both Kit Ltd and Kat Ltd consists of ordinary shares of £1 each. There have been no changes to the balances of share capital and share premium during the year. No dividends were declared and paid by Kat Ltd during the year
- Kit Ltd acquired 80% of shares in Kat Ltd on 1 October 20X8
- At 1 October 20X8 the balance of retained earnings of Kat Ltd was £540,000
- The fair value of the property, plant and equipment of Kat Ltd at 1 October 20X8 was £2,854,000 as compared with a book value of £1,954,000. The revaluation has not been reflected in the books of Kat Ltd. (Ignore any depreciation implications)
- During the year Kat sells Kit £100,000 worth of goods at a profit margin of 40%. One quarter of the goods remain in Kit's inventory at the year–end
- Goodwill has been impaired by 20%

Required:

Prepare the consolidated statement of financial position as at 30 September 20X9.

Solution:

Consolidated Statement of Financial Position as at 30 September 20X9

	£000	£000
ASSETS		
Non-current assets		
Goodwill (W2)		216
Property, plant and equipment (15,910 + 2,095 + 900)		18,905
		19,121
Current assets		
Inventories (4,521 + 642 – 10 [W4])	5,153	
Trade receivables (2,815 + 361)	3,176	
Cash (29 + 264)	293	
		8,622
Total assets		27,743
Equity and liabilities		
Equity		
Called-up share capital		1,700
Share premium		500
Retained earnings (W4)		19,847
Equity attributable to holders of the parent		22,047
Non-controlling interest (W3)		632
Non-current liabilities		
Long-term loan (48 + 586)		634
Current liabilities		
Trade payables (2,998 + 350)	3,348	
Taxation (926 + 156)	1,082	
		4,430
Total equity and liabilities		27,743

(1) Goodwill

	£000
Price paid	2,502
Share capital and premium acquired (1,350 × 80%)	(1,080)
Retained earnings acquired (540 × 80%)	(432)
Revaluation adjustment (900 × 80%)	(720)
Goodwill at acquisition	270
Impairment (270 × 20%)	(54)
Goodwill in SFP	216

(2) NCI

	£000
Share capital and premium attributable to NCI (1,350 × 20%)	270
Retained earnings* attributable to NCI (910 × 20%)	182
Revaluation adjustment (900 × 20%)	180
Total	632

* Retained earnings of Kat = 920 – 10 (W4) = £910

(3) Retained earnings

	£000
Parent	19,605
Subsidiary (910* – 540 = 370 × 80%)	296
Impairment	(54)
Total	19,847

(4) Unrealised profit

	£000	*Profit structure*
Sale price	100	100%
Cost (100 × 0.6)	(60)	60%
Gross profit (% on sales)	40	40%

One quarter of the goods remain in inventory. The profits made by Kat on these are unrealised and must therefore be eliminated. One quarter of the profits = £40 × 25% = £10.

Seller is the subsidiary:

Dr	S's closing retained earnings	10
Cr	Group inventory	10

The answer to the above example can be found in Chapter 19.

8 Summary

Consolidated SOFP

Add together the assets and liabilities of P and S to show control

Standard workings

- Goodwill
- Non-controlling interest
- Retained earnings

Adjustments

Intra-group transactions and unrealised profits must be eliminated.

9 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 15 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 4 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 49 (Bryson plc)
- Question 51 (Spencer plc)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 15 of the Financial Statements text book.

- Workbook Activities 6 – 8

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q30-31 are simpler questions for students who may be struggling
- Q64-65 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

- Group statement of financial position – (Chapter 15: activities 1, 2, 3, 4 and 5

Revision kit (for recapping and revising the chapter)

Questions 53 and 55

16

Consolidated statement of profit or loss

Learning objectives:

At the end of this chapter you will be able to:

- Describe the key components of a consolidated statement of profit or loss
- Explain the basic consolidation process for a parent and subsidiary in relation to the preparation of a consolidated statement of profit or loss
- Draft a consolidated statement of profit or loss

Contents:

1 Preparing a consolidated statement of profit or loss

General approach:

The parent controls the subsidiary. This control is represented by adding together the statements of profit or loss for the parent and the subsidiary undertaking in full.

The parent company does not own all of the subsidiary's profit. Ownership is represented by calculating the profit attributable to the equity holders of the parent company and the profit attributable to the non-controlling interest.

2 Example 1

Cassa Ltd acquired 80% of the ordinary share capital of Role Ltd on 1 October 20X8.

Statements of profit or loss for the year ended 30 September 20X9

	Cassa Ltd	*Role Ltd*
	£000	£000
Revenue	15,200	5,400
Cost of sales	(8,150)	(2,850)
Gross profit	7,050	2,550
Administrative costs	(1,500)	(650)
Distribution costs	(1,750)	(385)
Profit from operations	3,800	1,515
Finance costs	(580)	(155)
Profit before tax	3,220	1,360
Tax	(1,150)	(300)
Profit for the year	2,070	1,060

Required:

Prepare the consolidated statement of profit or loss for the year ended 30 September 20X9.

Solution:

Cassa Group Consolidated statement of profit or loss for the year ended 30 September 20X9

	£000
Revenue (15,200 + 5,400)	20,600
Cost of sales (8,150 + 2,850)	(11,000)
	———
Gross profit	9,600
Distribution costs (1,500 + 650)	(2,150)
Admin costs (1,750 + 385)	(2,135)
	———
Profit from operations	5,315
Finance costs (580 + 155)	(735)
	———
Profit before tax	4,580
Tax (1,150 + 300)	(1,450)
	———
Profit for the year	3,130
	———
Attributable to:	
Equity holders of the parent (bal. fig)	2,918
Non-controlling interest (20% of role's profit of £1,060)	212
	———
	3,130
	———

The answer to the above example can be found in Chapter 19.

3 Adjustments

Transactions between parent and subsidiary

- Cancel sales and purchases made between parent and subsidiary in the consolidated statement of profit or loss
- Exclude dividends received by parent from subsidiary during the year

Unrealised profits (PUPs)

- If the parent and subsidiary trade with each other, goods may be sold which include a profit element
- To the extent that the goods have not yet been sold on outside of the group, that profit is regarded as unrealised
- Unrealised profit must be removed from the consolidated accounts

Unrealised profits (PUPs) adjustment in consolidated P&L account

- Dr: Cost of sales (P&L)
- Cr: Inventory (SOFP)

Unrealised profits (PUPs) adjustment if subsidiary sells to parent

- Also need to also adjust the profit attributable to the non-controlling interest as follows:

	£
NCI % of subsidiary company profit after tax	X
Less: NCI % of PUP	(X)
	——
	X
	——

4 Example 2

Jay plc acquired 90% of the issued share capital of Silent Bob Ltd on 1 April 20X1.

Extracts from their statements of profit or loss for the year ended 31 March 20X2 are shown below.

	Jay plc	*Silent Bob Ltd*
	£000	£000
Revenue	140,800	59,000
Cost of sales	(100,300)	(38,000)
Gross profit	40,500	21,000
Other income – dividend from Silent Bob Ltd	4,000	–
Distribution costs and administrative expenses	(12,500)	(3,000)
Profit before tax	32,000	18,000
Income tax expense	(8,000)	(3,000)
Profit for the year	24,000	15,000

Additional data

During the year, Silent Bob Ltd sold goods which had cost £80,000 to Jay plc for £480,000. 25% of these goods still remain in inventory at the end of the year.

Required:

Draft the consolidated statement of profit or loss for Jay plc and its subsidiary undertaking for the year ended 31 March 20X2.

Solution:

Jay plc – Consolidated statement of profit or loss for the year ended 31 March 2010.

	£000
Revenue (W1)	199,320
Cost of sales (W2)	(137,920)
Gross profit	61,400
Other income – dividend from Silent Bob Limited	–
Distribution costs and administrative expenses (12,500 + 3,000)	(15,500)
Profit before tax	45,900
Income tax expense (8,000 + 3,000)	(11,000)
Profit for the year	34,900
Attributable to:	
Equity holders of the parent (bal. fig)	33,410
Non-controlling interest (W4)	1,490
	34,900

(W1) **Revenue**

There has been intra-group trading between Jay plc and Silent Bob Ltd. This must be removed from the consolidated financial statements.

	£000
Jay plc	140,800
Silent Bob	59,000
Intercompany transaction	(480)
Total	199,320

(W2) **Cost of sales**

There has been intra-group trading between Jay and Silent Bob. The value of the intra-group purchases is removed from consolidated cost of sales.

Some of the goods sold by Silent Bob to Jay remain in Jay's inventory. Therefore, the intra-group profit on the remaining items must be eliminated.

	£000
Jay plc	100,300
Silent Bob	38,000
Intercompany transaction	(480)
Provision for unrealised profits (W3)	100
Total	137,920

(W3) **Provision for unrealised profits (PUP)**

	£000
Selling price	480
Cost of goods	(80)
Profit	400
Unrealised profit 400 × 25%	100

Remember, it is the profit that **remains** in group inventory that is eliminated.

(W4) **Non-controlling interest**

	£000
NCI % of Silent Bob's profit after tax (10% × £15,000)	1,500
NCI % of PUP (only if the sub is the seller) (10% × £100)	(10)
Profit	1,490

The answer to the above example can be found in Chapter 19.

5 Summary

Control

Add together the incomes and expenses of the parent and subsidiary

Ownership

Split the profit attributable to the equity holders of the parent and the non-controlling interest

Adjustments

Remove all transactions between the parent and subsidiary, including unrealised profits

6 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 16 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 5 of the Financial Statements pocket notes.

Real assessment standard question practice

Revision kit:

- Question 50 (Sugar plc)
- Question 52 (Mithchell plc)

Additional, more challenging questions

The following questions can be found at the rear of Chapter 16 of the Financial Statements text book.

- Workbook Activities 4 and 5

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q32-33 are simpler questions for students who may be struggling
- Q66-67 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

Group statement of profit or loss – (Chapter 16): activities 1, 2 and 3

Revision kit (for recapping and revising the chapter)

Questions 54 and 56

Consolidated accounts: Associates

17

Learning objectives:

At the end of this chapter you will be able to:

- Describe the key features of a parent/associate relationship.

Contents:

1 Associates

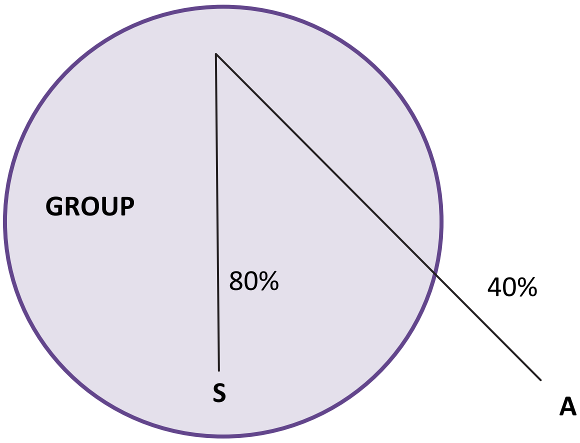
IAS 28 definitions

Associate – An associate is an entity over which an investor is able to exercise significant influence

Significant influence – Power to participate in, but not control, the decisions of another entity

Presumed to exist when the investor holds between 20% – 50% of the equity shares

Normally evidenced by representation on the board of directors



Equity accounting in the group accounts for associates

Statement of financial position

- The carrying value of the associate is the cost of investment in the associate plus the investor's share of the increase in post-acquisition reserves up to the year end
- Presented as a single line within non-current assets, called 'Investment in associates'

Equity accounting in the group accounts for associates

Statement of profit or loss

- The consolidated statement of profit or loss shows the group's share of the associate's profit after tax.
- This is presented in a single line, as 'Share of profit of associates' in arriving at group profit before tax

2 Summary

An associate

An entity over which an investor exerts significant influence but not control

Accounting treatment

Associates are equity accounted

3 Further reading and questions

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 17 of the Financial Statements text book.

Less detailed summaries can be found in Chapter 4 and 5 of the Financial Statements pocket notes.

If you are attending a revision course, please do not attempt the revision kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's supplementary question bank (for additional personalisation)

- Q34-35 are simpler questions for students who may be struggling
- Q68-69 are trickier questions to challenge more able students

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study text (for teaching throughout the chapter)

- Group SOFP example P, S and A – (Chapter 17)
- Group SOP&L example P, S and A – (Chapter 17)

Additional questions

18

Question 1

You work as an accounting technician for a firm of chartered accountants. Karl Hayes, a self-employed builder, is one of your clients and the following issues relate to his year end accounts.

(1) The trade receivables balance is £19,100. A debt of £400 is considered to be irrecoverable and is to be written off. The balance on the allowance for doubtful debts is currently £735 and the allowance is to be revised to 5% of trade receivables.

The amount to be charged to the statement of profit or loss for the change in the doubtful debt allowance is:

A £935

B £735

C £200

D £220

C

Trade receivables	19,100
Less bad debt	(400)
	18,700
5% allowance	935
Existing allowance	(735)
Increase in allowance	200

(2) During the year a non-current asset had been disposed of. The profit on sale was £750. The cost of the asset had been £3,400 and the proceeds on sale were £2,150.

The accumulated depreciation to date was:

A £2,150

B £2,650

C £2,000

D £1,250

C

Proceeds	2,150
Profit	(750)
Carrying Value (CV)	1,400
Cost of the asset	3,400
Accumulated depreciation (difference)	(2,000)

(3) The balance on the rent and rates account as shown on the trial balance was £2,850 Dr.

At the year end, rates had been prepaid by £720 and the rent was due at the year end of £500.

The amount to be charged to the statement of profit and loss for the year was:

A £2,630

B £3,070

C £1,630

D £4,070

A

Rent and rates account			
Detail	£	**Detail**	£
Balance b/d	2,850	Prepayment balance c/d	720
Accrual balance c/d	500	Profit and loss	2,630
	3,350		**3,350**
Prepayment balance b/d	720	Accrual balance b/d	500

(4) The following information relates to items in the purchase ledger control account:

Opening balance	£15,100 Cr
Payments to suppliers	£83,200
Returns to suppliers	£1,100
Discounts received	£4,100
Amounts offset against items in the sales ledger	£1,560
Purchases on credit from suppliers	£96,000

(**NB**: A supplier was also a customer.)

The closing balance on the purchase ledger account would be:

A £34,660

B £23,340

C £21,140

D None of these

C

Purchase ledger control account			
Detail	£	**Detail**	£
Returns	1,100	Balance b/d	15,100
Discounts	4,100	Purchases	96,000
Payments to suppliers	83,200		
Contra offset against ledger	1,560		
Balance c/d	21,140		
	111,100		**111,100**

(5) The trial balance included the following information:

Revenue £131,7000, returns outward £1,100, returns inward £1,700, purchases £96,000, opening inventory valuation £16,200 and a note to the information showed that the closing inventory valuation was £17,220 and that goods which had cost £1,500 had been used by Karl for his own use.

(a) The cost of goods sold for the period was:

A £91,780

B £94,420

C £95,380

D £92,380

D

Cost of goods sold:	£
Inventories at start	16,200
Add purchases (net of drawings £1,500)	94,500
Less returns	(1,100)
Less closing inventories	(17,220)
	92,380

(b) The gross profit for the period was:

A £32,080

B £37,620

C £38,220

D None of these

B

	£
Net sales (sales less returns inwards	130,000
Cost of goods sold	(92,380)
	37,620

Question 2

SPICE LTD

The following summarised trial balance has been extracted from the books of Spice Ltd.

	Dr	*Cr*
	£	£
Revenue		400,000
Purchases	200,000	
Administrative expenses	100,000	
Distribution expenses	50,000	
Plant and machinery – cost	100,000	
Plant and machinery – accumulated depreciation at 1 January 20X1		20,000
Trade receivables	30,000	
Inventory – 1 January 20X1	20,000	
Share capital		10,000
Trade payables		30,000
Retained earnings – 1 January 20X1		100,000
Cash	60,000	
	560,000	560,000

The following notes are relevant to the preparation of the financial statements for the year ended 31 December 20X1:

- The current year tax bill has been estimated at £10,000.
- The cost of inventory as at 31 December 20X1 is £15,000.
- Depreciation on plant and machinery is charged to cost of sales on a straight line basis at 10% per annum.

Required:

Prepare the statement of profit or loss for the year ended 31 December 20X1 and the statement of financial position as at 31 December 20X1.

Solution:

SPICE LTD

Statement of profit or loss for the year ended 31 December 20X1

	£
Revenue	400,000
Cost of sales (W1)	(215,000)
Gross profit	185,000
Administrative expenses	(100,000)
Distribution expenses	(50,000)
Profit before tax	35,000
Income tax expense	(10,000)
Profit after tax	25,000

Statement of financial position as at 31 December 20X1

	£
Assets	
Non-current assets	
Property, plant and equipment (£100,000 – £20,000 – £10,000 (W1))	70,000
Current assets	
Inventories	15,000
Trade and other receivables	30,000
Cash and cash equivalents	60,000
Total assets	175,000
Equity and liabilities	
Share capital	10,000
Retained earnings (£100,000 + £25,000 (P/L)	125,000
Trade and other payables	30,000
Tax payable	10,000
Total equity and liabilities	175,000

(W1) **Cost of sales**

	£
Opening inventory	20,000
Purchases	200,000
Depreciation (100,000 × 10%)	10,000
Closing inventory	(15,000)
	215,000

Question 3

STARBOLD PLC

The following trial balance has been extracted from the books of Starbold plc, a listed company, as at 31 March 20X7.

	£000	£000
Office rent	100	
Audit fee	20	
Salaries	150	
Irrecoverable debts	25	
General administration	125	
General distribution	25	
Storage costs	100	
Advertising	50	
Called up share capital (all ordinary shares of £1 each)		206
Cash at bank and in hand	33	
Trade receivables	233	
Non-current asset investments	280	
Dividends received		8
Interim dividend declared and paid	20	
Over provision of last year's corporation tax		3
Land and buildings at cost	200	
Land and buildings accumulated depreciation		30
Plant and machinery at cost	400	
Plant and machinery accumulated depreciation		170
Retained earnings (at 1 April 20X6)		235
Purchases	1,210	
Revenue		2,265
Inventories at 1 April 20X6	140	
Trade payables		194
	3,111	3,111

Additional information

(1) Inventories at 31 March 20X7 had a cost of £150,000 but a net realisable value of £85,000.

(2) Depreciation for the year to 31 March 20X7 is to be charged against administrative expenses as follows.

	£000
Land and buildings	5
Plant and machinery	40

(3) Corporation tax of £165,000 is to be provided against profits for the year to 31 March 20X7.

(4) Salaries are to be apportioned equally between cost of sales, administration expenses and distribution costs.

Required:

Draft the statement of profit or loss and, the statement of changes in equity for the year ended 31 March 20X7 along with the statement of financial position as at 31 March 20X7.

Solution:

STARBOLD PLC

Statement of profit or loss for the year to 31 March 20X7

	£000
Revenue	2,265
Cost of sales (W1)	(1,315)
	–––––
Gross profit	950
Distribution costs (W1)	(225)
Administrative expenses (W1)	(365)
	–––––
Profit from operations	360
Income from investments	8
	–––––
Profit before tax	368
Taxation (165 – 3)	(162)
	–––––
Profit for the year	206
	–––––

Statement of changes in equity

	Share capital	*Retained Earnings*	*Total*
	£000	£000	£000
Balance at 1 April 20X6	206	235	441
Profit for the year		206	206
Dividends		(20)	(20)
	––––	––––	––––
Balance at 31 March 20X7	206	421	627
	––––	––––	––––

Statement of financial position as at 31 March 20X7

	£000
Assets	
Non-current assets	
Property, plant and equipment (W2)	355
Investments	280
	635
Current assets	
Inventories	85
Trade receivables	233
Cash and cash equivalents	33
	351
Total assets	**986**
Equity and liabilities	
Equity	
Called up share capital	206
Retained earnings	421
Total equity	**627**
Current liabilities	
Trade and other payables	194
Taxation	165
Total equity and liabilities	**986**

Workings:

(W1) **Apportionment of expenses**

	Cost of sales	*Distribution costs*	*Admin expenses*
	£000	£000	£000
Office rent			100
Audit fee			20
Salaries	50	50	50
Irrecoverable debts			25
General administration			125
General distribution		25	
Storage costs		100	
Advertising		50	
Purchases	1,210		
Opening inventories	140		
Closing inventories	(85)		
Depreciation			
– Land and buildings			5
– Plant and machinery			40
	1,315	225	365

(W2) **Property, plant and machinery**

	Carrying value
	£000
Land and buildings (200 – 30 – 5)	165
Plant and machinery (400 – 170 – 40)	190
	355

Question 4

MLH LTD

The Chief Accountant of MLH Ltd has asked you to help prepare the financial statements for the year ended 30 September 20X9. The trial balance of the company as at 30 September 20X9 is set out below.

Trial balance as at 30 September 20X9

	Debit	*Credit*
	£000	£000
Ordinary share capital		21,000
Interest	900	
Trade receivables	20,200	
6% Long term loan		30,000
Distribution costs	12,800	
Administrative expenses	7,610	
Revenue		134,840
Retained earnings		16,570
Cash at bank	1,930	
Accruals		1,250
Prepayments	618	
Share premium		5,000
Land – cost	35,900	
Buildings – cost	12,800	
Fixtures and fittings – cost	6,950	
Motor vehicles – cost	17,320	
Office equipment – cost	5,970	
Buildings – accumulated depreciation		9,020
Fixtures and fittings – accumulated depreciation		4,370
Motor vehicles – accumulated depreciation		10,030
Office equipment – accumulated depreciation		2,320
Inventories as at 1 October 20X8	20,730	
Trade payables		15,490
Purchases	99,540	
Allowance for doubtful debts		620
Returns inwards	456	
Returns outwards		714
Interim dividend paid	4,500	
Final dividend paid	3,000	
	251,224	251,224

Further information:

- The authorised share capital of the company, all of which has been issued, consists of ordinary shares with a nominal value of £1.
- Inventories at the close of business on 30 September 20X9 were valued at cost at £13,870,000.
- The corporation tax charge for the year has been calculated as £5,190,000.
- The land has been revalued up by professional valuers by £3,200,000. The revaluation is to be included in the financial statements for the year ended 30 September 20X9.
- Goods sold to a customer on credit for £121,000 in August 20X9 which originally cost £72,000 were returned to the company on 29 September 20X9. No entries have been made in the accounts to reflect this return of goods.
- The company ran a 4 month advertising campaign starting on 1 September 20X9 it cost £76,000.
- Interest for the last 6 months of the year has not been included in the accounts.

Required:

Draft a statement of profit or loss, statement of changes in equity and a statement of financial position for MLH Ltd as at 30 September 20X9.

You are also required to calculate the following profitability ratios:

1	Return on capital employed
2	Return on shareholder's funds
3	Gross profit %
4	Administration expenses/revenue %
5	Operating profit %

Solution:

MLH LTD

Statement of profit and loss for the year ended 30 September 20X9

	£000
Continuing operations	
Revenue (134,840 – 456 – 121)	134,263
Cost of sales (20,730 + 99,540 – 13,870 – 72 – 714)	(105,614)
Gross profit	28,649
Distribution costs (12,800 – 57)	(12,743)
Administrative expenses	(7,610)
Profit from operations	8,296
Finance costs (900 + 900)	(1,800)
Profit before tax	6,496
Tax	(5,190)
Net profit for the year	1,306

MLH

Statement of changes in equity as at 30 September 20X9

	Share capital	**Share premium**	**Revaluation reserve**	**Retained earnings**	**Total**
	£000	**£000**	**£000**	**£000**	**£000**
At 1 October 20X8	21,000	5,000		16,570	42,570
Revaluation			3,200		3,200
Profit for year				1,306	1,306
Dividends				(7,500)	(7,500)
At 30 September 20X9	21,000	5,000	3,200	10,376	39,576

MLH Ltd

Statement of Financial Position as at 30 September 20X9

	£000
ASSETS	
Non-current assets	
Property, plant and equipment (W1)	56,400
	———
	56,400
	———
Current assets	
Inventories (13,870 + 72)	13,942
Trade and other receivables (20,200 + 618 – 121 + 57 – 620)	20,134
Cash and cash equivalents	1,930
	———
	36,006
	———
Total assets	92,406
	———
EQUITY AND LIABILITIES	
Equity	
Called-up share capital	21,000
Share premium	5,000
Revaluation reserve	3,200
Retained earnings (W2)	10,376
	———
Total equity	39,576
Non-current liabilities	
Loan	30,000
Current liabilities	
Trade and other payables (1,250 + 15,490 + 900)	17,640
Tax liabilities	5,190
	———
Total equity and liabilities	92,406
	———

(W1) **Property Plant & Equipment**

	Cost	*Accumulated Depreciation*	*Carrying value*
	£000	*£000*	*£000*
Land	35,900 + 3,200	–	39,100
Buildings	12,800	(9,020)	3,780
Fixtures & Fittings	6,950	(4,370)	2,580
Motor Vehicles	17,320	(10,030)	7,290
Office Equipment	5,970	(2,320)	3,650
	———	———	———
	82,140	25,740	56,400
	———	———	———

(W2) **Retained earnings note**

B/fwd	16,570
Profit for the year (from P&L)	1,306
Interim dividend paid	(4,500)
Final dividend paid	(3,000)
	———
	10,376

Profitability ratios

1 **Return on capital employed**

8,296/(39,576+30,000) = 11.9%

2 **Return on shareholder's funds**

1,306/39,576 = 3.3%

3 **Gross profit %**

28,649/134,263 = 21.3%

4 **Expenses/revenue %**

7,610/134,264 = 5.7%

5 **Operating profit %**

8,296/134,263 = 6.2%

Question 5

TOAK LTD

Toak Limited compiles its financial statements to 30 June annually. At 30 June 20X1, the company's trial balance was as follows:

		£000	£000
Revenue			15,330
Purchases		7,780	
Inventory at 1 July 20X0		1,890	
Distribution costs		1,540	
Administrative expenses		1,000	
Land at valuation		10,500	
Buildings:	– cost	8,000	
	– accumulated depreciation at 1 July 20X0		1,600
Plant and equipment:	– cost	12,800	
	– accumulated depreciation at 1 July 20X0		2,480
Trade receivables and payables		4,280	2,080
Taxation			40
Bank			730
Ordinary shares of 50p each:	as at 1 July 20X0		8,000
	Issued 1 February 20X1		5,000
Share premium account:	as at 1 July 20X0		2,000
	arising on shares issued during year		1,000
Dividend paid 1 June 20X1		520	
Revaluation reserve as at 1 July 20X0			3,000
Retained earnings			3,100
5% debentures (redeemable 20Y0) (issued 1 January 20X1)			4,000
Debenture interest paid		50	
		48,360	48,360

The following matters remain to be adjusted for in preparing the financial statements for the year ended 30 June 20X1.

(1) Inventory at 30 June 20X1 amounted to £1,860,000 at cost. A review of inventory items revealed the need for some adjustments for two product lines:

   (i) items which had cost £80,000 and which would normally sell for £120,000 were found to have deteriorated. Remedial work costing £20,000 would be needed to enable the items to be sold for £90,000.

   (ii) some items sent to customers on sale or return terms had been omitted from inventories and included as sales in June 20X1. The cost of these items was £20,000 and they were included in sales at £30,000. In July 20X1, the items were returned in good condition by the customers.

(2) On 1 July 20X0, the land and buildings were revalued: land was valued at £12,000,000 and the buildings were valued at £9,000,000. At the date of the valuations, the buildings had a remaining estimated useful life of forty years. It is company policy to make the annual transfer within the statement of changes in equity for 'excess depreciation'.

(3) Depreciation is to be charged on buildings and plant and equipment as follows:

Buildings	at a constant rate over the estimated useful life of the buildings
Plant and equipment	15% per year on cost

At the date of purchase, ten years ago, the buildings had an estimated useful life fifty years.

60% of the total depreciation charge for the year is to be charged to cost of sales, and 20% each to distribution costs and administrative expenses respectively.

(4) The taxation balance represents an overprovision in relation to the tax liability of the previous year. The corporation tax charge for the year ended 30 June 20X1 has been estimated at £700,000.

(5) Interest is payable on the 5% debenture on 31 March and 31 October annually.

Required:

Produce a statement of profit or loss and other comprehensive income, a statement of changes in equity and statement of financial position for the year ended 30 June 20X1.

You are also required to calculate the following ratios:

1	Return on capital employed %
2	Current ratio
3	Gross profit %
4	Interest cover
5	Gearing %

Solution:

Toak Limited

Statement of profit or loss for the year ended 30 June 20X1

	£000
Revenue (£15,330 – £30)	15,300
Cost of sales (W1)	(9,087)
Gross profit	**6,213**
Distribution costs (£1,540 + £429 (W2))	(1,969)
Administrative expenses (£1,000 + £429 (W2))	(1,429)
Operating profit from operations	**2,815**
Finance costs (6/12 × 5% × £4,000)	(100)
Profit before tax	**2,715**
Tax (£700 – £40 overprovision)	(660)
Profit after tax	**2,055**
Other comprehensive income	
Gain on revaluation (£1,500 + £2,600 (W3))	4,100
Total comprehensive income	**6,155**

Task 2

Statement of changes in equity

	Share Capital	*Share premium account*	*Revaluation reserve*	*Retained earnings*	*Total*
	£000	£000	£000	£000	£000
As at 1 July 20X0	8,000	2,000	3,000	3,100	16,100
Issue of shares	5,000	1,000			6,000
Total comprehensive income for the year			4,100	2,055	6,155
Excess dep'n transfer (W3)			(65)	65	
Dividend paid				(520)	(520)
As at 30 June 20X1	13,000	3,000	7,035	4,700	27,735

Workings:

(W1) **Cost of sales**

		£000	£000
Opening inventory			1,890
Purchases			7,780
			9,670
Less:	Closing inventory		
	At cost	1,860	
Less:	Adjustment 1 (i) ((90,000 – 20,000) – 80,000)	(10)	
Add:	Adjustment 2 (ii)	20	
Closing inventory at 30 June 20X1			(1,870)
			7,800
Depreciation (W2)			1,287
			9,087

(W2) **Depreciation**

	£000
Buildings (£9,000 × 1/40)	225
Plant and equipment (£12,800 × 15%)	1,920
	2,145
Allocated:	
Cost of sales (60% × £2,145)	1,287
Distribution costs (20% × £2,145)	429
Administrative expenses (20% × £2,145)	429
	2,145

(W3) **Impact of revaluation in year**

Revaluation surplus on land (£12,000,000 – £10,500,000) = £1,500,000

Revaluation surplus on buildings (£9,000,000 – (£8,000,000 – £1,600,000)) = £2,600,000

Increase in annual depreciation charge on buildings resulting from revaluation:

revised charge (£9,000,000 / 40 yrs) = £225,000 – original charge (£8,000,000 /50 yrs) £160,000 = £65,000

Toak Limited

Statement of financial position for the year ended 30 June 20X1

	£000
Non-current assets	
PPE (£12,000 + £8,775 + £8,400) (W1))	29,175
Current assets	
Inventory (per (W1) of P&L workings)	1,870
Trade & other receivables (W2)	4,250
	6,120
Total assets	**35,295**
Equity	
Share capital	13,000
Share premium	3,000
Revaluation reserve	7,100
Retained earnings	4,635
Total equity	27,735
Non-current liabilities	
5% Debenture	4,000
Current liabilities	
Trade & other payables (W3)	2,130
Tax liability	700
Bank overdraft	730
Total current liabilities	3,560
Total Equity & Liabilities	**35,295**

(W1) **PPE**

	Land	*Buildings*	*Plant*
	£000	£000	£000
Asset valuation/cost b/fwd	10,500	8,000	12,800
Accumulated dep'n b/fwd		(1,600)	(2,480)
	———	———	———
CV b'fwd	10,500	6,400	10,320
Revaluation surplus in year	1,500	2,600	
	———	———	———
Revised CV at 1 July 20X0	12,000	9,000	10,320
Depreciation charge		(225)	(1,920)
	———	———	———
Total	12,000	8,775	8,400
	———	———	———

(W2) **Trade and other receivables**

	£000
Trade receivables	4,280
Revenue – sale or return adjust	(30)
Total	4,250

(W3) **Trade and other payables**

	£000
Trade payables	2,080
Interest accrual (£4,000 × 5% × 3/12)	50
Total	2,130

Profitability ratios

1 **Return on capital employed**

(2,815 / (27,725 + 4,000)) × 100 = 4.6%

2 **Current ratio**

6,120 / 3,560 = 1.7: 1

3 **Gross profit %**

6,213 / 15,300 × 100 = 40.6%

4 **Interest cover**

2,815 / 100 = 28.1 times

5 **Gearing %**

(4,000 / (27,735 + 4,000)) × 100 = 12.6%

Question 6

SALLY'S CUP CAKES LTD

Sally's Cup Cakes Ltd compiles its financial statements to 31 December each year. At 31 December 20X2, the company's trial balance was as follows:

	Dr	*Cr*
Sales revenue		39,600
Purchases	16,560	
Inventory at 01/01/X2	2,780	
Distribution costs	2,160	
Admin expenses	2,920	
Land at valuation	21,000	
Buildings at cost	16,000	
Accumulated Depreciation		4,260
Plant & equipment at cost	25,600	
Accumulated depreciation		4,960
Trade receivables & trade payables	8,240	4,480
Cash at bank	10,320	
Ordinary shares (nominal value £1)		28,000
Share premium		8,000
Revaluation reserves		6,000
Retained earnings		8,980
10% Loan notes (redeemable 2018)		8,000
Research & development	5,000	
Tax		1,000
Lease payment	2,700	
	113,280	**113,280**

Further Information:

1 *Share issue*

During the year Sally's Cup Cakes issued 4,000 shares for £1.50. The share issue has been accounted for in the trial balance.

2 *Loans*

Interest on the loan has not been included in the accounts

3 *Revaluations*

Land is required to be revalued to £24,000. No change was required to the value of the building.

4 *Intangibles*

During the year £5,000 was been spent on researching recipes. On the 30 June 20X2 it was decided that this project fulfilled all the criteria for development of which £3,000 relates to expenditure since them.

5 *Impairment*

It has just come to light that a piece of machinery has been impaired due to technological advances. The carrying value of the asset is £6250, the net realisable value is £5,520 and its value in use is £5,200. No adjustments have been made in the trial balance.

6 *Closing inventories*

Inventory at 31 December 20X2 amounted to £3,120 at cost. Items which had cost £900 have been damaged but after further expenditure of £200 can be sold for £800.

7 *Tax*

The tax in the trial balance relates to an overestimate of tax in the previous year. The tax for 20X2 has been estimated at £5,000.

8 *Leases*

Sally entered into a non-cancellable 5 year lease on 1 January 20X2 to acquire a motor vehicle for use in the business. The vehicle had a fair value of £10,000 and the annual lease payment is £2,700 per year in arrears. The finance charge is to be allocated using the actuarial method and the implicit interest rate is 10.29%. The vehicle is to be depreciated over 5 years and the only entry in the accounting system is the lease payment made to date of £2,700. Depreciation on the finance lease asset is to be charged as a distribution cost.

9 *Provisions*

During the financial year a customer became ill after eating one of the cupcakes and decided to sue the company. The solicitor has advised Sally that there is a 60% chance she will lose in court and he believes that she will have to pay out £3,500.

10 *Events after the reporting date*

On 31 January 20X3 Sally was informed that one of its customers, Petty's tea shop, had ceased trading. The liquidators advised Sally that it was very unlikely to receive payment of any of the £1,200 due from Petty's at 31 December 20X2.

11 *Revenue*

Sally entered into a contract with a large supermarket chain to supply cupcakes on a regular basis. Sally has agreed a substantial discount on the following items:

– Same quantity of cupcakes will be supplied each month

– Quantities can only be changed at the end of each six month period

– Payment must be made six months in advance

The supermarket paid £5,000 on 1 October 20X2 for six months supply of cup cakes to 31 March 20X3 which has been recognised as revenue in the trial balance.

Required:

You are required to prepare a statement of profit or loss and a statement of changes in equity for the year ended 31 December 20X2, together with a statement of financial position as at 31 December 20X2 for Sally's Cup Cakes Ltd.

Solution:

Sally Cup Cakes Ltd

Statement of profit or loss for the year ended 31 December 20X2

	£
Continuing operations	
Revenue (£39,600 – £2,500)	37,100
Cost of sales (W1)	(19,250)
Gross profit	17,850
Distribution costs (W2)	(4,160)
Administrative expenses (W3)	(4,120)
Profit from operations	9,570
Provision	(3,500)
Finance costs (W4)	(1,829)
Profit before tax	4,241
Tax (£5,000 – £1,000)	(4,000)
Profit for the period from continuing operations	241
Other comprehensive income for the year	
Gain on revaluation of land	3,000
Total comprehensive income for the year	3,241

Sally's Cup Cakes Ltd

Statement of changes in equity for the year ended 31 December 20X2

	Share capital	**Share premium**	**Revaluation reserve**	**Retained earnings**	**Total**
	£	£	£	£	£
At 31 Dec 20X1	24,000	6,000	6,000	8,980	44,980
Revaluation			3,000		3,000
Profit for year				241	241
Share issue	4,000	2,000			6,000
	———	———	———	———	———
At 31 Dec 20X2	28,000	8,000	9,000	9,221	54,221
	———	———	———	———	———

***Workings* for statement of profit or loss:**

(W1) **COS**

	£
Research	2,000
Impairment	730
Closing inventories	(2,820)
Purchases	16,560
Opening inventories	2,780
Total	**19,250**

(W2) **Distribution costs**

	£
Depreciation	2,000
Distribution costs	2,160
Total	**4,160**

(W3) **Administrative expenses**

	£
Irrecoverable debt	1,200
Administrative expense	2,920
Total	**4,120**

(W4) **Finance costs**

	£
Loan	800
Finance lease	1,029
Total	**1,829**

Sally's Cup Cakes Ltd – Statement of financial position as at 31 December 20X2

	£
ASSETS	
Non-current assets	
Property, plant and equipment (W5)	63,650
Intangibles	3,000
	———
	66,650
Current assets	
Inventories	2,820
Trade and other receivables (W6)	7,040
Cash and cash equivalents	10,320
	———
	20,180
	———
Total assets	86,830
	———
EQUITY AND LIABILITIES	
Equity	
Share capital	28,000
Share premium	8,000
Revaluation reserve	9,000
Retained earnings	9,221
	———
Total equity	54,221

Non-current liabilities	
Loan	8,000
Finance lease (W7)	6,486
	14,486
Current liabilities	
Trade and other payables (W8)	7,780
Tax liability	5,000
Provision	3,500
Finance lease (W7)	1,843
	18,123
Total equity and liabilities	86,830

***Workings* for statement of financial position:**

(W5) **PPE**

	£
Land	21,000
Revaluation	3,000
Buildings @ cost	16,000
Accumulated depreciation	(4,260)
Plant and equipment @ cost	25,600
Accumulated depreciation	(4,960)
Finance Lease – addition	10,000
Depreciation charge	(2,000)
Impairment of plat	(730)
Total	**63,650**

(W6) **Trade and other receivables**

	£
Irrecoverable debt	(1,200)
Trade receivables	8,240
Total	**7,040**

(W7) **Finance lease creditor**

	B/fwd	Int @ 10.29%	Payment	C/fwd
Year	£	£	£	£
1	10,000	1,029	(2,700)	8,329
2	8,329	857	(2,700)	6,486

P&L	**£**	**SOFP**	**£**
Finance Cost	1029	PPE (10000 – 2000)	8000
Depreciation	2000	NCL	6486
(10000 / 5)		CL (8329 – 6486)	1843

(W8) **Trade and other payables**

	£
Loan interest	800
Trade payables	4,480
Prepaid income	2,500
Total	**7,780**

Adjustments:

1 Share Issue

Share issue is already included in the TB so just need to show share capital and share premium in the SOCIE.

4,000 × £1.50 = 6,000 (nominal value = £1)

Share capital £4,000

Share premium = £2,000

2 Loans

£8,000 × 10% = £800

Dr Finance costs £800

Cr Accruals £800

3 Revaluations

Land Bfwd £21,000

Revaluation £24,000

Gain £3,000

Dr Land £3,000 (also needs to show in SOCIE & OCI)

Cr Revaluation reserve £3,000

4 Intangibles

£2,000 of cost relates to research and therefore needs to be written off to P&L. However the remaining £3,000 relates to development costs and therefore it is required to be capitalised.

Dr COS	£2,000
Cr Intangible assets	£3,000

5 Impairment

Carrying value	Vs	Recoverable amount
£6,250	Lower	£5,520

Higher	NRV	VIU
	£5,520	£5,200

CV is greater than the RA so therefore the asset has been impaired by £730.

Dr COS	£730
Cr PPE	£730

6 Closing inventories

Lower of cost	and	NRV
£900		£800 – £200 = £600

Inventories need to be reduced by £300

£3,120 – £300 = £2,820

Dr SOFP	£2,820
Cr COS	£2,820

7 Tax

Over estimate	£(1,000)
Current tax	£5,000
P&L tax charge	£4,000
SOFP accrual	£5,000

8 Leases

Year	Bfwd	Int 10.29%	Payment	Cfwd
	£	£	£	£
1	10,000	1,029	(2,700)	8,329
2	8,329	857	(2,700)	6,486

Asset recognition

Dr NCA £10,000

Cr HP lease creditor £10,000

Interest for Year 1
Dr Finance Cost £1,029
Cr HP lease creditor £1,029

Payment for Year 1
Dr HP Lease creditor £2,700
Cr Lease payment (per TB) £2,700
(normally would be bank if not already accounted for in TB)

Depreciation in Year 1

Dr Distribution costs	£2,000
Cr Accumulated depreciation	£2,000

In summary

P&L	**£**	**SOFP**	**£**
Finance Cost	1,029	PPE (10,000 – 2,000)	8,000
Depreciation	2,000	NCL	6,486
(10,000 / 5)		CL (8,329 – 6,486)	1,843

9 Provisions

Need to provide for a provision:

1	Past event	legal obligation
2	Probable	60% (>50% therefore probable)
3	Reliable estimate	Yes – solicitor

Dr Provision P&L	£3,500
Cr Provision SOFP	£3,500

10 Events after the reporting date

Irrecoverable debts needs to be identified as this is an adjusting event as Pettys Ltd balance existed at the year end.

Dr Admin Expenses	£1,200
Cr Trade receivables	£1,200

11 Revenue

We only recognise the revenue which relates to the financial year end 20X2.

October 20X2 – December 20X2 = 3 months
Received payment for 6 months
£5,000 × 3/6 = £2,500

Dr Revenue	£2,500
Cr Prepaid Income	£2,500