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***Financial
Accounting***



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Chapter 1

INTRODUCTION TO ACCOUNTING

1. Introduction

In this chapter we will look at what accounting is and why accounting information is prepared. We will also consider the different types of business entity that you can be asked to deal with and also the different users of financial statements.

2. Definition of accounting

Accounting comprises the recording of transactions, and the summarising of information.

Recording

Summarising

- Statement of Financial Position (Balance Sheet)
- Statement of Profit or Loss



3. Types of business entity

There are two types of business entity that you can be asked to deal with in the examination:

Sole trader

Limited liability company

Additionally, you should be aware of the following, although you cannot be asked any accounting entries:

Partnerships

In all cases, we apply the separate entity concept – that is that the business is regarded as being separate from the owner (or owners) and that accounts are prepared for the business itself.



4. Users of accounting information

Users of the financial information for a business will include the following:

- management
- owners / shareholders
- potential investors
- lenders
- employees
- the government
- the public

The main financial statements that are likely to be available to all users are the Statement of Financial Position and the Statement of Profit or Loss. Other statements may be required to be produced (or may be produced even if not required), such as a Statement of Cash Flows. We will consider these later.





Chapter 2

THE STATEMENT OF FINANCIAL POSITION AND STATEMENT OF PROFIT OR LOSS

1. Introduction

In this chapter we will look at what information the Statement of Financial Position and Statement of Profit or Loss are giving and also examine the standard layout and terminology that will be required from you in the examination.

2. The dual (or double) effect of transactions

Let us consider the effect of the following transactions on a sole trader:

- (a) The owner puts \$10,000 into a separate bank account for the business:

The business owns

The business owes

- (b) The business buys a shop for \$2,000

The business owns

The business owes



- (c) The business buys goods for resale (in cash) for \$1,000

The business owns

The business owes

- (d) The business buys more goods for resale (on credit) for \$2,000

The business owns

The business owes

- (e) The business buys a car for \$3,000 (cash)

The business owns

The business owes

- (f) The business sells half of the goods for \$2,400 (cash)

The business owns

The business owes

- (g) The business sells the remainder of the goods for \$2,800 on credit

The business owns

The business owes



- (h) The business pays \$600 of the amount owing, on account

The business owns

The business owes

- (i) The business pays electricity of \$200

The business owns

The business owes

- (j) The business receives half of the amount owing to it, on account.

The business owns

The business owes

- (k) The owner takes \$1,200 from the business

The business owns

The business owes

Check on profit:

In each case, the summary we have prepared is effectively a Statement of Financial Position and shows the owner: how much they are owed, why they are owed it, and how the amount is held within the business.

The check made on the profit is effectively a Statement of Profit or Loss. This shows the owner how the profit was actually made.



3. The Statement of Financial Position

Below is an example of the layout of a Statement of Financial Position for a sole trader:

Statement of Financial Position as at 31 March 2009

	\$	\$
ASSETS		
Non-current assets		
Land and Buildings	100,000	
Plant and Equipment	50,000	
Fixtures and Fittings	20,000	
Motor Vehicles	30,000	
	<hr/>	200,000
Current assets		
Inventories	10,000	
Accounts receivable	12,000	
Prepayments	3,000	
Cash	4,000	
	<hr/>	29,000
		<hr/>
		\$ 229,000
CAPITAL AND LIABILITIES		
Capital		
Capital at 1 April 2008	130,000	
Profit for year to 31 March 2009	50,000	
Less: withdrawals	(10,000)	
	<hr/>	170,000
Non-current liabilities		
8% Loan		25,000
Current liabilities		
Accruals	2,000	
Accounts payable	20,000	
Bank overdraft	12,000	
	<hr/>	34,000
		<hr/>
		\$ 229,000



Terminology:**Asset**

anything owned by the business

Non-current asset

an asset the business intends to keep (longer than 12 months)

Current asset

not a non-current asset (!)

Inventory

an asset bought by the business intended for sale

Accounts receivable

amount owed to the business by customers

Prepayment

a payment made by the business in advance

Capital

amount owing by the business to the proprietor (owner)

Drawings (or withdrawals)

anything taken from the business by the owner

Liability

amount owing by the business



Current liability

a liability due within 12 months of Statement of Financial Position date

Non-current liability

a liability due more than 12 months from the date of the Statement of Financial Position

Accounts payable

liability due to suppliers

Bank overdraft

liability due to the bank (a "negative" bank balance)



4. The Statement of Profit or Loss

Below is an example of the layout of a Statement of Profit or Loss for a sole trader:

Statement of Profit or Loss for the year ended 31 March 2009

	\$	\$
Sales revenue		180,000
Cost of sales:		
Opening Inventory	30,000	
Purchases	120,000	
	<u>150,000</u>	
Closing Inventory	(40,000)	
		110,000
Gross Profit		70,000
Other income:		
Rent received	10,000	
Interest received	<u>1,000</u>	<u>11,000</u>
		81,000
Expenses:		
Rent	5,000	
Electricity	3,000	
Telephone	2,000	
Wages and salaries	15,000	
Motor expenses	<u>6,000</u>	
		<u>31,000</u>
		<u>\$50,000</u>

Terminology

Revenue

Purchases

Trading Account

5. The difference between Capital and Revenue items

You should note from the previous exercises that when we pay for anything, there are two possible reasons. Either we buy an asset, which appears on the Statement of Financial Position, or we pay an expense, which appears on the Statement of Profit or Loss.

We call the purchase of assets (for the Statement of Financial Position) Capital Expenditure, whereas the payment of expenses (for the Statement of Profit or Loss) is called Revenue Expenditure.



6. The Accounting Equation

You should note from the earlier illustrations that at any point in time:

$$\text{ASSETS} = \text{CAPITAL} + \text{LIABILITIES}$$

It follows from this that:

$$\text{ASSETS} - \text{LIABILITIES} = \text{CAPITAL}$$

The term "net assets" is often used to refer to assets – liabilities, and so:

$$\text{NET ASSETS} = \text{CAPITAL}$$

Over a period of time (for example, over a year), the net assets of a business will change. Since the above equation is true at any point in time, it also holds true that over a period of time:

$$\text{INCREASE IN NET ASSETS} = \text{INCREASE IN CAPITAL}$$

There are only three reasons why the capital of a business should change over time:

- More capital introduced (this will increase the capital)
- Profit for the period (this will increase the capital)
- Drawings during the period (this will reduce the capital)

Therefore, finally, over a period of time,

$$\text{INCREASE IN NET ASSETS} = \text{CAPITAL INTRODUCED} + \text{PROFIT} - \text{DRAWINGS}$$

Example 1

On 1 January, net assets of a business were \$25,000. On 31 December they had increased to \$32,000. During the year the owner had introduced more capital of \$10,000 and had made drawings of \$7,000.

You are required to calculate the profit for the year

Example 2

On 1 January, the net assets of a business were \$118,000. On 31 December, the net assets were \$150,000. During the year the owner had introduced no additional capital, and the profit for the year was \$54,000

How much were the drawings during the year?

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3. The general rules of double entry

A debit entry represents one of the following:

- an increase in an asset
- a decrease in a liability
- an item of expense

A credit entry represents one of the following:

- an increase in a liability
- a decrease in an asset
- an item of income

4. Worked example

We will work through the following entries together (use big t-accounts, because we will do other things later with the same accounts):

Example 1

The following are the transactions of Kristine's business during her first month of trading.

Record each transaction in t-accounts.

- (a) Kristine starts a business and pays in \$5,000 as capital
- (b) The business buys a car for \$1,000 cash
- (c) They buy goods for resale for \$500 cash
- (d) They buy more goods for resale for \$600 on credit from Mr A
- (e) They pay rent of \$200 cash
- (f) They sell half the goods for \$800 cash
- (g) They sell the remaining goods on credit for \$900 to Mrs X
- (h) They pay \$400 cash on account of the amount owing to Mr A
- (i) They receive \$500 from Mrs X
- (j) Kristine withdraws \$100 cash from the business



5. Balancing the accounts

In the previous example we have now recorded all the entries. However, before we can go further we need to calculate the net figure, or balance, on each account.

With such a small example, the balances may be obvious. However we should balance it neatly.

The rules for balancing are:

- (a) draw total lines on both sides of the t-account
- (b) add up the bigger of the two sides and put this total on both sides of the account
- (c) fill in the missing figure on the smaller of the two sides – this figure is the balance on the account
- (d) carry forward this balance by also writing it on the opposite side of the account, below the total lines.

The figures above the total lines can now be effectively ignored, because we have replaced them by the net figure or balance, below the total lines.

Example 2

Go back to the previous example and balance off the accounts.

6. The trial balance

Although we now know the balance on each account, there are many mistakes that we could have made. For instance, when recording the transactions we could have accidentally debited and credited with different figures. A very common error is to enter (say) \$1,200 in one account but \$2,100 in the other account. This is known as a transposition error.

There is a very simple and quick check we can make to see if the debits and credits are equal.

The check is to list the balances on every account. The total of the debit balances should equal the total of the credit balances.

We call this list the Trial Balance.

Example 3

Prepare a Trial Balance from the previous example



Note that the trial balance is not a T-account – simply a list.

Note also although there must be errors if the trial balance does not balance (and we would have to check everything to find the errors), there can be errors that will not be found by preparing a trial balance.

Errors that will not be revealed from the Trial Balance:

7. Closing off the accounts

Now that we have recorded all of the transactions and have checked that the double entry is correct, we are in a position to produce the financial statements.

We do this by examining each account in turn and 'closing off'.

The rules for this are as follows:

Statement of Financial Position items:

These are assets and liabilities. They exist at the end of the period, and still exist at the beginning of the next period.

We therefore simply leave the balance on the account.

Statement of Profit or Loss items:

These are total income or expense for the period. We have now finished with the current period but wish to use the same accounts to record the income and expenditure of the next period.

We do this by opening a new account in the nominal ledger called Statement of Profit or Loss.

For items of **income**, the entry is:

Debit the Income t-account, and

Credit the Statement of Profit or Loss t-account

For items of **expenditure**, the entry is:

Debit the Statement of Profit or Loss t-account, and

Credit the Expense t-account

Example 4

For the previous example, open a Statement of Profit or Loss t-account and close off all the accounts.



8. Preparation of the Financial Statements

Having closed off all of the t-accounts, the balance remaining on the Statement of Profit or Loss account is the profit (or loss) for the period.

We can now produce a 'pretty' version of the Statement of Profit or Loss suitable for presentation to the owner by re-writing the figures from the t-account in the standard format.

The balances remaining on the accounts all represent Statement of Financial Position items. We can now list them in the standard format to produce our Statement of Financial Position.

Note that this preparation of the Statement of Financial Position and Statement of Profit or Loss does not result in any additional entries in the t-accounts.

Example 5

For the previous example, prepare a Statement of Financial Position and a Statement of Profit or Loss

9. 'Tidying up' the owner.

Although the financial statements are now finished, the amount owing to the owner at the end of the period is split between three accounts in the nominal ledger – the Capital Account, the Drawings Account, and the Statement of Profit or Loss Account.

Our very last task is to put all the balances together so that we leave on the Capital Account a balance equal to the final amount owing.

We achieve this by making the following two entries:

- (a) Debit Statement of Profit or Loss t-account, and
Credit Capital Account
with the balance on the Statement of Profit or Loss account.
- (b) Debit Capital account, and
Credit Drawings account
with the balance on the Drawings account.

Example 6

Go back to the original t-accounts and finish them by tidying up the owner's accounts.





Chapter 4

ACCRUALS AND PREPAYMENTS

1. Introduction

In the previous chapter we went through the steps for recording transactions through to the preparation of the financial statements.

However, there are four types of adjustments that the accountant will normally have to make when preparing the financial statements to deal with items that will not have been recorded on a day by day basis by the bookkeeper.

These adjustments are: accruals and prepayments; depreciation; bad and doubtful debts; and inventory.

We will deal with these adjustments separately – accruals and prepayments in this chapter, and the others in the subsequent chapters.

2. Prepayments

A prepayment is a payment in advance. For example, it is normal to pay car insurance for a whole year at the beginning of the year. If our year-end were to occur half-way through the insurance period, then we would only have actually used half of the insurance. The other half of the payment would be paid in advance, and in theory – were we to close down – would be repayable to the company. In practice, it would not be repaid because we would stay in business and use the rest of the insurance in the following period. For this reason we do not show the amount of the over-payment as an account receivable, but show it separately in the Statement of Financial Position as a prepayment.

The bookkeeper will have recorded the whole amount of the payment. However, if again we had paid for a year but only used half a year so far, then it would be wrong to show the full payment as an expense in the Statement of Profit or Loss.

We will illustrate the accounting treatment for prepayments by means of an example. At the end of this chapter we will summarise all the entries needed.

Example 1

Karen started business on 1 January 2000.

During the year to 31 December 2000, she made the following payments for insurance:

5 January 2000	\$800	for the 6 months to 30 June 2000
15 June 2000	\$2,000	for the 12 months to 30 June 2001

- Show extracts from the Statement of Profit or Loss and Statement of Financial Position
- Write up the t-account for Insurance for the year to 31 December 2000
- Close off the t-account



3. Accruals

An accrued expense (or accrual) is the name we give to an amount owing for which we have not received an invoice. For example, suppose we receive electricity bills every 3 months, at the end of March, June, September, and December. If our accounting year end occurs at the end of July, then we will owe for the electricity used in July, even though we will not receive an invoice until after the end of September. The bookkeeper will only have entered the bills received, and it is therefore up to the accountant to make an adjustment for the amount still owed.

Again, we will illustrate the entries by an example and summarise the rules at the end of the chapter.

Example 2

Amit started business on 1 April 2000, and during the year to 31 March 2001 he made the following payments in respect of telephone:

- 18 July 2000 \$500 for the 3 months to 30 June 2000
- 22 October 2000 \$600 for the 3 months to 30 September 2000
- 14 January 2001 \$750 for the 3 months to 31 December 2000

As at 31 March 2001, Amit estimated that \$950 was owing for the 3 months to 31 March 2001. He had however not received a bill from the telephone company.

- (a) **Show extracts from the Statement of Profit or Loss and Statement of Financial Position.**
- (b) **Write up the t-account for Telephone for the year to 31 March 2001**
- (c) **Close off the account**



4. Subsequent accounting periods

In both of the two previous examples, we were dealing with the first year of trading. At the end of the year we left balances on the t-accounts for Prepayments (in the case of Karen) and on Accruals (in the case of Amit).

As a result, we would start the next accounting period with a balance brought forward, and we should therefore consider what entries are needed in the second period.

We will use the same examples as before, continuing into a second year.

Firstly Karen:

Example 3

During the year to 31 December 2001, Karen made the following payment in respect of insurance:

12 June 2001 \$2,400 for the 12 months to 30 June 2002

- (a) **Write up the t-accounts for Insurance and for Prepayments for the year to 31 December 2001**
- (b) **Close off the accounts**
- (c) **Show extracts from the Statement of Profit or Loss and Statement of Financial Position**

Now Amit,

Example 4

During the year to 31 March 2002 he made the following payments in respect of telephone:

12 April 2001 \$950 for the 3 months to 31 March 2001

15 July 2001 \$1,000 for the 3 months to 30 June 2001

24 October 2001 \$1,200 for the 3 months to 30 September 2001

12 January 2002 \$1,350 for the 3 months to 31 December 2001

As at 31 March 2002, Amit estimated that \$1,500 was owing for the 3 months to 31 March. He had however not received a bill from the telephone company.

You are required to:

- (a) **write up the t-accounts for Telephone and for Accruals for the year to 31 March 2002**
- (b) **close off the accounts**
- (c) **show extracts from the Statement of Profit or Loss and Statement of Financial Position**



4. Summary of entries

(a) Prepayments

1. Reverse any Prepayments brought forward:

DR Expense Account (e.g. Insurance, Rates)
CR Prepayments Account

2. Enter any payments during the period:

DR Expense Account
CR Cash Account

3. Enter any prepayments at the end of the period:

DR Prepayments Account
CR Expense Account

4. Close-off the accounts:

Transfer the balance on the expense account to the Statement of Profit or Loss.

DR Statement of Profit or Loss t-account
CR Expense Account

Leave the balance on the prepayments account and show in the Statement of Financial Position.

(b) Accruals

1. Reverse any accruals brought forward:

DR Accruals Account
CR Expense Account (e.g. Telephone, Electricity)

2. Enter any payments during the period:

DR Expense Account
CR Cash Account

3. Enter any accruals at the end of the period:

DR Expense Account
CR Accruals Account

4. Close-off the accounts:

Transfer the balance on the expense account to the Statement of Profit or Loss.

DR Statement of Profit or Loss t-account
CR Expense Account

Leave the balance on the accruals account and show in the Statement of Financial Position.

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Chapter 5

IAS 37 – PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

1. Definitions

A **provision** is a liability where the timing or the amount is uncertain.

A **contingent liability** is a liability that may result, but depends (or is contingent) on the outcome of uncertain events.

For example, the company may have been taken to court, but the outcome of the case is not yet known. If they lose the case then they may have to pay a fine. There is therefore a potential liability, but it is not certain. The question is as to whether or not we show the potential liability in the accounts.

A **contingent asset** is where there may be an asset resulting for the company, but, again, it is not certain.

2. The requirements of IAS 37:

Provisions:

If the payment is **probable** (i.e. more than 50% likely) then the liability should be recognised in the financial statements.

If the payment is **possible** (i.e. between 5% and 50% likely) then the liability is not recognised in the financial statements, but should be disclosed by way of a note.

If the payment is **remote** (i.e. less than 5% likely) then it is not recognised in the financial statements and nor is it disclosed by way of a note.

Contingent liabilities:

These are disclosed as notes to the statements (but not accrued) unless the likelihood of payment is **remote** (less than 5%) in which case there is no disclosure required.

But, if a past event has given rise to the possible obligation (for example, a lawsuit) then it is treated as a provision and if the payment is **probable** (i.e. more than 50% likely) then it should be recognised in the financial statements.



Contingent assets:

If **virtually certain** (i.e. more than 95% likely) then it is not a contingent asset and should be recognised.

If **probable** (i.e. more than 50% likely) then it should be disclosed by way of a note to the financial statements.

(If the likelihood is only either **possible** or **remote** (i.e. less than 50%) then no recognition and no disclosure by way of note.)

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Chapter 6

DEPRECIATION

1. Introduction

In this chapter we will explain what depreciation is and why it is needed. We will also look at the different methods of calculating depreciation of which you need to be aware, and the accounting entries.

2. Non-current assets

A non-current asset is an asset intended for use on a continuing basis in the business.

A tangible non-current asset is one that can be touched and refers to such items as plant, buildings and motor vehicles.

A non-tangible non-current asset is one that cannot be touched and refers to such items as goodwill and patents (we will cover these in a later chapter).

3. Depreciation

Depreciation is the charging of the cost of a non-current asset over its useful life.

The purchase of a car for \$10,000 is an expense of running the business just as electricity is an expense. However, if the car is expected to last 5 years, it would be misleading to have one expense in the Statement of Profit or Loss of \$10,000 every 5 years and nothing in the other years. It would be more sensible to reflect the fact that the car is being used in the business over 5 years by charging an expense each year of (say) \$2,000.

The charge of \$2,000 in the Statement of Profit or Loss each year is known as depreciation. At the same time, the Statement of Financial Position value of the car will be reduced by \$2,000 each year to reflect the fact that it is being used up.

The way in which \$2,000 was calculated in the above illustration is known as the straight-line method of depreciation. There are other methods and we will cover the methods that you need to know in the following sections of this chapter.

The purpose of depreciation is not to place a true value on the asset in the Statement of Financial Position. It is a method of applying the accruals, or matching, concept by charging the cost of the asset to the Statement of Profit or Loss as it is being used up.



4. Methods of calculating depreciation

There are several methods of calculating depreciation. The methods that you are expected to be aware of are the following:

- straight line method
- reducing balance method

These are the most common methods in practice.

Straight line method

Under this approach we charge an equal amount of depreciation each year.

The depreciation charge each year is calculated as:

$$\frac{\text{Original cost} - \text{residual value}}{\text{Estimated useful life}}$$

Example 1

Sarkans has a year end of 31 December each year.

On 1 April 2002 he purchases a car for \$12,000. The car is expected to last for 5 years and to have a scrap value at the end of 5 years of \$2,000.

You are required to calculate the depreciation charge for each of the first three accounting periods, and to show extracts from the Statement of Financial Position and Statement of Profit or Loss for each of the three accounting periods.

(Note, in the first accounting period we have charged a fraction of the annual depreciation because the asset was purchased during the year. A very common alternative in practice is to charge a full year in the year of purchase, regardless of when in the year it was actually purchased. In the examination, read the question carefully. If you are told to charge a full year in the year of purchase then do so. If you are not told, then charge a fraction (or time-apportion) as above.)



Reducing balance method

Under this approach we charge more depreciation in the early years of an asset's life, with a progressively lower charge in each subsequent year.

The depreciation charge each year is a fixed percentage of the net book value (or written down value) at the end of the previous year.

Example 2

Zils has a year end of 31 December each year.

On 5 April he purchased a machine for \$15,000.

His depreciation policy is to charge 20% reducing balance, with a full years charge in the year of purchase.

You are required to calculate the depreciation charge for each of the first three accounting periods, and to show extracts from the Statement of Financial Position and Statement of Profit or Loss for each of the three accounting periods.

5. Accounting for depreciation

Whichever method is used, the accounting entries are the same.

We will illustrate the required entries using an example, and will then summarise the entries afterwards.

Example 3

Melns has a year end of 30 June each year.

On 1 January 2002 he purchased a car for \$15,000.

The car has an expected life of 5 years, with an estimated scrap value of \$1,000.

Melns depreciation policy is to use straight line depreciation.

Show the accounting entries for the first three accounting periods.

The accounting entry for charging depreciation each year is:

Debit Depreciation Expense account

Credit Accumulated Depreciation account

The balance on the Depreciation Account will appear in the Statement of Profit or Loss as an expense.

The balance on the Accumulated Depreciation account will appear in the Statement of Financial Position as a deduction from the cost of the asset.



6. Sale of non-current assets

In practice it is unlikely that an asset will be kept for the precise useful life that was estimated for depreciation purposes – it might be kept for a longer period or for a shorter period. It is also extremely unlikely that any sale proceeds will exactly equal the value of the asset as shown in the financial statements.

On sale, we remove the asset from our books and calculate any difference between the proceeds and the value in the financial statements. This difference (which is really the effective over or under charge of depreciation) is called the profit or loss on sale and is shown in the Statement of Profit or Loss.

Example 4

In example 3, Melns sells the car on 30 September 2004 for \$6,500.

Write up the ledger accounts for his fourth accounting period and show extracts from his Statement of Financial Position and Statement of Profit or Loss.

Note that in this example we have charged depreciation in the year of sale for the 3 months the car was owned. Very often you will be told that the depreciation policy is to charge no depreciation in the year of sale. The net result in the Statement of Profit or Loss will be exactly the same.

Summary of the accounting entries for the sale of a non-current asset:

DR Disposal Account

CR Asset Account

with the cost of the asset sold

DR Accumulated Depreciation Account

CR Disposal Account

with the accumulated depreciation on the asset sold

DR Cash

CR Disposal Account

with the proceeds of sale

The balance remaining on the Disposal Account is the profit or loss on sale. This should be transferred to the Statement of Profit or Loss.



7. Revaluation of non-current assets

During a period of high-inflation, the value of non-current assets may be well in excess of their net book value.

In this situation a company may choose to show the current worth of such assets on their Statement of Financial Position.

Any profit resulting from such revaluation is an unrealised profit (in that the asset has not been sold and therefore no real profit has actually been made). As a result, the profit is shown separately from the Statement of Profit or Loss in a revaluation reserve. (For a limited company this must be the case. For a sole trader, where the owner has unlimited liability, this is not a rule even though it is good practice.)

IAS 16 Property, Plant and Equipment requires that when an item of property, plant or equipment is revalued, then the entire class of property, plant and equipment to which the asset belongs must be revalued.

When a non-current asset has been revalued, the future charge for depreciation should be based on the revalued amount and the remaining economic life of the asset.

The depreciation charge will be higher than it was before the revaluation, and then excess of the new charge over the old charge should be transferred from the revaluation reserve to accumulated profits.

Example 5

Purpurs has a year end of 31 December each year.

In his Statement of Financial Position as at 31 December 2002 he has buildings at a cost of \$3,600,000 and accumulated depreciation of \$1,080,000.

His depreciation policy is to charge 2% straight line.

On 30 June 2003, the building is to be revalued at \$3,072,000. There is no change in the remaining estimated useful life of the building.

Show the relevant ledger accounts for the year to 31 December 2003.





Chapter 7

THE PROVISIONS OF IAS 16 PROPERTY, PLANT AND EQUIPMENT

1. The main points of IAS 16 are as follows:

- the conditions for recognition of a tangible non-current asset are that
 - i) it is probably that future benefits will flow to the enterprise from the asset
 - ii) the cost of the asset can be measured reliably
- depreciation should be charged over the useful life of the asset. Land normally has an unlimited life and therefore does not require depreciation.
- any upward revaluation should be credited to a revaluation reserve. Any downward revaluation should be charged as an expense in the Statement of Profit or Loss.
- if one asset in a class is revalued, then all assets in that class should be revalued.

2. Disclosure requirements

The following should be disclosed in the financial statements:

- (a) the methods of depreciation used
- (b) the total cost of each asset heading, and the related accumulated depreciation, at the beginning and end of the period.
- (c) a reconciliation of the net book value at the beginning and end of the period, showing additions, disposals, revaluations, and depreciation.

(We will look at examples of the layout in the later chapter on limited companies financial statements.)





Chapter 8

IRRECOVERABLE DEBTS AND ALLOWANCES

1. Introduction

In this chapter we will consider what a company should do in the situation where an accounts receivable does not pay his debt, or where there is some doubt about the eventual payment of all or part of the debt.

We will examine both the accounting entries and the presentation in the financial statements.

2. Definitions

An **irrecoverable debt** is where we are reasonably certain that the receivable is not going to pay. For example, the customer may have died leaving no assets, or may have disappeared without trace.

A **doubtful debt** is where we are worried that the receivable might not pay. For example, the debt may have been outstanding for some time and the customer may not be replying to letters.

(Note that obviously if a customer refuses to pay we are at liberty to take them to court. However, it may be that the costs of going to court will be more than the amount of the debt and that therefore we decide not to do so.)

3. Treatment in the financial statements

It is important that we do not overstate assets in the Statement of Financial Position (that we apply the prudence concept) and that therefore we should only show the receivables that we feel confident will pay.

Equally, if we realise that we might not receive payment (and therefore lose money) we should show this as an expense in the Statement of Profit or Loss as soon as any doubt arises.

As a result the treatment is as follows:

Irrecoverable debts:

These are removed completely, and will no longer appear as part of accounts receivable.

Doubtful debts:

We will leave the debt outstanding as part of accounts receivable (because we are still trying to collect the money), but we will deduct from receivables an "allowance for receivables" equal to the amount of any doubtful ones, so that the net figure left in the Statement of Financial Position is the total receivables for which we foresee no problem.



Specific allowance for receivables:

This is an allowance for particular (or specific) debts, where we know that there is a problem (for example, the debt has been owing for a long time).

General allowance for receivables:

It may be that in our company it is the nature of the business that on average (say) 5% of our debtors end up not paying. However, it may be that at the year-end all of the individual debts are reasonably recent and we have no way of identifying which particular customers will end up not paying. We do feel, however, that probably 5% of them will not pay. Again, to be prudent, we will deduct 5% from receivables to leave only the amount we are reasonably certain of. As this 5% does not relate to any specific customer, we call it a general allowance for receivables.

In all cases, the cost of removing irrecoverable debts and of allowing for doubtful debts is charged as an expense in the Statement of Profit or Loss.

Example 1

At the end of the first year of trading there is a balance on the receivables account of Street of \$62,500.

On investigation, this amount is found to include two debts from A plc and B plc which are to be regarded as irrecoverable. The amounts owing are \$2,500 and \$1,600 respectively.

In addition there is \$2,800 owing from Z plc which is regarded as doubtful.

Street has a policy of maintaining a general allowance for receivables of 4%.

Show extracts from the Statement of Financial Position and Statement of Profit or Loss of Street.



4. The accounting entries

Each individual entry that can be required is very easy. The problem in examinations results from the fact that there can be many accounting entries required in a question and it is easy to get lost!

We will illustrate the necessary entries using two worked examples.

Example 2

Cilla started business on 1 January 2000. As at 31 December 2000, the balance on her Receivables Account was \$82,000.

On investigation this was found to include the following debts:

- (a) John owed \$5,000 which is irrecoverable
- (b) George owed \$8,000 and is a doubtful debt
- (c) Paul owed \$3,000 which is irrecoverable
- (d) Ann owed \$2,000 and is a doubtful debt

In addition it had been decided to have a general provision of 4% of remaining debts.

- (a) **Write up the Accounts Receivable, Irrecoverable debts Expense, and Allowance for Receivables accounts**
- (b) **Show extracts from Cilla's Statement of Financial Position and Statement of Profit or Loss**



To be able to illustrate all of the possible entries, we now need to look at the position in the following year.

Example 3

During the year ended 31 December 2001, Cilla had made sales on credit of \$261,000 and had received cash from customers of \$238,000.

These amounts had been entered into the Receivables Account, and a balance extracted.

On investigation, the following was discovered:

- (a) Paul had paid \$2,200 of his previously irrecoverable debt (we do not expect to receive any more)
- (b) George had still not paid the \$8,000 owing, and must now be regarded as irrecoverable
- (c) Ann had paid her debt of \$2,000 in full
- (d) Ringo was owing \$4,000 which is irrecoverable
- (e) Mick was owing \$6,000 and is a doubtful debt
- (f) It was decided to maintain the general allowance for receivables at 4% of the remaining debts

(Note: the amounts received from Paul and Ann are included in the total cash receipts for the year of \$238,000)

- (a) **Write up the Accounts Receivable, Irrecoverable Debts Expense, and Allowance for Receivables accounts**
- (b) **Show extracts from Cilla's Statement of Financial Position and Statement of Profit or Loss**

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Chapter 9

INVENTORY AND IAS 2

1. Introduction

In this chapter we will look at the adjustment for inventory. Although the actual entries are very simple indeed, they may seem a little strange because with modern computerised accounting it is now common to have continuous accounting for inventory. This will be explained within the chapter. We will also consider the methods of valuing inventory and the provisions of IAS 2 Inventories.

2. The accounting entries

You will recall that whenever we buy goods for resale we debit a purchases account, and that whenever we sell goods we credit a sales account. In all of the examples in these notes until now there has been no inventory at the end of the period and therefore the gross profit was simply the difference between the sales and the purchases.

No entries have been made to an inventory account as part of the day to day bookkeeping, and this will remain the case. Any inventory left at the end of the period will be adjusted for by the accountant when preparing the financial statements.

We will explain the necessary entries by way of three very short examples. Firstly with no inventories; secondly with inventory at the end of the period; and thirdly with inventory at both the beginning and end of the period.

Example 1

In year 1 (the first year of trading), a business had purchases of \$20,000 and sales of \$30,000. There was no inventory at the end of the period.

- (a) **Show the trading account of the business for year 1, in a form suitable for presentation to the owners, and**
- (b) **Write up the accounts for purchases and sales, and close them off at the end of the year.**



Example 2

In year 2, the business had purchases of \$25,000 and made sales of \$34,000. There was inventory at the end of the period of \$4,000.

- (a) **Show the trading account of the business for year 2, in a form suitable for presentation to the owners, and**
- (b) **Write up the accounts for purchases, sales, and inventory, and close them off at the end of the year.**

Example 3

In year 3, the business had purchases of \$38,000 and made sales of \$50,000. There was inventory at the end of the period of \$6,000.

- (a) **Show the trading account of the business for year 3, in a form suitable for presentation to the owners, and**
- (b) **Write up the accounts for purchases, sales, and inventory, and close them off at the end of the year.**

Summary of the accounting entries

At the end of each period, two entries are required:

- (a) remove the opening inventory:

Debit	Statement of Profit or Loss account
Credit	Inventory account
- (b) create the closing inventory

Debit	Inventory account
Credit	Statement of Profit or Loss account

Note that the Inventory account does not keep a day-by-day record of inventory and is therefore only correct at the end of each period after the adjusting entries have been made.



3. The valuation of inventory

The figure for the closing inventory in the above examples would have come from physically counting the inventory. (There are often day by day inventory records kept, but because of the importance of the accuracy of the figure a physical count would still be made as a check.)

The basic rule for valuation is:

Inventory should be valued at the lower of cost and net realisable value.

Cost is the cost of getting the goods to the state that they are in.

Net realisable value is the selling price less any extra costs that there will be in order to get the goods in a state to be sold.

Normally the lower of the two will be the cost (otherwise the business would always be making losses). However, there can be occasions (such as damaged, or obsolete items) when the net realisable value is the lower.

This rule is an application of the prudence concept, in that we will only take profit when it is actually realised (the reason for normally valuing at cost), but that we should charge any loss as soon as it is foreseen (the reason for valuing at net realisable value if this is lower than the cost).

Example 4

A company has closing inventory as follows:

<i>Item</i>	<i>Units</i>	<i>Cost p.u. to date</i>	<i>Estimated further costs to be incurred p.u.</i>	<i>Estimated final selling price p.u.</i>
A	100	10	3	15
B	200	12	5	16
C	150	6	4	11

Calculate the total value of inventory at the end of the period.



4. The determination of cost

The rule in section 3, i.e. that we value at the lower of cost and net realisable value, always applies. However, the cost of an item may not be as obvious as might be seemed.

Suppose that we buy and sell lamps. During the year we have bought 10,000 lamps and at the end of the year we have 1,000 left in inventory.

What was the cost of these 1,000 lamps? The cost is obviously what we paid for them! Suppose at the beginning of the year we were having to pay \$1 a lamp but there have been large price increases and by the end of the year we were having to pay \$5 a lamp (for identical lamps). Are the ones that we have left in inventory old ones (that therefore cost \$1 each) or new ones (that therefore cost \$5 each)?

Unless the cost is actually marked on each lamp, the only way in which we can establish a cost it to have a policy of valuation.

There are four approaches that you should be aware of:

(a) unit cost

This is where we can establish the cost of each individual item (e.g. the cost is marked on each item).

(b) FIFO: first-in-first-out

With this approach we value inventory on the basis that every time we sold items during the year we were selling the oldest ones first

(c) Average cost

Under this approach we value the inventory remaining after each sale at the average cost of the inventory prior to the sale.

(d) Selling price less an estimated profit margin

The first and last approaches do not need illustrating. We will explain the other two approaches by means of an example.



Example 5

On 1 November 2002 a company held 300 units of finished goods valued at \$12 each.

During November the following purchases took place:

<i>Date</i>	<i>Units purchased</i>	<i>Cost per unit</i>
10 November	400	\$12.50
20 November	400	\$14
25 November	400	\$15

Goods sold during November were as follows:

<i>Date</i>	<i>Units sold</i>	<i>Sales price per unit</i>
14 November	500	\$20
21 November	400	\$20
28 November	100	\$20

Calculate the value of the closing inventory applying the FIFO and average cost bases of valuation.

(a) FIFO

(b) Average cost

3. The provisions of IAS 2: Inventories

The following are the main provisions of the accounting standard:

- (a) Inventories should always be valued at the lower of cost and net realisable value
- (b) The cost of inventories should include all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition.

Overhead expenses which should be excluded from cost are:

- selling costs
- storage costs
- abnormal wastage
- administrative costs

(i.e. only the costs of production should be included)

- (c) For measuring cost, unit cost should be used if costs can be specifically identified. However, if this is not possible, then the benchmark treatments are FIFO and average cost.
- (d) Disclosure requirements:
 - the accounting policy for valuation
 - the inventory total, analysed appropriately
 - the amount of any inventories valued at net realisable value



4. Continuous inventory recording

In the accounting entries illustrated in section 2 of this chapter, the only entries for inventory are made at the end of the period. The inventory account does not keep a day to day record of inventory.

However, in practice it is very common to keep day by day records of inventory, and often (due to the use of computers) these are integrated into the accounting. When this happens, then a record is kept of each movement of inventory.

Although this would make the day by day accounting slightly different, the need to physically count the inventory at the end of the period would remain (as a check on the records). Also, the valuation rules will remain – for example, any damaged inventory might need to be valued lower.

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Chapter 10

BOOKS OF PRIME ENTRY

1. Introduction

We have now covered all of the day-to-day bookkeeping (and also the four types of adjustment required for preparation of the financial statements). However, it would be far too time-consuming for all but very small businesses to record every single transaction in the way we have been doing.

In practice we make the process more efficient by listing each transaction in one of several books (known as the books of prime entry) and only make the double entries in the nominal ledger at the end of each month using the totals from the books of prime entry.

2. The Books of Prime Entry

As stated in the introduction, these are books in which we simply list each transaction as it occurs. (They are also called Books of First or Original Entry). They do not form part of the double entry – they are simply lists – but they do mean that we have a record.

At the end of each month we will take the totals from these books and perform the double entry in the nominal ledger accounts.

Each business will keep whatever books of prime entry that it finds useful, however the main ones (of which you should be aware) are the following:

The Cash Book

This will list all receipts and payments in and out of the bank.

It will usually be split into two books – one for receipts and one for payments.

The Purchases Journal (or purchase day book)

This will list all purchases on credit

The Sales Journal (or sales day book)

This will list all sales on credit

The Petty Cash Book

The will record all receipts and payments of loose cash.

The Journal

This will be used to record any other, less common, transactions that are not covered by the other books.

(The entries for dealing with the Inventory at the end of a period, that we covered in the previous chapter, are an example of a transaction that may be recorded in this book).



3. The Receivables and Payables Ledgers

You will remember that in the Nominal Ledger we have a Receivables Account and a Payables Account. The balances on these accounts represent the total receivables and total payables respectively. However, they do not show the amounts owing from or to each individual customer or supplier.

This is fine for the Statement of Financial Position – all we need is the total receivables and total payables. However, we obviously need a day by day record for each individual customer and each individual supplier, in order to be able to chase customers and to know how much to pay each supplier.

A record of how much each customer is owing to us will be kept in the Receivables Ledger. There will be an account for each customer and an entry will be made every time we make a sale or receive cash. The information will be obtained from the Sales Journal and from the Cash Receipts Book.

It is extremely important to note that the Receivables Ledger is not normally part of the double entry system of the business, but it simply a memorandum (or note) record of the amount owing to us by each individual.

In a similar way a record will be kept of how much we are owing to each individual supplier in the Payables Ledger.

A comprehensive illustration

Pattie started business on 1 January 2008 as a trader in chairs. Her transactions during her first month were as follows (in date order):

- (a) She paid \$6,000 into a separate bank account for the business.
- (b) The business bought chairs for \$1,600 cash.
- (c) The business sold some of the chairs for \$1,200 cash.
- (d) The business bought a van for \$2,500 cash
- (e) The business bought more chairs for \$400, on credit from Chris.
- (f) The business bought more chairs for \$800 from Chris, on credit
- (g) The business bought chairs for \$600 on credit from William
- (h) The business sold some of the chairs for \$2,100 to Ann on credit.
- (i) The business sold some chairs for \$350, on credit to Edwina
- (j) The business sold some chairs on credit for \$700 to Andrew
- (k) Rent for the month was paid of \$300
- (l) Paid three quarters of the amount due to Chris
- (m) Received \$1,000 from Ann in respect of the amount owing by her
- (n) Pattie paid another \$4,000 of her own money into the business bank account
- (o) Chairs were purchased on credit from William for \$1,000, and on credit from Bertha for \$1,600
- (p) Chairs were sold for \$1,350 on credit to Tony
- (q) Chairs were sold to George for \$2,100 on credit



- (r) The business paid wages of \$400 to the shop assistant
- (s) Pattie withdrew \$700 cash from the business bank account, for herself.
(there was no closing inventory)
- (a) **Write up the books of Prime Entry for the month**
- (b) **Write up the relevant accounts in the Receivables and Payables Ledgers**
- (c) **Post the totals from the Books of Prime Entry to the relevant accounts in the Nominal Ledger**
- (d) **Prepare a Trial Balance at the end of the month.**

5. A diagram of the complete bookkeeping system



6. The petty cash book

In the above example, there was no petty cash. This is very common in examinations, and 'cash' refers to all cash – we do not separate between cash at bank and petty cash.

However, in practice there will be two records kept of cash – the cash receipts and cash payments books will record cash in and out of the bank, whereas the petty cash book will record cash in and out of the petty cash box (the loose cash).

Normally this book will record both receipts and payments (in one book) since there are unlikely, in most businesses, to be many transactions. It is also often the only book of prime entry that is actually part of the double entry bookkeeping i.e. we will actually debit the petty cash book with receipts.

Since most companies will have expenditure from petty cash, but no receipts of loose cash, money will periodically have to be taken from the bank. If this is not controlled properly, there is a danger of theft by an employee. One very standard way of controlling is the **imprest system** of petty cash, whereby cash is drawn from the bank at regular intervals e.g. weekly, and the amount drawn is exactly equal to the amount spent during the previous week. As a result the balance is always 'topped up' to the same fixed amount, which fixes an upper limit on the amount that could ever be stolen.

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Chapter 11

JOURNAL ENTRIES

1. Introduction

We mentioned in the last chapter that one of the books of prime entry is known as the journal, and is used to list unusual transactions.

A journal entry is an entry in this book. However, it is also used in the examination to refer to any entry that is written down in words (as opposed to actually entered in t-accounts).

In this chapter we will explain how journal entries are written in the examination.

2. The format of journal entries

A journal entry is the name given to an entry that is written in words

The format is always as follows:

- (a) write the debit entry first, followed by the credit entry on the next line.
- (b) write below the entry a brief description of why the entry is to be made. This is known as the narrative.

Example 1

The business purchases goods for resale from Mike for \$2,500 on credit.

You are required to write down the journal entry for this transaction.





Chapter 12

SALES TAX

1. Introduction

In this chapter we will explain the principles of the operation of a sales tax (e.g. VAT in the UK).

We will also explain how to calculate the sales tax on transactions, and the effect on the accounting entries.

2. The principles of sales tax

If a business is registered with the state for sales tax, then they are required to add the tax to the price of all their sales. They are acting as tax collectors for the state, and the tax that they have charged on their sales is payable to the state periodically (in some countries it is accounted for monthly and in some countries three-monthly). The tax charged on their sales is known as **output tax**.

However, the business will have suffered (i.e. will have been charged) sales tax on their purchases. The tax they have suffered is known as **input tax**.

At the end of each period, the excess of the output tax collected by the company over the input tax suffered by the company is payable to the state.

If in any period the input tax exceeds the output tax then the difference will be repaid by the state.

Illustration:



3. The calculation of sales tax

The rate of sales tax is determined by the state and differs from country to country. Also, many countries have different rates of sales tax depending on the nature of the item being sold.

Some businesses quote their selling price without sales tax, and then add the relevant percentage. Other businesses (particularly shops selling to the general public) quote a selling price including sales tax.

It is important in the examination to be able to identify the net sales price, the gross sales price, and the amount of sales tax.

Example 1

Alpha sells goods at a net (or tax exclusive) price of \$150.

The rate of sales tax is 16%.

What is the gross (or tax inclusive) selling price?

Example 2

Beta sells goods at a gross (or tax inclusive) price of \$120.

The rate of sales tax is 16%.

What is the net (or tax exclusive) selling price, and what is the amount of the sales tax?

Example 3

Gamma sells goods at a gross (or tax inclusive) price of \$220.

The rate of sales tax is 17.5%.

What is the net (or tax exclusive) selling price, and what is the amount of the sales tax?



4. The accounting entries

Input tax

When a company makes purchases, the amount charged will include sales tax, but the tax suffered will be recovered from the state.

The entry is therefore:

Dr Purchases (with the net cost)
Dr Sales tax (with the amount of the tax)

Cr Payables / Cash (with the gross cost)

Output tax

When a company makes sales, the amount charged includes sales tax, but the tax collected will be paid to the state.

The entry is therefore:

Dr Receivables / Cash (with the gross amount)

Cr Sales (with the net amount)
Cr Sales tax (with the amount of the tax)

The balance on the Sales Tax account will represent the amount of sales tax owing to or from the state.

If, at the end of the period, there is a credit balance, then the balance will be paid to the state:

Dr Sales tax
Cr Cash

If alternatively there is a debit balance, then the state will repay the business:

Dr Cash
Cr Sales tax

(**note** that more commonly a debit balance is not repaid, but is left on the account to reduce the payment to the state in the following period)



Example 4

Delta's purchases and sales for December are as follows:

	<i>Net</i>	<i>Sales tax</i>	<i>Gross</i>
Purchases on credit	432,000	75,600	507,600
Sales on credit	624,000	109,200	733,200

Record these transactions in the ledger accounts.

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Chapter 13

ACCOUNTING FOR LIMITED COMPANIES

1. Introduction

Most of our examples so far have related to sole traders. In this chapter we will consider limited companies.

All the day to day double entries are as we have covered, but there are various differences that we need to consider in terms of the layout of the financial statements and the terminology,

2. The key features of a limited company

A limited company is a separate legal entity

The owners of the company (shareholders) are separate from the management (directors)

The shareholders have limited liability for the debts of the company

There are more formalities required (e.g. disclosure, audit)



3. Share capital

The capital paid in by the owners is known as share capital, and each shareholder receives a certificate stating how many shares he owns.

Each share has a **nominal value**. This is the amount printed on the share. However, this is not necessarily the amount of capital that was paid in – simply the minimum price at which shares may be issued. (Any excess paid when shares are issued is known as the share premium – this will be dealt with later in this chapter).

The amount of the dividend will often be expressed in relation to the nominal value.

For example, if a company has shares with a nominal value of \$1 and declares a dividend of 10%. The dividend will be 10% of \$1 – i.e. 10c.

The nominal value bears no relationship to the market value. The **market value** is the amount at which shares may be traded between shareholders and shareholders will hope that this will rise over time. There is no direct relevance of the market value to the company (and it will not be shown in the financial statements), but the company will be concerned with it – partly because shareholders will be wanting the market value to increase, and partly because a falling market value will make it harder for the company to raise more finance.

4. Types of shares

The share capital may be of two types – ordinary shares and preference shares.

Ordinary Shares

These are the normal shares – they give the owners the right to vote at company meetings and to receive dividends.

The amount of the dividend will be recommended by the directors, but will be voted on by the shareholders, and will vary according to the level of profits made by the company.

Dividends are often paid twice a year – one payment during the year (an **interim dividend**) and one payment after the end of the year when the profit is known (a **final dividend**).

Dividends are not an expense of the company, but an appropriation of the profit (equivalent to drawings for a sole trader).

Ordinary shares are sometimes referred to as **equity shares**.

Preference Shares

Preference shares carry a fixed rate of dividend, and this dividend must be paid before any ordinary dividend.

If the profits are not sufficient to cover the preference dividend, then the preference shareholders get whatever there is and the ordinary shareholders get nothing.



5. Issue of shares

The company can issue shares at any price it wants, provided that it is not less than the nominal value (the amount printed on the shares and stated in the statutes of the company).

If shares are issued at a price higher than the nominal value, then the extra is known as **share premium**.

The total raised is effectively the capital, but it is shown as two separate items on the Statement of Financial Position – share capital (the nominal amount) and share premium (the excess).

Example 1

A company is formed on 1 January 2003 and issues 10,000 \$1 shares at a price of \$1.20 each.

Show what will appear in the Statement of Financial Position under the heading 'equity'.

Rights issues and public issues

There are two main ways in which a company can raise more capital from shareholders.

Rights issue

This is an offer of shares to existing shareholders.

The offer must be to all existing shareholders in the same ratio.

Example 2

A company is formed by the issue of 10,000 \$1 shares at a price of \$1.20 per share.

5 years later, the company has a rights issue of 1 for 5 at \$3 per share.

Show what will appear on the Statement of Financial Position under the heading 'equity' after the rights issue (assuming that all of the rights are taken up).

If a shareholder does not want to take up his rights then he does not have to. He can however sell the rights to others and they are then entitled to buy the shares.

Public issue

A public issue is an issue of shares to the general public. The issue is normally advertised in the newspapers and anybody can apply to buy shares.

This will normally be relevant only for companies wishing to raise large amounts of money.

In order to be able to have a public issue, the company must have the permission of existing shareholders and must also become a plc (or public limited company) which normally carries with it more legal requirements.



6. Reserves

'Reserves' is the name given to anything owed to the shareholders above the share capital.

The share premium is one example of a reserve – it is owed to the shareholders, but is classified on the Statement of Financial Position separately from the share capital.

Another example is accumulated profits (or retained earnings). With a sole trader, the capital keeps increasing with any profits made and reducing due to any drawings. For a limited company, the total profits less dividends to date are shown as a separate item on the Statement of Financial Position (under the heading 'capital' or 'equity').

Again, this is an example of a reserve in that it is money owed to the shareholders, but is separate from the share capital.

Other reserves that you should be aware of are:

Revaluation reserve

Any profit on revaluation of an asset is not shown on the Statement of Profit or Loss, but is kept separately in a Revaluation Reserve. This is because it is a profit that has not been realised. It is a requirement that this profit be kept separate.

Plant replacement reserve

This is not a legal requirement, but is quite common. Most companies will not distribute all their profits as dividends, but will retain some in order to finance the expansion of the company. Even if the company is not expanding, the assets will need replacing in time and again, the company will need to retain some profits in order to finance it.

In order to ensure that shareholders are aware as to why profits are being retained, some companies will transfer some of the profits to a plant replacement reserve. This is still money owed to the shareholders and is shown as part of the total equity, but showing it as a separate item makes the reason more clear to the shareholders.

Capital and Revenue Reserves.

It is a rule that a company may only distribute to shareholders (as dividend) any realised profits that have been made. Anything else – original capital or unrealised profits may not be distributed as dividend. They may only be paid to shareholders if the company closes down, and only then provided that all liabilities have been paid off in full.

Capital reserves are those reserves that may not be distributed as dividends. The two examples of which you must be aware are Share Premium account and Revaluation account.

Revenue reserves are those reserves that may be distributed as dividends. Examples of which you should be aware are Retained Earnings and Plant Replacement Reserve.

The reason for this rule about only being able to distribute realised profits is to protect creditors. If the rule did not exist then it would be possible to create fictitious profits by, for example, revaluing assets. The high profits could then be used to pay high dividends, leaving nothing for the creditors! This clearly can not be allowed.



7. Bonus issue of shares

A bonus issue of shares (or a **scrip issue, or capitalisation issue**) is an issue of free shares to existing shareholders, in proportion to their existing shareholdings. It is done by using the reserves of the company.

No cash or other consideration is passed from the shareholders to the company.

The bonus issue is financed from reserves, and the necessary bookkeeping entry is:

Debit	Reserves
Credit	Share Capital

Any reserve may be used to finance the bonus issue. However, capital reserves will be used in preference to revenue reserves.

- The total amount owing to shareholders in the Statement of Financial Position will not change, and the issue of bonus shares is generally used as a way of 'tidying up' the Statement of Financial Position.

8. Types of debt

A company may have long term debt borrowings, just as a sole trader.

However, although they may have simple long term loans, it is common to issue debt and therefore raise the finance from many people instead of just from one source.

Debt is issued in a similar way to share capital, and the lenders will receive a certificate. However, it is only debt and the lenders will receive fixed interest each year, which is an expense in the Statement of Profit or Loss.

The treatment in the Statement of Financial Position is no different from that for a sole trader – it is shown under the heading 'non-current liabilities'. It can have several names – e.g. 10% debentures; 8% loan notes; 9% bonds. In each case the quoted % refers to the rate of interest that has been promised.

9. Taxation

A limited company is a separate legal entity and therefore will pay tax. (A sole trader will pay tax, but as an individual on all his income. The business itself is not a legal entity and will not itself pay tax).

As a result, there will normally be a tax expense in the Statement of Profit or Loss of a company. Also, since it is not normally possible for the tax to be calculated until the end of the year, there will normally be a liability for tax on the Statement of Financial Position (a current liability).

You cannot be expected to calculate tax in this examination.



10. The layout of Financial Statements

The layout of the financial statements is very similar to that of a sole trader. There are however a few important differences:

- (a) the capital will be shown differently in the Statement of Financial Position
- (b) the company will prepare two Statements of Profit or Loss, one for internal management use which is exactly the same as for a sole trader, but also a summarised version. The reason is that the financial statements of a limited company are available to the general public and they are therefore only required to make a summary version available.
- (c) the financial statements will also include a 'Statement of Changes in Equity' in order to inform shareholders as to why the equity balances have changed over the year.

Note that a limited company will normally also be required to produce a Statement of Cash Flows. We will deal with this in a separate chapter

(Note also, that in practice the financial statements will always show last years figures also (or comparative figures). However you will never be required to show these in examinations.



Statement of Financial Position as at 31 December 2008

ASSETS	\$	\$
Non-current assets		
Property, plant and equipment	100,000	
Goodwill	<u>20,000</u>	
		120,000
Current assets		
Inventories	5,000	
Trade receivables	8,000	
Prepayments	500	
Cash	<u>1,500</u>	
		15,000
Total assets		<u>135,000</u>
EQUITY AND LIABILITIES		
Capital and reserves		
Share capital	50,000	
Capital reserves	15,000	
Retained earnings	<u>42,000</u>	
		107,000
Non-current liabilities		
10% Loan Notes	<u>20,000</u>	
		20,000
Current liabilities		
Trade and other payables	6,000	
Short term borrowings	<u>2,000</u>	
		8,000
Total equity and liabilities		<u>135,000</u>



Statement of Profit or Loss for year ended at 31 December 2008

	\$
Revenue	100,000
Cost of sales	(40,000)
Gross profit	60,000
Other income	2,000
	62,000
Distribution costs	(26,000)
Administrative expenses	(9,000)
	27,000
Finance costs (Interest)	(2,000)
Profit before tax	25,000
	25,000
Income Tax expense	(5,000)
Profit for the year	20,000

Statement of Changes in Equity

	<i>Share capital</i>	<i>Share premium</i>	<i>Revaluation reserve</i>	<i>Retained Earnings</i>	<i>Total</i>
	\$	\$	\$	\$	\$
Balance b/f	40,000	-	-	27,000	67,000
Surplus on revaluation			5,000		5,000
Net profit for the period				20,000	20,000
Dividends paid				(5,000)	(5,000)
Issue of share capital	10,000	10,000			20,000
Balance c/f	50,000	10,000	5,000	42,000	107,000

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Chapter 14

STATEMENTS OF CASH FLOWS

1. Introduction

Companies are required by IAS 7 Statements of Cash Flows to include a Statement of Cash Flows in their financial statements.

In this chapter we will look at the required format and explain how to prepare a Statement of Cash Flows.

2. Description

A Statement of Cash Flows is simply a summary of the cash receipts and payments. The purpose is to provide users of the financial statements with more information than is provided just by the Statement of Profit or Loss and Statement of Financial Position.

For example, the company may have issued shares during the year, but the cash balance at the end of the year may be lower than at the end of the previous year. An ordinary shareholder may be puzzled by this, but maybe the explanation is that the company had very large expenditure on non-current assets. To you as an accountant, this may be obvious from inspection of the Statement of Financial Position, but a Statement of Cash Flows will make it more obvious to the shareholder.

3. The indirect method

There are two approaches allowed in preparing a Statement of Cash Flows – the direct method and the indirect method. We will look at the indirect method first which is more common in practice.



Statement of Cash Flows - PROFORMA

- X plc Statement of Cash Flows for the year ended 31 December 2008

	\$	\$
<i>Cash flows from operating activities</i>		
Net profit before taxation	x	
Adjustments for:		
Depreciation	x	
Profit on sale of non-current assets	(x)	
Interest expense	<u>x</u>	
Op. profit before working cap. changes	x	
Increase in accounts receivable	(x)	
Increase in inventories	(x)	
Increase in accounts payable	<u>x</u>	
Cash generated from operations	x	
Interest paid	(x)	
Dividends paid	(x)	
Taxation paid	<u>(x)</u>	
Net cash from operating activities		x
<i>Cash flows from investing activities</i>		
Purchase of non-current assets	(x)	
Sale proceeds of non-current assets	x	
Interest received	x	
Dividends received	<u>x</u>	
Net cash from investing activities		x
<i>Cash flows from financing activities</i>		
Proceeds from issue of shares	x	
Repayment of debenture loan	<u>(x)</u>	
Net cash from financing activities		<u>x</u>
Net increase in cash & cash equivalents		x
Cash and cash equivalents b/f		<u>x</u>
Cash and cash equivalents c/f		<u>x</u>



Example 1

Blair Limited -Statement of Financial Position as at 31 December 2008

	2008		2007
	\$	\$	\$
ASSETS			
Non-current assets	545,000		410,000
Current assets:			
Inventories	90,000		81,000
Receivables	83,000		75,000
Cash	45,000		64,000
	<u>218,000</u>		<u>220,000</u>
	<u>763,000</u>		<u>630,000</u>
EQUITY AND LIABILITIES			
Capital and reserves:			
\$1 ordinary shares	150,000		100,000
Share Premium Account	20,000		
Accumulated profits	<u>476,000</u>		<u>431,000</u>
	<u>646,000</u>		<u>531,000</u>
Current liabilities:			
Trade payables	97,000		69,000
Corporation tax payable	<u>20,000</u>		<u>30,000</u>
	<u>117,000</u>		<u>99,000</u>
	<u>763,000</u>		<u>630,000</u>

Statement of Profit or Loss for the year ended 31 December 2008

	\$
Turnover	1,000,000
Cost of sales	<u>700,000</u>
Gross profit	300,000
Administrative expenses	<u>199,000</u>
Operating profit	101,000
Interest	<u>1,000</u>
Profit before tax	100,000
Tax	<u>39,000</u>
Profit after tax	<u>\$61,000</u>

The following information is relevant:

- (1) Administrative expenses include depreciation of \$40,000
- (2) During the year there had been sales of non-current assets for \$30,000. The assets sold had originally cost \$50,000 and had a net book value of \$20,000.



(3) Dividends paid during the year were \$16,000

Produce a Statement of Cash Flows for the year ended 31 December 2008

4. The direct method

In the previous paragraph, where we used the indirect method, we established the cash flow from operations by taking the profit from the Statement of Profit or Loss and working backwards – eliminating non-cash items and adjusting for changes in working capital.

The alternative approach is to calculate the cash flow from operations directly by taking the cash receipts from customers and deducting the cash payments. This is known as the direct method. (Note that the rest of the Statement of Cash Flows stays the same as before.)

The layout for arriving at the cash flow from operations is as follows:

Cash received from customers	x
Cash payments to suppliers	(x)
Cash paid to and on behalf of employees	(x)
Other cash payments	<u>(x)</u>
Net cash inflow from operating activities	<u>x</u>



Example 2

Gatis has the following Statement of Profit or Loss for the year ended 31 December 2007:

	\$
Revenue	1,200,000
Cost of sales	(840,000)
Gross profit	360,000
Distribution and administrative expenses	(120,000)
Net profit before tax	240,000

The following are extracts from Gatis's Statements of Financial Position:

	2007 \$	2006 \$
Current assets		
Inventory	160,000	140,000
Trade receivables	259,000	235,000
Current liabilities		
Trade payables	168,000	138,000

You are given the following further information:

- (1) expenses include depreciation of \$36,000, bad debt write-offs of \$14,000 and employment costs of \$42,000
- (2) during the year Gatis disposed of a non-current asset for \$24,000 which had a book value of \$18,000, the profit on which had been netted off expenses.

You are required to show:

- (a) **how the cash generated from operations would be presented on the Statement of Cash Flows using the indirect method.**
- (b) **how the cash generated from operations would be presented on the Statement of Cash Flows under the direct method.**

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Chapter 15

BANK RECONCILIATIONS

1. Introduction

There are many errors that can be made in the bookkeeping – for example, it is very easy to enter a number incorrectly – and it is therefore important to carry out as many checks as possible on the accuracy.

One of the most obvious checks is to compare the cash book with the bank statement. The balance on both should be the same. If there are any errors then this check should discover that they exist.

In principle this check is very simple, but it can be a little more involved due, mainly, to the use of cheques in many countries.

2. Terminology

Before we explain the nature of bank reconciliations, it is important to make sure that you are familiar with the terminology related to bank transactions.

Balance on bank statement

One important aspect to be aware of is that if you put money into the bank, the bank statement will show a credit balance. This is despite the fact that in the books of the business we will debit the cash account and say that we have a debit balance. The reason for this is that the bank statements is a reflection of the balance on your account in the books of the bank. As far as the bank is concerned, they owe you money – hence the credit balance.

It is very easy to get confused in an exam question, and so be very careful. A credit balance on the bank statement means that you have money, whereas a debit balance on the bank statement means that you are overdrawn.

Cheques

Drawer (of cheque)

Unpresented cheques (or outstanding cheques)

Deposits not yet credited



Dishonoured cheques

Credit transfers

Standing orders

Direct debits

3. Reasons why the balance on the bank statement may differ from the balance in the cash account

If there is a difference between the balance on the bank statement and the balance in the cash account, then clearly we need to find out why.

There are three types of situations that can result in a difference:

- **cash book errors and omissions**

Examples:

If there are any cash book errors or omissions, then these must be corrected

- **bank mistakes**

Examples:

If there are any errors by the bank, then the bank must be informed and these errors corrected by the bank



● **'timing differences'**

Even if all the entries in the bank statement and the cash book are correct, the two balances are unlikely to agree. This is because of unrepresented cheques and lodgements not credited. The receipts and payments have been correctly entered in the cash book, but because of the time delay they have not yet appeared in the bank statement. This is not a mistake on the bank's part – the transactions will appear at some time in the future – and so no correction is necessary. However, if we list the unrepresented cheques and lodgements not yet credited, we should be able to explain (or reconcile) the difference between the balances. If we cannot reconcile the two then there must be errors remaining which we must find.

The statement reconciling the balances is called a bank reconciliation statement.

4. The preparation of a bank reconciliation statement

- compare the cash account to the bank statement and tick off all items that agree
- any remaining items must be either errors or timing differences
- correct any errors in the cash account by putting through the necessary debits or credits (in the examination write up a t-account, starting with the balance given in the question and ending with the correct balance)
- prepare a bank reconciliation statement. This is always a statement (not a t-account), starting with the balance on the bank statement, listing any bank errors and timing differences, and ending with what should be the corrected balance in the cash account.

Pro-forma bank reconciliation statement:

Balance per bank statement	x
Add/Less bank errors	x
	<hr/>
	X
Add: Lodgements not credited	x
Less: Unpresented cheques	(x)
	<hr/>
Balance as per (corrected) cash account	x



Example 1

At 31 December 2007, the balance on the cash account was \$11,820 (DR) , but the balance appearing on the bank statement was \$15,000 (CR).

The reasons for the difference were as follows:

- (1) Bank charges of \$20
- (2) A payment of \$1,200 had been entered in the cash account as \$2,100
- (3) A cheque for \$200 had been dishonoured
- (4) There were unpresented cheques totalling \$6,500
- (5) Lodgements of \$4,000 had not yet appeared on the bank statement

Calculate the correct balance on the cash account, and prepare a bank reconciliation statement.

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Chapter 16

CONTROL ACCOUNTS

1. Introduction

The last chapter – bank reconciliations – covered a method of checking the accuracy of the entry of transactions concerning cash in and out of the bank.

However, a great many of the transactions of a company involve purchases and sales on credit. It is important to have a way of checking these also. This chapter covers a way of checking them.

It is important that you revise, and are happy with, the earlier chapter on Books of Prime Entry. You will not be asked to write up these books, but, as you will see, it is very likely that you will be presented with errors that have been made in these books.

2. Control Accounts

You will remember that in practice, the following occurs if we make a sale on credit:

- (a) the invoice is listed in the Receivables Journal (no double entry)
- (b) the amount of the invoice is taken from the Receivables Journal and entered in the account of the relevant customer in the Receivables Ledger (not double entry)
- (c) at the month end, the total of the Receivables Journal is posted in the Nominal Ledger:

Debit: Receivables account,

Credit: Sales account

In a similar way, if cash is received from a customer:

- (a) the amount is listed in the Cash Receipts book (no double entry)
- (b) the amount of the receipt is taken from the Cash Receipts book and entered in the account of the relevant customer in the Receivables Ledger (no double entry)
- (c) at the month end, the total of the Cash Receipts book is posted in the Nominal Ledger:

Debit: Cash account;

Credit: Receivables account.

As a result, we end up with several 'receivables' accounts. We have an account for each individual customer in the Receivables Ledger, and also a (total) Receivables account in the Nominal Ledger.

To avoid any confusion, we call the account in the Nominal Ledger the Total Receivables Account, or (more commonly) the **Receivables Ledger Control Account**.

An obvious check that we can perform every month is to ask the bookkeeper in charge of the Receivables Ledger to list all the individual balances and to total them up. This total should agree with the balance on the Receivables Ledger Control Account. If the two figures do not agree, then there must be an error (or errors) that need to be corrected.



If the Receivables Ledger Control Account contains errors, then our Financial Statements will be incorrect. If the Receivables Ledger contains errors, then we risk chasing individual customers for the wrong amounts, or alternatively not chasing debtors when we should be doing so!

This check will not discover all types of errors, but is a simple exercise to perform and certainly detect many types of errors.

3. Returns, discounts, and contra entries

Before we look at examples of control accounts, there are three 'special' types of entry that we need to consider.

These entries may be necessary in any type of examination question, but are particularly common in control account questions.

Returns

Suppose we sell goods for \$500 on credit to Mr X.

A week later, Mr X returns half the goods to us (and we accept the return).

Clearly, the return must be recorded in the individual account in the Receivables Ledger, and the Receivables Ledger Control Account in the Nominal Ledger.

Discounts

Suppose we sell goods for \$1,000 on credit to Mr Y, and offer him a 5% discount if he pays the invoice within 1 month.

Mr Y does pay the account within 1 month and therefore pays us only \$950

Clearly, the discount must be recorded in the individual account in the Receivables Ledger, and the Receivables Ledger Control Account in the Nominal Ledger.



Contra entries

Suppose we sell goods for \$800 on credit to Mr Z.

Mr Z also happens to be a supplier, and we buy goods from him for \$1,000 on credit.

We agree with Mr Z that instead of him paying us in full, and us paying him in full, we will simply pay to him the net amount owing of \$200.

This bookkeeping entry to 'cancel' or 'set-off' the balances is known as a **contra entry**.

Clearly, the contra entry must be recorded in the individual account in the Receivables Ledger, and the Receivables Ledger Control Account in the Nominal Ledger.

4. The Payables Ledger Control Account

Throughout this chapter so far, we have been using sales on credit to illustrate the use of Control Accounts.

However, exactly the same situation occurs with purchases on credit, and the balance on the Total Payables Account – or Payables Ledger Control Account – should equal the total of the list of individual balances in the Payables Ledger.

Returns, discounts and contra entries stand to be applicable in exactly the same sort of way as with the Receivables Ledger Control Account.



Example 1

Scimitar Co, proves the accuracy of its receivables and payables ledgers by preparing monthly control accounts. At 1 September 2007 the following balances existed in the company's accounting records, and the control accounts agreed:

	<i>Debit</i>	<i>Credit</i>
	<i>\$</i>	<i>\$</i>
Receivables ledger control account	186,220	–
Payables ledger control account	–	89,290

The following are the totals of transactions which took place during September 2007, as extracted from the company's records.

	<i>\$</i>
Credit sales	101,260
Credit purchases	68,420
Sales returns	9,160
Purchases returns	4,280
Cash received from customers	91,270
Cash paid to suppliers	71,840
Cash discounts allowed	1,430
Cash discounts received	880
Irrecoverable debts written off	460
Refunds to customers	300
Contra settlements	480

Prepare the receivables ledger control and payables ledger control (total) accounts for the month of September 2007.

WHEN YOU FINISHED THIS CHAPTER YOU SHOULD ATTEMPT THE [ONLINE F3 MCQ TEST](#)



Chapter 17

ADJUSTMENTS TO PROFIT AND SUSPENSE ACCOUNTS

1. Introduction

These are two areas, often related, asking you to show the effect of correcting errors. They are a good way of testing your knowledge and understanding of bookkeeping, without requiring you to produce lots of t-accounts.

2. Adjustments to profit

In these questions, a set of draft (or rough) financial statements have been prepared. However, subsequently various errors and omissions have been discovered.

Our task is to calculate the correct profit. However, you are not required to produce a new Statement of Profit or Loss. Therefore we produce a statement which starts with the profit from the financial statements, adds or subtracts to adjust for the various errors listed, and ends with the correct profit.

Example 1

Alison's draft financial statements show a net profit for the year of \$52,380. Subsequently, the following errors come to light:

- (a) No entry has been made for \$563 cash received from Adele, a customer whose debt was written off last year as irrecoverable.
- (b) Closing inventory valued in the draft accounts at its cost of \$8,920, was believed to have a potential sales value of \$7,930
- (c) Goods which had cost \$2,000 had been sent to a customer just before the year end on a sale or return basis. These had been accounted for as a firm sale, with a profit of 20% of cost. No confirmation of the sale had been received from the customer.
- (d) A payment for rent charged in full to the current year included \$490 which relates to the next accounting period. No adjustment had been made for this when preparing the draft accounts.

Prepare a statement of adjustments to profit in order to calculate the correct net profit for the year.



5. Suspense Accounts

In an earlier chapter we looked at the Trial Balance. The trial balance should balance, and if it does not then there must be errors somewhere that need to be found.

However, it is likely that the difference on the trial balance is the net result of several errors. In practice, we would have to start checking the bookkeeping entries until we found an error. It would then be useful to have a note of how much errors still remained in order that we would know when we had finally found all the errors!

A common way of doing this (and a common exercise in the examination) is to open a t-account called the Suspense Account (or Difference Account) with a balance equal to the trial balance difference. This is in some ways an artificial account, in that had the double entries all been correct then there would be no trial balance difference.

However, it does provide a useful check when finding errors. Every time we find an error in the bookkeeping, we will correct it and at the same time make an entry in the Suspense Account to show that part of the difference had been found. When all the errors have been found, the balance on the Suspense Account will fall to zero.

Example 2

Biruta has prepared the following trial balance.

	<i>Dr</i>	<i>Cr</i>
Motor Van, at cost	5,500	
Inventory	6,230	
Receivables Ledger Control	19,167	
Cash at bank	218	
Petty Cash	50	
Payables Ledger Control Account		13,166
Prepayments	490	
Accruals		70
Motor Van – accumulated depreciation		2,000
Sales		93,870
Purchases	76,182	
Rent expense	1,200	
Wages expense	12,500	
Electricity expense	516	
Telephone expense	230	
Accountancy expense	500	
Van expenses	280	
Depreciation expense	1,000	
Capital		10,000
	<hr/> 124,063	<hr/> 119,106



The trial balance does not balance, and Biruta realises that this means that there must be errors in the bookkeeping.

On investigation, the following errors are discovered:

- (a) A transposition error was made when posting a sales day book total of \$8,132. The correct figure was entered in the receivables ledger control account, but it was posted to the sales account as \$1,832
- (b) The balance on the electricity account was incorrectly recorded and should read \$615
- (c) One cash payment for electricity of \$200 had been recorded throughout as \$20
- (d) When accounting for the telephone accrual of \$70 at the year end, a single entry had been made. It was the expense account entry that had been missed out.
- (e) A mistake had been made when casting the purchases account. The total should have been \$77,356

You are required to open a suspense account. For each error make any relevant entries in the suspense account.

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Chapter 18

MARK-UP AND MARGINS

1. Introduction

Occasionally it is the case that all selling prices are calculated so as to give a fixed percentage profit.

This information means that if we know the cost of sales we are able to calculate the sales (and vice versa). Make sure that you can do the arithmetic, but that also you learn the terminology and remember the difference between a mark-up and a gross profit margin.

2. Mark-up

A mark-up is the gross profit expressed as a percentage of the cost.

Example 1

- (a) Jelena has cost of goods sold of \$20,000 and applies a mark-up of 20%.
What are the sales?
- (b) Karen has sales of \$50,000 and applies a mark-up of 25%.
What is her cost of goods sold?

3. Gross profit margin

The gross profit margin is the gross profit expressed as a percentage of the selling price.

Example 2

- (a) Peter has sales of \$120,000. His gross profit is 20%.
What is his cost of goods sold?
- (b) Paul has a cost of goods sold of \$45,000 and a gross profit of 25%.
What are his sales?

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Chapter 19

ACCOUNTING CONVENTIONS AND POLICIES

1. Introduction

There are many accounting conventions and concepts underlying the preparation of financial statements.

In this chapter we will explain the main conventions and concepts, but you must also read the relevant chapter in the Study Text in detail

2. The fundamental accounting concepts.

These are contained in IAS 1 Presentation of Financial Statements, and must be followed.

Fair presentation

Financial statements should be 'fairly presented'

Going concern

It is assumed that a business will continue to operate for the foreseeable future.

Accruals

Assets, liabilities, equity, income and expenses are recognised when they occur, and not when cash is received or paid.

Consistency

Items should be treated in the same way from one period to the next, unless there is a significant change in the nature of the operations.



3. Other accounting concepts and qualitative characteristics

Materiality

Relevance

Reliability

Faithful Representation

Substance over form

Neutrality

Prudence

Completeness

Comparability

Understandability



4. Alternative Valuation Bases

Historical cost

Replacement cost

Net realisable value

Economic value



5. IAS 18 Revenue Recognition

This accounting standard defines when revenue should be recognised (i.e. at what date it should be regarded as having been earned).

Sale of goods:

Revenue should be recognised when all of the following conditions have been satisfied:

- (a) all the significant risks and rewards have been transferred to the buyer
- (b) the seller retains no effective control over the goods sold
- (c) the amount of revenue can be reliably measured
- (d) the benefits to be derived from the transaction are likely to flow to the enterprise
- (e) the costs incurred or to be incurred for the transaction can be reliably measured

Services:

The difference with services is that the service given is often spread over a period of time.

Revenue can be recognised according to the stage of completion of the transaction at the date of the Statement of Financial Position.

The same conditions apply as for sale of goods, except for condition (a) above.

Disclosure requirements:

The financial statements should disclose:

- the accounting policies for revenue recognition
- a split between different categories of revenue
- the amount of revenue from the exchange of goods or services (if material)

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Chapter 20

IAS 10: EVENTS AFTER THE REPORTING PERIOD

1. Introduction

This chapter covers the provisions of IAS 10. The provisions themselves are not difficult to learn, but you must make sure that you learn the terminology.

2. IAS 10: Events after the reporting period

If a company has a year end of 31 December 2008, then it will be some time before the financial statements are finalised and signed by the directors. It will take time to produce the financial statements, and then more time while they are checked by the auditors. It may not be until (say) 20 March 2009 before the financial statements become final and are signed.

Although the financial statements should show the position as at 31 December 2008, we are able to make changes at any time up to 20 March 2009 when the financial statements are finalised. If we discover any errors after 20 March 2009, then it is too late to change anything.

Events after the reporting period refer to events that occur between the date of the Statement of Financial Position and the date on which the financial statements become final.

There are two types of events:

Adjusting events

There are events that provide additional evidence about the estimation of amount at the Statement of Financial Position date (for example, the auditors discover an error in the valuation of inventory).

For these events, the financial statements will be changed.

Non-adjusting events

These are events that do not affect the value of assets and liabilities at the Statement of Financial Position date (for example, a factory is destroyed by fire after the date of the Statement of Financial Position).

For these events, the financial statements will not be changed. However, if the amount is material, they will be disclosed by way of a note giving details of the event.



Examples of adjusting and non-adjusting events:

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Chapter 21

INTANGIBLE ASSETS: GOODWILL, RESEARCH AND DEVELOPMENT

1. Introduction

In this chapter we will consider two types of intangible assets that you are required to know about for the examination. Intangible assets are assets which have a value to the business, but cannot be touched (i.e. have no physical substance).

The two that you must have knowledge of are goodwill, and research and development, and we will consider the accounting treatment of both.

2. Goodwill

Goodwill is the excess of the value of a business over the fair value of the net assets.

Purchased goodwill

This is goodwill that arises when a company purchases another company. It is commonly the case that the consideration paid is greater than the fair value of the net assets, and this excess is the goodwill.

Non-purchased goodwill

An existing company is likely to be worth more, were it to be sold, than the worth of the net tangible assets. A company could therefore claim that there was an extra asset of goodwill.

However, non-purchased goodwill should not normally be recognised in the financial statements. This is because no event has occurred to identify the value of the business.

3. Research and Development

IAS 38 Intangible assets governs the accounting treatment of these costs.

Research

This is 'original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding'.



Development

This is 'the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use'.

Accounting treatment

Research expenditure should all be charged to the Statement of Profit or Loss as an expense in the period in which it is incurred.

Development expenditure should be capitalised and shown as an asset on the Statement of Financial Position if (and only if) the following conditions apply:

- (a) there should be an identifiable product
- (b) the company should have the resources to be able to complete the development
- (c) there should be an identified market for the product
- (d) the expenditure should be measurable

If the costs are capitalised, then they must be amortised in line with the pattern of income resulting.

If the conditions are not fulfilled, then the expenditure should be written off in the Statement of Profit or Loss in the period incurred.

(Note that all the above only applies to intangible assets. If any tangible assets are purchased then they must be capitalised and depreciated as normal.)

Disclosure requirements

The following should be disclosed in the financial statements:

- (a) the amortisation method used for development expenditure
- (b) the amount of amortisation during the period
- (c) a reconciliation between the written down value brought forward and the value carried forward
- (d) the amount of research expenditure charged in the Statement of Profit or Loss for the period.

The position of each development project should be reviewed each year. If any project no longer meets the IAS 38 criteria then it should be written off.

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Chapter 22

GROUP ACCOUNTS

THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION (1)

1. Introduction

Consolidated accounts are required when one company controls other companies. This can happen in many ways, but you will only be expected to deal with the simplest situation, which is where one company controls one other company.

Each company will prepare its own set of accounts. However, another set of accounts will be prepared for the group as a whole. These are known as the consolidated accounts.

In this and the next chapter we will look at the Consolidated Statement of Financial Position. In the third chapter we will consider the Consolidated Statement of Profit or Loss.

2. Definitions

Consolidated accounts are required if ever one company controls another. The precise definition of control contains several provisions, but the most common situation is where one company owns more than 50% of the ordinary share capital of the other company.

Parent company

The parent company is the company that controls the other company.

Subsidiary company

The subsidiary company is the company that is controlled by the parent company.

Group of companies

This is the parent company plus its subsidiaries.

Consolidated accounts

These are the accounts for the whole group, where we treat the group as though it is one big company.

Non-controlling interest

If the parent company does not own 100% of the subsidiary then the part owned by others is known as the non-controlling interest.



3. The Consolidated Statement of Financial Position

The purpose of the Consolidated Statement of Financial Position is to show all the assets and liabilities that are controlled by the parent company – effectively as though it is one big company.

We will work through a simple example and then gradually bring in the various complications that can occur.

Example 1

On 1 January 2008, P acquired 100% of the ordinary shares of S, which was incorporated on that date.

On 31 December 2010, the Statements of Financial Position of each the two companies were as follows:

	<i>P</i>	<i>S</i>
Non-current assets	25,000	12,000
Investment in S, at cost	10,000	
Current assets	8,000	9,000
	<hr/> 43,000	<hr/> 21,000
Share capital - \$1 shares	25,000	10,000
Retained earnings	15,000	8,000
Current liabilities	3,000	3,000
	<hr/> 43,000	<hr/> 21,000

Prepare a Consolidated Statement of Financial Position at 31 December 2010 for the P group.



4. Pre-acquisition profits

In the previous example, P had acquired S on incorporation (i.e. on the date that the company was formed).

Very often a company acquires another company some years after incorporation in which case the company will have earned profits by the time that they are acquired.

As a result the purchase price paid by the parent company will be for the share capital plus any profits already earned. These profits earned before the date of acquisition are known as pre-acquisition profits.

Example 2

P acquired 100% of the share capital of S on 1 January 2006 for \$28,000, at which date the retained earnings of S amounted to \$8,000.

At 31 December 2009 the companies' Statements of Financial Position were as follows:

	<i>P</i>	<i>S</i>
Non-current assets	55,000	25,000
Investment in S, at cost	28,000	
Current assets	18,000	14,000
	<hr/> 101,000 <hr/>	<hr/> 39,000 <hr/>
Share capital - \$1 shares	60,000	20,000
Retained earnings	38,000	15,000
Current liabilities	3,000	4,000
	<hr/> 101,000 <hr/>	<hr/> 39,000 <hr/>

Prepare the Consolidated Statement of Financial Position at 31 December 2009 for the P group.



5. Goodwill arising on consolidation

In both of the previous examples the amount that the parent company paid for the subsidiary was equal to the value of the subsidiary as shown in its Statement of Financial Position.

However, there are two reasons why the parent company may have paid more than this amount.

One reason is that the non-current assets may have been worth more than the carrying value (this is particularly likely to apply to any land and buildings). We would therefore expect the parent company to have paid a 'fair value' for the assets.

A second reason is that the parent company may have paid more than the fair value of the assets and liabilities because they were acquiring the goodwill of the subsidiary. If they did pay for goodwill, then although it will not appear in the accounts of the individual companies it will mean that there is an extra asset to appear in the consolidated Statement of Financial Position.

Example 3

P acquired 100% of the share capital of S on 1 January 2005 for \$60,000. On 1 January 2005, the retained earnings of S were \$15,000 and the fair value of the non-current assets was \$9,000 more than the carrying value.

At 31 December 2009 the companies' Statements of Financial Position were as follows:

	<i>P</i>	<i>S</i>
Non-current assets	82,000	27,000
Investment in S, at cost	60,000	
Current assets	20,000	12,000
	<hr/> 162,000	<hr/> 39,000
Share capital - \$1 shares	50,000	10,000
Retained earnings	110,000	28,000
Current liabilities	2,000	1,000
	<hr/> 162,000	<hr/> 39,000

Prepare a Consolidated Statement of Financial Position as at 31 December 2009 for the P group.



Example 4

P acquired 100% of the share capital of S on 1 July 2004 for \$25,000. On 1 July 2004, the retained earnings of S were \$6,000 and the fair value of the non-current assets was \$6,000 more than their carrying value.

At 30 June 2010 the companies' Statements of Financial Position were as follows:

	P	S
Non-current assets	76,000	18,000
Investment in S, at cost	25,000	
Current assets	12,000	9,000
	<hr/> 113,000	<hr/> 27,000
Share capital - \$1 shares	40,000	5,000
Retained earnings	70,000	20,000
Current liabilities	3,000	2,000
	<hr/> 113,000	<hr/> 27,000

Prepare a Consolidated Statement of Financial Position as at 30 June 2010 for the P group.

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Chapter 23

GROUP ACCOUNTS

THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION (2)

1. Introduction

In the previous chapter we looked at the Consolidated Statement of Financial Position. However in every example the parent company owned 100% of the subsidiary.

In this chapter we will look at what happens when the parent company owns less than 100% but still has control of the subsidiary.

We will also look at the effect of any trading between the parent company and the subsidiary company.

2. Non-controlling interest

The fundamental point when the parent company owns less than 100% of the subsidiary is that in the Consolidated Statement of Financial Position we still show all the assets and liabilities of the group (because the parent company controls them), but we need to take account of the fact that part of these are in fact owned by the non-controlling interest.

Example 1

On 1 January 2008, P acquired 80% of the ordinary shares of S, which was incorporated on that date.

On 31 December 2010, the Statements of Financial Position of each of the two companies were as follows:

	<i>P</i>	<i>S</i>
Non-current assets	30,000	15,000
Investment in S, at cost	8,000	
Current assets	7,000	6,000
	<hr/> 45,000	<hr/> 21,000
Share capital - \$1 shares	25,000	10,000
Retained earnings	15,000	8,000
Current liabilities	5,000	3,000
	<hr/> 45,000	<hr/> 21,000

Prepare a Consolidated Statement of Financial Position at 31 December 2010 for the P group.



3. Goodwill arising on consolidation

The previous example was very simple because P acquired its holding in S on the date of incorporation and simply paid the value of its share of the assets less liabilities on that date.

However you will remember from the previous chapter that it is more likely that P would have acquired the holding on a later date and therefore may have paid more due to paying for goodwill.

As with all the other assets and liabilities, we wish to show the full value of the goodwill in the Consolidated Statement of Financial Position, but this will no longer simply be the difference between the amount paid and the value of the assets – it will be the difference between the **total** value of the business at the date of acquisition and the fair value of **all** the assets less liabilities at the date of acquisition.

The calculation of the goodwill arising on consolidation therefore becomes as follows:

Fair value of consideration transferred	X	
Plus: fair value of non-controlling interest at date of acquisition	X	
	<hr/>	X
Less: fair value of net assets at date of acquisition		
Share capital	X	
Retained earnings at date of acquisition	X	
	<hr/>	(X)
Goodwill arising on consolidation		<hr/> X

Example 2

P acquired 60% of the shares in S on 1 January 2007 when the retained earnings of S stood at \$6,000.

The fair value of the non-controlling interest at the date of acquisition was \$30,000.

On 31 December 2010, the Statements of Financial Position of each of the two companies were as follows:

	P	S
Non-current assets	50,000	30,000
Investment in S, at cost	40,000	
Current assets	14,000	12,000
	<hr/> 104,000	<hr/> 42,000
Share capital - \$1 shares	50,000	20,000
Retained earnings	44,000	16,000
Current liabilities	10,000	6,000
	<hr/> 104,000	<hr/> 42,000

Calculate the amount of the goodwill arising on consolidation.



We will show the full amount of the goodwill in the Consolidated Statement of Financial Position (in addition to showing the full amount of all the other assets and liabilities as usual). However, as before we will have an extra figure in the Statement of Financial Position showing the amount owing to the non-controlling interest.

The entitlement of the NCI will be made up of the following:

Fair value of the NCI at the date of acquisition	X
Plus: NCI's share of post-acquisition profits	X
	<hr/> X <hr/>

Example 3

Using the same information as in example 2, calculate the non-controlling interest at 31 December 2010.

(Note: you may be wondering why we have not calculated the non-controlling interest in the same way as in example 1 – i.e. by just taking 40% of the share capital and reserves of S.

The reason is that they are also entitled to a share of the goodwill arising on consolidation, which does not appear in S's own accounts.

We can calculate this and thus check the NCI as follows:

Fair value of NCI at date of acquisition	30,000
NCI in net assets at date of acquisition	
(40% x (20,000 + 6,000))	10,400
Goodwill attributable to NCI	<hr/> 19,600 <hr/>
NCI at 31 December 2010:	
Share capital (40% x 20,000)	8,000
Retained earnings (40% x 16,000)	6,400
Goodwill attributable to NCI	19,600
Total NCI	<hr/> 34,000 <hr/>

This is the same figure that we have already calculated.)



Now we need to calculate the retained earnings belonging to P. This will be calculated in the normal way:

Retained earnings of P		X
Retained earnings of S	X	
Less: pre-aquisition profits	X	
Post-acquisition profits of S	<u>X</u>	
P's share of post-acquisition profits of S		<u>X</u>
		<u>X</u>

Example 4

Using the information in example 2, calculate the retained earnings for inclusion in the Consolidated Statement of Financial Position as 31 December 2010.

We are now in a position to produce the Consolidated Statement of Financial Position as at 31 December 2010.

Example 5

Using the information in example 2 (and the workings from the later examples) prepare the Consolidated Statement of Financial Position at 31 December 2010 for the P group.



4. Inter-entity transactions

Although our work focuses on preparing a set of consolidated accounts, do remember that the parent company and the subsidiary company are two separate companies and that both of them prepare their own accounts in the normal way.

It is quite possible that the two companies trade with each other – i.e. that the parent company sells goods to the subsidiary company (or vice versa).

If this has happened, then there are two things that we need to be aware of when we come to prepare the consolidated accounts:

- (a) we only want to show receivables and payables from outside the group – we do not want to include receivables and payables between the parent and subsidiary
- (b) we only wish to record profits made as a result of sales outside the group

We will illustrate these two problems and how we deal with them by way of examples.

(a) Inter-entity balances

Example 6

Company P has a controlling interest in company S.

Extracts from the statements of financial position of each company individually as at 31 December 2010 are as follows:

	<i>P</i>	<i>S</i>
Receivables	50,000	30,000
Payables	35,000	40,000

Included in P's receivables is \$8,000 owing from S. S's payables include the \$8,000 owing to P.

Calculate the total receivables and payables to be shown on the Consolidated Statement of Financial Position as at 31 December 2010.

(b) Inventory sold at a profit within the group

The problem here relates to the situation where one of the companies has sold goods to the other company at a profit, and the receiving company still has some of the goods in inventory.

If the goods have been sold by the receiving company then all the profit has been realised and there is no problem.

If, however, some of the goods are still in inventory then there are two problems when we come to prepare consolidated accounts:

- (i) the inventory in the accounts of the receiving company will include the profit made by the selling company, whereas in the consolidated accounts we should be showing it at cost to the group.
- (ii) included in the profits of the selling company will be all the profit on goods sold to the other company. However the profit on any goods still in inventory should



not be included in the profit of the group because the goods have not left the group (and the profit has therefore not been realised)

To deal with both problems we do the following:

- (i) calculate the unrealised profit in inventory,
- (ii) reduce the inventory and reduce the retained earnings of the company that has sold the goods by the amount of the unrealised profit.

Example 7

P acquired 75% of the share capital of S on its incorporation. The Statements of Financial Position of the two entities as at 31 December 2010 are as follows:

	<i>P</i>	<i>S</i>
Non-current assets	50,000	25,000
Investment in S, at cost	15,000	
Inventory	13,000	7,000
Other current assets	10,000	6,000
	<u>88,000</u>	<u>38,000</u>
Share capital - \$1 shares	45,000	20,000
Retained earnings	30,000	15,000
Current liabilities	13,000	3,000
	<u>88,000</u>	<u>38,000</u>

During December 2010 S had sold goods to P for \$6,000. S sells to P at cost plus 25%.

P had not sold any of these goods and all were therefore included in inventory.

Additionally, P had not paid S for these goods and therefore the sum of \$6,000 is included in P's payables and in S's receivables.

Prepare a Consolidated Statement of Financial Position at 31 December 2010.

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Chapter 24

GROUP ACCOUNTS THE CONSOLIDATED STATEMENT OF PROFIT OR LOSS

1. Introduction

We have seen in the previous chapters that when one company controls another it is necessary for us to prepare a Consolidated Statement of Financial Position.

Similarly it is necessary for us to prepare a Consolidated Statement of Profit or Loss and we will look at how this is prepared in this chapter.

2. The Principles

As with the Consolidated Statement of Financial Position, the aim of the Consolidated Statement of Profit or Loss is to show the results of the group as if it were a single entity.

We will use the same principles as we applied for the Statement of Financial Position in that we will show the total profits made by the group and then show the extent to which these profits are owned by the parent company and are owned by the non-controlling interest.



Example 1

P acquired 80% of the share capital of S on that company's incorporation in 2008.

The respective Statements of Profit or Loss of the two companies for the year ended 31 December 2009 are as follows:

	<i>P</i>	<i>S</i>
Revenue	52,000	24,000
Cost of sales	12,000	10,000
Gross profit	40,000	14,000
Expenses	8,000	4,000
Profit before taxation	32,000	10,000
Income tax	12,000	3,000
Profit for the year	20,000	7,000
<i>Note: movement on retained earnings</i>		
Retained earnings brought forward	80,000	20,000
Profit for the year	20,000	7,000
Retained earnings carried forward	100,000	27,000

Prepare the Consolidated Statement of Profit or Loss and the movement on retained earnings for the P group.

In the previous example, P acquired S on the date of S's incorporation and is therefore entitled to its share of all S's retained earnings.

However, if P acquired S at a later date then P is only entitled to its share of S's post-acquisition retained earnings (just as when we prepared the Consolidated Statement of Financial Position).



Example 2

P acquired 60% of S on 1 January 2008, at which date the retained earnings of S were \$8,000.

The respective Statements of Profit or Loss of the two companies for the year ended 31 December 2010 are as follows:

	<i>P</i>	<i>S</i>
Revenue	85,000	31,000
Cost of sales	21,000	12,000
Gross profit	64,000	19,000
Expenses	12,000	7,000
Profit before taxation	52,000	12,000
Income tax	16,000	4,000
Profit for the year	36,000	8,000
Note: movement on retained earnings		
Retained earnings brought forward	120,000	17,000
Profit for the year	36,000	8,000
Retained earnings carried forward	156,000	25,000

Prepare the Consolidated Statement of Profit or Loss and the movement on retained earnings for the P group.



3. Inter entity (or intra-group) trading

Just as with the Consolidated Statement of Financial Position, the Consolidated Income Statement should show the results of the group as though it were a single entity.

When one company in the group sells goods to another company in the group, then the sales will have been included in the revenue of the selling company and an identical amount will have been included in the cost of sales of the other company. However, as far as the group's dealings with outsiders is concerned, no transaction has taken place.

In the Consolidated Income Statement, the figure for sales revenue should represent sales to outsiders, and the figure for cost of sales should represent purchases from outsiders. We will therefore need to reduce both the sales revenue and the cost of sales by the value of the inter entity sales during the year.

You will also remember from the previous chapter that if any goods sold at a profit within the group are still in inventory, then the unrealised profit needs to be excluded from the group profit.

We will achieve this (i.e. reduce the group profit) by increasing the cost of sales for the group by the amount of the unrealised profit in inventory.

Example 3

P acquired 55% of S on 1 June 2008.

The Income Statements of the two companies for the year ended 31 May 2009 are as follows:

	<i>P</i>	<i>S</i>
Revenue	120,000	110,000
Cost of sales	55,000	50,000
Gross profit	65,000	60,000
Expenses	9,000	10,000
Profit before taxation	56,000	50,000
Income tax	20,000	14,000
Profit for the year	36,000	36,000

During the year S sold goods to P for \$28,000 (including a mark-up of 40%). One quarter of these goods remained in P's inventory at the year end.

Prepare a Consolidated Income Statement for the P group.



Chapter 25

GROUP ACCOUNTS – FURTHER POINTS

1. Introduction

In this – the final chapter on group accounts – we will state the full definition of what is meant by a subsidiary, and explain the meaning of associated companies and how we deal with them.

2. The definition of a subsidiary

A subsidiary is an entity controlled by another entity.

Control is the power to govern the financial and operating policies of the entity so as to obtain benefits from its activities.

Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than one half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.

Control also exists when the parent owns half or less of the voting power of an entity when there is:

- power over more than half the voting rights by virtue of an agreement with other investors
- power to govern the financial and operating policies of the entity under statute or agreement
- power to appoint or remove the majority of the directors or equivalent governing body
- power to cast the majority of votes at meetings of the directors or equivalent governing body

3. Associate companies

An associate is an entity in which the investor has significant influence, but which is not a subsidiary.

Significant influence is the power to participate in the financial and operating policy decisions of the entity, but not to control these policies.

Although the full definition of an associate is more involved, as far as we are concerned for this examination it is where the investing company holds more than 20% of the shares (but not more than 50% - this would make it a subsidiary).

IAS 28 requires the use of what is called the **equity method** of accounting for investments in associates.



This means the following:

(i) Consolidated Income Statement

The investing company should add to the consolidated profit the group's share of the associated company's profit after tax.

(Note that the associate's revenue and costs are not added to those of the group as with a subsidiary – we simply add the group's share of the associate's profit.

(ii) Consolidated Statement of Financial Position

A figure for "investment in associates" is shown as an asset in the Consolidated Statement of Financial Position. This figure is the original cost of the investment plus the group's share of post-acquisition retained earnings of the associate.

Note: the above requirements only apply if consolidated accounts are being prepared because the parent company has subsidiaries. If there are no subsidiaries (and therefore no consolidated accounts) then the associate is treated simply as a trade investment and shown as a non-current asset.



Chapter 26

INTERPRETATION OF FINANCIAL STATEMENTS

1. Introduction

Financial statements are prepared to assist users in making decisions. They therefore need interpreting, and the calculation of various ratios makes it easier to compare the state of a company with previous years and with other companies.

In this chapter we will look at the various ratios that you should learn for the examination.

2. The main areas

When attempting to analyse the financial statements of a company, there are several main areas that should be looked at:

- **Profitability**

- **Liquidity**

- **Gearing**

We will work through an example to illustrate the various ratios that you should learn under each heading.



3. Worked example

Example 1

Statements of Financial Position as at 30 June

	2010		2009
	\$	\$	\$
ASSETS			
Non-current assets		3,218	1,982
Current assets			
Inventory	2,414		2,090
Receivables	2,275		1,699
Cash	864		240
		5,553	4,029
		8,771	6,011
EQUITY AND LIABILITIES			
Share capital and reserves		5,255	3,361
Non-current liabilities		1,200	960
Current liabilities		2,316	1,690
		8,771	6,011

Statement of Profit or Loss for the year ended 30 June

	2010	2009
	\$	\$
Revenue	17,232	13,044
Cost of sales	12,924	10,109
Gross profit	4,308	2,935
Distribution costs	804	610
Administrative expenses	1,608	1,217
Profit from operations	1,896	1,108
Finance costs	120	125
Profit before taxation	1,776	983
Company tax expense	629	346
Profit after taxation	1,147	637

Calculate the profitability, liquidity and gearing ratios.



● **Profitability**

$$\text{Return on capital employed} = \frac{\text{Profit before interest and tax}}{\text{Total long term capital}} \\ (= \text{capital} + \text{reserves} + \text{long-term liabilities})$$

$$\text{Net profit margin} = \frac{\text{Profit before interest and tax}}{\text{Revenue}}$$

$$\text{Asset turnover} = \frac{\text{Revenue}}{\text{Total long term capital}}$$

NB: ROCE = asset turnover × net profit margin

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Revenue}}$$

$$\text{Return on equity} = \frac{\text{Profit after tax and preference dividend}}{\text{Equity shareholders funds}}$$



- **Liquidity**

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

$$\text{Quick ratio (or acid test)} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

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

$$\text{Average collection period (receivables days)} = \frac{\text{Trade receivables}}{\text{Revenue}} \times 365 \text{ days}$$

$$\text{Average payment period (payables days)} = \frac{\text{Trade payables}}{\text{Purchases}} \times 365 \text{ days}$$



● **Gearing**

$$\text{Gearing} = \frac{\text{Total long-term debt}}{\text{Shareholders' equity} + \text{total long-term debt}} \%$$

$$\text{Leverage} = \frac{\text{Shareholders' equity}}{\text{Shareholders' equity} + \text{total long-term debt}}$$

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges}}$$

4. Limitations of ratio analysis

You must learn the various ratios. However, it is important that you are able to discuss briefly the relevance of the various ratios, and also their limitations.

Very few of the ratios mean much on their own – most are only useful when compared with the ratios for previous years or for similar companies.

Many of the ratios use figures from the Statement of Financial Position. These only represent the position at one point in time, which could be misleading. For example, the level of receivables could be unusually high at the year end, simply because a lot of invoicing was done just before the year end. Perhaps more sensible in that sort of case would be to use the average for the year. Normally in the examination you will be expected simply to use Statement of Financial Position figures at the end of the year, but do be prepared to state the problem if relevant.

WHEN YOU FINISHED THIS CHAPTER YOU SHOULD ATTEMPT THE [ONLINE F3 MCQ TEST](#)





Chapter 27

THE REGULATORY FRAMEWORK

1. Introduction

In this chapter we will look briefly at the regulatory system that exists for financial accounting, and the role of International Financial Reporting Standards.

2. The purpose of International Financial Reporting Standards (previously called International Accounting Standards).

In a perfect world, all accounts would be prepared according to the same 'set of rules'.

In practice each country has its own standards, and the purpose of International Financial Standards is, as far as possible, to develop a single set of standards worldwide.

IFRS's do not have the force of law, but most countries have changed their rules to be consistent with the IFRS's.

3. The International Financial Reporting Standards Foundation

This is the supervisory body, and their objectives are to develop a set of accounting standards and to promote their use throughout the world.

4. The International Accounting Standards Board (IASB)

It is the IASB that is actually responsible for issuing the IFRS's.

5. The IFRS Advisory Council (IAC)

This body consults with a wide range of interested parties and gives advice to the IASB.

6. The International Financial Reporting Interpretations Committee (IFRIC)

IFRIC issues guidance on the interpretation of IFRS's.



7. Exposure Drafts

An exposure draft is a proposed IFRS which is published for public comment. After all the comments have been considered, and revisions made where appropriate, the final version of the IFRS is published.

8. The Framework for the Preparation and Presentation of Financial Statements

This is not an accounting standard, but was issued by the IASB setting out the concepts underlying the preparation and presentation of financial statements.

IFRS's are developed within this framework.



Chapter 28

BUSINESS DOCUMENTATION

1. Introduction

The purpose of this chapter is to list the various business documents that the examiner expects you to be aware of.

2. Business Documents

Quotation

Details of the proposed price of goods or services to be supplied

Sales order

Details of the quantities ordered by the customer (which can be used by stores for packing the order, and by the accounts department for preparing the invoice).

Purchase order

Details of the quantities ordered from the supplier (which can be used to check against when the goods and invoice are received).

Goods received note

A list prepared by stores of the quantities of goods that have been received from the supplier (which can be used to check against the invoice and against the purchase order).

Goods despatched note (or delivery note)

A list prepared by the supplier and included with the goods (which serves the same purpose (and is often used instead of) the goods receive note).

Statement

A list sent to customers of invoices sent and cash received during the period (usually monthly) highlighting any balance outstanding. The balance is often analysed according to its age (for example up to 1 month old, between 1 and 2 months old, etc..)

Credit note

A 'negative' invoice issued when a customer has returned goods.

Debit note

Produced by the customer when goods are returned (for checking against the credit note when it received from the supplier).

Remittance advice

Sent by the customer to the supplier giving notification of payment.



Receipt

Issued to the customer by the supplier confirming that payment has been received.



Car a/c		Purchases a/c	
Cash	1,000	Cash	500
		Payables	600
			Balance 1,100
			<u>1,100</u>
		Balance	<u>1,100</u>
Payables a/c		Rent a/c	
Cash	400	Cash	200
Balance	200		
	<u>600</u>		
	Balance		
	200		
Sales a/c		Receivables a/c	
	Cash 800	Sales	900
	Receivables 900		Cash 500
Balance	1,700		Balance 400
	<u>1,700</u>		<u>900</u>
			<u>900</u>
	Balance	Balance	400
	1,700		
Withdrawals a/c			
Cash	100		

Example 3**Trial Balance**

	Debit	Credit
	\$	\$
Cash	4,100	
Capital		5,000
Car	1,000	
Purchases	1,100	
Payables		200
Rent	200	
Sales		1,700
Receivables	400	
Withdrawals	100	
	<u>6,900</u>	<u>6,900</u>



Example 4

Cash		Capital	
Balance	4,100	Balance	5,000

Car		Purchases	
Balance	1,000	Balance	1,100
			SOPOL 1,100
		<u>1,100</u>	<u>1,100</u>

Payables		Rent	
	Balance 200	Balance	200
			SOPOL 200
		<u>200</u>	<u>200</u>

Sales		Receivables	
SOPOL	1,700	Balance	400
	<u>1,700</u>		

Withdrawals	
Balance	100

Statement of Profit or Loss

Purchases	1,100	Sales	1,700
Rent	200		
Balance	400		
	<u>1,700</u>		<u>1,700</u>
		Balance (Profit)	400



Example 5**Statement of Financial Position**

	\$	\$
ASSETS		
Non-current assets		
Car		1,000
Current assets		
Cash	4,100	
Receivables	400	
		4,500
		<u>5,500</u>
CAPITAL AND LIABILITIES		
Capital		
Capital Introduced	5,000	
Profit	400	
Less: Withdrawals	(100)	
		5,300
Current liabilities		
Payables	200	
		200
		<u>5,500</u>

Chapter 4**Example 1**

<i>Insurance</i>			<i>Prepayments</i>		
Cash	800	Prepayments a/c	1,000	Insurance	1,000
Cash	2,000				
		SOPOL	1,800		
	<u>2,800</u>		<u>2,800</u>		

Statement of Profit or Loss

Expenses:	
Insurance	1,800

Statement of Financial Position

Current Assets	
Prepayment	1,000





Chapter 5

No examples

Chapter 6

Example 1

$$\text{Depreciation} = \frac{12,000 - 2,000}{5} = 2,000 \text{ p.a.}$$

2002:	$9/12 \times 2,000$	1,500
2003:		2,000
2004:		2,000

31.12.2002 31.12.2003 31.12.2004

Statement of Profit or Loss:

Depreciation	1,500	2,000	2,000
--------------	-------	-------	-------

Statement of Financial Position:

Cost	12,000	12,000	12,000
Less: Accumulated Depreciation	(1,500)	(3,500)	(5,500)
	<u>10,500</u>	<u>8,500</u>	<u>6,500</u>

Example 2

Cost	15,000
Yr 1 Depreciation (20%)	(3,000)
	<u>12,000</u>
Yr 2 Depreciation (20%)	(2,400)
	<u>9,600</u>
Yr 3 Depreciation (20%)	(1,920)
	<u>7,680</u>

Year 1 Year 2 Year 3

Statement of Profit or Loss:

Depreciation	3,000	2,400	1,920
--------------	-------	-------	-------

Statement of Financial Position:

Cost	15,000	15,000	15,000
Less: Accumulated Depreciation	(3,000)	(5,400)	(7,320)
	<u>12,000</u>	<u>9,600</u>	<u>7,680</u>



Example 3

$$\text{Depreciation} = \frac{15,000 - 1,000}{5} = 2,800 \text{ p.a.}$$

Y/e 30.6.02 $6/12 \times 2,800 = \$1,400$

Car		Accumulated Depreciation A/C			
Cash	15,000			2002 Dep Exp	1,400
		2003 Balance	4,200	2003 Dep Exp	2,800
		Cash	<u>4,200</u>		<u>4,200</u>
				Balance	4,200
		2004 Balance	7,000	2004 Dep Exp	2,800
			<u>7,000</u>		<u>7,000</u>
				Balance	7,000

Depreciation Expense A/C			
2002 Accum Dep	1,400	2002 Inc Stat.	1,400
	<u>1,400</u>		<u>1,400</u>
2003 Accum Dep	2,800	2003 Inc Stat.	2,800
	<u>2,800</u>		<u>2,800</u>
2004 Accum Dep	2,800	2004 Inc Stat.	2,800
	<u>2,800</u>		<u>2,800</u>

Example 4

Car		Accumulated Depreciation	
Balance	15,000	Balance	7,000
		Dep Exp (3/12 × 2,800)	700
			<u>7,700</u>
	<u>15,000</u>	Balance	7,700
			<u>7,700</u>
		Disposal	7,700
			<u>7,700</u>

Depreciation Expense		Disposal A/C	
Accum Depr	700	Car	15,000
	<u>700</u>	Accum Depr	7,700
		Cash	6,500
		Inc Stat (loss on sale)	800
			<u>15,000</u>



Example 5

Buildings				Accumulated Depreciation			
Balance	3,600,000	Revaluation a/c	528,000			Balance	1,080,000
		Balance	3,072,000	Balance	1,116,000	Dep Exp (W1)	36,000
	<u>3,600,000</u>		<u>3,600,000</u>		<u>1,116,000</u>		<u>1,116,000</u>
Balance	3,072,000			Revaluation	1,116,000	Balance	1,116,000
					<u>1,116,000</u>		<u>1,116,000</u>
						Dep Exp (W2)	44,522
Depreciation Expense				Revaluation A/C			
Accum Dep	36,000			Building	528,000	Accum Dep	1,116,000
Accum Dep	44,522	Inc Stat	80,522	Profit on reval.	588,000		
	<u>80,522</u>		<u>80,522</u>		<u>1,116,000</u>		<u>1,116,000</u>

(W1) Dep Exp = $6/12 \times 2\% \times 3,600,000 = \$36,000$

(W2) Dep Exp = $6/12 \times \frac{3,072,000}{34.5} = \$44,522$

With depreciation at 2% p.a., expected life of building was 50 years.

At date of revaluation, the accumulated depreciation is \$1,116,000. At the rate of \$72,000 p.a..

this is $\frac{1,116,000}{72,000} = 15.5$ years

So expected life remaining = $50 - 15.5 = 34.5$ years.

Chapter 7

No examples



Chapter 8

Example 1

Statement of Financial Position

	\$
Current assets	
Receivables (W1)	58,400
Less: Allowance for receivables (W2)	(5,024)
	<u>53,376</u>

Statement of Profit or Loss

Expenses	
Irrecoverable debts (2,500 + 1,600)	4,100
Increase in allowance for receivables	5,024
	<u>9,124</u>

(W1) Receivables: $62,500 - 2,500 - 1,600 = \$58,400$

(W2) Allowance for receivables:

Specific:	2,800
General: $(4\% \times (58,400 - 2,800))$	2,224
	<u>5,024</u>

Example 2

Receivables				Allowance for Receivables	
Balance	82,000	Irrecoverable	5,000		Irrecoverable 12,560
		Irrecoverable	3,000		
		Balance	74,000		
	<u>82,000</u>		<u>82,000</u>		
Balance	74,000				
Irrecoverable Debts Expense					
Receivables	5,000				
Receivables	3,000	Inc Stat	20,560		
Allowance a/c	12,560				
	<u>20,560</u>		<u>20,560</u>		

Calculation for allowance for receivables

Specific: $(8,000 + 2,000)$	10,000
General: $(4\% \times (74,000 - 10,000))$	2,560
	<u>12,560</u>



Example 3

Receivables				Allowance for Receivables			
Balance	74,000	Cash	238,000	Irrecov. debts	3,312	Balance	12,560
Sales	261,000	Balance	97,000				
	<u>335,000</u>		<u>335,000</u>	Balance	9,248		
Balance	97,000	Irrecoverable	8,000		<u>12,560</u>		<u>12,560</u>
Irrecoverable	2,200	Irrecoverable	4,000			Balance	9,248
		Balance	87,200				
	<u>99,200</u>		<u>99,200</u>				
Balance	87,200						
Irrecoverable Debts Expense							
Receivables	8,000	Receivables	2,200				
Receivables	4,000	Allowance	3,312				
		Inc Stat	6,488				
	<u>12,000</u>		<u>12,000</u>				

Calculation for allowance for receivables

Specific: (Mick)	6,000
General: $(4\% \times (87,200 - 6,000))$	3,248
	9,248
Balance brought forward	12,560
Decrease in allowance	<u>3,312</u>

Chapter 9**Example 1****Trading Account**

Sales	30,000
Purchases	20,000
Gross Profit	<u>10,000</u>

Sales				Purchases			
Inc Stat	30,000	Cash	30,000	Cash	20,000	Inc Stat	20,000
	<u>30,000</u>		<u>30,000</u>		<u>20,000</u>		<u>20,000</u>
Statement of Profit or Loss							
Purchases	20,000	Sales	30,000				
Profit	10,000						
	<u>30,000</u>		<u>30,000</u>				



Example 2

Trading Account

Sales		34,000
Less: Cost of Sales		
Purchases	25,000	
Closing inventory	(4,000)	21,000
Gross Profit		<u>13,000</u>

Sales

Inc Stat	34,000	Cash	34,000
	<u>34,000</u>		<u>34,000</u>

Purchases

Cash	25,000	Inc Stat	25,000
	<u>25,000</u>		<u>25,000</u>

Statement of Profit or Loss

Purchases	25,000	Sales	34,000
Profit	13,000	Inventory	4,000
	<u>38,000</u>		<u>38,000</u>

Inventory

Inc Stat	4,000
----------	-------

Example 3

Trading Account

Sales		50,000
Less: Cost of Sales		
Opening inventory	4,000	
Purchases	38,000	
Closing inventory	(6,000)	36,000
Gross Profit		<u>14,000</u>

Sales

Inc Stat	50,000	Cash	50,000
	<u>50,000</u>		<u>50,000</u>

Purchases

Cash	38,000	Inc Stat	38,000
	<u>38,000</u>		<u>38,000</u>

Statement of Profit or Loss

Inventory	4,000	Sales	50,000
Purchases	38,000	Inventory	6,000
Profit	14,000		
	<u>56,000</u>		<u>56,000</u>

Inventory

Balance	4,000	Inc Stat	4,000
Inc Stat	6,000	Balance	6,000
	<u>10,000</u>		<u>10,000</u>
Balance	6,000		



Example 4

A:	$100 \times \$10 =$	1,000
B:	$200 \times \$11 =$	2,200
C:	$150 \times \$6 =$	900
		<u>4,100</u>

Example 5

Closing stock (units):

$$300 + 400 + 400 + 400 - 500 - 400 - 100 = \mathbf{500 \text{ units}}$$

FIFO

$400 \times \$15 =$	6,000
$100 \times \$14 =$	1,400
<u>500 units</u>	<u>\$7,400</u>

Average cost

	<i>units</i>	<i>Total cost</i>	<i>Average cost</i>
	$300 \times \$12 =$	3,600	
10/11 Purchase	$400 \times \$12.50 =$	5,000	
	<u>700</u>	<u>8,600</u>	12.29
14/11 Sale	<u>500</u>		
	$200 \times \$12.29 =$	2,458	
20/11 Purchase	$400 \times \$14 =$	5,600	
	<u>600</u>	<u>8,058</u>	13.43
21/11 Sale	<u>400</u>		
	$200 \times \$13.43 =$	2,686	
25/11 Purchase	$400 \times \$15 =$	6,000	
	<u>600</u>	<u>8,686</u>	14.47
28/11 Sale	<u>100</u>		
	$500 \times \$14.47 =$	\$7,235	

Chapter 10**Cash Receipts Book**

<i>Description</i>	<i>Total</i>	<i>Capital</i>	<i>Sales</i>	<i>Receivables</i>
Pattie	6,000	6,000		
Chairs	1,200		1,200	
Ann	1,000			1,000
Pattie	4,000	4,000		
	<u>12,200</u>	<u>10,000</u>	<u>1,200</u>	<u>1,000</u>



Cash Payments Book

<i>Description</i>	<i>Total</i>	<i>Purchases</i>	<i>Van</i>	<i>Rent</i>	<i>Payables</i>	<i>Wages</i>	<i>Drawings</i>
Chairs	1,600	1,600					
Van	2,500		2,500				
Rent	300			300			
Chris	900				900		
Wages	400					400	
Pattie	700						700
	<u>6,400</u>	<u>1,600</u>	<u>2,500</u>	<u>300</u>	<u>900</u>	<u>400</u>	<u>700</u>

Payables Journal

<i>Supplier</i>	<i>Amount</i>
Chris	400
Chris	800
William	600
William	1,000
Bertha	1,600
	<u>4,400</u>

Receivables Journal

<i>Customer</i>	<i>Amount</i>
Ann	2,100
Edwina	350
Andrew	700
Tony	1,350
George	2,100
	<u>6,600</u>

Payables Ledger

<i>Chris</i>		<i>William</i>	
CPB	900	PJ	600
		PJ	1,000
Balance	300	Balance	1,600
	<u>1,200</u>		<u>1,600</u>
	Balance		Balance
	300		1,600
<i>Bertha</i>			
	PJ		1,600

List of balances

Chris	300
William	1,600
Bertha	1,600
	<u>3,500</u>



Receivables Ledger

Ann		Edwina	
RJ	2,100	CRB	1,000
		Balance	1,100
	<u>2,100</u>		<u>2,100</u>
Andrew		Tony	
RJ	700	RJ	1,350
George			
RJ	2,100		

List of balances

Ann	1,100
Edwina	350
Andrew	700
Tony	1,350
George	2,100
	<u>5,600</u>

Nominal Ledger

Cash		Capital	
CRB	12,200	CPB	6,400
		Balance	5,800
	<u>12,200</u>		<u>12,200</u>
Balance	5,800		
Sales		Receivables	
	CRB	RJ	6,600
		CRB	1,000
	RJ		
Balance	7,800		Balance
	<u>7,800</u>		<u>5,600</u>
			<u>6,600</u>
	Balance	Balance	5,600
Purchases		Van	
CPB	1,600	CPB	2,500
PJ	4,400		
	Balance		
	<u>6,000</u>		
Balance	6,000		



Rent		Payables	
CPB	300	CPB	900
		PJ	4,400
		Balance	3,500
			<u>4,400</u>
			<u>4,400</u>
			3,500

Wages		Drawings	
CPB	400	CPB	700

Trial Balance

	DR	CR
Cash	5,800	
Capital		10,000
Sales		7,800
Receivables	5,600	
Purchases	6,000	
Van	2,500	
Rent	300	3,500
Payables		
Wages	400	
Drawings	700	
	<u>21,300</u>	<u>21,300</u>

Chapter 11**Example 1**

DR Purchases 2,500
 CR Payables 2,500
 being the purchase of goods on credit

Chapter 12**Example 1**

Gross selling price = $150 + (16\% \times 150)$
 = $150 + 24 = \text{\$174}$

Example 2

If net selling price = x ,
 then $120 = x + (0.16 \times x)$
 $x = \frac{120}{1.16} = \text{\$103.45}$



Example 3

If net selling price = x
 then $220 = x + (0.175 \times x)$
 $= 1.175x$
 $x = \frac{220}{1.175} = \textbf{\$187.23}$

Example 4

<i>Purchases</i>		<i>Payables</i>	
432,000			507,600
<i>Sales</i>		<i>Receivables</i>	
	624,000	733,200	
<i>Sales Tax</i>			
75,600		109,200	
Balance	33,600		
	<u>109,200</u>	<u>109,200</u>	
	Balance		33,600

Chapter 13**Example 1****Statement of Financial Position**

Equity	
Share Capital	10,000
Share Premium	2,000
	<u>\$12,000</u>

Example 2***Share Capital Share Premium***

Share Capital	10,000	2,000
Share Premium	2,000	4,000
	<u>\$12,000</u>	<u>\$6,000</u>

Statement of Financial Position

Equity	
Share Capital	12,000
Share Premium	6,000
	<u>\$18,000</u>



Chapter 14

Example 1

Non-current asset			
Balance b/f	410,000	Depreciation	40,000
Acquisitions	195,000	Disposals	20,000
(balancing figure)		Telephone	
		Balance c/f	545,000
	<u>605,000</u>		<u>605,000</u>

Statement of Cash Flows

	\$	\$
Cash flows from operating activities		
Operating profit	101,000	
Depreciation	40,000	
Profit on sale of non-current assets	(10,000)	
	<u>131,000</u>	
Increase in inventories	(9,000)	
Increase in receivables	(8,000)	
Increase in payables	28,000	
Cash generated from operations	<u>142,000</u>	
Interest paid	(1,000)	
Taxation paid	(49,000)	
Dividends paid	(16,000)	
Net cash from operating activities		76,000
Cash flows from investing activities		
Purchase of non-current assets	(195,000)	
Sale of non-current assets	30,000	
	<u>(165,000)</u>	
Cash flows from financing activities		
Proceeds from issue of shares	70,000	
Net cash from financing activities		<u>70,000</u>
Net increase in cash		(19,000)
Cash and cash equivalents b/f		64,000
Cash and cash equivalents c/f		<u>45,000</u>



Example 2**Direct Method**

	\$
Cash received from customers (235,000 + 1,200,000 – 259,000 – 14,000)	1,162,000
Cash paid to suppliers (840,000 + 160,000 – 168,000 – 140,000 + 138,000)	(830,000)
Cash paid to employees	(42,000)
Other cash payments (120,000 – 36,000 – 42,000 + 6,000 – 14,000)	(34,000)
	<u>\$256,000</u>

Indirect Method

	\$
Operating profit	240,000
Depreciation	36,000
Profit on sale	(6,000)
	<u>270,000</u>
Increase in Inventory	(20,000)
Increase in Receivables	(24,000)
Increase in Payables	30,000
	<u>\$256,000</u>

Chapter 15**Example 1**

Cash a/c			
Balance	11,820	Bank charges	20
Error in payment	900	Dishonoured cheque	200
		Balance	12,500
	<u>12,720</u>		<u>12,720</u>
Balance	12,500		

Bank reconciliation statement

Balance at bank	150,000
Add: Lodgements not credited	4,000
Less: Unpresented cheques	(6,500)
Balance per cash account	<u>\$12,500</u>



Chapter 16

Example 1

Receivables Ledger Control Account

Balance	186,220	Returns	9,160
Sales	101,260	Cash	91,270
Refunds	300	Discounts	1,430
		Irrecoverable debts	460
		Contras	480
		Balance	184,980
	<u>287,780</u>		<u>287,780</u>
Balance	184,980		

Payables Ledger Control Account

Returns	4,280	Balance	89,290
Cash	71,840	Purchases	68,420
Discounts	880		
Contras	480		
Balance	80,230		
	<u>157,710</u>		<u>157,710</u>
		Balance	80,230

Chapter 17

Example 1

Statement of adjustments to profit

Draft profit	52,380
Debt recovered	563
Closing inventories (8,920 – 7,930)	(990)
Sales or return	(400)
Prepayment	490
Adjusted profit	<u>\$52,043</u>

Example 2

Suspense Account

Sales	6,300	Balance	4,957
		Electricity	99
		Telephone	70
		Purchases	1,174
	<u>6,300</u>		<u>6,300</u>



Chapter 18

Example 1

(a) Sales = 20,000 + (20% × 20,000) = **\$24,000**

(b) 50,000 = x + (0.25 × x) = 1.25x

Cost of goods sold: $x = \frac{50,000}{1.25} = \mathbf{\$40,000}$

Example 2

(a) Cost of goods sold = 120,000 – (20% × 120,000) = **\$96,000**

(b) 45,000 = x – 0.25x = 0.75x

Sales: $x = \frac{45,000}{0.75} = \mathbf{\$60,000}$

Chapter 19

No examples

Chapter 20

No examples

Chapter 21

No examples

Chapter 22

Example 1

Consolidated Statement of Financial Position

Non-current assets (25,000 + 12,000)	37,000
Current assets (8,000 + 9,000)	17,000
	<hr/> 54,000
Share capital	25,000
Retained earnings (15,000 + 8,000)	23,000
Current liabilities	6,000
	<hr/> 54,000



Example 2**Consolidated Statement of Financial Position**

Non-current assets (55,000 + 25,000)	80,000
Current assets (18,000 + 14,000)	32,000
	<u>112,000</u>

Share capital	60,000
Retained earnings (w)	45,000
Current liabilities	7,000
	<u>112,000</u>

Workings – retained earnings:

P	38,000
S	15,000
Less: pre-acquisition	<u>8,000</u>
	7,000
	<u>45,000</u>

Example 3**Consolidated Statement of Financial Position**

Non-current assets (82,000 + 27,000 + 9,000)	118,000
Goodwill arising on consolidation (W1)	26,000
Current assets (20,000 + 12,000)	32,000
	<u>176,000</u>

Share capital	50,000
Retained earnings (W2)	123,000
Current liabilities	3,000
	<u>176,000</u>

W1 Goodwill arising on consolidation:

Consideration	60,000
Less:	
Share capital	10,000
Pre-acquisition profits	15,000
Fair value adjustment	<u>9,000</u>
	34,000
	<u>26,000</u>



W2 Retained earnings:

P		110,000
S	28,000	
Less: pre-acquisition	15,000	
		<u>13,000</u>
		<u>123,000</u>

Example 4

Consolidated Statement of Financial Position

Non-current assets (76,000 + 18,000 + 6,000)	100,000
Goodwill arising on consolidation (W1)	8,000
Current assets (12,000 + 9,000)	<u>21,000</u>
	<u>129,000</u>
Share capital	40,000
Retained earnings (W2)	84,000
Current liabilities	<u>5,000</u>
	<u>129,000</u>

W1 Goodwill arising on consolidation:

Consideration	25,000
Less:	
Share capital	5,000
Pre-acquisition profits	6,000
Fair value adjustment	<u>6,000</u>
	<u>17,000</u>
	<u>8,000</u>

W2 Retained earnings:

P		70,000
S	20,000	
Less: pre-acquisition	6,000	
		<u>14,000</u>
		<u>84,000</u>



Chapter 23

Example 1

Consolidated Statement of Financial Position

Non-current assets	45,000
Current assets	13,000
	<hr/> 58,000

Share capital	25,000
Retained earnings (W1)	21,400
	<hr/> 46,400
Non-controlling interest (W2)	3,600
Total equity	<hr/> 50,000
Current liabilities	8,000
	<hr/> 58,000

W1 retained earnings

P		15,000
80% share of S	8,000 x 80%	6,400
		<hr/> 21,400

W2 non-controlling interest

Share capital – 20% x 10,000	2,000
Post-acquisition earnings – 20% x 8,000	1,600
	<hr/> 3,600

Example 2

Goodwill arising on consolidation:

Consideration transferred	40,000
Fair value of NCI	30,000
	<hr/> 70,000
Share capital	20,000
Pre-acquisition retained earnings	6,000
	<hr/> 26,000
Goodwill arising on consolidation	<hr/> 44,000

Example 3

Non-controlling interest

Fair value of the NCI at the date of acquisition	30,000
NCI's share of post-acquisition profits (40% x (16,000 – 6,000))	4,000
	<hr/> 34,000



Example 4**Retained earnings**

Retained earnings of P		44,000
Retained earnings of S	16,000	
Less: pre-acquisition profits	6,000	
Post-acquisition profits of S	10,000	
P's share of post-acquisition profits of S (60% x 10,000)		6,000
		<u>50,000</u>

Example 5**Consolidated Statement of Financial Position**

Non-current assets	80,000
Goodwill arising on consolidation	44,000
Current assets	26,000
	<u>150,000</u>
Share capital	50,000
Retained earnings	50,000
	<u>100,000</u>
Non-controlling interest	34,000
Total equity	<u>134,000</u>
Current liabilities	16,000
	<u>150,000</u>

Example 6**Extract from the Consolidated Statement of Financial Position:**

Receivables (50,000 + 30,000 – 8,000)	72,000
Payables (35,000 + 40,000 – 8,000)	67,000



Example 7**Consolidated Statement of Financial Position**

Non-current assets	75,000
Inventory (W1)	18,800
Other current assets (W2)	10,000
	<u>103,800</u>

Share capital	45,000
Retained earnings (W4)	40,350
	<u>85,350</u>
Non-controlling interest (W5)	8,450
Total equity	<u>93,800</u>
Current liabilities (W6)	10,000
	<u>103,800</u>

Provision for unrealised profit in inventory:

The selling price of the inventory is \$6,000 and therefore the unrealised profit is $25/125 \times \$6,000 = \$1,200$.

We must reduce the inventory by this amount, and must also reduce S's retained earnings (because it is S who sold the goods and will have taken credit for the profit in its own accounts).

W1 Inventory:

Inventory in P	13,000
Inventory in S	7,000
Provision for unrealised profit	(1,200)
	<u>18,800</u>

W2 Other current assets:

$$10,000 + 6,000 - 6,000 = \$10,000$$

W3 Current liabilities:

$$13,000 + 3,000 - 6,000 = \$10,000$$

W4 Retained earnings:

P's retained earnings	30,000
P's share of S's retained earnings:	
$75\% \times (15,000 - 1,200)$	10,350
	<u>40,350</u>

W5 Non-controlling interest:

Share capital: $25\% \times 20,000$	5,000
Retained earnings:	
$25\% \times (15,000 - 1,200)$	3,450
	<u>8,450</u>

Note: there is no goodwill arising on consolidation because the shares were acquired on incorporation at cost.



Chapter 24

Example 1

Consolidated Statement of Profit or Loss

Revenue (52,000 + 24,000)	76,000
Cost of sales (12,000 + 10,000)	22,000
Gross Profit	54,000
Expenses (8,000 + 4,000)	12,000
Profit before taxation	42,000
Income tax (12,000 + 3,000)	15,000
Profit for the year	27,000

Profit attributable to:

Owners of the parent (bal. figure)	25,600
Non-controlling interest (20% x 7,000)	1,400
	27,000

Note: movement on retained earnings

Retained earnings brought forward (80,000 + (80% x 20,000))	96,000
Group profit for the year	25,600
Retained earnings carried forward	121,600

Example 2

Consolidated Statement of Profit or Loss

Revenue (85,000 + 31,000)	116,000
Cost of sales (21,000 + 12,000)	33,000
Gross Profit	83,000
Expenses (12,000 + 7,000)	19,000
Profit before taxation	64,000
Income tax (16,000 + 4,000)	20,000
Profit for the year	44,000

Profit attributable to:

Owners of the parent (bal. figure)	40,800
Non-controlling interest (40% x 8,000)	3,200
	44,000

Note: movement on retained earnings

Retained earnings brought forward (120,000 + (60% x (17,000 – 8,000)))	125,400
Group profit for the year	40,800
Retained earnings carried forward	166,200



Example 3**Consolidated Statement of Profit or Loss**

Revenue (120,000 + 110,000 – 28,000 (W1))	202,000
Cost of sales (55,000 + 50,000 – 28,000 (W1) + 2,000 (W2))	79,000
Gross Profit	123,000
Expenses (9,000 + 10,000)	19,000
Profit before taxation	104,000
Income tax (20,000 + 14,000)	34,000
Profit for the year	70,000
Profit attributable to:	
Owners of the parent (bal. figure)	54,700
Non-controlling interest (45% x (36,000 – 2,000 (W2)))	15,300
	70,000

W1 Intra-group sales:

Sales price	140%	28,000
Cost of sales	100%	20,000
Profit	40%	8,000

S will have recorded \$28,000 in sales, and P will have recorded \$28,000 in cost of sales, and so we subtract \$28,000 from both.

(Note: although we need to do this so as to show only sales and purchases from outside the group, this adjustment will not affect the total profit. If all the inter entity sales had subsequently been sold outside the group then no other adjustment would be necessary because all the profit would have been realised).

W2 Unrealised profit:

One quarter of the inter-entity sales remain in inventory and therefore the unrealised profit is $\frac{1}{4} \times \$8,000 = \$2,000$.

We therefore reduce S's inventory by \$2,000 which will increase the cost of sales.

Chapter 25**No examples**

Chapter 26

Example 1

		2010	2009
Net profit margin	$\left(\frac{1,896}{17,232} \right)$	11%	8.5%
Gross profit margin	$\left(\frac{4,308}{17,232} \right)$	25%	22.5%
Return on capital	$\left(\frac{1,896}{6,455} \right)$	29.4%	25.6%
Asset turnover	$\left(\frac{17,232}{6,455} \right)$	2.67	3.02
Return on equity	$\left(\frac{1,147}{5,255} \right)$	21.8%	19.0%
Current ratio	$\left(\frac{5,553}{2,316} \right)$	2.4	2.4
Quick ratio (or acid test)	$\left(\frac{3,139}{2,316} \right)$	1.36	1.15
Inventory days	$\left(\frac{2,414}{12,924} \times 365 \right)$	68.2 days	75.5 days
Receivables days	$\left(\frac{2,275}{17,232} \times 365 \right)$	48.2 days	47.5 days
Payables days	$\left(\frac{2,316}{12,924} \times 365 \right)$	65.4 days	61.0 days
Gearing ratio	$\left(\frac{1,200}{6,455} \right)$	18.6%	22.2%
Leverage	$\left(\frac{5,255}{6,455} \right)$	81.4%	77.8%
Interest cover	$\left(\frac{1,896}{120} \right)$	15.8	8.9

Chapter 27

No examples

Chapter 28

No examples

