F3 - FA - Financial Accounting

Notes

(Association of Chartered Certified Accountants)

ACCA –

FINANCIAL ACCOUNTING

STUDY NOTES

1

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Chapter 1

INTRODUCTION TO ACCOUNTING

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ACCOUNTING

Accounting is the system of recording, analyzing and summarizing business and financial transactions and verifying and reporting the results.

Recording means that the transactions should be recorded as they occur to provide up to date information to the management. This is done in books of prime entry (Details in chapter 4). Hence, day to day transactions should be recorded e.g., cash paid, cash received, sales, expenses etc.

Analyzing of the transactions is then done and they are posted to ledgers. Ledgers contain separate accounts for every type of transaction e.g. cash, sales, purchases etc. (Details in chapter 3).

Summarizing means that the transactions for a period are summarized in the financial statements to provide information to the concerned parties. There are lots of transactions in a business and summarizing them makes them understandable for users.

NEED FOR ACCOUNTING

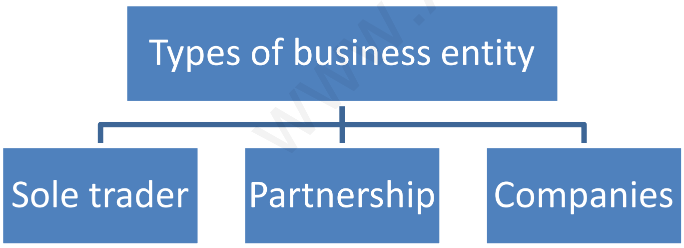
Any organization/business/individual that needs to keep track of their income, expenses, assets and liabilities needs accounting.

BUSINESS

A business is an organisation where goods and services are exchanged for one another or for money. It is an activity undertaken with the intention to make profit, but result can be profit or loss. Thus, it is an organization which sells something or provides a service with the objective of earning profit.

BUSINESS ENTITY / ORGANIZATION

It is a place where a group of people are working together to achieve a common goal.



Sole Trader

A sole trader is the simplest form of business where it is owned and managed (operated) by one person (although there might be any number of employees). These are the people who work for themselves. Sole trader term refers to the ownership of business and a sole trader can have employees.

The sole trader and their business are legally the same entity and therefore the sole trader is fully and personally liable for any losses of the business.

E.g. small retailer, painter, decorator etc.

Partnership

A partnership occurs when two or more people decide to share the risks and rewards of a business together. It is where a business is owned jointly by a number of partners (minimum 2). Some, or all, of them will be actively involved in the business. Partners share profits and losses in accordance with their agreement. The maximum number of partners allowed in a business varies with respect to law of every country.

The partners and their business are legally the same entity and therefore the partners are jointly and severally liable for the losses of their business.

E.g. Accounting firms, law firms, estate agents etc.

Companies

A company is a business owned by many people and operated by many (though not necessarily the same) people.

A company is a legal entity in its own right, and therefore the shareholders have only **limited liability** for any losses a company makes. Limited liability means that the owners (shareholders) are only responsible for the amount to be paid for their shares. (Discussed in detail later)

Limited companies are of two types:

1. Public (shares issued to general public)
2. Private (share issue restricted to friends and family)

E.g. Shell, Unilever, Google, Apple etc.

CONCEPT OF LIMITED AND UNLIMITED LIABILITY

Unlimited liability means that in case a business becomes bankrupt or is shut down, the owners will have to repay the liabilities (payables) of business with their own personal assets, if required.

Limited liability means that shareholders of a company are only responsible for the amount of money they have invested. If business becomes bankrupt or is shut down, shareholders lose only the amount of capital invested in business (money paid for buying shares). Even in case of further loss, they do not need to make any payment from their personal assets.

Non-for-profit entities

It is not just profit making businesses that will need to have accounting information and prepare financial statements – also charities, clubs and government (or public sector) organisations need it.

EXAMPLE 1

Which of the following are advantages to the owner of business of operating as a sole trader as opposed to company?

1) Legal separation of the entity from the owners
2) Unlimited liability

- **A.** 1 and 2
- **B.** 2 only
- **C.** 1 only
- **D.** Neither 1 nor 2

Answer: Option D

BUSINESS TRANSACTIONS

A transaction is an exchange of goods or services between two persons or parties. It is an event (measurable in terms of money) that **changes the financial position** of a business entity e.g. sale / purchase of goods or services etc.

Every business buys and sells goods or services and gets paid for what it sells and has to pay for what it buys. Many businesses have employees and have to pay for their work. All businesses incur expenses for services they receive such as electricity, water, telephone services. They all are business transactions.

NATURE, PRINCIPLES AND SCOPE OF FINANCIAL REPORTING

Financial reporting is mainly a method of reporting the results and financial position of a business. It is not primarily concerned with providing information towards the more efficient running of the business. In fact, financial accounting provides historical (past) information.

TYPES OF EVENTS

In accounting, an event is anything that happens in business. Events can be distributed into following two types:

- **Monetary events:** Events which are related with money or which can be measured in money terms (currency), i.e. events which change the financial position of a business. Examples are paying cash, buying building, selling an item etc.

- **Non-monetary events:** Events which are not related with money i.e. which do not change the financial position of a business. Examples are winning a game, delivering a lecture, having a meeting etc.

Only those events are considered in accounting which can be measured in monetary terms, as stated by the **Money Measurement Concept**.

EXTERNAL AND INTERNAL EVENTS

- **External event:** An external transaction would occur with an outside party, such as the purchase or sales of a good.

- **Internal event:** An internal event involves a change within the business, such as the consumption of raw materials in the manufacture of a product.

Recording of transactions:

The primary objective is to know whether business has made a profit or suffered a loss after a certain period.

Nature of Transaction

Cash transaction | **Credit transaction**

- With a **cash transaction**, the buyer pays for the goods or services immediately as they are received or possibly in advance. Cash is directly involved in a cash transaction e.g., payment through bank or payment through cash in hand.

- With a **credit transaction**, the buyer doesn't have to pay for the goods or services on receipt but is allowed some time. Cash is indirectly involved in a credit transaction. Payments and receipts are postponed for some future time (credit period) e.g. business buys goods for resale and payment is made after one month.

Parties to a Credit Transaction

Receivable
(A person who owes money to business)

Payable
(A person to whom business owes money).

<u>TYPES OF ACCOUNTING</u>

ACCOUNTING

Financial Accounting

- Production of summary financial statements / accounting reports for external users
- Prepared annually (six-monthly or quarterly in some countries).
- Generally required by law.
- Reflects past performance and current position.
- Information is calculated and presented in accordance with International Financial Reporting Standards (IAS or IFRS)

Management Accounting

- Preparation of accounting reports for internal users e.g. Management, employees.
- Normally prepared on monthly basis.
- Not mandatory.
- Production of detail accounts, used by management to control the business and plan for the future.
- Includes budgets and forecast of future activities as well as reflecting past performance.

<u>KEEPING A RECORD</u>

Transactions are recorded in accounts. The system of recording transactions is therefore called the accounting system. It is also called the **book keeping system** and sometimes **ledger accounts.**

Ledger

Ledger is a book of **Account** in which all different accounts are maintained.

Accounts (T-Accounts)

An account is a summarized record in which financial transactions of similar nature are recorded.

As mentioned above, accounting consists of three main steps.

1. **Recording** in books of prime entry.
2. **Classifying** the transactions according to their nature and posting them in their particular accounts e.g. Sales transactions are posted to the sales account and expenses are posted to the expense accounts.
3. **Summarizing** Accounting data is transformed into meaningful form and summarized commonly in two financial statements named as **STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME** and **STATEMENT OF FINANCIAL POSITION.**

ELEMENTS OF ACCOUNTING

There are FIVE elements of accounting. Accounting of all transactions is based on these five elements which are assets, liabilities, incomes, expenses and capital.

ASSETS

Assets are useful or valuable things owned and controlled by a business to earn income and profit. A business gets economic benefits out of these items e.g. cash, building, furniture etc.

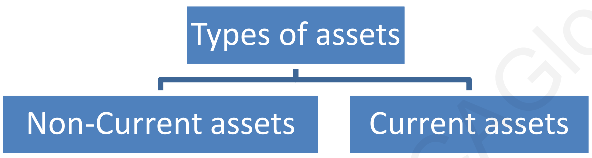
Definition as per IAS 1

An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

In this definition, **control** means that the asset will provide benefit to the organisation only and the organisation can use it in any way it wants e.g. a business may rent out a building it owns/controls or may use it for administration or as factory for production.

Past event here means that the asset must have been already acquired e.g. if business purchased a machine yesterday, it will be an asset of organisation today. But if the organisation plans to buy a car tomorrow, it will not be its asset today.

Inflow of economic benefits means that either business will be able to earn cash from it or the asset can be used to reduce costs of the organisation.



Non-Current Assets

These are assets bought with the **intention of use** rather than resale. They are expected to be used by a business for more than a year to help generate income. These are held and used in operations for a long time.

These may be tangible or intangible e.g. machinery, building, software etc. A factory building or a machine may be used for production for many years. Similarly, a computer might be used by administration staff for many years.

Current Assets

These are assets bought with the intention of resale and are held only for a short time. These may be cash or expected to generate cash or other economic benefits within 12 months. They change from day to day in the normal course of trading and the organisation intends to turn them into cash within one year e.g. inventory, receivables, prepayments, bank, cash etc.

LIABILITIES

Liability is the money owed by the business for resources supplied by people or organizations other than the owner e.g. amounts payable to suppliers.

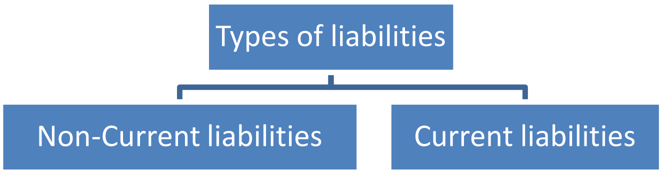
Definition as per IAS 1

A liability is a present obligation arising from past event, the settlement of which is expected to result in an outflow of economic benefits.

In this definition, **present obligation** means that the compulsion to pay exists on the day it is being recorded as liability. E.g. organisation took a loan from bank last year and has to repay it over next five years, organisation has bought inventory from supplier on credit.

Past event here also means that the obligation to pay must have already arisen by some action the past.

Out flow of economic benefits means that to settle the obligation, business will have to pay cash or another asset or may have to perform a service to compensate for the liability e.g. cash paid to bank for settlement of loan, a lawyer handling a case for the amount received in advance.



<u>Non-Current liabilities</u>

These are liabilities payable after more than 12 months' time from the reporting date e.g. loan etc.

<u>Current liabilities</u>

These are liabilities payable in less than 12 months' time from the reporting date e.g. trade payable, overdraft

The point to be noted over here is that the judgment as to whether a liability is current or non-current is made on the basis of its repayment date from the **reporting date** not from the date when the liability arose. This is because reporting date is the date at which financial statements are prepared in which elements of accounting are reflected.

EXAMPLE 2

Which of the following is a long term liability?

- **a)** Loan payable in three years' time
- **b)** Trade payables
- **c)** Sales tax payable
- **d)** Bank overdraft

Answer: Option C

<u>CAPITAL / EQUITY</u>

Capital is the amount invested in a business by its owner (the sole trader/shareholders). It may include:

- Money initially injected by the sole trader to start the business up
- Money subsequently injected by the sole trader
- Profits made by the business, less
- Money taken out of the business by the sole trader as drawings.

Note that profits made by a business are effectively a return for the sole trader on the money that they initially invested. Any profits not taken out of the business as drawings are therefore in effect extra capital.

Capital is a type of **liability** to the business, as the business theoretically owes this amount back to the sole trader.

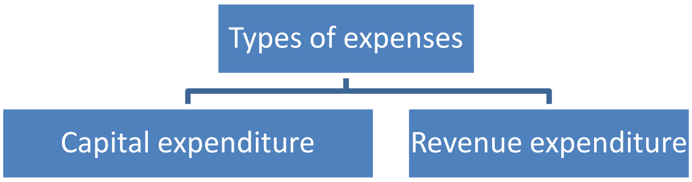
DRAWINGS

Drawings are a reduction in the liability of business to the owner. If the owner takes out cash or goods from business for personal use, it reduces the liability of the business towards owner. These are called drawings.

EXPENSES

Expenses are decrease in economic benefits during the accounting period in the form of outflows or depletion (decrease in value) of assets or occurrence of liabilities.

Expenses are cost of supply of goods or services i.e. cost of operating a business.



Capital expenditure

Capital expenditure is made when a business spends money either to:

- Buy non-current assets for use in business and not for resale.
- Add to the value of an existing non-current asset by improvement in its earning capacity (future inflow of economic benefits).

They are mentioned as non-current assets in Statement of Financial Position (Format at the chapter end).

Revenue expenditure

Revenue expenditures are expenses incurred either

- In the ordinary course of the business i.e. operational expenses
- To maintain the existing earning capacity of the business and non-current assets (repair and maintenance)

They are mentioned as Expenses in Statement of Profit or Loss (Format at the chapter end).

EXAMPLE 3

Expenditure	***Type of Expenditures***
Buying motor vehicle	Capital
Petrol costs for motor vehicle	Revenue
Repairs to motor vehicle	Revenue
Putting extra headlights on motor vehicle	Capital
Buying machinery	Capital
Electricity costs of using machinery	Revenue
We spent $2,500 on machinery, $2,000 was for an item added to the machine: $500 for repairs	Capital $2,000 Revenue $500
Painting outside of new building	Capital
Three years later – repainting outside of building above	Revenue

Error in recording

If the capital expenditure or revenue expenditure is mistaken one for the other, then gross profit or net profit figure (or both) will be incorrectly stated, as will the statement of financial position figures.

If capital expenditure is treated as revenue expenditure, then the assets and profits are understated and vice versa.

INCOME

Income means inflow of economic benefits (whether by sale for cash or on credit). The definition of income covers both revenue and gains.

Types of income

- Capital income
- Revenue income

Capital income: It is the income which arises from the sale of non-current assets

Revenue income: Revenue income arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including revenue, sales and turnover.

Profit
The excess of income over expenditures is recognised as profit.

Loss
The excess of expenditures over income is recognised as loss.

Purchases
Items which are purchased with the intention of **resale** are called purchases, whether these are on cash or credit basis.

Inventory
Goods (purchased for resale) that remain unsold at the end of an accounting year i.e. unsold "purchases" are called Stock or Inventory.

FINANCIAL STATEMENTS

The objective of financial statements is to provide summarised information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. The businesses should produce information about their activities because there are user groups who want or need to know that information in order to make economic decisions. The users need to assess ability of business to generate cash, meet its expenses, pay liabilities etc.

The two most commonly made financial statements for sole traders are:

- Statement of profit or loss and other comprehensive income
- Statement of financial position

The elements of accounting are distributed between these two financial statements.

Assets
Liabilities } Statement of financial position (SOFP)
Capital

Income
} Statement of profit or loss (P&L)
Expense

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

It is that component of financial statements that shows the financial performance of a business for an accounting period by comparing its income and expenses.

Income and expenses in a reporting period are components of profit or loss for the period. Therefore, they show how company has been performing. The reporting period is chosen depending upon the purpose for which the statement is produced e.g. it can be a year, a quarter etc.

Statement of Profit or Loss
For the year ended 30 June 20x8

	$	$
Sales		
Cost of sales		
Opening inventory		
Add: purchases		
Add: carriage inwards		
Less: closing inventory		
Gross profit		
Expenses		
Rent and rates		
Wages and salaries		
Carriage outwards		
Postage and stationery		
Insurance		
Irrecoverable debts		
Sundry expenses		
Depreciation: Equipment		
Motors		
Operating profit		
Interest payable		
NET PROFIT		

STATEMENT OF FINANCIAL POSITION

It is that component of financial statements that shows the financial position of a business at a point in time, by stating the assets, liabilities and capital of business. It is a list of all the assets controlled by business and all the liabilities owed by the business at a particular point in time along with specification of owner's capital in the company. Monetary figures are allocated to assets and liabilities and balancing figure is equity/capital.

Statement of Financial Position
As at 30 June 20x8

	$	$
ASSETS		
Non-current assets		
Land and Building		
Equipment		
Motor vehicles		
Current assets		
Inventory		
Trade receivables		
Prepayments		
Bank and cash		
TOTAL ASSETS		
CAPITAL AND LIABILITIES		
Capital		
Opening capital		
Add: Capital Introduced		
Add: profit for the year		
Less: drawings		
Closing capital		
Non-current liabilities		
10% Loan repayable 20x6		
Current liabilities		
Trade payables		
Accruals		
TOTAL LIABILITIES AND CAPITAL		

CALCULATION OF CLOSING CAPITAL

Capital is also known as **NET ASSETS**. The formula used to derive closing capital is as follows:

Closing Capital = Opening Capital + Capital introduced + Profit/(Loss) – Drawings

Where:

- Opening capital/net assets is the capital at the start of a period (an year / 6 months etc.)
- Closing capital/net assets is the capital at the end of the period
- Capital introduced is the amount of new funds invested in the business by the owner
- Profit/Loss earned during the period
- Drawings are the goods/funds taken out of the business by the owner during the period

EXAMPLE 4

Shaun had net assets of $13,000 at 30 September 20X6. During the year to 31 August 20X7, he introduced $9,800 additional capital into the business. Profits were $8,000, of which he withdrew $4,200.

What was the balance on Shaun's capital account at 31 August 20X7?

$ ____________

Answer: $19,000

NOTE: Assets in the statement of financial position are shown in order of their increasing **liquidity.**

- **Liquidity:** Ease with which an asset can be converted into cash.
- **Working capital/ Net Current Assets** is the excess of current assets over current liabilities.
- **Gross Profit** is the difference between sales and cost of goods sold.
- **Net Profit** is the difference between gross profits and other expenses

Debtor/ Receivable
A person to whom the business has sold items and by whom the business is owed money. A receivable is an asset of business (the right to receive payment is owned by the business)e.g. sale of any non-current asset on credit.

Trade Receivable/ Trade debtor
A person who owes the business money for debts incurred in the course of trading operations i.e. because the business has sold its goods or services. E.g. Business is involved in producing medicine and sale of those medicines is on credit to shopkeepers (its customer).All trade debtors are current assets of the business.

Creditor/ Payable
A person from whom a business has purchased items and to whom a business owes money. An account payable is a liability of the business. E.g. purchase of a plant and machinery on credit.

Trade payable / Trade creditor
A person to whom a business owes money for debts incurred in the ordinary course of trading operations. The term might refer to debts still outstanding which arise from the purchase from suppliers of materials, components or goods for resale. E.g. purchase of stock of medicine for resale on credit. These are the current liabilities of business. All trade payables are current liability of the business.

EXAMPLE 5

Which one of the following sentences does not explain the distinction between financial accounts and management accounts?

a) Financial accounts are primarily for external users and management accounts are primarily for internal users.
b) Financial accounts are normally produced annually and management accounts are normally produced monthly.
c) Financial accounts are more accurate than management accounts.
d) Financial accounts are audited by an external auditor and management accounts do not normally have an external audit.

Answer: Option C

Chapter 2

ACCOUNTING EQUATION

IN THIS CHAPTER

- **THE BUSINESS ENTITY CONCEPT/ SEPERATE ENTITY CONCEPT**
- **THE ACCOUNTING EQUATION**
- **THE DUALITY CONCEPT/ DOUBLE ENTRY CONCEPT**
- **EXPANDED FORM OF ACCOUNTING EQUATION**
- **STAKEHOLDERS**

THE BUSINESS ENTITY CONCEPT/ SEPERATE ENTITY CONCEPT

It states that the business entity must be treated separate from its owner. Accounting is done only for business not for owner.

Thus, the financial accounts should show only the activities of the business and not the personal activities of its owner.

THE ACCOUNTING EQUATION

A consequence of the separate entity concept is that a business will buy assets using borrowed funds or capital.

Therefore the accounting equation always holds true

An ***asset*** is something that the business OWNS
A ***liability*** is something that the business OWES
Capital is how much the business OWES to the owner. (a liability towards owner)

Assets – Liability = Capital / Net assets/ Equity

THE DUALITY CONCEPT/ DOUBLE ENTRY CONCEPT

This concept states that every transaction has dual effects, which are equal and opposite.

When the dual effect is taken into account, the accounting equation will remain true.

PROFIT/LOSS AND DRAWINGS
When a sale is made at a profit, one asset (inventory) is replaced by another (cash or a receivable).
The amounts however are not equal – the difference being **profit**.

In order for the accounting equation to hold true after this transaction has been recorded, the profit/loss must be reflected in capital. Profits are added to capital and losses are deducted from capital.

In case of **drawing** also, one impact is on reduction of assets of business while the other is a reduction in capital.

Business owners draw money for their personal use from business. This is accounted for as withdrawal or appropriation (distribution) of profit and not as expense incurred by business. Profits are capital as long as they are retained in the business. Once they are appropriated, the business suffers a reduction in capital.

EXAMPLE 1

EFFECTS OF SOME IMPORTANT TRANSACTION ON ACCOUNTING EQUATION

1. Owner puts money into business ($1000)

Cash $1,000	=	Capital $1,000

The above equation reflects that the business began by owning the **cash** that owner has put into it i.e. $1,000. As business is a separate legal entity in accounting terms and so it owes money to the owner as capital.

2. Owner took loan from bank for business ($500)

Cash ($1000 + $500)	=	Capital $1000 + Loan $500

The above equation reflects that the business began by owning further **cash** that has been received from bank i.e. $500. On the other hand, now the business owes money to the bank and it is therefore a liability.

3. Purchase of building ($600)

Cash ($1500 – $600) + Building $600	=	Capital $1000 + Loan $500

This equation reflects an increase of one asset i.e. building and simultaneous decrease of another asset i.e. cash. This leaves $900 in cash.

4. Purchase of goods $100 for cash and $100 on credit

Cash ($900 – $100) + Building $600 + Inventory $200	=	Capital $1000 + Loan $500 + Trade payable $100

This equation shows an increase in inventory of $200. Against this there is a decrease in cash of only $100. Therefore, remaining gives rise to $100 worth liability i.e. trade payable.

5. Sale of all the stock goods for $300 ($200 on credit; $100 on cash)

Cash ($800 +$100) + Building $600 + Inventory 0 + Trade receivable $200	=	Capital $1000 + Profit $100 + Loan $500 + Trade payable $100

Here the owner had sold good costing $200 to earn income of $300. The owner has earned a profit of $100 on the day's trading. But against sale of $300, only $100 was received in cash. Remaining amount is now an asset i.e. trade receivable. On the other hand, the profit earned will be added to capital as this will increase the amount of money owed by the business to the owner (Profits are added to owner's capital and losses are deducted from owner's capital.

6. Payment to trade payable $100

Cash ($900-$100) + Building $600 + Inventory + Trade receivables $200	=	Capital $1,100 + Loan $500 + Trade payable 0

In this transaction, cash has decreased by $100 as this was sent as settlement of outstanding amount to trade payable. The trade payable now no longer exists and $800 cash has been left behind after this transaction.

7. Owner took $200 of cash for personal use

Cash ($800 – $200) + Building $600 + Inventory 0 + debtors $200	=	Capital ($1,100 – drawings $200) + Loan $500

In this transaction, the withdrawal of cash resulted in reduction of cash from business as well as a reduction in capital.

- If a business makes a profit, its capital and net assets increase.
- If a business makes a loss, its capital and net assets decrease.

Equation will always remain balanced because of dual effect of transactions but after every transaction there is a change in financial position.

EXPANDED FORM OF ACCOUNTING EQUATION

Assets = Liabilities + Capital + Profit / (Loss) – Drawings

Net Assets Equation
Assets – Liabilities = Capital + Profit –Loss – Drawings
Net Assets = Capital + Profit –Loss– Drawings

The Financial Statements
The detailed accounting equation can be rearranged to produce a Statement of Financial Position. Accounting equation is the simplest form of statement of financial position.

EXAMPLE 2

Bella had capital in her business on 1 January 20X6 of $16,500. At 31 December 20X6, the capital was $11,350. Bella did not introduce any further capital in the business during the year but made drawings of $3,300.

Calculate the profit / (loss) of Bella for the year ended 31 December 20X6.

Answer: Loss $1,850

EXAMPLE 3
Inventory worth $5,000 is sold for $8,000. The complete effect of this transaction on the accounting equation will be?

a) Profit will be increased by $3,000
b) Inventory will decrease by $5,000, cash will increase by $8,000 & profit will increase by $3,000
c) Inventory will decrease by $5,000, & profit will increase by $8,000
d) Cash will increase by $8,000 & profit will increase by $3,000

Answer: Option B

USERS OF ACCOUNTING INFORMATION/STAKEHOLDERS

1. Owners of the business

Owners of the business are interested in their current and future profits and security of their investment. Profits are shown by Statement of Profit or Loss and Other comprehensive Income and financial strength is shown by the Statement of Financial Position (SOFP).

If the organisation does not perform well or goes bankrupt, it is the owner's money which is at risk. Therefore, owners are interested in knowing how their capital is utilised, the types of assets and liabilities business has and the strength of performance and position of business.

2. Trade Receivables/Customers

They need to know if the company will continue to supply them in future. This is especially important if they are dependent on company for a particular product.

3. Trade Payables/Suppliers

Suppliers need information to identify they will be regularly and timely paid.

4. Lenders

They need to know the ability of business to repay them. It enables them to determine whether principal (actual) amount of loan and interest will be paid when due.

Long term loans may also be backed by 'security' given by business over specific assets. The value of these assets will be indicated in the SOFP.

5. Government. (Inland revenue)

Information is needed to make financial policies for economy and calculation of tax payable by a business. Government agencies are interested in efficient allocation of resources and company profitability to properly regulate them. They need relevant data for calculation of national statistics also e.g. growth in economy.

6. Employees

Employees and their representative groups (e.g. labour unions) need to know the financial position and performance of a business to check the security of their employment. It also gives them information about their future salaries, bonuses and benefits.

7. Public

They want to assess the effect of company on economy (e.g. GDP) and environment (e.g. pollution). They also want to see the employment opportunities and impact on local community (e.g. local suppliers)

8. Financial analysts / advisors

They want information to base their future investments on it. Stockbrokers may need information to give advice to investors and their clients.

EXAMPLE4

Which of the following best explains why employees are interested in the financial statements of their employer?

a) To compare the business with its competitors in order to decide whether to seek employment with one of those competitors.
b) To assess the effect of the business on the local economy, community and environment.
c) To assess whether the business will continue in the foreseeable future and their employment is secure
d) To assess the profitability of the business in order to decide whether to invest in it.

Answer: Option C

EXAMPLE 5
The financial statements are used by different user groups for different reasons.

For each user group what is their primary area of interest?

	Profitability	**Liquidity**
Banks		
Shareholders		

Answer:

	Profitability	**Liquidity**
Banks		✓ Liquidity
Shareholders	✓ Profitability	

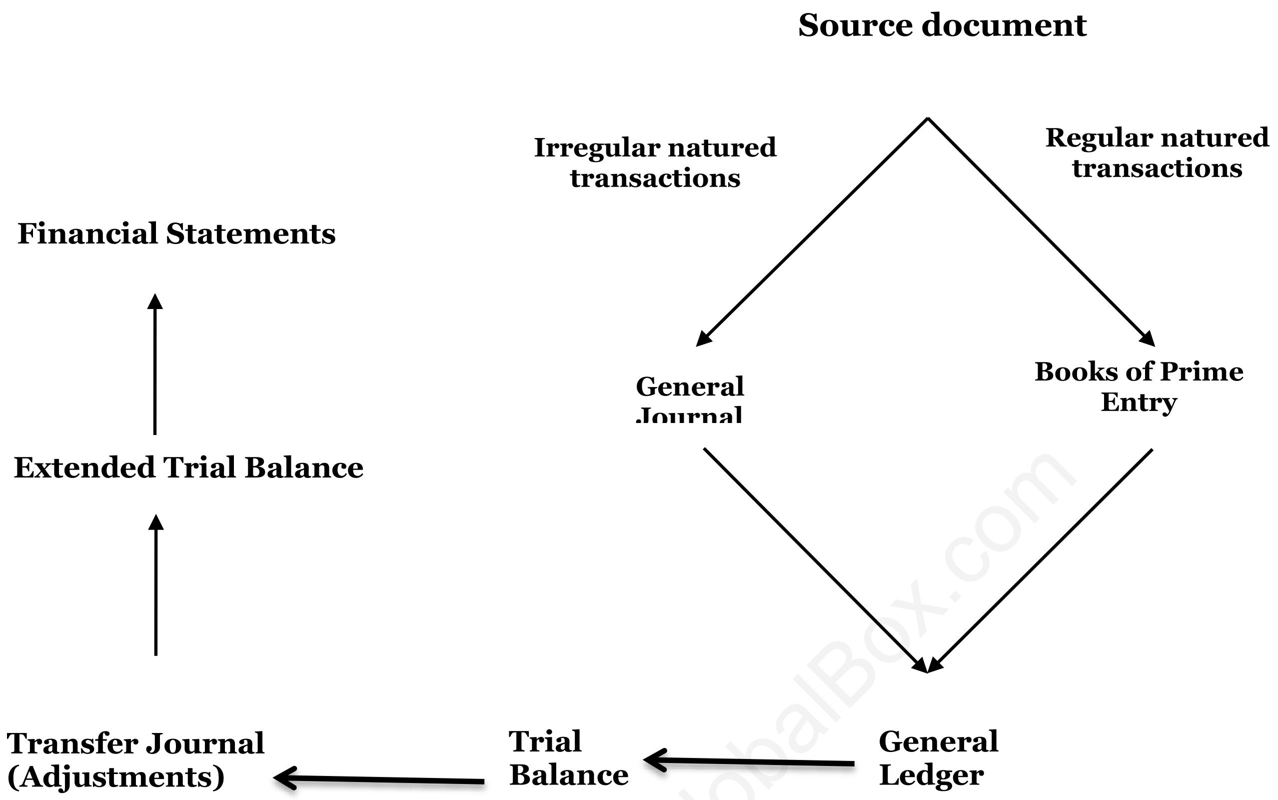
Chapter 3

DOUBLE ENTRY BOOK KEEPING RULES

IN THIS CHAPTER

- ACCOUNTING CYCLE
- THE DUALITY CONCEPT/ DOUBLE ENTRY CONCEPT
- TRIAL BALANCE
- ACCOUNT CODES
- JOURNAL
- DISCOUNTS

ACCOUNTING CYCLE



The above is a summary of accounting cycle in a business. Following are the steps involved in it:

- The accounting process starts with 'recording' from source document e.g. sale invoice, purchase invoice, electricity bill etc.
- The regular natured transactions are then recognised in books of prime entry (also known as day books). Examples include transactions like sales, purchases, sale return, purchase return etc. These transactions occur frequently in business.
- The irregular natured (infrequently occurring) transactions are recognised in general ledger e.g. purchase or sale of non-current assets.
- From these documents data is then transferred to general ledger and 'classified' into relevant accounts. The total of transactions from individual day books is transferred to general ledger. Here the double entries are recognised (Discussed later). T-Accounts are prepared in general ledger (Discussed later)
- The carried down balances of T-accounts is then transferred to trial balance.
- After balancing trial balance, year-end adjustments and correction of errors entries are recorded in transfer journal. The year-end adjustments include item such as inventory, depreciation, irrecoverable and doubtful debts, accruals and pre-payments etc. (All of these discussed in later chapters)
- The balances are again checked for mathematical accuracy in extended trial balance.
- The data is then 'summarised' and financial statements are prepared.

General Ledger (Main or Nominal Ledger)
It is the book which contains "Ledger Accounts" of each type of asset, liability, revenue and expense. Hence, the double entries for transactions are passed in this book.

THE DUALITY CONCEPT AND DOUBLE ENTRY

In the previous chapter, we learnt that each transaction has two equal and opposite effects such that the accounting equation always proves correct:

Assets = Liabilities + Capital

Traditionally one effect is referred to as the **Debit** (abbreviated to **Dr**) and the other as the **Credit** (abbreviated to **Cr**).

Ledger accounts, debits and credits

In practice it is far too time consuming to write up the accounting equation each time that the business undertakes a transaction. Instead the two effects of each transaction are recorded in ledger accounts.

Transactions are recorded in ledger accounts (or T accounts).

There is a ledger account for each asset, liability, and income and expense item.

These individual ledger accounts are all held in the General ledger.

Format of the Ledger Account

The Ledger account ('T' account)

Title of account

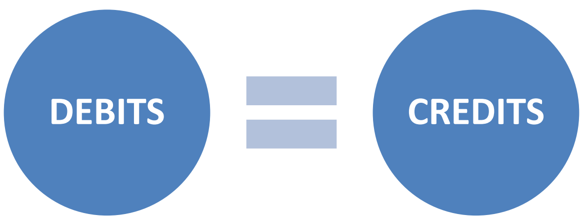
Debit (Dr.)			Credit (Cr.)		
Date	Narrative	Amount	Date	Narrative	Amount
		$			$

The left hand side is called the DEBIT side
The right hand side is called the CREDIT side.

We post entries to the Debit or Credit side depending if they are increases or decreases to the account.

DEBIT AND CREDIT RULES

For every transaction the total amounts of debits must be equal the total amounts of credits.



Whether an entry is to the debit or credit side of an account depends on the type of account and the type of transaction:

Rule

	Increase	Decrease
Assets	Dr.	Cr.
Liabilities	Cr.	Dr.
Revenue	Cr.	Dr.
Expenditures	Dr.	Cr.
Capital	Cr.	Dr.
Drawings	Dr.	Cr.

For **increases**, remember **DEAD CLIC**!

Debit	Credit
In	in
Expense (Statement of Profit or Loss)	Liability (Statement of Financial Position)
Asset (Statement of Financial Position)	Income (Statement of Profit or Loss)
Drawings (Statement of Financial Position)	Capital (Statement of Financial Position)

If you remember the increases, the decreases will just be the opposite!

i.e. ↓ In expenses and assets will be credit

↓ In liabilities, income and capital will be debit.

EXAMPLES OF COMMONLY USED DOUBLE ENTRIES – WITH IMPACT ON ELEMENTS OF ACCOUNTING

	TRANSACTION	DOUBLE ENTRY	REASON & IMPACT
1.	Investment of cash by owner in business	Dr. Cash/Bank	Increase in asset – SOFP
		Cr. Capital	Increase in capital – SOFP
2.	Introduction of asset by owner in business	Dr. Asset	Increase in asset – SOFP
		Cr. Capital	Increase in capital – SOFP
3.	Purchase of non-current asset on cash	Dr. Asset	Increase in asset – SOFP
		Cr. Cash/ Bank	Decrease in asset – SOFP
4.	Purchase of non-current asset on credit	Dr. Asset	Increase in asset – SOFP
		Cr. Payable	Increase in liability – SOFP
5.	Purchase of inventory on cash	Dr. Purchases	Increase in expense – P&L
		Cr. Cash	Decrease in asset – SOFP
6.	Purchase of inventory on credit	Dr. Purchases	Increase in expense – P&L
		Cr. Trade payable	Increase in liability – SOFP
7.	Payment to trade payable/Creditor	Dr. Trade payable	Decrease in liability – SOFP
		Cr. Cash	Decrease in asset – SOFP
8.	Returning an item purchased on credit	Dr. Trade payable	Decrease in liability – SOFP
		Cr. Purchase return	Decrease in expense – P&L
9.	Making a cash sale	Dr. Cash/Bank	Increase in asset – SOFP
		Cr. Sales	Increase in income – P&L
10.	Making a credit sale	Dr. Trade receivable	Increase in asset – SOFP
		Cr. Sales	Increase in income – P&L
11.	Getting a credit sale returned	Dr. Sales return	Decrease in income – P&L
		Cr. Trade receivable	Decrease in asset – SOFP
12.	Cash received from trade receivable	Dr. Cash/Bank	Increase in asset – SOFP
		Cr. Trade receivable	Decrease in asset – SOFP
13.	Payment of cash expense	Dr. Expense	Increase in expense – P&L
		Cr. Cash	Decrease in asset – SOFP
14.	Expense payable	Dr. Expense	Increase in expense – P&L
		Cr. Payable	Increase in liability – SOFP
15.	Loan received	Dr. Cash/Bank	Increase in asset – SOFP
		Cr. Loan	Increase in liability – SOFP
16.	Other income earned (e.g. interest income)	Dr. Receivable	Increase in asset – SOFP
		Cr. Income	Increase in income – P&L
17.	Cash receipt of other income	Dr. Cash	Increase in asset – SOFP
		Cr. Income	Increase in income – P&L
18.	Cash drawings by owner	Dr. Drawing	Decrease in capital - SOFP
		Cr. Cash	Decrease in asset – SOFP
19.	Goods drawing by owner	Dr. Drawing	Decrease in capital - SOFP
		Cr. Purchases	Decrease in expense – P&L
20.	Repayment of loan	Dr. Loan	Decrease in liability– SOFP
		Cr. Cash/Bank	Decrease in asset – SOFP
20.	Cash deposited in bank	Dr. Bank	Increase in asset – SOFP
		Cr. Cash	Decrease in asset – SOFP
20.	Cash withdrawn from bank	Dr. Cash	Increase in asset – SOFP
		Cr. Bank	Decrease in asset – SOFP

Note: Double entries regarding discounts and sales tax are discussed later.

EXAMPLE 1

1) **What transaction is presented by the entries: Debit Bank, Credit M Smith?**
   a) Sale of goods to Smith for cash
   b) Purchase of goods from Smith for cash
   c) Receipt of cheque from Smith
   d) Payment of cheque to Smith

Answer: Option C

EXAMPLE 2

Which of the following statement concerning a credit entry is incorrect?
   a) Credit entries record increase in capital or liabilities
   b) Credit entries record decrease in assets
   c) Credit entries record increase in profits
   d) Credit entries record increase in expense

Answer: Option D

EXAMPLE 3

A machine (cost $5,000) is bought on credit from Mr. Pete. Subsequently, $1,000 of the debt to Mr. Pete is paid by cheque. Which of the following correctly records the transactions?

a) Debit Mr. Pete $5,000, Credit machine $5,000. Debit bank $1,000, Credit Mr. Pete $1,000
b) Debit Mr. Pete $5,000, Credit machine $5,000. Debit Mr. Pete $1,000, Credit Bank $1,000
c) Debit machine $5,000, Credit Mr. Pete $5,000. Debit bank $1,000, Credit Mr. Pete $1,000
d) Debit machine $5,000, Credit Mr. Pete $5,000. Debit Mr. Pete $1,000, Credit Bank $1,000

Option D

e) **Summary of steps to record a transaction**

1. Identify the two accounts that are affected.
2. Consider whether they are being increased or decreased.
3. Decide whether each account should be debited or credited.
4. Check that a debit entry and a credit entry for equal amounts have been made.

Balancing off a ledger account

At the end of an accounting period, the ledger accounts must be balanced off to obtain a closing balance.
The process to achieve this is:

1. Add up debit and credit side of T account.
2. Take the higher total and make it the total for both sides of the account.
3. Insert a balancing figure to the side of the T account which does not currently add down. Call this balancing figure 'balance c/d' (carried down/ carried forward).
4. Carry the balance down diagonally and call it 'balance b/d' (brought down/ brought forward).
5. Do not show a balance c/f or balance b/f but instead put the balancing figure on the smallest side and label it 'Statement of Profit or Loss' while balancing the Income or Expense accounts.

   - Where the closing balance is on the credit side (Debit balance), it is either an **asset** or **expense**
   - Where the closing balance is on the debit side (Credit balance), it is either a liability or income

EXAMPLE

Balance off the following account:

Cash at bank account

	$		$
Balance b/d	200	Wages	120
Capital	4,800	Sundry expenses	36
Sales	1,400	Rent	175
Receivables	1,500	Motor expenses	44
		Payables	3,000
		Drawings	300

1. Add up debit and credit side of T account.

Cash at bank account

	$		$
Balance b/d	200	Wages	120
Capital	4,800	Sundry expenses	36
Sales	1,400	Rent	175
Receivables	1,500	Motor expenses	44
		Payables	3,000
		Drawings	300
	7,900		3,675

2. Take the higher total and make it the total for both sides of the account.

Cash at bank account

	$		$
Balance b/d	200	Wages	120
Capital	4,800	Sundry expenses	36
Sales	1,400	Rent	175
Receivables	1,500	Motor expenses	44
		Payables	3,000
		Drawings	300
	7,900		7,900

3. Insert a balancing figure to the side of the T account which does not currently add down. Call this balancing figure 'balance c/d' (carried down/ carried forward).

Cash at bank account

	$		$
Balance b/d	200	Wages	120
Capital	4,800	Sundry expenses	36
Sales	1,400	Rent	175
Receivables	1,500	Motor expenses	44
		Payables	3,000
		Drawings	300
		Balance c/d	**4,225**
	7,900		7,900

4. Carry the balance down diagonally and call it 'balance b/d' (brought down/ brought forward).

Cash at bank account

	$		$
Balance b/d	200	Wages	120
Capital	4,800	Sundry expenses	36
Sales	1,400	Rent	175
Receivables	1,500	Motor expenses	44
		Payables	3,000
		Drawings	300
		Balance c/d	4,225
	7,900		7,900
Balance b/d	4,225		

TRIAL BALANCE

Trial balance is a memorandum listing of all account balances. It is an internal check; it checks mathematical accuracy of double entry bookkeeping. It is prepared by the balances (b/d) extracted from T accounts.

It has two columns DEBIT & CREDIT and they should be equal to each other indicating that there are no mathematical errors (e.g. in class)

Important point: Remember that trial balance itself is not a part of double entry book keeping system.

Format

ABC
TRIAL BALANCE
FOR THE YEAR ENDED DECEMBER 31, 20X8

	DR.	**CR.**
Cash	X	
Motor vehicle	X	
Equipment	X	
Inventory	X	
Bank overdraft		X
Bank loan		X
Capital		X
Gas expenses	X	
Sales		X
Salaries	X	
Total	XX	XX

Equal

ACCOUNT CODES

Every account must be separately identifiable. It is often quicker and more convenient to give accounts their own unique code number as well.

Benefits of codes

- A code number is usually quicker to write than an account name
- Using unique codes can reduce the risk of errors

In computerized accounting, it is easier for computers to process code number than account names.

JOURNAL

There are occasions when a transaction needs to be moved from one T account to another. Whenever an amount is moved from one account to another it is important that a record of the movement is kept. The document used to record this transfer is called a journal. (Transfer Journal)

Uses of journal

- The purchase and sale of non-current assets on credit
- Correction of errors
- Writing off irrecoverable debts

DISCOUNTS

Discounts are a reduction in price of goods or incentive for the buyer.

Types of Discounts

Trade discount is a reduction in price e.g. bulk purchase discount.

Cash discount / Settlement discount which is given on early settlement of a debt.

Only cash discount is accounted for in the financial record's discount T account. Trade discount decreases the list price of an item and is shown on the source document only. No double entry is passed for trade discount.

Cash/Settlement Discounts may be given in the case of credit transactions for prompt payment:

- A business may give its customer a discount – known as **Discount Allowed**.
- A business may receive a discount from a supplier – known as **Discount received**.

The treatment of settlement discount has changed recently (Prepare both for exams). For better understanding both treatments are mentioned below:

OLD TREATMENT

Historically, income from a credit sale in which a settlement discount has been offered has been recognised in full at the point of sale. Accounting for the settlement discount only takes place if the customer pays within the required settlement period (thus accepting the discount).The discount allowed would be recorded as an expense in the seller's statement of profit or loss and revenue would remain at the full amount.

Example:

A Ltd sold goods with a list price of $1,500 on credit to a customer. A Ltd has a 30 day payment period and has offered the customer a 5% prompt payment discount if payment is made within 14 days.

Solution:

In per old treatment, the initial sale would have been recorded as:

Dr. Receivables $1,500 Cr. Revenue $1,500.

If the customer pays within the 14 day settlement period the accounting entry would be

Dr. Cash $1,425 Dr. Discounts Allowed $75 Cr. Receivables $1,500.

If the customer pays after the 14 day period, A Ltd would record the receipt as:

Dr. Cash $1,500 Cr. Receivables $1,500.

Double entries for Discount allowed and Discount received

As per above old treatment, the double entries for settlement discounts are:

Discount allowed

Dr Discount allowed (expense)	X
Cr Trade Receivables	X

Discount received

Dr Trade Payables	X
Cr Discount received (income)	X

NEW TREATMENT

As per the revised treatment, when prompt payments discounts are offered, it means that the expected consideration is variable (variable consideration) as the amount the entity will actually receive is dependent upon the customer choice as to whether it will take advantage of the discount.

The recently changed treatment requires that where a contract contains elements of variable consideration, the entity should estimate the amount of variable consideration to which it will be entitled under the contract. It says that variable consideration is only included in the transaction price if, and to the extent that, it is highly probable that its inclusion will not result in a significant revenue reversal in the future when the uncertainty has been subsequently resolved.

When an entity enters into a sale with a customer and a prompt payment discount has been offered, the amount of revenue to be recognised initially will need to be estimated taking into account the probability of the discount being accepted. When the entity expects that the customer will accept the discount, revenue should be recorded net of the discount.

Example:

J Ltd sold goods with a list Price of $2,000 on credit to a customer. J Ltd has a 30 day payment period and has offered the customer a 3% prompt payment discount if payment is made within 15 days. Based on past experience the customer is expected to take up the 3% discount.

Solution:

The initial sale will be recorded as:

Dr. Receivables $1,940 Cr. Revenue $1,940.

If the customer pays within the 14 day settlement period the accounting entry would be:

Dr. Cash $1,940 Cr. Receivables $1,940.

If the customer does not pay within the 14 day period, when payment is made A Ltd would record this as

Dr. Cash $2,000 Cr. Receivables $1,940 Cr. Revenue $60.

This text includes treatment of both discounts as current exams have a mix of questions. Going forward, only new treatment will be applicable.

COMPREHENSIVE EXAMPLE

Graham Winston started his business on 1 March 20X5. His first month's transactions are listed below:

1. Introduces $5,000 into the business current account and brings his van, worth $4,600 into the business.
2. Buys goods for resale costing $3,000 on credit
3. Sells goods for $2,000 on credit
4. Sells goods for cash of $1,400
5. Pays wages of $120, and sundry expenses of $36
6. Buys goods costing $1,800 on credit
7. Sells goods for $6,300 on credit
8. Pay rent of $175 and motor expense of $44
9. Receives $1,500 from credit customers and pays $3,000 to suppliers for goods previously received on credit
10. Draws $300 from the bank account for his personal expenses

Required:

a. Record Graham Winston's transactions in appreciate ledger accounts.
b. Prepare a statement of profit or loss for the month to 31 March 20X5 and a statement of financial position at that date by:
   i. Transferring all income and expense account balances to the statement of profit or loss: and
   ii. Bringing down a balance on all statement of financial position accounts and presenting these in the statement of financial position.

SOLUTION

a.

Cash at bank account

	$		$
Capital	5,000	Wages	120
Sales	1,400	Sundry expenses	36
Receivables	1,500	Rent	175
		Motor expenses	44
		Payables	3,000
		Drawings	300
		Balance c/d	4,225
	7,900		7,900
Balance b/d	4,225		

Van account

	$		$
Capital	4,600		
		Balance c/d	4,600

Capital account

	$		$
Drawings	300	Cash at bank	5,000
		Van	4,600
Balance c/d	13,825	Profit	4,525
	14,125		14,125
		Balance b/d	13,825

Purchases account

	$		$
Payables	3,000	Statement of profit or loss	4,800
Payables	1,800		
	4,800		4,800

Payables account

	$		$
Cash at bank	3,000	Purchases	3,000
Balance c/d	1,800	Purchases	1,800
	4,800		4,800
		Balance b/d	1,800

Sales account

	$		$
		Receivables	2,000
		Cash at bank	1,400
Statement of profit or loss	9,700	Receivables	6,300
	9,700		9,700

Receivables account

	$		$
Sales	2,000	Cash at bank	1,500
Sales	6,300	Balance c/d	6,800
	8,300		8,300
Balance b/d	6,800		

Wages account

	$		$
Cash at bank	120	Statement of profit or loss	120
	120		120

Sundry expenses account

	$		$
Cash at bank	36	Statement of profit or loss	36
	36		36

Rent account

	$		$
Cash at bank	175	Statement of profit or loss	175
	175		175

Motor expenses account

	$		$
Cash at bank	44	Statement of profit or loss	44
	44		44

Drawings account

	$		$
Cash at bank	300	C/d	300
	300		300

b.

i.

Graham Winston

Statement of profit or loss for the month ending 31 March 20X5

	$	$
Sales		9,700
Less: cost of sales – purchases		(4,800)
		4,900
Gross profit		
Expenses		
Wages	120	
Sundry	36	
Rent	175	
Motor expenses	44	(375)
Net profit		4,525

ii.

Statement of financial position at 31 March 20X5

	$		$
ASSETS			
Non-current assets-van			4,600
Current assets			
Receivables	6,800		
Cash at bank	4,225		11,025
TOTAL ASSETS			**15,625**
CAPITAL AND LIABILITIES			
Opening capital			
Capital introduced	9,600		
Add: Profit	4,525		
Less: Drawings	(300)		
Closing capital			13,825
Current liabilities			
Payables			1,800
LIABILITIES AND CAPITAL			**15,625**

Chapter 4

BOOKS OF PRIME ENTRY AND BUSINESS DOCUMENTATION

IN THIS CHAPTER

- DOCUMENTS
- BOOKS OF PRIME ENTRY
- CASH RECEIPTS RECORDING AND DOCUMENTATION
- IMPREST SYSTEM
- PETTY CASH BOOK
- NON-IMPREST SYSTEM
- CONTROLS OVER PETTY CASH

DOCUMENTS

When a business buys or sells, each stage of the transaction is documented. The documentation can be manual and now a days, more popularly, electronic.

Why do we need documentation?

- As evidence of the transaction and its details
- As evidence of the stage the transaction has reached
- For checking and confirming transaction
- For recording the transaction details

Processing Transactions

Depending on the way in which orders are made, a transaction is processed in different ways and with different documentation.

Cash Transactions

These are quite simple and easy to understand. The buyer orders goods or services and pays for them immediately or on delivery. The seller provides the service or delivers the goods and often gives the customer a receipt, which serves the purpose of evidence for payment.

Receipt

An evidence of payment

Credit Transactions

For any credit transaction, both parties to the transaction, buyer and seller, must agree what the credit terms should be, such as span of time available for payment (credit period) and maximum borrowing amount (credit limit).

These terms should be monitored and approved by the credit control authority in the selling organization.

Source document

Whenever a transaction takes place involving sales or purchases, receiving or paying money, or owing money or being owed money, it is usual for the transaction to be recorded on a source document.

Invoice

It is a demand for payment

Credit sale

A business usually likes to receive an order in writing for a credit transaction. Since the customer initiates the written order, the order document is a purchase order.

If the order is for the purchase of goods that the supplier has already in stock, the supplier will produce a dispatch note for the warehouse and a delivery note. The goods are then delivered to the customer, who signs the delivery note. A copy of the sales invoice is kept with the supplier and a copy is sent to the customer. When a customer pays, the payment might be accompanied by a remittance advice, this is a document containing the details of the payment, including the sale invoice number.

A credit purchase

The person who desires the goods fills in a purchase requisition form and the controlling authority approves this. This form is now passed on to the person responsible for placing orders for the goods.

A purchase order is prepared and sent to the chosen supplier, once the details have been discussed with the supplier, and the sales price and credit terms agreed. When the goods are delivered, a delivery note accompanies it. Goods received are reconciled with the delivery note. The delivery details are copied onto goods received note. The supplier sends an invoice soon after the delivery. It is called a purchase invoice. This invoice goes to the accounts department. The accounts department checks the details on the invoice against the purchase order. If the invoice is correct, it is then authorized by a senior manager. The details of the authorized invoice are then recorded in the accounting systems, and payment is made when the agreed credit period comes to an end.

Production Dept. → Store Dept. Warehouse → Purchase Dept.

Issue requisition — Purchase requisition

BUYER		**SELLER**
Enquiry letter	→	
	←	Pricelist/ quotation/ catalogue
Purchase order	→	
	←	Acknowledgement letter (confirmation of purchase order.)
Goods Received Note (Internal doc)	←	Dispatch note / delivery note / advice note along with goods delivered to warehouse
Purchase invoice (for buyer).	←	Sales invoice (to Head Office)
Goods return note (an internal doc) Debit note	→	
	←	Credit note (acceptance of returned goods)
	←	Statement along with remittance advice
Payment along with remittance advice	→	

Returns, credit and debit notes

It is common in business for a customer to return goods to a supplier, either because they don't match the original order or they bear some fault. Sometimes, goods are sold to a dealer on a 'sale or return' basis, which means that if the retailer doesn't resell the goods, they can be sent back to the supplier.

Credit note

Is a document which cancels all or part of previously issued invoice. If the buyer is not satisfied with the goods and the seller agrees to take the goods back, the seller will issue a credit note for the items returned. The amount owed to the seller is then the amount of the original invoice less the value of the credit note.

Credit note is opposite of the invoice. It is a source document for credit transactions.

Debit note by buyer

It is a formal request for the issuance of credit note. It is sent by the customer, along with goods returned.

Debit note is not a source document.

Debit note by seller

A debit note is an adjusting document similar to a credit note. It is sent from a supplier to a customer when there is a need to increase the amount owed by the customer.

Remittance advice

It is sent with the payment and shows what a payment represents. It details the payment or it shows what items are being paid.

Proforma invoice/dummy invoice:

When a customer does not want credit and/or wishes to pay in advance for goods, he may request a Proforma invoice from the supplier

a) This will show all the details of the sale on a regular invoice but will not be entered into the seller's books of account, it is a dummy invoice.
b) The customer will create a cheque or get the cash to pay the proforma invoice.
c) When the seller receives the cash or cheque it creates a real invoice which is recorded as normal. Because it is paid immediately the invoice is effectively a COD (cash on delivery) invoice.

Proforma invoices are vital for a seller, who cannot settle in advance of dispatch but which has customers who do not want credit and need an 'invoice' against which to raise payment (and because their procedures do not permit payment except against invoice). It is commonly used in import export business. Buyers whose credit is not good also have little choice but to pay against proforma invoices.

<u>**Other terms**</u>

Ex-Work: If this is written on an invoice it means that cost of goods does not include cost of delivery.

FOB (free on board): This means that goods will be transported free, to the ship by the supplier.

Advice Note:

Document issued to a customer or received from a supplier, advising that a delivery will be made on a specific day and listing the items to be delivered.

Delivery Note:

Document sent with products delivered to a customer. One copy kept by the customer, one copy signed by the customer and retained by the supplier.

Price Quotation:

Document sent to a potential customer quoting for some goods or a service. If signed by the customer, it becomes a purchase order from the customer.

Purchase Invoice:

Written request for payment from a supplier, giving details of items delivered.

Sales invoice:

Written request to a credit customer for payment, giving details of items sold.

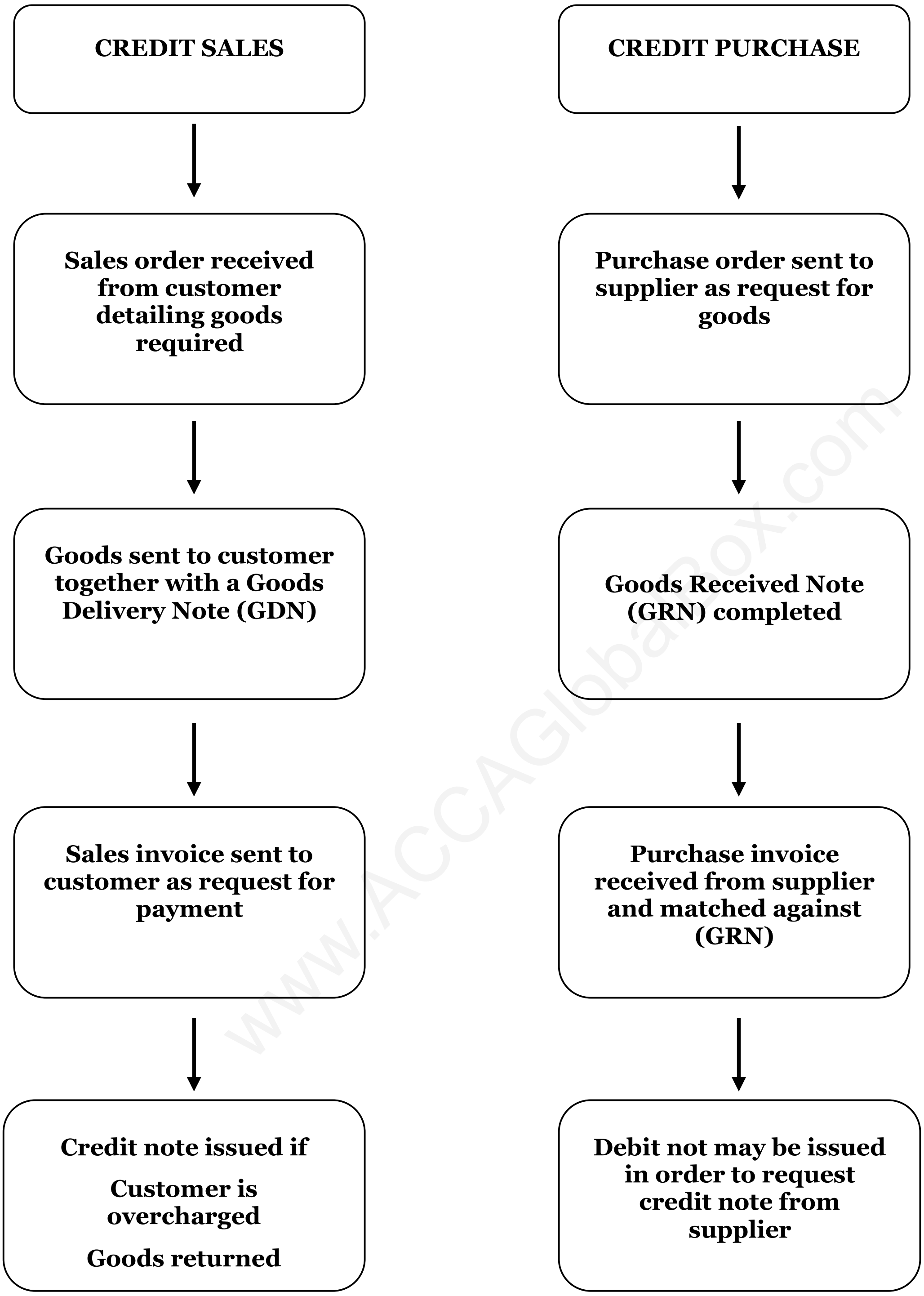
Internal Cheque Requisition:

A form used within a business for properly authorizing payments to be made to a supplier.

Statement of account:

A list of invoices, credit notes, settlement discount and payments for a given period of time, sent by a supplier to a credit customer. The statement also shows the current amount owed by the customer.

SOURCE DOCUMENTS

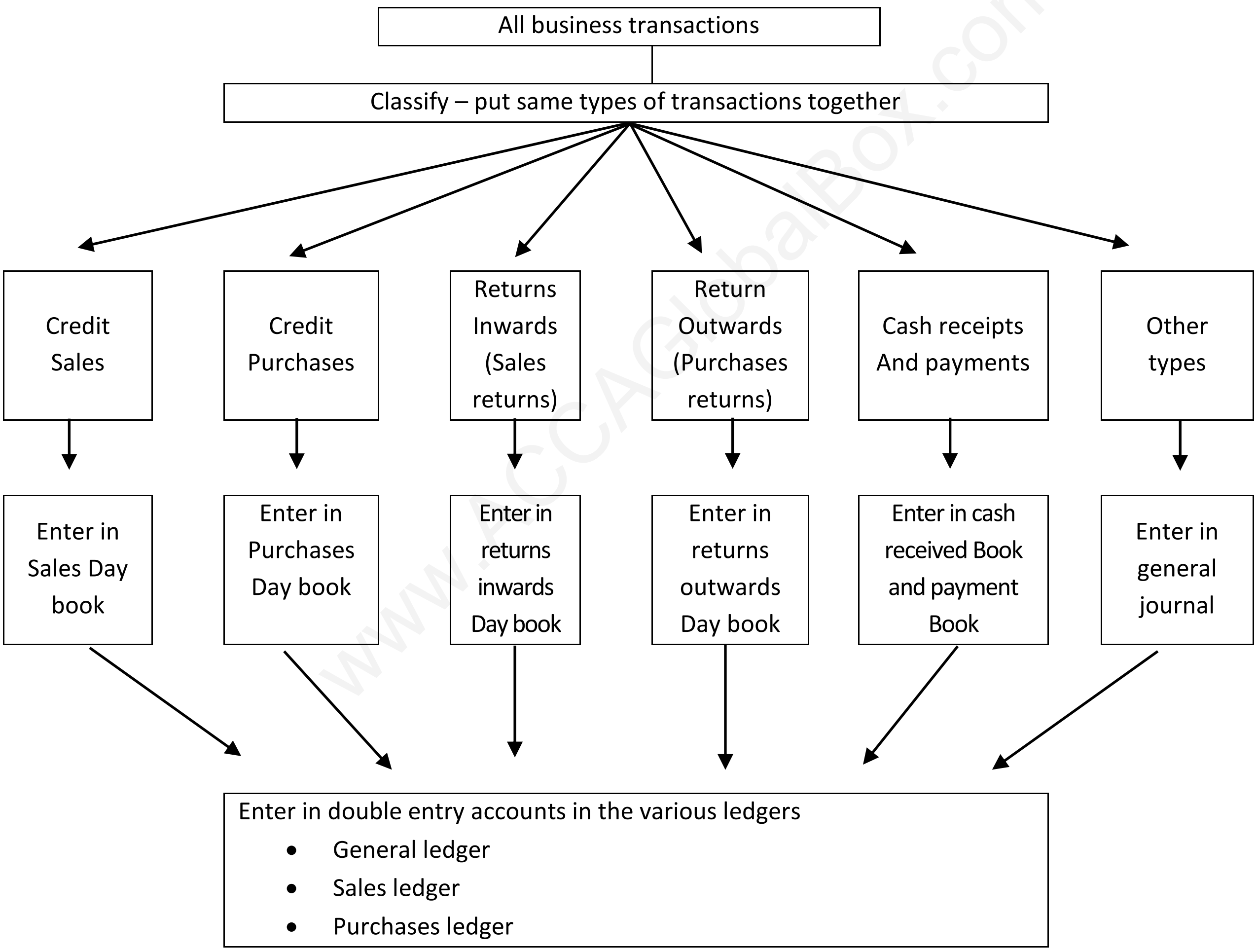


BOOKS OF PRIME ENTRY

All transactions are initially recorded in a book of prime (or original) entry. This is because:

- If ledgers were updated each time a transaction occurred, the ledger accounts would quickly become cluttered and errors might be made.
- Entry of a transaction to a book of prime entry does not record the double entry required for that transaction.
- Producing a list of similar transactions means that the periodic total can be accounted for rather than each individual transaction.
- This reduces the number of entries into the accounting system and so reduces the chances for error.
- The book of prime entry is the source for double entries to the ledger accounts.
- The double entry arising from the book of prime entry will be recorded periodically (daily, weekly, monthly) depending on the volume of transactions.

DIAGRAM OF BOOKS USED



Several books of prime entry exist, each recording a different type of transaction:

	SOURCE DOC.	DAY BOOKS
1.	Sales invoice (Credit Sales)	Sales Day Book
2.	Purchase invoice (Credit Purchases)	Purchase Day Books
3.	Credit note sent (sales return or return inward)	Sales Return Book
4.	Credit Note received (purchase return or return outward)	Purchase Returns Book
5.	All cash receipts	Cash Received Book (CRB)
6.	All cash payments	Cash Payment Book (CPB)
7.	Petty cash vouchers	Petty Cash Book
8.	Journal vouchers	Transfer Journal

Purchase day book

It is the book of original entry which records all the purchases made on credit (purchase invoices).

Date	Ref #	Trade payable	Trade payable Ledger Ref.	Total	Sales tax	Purchases	Expenses
				$	$	$	$

Purchase return day book / return outward book

This is a complete record of goods returned to the supplier.

Date	Credit No. #	Trade payable	Trade payable Ledger Ref.	Total	Sales tax	Net
				$	$	$

Sales day book

It is the book of original entry which records all the sales made on credit (sales invoices).

Date	Invoice #	Trade receivable	Trade receivable Ledger Ref.	Total	Sales tax	Sales 1	Sales-2
				$	$	$	$

Sales return book / return inward book

This is a complete record of goods returned by customers.

Date	Credit Note #	Trade receivables	Trade receivable Ledger Ref.	Total	Sales tax	Sales Net
				$	$	$

Sales tax in day books

If a business is registered for sales tax, the sales and purchases day books must include entries to record the tax.

Cash receipt book

It records:
- Cash receipts from trade receivables
- Cash receipts from all other sources

Date	Receipt from Trade receivables	Trade receivable Ledger Ref.	Total	Sales tax	Sales	Rent received	Discount allowed*
			$	$	$	$	$

- *Discount columns are memorandum column and do not form part of the cash book (as per old treatment of discount)
- Sales tax on credit sales is never recorded in CRB because it is already recorded in SDB
- Sales tax on cash sales in recoded in CRB because we are recording this transaction for the first time.

Cash payment book

It records:
- Cash payments to trade payables
- Cash payments to all other parties

ANALYSIS OR BREAKUP COLUMN										
Date	Cheque #	Payee	Trade payable	Trade payable Ledger Ref.	Total	Sales tax	Purchases	Interest paid	Drawings	Discount received (as per old treatment of discount)
					$	$	$	$	$	$

- Sales tax on credit purchases is never recorded in CPB because already recorded in PDB.
- Sales tax on cash purchases is recorded in CPB because we are recording this transaction for the first time.

The Journal

The journal is a book of prime entry which records transactions which are not routine (and not recorded in any other book of prime entry), for example:
The journal is a clear and comprehensible way of setting out a bookkeeping double entry that is to be made e.g.

- Year-end adjustments
- Depreciation charge for the year
- Irrecoverable debt write-off
- Movement in allowance for receivables
- Accruals and prepayments
- Closing inventory
- Acquisitions and disposals of noncurrent assets
- Correction of errors etc.

Presentation of a journal

A journal should be laid out in the following way:

Dr Noncurrent asset $X

Cr Cash $X

To record the purchase of a new non-current asset.

A brief narrative should be given to explain the entry.

CASH RECEIPTS RECORDING AND DOCUMENTATION

Cash receipts should be properly controlled as they are of high importance for a business to maintain a reasonable cash position. The controls will arise from the following concerns:

- Receipts must be banked promptly.
- Record of receipts must be complete.
- Loss of receipts through theft or accident must be prevented.

Remittance advices
When a cheque arrives from a trade customer, it is usually accompanied by a remittance advice.
A *remittance advice* shows which payments the cheque covers.
If there are differences, these will be dealt with by the sales ledger department.

Receipts
A receipt is a document given by the seller or the buyer when goods change hands in exchange for payment. It may be a till receipt, a written receipt or some other form of receipt.

Till receipts
Cash registers or tills are used mainly in retail shops where the money is handed over directly by the customer when the transaction takes place, in form of cash, cheques and card vouchers.

Written receipts
Where a cash register is not used, a written or typed receipt may be required. The information that appears on the receipt should be same to the one produced by a till receipt.

- Name of selling business
- Date of transaction
- Total value of goods purchased
- Sales tax registration number
- Amount rendered by customer
- Till number

Evidence of payment other than in cash
- Credit card—signed credit card voucher.
- Debit card—signed debit card voucher
- Cheque—payment will appear on customer's bank statement
- Banker's draft—issuing bank will hold record of items issued.

IMPREST SYSTEM

The best way to deal with petty cash is by way of an imprest system. This works as follows:

1. The business decides on the amount of cash to be held as a float and withdraws this from the bank. This is referred to as the 'petty cash float'.
2. As payments are made from the float, these are recorded in the petty cash book. All expenditure must be evidenced by an expense receipt which is attached to an expense voucher.
3. When the petty cash runs low, a cheque is drawn to return the petty cash to the exact amount of the original float. At this stage the expense vouchers should be produced to the cheque signatory. The total of these will equal the cheque required.

At any stage therefore:
Float = Cash in petty cash box + sum total of expense vouchers since last reimbursement

Petty Cashier

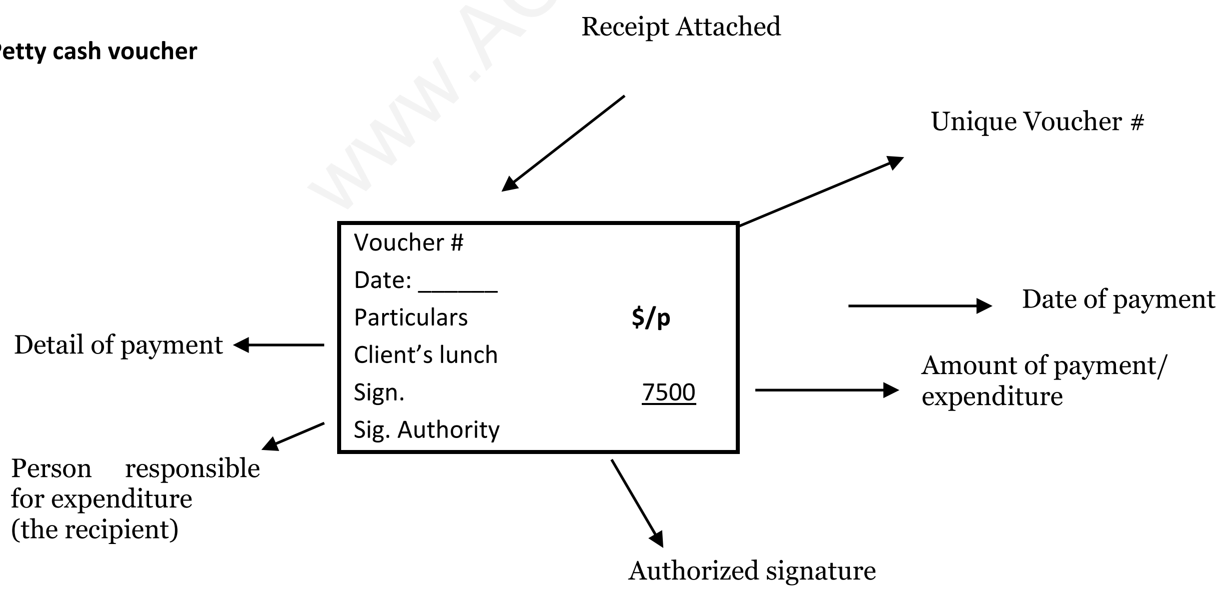
a) Makes sure that cash is held in a safe place
b) There should be a valid reason for payment
c) Documents should be properly authorized
d) Actual payment should be made

Petty cash system vouchers

1) Petty cash payment vouchers → Small expense payment
2) Petty cash receipt vouchers → Receipts other than petty cash
3) IOU (I owe you) forms → Borrowing from petty cash

Petty cash limit: Imprest amount
Authorization limit: Given to petty cashier and others

Petty cash voucher



Nature of expenses and amendment of vouchers

1. Expenses incurred
2. Advance payments for expenses (needs amendment)

The amount to be reimbursed at the start of a month to refresh petty cash to impress amount can be calculated using either of the following two formulas

Formula – 1	**$**
Imprest amount required at start of month	-
Less: Cash in the box	-
Less: IOU forms	-
= Cash needed /Reimbursed Amount	-

Formula – 2

Increase in imprest required in next month (if any)	-
Add: Total payments	-
Add: Total receipts	-
= Cash needed/ Reimbursed Amount	-

PETTY CASH BOOK

All transactions involving small amounts of petty cash are recorded in the petty cash book.

- The petty cash system is usually designed to deal with sundry small payments in cash made by a business, e.g. paying the milkman, purchasing biscuits, buying stationery or reimbursing travel expenses.
- The cash receipts will be recorded together with the payments which will be analysed in the same way as a cash book.

DATE	RECEIPT $	VOUCHER/ REF NO	DETAIL OF EXP.	TOTAL PAYMENT $	Sales tax $	TRAVEL EXP $	OFFICE EXPENSE $

NON-IMPREST SYSTEM

Most petty cash systems operate with an imprest system, because there is an in-built check to make sure that cash is not stolen. However, it is also possible to set up a system that is non-imprest system, and simply to pay a fixed amount of money into petty cash very so often, to top it up.

For example, suppose that an organization thinks that petty cash expenditure should be about $50 every week, and it wants to top up the petty cash every two weeks. Withdrawals from petty cash are made using the procedures already described.

A petty cash box could be set up with an initial amount of $100 in it. Every two weeks, a further $100 would be drawn from the bank account and aid into the petty cash box.

Disadvantage: this system could work well if petty cash expenditure each week is in fact just less than $50. However, problems might be encountered if expenditure is higher than expected in any two-week period, so that the petty cash box might run out of cash.

Equally if expenditure were significantly less than $50 each week, then a large surplus would begin to grow in the petty cash box, possible increasing the risk of losses through theft.

CONTROLS OVER PETTY CASH

The following controls and security over petty cash should be found in a business:
- Petty cash must be kept in a petty cash box.
- Petty cash box must be secured in a safe.
- Person responsible for petty cash must be reliable and know what he/she is doing.
- All petty cash must be supported by invoices.
- Petty cash vouchers must be signed by the claimant and the person responsible for running the petty cash.
- Regular spot checks must be carried out to ensure that the petty cash is accurate.

EXAMPLE 1

Your company has a petty cash imprest of $750; this is to be increased to $800. At the en d of the month the cash in hand was $57 and payment vouchers totalled $673. In addition the cash box contained an IOU from a member of staff for $20.

How much cash in withdrawn from the bank to restore and increase the imprest?

Answer: $723

EXAMPLE 2

The petty cash imprest is $500. A spot check by the auditor of the petty cash revealed cash in hand of $45. In addition valid vouchers to the value of $395 were produced by the cashier.

How much cash is missing?

EXAMPLE 3

Sales tax on credit sales against which cash has been received is recorded in:

a) Sales day book only
b) Sales day book and cash book
c) Sales tax book
d) Cash book only

Answer: Option A

Chapter 5

SALES TAX

IN THIS CHAPTER

- **PRINCIPLES OF SALES TAX**
- **RATES OF SALES TAX**
- **ACCOUNTING FOR SALES TAX**
- **HOW TO CALCULATE GROSS PRICE FROM NET PRICE**
- **HOW TO CALCULATE NET PRICE / SALES TAX FROM GROSS PRICE?**

PRINCIPLES OF SALES TAX

- Sales tax is a form of indirect taxation.
- Tax is collected from main producer to final customer, at each transfer point.
- It is a tax on the supply of goods and services and is administered by a government tax agency. In the UK, this is Her Majesty's Revenue and Customs (Tax authorities).
- A business that is registered for Sales tax is a collection agent on behalf of government and Tax authorities. Although the final customer actually bears the sales tax, the amount is collected and paid by traders who are part of the chain and make the sale (if sales tax registered). Each trader has to assume his customer is the final customer, collect the tax and transfer it to tax authorities.
- Sales tax paid on purchases is called as **input tax** and sales tax charged on sales is called as **output tax**.
- Sales tax is excluded from the reported sales and purchases of the **Sales tax registered business** (Net of Sales tax figures shown in Financial Statements).
- Periodically the business pays the sales tax to the tax authorities. If output tax exceeds input tax, the business pays the excess to the tax authorities. If input tax exceeds output tax, the business is repaid the excess by the tax authorities.
- Output tax is a current liability of the business payable to Tax authorities.
- Input tax can be reclaimed from Tax authorities and recorded as an asset.
- Sales tax is charged on most goods and services.
- If a business is not registered for Sales tax, it can neither charge sales tax nor can recover it.
- Businesses whose sales are below a certain level need not register for sales tax, although they may do so voluntarily.
- If an unregistered trader purchases from a registered trader, sales tax paid will be treated as an expense for the unregistered trader, because it will not be recoverable.
- Sales tax should not be included in income or expenses, whether of a capital or revenue nature.

RATES OF SALES TAX

Categorization of businesses based on Sales tax:

1. Tax Exempted Firms e.g. educational institutions, health organizations and financial institutions etc.
2. Zero Rated Firms e.g. medicines, food items other than luxury food items etc.
3. Sales tax Registered Firms

   - Lower rated e.g. Fuel and energy used for domestic purposes etc.
   - Standard rated

TAX RATES	
Lower Rate	**5% (Fuel and energy)**
Standard Rate	**17.5% or 20%**
Zero Rate	**0%**

	Tax exempted firms	Zero rated firms	Sales tax registered firms
1)	They do not charge Sales tax on their Sales.	They do not charge Sales tax on their sales.	They do charge Sales tax on their sales.
2)	They have to pay Sales tax on their purchases from Sales tax registered companies.	They have to pay Sales tax on their purchases from Sales tax registered companies	They have to pay Sales tax on their purchases from other registered companies
3)	They do not get refund of Sales tax , paid on their purchases, from tax authorities	They get refund of Sales tax, paid on their purchases, from tax authorities	They get refund of Sales tax , paid on their purchases, from tax authorities

ACCOUNTING FOR SALES TAX

A Sales tax registered business will need a Sales tax ledger account. This may be a receivable or a payable account depending on the circumstances. It is not included in income or expenses in statement of profit or loss.

Calculation of Sales tax

It is common for a rate of 17.5% or 20%sales tax to be charged on the selling price.

The following is therefore true:

Net selling price (tax exclusive price)		100%
Sales tax	20%	
Gross selling price (tax inclusive price)		120%

- The net selling price is the amount that the business wishes to achieve.
- The gross selling price is the price charged to customers
- The difference is paid to the tax authorities.

Formula to Remember

Gross price = Net price + Sales tax
= $100 + 20% of 100 = 100 + 20 = $120

- Receivables' account is debited with gross price because the customer must pay full amount due.
- Sales account is credited with net price (provided seller is Sales tax registered).
- This is because Sales tax is not income of business and it will have to be paid to the tax authorities.

Registered Seller
Dr. Trade receivables $120 Cr. Sales $100 Cr. Sales tax $20
Dr. Cash $120 Cr. Trade receivables $120

- Payables' account is credited with gross price as the supplier must be paid full amount due.
- Purchases account is debited with net price (provided buyer is Sales tax registered).
- The purchase account does not include Sales tax because it is not an expense – it will be recovered.

Registered Buyer
Dr. Purchases \$100 Dr. Sales tax \$20 Cr. Trade payables \$120
Dr. Trade payables Cr. Cash \$120

- Sales tax on credit sales / credit purchases will be recorded in Sales day book / Purchase day book respectively.
- Sales tax on cash sales / cash purchases will be recorded in Cash Receipts Book / Cash Payments Book respectively.

Sales return

Sales return account is debited with net price (provided seller is Sales tax registered)
Dr. Sales Return
Dr. Sales tax
Cr. Receivables

Purchase return
Purchases return account is credited with net price (provided buyer is Sales tax registered)
Dr. Payables
Cr. Purchases Return
Cr. Sales tax

NOTE: Persons not registered for sales tax will have to incur it as an expense as they will not get the recovery of amount paid.

HOW TO CALCULATE GROSS PRICE FROM NET PRICE

If net price = \$200 and Sales tax is 20% then gross price?
Since Gross price = Net price + Sales tax
Gross price = 200 + 20% of 200
= 200 + 40
Hence gross price = \$240

*Sales tax rate is always applied on net amount to calculate Sales tax amount.

HOW TO CALCULATE NET PRICE / SALES TAX FROM GROSS PRICE?

If gross price is \$240 and Sales tax is 20% then net price?

Since Gross price = Net price + Sales tax
\$240 = X + 20%X
\$240 = X (1+0.2)
\$240 = X (1.2)
240/1.2 = X
\$200 = X
Net price – X = \$200
Or Sales tax= Gross price – net price
= \$240 - \$200 = \$40

Tip: If the gross amount (inclusive of tax) is given, the Sales tax can be found by multiplying the gross amount by 20/120If net amount (exclusive of tax)) is given, the Sales tax can be found by multiplying the net amount by 20/100.If only Sales tax amount is given, then net amount can be found by multiplying Sales tax amount by 100/20

Sales tax and settlement discounts

The problem with offering a settlement discount is that when the invoice is prepared, it is still not known whether or not the customer will take the settlement discount. So should sales tax be charged on the invoice total before the settlement discount or after deducting the settlement discount?
The rule is that the amount of sales tax payable should be calculated on the assumption that the settlement discount will be accepted by the customer. This means that the sales tax is calculated at 20% of the invoice sub-total, less the amount of the settlement discount.

This is the Sales tax payable, whether or not the customer subsequently takes the settlement discount.

Adjustment of Discount for Sales tax

In case of cash/settlement discounts being offered, Sales tax is calculated on the invoice amount less the cash discount. Even if the cash discount is not availed, Sales tax will remain unchanged.

Example

80 buckets @ $20 each	$1,600
Less Trade Discount @ 25%	$(400)
	$1,200
Add Sales tax @ 20%	$ 234*
	$1,434

Note: Cash discount of 2.5% if paid within 30-days.
***Sales tax Calculation;**

Cash discount	=	$1,200 x 2.5%	= $30
Net of Discount Amount	=	$1,200 - $30	= $1,170
Sales tax	=	$1,170 x 20%	= $234*

Sales tax requirements (Sales tax invoice)

If a business is sales tax registered, then it must charge tax on its sales and must issue a sales tax invoice. To be a valid invoice, certain information must be included on the invoice. That information is as follows:

Sales tax registration number

All Sales tax registered business will have a unique Sales tax registration number. The requirement to put this number on a Sales tax invoice enables Tax authorities to determine whether the invoice came from a valid Sales tax registered number.

Tax point

The tax point on an invoice is the date when a transaction is deemed to have taken place for sales tax purpose. It enables the Sales tax on the transaction to be recorded in the correct sales tax period. There are quite complex tax point rules, but usually the tax point is the invoice date.

Rate of Sales tax

The rate of Sales tax on an invoice must be shown. The three rates of sales tax are currently standard rate (20%), reduced rate (5%) and zero rates (0%). Sales tax rates can be shown on an item by item basis where the items have different Sales tax rates, or, as in the example invoice, a single rate might be applied to all the items.

The Sales tax account

The Sales tax account is a statement of financial position account and may show a receivable balance (i.e. the tax authorities owe a business money) or a payable balance (i.e. a business owes the tax authorities money) depending on the circumstances. A credit balance on the sales account is usual for most businesses, however, some will have a debit or receivable balance (i.e. they have paid more Sales tax on purchases than they have charged on sales).Where this is the case, Sales tax is reported as a current asset in the statement of financial position.

Sales tax

Payables	75	Receivables 100
c/d	25	

Payment/Recovery of Sales tax

Sales tax is paid to or recovered from the tax authorities periodically.

- Where Sales tax owed to the authorities is paid, the accounting entry is:
  Dr Sales tax payable
  Cr Cash

- Where Sales tax recoverable from the authorities is received, the accounting entry is
  Dr Cash
  Cr Sales tax receivable

EXAMPLE 1

On 1 June 20X7 the opening balance on Amber's sales tax account is $5,250 credit. During the quarter she makes sales net of sales tax of $62,150 and purchases inclusive of sales tax of $71,940.

The rate of sales tax is 10%.

What is the balance on Amber's sales tax account at 31 August 20X7?

Answer: $4,925 – Credit balance

EXAMPLE 2

A summary of the transactions of Witney plc, which is registered for Sales tax at 17.5%, shows the following for the month of November 20X4:

Outputs	$122,610 (inclusive of Sales tax)
Inputs	$78,857 (exclusive of Sales tax)

At the beginning of the month Witney owed $7,200 to Tax authorities and during November paid $6,800 to them.

What is the amount owing to tax authorities at 30 November 20X4?

Answer: 4,861

Chapter 6

CONTROL ACCOUNTS, PERSONAL LEDGERS AND CONTROL ACCOUNTS RECONCILIATION

IN THIS CHAPTER

- **INTRODUCTION**
- **CONTROL ACCOUNTS**
- **RECONCILIATION OF CONTROL ACCOUNT**
- **TRADE ACCOUNTS PAYABLE**
- **TRADE ACCOUNT RECEIVABLE**

INTRODUCTION

Transaction occurs

⇓

It is recorded in books of prime entry-Day Books

Sales

Purchases

Sales returns

Purchase returns

Cash book

⇓

Ledger

General Ledger	Personal Ledger	
General Ledger OR Nominal ledger	**Personal Ledger** **(**Contains Memorandum accounts and is not part of double entry process)	
General ledger Includes -Receivables ledger control account -Payables ledger control account	Payable ledger/ Purchase Ledger/ Trade payable Ledger **Includes individual payable accounts**	Receivable Ledger/ Sales Ledger/ Trade receivable Ledger **Includes individual receivable accounts**

- The **General Ledger** contains all accounts or a summary of all accounts necessary to produce the trial balance and financial statements.

- The **Accounts receivable ledger** contains an account for each credit customer to show how much each one owes.

- **Receivables ledger control account**

  An account to summarize all the transactions regarding receivables in total is **the receivables control account.** It is normally contained within the general ledger. The balance on the receivables control account at any time will be the total amount due to the business from all its credit customers.

- The **Accounts payable ledger** contains an account for each credit supplier to show how much we owe them.

- **<u>Payables ledger control account</u>**
  An account to summarize all the transactions regarding payables in total is **the payables control account.** It is normally contained within the general ledger. The balance on this account at any time will be the total amount owed by business to all its credit suppliers.

Where there are individual accounts in a receivables or payables ledger and a control account in the general ledger, only one can form part of the double entry system. The other exists for memorandum purposes. It is normally the case that the control accounts form part of the double entry.

CONTROL ACCOUNTS

Control accounts are ledger accounts that summarise a large number of transactions.

The daybooks are totalled periodically and relevant totals are posted to the control accounts.

Their main area of use is in the receivables and payables section.

Note that any entries to the control accounts must also be reflected in the individual accounts within the accounts receivable and payable ledger.

Entries in control accounts-an overview

Receivables control account

Opening debit balance		b/d (refund)	
		Cash received	XX
Sales	XX		
Dishonored cheques	XX	Return inwards	XX
Cash paid to clear credit (refund)	XX	Irrecoverable debt expense*	XX
		Contra against payables	XX
Closing credit balance (if any)	**XX**	**Closing debit balances**	**XX**

*The concept of Irrecoverable debt expense is discussed later.

Payables control account

Cash paid	XX	Opening credit balance	XX
		Purchases and other expenses	XX
Return outwards	XX		
Contra against payables	XX	Cash received (credit taken)	XX
Closing credit balance	**XX**	**Closing debit balance (if any)**	**XX**

Contra Entries

The situation may arise where a customer is also a supplier. Instead of both owing each other money, it can agreed that a contra be made of the balances i.e. they are cancelled.

The double entry for this type of contra is:

Dr Payables ledger control account
Cr Receivables ledger control account

The individual receivable and payable accounts must also be updated to reflect this.

Credit balances on the receivables ledger control account.

Sometimes the receivables ledger control account may show a credit balance, i.e. we owe the customer money. These amounts are usually small and arise when:

- The customer has overpaid.
- Credit notes have been issued for fully paid for goods.
- Payment is received in advance of raising invoices.

The payables ledger control account may show a debit balance for similar reasons.

The purpose of control accounts

- They provide an internal check on the accuracy of entries made in the personal accounts in the receivables ledger and payables ledger.
- Control accounts can help in locating errors.
- Extraction of trial balance is more convenient and speedy
- They keep the accounts in trial balance down to a manageable size.

EXAMPLE 1

The following receivables ledger control account has been prepared by a trainee accountant:

Receivables ledger control account

	$		$
Opening balance	128,810	Cash from credit customers	488,790
Credit sales	594,580	Contras	1,200
Irrecoverable debts	1,800		
Sales return	4,920	Closing balance	240,120
	730,110		730,110

What should the closing balance on the account be when the errors are corrected?

Answer: $226,680

EXAMPLE 2

The payable ledger control account below contains a number of errors:

Payable ledger control account

	$		**$**
		Balance b/f	339,800
Cash paid to suppliers	2,120,000	Credit purchases	2,368,600
Purchase returns	52,700	Contras against receivables	64,000
Refunds received from suppliers	3,900		

Currently closing balance is unknown. Calculate what should be the closing balance when all the errors are corrected?

Answer: $475,600

RECONCILIATION OF CONTROL ACCOUNT

The control accounts should be balanced regularly and the balance agreed with sum of individual suppliers'/customers' balances.

The reconciliation is a working to ensure that the entries in the ledger accounts agree with the entries in the control account. The two should have the same closing balance as ideally they have had exactly the same entries in both accounts.

- A receivables' ledger reconciliation compares the total of the accounts in the receivables ledger with the balance on the receivables ledger control account.
- A payables' ledger reconciliation compares the total of the accounts in the payables ledger with the balance on the payables ledger control account.

If there are differences between the control account and the ledger accounts, they must be identified and reconciled.

For example, if we wanted to check the accuracy of the accounts receivables ledger, one way we can do this is by getting the information from different sources:

- The sales can be taken from the sales day book.
- The cash received and discounts allowed are recorded in the cash book.
- The opening balances can be taken from the prior month's closing balances.

An alternative way to check the accuracy of the accounts receivables ledger is to compare the sum total of the individual receivables accounts with the balance on the receivables ledger control account (part of double entry book-keeping system).

The differences arise for one or more of the following reasons:

- An incorrect amount may be posted to the control account because of misstatement in the book of prime entry. A journal entry must then be made in the nominal ledger to correct the control account and the corresponding sales or expense account.
- A transposition error may occur in posting an individual's balance from book of prime entry to the memorandum ledger. No accounting entry would be required to do this, except to alter the figure in the personal account.
- A transaction may be recorded in control account and not in the memorandum account or vice versa. If it involves control account, a double posting is required, otherwise, a single posting will be sufficient.
- Sum of balances may be wrongly drawn from the personal accounts. This would simply involve correcting the total of balances.

Errors affecting control account only

- Casting error in any book of prime entry (i.e. SDB, SRDB, CRB, Discount allowed etc.) or (PDB, PRDB, CPB, Discount Received etc.)
- Transposition error in the total of day books

Errors affecting sales ledger / purchase ledger

- Omission of an individual balance from total of list
- Casting error in the totaling of list
- Debit balance taken as credit & credit balance taken as debit
- Transposition error in an individual balance

Errors affecting control accounts and personal ledgers

- Recording of invoice with wrong figure in the SDB/PDB e.tc
- Omission of invoice from SDB/PDB e.tc
- Omission of Contra Entry
- Cheque received from trade receivable paid to trade payable not recorded in cash receipt

- Discount Received/Discount allowed not recorded in day book

TRADE ACCOUNTS PAYABLE

It consists of those liabilities that are related to the trade of the business. Trade payables include those businesses and organizations, which supply the business with goods for the trading inventories of the business as well as office supplies.

Other payables

It will not be normally recorded in the purchase ledger and balances owed should instead be recorded in general ledger, such as:

- Liabilities related to wages and salaries.
- Output sales tax
- Amounts payable for goods and services not directly related to main trade of business.

Recording

- Individual invoices are credited to individual suppliers' payables ledger accounts.
- Total of batch of invoices are credited to payables control account.
- Net amount of purchases (excluding sales tax) are debited to purchases account.

Age analysis of payables

'Age analysis of payables will consist of a listing of payables balances analyzed between different 'ages' of debt represented by different items in the balance, measured in months'.

Age Credit analysis Report

It is a report showing amounts owed (you have to pay) to each credit supplier in terms of the time that each credit has been outstanding.

Purpose

a) Control over credit period
b) Arrangement of funds
c) Expected cash outflows
d) To draw favourable conditions from supplier

Form – A **OUTSTANDING FOR**

SUPPLIER	LED REF.	TOTAL OWED $	30 DAYS $	30-60 DAYS $	61-90 DAYS $	> 90 DAY $

Debit balance in trade payables account

Debit balance in the trade payables/payables account is unusual but they can sometime arise. Following are some of the situations in which they might occur.

- An over payment of the supplier's balance might be made in error
- A credit note might be received after full payment has been made of the balance.

TRADE ACCOUNT RECEIVABLE

The need for personal accounts
Although the total receivables is known to the business, it is important at times to be able to know that how much an individual customer owes to the business and the terms and timing of repayment.

There are some other reasons as well:

a) A customer might want to enquire about his outstanding amount.
b) Credit check may need to be carried out by the credit control department to assess the position of a customer who is demanding further credit.
c) Managers might want to assess the timing of cash inflows so that they can be matched against payments to be made to suppliers of the business.

SALES LEDGER/TRADE RECEIVABLE LEDGER

It contains the individual personal accounts showing what each individual account receivable (trade receivables account) of the business, owes.
The format of T account of personal ledgers is the same as control account; but for individual customers.

Credit balance in trade receivable's account
Credit balances in the trade receivable's ledger are unusual but they can sometime arise. Following are some of the situations in which they might occur

- An over payment made by customer in error.
- A credit note/debit note might be issued after full payment has been received.

Personal accounts and integrated sales ledger
In some computerized systems, the sales ledger is integrated with the general ledger. Personal customer's accounts effectively do form part of the double entry system, and there is no separate total receivables or receivables control account.

Checking the sales ledger recording
After all the posting, recording of cash received, credit notes and invoices sent, we can check the accuracy of the figures in the sales ledger memorandum accounts. This is done so by calculating the balances on individual ledger accounts and comparing them with control accounts.

COMPREHENSIVE EXAMPLE – Preparing a control account reconciliation

Dora's maintains payables ledger control account and payables ledger accounts separately. Individual ledger account balances are listed and totalled on a monthly basis, and reconciled to the control account balance. Information for the month of August is as follows:

Payables ledger account balances total at 31 August = $59,298.

Payables ledger control account balance at 31 August = $65,496.

The following errors have been discovered as a part of reconciliation process:

- The total of discount received for the month, amounting to $5,145, has not been entered in the control account but has been entered in the individual ledger accounts.
- An individual credit balance of $615 has been incorrectly treated as a debit in list of balances.
- A cash payment to a supplier amounting to $189 has been correctly treated in the control account, but no entry has been made in the supplier's individual ledger account.
- The purchases day book total for August has been under-cast (understated) by $6,000.
- Contras with the receivables ledger, amounting in total to $6,012, have been correctly treated in the individual ledger accounts but no entry has been made in the control account.

Step 1

The total of discount received in the cash book should have been debited to the payables ledger control account and credited to discount received. Thus, if the posting has not been entered in either double entry account it clearly should be. As this has already been entered into the individual ledger accounts, no adjustment is required to the list of balances.

$5,145 should be debited to control account as a result of this adjustment.

Step 2

Individual credit balances are extracted from the payables ledger. Here, this error affects the ledger accounts balance. No adjustment is required to the control account, only to the list of balances.

As the entry has been made to the wrong side, correction will have to be by double amount. $1,230 will be added to list of balances.

Step 3

The information clearly states that the error has been made in the individual ledger accounts. Amendments should be made to the list of balances. Again, no amendment is required to the control accounts.

$189 will be subtracted from list of balances.

Step 4

The total of the purchases day book is posted by debiting purchases and crediting payables ledger control account. If the total is understated, the following bookkeeping entry must be made, posting the $6,000 understatement:

Dr Purchases $6,000

Cr Payables ledger control account $6,000

As the individual ledger accounts in the payables ledger are posted individually from the purchases day book, the total of the day book being understated will not affect the listing of the balances in the payables ledger.

Step 5

Here it is clear that the error affects the control account, not the payables ledger. Correction should be made by the bookkeeping entry:

Dr Payables ledger control account $6,012

Cr Receivables ledger control account $6,012

Payables ledger control account

20X7	$	20X7	$
Discount received	5,145	31 Aug	
Sales receivable ledger control	6,012	Balance	65,496
Balance c/f	60,339	Purchase	6,000
	———		———
	71,496		71,496

Reconciliation of individual balances with control account balance

	Cr $
Balances as extracted	59,298
Credit balance incorrectly treated	1,230
Cash payment	(189)
	———
Net total agreeing with control account	60,339

Age analysis

There needs to be a way of knowing whether some of the invoices are *long overdue* so that those invoices can be followed up with the customer. It is advisable to prepare a single schedule that summarizes the age of the items in several accounts.

This is achieved by what is called an age analysis of receivables.

An age analysis of receivables breaks down the customer balances on the sales ledger into different periods of outstanding debt.

Age Debt Analysis Report

It's a report showing amounts owed by each credit customer (Trade receivable) in terms of the time that each debt has been outstanding.

Purpose

- Control over credit period
- Potential Irrecoverable debts
- Payment pattern of trade receivables

How is the age analysis used?

- Age analysis of receivables may be used to help decide what action to take about older debts.
- Performance of our credit control department can be checked, once the debt situation is known/may result in improved debt collection.
- Information about credit limit becomes easily available.

Form – A **OUTSTANDING FOR**

CUSTOMER	LED REF.	TOTAL OWING $	30 DAYS $	30-60 DAYS $	61-90 DAYS $	> 90 DAY $

Irrecoverable debts

For Irrecoverable debts there is an Irrecoverable debt account in the general ledger, when it is decided by the business managers that a customer will not pay. The customer name is struck off the ledger and the amount previously owed is known as Irrecoverable debt.

Write off

DEBIT Irrecoverable debts account (expense)
CREDIT Total receivables account

This is also called write off of a debt.

Irrecoverable debt and sales tax

A business may be able to claim relief from sales tax on following Irrecoverable debts.

- At least six months old
- Written off in the accounts of the business.

Sales tax Irrecoverable debt relief

Dr Sales tax account	XX	
Irrecoverable debts	XX	
Cr Total receivables		XX

Recovery of Irrecoverable debt

Dr Cash	XX	
Cr Irrecoverable Debts Expense		XX

Preparing a control accounts reconciliation

The format of control account reconciliation in the case for sales is as follows:

Receivables ledger control account

	$		$
Balance given by the examiner	X	Adjustments or errors	X
Adjustments for errors	X	Revised balance c/f	X
	X		**X**

Reconciliation of individual receivables balances with control account balance

	$
Balance as extracted from list of receivables	X
Adjustments for errors	X(X)
Revised total agreeing with balance c/f on control account	**X**

- The examiner will provide details of the error(s).
- You must decide for each whether correction is required in the control account, the list of individual balances or both.
- When all errors have been corrected, the revised balance on the control account should agree to the revised total of the list of individual balances.

EXAMPLE 3

The balances in Finca company's sales ledger at 31st December were totalled and their sum was found to be $83,795. At the same day, the debit balance on the receivables ledger control account was $82,511. Upon investigations the following facts were discovered:

- **(i)** One customer, whose balance was $420 credit, had been omitted from the list of sales ledger balances.
- **(ii)** An irrecoverable debt of $500 had not been entered in the nominal ledger.
- **(iii)** Cash received of $280 had been debited to the customers' personal account
- **(iv)** A customer's cheque for $804 had been dishonoured by bank but no adjustment had been made in the control account.

What will be the adjusted total of sales ledger balances and receivables ledger control account after correction of above errors?

Answer: Sales Ledger = $82,815 Sales ledger control account = $82,815

EXAMPLE 4

The purchase day book of James Co. has been under cast by $1,200, and the sales day book has been overcast by $1,500. James Co. maintains payables and receivables ledger control accounts as part of the double entry bookkeeping system.

The effect of correcting these errors will be to:

- **a)** Make adjustments to the ledger balances of the individual customers and suppliers, with no effect on profit
- **b)** Make adjustments to the ledger balances of the individual customers and suppliers, with a decrease in profit of $2,700
- **c)** Make adjustments to the control accounts, with the decrease in profit of $2,700
- **d)** Make adjustments to the control accounts, with no effect on profit

Answer: Make adjustments to the control accounts, with the decrease in profit of $2,700

EXAMPLE 5

Spencer received a statement from one of its suppliers, Mike, showing a balance due of $5,820. The amount due according to the payables ledger account of Spencer was only $1,800. Comparison of the statement and the ledger account revealed the following differences:

1. A cheque sent by Spencer for $680 has not been allowed for in Mike's statement.
2. Mike has not allowed for goods returned by Spencer $360.
3. Spencer made a contra entry, reducing the amount due to Mike by $4,250, for a balance due from Mike in Spencer's receivable ledger. No such entry has been made in Mike's records.

What difference remains between the two companies' records after adjusting for these items?
Answer: $1,270

Chapter 7

IRRECOVERABLE DEBTS AND ALLOWANCES FOR RECEIVABLES

IN THIS CHAPTER

INTRODUCTION

Following the accruals and realization concepts, credit sales are recognized when earned, i.e. when we have invoiced the customer. If at a later point doubt exists about the collectability of the debt then a loss is recognized immediately. Two types of adjustments are made in relation to irrecoverable & doubtful debts.

TRADE RECEIVABLE

A **trade receivable** is a customer who owes money to the business as a result of buying goods or services on credit in the course of normal trading operations.

The provision of credit facilities

The majority of businesses will sell to their customers on credit and state a defined time within which they must pay (a credit period). The main benefits and costs of doing so are as follows:

Benefits

- The business may be able to enter new markets.
- There is a possibility of increased sales.
- Customer loyalty may be encouraged.

Costs

- Can be costly in terms of lost interest since the business is accepting payment later.
- Cash flow of the business may deteriorate.
- There is a potential risk of irrecoverable debts.

Credit limits

It is also normal for a business to set a credit limit for each customer. This is the maximum amount of credit that the business is willing to provide.

The use of credit limits may:

- Reduce risk to business of irrecoverable debts by limiting the amount sold on credit
- Help build up the trust of a new customer
- Be part of the credit control strategy of a business.

NON PAYMENT OF DEBTS

More often than not, credit customers pay the amount that they owe on time. They do this tomaintain a good relationship with their supplier and ensure on-going supply.

In some cases, however, a debt is not paid by the time that the credit term has expired. It may even become apparent before this time that it will not be paid, for example if a customer has been declared bankrupt.

Where debts remain unpaid, they are considered to be either

- Irrecoverable
- Doubtful,

As the existence of the recorded asset (the receivable) is in question, adjustment must be madein the accounts. These adjustments are treated as year-end adjustments.

IRRECOVERABLE DEBT (RECEIVABLES EXPENSE)

During the year some debts will become uncollectible and will be written off at that time.
Writing off means removing the amount from trade receivables account and charging it as expense against profit for the period.

Reasons for Irrecoverable Debts

- The customer has gone bankrupt
- The customer is out of business
- Dishonesty may be involved
- Outright refusal to pay
- Disappearance of customer
- Death of customer

The accounting entry to remove such known irrecoverable debts is:

Dr:	**Irrecoverable Debt Expense (Statement of profit or loss)**		**X**
	Cr:	**Accounts Receivable Control a/c**	**X**

Irrecoverable debts are presented in financial statements as follows:

- The original sale remains in the accounts as this did actually take place. Non-recovery is an administration issue. The sale will not be reversed because of it.
- The irrecoverable debts expense/receivables expense is reported below gross profit in the statement of profit or loss (mostly in administration expenses)
- The receivable amount is removed from both receivables control account and personal ledger.

EXAMPLE 1

Mr. Lancaster's accounts receivable control account has a balance of $44,000. Whilst finalizing his accounts he learns that one of his customers Ms. Sadie has just been declared bankrupt. She owes Lancaster$6,000.

Prepare ledger accounts to reflect this situation.

Answer:

Accounts Receivable Control a/c

	$		$
Receivables	44,0000	Irrecoverable debt expense	6,000
		c/d	38,000

Irrecoverable Debts Expense

	$		$
Receivables	6,000		
		P&L	6,000

Recovery of Debts Written Off

When an irrecoverable debt is recovered the double entry is:

Dr. Cash / Bank A/C
Cr. Irrecoverable Debts expense A/C* ***OR***
Cr. Irrecoverable Debts Recovered A/C*

*This amount can be showed either as a decrease in expense or an increase in income depending upon the policy of the company.

EXAMPLE 2

Anthony sells goods on credit to Lalit for $15,000 on 1 January 20X7. On 18 March 20X7 Anthony discovered that Lalit has left the country without paying. He therefore considers the debt to be irrecoverable and write it off. However two months later Lalit sends Anthony$11,000 in settlement of his debt.

Complete the ledger accounts below:

Accounts Receivable

Sales

Irrecoverable debts expense

Bank

Irrecoverable Debts Recovered

DOUBTFUL DEBTS

A doubtful debt is a receivable which a business **may not** be paid. Thus, at the end of the year there may be amounts owing to the business, which the accountant considers will become irrecoverable debts in the future. Prudence requires that an allowance is made for these doubtful debts.

The purpose of this type of adjustment is to ensure that the amount of trade receivables reported on the statement of financial position is not overstated. Doubtful receivables are also not removed from receivables account in case the customer does pay up. An allowance is created for these which is then set off against the balance of receivable in statement of financial position.

PROCEDURE FOR CALCULATION OF ALLOWANCE

This is procedure commonly followed in businesses as risk is involved in selling items on credit.

- When an allowance is first made, it is charged as an expense in the statement of profit or loss. The credit side of the entry is to create an allowance for receivables.
- The closing balance of allowance is subtracted from the closing balance of receivables. The net receivables are then presented on the face of statement of financial position in current assets.
- If allowance already exists, and there is an increase in its amount, the difference is debited to irrecoverable debt expense account and credited to allowance account.
- The allowance account has brought down and carried down balances as it is related to statement of financial position. The receivables/irrecoverable debt expense account is closed off and charged to statement of profit or loss every year.
- If allowance already exists, and there is a decrease in its amount, the difference is debited to allowance account and credited to irrecoverable debt expense account. This decreases the irrecoverable debt expense amount to be recognised in statement of profit or loss.

Increase in allowance

The accounting treatment to create a new allowance or to increase an existing allowance is:

Dr.	**Irrecoverable debts expense (P&L)**	**X**
	Cr. Allowance for Doubtful Debts (SFP)	**X**

The amount of the double entry (X) equals the movement on the allowance for doubtful debts account. i.e. the increase in the allowance for doubtful debts.

Decrease in allowance

The accounting treatment to reduce an existing allowance

Dr.	**Allowance for doubtful debts (SFP)**	**X**
	Cr. Irrecoverable debt expense (P&L)	**X**

The amount of the double entry (X) equals the change in the allowance i.e. the decrease in allowance.

The **movement** is calculated by subtracting opening balance from closing balance. If answer is negative it is a decrease in allowance for doubtful debts and the treatment for reducing an existing allowance is applied, as described above.

The allowance for doubtful debts account is also called **'Allowance for Receivables'**

TYPES OF DOUBTFUL DEBTS

The allowance for receivables is calculated after all irrecoverable debts have been written off. There are two types of amounts that are likely to be considered as doubtful debts in an organization's accounts.

Specific Allowance

These will be some specific debts where the receivable in known to be in financial difficulties and therefore the amount owing from that receivable may not be recoverable. The allowance to be made against such a receivable in known as specific allowance. Thus, it is against a particular customer's balance, either full or a part of it.

General Allowance

The **past experience** and **history** of a business will indicate that not all of its debts will be recoverable in full. It may not be possible to indicate the precise receivables that will not pay but an estimate may be made that a certain %age of receivable is likely not to pay its debts. The allowance required against this %age of receivable is known as general allowance. Thus, this allowance is against all customers not any specific one.

Total allowance= Specific allowance +General allowance

EXAMPLE 3

Robin has receivables of $11,200 at his year-end of 31st December 20X7. Of these he decides that there is some doubt as to whether or not he will receive a sum of $500 from Peter. He also wishes to provide against the possibility of not receiving 2% of his remaining receivables:

So

Total allowance required = Specific allowance + General allowance
= $500 + ($11,200 - $500) x 2%
= $500 + $214
= $714

Note

- The balance on the allowance for doubtful debts account is netted off against the balance on the Accounts Receivable account when preparing the statement of financial position.
- The allowance for doubtful debts is a period –end adjustment.
- The balance on the allowance account can increase or decrease from year to year.
- General allowance percentage is usually applied on the receivables' figure after deducting specific allowance.

Steps for calculation:

When calculating and accounting for a movement in the allowance for receivables, the following steps should be taken:

(1) Write off irrecoverable debts.
(2) Calculate the receivables balance after adjustment of the write-offs.
(3) Ascertain the specific allowance for receivables required.
(4) Deduct the debt specifically allowed for from the receivables balance (be sure to deduct the full amount of debt rather than the amount of specific allowance).
(5) Multiply the remaining receivables balance by the general allowance percentage to give the general allowance required.
General allowance = General allowance% x (Closing receivables – irrecoverable debts – debts specifically allowed for).
(6) Add the specific and general allowances required together.
(7) Compare to the brought forward allowance.
(8) Account for the change in allowance.

AGEING ANALYSIS

Where credit facilities are offered, it is normal for a business to maintain an Aged Receivables Analysis.

- Analysis is usually a list, ordered by name, showing how much each customer owes and how old their debts are.
- The credit control function of a business uses the analysis to keep track of outstanding debts and follow up any that are overdue.
- Timely collection of debts improves cash flow and reduces the risk of them becoming irrecoverable.
- When using this method different rates are applied on debts depending on the time for which they have being outstanding. Debts are grouped according to their "age" and allowance calculated.

EXAMPLE 4

A company has a total of $25,000 outstanding from customers. This can be analyzed as follows:

		$
More than six months old	3000 x 50%	1500
3-6 months old	6000 x 25%	1500
1-3 months old	6000 x 5%	300
Less than one month old	10000 x 3%	300
Total allowance will be	=	3600

IRRECOVERABLE DEBTS EXPENSE ACCOUNT – A SUMMARY

Many of the accounting entries that we have seen throughout the chapter have been to the irrecoverable debts expense account.

The following is a summary of the entries which may be made to this account:

Irrecoverable Debts expense/Receivables expense

	$		$
Trade Receivable	XX	Cash	XX
Irrecoverable debts written off)		(Irrecoverable debts recovered)	
Increase in allowance	XX	Decrease in allowance	XX
P&L*		**P&L***	
	XX		XX

*This is the balancing figure charged to statement of profit or loss in respect of Irrecoverable debts. It can be a debit balance or a credit balance.

EXAMPLE 5

Receivables at 31st July 20X7 $46,000
Allowance at 31st July 20X6 $2,400

On reviewing the receivables account it was found that an irrecoverable debt of $1,900 has not been written off and the recovery of a debt of $560 previously written off had not yet been entered in the books. The company wishes to make an allowance for receivables of 5% at the year end.

What is the net charge to the statement of profit or loss for the year ended 31st July 20X7 in respect of receivables?
Answer: $1,145

EXAMPLE 6

At 1 November 2009, Telway Co had an allowance for receivables of $90,000. At 31 October 2010, its trade receivables were $1,232,000 of which $60,000 was identified as unrecoverable and was written off. TelwayCo's allowance for receivables has now been adjusted to 5% of remaining trade receivables.

What amount should be recorded in the statement of profit or loss for the receivables expense for the year ended 31 October 2010?

Answer: $28,600 Debit

TECHNICAL ARTICLE – TRADE RECEIVABLES

This is a technical article for Financial Accounting by ACCA examining team

Trade receivables arise when a business makes sales or provides a service on credit. For example, if Ben sells goods on credit to Candar, Candar will take delivery of the goods and receive an invoice from Ben. This will state how much must be paid for the goods and the deadline for payment, e.g. within 30 days. Ben now has a trade receivable – the amount payable to him by Candar.

The total value of trade receivables for a business at any one time represents the amount of sales which have not yet been paid for by customers. The trade receivables figure will depend on the following:

1. The value of credit sales. The greater the value of credit sales then, other things being equal, the greater the total of trade receivables.
2. The period of credit given. The longer the period of credit given to customers then, other things being equal, the greater the total of trade receivables.
3. The efficiency with which the business administers its trade receivables. The more inefficient the business is in billing its customers and collecting overdue accounts then, other things being equal, the greater the total of trade receivables.

RECORDING THE CREDIT SALE

Let's imagine that Ingrid makes a credit sale of $6,450 to Manfredi. The sale was made on 17 March 20X0 and the goods have been delivered to Manfredi along with an invoice for $6,450. The invoice states that the amount owing should be paid within 30 days from the date of the invoice.

The invoice will be processed through Ingrid's accounting system. The original entry will be in Ingrid's Sales Day Book which lists all credit sales chronologically. Total credit sales (including the $6,450) will be posted from the Sales Day Book to the debit of trade receivables account and the credit of sales account – both accounts being in the General Ledger. The $6,450 will also be posted to the debit of a personal account opened for Manfredi and kept in the Receivables Ledger.

In a computerised accounting system, all these accounting entries and the production of the invoice would take place simultaneously.

Manfredi's account will look something like Table 1 below in the Receivables Ledger.

Table 1: Manfredi's account in the receivables ledger

Manfredi

20X0	**$**	**20X0**	**$**
17 Mar Sales	6,450		

Manfredi's account shows a debit balance. This is an asset because it 'is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity' (IASB Framework for the Preparation and Presentation of Financial Statements, paragraph 40).

Here the 'entity' is Ingrid's business, the 'past event' is the sale, and the 'future economic benefits' are represented by the cash received from Manfredi when he settles the invoice.

The debit balance is also a current asset because it meets the criteria in paragraph 66 of IAS 1, Presentation of Financial Statements. This states that an entity should classify an asset as current when any one of the following applies:

- **(a)** The entity expects to realise the asset, or intends to sell or consume it, in its normal operating cycle
- **(b)** The entity holds the asset primarily for the purpose of trading.
- **(c)** The entity expects to realise the asset within 12 months after the reporting period.
- **(d)** The asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

In this example, the asset meets criterion (c) because the amount is payable within 30 days, and also criterion (a) because Ingrid's normal operating cycle is buying and selling on credit, collecting cash from customers, and paying suppliers.

The effect on the accounting equation is that inventory will decrease by the cost of the goods sold and receivables will increase by the selling price of the goods sold. So total assets increase by the profit made on the sale. This also increases capital/equity. There is no change in liabilities.

The profit on this transaction is therefore taken when the goods are sold even though no money has exchanged hands yet. This is because this transaction meets all of the recognition rules in paragraph 14 of IAS 18:

- **(a)** The entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
- **(b)** The entity retains neither continuing managerial involvement to the degree usually associated with ownership, nor effective control over the goods sold.
- **(c)** The amount of revenue can be measured reliably.
- **(d)** It is probable that the economic benefits associated with the transaction will flow to the entity.
- **(e)** The costs incurred, or to be incurred, in respect of the transaction can be measured reliably.

All these criteria are met here:

- Manfredi now possesses and controls the goods (criterion (a)) and Ingrid doesn't (criterion (b))
- Manfredi has agreed the price (as per the invoice), meeting criterion (c)
- Manfredi is likely to pay the invoice (Ingrid wouldn't have sold to Manfredi otherwise, and can sue for payment if necessary) (criterion (d))
- Ingrid's costs of buying and selling the goods are measurable (criterion (e)).

What happens now?

If all goes well, Manfredi will keep to the terms of the agreement and Ingrid will receive payment within 30 days. If Manfredi pays on 16 April 20X0, Ingrid will debit this in her Cash Book (in the Bank column) and credit the trade receivables account (in the General Ledger). The payment will also be credited to Manfredi's account in the Receivables Ledger, as shown in **Table 2** below.

Table 2: Manfredi's account in the receivables ledger (post-payment)

Manfredi

20X0		**$**	**20X0**		**$**
17 Mar	Sales	6,450	16 Apr	Bank	6,450

This now completes the transaction cycle. The asset trade receivables reduces by the amount of the payment, and cash at bank increases by the same amount.

ENCOURAGING PROMPT PAYMENT

Sometimes, the entity may give a discount if a customer pays an invoice early. This is to encourage prompt payment by the customer. The accounting entries depend upon whether or not the entity expects the customer to take advantage of the prompt payment/settlement discount:

- Customer is expected to take advantage of discount
  For example, let's suppose that Ingrid allows a 2% discount to Manfredi if the invoice is paid within 14 days – half the normal period of credit. If Ingrid expects that Manfredi will take advantage of the discount, the invoice is issued with the discount already deducted – ie $6,321 (98%). If, subsequently, Manfredi doesn't pay within 14 days, an invoice for the additional amount (ie $129 representing the discount that was not taken advantage of) is issued on the 31 March.

- Customer is not expected to take advantage of discount
  In this scenario, Ingrid does not expect Manfredi to pay within 14 days, and so the invoice is issued for the full amount. However, if after the full invoice has been issued, Manfredi then pays within the 14 days. Ingrid can issue a credit note for $129 for the prompt payment/settlement discount.

CUSTOMER FAILS TO PAY

It may be that Manfredi does not pay by the due date. At this point Ingrid should implement her procedures to monitor and collect overdue accounts. These should be efficient, fair and legal. Ingrid may ultimately have to employ the services of a debt collector and/or resort to legal proceedings against Manfredi. These procedures are beyond the scope of this article, although some of the basics of good credit control will be covered later.

However, there may come a time when Ingrid has to accept that the amount due from Manfredi will not be collectible. This might be because, for example, Manfredi has been declared bankrupt or has disappeared and cannot be traced.

At this point, Ingrid is going to have to face the fact that her trade receivable of $6,450 is no longer the asset she thought it was because it is now no longer probable that the economic benefits associated with the transaction will flow to her (IAS 18, paragraph 14 (d) – see above). Suppose that on 28 December 20X0 Ingrid decides to write the amount off as an irrecoverable debt. This will be recorded in Manfredi's account in the Receivables Ledger as shown in **Table 3** (below).

Table 3: Manfredi's account in the receivables ledger (irrecoverable debt)

Manfredi

20X0	**$**	**20X0**	**$**
17 Mar Sales	6,450	28 Dec Irrecoverable debts	6,450
	6,450		6,450

The original entry for the write off will be in the journal:

	$	**$**
Dr Irrecoverable debts	6,450	
Cr Receivables control		6,450

Invoice due from customer Manfredi written off as irrecoverable
The amounts will then be posted to the double entry system by debiting irrecoverable debts and crediting trade receivables – both accounts will be in the General Ledger.

The trade receivable now ceases to be an asset and becomes an expense. The adverse effect on profit can be significant. If Ingrid sells her goods at a uniform gross margin of 30%, the effect of the non-collection of the amount due can be summarised as shown in **Table 4**.

Table 4: Ingrid sells her goods at a uniform gross margin of 30%

MAKING AN ALLOWANCE FOR RECEIVABLES

Let us now assume that the financial year end for Ingrid is 31 December 20X0. The irrecoverable debt arising from the sale to Manfredi has been recognised in the same year in which the sale was made. Ingrid may feel that it would be prudent to make an additional charge for irrecoverable debts based on the total of trade receivables as at the end of the year.

Ingrid expects that a fairly fixed percentage of trade receivables will prove to be uncollectible each year.

Suppose that Ingrid estimates that on average 3% of trade receivables will prove to be uncollectible. This means that if Ingrid's trade receivables as at 31 December 20X0 totalled $541,800 then she can expect to write off about $16,254 of this in 20X1. It would be appropriate to charge this amount as an expense in the year in which the related sales took place (the matching principle) even though Ingrid will not find out which specific receivables are uncollectible until 20X1.

Suppose now that the total trade receivables written off as irrecoverable during 20X0 was $196,201 (this will include Manfredi's debt). The total amount charged in the income statement for 20X0 will now be:

	$
Irrecoverable debts	196,201
Add end of year allowance for receivables	16,254
Receivables expense for 20X0	212,455

And the amount included in current assets in the statement of financial position as at the end of 20X0 will be:

	$
Trade receivables	541,800
Less: Allowance for receivables	16,254
	252,546

This will all be recorded in the ledger accounts as shown in **Table 5.**

Table 5: Ingrid's ledger account

Irrecoverable debts

20X0	$	20X0	$
Trade receivables	196,201	31 Dec Statement of profit or loss	212,455
31 Dec Allowance for receivables	16,254		
	212,245		212,455

Allowance for receivables

20X0	$	20X0	$
		31 Dec Irrecoverable debts	16,254

OUT WITH THE OLD AND IN WITH THE NEW

We're not quite finished yet. If 20X0 was not Ingrid's first year of operation she would have made an allowance for trade receivables at the end of 2009. So, if Ingrid's trade receivables totalled $400,932 as at 31 December 2009, she would have made an allowance for receivables of $12,028 (3% of $400,932). It is important that this allowance is reversed for 20X0 so that the irrecoverable debts of $12,028 anticipated and charged in 2009 are not charged again in the income statement for 20X0.

The total amount charged in the income statement for 20X0 will now be:

	$
Irrecoverable debts	196,201
Deduct start of year allowance for receivables	(12,028)
Add end of year allowance for receivables	16,254
Receivables expense for 20X0	212,455

And the amount included in current assets in the statement of financial position as at the end of 20X0 will be unchanged:

	$
Trade receivables	541,800
Less: Allowance for receivables	16,254
	252,546

This will be recorded in the ledger accounts as shown in **Table 6.**

Irrecoverable debts

20X0	**$**	**20X0**	**$**
Trade receivables	196,201	31 Dec Statement for receivables (old)	12,028
31 Dec Allowance for receivables	16,254	31 Dec Statement of profit or loss	200,427
	212,455		212,455

Allowance for receivables

20X0	**$**	**20X0**	**$**
31 Dec Irrecoverable debts (old)	12,028	01 Jan Balance b/f	12,028
31 Dec Balance c/d	16,254	31 Dec Irrecoverable debts (new)	16,254
	26,282		28,228
		20X1	
		01 Jan Balance b/d	16,254

You will note that the allowance for the receivables account has just two entries for the year. At the end of each accounting period the old allowance is taken out and the new allowance is put in. In each case, the other entry is made in the irrecoverable debts account. This is an expense account which is closed off to the income statement each year.

The above method is relatively easy to understand if you are new to this, and it can always be relied on to get the correct figures. The charge in the income statement will always be: receivables written off – last year's allowance for receivables + this year's allowance for receivables.

The figure in the statement of financial position will always be: trade receivables – this year's allowance for receivables.

THE INCREMENTAL APPROACH

This is an alternative way of updating the allowance for trade receivables at the end of each accounting period.

It reduces the number of entries in the ledger accounts, but is a bit more difficult to master. Using this method, the start of year allowance for receivables is just changed to give the end of year allowance. The problem is that the change in the allowance may result in an increase or a decrease.

Using the same data as before, the receivables expense charged in the income statement for 20X0 will be:

	$
Irrecoverable debts written off	196,201
Increase in allowance for receivables	4,226
Receivables expense	200,427

The amount included in current assets in the statement of financial position as at the end of 20X0 will be as before:

	$
Trade receivables	541,800
Less Allowance for receivables	16,254
	525,546

The entries in the ledger accounts will be as shown in **Table 7**.

Table 7

Irrecoverable debts

20X0	**$**	**20X0**	**$**
Trade receivables	196,201	31 Dec Statement of profit or loss	200,427
31 Dec Allowance for receivables (increase)	4,226		
	200,427		200,427

Allowance for receivables

20X0	**$**	**20X0**	**$**
31 Dec balance c/d	16,254	01 Jan Balance b/f	12,028
		31 Dec Irrecoverable debts (increase)	4,226
	16,254		16,254
		20X1	
		01 Jan Balance b/d	16,254

If the allowance for receivables had been decreased, the allowance for receivables would have been debited with the decrease and the irrecoverable debts account would have been credited. Here's an illustration. Suppose that in 20X1 receivables written off as irrecoverable totaled $166,400, and that the allowance for receivables is to be reduced to $15,000. The ledger accounts for 20X1 would be as shown in **Table 8**.

Table 8

Irrecoverable debts

20X0	**$**	**20X0**	**$**
Trade receivables	166,400	31 Dec Allowance for receivables (decrease)	1,254
		31 Dec Statement of profit or loss	165,146
	166,400		166,400

Allowance for receivables

20X1	$	20X1	$
31 Dec irrecoverable debts (decrease)	1,254	01 Jan Balance b/f	16,254
31 Dec balance b/d	15,000		
	16,254		16,254
		20X2	
		01 Jan Balance b/d	15,000

CREDIT CONTROL

Earlier we saw that irrecoverable debts can severely decrease profit (and cash flow). It is therefore important that a business does all it can to reduce the incidence of irrecoverable debts. Some think that good credit control is all about chasing up overdue accounts effectively. In fact, good credit control should start much earlier. The following considerations are the foundations of good credit control:

- Who gets credit?
  The initial screening of potential credit customers is important. A credit sale is essentially a free gift to the customer until the invoice is paid. It is no use making a credit sale to a questionable customer just to achieve the sale. The profit is more than wiped out if the customer defaults. On the other hand, over enthusiastic vetting at this stage could result in lost sales to potentially good customers.

- Terms of credit
  These should be set up and agreed in advance. They will include the credit limit (the maximum amount the customer can owe at any point in time), the credit period, whether discount can be claimed for quick payment, if interest is chargeable if the payment terms are not met, and so on. The terms of credit need not be the same for each customer.

- Administration of billing and collection
  Efficiency here will be important. Invoices should be issued quickly and should be accurate. Customers generally will not pay unless, and until, they receive the invoice, so delays in invoicing will result in delays in payment. Errors in invoices also hold things up. The payment patterns of customers should be known, if possible, and invoices issued to take advantage of these. Businesses should also review their procedures for issuing statements and reminders.

Collection of overdue accounts

As mentioned earlier, procedures here need to be systematic, fair, reasonable and within the law. Avoiding the issue of non-payment, or just hopefully sending out computer generated reminders every few months, are unlikely to be effective.

On the other hand, threatening a customer might be effective but will most likely land the business in court.

FINALLY, SOME GOOD NEWS!

Having written off Manfredi's debt in 20X0, Ingrid is surprised to receive a payment of $6,450 from Manfredi in 20X1 along with a letter apologising for the delay. There are two ways to record this.

Method A

	$
Dr Bank	6,450
Cr Irrecoverable debts	6,450

Method B

	$
Dr Bank	6,450
Cr Trade receivables (and Manfredi's personal account)	6,450

And

	$
Dr Trade receivables (and Manfredi's personal account)	6,450
Cr Irrecoverable debts	6,450

The difference between the two methods is that Method B reverses the irrecoverable debt write off.

Method A might be appropriate where a full or part payment is received at the end of bankruptcy proceedings or from a debt collection agency.

Method B might be more suitable when full payment is unexpectedly received from the customer. In this situation, the business should question whether it was a bit too hasty in writing the receivable off in the first place, and review its procedures generally.

Chapter 8

ACCOUNTING FOR INVENTORY

IN THIS CHAPTER

ACCOUNTING FOR CLOSING INVENTORY

Movements of trading inventory, during the year, are recorded using the Sales and Purchases accounts. In order to calculate gross profit, it is necessary to calculate cost of sales.

If we have opening and closing inventory then under the **Matching concept** we should adjust purchases for opening and closing inventory in order to determine the **Cost of Sales** or **Cost of goods sold**.

Cost of sales = Opening Inventory + Purchases – Closing inventory

- Goods might be unsold at the end of a reporting period and so be still held in inventory. The closing inventory value is subtracted from current year's purchases and carried forward to the next period, where it is matched with the income it earns.

- Carriage inwards is added to cost of purchase and therefore included in cost of sales as it is a cost directly related to purchases.

- In case of carriage inwards and purchase returns, following will be the formula of cost of sales

Cost of sales = Opening inventory + Purchases – Purchase returns + Carriage inwards – Closing inventory

- Carriage outwards is a distribution cost and deducted as expense after gross profit.

DOUBLE ENTRIES

PURCHASES

Whenever purchases are made during the year, they are recorded as expense by debiting the purchases account as follows:

Dr. Purchases

Cr. Cash/Trade payable

PURCHASES IN P&L

Purchases for the year are transferred to the statement of profit or loss at the year-end for calculation of cost of sales. The purchases account is balanced off and the balance is transferred to statement of profit or loss by the following double entry.

Dr. Cost of sales (P&L)

Cr. Purchases

Note: Inventory account must be kept but it only used at the reporting date when the business values the inventory. Goods purchases are recorded during the year in purchases account as expense.

CLOSING INVENTORY

Closing inventory is inventory which has been purchased but not sold during a period. It does not form part of the cost of sales and so must be transferred from being an expense in the statement of profit or loss to become a year-end asset in the statement of financial position:

Dr Inventory (statement of financial position)

Cr Closing inventory (cost of sales)

The debit entry creates a **current asset** in the statement of financial position and the credit entry **reduces the cost of sales** expense in the statement of profit or loss.

OPENING INVENTORY

Except for the first year of trade, a business will always have both opening and closing inventories. Opening inventory is inventory that was already held at the start of the period. In other words it is the closing inventory of the previous period, which was included in that period's statement of financial position as an asset.

The cost of this inventory forms part of the cost of sales for the current period. Therefore, it is transferred from the statement of financial position inventory account (in which it is later replaced by the current period's closing inventory) to cost of sales in the statement of profit or loss:

Dr. Opening inventory (cost of sales)

Cr. Inventory (statement of financial position)

The debit entry **increases the cost of sales** expense in the statement of profit or loss and the credit entry **removes the asset** previously recorded in the statement of financial position.

EXTRACT OF STATEMENT OF PROFIT OR LOSS

Opening inventory	X
Add: Purchases	X
Less: Purchase returns	(X)
Add: Carriage inwards	X
Less: Closing inventory	(X)
Cost of sales	**XX**

FORMS OF INVENTORY

Depending on the type of organization, inventory held at the year-end may comprise some or all of the following elements:

- **Raw materials** or components from suppliers
- **Work-in-progress** i.e. Raw materials that have had some work done on them but which are not completed at the date of valuation (usually year-end)
- **Finished goods** or goods for resale

COST OF INVENTORY

This is expenditure incurred in the normal course of business in bringing the product or service to its present location and condition.

- For a retailer the cost of inventory is **purchase cost** only
- For a manufacturer the cost of inventory is **production cost** where
  Production cost = Purchase cost +Conversion cost

Purchase Costs will include

- Purchase price of materials / components *plus*
- Import duties *plus*
- Transport and handling (carriage inwards) costs *less*
- Trade discounts, rebates & subsidies

Note: Settlement discounts do not affect the cost of inventory; they only affect the final amount paid to the creditor.

Conversion Costs will include

Costs incurred in converting raw materials and necessarily incurred in bringing the product to its present location and condition. These are not normally applicable to a retailer. These include:

- Direct labour costs
- Direct expenses
- Other direct costs, e.g. subcontracting
- Attributable production overheads absorbed, based on a normal capacity of the facilities.
- Any other overheads attributable to bringing the product or service to its present location and condition. This is a matter of judgment.

The cost of Inventory **Excludes:**

- Non – manufacturing Overheads
- Storage costs
- Selling costs
- Abnormal wastage costs

EXAMPLE 1

Edward Co. purchased some raw material inventory from a supplier at a list price of $6,000. It got a settlement discount of $500 on this purchase.
The raw materials have been converted into finished goods inventory by the process. The process cost $5,500 made up of $3,000 direct labour, $1,300 electricity cost, $500 attributable production overheads and $700 share of post- production storage costs. The finished goods will be sold for $14,000 after incurring selling costs of 10%.

What is the value of finished goods inventory to be shown in Edwards Co.'s financial statements?

Answer: $10,800

IDENTIFICATION OF THE COST OF INVENTORY

Nature of the problem

In order to come up with an inventory figure at the year end, it is necessary to determine the volume or units of inventory held at the period-end and to place a value on that inventory according to the valuation rule as per IAS 2.

Where a business deals in homogeneous products then in conditions of price change, it is often very difficult to identify the discrete cost of each item sold and therefore to determine the cost of the item left over at the year end.

Our concern or task is to devise a pricing technique or accounting system which we can use to attribute an approximation of original cost to each of the items issued from stores and therefore determine the cost of inventory left over at the year end.

PRICING TECHNIQUES IN USE

FIFO (First in First Out)

Assumes that the components are used in the order in which they are received, i.e. Oldest inventory issued first and consequently closing inventory comprises the newest items.

LIFO (Last in First Out)

Assumes that the newest components are issued first leaving oldest items in inventory **(This technique is no longer allowed under IAS-2 Inventories)**

AVCO (Weighted Average Costing)

Each component in the inventory is assumed to have been purchased at the average price of all components in the inventory (store).

IAS-2 Inventories states that the most appropriate assumption is one that 'provides a fair approximation to the expenditure actually incurred.'

EXAMPLE 2

Assume that a firm has just completed its first financial year and is about to value inventory at cost price. It has dealt in only one type of goods. A record of the transactions is shown below:

	Bought			**Sold**	
20X5		$	20X5		$
January	10@$20 each	200	May	9@$35 each	315
April	12@$25 each	300	November	20@$40 each	800
October	15@$30 each	450			
	37	950		29	1,115

The following pages show how stores ledger sheets might be used to determine closing inventory based on FIFO and Average Cost. Immediately below we will calculate the value of inventory using FIFO and AVCO approaches, for the 8 units of inventory unsold at the year end.

Stores Ledger Account - FIFO

Material -------------- Code ----------------- Maximum Quantity: ---------

Minimum Quantity: ----------

	Receipts				Issues				Inventory		
Date	**GRN No.**	**Qty**	**Unit Price ($)**	**Amount ($)**	**Stores Req. No.**	**Qty**	**Unit Price ($)**	**Amount ($)**	**Qty**	**Unit price**	**Amount ($)**
January		10	20	200					10	20	200
April		12	25	300					10	20	200
									12	25	300
May						9	20	180	1	20	20
									12	25	300
October		15	30	450					1	20	20
									12	25	300
									15	30	450
November						1	20	20			
						12	25	300			
						7	30	210			
									8	30	240

Stores Ledger Account – Average Cost

Material -------------- Code ----------------- Maximum Quantity: -----------------

Minimum Quantity: -----------------

Receipts					Issues				Inventory		
Date	**GRN No.**	**Qty**	**Unit Price ($)**	**Amount ($)**	**Stores Req. No.**	**Qty**	**Unit Price ($)**	**Amount ($)**	**Qty**	**Average cost of inventory held ($)**	**Total value of Stock held ($)**
January		10	20	200					10	20.00	200
April		12	25	300					22	22.73	500
May						9	22.73	204.57	13	22.73	295.43
October		15	30	450					28	26.62	745.43
November						20	26.62	532.40	8	26.62	213.03

The application of the FIFO and AVCO assumptions will differ depending on whether inventory records are maintained

- Only at the period end, or
- Continuously.

Where period end records are maintained, all purchases and sales are assumed to have taken place on the last day of the period. Actual purchase and sale dates are ignored.

Where continuous records are maintained, actual purchase and sale dates are relevant. Records are updated after each purchase and issue of inventory.

EFFECT OF FIFO VS AVCO ON CLOSING INVENTORY VALUATION

A **higher** closing inventory valuation
- Higher Net Assets Value
- Higher profits

A **lower** closing inventory valuation
- Lower Net Assets Value
- Lower profits

- Assuming that the price of inventory items have risen throughout the period, then for that given period, closing inventory determined using FIFO will have a higher value than inventory determined using AVCO.
- This is because **FIFO** assumes that the newest (more expensive) purchase remain in inventory, whereas **AVCO** assumes the average prices for all units of inventory.
- Therefore gross profit will be higher where closing inventory is determined using FIFO as opposed to AVCO.
- This is because the higher the value of closing inventory, the higher the reported profit, for that particular year.
- The impact of Opening inventory is opposite to that of Closing Inventory.

Remember that:

Closing stock	**GP**	**CGS**
↑	↑	↓
↓	↓	↑

EXAMPLE 3

Alpha Co. is preparing its financial statements for the current year. Its closing inventory was understated by $180,000.

What will be the impact of this error on financial statements if the error is not corrected?

a) The current year's profit will be overstated and next year's profit will be understated
b) The current year's profit will be understated but there will be no effect on next year's profit
c) The current year's profit will be overstated but there will be no effect on next year's profit
d) The current year's profit will be understated and next year's profit will be overstated

Answer: The current year's profit will be understated and next year's profit will be overstated

INVENTORY VALUATION – IAS 2

IAS 2 Values inventory at:

↓

The Lower of

↙ ↘

Cost OR Net Realisable Value (NRV)

COST: The cost of inventory comprises all costs incurred in bringing the asset to its present location and condition based on a normal level of activity.

Net Realisable Value
Net realizable value (NRV) = Estimated selling price in the ordinary course of business *less* all further costs to complete *less* Costs incurred in making the sale *less* Discounts.

The valuation rule above is an application of **Prudence**. Prudence requires caution in conditions of uncertainty.

- Where we expect to make a profit from future sales (NRV is higher than Cost) we value inventory at the lower figure, i.e. Cost. The result of this is that we do not anticipate a profit in the current period's accounts. The profit will be recorded next year when the inventory is actually sold.
- Where we expect to make a loss, from future sales of this year's inventory (NRV is lower than Cost); we value inventory at the lower figure which is now NRV. The result of this is that the loss that will occur next year is brought forward into this year's account.

Additionally, the rule ensures the lowest inventory figure is reported on the Statement of Financial Position.

A higher degree of certainty is required before we can recognize a profit, i.e., we wait until we make a sale.
A loss is recognized as soon as foreseen, we don't wait until it is realized on sale.

Note: **NRV is the 'Best Estimate' available at the Reporting date!**

EXAMPLE 4

At 30 June 20X7 Brian's inventory was valued at its cost of $42,800. This includes items costing $11,100 which have been superseded by an updated design. Brian will be able to sell these items through an agent for $12,000. The agent's commission will be 10% of selling price.

What is the value of closing inventory on 30 June 20X7 in financial statements of Brian?

Answer: $ 42,500

SEPARATE VALUATION RULE

Normally the reporting entity will expect to value inventory at cost. However where there are indications that NRV may be less than cost then the valuation under IAS 2 should ideally be based on an item-by-item comparison of Cost and NRV.

EXAMPLE 5
Calculate the value of inventory to be shown in the Statement of Financial Position for the following items.

Inventory Item	Cost	NRV	Statement of Financial Position Valuation
1	27	32	27
2	14	8	8
3	43	55	43
4	29	40	29
	113	135	107

DRAWINGS OF INVENTORY

It is not unusual for a sole trader to take inventory from their business for their own use. This type of transaction is a form of drawings. The correct double entry to account for such drawings is:

Dr Drawings (cost of inventory taken)
Cr Cost of sales (cost of inventory taken)

The credit entry ensures that the cost of inventory taken is not included as part of the cost of inventory sold in the statement of profit or loss.

NECESSITY OF INVENTORY TAKE AT YEAR END

Larger businesses will often maintain perpetual inventory systems, i.e., a continuous record of the quantity and value of inventory. However items of inventory may be damaged, lost or stolen and so inventory should be physically counted. The condition of the inventory may lead to inventory being valued at NRV.

Where inventory taking is carried out at the year end, it does not usually take place on one day in practice. Logistical problems (i.e., not enough people to count the entire inventory in one day) determine that the inventory taking occurs over a number of days.

Where inventory taking is carried out across the year end it will be necessary to keep a careful track of inventory coming in and going out of the business to ensure that

- No inventory held at the year-end is omitted
- Inventory coming in after the year end is not erroneously included.

INVENTORY RECORD KEEPING

The record of inventory can be maintained on a continuous or periodic basis. In complicated cases, where a business holds considerable quantities of varied inventory, continuous inventory records are maintained. This means that a record is maintained for every item of inventory coming in and going out from the business.

TRANSACTIONS ON A SALE OR RETURN BASIS

Goods sold on a sale or return basis or on approval, remain the property of the supplier until either sold by the agent, or accepted by the agent as the result of an agreed period of time expiring.

Therefore, the goods are not included in the closing inventory of the holder, but are included in closing inventory of the supplier.

EXAMPLE 6
A severe flood on 30 June 2009 destroyed some of Lincoln Company's inventory and its inventory records. The following information is available:

	$
Inventory 1 June	250,000
Sales for June	520,000
Purchases for June	380,000
Inventory in good condition following the flood at 30 June	150,000
Standard gross profit percentage on sales is 20%	

Based on this information, what is the value of the inventory destroyed?
Answer: $64,000

EXAMPLE 7

Which of the following statements about the treatment of inventory of finished goods in financial statements are correct?

(1) Inventory should be valued at the lower of cost and net realisable value.
(2) Inventory costs may include costs such as import duties and freight.
(3) Inventory costs include fixed and variable production overheads.
(4) A company's financial statements must disclose the accounting policies used in measuring inventories.

A All four statements are correct.
B (1), (2) and (3) only
C (2), (3) and (4) only
D (1) and (4) only

Answer: Option A

Chapter 9

NON-CURRENT ASSETS

IN THIS CHAPTER

- **NON - CURRENT ASSETS**
- **TANGIBLE NON-CURRENT ASSETS**
- **ACCOUNTING FOR TANGIBLE NON-CURRENT ASSETS**
- **COST OF A NON-CURRENT ASSET**
- **SUBSEQUENT EXPENDITURE ON A NON-CURRENT ASSET**
- **DEPRECIATION**
- **DEPRECIATION POLICY**
- **CHANGE IN ESTIMATES**
- **REVALUATION OF NON-CURRENT ASSETS**
- **DISPOSAL OF NON-CURRENT ASSETS**
- **NON CURRENT ASSET REGISTER**
- **DISCLOSURES**

NON - CURRENT ASSETS

A non-current asset is an asset which is intended for continued use in a business – generally meaning over more than one accounting period. They are used to generate income directly or indirectly for a business and are not normally liquid assets (i.e. not easily and quickly converted into cash without a significant loss in value)

Non-current assets are distinguished from current assets by the following characteristics:

- They are long term in nature
- They are not normally acquired for resale
- They could be tangible or intangible
- They are used to generate income directly or indirectly for a business
- They are not normally liquid assets (i.e. not easily and quickly converted into cash without a significant loss in value).

Non-current assets can be tangible or intangible. In this chapter, you will study the accounting of Tangible Non-current assets only.

TANGIBLE NON-CURRENT ASSETS

Have physical substance e.g. Land and buildings, Plant and equipment, Motor vehicles, Computers, Fixtures and fittings etc.

The rules for accounting for tangible non-current assets are provided by ***IAS 16 Property, Plant and Equipment***. As per IAS 16, the **recognition criteria** of property, plant and equipment is:

a) It is probable that future economic benefits associated with the item will flow to the entity and
b) The cost of the item can be measured reliably

ACCOUNTING FOR TANGIBLE NON-CURRENT ASSETS

A non-current asset is purchased for continuing use in a business throughout its useful life. At the end of this useful life (or possibly before), it is disposed of.

Throughout the next sections of the chapter, we'll consider the necessary accounting entries at each stage of a non-current asset's life:

1. Initial purchase and subsequent recognition
2. Depreciation each year throughout the asset's useful life
3. A possible revaluation to reflect an increase in the asset's value
4. Disposal at the end of the asset's useful life

COST OF A NON-CURRENT ASSET

The cost of a non-current asset according to IAS 16 includes all costs directly attributable to bringing the asset to the location and condition necessary for it to operate normally and in the way intended by management.

Directly attributable costs include:

- The initial purchase price of the asset
- Delivery costs
- Non-refundable import taxes after deducting trade discounts and rebates
- Stamp duties and import duties
- Installation and assembly costs
- Testing costs (Before asset goes into commercial production)
- Costs of site preparation
- Professional fee e.g. lawyer, broker or architect's fee

The cost of purchasing or constructing a non-current asset is capitalised in the statement of financial position by:

Dr Non-current asset (at Cost)
Cr Cash/Payable (at Cost)

Costs **NOT** capitalised (included) in the cost of asset are as follows:

- General overheads cost
- Training cost of staff
- Fuel in a vehicle on delivery
- Administration costs
- Warranty costs
- Maintenance expenses

SUBSEQUENT EXPENDITURE ON A NON-CURRENT ASSET

Having acquired a non-current asset, it is normal to spend money on it at a later date on costs such as repairs and maintenance. IAS 16 criteria for recognition of subsequent expenditure are the same as **initial recognition** criteria stated above:

a) It is probable that future economic benefits associated with the item will flow to the entity and
b) The cost of the item can be measured reliably

The subsequent expenditure which enhances the performance of the asset may be **capitalised** as part of its cost. This may include, for example, an extension to a building in order to provide more trading space, major improvements, major overhauls etc.

Other expenditure is **revenue expenditure** and must be expensed in the Statement of Profit or Loss. This includes Insurance costs, Repairs and Maintenance, Renewals, Repainting etc. These are the costs incurred to maintain existing performance of asset.

Subsequent expenditure that enhances performance of asset
Dr. Non-current asset (Statement of financial position)
Cr. Cash / Payable

Subsequent expenditure that does not enhance performance of asset
Dr. Expense (Statement of profit or loss)
Cr. Cash / Payable

EXAMPLE 1
Tetrastar bought a production machinery from abroad. The cost of the machine was $210,000. Tetrastar had to incur import duties and non-refundable sales tax of 15,000 and 18,000 respectively. The installation costs were $18,000 and the employees received specific training on how to use this particular machine, at a cost of $6,000. Before using the machine to make customers' orders, a test was undertaken which used up material costing $17,000.

What should be the cost of machine in Tetrastar's Statement of Financial Position?

$ ____________

Answer: $278,000

DEPRECIATION

Depreciation is the systematic allocation of the depreciable value of an asset over its useful life.
Depreciation of non-current assets is based on the MATCHING CONCEPT (Income/expenses recognized in the period they are earned/incurred).

In simple terms, depreciation is a mechanism to reflect the wearing out of a non-current asset. It may arise from the following:

- Use
- Physical wear and tear
- Passing of time
- Obsolescence through technology and market changes etc.

Depreciable Amount

It is the total amount to be depreciated over the estimated useful life of asset. It is calculated as follows:

Depreciable amount = Cost / Revalued amount of asset – Residual value

Residual Value/Net Realizable Value

It is the estimated amount that an entity would currently obtain from disposal of asset, after deducting the estimated costs of disposal, if the asset were already of the age and the condition expected at the end of its useful life. It could be scrap value or second hand value. Often the residual value is nil.

Useful Life

It is the period over which the business/entity expects to use the non-current asset.

The only asset that is deemed to have an unlimited useful life is freehold land.

Important Points

1. Depreciation is a non-cash expense.
2. Depreciation is not a fund set aside for replacement of asset because

   a) Asset might not be replaced
   b) It might be replaced with a different asset
   c) It might be at different cost due to technological advancement

Accounting for Depreciation

1. A charge for depreciation is made in an expense account for the period.
2. Provide for wearing out of the asset using an “accumulated depreciation” account. This account shows the accumulated depreciation to date.(It is used in the sense of reducing the Statement of Financial Position value of an asset)
3. The non-current asset is shown on the Statement of Financial Position at the Carrying Value.

   Carrying value = Cost – Accumulated Depreciation.

Accounting Entry

Dr. Depreciation expense a/c (P&L)*
Cr. Accumulated depreciation a/c (SOFP)*

The **depreciation expense** account is an expense account in Statement of Profit or Loss account, which is closed off and its balance transferred to P&L each year i.e. it does not include cumulative amounts. There is no brought down or carried down balance of this account.

The **accumulated depreciation** account is a statement of financial position account, which as the name suggests, includes all depreciation on an asset to date. The account will have brought down balance of total depreciation charged till the start of reporting period. After charging current year's depreciation, the carried down balance is calculated.

Methods of Depreciation
(i) Straight line method,
(ii) Reducing balance method,
(iii) Sum of digits method,

Straight Line Method

This method results in a constant annual charge for depreciation over an asset's useful life. It assumes that the benefits of using an asset are spread evenly over its life. Therefore, the asset's cost is charged evenly (in equal instalments) over its life. As it is in equal instalments, carrying value of asset declines at a steady rate or in a 'straight line' over time.

$$\text{Annual depreciation} = \frac{\text{Cost – residual value}}{\text{Expected useful life}}$$ OR

Annual depreciation = (Cost – Residual Value) x %age of Depreciation

The depreciation charge can be apportioned on a monthly basis as well.

EXAMPLE 2
A machine cost of $6000 and has an estimated residual value of $1000. The expected useful life is 5 years. Fill in the figures below:

End of year	Cost ($)	Depreciation Exp	Accumulated Dep '$'	NBV '$'
1.	6000	$\frac{6000-1000}{5Y}=1000$	1000	5000
2.	6000	$\frac{6000-1000}{5Y}=1000$	2000	4000
3.	6000	$\frac{6000-1000}{5Y}=1000$	3000	3000
4.	6000	$\frac{6000-1000}{5Y}=1000$	4000	2000
5.	6000	$\frac{6000-1000}{5Y}=1000$	5000	1000

Reducing Balance Method

In this method, the annual depreciation charge is a fixed percentage of the brought forward carrying value of the asset.

This method results in a reducing annual charge for depreciation over an asset's useful life. It assumes that the benefits of using an asset are greater in earlier years of its useful life than in later years, so larger depreciation charges are made in early years.

In this method depreciation expense is calculated as follows:

Depreciation expense (Annual) = Carrying Value x %age of depreciation

The calculation of depreciation expense here will not be impacted by the residual value of asset. The impact is already adjusted in the percentage of depreciation. In F3/FFA exam, the depreciation rate will always be given in question. The annual depreciation charged may be apportioned on a monthly basis.

EXAMPLE 3

A business acquires a fixed asset for $10,000, which he will use for 3 years at which time he will sell for $2160. Using the reducing balance method and a rate of 40%, show the annual depreciation charges.

	Depreciation charge	Cost – Accumulated Depreciation	Carrying value
Y-1	4000	$10,000 – 4000	= 6,000
Y-2	2400	$10,000 – 6,400	= 3,600
Y-3	1440	$10,000 – 7,840	= 2,160

Sum of digits method

This is a variation in the reducing balance method and the aim is to show a higher depreciation charge in the earlier years of life of the asset. To calculate depreciation, the reciprocal is required which is obtained as under:

$$SOD = \frac{n\,(n + 1)}{2}$$

EXAMPLE 4

Berletta Co. purchased a machine on July 1, 20X6 costing $42,000. The estimated residual value is $2,000 and the useful life is expected to be four years. Calculate depreciation charge and show extracts of financial statements.

$$SOD = \frac{n\,(n + 1)}{2} \qquad SOD = \frac{4\,(4 + 1)}{2} = 10$$

Statement of profit or loss

	20X6	20X7	20X8	20X9
Depreciation	16,000	12,000	8,000	4,000
	(4/10,	3/10,	2/10,	1/10)

Statement of Financial Position

Cost	42,000	42,000	42,000	42,000
Less: Acc.dep.	(16,000)	(28,000)	(36,000)	(40,000)
	26,000	14,000	6,000	2,000

Important points - Depreciation

- The method used must be fair in allocating the charges between different accounting periods according to the benefit estimated to be earned.
- Whatever method is selected it must be applied for similar assets and consistently.
- It should be easy to apply in practice
- The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the entity.
- A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate.
- Depreciation begins when the asset is available for use and continues until the asset is derecognised, even if it is idle
- The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, any change is accounted for prospectively as a change in estimate under IAS 8.

DEPRECIATION - ACCOUNTING POLICY

Pro-rata depreciation based on the exact number of months that the asset has been owned (Time apportioned depreciation).

Previously another policy of depreciation also existed. It was 'Provide a full year's depreciation in the year of acquisition and none in the year of disposal.' This policy is now obsolete.

EXAMPLE 5

If accounting year of business ends at 31st December, 2000 then depreciation charge for an asset costing $10,000 acquired on 1st November 2000 (using straight line method @20%) will be.

$$\text{Depreciation charge} = \frac{\$10{,}000 \times 20\%}{12 \text{ months}} \times 2 \text{ months}$$

$$= \$333$$

EXAMPLE 6

A business purchased equipment on 1 May 2009 for $10,000. It has a depreciable life of four years and a residual value of $2,000. Depreciation is charged straight-line on a monthly basis.
What was the carrying amount of the equipment in the financial statements at 31 October 2010?

Answer: $7,000

CHANGE IN ESTIMATES

The following are all based on estimates made by the management of a business:

- Depreciation method
- Residual value
- Useful life.

Different estimates would result in varying levels of depreciation and consequently profits.
It can be argued that these subjective areas could therefore result in manipulation of the accounts by management.
In order to reduce the scope for such manipulation and increase consistency of treatment, **IAS 16** requires the following:

- Depreciation method should be reviewed at each year end and changed if the method used no longer reflects the pattern of use of the asset
- Residual value and useful life should be reviewed at each year end and changed if expectations differ from previous estimates.
- The carrying amount of the asset (Net Book Value) is then depreciated using the new estimates.

In case of any change in estimate, the following formula is used.

Formula for calculating revised depreciation

$$\text{Revised Depreciation Expense (per year)} = \frac{\text{Carrying Value – Revised Residual Value}}{\text{Remaining Useful life of asset}}$$

EXAMPLE 7

Renada bought an item of machinery his framing business for $50,000 on 1 October 20X6. He expected the machinery to have a useful life of ten years and residual value of $1,500. On 1 October 20X7, Renada reviewed these estimations and believes the machinery to have a remaining useful life of 6 years and no residual value.
What is the depreciation charge for the year ended 30 September 20X8?

Answer: $7,525

REVALUATION OF NON-CURRENT ASSETS

Revaluation

Some non-current assets such as land and buildings rise in value over time. Businesses may choose to reflect the current value of the asset in their Statement of Financial Position. This is known as revaluing the asset.

Accounting for a Revaluation

- The difference between the Carrying Value of the asset and the revalued amount (normally a gain) is recorded in a revaluation reserve in the Statement of Financial Position. This is done after reversing the accumulated depreciation balance of the asset to date.
- Although a revaluation is, in effect a gain to a business, it is an unrealised gain (i.e. it is a 'paper profit' only until the asset is actually sold for the inflated value). It is not realized in the form of cash.
- Therefore the revaluation increase cannot form part of the profit for a period.
- Instead the revaluation increase is reported as other comprehensive income in the Statement of Profit or Loss and Other Comprehensive Income, and accumulated in a revaluation reserve in the capital section of the statement of financial position.
- An upward revaluation should be credited to revaluation surplus, unless it reverses a previous downward revaluation which was charged as an expense.
- If one asset in a class is revalued, all assets of that class must be revalued. This is to prevent selective revaluation of only those assets that have increased in value.
- IAS 1 requires that a revaluation gain is disclosed in "other comprehensive income" on the statement of financial position and in Statement of Changes in Equity in case of companies (Discussed later).
- After revaluation, asset will be depreciated as per the revised useful life and residual value

Steps to Record a Revaluation

For increase in value of asset following steps are followed:

1. Accumulated Depreciation A/C Dr
   Asset A/C Cr
2. Asset A/C Dr
   Revaluation gain A/C Cr

For decrease in value entry 2 would be reversed i.e.

Revaluation loss A/C Dr
Asset A/C Cr

A **compound entry** of Revaluation would result as a combination of the above 2 double entries. E.g.

Asset A/C Dr
Accumulated depreciation A/C Dr
Revaluation A/C Cr

For a non-depreciable asset like land, only one entry is passed for revaluation. Accumulated depreciation reversal is not required.

Depreciating a revalued asset

The depreciation charge for an asset which has been revalued is calculated as:

$$\text{Depreciation charge} = \frac{\text{Revalued Value – residual value}}{\text{Remaining useful life}}$$

If revaluation is done during the year, then the depreciation expenses should be time-apportioned.

Excess depreciation reserves transfer

Each year, the amount by which the new depreciation exceeds the old depreciation should be transferred from the revaluation reserve in the capital section of the statement of financial position to the retained earnings. This is achieved by:

Dr Revaluation reserve
Cr Retained earnings

This reserves transfer is disclosed in the statement of changes in equity.

EXAMPLE 8

The table shows how a building appears in the Statement of Financial Position.

Building at cost	$500,000	
Accumulated depreciation	($180,000)	
Carrying Value		$320,000

The building is revalued to $490,000 to reflect its present market value in the Statement of Financial Position. What is the journal entry to record the revaluation?

a) DR: Building $170,000 CR: Profit and loss account $170,000
b) DR: Non-current asset at cost $310,000
DR: Accumulated depreciation $180,000CR: Revaluation reserve $490,000
c) DR: Accumulated depreciation $180,000 CR: Building $10,000
CR: Revaluation reserve $170,000
d) DR: Non-current asset at cost $170,000 CR: Revaluation reserve $170,000

Answer: Option C

DISPOSAL OF NON-CURRENT ASSETS

In order to record a non-current asset disposal, a new ledger account known as the disposals account is required. This is a profit or loss account, and is closed off to show the profit or loss on disposal.

When a non-current asset is disposed off there will usually be a profit or loss on disposal.

- Profit on disposal would be shown as sundry income in the P&L (Statement of Profit or Loss).
- Loss on disposal shown as part of expenses.

Accounting Entries

1.	Dr. Disposal A/C	xx	
	Cr. Non-curent asset A/C		xx
	(For transfer of cost of non-current asset to disposal account)		
2.	Dr. Accumulated depreciation A/C	xx	
	Cr. Disposal account		xx
	(For transfer of accumulated depreciation of non-current asset to disposal account)		
3.	Dr. Receivable / Bank A/C	xx	
	Cr. Disposal account		xx
	(Being the recording of disposal proceeds/credit sale)		

Disposal through a part exchange agreement

A part exchange agreement arises where an old asset is provided in part payment for a new one, the balance of the new asset being paid in cash.

Dr. New asset A/C	xx	
Cr. Disposal A/C		xx (part exchange value for Old asset)
Cr. Bank/Payables A/C		xx

Part exchange allowance = Cost of new asset – Cash paid (also called trade in value)

4. The balance on the disposal account is transferred at the year end to the statement of profit or loss.

For profit on disposal			**For loss on disposal**		
Dr. Disposal A/C	Xx		Dr. P&L A/C	Xx	
Cr. P&L A/C		xx	Cr. Disposal A/C		xx

Disposing of a revalued asset

The accounting entries to record the disposal of a revalued asset are the same as those for an asset held at historical cost.

Format of disposal account

Non-Current Asset Disposal A/C

Cost/Revalued value	XX	Accumulated depreciation	XX
Cash/New asset	XX		
P&L (Bal. Fig. - profit)	XX	P&L (Bal. Fig. – loss)	XX
	XX		XX

EXAMPLE 9

Casie purchased a new item of machinery. The new machinery cost $25,000 and Casie paid a cheque for $14,800 to the dealer. In addition the dealer accepted an old item of machinery in part exchange. The old machinery had been bought five years ago for $22,800 and had been depreciated by $14,100 to date.

What is the profit or loss on disposal of the old machinery?

Answer: $1,500 profit

NON CURRENT ASSET REGISTER

Capital transactions often represent large sums of money invested by the business. It is important that this expenditure is traced. The journal is often used as a book of prime entry to record acquisitions and disposals. The problem with the journal is that it does not contain enough information.

Role of Non-Current Asset Register

It is used to record details of all non-current assets owned by the business broken down perhaps by department, location or asset type.

The non-current asset register is used for internal control purposes. Although often computerized it does not form part of the double entry system.

There is no set format for a Non-Current Asset register.

Contents of an asset register may include Asset number, Asset depreciation, Location reference, Supplier reference, Purchase date, Cost of asset, Useful life, Depreciation method, Residual value, Accumulated depreciation b/f, Depreciation expense for the year, Carrying value (CV), Disposal date and Disposal proceeds

Entries in the Non-Current Asset register will arise from Purchase of an asset, Disposal of an asset, Loss or destruction of an asset, Transfer of an asset, Revision of an estimated useful life, Scrapping of an asset, Depreciation etc.

Reasons for Maintaining Non-current Asset Register

The Non-Current Asset register provides information:

- To enable reconciliation to nominal ledger account balances
- To enable depreciation charges to be posted to nominal ledger
- Ease of calculation of profit or loss on disposal of asset.
- For physical verification /audit purposes.

Reconciliation of Non-Current Asset Register to the General Ledger

The two systems are not integrated so

- Check that total costs on register for each category of non-current Asset equals the balance on the nominal ledger
- If discrepancies arise, check the figures in both systems back to the appropriate book of prime entry.

Discrepancy between Non-Current Asset Register and Actual Non-current assets

Non-current asset register may not reconcile to the non-current assets actually present because:

- The asset was stolen and it has not been reported or noticed
- An asset may become obsolete or damaged and so should be written down. Financial record does not tie up to physical condition.
- New assets purchased but not recorded in non-current assets register.
- Error made in entering details in the non-current assets register.
- Asset physically present but not in records.

To overcome these problems:

- Physically inspect Non-Current Assets on register
- Have tight administrative procedures for recording the movement of Non-Current Assets.

SAMPLE NON-CURRENT ASSET REGISTER FORMAT

Fixed Asset Register Format

Class/ Group of Assets:			
Register prepared as at close of business:			
Assets:	1	2	3
Acquisition date			
Further Description, If any:			
Location:			
Estimated			
Life (yrs):			
Estimated			
Residual			
Value:			
Depreciation			
Method			
Cost:			
Depreciation b/d:			
Period depreciation			
Disposal date:			
(if sold)			
Proceeds:			
(if sold)			
P/L on sale:			
C/d figures			
(if unsold):			
Cost:			
Accumulated depreciation:			

DISCLOSURES

For each class of property, plant and equipment, disclose:

- Basis for measuring carrying amount
- Depreciation method(s) used
- Useful lives or depreciation rates
- Changes in accounting estimates
- Gross carrying amount and accumulated depreciation and impairment losses
- Reconciliation of the carrying amount at the beginning and the end of the period, showing:

- Additions
- Disposals
- Acquisitions through business combinations
- Revaluation increases or decreases
- Impairment losses
- Reversals of impairment losses
- Depreciation
- Other movements

If property, plant, and equipment is stated at revalued amounts, certain additional disclosures are required:

- The effective date of the revaluation
- Whether an independent valuer was involved
- The methods and significant assumptions used in estimating fair values
- The extent to which fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques
- For each revalued class of property, the carrying amount that would have been recognised had the assets been carried under the cost model
- The revaluation surplus, including changes during the period and any restrictions on the distribution of the balance to shareholders

EXAMPLE 10

XYX Co's non-current assets had written down values of $368,400 and $485,000 at the beginning and end of the year respectively. Depreciation for the year was $48,600. Assets originally costing $35,000, with a carrying amount of $18,100 were sold in the year for $15,000.

What were the additions to non-current assets in the year?

Answer: $183,300

Chapter 10

ACCRUALS AND PREPAYMENTS

IN THIS CHAPTER

- INTRODUCTION
- ACCRUED EXPENSE
- PREPAID EXPENSE
- ACCRUED INCOME
- PRE-RECEIVED INCOME
- ERRORS IN RECORDING

INTRODUCTION

The **Accruals Concept** says that income and expenses should be included in the statement of profit or loss account of the period in which they are earned or incurred, not when cash is paid or received.

Recording Expenditure and Income
Throughout the year, when an invoice for an expense incurred is paid, this is accounted for by:

Dr Expense
 Cr Cash

Similarly, when income is received, this is accounted for by:
Dr Cash
 Cr Income

At this stage, consideration is not given to the period to which the invoice or income relates.

Therefore if the following year's rent is paid in advance, for example, it is still recorded in the ledger accounts this year even though it does not relate to the current accounting period.

ACCRUED EXPENSE

An accrual arises where expenses of the business, relating to the year, have been incurred but not yet paid by the year end. In this case, it is necessary to record the extra expense relevant to the year and create a corresponding statement of financial position liability. If no invoice has been received, the amount must be estimated: (called an accrual):

Dr Expense account X
 Cr Accrued Expense X

The credit entry creates a current liability in the statement of financial position – an accrual expense.

The debit entry ensures that the statement of profit or loss includes the expense relating to the whole year, thus reducing profit in it.

PREPAID EXPENSE

Expense which has not been incurred but has been paid in advance.

A prepayment arises where some of the following year's expenses have been paid in the current year. In this case, it is necessary to remove that part of the expense which is not relevant to this year and create a corresponding statement of financial position asset (called a prepayment):

Dr Prepaid expense X
 Cr Expense account X

The debit entry creates a current asset in the statement of financial position – a prepayment.

The credit entry removes the expense relating to the following year from the current year's statement of profit or loss, thus increasing the profit for the year.

EXAMPLE 1

Tonya has paid $16,560 for rent for the six month period to 31 October 20X7.

What accrual or prepayment is required when preparing accounts for the year ended 31 August 20X7?

Answer: $5,520 - Prepayment

ACCRUED INCOME

Accrued income arises where income has been earned in the accounting period but has not yet been received. In this case, it is necessary to record the extra income in the statement of profit or loss and create a corresponding asset in the statement of financial position (called accrued income):

Dr	**Accrued income (SOFP)**	**X**	
	Cr Income (P&L)		**X**

Accrued income is a current asset in the statement of financial position.

PRE-RECEIVED INCOME

Pre-received income (also known as Deferred Income) arises where income has been received in the accounting period but which relates to the next accounting period (not earned yet). In this case, it is necessary to remove the income not relating to the year from the statement of profit or loss and create a corresponding liability in the statement of financial position (called pre-received income):

Dr	**Income (P&L)**	**X**	
	Cr Pre-received Income (SOFP)		**X**

Pre-received income is a liability in the statement of financial position.

ACCRUED AND PREPAID EXPENSE ACCOUNT – A SUMMARY

Following is the summarised version of maximum adjustments in an expense account including opening and closing accrual and prepayment.

EXPENSE A/C

Opening prepayment	XX	Opening accrual	XX
Cash (paid)	XX	P&L (Charge to P&L)	XX
Closing accrual	XX	Closing prepayment	XX
	XX		XX

ACCRUED AND PRE-RECEIVED INCOME ACCOUNT – A SUMMARY

Following is the summarised version of maximum adjustments in an income account including opening and closing accrued and pre-received income.

INCOME A/C

Opening accrual	XX	Opening pre-received income	XX
P&L (Charge to P&L)	XX	Cash (received)	XX
Closing pre-received income	XX	Closing accrual	XX
	XX		XX

IMPORTANT POINTS

ITEM	NATURE
Accrued expense	Current liability
Pre-paid expense	Current asset
Accrued income	Current asset
Pre-received income	Current liability

- If we have incurred an expense in this period which will not be paid for until the next period, we use an accrual to match the particular expense against the revenue of this period.

EXAMPLE 2

The annual insurance premium for Donald Ltd for the period 1 July 20X6 to June 20X7 is $13,200, which is 10% more than the previous year. Insurance premiums are paid on 1 July.

What is the statement of profit or loss charge for insurance for the year ended 31 December 20X6?

Answer: $12,600

EXAMPLE 3

The statement of profit or loss for the year ended 31 August 20X7 shows $21,800 for motor expenses. Payments for motor expenses during the year totalled $19,000 and there was an accrued expense at 1 September 20X6 of $4,600.

What is the accrual/prepayment for motor expenses as at 31 August 20X7?

Answer: Accrued expense - $7,400

EXAMPLE 4

Following is the extract from electricity account of Alpha Co. for the year ended 30 June 20X7:

Electricity Account

Balance b/d (standing charges)	$74	Balance b/d (meter usage)	375
Bank	$394		
Bank	$427		
Bank	$507		
Bank	$670		

The last bill received and paid was for $670 consisting standing charges of $180 for the three months to 31st August 20X7 and meter charges for the three months to 31st May 20X7.

What is the electricity to the statement of profit or loss of Alpha Co. for the year ended 30 June 20X7?

Answer: $1,740

EXAMPLE 5

Gamma Ltd had rented its building to Beta Ltd. At 31st December 20X8, Beta Ltd owed $5,900 for rent, but at 31st December 20X9, had paid $1,800 in advance. During the year Gamma Ltd had received $26,800 in rental from Beta Ltd.

What is the rental income to be shown in the statement of profit or loss of Gamma Ltd for the year ended 31st December 20X9?

Answer: $19,100

ERRORS IN RECORDING

Errors that occur, while recording of accruals & prepayments, their impact on financial statements and corrections to be made are as follows:

Case 1
Accrual not treated as accrual (omission).
Expense understated Profit Overstated
Current Liability Understated
The correct double entry has to be passed for the correction of this error.

Case 2
Prepaid expense not treated as prepayment (omission)
Expense overstated Profit understated
Current Assets Understated
The correct double entry has to be passed for the correction of this error.

Case 3
Accrued expense recognised as prepaid expense
Expense understated (Double amount) Profit Overstated (Double amount)
Current Liability Understated (Single amount)

The correct double entry with double amount has to be passed for the correction of this error. The total difference in the amounts of assets and liabilities will be double the amount of error.

Case 4

Prepaid expense recognised as accrued expense

Expense overstated (Double amount) Profit understated (Double amount)
Current Assets Understated (Single amount)

The correct double entry with double amount has to be passed for the correction of this error the total difference in the amounts of assets and liabilities will be double the amount of error.

EXAMPLE 6

Timmy is preparing his financial statements for the year ended 30 November 20X7. Timmy has included within his expenses office rental of $36,000 paid on 1 February 20X7 for the following 18 months.

What is the effect of this error on Roger's net profit?

Answer: Profit will be understated by $16,000

EXAMPLE 7

Mary has prepared draft financial statements for the year ended 30 June 20X7. The following items still require adjustment:

- The accounts do not include a cost for telephone expense for June 20X7 which is expected to be $1,570.
- The accounts include an advance payment of $2,400 for rent made on 1 February 20X7; the payment is for the next 20 months.

What is the net impact on profit after the correction of above errors, if any?

Answer: Profit will increase by $230

EXAMPLE 8

Ross's financial year end is 31 May. The rent for Ross's premises is paid quarterly in advance on 1 February, 1 May,1 August and 1 November each year. The annual rent was $72,000 per year until 31 July 2008. It was increased from that date to $84,000 per year.

What rent expense and end of year prepayment should be included in the financial statements for the year ended31 May 2009?
Expense Prepayment

A. $82,000 $14,000
B. $83,000 $7,000
C. $83,000 $14,000
D. $82,000 $7,000

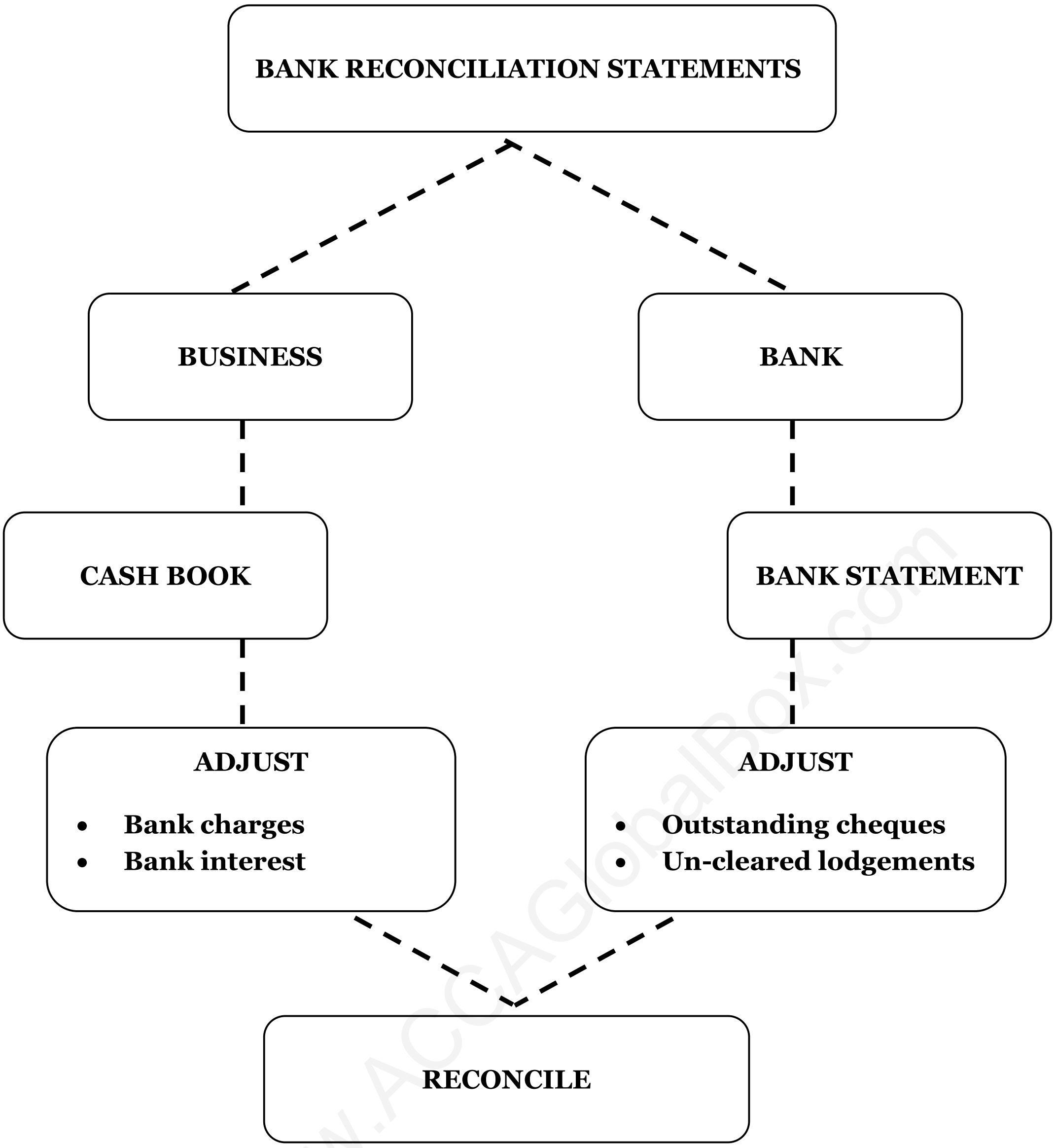
Answer: Option A

Chapter 11

BANKING RECONCILIATIONS

IN THIS CHAPTER

- INTRODUCTION
- DIFFERENCES BETWEEN THE BANK STATEMENT AND THE CASH BOOK
- THE BANK STATEMENT BALANCE NEEDS TO BE ADJUSTED FOR THESE ITEMS
- ERRORS IN THE CASH BOOK
- ERRORS IN THE BANK STATEMENT



INTRODUCTION

The objective of bank reconciliation is to reconcile the difference between:

- The cash book balance, i.e. the business' record of their bank account, and
- The bank statement balance, i.e. the bank's records of the bank account

The cashbook is the book of original entry for all transactions related to the company's bank account. The amount is then transferred to the cash at bank T-account in the nominal ledger.

A bank statement is a record of transactions on the business bank account maintained by the bank in its own books.

Mirror image

Note that the bank statement is a mirror image of cash book. The debits and credits are reversed in bank statements because the bank will be recording the transaction from its point of view, in accordance with the business entity concept.

Cash is an asset in business' own accounts but a liability in the bank statement as this amount owed by the bank and vice versa.

DIFFERENCES BETWEEN THE BANK STATEMENT AND THE CASH BOOK

When attempting to reconcile the cash book with the bank statement, two types of difference may be found:

- Unrecorded items
- Timing differences.

UNRECORDED ITEMS

These are items which arise in the bank statements before they are recorded in the cash book. Such 'unrecorded items' may include:

Payments made but not recorded:

- Standing orders
- Direct debits
- Bank service charges
- Interest charges
- Dishonoured cheques

Dishonoured cheques are the cheques returned by customer's bank, may be due to insufficient funds. It would have been debited in cash book as soon as was received so has to be written back in ledger accounts as receivable.

Payments received but not recorded:

- Interest received
- Dividend received
- Direct credit transfer from customer

They are not recorded in the cash book simply because the business does not know that these items have arisen until they see the bank statement.

The cash book must be adjusted to reflect these items.

TIMING DIFFERENCES

These items have been recorded in the cash book, but due to the bank clearing process have not yet been recorded in the bank statement:

Un-cleared lodgements are cheques received from customers, debited to the bank ledger account and paid into the bank, but which have not yet cleared as available funds.

Un-presented cheques are cheques which have been written in payment to a supplier and credited to the bank ledger account. The recipient has, however, either not paid the cheque into the bank yet, or has paid it in, but it has not yet cleared.

THE BANK STATEMENT BALANCE NEEDS TO BE ADJUSTED FOR THESE ITEMS:

Balance per bank statement		X
Less: Outstanding/unpresented cheques		(X)
Add: Outstanding/uncleared lodgements	X	
Balance per cash book (revised)		X

ERRORS IN THE CASH BOOK

The business may make a mistake in their cash book. The cash book balance will need to be adjusted for these items.

ERRORS IN THE BANK STATEMENT

The bank may make a mistake, e.g. record a transaction relating to a different person within our business' bank statement. The bank statement balance will need to be adjusted for these items.

Common examples of errors include:

- Amounts credited or charged in error to a particular customer by the bank
- Amounts debited in the ledger account when they should have been credited or vice versa
- Wrong amounts recorded in the ledger account.

How to find Balance as per Cash Book

		$
Opening cash balance		XX
Add:	Cash Receipt Book total	XX
Less:	Cash Payment Book total	(XX)
Closing balance as per Cash Book		XX

STEPS FOR RECONCILIATION

- Make adjustments for unrecorded items in cash book
- Correct the errors in cash book
- Make adjustments for timing differences in bank statement
- Correct the errors made by the bank.

Formula – 1

		$	$
Balance as per cash book (unadjusted bal.)			XX
Add: Direct Credits		XX	XX
Less:	Direct debits	XX	
	Standing order payments	XX	
	Dishonoured cheques	XX	(XX)
Adjusted balance			XX

Error in recording transactions will be employed in class.

Formula – 2

		$
Balance as per Bank Statement (Unadjusted)		XX
Add:	Outstanding lodgments /un-credited cheques	XX
Less:	Un-presented cheques	(XX)
Add/Less: Errors		X/(X)
Balance as per cash book (adjusted)		XX

EXAMPLE 1

Julia's cash book balance at month end is $2369.37. Upon reconciliation with bank statement it is found that bank statement does not yet include a cheque payment of $394.60 (un-presented cheque) and payments deposited into bank account totaling $936.03. A direct debit for $393.60 appeared on the bank statement but was not entered in cash book.

Find the balance as per bank statement.

	$
Balance as per cash book	3,690
Less: Direct Debit	(240)
Adjusted Balance of Cash Book	**3,450**
Balance as per bank statement	?
+ Outstanding lodgments / Un-credited cheques	986
Un-presented Cheques	(230)
Adjusted Bank Statement Balance	**3,450**

Same after Reconciliation

Answer: $2,694 Cr.

EXAMPLE 2

A business has a debit balance on its cash book of $148.00 but the bank statement shows a different balance. The following items have also been discovered:

- The bank statement shows that there were bank charges for the period of $10 which have not been recorded in the cash account;
- A standing order payment for $25 has also been mistakenly omitted from the cash account;
- Cheques totaling $125 had been written and posted to suppliers but had not yet been presented;
- A cheque for $85 had been paid into the bank but was still outstanding.

What is the balance as per the bank statement?

Answer: $153 Cr.

Chapter 12

CORRECTION OF ERRORS

IN THIS CHAPTER

- TYPES OF ERRORS IN DOUBLE ENTRY
- SUSPENSE ACCOUNT
- APPROACH TO QUESTIONS (ERRORS NOT EFFECTING TB)
- APPROACH TO QUESTIONS (ERRORS EFFECTING TB)
- ADJUSTMENTS TO PROFIT

TYPES OF ERRORS

There are three main categories of errors tested in F3/FFA exam. These are as follows:

i. **Errors in double entry**

   a) Errors effecting trial balance

   b) Errors not effecting trial balance

ii. **Errors in day books** e.g. omission, casting etc.

iii. **Errors in T-Accounts**

   a) Omission of opening balance

   b) Casting

DOUBLE ENTRY ERRORS

Errors NOT affecting Trial balance	***Errors affecting Trial Balance***
Error of commission	Error of partial omission
Error of principle	Error of original entry (different amounts for Dr& Cr)
Error of complete omission	Incorrect additions in any account etc
Error of original entry (wrong amount for both Dr /Cr)	(casting error)
Error of compensation	
Error of complete reversal of entry	
Important point	**Important point**
No suspense account is required in order to rectify these errors.	For rectification of these errors, a suspense account will be required.

TYPES OF ERRORS IN DOUBLE ENTRY

Error of Commission

Where a transaction has been recorded in the correct category of account but in the wrong account.

Example: Payment of salaries treated as payment of telephone expense

Actual Entry	***Wrong Entry***	***Correction Entry***
Salaries A/C	Telephone exp A/C	Salaries A/C
Cash A/C	Cash A/C	Telephone exp. A/C

Error of Principle

Where a transaction has been recorded in the wrong category of accounts as well as in the wrong accounts.

Example: New vehicle bought for cash recorded in purchases account

Actual Entry	*Wrong Entry*	*Correction Entry*
Vehicle A/C	Purchase A/C	Vehicle A/C
Cash A/C	Cash A/C	Purchases A/C

Error of Omission

(a) Complete Omission

A transaction has been completely omitted from the accounting records.

Example: Not recording credit sales

Actual Entry	*Wrong Entry*	*Correction Entry*
Debtors A/C 110	-	Debtors 110
Sales A/C 110		Sales 110

(b) Partial Omission

Example: Only recording the debit entry for credit sales

Actual Entry	*Wrong Entry*	*Correction Entry*
Debtors A/C 110	Debtors A/C 110	*Suspense A/C 110
Sales A/C 110		Sales A/C

Or

Example: Only recording credit side of credit sales

Actual Entry	*Wrong Entry*	*Correction Entry*
Debtors A/C 110	-	Debtors A/C 110
Sales A/C 110	Sales A/C 110	* suspense A/C 110

Error of complete reversal of entry

The correct amount has been posted to the correct account but the debit and credit reversed.

Example: Reversal entry for credit purchases

Actual Entry	*Wrong Entry*	*Correction Entry*
Purchases 10	Creditors 10	Purchases 20
Creditors 10	Purchases 10	Creditors 20

Error of Original Entry (Covering error of transposition)

(a) When the wrong amounts are posted to both the debit and credit entry

Actual Entry	*Wrong Entry*	*Correction Entry*
Cash 110	Cash 101	Cash 9
Sales 110	Sales 101	Sales 9

Or

Actual Entry	*Wrong Entry*	*Correction Entry*
Cash 100	Cash 1000	Sales 900
Sales 100	Sales 1000	Cash 900

(b) When the different amounts are posted for the debit and the credit entry

Actual Entry	*Wrong Entry*	*Correction Entry*
Purchases 110	Purchases 110	Suspense A/C 100
Creditors 110	Creditors 10	Creditors 100

Or

Actual Entry	*Wrong Entry*	*Correction Entry*
Purchases 110	Purchases 10	Purchases 100
Creditors 110	Creditors 110	Suspense 100

Or

Actual Entry	*Wrong Entry*	*Correction Entry*
Purchases 110	Purchases 10	Purchases A/C 100
Creditors 110	Creditors 101	Creditors A/C 9
		Suspense A/C 91

Note: Suspense account is required only when the trial balance does not balance i.e. when the debits and credits are not equal

Error of Compensation

Two different errors have been made which cancel out each other.

Wrong Entry 1	*Wrong Entry 2*	*Correction Entry*
Debtors 100	Cash 80	Cash20
Sales 80	Sales 100	Sales 20

Or

Entry 1	*Entry 2*	*Correction Entry*
Furniture A/C 150	Purchases 60	Furniture 50
Creditors A/C 200	Cash 10	Cash 50

SUSPENSE ACCOUNT

A suspense account is used as a temporary account to deal with errors and questions. When preparing a trial balance or an extended trial balance it is likely that a suspense account will have to be opened and then any errors and questions adjusted forward the suspense account cleared.

The suspense account cannot be allowed to remain permanently in the trial balance. So, before the trial amounts are prepared, the suspense account must be cleared by investigating and correcting each of the errors that have caused trial balance not to balance.

Suspense account is opened when:

- Single sided entry – a debit entry has been made but no corresponding credit entry or vice versa.
- Debit and credit entries have been made but at different values
- Two entries have been made on the same side.
- An incorrect addition in any individual account, i.e. miscasting.
- Opening balance has not been brought down.
- Extraction error – the balance in the trial balance is different from the balance in the relevant account.

APPROACH TO QUESTIONS (ERRORS NOT EFFECTING TRIAL BALANCE)

A good approach is to consider:

1. What was the double entry? ('Did do').
2. What should the double entry have been? ('Should do').
3. What correction is required? ('to correct').

Always assume that if one side of the double entry is not mentioned, it has been recorded correctly.

APPROACH TO QUESTIONS (ERRORS EFFECTING TRIAL BALANCE)

Take the question solving approach as before:

- Use the suspense account to make the 'did do' Dr = the 'did do' Cr and then part of the correction journal will be to reverse this suspense account entry.
- Where an opening balance has not been brought down, journal it in and send the opposite entry to suspense.
- The correction journal must always include an equal debit and credit.
- The side of double entry about which question is silent is always assumed to be correctly recorded.

ERRORS IN DAY BOOKS

- If an entry is omitted from day book completely, then both the debit and credit side are missing. The correct original double entry has to be passed to correct this error.
- If there is an error in casting of day book, then the column with calculation error might result in either of debit or credit side being higher than the other. In this case, a suspense account will need to be opened and difference amount adjusted.

ERRORS IN T-ACCOUNTS

- If an opening balance is missing in a T-account, the closing balance taken in trial balance would be wrong. This will require an adjustment via suspense account.
- If a casting error is performed while calculating the balances of T-Account, the closing balance taken in trial balance would be wrong. This will require an adjustment via suspense account.

EXAMPLE 1

The trail balance of a company shows total Debits of $251,638 and total Credits of $236,502.

Which of the following explains the difference in full?

a) Discount allowed of $7,568 have been shown on the wrong side of the trail balance
b) Discount received of $7,568 have been credited to payables ledger control account
c) An opening accrual of $15,136 has been omitted from electricity expense account
d) The sales day book has been under-cast by $15,136

(Follow old treatment of discount for this example)
Answer: An opening accrual of $15,136 has been omitted from electricity expense account

EXAMPLE 2

When Delta Co.'s trial balance failed to agree, a suspense account was opened for the difference. The trial balance totals were:

Debit $ 864,390

Credit $ 860,930

The company does not have control accounts for its receivables and payables ledgers. The following errors were found:

1. In recording an introduction of capital, cash received of $333,000 was credited to the capital account as $330,000
2. Cash $2,800 paid for plant repairs was correctly accounted for in the cash book but was credited to the plant asset account.
3. The petty cash book balance $500 had been omitted from the trial balance.
4. A cheque for $78,400 paid for the purchase of machinery was debited to the machinery account as $87,400.
5. A contra between the receivables ledger and the payables ledger for $1,200 which should have been credited in the receivables ledger and debited in the payables ledger was actually debited in the receivables ledger and credited in the payables ledger.

Which of these errors will require an entry to the suspense account to correct them?

a) All five items
b) 3 and 5 only
c) 2,4 and 5 only
d) 1, 2, 3 and 4 only

What will the balance on the suspense account be after making the necessary entries to correct the errors affecting the suspense account?

Answers: Option D and**$2,440 Debit**

ADJUSTMENTS TO PROFIT

The correction journal may result in a change in profit, depending on whether the journal debits or credits the Statement of profit or loss:

Dr	Statement of Financial Position account		No impact to profit
	Cr	Statement of Financial Position account	
Dr	Statement of Profit or Loss		No impact to profit
	Cr	Statement of Profit or Loss	
Dr	Statement of Profit or Loss		Profit decreases
	Cr	Statement of Financial Position account	
Dr	Statement of Financial Position account		Profit decreases
	Cr	Statement of Profit or Loss	

EXAMPLE 3 – Calculation of opening balance of suspense account

- Rent paid of $200 has been credited to the rent expense account.
- The year-end bank balance of $860 at the bank has been entered on the trial balance as a debit of $680.

What is the debit balance of suspense account as a result of these errors?
Answer: Dr. 580

Chapter 13

SOLE TRADERS FINAL ACCOUNTS

SOLE TRADER FINAL ACCOUNTS

Purpose of Final Accounts

Financial statements summarize all the transactions of a business for a specific period. Hence financial information is available for all its users.

ADJUSTMENTS TO FINANCIAL STATEMENTS

At the end of a period, closing adjustments are made for inventory, depreciation, accruals/prepayments, irrecoverable and doubtful debts, provisions etc. as has been discussed in earlier chapters, hence financial statements are prepared.

TECHNICAL ARTICLE BY EXAMINER

Many candidates are unable to handle certain adjustments properly in the exam. This article explains how to treat the main possible post trial balance adjustments, including:

- Inventory/stock
- Accruals and prepayments
- Interest
- Depreciation
- Bad debts and allowances for receivables/debtors.

The most important point, which must be understood at the outset, is that all these adjustments have an impact on both the statement of profit or loss and in the statement of financial position. If the trial balance balances, your answer must balance, and therefore any changes to the trial balance must balance. Having said that, it is more important to complete the question within the time allowed, without spending time on getting the statement of financial position to balance.

INVENTORY/STOCK

This is a fairly familiar adjustment. The cost of goods sold consists of opening inventory plus purchases, minus closing inventory. The closing inventory is thus a deduction (credit) in the statement of profit or loss, and a current asset (debit) in the statement of financial position.

The ledger account behind the adjustment causes problems for some candidates. This is how the inventory/stock account will look at the time the trial balance is being prepared. The entry is the transfer from the statement of profit or loss for the closing inventory of the previous year (figures invented):

Inventory/stock

2004	**$**		
31 Dec Statement of profit or loss	38,000		

In the current year, last year's closing inventory is this year's opening inventory. It must be transferred out to this year's statement of profit or loss, before the entry for the new closing inventory is made:

Inventory/stock

2004	**$**	**2005**	**$**
31 Dec Statement of profit or loss	38,000	31 Dec Statement of profit or loss	38,000
2005	**$**		

31 Dec Statement of profit or loss	45,000	

There will sometimes be a requirement to adjust inventory/stock to allow for damaged or slow-moving items. IAS 2, Inventories and SSAP 9, Stocks and Long-term Contracts both require inventories/stock to be included at the lower of cost and net realisable value. It may therefore be necessary to reduce the inventory/stock figure to reflect a net realisable value below cost for the items detailed.

ACCRUALS AND PREPAYMENTS

The statement of profit or loss has to include the expenses relating to the period, whether or not they have been paid. The figures in the trial balance will usually be the amounts paid in the period, and they need adjusting for outstanding amounts and amounts paid which relate to other periods to obtain the charge in the statement of profit or loss.

Unpaid balances relating to the period should be included in the statement of financial position as current liabilities. If the expense has been paid in advance, the amount prepaid is included in the statement of financial position as a current asset. In the statement of profit or loss, the total expense is needed with a working showing the detail. Don't show two figures in the outer column for the same expense heading. For example, the trial balance shows:

	$
Wages	136,000
Insurance	4,000

At 31 December 2005, wages owing amounted to $3,800, and insurance paid in advance was $600. This is presented as follows:

Statement of profit or loss	$
Wages (136,000 + 3,800)	139,800
Insurance (4,000 - 600)	3,400

Statement of Financial Position	$
Current Assets	
Inventory/stock	-
Receivables/debtors	-
Prepayments	600
Cash	-
Current liabilities	
Trade payables/creditors	-
Accruals	3,400

The underlying ledger accounts

Wages

	$		$
Balance	136,000	Statement of profit or loss	139,800
Balance carried down	3,800		
	139,800		139,800
		Balance brought down	3,800

Insurance

	$	2005	$
Balance	4,000	Statement of profit or loss	3,400
		Balance carried down	<u>600</u>
Balance brought down	<u>4,400</u>		<u>4,000</u>
	600		

Similar adjustments may be needed for income, such as rent receivable. Be careful here. Income received in advance is a liability and should be included alongside accruals for unpaid expenses, thereby changing the heading to 'Accruals and deferred income'. Income in arrears is an asset which should be included with prepayments using the heading 'Prepayments and accrued income'.

INTEREST

Interest payable is really another accrual but there are one or two special points. First, the question may not give explicit instructions to accrue for interest. The trial balance may contain:

	Dr $	Cr $
8% Loan stock/debenture		10,000
Interest on loan stock/debentures	4,000	

Candidates are expected to note that only half the loan interest has been paid, and accrue for the other $4,000. Examiners generally indicate in some way that the loan stock/debentures have been in issue for the whole year if they want this adjustment to be made. Second, the interest is a current liability and the loan stock/debentures are a non-current liability. Present them appropriately and don't combine them.

DEPRECIATION

Depreciation is a slightly more complex adjustment. Depreciation spreads the cost of non-current/fixed assets fairly over assets' useful lives, so that a charge against profit appears in the statement of profit or loss.

Methods of depreciation

There are two main methods of depreciation which are tested in basic level examinations:

- Straight line method – a percentage of cost (or cost less residual value) is charged each year
- Reducing balance method – a percentage is charged on the carrying amount (cost less accumulated depreciation to date).

Depreciation policies

Some businesses adopt a policy of charging a full year's depreciation in the year the asset was purchased, and none in the year of its sale. Others take proportionate depreciation for the number of months of ownership of the asset in the year. The first requirement, therefore, is to read the question carefully to find out what has to be done for each non-current asset.

Statement of profit or loss

The current year's depreciation charge is calculated and appears as an expense. Do not include the accumulated depreciation. The accumulated depreciation is the total depreciation charged during an asset's life (assuming no revaluation) and as such previous costs will have been charged against profits in earlier periods.

Statement of financial position

The statement of financial position shows the cost, accumulated depreciation (the figure in the trial balance plus the current year's charge from the statement of profit or loss), and the carrying amount. The easiest way to present this is as a table, as follows (figures invented):

	Cost	Accumulated depreciation	Carrying amount
	$	$	$
Buildings	800,000	80,000	720.000
Plant and equipment	390,000	260,000	130,000
Motor vehicles	210,000	100,000	111,000
	1,400,000	440,000	960,000

The underlying ledger accounts

It would be possible to use just one account for each non-current/fixed asset, showing cost and depreciation. However, they are usually kept separate, in order to present the separate figures in the statement of financial position as shown above. This results in (figures invented):

Plant and machinery – cost

	$		$
Balance brought down	360,000	Balance carried down	390,000
Cash	30,000		
	390,000		390,000
Balance brought down	390,000		

Plant and machinery – accumulated depreciation

	$		$
Balance carried down	260,000	Balance brought down	221,000
		Statement of profit or loss	39,000
	260,000		260,000
		Balance brought down	260,000

A third account is required to handle disposals. When a non-current/fixed asset is sold, the cost and accumulated depreciation relating to the asset are transferred out of the accounts to a disposal account. The proceeds of sale are credited to the account, and the balance on the account is then the profit or loss on the sale, to be transferred to the statement of profit or loss.

IRRECOVERABLE DEBTS AND ALLOWANCE FOR RECEIVABLES/DEBTORS

These adjustments probably cause most difficulty for candidates in an examination.

Irrecoverable debts

Writing off a bad debt means taking a customer's balance in the receivables/sales ledger and transferring it to the statement of profit or loss as an expense, because the balance has proved irrecoverable. There are two separate exam possibilities here:

- Bad debts appear as an item in the trial balance. This means the debts have already been written off. In other words, receivables/debtors have already been reduced. All that is necessary is to put the figure in the statement of profit or loss as an expense

- Bad debts appear as an adjustment outside the trial balance. Two entries are now needed. The amount goes into the statement of profit or loss as an expense and is deducted from the receivables/debtors figure in the statement of financial position.

Allowance for receivables/debtors

This allowance is set up in order to include a realistic value for receivables/debtors in the statement of financial position, without actually writing off the debt. The balance is left in the receivables/sales ledger so that collection procedures continue, but the receivables/debtors in the statement of financial position are valued as if the amount is not to be recovered. The trial balance shows:

	Dr $	Cr $
Trade receivables / debtors	180,000	
Allowance for receivables/debtors		4,000

This means that the business already has an allowance, taken from the statement of profit or loss in previous years. If nothing more is to be done, this should show in the statement of financial position, under current assets:

	Dr $	Cr $
Trade receivables / debtors	180,000	
Less: Allowance for receivables/.debtors	4,000	176,000

Alternatively, if preparing a company statement of financial position for publication, it should show:

Trade receivables/debtors (180,000 – 4,000) 176,000

The figures in brackets are a working, not part of the statement of financial position. Continuing the example, it is more likely that the question will require the allowance to be adjusted. Let us say that the allowance is to be increased to $5,400. Given that there is already $4,000, $1,400 should be taken out of this year's statement of profit or loss. The result is:

Statement of profit or loss	$
Increase in allowance for receivables/debtors	1,400

Remember that it is only the increase or decrease in the allowance that goes into the statement of profit or loss.

Statement of financial position	Dr $	Cr $
Trade receivables/debtors	180,000	
Less: Allowance for receivables	5,400	174,600

The underlying ledger accounts

There are several ways of dealing with bad debts, and allowances for receivables/debtors, in ledger accounts. One way is to have both in one account. However, for examination purposes, it may be easier to have two accounts, one for debts written off and one for the allowance:

Bad debts (figures invented)

	$		$
Transfers in from receivables/sales ledger	18,500	Statement of profit or loss	18,500
	18,500		18,500

Allowance for receivables/debtors (using figures above)

	$		$
Balance carried down	5,400	Balance brought down	4,000
	_____	Statement of profit or loss	5,400
	5,400	Balance brought down	5,400

Irrecoverable debts recovered

Sometimes, a debt written off in one year is actually paid in the next year – a debit to cash and a credit to bad debts recovered. The credit balance on the account is then transferred to the credit of the statement of profit or loss (added to gross profit or included as a negative in the list of expenses). This is better than crediting the recovery to the bad debts account, because that would obscure the expense from bad debts for the year.

SAMPLE FORMAT

NAME OF BUSINESS
STATEMENT OF PROFIT OR LOSS
FOR THE YEAR ENDED 31 DECEMBER 20X7

	$	$
Sales		XX
Cost of sales		
Opening stock	xx	
Purchases	xx	
Purchases returns	(xx)	
Closing stock	(xx)	(XX)
Gross profit		XX
Other income – discounts received		xx
		XX
Expenses		
Operating expenses	xx	
Wages and salaries	xx	
Discounts allowed	xx	
Irrecoverable debts	xx	
Loan interest	xx	
Depreciation	xx	
Other operating expenses	xx	(XX)
Net profit for the year		**XX**

NAME OF BUSINESS
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X7

	$	$
Non-current assets		
Property (Cost – Accumulated depreciation)	xx	
Equipment (Cost – Accumulated depreciation)	xx	XX
Current assets		
Inventories	xx	
Trade receivables net of allowance for Doubtful debts	xx	
Prepayments	xx	
Bank	xx	
Cash in hand	xx	XX
Total assets		**XX**
Equity and Liabilities		
Opening capital	xx	
Net profit for the year	xx	
Drawings	(xx)	
Closing capital		XX
Non-Current liabilities		
Loan		XX
Current liabilities		
Trade payables	xx	
Accruals	xx	XX
Total Liabilities & Capital		**XX**

COMPREHENSIVE EXAMPLE

The following is the trial balance extracted from the books of Delta at 31 December 20X9:

	$	$
Capital at 1 Jan 20X9		20,000
Loan account, Omega		2,000
Drawings	1,750	
Freehold premises	8,000	
Furniture and fittings	500	
Plant and machinery	5,500	
Inventory at 1 Jan	8,000	
Cash at bank	650	
Allowance for doubtful debts		740
Purchases	86,046	
Sales		124,450
Irrecoverable debts	256	
Irrecoverable debts recovered		45
Accounts receivables	20,280	
Accounts payable		10,056
Bank charges	120	
Rent	2,000	
Returns inwards	186	
Returns outwards		135
Salaries	3,500	
Wages	8,250	
Travelling expenses	1,040	
Discounts allowed*	48	
Discounts received		138
General expenses	2,056	
Gas, electricity and water	2,560	
Carriage outwards	546	
Traveller's salaries and commission	5,480	
Printing and stationery	6440	
	157,564	157,564

You are required to draw up the statement of profit or loss to 31 December 20X9 and the statement of financial position at that date, after taking into account the following:

- ***a.*** Inventory at 31 December 20X9 $7,550:
- ***b.*** Interest on the loan at 5% pa had not been paid at 31 December:
- ***c.*** Rent includes $250 for premises paid in advance at 31 March next:
- ***d.*** Depreciate plant and machinery by 10% pa:
  Depreciate furniture and fitting by 5% pa:
- ***e.*** Adjust the allowance for doubtful debts to 5% of receivables:
- ***f.*** Show wages as part of cost of sales

*(as per old treatment of discount)

DELTA Answer:

Statement of profit or loss for the year 31 December 20X9

	$	$	$
Sales			124,450
Less: Returns			186
			124,264
Opening inventory		8,000	
Add: Purchases	86,046		
Less: Returns	135		
	85,911		
Carriage inwards	156		
Wages	8,250		
		94,317	
Less: Closing inventory		(7,550)	
			94,767
Gross profit			29,497
Discount received			138
			29,635
Salaries		3,500	
Travellers' salaries		5,480	
Discounts allowed		48	
General expenses		2,056	
Gas, electricity and water		2,560	
Rent (W2)		1,750	
Carriage outwards		546	
Carriage and stationery		640	
Irrecoverable debts (W4)		485	
Loan interest (W1)		100	
Depreciation (W3)		575	
Bank charges		120	
			18,900
Net profit			10,735

Statement of financial position as at 31 December 20X9

	Cost	Dep'n	
	$	$	$
Non-current assets			
Premises	8,000	--	8,000
Plant and machinery	5,500	550	4,950
Furniture and fittings	500	25	475
	14,000	575	13,425
Current assets			
Inventories		7,550	
Receivables	20,280		
Less: Allowance (W4)	1,014	19,266	
Prepayments		250	
Cash at bank		650	27,716
TOTAL ASSETS			**41,141**
CAPITAL AND LIABILITIES			
Capital: Balance at 1 Jan 20X9		20,000	
Add: Profit for the year		10,735	
		30,735	
Less: Drawings		1,750	
Closing capital			28,985
Non-current liabilities			
Loan – Omega			2,000
Current liabilities			
Payables	10,056		
Accruals – loan interest	100		10,156
CAPITAL AND LIABILITIES			**41,141**

Working:

(W1) Loan interest

Accrual required = 5% x $2,000

= $100

(W2)

Rent

	$		$
Cash	2,000	Statement of profit or loss	1,750
		Prepayment c/d	250
	2,000		2,000
Payment b/d	250		

(W3) Depreciation

Plant and machinery 10%X$5,500	50
Furniture and fittings 5%X$500	25
	575

(W4) Irrecoverable debts

Irrecoverable debts account

	$		$
Balance c/d (per trial balance)		Balance c/d (per trial balance)	
Irrecoverable debts	256	Irrecoverable debts recovered	45
Allowance for doubtful debts	274	Statement of profit or loss	485
	530		530

Allowance for doubtful debts account

	$		$
Balance required c/d		Balance b/d (per trial balance)	740
5%X$20,280	1,014	Irrecoverable debts accounts	274
	1,014		1,014

Chapter 14

INCOMPLETE RECORDS

IN THIS CHAPTER

- INTRODUCTION
- NET ASSETS APPROACH
- RECONSTRUCTION OF LEDGER ACCOUNTS (TO FIND A BALANCING FIGURE)
- SALES, PURCHASES, INVENTORY AND COST OF SALES
- INVENTORY STOLEN OR LOST
- ACCRUALS AND PREPAYMENTS

INTRODUCTION

Incomplete records problems involve preparing a set of year end accounts for a business which does not have a full set of accounting records.

Areas in which records may be incomplete and for which you may see problems include:

1. Analysis of capital – using the "Net Assets" approach
2. The cash book
3. Credit sales and closing debtors
4. Credit Purchases and trade receivables (same working as in control accounts chapter)
5. Purchases, inventory and cost of sales
6. Stolen goods and goods destroyed
7. Accruals and prepayments (Same working as in accruals and prepayments chapter)

NET ASSETS APPROACH

Change in Capital

If given a list of opening and closing balances for assets and liabilities, you can determine opening and closing capital.

This is done from the Accounting Equation:

- **Assets – Liabilities (Net assets) = CAPITAL**

  Opening capital and closing capital are also linked by the following equation:

- **Closing capital = Opening Capital + New Capital + Profits – Drawings**

  This can be rearranged as:

  Closing Capital – Opening Capital = New Capital + Profits – Drawings

  "Closing N. Assets minus Opening N. Assets" is often referred to as the **"Change in Net Assets".**

- **Change In Net Assets = New Capital + Profits – Drawings**

  What figure you have to determine and which equation(s) you use will be dependent on the information provided. But you do need to know and understand these relationships. You will be given sufficient information such that there is only one unknown.

EXAMPLE 1

Alan runs a small food business and has kept no accounting records in the year ended 30 June 20X7. He knows that he has taken $6,800 cash out of his business during the year plus inventory which cost the business $250. He invested $20,000 into the business in January to get a motor vehicle for delivery.

Alan knows that at the last year end his business had assets of $40,000 and liabilities of $14,600. He has also calculated that the assets of the business at 30 June 20X7 are worth $56,000 and the liabilities $18,750.

What profit or loss has Alan made in the year?

Answer: 1,100 loss

RECONSTRUCTION OF LEDGER ACCOUNTS (TO FIND A BALANCING FIGURE)

The second type of incomplete record activity that may come up revolves around reconstructing ledger accounts to determine amounts to be reported in the profit and loss account or to determine closing balances for inclusion in the Statement of Financial Position.

This type of task is a test double entry bookkeeping skills.

Remember that under the duality convention there are two aspects to every transaction, i.e. for every $1 of debit you must recognize $1 of credit!

The Cashbook
Many questions will involve the preparation of the cash and/or bank account.

CASH A/C (Typical Entries)

Bal b/d	X	Cash expenses	X
		Bank (takings banked)	X
Sales Receipts (cash &cheques)	X	Drawings	X
		Bal c/d	X

BANK A/C (Typical Entries)

Bal b/d	X	Expenses (cheques)	X
Cash a/c (till receipts banked)	X	Trade receivable Payments	X
Debtors (cheques from credit customers)	X	Drawings	X
		Bal c/d	X

The information in the bank statement or cashbook provides the core information for reconstructing a detailed set of accounts.

These figures will then usually be adjusted because of application of the accruals concept.

SALES, PURCHASES, INVENTORY AND COST OF SALES

Profit

Gross profit Mark-up   Gross profit Margin

(a) Mark-Up Percentage

Means gross profit as a percentage of COST! Therefore if you know the cost of the goods you can work out profit using the mark-up percentage.

Formula:

$$\frac{\text{Gross Profit}}{\text{Cost}} \times 100$$

(b) Margin Percentage

Means gross profit as a percentage of SALE! Therefore if you know the sale price of the goods you can work out profit using the margin percentage.

Formula:
Gross Profit x 100
Sales

INVENTORY STOLEN OR LOST

In incomplete record questions, inventory may have been lost – probably due to a fire or flood.

- Closing inventory that has not been lost is subtracted from cost of sales because by definition, the inventory has not been sold in the year.
- Lost inventory has also not been sold in the year.
- Therefore, to work out the cost of lost inventory, complete the trading account from the information given and then lost inventory can be calculated as a balancing figure.

Inventory stolen or lost would originally have been debited to purchases. However as the items are no longer available to be sold then they should be taken out of purchases.

Double entries for inventory and lost inventory
Actual closing inventory is posted by the following double entry to ensure loss is incorporated:
Dr Inventory (SFP)
Cr Statement of Profit or Loss

If inventory is insured then following double entry is passed separately:
Dr Receivable from insurance company
Cr Statement of Profit or Loss

EXAMPLE 2

Alicia does not keep full accounting records but wishes to calculate her sales revenue for the year.
The information available is:

1	Opening inventory	$17,000
2	Closing inventory	$24,000
3	Purchases	$91,000
4	Standard gross profit percentage on sales revenue	40%

Which of the following is the sales figure for the year calculated from these figures?

Answer: $140,000

EXAMPLE 3

Harry reduced his inventory level by $12,000 during the year and made sales of $ 540,000. His markup on cost is 20%.
What are his purchases during the year?
Answer: 438,000

EXAMPLE 4

Gamma Co. makes purchases of $20,250 and sales of $26,520 in the year ended 31 December 20X6. The owner took goods costing $590 from business without paying for them. Closing stock was valued as its cost of $2,240 and the gross margin achieved was a constant 30% on sales.

What was the cost of the opening inventory at 1 January 20X6?

Answer: $1,144

ACCRUALS AND PREPAYMENTS

We saw earlier that 'sales' could be calculated by adjusting receipts from customers, for opening and closing balances of Receivables in a Receivables control a/c.

The same principle can be applied to calculate income and expense items for inclusion in the P & L, by adjusting payments/receipts in the cashbook for opening and closing accruals and prepayments.

COMPREHENSIVE EXAMPLE

The assets and liabilities as at the close of business on 31 October 20X8 of J Patel, retailer, are summarized as follows:

	$	**$**
Motor vehicles		
At cost	9,000	
Accumulated Depreciation	1,800	
		7,200
Fixtures and fittings		
At cost	10,000	
Accumulated depreciation	6,000	
		4,000
Inventory		16,100
Accounts receivable		19,630
Cash		160
		47,090
Capital – J Patel	30,910	
Bank overdraft	6,740	
Accounts payable	9,440	
		47,090

All receipts from credit customers are paid intact into the business bank account, whilst cash sales receipts are banked after deduction of cash drawings and providing for the shop till cash float. The cash float was increased from $160 to $200 in September 20X9.

The following is a summary of the transactions in the business bank account for the year ended 31 October 20X9:

Bank account

Receipts	$	Payments	$
Credit sales	181,370	Drawings	8,500
Cash sales	61,190	Motor van (bought 1 May 20X9)	11,200
Proceeds of sale of land owned privately by J Patel	16,000	Purchases	163,100
		Establishment and administrative expenses	33,300
		Sales and distribution expenses	29,100

Additional information for the year ended 31 October 20X9

(a) A gross profit of 33 1/3% has been achieved on all sales.
(b) Irrecoverable debts of $530 have been written off during the year.
(c) Receivables at 31 October 20X9 were reduced by $8,130 as compared with a year earlier.
(d) Payables at 31 October 20X9 amounted to $12,700.
(e) Depreciation is to be provided at the following annual rates on cost
Motor vehicles 20%
Fixtures and fittings 10%
(f) Inventory at 31 October 20X9 has been valued at $23,700.

Required:

Prepare a Statement of profit or loss and other comprehensive income for the year ended 31 October 20X9 and a Statement of Financial Position as at that date for J Patel.

SOLUTION

J Patel

Statement of profit or loss for the year 31 October 20X9

	$	$	%
		238,140	100
Opening inventory	16,100		
Purchases (W3)	166,360		
	182,460		
Closing inventory:	23,700		
Cost of sales		158,760	$66\frac{2}{3}$
		79,380	$33\frac{1}{3}$
$Gross\ profit \frac{33\frac{1}{3}}{66\frac{2}{3}} X\ 158{,}760$			
Establishment and administrative expenses		33,300	
Sales and distribution expenses		29,100	
Irrecoverable debts written off		530	
Depreciation			
Fixtures and fittings		1,000	
$Motor\ vheciles\ 1{,}800 + \frac{6}{12} x\ 2{,}240)$		2,920	
		_____	66,850
Net profit			12,530

J Patel

Statement of financial position as at 31 October 20X9

ASSETS	Cost	Depreciation	
	$	$	$
Non-current assets			
Fixtures and fittings	10,000	(7,000)	3,000
Motor vehicles	20,200	(4,720)	15,480
	30,200	(11,720)	18,480
Current assets			
Inventory		23,700	
Receivables		11,500	
Balance at bank (W4)		6,620	
Cash in hand		200	42,020
TOTAL ASSETS			**60,500**
CAPITAL AND LIABILITIES			
Capital – At 1 November 20X8		30,710	
Add: New capital – proceeds of sale of land		16,000	
Net profit for year		12,530	
Drawings ($8,500 + 3,140 (W2)		(11,640)	
Closing capital			47,800
Current liabilities			
Trade payables			12,700
CAPITAL AND LIABILITIES			**60,500**

Working:

(W1)

Trade receivables account

	$		$
Balance b/d	19,630	Cash banked from credit sales	181,370
Credit sales (bal fig)	173,770	Irrecoverable debts written off	530
		Balance c/d	11,500
	193,400		193,400

(W2)

Cash

	$		$
Balance b/d	160	Banking	61,190
Cash from cash sales	64,370	Drawings (bal fig)	3,140
(total sales – credit sales)		Balance c/d	200
(238,140 – 173,770))			
	64530		64530

(W3)

Trade payables account

	$		$
Cash paid (per bank)	163,100	Balance b/d	9,440
Balance c/d	12,700	Purchases (balancing figure)	166,360
	175,800		175,800

(W4)

Bank

	$		$
Receipts	258,560	Balance b/d	6,740
		Payments	245,200
		Balance c/d	6,620
	258560		258,560

Chapter 15

LIMITED COMPANIES

IN THIS CHAPTER

- LIMITED COMPANIES – AN INTRODUCTION
- SHARES
- IAS 1 FORMAT OF COMPANY ACCOUNTS
- STATEMENT OF FINANCIAL POSITION
- OTHER SOURCES OF FINANCE
- STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
- STATEMENT OF CHANGES IN EQUITY

LIMITED COMPANIES – AN INTRODUCTION

Many businesses are set up as limited companies. These are owned by shareholders (also known as members) and run by the Board of Directors.

Ownership

The ownership of a company is split into a number of shares. Investors pay for each share issued to them and so inject capital into the business.

The shareholders of a company have **limited liability** for any losses that the company makes, hence the title 'limited company'. Once a shareholder has paid for their shares, they cannot be pursued for any further money by creditors of the company.

The profit is distributed in the form of dividends which is a return for shareholder's investment.
These are discussed in more detail later.

Management

A company is managed by its directors. They are elected by the shareholders to run the company in order to make profits. The directors and shareholders may or may not be the same people. Most shareholders will have nothing to do with the day to day operation of their company.

Advantages and Disadvantages over Sole Traders
A company has a number of advantages and disadvantages over sole traders:

Advantages

- Limited liability of the owners for any losses of the business
- Easier access to finance (through further share issues)
- Ownership can be transferred easily through a sale of shares
- Possible tax advantages

Disadvantages

- More regulation with regard to accounting and financial statements
- Governed by law in most countries e.g. the Companies Act 2006 in the UK, which brings about costs of compliance
- Accounts must be made publicly available, meaning that competitors may access sensitive information.
- Costs of forming a company may be high.

SHARES

When a company is set up, the number of shares which it may issue is documented. This is known as the **authorised share capital**. The company may not issue all authorized share capital at once.

Share capital terminology

- **Authorised share capital** is the nominal value of the maximum number of shares that a company can have in issue at any particular point in time.

- **Issued share capital** is the share capital that has actually been issued to shareholders. The number of issued shares is used in the calculation of dividends

- **Called up share capital** is the amount of the nominal value paid by the shareholder plus any further amounts that they have agreed to pay in the future.

- **Paid up share capital** is the amount of the nominal value which has been paid at the current date.

Types of Shares

There are a number of different types of shares which companies may issue. The following are included within the F3/FFA syllabus:

Ordinary shares

All companies issue ordinary shares. These:

- Carry voting rights
- Entitle their holder to a dividend at the discretion of the directors

Preference shares

A company may also issue preference shares. These

- Do not carry voting rights
- Entitle their holder to a fixed dividend, which is paid out of profits ahead of an ordinary share dividend.

There are two types of preference share:

- **Irredeemable preference shares** exist, much like ordinary shares. The amount issued in form of Irredeemable preference shares is not payable after a fixed period.

- **Redeemable preference shares** are issued for a fixed term. At the end of this term, the shareholder redeems their shares and in return is repaid the amount they initially bought the shares for (normally plus a premium). In the meantime they receive a fixed dividend.

Although legally, these are shares, it is obvious that they have the characteristics of a loan from shareholders to the company. For this reason they are accounted for as liabilities.

The preference shares are also divided in **cumulative** and **non-cumulative** preference shares depending upon the method of payment of dividend.

IAS 1 FORMAT OF COMPANY ACCOUNTS

Many shareholders are not involved in day to day operation of a company, they need some method of feedback on how their company is performing which is provided by directors through annual accounts.

International Accounting Standard (IAS) 1 provides standard formats for these accounts. The set of company accounts should include:

- A statement of financial position
- A statement of profit or loss and other comprehensive income
- A statement of changes in equity
- A statement of cash flows
- Notes to the accounts

STATEMENT OF FINANCIAL POSITION

The statement of financial position for a company is very similar to that for a sole trader. The main difference is the capital section, as shares must be represented.

Statement of Financial Position as at 31 December 20X7

	$	$
Non-current assets		
Tangible assets		
Land and buildings	X	
Plant and machinery	X	
Motor vehicles	X	
		X
Intangible assets		
Goodwill	X	
Development costs	X	
Investments	X	X
		X
Current assets		
Inventory	X	
Accounts receivable	X	
Prepayments and accrued income	X	
Investments	X	
Cash at bank and in hand	X	X
TOTAL ASSETS		**X**
Capital and reserves		
Ordinary share capital		X
8% Preference share capital		X
Share premium account	X	
Revaluation Reserve	X	
General Reserve	X	
Retained Earnings	X	X
		X
Non-current liabilities		
10% Loan notes		X
Current liabilities		
Trade accounts payable	X	
Income tax liability	X	
Loan note interest payable	X	
Accruals and pre-received income	X	X
TOTAL EQUITY AND LIABILITIES		**X**

Share Capital and Share Premium

The share capital and share premium accounts relate to ordinary shares.

Share values

Each share has a face value, known as its **nominal value**. Often this is 25c, 50c or $1.As the name suggests, this value is nominal and is generally a lot less than the price that a company can issue the share to an investor for. This price is known as the share's **issue price**. It is illegal to issue a share for less than its nominal value. Once issued by the company, shares may be sold by shareholders. The price achieved by them is the **market value** of the share.

The market value of a share is irrelevant to a company for accounting purposes – once the share has been issued, no further accounting entries are required by the company. Both the nominal value and issue price are, however, relevant.

The difference between issue price and nominal value of share is called share premium.

Accounting for a share issue

The accounting entry to record the issue of shares is:

Dr Cash (Proceeds received)
Cr Share capital (Nominal value of shares issued)
Cr Share premium (Premium on issue of shares)

The share capital account therefore only includes the nominal value of shares issued, with the balance of any issue proceeds accumulating in the share premium account.

Accounting for a rights issue

A rights issue is an issue of new shares to existing shareholders in proportion to their existing shareholding. The issue price is normally less than market value to encourage shareholders to exercise their rights and buy shares .As rights issues are a normal issue of new shares for cash, they are recorded as seen in the previous section.

Advantages of a rights issue

- Often successful due to the reduced price offered to investors
- Cheapest way to issue shares

Disadvantages of a rights issue

- More expensive than raising debt finance
- It may not be successful in raising the finance required.

Accounting for a bonus issue

A bonus issue is an issue of new shares at no cost to existing shareholders, in proportion to their existing shareholding. This issue is may be made when company is unable to pay cash dividends and thus gives dividends in form of shares, which is known as **scrip dividend**.

An issue of this type does not raise cash, but is funded by the existing share premium account (or retained profits if the share premium account is insufficient), and accounted for by:

Dr Share premium/Retained profits (Nominal value of shares issued)
Cr Share capital (Nominal value of shares issued)

Advantages of a bonus issue

- Reduces the market value of each share which makes them more saleable
- Issued share capital is brought more into line with assets employed in the company.

Disadvantages of a bonus issue

- Issue costs arise, although no funds are raised
- Earnings per share (profits divided by number of shares) declines. This is a key performance indicator.

EXAMPLE 1

At1June2009, Jevan Co's capital structure was as follows:

	$
Ordinary share capital (1,000,000 sharesof50ceach)	500,000
Share premium account	400,000

In July 2009, Jevan Co made a rights issue of 1 share for every 4 held at $1 per share. This was fully taken up.

In October 2009, Jevan Co made a bonus issue of 1 share for every 5 held, using the share premium account to finance the issue. All shares in issue qualified for the bonus issue.

What is the company's capital structure at 31 May2010?

	Ordinary share capital	Share premium account
	$	$
A	625,000	525,000
B	750,000	650,000
C	750,000	400,000
D	1,000,000	400,000

Answer: Option C

	Share capital	Share premium
	$	$
Opening balance	500,000	400,000
Rights issue		
(1,000,000 x 1/4 x 50c)	125,000	
(1,000,000 x 1/4 x 50c)		125,000
Bonus issue		
(1,250,000 x 1/5 x 50c)	125,000	(125,000)
(1,250,000 x 1/5 x 50c)		
Total	750,000	400,000

EXAMPLE 2

Which of the following statements is true regarding the share premium account?

(i) It constitutes part of the equity of the company.
(ii) It can be paid out as dividend.
(iii) It will increase if and when new shares are issued at a price above nominal value.
(iv) It can be used to finance the issue of bonus shares.

A (i) and (ii) only
B (iii) and (iv) only
C (i), (iii) and (iv) only
D (i), (ii), (iii) and (iv)

Answer: Option C

Retained earnings and general reserve

Any profits made by a sole trader, but not taken out of the business as drawings, are added back to his capital in the statement of financial position.

In the same way, any profits made by a company, which are not paid out as a dividend, are added to shareholders' capital in the statement of financial position. These are normally accumulated in an account known as retained profits, retained earnings, accumulated profits or simply reserves.

In some cases, an amount of profit is kept separate and accumulated in a general reserve. This profit may be kept separate by the directors as it is earmarked to fund a future strategy.

The retained earnings balance plus any general reserve balance is therefore the cumulative profits of a company made to date.

Revaluation Reserve

In IAs 16, we considered the possibility of a company revaluing a non-current asset upwards to reflect market values.

The increase in value as a result of this exercise is a profit on paper, however no actual profit is achieved until such time as the asset is sold. Therefore the revaluation surplus is recorded in are valuation reserve rather than as retained earnings.

Reserves

The equity section of a statement of financial position, other than share capital, is often referred to as 'reserves':

	$
Share premium	X
Retained earnings	X
General reserve	X
Revaluation reserve	X

Share premium and the revaluation reserve are **capital reserves**. These cannot be paid out as a dividend. Retained earnings and the general reserve are **revenue reserves**. These are distributable, and so can be paid out as a dividend if the profit for the year is insufficient for this purpose.

OTHER SOURCES OF FINANCE

Loan notes

A company can raise finance either through the issue of shares or by borrowing money. Money may be borrowed from a bank or from other parties through the issue of loan notes.

Loan notes, also known as loan stock, corporate bonds or debentures, are effectively a loan from other parties to a company.

In return for their cash, loan note investors are given loan notes – effectively IOUs – which are redeemable by the company at a certain point in the future.

These loan notes are traded in much the same way as shares, and therefore if the original lender needs to access their money before the loan note redemption date, they simply sell their loan notes to another party.

An issue of loan notes is recorded by:

Dr Cash

Cr Loan notes (non-current liability)

Interest paid on the loan notes is recorded by:

Dr Finance cost (interest expense)

Cr Cash / accrual

Redeemable preference shares

As mentioned previously, although redeemable preference shares are legally shares, they have the commercial substance of debt, and are therefore accounted for as such.

The accounting entry to record an issue of redeemable preference shares is:

Dr Cash (Issue proceeds)

Cr Redeemable preference shares (non-current liabilities) Issue proceeds

Dividends are recorded by:

Dr Finance cost (interest expense)

Cr Cash / Accrual

The treatment of redeemable preference shares is an example of the accounting concept of **substance over form**.

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

IAS 1 requires companies to provide a performance statement which reports both

- Profit, and
- Other comprehensive income.

These may be reported together in a single Statement of Profit or Loss and Other Comprehensive Income or separately in a statement of profit or loss and statement showing other comprehensive income.

The term 'statement of profit or loss' is generally used to refer to that part of the statement which provides detail of profit (i.e. income and expenses), even where a single Statement of Profit or Loss and Other Comprehensive Income is provided.

Single statement proforma

Statement of Profit or Loss and Other Comprehensive Income for a company for the year ended 31 December 2008.

	$
Revenue	385,000
Cost of sales	(188,000)
Gross profit	197,000
Distribution costs	(38,500)
Administrative expenses	(37,700)
Operating profit	120,800
Finance costs	(8,000)
Profit before tax	112,800
Tax	(53,000)
Profit for the period	59,800
Other comprehensive income	
Revaluation surplus	20,000
Total comprehensive income	79,800

Expenses
A company's expenses should be aggregated on the face of the statement of profit or loss. They are not simply listed out as for a sole trader:

Cost of Sales includes:
- Purchases
- Direct labour in a manufacturing department
- Overheads relating to a manufacturing department
- The opening and closing inventory adjustment
- Carriage in
- Depreciation on non-current assets used in production.

Distribution costs include:
- Carriage out (freight costs)
- The salaries of staff involved in distribution, sales and marketing
- Overheads relating to distribution, sales and marketing
- Depreciation on non-current assets used in distribution, sales and marketing

Administrative expenses include:
- Directors' remuneration
- The salaries of staff involved in administration
- Irrecoverable debt expense
- Overheads relating to administration
- Depreciation on non-current assets used for administration
- Audit and professional fees

It includes all expenses not classified in cost of sales and distribution expenses

Finance costs include:
- Interest expenses
- The dividends paid to redeemable preference share holders

Tax

As mentioned, companies are liable for corporate income tax on their profits (known in the UK as corporation tax).The calculation of tax is outside the scope of the F3 paper so where it Is relevant, you will be provided with the tax charge.

In most jurisdictions, tax is paid several months after the end of the accounting period. At the period end, an **estimated** amount is accrued based on the year's profits by passing following double entry:

Dr **Income tax (statement of profit or loss)**
Cr **Tax payable (liability in SFP)**

When the tax is actually paid some months later, it is recorded by following double entry by actual amount paid:

Dr **Tax payable (SFP)**
Cr **Cash**

Since the amount paid is likely to differ from the estimated tax charge originally accrued, a balance is left on the tax payable account:

Tax payable

Cash (tax paid)	X	Income tax (estimated tax charge)	X
Overprovision c/f	X	Under-provision c/f	X

An **over-provision** arises where the actual tax paid is less than the estimated tax charge. This **reduces** the following year's tax charge in the statement of profit or loss.

An **under-provision** arises where the actual tax paid is more than the estimated charge. This **increases** the following year's tax charge in the statement of profit or loss.

EXAMPLE 3
Orange, a limited liability company, shows an under-provision of $5,000 on its tax liability account at the end of the year ended 31 December 20X7 before accounting for that year's tax charge.

It estimates tax on profits for the year to be $89,000.

What amounts of tax expense and tax liability should be shown in the financial statements for the year ended 31 December 20X7 in respect of tax?

Answer: Tax expense in P&L = $94,000 **Tax Liability in SOFP = $89,000**

Other comprehensive income

Other comprehensive income is income which is not allowed to be recognised in profit because it is unrealised (until the time asset is actually sold).

For the purposes of the F3 exam, the only item of other comprehensive income which you willsee is a surplus on revaluation of a non-current asset.

STATEMENT OF CHANGES IN EQUITY

The statement of changes in equity reconciles the capital and reserves balances in the statement of financial position at the start of the year to the balances at the end of the year .As such it links the statement of profit or loss and other comprehensive income and financial position:

Statement of changes in Equity
For the period ended31st December 20X7

	Ordinary share capital	Share premium	General Reserve	Revaluation reserve	Retained earnings	Total
At 1 January 20X7	X	X	X	X	X	X
Change in accounting policy (IAS 8)	-	-	-	-	X/(X)	(X)
Restated balance	**X**	**X**	**X**	**X**	**X**	**X**
Share issue	X	X				X
Bonus issue	X	(X)	(X)		(X)	
Net profit for the year					X/(X)	X
Revaluation gain			X			
Dividends declared (see notes later)					(X)	(X)
Reserve transfer*				(X)	X	-
At 31 December 20X7	X	X	X	X	X	X

** A reserves transfer arises where an asset has been revalued and the new depreciation based on the revalued amount exceeds the old depreciation based on historical cost.*

Dividends
Dividends are the return which a company pays to its shareholders and is distribution of profits to shareholders.

Irredeemable preference share dividends and ordinary share dividends appear in the statement of changes in equity.

- Preference share dividends are fixed and are paid annually
- Ordinary share dividends are paid at the discretion of directors.

This section does not deal with redeemable preference shares. Remember that these shares are treated as debt and the dividend is therefore treated as interest and charged in finance cost in SOCI.

Ordinary share dividends
Dividends on ordinary shares are announced on a per share basis and are recognised when they are declared by passing the following double entry.

Dr Retained earnings (SOCE)
Cr Cash or dividend payable (SFP)

EXAMPLE 4

Magnet ltd. has issued capital of 1000,000 $1 ordinary shares. It declared and paid following dividends on ordinary shares during year ended 31st December 20X6.

Date	
12th January 20X6	Final dividend of $0.75/share declared for year ended 31st December 20x5
30th March 20X6	Final dividend for year ended 31st December 20x5 paid
5th July 20X6	Interim dividend paid of $0.85/share

A final dividend of $0.85/share was proposed on 31st December 20X6 and it was finally declared in January 20x7.

What will be the total dividend charged to statement of changes in equity for the year ended 31st December 20X6?

Answer: $1,600,000

EXAMPLE 5

At 31 May 2009 the following items have not yet been included in a company's financial statements:
(1) In June 2009 the company recorded a receipt of $3,000 rent from a tenant for the three months to 31 May 2009.
(2) The company recorded a payment for $6,000 buildings insurance on 1 December 2008, for the year to
30 November 2009.
(3) The accounts show the company made a loan of $10,000 to an employee, repayable on 1 June 2009. On the due date the employee repaid the loan and paid interest due of $500 on the loan to that date.

What amounts should be recognised in respect of these items in the company's statement of financial position at 31 May 2009?
Current assets Current liabilities
$ $
A 13,500 3,000
B 6,500 nil
C 3,500 3,000
D 16,500 nil

Answer: Option D

COMPREHENSIVE EXAMPLE

The following information has been taken from the books of Jonkirst Co, a limited liability company, as at 31 May20X7.

	Dr	Cr
	$000	$000
Discounts received		65
Share premium account		260
Property expenses	130	
Trade payables		375
Loan note interest	43	
$1 Ordinary shares		2,340
Retained earnings at 1 June 20X6		410
Allowance for receivables at 1 June 20X6		50
Sales revenue		7,515
Cash	20	
Inventory at 1 June 20X6	455	
Other operating expenses	366	
Marketing expenses	65	
Wages and salaries	878	
Bank		124
Returns inward	124	
Trade receivables	1,180	
Purchases	4,641	
7% Loan notes		614
Receivables expense	195	
Land at cost	962	
Buildings at cost	1,940	
Motor vehicles at cost	312	
Furniture and equipment at cost	1,560	
Accumulated depreciation at 1 June 20X6		
Buildings		468
Motor vehicles		104
Furniture and equipment		546
	12,871	12,871

You have also been provided with the following information:

1. Inventory at 31 May20X7 was valued at $357,000 based on its original cost. However, $35,000 of this inventory is now obsolete and the directors have agreed to sell it in June 20X7 for a cash price of $25,000.
2. The marketing expenses include$10,000 which relates to June 20X7.
3. Based on past experience the allowance for receivables is to be increased to 5% of trade receivables.
4. There are wages and salaries outstanding of $55,000 for the year ended 31 May 20X7.
5. Buildings are depreciated at 5% of cost. At 31 May 20X7 the buildings were professionally valued at $2,300,000 and the directors wish this valuation to be incorporated into the accounts.
6. Other depreciation is to be charged for as follows:
   (i) Motorvehiclesat25% of written down value.
   (ii) Furniture and equipment at20% of cost.
7. Taxof$200,000 is to be provided for the year.
8. No dividends have been paid or declared.

Required:

(a) Prepare the following statements, for internal use:

(i) The statement of profit or loss for the year ended 31 May 20X7;and

(ii) The statement of financial position as at 31 May 20X7

Solution

Jonkirst Co
Statement of profit or loss for the year ended 31 May 20X7

	$000	$000
Sales revenue		7,515
Less returns inward		(124)
		7,391
Opening inventory	455	
Add purchases	4,641	
	5,096	
Less closing inventory (357 – 10)	(347)	
Cost of sales		(4,749)
		2,642
Discounts received		65
Gross profi t		2,707
Property expenses	130	
Other operating expenses	366	
Marketing expenses (W1)	55	
Wages and salaries (W2)	933	
Loan note interest	43	
Receivables expense (W3)	204	
Depreciation: Buildings (W6)	97	
Motor vehicles (W5)	52	
Furniture and equipment (W4)	312	
		(2,192)
Profit before taxation		515
Tax		(200)
Net profit for the period		315
Other comprehensive income		925
Total comprehensive income		1,240

(ii)

Jonkirst Co
Statement of financial position as at 31 May 20X7

Assets	Cost/	Accumulated	Carrying
Non current assets	Valuation	Depreciation	Value
	$000	$000	$000
Land	962	0	962
Buildings (W6)	2,300	0	2,300
Furniture and equipment (W4)	1,560	858	702
Motor vehicles (W5)	312	156	156
	5,134	1,014	4,120
Current assets			
Inventory		347	
Trade receivables (W3)	1,180		
Less allowance	(59)	1,121	
Prepayments (W1)		10	
Cash		20	1,498
Total assets			5,618
Equity and liabilities			
Capital and reserves			
$1 Ordinary shares			2,340
Share premium account			260
Revaluation reserve (W6)			925
Retained earnings ($410 + $315)			725
			4,250
Non-current liabilities			
7% Loan notes			614
Current liabilities			
Trade payables		375	
Tax		200	
Accruals (W2)		55	
Bank overdraft		124	754
Total equity and liabilities			5,618

W1 Marketing expenses

	$		$
Balance as per TB	65,000	Statement of profit or loss	55,000
		Prepayment c/f	10,000
	65,000		65,000

W2 Wages and Salaries

	$		$
Balance as per TB	878,000	Statement of profit or loss	933,000
Wages accrued c/f	55,000		
	933,000		933,000

W3 Receivables Expense

	$		$
Balance as per TB	195,000	Statement of profit or loss	204,000
Allowance for receivables	9,000		
	204,000		204,000

Allowance for receivables

	$		$
Balance c/f	59,000	Balance as per TB	50,000
		Receivables expense	9,000
	59,000		59,000

W4 Furniture and Equipment Accumulated Depreciation

	$		$
Balance c/f	858,000	Balance as per TB	546,000
		Statement of profit or loss(20% of $1,560,000)	312,000
	858,000		858,000

W5 Motor Vehicles Accumulated Depreciation

	$		$
Balance c/f	156,000	Balance as per TB	104,000
		Statement of profit or loss (25% of ($312,000 – $104,000))	52,000
	156,000		156,000

W6 Revaluation Reserve

Depreciation on buildings for the year is calculated as $1,940,000 x 5% = $97,000
Therefore the net book value of the buildings is $1,375,000 at the end of the year, i.e. $1,940,000 – $468,000 – $97,000.
When the buildings are revalued at the end of the year a revaluation reserve is created of $925,000. i.e. $2,300,000 – $1,375,000 = $925,000.

COMPREHRNSIVE EXAMPLE 2

Screeth is a limited liability company with the following trial balance as at 31 October 20x8.

	Dr $000	Cr $000
Distribution costs	250	
Administrative expenses	126	
Salaries	1,180	
Discounts received		83
Sales		9,427
Property expenses	290	
Returns inward	166	
Cash	27	
Insurance	130	
Purchases	6,243	
Inventory at 1 November 20x7	610	
Bank		311
Loan note interest	58	
Share premium account		350
Retained earnings at 1 November 20x7		875
Allowance for receivables at 1 November 20x7		70
Trade payables		507
Trade receivables	1,700	
7% Loan notes		822
Receivables expense	260	
$1 Ordinary shares		2,850
Dividends paid: Final for year ended 31 October 20x7	200	
Land at cost	1,295	
Buildings at cost	2,640	
Motor vehicles at cost	420	
Furniture and equipment at cost	800	
Accumulated depreciation at 1 November 20x7		
Buildings		625
Motor vehicles		140
Furniture and equipment		335
	16,400	16,400

Further information relating to Screeth:

1. The insurance includes $10,000 which relates to November 20x8.
2. Buildings are depreciated at 5% of cost. Building depreciation during the year is allocated 50% to distribution costs and 50% to administrative expenses.
3. At 31 October 20x8 the buildings were professionally valued at $3,150,000 and the directors wish this valuation to be incorporated into the accounts.
4. Depreciation is to be charged as follows:
   (i) Motor vehicles at 25% of written down value, allocated to distribution costs
   (ii) Furniture and equipment at 20% of cost, allocated to administrative expenses.
5. Inventory at 31 October 20x8 was valued at $480,000 based on its original cost.
6. Based on past experience the allowance for receivables is to be increased to 5% of trade receivables and allocated to administrative expenses.
7. There are salaries outstanding of $60,000 for the year ended 31 October 20x8.
8. The items listed below should be apportioned as indicated:

	Cost of Sales	Distribution Costs	Administrative Expenses
Property expenses	20%	30%	50%
Insurance	20%	40%	40%
Salaries	25%	35%	40%
Discounts received			100%

9. Tax of $120,000 is to be provided for the year.

Required:

Prepare, the following financial statements for Screeth:

(a) The statement of profit or loss and other comprehensive income for the year ended 31 October 20x8.

(b) The statement of financial position as at 31 October 20x8.

SOLUTION SUMMARY

	$ 000
Profit for the year	130
Total comprehensive income for the year	1,397
Non-current assets	4,960
Current assets	2,132
Equity	5,272
Non-current liabilities	822
Current liabilities	998

Chapter 16

STATEMENT OF CASH FLOWS

IN THIS CHAPTER

- **THE DIFFERENCE BETWEEN PROFIT AND CASH**
- **BENEFITS AND DRAWBACKS OF A STATEMENT OF CASH FLOW**
- **DEFINITIONS IN IAS – 7**
- **METHODS OF PREPARATION OF STATEMENT OF CASH FLOWS**
- **DIRECT/GROSS METHOD**
- **COMPARISON OF THE METHODS**

THE DIFFERENCE BETWEEN PROFIT AND CASH

As we have seen in earlier chapters, profit is calculated on the accruals basis as:

Income earned	X
Expenses incurred	(X)
Profit/loss	X/(X)

Cash flow is calculated on a cash basis:

Cash received (inflow)	X
Cash paid (outflow)	(X)
Net cash In / (out flow	X/(X)

A business must control its cash flows as well as its profits. The production of a statement of cash flows is one way in which cash may be controlled and monitored.

BENEFITS AND DRAWBACKS OF A STATEMENT OF CASH FLOW

Benefits of statements of cash flow

- There is no possibility of manipulation, as cash flows are based on fact
- The long term survival of a business depends on its ability to generate cash
- Cash flows are easier for many users to understand than profits based on accruals accounting
- Cash flows are categorised so that users can see how a business generates cash and on what it spends cash
- A statement of cash flows provides a basis to estimate future cash flows
- A statement of cash flows is the best indicator of liquidity

Drawbacks of statements of cash flow

- In common with other financial statements, it is historic and provides no detail of budgeted or forecast future cash flows
- Non cash transactions such as bonus issues of shares are not reflected

DEFINITIONS IN IAS – 7

The standard gives the following definitions, the most important of which are cash and cash equivalents.
Cash comprises cash on hand and demand deposits

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value.

Cash flows are ***inflows*** and ***outflows*** of cash and cash equivalents.

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
Financing activities are activities that result in changes in the size and composition of the equity capital and borrowings of the entity.

METHODS OF PREPARATION OF STATEMENT OF CASH FLOWS

The standard offers a choice of method for the “Operating Activities” section of the Statement of Cash Flows.

1. Direct method.
2. Indirect method.

The statement of cash flows

The format and content of the statement of cash flows are prescribed by IAS 7 Statements of cash flow. It requires that cash flows are listed under one of three headings:

- Cash flows from operating activities
- Cash flows from investing activities
- Cash flows from financing activities.

PERFORMA: STATEMENT OF CASH FLOWS

Statement of cash flow for the year ended 31 December 20X5

	$	**$**
Net cash flow from operating activities		
Net profit before taxation	X	
Adjustments:		
Add : Interest payable (interest expense)	X	
Add : Depreciation/amortization	X	
Add : Loss on disposal of non-current assets	X	
Less Profit on disposal of non-current assets	(X)	
Operating profit before working capital changes		*X*
(Increase)/decrease in inventories/trade receivables		(X)/X
Increase/(Decrease) in trade payables		X/(X)
Cash generated from operations		*X*
Less : Interest paid	(X)	
Dividends paid	(X)	
Income taxes paid	(X)	
		(X)
Net cash from operating activities		***X***
Cash flows from investing activities		
Purchase of property, plant and equipment/intangible non-current assets	(X)	
Proceeds of sale of non-current assets(cash inflow)	X	
Interest/dividends received (cash inflow)	X	
Net cash used in investing activities		***X/(X)***
Cash flows from financing activities		
Proceeds from issue of shares (Cash inflow)	X	
Receipt of loans (Cash inflow)	X	
Repayment of loans (Cash outflow)	(X)	
Net cash used in financing activities		***X/(X)***
Net increase / (decrease) in cash and cash equivalents		X/(X)
Cash and cash equivalents at the beginning of the period		X/(X)
Cash and cash equivalents at the end of the period		X/(X)

Cash flows from operating activities

This is perhaps the key part of the Statement of Cash Flows because it shows whether, and to what extent, companies can generate cash from their operations (the main revenue-producing activities of the entity).

The standard gives the following as examples of cash flows from operating activities.

- Cash receipts from the sale of goods and the rendering of services
- Cash receipts from royalties, fees, commissions and other revenue
- Cash payments to suppliers for goods and services
- Cash payments to and on behalf of employees
- Cash payments/refunds of income taxes unless they can be specifically identified with financing of investing activates
- Cash receipts and payments from contracts held for dealing for trading purposes.

Depreciation / amortisation / loss on disposal of non-current assets is added back as they are non-cash expenses.

Interest expense is added back as it is not part of cash generated from operations.

Note: If profit before interest and tax (operating profit) is used as the first item then an adjustment for interest payable is not necessary.

Increase in inventories and trade receivables are deducted because this is part of the profit not yet realized into cash but tied up in the respective assets. On the contrary, the decrease of inventories and receivables are added in operating profit, because this shows the realized profits i.e. the realization of cash.

The ***decrease in trade payables*** is deducted as it results in a cash outflow since cash is leaving the business to reduce the amount owing. On the contrary; the increase in trade payables are added, as the increase in payables means more cash inflow towards organization.

The actual amount paid for ***interest, tax and dividends*** will result in a cash outflow.

A working may be necessary determine the actual payment.

Calculation of interest/income taxes paid

The cash flow should be calculated by reference to:

- The charge to profits for the item (shown in the statement of profit or loss) ; and
- Any opening or closing payable balance shown on the statement of financial position.

A T account working may be useful:

e.g. **Interest payable**

	$		$
		Interest accrual b/f	X
Cash paid (ß)	X	Interest charge (P&L)	X
Interest accrual c/f	X		
	X		X

If there is no opening or closing shown by statement of financial position, it means that the charge to profits is the cash outflow.

Calculation of dividends paid

The cash flow should again be calculated by reference to the charge to profits and the opening or closing dividend payable shown in the statement of financial position.

Note that the charge to profits for dividends is not shown in the Statement of profit or loss. It can, however, be derived using an accumulated profits T account working.

Cash flows from investing activities

The cash flows classified under this heading show the extent of new investment in assets which will generate future profit and cash flows. The standard gives the following examples of cash flows arising from investing activities.

- Cash payments to acquire property, plant and equipment, intangibles and other long term assets, including those relating to capitalized development costs and self-constructed property, plant and equipment.
- Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets
- Cash payments to acquire shares or debentures of other entities.
- Cash receipts from sales of shares or debentures of other entities
- Cash advances and loans made to other parties
- Cash receipts from the repayment of advances and loans made to other parties
- Interest received
- Dividends received

Below is a format which can be used **to *calculate the amount paid to acquire non-current assets:*** This applies if there are no details of cost and accumulated depreciation in the Statement of Financial Position.

Calculation of purchase of property, plant and equipment and proceeds of sale of equipment

These amounts are often the trickiest to calculate within a statement of cash flows. It is therefore recommended that T account workings are used.

The following T accounts will be required for each class of assets:

- Cost account
- Accumulated depreciation account
- Disposals account (where relevant).

Data provided in the source financial statements should then be entered into these T accounts and the required cash flows found – often as balancing figures.

In some cases, insufficient detail is provided to produce separate cost and accumulated depreciation accounts. Instead, a carrying value account should be used:

Carrying value(CV)

	$		$
CV b/f	X		
Additions at CV (= cash to purchase PPE)	X		
		Disposals at CV	X
Revaluation	X	Depreciation charge for year	X
		Carrying value c/f	X
	X		X

Calculation of interest and dividends received

Again, the calculation should take account of both the income receivable shown in the statement of profit or loss and any relevant receivables balance from the opening and closing statement of financial positions.

A T account working may be useful e.g.

Interest receivable

	$		$
Interest receivable b/f	X		
Statement of profit or loss (Interest income)	X	Cash received (ß)	X
		Interest receivable c/f	X
	X		X

Cash flows from financing activities

This sections of the Statement of Cash Flows shows the share of cash which the entity's capital providers have claimed during the period. This is an indicator of likely future interest and dividend payments. The standard gives the following examples of cash flows which might arise under these headings.

- Cash proceeds from issuing shares
- Cash payments to owners to acquire or redeem the entities shares
- Cash proceeds from issuing debentures , loans notes , bonds, mortgages and other short or long-term borrowings
- Cash repayments of amounts borrowed
- Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease

Calculation of proceeds of issue of shares

This cash inflow is derived by comparison of the sum brought forward and sum carried forward balances on two accounts:

- Share capital
- Share premium.

Calculation of proceeds of issue of loans/repayment of loans

This cash flow is derived by simply subtracting the brought forward balance from the carried forward.

Net increase in cash and cash equivalents

This is the overall increase in cash and cash equivalents during the year.

DIRECT/GROSS METHOD

The gross method involves adding together operating cash inflows and subtracting outflows to obtain the operating cash flows.

	$
Cash receipts from customers (W 1)	X
Cash payments to suppliers (W 2)	(X)
Cash payments to and on behalf of employees	(X)
Other cash payments (W 3)	(X)
Net cash flow from operating activities	X

Workings:

(W 1) Sales + opening receivables – closing receivables

(W 2) Purchases + opening payables – closing payables
The purchases figure can be calculated as follows:
Cost of sales + closing inventory – opening inventory

(W 3) Distribution costs + administration costs + other expenses – non-cash expenses + non cash income

COMPARISON OF THE METHODS

Net method

- The reconciliation highlights the fact that profit and cash are not equal
- Does not show significant elements of trading cash flows
- Low cost in preparing the information

Gross method

- Discloses information not shown elsewhere in the financial statements
- Shows the cash flows from trading
- Enables the users to estimate future cash flows

Note: The total cash flows from operating activities will be the same under both methods.

EXAMINER ARTICLE

The Financial Accounting examiner wrote an article on statement of cashflows. Following is the article for revision of concepts mentioned above.

COMPUTING CASH FLOWS

Cash flows are either receipts (i.e. cash inflows and so are represented as a positive number in a statement of cash flows) or payments (i.e. cash out flows and so are represented as a negative number using brackets in a statement of cash flows).

Cash flows are usually calculated as a missing figure. For example, when the opening balance of an asset, liability or equity item is reconciled to its closing balance using information from the statement of profit or loss and/or additional notes, the balancing figure is usually the cash flow.

Common cash flow calculations include the tax paid, which is an operating activity cash out flow, the payment to buy property plant and equipment (PPE) which is an investing activity cash out flow and dividends paid, which is a financing activity cash out flow. The following examples illustrate all three of these examples.

EXERCISE CALCULATING THE TAX PAID

At the start of the accounting period the company has a tax liability of $50 and at the reporting date a tax liability of $90. During the year the tax charged in the statement of profit or loss was $100.

Required: Calculate the tax paid.

Solution

It is necessary to reconcile the opening tax liability to the closing tax liability to reveal the cash flow – the tax paid - as the balancing figure. A vertical presentation of the numbers lends itself to noting the source of the numbers.

Tax liability	$	Explanation
Opening balance	50	Credit balance
Tax charge	100	The tax charged in the profit or loss means that the entity now owes more tax. The debit charged as the expense in profit or loss is posted and a credit to the tax liability account reflects the effect of increase in the tax liability
	_____	
Sub-total	150	This sub-total represents the amount of the tax liability that there would have been at the reporting date in the event that no tax had been paid
Cash flow – the payment of tax	60	This is the last figure written in the reconciliation. It is the balancing figure and explains why the actual year-end tax liability is smaller than the sub-total
	_____	
Closing balance	90	This is the closing balance of the tax liability
	_____	

This simple technique of taking the opening balance of an item (in this case the tax liability) and adding (or subtracting) the non-cash transactions that have caused it to change, to then reveal the actual cash flow as the balancing figure, has wide application.

EXERCISE CALCULATING THE PAYMENTS TO BUY PPE

At the start of the accounting period the company has PPE with a carrying amount of $100. At the reporting date the carrying amount of the PPE is $300. During the year depreciation charged was $20, a revaluation surplus of $60 was recorded and PPE with a carrying amount of $15 was sold.

Required: Calculate the cash paid to buy new PPE.

Solution

Here we can take the opening balance of PPE and reconcile it to the closing balance by adjusting it for the changes that have arisen in period that are not cash flows. The balancing figure is the cash spent to buy new PPE.

PPE	$	Explanation
Opening balance	100	Debit balance
Deprecation	(20)	Deprecation reduces the carrying amount of the PPE without being a cash flow. The double entry for depreciation is a debit to statement of profit or loss to reflect the expense and to credit the asset to reflect its consumption.
Revaluation surplus	60	The revaluation gain increases PPE without being a cash flow. The double entry is a credit to the revaluation surplus to reflect the gain and to debit the asset to reflect its increase
Disposal	(15)	The carrying amount of the PPE that has been disposed of reduces the PPE thus a credit to the asset account which is then posted as a debit in the disposals account
	_____	
Sub-total	125	This sub-total represents the balance of the PPE if no PPE had been bought for cash
Cash flow – the payment to buy PPE	175	This is the last figure written in the reconciliation This balancing figure explains why the actual PPE at the reporting date is greater than the sub-total
	_____	
Closing balance	300	
	_____	

EXERCISE CALCULATING THE DIVIDEND PAID

At the start of the accounting period the company has retained earnings of $500 and at the reporting date retained earnings are $700. During the reporting period a profit for the year of $450 was reported.

Required: Calculate the dividend paid.

Solution

As before, to ascertain the cash flow – in this case dividends paid - we can reconcile an opening to closing balance – in this case retained earnings. This working is in effect an extract from the statement of changes in equity.

Retained earnings	$	Explanation
Opening balance	500	Credit balance
Profit for the year	450	The profit for the year is a credit and increases the retained earnings
	_____	
	950	This sub-total represents the balance on retained earnings in the event that no dividends have been paid
Cash flow – the dividends paid	250	This is the last figure written in the reconciliation. This balancing figure of dividends paid explains why the actual year-end retained earnings is less
	_____	
Closing balance	700	
	_____	

CLASSIFICATION OF CASH FLOWS

IAS 7, *Statement of Cash Flows* requires an entity to present a statement of cash flows as an integral part of its primary financial statements. A statement of cash flow classifies and presents cash flows under three headings:

(i) Operating activities
(ii) Investing activities and
(iii) Financing activities

Operating activities can be presented in two different ways. The first is the direct method which shows the actual cash flows from operating activities – for example, the receipts from customers and the payments to suppliers and staff. The second is the indirect method which reconciles profit before tax to cash generated from operating profit. Under both of these methods the interest paid and taxation paid are presented as cash outflows.

Investing activity cash flows are those that relate to non-current assets. Examples of investing cash flows include the cash outflow on buying property plant and equipment, the sale proceeds on the disposal of non-current assets and any cash returns received arising from investments.

Financing activity cash flows relate to cash flows arising from the way the entity is financed. Entities are financed by a mixture of cash from borrowings from third parties (debt) and by the shareholders (equity). Examples of financing cash flows include the cash received from new borrowings or the cash repayment of debt as well as the cash flows with shareholders in the form of cash receipts following a new share issue or the cash paid to them in the form of dividends.

This topic is examined in much more depth in the F7 examination than it is at F3. For example, in F3, an extract, or the whole statement of cash flow might be required. F7, however, is more likely to ask for an extract from the statement of cash flows using more complex transactions (for example, the purchase of PPE using finance leases). However, that does not mean that F7 will never require the preparation of a complete statement of cash flows so be prepared.

OPERATING ACTIVITIES – THE INDIRECT METHOD AND DIRECT METHOD

There are two different ways of starting the cash flow statement, as IAS 7, *Statement of Cash Flows* permits using either the 'direct' or 'indirect' method for operating activities.

The direct method is intuitive as it means the statement of cash flow starts with the source of operating cash flows. This is the cash receipts from customers. The operating cash out flows are payments for wages, to suppliers and for other operating expenses are then deducted. Finally the payments for interest and tax are deducted.

Alternatively, the indirect method starts with profit before tax rather than a cash receipt. The profit before tax is then reconciled to the cash that it has generated. This means that the figures at the start of the cash flow statement are not cash flows at all. In that initial reconciliation, expenses that have been charged against profit that are not cash out flows; for example depreciation and losses, have to be added back, and non-cash income; for example investment income and profits are deducted. The changes in inventory, trade receivables and trade payables (working capital) do not impact on the measurement profit but these changes will have impacted on cash and so further adjustments are made. For example, an increase in the levels of inventory and receivables will have not impacted on profit but will have had an adverse impact on the cash flow of the business. Thus in the reconciliation process the increases in inventory and trade receivables are deducted. Conversely decreases in inventory and trade receivables are deducted. The opposite is applicable for trade payables. Finally the payments for interest and tax are presented.

The following exercise illustrates both the direct and indirect methods operating activities section.

EXERCISE: THE DIRECT AND INDIRECT METHOD

Extracts from the financial statements are as follows

	$
Operating profit	80,000
Investment income	12,000
Finance cost	(10,000)
Profit before tax	82,000
Tax	(32,000)
Profit for the year	50,000
Other comprehensive income	
Revaluation gain	40,000
Total comprehensive income	90,000

	Closing balance	Opening balance
Current assets		
Inventory	30,000	25,000
Receivables	20,000	26,000
Current liabilities		
Trade payables	14,000	11,000

Additional information

During the year depreciation of $50,000 and amortisation of $40,000 was charged to profit.

Receipts from customers, combined with cash sales, were $800,000, payments to suppliers of raw materials $400,000, other operating cash payments were $100,000 and cash paid on behalf and to employees was $126,000.

Interest paid is $12,000 and taxation paid is $13,000.

Required:

(a) Using the direct method prepare the operating activities section of the statement of cash flows.

(b) Using the indirect method determine the operating activities section of the statement of cash flows.

Answer (a) direct method

The direct method is relatively straightforward in that all the data are cash flows so it is really just a case of listing the receipts as positive and the payments as negative.

Operating activities – Direct method	$	$
Cash receiv3ed from customers	800,000	
Cash paid to suppliers	(400,000)	
Cash paid to staff	(100,000)	
Other operating payments	(26,000)	
Cash generated	174,000	
Interest paid	(12,000)	
Taxation paid	(13,000)	149,000

Answer (b) indirect method

The indirect method is more commonly examined. Here as we start with profit before tax we have to add back all the non-cash expenses charged, deduct the non-cash income and adjust for the changes in working capital. Only then are the two actual cash flows of interest paid and tax paid presented. Having a good understanding of the format of the statement of cash flows is key to a successful attempt at these questions.

Operating activities – Indirect method	$	$
Operating activities		
Profit before tax	82,000	
Investment income	(12,000)	
Finance cost	10,000	
Depreciation	50,000	
Amortization	40,000	
Increase in inventory (30,000 – 25,000)	(5,000)	
Decrease in receivables (20,000 – 26,000)	6,000	
Increase in payables (14,000 – 11,000)	3,000	
Cash generated	174,000	
Interest paid	(12,000)	
Taxation paid	(13,000)	149,000

Note how whichever method is used that the same cash is generated from operating activities.

FORMAT OF THE CASH FLOW STATEMENT – INDIRECT METHOD

You may be asked to prepare a statement of cash flows. The following is a pro forma showing the indirect method.

1. Operating activities		
Profit before tax	X	
Investment income	(X)	
Finance cost	X	
Depreciation	X	
Less capital government grant released	(X)	
Amortisation of intangible assets	X	
Impairment loss charged in profit or loss	X	
Loss on disposal of assets (profit)	X/(X)	
Increase in provisions (decrease)	X/(X)	
Changes in working capital		
Increase / decrease in inventory	(X) / X	
Increase / decrease in receivables and prepayments	(X) / X	
Increase / decrease in trade payables and accruals	X/(X)	
Cash generated	X	
Interest paid	(X)	
Taxation paid	(X)	X
2. Investing activities		
Payments to buy PPE / Intangibles / Investments	(X)	
Proceeds from sale of PPE / Intangibles / Investments	X	
Dividends received from investments	X	
Capital government grants received	X	(X)
3. Financing activities		
Proceeds from an equity share issue	X	
Dividends paid	(X)	
Proceeds from the issue of new debt	X	
Repayment of debt	(X)	
Capital repayment of finance lease obligations	(X)	X/(X)
Change in cash and cash equivalents		X/(X)
Opening cash and cash equivalents		X/(X)
Closing cash and cash equivalents		X/(X)

Cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash, and that are subject to an insignificant risk of changes in value.

COMPREHENSIVE EXAMPLE

Traffold, a limited liability company, is preparing its statement of cash flows for the year ended 31 May 20X8.

Traffold				
Statements of financial position as at 31 May	20X8		20X7	
Assets		$000		$000
Non-current assets				
Cost		65,251		53,525
Accumulated depreciation		(14,798)	(12,509)	
		50,453		41,016
Current assets				
Inventory		16,503		14,563
Trade receivables		6,214		8,664
Bank		595		536
		23,312		23,763
Total assets		73,765		64,779
Equity and liabilities				
Capital and reserves				
$1 Ordinary share capital	21,000		17,000	
Share premium		7,892		6,425
Revaluation reserve		7,454		4,092
Retained earnings		19,979		18,190
		56,325		45,707
Non-current liabilities				
9% loan notes		6,734		8,825
Current liabilities				
Trade payables		9,505		8,951
Taxation		1,201		1,296
		10,706		10,247
Total equity and liabilities	73,7651		64,779	

Traffold

Statement of profit or loss for the year ended 31 May 20X8

		$000
Sales revenue		28,775
Cost of sales		(14,821)
Gross profit		13,954
Distribution costs		(4,908)
Administrative expenses	(3,410)	
Profit from operations		5,636
Interest received	57	
Finance cost		(794)
Profit before tax	4,899	
Taxation		(1,570)
Profit for the period		3,329

Additional information

(i) Dividends paid during the year were $1,540,000.

(ii) There were no amounts outstanding in respect of interest payable or receivable as at either year end.

(iii) Total depreciation for the year was $2,487,000.

(iv) The only revaluation of non-current assets was of a piece of freehold land.

(v) During the year, the company sold equipment for $766,000 realising a profit of $66,000.

Required:

Prepare a Statement of Cash Flows for Traffold for the year ended 31 May 20X8 in accordance with IAS 7 – Statement of Cash Flows, using the indirect method.

ANSWER

Traffold
Statement of cash flows for the year ended 31 May 20x8

	$000	$000
Cash flows from operating activities		
Net profit before tax	4,899	
Adjustments for:		
Depreciation	2,487	
Interest received	(57)	
Interest paid	794	
Profit on equipment disposal	(66)	
Operating profit before working capital changes	8,057	
Increase in inventory	(1,940)	
Decrease in receivables	2,450	
Increase in payables	554	
Cash generated from operations	9,121	
Interest received	57	
Interest paid	(794)	
Tax paid (W2)	(1,665)	
Net cash from operating activities		6,719
Cash flows from investing activities		
Purchase of property, plant and equipment (W1)	(9,262)	
Proceeds from sale of equipment	766	
Net cash used in investing activities		(8,496)
Cash flows from financing activities		
Proceeds from issue of share capital	5,467	
Repayment of long term borrowing	(2,091)	
Dividends paid	(1,540)	
Net cash used in financing activities		1,836
Net increase in cash and cash equivalents		59
Cash and cash equivalents at the beginning of period		536
Cash and cash equivalents at end of period		595

Workings (all in $000):

W1 Additions of non-current assets:

Opening net book value	41,016
Disposals (766 – 66)	(700)
Depreciation	(2,487)
Revaluation (7,454 – 4,092)	3,362
	41,191
Additions (Balancing figure)	*9,262*
Closing net book value	50,453

Or

Non-current assets NBV

B/forward	41,016	Disposals	700
Revaluation	3,362	Depr'tion	2,487
Add'ns (bal)	*9,262*	C/f	50,453
	53,640		53,640

W2 Taxation

Balb/f	1,296
P&L expense	1,570
Tax paid	*(1,665)*
Closing balance	1,201

Or

Taxation

Paid	*1,665*	B/f	1,296
C/f	1,201	Inc state	1,570
	2,866		2,866

Note: the entries in italics in these t-accounts are the 'balancing figures'.

COMPREHENSIVE EXAMPLE 2

You are presented with the following information for Dawson.

Dawson – Statement of Financial Position as at 31 May

	20X0		20X1	
	$000	**$000**	**$000**	**$000**
Assets				
Non-current assets				
Tangible		1,200		1,400
Intangible		460		450
Investment		180		240
		1,840		2,090
Current assets				
Inventory	450		500	
Receivables	270		300	
Bank	-		50	
		720		850
Total assets		2,560		2,940
Equity & Liabilities				
Equity				
Ordinary share capital		1,000		1,200
Share premium		-		15
Retained earnings		1,150		1,230
		2,150		2,445
Long-term loans		40		150
Current liabilities				
Payable	200		220	
Bank overdraft	50		-	
Taxation	120		125	
		370		445
Total equity and liabilities		2,560		2,940

Dawson –Statement of profit or loss for the year ended 31 May 20X1

	$000
Profit before tax	310
Income tax expense	120
Profit for the year	190

Additional information for the year ended 31 May 20X1;

(i) No intangible non-current assets were acquired or sold.

(ii) Non-current assets with net book value of $160,000 were sold for a profit of $85,000.

(iii) Depreciation charged on tangible non-current assets was $305,000.

(iv) Interest charged in the Statement of profit or loss was $24,000.

(v) There were no prepaid or accrued expenses at the beginning or end of the year.

(vi) Dividends of $110,000 were paid during the year.

Required

a) Prepare a Statement of Cash Flows for Dawson for the year ended 31 May 20X1 in accordance with IAS 7.

b) Review the Statement of Cash Flows you have prepared in part (a) and comment on the financial position of Dawson.

SOLUTION HINT:

In case of statement of cashflows, when the net cashflows from operating, financing and investing activities are added to the opening balance of cash and cash equivalent, the balance should be equal to closing balance of cash and cash equivalents already given in question.

Chapter 17

INTERNATIONAL ACCOUNTING STANDARDS

IN THIS CHAPTER

- ACCOUNTING STANDARDS
- IAS 8 ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS
- IAS 10 EVENTS AFTER THE REPORTING PERIOD
- IAS 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS
- IFRS 15 REVENUE FROM CONTRACT WITH CUSTOMERS
- IAS 38 INTANGIBLE ASSETS

ACCOUNTING STANDARDS

Accounting standards must be applied by companies in order that their financial statements are fairly presented. The Standards covered in this chapter are:

- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 10 Events after the Reporting Period
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- IFRS 15 Revenue from contract with customers
- IAS 38 Intangible Assets

IAS 8 ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

An **accounting policy** is a specific principle or rule applied by a company in preparing its financial statements. They are generally driven by accounting standards. The following are examples of accounting policies:

- The creation of an allowance for receivables
- The depreciation of non-current assets
- The revaluation of certain classes of non-current assets

An **accounting estimate** is a judgment required in the application of accounting policies.
For example

- The method used to calculate the allowance for receivables
- The method of and rate at which non-current assets are depreciated (20% straight line, 10% reducing balance etc.)

Change in accounting policy

Accounting policies should be applied consistently over time and across similar assets/liabilities.
A change in accounting policy is only allowed if it:

- Is required by an accounting standard, or
- Results in more reliable and relevant financial statements (voluntary).

Where an accounting policy is changed, the change is applied **retrospectively** i.e. the financial statements are changed so that balances are as they would be had the new policy always been in place. This is achieved through a prior period adjustment.

Change in accounting estimates

By its nature, an estimate may need to be revised if circumstances change. For example, 10%straight line depreciation of a non-current asset is based upon an estimated 10 year useful life. It may however become apparent after using the asset for a few years that the total useful life is less than 10 years.

IAS 8 therefore allows changes in accounting estimates, and requires that they are accounted for **prospectively**. In other words, the revised estimate is applied going forward but does not result in a prior period adjustment.

Errors

If a current period error is discovered during the current period, it can be corrected before the financial statements are issued.

If, however, a material prior period error is discovered during the current period, it should be corrected **retrospectively** i.e. the financial statements are changed so that they appear as they would have been had the error never occurred. This is achieved through a prior period adjustment

Prior period adjustments

Prior period adjustments are made where:

- There is a change in accounting policy, or
- There is a prior period error.

In both cases:

- The balance on retained earnings at the start of the current period is adjusted, and
- Comparative information is restated to reflect the situation had the new policy always been in place / the error never occurred.

Restatement of the opening retained earnings balance is disclosed in the statement of changes in equity:

Statement of changes in equity

	Share capital	Share premium	Revaluation reserve	General reserve	Retained earnings	Total
	$	$	$	$	$	$
Balance at 31 Dec. 20X6	20,000	63,000	20,000	100,000	69,697	272,697
Prior period adjustment	-	-			(1,000)	(1,000)
Restated	***20,000***	***63,000***	***20,000***	***100,000***	***68,697***	***271,697***
Issue of share capital	5,000	12,000	-	-	-	271,697
Dividends	-	-	-	-	(10,000)	(10,000)
Total Comprehensive Income for year	-	-	20,000	-	59,800	79,800
Reserves transfer	-	-		2,000	(2,000)	-
Balance at 31 December 20X7	**25,000**	**75,000**	**20,000**	**102,000**	**57,800**	**358,497**

Disclosures

Disclosures relating to **changes in accounting policy** caused by a new standard or interpretation include:

- The title of the standard or interpretation causing the change
- The nature of the change in accounting policy
- A description of the transitional provisions, including those that might have an effect on future periods
- For the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
  - For each financial statement line item affected, and
  - For earnings per share (only if the entity is applying IAS 33)
- The amount of the adjustment relating to periods before those presented, to the extent practicable
- If retrospective application is impracticable, an explanation and description of how the change in accounting policy was applied.

Financial statements of subsequent periods need not repeat these disclosures.

Additional disclosure relating to **voluntary changes** in accounting policy include:

- The reasons why applying the new accounting policy provides reliable and more relevant information

Disclosures Relating to **Changes in Accounting Estimate**

Disclose:

- The nature and amount of a change in an accounting estimate with effect on the current period and future periods
- If the calculation of estimate is impracticable, an entity shall disclose that fact.

Errors

An entity must correct all material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

- Restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

However, if it is impracticable to determine then the opening balances of earliest period possible will be restated.

IAS 10 EVENTS AFTER THE REPORTING PERIOD

An event after the reporting period is an event that occurs between the accounting period end and the date on which the financial statements are authorised for issue.

The cut-off date is when financial statements are authorized for issuance, regardless of whether information is publicly available or not. This date should be disclosed. The authorisation of financial statements is done by directors.

In order to deal with the issue, IAS 10 splits events after the reporting period into adjusting and non-adjusting.

Events after the reporting date:
Those material events which occur between the reporting date and the date on which the financial statements are approved

Adjusting	**Non-adjusting**
'Provides additional evidence of conditions existing at the reporting date.'	'concern conditions which did not exist at the reporting date'
Adjust the Financial Statements to reflect the event	Do not adjust the Financial Statements
	Disclose by note, if important to users' understanding

As the financial statements are not yet in the public domain when the event occurs, the question arises as to whether the financial statements should be adjusted to reflect the event, even though it has not occurred during the reporting period. Non-adjustment may mislead users of the accounts.

Adjusting events – examples

Adjusting events, as is evident by the name, require adjustments in the financial statements. Following are some examples:

- Invoices received in respect of goods or services received before the year end
- The resolution after the reporting date of a court case giving rise to a liability
- Evidence of impairment of assets, such as news that a major customer is going into liquidation or the sale of inventories below cost
- Discovery of fraud or errors showing that financial statements were incorrect
- Determination of employee bonuses/profit shares
- The tax rates applicable to the financial year are announced
- The auditors submit their fee
- The sale of a non-current asset at a loss indicates that it was impaired at the reporting date
- The bankruptcy of a customer indicates that their debt was irrecoverable at the reporting date
- The sale of inventory at less than cost indicates that it should have been valued at NRV in the accounts
- The determination of cost or proceeds of assets bought/sold during the accounting period indicates at what amount they should be recorded in the accounts

Non-adjusting events – examples

Usually non-adjusting events do not require adjustments. However, if the event is of such importance that its non-disclosure will affect the economic decision making of users it should be disclosed in the notes to the accounts. Some examples of non-adjusting events are as follows:

- Business combinations
- Discontinuance of an operation
- Major sale/purchase of assets
- Destruction of major assets in natural disasters
- Major restructuring
- Major share transactions
- Unusual changes in asset prices/foreign exchange rates
- Commencing major litigation
- A purchase or sale of a non-current asset
- The destruction of assets due to fire or flood
- The announcement of plans to discontinue an operation
- An issue of shares

Going concern

Exception to IAS 10:

Financial statements are prepared on a going concern basis. A post Statement of Financial Position event may indicate that the entity is no longer a going concern (has gone into liquidation).

In this situation the financial statements should be adjusted so that they are no longer prepared on the going concern basis. 'Break up' basis should be adopted instead. This means assets should be recognised at their recoverable amount now.

The fact that company no longer is going concern, is reflected by different indicators e.g. substantial sale of non-current assets without replacement, loss of key staff or markets etc.

Dividends

IAS 10 as revised in 1999 has changed the requirements of the original IAS 10 in this area. It is now **not acceptable** to include dividends declared on equity **after** the reporting date in the Statement of Financial Position as liabilities.

If dividends are declared **before** the year-end then they must be shown in the Statement of Changes in Equity and accrued for in the Statement of Financial Position, as this is the date on which entity has obligation.

Accounting treatment

Adjusting events

The financial statements should be adjusted to reflect adjusting events.

Non-adjusting events

Do not impact going concern → Do not adjust financial statements but disclose event

Impact going concern → Financial statements should be presented on break up basis*

** Financial statements prepared on the break-up basis are not in the F3/FFA syllabus*

Disclosures

Non-adjusting events should be disclosed if they are of such importance that non-disclosure would affect the ability of users to make proper evaluations and decisions. The required disclosure is

(a) the nature of the event and

(b) An estimate of its financial effect or a statement that a reasonable estimate of the effect cannot be made.

A company should update disclosures that relate to conditions that existed at the end of the reporting period to reflect any new information that it receives after the reporting period about those conditions.

Companies must disclose the date when the financial statements were authorised for issue and who gave that authorisation. If the enterprise's owners or others have the power to amend the financial statements after issuance, the enterprise must disclose that fact.

EXAMPLE 1

Which of the following events after the reporting period would be non-adjusting events as defined by IAS 10 Events after the reporting period?

(i) The destruction of a major plant by fire.
(ii) The resolution of a court case giving rise to a liability at the year end.
(iii) The discovery of a fraud showing that the financial statements are incorrect.
(iv) The announcement of a major restructuring.
None of the above affect the going concern assumption.

A (i) and (ii)
B (iii) and (iv)
C (ii) and (iii)
D (i) and (iv)

Answer: Option D

EXAMPLE 2

Which of the following material events that took place after the reporting date, but before the financial statements were approved, are non-adjusting when applying IAS 10 *Events after the reporting period*?
(i) Inventory held at the reporting date was sold for less than cost.
(ii) Capital raised by issuing shares at a premium.
(iii) A company reorganisation which results in discontinuing a line of activity producing 25% of its profit.
(iv) The settlement of a claim for compensation from a former employee wrongly dismissed just before the reporting date.

A (i) and (ii)
B (i), (iii) and (iv)
C (i) and (iii) only
D (ii) and (iii)

Answer: Option D

IAS 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

All of the transactions which we have seen and accounted for in earlier chapters have already happened or been certain to happen, for example sales, purchases, the payment of expenses, accruing for unpaid expenses.

IAS 37 deals with **uncertain** future transactions. Examples may include:

- A business is involved in a court case and may win damages
- A business provides a one year warranty on good sold and may have to meet repair costs.

The issue is whether these uncertain future transactions should be reflected in the financial statements. IAS 37 provides detailed guidance on both **provisions** and **contingent liabilities** (uncertain expenses or losses) and **contingent assets** (uncertain income or gains).

Liabilities of uncertain timing or amount

Provisions	**Contingent liabilities**
A provision is a liability of uncertain timing or amount. A provision is recorded in the financial statements if the following conditions are met: • A present obligation as a result of a past event • A probable transfer of economic benefits • A reliable estimate of the amount can be made.	Contingent liabilities are disclosed by note in the financial statements A possible obligation as a result of a past event whose existence or non-existence will be confirmed by the occurrence or non-occurrence of future uncertain events not under the control of the entity Or A present obligation but *Either* It is not probable a transfer of economic benefits will be required Or A reliable estimate cannot be made. *Exception:* If it is remote that a transfer of economic benefits will occur then the matter is ignored in the financial statements

Provisions and contingent liabilities

Where there is an uncertain future obligation to pay an expense, the likelihood of payment should be assessed

- If there is a **remote** chance of payment, the uncertain obligation should be ignored
- If there is a **possible** chance of payment, the uncertain obligation should be disclosed as a contingent liability in the financial statements, but not accounted for
- If there is a **probable** chance of payment, the uncertain obligation should be provided for in the financial statements, as long as the other conditions to make a provision are met
- Remote, possible and probable are not defined numerically, although probable is 'more likely than not to occur'. It is therefore generally taken as a more than 50% chance of occurring.

Recognition of provisions

An uncertain future obligation is only reflected in the financial statements where:

- There is a present obligation as a result of a past event, and
- It is probable that payment will be made (as mentioned above), and
- A reliable estimate of the amount of payment can be made.

The present obligation can be legal or constructive.

A **legal obligation** is an obligation which derives from a contract or legislation. E.g. a company has breached a contract and is being sued.

A **constructive obligation** is an obligation which derives from an entity's established pattern of practice. E.g. a company has announced publicly that it will make good damage to the environment, even though it is not legally obliged to do so.

Accounting for provisions

A provision is reported as a liability in the statement of financial position. It is created by:

Dr **Expense** category (e.g. legal expenses)
Cr **Provision for expense**

When the provision is used for the purpose it was created, the correct entry is:

Dr **Provision for expense**
Cr **Cash**

If a provision is also required at subsequent period ends after its creation, only the movement in provision should be recorded.

An ***increase*** in provision is recorded by:

Dr **Expense**
Cr **Provision for expense**

A ***decrease*** in provision is recorded by:

Dr **Provision for expense**
Cr **Expense**

Important points:

- A provision should not be recognised for **future operating losses** as there is no present obligation arising as a result of a past event

- An **onerous contract** is a contract where the expected future inflow of economic benefits is less than the avoidable costs under it. A provision should be recognized for expected loss under onerous contract.

- In case of **restructuring** of business, provision should be recognized. A restructuring is a programme that is planned and controlled by management, and materially changes either the scope of a business undertaken by an entity; or the manner in which that business is conducted.

- The provision should be recognized by the costs of restructuring if the following two criteria (both) are met:

    - A detailed formal plan has been made
    - An announcement has been to those being affected by the restructuring

- Contingent liabilities should be disclosed in financial statements unless the possibility of outflow is remote.

CONTINGENT ASSETS

- **Contingent assets** are possible assets arising from a past event, whose existence or non-existence will be confirmed by the occurrence or non-occurrence of future uncertain events not under the control of the entity.
- **Contingent assets** are ignored in the financial statements, except if it is probable that an inflow of economic benefits will arise, in which case the contingent asset can be disclosed by note.
- **Reimbursement:** A business may be entitled to reimbursement of full or partial expenditure related to settle a provision. In this case, provision and reimbursement are separately recognised in financial statements. The reimbursement asset should only be recognised when it is virtually certain that the amount will be received.

Summary

Degree of probability	**Percentage degree of probability**	**Contingent liabilities**	**Contingent assets**
Virtually certain (therefore not contingent)	Probability above 95%	Provide	Recognize
Probable	Probability above 50% and up to 95%	Provide	Disclose by note
Possible	Probability 5% to 50%	Disclose by note	No disclosure
Remote	Probability below 5%	No disclosure	No disclosure

If the receipt is **virtually certain** the asset is not contingent and is recorded by:

Dr **Asset (receivable)**
Cr **Income**

Virtually certain is not defined, although is commonly taken to be more than a 95% likelihood.

Disclosures

Reconciliation for each class of provision by showing opening balance, additions, used (amounts charged against the provision), released (reversed) and closing balance.

Prior year reconciliation is not required.
For each class of provision, a brief description of nature, timing, uncertainties, assumptions, reimbursement and if any
EXAMPLE 3

Which of the following statements are correct?
(i) A liability is a present obligation, arising from past events, the settlement of which is expected to result in an outflow of economic resources.
(ii) An uncertain liability may be called a provision.
(iii) A contingent liability is recognised in the financial statements.

A (i) only
B (i) and (ii) only
C (ii) and (iii) only
D (i), (ii) and (iii)

Answer: Option B

EXAMPLE 4

Which of the following statements about the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are correct?

1. Contingent assets and liabilities should not be recognised in the financial statements.
2. A contingent asset should only be disclosed in the notes to a financial statement where an inflow of economic benefits is probable.
3. A contingent liability may be ignored if the possibility of it crystallising is remote.

A All three statements are correct
B 1 and 2 only
C 1 and 3 only
D 2 and 3 only

Answer: Option A

IFRS 15 – REVENUE FROM CONTRACTS WITH CUSTOMERS

IFRS 15 specifies how and when an IFRS reporter will recognise revenue.

THE FIVE-STEP MODEL FRAMEWORK

The standard provides a single, principles based five-step model to be applied to all contracts with customers.

STEP 1: IDENTIFY THE CONTRACT WITH THE CUSTOMER

A contract with a customer will be within the scope of IFRS 15 if all the following conditions are met:

- The contract has been approved by the parties to the contract;
- Each party's rights in relation to the goods or services to be transferred can be identified;
- the payment terms for the goods or services to be transferred can be identified;
- the contract has commercial substance; and
- It is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

At the inception of the contract, the entity should assess the goods or services that have been promised to the customer, and identify as a performance obligation:

- a good or service (or bundle of goods or services) that is distinct; or
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A series of distinct goods or services is transferred to the customer in the same pattern if both of the following criteria are met:

- Each distinct good or service in the series that the entity promises to transfer consecutively to the customer would be a performance obligation that is satisfied over time; and
- A single method of measuring progress would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

A good or service is distinct if both of the following criteria are met:

- The customer can benefit from the good or services on its own or in conjunction with other readily available resources; and
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Factors for consideration as to whether a promise to transfer the good or service to the customer is separately identifiable include, but are not limited to:

- The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract.
- The good or service does not significantly modify or customise another good or service promised in the contract.

- The good or service is not highly interrelated with or highly dependent on other goods or services promised in the contract.

STEP 3: DETERMINE THE TRANSACTION PRICE

The transaction price is the amount to which an entity expects to be entitled in exchange for the transfer of goods and services. When making this determination, an entity will consider past customary business practices.

Where a contract contains elements of variable consideration (e.g. early settlement discount offered), the entity will estimate the amount of variable consideration to which it will be entitled under the contract.

However, a different, more restrictive approach is applied in respect of sales or usage-based royalty revenue arising from licences of intellectual property. Such revenue is recognised only when the underlying sales or usage occur.

STEP 4: ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS IN THE CONTRACTS

Where a contract has multiple performance obligations, an entity will allocate the transaction price to the performance obligations in the contract by reference to their relative standalone selling prices. If a standalone selling price is not directly observable, the entity will need to estimate it. IFRS 15 suggests various methods that might be used, including:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach (only permissible in limited circumstances).

STEP 5: RECOGNISE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION

Revenue is recognised as control is passed, either over time or at a point in time.

Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly. These include, but are not limited to:

- Using the asset to produce goods or provide services;
- Using the asset to enhance the value of other assets;
- Using the asset to settle liabilities or to reduce expenses;
- Selling or exchanging the asset;
- Pledging the asset to secure a loan; and
- Holding the asset.

An entity recognises revenue over time if one of the following criteria is met:

- The customer simultaneously receives and consumes all of the benefits provided by the entity as the entity performs;
- The entity's performance creates or enhances an asset that the customer controls as the asset is created; or
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time. Revenue will therefore be recognised when control is passed at a certain point in time. Factors that may indicate the point in time at which control passes include, but are not limited to:

- The entity has a present right to payment for the asset;
- The customer has legal title to the asset;
- The entity has transferred physical possession of the asset;
- The customer has the significant risks and rewards related to the ownership of the asset; and
- The customer has accepted the asset.

CONTRACT COSTS

The incremental costs of obtaining a contract must be recognised as an asset if the entity expects to recover those costs.

Costs incurred to fulfill a contract are recognised as an asset if and only if all of the following criteria are met:

- The costs relate directly to a contract (or a specific anticipated contract);
- The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
- The costs are expected to be recovered.

The asset recognised in respect of the costs to obtain or fulfill a contract is amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services to which the asset relates.

PRINCIPLES OF REVENUE RECOGNITION

Sale on return basis

- In case of sale on return basis, an estimate should be made of the amount of goods expected to be returned.
- The most likely amount of return can be determined by past experience or by assigning probability to estimated figures
- For the goods expected to be returned, sale is not recognized. A refund liability is recorded with the amount.
- The right to receive inventory with a corresponding adjustment to cost of sales
- If the item is ultimately not returned, then it will be recognized as sale at the point of confirmation of no return.

Warranty

- In case of option to purchase warranty separately (extended), warranty is distinct and should be recognized as a separate performance obligation

If a customer does not have the option to purchase a warranty separately, an entity shall account for the warranty in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Asset* **Principal versus agent considerations**

- When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (i.e. the entity is a principal) or to arrange for the other party to provide those goods or services (i.e. the entity is an agent).
- An entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if the entity obtains legal title of a product only momentarily before legal title is transferred to a customer.
- When an entity that is a principal satisfies a performance obligation, the entity recognises revenue in the gross amount of consideration to which it expects to be entitled in exchange for those goods or services transferred.
- An entity is an agent if the entity's performance obligation is to arrange for the provision of goods or services by another party. When an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services.

Indicators that an entity is an agent are as follows:

a. Another party is primarily responsible for fulfilling the contract;
b. The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return;
c. The entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited;
d. The entity's consideration is in the form of a commission; and
e. The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

Repurchase agreements

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

Repurchase agreements generally come in three forms:

a. An entity's obligation to repurchase the asset (a forward);
b. An entity's right to repurchase the asset (a call option); and
c. An entity's obligation to repurchase the asset at the customer's request.

IAS 38: INTANGIBLE ASSETS

The accounting issue

Businesses spend money on research and development to produce future benefits. Should the business:
Write off the expenditure to the Statement of Profit or Loss and Other Comprehensive Income in the period in which it is incurred to follow the prudence concept, on the basis that it is not certain that future benefits will arise?

Or
Attempt to match the expenditure to the future benefits by capitalizing the expenditure as an intangible non-current asset as it is incurred and then amortise the asset over the accounting periods to which the benefits relate, in compliance with the matching concept?

Where prudence and matching conflict, prudence normally prevails. IAS 38, however, allows the matching concept to override the prudence concept in limited situations.

Definitions:

- An ***intangible asset*** is defined as an identifiable non-monetary asset without physical substance.
- ***Monetary assets*** – are money held and assets to be received in fixed or determinable amounts of money e.g. receivable balances, cash, bank.
- ***Research*** – original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- ***Development –*** 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 before the start of commercial production or use.

Accounting treatment of research expenditure

All **research** expenditure should be written off to the Statement of Profit or Loss as it is incurred. **This is in compliance with the prudence concept.**

Research expenditure does not directly lead to future benefits and therefore it is not possible to follow the matching concept.

Any capital expenditure on research equipment should be capitalised as normal e.g. a machine purchased to help carry out research should be capitalised as a tangible non-current asset and depreciated over its useful economic life.

Accounting treatment of development expenditure

Development expenditure must be capitalised as an intangible asset provided that certain criteria are met.

The criteria for capitalization are:

- **S**eparate project
- **E**xpenditure identifiable and reliably measured
- **C**ommercially viable
- **T**echnically feasible
- **O**verall profitable
- **R**esources available to complete

Note – once expenditure has been treated as an expense it cannot be reinstated as an asset.
If the above criteria are not met (completely), development expenditure must be written off to the Statement of Profit or Loss and Other Comprehensive Income as it is incurred.

Subsequent treatment of CAPITALIZED development expenditure

- The asset should be amortised over the period that is expected to benefit. This is so that the costs are **'matched'** against the **revenue** in the Statement of Profit or Loss and Other Comprehensive Income.
- Amortisation should commence with commercial production.
- Each project **should be reviewed at each year-end to ensure that the SECTOR criteria are still met**. If the criteria are no longer met, the previously capitalised expenditure must be written off to the Statement of Profit or Loss and Other Comprehensive Income immediately.

If a policy of capitalisation is adopted, it should be applied to all projects that meet the criteria.

Amortisation of intangible non-current assets

As tangible non-current assets are depreciated, so intangible non-current assets are amortised.
The purpose of amortisation is to spread the cost of an intangible asset over its useful life.

Amortisation commences when commercial exploitation of the development project begins. It is accounted for by:

Dr **Amortisation expense (P&L)**
Cr **Accumulated amortisation (SFP)**

Disclosure

For each class of intangible asset, disclose:

- Useful life or amortisation rate
- Amortisation method
- Gross carrying amount
- accumulated amortisation and impairment losses
- Line items in the Statement of profit or loss in which amortisation is included
- Reconciliation of the carrying amount at the beginning and the end of the period showing:
    - Additions (business combinations separately)
    - Assets held for sale
    - Retirements and other disposals
    - Revaluations
    - Impairments
    - Reversals of impairments
    - Amortisation
    - Other changes
- Basis for determining that an intangible has an indefinite life
- Description and carrying amount of individually material intangible assets
- Contractual commitments to acquire intangible assets

Additional disclosures are required about:

- Intangible assets carried at revalued amounts
- The amount of research and development expenditure recognised as an expense in the current period

EXAMPLE 5

Which of the following statements are correct?

(i) The development costs of a product are capitalised so that they can be matched with the future revenue flows from the product.

(ii) Research costs on the future market potential prior to launching a new product, can be capitalised.

(iii) Brands developed by a business can never be capitalised by the business within its own financial statements.

A (i) and (ii) only

B (ii) and (iii) only

C (i) and (iii) only

D (i), (ii) and (iii)

Answer: Option C

Chapter 18

CONSOLIDATION

IN THIS CHAPTER

- **DEFINITIONS**
- **CONTROL**
- **GROUP STRUCTURE**
- **THE NEED FOR GROUP ACCOUNTS**
- **GROUP ACCOUNTING METHODS**
- **CONSOLIDATION METHODS**
- **THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION**
- **NON-CONTROLLING INTEREST**
- **INTER-COMPANY BALANCES, UNREALIZED PROFITS, AND THE CONSOLIDATION SCHEDULE**
- **BASIC RULES – WHOLLY OWNED SUBSIDIARIES**
- **THE CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME**
- **ASSOCIATES**

Scope

The Standards for consolidation should be applied in accounting for a group & also for investment in subsidiary in Parent's separate Financial Statements.

DEFINITIONS

Group of Companies arises when one company (Parent) takes control of another company (subsidiary).

Subsidiary is a company controlled by another company.

Parent is a company that controls one or more entities.

Non-Controlling Interest is a collective representation of the shareholders that normally own 49% or less of equity.

Consolidated Financial Statements: Financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Power: Existing rights that give the current ability to direct the relevant activities

CONTROL

According to IFRS 10 *Consolidated Financial Statements* an investor controls investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Control means power to govern the financial & operating policies of a company to obtain benefit from its activities. A group of companies arises when one company takes control of another. This can happen in a number of ways. The most common way is when one company (the parent) acquires more than 50% of the equity shares of another company (the subsidiary). This gives the parent the majority of the votes, which enables it to appoint the board of directors, which in turn means that it controls the day to day affairs of the company. The other shareholders will normally own 49% or less of the equity shares, and collectively they are known as the **Non- controlling interest.**

Control can exist when a parent owns less than half of the voting power of a company when there is;

- Power over more than half of the voting rights as the result of an agreement with other investors;
- Power to govern the financial and operating policies of the company under the law or an agreement;
- Power to appoint or remove a majority of the directors;
- Power to cast the majority of votes at meetings of the board of directors (IAS 27).

However, all of these situations are based on the idea that one company controls another. It is just means of obtaining control that are different. In the exam you will only be set a computational question on a typical situation where the parent owns the majority of the ordinary shares in the subsidiary.

GROUP STRUCTURE

The group structure is often shown diagrammatically as follows;

Big	Parent
51% ordinary shares	
Small	Subsidiary

This shows that Big own 51% of the ordinary shares of Small. Big is the parent of Small, its subsidiary. Together they from the "The Big Group"; In practice group structures can be a lot more complicated than this, but the FFA/F3 syllabus only covers simple groups.

IFRS 10 states that group accounts must include **all** subsidiaries of the parent.

In practice, there is one exception, if a subsidiary;

- Is held exclusively with a view to disposal within 12 months from acquisition, and
- Has not previously been consolidated, and
- A number of specific conditions are met (for example, management is actively seeking a buyer).

It may be classified as 'held for sale'. A subsidiary that is classified as held for sale is no consolidated, but accounted for under IFRS 5 *Non-current Assets Held for sale and Discounted Operations* (which is outside the scope of the syllabus for this paper).

GROUP ACCOUNTING METHODS

Consolidation is done on the basis of accounting concept of SUBSTANCE OVER FORM.

The following key rules apply under the consolidation method;

- Uniform accounting policies will be applied across the group.
- Inter-company transactions and profits will be eliminated.
- The same year-end will be used across the group. (Sometimes this is not possible for legal reasons. In these cases the consolidated accounts would be based upon interim accounts drawn up to the group Statement of financial position date). Thus, if year-end dates differ, gap should not be more than 3 months and significant transactions between the gaps should be adjusted.

CONSOLIDATION METHODS

Purchase method us used in preparing consolidated accounts. It is based on the concept of single economic entity.

Exemptions from Consolidation

Group accounts do not have to be prepared if;

- The parent is a subsidiary of another entity
- The Non-controlling interest (if any) do not object
- The parent is not listed or about to become listed, and
- The ultimate parent of the group produces group accounts that comply with IFRSs.

In this situation, one set of consolidated accounts is prepared by the ultimate parent for the whole group.

THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

1. At the date of acquisition, the investment by the parent company in the subsidiary company is cancelled of against the equity (share capital, state premium, and retained earnings of subsidiary company. Any excess remaining is known as **goodwill**.
2. All **assets** and **liabilities** of subsidiary company are than added on a line by line basis with the assets and liabilities of the parent company.
3. In the consolidated statement of financial position, the share capital and share premium will ALWAYS be of Parent Co. *only*.
4. If the parent contacts less than 100% of a subsidiary, the remaining investment is known as **non-controlling interest** and a portion of equity shall now be attributable to NCI.
5. **Consideration** might be paid in the following ways:

- **By cash**
  The consideration is calculated by multiplying the number of shares acquired with per share cash paid i.e.

Total no. of shares of subsidiary co. x % holding x cash paid per share.

- **By share for share exchange**

  The consideration is calculated by multiplying the number of shares issued by Parent Co. with per share price of Parent Co. at the date of acquisition. i.e.

No. of shares issued by Parent co. x Parent co. per share price

The calculation is based on fair value of consideration transferred. Therefore, in share for share exchange, the fair value is based on market value of shares given (P. Co) at the date of acquisition.

EXAMPLE
Mountain Co purchased 60,000 Hill Co's ordinary shares on 1st February 20X7. The purchase consideration composed:
- $1.70 cash per share acquired
- Five shares in Mountain Co for every three shares acquired in Hill Co. Mountain Co's shares have nominal value of $1 and fair value of $ 2.50

What is the total amount of consideration transfer red on the acquisition of Hill Co?

Answer: $352,000

6. **Intra-group balances**: Such intra-group balances shall be removed from consolidated statement of financial position (CSOFP) only if the balances reconcile.

Dr. Payables
Cr. Receivables

EXAMPLE

Tomsett Co, a limited liability company, owns 65% of the shares in Frew Co. Frew Co owes Tomsett Co $5,000. Tomsett Co has receivables of $300,000 and Frew Co has receivables of $130,000.
What are the consolidated receivables for Tomsett Co?
Answer: $425,000

EXAMPLE
Berino, a limited liability company, owns 70% of the shares in Muggie. Berino has payables of $244,000. Muggie has payables of $40,000 of which $6,000 is owed to Berino. Berino has receivables of $360,000 and Muggie has receivables of $150,000.

What amounts should be recorded for consolidated receivables and payables in the group accounts of Berino?
Answer: Payables: $278,000Receivables: $504,000

7. Intra-Group unrealized profits

The most important rule to remember is that these rules only apply to inventory on hand at the year-end. Inter-company profits on goods that have eventually been sold onto third parties will have been realized by the year-end and do not cause a problem.

The rules are;
The consolidated inventory value will be reduced by the element of unrealized profit at the year-end. This is known as the *provision for unrealized profit*. It is always deducted from the inventory value in the top half of the Statement of financial position.

- This unrealized profit will also be deducted from the selling company's revenue reserves in the group reserve calculation.

Downstream transactions: if P Co has sold goods to S Co and these goods remain the in inventory at the year end, the profit recognized by the parent Co. Shall be eliminated (No impact on NCI)

Dr. Consolidated Reserves
Cr. Inventory

Upstream transactions: If the S Co. has sold goods to the P.Co. The profits have been earned by the S.Co. and shall be eliminated not only from group reserve but also from NCI
Dr. Consolidated Reserves
Dr. NCI
Cr. Inventories

EXAMPLE

Tree Co. has owned 80% of Plant Co. for several years. During the year Plant Co. sold goods with a sale value of $400,000 to Tree Co. at a markup of 25%. Tree Co. One third of these goods were still in inventory at the year end.

What amount should be deducted from consolidated inventory at the year end?
Answer: Unrealised profit of $30,000

8. Fair Value Adjustment

For Fair value adjustments, revise the fair value of non-current assets and treat the difference as follows:

- Increase/ Decrease the value of non-current asset as per the fair value difference
- The fair value adjustment should be included in the calculation of goodwill.

Any additional depreciation due to fair value adjustment will be subtracted from the carrying value of non-current assets and consolidated reserves.

9. Intra-group loans: The portion of loan given by the P. Co to its subsidiary is an intra-group receivable, payable and shall be eliminated as such.

Dr. Loan liability
Cr. Loan Asset

Any interest receivable payable on such loans shall also be eliminated but only to the extent related to the parent

Dr. Interest payable
Cr. Interest receivable

If the P.Co has not recorded interest receivable on loans given to the sub Co. the first treatment is to record the interest receivable.

Dr. Interest receivable
Cr. Consolidated reserves

After this an intra-group interest receivable payables exists which shall be eliminated

Dr. Interest payable
Cr. Interest receivable

If P. Co. Has recorded the receivable but subsidiary company has not included a payable in its own financial statements, first treatment is to record the interest payable.

After this an intra-group interest receivable, payable asset which shall be eliminated.

10. Intra-group dividends: If the parent Co has not recorded the dividend recoverable the first treatment is to record the receivables.

Dr. Dividend receivable
Cr. Consolidated reserve

After this an intra-group, dividends receivable/payable exists which shall be eliminated:

Dr. Consolidated reserves
Dr. Non-Controlling Interest
Cr. Dividend payable

11. Redeemable Preference Shares: Treat like any other long-term loan i.e. eliminate as an inter-company loan and adjust for any interest accrual.

12. Full or fair value of Non-Controlling Interest: IFRS-3, allows/requires goodwill to be stated at full value i.e. a part of goodwill shall now be attributable to NCI.

Now goodwill impairment shall be charged not only to be parent company but also to NCI

Dr. NCI
Dr. Consolidated Reserves
Cr. Goodwill

<u>Goodwill in consolidated Statement of financial position</u>:

Acquisition-date Fair values of consideration transferred by parent	X	
Plus: Fair (or full) value of the NCI at date of acquisition		X
Less: Fair value of subsidiary's identifiable net assets at date of acquisition	<u>(X)</u>	
Equals: Total Goodwill		**X**

Pre and Post Acquisition Reserves
Subsidiaries have usually traded on their own account before they are acquired by their new parent, and so they will already have a balance on their revenue reserves. On acquisition, this balance is frozen and does not form part of group reserves. This is because these profits have been bought rather than earned. Only the post acquisition reserves have been earned by the group when the subsidiary was part of the group and so they will be included as part of the group reserves.

Goodwill is the difference between the fair value of the consideration and the fair value of the net assets acquired.

The detailed format for calculating goodwill is as follows:

Cost of investment by Parent Co.	X	
Fair value of NCI at the date of acquisition	<u>X</u>	XX
Fair value of net assets of subsidiary co.		
Share capital	X	
Share premium	X	
Pre-acquisition retained earnings	X	
Pre-acquisition revaluation reserve	X	
Fair value adjustment	<u>X/(X)</u>	<u>(XX)</u>
GOODWILL		**XX/(XX)**

The accounting treatment for goodwill is set out in IFRS 3 *Businesses Combinations.* Goodwill, like all assets, must be capitalized at its cost as calculated on the day of acquisition.

EXAMPLE

Kinder Co has 5 million $1 issued ordinary shares. At 1 May 2010 Peak Co purchased 60% of Kinder Co's $1 ordinary shares for $4,000,000. At that date Kinder Co had net assets with a fair value of $4,750,000 and a share price of $1·10. Peak Co valued the non-controlling interest in Kinder Co at acquisition as $2,200,000.

What is the total goodwill on acquisition at 1 May 2010?

Answer: $1,450,000

EXAMPLE

Scarfell has 10 million $1 issued ordinary shares. At 1 May 20X9 Snowdon purchased 70% of Scarfell's $1 ordinary shares for $8,000,000. At that date Scarfell had net assets with a fair value of $8,750,000 and its share price was $1·20. It is group policy to value the non-controlling interest at the fair value of the subsidiary's identifiable net assets using the market value of the shares at acquisition.

What was the total goodwill arising on acquisition at 1 May 20X9?
Answer: $2,850,000

Bargain Purchase Gain

Sometimes a company may be purchased for less than the fair value of its net assets. This may happen if the company is in financial difficulties and the only option for the present owners is to sell the company as quickly as possible. In these situations Bargain Purchase Gain (negative goodwill) arises. IFRS 3 states that it should be recognized immediately in the Statement of Profit or Loss as a gain.

NON-CONTROLLING INTEREST (NCI)

IAS – 27 defines non-controlling interest as the equity in a subsidiary not attributable, directly or indirectly, to a parent.

The calculation of NCI is done as follow:

Fair value of NCI	X
Plus NCI's share of post-acquisition retained earnings	X
Adjustments	X/(X)
-	XX

EXAMPLE

Katwal Co. acquired 70% of Berta Co.'s 200,000 shares for $360,000 on 1st July 20x6. At that date, market price of Katwal's share was $4.2 per share and that of Berta was $3 per share. Berta's retained earnings at the date of acquisition were of $250,000.The retained earnings of Berta Co. at 30 June 20x7 were $320,000.

At what value will the non-controlling interest be presented in statement of financial position at 30 June 20x7?

Answer: $201,000

CONSOLIDATED RETAINED EARNINGS

Parent Co. Total retained earnings	X
Group share of post-acquisition retained earnings	X
Adjustments (e.g. unrealised profit)	X/(X)
	XX

Note: See TWO Examiner's articles at the end of the chapter for a detailed revision of concepts of consolidation by Financial Accounting examiner.

THE CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

- The basic idea is to show the results of the group as if it were a single entity.
- The majority of figures are simple aggregations of the results of the parent and all the subsidiaries (line by line) down to profit after tax.
- In aggregating the results of the parent and subsidiaries, intra-group transactions such as dividend income, interest income and unrealised profits are eliminated.
- Any non-controlling interest is ignored until profit after tax. Their interest in profits after tax is then subtracted as a one-liner to leave profits attributable to members of the parent.

OTHER ADJUSTMENTS

- If the subsidiary is acquired during the current accounting period it is necessary to apportion the profit for the period between its pre-acquisition and post-acquisition elements. This is dealt with by determining on a line-by-line basis the post-acquisition figures of the subsidiary.
- After profit after tax in consolidated statement of profit or loss, total profits are divided between profits attributable to group and profit attributable to NCI
- Any dividend income in the parent must be cancelled against dividends paid from the subsidiary undertaking.
- Where group companies trade with each other one will record a sale and the other an equal amount as a purchase. These items must be removed from the consolidated statement of profit or loss by cancelling from both sales and cost of sales.
- The unrealized profit adjustment is to increase cost of sales. In case of upstream transaction, the unrealized profit is deducted from profit attributable to NCI also.
- Investment in loans means an intra-group finance cost as well as inter-group dividends.
- These will cancel out in basically the same way as for dividends.
- There is no impact of fair value adjustment on acquisition at the statement of profit or loss. However, any additional depreciation related to such fair value adjustment must be charged by adding to cost of sales and deducting from profit after tax of subsidiary while calculating profit attributable to NCI

P group plc - Pro-forma Consolidated statement of profit or loss
For year ended 30 November 20X6

	$'m
Sales revenue (P+S less intra-group sales)	X
Cost of Sales (P+S less intra-group purchases plus unrealised profit in inventory)	(X)
Gross Profit	X
Distribution Costs (P+S)	(X)
Administrative Expenses (P+S)	(X)
Group operating Profit	X
Interest and similar income receivable (P+S less intra group interest income)	X
Interest expenses (P+S less intra-group interest expense)	(X)
	X
Share of Profits of Associate (PAT)	X
Profit before tax	X
Income tax expense (P+S)	(X)
Profit for the period	X
Profit attributable to :	
Owners of the parent	X
Non-controlling interest	X
	X

TYPES OF INVESTMENTS

There are a number of levels of investment that one company can have in another.

A **simple trade investment** would be for a small proportion of the share in a company. The investing company would account for the investment at cost in its statement of financial position and record its share of any dividends received in the statement of profit or loss.

A **subsidiary** is where the investing company controls its investment.

ASSOCIATES

In practice there are many investments that are half way between these two extremes. These are major long-term investments over which the investing company has significant influence but not control. These are called associates and they are accounted for using the **equity method** as set out in **IAS 28** ***Investment Associates.***

Definition of an Associate

An associate is an entity in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Significant influence is the power to participate in the financial and operating policy decisions of the investee.

A holding of between 20% and 50% of the voting power (equity) of the investee usually gives the investor significant influence.

Significant influence can also be indicated by;

- Participation in policy making (including decisions about dividends and other distributions).
- Representation on the board of directors of the other company.
- Material transactions between the investor and the investee
- Interchange of managerial personnel, and
- Provision of essential technical information.

Equity Accounting for Associates

In the investing company's own financial statements an investment in an associate would be recorded at cost in the Statement of financial position, and the Statement of profit or loss would show the dividends received.

If the investing company is already preparing group accounts for its subsidiaries, then it must also account for the associates using the equity method.

Equity Method

Under the equity method the investing group accounts for its share of the profits and net assets of the associate. The method to calculate value of investment is mentioned below;

Associate companies in the group Statement of financial position;

		$
Cost of investment in Associate	X	
Share of post-acquisition retained earnings	X	
Adjustments	X/(X)	
Carrying value of the associate in the Statement of financial position		XX

Associate companies in the group profit and loss account;

The dividend income from the associate is eliminated. It is replaced by group's share of the associate's profits. The Statement of profit or loss will record the group's share of the associate's profit for the year as one line before profit before tax.

The cost of the investment in the associate and the dividend income from the associate are eliminated, but any other inter-company items are not cancelled. The share of profit after tax from associates is credited in consolidated retained earnings.

EXAMPLE

At 1 July 20X9 Conga Group acquired 25% of the ordinary share capital of Eel Co for $960,000 when the reserves of Eel Co were $1,080,000. Eel Co appointed two of Conga Group's directors to the board of Eel Co. Both companies prepare accounts to 31 May each year. The summarised statement of financial position for Eel Co at 31 May 2010 is as follows:

		$000
Called up share capital	1,200	
Share premium account	675	
Retained earnings		1,710
		3,585

Eel Co has not issued any new shares since Conga Group acquired its holding.

What amount of investment in Eel Co will appear in the consolidated statement of financial position of Conga Group at 31 May 2010?

Answer: $1,117,500

EXAMPLE

Which of the following statements is/are incorrect?

1. P owns 45% of the ordinary share capital of S, which means that S is an associate of P
2. Y can appoint 4 out of 7 directors to the board of X, which means that Y has control over X
3. Q has the power to govern the financial and operating policies of R, which means that R is an associate of Q
4. I owns 19% of the share capital of J, but by agreement with the majority shareholder, has control over the financial and operating policies of J, so J is an associate of I

a) 1 and 2 only
b) 1, 2 and 3 only
c) 3 and 4 only
d) 4 only

Answer: Option C

COMPREHENSIVE EXAMPLE

You are presented with the following the following information for Bradshaw Co. and its subsidiary, Martin;

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 OCTOBER 20X9

	Bradshaw	***Martin***
	$000	***$000***
Revenue	125,000	77,900
Cost of sales	(65,000)	(38,500)
Gross profit	60,000	39,400
Distribution costs	(6,750)	(8,050)
Administrative expenses	(17,500)	(9,780)
Finance cost	--	(20)
Income from Martin; Loan note interest	15	--
Dividends	5,200	--
Profit before tax	40,965	21,550
Income tax expense	(19,250)	(10,850)
Profit for the year	21,715	10.700

STATEMENTS OF FINANCIAL POSITION AS AT 31 OCTOBER 20X9

		Bradshaw	***Martin***	
ASSETS	***$000***	***$000***	***$000***	***$000***
Non-current assets				
Property, plant and equipment		75,000		31,901
Investments:				
$1 ordinary shares in Martin at cost		34,000		--
Martin loan notes		150		
		109,150		31,901
Current assets:				
Inventory, at cost	9,750		4,162	
Receivables	17,125		11,325	
Cash and cash equivalents	3,150	30,025	1,255	16,742
Total assets		139,175		48,643
EQUITY & LIABILITIES				
Capital & Reserves				
$1 Ordinary shares		77,000		23,150
Retained earnings		35,362		9,538
Total equity		112,362		32,.688
Non-current liabilities				
10% Loan note		--		200
Current liabilities				
Payables	16,613		9,500	
Tax	10,200		6,255	
Total liabilities		26,813		15,755
Total equity and liabilities		139,1754		48,643

The following information is also available:

1. Bradshaw purchased 18,520,000 $1 ordinary shares in Martin on 1 November 20X8. At that date Martin's retained earnings were $5,338,000.
2. It is group policy to value the non-controlling interest at full fair value. The value of the non-controlling interest at the acquisition date was $7,408.
3. Bradshaw owns $150,000 of Martin's loan notes. The annual interest of $15,000,000. Bradshaw made a profit of these goods of $2,500,000. Martin still has all these goods in inventory at 31 October 20X9.
4. During the year ended 31 October 20X9 Bradshaw sold goods to Martin for $15,000,000. Bradshaw made a profit on these goods in inventory at 31 October 20X9.
5. At 31 October 20X9 Martin owed Bradshaw $3,000,000 for some of the goods that Bradshaw supplied during the year.
6. All Martin's dividends of $6,500,000 were paid in the financial year ended 31 October 20X9.

Required:

a. Calculate the goodwill arising on the acquisition of Martin as at 1 November 20X8.
The following mark allocation is provided as guidance for this requirement:

b. Prepare the following financial statements of Bradshaw:

i. The consolidated statement of profit or loss for the year ended 31 October 20X9.

ii. The consolidated statement of financial position as at 31 October 20X9.

EXAMINER ARTICLE 1

Although 2011 saw a number of new accounting standards issued in respect of groups, throughout 2012 the Paper F3/FFA syllabus still continues to examine the principles contained in:

- IAS 27, Consolidated and Separate Financial Statements
- IAS 28, Investments in Associates
- IFRS 3, Business Combinations

From December 2011, Paper F3/FFA saw two main new examinable areas added to its syllabus – the preparation of simple consolidated financial statements and the interpretation of financial statements.

This article focuses on some of the main principles of consolidated financial statements that a candidate must be able to understand and gives examples of how they may be tested in multiple-choice questions (MCQs).

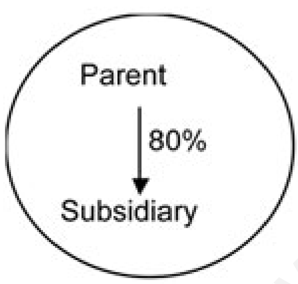
It does not attempt to cover every technical aspect of consolidation, but to give candidates the tools they need to prepare for the style and level of testing, they can expect to see in this paper.

(1) How is a parent-subsidiary relationship identified?

IAS 27 defines consolidated financial statements as 'the financial statements of a group presented as those of a single economic entity.'

A group is made up of a parent and its subsidiary.

Illustration 1 shows an example of a typical group structure.



The illustration shows how a parent company has control over a subsidiary. At Paper F3 level, it is assumed that control exists if the parent company has more than 50% of the ordinary (equity) shares – ie giving them more than 50% of the voting power.

However, there are examples where a holding of less than 50% of the ordinary shares can still lead to control existing. This may be because the parent has:

- The power over more than 50% of the voting rights by virtue of agreement with other investors
- The power to govern the financial and operating policies of the entity under statute or an agreement
- The power to appoint or remove the majority of the members of the board of directors, or
- The power to cast the majority of the votes at meetings of the board of directors.

A typical MCQ may describe a number of different investments and you would need to decide if they are subsidiaries – i.e. if control exists. Illustration 2 is an example of a typical question.

Illustration (2)

Green Co owns the following investments in other companies:

	Equity shares	Non-equity shares held
Violet Co	80%	Nil
Amber Co	25%	80%
Black Co	45%	25%

Green Co also has appointed five of the seven directors of Black Co.

Which of the following investments are accounted for as subsidiaries in the consolidated accounts of Green Co Group?

- **A.** Violet only
- **B.** Amber only
- **C.** Violet and Black
- **D.** All of them

Answer

Let's consider each of the investments in turn to determine if control exists and, therefore, if they should be accounted for as a subsidiary.

- Violet Co – by looking at the equity shares, Green Co has more than 50% of the voting shares – ie an 80% equity holding. This gives them control and, therefore, Violet Co is a subsidiary.
- Amber Co – you must remember to look at the equity shares, as despite having the majority of the non-equity shares, these do not give voting power. As Green Co only has 25% of the equity shares, they do not have control and, therefore, Amber Co is not a subsidiary.
- Black Co – by looking at the percentage of equity shares, you may incorrectly conclude that Black Co is not a subsidiary, as Green Co has less than half of the voting rights. However, by looking at the fact that Green Co has appointed five of the seven directors, effectively they have control over the decision making in the company. This control should make you conclude that Black Co is a subsidiary.

Therefore the correct answer is C.

Illustration (3)

Pink Co acquired 80% of Scarlett's Co ordinary share capital on 1 January 2012.
As at 31 December 2012, extracts from their individual statements of financial position showed:

	Pink c	Scarlett Co
	$	$
Current assets: Receivables	50,000	30,000
Current liabilities: Payables	70,000	42,000

As a result of trading during the year, Pink Co's receivables balance included an amount due from Scarlett of $4,600.

What should be shown as the consolidated figure for receivables and payables?

	Receivables	Payables
	$	$
A.	80,000	112,000
B.	75,400	112,000
C.	74,000	103,600
D.	75,400	107,400

Answer

From the question, we can see that Pink Co has control over Scarlett Co. This should mean that you immediately consider adding together 100% of Pink Co's balances and Scarlett Co's balances to reflect control.

However, the intra-group balances at the year end need to be eliminated, as the consolidated accounts need to show the group as a single economic entity – in other words, the group position with the outside world.

As Pink Co shows a receivable of $4,600, then in Scarlett Co's individual accounts there must be a corresponding payable of $4,600. When these balances are eliminated, the consolidated figures become:

Receivables ($50,000 + $30,000 – $4,600) = $75,400

Payables ($70,000 + $42,000 – $4,600) = $107,400

Therefore, the correct answer is D, not A which completely omits the elimination of the intra-group balances, nor answer B which omits to cancel the corresponding payable within liabilities.

You would not select answer C, which incorrectly adds 100% of Pink Co (the parent) and only 80% of Scarlett Co (the subsidiary).

(3) Adjustments for unrealised profits

Another common adjustment that you could be asked to deal with is the removal of unrealised profit. This arises when profits are made on intra-group trading and the related inventories have not subsequently been sold to customers outside the group.

The following illustration demonstrates this in the context of the consolidated income statement.

Illustration (4)

Purple Co acquired 70% of the voting share capital of Silver Co on 1 October 2011.

The following extracts are from the individual income statements of the two companies for the year ended 30 September 2012:

	Purple Co	Silver Co
	$	$
Revenue	79,300	29,900
Cost of sales	(54,990)	(17,940)
Gross profit	24,310	11,960

Purple Co had made sales to Silver Co during the year of $5,000. Purple Co had originally purchased the goods at a cost of $4,000. Half of these items remained in inventory at the year end.

What should be the consolidated revenue for the year ended 30 September 2012?

- **A.** $104,700
- **B.** $95,230
- **C.** $108,700
- **D.** $104,200

Answer

Even though this question requires an extract from the consolidated income statement, the principle is still the same as Illustration (3) – consolidate the group as if it is a single economic entity by adding in 100% line by line, and showing group performance with the outside world.

Therefore, answer B would not be selected as it incorrectly adds 100% of Purple Co and only 70% of Silver Co.

The other adjustment that requires careful consideration is the intra-group trading. In the consolidated income statement we must always consider two steps:

- Has there been any intra-group trading during the year, irrespective of whether the goods are included in inventory?
- Do any of the items remain in inventory at the end of the year?

In this question, $5,000 of sales have been made from Purple Co selling to Silver Co. This must be eliminated, irrespective of whether the items remain unsold at the year end. This is because the consolidated income statement needs to show revenue (and costs of sales) and, therefore, performance with the outside world.

The second step here is to identify the provision for unrealised profit. Purple Co has made a profit of $1,000 (calculated as revenue of $5,000 – cost of $4,000). As only half of the items remain in inventory, their value is overstated by half of that profit – that is, $500. Note: in many Paper F3 questions, you will be expected to calculate the profit made by using margins or mark-ups, which are not discussed here.)

The consolidation adjustment, in effect, is saying that the group has made a profit of $500 on items, which have not been sold on to a third party – so effectively selling inventory at a profit to itself, therefore inflating the value of the inventory held by the group in the statement of position and the profit in the income statement.

The adjustment would be:

Cr. Inventory (CSOFP)	$500
Dr. Cost of sales	$500

However, by reading the question stem carefully, you will see that eliminating the unrealised profit is a red herring, as we are being asked for consolidated revenue.

Therefore, the consolidated revenue is calculated as:
$79,300 + $29,900 – $5000 = $104,200

The correct answer is D.

Had the question stem asked for the consolidated cost of sales figure, the answer would be correctly calculated as:

$54,990 + $17,940 + $500 – $5,000 = $68,430

Note: Answer A is incorrect, as although it correctly cancels the intra-group sale of $5,000, it incorrectly adds the $500 adjustment for unrealised profit to the revenue figure ($79,300 + $29,900 – $5,000 + $500 = $104,700)

Answer C is also incorrect because it omits the cancelling of $5,000 sales and deals incorrectly with the provision for unrealised profit of $500. ($79,300 + $29,900 – $500 = $108,700).

(4) How is goodwill calculated?

Another typical Paper F3 question will require you to calculate goodwill.

Under this syllabus, only the full goodwill method is examinable and is calculated as:

		$
(1)	Fair value of consideration transferred	X
(2) Plus:	Fair value of non-controlling interest	X
(3) Less:	Fair value of net assets at acquisition	X
	Goodwill at acquisition	X

Even though we only own 80% of the share capital, the full goodwill method brings 100% of the goodwill on to the consolidated statement of financial position. This is consistent with the treatment of other assets and the concept of control. This is why we need to include the fair value of the non-controlling interest in our goodwill calculation. See Illustration 5 below for a typical MCQ on goodwill.

Illustration (5)

Red Co acquired 80% of Blue Co's 40,000 $1 ordinary share capital on 1 January 2012 for a consideration of $3.50 cash per share.

The fair value of the non-controlling interest was $50,000 and the fair value of the net assets acquired was $145,000.

What should be recorded as goodwill on acquisition of Blue Co in the consolidated financial statements?

- **A.** $17,000
- **B.** $45,000
- **C.** $46,000
- **D.** $112,000

Answer

Goodwill can be tested in a variety of different ways. Always start by reading the question requirement carefully to determine what is being asked for. Here, in this specific question, it is the goodwill on acquisition that is being asked for, whereas other questions may ask for the cost of investment that would be recorded in the parent's books.

If we consider each component in turn, the first thing to identify is how much the parent company has paid to acquire control over the subsidiary. In this question, Red Co acquires control by paying $3.50 cash per share.

Remember: Red Co has only acquired 80% of Blue Co's shares, so consideration transferred is 80% x 40,000 = 32,000 x $3.50 = $112,000.

Had the question asked for the cost of the investment that would be recorded in the parent's books this would be it – hence the inclusion of the distracter, the incorrect answer D.

Secondly, once we have identified the amount of consideration transferred to acquire control over the subsidiary, the fair value of the non-controlling interest needs to be identified. In this question the fair value of the non-controlling interest is given, so in our calculation we just need to add it to the consideration transferred.

In the final part of the calculation, following on from the point just made, it is necessary to look at all (100%) of the fair value of net assets at acquisition. Again this figure is given in this question and just requires slotting into our goodwill working. In other MCQs, you may be expected to do more work on finding the fair value of the net assets at acquisition.

Goodwill can then be calculated as:

	$
Consideration transferred	112,000
Plus: Non-controlling interest	50,000
	162,000
Less: fair value of net assets at acquisition	(145,000)
	17,000

The correct answer is A.

Note: Answer B ignores that Red Co only acquired 80% of the shares and calculates the cost of investment incorrectly as 40,000 x $3.50 = $140,000 – therefore, goodwill of $140,000 + $50,000 – $145,000 = $45,000.

Answer C is incorrect as, despite calculating the cost of investment correctly as $112,000 + non controlling interest of $50,000 = $162,000, it incorrectly deducts (80% x $145,000) as the share of net assets at acquisition giving goodwill of $46,000.

(5) What is an associate and how does equity accounting work?
We began this article with consideration of how to identify a subsidiary, and we conclude it with consideration of a relationship between a parent and an associate.

The Paper F3 syllabus is limited to the definition and identification of an associate and describing the principle of equity accounting only.

An associate is defined by IAS 28, Investments in Associates as 'an entity over which the investor has significant influence'.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control over those policies.

IAS 28 also states that a holding between 20% and 50% of the ordinary (equity) shares can be presumed to give the investor significant influence unless it can be demonstrated otherwise.

Conversely, significant influence can still be demonstrated where less than 20% of the voting rights are obtained, usually evidenced by:

- Representation on the board of directors of the investee
- Participation in the policy-making process
- Material transactions between the investor and investee
- Interchange of management personnel
- Provision of essential technical information.

Once we have identified an associate exists, we do not consolidate line by line like we do for a subsidiary (neither do we calculate goodwill). This is simply because we do not have control.

For an associate we have to equity account, which means we simply bring in our share of the associate's results. In the consolidated income statement, any dividend income received from the associate is replaced by bringing in one line that shows the parent's share of the associate's profit.

In the consolidated statement of financial position, the investment in the associate is shown as a single figure in non-current assets. It is calculated as the cost of the investment + parents share of post-acquisition retained profits (ie the profits the associate has earned since the parent has had significant influence).

Illustration (6)

Which of the following investments owned by Indigo Co should be equity accounted in the consolidated financial statements?

- 30% of the non-voting preference share capital in Yellow Co
- 18% of the ordinary share capital in Blue Co with directors of Indigo Co having two of the five places on the board of Blue Co
- 45% of the ordinary share capital of Red Co, with directors of Indigo Co having four of the six places on the board of Red Co

A. 1 and 2
B. 2 only
C. 1 and 3 only
D. 2 and 3 only

Answer

Statement (1): Although a 30% holding appears to fall within the 20–50% range, it is a 30% holding in non-voting preference share capital. These do not give Indigo Co significant influence over Yellow Co and, therefore, Yellow Co is not an associate and would not be equity accounted.

Statement (2): Despite only 18% of the ordinary share capital being held by Indigo Co, as we have already discussed, we do not just consider the percentage of equity shares held, but also look at whether there can be an exercise of significant influence. Having two out of the five directors effectively gives Indigo Co influence, but not control, over decision making in the company and, therefore, Blue Co is an associate and would be equity accounted.

Statement (3): Don't just look at the 45% holding and presume it is an associate without considering the other facts. By looking at the ability to appoint directors shows that Indigo Co has four of the six directors, effectively giving them control over the decision making in the company. Having control should make you spot that actually Red Co is a subsidiary and, therefore, would be consolidated line by line in the group accounts and would not be equity accounted.

Therefore, the correct answer is B – Statement 2 only.

(6) Concluding exam tips

Remember that at Paper F3/FFA, despite the current exam format testing MCQ only, a good solid platform of understanding the principles of consolidation is required.

Although you are only being asked for extracts and calculations of typically one figure, learning standard consolidation workings can help with your exam approach.

Practising full length consolidation questions will help you grasp a better understanding of consolidation. It is important to understand how each calculation fits into the consolidated financial statement, and this will also benefit your future studies when you revisit consolidation in your later Paper F7 and Paper P2 studies.

When answering MCQs, remember to:

- Read the questions requirement carefully and understand what is being asked for
- Think about relevant consolidation workings or extracts that may help you
- Calculate what you think the correct figure is before you look at MCQ answer options – be careful not to let the distracters catch you out, so think carefully about your calculation
- Re-read the question to ensure you understand it and check you are answering the question set if your initial calculation does not match any of the answer options.

EXAMINER ARTICLE 2

ASSETS AND LIABILITIES

When preparing a group statement of financial position the assets and liabilities of the parent and the subsidiary are subject to consolidation adjustments and then added together. For example, as the objective of the exercise is to prepare the group statement of financial position as if the group were a single entity, it is necessary to eliminate the balances on any intra-group current accounts as the group should only be reporting external assets and liabilities. In addition it is also necessary to recognise any fair value adjustments (FV) that will have arisen on the subsidiary's net assets at the date on acquisition and to replace the parent's investment in the subsidiary with the goodwill arising on consolidation.

EQUITY

In Paper F3, the equity section of the group statement of financial position will contain the share capital and share premium of the parent only. It may also be necessary to ascertain the post-acquisition profits of the subsidiary as this will be shared between the owners of the subsidiary – ie will be split between the parent in the group retained earnings (RE) and non-controlling interest (NCI) in the proportion that they share profits and losses.

The following example explains the whole process by taking you through an exercise where all of these issues feature.

Question:

Two years ago Singapore paid $90,000 for a controlling interest of 80% in the Marina Bay's equity when the retained earnings were $25,000. The summarised statement of financial positions at the reporting date are as follows:

	Singapore	Marina bay
	$	$
Investment in Marina Bay	90,000	
Property plant & equipment	30,000	30,000
Current assets	30,000	30,000
	150,000	60,000
Equity shares	25,000	15,000
Retained earnings	100,000	40,000
	125,000	55,000
Liabilities	25,000	5,000
	150,000	60,000

Additional information

I. At the date of acquisition the fair value of the NCI of Marina Bay was measured at $20,000
II. For consolidation purposes at the date of acquisition the fair value of the non-depreciable land of Marina Bay exceeded its carrying value by $25,000. Marina Bay has not incorporated this fair value adjustments into its individual financial statements.
III. At the reporting date Singapore is owed $5,000 by Marina Bay.

Required – Prepare the Singapore group statement of financial position.

Answer

In approaching such a question there are regular workings that have to be processed. It is necessary to establish the post-acquisition profits of the subsidiary (which are then split between the group and the NCI), the goodwill arising on acquisition as well as the closing balances of the NCI and group retained earnings. It is a good habit to first prepare a working showing the group structure to ensure that we have noted the parent's and the NCI's interest in the subsidiary's profits and how long the subsidiary has been a member of the group.

W1 Group structure

	Singapore (the parent)	
Two years ago	↓	80% / 20% NIC
	Marina Bay (the subsidiary)	

In the next working the fair value of the net assets of the subsidiary at the date of acquisition are established by taking into account the fair value adjustment on the land. The post-acquisition profits of the subsidiary are also determined and split between parent and the NCI in the proportion of their shareholdings. The net assets of the subsidiary are represented by its equity. Note that the subsidiary's net assets at the date of acquisition need a fair value adjustment on its PPE. This adjustment is still necessary at the reporting date as the asset is still held.

W2 Net assets of the subsidiary

	At acquisition	At reporting date	Post-acquisition
	$	$	$
Equity shares	15,000	15,000	15,000
Retained earnings	25,000	40,000	15,000
Book value of the net assets	40,000	55,000	
Fair value adjustment on PPE	25,000	25,000	
Fair value of the net assets	65,000	70,000	

From this we can see the subsidiary's post-acquisition profits are $15,000. These belong to, and so are allocated, 80% to the group's retained earnings and 20% to the NCI. Further we can note that the net assets of the subsidiary at acquisition is $65,000, a key figure for the calculation of goodwill which is our next working. In some questions the fair value of the net assets at acquisition might be given (in this case $65,000) and, so, the FV on the land ($25,000) is ascertained as a balancing figure in the net assets at acquisition column.

Now the goodwill (the premium arising on consolidation) can be ascertained by comparing the value of the whole business as represented by what the parent paid for its controlling interest combined with the NCI, set against the fair value of the identifiable net assets of the subsidiary.

W3 Goodwill

	$
FV of Parent's investment at acquisition – the controlling interest	90,000
NIC # FV at acquisition – the non-controlling interest	20,000
FV of Net assets at acquisition (w2)	(65,000)
Goodwill arising on consolidation	45,000

The next working in line is to determine the NCI at the reporting date. This is done by taking account of the entries that we have already seen above. NCI is part of equity (the ownership) of the group and so the opening balance at the date of acquisition will increase with its share of any profits and decrease with any share of losses.

W4 NCI

	$
Opening balance w3	20,000
Plus NIC% of post-acquisition profit (20% x 15,000) w2	3,000
	23,000

Our final working is the retained earnings of the group which comprises the parent's retained earnings plus its share of the subsidiary's post-acquisition profits and losses from the above workings.

W5 Group retained earnings (RE)

	$
Parent	100,000
Plus the % of post-acquisition profit (80% x 15,000) w2	12,000
	112,000

Finally the group statement of financial position can be prepared. The parent's investment in the subsidiary is eliminated as an intra-group item and is replaced with the goodwill. The assets and liabilities are then added together in full, as despite the parent only owning 80% of the shares of the subsidiary, the subsidiary is fully controlled. The non-controlling interest in the subsidiary's net assets is separately reported. There is a consolidation adjustment in respect of the fair value adjustment on the PPE. Because at the reporting date Singapore is owed $5,000 by Marina Bay this is an intra-group item and this receivable is eliminated from the group accounts as a consolidation adjustment. It also means that Marina Bay will have a payable to Singapore of the same amount which will also be eliminated as a consolidation adjustment.

Singapore group statement of financial position

		$
Goodwill	W3	45,000
Property plant &	(30,000 + 30,000 + fair value) adjustment 25,000	85,000
Current assets	(30,000 + 30,000 less 5,000 inter - company)	55,000
		185,000
Equity shares	(parent only)	26,000
Retained earnings	W5	112,000
NIC	W4	23,000
Equity		160,000
Liabilities	(25,000 + 5,000 less 5,000 intra-group)	25,000
		185,000

Chapter 19

ANALYSIS OF FINANCIAL STATEMENTS

IN THIS CHAPTER

- **THE INTERNAL AND EXTERNAL USERS OF ACCOUNTING INFORMATION**
- **TECHNIQUES OF INTERPRETATION**
- **RATIO ANALYSIS**
- **TYPES OF RATIOS**

THE INTERNAL AND EXTERNAL USERS OF ACCOUNTING INFORMATION

We have already discussed the users of accounting information in earlier chapters. The main uses we will normally be concerned with are management, lenders and shareholders (including potential shareholders).

The needs of the main users are as follows:

User Group	Information Needs
Current (and future) investors and investment analysts	They need to access the financial performance of organization to understand the level of risk and the returns provided by their investment. Also for Investment decisions-buying and selling shares Key information requirements: ability to generate cash, level of profitability, and dividends.
Lenders	They need information on the ability of the organization to repay, loans and any interest. Thus, for borrowing and credit purposes Key information: profitability, ability to manage working capital (liquidity), current level of borrowing, value of assets.
Customers	Customers that are dependent on the organization for significant levels of business or are considering placing long term contracts will need to know whether it will stay in business or not. Key information requirements: ability to generate cash, and profitability
Suppliers (and trade creditors)	They will want to know whether the organization will stay in business & whether they will be paid. Key information requirements: ability to generate cash, & profitability.
Management	They need information for control of costs and improved profitability, which is also their key information requirement.

TECHNIQUES OF INTERPRETATION

Factors that need to be considered include;

- Markets in which the business operates
- General economic conditions
- Size of business in relation to competitors

RATIO ANALYSIS

Having calculated the ratios, the results must be analyzed; Consideration needs to be given to such matter as;

- If a ratio has been computed over a number of time periods does it show a worsening or an improving situation?
- Can the ratio be compared to an objective standard? That is, can it be compared individual ratio?
- Do all the ratios when taken together support the conclusions drawn from each individual ratio?

The final stage of interpretation is the critical review.
The limitations of the data used to calculate the ratios need to be considered so that a prudent overall conclusion can be reached.

Comparison

The information gathered by calculating ratios will allow comparisons with;

a) The performance of the business in previous years
b) The budgeted or planned performance in the current year
c) The performance of similar businesses

The ratios themselves do not tell one what to do, but they do help to point one in the right direction. Ratios should, therefore, make it easier to make better decisions.

However, even comparing the financial statements of apparently similar businesses can be misleading because;

a) Business may use different accounting policies. For example, some business measure non-current assets at historic cost while other revalue them.
b) Ratios may not be calculated according to the same formula. For example, there are several possible definitions of gearing and return on capital employed.
c) Large organization can achieve economies of scale (e.g. by negotiating extended credit periods or discounts for bulk buying with suppliers). These measures may not be available to smaller businesses.
d) Companies within the same industry can serve completely different markets and there may be differences in sales mix and product range. These can affect profitability ratios such as profit margin and expenses to sales.

TYPES OF RATIOS

Ratios fall into several groups, the relevant of particular ratios depending on the purpose for which they are required. The groups to be considered here are;

- Profitability ratios
- Liquidity ratios
- Efficiency ratios
- Gearing ratios
- Investor ratios

PROFITABILITY RATIOS

There are several ratios which attempt to assess the profitability of a business. These are more conveniently expressed in percentage from and look at various aspects of a business's operations.

Gross profit percentage

Gross profit is expressed as a percentage of sales. It is also known as the **gross profit margin**

Gross profit percentage	$= \frac{\text{Gross Profit}}{\text{Sales}} \times 100$

Changes in the gross profit percentage ratio can be caused by a number of factors. For example, a decrease may indicate greater competition in the market and therefore lower selling prices and a lower gross profit or, alternatively, an increase in the cost of purchases. An increase in the gross profit percentage may indicate that the company is in a position to exploit the market and charge higher prices for its products or that it is able to source its purchases at a lower cost.

The gross profit margin looks at the performance of the business at the direct trading level. Typically variations in this ratio are as a result of changes in the selling price/sales volume or changes in cost of sales. For example, cost of sales may include inventory write downs that may have occurred during the period due to damage or obsolescence, exchange rate fluctuations or import duties.

EXAMPLE 1

Which of the following will reduce a company's gross profit ratio, when sales are increasing?
(i) A change in the product sales mix resulting in fewer sales of the more profitable products.
(ii) Increasing costs of purchases not passed on to customers.
(iii) An increase in the amount of inventory held.

A (i) and (ii) only
B (iii) only
C (ii) and (iii) only
D (i), (ii) and (iii)
Answer: Option A

Percentage Change in Sales

Increase or decrease in sales/revenue expressed as a **percentage** of the earliest year's sales.

Percentage change in sales	$= \frac{\text{Current sales} - \text{Previous period sales}}{\text{Previous period sales}} \times 100$

Net profit percentage

The relationship between the gross and the net profit percentage gives an indication of how well a company is managing its business expenses.

Net profit percentage	$= \frac{\text{Net Profit}}{\text{Sales}} \times 100$

The operating profit margin (or net profit margin) is generally calculated by comparing the profit before interest and tax of a business to revenue. If the net profit percentage has decreased over time while the gross profit percentage has remained the same, this might indicate a lack of internal control over expenses.

Return on Capital Employed (ROCE)

Profit expressed as a percentage of the capital invested in the business.

The return on capital employed (ROCE) ratio is another important profitability ratio. It measures how efficiently and effectively management has deployed the resources available to it, irrespective of how those resources have been financed.

Total capital employed in the business	$= \dfrac{\text{Profit before interest and tax}}{\text{Share capital + Reserves + Non-current liabilities}} \times 100$

The denominator could alternatively be calculated as total assets less current liabilities. This is the profit available for all the providers of finance as a percentage of all of the sources of finance.

This ratio is useful when comparing the performance of two or more companies, or when reviewing a company's performance over a number of years.

Movements in return on capital employed are best interpreted by examining profit margins and asset turnover in more detail (often referred to as the secondary ratios) as ROCE is made up of these component parts. For example, an improvement in ROCE could be due to an improvement in margins or more efficient use of assets.

Return on Owner's Equity (ROOE)

Equity shareholders' capital employed	$= \dfrac{\text{Profit after interest and preference dividend before tax}}{\text{Ordinary share capital + Reserves}} \times 100$

This is the profit available to the ordinary shareholder (before tax) as a percentage of the ordinary shareholder's capital. This is sometimes called **return on owner's equity** (ROOE).

Structure of operating ratios;

ROCE can be broken down into a further pattern of operating ratios as shown in the diagram below;

Analysis of ROCE

As can be seen from the diagram the initial breakdown of ROCE is into two further ratios;

- Profit margin
- Rate of asset utilization or asset turnover

Note; The product of these two gives the return on capital employed;

$$\frac{\text{Operating profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Operating assets}} = \frac{\text{Operating profit}}{\text{Operating assets}} = \text{ROCE}$$

Asset turnover;

$$\text{Asset turnover} = \frac{\text{Sales}}{\text{Operating assets}}$$

The resultant figure indicates how many $s of sales are being made for every $1 of operating assets or capital employed. Asset turnover shows how efficiently management have utilised assets to generate revenue.

This ratio measures the ability of the organisation to generate sales from its capital employed. As mentioned below, a possible variant is non-current asset turnover (revenue ÷ non-current assets). Generally the higher the better, but in later studies you will consider the problems caused by overtrading (operating a business at a level not sustainable by its capital employed). Commonly a high asset turnover is accompanied with a low return on sales and vice versa.

Non-current asset turnover

$$\text{Non-current asset turnover} = \frac{\text{Sales}}{\text{Non-current assets}}$$

The resultant figure indicates the amount of $ sales being made for every $1 investment in non-current assets.

This measures the efficiency of just the non-current asset utilization rather than all of the assets in total.

LIQUIDITY RATIOS

Liquidity refers to the amount of cash a company can generate quickly to settle its debts. A reasonable level of liquidity is essential to the survival of a company, as poor cash control is one of the main reasons for business failure.

The current ratio

The current ratio compares a company's liquid assets (i.e. cash and those assets held which will soon be turned into cash) with short-term liabilities (payables/creditors due within one year).

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

The higher the ratio the more liquid the company. As liquidity is vital, a higher current ratio is normally preferred to a lower one. However, a very high ratio may suggest that funds are being tied up in cash or other liquid assets, and may not be earning the highest returns possible. A very high current ratio is not necessarily good. It could indicate that a company is too liquid. Cash is often described as an 'idle asset' because it earns no return, and carrying too much cash is considered wasteful. A high ratio could also indicate that the company is not making sufficient use of cheap short-term finance and the ratio may suggest that funds are being tied up in cash or other liquid assets, and may not be earning the highest returns possible.

EXAMPLE

The statement of financial position for EJW Co, a limited liability company, includes the following:

Current assets $000	**Current Liabilities $000**
Inventory 485	Trade payables 289
Trade receivables 286	Accrued expense 55
Prepayments 14	Taxation 116
Cash and cash equivalents 25	

What is EJW Co's current ratio?

A 1·76
B 70·7%
C 0·56
D 0·71

Answer: Option A

The Quick Ratio/Acid Test Ratio/Liquidity Ratio

A stricter test of liquidity is the acid test ratio (also known as the quick ratio) which excludes inventory/stock as a current asset. This approach can be justified because for many companies inventory/stock cannot be readily converted into cash. In a period of severe cash shortage, a company may be forced to sell its inventory/stock at a discount to ensure sales.

$$\text{Quick ratio} = \frac{\text{Current Assets}}{\text{Current liabilities}}$$

Caution should always be exercised when trying to draw definite conclusions on the liquidity of a company, as both the current ratio and the acid test ratio use figures from the statement of financial position. The statement of financial position is only a 'snapshot' of the financial position at the end of a specific period. It is possible that the statement of financial position figures are not representative of the liquidity position during the year. This may be due to exceptional factors, or simply because the business is seasonal in nature and the statement of financial position figures represent the cash position at just one particular point in the cycle.

EFFICIENCY RATIOS

Inventory turnover ratio

Company needs to carefully plan and manage its inventory/stock levels. Ideally, it must avoid tying up too much capital in inventory/stock, yet the inventory/stock levels must always be sufficient to meet customer demand. The inventory/stock turnover period indicates the average number of days that inventory/stock is held for.

$$\text{Inventory/stock turnover period} = \frac{\text{Average Inventory}}{\text{Cost of sales}} \times 365$$

Note;

The average of opening and closing inventories is used here, but examination questions frequently do not provide the opening inventory figure and the **closing** inventory has to be taken instead of the average inventory. In any case, the average of opening and closing inventory will not necessarily give the true average level of inventory during the year if the inventory fluctuates a lot from month to month.

A change in the inventory/stock turnover period can be a useful indicator of how well a company is doing. A lengthening in the inventory/stock turnover period may indicate a slowing down of trading or an unnecessary build up of inventory/stock.

Receivables' collection period (or average period of credit allowed to customers)

Most companies offer their customers credit in order to increase their sales. However, giving credit to customers incurs an opportunity cost as the cash is tied up in financing receivables/debtors, and there is also the risk of the debts not being paid. Therefore, companies will normally seek to collect their debts as soon as possible. The receivables/debtors collection period (in days or months) provides an indication of how successful (or efficient) the debt collection process has been.

Receivables' collection period $= \dfrac{\text{Average Trade Receivables}}{\text{Sales}} \times 365$

The receivables collection period relates closing trade debts to the average daily credit sales. It shows the number of days that receivables are outstanding on average.

Average creditors' payment period

This relates closing payables to average daily credit purchases. It shows the number of days it take the business to pay its payables. The payables/creditors payment period links the value of payables/creditors with the amount of goods and services that a company is purchasing on credit.

Payables' payment period $= \dfrac{\text{Average Trade payables}}{\text{Purchases}} \times 365$

Again it has been assumed here that all purchases are on credit.

A common view is that payables provide a source of free finance to the company, and that the payments to payables/creditors should be deferred as long as possible. However, this view ignores the value of any cash settlements or discounts that may be offered by suppliers. In addition, excessive delays in payment may result in a reduction in the general terms of trade that suppliers are prepared to offer.

The working capital cycle

The investment made in working capital is largely a function of sales and, therefore, it is useful to consider the problem in terms of a firm's working capital (or **cash operating**) cycle.

Working capital cycle	**= Inventory holding period + Receivables collection period – Payables payment period**

The cash operating cycle;

The cycle reflects a firm's investment in working capital as it moves through the production process towards sales.

Conclusion;

The working capital of a business can be considered in total to assess liquidity and then broken down into its individual elements to assess the efficiency of the control of these elements.

Solvency ratios/ Financing ratios

Most companies will be financed by a variety of sources of finance, some by share capital and some by loan finance. Typical examples of sources of finance are given below;

Source of finance	***Priority in relation to profit***	***Priority on liquidation***
Secured loan stock (debentures)	Interest must be paid whether or not the company makes a profit	Secured by a fixed or floating charge-first claim on assets
Unsecured loan stock	Interest must be paid whether or not the company makes a profit	Rank as unsecured
Preference share capital (assumed non-participating)	If the company makes a profit, the preference dividend has a priority over the ordinary dividend	Cannot be repaid until all liabilities have been met. Has priority over ordinary shareholders
Ordinary share capital	Dividends paid after debenture interest and fixed preferences dividends have been paid	Rank behind all the above but usually entitled to surplus assets in a liquidation

The aim of solvency ratios is to assess how much a business is financed by loan capital rather than owner's capital.

A large proportion of borrowed capital is risky as interest and capital repayments are legal obligations and must be met if the company is to avoid insolvency. The payment of an annual equity dividend on the other hand is not a legal obligation. Despite its risks, borrowed capital is attractive to companies as lenders accept a lower rate of return than equity investors due to their secured positions. Also interest payments, unlike equity dividends, are corporation tax deductible.

Levels of capital gearing vary enormously between industries. Companies requiring high investment in tangible assets are commonly highly geared. Consequently, it is difficult to generalise about when capital gearing is too high. However, most accountants would agree that gearing is too high when the proportion of debt exceeds the proportion of equity.

The gearing ratio is of particular importance to a business as it indicates how risky a business is perceived to be based on its level of borrowing. As borrowing increases so does the risk as the business is now liable to not only repay the debt but meet any interest commitments under it. In addition, to raise further debt finance could potentially be more difficult and more expensive.

Equity gearing

The gearing ratio measures the company's commitments to its long-term lenders against the long-term capital in the company. The level of gearing will be influenced by a number of factors, for example the attitude of the owners and managers to risk, the availability of equity funds, and the type of industry in which the company operates.

$$\text{Equity gearing} = \frac{\text{Preference share capital plus loans}}{\text{Ordinary share capital and reserves}}$$

Total gearing;

$$\text{Total gearing} = \frac{\text{Preference share capital plus loans}}{\text{Total long term capital}}$$

There is no real difference between the two types of calculation as the component of the numerator remains the same.

Some prefer to use the equity gearing as it shows a more pronounced change if either fixed return capital or equity capital changes. Most use the second calculation as it is perhaps clearer to not the relationship of fixed interest finance to total finance.

There is no immediate cut-off between a low-geared company and a highly-geared company. Gearing is a matter of degree.

Interest cover

The interest cover ratio measures the amount of profit available to cover the interest payable by the company.

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

The lower the level of interest cover the greater the risk to lenders that interest payments will not be met. If interest payments and capital repayments are not paid when they fall due there can be serious consequences for a company. In the event of a default, a lender may have the right to seize the assets on which the loan is secured and sell them to repay the amount outstanding. Where lenders do not have security on their loan, they could still apply to the courts for the winding up of a company so that assets can be liquidated and debts repaid.

EXAMPLE

The following information has been extracted from the statement of comprehensive income of Blenda Co for the year ended 30 September 20X5:

	$
Profit from operations	460,000
Interest payable	(57,500)
	402,500
Taxation	(110,000)
Profit for the year	292,500

Blenda Co has also paid an ordinary dividend $52,000.

What is the interest cover of Blenda Co?

Answer: 8 times

INVESTOR RATIOS

Information required by investors

An investor is interested in the company earned by the company for his and the return on his investment (the income earned related to the market price of the investment).

An investor in ordinary shares can look to the earnings of the company available to pay the ordinary dividend or to the actual ordinary dividend paid as a measure of the income earned by the company for him. The ratios he would compute in each case would be;

Dividends	**Earnings**
Dividends per share	Earnings per share
Dividend cover	Price earnings ratio
Dividend yield	

Suppose that the company in the illustration is quoted on the Stock Exchange and that the market value of each ordinary share is 204 cents.

Earnings per Share (EPS);

When a company pays a dividend, the directors take many factors into account, including the need to retain profits four future expansions. Earnings per share look at the profits which could in theory be paid to each ordinary shareholder.

$$\text{EPS} = \frac{\text{Net profit or loss attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

The earnings per share ratio of a company represents the relationship between the earnings made during an accounting period (and available to shareholders) and the number of shares issued. For ordinary shareholders, the amount available will be represented by the net profit after tax (less any preference dividend where applicable).

Many investment analysts regard the earnings per share ratio as a fundamental measure of a company's performance. The trend in earnings per share over time is used to help assess the investment potential of a company's shares. However, an attempt should be made to take into account the effect of a company increasing its retained earnings. Most companies retain a significant proportion of the funds they generate, and hence their earnings per share will increase even if there is no increase in profitability.

EXAMPLE

Four companies JME Co, CB Co, JN Co and SOB Co have the same trading practices and accounting policies. The following information has been extracted from their fi nancial accounts:
Company Equity shares in issue EPS
JME Co 5 million ordinary shares of $1 each 20 cents
CB Co 15 million ordinary shares 50 cents each 10 cents
JN Co 100 million ordinary shares of 25 cents each 5 cents
SOB Co 500 million ordinary shares of 10 cents each 3 cents

Which company makes the most total profit for its equity shareholders?
A JME Co
B CB Co
C JN Co
D SOB Co

Answer: Option D

Dividend per share;

$$\text{Dividend per share} = \frac{\text{Total ordinary dividend}}{\text{Total number of ordinary shares}}$$

Dividend Cover

Definition;

A measure of how many times the profit covers the ordinary dividend payment. This is calculated by dividing profit available for ordinary shareholders (i.e. after preference dividend) by the dividend for the year (i.e. interim plus final).

Note: The profits available for ordinary shareholders are after the deduction of the preference dividend.

$$\text{Dividend cover} = \frac{\text{EPS}}{\text{Dividend}}$$

The cover represents the 'security' for the ordinary dividend - in this company the cover is reasonable.

The dividend cover ratio focuses on the security of the current rates of dividends, and therefore provides a measure of the likelihood that those dividends will be maintained in the future. It does this by measuring the proportion represented by current rates of dividends of the profits from which such dividends can be declared without drawing on retained earnings. The higher the ratio, the more profits can decline without dividends being affected.

Dividend yield

This expresses dividend per share as a percentage of the current share price.

$$\text{Dividend Yield} = \frac{\text{Dividend per share}}{\text{Current share price per share}}$$

The dividend yield compares the amount of dividend per share with the market price of a share, and provides a direct measure of the return on investment in the shares of a company. Investors are able to use this ratio to assess the relative merits of different investment opportunities.

Price Earnings Ratio (P/E RATIO);

$$\text{P/E ratio} = \frac{\text{Market value per share}}{\text{EPS}}$$

The price earnings ratio compares the benefits derived from owning a share with the cost of purchasing such a share. It provides a clear indication of the value placed by the capital market on those earnings and what it is prepared to pay for participation. It reflects the capital market assessment of both the amount and the risk of these earnings, albeit subject to overall market and economic considerations.

The P/E ratio is based on current EPS but the inventory market is pricing the share on expectations of future EPS. Fit the market considers that a company has significant growth prospects; the market price of the share will rise giving higher P/E ratio,

Earnings yield

$$\text{Earnings yield} = \frac{\text{EPS}}{\text{Market value per share}} \times 100$$

This term is not often referred to these days. It expresses the earnings per share as a percentage of the current share price i.e.

Conclusion;

An investor or potential investor in a company will be concerned with the return that he is receiving or is likely on that investment. This may be measured of the actual return, dividend paid, or the potential return, and earnings for the year.

Main limitations of ratio analysis

- Inflation may distort comparisons of ratios over time.
- Different accounting policies may distort intercompany comparisons.
- The ratios are only as good as the financial information on which they are based.
- The accounting information used to prepare the ratios may be out of date.
- Changes in accounting policies from year to year may produce misleading ratios.
- Usually the information presented in the published accounts is summarised, making a detailed analysis impossible.
- Using industry averages as a basis for comparison can be misleading as they are the average of the ratios from a number of companies.

Further information for interpretation.

The further information that would be useful to help interpret a company's financial position is as follows.

- The nature of the business and type of market
- The statement of cash flow
- Forecast financial statements
- Comparative industry ratios
- The company's accounting policies
- Product mix of goods sold including relative profit margins
- Company access to bank overdraft facilities

Chapter 20

REGULATORY FRAMEWORK AND ACCOUNTING CONCEPTS

IN THIS CHAPTER

- **THE REGULATORY FRAMEWORK**
- **ACCOUNTING STANDARDS**
- **THE CONCEPTUAL FRAMEWORK**
- **UNDERLYING ASSUMPTION**
- **QUALITATIVE CHARACTERISTICS**
- **THE BALANCE BETWEEN QUALITATIVE CHARACTERISTICS**
- **HISTORICAL COST ACCOUNTING AND ALTERNATIVE**
- **BASIC PRINCIPLES OF ACCOUNTING**

THE REGULATORY FRAMEWORK

The development of international accounting rules and regulations, known as IAS or IFRS, is contributed to by a number of bodies:

International Financial Reporting Standards Foundation (IFRS Foundation)
Trustees are from varied professional backgrounds and geographical location. Oversees, funds, appoints and monitors the operational effectiveness of:

IFRS Advisory Council (IFRS AC)

Provide advice to IASB on:

- their agenda and work prioritization
- the impact of proposed standards
- Provides strategic advice

International Accounting Standards Board (IASB)
Members from varied professional backgrounds and geographical locations

- Develop new accounting standards (known as IFRS)
- Liaise with national standard-setting bodies to promote convergence of international and national accounting standards

International Financial Reporting Standards Interpretations Committee (IFRS IC)

- Assist the IASB to establish and improve standards
- Issues Interpretations (known as IFRICs) which provide timely guidance on emerging accounting issues not addressed in full standards
- Assist in the international/national convergence process

Purpose of Framework

The main purpose of the 'Framework for the Preparation and Presentation of Financial Statement' are:

- **i.** To provide a framework for the future development of international accounting standards and the review of existing ones.
- **ii.** To inform interested parties (e.g. national standards setting bodies) of the approach taken by the IASB in formulating standards.
- **iii.** To provide guidance to practitioners when applying international accounting standards.
- **iv.** To provide a basis of reducing the number of alternative accounting treatments and promoting harmonization.
- **v.** To assist auditors in forming an opinion as to whether financial statements confirm with international accounting standards.
- **vi.** To assist the users of financial statements when interpreting the information.

ACCOUNTING STANDARDS

The international accounting standards currently in force are either:

- IFRS – International Financial Reporting Standards, or
- IAS – International Accounting Standards.

IFRS and IAS have exactly the same standing. The difference between the two is historic: all new standards issued up until 2000 were IAS; thereafter they have been labeled IFRS.

Role International Financial Reporting Standards
The **arguments fo**r having accounting standards

- Accounting standard creates harmonization and reduce the risk of creative accounting.
- Companies are obliged to disclose the accounting policies they have used in the preparation of accounts.
- Accounting standards should increase the credibility of accounts by increasing uniformity of accounting treatment between companies.
- Accounting standards provide a focal point for discussion about accounting practice.

The **arguments against** having accounting standards

- Sometimes the accounting method advocated may not be appropriate in some particular circumstances.
- Accounting standards may be overly prescriptive, reducing flexibility and the opportunity for accounts to use their professional judgment.
- Standards may be too general, resulting in a lack of clear guidance in some situations.
- If standards contain too many detailed rules, there is a danger that preparers will develop creative accounting techniques.
- Accounting standards may have been drafted as a consequence of a particular pressure group.
- Some accounting standards can be expensive to comply with.

THE CONCEPTUAL FRAMEWORK

As well as issuing accounting standards specific to particular issues, the IASB has issued a general conceptual framework for financial reporting. This is referred to as the Framework. It provides the concepts that underlie financial statements and the qualitative characteristics that a set of financial statements should possess.

UNDERLYING CONCEPTS

Fair presentation

Financial statements are often described as giving a 'fair presentation' of financial position and performance. In the UK this is referred to as a 'true and fair view' of financial position and performance. Fair presentation has no legal definition but is assumed to be achieved where accounting standards and the Framework are followed.

Accruals

The financial statements are prepared on the accruals basis, meaning that transactions are reported in the period to which they relate, regardless of when cash is received or paid.

BASIC UNDERLYING ASSUMPTION

The old Framework identified two underlying assumptions i.e. accruals concept and going concern. The Conceptual Framework now, makes it clear that financial information should be prepared on an accruals basis but only identifies **one underlying assumption** i.e. **going concern**.

Going concern

Accounts are normally prepared on the going concern basis. This means that they are prepared on the assumption that a business will continue for the foreseeable future, assumed to be a year.

Consistency

Transactions should be accounted for consistently year on year. This facilitates comparison between different years' accounts and trend analysis. E.g. IAS 8 allows a change in accounting policy only where it results in fairer presentation.

Business entity

The financial statements of a sole trader business report the position and performance of that business. They do not include any detail of the personal finances of the sole trader.

QUALITATIVE CHARACTERISTICS

For the financial information to be useful for the users financial statements should possess the following characteristics.

There are two **basic** qualitative characteristics of useful financial information

Relevance

Financial statements are relevant where they provide all required information that is important for the user to make economic decisions.

Materiality: An item is **material** if its omission or misstatement will influence the economic decisions of the user.

Faithful representation

Apart from including all the relevant information in the financial statements the financial statements should also be prepared faithfully. The financial statement should give 'True & Fair' view of the financial transactions on which these statements are based.

Completeness: For financial statements to be reliable, the financial information should be complete and without omissions.

Substance over form: The financial information should reflect economic substance and not the legal form of transactions.

Following are not basic characteristics but they do **enhance** usefulness of financial statements:

Comparability

In order for financial statements to be useful, they should be comparable:
- With the financial statements of other businesses
- With the financial statements of the same business over time.

This is achieved by consistency of accounting policies and disclosure of accounting policies, including any changes in them for fairer presentation.

Understandability

Financial statements should be understandable to users. For this purpose, users are assumed to have reasonable knowledge of business and economics.

However, items should not be excluded from the financial statements simply because they are perceived to be complex.

Timeliness

For information to be useful, it should be available to users in time so that users can make more informed decisions.

Verifiability

If different knowledgeable persons can conclude that financial information provided is presented faithfully, the information is verifiable.

THE BALANCE BETWEEN QUALITATIVE CHARACTERISTICS

Conflicts between qualitative characteristics may arise. For example:

- Financial statements may be less understandable if they are more complete (i.e. including a complex transaction)
- If all information is included to enhance completeness, some of the information may be irrelevant for the user. Including all the information to enhance completeness will be a time demanding task which will affect timeliness of information.

The Framework requires that in these cases, a balance is achieved. These characteristics should be present in financial statements subject to a threshold known as **materiality**.

Items in the financial statements are material if their omission or misstatement could influence users of the accounts. It is therefore particularly important that the characteristics above are applied to material items.

HISTORICAL COST ACCOUNTING AND ALTERNATIVES

The application of historical cost accounting means that assets are recorded at the amount they originally cost, and liabilities are recorded at the proceeds received in exchange for the obligation. This approach to accounting is considered by some to contradict the requirements of the Framework and qualitative characteristics by being unhelpful to users of the accounts. In particular, in the context of a non-current asset, historical cost does not provide indication of:

- A possible selling price
- What revenues the asset may generate for the business
- How much the asset may cost to replace.

To overcome these issues, alternatives to historical cost accounting may be:

- Net realisable value
- Economic value (assets are carried at the present value of future cash flows they are expected to generate, and liabilities at their settlement value)
- Replacement cost

Advantages and Disadvantages of Historical Cost Accounting

Advantages

- Simple to understand
- Cost is objective and verifiable
- Results in comparable financial statements

Disadvantages

- The carrying value of assets is often substantially different to market value
- No account is taken of inflation meaning that profits are overstated and assets understated
- Financial capital is maintained but not physical capital (i.e. the same amount of money will buy less inventory at the end of the year than start of the year when prices are rising)

EXAMPLE

During periods of general price inflation, what is the effect of using the historical cost concept on the value of a company's non-current assets and profits?

	Non-current asset values	Profit
A	understated	overstated
B	understated	understated
C	overstated	overstated
D	overstated	understated

Answer: Option A

Basic Principles of Accounting

Accounting principles are conventions or accepted practice, which apply generally to transactions. Accountants have developed these accounting principles over time.

1. The Separate/Business Entity Concept
Means that a business is treated as a separate entity, distinct from its owners etc. accounting is done only for the business and not for the owner.

2. Matching Concept/Accruals Concept
Income and expenses are recognized in the period in which they are earned/incurred, not when cash is received or paid.

3. Money Measurement Concept
Means that accounts deal only with items to which a monetary value can be attributed.

4. Historic Cost
The historic cost accounting system is a system of accounting in which all values are based on the historic cost incurred.

5. Going Concern Concept
Implies that a business will continue its operations in the foreseeable future.

6. Prudence Concept
Where there is uncertainty, a cautious approach should be taken, so that gains and assets are not overstated and losses and liabilities are not understated. Thus, anticipated loss should be treated as soon as possible and anticipated income should not be treated until actually realized.

7. **Materiality Concept**
States that a matter is material if its omission/misstatement would reasonably influence the decision of a user of accounts.

8. **Separate Valuation Concept**
Means that each component of an asset or liability must be valued separately.

9. **Consistency Concept**
Means that similar items in a set of accounts should be given similar accounting treatment and that the same treatment should be applied both within a particular accounting period or from one period to another in accounting for similar items.

10. **Realization Concept**
States that profit can only be recognized when it is actually earned and not before e.g. opening a revaluation reserve for increase in values of fixed assets is an application of the realization concept.

EXAMPLE
Which of the following statements about accounting concepts are correct?

(i) The historical cost concept requires that non-current assets be initially recognised at their purchase cost.

(ii) The accruals concept means that transactions are recognised when the cash is received or paid, not when they actually occur.

(iii) The substance over form convention is that the economic reality of a transaction should be reflected in the financial statements rather than the legal form.

(iv) The prudence concept means it is desirable to understate liabilities in financial statements.

A. A (i) and (ii)
B. (iii) and (iv)
C. (i) and (iii)
D. D (ii) and (iv)

Answer: Option C

EXAMPLE
When accounting for the cost of advertising that is expected to significantly enhance future sales, which of the following should take precedence?

A Neutrality
B Matching
C Consistency
D Prudence
Answer: Option D

Chapter 21

GOVERNANCE AND FINANCIAL REPORTING

IN THIS CHAPTER

- GOVERNANCE
- CORPORATE GOVERNANCE
- LEGAL RESPONSIBILITIES OF DIRECTORS
- RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

GOVERNANCE AND FINANCIAL REPORTING

GOVERNANCE

Governance is the action or manner of running (governing) an organization. The responsibility of the preparation of the financial statements lies those who are charged with **governance** of a company.

CORPORATE GOVERNANCE

The simplest and most concise definition of corporate governance was provided by the Cadbury Report in 1992, which stated: Corporate governance is the system by which companies are directed and controlled.

Though simplistic, this definition provides an understanding of the nature of corporate governance and the vital role that leaders of organisations have to play in establishing effective practices. For most companies, those leaders are the directors, who decide the long-term strategy of the company in order to serve the best interests of the owners (members or shareholders) and, more broadly, stakeholders, such as customers, suppliers, providers of long-term finance, the community and regulators.

LEGAL RESPONSIBILITIES OF DIRECTORS

Company directors are responsible for the management of their companies. They must act in a way most likely to promote the success of the business and benefit its shareholders. They also have responsibilities to the company's employees, its trading partners and the state. A director needs wide range of powers to help promote the company. However, they face serious penalties if they abuse those powers or use them irresponsibly.

Statutory duties of a director

The Companies Act 2006 sets out the **seven** general statutory duties of a director. These are listed below.

1. **To act within powers:** This requires a director to comply with the company's constitution and decisions made under the constitution and to exercise the powers only for the reasons for which they were given.
2. **To act in a way the director considers (in good faith) is most likely to promote the success of the company for the benefit of its members as a whole (or, if relevant, other purposes specified in the constitution).** In performing this duty, a director must have regard to all relevant matters, but the following are specifically identified in legislation:

- The likely consequences of any decision in the long term;
- The interests of the company's employees;
- The need to foster the company's business relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment;
- The desirability of the company maintaining a reputation for high standard business conduct; and the need to act fairly as between members of the company.

3. **To exercise independent judgment**, that is, not to subordinate the director's power to the will of others. This does not prevent directors from relying on advice, so long as they exercise their own judgment on whether or not to follow it.

4. **To exercise reasonable care, skill and diligence**. This requires a director to be diligent, careful and well informed about the company's affairs. If a director has particular knowledge, skill or experience relevant to his function (for instance, is a qualified accountant and acting as a finance director), expectations regarding what is 'reasonable' will be judged accordingly (regulation 25).
5. **To avoid conflicts (or possible conflicts) between the interests of the director and those of the company**. The prohibition will not apply if the company consents (and consent meets the necessary formal requirements).
6. **Not to accept benefits from third parties (i.e. a person other than the company) by reason of being a director or doing anything as director**. The company may authorise acceptance (subject to its constitution), for instance to enable a director to benefit from reasonable corporate hospitality; and
7. **To declare any interest in a proposed transaction or arrangement**. The declaration must be made before the transaction is entered into and the prohibition applies to indirect interests as well as direct interests.

In addition to these duties, a director has duties:

- To consider or act in the interests of creditors (particularly in times of threatened insolvency)
- To maintain confidentiality of the company's affairs (a duty which to a large extent follows from the general duties outlined above).

RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

In relation to financial and accounting matters, directors have extensive, specific duties. Under company law, responsibility for the preparation of financial statements rests with the directors.

A company is required to keep adequate accounting records, being those that are sufficient to show and explain the company's transactions. Directors have a duty to prepare accounts, a directors' report and (for quoted companies) a directors' remuneration report, and a number of subsidiary and associated responsibilities in relation to those.

Specifically, directors are responsible for:

- The preparation of the financial statements of the company in accordance with the applicable financial reporting framework (e.g. IFRSs)
- The internal controls necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud
- The prevention and detection of fraud

There should be a statement of directors' responsibilities and it should be clearly mentioned in directors' report or auditors' report.

It is the directors' responsibility to ensure that the entity complies with the relevant laws and regulations. Directors should report the going concern status of the business. Companies over a certain size limit are also subjected to an annual audit of their financial statements. This is also responsibility of directors.