# ACCA

## Paper FA

# Financial Accounting

FOR EXAM UNTIL AUGUST 2024

# Contents

# Chapter1 Financial reporting and the financial statements

**Learning outcomes:**

- Define financial reporting – recording, analysing and summarising financial data.
- Identify and define types of business entity – sole trader, partnership, limited liability company.
- Explain the legal differences between a sole trader, partnership and a limited liability company.
- Identify the advantages and disadvantages of operating as a sole trader, partnership or limited liability company.
- Define the nature, principles and scope of financial reporting.
- Identify the users of financial statements and state and differentiate between their information needs.
- Describe the purpose of each of the financial statement.

## 1 Types of business entity

### 1.1 Sole Traders

A sole trader is an individual who owns, controls, and manages a business alone.

✧ **Characteristic of sole trader**

- Change in Business Ownership

-To change the owner of a sole trader business, the existing sole trader would sell their business to the new owner.

-The sole trader is the only person in charge, so this decision is made without involving others.

- Business Continuation

-If a sole trader exits the business, it cannot continue unless sold to another individual.

- Taxation

-Sole traders are taxed on the profit the business makes. The tax authorities do not tax the individual owner separately.

- Ownership of Business Property

-There is no separation of ownership between a sole trader business and its owner.

- Legal Action

  -The sole trader is legally liable for any penalties and fines incurred if a legal dispute occurs and a court judgment is made against the business

✧ **Advantages of Sole Traders**

- Control

  -A sole trader has complete control over their business.

  -The owner owns the business assets and is fully entitled to all the profits generated by the business.

- Business Formalities

  - It is easy for a sole trader to set up and operate a business. There is no need to comply with companies' legislation and no requirement to publish financial statements.

  -However, the sole trader may still need to produce financial statements to provide information for the tax authorities.

- Flexibility

  -A sole trader can choose how to operate and is not bound by any workload requirements.

✧ **Disadvantages of Sole Traders**

- Liability

  -A sole trader is fully liable for all the business's debts. Any personal possessions may have to be sold to pay off the business's debts.

- Raising Finance

  -A sole trader may not be able to raise the money needed to develop the business in the longer term.

  -The only available finance sources may be the owner's capital or short-term finance from the bank (overdraft).

- Business Continuity

  -The business will cease if the sole trader dies or retires unless arrangements have been made for it to be sold or transferred to someone else.

**1.2 Partnerships**

A partnership is where two or more people own and run a business together to make profits.

✧ **Characteristic of partnership**

- Change in Business Ownership

-All the partners must agree to a new partner being admitted to the partnership.

-A partner will typically buy into the partnership by investing.

- Business Continuation

-If a partner leaves a partnership, the partnership automatically ends unless the partnership agreement allows the remaining partners to continue the partnership.

- Taxation

-Like a sole trader business, the partnership is taxed on its profits. The tax authorities do not tax the individual partners separately.

- Ownership of Business Property

-There is no separation of ownership between a partnership business and its owner (partners).

- Legal Action

-The partners are legally liable for any penalties and fines incurred if a legal dispute occurs and a court judgement is made against the partnership.

✧ **Advantages of Partnerships**

- Defined Roles

- A partnership will have a partnership agreement that sets out how the business will be managed concerning each partner's work scope and the profit-sharing arrangements.

- Raising Finance

-If the existing partners bring another partner into the business, the new partner will be required to contribute financially.

- Paperwork

- A partnership does not have to publish its financial statements. However, financial information may be kept for proper accounting records and to avoid disputes concerning tax expenses.

- Skills and Knowledge

- Different partners have different business skills and knowledge. This can enhance the business because they can concentrate on what they do best.

- Risks

-Having more partners in a partnership will spread the business risk to more people. The impact of poor performance and losses will be reduced for each partner.

✧ **Disadvantages of Partnerships**

- Costs

    - Drawing up a legally binding partnership agreement will cost money.
- Decision Making

    -The time taken to make decisions may be slow in a partnership if the partners disagree. This can slow down the progression and development of business.
- Profit Sharing

    -Since profits and losses are shared among the partners, there may be no incentive for the partners to work harder than the other partner.
- Business Continuity

    -A partnership may need to be dissolved if one of the partners cannot continue working.

    -For the partnership to continue, the remaining partners may need to admit a new partner and establish a new partnership.
- Liability

    -Each partner’s personal assets are at risk if the business fails. Personal bankruptcy can occur.
- Disagreements and Disputes

    - Severe disagreements or disputes not resolved promptly between partners can result in hung decisions or, in the worst-case scenario, the partnership breaking up.

**1.3 Limited Liability Companies**

A limited liability company is owned by shareholders by issuing shares and run by the board of directors appointed by shareholders. The shareholders are only responsible for the amount paid for their shares. They are not responsible for the company’s debts.

✧ **Characteristic of Limited Liability Companies**

- Change in Business Ownership

    -Shareholders can buy and sell shares in a limited company without needing other shareholders to agree.

    -However, smaller companies can restrict the sale to make the shares available to existing shareholders before being placed on the open market.
- Business Continuation

    -If a company's shareholders change, this does not affect the company’s existence.
- Taxation

-The limited liability company is taxed based on the profits it generates. The individual owners (shareholders) are taxed separately.

- Ownership of Business Property

  -A limited liability company can own a property itself. The ownership does not need to be in anyone else's name. Individual shareholders do not have control over the property.

- Legal Action

  -The legal repercussions of a limited liability company are limited to the business only.

  -The owner's (shareholders) legal liability is limited to the value of the shares they own. It is the company that is legally liable, not its shareholders.

✧ **Advantages of Limited Liability Companies**

- Liability

  -Limited liability can protect directors and shareholders (owners) from legal actions brought against them.

  -The shareholders' liability is limited to the value of their invested shares. -

  -Personal possessions of the shareholders cannot be used to repay any of the business's debts.

- Raising Finance

  - Limited liability companies may have easier access to finance and may attract a wider pool of industry experts. It can issue shares to existing shareholders or the public to raise money for the business.

- Business Continuation

  - A limited liability company can be transferred from one owner to another. If the current shareholders decide to sell their shares, another shareholder can purchase them, and the business will continue to operate as usual.

✧ **Disadvantages of Limited Liability Companies**

- Costs

  -Setting up a limited liability company requires a substantive initial investment. There is also considerably more administration involved in running a limited liability company than a partnership or sole trader.

- Taxation

  -The profits of a limited liability company are taxed. The owners (shareholders) and directors (employees of the company) are also individually taxed.

- Public Eye

  - A company cannot keep its business affairs private as it relies on the public to invest money into the business (by purchasing shares). A limited liability company must hold general meetings and file annual reports with the company registrar.

# 2 Financial report

### 2.1 Financial report definition

Financial reporting is the recording, analysing, and summarising of financial data to present the financial performance of a business.

✧ **Recording**

A bookkeeper records all business transactions promptly so that the information is updated. The records should show enough information about its transactions to help managers prepare financial statements and meet legal requirements.

For example, a business records information such as customer sales and purchase of goods.

✧ **Analysing**

A bookkeeper analyses individual transaction records and sorts the information into different categories so the business can analyse information concisely.

For example, transactions are categorised according to their accounting type so that managers can identify the business's main expenses or how much cash it has received from each customer.

✧ **Summarising**

Complete accounting records usually contain too many details for the needs of most interested parties in the business's financials. Therefore, businesses summarise their financial transactions and position in annual financial statements. This enables users to obtain an overview of the business without looking through detailed accounting records.

### 2.2 Contents of Financial Statements (延展阅读 ACCA hub)

- ✧ A statement of financial position at the end of the period (Balance sheet)
- ✧ A statement of profit or loss and other comprehensive income for the period (Income Statement)
- ✧ A statement of changes in equity for the period
- ✧ A statement of cash flows for the period
- ✧ Notes, comprising a summary of accounting policies and other explanatory notes.
- ✧ A statement of financial position at the end of the period: (Balance Sheet):

showing the financial position of a business at a point in time

✧ A statement of profit or loss and other comprehensive income for the period (Income Statement): showing the financial performance of a business over a period

**2.2.1 Statement of Financial Position**

✧ The "financial position" can be defined as a company's net worth (assets minus liabilities). The statement of financial position a shows the book value or carrying amount of the entity at a particular date for:
 Assets (resources controlled)
 Liabilities (obligations owed)
 owners' Capital or Equity (how the business is financed)

| **Glara's Statement of Financial Position as at 31 December 2014** | | |
|---|---|---|
| | $ | $ |
| **Non-Current Assets** | | |
| Property | X | |
| Equipment | X | |
| Motor Vehicle | X | |
| | | X |
| **Current Assets** | | |
| Inventory | X | |
| Trade Receivables | X | |
| Prepayments | X | |
| Cash at Bank and in hand | X | |
| | | X |
| **TOTAL ASSETS:** | | X |

| | | |
|---|---|---|
| **Capital** | | |
| Capital brought forward | X | |
| Profit for the year | X | |
| Capital introduced | X | |
| Less: (Drawings) | (X) | |
| | | |
| Total Capital: | | X |
| | | |
| **Non-Current Liabilities** | | |
| Bank Loan | | X |
| | | |
| **Current Liabilities** | | |
| Trade Payables | X | |
| Accruals | X | |
| Overdraft | X | |
| | | X |
| **TOTAL CAPITAL AND LIABILITIES:** | | X |

**2.2.2 Statement of Profit or Loss**

This statement comprises:

- trading account summarising trading transactions (Sales – Cost of sales = Gross Profit)
- profit and loss account (also called income and expenditure account) for all other items of income and expenditure legitimately earned because of business activities.

✧ **Other Comprehensive Income**

Other comprehensive income consists of items of income and expense which are not recognised in profit or loss. For example, a surplus arising on revaluation of a property which is not recognised in profit or loss (because it is not realised as cash).

**Example 2**

Glara's Statement of Profit or Loss and Other Comprehensive Income details the business's financial performance in terms of Income and Expenses.

| **Glara's Statement of Profit or Loss for the year ended 31 December 20X2** | | |
|---|---|---|
| | **$** | **$** |
| **Sales** | X | |
| Less: Sales Returns | (X) | |
| | | X |
| **Cost of Goods Sold** | | |
| Opening Inventory | X | |
| Purchases | X | |
| Less: Purchase Returns | (X) | |
| | X | |
| Less: Closing Inventory | (X) | |
| | | X |
| **Gross Profit:** | | X |

| | | |
|---|---|---|
| **Other Income** | | X |
| | | |
| **Expenses** | X | |
| Electricity | X | |
| Rental | X | |
| Repairs | X | |
| Sundry Expenses | X | |
| Discounts Allowed | X | |
| Loan Interest | X | |
| | | (X) |
| | | |
| **Net Profit:** | | |
| | | |
| **Other Comprehensive Income** | | |
| Gains on Property Revaluation | | X |
| | | |
| **Total Comprehensive Income for the year:** | | X |

- **Relationship between a statement of financial position at the end of the period and a statement of profit or loss and other comprehensive income for the period**

$\boxed{\text{Capital at year beginning}} + \boxed{\text{New capital}} + \boxed{\text{Profit this year}} - \boxed{\text{Drawings}} = \boxed{\text{Capital at year end}}$

- **Drawings** are amounts (cash or goods) taken out of a business by its owner for his/her personal used .

### 2.2.3 Statement of Cash Flows

- The statement of cash flows is a historical statement. It shows cash inflows and outflows that have already taken place. Users can see where cash in the business has come from and how it has been spent.
- A business's cash position is one of the most important measures of its financial situation. If a business runs out of cash, it cannot survive even though it is making profits.
- The statement of cash flows classifies the movement of cash into three categories:
  Operating Activities
  Investing Activities
  Financing Activities

**Example 3**

Kenravi Co is a large limited company that manufactures clothing. The Statement of Cash Flows is shown below:

| **Kenravi Co Statement of Cash Flows for the year ended 30 April 20X5** | | |
|---|---|---|
| | $ | $ |
| **Cash Flows from Operating Activities** | | |
| Cash generated from operations | X | |
| Interest paid | X | |
| Income taxes paid | X | |
| Net cash from operating activities: | | X |
| | | |
| **Cash Flows from Investing Activities** | | |
| Purchase of property, plant and equipment | X | |
| Proceeds of sale of equipment | X | |
| Interest received | X | |
| Dividends received | X | |
| Net cash used in investing activities: | | X |

| | | |
|---|---|---|
| **Cash Flows from Financing Activities** | | |
| Proceeds of issue of shares | X | |
| Repayment of loans | X | |
| Dividends paid | X | |
| Net cash used in financing activities: | | X |
| | | |
| Net increase in cash and cash equivalents | | X |
| Cash and cash equivalents at beginning of period | | X |
| **Cash and cash equivalents at end of period** | | **X** |
| | | |

### 2.2.4 Statement of Changes in Equity

- The purpose of the statement of changes in equity is to state the changes in equity that have occurred in the financial year. The statement reconciles the equity account balances at the start and end of the year.
- Equity of a business includes share capital, share premium, revaluation surplus and retained earnings.

| | **Share capital** | **Share premium** | **Revaluation surplus** | **Retained earnings** | **Total** |
|---|---|---|---|---|---|
| | **$** | **$** | **$** | **$** | **$** |
| Balance at 31 December 20X5 | x | x | x | x | x |
| Changes in accounting policy | | | | x/(x) | x/(x) |
| Restated balance | x | x | x | x | x |
| **Changes in equity for 20X6** | | | | | |
| Issuance of share capital | x | x | | | x |
| Dividends (paid and declared) | | | | (x) | (x) |
| Total comprehensive income for the year | | | x/(x) | x/(x) | x/(x) |
| Transfer to retained earnings | | | (x) | x | |
| Balance at 31 December 20X6 | x | x | x | x | x |

## 3 Who are the Users?

- ✧ The ultimate objective of accounting is to provide information in reports which can be used by internal and external decision makers.
- ✧ Accounting reports users include:

**Management**

Management: Appointed by the company's owners to supervise the day-to-day activities of the company. They need information about the company's financial situation as it is currently and as it is expected to be in the future. This is to enable them to manage the business efficiently and to make effective decisions.

**Shareholders**

Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

**Trade payables/Suppliers**

Suppliers and other payables: Suppliers and other payables are interested in information that enables them to determine whether amounts owing to them will be paid when due.

**Trade receivables/Customers**

Customers: Customers have an interest in information about the continuance of an enterprise, especially when they have a long term involvement with or are dependent on, the enterprise.

**Lenders**

Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

**Employees**

Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to prove remuneration, retirement benefits and employment opportunities

**Government and their agencies**

Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information to regulate the activities of enterprises, determine taxation policies and as the basis for national income and similar statistics.

**General public**

Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

# Chapter 2: Elements of Financial Statements and the Double-Entry

**Learning outcomes:**

- Identify and define assets, liabilities, equity, income and expenses.
- Explain and apply the accounting equation.
- Define non-current assets.
- Explain the difference between asset and expense items.
- Classify expenditure as asset expenditure or expenses charged to profit or loss.
- Explain how the accounting equation, IFRS Accounting Standards and the business entity concept underlie the statement of financial position.

## 1. Elements of the Statement of Financial Position

The Statement of financial position provides a snapshot of an organisation's assets, liabilities and capital balances at a specified date.

✧ **Assets**

- IAS 1 defines an asset as a present economic resource controlled by the entity due to past events and has the potential to produce economic benefits.

  **Assets can be split into two categories: current assets and non-current assets.**
- **Current assets** – cash or assets that can be converted into cash or used within the next 12 months. For example, cash in bank, amounts due from customers, and goods held for resale.
- **Non-current assets** – assets that a business uses for more than 12 months to generate profits or cash flow. For example, offices, shops, warehouses, delivery vehicles and production equipment.
- Non-Current Assets can be further split into two: tangible and intangible.

  **Tangible non-current assets** are non-current assets that have a physical form and can be touched. For example, machinery, fixtures and fittings, and computer equipment.

  **Intangible non-current assets** are non-current assets that do not have a physical form. For example, software licences purchased for use by the business for more than 12 months.

✧ **Liabilities**

- IAS 1 defines a **liability** as a present obligation of the entity to transfer an economic resource as a result of past events.

- Liabilities can be split into two categories: **current and non-current.**

  **Current liabilities** – amounts owed by the business falling due for payment within one year of the reporting date. For example, amounts due to suppliers for goods purchased on credit are trade payables.

  **Non-current liabilities** – amounts owed by the business falling due for payment beyond one year from the reporting date (total liabilities − current liabilities).

✧ **Capital/ Equity**

- A business's capital or equity balance is the residual interest owners hold in its assets after deducting all its liabilities.
- It is the difference between total assets and total liabilities:

  **Total Assets – Total Liabilitie**

## 2. Elements of the Statement of Profit or Loss

There are two absolute profit measures, only one of which is shown in the trading account.

- **Gross Profit** - this is calculated in the trading account and is the excess of sales over the cost of goods sold during the period.
- **Net Profit** - this is calculated in the profit and loss account and is the remaining profit after all other costs incurred in the period have been deducted from the gross profit.
- **Income** is increases in assets, or decreases in liabilities, that result in increases in equity - other than those relating to contributions from holders of equity claims (i.e. shareholders)
- **A sale** is usually recognised as taking place when goods are despatched (or services provided) to a customer.
- **Expenses** are decreases in assets, or increases in liabilities, that result in decreases in equity - other than those relating to distributions to holders of equity claims.
- **Cost of sales** is the cost of goods that have been sold. It includes all the costs connected with the purchase and manufacture of goods. Costs incurred are matched with revenues earned.
- **Other expenses** can include various costs such as electricity, rent, salaries, and interest paid.

## 3. Asset Expenditure vs Expenses

When items of expenditure are incurred, a decision must be made whether they

affect:
Statement of financial position as an asset expenditure
Statement of profit or loss as expenses

- **Asset Expenditure**

Asset expenditure relates to the purchase of non-current assets. Asset expenditure is incurred in:
-Acquiring property and equipment for long-term use (benefits future accounting periods).
-Increasing the revenue-earning capacity of an existing non-current asset (by increasing efficiency or useful life).

- **Expenses (revenue expenditure)**

**Expenses**, commonly called operating expenses, are incurred in the business's daily running (operation). **Examples** include:
-buying or manufacturing goods which are sold and providing services
-selling and distributing goods
-administration costs
-repairing long-term assets
-These costs are immediately charged to profit or loss and matched with the accounting period's revenues.

**Activity 1**
Classify the following items of expenditure as asset expenditures or expenses:
$27,000 on a new car.
$1,800 road tax incorporated in the car's purchase price in (1) above.
$10,000 on a second-hand delivery van.
$12,000 on refurbishing van in (3) above.
$1,000 monthly rental of a vehicle.
**Solutions**
Asset Expenditure.
Expense. Road Tax is an annual running cost.
Asset Expenditure. The fact that the asset acquired is second-hand is irrelevant.
Asset Expenditure. Refurbishment is the same as renovation. This suggests that the useful life of the existing asset is increased. In this case, the expenditure may be incurred to bring the asset to use in the business.
Expense. A rented asset is not owned and should not be classified as an asset.

# 4. The Duality Concept

The **Duality concept** is one of the accounting principles used in recording financial information. It states that every transaction has a double (or dual) effect on the business's position as recorded in its accounts. The second effect is equal to and "opposite" of the first effect.

**Example 1 ( from acca hub)**

| **Transaction** | | **Duality Statement** |
|---|---|---|
| Sells goods on cash | | Sales income increases, and receivables asset increases. |
| Sells goods on credit | | Payables liability decreases, and bank asset decreases. |
| Purchases goods for resale for cash | | Goods for resale expense increase, and bank asset decreases. |
| Purchases goods for resale on credit | | Capital introduced increases and bank asset increases. |
| Pays a supplier for some equipment bought on credit | | Sales income increases, and bank asset increases. |
| Purchases some equipment for cash | | Equipment asset increases, and bank asset decreases. |
| Starts the business by introducing cash | | Goods for resale expense increases, and payables liability increases. |

## 5. The Accounting Equation

- The elements of financial statements are assets, liabilities, capital, income and expenses. These elements relate to one another, and their relationship is expressed in the accounting equation:
  Capital or Net Assets = Assets – Liabilities
- At any point in time when transactions have been recorded correctly, the accounting equation will always balance.
- **Capital** is also known as net assets and belongs to the owner. It is the amount the owner invested minus any amounts that owners have taken out of the business (drawings) plus the profit made by the business.

- **Closing Capital = Total Capital Introduced – Drawings + Profits**
- **Assets – Liabilities = Total Capital Introduced – Drawings + Income – Expense**
-

# 6. The Accounting Equation and Double Entries

- A transaction recorded using double entries will always cause the Accounting Equation to balance. This is due to the dual impact of Double Entry, where each transaction creates a Debit and Credit entry that equals.
- The expanded accounting equation can be rearranged to show only positive signs:
  **Assets + Drawings + Expenses = Capital + Liabilities + Income**
  The positive elements on the right side of the formula increase with a debit entry, while the negative elements on the left increase with a credit entry.

| Category | A debit entry will… | A credit entry will… |
|---|---|---|
| Asset | Increase an asset | Decrease an asset |
| Liability | Decrease a liability | Increase a liability |
| Income | Decrease income | Increase income |
| Expense | Increase an expense | Decrease an expense |
| Capital | Decrease capital | Increase capital |
| Drawings | Increase drawing | Decrease drawing |

**Example 2 ( from acca hub)**

Yuma owns a business that makes and delivers handmade furniture to customers.
What is the effect of the transaction on the business and the double entry to record the transaction?
She buys a vehicle for the business and pays $5,000 using funds from the bank.

- The vehicle (Asset) increases by $5,000, and the bank (Asset) decreases by $5,000.

The double entry to record this is DR Vehicles $5,000 and CR Bank $5,000.

- She obtains a loan of $2,000 from a friend.

The bank (Asset) increases by $2,000, and the loan (Liability) increases by $2,000. The double entry to record this is DR Bank $2,000 and CR Loan $2,000.

- She buys office furniture paying $500 cash.

The office furniture (Asset) increases by $500, and the bank (Asset) decreases by $500. The double entry to record this is DR Office Furniture $500, and CR Bank $500.

- She pays a supplier for chairs and a table bought on credit for $1,200 credit.

The payable (Liability) decreases by $1,200, and the bank (Asset) reduces by $1,200. The double entry to record this is DR Payables $1,200 and CR Bank $1,200.

- She purchases a batch of raw materials paying $800 cash.

The purchases (Expense) increase by $800, and the bank (Asset) decrease by $800. The double entry to record this is DR Purchases $800 and CR Bank $800.

- Yuma pays rent in cash of $2,000 for the year.

The rent (Expense) increases by $2,000, and the bank (Asset) decreases by $2,000. The double entry to record this is DR Rent $2,000, and CR Bank $2,000.

**Example 3 ( from acca hub)**

What is the double entry to record the following transactions?

① Starts the business by introducing cash.

② Purchases some equipment for cash.

③ Pays a supplier for some equipment bought on credit.

④ Purchases goods for resale on credit.

⑤ Purchases goods for resale for cash.

⑥ Sells goods on credit.

⑦ Sells goods for cash.

**Example 4**

(1) Cash introduced $1,000,000 by owner

(2) Paid rent expenses $100,000 by cash

(3) Credit purchase $600,000

(4) Credit sales $800,000

(5) Cash received $600,000 from credit customers

(6) Cash paid $400,000 to credit suppliers

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（1）Cash

（2）Capital

（3）Rent

（4）Purchase

（5）Payable

（6）Receivable

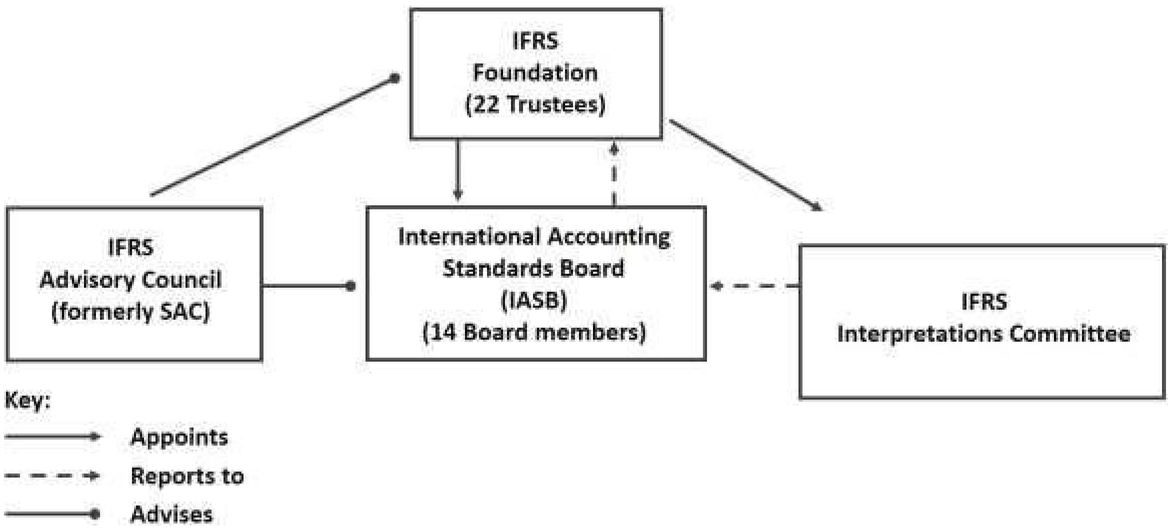
（7）Sales

# Chapter 3: The Regulatory and Conceptual Framework

**Learning outcomes:**

- Explain the purpose of the regulatory system
- Explain the role of IFRS Accounting Standards in preparing financial statements.
- Explain what is meant by governance specifically in the context of the preparation of financial statements.
- Describe the duties and responsibilities of directors in the preparation of the financial statements.
- Define and apply key principles and concepts of accounting
- Define and apply the qualitative characteristics of useful financial information.
- Explain how the accounting equation, IFRS Accounting Standards and the business entity concept underlie the statement of financial position.

## 1 Introduction to the Regulatory Framework




### 1.1 IFRS Foundation – Trustees

The Trustee foundation is an independent body that oversees the International Accounting Standards Board (IASB) and the International Sustainability Standards Board (ISSB).

The objectives of the IFRS Foundation are to:

- Develop a single set of high quality, understandable, enforceable and globally accepted IFRSs through its standard-setting body, the IASB
- Promote the use and rigorous application of those standards
- Take account of the financial reporting needs of emerging economies and small and medium sized entities (SMEs)
- Bring about convergence of national accounting standards and IFRSs to high quality solutions

### 1.2 International Accounting Standards Board (IASB)

- The International Accounting Standards Board (IASB) is an independent, privately funded body that develops and approves IFRSs.
- The Interpretations Committee works closely with IASB to support the application of the standards.
- The Board is also responsible for approving interpretations of IFRSs that the IFRS Interpretations Committee develops.

### 1.3 **International Sustainability Standards Board (ISSB)**

- International investors with global investment portfolios are increasingly calling for high-quality, transparent, reliable and comparable reporting by companies on sustainability issues such as climate and other environmental, social and governance (ESG) matters.
- The Trustees announced the creation of a new board (ISSB) in November 2021 to meet the demand for sustainability standards.
- ISSB's role is to deliver comprehensive global sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities.

### 1.4 IFRS Interpretations Committee (IFRS IC)

- The IFRS IC reviews and provides guidance on issues arising when IFRSs have been implemented.
- The IFRS IC also provides guidance on issues not addressed in IFRSs.
- The committee's responsibilities include:
  interpreting the application of IFRS Standards
  Provide timely guidance on financial reporting issues not explicitly addressed in IFRS Standards.

1.5 **IFRS Advisory Council (IFRSAC)**

- The IFRS Advisory Council advises the IFRS Foundation Trustees and the standards-setting boards (IASB and ISSB).
- The board consults the IFRSAC on their agenda, priorities, and issues related to the application and implementation of IFRSs.
- The council provides a forum for participation by other interested parties (e.g. the Organisation for Economic Change and Development (OECD), the United States Financial Accounting Standards Board (FASB) and the European Commission).
- Its primary responsibility is to advise the standards-setting board on agenda issues, work priorities and the views of IFRS Advisory Council members on the development of standards projects.

# 2. Developing IFRS Standards ( 延展阅读）

**Due Process**

IFRS Standards are developed through a due process which ensures that standard setting is transparent and considers a wide range of views from interested parties.

**Project Development**

Due process for projects typically, but not necessarily, involves the following steps:

- Setting the Agenda

When deciding what standards to develop, the IASB focuses on the relevance of the information to investors. It also looks at the availability of existing guidance and whether publishing an IFRS will lead to adopting a common approach.

- Planning the Project

The IASB draws up a project plan. The board may develop the standard itself or with another standard setter, for example, the US standard-setting body, Financial Accounting Standards Board.

The board consults with the Advisory Council about adding the topic to the Board'sagenda,and an advisory group (working group) is formed to advise the Board on the project.

- Developing and Publishing a Discussion Paper

A discussion paper is developed and published for public comment (also called a discussion document). The discussion paper gives an overview of the issues, such as a summary of possible approaches and the initial views of the authors.

Discussion paper must be approved by a majority of the Board’s members.

- Developing and Publishing an Exposure Draft

After considering comments and dissenting opinions (alternative views) received, an exposure draft is developed. The draft is then published again for public comment.

The IASB may publish a second exposure draft if comments identify significant issues.

- Developing and Publishing an IFRS

After the IASB has considered all the comments received and is satisfied that it has addressed all the points raised during the consultation process, it drafts the final version of the IFRS. IASB then has the final draft externally reviewed and obtains approval from its members that it should be published.

- Procedures after an IFRS is issued

After publication, the IASB may discuss with interested parties any unforeseen issues that have happened because of the IFRS being applied. In time, the IASB may formally review the standard if, for example, the financial reporting and legal environment have changed.

# 3 Introduction to Corporate Governance （延展阅读）

### 3.1 Global Definitions

The Organisation for Economic Cooperation and Development (OECD) defines corporate governance as:

**"The system by which business corporations are directed and controlled**. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation and spells out the rules and procedures for making decisions on corporate affairs. It also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."

The Australian Securities Exchange defines corporate governance as:

**"The system by which companies are directed and managed.** It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised. Good corporate governance structures encourage companies to create value (through entrepreneurism, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved."

### 3.2 Concept of Corporate Governance

Corporate governance is a set of rules intended to create transparency and protect the interests of shareholders and stakeholders. It sets to prescribe the roles and responsibilities of directors as the stewards of the company, which helps align the directors' interests with that of the shareholders.

The way corporate governance operates will vary significantly between companies. In some companies, the owner will own all the shares or a great majority of them, and corporate governance procedures will be simple. In other companies, no single party holds a majority of shares, but some financial institutions may have significant shareholdings.

Corporate governance mechanisms are needed to ensure that companies not only take account of the views of powerful shareholders with more considerable shareholdings but also act in the interests of shareholders owning a smaller proportion of shares.

The concept of corporate governance revolves around these three aspects:

- **Risk Management**

A company's management must manage the level of risk the business faces and refrain from making decisions that will create uncontrollable risk. The management should also disclose to its stakeholders the existence and standing of faced risk in the financial statements. Companies should maintain sound internal control systems to manage their risk levels.

For example, a company having repeatedly breached lending covenants would be on the verge of having its borrowing facilities withdrawn. This constitutes poor risk management as such actions would affect its ability to trade.

- **Quality of Information**

The company's management should ensure that proper accounting and information systems are in place to produce reliable financial statements. Information provided should be relevant, timely, accurate and represent a true and fair view of the company's position.

For example, a company investing in accounting software to streamline its trading activities ensures that information is accurate and produced on time. The company employs proper corporate governance as the quality of information is secured.

- **Stewardship**

A company's management should be open and transparent and present critical decisions on the business's performance. They should also explain the overall strategy and their intentions for the future so that investors can decide whether these align with their expectations.

For example, a company portrays stewardship by providing financial information on how it has performed over the year and the strength of its asset base.

### 3.3 Corporate Governance and Financial Statements

The UK Corporate Governance Code (which applies to all listed companies but is also considered best practice for unlisted companies and non-corporate entities) states that:

- **The board of directors must:**

-present a balanced and understandable assessment of the company's position by issuing a set of financial statements

-maintain a sound system of internal control concerning risk management

- **An audit committee (consisting of at least three independent non-executive directors) must:**

-monitor the integrity of the financial statements

-review the internal controls and risk management systems

-monitor the internal and external auditors.

- **Duties and Responsibilities of Directors**

The directors of a company have a fiduciary duty to act in good faith on behalf of the company. A business's directors are responsible for preparing the financial statements, ensuring appropriate accounting systems are in place and keeping proper records.

Concerning financial statements, a company's board of directors is collectively responsible for their:

- ✓ preparation every financial year to show a "true and fair view."
- ✓ presentation to and approval by the shareholders.
- ✓ To satisfy this responsibility, the directors should:
- ✓ Only approve the financial statements if they are satisfied that the financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss
- ✓ State in the financial statements that the responsibility of preparing them lies with the directors
- ✓ Consider the appropriateness of their use of going concern principles and convey the message in the financial documents
- ✓ Explain the company's business model and its strategy for delivering the objectives of the company in the financial statements
- ✓ Ensure that the financial statements are prepared per the form and content as prescribed by law and GAAP (e.g. IFRS)
- ✓ Ensure that adequate accounting records are kept from which the financial statements are prepared.

- **Other responsibilities of the directors of an organisation include:**

- ✓ **Prevention of Fraud** – They have a duty to prevent and detect fraud. This goes beyond the financial statements, although misstatements may be made for fraudulent reasons.
- ✓ **Cooperate with Auditors** - Directors should cooperate with the company's

auditors and not collude, mislead or deceive them. They must provide the auditors with the information and explanations they need to conduct their audit.

### 3.4 Audit Committee Responsibilities

An audit committee is a branch of a business's board of directors that takes charge of a company's financial reporting responsibilities and ensures internal controls are kept in place.

The responsibilities of the audit committee in a business include:

- ✓ Ensuring that the interests of shareholders are adequately protected concerning financial reporting and internal control.
- ✓ Monitoring the integrity of the financial statements and announcements relating to the company's financial performance, including review of the significant financial reporting judgments made.
- ✓ Reviewing the company's internal control, internal financial controls and risk management systems.
- ✓ Monitoring and reviewing the effectiveness of the internal audit function.
- ✓ Reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process.

### 3.5 Ethics and Governance

As well as being based on legal requirements, corporate governance is founded on a series of ethical concepts.

**ACCA's Code of Ethics and Conduct**

The ACCA Code of Ethics and Conduct is binding on all ACCA members, students, and partners in an ACCA practice. The ethical concepts that apply to the preparation of accounting information are:

**Integrity**

The Cadbury report on governance stressed that the integrity of reports depends on the integrity of those who prepare the reports. Integrity is about being straightforward. It means reporting financial information honestly, not misleading the users of financial statements, and producing a balanced picture of the company's affairs.

**Objectivity**

In preparing financial statements, accountants should be unbiased when they make judgements about what should be included in them. They should not be influenced by their self-interest or pressures from others towards distorting the financial statements.

**Professional Competence and Due Care**

Accountants preparing or reviewing financial statements must have sufficient knowledge to do so properly. They also need to carry out their work carefully, avoiding errors.

**Professional Behaviour**

Professional behaviour includes compliance with the laws and standards related to financial statements. It also has a broader meaning: avoiding behaving in a way that could generally damage the accounting profession's reputation.

**Confidentiality**

Confidentiality means respecting the confidential nature of information acquired through professional relationships. Confidential information should not be disclosed unless there is specific permission or a legal or professional duty.

# 4 Conceptual Framework Definition and Purpose

The conceptual framework is a statement of generally accepted assumptions and principles that provides a frame of reference for developing new practices and evaluating existing ones.

The purpose of the Conceptual Framework for Financial Reporting (Conceptual Framework) is to assist:

- the IASB (Board) in developing IFRS standards
- the preparers of financial statements in developing consistent accounting policies

all parties to understand and interpret the standards.

- The Conceptual Framework is not a standard. Therefore, nothing in the Conceptual

Framework can override a specific IFRS.

### 4.1 Fundamental qualitative characteristics

- **Relevance**

✓ Information should influence the economic decisions of users. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both.

✓ The relevance of information is affected by its nature and materiality.

✓ Materiality: Information is material if its omission or misstatement could influence the economic decisions of users taken based on the financial statements.

- **Faithful representation**

- ✓ Information must represent faithfully the transactions. To be a faithful representation, information must be **complete, neutral and free from error.**
- ✓ Faithful representation of a transaction is only possible if it is accounted for according to its substance and economic reality.
- ✓ **Substance over form**: Transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form

**4.2 Enhancing qualitative characteristics**

- **Comparability**

Comparability means users should be able to make comparisons between information:

- ✓ about the same business in different periods
- ✓ between different businesses in the same period
- ✓ Comparability requires consistent measurement and classification, and presentation of the financial effects of similar transactions and events.
- ✓ Comparability does not always mean using the same methods to prepare information..

- **Verifiability**

- ✓ **Verifiability** means giving financial statements users confirmation that their financial information is faithfully represented.
- ✓ Verifiability means that knowledgeable, independent observers can reach a consensus that a particular representation has the fundamental quality of faithfulness.

- **Timeliness**

Timeliness links to relevance. For information to influence users' decisions, it must be available when users make their decisions. Older information is generally less useful (but may still be useful in identifying and assessing trends).

- **Understandability**

- ✓ Understandability means showing information clearly and concisely. Some items in the financial statements are complicated.
- ✓ However, if they are omitted, the statements will be incomplete. Understandability also assumes that the users of the financial statements have some accounting knowledge.
- ✓ Information about complex matters should not be excluded because it may be too difficult for certain users to understand.

**Example 1**

| Action | Characteristic |
|---|---|
| Shareholders have been asked if there is anything in the annual financial statements that confuses them, and they have said everything is clear. | Relevance |
| The auditors have completed their audit work and have found that the accounting records support the financial statements. | Faithful Representation |
| Management checks information before publication to ensure it is all correct and does not miss anything. | Comparable |
| Financial advisers use financial information to see how the company is doing compared to other companies and to advise their clients. | Verifiable |
| Investors use financial information to judge a company's prospects and decide whether to continue to invest in the company. | Timeliness |
| The accounts department prepares financial information covering an accounting period within two weeks of the end of the period. | Understandable |

# 5. Accounting Principles

Accounting principles are the fundamental concepts accountants use to prepare financial statements. Standard-setting boards consider these principles when developing new frameworks and financial standards.

### 5.1 Materiality

- The item's nature and size are evaluated when determining whether the information is material.
- If the item's non-disclosure could influence the economic decisions of users based on the financial statements, it is material.

- Each material item should be presented separately in the financial statements. At the same time, immaterial amounts of a similar nature or function should be aggregated and need not be presented separately.

**5.2 Offsetting**

- An entity shall not offset assets and liabilities or income and expenses unless required or permitted by an IFRS.
- Offsetting between these elements in the financial statements is not allowed unless the offsetting reflects the substance of the transaction.

**5.3 Consistency**

- Consistency is needed to achieve comparability. It means treating and consistently presenting similar items in the financial statements over different periods unless there are appropriate reasons to make a change.
- Reasons for change in the treatment of similar items could be due to the following:

✓ a significant change in its operations or if another classification provides a more suitable presentation of its transaction.
✓ Required by a new IFRS standard
✓ Changes in accounting policies need to be disclosed in the notes of financial statements.

**5.4 Prudence**

- Prudence is the exercise of caution when making judgements under conditions of uncertainty. In preparing a business's financial statements, assets and income should not be overstated, while liabilities and expenses should not be understated.
- The main problem with exercising prudence is that it may result in the understatement of assets (and income) and the overstatement of liabilities (and expenses).

**5.5 Duality (dual aspect)**

Also known as the dual effect or dual aspect, the double entry concept explains that every transaction has at least two impacts on a business, a debit and credit entry.

**5.6 Historical Cost and Current Value**

- The historical cost concept states that all transactions are initially recorded at historical cost, which is the cost at the time of the transaction. The historical cost system of accounting is particularly relevant to Assets.

- Current value measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date.

  Some bases of current value include:

  Fair value (price on an active market, or present value of future cashflows)

Value-in-use (value derived from use of the asset)

Current cost (value of an equivalent asset on measurement date)

**5.7 Substance over Form**

Substance over form is part of faithful representation. It means that the treatment of items in a company's financial statements should be determined by their commercial reality and not by how they could be treated for legal purposes.

# 6 Basis of Financial Statements Preparation

The financial statements are prepared by the management (directors) of a company with these three basic assumptions:

**6.1 Going concern**

- It assumes that an entity will continue operating for the foreseeable future (the next 12 months). During that time, the company directors do not intend or will not be forced to liquidate the business or cease trading.
- Going concern underlies the basis of the preparation of all published financial statements. It is so fundamental that users are entitled to assume that this basis has been applied unless an alternative basis is stated (in the notes to the financial statements).

**Example 2**

A retailer commences business on 1 January and buys inventory of 20 washing machines, each costing $100. During the year he sells 17 machines at $150 each. How should the remaining machines be valued at 31 December in the following circumstances?

1)He is forced to close his business at the end of the year and the remaining machines will realize only $60 each in a forced sale

2)He intends to continue his business into the next year

**Solutions :**

1) If the business is to be closed, the remaining three machines must be

valued at the amount they will realize in a forced sale 3* $60=$180;

2) If the business is regarded as a going concern, the inventory unsold at 31 December will be carried forward into the following year, when the cost of the three machines will be matched against the eventual sale proceeds in computing that year's profit. The three machines will therefore be valued at cost: 3*$100=$300

### 6.2 Accruals basis

- The financial statements cover all transactions and events in the stated accounting period.
- Transactions and events are recognised in a company's accounting records when they happen and are not based on cash settlement.
- The accruals basis links to the matching concept that expenses are recognised in the same accounting period as the revenues they relate to.

### 6.3 Business Entity

- The contents of the financial statement relate to the business.
- The business is a separate entity from its owners/shareholders. The financial statements should only include transactions that relate to the business and not transactions that relate to the shareholders' personal interests.
- The business entity concept is an accounting concept, not a legal concept. Therefore, it applies to sole traders and partnerships even though the business and the owners are not legally distinct.

# Chapter 4: Maintaining Accounting Records and Accounting Systems

<u>**Learning outcomes:**</u>

- Identify and explain the function of the main data sources in an accounting system.
- Describe the key features of a computerised accounting system, including the use of external servers to store data (the cloud).
- Describe how an accounting system contributes to providing useful accounting information and complies with organisational policies and deadlines.
- Identify the main types of business transactions e.g. sales, purchases, payments, receipts.
- Describe the main types of general ledger accounts, including their nature and function.
- Describe how financial data is initially recorded in the accounting system.
- Explain the use of journal entries and how journal entries are posted into general ledger accounts.
- Identify correct journal entries from given narrative.
- Illustrate how to balance and close the general ledger accounts at the year end.

## 1. Flow of Accounting Information

- The eventual goal of accounting is to present fairly and accurately all financial transactions in the financial statements.
- The process starts with recording all **business transactions** with information available in the **financial documents** and classifying them into the relevant **ledger accounts** through computerised systems or journals. At year-end, balances of each ledger account form the **trial balance**, which is used as a basis to prepare the **financial statements**.

### 1.1 Business transactions

Business transactions are the business's day-to-day activities that have monetary value and will need to be recorded in the accounting records.

The main types of business transactions are:

- Sales

Sales are the exchange of goods change of goods or services for money. These may be for cash or credit. Cash sales are made in exchange for immediate cash payment, while credit sales are made with a promise of payment to the business in the future.

- Sale Returns

Sales returns are faulty or incorrect goods returned from a customer due to faulty or damaged goods being supplied.

- Purchases

Purchases are the exchange of money for goods or services. Cash purchases are made in exchange for an immediate cash payment, while credit purchases are made with a promise to pay the supplier in the future.

- Purchase Returns

Purchase returns are faulty or incorrect goods sent back to the supplier due to faulty or damaged goods being supplied.

- Payments

Payments are the settlement or transfer of money to a third party

- Receipts

Receipts are due to the business receiving money from a third party

**1.2 Financial documents**

- Quotation

A document sent to a customer by a company stating the fixed price that would be charged to produce or deliver goods or service.

- Purchase order

A document of the company that details goods or services which the company wishes to purchase from another company.

- Sales order

A document of the company that details an order placed by a customer for goods or services.

- Goods dispatched note

A document of the company that lists the goods that the company has sent out to a customer.

- Goods received note

A document of the company that lists the goods that a business has received from a supplier.

- Invoice

A document issued by supplier to a customer showing descriptions of the transactions and is primarily a demand for payment.

- Debit note

A document sent by a customer to a supplier in respect of goods returned or overpayment made by the customer. It is a formal request for the supplier to issue a credit note. Debit note might be issued to adjust an invoice already issued.

- Credit note

A document sent by a supplier to a customer in respect of goods returned or overpayment made by the customer.

- Statement

A document sent out by a supplier to a customer listing the transactions, including all invoices and credit notes issued and all payments received from the customer.

- Remittance advice

A document sent to a supplier with payment, detailing which invoices are being paid and which credit notes offset.

- Receipt

A document confirming confirmation that a payment has been received.

**Example 1**

Manish buys goods on credit from Lisa but finds that some of them are faulty.
What document would Manish return to Lisa with the faulty goods?
Statement
Debit note
Sales invoice
Purchase invoice

**1.3 Leger**

(1) Purpose of General Ledgers

Most users of financial **statements** do not require the detail of every transaction that large businesses will encounter daily. Therefore, the financial information of each transaction should be summarised before completing the final accounts.

- Information from the source document is classified into their respective ledger accounts using double entries via computerised systems or the Journal.
- The general ledger contains individual accounts for the business's assets, liabilities, capital, income and expenses. For example, information on a sales invoice is posted into the Sales ledger and Cash or Trade Receivables account.
- The general ledger contains all the individual ledger accounts used by a business.

(2) T-Accounts

The individual ledger accounts within the general ledger are called T-accounts, as it is a graphical representation of a ledger account.

(3) Main General Ledger Accounts

✧ Statement Of Financial Position Accounts

Statement of financial position accounts are those used for recording assets, liabilities and capital transactions. These accounts are included in the Statement of Financial Position:

**Examples of statement of financial position ledger accounts are:**

- Trade Receivables – This asset ledger account records sales made where the settlement has not been received. A debit entry into the Trade Receivables ledger increases its balance.
  Credit sales increase the trade receivables balance, while payment received from credit customers reduces its balance.

✧ Income and Expenditure Accounts

Income and expenditure (expense) accounts record the transactions determining profit (or loss) for a period.

**Examples of income and expenditure ledger accounts are:**

- Sales – This income ledger account records the business's cash or credit sales. A credit entry into the Sales ledger increases its balance. Sales generated by the business increase the Sales balance. A sales return transaction reduces the Sales ledger balance if no separate Sales Return ledger is maintained.

**(4) Balancing ledger accounts**

- If the total debits exceed the total credits there is said to be a **debit balance** on the account; if the credits exceed the debits then the account has a **credit balance**.
- Balancing off Assets, Liabilities and Capital accounts
  (a) Total both sides of the T account and find the **larger side**;
  (b) Put the larger total on the larger side (debit or credit side);
  (c) Insert a balancing figure to **smaller side** of the T account to make two sides equal. Call this balancing figure 'balance carried down (c/d) or balance carried forward (c/f);
  (d) Carry the balance down **diagonally** and call it 'balance brought down (b/d) or balance brought forward (b/f).

**(5) Closing off Income and Expenses accounts**

(a) At the end of a period, any amounts that relate to that period are **transferred** to statement of profit or loss.
(b) This is done by **closing** the account.
(c) DO NOT show a balance c/d or balance b/d but instead put the balancing figure on the smaller side and label it **"statement of profit or loss**"

| | Dr | Cr |
|---|---|---|
| Assets accounts | X | |
| Liabilities accounts | | X |
| Capital account | | X |
| Income accounts | | X |
| Expenses accounts | X | |
| Total | X | X |

### 1.4 Trial balance

- At suitable intervals, the entries in each ledger accounts are totaled.
- Total balances are usually collected in a trial balance which is then used as a **basis** for preparing a statement of profit or loss and other comprehensive income and a statement of financial position.

### 1.5 Financial statements

The balances on **income** and **expenses** accounts are transferred to the **statement of profit or loss and other comprehensive income,** while the balances on **assets** and **liabilities** are transferred to the **statement of financial position.**

## 2. Journal

- The **journal** keeps a record of unusual movement between accounts.
- It is used to record any double entries made which do not arise from the other books of prime entry.

For example

- ✓ Period-end adjustment
- ✓ Correction of errors
- ✓ Large or unusual transactions

The **format** of a journal entry

| **Date** | **Debit** | **Credit** |
|---|---|---|
| | $ | $ |
| Account to be debited | X | |
| Account to be credited | | X |
| (Narrative to explain the transaction) | | |

## 3. Computerised Accounting Systems ( 延展阅读）

- Using a computerised system, a business may input details of the source document, and an automated double entry is generated to the relevant ledger accounts.
- In a computerised system, activities are categorised into three processes:
  Inputs – Inputs are data entered into the accounting system from the source documents.
  Processing – Data entered is posted into the relevant ledger accounts
  Output – Financial statements and other reports are produced for management use

## 4. Desktop vs Cloud Accounting Systems （延展阅读）

A desktop accounting (on-premise) software system is hosted on a computer's hard drive. The software is initially installed on the business premise's desktop and is maintained regularly.
A cloud accounting software system is hosted, updated, and maintained online. The organisation pays a fee to a service provider that hosts the software on remote servers.

## 5. Accounting system （延展阅读）

# Chapter 5: Recording Business Transactions and Sales Tax

Learning outcomes:

- Record sale and purchase transactions in the general ledger account.
- Record sales returns and purchase returns in the general ledger accounts.
- Describe the principles of the operation of a sales tax.
- Calculate sales tax on transactions and record the consequent accounting entries.
- Understand the settlement discount and trade discount.
- Explain the purpose of bank reconciliations.
- Prepare the reconciliation of the bank general ledger account to the bank statement or internet banking records.
- Identify the main reasons for differences between the bank general ledger account and the bank statement or internet banking records.
- Identify and correct errors and/or omissions in the bank general ledger account.

## 1 Recording Business Transactions

**1.1 Cash sales :** received cash payment at sales point.

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Cash/Bank | Asset | Cash (Asset) increased |
| CR | Sales | Income | Sales (Income) increased |

**1.2 Credit sales :** A credit sale arises from a sale to a customer for future payment. At the point of sale, the customer owes the business the sale amount. The amount is classified as trade receivables. The double entry to record a credit sale is:

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Trade Receivables | Asset | Receivables (Asset) increased |
| CR | Sales | Income | Sales (Income) increased |

**1.3 Sales Return:** Sale returns are goods returned to the business by the customers due to an error on the business's part, such as delivering damaged or incorrect items. Credit notes are issued by the business to reduce the value of the previously issued sales invoice.

| | | | |
|---|---|---|---|
| DR | Sales Return | Expense | Sales (Income) decreased |
| CR | Trade Receivables | Asset | Receivables (Asset) decreased |

**1.4 Receipts from Customer:** At the end of the credit term, the customers should pay the business for the outstanding balance for purchases. The double entry to record receipts from credit customers is:

| | **Individual Account** | **Category** | **Explanation** |
|---|---|---|---|
| DR | Bank/Cash | Asset | Bank/Cash (Asset) increased |
| CR | Trade Receivables | Asset | Receivables (Asset) decreased |

**1.5 Cash Purchases:** A cash purchase arises from a purchase from a supplier for immediate payment. The double entry to record a cash purchase is:

| | | | |
|---|---|---|---|
| DR | Purchases | Expense | Purchases (Expense) increased |
| CR | Cash/Bank | Asset | Cash (Asset) decreased |

**1.6 Credit :** A credit purchase arises from a purchase from a credit supplier for future payment. At the point of purchase, the business owes the business to the seller. The purchase amount is classified as Trade Payables.

| | **Individual Account** | **Category** | **Explanation** |
|---|---|---|---|
| DR | Purchases | Expense | Purchases (Expense) increased |

| | | | |
|---|---|---|---|
| CR | Trade Payables | Liability | Payables (Liability) increased |

**1.7 Purchase Returns:** Purchase returns are goods returned to the seller by the business due to an error, such as delivering damaged or incorrect items. The seller issues credit notes to reduce the value of the previously issued purchase invoice.

| | | | |
|---|---|---|---|
| DR | Trade Payables | Liability | Payables (Liability) decreased |
| CR | Purchase Return | Expense | Purchase (Expense) decreased |

**1.8 Payments to Suppliers:** At the end of the credit term, the business should pay the supplier for the purchased items. The double entry to record payments made to suppliers is:

| | **Individual Account** | **Category** | **Explanation** |
|---|---|---|---|
| DR | Trade Payables | Liability | Payables (Liability) decreased |
| CR | Bank/Cash | Asset | Cash (Asset) decreased |

**1.9 Petty Cash Transactions**

- **Petty cash** refers to small amounts of money kept on business premises for small-value purchases.
- The petty cash ledger records when cash is used to make sundry small payments such as postage stamps, coffee and taxi fares.
- The petty cash will be kept securely in a locked cash box.
- The amount of money typically held in the petty cash box is known as a float.
- **The two sources of petty cash are**:

**Small Receipts**

A business may make petty cash sales on small-value items on the business premise. For example, a business client comes to the office for a meeting and uses the office photocopier to print some documents. They may pay a small fee due in cash. This would be placed in the cash float.

**Imprest System**

The business decides how much float it would like to keep in the cash box by employing an impress or non-impress system. Periodically, cash is withdrawn from the bank account to maintain the amount of the float.

- **Methods of Replenishing**

An imprest system of replenishing is where a fixed sum of money is maintained in the petty cash tin to pay for items of petty expenditure. This sum is replenished at regular intervals or when needed.

**Key Point**

Imprest Amount = Balance in the Petty Cash tin + Petty Cash Vouchers

**Example 1**

In a week, the petty cash tin had the following transactions:

| | $ | $ |
|---|---|---|
| Imprest balance at the beginning of the week | | 100 |
| Less: Paid during the week | | |
| Stationery | 9 | |
| Tea and coffee | 14 | |
| Telephone | 2 | |
| Taxi | 4 | |
| Auditor’s lunch | 39 | |
| | | 68 |
| Petty cash-in-hand at the end of the week | | 32 |

At the end of the week, $68 of cash will be drawn from the bank to reimburse the petty cash tin to top it up to the imprest balance of $100.

- **A non-imprest system** is any other method of replenishing than an imprest system. An amount added into the petty cash tin, regardless of the petty cash taken out during the week, is a non-imprest system.

**For example**, a business starts with $125 in the petty cash tin at the beginning of the period. During the week, the business uses up $38 of petty cash. $40 is added back into the petty cash tin, bringing to total petty cash amount to $127.

**Another example** of a non-imprest method is when a business replenishes a fixed amount of $30 regardless of the balance in the Petty Cash tin.

- The petty cash tin is reimbursed by transferring money from the business bank account. **The double entry to record petty cash replenishment is:**

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Petty Cash | Asset | Petty Cash (Asset) increased |
| CR | Bank | Asset | Cash in Bank (Asset) decreased |

- **Need for a Record:**

The Petty Cash ledger is maintained, and relevant transactions are recorded to establish internal controls.

The record of petty cash transactions helps minimise the risk of theft and fraud (expenses must have documentary support).

Every payment out of the petty cash tin is supported with a voucher. The cashier will authorise the voucher.

At the end of each month, the petty cash book is totalled, and the expense totals are posted to the general ledger accounts.

The record of petty cash transactions in the ledger also collects information valuable to the manager's operations. If the petty cash expenses are high in a period, the petty cash ledger can provide the transaction documentation to support any issues.

# 2 Sales tax

### 2.1 General Principles

- An indirect tax is a tax charged on goods and services rather than on the profits made by a business.
- Indirect taxes are not taken directly from a person through their tax affairs but via the business where they bought the item.
- Sales tax is an example of an indirect tax.
- Businesses must register with the tax authorities in their country to become sales tax collecting agents for the government. Businesses charge tax on sales (output tax) and reclaim tax on purchases (input tax).
- A business must be registered to collect or reclaim sales tax.

**Output Tax** is the sales tax charged on sales to customers.

**Input Tax** is the sales tax paid on purchases of goods and services.

- If Output tax exceeds Input Tax = Tax Payable to authorities **(Current Liability)**

If Input tax exceeds Output Tax = Tax Reclaimable from authorities (**Current Asset)**

### 2.2 Sales Tax Calculation

- **Gross Figure:** the sale or purchase price,**including sales tax**
  Sale tax = gross figure * sale tax%/ (sale tax % + 100%)

- **Net Figure**: the sale or purchase price, **excluding sales tax**.

Sale tax= net figure * sale tax %

**Example 2 ( from hub)**

Hanna is a sole trader selling furniture from her shop. The sales tax rate in Hanna's country is 20%. This example illustrates her sale of a table.
If the Net price of the table is $250, the sales tax is:

| Net Amount | Sales Tax | Gross Amount |
|---|---|---|
| $250 | $50<br>($250 * 20/100) | $300<br>($250 + $50) |
| Always 100% | 20% | 120% |

If the Gross price of the table is $300, the sales tax is:

| Net Amount | Sales Tax | Gross Amount |
|---|---|---|
| $250<br>($300 - $50) | $50<br>($300 * 20/120) | $300 |
| Always 100% | 20% | 120% |

**Example 3 ( from Hub)**

Binta works at a luxury car dealership. She makes a sale to a customer for $23,500, excluding sales tax. The sales tax rate is 25%.
How much sales tax is charged on this transaction, and what is the total amount due from the customer?

| | Sales Tax ($) | Amount due from customer ($) |
|---|---|---|
| a) | 5,875 | 23,500 |

| | | |
|---|---|---|
| b) | 4,700 | 23,500 |
| c) | 5,875 | 29,375 |
| d) | 4,700 | 28,200 |

**Example 4 ( from hub)**

Desmond makes two sales of goods to customers for $800 (net price) and the other for $1,200 (gross price). The sales tax rate is 20%.

How much sales tax does Desmond charge on these sales?

A $333

B $360

C $373

D $400

**Solutions**

1 C. The sale is a net figure (excluding sales tax). The sales tax is 25% × $23,500 = $5,875. The amount due from the customer is the gross figure of $23,500 + $5,875 = $29,375.

2 B. The sales tax due on the $800 net is 20% × $800 = $160. The sales tax due on the $1,200 gross is 20 ÷ 120 × $1,200 = $200. The total is $360 ($200 + $160).

## 2.3 Accounting for Sales Tax

- **Cash and Credit Sales**

DR Cash/ Trade Receivables (Asset)

CR Sales (Income)

CR Sales Tax (Liability)

- **Sale returns**

DR Sales Tax (reduce Liability)

CR Trade Receivables account (reduce Asset)

- **Cash and Credit Purchase**

DR Purchases (Expense)

DR Sales Tax (Asset)

CR Cash/ Trade Payables (reduce Asset/ increase Liability)

- **Purchase returns**

DR Trade Payables (reduce liability)

CR Sales Tax (reduce Asset)

CR Purchase Returns (reduce Expense)

## 2.4 Payment to/Receipt from Tax Authorities

- At the end of every quarter, the sales tax returns are filled with the output and input sales tax amount.
- If the output tax exceeds the input tax (more sales), the business will make payment to the tax authorities.
- If the input tax exceeds the output tax (more purchases), the business will collect refunds from the tax authorities.
- When a business makes a payment for the balance owed to the tax authorities, the double entry is:

**DR Sales Tax (reduce Liability)**

**CR Cash (reduce Asset)**

- When a business receives a refund from the tax authorities, the double entry is:

**DR Cash (increase Asset)**

**CR Sales Tax (reduce Asset)**

- The Sales Tax ledger is summarised in the below T-Account after all the relevant entries have been posted:

| DR | **Sales Tax (Liability)** | | CR |
|---|---|---|---|
| Balance b/d (if reclaimable position) | X | Balance b/d (if payable position) | X |
| Cash/Credit Purchases (Input) | X | Cash/Credit Sale (Output) | X |
| Sale Returns | X | Purchase Returns | X |
| Cash paid to tax authorities | X | Cash received from tax authorities | X |
| Balance c/d | XX | Balance c/d | |
| | X | | X |
| Balance b/d (if reclaimable) | | Balance b/d (if payable) | XX |

**Example 4 ( from hub)**

Complete the sales tax ledger account from the list of transactions during a period.

| Narrative | $ |
|---|---|
| Sales tax on cash sales | 1200 |
| Sales tax on credit sales | 300 |
| Sales tax on credit purchases | 750 |
| Sales tax on cash purchases | 120 |
| Cash paid to tax authority | 560 |
| Amount due to tax authority at start of period | 560 |

The Sales Tax ledger will show the following after the above entries are made:

| Dr | | | | | Cr |
|---|---|---|---|---|---|
| Date | Narrative | $ | Date | Narrative | $ |
| | Sales tax on credit purchases | 750 | | Amount due to tax authority at start | 560 |
| | Sales tax on cash purchases | 120 | | Sales tax on cash sales | 1,200 |
| | Cash paid to tax authority | 560 | | Sales tax on credit sales | 300 |
| | Balance c/d | 630 | | | |
| | | 2,060 | | | 2,060 |

# 3 Discounts Allowed and Received

**3.1 Trade Discounts**

- Trade discounts offered to customers are guaranteed discounts, and customers are expected to take advantage of the discount. Therefore, trade discounts offered are **always considered when recognising sales.**
- Trade discounts on **sales are discounts allowed**, while trade discounts **on purchases are discounts received.**
- In both scenarios, the sale or purchase transaction is recorded **net of the trade discount.**

**Example 5 ( from hub)**

The listed price of a new fragrance is \$40 a bottle. Maple Leaf offers Kirby, a retail shop owner, a 25% discount on ten bottles. Kirby takes advantage of the discount price offered. What are the accounting entries in Maple Leaf's ledgers if Kirby:

- **pays immediately in cash:**

Maple Leaf has made a cash sale of \$300 (\$40 × 10 bottles − trade discount 25%). The double entry to record this is DR Cash \$300 and CR Sale \$300.

- **is given 30 days in which to pay:**

Maple Leaf has made a credit sale of \$300. The double entry to record this is DR Trade Receivables \$300 and CR Sale \$300.

### 3.2 Settlement Discounts

- A **settlement discount (or prompt payment discount)** is a discount offered to customers or given by suppliers for payment made **within** a specific timeframe. It is offered **only in credit transactions.**
- A settlement discount encourages the customers to pay outstanding balances to the business earlier than the standard credit agreement term (credit period).
-

#### 3.2.1 Settlement Discounts Allowed

Settlement discounts allowed are offered to customers who pay the amount owed to the business within an agreed time.

**Situation 1 :** If the supplier **expects** the customer t**o take advantage of the** settlement discount, sales are recorded at the **net amount after deducting settlement discounts.** This is the same treatment as trade discounts.

**Example 6 (expects to take up settlement discount)**

Simon sells Arthur $500 of goods on credit and offers him a 5% discount for payment within seven days. Simon expects Arthur to take advantage of the discount offered. What are the accounting entries in Simon's ledgers if Arthur:

-Takes the discount
-Does not take the discount

**Solution:**

- **Simon expects Arthur to take up the settlement discount at the initial sale entry.**

  DR Trade Receivables $475

  CR Sale $475.

- **When Arthur takes up the discount by paying within seven days**
  DR Cash $475
  CR Trade Receivables $475.

- **Arthur does not take up the settlement discount means that he pays $500 after seven days.**
  DR Cash $500 (record cash receipt)
  CR Trade Receivables $475 (remove receivables balance)
  CR Sales $25 (balancing figure)

**Example 7 (not expected to take up settlement discount)**

Hannah sells Joycelyn $650 of goods on credit and offers her a 15% discount for payment within two weeks. Hannah does not expect Joycelyn to take advantage of the discount offered as she has not taken it up in the past. What are the accounting entries in Hannah's ledgers if Joycelyn:

-Pays in 30 days (the credit term)

-pays in 10 days

**Solution:**

- **Hannah does not expect Joycelyn to take up the settlement discount at the initial sale entry**

  DR Trade Receivables $650

  CR Sale $650.

- **If Joycelyn pays in 30 days, she pays for the full amount.**

  DR Cash $650

  CR Trade Receivables $650.

- **If Joycelyn pays in 10 days, she is eligible for the settlement discount and pays only**: $650 − Settlement Discount $97.50 ($650 × 15%) = $552.50

  DR Cash $552.50 (record cash receipt)

  DR Sale $97.50 (balancing figure)

  CR Trade Receivables $650 (remove receivables balance)

### 3.2.2 Settlement Discount Received

- **Settlement discounts received** are given by a supplier on purchases where the business pays within an agreed time.
- Settlement discounts on purchases are recorded differently than other forms of discount as **it is only recorded on payment.**
- **At the point of purchas**e, the **full invoice** amount is recognised as **purchases** (expense). There should be no deduction of the settlement discount even if the business expects to take it up.

- The settlement discount is only recorded when the **discount is taken up during payment**
- **At point of purchase**

Dr purchase

Cr trade payable

- **At point of payment**

**(1) Suppose the business pays within the stipulated period and takes advantage of the settlement discount.**

DR Trade Payables (to clear the balance owed to the supplier)

CR Cash (by the actual amount paid)

CR Discount Received (by the settlement discount amount)

**(2) If the business pays after the stipulated time-frame.**

DR Trade Payables

CR Cash

| **Example 8 ( from hub)** |
|---|
| Clara buys goods from Jaime for $100 on credit. Jaime offers Clara a 5% discount for early settlement within seven days. What are the accounting entries in Clara's ledgers if:<br><br>-Clara pays within seven days<br>-Clara pays after seven days<br>**Solution:**<br><br>**<u>1.Record the purchase at full price</u>**<br>At the point of the credit purchase<br><br>DR Purchases $100<br>CR Trade Payables $100<br>**<u>2. Record the cash payment</u>**<br>**If Clara pays within seven days, she takes advantage of the settlement discount.**<br>The actual payment will be net of the settlement discount: $100 – Settlement Discount $5 ($100 – 5%) = $95. The double entry to record is:<br><br>DR Trade Payables $100 (remove payables balance)<br><br>CR Cash $95 (record cash payment)<br><br>CR Discounts Received $5 (balancing figure) |

**If Clara pays after seven days, she is not entitled to the settlement discount and pays the full price of $100.**

DR Trade Payables $100

CR Cash $100

## 4 Bank statement

- Weekly or monthly, a business will receive a bank statement from the bank, which would be used to check the amount shown in the cash book prepared by the business
- The statement shows:
  The balance in the account at the beginning of the month
  The individual deposits received
  Cheques that have been presented and paid during the month
  Any other adjustments made, e.g. bank charges, bank interest
  Account balance at month-end
- The balance in the account represents a liability on the part of the bank and is therefore reflected on the bank statement by a credit balance.
- A debit month-end balance on the bank statement thus represents an overdraft position.

## 5 Bank reconciliation

- Our cash book and the bank statement as on a particular date will seldom agree. To prove the accuracy of both records, therefore, it is necessary to compare them, isolate factors that cause a variance in the balances, and satisfy ourselves that if these factors are taken into account, the two sets of records will be in agreement. To formalize this process of reconciliation, a bank reconciliation statement is prepared.
- There are three main reasons why the two records are seldom in agreement:

| Unrecorded Difference | Timing Difference | Error |
|---|---|---|
| 1.Direct Debit<br><br>Standing Order<br>Bank interest on deposit 4.Bank interest on overdraft 5.Bank Charge<br>6.Dishonored cheque<br>7.Credit transfer | Uncleared lodgement (Deposit - in - transit)<br>Unpresent cheque | 1.Business error<br><br>2.Bank error |

| Dr | Cash | book | Cr |
|---|---|---|---|
| | $ | | $ |

**Bank reconciliation statement As at the end of the year xxxx**

| | $ |
|---|---|
| Balance as per bank statement | X / (X) |
| Less: unpresented cheques | (X) |
| Add: deposit-in-transit | X |
| Add/less: bank error | X / (X) |
| Balance as per adjusted cash book | X / (X) |

**Example 9 ( from hub)**

**For each of the differences below, state whether the difference should be adjusted in the Bank ledger or included in the bank reconciliation.**

A business makes payments of $500 on 30 December that has yet to appear on the bank statement.

The bank statements show a direct debit payment of $600 that the business has not recorded.

The bank statements show a dishonoured cheque of $200 that had been received from a customer and banked by the business.

A business deposits $800 of receipts on 29 December that has yet to appear on the bank statement.

The bank statement shows $100 of interest charges. Upon investigation, these charges have been included on the bank statement in error.

**Solutions**

Included in the Bank Reconciliation. This is an unpresented cheque (timing difference).

Adjusted in the Bank ledger. This direct debit transaction is omitted from the ledger and needs to be included to derive the updated bank ledger balance.

Adjusted in the Bank ledger. The business recorded cash received, but the bank dishonoured the cheque. No money was received. The bank ledger needs to be adjusted to reflect the correct balance.

Included in the Bank Reconciliation. This is an outstanding lodgement (timing difference).

Included in the Bank Reconciliation. This bank error should not be amended in the Bank ledger. The business should notify the bank to resend a corrected bank statement.

**Example 9 ( from hub)**

Tabby Wear Co is a company that sells children's clothing to clothing retailers with a financial year-end of 31 December.

On 30 June 20X5, Tabby received her bank statement with a CR balance of $23,325. Tabby Wear Co's Bank ledger balance is only DR $17,970. A bank reconciliation is prepared for the difference of $5,355. (From the bank's perspective, CR in the bank statement is a positive balance).

Upon investigation, Tabby identifies the following:

1. Tabby Wear Co made payments of $20,110 on 29th June 20X5. These payments have not appeared on the bank statement.

-This is an unpresented cheque and is a timing difference. This amount will be adjusted in the bank reconciliation.

2. Tabby Wear Co banked receipts of $10,935 on 30th June 20X5. Similarly, these receipts have not appeared on the bank statement.

-This is an outstanding lodgement and is a timing difference. This amount will be adjusted in the bank reconciliation.

3. The bank has deducted bank charges of $625 on the bank statement in error.

-This bank error will be adjusted in the bank reconciliation.

4.A standing order for a phone bill payment of $2,300 is shown in the bank statement but omitted from the Bank ledger.

-This standing order of $2,300 will be adjusted in the Bank ledger via the journal. The journal entry to record this is DR Phone Expense, CR Bank.

5.A dishonoured cheque from a credit customer for $895. Tabby Wear Co had banked this cheque, but the bank informed them that the customer had insufficient funds to pay this receipt.

-This dishonoured cheque of $895 is adjusted in the Bank ledger as the receipt was not transferred. The journal entry is DR Trade Receivables, CR Bank.

The Bank ledger should be as follows once the correction entries (4 and 5) are made:

| **DR** | | | **Bank (Asset)** | | **CR** |
|---|---|---|---|---|---|
| 30-June | Balance b/d | $17,970 | 30-June | Standing Order | $2,300 |
| | | | 30-June | Dishonoured Cheque | $895 |
| | | | 30-June | Balance c/d (Revised) | $14,775 |
| | | **$17,970** | | | **$17,970** |
| 01-July | Balance b/d | $14,775 | | | |

The revised balance in the Bank ledger ($14,775) is compared again to the balance in the bank statement ($23,325). Since there is still a difference of $8,550 ($23,325 – $14,775), a Bank Reconciliation is prepared.

The Bank Statement balance is entered at the top, and all the timing differences and bank errors are recorded. The totalled balance should agree with the Bank ledger balance:

**Example 9 ( from hub)**

**Bank Reconciliation Statement**

| | |
|---|---|
| Bank Statement Balance | $23,325 |
| Less: Unpresented Cheques | ($20,110) |
| Add: Outstanding Lodgements | $10,935 |
| Add: Bank Charges in Error | $625 |
| Bank Ledger Balance | **$14,775** |

The DR $14,775 balance is the correct Bank ledger closing balance to be reported in the trial balance and the financial statements.

# Chapter 6: Receivables and Payables

**Learning outcomes**

- Identify and explain examples of receivables and payables.
- Identify the benefits and costs of offering credit facilities to customers.
- Describe the purpose of an aged receivables analysis.
- Describe the purpose of customer credit limits.
- Prepare the journal entries to write off an irrecoverable debt.
- Record an irrecoverable debt recovered.
- Demonstrate the impact of irrecoverable debts on the statement of profit or loss and on the statement of financial position.
- Prepare the journal entries to create and adjust an allowance for receivables.
- Illustrate how to include movements in the allowance for receivables in the statement of profit or loss and how the closing balance of the allowance should appear in the statement of financial position.
- Account for contras between trade receivables and trade payables.
- Prepare, reconcile and explain the purpose of supplier statements.

## 1 Introduction to Receivables

### 1.1 Receivables Definition

**Receivables** are the amounts due to the business from individuals, organisations, or other entities to satisfy a debt or a claim

### 1.2 Examples of Receivables

- **Trade Receivables** – These are amounts due from customers for credit sales of goods or services.
- **Prepayments or Prepaid Expenses** – These are the amounts that have already been paid by the business but relate to a future accounting period. For example, insurance that was paid in advance by the business.
- **Other Receivables** – This would include receivables that cannot be classified under a specific receivable heading in the financial statements. **Examples of other**

**receivables include:** Rents due to be received from tenants, Interest receivable (from bank deposits)

**1.3 Credit Facilities**

- **Credit facilities** offered to customers allow the customer to purchase goods or services from the business for payment in the future. A business provides this option to customers to have an advantage over its competitors.
- **Advantages and Disadvantages of Credit Facilities**

| Advantages | Disadvantages |
|---|---|
| Seller increases revenues.<br>Buyer obtains and can use purchased item immediately.<br>Minimises the need to carry cash or write cheques.<br>Makes expensive items affordable by allowing them to be paid for over a period.<br>Buyer convenience, as the buyer does not have to be present at the point of purchase (e.g. online shopping). | May increase the cost of items purchased (For example, if a customer does not pay on time, the business may have to borrow money from its bank and be charged interest fees).<br>Legal fees may be incurred for credit customers who refuse to pay.<br>Late payment fees and penalties may be costly to the buyer.<br>Administrative costs to the seller and the risk of irrecoverable ("bad") debts.<br>It may require security or other guarantees. |

- **Credit terms** define the agreed time and the penalties resulting from payment exceeding that period.
- It is the job of the business's **credit controller** to ensure that customers pay the amounts owed within the credit terms.
- Customers will also be given a **credit limit**. This is the maximum amount the customer can owe the business for sales already made before it expects payment from them.
- **Aged Receivables (Debt) Analysis:**is a report of all the receivables balances analysed by customer name with information on each customer's credit limit and cumulative turnover for the accounting period as well as the age of the outstanding amount. The receivable ageing will be used in conjunction with **credit control** procedures.

**1.4 Irrecoverable Debts**

- **Irrecoverable** or **bad debt** is an account receivable which will likely remain uncollectable and should be written off.

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Irrecoverable Debt | Expense | Bad Debt (Expense) increased |
| CR | Receivables | Asset | Receivables (Asset) decreased |

**Example 1 ( from hub)**

A business sells $500 of goods to Mr Maxwell on credit. The double entry to record the initial sale is: DR Trade Receivable $500, CR Sales/ Revenue $500

During the year, the debt is found to be irrecoverable. The double entry to record the irrecoverable debt is: DR Irrecoverable Debt $500, CR Trade Receivable $500


### 1.5 Subsequent Bad Debt Recovery

- A bad debt written off may subsequently become recoverable. The double entry to record an irrecoverable debt recovery is:

**Step 1: Reverse the irrecoverable debt write-off**

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Receivables | Asset | Receivables (Asset) increased |
| CR | Irrecoverable Debt | Expense | Bad Debt (Expense) decreased |

**Step 2: Record the receipt**

| | Individual Account | Category | Explanation |
|---|---|---|---|

| | | | |
|---|---|---|---|
| DR | Bank | Asset | Bank (Asset) increased |
| CR | Receivables | Asset | Receivables (Asset) decreased |

**Step 3: Net effect** of the above two entries is **DR Bank, CR Irrecoverable Debt.**

| | **Individual Account** | **Category** | **Explanation** |
|---|---|---|---|
| ~~DR~~ | ~~Receivables~~ | ~~Asset~~ | ~~Receivables (Asset) increased~~ |
| DR | Bank | Asset | Bank (Asset) increased |
| CR | Irrecoverable Debt | Expense | Bad Debt (Expense) decreased |
| ~~CR~~ | ~~Receivables~~ | ~~Asset~~ | ~~Receivables (Asset) decreased~~ |

## 1.6 Allowance for Receivables

- In general, businesses estimate expected credit losses on trade receivables. The **expected loss estimate** is recognised as an expense under Allowance for Receivables. These may be specific or general.
- **Specific allowances** are made against one particular receivable.
- **General allowances** are made against non-specific balances and may represent a percentage of the amount due.

### 1.6.1 Presentation of Allowance for Receivables

The amount of the loss allowance is offset against Trade Receivables for presentation in the statement of financial position.

| | $ | $ |
|---|---|---|
| Current assets | | |
| Inventory | | x |
| Trade receivables | x | |
| Less: Allowance for Receivables | (x) | x |
| Cash | | x |
| | | x |

### 1.6.2 Accounting for Allowance for Receivables

**The steps needed to account for the allowance for receivables are:**

- Calculate the closing allowance for the receivables balance at the year-end
- Calculate the difference between the closing allowance for receivables and the opening allowance for receivables.
- The increase or decrease is adjusted in the Allowance for Receivables ledger account to reflect the closing allowance for receivables.
- If the current closing allowance calculated is **more than t**he opening allowance balance, the double entry to record the adjustment is:

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Irrecoverable Debt | Expense | Bad Debt (Expense) increased |
| CR | Allowance for Receivables | Asset | Receivables (Asset) decreased |

- If the current closing allowance calculated is **less than** the opening allowance balance, the double entry to record the adjustment is:

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Allowance for Receivables | Asset | Receivables (Asset) increased |
| CR | Irrecoverable Debt | Expense | Bad Debt (Expense) decreased |

**The term 'receivables expense' may also be used for 'irrecoverable debts expense'**

- If a **specific doubtful d**ebt is deemed irrecoverable, the Receivables and Allowance for Receivables accounts are reduced by the irrecoverable amount.
- There is no need to recognise a further bad debt (as it has already been written off in maintaining the allowance for receivables). **There will be no further SOCI effect.**

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Allowance for Receivables | Asset | Receivables (Asset) increased |
| Cr | Receivables | Asset | Receivables (Asset) decreased |

**Example 2 ( from hub)**

Kimi runs a small factory making tins of paint. Kimi has a financial year end of 31 December 20X6. The balance of receivables in her general ledger is made up of the following balances at year-end:

| | | |
|---|---|---|
| 30 days | Husna | $1,350 |
| 30 days | Manisha | $23,540 |
| 60 days | Ken | $12,800 |
| 60 days | Jing | $42,800 |
| 90+ days | Han | $12,960 |
| | Total | $93,450 |

Kimi was notified that Husna had been made bankrupt and that she would not receive the amount owed by that business.

In addition, she believes that there is a possibility that Han would not pay the amount outstanding, and a specific allowance against the amount should be made.

She would also like to make a general allowance against the remaining balances of 2%. The general allowance brought forward from last year was $267.

What is the balance of the Trade Receivables, Irrecoverable Debt and Allowance for Receivables account at the financial year-end?

**Solutions :**

- **Write off Irrecoverable Debt:**

Husna has become bankrupt and is unlikely to pay back the amount owed to Kimi. Therefore, the outstanding balance owed by Husna of $1,350 should be written off. The double entry is:

| | | |
|---|---|---|
| DR | Irrecoverable Debt | $1,350 |
| CR | Trade Receivables | $1,350 |

- **Allowance for Receivables (Specific Allowance):**

Kimi wishes to set aside a specific allowance against Han’s balance of $12,960. The double entry is:

- **Allowance for Receivables (General Allowance)**:

| | | |
|---|---|---|
| DR | Irrecoverable Debt | $12,960 |
| CR | Allowance for Receivables | $12,960 |

Besides the specific allowance against Han, Kimi makes a closing general allowance against 2% of the remaining receivable balance.

The remaining receivable balance is = Total Receivables $93,450 − Husna $1,350 − Han $12,960 = $79,140

Closing General Allowance = 2% × $79,140 = $1,582.80

Opening General Allowance = $267

Since the current closing allowance is more than the opening allowance, the excess of $1,315.80 ($1,582.80 − $267) is written off. The double entry is:

| | | |
|---|---|---|
| DR | Irrecoverable Debt | $1,315.80 |
| CR | Allowance for Receivables | $1,315.80 |

# 2 Introduction to Payables

**2.1 Definition**

**Payables** are the amounts owed for the cost of purchases or other obligations entered but not yet paid.

**2.2 Examples of payables include:**

- **Trade Payables** – These are the amounts owed to trade suppliers regarding credit purchases of goods or services.
- **Bank Overdraft** – An overdraft exists where the balance of cash held at the bank is negative. This sum is repayable to the bank on demand.
- **Sales Tax Liability** – The amounts owed to the tax authority for sales tax collected on sales to customers.
- **Income Tax Liability** – This is the income tax due from profits the business makes.

- **Accruals** – These are expenses of the business that has been incurred during the accounting period and has not yet been paid, such as electricity and rent.
- **Other Payables** – Examples of other payables are:

Prepaid Income
Loans and interest thereon (may include penalty payments).
Advance payments received from customers.
Salaries and wages earned by but not yet paid to employees.
Dividends declared by a company but not yet paid to shareholders.

### 2.3 The Trade Payables Ledger

#### 2.3.1 Receivables and Payables Contra

- Contra entries or contras are made when an amount of money is owed to a supplier, who is also a customer who owes money, ie someone appears as both a trade payable and a receivable.
- The double entry for a contra is always:
- Dr Payables ledger control account          Cr Receivables ledger control account

### 2.4 Supplier Statements

- The supplier issues the statement of accounts (supplier statement) at each month's end.
- The statement of account shows the outstanding balance at the month's end.
- It includes the opening balance plus the invoices raised by the supplier during the month, less any credit notes and payments received by the supplier.

#### 2.4.1 Supplier Statement Reconciliation

- A **supplier statement reconciliation** is a reconciliation between the balances in the Trade Payables ledger and the supplier statement.
- The **Trade Payables ledger** represents the balance outstanding to suppliers. It is the value of purchase invoices received, less credit notes and payments to suppliers.
- The supplier account and the supplier statement balance should match as both show the amount owed from a business to the supplier. **However, these balances may differ due to timing differences or entry errors.**
- **Differences may arise due to timing differences, such as:**

Supplier has recorded invoices or credit notes that a business has not received
Payments were made to the supplier after the Supplier Statement was generated
Payments made but not yet received by the supplier

# Chapter 7: IAS 37 Provisions, Contingent Liabilities and Contingent Assets

**Learning outcomes**

- Define "provision", "contingent liability" and "contingent asset" in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.
- Distinguish between and classify items as provisions, contingent liabilities or contingent assets.
- Illustrate the different methods of accounting for provisions, contingent liabilities and contingent assets.
- Calculate provisions and changes in provisions.
- Account for the movement in provisions.
- Report provisions in the financial statements.

## 1 Provisions

### 1.1 Definition

A provision is a liability of **uncertain timing or amount**.

**For example**:

- Sharif gives warranties on the computers he sells. If the product is faulty, the customer can return it. Therefore, Sharif has to make a provision as he may need to refund a customer their money.
- Sharif has moved from one of his shops because the premises are too small for him to operate. There are another three years left on the lease, and Sharif has been told that he must pay the landlord the remaining rental payments. This is known as an onerous contract and is an example of a provision as stated in IAS 37.

### 1.2 Recognition Criteria

For any liability, including provisions, to be recognised, all three of the following criteria must be satisfied:

- A present obligation (legal or constructive) exists due to a past event (obligating event).
- An outflow of resources to settle the obligation is probable.
- A reliable estimate of the obligation can be made.

### 1.3 Measurement

The amount recognised as a provision should be the **best estimate** of the expenditure required to settle the present obligation at the statement of financial position date, that is, the amount that an enterprise would rationally pay to settle the obligation at the statement of financial position date or to transfer it to a third party. This means:

- Both measurements are at discounted present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the liability.
- Provisions for one-off events (restructuring, environmental clean-up, settlement of a lawsuit) are measured at the most likely amount.
- Provisions for large populations of events (warranties, customer refunds) are measured at a probability- weighted expected value.

**Example 1 ( from hub)**

Cassie sells skateboards with a six-month warranty. During the second half of the year to 30 June 20X5, she sold 504 boards. (The warranty on boards sold in the year's first half will have expired.) If a board comes back for minor repairs, it will cost her $10; If it needs major repairs, it will cost her $30.

From experience, Cassie estimates that 20% of boards will come back for minor repairs, and 5% will come back for major repairs.

How should Cassie estimate the amount of provision needed?

**Solutions**

Provisions for warranties, such as in Cassie's case, involve many individual items. Cassie will know her repair costs, but she must estimate how many items will be affected.

This can be done using the expected value method.

Minor repairs: (504 × 20%) × $10= $1,008

Major repairs: (504 × 5%) × $30 = $756

This gives her an amount of $1,764 ($1,008 + $756) for potential repairs under warranty as at 30 June 20X5.

### 1.4 Accounting Treatment

- If the current provision calculated is **more** than the opening provision balance,

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Individual Expense | Expense | Individual Expense increased |
| CR | Provision Account | Liability | Provisions (Liability) increased |

- If the current provision calculated is **less** than the opening provision balance,

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Provision Account | Liability | Provisions (Liability) decreased |
| CR | Individual Expense | Expense | Individual Expense decreased |

## 2 Contingent liability

- A possible obligation depending on whether some uncertain future event occurs
- A present obligation but payment is not probable or the amount cannot be measured reliably
- Since there is common ground as regards liabilities that are uncertain, IAS37 also deals with contingencies. It requires that enterprises should not recognize contingent liabilities- but should disclose them, unless the possibility of an outflow of economic resources is remote.

## 3 Contingent asset

- A possible asset that arises from past events, and Whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.
- Contingent assets should not be recognized – but should be disclosed where an inflow of economic benefits is probable. When the realization of income is virtually certain, then it should be recognised as an asset in the statement of financial position as it is no longer a contingent asset.

# 4 Disclosure Requirements

## 4.1 Provisions

For each class of provision, the following **must be disclosed:**

- A brief description of the obligation (nature and timing)
- An indication of uncertainties and assumptions about the amount or timing of outflows
- Any expected reimbursement due relating to the provision
- A detailed breakdown of the movement in the provision – opening and closing balances, additions, amounts used and any reversals

## 4.2 Contingencies

The following disclosures are required for contingencies:

- Nature of the contingent liability/asset.
- Estimate of financial effect (where practicable).
- The uncertainties affecting the amount or timing.

# 5 Summary

The below table summarises the disclosure requirements for each of the conditions:

| Conditions | Assets | Liabilities |
|---|---|---|
| Expected/ Virtually Certain (>95%) | Recognised as an Asset | Recognised as a Liability |
| Probable (51% - 95%) | Disclosed as Contingent Asset | Recognised as a Provision |
| Possible (5% - 50%) | No disclosure | Disclosed as Contingent Liability |
| Remote (<5%) | No disclosure | No disclosure |

# Chapter 8: IAS 2 Inventories

**Learning outcomes**

- Identify the definition of inventory.
- Describe the need for adjustments to inventories in preparing financial statements.
- Record opening and closing inventories.
- Apply the requirements of IAS 2 Inventories for valuing inventories.
- Identify which costs should be included in valuing inventories.
- Explain the use of continuous and period end inventory records.
- Calculate the value of closing inventories using FIFO (first in, first out) and AVCO (average cost).
- Identify the impact of inventory valuation methods on profit and on assets.

## 1 Inventory definition

- Inventories are assets:
  - held for sale in the ordinary course of business;
  - in the process of production for such sale
  - in the form of materials or suppliers to be consumed in the production process or in the rendering of service.

- Inventories can include any of the following:
  - Goods purchased and held for resale
  - Finished goods produced
  - Work in progress being produced
  - Raw material

## 2 Accounting treatment

### 2.1 Cost of good sold

**Cost of Goods Sold = Opening Inventory + Cost of Goods – Closing Inventory**

### 2.2 Accounting for opening inventory

- **Remove the Opening Inventory:** Opening inventories are removed and transferred to the Cost of Goods Sold account. This entry is necessary because the opening inventories are now used to generate sales in the current accounting period.

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Cost of Goods Sold | Expense | Opening Inventory cost now included as Expenses |
| CR | Inventory | Asset | Inventory (Asset) decreased |

**2.3 Accounting for opening inventory**

- **Close off the Purchases account:** A business makes purchases for inventory for resale.
- **At the point of purchase**
  **Dr Purchases account    Cr cash/payables**
- **At year-end**
  the amount in the Purchases account is closed off and transferred to the Cost of Goods Sold.

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Cost of Goods Sold | Expense | Purchases (Expense) is transferred to COGS |
| CR | Purchases | Expense | Purchases (Expense) is closed off |

**2.4 Post the Closing Inventory**

- The closing balance is presented in the statement of financial position as a current asset.
- Since closing inventories are items purchased that are not sold in the accounting period, their cost should not be reflected as an expense in the Cost of Goods Sold account (SPL). Therefore, the value of closing inventory is transferred out of expenses and reflected as Closing Inventory in the statement of financial position.

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Inventory | Asset | Inventory (Asset) increased |
| CR | Cost of Goods Sold | Expense | Costs (Expense) decreased |

# 3 Inventory Quantity

**3.1 The Continuous Approach**

In this approach, each product sold by a business has its inventory record, either on a manual card or a computer record.

The card records quantities of purchases and sales of that product. It is set up to keep a running total of the amount of inventory as each new transaction (either sales or purchases) takes place. The record identifies how much inventory the business holds at any time.

**3.2 The Periodic Approach**

In this approach, there are no record cards. Inventory is physically counted at the end of the year (inventory count), and their quantities are recorded in a list.

The inventory count is usually performed on the last day of the accounting period when the business is closed with no inventory movements occurring.

Keeping continuous records can be time-consuming for businesses with multiple lines of products to sell, even if they are computerised. A business typically performs an inventory count at year-end, **even when continuous records are kept. It may also carry out inventory counts on specific items during the year to keep a check on the card records.**

# 4 IAS 2 Inventories

Under IAS 2 Inventories, inventories are valued at the **lower of cost** or **net realisable value (NRV).**

**4.1 Cost of inventory**

**(1) Cost of inventory**

Purchase

Purchases price

Import duties and other taxes
Transport cost
Less any trade discounts
**(2) Cost of conversion**
Direct material and direct labor
Fixed and variable production overheads
(3) Other costs incurred in bringing the inventories to their present location and condition

**4.2 Excluded in calculating the cost of inventory as:**
Administrative cost, carriage outwards, abnormal costs, staff training cost

**4.3 Net Realisable Value (NRV)**

- **The net realisable value (NRV)** of an item of inventory is its selling price after all further costs to complete and sell the item have been considered.
- **NRV = Estimated selling price − Estimated future costs of completion − Estimated future selling expenses (if inventory is still in production)**

**Example 1 ( from hub）**
Hiroto has carried out an inventory count and has 20,000 toy cars in his warehouse. He has established the following information on the potential inventory value of each toy car.

| | |
|---|---|
| Cost before trade discount | $7.00 |
| Selling price | $7.00 |
| Selling expenses | $0.25 |
| Trade discount received | 5% |

What is the correct valuation of the inventory per IAS 2?
a) $133,000
b) $135,000
c) $140,000

**Solutions**
**The correct answer is A, $133,000.**

The cost of each toy car is $7. Trade discounts are included in the calculation of inventory. Each vehicle costs $6.65 ($7 × 95%), and the total is $133,000 ($6.65 × 20,000). The net realisable value of each toy car is $6.75 ($7 − $0.25), and the total NRV would be $135,000.
The lower of these is $133,000.
Answer B did not take the lower of cost and net realisable value.
Answer C did not deduct the trade discount from the purchase price and valued the inventory at $140,000 ($7 × 20,000).

### 4.4 Pricing Valuation Methods

There are two methods of calculating the cost of inventory:

- **First In-First Out (FIFO)**

This method assumes that inventories that are purchased first are sold first.

- **Average Cost (AVCO)**

The average cost (AVCO) is calculated by determining the average cost for items held in the opening inventory and purchased during the period. There are two main methods of calculating average cost.

**-periodic weighted average.**

- **cumulative weighted average.**

- **FIFO and AVCO** calculate the cost of inventory, which is then compared to the net realisable value to determine which is lower and should be presented as the inventory value in the statement of profit or loss.

**Example 2**

**You are given the following information relating to the stock movement of J Beth for the month of August 20X9**

| Date | Description | units/cost price |
|---|---|---|
| 20X9 Aug | 1 Opening inventory | 800 units at $10 each |
| | 8 Purchases | 600 units at $12 each |
| | 15 Sales | 750 units |
| | 22 Sales | 300 units |
| | 28 Purchases | 350 units at $11 each |
| | 31 Sales | 200 units |

**Required:**

Showing clearly the closing inventory balance and the cost of goods sold, using the following methods of inventory valuation:

(a)FIFO

(b) Weighted average (periodic)

(c)Weighted average (continuous)

**Solutions:**

**(a) FIFO**

| Date | In | | | Out | | | Balance | | |
|---|---|---|---|---|---|---|---|---|---|
| | Unit | $/unit | $ | Unit | $/unit | $ | Unit | $/unit | $ |
| 1 | | | | | | | 800 | 10 | 8,000 |
| 8 | 600 | 12 | 7,200 | | | | 800<br>600 | 10<br>12 | 8,000<br>7,200 |
| 15 | | | | 750 | 10 | 7,500 | 50<br>600 | 10<br>12 | 500<br>7,200 |
| 22 | | | | 50<br>250 | 10<br>12 | 500<br>3,000 | 350 | 12 | 4,200 |
| 28 | 350 | 11 | 3,850 | | | | 350<br>350 | 12<br>11 | 4,200<br>3,850 |
| 31 | | | | 200 | 12 | 2,400 | 150<br>350 | 12<br>11 | 1,800<br>3,850 |

**(b) Weighted average (periodic)**

Cost/unit = $\dfrac{800 \times 10 + 600 \times 12 + 350 \times 11}{800 + 600 + 350}$ = $10.89 / unit

Value of Closing inventory = 500 units x $10.89 / unit = $ 5,445

**(c) Weighted average (continuous)**

| Date | In | | | Out | | | Balance | | |
|---|---|---|---|---|---|---|---|---|---|
| | Unit | $/unit | $ | Unit | $/unit | $ | Unit | $/unit | $ |
| 1 | | | | | | | 800 | 10 | 8,000 |
| 8 | 600 | 12 | 7,200 | | | | 1400 | 10.86 | 15,200 |
| 15 | | | | 750 | 10.86 | 8,145 | 650 | 10.86 | 7,055 |
| 22 | | | | 300 | 10.86 | 3,258 | 350 | 10.86 | 3,797 |
| 28 | 350 | 11 | 3,850 | | | | 700 | 10.92 | 7,647 |
| 31 | | | | 200 | 10.92 | 2,184 | 500 | 10.92 | 5,463 |

结论

In periods of inflation, the newest goods are likely to have cost more than the oldest goods. Hence by matching the cost of the oldest goods with the sales revenue, FIFO will give a lower cost of goods sold figure, a higher closing inventory valuation, and have a higher reported profit than AVCO.

# 5 Disclosure Requirements

- For businesses that manufacture goods, the disclosure should include the accounting policy for inventory and a breakdown of inventory into appropriate classifications such as materials, work-in-progress and finished goods.
- The valuation method it has used in valuing its inventories
- How the business has applied those methods to calculate the inventory value

# Chapter 9 IAS 16 Property, Plant and Equipment (PPE)

**Learning outcomes**

- Record the acquisition and disposal of tangible non-current assets in the general ledger accounts
- Calculate and record gains or losses on disposal of tangible non-current assets in the statement of profit or loss, including part exchange transactions.
- Record the revaluation of a tangible non-current asset in the general ledger accounts and illustrate how it is presented in the statement of profit or loss and other comprehensive income and in the statement of financial position.
- Calculate the gain or loss on disposal of a revalued tangible non-current asset.
- Illustrate how tangible non-current asset balances and movements are disclosed in financial statements.
- Explain the purpose and function of a non-current asset register
- Calculate the charge for depreciation using straight line and diminishing (reducing) balance methods.
- Identify the circumstances where different methods of depreciation would be appropriate.
- Illustrate how the depreciation expense and accumulated depreciation are recorded in the general ledger accounts.

## 1 IAS 16 Property, Plant and Equipment (PPE)

The principal issues prescribed in the standard are:

- The determination of an asset's carrying amount
- The initial recognition of assets at acquisition
- The depreciation charges of assets
- Any impairment losses to be recognised

## 2 Initial Measurement of PPE

### 2.1 Cost of Tangible Non-Current Assets

- IAS 16 states that a tangible non-current asset should be initially recorded at its cost, Cost includes all costs necessary to bring the asset to working condition for its intended use.
- The component of cost:

(a) **Purchases price**, including any import duties paid, but excluding any trade discount and sales tax paid;

(b) **Directly attributable costs** of bringing the asset to **working condition** for its intended use:

- the cost of site preparation
- initial delivery and handling costs
- installation and assembly costs
- professional fees
- cost of testing whether the asset is working properly
- staff costs arising directly from the construction or acquisition of the asset
- Cost of extension to buildings
- Interest on the loan used to finance the acquisition of the asset

* The **costs of training staff** to use a new asset cannot be a component of the asset. They should be recognized as expenses.

(c) Initial estimate of the **costs of dismantling and removing** the item and **restoring the site** on which it is located

# 3 Categories of Non-Current Assets

A business's tangible non-current assets can include various types of assets. Each asset type will have its ledger account in the general ledger.

Categories of tangible non-current assets (Property, Plant and Equipment) are:

- **Land and Buildings** such as building premises
- **Plant and Machinery** such as factory machinery that may be fixed or mobile
- **Fixtures and Fittings** such as shelving in a shop and shop display unit
- **Office Equipment** such as computers, printers and cash registers
- **Motor Vehicles** such as delivery vans and company cars

| **Non-Current Assets** | Cost | Accumulated Depreciation | Carrying Amount |
|---|---|---|---|
| Property, Plant and Equipment: | | | |
| Land and Buildings | X | (X) | XX |
| Plant and Machinery | X | (X) | XX |
| Fixtures and Fittings | X | (X) | XX |
| Office Equipment | X | (X) | XX |
| Motor Vehicles | X | (X) | XX |
| | | | **XX** |

The **carrying amount** is the cost of the non-current asset less the accumulated depreciation. The statement of financial position will reflect each asset category's carrying amount.

# 4 Double Entry for PPE Acquisition

**Acquisition of non-current assets**

Dr Non current asset

Cr Cash/ bank loan/ trade payable

# 5 Depreciation

**5.1 Depreciation definition**

- **Depreciation** is the expense charged to the statement of profit or loss in each accounting period to reflect **how much of the economic benefit** associated with a tangible non-current asset has **been used up** in the accounting period.
- **Accounting treatment**

  Dr depreciation (SPL)  Cr Accumulated depreciation (SOFP)
- Non-current assets generate profits for a business. Depreciation is the cost of the business using the non-current asset. Therefore, the depreciation cost is included as an expense in the statement of profit or loss so that the cost of using the asset **matches** the profits generated from it. This is an application of the **accruals principle.**

**5.2 Depreciation methods**

**(1)The straight line method**

The total depreciable amount is charged in equal installments to each accounting period over the expected useful life of the asset.

**Annual depreciation = (Cost - Residual value) ÷ Expected useful life**

***Residual value** is the net amount which the entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

**Example1**

A business buys a machine for $ 3,500. It is expected to have a useful life of 3 years after which time it will have a scrap value of $ 500.

**Required：Calculate the depreciation charge for each year?**

(3,500-500) / 3 = 1,000per year

**(2)Reducing balance method**

A fixed depreciation rate (say 20% p.a.) is applied to the non-current asset's net book value (cost less accumulated depreciation) every year. Since net book value diminishes yearly, the depreciation charge falls every year.

**Annual depreciation = x% x Net Book Value (NBV)**

**Note:** the residual value **dose not** impact reducing balance calculations of depreciation.

**Example 2**

Tareq purchases ten laptops for $1,000 each on 1 January X1. Tareq depreciates his office equipment at a rate of 30% using the reducing balance method.

**What is the ten laptops' carrying value/ carrying amount for each year?**

**Solutions**

| | | **$** |
|---|---|---|
| Cost | | 10,000 |
| Depreciation (Y1) | 30% of $10,000 | (3,000) |
| Carrying amount (end of Y1) | | 7,000 |
| | | |
| Depreciation (Y2) | 30% of $7,000 | (2,100) |
| Carrying amount (end of Y2) | | 4,900 |
| | | |
| Depreciation (Y3) | 30% of $4,900 | (1,470) |
| Carrying amount (end of Y3) | | **3,430** |

**5.3 Policy**

- Policy is to charge depreciation at X% per year on the straight line basis, with **proportionate** depreciation in the year of purchase and disposal or
- ignore depreciation in the year of disposal or charge the full year depreciation in

the year of acquisition

- or other policy specified

### 5.4 Changes in Depreciation Method, Useful Life or Residual Value

- Change method of depreciation

Where there is a change to a different method of depreciation, write off the carrying value over its remaining useful life, using the new method.

**Example 3**

Tareq purchased a delivery truck on 1 July 20X4 for $40,000, which had an estimated useful life of eight years, a residual value of $4,000 and was initially depreciated at a rate of 25% a year using the reducing-balance method.

Tareq decided that from 1 July 20X5 onwards, the delivery truck would generate equal economic benefits each year.

The impact of the change in depreciation method includes:

1 Change in depreciation method

Future depreciation charges associated with the delivery truck are based on the asset's carrying amount at the date of the change, and the truck will be depreciated under the new method.

In this example, the change date is 1 July 20X5, and the new method is straight-line depreciation.

2 Carrying Value at the date of the change

The carrying amount of the delivery truck on 1 July 20X5 (after one year of reducing-line balance depreciation at the rate of 25%) is:

| | $ |
|---|---|
| Cost | 40,000 |
| Depreciation year 1($40,000 × 25%) | (10,000) |
| Carrying amount at the end of year | 30,000 |

3 Establish the Remaining Useful Life and Residual Value

At the date of purchase (1 July 20X4), Tareq had estimated that the truck's useful life was eight years.

Therefore, the remaining useful life is seven years on 1 July 20X5 (one year later). The residual value is unchanged at $4,000.

4 Calculate the depreciation charge based on the new method

The depreciation charge is ($30,000 − $4,000) ÷ 7 years = **$3,714**

**5.5 Change in expected useful life or residual value of the assets**

If a non-current asset appears to have a different useful life from that originally determined, then the carrying value should be written off over the revised remaining useful economic life.

**Example 4**

Tareq purchased a mixing machine on 1 July 20X4 for $22,000. At that date, he estimated that the residual value was $2,000 and the useful life was eight years. The machine is depreciated using the straight-line method.

As a result of new technologies being introduced for mixing machines, on 1 July 20X7, Tareq re-assessed the useful life of the mixing machine down to six years and the residual value down to $1,000.

At the date of change (1 July 20X7), Tareq needs to establish the following:

**Solutions**

1 Cost = $22,000

2 Accumulated depreciation = [($22,000 − $2,000) ÷ 8 yrs] × 3 years = $7,500

3 Carrying Value = $22,000 − $7,500 = <u>$14,500</u>

4 Revised Useful Life

The revised useful life on 1 July 20X7 is 6 − 3 years = <u>3 years</u>

5 Revised residual value

The revised residual value is $2,000 − $1,000 = <u>$1,000</u>

On 30 June 20X8, the depreciation charge for the mixing machine is: ($14,500 − $1,000) ÷ 3 years = **$4,500**

**6 Disposal of non current asset**

There are **four steps** to follow in recording the disposal of non-current assets. The double-entry steps revolve around the Disposal Account.

**(1). Remove Asset from the Cost Account**

First, the business removes the asset's cost from the Non-Current Asset − Cost account by transferring it to the disposal account.

**Dr Disposal account ( offset to disposal account)**

**Cr Non current aseet Cost ( the asset is being removed)**

**(2).Remove Asset from the Accumulated Depreciation Account**

Next, the accumulated depreciation is removed from the Asset − Accumulated Depreciation account by transferring the amount to the Disposal account.

**Dr Non current asset-accumulated depreciation ( the accumulated depreciation of asset is removed)**

**Cr Disposal account ( offset to disposal account)**

**(3). Record Sales Proceeds**

The sales proceeds received are recorded in the Disposal and Cash/Bank accounts. If the disposal of the asset generates no sales proceeds, this entry is omitted.

**Dr Bank**

**Cr Disposal ( offset to disposal account)**

**(4) . Record Profit or Loss on Disposal**

Finally, the Disposal account is closed off. The balance c/d is the profit or loss on disposal and is recorded as an income or expense in the Statement of Profit or Loss.

- If the sales proceeds exceed the carrying amount (profit on disposal,) the double entry is:

**Dr Disposal ( Offset to Disposal account)**

**Cr Profit on disposal ( Income has increased）**

- If the sales proceeds are less than the carrying amount (loss on disposal), the double entry is:

**Dr Loss on disposal ( Loss expense increase in SPL)**

**Cr Disposal ( Offset to disposal account)**

- The Disposal account is created for each non-current asset disposal. The entries that are included in the Disposal account are summarised as follows:

**DR** **Disposal Account** **CR**

| | | | |
|---|---|---|---|
| Non-Current Asset – Cost | X | Non-Current Asset – Acc. Depreciation | X |
| Profit on Disposal (if Profit) | X | Bank (Sales Proceeds) | X |
| | | Loss on Disposal (if Loss) | X |
| | X | | X |

**Example 5**

On 31 December 20X2, Salma scrapped an old broken laptop. She bought the item for the business three years ago at the cost of $800, and he expected the business would be able to sell it for $100 after five years. This asset was depreciated using the straight-line method.

**Calculate the profit or loss on the disposal of the cash register. Compute the effect of disposal on the individual ledger accounts.**

**Solutions:**

Sales Proceeds = $0 since scrapped

Annual depreciation charge = ($800 − $100)/ 5 years = $140
Accumulated depreciation = $140 × 3 years = $420
Carrying amount at end of Y3 = $800 − $420 = $380
Since the sales proceeds ($0) are less than the carrying amount ($380), Salma made a loss on disposal of $380.
To record the disposal of a non-current asset, the below steps are followed:

- Remove asset from the Cost account

| | | |
|---|---|---|
| DR | Disposal | $800 |
| CR | Office Equipment - Cost | $800 |

- Remove asset from the Accumulated Depreciation account

| | | |
|---|---|---|
| DR | Office Equipment – Acc. Depreciation | $420 |
| CR | Disposal | $420 |

- Record sales proceeds
- Since the cash register is scrapped, no entry is needed.
- Record Profit or Loss on Disposal

| | | |
|---|---|---|
| DR | Loss on Disposal | $380 |
| CR | Disposal | $380 |

The impact of the disposal on the individual ledger accounts is shown in the below T-Accounts:

**DR** **Disposal Account** **CR**

| DR | | CR | |
|---|---|---|---|
| Office Equipment - Cost | $800 | Office Equipment - Acc. Depr | $420 |
| | | Sale Proceeds (Bank) | - |
| | | Loss on Disposal (balancing figure) | $380 |
| | $800 | | $800 |

- **If part exchange allowance**

Using the asset on hand to exchange a new one.
Instead of receiving cash proceeds, a part exchange allowance is made against the cost of a replacement asset:

| | |
|---|---|
| Dr New asset cost | XX |
| Cr Disposal account | XX |
| Cr Cash account / bank loan account | XX |

# 7 Subsequent Measurement

**7.1 Background**

- All property, plant and equipment are initially measured at cost. The cost of an asset is its purchase price and other expenses necessary to bring the asset to working condition for its intended use. These non-current assets are depreciated, and their carrying amount is reflected in the statement of financial position.
- However, there may be assets whose market value (the price at which the asset can be sold in an open market) is considerably higher than their carrying value. The financial statement will not correctly represent the economic substance of the assets.

Therefore, an asset may be subsequently revalued.

**7.2 Double Entry for NCA Revaluation**

Five adjustments are relevant to property, plant and equipment revaluation. These adjustments are:

- Upward Revaluation of Assets
- Revised Depreciation Charge
- Excess Depreciation Transfer
- Upwards or Downwards Revaluation for assets previously revalued
- Disposal of Revalued Assets

**(1) Upward Revaluation of Assets**

| **Individual Account** | **Category** | **Explanation** | |
|---|---|---|---|
| DR | NCA – Cost | Asset | Increase asset to its revalued amount |
| DR | NCA – Acc. Depreciation | Asset | Remove the total acc. depreciation |
| CR | Revaluation Surplus | Equity | Record the revaluation adjustment in the equity account |

**(2)Revised Depreciation Charge**

After an asset has been revalued, it still needs to be depreciated.

The revised depreciation charge is calculated as = Revalued amount ÷ Remaining useful life

The double entry to record the revised depreciation is similar to any depreciation charge:

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Depreciation Expense | Expense | Depreciation (Expense) increased |
| CR | NCA – Acc. Depreciation | Asset | Accumulated Depreciation reduces the value of the non-current asset (Asset) |

**(3) Excess Depreciation Transfer**

- It is up to the business to adopt this transfer adjustment; it is not mandatory.
- The excess depreciation is the difference between the revised depreciation charge and the original depreciation charge had there been no revaluation.
- The double entry to transfer the excess depreciation is:

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Revaluation Surplus | Capital | Reduces the revaluation surplus account that is created when the asset is revalued. |
| CR | Retained Earnings | Capital | Retained earnings (capital) increased |

- This is simply a transfer between the equity accounts and has no impact on the profit for the year, as reported in the statement of profit or loss.

**Example 6**

Hassan owns a business that operates a hotel. The business owns the hotel building, and on 31 December 20X2, its carrying amount based on cost is:

| | Cost $ | Accumulated depreciation ($) | Carrying amount ($) |
|---|---|---|---|
| Hotel property | 500,000 | (112,500) | 387,500 |

The hotel building is depreciated on a straight-line basis over 40 years. The building has been depreciated for nine years. On 1 January 20X3, Hassan decided to revalue his hotel building. The hotel has a market value of $600,000 on that date.

Hassan has a policy of transferring excess depreciation to retained earnings.

**1 Calculate the amount of revaluation adjustment**

| | Hotel building ($) |
|---|---|
| Market value | 600,000 |
| Carrying amount | (387,500) |
| **Revaluation adjustment** | **212,500** |

From the revaluation adjustment of $212,500, $112,500 relates to accumulated depreciation, and $100,000 relates to cost.

The double entry to record the revaluation upwards is:

| | | |
|---|---|---|
| DR | Property – Cost | $100,000 |
| DR | Property – Acc. Depreciation | $112,500 |
| CR | Revaluation Surplus | $212,500 |

**2 Revised Depreciation**

Hassan's hotel building has been revalued to $600,000. The total useful life is 40 years, and nine years' worth of depreciation has already been charged.

The revised depreciation charge is $600,000 ÷ (40 − 9 = 31 years) = $19,355

The double entry to record the revised depreciation yearly is:

| | | |
|---|---|---|
| DR | Depreciation Expense | $19,355 |
| CR | Property – Acc. Depreciation | $19,355 |

**3 Transfer Excess Depreciation**

Revised Depreciation = $19,355

Original Depreciation = $500,000 ÷ 40 years = $12,500

The excess depreciation = $19,355 − $12,500 = $6,855

The double entry to transfer the excess depreciation is:

| | | |
|---|---|---|
| DR | Revaluation Surplus | $6,855 |
| CR | Retained Earnings | $6,855 |

The balance in Hassan's revaluation surplus account is now = CR $212,500 + DR $6,855 = CR $205,645.

**(4) Upwards/Downwards Revaluation on previously Revalued Assets**

If the asset is revalued downwards, the revaluation adjustment is calculated by comparing the carrying value and the revaluation amount. The double entry to adjust for the downward revaluation of a previously revalued asset is:

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Revaluation Surplus | Capital | Reduce the revaluation surplus by the revaluation adjustment |
| DR | NCA – Acc. Depreciation | Asset | Remove the total acc. depreciation |
| CR | NCA – Cost | Asset | Reduce asset to its revalued amount |

- The revaluation adjustment is debited to the revaluation surplus up to the initial revaluation surplus credit. **If the downward revaluation exceeds the amount previously credited, the excess is expensed off to profit or loss.**

**Example 7**

**Continuation from Example 6 previously.**

On 31 December 20X6, Hassan's building was valued at $510,000.

Hassan's building will have been straight-line depreciated for four years from the initial revaluation (20X3, 20X4, 20X5 and 20X6). Therefore, the accumulated depreciation on 31 December 20X6 is $19,355 × 4 years = $77,420.
The carrying value is $600,000 − $77,420 = $522,580.
The revaluation adjustment is as follows:
Cost = $600,000 − $510,000 = $90,000
Acc. Depreciation = $77,420
The double entry to record the downward revaluation is:

| | | |
|---|---|---|
| DR | Revaluation surplus | $12,580 |
| DR | Building: accumulated depreciation | $77,420 |
| CR | Building: cost/valuation | $90,000 |

The balance in the revaluation surplus account is now CR $205,645 + DR 12,580 = CR 193,065.
**What if the building needs to be reduced to $250,000 instead?**
The revaluation adjustment is: $522,580 − $250,000 = $272,580
Cost portion = $600,000 − $250,000 = $350,000
Acc. Depreciation portion = $77,420
We have identified earlier that the balance in Hassan's revaluation surplus account is CR $205,645. Therefore, the excess of 66,935 ($272,580 − $205,645) is debited to expenses in profit or loss.
DR Revaluation Surplus $205,645
DR Profit or Loss $66,935
DR Building − Acc. Depreciation $77,420
CR Building − Cost $350,000
The balance in the revaluation surplus account is now CR $205,645 + DR $205,645 = 0

### 7.3 Disposals of Revalued Assets

The disposal of a revalued asset is accounted for in the same manner as a typical asset mentioned in above. The only difference is that any balance that remains in the revaluation surplus account is transferred to the retained earnings as the gain in revaluation can now be realised with the sale of the asset.

# 8 Purpose and Function of Non-Current Asset Register

- The acquisition, depreciation and disposal of tangible non-current assets recorded in the general ledger accounts show the transaction balance of each asset category. It does not retain any detail about individual assets once it is closed off at the end of the year.

- A business keeps track of individual assets' cost, carrying amount, depreciation and disposal using a separate record known as the **non-current asset register**
- The **Non-Current Asset Register** is a memorandum document where each asset is listed, which will include information on all the activities relating to the asset.
- The non-current asset register has information on each asset:

  Date of Purchase
  Description
  Location
  Useful Economic Life
  Depreciation Method
  Depreciation Amount
  Carrying amount
  Ultimate Disposal proceeds
- The non-current asset register is useful for a business as it is used to verify the existence of assets within a business. The business can perform an asset count at each location according to the non-current asset register.
- Since the same information concerning the non-current asset is recorded in the general ledger and the asset register, the two balances should agree. Therefore, the asset register also acts as a source of supporting documentation to verify the accuracy of balances in the ledger accounts.
-

# 9 Property, Plant and Equipment Disclosure

The following information is required to be disclosed in the financial statements for each class of property, plant and equipment:

- Measurement bases used for determining gross carrying amount.
- Depreciation methods used.
- Useful lives or the depreciation rates used.
- Gross carrying amount and accumulated depreciation at the period's beginning and end. (Comparatives are not required.)
- A reconciliation of the carrying amount at the beginning and the end of a period showing:

  Additions
  Disposals
  increases or decreases resulting from revaluations
  depreciation
  other movements

# Chapter 10 IAS38 Intangible non current asset

**Learning outcomes**

- Identify types of intangible assets.
- Identify the definition and treatment of "research" and "development" in accordance with IAS 38 Intangible Assets.
- Calculate and account for amounts to be capitalised as development expenditure or to be recognised as an expense from given information.
- Explain the purpose of amortisation.
- Calculate and account for amortisation.
-

## 1 Introduction to Intangible Assets

### 1.1 Definition

An intangible asset is an identifiable non-monetary asset without physical substance. Examples copyrights, computer software and licenses

### 1.2 Recognition

- IAS 38 requires an enterprise to recognise an intangible asset, whether purchased or self-created (at cost) if, and only if:
- it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
- the cost of the asset can be measured reliably.

### 1.3 If recognition criteria not met

- If an intangible item does not meet both the definition of and the criteria for recognition as an intangible asset, IAS 38 requires the expenditure on this item to be recognised as an expense when it is incurred.

### 1.4 Examples of intangible asset

Computer software

Patents and licences (exclusive rights to use a process, product or name)

Copyright (legal right belonging to the originator of a material which cannot be reproduced or copied)

Trademarks (a legally registered or established symbol or word that is used to represent a company or product)

Brands (a symbol or wording identifying a product)

Intellectual property (technical knowledge obtained from a development activity)

Goodwil (value of business above the value shown in the financial statement, coming from the strength of a brand and reputation)
Development cost

# 2 Amortisation

- The amortizable (depreciable) amount should be allocated systematically over the best estimate of useful life. The amortisation period:

-commences when the asset is available for use
-ceases when the asset is derecognised (if it is sold)

- The carrying amount (Intangible Asset Cost – Accumulated Amortisation) is reduced to reflect the consumption of economic benefits over time.
- Amortisation Method

-The amortisation method should reflect the consumption pattern (For example, the unit of the production method). The straight-line method should be used if a pattern cannot be determined reliably.

- The amortisation charge is recognised as an expense unless included in the carrying amount of another asset.
- Amortisation methods should be reviewed at least annually at each financial year-end. The amortisation charge for current and future periods should be adjusted for any changes in the:

-period (if the expected useful life is significantly different)
-method (to reflect a changed pattern).

# 3 Double Entries for Intangible Assets

- The double entry to record the purchase of an intangible asset is:

| | **Individual Account** | **Category** | **Explanation** |
|---|---|---|---|
| DR | Intangible Asset – Cost (SFP) | Asset | Intangible Asset (Asset) is recognised |
| CR | Bank/Cash (SFP) | Asset | Bank (Asset) has decreased |

- Amortisation is the systematic allocation of the depreciable amount of an intangible asset (its cost minus residual value) over the period expected to benefit from its use.

The double entry to record the amortisation of an intangible asset is:

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Amortisation (SPL) | Expense | Amortisation (Expense) increased |
| CR | Intangible Asset – Acc. Amortisation (SFP) | Asset | Acc. amortisation reduces the value of IA |

# 4 Research and Development

**4.1 Introduction of Research and Development**

- It may be challenging for businesses to determine a value of an **internally generated intangible asset.** Specifically, it is often difficult to determine whether:

there is an **identifiable** asset
future economic benefits are **probable**
cost can be measured **reliably**.

- It isn't easy to distinguish the cost of generating a brand, for example, from the cost of developing the business as a whole, maintaining goodwill, or operating on a day-to-day basis.
- Therefore, **internally generated intangible assets** such as brands, publishing titles, customer lists and items similar in substance **cannot** be capitalised and recognised as intangible assets in the Statement of Financial Position.
- The only exception is research and development costs.

**Research:** Research is an **original and planned investigation** undertaken to gain new scientific or technical knowledge and understanding.

**Example:** Aiming to obtain new knowledge;Seeking applications of research findings;Formulating and designing possible new or improved product or process alternatives

**Development:** 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 commencement of commercial production or use.

**Example:**Design, construction and testing of pre-production prototypes and models and chosen alternative materials, processes, etc;Designing tools, etc., involving new technologyDesign, construction and operation of a pilot plant (not of a scale economically feasible for commercial production).

### 4.2 Accounting for Research and Development

#### 4.2.1 Research cost

**Research costs are always treated as expenses** and cannot be capitalised as intangible assets because it is uncertain whether the research will generate future economic benefits.

The double entry to account for research expenditure is:

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Research (SPL) | Expense | Research (Expense) has increased |
| CR | Bank/Cash (SFP) | Asset | Bank (Asset) has decreased |

#### 4.2.2 Recognition of Development

Development cost can only be capitalised as an intangible asset if it meets all the following criteria below:

- **Technical feasibility** of completing the development of the intangible asset
- **Intention** to complete the development of the intangible asset
- **Ability** to use or sell the intangible asset
- The intangible asset will generate **future economic benefit**
- Sufficient **resources** to complete the intangible asset
- Cost can be **measured reliably**

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Intangible Asset (SFP) | Asset | Intangible Asset (Asset) is recognised |
| CR | Bank/Cash (SFP) | Asset | Bank (Asset) decreased to pay for development cost |

- The capitalised development cost will be amortised over its useful life and charged to the Statement of Profit or Loss. Development expenditure has no residual value since no active market exists (each development will be unique).
- If any of the above criteria is not met, the development cost cannot be capitalised and must be treated as an expense in the Statement of Profit or Loss.

| | Individual Account | Category | Explanation |
|---|---|---|---|
| DR | Development (SPL) | Expense | Development (Expense) has increased |
| CR | Bank/Cash (SFP) | Asset | Bank (Asset) has decreased |

**Example 1**

On 1 April 20X6, Brooks established a new research and development unit to acquire scientific knowledge on the use of synthetic chemicals for pain relief. The following expenses were incurred during the year ended 31 March 20X7.

1.Purchase of building for $400,000. The building is to be depreciated on a straight-line basis at the rate of 4% per annum on cost.

The purchase of a building is a tangible non-current asset purchase, not an intangible asset. Brooks will capitalise the purchase cost with the following entry:

| | | |
|---|---|---|
| DR | Building - Cost | $400,000 |
| CR | Bank | $400,000 |

2.At the year-end, the depreciation charge is $400,000 × 4% = $16,000 and should be expensed off by:

| | | |
|---|---|---|
| DR | Depreciation (Expense) | $16,000 |
| CR | Building – Acc. Depreciation | $16,000 |

3.Wages and salaries of research staff are $2,355,000.

Research costs must always be expensed off. The double entry is:

| | | |
|---|---|---|
| DR | Research (Expense) | $2,355,000 |
| CR | Bank | $2,355,000 |

4.Development cost that meets the criteria to be capitalised has been calculated to be $60,000. It is amortised using the straight-line method of 25% per annum.

The cost to be capitalised is $60,000. The double entry is:

| | | |
|---|---|---|
| DR | Intangible Asset | $60,000 |
| CR | Bank | $60,000 |

5.The amortisation charge for the year is $60,000 × 25% = $15,000

| | | |
|---|---|---|
| DR | Amortisation (Expense) | $15,000 |
| CR | Intangible Asset – Acc. Amortisation | $15,000 |

6. The total amount expensed in the statement of profit or loss is:

| | |
|---|---|
| Building depreciation ($400,000 × 4%) | $16,000 |
| Wages and salaries of research staff | $2,355,000 |
| Intangible Asset Amortisation ($60,000 × 15%) | $15,000 |
| | $2,386,000 |

# 5 Intangible Assets Disclosures

The financial statements should disclose each class of intangible assets:

- Useful lives or amortisation rates used.
- Amortisation methods used.
- Gross carrying amount and accumulated amortisation.
- A reconciliation of the carrying amount at the beginning and the end of the period showing additions, disposals, amortisation, etc.
- The **aggregate** amount of R&D expenditure recognised as an expense during the period.

# Chapter 11 Accruals, Prepayment, Accrued and Deferred Income

Learning outcomes

- Understand the matching concept applies to accruals and prepayment.
- Identify and calculate the adjustments needed for accruals and prepayments in preparing financial statements.
- Identify and calculate the adjustments needed for accrued and prepaid income in preparing financial statements.
-

## 1 Prepayments

Prepayments are expenses paid in excess of the accounting period concerned. They are treated as unexpired values to be placed in the statement of financial position as a **current asset.**

**Example1**

The annual insurance charge for a business is $24,000 pa. $30,000 was paid on 1 January 20X7 in respect of future insurance charges.

**What is the year-end prepayment and what is the insurance expense for the year?**

The double entry required is:

- Record the payment： Dr Insurance expense 30,000　　Cr Cash 30,000
- Year end adjustment： Dr Prepayment 6,000　　Cr Insurance expense 6,000

**Profits** – The double entry to create prepayment is to **credit the expenses account**. Expenses decrease, which will lead to an **increased profit figure.**

**Net Assets** – The corresponding entry is to debit the Prepayment asset account. Net Assets or Capital is the Assets less Liabilities of a business. Since assets have increased, the business's **net assets will also increase.**

- Reverse the prepayment：　Dr Insurance expense 6,000　　Cr Prepayment 6,000

**Insurance expense**

| | $ | | $ |
|---|---|---|---|
| Cash | 30,000 | SPL | 24,000 |
| | ______ | Prepayment c/f | 6,000 |
| | 30,000 | | 30,000 |
| Prepayment b/f | 6,000 | | |

**Example 2**

During the year ended 30 September 20X7, a business paid $10,200 for insurance to cover the period from 1 July 20X7 to 30 June 20X8. The opening prepayment for insurance expenses was $6,850.
What should the expense be in the statement of profit or loss for the year ended 30 September 20X7?

**Solutions**
The business needs to recognise prepayment.
First, calculate the closing prepayment. Nine months have been prepaid (from 1 October 20X7 to 30 June 20X8). The closing prepayment is, therefore, $7,650 (= $10,200 ÷ 12 × 9).

Without drawing up a T-account, the expense for the year can then be found:

| | $ |
|---|---|
| Paid | 10,200 |
| Add: Opening prepayment | 6,850 |
| Minus: Closing prepayment | (7,650) |
| Expense | 9,400 |

The calculation of expenses in an accrual or prepayment is,
**Amount Paid + Opening Prepayment – Closing Prepayment = Expense**

## 2 Accruals

Accruals are expenses due and unpaid that have not been recorded in the books for the accounting period concerned. Accruals will appear in the statement of financial position as current liabilities.

**Example 3**

A business' electricity charges amount to $12,000 pa. In the year to 31 December 20X7, $9,000 has been paid. The electricity for the final quarter is paid in January 20X8.

What year end accrual is required and what is the electricity expense for the year?

- Record the payment： Dr Electricity expense 9,000 Cr Cash 9,000
- Year end adjustment： Dr Electricity expense 3,000 Cr Accruals 3,000

Profits – The double entry to create accruals is to debit the expenses account. Expenses increases, which will lead to a reduced profit figure.

Net Assets – The corresponding entry is to credit the Accruals liability account. Net assets or capital is the assets less liabilities of a business. Since liability has increased, the net assets of the business will decrease.

- Reverse the accrual： In the next accounting period, the supplier will invoice the business for the expense, and the business will make payment. As a result, double entries are made for:

  Dr Accruals 3,000    Cr Electricity expense 3,000
- Record the expense payment

  Dr Electricity expense 3,000    Cr Bank/payables 3,000

**Example 4**

The accounting year end is 31 December 20X6. A gas bill for $300 arrives on 2 February 20X7 for the quarter to 31 January 20X7.

Show the 31 December 20X6 ledger entries for the accrued expense.

Solutions:

The Year 2 financial period is from 1 Jan 20X6 to 31 Dec 20X6. Therefore, the gas bill of $300 for the quarter to 31 January 20X7 is only invoiced in the following year.

This means that the gas bill is from the quarter 1 Nov X6 to 31 Jan X7.

At the year-end, 31 Dec X6, 2 months of gas expenses have been incurred but not invoiced/paid. Therefore, an accrual adjustment is needed.

Amount accrued = $300 × 2/3 months = $200. The double entry to record the accruals is DR Gas Expense $200, CR Accruals $200.

**Example 5**

During the year ended 30 June 20X5, a business pays $5,905 for electricity to cover the opening accrual of $590 and the invoices received during the year. The last invoice was $1,860 and covered the period from 1 March 20X5 until 31 May 20X5.

What should the expense be in the statement of profit or loss for the year ended 30 June 20X5?

Solutions

The business needs to accrue for one month's electricity (June), which is $620 ($1,860 ÷ 3).

Without drawing up the ledger T-account, the expense for the year can be found:

| | $ |
|---|---|
| Paid | 5,905 |
| Minus: Opening accrual | (590) |
| Add: Closing accrual | 620 |
| Expense | 5,935 |

**Amount Paid – Opening Accrual + Closing Accrual = Expense**

# 3 Accrued Income

Accrued income is recognised as an asset to reflect the income owed to the business since revenue has been provided but payment has not yet been received. (receipt in arrears).

**Example 6**

A business earns bank interest income of $300 per month. $3,000 bank interest income has been received in the year to 31 December 20X7.

What is the year-end asset and what is the bank interest income for the year?

- Record the receipt： Dr Bank 3,000 Cr Bank Interest Income 3,000
- Year end adjustment： Dr: Accrued income $600Cr: Bank Interest income $600
- Reverse the accrued income：

In the next financial period where payment has been received, the business will reverse the accrued income adjustment made in the previous period and record the income receipt.

Dr Bank interest income 600 Cr Accrued income

- Record of income receipt: Dr Bank 600 Cr Income 600

**Amount received -opening accrued income +closing accrued income=income**

# 4 Deferred Income (prepaid income）

.Payment has been received in the current financial period for income generated in the following financial period. The business records the **income receipt** during the year, then calculates and **creates the deferred income** amount adjustment.
At year-end, the business will adjust for deferred/prepaid income for income generated for payments in advance

**Example 7**

A business rents out a property at an income of $4,000 per month. $64,000 has been received in the year ended 31 December 20X7.
What is the year-end liability and what is the rental income for the year?

- Record of income receipt: Dr Bank/ Cash 64,000 Cr Rental income 64,000
- Year end adjustment: Dr Rental income 16,000 Cr Deferred income 16,000
- Next year reversal the deferred income: Dr Deferred income 16,000 Cr Rental income 16,000

**Amount received + opening deferred income -closing deferred income= income**

**Summary**

| Category | Explanation | Asset | Liability | Double Entry |
|---|---|---|---|---|
| Accruals | Expenses incurred before payment made | | ✓ | DR Expenses<br>CR Accruals |
| Prepayments | Payment made before Expenses incurred | ✓ | | DR Prepayments<br>CR Expenses |
| Accrued Income | Income earned before payment received | ✓ | | DR Accrued Income<br>CR Income |
| Deferred Income | Payment received before Income earned | | ✓ | DR Income<br>CR Deferred Income |

# Chapter 12 IAS10 Events After The Reporting Period

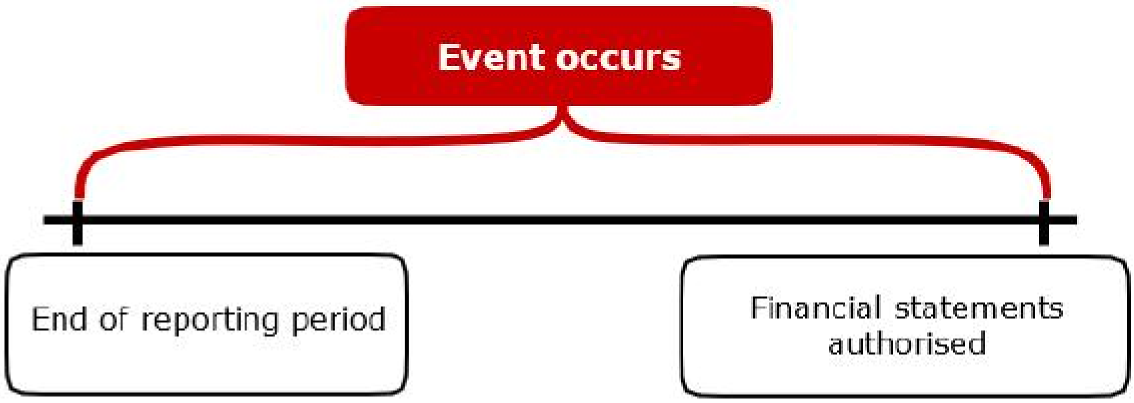
**Learning outcomes**

- Define an event after the reporting period in accordance with IAS 10 Events after the Reporting Period.
- Classify events as adjusting or non-adjusting.
- Distinguish between how adjusting and non-adjusting events are reported in the financial statements.

## 1 Events After Reporting Period

IAS 10 defines events after the reporting period as favourable and unfavourable events that occur between the end of the reporting period (the reporting date) and the date on which the financial statements are authorised for issue (per statutory requirements).

The following timeline shows when the events occur:




## 2 Adjusting Events

These events provide further evidence of conditions that existed at the reporting date. **Examples of adjusting events are:**

- The discovery after the year-end of a fall in the value of a property that took place before the year-end.
- The amount receivable from a customer who has become bankrupt after year-end.
- Sale of inventory for less than its cost after the year-end. After-date sales may

give evidence about NRV.

- Discovery of fraud or errors showing the financial statements to be incorrect.
- Confirmation of an amount receivable or payable in respect of a legal case that is settled after the year-end.
- Determination after the reporting date of purchase price or proceeds of an asset purchased or sold before the reporting date.

## 3 Events Not Requiring Adjustment (Non-Adjusting):

These are events indicative of conditions that arose after the reporting date. Examples of non-adjusting events are:

- The acquisition or disposal of non-current assets after the year-end.
- Fire, flood or other catastrophes that destroy assets after the year-end.
- The announcement of plans to close down part of the business.
- Lawsuits against the business, or started by the business, that begins after year-end.
- The announcement of a restructuring plan after year-end.
- Decline in the market value of investments after the reporting date.
- A major acquisition of another entity.
- Dividends proposed or **declared after the reporting date** and before the financial statements were authorised are disclosed in the notes to the financial statements

| | |
|---|---|
| **1.** Discovery of fraud during the annual inventory count: the discovery is after the year-end, but the fraud existed at the reporting date (when the annual inventory count was performed). | Adjusting |
| **2.** Sales of inventories at less than cost: sales of inventories at less than cost means NRV is less than cost. | Adjusting |
| **3.** Exchange-rate fluctuations: movements in foreign exchange rates after the reporting date are in response to changes in economic conditions, etc., after the reporting date. | Non-Adjusting |
| **4.** Nationalisation or privatisation by the government: government action is after the reporting date. | Non-Adjusting |
| **5.** Out-of-court settlement of a legal claim: the settlement determines the outcome of a current uncertainty (which is now eliminated). | Adjusting |
| **6.** Rights issue of equity shares: the rights are not available to shareholders until after the reporting date. | Non-Adjusting |
| **7.** Strike by workforce: the strike action is after the reporting date (even if the reason for the action was an event before the reporting | Non-Adjusting |

date).

**8.** Earthquake: the natural disaster was not a condition existing at the reporting date. Non-Adjusting

# 4 Accounting Treatment for Events after Reporting Period

- Adjusting Events

An adjusting event provides further evidence of existing conditions at the reporting date and should be retrospectively adjusted in the financial statements.

The effect of the liability or asset is recognised or amended using journal entries.

- Non-Adjusting Events

For non-adjusting events, no adjustments are made to the financial statements.

However, the business will identify if the event is significant or material. If it is, the event is disclosed in the financial statement notes.

the nature of the event
an estimate of the financial impact
a statement that a reliable estimate of the financial impact is not possible.
If the non-adjusting event is immaterial, no disclosure is necessary.

# Chapter 13 Capital Structure and Finance Cost

**Learning outcomes:**

- Describe the capital structure of a limited liability company including:
- Describe the nature of equity, including retained earnings and other components of equity.
- Identify and record the other components of equity which may appear in the statement of financial position.
- Record movements in the share capital and share premium accounts.
- Define a bonus (capitalisation) issue and its advantages and disadvantages.
- Define a rights issue and its advantages and disadvantages.
- Calculate and record a bonus (capitalisation) issue in the statement of financial position.
- Calculate and record a rights issue in the statement of financial position.
- Calculate and record dividends in the general ledger accounts and the financial statements.
- Calculate and record finance costs in the general ledger accounts and the financial statements.
- Identify the components of the statement of changes in equity.

## 1 Limited Liability Company

- ➢ A limited liability company is where investors invest in the company by buying shares and becoming shareholders.
- ➢ Shareholders require profits on their investments in the form of dividend payments or share value appreciation.
- ➢ Directors are hired to run the company on behalf of the shareholders, and shareholders are only liable for their investments.

## 2 Capital Structure

- ➢ A business's capital structure refers to the composition of its finance, a combination of equity (shares) and loans (debt) and other sources of finance that it uses as long-term financing.

For example, a company with $20 million in equity and $80 million in debt is said to be 20% equity financed and 80% debt financed

- ➢ The three primary sources of raising finance are:

Ordinary Shares
Preference Shares
Borrowings/ Loan Notes

# 3 Terminology

- The share capital of a limited liability company represents the capital invested by its shareholders through the purchase of shares. Shares purchased by shareholders can be ordinary or preference shares. Below are some of the terminologies used in respect of share capital:
- Par Value of Share Capital

Every share has a face value known as its par value (legal or nominal value). For example, shares can have any par value, such as $1, 50 cents, or 10 cents. In exam questions, you will be given the par value.

For example, Tahsul Co is set up as a limited liability company. The par value of each share is set at $0.50. To raise $400,000, Tahsul Co would need to issue 800,000 ($400,000/$0.50) shares at their par value.

- Authorised Share Capital

When a company is set up, it establishes the par value of each share and the maximum number of shares it can issue. This maximum number of shares is the company's authorised share capital. This authorised share capital amount can be changed by agreement with the shareholders.

For example, Tahsul Co has authorised share capital of 1,000,000 $1 shares.

- Issued Share Capital

The issued share capital (sometimes called allotted share capital) is the number of shares a company has issued to shareholders. The issued share capital cannot exceed the authorised share capital.

For example, Tahsul Co has issued 400,000 $1 shares to shareholders. This means that 600,000 $1 shares are still available to be issued in the future.

- Called-Up Share Capital

A company may not necessarily sell its issued share capital at its par value. The amount issued/called up to its shareholders may be a percentage of the par value.

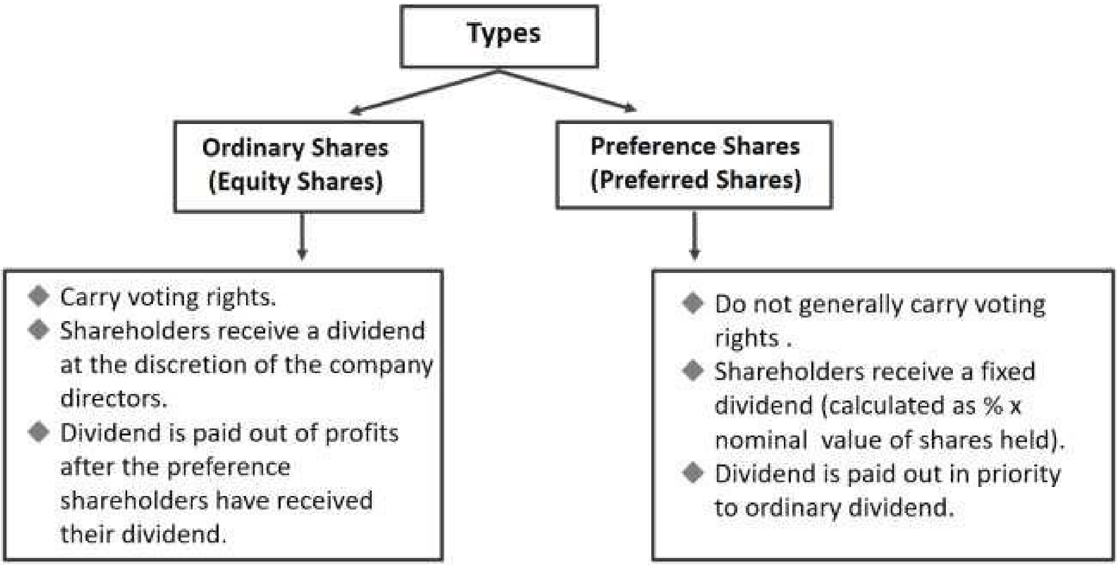
For example, Tahsul Co called up 60% of the par value of the shares in an issue. This means the called-up share capital is $240,000 (400,000 shares × $1 each × 60%). This is the value of share capital that will appear in the statement of financial position.

- Paid-Up Share Capital

When a company calls up a fraction of the par value, shareholders may take their time to make pay. The amount of share capital paid is the Paid-up share capital. The

amount of share capital remaining unpaid is the call-in arrears.
For example, Tahsul Co has received $220,000 of the amount due for the called-up share capital. This means that the paid-up share capital is $220,000, and there will be a receivable balance (call in arrears) of $20,000 in the Statement of Financial Position.

# 4 Types Of Shares




Ordinary shares
The ordinary shareholders are the real owners of the profit after any preferential rights have been satisfied. Upon winding up of a company the ordinary shareholders will receive any surplus after all prior claims by trade payables or preference shareholders have been met.

# 5 Share capital Value

- Nominal or par value: Each share has a nominal or par value, often $1, 50c or 25c. This value is often used as a means of calculating dividends to shareholders (paid as a percentage of the nominal value) Shares are issued by the company at an issue price. This is at least equal to the nominal value of the shares, but often exceeds it.

- The market value of a share fluctuates according to the success and perceived expectations of a company. If a company is listed on the stock exchange, the value is determined by reference to recent transactions between buyers and seller of shares. This value dose not feature in the financial statements.

**Example 1**

On 1 June 20X0 Rab Co issued a further 200,000 ordinary shares of 50c each for 80c per share.

Required: Show the double entryThe journal entry will therefore be:

| | | | |
|---|---|---|---|
| Dr | Bank/cash | 160,000 | No. of share * issue price |
| Cr | Ordinary share capital | 100,000 | No. of share * par value |
| Cr | Share premium | 60,000 | No. of share*(issue price -par value) |

# 6 Rights issue and Bonus issue

- **Rights issue**

A rights issue is an issue of shares for cash. The 'rights' are offered to existing shareholders, who can sell them if they wish. This is beneficial for existing shareholders in that the shareholders are usually issued at a discount to the current market price.

**Example 2**

The current issued and paid-up capital comprises of 1,000,000 shares of $1.00 each. Prevailing market price of the share is $3.40. The company decides to raise more funds through a rights issue of one for every 50 held at a discounted price of $2.50 per share Assuming all rights are exercised.

Required: Show the double entry

The journal entry will therefore be:

| | | | |
|---|---|---|---|
| Dr | Bank/cash | 50,000 | No. of share * issue price |
| Cr | Ordinary share capital | 20,000 | No. of share * par value |
| Cr | Share premium | 30,000 | No. of share*(issue price -par value) |

**Advantages of right issue**

More cost-effective way for the company to raise finance than a fresh issue to the public

A more time-efficient way to issue shares

If all rights are taken up shareholders will maintain existing percentage shareholding

As shares offered at below market value, shareholders are more likely to buy them

**Disadvantages of right issue**

Unwelcome predators may try to acquire shares where not all rights are taken up

Effect on future dividend policy as company will have issued more shares under the rights issue than it would have under a fresh issue to the public

Will cause the share price to fall as shares are issued at below market value

- **Bonus issue**

Some extra shares may be issued to existing shareholders without them having to pay anything. Such an issue is called a bonus issue.

**Example 3**

The current issued and paid-up capital comprises of 10,000,000 shares of $1.00 each. The company decides to issue a bonus issue of one for every 50 held for existing shareholders.

Required: Show the double entry

(1) If balance of share premium account $280,000

(2) If balance of share premium account $80,000

| | | |
|---|---|---|
| (1) Dr | Share premium account | $200,000 |
| Cr | Ordinary share capital | $200,000 |
| (2) Dr | Share premium account | $80,000 |
| Dr | Retained earnings | $120,000 |
| Cr | Ordinary share capital | $200,000 |

**Advantages of bonus issue**

(a)Bonus issues can be made from the share premium account which has few other uses.

(b)Will allow the share price to fall (without disadvantaging shareholder wealth) to make the company‘s share more affordable to new investors.

(c)Shareholders will now own more shares and could sell part of their holding.

**Disadvantages of bonus issue**

(a)Does not raise any cash.

(b)Could jeopardize payment of future dividend if profits fall.

Notes:
(a)A rights issue involves the issue of new shares for cash and therefore more capital will be raised.
(b)A bonus issue will result in more shares in issue without affecting the value of the company as a whole.
(c)Both a rights and a bonus issue involve the potential issue of shares to existing shareholders. Therefore neither will increase the number of shareholders in a company.

# 7 Preference shares

Preference shares carry preferential rights to dividend, usually at a fixed rate. They will carry preferential rights to repayment of capital in the event of a winding up, if the articles or terms of issue so provide. However, in general, preference shareholders do not have voting rights.

**Redeemable preference shares**: are preference shares which are repayable by the company at a specific future date. On this date the shares are cancelled and the shareholders repaid.
These shares have the characteristics of debt. They are therefore classified as a liability on the statement of financial position.
Double entry to record:
Dr Cash
Cr liability

Any dividend for redeemable preference shares is actually finance cost.
Double entry to record:
Dr: Expenses
Cr: Cash/Payable

**Irredeemable preference shares**: are preference shares which are not redeemable. They remain in existence indefinitely.
These shares are classified as equity on the statement of financial position.
The dividends should be treated as an appropriation of profit.

# 8 Reserves

Share capital and reserves are owned by the shareholders. They are known collectively as shareholders    equity. There are two types of reserves: Capital reserves and Revenue reserves.

- **Capital reserves**

  ① Share Premium

'Premium' means the difference between the issue price of the shares and its par value. When a company is first set up, the issue price of its shares will probably be the same as their par value and so there would be no share premium. If the company does well, the market value of its shares will increase, but not the par value. The price of any new shares issued will be approximately their market value.

The difference between cash received by the company and the par value of the new shares issued is transferred to the share premium account

Share premium is a capital reserve. One common use of the share premium account is to finance the issue of bonus shares. Other use may depend on national legislation.

  ② Revaluation surplus

The gain on the revaluation cannot go to the statement of profit or loss, as it has not been realized.

Instead it is recognized in the statement of other comprehensive income, as other comprehensive. At the same time, the gain is transferred to a revaluation surplus, part of equity in the statement of financial position.

The result of an upward revaluation of a non-current asset is a 'revaluation surplus'. This reserve is non- distributable as it represents unrealized profits on the revalued assets. It is another capital reserve.

- **Revenue reserves**

Retained earnings

Retained earnings are accumulated earnings of a company since its inception less dividends known as revenue reserves.

# 9 Dividends

Many companies pay dividends in two stages during the course of their accounting year: an interim dividend and a further final dividend.

Dividends on ordinary and irredeemable preference shares

The double entry is:

(1)Intend to declare but not pay out

Dr Accumulated/Retained profits    Cr Dividend payable

(2)Pay out by cash

Dr Dividend payable    Cr Cash

Dividends proposed or declared after the end of the reporting period are not recognised as a liability in the accounts at the reporting date, but are disclosed in the

notes to the accounts. (see chapter 20 IAS 10)
Dividends paid are shown in the statement of changes in equity
Dividends income from investment that be shown in the Statement of profit or loss and other comprehensive income.

**Example 4**

The issued share capital of Alpha, a limited liability company, is as follows:

| | |
|---|---|
| Ordinary shares of 10c each | 1,000,000 |
| 8% redeemable preference shares of 50c each | 500,000 |

In the year ended 31 October 20X7, the company has paid the preference dividend for the year and an interim dividend of 2c per share on the ordinary shares. A final ordinary dividend of 3c per share was proposed, before the reporting date.

What is the total amount to be recognised for dividends in the financial statements for the year ended 31 October 20X7?

## 10 Statement of changes in equity

| | Share Capital | Share Premium | Revaluation Surplus | Retained Earning | General Reserves | Total |
|---|---|---|---|---|---|---|
| At b/d | X | X | X | X | X | X |
| Right issue | X | X | | | | X |
| Bonus issue | X | (X) | | | | - |
| Revaluation of assets | | | X | | | X |
| Net profit for the year | | | | X | | X |
| Dividends | | | | (X) | | (X) |
| At c/d | X | X | X | X | X | X |

## 11 Debentures

- Loan notes can be issued at a discount to their nominal value. (unlike shares)
- Interest is always paid based on the nominal value.
- A debenture is a long-term debt instrument issued by a company.
- In exchange for cash, the company promises to pay a principal amount at a specific date as well as interest on that principal amount at a specific rate per period.
- Upon issuance the debenture becomes a long-term liability in the statement of financial position (balance sheet), since repayment date can be 2, 5 or even 10 years from date of issue.
- Here are the features of a debenture:

Issued in denominations of $100, $1,000, $10,000 etc, called the par value

Holder of a debenture is a creditor, not a shareholder

Interest is paid periodically, say half-yearly or yearly

Interest must be paid, with priority over dividends of preference and ordinary shares

Debentures are normally secured on the issuing company's assets

- Accounting treatment

Loan notes, debentures and redeemable preference shares are shown as non-current liabilities on the statement of financial position, unless they are to be redeemed in the next year.

Loan note and debenture interest and dividends on redeemable preference shares are treated as an expense in the statement of profit or loss.

**Example 5**

Frank, a company, issues $400,000 12% loan notes for $380,000 on 1 August 20X7. Interest is payable quarterly on the first day of November, February, May and August. What accounting entries are required in the year ended 30 September 20X7?

B.Dr Cash $380,000

Cr Non-current liabilities $380,000 And

Dr Interest $8,000

Cr Current liabilities $8,000

# 11 Income Tax

- Companies are charged income tax on their profits.

  Accounting for income tax is initially based on estimates, since a company's tax bill is not finalized and paid until N months after its year end.( depend on national tax legislation)

  This means that a company will normally under- or over provide for tax in any given year

  Tax will therefore appear in the financial statement being

- Double entry to record:

Tax charged against profits will be accounted for by

Dr Income tax expense (SPL)

Cr Current tax payable (SOFP)

- When the tax liability eventually is paid, the accounting entry would be

Dr Current tax payable (SOFP)

Cr Cash (SOFP)

- A charge to profits in the statement of profit or loss being

--- Current year estimated tax + previous year's under provision;

--- Current year estimated tax – previous year's over provision

- A year end liability in the statement of financial position being the current year's estimated tax.
- A tax paid in the statement of cash flow

# Chapter 14 Trial balance

**Learning outcomes:**

- Describe the purpose of a trial balance.
- Extract general ledger balances into a trial balance.
- Prepare extracts of an opening trial balance.
- Explain the limitations of a trial balance.
- Correction of Errors
  Identify the types of error which may occur in accounting systems.
  Identify errors which would be highlighted by the extraction of a trial balance and those which would not.
  Prepare journal entries to correct errors.
- Calculate the impact of errors on the statement of profit or loss and other comprehensive income and the statement of financial position.
- Explain the purpose of a suspense account.
- Identify errors leading to the creation of a suspense account.
- Record entries in a suspense account.
- Prepare journal entries to clear a suspense account.
- Preparing Financial Statements
- Incomplete records
- Apply techniques used in incomplete record situations

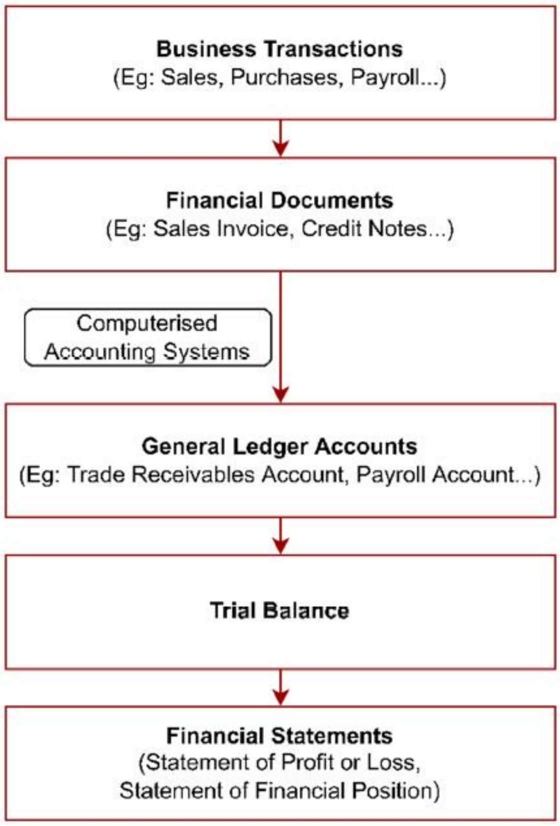
## 1 Trial balances

### 1.1 Nature of trial balance

- A trial balance is a list of all the closing debit and credit balances from each ledger account in the general ledger.
- It lists all the debit and credit balances on the individual ledger accounts.
- Asset and expense accounts will have debit balances
- Liabilities and income accounts will have credit balances.
- A trial balance can be used to **test the accuracy** of the double entry accounting records. If the two columns of the list are not equal, there must be an error in recording the transactions in the accounts. A list of account balances, however, will not disclose some other errors.

| | **Dr** | **Cr** |
|---|---|---|
| Machine | $ | |
| Office Equipment | $ | |
| Accumulated Depreciation | | $ |

| | | |
|---|---|---|
| Intangible Assets | $ | |
| Inventory | $ | |
| Receivables | $ | |
| Allowance for Receivables | | $ |
| Cash at bank | $ | |
| Petty Cash | $ | |
| Loan | | $ |
| Payables | | $ |
| Overdraft | | $ |
| Ordinary Share | | $ |
| Share Premium | | $ |
| Irredeemable Preference | | $ |
| Retained Earning | | $ |
| Sales | | $ |
| Sales Return | $ | |
| Purchase | $ | |
| Purchase Return | | $ |
| Sundry Expense | $ | |
| Other Income | | $ |



### 1.2 Purpose of trail balance

- To ensure double entries are correctly posted

The concept of double entry in the general ledger states that the debit entry must equal the credit entry. If an error occurs and only one side of the entry is posted to the general ledger, the trial balance will not balance as the credit balances do not equal the debit balances.

- Used as a starting point for preparing the financial statements

The financial statements are the end product of the accounting process. The Trial Balance extracted will help identify if double entries have been correctly posted. This makes the preparation of the final accounts more efficient.

### 1.3 Limitations of a Trial Balance

- A trial balance may not identify all errors in the general ledger.

It only gives evidence of whether the total debits and credits balances or not. Although debits and credits agree in the trial balance, there could still be errors. For this reason, the trial balance cannot be relied upon to identify all the errors in the general ledger.

- A trial balance will not identify error corrections.

An error identified in a trial balance merely indicates the existence of an error. It does not inform the cause of the problem and how to correct it. The trial balance is only the starting point for investigating errors in the general ledger

## 2.Types of Errors

### 2.1Errors will not affect the agreement of T/B.

Examples are:

(a)Errors of omission

If sales invoice or purchase invoice or any other transaction document is completely left out, both debit and credit would have been omitted.

(b)Errors of commission

A debit (or credit) entry is posted to the wrong personal account within the same category. E.g. a receipt from debtor A is credited to debtor B's account.

(c)Errors of principle

An entry is posted to a wrong account in the wrong category. E.g. purchase of a fixed asset is posted to the Purchases account (i.e. capital vs. revenue expenditure).

(d)Compensating errors

An error on the debit side is compensated by an error of the same amount on the credit side.

### 2.2 Errors will affect the agreement of TB

Examples include:

(a)Only one debit (or one credit) entry is made

(b)Two debits or two credits

(c)Transposition error

e.g. a posting of $47 is made to John's account, when the correct amount should have been $74

(d)Balances are listed on the wrong side of the trial balance

(e)Casting errors in ledgers

# 3.Correction of errors

### 3.1Correction of errors by journals

Errors which leave total debits and credits in the ledger accounts in balance can be corrected by using journal entries.

| Date | Debit | Credit |
|---|---|---|
| | $ | $ |
| Account to be debited | X | |
| Account to be credited | | X |
| (Narrative to explain the transaction) | | |

### 3.2Using Suspense Account to Correct Errors

Usually errors are noted when the total debits do not agree with total credits in the trial balance, although a balanced trial balance does not necessary guarantee the accuracy of the accounts, as mentioned above. Here are the steps taken to correct errors:

(a)Open a suspense account to make up the difference between total debits and total credits in the trial
balance.

(b)Upon further investigation when errors are revealed, the necessary adjusting entries should be recorded in the general journal.
(c)The suspense account is used, for example, when the bookkeeper knows which debit entry to adjust but not the credit entry, or vice versa.
(d)Post the corresponding credit (or debit) entry to the suspense account.
(e)All errors are to be located and the suspense account completely eliminated.

Remember the suspense account is merely a temporary account that should not appear anywhere in the financial statement.

**Example 1**

Perry Dew, a sole trader, makes up his business accounts to 31 December. The total debits and total credits in his trial balance as at 31 December 20X7 did not agree, $7,240 short on the credit side.

Upon further investigation, he noted the following errors.

·The rental income account (total $2,500) was omitted in the trial balance.

·Return outwards $360 was posted to the debit side of the Return inwards account.

·An ex-customer whose debt was previously written off as bad repaid $4,020. The amount was recorded as a receipt in the cash book and nowhere else.

To clear the difference in the trial balance, the adjusting entries are:

| | | |
|---|---|---|
| Dr | Suspense | 2,500 |
| Cr | Rental income | 2,500 |
| Dr | Suspense | 720 |
| Cr | Return outwards | 360 |
| Cr | Return inwards | 360 |
| Dr | Suspense | 4,020 |
| Cr | Irrecoverable debts expense | 4,020 |

| Suspense account | | | |
|---|---|---|---|
| Rental income | 2500 | Difference per T/B | 7240 |
| Return outwards | 360 | | |
| Return inwards | 360 | | |
| Irrecoverable debts expense | 4020 | | |
| | 7240 | | 7240 |

As seen above, any balance on the suspense account should be completely wiped out. The adjusting entries should restore equality of debits and credits in the trial balance.

**Example 2**

A limited liability company's trial balance does not balance. The totals are: Debit $384,030 Credit $398,580

A suspense account is opened for the difference.

Which of the following pairs of errors could clear the balance on the suspense account when corrected?

A.Debit side of cash book under cast by $10,000; $6,160 paid for rent correctly entered in the cash book but entered in the rent account as $1,610.

B.Debit side of cash book overcast by $10,000; $1,610 paid for rent correctly entered in the cash book but entered in the rent account as $6,160.

C.Debit side of cash book under cast by $10,000; $1,610 paid for rent correctly entered in the cash book but entered in the rent account as $6,160.

D.Debit side of cash book overcast by $10,000; $6,160 paid for rent correctly entered in the cash book but entered in the rent account as $1,610.

**Example 3**

The debit side of a trial balance totals $800 more than the credit side.

Which one of the following errors would fully account for the difference?

A.$400 paid for plant maintenance has been correctly entered in the cash book and credited to the plant account.

B.Gain on disposal $400 has been debited to the loss on disposal account.

C.A receipt of $800 for commission receivable has been omitted from the records.

D.The petty cash balance of $800 has been omitted from the trial balance.

**Example 4**

A suspense account was opened when a trial balance failed to agree. The following errors were later discovered.

1)A gas bill of $420 had been recorded in the gas account as $240.

2)Rent expenses $50 was recorded at credit side of trade payable.

3)Interest received of $70 had been entered in the bank account only.

What was the original balance on the suspense account?

# 4 Year-end adjustments

In the process of yearend adjustments we, normally, deal with following transactions:

(a)Inventory valuation

(b)Accrual & Prepayments

(c)Accrued income & Prepaid income

(d)Depreciation

(e)Allowance for receivables

# 5 Reason for Incomplete Records

**5.1 Reasons for keeping complete and accurate accounting records**

- Comply with legislation, including tax regulations (For example, sales tax
- Produce financial statements (for interested users)
- Control operations (For example, to receive amounts due from customers)
- Safeguard assets (If recorded, their existence can be confirmed by physical inspection)

**5.2 Records may be incomplete due to the following reasons**

- There is no legal requirement to keep complete records
- The cost of a bookkeeper is not justified
- Information for the preparation of financial statements can be obtained from other sources (for example, adding up unpaid invoices kept in a drawer to determine trade payables)
- Data loss from accidents or fraud

**5.3 Solving Incomplete Records**

In such cases, there are several techniques to derive missing figures or elements in the financial statements to construct missing accounts, such as:

- **Manipulation of the accounting equation**

Capital = Assets – Liabilities

Capital is calculated as Opening Capital + Capital Introduced + Profits − Drawings

(Opening Capital + Capital Introduced + Profit − Drawings) = Assets − Liabilities

Profit = Assets − Liabilities − Opening Capital − Capital Introduced + Drawings

**Example 5**

Milos started his business on 1 January with $10,000 in cash. He bought a kiosk for $9,000 and inventory for $1,000.

He did not introduce any further capital into the business during the year.

He withdrew $100 weekly, except for the first two weeks when he drew nothing.

At the end of the year, on 31 December, he had the following assets and liabilities:

| | |
|---|---|
| Kiosk | Estimated useful life is another two years |
| Trade receivables | $950 |
| Trade payables (wholesaler) | $1,650 |
| Inventories | $550 |
| Cash | $370 |

Calculate Milos' profit for the year.

**Solution**

The profit for the year is $1,220.

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Profit | = | Assets | − | Liabilities | − | Opening Capital | − | Capital introduced | + | Drawings |
| 1,220 | = | 7,870(W1) | | 1,650 | − | 10,000 | − | 0 | + | 50 weeks × $100 5,000 |

Working 1:

Non-Current Assets = Cost $9,000 − Acc. Depr ($9,000/3 years*) = $6,000

Current Assets = Receivables $950 + Inventories $550 + Cash $370 = $1,870

Total Assets = $6,000 + $1,870 = $7,870

*Note: Regarding the kiosk as of 31st December, it has a remaining useful life of 2 years after 1 year has lapsed, so its total useful life is 3 years.

- **Derive missing figures from ledger accounts**

✓ Trade Receivables Account

The Trade Receivables account can derive the total sales or cash received from customers.

| DR | | Trade Receivables Account | CR |
|---|---|---|---|
| Balance b/d | X | Cash from customers | X |
| Total Sales | X | Balance c/d | X |
| | XX | | XX |

The below pro forma template provides the same outcome:

| | $ |
|---|---|
| Cash received from customers | X |
| Add closing customer balances outstanding(receivables) | X |
| Less opening customer balances outstanding(receivables) | (x) |
| Credit sales in the year | x |

**Example 6**

Hiroto has an air-conditioning business. He makes sales mainly on credit, issuing sales invoices for every sale.As his business has grown, he has not kept track of the amounts owed to him by customers at the end of his current accounting year, 31 December 20X9.However, he kept the bank statements that recorded all receipts from his credit customers and all sales invoices for the year.Total cash received from credit customers during the year $136,800. Total credit sales invoices $162,400.

| | 1 January 20X9 | 31 December 20X9 |
|---|---|---|
| Customer balances outstanding | $27,200 | ? |

**How much money is Hiroto owed from his customers at 31 December 20X9?**

**Solutions**

| **DR** | | | | | **CR** |
|---|---|---|---|---|---|
| **Date** | **Narrative** | **$** | **Date** | **Narrative** | **$** |
| 1 January 20X9 | Balance b/d | 27,200 | | Cash received from customers | 136,800 |
| | Sales | 162,400 | | | |
| | | | 31 December 20X9 | Balance c/d | 52,800 |
| | | 189,600 | | | 189,600 |

✓ Trade Payables Account

The Trade Payables Account can derive the Total Purchase or Cash paid to suppliers.

| DR | | Trade Payables Account | CR |
|---|---|---|---|
| Cash to suppliers | X | Balance b/d | X |
| Balance c/d | X | Total Purchases | X |
| | XX | | XX |

The below pro forma template provides the same outcome:

| | $ |
|---|---|
| Cash paid to suppliers | X |
| Add closing outstanding balances to suppliers(payables) | X |
| Less opening outstanding balances to suppliers(payables) | (x) |
| Credit purchases in the year | x |

**Example 7**

Hiroto makes purchases for his business using both cash and credit transactions. He keeps a record of the payments made to his suppliers, but he does not specify whether they are cash purchases or for the payment of supplier invoices. He does, however, keep all purchase invoices.

Total cash paid to suppliers $122,800. Total purchase invoices $117,300.

| | **1 January 20X9** | **31 December 20X9** |
|---|---|---|
| Balances outstanding to suppliers | $19,500 | ? |

**How much does Hiroto owe his suppliers at 31 December 20X9?**

| DR | | | | | CR |
|---|---|---|---|---|---|
| Date | Narrative | $ | Date | Narrative | $ |
| | Cash paid to suppliers | 122,800 | 1 January 20X9 | Balance b/d | 19,500 |
| | | | | Purchases | 117,300 |
| 31 December 20X9 | Balance c/d | 14,000 | | | |
| | | 136,800 | | | 136,800 |

- Bank Ledger Account

The Bank account can be used to derive cash received from customers, cash paid to suppliers, drawings taken by the owner and money paid for other expenses.

| DR | | Bank and Cash Account | CR |
|---|---|---|---|
| Balance b/d (deposit balance) | X | Balance b/d (overdraft balance) | X |
| Cash from customers | X | Cash to suppliers | X |
| Balance c/d (overdraft balance) | X | Drawings | X |
| | | Other expenses paid | X |
| | | Balance c/d (deposit balance) | X |
| | XX | | XX |

- Markups and margins cost structure

In some situations, we may need to make use of the relationship between sales, cost of goods sold and gross profit to reconstruct the trading account. Gross profit margin and markup are especially useful to calculate any cost of goods stolen or destroyed in a fire.

---**Gross profit margin** is gross profit divided by sales, measured as a percentage.

For example, if gross profit margin is consistently set at 20%, then gross profit is always 20% of sales while cost of goods sold is always 80% of sales.

---**Mark-up** means a suitable percentage is added to cost to arrive at the selling price. Say markup is 10%. If cost of stock is $100, selling price will then be $100 plus 10%, or $110, or a gross profit of $10 (10% of cost price).

**Example 8**

The following information is available for Orset, a sole trader who does not keep full accounting records:

| | | |
|---|---|---|
| Inventory | at 1 July 20X6 | 138,600 |
| at 30 June 20X7 | | 149,100 |
| Purchases for year ended 30 June 20X7 | | 716,100 |

Orset makes a standard gross profit of 30 %percent on sales.

Based on these figures, what is Orset's sales figure for the year ended 30 June 20X7?

**Inventory destroyed, stolen or otherwise lost.**

| | |
|---|---|
| Calculated cost of goods sold based on gross profit margin or mark-up | X |
| Cost of goods sold derived by taking opening inventory | |
| Add Purchase less closing inventory | X |
| Difference = cost of goods stolen or destroyed | X |

**Example 9**

A fire on 30 September destroyed some of a company's inventory and its inventory records. The following information is available:

| | |
|---|---|
| Inventory 1 September | 318,000 |
| Sales for September | 612,000 |
| Purchases for September | 412,000 |
| Inventory in good condition at 30 September | 214,000 |
| Standard gross profit percentage on sales is 25% | |

**Based on this information, what is the value of the inventory lost?**

# Chapter 15 Preparing financial statements

**Learning outcomes**

- Identify and report reserves in a company statement of financial position
- Prepare a statement of financial position or extracts as applicable from given information using accounting treatments as stipulated within sections D, E and examinable documents.
- Prepare a statement of profit or loss and other comprehensive income or extracts as applicable from given information using accounting treatments as stipulated within section D, E and examinable documents.
- Understand how accounting concepts apply to revenue and expenses.
- Disclose items of income and expenditure in the statement of profit or loss

## 1 General-Purpose Financial Statements

✓ General-purpose financial statements are intended to meet the information needs of primary users in making decisions relating to providing resources to the entity.

✓ Financial statements are a structured financial representation of an entity's:
Financial Position
Financial Performance

## 2 Introduction to SPL&OCI

✓ Overall, the statement of profit or loss and other comprehensive income reports the financial performance of an entity in two ways:
Profit or Loss –total income minus expenses
Other Comprehensive Income – income/gains or expenses/losses not recognised in profit or loss but instead recognised in reserves. For example, revaluation surplus
IAS 1 Presentation of Financial Statements states that the statement of profit or loss and other comprehensive income (SPL & OCI) can be prepared either as a single statement or as two separate statements:
single statement of comprehensive income
two statements
A Statement of Profit or Loss
A Statement of Other Comprehensive Income (which begins with profit or loss for the period)

✓ IAS 1 gives the following suggested format for a statement of profit or loss and other comprehensive income.

**A Sole Trader**

A SOLE TRADER

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED XX XX XXXX

| | $ | $ |
|---|---|---|
| Sales | | x |
| Less: Cost of sales | | |
| Opening stock | x | |
| Purchases | x | |
| Less: Closing stock | (x) | |
| | | (x) |
| Gross profit | | x |
| Add: Other income | | x |
| Less: Expenses... | | (x) |
| Net profit | | x |

**A Limited liability Company**

IAS 1 gives the following suggested format for a statement of profit or loss and other comprehensive income.

ABC CO.STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED XX XX XXXX

| | |
|---|---|
| Turnover | X |
| Cost of sales | (x) |
| Gross profit | x |
| Other revenue | x |
| Distribution cost | (x) |
| Administration cost | (x) |
| Other operation expenses | (x) |
| Profit from operating | x |
| Finance cost | (x) |
| Profit beforeTax | |
| Tax | (x) |
| Profit for the year | x |

Other comprehensive income for the year ended

| | |
|---|---|
| Profit for the year | x |
| Other comprehensive income | |
| Gain on property revaluation | x |
| Total comprehensive income for the year | **x** |

## 3. Disclosure Requirements

IAS 1 Presentation of Financial Statements requires certain items to be disclosed on the statement of profit or loss and other comprehensive income. The ones that are examinable in your syllabus are shown below:

- Revenue – The income generated from the ordinary operating activities of an entit
- Finance Costs – The costs incurred from borrowing
- Share of profits and losses of associates
- Tax Expense – The tax on the profits for the year of a company.

Components of other comprehensive income

Other items are specifically required to be disclosed by IAS 1. However, these items can be shown on the SPL&OCI itself or in the notes to the financial statements. They include:

- Write down of Inventory
- Write down and Disposals of property, plant and equipment
- Litigation settlements
- Other reversals of provisions

## 4. Introduction to the Statement of Financial Position

- The "financial position" can be defined as a company's net worth (Assets less liabilities). The statement of financial position is a statement of the book value or carrying amount at a particular date of the entity, presenting its:

Assets (resources controlled)

Liabilities (obligations owed)

owners' Capital or Equity (how to business is financed)

- IAS 1 Presentation of Financial Statements states that the statement of financial position is required to have the following items:

Property, plant and equipment

Intangible assets

Inventories

Trade and other receivables

Cash and cash equivalents

Trade and other payables

Provisions

Current tax liabilities

Share capital and reserves

Like the statement of profit or loss and other comprehensive income, the statement of financial position of a sole trader would be different from that of a limited company. The sole trader's version of the SOFP follows the same principles but has more detail presented and a different capital/equity section.

Sole Trader Statement of Financial Position

| | Cost | Depreciation | Carrying value |
|---|---|---|---|
| | $ | $ | $ |
| Non-current assets | | | |
| Property | X | (X) | X |
| Motor Vehicles | X | (X) | X |
| | X | (X) | X |
| | | | |
| Current assets | | | |
| Inventories | | X | |
| Receivables | X | | |
| Less: allowance for receivables | (X) | | |
| | | X | |
| Prepayments | | X | |
| Cash at bank and in hand | | X | |
| | | | X |
| Total assets | | | X |

| | | |
|---|---|---|
| Capital | | |
| Capital brought forward | X | |
| Profit for the year | X | |
| Less: drawings | (X) | |
| | | X |
| Non-current liabilities | | |
| Bank loan | | X |
| | | |
| Current liabilities | | |
| Payables | X | |
| Other payables | X | |
| Overdraft | X | |
| | | X |
| | | X |

Company Statement of Financial Position

| | $ |
|---|---|
| Non-current assets | |
| Property, plant and equipment | X |

| | |
|---|---|
| Intangibles | X |
| | X |
| Current assets | |
| Inventories | X |
| Trade and other receivables | X |
| Cash and cash equivalents | X |
| Total assets | X |
| Equity | |
| Share capital | X |
| Retained earnings | X |
| Other reserves | X |
| | X |
| Non-current liabilities | X |
| Current liabilities | X |
| Total Equity and Liabilities | X |

# 5 SFP – Disclosures

Purpose of Disclosures

Disclosures in the statement of financial position are essential for the users of financial statements to understand the financial information. The statement of financial position produced for a company includes only the totals, and all the detail is given in the disclosure notes.

The purpose of financial statements is to provide information about a business entity's financial position, financial performance and cash flows.

A full set of disclosures must be completed to do this and meet the qualitative characteristic of understandability.

Disclosures are required for the following items under the statement of financial position:

Property, Plant and Equipment

Intangible Assets

Provisions

Events after the Reporting Period

Inventories

The specific requirements of the items above are explained in their chapters.

Example

The following trial balance has been extracted from the ledger or Mr Yousef, a sole trader. TRIAL BALANCE AS AT 31 MAY 20X6

| | Dr<br>$ | Cr<br>$ |
|---|---|---|
| Sales | | 138,078 |
| Purchases | 82,350 | |
| Carriage | 5,144 | |
| Drawings | 7,800 | |
| Rent and insurance | 6,622 | |
| Postage and stationery | 3,001 | |
| Advertising | 1,330 | |
| Salaries and wages | 26,420 | |
| Irrecoverable debts | 877 | |
| Allowance for receivables | | 130 |
| Receivables | 12,120 | |
| Payables | | 6,471 |
| Cash on hand | 177 | |
| Cash at bank | 1,002 | |
| Inventory as at 1June 20X5 | 11,927 | |
| Equipment at cost | 58,000 | |
| Accumulated depreciation | | 19,000 |
| Capital | | 53,091 |
| | 216,770 | 216,770 |

The following additional information as at 31 May 20X6 is available.
Rent is accrued by $210.
Insurance has been prepaid by $880.
$2,211 of carriage represents carriage inwards on purchases.
Equipment is to be depreciated at 15%
The allowance for receivables is to be increased by $40.
Inventory at the close of business has been valued at $13,551.

Required
Prepare an income statement for the year ended 31 May 20X6 and a statement of financial position as at that date.

# Chapter 16 Statement of Cash Flow

**Learning outcomes**

- Differentiate between profit and cash flow.
- Describe the need for management to control cash flow.
- Explain the benefits and drawbacks to users of the financial statements of a statement of cash flows.
- Classify the effect of transactions on cash flows.
- Calculate the figures needed for the statement of cash flows in accordance with IAS 7 Statement of Cash Flows
- Prepare a statement of cash flows or extracts as applicable.
- Identify the treatment of given transactions in a statement of cash flows.

## 1 The need for cash flow statement

The purpose of a cash flow statement is to show the effect of a company's transactions on its cash balance. It has often been thought that the cash flow statement is more easily understood than the Statement of profit or loss and other comprehensive income and statement of financial position.

The cash flow statement is also less susceptible to manipulation because cash receipts and payments can be determined objectively, whereas using accounting policies the Statement of profit or loss and other comprehensive income and statement of financial position can be adjusted to show the results required.

The cash flow statement can highlight trading cash flows and major cash inflows and outflows during the year.

## 2 Definition

IAS 7 Cash Flow Statements defines the following:
**Cash** represents cash on hand and in the bank.
**Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
Cash flows are inflows and outflows of cash and cash equivalents.
**Operating activities** are the principle revenue –providing activities of the enterprise 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 borrowing of the enterprise.

Reporting cash flows from operating activities

# 3 IAS 7 allows two methods of reporting cash flows from operating activities:

✓ **The DIRECT method**

Whereby major classes of gross cash receipts and gross cash payments are disclosed (preferred method per IAS 7, para.18)

Direct method format

Statement of Cash Flows for the year ended x/x/x

| | $ | $ |
|---|---|---|
| Cash flow from operating activities | | |
| Cash receipts from customers | X | |
| Cash paid to suppliers and employees | (X) | |
| Cash generated from operations | X | |
| interest paid | (X) | |
| income tax paid | (X) | |
| Net cash flow from operating activities | | X |

# 4 Formula to learn

➢ Cash receipts from customers

The total cash receipts from customers = Opening trade receivables + Sales – Closing trade receivables

➢ Cash paid to suppliers

The total cash paid to suppliers = Opening trade payables + Purchases – Closing trade payables

➢ Cash paid to employees

The total cash paid to employees = Amount owed to employees at the start of the period + Wages and salaries expenses − Amount owed to employees at the end of the period

➢ Interest paid

The total interest paid = Opening interest payable + Interest charge − Closing interest payables

- Tax paid

The total tax paid = Opening tax payables + Tax charge − Closing tax payables

Other part is same as indirect format

The INDIRECT method

Whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any accruals or prepayments of operating expenses, and items relating to investing or financing cash flows.

IAS 7 (Revised) encourages enterprises to report cash flows from operation activities using the direct method. It is believed that the direct method will provide more useful information about an entity's cash flows, but it may not be practical or cost effective in many circumstances.

When the indirect method is adopted, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

- Non-cash items such as depreciation.
- All other items for which the cash effects are investing or financing cash flows
- Changes during the period in inventories and operating receivables and payables.

Indirect method format

Statement of Cash Flows for the year ended x/x/x

| | $ | $ |
|---|---|---|
| Cash flow from operating activities | | |
| Profit before taxation | X | |
| Adjustment for | | |
| Depreciation charge | X | |
| Loss/profit on disposal on non-current assets | X/(X) | |
| Finance cost | X | |
| Investment income | ( X) | |
| Net profit before working capital changes | X | |
| (increase)/decrease in inventory | (X)/X | |
| (increase)/decrease in trade receivable | (X)/X | |
| Increase/(decrease) in trade payable | X/(X) | |
| Cash generated from operations | X | |
| Finance cost paid | (X) | |
| Income tax paid | (X) | |
| Net cash flow from operating activities | | X |

Cash flow from investing activities

| | | |
|---|---|---|
| Purchase of property, plant and equipment | (X) | |
| Proceeds from sale of equipment | X | |
| Interest received / investment income received | X | |
| Dividends received | X | |
| Net cash used in investing activities | | (X) |

Cash flow from financing activities

| | | |
|---|---|---|
| Proceeds from issuance of share capital | X | |
| Dividends paid * | (X) | |
| Net cash flow from financing activities | | X |
| Net increase/(decrease) in cash & cash equivalents Cash & | | X/(X) |
| cash equivalents at beginning of period | | X/(X) |
| Cash & cash equivalents at end of period | | X/(X) |

Note: * This could also be shown as an operating cash flow.

Proceeds from long-term borrowings/repayment of loan X/(X)

| | Reference to notes | 20x6 | 20x7 |
|---|---|---|---|
| NCA (net book value) | 1,2,3 | 1,000,000 | 1,800,000 |
| Current assets | | | |
| Inventories | | 600,000 | 1,600,000 |
| Receivables | | 1,270,000 | 1,800,000 |
| Cash | | 140,000 | 0 |
| Capital and reserves | | | |
| Ordinary share | 4 | 500,000 | 600,00 |
| Share premium | 4 | 420,000 | 820,000 |
| Revaluation surplus | 5 | | 300,000 |
| Retained earning | | 920,000 | 1,080,000 |
| Current liabilities | | | |
| Bank overdraft | | | 260,000 |
| Income tax | | 120,000 | 40,000 |
| Trade payable | | 1,050,000 | 2,100,00 |

| SPL | | 31 October |
|---|---|---|
| | 20X6 | 20X7 |
| | $ | $ |
| Sales (all on credit) | 8,400,000 | 9,000,000 |
| Cost of sales | (6,300,000) | (7,200,000) |
| **Gross profit** | 2,100,000 | 1,800,000 |
| Operating expenses | (1,500,000) | (1,600,000) |
| **Profit before tax** | 600,000 | 200,000 |
| Income tax | (120,000) | (40,000) |
| **Profit for the year** | 480,000 | 160,000 |

Notes:

1.On 1 Nov. 20X6 office equipment that had cost $240,000, with a net book value of $80,000, was sold for $30,000

2.The purchase of new non-current assets took place near the end of the year.

3.The depreciation charge for the year ended 31 October 20X7 was $120,000

4.The ordinary share issue was 31 October 20X7.

5.Some of the non-current assets were revalued upwards by $300,000 on 31 Oct 20X7.

Required: Prepare statement of cash flow for the year ended 31 Oct 20X7, using indirect format in IAS 7.

# Chapter 17 Consolidated Financial statements

**Learning outcomes**

- Define and describe the following terms in the context of group accounting
- Identify subsidiaries within a group structure.
- Describe the components of and prepare a consolidated statement of financial position or extracts thereof
- Calculate goodwill (excluding impairment of goodwill) where non-controlling interest is valued at its fair value at the acquisition date as follows
- Describe the components of and prepare a consolidated statement of profit or loss or extracts thereof
- Define and identify an associate and significant influence and identify the situations where significant influence exists.
- Describe the key features of a parent-associate relationship and be able to identify an associate within a group structure.
- Describe the principle of the equity method of accounting for associate entities.

## 1 The nature of business combinations

What is a "group"?
Every entity is a separate legal entity. Each one is required to prepare its own financial statements that will provide useful information for making economic decisions. However, sometimes a number of entities (known as subsidiaries) will operate under the control of another entity (known as the parent). Together they form a group, and the group operates as a single economic entity.

## 2 Definitions

--- A parent is an entity that controls one or more other entities.
--- A subsidiary is an entity controlled by another entity.
--- A group contains a parent and all its subsidiary
--- Non-controlling interest (NCI)is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

## 3 Subsidiary

IAS 27 states that control can usually be assumed to exist when the parent owns more than half (i.e. over 50%) of the voting power of an entity unless it can be clearly shown that such ownership does not constitute control (these situation will be very rare).

IAS 27 lists the following situations where control exists, even when the parent owns only 50% or less of the voting power of an entity.
The parent has power over more than 50% of the voting rights by virtue of agreement with other investors.
The parent has power to govern the financial and operating policies of the entity by statute or under an agreement.
The parent has the power to appoint or remove a majority of members of the board of directors (or equivalent governing body).
The parent has power to cast a majority of votes at meetings of the board of directors.

# 4 Associate

An entity over which another entity exerts significant influence.
IAS 28 states that if an investor holds 20% or more of the voting power of the entity, it can be presumed that the investor has significant influence over the entity, unless it can be clearly shown that this is not the case.
Significant influence can be presumed not to exist if the investor holds less than 20% of the voting power of the entity, unless it can be demonstrated otherwise.
The existence of significant influence is usually evidenced in one or more of the following ways:
(a)Representation on the board of directors (or equivalent) of the investee.
(b)Participation in the policy making process.
(c)Material transactions between investor and investee.
(d)Interchange of management personnel.
(e)Provision of essential technical information.

**Example 1**
Which of the following statements is/are incorrect?
(1)A owns 25% of the ordinary share capital of B, which means that B is an associate of A
(2)C can appoint 4 out of 6 directors to the board of D, which means that C has control over D
(3)E has the power to govern the financial and operating policies of F, which means that F is an associate of E
(4)G owns 19% of the share capital of H, but by agreement with the majority shareholder, has control over the financial and operating policies of H, so H is an associate of G
A 1 and 2 only
B 1 ,2 and 3 only

C 3 and 4 only

D 4 only

# 5 Equity method

IAS 28 requires the use of the equity method of accounting (or 'equity accounting') for investments in associates.

The basic principle of equity accounting is that parent should take account of its share of the earnings of the associate, whether or not associate distributes the earnings as dividends. Parent achieves this by adding to consolidated profit the group's share of associate's profit after tax.

The parent company should also include its shares of the associate's other comprehensive income in the other comprehensive income section of its consolidated Statement of profit or loss and other comprehensive income.

A figure for investment in associates is shown in the consolidated statement of financial
position which at the time of the acquisition of the associate must be stated at cost. This amount will increase (or decrease) each year by the amount of the group's share of the associated company's increase (or decrease) in post- acquisition retained reserves.

**Example 2**

P Co., acquires 30,000 of the 100,000 $1 ordinary shares in A Co. for $60,000 on 1 January 20X6. In the year to 31 December 20X6, A Co. earns profits after tax of $24,000 from which it pays a dividend of
$6,000.

How will A Co.'s results be accounted for in the individual and consolidated accounts of P Co. for the year ended 31 December 20X6?

**Solution**

In the individual accounts of P Co., the investment will be recorded on 1 January 20X6 at cost. Unless there is impairment in the value of the investment, this amount will remain in the individual statement of financial position of P Co. permanently.

The only entry in P Co.'s individual statement of profit or loss will be recorded dividends received.

For the year ended 31 December 20X6.

P Co. will

| | | |
|---|---|---|
| Dr | Cash | $1,800 |
| Cr | Dividend income (6,000*30%) | $1,800 |

In the consolidated accounts of P Co. equity accounting principles will be used to account for the investment in A Co.

Instead of showing the dividend received, the consolidated statement of profit or loss will include the group's share of A Co.'s profit after tax for the year

(30%*$24,000=$7,200), which is shown before group profit before tax.

| | |
|---|---|
| Cost of investment in associate | $60,000 |
| Share of A's profit for the year | $ 7,200 |
| Less dividend received | ($1,800) |
| Investment in associate | $65,700 |

Equity accounting is only applied in the consolidated accounts. A company only has to prepare consolidated accounts if it has one or more subsidiaries. If a company has no subsidiaries, then it is not required to prepare consolidated accounts and so any investment in associates will be treated as a simple investment in the parent company's individual accounts.

# 6 Trade investment

An investment in the shares of another entity is held, and is not an associate or a subsidiary. for the accretion of wealth.
Trade investments are simply shown as investments under non-current assets in the consolidated statement of financial position

Example 3
Clementine has owned 21% of the ordinary shares of Tangerine for several years.
Clementine does not have any investments in any other companies.
How should the investment in Tangerine be reflected in the financial statements of Clementine?
A.The revenues and costs and assets and liabilities of Tangerine are added to the revenues and costs and assets and liabilities of Clementine on a line by line basis.
B.An amount is shown in the statement of financial position for 'investment in associate' being the original cost paid for the investment plus Clementine's share of the profit after tax of Tangerine. 21% of the profit after tax of Tangerine should be added to C. Clementine's profit after tax in the statement of profit or loss each year.
C.An amount is shown in the statement of financial position under 'investments' being the original cost paid for the investment, this amount does not change. Dividends received from Tangerine are recognized in the statement of profit or loss of Clementine.
D.An amount is shown in the statement of financial position under "investments" being the original cost paid for the investment, this amount does not change. 21% of the profit after tax of Tangerine should be added to Clementine's profit after tax in the statement of profit or loss each year.

# 7 Basic principle of consolidated financial statement

Consolidation means adding together.

Consolidation means cancellation of like items internal to the group.

Consolidate as if the parent owned everything then show the extent to which the parent does not own everything

# 8 Basic format for consolidated statement of financial position

| | H | S | Group |
|---|---|---|---|
| **ASSET** | | | |
| Non-current assets | X | X | X |
| Cost of investment | X | | |
| Goodwill | | | X |
| Current assets | X | X | X |
| | X | X | X |
| | | | |
| **EQUITY & LIABILITY** | | | |
| Share capital | X | X | X |
| Reserve | X | X | X |
| NCI (if not 100% subsidiary) | | | X |
| | | | X |
| Non-Current liability | X | X | X |
| Current liability | X | X | X |
| | X | X | X |

### 8.1 Group structure

**P - S 80% at the date of acquisition**

### 8.2 Goodwill

The company may have acquired shares in the subsidiary at a price greater than their fair value. This raises the issue of goodwill.

Goodwill arising on consolidation is recognized as an intangible asset in the consolidated statement of financial position.

- **Full goodwill method**

| | |
|---|---|
| Cost of investment | X |
| Fair value of NCI at DOA | X |
| Less: Fair value of net asset of S at DOA( working) | (X) |
| Goodwill at DOA | X |

➢ **Fair value of net asset of S at DOA**

| | At date of acquisition |
|---|---|
| Share capital | X |
| Share premium | X |
| Retain earning | X |
| Fair value adjustment | X |
| Total | X |

➢ Fair value of net assets at acquisition

The land and buildings of the subsidiary may be worth more than their carrying amount at acquisition.

(a)The subsidiary's land and buildings must be included in the consolidated statement of financial position at their fair value.

(b)The difference between the fair value of the subsidiary's land and buildings and the carrying value of those land and buildings must be taken into account in the goodwill calculation.

➢ Acquisition part way through the year

When a parent acquires a subsidiary part way through the year, the profits for the period need to be apportioned between pre-acquisition and post-acquisition.

Profit earned before acquisition - to calculate goodwill

DOA retain earning = 期初的 retained earning + n/12 profit

➢ Profit earned after acquisition - to calculate group retained earnings

To do this, we usually assume that the subsidiary's profit accrues evenly over the year. Then we can take the profit for the year and calculate the pre- and post-acquisition profits based on the number of months the parent has owned the subsidiary.

Example 4

Fanta acquired 100% of the ordinary share capital of Tizer on 1 October 20X7.

On 31 December 20X7 the share capital and retained earnings of

Tizer were as follows:

| | |
|---|---|
| | $000 |
| Ordinary shares of $1 each | 400 |
| Retained earnings at 1 January 20X7 | 100 |
| Retained profit for the year ended 31 December 20X7 | 80 |
| | 580 |

The profits of Tizer have accrued evenly throughout 20X7. Goodwill arising on the acquisition of Tizer was $30,000.

**What was the cost of the investment in Tizer?**

- Acquisition by shares

The parent could pay cash for the subsidiary, as we have assumed so far. However, the parent could pay a combination of cash as well as shares in itself, or perhaps just shares in itself to acquire the subsidiary. The fair value of share is their market price on the date of acquisition.

Example 5

P Co. has acquired all the share capital of S Co. (12 000 $1 shares) by issuing 5 of its own $1 share for every 4 shares in S Co. The market value of P Co.'s shares was $6 at the date of acquisition. The fair value of the net assets of S Co. at the date of acquisition was $75,000.

Example 6

Tempo Co. acquired 100% of the equity shares capital of Lento Co. This consisted of40,000 shares of
$0.50 each. It paid for the acquisition by issuing 60,000 new shares of $1 each in Tempo Co, and exchanging three new shares in Tempo Co. for every 2 shares in Lento Co. . The market value of Tempo Co. shares at the time of the acquisition was $3.50 per share. The fair value of the net assets acquired in Lento Co. was $50,000.

What was the goodwill arising on the acquisition of the shares in Lento Co. by Tempo Co.?

| |
|---|
| |

**8.3 Unrealized profit (URP)**

- ✓ Inventory should be valued at cost to the group. And only the recognized profit earned by the group should be included in retained earnings.
- ✓ 当母公司卖东西给子公司，形成 URP of P = unsold part * profit
  Dr group retain earning   cr closing inventory
- ✓ 当子公司卖东西给母公司，形成 URP of S = unsold part * profit
  Dr S retain earning   cr closing inventory

**8.4 Intra-group trading**

When one company in a group engages in trading with another group company.
Any receivables and payables balances outstanding between the companies are cancelled on consolidation.
Dr trade payable   Cr trade receivable

**8.5 Non-controlling interest**

The parent may not have acquired all the shares of the subsidiary. This raises the issue of non-controlling interest.
Non-controlling interest shows the extent to which net assets controlled by the group are owned by other parties.
NCI is shown in the equity section of the consolidated statement of financial position and is included in the financial statements at its fair value plus the NCI's share of post-acquisition related earnings.

**NCI at DOC**

$

| | |
|---|---|
| FV of NCI at date of acquisition | X |
| NCI's share of S' post -acquisition retained earning | X |
| Total Non-controlling interest | X |

**8.6 Group Retained earnings**

Any pre-acquisition retained earnings of a subsidiary company are not aggregated with the parent company's retained earnings in the consolidated statement of financial position.

The figure of consolidated retained earnings comprises the retained earnings of the parent company plus the post-acquisition retained earnings only of subsidiary companies.

Other reserves are treated in the same way as retained earnings.

Group's retained earning

| | $ |
|---|---|
| P's retained earning | X |
| Less: URP from goods sold by P to S | (X) |
| Add：group share of S's post-acquisition reserve | X |
| | X |

The following information is relevant for question example 7-9

On 1 January 20X5 Alpha purchased 80,000 ordinary shares in Beta for $180,000. At that date Beta's retained profits amounted to $90,000 and the fair values of Beta's assets at acquisition were equal to their book values. The fair values of NCI at acquisition were $38,000.

Three years later, on 31 December 20X7, the SOFP of the two companies were:

| | Alpha | Beta |
|---|---|---|
| | $ | $ |
| Sundry net assets | 230,000 | 260,000 |
| Shares in Beta | 180,000 | -- |
| | 410,000 | 2 60,000 |
| Share capital | | |
| Ordinary shares of $1 each | 200,000 | 100,000 |
| Accumulated profits | 210,000 | 1 60,000 |
| | 410,000 | 260,000 |

The share capital of Beta has remained unchanged since 1 January 20X5.

The impairment review of the goodwill at the yearend reveals no impairment loss.

Example 7

What amount should appear in the group's consolidated statement of financial position at 31 December 20X7 for goodwill?

Example 8

What amount should appear in the group's consolidated statement of financial position at 31December 20X7 for non-controlling interest?

Example 9

What amount should appear in the group's consolidated statement of financial position at 31 December 20X7 for accumulated profits?

简化版合并资产负债表

| | P | S | Group |
|---|---|---|---|
| Non current asset | X | X | P+S + FV adjustment |
| Goodwill | | | Working |
| Current asset | | | |
| Inventory | X | X | P+S-URP |
| Trade receivable | X | X | P+S-Intra group trading |
| Cash | X | X | P+S |
| Equity | | | |
| Share capital | X | X | Only parent |
| Share premium | X | X | Only parent |
| Retained earning | X | X | working |
| NCI | | | Working |
| Long term debt | X | X | P+S |
| Trade payable | X | X | P+S-Intra group trading |

**9 Basic format for consolidated statement of profit or loss and other comprehensive income.**

NSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR END

| | $ | $ |
|---|---|---|
| Revenue (P+S – **All inter-group transaction**) | | X |
| Cost of sale (P+S – **All inter-group transaction**) | X | |
| Add: Unrealised profit (P to S) and (S to P) | X | |
| | | (X) |
| Gross profit | | X |
| Less: distribution cost (P+S) | | (X) |
| Less: administrative expense (P+S) | | (X) |
| Operating profit | | X |
| Investment income (external only) | | X |
| Finance cost (P+S) | | (X) |
| Income from associate | | |
| G% of A's PAT | | X |
| Less: tax charge (P+S) | | (X) |
| **Group profit for the year** | **X** | |
| **Attributable to:** | | |
| Equity holders of the Parent | | X |
| NCI | | X |
| | | X |

- intra-group trading

When one company in a group sells goods to another an identical amount is added to the sales revenue of the first company and to the cost of sales of the second. As far as the entity's dealing with outsiders are concerned, no sale has taken place. An adjustment is therefore necessary to reduce the sales revenue and cost of sales figure by the value of intra-group sales during the year.

Dr Sale
Cr cost of sale

➢ URP

Whenever goods sold at a profit within the group remain in the inventory of the purchasing company at the year end, the unrealized profit on unsold inventory should be excluded from the closing inventory.

Dr cost of good
Cr inventory

➢ Acquisitions part way through the year

If the subsidiary is acquired part way through the accounting year, it is necessary to split the profits earned between those earned pre-acquisition and those earned post-acquisition.

Only the post-acquisition figures are included in the consolidated statement of profit or loss.

**Example 10**

On 1 April 20X7 Possum acquired 60% of the share capital of Koala for \$120,000. During the year Possum sold goods to Koala for \$30,000, including a profit margin of 25%. 40% of these goods were still in inventory at the year end.
The following extract was taken from the financial statements of Possum and Koala at 31 March 20X8.

| | Possum | Koala |
|---|---|---|
| | \$000 | \$000 |
| Revenue | 750 | 400 |
| Cost of sales | (420) | (100) |
| Gross profit | 330 | 300 |

**What is the consolidated gross profit of the Possum group at 31 March 20X8?**

**Example 11**

The following are the financial statements relating to Black, a limited liability company, and its subsidiary company Bury.

**STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 OCTOBER 20X7**

| | Black | Bury |
|---|---|---|
| | $000 | $000 |
| Sales revenue | 245,000 | 95,000 |
| Cost of sales | (140,000) | (52,000) |
| Gross profit | 105,000 | 43,000 |
| Distribution costs | (12,000) | (10,000) |
| Administrative expenses | (55,000) | (13,000) |
| Dividend income from Bury | 7,000 | - |
| Profit before tax | 45,000 | 20,000 |
| Tax | (13,250) | (5,000) |
| Profit for the year | 31,750 | 15,000 |

**STATEMENT OF FINANCIAL POSITION AS AT 31 OCTOBER 20X7**

Assets

Non-current assets

| | Black | | Bury | |
|---|---|---|---|---|
| | $000 | $000 | $000 | $000 |
| Property, plant and equipment | 110,000 | | 40,000 | |
| Investments | | | | |
| (21,000,000 $1 ordinary shares | 24,000 | | - | |
| in Bury at cost) | | | | |
| | | 134,000 | | 40,000 |
| Current assets | | | | |
| Inventory, at cost | 13,360 | | 3,890 | |
| Trade and dividend receivables | 14,640 | | 6,280 | |
| Bank | 3,500 | | 2,570 | |
| | | 31,500 | | 12,740 |
| Total assets | | 165,500 | | 52,740 |
| Equity and liabilities | | | | |
| Equity | | | | |
| $1 Ordinary shares | 100,000 | | 30,000 | |
| Retained earnings | 36,500 | | 10,280 | |
| | | 136,500 | | 40,280 |
| Current liabilities | | | | |
| Payables | 9,000 | | 2,460 | |
| Dividend | 20,000 | | 10,000 | |
| | | 29,000 | | 12,460 |
| Total equity and liabilities | | 165,500 | | 52,740 |
| | | | | |
| Additional information | | | | |

(a)Black purchased its $1 ordinary shares in Bury on 1 November 20X2. At that date the balance on Bury's retained earnings was $2 million. The fair value of the non-controlling interest at the date of acquisition was $8,800,000.
(b)During the year ended 31 October 20X7 Black sold goods which originally cost $12 million to Bury. Black invoiced Bury at cost plus 40%. Bury still has 30% of these goods in inventory at 31 October 20X7.
(c)Bury owed Black $1.5 million at 31 October 20X7 for some of the goods Black supplied during the year.

# Chapter 18 Interpretation of Financial Statement

**Learning outcomes**

- Describe how the interpretation and analysis of financial statements is used in a business environment.
- Explain the purpose of interpretation of ratios.
- Explain the interrelationships between ratios.
- Analysis of financial statement
- Calculate and interpret the relationship between the elements of the financial statements with regard to profitability, liquidity, efficient use of resources and financial position.

## 1 Profitability

➢ Return on capital employed (ROCE)

It is impossible to assess profits or profit growth properly without relating them to the amount of funds (capital) that were employed in making the profits.

The most important profitability ratio is therefore return on capital employed, which states the profit as a percentage of the amount of capital employed.

ROCE measures the overall efficiency of a company in employing the resources available to it.

$$\text{ROCE} = \frac{\text{Profit before interest and tax}}{\text{Capital Employed(Total Assets - Current Liabilities)}} \times 100$$

$$\text{ROCE} = \frac{\text{Profit before interest and tax}}{\text{Share Capital} + \text{Reserves} + \text{Long-term Liabilities}} \times 100$$

Capital employed= Shareholders’ equity plus long-term liabilities (or total assets less current liabilities)

➢ **Return on equity (ROE)**

ROE gives an indication of the return to shareholders.

$$\text{ROE} = \frac{\text{Profit after interest and tax}}{\text{Ordinary share capital} + \text{reserves}}$$

- **Asset turnover**

Asset turnover is a measure of how well the asset of a business are being used to generate

$$\text{Asset turnover} = \frac{\text{Revenue (net of discount)}}{\text{Capital employed}}$$

- Net profit margin

$$\text{Net profit \%} = \frac{\text{Net profit}}{\text{Revenue}} \times 100\%$$

# 2 Introduction to Liquidity Ratios

Short-term liquidity ratios concern financial stability. If they indicate that an entity cannot meet short-term liabilities from available assets, there will be going concern implications. The two most common measures are the current ratio and the quick ratio.

- Current ratio

The current ratio measures the adequacy of current assets to meet short-term liabilities (without raising additional finance). This ratio is an overall measure of liquidity and the state of trading.

$$\text{Current ratio} = \frac{\text{Current assets (at period end)}}{\text{Current liabilities (at period end)}}$$

- Quick ratio / Acid test ratio

The quick test (or acid test) ratio measures immediate liquidity by eliminating from current assets the least liquid assets (inventories). This reflects the possibility that the company finds it challenging to convert inventory into cash compared to other current assets.

$$\text{Quick ratio} = \frac{\text{Current assets - inventory (at period end)}}{\text{Current liabilities (at period end)}}$$

➢ Window Dressing

Window dressing is a particular type of creative accounting which is used to present financial statements in a more favourable light to gain benefits such as:

obtain funding/borrow money

reduce tax payments

smooth profits

hide liquidity/profitability problems that might reflect poor management decisions.

# 3 Efficiency Ratios

he efficiency ratios analyse how well a company manages its assets and liabilities internally.

The efficiency ratios calculate inventory turnover (inventory holding period), account receivables (receivables collection period) and account payables (payables payment period) days.

➢ Inventory Turnover

Inventory turnover measures the average time a company holds unsold goods. The ratio measures operational and marketing efficiency.

$$\text{Inventory turnover} = \frac{\text{Inventories}}{\text{Cost of sales}} \times 365 \text{ (days in period)}$$

A high inventory turnover ratio generally indicates efficiency in selling goods quickly. If declining, inventories are turning over less quickly.

**Negative reasons may be:**

fall in demand for goods

poor inventory control (storage and insurance cost increases)

over-investment in inventory exceeding immediate requirements

carrying obsolete inventory (possibly resulting in write-offs)

**Positive reasons may be:**

bulk buying to take advantage of trade (bulk) discounts

increasing inventory levels to avoid stockouts (For example, due to erratic demand or where supply is unreliable).

➢ Accounts Receivable Days

Accounts receivable days show the average time it takes to receive payment from credit customers (the number of calendar days over which receivables are uncollected).

$$\text{Accounts Receivable Days} = \frac{\text{Closing Trade Receivables}}{\text{Credit Sales}} \times 365$$

➢ Accounts Payable Days

Accounts payable days represent (average) the time (i.e. number of days) it takes to pay for supplies received on credit.

$$\text{Accounts Payable Days} = \frac{\text{Closing Trade Payables}}{\text{Cost of Sales}} \times 365$$

Operating (Working Capital) Cycle

The working capital cycle shows the amount of time (in days) that an entity takes to convert resource inputs (inventory) to cash receipts. It is the period from when cash is spent on purchases to when money is collected from customers.

➢ The working capital cycle is derived from the previous three figures for a trading company:

Working capital cycle = Inventory days + Account receivable days − Account payable days

For a manufacturing business, inventory days include the average time raw materials are held and the time taken to produce goods.

Working capital is the difference between current assets and current liabilities. If the cycle is increasing, it may be due to the following:

Poor working capital control

a deliberate policy to build up finished goods inventory or attract more customers by giving a more extended credit period.

# 4 Introduction to Position Ratios

Position ratios focus on how a company is financed. They indicate whether its current financing mix will likely cause problems over the longer term. The two main position ratios are the debt/gearing ratio and interest cover.

➢ Gearing Ratio (Leverage)

The gearing ratio measures the proportion of borrowed funds (which earn a fixed return) to equity capital (shareholders' funds) or total capital. This ratio provides information about the financial risk of a company.

Borrowings incur commitments to pay future interest and capital repayments, which can be a financial burden and increase the risk of insolvency.

$$\text{Gearing Ratio} = \frac{\text{Long - term debt}}{\text{Capital Employed}} \times 100\%$$

$$\text{Gearing Ratio} = \frac{\text{Long - term debt}}{\text{Equity}} \times 100\%$$

- Interest cover

It measures the ability to pay interest on outstanding debt from profits generated during the period. It is an indicator of the protection available to loan providers and is often used by lenders when making loan approval decisions.

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

Overtrading

# 5 Overtrading

Overtrading arises when trade increases rapidly without securing additional long-term capital (it is under-capitalised). Symptoms include:

fast sales growth

inventories, receivables, and payables increasing

cash and cash equivalents decreasing