Chapter -1 Introduction to Accounting

1 The purpose of financial reporting

Financial reporting is a way of recording, analyzing, and summarizing financial data.

2 Types of Business Entity

2.1 What is a business?

Business of whatever size or nature exist to make a profit.

- Commercial or industrial concern
- Organization which use economic resources to create goods or services
- Organization providing jobs for people
- Money in resources

Profit is the excess of income over expenditure. When expenditure exceeds revenue, the business is running at a loss.

2.2 Types of business entity

Three Main Type of Business
Entity ○ Sole traders

- Limited liability companies
- Partnerships

In Law, sole traders and partnerships are not separate entities from their owners. Limited Liability Company is **legally a separate entity** from its owners. For accounting purposes, all three entities are treated as **separate** business.

2.3 Sole Traders

Sole traders are people who work for themselves.

In law, a sole trader is not legally separate from the business they operate. The owner is legally responsible for the business.

Advantages of being sole trader

This type of structure is ideal if the business is not complicated, and especially if it does not require a great deal of outside capital. Advantages include.

a) Limited paperwork and therefore cost in establishing this type of structure
b) Owner has complete control over the business
c) Owner is entitled to profits and the ownership of assets
d) Less stringent reporting obligations compared with other business structures–no requirement to make financial accounts publicly available, no audit requirement. **e)** Can be highly flexible

Disadvantages of being a sole trader

- **a)** Owner is personally liable for all debts (unlimited liability)
- **b)** Personal property may be vulnerable for debts and other business liabilities
- **c)** Large sums of capital are less likely to be available to a sole trader, leading to reliance on overdrafts and personal savings
- **d)** May lead to long working hours without the normal employee recreation leave and other benefits
- **e)** May be issues of continuity of business in the event of death or illness of the owner

2.4 Partnerships

Partnerships occur when two or more people decide to run a business together.

Advantages of Partnerships

- **a)** Less stringent reporting obligations – no requirement to make financial accounts publicly available, no audit requirement, unless the partnership has LLP status
- **b)** Additional capital can be raised because more people are investing tin the business
- **c)** Division of roles and responsibilities and an increased skill set
- **d)** Sharing of risk and losses between more people
- **e)** No company tax on the business (profits are distributed to partners and then subject to personal tax.

Disadvantages of Partnerships

- **a)** Partners are jointly personally liable for all debts (unlimited liability) unless they have formed an LLP
- **b)** There are costs associated with setting up partnership agreements
- **c)** There may be issues of continuity of business in the event of death or illness of the partners
- **d)** Slower decision making due to the need for consensus between partners
- **e)** Unless a clause is written into the original agreement, when one partner leaves, the partnership is automatically dissolved, and another agreement is required between existing partners

2.5 Limited Liability Companies

Limited liability companies are incorporated to take advantage of '**limited liability**' for their owners (shareholders). The shareholders of a limited liability company are only responsible for the amount paid for their shares.

Shareholders may be individual or other companies.

There is a clear distinction between shareholders and directors of limited companies.

- **a)** Shareholders are the owners but have limited rights as shareholders over the day to day running of the company. They provide capital and receive a return (dividend).
- **b)** The board of directors are appointed to run the company on behalf of shareholders. In practice, they have a great deal of autonomy. Directors are often shareholders. The reporting requirements for limited liability companies are much

more stringent than for sole traders or partnerships. In the UK, there is a legal requirement for a company to:

- Be registered at company House.
- Complete a Memorandum of Association and Articles of Association to be deposited with the Registrar of Companies
- Have at least one director (two for a public limited company (PLC) who may also be a shareholder.
- Prepare financial accounts for submission to Companies House
- Have its financial accounts audited (larger companies only); and
- Distribute the financial accounts to all shareholders.

Advantages of trading as a limited liability company a) Limited liability make investment less risky

b) Limited liability makes raising finance easier

c) A limited liability company have a separate legal identity

d) There are tax advantages

e) It is relatively easy to transfer shares

Disadvantages of trading as a limited liability company

a) To publish annual financial statements

b) To comply with legal and accounting requirements

c) The financial statements of larger limited liability companies have to be audited

d) Share issues are regulated by law

3 Nature, principles and scope of financial reporting

3.1 Financial accounting

Mainly a method of reporting the financial performance and financial position of a business. Their principal function is to satisfy the information needs of persons They provide historical information.

3.2 Management accounting

The information needs of management go far beyond those of other account users. Managers have the responsibility of planning and controlling the resources of the business. Therefore they need much more detailed information. They also need the plan for the future.

Management (or cost) accounting is a management information system which analyses data to provide information as a basis for managerial action.

4 User and stakeholders need

4.1 The need for financial statements

There are various groups of people who need information about the activities of a business.

The international Accounting Standard, IAS 1 presentation of Financial Statements states; The objective and financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

4.2 Users of financial statements and accounting information

The following people are likely to be interested in financial information about a large company with shares that are listed on a stock exchange.

a) Managers of the company
b) Shareholders of the company
c) Trade contacts, Suppliers, Customers
d) Providers of finance to the company
e) The taxation authorities
f) Employees of the company
g) Financial analysts and advisers
h) Government and their agencies
i) The public

QUESTION (1)

Which of the following is most useful for managers? A. Financial statements for the last financial year

B. Tax records for the past five years
C. Budgets for the coming financial year
D. Bank statements for the past year

5 Governance

Corporate governance is the system by which companies and other entities are directed and controlled. The board of directors of a company are usually the top management and are those who are **charged with governance** of the company.

5.1 Legal responsibilities of directors

Directors have a duty of care to show **reasonable competence** and may have to indemnify the **company** against loss cause by their negligence. Directors are also said to be in a **fiduciary position** in relation to the company, which means that they must act honestly in what they consider to be the best interest of the company and in good faith.

In the UK, the companies Act 2016 sets out seven statutory duties of directors. Directors should.

- Act within their powers.
- Promote the success of the company
- Exercise independent judgments
- Exercise reasonable skill, care and diligence
- Avoid conflicts of interest
- Not accept benefits from third parties and
- Declare interest in a proposed transaction or arrangement When exercising this duty directors should consider:
- The consequence of decisions in the long term
- The interests of the employees
- The need to develop good relationships with customers and suppliers
- The impact of the company on the local community and the environment
- The desirability of maintaining high standard of business conduct and a good reputation ▪ The need to act fairly between all members of the company

5.2 Responsibility for the financial statements

Directors are **responsible for the preparation of the financial statements** of the company. Specifically, directors are responsible for

- The preparation of the financial statements of the company in accordance with the applicable financial reporting framework (e.g., IFRSs)
- The internal controls necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud
- The prevention and detection or fraud

It is the directors' responsibility to ensure that the entity **complies with the relevant laws and regulations.**

6 The main elements of financial reports

The principal financial statements of a business are the statement of financial position and the statement of profit or loss

6.1 Statement of financial position

The statement of financial position is simply a **list** of all the **assets owned and all the liabilities owed by a business** as at a particular date.

6.1.1 Assets

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

6.1.2 Liabilities

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

QUESTION (2)
Which of the following is an asset according to the definition in the conceptual framework?

A. Bank overdraft
B. Factory buildings
C. Payables
D. Amounts owed to tax authorities

6.1.3 Capital and equity
Equity is the residual interest in the assets of the entity after deducting all its liabilities.

6.2 Statement of profit or loss
A statement of profit or loss is a **record of income generated and expenditure incurred** over a given period. The statement shows whether the business has had more revenue than expenditure (a profit) or vice versa (loss).

6.2.1 Revenue and expenses
Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.
Grains represent other items that meet the definition of income and may or may not, arise during the ordinary activities of an entity.
Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

6.3 Purpose of financial statements
Both the statement of financial position and the statement of profit or loss are summaries of accumulated data.

QUESTION (3)
The financial statements of a limited liability company will consist solely of the statement of financial position and statement of profit or loss.
Is this statement true or false?

A. True
B. False

Test Your Understanding (1)

Which group of people are most likely to be interested in the financial statement of a sole trader?

1- Shareholders of the company

2- The business's bank manager

3- The tax authorities 4- Financial analysts A- 1 and 2 only

B- 2 and 3 only

C- 2,3 and 4 only

D- 1,2 and 3 only

Test Your Understanding (2)

Which of the following statements is/are true?

1- A supplier of goods on credit is interest only in the statement of financial position, ie an indication of the current state of affairs.

2- The objective if financial statements is to provide information about the financial position, performances and changes in financial position of an entity that is useful to a wide range of users making economic decisions.

A- 1 only

B- 2 only

C- Both 1 and 2

D- Neither 1 or 2

Test Your Understanding (3)

Which of the following are advantages of trading as a limited liability company?

1- Operating as a limited liability company makes raising finance easier because additional shares can be issued to raise additional cash

2- Operating as a limited liability company is more risky than operating as a sole trader because the shareholders of a business are liable for all the debts of the business whereas the sole trader is only liable for the debts up to the amount he has invested.

A- 1 only

B- 2 only

C- Both 1 and 2

D- Neither 1 nor 2

Test Your Understanding (4)

Which of the following statements is /are true?

1. The directors of a company are ultimately responsible for the preparation of financial statements, even if most of the work on them is performed by the finance department.
2. If financial statements are audited, then the responsibility for those financial statements instead falls on the auditors instead of the directors.

3. There are generally no laws surrounding the duties of directors in managing the affairs of a company.

A- 1 only

B- 1 and 2 only

C- 1,2 and 3

D- 1 and 3 only

Test Your Understanding (5)

Which ONE of the following statements correctly describes the contents of the Statement of Financial Position?

A- A list of ledger balances shown in debit and credit column.

B- A list of all the assets owned and all liabilities owed by a business

C- A record of income generated, and expenditure incurred over a given period

D- A record of the amount of cash generated and used by a company in each period

E-

Test Your Understanding (6)

Which ONE of the following statements correctly describes the contents of the Statement of Profit or Loss?

A- A list of ledger balances shown in debit and credit column.

B- A list of all the assets owned and all liabilities owed by a business

C- A record of income generated, and expenditure incurred over a given period

D- A record of the amount of cash generated and used by a company in each period

Test Your Understanding (7)

Which of the following are TRUE of Partnership?

The partner's individual exposure to debt is limited

Financial statements for partnership by law must be produced and made public.

A partnership is not a separate legal entity from the partners themselves.

A- 1 and 2 only

B- 2 only

C- 3 only

D-1 and 3 only

Chapter-2 The regulatory framework

1 The regulatory system

The following factors that have shaped financial accounting can be identified:

- National/local legislation
- Accounting concepts and individual judgment
- Accounting standards
- Other international influences
- Generally accepted accounting principles (GAAP)
- Fair presentation

2 The International Accounting Standards Board (IASB)

The International Accounting Standard Board (IASB) is an independent, privately funded body that develops and approves IFRSs. The IASB operates under the oversight of the **IFRS Foundation**.

2.1 The IFRS Foundation

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.
- To promote the use and rigorous application of those standards.
- To take account of the financial reporting needs of emerging economies and small and medium size entities (SMEs); and
- To bring about convergence of national accounting standards and IFRs to high quality solutions.

2.2.1 IFRS Advisory council

The IFRS advisory council (formerly called the Standards Advisory Council or SAC) is essentially a forum used by the IASB to consult with the outside world. It consults with national standard setters, academics, user groups and a host of other interested parties to advise the IASB on a range of issues, from the IASB's work program for developing new IFRSs to giving practical advice on the implementation of particular standards.

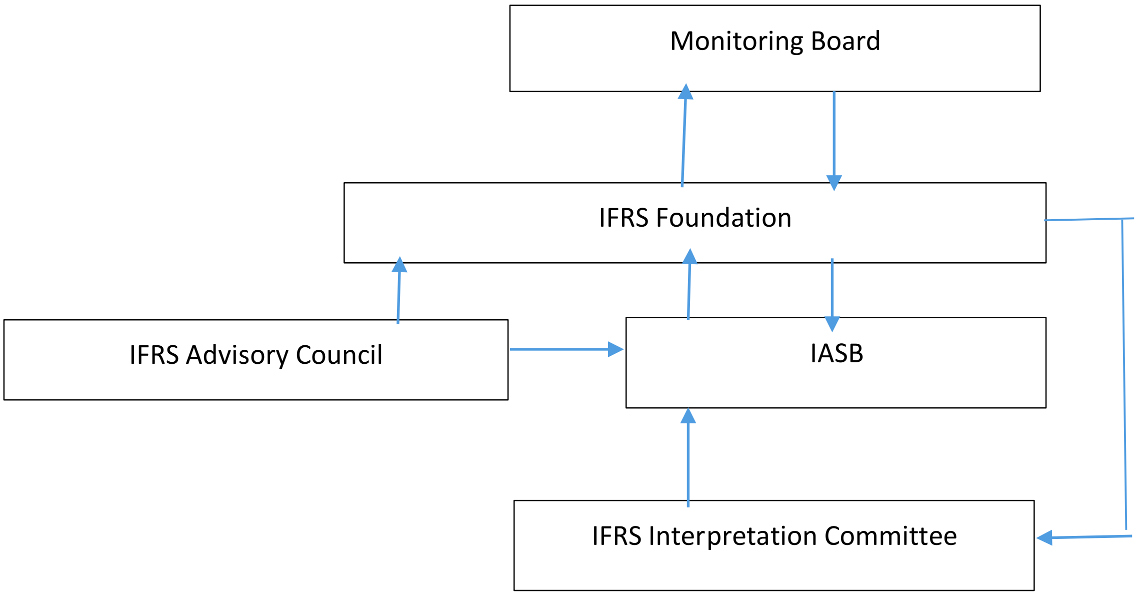
2.2.2 IFRS interpretations committee

The IFRS Interpretations Committee (formerly called the international Financial Reporting Interpretations Committee or IFRIC) was set up in March 2002 and provides guidance on specific practical issues in the interpretation of IFRSs.

The IFRS Interpretations Committee has two main responsibilities.

- To review, on a timely basis, newly identified financial reporting issues not specifically addressed in IFRSs

- To clarify issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance, with a view to reaching a consensus on the appropriate treatment.



3 International financial Reporting Standards (IFRSs)

IFRSs are created in accordance with due process. There are currently 41 IASs and 16 IFRSs in issue.

Prior to 2003, standards were issued as International Accounting Standards (IASs). In 2003 IFRS 1 was issued and all standards are now designed as IFRSs.

3.1The use and application of IFRSs

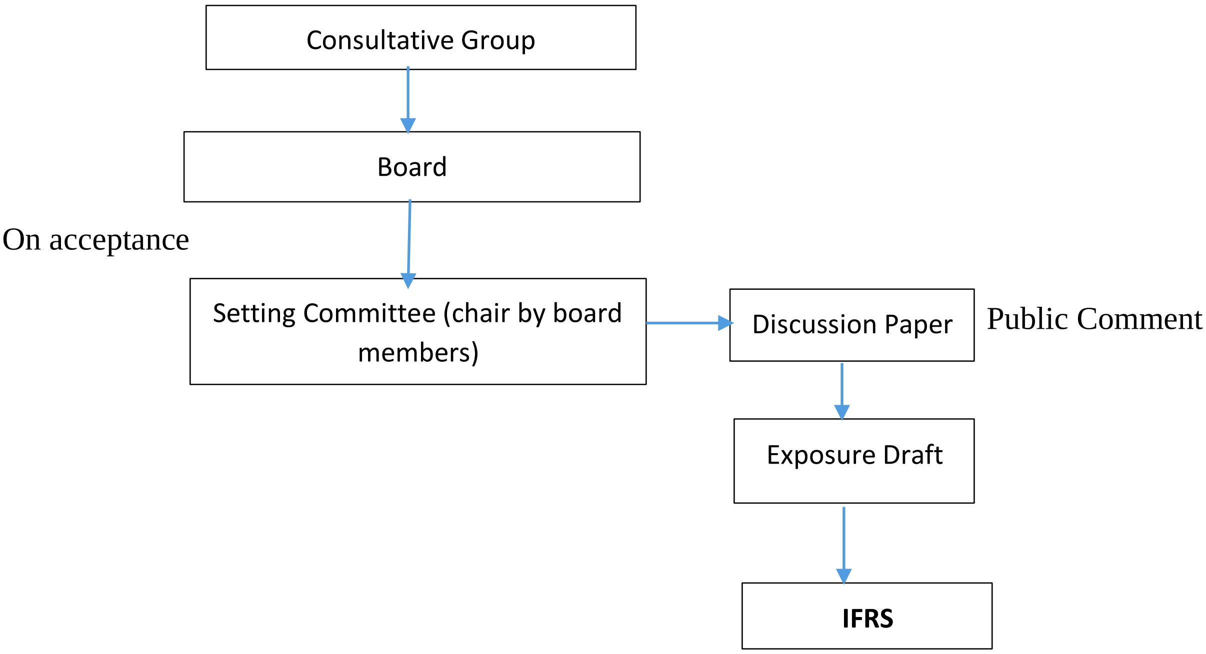
IFRSs have helped to both improve and harmonize financial reporting around the world. The standards are used in the following ways.

- As national requirements
- As the basis for all or some national requirements
- As an international benchmark for those countries which develop their own requirements
- By regulatory authorities for domestic and foreign companies By companies themselves

3.2 Standard-setting process

The IASB prepares IFRSs in accordance with due process. You do not need to know this for your exam, but the following diagram may be of interest.

The procedure can be summarized as follows,



3.2.1 Current IFRSs

Conceptual framework for Financial Reporting 2010

IFRS 1	First-time adoption of International Financial Reporting Standards
IFRS 2	Share-based payment
IFRS 3*	Business combinations
IFRS 4	Insurance contracts
IFRS 5	Non-current assets held for sale and discontinued operations
IFRS 6	Exploration for the evaluation of mineral resources
IFRS 7	Financial instruments: disclosures
IFRS 8	Operating segments
IFRS 9	Financial instruments
IFRS 10*	Consolidated financial statements
IFRS 11	Joint arrangements
IFRS 12	Disclosure of interests in other entities
IFRS 13	Fair value measurement
IFRS 14	Regulatory deferral accounts
IFRS 15*	Revenue from contracts with customers
IFRS 16	Leases
IAS 1*	Presentation of financial statements
IAS 2*	Inventories
IAS 7*	Statement of cash flows
IAS 8	Accounting policies, changes in accounting estimates and errors
IAS 10*	Events after the reporting period
IAS 11	Construction contracts
IAS 12	Income taxes

IAS 16*	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits (2011)
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	The effects of changes in foreign exchange rates
IAS 23	Borrowing costs
IAS 24	Related party disclosures
IAS 26	Accounting and reporting by retirement benefit plans
IAS 27*	Separate financial statements (2011)
IAS 28*	Investments in associates and joint ventures (2011)
IAS 29	Financial reporting in hyperinflationary economies
IAS 32	Financial instruments: presentation
IAS 33	Earnings per share
IAS 34	Interim financial reporting
IAS 36	Impairment of assets
IAS 37*	Provisions, contingent liabilities and contingent assets
IAS 38*	Intangible assets
IAS 39	Financial instruments: Recognition and measurement
IAS 40	Investment property
IAS 41	Agriculture

***IAS 17 will be replaced by IFRS 16 from 1 January 2019, however earlier adoption is permitted if an entity is also applying IFRS 15.

3.3 Scope and application of IFRSs

3.3.1 Scope

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are **not intended to be applied to immaterial terms, nor are they retrospective**. Each individual standard lays out its scope at the beginning of the standard.

3.3.2 Application

Within each individual **country local regulations govern**, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and/or professional accountancy bodies in the country con

Test Your Understanding (1)

Who issues International Financial Reporting Standards?

A- IFRS Advisory Committee

B- The Stock Exchange

C- The International Accounting Standards Board

D- The government

Test Your Understanding (2)

Which of the following best describes corporate governance?

A- Corporate governance is the system of rules and regulations surrounding financial reporting

B- Corporate governance is the system by which companies and other entities are directed and controlled.

C- Corporate governance is carried out by the finance department in preparing the financial statements

D- Corporate governance is the system by which an entity monitors its impact on the natural environment

Test Your Understanding (3)

Which of the following statement is/are true?

1- IFRS Interpretation Committee is a forum for the IASB to consult with the outside world.

2- The IFRS Foundation produces IFRSs. The IFRS foundation is overseen by the IASB.

3- One of the objective of the IFRS Foundation is to bring about convergence of national accounting standards

A- 1 and 3 only

B- 2 only

C- 2 and 3 only

D- 3 only

Test Your Understanding (4)

What is the role of IASB?

A- Oversee the standard setting and regulatory process

B- Formulate international financial reporting standards

C- Review defective accounts

D- Control the accountancy profession

Test Your Understanding (5)

Which ONE of the following is NOT an objectives of the IFRS Foundation?

A- Through the IASB, develop a single set of globally accepted International Financial Reporting Standards (IFRSs)

B- Promote the use and rigorous application of International Financial Reporting Standards

C- Ensure International Financial Reporting Standards (Focus) primarily on the needs of global, multi-national regulations

D- Bring about the convergence of national accounting standards and IFRs

Test Your Understanding (6)

Which one of the following statements correctly describes how International Financial Reporting Standers (IFRS) should be used?

A- To provide examples of best financial reporting practice for national bodies who develop their own requirement

B- To ensure high ethical standards are maintained by financial reporting professional internationally

C- To facilitate the enforcement of a single set of global financial reporting standards

D- To prevent national bodies from developing their own financial reporting standards

Chapter (3) The qualitative characteristics of financial information

1 Background

In preparing the financial statements, accountants follow certain fundamental assumptions.

2 The IASB's conceptual framework

The IASB's conceptual framework is the basis on which IFRSs are formulated. The main underlying assumption for financial statements is going concern.

2.1 Introduction to conceptual framework

The conceptual framework for financial reporting 2010 (Conceptual framework) is a set of principles which underpin the foundations of financial accounting. The conceptual framework is not an accounting standard itself.

2.2 Underlying Assumption

The conceptual framework sets out one important underlying assumption for financial statements, **the going concern concept**.

2.2.1 Going Concern

The financial statement are normally prepared on the assumption that an entity is a **going concern** and will continue in operation for foreseeable future (at least the nest 12 moths). Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

(Conceptual Framework for Financial Reporting 2010: para 4.1) The main significance of the going concern concept is that the assets **should not be valued at their break- up value** (the amount they would sell for it they were sold off piecemeal and the business were broken up).

If the going concern assumption is not followed, that fact must be disclosed, together with the following information.

The basis on which the financial statement has been prepared.

The reasons why the entity is not considered to be going concern.

2.2.2 Accrual Basis

The effects of transactions and other events are **recognized when they occur, and they are recorded** in the accounting records and reported in the financial statements of the periods to which they relate.

According to the accrual's assumption, in computing profit **revenue earned must be matched against the expenditure incurred** in earning it. This is also known as the **matching convention**.

3 The qualitative characteristics of financial information

The conceptual framework states that qualitative characteristics are the attributes that make the information provided in financial statements useful to users.
The two fundamental qualitative characteristics are **relevance and faithful representation**. Enhancing qualitative characteristics are **comparability, verifiability, timeliness and understandability.**

3.1 Relevance

Relevant financial information can make a difference in the decisions made by users. Financial information can make a difference in decisions if it has **predictive value, confirmatory value or both.**
The manner of showing information will enhance the ability to make predictions, e.g. by highlighting unusual items.
The relevance information is affected by its nature and **materiality**.

3.1.1 Materiality

Information is **material if omitting it or misstating it could influence decisions that users make** based on financial information about a specific reporting entity.

3.2 Faithful Representation

Financial reports represent **economic phenomena in** words and numbers. To be useful, financial information must not only represent relevant phenomena but must **faithfully represent** phenomena that it purports to represent.
To be a faithful representation information must be **complete, neutral and free from error**.
Complete include all information necessary for users
Neutral without bias in the selection or presentation of financial information. **Free from error** no errors or omission in description and in the process by which the financial information was produced.

3.2.1 Substance over form

This is **not a separate qualitative characteristic** under conceptual framework, and it is **implied** in faithful representation. Faithful representation of a transaction of a transaction is only possible if it is accounted for according to **its substance and economic reality**. Example: Leasing agreement.

3.3 Enhancing qualitative characteristics

3.3.1 Comparability

Comparability is the qualitative characteristic that enable users to identify and understand similarities in, and differences among, items.
Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or date.

Corresponding information for preceding periods should be shown to enable comparison to be made over time.

3.3.2 Verifiability

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. It means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

3.3.3 Timeliness

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older information is the less useful it is.

3.3.4 Understandability

Classifying, characterizing and presenting information clearly and concisely makes it understandable.

Financial reports are prepared for **users who have a reasonable knowledge of business** and economic activities and who review and analyze the information diligently.

4 Other Accounting Concepts

There are other accounting concepts which are useful in the preparation of financial statements.

1. Fair presentation
2. Consistency
3. The business entity concept

1.1 Fair presentation

Financial statements are required to give **a fair presentation or present fairly in all material** respect the financial results of the entity. **Compliance with IFRSs** will almost always achieve this. If the management decides that compliance with a requirement of an IFRS would be misleading, **departure from IFRSs** is required to achieve a fair presentation. **IAS 1 refers** to what is required for a fair presentation.

a) Selection and application of **accounting policies**

b) **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information

c) Additional disclosures where required.

1.2 Consistency

To maintain consistency, the presentation and classification of items in the financial statements should stay the same from one period to the next, except as follows.

1. There is **significance change in the nature** of the operations or a review of the financial statements indicates a **more appropriate presentation**.

2. A change in presentation is **required by IFRS**.

1.3 The business entity concept

Financial statements always treat the business as a separate entity.
The business entity concept is always to treat a business as a separate entity from its owner(s).

Question 1

Which of the following statements **best describes** the consistency concept? A. Only material items are disclosed.

B. The way an item is presented always remains the same.
C. Presentation and classification of items should remain the same unless a change is required by an IFRS.

Question 2

Making an allowance for receivables is an example of which concept?

A. Accruals
B. Going concern
C. Materiality
D. Fair presentation

Test Your Understanding (1)

Which accounting concept should be considered if the owner of a business takes a goods from inventory for their own personal use? A- The fair presentation concept

B- The accruals concept
C- The going concern concept D- The business entity concept

Test Your Understanding (2)

Sales revenue should be recognized when goods and services have been supplied;costs are incurred when goods and services have been received. Which accounting concept govern the above?

A- The business entity concept
B- The materiality concepts
C- The accrual concepts
D- The duality concepts

Test Your Understanding (3)

Which accounting concept states that omitting or misstating this information could influence user of the financial statements?

A- The consistency concepts
B- The accruals concept

C- The materiality concepts

D- The going concern concept

Test Your Understanding (4)

According to the IASB's Framework for Financial Reporting, which two of the following are part of the faithful representation?

1- It is neutral

2- It is relevant

3- It is presented fairly

4- It is free from material error

A- 1 and 2

B- 2 and 3

C- 1 and 4

D- 3 and 4

Test Your Understanding (5)

Which of the following accounting concepts means that similar items should receive a similar accounting treatment?

A- Going concern

B- Accruals

C- Matching

D- Consistency

Test Your Understanding (6)

Listed below are some characteristics of financial information

1- Relevance

2- Consistency

3- Faithful representation

4- Accuracy

Which of these characteristics of financial information according to the IASB's Conceptual Framework for Financial Reporting?

A- 1 and 2 only

B- 2 and 4 only

C- 3 and 4 only

D- 1 and 3 only

Test Your Understanding (7)

Which ONE of the following statements describes faithful representation, a qualitative characteristic of faithful representation?

- A- Revenue earned must be matched against the expenditure incurred in earning it.
- B- Having information available to decision-makers in time to be capable of influencing their decisions
- C- The presentation and classification of items in the financial statements should stay the same from one period to the next.
- D- Financial information should be complete, neutral and free from error.

Test Your Understanding (8)

Listed below are some comments on accounting concepts.

1- Financial statements always treat the business as a separate entity

2- Materiality means that only items having a physical existence may be recognized as assets.

3- Provision are estimates and therefore can be altered to make the financial results of a business more attractive to investors,

Which, if any, of these comments is correct, according to the IASB's Conceptual Framework for Financial Reporting?

- A- 1 only
- B- 2 only
- C- 3 only
- D- None of them

Test Your Understanding (9)

The IASB's Conceptual Framework for financial reporting gives six qualitative characteristics of financial information, what are these six characteristics?

- A- Relevance, Faithful representation, Comparability, Verifiability, Timeliness and Understandability
- B- Accuracy, Faithful representation, Comparability, Verifiability, Timeliness and Understandability
- C- Relevance, Faithful representation, Consistency, Verifiability, Timeliness and Understandability
- D- Relevance, Comparability, Comparability, Verifiability, Timeliness and Understandability

Test Your Understanding (10)

Which of the following statements about accounting concepts and policies is/are correct?

1- Companies should never change the presentation or classification of items in their financial statements, even if there is a significant change in operations

2- Companies should create provision in times of company growth to be utilized in more difficult times, to smooth profits.

A- 1 only

B- 2 only

C- 1 and 2

D- Both are incorrect

Chapter (4)
Sources, Records and books of prime entry

1- The role of source documents

Business transactions are recorded on source documents. Documents used to record the business transactions in the book of accounts of the business include the following.

- **Quotation**

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

- **Purchase order**

  A document of the company that details goods or services which the company wishes to purchase from another company. Purchase orders are sequentially renumbered.

- **Sales order**

  A document of the company that details an order placed by a customer for goods or services. Purchase orders are sequentially renumbered

- **Goods received notes**

  A document of the company that lists the goods that a business has received from the suppliers. It is usually prepared by the business own warehouse or goods receiving areas.

- **Good, dispatched notes**

  A document of the company that lists the goods that the company has sent to a customer. The company will keep a record of goods dispatched notes in case of any quires by the customer about the goods sent.

- **Statements**

  A document sent out by a supplier to a customer in respect of goods returned or overpayment made by the customer's account, including all invoices, credit notes issued and all payment received from the customers.

- **Credit note**

  A document sent by a supplier to a customer in respect of goods returned or over payment made by the customer. It is a "negative invoice"

- **Debit note**

  A document sent by a customer to a supplier in respect of goods returned or over payment. It is a formal request for the supplier to issue a credit note.

- **Remittance advice**

  A document sent to a supplier with a payment dealing which invoices are being paid and which credit note offset**.**

- **Receipt**

  A document confirming confirmation that payment has been received. This is usually in respect of cash sales, e g a till receipt from a cash register.

- **Invoice**

  Invoice is primarily demand for payment.

  Sales invoice

  When a business sells goods or services on credit to a customer, it sends out an invoice. The invoice is a request for the customer to pay what they owe. The details on the invoice should match the details on the sales order.

  Purchase invoice

  When a business buys goods or services on credit it receives an invoice from the supplier. The details on the invoice should match the details on the purchase order.

What does an invoice show?

Invoice should be numbered. Information usually shown on the invoice include the following.

a) Name and address of the seller and the purchaser

b) Date of the sale

c) Description if what is being sold

d) Quantity and unit price of what has been sold

e) Details of trade discount, if any

f) Total amount of the invoice including (usually) details any of sales tax

g) Sometimes, the date by which payment is due, and other terms of sale

h) Details of any cash or settlement discount and discount amount

Uses of invoices

Invoice may be use for different purpose.

- Copy to customer as a request for payment
- Copy to accounts department to match to eventual payment

- Copy to warehouse to generate a dispatch of goods, as evidenced by a goods dispatched note
- Copy matched sales order and kept in the sales department as a record of sales.

1.4 Credit note and Debit note

A **credit note** is a document relating to *returned of goods or refunds when a customer has been overcharged*. It can be regarded as a ***negative invoice***. Debit note

Debit note is issued **to a supplier** as a means of formally requesting a credit note.

Test your understanding (1)

China supplies sends out a……………………………. to a credit customer in order to correct an error where a customer has been overcharged on an ……………………………..

2- The need for book of prime entry

The main books of prime entry are as follows.

1. Sales daybook
2. Purchase daybook
3. Sales return daybook
4. Purchase return daybook
5. Journal
6. Cash book
7. Petty Cash book

3- Sales and purchase day books

3.1 The sales daybook `

The sales daybook is the book of prime entry for credit sales.

3.2 The Purchase daybook

A business also keeps a record in the purchase daybook of all invoices it receives. The purchase daybook is the book of prime entry for credit purchases.

3.3 The Sales return daybook

When customers return goods for some reason, a credit note is raised. All credit notes are recorded in the sales returned daybook.

3.4 The Purchase return daybook

The purchase return daybook is the book of prime entry for credit notes received from suppliers.

Test your understanding (2)

Which of the following documents should accompany a return of goods to a supplier?

A. Debit note

B. Remittance invoice

C. Purchase invoice

D. Credit note

Test your understanding (3)

Which of the following are books of prime entry?

1 Sales daybook

2 Cash Book

3 Journal

4 Purchase ledger

A. 1 and 2 only

B. 1,2 and 3 only

C. 1 only

D. All of them

Test your understanding (4)

In which book of prime entry will a business record debit notes in respect of goods which have been sent back to suppliers?

A. The sales return daybook

B. The cash book

C. The purchase return daybook

D. The purchase daybook

Test your understanding (5)

Which of the following would be recorded in the sales daybook?

A. Cash received

B. Sales invoices

C. Credit notes received

D. Trade discounts

4- Cash book

The cash book may be a manual record or a computer file. It records all transactions that go through the bank account. The cash book is the book of prime entry for cash receipts and payments.

4.1 Example

At the beginning of 1 Sept, Robin Plenty had $900 in the bank.
During 1 Sept 20X7, Robin Plenty had the following receipts and payments.

a) Cash sale; receipt of $80.
b) Payment from credit customer Hay $380.
c) Payment from credit customer Been $720.
d) Payment from credit customer Seed $140.
e) Cheques received from Len Dinger $1,800 to provide a short-term loan.
f) Second cash sales: receipt of $150.
g) Payment to Supplier Kew $120.
h) Payment to supplier Hare $310.
i) Payment of telephone bill $400.
j) Payment of gas bill $280.
k) $100 in cash withdrawn from bank for petty cash.
l) Payment of $1,500 to Hess for new plant and machinery.

5-Petty Cash book

Most business keep a small amount of cash on premises to make occasional small payments in cash, e.g staff refreshment, postage stamp, to pay the office cleaner, taxi fares, etc. This is often called the cash float or petty cash account. Under **imprest system**, the petty cash is kept at an agreed sum, so ***that each topping up is equal to the amount paid out in the period.***

Cash still held in petty cash + voucher payment = the imprest amount

Example

DEF operates an imprest system for petty cash. During February 20X9, the following petty
cash transactions took place.

		$
3.2.20X9	Stamps	12.00
2.20X9	Milk	25.00
8.2.20X9	Taxi fare	15.00
17.2.20X9	Stamps	5.00
18.2.20X9	Received from staff copying	8.00

28.2.20X9	Stationery	7.50

The amount remaining in petty cash at the end of the month was $93.50. What is the imprest amount?

A. $166.00

B. $150.00

C. $72.50

D. $56.50

Test your understanding (6)

Which one of the following statements about an imprest system of petty cash is ***correct***?

A. An imprest system for petty cash controls small cash expenditure because a fixed amount is paid into petty cash at the beginning of each period.

B. The imprest system provides a control over petty cash spending because the amount of cash held in petty cash at any time must be equal to the value of the petty cash vouchers for the period.

C. An imprest system for petty cash can operate without the need for petty cash vouchers or receipts for spending.

D. An imprest system for petty cash helps with management of small cash expenditures and reduce the risk of fraud.

Test your understanding (7)

Which one of the following provides evidence that an item of expenditure on petty cash has been approved or authorized?

A. Petty cash voucher

B. Record of the transaction in the petty cash book

C. Receipts for the expenses

D. Transfer of cash from the bank account into petty cash.

Question-1

State which books of prime entry the following transactions would be entered?

A. Your business pays A Brown (a supplier) $450.00

B. You send D Smith (a customer) an invoice for $650

C. Your accounts manager asks you for $12 urgently in order to buy some envelopes

D. You receive an invoice from A Brown for $300

E. You pay D Smith $500

F. F Jones (a customer) returns goods to the value of $250 G. You return goods to J Green to the value of $504

H. F Jones pays you $500.

Write down your answer

Chapter (5)
Ledger Account and Double Entry

1- Why do we need leger accounts?

The records of transactions, assets and liabilities should be kept in the following ways.

a) In chronological order and dated so that transactions can be related to a particular period of time.
b) Built up in cumulative in totals.
   - Day by days
   - Week by week
   - Month by month
   - Year by year

Ledger accounts **summarize** all the individual transactions listed in the books of prime entry.

2- The nominal ledger

The principal accounts are contained in a ledger called **the general or nominal ledger** which is an accounting records and summarize the financial affair of a business.

Examples of accounts in the nominal ledger include the followings

a) Property, plant and equipments (Non-current Assets)
b) Proprietor's Capital (Capital)
c) Inventories (Raw material, finished goods) (current assets)
d) Total Trade account receivables control (current Assets)
e) Total Trade account payable control (Current liabilities)
f) Wages and salaries (Expense)
g) Rent and Tax (Expense)
h) Sales Total cash and bank (current assets or liability)

2.1 The format of ledger account

Name of Account

Debit Side (DR)	Credit side (CR)

3-The accounting equation

Assets = Capital + Liabilities

This is also known as **the statement of financial position equation**.

Test your understanding (1)

Which of the following is correct?

A. Capital= Assets + Liabilities
B. Capital = Assets – Liabilities
C. Capital = liabilities- Assets
D. Capital + Assets= Liabilities

Test your understanding (2)

Which of the following can the accounting equation can be rewritten as?

A. Assets + profit –drawings-liabilities = Closing capital
B. Assets – Liabilities – drawings= opening capital + profit
C. Assets – Liabilities – opening capital + drawings = profit
D. Assets – profits-drawings = closing capital – liabilities

Test your understanding (3)

A trader's net profit for the year may be computed by using which of the following formulae?

A. Opening capital + Drawings – capital introduced – closing capital
B. Closing capital+ Drawings - Capital introduced – opening capital
C. Opening capital – drawings + capital introduced – closing capital
D. Opening capital – drawings – capital introduced – closing capital

Test your understanding (4)

The profit earned by a business in 20X7 was $72,500. The proprietor injected new capital of $8,000 during the year and withdrew goods for his private use which had cost $2,200.
If net assets at the beginning of 20X7 were $101,700, what were the closing net assets?

A. $35,000

B. $39,400

C. $168,400

D. $180,000

Test your understanding (5)

The profit earned by a business in 20X7 was $35,400. The proprietor injected new capital of $10,200 during the year and withdrew a monthly salary of $500.
If net assets at the end of 20X7 were $95,100, what was the proprietor's capital at the beginning of the year?

A. $50,000

B. $55,500

C.$63,900

D.$134,700

Test your understanding (6)

The net assets of Altese, a tarder, at 1 January 20X2 amounted to $128,000. During the year to 31 Dec 20X2 Altese introduced a further $50,000 of capital and made drawings of $48,000.
At 31 Dec 20X2 Altese's net assets totaled $184,000.
What is Altese's total profit or loss for the year ended 31 Dec 20X2?

A. $54,000 profit

B. $54,000 loss

C. $42,000 loss

D. $58,000 profit

3.1 The business entity concept

Regardless of how a business is legally set up, for accounting purposes, a business is always treated separately from its owners.

Capital is an investment of money (fund) with the intention of earning a return. The business is a **separate entity** in accounting terms and so it owes the money to Liza as Capital.

3.2 Drawings

Drawings are amounts of money **taken out** of a business **by its owner**.
Drawings are relevant for sole trader and the partnership. In limited companies, the owners, ie shareholders, are paid dividends.

Test your understanding (7)

A sole trader took some goods costing $800 from inventory for his own use. The normal selling price of the goods is $1,600.
Which of the following journal entries would correctly record this?

A. Inventory A/C	Dr	$800, Purchase A/C	Cr	$800
B. Drawings A/C	Dr	$800, Purchases A/C	Cr	$800
C. Sales A/C	Dr	$1,600, Drawings A/C	Cr	$1,600
D. Drawing A/C	Dr	$1,600, Sales A/C	Cr	$1,600

3.3 Payables and Receivables

Trade accounts payable

- Trade accounts payable are liabilities.
- A payable is a person or organization to whom a business owes money incurred in the course of trading operations.
- Sometimes it is abbreviated to ''**accounts payables''** or ''**payables**'' and referred to as ''**trade creditor''**.

Trade accounts receivable

- Trade accounts receivable are assets.
- Just as a business might buy goods on credit, so too might it sell goods to customers on credit. A customer who buys goods without paying cash for them straightway is a receivable.
- Amounts owed by receivables are called trade accounts receivable, "**accounts receivable**'' or "**receivables**'', ''**trade debtor''.**

3.3 Matching Concept

The matching convention requires that ***revenue earned is matched with the expenses incurred*** in earning it. The matching convention comes from the ***accruals assumption***.

Example (1)

a) Little Doolittle starts a business with $2,500.
b) She purchases a market stall from Len Turnip, who is retiring from his fruit and vegetables business. The cost of the stall is $1,800.
c) She also purchase some flowers and potted plants from a trader in the wholesale market, at a cost of $650.
d) On 3 July Liza has a very successful day. She sells all of her flowers and plants for $900 cash. Liza decides to pay herself $180 in wages.

e) The next market day is on 10 July and Liza purchases more flowers and plants for cash at a cost of $740. She is not feeling well because of a heavy cold, and so she decides to accept help her for the day from her cousin Ethel. Ethel is to be paid a wage of $40 at the end of the day.

f) Trading 10 July was again very brisk, and Liza and Ethel sold all their goods for $1,100 cash. Liza paid Ethel her wage pf $40 and drew out $200 for herself.

g) Liza Doolittle realizes that she is going to need more money in the business and so she makes the following arrangements.

   She immediately invests a further $250 of her own capital.

   She persuades her Uncle Henry to lend her $500 immediately. Uncle Henry tells her that she can repay the loan whenever she likes but, in the meantime, she must pay him an interest of $5 each week at the end of the market day. They agree that it will probably be quite a long time before the loan is eventually paid.

h) She decided to buy a secondhand van to pick up flowers and plants from her supplier and bring them to her stall in the market. She finds a car dealer, Laurie Loader, who agree to sell her a van on credit for $700. Liza agrees to pay for the van after 30 days' trial use.

i) During the week, Liza's Uncle George telephones her to ask whether she would sell him some garden gnomes and furniture for his garden. Liza tells him that she will look for a supplier. After some investigations, she buys what Uncle George has asked for, paying $300 in cash to the supplier. Uncle George accept delivery of the goods and agrees to pay $350, but she asks if she can wait until the end of the month for payment. Liza agrees.

j) Liza buys flowers and plants costing $800. Of these purchases, $750 are paid in cash, with the remaining $50 on 7day's credit. Liza decides to use Ethel's services again as an assistant on market day, at an agreed wage of $40.

k) On 17 July, Liza succeeds in selling all her goods earning revenue of $1,250 (all in cash). She decides to withdraw $240 for her week's work. She also pays Ethel $40 in cash. She decides to make the interest payment to her Uncle Henry the next time she sees him.

   Required

   State the accounting Equation.

Example (2)

How would each these transactions affect the accounting equation?

1. Purchasing $800 worth of inventory on credit
2. Paying the telephone bill $50
3. Selling $450 worth of inventory for $650
4. Paying $800 to the supplier

4-Double entry bookkeeping

4.1 Dual effect (duality concept)

Double entry bookkeeping is **the method** used to transfer the weekly/monthly totals from the books of prime entry into to the nominal ledger.

An account is maintained for every asset, liability, income and expenses. ***Every transaction is recorded twice so that every debit is balanced by a credit.***

Debit Entry	Credit Entry
○ Increase an asset	Decrease an asset
○ Decrease a liability	Increase a liability
○ Increase an expense	Increase income

Example (3)

Complete the following table relating to transactions of a bookshop.

A. Purchase of book on credit
   Accounts payable increase
   Purchases expense increases
B. Purchase of cash register Own a cash register
   Cash at bank decrease

C. Payment received from a credit customer
   Accounts receivable decrease
   Cash at bank increase
D. Purchase of van
   Own a van
   Cash at bank decrease

Example (4) Double entry for cash transaction

1. A cash sale of $250
2. Payment for rent bill totaling $150
3. Buying some goods for cash at $100
4. Buying some shelves for cash at $200

Example (5) Credit transactions

Recorded in the sales daybook and the purchase day book are the following transactions.

a) The business sells good on credit to a customer Mr A $2,000.
b) The business buys goods on credit from a supplier Mr B for $100.

How and where are these transactions posted in the ledger accounts?

Question (1)

See if you can identify the debit and credit entries in the following transactions.

1. Bought a machine on credit from A, cost $8,000.
2. Bought goods on credit from B cost $500.
3. Sold goods on credit to C value $1,200.
4. Paid D (a credit supplier) $300.
5. Collected $180 from E a credit customer
6. Paid wages $4,000.
7. Received rent bill of $700 from Landlord G
8. Paid rent of $700 to landlord G
9. Paid insurance premium $90
10. Received a credit note for $450 from Supplier H
11. Sent out a credit note for $200 to customer I

Question (2)

A. Ron Knuckle set up a business selling keep it equipment, trading under the name of BUY Biceps Shop. He put $7000 of his own money into a business bank account and in his first period of trading, the following transactions occurred.

B. Paid rent of shop for the period	$3,500	
C. Purchase equipment (Inventories) on credit	$5,000	
D. Raised loan from bank	$1,000	
E. Purchase of shop fitting for cash	$2,000	
F. Sales of equipment: cash		$10,000
G. Sales of equipment: on credit		$2,500
H. Payment for trade accounts payables		$5,000
I. Payment from trade accounts receivables		$2,500
J. Interest on loan (paid)	$100	
K. Other expenses (all paid in cash)	$1,900	
L. Drawings	$1,500	

Show the double entry for the above transactions.

5-The Journal

The journal keeps a record of unusual movement between accounts. It is used to record of any double entries made which do not arise from others book of prime entry, ie non routine transactions. For example, journal entries are made when error were discovered and need to be corrected.

The format of Journal

Date	Account Name	Debit ($)	Credit ($)
	Account to be debited	×××	
	Account to be credited		×××

Example (6)

The following is a summary of the transaction of Hair by Fiona Middleton hairdressing business, which Fiona is the sole proprietor.

1 Jan Put in cash of $2,000 as capital

Purchased brushes and combs for cash $50.

Purchased hairdryers from Gilory Ltd on credit $150.

30 Jan Paid three months' rent to 31 March $300.

Collected and paid in takings $600.

31 Jan Gave Mrs Sullivan a perm, highlights etc on credit $80.

Required

Show the transactions by means of journal entries.

Question (3)

In business, the journal is used to post what types of transactions?

A. Unusual movement

B. Cash daybook

C. Purchases

D. Sales

6-Day Book Analysis

Entries in the daybook are totaled and analyzed before posting in the nominal ledger.

6.1 Sales Day Book

Date	Invoice	Customer	Total Amount ($)	Boot Sales ($)	Shoe Sales ($)
1 Jan 20X0	247	Jones & Co	105.00	60.00	45.00
	248	Smith Co	86.40	86.40	
	249	Alex & Co	31.80		31.80

Sales	250	Enor College day book	1264.60	800.30	464.30
			1487.80	**946.70**	**541.10**

Trade Receivable A/C	Debit	$1487.80
Sales A/C	Credit	$1487.80
(OR)		
Trade Receivable A/C	Debit	$1487.80
Sale of Boot A/C	Credit	$946.70
Sale of Shoe A/C	Credit	$541.10

6.2 Purchases Day Book

Date	Internal Invoice	Supplier invoice	Supplier	Total Amount ($)	Purchases ($)	Electricity ($)
15 Mar 20X0	654	YH00939	COOK & Co	315.00	315.00	
	655	AO0167	W Butler	29.40	29.40	
	656	1267	EEB	116.80		116.80
	657	GB1779	Show Fair Co	100.00	100.00	
				561.20	**444.40**	**116.80**

Purchases A/C	Debit	$444.40
Electricity A/C	Debit	$116.80
Trade Account payables A/C	Credit	$561.20

6.3 Sales Return Day Book

Sales Return day book

Date	Credit note	Customer and goods	Amount ($)
10 April 20X8	CR008	Owen Plenty (three pairs of boots)	135.00

This will be posted as follows,

Sales return A/C	Debit	$135.00
Trade account receivable A/C	Credit	$135.00

6.4 Purchases Return Day Book

Purchase return daybook

Date	Supplier and goods	Amount ($)
29 April 20X8	Boxes Co	46.60

300 cardboard boxes

This will be posted as follows,

Trade account payable A/C	Debit	$46.60
Purchase return A/C	Credit	$46.60

5- The receivable ledger and payable ledger

The receivable and payable ledgers contain the personal accounts of individual customers and suppliers. They do not normally from part of the double entry system.

7.1 Impersonal accounts and personal accounts

The **account in the nominal ledger (ledger accounts) relate** to type of income, expenses, assets and liability etc- rather than to the person to whom the money is paid or for whom it is received. Therefore, they are **called impersonal accounts**.

The **personal accounts** are contained in the receivable and payable ledgers.

7.2 The receivable ledger

The ***receivable ledger*** is a ledger for ***customers' personal accounts***. The need for personal account for each customer is a practical one.

1. A customer might telephone and ask how much they currently owe. Staff must be able to tell them.
2. It is common practice to send out the statements to credit customers at the end of each month, showing how much, they still owe, and itemizing new invoice sent out and payment received during the month.
3. The manager of the business will want to keep a check on the credit position if an individual customer, and to ensure that no customer is exceeding their credit limit by purchasing more goods.
4. Most important is the need to match payments received against debt owed.

7.3 The payable ledger

The payable ledger is a ledger for suppliers' personal accounts. These are separate accounts for each individual supplier.

Test your understanding (8)

Jones Co has the following transactions:

1- Payment of $400 to J Bloggs for the cash purchase

2- Payment of $250 to J Doe in respect of an invoice for goods purchased last month
Write the correct ledger entries to record this transaction.

Test your understanding (9)

Tin Co purchases $250 worth of metal from Steel Co. Tin Co agrees to pay steel Co in 60 days' time.

What is the double entry to record the purchase in Steel Co's Book?

A. Debit Sale $250, Credit receivable $250

B. Debit purchase $250, Credit payable $250

C. Debit receivables $250, Credit sales $250

D. Debit payables $250, Credit purchase $250

Chapter (6)
From Trail Balance to Financial Statements

1- The Trial Balance

A trial balance is a list of ledger balances shown in debit and credit columns.
Balances are usually collected in a trial balance which is then used as a basis for preparing a statement of profit or loss and a statement of financial position. A trial balance can be used to test the accuracy of the double entry accounting records. It works by listing the balance on ledger accounts, some of which are debits and some credits. Total debit should equal total credits.

Question (1)

As at 30.3.20X7, your business has the following balances on its ledger accounts.

Accounts Balances ($)	
Bank Loan	12,000
Cash At bank	11,700
Capital	13,000
Local Business taxes	1,880
Trade accounts payables	11,200
Purchases	12,400
Sales	14,600
Sundry payables	1,620
Trade account receivables	12,000
Bank loan interest	1,400
Other expenses	11,020
Vehicles	2,020

During 31.3.20X7, the business made the following transactions.

a) Bought materials for $1,000, half for cash and half for credit.
b) Made $1,040 sales, $800 of which was for credit.
c) Paid wages to shop assistant of $260 in cash.

You are required to draw up a trial balance showing the balances as at the end of 31.3.20X7.

2-The Statement of Profit or Loss

A profit or loss ledger account is opened to gather all item relating to income and expenses. When rearranged, these items make up ***the statement of profit or loss***. The statement of profit or loss shows the performance of the business.

The Format of Statement of profit or loss Account

	$	$	$
Revenue		×××	
Sales return		(×××)	×××
Less: Cost of Sale			
Opening Inventory		×××	
Purchase	×××		
Carriage inward	×××		
Return outward	(×××)	×××	
Closing Inventory		(×××)	(×××)
Gross Profit			×××
Income			×××
Expenses			(×××)
Net Profit for the year			×××

Question (2)

The following balances are given for Ron Knuckle's business.

Purchase	$5000
Rent	$3500
Sales	$12,500
Bank Loan interest	$100
Other expense	$1,900

Required

Draw up Ron Knuckle's statement of profit or loss.

Question (3)

In a period, sales are $140,000, purchases $75,000 and other expenses $25,000. What is the figure for the profit for the year to be transferred to the capital account?

A. $40,000

B. $65,000

C.$75,000

D.$140,000

3-The Statement of Financial Position

The statement of financial position shows the financial position of the business.

The format of statement of financial position

	$	$
Non-current assets		
Property, Plants & Equipment		****
Current assets		
Inventory	****	
Trade Receivables	****	
Cash at bank	****	
Cash in hand	****	
Other receivables	****	****
Total Assets		****
Equity		
Opening capital	***	
Net profit for the year	***	
(-) Drawings	(***)	
Closing capital		****
Non-current liabilities		
Loan		****
Current liabilities		
Trade Payables	****	
Other Payables	****	****
Total Equity & Liabilities		****

Question (4)

Alpha has the following opening balances on its ledger accounts.

Fixtures	$5,000
Trade accounts receivable	$2,000
Bank account	$1,000
Loan	$3,000

A- What is the total assets figure?

a) $6,000

b) $5,000

c) $8,000

d) $3,000

B- What is the opening capital for capital?

a) $6,000

b) $5,000

c) $8,000

d) $3,000

Test your understanding (1)

The following totals appear in the day books for March 20X8.

	$
Sales day book	40,000
Purchases day book	20,000
Return inwards day book	2,000
Return outwards day book	4,000

Opening and closing inventories are both $3,000. What is the gross profit for March 20X8?

A. $22,000

B. $24,000

C. $20,000

D. $18,000

Test your understanding (2)

William's trial balance at 30 Sept 20X5 includes the following balances:

Trade receivables	$75,943
Receivable Allowance	$4,751

How should these balances be reported in William's statement of financial position as at 30 Sept 20X5?

A. An asset of $71,192

B. An asset of $75,943 and a liability of $4,751

C. A liability of $71,192

D. A liability of $75,943 and an asset of $4,751

Test your understanding (3)

A trial balance is made up of a list of debit balances and credit balances.

Which of the following statements is correct?

A. Every debit balance represents an expense.

B. Assets are represented by debit balances.

C. Liabilities are represented by debit balances.

D. Income is included in the list of debit balances.

Test your understanding (4)

At 31 Oct 20X6, Roger's trial balance included the following balances:

	$
Machinery at cost	12,890
Accumulated depreciation	8,950
Inventory	5,754
Trade receivables	11,745
Trade payables	7,830
Bank overdraft	1,675
Cash at bank	150

What is the value of Roger's current assets at 31 Oct 20X6?

A. $17,649

B. $17,499

C. $15,974

D. $13,734

Test your understanding (5)

At 30 November 20X5 Jenny had a bank loan of $8500 and a balance of $678 in hand in her bank account.

How should these amounts be recorded on Jenny's opening trial balance at 1 Dec 20X5?

A. Debit $7,822

B. Credit $7,822

C. Credit $8,500 and Debit $678

D. Debit $8,500 and Credit $678

What is the total of the debit balance at 31 Oct 20X5?

A- $267,049 C-$283,148

B-$275,282 D-$284,931

Chapter (7)
Inventory (IAS-2)

1 Cost of Goods sold

Opening Inventory		×××
Add: Cost of purchase (or) Cost of production	×××	
Add: Carriage inwards	×××	
Less: Return Outwards	(×××)	×××
Less: Closing Inventory		(×××)
		×××

Example (1)

Perry P Louis, trading as the Umbrella shop, ends his financial year on 31 Sept each year. On

1 Oct 20X4 he had no goods in inventory. During the year of September 20X5, he purchase 30,000 umbrellas costing $60,000 from umbrella wholesalers and suppliers. He resold the umbrellas for $5 each, and the sales for the year amounted to $100,000 (20,000 umbrellas).

At 30 September, there were 10,000 unsold umbrellas left in inventory, valued at $2 each.

What was Perry P Louis's gross profit for the year?

Example (2) Carriage inwards and Carriage Outwards

On 1 July 20X5, he had clocks in inventory valued at $17,000. During the year to 30 June 20X6 he purchased more clocks at a cost of $75,000. Carriage inwards amounted to $2,000. Sales for the year were $162,000. Other expenses of the business amounted to $56,000 excluding carriage outwards which cost $2,500. The value of the goods in inventory at the year-end was $15,400.

Prepare the statement of the profit or loss for the year ended 30 June 20X6.

1.2 Goods written off or written down

A trader might be unable to sell all the goods that they purchases, because a number of things might happen to the goods before they can be sold. For example

- Goods might be **lost or stolen**
- Goods might be **damaged**
- Goods might become **obsolete or out of fashion**

The business will make a loss if their sales value is nil or less than their cost. The value of the inventories should be written down to:

- Nothing, if they are worth less
- Their net realizable value, if this is less than original cost.

The loss will be reported as soon as the loss is foreseen according to ***prudence concept***.

Prudence Concept

Assets and income should not be overstated, liabilities and expenses should not be understated. Therefore, foreseeable loss should be recognized immediately and income should be recognized when realized.

Example (3)

Lucas Wagg, trading as Fairlock fashions, ends his financial year on 31 March. At 1 April 20X5 he had goods in inventory valued at $8,800. During the year to 31 March 20X6, he purchased goods costing $48,000. Fashion goods which cost $2,100 were still held in inventory at 31 March 20X6, and Lucas Wagg believes that could only now be sold at a sale price of $400. The goods still held in inventory at 31 March 20X6 (including the fashion goods) had an original purchase cost of $7,600. Sales for the year were $81,400.

Calculate the gross profit of Fairlock Fashions for the year ended 31 March 20X6.

Question (2)

Gross profit for 20X7 can be calculated from:

A. Purchase for 20X7, plus inventory at 31 December 20X7, less inventory at 1 January 20X7.
B. Purchase for 20X7, less inventory at 31 December 20X7, plus inventory at 1 January 20X7.
C. Cost of goods sold during 20X7, plus sales during 20X7.
D. Profit for the year for 20X7, plus expenses for 20X7

2 Accounting for opening and closing inventory

There are three basic steps concerning with inventory

1. Managing to get a precise count of inventory in hand at any one time
2. Valuing inventory
3. Double entry bookkeeping for inventory

2.1 Ledger accounting for inventories

The inventory account is only ever use **at the end of an accounting period,** when the business counts and values the inventory in hand, in an inventory count.

(a) When an inventory count is made, the business will have a value for its closing inventory, and the double entry is

Debit Inventory A/C (Closing inventory value) ×××
Credit Profit and Loss A/C
×××

(b) Closing inventory at the end of one period becomes opening inventory at the start of the next period. When the value of opening inventory is taken to the profit or loss account. Debit Profit and Loss A/C ×××
Credit Inventory A/C (Opening inventory value) ×××

Question (3)

A business is established with capital of $2,000 and this amount is paid into a business bank account by the proprietor. During the first year's trading, the following transactions occurred.

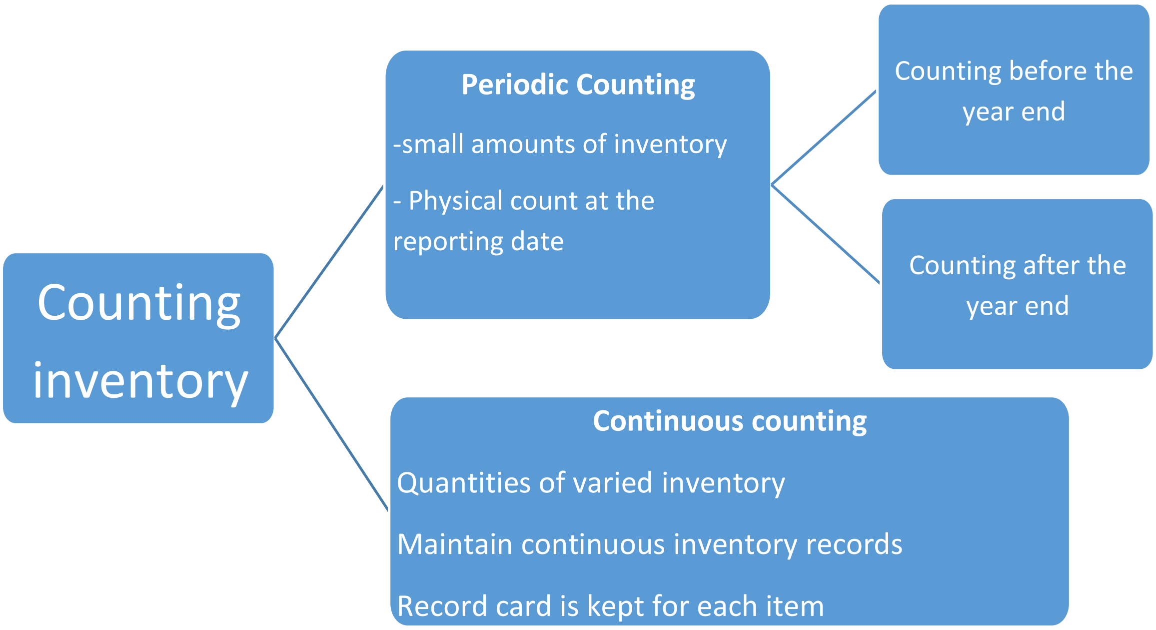
	$
Purchase of goods for resale	4,300
Payment for trade accounts payable	3,600
Sales, all on credit	4,000
Payment from trade account receivables	3,200
Non-current assets purchase for cash	1,500
Other expenses, all paid in cash	900

All 'other expenses' relate to the current year. Closing inventory is valued at $1,800.

Prepare the ledger accounts, profit or loss account for the year and statement of financial position at the end of the year.

3 Counting inventory

The quantity of inventories held at the end is established by means of **a physical count** of inventory in an annual accounting exercise, or by a 'c**ontinuous**' inventory count.



Question (4) Counting before the financial year end

The inventory value for the financial statements of High Tech Co for the year ended 30 April 20X5 was based on an inventory count on 28 April 20X5, which gave a total inventory value of $200,000.

Between 28 April and 30 April 20X5, the following transactions took place.

	$
Purchases of goods	45,000
Sales of goods (Mark-up 25%)	75,000
Goods return by High Tech to Supplier	3,000
Goods return by the customer	12,500

What figure should be included in the financial statements for inventories on 30 April 20X5?

Question (5) Counting after the financial year end

In preparing financial statements for the year ended 31 Dec 20X7, the inventory count was carried out on 5 Jan 20X8. The value of inventory count was $550,000. Between 31 Dec 20X7 and 5 Jan 20X8, goods with a cost of $155,500 were received into inventory and sales of $200,000 were made at a margin of 20%.

What amount should be stated in the statement of financial position as at 31 Dec 20X7?

Test Your Understanding (1)

The inventory value for the financial statements of Global Co for the year ended 30 June 20X3 was based on an inventory count on 7 July 20X3, which gave a total inventory value of $950,000.

Between 30 June and 7 July 20X6, the following transaction took place.

Purchase of goods	$11,750
Sales of goods (markup on cost at 15%)	$14,950
Goods return by Global Co to supplier	$1,500

What figure should be included in the financial statements for inventories at 30 June 20X3?

A. $952,750

B. $949,750

C. $926,750

D. $958,950

4 Valuing inventories

There are several methods which might be used for valuation of inventory.

- Valued at expected **selling price**
- Valued **at Net Realizable Value** (expected selling price less any costs still to be incurred for sale)
- Valued at their **historical cost** (the cost at which they are originally sold)
- Valued at their current **replacement cost** of inventories

Historical costs are **normal basis** of inventory valuation. The only time when historical cost is not used is where it is **prudent to use a lower value**.

The use of **selling price in** inventory valuation is **ruled out because** this would create a profit for the business before the inventory has been sold.

IAS 2 states that '**inventory shall be measured at lower of cost and net realizable value'**

Question (6)

The following figures relate to the inventory held at the year end.

	A ($)	**B ($)**	**C ($)**
Cost	20	9	12
Selling price	30	12	22
Modification cost to enable sale	-	2	8
Marketing costs	7	2	2
Units held	200	150	300

Calculate the value of inventory held.

Test Your Understanding (2)

The closing inventory at cost of accompany at 31 January 20X3 amounted to $284,700.

The following items were included at cost in the total:

1- 400 coats, which had cost $80 each and normally sold for $150 each. Owing to defect in manufacture, they were all sold after the reporting date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.

2- 800 skirts, which had cost $20 each. These too were found to be defective. Remedial work in February 20X3 cost $5 per skirt and selling expenses for the batched totaled $800. They were sold for $28 each.

What should the inventory value be according to IAS 2 Inventories after considering the above items?

A. $281,000

B. $282,800

C.$329,200

D.None of these

4.1 Determining the purchase cost

There are several methods which are used in practice.

- First In First Out (FIFO)
- Average Cost Method (Periodic AVCO and Perpetual AVCO)
- Last In First Out

IAS 2 Inventories does not permit the use of LIFO.

First In First Out (FIFO)

FIFO assumes that materials are **issued out of inventory in the order in which they were delivered into inventory**, i.e. issues are priced at the cost of the earliest delivery remaining in inventory.

Test Your Understanding (3)

A company values its inventory using the first in first out (FIFO) method. At 1 May 20X2 the company had 700 engines in inventory, valued at $190 each.

During the year ended 30 April 20X3 the following transactions took place:

20X2	
1 July	Purchased 500 engines at $220 each
1 Nov	Sold 400 engines for $160,000.
20X3	
1 Feb	Purchased 300 engines at $230 each.
15 April	Sold 250 engines for $125,000.

What is the value of the company's closing inventory of engines at 30 April 20X3?

A. $188,500

B. $195,500

C.$166,000

D.None of these figure

Test Your Understanding (4)

An inventory card shows the following details.

February	1	50 units in stock at a cost of $40 per unit
	7	100 units purchased at a cost of $45 per unit
	14	80 units sold
	21	50 units purchased at a cost of $50 per unit
	28	60 units sold

What is the value of inventory at 28 Feb using the FIFO method?

A. $2,450 B. $2,700 C. $2,950

D. $3,000

Average cost Method

The **cumulative or continuous weighted** average pricing method calculates a **weighted average price for all units** in inventory. Is**sues** are priced at this **average cost**, and the balance of **inventory remaining would have the same unit valuation.**

Test Your Understanding (5)

The information below relates to inventory item Z.

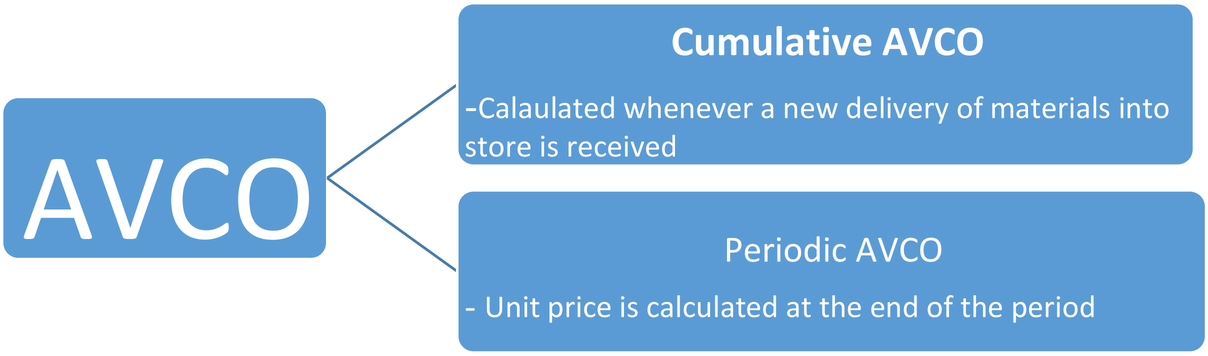
March	1	50 units held in opening inventory at a cost of $40 per unit
	17	50 units purchase at a cost of $50 per unit
	31	60 units sold at a selling price of $100 per unit

Under AVCO, what is the value of inventory held for item Z at the end of March 31?

A. $4,000

B. $1,800

C. $2,000
D. $2,500



Question (8)

On 1 November 20X2, a company held 300 units of finished goods items No9639 in inventory. These were valued at $12 each. During November 20X2 three batches of finished goods were received into the store from the production department, as follows.

Date	Unit Received	Production Cost per unit
10 Nov	400	$12.50
20 Nov	400	$14
25 Nov	400	$15

Goods sold out of inventory during November were as follows.

Date	Units sold	Sale price per unit
14 Nov	500	$20
21 Nov	500	$20
28 Nov	100	$20

What was the profit from selling inventory item 9639 in Nov 20X2, applying the following principles of the inventory valuation?

a) FIFO (b) AVCO (using cumulated AVCO)

5 IAS 2 Inventories

5.1 Scope

IAS 2 Inventories lays out the ***required accounting treatment for inventories*** under International Financial Reporting Standards.

The followings items are ***excluded*** from the scope of the standard.

- ❖ Working in progress under construction contracts (IAS 11-Construction Contracts)
- ❖ Financial instruments (Shares, Bonds)
- ❖ Livestock, agricultural and forest product, and mineral ores

Definitions

The standard gives the following important definitions.

Inventories

Inventories are assets:

- Held for sale in the ordinary course of business
- In the process of production for such sales; or
- in the form of materials or supplies to be consumed in the production processes or in the rendering of business
  (Goods purchased held for resale, finished goods produced, Work in progress (WIP) and Raw materials)

Net Realizable Value (NRV)

It is the **estimated selling price** in the ordinary course of business **less** *the estimated costs of completion and the estimated costs necessary to make the sale*.

5.2 Measurement of inventories

Inventories should be measured at the lower of cost and net realizable value.

5.3 Cost of Inventories

The cost of inventories will consist of all of the following costs

- Costs of purchase
- Cost of conversion
- Other costs incurred in bringing the inventories to their present location and condition

5.3.1 Cost of purchase

- Purchase price less any trade discounts, rebates and other similar discounts
- Import taxes and other taxes (irrecoverable)
- Directly attributable cost of transport, handling and other costs

5.3.2 Cost of conversion

Cost of conversion of inventories consist of **two main parts.**

- Costs directly related to the units of production, e.g direct material and direct labour
- Fixed and variable production overheads that are incurred in converting materials into finished goods, allocated on a systematic basis.

The fixed production overhead must be allocated to items of inventory on the basis of normal capacity of the production facilities.

5.3.3 Other costs

Any other costs should **only be recognized** if they are **incurred in bringing** the inventories to their present location and condition.

The following cost would **not be included in costs of inventories and recognized as an expenses** in the period they are incurred.

- **Adnormal amount** of wasted materials, labor or other production costs
- **Storage costs**, unless those costs are necessary in the production process before a further production stages
- **Administrative overheads that** do not contribute to bringing inventories
- **Selling costs**

Test Your Understanding (6)

What is included in the cost of purchase of inventories according to IAS -2?

A. Purchase price less trade discount

B. Purchase price plus transport cost less trade discount

C. Purchase price less import duties less trade discount

D. Purchase price plus import duties plus transport cost less trade discount

Test Your Understanding (7)

Which of the following costs may be included when arriving at the cost of finished goods inventory for inclusion in the financial statements of a manufacturing company?

1 Carriage inwards

2 Carriage outwards

3 Depreciation of factory plant

4 Finished goods storage costs

5 Factory supervisor wages

A. 1 and 5 only

B. 2, 4 and 5 only

C. 1,3 and 5 only

D. 1, 2, 3 and 4 only

Question (10)

You are the accountant at Water Pumps Co, and you have been asked to calculate the valuation of the company's inventory at cost at its year end of 30 April 20X5.

Water Pumps manufactures a range of pumps. The pumps are assembled from components bought by Water Pumps (the company does not manufacture any parts).

The company does not use a standard costing system, and WIP and finished goods are valued as follows.

a) Material costs are determined from the product specification, which lists the components required to make a pump.

b) The company produces a range of pumps. Employees record the hour spent on assembling each type of pump; this information is input into the payroll system which prints the total hour spent each week assembling each type of pump. All employees assembling pumps are paid at the same rate and there is no overtime.

c) Overheads are added to the inventory value in accordance with **IAS 2 Inventories.** The financial accounting records are used to determine the overhead cost, and this is applied as a percentage based on the direct labor cost.

For direct labour cost you have agreed that the labour expended for a unit in WIP is half that of a completed unit.

The draft accounts shows the following materials and direct labour costs in inventory.

	Raw materials	WIP	Finished Goods
	$	$	$
Materials	74,786	85,692	152,693
Direct labour		13,072	46,584

The costs incurred in April, as recorded in the financial accounting records, were as follow.

	$
Direct labour	61.320
Selling costs	43,550
Depreciation and finance costs of production machines	4,490
Distribution costs	6,570
Factory manager's wages	2,560
Other production overheads	24,820
Purchasing and accounting costs relating to production	5,450
Other accounting costs	7,130
Other administration costs	24,770

For your calculations assume that all WIP and finished goods were produced in April 20X5 and that the company was operating at a normal level of activity.

Required

Calculate the value of overheads which should be added to WIP and finished goods in accordance with **IAS 2 Inventories.**

5.5 Net Realizable Value (NRV)

The principal situations in which NRV is likely to be less than cost,

a) An increase in cost or a fall in selling price

b) A physical deterioration in the condition of inventory

c) Obsolescence of product

d) A decision as part of the company's marketing strategy to manufacture and sell products at a loss

e) Errors in production or purchasing

A written down of inventories would normally take place **on an item-by-item basis, but similar or related items may be grouped together.**

Test Your Understanding (8)

S sell three products – Basic, Super and Luxury. The following information was available at the year end.

	Basic $ Per unit	Super $ Per unit	Luxury $ Per unit
Original cost	**6**	**9**	**18**
Estimated selling price	**9**	**12**	**15**
Selling and Distribution costs	**1**	**4**	**5**
Unit of inventory	**200 units**	**250 units**	**150 units**

What is the value of inventory at the year end?

A. $4,200

B. $4,700

C. $5,700

D. $6,150

5.6 Recognition as an expenses

The following treatment is required **when inventories are sold:**

a) The carrying number of inventories shall be recognized as an expense in the period in which the related revenue is recognized.

b) The amount of any written down of inventories to net realizable value and all losses of inventories shall be recognized as an expense.

c) The amount of any reversal of any write down of inventories, arising from an increase in net reliable value, shall be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reveal occurs.

5.6 Disclosure

Disclosure in the financial statements include the following:

- The accounting policies adopted in measuring inventories, including the cost formula is used.

- The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity.
- The carrying amount of inventories carried at fair value less costs to sell (NRV)

Test Your Understanding (9)

Which of the following statements about the valuation of inventory are correct, according to IAS-2 Inventories?

1. Inventory item are normally to be valued at the higher of cost and net realizable value.
2. The cost of goods manufactured by an entity will include materials and labor only. Overhead costs cannot be included.
3. LIFO (Last In, First Out) cannot be used to value inventory.
4. Selling price less estimated profit margin may be used to arrive at cost if this gives a reasonable approximation to actual cost.

   A- 1, 3 and 4 only

   B- 1 and 2 only

   C- 3 and 4 only

   D- None of the statements are correct

Test Your Understanding (10)

A company with an accounting date of 31 October carried out a physical check of inventory on 4 Nov 20X3, leading to an inventory value at cost at this date of $483,700.
Between 1 Nov 20x3 and 4 Nov 20X3 the following transactions took place:

1. Goods costing $30,400 were received from suppliers.
2. Goods that had cost of $14,800 were sold for $20,000.
3. A customer returned, in good condition, some goods which had been sold to him in Oct for $600 and which had cost $400.
4. The company returned goods that had cost $1,800 in Oct to supplier and received a credit note from them.

What figure should appear in the company financial statements at 31 Oct 20X3 for closing inventory, based on this information?

   A- $458,700

   B- $505,900

   C- $508,700

   D- $461,500

Test Your Understanding (11)

In preparing its financial statements for the current year, a company's closing inventory was understated by $300,000.
What will be the effect of this error if it remains uncorrected?

A- The current year's profit will be overstated and next year's profit will be understated.

B- The current year's profit will understated but there will be no effect on next year's profit.

C- The current year's profit will be understated and next year's profit will be overstated.

D- The current year's profit will be overstated but there will be no effect on the next year's profit.

Test Your Understanding (12)

The final year of Mitex Co ended on 31 Dec 20X1. An inventory count on Jan 4 20X2 gave a total inventory value of $527,300.

The following transactions occurred between January 1 And January 4

Purchase of goods	$7,900
Sales of goods (gross profit margin 40% on sales)	$15,000
Goods returned to a supplier	$800

What inventory value should be included in Mitex Co's financial statements at 31 December 20X1? A- $525,400

B- $527,600

C- $529,200

D- $535,200

Test Your Understanding (13)

Which of the following statements about IAS 2 Inventories is correct?

A- Production overheads should be included in cost on the basis of a company's normal level of activity in the period.

B- In arriving at the cost of purchase of inventories, trade discount received and settlement discount received must be deducted.

C- In arriving at the cost of inventories, FIFO, LIFO and weighted average cost formula are acceptable.

D- It is permitted to value finished goods inventories at material s plus labour cost only, without adding production overheads.

Test Your Understanding (14)

You are preparing the financial statements for a business. The cost of the items i closing inventory is $41,875. This includes some items which cost $1,960 and which were damaged in transit. You have estimated that it will cost $360 to repair the items, and they can then be sold for $1,200. What is the correct inventory valuation for inclusion in the financial statements?

A- $39,915

B- $40,755

C- $41,515

D- $42,995

Test Your Understanding (15)

IAS 2 inventories ***defines*** the items that may be included in computing the value of inventory of finished goods manufactured by a business.

Which of the following lists consists only of items which may be included in the statement of financial position value of such inventories, according to IAS 2?

A- Supervisor's wages, carriage inwards, carriage outwards, raw material

B- Raw materials, carriage inwards, costs of storage of finished goods, plant depreciation C- Plant depreciation. Carriage inwards, raw materials, supervisor's wages.

D- Carriage outwards, raw materials, Supervisor wages, plant depreciation

Test Your Understanding (16)

A firm has the following transactions with its product R.

1 January 20X1	Opening inventory: nil
1 February 20X2	Buys 10 units at 300 per unit
11 February 20X1	Buys 12 units at $250 per unit
1 April 20X1	Sells 8 units at $400 per unit
1 August 20X1	Buys 6 units at $200 per unit
1 December 20X1	Sells 12 units at $400 per unit

The firm uses periodic weighted average cost (AVCO) to value its inventory. What is the inventory value at the end of the end of the year?

A- $nil

B- $2,057.12

C- $2,400.00

D- $2,007.20

Test Your Understanding (17)

A company has decided to switch from using the FIFO method of inventory valuation to using the average cost method (AVCO).

In the first accounting period where the change is made, opening inventory valued by the FIFO method was $53,200. Closing inventory valued by AVCO method was $59,800.

Total purchase and during the period were $136,500. Using continuous AVCO method, opening inventory would have been valued at %56,200.

What is the cost of materials that should be included in the statement of profit or loss for the period? A- $129,900

B- $132,900

C- $135,900

D- $140,100

Test Your Understanding (18)

The closing inventory of X amounted to $116,400 **excluding** the following two inventory lines: 400 items which had cost $4 each. All were sold after the reporting period for $3 each, with selling expenses of $200 for the batch.

200 different items which has cost of $30 each. These items were found to be defective at the end of the reporting period. Rectification work after the statement of financial position

amounted to $1,200, after which they were sold for $35each, with the selling expenses totaling $300.
Which of the following total figure should appear in the statement of financial position of X for inventory?

A- $122,300

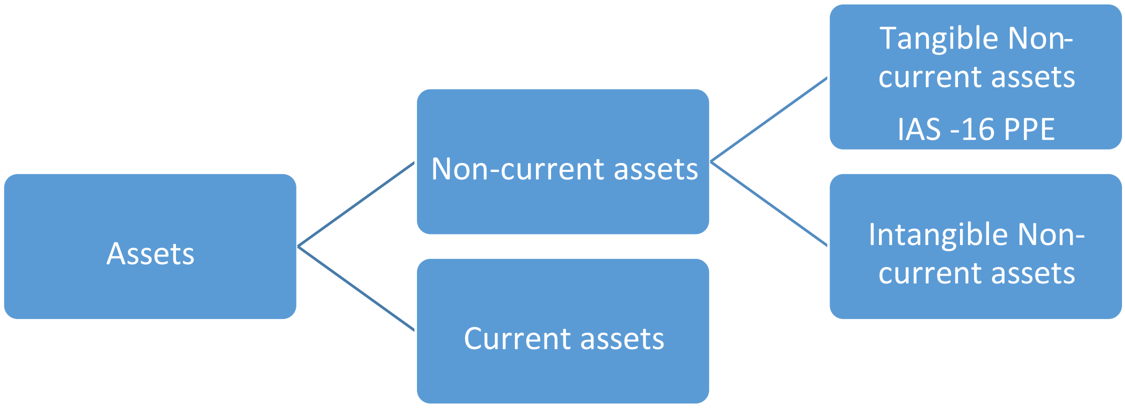
B- $121,900

C- $122,900

D- $123,300

Chapter (8)
Tangible Non-current Assets

1 Non-current assets and current assets



Non-current Assets

Non-current assets are assets that are brought by the business for use in the long term and which are intended to use by the business on a continuing basis and include both tangible and intangible assets.

Tangible Non-current Assets

Tangible non-current assets are those with physical form. (e.g Property, Plants and equipment)

Intangible Non-current Assets

Intangible non-current assets are those without physical form. (e.g Development cost, License, Patents)

Current Assets

Current assets are assets that will be realized, consumed or sold in the normal operating cycle of the business or are assets held primarily for trading. They include trade receivables and inventories.

Test Your Understanding (1)

Which one of the following statements correctly defines non-current assets?

A. Assets that are held for use in the production of goods or services and are expected to be used during more than one accounting period

B. Assets which are intended to be used by the business on a continuing basis, including both tangible and intangible assets that do not meet IASB definition of a current asset

C. Non-monetary assets without physical substance that are controlled by entity and from which future benefits are expected to flow

D. Assets in the form of materials or supplies to be consumed in the production process

2 Capital and revenue expenditure

Capital Expenditure	Revenue Expenditure
• the acquisition of non-current assets • improvement to existing noncurrent assets • Recognition as non-current assets in SOFP	• to maintain the existing capacity of non-current assets • for the purpose of the trade of the business • Recognition as an expenses (selling and distribution, Administration) in SOPL.

2.2 Example

A business purchases a building for $30,000. It then adds an extension to the building at a cost of $10,000. The building needs to have a few broken windows mended, its floors polished and some missing roof tiles replaced. The cleaning and maintenance job cost $900.

Distinguish between the capital expenditure and revenue expenditure.

2.3 Capital income and revenue income

Capital income

- proceeds from the sales of non-trading assets (non-current assets including long-term investment)
- E.g. proceeds from sales of machinery and vehicles which it no longer needs

Revenue income

- the sale of trading assets such as inventory
- the provision of services
- interest and dividend received from investments held by the business

➢ **The above transaction are reported in SOPL.**

2.4 Capital transaction

- Raising additional capital from owner(s) of the business
- Raising and Repaying Loans

❖ **None of these transactions would be reported through the statement of profit or loss.**

2.5 Question

State whether each of the following items should be classified as "capital" or "revenue" expenditure or income for the purposes of preparing the statement of profit or loss and the statement of financial position of the business.

A. The purchase of a property (e.g an office building)

B. The annual depreciation of such a property

C. Solicitor's fees in connection with the purchase of such property

D. The costs of adding extra storage capacity to a computer used by the business

E. Computer repair and maintenance costs

F. Profit on sale of an office building

G. Revenue from sale of an office buildings

H. The cost of new plant

I. Custom duty charged on the plant when imported into the country

J. The carriage costs of transporting the new plant form the supplier's factory to the premises of the business purchasing the plant.

K. The cost of installing the new plant in the premises of the business

L. The wages of the machine operators.

3 IAS 16 Property, Plants and Equipment

Objectives

IAS-16 Property, Plants and equipment stated that the accounting treatment of tangible noncurrent assets.

3.1 Definitions

Property plants and equipment

They are tangible items that:

-are held for **use** in the production or supply of goods or services, for rental to others, or for administrative purposes; and

- are expected to be used **during more than one period.**

Cost

The amount of cash or cash equivalent paid or the fair value of other consideration given to acquire an asset **at the time of its acquisition or construction**.

Fair Value

The amount for which an asset can be **exchanged between knowledgeable, willing parties** in an arm's length transaction.

Carrying Amount

The amount at which an asset is recognized **after deducting any accumulated depreciation and impairment losses**.

3.2 Recognition in the accounts

The recognition of PPE depend on ***two criteria.***

1. It is **probable** that future economic benefits associated with the asset will flow to the entity.
2. **The cost of the assets** to the entity can be **measured reliably**.

3.3 Initial Measurement

Property, Plants and equipment will initially be **measured at cost**.

3.4 Components of cost

- **Purchase price including** any import duties paid, but **excluding** any trade discount and sale tax paid
- Initial **estimate of the costs of dismantling and removing** the item and restoring the site on which it is located

- Directly attributable costs of bringing the assets to **working condition** for its intended use.
  - Site preparation (leveling the floor of factory)
  - Initial delivery and handling costs
  - Installation and assembly costs
  - Professional fees (Lawyers, architects, engineers)
  - Costs of testing whether the asset is working properly, after deducting the net proceeds from selling samples produced when testing equipment
  - Staff cost arising directly from the construction or acquisition of the assets.

Recognized as an expense

- Expenses of operations that are incidental to the construction or development of the item
- Administration and other general overheads
- Start-up and similar pre-production cost
- Initial operating losses before the assets reaches planned performances
- Staff training costs
- Maintenance contracts purchased with the asset

3.5 Subsequent Expenditure

Subsequent expenditure is added to the carrying amount of the asset, but only when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset will flow to the enterprise.

-Improvement the condition of the asset beyond the previous performance

Examples

- Modification of an item of plant to extend its useful life, including increased capacity
- Upgrade of machine parts to improve the quality of output
- Adoption of a new production process leading to large reductions in operating costs

Test Your Understanding (2)

W bought a new printing machine. The cost of the machine was $80,000. The installation costs were $5,000 and the employees received training on how to use the machine, at a cost of $2,000. Before using the machine to print customers' orders, a test was undertaken and the paper and ink cost of $1,000.

What should be the cost of the machine in the company's statement of financial position?

A. $80,000

B. $85,000

C. $86,000

D. $88,000

4 Depreciation Accounting

4.1 What is depreciation?

The need to depreciate non-current assets arises from the **accruals assumption.** Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. Depreciation is a means of spreading the cost of a non-current asset over its useful life in order **to match the cost of the asset with the entity's consumption of the asset's economic benefits.**

Test Your Understanding (3)

Which of the following statements regarding depreciation is correct? A. All non-current assets must be depreciated.

B. Straight line depreciation is usually the most appropriate method of depreciation.

C. A change on the chosen depreciation method is accounted for retrospectively, with all previous depreciation charges reversed and recalculated.

D. Depreciation charges must be based on the carrying amount of an asset (less residual value if appropriate)

Test Your Understanding (4)

What is the purpose of charging depreciation in financial statements?

A. To allocate the cost of a non-current asset over the accounting periods expected to benefit from its use

B. To ensure that funds are available for the eventual replacement of the asset

C. To reduce the cost of the asset in the statement of financial position to its estimated market value.

D. To account for the 'wearing out' of the asset over its life

Two Common Misconception about the purpose and effect of depreciation

- To reflect the fall in value of an assets over its life
- To replace an asset at the end of its useful life

4.2 Requirement of IAS 16 for depreciation

IAS 16 requires the **depreciable amount** to be allocated on **a systematic basis** to each of accounting period during the **useful life** of the asset.

Depreciable amount

It is the cost of an asset or other amount substituted for historical cost, less its estimated residual value.

4.3 Useful Life

Useful life either:

- The period over which an asset is expected to be available for use by an entity or
- The number of production or similar units expected to be obtained from the asset by an entity

The following factors should be considered when estimating the useful life of a depreciable asset

- Expected usage
- Expected physical wear and tear
- Obsolescence
- Legal or other limits on the use of the assets

The useful life should be reviewed at least each financial year-end.

4.4 Residual Value

The residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal if the asset were already of the age and in the condition expected at the end of its useful life.

4.5 Depreciation Method

- Straight Line Method
- Reducing Balance Method

4.6 Straight Line Method

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

$$Annual\ Depreciation\ Expenses = \frac{\text{Original cost}-\text{Residual Value}}{\text{Useful life}}$$

4.7 Example

a) A non-current asset costing $20,000 with an estimated life of 10 years and no residual value. Calculate the annual depreciation charge.

b) A non-current asset costing $60,000 has an estimated life of 5 years and a residual value of $7,000. Calculate the annual depreciation charge by using the straight-line method.

4.8 Example

A business which has an accounting year that runs from 1 Jan to 31 Dec, purchase a new noncurrent asset on 1 April 20X1, at a cost of $24,000. The expected life of the asset is 4 years, and it residual value is nil. What should the depreciation charge for 20X1 be?

4.9 The Reducing Balance Method

The **reducing balance method** of depreciation calculates the annual depreciation charge as a fixed percentage of the carrying amount of the asset, as at the end of the previous accounting period.

4.10 Example

A business purchases a non-current asset at a cost of $10,000. Its estimated residual value is $2,160. The business wishes to use the reducing balance method to depreciate the asset and calculates that the rate of depreciation should be 40% of the carrying amount of an asset.

Question 1

A lorry bought for a business cost of $17,000. It is expected to last for 5 years and then be sold for scrap $2,000.

Required

Work out the depreciation to be charged each year under:

A. The straight line method

B. The reducing balance method

4.11 Change in method of depreciation

Once the decision has been made, the chosen method of depreciation should be applied consistently ***from year to year.*** However, IAS 16 requires that the depreciation method should be reviewed at least each financial year end. If there has been a significant **change in the expected pattern of economic benefits** from those assets**, the method should be changed** to suit this new pattern.

Change in depreciation method effect the current and future period, i.**e prospective application**.

4.12 Example

Jakob Co purchased an asset for $100,000 on 1.1.X1. It has an estimated useful life of 5 years, and it was depreciating using the reducing balance method at a rate of 40%. On 1.1.X3 it was decided to change the method to straight line.

Show the depreciation charge for each year to 31 Dec of the assets' life.

4.13 Ledger entries for depreciation

Depreciation Expense A/C	Debit (SOPL)
Accumulated Depreciation A/C	Credit (SOFP)

4.14 Example

Brian Box prospers in his computer software business, and before long he purchases a car for himself, and later for his chief assistant Bill Ockhead. Relevant data is as follows,

	Purchase date	Cost	Life	Residual Value
Brian Box Car	1 June 20X6	$20,000	3years	$2,000
Bill Ockhead Car	1 June 20X7	$8,000	3years	$2,000

The straight-line method is to be used.

a) Prepare the motor Vehicles account and Motor Vehicle Accumulated Depreciation A/C for the years to 28 Feb 20X7 and 20X8.

b) Calculate the carrying amount of the motor Vehicles as at 28 Feb 20X8.

5 Revaluation of Non-current assets

IAS 16 allows entities to choose between keeping an asset **recorded at cost** or revaluing **it to fair value**.

IAS 16 requires that when an item of property, plants and equipment is revalued**, the whole class of assets** to which it belongs should be revalued.

A **class of assets** is simply a group of assets of similar nature and use – eg Land and building, Machinery, motor vehicles, fixture and fittings.

When non-current assets are revalued, depreciation should be charged **on the revalued amount.**

Excess Depreciation

The difference between the new depreciation charge based on the revalued carrying amount and the old depreciation charge on the revalued carrying amount is known as **"excess depreciation"**

IAS 16 allows entities **to transfer** an amount equal to the excess depreciation **from revaluation surplus to retained earnings** in the equity section of the statement of financial position, if they wish to do so. It will be shown in **statement of changes in equity.**

Test Your Understanding (6)

Which of the following statements regarding non-current asset accounting is **correct?**

A. All non-current assets should be revalued each year.

B. Non-current assets may be revalued at the discretion of management. Once revaluation has occurred it may be repeated regularly for all non-current asset in a class.

C. Management can choose which non-current assets in a class of non-current assets should be revalued.

D. Non-current assets should only be revalued to reflect the rising price.

5.1 Example

When Ira Van commenced trading as a car hire dealer on 1 Jan 20X1, he purchased business premises at a cost of $50,000.

For the purpose of accounting for depreciation, he decided the following.

a) The land part of the business premises was worth $20,000; this would not be depreciated.

b) The building part of the business premises was worth the remaining $30,000. This would be depreciated by the straight-line method to a nil residual value over 30 years.

After 5 years of trading, on 1 Jan 20X6 Ira decides that his business premises are now worth $150,000, divided into:

	$
Land	75,000
Building	75,000

Required

a) Calculate the annual charge for depreciation for the first five year of the building life and the statement of financial position value of the land and building as at the end of each of first five year.

b) Demonstrate the impact of the revaluation will have on depreciation charge and the statement of financial position value of the land and building. (Revaluation Surplus, Depreciation charge after Depreciation and Excess Depreciation)

Test Your Understanding (7)

A company bought a property four years ago on 1 January for $170,000. Since then property prices have risen substantially and the property has been revalued at $210,000.

The property was estimated as having a useful life of 20 years when it was purchased. What is the balance on the revaluation surplus reported in the statement of financial position?

A. $210,000

B. $136,000

C. $74,000

D. $34,000

Test Your Understanding (8)

Gusna Co purchased a building on 31 Dec 20X1 for $750,000. At the date of acquisition, the useful life of the building was estimated to be 25 years and depreciation is calculated using the straight line method. At 31 December 20X6, an independent valuer valued the building at $1,000,000 and the revaluation was recognized in the financial statements. Gusna's accounting policies state that excess depreciation arising on revaluation of non-current assets can be transferred from the revaluation surplus to retained earning?

What is the depreciation charge on the building for the year ended 31 December 20X7?

A. $40,000

B. $50,000

C. $30,000

D. $42,500

What is the journal entry to record the transfer of excess depreciation from the revaluation surplus to retained earnings?

A- Dr Revaluation surplus	$20,000	
Cr Retained earnings		$20,000
B- Dr Revaluation surplus	$12,500	
Cr Retained earnings		$12,500
C- Dr Retained earnings	$20,000	
Cr Revaluation Surplus		$20,000
D- Dr Revaluation surplus	$12,500	
Cr Retained Earnings		$12,500

5.2 Revaluation Upwards and Downwards

Gain on revaluation should be credited to other comprehensive income and accumulated in equity under the heading of "revaluation surplus" unless it represents the reversal of a revaluation decrease of the same asset previously recognized as an expense, in which case it should be recognized as income.

Loss on revaluation should be recognized as an expense to the extent that it exceeds any amount previously credited to the revaluation surplus relating to the same asset.

When a revalued asset is disposed of, any revaluation surplus may be transferred directly to the retained earnings, or the profit would be realized and could be taken to the statement of profit or loss.

6 Non- current asset disposal

Assets is permanently withdrawn from use, or sold, or scrapped and no future economic benefits.

Gain or losses on the disposal of non-current asset is the difference between:

	$
Net Proceeds (Gross proceed – disposal costs)	***
(-) Carrying amount at disposal date	(***)
Gain or loss on disposal	***

6.1 Example

A business purchased a non-current asset on 1 Jan 20X1 for $25,000. It had an estimated useful life of 6 years and the estimated residual value of $7,000. The assets were eventually sold after 3 years on 1 Jan 20X4 to another trader who paid $17,500 for it.

What was the profit or loss on disposal, assuming that the business uses the straight-line method for depreciation?

6.2 Example

A business purchased a machine on 1 July 20X1 at a cost of $35,000. The machine has an estimated residual value of $3,000 and a life of 8 years. The machine was sold for $18,600 on 31 Dec 20X4, the last day of the accounting year of the business. To make the sale, the business had to incur dismantling costs and costs of transporting the machine to the buyer's premises. These amounted to be $1,200. The business uses the straight-line method for depreciation.

What was the profit or loss on the disposal of the machine?

Test Your Understanding (9)

A non-current asset (cost $10,000, depreciation $7500) is given in part exchange for a new asset costing $20,500. The agreed trade in value was $3,500. Which of the following will the statement of profit or loss include?

A. A loss on disposal of $1,000

B. A profit on disposal of $1,000

C. A loss on purchase of new asset $3,500

D. A profit on disposal of $3,500

6.3 Example: Disposal of asset: Ledger accounting entries

A business includes $110,000 worth of machinery at cost in its accounts. Its policy is to depreciate plant and machinery at 20% per annum straight line. The total accumulated depreciation now stands $70,000. The business sells for $19,000 a machine which it purchased exactly 2 years ago for $30,000. **Show the relevant ledger entries.**

6.3 Example: Disposal of asset: Ledger accounting entries

A business purchased two rivet-making machines on 1 January 20X5 at a cost of $15,000 each. Each had an estimated life of five years and a nil residual value. The straight-line method of depreciation is used.

Owing to an unforeseen slump in market demand for rivets, the business decided to reduce its output of rivets and switch to making other product instead. On 31 March 20X7, one rivet –making machine was sold (on credit) to a buyer for $8,000.

Later in the year, however, it was abandoned production of rivets together, and the second machine was sold on 1 Dec 20X7 for $2,500 cash.

Prepare the machinery account, depreciation of machinery account and disposal of machinery account for the accounting year to 31 Dec 20X7.

Test Your Understanding (10)

Alpha sells machine B for $50,000 cash on 30 April 20X4. Machine B cost $100,000 when it was purchased and has a carrying amount of $65,000 at the date of disposal. What are the journal entries to record the disposal of machine B?

A- Dr Accumulated depreciation	$35,000	
Dr Loss on disposal (SPL)	$15,000	
Dr Cash	$50,000	
Cr Non-current asset-cost		$100,000
B- Dr Accumulated Depreciation	$65,000	
Cr Loss on disposal	$35,000	
Cr Non-current asset-cost		$100,000
C- Dr Accumulated depreciation	$35,000	
Dr Cash	$50,000	
Cr Non-current assets		$65,000
Cr Profit on disposal (SPL)		$20,000
D- Dr Non-current assets	$65,000	
Dr Accumulated depreciation	$35,000	
Cr Cash	$50,000	
Cr Profit on disposal (SPL)		$50,000

7 Disclosure in Financial statements

The disclosure requirements in IAS 16 are extensive and include both numerical and narrative disclosure.

The financial statements should show a reconciliation of the carrying amount of non-current assets at the beginning and end of the period. The reconciliation should show the movement of the non-current assets balance and include the following.

- Addition
- Disposals
- Increase or decrease from revaluation
- Reductions in carrying amount
- Depreciation
- Any other movement

The financial statement should disclose the following

a) An accounting policy (measurement bases)

b) For each class of PPE

   - Depreciation method used
   - Useful life or depreciation rate
   - Gross mount of depreciable assets and the related accumulate depreciation at the beginning and end of the period

c) For revalued assets

   - Effective date of revaluation
   - Whether independent valuer was involved
   - Carrying amount of each class of PPE
   - Revaluation surplus

8 The Asset register

An assets register is used to record of all non-current assets and is an internal check on the accuracy of the nominal ledger. The asset register lists out all details of each non-current asset that is owned by the business. Most businesses will keep an asset register.

8.1 Data kept in the asset register

- The internal reference number (for physical identification purposes)
- Manufacturer's serial number (for maintenance purposes)
- Description of asset
- Location of asset
- Department which owns asset

- Purchase date (for calculation of depreciation)
- Cost
- Depreciation method and estimated useful life
- Carrying amount

8.2 Purpose of the asset register

The assets register is separate from the nominal ledger and contains much more detail about the assets owned by the business. Its main use is an internal control to make sure that the information contained in the nominal ledger is accurate and correct.

Non-current asset at cost (from general ledger)	***
Accumulated Depreciation (from general ledger)	(***)
Carrying amount	***

Any difference should be investigated and corrected. Difference usually arises from computational errors because

- Assets have been stolen, damaged or scrapped (for nil proceeds)
- Assets are obsolete
- There are new assets, not yet recorded in the register There are error in register, vice visa.

Therefore, all physical non-current assets should be checked to the asset register. This helps to deter theft and ensures that all items are accounted for.

Test Your Understanding (11)

Why might the asset register not reconcile with the non-current assets?

A. Asset stolen or damaged

B. New assets, not yet recorded in the register

C. Errors in the register

D. All of the above

Test Your Understanding (12)

Which of the statements below correctly states the purpose of the asset register?

A. An internal control to ensure the details of all assets are readily available in the event of loss or theft

B. To ensure the organization is aware of the age of plant and machinery

C. An internal control to ensure information relating to non-current assets in the nominal ledger and the financial statements is correct.

D. To enable the organization to comply with IAS 16 Property, plant and equipment

Test Your Understanding (13)

An asset register showed a carrying amount of $67,460. A non-current asset costing $15,000 had been sold for $4,000, making a loss on disposal of $1,250. No entries had been made in the asset register for this disposal.

What is the correct balance on the asset register?

A. $42,710

B. $51,210

C. $53,710

D. $62,210

Test Your Understanding (14)

An organization's asset register shows a carrying amount of $145,600. The non-current asset account in the nominal ledger shows a carrying amount of $135,600. The difference could be due to a disposed asset not having been deducted from the asset register.

Which one of the following could represent that asset?

A. Asset with disposal proceeds of $15,000 and a profit on disposal of $5,000

B. Asset with disposal proceeds of $15,000 and a carrying amount of $5,000

C. Asset with disposal proceeds of $15,000 and a loss on disposal of $5,000

D. Asset with disposal proceeds of $5,000 and a carrying amount of $5,000

Chapter (9)
Intangible Non-current assets

1 Intangible assets

Intangible assets are non-current assets with ***no physical substance***.

- Goodwill
- Intellectual rights (patents, performing rights and authorship rights) -

    Research and development costs

Test your Understanding (1)

According to IAS 38 Intangible assets, which of the following are intangible non-current assets in the financial statement of Lota Co?

1. A patent for a new glue purchased for $20,000 by Lota Co
2. Development cost capitalized in accordance with IAS 38
3. A license to broadcast a television series, purchased by Lota Co for $150,000
4. A state if the art factory purchased by Lota Co for $1.5 million

A. 1 and 3 only

B. 1, 2 and 3 only

C. 2 and 4 only

D. 2, 3 and 4 only

1.1 Accounting Treatment

In accordance with IAS 38 Intangible Assets, intangible assets are **capitalized** in the accounts and **amortized**. **Amortization** is intended to write off the assets over its useful life (under the accruals concept). Amortization is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

$$\boldsymbol{Amortisation} = \frac{\textbf{Cost} - \textbf{Residual value}}{\textbf{Estimated Useful life}}$$

Amortization A/c (SPL)	Debit
Accumulated Amortization A/C (SOFP)	Credit

Example- Patent

A business buys a patent for $50,000. It expects to use the patent for the next ten years, after which it will be valueless.

Calculate the annual Amortization of a patent.

Test your Understanding (2)

PF purchased a quota for carbon dioxide emissions for $15,000 on 30 April 20X6 and capitalized it as an intangible asset in its statement of financial position. PF estimates that quota will have a useful life of three years. What is the journal entry required to record the amortization of quota in the accounts for the year ended 31 December 20X4?

A-	Dr Expense	$15,000	
	Cr Accumulated Amortisarion		$15,000
B-	Dr Expense	$5,000	
	Accumulated Amortisarion		$5000
C-	Dr Intangible assets	$5,000	
	Cr Accumulated Amortisarion		$5,000
D-	Dr Accumulated Amortisation	$15,000	
	Cr Intangible assets		$5,000

Test your Understanding (3)

Theta Co purchased a patent on 31 December 20X3 for $250,000. Theta Co expects to use the patent for ten years, after which it will be valueless. According to IAS 38 Intangible assets, what amount will be amortised in Theta Co's statement of profit or loss and other comprehensive income for the year ended 31 Dec 20X4?

A. $250,000

B. $125,000

C. $25,000

D. $50,000

2 Research and Development

2.1 Definitions

Research

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

Example

- Activities aimed at obtained new knowledge
- The search for the applications of research findings or another knowledge
- The search for product or process alternatives
- The formulation and design of possible new or improved product or process alternatives

Development

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

Example

The design, construction and testing of pre-production prototypes and models
The design of tools, jigs, molds, and dies involving new technology
The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.
The design, construction and testing of a chosen alternative for new/improved materials

Depreciable Amount

It is the cost of an asset, or other amount substituted for cost, less its residual value.

Useful Life

Useful life is the period over which an asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity.

2.2 Components of R&D costs

R&D costs will include all costs that are **directly attributable** to R&D activities, or that can be allocated on **a reasonable basis.**
The following costs which may be included in R&D,

- Salaries, wages and other employment-related costs of personnel engaged in R& D activities
- Costs of materials and services consumed in R&D activities
- Depreciation on PPE that are used for R&D activities
- Overhead costs, other than general administrative costs, related to R&D activities.
- Other costs, such as the amortization of patents and licenses that used for R&D activities

2.3 Recognition of R&R costs

Recognition

- ➢ It is probable that the cost will produce future economic benefits for the entity
- ➢ Where the costs can be measured reliably

Research cost should be recognized as **an expense** in the period in which they are **incurred due to uncertainty** about the resulting benefit from them.

Development expenditure must be recognized as an **intangible asset (Deferred expenditure**) if, an only if, the business can demonstrate that **all criteria in IAS 38 have been met.** If the criteria in **IAS-38 are not satisfied**, development expenditure **must be written off** as **an expense** in the period in which it is incurred.

Recognition Criteria (PIRATE)

- Probable future economic benefits
- Intention to complete the intangible asset and use or sell it
- Resources to complete or sell
- Ability to use or sell
- Technical feasibility of completion for use or sale
- Expenditure are measured reliability

2.4 Amortization of development costs

Once capitalized as an asset, development cost must be **amortized and recognized as an expense** to match the costs with the related revenue or cost savings. (Matching Concept)

The amortization will begin **when an asset is available for use**. Amortization must be **done on a systematic basis to reflect the pattern** in which the related economic benefits are recognized.

The amortization period and amortization method should be reviewed at each financial year end.

If it has a **finite useful life**, it should then be **amortized** over that life.

If the intangible asset is considered to have **an indefinite useful life**, it should **not be amortized** but should be subjected to **an annual impairment review.**

Test your Understanding (4)

What is the purpose of amortization?

A. To allocate the cost of an intangible non-current assets over its useful life

B. To ensure that funds are available for the eventual purchase of a replacement noncurrent asset

C. To reduce the cost of an intangible non-current asset in the statement of financial position to its estimated market value

D. To account for the risk associated with intangible assets

Test your Understanding (5)

According to IAS 38 intangible assets, which of the following statements are correct?

Research expenditure should not be capitalized.

Intangible assets are never amortized.

Development expenditure must be capitalized if certain conditions are met.

A. 1 and 3 only

B. 1 and 2 only

C.2 and 3 only

D. All three statement are correct

Test your Understanding (6)

According to IAS 38 *Intangible assets*, which of the following statements about research and development expenditure are correct?

1. Research expenditure, other than capital expenditure on research facilities, should be recognized as an expense as incurred.
2. In deciding whether development expenditure qualifies to be recognized as an asset, it is necessary to consider whether there will be adequate finance available to complete the project.
3. Development expenditure recognized as an asset must be amortized over a period not exceeding five years.

A. 1, 2, and 3

B. 1 and 2 only

C. 1 and 3 only

D. 2 and 3 only

Test your Understanding (7)

According to IAS 38 *Intangible assets*, which of the following statements about research and development expenditure are correct?

1. If the certain criteria are met, an entity may decide to capitalize development expenditure.
2. Research expenditure, other than capital expenditure on research facilities, should be recognized as an expense as incurred.
3. Capitalized development expenditure must be amortized over a period not exceeding 5 years.
4. Capitalized development expenditure must be disclosed in the statement of financial position under intangible non-current assets. A. 1, 2 and 4 only

B. 1 and 3 only

C. and 4 only

D. and 4 only

Test your Understanding (8)

According to IAS 38 Intangibles assets, which of the following statement is/ are correct?

1. Capitalized development expenditure must be amortized over a period not exceeding five years
2. If all the conditions specified in IAS 38 are met, development expenditure may be capitalized if the directors to do so.

3. Capitalized development costs are shown in the statement of financial position under the heading of non-current assets.
4. Amortization of capitalized development expenditure will appear as an item in the company's statement of changes in equity.
   A. 3 only
   B. 2 and 3
   C. 1 and 4
   D. 1 and 3

Test your Understanding (9)

According to IAS 38 Intangible assets, which of the following statements about intangible assets are correct?

1. If certain criteria are met, research expenditure must be recognized as an intangible asset.
2. If certain criteria are met, development expenditure must be capitalized.
3. Intangible assets must be amortized if they have a definite useful life.

A. 2 and 3 only

B. 1 and 3 only

C.1 and 2 only

D. All three statements are correct

2.5 Impairment of development costs

The development costs should be written down to the extent that the **unamortized balance is no longer likely to be recovered from the expected future economic benefit.**

3 Disclosure in financial statements

IAS 38 requires both numerical and narrative disclosure for intangible assets.
The reconciliation should show the movement on intangible assets, including:

- ✓ Additions
- ✓ Disposals
- ✓ Reductions in carrying amount
- ✓ Amortization
- ✓ Any other comments

2.6 Question

Y Co is a company which specialize in developing new materials and manufacturing processes for the furniture industry. The company receives payments from a variety of manufacturers, which pay for the right to use the company patented fabrics and processes. R&D costs for the year ended to 30 Sept 20X5 can be analyzed as follows.

	$
Project A New flame- proof padding. Expected to cost a total of $400,000 to complete development. Expected total revenue $2,000,000 once work completed- probably late 20X6. Customers already placed advances orders for the material after seeing demonstrations of its capabilities earlier in the year.	280,000
Project B New color-fast dye. Expected cost a total of $3,000,000 to complete. The dye is being developed as a cheaper replacement for a dye already used in Y Co.'s most successful product; cost saving over $10,000,000 are expected from its use. Although Y has demonstrated that the dye is a viable product, and has an intention to finish developing it, the completion date is currently uncertain because external funding will have to be obtained before the development work can be completed.	150,000
Project C Investigation of new adhesive recently developed in aerospace industry. If this proves effective then Y Co may well generate significant income because it will be used in place of existing adhesive.	110,000

1. **Explain how the three research projects A,B,C will be dealt with In Y Co.'s statement of profit or loss and the statement of financial position.(In each case, explain your proposed treatment in terms of IAS 38 Intangible assets)**

Y Co has the following balances relating to deferred development expenditure at 30 Sept 20X4.

	$
Deferred development expenditure	1,250,000
Amortization	(125,000)
Carrying value	1,125,000

The existing deferred development expenditure is being amortised over ten years on a straight line basis.

Show how these balances and the R&D costs in the previous question will be disclosed in the accounts of Y Co at 30 Sept 20X5. Show the extracts from the:

A. Statement of profit or loss
B. Statement of financial position
C. Notes to the accounts

Test your Understanding (10)

XY Co has development expenditure of $500,000. Its policy is to amortise development expenditureat 2% per annum. Accumulated amortization brought forward is $20,000.

What is the charge in the statement of profit or loss for the year's amortization?

A. $10,000 B. $400

C.$20,000 D. $9,600

What is the amount shown in the statement of financial position for the development expenditure?

A. $500,000 B. $480,000

C. $470,000 D.$490,000

Test your Understanding (11)

The following balances existed in the accounting records of Koppa Co, at 31 Dec 20X7.

	$'000
Development costs capitalized, 1 Jan 20X7	180
Research and development expenditure for the year	162

In preparing the company's statement of profit or loss and other comprehensive income and the statement of financial position at 31 Dec 20X7 the following further information is relevant.

The $180,000 total for development costs as at 1 Jan 20X7 relates to two projects:

	$'000
Project 836: Completed project (Balance being amortized over the period expected to benefit from it. Amount to be amortized in 20X7: $20,000)	82
Project 910: In progress	98
	180

The research and development expenditure for the year is made up of:

	$'000
Research expenditure	103
Development cost on the project 910 which continues to satisfy the requirement In IAS 38 for capitalization	59

Required

What amount should be charged in the statement of profit or loss and other comprehensive income for research and development costs for the year ended 31 Dec 20X7?

What amount should be disclose as an intangible asset in the statement of financial position for the year ended 31 Dec 20X7?

Chapter (10)
Accruals and Prepayments

1 Accruals (Accrued Expenses)

Accruals are expenses which ***relate to the accounting period*** and which are charged against the profit for a particular period, even though they have ***not yet been paid*** for. They are shown in the statement of financial position as ***Liability***.

Double Entry for Accruals or Accrued Expenses

Expenses A/C	: Dr (SOPL- Expenses +)
Accruals A/C	: Cr (SOFP-Current Liability)

Example 1.1

Willie woggle opens a shop on 1 May 20X6 to sell hiking and camping equipment. The rent of the shop is $12,000 per annum, payable quarterly in arrears (with the first payment 31 July 20X6).Willie decides that his accounting period should end on 31 Dec each year. Required

Calculate the rent amount charged to the statement of profit or loss for the year ended 31 Dec 20X6.

Calculate the accrued rental shown in the statement of financial position as at 31 Dec 20X6.

Question -1

Ratsnuffer is a business dealing in pest control. Its owner, Roy Dent, employs a team of 8 who were paid $12,000 per annum each in the year to 31 Dec 20X5. At the start of 20X6 he raised salaries by 10%to $13,200 per annum each.

On 1 July 20X6, he hired a trainee at a salary of $8,400 per annum.

He pays his workforce on the first working day of every month, one month in arrears, so that his employees receive their salary for January on the first working day in February,etc.

Required,

a) Calculate the cost of salaries which would be charged in the statement of profit or loss for the year ended 31 Dec 20X6.

b) Calculate the amount of actually paid in salaries during the year.

c) State the amount of accrued charges for salaries which would appear in the statement of financial position as at 31 Dec 20X6

Test Your Understanding (1)

A company pays rent quarterly in arrears on 1 Jan, 1 April, 1 July and 1 Oct each year. The rent was increased from $90,000 per year to $120,000 per year as from 1 Oct 20X2.

What rent expenses and accrual should be included in the company's financial statements for the year ended 31 January 20X3?

	Rent Expense ($)	Accrual ($)

A. 100,000 20,000

B. 100,000 10,000

C. 97,500 10,000

D. 97,500 20,000

2 Prepayment (Prepaid Expenses)

Prepayments are expenses which have ***already been paid but relate to a future*** accounting period, but should not be charged against profit until a later period, because they relate to the later period. They are shown in the statement of financial position as an **Asset**.

Double Entry for Prepayment or Prepaid Expenses

Prepayment A/C : Dr (SOFP- Current Asset)

Expenses A/C : Cr (SPL- Expenses -)

Example 2.1

The Square Wheels Garage pays fire insurance annually in advance on 1 June each year. The firm's financial year end is 28 February. From the following record of insurance payments

Insurance Payment

1 June 20X6	$600 (for the year to 31 May 20X7)
1 June 20X7	$700 (for the year to 31 May 20X8)

Required

Calculate the charged to statement of profit or loss for the financial year to 28 Feb 20X8.

Calculate the prepayment shown in the statement of financial position as at 28 Feb 20X8.

Test Your Understanding (2)

During 20X4, B, a limited liability company, paid a total of $60,000 for rent, covering the period from 1 Oct 20X3 to 31 March 20X5.

What figure should appear in the company's financial statements for the year ended 31 Dec 20X4?

	Statement of profit or loss	Statement of financial position
A.	$40,000	10,000 prepayment
B.	$40,000	15,000 Prepayment
C.	$50,000	10,000 Accrual
D.	$50,000	15,000 Accrual

3 Accrued Income

Accrued income arises where income has been ***earned in the accounting period but has not yet been received***. In this case, it is necessary ***to record the extra income*** in the statement of profit or loss and create ***a current asset*** in the statement of financial position (called accrued income):

<u>Double entry for Accrued Income</u>

Accrued Income A/C : Dr (SOFP- Current asset)
Income A/C : Cr (SPL – Income +)

4 Advanced Income

Advanced/ Pre-received income (also known as Deferred Income) arises where income has been ***received in the accounting period but which relates to the next accounting period*** (not earned yet). In this case, it is necessary to ***remove the income not relating to the year*** from the statement of profit or loss and create a current liability in the statement of financial position (called advanced income or pre-received income):

<u>Double entry for Advanced Income</u>

Income A/C : Dr (SPL- Income -)
Advanced Income A/C : Cr (SOFP- Current Liabilities)

Example:

A company has sublet part of its offices and in the year ended 30 Nov 20X3 the rent receivable was:

Until 30 June 20X3 $8,400 per year
From 1 July 20X3 $12,000 per year

Rent was paid quarterly in advance on 1 January, April, July, and October each year.

Required:

What amount should appear in the company financial statement for the year ended 30 November20X3.

Test Your Understanding (3)

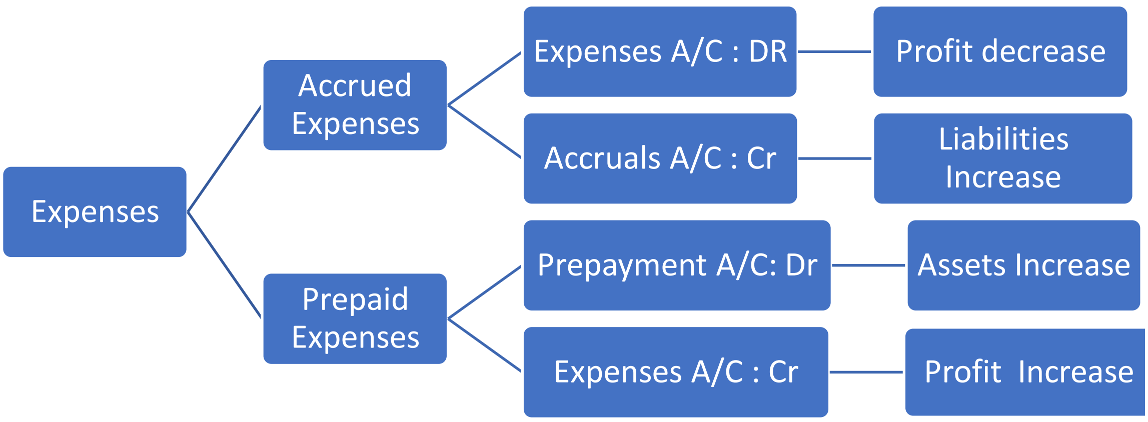
A company receives rent for subletting part of office block.
Rent, receivable quarterly in advance, is received as follows:

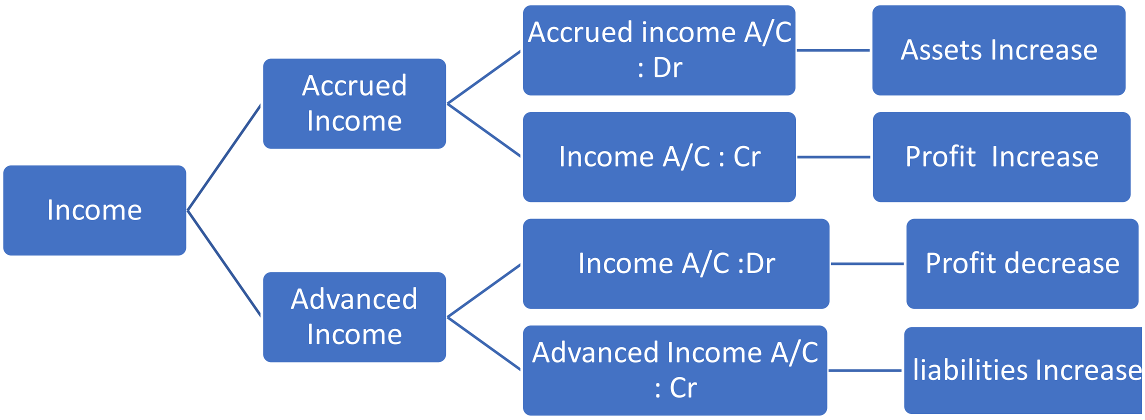
Date of receipt	Period covered	$
1 Oct 20X1	3 Months to 31 Dec 20X1	7,500
30 Dec 20X1	3 Months to 31 March 20X2	7,500
4 April 20X2	3 Months to 30 June 20X2	9,000
1 July 20X2	3 Months to 30 Sept 20X2	9,000
1 Oct 20X2	3 Months to 31 Dec 20X2	9,000

What figure, based on the receipts, should appear in the company's financial statements for the year ended 30 Nov 20X2?

	SOPL	SOFP
A.	$34,000 Debit	Rent in arrear Dr $3,000
B.	$34,500 Credit	Rent received in advance Cr $6,000
C.	$34,000 Credit	Rent received in advance Cr $3,000
D.	$34,000 Credit	Rent in arrear Dr $3,000

4 Effect on Profit and Net Assets





Test Your Understanding (4)

Buster's draft financial statements for the year to 31 Oct 20X5 report a loss of $1,486. When he prepared the financial statements, Buster did not include an accrual of $1,625 and a prepayment of $834.

What is Buster's profit or loss for the year to 31 Oct 20X5 following the inclusion of the accrual and prepayment?

A. A loss of $695
B. A loss of $2,277
C. A loss of $3,945
D. A profit of $1,807

Test Your Understanding (5)

The trainee accountant at Judd Co has forgotten to make an accrual for rent for December in the financial statements for the year ended 31 Dec 20X2. Rent is charged in arrears at the end of Feb,May August and November each year. The bill payable in Feb is expected to be $30,000. Judd Co's draft statement of profit or loss shows a profit of $25,000 and draft statement of financial position shows net assets of $275,000.

What is the profit or loss for the year and what is the net asset position after the accrual has been included in the financial statements?

	Profit for the year	Net asset position
A.	$15,000	$265,000
B	$15,000	$285,000

C. $35,000	$265,000
D. $35,000	$285,000

Test Your Understanding (6)

B, a limited company, receives rent for subletting part of its office premises to a number of tenants. In the year ended 31 Dec 20X4, B received cash of $318,600 from its tenants. Details of rent in advance and in arrears at the beginning and end of 20X4 are as follow:

	31 December 20X4	31 December 20X3
Rent received in Advance	28,400	24,600
Rent owing by tenant	18,300	16,900

All rent owing was subsequently received.

What figure for rental income should be included in the statement of profit or loss of B for 20X4?

A. $341,000

B. $336,000

C. $300,800

D. $316,200

Test Your Understanding (7)

At 31 March 20X2 a company had oil in hand to be used for heating costing $8,200 and unpaid heating oil for $3,600. At 31 March 20X3 the heating oil in hand was $9300 and there was an outstanding heating oil bill of $3,200. Payments made for heating oil during the year ended 31 March 20X3 totaled $34,600.

Based on these figures, what amount should appear in the company's statement of profit or loss and other comprehensive income for heating oil for the year?

A. $23,900

B. $36,100

C. $45,300

D. $33,100

Chapter (11) Provisions and contingencies

1 Provision

- Provision is a liability of uncertain timing or amount.
- Liability is a present obligation of the entity arising from past events, the settlement is an outflow of economic benefits from the entity.

1.1 Recognition criteria

1. Present obligation as a result of past events
2. Probable transfer of future economic benefits to settle obligation
3. Reliable estimate amount of obligation

Obligation □
Legal obligation

- Constructive obligation

Constructive obligation

- According to past practice or published policies, entity has indicated to other parties that it will accept certain responsibilities
- Entity has created valid expectation to other parties that it will discharge those responsibilities

Probable

- Event is more likely than not to occur
- Indicate a probability of more than 50%

1.2 Measurement

- The amount recognized as a provision should be the **best estimate** of the expenditure required to settle the present obligation
- The estimates will be determined by the **judgement** of the entity's management supplemented by the **experience of similar transactions**
- If the provision relates to **just one item**, the best estimate of the expenditure will be the **most likely outcome**.
- When the provision is needed that involves **a lot of items**, then the provision is calculated using **expected value** approach, estimated by **weighting of possible outcomes** by their associated probabilities

Dr Expenses (SOPL) First set up / Increase in Provisions
Cr Provisions (SOFP)

Decrease in Provisions → Dr Provisions (SOFP)
→ Cr Expenses (SOPL)

1.3 Example: provisions

A business has been told by its lawyers that it is likely to have to pay $10,000 damages for a product that failed. The business duly set up a provision at 31 December 20X7. However, the following year, the lawyers found that damages were more likely to be $50,000.

Required
How is the provision treated in the accounts at:

(a) 31 December 20X7?

(b) 31 December 20X8?

1.4 Example *Warranty*

Parker Co sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defect that becomes apparent within the first six months of purchase. The company's past experience and future expectations indicate the following pattern of likely repairs.

%of goods sold	*Defects*	*Cost of repairs if all items suffered from these defects* $m
75	None	-
20	Minor	1.0
5	Major	4.0

What is the provision required?

Test Your Understanding (1)

X Co sells goods with a one-year warranty and had a provision for warranty claims of $64,000 at 31 Dec 20X0. During the year ended 31 Dec 20X1, $25,000 in claims were paid to customers. On 31 December 20X1, X Co estimated that the following claims will be paid in the following year:

	Probability	Anticipated cost
Worst case	5%	$150,000
Best case	20%	$25,000
Most likely	75%	$60,000

What amount should X Co record in the statement of profit or loss for the year ended 31 Dec 20X1 in respect of the provision?

A. $57,500

B. $6,500

C. $18,500

D. $39,000

Test Your Understanding (2)

When a provision is needed that involves several outcomes, the provision is calculated using the expected value of expenditure. The expected value of expenditure is the total expenditure of:

A. Each possible outcome

B. Each possible outcome weighted according to the probability of each outcome happening

C. Each possible outcome divided by the number of outcomes

D. Each possible outcome multiplied by the number of outcomes

2 Contingent liabilities and contingent assets

2.1 Contingent liability

- A **possible obligation** 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 entity; or
- A **present obligation** that arises from past events **but** is not recognized because:
  - It is **not probable** that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - The **amount** of the obligation **cannot be measured** reliably.

Treatment of contingent liabilities

Contingent liabilities should not be recognized in financial statements, but they should be disclosed. The required disclosures are:

- A brief description of the nature of the contingent liability
- An estimate of its financial effect
- Details of any uncertainties
- The possibility of any reimbursement

2.2 Contingent assets

A possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within control of the entity.

A contingent asset **must not be recognized** in the accounts, but should be **disclosed** if it is **probable** that the economic benefits associated with the asset will flow to the entity.

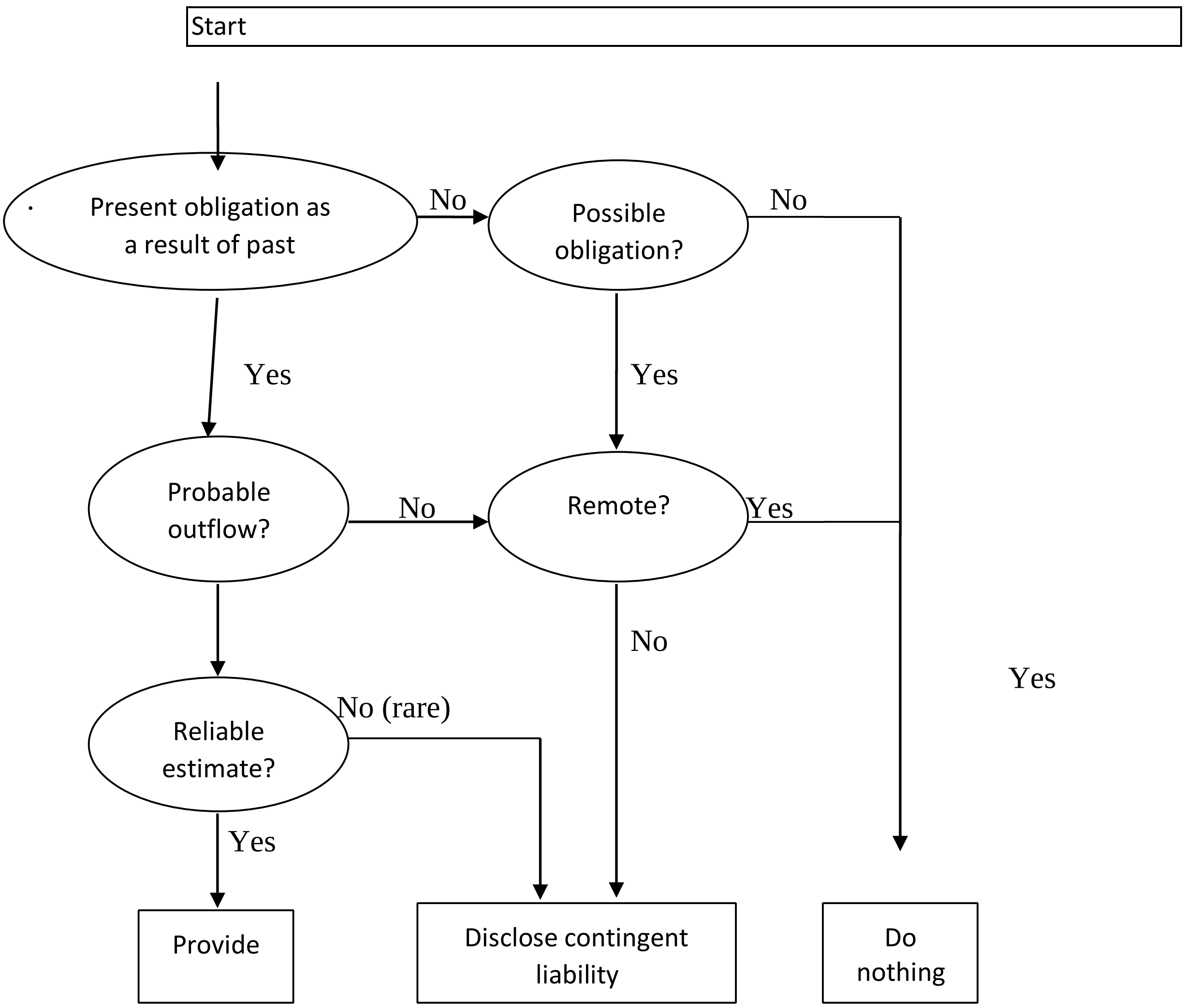
If the flow of economic benefits associated with the contingent asset becomes **virtually certain**, it should then be **recognized as an asset** in the SOFP.

Treatment of contingent assets

Contingent assets must not be recognized in financial statements but they should be disclosed if they are probable. The required disclosures are:

- A brief description of the nature of the contingent assets
- An estimate of its financial effect

2.3 Flow chart



Economic benefits	***Liabilities***	***Assets***
Virtually certain	-	Recognized
Probable (Disclosure)	Recognized	Contingent assets

Possible	Contingent liabilities (Disclosure)	Do nothing
Remote	Do nothing	-

Test Your Understanding (3)

The following items must be considered in finalizing the financial statements of Q, a limited liability company:

The company gives a warrantied on its products. The company's statistics show that about 5% of sales give rise to a warranty claim.

The company has guaranteed the overdraft of another company. The likelihood of a liability arising under the guarantee is assessed as possible.

According to IAS 37 Provision, Contingent Liabilities and Contingent Assets, what is the correct action to be taken in the financial statements for these items?

	Create a provision	Disclose by note only	No action
A.	1	2	
B.		1	2
C.	1,2		
D.	2	1	

2.4 Question *Accounting treatment*

During 20X0 Smack Co gives a guarantee of certain borrowings of Pony Co, whose financial condition at that time is sound. During 20X1, the financial condition of Pony Co deteriorates and at 30 June 20X1 Pony Co files for protection from its creditors.

What accounting treatment is required?

(a) At 31 December 20X0?

(b) At 31 December 20X1?

Answer

(a) At 31 December 20X0

There is a **present obligation** as a result of a past obligating event. The obligating event is the giving of the **guarantee,** which gives rise to a **legal obligation**. However, at 31 December 20X0 no transfer of resources is probable in settlement of the obligation. No provision is recognized. The guarantee is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

(b) At 31 December 20X1

As above, there is a **present obligation** as a result of a past obligating event, namely the giving of the **guarantee.**

At 31 December 20X1 it is probable that a transfer of resources will be required to settle the obligation. A provision is therefore recognized for the best estimate of the obligation.

2.5 Question *Accounting treatment*

After a wedding in 20X0 ten people died, possibly as a result of food poisoning from products sold by Callow Co. Legal proceedings are started seeking damages from Callow but it disputes liability. Up to the date of approval of the financial statements for the year to 31 December 20X0, Callow's lawyers advise that it is probable that it will not be found liable. However, when Callow prepares the financial statements for the year to 31 December 20X1 its lawyers advise that owing to developments in the case, it is probable that it will be found liable.

What is the required accounting treatment?
(a) At 31 December 20X0?
(b) At 31 December 20X1?

Answer

(a) At 31 December 20X0

On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events. No provision is recognized. The matter is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

(b) At 31 December 20X1

On the basis of the evidence available, there is a present obligation. A transfer of resources in settlement is probable.

A provision is recognized for the best estimate of the amount needed to settle the present obligation.

2.6 Question

An oil company causes environmental contamination in the course of its operations, but cleans up only when required to do so under the laws of the country in which it is operating. One country in which it has been operating for several years has up to now had no legislation requiring cleaning up. However, there is now an environmental lobby in this country. At the date of the company's year end, it is virtually certain that a draft law requiring clean-up of contaminated land will be enacted very shortly. The oil company will then be obliged to deal with the contamination it has caused over the past several years.

What accounting treatment is required at the year end?

Answer

At the yearend there is a present obligation as a result of a past obligating event. Because it is virtually certain' that the law will be enacted, the past contamination becomes an obligating event. It is highly probable that an outflow of economic resources will be required to settle this. A provision should therefore be made of the best estimate of the costs involved.

In which of the following circumstances might a provision be recognized?

(a) A company is obliged to incur cleanup costs for environmental damage (that has already been caused).

(b) A company intends to carry out future expenditure to operate in a particular way in the future.

3 Disclosure in financial statements

Example

Warren Tees Ltd., is a manufacturer of golf tees. Tees purchased are covered by a three year warranty, whereby the company will replace any defective tees.

At the year end of last year on 31 March 20X6, a provision of $150,000 was made. During this year, $75,000 was paid for the cost of replacing tees under warranty. At the end of this year, the company estimated that a provision of $135,000 was needed.

Disclosure

Note X; Provisions

	Warranty provision
	$000
At 1 April 20X6	150
Increase in the provision during the year	60
Amounts used during year	(75)
At 31 March 20X7	135

Test Your Understanding (4)

Which of the following statements about provisions and contingencies is/ are correct?

1. A company should disclose detail of the change in carrying amount of a provision from the beginning to the end of the year.
2. Contingent assets must be recognized in the financial statements in accordance with prudence concept.
3. Contingent liabilities must be treated as actual liabilities and provided for if it is probable that they will arise.

A- 3 only

B- 2 and 3 only

C- 1 and 3 only

D- All these statements are correct

Test Your Understanding (5)

An ex-director of X Company has commenced an action against the company claiming substantial damages for wrongful dismissal. The company's solicitors have advised that the ex-director is unlikely to success with his claim, although the chance of X paying any monies to the ex-director is not remote.

Legal costs (to be incurred whether the claim is successful or not) 50,000

Settlement of claim if successful 500,000

According to IAS 31 Provision, contingent liabilities and contingent assets, how this claim should be treated in the financial statements.

A- Provision of $550,000

B- Disclose a contingent liability of $550,000

C- Disclose a provision of $50,000 and a contingent liability of $500,000

D- Provision for $500,000 and a contingent liability of $50,000

Chapter – (12) Irrecoverable Debt and Allowances

1- Irrecoverable Debts

Irrecoverable debts are specific debts owed to a business which it decides are *never going to be paid*. Irrecoverable debts (Bad debts) are debts which are *definitely not expected to be paid*. An irrecoverable debt could occur *when a customer has gone bankrupt*. They are written off as an expense in statement of profit or loss.

Double Entry for irrecoverable debt

Irrecoverable Debt A/C:	Dr (SOPL-Expense)
Trade Receivable A/C:	Cr (SOFP)

1.1 Question

Design Co has a total balance for trade receivables of $25,000 at the year end. A review of the receivable balance highlights that one of its customers, Mann Co, has gone bankrupt. Design Co is owed $4,000 by Mann Co for design work done during the year. This debt is now considered irrecoverable.

Required

a) What is the balance for trade receivables to be shown in the statement of financial position at the year end?
b) What is the irrecoverable debts expense to be shown in the statement of profit or loss at the year end?

1.2 Question

At 1 October 20X5, a business had total outstanding debts of $8,600. During the year to 30 September 20X6 the following transactions took place.

a) Credit sales amounted to $44,000
b) Payment from various customers (Account receivable) amounted to $49,000.
c) Two debts, for $180 and $420, were declared irrecoverable and the customers are no longer purchasing goods from the company. These are to be written off.

Required

Prepare the trade receivable ledger account and the irrecoverable debts expense account for the year.

1.3 Irrecoverable debts written off and subsequently paid

An irrecoverable debt which has been written off might occasionally be unexpectedly paid. Regardless of when the payment is received,

Double Entry for Irrecoverable debt Recovered

Cash/ Bank A/C	: Dr
Irrecoverable debts A/C	: Cr

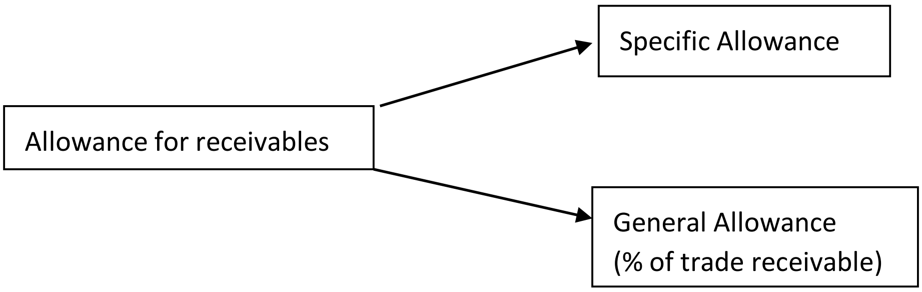
2- Allowances for Receivables

Doubtful debts (Allowance for receivables, Bad debt provision)

A doubtful debt is a debt which is possibly irrecoverable. Some debts which the business thinks might not be paid; these are known as doubtful debts. Doubtful debt may occur when an invoice is in dispute, or when a customer is in financial difficulty.

An impairment amount in relation to receivables that reduces the receivables asset to its irrecoverable amount in the statement of financial position. It is offset against trade receivables, which is shown at the net amount.

An allowance for receivables accounts for potential irrecoverable debts, as a ***prudent precaution*** by the business.



2.1- Accounting Treatment in financial statement

The accounting treatment for allowance for receivable is as follows.

1- When an allowance is first made, the initial allowance is charged as an expense in SOPL.

Example: a company has a trade receivable balance of $50,000 but requires an allowance for receivable equivalent to 5% of the balance.

Allowance for receivable = 5%*$50,000 = $2500 (SOPL- Expense)

<u>SOFP Extract</u>

<u>Current Assets</u>

Trade Receivable	50,000
(-) Allowance for receivable	<u>(2,500)</u>
	47,500

2.2- Accounting Entries for allowance for receivables

<u>If increase in allowance for receivable,</u>

Irrecoverable Debts Expense A/C	: Dr (SOPL)
Allowance for receivable A/C	: Cr (SOFP)

<u>If Decrease in allowance for receivable,</u>

Allowance for Receivable A/C	: Dr (SOFP)
Irrecoverable Debts Expenses A/C	: Cr (SOPL)

Example

Alex Gullible has total trade receivable outstanding at 31 Dec 20X2 of $28,000. He has calculated that equivalent of 1% of these balances might not be collected and wishes to make an appropriate allowance. Before now, he has not made any allowance for receivables at all.

On 31 Dec 20X3 his trade accounts receivable amounted to $40,000. Upon reviewing the balances, he calculated that an allowance should be made equivalent of 5% of the total balance.

Required

What accounting entries should Alex make on 31 Dec 20X2 and 31 Dec 20X3, and what figures for trade receivables will appear in his statement of financial position as at those dates?

For each of these three years, prepare the statement of profit or loss of the business, and state the value of trade receivables appearing in the statement of financial position as at 31 December.

Question- 2.2

Horace Good running fears that his business will suffer an increase in defaulting receivables in the future and so he needs to make an allowance for receivables equivalent to 2 % of outstanding trade receivables at the reporting date from 28 Feb 20X6. On 28 Feb 20X8, Horace determines that the allowance has been overestimated and he recalculates it to be the equivalent of 1% of outstanding trade receivables. Outstanding receivables balances at the various reporting dates are as follows.

	$
28 Feb 20X6	15,200
28 Feb 20X7	17,100
28 Feb 20X8	21,400

Required

1- Show extracts from the following ledger accounts for each of the three years above.
   a) Trade Receivable
   b) Allowance for receivables
   c) Profit or loss account
2- Show how receivables would appear in the statement of financial position at the end of each year.

Test Your Understanding (1)

At 31 Dec 20X2 a company's receivables toatalled $400,000 and an allowance for receivables of $50,000 had been brought forward from the year ended 31 Dec 20X1.

It was decided to write off debts totaling $38,000. The allowance for receivables was to be adjusted to the equivalent of 10 % of the receivables.

What charge for receivable expenses should appear in the company's statement of profit or loss for the year ended 31 December 20X2?

A. $74,200

B. $51,800

C. $28,000

D. $24,200

Test Your Understanding (2)

At 1 July 20X2 the receivable allowance of Q was $18,000.

During the year ended 30 June 20X3 debts totaling $14,600 were written off. The receivables allowance required was to be $16,000 as at 30 June 20X3.

What amount should appear in Q's statement of profit or loss for receivable expenses for the year ended 30 June 20X3?

A. $12,600

B. $16,600

C. $48,600

D. $30,600

Test Your Understanding (3)

At 30 Sep 20X2 a company's allowance for receivable amounted to $38,000, which was equivalent to 5% of the receivable at that date.

At 30 Sept 20X3 receivable totalled $868,500. It was decided to write off $28,500 of debts as irrecoverable. The allowance for receivables required was to be equivalent of 5% of receivables.

What should be the charge in the statement of profit or loss for the year ended 30 Sept 20X3 for receivable expenses?

A. $42,000

B. $$33,925

C. $70,500

D. $32,500

Test Your Understanding (4)

Which of the following would a decrease in the allowance for receivables result in?

A- Increase in liabilities

B- Decrease in working capital

C- Decrease in net profit

D- Increase in net profit

Test Your Understanding (5)

A company has been notified that a customer has been declare bankrupt. The company had previously made an allowance for this debt. Which of the following is the correct double entry to account for this new information?

	Debit	Credit
A.	Irrecoverable debt	Receivables
B.	Receivables	Irrecoverable debts
C.	Allowance for receivables	Receivables
D.	Receivables	Allowance for receivables

Test Your Understanding (6)

An increase in an allowance for receivables of $8,000 has been treated as a reduction in the allowance in the financial statements. Which of the following explains the resulting effects?

A- Net profit is overstated by $16,000, receivables overstated by $8,000

B- Net profit is understated by $16,000, receivables understated by $16,000

C- Net profit is overstated by $16,000, receivables overstated by $16,000

D- Gross profit is overstated by $16,000, receivables overstated by $16,000

Test Your Understanding (7)

At the beginning of the year the allowance for receivables was $850. At the year-end, the allowance required was $1,000. During the year $500 of debts were written off, which includes $100 previously included in the allowance for receivables.

What is the charge to the statement of profit or loss for receivables expenses for the year?

A. $1,500

B. $1,000

C. $650 D. $550

Test Your Understanding (8)

Top Co has total receivables outstanding of $280,000. The accountant believes that approximately 1 % of these balances will not be collected, so wishes to make an allowance of $28,000. No previous allowance has been made for receivables.

Which of the following is correct double entry to create this allowance?

	Debit	Credit
A.	Irrecoverable debt	Allowance for receivables
B.	Allowance for receivables	Receivables
C.	Irrecoverable debts	Receivables
D.	Receivables	Allowance for receivables

Chapter (13)
Sales Tax

1. The nature of the sales tax and how it is collected

- Sales tax is an indirect tax levied on the sale of goods and services. It is usually administered by the local tax authorities.
- Sales tax is a cumulative tax, collected at various stages during the life of foods or services.
- Thus, the total sales tax over the life of goods and services is borne by the ultimate consumer but it is collected on behalf of the tax authorities at the different stages in the product's life.
- Sales tax does not effect on the statement of profit or loss unless it is irrecoverable.

1.1 Example

Assume that the rate of sales tax is 15% on all items.

	Price net of Sales tax ($)	Sales tax 15%($)	Total ($)
1- Manufacturer purchases raw materials And component	40	6	46
Manufacturer sells the television to wholesaler	200	30	230
The manufacturer hands over to tax authorities		**24**	230
			368
2- Wholesaler purchase television	200	30	
Wholesaler sell to a retailer	320	48	368
Wholesaler hands over to tax authorities		**18**	552
3- Retailer purchase television	320	48	
Retailer sell television	480	72	552
Retailer hands over to tax authorities		**24**	
4- Customer purchase television	480	***72***	

The tax authorities would collect the sales tax as follows.

	$
Supplier of material and components	6
Manufacturer	24
Wholesaler	18
Retailer	24
Total sales tax paid (equal to the customer paid)	**72**

1.2 Input Sales Tax

Sales tax paid (or suffered) on goods and services bought by a business are referred to as input sales tax.

1.3 Output Sales Tax

- Sales tax charged (or collected) on goods and services sold by a business are referred to as output sales tax.
- In order to charge sales tax, a business must be registered for sales tax.
- Charge sales tax on the goods and services sold at the rate prescribed by the Government. This is output sales tax.
- Pay sales tax on goods and services purchased from other businesses. This is input sales tax.
- Pay to the tax authorities the difference between the sales tax collected on sales and the sales tax paid to suppliers for purchases. Payments are made at prescribed intervals.

Sales Tax A/C

	$		**$**
Input sales tax	xxx	Output sales tax	xxx
Paid to Government/Payable	xx	Refund from Government	xxx
	xxxx		xxxx

1.4 Irrecoverable Sales Tax

Some sales tax is **irrecoverable**. Sales tax which paid on input **cannot be reclaimed** from government is referred to as **irrecoverable sales tax**. The following conditions in which sales tax cannot be reclaimed,

- Where a trader is not registered for sales tax
- Where inputs are not related to taxable business activities

In these cases, the trader must bear the cost of sales tax and account for accordingly. For example,

If a business pays $500 for entertaining expenses and suffers irrecoverable input sales tax of $75 on this amount, and the total is $575.

Entertaining Expenses A/C: Dr $575 (SOPL – Expenses)
Bank/ Payable A/C : Cr $575

For Example,

If a business pays $5,000 for a motor vehicle and suffers irrecoverable input sales tax of $400, total amount is $5400.

Motor Vehicle at cost A/C: Dr $5,400 (SOFP- Non-current Asset)
Bank A/C : Cr $5,400

1.5 Amounts inclusive and exclusive of tax

Gross amount of sales or purchase is **the amount inclusive of sales tax**.
The **net amount** of sales or purchase is **the amount exclusive of sales tax**.
For example, if the net amount of a purchase is $100, and the rate of sales tax is 15%, the amounts are as follow

	%
Purchase (net amount or exclusive of sales tax)	100
Sales tax	15
Gross amount inclusive of sale tax	115

Therefore, the net amount is equal to the gross amount/ (1+tax rate).

For example, if the gross amount of a purchase is $80, and the rate of sales tax is 15%, the sales tax and net amounts are as follow,

	%
Purchase (net amount or exclusive of sales tax)	100
Sales tax	15
Gross amount (inclusive of sales tax)	115

Therefore, the net amount of sales tax = 80 / (1+15%) = $69.57
The input sales tax = 80- 69.57= (80 / 115)*15 =10.43

2- Accounting for Sales tax

Sales tax charged on sales is collected by the business on behalf of the tax authorities. It does not form part of the revenue of the business. Therefore,

Cash or trade receivable A/C : Dr
Sales A/C : Cr
Sales tax control A/C (output sales tax): Cr

Example 2.1
The business sells foods for $600 (net amount), the sales tax rate is 15%. Prepare the journal entry for this transaction.

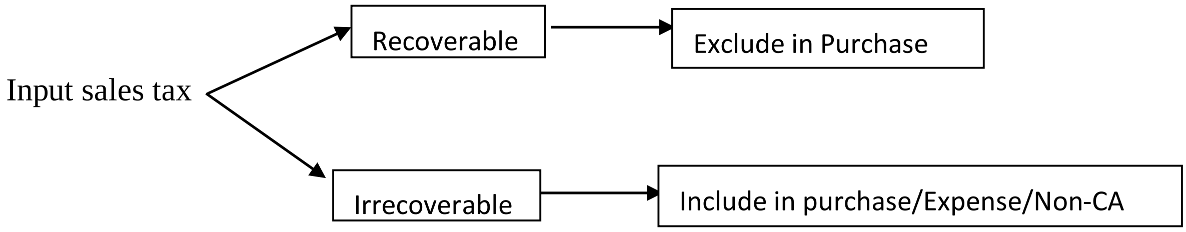
If the input sales tax on purchase is **recoverable**, the cost of purchases should **exclude** the sales tax and be recorded net of tax.

Purchases A/C : Dr
Sales tax control A/C : Dr (input sales tax recoverable)
Cash or trade payable A/C : Cr

Example 2.2

The business purchase goods on credit for $400 (exclusive of sales tax), the sales tax rate is 15%. Prepare the journal entry for this transaction.

If the input sale tax is **not recoverable (irrecoverable),** the cost of purchase must **include** the tax.



Question

Are trade receivables and trade payables shown in the accounts inclusive of sales tax or exclusive of sales tax?

Answer

They are shown ***inclusive of sales tax***, as the statement of financial position must reflect the total amount due from receivable and due to payables.

2.1 Payables for sales tax

An **outstanding** payable for sales tax will appear as a **current liability** in the statement of financial position.

The sales tax paid to the authorities each quarter is the difference between recoverable input sales tax on purchases and output sales tax on sales.

Occasionally, a business will be ***owed money by the authorities***. In such situation, the sales tax refund owed by the authorities would be a ***current asset*** in the statement of financial position.

Example 2.3

A business is invoiced for input sales tax of $8,000 and charges sales tax of $15,000 on its credit sales and sales tax of $2,000 on its cash sales.

Prepare the sales tax control account.

Question

A business is its first period of trading charges $4,000 of sales tax on its sales and suffer $3,500 of sales tax on its purchases which includes $250 irrecoverable sales tax on business entertaining. Prepare the sales tax control Account.

Test Your Understanding (1)

W is the registered for sales tax. The managing director has asked four staff in the accounts department why output tax for the last quarter does not equal to 20% of sales (20% is the rate of tax). Which one of the following four supplies she received was not correct?

A- The company had some exports that were not liable to sales tax.

B- The company made some sales of zero-rated products.

C- The company made some sales of exempt products.

D- The company sold some products to businesses not registered for sale tax.

Test Your Understanding (2)

The following information relates to Eva Co's sales tax for the month of March 20X3.

	$
Sales (including sales tax)	109,250
Purchase (net of sales tax)	64,000

Sales tax is charged at a flat rate of 15%. Eva Co's sales tax account showed an opening credit balance of $4,540 at the beginning of the month and a closing debit balance of $2,720 at the end of the month. What was the total sales tax paid to regulatory authorities during the month of March 20X3?

A. $6,470.00

B. $11,910.00

C. $14,047.50

D. $13,162.17

Test Your Understanding (3)

Alana id not registered for sales tax purposes. She has recently received an invoice for goods for resale which cost $500 before sales tax which is levied at 15%. The total value was therefore $575.
What is the correct entry to be made in Alana's general ledger in respect of an invoice?

A- Dr Purchase $500, Dr Sales tax $75, Cr Payable $575

B- Dr Purchases $575, Cr Sales tax $75, Cr Payable $500

C- Dr Purchase $500, Cr Payable $500

D- Dr Purchases $575, Cr payables $575

Test Your Understanding (4)

Information relating to Lauren Co's transactions for the month of May 20X4 is shown below:

Sales (including sales tax)	$140,000
Purchases (net of sales tax)	$65,000

Sales tax is charged at a flat rate of 20%.Lauren Co's sales tax account had a zero balance at the beginning of the month and at the end of the month.

- Lauren Co's sales for the month of $140,000 included $20,000 of sales exempt from sales tax.

What was the total sales tax paid to regulatory authorities at the end of May 20X4 (to the nearest $)?

A. $7,000

B. $20,000

C. $23,333

D. $13,000

Test Your Understanding (5)

A business commenced with capital in cash of $1,000. Inventory costing $800 plus sales tax is purchased on credit, and half is sold for $1,000 plus sales tax, the customer is paying in cash at once. The sales tax rate is 20%.

What would the accounting equation after these transaction show? A-

Assets $1,800 less liabilities $200 equal Capital $1,600.

B- Assets $2,200 less liabilities $1,000 equal Capital $1,200

C- Assets $2,600 less liabilities $800 equal Capital $1,800

D- Assets $2,600 less liabilities $1,000 equal Capital $1,600

Test Your Understanding (6)

Trade receivables and payables in the financial statements of a sales tax registered trader will appear as described by which of the following?

A- Inclusive of sales tax in the statement of financial position

B- Exclusive of sales tax in the statement of financial position

C- The sales tax is deducted and added to the sales tax account in the statement of financial position

D- Sales tax does not appear in the statement of financial position because the business simply acts as a collector on behalf of the tax authorities

Test Your Understanding (7)

Which of the following correctly describe the entry in the sales account for a sale for a sales tax registered trader?

A- Credited with the total sales made, including sales tax

B- Credited with the total sales made, excluding sales tax

C- Debited with the total sales made, including sales tax

D- Debited with the total sales made, excluding sales tax

Test Your Understanding (8)

Sales (including sales tax) amounted to $27,612.50 and purchases (excluding sales tax) amounted to $18,000. What is the balance on the sales tax account, assuming all items are subject to sales tax at 17.5%.

A- $962.50 debit

B- $962.50 credit

C- $1,682.10 debit

D- $1,682.10 credit

Chapter (14)
Control Accounts

1 What are control accounts?

A **control account** is an account **in the nominal ledger** in which a record is kept of the **total value of a number of similar but individual items**. It is an ***impersonal*** account which is **part of the double entry system**. Control accounts are used chiefly for trade receivables and payables.

a) A receivables control account is an account in which records are kept of transactions involving all receivable in total. The balance on the receivables control account at any time will be the total amount due to the business at that time from its receivables.
b) A payables control account is an account in which records are kept of transactions involving all payables in total. The balance on this account at any time will be the total amount owed by the business at that time to its payables.

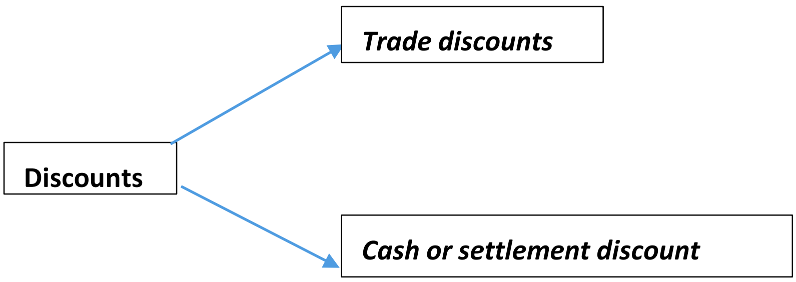
Although control accounts are used mainly in accounting for receivables and payables, they can also be kept for other items, such as inventories, wages and salaries, and cash.

1.1 Control accounts and personal accounts

The personal accounts of individual customers of the business are kept in the receivable's ledger, and the amount owed by each receivable will be a balance on the receivable's personal account. The amount owed by all the receivable together (ie all trade receivables) will be a balance on the receivables control account.

At any time, the balance on the receivables control account **should be equal** to the sum of the individual balances on the personal accounts in the receivable ledger.

2 Discounts



2.1 Types of discount

A discount is a reduction in the price of goods below the amount at which those goods would normally be sold to other customers. There are two types of discount.

- Trade discount
- Cash or settlement discount

2.1.1 Trade discount

A trade discount is a reduction in the cost of goods owing to the nature of the trading transaction. It is usually results from the buying goods in bulk.

A trade discount is a reduction in the amount of money demanded from a customer.

- If a trade discount **is received by a business** for goods purchased from a supplier, the amount of money demanded from the business by the supplier will be net of discount. **Trade discounts received** should be ***deducted from the gross cost of purchase. Example***

Company A purchases goods on credit from Supplier B at a gross cost of $100, and receives a trade discount of 5% from the supplier. The double entry for this transaction is

Purchase A/C	: Dr $95
Trade payable A/C	: Cr $95

- If a trade discount **is given by a business** for goods sold to a customer, the amount of money demanded by the business will be after deduction of the discount. **Trade discount allowed** should be ***deducted from the gross sales price***.

Example

Company B Sells goods on credit to Customer A at a gross sales price of $100 and offers a trade discount of 10% to the customer. The double entry for this transaction is

Trade receivable A/C	: Dr $90
Sales A/C	: Cr $90

2.1.2 Cash/Settlement Discount Received

Cash or settlement discount received are included as other income in the statement of profit or loss.

Double Entry for Settlement discount received

Trade Payable A/C	: Dr
Discount Received A/C	: Crnn (SOPL- income)

Example

Soft supplies Co recently purchase from Hard Import Co 10 printers originally priced at $200 each. A 10% trade discount was negotiated together with a 5% cash discount if payment was made within 14 days. Calculate the following.

A. The total of trade discount

B. The total of the cash discount

2.1.3 Cash/Settlement Discount Allowed

This is an area in which the application of IFRS 15 *Revenue from contracts with Customers* can be quite complex.

If a business expects a customer to take up **a cash discount or settlement discount allowed** on sale, revenue should be recognized net of discount when recording the sale.

If it transpires that the customer **does not take up** the discount when they make payment, then the amount of the discount is subsequently recognized as revenue.

Conversely, if the customer is not expected to take up the discount, the full invoiced amount with no discount is recognized as revenue when recording the sale.

If it transpires that the customer **does take up** the discount when they make payment, the revenue is subsequently reduced by the amount of the discount.

Example

Chippies sells goods to Table Tops at a price of $7,600 including delivery. Table Tops is allowed 60 days credit before payment, but is also offered a discount of 5% for payment within 10 days of the invoice date.

Accounting for the sale

Chippies expects Table Tops to take advantages of the discount.

Trade Receivable A/C	Debit	$7,220
Sales A/C	Credit	$7,220

Accounting for payment Received

Customer does not take the discount

Bank A/C	Debit	$7,600
Trade Receivables A/C	Credit	$7,600
Trade Receivable A/C	Debit	$380
Sales A/C	Credit	$380

Customer take the discount

Bank A/C	Debit	$7,220
Trade Receivable A/C	Credit	$7,220

OR

Accounting for the sale

Chippies did **not expect** Table Tops to take advantages of the discount.

Trade Receivable A/C	Debit	$7,600
Sales A/C	Credit	$7,600

Accounting for payment Received

Customer does not take the discount

Bank A/C	Debit	$7,600
Trade Receivables A/C	Credit	$7,600

Customer take the discount

Bank A/C	Debit	$7,220
Trade Receivable A/C	Credit	$7,220
Sales A/C	Debit	$380
Trade Receivable A/C	Credit	$380

Test Your Understanding (1)

Your organization sold goods to PQ Co for $800 less trade discount of 20% and settlement discount of 55 for payment within 14 days. At the time of the sale, you expect PQ to take up the settlement discount. The invoice was settled by cheque five days later. Which of the following gives the entries required to record BOTH of these transaction?

	Debit ($)	Credit ($)

A- PQ Co	608	
Sales		608
Bank	608	
PQ Co		608
B- PQ Co	640	
Sales		640
Bank	640	
PQ Co		640
C- PQ Co	608	
Sales		608
Bank	640	
PQ Co		608
Sales		32
D- PQ Co	640	
Sales		640
Bank	608	
Sales	32	
PQ Co		640

Test Your Understanding (2)

Y Ltd keeps a receivable ledger control account as part of its accounting system. The following transactions took place in March.

a) Invoice totaling $5,000 are raised to customer X in March. These invoices offer the customer a 5% discount if they pay within 14 days. Of these invoices, Yltd expects invoices amounting to $2,000 to be paid with the discount taken.

b) Customer Z pays cash of $2,850 for invoice with the face values of $3,000.They took advantage of discounts totaling 150 for early payment, however Yltd had not expected Customer Z to take up the discounts.

Which of the following entries correctly record these transaction?

A. Debit Receivable ledger control $5,000, Credit Sales $5,000, Debit Cash $2,850, Credit Receivable Ledger Control$2,850

B. Debit Receivable ledger control $4,900, Credit Sales $4,900, Debit Cash $2, 850, Debit Sale $150, Credit Receivable Ledger Control$3,000

C. Debit Receivable ledger control $5,000, Credit Sales $5,000, Debit Cash $2,850, Debit Sale $150, Credit Receivable Ledger Control$2,850

D. Debit Receivable ledger control $4,900, Credit Sales $4,900, Debit Cash $2,850, Credit Receivable Ledger Control$2,850

Test Your Understanding (3)

You are an accounts assistant at Cuppa Supplies, a company that sells cups and mugs. The following is an extract from a sales invoice raised by the bookkeeper in your company to a customer, Oasis Café.

Invoice No: 3242

Date: 31 Oct 20X6

Description	Qty	unit price ($)	Net Amt ($)
Coffee cups	200	5.00	1,000
		Sale Values	1,000
		Sales Tax	0
		Amt payable	1,000

A discount of 5% of the full price applies if payment is made within 7 days.

If you pay within 7 days, the discounted price is : $950

Senior management at your company do not expect Oasis Café to take the advantage of the discount. However, you receive a payment from Oasis Café on 3 November 20X6.

Required Record the above **Both** transactions.

Question

You are required to ***prepare the statement of profit or loss*** of Seesaw Timber Merchant for the year ended 31 March 20X6, given the following transactions.

	$
Purchases at gross cost	120,000
Trade discount received	4,000
Settlement discount received	1,500
Cash sales	34,000
Credit sales at invoice price	150,000
Cash discount allowed	8,000
Selling expenses	32,000
Administrative Expenses	40,000
Drawing by proprietor	22,000

\

2.2 Supplier Statements

A supplier will usually send a monthly statement showing invoices issued, credit notes, payments received and discounts given. It is vitally important that these statements are compared to the supplier's personal account in the payables ledger. Any discrepancies need to be identified and any errors corrected

.

STATEMENT OF ACCOUNT

Pickett (Handling Equipment) Co
Unit 7, Western Industrial Estate
Dunford DN2 7RJ

Accounts Department Date : 31 May 20X1 Finstar Co
67 Lake Avenue A/C No: F023
Dunford DN4 5PS

Date	Details	Debit $	c	Credit $	c	Balance $	c
30/4/X1	Balance brought forward					492	22
3/5/X1	Invoice no:34207	129	40			621	62
4/5/X1	Invoice no:34242	22	72			644	34
5/5/X1	Payment Received			412	17	232	17
17/5/X1	Invoice no:34327	394	95			627	12
18/5/X1	Credit note no:00192			64	40	562	72
21/5/X1	Invoice no:34392	392	78			955	50
28/5/X1	Credit note no:00199			107	64	847	86
	Amount now due				$	**847**	**86**

Terms: 30 days net, 1% discount for payment in 7days.E & OE

Register office: 4 Arkwright road, London E16 4PQ Registered in England No.2182417

This statement is received on 1 June 20X1 and is passed to Linda Kelly who is the payables leger clerk at Finstar Co. Linda obtains a printout of transactions with Pickett Co from Finstar's payable ledger system.

FINSTAR CO **PAYABLE LEDGER**

ACCOUNT NAME: PICKETT (HANDLING EQUIPMENT) CO ACCOUNT REF: PO42

DATE OF REPORT: 1 JUNE 20X1

Date	Transaction	(Debit)/Credit $
16/3/20X1	Invoice 33004	350.70
20/3/20X1	Invoice 33060	61.47
6/4/20X1	Invoice 34114	80.05
3/5/20X1	Invoice 34207	129.40
4/5/20X1	Payment	(412.17)
6/5/20X1	Invoice 34242	22.72
19/5/20X1	Invoice 34327	394.95
19/5/20X1	Credit note 00192	(64.40)
28/5/20X1	Payment	(117.77)
30/5/20X1	Credit note 00199	(107.64)
	Balance	**337.31**

Make Supplier Statement Reconciliation.

2.2.1 The reasons for reconciling items

Reconciling items may occur as a result of the following items.

•Payments in transit (timing difference)

•Omitted invoices and credit notes (Error or omission or timing difference) Other errors

Test Your Understanding (4)

A supplier sends you a statement showing a balance outstanding of $14,350. Your own records show a balance outstanding of $14,500.

Which one of the following could be the reason for this difference?

A. The supplier sent an invoice for $150 which you have not yet recorded.

B. The supplier has allowed you $150 cash discount which you have omitted to w=enter in your ledgers

C. You have paid the supplier $150 which has not yet accounted for.

D. You have returned goods worth $150 which the supplier has not yet accounted for.

3 The operation of control accounts

3.1 Example: Accounting for Receivables

At 1 July 20X2, the Outer Business Company had no trade accounts receivable. During July, the following transactions affecting credit sales and customers occurred.

3July: invoiced A Arnold for the sale on credit of hardware goods: $100

11July: invoiced B Bagshaw for the sale on credit of electrical goods: $150

15July: invoiced C Cloning for the sale on credit of hardware goods: $250

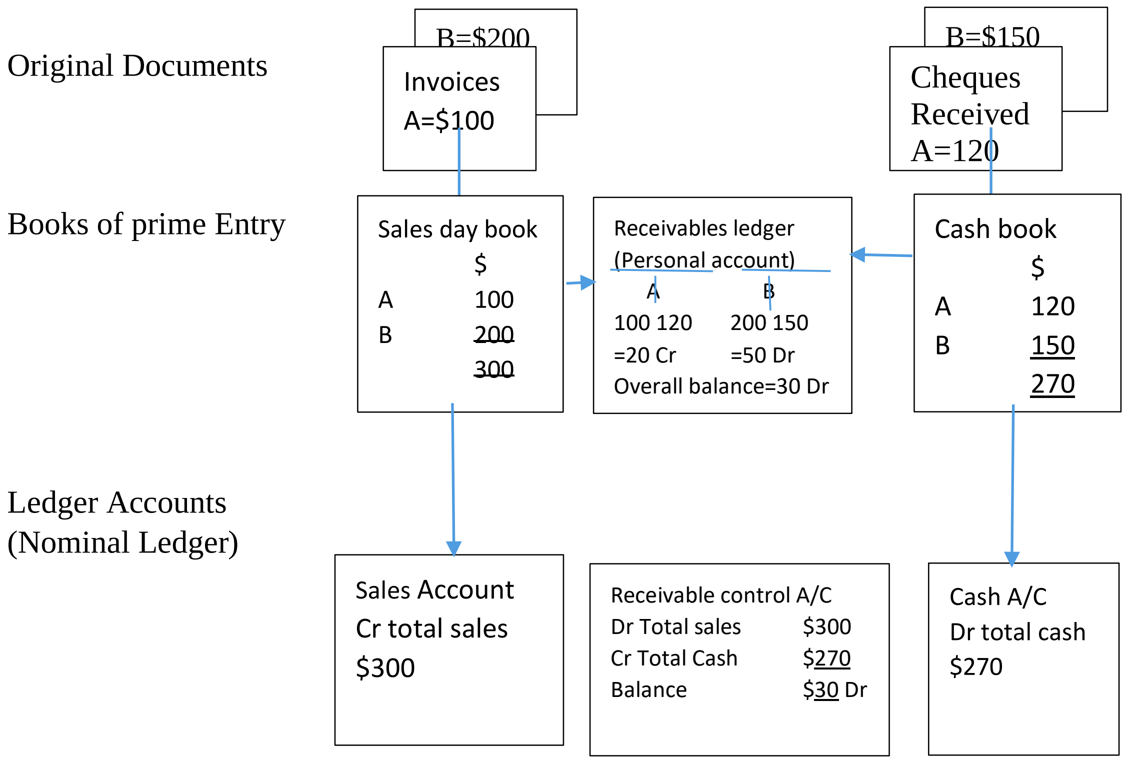
10 July: received payment from A Arnold of $90, in settlement of their debt in full, having taken a permitted discount of $10 for payment within seven days.

18 July: received a payment of $72 from B Bagshaw in part settlement of $80 of their debt; a discount of $8 was allowed for payment within seven days of invoice

28 July: received a payment of $120 from C Cloning, who was unable to claim any discount.

3.2 Summary of entries

The flowchart of the use of the receivable ledger and receivable control account



Notes

1. The receivable ledger is not part of the double entry system
2. Nevertheless, the total balance on the receivables ledger should equal the balance on the receivable control account.

3.3 Accounting for Payables

There is no difficulty in dealing with similar examples relating to purchase and payables. The entries were made in the purchase daybook and payables ledger personal accounts.

3.4 Entries in Control Accounts

Question 3.4.1

A payable control account contains the following entries:

	$
Bank	79,500
Credit Purchase	83,200
Discounts received	3,750
Contra with receivable control account	4,000
Balance c/f at 31 Dec 20X8	12,920

There are no other entries in the account. What was the opening balance brought forward at 1 Jan 20X8?

Question 3.4.2

On examining the books of Exports Co, you ascertain that on 1 Oct 20X8 the receivable ledger balances were $8,024 debit and $57 credit, and the payable ledger balances on the same date $6,235 credit and $105 debit.

For the year ended 30 Sept 20X9 the following particulars are available.

	$
Sales	63,728
Purchases	39,974
Cash from trade account receivable	55,212
Cash to trade account payable	37,307
Discount received	1,475
Discount allowed	2,328
Return inwards	1,002
Return outwards	535
Irrecoverable debts	326
Cash receipt in respect of the debit balances in the payable ledger	105
Settlement by Contra	434
Allowances to customers on goods damaged in transit	212

On 30 Sept 20X9 there were no credit balances in the receivable ledger except those outstanding on 1 Oct 20X8, and no debit in the payables ledger.

Required

Write up the following accounts recording the above transactions bringing down the balances as on 30 Sept 20X9:

a) Receivable control account

b) Payables control account

4 The Purpose of the control accounts

4.1 Reasons for having control accounts

The reasons for having the control accounts are as follows.

a) They provide a check on the accuracy of entries made in the personal accounts in the receivables and payables ledger.

b) The control accounts also assist in the location of errors, where postings to the control accounts are made daily or weekly, or even monthly.

c) Where there is a separation of clerical (bookkeeping) duties, the control account provides an internal check.

d) To provide total receivable and payables balances more quickly for producing a trial balance or statement of financial position.

Test Your Understanding (5)

Which one of the following is NOT a purpose of a receivables ledger control account?

A. A receivable ledger control account provides a check on the overall accuracy of the personal ledger account

B. A receivables ledger control account ensures the trial balance balances

C. A receivable ledger control account aims to ensure there are no errors in the personal ledger

D. Control accounts help deter fraud.

Test Your Understanding (6)

You are given the following information:

Receivable ledger at 1 Jan 20X3	$10,000
Receivable ledger at 31 Dec 20X3	$9,000
Total receipt during 20X3 (including cash sales)	$85,000

What is the figure for sales on credit during 20X3?

A- $81,000

B- $86,000

C- $79,000

D- $84,000

Test Your Understanding (7)

Which of the following items could appear on the credit side of a receivable ledger control account?

1. Cash received from customers
2. Irrecoverable debts write off
3. Increase in allowance for receivables
4. Sales
5. Credit for goods returned by customers
6. Cash refunds to customers

A- 1,2 and 5

B- 1,2,3 and 6

C- 3,4 and 5

D- 4 and 6

Test Your Understanding (8)

An inexperienced bookkeeper has drawn up the following receivable ledger control account:

RECEIVABLE LEDGER CONTROL ACCOUNT

	$		$
Opening balance	180,000	Credit Sales	190,000
Cash from credit customer	232,200	Irrecoverable debts written off	1,500
Sales return	8,000	Contra against payables	2,400
Cash refunds to credit customer	3,300	Closing balance (Balancing figure)	229,600
	423,500		423,500

What should the closing balance be after correcting the errors made in preparing the account?

A- $130,600

B- $129,200

C- $142,400

D- $214,600

Test Your Understanding (9)

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

PAYABLE LEDGER CONTROL ACCOUNT

	$		$
Opening balance (amount owed to supplier)	318,600	Purchase	1,268,600
Cash paid to suppliers	1,364,300	Contra against receivables	48,000
Purchase return	41,200	Discount received	8,200
Refund received from supplier	2,700	Closing balance (Balancing figure)	402,000
	1,726,800		1,726,800

All items relates to credit purchase.

What should the closing balance be when all the errors are corrected?

A- $128,200

B- $509,000

C- $224,200

D- $144,600

Test Your Understanding (10)

The following control account has been prepared by trainee accountant:

RECEIVABLE LEDGER CONTROL ACCOUNT

	$		$
Opening balance	308,600	Cash received from credit customer	148,600
Credit Sales	154,200	Interest charged on overdue account	2,400
Cash Sales	88,200	Irrecoverable debts	4,900
Contra against payables	4,600	Allowance for receivable	2,800
		Closing balance (Balancing figure)	396,800
	555,500		555,500

What should the closing balance be when all the errors made in preparing the receivable ledger control account have been corrected?

A- $395,200

B- $304,300

C- $307,100

D- $309,500

Test Your Understanding (11)

Which of the following lists is composed only of items which would appear on the credit side of the receivable control account?

A- Cash received from customers, sale returns, irrecoverable debts written off, contras against amount due to suppliers in the accounts payable ledger

B- Sales, cash refund to customers, irrecoverable debts written off

C- Cash received from customers, interest charged on overdue account, irrecoverable debts written off

D- Sales, Cash received from customers, interest charged on overdue account, contras against amount due to suppliers in the accounts payable ledger

1.2 Balancing and agreeing control accounts with receivables and payables ledgers

Question 4.2.1

April Showers sells goods on credit to most of its customers. In order to control its receivables collection system, the company maintains a receivable control account. In preparing the accounts for the year to 30 Oct 20X3 the accountant discovers that the total of all the personal accounts in the receivables ledger amount to $12,802, whereas the balance on the receivables control account is $12,550.

Upon investigating the matter, the following errors were discovered.

a) Sales for the week ending 27 March 20X3 amounting to $850 had been omitted from the control account.

b) A customer account balance of $300 had not been included in the list of balances.
c) Cash received of $750 had been entered in a personal account as $570.
d) Discount received totaling $100 had not been entered in the control account.
e) A personal account balance had been undercast by $200
f) A contra item of $400 with the payable ledger had not been entered in the control account.
g) An irrecoverable debt of $500 had not been entered in the control account.
h) Cash received of $250 had been debited to a personal account.
i) Discount received of $50 had been debited to Bell's receivables ledger account.
j) Return inwards valued at $200 had not been included in the control account.
k) Cash received of $80 had been credited to a personal account as $8.
l) A cheque for $300 received from a customer had been dishonored by the bank, but no adjustment had been made in the control account.

Required

1. Prepare the corrected receivable control account, bringing down the amended balance as at 1 Nov 20X3.
2. Prepare a statement showing the adjustments that are necessary to the list of the personal account balances so that it reconciles with the amended receivables control account balances.

Question 4.2.2

ABC has a payables control account balance of $12,500 at 31 Dec 20X6. However the extract of the balances from the payables ledger totals $12,800. Investigation finds the following errors: purchases for week 52 of $1,200 had been omitted from the control account; a supplier account of $900 had been omitted from the list of balances.

What is the correct payables balance at 31 Dec 20X6?

A. $12,500
B. $13,400
C. $12,800
D. $13,700

Question 4.2.3

XYZ has a payable control account balances of $17,250 at 31 Dec 20X9. However the extract of balances from the payables ledger total of $14,500. Investigation finds the following errors: a contra entry of $750 had been omitted from the control account, an account with a balance of $500 debit had been included as $500 credit in the list of balances and payment totaling $3000 had been posted to the individual accounts but the double entry postings had not yet been made.

Required

a) Prepare the corrected payables control account, bringing down the amended balances at 31 Dec 20X9.

b) Prepare a statement showing the adjustments that are necessary to the list of personal account balances so that it reconciles with the amended payables control account balance.

Test Your Understanding (12)

Your payables control account has a balance at 1 Oct 20X8 of$34,500 credit. During October, credit purchases were $78,400, cash purchases were $2,400 and payment made to suppliers excluding cash purchase, and after deducting settlement discounts of $1,200 were $68,900. Purchase returns were $4,700.

What was the closing balance?

A- $38,100

B- $40,500

C- $47,500

D- $49,900

Test Your Understanding (13)

A receivables ledger control account had a closing balance of $8,500. It contained a contra to the payable ledger of $400, but this had been entered on the wrong side of the control account. What should be the correct balance on the control account?

A- $7,700 debit

B- $8,100 debit

C- $8,400 debit

D- $8,900 debit

Test Your Understanding (14)

The accountant at Borris Co has prepared the following reconciliation between the balance on the trade payable ledger control account in the general ledger and the list of balances from the supplier ledger:

Balance on general ledger control	68,566
Credit balance omitted from list of balances from the payable ledger	(127)
	68,439
Under casting of purchase day book	99
	68,538

What balance should be reported on Borris Co's statement of financial position for trade payables? A- $68,439

B- $68,538

C- $68,566

D- $68,665

CHAPTER- 15 Bank Reconciliation

1 Bank statement and cash book ▪ Bank statement

The bank statement is sent by the bank to each of customer monthly, itemizing

a. The balance owed at the beginning owed at the beginning of the month
b. News debts incurred during the month
c. Payments made during the month
d. The balance owed at the end of the month

▪ Cash book

The cash book of a business is the record of **how much cash the business believes** that it has in the bank.

In theory, the entries appearing on a business's bank statement should be exactly the same as those in the business cash book. The balance shown by the bank statement should be the same as the cash book balance on the same date.

2 Bank Reconciliation

2.1 Bank reconciliation

A bank reconciliation is a comparison of a bank statement (sent monthly, weekly or even daily by the bank) with the cash book. Differences between the balance on the bank statement and the balance in the cash book will be errors or timing differences, and they should be identified and satisfactorily explained.

2.2 Why is a bank reconciliation necessary?

A bank reconciliation is needed to identify and account for the differences between the cash book and the bank statement.

2.3 What to look for when doing a bank reconciliation Correction an adjustment in the cash book

1. Standing order payment
2. Dividend received or paid direct into the bank
3. Bank interest and bank charges
4. Errors in the cash book

The **corrected cash book balance** is the balance that is shown in the statement of financial position.

Items reconciling the corrected cash book balance to the bank statement

Unpresented cheques or outstanding cheque

Cheque drawn (ie paid) paid by the business and credited in the cash book, ***which have not yet been presented to the bank,*** or cleared and so ***do not appeared*** in the bank statement.

Outstanding lodgements or deposit credited after date

Cheques received by the business, paid into the bank and debit in the cash book, but which have ***not yet been cleared and entered in the account*** by the bank, and ***so do not yet appeared*** on the bank statement.

3 Worked Examples

Example 3.1

At 30 Sept 20X6, the balance in the cash book of Wordsworth Co was $805.15 debit. A bank statement on 30 Sept 20X6 showed Wordsworth Co to be in credit by $1.112.30.

On investigation off the differences between two sums, it was established that:

a. The cash book has been undercast by $90.00 on the debit side.
b. Cheques paid in not yet credited by the bank amounted to $208.20, called outstanding lodgments.
c. Cheques drawn not yet presented to the bank amounted to $425.35 called presented cheques.

Required

1. Show the correction on the cash book.
2. Prepare a statement reconciling the balance per bank statement to the balance per cash book.

Question 3.2

On 31 Jan 20X8 a company's cash book showed a credit balance of $150 on its current account which did not agree with the bank statement balance. In performing the reconciliation the following points come to light.

Not recorded in the cash book	$
Bank Charges	36
Transfer from deposit account to current account	500
Not recorded in the bank statement	
Unpresented cheques	116
Outstanding lodgements	630

It was discovered that the bank had debited the company's account with a cheque for $400 in error.

What was the original balance on the bank statement?

Question 3.3

A company's bank statement shows $715 direct debits and $353 investment income not recorded in the cash book. The bank statement does not show a customer's cheque for $875 entered in the cash book on the last day of the accounting period. If the cash book shows a credit balance of $610. What balance appears on the bank statement?

A. $1847 debit
B. $1847 credit
C. $972 credit
D. $972 debit

Question 3.4

Given the facts in the question above, what is the figure for the bank balance to be reported in the final accounts?

A. $1,847 credit
B. $972 credit
C. $972 debit
D. $1,847 debit

Example 3.5

On 30 Jun 20X0, Cook's cash book showed that he had an overdraft of $300 on his current account at the bank. A bank statement as at the end of June 20X0 showed that Cook was in credit with the bank by $65.

On checking the cash book with the bank statement you find the following.

a. Cheques drawn, amounting to $500, had been entered in the cash book but had not been presented.
b. Cheques received, amounting to $400, had been entered in the cash book, but had not been credited by the bank.
c. On instructions from the ban had transferred interest received on his deposit account amounting to $60 to his current account, recording the transfer on 5 July 20X0. This amount had, however, been credited in the cash book as on 30 June 20X0.
d. Bank charges of $35 shown in the bank statement had not been entered in the cash book.
e. The payments side of the cash book had been undercast by $10.
f. Dividends received amounting to $200 had been pais direct to the bank and not entered in the cash book.
g. A cheque for $50 drown on deposit account had been shown in the cash book as drawn on the current account.
h. A cheque issued to Jone for $25 was replaced when out of date. It was entered again in the csh book, no other entry being made. Both cheques were included in the total of unpresented cheques shown above.

Required

1) Indicate the appropriate adjustment in the cash book.
2) Prepare a statement reconciling the corrected cash book balance with that shown in the bank statement.

Question 3.6

From the information given below relating to PWW Co you are required to:

a. Make such additional entries in the cash at bank account of PWW Co as you considered necessary to show the correct balance at 31 Oct 20X2.

b. Prepare a statement reconciling the correct balance in the cash at bank account as shown in (a) above with the balance at 31 Oct 20X2 that is shown on the bank statement from the Z bank Co.

CASH AT BANK ACCOUNT IN THE LEDGER OF PWW CO

20X2 Oct		$	20X2 Oct		$
1	Balance b/f	274	1	wages	3,146
8	Q Manufacturing	3,443	1	Petty Cash	55
8	R Cement	1,146	8	Wages	3,106
11	S Co	638	8	Petty Cash	39
11	T & Sons	512	15	Wages	3,029
11	U & Co	4,174	15	Petty Cash	78
15	V Co	1,426	22	A & Sons	929
15	W Electrical	887	22	B Co	134
22	X and Associates	1,202	22	C & Company	77
26	Y Co	2,875	22	D & E	263
26	Z Co	982	22	F Co	1,782
29	ABC Co	1,003	22	G Associates	230
29	DEE Corporation	722	22	Wages	3,217
29	GHI Co	2,461	22	Petty Cash	91
31	Balance c/f	14	25	H & Partners	26
			26	J Sons & Co	868
			26	K & Co	107
			26	L, M & N	666
			28	O Co	112
			29	Wages	3,191
			29	Petty Cash	52
			29	P & Sons	561
		21,759			21,759

Z BANK CO- STATEMENT OF ACCOUNT WITH PWW CO

20X2 Oct		Payment $	Receipt $	Balance $
1				1,135
1	Cheque	55		
1	Cheque	3,146		
1	Cheque	421		2,487
2	Cheque	73		

2	Cheque			155		2,715
6	Cheque			1212		2,927
8	Sundry credit				4,589	
8	Cheque			3,106		
8	Cheque			39		1,483
11	Sundry credit				5,324	3,841
15	Sundry credit				2,313	
15	Cheque			78		
15	Cheques			3,029		3,047
22	Sundry credit				1,202	
22	Cheque			3,217		
22	Cheque			91		941
25	Cheque			1,782		
25	Cheque	134	975			
26	Cheque	929				
26	Sundry credit				3,857	
26	Cheque	230				
27	Cheque	263				
27	Cheque			77		1,383
29	Sundry credit				4,186	
29	Cheque			52		
29	Cheque			3,191		
29	Cheque			26		
29	Dividend on investment				2728	
29	Cheque			666		4,362
31	Bank Charges			936		3,426

Test Your Understanding (1)

Your cash book at 31 Dec 20X3 show a bank balance of $565 overdrawn. On comparing this with your bank statement at the same date, you discover the following.

1- A cheque for $57 drawn by you on 29 Dec 20X3 has not yet been presented for payment.

2- A cheque for $92 from a customer, which was paid into the bank on 24 Dec 20X3, has been dishonored on 31 Dec 20X3.

What is the correct bank balance to be shown in the statement of financial position as at 31 Dec 20X3?

A. $715 overdrawn B.

$657 overdrawn

C. $473 overdrawn

D. $53 overdrawn

Test Your Understanding (2)

The cash book shows a bank balance of %5,675 overdrawn at 31 August 20X5. It is subsequently discovered that a standing order for $125 has been entered twice, and that a dishonored cheque for $450 has been debited in the cash book instead of credited.

What is the correct bank balance?

A. $5,100 overdrawn

B. $6,000 overdrawn

C. $6,250 overdrawn

D. $6,450 overdrawn

Test Your Understanding (3)

A business had a balance at the bank of $2,500 at the start of the month. During the following month, it paid for materials invoiced at $1,000 less trade discount of 20% and settlement discount of 10%. It received a cheque from a customer in respect of an invoice for $200, subject to settlement discount of 5%.

What was the balance at the bank at the end of the month?

A- $1,970

B- $1,980

C- $1,990

D- $2,000

Test Your Understanding (4)

The bank statement on 31 Oct 20X7 showed an overdraft of $800. On reconciling the bank statement, it was discovered that a cheque drawn by your company for $80 had not been presented for payment, and that a cheque for $130 from a customer has been dishonored on 30 Oct 20X7, but that this had not yet been notified to you by the bank.

What is the correct bank balance to be shown in the statement of financial position at 31 Oct 20X7?

A. $1,010 overdrawn

B. $880 overdrawn C. $750 overdrawn

D. $720 overdrawn

Test Your Understanding (5)

The following information relates to a bank reconciliation.

1. The bank balance in the cashbook before taking the items below into account was $8,970 overdrawn
2. Bank charges of $550 on the bank statement have not been entered in the cashbook.
3. The bank has credited the account in error with $425 which belongs to another customer.
4. Cheque payment totaling $3,275 have been entered in the cash book but have not been presented for payment.

5. Cheques totaling $5,380 have been correctly entered on the debit side of the cashbook but have not been paid in at the bank.

What was the balances as shown by the bank statement **before** taking the above items into the account?

A. $9,520overdrawn

B. $11,200 overdrawn

C. $9,520 in credit

D. $11,200 in credit

Test Your Understanding (6)

The following bank reconciliation statement has been prepared by a trainee accountant:

Bank Reconciliation 30 Sept 20X2

	$
Balance per bank statement (overdrawn)	36,840
Add: lodgement credited after date	51,240
	88.080
Less: unpresented cheque	43,620
Balance per cash book	44,460

Assuming the amounts stated for items other than the cash book balance are correct, what should the cash book balance be?

A. $44,460 credit as stated

B. $60,020 credit

C. $29,220 debit

D. $29,220 credit

Test Your Understanding (7)

Listed below are some possible causes of difference between the cash book balance and the bank statement balance when preparing a bank reconciliation:

1. 1 Cheque paid in, subsequently dishonored
2. Error by the bank
3. Bank charges
4. Lodgements credited after date
5. Unpresented cheques not yet presented

Which of these items require an entry in the cash book?

A- 1 and 3 only

B- 1,2,3,4 and 5

C- 2,4, and 5 only

D- 4 and 5 only

Test Your Understanding (8)

Which of the following statements about bank reconciliations are correct?

1. A difference between the cash book and the bank statement must be corrected by means of a journal entry.
2. In preparing a bank reconciliation, lodgments recorded before date in the cash book but credited by the bank after date should reduce an overdrawn balance in the bank statement.
3. Bank charges not yet entered in the cash book should be dealt with by an adjustment in the bank reconciliation statement.
4. If a cheque received from customer is dishonored after the date, a credit entry in the cash book is required A- 2 and 4

   B- 1 and 4

   C- 2 and 3

   D- 1 and 3

Test Your Understanding (9)

The following bank reconciliation statement has been prepared by a trainee accountant:

		$
Balance per bank statement (overdrawn)		3,860
Less: unpresented cheque		9,160
		5,300
Add: deposits credited after date	16,690	
Balance per cash book	21,990	

What should be the correct balance per the cash book?

A. $21,990 balance at bank as stated

B. $3,670 balance at the bank

C. $11,390 balance at the bank

D. $3,670 overdrawn

Test Your Understanding (10)

The following attempt at a bank reconciliation statement has been prepared by Q Co:

Balance per bank statement (overdrawn)	38,600	
Add: deposits not credited	41,200	
	79,800	
Less: unpresented cheque	3,300	
Overdraft per cash book		76,500

Assuming the bank balance of $38,600 to be correct, what should be the cash balance be?

A. $76,500 overdrawn, as stated

B. $5,900 overdrawn

C. $700 overdrawn

D. $5,900 cash at bank

CHAPTER -16 CORRECTION OF ERRORS

1 Types of error in accounting

There are five main types of errors. Some can be corrected by journal entry, some require the use of suspense account.

1. Errors of transposition
2. Errors of omission
3. Errors of principle
4. Errors of commission
5. Compensating errors

Once an error has been detected, it needs to be put right.

- If the correction **involves a double entry** in the ledger accounts, then it is done by using **journal entry**.
- When the error **breaks the rule of double entry**, then it is corrected by the use of a **suspense account** as well as a journal entry.

1.1 Errors of transposition

An error of transposition is when two digits in a figure are accidentally recorded the wrong way round.

1.2 Errors of Omission

An error of omission means failing to record a transaction at all, or making a debit or credit entry, but not the corresponding double entry.

1.3 Errors of principle

An error of principle involves making a double entry in the belief that the transaction is being entered in the correct accounts, but subsequently finding out that the accounting entry breaks the rules of an accounting principle or concept.

1.4 Errors of commission

Errors of commission are where the bookkeeper makes a mistake in carrying out his or her task of recording transactions in the accounts. Two common types of errors of commission.

a) Putting a debit/credit entry in the wrong account
b) Errors of casting (adding)

1.5 Compensating Errors

Compensating errors are errors which are, coincidently, equal and opposite to one another.

1.6 Summary: Errors that can be deducted by a trial balance

- Errors of transposition
- Errors of omission (if the omission is one sided)
- Errors of commission (if one-sided, or two debit entries are made)

Others errors will not be deducted by extracting a trial balance, but may be spotted by other controls (such as bank or control account reconciliations).

Test Your Understanding (1)

Which one of the following would be an error of principle?

A. Plant and machinery purchased was credited to a non-current assets account.

B. Plant and machinery purchased was debited to the purchases account.

C. Plant and machinery purchased was debited to the equipment account.

D. Plant and machinery purchased was credited to the equipment account.

Test Your Understanding (2)

What is an error of commission?

A. An error where a transaction has not been recorded.

B. An error where one side of a transaction has been recorded in the wrong account, and that account is of a different class to the correct account.

C. An error where one side of a transaction has been recorded in the wrong account, and that account is of the same class as the correct account.

D. An error where the numbers in the posting have been transposed

Test Your Understanding (3)

Where a transaction is entered into the correct ledger accounts, but the wrong amount is used, what is the error known as?

A- An error of omission

B- An error of original entry

C- An error of commission

D- An error of principle

Test Your Understanding (4)

Two types of common errors in bookkeeping are error of principle and errors of transposition. Which of the following correctly states whether or not these errors will be revealed by extracting a trial balance?

	Errors of principle	*Errors of transposition*
A.	Will be revealed	will not be revealed
B.	Will be revealed	Will be revealed
C.	Will not be revealed	will not be revealed
D.	Will not be revealed	Will be revealed

2 The correction of errors

2.1 Journal entries

Some errors can be corrected by journal entries. The format of journal entry is as follow.

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

2.2 Example

Write out the journal entries which would correct these errors.

1. A business receives an invoice for $250 from a supplier which was omitted from the books entirely.
2. Repair worth $150 were incorrectly debited to the non-current asset (machinery) account instead of the repair account.
3. The bookkeeper of the business reduces the cash sales by $280 because he was not sure what the $280 represented. In fact, it was a withdrawal on account of profit.
4. Telephone expense of $540 were incorrectly debited to the electricity account.
5. A page in the sales daybook has been added up to $28,425 instead of$28,825.

2.3 Question

A business sells $500 of goods on credit. What is the correct journal to reflect this transaction?

A. Debit sales $500, Credit trade receivable $500

B. Debit trade receivable $500, Credit sales $500

2.4 Suspense Accounts

A suspense account is an account showing a balance equal to the difference in a trial balance.
A suspense account is a temporary account which can be opened for several reasons.
The most common reasons are as follows.

a) A trial balance is drawn up which does not balance (ie total debits do not equal total credits).

b) The bookkeeper of a business knows where to post the credit side of a transaction but does not know where to post the debit (or vice versa).

Under no circumstances should there still be a suspense account when it comes to preparing the statement of financial position of a business. **The suspense account must be cleared** and all the correcting entries made before the final accounts are drawn up.

2.5 Question

At the year-end of T Down & Co, an imbalance in the trial balance was revealed which resulted in the creation of a suspense account with a credit balance of $1,040.
Investigation revealed the following errors.

1. A sale of goods on credit for $1,000 had been omitted from the sales account.
2. Delivery and installation costs of $240 on a new item of plant had been recorded as a revenue expenses.
3. Cash discount of $150 on paying a supplier, JW, had been taken, even though the payment was made outside the time limit.
4. Inventory of stationary at the end of the period of $240 had been ignored.
5. A purchase of raw materials of $350 had been recorded in the purchase account as $850.
6. The purchase return daybook included a sales credit note for $230 which had been entered correctly in the account of the customer concerned, but included with purchase return in the nominal ledger.

Required

a) Prepare journal entries to correct each of the above errors. Narratives are not required.
b) Open suspense account and show the corrections to be made.
c) Prior to the discovery of the errors, T Down & Co.'s gross profit was calculated at $35,750 and the profit for the year at $18,500.

2.6 Effect if correction of errors on profit for the year and total assets

Question 2.6.1

A Company's statement of profit or loss for the year ended 31 Dec 20X5 show a profit for the year of $65,000. It was later found that $18,000 paid for maintenance to motor vehicles had been debited to the motor vehicles at cost account and had been depreciated as if it was a new motor vehicle. It is the company policy to depreciate motor vehicles 25 % per year k on the straight-line basis, with a full year's charge in the year of acquisition. What would be the profit for the year after adjusting for this error?

A. $78,500

B. $47,000

C. $83,000

D. $51,500

Question 2.6.2

Beta Co has total assets of $555,000 and profit for the year of $160,000 recorded in the financial statements for the year ended 31 Dec 20X3. Inventory costing $45,000 which was received into the warehouse on 2 Jan 20X4, was included in the financial statements at 31 Dec 20X3 in error.

What would be the profit for the year and total assets after adjusting for this error?

	Profit For the year	Total Assets
A.	$205,000	$600,000
B.	$115,000	$600,000
C.	$205,000	$510,000
D.	$115,000	$510,000

Question 2.6.3

Rogitts Co purchases goods on credit with a list price of $75,000 from Bodean Co and received a trade discount of 10%. Rogitts Co paid the full amount due to Bodean Co within 25 Days and received a settlement discount of 5% for the prompt payment. The trainee accountant at Rogitts Co recorded the purchase of goods in the purchase account net of both discount. At the year end all these goods had been sold.

What is the effect on gross profit and profit for the year of correcting the trainee accountant's mistake?

	Gross profit	Profit for the year
A.	Decreased by $3,375	no effect
B.	Decreased by $3,375	decreased by $3,375
C.	Increased by $10,875	increased by $10,875
D.	Decreased by $10,875	no effect

Test Your Understanding (5)

The debit side of a trial balance total $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 asset account

B- Credit note issued to a customer of $400 has been debited to trade receivables.

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.

Test Your Understanding (6)

The bookkeeper of Peri made the following mistakes:

Sales return $384 were credited to the purchase returns account.

Purchase returns of $296 were debited to the sales return account.

Which one of the following journal entries will correct the errors?

	Dr($)	Cr($)
A- Sales returns	768	
Purchase return		592
Suspense Account		176
B- Sales returns	88	
Purchase return	88	
Suspense Account		176
C- Sales returns	680	
Purchase return		680
D- Suspense Account	176	
Sales return		88
Purchase return		88

Test Your Understanding (7)

A company's trial balance failed to agree, the totals being

Debit	$815,602
Credit	$808,420

Which one of the following errors could fully account for the difference?

A- The omission from the trial balance of the balance on the insurance expense account $7,182 debit

B- Settlement discounts received from suppliers of $3,591 were credited in error to the purchase account

C- No entries made in the records for cash sale totaling $7,182

D- The return outwards total of $3,591 was included in the trial balance as a debit balance.

Test Your Understanding (8)

A business statement of profit or loss and other comprehensive income for the year ended 31 Dec 20X4 showed a net profit of $83,600. It was later found that $18,000 paid for the purchase of motor van had been debited to motor expenses account. It is the company's policy to depreciate motor vans at 25 % per year, with a full year's charge in the year of acquisition.
What would the net profit be after adjusting for this error?

A- $106,100

B- $70,100

C- $97,100

D- $101,600

Test Your Understanding (9)

An organization restores its petty cash balance to $250 at the end of each month. During October, the total expenditure column in the petty cash book was calculated as being $210, and the imp rest was restored by this amount. The analysis columns posted to the nominal ledger totaled only $200.
Which one of the following would this error cause?

A. The trial balance being $10 higher on the debit side

B. The trial balance being $10 higher on the credit side

C. No imbalance in the trial balance

D. The petty cash balance being $10 lower than it should be

Test Your Understanding (10)

Net profit was calculated as being $10,200. It was later discovered that capital expenditure of $3,000 had been treated as revenue expenditure, and revenue receipt of $1,400 had been treated as capital receipt.

What is the net profit after correcting this error?

A- $5,800

B- $8,600

C- 11,800

D- 14,600

Test Your Understanding (11)

The accountant at Investotech discovered the following errors after calculating the company profit for 20X3:--

1. A non-current asset costing $50,000 has been included in the purchase account
2. Stationery costing $10,000 has been included as closing inventory of raw materials, instead of stationery expenses

What is the effect of this errors on gross profit and net profit?

A. Understatement of gross profit by $40,000 and understatement of net profit by $30,000

B. Understatement of both gross profit and net profit by $40,000

C. Understatement of gross profit by $60,000 and understatement of net profit by $50,000

D. Overstatement of both gross profit and net profit by $60,000

Test Your Understanding (12)

Beta Co has total assets of $650,000 and profit for the year of $150,000 recorded in the financial statements for the year ended 31 Dec 20X3. Inventory costing $50,000, with a resale value of $75,000, was received into the warehouse on 2 Jan 20X4 and included in the inventory value that are recorded in the financial statements at 31 Dec 20X3.

What would the total assets figure in the statement of financial position, and the adjusted profit for the year, be after adjusting for this error?

Total asset (SOFP)	Profit for the year
A- $700,000	$200,000
B- $600,000	$100,000
C- $725,000	$225,000
D- $600,000	$75,000

Test Your Understanding (13)

The suspense account shows a debit balance of $100. What could this balance due to?

A- Entering $50 received from A Turner on the debit side of A Turner's account

B- Entering $50 received from A Turner on the credit side of A Turner's account

C- Undercasting the sales daybook by $100

D. Undercasting the purchase account by $100

Test Your Understanding (14)

A suspense account shows a credit balance of $130. Which of the following could be due to?

A- Omitting a sale of $130 from the sales ledger

B- Recording s purchase of $130 twice in the purchase account

C- Failing to write off a bad debt of $130

D- Recording an electricity bill paid of $65 debiting the bank account and crediting the electricity account

Test Your Understanding (15)

A suspense account was opened when a trial balance failed to agree. The following errors were later discovered.

- A gas bill of $420 had been recorded in the gas account as $240.
- A sales invoice to a customer for $50 had been credited to accounts receivable
 Interest received of $70 had been entered in the bank account only.

What was the original balance on the suspense account?

A- Debit $210

B- Credit $210

C- Debit $160

D- Credit $160

Test Your Understanding (16)

A trial balance extracted from a sole trader's records failed to agree, and a suspense account was opened for the difference.

Which of the following errors would require an entry in the suspense account in correcting them?

1- Sales returns were mistakenly debited to the purchases returns account.

2- Cash received from the sale of a non-current asset was correctly entered in the cash book but was debited to the disposal account

3- The balance on the rent account was omitted from the trial balance

4- Goods taken from inventory by the proprietor had been recorded by crediting drawings account and debiting purchases account.

A- All four items

B- 2 and 3 only

C- 2 and 4 only

D- 1 and 3 only

Test Your Understanding (17)

A company's trial balance totals were:

Debit	$387,642	
Credit		$379,511

A suspense account was opened for the difference.

Which one of the following errors would have the effect of reducing the difference when corrected?

A- The petty cash balance of $500 has been omitted from the trial balance

B- $4,000 received for rent of part of the office has been correctly recorded in the cash book and debited to rent account

C- $3,000 paid for repairs to plant has been debited to the plant asset account

D- An invoice for Mr A Smith for $400 has been posted to the account of Mrs B Smith in error

Test Your Understanding (17)

A company's trial balance failed to agree, the out of balance difference of $25,000 being posted to suspense account.

Subsequent investigation revealed the difference was due to one side of an entry to record the purchase of machinery for $25,000, by cheque, failing to post to the plant and machinery account. Which of the following journal entries would correct the error?

		Debit ($)	Credit ($)
A-	Plant and Machinery	25,000	
	Bank current account		25,000
B-	Suspense account	25,000	
	Plant and Machinery		25,000
C-	Plant And Machinery	25,000	
	Suspense account		25,000
D-	Bank current account	25,000	
	Suspense account		25,000

CHAPTER- 17 Incomplete Records

1 Incomplete records questions

Incomplete records questions may test your ability to prepare accounts in the following situations.

- The proprietor of the business does not keep a full set of accounts.
- Some of business accounts are accidentally lost or destroyed.
- Some essential figure is unknown and must be calculated as a balancing figure.

2 The accounting and business equations

Two equations are very useful in incomplete records calculations.

1. The accounting equation
2. The business equation

2.1 The accounting equation

Assets = Capital +Liabilities

Capital = Assets – Liabilities
Capital = Net Assets

2.2 Example: Opening Statement of financial position

Suppose Joe Han's business has the following assets and liabilities as at 1 Jan 20X3.

	$
Fixture and Fitting at cost	7,000
Provision for depreciation of Fixture and fitting	4,000
Motor Vehicle at cost	12,000
Provision for depreciation of motor vehicles	6,800
Inventory	4,500
Trade receivable	5,200
Cash at bank and in hand	1,230
Trade payables	3,700
Prepayment	450
Accrued rent	2,000

Required

Prepare the statement of financial position for the business, inserting a balancing figure for proprietor's capital.

2.3 The business equation

The business equation is simply an extension of the accounting equation.
Closing net assets= Opening net assets + Capital introduced + Profit – Drawings

Profit / (loss) = (Closing net assets- Opening net assets) – Capital introduced + Drawings

Profit/ (loss) = movement in net assets – Capital introduced + Drawings

2.4 Example

Joe starts up his computer shop on 1 Jan 20X1 from the rented premises, with $5,000 inventory and $3,000 in the bank. All his sales are for cash. He keeps no record of his takings.
At the end of the year, he has inventory worth $6,600 and $15,000 in the bank. He owes $3,000 to suppliers. He had paid in $5,000 he won the lottery and drawn out $2,000 to buy himself a motorbikes. The motorbike is not used in the business. He has been taking drawings of $100 per week. What is his profit at 31 Dec 20X1?

Question

Net assets at the beginning of 20X7 were $101,700. The proprietor injected new capital of $8,000 during the year and took drawings of $2,200. Net assets at the end of 20X7 were $180,000.
What was the profit earned by the business?

A. $72,500 profit
B. $88,300 profit
C. $84,300 profit
D. $(84,100) loss

2.5 Drawings

Where such personal items of receipts or payments are made, the following adjustments should be made.

a) Receipt should be set off against drawings. For example, id a business owner receives $600 in dividend income from investments not owned by the business and pays it into their business bank account, then the accounting entry

Cash A/C	Dr
Drawings A/C	Cr

b) Payment should be charged to drawing on account

Drawings A/C	Dr
Cash A/C	Cr

If the trader has taken goods from inventory for personal use, the goods should be taken out of purchases and not included in inventories. The value of the goods taken ***is recorded at cost*** to the business, not at sale price.

Drawings A/C	Dr
Purchase A/C	Cr

Test Your Understanding (1)

Which of the following calculations could produce an acceptable figure for a trader's net profit for a period if no accounting records has been kept?

A- Closing net assets plus drawings minus capital introduced minus opening net assets

B- Closing net assets minus drawings plus capital introduced minus opening net assets

C- Closing net assets minus drawings minus capital introduced minus opening net assets

D- Closing net assets plus drawings plus capital introduced minus opening net assets

Test Your Understanding (2)

A sole trader's business made a profit of $32,500 during the year ended 31 March 20X8. This figure was after deducting $100 per week wages for himself. In addition, he put his home telephone bill through the business books, amounting to $400 plus sales tax at 17.5%. He is registered for sales tax and therefore has charged only the net amount to his statement of profit or loss and other comprehensive income.

His capital at 1 April 20X7 was $6,500. What was his capital at 31 March 20X8?

A- $ 33,730

B- $33,800

C- $38,930

D- $39,000

3 Credit Sales & Trade Receivables

Receipt from trade receivables	***
(+) Closing Trade Receivables	***
(-) Opening Trade Receivables	(***)
Credit sales	***

3.1 Example

Joe Han's business had trade receivables of $1,750 on 1 April 20X4 and trade receivables of $3,140 on 31 March 20X5. If payment received from receivables during the year to 31 March 20X5 were $28,490, and if there is no bad debts, calculate the credit sales during the period by using Formula and T-account alternatively.

Test Your Understanding (4)

A business has compiled the following information for the year ended 31 Oct 20X2:

Opening inventory	$386,200
Purchases	$989,000
Closing inventory	$422,700

The gross profit as a percentage of sales is always 40%

Based on these figures, what is the sales revenue for the year?

A- $1,333,500

B- $1,587,500

C- $2,381,250

D- The sales figure cannot be calculated from this information

Test Your Understanding (5)

Alpha is a sole trader who does not keep proper accounting records.

Alphas's first year of trading was 20X4. From reviewing Alpha's bank statements and the incomplete records relating to cash maintained, the following summary has been compiled. Bank and cash summary, Alpha, 20X4

Cash received from credit customers and paid into the bank	$381,600
Expenses paid out of cash received from credit customer before banking	$6,800
Cash sale	$112,900
Closing trade receivable	$0

Which of the following correctly represents Alpha's sales figure for 20X4?

A- $508,500

B- $112,900

C- $381,600

D- $494,100

3Purchases and Trade Payables

FORMULA TO LEARN	**$**
Payment to trade payables during the period	xxx
Plus closing balance of trade payables	xxx
Less opening balance of trade payables	(xxx)
Credit purchases during the period	xxx

4.1 Example

Joe Han's business had trade payables of $3,728 on 1 Oct 20X5 and trade payables of $2,645 on 30 Sept 20X6. If payment to trade payable during the year to 30 Sept 20X6 were $31,479, calculate the purchases during the year by using the formula and T-account alternatively.

4.2 Question

Mr Harmon does not keep full accounting records, but the following information is available in respect of his accounting year ended 31 Dec 20X9.

Cash purchase during the year	3,900
Cash pai,d for goods supplied on credit	27,850
Trade payables at 1 Jan 20X9	970
Trade payable at 31 Dec 20X9	720

In his trading account for 20X9, what will be the Harmon's figure for purchases?

Test Your Understanding (6)

Senji does not keep proper accounting records, and it is necessary to calculate her total purchase for the year ended 31 January 20X3 from the following information:

	$
Trade payables: 31 Jan 20X2	130,400
31 Jan 20X3	171,250
Payment to supplier	888,400
Cost of goods taken from inventory by Senji for her personal use	1,000
Refunds received from customers	2,400
Discount received	11,200

What is the figure for purchases that should be included in Senji's financial statement?

A- $914,650

B- $937,050

C- $939,500

D- $941,850

5 Establishing cost of sales

FORMULA TO LEARN	$
Opening inventory	xxx
Plus purchase	xxx
Less closing inventory	(xxx)
Equal the cost of goods sold	xxx

The Cost of goods sold	xxx
Plus closing inventory	xxx
Less opening inventory	(xxx)
Equal Purchases	xxx

5.1 Examples

The inventory of Joe Han's business on 1 July 20X6 has a value of $8,400 and an inventory count at 30 June 20X7 showed inventory to be valued at $9,350. Sales for the year to 30 June 20X7 are $80,000, and the business makes a mark- up of 331/3% on cost for all the items that sells. What are the purchases during the year?

5.2 Gross Profit Margin and Gross profit Mark-up

Two different terms may be given to you in the exam in the calculation of profit.

Mark-up is the profit as a percentage of **cost**. (GP/CGS*100)

Gross profit margin is the profit as a percentage of **sales**. (GP/Sales*100)

5.3 Question

Harry has budgeted sales for the coming year of $175,000. He achieves a constant mark-up of 40% on cost. He plans to reduce his inventory level by $13,000 over the year.

What will the Harry's purchases be for the year?

5.4 Question

Using the same facts as in the question above, calculate Harry's purchases for the year if he achieves a constant margin of 40% on sales.

Test Your Understanding (7)

On 31 Dec 20X0 the inventory of V was completely destroyed by fire. The following information is available:

Inventory at 1 Dec 20X0 at cost $28,400

Purchases for Dec 20X0 $49,000

Sales for Dec 20X0 $64,800

Standard gross profit percentage on sale revenue 30%

Based on this information, which of the following is the amount of inventory destroyed?

A- $45,360

B- $32,640

C- $40,791

D- $19,440

Test Your Understanding (8)

The following information is available for the year ended 31 Dec 20X4 for a trader who does not keep proper accounting records:

	$
Inventories at 1 Jan 20X4	38,000
Inventories at 31 Dec 20X4	45,000
Purchases	637,000
Gross profit percentage on sales= 30%	

Based on this information, what was the trader's sales figure for the year?

A- $900,000

B- $819,000

C- $920,000

D- $837,200

Test Your Understanding (9)

A sole trader who does not keep full accounting records wishes to calculate her sale revenue for the year.

The information available is:

Opening inventory	$17,000
Closing inventory	$24,000
Purchases	$91,000

Standard gross profit percentage on sales revenue 40%

Which of the following is the sales figure for the year calculated from these figures?

A- $117,600

B- $108,000

C- $210,000

D- $140,000

Test Your Understanding (10)

Aluki fixes prices to make a standard gross profit percentage on sales of 20%.

The following information for the year ended 31 January 20X3 is available to compute her sale total for the year

Inventory: 1 Feb 20X2	$243,000
31 Jan 20X3	$261,700
Purchases	$595,400
Purchase return	$41,200

What is the sales figure for the year ended 31 January 20X3?

A- $669,375

B- $702,600

C- $772,375

D- $741,480

6- Stolen goods or goods destroyed

	$
Cost of goods sold and lost (Actual Cost of sales)	xxx
Estimated Cost of sales	(xxx)
Cost of goods lost	xxx

6.1 Example

Orlean Flames is a shop which sells fashion clothes. On 1 Jan 20X5, it had trade inventory which cost $7,345. During the 9 months to 30 Sept 20X5, the business purchased goods from suppliers costing $106,420. Sales during the same period were $154,000. The shop makes a gross profit of 40% on cost for everything it sells. On 30 Sept 20X5, there was a fire in the shop which destroyed most of the inventory in it. Only a small amount of inventory, known to have a cost $350, was undamaged and still fit for sale.

How much of the inventory was lost in the fire?

6.2 Example

Beau Gullard runs a jewelry shop on the high street. On 1 Jan 20X9, his trade inventory, at cost, amounted to $4,700 and his trade payables $3,950.

During the 6 months to 30 June 20X9, sales were $42,000. Beau Gullard makes a gross profit of 331/3% on the sale value of everything he sells.

On 30 June, there was a burglary at the shop, and all the inventory was stolen.

In trying to establish how much inventory had been taken Beau Gullard was only able to say that:

a. He knew from his bank statements that he had paid $28,400 to trade account payables in the 6-month period to 30 June 20X9.
b. He currently had payables due of $5,550.

Required

1. Calculate the amount of inventory stolen.
2. Calculate the gross profit for the 6 month to 30 June 20X9.

6.3 Accounting for inventory destroyed, stolen or otherwise lost

1- If the lost goods were **not insured**, the business must **bear loss, and the loss** is shown in the statement of profit or loss.

Expenses A/C	Dr (eg administrative expense)
Cost of sale A/C	Cr

2- If the goods were insured, the business will not suffer a loss, because the insurance will pay back the cost of the lost goods. There is no charge at all in the statement of profit or loss.

Insurance Claim A/C (Receivable)	Dr (SOFP-Current Assets)
Cost of sales A/C	Cr

When the claim is paid, the account is then closed by

Cash A/C	Dr
Insurance Claim A/C	Cr

Test Your Understanding (11)

A sole trader fixes his price to achieve a gross profit percentage on sale revenue of 40%. All his sales are for cash. He suspects that one of sales assistants is stealing cash from revenue.

His trading account for the month of June 20X3 is as follow:

	$
Recorded sales revenue	181,600
Cost of sales	114,000
Gross profit	67,600

Assuming that the cost of sales figure is correct, how much cash could the sales assistant have taken?

A- $5,040

B- $8,400

C- $22,000

D- It is not possible to calculate a figure from this information

Test Your Understanding (12)

A fire on 30 Sept 20X2 destroyed some of a company's inventory and its inventory and its inventory records.

The following information is available:

Inventory at 1 Sept 20X2	$318,000
Sales for September 20X2	$612,000
Purchase for September	$412,000
Inventory in good condition at 30 Sept 20X2	$214,000

Standard gross profit percentage on sales is 25%.

Based on this information, what is the value of inventory lost?

A- $96,000

B- $271,000

C- $26,400

D- $57,600

Test Your Understanding (13)

A sole trader fixes her prices by adding 50% to the cost of all goods purchased. On 31 October 20X3 a fire destroyed a considerable part of the inventory and all inventory records.

Her trading account for the year ended 31 October 20X3 include the following figures:

	$	$
Sales		281,250
Opening inventory	183,600	
Purchases	249,200	
Closing inventory	204,600	228,200
Gross Profit		53,050

Using this information, what inventory loss has occurred?

A- $61,050

B- $87,575

C- $40,700

D- $110,850

7 The Cash Book

A ***two-column cash book*** is a cash book with one column for cash receipts and payments, and one column for money paid into and out of the business bank account.

7.1 Theft of cash from the till

When cash is stolen from the till, the amount stolen will be a credit entry in the cash book, and debit in either the expense section in the statement of profit or loss or insurance account, depending on whether the business is insured.

7.3 Example

Suppose, for example, that a business had, on 1 Jan 20X8, trade receivable of $2,000, cash in the bank $3,000 and cash in hand of $300.

During the year to 31 Dec 20X8, the business banked $95,000in takings.

It is also paid out the following expenses in cash from the till.

Drawings	$1,200
Sundry Expense	$800

On 29 August 20X8 a thief broke into the shop and stole $400 from the till.

At 31 Dec 20X8 trade receivables amounted to $3,500, cash in the bank $2,500 and cash in the till $150.

What was the value of sales during the year?

8 Accruals and prepayments

8.1Example

On 1 April 20X6, a business had prepaid rent of $700 which relates to the next accounting period. During the year to 31 March 20X7 it pays $9,300 in rent, and at 31 March 20X7 the prepayment of rent is $1,000. Calculate the rent charged in statement of profit or loss.

8.2 Example

A business has accrued telephone expenses as at 1 July 20X6 of $850, pays $6,720 in telephone bills during the year to 30 June 20X7, and has accrued telephone expenses of $1,140 as at 30 June 20X7. Calculate the telephone expenses shown in statement of profit or loss.

CHAPTER-(18)
Preparation of Financial Statements for Sole Traders

Topic List
1- Preparation of final accounts

1 Preparation of final accounts

1-1 Format of the sole trader final accounts

Business Name

Statement of profit or loss for the year ended xx/xx/xxxx

	$	$	$
Revenue		xxx	
Return inwards		(xxx)	xxx
Less: Cost of Sales			
Opening inventory		xxx	
Purchases	xxx		
Carriage inwards	xxx		
Return outwards	(xxx)	xxx	
Closing inventory		(xxx)	(xxx)
Gross Profit			xxx
Other income			
Discount received		xxx	
Decrease allowance for doubtful debt		xxx	xxx
			xxx
Expenses			
Discount allowed		xxx	
Carriage outwards		xxx	
Administrative Expenses		xxx	
Distribution costs		xxx	(xxx)
Net Profit			xxx

Business Name
Statement of Financial Position as at xx/xx/xxxx

	Cost $	Acc: Depn $	C.A $
Assets			
Non-current assets			
Property, Plants & Equipment	xxx	xxx	xxx
Current Assets			
Inventory		xxx	
Trade Receivables	xxx		
Allowance for doubtful debts	(xxx)		
Bank		xxx	
Cash		xxx	
Prepayments		xxx	xxx
Total Assets			xxx
Capital			
Opening capital			xxx
Net Profit			xxx
Drawings			(xxx)
Closing Capital			xxx
Non-current Liabilities			
Loan			xxx
Current Liabilities			
Trade Payables		xxx	
Bank overdrafts		xxx	
Accruals		xxx	xxx
Total Capital and Liabilities			xxx

1.2 Example

The following trial balance was extracted from the ledger of Stephen Chee, a sole trader, as at 31 May 20X1- the end of his financial year.

STEPHEN CHEE
TRIAL BALANCE AS AT 31 MAY 20X1

	Dr ($)	Cr ($)
Property at cost	120,000	
Equipment at cost	80,000	
Provision for depreciation (as at 1 June 20X0)		
-on property		20,000
-on equipment		38,000
Purchases	250,000	
Sales		402,200
Inventory as at 1 June 20X0	50,000	
Discount received		4,800

Returns Outward		15,000
Wages and salaries	58,800	
Irrecoverable debts	4,600	
Loan Interest	5,100	
Other operating expenses	17,700	
Trade payables		36,000
Trade receivables	38,000	
Cash in hand	300	
Bank	19,300	
Drawings	24,000	
Allowance for receivables		500
17% long term loan		30,000
Capital as at 1 June 20X0		121,300
	667,800	667,800

The following additional information as at 31 May 20X1 is available.

a) Inventory as at the close of business has been valued at cost at $42,000.

b) Wages and salaries need to be accrued by $800.

c) Other operating expenses are prepaid by $300.

d) The allowance for receivables is to be adjusted so that it is 2% of trade receivables.

e) Depreciation for the year ended 31 May 20X1 has still to be provided for as follows. Property: 1.5% per annum using the straight line method

 Equipment: 25% per annum using the reducing balance method.

Required

Prepare Stephen Chee's statement of profit of loss for the year ended 31 May20X1 and his statement of financial position as at that date.

1.3 Question

Donald Brown, a sole trader, extracted the following trial balance on 31 Dec 20X0.

TRIAL BALANCE AS AT 31 DEC 20X0

	Dr ($)	**Cr($)**
Capital as at 1 Jan 20X0		26,094
Receivables	42,737	
Cash in hand	1,411	
Payables		35,404
Fixture and fittings at cost	42,200	
Discount received		1,175
Inventory as at 1 Jan 20X0	18,460	
Sales		491,620
Purchases	387,936	
Motor Vehicles at cost	45,730	
Lighting and Heating	6,184	
Motor Expenses	2,862	
Rent	8,841	
General expenses	7,413	
Bank overdraft		18,557
Provision for depreciation		
Fixture and fittings		2,200
Motor Vehicles		15,292
Drawing	26,568	
	591,646	591,646

The following information as at 31 Dec is also available.

a) $218 is owing for motor expenses.

b) $680 has been prepaid for rent.

c) Depreciation is to be provided for the year as follows. - Motor vehicles: 20% on cost.
   - Fixture and fittings: 10% reducing balance method

d) Inventory at the close of business was valued at $19,926.

Required

1. Prepare Donald Brown's statement of profit or loss for the year ended 31 Dec 20X0.
2. Which of the following formulas correctly describes the figure to be entered as a capital on Donald Brown's statement of financial position?
   - A. Balance b/f + gross profit for the year –drawings
   - B. Balance b/f – gross profit for the year + drawings
   - C. Balance b/f + gross profit for the year – drawings
   - D. Balance b/f –profit for the year + drawings

   What is the net effect on profit of the adjustments in notes (a) to (c) abo

Chapter-(19) Introduction to Company Accounting

1 Limited Liability and Accounting records

There are some important differences between the accounts of a limited liability company and those of sole traders or partnership.

Limited Liability

Limited Liability companies offer limited liability to their owners.
Limited liability means that the maximum amount that an owner stands to lose, in the event that the company becomes insolvent and cannot pay off its debts, is their share of the capital in the business.

Unlimited Liability

Unlimited liability means that if the business run up debts that it is unable to pay, the proprietors will become personally liable for the unpaid debts and would be required, if necessary, to sell their private possessions to repay them.
Thus limited liability is a **major advantage** of turning a business into a limited liability company.

Disadvantage

- ✓ Compliance with legislation
- ✓ Compliance with national accounting standards and/or International Financial Reporting Standards
- ✓ Formation and annual registration costs

The Accounting records of limited companies
Companies are normally required by law to keep accounting records which are sufficient to show and explain the company's transactions.
The detailed requirements of accounting records which must be maintained will vary from country to country.

2 Share Capital

Capital of limited liability companies

The proprietors' capital in a limited liability company consists of **share capital**. When a company is set up **for the first time**, it issues shares, which are paid by investors, who then **become shareholders** of the company. Shares are denominated in units of 25 cents, 50 cents, $1 or whatever seems appropriate.
The **face value** of the share is called their **par value or legal value** (or sometime the **nominal value**).

Authorized Share Capital The maximum amount of share capital that a company is empowered to issue**.**

Issue share capital

The amount of share capital that has been issued to shareholders.

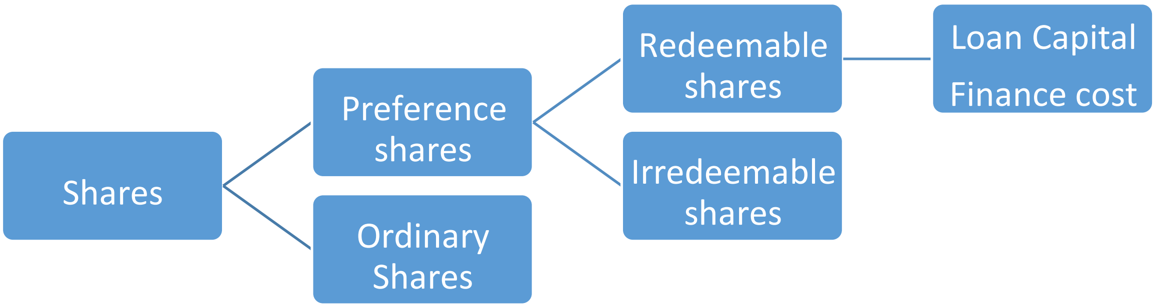
Called-up share capital

The amount of the company has asked shareholders to pay, for the time being on shares issues to them.

Paid-up Share Capital

The amount actually paid by shareholders on shares issued to them

2.1 Ordinary Shares and Preference shares



Preference Shares	Ordinary Shares
Priority right to return of their share capital if the company wound up	Should the company be wound up, any surplus not distributed is shared between the ordinary shareholders.
Do not carry voting right	Carry voting right, therefore the effective owner of the equity.
Right to a final dividend which is express as a percentage of their par value	Carry no right to fixed dividend and fluctuate the dividend amount

Redeemable Preference Shares

It mean that the company will redeem (repay) the nominal value of those shares at a later date. They are treated like loans and are included as non-current liabilities in the statement of financial position. Remember to reclassify as current liabilities if the redemption is due within 12 months.

Irredeemable Preference Shares

They are treated just like other shares. They form part of equity and their dividends are treated as appropriation of profit.

Question

How would you classify redeemable preference shares 20X9 in the financial statement for the year ended 30 June 20X8, if the shares are due to be redeemed in September 20X9?

A- As part of equity

B- A long term liability

C- A current liability

Question

Garden Gloves Co has issued 50,000 ordinary shares of 50 cents each and 20,000 7% preference shares of $1 each. Its profit after taxation for the year to 30 September 20X5 were $8,400. The management board has decided to pay an ordinary dividend (ie a dividend on ordinary shares) which is 50% of profit after tax and preference dividend. **Required**

Show the amount in total of dividends and of retained profits and calculate the dividend per share on ordinary shares.

2.2 Loan Stock or bonds

Limited Liability Company may issue loan stock or bonds. These are long-term liabilities or loan capital which is the same ways as issuing share capital raise finance. They are different from share capital in the following ways.

- ✓ **Shareholders** are **members** of a company, while ***provider of loan capital*** are ***creditors***.
- ✓ **Shareholders** received **dividends** whereas the ***holder of loan capital*** are entitled to a ***fixed rate of interest***.
- ✓ ***Loan capital holder*** can take a ***legal action*** against company if their interest is not paid when due, whereas **shareholders cannot reinforce** the payment of dividend.
- ✓ ***Loan stock is often secured*** on company assets, whereas **shares are not**.

3 Reserves

Share capital and reserves are owned by the shareholders. They are known collectively as shareholders equity.

Shareholders' equity consist of the following.

- Par value of issued share capital
- Other equity (Share premium, revaluation surplus, general reserves and retained earnings)

3.1 Share premium

A share premium account is an account into which sum received as payment for shares in excess of their nominal value must be placed.

Example

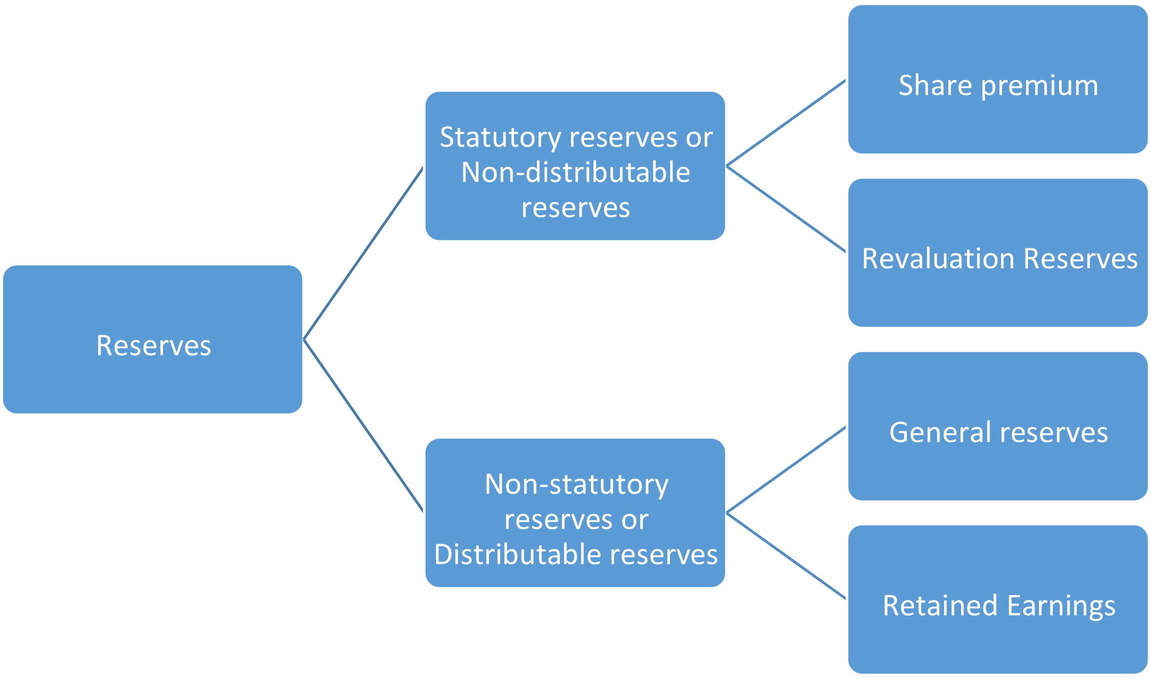
X Co issues 1,000 $1 ordinary shares at $2.60 each.

Prepare journal entry for this transaction.

Question

AB Co issues 5,000 50c shares for $6,000. What are the entries for share capital and share premium in the statement of financial position?

	Share Capital	Share Premium
A-	$5,000	$1,000
B-	$1,000	$5,000
C-	$3,500	$3,500
D-	$2,500	$3,500



Statutory Reserves or Non-Distributable Reserves

They are reserves which a company is required to set up by law and which are not available for the distribution of dividends.

Non-statutory Reserves or Distributable Reserves

They are reserves consisting of profits which are distributable as dividends, if the company so wishes.

Question

A company has authorized share capital of 1,000,000 50c ordinary shares and an issued share capital of 800,000 50c ordinary shares. If an ordinary dividend of 5% is declared, what is the amount payable to shareholders?

A- $50,000

B- $20,000

C- $40,000

D- $25,000

3.2 Retained Earnings

This is the most significant reserve and is variously described as

- Revenue Reserves
- Retained Earnings
- Accumulated profits
- Undistributed profits Unappropriated profits

3 Bonus and Right Issues

A company can increase its share capital by means of **a bonus issue or a right issue**.

3.1 Bonus (Capitalization) Issues

A company may wish to increase its share capital without wishing to raise additional finance by issuing new shares.

It is open to such a profitable company to reclassify some of its reserves as share capital. This is purely a paper exercise which raise no funds.

Advantages

Increase capital without diluting current shareholders' holdings

Capitalizes reserves, so they cannot be paid dividends

Disadvantages

Does not raise any cash

Could jeopardize payment of future dividends if profits fall.

Example

Bubbles Co

Statement of financial position (Extract)

Shareholders' Equity

	$'000	$,000
Share Capital ($1 ordinary shares)		1,000
Reserves		
Share premium	500	
Retained Earnings	2000	
		2,500
		3,500

Bubbles Co decided to make a "3 for 2" bonus issue.

Question

Clarke Fringland Co

Statement of financial position as at 31 December 20X3

(Extract)	$'000
Share Capital (50c)	10,000
Share Premium	7,000
Retained Earnings	8,000
	25,000

Clarke Fringland Co has decided on a bonus issue of shares '1 for 4' and will use the share premium account for this purposes.

Required

What is the double entry to record the bonus issue of shares and what is the adjusted financial position extract after the bonus issues?

3.2 Right Issues

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

Advantages

Raise cash for the company

Keeps reserves available for future dividends

Disadvantages

Dilutes shareholders' holdings if they do not take up right issues

Question

Clarke Fringland Co

Statement of financial position as at 31 December 20X3 (Extract)

	$'000	Share
Capital (50c)	10,000	
Share Premium	7,000	
Retained **Earnings**	8,000	
	25,000	

Clarke Fringland decided on a right issues of 1 for 4 at $1.2

Question

X Co has the following capital structure.

	$
400,000 ordinary shares of 50c	200,000
Share premium account	70,000
Retained Earnings	230,000
Shareholders' equity	500,000

Show its capital structure following;

(a) A 1 for 2 bonus issue

(b) A right issues of 1 for 3 at 75c following the bonus issue, assuming all rights taken up

4 Leger Accounts and Limited liability

Limited companies keep **ledger accounts.** The **only difference** between the ledger accounts of companies and sole trader is the nature of the transactions, assets and liabilities for which accounts need to be kept.

1- Taxation

Tax charged against profit will be accounted for by:

Debit SOPL

Credit Taxation

When the companies paid tax eventually

Debit Taxation

Credit Cash

2- Dividends

Dividend declared out of profits will be disclosed in the notes if they are unpaid at the year end.

When dividends are paid,

Debit Dividend paid Account

Credit Cash

3- Loan Stock

Loan stock is a long-term liability in SOFP.

Interest payable on such loan,

Debit Interest account (Finance costs)

Credit Interest payable

4- Share capital and Reserves

There will be a separate account for

Each different class of share capital

Each type of reserves

Chapter-(20) Preparation of financial statements for companies

1 IAS 1: Presentation of financial statements

IAS 1 *Presentation of financial statements* gives substantial guidance on the form and content of published financial statements.

- A complete set of financial statements includes the following.
- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of changes in equity
- Statement of cash flows
- Notes, including a summary of significant accounting policies and other explanatory information

IAS 1 gives guidance on the format and content of all of these, apart from the statement of cash flows, which is covered by IAS 7.

1.1 Identification of financial statements

The entity should identify each component of the financial statements very clearly. IAS 1 also requires disclosure of the following information in a prominent position.

- **Name** of the entity (or other means of identification)
- Whether the accounts cover the **single** entity only or a **group** of entities
- The **reporting date** or the period covered by the financial statements (as appropriate)
- The **reporting currency** used in presenting the figures in the financial statements

2 The statement of financial position

2.1 Statement of financial position

IAS 1 gives the following suggested format for a statement of financial position.

ABC Co
STATEMENT OF FINANCIAL POSTION AS AT 31 DECEMBER 20X2

	20X2		20X1	
	$000	$000	$000	$000
Assets				
Non-current assets				
Property, plant and equipment	xxx		xxx	
Goodwill	xxx		xxx	
Other intangible assets	xxx	xxx	xxx	xxx
Current Assets				
Inventories	xxx		xxx	
Trade receivables	xxx		xxx	
Other current assets	xxx		xxx	
Cash and cash equivalents	xxx	xxx	xxx	xxx
Total assets		**xxx**		**xxx**
Equity and liabilities				
Equity				
Share Capital	xxx		xxx	
Retained Earnings	xxx		xxx	
Other components of equity	xxx	xxx	xxx	xxx
Non-current liabilities				
Long term borrowings	xxx		xxx	
Long term provisions	xxx	xxx	xxx	xxx
Current Liabilities				
Trade and other receivables	xxx		xxx	
Short term borrowings	xxx		xxx	
Current portion of long term borrowings	xxx		xxx	
Current tax payable	xxx		xxx	
Short term provision	xxx	xxx	xxx	xxx
Total equity and liabilities		**xxx**		**xxx**

3 The statement of profit or loss and other comprehensive income

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 31 DECEMBER 20X2
Illustrating the classification of expenses by function

	20X2 $000	20X1 $000
Revenue	xxx	xxx
Cost of sales	(xxx)	(xxx)
Gross profit	xxx	xxx
Other incomes	xxx	xxx
Distribution costs	(xxx)	(xxx)
Administrative expenses	(xxx)	(xxx)
Other expenses	(xxx)	(xxx)
Finance cost	(xxx)	(xxx)
Profit before tax	xxx	xxx
Income tax expenses	(xxx)	(xxx)
Profit for the year	xxx	xxx
Other comprehensive income		
Gain on property revaluation	xxx	xxx
Total comprehensive income for the year	**xxx**	**xxx**

4 Statement of changes in equity

An example statement of changes in equity is shown below.
ABC CO
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X2

	Share capital	*Share premium*	*Revaluation surplus*	*Retained earnings*	*Total*
Balance at 1.1.X2	xxx	xxx	xxx	xxx	xxx
Changes in accounting policy				(xxx)	(xxx)
Restated balance	xxx	xxx	xxx	xxx	xxx
Changes in equity for 20X2					
Dividends				(xxx)	(xxx)
Total comprehensive income for the year			xxx	xxx	xxx
Issue of share capital	xxx	xxx			xxx
Balance at 31.1.X2	xxx	xxx	xxx	xxx	xxx

****Dividend paid*** during the year are not shown on the statement of profit or loss; they are shown in the statement of changes in equity.

5 Notes to the financial statements

Disclosure notes are included in a set of financial statements to give users extra information. The following topics need to show the disclosure notes.

- IAS 16 Tangible non-current assets
- IAS 38 Intangible non-current assets
- IAS 37 Provision
- IAS 10 Events after the reporting period
- IAS 2 Inventory

6 Company accounts for internal purposes

The financial accounts used internally look very similar to those produced for external reporting for various reasons.

a. The information required by internal users is similar to that required by external users. Any additional information for managers is usually provided by management accounts.
b. Financial accounts produced for internal purposes can be used for external reporting with very little further adjustment.

6.1 Question

The accountant of Zabit Co has prepared the following trial balances as at 31 December 20X7.

	$000
50c ordinary shares (fully paid)	350
7% $1 preference shares (fully paid)	100
10% loan stock (secured)	200
Retained earnings 1.1.X7	242
General reserves 1.1.X7	171
Land and building at cost 1.1.X7	430
Plant and machinery at cost 1.1.X7	830
Accumulated Depreciation	
Buildings 1.1.X7	20
Plant and Machinery 1.1.X7	222
Inventory 1.1.X7	190
Sales	2,965
Purchases	2,152
Preference dividend	7
Ordinary dividend (interim)	8
Loan interest	10

Wages and salaries	254
Light and heat	31
Sundry expenses	113
Suspense account	135
Trade accounts receivable	179
Trade account payable	195
Cash	126

Notes

1. Sundry expenses include $9,000 paid in respect of insurance for the year ending 1 September 20X8. Light and heat does not include an invoice of $3,000 for electricity for 3 months ending 2 January 20X8, which was paid in February 20X8. Light and heat also includes $20,000 relating to salespeople's commission.
2. The suspense account is in respect of the following items.

$'000	
Proceeds from the issue of 100,000 ordinary shares	120
Proceeds from sales of plant	300
	420
Less consideration for the acquisition of Mary & Co	285
	135

3. The net assets of Mary & Co were purchased on 3 March 20X7. Assets were valued as follows.

	$'000
Investments	231
Inventory	34
	265

All the inventory acquired was sold during 20X7. The investments were still held by Zabit
at 31.12.X7.

4. The property was acquired some years ago. The building element of the cost was estimated at $100,000 and the estimated useful life of the assets was 50 years at the time of purchase. As at 31 December 20X7 the property is revalued at $800,000.
5. The plant which was sold had cost $350,000 and had carrying amount of $274,000 as at 1.1.20X7. $36,000 depreciation is to be charged on plant and machinery for 20X7.
6. The loan stock has been in issue for some years. The 50c ordinary shares all rank for dividends at the end of the year.
7. The management is wish to provide for:
   i. Loan stock interest due
   ii. A transfer to general reserve of $16,000

iii. Audit fees of $4,000

8. Inventory as at 31 December 20X7 was valued at $220,000 (cost).
9. Taxation is to be ignored.

Required

Prepare the financial statements of Zabit Co as at 31 December 20X7, including the statement of changes in equity. No other notes are required.

7 IFRS 15 Revenue from Contract with Customer

IFRS 15 Revenue from contract with customers replaces IAS 18 Revenue (effective for annual reporting period beginning on or after 1 January 2018.

IFRS 15 is concerned with reporting the nature, amount, timing and uncertainty of revenue and cash flows resulting from contract with customers.

Revenue from contract with customers arises from common transaction.

- The sale of goods
- The rendering of services

7.1 Introduction

Revenue is generally **recognized as earned at the point of sale**, because at that point **four criteria** will generally have been **met**.

1. The product or service has been **provided for the buyer**.
2. The buyer has **recognized their liability** to pay for the goods or services provided.
3. The buyer has indicated their **willingness to hand over cash** or other assets in settlement of their liability.
4. The **monetary value** of goods or services has been established.

IFRS 15 applies to long-term service contracts as well as simpler sales transactions involving single product or services.

7.2 Scope

IAS 15 covers the revenue from contract with customers except:

Leases within the scope of IAS 17
Insurance contracts within the scope of IAS 4
Financial instruments and other contractual rights and obligations within the scope of IFRS 9, IFRS 10, IFRS 11, IAS 27 or IAS 28.
Non-monetary exchanges between entities in the same line of business

7.3 Definitions

Revenue

Revenue is income arising in the course of an entity's ordinary activities.

Income

Income is increases in the economic benefits during the accounting period in the form of inflows or enhancement of assets or decrease of liabilities that result in an increase in equity, other than those relating to contribution from equity participants.

Contract

A contract is an agreement between two or more parties that creates enforceable rights and obligations.

Customer

A customer is a party that has contracted with an entity to obtain goods or services that are an ouput of the entity ordinary activities in exchange for consideration.

Performance obligation

A performance obligation is a promise in a contract with a customer to transfer to the customer either: a goods or services (or a bundle of goods or services) that is distinct; or a series of distinct goods or services that are substantially the same that have the same pattern of transfer to customers.

Transaction Price

Transaction price is the amount of consideration to which an entity expects to be entitled in exchange of transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

*** Revenue does not include sales taxes, value added taxes or goods and services taxes which only collected for third parties, because they do not represent economic benefits flowing to the entity.

7.4 Recognition Criteria

The key principles of IFRS 15 is that revenue is recognized to depict the transfer of promised goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. This is achieved by ***five step* model**:

- ✓ Identify the contract(s) with customer
- ✓ Identify the performance obligation in the contract
- ✓ Determine the transaction price
- ✓ Allocate the transaction price to the performance obligations in the contract ✓

Recognize revenue when (or as) the entity satisfies a performance obligation

7.5 Example

TDF is a company that manufactures office furniture. A customer placed an order on 22 December 20X4 for an office desk at a price of $300 plus sales tax at 20% of $60. The desk was delivered to customer on 25 January 20X5, who accepted the goods as satisfactory by signing a delivery note.TDF then invoiced the customer for the goods on 1 February 20X5. The customer paid $360 to TDF on 1 March 20X5.

Required

How should TDF for revenue?

7.6 Question

Discus under what circumstances, if any, revenue might be recognized at the following stages of a sale.

a) Goods are acquired by the business which it confidently expects to resell very quickly
b) A customer places a firm order for the goods
c) The goods are delivered to the customer
d) The customer is invoiced for the goods
e) The customer pays for the goods
f) The customer's cheque in payment for the goods is cleared by the bank

8 Practice Question

USB, a limited liability company, has the following trial balance at 31 December 20X9.

	Debit	Credit
	$'000	$'000
Cash at bank	100	
Inventory 1 Jan 20X9	2,400	
Administrative Expenses	2,206	
Distribution costs	650	
Non-current assets at cost:		
Buildings	10,000	
Plant and equipment	1,400	
Motor Vehicles	320	
Suspense		1,500
Accumulated Depreciation		
Building		4,000
Plant and equipment		480
Motor Vehicles		120
Retained Earnings		560
Trade receivables	876	
Purchases	4,200	
Dividend paid	200	
Sales revenue		11,752
Sales tax payable		1,390
Trade payables		1,050
Share premium		500
$1 ordinary shares		1,000
	22,352	**22,352**

The following additional information is relevant.

a) Inventory at 31 December 20X9 was valued at $1,600,000. While doing the inventory count, errors in the previous year's inventory count were discovered. The inventory brought forward at the beginning of the year should have been $2.2m, not $2.4m as above.

b) Depreciation is to be provided as follows.

   i. Buildings at 5% straight line, charged to administrative expense. ii. Plant and equipment at 20% on reducing balance basis, charged to cost of sales iii. Motor vehicles at 25% on reducing balance basis, charged to distribution costs.

c) No final dividend is being proposed.

d) A customer has gone bankrupt owing $76,000. This debt is not expected to be recovered and an adjustment should be made. An allowance for receivables of 5% is to be set up.

e) 1m new ordinary shares were issued at $1.5 on 1 December 20X9. The proceeds have been left in a suspense account.

Required

Prepare the following.

1. Statement of profit or loss for the year ended 31 Dec 20X9.
2. Statement of changes in equity for the year ended 31 Dec 20X9.
3. Statement of financial position as at 31 Dec 20X9.

All statements are to be prepared in accordance with the requirement of IFRSs. Ignore taxation.

15 marks

Test Your Understanding (1)

Which of the following items may appear as current liabilities in the company statement of financial position?

1- Reevaluation surplus

2- Loan due for repayment within one year

3- Taxation

4- Preference dividend payable on redeemable preference share

Test Your Understanding (2)

Which of the following might appear as an item in the company's statement of changes in equity?

1- Profit on disposal of properties

2- Surplus on reevaluation of properties

3- Equity dividend proposed after the reporting date

4- Issue of share capital

A- 1,3 and 4 only

B- 2 and 4 only

C- 1 and 2 only

D- 3 and 4 only

Test Your Understanding (3)

Which of the following items are required to be disclosed by limited liability Company, either on the face of their main financial statements or in the notes, according to International Financial Reporting Standards?

1- Share capital

2- Finance costs

3- Dividend proposed

4- Depreciation and Amortization

A- 1,2 and 3 only

B- 2,3 and 4 only

C- 1,2 and 4 only

D- All four items

Test Your Understanding (4)

Which of the following could appear as separable items in the statement of changes in equity required by IAS 1 Presentation of Financial Statements as part of a company's financial statements?

1- Dividend on equity shares paid during the period

2- Loss on sale of investment

3- Proceeds of an issue of ordinary shares

4- Dividends proposed after the year end

A- 1,3 and 4 only

B- 1,2 and 4 only

C- 1 and 3 only

D- All four items

Test Your Understanding (5)

Which one of the following items does not appear under the heading 'equity and reserves' on a company statement of financial position?

A- Share premium account

B- Retained Earnings

C- Revaluation Surplus

D- Loan Stock

Test Your Understanding (6)

Which of the following statements about limited liability companies' accounting is/are correct?

1- A revolution surplus arises when a non-current asset is sold at a profit.

2- The authorized share capital of a company is the maximum nominal value of shares and loan notes the company may issue.

3- IAS 10 Events after the reporting period requires all non-adjusting events to be disclosed in the notes to the financial statements.

A- 1 and 2 only

B- 2 only

C- 3 only

D- None of the statements are correct

Test Your Understanding (7)

Fruitz Co has a liability relating to 20X1 brought forward in 20X2 of $16,000. This liability is finally agreed at $ 18,500, which is paid in 20X2.

Fruitz's accountant estimates their tax liability for profit earned in 20X2 will be $20,000.

What should the charge for taxation be in Fruitz's statement of profit or loss for the year ended 31 December 20X2?

A- $22,500

B- $15,000

C- $17,500

D- $20,000

Test Your Understanding (8)

The correct ledger entries needed to record the issue of 200,000 $1 shares at a premium of 30c, and paid for in full, would be

A-	Dr Ordinary share capital	$200,000	
	Cr Share premium account		$60,000
	Cr Cash		$140,000
B-	Dr Cash	$260,000	
	Cr Ordinary share capital		$200,000
	Cr Share Premium account		$60,000
C-	Dr Ordinary share capital	$200,000	
	Cr Share premium account		$60,000
	Cr Cash		$260,000
D-	Dr Cash	$200,000	
	Dr Share Premium Account	$60,000	
	Cr Ordinary share capital		$260,000

Chapter (21) Events after the reporting period

1 Definition

Events occurring after the reporting period are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date on which the financial statements are authorised for issue.

2 Two types of events

- ***Adjusting events*** Those that provide evidence of conditions that existed at the end of the reporting period
- ***Non-adjusting events*** Those that are indicative of conditions that arose after the reporting period

2.1 Events requiring adjustment (Adjusting Events)

An entity shall adjust the amounts recognized in its financial statements to reflect adjusting events after the reporting period.

Examples of adjusting events

- Customer goes bankrupt, inslovency of customer with a balance owing at the year end
- Going concern assumption is no longer appropriate due to operating results and the financial position have deteriorated after the reporting period
- Evidence of a permanent diminution in property value prior to the year end
- Sale of inventory after the reporting period for less than its carrying value at the year end
- Amounts received or paid in respect of legal or insurance claims which were in negotiation at the year end
- Determination after the year end of the sale or purchase price of assets sold or purchased before the year end
- Evidence of a permanent diminution in the value of a long-term investment prior to the year end
- Discovery of error or fraud which shows that the financial statements were incorrect

2.2 Events not requiring adjustment (non-adjusting events)

- An entity shall not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the reporting period
- If non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions of users taken on the basis of the financial statements

- An entity shall disclose the following for each material categories of non-adjusting event after the reporting period
   - The nature of the event
   - An estimate of its financial effect, or a statement that such an estimate cannot be made

Examples of non-adjusting events

- Acquisition of, or disposal of, a subsidiary after the year end
- Announcement of a plan to discontinue an operation
- Major purchases and disposals of assets
- Destruction of a production plant by fire after the reporting period
- Announcement or commencing implementation of a major restructuring
- Share transactions after the reporting period
- Litigation commenced after the reporting period

2.3 Dividends

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.

Question

State whether the following events occurring after the reporting period require an adjusting to the assets and liabilities of the financial statements.

(a) Purchase of an investment

(b) A change in the rate of tax, applicable to the previous year

(c) An increase in pension benefits

(d) Losses due to fire

(e) An irrecoverable debt suddenly being paid

(f) The receipt of proceeds of sales or other evidence concerning the net realizable value of inventory

(g) A sudden decline in the value of property held as a long-term asset

Test Your Understanding (1)

Which of the following materials events after the reporting period and before the financial statements are approved by the directors should be adjusted for in those financial statements?

1. A valuation of property providing evidence of impairment in value at the reporting period
2. Sale of inventory held at the end of the reporting period for less than cost
3. Discovery of fraud or error affecting the financial statements
4. The insolvency of a customer with a debt owing at the end of the reporting period which is still outstanding

A. All of them
B. 1, 2 and 4 only
C. 3 and 4 only
D. 1,2 and 3 only

Test Your Understanding (2)

The draft financial statements of a limited liability company are under consideration. The accounting treatment of the following materials events after the reporting period needs to be determined.

1. The bankruptcy of a major customer, with a substantial debt outstanding at the end of the reporting period.
2. A fire destroying some of the company's inventory (the company's going concern status is not affected)
3. An issue of shares to finance expansion
4. Sale for less than cost of some inventory held at the end of the reporting period

According to IAS 10 Events after the reporting period, which of the above events require an adjustment to the figures in the draft financial statements?

A. 1 and 4 only
B. 1,2 and 3 only
C. 2 and 3 only
D. 2 and 4 only

Test Your Understanding (3)

In finalizing the financial statements of a company for the year ended 30 June 20X4, which of the following material matters should be adjusted for?

1. A customer who owed $180,000 at the end of the reporting period went bankrupt in July 20X4.
2. The sale in August 20X4 for $400,000 of some inventory items valued in the statement of financial position at $500,000.
3. A factory with a value of $3,000,000 was seriously damaged by a fire in July 20X4. The factory was back in production by August 20X4 but its value was reduced to $2,000,000. 4. The company issued 1,000,000 ordinary shares in August 20X4.

A. All four items
B. 1 and 2 only
C. 1 and 4 only
D. 2 and 3 only

Test Your Understanding (4)

IAS 10 Events after the reporting period regulates the extent to which events after the reporting period should be reflected in financial statements.

Which one of the following lists of such events consists only of items that, according to IAS 10, should normally be classified as non-adjusting events?

A. Insolvency of an account receivable which was outstanding at the end of the reporting period, issue of shares or loan notes, an acquisition of another company.

B. Issues of shares or loan notes, changes in foreign exchange rates, major purchases of noncurrent assets.

C. An acquisition of another company, destruction of a major non-current assets by fire, discovery of fraud or error which shows that the financial statements were correct.

D. Sale of inventory which gives evidence about its value at the end of the reporting period, issue of shares or loan notes, destruction of a major non-current assets by fire.

Test Your Understanding (5)

Which of the following events occurring after the reporting period are classified as adjusting, if material?

A. The sale of inventory valued at cost at the end of the reporting period for a figure in excess of cost.

B. A valuation of land and buildings providing evidence of an impairment in value at the year end

C. The issue of share or loan note

D. The insolvency of a customer with a balance outstanding at the year end.

Test Your Understanding (6)

The financial statements of Overexposure Co for the year ended 31 December 20X1 are to be approved on 31 March 20X2. Before they are approved, the following events take place.

1. On 14 Feb 20X2 the directors took the strategic decision to sell their investment in Quebec Co despite the fact that this investment generated material revenues.
2. On 15 March 20X2, a fire occurred in the eastern branch factory which destroyed a material amount of inventory. It is estimated that it will cost $505,000 to repair the significant damage done to the factory.
3. On 17 March 20X2, a customer of Overexposure Co went into liquidation. Overexposure has been advised that it is unlikely to receive payment for any of the outstanding balances owed by the customer at the year end.

How should these events reflected in the financial statements at 31 December 20X1?

	Adjust	Disclose	Do Nothing
A.	3	2,3	1
B.	2,3	1	-
C.	3	1,2	-
D.	2	3,1	-

Test Your Understanding (7)

Which of the following events between the reporting date and the date the financial statements are authorized for issue must be adjusted in the financial statements?

1. Declaration of equity dividends
2. Decline in market value of investments
3. The announcement of changes in tax rates
4. The announcement of a major restructuring

A- 1 only

B- 2 and 4

C- 3 only D- None of them

Test Your Understanding (8)

If a material event occurs after the reporting date but before the financial statements are authorized for issue outside the organization, and this event does not require adjustment, what information should be disclosed in the financial statements?

A- The nature of the event and an estimate of the financial effect (or a statement that such an estimate cannot be made)

B- The nature of the event only

C- An estimate of the financial effect (or a statement that such an estimate cannot be made) only

D- No disclosure required

CHAPTER- (22) Statement of Cash Flow (IAS-7)

1 IAS 7 Statement of cash flow

Statement of cash flows are useful addition to the financial statements of a company because accounting profit is not the only indicator of performance. They concentrate on the sources and ca

- The amount that could afford to pay as dividend depends on the sufficient cash available, not on profit.
- The ability to pay higher wages depends on the availability of cash.
- Survival of a business entity depends not so much on profits as on its ability to pay its debts when they fall due.

1.1 Objective of IAS 7

The aim of IAS 7 is to provide information for users of financial statements about an entity's ability to generate cash and cash equivalent, as well as indicating the cash needs of the entity. The statement of cash flows provides historical information about cash and cash equivalents, classifying cash flows between operating, investing and financing activities.

1.2 Definitions

Cash comprises cash on hand and demand deposits.
Cash equivalents are short-term, highly liquid investments that are readily convertible to known amount 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 principal revenue-producing activities of the enterprise and other activities that are not investing and financing activities.
Investing activities are the acquisition and disposal of non-current assets and other investments not included in cash equivalents.
Financing activities are activities that result in charges in the size and the composition of the equity capital and borrowing of entity.

1.3 Reporting cash flow from operating activities

The standard offers a choice of method for this part of the statement of cash flows.

1. Direct Method
2. Indirect Method

1.4 Format of statement of cash flow

Statement of cash flow for the year ended (Direct Method)

	$m	$m
Cash flow from operating activities		
Cash receipt from customers	xxx	
Cash paid to suppliers and employees	(xxx)	
Cash generated from operation	(xxx)	
Interest paid	(xxx)	
Income tax paid	(xxx)	
Net cash from operating activities		xxx
Cash flow from investing activities		
Purchase of property, plant and equivalents	(xxx)	
Proceed from sales of PPE	xxx	
Interest received	xxx	
Dividend received	xxx	
Net cash used/ inflow from investing activities		(xxx)/xxx
Cash flows from financing activities		
Proceeds from issue of share capital	xxx	
Proceeds from long term borrowings	xxx	
Dividend paid*	(xxx)	
Net cash used in financing activities		xxx
Net increase/decrease in cash and cash equivalent		xxx/(xxx)
Cash and cash equivalents at the beginning of the period		xxx
Cash and cash equivalent at the end of the period		xxx

*Dividend paid could be shown as an operating cash flow.

Note. Cash and cash equivalents	B/d	C/d
	$	$
Cash on hand and balance in cash	xxx	xxx
Short term investment	xxx	xxx
Cash and cash equivalent	xxx	xxx

Statement of cash flow for the year ended xx/xx/xxxx (Indirect Method)

	$m	$m
Cash flow from operating activities		
Net profit before taxation	xxx	
Adjustment for:	(xxx)	
Depreciation expenses	xxx	
Disposal loss	xxx	
Disposal profit	(xxx)	
Interest Expenses	xxx	
Investment income	(xxx)	
Operating profit before working capital changes	xxx	
Inventory increase/decrease	(xxx)/xxx	
Trade receivable increase/decrease	(xxx)/xxx	
Trade payable increase/ decrease	xxx/(xxx)	
Cash generated from operation	xxx	
Interest paid	(xxx)	
Income tax paid	(xxx)	
Net cash from operating activities		xxx
Cash flow from investing activities		
Purchase of property, plant and equivalents	(xxx)	
Proceed from sales of PPE	xxx	
Interest received	xxx	
Dividend received	xxx	
Net cash used/ inflow from investing activities		(xxx)/xxx
Cash flows from financing activities		
Proceeds from issue of share capital	xxx	
Proceeds from long term borrowings	xxx	
Dividend paid*	(xxx)	
Net cash used in financing activities		xxx
Net increase/decrease in cash and cash equivalent		xxx/(xxx)
Cash and cash equivalents at the beginning of the period		xxx
Cash and cash equivalent at the end of the period		xxx

1.5 Example : Direct Method

Boggis Co had the following transactions during the year.

a) Purchases from suppliers were $19,500 of which of $2,550 was unpaid at the year end. Brought forward payables were $1,000.

b) Wages and salaries amounted to $10,500 of which $750 was unpaid at the year end. The accounts for the previous year showed an accrual for wages and salaries of $1,500.

c) Interest of $2,100on long-term loan was paid in the year.

d) Sales revenues was $33,400 including $900 receivable at the year end. Brought forward receivables were $400.

e) Interest on cash deposits at the bank amounted to $75.

Calculate the cash flow from operating activities using direct method.

2 Preparing a statement of cash flow

2.1 Example

Colby Co's statement of profit or loss for the year ended 31 Dec 20X2 and statement of financial position at 31 Dec 20X1 and 31 Dec 20X2 were as follows.

COBLY CO

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000	$'000
Revenue		720
Raw material consumed	70	
Staff cost	94	
Depreciation	118	
Loss on the disposal of non-current assets	18	(300)
		420
Interest payable		(28)
Profit before tax		392
Taxation		(124)
Profit for the year		268

COLBY CO

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X2		20X1	
	$'000	$'000	$'000	$'000
Assets				
Property, plant and equipment				
cost	1,596		1,560	
Depreciation	318	1278	224	1,336
Current Assets				
Inventory	24		20	
Trade receivables	76		58	
Bank	48	148	56	134

Total assets		1,426		1,470
Equity and liabilities				
Capital and reserves				
Share capital	360		340	
Share premium	36		24	
Retained Earning	716	1,112	514	878
Non-current liabilities				
Non- current loans		200		500
Current liabilities				
Trade payables	12		6	
Taxation	102	114	86	92
Total equity and liabilities		1,426		1,470

During the year the company paid $90,000 for new piece of machinery.
Dividends paid during 20X2 totaled $66,000 and interest paid was $28,000. Required
Prepare a statement of cash flow for the year ended 31 Dec 20X2 in accordance with the requirement of IAS 7, using the indirect method.

2.2 Question

Set out below are thyoue financial statements of Shabnum Co. You are the financial controller, face with the task of implementing IAS 7 Statement of cash flows.
SHABNUM CO
STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000
Revenue	2,553
Cost of sales	(1,814)
Gross profit	739
Distribution cost	(125)
Administrative expense	(264)
	350
Interest received	25
Interest paid	(75)
Profit before taxation	300
Taxation	(140)
Profit for the year	160

SHABNUM CO
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X2	20X1
	$'000	$'000
Assets		
Non-current assets		
Property, plant and equipment	380	305
Intangible	250	200

Investment	-	25
Current Assets		
Inventories	150	102
Receivables	390	315
Short term investment	50	-
Cash in hand	2	1
Total Assets	1,222	948
Equity and Liabilities		
Equity		
Share Capital ($1 ordinary shares)	200	150
Share premium Account	160	150
Revaluation Surplus	100	91
Retaining Earnings	260	180
Non-current liabilities		
Loan	170	50
Current Liabilities		
Trade payables	127	119
Bank overdraft	85	98
Taxation	110	120
Total Equity and Liabilities	1,222	948

The following information is available.

a) The proceeds of the sale of non-current assets investments amounted to $30,000.

b) Fixtures and fittings, with an original cost of $85,000 and carrying amount $45,000, were sold for $32,000 during the year.

c) The following information relates to Property, plant and equipment.

	31.12.20X2	31.12.20X1
	$'000	$'000
Cost	720	595
Accumulated Depreciation	340	290
Carrying Amount	380	305

d) 50,000 $1 ordinary shares were issued during the year at a premium of 20c per share.

e) Dividends totaling $80,000 were paid during the year.

Required

a) Prepare the net cash flows from operating activities for the year to 31 Dec 20X2 using the format laid out in IAS 7.
b) Prepare the net cash flows from investing activities for the year to 31 Dec 20X2 using the format laid out in IAS 7.
c) Which one of the following options gives the net cash flows from financing activities for the year?
    A. $180k inflow
    B. $189k outflow
    C. $350k outflow
    D. $360k inflow

d) Prepare the note to the statement of cash flows for the year to 31 December 20X2 using the format laid out in IAS 7.

2.3 The advantages of cash flow accounting

a. The survival of the business depends on **the ability to generate cash**.
b. Cash flow is **more comprehensive** than profit.
c. Creditors of the business are **more interested in an enterprise's ability to repay** them than in its profitability.
d. Cash flow reporting provides **a better means** of comparing the results of different companies than traditional profit reporting.
e. Cash flow reporting **satisfies the needs of all users** better.
f. Cash flow forecasts are **easier to prepare,** as well as more useful, than profit forecasts.
g. They can in some respects **audited more easily** than accounts based on the accruals concept.
h. Cash flow information can **be retrospective** and can also include a forecast for the future.
i. **Forecasts can subsequently be monitored** by the publication of variance statements which compare actual cash flows against forecast.

Test Your Understanding (1)

Which of the following items could appear in company's statement of cash flows?

1. Surplus on revaluation of non-current assets
2. Proceeds of issue of shares
3. Proposed dividend
4. Irrecoverable debts written off
5. Dividend received

A- 1, 2 and 5 only

B- 2,3,4, 5 only

C- 2 and 5 only

D- 3 and 4 only

Test Your Understanding (2)

Part of the process of preparing a company's statement of cash flows is the calculation of cash inflow from operating activities.

Which of the following statements about that calculation (using the indirect method) are correct?

1. Loss on sale of operating non-current assets should be deducted from net profit before taxation.
2. Increase in inventory should be deducted from operating profits
3. Increase in payables should be added to operating profit
4. Depreciation charges should be added to net profit before taxation

A- 1,2 and 3

B- 1, 2 and 4

C- 1,3 and 4

D- 2, 3 and 4

Test Your Understanding (3)

In the course of preparing a company's statement of cash flows, the following figures are to be included in the calculation of net cash from operating activities.

	$
Depreciation charges	980,000
Profit on sale of non-current assets	40,000
Increase in inventories	130,000
Decrease in receivables	100,000
Increase in payables	80,000

What will the net effect of these items be in the statement of cash flows?

A-	Addition to operating profit	890,000
B-	Subtraction from operating profit	890,000
C-	Addition to operating profit	1,070,000

D- Addition to operating profit 990,000

Test Your Understanding (4)

Part of a company's draft statement of cash flow is shown below:

	$'000
Net profit before tax	8,640
Depreciation Charges	(2,160)
Proceeds of sale of non-current assets	360
Increase in inventory	(330)
Increase in account payable	440

The following criticisms of the above extract have been made:

1 Depreciation charges should been added, not deducted.

2 Increase in inventory should have been added, not deducted.

3 Increase in accounts payable should have been deducted, not added.

4 Proceeds of sale of non-current assets should not appear in this part of the statement of cash flows.

Which of these criticisms are valid?

A- 2 and 3 only

B- 1 and 4 only

C- 1 and 3 only

D- 2 and 4 only

Test Your Understanding (5)

In preparing a company's statement of cash flows complying with IAS 7 Statement of Cash Flows, which, if any, of the following items could form part of the calculation of cash flow from financing activities?

1 Proceeds of sale of premises

5 Dividends received

6 Bonus issue of shares

A- 1 0nly

B- 2 only

C- 3 only

D- None of them

Test Your Understanding (6)

Which of the following assertions about statement of cash flow is/ are correct?

1. A statement of cash flows prepared using the direct method produces a different figure for operating cash flow from that produced if the direct method is used.
2. Right issue of share do not feature in statement of cash flows.

3. A surplus on revaluation of a non-current asset will not appear as an item in a statement of cash flows.
4. A profit on the sale of a non-current asset will appear as an item under Cash Flows from Investing Activities in a statement of cash flows.

A- 1 and 4

B- 2 and 3

C- 3 only

D- 2 and 4

Test Your Understanding (7)

IAS 7 requires the statement of cash flows to open with the calculation of net cash from operating activities at by adjusting net profit before taxation.

Which of the following lists consist only of items which could appear in such a calculation?

A. Depreciation, increase in receivables, decrease in payables, proceeds from sale of equipment, increase in inventories

B. Increase in payables, decrease in inventories, profit on sale of plant, depreciation, decrease in receivables

C. Increase in payables, proceed from sale of equipment, depreciation, decrease in receivables, and increase in inventories.

D. Depreciation, interest paid, proceeds from sale of equipment, decrease in inventories

Test Your Understanding (8)

The following extract is from the financial statements of Pompeii, a limited liability company at 31 October:

	20X9 $'000	20X8 $'000
Equity and Liabilities		
Share capital	120	80
Share Premium	60	40
Retained Earnings	85	68
	265	188
Non-current Liabilities		
Bank Loan	100	150
	365	365

What is the cash flow from financing activities to be disclosed in the statement of cash flows for the year ended 31 Oct 20X9?

A- $60,000 inflow

B- $10,000 inflow

C- $110,000 inflow

D- $27,000 inflow

Test Your Understanding (9)

The following information is available about the plant, property and equipment of Lok Co for the year ended to 31 December 20X3?

	$'000
Carrying amount of assets at the beginning of the year	462
Carrying amount of assets at the end of the year	633
Increase in revaluation surplus during the year	50
Disposals during the year, at cost	110
Accumulated depreciation on the assets disposed of	65
Depreciation charge for the year	38

What will be included in cash flows from investing activities for the year, in a statement of cash flows that complies with IAS 7 Statement of Cash Flows?

A- $104,000

B- $159,000

C- $166,000

D- $204,000

Test Your Understanding (10)

Big Time Co had the following transactions during the year.

Purchases from supplier were $18,500, of which $2,550 was unpaid at the year end. Brought forward payables were $1,000.

Wages and salaries amounted to $9,500 of which $750 was unpaid at the year end. The financial statements for the previous year showed an accrual for wages and salaries of $1,500. Interest of $2,100 on a long term loan was paid in the year.

Sales revenues was $33,400 including $900 receivables at the year end. Brought forward receivables were $400.

Interest on cash deposits at the bank amounted to $175.

Using the direct method, what is Big Time Co's cash flow from operating activiites?

A- $3,425

B- $3,775

C- $1,425

D- $6,775

Test Your Understanding (11)

Which one of the following statement is correct?

A. If a business makes a profit, it has positive cash flow.

B. If a business makes a loss, it has negative cash flow.

C. A business may make a profit but have negative cash flow.

D. A business that breaks even has cash inflows equal to cash used.

Test Your Understanding (12)

Toots Co has made healthy profits for the past year, although at times the company has been close to running out of cash. Because Toots Co is profitable, Adam, their accountant is unconcerned by the cash shortage. Jo, the financial controller at Toots Co, is concerned. Jo tells Adam, "Profits are fine on paper, but in the real world cash is king'. Jo believes Toots Co need to take a more proactive approach to cash flow management.

Adam and Jo have two different views. Who is correct, and why?

A- Adam is correct. A profitable business should not waste management time on cash flow issues.

B- Adam is correct. A profitable will always survive and prosper.

C- Jo is correct. Proactive cash flow management is required under IAS 7 Statement of Cash Flows.

D- Jo is correct. A business that does not have cash available to fund operations is likely to fail.

Chapter (23)
Introduction to Consolidated financial Statements

1 Group and Consolidation

The central company, called a parent, generally owns most or all of the shares in the other companies, which are called subsidiaries.

<u>The relevant IFRS for Consolidation are:</u>

IAS 27 Separate Financial Statements
IAS 28 Investments in Associate and Joint Ventures
IFRS 3 Business combination
IFRS 10 Consolidated Financial Statements

2 Definitions

Control

An investor controls an investee when investor is exposed, or has rights, to variable returns from its environment with the investee and can affect those returns through its power over the investee.

Power

Existing rights that give the current liability to direct the relevant activities of the subsidiary.

Subsidiary

An entity that is controlled by another entity (known as parent)

Parent

An entity that controls one or more entities

Group

A parent and all its subsidiaries

Consolidated Financial Statements

The financial statement of the group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity,

Non-controlling Interest

The equity in a subsidiary not attributable, directly or indirectly, to a parent.

Trade or Simple investment

An investment in the share of another entity that is held for the accretion of wealth and is not an associate or a subsidiary.

3 Investment in Subsidiaries

Control can usually be assumed to exist when the parent owns more than half (ie over 50%) of the voting power of the entity unless it can clearly show that such ownership does not constitute control.

The following situations show where control exists, even when the parents own only 50% or less of voting power of the entity.

- The parent has the power over more than 50% of the voting rights by virtue of agreement with other investors
- The parent has the 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 most of the board of directors (or equivalent governing body)
- The parent has the power to cast a majority of voted at meetings of the board of directors.

IAS 10 requires a **parent to present consolidated financial statements** in which the accounts of the parent and subsidiary are combined and presented **as a single entity**.

Question

Socket Co has 100,000 shares of $1 each. On 1 January 20X3, Power Co acquired 45,000 of these shares. In addition, Power Co can appoint 4 out of the 5 directors of Socket Co, thus exercising control over activities.

How should Socket Co be treated in the Consolidated Financial Statements of Power Co?

4 Associates and trade investments

Associate

An entity over which the investor has **significant influence.**

Significant Influence

The power to **participate i**n the financial and operating policy decision of the investee but which is not control or joint control of those policies.

The **existence of significant influence** is usually evidenced in one or more of the following ways.

- Representation on the board of directors (or equivalent) of the investee
- Participation in the policy making process
- Material transactions between investor and investee
- Interchange of management personnel
- Provision of essential technical information

Equity Method

IAS 28 requires the use of the equity method of accounting (or equity accounting) for investment in associates.

<u>Consolidated Statement of Profit or Loss</u>

Consolidated Profit	×××
Group's share of A Co's profit after tax	×××
	×××

Consolidated Statement of financial Position

Non-current Assets

Investment in associate

Cost of investment in Associate	×××
Share of A's profit for the year	×××
Less dividend	×××
	×××

Example

P Co acquires 25,000 of the 100,000 $1 ordinary shares in A Co for $60,000 on 1 January 20X8.In the year to 31 December 20X8, A Co earns profits after tax of $24,000, from which it pays as a dividend of $6,000.

How will A Co's results be accounted for in the individual and consolidated accounts of PCo for the year ended 31 December 20X8?

No Consolidated Accounts

Equity accounting is **available for consolidated accounts** and individual accounts. A company only must 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 investments in associates can be accounted for as an investment at cost or by using the equity method.

Trade Investments

A trade investment is a simple investment in shares of another entity that is not an associate or subsidiary.

Trade investments are simply shown as investments under non-current assets in the consolidated statement of financial position of the group.

Question

Which of the following investments would be treated as an associate in the consolidated financial statements of Smith Co?

A- Smith Co owns 15% of the ordinary shares of Red Co and has significant influence over Red Co.

B- Smith Co owns 45% of the ordinary shares of Pink Co and can appoint 4 out of 5 directors to the board of directors of Pink Co.

C- Smith Co owns 40% of the preference shares (non-voting) and 15% of the ordinary shares of Yellow Co.

D- Smith Co owns 60% of the preference shares (non-voting) and 40% of ordinary shares of Aquamarine Co.

5 Content of Consolidated Financial Statements

Most parent company present their own individuals accounts and their group accounts in a single package. The package typically comprises the following

- Parent company financial statements
- Consolidated statement of financial position
- Consolidated statement of profit or loss and other comprehensive income
- Consolidated statement of cash flows

Test Your Understanding (1)

Which of the following companies are subsidiaries of Gamma Co?

Zeta Co: Gamma Co owns 51% of the non-voting preference shares of Zeta Co

Lota Co: Gamma Co has three representatives on the board of directors of Lota. Each director can cast 10 votes each out of the total of 40 votes at board meetings.

Kappa Co: Gamma Co owns 75% of the ordinary shares of Kappa Co, however Kappa Co is located overseas and is subject to tax in that country.

A- Zeta Co, Lota Co and Kappa Co

B- Zeta Co and Kappa Co

C- Lota Co and Kappa Co

D- Zeta Co and Lota Co

Test Your Understanding (2)

Evergreen Co owns 35% of the ordinary shares of Decidous. What is the correct accounting treatment of the revenues and costs of Decidous for reporting period in the consolidated statement of profit or loss of the Evergreen group?

A- Revenues and cost of Decidous are added to the revenues and costs of Evergreeen on a line by line basis.

B- 35% of the profit after tax of Decidous should be added to the Evergreen's consolidated profit before tax

C- 35% of the revenue and costs of Decidous are added to the revenue and cost of Evergreen on a line by line basis.

D- The revenues and costs of Decidous are added to the revenues and costs of Evergreen Co on a line by line basis, then 65% of the profit after tax is deducted so that only Evergreen Co's share remains in the consolidated financial statements.

Test Your Understanding (3)

Which of the following statements is/are correct?

1- A Co owns 25% of the ordinary shares of B Co, which means that B Co is an associate of A Co,

2- C Co can appoint 4 out of 6 directors to the board of D Co, which means that C Co has control over D Co.

3- E Co has the power to govern the financial and operating policies of F Co, which means that F Co is an associate of E Co,

4- G Co owns 90% of the share capital of H Co, but by agreement with the minority shareholder, has control over the financial and operating policies of H Co, so H Co is an associate of G Co.

A- 1 and 2 only

B- 1,2 and 3 only

C- 3 and 4 only

D- 4 only

Test Your Understanding (4)

Which of the following statements relating to parents and subsidiaries are correct?

1- A parent company could consolidate a company in which it holds less than 50% of the ordinary share capital in certain circumstances

2- Goodwill on consolidation will appear as an item in the parent company's individual statement of financial position.

3- Consolidated financial statements ignore the legal form of the relationship between parents and subsidiaries and present the results and position of the group as if it was a single entity.

A- 1 and 2 only

B- 1 and 3 only

C- 2 and 3 only

D- 3 only

Test Your Understanding (5)

P Co, the parent company of a group,owns shares in three other companies. P Co's holding are:

Q shares giving control of 60% of the voting rights in Q Co

R shares giving control of 20% of the voting rights in R Co. P Co also has the right to appoint or remove all the directors of R Co

S share giving control of 10 % of the voting rights in S Co, plus 90% of the non-voting preference shares Which of these companies are subsidiaries of P Co?

A- Q Co, R Co, S Co

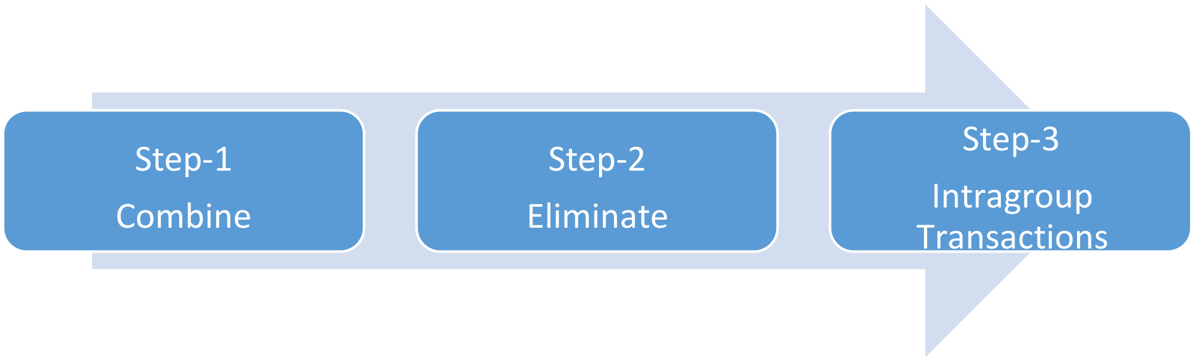
B- Q Co and S Co only

C- R Co and S Co only

D- Q Co and R Co only

Chapter (24)
The Consolidated Statement of Financial Position

1- Summary for Consolidation procedures



Question (1)

P Co; acquires 100% of S Co; on 31 Dec 20X0.

Statement of financial position at 31 Dec 20X0

	P $'000	S $'000
Non-current Assets		
Property, Plants and Equipment	1,000	600
Investment in S	900	
Current Assets	200	200
	2,100	**800**
Equity		
Share capital	1,000	500
Retained Earning	800	200
Current Liabilities	300	100
	2,100	**800**

Required

Prepare a consolidated statement of financial position as at 31 Dec 20X0.

Question (2)

P Co; acquire 80% of S Co; on 31 March 2014.

Statement of financial position at 31 March 2014.

	P $'000	S $'000
Non-current Assets		
Property, Plants and Equipment	1,650	750
Investment in S (400,000 shares)	1,100	
Current Assets	250	650
	3,000	**1,400**
Equity		
Share capital ($1)	1,500	500
Retained Earning	900	400
Current Liabilities	600	500
	3,000	**1,400**

Required

Prepare a consolidated statement of financial position as at 31 March 2014.

Question-3

P Co; acquired 80% of S Co; on 1 Jan 2014 when the balance on the retained earnings of S Co; stood at $505,000.

Statement of financial position at 31 Dec 2015.

	P $'000	S $'000
Non-current Assets		
Property, Plants and Equipment	3,330	550
Investment in S	1,540	
Current Assets	1,030	660
	5,900	**1,210**
Equity		
Share capital	2,500	525
Retained Earning	3,000	585
Current Liabilities	400	100
	5,900	**1,210**

Required

Prepare a consolidated statement of financial position as at 31 Dec 2015.

Question-4

The following summarized statements of financial position are provided for Donald and Kim as at 31 Dec 2017.

	Donald $'000	**Kim $'000**
Non-current Assets		
Property, Plants and Equipment	2,000	500
Investment in S	1,900	
Current Assets	200	800
	4,100	**1,300**
Equity		
Share capital	3,000	300
Retained Earning	1,000	900
Current Liabilities	100	100
	4,100	**1,300**

Donald purchases 225,000 shares in Kim on 1 Jan 2016 for $1,900,000 when Kim's Retained Earnings were $750,000.

Required

Prepare a consolidated statement of financial position as at 31 Dec 2017.

Question-5

Apple Co; acquired 75% of the Orange Co; two year ago on 1 June 20X1 when the balance on the retained earnings of Orange Co; stood at $125,000.

Statement of financial position at 31 May 20X3.

	Apple $'000	**Orange $'000**
Non-current Assets		
Property, Plants and Equipment	2,300	400
Investment in S	1,000	
Current Assets	900	500
	4,200	**900**
Equity		
Share capital	1,000	475
Retained Earning	2,750	275
Current Liabilities	450	150
	4,200	**900**

Required

Prepare a consolidated statement of financial position as at 31 May 20X3.

Question-6

Hinge Co acquired 80% of the ordinary shares of Singe Co on 1 April 20X5. On 31 December 20X4, Singe Co's accounts showed a revaluation surplus of $4,000 and retained earnings of $15,000. The fair value of NCI at acquisition was $7,000. The statement of financial position of two companies at 31 December 20X5 are set out below.

Statement of financial position as at 31 December 20X5

	Hinge Co		Singe Co	
Assets	$	$	$	$
Non-current assets				
Property, Plant and Equipment	32,000			30,000
16,000 ordinary shares of 50c each in Singe Co	50,000	82,000		
Current Assets		85,000		43,000
		167000		**73,000**
Equity				
Ordinary shares $1 each / 20,000 ordinary share of 50c each		100,000		10,000
Revaluation surplus		7,000		4,000
Retained Earnings		40,000		39,000
		147,000		53,000
Current Liabilities		20,000		20,000
		167,000		**73,000**

Required

Prepare the consolidated statement of financial position of Hinge Co at 31 December 20X5. You should assume that profits have accrued evenly over the year to 31 December 20X5.

Question-7

Prestend is the parent company of Northon. The following are the statements of financial position for both companies as at 31 October 20X7.

	Prestend		Northon	
Assets	$'000	$'000	$'000	$'000
Non-current assets				
Property, plants and equipment		4,200		3,300
Investments: Share in Northon at cost		3,345		-
Current Assets				
Inventory	1,500		800	
Receivable	1,800		750	
Bank	600	3900	350	1900

Total Assets		**11445**		**5,200**
Equity				
$1 Ordinary Shares		9,000		4,000
Retained Earnings		525		200
		9,525		4,200
Current Liabilites				
Payables	1,220		200	
Tax	700	1,920	800	1000
Total equity and liabilities		**11445**		**5,200**

The following information is also available.

a) Prestend purchased 2,800,000 shares in Northon a year ago when Northon had retained earnings of $60,000. The fair value of the non-controlling interest at the date of acquisition was $1,415,000.

b) During the year Prestend sold goods with an invoice value of $240,000 to Northon. These gooda were invoiced at cost plus 20%. Half of the goods are still in Northon's inventory at the year end.

c) Northon owes Prestend $30,000 at 31 October 20X7 for goods it purchased during the year.

Required

Calculated the goodwill in acquisition.

Prepare the consolidated statement of financial position for the Prestend group as at 31 October 20X7.

Question-8 Types of Consideration transferred

P Co has acquired all of the share capital of S Co (12,000 $1 ordinary shares) by issuing 5 of its own $1 shares for every 4 share 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.

The following information is relevant for Question (1) to (3)

On 1 January 20X0 Alpha Co purchased 90,000 ordinary $1 shares in Beta Co for $270,000. At that date Beta's retained earnings amounted to $90,000 and the fair values of Beta Co's at acquisition were equal to their book values.

Three year later, on 31 December 20X2, the statements of financial position of the two companies were:

	Alpha Co	Beta Co
	$'000	$'000
Sundry net assets	230,000	260,000
Shares in Beta	180,000	-
	410,000	260,000
Share capital		
Ordinary share of $1 each	200,000	100,000
Retained Earnings	210,000	160,000
	410,000	260,000

The share capital of Beta Co has remained unchanged since 1 January 20X0. The fair value of the noncontrolling interest at the acquisition was $42,000.

Test Your Understanding (1)

What amount should appear in the group's consolidated statement of financial position at 31 December 20X2 for goodwill?

A- $52,000

B- $80,000

C- $122,000

D- $212,000

Test Your Understanding (2)

Which amount should appear in the group's consolidated statement of financial position at 31 December 20X2 for non-controlling interest?

A- $49,000

B- $58,000

C- $51,000

D- $42,000

Test Your Understanding (3)

What amount should appear in the group's consolidated statement of financial position at 31 December 20X2 for retained earnings?

A- $280,000

B- $291,000

C- $354,000

D- $273,000

The following information is relevant for Question (4) to (5)

Hilton Co acquired 80% of the share capital of Shrew Co 1 January 20X3 for $280,000.

The statements of financial position of the two companies at 31 December 20X3 were as follow:

Statement of financial position

	Hilton Co	Shrew Co
	$	$
Sundry assets	660,000	290,000
Investment in Shrew	280,000	-
	940,000	290,000
Issued Share Capital	400,000	140,000
Share Premium	320,000	50,000
Retained Earnings		
At 1 Jan 20X3	140,000	60,000
Profit for the year	80,000	40,000
	940,000	290,000

There have been no changes in the share capital or share premium account of either company since 1 January 20X3. The fair value of the non-controlling interest on acquisition was $65,000.

Test Your Understanding (4)

What figure for goodwill on consolidation should appear in the consolidated statement of financial position of the Hilton group at 31 December 20X3?

A- $30,000

B- $55,000

C- $95,000

D- $(10,000)

Test Your Understanding (5)

What figure for non-controlling interest should appear in the consolidated statement of financial position of Hilton group at 31 December 20X3?

A- $77,000

B- $85,000

C- $73,000

D- $105,000

Test Your Understanding (6)

Fanta Co acquired 100% of the ordinary share capital of Tizer Co on 1 October 20X7.
On 31 December 20X7 the share capital and retained earnings of Tizer Co 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

The profits of Tizer Co have accrued evenly throughout 20X7. Goodwill arising on the acquisition of Tizer Co was $30,000.
What was the cost of the investment in Tizer Co?

A- $400,000

B- $580,000

C- $610,000

D- $590,000

Test Your Understanding (7)

Mercedes Co has owned 100% of Benz Co since incorporation. At 31 March 20X9 extracts from their individual statements of financial position were as follows,

	Mercedes Co ($)	Benz Co ($)
Share Capital	100,000	50,000
Retained Earnings	450,000	120,000

During the year ended 31 March 20X9, Benz Co had sold goods to Mercedes Co for $50,000. Mercedes Co still had these goods in inventory at the year end. Benz Co uses a 25% mark up on all goods.
What are the consolidated retained earnings of Mercedes Group at 31 March 20X9?

A- $560,000

B- $580,000

C- $570,000

D- $557,500

Test Your Understanding (8)

Micro Co acquired 90% of the $100,000 ordinary share capital of Minnie Co for $300,000 on 1 January 20X9 when the retained earnings of Minnie Co were $156,000. At the date of acquisition the fair value of plant held by Minnie Co was $20,000 higher than its carrying amount. The fair value of the noncontrolling interest at the date of acquisition was $75,000.

What is the goodwill arising on the acquisition of Minnie Co?

A- $119,000

B- $99,000

C- $139,000

D- $24,000

Test Your Understanding (9)

Breakspear Co purchased 600,000 of the voting equity shares of Fleet Co when the value of the noncontrolling interest in Fleet Co is $150,000.

The following information relates to Fleet at the acquisition date.

	At acquisition $'000
Share capital, $0.5 ordinary shares	500
Retained Earnings	150
Revaluation Surplus	50

The goodwill arising on acquisition is $70,000. What was the consideration paid by Breakspear Co for the investment in Fleet Co?

A- $420,000

B- $770,000

C- $620,000

D- $570,000

Test Your Understanding (10)

Date Co owns 100% of the ordinary share capital of Prune Co. The following balances relate to Prune Co.

	At acquisition $'000	At 31.12.X8 $'000
Tangible Non-current Assets	500	500
Freehold Land	350	450

At acquisition, the fair value of Prune Co's land was $50,000 more than shown in the financial statements of Prume Co.At 31 December 20X8, Date Co's financial statements show a total tangible non-current asset balance of $1,250,000.

What amount should be included in the consolidated financial statements of the Date group at 31 December 20X8 for tangible non-current assets?

A- $2,250,000

B- $1,000,000

C- $1,850,000

D- $2,200,000

Test Your Understanding (11)

Six Co owns 80% of the equity share capital of Seven Co. At 31 December 20X4, the trade receivables and trade payables of the two companies are as follows:

	Six Co	Seven Co
Trade Receivable	$64,000	$39,000
Trade Payable	$37,000	$48,000

These figures include $30,000 that is owed by Seven Co to Six Co for the purchase of goods, for which Six Co not yet paid. These goods were sold by Six Co for a profit of $15,000 and 50% of them were still held as inventory by Seven Co at 31 December 20X4.

What should be the amounts for trade receivables and trade payables in the consolidated statement of financial position as at 31 December 20x4?

A- Trade receivables $73,000 and Trade payables $55,000

B- Trade receivables $88,000 and Trade payables $70,000

C- Trade receivables $95,000 and Trade payables $77,000

D- Trade receivables $103,000 and Trade payables $85,000

Test Your Understanding (12)

Donna Co acquired 80% of the equity share capital of Blitsen Co on 1 January 20X4 when the retained earning of the Blisten Co were $40,000. The fair value of the non-controlling interest at this date was $25,000. At 31 December 20X4,the equity capital of Blitsen Co was as follow:

	$'000
Share capital	40
Share premium	10
Retained Earnings	60

During the year Blitsen Co sold goods to Donna Co for $20,000. This price included a mark-up of $12,000 for profit. At 31 December 20X4, 50% of these goods remained unsold in the inventory of Donna Co.

What is the value of the non-controlling interest in the Donna Group at 31 December 20X4, for the purpose of preparing the consolidated statement of financial position?

A- $20,800

B- $27,800

C- $26,600

D- $29,000

Test Your Understanding (12)

Volcano Co acquired 75% of the equity share capital of Lava Co on 1 September 20X3. The retained profit of the two individual companies at the beginning and end of the financial year were as follow.

	Volcano Co	Lava Co
	$'000	$'000

Retained Earnings at 1 January 20X3	596	264
Retained Earnings at 31 December 20X3	650	336

What is the parent company's share of consolidated retained earnings that should be reported in the consolidated statement of financial position of the Volcano Group at 31 December20X3?

A- $668,000

B- $674,000

C- $704,000

D- $722,000

Test Your Understanding (13)

On 1 August 20X7 Patronic purchased 18 million of the 24 million $1 equity shares of Sardonic. The acquisition was through a share exchange of two shares in Patronic for every three shares in Sardonic. The market price of a share in Patronic at 1 August 20X7 was $5.75.
What is the fair value of the consideration transferred for the acquisition of Sardonic?

A- $103.5 million

B- $69 million

C- $155.25 million

D- $92million

Chapter (25)

The Consolidated Statement of Profit or Loss

Question-1

P Co acquired 75% of the ordinary shares of S Co on that company's incorporation in 20X3. The summarized statement of profit or loss of the two companies for the year ended 31 December 20X6 are set out below.

	P Co ($)	S Co ($)
Revenue	75,000	38,000
Cost of Sales	30,000	20,000
Gross Profit	45,000	18,000
Administrative Expenses	14,000	8,000
Profit before taxation	31,000	10,000
Income taxes	10,000	2,000
Profit for the year	21,000	8,000
Notes: Movement on retained earnings		
Retained Earnings brought forward	87,000	17,000
Profit for the year	21,000	8,000
Retained Earnings carried forward	108,000	25,000

S Co had recorded sales of $5,000 at a gross profit margin of 40% to P Co during 20X1. 50% of the goods remained in P Co's inventories at 31 December 20X1.

Required

Prepare the consolidated statement of profit or loss and movement on retained earnings for the group.

Question-2

P Co acquired 60% of the equity of S Co on 1 April 20X5. The statement of profit or loss of the two companies for the year ended 31 December 20X5 are set out below.

	P Co ($)	S Co ($)
Revenue	170,000	80,000
Cost of Sales	65,000	36,000
Gross Profit	105,000	44,000
Administrative Expenses	43,000	12,000
Profit before taxation	62,000	32,000
Income taxes	23,000	8,000
Profit for the year	39,000	24,000
Notes: Movement on retained earnings		
Retained Earnings brought forward	81,000	40,000
Retained Earnings carried forward	108,000	58,000

Required

Prepare the consolidated statement of profit or loss and movements on retained earnings.

Test Your Understanding (1)

Tin Co acquired 90% of the equity share capital of Drum Co on 1 April 20X3. The following information relates to the financial year to 31 December 20X3 for each company.

	Tin Co	Drum Co
	$'000	$'000
Retained Earnings at 1 Jan 20X3	840	170
Profit for the year	70	60
Retained Earnings at 31 Dec 20X3	910	230

Neither company paid any dividend during the year.

What profit is attributable to the parent company in the consolidated statement of profit or loss of the Tin Group for the year ended 31 Dec 20X3?

A- $83,500

B- $110,500

C- $115,000

D- $124,000

Test Your Understanding (2)

Sand Co acquired 80% of the equity share capital of Sun Co several year ago. In the year to 31 December 20X4, Sand Co made a profit after taxation of $120,000 and Sun Co made a profit after taxation of $35,000. During the year Sun Co sold goods to Sand Co at a price of $40,000. The profit markup was 40%on the sales price. At 31 December 20X4, 25% of these goods were still held in the inventory of Sand Co.

What profit is attributable to the parent company in the consolidated statement of profit or loss of the Sand Group for the year to 31 December 20X4?

A- $144,000

B- $148,000

C- $144,800

D- $151,000

Test Your Understanding (3)

X Co acquired 80% of the equity share capital in Y Co on 31 July 20X6. Extract from the two companies statement of profit or loss for the year ended 30 Sept 20X6 were as follow.

	X Co	Y Co
	$'000	$'000
Revenue	3,400	2,400
Cost of sales	1,500	1,800

During the year ended 30 Sept 20X6, Y Co sold goods for $5,000 each month to X Co, at a mark up of 25%. At the end of the year X Co had 50% of these goods left in inventory.

What is the group gross profit for the year ended 30 Sept 20X6?

A- $1,901,000

B- $1,999,000

C- $2,004,000

D- $1,904,000

Test Your Understanding (4)

WX acquired 75% of the equity share capital of YZ several years ago. At 31 March 20X6, WX had goods in inventory valued at cost of $60,000 that had been purchased from YZ at a mark-up of 20%. What is the effect on the profit attributable to the non-controlling interest, and the profit attributable to the parent company for the year ended 31 March 20X6?

	Profit attributable to non-controlling interest	Profit attributable to WX
A-	No effect	Decreased by $5,000
B-	No effect	Decreased by $12,000
C-	Decreased by $3,000	Decreased by $9,000
D-	Decreased by $2,500	Decreased by $7,500

Test Your Understanding (5)

P owns 80% of the equity share capital of S. The profit after tax of S for the year ended 31 December 20X6 was $60 million. During 20X6, P sold goods to S for $4million at cost plus 20%. At the yearend, 50% of these goods were left in the inventory of S.

What is the non-controlling interest share of the after-tax profit of S for the year ended 31 December 20X6?

A- $11.36million

B- $11.6million

C- $11.68million

D- $12million

Test Your Understanding (6)

The summarized statement of profit or loss of two companies, Liverton and Everpool, for the year ended 31 May 20X6 are provided below. Liverton acquired 3,000,000 ordinary shares in Everpool for $3,500,000 on 1 June 20X4. At that time, the retained earnings of Everpool were $200,000 and the fair value of the non-controlling interest in Everpool was $1,000,000.

Statement of profit or loss for the year ended 31 May 20X6

	Liverton	Liverpool
	$'000	$'000
Sales revenue	6,400	2,600
Cost of sales	(3,700)	(1,450)
Gross Profit	2,700	1,150
Distribution costs	(1,100)	(490)
Administrative expense	(700)	(320)
Profit from operation	900	340

Dividend received from Everpool	150	-
Profit before tax	1,050	340
Tax	(400)	(80)
Profit for the year	650	260

The following information is also available

a) Everpool's total share capital consists of 4,000,000 ordinary shares of $1 each.

b) During the year ended 31 May 20X6 Liverton sold goods costing $110,000 to Everpool for $200,000. At 31 May 20X6, 60% of these goods remained in Everpool's inventory.

Required

Calculate the total goodwill arising on the acquisition of Everpool.

Prepare the consolidated statement of profit or loss for Liverton for the year ended 31 May 20X6.

Chapter (26)
Interpretation of financial statements

1 Information required by users

Users of financial statements can gain a better understanding of the **significance** of the information in financial statements by comparing it with other relevant information.

1.1 User group

(a) **Management**

They will use comparisons to ensure that the business is performing efficiently and according to plan.

(b) **Employees and Trade Unions**

They need information to be able to assess the employer's stability and profitability, and their ability to provide remuneration and other benefits.

(c) **Governments**

They need to able to assess taxation and regulate industries as well as using information for statistical purposes**.**

(d) **Present and Potential Investors**

They will assess the company with a view to judging whether it is a sound investment. They ness information on risk and return on investment and the ability of the entity to pay dividend.

(e) **Lenders and suppliers**

They will want to judge its creditworthiness, to assess whether loans and related interest and invoices will be paid when due.

(f) **Customers**

They will want to judge whether the company will continue in existence, especially where they have a long-term involvement with the company or a dependence on their product**.**

2 The broad categories of ratios

Basic ratios can be grouped into five categories.

1. Profitability and return
2. Long-term solvency and stability
3. Short-term solvency and stability
4. Efficiency (turnover ratios)
5. Shareholders' investment ratio

3 Profitability and return

Profitability ratios include:

1. Return on capital employed (ROCE)
2. Return on equity (ROE)
3. Net profit as a percentage of sales
4. Asset turnover ratio
5. Gross profit as a percentage of sales

3.1 Return on capital employed (ROCE)

$$\textbf{ROCE} = \frac{\textbf{Profit before interest and taxation (PBIT)}}{\textbf{Capital employed}} \textbf{ x 100}$$

PBIT = Profit before tax + Interest on long term liabilities

Capital employed = Shareholders' equity + long term liabilities (or)
Total assets – current liabilities

ROCE measures the overall efficiency of a company, generating profit from use of resources.
Three comparison for ROCE

1. Change in ROCE from **one year to the next**
2. ROCE being earned by **other companies**
3. Comparison of ROCE with **current market borrowing rates**

ROCE $= \frac{\text{PBIT}}{\text{Capital employed}}$

Profit Margin $= \frac{\text{PBIT}}{\text{Sales}}$

Asset turnover $= \frac{\text{Sales}}{\text{Capital employed}}$

3.2 Return on equity (ROE)

$$\textbf{ROCE} = \frac{\textbf{Profit after tax and preference dividend}}{\textbf{Equity shareholders funds}} \textbf{ x 100}$$

ROE is not a widely used ratio.

3.3 Profit margin (Net profit as a percentage of sales)

$$\textbf{Profit margin} = \frac{\textbf{Profit befor interest and tax (PBIT)}}{\textbf{Sales}} \textbf{ x 100}$$

Profit margin measures high or low profit on its sales.

3.4 Asset turnover

$$\textbf{Asset turnover} = \frac{\textbf{Sales}}{\textbf{Capital employed}}$$

Asset turnover is a measure of how well the assets are being used to generate sales.

3.5 Gross profit margin (Gross profit as a percentage of sales)

$$\textbf{Gross profit} = \frac{\textbf{Gross profit}}{\textbf{Revenue}} \textbf{ x 100}$$

Gross profit margin measures high or low gross profit on its sales.

4 Long-term solvency: debt and gearing ratios

1. Debt ratio
2. Gearing ratio
3. Leverage ratio
4. Interest cover

Debt ratios are concerned with how much the company owes in relation to its size and whether its debt burden seems heavy or light.

(a) When a company is heavily in debt, banks and other potential lenders may be unwilling to advance further funds.

(b) When a company has a heavy debt burden, there will be very little profit left over for shareholders after interest. If interest rates were to go up or the company was to borrow more, it might be incurring interest charges in excess of PBIT. This might eventually lead to the liquidation of the company.

(c)

4.1 Debt ratio

$$\textbf{Debt ratio} = \frac{\textbf{Total debts}}{\textbf{Total assets}} \textbf{ x 100}$$

Total debts = Non-current liabilities + Current liabilities
Total assets = Non-current assets + Current assets
There is **no absolute guide** to the maximum safe debt ratio but **50% is a safe limit to debt**.

4.2 Gearing ratio

$$\textbf{Gearing ratio} = \frac{\textbf{Total long-term debts}}{\textbf{Shareholders' equity+Total ling-term debt}} \textbf{ x 100}$$

There is **no absolute limit** to what a gearing ratio ought to be.
A company with a gearing ratio of **more than 50%** is said to be **highly geared**.

4.3 Leverage ratio

$$\textbf{Leverage ratio} = \frac{\textbf{Shareholdes' equity}}{\textbf{Shareholders' equity+Total ling-term debt}} \textbf{ x 100}$$

4.4 Interest cover

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

The interest cover ratio shows whether a company is earning enough PBIT to pay its interest costs comfortably.
An interest cover of **two times or less** would be **low**.

It should really **exceed three times** before the company's interest costs are to be considered within **acceptable limits**.

Example:

Consider the three companies below.

	Company A	Company B	Company C
	$'000	$'000	$'000
PBIT	40	40	40
Interest	10	25	30
Profit before tax	30	15	10
Taxation	9	5	3

Profit after tax	21	10	7

5 Short-term solvency and liquidity

Liquidity ratios

1. Current ratio
2. Quick or Acid test ratio

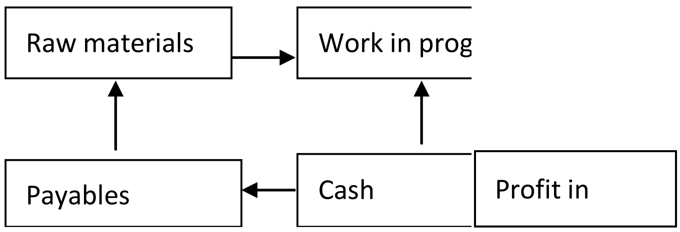
Efficiency ratios

1. Trade receivables collection period
2. Trade payables payment period
3. Inventory turnover period

Liquid fund consist of

- Cash
- Short term investments
- Fixed term deposits with bank
- Trade receivables

Cash cycle



5.1 Current ratio

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

Current ratio measures whether the company has enough current assets to pay off its current liabilities.
A current ratio in **excess of 1** should be expected.

5.2 Quick or Acid test ratio

$$\textbf{Quick ratio} = \frac{\textbf{Current assets less Inventories}}{\textbf{Current liabilities}}$$

The quick ratio should ideally be:

- **at least 1** for **slow inventory turnover** company **less than 1** is acceptable for **fast inventory turnover** company

5.3 Trade receivables collection period

$$\textbf{Trade receivable collection period} = \frac{\textbf{Trade receivables}}{\textbf{Credit revenue}} \textbf{ x 365}$$

5.4 Trade payables payment period

$$\textbf{Trade payables payment period} = \frac{\textbf{Trade payables}}{\textbf{Credit purchases (or)cost of sales}} \textbf{ x 365}$$

5.5 Inventory turnover period

$$\textbf{Inventory turnover period} = \frac{\textbf{Inventory}}{\textbf{Cost of sales}} \textbf{ x 365}$$

5.6 QUESTION

Which of the following should the quick ratio include?

A. Inventory of finished goods

B. Raw materials and consumables

C. Long-term loans

D. Trade receivables

5.7 QUESTION

Calculate liquidity and working capital ratios from the accounts of the TEB Co, a business which provides service support (cleaning etc) for customers worldwide. Comment on the results of your calculations.

	20X7	20X6
	$m	$m
Revenue	2,176.2	2,344.8
Cost of sales	1,659.0	1,731.5

Gross profit	517.2	613.3
Current assets		
Inventories	42.7	78.0
Receivables (Note 1)	378.9	431.4
Short-term deposits and cash	205.2	145.0
	626.8	654.4
Current liabilities		
Loans and overdrafts	32.4	81.1
Tax on profits	67.8	76.7
Dividend	11.7	17.2
Payables (Note 2)	478.2	467.2
	599.1	642.2
Net current assets	27.7	12.2

Note

1	Trade receivables	295.2	335.5
2	Trade payables	190.8	188.1

5.8 QUESTION

(a) Calculate the operating cycle for Moribund for 20X2 on the basis of the following information.

	$
Inventory: raw materials	150,000
Work in progress	60,000
Finished goods	200,000
Purchases	500,000
Trade accounts receivable	230,000
Trade accounts payable	120,000
Sales	900,000
Cost of goods sold	750,000

Tip. You will need to calculate inventory turnover periods (total year-end inventory over cost of goods sold), receivables as daily sales, and payables in relation to purchases all converted into 'days'.

(b) List the steps which might be taken in order to improve the operating cycle.

- Reducing the average raw materials inventory turnover
- Reducing the time taken to produce goods
- Increasing the period of credit taken from suppliers
- Reducing the average finished goods inventory turnover
- Reducing the average receivables collection period

6 Interpreting information

6.1 QUESTION

The statements of profit or loss for Egriff are given below.

	31 May 20X3		31 May 20X4	
	$’000	$’000	$’000	$’000
Revenue		20,000		260,000
Cost of sales gross profit		(15,400)		(21,050)
Gross profit		4,600		4,950
Expenses				
Administrative	800		900	
Selling and distribution	1,550		1,565	
Depreciation	110		200	
Loan note interest	–		105	
		(2,460)		(2.770)
Profit for the year		2.140		2,180

Egriff issued loan notes during the year to fund the expansion of the business. Non-current assets have increased from $3.8m in 20X3 to $4.6m in 20X4.

Require

(a) Calculate the following ratios for Egriff for both years.

(i) Gross profit percentage

(ii) Net profit percentage

(c) Comment on the success of the business expansion using the ratios you have calculated.

6.2 QUESTION

Which two of the following are valid reasons why the inventory turnover period of a company increases from one year to the next?

1 A slowdown in trading
2 A marketing decision to reduce selling prices
3 Seasonal fluctuations in orders
4 Obsolete goods

A 1 and 2
B 2 and 3
C 1 and 4
D 3 and 4

6.3 QUESTION

Information on Alpha for the previous two years is given below.

		20X1	20x2
Debt ratio =	$\frac{\text{long-term debt}}{\text{Shareholders' equity}}$	45%	55%
Interest cover		4 times	2 times

Which of the following statements regarding Alpha is/are correct?

1 In 20X2, Alpha's profits more comfortably cover its interest payments compared to 20X1. 2 The debt position of Alpha has worsened since 20X1.
3 A rights issue of shares could help to reduce the debt ratio.

A 1 only
B 2 only
C 2 and 3 only
D 1 and 2 only

6.4 QUESTION

'The ratio has increased in 20X8 compared to 20X7 because we have increased the length of time allowed for customers to pay their invoices.'

A decrease in which ratio could be explained by the statement above?

A The receivables collection period
B The gearing ratio
C Interest cover
D The payables payment period

6.5 QUESTION

Information on Beta for the previous two years is given below.

	20X1	20X2
Quick ratio	1.5:1	1.5:1
Current ratio	1.8:1	3:1
Inventory	15 day	27 days

Which of the following statements regarding Beta is/are correct?
1 Beta appears to have fewer inventories in 20X2 than in 20X1.
2 The debt position of Beta is worsening.
3 Stock obsolescence could be a problem for Beta.

A 1 only
B 1 and 3 only
C 3 only
D 2 and 3 only

6.6 QUESTION

ROCE has increased from 28% in 20X2 to 35% in 20X3.
Which of the following statements relating to this increases is/are correct?
1 An increase in profit margin in 20X3 could account for the increase in ROCE.
2 The increase suggests the company is more efficient in employing its resources in 20X3 compared to 20X2.
3 If profit margin has remained constant, the increase in ROCE suggests a decrease in assets turnover.
A 1 and 2 only
B 2 and 3 only
C 1 and 3 only
D All three statements are correct

7 Limitations of ratio analysis

Ratio analysis has limitations.

Ratio analysis is not foolproof. There are many problems in trying to identify trends and make comparisons. Below are just a few.

Information problems

- The base information is often out of date, so timeliness of information leads to problems of interpretation
- Historical cost information may not be the most appropriate information for the decision for which the analysis is being undertaken
- Information in published accounts is generally summarized information and detailed information may be needed
- Analysis of amounting information only identifies symptoms, not causes, and is therefore of limited use

Comparison problems: trend analysis

- Effects of price changes make comparisons difficult unless adjustments are made
- Impacts of changes in technology on the price of assets, the likely return and the future markets
- Impacts of a changing environment on the results reflected in the accounting information
- Potential effects of changes in accounting policies on the reported results
- Problems associated with establishing a normal base year to compare other years with

Comparison problems: across companies

- Selection of industry norms and the usefulness of norms based on averages
- Different firms having different financial and business risk profiles and the impact on analysis
- Different firms using different accounting policies
- Impacts of the size of the business and its comparators on risk, structure and returns
- Impacts of different environments on results, eg different countries or home-based versus multinational firms

Test Your Understanding (1)

Which one of the following would help a company with high gearing to reduce its gearing ratio?

A- Making a rights issue of equity shares

B- Issuing further long-term loan notes

C- Making a bonus issue of shares

D- Paying dividend on its equity shares

Test Your Understanding (2)

A company's gross profit as a percentage of sales increased from 24% in the year ended 31 December 20X1 to 27% in the year ended 31 December 20X2.

Which of the following events is most likely to have caused the increase?

A- An increase in sales volume

B- A purchase in December 20X1 mistakenly being recorded as happening in January 20X2

C- Overstatement of the closing inventory at 31 December 20X1

D- Understatement of the closing inventory at 31 December 20X1

Test Your Understanding (3)

Which of the following transactions would result in an increase in capital employed?

- A- Selling inventory at a profit
- B- Writing off a bad debt
- C- Paying a payable in cash
- D- Increasing the bank overdraft to purchase a non-current asset

Test Your Understanding (4)

From the following information regarding the year to 31 August 20X6, what is the account payable payment period? You should calculate the ratio using purchases as the denominator,

	$
Sales	
43,000 Cost of Sales	
32,500	
Opening Inventory	6,000
Closing inventory	3,800
Trade account payables at 31 August 20X6	4,750

- A- 40 days
- B- 50 days
- C- 53 days
- D- 57 days

The following information is relevant for Question 28.5 to 28.7

Quality Co are drafting their financial statements. An extract from their draft statement of financial position at 31 March 20X8 is set out below.

	$	$
Non-current assets		450
Current assets- Inventory	65	
Receivables	110	
Prepayments	30	
	205	
Current liabilities- Payables	30	
Bank overdrafts	50	
	80	125
		575
Non-current Liability- Loan		(75)
		500
Ordinary share capital		400
Statement of profit or loss		100
		500

Note. The bank overdraft first occurred on 30 September 20X7.

Test Your Understanding (5)

What is the gearing of the company? You should calculate gearing using capital employed as the denominator.

A- 13%

B- 16%

C- 20%

D- 24%

Test Your Understanding (6)

What is the quick ration of the company?

A- 1.75

B- 2.56

C- 2.88

D- 3.20

Test Your Understanding (7)

What is the current ratio of the company?

A- 1.75

B- 2.56

C- 2.88

D- 3.20

Test Your Understanding (8)

Which of the following is a ratio which is used to measure how much business owes in relation to its size?

A- Assets turnover

B- Profit Margin

C- Gearing

D- Return on capital employed

Test Your Understanding (9)

A business operates on a gross profit margin of 331/3%. Gross profit on a sale was $800, and expenses were $680.

What is the net profit margin?

A- 3.75%

B- 5%

C- 11.25%

D- 22.67%

Test Your Understanding (10)

A company has the following details extracted from its statement of financial position:

	$'000
Inventories	1,900
Receivables	1,000
Bank overdrafts	100
Payables	1,000

The industry the company operates in has a current ratio norm of 1.8. Companies who manage liquidity well in this industry have a current ration lower than the norm.

Which of the following statements accurately describes the company liquidity position?

A- Liquidity appears to be well managed as the bank overdraft is relatively low.

B- Liquidity appears to be poorly-controlled as shown by the large payables balance

C- Liquidity appears to be poorly-controlled as shown by the company's relatively high current ratio

D- Liquidity appears to be poorly-controlled as shown by the existence of a bank overdraft