Mock Exam One

AAT L4 Financial Statements for Limited Companies

(For AAT exam assessments from September 2020)

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This practice assessment is one of a set of five AAT mock practice assessments which have been published for this subject. They are produced by expert AAT tutors to ensure real AAT exam style and real AAT exam standard tasks and ensure the best chance of success.

All practice assessments are relevant for the current syllabus.

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We hope very much that you enjoy this AAT mock practice assessment and wish you the very best for your exam success!

For feedback please contact our team aatlivelearning@gmail.com

Mock Exam One

Financial Statements for Limited Companies

Assessment information:

You have **2 hours and 30 minutes** to complete this practice assessment.

This assessment contains **8 tasks** and you should attempt to complete **every** task.
Read every task carefully to make sure you understand what is required.

In tasks 1, 2 and 6 you may be presented with tables that can be used for your workings for your proformas. You don't have to use the workings tables to achieve full marks in these tasks, but any data entered into the workings tables will be taken into consideration if you make errors in the proforma.

Tasks 3, 4 and 8 require extended writing as part of your response to the questions. You should make sure you allow adequate time to complete these tasks.

Where the date is relevant, it is given in the task data.

Both minus signs and brackets can be used to indicate negative numbers **unless** task instructions say otherwise.

You must use a full stop to indicate a decimal point. For example, write 100.57 not 100,57 or 100 57

You may use a comma to indicate a number in the thousands, but you don't have to. For example, 10000 and 10,000 are both acceptable.

Task 1 (32 marks)

You have been asked to prepare the statement of cash flows and statement of changes in equity for XYZ Ltd for the year ended 31 August 20X9.

The most recent statement of profit or loss and statement of financial position (with comparatives for the previous year) of XYZ Ltd are shown below.

XYZ Ltd - Statement of financial position as at 31 August 20X9

	£000 20X9	**£000 20X8**
Assets		
Non-current assets		
Property, plant and equipment	11,380	9,800
Current assets		
Inventories	278	340
Trade receivables	255	430
Cash and cash equivalents	31	670
	564	1,440
Total assets	11,944	11,240
EQUITY AND LIABILITIES		
Equity		
Share capital (£1 ordinary shares)	6,000	5,000
Share premium account	1,000	2,000
Revaluation reserve	2,000	0
Retained earnings	2,091	2,189
Total equity	11,091	9,189
Non-current liabilities		
Loan certificates	500	1,500
Current liabilities		
Trade payables	250	452
Tax liability	103	99
	353	551
Total liabilities	853	2,051
Total equity and liabilities	11,944	11,240

XYZ Ltd - Statement of profit or loss for the year ended 31 August 20X9

	£000
Continuing operations	
Revenue	2,450
Cost of sales	-845
Gross profit	1,605
Loss on disposal of PPE	-300
	1,305
Distribution costs	-420
Administrative expenses	-230
Profit from operations	655
Finance costs	-150
Profit before tax	505
Tax	-103
Profit for the period from continuing	402
Other comprehensive income	2,000
Total comprehensive income	2,402

Further information

- Total depreciation charged for the year was £180,000 and is included within administration and distribution expenses.
- There were no prepaid expenses or accrued expenses at the beginning or end of the year.
- A 1 for 5 bonus issue occurred for shareholders during the year out of the share premium.
- Property, plant and equipment with a carrying value of £700,000 was sold in the year.
- A property was revalued upwards during the year by £2.0 million.
- A dividend was paid in the year of £500,000.

(a) Draft a reconciliation of profit before tax to net cash from operating activities for XYZ Ltd for the year ended 31 August 20X9.

(13 marks)

(b) Draft the statement of cash flows for XYZ Ltd for the year ended 31 August 20X9.

(19 marks)

Note the following:

- You don't have to use the workings tables to achieve full marks on this task. However, any data that you enter into the workings tables will be taken into consideration if you make errors in the main proforma.
- You must enter a figure into the main proforma in order for your workings to be taken into account.
- Show any items that need to be deducted as negative figures.

(You will be asked to draft a statement of changes in equity in Task 2 using the same data. You will be able to view the data again in Task 2).

Reconciliation of profit before tax to net cash from operating activities

	£000
Adjustments for:	
Cash generated by operations	
Net cash from operating activities	

Statement of cash flows for the year ended 31 August 20X9

	£000
Net cash from operating activities	
Investing activities	
Net cash from investing activities	
Financing activities	
Net cash used in financing activities	
Net increase / (decrease) in cash and cash equivalents	
Cash and cash equivalents at the beginning of the year	
Cash and cash equivalents at the end of the year	

Picklist for completion of the two statements above: Adjustment in respect of inventories, Adjustment in respect of trade payables, Adjustment in respect of trade receivables, Loan certificates, Depreciation, Finance costs, Interest paid, Proceeds on disposal of PPE, Profit after tax, Profit before tax, Loss on disposal of PPE, Purchases of PPE, Revaluation, Proceeds of share issue, Tax paid, Dividends paid.

Workings:

Proceeds on disposal of PPE	£000
Total disposal proceeds	

Purchases of PPE	£000
PPE at start of the year	
Total PPE additions	

Picklist for completion of workings tables (optional): Carrying amount of PPE sold, Depreciation charge, PPE at end of the year, PPE at start of the year, Loss on disposal of PPE, Revaluation.

End of Task

Task 2 (8 marks)

This task is a continuation of the scenario in Task 1 and uses the same data. You have been asked to prepare a statement of changes in equity for XYZ Ltd for the year ended 31 August 20X9.

The statement of profit or loss and statement of financial position (with comparatives for the previous year) of XYZ Ltd are shown below.

XYZ Ltd - Statement of financial position as at 31 August 20X9

	£000 20X9	**£000 20X8**
Assets		
Non-current assets		
Property, plant and equipment	11,380	9,800
Current assets		
Inventories	278	340
Trade receivables	255	430
Cash and cash equivalents	31	670
	564	1,440
Total assets	11,944	11,240
EQUITY AND LIABILITIES		
Equity		
Share capital (£1 ordinary shares)	6,000	5,000
Share premium account	1,000	2,000
Revaluation reserve	2,000	0
Retained earnings	2,091	2,189
Total equity	11,091	9,189
Non-current liabilities		
Loan certificates	500	1,500
Current liabilities		
Trade payables	250	452
Tax liability	103	99
	353	551
Total liabilities	853	2,051
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XYZ Ltd - Statement of profit or loss for the year ended 31 August 20X9

	£000
Continuing operations	
Revenue	2,450
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Distribution costs	-420
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Profit before tax	505
Tax	-103
Profit for the period from continuing	402
Other comprehensive income	2,000
Total comprehensive income	2,402

Further information

- Total depreciation charged for the year was £180,000 and is included within administration and distribution expenses.
- There were no prepaid expenses or accrued expenses at the beginning or end of the year.
- A 1 for 5 bonus issue occurred for shareholders during the year out of the share premium.
- Property, plant and equipment with a carrying value of £700,000 was sold in the year.
- A property was revalued upwards during the year by £2.0 million.
- A dividend was paid in the year of £500,000.

Draft the statement of changes in equity for XYZ Ltd for the year ended 31 August 20X9.

(8 marks)

Note:
Show any items that need to be deducted as negative figures (use minus signs or brackets).

Statement of changes in equity for the year ended 31 August 20X9

	Share capital £000	Share Premium £000	Revaluation Surplus £000	Retained Earnings £000	Total Equity £000
Balance at 1 September 20X8					
Changes in equity					
Total comprehensive income					
Dividends					
Issue of share capital					
Balance at 31 August 20X9					

End of Task

Task 3 (10 marks)

You are preparing the financial statements of KLM Ltd for the year ended 31 August 20X9. KLM Ltd is a manufacturer of cakes and biscuits. On 12 March 20X9 KLM Ltd purchased a new bakery oven for use in its factory, the purchase cost was £280,000 and it was financed wholly by a bank loan. The new bakery oven could be sold today for a second hand value of £150,000.

(a) (i) Explain the definitions of assets and liabilities as elements within the financial statements, according to the IASBs Conceptual Framework for Financial Reporting.

(2 marks)

(a) (ii) Explain why the new bakery oven and bank loan should be recognised as an asset and liability respectively, according to the IASBs Conceptual Framework for Financial Reporting.

(6 marks)

(a) (iii) Identify from the information above TWO measurement bases which could be used to determine how the bakery oven is recognised in the financial statements as at 31 August 20X9.

End of Task

Task 4 (12 marks)

PQR is preparing its financial statements for the year ended 31 October 20X7.

PQR publishes trade magazines and sells them to retailers. PQR has just concluded negotiations with a large supermarket chain for the supply of a large quantity of several of its trade magazine titles on a regular basis.

PQR has agreed a substantial discount on the following terms:

- The same quantity of each trade magazine will be supplied each month.
- Quantities can only be changed at the end of each six month period.
- Payment must be made six months in advance.

The supermarket paid £150,000 to PQR on 1 September 20X7 for six months' supply of trade magazines to the period ended 29 February 20X8. At 31 October 20X7, PQR had supplied trade magazines for two months.

(a) Explain, with reasons, how the matter above should be treated in PQR Ltd's individual financial statements for the year ended 31 October 20X7. Use the figures from above to illustrate your answer where possible.

(6 marks)

PQR also owns a building which it uses as its offices and warehouse. PQR has a policy of regularly revaluing its non-current assets. The original cost of the building in May 20X2 was £1,000,000; it has not been depreciated. The building was recently revalued on 31 October 20X6 by a professional valuer at £1,800,000.

PQR also owns a brand name which it acquired on 1 July 20X7 for £500,000.

The economic climate had deteriorated during 20X7, causing PQR to carry out an impairment review of its assets. PQR's building was valued at a market value of £1,500,000 on 31 October 20X7 by a professional valuer.

A brand specialist valued PQR's brand name at a market value of £200,000 on the same date. PQR's management accountant calculated that the brand name's value in use at 31 October 20X7 was £150,000.

(b) Explain, with reasons, how the matters above should be treated in PQR Ltd's individual financial statements for the year ended 31 October 20X7. Use the figures from above to illustrate your answer where possible.

(6 marks)

End of Task

Task 5 (15 marks)

(a) Which ONE of the international accounting standards below prescribes how property, plant and equipment should be accounted for by an organisation adopting IFRS.

(2 marks)

IAS 1 ☐

IAS 2 ☐

IAS 16 ☐

(b) Reconciliation of a cash book to the bank statements, or a purchase ledger account to a supplier statement would support which one of the qualitative characteristics of useful financial information. Choose ONE only.

(3 marks)

Verifiability ☐

Timeliness ☐

Comparability ☐

Relevance ☐

You are working as an assistant to the management accountant of a client. The management accountant has asked you to post a journal for an amount of £5,900, the posting to be made from motor vehicle repairs to motor vehicles at cost within non-current assets.

You have checked the details of the invoices that were paid and feel there is no justification to make such a posting.

(c) Which ONE of the following is NOT a likely response to the management accountants request. Choose ONE only.

(3 marks)

Seek guidance from your practice manager regarding the posting of this journal.	☐
Discuss the matter with the management accountant to see if there is a valid case for posting this journal.	☐
Post the journal without question as the management accountant is your client.	☐

The following measures relate to a non-current asset:

- Net book value £20,000
- Net realisable value £18,000
- Value in use £22,000
- Replacement cost £50,000

(d) The recoverable amount of the asset is

(3 marks)

£18,000	☐
£20,000	☐
£22,000	☐
£50,000	☐

WDC is reviewing events after its reporting period. WDC's year end is 30 September 20X1.

(e) Which ONE of the following would be classified by WDC as a non-adjusting event according to IAS 10 *Events After The Reporting Period.*

(4 marks)

WDC was notified on 5 November 20X1 that one of its customers was insolvent and was unlikely to repay any of its debts. The balance outstanding at 30 September 20X1 was £42,000.	☐
On 30 September WDC had an outstanding court action against it. WDC had made a provision in its financial statements for the year ended 30 September 20X1 for damages awarded against it of £22,000. On 29 October 20X1 the court awarded damages of £18,000.	☐
On 5 October 20X1 a serious fire occurred in WDC's main production centre and severely damaged the production facility.	☐
The year end inventory balance included £50,000 of goods from a discontinued product line. On 1 November 20X1 these goods were sold for a net total of £20,000.	☐

End of Task

Task 6 (30 marks)

The summarised statement of financial position of ABC Ltd and XYZ Ltd at 31 August 20X9, as well as further information, is shown below.

Statement of financial position as at 31 August 20X9

	ABC Ltd £000	XYZ Ltd £000
Assets		
Non-current assets		
Property, plant and equipment	10,000	1,500
Investment in XYZ Ltd	4,000	
	14,000	1,500
Current assets		
Inventories	3,400	670
Trade and other receivables	1,600	900
Cash and cash equivalents	1,800	780
	6,800	2,350
Total assets	20,800	3,850
EQUITY AND LIABILITIES		
Equity		
Share capital	5,000	1,000
Retained earnings	9,500	2,400
Total equity	14,500	3,400
Non-current liabilities	5,000	0
Current liabilities		
Trade and other payables	1,180	400
Taxation	120	50
	1,300	450
Total liabilities	6,300	450
Total equity and liabilities	20,800	3,850

Additional notes

- ABC Ltd had acquired 60% of the share capital of XYZ Ltd on the 1 June 20X1. On the acquisition date the retained earnings of XYZ Ltd were £2.0 million and its share capital was £1.0 million.
- ABC Ltd has decided that non-controlling interest will be valued at their proportionate share of net assets.
- There was cash in transit of £300,000 from XYZ Ltd to ABC Ltd at the year ended 31 August 20X9.
- Included in ABC's trade and other receivables is £650,000 owed from XYZ.
- Included in XYZ's trade and other payables is £350,000 owed to ABC.
- ABC Ltd sold inventory to XYZ Ltd for £1,000,000 during the year, these goods had cost ABC Ltd £400,000. One quarter of these goods still remain unsold for the year ended 31 August 20X9.

Draft the consolidated financial position of ABC Ltd and its subsidiary undertaking as at 31 August 20X9.

(30 marks)

Note the following:

- You don't have to use the workings tables to achieve full marks for this task. However, any data that you enter into the workings tables will be taken into consideration if you make errors in the main proforma.
- Show any items that need to be deducted as negative figures (use minus signs or brackets).

ABC Ltd - Consolidated statement of financial position
as at 31 August 20X9

	£000
Assets	
Non-current assets	
Goodwill	
Property, plant and equipment	
Current assets	
Inventories	
Trade and other receivables	
Cash and cash equivalents	
Total assets	
EQUITY AND LIABILITIES	
Equity	
Share capital	
Retained earnings	
Non-controlling interest	
Total equity	
Non-current liabilities	
Current liabilities	
Trade and other payables	
Taxation	
Total liabilities	
Total equity and liabilities	

Goodwill	£000

Picklist for goodwill: Consideration, Non-controlling interests at acquisition, Net assets acquired.

Retained earnings	£000

Picklist for retained earnings: ABC Ltd, Provision for unrealised profit for inventory sold, XYZ Ltd - attributable to ABC Ltd.

Inventory	£000

Picklist for inventory: ABC Ltd, Provision for unrealised profit for inventory sold, XYZ Ltd.

Trade and other receivables	£000

Picklist for trade and other receivables: ABC Ltd, XYZ Ltd, Inter-company adjustment, Cash in transit.

Cash and cash equivalents	£000

Picklist for cash and cash equivalents: ABC Ltd, XYZ Ltd, Cash in transit.

Trade and other payables	£000

Picklist for trade and other payables: ABC Ltd, XYZ Ltd, Inter-company adjustment.

End of Task

Task 7 (20 marks)

You have been provided with the financial statements of PQR Ltd for the year ended 30 June 20X6. You are required to prepare financial ratios to assist your manager in the analysis of this company. PQR's statement of profit or loss and statement of financial position are shown below.

PQR Ltd - Statement of financial position as at 30 June 20X6

	£000
	20X6
Assets	
Non-current assets	
Property, plant and equipment	1,300
Current assets	
Inventories	150
Trade receivables	250
Cash and cash equivalents	530
	930
Total assets	2,230
EQUITY AND LIABILITIES	
Equity	
Share capital (£1 ordinary shares)	600
Share premium account	150
Retained reserves	245
Total equity	995
Non-current liabilities	
Bank loans	900
Current liabilities	
Trade and other payables	250
Tax liability	85
	335
Total liabilities	1,235
Total equity and liabilities	2,230

PQR Ltd - Statement of profit or loss for the year ended

	£000
Revenue	4,500
Cost of sales	-3,845
Gross profit	655
Distribution costs	-142
Administrative expenses	-155
Profit from operations	358
Finance costs	-150
Profit before tax	208
Tax	-85
Profit for the period	123

(a) Identify the formulas that are used to calculate each of the following ratios.

(10 marks)

Asset turnover (non-current assets)	
Inventory holding period (days)	
Current ratio	
Return on shareholders' funds	
Return on capital employed	

Picklist for asset turnover (non-current assets):

- revenue / non-current assets
- revenue / total assets - current liabilities
- non-current assets / revenue
- revenue / total assets + current liabilities

Picklist for inventory holding period (days):

- inventories / revenue x 365
- inventories / cost of sales x 365
- cost of sales / inventories x 365
- revenue / inventories x 365

Picklist for current ratio:

- current assets / non-current liabilities
- current assets - inventories / current liabilities
- current assets + inventories / current liabilities
- current assets / current liabilities

Picklist for return on shareholders' funds:

- profit before tax / total equity x 100%
- profit from operations / capital employed x 100%
- profit after tax / total equity x 100%
- profit from operations / revenue x 100%

Picklist for return on capital employed:

- profit before tax / total equity x 100%
- profit from operations / (total equity + non-current liabilities) x 100%
- profit after tax / total equity x 100%
- profit from operations / (total equity + current assets - current liabilities) x 100%

(b) Calculate the above ratios to ONE decimal place.

(10 marks)

Asset turnover (non-current assets)		times
Inventory holding period		days
Current ratio		: 1
Return on shareholders' funds		%
Return on capital employed		%

End of Task

Task 8 (23 marks)

Susan has been approached by Adrian who is a personal friend. Adrian has asked Susan to invest £30,000 of her personal savings to buy shares in Adrian's company, VUW Ltd.

You have calculated the following ratios in respect of VUW Ltd's most recent financial statements and have obtained last year's figures for comparative purposes.

	20X8	**20X7**
Gearing	145%	85%
Interest cover	1.7 times	3.1 times
Trade payables	54 days	31 days
Operating profit percentage	13.6%	12.4%

Prepare notes for Susan as follows:

(a) Assess whether EACH of VUW Ltd's ratios are better or worse as compared to the previous year's figures and what this may tell you about the company.

(20 marks)

Gearing

Interest cover

Trade payables

Operating profit percentage

(b) Recommend with reasons, whether or not Susan should buy shares in VUW Ltd, based solely on your analysis of the ratios in part (a) above.

(3 marks)

End of Task

1

Mock Exam One
Financial Statements for Limited Companies
Solutions

Task 1 (32 marks)

Task 1 & 2 of your exam will be calculative and will test drafting statutory financial statements for a limited company.

You will be required to either prepare a statement of profit or loss and other comprehensive income and a statement of changes in equity in Task 1 and a statement of financial position in Task 2. Alternatively, you will be required to prepare a reconciliation of profit before tax to net cash generated from operating activities and a statement of cash flows in Task 1 and a statement of changes in equity in Task 2.

You need to make sure that you are as comfortable completing the statement of cash flow version of this task as you are with the version dealing with the statement of profit and loss/statement or financial position. According to the examiner the statement of cash flow version is the task that students find the most difficult.

You need to make sure that you adopt a methodical approach to completing these tasks and always use the workings tables provided to assist you.

Task 1 and 2 examinability:

- Draft a statement of profit or loss and other comprehensive income. Make appropriate entries in the statement in respect of information extracted from a trial balance and additional information.
- Draft a statement of financial position. Make appropriate entries in the statement in respect of information extracted from a trial balance and additional information.
- Draft a statement of changes in equity. Make appropriate entries in the statement in respect of information extracted from a trial balance and additional information or other financial statements provided.
- Draft a statement of cash flows. Make appropriate entries in the statement, using the indirect method, in respect of information extracted from a statement of profit or loss and other comprehensive income for a single year, and statements of financial position for two years, as well as any additional information provided.

Reconciliation of profit before tax to net cash from operating activities

	£000
Profit before tax	505
Adjustments for:	
Depreciation	180
Loss on disposal of PPE	300
Finance costs	150
Adjustment in respect of inventories	62
Adjustment in respect of trade receivables	175
Adjustment in respect of trade payables	-202
Cash generated by operations	1170
Interest paid	-150
Tax paid	-99
Net cash from operating activities	921

Workings: Reconciliation of profit before tax to net cash from operating activities

When the indirect method of presenting the statement of cash flows is used (the only method examinable by AAT), the net profit or loss for the period is adjusted for the following items:

- **Non-cash transactions** e.g. revaluation of PPE, depreciation, amortisation, changes in inventory, gains/losses on disposal. PPE means 'property, plant and equipment'.
- **Items related to investing or financing activities** e.g. purchase cost and sale proceeds for PPE purchased or sold in the year, dividends paid, proceeds from share issues (equity) or proceeds from or repayment of borrowings such as bank loans, preference shares, debentures, loan certificates or loan stock.

Entities that are classified as small under the Companies Act 2006 do not have to prepare a cash flow statement as part of their statutory financial statements, however, that does not mean they are precluded from preparing such a statement, if the directors so wish.

Once the adjustments above are included in the reconciliation statement, the final figure will be the 'net cash flow' (not profit) from operating (trading) activities. This reconciliation converts profits prepared using the accruals concept into 'real actual cash' received or paid from the business for its operating (trading) activities.

Operating activities do not account for 'investing' or 'financing' activities which are more remote from the trade and therefore presented separately in the cash flow statement for users of the financial statements.

- To prepare the reconciliation we always start with the profit before tax, which you get from the statement of profit or loss.
- Add back non-cash items which have been deducted to arrive at profits. These include a loss on disposal (this is not cash, it is the difference between the carrying value of the asset sold compared to the cash proceeds received) and depreciation.
- Add back finance costs (interest paid) when calculating 'cash generated from operations', we also at this stage ignore tax (we ignored tax as we started with profits before tax).
- Then adjust for changes in working capital levels e.g. trade receivables, inventory and trade payables for the year ended.

An acronym which may help to recall whether you add or deduct changes in working capital within the reconciliation statement is **A Police Constable in a London Car Park (APC in an LPC).** The A is for Assets such as inventory and trade receivables and the L is for Liabilities such as trade payables. In both cases the P is the Previous year's figure and the C is the Current year's figure in the statement of financial position.

The above indicates the order in which you deduct the two figures from either the current or previous year, for the asset or liability to get the right answer in your calculator. If the answer is positive it indicates you add the difference calculated and if a negative figure it indicates you deduct the difference calculated.

- Inventory is an asset (**APC**) so deduct the previous year (340) from the current year (278) the difference is + 62. So, add back £62,000.

The reason for the above is that cost of sales needs to be adjusted to include only purchases for the year, since purchases have been adjusted by the valuation of opening and closing inventory levels, which are both are non-cash items. Given inventory levels have fallen, then £62,000 more has been charged to cost of sales compared with the real purchases figure for the year. This would have reduced profits by £62,000 'non-cash' so add it back to find cash rather than profit.

- Trade receivables is an asset (**APC**) so deduct the previous year (430) from the current year (255) the difference is + 175. So, add back £175,000.

The reason for the above is that the trade receivables has fallen so more money was collected compared with sales earned included in the statement of profit or loss. We therefore add £175,000 to sales and therefore profits to find cash rather than profit.

- Trade payables is a liability (**LCP**) so deduct the current year (250) from the previous year (452) the difference is -202. So, we deduct £202,000.

The reason for the above is that the trade payables amount has fallen, so more money has been paid to suppliers in the year, compared to purchases included in the statement of profit or loss as an expense for the year. £202,000 more was paid to suppliers so take this extra amount away from profits to find cash rather than profit.

In summary we adjust for inventory levels to include only the purchases figure for the year (not cost of sales), we then take away the extra money repaid to suppliers that was not included in the purchases figure.

The exam will normally have auto sum as a function to automatically calculate 'cash generated from operations', so it is important to ensure you enter figures correctly as either positive or negative. Cash generated from operations ignores tax and finance costs.

Finally, deduct interest paid (finance costs we added back earlier) and tax paid. As a tip 'tax paid' in your exam will always be the previous year's tax liability in the statement of financial position, since that is what would have been paid during the year. The current year's tax charge of £103,000 in the statement of profit or loss is a liability unpaid in the statement of financial position for the current year. What was paid is the £99,000 tax liability from the previous year as this no longer exists as a liability in the statement of financial position.

Workings: Statement of cash flows for the year ended 31 August 20X9

IAS 7 prescribes how to present information in a statement of cash flows to show how an entity's cash and cash equivalents changed during the period. The presentation of information classifies cash flows during the period according to operating, investing and financing activities. Only the indirect method is examinable when presenting cash-flow statements in your exam which is the presentational layout we use here and what AAT will provide in the exam by proforma.

When testing cash-flow statements AAT will not examine dividends received or interest received. Interest received and dividends received can be classified as either operating activities, or investing activities, because they represent returns on investments made. Some accountants prefer to classify these items under operating activities, because they contribute to the operating profit before taxation. Either method is acceptable by IAS 7.

Interest paid on borrowings and dividends paid can be classified as either operating activities, or financing activities. Some accountants prefer to classify these items as operating activities, because the funds are used to facilitate the trading of the company. Either method is acceptable by IAS 7.

AAT expect interest paid to be included under ‘operating activities’ and dividends paid to be included under ‘financing activities’.

Preparing the cash-flow statement

Take the cash figure from the reconciliation of profit before tax to net cash from operating activities (+ £921,000) and include this amount in the cashflow statement.

For ‘investing activities’, present any proceeds from the sale of PPE or any payments to purchase PPE. PPE means ‘property, plant and equipment’ which are non-current assets working within the business for the long-term (beyond one year) and therefore ‘investing activities’ of the business.

Workings boxes will be included in the exam task for the calculation of cash payments to acquire assets or for the cash proceeds received from the sale of assets during the year. The exact workings and terminology used by AAT has been included below. General ledger accounts are also included as workings to help further your logic and understanding.

We are not given the figure for cash proceeds from the sale of PPE. A disposal account (included in the statement of profit or loss) would have been prepared which would have compared the carrying value of the asset (its original cost – accumulated depreciation) to the bank proceeds received to work out any profit or loss for the year from the sale of PPE.

The carrying value (£700,000) would be a debit balance overall (its an asset so should be in debit), this would have been debited to the disposal account and non-current assets (PPE) credited to remove the carrying value of the PPE sold in the year. Sale (cash) proceeds are a debit to the bank (increasing this asset) and a credit to the disposal account, to work out the gain or loss on disposal. We don’t know the amount received from the sale of PPE but do know it would be a credit to the disposal account.

There is loss of £300,000 on the sale of PPE and this is a debit to the statement of profit and loss (an expense), so must have been a credit of £300,000 as an entry in the disposal account to clear any balance at the year-end and close this account. If we include all of the above in the right place, by double entry logic we can prove the missing cash figure received which was the bank (cash) proceeds received.

Disposal account for PPE

Details	Amount £	Details	Amount £
(Cost - Accum Dep'n)	700	Loss on disposal (P&L)	300
		Bank (balance)	400
Total	700	**Total**	700

A quicker way of looking at the above is that a £300,000 loss was made, so the proceeds received must have been £300,000 less than the carrying value of £700,000 given in the task. Take away the £300,000 loss on disposal from the carrying value of £700,000 and the proceeds were £400,000.

We were not told of any cash acquisitions of PPE. The task did include a workings box for the amount to be calculated. The exact workings and terminology used by AAT has been included below in the workings box. A general ledger account for PPE (a non-current asset) has also been included to help further your logic and understanding.

All figures relevant in the task have been entered in the ledger account below including the revaluation movement in the year, the missing figure is a debit balance of £460,000 which must be the amount of PPE purchased in the year if all other entries are correct.

PPE account (Cost - Accumulated depreciation)

Details	Amount £	Details	Amount £
Balance b/d	9800	Depreciation	180
Revaluation	2000	Disposed PPE	700
Acquired PPE (balance)	460	Balance c/d	11380
Total	12260	**Total**	12260

Workings:

Proceeds on disposal of PPE	£000
Carrying amount of PPE sold	700
Loss on disposal of PPE	-300
Total disposal proceeds	400

Purchases of PPE	£000
PPE at start of the year	9,800
Depreciation charge	-180
Carrying amount of PPE sold	-700
Revaluation	2000
PPE at end of the year	-11,380
Total PPE additions	-460

Financing activities include all transactions to do with long-term debt (borrowings) or equity (ordinary shares). It shows how the business is financed in the long-term. Debt maybe repaid or debt borrowed, so compare the previous and current years non-current liabilities to find out what happened.

The AAT exam assumption is that interest paid is included under 'operating activities' and dividends paid are included under 'financing activities'.

Equity may include cash received from new ordinary share issues during the year and cash paid for dividends to ordinary shareholders during the year. Dividends paid were included in the task information. A bonus issue (free shares) was also mentioned, however no cash is received from a bonus issue, so there is no cash to include here.

We should now have 3 headings indicating where money was received from or paid to during the year. The auto sum function in the real exam may already add these figures together to now work out the net increase / (or decrease) in cash and cash equivalents. The figure calculated is -£639,000, this shows the net amount spent through the bank account for the year.

As a final check if we added -£639,000 to the opening bank balance £670,000 we should have left the closing bank balance of £31,000. So, you should be able to check during the exam whether the answer is 100% correct or not, after the cash-flow statement has been prepared.

Statement of cash flows for the year ended 31 August 20X9

	£000
Net cash from operating activities	921
Investing activities	
Proceeds on disposal of PPE	400
Purchases of PPE	-460
Net cash from investing activities	-60
Financing activities	
Loan certificates	-1000
Dividends paid	-500
Net cash used in financing activities	-1500
Net increase / (decrease) in cash and cash equivalents	-639
Cash and cash equivalents at the beginning of the year	670
Cash and cash equivalents at the end of the year	31

Task 2 (8 marks)

Draft the statement of changes in equity for XYZ Ltd for the year ended 31 August 20X9.

Statement of changes in equity for the year ended 31 August 20X9

	Share capital £000	Share premium £000	Revaluation surplus £000	Retained earnings £000	Total equity £000
Balance at 1 September 20X8	5,000	2,000		2,189	9,189
Changes in equity					
Total comprehensive income			2,000	402	2,402
Dividends				-500	-500
Issue of share capital	1000	-1000			
Balance at 31 August 20X9	6000	1000	2,000	2,091	11,091

Equity reserves represent the value attributable to the owners (ordinary shareholders) of the company. The book value of equity is calculated as the difference between assets and liabilities. The statement of changes in equity explains the changes in a company's share capital, accumulated reserves and retained earnings during the reporting period. It breaks down the changes in the owners' interest from one accounting period to the next. Small companies are not required to produce a statement of changes in equity within their financial statements but are encouraged to do so. Start by including the opening years balances from the previous year.

Include in total comprehensive income (see the statement of profit or loss for this figure), this consists of profits for the period from continuing operations (£402,000) and 'other comprehensive income' which is the revaluation surplus (£2,000,000) for the property revalued during the year. The purpose of other comprehensive income is to show 'unrealised gains and losses' meaning the revaluation surplus reflects an increase in the value of the property but since it has not actually been sold then the gain has not been 'realised'. Include any payment of dividends to ordinary shareholders, this amount is paid from retained earnings (accumulated profits) and deducted from this reserve to work out how much retained earnings are left that potentially could be paid out as dividends to ordinary shareholders in the future.

Include any share issues. A bonus issue is an offer of free shares to existing shareholders based on the number of shares currently held. It is normally used as an alternative to paying a dividend when a company is cash starved. Given there is no cash proceeds, the double entry would be DR share premium (reducing this reserve) and CR share capital (increasing this reserve). There was £5m in ordinary share capital before the bonus issue and it was a 1 for 5 bonus issue, so £5m ÷ 5 x 1 = £1m increase in ordinary share capital. The £1000,000 bonus issue increases share capital and reduces the share premium account. If all the above has been applied correctly the closing balances for reserves in the statement of changes in equity should agree to the closing balances for reserves within the statement of financial position for the year ended.

Task 3 (10 marks)

This task will contain written response questions where students need to demonstrate their knowledge and understanding of the regulatory framework, including the examinable sections of the IASB Conceptual Framework for Financial Reporting. This task will also assess ethical principles. You need to make sure your observations are entirely focused on and relevant to the question in order to achieve high marks.

Examinability of this task

- The purpose of financial statements
- The different types of business organisation (sole traders, partnerships, limited liability partnerships, companies, not-for-profit organisations (charities, clubs and societies), Public sector organisations (local authorities, central government and the National Health Service) and cooperatives)
- The types of limited company
- How the financial statements of limited companies differ from those of sole traders and partnerships
- Forms of equity, reserves and loan capital
- The reasons for the existence of a regulatory framework
- Sources of regulation: international accounting standards and company law (Companies Act 2006)
- The purpose of accounting standards
- The duties and responsibilities of the directors in respect of financial statements.
- Explain the International Accounting Standards Board (IASB) Conceptual Framework that underpins financial reporting.
- Discuss the ethical principles that underpin financial reporting in accordance with the AAT Code of Professional Ethics. Explain fundamental principles, identify the threats and apply the safeguards to resolve ethical conflict.

The purpose of the IASB Conceptual Framework's is to assist in developing and revising IFRSs and to help preparers of accounts to develop consistent accounting policies.

The IASB Framework addresses:

- The objective of financial reporting
- Qualitative characteristics of useful financial information
- Financial statements and the reporting entity
- The elements of financial statements
- Recognition and derecognition
- Measurement
- Presentation and disclosure

PIPCO is an acronym for your ethical principles:

- **P**rofessional competence and due care
- **I**ntegrity
- **P**rofessional behaviour
- **C**onfidentiality
- **O**bjectivity

ASSIF is an acronym for the five threats to your ethical principles:

- **A**dvocacy
- **S**elf-interest
- **S**elf-review
- **I**ntimidation
- **F**amiliarity

(a) (i) Explain the definitions of assets and liabilities as elements within the financial statements, according to the IASBs Conceptual Framework for Financial Reporting. (2 marks)

1 x mark for reference to any of the following points: maximum 2 marks

Asset

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

Liability

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.

(a) (ii) Explain why the new bakery oven and bank loan should be recognised as an asset and liability respectively, according to the IASBs Conceptual Framework for Financial Reporting.

(6 marks)

1 x mark for reference to any of the following points

For either the new bakery oven or bank loan to be recognised as an asset or liability they must satisfy the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- The item's cost or value can be measured with reliability.

2 x marks for reference to the following points

For the new bakery oven, it is probable that future economic benefits will flow to the entity by way of sales or profits the machine will generate from making cakes and biscuits. The asset has a cost or value that can also be measured reliably, the purchase cost was £280,000.

2 x marks for reference to the following points

A liability is recognised when it is probable that an outflow of economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In this case there is probably a contract with the bank for the loan, so the liability has a fulfilment value if settled or repaid in the future, which can be measured reliably.

(a) (iii) Identify from the information above TWO measurement bases which could be used to determine how the bakery oven is recognised in the financial statements as at 31 August 20X9.

1 x mark for reference to any of the following points. Other measurement bases could have been discussed other than the TWO methods included below.

Net realisable or market value is the £150,000 price the oven can be sold for today, minus any estimated costs of selling or disposing of the asset.

Historical cost is the amount of money originally spent to acquire the asset and this was £280,000. Historical cost means the original cost. Historical cost often bears little relation to the market value of the asset especially when the asset has been owned for several years.

Task 4 (12 marks)

This task will contain written response questions where students need to demonstrate their knowledge and understanding of how items should be treated (presented, valued or disclosed) in the financial statements in accordance with International Accounting Standards. This task may also expect you to make any supporting calculations. According to the examiners report, only 15% of students achieve the minimum requirement and this is the lowest performing task in the exam by students.

Students need to know general accounting treatment rules and understand what they entail and apply these rules to figures given in the task, alongside a straightforward explanation of what they are doing.

The main international accounting standards examinable:

- IAS 1 Presentation of Financial Statements
- IAS 2 Inventories
- IAS 7 Statement of Cash Flows
- IAS 10 Events After the Reporting Period
- IAS 12 Income Taxes
- IAS 16 Property, Plant and Equipment
- IAS 17 Leases
- IAS 18 Revenue
- IAS 36 Impairment of Assets
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 Intangible Assets

(a) Explain, with reasons, how the matter above should be treated in PQR Ltd's individual financial statements for the year ended 31 October 20X7. Use the figures from above to illustrate your answer where possible.

(6 marks)

1 x mark for reference to any of the following points

International Accounting Standard (IAS) 18 and International Financial Reporting Standard IFRS 15 both give guidance for revenue recognition. The basic foundation of the accounting principle is how to recognise revenue and other forms of income in the financial statements.

The revenue recognition principle is a cornerstone of accruals accounting as it determines the accounting period, which revenues and expenses are recognised. According to the principle, revenues are recognised when they are realised or realisable, and are earned (usually when goods are transferred or services rendered), no matter when the cash is received.

In the case of the matter above:

- There is a contract identified with the buyer.
- There is an identified performance obligation.
- A transaction price has been determined.
- The transaction price can be allocated to the performance obligations of the contract.

Revenue should therefore be recognised whenever PQR satisfies its performance obligations.

Revenue to be recognised for year ending 31 October 20X7

- £150,000 received from the supermarket on 1 September 20X7 for 6 months' supply.
- This equates to £25,000 per month, so for the year ended 31 October 20X7 it has earned 2 months of revenue (2 x £25,000) = £50,000 to be recognised as income for the year ended 31 October 20X7.

Only 2 months revenue will therefore be recognised as PQR has only supplied 2 months of trade magazines and incurred cost of sales for 2 months only for the year ended. This is because:

- Significant risks and rewards have been passed onto the buyer.
- Ownership of the goods has been passed to the buyer, meaning that the business selling the goods (PQR) has no control over the goods and therefore no influence over them.

- The revenue can be measured reliably.
- It is reasonably certain that the seller will be gaining economic benefit from selling the goods.
- The selling costs can be measured reliably.

The criteria for revenue recognition is not met for the remaining money received because significant risks and rewards have not been passed on to the buyer and ownership of the goods has not been passed on to the buyer.

The remaining £100,000 will be shown as deferred income in the statement of financial position at the year end and is not recognised as income in the statement of profit or loss for the year ended 31 October 20X7.

(b) Explain, with reasons, how the matters above should be treated in PQR Ltd's individual financial statements for the year ended 31 October 20X7. Use the figures from above to illustrate your answer where possible.

(6 marks)

IAS 36 Impairment of assets covers events such as a significant fall in market or economic value, obsolescence or physical damage to an asset.

Impairment is a reduction in the recoverable amount of an asset below its carrying value within the financial position. Assets must never be carried in the statement of financial position above their recoverable amount. If the carrying amount therefore exceeds the recoverable amount, the asset is impaired and should be written down.

1 x mark for reference to any of the following points

Building

The original revaluation gains of £800,000 (£1.8m - £1.0m) would have gone to a revaluation reserve and presented as equity reserves in the statement of financial position. The amount of gain is unrecognised and would have been reported as other comprehensive income in the statement of profit or loss.

The subsequent revaluation loss of £300,000 (£1.8m - £1.5m) can be offset against the revaluation reserve gain held within the statement of financial position, this amount should also be included under other comprehensive income (as a loss) within the statement of profit or loss.

Brand

Carrying value as at 31 October 20X7 is £500,000.

- Net realisable value £200,000 (fair value if sold today). Fair value is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less any costs of sale or disposal.

- Value in use is the present value of the future cash flows expected to be derived from the asset. The value in use £150,000 (cash earnings the brand will generate over its lifetime).
- The recoverable amount of an asset is always the higher of net realisable value or the value in use. The highest amount is the NRV £200,000.
- The impairment loss (carrying value £500,000 less NRV £200,000) is £300,000.

The impairment loss of £300,000 will be included as a recognised loss (expense) for the year and will reduce PQR's profits by this amount. The brand's carrying value will now be £200,000 in the statement of financial position, since £300,000 impairment loss will be credited to the asset account and expenses debited (increased) by the same amount.

Task 5 (15 marks)

Task 5 will cover International Accounting Standards and how items should be treated in the financial statements. It will comprise five stand-alone short form questions, the layout of which is either multiple choice, gap fill or drag and drop. This task may also expect you to make calculations

The main international accounting standards examinable:

- IAS 1 Presentation of Financial Statements
- IAS 2 Inventories
- IAS 7 Statement of Cash Flows
- IAS 10 Events After the Reporting Period
- IAS 12 Income Taxes
- IAS 16 Property, Plant and Equipment
- IAS 17 Leases
- IAS 18 Revenue
- IAS 36 Impairment of Assets
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 Intangible Assets

(a) Which ONE of the international accounting standards below prescribes how property, plant and equipment should be accounted for by an organisation adopting IFRS.

(2 marks)

IAS 1	☐
IAS 2	☐
IAS 16	☑

International accounting standard 16 (IAS 16) concerns accounting for 'property, plant and equipment' (non-current assets), including recognition, determination of carrying amounts and depreciation charges to be recognised in the financial statements. International accounting standard (IAS 1) Presentation of Financial Statements sets out the overall requirements for financial statements, including how they should be structured and presented. International accounting standard 2 (IAS 2) Inventory, sets out the accounting treatment for inventories.

(b) Reconciliation of a cash book to the bank statements, or a purchase ledger account to a supplier statement would support which one of the qualitative characteristics of useful financial information. Choose ONE only. (3 marks)

Answer is Verifiability ('the assurance of the information'). Timeliness would mean to receive information on time for making decisions. Comparability would mean the consistency of the format of information to compare one year or one business to another. Relevance means information that is both material and useful to users of the financial statements.

Verifiability	☑
Timeliness	☐
Comparability	☐
Relevance	☐

The qualitative characteristics of useful financial information.

- Verifiability
- Comparability
- Relevance
- Understandability
- Faithful representation
- Timeliness or.. 'V CRUFT'.

(c) Which ONE of the following is NOT a likely response to the management accountants request. Choose ONE only.

(3 marks)

To post the journal without question would be breaching the ethical principle of objectivity (scepticism, to question and not just accept someone else's opinion), professional behaviour could also be in breach as it could be 'breaking the rules' to post this journal.

Seek guidance from your practice manager regarding the posting of this journal.	☐
Discuss the matter with the management accountant to see if there is a valid case for posting this journal.	☐
Post the journal without question as the management accountant is your client.	☑

(d) The recoverable amount of the asset is

(3 marks)

£18,000	☐
£20,000	☐
£22,000	☑
£50,000	☐

The recoverable amount of an asset is the higher of its net realisable value (£18,000) and value in use (£22,000). Net realisable value is the sales proceeds (less any selling costs) the entity could receive if the asset was sold today (market value or fair value). The value in use is the present value of the assets future cash flows e.g. profits generated over the lifetime of the asset.

(e) Which ONE of the following would be classified by WDC as a non-adjusting event according to IAS 10 *Events After The Reporting Period.*

(4 marks)

WDC was notified on 5 November 20X1 that one of its customers was insolvent and was unlikely to repay any of its debts. The balance outstanding at 30 September 20X1 was £42,000.	☐
On 30 September WDC had an outstanding court action against it. WDC had made a provision in its financial statements for the year ended 30 September 20X1 for damages awarded against it of £22,000. On 29 October 20X1 the court awarded damages of £18,000.	☐
On 5 October 20X1 a serious fire occurred in WDC's main production centre and severely damaged the production facility.	☑
The year end inventory balance included £50,000 of goods from a discontinued product line. On 1 November 20X1 these goods were sold for a net total of £20,000.	☐

IAS 10 Events After The Reporting Period provides guidance for which events should lead to adjustments to the financial statements and which events should be disclosed as a note in the financial statements.

IAS 10 deals with events after the reporting period (year ended), favourable or unfavourable, that occur between the end of the reporting period and the date that the financial statements are authorised for issue (signed and approved by the board of directors). Adjusting events are those events that provide evidence of conditions that existed at the end of the reporting period (we adjust the financial statements). Non-adjusting events are those events that are indicative of conditions that arose after the end of the reporting period (disclosed as a note in the financial statements if material).

Examples of adjusting events (conditions existing at the year-end)

- The resolution of a court case, as the result of which a provision for damages are recognised as an expense in the financial statements, instead of by disclosure as a contingent liability in the notes to the financial statements.
- Evidence of impairment of assets.
- Bankruptcy of a major customer, therefore an irrecoverable debt.
- Sale of inventory at below cost, suggesting the need to reduce the figure for inventory in the statement of financial position to net realisable value.
- Discovery of fraud or errors that show the financial statements at the year end were incorrect.

Examples of non-adjusting events (conditions not existing at the year-end)

- Decline in market values for investments (non-current assets).
- Announcement of a plan to discontinue part of the enterprise.
- Major purchases and sale of assets.
- Destruction of a major assets (loss of productive assets) by fire, flood, strike etc.
- Sale of a major subsidiary.
- Major dealings in the company's ordinary shares or business combinations.

Notes to support the answer to part (e) above:

WDC was notified on 5 November 2011 that one of its customers was insolvent and was unlikely to repay any of its debts. The balance outstanding at 30 September 2011 was £42,000.

This is an adjusting event as more evidence exists for trade receivables at the year-end date.

On 30 September WDC had an outstanding court action against it. WDC had made a provision in its financial statements for the year ended 30 September 2011 for damages awarded against it of £22,000. On 29 October 2011, the court awarded damages of £18,000.

This is an adjusting event as more evidence for the amount of provision existing at the year-end date.

On 5 October 2011, a serious fire occurred in WDC's main production centre and severely damaged the production facility.

The fire was after the year end so doesn't affect the year end statement of financial position, it a non-adjusting event.

The year-end inventory balance included £50,000 of goods from a discontinued product line. On 1 November 2011, these goods were sold for a net total of £20,000.

This is an adjusting event as more evidence of the impairment for the valuation of inventory existing at the year-end date.

Task 6 (30 marks)

This task will examine the following:

Draft a consolidated statement of profit or loss for a parent company with one partly owned subsidiary.

You need to be able to:

- Consolidate each line item in the statement of profit or loss.
- Treat intercompany sales and other intercompany items, impairment losses on goodwill and dividends paid by a subsidiary company to its parent company.
- Calculate and treat unrealised profit on inventories and non-controlling interest.

Draft a consolidated statement of financial position for a parent company with one partly owned subsidiary.

You need to be able to:

- Consolidate each line item in the statement of financial position.
- Calculate and treat goodwill, non-controlling interest, pre- and post-acquisition profits, equity and unrealised profit on inventories.
- Treat adjustment to fair value, impairment of goodwill and intercompany balances.

Logical approach to consolidation questions:

1. Remove the investment in the subsidiary from the consolidated financial position, as this is replaced with the fair value of the total assets and total liabilities (net assets) of the subsidiary. Any difference between the investment cost (purchase price) and the fair value of the pre-acquisition reserves of the subsidiary owned by the parent is goodwill.
2. Deal with any cash in transit, intercompany balances and provision for unrealised profits (PUP) included within 'unsold' inventory.
3. Consolidate each line item in the statement of financial position. Remember to exclude the share capital of the subsidiary when you do this.
4. Goodwill. The excess purchase price (investment cost) less the ownership (%) of the fair value of the net assets (pre-acquisition reserves) on acquisition is goodwill. You may need to adjust the book value to fair value for net assets if the question includes this adjustment. You may need to reduce the goodwill (non-current asset) for any impairment, if impairment is included in the task.
5. Retained reserves of the parent are calculated (reserves of the parent + % ownership of post-acquisition reserves of the subsidiary). Provision for unrealised profits (PUP) included within 'unsold' inventory (if the parent made the sale to the subsidiary), or goodwill impairment will affect profits for the year and therefore the parents retained reserves.

6. Non-controlling interest (NCI). This represents the other interests of shareholders if the parent owns less than 100% of the shares of the subsidiary. This would be the % NCI of the subsidiaries share capital and its retained reserves. The retained reserves of the subsidiary may also need adjustment for any provision for unrealised profits (PUP) included within 'unsold' inventory (if the subsidiary made the sale to the parent), before the % NCI for retained reserves is calculated.

Draft the consolidated financial position of ABC Ltd and its subsidiary undertaking as at 31 August 20X9.

(30 marks)

ABC Ltd - Consolidated statement of financial position as at 31 August 20X9

	£000
Assets	
Non-current assets	
Goodwill	2200
Property, plant and equipment	11500
	13700
Current assets	
Inventories	3920
Trade and other receivables	1850
Cash and cash equivalents	2880
	8650
Total assets	22350
EQUITY AND LIABILITIES	
Equity	
Share capital	5000
Retained earnings	9590
Non-controlling interest	1360
Total equity	15950
Non-current liabilities	5000
Current liabilities	
Trade and other payables	1230
Taxation	170
	1400
Total liabilities	6400
Total equity and liabilities	22350

Inventory	£000
ABC Ltd	3400
Provision for unrealised profit for inventory sold	-150
XYZ Ltd	670
	3920

If goods are sold to each other in a group of companies and then sold on to a third party outside the group, then no adjustment is required since all profits have been realised.

Inter-group inventory 'not sold' at the year end, is unrealised profits and so must be removed in the consolidated financial position, this is called a provision for unrealised profit (PUP). Any profits 'unrealised' then DR retained reserves (reduce profits for the year) and CR Inventory (reduce the value of inventory as an asset). A PUP is always adjusted in the books of the company that made the sale of inventory when you are consolidating.

In this case it was ABC Ltd that made the sale. (£1,000,000 - £400,000) = £600,000 profits on sale x 25% (the amount unsold at year end) = £150,000 PUP. ABC Ltd has inventory with £150,000 too much included in its valuation.

Trade and other receivables	£000
ABC Ltd	1600
XYZ Ltd	900
Inter-company adjustment	-350
Cash in transit	-300
	1850

Intra-group trade receivables and trade payables at the year-end must be eliminated in the consolidated financial position. A 'group' cannot owe money to itself if represented as a 'single entity'. Given one company sells and the other company buys, then trade receivables in the books of the seller and trade payables in the books of the buyer should be the same, unless there is goods or cash in transit that has not been recorded at the year ended.

In transit items (goods or money sent), which has already been adjusted for in the senders books, may not have been adjusted in the receivers book at the year ended, in which case follow the transaction through to its ultimate destination and adjust the receivers books.

There was cash in transit of £300,000 from XYZ Ltd to ABC Ltd at the year ended 31 August 20X9. XYZ would have already adjusted its books for the money it sent (DR Trade payables CR Bank). We need to adjust ABC's ledger balances for the money received (DR Bank CR Trade receivables).

The workings above would include the trade receivables balances of both ABC and XYZ. We also take away the £300,000 cash in transit (this reduces the trade receivables of ABC). ABC had trade and other receivables of £650,000 owed from XYZ, but this has now fallen to £350,000 when we adjusted for the cash in transit.

Cash and cash equivalents	£000
ABC Ltd	1800
XYZ Ltd	780
Cash in transit	300
	2880

The above would be the bank balances of both companies as well as the additional £300,000 cash in transit received by ABC Ltd.

Trade and other payables	£000
ABC Ltd	1180
XYZ Ltd	400
Inter-company adjustment	-350
	1230

The above would be the trade payable balances of both companies. Intercompany balances should be eliminated. Included in XYZ's trade and other payables is £350,000 owed to ABC. The above working includes both companies trade payables less the inter-company balance eliminated.

Goodwill	£000
Consideration	4000
Non-controlling interests at acquisition	1200
Net assets acquired	-3000
	2200

ABC acquired 60% of the share capital of XYZ Ltd on the 1 June 20X1 for £4m. On the acquisition date the retained earnings of XYZ Ltd were £2.0 million and its share capital was £1.0 million.

The investment cost on the financial position of ABC shows £4 million was paid to acquire 60% x (£1m share capital + £2m retained earnings) £3m reserves = £1.8m fair value of net assets acquired. The excess paid is purchased goodwill and should be capitalised. £4m - £1.8m = £2.2m goodwill.

The workings box provided by AAT is the accounting standards working above and uses the same terminology as the accounting standard. The above takes a slightly different approach to the calculation, it includes 100% of XYZ's net assets (£1m share capital + £2m retained earnings). And since ABC only purchased 60% of the net assets, we include the other 40% non-controlling interest share of these net assets in the workings box for goodwill 40% NCI x (£1m share capital + £2m retained earnings) = £1.2 million.

Retained earnings	£000
ABC Ltd	9500
Provision for unrealised profit for inventory sold	-150
XYZ Ltd - attributable to ABC Ltd	240
	9590

ABC's retained reserves are included above as well as the % share of the post-acquisition retained earnings of XYZ which are owned by ABC, post-acquisition would be the profits that have accumulated after acquiring XYZ. XYZ Ltd – retained earnings attributable to ABC Ltd = 60% x (current retained earnings of XYZ 2,400 – pre-acquisition retained reserves 2,000) £400,000 = £240,000. ABC Ltd also had an adjustment made to its profits and hence its retained reserves of £150,000 for a provision for unrealised profit (PUP) for unsold inventory to XYZ at the year ended.

Non-controlling interest

There is no workings box provided in your exam for the calculation of non-controlling interest. Given ABC owns 60% of equity reserves (net assets) of XYZ, we must show the net assets of XYZ owned by other shareholders which is 40%. The year-end reserves of XYZ are (1,000 share capital + retained earnings 2,400) 3,400. 40% NCI x 3,400 = 1,360 NCI represented as the balance for total equity reserves (net assets) owned by other shareholders in the financial position.

Task 7 (20 marks)

This task will be about interpreting financial statements using ratio analysis.

You need to be able to calculate the following ratios:

Profitability

- ROCE (return on capital employed) = profit from operations / capital employed x 100%.

This ratio is always expressed as a percentage. Capital employed = total equity + non-current liabilities

- Return on shareholders' funds = profit after tax / total equity x 100%
- Gross profit percentage = gross profit / revenue x 100%
- Operating profit percentage = profit from operations / revenue x 100%
- Expense/revenue percentage. Specified expense as a % of revenue= specified expense / revenue x 100%

Liquidity

- Current ratio = current assets / current liabilities = X:1
- Quick ratio or 'acid test' ratio = current assets - inventories / current liabilities = X:1

Use of resources

- Inventory turnover = cost of sales / inventories = X times
- Inventory holding period (days) = inventories / cost of sales x 365 (days)
- Trade receivables collection period = trade receivables / revenue x 365 (days)
- Trade payables payment period = trade payables / cost of sales x 365 (days)
- Working capital cycle = inventory days + receivable days - payable days
- Asset turnover (net assets) = revenue / total assets - current liabilities = X times
- Asset turnover (non-current assets) = revenue / non-current assets = X times

Financial position

- Interest cover = profit from operations / finance costs (i.e. interest) = X times
- Gearing = total debt / total debt + total equity x 100%. Where total debt is all non-current liabilities only.

(a) Identify the formulas that are used to calculate each of the following ratios.
(10 marks)

Asset turnover (non-current assets)	revenue / non-current assets
Inventory holding period (days)	inventories / cost of sales x 365
Current ratio	current assets / current liabilities
Return on shareholders' funds	profit after tax / total equity x 100%
Return on capital employed	profit from operations / (total equity + non-current liabilities) x 100%

(b) Calculate the above ratios to ONE decimal place.

(10 marks)

Asset turnover (non-current assets)	3.5	times
Inventory holding period	14.2	days
Current ratio	2.8	: 1
Return on shareholders' funds	12.4	%
Return on capital employed	18.9	%

Workings

Asset turnover (non-current assets) = revenue / non-current assets = X times.
Asset turnover (non-current assets) = 4500 / 1300 = 3.5 times.

Inventory holding period (days) = inventories / cost of sales x 365 (days).
Inventory holding period (days) = 150 / 3845 x 365 = 14.2 days.

Current ratio = current assets / current liabilities = X:1.
Current ratio = 930 / 335 = 2.8 : 1.

Return on shareholders' funds = profit after tax / total equity x 100%.
Return on shareholders' funds = 123 / 995 x 100% = 12.4%.

ROCE (return on capital employed) = profit from operations / capital employed x 100%.
Capital employed = total equity + non-current liabilities.
ROCE (return on capital employed) = 358 / capital employed (995 + 900) x 100% = 18.9%.

Task 8 (23 marks)

For a full list of examinable ratios see task 7 solutions. Task 8 will be written response questions requiring you to identify, with reasons, whether a ratio is better or worse as compared to a comparative ratio. You need to be able to suggest factors that influence ratios, how they may interrelate and explain the limitations of using ratio analysis.

You also need to be able to effectively present the key findings from your analysis to meet user requirements, suggest how ratios could be improved and the potential consequences of doing so.

(a) Assess whether EACH of VUW Ltd's ratios are better or worse as compared to the previous year's figures and what this may tell you about the company.

(20 marks)

Maximum 5 marks for each ratio. 1 mark to identify whether the ratio is better or worse. 1-2 marks for each relevant point about what this may tell you about the company.

Gearing

Gearing is worse. This suggests the company is carrying too much long-term debt. This increases the financial risk of the company as more cash generated from operations is required to meet debt and interest payments. This may also affect Susan's ability to receive future dividends in the company. It could also be more difficult for the company to obtain finance in the future.

Gearing is inter-related strongly with interest cover, as when debt (gearing rises) then interest cover tends to worsen as interest payments will rise.

Interest cover

Interest cover is worse. This indicates less operating profit is available after meeting interest payments for debt and this makes the company a higher financial risk to investors and lenders. This worsening position is either caused by less profits available to meet interest payments, or higher interest payments. More debt (gearing) tends to make this ratio worse as interest payments tend to rise as the company takes on more debt. This could make it more difficult for the company to obtain more finance in the future.

Trade payables

Trade payables days are better. The ratio indicates VUW Ltd is taking longer to pay its suppliers. This is better for the working capital cycle and cash-flow generally. Taking longer to pay suppliers holds money in the bank account longer. It is a free source of short-term finance by taking longer to pay suppliers.

The reasons maybe renegotiated payment terms with suppliers, or that the company is cash starved and cannot pay its suppliers on time. It may indicate the company also has solvency problems.

Operating profit percentage

Operating profit percentage is slightly better. Reasons could be higher prices, higher volume of sales, lower cost of sales or lower expenses compared with the previous year. This ratio also tends to improve with the size and efficiency of the company e.g. large companies can share overhead over a greater volume of sales, or because of size, obtain bigger discounts for cost of sales, due to a higher volume of orders made from suppliers. Cost savings as a result of size are referred to as economies of scale.

(b) Recommend, with reasons, whether or not Susan should buy shares in VUW Ltd, based solely on your analysis of the ratios in (a) above.

(3 marks)

Maximum 3 marks. 1 mark for each relevant point made. 1 mark maximum for advice (buy or not to buy the shares).

Advice to Susan is not to buy the shares. The gearing and interest cover have worsened drastically. The company is taking much longer to pay its suppliers. These ratios indicate the company may have cash-flow problems. Only the operating profit percentage is better.