CHAPTER 4
PUBLISHED FINANCIAL STATEMENTS OF COMPANIES

Quick test

Question 1

	£
Sales	45,678
Add: opening accounts receivable	4,602
Less: Closing accounts receivable	(5,709)
Cash received	44,571

OR	£
Sales	45,678
Less: INCREASE in accounts receivable	(1,107)
Cash received	44,571

The answer can also be derived from the accounts receivable control account where the cash received is the balancing figure:

Accounts receivable

Opening balance	4,602		
Sales	45,678	Cash received	44,571
		Closing balance	5,709
	50,280		50,280

Question 2

(a)

	£
Cost of sales	105,066
Add: Closing inventory	5,757
Less: Opening inventory	(6,430)
Purchases	104,393

OR	£
Cost of sales	105,066
Less: DECREASE in inventory	(673)
Purchases	104,393

(b)

Purchases	104,393
Add: opening accounts payable	9,204
Less: Closing accounts payable	(8,580)
Cash paid	105,017

OR	£
Purchases	104,393
Add: DECEASE in accounts payable	624
Cash paid	105,017

The answer can also be derived from the accounts payable control account where the cash paid is the balancing figure:

Accounts payable

		Opening balance	9,204
Cash paid	105,017	Purchases	104,393
Closing balance	8,580		
	113,597		113,597

Question 3

	£
Rent expense	35,100
Less: Opening prepayment	(8,460)
Add: Closing prepayment	9,000
Cash paid	35,640

OR	£
Expense	35,100
Add: INCREASE in prepayment	540
Cash paid	35,640

Question 4

	£	
Statement of profit or loss tax charge		75,267
Add: PY liability	34,609	
Less: CY liability	(41,957)	
Cash paid	67,919	

Question 5

(a) (i)

Accumulated depreciation

		Opening balance	64,293	
Closing balance c/f	76,613	Depreciation for year	12,320	β
	76,613		76,613	

	£
Closing accumulated depreciation	76,613
Less: Opening accumulated depreciation	64,293
Depreciation expense for the year	12,320

(ii)

Asset cost

Opening balance	126,587		
Additions β	16,614	Closing balance c/f	143,201
	143,201		143,201

	£
Closing cost	143,201
Less: Opening cost	126,587
Cash paid for fixtures and fittings	16,614

(b) (i) The accumulated depreciation on the asset sold must be cleared from the accumulated depreciation account:

Accumulated depreciation

		Opening balance	64,293
Disposal	14,700	Depreciation for	
Closing balance c/f	76,613	year	27,020 β
	91,313		91,313

	£	£
Closing accumulated depreciation		76,613
Less: Opening accumulated depreciation	64,293	
Less: Acc deprn on asset sold	(14,700)	
		49,593
Depreciation expense for the year		27,020

(ii) The cost of the asset sold must be cleared from the cost account:

Asset cost

	Opening balance	126,587	Disposal	24,500
β	Additions	41,114	Closing balance c/f	143,201
		167,701		167,701

	£	£
Closing cost		143,201
Less: Opening cost	126,587	
Less: Cost of asset sold	(24,500)	
		102,087
Cash paid for fixtures and fittings		41,114

(iii)

	£
Sale proceeds	3,500
Less: NBV of asset sold (24,500 – 14,700)	(9,800)
Loss on sale	(6,300)

Question 6

(a)

	£
Interest expense for period 1 July 20X3 – 31 March 20X4	
7% x 100,000 x $^{9}/_{12}$	5,250
Interest expense for period April – 30 June 20X4	
7% x 150,000 x $^{3}/_{12}$	2,625
Interest expense for year ended 30 June 20X4	7,875

(b) (i) Cash paid for interest in the year ended 30 June 20X4 will be the same as the expense, i.e. £7,875

(ii)

	£
Expense	7,875
Add: Opening accrual	1,750
Less: Closing accrual	(2,625)
Cash paid for interest	7,000

Develop your understanding

Question 7

(i) Net cash flow for the year ended 31 March 20X8

	£000
Bank balance at 1 April 20X7	30
Decrease in cash	(156)
Bank overdraft at 31 March 20X8	£(126)

(ii) Cash flows from operating activities

Indirect method

	£000
Profit before tax	334
Add back interest (W1)	21
Add back: Depreciation (W2)	124
Loss on sale of plant (W3)	8
Increase in inventory	(142)
Decrease in receivables	26
Decrease in trade payables	(10)
Cash flow generated from operating activities	£361

(W1) Interest on debentures	£000
$(6\% \times 450 \times {}^{6}/_{12}) + (6\% \times 250 \times {}^{6}/_{12})$	£21

(W2) Depreciation	£000
Accumulated depreciation at 31 March 20X7	230
Less: depreciation on plant sold	(58)
	172
Accumulated depreciation at 31 March 20X8	296
Depreciation for year	£ 124

(W3) Profit/loss on sale of plant = Proceeds - NBV of plant
= 14,000 - (80,000 – 58,000)
= £(8,000) (loss)

(iii) Pilot plc

Statement of cash flows for the year ended 31 March 20X8

		£000	£000
Cash flows generated from operating activities		361	
Interest paid		(21)	
Tax paid (20X7 + part of 20X8) (120 + (150 – 90))		(180)	
Net cash from operating activities			160
Cash flows from investing activities			
Purchase of non-current assets		(260)	
Proceeds from sale of non-current assets		14	
Net cash used in investing activities			(246)
Cash flows from financing activities			
Issue of shares	200		
Repayment of debentures (450 – 250)	(200)		
Dividends paid	(70)		
Net cash used in financing activities			(70)

Net decrease in cash and cash equivalents	(156)
Cash and cash equivalents at beginning of year	30
Cash and cash equivalents at end of year	£(126)

(iv) Information provided:

- The statement of cash flows explains why, despite a healthy profit, the company has lost cash over the year – mainly through the acquisition of non-current assets, which was not financed by any other means other than operating activities
- Cash from operations was mainly used to pay tax liabilities
- Although the company issued shares, the funds raised have been used in entirety to repay the debentures
- The reconciliation of profit before tax to cash flows from operating activities provides much useful information, although for this company the profit and cash flow figures are similar
- However this aids understanding of management of working (liquid) capital and shows that the large increase in inventories has reduced the cash available for other purposes. This information is not obvious from just the statement of profit or loss and statement of financial position.

Question 8

Falmouth plc
Statement of comprehensive income for the year ended 30 June 20X1

	£000
Revenue	6,590
Cost of sales	(4,450)
Gross profit	2,140
Distribution costs	(69.3)
Administrative expenses	(828.5)
Finance costs	(56)
Profit before tax	1,186.2
Income tax	(256)
Profit for the year	930.2
Other comprehensive income	
Gain on revaluation of land and buildings	388
Total comprehensive income for the year	1,318.2

Falmouth plc
Statement of changes in equity for the year ended 30 June 20X1

	Equity share capital	*Revaluation reserve*	*Retained earnings*	*Total*
	£000	£000	£000	£000
Balance at 1 July 20X0	500	-	368	868
Total comprehensive income	-	388	930.2	1,318.2
Dividends paid	-	-	(56)	(56)
Balance at 30 June 20X1	500	388	1,242.2	2,130.2

Falmouth plc
Statement of financial position at 30 June 20X1

		£000	£000
Non-current assets			
Property, plant and equipment			2,150.7
Current assets			
Inventories		440	
Trade and other receivables		569.5	
Cash and cash equivalents		168	
			1,177.5
Total assets			3,328.2
Equity			
Equity share capital			500
Revaluation reserve			388
Retained earnings			1,242.2
			2,130.2
Non-current liabilities			
Borrowings			600
Current liabilities			
Trade and other payables		454	
Income tax payable	256 – 112	144	
			598
Total equity and liabilities			3,328.2

Workings

Sale of plant and machinery		£000
Original cost		320
Accumulated depreciation	60% x 320	(192)
Net book value at time of disposal		128
Proceeds		40
Loss on sale		88

Previous irrecoverable debt received

This amount had been written off as an irrecoverable debt in previous years. The correct accounting treatment is to credit the amount received to irrecoverable debts, i.e. to reduce this year's irrecoverable debt expense. The adjustment required is therefore:

Dr Receivables
Cr Irrecoverable debts

Expenses analysed by function*

		Cost of sales £000	*Distribution costs* £000	*Admin expenses* £000
Inventory at 1 July 20X0		380		
Purchases		4,304		
Wages and salaries				508
Light and heat	62 + 12			74
Irrecoverable debt expense	30 – 8			22
Increase in allowance for receivables	24 - 20			4
Other administration expenses				188.5
Directors' bonuses				24
Depreciation:				
Freehold building	400 /50			8
Plant and machinery 10% x	(1,460 - 320 + 40)	118		
Motor vehicles	33% x (440 - 230)		69.3	
Loss on sale of machinery		88		
Inventory at 31 June 20X1		(440)		
		4,450	69.3	828.5

* In the absence of details of how to allocate expenses across the functions, any reasonable allocation is acceptable

Finance costs:		
Interest payable on debentures	8% x 400	32
Dividends on redeemable preference shares	12% x 200	24
		56

Revaluation of freehold land and buildings	£000
Cost at 30 June 20X1	860
Accumulated depreciation at 1 July 20X0	(40)
Depreciation for year ended 30 June 20X1	(8)
NBV at 30 June 20X1	812
Revaluation surplus	388
Revalued amount at 30 June 20X1	1,200

	Property, plant and equipment	£000	£000	£000
	Freehold land and buildings (valuation)			1,200
	Plant and machinery			
	Cost:			
	Per trial balance		1,460	
+	Proceeds incorrectly credited		40	
-	Plant sold		(320)	
			1,180	
	Accumulated depreciation:			
	Per trial balance	444		
-	On plant sold	(192)		
	Depreciation for year	118	(370)	
				810
	Motor vehicles			
	Cost per trial balance		440	
	Accumulated depreciation:			
	Per trial balance	230		
	Depreciation for year	69.3	(299.3)	
				140.7
				2,150.7

Trade and other receivables		
Receivables	578 + 8	586
Less: allowance for receivables		(24)
Prepayments		7.5
		569.5

Long-term liabilities - borrowings	
Redeemable preference share capital	200
8% debentures	400
	600

Trade and other payables		
Payables		390
Accruals	12 + 24	36
Debenture interest payable	32 – 16	16
Redeemable preference dividend	24 – 12	12
		454

Take it further

Question 9

Birch plc
Statement of comprehensive income for the year ended 31 March 20X9

	£
Revenue	660,340
Cost of sales (W1)	(442,662)
Gross profit	217,678
Distribution costs (W1)	(32,280)
Administrative expenses (W1)	(180,780)
Profit before tax	4,618
Income tax expense	(6,100)
Loss for the period	(1,482)
Other comprehensive income	
Gain on revaluation of land and buildings	385,600
Total comprehensive income	384,118

Birch plc
Statement of changes in equity for the year ended 31 March 20X9

	Equity Share Capital	Preference Share Capital	Share Premium	Revaluation Reserve	Retained Earnings	Total
	£	£	£	£	£	£
Balance at 1/4/X8	200,000	100,000	130,000	-	119,704	549,704
Total comprehensive income for the year				385,600	(1,482)	384,118
Dividends declared	-	-	-	-	(5,000)	(5,000)
Balance at 31/3/X9	200,000	100,000	130,000	385,600	113,222	928,822

Birch plc
Statement of financial position at 31 March 20X9

	£
Assets	
Non-current assets	
Property, plant and equipment (800,000 + 57,188 (W2))	857,188
Intangibles (W3)	7,700
	864,888
Current assets	
Inventories	7,570
Trade and other receivables (172,800 – 7,000)	165,800
Cash and cash equivalents	124

	£
	173,494
Non-current asset held for sale (W5)	15,940
	189,434
Total assets	1,054,322
Equity and liabilities	£
Equity	
Equity share capital	200,000
Preference share capital (irredeemable)	100,000
Share premium	130,000
Revaluation reserve	385,600
Retained earnings	113,222
	928,822
Current liabilities	
Trade and other payables	111,580
Taxation	6,100
Dividends payable	5,000
Borrowings	2,820
	125,500
Total equity and liabilities	1,054,322

Workings

(1) Allocation of expenses

	Cost of sales	*Administrative expenses*	*Distribution costs*
	£	£	£
Per trial balance			
Manufacturing – direct costs	269,120		
Manufacturing – overheads	107,340		
Wages and salaries (63,150 x 60%/40%)		37,890	25,260
Administrative / distribution		138,010	7,020
Movement on allowance for receivables (7,000 – 5,000)		2,000	
Opening inventories	9,120		
Product Y costs (W3)	16,800		
Amortisation of development costs (W3)	700		
Closing inventories	(7,570)		
Depreciation			
Buildings (14,400 x 80%/20%)	11,520	2,880	
Plant	33,572		
Impairment charge (W5)	2,060		
	442,662	180,780	32,280

(2) Property, plant and equipment

	Land and Buildings	*Plant and equipment*
	£	£
Cost b/f	1,120,000	182,860
Machine held for sale	-	(30,000)
Acc dep b/f	(691,200)	(74,100)
Eliminated on machine held for sale (W5)	-	12,000
Depreciation charges for year (W4)	(14,400)	(33,572)
	414,400	57,188
Revaluation of land and buildings	385,600	-
Balance c/f at 31 March 20X9	800,000	57,188

(3) Product Y development costs

	£
Per trial balance	25,200
Written off as cost of sales (6/9 x 25,200)	(16,800)
Capitalised	8,400
Amortisation (8,400 x 3/36)	(700)
Balance c/f at 31 March 20X9	7,700

Note – Development costs can only be capitalised once the 6 criteria specified in IAS 38 *Intangible Assets* have been met. They cannot be capitalised retrospectively. In this question the product becoming commercially viable indicates that the criteria have probably been met. Amortisation of capitalised development costs commences from the date at which the asset becomes available for use, in this case from when the sales of the system commence. (See Chapter 11 for further details of internally generated intangible assets.)

(4) Depreciation

	£
Buildings (720,000 ÷ 50)	14,400

	£
Plant held throughout year ((182,860 – 30,000) ÷ 5)	30,572
On plant held for sale (30,000 ÷ 5 x 6/12)	3,000
	33,572

(5) Machine held for sale

	£
Cost	30,000
Acc dep to 30 September 20X8 (30,000 ÷ 5 x 2)	(12,000)
Carrying amount at classification as held for sale	18,000
Fair value less costs to sell (16,000 – 60)	(15,940)
Impairment	2,060

Note – IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires assets meeting the criteria to be classified as "held for sale" to be valued at selling price less costs to sell. Any difference in the carrying amount and this value is accounted for as an impairment loss. The impairment loss, if significant, could be shown separately on the face of the statement of comprehensive income (instead of within cost of sales) per IAS 1 *Presentation of Financial Statements*. Birch plc may decide to do this on the grounds that without this the loss for the period would have been a profit.

Question 10

Hemmingway plc
Statement of cash flows for the year ended 30 June 20X4

		£	£
Cash flows from operating activities			
Cash flow generated from operating activities		21,732	
Interest paid		(535)	
Tax paid		(3,000)	
Net cash from operating activities			18,197
Cash flow from investing activities			
Purchase of plant and machinery		(10,900)	
Proceeds from sale of plant and machinery		1,200	
Purchase of investments	(7,500 - 6,000)	(1,500)	
Net cash used in investing activities			(11,200)
Cash flow from financing activities			
Repayment of debentures	(13,000 - 2,800)	(10,200)	
Dividends paid		(3,000)	
Net cash used in financing activities			(13,200)
Net decrease in cash and cash equivalents			(6,203)
Cash and cash equivalents at start of year			4,713
Cash and cash equivalents at end of year			£ (1,490)

Note to cash flow statement
Reconciliation of profit before tax to cash flows from operating activities

Profit before tax		10,518
Add back: Finance cost		535
Operating profit		11,053
Add back: Depreciation		9,900
Less: Profit on sale of non-current assets	(1,200 - 500)	(700)
Increase in inventory	(12,631 - 11,412)	(1,219)
Decrease in receivables and prepayments	(10,987 - 12,784)	1,797
Increase in payables and accruals	(10,713 - 9,812)	901
Cash flow generated from operating activities		21,732

Workings	£	£
Interest on debentures		
3 months interest on £13,000 3/12 x 10% x 13,000		325
9 months interest on £2,800 9/12 x 10% x 2,800		210
		535

Depreciation		
Land and buildings		
Accumulated depreciation at start of year		10,000
Accumulated depreciation at end of year		12,000
Depreciation for year		2,000
Plant and machinery		
Accumulated depreciation at start of year	12,600	
Less: acc. deprn. on disposals (4,000 - 500)	(3,500)	
	9,100	
Accumulated depreciation at end of year	17,000	
Depreciation for year		7,900
Total depreciation		9,900

Tax paid	
Normally the whole of 20X3 tax is paid in 20X4 together with part of the 20X4 tax	4,000
However note the 20X4 tax in the statement of profit or loss of £2,000 is **less** than the 20X4 tax liability of £3,000.	
Some of the 20X3 charge must still be owing at 30 June 20X4	(1,000)
Tax paid	3,000

Purchase of plant and machinery	
Cost at start of year	29,100
Less: Cost of assets disposed of	(4,000)
	25,100
Cost at end of year	36,000
Additions	10,900

Dividends paid	
Opening retained earnings	28,597
Add: profit for the year	8,518
	37,115
Closing retained earnings	34,115
Dividends paid during year	3,000

Question 11

The IASB's *Conceptual Framework* identifies the underpinning characteristics – the fundamental ones are relevance and faithful representation. Information must be both relevant and faithfully represented to be useful.

Relevance
Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources. Financial information can make a difference to decisions if it has:

- Predictive value – it can be used to predict future outcomes.
- Confirmatory value – it provides feedback about previous evaluations (it confirms whether past predictions were reasonable).

Information's relevance is affected by its nature and materiality (in other words its 'significance'). Information may become less relevant if there is undue delay in its reporting.

Faithful representation
If information is to be useful, it must represent faithfully the transactions and other events it purports to represent. A faithful representation will be:

- Complete – all information necessary for a user to understand the transactions or events being depicted is included.
- Neutral (unbiased)
- Free from error – free from error in the context of faithful representation does not mean the information is perfectly accurate in all respects. Instead it means there are no errors or omissions in the description of it and the process used to produce the reported information has been selected and applied with no errors in the process.

Enhancing qualitative characteristics
According to the *Conceptual Framework* information that is relevant and faithfully represented can be enhanced by the following 'enhancing' qualitative characteristics:

Comparability
Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information should be produced so that valid comparisons can be made with information from previous periods and with information produced by other entities (for example, the financial statements of similar companies operating in the same line of business).

Verifiability
Verifiability helps to assure users that information is a faithful representation of the transactions or events it purports to represent. If information is verifiable it essentially means that it can be proven, for example it may be able to be checked it is true by examination, inspection or comparison. The *Conceptual Framework* states that "verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation".

Timeliness
Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. As a general rule older information is less useful than recent information. However, note that some information may still be timely for a long time after the end of a reporting period. This is true of information for users of financial information who need to identify and assess trends.

Understandability
Information is understandable if it is classified, characterised and presented clearly and concisely. When considering whether information is understandable bear in mind that financial reports are prepared for users who have a reasonable knowledge of business and economic activities.

Estimates and judgements
These are inherent in financial reporting and financial information would not be relevant if it did not contain estimates or be based on judgements. The making of estimates and judgements is inherent in a "principles-based" financial reporting system as opposed to one which is more "rules-based". The professionalism and experience of preparers and auditors will help estimates and judgements to be good ones.

Estimates and judgements do not mean financial statements are unreliable, provided the above qualitative characteristics are considered as the estimate is made or the judgement is applied. In this extract, Vodafone plc points out the use of estimates and judgements could result in material adjustments to the financial statements should it be determined later that a different choice would have been more appropriate. So the estimate should be the best estimate that could be made under the particular circumstances.

Certain areas of financial reporting give rise to more estimates and judgements having to be made. These are the areas where the greatest risk of the figures being incorrect or materially misstated exist. In the light of increased transparency of financial information, Vodafone has identified these areas, and provides further discussion of the steps it has taken to mitigate the risks, and the audit report also makes reference to them and will explain the approach the auditors have taken to verify the figures.

A discussion follows of how the qualitative characteristics are considered when estimates are made and judgement used.

Completeness – in making an estimate, management needs to use as complete information about the item or transaction as possible.

Neutrality – the estimate should be unbiased and not influenced by the effect of it on the financial results. Any models used should be unbiased. Prudence has been reintroduced in the 2015 Exposure Draft of the IASB's *Conceptual Framework* specifically in the context of the making of estimates. Cautious prudence should be exercised to ensure that assets and income are not overestimated, and liabilities and expenses not underestimated. What this really means is that any estimates made should be realistic. This will still ensure their neutrality.

Free from error – means as accurate as possible. There should be no errors in calculations or in the use of models.
The use of complete information will help ensure that the estimate is unbiased and as accurate as possible.

Comparability – it may not always be possible to compare company to company as different companies use different accounting policies and use estimates and judgements applicable to their situation. It is easier within the same company, although how estimates are made and judgements made will evolve and change as they are compared to actual figures and data. Disclosures are important to assist comparability, and areas where significant estimates and judgements have been used are required to be discussed in accounting policies.

Verifiability – estimates by their nature are less verifiable; judgements possibly unverifiable. Data gathered to help make an estimate should be supported by hard information as far as information, and models used should be robust.

Timeliness – estimates may become more certain with the passing of time as they are confirmed by actual transactions and events. Judgement is required to assess how good an estimate is, or whether more information is required or data needs to be gathered to support the estimate. Disclosures of the estimate may change.

Understandability – the disclosures of where estimates and judgements have been used, and what they are based on in accounting policies and notes to the financial statements need to be understandable. If models have been used to make estimates these should be included if they assist with understanding. Sensitivity analyses using different estimates can help understand the financial effects of estimates.