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CPA
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Technical Level

Financial Accounting (FA1.1) WorkbooK

Institute of Certified Public Accountants of Rwanda

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Contents

Overview of the Module

CPA level	Technical level
Title	Financial Accounting
Guided learning hours	130
Exam length	3 hrs

Introduction to the Module

To develop knowledge and understanding of the underlying principles and concepts relating to financial accounting and technical proficiency in the use of double-entry accounting techniques including the preparation of basic financial statements for single entities and simple groups. The syllabus also introduces basic techniques of interpretation of financial statements.

The preparation of financial statements is the main focus of financial accounting. A key objective of financial statements is to communicate information to interested parties, to help them to make economic decisions. Financial accounting involves the following activities:

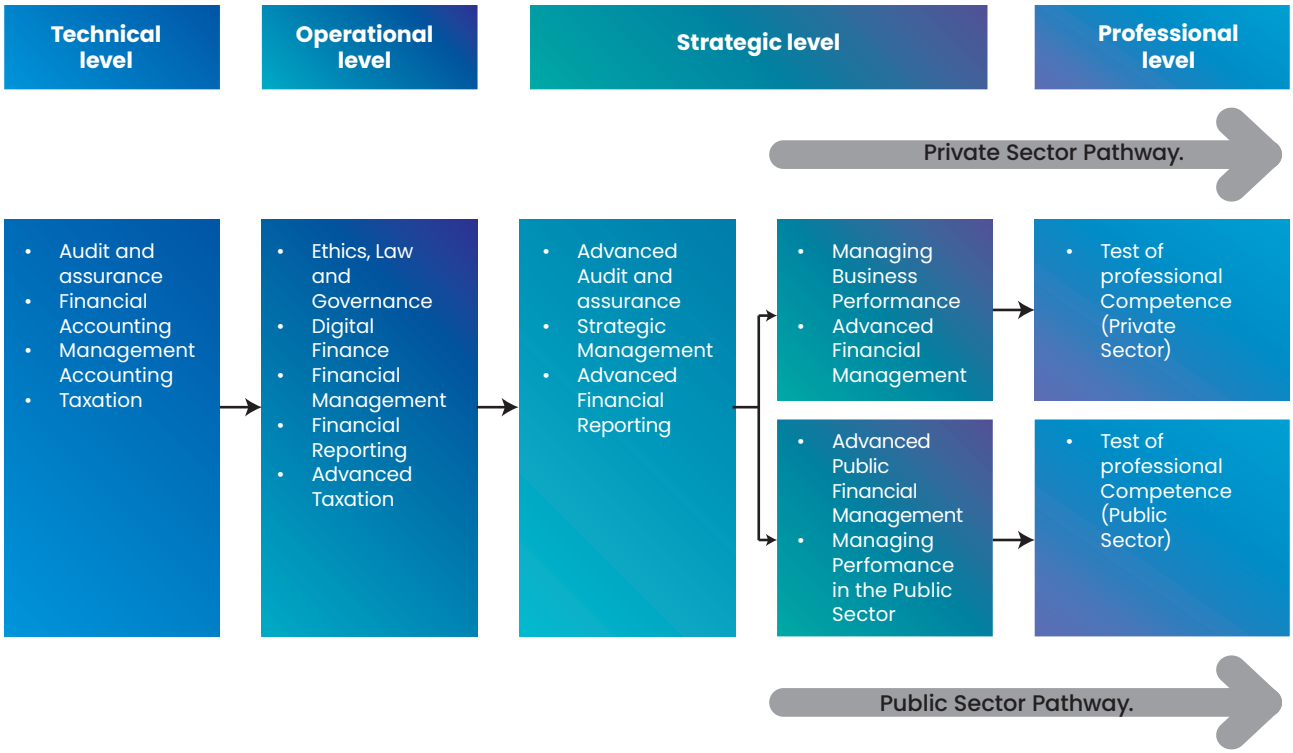
- **Recording –** recording business transactions as they occur
- **Classifying –** classifying the transactions into meaningful groups
- **Summarising –** summarising the groups of transactions into useful reports
- **Communicating –** communicating the information to interested parties.

As you progress through this module you will learn how to record, classify and summarise transactions for business and other organisations, and also how to produce financial statements from these records.

In the Financial Accounting module, you will also develop an understanding of how to analyse and interpret financial statements, including the use of ratios. This will include developing an ability to identify the financial situation for an organisation, in terms of profitability, liquidity, solvency, and use of resources.

Finally, the module will look at other aspects of an organisation that are relevant to financial accounting: ie the role of accounting in the organisation, the importance of internal control in its different forms, and how accounting systems in an organisation are developed, managed and utilised in the recording of financial transactions and other functions.

This module is one of four completed at the technical level of the CPA.



Key competencies

A. Demonstrate an understanding of the regulatory framework that underpins financial reporting.

B. Demonstrate an understanding of the key features of a published set of accounts.

C. Demonstrate an understanding of basic principles of consolidation.

D. Appreciate the analysis and interpretation of financial statements.

E. Draft statutory financial statements for a limited company.

F. Draft simple consolidated financial statements.

G. Interpret financial statements using ratio analysis.

H. Demonstrate an understanding of the role of accounting within the organisation.

I. Demonstrate an understanding of the importance and use of internal control systems.

J. Be able to identify and use the appropriate accounting system to meet specific organisational requirements.

Unit A: Regulatory Framework for Financial Reporting.

Learning outcomes

A.1. Explain the scope, elements and purpose, for different users, of preparing financial statements for external reporting.

A.2. Describe legislation and regulation which must be complied with in the preparation of the financial statements.

A.3. Explain the reasons for governance by legislation and regulation.

A.4. Explain the relevance of accounting standards.

A.5. Explain the duties and responsibilities of the directors or other responsible parties, of a corporate organisation.

Introduction to Unit A

As mentioned in the introduction to this module, the main focus of financial accounting is on the preparation of financial statements, and on the activities that support that process. Before looking at the specific processes involved in financial accounting, it is useful to consider the fundamental principles that underpin the financial statements, why statements are prepared, what they are intended to communicate, and other general aspects of the subject.

In this unit, we consider what is usually referred to as the 'regulatory framework'. This term refers to the range of documents and other influences on the way in which financial statements are prepared. These include the following:

Legislation and regulations	The most important item of legislation for companies is usually the Companies Act. Annual Finance Acts and other legislation on taxation, investment rules, etc, may also have specific impacts on financial statements.
Accounting concepts or principles	Some of these are specifically mentioned in documents such as the Conceptual Framework of the International Accounting Standards Board IASB, while others are part of Generally Accepted Accounting Principles (GAAP). These are discussed later in this Unit.

Accounting standards	These are key influences on financial statements, as they direct the overall format of statements, and they also deal with the treatment of specific transactions within the statements. The International Financial Reporting Standards (IFRSs) prepared by the IASB are an example of accounting standards, and some of these are covered in detail in this module. It should be noted that many countries develop and use their own national standards, but the use of IFRS is increasingly common.

Users of financial statements

There are a number of different groups who use the financial data that has been recorded, classified, summarised and communicated. These interested parties will have differing needs. We can identify several groups who would have an interest in the financial statements of a business:

Owners	Owners (ie shareholders in a limited company) are interested in knowing how well the business is performing, profit level, amount that may be withdrawn from the business.
Potential investors	Potential investor need to know about profit levels and forecasts of future returns on investment.
Lenders	Lenders require reassurance that interest and principal will be repaid
Managers	Managers at different levels of the organisation need information to make operational decisions, formulate plans, etc.
Employees	Employees are concerned about job security, career development, wages/salaries.
Customers	Customers wish to know whether the business will continue to operate, and goods and services will be received on time.
Suppliers	Suppliers need reassurance that business will continue to operate and amounts owing will be received on time.
Competitors	Competitors look for information to secure a strong position in the market.
Government agencies	Government agencies require tax information, statistical information, government policies on resource allocation.

Business analysts	Business analysts look for information relevant to advising their clients.
The general public	The general public have a wide range of interests including environmental issues, local economy factors.

The list includes both internal and external interested parties. Internal users may obtain the information they require from the accounts department or from internal management information systems.

Financial statements of some entities are publicly available so can be accessed by external parties. For example, companies that are registered on a stock exchange are required to provide a specified level of financial information on a regular basis.

The list above may be modified for other organisations. For example, users of the financial statements of a government department or agency would include Parliament, the electorate, charities, and other public sector bodies.

Elements of public sector financial statements

Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.

Statement of financial position	Assets Liabilities Equity
Statement of financial performance	Income Expenses

Assets	The definition of an asset is 'a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.'
Example - Inventory	The resource controlled by the entity is the item of inventory that the company owns and remains in its control until it is sold. The past event was the purchase of the inventory from a supplier. The future economic benefits are expected to flow to the entity is the future sale of the inventory, at which point the entity will receive cash from a customer.
Liabilities	The definition of 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.'

Example – Trade payables	The present obligation is the liability that the company has to pay its supplier's invoice. The past event was the point at which the company accepted the delivery of goods from its supplier. The outflow from the entity of resources embodying economic benefits is a rather complicated way of saying that the company will have to pay money to its supplier to settle its obligation.
Equity	The definition of equity is 'the residual interest in the assets of the entity after deducting all its liabilities.'
Income	The definition of income is 'increases in economic benefits during the accounting period in the form of inflows or enhancements of assets; or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.' The most common type of income is the inflow type referred to in the definition, such as sales revenue or bank interest earned which result in an inflow of cash to a company. Increases in income resulting from decreases in liabilities are rare.
Expenses	The definition of expenses is 'decreases in economic benefits during the accounting period in the form of outflows or depletions of assets; or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity participants.'
Examples	Examples of the outflow type of expense include rent paid. Depletions of assets includes the depreciation charge made in accordance with IAS 16. Expenses arising from increases in liabilities could include the recognition or increase of provisions in accordance with IAS 37.

Recognition of the elements of financial statements

Recognition is a term used to encapsulate the need or otherwise for an item to appear in a financial statement. It is defined as follows in the Conceptual Framework:

'The process of incorporating in the statement of financial position or statement of profit or loss an item that meets the definition of an element and satisfies both of the following criteria:

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

If we take the example of the purchase of inventory to explain this definition, we would recognise the transaction at the point at which we receive the delivery from our supplier because, at this point, we now have the right to sell the item, allowing us to receive a

future economic benefit, and we can measure the cost because we know how much the supplier will charge us for the items.

Measurement of the elements of financial statements

A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

Historical cost	Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation.
Realisable (settlement) value	Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.
Current cost	Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
Present value	Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Legislation and regulations

The financial statements of a company are directly impacted by the requirements of the applicable Companies Act (eg Companies Act 2018 in Rwanda, now superseded by the Law on Governing Companies 2021). One of the difficulties in preparing financial statements can arise from there being a range of different items of legislation that are relevant. A Companies Act is a useful method of ensuring that all (or, at least, most) of the relevant requirements are set out in a single document. Periodically, a new Companies Act may be required, which will incorporate all relevant legislation that has been enacted since the previous Companies Act.

The Companies Act includes a range of issues, such as registration of a company, legal status of companies, issue of shares, rights of shareholders, annual meetings, power of directors, audit requirements, etc.

The specific content on financial reporting within the Companies Act is not necessarily detailed, as the responsibility for this is given to the accounting profession, although the relative roles of legislation and the profession do vary from one country to another. The accounting profession's role is mainly achieved through the development and application of accounting standards and related activities.

The Law on Governing Companies, Rwanda, 2021 includes chapters on topics such as incorporation, shares and debentures, shareholder rights, management and administration (including accounting records, annual accounts, group accounts, audit), capital structure, types of company, registration, etc.

Relevant legislation sets out the legal duties of companies and their directors, shareholders, and others. It may also include content on sanctions and penalties for failing to exercise the duties set out in the legislation. The Companies Act, therefore, has a different status to measures such as accounting principles and accounting standards: it has the authority that is associated with any legislation, making it mandatory that all requirements are followed, and also carries the additional status in that failure to comply with it may result in penalties or sanctions.

It is important that issues such as the proper registration of companies, prompt filing of audited financial statements, proper administration of activities such as an Annual General Meeting (AGM) are carried out in full by all companies, and so having the force of legislation (and associated regulations) makes it much more likely that these are achieved.

Accounting standards do not have the force of legislation, although in some countries there may be legislation that makes reference to accounting standards and requires companies to comply with them.

Accounting standards

The International Accounting Standards Board (IASB) is the independent standard-setting body of the IFRS Foundation.

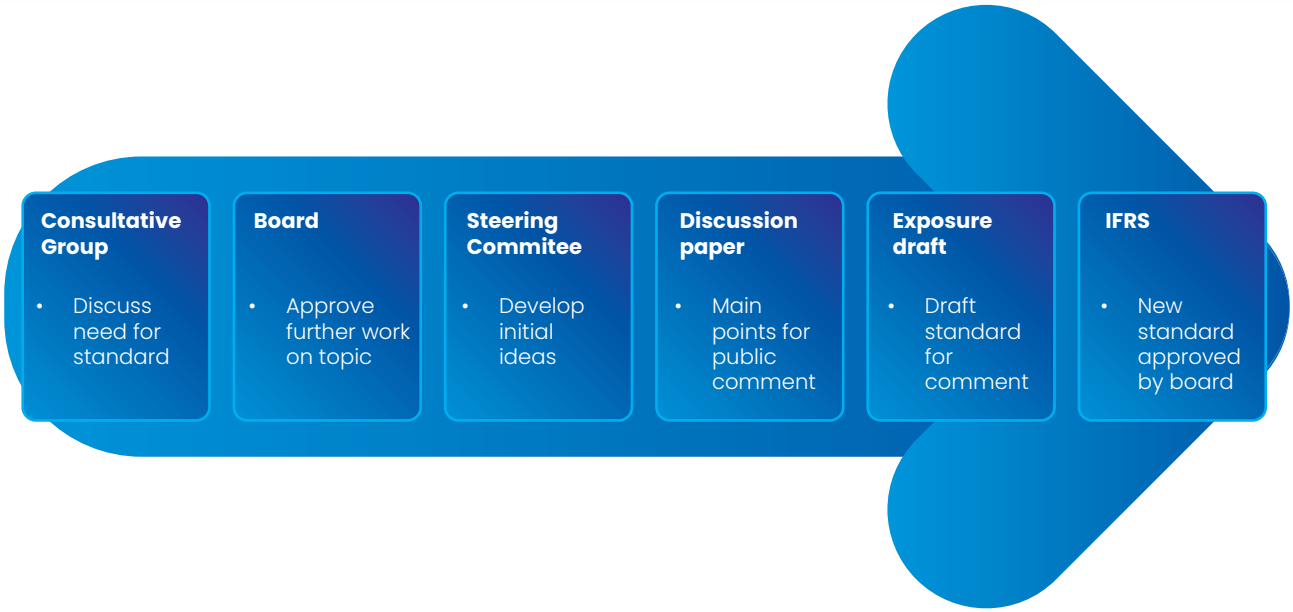
International Accounting Standards Board

The IASB members (currently 15 full-time members) are responsible for the development and publication of IFRSs. All meetings of the IASB are held in public and webcast. In fulfilling its standard-setting duties the IASB follows a thorough, open and transparent due diligence process of which the publication of consultative documents, such as discussion papers and exposure drafts, for public comment is an important component. The IASB engages closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters and the accountancy profession.

Prior to 2003, accounting standards were referred to as International Accounting Standards, or IASs. This has since changed and standards issued after 2003 are referred to as International Financial Reporting Standards, or IFRSs. The intent is that the IASs will be phased out and replaced by the newer IFRSs over time.

Accounting standards are documents that give guidance on how to prepare financial statements. There are many different accounting standards, each dealing with a separate area of the statements, e.g. inventories and intangible assets.

The process for setting IFRSs can be summarised as follows:



IASB objectives

- To develop, in the public interest, a single set of high-quality, understandable and enforceable global accounting standards. These require high-quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions.
- To promote the use and rigorous application of those standards.
- To bring about convergence of national accounting standards and International Financial Reporting Standards to high-quality solutions.

IFRS Advisory Council

The IFRS Advisory Council is the formal advisory body to the IASB and the Trustees of the IFRS Foundation. It consists of a wide range of representatives from groups that are affected by and interested in the IASB's work.

International Financial Reporting Interpretations Committee

The IFRS Interpretations Committee is the interpretive body of the IASB. The mandate of the Interpretations Committee is to review on a timely basis widespread accounting issues that have arisen within the context of current IFRSs and to provide authoritative guidance (IFRICs) on those issues.

Benefits of using international standards

- Consistency in accounting policies across the world, allowing easier comparison of financial statements across borders.
- Accountants can work in different countries and apply the same financial framework.
- Better quality information informing decisions across the world.
- The standards can be adopted or used as a template in developing companies, meaning costs are less and the process is easier.

Generally Accepted Accounting Practice (GAAP)

GAAP signifies all the rules which govern accounting, regardless of the source. The term 'Generally Accepted Accounting Practice' (GAAP) refers to the complete set of accounting regulations from all sources which apply in a given jurisdiction, together with any general accounting principles or conventions that are usually applied in that jurisdiction. GAAP therefore includes:

- accounting legislation
- accounting standards
- accounting concepts or conventions.

International Public Sector Accounting Standards

IPSAS are issued by the International Public Sector Accounting Standards Board (IPSASB). IPSASB focuses on the accounting and financial reporting needs of national, regional and local governments, related governmental agencies, and the constituencies they serve. IPSAS are generally based on IFRSs, but are adapted to the situation of the public sector.

IFRSs have been written with the needs of private sector companies in mind. Public and private sector organisations can have vastly different objectives, and so accounting standards aimed at companies, with their focus on generating profits and returns for shareholders, will often be inappropriate for the public sector. The underlying fundamental concepts are the same across all sectors, but the detailed requirements will need to be adapted for the public sector. IPSAS are therefore written either where the equivalent IFRS/IAS does not comprehensively/appropriately deal with a financial reporting issue or for which there is no related IFRS. For example, there is no IFRS dealing with revenue from non-exchange transactions (eg income from taxation), as private sector organisations rarely deal in non-exchange transactions, hence the rationale for issuing IPSAS 23 Revenue from Non-Exchange Transactions.

While national variations in accounting practices have endured for many years, more recently there has been pressure to harmonise financial reporting practice and regulation on a global basis in order to reduce inconsistencies.

IPSASB develops IPSASs to address public sector financial reporting issues in two different ways:

1. By addressing public sector financial reporting issues:
    - that have not been comprehensively or appropriately dealt with in existing International Financial Reporting Standards (IFRSs), or
    - for which there is no related IFRS; and
2. By developing IPSASs that are converged with IFRSs by adapting them to the public sector context, in line with a four-step process as follows:

Step 1: Are there public sector issues that warrant departure?

Step 2: Should a separate public sector project be initiated?

Step 3: Modify IASB documents

Step 4: Make IPSASB style and terminology changes to IASB documents

Exercise A1

Identify if the following statements are True or False:

a) The IASB has an objective to develop global accounting standards

b) The Companies Act is a summary of current accounting standards

c) One of the advantages of the use of IFRSs is that better quality financial information is provided

d) The IPSASB issues standards that largely based on IFRSs

Exercise A1 solution

Statement	Correct answer	Explanation/feedback
a) The IASB has an objective to develop global accounting standards	True	This is one of its three main objectives
b) The Companies Act is a summary of current accounting standards	False	A Companies Act deals with a wide range of topics, whereas accounting standards focus on specific accounting transactions and how they are treated in the financial statements
c) One of the advantages of the use of IFRSs is that better quality financial information is provided	True	IFRSs are prepared by experts in financial reporting from different countries, and are subject to rigorous consultation, which should result in standards that are of high quality.
d) The IPSASB issues standards that largely based on IFRSs	True	Most IPSASs are based on IFRSs, but are adapted for application in the public sector. There are also some IPSASs that have no IFRS equivalent, as the topic is not so relevant to the private sector

Duties of directors and other parties

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

The Law Governing Companies 07/2018 sets out several statutory duties of directors. Directors should:

- Keep accounting records
- Prepare annual accounts, have them audited, disclose them to the shareholders and deliver them to the Register General
- Act within their powers
- Promote the success of the company
- Exercise reasonable skill, care and diligence
- Act with loyalty to the company, which includes not using company assets for their own benefit, not competing against the company and not disclosing confidential information about the company
- Declare interest in a proposed transaction or arrangement
- Not enter into a contract knowingly that will result in the company becoming insolvent
- Disclose offices held on other companies' Board of Directors
- Act in a manner that does not unfairly prejudice or discriminate against existing shareholders
- Act in a manner that complies with the company's incorporation documents and the Law Governing Companies 07/2018

Law Governing Companies 07/2018

An overriding theme of the Law Governing Companies 07/2018 is the principle that the purpose of the legal framework surrounding companies should be to help companies do business. A director's main aim should be to create wealth for the shareholders. In essence, this principle means that the law should encourage a long-term view and regard for all stakeholders by directors and that stakeholder interests should be pursued in an enlightened and inclusive way.

When exercising this duty directors should consider:

- The consequences of decisions in the long term
- The interests of their employees
- The need to develop good relationships with customers and suppliers
- The impact of the company on the local community and the environment
- The desirability of maintaining high standards of business conduct and a good reputation
- The need to act fairly as between all members of the company

This list identifies areas of particular importance and modern-day expectations of responsible business behaviour, for example the interests of the company's employees and the impact of the company's operations on the community and the environment.

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

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

It is the directors' responsibility to ensure that the entity complies with the relevant laws and regulations. Directors should explain their responsibility for preparing accounts in the financial statements. They should also report that the business is a going concern, with supporting assumptions and qualifications as necessary. 'Going concern' refers to the expectation that the company is able to continue trading for the foreseeable future. Directors should present a balanced and understandable assessment of the company's position and prospects in the annual accounts and other reports, such as interim reports and reports to regulators. The directors should also explain the basis on which the company generates or preserves value and the strategy for delivering the company's longer-term objectives.

Companies over a certain size limit (revenue over FRW 400 million or if the company is categorised as a large tax payer) are subjected to an annual audit of their financial statements. An audit is an independent examination of the accounts to ensure that they comply with legal requirements and accounting standards. Note that the auditors are not responsible for preparing the financial statements. The findings of an audit are reported to the shareholders of the company. An audit gives the shareholders assurance that the accounts, which are the responsibility of the directors, fairly present the financial performance and position of the company. An audit therefore goes some way in helping the shareholders assess how well management have carried out their responsibility for stewardship of the company's assets.

Different types of public and private sector organisations

As we work through this module, the focus will mainly be on limited companies and their accounting requirements, but it is also useful to compare this with the arrangements other organisations, such as public sector organisations, non-profit organisations and partnerships. A summary of key aspects of the activities, structure, legal form and environment of different types of organisation is provided below, and this will be added to for the organisations that are the focus of financial statements preparation in later study units within this module.

Organisation	Activities/objectives	Legal form
Sole trader	Small commercial business with a single owner who also runs the business. Typically used in businesses such as tradesmen, small retail operations.	No distinction between owner and business, so owner is liable for all debts of the business.

Organisation	Activities/objectives	Legal form
Partnership	Often used in professional businesses, with two or more partners each contributing capital into the business, running the business and sharing profits/losses.	Partnership needs to be established under terms of partnership legislation and have a partnership agreement detailing issues such as the share of profits. Partners are each jointly and severally liable for the debts of the business.
Limited company	Full range of commercial activities, from a small business to a multinational company.	Owners (shareholders) are separate from the running of the business, which is conducted through directors. Legal basis is according to requirements of specific legislation.
Public sector organisation	Functions usually specified in legislation	Various forms, such as government departments, executive agencies, public commercial organisations, local authorities, etc. Form and legal status specified in legislation.
Non-profit organisations (eg clubs and societies, charities)	Non-profit organisations that operate for the purpose set up by its members. This typically covers activities such as sports or cultural interests.	To benefit from things like reclaiming tax on membership subscriptions, the club or society may need to be registered with an official body (eg as a registered charity that can be recognised by the tax authority).

Roles of accountant, auditor, and financial manager

The role of the accounting professional in society is varied and constantly changing. The profession aims to contribute to the global economy by providing relevant and reliable information to economic decision makers and promoting high standards of regulation, governance and ethics, across the public and private sector.

Accountants work across many entities, private and public, large and small. Many people rely on accountants to help them make decisions in their day-to-day lives, whether at work or in their private life. It is therefore crucial that accountants maintain professionalism when carrying out their duties, ensuring that they provide a reliable, honest and useful service.

Accountants have formed professional bodies for over a hundred years. These professional bodies aim to enforce high standards of performance and ethics in their members, providing reassurance to the public when using accountancy services.

Many of these professional bodies have formed partnerships and alliances across countries. For example, the International Federation of Accountants (IFAC) is the global organisation for the accountancy profession.

In Africa, The Pan African Federation of Accountants (PAFA) is an international body with more than 50 full members from across the continent of Africa. Its overall aims are as follows:

- Building effective professional accountancy organisations
- Advancing technical excellence
- Enhancing the quality and mobility of accountancy service

In pursuit of these aims, PAFA serves as a a forum for co-operation and assistance among African professional accountancy organisations for the further advancement of the status of the accountancy profession. It also provides encouragement assistance in the formation and development of national professional accountancy organisations in Africa.

PAFA also engages in the development and enhancement of the accountancy profession in the African continent through participation in the development and the dissemination of the standards, guidelines and other pronouncements of the International Accounting Standards Board (IASB) and the independent standard-setting boards under the auspices of the International Federation of Accountants (IFAC) and the establishment and implementation of appropriate strategies and work programmes.

Private sector accountancy firms might engage in a number of activities and provide different services to clients. Services that might be included are:

- Financial accounting
- Management accounting
- Financial management
- Auditing
- Taxation
- Consultancy
- Insolvency

Financial accounting

Financial accounting focuses mainly on producing financial statements for external use. In this module, a lot of our attention will be on the format of these statements, their content, and the process for preparing them. Financial accounting also encompasses the systems used to record and organise the information needed to prepare the financial statements, as well as the interpretation of the information within them.

Financial accounting focuses on:

- Financial information for external users – financial statements are primarily used by interested parties outside the organisation itself.
- Financial information that must be produced as dictated by law or regulation.
- Historic information – financial statements look backwards in time, usually over a period of one year.

Management accounting

There are several differences between financial and management accounting, and the main one is that the latter focuses mainly on internal reporting rather than external

reporting. The users of management accounting information are therefore more likely to be internal users (managers, directors, etc) rather than external users (government, suppliers, lenders, etc). In order to make operational decisions to run the business effectively, managers will need detailed information on budgets and costs. Management accounting focuses on:

- Tailored reporting as required by the decision makers of the organisation.
- Forecasting information – for example a financial plan for the next three years.
- Financial information that is not required by law or regulation.

Financial management

Financial management involves the planning, directing, monitoring, organising, and controlling of the monetary resources of an organisation. A financial manager needs to identify what monetary resources an organisation requires, secure those resources and manage them in the most efficient way.

Audit

Audit is broadly divided into internal and external audit:

- Internal audit activities, such as value for money audits, will identify where there are weaknesses in business systems and processes and how these may be improved.
- External audit focuses on the reliability of the financial statements, looking at financial systems and the statements themselves to ensure they are presented fairly.

Summary of Unit A and key learning outcomes

In Unit A, we looked at the Competency 'To demonstrate an understanding of the regulatory framework that underpins financial reporting'. This involved content on five learning outcomes.

Learning outcome	
Explain the scope, elements and purpose, for different users, of preparing financial statements for external reporting.	You should be able to list different users of financial reports, and explain their different needs. You should also be able to explain the different elements of financial statements, and how these are recognised and measured.
Describe legislation and regulation which must be complied with in the preparation of the financial statements.	You should be able to describe the need for legislation that impacts on financial reporting, including Companies Acts.

Explain the reasons for governance by legislation and regulation.	You should be able to describe how governance arrangements are applied in an organisation, and how these impact on financial reporting.
Explain the relevance of accounting standards.	You should be able to describe the role of the IASB and the process of issuing IFRSs, and also describe the role of the IPSASB and the process of issuing IPSASs.
Explain the duties and responsibilities of the directors or other responsible parties, of a corporate organisation.	You should be able to describe the main legal responsibilities of directors in a limited company, and how these differ from the role of shareholders, auditors, management and others

Quiz questions

1	Learning Outcome: A1
Which of the following users of the financial accounting information of a limited company would be particularly interested in knowing about the ability of the company to repay loans?	
A	General public
B	Lenders
C	Government agencies
D	Competitors

1	Feedback
A	General public may have a wide range of interests, but are not specifically interested in the ability of a company to pay back loans Lenders have a vested interest in knowing whether the company can pay back loans
B	Correct - Lenders have a vested interest in knowing whether the company can pay back loans
C	Government agencies are more interested in issues such as the tax payable on profits, compliance with regulations, etc Lenders have a vested interest in knowing whether the company can pay back loans
D	Competitors may be interested in the company's future activities, rather than past performance Lenders have a vested interest in knowing whether the company can pay back loans

2	Learning Outcome: A5
Which of the following statements refers to an activity that is related to financial accounting rather than management accounting?	
A	Preparing financial statements for a wide range of users
B	Preparing forecast information on cash requirements
C	Providing information for pricing decisions
D	Providing information that is mainly focused on future activity

2	Feedback
A	Correct. This is a central part of financial accounting activities
B	Forecasts are part of the work of management accounting Preparing financial statements for a wide range of users is a financial accounting activity
C	Pricing decisions are part of the work of management accounting Preparing financial statements for a wide range of users is a financial accounting activity
D	Financial accounting is more focused on past activity, not future activity Preparing financial statements for a wide range of users is a financial accounting activity

3	Learning Outcome: A5
Which of the following is the full name of the organisation known as PAFA?	
A	Premier Association for Finance in Africa
B	Professional Association of Financial Accountants
C	Pan African Federation of Accountants
D	Professional Forum for African Accountants

3	Feedback
A	PAFA stands for Pan African Federation of Accountants

B	PAFA stands for Pan African Federation of Accountants
C	Correct
D	PAFA stands for Pan African Federation of Accountants

4	Learning Outcome: A5
Which body has a mandate 'to review on a timely basis widespread accounting issues that have arisen within the context of current IFRSs and to provide authoritative guidance on those issues'	
A	International Public Sector Accountancy Standards Board (IPSASB)
B	International Accounting Standards Board (IASB)
C	International Financial Reporting Standards Advisory Council
D	International Financial Reporting Standards Interpretations Committee (IFRIC)

4	Feedback
A	IPSASB's role is in issuing standards for use in the public sector. The correct answer is International Financial Reporting Standards Interpretations Committee (IFRIC).
B	IASB's role is in issuing standards for use in the private sector. The correct answer is International Financial Reporting Standards Interpretations Committee (IFRIC).
C	The Advisory Council's role is in providing advice to IASB. The correct answer is International Financial Reporting Standards Interpretations Committee (IFRIC).
D	Correct

5	Learning Outcome: A5
Which of the following are the owners of a limited company?	
A	Directors
B	Management
C	Shareholders
D	Lenders

5	Feedback
A	Directors have specific responsibilities in relation to financial management, etc, but are not owners of the company. Ordinary shareholders are owners of the company.
B	Management are employees with specific responsibility in relation to their roles, but are not owners of the company. Ordinary shareholders are owners of the company.
C	Correct. Ordinary shareholders are owners of the company.
D	Lenders have a legal right to be have loans repaid, but this does not give them ownership of the company. Ordinary shareholders are owners of the company.

Unit A Exercises

Exercise A2

Identify 5 users of financial statements of a limited company and explain, for each, why they may rely on information from the financial statements.

Exercise A2 solution

The following are some important users of financial reports, but you may have included others in your answer:

User	Type of information
Shareholders	Shareholders of the company, or the company's owners, assess how well management is performing. They want to know how profitable the company's operations are and the profit they can afford to withdraw from the business for their own use.
Managers	Managers are appointed by the company's owners to supervise the day-to-day activities. They need information about the company's financial situation as it is currently and as it is expected to be in the future. This is to enable them to manage the business efficiently and to make effective decisions.
Clients, customers	Customers may rely on the provision of goods and services, and therefore will review the company's financial statements to ensure that they are a going concern and will continue to provide the goods/ service needed.
Lenders	Providers of finance to the company might include a bank, which allows the company to operate an overdraft or provides longer-term finance by granting a loan. The bank wants to ensure that the company can keep up interest payments and repay the amounts advanced.
Suppliers	Suppliers want to know about the company's ability to pay its debts. Customers need to know that the company is a secure source of supply and is in no danger of closing down.
Employees	Employees should have a right to information about the company's financial situation because their future careers and the size of their wages and salaries depend on it.
Tax authorities	The taxation authorities want to know about business profits to assess the tax payable by the company, including sales taxes.

The public	Companies affect the public in a variety of ways. For example, companies may make a substantial contribution to a local economy by providing employment and using local suppliers. A company may also have an effect on the environment, for example pollution.

Exercise A3

Referring to the definitions of the elements of financial statements given earlier in this unit, provide one or two examples of each of the following elements.

- Assets
- Liabilities
- Equity
- Income
- Expenses

Exercise A3 solution

Assets	Assets may be divided into current and non-current assets, as we will see in more detail in later units. Examples of current assets are: • Receivables (ie amounts owed to the organisations) • Inventory • Bank balances • Cash Examples of non-current assets are: • Property – land and buildings • Plant, equipment, machinery • Intangible assets • Investments

Exercise A3 solution	
Liabilities	Liabilities may also be divided into current and non-current. Examples of current liabilities are: • Payables (ie amounts owed by the organisation to suppliers and others) • Bank overdraft • Short-term loans Examples of non-current liabilities are: • Loans • Provisions • Leases • Debentures
Equity	For the purpose of this module, the main type of equity we will consider is ordinary shares. Other items that may come into this category are preference shares, and reserves (such as retained earnings).
Income	Income for a company is usually from sales to customers. It may also include items such as grants, depending on the nature of the grant.
Expenses	You could include a long list of potential expenses. These include: • Rent • Insurance • Depreciation • Wages and salaries • Transport • Carriage costs • Materials
Note	Some items may fall into more than one category, depending on the circumstances – eg lease liabilities may be split into current and non-current elements. When we look at specific IFRSs, we will deal with more examples of items where classification is more complex than shown in this table.

Unit B: Key features of a published set of accounts.

Learning outcomes

B1. Describe the key components and the purpose of a statement of financial position (balance sheet).

B2. Describe the key components and the purpose of a statement of comprehensive income.

B3. Describe the key components and the purpose of a statement of cash flows (statement of cash flows).

B4. Explain the content and purpose of disclosure notes to the accounts.

B5. Identify accounting standards and the effect of these on the preparation of the financial statements.

B6. Explain the main differences between the public sector and private sector and the implications for financial accounting and reporting.

Introduction to Unit B

In this unit our focus will be on the format, content, and process of preparation of financial statements. We will focus in this unit on the key financial statements that are required for a limited company. These are set out in the standard IAS 1 Presentation of Financial Statements, ie:

- Statement of financial position
- Statement of comprehensive income (also known as statement of profit or loss, or statement of profit or loss)
- Statement of cash flows

We will also look briefly at another statement required by IAS 1, the statement of changes in equity.

One of the things that you will learn throughout this module is the importance of notes to the accounts. We use the term 'disclosure' to refer to all the specific items of information that a standard requires to be included in the financial statements; this term covers both the figures in the actual statements (sometimes referred to as 'the face of the statement'), and additional information that is set out in the accompanying notes to the statements.

Preparing a full set of financial statements for a limited company requires the application of a range of accounting standards, and in this unit we refer to IFRS as the relevant framework of standards. There are many standards in the IFRS framework, and it

is not practical to include complex financial statements in the examples in this unit; so the focus is on the format of each statement, the process of preparing these, and some simple content. Once you are more familiar with the requirements of these IFRSs, we can work through more detailed examples of statements in Unit E later in this module.

As mentioned above, the focus of this unit is on the financial statements of a private sector company. The final section of this unit contrasts this with at the way in which financial statements for a public sector organization are prepared, and the form and content of their statements.

Note that, as the exam for Financial Accounting consists of multiple-choice questions, you are not required to prepare the full statements in the exam. However, some longer examples are included in this unit, and later units, so that you can see how individual transactions and adjustments are applied in the process of preparing the statements as a whole.

IAS 1 Presentation of financial statements

Each IAS or IFRS includes a statement at the beginning of its text on the key objective or objectives of that standard. The stated objective of IAS 1 *Presentation of Financial Statements* is:

> 'To provide guidance on the presentation, structure and content of general-purpose financial statements and to ensure users are able to compare organisations over time and with other organisations.'

IAS 1 applies to all financial statements prepared in accordance with International Financial Reporting Standards (IFRSs). The standard was revised for reporting periods starting on or after 1st January 2009, with minor amendments being made subsequently.

Purpose of financial statements

The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an organisation that is useful to a wide range of users in making economic decisions. Financial statements also show the result of stewardship of the organisation's resources.

According to IAS 1, financial statements must provide information on an organisation's:

- Assets
- Liabilities
- Equity
- Income
- Expenses
- Contributions by owners and distributions to owners
- Cash flows

Underlying assumptions

There are a number of assumptions set out in IAS 1, which underpin the preparation and presentation of financial statements:

Fair presentation (see below for details)	An organisation is required to 'present fairly' its financial statements. This means that transactions will be represented faithfully and in accordance with the definitions set out in the IASB Framework for the preparation and presentation of financial statements. The application of IFRSs is presumed to result in fair presentation.
Going concern	This concept was discussed in Unit A of this module. IAS 1 requires that financial statements should be prepared on a going concern basis; i.e. that the organisation will continue trading for the foreseeable future. If the going concern assumption does not apply, for example, there is an intention to liquidate the organisation or cease trading; then the details should be disclosed.
Accruals basis of accounting	An organisation is required to apply the accruals basis when preparing its financial statements (except for the statement of cash flows). This means that transactions are recognised when they satisfy the definitions and criteria contained in the IASB Framework. This also means that transactions may be recognised in the financial statements at a different time to when the cash receipt or payment takes place.
Materiality and aggregation	Items which are material need to be shown separately in the financial statements. Amounts which are not material may be added together and the subtotal can be shown.
Offsetting	Assets and liabilities, and income and expenses, should not be offset unless it is permitted by a particular standard. This is so that users are able to understand transactions and make economic decisions.
Frequency of reporting	Financial statements should be prepared at least annually. Any change to the reporting period should be disclosed giving reasons for the change.
Comparative information	For all amounts reported in the financial statements the organisation needs to disclose comparative information for the previous period.
Consistency of presentation	Transactions should be treated in the same way from one period to the next unless: a significant change in the organisation's operations has resulted in a more appropriate presentation; or an IFRS requires a change in presentation.

Reporting period

Limited companies and other organisations normally prepare and publish their financial statements on an annual basis, and IAS 1 states that they should be prepared at least as often as this. If (unusually) an organisation's accounting date is changed, for whatever reason, the period for which the statements are presented will be less or more than one year.

In such cases the organisation should also disclose:

- The reason(s) why a period other than one year is used; and
- The fact that the comparative figures given are not in fact comparable (in particular for the statement of financial position, statement of profit or loss, statement of cash flows, and related notes).

Note that limited companies that are listed on a stock exchange are usually required to prepare and publish interim financial statements more frequently. These interim statements may be less detailed than the full annual financial statements, but they must still be prepared on the same basis as the annual accounts.

Timeliness

IAS 1 states that accounts should be prepared at least annually. If the publication of financial statements is delayed too long after the accounting date, their usefulness will be severely diminished. An organisation with consistently complex operations cannot use this as a reason for its failure to report on a timely basis.

Fair presentation

IAS 1 states what is required for the financial statements to be presented fairly, or to comply with the fair presentation principle:

- Selection and application of accounting policies.
- Presentation of information in a manner which provides relevant, reliable, comparable and understandable information.
- Additional disclosures where required.
- Most importantly, financial statements should present fairly the financial position, financial performance and cash flows of an entity.
- Compliance with IFRSs is presumed to result in financial statements that achieve a fair presentation
- The following points made by IAS 1 expand on this principle
- Compliance with IFRSs should be disclosed.
- All relevant IFRSs must be followed if compliance with IFRS is disclosed.
- Use of an inappropriate accounting treatment cannot be rectified either by disclosure of accounting policies or notes or explanatory material.

Extreme case disclosures

In rare occasions, management may conclude that compliance with a requirement in a standard or interpretation may be so misleading that it would conflict with the objectives of the Conceptual Framework for Financial Reporting. The Conceptual Framework is the document that sets out the principles that underpin all the IFRSs and related documents that are prepared and published by the IASB. In such cases the entity needs to reduce the misleading aspects of compliance by disclosing:

- The standard's title, its nature and the reason why compliance with the standard has resulted in misleading information.
- For each period, the adjustment to each item that would be necessary to achieve fair presentation.

Components of financial statements

IAS 1 requires limited companies to prepare the following statements and related information:

- Statement of financial position
- Statement of profit or loss (or 'Statement of comprehensive income' where a section on 'other comprehensive income' is added)
- Statement of cash flows
- Statement of changes in equity
- Accounting policies and notes to the accounts
- Comparative information for the previous period

Note that other reports prepared by an organisation and included in its annual report are not part of the financial statements. For example, a management review of performance, environmental reports or value-added reports.

IAS 1 gives substantial guidance on the form and content of published financial statements, guidance on the minimum information to be included in the financial statements, and examples of formats for reporting (although these are not prescribed for use).

Other disclosures

IAS 1 also requires disclosure of the following information in a prominent position. These may seem trivial or obvious points of detail, but they are nevertheless crucial if the financial statements are to be meaningful. For example, it is essential that a user can identify which financial reporting period a financial statement refers to, hence the need for the reporting date or period.

- Name of the reporting organisation
- Whether the accounts cover the single organisation only or a group of organisations
- The reporting date or the period covered by the financial statements as appropriate
- The reporting currency

- The level of precision used in presenting the figures in the financial statements (figures in thousands or millions M, for example)

Statement of financial position

IAS 1 does not prescribe a format for the statement of financial position. Therefore, it would be acceptable to present the statement of financial position in different formats, eg:

- assets less liabilities = equity

OR

- assets = equity plus liabilities.

Current and non-current

IAS 1 distinguishes between current and non-current assets and liabilities. Whether an asset should be treated as current or non-current depends on the operating cycle of the organisation. Operating cycle is 'the time between the acquisition of assets for processing and their realisation in cash or cash equivalents'.

An asset should be classified as a current asset in the following circumstances:

- The asset is expected to be realised in, or is held for sale or consumption in, the normal course of the entity's operating cycle.
- The asset is held primarily for trading purposes or for the short term and expected to be realised within 12 months of the reporting date.
- The asset is cash or cash equivalent asset that is not restricted in its use.

Examples of current assets include inventories, trade receivables and marketable securities that are expected to be realised within 12 months or in the course of the normal operating cycle of the business.

All other assets should be classified as non-current assets.

A liability should be classified as a current liability when it:

- is expected to be settled in the normal course of the entity's operating cycle; or
- is due to be settled within 12 months of the reporting date; or
- the organisation does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date.

All other liabilities should be classified as non-current liabilities.

Although IAS 1 makes the distinction between current and non-current assets and liabilities, it does not absolutely prescribe that organisations need to split assets and liabilities into current and non-current. Organisations can instead present them in order of liquidity. However, it does state that this split would need to be done if the nature of the business indicates that it is appropriate. In almost all cases it would be appropriate to split items into current and non-current, and this approach is adopted in this module.

The operating cycle

IAS 1 emphasises how helpful information on the operating cycle is to users of financial statements. Where there is a clearly defined operating cycle within which the entity supplies goods or services, then information disclosing those net assets that are continuously circulating as working capital is useful.

This distinguishes them from those net assets used in the long-term operations of the entity. Assets that are expected to be realised and liabilities that are due for settlement within the operating cycle are therefore highlighted.

Share capital and reserves

For issued share capital and reserves, IAS 1 requires the following disclosures:

- Number of shares authorised, issued and fully paid, and issued but not fully paid
- Par value
- Reconciliation of shares outstanding at the beginning and the end of the period
- Descriptions of rights, preferences and restrictions
- Shares in the entity held by the entity, including shares held by subsidiaries and associates
- Shares reserved for issuance under options and contracts
- A description of the nature and purpose of each reserve within equity.

Statement of profit or loss

The statement recognises all items of income and expense unless an accounting standard requires otherwise.

IAS 1 lists the following as the **minimum** to be disclosed on the face of the statement of profit or loss:

- Revenue
- Finance costs
- Share of the profit or loss of associates and joint ventures accounted for using the equity method.
- Tax expense
- A single amount for the total of discontinued operations
- Profit or loss

The standard also requires the preparation of a section for 'other comprehensive income'. The content of other comprehensive income includes:

- Each component of other comprehensive income classified by nature.
- Share of the other comprehensive income of associates and joint ventures accounted for using the equity method.
- Total comprehensive income.

All figures in the statement of profit or loss are to be stated in gross terms; ie income and expenditure items should not be netted off against each other. The only situations where income and expense items can be offset are:

- When this is permitted or required by an IAS/IFRS, or
- When gains, losses and related expenses arising from the same or similar transactions and events are immaterial, in which case they can be aggregated.

An analysis of expenses must be shown either on the face of the statement of profit or loss or by note. Expenses may be classified according to the nature of the expenses or by their function:

> The nature method groups expenses according to their nature, ie the type of expense. For example, depreciation, purchases of materials, employee benefits, transport costs.

> The function method groups expenses according to their function, ie what the expense is used for. For example, cost of sales, distribution costs, administrative expenses.

The organisation should choose the method that is both reliable and most relevant. If the function method is used, further disclosure of information is required, for example, depreciation, amortisation, and employee benefit expenses.

An illustrative example of the statement of profit or loss suitable for publication is shown below. We will then look at how the different types of income and expenses are categorised, and we will also provide an explanation of how the statement of profit or loss is linked to the statement of changes in equity and the statement of financial position.

Statement of profit or loss for the year ended 31 December 20x5	**FRW 000**
(i) Revenue	1,148
(ii) Cost of sales	(647)
Gross profit	**501**
Other income	0
(iii) Distribution costs	(129)
(iv) Administrative expenses	(120)
(v) Other operating income	10

(vi) Other operating expenses	
Profit from operating activities	**257**
(vii) Investment income	8
(viii) Finance costs	(2)
Profit before tax	**263**
(ix) Income tax expense	(72)
Profit/(loss) for the year	**191**

Each line in the statement is explained in the table below:

Revenue	**Revenue is income arising in the ordinary course of an enterprise's business.**
Cost of sales	'Cost of sales' refers to the direct costs attributable to the production of the goods sold by a company. Expenditure classified under cost of sales will include direct costs (inventory, purchases, and production costs), overheads and depreciation.
Distribution costs	These are costs incurred after the production of the finished goods and up to and including transfer of the goods to the customers. Distribution costs may include transport costs, selling and advertising costs and warehousing costs.
Administrative expenses	These are all those operating costs that have not been classified as either cost of sales or distribution costs. Bad debts and changes in the allowance for receivables should be included as part of the administrative expenses. Different enterprises may classify costs differently and the choice of classification will affect gross profit. This can make inter-firm comparisons difficult.

Other operating income Other operating expenses	To make sound economic decisions, investors need to be able to identify income and expenses that are likely to be incurred in the future. IAS 1 therefore requires that certain income/expenses be separately disclosed. These are items within the ordinary activities of the enterprise which are of such size, nature or incidence that their separate disclosure is required in the financial statements in order for the financial statements to give a fair presentation. Other income items include: • Government grant amortisation • Negative goodwill • Revaluation surplus of investment properties • Examples of other operating expenses can include: • Write-down of assets (impairment loss) • Revaluation deficits of investment properties
Investment income	This will include bank interest receivable and any income from current and non-current asset investments (e.g. dividends).
Finance costs	These include bank interest payable, loan interest payable and finance charges on finance leases.
Tax expense	This will be tax payable on the profit for the period, allowing for any adjustment for over (under) provision on the previous year and deferred taxes.
Profit/(loss) for the year	This is the profit or loss after all income and expenses have been taken into account

The following is an example of the calculation of operating costs, which shows clearly the classification of the various costs. The total must agree to the figures posted to the statement of profit or loss. This is a key working, and it is recommended that students familiarise themselves with this working at an early stage of their studies. Note that the items shown below are an example only and will depend on the specifics of the question.

	Cost of sales	**Distribution. costs**	**Administrative expenses**
Opening inventory	X		
Purchases	X		
Closing inventory	(X)		
Distribution costs (TB)		X	
Production costs	X		

Administrative expenses (TB)			X
Depreciation	X	X	X
Profit/loss on disposal	X	X	X
Total	**XX**	**XX**	**XX**

Statement of changes in equity

The statement of changes in equity (SCE) shows how the components of the shareholders' stake in the company (i.e. equity) have changed during the financial period. The statement of changes in equity shows the opening balance, the movement during the year, and the closing balance. The components include share capital, share premium, and retained earnings, as well as the revaluation reserve.

As with the previous statements, IAS 1 does not prescribe a format but provides an illustrative structure for the statement. The statement of changes in equity acts as a working for the equity section of the statement of financial position. The closing balances in the statement of changes in equity, once calculated, can be transferred directly to the equity part of the statement of financial position.

The following example shows the components of statement of changes in equity, and the table below explains the entries.

Statement of changes in equity for the year ended 31 December 2015

(FRW 000)	Share capital	Share premium	Retained earnings	Revaluation reserve	Total equity
(i) Balance at beginning of year	100	250	1,250	480	2,080
(ii) Retrospective adjustment	0	0	0	0	0
(iii) Restated balance (= i + ii)	100	250	1,250	480	2,080
(iv) Share issues	0	0			0
(v) Dividends payable			(50)		(50)
(vi) Total comprehensive income for the year (from SCI)			211	25	236
(vii) Balance at end of year (= iii + iv + v + vi)	100	250	1,411	505	2,266

Balance at beginning of year	The balance at the beginning of year can normally be extracted from a trial balance. Occasionally, closing balances are shown in the trial balance and movements during the year have already been posted to the ledger. Read the question in exercises carefully as you need to be able to move forward from opening balances to closing balances, as well as work backwards from closing balances to opening balances.
Retrospective adjustment	Retrospective adjustments are very specific adjustments, and these are not covered in detail in this module.
Restated balance	The restated balance is equal to opening balance + /- retrospective adjustment.
Share issues	The issue of shares will impact the share capital account, and possibly the share premium account as well.
Dividends payable	Dividends payable include ordinary and preference dividends paid and payable. In some situations, we may treat preference shares as non-current liabilities because the preference shares are redeemable. If this is the case, then preference dividends payable will be included within finance costs in the statement of profit or loss rather than in statement of changes in equity. Note that dividends can only be paid out of retained earnings.
Total comprehensive income for the year	No calculations are required - the figures are transferred directly from the statement of profit or loss. FRW 211,000 is equal to profit/(loss) for the year and FRW 25,000 equals total other comprehensive income - lines (xi) and (xv) in our statement of profit or loss example above. The total of FRW 236,000 must equal the total comprehensive income for the year – line (xvi).
Balance at end of year	This is equal to opening balance plus or minus the movements in the year. The balance for each component is transferred to the relevant line in the equity section of the statement of financial position.

Purpose of the statement of changes in equity

The statement of changes in equity collects in one statement all the recognised changes in equity over the year. It emphasises that there are significant types of gains and losses which are not reported in the statement of profit or loss, but which are carried directly to reserves. It encourages shareholders not to take a narrow view of how their wealth has changed in the year (focussing solely on profit after tax). It shows share issues in the year. This is useful to shareholders as it signals potential dilution of their voting rights. It shows profits for the year and dividends paid during the year. This gives insight into dividend cover, hence the risk attaching to dividends.

Statement of cash flows

The form and content of the statement of cash flows is prescribed by the standard IAS 7 *Statement of Cash Flows,* and so reference will be made to that standard in discussing the statement.

One question is why the statement of cash flows is needed when the other two statements provide information on an accruals basis on income, expenditure, assets, liabilities and capital. The statement of profit or loss shows whether or not we made profit, but it does not tell the user if the business has enough money to pay its employees, its creditors, the tax authority, etc. The statement of profit or loss is not an indicator of solvency – a very profitable business may go bankrupt if it does not have sufficient cash to keep the business operating.

The statement of financial position provides limited information on solvency, but it only gives the cash and bank balances at a particular date and therefore does not provide a full picture of cash transactions in the period. Comparative figures in the current and previous statements of financial position show the user the opening and closing cash balances, but this is still of limited use and may in fact be misleading

The statement of cash flows gives information about the changes in cash during the reporting period and classifies cash flows arising from operating, investing and financing activities. It is intended to provide a clear, comprehensive and understandable picture of the cash transactions in the financial period. It summarises under the three headings (operating, investing, financing cash flows) all the cash inflows and all the cash outflows.

There is a generally held view that accruals accounting is superior to cash accounting for external financial reporting as it provides more reliable and comparable information for users to base their decisions on. However, there are limitations to the accrual-based statements, and we should not lose sight of the importance of cash in a business. Before looking at the preparation of a full statement of cash flows, it may be helpful to look at an example of two businesses with similar statement of profit or loss and consider how a statement of cash flows can help to identify additional crucial information for the user.

	Quick Ltd		**Slow Ltd**	
		FRW 000		**FRW 000**
Income:				
Cash sales		10,000		2,000
Credit sales (note 1)		**Nil**		**8,000**
		10,000		**10,000**
Open inventory	Nil		Nil	
Cash purchases	6,000		9,000	
Closing inventory	**(1,000)**		**(4,000)**	

Cost of sales		**(5,000)**		**(5,000)**
Gross profit		5,000		5,000
Less expenses:				
Depreciation	1,500		1,500	
Rent (note 2)	500		500	
Other expenses	**500**		**500**	
		(2,500)		**(2,500)**
Net profit		**2,500**		**2,500**

Note 1 – FRW 2,000,000 of Slow Ltd's credit sales were unpaid at the end of the period.

Note 2 – all Quick Ltd rent was paid in cash, but half of the Slow Ltd rent has been accrued.

Most of the key figures in the statements are quite similar, so it appears at first glance that the companies' performance is comparable. For example, revenue is FRW 10,000,000, gross profit FRW 5,000,000 and net profit FRW 2,500,000 for both companies; so in terms of profitability, the performances are similar. However, we have enough information to determine how the cash/bank balance has been affected by these transactions. Assuming the balances are zero at the beginning of the period, the T-accounts would look like this:

Quick Ltd – cash/bank

Sales	10,000	Rent	500
		Other	500
		Purchases	6,000
		Balance	*3,000*
	10,000		**10,000**

Slow Ltd – cash/bank

Sales	2,000	Rent	250
Receivables	6,000	Other	500
		Purchases	9,000
Balance	*1,750*		
	9,750		**9,750**

Of course, there will be other transactions during the period (for things like purchasing non-current assets or issuing shares). The point here is that the statement of profit or loss, because if focuses on profitability and is accruals based, does not give information on the cash position. It is clear from the T-accounts that the cash position for Quick Ltd is much better than for Slow Ltd (which in fact has an overdraft). Users of accounts, such as lenders or suppliers, do not have access to detailed T-accounts; so to provide them with useful information on the companies' cash positions we need an additional statement to supplement the statement of profit or loss and the statement of financial position. This is the gap that the statement of cash flows is intended to fill.

Format of statement of cash flows

It is crucial that you become familiar with the structure of the statement of cash flows. As mentioned above, the statement of cash flows is divided into three main sections; these each focus on operating cash flows, investing cash flows and financing cash flows. Each of these terms is defined in IAS 7, and you need to be able to determine which section each cash flow transaction needs to be included within as you prepare information that is to be included in a statement of cash flows.

Operating activities

Operating cash flows are the primary revenue-earning activities of the business. These will include cash flows relating to activities for production, sales, services, etc. The standard defines operating activities as 'the principal revenue producing activities and other activities that are not investing or financing activities'. The volume of cash flows arising from operating activities is a key indicator of the organization's effectiveness in generating sufficient cash to repay loans, maintain the entity's operating capability, pay dividends, and make new investments without recourse to external sources of financing.

Examples of operating cash flows include:

- Cash receipts from the sale of goods/services
- Cash payments to suppliers
- Payments to and on behalf of employees
- Payments of income taxes

Investing activities

IAS 7 defines Investing activities as 'the acquisition and disposal of non-current assets and other investments not included in cash equivalents'. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Investing activities include the following:

- Cash payments to acquire land, building, equipment
- Cash receipts from the sale of land, building, equipment
- Cash payments to other enterprises (loan, investment)
- Cash receipts from other enterprises (loan repayments, sale of investment

Financing activities

Financing activities are defined by IAS 7 as 'the activities that result in changes in the size and composition of the equity capital and borrowings'. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the organization.

Financing activities include the following:

- Proceeds from issuing shares
- Payments to acquire the company's own shares
- Cash proceeds from loans raised
- Cash repayments of loans
- Payments to reduce a lease liability

Cash and cash equivalents

The sum of the three sections listed above will equal the net increase or decrease in cash and cash equivalents for the period.

Cash equivalents	'Short-term, highly liquid investments that are readily converted to known amounts of cash, and which are subject to insignificant risk of changes in value'. IAS 7

Non-cash transactions

Non-cash transactions are **not** included in the statement of cash flows. These include the acquisition of fixed assets by long-term credits or finance leases; settlement of accounts payable by non-cash means, such as issuing and transferring additional shares to the creditors; depreciation charges; or transfers between one non-cash item and another.

As examples, a company may acquire land and buildings by borrowing under a long-term mortgage, or it can convert long-term bonds into ordinary shares. These transactions present rather common investing and financing activities, but they are not reflected in the statement of cash flows because they do not involve any increase or decrease in the company's cash or cash equivalents.

Direct and indirect methods

IAS 7 allows either of two methods to be used for deriving the net cash in/out flow from operating activities: ie the direct method or the indirect method. It is only the operating activities part of the statement of cash flows that is different depending on whether the direct or indirect method is used.

Direct method

With the direct method, the main operating cash flows into and out of the organisation are detailed as follows:

Cash flows from operating activities:	FRW
Cash received from customers	X
Cash payments to suppliers	(X)
Cash payments to and on behalf of employees	(X)
Cash generated from operations	XXX

When the indirect method is used, the cash generated from operations is calculated by adjusting the profit figure (before taxation) in the statement of profit or loss. The profit or loss figure is based on accruals accounting, and therefore needs to be adjusted in order to become a cash figure in the statement of cash flows. This is one of the tricky elements of preparing a statement of cash flows and therefore needs careful attention when tackling questions.

In this module, we will focus on the procedures involved in preparing a statement of cash flows using the indirect method only, but it is important for you to be aware that there is an alternative approach that is allowed by the standard.

Cash flows from operating activities - indirect method

The following is a typical presentation for the first part of the statement of cash flows, showing the main adjustments required to derive 'net cash from operations'. Remember, the profit figure is based on accruals transactions and adjustments, so these need to be reversed in order to derive a figure that represents the cash movement only in the period.

Cash flows from operating activities	FRW	
Profit before tax	XX	(accruals figure)
Adjust for:		
Depreciation	XX	
Loss (profit) on sale of property, plant and equipment	XX/(XX)	
Investment income (as in statement of profit or loss)	(XX)	
Interest payable (as in statement of profit or loss)	XX	
Movements in working capital		
(Increase) Decrease in inventories	(XX)/XX	
(Increase) Decrease in trade receivables	(XX)/XX	
(Increase) Decrease in prepayments	(XX)/XX	
Increase (Decrease) in trade payables	XX/(XX)	

Increase (Decrease) in accruals	XX/(XX)	
Cash generated from operations	XX/(XX)	
Less Interest paid	(XX)	
Less Tax paid	(XX)	
Net cash flow from operating activities	XX/(XX)	(cash figure)

The indirect method begins with the profit before tax figure from the statement of profit or loss. This is an accruals figure, not a cash flow, so we need to make some adjustments to it. It also includes transactions that the standard requires separate disclosure for (ie tax and interest).

Note that most of these adjustments can be either a plus or a minus figure, and it is very important that you consider which way round each entry should be. In a statement of cash flows, outflows are normally shown as negative figures, ie in brackets. The explanation as to when an item should be positive or negative in the statement can be summarised for the main items as follows:

- Depreciation is not a cash expense, but is deducted in arriving at the profit figure in the statement of profit or loss. It therefore needs to be eliminated in the statement of cash flows by adding it back to profit.
- By the same logic, a loss on disposal of a non-current asset needs to be added back. A profit on disposal, in contrast, needs to be deducted in the statement of cash flows.
- An increase in inventories means that the company has less cash, as it must have used cash to buy inventory. A decrease in inventory means that cash is kept in the business, so it is added back to the profit figure.
- An increase in receivables means that the company's customers have not paid as much as previously, so there is therefore less cash coming into the business. Conversely, a decrease in receivables indicates that customers are paying more quickly, so more cash is coming into the business.
- If the business makes a payment to a creditor, this results in cash going out of the business. So a decrease in the level of payables should be deducted in the statement of cash flows, whereas an increase in payables should be added.

Cash flows from investing activities

The second section of the statement contains the cash flows from investing activities. This includes acquisition and disposal of non-current assets and other investments not included in cash equivalents, as well as interest received, and dividends received.

The content of the investing activities section of the statement is as follows:

Cash flows from investing activities:	**FRW**
Purchase of non-current assets	(XX)
Proceeds on the sale of non-current assets	XX
Interest received	XX
Dividends received	XX
Net cash flow from investing activities	(XX)/XX

Cash flows from financing activities

The third section of the statement contains the cash flows from financing activities. This includes activities that result in changes in the size and composition of the equity capital and borrowings. Dividends paid are also normally shown here.

The content of this section of the statement is as follows:

Cash flow from financing activities	**FRW**
Issue of new capital	XX
Redemption of capital	(XX)
Raising of loans	XX
Redemption of loans	(XX)
Dividends paid	(XX)
Net cash flow from financing activities	(XX)/XX

Net increase/(decrease) in cash and cash equivalents

The total of the cash flows determined in the operating, investing and financing sections will be either a net increase or decrease in cash and cash equivalents for the period. This figure can be reconciled to the opening and closing cash and cash equivalents figures from the statement of financial position.

The final part of the statement is shown below:

	FRW
Net increase in cash and cash equivalents	(XX)/XX
Cash and cash equivalents at start	(XX)/XX
Cash and cash equivalents at end	(XX)/XX

Notes to the financial statements

According to IAS 1, the notes to the financial statements will amplify the information given in the statement of financial position, statement of profit or loss and statement of changes in equity. To some extent, the contents of the notes will be determined by the level of detail shown on the face of the statements. For example, we saw above that companies may choose to show the details of their operating expenses on the face of the statement of profit or loss or in a note.

The notes to the financial statements should:

- Give information about the basis of preparation and the specific accounting policies used
- Disclose information required by IFRSs that is not shown elsewhere in the statements
- Show any other relevant information

The organisation should also disclose in the notes:

- The amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the related amount per share; and
- The amount of any cumulative preference dividends not recognised.
- Other information required, if not shown elsewhere in the accounts are:
- Domicile, legal form, country of incorporation, address of registered office;
- Description of the organisation's operations and principal activities.

Disclosure of accounting policies

To be clear and understandable it is essential that financial statements should disclose the accounting policies used in their preparation. This is because policies may vary, not only from entity to entity, but also from country to country. The accounting policies section should describe the measurement bases used in preparing the statements and the other accounting policies used that are relevant to the users' understanding. This information may be shown in the notes or sometimes as a separate component of the financial statements. As an aid to users, all the major accounting policies used should be disclosed in the same place.

The information on measurement bases used is obviously fundamental to an understanding of the financial statements. Where more than one basis is used, it should be stated to which assets or liabilities each basis has been applied. For example, some companies will hold their land and buildings at current value but hold their plant and machinery at cost. The accounting policies note would need to disclose the different measurement bases used for different types of non-current assets in order that the users of the accounts understand what underlies the total property, plant and equipment balance in the accounts.

There is a wide range of policies available in many accounting areas. Examples where such differing policies exist are as follows, although the list is not exhaustive and it contains some items which you will not be familiar with yet, but will be covered later in this module.

General	overall valuation policy (for example historical cost, general purchasing power, replacement value) events after the reporting period leases, hire purchase or instalment transactions and related interest taxes construction contracts franchises
Assets	receivables inventories and related cost of goods sold depreciable assets and depreciation research and development patents and trademarks goodwill
Liabilities and provisions	warranties commitments and contingencies pension costs and retirement plans severance and redundancy payments
Profits and losses	methods of revenue recognition maintenance, repairs and improvements gains and losses on disposals of property

Accounting Standards

We have already introduced the main requirements of IAS 1 Presentation of financial statements in this unit, and we have already made some passing references to other standards, such as IAS 16 Property, plant and equipment. When it comes to preparing full financial statements for a company, you will need to have knowledge of the main requirements of these and for a number of other standards.

In this unit, we will focus on summarising the key point of the following standards, and these are then discussed in more detail, together with more complex practical examples, in Unit E

(Note – in Unit C, we will consider the accounting requirements of the main standards relating to consolidated financial statements, and deal with more complex examples of these in Unit F.)

Standard	Accounting requirements
IAS 1 Presentation of financial statements	Financial statements and other requirements: • Statement of financial position • Statement of profit or loss, or statement of comprehensive income • Statement of cash flows • Statement of changes in equity • Accounting policies and notes to the accounts • Comparative information for the previous period IAS 1 gives substantial guidance on the form and content of published financial statements, guidance on the minimum information to be included in the financial statements, and examples of formats for reporting.
IAS 2 Inventories	Inventories are assets that meet one or more of the following conditions: • Are held for sale in the ordinary course of business • Are in the process of production for such sale • Are in the form of materials or supplies to be consumed in the production process or in the rendering of services. Measurement: • Inventories should be measured at the lower of cost and net realisable value Cost of inventory: • Costs of purchase + Costs of conversion + Other costs incurred in bringing the inventories to their present location and condition.
IAS 7 Statement of cash flows	This standard provides further guidance on the form and content of the statement of cash flows, which we have already summarised above in the context of the requirements of IAS 1.
IAS 10 Events after the reporting period	Events after the reporting period are those events, favourable and unfavourable, that occur between the reporting date and the date when the financial statements are authorised for issue. Adjusting events: • Events that provide evidence of conditions that existed at the reporting date Non-adjusting events: • Events that are indicative of conditions that arose after the reporting date

Standard	Accounting requirements
IAS 16 Property, plant and equipment	This standard provides the accounting treatment requirements in relation to non-current assets that are tangible (ie have a physical substance). Coverage includes: • Measurement at cost or at revalued amount • Depreciation • Impairment • Additions • Disposals (through sale, write-off, etc) The accounting treatment for each aspect of PPE is covered in detail in Unit E
IAS 37 Provisions, contingent liabilities, and contingent assets	Provisions: • A provision is a liability of uncertain timing or amount IAS 37 states that a provision should be recognised as a liability in the financial statements when all three of the following criteria have been met: • An entity has a present obligation as a result of a past event • It is probable that an outflow of economic benefits will be required to settle the obligation • A reliable estimate can be made of the obligation. Accounting treatment: Debit Expense Credit Liability – current or non-current Contingent liabilities: A contingent liability arises in one of the following situations: • A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events that are not wholly within the control of the entity

Standard	Accounting requirements

	• A present obligation that arises from past events but is not recognised because:
	  • It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or
	  • The amount of the obligation cannot be measured with sufficient reliability.
	Note that the distinction between a provision and a continent liability includes this point about the contingent liability meeting some but not all of the three criteria for recognising a provision discussed above.
	Accounting treatment:
	• Contingent liabilities should not be recognised in the financial statements, but may require disclosure in the notes.

	Contingent asset: • A contingent asset is a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. • A contingent asset must **not** be recognised in the financial statements.

Standard	Accounting requirements
IAS 38 Intangible assets	An intangible asset is an identifiable non-monetary asset without physical substance. Research expenditure: • Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. • Research expenditure must be treated as an expense, not a non-current asset Development costs • Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production. • Development costs is capitalised and shown as an intangible asset. • Development costs are amortised (similar to depreciation) over the useful life of the asset. IAS 38 also defines goodwill, which we will discuss in the context of group accounts in Unit F
IFRS 15 Revenue from contracts with customers	IFRS 15 is concerned with reporting the nature, amount, timing and uncertainty of revenue and cash flows resulting from contracts with customers. Revenue from contracts with customers arises from fairly common transactions, ie: • The sale of goods • The rendering of services Generally, revenue is recognised when the entity has transferred control of goods and services to the buyer. Control of an asset is described in the standard as 'the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset' (IFRS 15).

Public sector organisations

Public sector organisations have different characteristics to private sector organisations, and this has an impact on their funding, relationships with other organisations and their financial and non- financial objectives.

Public sector organisations often have externally set financial objectives and targets (eg a local authority may have objectives that are set by central government), and this influences the format and presentation of their financial statements. Additionally, the use of public funds requires public sector organisations to demonstrate financial accountability, both as individual organisations, and as larger groups of organisations. This allows users of the accounts to assess the stewardship of the organisation.

Accounting standards have been developed specifically for public sector organisations. These are called International Public Sector Accounting Standards (IPSAS). We will explain how these standards are developed and applied in practice, and the impact they have on the financial statements.

Objectives of public sector organisations

Public and private sector organisations have different objectives and therefore the financial statements will report different things and be used in different ways by the users of the accounts. The overriding emphasis in the financial statements of the public sector is often to demonstrate how and where money has been spent, not how profit has been generated. This can lead to the matching of income and expenditure to specific areas of activity. This may be important when the organisation has a mix of duties; either providing both statutory and non-statutory services or acting as both a commissioner and provider of services.

Public sector organisations also have a duty to demonstrate that funds have been spent wisely. This leads to value for money reporting that ties up the financial and non-financial aspects of performance.

Users of both public and private sector financial statements will be interested in whether an organisation is financially viable. The ways in which this will be demonstrated will be assessed in different ways though. In the public sector non-recurring items of income and expenditure, such as profits or losses on the sale of non-current assets, are often disclosed on the face of the income statement (or equivalent) rather than included as part of the organisation's expenses.

Some items included in private sector financial statements will often not be included in public sector ones as they are not relevant. For example, public sector financial statements do not usually include a charge for taxation as public sector organisations do not usually have to pay taxation on their income or surpluses.

Sourcing of funding

Public sector organisations nearly all receive money in some form which is derived from taxation. Sometimes this may be direct, such as a local authority charging a property-based tax to local residents. Most funding from taxation is more indirect – income and capital taxes will be collected by a central tax authority and then distributed to public sector organisations.

Sources of funding in the public sector are shown in the table below. Note that not all public sector organisations have access to all sources of finance; for example, laws and regulations may prohibit some organisations from having loans or finance leases.

Source of funding	Key points
Taxation	Taxation of individuals and businesses will be collected by government and redistributed to public sector organisations.
Grants	Grants are amounts received from government bodies. This includes grants from other parts of government in the same country (e.g. local authority receives a grant to build a new road from the national government's transport authority), or may be from outside the country (e.g. grants received from the World Bank).
Commissioning agreements	Commissioning agreements involve a public sector organisation performing services and being paid according to the services provided. For example, in the UK and many other countries, state owned hospitals earn most of their revenue through commissioning agreements, meaning that they earn income according to the amount of operations and treatments carried out.
Fees, charges, fines	Examples are: • Rent charged to housing tenants • Refuse collection fees charged to businesses • Fees for private treatments provided by a hospital • Fines for motor or other offences
Commercial income	Some public sector organisations carry out commercial activities and receive income from them in the same way as a private sector company. For example, a university will earn commercial income from any restaurants, cafes and bookshops that it owns and runs.
Donations	This is less common in the public sector than the charitable sector. Organisations that may receive donations include universities (e.g. legacies from alumni) and museums. Donations may be in the form of assets rather than cash, such as if an art collector bequeaths their art collection to a national museum.

Capital receipts	Capital receipts are the proceeds from the sale of capital items (i.e. non-current assets). Many public sector organisations restrict the use of capital receipts to ensure that they are reinvested in new capital acquisitions as opposed to being used to fund the day-to-day operating expenses of the organisations.
Loans or finance leases	Public sector organisations may borrow money or use finance leases to finance non-current assets or sometimes use short-term borrowing to manage day-to-day cash flow. There are restrictions on borrowing in many parts of the public sector.
Shares	More typical as capital funding for a private sector company, but some public sector organisations may be established in the form of a limited company.
Partnerships with private sector	A public sector organisation may enter into an agreement with a private sector partner resulting in funding of a project by that partner.
Investment income	This includes interest and dividends earned on money invested. Note that some government organisations may have their funds held in a central treasury account rather than a commercial bank account, and hence receive no investment income.

Impact on financial reporting

The variety of sources of income may result in the following features of financial reporting in the public services:

A focus on the source of income (as opposed to the private sector, where the statement of financial performance would show revenue only). For example, a municipal authority's statement of financial performance will need to show amounts raised through direct taxation, fees and charges etc. so that users of the accounts can see how its operations have been funded.
A need to match income to expenditure to ensure that funds received for specific purposes have been applied correctly. For example, if a university has a fundraising campaign to restore its old library, it will need to show how the funds raised have been spent on this purpose and not just used to fund the university's regular day-to-day expenditure.

Income generated from fees and charges may need to be separately accounted for to illustrate that fee charging services have contributed (or not) to non-fee charging services. For example, a municipal authority which rents out houses to low-income families may be required to show the overall surplus or deficit generated on housing operations in order to determine the extent to which other activities need to cross subsidise their housing activities.
Grants and donations may have special terms attached to them which require separate reporting, including demonstrating the outcomes achieved through the funding.

The objectives of public sector organisations contribute directly to the way in which financial performance is reported. For example, some parts of the public sector report any profit or loss on non-current assets separately from their operating income and expenditure so that any operating surplus or deficit will reflect the organisation's performance in relation to its operating activities only.

The overriding principle in reporting financial performance in public sector organisations is that:

> ***The reporting organisation needs to demonstrate that public funds have been spent on the purposes intended and that resources have not been wasted.***

Unlike the private sector, where revenue is generated from sales, the public in general cannot opt out of paying taxes. This heightens the need for organisations to demonstrate that they have also spent their money wisely. Therefore, in addition to the objectives of the public sector in shaping financial reporting requirements, the financing source also plays a part in defining how financial performance is reported. In other words, has the money which, ultimately, the taxpayer has provided been spent wisely and on the purpose intended?

Many public sector organisations are subject to some element of financial objectives and financial targets. They may be required to break even, or to generate a certain return on amounts invested in them. Their performance against their targets will be reported in the financial statements.

Summary of Unit B and key learning outcomes

In Unit B, we looked at the Competency 'To demonstrate an understanding of the key features of a published set of accounts'. This involved content on six learning outcomes.

Learning outcome	
Describe the key components and the purpose of a statement of financial position (balance sheet).	You should now be able to describe the overall format of the statement of financial position, and define the main elements of the statement.

Describe the key components and the purpose of a statement of comprehensive income.	You should now be able to describe the overall format of the statement of profit or loss, and define the main elements of the statement.
Describe the key components and the purpose of a statement of cash flows (statement of cash flows).	You should now be able to describe the overall format of the statement of cash flows, and identify transactions that are presented in each of the three sections of the statement.
Explain the content and purpose of disclosure notes to the accounts.	You should now be able to summarise the requirements of IAS 1 in respect of the use of notes to the financial statements.
Identify accounting standards and the effect of these on the preparation of the financial statements.	You should now be able to describe the main accounting requirements of key IFRSs. This will be developed further in Units E and F.
Explain the main differences between the public sector and private sector and the implications for financial accounting and reporting.	You should now be able to describe the differences between the public and private sectors, their objectives, and the differences in financial reporting.

Quiz questions

1	Learning Outcome: B1
Which of the following financial statements would provide a user with information on a limited company's current liabilities at the end of the financial year?	
A	Statement of cash flows
B	Statement of profit or loss
C	Statement of changes in equity
D	Statement of financial position

1	Feedback
A	The statement of cash flows only includes items that are cash inflows or cash outflows, so liabilities are not relevant. The statement of financial position would provide a user with information on a limited company's current liabilities at the end of the financial year
B	The statement of profit or loss includes income and expenses, but not liabilities. The statement of financial position would provide a user with information on a limited company's current liabilities at the end of the financial year
C	The statement of changes in equity presents analysis of the company's capital and reserves, but does not include liabilities. The statement of financial position would provide a user with information on a limited company's current liabilities at the end of the financial year
D	**Correct**

2	Learning Outcome: B1
Which of the following is a current asset?	
A	Raw materials for use in production of goods for resale
B	Office equipment
C	Bank loan

D	Bank overdraft

2	Feedback
A	**Correct**
B	**Incorrect** Office equipment is an asset, but as it is of use over more than one financial reporting period, this would normally be classified as a non-current asset Raw materials for use in production of goods for resale is a current asset
C	**Incorrect** A bank loan is a liability, not an asset Raw materials for use in production of goods for resale is a current asset
D	**Incorrect** A bank loan is a current liability, not a current asset Raw materials for use in production of goods for resale is a current asset

3	Learning Outcome: B3
A limited company is preparing its cash flow statement for the year to 31 December 20X3, using the indirect method. Opening receivables were FRW 85,600 and closing receivables were FRW 93,450. When preparing the cash flow from operating activities, what is the required adjustment to net profit before taxation for the change in trade receivables in the period?	
A	Add FRW 7,850
B	Add FRW 85,600
C	Deduct FRW 93,450
D	Deduct FRW 7,850

4	Learning Outcome: B1
Which of the following items is defined by the Conceptual Framework as 'the residual interest in the assets of the entity after deducting all its liabilities'	

4	Learning Outcome: B1
A	Assets
B	Equity
C	Income
D	Profit

4	Feedback
A	Incorrect This is the definition of equity
B	**Correct**
C	**Incorrect** This is the definition of equity
D	**Incorrect** This is the definition of equity

5	Learning Outcome: B1
Which of the following is **not** part of shareholders' equity in a limited company?	
A	Share premium
B	Retained earnings
C	Reserves
D	Debentures

5	Feedback
A	**Incorrect** Share premium is part of shareholders' equity Debentures are usually classified as long-term liabilities

B	**Incorrect** Retained earnings is part of shareholders' equity Debentures are usually classified as long-term liabilities
C	**Incorrect** Reserves are part of shareholders' equity Debentures are usually classified as long-term liabilities
D	**Correct.** Debentures are usually classified as long-term liabilities

6	Learning Outcome: B3
Which of the following is a cash flow that would be shown under 'investing activities' in the cash flow statement of a limited company according to IAS 7?	
A	Proceeds from the sale of land
B	Depreciation charge on buildings
C	Loss on the disposal of property, plant and equipment
D	Payments for the redemption of long-term loans

6	Feedback
A	**Correct**
B	**Incorrect** Depreciation charge on buildings is not a cash flow, but is shown as an adjustment to profit before tax in the operating activities section Proceeds from the sale of land would be shown under investing activities
C	**Incorrect** Loss on the disposal of property, plant and equipment is not a cash flow, but is shown as an adjustment to profit before tax in the operating activities section Proceeds from the sale of land would be shown under investing activities

D	**Incorrect** Payments for the redemption of long-term loans is shown in the financing activities section Proceeds from the sale of land would be shown under investing activities

7	Learning Outcome: B1
Which of the following is defined by the Conceptual Framework as 'present economic resources controlled by the entity as a result of past events'	
A	Income
B	Assets
C	Capital
D	Profits

7	Feedback
A	**Incorrect** This is a definition of assets
B	**Correct**
C	**Incorrect** This is a definition of assets
D	**Incorrect** This is a definition of assets

8	Learning Outcome: B1

A company has the following balances at the end of the year:

Raw materials	FRW 15 million
Finished goods	FRW 27 million
Trade receivables	FRW 41 million
Trade creditors	FRW 8 million
Vehicles	FRW 18 million
Cash	FRW 39 million

What is the value of the company's current assets at the end of the year?

A	FRW 107 million
B	FRW 122 million
C	FRW 148 million
D	FRW 140 million

8	Feedback
A	Incorrect 15 + 27 + 41 + 39 = 122
B	Correct 15 + 27 + 41 + 39 = 122
C	Incorrect 15 + 27 + 41 + 39 = 122
D	Incorrect 15 + 27 + 41 + 39 = 122

9	Learning Outcome: B1

Which of the following is the correct formula for the calculation of retained earnings carried forward for a limited company?

A	Retained earnings carried forward = retained earnings brought forward + profit after tax - dividends paid

B	Retained earnings carried forward = retained earnings brought forward - profit after tax - dividends paid
C	Retained earnings carried forward = retained earnings brought forward + profit after tax + dividends paid
D	Retained earnings carried forward = retained earnings brought forward - profit after tax + dividends paid

9	Feedback
A	**Correct**
B	**Incorrect** Retained earnings carried forward = retained earnings brought forward + profit after tax - dividends paid
C	**Incorrect** Retained earnings carried forward = retained earnings brought forward + profit after tax - dividends paid
D	**Incorrect** Retained earnings carried forward = retained earnings brought forward + profit after tax - dividends paid

10	Learning Outcome: B4
Which of the following statements is true for a company that presents financial statements that comply with IFRS?	
A	The company is encouraged to include notes to the financial statements in order to provide more detailed information, but this is optional.
B	Notes are only required for the statement of financial position, not for other financial statements
C	IAS 1 requires the company to include notes in order to disclose information required by IFRSs that is not shown elsewhere in the statements
D	Notes are prepared by the external auditors.

10	Feedback
A	**Incorrect** Notes are not optional. IAS 1 requires the company to include notes in order to disclose information required by IFRSs that is not shown elsewhere in the statements.
B	**Incorrect** Notes are required for all financial statements. IAS 1 requires the company to include notes in order to disclose information required by IFRSs that is not shown elsewhere in the statements.
C	**Correct**
D	**Incorrect** The financial statements, including the notes, are the responsibility of directors and management. IAS 1 requires the company to include notes in order to disclose information required by IFRSs that is not shown elsewhere in the statements.

11	Learning Outcome: B6
Which one of the following statements is true?	
A	According to IAS 38 Intangible Assets, research expenditure should be capitalised as an asset in the statement of financial position
B	According to IAS 16 Property, plant and equipment (PPE), an item of PPE may be measured at cost or revalued amount
C	According to IAS 10 Events after the reporting period, all events that occur after the date of the statement of financial position are treated as non-adjusting events
D	According to IAS 37, Provisions, contingent liabilities, and contingent assets, a provision is a liability of known amount and timing

11	Feedback
A	**Incorrect** Research expenditure must be treated as an expense in the statement of profit or loss
B	**Correct**

C	**Incorrect** Events after the date of the statement of financial position may be either adjusting or non-adjusting
D	**Incorrect** A provision is a liability of unknown amount and timing

12	Learning Outcome: B6
Which of the following statements is true?	
A	Public and private sector organisations have similar objectives.
B	Public sector organisations focus on maximising tax income, in the same way that private sector organisations focus on the profit objective.
C	Public sector organisations may have multiple objectives, whereas private sector organisations will usually focus on the profit objective.
D	Public sector organisations have an objective to maximise expenditure in the reporting period.

12	Feedback
A	**Incorrect** Public sector organisations may have multiple objectives, whereas private sector organisations will usually focus on the profit objective
B	**Incorrect** Public sector organisations may have multiple objectives, whereas private sector organisations will usually focus on the profit objective. There may be an objective in relation to raising tax income, but this is not usually the dominant objective
C	**Correct**
D	**Incorrect** Public sector organisations usually have a duty to provide value for money, and this does not necessarily involve maximising expenditure Public sector organisations may have multiple objectives, whereas private sector organisations will usually focus on the profit objective

Unit B Exercises

Exercise B1

Identify whether the following are adjusting or non-adjusting events and state how each should be treated in the financial statements of the company

a) Three weeks after the reporting date there was a fire at the stores which destroyed a large amount of inventory. The inventory destroyed had been included in the closing inventory at FRW 80 million.

b) Closing trade receivables are FRW 64 million. Shortly after the year end a major customer was declared bankrupt. It is now anticipated that although the customer owed FRW 25 million as at the year end, only 10% of the debt will be collected.

Exercise B1 solution

a) This is a non-adjusting event, as the fire does not provide information about a condition that existed at the reporting date.

Disclose as a note, if the amount is material.

b) This is an adjusting event, as the debt was probably already in doubt at the reporting date.

Reduce the receivables amount by 90% and charge as an expense.

Debit	Expense – bad debt written off FRW 56 million
Credit	Receivables FRW 56 million

Exercise B2

How should the following event be treated in the financial statements of Company Z?

A legal claim is being pursued by Company Z, and the company is confident of winning the case in court. If it does win, Company Z expects to be awarded compensation in the region of FRW 200 million.

Exercise B2 solution

There is a possible asset and as the claim is being pursued it must arise from past events. This is therefore a contingent asset.

This should not be included in the financial statements, but should be assessed continually to determine whether it is virtually certain of being paid, in which case it will no longer be contingent and can be accounted for as a receivable.

Unit C: Basic principles of consolidation.

Learning outcomes

C1. Describe the key components of a set of consolidated financial statements – parent, subsidiary, non- controlling interest (minority interest), goodwill, fair values, pre and post-acquisition profits and equity.

C2. Explain the process of basic consolidation for a parent and subsidiary.

C3. Describe the effect of consolidation on each of the key elements - parent, subsidiary, non-controlling interest (minority interest), goodwill, fair values, pre and post-acquisition profits and equity.

C4. Explain the key features of a parent / associate relationship.

Introduction to Unit C

So far in this module, we have referred to limited companies that operate and prepare financial statements as single entities. We are now going to look at situations where one or more companies are required to prepare additional financial statements, as the companies are connected, and so users need to have a wider picture of the financial situation of the companies. This is referred to as 'group accounts' or 'consolidated accounts'.

You will see examples where a company owns shares in another company, which means that the shareholders have an interest in knowing how the other company is performing.

In this unit, we will introduce you to the main concepts of consolidation, and the basic processes involved in preparing consolidated financial statements. We will look at transactions and other events in which one company acquires control or influence of one or more other businesses.

In this unit we will be looking at the main requirements of financial reporting standards in relation to two different situations:

- Subsidiaries
- Associates

The same principles of accounting apply in business combinations as in single-entity statements – ie we will be applying the usual double-entry approach, and referring to standards such as IAS 16 for depreciation, etc. However, there are also some additional standards that refer specifically to the treatment of transactions that are peculiar to groups, and it is important that you are familiar with the main requirements of these standards, ie:

- IAS 27 Separate financial statements
- IAS 28 Investments in associates and joint ventures (introductory only)
- IFRS 3 Business combinations
- IFRS 10 Consolidated financial statements

Principles of consolidation

Before considering the detailed processes involved in preparing consolidated financial statements, we need to introduce some important terminology.

As mentioned above many companies grow by acquiring ordinary shares in another company, as illustrated in the diagram below:

Company A
75%
Company B

Company A has acquired 75% of the ordinary share capital in Company B. Company A will show the cost of these shares as an investment in their own statement of financial position. Company B may pay a dividend and 75% of that will be paid to Company A and will be shown as investment income in their own statement of profit or loss.

Legally Company A owns shares in Company B but we need to look at the substance of the transaction. As Company A owns more than 50% of the ordinary shares of Company B, it can control the company and all the decisions that are made by the company.

Company A is known as the parent and Company B as the subsidiary, and together they are known as a group.

IFRS 10 gives the following definitions, which are very important throughout this workbook. You may want to keep referring back to these as you work through the material.

Key definitions

Parent	**An entity that controls one or more entities. (IFRS 10)**
	The parent is the investor, i.e. the company which buys the controlling interest in another company.
Control	An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. (IFRS 10)
	In the example above, Company A owns 75% of Company B and it has control over it. We will look at the nature of control in more detail later, but you can assume that if a company owns more than 50% of the ordinary shares, it has control.
Subsidiary	An entity that is controlled by another entity. (IFRS 10)

	The subsidiary is the investee, i.e. the company that is being controlled by the parent.
Group	A parent and all its subsidiaries (IFRS 10)
Consolidated financial statements	The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries of the parent and its subsidiaries are presented as those of a single economic entity. (IFRS 10)

Process and effects of consolidation – parent and subsidiary

We will now look at a numerical example to illustrate the process of consolidation, and the effect on the financial statements, starting with the statement of financial position.

Consolidated statement of financial position

Company North acquired 75 million shares in company South on 1 January 20X9 for a cost of FRW 135 million.

Statements of financial position at 1 January 20X9

FRW million	**North**	**South**
Tangible non-current assets	693	240
Investment	135	0
Current assets	76	80
Total assets	904	320
Share capital (FRW 1 shares)	100	100
Retained earnings	730	80
Non-current liabilities	50	100
Current liabilities	24	40
Total equity and liabilities	904	320

Key points:

- North has acquired 75% of the shares in S.
- The separate financial statements of North reflect this as a one-line investment.
- North is the parent as it has control over South, the subsidiary.

We will now prepare the consolidated statement of financial position for the group by working through the following process and identifying the key information from the figures above.

- Group Structure:

North
75%
South

- North has acquired their share of the net assets at acquisition. The net assets are FRW 180m. (Share capital of FRW 100m and retained earnings of FRW 80m).
- North's share of this is FRW 135m (FRW 180 × 75%)
- The investment in South will be cancelled out against North's share of South's net assets. A figure for non-controlling interest is required as we add in 100% of the assets and liabilities of South but actually 25% is owned by shareholders outside of the group.
- Retained earning of the group must be calculated
- Then add together the assets and liabilities of the parent and the subsidiary that it controls.

Consolidated statement of financial position at 1 January 20X9		
	Calculations and adjustments	**FRW million**
Tangible non-current assets	North + South = 693 + 240 =	933
Investment	Cancelled out on consolidation	
Current assets	North + South = 76 + 80 =	156
Total assets		1,089
Share capital (FRW1 shares)	North only, South's cancelled on consolidation	100
Retained earnings	North only, South's cancelled on consolidation	730
Non-controlling interest	180 x 25%	45
Non-current liabilities	North + South = 50 + 100 =	150
Current liabilities	North + South = 24 + 40 =	64
Total equity and liabilities		1,089

You should note the following points about the process of preparing a consolidated statement of financial position:

- The investment in South of FRW 135m has been cancelled out against the parents share of South's share capital and retained earnings at the date of acquisition.
- The consolidated statement is prepared for shareholders of North only, and so the share capital in the statement will just be the parent's.
- The assets and liabilities of South have been added to North's.
- A new line has been added called non-controlling interest, this arises as whilst North controls South they do not actually own all of South. This figure shows the net assets which have been consolidated but which are owned by shareholders outside of the group.
- Calculation of investment figure:

Cost of shares acquired	135
Less: share of fair value of net assets at acquisition	
(Share capital and retained earnings of S = FRW 180m x 75%)	(135)
	0

- Calculation of non-controlling interest (NCI):

Net Assets of Subsidiary at reporting date	
Share Capital	100
Retained earnings	80
	180
NCI = 180 x 25% =	45

The key points to note at this stage are:

- Preparation of consolidated financial statements reflects the (ultimate) control the parent has over its subsidiary.
- The consolidated statements are a means of reporting to the shareholders of the parent company
- They are prepared as if the group is a single entity.
- These additional set of financial statements are prepared for the shareholders of North, and they enable the shareholders to make more informed decisions over the whole of the group (ie North + South taken together).

In reality, companies may acquire many subsidiaries, but we will focus in the module on preparing consolidated financial statements for a parent and one subsidiary.

Goodwill

In the example of North and South above, we cancelled out the cost of the investment

with the parent's share of net assets. This meant that the parent paid exactly the same as their share of net assets. In reality the consideration (cost of the investment) will usually be higher as they are not only buying the net assets but the reputation and future potential of the business. This gives rise to 'goodwill'.

Goodwill is defined by IFRS 3 as:

'An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised'.

Goodwill is included as an intangible non-current asset in the consolidated statement of financial position.

If consideration is less than the fair value of the identifiable net assets acquired, the difference is *negative goodwill*. If negative goodwill arises, IFRS 3 requires the acquirer to review the fair values of the net assets acquired to ensure that there is no error, and recognise any negative goodwill which remains as 'other income'.

Calculation of goodwill	**FRW**
Cost of shares acquired	X
Less: share of fair value of net assets at acquisition (based on percentage of parent's ownership)	(X)
Goodwill (before any impairment)	X
Less: Impairment to date	(X)
Goodwill	X

Goodwill must be calculated on the basis of the fair values of the assets acquired and the consideration paid (ie the amount paid to acquire the shares).

Once calculated, there is no need to recalculate the goodwill on acquisition at each year end date as the value determined will not alter, other than by impairment. A company is required to test for potential impairment of goodwill annually.

Goodwill is shown as an intangible asset in the consolidated statement of financial position.

When goodwill is impaired the goodwill asset will be reduced (credited), and retained earnings reserve will be reduced by the same amount (debited).

The figure for the investment in the subsidiary (which appears in the parent's statement of financial position) is eliminated on consolidation; instead we will show assets and liabilities of the subsidiary.

Intra-group trading

When consolidating, we need to cancel out items that are assets in one group company and liabilities in another arising from intra-group trading. These are known as intra-group or inter-company balances.

Where companies within a group trade with each other, there are several ways in which balances with each other can arise. The most common of these are described below:

Debentures/Loan stock	Where one company in the group has made a loan to another – in one company there is a payable and in the other there is a receivable (normally shown as investment). These are cancelled on consolidation. The cancellation process is very simple: the credit balance of one company is offset against the debit balance of the other company, eliminating both balances from the consolidated statement of financial position. We only include debentures/loan stock held by third parties in the consolidated statement of financial position.
Inter-company accounts	These are intra-group trading balances, e.g. current assets of subsidiary might include amounts owing from parent. These amounts will be included as current liabilities by the parent. The treatment of inter-company account balances is the same as for debentures/loan stock. Inter-company accounts may not agree due to goods in transit or cash in transit. If the difference is cash in transit, increase the consolidated cash balance by that amount. If the difference is goods in transit, increase the consolidated inventory by that amount.
Bank balances	Bank overdrafts (liability) and cash at bank (asset) must be shown separately. It is not permissible to offset bank overdrafts against cash at bank.
Unrealised profit in inventory	Group companies often sell goods (or any other assets) to one another. Transfers may include an element of profit. If goods or assets are subsequently sold, the group has realised the profit and no further adjustment is necessary. If goods or assets are still held within the group at the year end, we need to remove any unrealised profit. In consolidated accounts, we want to reflect only profits made by group companies trading with third parties. The exact adjustments depend on whether Parent (P) sold to Subsidiary (S) or Subsidiary (S) sold to Parent (P).
	P sells to S: Profit in inventory arising when P sells to S is not realised outside the group. This profit must be calculated and removed from inventory at the reporting date and also from P's retained earnings at the reporting date. Debit P's retained earnings Credit Closing inventory (in consolidated statement of financial position)

	S sells to P: Profit in inventory arising when S sells to P is not realised outside the group. This profit must be calculated and removed from inventory at the reporting date and also from S's retained earnings at the reporting date. Debit S's retained earnings Credit Closing inventory (in consolidated statement of financial position)

Unrealised profit is calculated using one of the three methods below, depending on what information is available:

Using gross profit margin	Example: P sold goods to S for FRW 10,000. The profit margin was 40%. At the year end, S had sold half of these goods on to third party. Unrealised profit = Inventory value X % margin/100% Inventory = half of 10,000 = 5,000 Unrealised profits = 5,000 x 40%/100% = 2,000
Using mark-up	Example: P makes sales of FRW 10,000 to S. This figure comprises cost plus 25% mark up. S had sold half of these goods on to third party Unrealised profit = Inventory value X % mark-up / (100% + mark-up %) Inventory = half of 10,000 = 5,000 Unrealised profits = 5,000 x 25 / (100% + 25%) = 1,000
Using profit figure	Unrealised profit = profit figure given multiplied by the percentage of goods unsold

Example – unrealised profits in inventory

During the accounting period, P sold goods to S for FRW 20,000, which gave P a profit of FRW 4,000. One quarter of these goods were included in the closing inventory of S at the end of the reporting period.

Show the required accounting entries when consolidating the financial statements of P and S.

Solution

Unrealised profit = 25% x FRW 4,000 = FRW 1,000.

The adjustment in the consolidated statement of financial position would be as follows:

Debit	P retained earnings (25% x 4,000)	FRW 1,000
Credit	Closing inventory	FRW 1,000

The inventory still held by S, valued at FRW 5,000 in S's inventory, is being reduced to its cost to the group of FRW 4,000.

Note that if S sold inventory to P, it would be S's retained earnings that would be impacted. Look out for this difference, as it will impact the resultant calculations in the step-by-step consolidation process.

Consolidated statement of profit or loss

The consolidated statement of profit or loss is prepared on the same basis as the consolidated statement of financial position and therefore most of the key principles will already be familiar to you.

The consolidated statement of profit or loss shows the income generated from the group's resources. Watch out for the following issues:

- Intra-group sales must be eliminated from both the revenue of the selling company and the cost of sales of the buying company. DR Revenue CR Cost of sales.
- Unrealised profit included in year-end inventory must be eliminated. DR Cost of sales CR Closing inventory.
- Any intra-group interest must be eliminated from interest receivable and interest payable respectively.
- Dividends from subsidiaries must be eliminated since the whole of the profits of those subsidiaries are being consolidated and it would be double counting to include the dividends as well.
- Non-controlling interest is calculated by taking the non-controlling interest's share of the subsidiary's profit after tax. Two figures exist for non-controlling interest: the statement of financial position figure is based on net assets and the statement of profit or loss figure is based on profit.

Associates

We can now turn to consider a different type of relationship between two companies. Unlike the parent/subsidiary arrangement, this does not meet the criteria for 'control' set out in IFRS 10. Instead, the relationship is that of an associate, and it is characterised by the presence of 'significant influence':

Associate	An entity over which the investor has significant influence.
Significant influence	The power to participate in the financial and operating policy decisions of the investee but is not control of those policies.

We assume that an investor has 'significant influence' over an entity when it holds over 20% of the share capital (and therefore voting influence), unless there is some other evidence that indicates that significant influence is not actually being exercised. If the holding is less than 20% the entity will be presumed not to have significant influence unless

such influence can be clearly demonstrated. If the shareholding is more than 50%, this will usually indicate control rather than significant influence, and therefore a subsidiary relationship, rather than associate.

The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

- Representation on the board of directors;
- Participation in the policy-making process;
- Material transactions between the entity and investee;
- Interchange of managerial personnel;
- Provision of essential technical information.

Note that if the investor holds more than 50% of the share capital it is likely that it controls the entity, in which case we have a parent/subsidiary relationship.

The change in an entity's net assets is equivalent to profit/loss in a period. Rather than consolidating on a line-by-line basis, as we saw with the parent/subsidiary arrangement, the method of consolidating is the 'equity method'. IAS 28 requires all investments in associates to be accounted for in the consolidated statements using the equity method, except when that investment qualifies for exemption.

Equity method	A method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the investor's share of the associate's post-acquisition profits

The associate will be represented in the group accounts by just one line in the statement of financial position (investment in associate) and one line in the statement of profit or loss (income from associate).

The basic principle of the equity method is that on initial recognition the investment (in the associate) is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of profit or loss of the investee after the date of acquisition. The investment is recognised in the consolidated statement of financial position as a non-current asset, labelled 'investment in associate'.

To understand how to consolidate an associate's statement of financial position, contrast the method with consolidation of a subsidiary:

Consolidation of a subsidiary (acquisition accounting)	**Consolidation of an associate (equity accounting)**
Line by line consolidation: Each type of asset and liability in the parent's and subsidiary's statement of financial positions are summed.	No line by line consolidation: Instead one line is added to non-current assets – 'investment in associates'.

Consolidation of a subsidiary (acquisition accounting)	Consolidation of an associate (equity accounting)
Goodwill: Goodwill is calculated and is presented in non-current assets.	No goodwill.
Non-controlling interest: NCI is calculated and presented in equity.	No non-controlling interest.
Retained earnings: Group retained earnings calculation.	Retained earnings: Group retained earnings calculation – same approach.
Intra-group balances elimination.	Intra-group balances cannot be eliminated.

Because a parent controls the subsidiary, we consolidate 100% of the subsidiary's assets and liabilities into the consolidated statement of financial position. Goodwill arises because a premium has been paid for the net assets.

But an associate is not controlled by the investor and therefore we only show the original investment that has been made, plus the share of post-acquisition profits. Consolidating all of the assets and liabilities would be misleading to the users of the accounts.

Summary of Unit C and key learning outcomes

In Unit C, the overall aim was to 'Demonstrate an understanding of basic principles of consolidation. In the unit, we looked at the following areas. Note that each of these will be developed further in Unit F, and the content in Unit C is mainly introductory.

Learning outcome	
Describe the key components of a set of consolidated financial statements – parent, subsidiary, non-controlling interest (minority interest), goodwill, fair values, pre and post-acquisition profits and equity.	You should now be able to provide a basic description of each of these terms and carry out basic calculations for each.
Explain the process of basic consolidation for a parent and subsidiary.	You should now be able to outline the process for be determining amounts to be included in consolidated financial statements.

Describe the effect of consolidation on each of the key elements - parent, subsidiary, non-controlling interest (minority interest), goodwill, fair values, pre and post-acquisition profits and equity	You should now be able to explain how each of these items or transactions affect the consolidated statement of financial position and the consolidated statement of profit or loss.
Explain the key features of a parent / associate relationship	You should now be able to describe the nature of the parent / associate relationship and to explain how the equity method is applied in preparing consolidated financial statements for an arrangement with an associate.

Quiz questions

1	Learning Outcome: C1
Which of the following statements is true?	
A	A subsidiary is a company that is less than 50% owned by a parent company
B	Consolidated financial statements are prepared for the shareholders of the subsidiary company
C	A subsidiary is a company that is controlled by a parent company
D	A subsidiary is a company that has agreed to manufacture goods on behalf of a parent company

1	Feedback
A	**Incorrect** A parent will normally own 50% or more of the shares of a subsidiary, in order to have control over the subsidiary
B	**Incorrect** Consolidated financial statements are prepared for the shareholders of the parent company
C	**Correct**
D	**Incorrect** A subsidiary is a company that is controlled by a parent company, usually through the parent owning 50% or more of the shares in the subsidiary. It is not essential for there to be other agreements, such as in relation to manufacture of goods.

2	Learning Outcome: C4
Which of the following is a description of 'significant influence'?	
A	When the investor is exposed, or has rights, to variable returns from its involvement with the investee

B	A method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the investor's share of the associate's post-acquisition profits
C	The ability to affect returns through its power over the investee.
D	The power to participate in the financial and operating policy decisions of the investee, but is not control of those policies

2	Feedback
A	**Incorrect** This is part of the description of control by a parent over a subsidiary
B	**Incorrect** This is a description of equity accounting
C	**Incorrect** This is part of the description of control by a parent over a subsidiary
D	**Correct**

3	Learning Outcome: C3
If a parent has a bank balance of FRW 600,000, and the subsidiary has a bank overdraft of FRW 150,000, what amount(s) should be shown on the consolidated statement of financial position?	
A	Bank account (current asset) FRW 600,000, and Bank overdraft (current liability) FRW 150,000
B	Bank account (current asset) FRW 600,000 only
C	Bank overdraft (current liability) FRW 150,000
D	Bank account (current asset) FRW 450,000

3	Feedback
A	**Correct**

B	**Incorrect** Both a current asset and current liability should be shown, as it is not permissible to net these off in consolidation: Bank account (current asset) FRW 600,000, and Bank overdraft (current liability) FRW 150,000
C	**Incorrect** Both a current asset and current liability should be shown, as it is not permissible to net these off in consolidation: Bank account (current asset) FRW 600,000, and Bank overdraft (current liability) FRW 150,000
D	**Incorrect** It is not permissible to net these off a bank balance and bank overdraft in consolidation: Bank account (current asset) FRW 600,000, and Bank overdraft (current liability) FRW 150,000

4	Learning Outcome: C3
Which of the following is a description of the process of preparing a consolidated statement of financial position for a parent and subsidiary?	
A	The consolidated statement of financial position will show the ordinary share capital of the parent company only
B	The consolidated statement of financial position will show the ordinary share capital of the parent company and subsidiary added together
C	The consolidated statement of financial position will show the ordinary share capital of the parent plus the percentage of shares in the subsidiary that the parent controls
D	The consolidated statement of financial position will show the ordinary share capital of the subsidiary company only

4	Feedback
A	**Correct**
B	**Incorrect** The consolidated statement of financial position will show the ordinary share capital of the parent company only

C	**Incorrect** The consolidated statement of financial position will show the ordinary share capital of the parent company only
D	**Incorrect** The consolidated statement of financial position will show the ordinary share capital of the parent company only

Unit D: Financial Statement Analysis and Interpretation.

Learning outcomes

D1. Demonstrate an understanding of the relationship between the elements of the financial statements – assets, liabilities, equity, income, expenses, contributions from owners and distributions to owners.

D2. Explain how to calculate accounting ratios – profitability, liquidity, efficiency, financial position.

D3. Explain the inter-relationships between ratios.

D4. Explain the purpose of the interpretation of ratios.

D5. Describe how the interpretation and analysis of accounting ratios is used in a business environment.

Introduction to Unit D

We have looked at the content and presentation of various financial statements in the earlier units of this module, with the assumption that the objective is to present information that is useful to users of the accounts. Financial statements do not necessarily tell the user a great deal in terms of how an organisation has performed, unless there is additional information to help interpret their meaning.

Effective analysis of financial statements can benefit from the use of a number of tools, one of which is accounting ratios. Accounting ratios are figures taken from the financial statements, expressed in terms of other figures. These ratios allow us to do carry out more detailed analysis of the statements, such as:

- Compare performance with that of previous accounting periods
- Make comparisons with similar businesses/industry averages
- Interpret performance of a business.

A number of different ratios are used to interpret financial statements. In this module we focus on the most commonly used ones, which can be grouped into the following five categories:

- Profitability
- Efficiency
- Liquidity
- Long term solvency

- Shareholder investment

Elements of financial statements

In Unit A of this module, we introduced the main elements of the financial statements, as set out in the Conceptual Framework of the IASB – ie assets, liabilities, equity, income, expenses. We also saw how these are fundamental to the way in which the main financial statements of a business are constructed. It is important that you bring an understanding of the relationship between these elements, and of how they are included and presented in specific financial statements, to the study of accounting ratios and the interpretation of financial statements.

It will also be important to develop further knowledge of specific transactions, how they are accounted for in the financial systems, and how they are presented in the financial statements. Throughout Unit E (and also in Unit F, in the context of consolidated financial statements), you will increase and deepen your knowledge of the requirements of IFRS. This means that we will be able to look at more complex examples of accounting ratios, using more detailed financial statements, in Unit G.

Users of financial statements

Before looking at accounting ratios and other aspects of financial statement interpretation, it is important to remind ourselves of who the various users of financial statements are likely to be, and also to note the different interests that each individual or group will have in the organisation and its performance.

User	Interest in financial statements
Owners	Owners are interested in knowing how well the business is performing, profit level, amount that may be withdrawn from the business.
Potential investors	Potential investor need to know about profit levels and forecasts of future returns on investment.
Lenders.	Lenders require reassurance that interest and principal will be repaid
Managers	Managers need day-to-day information to make operational decisions.
Employees	Employees are concerned about job security, career development, wages/salaries.
Customers	Customers wish to know whether the business will continue to operate and goods and services will be received on time.
Suppliers	Suppliers need reassurance that business will continue to operate and amounts owing will be received on time.
Competitors	Competitors look for information to secure a strong position in the market.

User	Interest in financial statements
Government agencies	Government agencies require tax information, statistical information, government policies on resource allocation.
Business analysts	Business analysts look for information relevant to advising their clients.
The general public	The general public have a wide range of interests including environmental issues, local economy factors.
Users	Interest and information requirements
Shareholders and potential investors	Investment information, and decisions in respect of - risk and return of investment - ability of the entity to pay dividends
Lenders	Assessment as to whether loans and interest will be paid when due
Suppliers and other payables	Assess the likelihood of the company paying amounts due on time
Employees	Assessment of the company's stability and profitability Assessment of the company's ability to make wage and salary payments, etc
Government and agencies	Assess overall economy and the company's contribution to specific industry Regulation Taxation due Collation of information for national statistics
Customers	Whether the company will continue in existence and honour obligations such supporting warranties Information on ethical practices
The public	Assess trends and developments in the company's activities.

Accounting ratios – categories and purpose for users

Accounting ratios can help to summarise and present financial information in a more easily understood form. They can assist in assessing the performance of an organisation by identifying significant relationships between different figures. The term 'ratios' is used as a general reference for all items that might be used in this way; we will therefore look at some that are indeed expressed as a ratio (ie one amount is compared in relation to

another and stated in the form 2:1 or 3:2, etc) and also at other figures that are measured as a percentage or as a frequency (eg '3 times per year') or as a period of time (eg 30 days).

Profitability ratios

The usefulness of the figures shown in the statement of profit or loss will be greatly enhanced by expressing profit as a percentage of revenue or capital employed, thereby allowing comparison with previous years and other organisations. In addition these ratios will provide an indication of how well an organisation controls its costs.

The most commonly used profitability ratios are:

- Return on capital employed (ROCE) (%)
- Return on equity (ROE) (%)
- Net profit margin (%)
- Gross profit margin (%)

Efficiency (or working capital) ratios

To be successful it is essential that a business makes good use of its assets. We can get an indication of this through calculating:

- Asset turnover or turnover of capital employed (times)
- Non-current asset turnover (times)
- Current asset turnover (times)
- Average inventory days
- Average trade receivables days
- Average trade payables days

Liquidity ratios

Of crucial importance to any organisation is its ability to generate cash and be able to meet day-to-day debts as they fall due. To help assess an organisation's liquidity we use the following ratios:

- Current ratio
- Quick ratio (or acid test ratio)

Both these ratios are expressed as x:y, (eg 2:1, 1.5:1), and they are discussed in more detail later in this unit.

Care must be taken when interpreting the current ratio and in particular it is important to consider the makeup of current assets. If current assets predominately comprise inventory and receivables, then a business with a healthy current ratio might still experience liquidity problems since it is not always easy to turn these assets into cash at short notice. For this reason, the acid test ratio should be used in conjunction with the current ratio.

Long term solvency and debt ratios

Investors and lenders will be interested in an organisation's long-term funding arrangements and in particular its dependence on borrowed funds. The greater an organisation's dependence on borrowed funds, the higher the risk that it will be unable to meet interest and capital repayments when they become due. The following ratios assist our understanding of this area.

- Gearing ratio (%)
- Interest cover (times)

Shareholder investment ratios

Of prime concern to investors are the likely return from and the level of risk attached to an investment. We will consider the following ratios to assess the return to investors:

- Ordinary dividend cover (times)
- Earnings per share (EPS) – see later in this unit

Links between ratios

Notice that there is some overlap between these five categories of ratio. For example, we have included the ROCE under *profitability*, but *investors* will also be interested in this ratio as it indicates how efficiently an organisation uses its long term funds to generate profits. As well as indicating *efficiency* the ratios for inventory days, receivables days and payables days also tell us about an organisation's *liquidity*.

In this section we consider the main ratios listed above, along with explanations of what these ratios mean, how to interpret each one, as well as how to link them.

Calculation and application of ratios

All the ratios discussed here make use of information from the financial statements, so it is important that you are able to find the relevant figures from the appropriate statements.

Note also that each ratio is expressed in a particular way – ie as a percentage, as a number of times in the period, as a number of days, etc.

Ratio	Formula
Return on capital employed (%) (ROCE)	(Profit from operating activities / capital employed) x 100

Capital employed is defined as shareholders' funds plus non-current liabilities, and represents the total investment in the business – both shareholders' and lenders' investment.

ROCE quantifies the return the company is earning on the capital it uses.

ROCE shows us how efficiently the company uses the capital it has employed to generate a profit.

If a company wants to improve its return on capital employed it either improves its net profit margin and/or its asset utilisation. We will look at this in more detail later in the unit

and Unit G.

ROCE is often the 'headline' ratio, i.e. the one which we first look at before investigating performance further.

Note that capital employed = total assets – current liabilities

Ratio	Formula
Return on equity (%) (ROE)	(Profit from operating activities / shareholders' funds) x 100

ROE is a measure of the return on the shareholders' investment only.

ROCE is more commonly used when assessing overall profitability and efficiency, but ROE is useful to shareholders.

Ratio	Formula
Net profit margin (%)	(Profit from operating activities / revenue) x 100

Net profit margin tells us how much of its revenue the company retains in net profit.

Net profit margin is impacted by revenue and expenses and consideration must be given to both elements when interpreting performance.

Net profit margin should be compared to gross profit margin (see below) to understand cost behaviour.

Ratio	Formula
Gross profit margin (%)	(Gross profit / revenue) x 100

Gross profit margin tells us how much of every FRW 1 in revenue the company retains in gross profit, i.e. before indirect expenses.

Gross profit margin tells us how well the cost of sales is being controlled.

Compare to net profit margin to understand cost behaviour.

Ratio	Formula
Turnover of capital employed or Asset turnover (times)	Revenue / capital employed

Asset turnover tells us how efficiently a business is utilising its assets to generate sales.

The higher the ratio the more efficient the business operates.

This ratio is easier to understand when broken down into non-current and current asset turnover, see below.

Ratio	Formula
Non-current asset turnover (times)	Revenue / non-current assets

Non-current asset turnover tells us how efficiently a business is utilising its non-current assets to generate sales.

To be efficient a business should aim to generate maximum revenue using a small asset base. To achieve this, a business must hold productive, efficient property, plant and equipment, and dispose of unproductive, obsolete assets.

Ratio	Formula
Current asset turnover (times)	Revenue / current assets

Current asset turnover tells us how efficiently a business is utilising its current assets to generate sales.

To be efficient a business should aim to generate maximum revenue whilst maintaining a relatively small amount of current assets, i.e. cash, receivables and inventory.

Holding low levels of cash, receivables and inventory, and therefore being efficient, must be balanced with the need to stay liquid (see below).

Ratio	Formula
Average inventory days	(Average inventory / cost of sales) x 365

The average inventory days figure tells us how long an average inventory holding will take to sell.

This is dependent on the type of industry the business operates in; we would expect it to be only a few days for fresh food, but a much longer period for expensive jewellery, for example.

Ratio	Formula
Average trade receivables days	(Average trade receivables / credit sales) x 365

The average receivables days figure tells us how efficiently the business collects its debts.

The target for most businesses is to collect debts due within 30 days.

The time taken to collect debts has an immediate impact on the liquidity of the business.

Compare to average trade payables days to assess liquidity.

Ratio	Formula
Average trade payables days	(Average trade payables / credit purchases) x 365

The average payables days figure tells us how quickly the business pays its suppliers.

Compare to average trade receivables days to assess liquidity.

Consider the reputational risk to the company if the number of days is longer than average.

Ratio	Formula
Current ratio	Current assets / current liabilities

The current ratio tells us how able the company is in meeting its short-term liabilities.

Expressed as x:y (for example a current ratio of 2:1 means the company has double the amount of current assets to liabilities).

Whether a current ratio is good or bad depends on the type of business under consideration. A large supermarket could maintain a current ratio of 0.58:1because it gives limited (if any) credit to its customers but has the usual credit terms with suppliers, meaning that its liquidity is healthy. However, a manufacturing company with a long production cycle (time taken to convert raw materials into the final product) may need to sustain a higher current ratio to maintain liquidity.

Ratio	Formula
Quick ratio (or acid test)	(Current assets - inventory) / current liabilities

Expressed as x:y

A company with a long inventory days ratio (e.g. expensive jewellery shop) will have a large value of inventory, meaning a relatively high current ratio. However, the quick ratio will eliminate the impact of inventory and will give a more prudent assessment of whether the company's short-term liabilities can be met easily.

Ratio	Formula
Gearing (%)	(Non-equity finance / capital employed) x 100

Gearing tells us how reliant we are on debt as a form of finance.

Companies have to pay interest regardless of their profitability. This means that a highly geared company (i.e. one that is more heavily reliant on debt) is a more risky investment as its profits are more volatile.

Gearing over 50% is considered risky, although all other ratios must be considered when evaluating this.

Ratio	Formula
Interest cover (times)	Profit from operating activities / finance costs

Interest cover tells us how many times finance costs could be paid from the available profits.

Interest cover tells us how easily the company can pay its finance costs, and therefore if it can afford its current level of debt.

A company must pay any interest owed and therefore a low interest cover ratio (usually less than 2.5 times) is a warning sign that the company has too much debt and may struggle to pay interest costs if profits decline.

Ratio	**Formula**
Ordinary dividend cover (times)	Profit attributable to ordinary shareholders / ordinary dividends

Profit attributable to ordinary shareholders is profit after tax and after preference dividends.

Ordinary dividend cover tells us how many times the ordinary dividend could be paid from the available profits.

Unlike finance costs and preference dividends, a company can choose the size of ordinary dividend to pay to its shareholders.

Ratio	Formula
Earnings per share (Basic) (EPS)	Profit attributable to ordinary shareholders / number of ordinary shares

EPS tells us the profit earned by each ordinary share in issue.

EPS is governed by IAS 33 which is not covered in detail in this module.

EPS represents the maximum dividend that a company could pay if it chooses to pay all its profits to its shareholders.

To understand ROCE a little more we can split the ratio into component parts. This can be done as follows:

Return on capital employed (%) (ROCE)	=	(Profit from operating activities / capital employed) x 100
= Profit from operating activities / revenue	x	Revenue / capital employed
= Net profit margin	x	Asset turnover

This is a simple mathematical trick (revenue cancels out) but it helps us to understand how to interpret ROCE when analysing company performance. You may need to refer to the earlier definitions of Net profit margin and Asset turnover to confirm that these comparisons are valid.

To improve ROCE the company could improve profitability (i.e. net profit margin) and/or efficiency (i.e. asset turnover). We will consider how to improve profitability in more detail in examples in Unit G.

Use of ratios in business and other organisations

In the discussion on the use of ratios above, we have noted the specific use of individual ratios in a business context – eg using the current ratio to assess the liquidity of a company. The objective of this approach is to identify problems or potential problems, and to take appropriate action to remove or prevent this problem – eg accessing additional funding to overcome a liquidity problem.

But it is also important to note the limitations in the use of accounting ratios.

Limitations of ratio analysis

Financial ratios can be very helpful in gaining a deeper understanding of an organisation's

financial situation. However, it is important to be aware of their limitations and to be careful in how they are actually used. Some of the main limitations are listed below.

Financial statements are historic in nature, thus any ratios calculated are based on past rather than future performance.

Comparison of results may be difficult due to:

- Use of different accounting policies.
- One-off items that distort results (e.g. a large bad debt)
- Definition of ratio used (e.g. ROCE and gearing both have several definitions. In order to make meaningful comparison it is important to apply each definition consistently)
- Judgements (e.g. useful life of NCA, allowance for receivables)
- Economic conditions (e.g. high inflation)
- Seasonal variations (e.g. impact on inventory)

Ratios indicate problems but on their own they do not necessarily identify or recommend the most appropriate solutions.

Key performance indicators (KPIs)

Key performance indicators are used to measure performance in many different types of entity, from private sector to public, and are used to evaluate success in a particular area of activity. KPIs are set to be in line with objectives, sometimes strategic, others operational.

Examples of KPIs:

- Customer attrition
- Product rejection rate
- Customer satisfaction
- Wages costs /sales (as a %)

These are just a few examples of thousands of KPIs used across different industries. As you can see, KPIs try to measure success in a broader sense, rather than a sole focus on financial performance. Managers will use KPIs, as well as financial ratios, to build up a picture of company success.

KPIs have become a common way to assess performance in the public services. This is because the objectives of public service entities are broad and complex, and they do not have the overarching objective of profitability (like companies). KPIs can therefore attempt to quantify success of their wider service objectives, rather than just focusing on the financial statements.

Benchmarking

Benchmarking is the process of systematic comparison of a service, practice, or process against one or more similar activities. It is intended to bring about continuous improvement in service delivery by comparing existing practices and processes with a point of reference against which they can be measured. From this investigation good practice or best practice can be identified. For example, a company may choose to benchmark their call centre function with the industry leader of that activity, and will compare processes, KPIs and outcomes.

Benchmarking is only of use to an organisation if it is used in context. For a benchmarking exercise to be meaningful, comparisons need to be made over time. This will allow for trends to be spotted and can help identify how successful actions to improve performance have been.

Benchmarking will identify areas that need improvement but will not generate improvement automatically. There is a risk that when areas below the benchmark are identified, this results in an increase of resource or capacity to the service without further questioning why performance is below the benchmark. For benchmarking to be effective it is essential that the underlying reasons for performance are questioned.

It is also useful to compare performance with other similar bodies. When comparisons are made with other organisations, care must be taken to ensure that like is compared with like. It is also important to compare over time. If not, attention may be drawn into justifying why performance is worse. Is it due to a blip in this particular year? Is it due to the fact that our organisation is not really comparable to the benchmark?

Entities across the public and private sector join 'benchmarking clubs' which encourage the sharing of data between similar organisations to allow effective benchmarking to take place.

Summary of Unit D and key learning outcomes

In Unit D, the overall aim was to 'Appreciate the analysis and interpretation of financial statements'. In the unit, we looked at the following areas. (Note that each of these will be developed further in Unit G, and the content in Unit D is mainly introductory.)

Learning outcome	
Demonstrate an understanding of the relationship between the elements of the financial statements – assets, liabilities, equity, income, expenses, contributions from owners and distributions to owners	You should now be able to describe various ratios and identify where in the financial statements the required financial information can be found
Explain how to calculate accounting ratios – profitability, liquidity, efficiency, financial position	You should now be able to define and calculate each of the ratios discussed in this unit

Explain the inter-relationships between ratios	You should now be able to link ratios from the same category (eg liquidity), and to discuss how their results are related
Explain the purpose of the interpretation of ratios	You should now be able to discuss how ratios can be utilised by different user groups, and what purpose they can be applied to within a business
Describe how the interpretation and analysis of accounting ratios is used in a business environment.	You should now be able to discuss the application and limitations of a range of accounting ratios in a business environment

Quiz questions

1	Learning Outcome: D3
Which of the following is an example of a Liquidity ratio?	
A	Earnings per share
B	Current ratio
C	Gearing ratio
D	Asset turnover

1	Feedback
A	**Incorrect** EPS is an investor ratio Current ratio is a liquidity ratio
B	**Correct**
C	**Incorrect** Gearing ratio is a solvency, or long-term liquidity ratio Current ratio is a liquidity ratio
D	**Incorrect** Asset turnover is an efficiency or working capital ratio Current ratio is a liquidity ratio

2	Learning Outcome: D5
Which of the following is a limitation of accounting ratios?	
A	They can not be used in smaller businesses
B	They can not be used to compare different organisations
C	They are not usable for financial statements that do not comply with IFRS
D	Financial statements are historic in nature, thus any ratios calculated are based on past rather than future performance

2	Feedback
A	**Incorrect** Ratios may be applied in businesses of different sizes A limitation is that financial statements are historic in nature, thus any ratios calculated are based on past rather than future performance
B	**Incorrect** Ratios can be used to compare different organisations, but care must be taken to use in comparable organisations as far as possible A limitation is that financial statements are historic in nature, thus any ratios calculated are based on past rather than future performance
C	**Incorrect** Accounting ratios are not limited to use on financial statements based on IFRS, and can for example be used on financial statements prepared using national accounting standards. In some cases, the ratio may need to be adapted to be relevant to the content of the statements. A limitation is that financial statements are historic in nature, thus any ratios calculated are based on past rather than future performance
D	**Correct**

3	Learning Outcome: D2
Which of the following ratios requires use of the figure for finance costs?	
A	Interest cover
B	Return on capital employed
C	Current ratio
D	Gearing

3	Feedback
A	**Correct.** Interest cover = Profit from operating activities / finance costs

B	**Incorrect** Return on capital employed = (Profit from operating activities / capital employed) x 100 Interest cover = Profit from operating activities / finance costs
C	**Incorrect** Current ratio = current assets : current liabilities Interest cover = Profit from operating activities / finance costs
D	**Incorrect** Gearing = (Non-equity finance / capital employed) x 100 Interest cover = Profit from operating activities / finance costs

4	Learning Outcome: D2
How is the ratio for Average trade receivables usually expressed?	
A	As a percentage
B	As a number of days
C	As a monetary amount
D	As a number of times

4	Feedback
A	**Incorrect** The formula is (Average trade receivables / credit sales) x 365, which gives the average number of days it takes for payment to be received from credit customers
B	**Correct.** The formula is (Average trade receivables / credit sales) x 365, which gives the average number of days it takes for payment to be received from credit customers
C	**Incorrect** The formula is (Average trade receivables / credit sales) x 365, which gives the average number of days it takes for payment to be received from credit customers

4	Feedback
D	**Incorrect** The formula is (Average trade receivables / credit sales) x 365, which gives the average number of days it takes for payment to be received from credit customers

Unit E: Statutory financial statements for a limited company.

Learning outcomes

E1. Apply accounting standards and relevant legislation to correctly identify, and accurately adjust, accounting information.

E2. Use appropriate information to accurately draft a statement of comprehensive income.

E3. Use appropriate information to accurately draft a statement of financial position (balance sheet).

E4. Prepare notes to the accounts which satisfy statutory current disclosure requirements, in respect of accounting policies, non-current assets, current and long term liabilities, equity.

E5. Draft an accurate statement of cash flows.

Introduction to Unit E

In this unit our focus will be on the format of financial statements and the application of accounting standards to prepare elements of the financial statements. To do this, you will need to apply knowledge gained in the preceding units. In particular, you will need to recognise situations and events that require the application of particular accounting standards and identify the appropriate accounting treatment required by that standard. It can become quite complex when an example requires the preparation of financial statements, and the content of the question involves a number of different standards; you therefore need to apply a methodical approach to working through the requirements of the example and compiling the required statements.

You also need to be able to deal with transactions involving shares and dividends so that you can include these correctly in the financial statements for limited companies. We will look at the main transactions in the next section of this unit before applying this knowledge in practical examples.

In this unit we prepare the statement of profit or loss, the statement of financial position, and the statement of cash flows for a business. You are not required to prepare the full statements in the exam, but it is useful to see how each statement is put together so that you understand the relationships between different accounts.

Accounting standards

In Unit B of this module, we looked at a selection of IFRSs, including a brief outline of the scope and the main accounting requirements of each standard. We will look at the accounting treatment for these standards in more detail in this unit, together with numerical examples to demonstrate how these are reflected in the financial statements of a business. Here is reminder of the group of standards that we will be looking at:

IAS 1 Presentation of financial statements
IAS 2 Inventories
IAS 7 Statement of cash flows
IAS 10 Events after the reporting period
IAS 16 Property, plant, and equipment
IAS 37 Provisions, contingent liabilities, and contingent assets
IAS 38 Intangible assets
IFRS 15 Revenue from contracts with customers

Capital structure of a company

In the previous units, we have made reference to items such as ordinary share capital, debentures, dividends, etc. These are important aspects of a company's structure and funding, and it is important to understand how they are accounted for in the financial systems of a company and in the financial statements.

Equity

Owners' capital is represented by shares. This is also referred to as 'equity'. When a company is set up, it issues shares, which are paid for by investors who become shareholders. Dividends are paid to shareholders and represent an appropriation of the profit of the company.

Shareholders benefit from investing in companies by receiving dividends and by the increase in market value of their shares.

Shares can be ordinary shares or preference shares. Ordinary shares are the most common type of shares. An ordinary share gives the right to its owner to a share in the profits of the company (dividends) and a vote at general meetings of the company. However, the amount of this dividend fluctuates and is dependent on the company's financial performance in any one year. As the true owners of the company, ordinary shareholders benefit from growth in the company because their shares rise in value as a result.

Preference shareholders have priority over ordinary shareholders. Preference shares carry the right to a final dividend expressed as a fixed percentage of their par value and this

dividend is paid prior to the ordinary dividend. Unlike ordinary shares, preference shares do not carry a right to vote, and their holders do not benefit from growth in the company.

If a company requires more capital, new shares may be issued. New shares may be issued though one of the following methods:

- A general issue – shares are available to the general public.
- A rights issue – shares are only available to existing shareholders.
- A bonus issue (or scrip or capitalisation issue) – a bonus issue does not raise extra capital for the company but converts reserves to share capital.

When a company is set up shares are denominated in units of FRW 1, FRW 2, or whatever is felt to be appropriate. The face value of shares is referred to as their 'par' (or 'nominal') value. For example, when a company sets up with share capital of FRW 100,000 it may issue 100,000 shares of par value FRW 1 each, or 50,000 shares of FRW 2 each, etc.

The par value of shares will be different from their market value, which is the price at which someone is prepared to pay for shares. The market price may increase or decrease in value according to how the company and the stock market in general are performing, but the par value will not change.

Dividends

Dividends in a limited company are essentially the equivalent of drawings in a sole trader's business. It is the mechanism available to reward owners with some of the profit. Dividends reduce capital, or more specifically the retained earnings account.

Many companies pay dividends in two stages: mid-year, sometimes referred to as an interim dividend, and at the year-end, the final dividend.

Dividends to ordinary shareholders that have been proposed should not be recognised in the statement of financial position as a liability, but are disclosed as a note.

Dividends are only recognised if they have been declared, approved or paid before the statement of financial position date.

Dividends that have been declared or approved before the statement of financial position date will be debited to retained earnings (and payables credited).

Dividends that have been paid are debited to retained earnings and credited to the bank account.

Reserves

The term 'reserves' covers all surpluses existing in a company. Sole traders' profits are credited to their capital account. In a company, however, profits are carried forward under the heading of retained earnings. The statement of financial position includes various reserves, which may be capital (non-distributable) or revenue (distributable) in nature.

Revenue reserves consist of undistributed trading profits. These profits could be paid out to the shareholders as dividends. This means this is a distributable reserve. An example of a revenue reserve is the retained earnings account shown on a company's statement of financial position. The retained earnings balance is calculated as follows:

Retained earnings c/f = retained earnings b/f + profit after tax - dividends paid/ payable

Shown as a T-account, the retained earnings entries are as follows:

Retained earnings

		FRW			FRW
Dividends (bank/payables)		X	Balance b/d		X
Balance c/d		X	Profit after tax		X
		X			X

Provided that a company is earning profits, this reserve generally increases from year to year. Most companies do not distribute all profits as dividends. Even if a loss is made in one particular year, a dividend can be paid from previous years' retained earnings. One reason for retaining some profit yearly is to enable the company to pay dividends even when profits are low.

Capital reserves consist of profits and gains which cannot legally be distributed as dividends. An example of a capital reserve is a share premium account. Another example of a capital reserve is a revaluation reserve which arises when an upward revaluation of a non-current asset takes place. This is non-distributable as it represents unrealised profits on the revalued assets. The relevant part of a revaluation reserve can only become realised if the asset in question is sold, thus realising the gain (ie turning it into a current asset in the form of cash or a receivable).

Loans

Limited companies may issue loan stock or bonds. These are long-term liabilities described as loan capital because they are a means of raising finance, in the same way as issuing share capital. They are different from share capital in the following ways:

- Shareholders are members of a company; providers of loan capital are payables.
- Shareholders receive dividends (appropriations of profit); holders of loan capital are entitled to a fixed rate of interest (expense charged against revenue).
- Loan capital holders can take legal action against a company if their interest is not paid when due; shareholders cannot enforce the payment of dividends.
- Loan stock is often secured on company assets; shares are not.
- Holders of loan capital are in less risky positions than shareholders (greater security, income is fixed). Preference shares are similar to loan capital because the annual preference dividend is normally fixed.

Interest is calculated on the par value of loan capital. If a company has FRW 700,000 (par value) 12% loan stock in issue, interest of FRW 84,000 will be charged in the income statement per year. Interest is usually paid half yearly. 'Debentures' is another term for loan stock.

Tax in the financial statements

The tax expense statement of profit or loss comprises the following elements:

a) Current tax expense: This is the current year estimated tax charge which needs to be accrued for the payment of tax in the following year. This number is usually given in the additional information section of a statement of financial position/income statement question, and needs to be adjusted for with the following journal entry:

Dr Tax expense (income statement)

Cr Payables (statement of financial position)

b) An adjustment relating to previous accounting periods: The amount accrued under a) above is an estimate. Therefore, when the tax is actually paid over to the tax authorities, companies will often end up paying more or less than they accrued. The difference is shown in the accounts (income statement) for the year in which the payment is made, even though it relates to the previous year.

The adjustment relating to the previous year is usually shown in the trial balance.

- A debit balance signifies that the company had to pay more than it had accrued last year and therefore increases the total tax charge in this year's income statement.
- A credit balance signifies that it paid less than previously accrued, and this decreases the total tax charge in this year's income statement.

Tax balances in the statement of financial position are usually a current liability that represents the current tax payable for the current year. This is the estimated liability for tax to be paid over to the tax authorities after the year-end. Note that if there has been an under or over provision as a result the tax estimate made in previous accounting periods, this has no impact on the statement of financial position.

Example

In the accounting year to 31 December 20X5 Wyvis Ltd made a profit before taxation of FRW 10,000. Tax for the current year is estimated as FRW 50,000. In the previous year, tax on profits had been estimated as FRW 35,000 but it was subsequently confirmed as FRW 38,000 by the tax authority.

Show the balances relating to taxation that will be taken to the income statement for the year ending 31 December 20X5, and the statement of financial position.

Solution

Extract from income statement:

Taxation:	FRW	FRW
Current year charge	50,000	
Under-provision from 20X4 (FRW 38,000 - FRW 35,000)	3,000	
Total charge for the year		(53,000)

Extract from statement of financial position:

Current liabilities	FRW
Taxation on corporate profits	50,000

Issue of shares

It is important to understand the different types of share issue and how each affects the accounts of the company, as well as being able to reflect this in the company's statement of financial position. We will consider the three main types here.

General issues	New shares are created and offered for sale to anyone who wants to buy them. This may be at par (at the nominal value of the share) or at a premium (where the offer price is greater than nominal value).
Rights issues	New shares are created and offered for sale but the existing shareholders are invited to buy them first. Rights issues may also be issued at a premium.
Bonus issues	Similar to a rights issue in that shares are given to existing shareholders on the basis of X shares for every Y held (eg '3 for 2' means that a shareholder would receive 3 new bonus shares for every 2 shares that they currently own). Unlike general and rights issues, the bonus shares do not generate cash for the company. The shares are free to the existing shareholders. So that the accounting entries balance, the financing of the shares needs to be recorded as a reduction in the company's reserves. Issuing bonus shares is one of the few things that capital reserves can be used for. To account for a bonus share issue, the share capital account and the share premium account need to be adjusted. If the share premium account is insufficient to account for the full bonus issue, the retained earnings account would usually be used to account for any shortfall.

Shareholders' equity

Share capital and reserves are 'owned' by the shareholders. They are known collectively as 'shareholders' equity'. Shareholders' equity consists of the following:

- Par value of issued capital.
- Other equity.

The share capital itself might consist of both ordinary shares and preference shares. However, it is the ordinary shareholders, who own the 'equity' in the company i.e. they own all reserves. Other equity consists of:

- Share premium (ie capital paid up in excess of par value)
- Revaluation reserve

- Retained earnings
- Other reserves (eg a general reserve)

The 'premium' aspect of the share premium account refers to the difference between the issue price of the share and its par value. A share premium account comes into being when a company issues shares at a price in excess of their par value. The market price of the shares has no bearing on the company's accounts.

A share premium account is an account that is credited for any premium arising as a result of a share issue. The account constitutes capital of the company which cannot be paid out in dividends (it is a capital reserve). The reason for creating capital (or 'non-distributable') reserves is to maintain the capital of the company. This provides security for the company's creditors. One common use of the share premium account is to 'finance' the issue of bonus shares, as mentioned above.

Accounting for a general issue

Bookkeeping entries for a general issue of 50,000 ordinary shares issued at par value of FRW 10:

	Debit	Credit
Bank account	500,000	
Ordinary share capital account		500,000

For 50,000 ordinary FRW 10 shares issued at a premium (i.e. sale price is in excess of par value) of FRW 2 each, the bookkeeping entries would be:

	Debit	Credit
Bank account (50,000 * FRW 12)	600,000	
Ordinary share capital account (50,000 * FRW 10)		500,000
Share premium account (50,000 * FRW 2)		100,000

Accounting for a rights issue

In a rights issue, new shares are created and offered for sale, but the existing shareholders are offered the chance to buy them first. This is usually on the basis of shareholders being given the right to buy a certain number of shares for every share currently held. For example, a 3 for 5 rights issue would mean that for every 5 shares owned the shareholder has the option to buy a further 3 shares.

The bookkeeping entries for a rights issue will be the same as for a general issue. This is because the impact on the company is exactly the same – it has more cash and more ordinary shares. The only difference is who they are being offered to initially.

Accounting for a bonus issue

A company has an issued and fully paid ordinary share capital of 10,000 ordinary shares with a par value of FRW 25 each. It issues bonus shares on a 3-for-5 basis. The company

currently has a FRW 100,000 balance on a share premium account.

10,000/5 * 3 = 6,000 new shares are issued at FRW 25 each (note, this is not a cash transaction).

	Debit	Credit
Share premium account	100,000	
Retained earnings	50,000	
Ordinary share capital account (6,000 bonus shares at FRW 25)		150,000

Share capital and reserves

For issued share capital and reserves, IAS 1 requires the following disclosures:

- Number of shares authorised, issued and fully paid, and issued but not fully paid
- Par value
- Reconciliation of shares outstanding at the beginning and the end of the period
- Descriptions of rights, preferences and restrictions
- Shares in the entity held by the entity, including shares held by subsidiaries and associates
- Shares reserved for issuance under options and contracts
- A description of the nature and purpose of each reserve within equity.

Application of IFRS

Before we look at the preparation of full financial statements, we need to return to the set of standards that were introduced in Unit B.

In Unit E, we need to consider in more detail how the individual standards are applied, and to work through examples to see how the amounts to be included in the financial statements are determined.

The standards we are looking at here are listed below in the order that we will consider them in this unit (note that those dealing with consolidated financial statements will be considered in Unit F):

- IAS 16 Property, plant and equipment
- IAS 2 Inventories
- IAS 10 Events after the reporting period
- IAS 37 Provisions, contingent liabilities, and contingent assets
- IAS 38 Intangible assets

- IFRS 15 Revenue from contracts with customers

IAS 16 Property, plant and equipment

IAS 16 is a central standard, as it deals with the accounting treatment of important assets, and covers the events and transactions that arise throughout the life of these assets:

- Additions (acquiring assets through purchase or other transactions)
- Depreciation
- Revaluation (and impairment)
- Improvement or other modification
- Disposal (through sale or other events)

We will look at the accounting treatment for each of these in this section of Unit E

Additions

Acquisition of assets that come within the definition of property, plant and equipment, is an example of capital expenditure, i.e. the creation of a non-current asset. The accounting entry for an addition is:

Dr Asset account (e.g. buildings, vehicles)

Cr Bank or payables

Property, plant and equipment assets are initially measured at historic cost (i.e. what the business paid for it). The cost of the asset includes the purchase price, plus other costs that are directly incurred in acquiring the asset or bringing it to its required condition or location (eg delivery or installation costs).

Expenditure to improve the asses (or enhancement expenditure) is expenditure that adds value to the asset. For example, expenditure that results in increasing the asset's capacity, improving the quality of output, extending the economic life of the asset or reducing the operating costs of the asset. This expenditure can be capitalised, and this is recorded using the same double entry as shown above for the initial acquisition.

However, expenditure on ongoing repairs and maintenance, or any other regular expenditure related to an asset that does not increase or otherwise improve the asset in some way, cannot be capitalised. So, the cost of replacing a broken window in a building would not be capitalised, but would be treated as an expense in the statement of profit or loss.

Depreciation

A depreciation charge is used to recognise the ongoing cost of having the asset and using it in the course or running the business's operations. It is, therefore, the accounting mechanism for ensuring that the accounting period bears the expense of utilising property, plant and equipment during an accounting period.

Each expense should be charged to the appropriate accounting period (irrespective of

when the cash transaction takes place), and we need to match the cost of using the asset with the benefits derived from it. We therefore recognise depreciation each year that the asset is in productive use in the business (for its useful economic life).

The depreciation charge achieves two impacts:

- It includes an expense in the statement of profit or loss (debit).
- It reduces the value of the asset in the statement of financial position (credit).

Note that land is not depreciated as it is deemed to have an infinite useful economic life.

Straight line method of depreciation

This approach results in a charge that is the same in each year of the asset's life. The following formula can be used to determine the depreciation charge

Depreciation charge = (Cost of asset – Residual value) / Number of years

The residual value is the amount that it is estimated the business can sell the asset for at the end of its useful life.

For example,

Cost	=	FRW 110,000
Residual value	=	FRW 10,000
Number of years	=	10 years
Depreciation charge	=	(110,000-10,000) / 10 = FRW 10,000

Reducing balance method

Using the reducing balance method, depreciation is calculated by charging a fixed percentage on the asset's carrying amount (net book value) each year. The carrying amount is the amount recognised in the asset cost account minus any depreciation to date.

The reducing balance method acknowledges that for some non-current assets (such as plant, equipment and vehicles) the benefits derived may be higher in the earlier years. And, therefore, the depreciation charge should be higher in the early years, decreasing through the asset's economic life.

Example:

A vehicle was purchased for FRW 250 million and is expected to be sold for FRW 30 million in 3 years. Depreciation is to be calculated using a fixed rate of 50% using the reducing balance method.

Over the life of the asset, the depreciation charge, carrying value and accumulated depreciation will be as follows:

Year	Cost FRW million	Depreciation charge	Accumulated depreciation	Carrying Amount
1	250	125	125	125
2	250	62.5	187.5	62.5
3	250	31.25	218.75	31.25

The reducing balance method does not bring the carrying amount to zero at the end of the asset's useful economic life. But, in this example, it is brought close to the expected residual value. When the asset is disposed of, the entity will calculate a profit or loss on disposal by comparing the carrying amount at the time of disposal to the actual cash proceeds from selling the asset.

Depreciation is recognised as an annual expense. For example, in year 1 for the example above, the double entry would be:

Dr	Depreciation expense	FRW 125 million
Cr	Accumulated depreciation account	FRW 125 million

Note that the ledger account containing the original cost of the asset is not usually affected by depreciation. Instead, an accumulated depreciation account is usually maintained for each class of property, plant and equipment.

Statement of financial position as at end of year 1:

	Cost	Accumulated depreciation	Carrying amount
Vehicles	250	(125)	125

The accumulated depreciation shows the extent to which the asset has been charged as an expense in previous accounting periods.

The carrying amount represents the extent to which the asset has yet to be consumed as an expense in future accounting periods.

Exercise E1

An item of equipment has been acquired for FRW 550 million. It is expected to be used in the business for three years. An agreement has already been made that it will be sold for FRW 50 million at the end of the third year.

(a) Calculate of the amount of depreciation each year using the straight line method

(b) Calculate of the amount of depreciation each year using the reducing balance method at a rate of 55%.

You may 'round' the depreciation charge each year to the nearest FRW million

Exercise E1 solution				
(a)	Cost	Depreciation	Accumulated depreciation	Carrying amount
Year 1	550	167	167	383
Year 2	550	167	333	217
Year 3	550	167	501	49
(b)				
Year 1	550	303	303	247
Year 2	550	136	439	111
Year 3	550	61	500	50

Disposal of non-current assets

A business may dispose of an asset when it is no longer needed, or if it is damaged, or for other reasons. The actual reason does not impact on the accounting for the disposal.

Two actions are necessary to account for the disposal:

- We need to remove the asset from the business's books, so that there are no longer any balances in the ledgers that relate to this asset. This means that we need to know what entries have been made previously – these will principally be the cost of the asset and the accumulated depreciation.
- We need to determine whether a profit or loss has been made in the disposal. This is determined by comparing the selling price with the net book value of the asset at the time of the disposal.

To account for the disposal, we need to set up a disposal account, which is used to determine any profit or loss on disposal on the transaction.

We remove the non-current asset from the accounting records (this will either be the initial cost or the new valuation if the asset was re-valued) and post it in the disposal account:

Dr Non-current asset disposal account

Cr Non-current asset cost account

All depreciation associated with that asset being disposed of must also be removed from the relevant account. To do this, we need to know how much depreciation has been charged to date:

Dr Accumulated depreciation account

Cr Non-current asset disposal account

The balance in the non-current asset disposal account is now the asset's carrying amount (ie the difference between the asset's cost and its accumulated depreciation to date).

We then record the amount received for the sale of the asset (the proceeds on disposal).

Dr Cash / bank or receivables

Cr Non-current asset disposal account

The balance on the disposals account will now represent the profit or loss on the sale and should be transferred to the statement of profit or loss.

If there is a credit balance on the non-current asset disposal account, then there is a profit on the sale:

Dr Non-current asset disposal account

Cr Income statement

If there is a debit balance, then a loss has been made on the sale:

Dr Statement of profit or loss

Cr Non-current asset disposal account

Exercise E2

Company QP purchased equipment in Year 1 for FRW 330 million. At the end of Year 4, the equipment has been depreciated by FRW 210 million. It was sold at the end of Year 3 for FRW 85 million.

Calculate the profit or loss on disposal of the equipment.

Exercise E2 solution

Disposal account

Equipment at cost	330	Accumulated depreciation	210
		Bank	85
		Loss on disposal	45
	330		330

Revaluation

In this unit, we have looked at situations where assets are valued at historic cost, ie the figure shown in the accounts is the amount paid to acquire or create the asset. IAS 16 also allows non-current assets to be subsequently revalued. To ensure that the statement of financial position provides useful and relevant information, a company may revalue property, plant and equipment (usually land or buildings) so that the asset values are more up to date.

An important point to note is that when a non-current asset is revalued, depreciation is charged on the *revalued amount* (over the remaining useful life).

The simplified double entry for revaluation is as follows:

Dr Asset account

Cr Revaluation reserve

The relevant non-current asset account is debited to increase its value to the revalued amount. The corresponding credit goes to the revaluation reserve; this is a capital reserve which appears in the capital section of the statement of financial position.

When an asset has been depreciated prior to the revaluation taking place, it is important take this accumulated depreciation into account so that the resulting carrying amount reflects the revalued amount for the asset. The following worked example demonstrates this.

Exercise E3

Company HG owns property that cost FRW 3 million in Year 1. At the end of Year 5, accumulated deprecation was FRW 0.4 million.

Comparison with other properties in the city, the company have identified that the asset has a current market value of FRW 5 million.

How should this be reflected in the financial statements at the end of Year 5?

Exercise E3 solution

The statement of financial position should include the asset at a carrying amount of FRW 5 million.

This can either be shown as :	Cost	5.0
Accumulated depreciation		0
Carrying amount		5.0
Revaluation reserve		2.4
Or as:	Cost	5.4
Accumulated depreciation		(0.4)
Carrying amount		5.0
Revaluation reserve		2.4

IAS 2 Inventories

The following requirement from IAS 2 sets out the key feature of the approach to measuring inventories:

> **'Inventories should be measured at the lower of** *cost* **and** *net realisable value'*

We will look at the two key terms referred to – ie 'cost' and 'net realisable value'

Cost of inventory

We usually think of 'cost' as simply being the purchase price of the asset, but IAS 2 includes several potential elements of cost, ie:

- Costs of purchase
    - Import duties
    - Other taxes
    - Transport (carriage in)
    - Cost of handling
    - Any other cost directly attributable to the acquisition of finished goods, services and materials
- Costs of conversion
    - Costs directly related to the units of production, for example direct materials, direct labour.
    - Fixed and variable production overheads that are incurred in converting materials into finished goods, allocated on a systematic basis.
- Other costs incurred in bringing the inveWntories to their present location and condition

The standard also notes costs that can not be included in the cost of inventory:

- Abnormal amounts of wasted materials, labour or other production costs
- Storage costs
- Administrative overheads unrelated to production
- Selling costs

The cost of inventories should be assigned by specific identification of individual costs, which may include:

- Items which are not ordinarily interchangeable.
- Goods or services produced and segregated for specific projects.

Specific costs should be attributed to individual items of inventory when they are segregated for a specific project, but not where inventories consist of a large number of identical or very similar items. In the latter situation, one of two approaches may be taken – first in, first out method (FIFO) or weighted average cost (AVCO).

Two further techniques are mentioned by the standard, both of which produce results

that approximate to cost, and so either of these is permitted:

- Standard costs are set up to take account of normal production values: amount of raw materials used, labour time and so on. They are reviewed and revised on a regular basis.
- Retail method - this is often used in the retail industry where there is a large turnover of inventory items which nevertheless have similar profit margins. The only practical method of inventory valuation may be to take the total selling price of inventories and deduct an overall average profit margin, thus reducing the value to an approximation of cost.

Net realisable value of inventory

Net realisable value (NRV) is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

As a general rule assets should not be carried at amounts greater than those expected to be realised from their sale or use. In the case of inventories this amount could fall below cost when items are damaged or become obsolete, or where the costs to completion the inventory in order to make it ready for sale have increased.

The assessment of NRV should take place at the same time as estimates are made of selling price, using the most reliable information available. Net realisable value must be reassessed at the end of each period and compared again with cost. If the NRV has risen for inventories held over the end of more than one period, then the previous write-down must be reversed to the extent that the inventory is then valued at the lower of cost and the new NRV. This may be possible when selling prices have fallen in the past and then risen again. Sometimes, a write-down to NRV may be of such size, incidence or nature that it must be disclosed separately.

Recognition as an expense

The following treatment is required when inventories are sold:

- The carrying amount is recognised as an expense in the period in which the related revenue is recognised (cost of sales).
- The amount of any write-down of inventories to NRV and all losses of inventories are recognised as an expense in the period that the write-down or loss occurs (by reducing value of closing inventory).
- The amount of any reversal of any write-down of inventories, arising from an increase in NRV, is recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs (by increasing value of closing inventory).

Example: Endeavour Ltd has three items of inventory: products Aon, Dha and Tri. Using the following information, calculate the total value of inventory held by Endeavour Ltd.

	Aon	Dha	Tri
Cost (FRW 000)	15	7	14

Selling price (FRW 000)	18	14	25
Modification cost to enable sale (FRW 000)	3		5
Additional marketing costs (FRW 000)	5	1	4
Units held (units)	300	400	500

To determine the correct closing inventory valuation, we need to determine the cost and NRV of each item. The NRV is calculated as selling price less any modification costs and also less any marketing costs. This gives the following NRVs and hence the following inventory valuation:

Product	Cost	NRV	Valuation	Quantity	Total value
Aon	15	10 *(=18-3-5)*	10	300	3,000
Dha	7	13 *(= 14-1)*	7	400	2,800
Tri	14	16 *(=25-5-4)*	14	500	7,000
Total					**12,800**

IAS 10 Events after the reporting period

In Unit B, we noted that IAS 10 distinguishes between adjusting and non-adjusting events.

Adjusting events	Events that provide evidence of conditions that existed at the reporting date	These events must be reflected in the financial statements
Non-adjusting events	Events that are indicative of conditions that arose after the reporting date (but do not provide evidence of conditions)	These events must not be reflected in the financial statements. Material ones must be disclosed by note, if non-disclosure could affect the economic decisions of users of the financial statements

Examples of adjusting events:

- Settlement of a court case confirming a present obligation at the reporting date
- Customer declared bankrupt soon after reporting date
- Sale of inventories soon after reporting date for less than the value in statement of financial position
- Discovery of fraud or error affecting the financial statements

Examples of non-adjusting events:

- Inventory destroyed in a fire after reporting date
- Decline in market value of investments after reporting date
- Major business combination/restructure after reporting date

Going concern

IAS 10 requires that an entity's financial statements must not be prepared on a going concern basis if its management determines after the accounting date that it intends to liquidate or cease trading, or that it has no realistic alternative but to do so.

Some of the valuation bases used under the going concern method would not be appropriate for a company that is going to be liquidated or cease trading. For example, any plant and machinery in a company's factory is generally held at historic cost less accumulated depreciation under IAS 16, but if the company is to be liquidated it would of course be more appropriate to value plant and machinery at whatever it can be sold for by the company, which may be nil.

Date of authorisation

IAS 10 requires that the date of authorisation for issue of the financial statements must be disclosed, together with the name of the person authorising, usually a director. This disclosure is important, because this date marks the end of the period in which events after the reporting period are reflected in the financial statements.

Exercise E4

Identify whether the following are adjusting or non-adjusting events and state how each should be treated in the financial statements of the company.

1. Two weeks after the year end, a major customer was declared bankrupt. It is now anticipated that although the customer owed FRW 150,000 as at the year end, only 20% of the debt will be collected. Closing trade receivables are FRW 500,000.
2. 20 days after the reporting date, there was a flood that destroyed a large amount of inventory. The inventory destroyed had been included in the closing inventory at FRW 80,000.
3. Twelve days after the reporting date an item of inventory was sold for FRW 27,000. This item was included in the closing valuation at FRW 52,000. Closing inventory has been valued at FRW 205,000.

Exercise E4 solution

1. This is an *adjusting* event as the conditions were in place at the reporting date The debt should be written off to the extent that it will not be collected (ie 80% of the 150,000, which is FRW 120,000).

Dr Expenses	FRW 120,000
Cr Trade receivables	FRW 120,000

2. This is a *non-adjusting* event per IAS 10. The conditions were not in place at the reporting date. The amount is material so it should be disclosed in a note to the accounts.
3. This is an *adjusting* event.

The NRV is FRW 27,000, therefore inventory is overvalued in the statement of financial position by FRW 25,000 (52,000 – 27,000).

Dr	Cost of sales	FRW 25,000
Cr	Inventory	FRW 25,000

IAS 37 Provisions, contingent liabilities, and contingent assets

IAS 37 gives guidance to follow when faced with situations involving uncertainty, so that the accounting treatment is reasonably clear, despite the inherent uncertainty in the situation itself. There are several types of situation that involve a degree of uncertainty, and it is therefore necessary to have guidance on how to account for that uncertainty. For example, if a former employee enters in legal action against a company, and as a result the company may have to pay the employee significant amounts of money, it is not certain what (if any) liability exists until the situation is resolved (eg by a court or tribunal ruling).

Provisions

IAS 37 gives the following definition of a provision:

> A provision is a liability of uncertain timing or amount.
>
> A liability is an obligation of an entity to transfer economic benefits as a result of past transactions or events.

IAS 37 makes a distinction between provisions and other liabilities such as trade payable and accruals. In the case of a provision, there is uncertainty about the timing or amount of the future expenditure. While uncertainty is clearly present in the case of some accruals transactions, the uncertainty is generally much less than for provisions.

IAS 37 states that a provision should be recognised as a liability in the financial statements when all three of the following criteria have been met:

1. An entity has a present obligation as a result of a past event
3. It is probable that an outflow of economic benefits will be required to settle the obligation
4. A reliable estimate can be made of the obligation.

A present obligation as a result of a past event:

This criterion means that an event in the past must have triggered a *potential* liability. An example is that a company is being sued by an employee as a result of an accident at work. In this instance, the past event would be the accident and the initiation of legal proceedings. The obligation would be the need for the company to pay the employee in the future to settle the claim (which at this stage is uncertain).

Note that as well as situations where there is a clear legal obligation, a provision can arise where there is no legal obligation but there is a *constructive* obligation. A constructive obligation arises when the company's pattern of policies and practices has indicated to other parties that it will accepts certain responsibilities, and has therefore created a valid expectation that it will discharge these responsibilities.

A probable outflow of economic benefits

Usually, this results in a payment being made, but it could also refer to a transfer of other assets or providing a service free of charge. The criterion is satisfied if it is over 50% likely that the obligation will have to be settled. Legal advice will usually be required to determine whether the company is likely to lose the case or not.

A reliable estimate

A reliable estimate is needed for every figure in the financial statements, including provisions. In the example above, the legal experts would advise on the estimated amount that would be paid if the case was lost by the company.

Accounting treatment:

Provisions are charged to expenses in the income statement (debit) and the liability is recognised within the statement of financial position (credit).

Dr Expense (Income statement)

Cr Liability – current or non-current (SFP)

IAS 37 also requires that provisions should be reviewed at each accounting date and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision should be reversed. It is also a requirement that a provision should be used only for expenditures for which the provision was originally recognised. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Example

In 20X4, Company LOM was being sued by a former employee for discrimination. LOM's legal team have advised that they are likely to have to pay compensation of around FRW 20 million. In 20X5, the case was decided in court and the company was ordered to pay the employee FRW 25 million.

Before a provision can be recognised, all three criteria need to be met:

1. Present obligation as a result of a past event:

- The past event was the alleged discrimination and the subsequent legal action
- The present obligation is the legal obligation to pay compensation following the court case.

2. Probable transfer of economic benefits will be required to settle the obligation:
    - As the legal team advise that the company is likely to have to pay compensation, then this criterion has been met.
3. A reliable estimate can be made of the obligation:
    - The legal team have been able to estimate likely compensation (ie FRW 20 million) based on similar cases.

The accounting entry for making a provision in the 20X4 accounts will be:

Dr Expense – creation of provision	FRW 20 million
Cr Provisions (current liabilities)	FRW 20 million

If it is likely that settlement will have to be paid within one year, then the provision will be categorised as a current liability.

In the following year, LMO pays compensation of FRW 25 million, rather than the FRW 20 million previously estimated by its legal advisors. This will require an additional expense, as the initial provision is not enough to cover the settlement amount:

Dr Expense – increase in provision	FRW 50 million
Dr Provisions (liabilities)	FRW 20 million
Cr Bank	FRW 25 million

Contingent liabilities

The second part of IAS 37 deals with contingent liabilities. This kind of liability arises in one of the following situations:

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

A present obligation that arises from past events but is not recognised because:

- It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or
- The amount of the obligation cannot be measured with sufficient reliability.

Although a provision and a contingent liability are identified as distinct type of liability in IAS 37, there is some overlap in the situations that give rise to them, as a liability that fulfils some but not all of the three criteria for a provision will be treated as a contingent liability.

Accounting treatment:

Contingent liabilities should **not** be recognised in the financial statements, but may require disclosure.

Contingent liabilities should be assessed continually to identify whether the criteria for recognising a provision have been met.

Contingent assets

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. An example of a contingent asset is the possible gain arising from a pending legal action or other claim.

Accounting treatment:

Contingent assets must **not** be recognised. It is only when the potential economic benefits become virtually certain that they should be recognised, because then the asset is no longer contingent (ie it does not depend on a future event).

Contingent assets should be assessed continually to identify whether the uncertainty has been removed. If events confirm the existence of an asset, it should be recognised provided that it can be measured reliably.

Exercise E5

For each of the events below, determine whether how they should be treated in the financial statements of Company AC according to IAS 37:

1. The government have passed legislation, which comes into force in a year's time. As a result, Company AC will need to spend FRW 1 million on new software.
2. Company AC have admitted legal liability in relation to a claim by Company M, but the amount of damages to be paid has not been decided yet.
3. Company AC have taken Company W to court, and have been advised that they are likely to win the case and will be due compensation of approximately FRW 2 million from Company W.

Exercise E5 solution

1. No action is required, as the obligation arises from a *future* event (the legislation is not yet in force). Both provisions and contingent assets require the obligation to arise from past events.
2. Company AC has admitted liability, so the obligation exists and arises from past events. It meets two of the three criteria for recognition as a provision, but to be included in the accounts a reliable estimate of the amount is required. It should be disclosed in a note to the accounts, as a contingent liability.
3. In this case, there is a potential asset that arises from past events. This is therefore a contingent asset. It should not be included in the financial statements, but should be assessed continually to determine whether it is virtually certain of being paid, in which case it will no longer be contingent and can be accounted for as an asset (ie a receivable).

IAS 38 Intangible assets

The definition of an intangible asset given in IAS 38 is:

An intangible asset is an identifiable non-monetary asset without physical substance

The standard provides guidance on how to account for different types of intangible asset, but in this unit we will focus on the treatment of research and development costs. Goodwill is discussed in Unit F, in the context of consolidation.

Although the terms 'research' and 'development' are often taken together, IAS 38 requires them to be accounted for separately and in quite different ways.

We can refer to the accounting concepts of accruals and matching to see how IAS 38 approaches the question of whether certain costs can be capitalised – ie treated as a non-current asset, rather than as an expense for the reporting period. For example, If a motor car company spends millions of pounds developing a new model before it becomes available for sale, should they have to write off these expenses to the income statement, potentially incurring a loss for many years before becoming profitable? It is important to note that the business is aiming to match expenditure to related income, but no income is being generated in this situation for several years.

The answer to this scenario is that in certain specific cases this type of costs can be capitalised. Such capitalised costs are then amortised (this is the term used for depreciation of intangible assets) over the life of the product (ie usually the period over which sales are expected to be generated).

Accounting treatment of research and development costs:

Research costs	Research costs must be charged as an expense to the income statement
Development costs	Development costs should be capitalised and recognised as an intangible non-current asset on the statement of financial position

The standard also outlines specific criteria which, when demonstrated by the entity, result in the recognition of development expenditure as an intangible asset. You may find it helpful to use the initial letters of the six criteria to remember them (STEMIC):

Sellable or useable by the entity
Technically feasible to complete it such that it can become sellable or usable
Economic benefits must be expected to flow to the entity from the development of the intangible asset
Measurable expenditure – the entity can determine the costs incurred in developing the intangible asset
Intention to complete – the entity must be able to demonstrate its intention to complete the development of the intangible asset
Completable – the entity can demonstrate it has adequate technical, financial and other resources to complete the development of the intangible asset

The accounting treatment for research costs is that they should be written off to the statement of profit or loss as an expense as they are incurred.

Dr Expense

Cr Bank/payables

The accounting treatment for development costs is either that they should be written off to statement of profit or loss as an expense as they are incurred if they don't meet the criteria for capitalisation; or they should be capitalised if they do meet all the criteria. Where development costs are capitalised, they are recognised as an intangible asset (non-current asset in the statement of financial position) and amortised over the useful life once commercial production and related benefits (eg sales) commence.

So if the costs meet all criteria for capitalisation the following accounting entries are required:

Dr Intangible assets

Cr Bank or payables

Then the expenditure is brought into the statement of profit or loss over a specified period, matched to the income generated from the development project. This is called amortisation, and it is exactly the same as depreciation.

Dr Expense

Cr Accumulated amortisation

Exercise E6

New Limits Ltd has recently significantly increased its investment in research and development in order to produce improved products. Management are keen to know whether any of the costs incurred can be treated as capital expenditure and can be recognised in the statement of financial position. The costs incurred in the past year were as follows:

1) FRW 16 million was spent on salary costs of the team that were in the final stages of the development of a new technology. The new technology is in its final stages of testing and expected to come into use next financial year. The technology is expected to result in savings in production costs for the company of around FRW 5 million per year, and it will have a useful economic life of 4 years.

2) FRW 3 million was spent on the development of a new production processes. The project is in its early stages, but management are confident it will lead to cost savings, and forecast that the new process will be ready for implementation in between 5 and 10 years. The Director of Finance is concerned that the time horizon for the development of the product is too long, and she believes the organisation should focus its resources on projects that are closer to implementation.

How should these two items be accounted for?

Exercise E6 solution

1) From the information available this expenditure appears to meet the criteria for recognition of an asset as per IAS 38 Intangible Assets:

- The proposed technology can be used by the entity.
- The information available suggests it is technically feasible.
- Economic benefit is expected to be received by the entity in the form of cost savings.
- The expenditure is measurable and identified as FRW 4 million (ie 16/4 years).
- The organisation has the intention to bring it into use next year (and hence to complete it).

Given the organisation is in the pre-implementation final test stage, and no concerns about feasibility have been raised it would be reasonable to conclude that the project will be completed by the entity.

Accounting entries:

Dr	NCA Intangible assets	FRW 4 million
Cr	Expenses	FRW 4 million

(assuming this is where the expenditure has already been recorded)

The assets will be amortised when they come into use and result in economic benefits for the entity.

2) The expenditure does not meet all six criteria for recognition and will therefore be written off in the income statement. Specifically, the entity does not appear to have a clear intention to complete the project, and seems unlikely the resources needed in order to complete it will be given to the project.

Also, noting the expected time horizon before completion and that the project is in its early stages, there is still some uncertainty as to whether it is technically feasible or whether it will genuinely result in future economic benefits (cost savings) for the entity.

IFRS 15 Revenue from contracts with customers

Revenue is an important measure of an entity's performance. It is used widely by investors and other users for making comparisons and investment decisions.

Core principles

The core principles within the standard are that an entity should recognise revenue all of the following apply:

- It transfers goods or services to a customer based upon the amount of consideration (payment) to which the entity expects to be entitled from the customer.
- The goods or services are transferred when the customer has control of them.
- The disclosures are designed to help investors understand the nature, amount, timing and uncertainty of revenue.

Entities most affected by this standard are likely to be those offering complex bundles of goods and services or provide long-term service contracts such as a mobile phone company offering a handset and the ability to make calls.

There are a number of key terms in this standard, and it is important that you are familiar with their definitions:

Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
Revenue	Income arising in the course of an entity's ordinary activities.

Income	Increases in economic benefits in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity (other than those from equity participants).
Stand-alone selling price	The price at which a good or service would be sold separately to a customer.
Performance obligation	A promise to transfer to the customer either: (i) a distinct (bundle of) goods or services (ii) a series of substantially the same distinct goods or services that have the same pattern of transfer to the customer, and the pattern of transfer is both over time and represents the progress towards complete satisfaction of the performance obligation.

Five-Step model

IFRS 15 establishes a five-step model that will apply to revenue earned from a contract with a customer, regardless of the type of revenue transaction or the industry. Every entity must follow this five-step model in order to comply with IFRS 15.

Step 1: Identify the contract(s) with the customer	A contract can be written, oral or implied but for IFRS 15 to apply the following criteria must be met: • Parties have approved the contract and are committed to perform their responsibilities • Parties can identify the payment terms • The contract has commercial substance • It is probable that the consideration will be paid.
Step 2: Identify the performance obligations in the contract	It is crucial to identify the performance obligations in the contract. This is because it is only when those performance obligations are satisfied that revenue can be recognised. Remember that the performance obligation is the promise to provide goods or services. Goods or services are distinct if they can be sold separately. The distinctiveness of the goods or services is crucial in identifying a separate obligation.
Step 3: Determine the transaction price	A business needs to determine the amount of consideration it expects to receive in order to recognise revenue.

Step 4: Allocate the transaction price	For a contract that has more than one performance obligation, an entity should allocate the transaction price to each performance obligation. This allocation should be based on the relative stand-alone selling price of the goods or services.
Step 5: Recognise revenue when or as a performance obligation is satisfied	A performance obligation is satisfied when control of the goods or services is transferred to the customer.

In Step 5, performance obligation can be satisfied *at a point in time* **or** *over a period of time***.**

Performance obligations satisfied over a period of time

For a performance obligation to be satisfied over a period of time it must meet any one of the following criteria:

- The customer simultaneously receives and consumes the benefit provided by the entity's performance as the entity performs it.
- The entity's performance creates or enhances an asset, for example, work in progress, that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed.

Performance obligations satisfied at a point in time

The key is to determine the date that control is transferred. IFRS 15 gives the following as indicators that control has been transferred:

- The entity has a present right to payment
- The entity has transferred physical possession of the asset
- The customer has accepted the asset
- The customer has the significant risk and rewards of the asset
- The customer has legal title to the asset.

Example

A computer manufacturer agrees to supply 50 computers on 1 December 20X6. The price is agreed at FRW 20 million. An invoice, dated 15 December 20X6 was issued to the customer.

How should revenue on this contract be recognised?

Solution

The contract is for the supply of computers and the performance obligation is the promise to supply these computers. The transaction price is FRW 20 million and there is only one performance obligation.

The final step then is to determine when the performance obligation is satisfied and control is transferred. The contract does not meet any of the criteria to be recognised over a period of time so should be recognised at a point in time.

They should recognise revenue at the date the computers are supplied as the indicators are that control is transferred at that date, this being 1 December 20X6, although invoice was dated 15 December 20X6.

Exercise E7

An airline manufacturer agrees to manufacture a specialised plane for a customer. The plane cannot be used by the manufacturer and the contract specifies that payments are due throughout the period of manufacture.

Discuss whether the revenue should be recognised over a period of time or over at a point it time

Exercise E7 solution

Looking at the criteria for recognising over a period of time, the third criterion is met as the asset is being created for the customer and has no alternative use. Also, the contract allows for payments throughout the manufacturing period from the customer to the manufacturer.

Revenue should be recognised over a period of time and the manufacturer would then need to decide how to recognise the revenue over that period of time.

When a contract spans more than one accounting period and meets one of the criteria to be recognised over a period of time the entity will need to determine how to best recognise the revenue over that period of time.

The standard says this should be done by a method that best depicts the transfer of goods or services.

Example

Company BB enters into a cleaning contract for an agreed price of FRW 192 million, to provide cleaning services to a school over a 24 month period.

Discuss how Company BB should recognise the revenue for this contract.

Solution

There is a clear contract with a single performance obligation and a contract price of FRW 192 million. The contract meets one of the conditions for the revenue to be recognised over a period of time as the customer receives and consumes the benefit as it is provided.

Company BB would then have to decide how best to spread the revenue over the 24 month period. The most likely method given the service provided is to spread the FRW 192 million evenly over the contract, so they would recognise FRW 8 million a month as revenue.

An entity may agree to build an asset for another entity and that may take place over a few years. This was previously known as a 'construction contract'.

The standard requires the entity to choose a method of revenue recognition that best depicts performance. This may be either:

- An input method – for example based on the percentage of cost incurred to date compared to the total costs.
- An output method – for example based on work certified to date.

Example

A business is awarded a contract to build a sports centre for an agreed price of FRW 300 million and they expect the costs to be FRW 200 million. At their year end they have spent FRW 100 million and they estimate that future costs to complete will be FRW 110 million . A surveyor values the work completed to date as FRW 150 million

Solution

Using the input method the contract will be 48% complete at the year end, this is calculated by taking cost incurred to date over total expected costs (FRW 100 million / FRW 210 million). This percentage would then be used to calculate the amount of revenue and cost to be recognised on the contract.

Using the output method the contract will be 50% complete at the year end, this is calculated by taking the work certified over the total contract value.

The following approaches can be used to calculate the figures required for the statement of profit or loss and the statement of financial position:

Statement of profit or loss

Revenue (total contract revenue x % complete)	X
Less: Cost of sales (total contract cost x % complete)	(X)
Profit/loss	X/(X)

Statement of financial position

Costs incurred	X
Profit recognised (as in statement of profit or loss)	X
Less: Progress billings	(X)
Contract asset/(liability)	X/(X)

Exercise E8

Entity K has two outstanding contracts (Contract A and Contract B) with two customers to design and deliver customer-specific machines.

Entity K has determined that it is appropriate to measure the performance obligations to date based on the stage of completion.

	Contract A	Contract B
Contract prices	FRW 15 000 000	FRW 18 000 000
Costs incurred	FRW 6 000 000	FRW 6 000 000
Estimated further costs to completion	FRW 4 000 000	FRW 6 000 000
Stage of completion	50%	50%
Amount billed to customer	FRW 7 500 000	FRW 10 800 000

Exercise E8 solution

The relevant recognition requirements of the contracts are as below:

	Contract A	Contract B
Statement of profit or loss:		
Revenue (50% × contract price)	7 500 000	9 000 000
Direct contract expenses		
(50% × total costs)	(5 000 000)	(6 000 000)
Gross profit	2 500 000	3 000 000
Statement of financial position:		
Contracts in progress:		
Costs incurred	6 000 000	6 000 000
Recognised profits in statement of profit or loss	2 500 000	3 000 000
	8 500 000	9 000 000
Less: Progress billings	(7 500 000)	(10 800 000)
Contract asset/ (liability)	1 000 000	(1 800 000)

Exercise E9

Dotafone gives free phones when customers enter into a three year mobile phone plan. Dotafone have correctly allocated the transaction price with FRW 1 million relating to the phone and FRW 4.2 million to the network service provided.

On 1 January 20X5 they entered into 500 of these contracts and their year end is 31 December.

Calculate the amounts that will be shown in revenue for the three years of the contract.

Exercise E9 solution

	FRW million
Year 1 – handset (1 million × 800)	500
Year 1 – network service (4.2/3 × 500)	700
Year 1 – Total 1	1,200
Year 2 – network services	700
Year 3 – network services	700

Preparation of complete financial statements – statement of profit or loss, statement of financial position and statement of changes in equity

So far in this unit we have limited discussion to how specific transactions and events are treated in the accounts of a limited company, with reference to the standards that deal with those transactions and events.

As the examination for this module comprises 50 multiple-choice questions, you will not be required to prepare a full financial statement as part of the examination. However, it is a useful learning exercise to work through a full set of financial statements to get a better understanding of how the requirements of the financial reporting standards impact on the statements, and the process involved in working from some basic information (eg a trial balance and some additional details) to completing the financial statements.

In the following example, we will look at the preparation of a statement of profit or loss, a statement of financial position, and a statement of changes in equity. Later in this unit, we will look at the preparation of a cash flow statement.

Exercise E10

The following trial balance has been taken from the financial records of Gravir Company on 31 December 20X6

	FRW million	
Ordinary share capital		200
Debentures		10
Share premium		10
General reserve		6
Retained earnings		76
Revenue		255
Purchases	130	
Distribution costs	43	
Administrative expenses	39	
Development costs	20	
Buildings	160	
Buildings depreciation		15
Vehicles	85	
Vehicles depreciation		25
Equipment	30	
Equipment depreciation		6
Inventory 1 January	18	
Receivables	30	
Bank	59	
Payables		5
Provision		6
	614	614

The following information is also available:

1) Inventory at 31 Dec 20X6 was FRW 5 million.
2) Depreciation is to be allocated as follows: 60% to distribution costs, 40 % to administration expenses:
   - Buildings are to be depreciated over 40 years
   - Vehicles are to be depreciated at 25% on a reducing balance basis
   - Equipment is to be depreciated over 5 years
3) The provision is to be increased by 50%. The provision is expected to be settled within the next 12 months, and any changes are treated as administrative.
4) The tax for the year to 31 December 20X6 is estimated to be FRW 13 million.
5) On 4 January 20X7, FRW 4 million of inventory was found to be damaged and of no use or scrap value.
6) FRW 10 million of the development costs were on a project that has been discontinued. The remainder of the development costs relate to a project that will come into commercial production in 20X7.
7) On 5 January 20X7, the company discovered that a customer that owed FRW 2 million on 31 December 20X6 had been declared bankrupt.

Prepare the statement of profit or loss, the statement of financial position, and the statement of changes in equity for Gravir Company for the year to 31 December 20X6.

Exercise E10 Solution

Statement of profit or loss for Gravir Company for the year ended 31 December 20X6

	FRW million	FRW Million
Revenue		255
Cost of sales (18+130-5)		(143)
Gross profit		112
Distribution costs (43 + 15 from workings)		(58)
Administrative expenses (39 + 25 from workings)		(64)
Profit/(loss) before taxation		(10)
Taxation		(13)
Profit/(loss) after taxation		(23)

Statement of financial position for Gravir Company as at 31 December 20X6		
Non-current assets	FRW million	
Buildings (160-15-4)	141	
Vehicles (85-25-15)	45	
Equipment (30-6-6)	18	204
Development costs (20-10)		10
		214
Current assets		
Inventory	5	
Receivables (30-2)	28	
Bank	59	92
Total assets		306
Equity		
Ordinary share capital	200	
Share premium	10	
General reserve	6	
Retained earnings (76 – 23 loss for year)	53	269
Non-current liabilities		
Debentures		10
Current liabilities		
Trade payables	5	
Tax payables	13	
Provision	9	27
Total equity and liabilities		306

Statement of changes in equity for Gravir Company as at 31 December 20X6					
FRW million	Ordinary share capital	Share premium	General reserve	Retained earnings	Total
Balance at 1 January 20X6	200	10	6	76	292
Total comprehensive income for the year				(23)	
Issue of shares					0
Dividend paid					0
Transfers					0
Balance at 31 December 20X6	200	10	6	53	269

Workings			**Distribution**	**Administration**
Trial balance			43	39
Depreciation				
Buildings	*160/40*	4		
Vehicles	*(85-25)*25%*	15		
Equipment	*30/5*	6		
		25		
Split 60/40			15	10
Provision increase	6 * 50% = 3			3
Development costs: - Discontinued				10
Bad debt				2
Total			58	64

Notes to the financial statements

As mentioned earlier in this unit, the notes to the financial statements are an integral element of the overall disclosure of information to users, and are essential for full compliance with IFRS.

In this section we will look at the additional information that is required by IFRSs, and which is usually achieved by adding detailed tables or other summaries to provide this additional content.

IAS 16 Property, plant and equipment

IAS 16 contains disclosure requirements for property, plant and equipment.

The key disclosures (detailed in paragraph 77 of the standard) are as follows:

- Measurement bases used – as part of a policy note, together with other policies in relation to PPE
- Depreciation methods used
- Useful lives
- The gross carrying amount and accumulated depreciation at the beginning and end of the period
- A reconciliation of the carrying amount at the beginning and end of the period showing:
    - revaluations
    - additions
    - disposals
    - depreciation for the period
    - any other changes.
    - And for revalued assets, the following should be disclosed:
    - The effective date of the revaluation
    - Whether an independent valuer was involved
    - The carrying amount of each class of property, plant and equipment that would have been included in the financial statements had the assets been carried at cost less depreciation
    - The revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders.

The key disclosures for IAS 16 may be presented in a table:

	Land	**Buildings**	**Equipment**	**Total**
	FRW million	FRW million	FRW million	FRW million
Cost/Valuation				

	Land	Buildings	Equipment	Total
As at 1 January 20X1	650	8,100	500	9,250
Revaluations	250	0	0	250
Additions	0	300	100	400
Disposals	0	(150)	(50)	(200)
As at 31 December 20X1	900	8,250	550	9,700
Accumulated depreciation				
As at 1 January 20X1	0	730	100	830
Disposals	0	(40)	(22)	(62)
Revaluations	0	0	0	0
Charge for the year	0	206	118	324
As at 31 December 20X1	0	896	196	1,092
Carrying value				
As at 1 January 20X1	650	7,370	400	8,420
As at 31 December 20X1	900	7,354	354	8,608

IAS 37 Provisions, contingent liabilities, and contingent assets

Provisions

Disclosures for provisions are set out in paragraphs 84-85 of the standard:

(a) Disclosure of details of the change in carrying amount of a provision from the beginning to the end of the year, including additional provisions made, amounts used and other movements.

(b) For each class of provision, disclosure of the background to the making of the provision and the uncertainties affecting its outcome, including:

  (i) A brief description of the nature of the provision and the expected timing of any resulting outflows relating to the provision

  (ii) An indication of the uncertainties about the amount or timing of those outflows and, where necessary to provide adequate information, the major assumptions made concerning future events

(iii) The amount of any expected reimbursement relating to the provision and whether any asset that has been recognised for that expected reimbursement

Contingent liabilities

Disclosure requirements for contingent liabilities are set out in paragraph 86 of the standard

Unless remote, the following should be disclosed for each contingent liability:

(i) A brief description of its nature; and where practicable

(ii) An estimate of the financial effect

(iii) An indication of the uncertainties relating to the amount or timing of any outflow

(iv) The possibility of any reimbursement

If a contingent liability is 'remote' (ie it is considered extremely unlikely that the company will become liable for this item), there is no need to make a disclosure.

Contingent assets

Where an inflow of economic benefits is *probable*, paragraph 89 of the standard requires the company to disclose the following:

(i) A brief description of its nature; and where practicable

(ii) An estimate of the financial effect.

IAS 38 Intangible assets

The standard requires a reconciliation of the carrying amount of intangible assets at the beginning and end of the period. As for tangible assets in IAS 16 this can be shown as a table:

Intangible assets FRW million	**Brands**	**Development costs**	**Total**
Cost			
At 1 January 20X0	150	220	370
Additions in year	12	40	52
Disposals in year	(8)	(10)	(18)
At 31 December 20X1	154	250	404
Amortisation			
At 1 January 20X0	20	50	70
Charge for year	15	50	65

Intangible assets FRW million	Brands	Development costs	Total
Eliminated on disposal	(2)	(5)	(7)
At 31 December 20X1	33	95	128
Carrying amount			
At 31 December 20X0	130	170	300
At 31 December 20X1	121	155	276

Paragraph 118 of the standard also requires the following information to be disclosed:

(i) The accounting policies for intangible assets that have been adopted.

(ii) For each class of intangible assets (including development costs), disclosure is required of the following:

- The method of amortisation used
- The useful life of the assets or the amortisation rate used
- The gross carrying amount, the accumulated amortisation and the accumulated impairment losses as at the beginning and end of the period
- The carrying amount of internally generated intangible assets
- The line item(s) of the statement of profit or loss in which any amortisation of intangible assets is included.

IAS 2 Inventories

The standard requires a company to disclose the following in the financial statements:

- Accounting policies adopted in measuring inventories, including the cost formula used
- The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity
- The carrying amount of inventories carried at fair value less costs to sell
- The amount of inventories recognised as an expense in the period
- The amount of any write-down of inventories recognised as an expense in the period
- The amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as an expense in the period
- The circumstances that led to the reversal of a write-down of inventories
- The carrying amount of inventories pledged as security for liabilities

The financial statements must also disclose one of two things:

- An analysis of operating costs by function (including a cost of sales figure); or
- An analysis of operating costs by their nature.

Where an entity analyses its operating costs by their nature, then IAS 2 requires disclosure of the amounts recognised as expenses for:

- raw materials and consumables
- labour costs
- other operating costs
- the net change in inventories for the period

IAS 10 Events after the reporting period

In paragraph 21 of the standard, the following disclosure requirements are given for material events occurring after the reporting period that do not require adjustment:

(a) The nature of the event.

(b) An estimate of the financial effect, or a statement that such an estimate cannot be made.

Statement of cash flow

In Unit B, we looked at the format of the statement of cash flow and the main entries that are recorded within each section of the statement. In this unit, we will focus on the preparation of the statement, using numerical examples.

Key points to remember as we look at examples, are:

- The statement focuses on cash transactions.
- Non-cash transactions are only included in order to adjust an accruals figure (profit or loss for the period) to a cash figure.
- As well as determining the correct amount to include in the statement, you need to be careful to show this correctly as a cash inflow or outflow, so showing as a positive or negative figure is important to get right.
- The three sections of the statement need to be used correctly, so take care to identify which section each cash flow relates to (although there is a small number of entries that can appear in different places, such as interest payments).
- The statement can be prepared on a direct or indirect basis. We will focus on the indirect basis in the examples in this unit.

Now we can look at an example and work through the process for preparing each section of the statement of cash flow.

Example:

The following information has been taken from the financial statements of Point Company:

Statements of financial position as at 31 December

	20X6	20X5
	FRW million	FRW million
Non-current assets carrying amount	333,060	366,240
Current assets		
Inventories	76,860	78,960
Receivables	32,200	88,200
	442,120	533,400
Equity and liabilities		
Equity		
Ordinary shares par value FRW 1000	215,040	210,000
Retained earnings	127,960	122,080
Non-current liabilities		
Loans	32,760	41,020
Current liabilities		
Payables	42,000	62,300
Bank overdraft	24,360	98,000
	442,120	533,400

Income statement for year ended 31 December 20X6	FRW million
Revenue	442,120
Cost of sales	(280,000)
Gross profit	162,120
Other costs	(128,100)
Operating profit	34,020
Interest receivable	2,660
Interest payable	(4,060)
Profit before tax	32,620
Taxation	(19,880)
Profit after tax	12,740

Notes:

		FRW million
1. Working for retained earnings:		
Profit after tax		12,740
Dividends		(6,860)
Retained earnings for year		5,880
2. Interest receivable and payable: all amounts owing or due were received in the financial year		
3. Depreciation charged in the year		8,400
4. Asset sales:		
- Book value		28,000
- Proceeds		35,000
5. Payables:	20X6	20X5
- Trade payables	36,400	54,880
- Taxation	5,600	7,420
	42,000	62,300

Prepare the statement of cash flows for Point Company in compliance with IAS 7 for the year ended 31 December 20X6

Solution

Note – the individual cash flows for interest paid and tax paid in the period (ie the cash amount paid, which in some examples may be different from interest *payable* and taxation *payable)* should be shown separately in the face of the statement, and investment income (or interest received – again the cash figure) should be shown within Investing activities. This means that some adjustments to the Profit before tax figure need to be made to remove the accruals figure for interest paid and investment income, and to insert the cash amount for each item. In the solution below, you will see some items appearing twice, either to remove an accruals figure and replace it with a cash figure, or to show the individual cash flow separately rather than it being hidden within a total, or to move an item from one section of the statement to another

Statement of cash flow for Point for year ended 31 December 20X6		
		FRW million
Cash flows from operating activities		
Profit before tax	32,620	
Adjust for:		

Depreciation (note 3)	8,400	
Profit on sale of PPE (note 4)	(7,000)	
Investment income	(2,660)	
Interest payable	4,060	
		35,420
Movements in working capital		
Decrease in inventories	2,100	
Decrease in trade receivables	56,000	
Decrease in trade payables	(18,480)	39,620
Interest paid	(4,060)	
Tax paid	(21,700)	(25,760)
Net cash from operating activities		**49,280**
Cash flows from investing activities		
Purchase of assets (w1)	(3,220)	
Proceeds from sale of assets	35,000	
Interest received	2,660	
Net cash from investing activities		**34,440**
Cash flows from financing activities		
Proceeds from issue of share capital (215,040 – 210,000)	5,040	
Redemption of loan (41,020 – 32,760)	(8,260)	
Dividends paid	(6,860)	
Net cash from financing activities		**(10,080)**
Net increase in cash		73,640
Cash at beginning of period		(98,000)
Cash at end of period		(24,360)
Working 1		
Non-current assets (net)	Debit	Credit

Opening balance	366,240	
Depreciation		8,400
Asset sold		28,000
Acquired (balancing figure)	3,220	
Closing balance		333,060
	369,460	369,460

Summary of Unit E and key learning outcomes

In Unit E we looked at the Competency 'Draft statutory financial statements for a limited company'. This involved content on five learning outcomes.

Learning outcome	
Apply accounting standards and relevant legislation to correctly identify, and accurately adjust, accounting information	You should now be able to correctly apply the requirements of IAS 1, IAS 2, IAS 7, IAS 10, IAS 16, IAS 37, IAS 38, and IFRS 15
Use appropriate information to accurately draft a statement of comprehensive income.	You should now be able to prepare a statement of profit or loss (statement of comprehensive income), a statement of financial position, and a statement of changes in equity from a trial balance and additional information
Use appropriate information to accurately draft a statement of financial position (balance sheet).	
Prepare notes to the accounts which satisfy statutory current disclosure requirements, in respect of accounting policies, non-current assets, current and long term liabilities, equity	You should now be able to prepare relevant notes to comply with the disclosure requirements of the standards listed above
Draft an accurate statement of cash flows (cash flow statement).	You should now be able to prepare a statement of cash flows from accruals based financial information

Quiz questions

1	Learning Outcome: E1
Which of the following is true of dividends in a limited company's accounts?	
A	Dividends reduce the retained earnings account
B	Dividends are charged to administration expenses
C	Dividends increase the retained earnings account
D	Dividends are charged to distribution expenses

1	Feedback
A	**Correct**
B	**Incorrect** Dividends reduce the retained earnings account
C	**Incorrect** Dividends reduce the retained earnings account
D	**Incorrect** Dividends reduce the retained earnings account

2	Learning Outcome: E1
Which of the following statements is true?	
A	Shares are secured on company assets, and loans are never secured on company assets
B	Shareholders are payables, and providers of loan capital are members of a company
C	**Holders of loan capital are in more risky positions than ordinary shareholders**
D	Loans are often secured on company assets, whereas shares are not secured on company assets

2	Feedback
A	**Incorrect** Loan stock is often secured on company assets; shares are not secured on company assets
B	**Incorrect** Shareholders are members of a company; providers of loan capital are payables. Loan stock is often secured on company assets; shares are not secured on company assets
C	**Incorrect** Holders of loan capital are in less risky positions than ordinary shareholders Loan stock is often secured on company assets; shares are not secured on company assets
D	**Correct**

3	Learning Outcome: E2
Which of the following describes the treatment of taxation in the statement of profit or loss	
A	The taxation charge is made up of the estimate of the next year's tax expense and an adjustment for an over or under spend in the current period
B	The taxation charge is based on the invoice for the current year's actual taxation liability
C	The taxation charge is made up of the estimate of the current year's tax expense and an adjustment for an over or under spend in the previous period
D	The taxation charge is based on the invoice for the previous year's actual taxation liability

3	Feedback
A	**Incorrect** The taxation charge is made up of the estimate of the current year's tax expense and an adjustment for an over or under spend in the previous period
B	**Incorrect** The taxation charge is made up of the estimate of the current year's tax expense and an adjustment for an over or under spend in the previous period

C	**Correct**
D	**Incorrect** The taxation charge is made up of the estimate of the current year's tax expense and an adjustment for an over or under spend in the previous period

4	Learning Outcome: E1
A company makes a rights issue of shares. The shares have a nominal (par) value of FRW 1,000, and are offered in the rights issue at FRW 1,500 per share. There are a total of 50,000 shares being offered in the rights issue, and all these have been sold. What is the impact on the share premium account as a result of the rights issue?	
A	Share premium account will not change
B	Share premium account will increase by FRW 25 million
C	Share premium account will decrease by FRW 25 million
D	Share premium account will increase by FRW 75 million

4	Feedback
A	**Incorrect** Share premium account will increase by FRW 25 million 1,500-1,000 = FRW 500 premium per share. 500 * 50,000 = FRW 25 million
B	**Correct** 1,500-1,000 = FRW 500 premium per share. 500 * 50,000 = FRW 25 million
C	**Incorrect** Share premium account will increase by FRW 25 million 1,500-1,000 = FRW 500 premium per share. 500 * 50,000 = FRW 25 million
D	**Incorrect** Share premium account will increase by FRW 25 million 1,500-1,000 = FRW 500 premium per share. 500 * 50,000 = FRW 25 million

5	Learning Outcome: E2
Which section of the statement of profit or loss includes bank interest payable and loan interest payable?	
A	Finance charges
B	Distribution costs
C	Cost of sales
D	Administrative expenses

5	Feedback
A	**Correct**
B	**Incorrect** These are shown within Finance charges
C	**Incorrect** These are shown within Finance charges
D	**Incorrect** These are shown within Finance charges

6	Learning Outcome: E3
Which of the following would be shown in the statement of changes in equity?	
A	Movement in provisions
B	Movement in working capital
C	Movement in retained earnings
D	Movement in debentures

6	Feedback
A	**Incorrect** Provisions are liabilities, not part of equity Movement in retained earnings is included in the statement of changes in equity
B	**Incorrect** Working capital is made up of current assets and current liability, and is not part of equity Movement in retained earnings is included in the statement of changes in equity
C	**Correct**
D	**Incorrect** Debentures are liabilities, not part of equity Movement in retained earnings is included in the statement of changes in equity

7	Learning Outcome: E1
Which of the following statements is true, according to IAS 2 Inventories?	
A	The cost of inventory includes fixed and variable overheads incurred in converting materials to finished goods
B	The cost of inventory includes storage costs
C	The cost of inventory includes administrative costs that are not related to production
D	The cost of inventory includes selling costs

7	Feedback
A	**Correct**
B	Incorrect Storage costs are not included in the cost of inventory The cost of inventory includes fixed and variable overheads incurred in converting materials to finished goods

C	**Incorrect** Administrative costs that are not related to production are not included in the cost of inventory The cost of inventory includes fixed and variable overheads incurred in converting materials to finished goods
D	**Incorrect** Selling costs are not included in the cost of inventory The cost of inventory includes fixed and variable overheads incurred in converting materials to finished goods

8	Learning Outcome: E5
Which of the following is a key disclosure requirement under IAS 16 Property, plant and equipment, and is usually presented as a note to the financial statements?	
A	A schedule of depreciation charges over the next 10 years for all buildings
B	Information on the programme of replacement for each class of property, plant and equipment
C	A reconciliation of the opening and closing balances for all intangible assets
D	A reconciliation of the carrying amount at the beginning and end of the period showing revaluations, additions, and other changes in the period

8	Feedback
A	**Incorrect** IAS 16 requires a reconciliation of the carrying amount at the beginning and end of the period showing revaluations, additions, and other changes in the period
B	**Incorrect** IAS 16 requires a reconciliation of the carrying amount at the beginning and end of the period showing revaluations, additions, and other changes in the period
C	**Incorrect** IAS 16 does not deal with intangible assets, only property, plant and equipment IAS 16 requires a reconciliation of the carrying amount at the beginning and end of the period showing revaluations, additions, and other changes in the period
D	**Correct**

9	Learning Outcome: E1
Which of the following is a promise to transfer a distinct bundle of goods and services to a customer, under IFRS 15 Revenue from contracts with customers?	
A	**Contract**
B	Performance obligation
C	Deferred income
D	Warranty

9	Feedback
A	**Incorrect** This is the definition of one type of performance obligation
B	**Correct**
C	**Incorrect** This is the definition of one type of performance obligation
D	**Incorrect** This is the definition of one type of performance obligation

10	Learning Outcome: E1
Which of the following statements is true, according to IAS 38 Intangible assets?	
A	Research costs relate to a project that is technically feasible to complete, such that it can become sellable or usable
B	Development costs should be capitalised and recognised as an intangible non-current asset on the statement of financial position
C	Research costs should be capitalised and recognised as an intangible non-current asset on the statement of financial position
D	Development costs must be charged as an expense to the income statement

10	Feedback
A	**Incorrect** 'Technically feasible to complete it such that it can become sellable or usable' is one of the criteria for capitalising development costs, not research costs
B	**Correct**
C	**Incorrect** Research costs should not be capitalised Development costs should be capitalised and recognised as an intangible non-current asset on the statement of financial position
D	**Incorrect** Research costs must be charged as an expense to the income statement Development costs should be capitalised and recognised as an intangible non-current asset on the statement of financial position

11	Learning Outcome: E1
Which of the following statements is true, according to IAS 37 Provisions, contingent liabilities, and contingent assets?	
A	Contingent liabilities can be recognised in the statement of financial position if a reliable estimate can be made
B	Contingent assets are non-current assets that the company is waiting to be delivered or installed before they can be used in production
C	Provisions are liabilities where the company does not expect to have to make payment to settle them
D	Contingent liabilities should be assessed continually to identify whether the criteria for recognising a provision have been met

11	Feedback
A	**Incorrect** Contingent liabilities are never recognised in the statement of financial position Contingent liabilities should be assessed continually to identify whether the criteria for recognising a provision have been met

11	Feedback
B	**Incorrect** A contingent asset is a possible asset that arises from past events Contingent liabilities should be assessed continually to identify whether the criteria for recognising a provision have been met
C	**Incorrect** A provision is a liability in which it is probable that an outflow of economic benefits will be required to settle the obligation Contingent liabilities should be assessed continually to identify whether the criteria for recognising a provision have been met
D	**Correct**

12	Learning Outcome: E1
A company had payables of FRW 400 million at the start of the year and at the end of the year the balance was FRW 500 million. What adjustment to profit should be shown in the operating activities section of the cash flow statement to take account of this?	
A	FRW 100 million should be added to the profit figure
B	FRW 100 million should be shown as a cash outflow
C	FRW 100 million should be deducted from the profit figure
D	FRW 100 million should be shown as a cash inflow

12	Feedback
A	**Correct**
B	**Incorrect** The payables balance has increased by FRW 100 million. This is added to the profit figure as there is an inflow of cash from operating activities; ie FRW 100 million more purchases have been achieved without the need to pay cash for them during the period.

12	Feedback
C	**Incorrect** The payables balance has increased by FRW 100 million. This is added to the profit figure as there is an inflow of cash from operating activities; ie FRW 100 million more purchases have been achieved without the need to pay cash for them during the period.
D	**Incorrect** The payables balance has increased by FRW 100 million. This is added to the profit figure as there is an inflow of cash from operating activities; ie FRW 100 million more purchases have been achieved without the need to pay cash for them during the period.

Unit E Exercises

Exercise E11

The following trial balance has been taken from the financial records of Newvale Company on 31 December 20X6

	FRW Million	
Ordinary share capital		150
Share premium		14
General reserve		9
Retained earnings		57
Revenue		188
Purchases	87	
Distribution costs	17	
Administrative expenses	22	
Development costs	5	
Buildings	250	
Buildings depreciation		40
Plant and machinery	60	
Plant and machinery depreciation		10
IT equipment	12	
IT equipment depreciation		8
Inventory 1 January 20X6	7	
Receivables	24	
Bank	16	
Payables		24
	500	500

The following information is also available:

1) Inventory at 31 Dec 20X6 was FRW 15 million.

2) Depreciation is to be allocated as follows: 50% to distribution costs, 50 % to administration expenses:

   - Buildings are to be depreciated over 50 years
   - Plant and machinery are to be depreciated at 20% on a reducing balance basis
   - IT equipment is to be depreciated over 4 years

3) A new provision is to be created for an estimated liability of FRW 8 million.

4) The tax for the year to 31 December 20X6 is estimated to be FRW 6 million.

5) On 4 January 20X7, a fire damaged inventory that cost FRW 3 million and had a resale value (before damage) of FRW 6 million. The damaged inventory has no scrap value.

6) FRW 1 million of the development costs relate to research into a new material. The remainder of the development costs relate to a project that is expected to come into commercial production in 20X7.

7) On 5 January 20X7, the company discovered that a customer that owed FRW 2 million on 31 December 20X6 had been declared bankrupt. 50% of the amount owed is expected to be recovered from the customer.

8) FRW 5 million is to be transferred to the general reserve.

Prepare the statement of profit or loss, the statement of financial position, and the statement of changes in equity for Newvale Company for the year to 31 December 20X6.

Exercise E11 solution

Statement of profit or loss for Newvale Company for the year ended 31 December 20X6

	FRW million	**FRW Million**
Revenue		188
Cost of sales (7+87-15)		(79)
Gross profit		109
Distribution costs (17 + 9 depreciation)		(26)
Administrative expenses (22 + 8 provision + 9 depreciation + 1 research costs + 1 bad debt))		(41)

Profit/(loss) before taxation		42
Taxation		(6)
Profit/(loss) after taxation		(36)
Statement of financial position for Newvale Company as at 31 December 20X6		
Non-current assets	FRW million	
Buildings (250-40-5)	205	
Plant and machinery (60-10-10)	40	
IT equipment (12-8-3)	1	246
Development costs (5-1)		4
		250
Current assets		
Inventory	15	
Receivables (24-1)	23	
Bank	16	54
Total assets		304
Equity		
Ordinary share capital	150	
Share premium	14	
General reserve (9+5)	14	
Retained earnings (57+36-5)	88	266
Non-current liabilities		
Current liabilities		
Trade payables	24	

Tax payables	6	
Provision	8	38
Total equity and liabilities		304

Statement of changes in equity for Gravir Company as at 31 December 20X6

FRW million	**Ordinary share capital**	**Share premium**	**General reserve**	**Retained earnings**	**Total**
Balance at 1 January 20X6	150	14	9	57	230
Total comprehensive income for the year				36	36
Issue of shares					0
Dividend paid					0
Transfers			5	(5)	0
Balance at 31 December 20X6	150	14	14	88	266

Working:				
Depreciation				
Buildings	*250/50*	5		
Plat & machinery	*(60-10)*20%*	10		
IT Equipment	*12/4*	3		
		18	Distribution	Administration
Split 50/50			9	9

Note:

As the fire took place after the reporting date and does not provide information about a condition that existed at the reporting date, it is a non-adjusting event and no change to the closing inventory figure is required. It may be disclosed as a note to the financial statements, if it is material.

Exercise E12

The following information has been taken from the financial statements of Gress Company:

Statements of financial position as at 31 December

	20X7		20X6	
	FRW million	FRW million	FRW million	FRW million
Non-current assets carrying amount		154,635		170,040
Current assets				
Inventories	31,200		29,900	
Receivables	22,685		40,950	
Equity and liabilities		53,885		70,850
		208,520		**240,890**
Equity				
Ordinary shares par value FRW 1000	101,400		101,400	
Retained earnings	57,850		52,780	
		159,250		154,180
Non-current liabilities				
Loans		15,210		19,045
Current liabilities				
Payables	22,750		21,450	
Bank overdraft	11,310	34,060	46,215	67,665
		208,520		**240,890**

Income statement for year ended 31 December 20X7	FRW million
Revenue	210,000
Cost of sales	(136,500)
Gross profit	73,500
Other costs	(59,475)
Operating profit	14,025
Interest receivable	1,235
Interest payable	(1,885)
Profit before tax	13,375
Taxation	(2,145)
Profit after tax	11,230

Notes:	FRW million
1. Working for retained earnings:	
Profit after tax	11,230
Dividends	(6,160)
Retained earnings for year	5,070
2. Interest receivable and payable: all amounts owing or due were received in the financial year	
3. Depreciation charged in the year	13,530
4. Asset sales:	
- Book value	6,500
- Proceeds	5,525
Prepare the statement of cash flows for Gress Company in compliance with IAS 7 for the year ended 31 December 20X7	

Exercise E12 solution		
Statement of cash flow for Gress Company for the year ended 31 December 20X7		
Cash flows from operating activities		FRW million
Profit before tax		13,375
Adjust for:		
Depreciation (note 2)	13,530	
Profit on sale of PPE (note 3)	975	
Investment income	(1,235)	
Interest payable	1,885	
		28,530
Movements in working capital		
Decrease in inventories	(1,300)	
Decrease in trade receivables	18,265	
Decrease in trade payables	1,300	
		18,265
Interest paid	(1,885)	
Tax paid	(2,145)	(4,030)
Net cash from operating activities		**42,765**
Cash flows from investing activities		
Purchase of PPE (w1)	(4,625)	
Proceeds from sale of equipment	5,525	
Interest received	1,235	
Net cash from investing activities		**2,135**
Cash flows from financing activities		
Proceeds from issue of share capital		
Redemption loan	(3,835)	

Dividends paid	(6,160)	
Net cash from financing activities		**(9,995)**
Net increase in cash		**34,905**
Cash at beginning of period		(46,215)
Cash at end of period		(11,310)
Working 1		
Non-current assets (net)		
Opening balance	170,040	
Depreciation		13,530
Asset sold		6,500
Acquired (balancing figure)	4,625	
Closing balance		154,635
	174,665	174,665

Exercise E13

Harray Company purchased a building on 1 January 20X5 for FRW 80 million. The depreciation policy of Harray Company is to depreciate buildings on a straight-line basis over 40 years.

Show the building cost and accumulated depreciation ledger accounts for the year ended 31 December 20X5, and show how these would be included in the statement of financial position at the end of the year.

Exercise E13 solution

Buildings			
1 Jan Bank	80	31 Dec Balance carried forward	80
	80		80

Accumulated depreciation – buildings			
31 Dec Balance carried forward	2	31 Dec Income statement	2
	2		2

The depreciation charge for the year is calculated as 80 /40 = 2. The balance carried forward will be the accumulated depreciation figure used in the statement of financial position:

Statement of financial position of Harray Company as at 31 December 20X5 (extract)

FRW million	Cost	Accumulated depreciation	Carrying amount
Buildings	80	(2)	78

Exercise E14

At 1 January Year 1, Scalp Company owned a building that cost FRW 600 million when it was purchased in 2005. The company's policy is to depreciate buildings over 50 years using the straight line method.

On 30 September Year 11, a revaluation to FRW 750 million was recognised. At this date the building had a remaining useful life of 40 years.

How should the asset be recorded in the financial statements for the year to 31 December Year 11?

Exercise E14 solution

To enter the revaluation into the accounts of the company, we need to identify how much the asset *has been revalued by*. This is determined by taking the difference between the new value of the asset and the previous carrying amount. This amount is credited to the revaluation reserve. The depreciation charge after the revaluation is based *on the revalued amount*.

The carrying amount before revaluation for Scalp's asset, as the asset will have been depreciated by ten years at this point, is:

(600– 120) = 480

The new valuation for the asset is FRW 750 million. This means the asset has been re-valued by 750– 480 = 270 million. The double entry in the accounts to record the revaluation will be:

Dr	Buildings (to increase from 600 to 750 million)	150
Dr	Buildings accumulated depreciation (to remove previous depreciation)	120
Cr	Revaluation reserve	270

It is important to remember that from this point onwards, the depreciation charge should be based on the *new* asset valuation and the *remaining* useful life of the asset. So, for Year 11 the depreciation charge is 750 / 40 = 19 million.

Exercise E15

Melb Company is in the process of producing its financial statements for the year ended 31 December 20X7. There are two outstanding issues to be resolved before the financial statements are complete:

- A provision of FRW 35 million was recognised in the 20X6 financial statements. This provision arose due to a dispute with a customer, the customer claiming that they overpaid Melb by FRW 35 million. This dispute was eventually resolved in October 20X7 and Melb agreed to pay the company FRW 22 million.
- Melb have treated FRW 670 million of development expenditure as an intangible asset, with none having been amortised as at 1 January 20X7. The result of this expenditure is a new, more efficient manufacturing process, expected to save the company FRW 150 million a year for 20 years from 1 April 20X7.

No accounting entries 20X7 have been recognised for these events.

Show the accounting entries required for the year-ended 31 December 20X7 for the two events above.

Exercise E15 solution

Provision:

Debit Provision	35
Credit Other income	13
Credit Bank	22

Development costs:

Debit Expenses (670 /20)	33.5
Credit Accumulated amortisation	33.5

Exercise E16

Identify the correct accounting entries for each of the following transactions:

a) Research costs of FRW 300 million have been incurred and debited to intangible assets (development costs) in the statement of financial position.

b) Development costs of FRW 150 million have been incurred on developing a product line which is expected to come into profitable production next year. The costs have been charged to cost of sales.

c) Development costs of FRW 400 million have been incurred on a piece of machinery which it has now been established is not viable. The costs have been included in intangible assets in the statement of financial position.

d) Development costs of FRW 250 million have been incurred on a new product line which went into profitable production this year. The product was in profitable production for 10 months of the year and is expected to be profitable for 50 months in total. The costs of FRW 250 million have been debited to cost of sales.

Exercise E16 solution

a) Research costs should be written off to profit or loss in the year they are incurred.

Dr Cost of sales	FRW 300 million
Cr Intangible assets (development costs)	FRW 300 million

b) Benefits are expected so the costs should be capitalised.

Dr Intangible assets (Development costs)	FRW 150 million
Cr Cost of sales	FRW 150 million

c) The machine is not viable and benefits are not expected, therefore write off as an expense in the year.

Dr Cost of sales	FRW 400 million
Cr Intangible assets (development costs)	FRW 400 million

d) Benefits are being realised so the costs should be capitalised.

Dr Intangible assets	FRW 250 million
Cr Cost of sales	FRW 250 million

Benefits already being received so need to amortise

FRW 250 million / 50 months = FRW 5 million per month x 10 months this year = FRW 50 million

Dr Cost of sales	FRW 50 million
Cr Accumulated amortisation	FRW 50 million

The company must review the deferred cost annually for impairment and must write it off immediately if these criteria are no longer met.

Unit F: Simple consolidated financial statements.

Learning outcomes

F1. Draft a consolidated statement of profit or loss for a parent company with one partly owned subsidiary.

F2. Draft a consolidated statement of financial position (balance sheet) for a parent company with one partly owned subsidiary.

F3. Apply current standards to accurately calculate and appropriately deal with the accounting treatment of goodwill, non-controlling interest (minority interest) and post-acquisition profits, in the group financial statements.

Introduction to Unit F

In Unit C, we introduced you to the main concepts of consolidation, and also looked at the basic processes involved in preparing consolidated financial statements. This involved transactions and other events in which one company acquires control or influence of one or more other businesses. We also saw that this involved two types of situation in which companies are related and their financial statements require consolidation, ie:

- Subsidiaries
- Associates

As mentioned in Unit C, the same principles of accounting apply in business combinations as in single-entity statements – ie we apply the usual double-entry approach, and referring to standards such as IAS 16 for depreciation, etc. However, there are also some additional standards that refer specifically to the treatment of transactions that are peculiar to groups, and it is important that you are familiar with the main requirements of these standards, ie:

- IAS 27 Separate financial statements
- IAS 28 Investments in associates and joint ventures (introductory only)
- IFRS 3 Business combinations
- IFRS 10 Consolidated financial statements

In Unit F, we will focus on examples of consolidated financial statements for a parent and a subsidiary.

Note that in the Financial Accounting exam, you will not be required to prepare a full set of statements, as the exam consists of short multiple-choice questions. But it is important to understand the interrelationships between the statements, and the individual transactions or adjustments involved in preparing these. This unit will include examples of preparing

consolidated financial statements from the statements of individual companies, starting with the consolidated statement of financial position.

IAS 27 Separate financial statements

IAS 27 (revised) is a fairly short standard which prescribes how a company presents its investment in a subsidiary (or associate or joint venture) in its separate financial statements.

'Separate financial statements' are statements published by the investor which reflect the investor as a single entity. This means the statements do not contain any elements from the subsidiary, i.e. no consolidation has taken place.

Statement of financial position

When an entity prepares separate financial statements, it shall account for investments in subsidiaries (or joint ventures or associates) using one of the following methods:

- at cost
- at fair value in accordance with IFRS 9 Financial Instruments
- using the equity method in accordance with IAS 28.

Separate financial statements can, but are not required to be, presented in addition to consolidated financial statements or, where an entity does not have subsidiaries, individual financial statements in which investments in associates and joint ventures are accounted for using the equity method. Separate financial statements do not need to be attached to those consolidated or individual financial statements. The entity must apply the same accounting policy for each category of investments.

Statement of comprehensive income

An entity should recognise any dividend from a subsidiary (or joint venture or associate) in profit or loss in its separate financial statements when the right to receive the dividend is established. This will be shown as 'investment income' in the statement of comprehensive income.

Consolidated statement of financial position – parent and subsidiary

Consolidated financial statement exercises in this unit usually consist of information on two separate companies, one a parent and the other a subsidiary. The task required of you is to then take that information and bring it together to create a set of financial statements to reflect the financial performance and position of the 'group'.

This is not as straightforward as simply adding all the figures together (although that is what might be done with some individual items), and it is essential that you take a methodical approach to creating the group statements. The following steps will ensure that you do this correctly.

Step 1 – Establish the group structure

We must establish the proportion of ordinary shares of the subsidiary that the parent owns. A diagram is sometimes used to visually show this relationship. This may not seem worthwhile here, but in a situation where there are a number of adjustments to be made to reflect the group arrangement , it can be helpful to use a methodical approach.

Parent (P)	65%
Subsidiary (S)	

This indicates that P owns 65% of the ordinary shares of S, and the non-controlling interest is 35%.

The percentage of shares owned is important. We will need this figure to calculate goodwill and non-controlling interest later.

Step 2 – Set out the net assets of the subsidiary

Net assets:	At date of acquisition (FRW)	At date of reporting (FRW)
Share capital	X	X
Retained earnings	X	X
Total	X	X

This working is required to help us calculate goodwill and group retained earnings

It is important to realise that the net assets of a company are always the same as its share capital and reserves (application of the accounting equation). So that the totals above equate to the net assets of the subsidiary at two points in time.

It is usual to assume the share capital is the same at both dates, unless the exercise tells you otherwise.

The distinction between assets held by a subsidiary at the date of acquisition and at the date of the statement of financial position is important:

- The assets (i.e. share capital and reserves) held at the date of acquisition are used in the goodwill calculation (see step 3).
- The assets held at the reporting date are used to calculate non-controlling interest (see step 4).

Step 3 – Calculate goodwill on acquisition

	FRW
Consideration transferred (for shares acquired)	X
Less: share of net assets at acquisition (apply the group % in Step 1 to the net assets at the date of acquisition in Step 2)	(X)

Goodwill (before any impairment)	X
Less: Impairment to date	(X)
Goodwill	**X**

Goodwill must be calculated on the basis of the fair values of the assets acquired and consideration paid.

Goodwill is shown as an intangible asset in the consolidated statement of financial position, unless it is impaired to nil. The investment in the subsidiary is eliminated on consolidation.

Step 4 – Calculate the non-controlling interest

The non-controlling interest (i.e. the amount that is not owned by the parent) is presented as a separate figure in the income statement and the statement of financial position (within total equity, but separately from the parent shareholder's equity).

Non-controlling interest = Share of net assets at date of reporting (see step 2)

The group structure in Step 1 will tell you the percentage of ordinary shares owned by the non-controlling interest. Apply this percentage to net assets at the date of reporting. Be careful here. It is the net assets at the date of reporting, not at date of acquisition that we are allocating to non-controlling interest.

The non-controlling interest amount appears only on the consolidated statement of financial position, not on the individual (separate) company statements of financial position.

Step 5 – Calculate group retained earnings

	FRW
Parent's retained earnings (100%)	X
Subsidiary - group share of post-acquisition retained earnings	X
Less: Goodwill impairment (see step 3)	(X)
Group retained earnings	**X**

Always include 100% of any earnings that relate to the parent company.

Pre-acquisition retained earnings are those of the subsidiary at the date of acquisition by the parent. These are capitalised at the date of acquisition by including them in the goodwill calculation (step 3).

Post-acquisition retained earnings are those that have been earned by the subsidiary subsequent to acquisition by the parent company.

Since pre-acquisition retained earnings have already been used in the goodwill calculation, we will include only the group share of the subsidiary's retained earnings since the date of the acquisition (i.e. post-acquisition). Do not double-count the pre-acquisition retained earnings.

The same calculation would be used for other reserves, if necessary; i.e. general reserves, revaluation reserve etc.

Step 6 – Consolidate

Most of the required work has now been completed and all that remains is to bring this information together in the statement of financial position. This is best demonstrated using a worked example.

Example

A parent company acquired shares in a subsidiary company on 1 January 20X1 when the subsidiary's retained earnings were FRW 50 million.

The following information shows the *separate* statements of financial position at 31 December 20X6 for the parent and subsidiary:

	Parent FRW million	Subsidiary FRW Million
Tangible non-current assets	900	300
Investment (80m shares in subsidiary)	135	0
Current assets	95	100
Total assets	1,130	400
Share capital (FRW 1 shares)	100	100
Retained earnings	1,000	250
Current liabilities	30	50
Total equity and liabilities	1,130	400

Prepare the consolidated statement of financial position as at 31 December 20X6.

Solution

Step 1 – Establish the group structure

Parent (P)	80%
Subsidiary (S)	

P owns 80% of the ordinary shares of S (80/100). Third parties (non-controlling interests) own the remainder (20%).

Step 2 – Set out the net assets of the subsidiary

Net assets:	At date of acquisition FRW million	At date of reporting FRW million
Share capital	100	100
Retained earnings	50	250
Total	150	350

Step 3 – Calculate goodwill on acquisition

	FRW million
Consideration transferred	135
Less: share of net assets at acquisition (80% x 150)	(120)
Goodwill (before any impairment)	15
Less: Impairment to date	(0)
Goodwill	**15**

Step 4 – Calculate the non-controlling interest

Non-controlling interest =	20% x 350 = FRW 70 million

Step 5 – Calculate group retained earnings

	FRW million	**FRW million**
Parent's retained earnings (100%)		1,000
Subsidiary - group share of post-acquisition retained earnings:		
Retained earnings at date of reporting	250	
Less: retained earnings at date of acquisition	(50)	
Post-acquisition retained earnings	200	
Group share = 80% x 200		160

	FRW million	FRW million
Less: Goodwill impairment (see step 3)		(0)
Group retained earnings		**1,160**

Now we can include the figures calculated from the previous steps in the consolidated statement of financial position.

Consolidated statement of financial position at 31 December 20X6:

		FRW million
Tangible non-current assets	P + S = 900 + 300 =	1,200
Goodwill	Cancels out investment (see step 3)	15
Current assets	P + S = 95 + 100 =	195
Total assets		1,410
Share capital (FRW 1 shares)	P only (S's cancelled on consolidation)	100
Retained earnings	See step 5	1,160
Non-controlling interest	See step 4	70
Current liabilities	P + S = 30 + 50 =	80
Total equity and liabilities		1,410

P = parent company, S = subsidiary company

Intra-group trading

There are some situations in the consolidation process where we need to cancel out items that are assets in one group company and liabilities in another. These can arise through intra-group trading, and are known as intra-group or inter-company balances.

Where group companies trade with each other, there are several ways in which balances with each other can arise. The most common of these are listed below:

Debentures/Loan stock	Where one company in the group has made a loan to another – in one company there is a payable and in the other there is a receivable (normally shown as investment). These are cancelled on consolidation. The cancellation process is very simple: the credit balance of one company is offset against the debit balance of the other company, eliminating both balances from the consolidated statement of financial position. We only include debentures/loan stock held by third parties in the consolidated statement of financial position.
Inter-company accounts	These are intra-group trading balances, e.g. current assets of subsidiary might include amounts owing from parent. These amounts will be included as current liabilities by the parent. The treatment of inter-company account balances is the same as for debentures/loan stock. Inter-company accounts may not agree due to goods in transit or cash in transit. If the difference is cash in transit, increase the consolidated cash balance by that amount. If the difference is goods in transit, increase the consolidated inventory by that amount.
Bank balances	Bank overdrafts (liability) and cash at bank (asset) must be shown separately. It is not permissible to offset bank overdrafts against cash at bank.
Unrealised profit in inventory	Group companies often sell goods (or any other assets) to one another. Transfers may include an element of profit. If goods or assets are subsequently sold, the group has realised the profit and no further adjustment is necessary. If goods or assets are still held within the group at the year end, we need to remove any unrealised profit. In consolidated accounts, we want to reflect only profits made by group companies trading with third parties. The exact adjustments depend on whether Parent (P) sold to Subsidiary (S) or Subsidiary (S) sold to Parent (P).
Parent sells to Subsidiary	Profit in inventory arising when P sells to S is not realised outside the group. This profit must be calculated and removed from inventory at the reporting date and also from P's retained earnings at the reporting date. Debit P's retained earnings (in Step 5) Credit Closing inventory (in consolidated statement of financial position)

Subsidiary sells to Parent	Profit in inventory arising when S sells to P is not realised outside the group. This profit must be calculated and removed from inventory at the reporting date and also from S's retained earnings at the reporting date. Debit S's retained earnings (in Step 2 – reporting date column) Credit Closing inventory (in consolidated statement of financial position) Unrealised profit is calculated using one of the three methods below; depending on the information you are given in the question:
	a) Gross profit margin given: Example: P sold goods to S for FRW 10 million. The profit margin was 40%. At the year end, S had sold half of these goods on to third party. Unrealised profit = Inventory value X % margin/100% Inventory = half of 10 million = 5 million Unrealised profits = 5 million x 40%/100% = 2 million
	b) Mark up given Example: P makes sales of M10,000 to S. This figure comprises cost plus 25% mark up. S had sold half of these goods on to third party Unrealised profit = Inventory value X % mark-up/(100% + % mark-up) Inventory = half of 10 million = 5 million Unrealised profits = 5 million x 25/(100%+25%) = 1 million **c) Profit given** Unrealised profit = profit figure given X % of goods unsold.

Example

During the accounting period, P sold goods to S for FRW 20 million, which gave P a profit of FRW 4 million. One quarter of these goods were included in the closing inventory of S at the end of the reporting period.

Show the required accounting entries when consolidating the financial statements of P and S.

Solution

One quarter of the inventory is still held by S, so the 'profit' made by P in the sale is still unrealised – ie the goods have not been sold to an entity outside the group:

Unrealised profit = ¼ x FRW 4 million = FRW 1 million.

The adjustment in the consolidated statement of financial position would be as follows:

Debit	P retained earnings (1/4 x 4 million)	FRW 1 million
Credit	Closing inventory	FRW 1 million

The inventory still held by S, valued at FRW 5 million in S's inventory, is being reduced to its cost to the group of FRW 4 million.

Note that if S sold inventory to P, it would be S's retained earnings that would be impacted. Look out for this subtlety as it will impact the resultant calculations in the step-by-step consolidation process.

Now here is a more comprehensive worked example, which incorporates some additional adjustments.

Example

Statement of financial position at 31 December 20X6	Borve FRW million	Tongue FRW million
Assets		
Property, plant and equipment	1,450	500
Investment – 80 million ordinary shares in Tongue	400	0
Investment – 50 million debentures in Tongue	50	0
Inventory	45	20
Receivables	30	50
Cash	25	10
Total assets	2,000	580
Equity and liabilities		

Ordinary share capital (FRW 1 shares)	250	100
Retained earnings	1,665	355
Debentures	0	100
Payable – owed to Tongue	35	0
Other payables	50	25
Total equity and liabilities	2,000	580

1. The Borve company acquired its shares in the Tongue company on 30 April 20X6. At that date the retained earnings of Tongue amounted to FRW 300 million.
2. On 30 April 20X6 the fair value of Tongue's property, plant and equipment was FRW 550 million. This is not reflected in Tongue's statement of financial position above.
3. At 31 December 2016 Borve's inventory includes FRW 15 million relating to goods purchased from Tongue. These goods had cost Tongue FRW 10 million.

Prepare a consolidated statement of financial position at 31 December 20X6.

Solution

Step 1 – Establish the group structure

Borve	80%
Tongue	

Percentage of shares owned in Tongue = 80/100 = 80%

This indicates that Borve owns 80% of the ordinary shares of Tongue. The remainder is the non-controlling interest, ie 20%.

Step 2 – Set out the net assets of the subsidiary

Net assets:	At date of acquisition (FRW million)	At date of reporting (FRW million)
Share capital	100	100
Retained earnings	300	355
Unrealised profit (15 – 10)	0	(5)
Revaluation reserve (550 – 500)	50	50
Total	450	500

At the date of acquisition, the fair value of property, plant and equipment was FRW 550 million. The statement of financial position of Tongue must be adjusted to reflect this:

Debit	Property, plant and equipment	50 million
Credit	Revaluation reserve	50 millioin

At 31 December 2016, Borve's inventory includes FRW 15 million relating to goods purchased from Tongue. These goods had cost Tongue FRW 10 million. As these goods have not been sold at the year end, there is an unrealised profit of 15 - 10 = 5 million. This unrealised profit must be eliminated so that inventory is valued at cost and only profits made by group companies trading with third parties are reflected in the consolidated accounts.

Since Tongue sold to Borve, it is Tongue's retained earnings that must be adjusted.

Step 3 – Calculate goodwill on acquisition

Consideration transferred	**FRW million**
Consideration transferred	400
Less: share of net assets at acquisition (80% x 450)	(360)
Goodwill (before any impairment)	40
Less: Impairment to date	(0)
Goodwill	40

Step 4 – Calculate the non-controlling interest

Non-controlling interest =	20% x 500 = 100 million

Step 5 – Calculate group retained earnings

	FRW million	FRW million
Parent's retained earnings (100%)		1,665
Subsidiary: group share of post-acquisition retained earnings:		
Retained earnings at date of reporting	355	
Unrealised profit	(5)	
Less: retained earnings at date of acquisition	(300)	
Post-acquisition retained earnings	50	

Group share = 80% x 50		40
Less: Goodwill impairment (see step 3)		(0)
Group retained earnings		1,705

Borve – Consolidated statement of financial position at 31 March 2016:

Consolidated statement of financial position	Workings	FRW million
Assets		
Property, plant and equipment	(1,450 + 500 + 50)	2,000
Goodwill	Step 3	40
Inventory	(45 + 20 – 5)	60
Receivables	(30 + 50 – 35)	45
Cash	(25 + 10)	35
Total assets		2,180
Equity and liabilities		
Ordinary share capital (FRW 1 shares)	Borve only	250
Retained earnings	Step 5	1,705
Non-controlling interest	Step 4	100
Debentures	(100 – 50)	50
Payables	(35-35+50 + 25)	75
Total equity and liabilities		2,180

Consolidated statement of profit or loss – parent and subsidiary

The consolidated statement of profit or loss shows the income generated from the group's resources. The following points are important to bear in mind as we work through examples:

- Intra-group sales must be eliminated from both the revenue of the selling company and the cost of sales of the buying company.
    - Debit Revenue
    - Credit Cost of sales.

- Unrealised profit included in year-end inventory must be eliminated
    - Debit Cost of sales
    - Credit Closing inventory.
- Any intra-group interest must be eliminated from interest receivable and interest payable respectively.
- Dividends from subsidiaries must be eliminated since the whole of the profits of those subsidiaries are being consolidated and it would be double counting to include the dividends as well.
- Non-controlling interest is calculated by taking the non-controlling interest's share of the subsidiary's profit after tax. Two figures exist for non-controlling interest: the statement of financial position figure is based on net assets and the statement of profit or loss figure is based on profit. It is important to note this distinction.

Example

Statement of profit or loss for the year ended 31 December 20X7

	Shade **FRW million**	**Braga** **FRW million**
Revenue	550	305
Cost of sales	(150)	(100)
Gross profit	400	205
Distribution costs	(60)	(30)
Admin expenses	(140)	(35)
Investment income – dividend received from Braga	49	0
Interest received	25	0
Debenture interest payable	(40)	(50)
Profit before tax	234	90
Taxation	(90)	(20)
Profit for the year	144	70

1. The Shade company owns 70% of the share capital in the Braga company. At the date of acquisition Braga had retained earnings of FRW 200 million.
2. During the year Shade had sold goods to Braga for FRW 60 million. These had cost Shade FRW 40 million. At 31 December 20X7 Braga still had half of these goods in inventory.

3. During the year Shade paid dividends of FRW 75 million.
4. Braga has in issue FRW 500 million 10% debentures. Shade owns 50% of these debentures.

Prepare a consolidated statement of profit or loss for the year ending 31 December 20X7.

Solution

Step 1 - Establish the group structure

Shade	70%
Braga	

Shade owns 70% of the ordinary shares of Braga and non-controlling interest is 30%.

We need to know the group structure so that we can allocate the appropriate portion of Braga's profit after tax figure to non-controlling interest.

Step 2 - Unrealised profits

Calculation	**FRW**
Goods transferred from Shade to Braga	60
Cost of goods transferred	(40)
Profit	20
Unrealised profit (50% x 20)	10

The required adjustment is:

Debit	Cost of sales	10
Credit	Closing inventory	10

Step 3 - Revenue and cost of sales

Calculation	**FRW**
Revenue - Shade	550
Braga	305
Total	855
Less: Intra-group sale	(60)
Consolidated revenue	795

Intra-group sales have been eliminated, but we also need to eliminate intra-group purchases from cost of sales, and eliminate any unrealised profits from cost of sales.

Calculation	**FRW**
Cost of sales Shade	150
Braga	100
Total	250
Less: Intra-group purchase	(60)
Add: Unrealised profit (step 2)	10
Consolidated cost of sales	200

If the subsidiary sells to the parent, the entries for unrealised profits will be similar, except that the unrealised profit will arise in the subsidiary and will thus affect the NCI.

Step 4 - Investment income and interest payable

Investment income - The FRW 49 million received from Braga must be excluded from the consolidated statement of profit or loss.

Interest receivable – Interest receivable includes Shade's share of the debenture interest paid by Braga.

Calculation		**FRW**
Interest receivable on debentures	10% x 500	50
Shade's share of interest	50% x 50	25

The FRW 25 million received by Shade must be cancelled against the interest payable in Braga's statement of profit or loss to leave the net interest payable to outside the group of 50 - 25 = FRW 25 million.

Step 5 - Non-controlling interest (NCI)

The non-controlling interest is 30% (see step 1) of Braga's profit after tax figures.

NCI = 30% x FRW 70 million = FRW 21 million

If unrealised profits arise in the subsidiary, we must deduct the unrealised profit from the subsidiary's profit after tax before calculating the non-controlling interest. So it is important to be careful to note which company is selling and which is purchasing the goods.

Step 6 - Dividends

We include Shade's dividend only.

Shade – Consolidated Statement of profit or loss for the year ended 31 Dec 20X7

	Workings	FRW
Revenue	Step 3	795
Cost of sales	Step 3	(200)
Gross profit		595
Distribution costs	(60 + 30)	(90)
Admin expenses	(140 + 35)	(175)
Interest payable	(40 + (50 – 25))	(65)
Profit before tax		265
Taxation	(90 + 20)	(110)
Profit for the year		155
Attributable to:		
Equity shareholders in Shade	Balancing figure	134
Non-controlling interest	(30% x 70)	21
Profit for the year		155

The balancing figure of FRW 134 million, i.e. the profit attributable to equity shareholders in Shade, can be calculated in two ways:

Total profit for the year FRW 155 million less profit attributable to NCI FRW 21 million, or the following more complex reconciliation –

Calculation:	**Workings**	**FRW**
Profit for year	(144 + 70)	214
Less: unrealised profit	Step 2	(10)
Less: intra-group dividend	In statement of profit or loss	(49)
Less: NCI	(30% x 70)	(21)
Profit attributable to shareholders in Shade		134

Summary of Unit F and key learning outcomes

In Unit F, we looked at the Competency: 'Draft simple consolidated financial statements'. This involved content on three broad learning outcomes.

Draft a consolidated statement of profit or loss for a parent company with one partly owned subsidiary.	You should now be able to prepare a consolidated statement of profit or loss, taking the information from two separate statements and applying line-by-line consolidation. This includes accounting for intra-group transactions, eliminations, and other adjustments.
Draft a consolidated statement of financial position (balance sheet) for a parent company with one partly owned subsidiary.	You should now be able to prepare a consolidated statement of financial position, taking the information from two separate statements and applying line-by-line consolidation. This includes accounting for intra-group transactions, eliminations, and other adjustments.
Apply current standards to accurately calculate and appropriately deal with the accounting treatment of goodwill, non-controlling interest (minority interest) and post-acquisition profits, in the group financial statements.	You should now be able to apply the key accounting requirements of • IAS 27 Separate financial statements • IFRS 3 Business combinations • IFRS 10 Consolidated financial statements

Quiz questions

1	Learning Outcome: F3
Which of the following statements is true?	
A	A subsidiary is a company that is 100% owned by a parent company
B	Consolidated financial statements are only prepared if the parent and subsidiary operate in the same industry
C	A subsidiary is a company that has entered into a long-term contract with the parent company
D	Control can usually be assumed if the parent owns more than 50% of the subsidiary's shares

1	Feedback
A	**Incorrect** A parent will normally own 50% or more of the shares of a subsidiary, in order to have control over the subsidiary Control can usually be assumed if the parent owns more than 50% of the subsidiary's shares
B	**Incorrect** The parent and subsidiary do not need to operate in the same industry. Control can usually be assumed if the parent owns more than 50% of the subsidiary's shares
C	**Incorrect** Control can usually be assumed if the parent owns more than 50% of the subsidiary's shares
D	**Correct**

2	Learning Outcome: F2
Which of the following is the correct accounting entry to account for unrealised profits from intra-group sales from the parent to the subsidiary?	

A	Debit	Parent's retained earnings
	Credit	Closing inventory
B	Debit	Subsidiary's retained earnings
	Credit	Closing inventory
C	Debit	Closing inventory
	Credit	Parent's retained earnings
D	Debit	Closing inventory
	Credit	Subsidiary's retained earnings

2	Feedback
A	**Correct**
B	**Incorrect** Debit Parent's retained earnings Credit Closing inventory
C	**Incorrect** Debit Parent's retained earnings Credit Closing inventory
D	**Incorrect** Debit Parent's retained earnings Credit Closing inventory

3	Learning Outcome: F2
Minch Company acquires 80% of the ordinary shares of Caol Company for FRW 300 million on 31 December 20X7, when Caol's net assets total FRW 320 million. What is the goodwill arising on consolidation?	
A	FRW 20 million
B	FRW 44 million
C	FRW 64 million
D	FRW 16 million

3	Feedback
A	**Incorrect** Cost of share acquired 300 Net assets acquired (80% x 320) 256 Goodwill 44
B	**Correct** Cost of share acquired 300 Net assets acquired (80% x 320) 256 Goodwill 44
C	**Incorrect** Cost of share acquired 300 Net assets acquired (80% x 320) 256 Goodwill 44
D	**Incorrect** Cost of share acquired 300 Net assets acquired (80% x 320) 256 Goodwill 44

4	Learning Outcome: F2
Muirnan Company owns 75% of Clish Company. At the reporting date, Clish had net assets of FRW 120 million and ordinary share capital of FRW 60 million. What is the amount for non-controlling interest in the consolidated statement of financial position?	
A	FRW 15 million
B	FRW 120 million
C	FRW 30 million
D	FRW 90 million

Non-controlling interest = 25% of net assets at reporting date = 25% × 120 = 30

4	Feedback
A	**Incorrect** Non-controlling interest = 25% of net assets at reporting date = 25% × 120 = 30
B	**Incorrect** Non-controlling interest = 25% of net assets at reporting date = 25% × 120 = 30
C	**Correct** Non-controlling interest = 25% of net assets at reporting date = 25% × 120 = 30
D	**Incorrect** Non-controlling interest = 25% of net assets at reporting date = 25% × 120 = 30

5	**Learning Outcome: F1**
Mob Company controls 70% of Dot Company's ordinary share capital. During 20X7, Mob reported revenue of FRW 60 million while Dot reported revenue of FRW 10 million. There were no intragroup sales. What revenue will be reported in the group financial statements for 20X7?	
A	FRW 70 million
B	FRW 60 million
C	FRW 50 million
D	FRW 67 million

5	Feedback
A	**Correct** The consolidated statement of profit or loss shows all income generated by the group's resources. This is the case even if the equity share in subsidiary is less than 100%. Consolidated statement of profit or loss - revenue = 60 +10 = FRW 70 million

5	Feedback
B	**Incorrect** The consolidated statement of profit or loss shows all income generated by the group's resources. This is the case even if the equity share in subsidiary is less than 100%. Consolidated statement of profit or loss - revenue = 60 +10 = FRW 70 million
C	**Incorrect** The consolidated statement of profit or loss shows all income generated by the group's resources. This is the case even if the equity share in subsidiary is less than 100%. Consolidated statement of profit or loss - revenue = 60 +10 = FRW 70 million
D	**Incorrect** The consolidated statement of profit or loss shows all income generated by the group's resources. This is the case even if the equity share in subsidiary is less than 100%. Consolidated statement of profit or loss - revenue = 60 +10 = FRW 70 million

Unit F Exercises

Exercise F1

Creed Company acquired 180 million of the ordinary shares in Avain on 1 January 20X6 for FRW 600 million, and the retained earnings at that date were FRW 32 million.

The following balances are extracted from the statement of financial position of Avain as at 31 December 20X8:

	FRW million
Share capital – FRW 1 ordinary shares	240
Retained earnings	38

Creed had retained earnings of FRW 500 million as at 31 December 20X8.

Calculate the consolidated retained earnings as at 31 December 20X8.

Exercise F1 solution

180/240 = 75%

Parent

75%

Subsidiary

	FRW million	**FRW million**
Parent's retained earnings (100%)		500
Subsidiary – group share of post-acquisition retained earnings:		
Retained earnings at date of reporting	38	
Less: retained earnings at date of acquisition	(32)	
Post-acquisition retained earnings	6	
Group share = 75% × 6		4.5
Group retained earnings		504.5

Exercise F2	**FRW Million**	**FRW Million**
Statement of profit or loss for the year ending 31 December 20X7	Cross	Luer
Revenue	1,000	750
Cost of sales	(350)	(400)
Gross profit	650	350
Distribution costs	(50)	(120)
Administrative expenses	(150)	(110)
Investment income (dividend received from Luer)	48	0
Profit before tax	498	120
Tax	(150)	(35)
Profit for the year	348	85
(1) Cross owns 80% of the ordinary share capital of Luer.		
(2) During the year Luer had sold goods to Cross for FRW 40 million. These had cost Luer FRW 20 million. At 31 December 20X7 Cross still had half of these goods in inventory.		
Prepare a consolidated statement of profit or loss for the year ending 31 December 20X7.		

Exercise F2 solution		
1.	Cross 80% Luer	
Non-controlling interest – 20%		
2. Unrealised profits		
	FRW million	

Goods transferred from Cross to Luer	40	
Cost of goods transferred	(20)	
Profit	20	
Unrealised profit (50% × 20)	10	
3. Revenue and cost of sales		
Revenue - Cross	1,000	
Luer	750	
Total	1,750	
Less: intra-group sale	(40)	
Consolidated revenue	1,710	
Cost of sales - Cross	350	
Luer	400	
Total	750	
Less: Intra-group purchase	(40)	
Add: Unrealised profit	10	
Consolidated cost of sales	720	
4. Non-controlling interest		
NCI = 20% × 85 – 10	15	

Cross – Consolidated Statement of profit or loss for the year ended 31 Dec 20X7

	Workings	FRW million
Revenue		1,710
Cost of sales		(720)
Gross profit		990

Distribution costs	(50 + 120)	(170)
Admin expenses	(150 + 110)	(260)
Profit before tax		560
Taxation	(150 + 35)	(185)
Profit for the year		375
Attributable to:		
Equity shareholders in Cross	Balancing figure	360
Non-controlling interest		15
Profit for the year		375

Unit G: Interpretation of financial statements using ratio analysis.

Learning outcomes

G1. Calculate and interpret the relationship between the elements of the financial statements with regard to profitability, liquidity, efficient use of resources and financial position.

G2. Draw valid conclusions from the information contained within the financial statements.

G3. Present clearly and concisely issues, analysis and conclusions to the appropriate people.

Introduction to Unit G

In Unit D, you were introduced to the use of ratios and other tools to interpret the information contained in the financial statements of a company or other organisation. In that unit, the focus was on understanding the needs of the users of financial information, the definition of the main ratios used in analysing financial statements, and how these can be used to assess the profitability, liquidity, solvency, and efficiency of the organisation. In Unit G, we will turn to the practical processes involved in the calculation of these ratios, using the resulting information to carry out analysis of financial statements and drawing conclusions from the results.

It is important that you learn the definition of the main ratios that will be used in this unit. These were set out in Unit D, and they will be summarised again as we work through examples in this unit.

You should also take time to think about the meaning of each ratio in the context of the organisation in each example. Although you may see generalisations such 'a current ratio of 2:1 is ideal', in reality, this will depend on the circumstances of the individual organisation, the industry it operates in, and the economic situation at the time. And note the limitations of ratios that were set out in Unit D: the ratios themselves will never give you a ***definitive*** answer to questions about the organisation's financial situation, but they can help to guide you in terms of suggesting problem areas or aspects of the organisation that are performing well/poorly, improving/declining, etc and require further investigation.

Example

Della Cafes: Extract from statement of comprehensive income for the year ended 31 December:

Statement of profit or loss	20X6 FRW '000	20X5 FRW '000
Revenue	8,422,157	7,026,484
Cost of sales	(3,210,919)	(2,746,580)
Gross profit	5,211,238	4,279,904
Profit from operations	1,513,358	1,260,216
Profit for the year	1,179,669	863,957

Extract from statement of financial position as at year ended 31 December:

Statement of financial position	20X6 FRW '000	20X5 FRW '000
Non-current assets	4,511,376	3,262,364
Inventory	61,579	37,625
Trade receivables	256,729	206,777
Cash and cash equivalents	2,098,361	2,709,808
Total assets	**6,928,045**	**6,216,574**
Called up share capital	477,423	477,423
Share premium account	4,006,821	4,006,821
Retained earnings	1,429,890	593,966
Shareholders' funds	5,914,134	5,078,210
10% Debentures	750,000	750,000

Trade payables	263,911	388,364
Total equity and liabilities	**6,928,045**	**6,216,574**

Notes:	20X6	20X5
Number of ordinary shares in issue	9,548,470	9,548,470
Share price - FRW '000	1.35	1.05
Number of cafes in operation	6	4
Total ordinary dividends paid - FRW '000	343,745	286,454

Revenue for the year ended 31 December 20X4 was FRW 6,566,805,000.

The company commenced business in April 20X3.

a) Calculate ratios for 20X5

b) Calculate ratios for 20X6 and comment on the results

Solution

(Figures in FRW '000)

1. Trends in revenue

Annual % change in revenue =	(Revenue in 20X5 – Revenue in 20X4) / Revenue in 20X4
=	(7,026,484 – 6,566,805) /6,566,805
=	7.0%

2. Profitability ratios

Gross profit margin (20X5) =	Gross profit / Revenue
=	4,279,904 / 7,026,484
=	60.9%

Net profit margin (20X5) =	Profit from operating activities / Revenue
=	1,260,216 / 7,026,484
=	17.9%

Return on capital employed (20X5) =	Profit from operating activities / Capital employed
=	1,260,216 / (5,078,210 + 750,000)
=	21.6%

3. Short-term solvency (liquidity) ratios

Current ratio (20X5) =	Current assets / Current liabilities
=	2,954,210 / 388,364
=	7.6:1

Quick ratio (20X5) =	(Current assets – inventory) / Current liabilities
=	(2,954,210 – 37,625) / 388,364
=	7.5:1

4. Efficiency ratios

Asset turnover (20X5) =	Revenue / Capital employed
=	7,026,484 / (5,078,210 + 750,000)
=	1.2 times

Average inventory days (20X5) =	Average inventory x 365 / Cost of sales
=	(37,625 x 365) / 2,746,580
=	5 days

(Note that the year-end inventory figure is used here. This is because there is not enough information to work out an average inventory figure for each year, so we need to use the next best data available)

Average trade receivables days (20X5) =	Average trade receivables x 365 / Credit sales
=	(206,777 x 365) / 7,026,484
=	11 days

(Note that without further information, we need to assume that total revenue is an suitable

alternative to using credit sales in this ratio)

Average trade payables days (20X5) =	Average trade payables x 365 / Credit purchases
=	(388,364 x 365) / 2,746,580
=	52 days

(Note that without further information, we can use cost of sales in place of credit purchases in this ratio)

5. Long-term solvency

Gearing (20X5) =	Non-equity finance / Capital employed
=	750,000 / (5,078,210 + 750,000)
=	12.9%

6. Shareholder investment

Ordinary dividend cover (20X5) =	Profit attributable to ordinary shareholders / Ordinary dividends
=	863,957 / 286,454
=	3.0 times

Earnings per share (20X5) =	Profit attributable to ordinary shareholders / No. of ordinary shares
=	863,957 / 9,548,470
=	0.09 (ie FRW 90 per share)

Exercise G1

Calculate the **20X6 ratios** for Della Cafes using the information in the financial statements and comment on the results

Exercise G1 solution

1. Trends in revenue

Annual % change in revenue	=	(Revenue in 20X6 – Revenue in 20X4) / Revenue in 20X5
	=	(8,422,157 - 7,026,484) / 7,026,484
	=	19.9%

The revenue during 20X6 was 19.9% higher than 20X5.

The increase in revenue could be due to:

- Two new cafes being opened.
- The existing cafes becoming established and gaining a more loyal customer base.
- Increase in sales prices whilst maintaining customer numbers.

2. Profitability ratios

Gross profit margin (20X6)	=	Gross profit / Revenue
	=	5,211,238 / 8,422,157
	=	61.9%

The ratio only takes into account cost of sales (ie food costs and other direct costs)

In 20X6, for every FRW 1,000 of revenue the cafe makes a gross profit of FRW 619.

This is an improvement on 20X5, which may be due to:

- The increase in the size of the overall activity allows the company to negotiate better discounts from suppliers.
- More experienced staff results in improved efficiency and less wastage.
- A loyal customer base allows the company to increase prices while maintaining the cost of sales.
- Better inventory control.

Net profit margin (20X6)	=	Profit from operating activities / Revenue
	=	1,513,358 / 8,422,157
	=	18.0%

This ratio takes account of the cost of sales and all other expenses.

In 20X6, for every FRW 1,000 of revenue the cafe makes an operating profit of FRW 180.

Another way of looking at this is that for every FRW 1,000 of revenue, FRW 820 covers food costs, wages and other expenses, the balance is operating profit.

There is no significant improvement on 20X5, despite improvement in gross profit margin, which may be due to failure to control expenses as the number of cafes expands.

ROCE (20X6)	=	Profit from operating activities / Capital employed
	=	1,513,358 / (5,914,134 + 750,000)
	=	22.7%

In 20X6, for every FRW 1,000 of funds invested, the business made a return of FRW 227.

There is a small improvement on the 20X5 performance.

This is in partly driven by an increase in profitability, as well as improvements in efficiency (see below).

3. Short-term solvency (liquidity) ratios

Current ratio (20X6)	=	Current assets / Current liabilities
	=	2,416,669 / 263,911
	=	9.2:1
Quick ratio (20X6)	=	(Current assets – inventory) / Current liabilities
	=	(2,416,669 – 61,579) / 263,911
	=	8.9:1

When commenting on liquidity, it is important to consider the composition of current assets.

In 20X6, for every FRW 1,000 of short-term liabilities, the business had:

- FRW 9,200 of current assets
- FRW 8,900 of 'quick' assets

With over FRW 2 billion in cash and cash equivalents the business currently has no liquidity problems

However, holding such huge amounts of cash and cash equivalents for too long may indicate an inefficient use of business resources.

4. **Efficiency ratios**

Asset turnover (20X6)	=	Revenue / Capital employed
=		8,422,157 / (5,914,134+ 750,000)
=		1.3 times

In 20X6 for every FRW 1,000 invested, the business makes approximately FRW 1,300 of revenue.

This is a slight improvement on 20X5 and is despite the opening of two new cafes during 20X6.

Average inventory days (20X6)	=	Average inventory x 365 / Cost of sales
=		(61,579 x 365) / 3,210,919
=		7 days

This ratio indicates how long on goods are held in inventory.

Inventory control seems to have deteriorated slightly from 20X5 to 20X6, and this suggests that further investigation is needed.

Note that it is possible to calculate ***average*** inventory for 20X6, but as we based the 20X5 figure on ***closing*** inventory, we should do the same for 20X6 to provide a valid comparison.

Average trade receivables days (20X6)	=	Average trade receivables x 365 / Credit sales
=		(256,729 x 365) / 8,422,157
=		11 days

This ratio provides an indication of how quickly customers pay for credit sales.

Approximately 30 days is typical for many industries, so this result suggests the company is able to collect quickly from its customers.

Average trade payables days (20X6)	=	Average trade payables / Credit purchases x 365
=		(263,911 / 3,210,919 x 365)
=		30 days

This ratio provides an indication of how quickly a business pays its trade payables / suppliers.

Taking too long will impact upon an organisations credit rating and might mean that it misses out on discounts for prompt payment.

30 days is in line with a typical industry average and represents a significant improvement on the performance in 20X5.

5. Long-term solvency

Gearing (20X6) =	Non-equity finance / Capital employed
=	750,000 / (5,914,134 + 750,000)
=	11.3%

This ratio indicates the business's reliance on long term debt as a form of finance.

In 20X6 for every FRW 1,000 of long-term funds:

- FRW 113 is in the form of long-term debt
- The balance of FRW 887 is provided by shareholders.

As expected for a company with huge cash reserves, gearing is very low.

Once gearing rises above 50%:

- Profit may not completely cover interest payments
- Long term lenders have invested more in the business than shareholders and have more to lose in the event of business failure
- Businesses are seen as a riskier investment.

6. Shareholder investment

Ordinary dividend cover (20X6) =	Profit attributable to ordinary shareholders / Ordinary dividends
=	1,179,669 / 343,745
=	3.4 times

In 20X6 the company has sufficient profits to pay its ordinary dividend 3.4 times.

This suggests the business is low risk and ties in with the gearing ratio above.

Earnings per share (20X6) =	Profit attributable to ordinary shareholders / No. of ordinary shares
=	1,179,669 / 9,548,470
=	FRW 124

The EPS ratio indicates profit each share has earned during the year.

In 20X6 each share earned a profit of FRW 124.

This represents the dividend that could have been paid to shareholders if the company choose to distribute all of the profits from 20X6 (without reducing retained earnings).

Overall comments

There are no concerns regarding gearing, investor, ROCE, and efficiency ratios.

There are no evident liquidity issues. However, there is currently too much tied up in cash and cash equivalents. It is not clear why the company is paying interest on a large amount of debentures when it has large amounts in the form of cash and cash equivalents. In the long term, failure to make proper use of the funds at its disposal might adversely impact on ROCE.

A significant improvement in gross profit percentage was cancelled out by an increase in operating expenses. It is important to review the operating expenses to determine why these have increased.

Summary of Unit G and key learning outcomes

In Unit G we looked at the Competency: 'Interpret financial statements using ratio analysis'. This involved content on three broad learning outcomes.

Calculate and interpret the relationship between the elements of the financial statements with regard to profitability, liquidity, efficient use of resources and financial position.	You should now be familiar with the main ratios used in determining a company's profitability, liquidity, and efficiency, with how these are calculated, and also the way that the results should be interpreted.
Draw valid conclusions from the information contained within the financial statements.	In this unit, we looked at examples of company financial statements and used these to calculate and interpret various ratios.
Present clearly and concisely issues, analysis and conclusions to the appropriate people.	In the exercises, we looked at the meaning of the ratio results and the actions that a company might need to take in response to this information.

Quiz questions

The following information is to be used in Quiz questions 1 and 2:

Rodel Company has the following summarised statements of profit or loss for 20X7 and 20X8

	20X8	**20X7**
	FRW million	FRW million
Revenue	80 000	56 000
Cost of sales	(44 000)	(33 600)
Gross profit	36 000	22 400
Expenses	(28 000)	(16 800)
Profit for the year	8 000	5 600

1	Learning Outcome: G1
What was Rodel's gross profit margin in 20X7 and 20X8?	
A	20X7 67% 20X8 82%
B	20X7 10% 20X8 10%
C	20X7 40% 20X8 45%
D	20X7 60% 20X8 55%

1	Feedback
A	**Incorrect** 20X7 22.4/56 * 100 = 40% 20X8 36/80 * 100 = 45%

1	Feedback
B	**Incorrect** 20X7 22.4/56 * 100 = 40% 20X8 36/80 * 100 = 45%
C	**Correct** 20X7 22.4/56 * 100 = 40% 20X8 36/80 * 100 = 45%
D	**Incorrect** 20X7 22.4/56 * 100 = 40% 20X8 36/80 * 100 = 45%

2	Learning Outcome: G1
What was Rodel's net profit margin in 20X7 and 20X8?	
A	20X7 17% 20X8 18%
B	20X7 10% 20X8 10%
C	20X7 40% 20X8 45%
D	20X7 29% 20X8 33%

2	Feedback
A	**Incorrect** 20X7 8/80 * 100 = 10% 20X8 5.6/56 * 100 = 10%
B	**Correct** 20X7 8/80 * 100 = 10% 20X8 5.6/56 * 100 = 10%

2	Feedback
C	**Incorrect** 20X7 8/80 * 100 = 10% 20X8 5.6/56 * 100 = 10%
D	**Incorrect** 20X7 8/80 * 100 = 10% 20X8 5.6/56 * 100 = 10%

The following information is to be used in questions 3 to 5:

Maddy Company's statements of profit or loss for year ended 31 December	**20X8 FRW million**	**20X7 FRW million**
Revenue	5,053	4,216
Cost of sales	(1,510)	(1,760)
Gross profit	3,543	2,456
Operating expenses	(980)	(800)
Net profit	2,563	1,656
Maddy Company's statements of financial position as at 31 December	20X8 FRW million	20X7 FRW million
Non-current assets	2,700	2,130
Inventory	41	23
Trade receivables	121	146
Cash and cash equivalents	1,370	1,570
Total assets	**4,232**	**3,869**
Called up share capital	286	286
Share premium account	2,400	2,400

Retained earnings	920	520
10% Debentures	450	450
Trade payables	176	213
Total equity and liabilities	**4,232**	**3,869**

3	Learning Outcome: G1
What was Maddy's current ratio in 20X7 and 20X8?	
A	20X7 8.2:1 20X8 8.7:1
B	20X7 10:1 20X8 15.3:1
C	20X7 0.7:1 20X8 0.7:1
D	20X7 0.8:1 20X8 0.9:1

3	Feedback
A	**Correct** 20X7 (23+146+1,570)/213 = 8.2:1 20X8 (41+121+1,370)/176 = 8.7:1
B	**Incorrect** 20X7 (23+146+1,570)/213 = 8.2:1 20X8 (41+121+1,370)/176 = 8.7:1
C	**Incorrect** 20X7 (23+146+1,570)/213 = 8.2:1 20X8 (41+121+1,370)/176 = 8.7:1

D	**Incorrect** 20X7 (23+146+1,570)/213 = 8.2:1 20X8 (41+121+1,370)/176 = 8.7:1

4	Learning Outcome: G1
What was Maddy's quick ratio in 20X7 and 20X8?	
A	20X7 18:1 20X8 24:1
B	20X7 7.4:1 20X8 7.8:1
C	20X7 8.0:1 20X8 8.5:1
D	20X7 8.2:1 20X8 8.7:1

4	Feedback
A	**Incorrect** 20X7 (146+1,570)/213 = 8.0:1 20X8 (121+1,370)/176 = 8.5:1
B	**Incorrect** 20X7 (146+1,570)/213 = 8.0:1 20X8 (121+1,370)/176 = 8.5:1
C	**Correct** 20X7 (146+1,570)/213 = 8.0:1 20X8 (121+1,370)/176 = 8.5:1

D	**Incorrect** 20X7 (146+1,570)/213 = 8.0:1 20X8 (121+1,370)/176 = 8.5:1

5	Learning Outcome: G1
What were Maddy's inventory days in 20X7 and 20X8?	
A	20X7 2 days 20X8 3 days
B	20X7 10 days 20X8 14 days
C	20X7 4 days 20X8 8 days
D	20X7 5 days 20X8 4 days

5	Feedback
A	**Incorrect** 20X7 (23 * 365)/1,760 = 5 days 20X8 (41 * 365)/ 3,543 = 4 days Note – there is not enough information to determine *average* inventory
B	**Incorrect** 20X7 (23 * 365)/1,760 = 5 days 20X8 (41 * 365)/ 3,543 = 4 days Note – there is not enough information to determine *average* inventory
C	**Incorrect** 20X7 (23 * 365)/1,760 = 5 days 20X8 (41 * 365)/ 3,543 = 4 days Note – there is not enough information to determine *average* inventory

5	Feedback
D	**Correct** 20X7 (23 * 365)/1,760 = 5 days 20X8 (41 * 365)/ 3,543 = 4 days Note – there is not enough information to determine *average* inventory

6	Learning Outcome: G2
Which of the following statements is true about the asset turnover ratio?	
A	The ratio makes use of the profit before interest and tax figure
B	A high ratio indicates that the business is operating efficiently
C	A low ratio indicates that the business is operating efficiently
D	The ratio is usually expressed as a percentage of profit

6	Feedback
A	**Incorrect** The ratio is Revenue/ Capital employed A high ratio indicates that the business is operating efficiently
B	**Correct**
C	**Incorrect** A high ratio indicates that the business is operating efficiently
D	**Incorrect** The ratio is usually expressed as the number of times assets are turned over A high ratio indicates that the business is operating efficiently

Unit H: Role of Accounting in Organisations.

Learning outcomes

H1. Describe the purpose, structure and organisation of the accounting function and its relationships with other functions within the organisation.

H2. Explain the various business purposes for which the following financial information is required:

- Statement of profit or loss (profit and loss account)
- Forecast of cash flow (statement of cash flows)
- Statement of financial position (balance sheet).

H3. Give an overview of the organisation's business and its critical external relationships with stakeholders.

H4. Explain how the accounting systems are affected by the organisational structure, systems, procedures, and business transactions.

H5. Explain the effect on users of changes to accounting systems caused by:

- External regulations
- Organisational policies and procedures.

Introduction to Unit H

In Unit H, we will look at various aspects of the role of accounting within an organisation. We will focus mainly on the way this operates in a commercial organisation, but many of the features will also be relevant in public sector organisations, charities, etc.

In previous units, we focused on the ways in which accounting standards are applied in the preparation of financial statements. This is central to the financial reporting function in an organisation. But the role of the overall accounting function is wider than that. Financial information, as well as being necessary for preparing financial statements, is also relevant and useful in the way that the organisation operates internally, and in its relationships with external stakeholders.

For example, as well as preparing financial information on the organisation's inventory, and presenting this in the statements of profit or loss (as part of the cost of sales) and the statement of financial position (as a current asset), this information (and other information on inventory) is needed other individuals and for other purposes, eg:

- By managers for controlling levels of inventory
- By management accountants to inform decisions on pricing of products

- By production managers for planning future production
- As part of overall risk management
- By auditors for confirming information in financial statements
- For following up suspicions of potential fraud

It is important that you have an understanding of how financial information and financial systems need to meet the wider requirements of the organisation, and not just the needs of financial reporting.

Some of these points were introduced in Unit A, but they are expanded on here. They should also mean more to you now that you have a deeper understanding of the financial reporting process and the information used in preparing financial statements.

The accounting function and systems

The complexity of the accounting function will depend on the size of the entity and the type of business that it is engaged in. A sole trader will probably keep a file of receipts and financial documents, but may use a local accountant to prepare their financial statements. Companies are required to maintain records in accordance with the law, and so have much stricter criteria to meet.

In larger accounting functions of big organisations, there may be clear sections of the function which perform the different tasks. There may be separate sections for the following:

Transaction processing	Maintaining the accounting records: payroll, sales ledger, purchases, cash book and general ledger
Financial accounting	Producing financial statements and other external reports for regulators, including taxation
Management accounting	Producing cost reports, forecasts and budgets, and any other information required by managers to support planning, performance measurement and decision making
Treasury management	Managing the organisation's cash flow and requirements for finance

Organisations (including companies, partnerships and sole traders) should keep accounting records which are sufficient to show and explain the company's transactions, and disclose with reasonable accuracy, at any time, the financial position of the company at that time. For companies, accounting records must also be sufficient to enable the directors to produce statements of financial position and profit or loss in accordance with the law. In other words, the records must be detailed enough that an accountant could produce those statements from the available records at any time.

In practice, accounting records should contain the following elements

Cash book	**Non-current asset register**
Receivables ledger	**Bank statements**
Bank statements	**Inventory sheets**

- The cash book is used to record all receipts and payments transactions (cash in and cash out of the organisation).
- Other items are used to record the assets and liabilities of the business.
- Information on inventory may be held in different ways, depending on the complexity of the raw materials, work in progress, or finished goods involved in the organisation's activities.

It is important to understand the need for appropriate accounting records within the organisation. Where it is not a normal retail trade, statements of all goods sold and purchased – showing enough details of the goods, buyers and sellers that they can all be identified – must be retained. If the company does not keep the required records, the directors and officers of the company may be found guilty of an offence. Usually, such records must be kept at the office registered with a government department or somewhere else that the directors think is fit. The law may also require that these accounting records are kept for a certain period of time; for example, in Rwanda (Law Relating to Companies 2018) the accounting records, financial statements and other records including minutes of shareholder meetings should be retained for ten years.

Culture of the accounting function

The accounting function is not just the accounting system plus the employees who operate it. A key element of any accounting function is the culture that exists within it. Culture is 'the way we do things around here'. It may be very different from the way a company might ideally want it to be.

Managers and owners set the standard for the accounting function because they operate it on a day today basis, and therefore determine its culture. This is often what makes one company and its accounting function different from another.

The culture of the accounting function may be:

(a) Based on teamwork – where everyone helps each other to ensure all tasks are completed on time and appropriately by the team as a whole.

(b) Based on individualism – where each member of staff sticks to their own roles and responsibilities.

(c) Based on control – where all rules and procedures are adhered to at all times. The control environment at an organisation will impact on how many and how often the levels of management interact with the staff.

(d) Laissez-faire (relaxed) – where controls are informal and trust is an important part of the control framework.

No particular culture is right or wrong, but a certain culture may be inappropriate to the accounting function in question eg a laissez-faire culture in respect of cash is always risky.

Centralised and decentralised arrangements

Accounting functions within companies can be centralised or decentralised. Some organisations may have limited staff or experience and so look to outsource some activities, such as payroll or debt collection.

A centralised accounting function is where the accounting tasks are performed at head office, regardless of where the company's other activities are carried out. All the data is stored at a central location and accounting function staff process it centrally, although this may be by accessing the system from many different locations.

Staff will be trained according to the department and role they work in, and may therefore have acquired highly specialised knowledge, which can result in increased efficiency. For example, a large retail organisation may have many branches, with a single head office. The company may have a central finance function within the head office, which allows the individual stores to focus on looking after the customers and reacting to what products are selling well in that particular branch.

In decentralised accounting functions the data is stored and processed locally, and perhaps independently by staff at different locations or with different computer networks. There is no link between processes, each being formed independently of the others.

In a decentralised system, the staff will need to have a broader awareness of what roles they may be working on; sometimes training and actual job roles will vary between sites. An advantage of a decentralised system may be that decision making is closer to the needs of each part of the organisation, and in some cases may be much quicker and more relevant to that location as a result.

Many organisations centralise some, or more rarely all, of the tasks carried out by an accounting function and then outsource this work to a third party, often under strict contractual agreements known as service level agreements (SLAs).

Outsourcing is where an organisation arranges for essential, but often routine or specialised, tasks to be carried out by a third party. Outsourcing of accounting functions is most popular for routine tasks, such as payroll, internal audit, supplier payments, debtors collection, etc that:

- Rely on information technology for processing
- Require highly specialised and up to date skills, knowledge or technology

An example is the 'buying in' of the specialised knowledge from a payroll bureau, common in many smaller entities. This shares the cost of specialised software and skilled staff across several companies, producing economies of scale and a cheaper service for all customers.

Stakeholders and the accounting function

In previous units (Units A, D and G in particular), we considered the needs of various users who interact with the financial statements and who may rely on them for providing crucial information. We noted that financial reporting is mainly focused on external reporting objectives, and these follow the requirements set out in standards and legislation. But there are also internal users, that may require financial information that is not contained in the published financial statements. The internal information may be available from other regular reports, such as budgets, sales projections, cash forecasts, etc, but others may be bespoke – ie prepared specifically for a unique situation, such as an investment appraisal for a new product.

The term 'stakeholders' is sometimes used to refer to the various groups and individuals who might have an interest in the financial statements. This term is to a large extent interchangeable with the term 'users' that we referred to in Unit A and elsewhere. But the term stakeholder implies a more active involvement.

Note also that financial statements are expected to provide a level of assurance to stakeholders. This term is particularly relevant in the context of audit, and you will find more about this term in modules that focus on audit. But it is important to note it in the context of preparing financial information, either in the form of published financial statements, or other forms of financial reporting. Although each stakeholder will judge the financial statements by different criteria, they will all gain assurance from learning that what they are reading has been subject to an independent review through the external audit process.

Examples of stakeholders:
Directors
Shareholders
Employees
Creditors
The public
Tax authorities

In reality, companies may have thousands of shareholders and a large number of managers in different departments, divisions, etc. It is therefore important that directors are accountable to shareholders. Financial accountability is largely achieved through the financial reporting process. In their role, the directors of a company act as stewards of the shareholders' investments (ie they are responsible for looking after their interests). They are in effect acting as agents of the shareholders, as individual shareholders are not able to participate directly in the activities of the company (except through things like the annual general meeting (AGM).

Accountability	This involves being required or expected to justify actions and decisions. It suggests an obligation or willingness to accept responsibility for one's actions.
Stewardship	The duties and obligations of a person who manages another person's property
Agents	People who are employed or used to provide a particular service.

It is important to understand the relationships between directors and shareholders, and to note the role of financial reporting within that:

- Directors are accountable for the shareholders' investment.
- Shareholders have bought shares in that company (they have invested).
- Shareholders expect a return from their investment.
- As the directors manage the company, they are in a position to affect that return.
- Financial statements provide information on profit, dividends, revenue, growth, value of assets, etc.
- Shareholders are also interested in capital growth, which is mainly reflected in the share price at any point in time. This is not included directly in the financial statements, but may be noted in accompanying information.
- Directors report to shareholders via the financial statements, related reports, and general meetings (AGM and potentially other meetings).

The exact nature of the return expected by the shareholder will depend on the type of company. Certain issues are true of any such investment, however. For example, if the directors mismanage the company, and it goes bankrupt, it will neither provide a source of future dividends, nor will it create capital growth in the investment – indeed, the opposite is true and the original investment may even be lost. Note that in a 'limited' company, the amount that a shareholder can lose is limited to the amount of their original investment, and creditors are not able to pursue them as individuals for payment of outstanding amounts.

Each type of stakeholder has a different role in relation to the organisation, and therefore has different informational needs. Organisations need to communicate appropriately with stakeholders. The accounting function and accounting systems of the organisation are often the key source of the information they require.

A stakeholder that has a high level of interest in the organisation and also a high level of power – for instance, a bank that has given the organisation a large overdraft, and is concerned that it is about to be breached – should be regarded as a key player when it comes to giving it the information it seeks. Organisations in this position should make sure that they satisfy the bank's interests in the company, and this may include being involved in its decisions, eg authorising large items of capital expenditure. Other stakeholders, with lower levels of interest and/or power, should simply be kept informed to the degree required by legislation or contractual requirements eg small shareholders should be sent copies of the annual financial statements and invited to the annual general meeting as required by company law.

It can also be useful to distinguish between internal and external stakeholders. Internal stakeholders will require different types of information, depending on their role within the organisation. Management and owners (in a limited company, the owners are the shareholders) will want to know how the organisation is performing, but will not necessarily need to have a detailed view of what payments any given customer has made on their account. Equally, a purchases ledger clerk will need a detailed schedule for review on a supplier-by-supplier basis.

Information provided to internal stakeholders is not formalised by regulatory or legal guidance; instead, the users will dictate what information they require and how they want this to be presented to ensure the most efficient way of using it for their own needs.

External stakeholders will usually require a more formal and standardised reporting format. If the organisation has a bank loan or overdraft, the bank will want to review the financial statements as well as any business forecasts. External stakeholders will have strict reporting timetables and deadlines. Statutory financial reports must be filed with the Registrar General's office on an annual basis in line with relevant legislation and appropriate accounting standards

Companies are required to keep appropriate financial records, and regulations are in place covering the requirements of the auditors' need for financial information.

The accounting function should be set up to ensure that the information it produces is accurate and useful for both internal and external stakeholders. An organisation can ensure these objectives are met by establishing robust processes and controls. These will enable an organisation's employees to understand exactly what is required of them, and ensure that there is sufficient training, time and resources allocated, so that they can provide this information to the standard required.

Stakeholder interests in financial statements

We have noted how internal and external stakeholders may have different needs in terms of information, particularly financial information. This is often related to the specific decisions or concerns that the stakeholder may have in terms of their relationship with the company.

As you have some understanding now of the content of the financial statements of a company, the needs of different users, and the ways in which financial statements can be analysed, you should be able to attempt the following exercise. Note that this is a wide-ranging question, with lots of different ways of approaching it, so there is no definitive answer. Some suggestions are provided in the exercise solution, but these are not mean to be exclusive or exhaustive, and you may have come up with your own equally valid points.

Exercise H1

Describe how each of the main financial statements might be used by the following:

- A shareholder
- A bank that has provided the company with a five-year secured loan

Exercise H1 solution

There are many different ways of approaching this question, and you may have come up with suggestions that are different from those provided below, but they may be equally valid as there is a wide range of potential uses for each of the statements.

Note that, as well as using individual figures from the statements, users may calculate relevant ratios as discussed in Units D and G.

	Shareholder	**Bank**
Statement of profit or loss	• Gross and net profit figures indicate overall profitability, which is important for long-term prospects of investment • Expenses indicate level of management control over different types of cost	• Profit does not guarantee that company is able to repay loan in cash when required • Profit before interest and tax indicates level of ability to cover interest costs
Statement of financial position	• Shareholders funds show wealth of company that the investor has a share in • Balance between cash levels and other assets indicates whether resources are being well managed	• Liquidity information is crucial for understanding ability of company to meet its commitments to make payments in cash • Other liabilities are important so that bank understands company exposure in other ways
Statement of cash flow	• Cash is 'life-blood' of company, so statement shows how healthy the entity is in terms of being able to generate cash to service its cash requirements	• Interest and principal repayments of loan need to be in cash, so this is important in understanding the company's cash position and ability to continue to generate cash as required

Statement of changes in equity	• Information on movement in reserves such as retained earnings are informative in relation to the shareholder's investment	• This may not be of high importance to the bank, but may give some general information about the overall health of the company and its management of reserves
Notes to the financial statements	• There may be important details here on things like valuation of assets, future commitments, reasons for accounting adjustments, etc	• There may be important details here on things like valuation of assets (which the bank may have a specific interest in), future commitments, reasons for accounting adjustments, etc

Exercise H2

The management of Orin Company have determined the following ratios from their recent financial statements. For each of the ratios listed, suggest the appropriate action that should be taken by management.

a) The trade payables payment days ratio has increased from 25 days to 50 days

b) The current ratio has stayed level at 2.1, but the quick ratio has fallen from 1.2:1 to 0.5:1

c) The inventory days have increased from 30 days to 75 days. The industry average is 20 days

d) Gross profit has increased from 20% to 23%, but net profit has fallen from 10% to 5%.

Exercise H2 solution

a) The trade payables payment days ratio has increased from 25 days to 50 days	This is a large increase, and may indicate either cash problems (ie cash not available to pay suppliers on time) or poor management practices in relation to payment of suppliers. 25 days is a reasonable time period (although this depends on the industry), and so reducing from 50 days to something nearer 25-30 days is appropriate. Management should identify why the increase has occurred (ie is it a cash issue or something else), and look at options for action. For example, they may need to discuss payment terms with individual suppliers, or look at ways of increasing the cash available by use of an overdraft or by getting customers to pay more quickly.

Exercise H2 solution	
b) The current ratio has stayed level at 2.1, but the quick ratio has fallen from 1.2:1 to 0.5:1	These two ratios probably need to be considered together. As the current ratio is static, liquidity appears to be ok. However, the fall in the quick ratio suggests this is being achieved through increases in inventory, rather than maintaining more liquid current assets.
c) The inventory days have increased from 30 days to 75 days. The industry average is 20 days	Management need to question why inventory has increased and is being held for longer periods. It may be, for example, that advantage was taken of an opportunity to buy in bulk and access discounted prices. But this may simply result in additional costs elsewhere (eg through storage costs, additional wastage, increased insurance). Management need to ensure that they have a clear policy on inventory control, re-ordering procedures, target levels for each type of inventory, etc. Note that this may also result in cash shortages, if large amounts of cash are being tied up in inventory, and this may also be a factor in the increase in payables payment days.
d) Gross profit has increased from 20% to 23%, but net profit has fallen from 10% to 5%.	The reduction in net profit is a concern, and it is likely to be a result of poor cost control. There may be a direct correlation between the increase in GP and the reduction in NP. For example, cost of sales can be reduced by purchasing cheap materials, which may be of poor quality. This may lead to an increase in costs elsewhere, such as additional inventory write-offs for materials which are not usable. Management need to examine operating expenses in detail to determine which costs have increased. They then need to investigate the reasons for these increases (inflation, poor cost control, wastage, etc) before specific actions can be decided.

Changes to accounting systems

Accounting systems are not static aspects of an organisation, but need to be maintained and adapted depending on changing circumstances. The changes may arise as a result of internal or external developments.

Internal pressures may result in managers and others looking to have access to additional or altered forms of financial information. For example, the introduction of new products or new locations of activity may mean that costs may need to be collected and analysed in a different way. Or an opportunity to expand into a new market may require information on how the company finances will be impacted by this new activity. Some of this information may already be available, but in some instances the managers may need to amend systems to collect new types of information or additional detail.

It is important, therefore, that the company's financial systems are reasonably adaptable. One aspect of this will relate to the software being used to host the financial information. Many companies purchase specialised accounting software for their accounting systems, and it is crucial that the need for amendments, expansion, or additional detail is considered when selecting the software. In other words, the company should not just select a software package that is suitable for current needs, but should also be aware of the potential for changing needs.

An additional aspect of this adaptability is in relation to the organisation's chart of accounts and specification of types of revenue, expense, asset and liability, as well as details on locations, products, divisions, etc. The chart of accounts sets out the full list of items that the organisation needs to collect financial information on, and allocates codes or other labels to these so that they can be recorded in the financial systems in a systematic manner. The design of the chart of accounts also needs to take account of the potential for future additions or other changes.

Some changes are required as a result of external pressures. Two major sources of change are from accounting standards and from legislation (or other regulations).

New accounting standards are introduced regularly, and the company needs to keep on top of developments in this area, as information is available a year or two ahead of the official introduction of a new IFRS. Existing IFRSs are also amended from time to time, and this may require a change in the accounting policies and/or some changes in practices in relation to the way financial transactions are recorded.

New legislation may also impact on things like the classification of items. For example, a specific type expense may become eligible for a new tax relief, so the company will need to start recording it separately from other expenses. Revised regulations may impact on requirements to keep financial records for a period of time, which will require action to update company policy and procedure documents, as well as potentially requiring new staff training on the matter.

Summary of Unit H and key learning outcomes

In Unit H we looked at the Competency: 'Demonstrate an understanding of the role of accounting within the organisation'. This involved content on five broad learning outcomes.

Describe the purpose, structure and organisation of the accounting function and its relationships with other functions within the organisation	You should now be able to describe and discuss the accounting function and the different activities that are part of it. You should also be able to describe different arrangements for the accounting function within an organisation.
Explain the various business purposes for which the following financial information is required: • statement of profit or loss (profit and loss account) • forecast of cash flow (statement of cash flows) • statement of financial position (balance sheet)	You should now be able to use financial information from the various financial statements to discuss how users might identify relevant information that helps them keep informed and make appropriate decisions.
Give an overview of the organisation's business and its critical external relationships with stakeholder	You should now be able to list different types of internal and external stakeholders, and the way in which they interact with the financial information of the company.
Explain how the accounting systems are affected by the organisational structure, systems, procedures, and business transactions	You should now be able to discuss accounting systems and how these are organised in a company, including issues such as centralisation and outsourcing.
Explain the effect on users of changes to accounting systems caused by: • external regulations • organisational policies and procedures	You should now be aware of the need to ensure that accounting systems are designed in a way that they can be adapted for changing circumstances, whether from internal or external pressures.

Quiz questions

1	Learning Outcome: H3
Which of the following terms refers to 'being required or expected to justify actions and decisions'	
A	Stewardship
B	Assurance
C	Accountability
D	Audit

1	Feedback
A	**Incorrect** This is a description of accountability
B	**Incorrect** This is a description of accountability
C	**Correct**
D	**Incorrect** This is a description of accountability

2	Learning Outcome: H1
Which of the following describes the activity of treasury management?	
A	Maintaining the accounting records: payroll, sales ledger, purchases, cash book and general ledger

B	Producing financial statements and other external reports for regulators, including taxation
C	Producing cost reports, forecasts and budgets, and any other information required by managers to support planning, performance measurement and decision making
D	Managing the organisation's cash flow and requirements for finance

2	Feedback
A	**Incorrect** This is a description of transaction processing Managing the organisation's cash flow and requirements for finance is a description of treasury management
B	**Incorrect** This is a description of financial accounting Managing the organisation's cash flow and requirements for finance is a description of treasury management
C	**Incorrect** This is a description of management accounting Managing the organisation's cash flow and requirements for finance is a description of treasury management
D	**Correct**

3	Learning Outcome: H5
Which of the following would be an example of an internal pressure requiring a change in the company's accounting system?	
A	The issuing of a new Exposure Draft by the IASB
B	The creation of a new division in the company, that will be responsible for marketing a new product

C	The launch of a new product by a competitor in the same industry
D	The issuing of additional regulations by government that impact on the way the Companies Act is applied in the company

3	Feedback
A	**Incorrect** A new Exposure Draft is an external pressure The creation of a new division, that will be responsible for marketing a new product is an example of an internal pressure
B	**Correct**
C	**Incorrect** A new product from a competitor is an external pressure The creation of a new division, that will be responsible for marketing a new product is an example of an internal pressure
D	**Incorrect** A new regulation is an external pressure The creation of a new division, that will be responsible for marketing a new product is an example of an internal pressure

4	Learning Outcome: H1
Which one of the following statements is true?	
A	Directors of a company are only required to comply with requirements to retain financial records for a period of time specified in the company's internal policies, which may be different for each company
B	Directors of a company are required to ensure that financial records are kept for a period of time as specified in legislation or other regulations
C	Directors of a company are only required to retain financial records if required to do so by external auditors

D	Directors of a company are only required to retain financial records for one financial year

4	Feedback
A	**Incorrect** Directors of a company are required to ensure that financial records are kept for a period of time as specified in legislation or other regulations
B	**Correct**
C	**Incorrect** Directors of a company are required to ensure that financial records are kept for a period of time as specified in legislation or other regulations
D	**Incorrect** Directors of a company are required to ensure that financial records are kept for a period of time as specified in legislation or other regulations

Unit I: Internal Control Systems in Accounting.

Learning outcomes

I1.	Identify the external regulations that affect accounting practice.
I2.	Describe the causes of, and common types of, fraud and the impact of this on the organisation.
I3.	Explain methods that can be used to detect fraud within an accounting system.
I4.	Explain the types of controls that can be put in place to ensure compliance with statutory or organisational requirements.

Introduction to Unit I

In this unit, we will be looking at internal controls, and how these are used in an organisation to ensure that it is operating effectively and in compliance with regulations, where applicable.

We considered different external requirements in Unit A, in the form of accounting standards, legislation, and other regulations. As well as being aware of these requirements, and designing accounting systems to implement these in the preparation of financial statements and other activities, we also need checks in place that tell us whether the systems are operating as planned. This is where internal controls come in.

Problems can arise in a system because someone makes an error in entering a transaction, and it is important that such errors are identified and corrected. There is also the possibility of ***deliberate*** action, that results in incorrect information in the system, and so we need controls to prevent and detect such instances of fraudulent activity.

Fraud is a large and complex topic, and we will only deal with the main aspects of it in this unit, and in particular in relation to the use of internal controls to prevent and detect instances of fraud.

External regulations

Unit A introduced the main external regulations that impact on a company and the way that it carries out its accounting and financial reporting. It is important that we briefly consider how the company can ensure that it applies or complies with these regulations.

The following are important to note in the context of external regulations and influences:

National legislation	Any business in Rwanda must comply with the local law in Rwanda. For a company, this means that they must comply with the Law Governing Companies 17/2018, or subsequent legislation where appropriate.
IFRS	The IFRS Standards set out the accounting treatment for various transactions. They set out the guiding principles regarding financial statements. Although IFRS Standards are not legally binding, the Law Governing Companies 17/2018 requires their application, and any deviation from IFRS Standards must be disclosed in a note to the financial statements.
Accounting principles and conventions	It is expected that financial reporting follows general principles and conventions. The application of judgement in putting these assumptions into practice is required. The IASB Conceptual Framework provides an important framework in addition to explaining the key assumptions and conventions of accruals accounting, and that the financial statements should be prepared on a going concern basis (and again, any deviation should be disclosed in the financial statements).

We can see from the list of external sources of regulation that compliance with all the requirements requires a considerable amount of knowledge and also the application of professional judgement. Many simple and regular transactions can be detailed in procedures, so that we can expect them to be applied consistently and accurately. For example, cash sales can be programmed through the use of bar codes on products, so that each time a product is sold, the bar code is scanned and the sale is correctly entered into the sales and cash accounts in the system.

However, many accounting transactions and events are more complex and less predictable. For example, if some inventory is found to have been damaged, someone has to determine whether there has been a reduction in the value of the inventory as a result. Also, if there has been a reduction, there is some judgement required to determine the amount to reduce the inventory valuation by. And then the correct journal entry has to be recorded in the accounting system.

There are several accounting controls that can assist in checking that the system is operating effectively and to identify where errors have occurred.

Trial balance	A trial balance is a list of nominal ledger balances shown in debit and credit columns, as a method of testing the accuracy of double-entry bookkeeping. If the total debits do not equal the total credits, one or more errors have occurred. These errors need to be identified and corrected.

Suspense accounts	If the trial balance does not balance, a suspense account will need to be created to record the difference. This is a temporary account for the difference. In addition to correcting some errors, suspense accounts are also opened when it is not known immediately where to post an amount. When the error is resolved, the suspense account is closed with the amount correctly posted using a journal entry. If the total debits in a trial balance exceed the total credits, then the suspense account will have a credit balance. If the total credits in a trial balance exceed the total debits, then the suspense account will have a debit balance. Periodically the suspense account must be cleared by investigating the errors and uncertainties and correcting them by means of journal entries.
Control accounts	Control accounts are set up to ensure that errors are minimised. These controls are also employed at regular intervals (e.g. monthly) during an accounting period. The reason for this is that it is usually much easier to spot errors and correct them as you go rather than wait until the end of the year and then do it. Control accounts are a simple concept. A business uses control accounts to record all receivables (or payables) in total, and by comparing this total to the summation of the individual customer accounts (or suppliers) it is possible to check for errors.
Bank reconciliations	A bank's reconciliation is a control exercised by comparing the cash book (the business's bank account) with the bank statement (provided by the business's bankers). It is unlikely that these two balances will be exactly the same, but we must be able to reconcile one balance with the other as they are based on the same sets of transactions. Reasons for the differences between the cash book and the business bank statement are: • omissions of transactions • the timing of the posting of transactions • errors in posting. Any errors in the company's accounting system that are identified need to be corrected.

Fraud

An important to point to note here is that accidental misreporting or genuine error when preparing the financial statements are not fraudulent – intent is required before we can refer to an incident as fraudulent. This means that in some respects the root cause of frauds are related to the individual or individuals who perpetrated the fraud. This may involve greed, debts, ambition, needs, desperation, poverty, etc.

The company can not usually control or influence an individual's intentions, desires, or external circumstances, but they can control the environment in the work place, and by doing so can reduce the risk that the individual is able to carry out the fraud. When looking at preventing fraud, therefore, rather than focusing on individuals and their circumstances, it is important to approach this from a risk reduction perspective, aiming to remove or reduce the opportunities for fraud. To some extent, therefore, the cause of any fraud, from a company's point of view, is that there were insufficient or ineffective controls in place to prevent the fraudulent action.

It is important for organisations to have effective internal controls to prevent (or at least reduce the likelihood of) fraud taking place. Fraud is a crime in which the criminal intentionally makes a gain or causes a loss to another person by depriving them of assets. There are two types of fraud that we need to consider:

- Misappropriation of assets
- Misstatement of the financial statements

The risk of fraud is increased if an accounting system has weaknesses that make it easier to misappropriate assets (eg by theft), or misstate financial information (eg by exaggerating sales). It is, therefore, important to build internal controls into accounting and other systems in order to reduce the risk or impact of fraud.

Internal controls are procedures that address the risk that the aims and objectives of the company will not be met.

Internal controls have several objectives:

- To protect the accounting system from systemic weaknesses, fraudulent activities, and human error
- To ensure the accounting system complies with applicable laws and regulations
- To ensure the systems operate to meet the company's aims and objectives

Organisations need to have strong internal controls to prevent fraud taking place, with particular focus on the importance of the segregation of duties within the accounting function. Segregation of duties involves ensuring that one individual is not responsible for an entire process (eg by ordering goods, receiving them, approving the payment, and making the payment).

Fraud detection

Internal controls within the accounting system should be designed not only to address weaknesses and prevent fraud and errors, but also to help detect when they have occurred.

There are several controls that detect whether fraud or errors have occurred:

Spot checks	These are checks carried out without warning to ascertain whether control activities have taken place
Performance reviews	These can make use of: • Budget reports, comparing actual results with budgeted results • Ratio analysis, comparing the current period with the previous period or other analysis of figures in the financial statements
Reconciliation	This compares information produced by the accounting system with external sources of information, such as bank statements and supplier statements
Control account reconciliations	This involves comparison of transactions that are recorded in individual accounts with totals in the control account (eg for receivables and payables)

Types of control

The main types of controls which can help prevent fraud include controls for the accounting system can be grouped into the following categories:

Segregation of duties	Ensuring that no individual can complete a process from beginning to end
Organisation controls	Appropriate arrangement of functions and responsibilities across the organisation
Authorisation	Requiring documents to be authorised before they can be processed
Physical controls	Securing assets by means of access controls, such as locks, and other devices such as alarms, sensors, etc. Also, systems to control temperature, humidity, etc where appropriate (eg in computer room or laboratory)
Supervisory controls	Use of supervisory checks on work carried out by individuals
Personnel controls	Ensuring personnel with appropriate qualifications, skills, etc are employed in the appropriate roles, and have appropriate training

Arithmetic and accounting	Checks to amounts on invoices and other documents, use of control accounts and trial balances
Management controls	Regular actions such as review of budgets, forecasts, plans

Internal controls can also be classified according to what they are designed to achieve:

Preventative controls	These controls are designed to limit the possibility of an undesirable outcome happening. The more important it is that an undesirable outcome should not arise, the more important it becomes to implement appropriate preventative controls. The majority of controls implemented in organisations tend to belong to this category. Segregation of duties is an example of a preventative control; eg the person who authorises payment of an invoice is separate from the person who ordered the goods, preventing one person securing goods for their own benefit.
Detective controls	These controls are designed to identify occasions of undesirable outcomes having happened. Their effect is, by definition, after the event and so they are only appropriate when it is possibly to accept the loss or damage incurred or where corrective measures are both readily available and reliable. Examples of detective controls include inventory checks (which detect whether inventory has been removed without authorisation) and reconciliations (which can detect unauthorised transactions).
Directive controls	These controls are designed to ensure that a particular outcome is achieved and that appropriate guidance is provided in order to do so. They are particularly important when it is critical that an undesirable event is avoided, typically associated with health and safety or with security. Examples of directive controls include a requirement that protective clothing is worn during the performance of dangerous duties, or that staff be trained with required skills before being allowed to work unsupervised.
Corrective controls	These controls are designed to correct undesirable outcomes that have happened. They can provide a route of recourse to achieve some recovery against loss or damage. An example of this would be contract terms which allow for recovery of overpayments.

Limitations of internal control systems

The inherent limitations of the effectiveness of internal controls include:

- People make mistakes that may not be picked up by software or human review.
- People may not operate controls properly, thus negating them.
- People may deliberately circumvent control systems if they want to defraud the company.
- Lack of review of the controls in place mean that there is no incentive for staff to follow them.
- An overreliance on controls, especially computerised controls, can breed complacency, so that errors are not detected.

Computer controls

There are two types of control in a computer environment:

Application controls	Application controls are manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.IFAC 2016
General IT controls	These are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operations of information systems. General IT controls commonly include controls over data centre and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development and maintenance. IFAC 2016

For application controls to operate effectively, they need to ensure the following:

- Completeness, accuracy, and authorisation of input
- Completeness and accuracy of processing
- Maintenance of master files and standing data files that they contain

Application controls		
Controls over input	Completeness	• Manual or programmed agreement of control totals • Document counts • One for one reconciliation of processed output to source documents • Programmed matching of input to an expected input control file • Procedures over resubmission of rejected inputs
Controls over input	Accuracy	• Programmes to review data fields (for example value, reference number, date) on input transactions for plausibility: • Digit verification (eg reference numbers are as expected) • Reasonableness test (eg VAT to total value) • Existence confirmations (eg customer name) • Character confirmations (no unexpected characters used in reference) • Necessary information (no transaction passed with gaps) • Permitted range (no transaction processed over a certain value) • Manual scrutiny of output and reconciliation to source • Agreement of control totals (manual/ programmed)

Controls over input	Authorisation	• Manual verifications to ensure information input was:
		  • Authorised
		  • Input by authorised personnel

Controls over processing		• Similar controls to input must be completed when input is completed, for example, batch reconciliations • Screen warnings can prevent people logging out before processing is complete

Controls over master files and standing data	• One-for-one confirmation (verifying that specific elements between two or more sources of data are consistent, for example by verifying that the staff listed in the company's HR records are the same as those listed on the payroll) • Cyclical or regular reviews of all master files and standing data by internal auditors • Record counts (number of documents processed) and hash totals (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions • Controls over the deletion of accounts that have no current balance

Summary of Unit I and key learning outcomes

In Unit I we looked at the Competency: 'Demonstrate an understanding of the importance and use of internal control systems'. This involved content on four broad learning outcomes.

Identify the external regulations that affect accounting practice	You should now be able to discuss external regulations and other influences on accounting practice, such as legislation, standards, and accounting principles
Describe the causes of, and common types of, fraud and the impact of this on the organisation	You should now be able to describe how fraud risk is increased in a poor internal control environment
Explain methods that can be used to detect fraud within an accounting system	You should now be able to describe the different types of detective control and how these are applied in an accounting system, including in computerised processes
Explain the types of controls that can be put in place to ensure compliance with statutory or organisational requirements	You should now be able to describe and provide examples of the various types of internal control and how these assist in complying with legislation, standards, and accounting principles

Quiz questions

1	Learning Outcome: I3
Which of the following statements is true?	
A	If and individual makes an error in entering information into the cash book, this is an example of a fraud
B	Fraud is a criminal activity
C	Internal controls should be designed so that fraud is impossible
D	For a fraud to be committed, two or more individuals need to be involved

1	Feedback
A	**Incorrect** An action needs to be intentional for it to be classed as fraud Fraud is a criminal activity
B	**Correct**
C	**Incorrect** Internal controls can reduce the risk of fraud, but can not totally eliminate the possibility of fraud Fraud is a criminal activity
D	**Incorrect** Some frauds may be made easier by more than one individual being involved, but a fraud can be committed by one individual in some situations (eg if internal controls are weak) Fraud is a criminal activity

2	Learning Outcome: I4
Which of the following is an example of a management control?	
A	Authorisation of invoices
B	Separate divisions for finance and production
C	Different individuals having responsibility for ordering and paying for goods
D	Monthly budget reports and actions

2	Feedback
A	**Incorrect** Authorisation of invoices is an example of an authorisation control (although management may, of course, be involved in carrying out authorisation activities) Monthly budget reports and actions is a management control
B	**Incorrect** Separate divisions for finance and production is an example of an organisational control Monthly budget reports and actions is a management control
C	**Incorrect** Different individuals having responsibility for ordering and paying for goods is an example of segregation of duties Monthly budget reports and actions is a management control
D	**Correct** Monthly budget reports and actions is a management control

3	Learning Outcome: I4
Which of the following is a description of application controls in a computerised environment?	

A	These controls relate to procedures used to initiate, record, process and report transactions or other financial data.
B	These controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operations of information systems.
C	These controls include system software acquisition, change and maintenance.
D	These controls include controls over data centre and network operations; system; access security; and application system acquisition, development and maintenance.

3	Feedback
A	**Correct** Application controls relate to procedures used to initiate, record, process and report transactions or other financial data
B	**Incorrect** This is a description of general IT controls Application controls relate to procedures used to initiate, record, process and report transactions or other financial data
C	**Incorrect** This is a description of general IT controls Application controls relate to procedures used to initiate, record, process and report transactions or other financial data
D	**Incorrect** This is a description of general IT controls Application controls relate to procedures used to initiate, record, process and report transactions or other financial data

4	Learning Outcome: I1
Which one of the following statements is true?	
A	A control account is used to monitor the effectiveness of internal controls

B	A suspense account may appear as an asset or liability in the statement of financial position
C	A trial balance is a list of nominal ledger balances shown in debit and credit columns, as a method of testing the accuracy of double-entry bookkeeping
D	If the bank account and banks statement balances do not agree, this must be due to an error by the company or the bank

4	Feedback
A	**Incorrect** A business uses control accounts to record all receivables (or payables) in total, and by comparing this total to the summation of the individual customer accounts (or suppliers) it is possible to check for errors A trial balance is a list of nominal ledger balances shown in debit and credit columns, as a method of testing the accuracy of double-entry bookkeeping
B	**Incorrect** A suspense account is a temporary account, and should be cleared periodically as errors are identified – it should not be included in the financial statements A trial balance is a list of nominal ledger balances shown in debit and credit columns, as a method of testing the accuracy of double-entry bookkeeping
C	**Correct**
D	**Incorrect** Differences between the bank account and the bank statement balance may arise from timing differences, rather than errors A trial balance is a list of nominal ledger balances shown in debit and credit columns, as a method of testing the accuracy of double-entry bookkeeping

Unit J: Accounting Systems.

Learning outcomes

J1. Identify weaknesses in accounting systems:
   a. potential for errors
   b. exposure to possible fraud.

J2. Explain how an accounting system can support internal control.

J3. Identify ways of supporting individuals who operate accounting systems using:
   a. training
   b. manuals
   c. written information
   d. help menus.

J4. Explain the value and benefit to a specific organisation of different types of accounting systems and software packages.

Introduction to Unit J

In Unit I, we looked at the importance of having appropriate internal controls to ensure that accounting systems are working effectively and to minimise the risk of fraud. It is an important skill for an accountant or auditor to be able to look at an accounting system and identify weaknesses, and also to be able to identify how the weaknesses can be overcome.

In this unit, we will look at how accounting systems can be assessed, so that weaknesses are identified, and improvements can be proposed that will result in a more effective system. This also involves considering how the individuals who operate a system need to be supported, and how software packages and other system features impact on the effectiveness of controls and of the system as a whole.

Systems

In order to identify weaknesses and then ensure that the system and related internal controls are compatible, it is important to understand what a system is intended to achieve.

There are therefore four steps required in any control system:

1) Set standards to be measured against (ie expectations)
2) Measure actual results
3) Compare the actual results with the predetermined standards (ie compare 1 and 2)

4) Take the necessary actions to control any problem areas.

Financial control may be classified under the general heading of administrative controls (procedures consciously designed and implemented with the intention of affecting how people act within an organisation). Financial control concentrates on the outcomes of actions.

Before we examine financial control mechanisms and procedures, you need to be aware of the three types of control: social, self and administrative controls.

Social controls	Social controls are concerned with norms. A person might undertake a task because it is the accepted social norm
Self controls	Self control, in the context of an organisation, is the level an individual internalises, identifies with or complies with administrative and social controls
Administrative controls	Administrative controls are rules, regulations and output controls. In organisations, this type of control is the easiest to implement

Administrative controls are designed to affect how people act within an organisation. They can be divided into:

- rules and regulations
- output controls

There are considered to be four conditions which must exist in order for output controls to operate. These provide an outline for the operation of a system of financial control. The activity must have these conditions.

Objective or objectives	The activity must have an objective or objectives. Budgets stem from objectives. Once budgets are set, they form an objective to be attained.
Measurable outputs	The activity must have measurable outputs. Success in achieving the objective(s) can be assessed (costs, revenues, volume of output).
A predictive model	A 'predictive model' of the activity must exist; ie we must have some expectation as to how the activity should have been carried out. The reason for any failure to meet objectives, along with appropriate corrective action can therefore be determined as we know what should have occurred.
Ability to take action	There must be an ability to take action so that failure to meet an activity's objective(s) can be addressed.

There is a range of other terminology in relation to control systems that you should be aware of:

Rules and regulations	Statements of desired patterns of organisational behaviour by individuals
Output controls	Controls which focus on the results of actions, leaving individuals with some discretion about how tasks are to be performed
Exceptions reporting	Exceptions reporting (management by exception) forms the basis of financial control. Exceptions reporting assesses the achievement of objectives by comparing actual results with the expected outputs from a system, and then reporting only when there is a (significant) difference between the two.
Variances	Differences between expected and actual outputs are termed variances. A favourable variance indicates a better-than-expected outcome. An adverse variance reflects a worse-than-expected outcome. All significant variances should be investigated.
Standards	These can also be used as a base with which to compare actual performance
Feedback and feedforward control	Exceptions reporting evaluates the achievement of objectives by comparing budgeted costs and revenues with actual results (feedback control) or of forecast costs and revenues with predetermined objective(s) (feedforward control). The idea of exceptions reporting is that managerial action should be triggered by any significant differences revealed by this comparison. Feedback and feedforward control do not indicate the reason for any variances; nor do they suggest what corrective action ought to be taken

Example

We can consider a company that operates a receivables control account. This collects transactions relating to credit customers – sales on credit, receipt of payments from customers, discounts allowed to customers, bad debts written off, etc. The total balance on the receivables control account should agree with the individual customer account balances taken together. If they do not agree, then an error has occurred.

We can see how the terminology discussed above can be applied to this situation:

- The objective of the system is to ensure that the correct amount is received from customers, and any outstanding balance is correctly accounted for as a receivable.
- The control account acts as a control mechanism in this system.
- The measurable output is the balance on the individual accounts and the control

account.

- The standard, or the expected result, is that the two totals are in agreement – if not, the control account will identify the extent of this error.
- The difference between the two totals is in effect a variance that needs to be accounted for (and corrected).
- The actions to be taken will be:
    - to determine what errors have taken place that have led to the difference between the totals
    - and to process journal entries to correct these in the accounting system.

Exercise J1

Using the example for a company's control account, prepare a similar analysis of how these terms would apply to an inventory control system

Exercise J1 solution

- The objective of the system is to ensure that inventory is managed effectively, that the level of inventory can be identified at any time, and that the balance at any time reconciles with the previous balance, plus any purchases, minus any usage or write-offs (eg from breakages).
- A periodic stock-take and reconciliation acts as a control mechanism in this system.
- The measurable amounts are the previous balance, purchases in the period, and issues or write-offs in the period.
- The standard, or the expected result, is that the current balance of inventory reconciles with the previous balance – if not, the reconciliation will identify the extent of this error (which may, for example, indicate some theft of inventory).
- The difference between the two totals is in effect a variance that needs to be accounted for (and corrected). If a fraud is indicated, a fraud investigation needs to be carried out, especially if the variance is large, indicating a significant fraud.
- The action to be taken will be to determine what errors have taken place that have led to the difference between the totals. A journal entry may be required to write off wastage or small amounts of pilfering, but a large difference may require a full fraud investigation.

Accounting systems

An accounting system is a one that takes raw data on transactions as its input, processes this, and then produces many outputs to meet the information needs of stakeholders.

Inputs include:

- Raw data from the accounting transactions
- Data from the users, meaning that all users must have training to ensure accurate usage of the system
- Data from management on subjective areas affected by them, such as journals, provisions and aged receivable adjustments

An accounting system is effective if it meets a range of objectives:

Cost effectiveness	Ensuring that something is good value. Organisations should consider their needs and the complexity of the information they require. The more complex the system, the more expensive it can be to maintain. The cost of training existing staff and new staff on a new or more complex system should be taken into account.
Reliability	Ensuring a process or system performs consistently well. The accounting system must operate effectively, processing all transactions accurately and fully, and must be compliant with applicable laws and regulations. The system should allow access to authorised users only, as and when required, and include data security protocols. A modern system will run regular and automated backups of data. Increasingly companies' data is held offsite 'in the cloud' negating the need for daily, manual backups by users onto discs, USB drives or other hardware.
Timeliness	The system should provide information at the required time. The accounting function and the underlying system needs to be set up in such a way that the reports are accurate and timely. The system will need to provide financial and management information to stakeholders when they require it. It is vital that the system can produce the information required by its users to enable regulatory compliance (such as quarterly VAT returns) and timely reviews of financial performance.

Management information systems (MIS)

Most of the information produced by the accounting function for both internal and external stakeholders is based on data about the transactions that it has processed over a given period. These are recorded in the accounting system.

However, some of the data comes from the wider Management Information System (MIS) which is the processing of the various information using computers (or computer software) from multiple departments or functions. This is particularly the case when

the accounting function is preparing information for its key internal stakeholder; ie the management of the company.

Increasingly, MIS systems will be incorporated with ERP or integrated accounting software, as more of the information that management require will be available from those sources. All companies require management information for a range of purposes including:

- Planning
- Control
- Performance measurement
- Decision making

Types of information

Different types and quantities of information are required by managers for different purposes.

Operational information	Operational information is used to ensure that specific tasks are planned and carried out properly within business. The operational level would deal with activities such as cash receipts and payments, bank reconciliations, etc.
Operational information	Tactical information is used to decide how the resources of the business should be deployed, and to monitor how efficiently they are being used. The tactical level would deal with cash flow forecasts and working capital management.
Strategic information	Strategic information is used to (a) plan the objectives of the company, and (b) assess whether the objectives are being met in practice.

Accounting software

Organisations will put in place a number of different accounting and information systems, which ones are used will depend on the type and size of the organisation. There are various factors that an organisation should consider when choosing an appropriate tool for maintaining its accounting records. There needs to be adequate support of the users of the software such as in the initial training, and then ongoing support and the different types available.

One dilemma facing organisation when they are looking to acquire a new system, such as an accounting system, is whether to purchase a product that is already available on the market and can be used directly in the company, or to have something made specifically for the company's own needs and circumstances. This is sometimes referred to as deciding whether to purchase something 'off-the-shelf' (ie ready to use, but not necessarily fitting all the company's individual needs), or to contract with a supplier to provide a 'bespoke' solution, which will be designed around the specific requirements of the company.

Simple accounting systems

Smaller organisations may have a very small finance department consisting of one or two people, and so they may use a basic bookkeeping software, doing much of their analysis using a spreadsheet tool like Microsoft Excel. In recent years, there has been more use of bookkeeping software, such as Intuit's Quickbooks, BUSY or Sage One. These simple bookkeeping services are relatively easy to use, and they help to prevent common errors which can occur in spreadsheet tools. They are particularly useful for small businesses where staff may not have knowledge of double entry or bookkeeping. Often these small businesses will employ the services of a qualified accountant to complete their financial statements using the information from their bookkeeping software.

Integrated accounting systems

Larger businesses may use more 'integrated' systems, which will combine the bookkeeping elements with inventory control and sales tracking systems. These systems can produce a variety of reports, from aged analysis of trade receivables, sales orders outstanding information through to when inventory items were received, by whom in the warehouse, and where those items are within the system. Some of these more complex systems, some of them Enterprise Resource Planning systems (ERP) and 'Cloud'-based integrated systems (where the software and the data are held remotely on specialised servers off-site from the users) are used by the multinational companies who want to review 'real time' data of their overseas branches, subsidiaries or joint ventures.

Cloud-based systems

Increasingly, cloud-based systems are being implemented as they can ensure the latest versions of the software are being used giving growing companies flexibility of the service (if the company needs more data space, it can be done very quickly rather than purchasing a new server to be brought into the building). As the data is held away from the premises, if a fire occurs, then the data can be restored on new machines relatively quickly, omitting the need for a 'full restore' from system back-ups. These cloud systems, originally dominated by software companies who focused on larger enterprises, such as Oracle and SAP, have also started to filter to smaller systems, such as Sage One and BUSY.

Accounting systems for the government of Rwanda

In recent years, there have been a number of public sector reforms, a significant one being the introduction of an Integrated Financial Management System (IFMIS), which has been developed for the government of Rwanda.

The Rwanda Revenue Authority (RRA) has introduced an e-filing and e-payment system for medium and large taxpayers for corporation tax, PAYE, withholding tax and VAT. Rwandan legislation also requires that electronic billing machines (EBMs) are used to generate invoices with the correct VAT charged. It is vital, therefore that the organisation has the required machines, software and, if necessary, tools to effectively transfer the data to or from the government software from the organisation's accounting systems.

Supporting users of accounting software

In order to ensure compliance with an accounting system, as well as using any software correctly, there will be set guidelines and procedures in place at the organisation. The employees must be aware of the importance of compliance with the internal (organisation

specific) requirements as well as the external reporting requirements (such as tax and financial reporting).

Accounting systems can vary and there may be different requirements for each organisation. Therefore, users of the systems will require support so that they can use the technology in the most efficient manner.

Training

When a new accounting system is installed at an organisation, or a new member of staff joins the team, it is essential that there will be a period of training to allow the staff to understand their role and the software they will be using in order to carry out their duties competently.

Staff need sufficient training to ensure that they know what information to produce and when it will be required. They also need to have a good understanding of how to use software to ensure that it is used in an efficient and accurate manner. Employees should be briefed on their roles and responsibilities within an organisation, including any legal requirements. This will start initially as a new recruit, but as laws or organisational changes are made, these regulations may need to be updated and further training sessions made available.

There are a number of options available in terms of types of training, each with different advantages and disadvantages:

Classroom based	This is the more 'traditional' form of training, and is useful for training groups of staff on the same subject at the same time
Online	A number of different types of online training have been developed, such as online webinars that can be viewed by individuals at any time. Online resources can be useful for training individual staff on specific subjects in a flexible manner.
Within software packages	Accounting and other software packages are often supplied with some training included as part of the deal. This may be in the form of some classroom training at the time of purchase and installation. It can also be an ongoing support, through access to helplines, or via help menus within the system.
Manuals	Manuals are useful for training new staff who need to become familiar with existing processes.
Coaching and mentoring	Coaching and mentoring are often used at higher levels of an organisation, to provide dedicated one-to-one support for managers and other staff.

Summary of Unit J and key learning outcomes

In Unit J, the overall aim was to 'Be able to identify and use the appropriate accounting system to meet specific organisational requirements'. In this unit, we looked at the following learning outcomes:

Learning outcome	
Identify weaknesses in accounting systems: • potential for errors • exposure to possible fraud	You should now be able to discuss how an accountant may identify weaknesses in internal controls in an accounting system
Explain how an accounting system can support internal control	You should now be able to discuss the types of internal control and the design of accounting systems to include appropriate internal controls
Identify ways of supporting individuals who operate accounting systems using: • training • manuals • written information • help menus	You should now be able to discuss how staff are trained and otherwise supported to ensure that accounting systems are operated effectively
Explain the value and benefit to a specific organisation of different types of accounting systems and software packages	You should now be able to discuss the different types of accounting systems and software, and how these provide information to different levels of management in a business

Quiz questions

1	Learning Outcome: J1
Which of the following terms refers to differences between expected and actual results that are produced by a system?	
A	Outputs
B	Forecasts
C	Budgets
D	Variances

	Feedback
A	**Incorrect** Differences between expected and actual outputs from a system are known as variances
B	**Incorrect** Differences between expected and actual outputs from a system are known as variances
C	**Incorrect** Differences between expected and actual outputs from a system are known as variances
D	**Correct**

2	Learning Outcome: J3
Which one of the following would be a particularly useful for training a new member of staff on existing processes?	
A	Classroom training
B	Manuals
C	Coaching

D	Mentoring

2	Feedback
A	**Incorrect** Manuals would be a particularly useful for training a new member of staff on existing processes, but the other methods could also be used.
B	**Correct**
C	**Incorrect** Manuals would be a particularly useful for training a new member of staff on existing processes, but the other methods could also be used.
D	**Incorrect** Manuals would be a particularly useful for training a new member of staff on existing processes, but the other methods could also be used.

3	Learning Outcome: J4
Which of the following types of system might combine bookkeeping elements with inventory control and sales tracking systems?	
A	Integrated system
B	Cloud-based system
C	Management information system
D	Bespoke system

3	Feedback
A	**Correct**
B	**Incorrect** An integrated system might combine bookkeeping elements with inventory control and sales tracking systems
C	**Incorrect** An integrated system might combine bookkeeping elements with inventory control and sales tracking systems

D	**Incorrect** An integrated system might combine bookkeeping elements with inventory control and sales tracking systems

4	Learning Outcome: J4
Which of the following refers to information that is to be used to decide how the resources of the business should be deployed, and to monitor how efficiently they are being used?	
A	Management information
B	Operational information
C	Strategic information
D	Tactical information

4	Feedback
A	**Incorrect** Tactical information is used to decide how the resources of the business should be deployed, and to monitor how efficiently they are being used
B	**Incorrect** Tactical information is used to decide how the resources of the business should be deployed, and to monitor how efficiently they are being used
C	**Incorrect** Tactical information is used to decide how the resources of the business should be deployed, and to monitor how efficiently they are being used
D	**Correct**

Financial Accounting – Module Summary

The introduction to the Financial Accounting module identified a number of key areas of financial accounting that would be covered in the 10 units:

- Preparation of financial statements for a single entity
- Preparation of consolidated financial statements
- Interpretation of financial statements
- The financial accounting context:

- Regulatory framework
- Internal controls
- Accounting systems

The following table provides an overview how Units A to J covered these areas, including a reminder of the key competency for each unit.

Unit A – Demonstrate an understanding of the regulatory framework that underpins financial reporting

This short unit covered some fundamental aspects of the financial accounting context, which are necessary for understanding the processes and requirements of preparing financial statements.

The topics covered included the needs of the users of financial statements, the role of legislation, regulation and accounting, standards, and the role of directors and others within a company.

Unit B – Demonstrate an understanding of the key features of a published set of accounts

This unit focused on the content of a set of financial statements, and the features of each of the main statements: the statement of profit or loss, the statement of financial position, the statement of cash flows, and the statement of changes in equity.

We also discussed the importance of the notes that accompany the financial statements, and the differences between the public and private sectors in the way that financial statements are prepared and presented.

This knowledge is essential for preparing financial statements, which was covered in Units E and F.

Unit C – Demonstrate an understanding of basic principles of consolidation

This brief unit serves as an introduction to Unit F, which is where the preparation of consolidated financial statements was covered.

It is important to understand when consolidation is required, the different types of consolidation (ie subsidiaries and associates), and the main differences between consolidated financial statements and the statements of a single company.

Unit D – Appreciate the analysis and interpretation of financial statements

As well as being able to prepare financial statements, this module also requires students to be able to discuss the content of financial statements in an effective way.

This involves both understanding the content of the statements, and being able to apply techniques such as ratio analysis to assist in this.

The unit covered the main ratios used in assessing a company's profitability, efficiency, liquidity, and long-term solvency, and these were developed in Unit G using practical examples.

Unit E – Draft statutory financial statements for a limited company

This is the largest unit in the Financial Accounting module, and focuses on the practical aspects of preparing financial statements for a single entity, building on the knowledge that was developed in Unit B in particular.

The unit also introduced a number of key accounting standards, which enable the student to account for a range of common accounting transactions and events.

The unit included a number of practical examples, both dealing with the requirements of specific standards, and bringing knowledge of the range of standards together to prepare full financial statements.

Unit F – Draft simple consolidated financial statements

This unit builds on the introductory content of Unit C and applies this in preparing consolidated financial statements.

Similar to Unit E, the unit includes a number of practical examples, illustrating specific adjustments that are required to account for particular situations, and providing practice in preparing full consolidated statements.

Unit G – Interpret financial statements using ratio analysis

Unit G builds on the introductory content of Unit D, using practical examples to develop skills in applying ratio analysis to assess the financial performance of a company.

The unit also looked at the use of ratios to draw conclusions and identify appropriate courses of action to restore or maintain effective financial performance.

Unit H – Demonstrate an understanding of the role of accounting within the organisation

Unit A identified a number of different users of financial information, and Unit H considered issues related to their needs and the way that financial statements and financial systems support these requirements.

To do this effectively, a student needs an understanding of company structures, the economic environment, and other factors, and these were discussed in this unit.

Unit I – Demonstrate an understanding of the importance and use of internal control systems

Financial statements can only be reliable if the systems that are used to prepare these contain reliable data. It is therefore essential that systems include internal controls that ensure the integrity of accounting data.

Unit I discussed the different types of internal control, providing examples of each, and also considered their role in the prevention and detection of fraud.

Unit J – Be able to identify and use the appropriate accounting system to meet specific organisational requirements.

Unit J follows on from the discussion of internal controls in Unit I, and looked at how accounting systems are designed, maintained, and managed, and how weaknesses can be identified and addressed.

Quiz answers

Unit A Quiz answers

1	B
2	A
3	C
4	D
5	C

Unit B Quiz answers

1	D
2	A
3	D
4	B
5	D
6	A
7	B
8	B
9	A
10	C
11	B
12	C

Unit C Quiz answers

1	C
2	D
3	A

4	A

Unit D Quiz answers

1	B
2	D
3	A
4	B

Unit E Quiz answers

1	A
2	D
3	C
4	B
5	A
6	C
7	A
8	D
9	B
10	B
11	D
12	A

Unit F Quiz answers

1	D
2	A
3	B
4	C

5	A

Unit G Quiz answers

1	C
2	B
3	A
4	C
5	D
6	B

Unit H Quiz answers

1	C
2	D
3	B
4	B

Unit I Quiz answers

1	B
2	D
3	A
4	C

Unit J Quiz answers

1	D
2	B
3	A
4	D

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