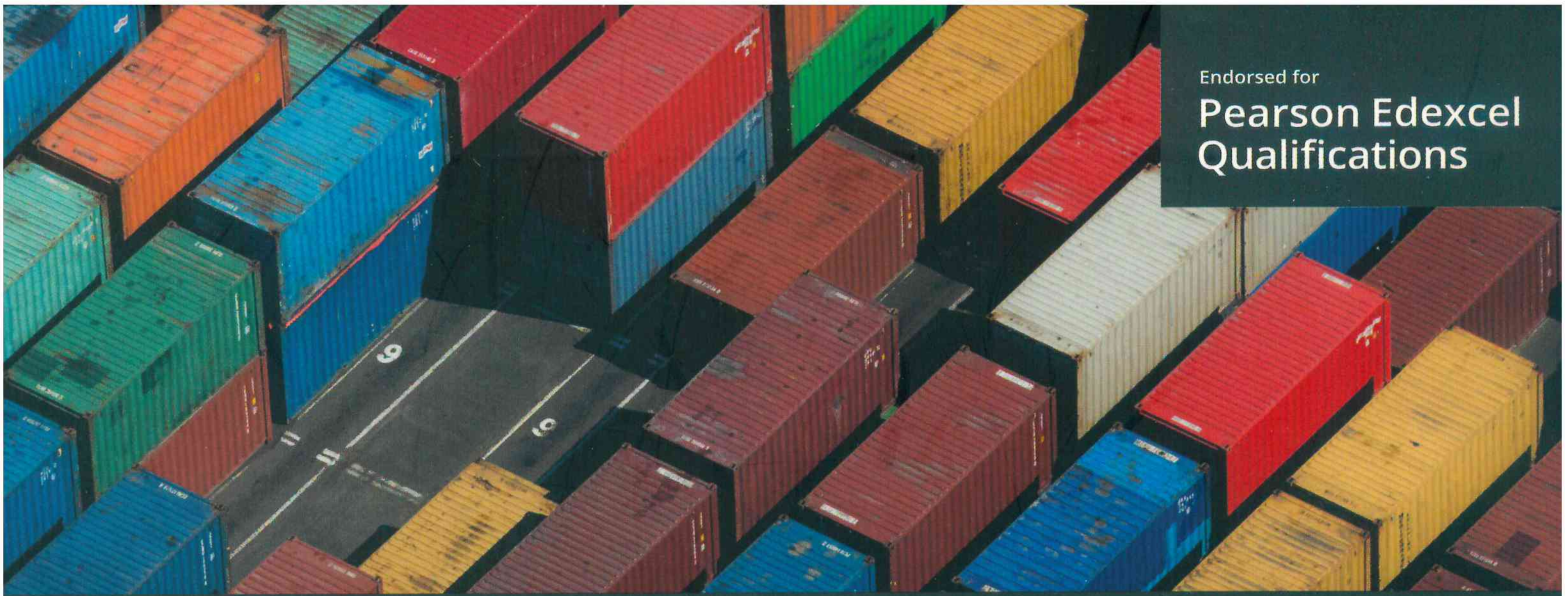


Endorsed for
Pearson Edexcel
Qualifications

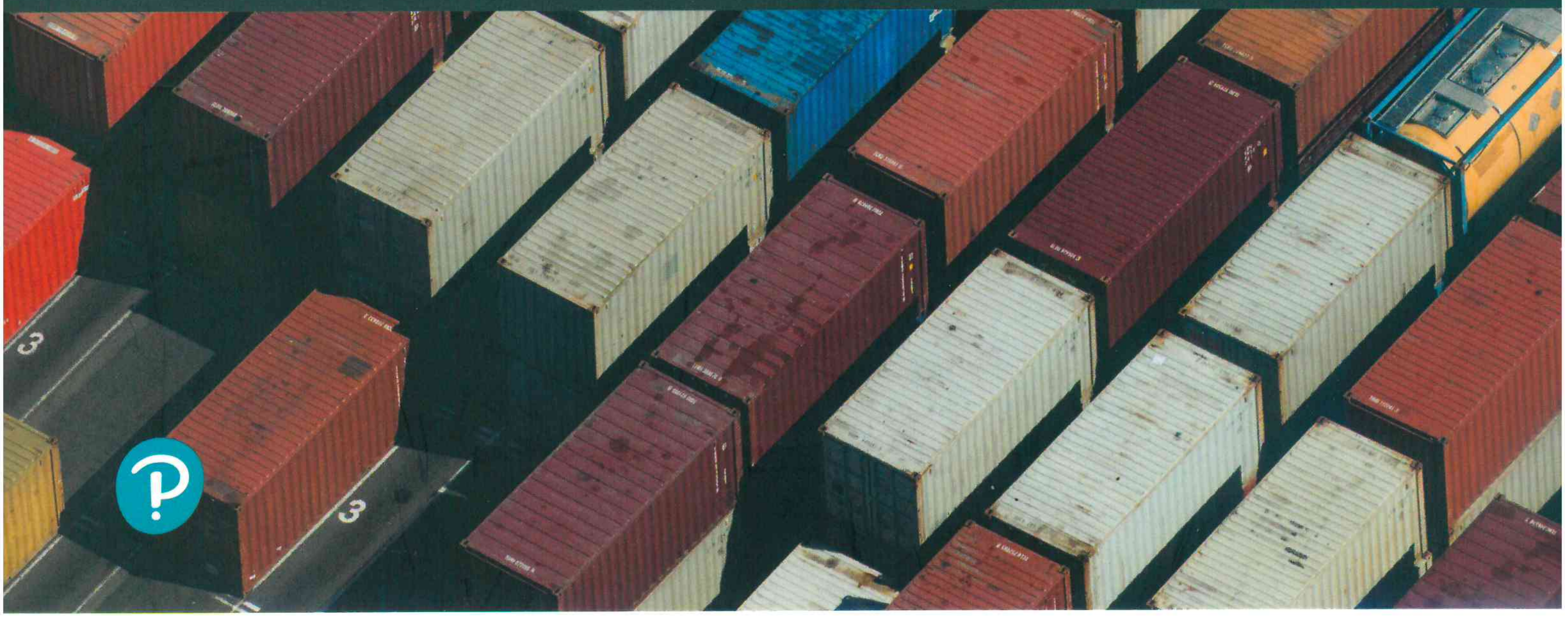
eBook included

PEARSON EDEXCEL INTERNATIONAL A LEVEL

ACCOUNTING

STUDENT BOOK 2

JOHN BELLWOOD
HILARY FORTES



PEARSON EDEXCEL
INTERNATIONAL A LEVEL

ACCOUNTING

Student Book 2

John Bellwood
Hilary Fortes

Published by Pearson Education Limited, 80 Strand, London, WC2R 0RL.

www.pearsonglobalschools.com

Copies of official specifications for all Edexcel qualifications may be found on the website: https://qualifications.pearson.com

Text © Pearson Education Limited 2020
Development edited by Sze Kiu Yeung
Copy edited by Sarah Wright
Proofread by Claire Annals and Martin Payne
Indexed by Georgina Bowden
Designed by © Pearson Education Limited 2020
Typeset © SPi Global
Original illustrations © Pearson Education Limited 2020
Illustrated by © SPi Global
Cover design by © Pearson Education Limited 2020

Cover images: Front: **Getty Images Incorporated:** Tom Blachford/Getty Images
Inside front cover: **Shutterstock.com:** Dmitry Lobanov

First published 2020

23 22
978 1 292274 59 1

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

ISBN 978 1 292274 59 1

Printed in Great Britain by Bell and Bain Ltd, Glasgow

Acknowledgements
We are grateful to the following for permission to reproduce copyright material:

Images:
(key: b-bottom; c-centre; l-left; r-right; t-top)

123RF GB LIMITED: Luca Bertolli/123RF 7, Subbotina/123RF 8, Hennadii Huchek/123RF 44, Dmytro Sidelnikov/123RF 57, Stockyimages/123RF 71, Papan Saenkutrueang/123RF 75, Stepan Popov/123RF 83, Hongqi Zhang/123RF 97, Mikkel Bigandt/123RF 107, Owen Smith/123RF 110, Elnur Amikishiyev/123RF 114, Rawpixel/123RF 140, Dolgachov/123RF 141TR, Katarzyna Białasiewicz/123RF 141TL, Belchonock/123RF 143, Soonthorn Wongsaita/123RF 152, Ying Feng Johansson/123RF 156, Maridav/123RF 160T, Belchonock/123RF 172, Yuhorakushin/123RF 176, Saphira/123RF 179, Susan Richey-Schmitz/123RF 182, Imagemax/123RF 183, Konstantin Faraktinov/123RF 189, Andriy Popov/123RF 202; **Alamy Images:** Matthew Richardson/Alamy Stock Photo 166B; **Getty Images Incorporated:** Rawi_earth/iStock/Getty Images 37, Kriangkrai Thitimakorn/Moment/Getty Images 42, David Crunelle/EyeEm/Getty Images 65, Monty Rakusen/Cultura/Getty Images 91, Seraficus/E+/Getty Images 98, SeanPavonePhoto/istock/Getty Images 104, Rebecca Nelson/DigitalVision/Getty Images 108T, SolStock/istock/Getty Images 126, Kali9/E+/Getty Images 130, Monty Rakusen/Cultura/Getty Images 134, Tshortell/istock/Getty Images 139,LeoPatrizi/iStock/Getty Images 157, Keith Brofsky/DigitalVision/Getty Images 160B, Arcaid/UniversalImagesGroup/Getty Images 161, Puripat Lertpunyaroj/Moment/Getty Images 164, Vasko/iStock/Getty Images 169, YinYang/Getty Images 171, Cayce Clifford/Bloomberg/Getty Images 175, Phototropic/Getty Images 180, Fiphoto/Getty Images 186, Rrrainbow/iStock/Getty Images 191, Rozkmina/iStock/Getty Images 198B, Nortonrsx/iStock/Getty Images 201, Kriangkrai Thitimakorn/Moment/Getty Images 7TL (FM); **Microsoft Corporation:** © Microsoft Corporation 198TR; **Pearson Education Asia Ltd:** Coleman Yuen/Pearson Education Asia Ltd 55; **Shutterstock:** Kheng Guan Toh/Shutterstock 20, Steve Heap/Shutterstock 24, F11photo/Shutterstock 2, IdeaStepConceptStock/Shutterstock 3, RawcapPhoto/Shutterstock 9, Borisovstudio/Shutterstock 30, Dmitry Kalinovsky/Shutterstock 35, Bacho/Shutterstock 45,Christian Mueller/Shutterstock 46, Stephen Coburn/Shutterstock 47, Eliane Haykal/Shutterstock 53, Shutterstock 59, Somrerk Witthayanant/Shutterstock 62, Mdd/Shutterstock 70, Snehal Jeevan Pailkar/Shutterstock 72, Olivier Le Moal/Shutterstock 77, Ramcreations/Shutterstock 79, Dynamic/Shutterstock 81, Martin Good/Shutterstock 84, Air Images/Shutterstock 94, Subbotina Anna/Shutterstock 101, Matt Ragen/Shutterstock 103, Zephyr_p/Shutterstock 108B, Basileus/Shutterstock 113TL, Dmitry Galaganov/Shutterstock 113TR, Igor Kardasov/Shutterstock 118, CRS Photo/Shutterstock 122, Steven Bostock/Shutterstock 128, Mr.1/Shutterstock 131, Robert Paul van beets/Shutterstock 144, Value ho/Shutterstock 149T, Amber McNamara/Shutterstock 149B, Mrfotos/Shutterstock 154, Worldpics/Shutterstock 163, RossHelen/Shutterstock 166T, Beboy/Shutterstock 168, ShutterOK/Shutterstock 173, Rawpixel.com/Shutterstock 181, Dasha Petrenko/Shutterstock 190, Steve Bower/Shutterstock 192, MSPhotographic/Shutterstock 195, Simon Mayer/Shutterstock 196, Andrey_Popov/Shutterstock 198TL, Wavebreakmedia/Shutterstock 199, Praphab Louilarpprasert/Shutterstock 203, IdeaStepConceptStock/Shutterstock 6BR(FM), F11photo/Shutterstock 6BL(FM), Eliane Haykal/Shutterstock 7B(FM), Olivier Le Moal/Shutterstock 7TR(FM).

All other images © Pearson Education

Endorsement statement
In order to ensure that this resource offers high-quality support for the associated Pearson qualification, it has been through a review process by the awarding body. This process confirms that this resource fully covers the teaching and learning content of the specification or part of a specification at which it is aimed. It also confirms that it demonstrates an appropriate balance between the development of subject skills, knowledge and understanding, in addition to preparation for assessment.
Endorsement does not cover any guidance on assessment activities or processes (e.g. practice questions or advice on how to answer assessment questions), included in the resource nor does it prescribe any particular approach to the teaching or delivery of a related course.
While the publishers have made every attempt to ensure that advice on the qualification and its assessment is accurate, the official specification and associated assessment guidance materials are the only authoritative source of information and should always be referred to for definitive guidance.
Pearson examiners have not contributed to any sections in this resource relevant to examination papers for which they have responsibility.
Examiners will not use endorsed resources as a source of material for any assessment set by Pearson.
Endorsement of a resource does not mean that the resource is required to achieve this Pearson qualification, nor does it mean that it is the only suitable material available to support the qualification, and any resource lists produced by the awarding body shall include this and other appropriate resources.

UNIT 2

ABOUT THIS BOOK

This book is for students following the Edexcel International Advanced Level (IAL) Accounting course.

The course has been structured so that teaching and learning can take place in any order, both in the classroom and in any independent learning. The book contains full coverage of the IAL unit. The nine topic areas within this unit match the titles and order of those in the specification.

Each topic area is divided into chapters to break the content down into manageable chunks. Each chapter features a mix of learning and activities. Global case studies are embedded throughout to show a range of examples within the context of the chapter. Checkpoint questions at the end of each chapter help you to assess understanding of the key learning points. There are exam-style questions at the end of each chapter to provide opportunities for exam practice. Answers are provided in the online teaching resource pack.

Topic openers
Introduce each of the key topics in the specification.

Learning objectives
Each chapter starts with a list of key assessment objectives.

Specification reference
The specification reference is given at the start of each chapter and in the running header.


LIMITED COMPANIES

In this unit you will learn about the financial statements of limited companies, as well as preparing financial statements in accordance with International Accounting Standard (IAS) 1. These financial statements include two that you are familiar with from your International Advanced Subsidiary studies – the statement of profit or loss and other comprehensive income and the statement of financial position. You will also learn about a new financial statement prepared by limited companies, known as the statement of changes in equity. Limited companies have a more complex capital structure than that of sole traders, and you will learn how to record and prepare the capital structure of limited companies. Finally, you will learn how to account for the merger or purchase of limited companies.

SPECIFICATION 2.1.1–2.1.3 1 FINANCIAL STATEMENTS OF LIMITED COMPANIES 3

1 FINANCIAL STATEMENTS OF LIMITED COMPANIES

UNIT 2 2.1.1–2.1.3

LEARNING OBJECTIVES

After you have studied this chapter, you should be able to:
- understand the nature of limited companies and explain the meaning of limited liability
- prepare financial statements in accordance with IAS 1, to include the statement of profit or loss and other comprehensive income, the statement of changes in equity and the statement of financial position
- explain the role and importance of the auditors' report and the directors' report
- evaluate the importance of disclosing continuing and discontinued activities and the significance of exceptional items.

GETTING STARTED

Have you considered what the differences might be for limited companies, based on what you have studied about financial statements of sole traders and partnerships? Do you think that the fundamental principles will be the same? Will accounting conventions and concepts still need to be applied? What is certain is that you will need good knowledge of the preparation of financial statements for sole traders and partnerships in order to prepare financial statements for limited companies. Before you start this chapter, it would be wise to practise questions on financial statements from our previous studies.

INTRODUCTION

The preparation of financial statements for limited companies is a continuation of the financial statements studied at International Advanced Subsidiary. These included financial statements for sole traders, partnerships, not-for-profit organisations and manufacturers. Before learning about the financial statements of limited companies, it would be useful to review these financial statements. Many of the conventions and concepts applied to these are also used to prepare the financial statements of limited companies.

ACTIVITY 1 SKILLS COMMUNICATION

CASE STUDY: FINANCIAL STATEMENTS

1 As a class, divide into small groups. Each group should look back at a different financial statement covered at International Advanced Subsidiary (refer to the specification) and prepare a short presentation to the rest of the class to highlight the layout/format of the financial statement.

The layout of the financial statements is similar to those you have previously studied. However, there are significant changes in terminology to learn, owing to the different nature of limited companies. As well as this new terminology, you will need to learn how to prepare a new financial statement – the statement of changes in equity.

THE NATURE OF LIMITED COMPANIES

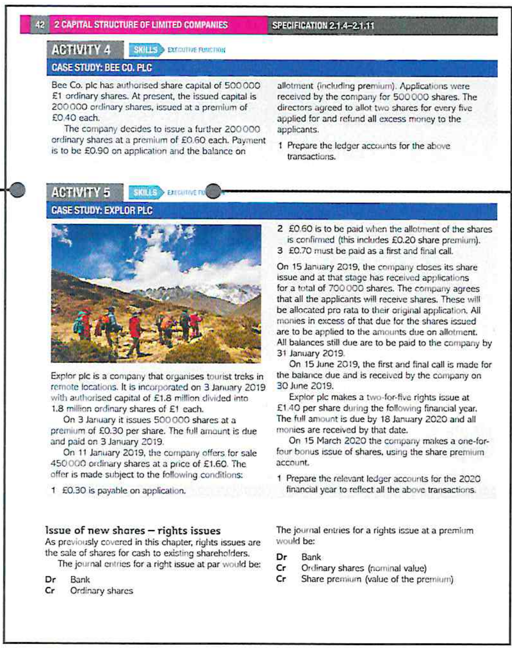
Limited companies differ from sole traders and partnerships in a number of significant ways. As a result, the financial statements differ in order to reflect these differences:
- The company is a separate legal entity, distinct from its owners. The company, not the owners, can make contracts and incur debts, and can sue or be sued.
- Owners are shareholders in the company but are not necessarily involved in the day-to-day running of the business.
- The company is managed by directors, appointed by the owners or shareholders. These directors become caretakers of the shareholders' investment.

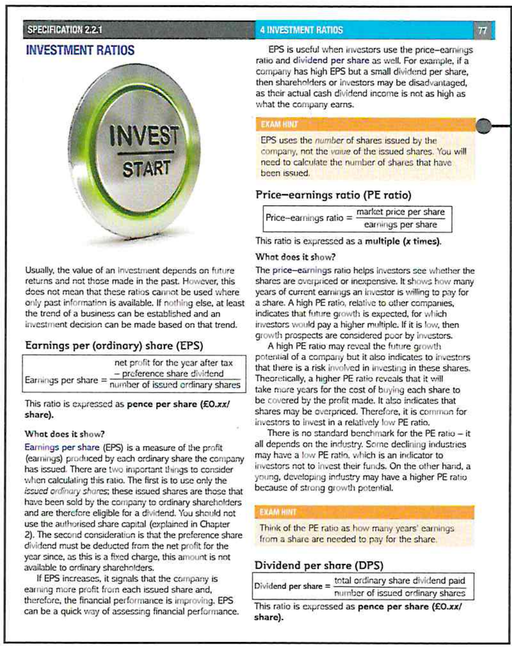
Key subject terms are colour coded within the text.

Getting started
An activity to introduce the key concepts in each chapter. Questions are designed to stimulate discussion and use of prior knowledge. These can be tackled as individuals, pairs, groups or the whole class.

Activity
Each chapter includes activities to embed understanding through case studies and questions.

Skills
Relevant exam questions have been assigned key skills, allowing for a strong focus on particular academic qualities. These transferable skills are highly valued in further study and the workplace.





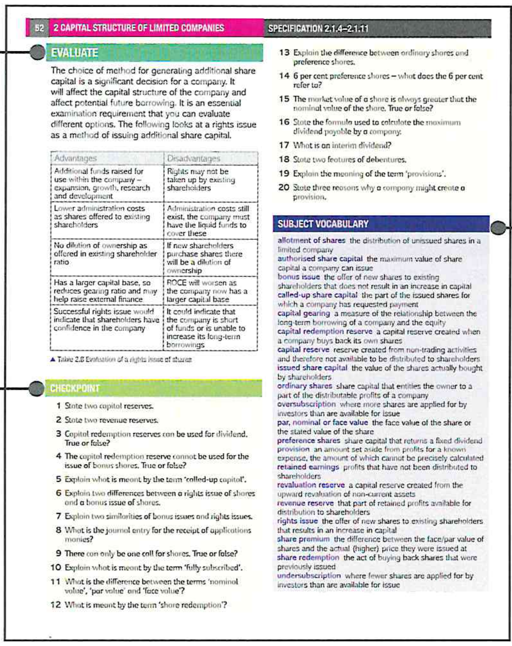
Exam hint
Tips give practical advice and guidance for exam preparation.

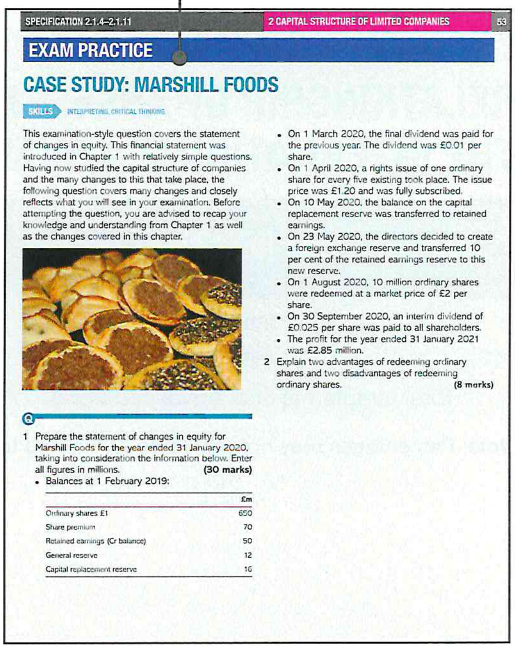
Subject vocabulary
An alphabetical list of all the subject terms in each chapter with clear definitions for EAL learners. Please note: A collated glossary is available at the back of the book.

Exam practice
Exam-style questions are found at the end of each chapter. They are tailored to the Pearson Edexcel specification to allow for practice and development of exam writing technique. They also allow for practice responding to the command words used in the exams.

Evaluate
See page ix.

Checkpoint
Questions to check understanding of the key learning points in each chapter. These are NOT exam-style questions.





ASSESSMENT OVERVIEW

The following tables give an overview of the assessment for this course. You should study this information closely to help ensure that you are fully prepared for this course and know exactly what to expect in each part of the assessment.

PAPER 2	PERCENTAGE OF IA2	PERCENTAGE OF IAL	MARK	TIME	AVAILABILITY
CORPORATE AND MANAGEMENT ACCOUNTING Written exam paper Paper code YAC11 Externally set and marked by Pearson Edexcel Single tier of entry	100%	50%	200	3 hours	January, June and November First assessment: June 2016

ASSESSMENT OBJECTIVES AND WEIGHTINGS

ASSESSMENT OBJECTIVE	DESCRIPTION	% IN IAS	% IN IA2	% IN IAL
A01	Demonstrate knowledge of accounting procedures and techniques and an understanding of the principles and concepts upon which they are based	30	24–25	27–28
A02	Select and apply knowledge and understanding of accounting procedures, techniques, concepts and principles to a variety of accounting situations. Present accounting information in an appropriate format	43–44	41–42	42–43
A03	Analyse financial information, interpret financial data and information and communicate reasoning, showing understanding	17	23–24	20–21
A04	Evaluate financial and non-financial evidence and make informed recommendations and decisions	9–10	10–11	10

Note: Percentages may not add up to 100 owing to rounding.

RELATIONSHIP OF ASSESSMENT OBJECTIVES TO UNITS FOR THE INTERNATIONAL ADVANCED LEVEL QUALIFICATION

UNIT NUMBER	ASSESSMENT OBJECTIVE			
	A01	**A02**	**A03**	**A04**
Unit 1	15%	21–22%	8–9%	4–5%
Unit 2	12–13%	20–21%	11–12%	5–6%
Total for International Advanced Level	27–28%	42–43%	20–21%	10%

Note: Percentages may not add up to 100 owing to rounding.

ASSESSMENT SUMMARY

PAPER 2	DESCRIPTION	MARKS	ASSESSMENT OBJECTIVES
CORPORATE AND MANAGEMENT ACCOUNTING Paper code YAC11	**Structure** Paper 2 assesses 100% of the total IA2 Accounting qualification and 50% of the IAL Accounting qualification. There will be two sections, A and B. Students must answer all questions in Section A and select from a choice of questions in Section B. Section A: two compulsory multi-part questions (110 marks); Section B: three multi-part questions from a choice of four (90 marks). **Assessment** This is a single tier exam paper. The assessment duration is 3 hours. Calculators may be used in the examinations.	The total number of marks available is 200	Questions will test the following Assessment Objectives: AO1 – 12–13% AO2 – 20–21% AO3 – 11–12% AO4 – 5–6%

EVALUATE QUESTIONS

In the exam you will see questions that ask you to 'Evaluate'. In your answer, you will need to compare two methods or ways of working and state which one you think is the most suitable for the scenario given and why. In this book there are 'Evaluate' sections. They give examples of possible methods you might be asked to evaluate, as well as a table showing arguments for and against the method. You could use these tables to help you plan an essay answer on the topic. Remember in the exam to always develop your points – the examiner will not award full marks if you only write bullet points. To achieve the highest marks, you will need to write a conclusion in which you decide which method is best. You need to justify your decision with reasons and you will also be expected to show a chain of reasoning – how your points have helped you to come to your conclusion.

CURRENCY

All of the examples in this textbook use GBP £ because all examination papers also use GBP £ only. However, you might want to challenge yourself by creating examples using the currency from your own country or other major currencies, such as USD $.

LIMITED COMPANIES

In this unit you will learn about the financial statements of limited companies, as well as preparing financial statements in accordance with International Accounting Standard (IAS) 1. These financial statements include two that you are familiar with from your International Advanced Subsidiary studies – the statement of profit or loss and other comprehensive income and the statement of financial position. You will also learn about a new financial statement prepared by limited companies, known as the statement of changes in equity. Limited companies have a more complex capital structure than that of sole traders, and you will learn how to record and prepare the capital structure of limited companies. Finally, you will learn how to account for the merger or purchase of limited companies.

1 FINANCIAL STATEMENTS OF LIMITED COMPANIES

UNIT 2
2.1.1–2.1.3

LEARNING OBJECTIVES

After you have studied this chapter, you should be able to:

- understand the nature of limited companies and explain the meaning of limited liability
- prepare financial statements in accordance with IAS 1, to include the statement of profit or loss and other comprehensive income, the statement of changes in equity and the statement of financial position
- explain the role and importance of the auditors' report and the directors' report
- evaluate the importance of disclosing continuing and discontinued activities and the significance of exceptional items.

GETTING STARTED

Have you considered what the differences might be for limited companies, based on what you have studied about financial statements of sole traders and partnerships? Do you think that the fundamental principles will be the same? Will accounting conventions and concepts still need to be applied? What is certain is that you will need good knowledge of the preparation of financial statements for sole traders and partnerships in order to prepare financial statements for limited companies. Before you start this chapter, it would be wise to practise questions on financial statements from our previous studies.

INTRODUCTION

The preparation of financial statements for limited companies is a continuation of the financial statements studied at International Advanced Subsidiary. These included financial statements for sole traders, partnerships, not-for-profit organisations and manufacturers. Before learning about the financial statements of limited companies, it would be useful to review these financial statements. Many of the conventions and concepts applied to these are also used to prepare the financial statements of limited companies.

ACTIVITY 1

SKILLS COMMUNICATION

CASE STUDY: FINANCIAL STATEMENTS

1 As a class, divide into small groups. Each group should look back at a different financial statement covered at International Advanced Subsidiary (refer to the specification) and prepare a short presentation to the rest of the class to highlight the layout/format of the financial statement.

The layout of the financial statements is similar to those you have previously studied. However, there are significant changes in terminology to learn, owing to the different nature of limited companies. As well as this new terminology, you will need to learn how to prepare a new financial statement – the **statement of changes in equity**.

THE NATURE OF LIMITED COMPANIES

Limited companies differ from sole traders and partnerships in a number of significant ways. As a result, the financial statements differ in order to reflect these differences:

- The company is a separate **legal entity**, distinct from its owners. The company, not the owners, can make contracts and incur debts, and can sue or be sued.
- Owners are **shareholders** in the company but are not necessarily involved in the day-to-day running of the business.
- The company is managed by directors, appointed by the owners or shareholders. These directors become caretakers of the shareholders' investment.

- The liability of shareholders for the debts of the company is limited to the amount of money invested and any unpaid amount on shares.
- It is the company, not the shareholders, that is liable for **corporation tax** on the profits.
- Profits are distributed to shareholders by way of **dividends**.
- The company is unaffected by any change of ownership unless it is merged with another company and becomes a subsidiary.

Why do limited companies exist? We have seen the small sole trader with a modest capital. This trader has unlimited liability for all debts of the business and has little or no access to additional capital. As the business grows, there is the need for additional capital and outside investors are needed to bring in their money, by buying **equity** in the business.

Limited companies are better able to raise capital and give investors some form of security. The capital of the company is divided into shares. The person investing becomes a shareholder and is a part-owner of the company. **Limited liability** means that shareholders' liability for the debts of a company is limited to the amount subscribed for shares including unpaid amounts on calls.

The limitation of liability is a big plus as it means these outside investors, who probably have no control over the day-to-day management of the business, have little risk and cannot lose more than the capital they have invested.

In all companies, directors are responsible for the day-to-day running of the business and are appointed by the shareholders at a general meeting. Each year they report on their stewardship to the annual general meeting of shareholders and submit audited accounts together with their annual reports.

In summary, a limited company is a business organisation whose legal identity is separate from its owners. These owners are known as shareholders. They have limited liability; their losses will be limited to the amount they have invested in the company by way of the purchase of shares.

THE REGULATORY FRAMEWORK FOR PUBLISHED ACCOUNTS

The regulatory framework provides a set of 'rules' for the preparation of financial statements. This enables comparisons to be made between different limited companies and for comparison of the performance of the same company over time. Limited companies are required to follow the requirements of IAS 1: Presentation of Financial Statements.

IAS 1 lists the various statements required in a complete set of financial statements. These are:

- a statement of financial position as at the end of the period
- a statement of profit or loss and other comprehensive income for the period
- a statement of changes in equity for the period
- a statement of cash flows for the period (see Chapter 5)
- notes to the accounts, comprising a summary of significant accounting policies and other explanatory information.

There is also an obligation on the company to present 'with equal prominence' all the above statements.

The wording 'true and fair view' is replaced by the requirement that financial statements shall 'present fairly' the financial position, financial performance and cash flows of an entity.

One objective of IAS 1 is to standardise the presentation of financial statements in order to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other companies. In addition, IAS 1 states that the purpose of financial statements is to provide information about the financial position, financial performance and cash flows of a company that is useful to a wide range of users in making decisions.

The next section looks at the first three financial statements in more detail.

THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

The format of the statement of profit or loss and other comprehensive income is similar to that of a sole trader, but it contains fewer details of individual incomes and expenses and contains several new terms. An example is shown below:

Statement of profit or loss and other comprehensive income: Any Company plc for the year ended 31 December 2019

	£	£
Revenue		100 000
Cost of sales		(38 000)
Gross profit		62 000
Other income		28 000
		90 000
Less: Expenses		
Distribution costs	24 000	
Administration expenses	19 000	(43 000)
Profit before interest and tax		47 000
Financial costs	(11 000)	
Profit on ordinary activities before tax		36 000
Corporation tax		(14 000)
Profit on ordinary activities after tax		22 000

IAS 1 allows for the analysis of expenses and other incomes by nature (raw materials, wages, depreciation, similar to a sole-trader approach) or by function (cost of sales, distribution costs, administration expenses and finance costs). The approach used should be the one that provides the most relevant and reliable information for the users.

EXAM HINT

In the examination, you should analyse the costs by function, as shown in the example above.

As a result of this approach, it is necessary to allocate and apportion costs and revenues to the specific categories shown in the statement of profit or loss and other comprehensive income. You should be familiar with this process from your studies of accounting at AS level.

The following provides a detailed explanation of each section of the statement of profit or loss and other comprehensive information.

Revenue – this shows the net revenue from sales during normal trading activities. This is the revenue less returns inwards.

Cost of sales – these are deducted from the revenue to arrive at the gross profit. These are the direct costs incurred in providing the product or service. It contains the same items as that of a sole trader's cost of sales, together with some items that can be allocated and apportioned to the cost of producing the product or service. These additional items include:

- **Discounts received** – these are deducted from the cost of sales. They are included in cost of sales as they are directly associated with the purchase of raw materials or inventory.
- **Direct expenses** – these are added to the cost of sales. They are included in the cost of sales as they are a direct cost of producing the product or service. These direct expenses could include factory power and direct wages of production staff.
- **Depreciation** – the cost of depreciation of those non-current assets used in the production process will be added to the cost of sales. Typical non-current asset depreciation would include factory depreciation and machinery depreciation.
- **Maintenance costs** – those costs apportioned to the product directly would be added to the cost of sales.

From this we can see that the cost of sales is similar to that of a manufacturer. Like a manufacturing account, inventory included in the cost of sales will include more than one type of inventory.

- **Opening inventory of raw materials** – this will be added to the cost of sales, as will any purchases of raw materials. This is the normal treatment for opening inventories.
- **Closing inventory of raw materials** – this will be deducted in the normal way from the cost of sales.
- **Opening inventory of finished goods** – this will be added to the cost of sales as goods are used up during the year.
- **Closing inventory of finished goods** – following the accruals concept, this will be deducted from the cost of sales as they are not matched to the revenue for the period.

EXAM HINT

In the examination where both types of inventory are given, it is acceptable to net off the two closing inventories and enter a single-figure adjustment.

When completing examination questions, it is essential that you present a detailed cost of sales calculation as an additional note to the statement of profit or loss and other comprehensive income. An example is given below:

Notes

Cost of sales	£
Opening inventory – raw materials	42 000
Add: Purchase of direct materials	100 000
Less: Discounts received	(2 000)
Less: Returns out	(5 000)
Less: Closing inventory of raw materials	(55 000)
Add: Factory depreciation	7 000
Add: Machinery depreciation	2 000
Add: Factory power	1 000
Add: Production staff wages	30 000
Add: Opening inventory of finished goods	2 000
Less: Closing inventory of finished goods	(1 000)
	121 000

Gross profit – this calculation is the same as the other financial statements you have studied; it is calculated by subtracting the cost of sales from the revenue.

Other income – consists of revenues from non-trading activities such as bank loan interest received and investment income. These amounts are added after the calculation of gross profit. When preparing the statement of profit or loss and other comprehensive income it is important to remember that some other incomes, which you have previously included here when preparing financial statements for sole traders, will be allocated to the expense functions. These include discounts received, which we will allocate to the cost of sales, and the decrease in the allowance for irrecoverable debts, which we will allocate to the costs of administration.

Distribution costs – these are deducted as they represent an expense to the company. Costs included in this category of expense are those associated with transferring the finished product or service to the customer, and sales and marketing costs such as storage costs, packing and delivery costs, the depreciation and running costs of the delivery vehicles, and the wages of staff involved in the distribution process. Some of these costs will be allocated to distribution costs, while others may need to be apportioned. Discounts allowed will be allocated to distribution costs as they are a cost incurred in the transfer of goods to the customer.

As with cost of sales, the total of the distribution costs will be given in the main body of the statement of profit or loss and other comprehensive income and a detailed breakdown of the costs will appear as notes to the statement. A typical example is shown below with some new accounts. You will need to think why these have been included in the costs of distribution.

Notes

Distribution costs	£
Commission on sales	15000
Delivery vehicle expenses	20000
Depreciation – delivery vehicles	20000
Rent of shops	43000
Transport staff wages	75000
Shop staff wages	59000
Warehouse power	3000
Rent of warehouse	21000
Shipping costs	15000
Promotion and advertising	12000
Warehouse manager salary	25000
Discounts allowed	8000
	316000

Administration expenses – are also deducted. These costs include office expenses such as rent and rates of office buildings, general expenses, depreciation of office equipment and head office staff wages and salaries. In addition, irrecoverable debts and any increase or decrease in the allowance for irrecoverable debts will be allocated to administration expenses. Auditors' fees (see Chapter 2) will be allocated to administration expenses. Some of these costs will again be allocated while some will be apportioned.

A typical example is given below:

Notes

Administration expenses	£
Irrecoverable debts	2000
Decrease – allowance for irrecoverable debts*	(500)
Discounts allowed	2500
Office staff wages	75000
Rent – office	24000
Power – office	13000
Auditors' fees	15500
Hire of office equipment	12000
Depreciation – office equipment	15000
	158500

*The decrease in the allowance is subtracted from the costs of administration.

Financial costs – deducted from gross profit and other income, these are the costs of servicing debt and include interest paid on bank overdrafts, bank loans and **debentures** (see Chapter 2). These costs are also shown as a note to the statement of profit or loss and other comprehensive income.

Notes

Financial costs	£
Bank loan interest	1350
Debenture interest	12000
	13350

EXAM HINT

Always check for interest payments on debt finance. You may need to calculate the annual interest payable on bank loans and debentures. Often it is missing from the list of balances or it may only include part of the annual cost.

Profit on ordinary activities before tax – this is the amount remaining after all expenses have been deducted from the gross profit and other income.

Corporation tax – this is a tax paid to the government based on the profits made by the company. Unlike a sole trader, the tax forms part of the financial statements of a limited company. It is deducted from the profit on ordinary activities before tax to arrive at the final figure in the statement of profit or loss and other comprehensive income.

Profit on ordinary activities after tax – the residual amount of profit that can be distributed to shareholders as dividends.

ACTIVITY 2

SKILLS COMMUNICATION, INTERPRETING

CASE STUDY: CORPORATION TAX

1 Using the internet, research the rate of corporation tax in the country in which you live. Compare it to other corporation tax rates around the world.

WORKED EXAMPLE

The following balances were extracted from the books of Gayle Fabrications plc at 31 December 2019:

Account	£
Direct materials	135 000
Discounts received on materials	2 100
Factory machinery (carrying value)	30 000
Fuel	33 000
Inventory of finished goods 1 January 2019	10 200
Marketing and promotion expenses	21 000
Motor lorries (carrying value)	51 000
Power	14 000
Rent on warehouse	35 000
Revenue	543 500
Vehicle running costs	12 700
Wages	172 000

Additional information:

- inventory of finished goods £8 000
- inventory of raw material £2 010
- power costs are to be apportioned between the factory, distribution and the office in the ratio 4:2:1
- fuel is to be apportioned between the factory and distribution in the ratio 2:9
- wages include:

Delivery staff	£45 000
Office staff	£15 000
Factory staff	£73 500
Sales staff	£38 500

- sales staff receive a commission of 1 per cent as a year-end bonus on all sales made. No entries have been made in the books
- depreciation on the non-current assets are calculated using the reducing balance method:
  Factory machinery at 20 per cent
  Motor lorries at 25 per cent.

You have been asked to calculate the cost of sales and the distribution costs prior to their inclusion in the statement of profit or loss and other comprehensive income.

You will be familiar with much of the process for completing these from your studies at AS level. The costs will need to be allocated to the cost of sales section and the distribution costs section. In addition, you will need to apportion certain costs between the two sections and calculate year-end adjustments such as accruals and depreciation. You need to be methodical and show all your workings.

Solution

Cost of sales	£
Direct materials	135 000
Discounts received	(2 100)
Fuel (W1)	6 000
Inventory of finished goods 1 January 2019	10 200
Power (W2)	8 000
Wages – factory staff	73 500
Inventory – finished goods 31 December 2019	(8 000)
Inventory – materials 31 December 2019	(2 010)
Depreciation – machinery (W3)	6 000
	226 590

Distribution costs	£
Fuel (W1)	27 000
Marketing and promotion	21 000
Power (W2)	4 000
Rent of warehouse	35 000
Vehicle running costs	12 700
Wages – delivery staff	45 000
Wages – sales staff	38 500
Sales staff commission (W4)	5 435
Depreciation – motor lorries (W3)	12 750
	201 385

Workings

W1 – Fuel is apportioned in the ratio factory (cost of sales):distribution 2:9

£33 000 ÷ 11 = £3 000, so:
Factory fuel is £3 000 × 2 = £6 000
Distribution fuel is £3 000 × 9 = £27 000

W2 – Power is apportioned in the ratio factory (cost of sales):distribution:office (administration expenses) 4:2:1

£14 000 ÷ 7 = £2 000, so:
Factory power is £2 000 × 4 = £8 000
Distribution power is £2 000 × 2 = £4 000

(The administration costs would be £2 000 × 1 = £2 000, but these are not required for this worked example. It is always a good idea to total up each section to make sure they equal the total costs given. In this example £8 000 + £4 000 + £2 000 does equal the amount given in the question.)

W3 – Depreciation is calculated as the carrying value × the reducing balance percentage

Machinery (cost of sales, as it is a direct cost) £30 000 × 20% = £6 000
Motor lorries (distribution, as it is a cost of distributing the finished goods) £51 000 × 25% = £12 750

W4 – Sales commission (distribution expense, as it is a cost incurred in the selling and distribution process) is calculated as revenue £543 500 × 1% = £5 435

WORKED EXAMPLE

Eleni Oils Ltd imports and exports cooking oils. A trainee accountant has drafted some financial information prior to the preparation of the financial statements for the year ended 31 December 2019. The following has been provided:

	£
Administration expenses	100 100
Cost of sales	495 300
Distribution costs	910 500
Revenue	3 100 000

Additional information:

- office staff wages owing £20 200
- dividends received from investments in other companies £29 300
- bank overdraft interest owing £2 300
- 7 per cent bank loan, repayable in 2024, of £130 000
- corporation tax to be paid on profits above £36 000 at a rate of 19 per cent, with any amount due being payable in the following year

You are asked to prepare a statement of profit or loss and other comprehensive income for the year ended 31 December 2019. Include as notes a section for finance costs. Show all your workings.

Solution

Statement of profit or loss and other comprehensive income: Eleni Products plc for the year ended 31 December 2019

	£	£
Revenue		3 100 000
Cost of sales		(495 300)
Gross profit		2 604 700
Other income		29 300
		2 634 000
Distribution costs	910 500	
Administration costs (W1)	120 300	1 030 800
Profit before interest and tax		1 603 200
Financial costs (W2)	11 400	
Profit on ordinary activities before tax		1 591 800
Corporation tax (W3)		(295 602)
Profit on ordinary activities after tax		1 296 198

Notes

Financial costs	£
Interest on bank overdraft	2 300
Interest on bank loan	9 100
	11 400

Workings

W1 – Administration costs include an additional £20 200 for wages owing.

W2 – Financial costs are made up of bank overdraft interest £2 300 plus 7 per cent of £130 000 loan interest

W3 – Corporation tax is calculated as:

(Profit on ordinary activities before tax less £36 000) × 19% = £295 602.

The statement of profit or loss and other comprehensive income would normally show notes for all sections of the statement where more than one figure is required. These would be for:

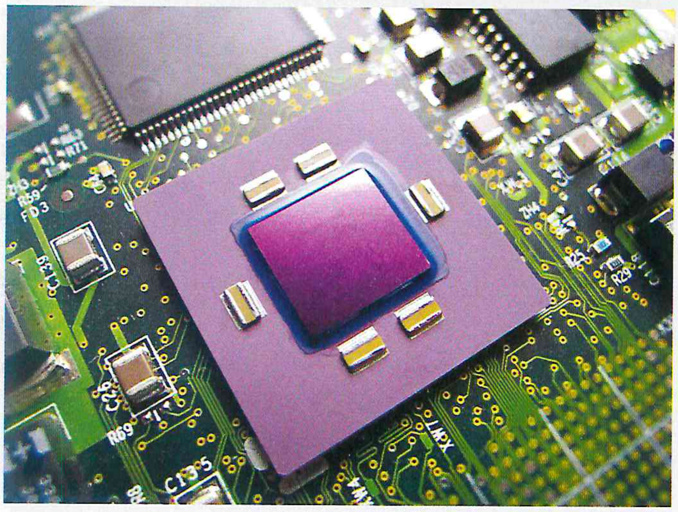
- cost of sales
- distribution costs
- administration costs
- finance costs.

In this example the cost of sales, the distribution costs and the administration costs are already prepared so there is only a need to add the financial cost as a note to the statement. In your examination you will be asked to prepare, if necessary, all sections as notes to the statement.

ACTIVITY 3

SKILLS EXECUTIVE FUNCTION

CASE STUDY: KOSTAS CERAMICS PLC



Kostas Ceramics plc manufacture products for the electronics industry. The following information has been provided at 30 November 2019:

	£
Administration expenses	43 800
Audit fees	32 000
Debenture interest paid	30 000
Depreciation – delivery vehicles	45 300
Depreciation – premises	10 000
Depreciation – machinery	25 000
Distribution expenses	47 000
Inventory – raw materials 1 December 2018	9 000
Inventory – finished goods 1 December 2018	4 700
Motor vehicle expenses	12 750
Power	42 000
Purchase of raw materials	348 560
Revenue	810 400
Wages	129 000

Additional information:

- inventory of raw materials at 30 November 2019 £12 000
- inventory of finished goods at 30 November 2019 £20 600
- power to be apportioned on the basis of factory 60 per cent, warehouse 30 per cent and the balance to offices, with a power bill for £25 000 outstanding
- premises depreciation is to be apportioned using the ratio Factory: Distribution: Administration 7:2:1
- wages are made up of:

Factory staff	£57 000
Warehouse and delivery staff	£34 600
Office staff	£37 400

- corporation tax of £4 800 has been calculated and is due to be paid by 31 July 2020.

1 Prepare the statement of profit or loss and other comprehensive income in accordance with IAS 1, to include notes for cost of sales, distribution costs and financial costs.

ACTIVITY 4

SKILLS EXECUTIVE FUNCTION

CASE STUDY: LARNACA PLC

Larnaca plc has a financial year that ends on 31 March. At 31 March 2019, the following figures were extracted from the books, subject to final adjustment.

	£	£
	Dr	**Cr**
Ordinary shares issued, fully paid		200 000
Retained profit at 1 April 2018		19 000
Bank balance	25 789	
8% debentures		25 000
8% cent loan		10 000
Remuneration of auditors	800	
Remuneration of directors	32 000	
Interest on loan	800	
Interest on debentures	2 000	
Office expenses	74 800	
Delivery expenses	68 000	
Leasehold workshop at cost	180 000	
Accumulated depreciation on leasehold workshop		60 000
Machinery at cost	160 000	
Accumulated depreciation on machinery		27 000
Additions to machinery at cost during the year	10 000	
Inventory at 31 March 2019	86 000	
Trade receivables	95 200	
Prepaid expenses	700	
Trade payables		50 500
Accrued expenses		5 340
Revenue		900 000
Cost of raw materials consumed	560 751	
	1 296 840	1 296 840

Additional information:

- the lease on the workshop expires on 31 March 2028. Provide for the annual depreciation at the rate of 10 per cent reducing balance method
- depreciation on machinery is 15 per cent on cost. A full year's depreciation is charged on all machinery owned at 31 March 2019
- the only distribution cost during the year was delivery expenses
- a provision for corporation tax of £11 000 is to be made
- the inventory at March 2019 has been accounted for in the cost of raw materials consumed.

1 Prepare the statement of profit or loss and other comprehensive income for the year ended 31 March 2019.

Benefits and limitations of classifying costs in the statement of profit or loss and other comprehensive income

By this stage of your studies you have probably become aware of the many different expenses and costs incurred by business organisations. In your studies of sole traders these were put into two distinct categories: cost of sales and expenses. In the financial statements of limited companies, the cost of sales category is maintained, but the other expenses are split, according to IAS 1, into further distinct categories.

Some of the benefits of this are as follows:

- it allows the users of financial information to see a standard presentation that will allow them to compare different companies on a reasonable basis
- it may allow a company to see how different sections of the business perform year on year. This will help with internal decision making
- it reduces the number of individual accounts on the face of the statement of profit or loss and other comprehensive income. This will reduce the length of the statement and make it easier to follow.

However, there are limitations to this approach:

- it makes it more complex to produce as some costs will need to be allocated and apportioned to the different categories on a fair and equitable basis, which might be difficult to achieve with accuracy
- Different companies might allocate and apportion on a different basis, making comparisons invalid
- finally, there will be cost and time implications, as more skilled staff may be needed, which will increase the costs to the company.

THE STATEMENT OF FINANCIAL POSITION

IAS 1 conforms to the accounting equation:

$$\boxed{\text{Assets} = \text{Equity} + \text{Liabilities}}$$

The layout is very similar to the one that you prepared for sole traders and partnerships. Assets and liabilities are still classified as non-current and current. It is the equity section that has the most significant differences; these reflect the differing nature of limited companies. With limited companies you will be introduced to further accounts for equity that will be fully developed in Chapter 2.

IAS 1 specifies what is required to be shown in the statement of financial position but does not set out the specific order or detail. Below is a typical statement of financial position you are likely to see in your examination. Following the statement there are brief explanations of each part of the statement, which focus on the new terms applicable to limited companies.

Statement of financial position: A Limited Company plc at 31 August 2019

	£	£	£
Assets			
Non-current assets			
Intangible asset – goodwill		50 000	
Property, plant and equipment		161 000	
Investments		5 000	
			216 000
Current assets			
Inventories		10 000	
Trade and other receivables:			
Trade receivables		20 000	
Other receivables		5 000	
Cash and cash equivalents		8 000	
			43 000
Total assets			**259 000**
Equity and liabilities			
Equity			
Share capital:			
Ordinary shares £1		90 000	
6% preference shares £1		30 000	
Share premium		10 000	
Revaluation reserve		10 000	
General reserve		9 000	
Retained earnings		25 000	
Total equity			174 000
Non-current liabilities			
4% debenture	50 000		
4.5% bank loan	10 000		
		60 000	
Current liabilities			
Trade payables and other payables:			
Trade payables	10 000		
Other payables	2 000		
Short-term borrowings	1 000		
Corporation tax payable	9 000		
Provisions	3 000		
		25 000	
Total liabilities			85 000
Total equity and liabilities			**259 000**

EXAM HINT

You must label all headings and lines (e.g. Total assets, Total equity and Total liabilities) accurately.

The following provides a detailed explanation of each section of the statement of financial position.

Assets – these are generally listed first in the statement of financial position. They are divided into non-current assets, including intangible assets, and current assets.

Non-current assets – these are assets controlled by the business intended for long-term continuing use.

Intangible assets – these are non-physical assets controlled by the business. They include purchased goodwill, patents, copyright and trademarks.

Property, plant and equipment – these are physical assets controlled by the business that are expected to be used for more than one trading period. It is the carrying value (i.e. the value after depreciation) of these assets that is recorded in the statement.

Investments – these are financial assets, such as shares in other companies, owned by the business.

Current assets – resources that are converted to cash within a year. As with sole traders they are listed in order of liquidity – least to most liquid.

Inventories – goods held for sale in the ordinary course of the business. They may include purchased goods for resale, finished manufactured goods, work in progress and raw materials.

Trade receivables – amounts due from customers arising from credit sales. It is usual to express this value after the deduction of any allowance for irrecoverable debts.

Other receivables – amounts owed to the business from non-trading activities.

Cash and cash equivalents – represent the amount of cash the company has plus any short-term investments that are readily convertible into cash, the most common being the bank.

Total assets – non-current assets + current assets.

Equity and liabilities – this section details the owners' funds and any liabilities owed by the company.

Equity – this consists of the share capital and reserves. This section of the statement of financial position is significantly different to that of a sole trader. It will be covered in detail in Chapter 2 and also later in this chapter under the heading 'Statement of changes in equity'. For the moment you need to know that the share capital represents funds invested in the business by the owners, and the reserves represent profit that has not been distributed to the owners of the company.

Share capital – this represents the amount of money invested in the company by the shareholders. It is made up of ordinary shares and preference shares. A detailed explanation of these is given in Chapter 2.

Reserves – these consist of profit generated by the business that has not been distributed to the owners. These will be covered in detail both later in this chapter and in Chapter 2. In the example above, the reserves include the following:

- **Share premium** – this is generated by selling shares at a price higher than the nominal value. In our example it would be created if the shares were sold for more than £1
- **Revaluation reserve** – this is generated if non-current assets are revalued above the carrying value
- **General reserve** – a transfer of profit to a reserve for a non-specific purpose
- **Retained earnings** – profit that has not been distributed to the shareholders.

Non-current liabilities – amounts owed over the longer term, where the repayment date is more than one year from the date of the statement of financial position. These would include bank loans and debentures. Debentures are covered in detail in Chapter 2. Briefly, they are long-term loans with a fixed rate of interest being payable, in our example 4 per cent.

Current liabilities – amounts owed that are expected to be settled or are due to be settled within the next 12 months.

Trade payables – amounts owing that arise from the normal trading activities.

Other payables – amounts owing for items such as bank loan interest.

Short-term borrowings – typically include bank overdrafts and short-term bank loans repayable within one year.

Corporation tax payable – corporation tax is a tax payable by the business on the net profit of the company. It is shown as a current liability, as the figure is calculated after the year end so is owed by the company at the date of the statement of financial position.

Provision – a liability of uncertain timing or amount. For example, provision for warranty: a company has an obligation to its customers for repairs but it is uncertain when these will be needed.

Total liabilities – Non-current liabilities + current liabilities.

Total equity and liabilities – equity + total liabilities.

Note: the total assets should equal the total equity and liabilities.

WORKED EXAMPLE

Dalia plc has the following balances in the books at 30 November 2019:

	£
4% bank loan (2026)	40 000
Bank	5 500
Building – carrying value	300 000
Cash	2 500
General reserve	40 000
Goodwill	20 000
Inventories	18 100
Motor vehicles – cost	30 000
Ordinary shares £0.75	215 600
Other payables	8 500
Accumulated depreciation (motor vehicles)	20 000
Provisions	1 000
Retained earnings	35 000
Revaluation reserve	20 000
Trade receivables	17 000
Trade payables	13 000

Additional information:

- bank loan interest £400 is outstanding
- motor vehicles are to be depreciated at 10 per cent per year using the reducing balance method
- corporation tax of £20 500 has been calculated. It is due to be paid on 31 May 2020.

1 You are asked to prepare the Statement of Financial Position of Dalia plc at 30 November 2019.

Solution

Dalia plc
Statement of financial position at 30 November 2019

	£	£	£
Assets			
Non-current assets			
Intangible asset – goodwill		20 000	
Property, plant and equipment (W1)		309 000	
			329 000
Current Assets			
Inventories		18 100	
Trade and other receivables:			
Trade receivables		17 000	
Cash and cash equivalents (W2)		8 000	
			43 100
Total assets			372 100
Equity and liabilities			
Equity			
Share capital:			
Ordinary shares £1		215 600	
Revaluation reserve		20 000	
General reserve		40 000	
Retained earnings (W4)		13 100	
Total equity			288 700
Non-current liabilities			
4.5% bank loan	40 000		
		40 000	
Current liabilities			
Trade payables and other payables:			
Trade payables	13 000		
Other payables (W3)	8 900		
Corporation tax payable	20 500		
Provisions	1 000		
		43 400	
Total liabilities			83 400
Total equity and liabilities			372 100

Workings

W1 – Depreciation of motor vehicles (£30 000 – £20 000) × 10% = £1 000

Carrying value = £30 000 – £21 000
= £9 000

Property, plant and equipment
= building + motor vehicle carrying value
= £300 000 + £9 000
= £329 000

W2 – Cash and cash equivalents = bank + cash
= £5 500 + £2 500
= £8 000

W3 – Other payables + bank loan interest owing = £8 500 + £400
= £8 900

W4 – Retained Earnings = £35 000 – £400 (interest owing) – £1 000 (depreciation on motor vehicles) – £20 500 (tax expense) = £13 100

As you may have realised by now, many of the accounting techniques you studied for AS level are required for A level as well. In the two worked examples in this chapter we have made end-of-year adjustments for amounts owing and depreciation as well as allocating and apportioning costs.

ACTIVITY 5

SKILLS CRITICAL THINKING

CASE STUDY: FINANCIAL STATEMENT HEADING

1 Define the following terms, giving an example for each:
   (a) intangible assets
   (b) equity
   (c) cost of sales
   (d) distribution costs

ACTIVITY 6

SKILLS EXECUTIVE FUNCTION

CASE STUDY: LATCHI PLC

The accountant for Latchi plc prepared a trial balance for the year ended 31 October 2019.

Latchi plc
Trial balance at 31 October 2019

	£000s	£000s
	Dr	**Cr**
Administration expenses	295	
Cash and cash equivalents	45	
Distribution expenses	400	
Inventory at 1 November 2018	120	
Ordinary shares £2		505
Plant and equipment:		
Cost	450	
Depreciation at 1 November 2018		320
Other payables		20
Property – carrying value	420	
Purchases	950	
Retained earnings at 1 November 2018		150
Revenue		1 835
Share premium		115
Trade payables		190
Trade receivables	455	
	3 135	3 135

Additional information:

- inventory at 31 October 2019 is £150 000
- depreciation of plant and equipment is to be provided for the year at 20 per cent straight-line method. It is apportioned between cost of sales 50 per cent, distribution 40 per cent and administration expenses 10 per cent
- corporation tax has been estimated at £20 000.

1 Prepare the statement of profit or loss and other comprehensive information for the year ended 31 October 2019.

2 Prepare the statement of financial position at 31 October 2019.

EXAM HINT

With the financial statements of limited companies, the values in the accounts are often very large. Therefore, it is common practice to shorten the digits in the account by changing the units. In the above example, the units are expressed as £000s, which means the numbers are expressed in thousands. So, the administration expenses of £295 are in fact £295 000. Another common abbreviation you will come across in examinations is £m. The numbers are therefore in millions.

ACTIVITY 7

SKILLS EXECUTIVE FUNCTION

CASE STUDY: ALLIED HOLDINGS PLC

Allied Holdings plc imports and exports consumer goods. The following trial balance was extracted at the year end.

Allied Holdings plc
Trial balance at 31 December 2019

	£ Dr	£ Cr
Ordinary shares		1 000 000
Preference shares		800 000
Share premium account		100 000
Retained earnings		62 000
Inventory 1 January 2019	43 000	
Land and buildings	1 950 000	
Plant and equipment (at cost)	143 000	
Motor vehicles (at cost)	25 000	
Fixtures and fittings (at cost)	12 000	
Trade receivables	38 300	
Trade payables		19 600
Purchases	191 000	
Revenue		503 000
Salaries	93 600	
Directors' remuneration	48 000	
Motor expenses	6 300	
Audit fees	3 500	
Irrecoverable debts	12 100	
Allowance for irrecoverable debts		1 100
Accumulated depreciation – plant and equipment		14 000
Motor vehicles		9 300
Fixtures and fittings		1 100
Cash at bank	11 100	
Debentures		66 800
	2 576 900	2 576 900

Additional information:

- inventory at 31 December 2019 was £18 900
- depreciation of 10 per cent per annum is to be provided on cost for plant and equipment and fixtures and fittings
- depreciation of 20 per cent per annum is to be provided on reducing balance for motor vehicles
- the provision for irrecoverable debts is to be made equal to 10 per cent of trade of receivables
- depreciation expense for plant and equipment is apportioned 90 per cent to cost of sales and the balance to distribution expenses
- all expenses relating to motor vehicles are apportioned as follows: 90 per cent to distribution expenses and 10 per cent to administration expenses
- fixtures and fittings depreciation is allocated to distribution costs
- salaries are apportioned on the basis of cost of sales 70 per cent, distribution costs 20 per cent and administration expenses 10 per cent.

1 Prepare the statement of profit or loss account, for Allied Holdings plc for the year ended 31 December 2019 and the statement of financial position at that date, in accordance with IAS 1.

As you will have noticed, the financial statements of limited companies have much in common with those of sole traders and partnerships. However, they differ in one major respect – limited companies are required to prepare an additional financial statement – the statement of changes in equity.

THE STATEMENT OF CHANGES IN EQUITY

IAS 1 requires that a statement of changes in equity is prepared. This financial statement shows the changes that have taken place over time to the shareholders' investment in the company. It is a more detailed account of the equity section in the statement of financial position than those of a sole trader or partnership.

It shows the changes in the capital in the company (think capital introduced for a sole trader), and it shows the amount of profit withdrawn from the company in the form of dividends (think drawings for a sole trader). It also shows the value of undistributed profits retained by the company (this is not added to the capital as it would be for a sole trader).

For a sole trader the equity section would be:

Opening capital + capital introduced + profit for the year – drawings = closing capital

For a limited company the equity would be:

Opening equity + equity introduced + retained earnings + profit after tax – dividends = closing equity.

An example of a statement of changes in equity is shown below, followed by an explanation of each section.

Note: It must be noted that much of the content of a statement of changes in equity requires an understanding of the capital structure of a limited company, which follows in Chapter 2. The worked examples and activities in this chapter will be basic with more complex examples and activities being available in Chapter 2.

IAS 1 states that the following information should be shown in the statement:

- profit after tax for the current year
- dividend payments to shareholders
- changes in the share capital and reserves.

WORKED EXAMPLE

The contents of the statement are best explained by working through an example. Here is a blank statement, showing just the headings:

Statement of changes in equity for the year ended 31 December 2019						
	Ordinary shares £	Share premium £	Retained earnings £	General reserve £	Revaluation reserve £	Total equity £
Balance at 1 January 2019						
Revaluation						
Issue of shares						
Profit						
Dividends paid						
Balance at 31 December 2019						

Balance at January 2019 – this represents the equity section of the statement of financial position at the end of the previous financial year (31 December 2018).

- Ordinary shares account – value of ordinary shares issued by the company, for example 100 000 £1 ordinary shares sold would result in **£100 000** worth of ordinary shares.
- Share premium account – the additional value of ordinary shares that have been sold to shareholders for more than the nominal value of the share. For example, if the 100 000 ordinary shares had been sold to shareholders for £1.20, this would result in a share premium of **£20 000** (100 000 shares × £0.20).
- Retained earnings – these represent the undistributed profits earned by the business in previous years, for example, **£30 000**.
- General reserve (see Chapter 2 for a full explanation) – these represent transfers from the retained earnings to an account to indicate that some of the previously earned profit may be needed in the future to fund activities such as replacement of non-current assets. For example, **£20 000** may have previously been transferred from retained earnings to this account.
- Revaluation reserve (see Chapter 2 for a full explanation) – this arises when non-current assets, typically property, has been revalued upwards. This increases the value of the asset, the contra entry being the credit entry in the revaluation account. For example, let us assume land had previously been revalued upwards by **£10 000**.
- Total equity – this is the total of the row and equates to the total of the equity section of the statement of financial position.

We can now enter these figures into the statement of changes in equity. Only the first row has been shown so that you can clearly see the entries made.

Statement of changes in equity for the year ended 31 December 2019						
	Ordinary shares £	Share premium £	Retained earnings £	General reserve £	Revaluation reserve £	Total equity £
Balance at 1 January 2019	**100000**	**20000**	**30000**	**20000**	**10000**	**180000**

Revaluation – this would show any increases in the value of non-current assets during the current financial year. Let us assume that during the year, property was revalued and showed an increase of **£10 000**. The entry in the statement of changes in equity would be shown as:

Statement of changes in equity for the year ended 31 December 2019						
	Ordinary shares £	Share premium £	Retained earnings £	General reserve £	Revaluation reserve £	Total equity £
Balance at 1 January 2019	100000	20000	30000	20000	10000	180000
Revaluation					**10000**	**10000**

Issue of shares – these show the value of shares issued during the financial year. This is covered in depth in Chapter 2. For this example, we will assume that during the year, 50 000 £1 ordinary shares were sold at a price of £1.10, that is, at a premium of 10p per share. Issue price = nominal value + premium value. The entry in the statement of changes in equity would consist of:

50 000 × £1 ordinary shares = **£50 000**

50 000 × £0.10 share premium = **£5 000**

Statement of changes in equity for the year ended 31 December 2019						
	Ordinary shares £	Share premium £	Retained earnings £	General reserve £	Revaluation reserve £	Total equity £
Balance at 1 January 2019	100000	20000	30000	20000	10000	180000
Revaluation					10000	10000
Issue of shares	**50000**	**5000**				**55000**

Profit – this represents the profit for the year and is added to the existing profits under the heading 'Retained earnings'. Let us assume the company made a profit for the year of £25 000. The entry would be:

Statement of changes in equity for the year ended 31 December 2019						
	Ordinary shares £	Share premium £	Retained earnings £	General reserve £	Revaluation reserve £	Total equity £
Balance at 1 January 2019	100000	20000	30000	20000	10000	180000
Revaluation					10000	10000
Issue of shares	50000	5000				55000
Profit			**25000**			**25000**

Dividends paid – these represent a withdrawal of profit from the company and thus reduce the value of the equity. For this worked example we will assume that the company paid dividends of **£5 000** to shareholders. The entry would be:

Statement of changes in equity for the year ended 31 December 2019						
	Ordinary shares £	Share premium £	Retained earnings £	General reserve £	Revaluation reserve £	Total equity £
Balance at 1 January 2019	100 000	20 000	30 000	20 000	10 000	180 000
Revaluation					10 000	10 000
Issue of shares	50 000	5 000				55 000
Profit			25 000			25 000
Dividends paid			**(5 000)**			**(5 000)**

Note that the £5 000 is in brackets as it is a reduction in equity and so must be subtracted from the total equity.

Balance at 31 December 2019 – this represents the totals for each section for the end of the financial year. This row should equal the total equity column!

Statement of changes in equity for the year ended 31 December 2019						
	Ordinary shares £	Share premium £	Retained earnings £	General reserve £	Revaluation reserve £	Total equity £
Balance at 1 January 2019	100 000	20 000	30 000	20 000	10 000	180 000
Revaluation					10 000	10 000
Issue of shares	50 000	5 000				55 000
Profit			25 000			25 000
Dividends paid			(5 000)			(5 000)
Balance at 31 December 2019	**150 000**	**25 000**	**50 000**	**20 000**	**20 000**	**265 000**

WORKED EXAMPLE

WE plc extracted the following balances at 30 November 2019:

Equity

Ordinary shares £0.80 £500 000

Retained earnings £89 500

Additional information:

- profit for the year before tax £25 000
- provision for corporation taxation £5 000
- during the year the company paid dividends of £10 500 to shareholders.

Complete the statement of changes in equity.

Solution

	Ordinary shares £	Retained earnings £	Total equity £
Balance at 1 December 2018	500 000	89 500	589 500
Profit		20 000	20 000
Dividends paid		(10 500)	(10 500)
Balance at 30 November 2019	500 000	99 000	599 000

Profit entered is the profit after the deduction of corporation tax.

ACTIVITY 8

SKILLS ANALYSIS, PROBLEM SOLVING

CASE STUDY: ADOPT-IT PLC

The equity section of Adopt-it plc at 1 April 2019 was:

Equity:	£
Ordinary shares	300 000
Retained earnings	171 590

Additional information for the year ended 31 March 2020:

- profit before tax £89 890
- provision for taxation £13 500
- dividends paid during the year £43 500.

1 Prepare a statement of changes in equity for the year ended 31 March 2020.

WORKED EXAMPLE

The equity section of a company at the start of the year, 1 February 2019 was:

Equity:	£m
Ordinary shares £1	25
Share premium	5
Retained earnings	10

Additional information:

- on 1 March 2019, the directors agreed to revalue the non-current assets. The carrying value of the land and buildings was £200 000. The agreed revaluation was £300 000
- dividends paid during the year amounted to £700 000 and profit after tax was £2.5m.

Complete the statement of changes in equity.

Solution

	Ordinary shares £m	Share premium £m	Retained earnings £m	Revaluation reserve £m	Total equity £m
Balance at 1 February 2019	25	5	10		40
Revaluation (W1)				0.1	0.1
Profit			2.5		2.5
Dividends paid			(0.7)		(0.7)
Balance at 31 January 2020	25	5	11.8	0.1	41.9

W1 – Increase in value is £300 000 – £200 000 = £100 000 (£0.1m)

ACTIVITY 9

SKILLS ANALYSIS, PROBLEM SOLVING

CASE STUDY: WHILL PLC

The following balances at 31 October 2018 were extracted from the accounting records of Whill plc:

Equity:	£
Ordinary shares £0.50	400 000
Share premium	100 000
Retained earnings	75 000

Additional information:

- on 1 March 2019, property was revalued from £250 000 to £425 000
- on 30 June 2019, the directors paid a dividend to shareholders of £21 000
- profit for the year before taxation was £47 000
- corporation tax for the year was calculated to be £15 000
- the directors decided to create a general reserve of £10 000 to cover possible staff redundancy costs.

1 Prepare a statement of changes in equity for the year ended 31 October 2019.

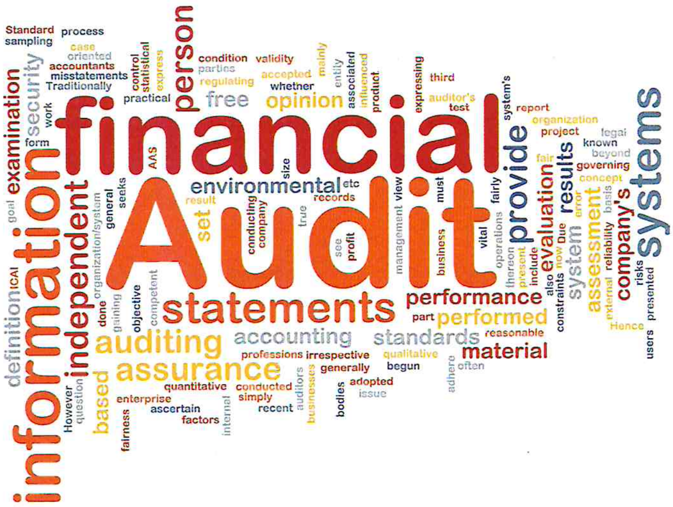
The statement of changes in equity provides the connection between the statement of profit or loss and other comprehensive income and the statement of financial position. It provides extra, vital information for the different uses of financial information.

In Chapter 2 you will learn about the capital structure of limited companies in detail and how various transactions affect the equity of the company. Many of these will directly affect the equity of the company and so will need to be included in the statement of changes in equity. We will therefore return to this financial statement in Chapter 2, where you will learn about more complex changes to the equity of a company and how these are recorded.

EXAM HINT

In the examination, you will often be provided with a table for the statement of changes in equity; however, you should be prepared to complete one without the headings being given.

ROLE OF THE AUDITOR



Auditors examine the financial records and financial statements of limited companies. These auditors could be internal or external to the company. Internal auditors are employed by the company to look in detail at the financial controls of the company. External auditors are independent of the company and would be appointed by the owners of the company, the shareholders. Their primary role is to prepare a report that states whether the financial statements are 'true and fair'.

Internal auditors would examine the control procedures of a company, for example the purchase and disposal of non-current assets or the control procedures for handling cash and cash equivalents within the business.

External auditors are not employees of the company but are independent. Their role is to investigate whether the company has maintained adequate financial records, and whether these records have been used to produce financial statements that accurately report the financial position of the company. As stated, their primary role is to ensure that the financial records and financial statements provide a true and fair view of the business. Furthermore, external auditors also make sure the records and statements have been prepared in accordance with the relevant legal and regulatory guidelines, as given in IAS 1: Presentation of Financial Statements. This process should give confidence to the users of the information, the stakeholders of the company, that the information contained in the financial statements can be relied upon when making decisions such as whether to purchase shares in the company.

True and fair

IAS 1 requires that the financial statements must 'present fairly' the financial position, the financial performance and cash flows of a business. The 'true and fair' view recognises the fact that the auditors cannot guarantee that the financial statements are 100 per cent accurate, as they do not have access to all the financial records of the company, nor will they have the time to analyse and evaluate this information. If the auditors are satisfied that the statements do show a true and fair view of the business, the report that they issue will state that the financial statements do show a true and fair view.

If the auditors feel that the records and statements do not represent a true and fair view, they will issue a qualified opinion in their report. This will raise issues in those areas where the records have not been maintained properly.

In extreme cases, the auditors may state that 'the financial statements do not show a true and fair view'. This might have serious implications for a company. It may result in difficulties raising external finance, as providers would have little trust in the information contained in the financial statements.

In addition to this primary role, auditors should:

- provide an independent opinion on whether the financial statements comply with relevant international accounting standards
- state whether the financial statements have been prepared on the basis of the business being a going concern or not being a going concern, since this would materially affect asset valuation
- test the financial recording procedures and control systems put in place by the company to minimise the risk of fraud, in order to have a reasonable chance of detecting material mis-statements caused by fraud
- ensure that the directors' report is included with the published financial statements and that the contents of the report are factually true and include all the important points relating to the performance of the business
- report on whether the company has complied with the requirements relating to corporate governance, if they are requested to by the shareholders.

Corporate governance

This sets out the systems and procedures by which companies are controlled and directed. The aim is to ensure that the management can ensure the long-term success of the business and balance the interests of all the major stakeholders in the company. The UK corporate governance code states the required standard of good practice for many areas of business, including the composition of the board of directors, the directors' remuneration and their relationship with stakeholders, with a view to minimising conflicts.

Corporate governance is a relatively new term. It has ethics as its main focus and recognises that the company should look after the interests of all stakeholders and not just its shareholders.

The auditors' report

The report usually has three main sections:

1. The separate responsibilities of the directors and the auditors – the directors being responsible for the preparation of the financial statements while the auditors are responsible for forming an opinion on the financial statements
2. The basis of the audit opinion expressed by the auditors – details of how the audit was carried out
3. The opinion – an overall assessment of the financial statements

Types of audit opinion

- **Unqualified opinion** – the auditors are satisfied the financial statements have been prepared correctly and give a true and fair view of the company's performance.
- **Qualified opinion** – the auditors feel that certain aspects of the financial statements have not been prepared properly and that it is sufficiently material to be brought to the attention of the shareholders.
- **Adverse opinion** – the auditors feel that the financial statements very significantly do not give a true and fair view of the company's financial performance.
- **Disclaimer opinion** – insufficient information was provided for the auditors to make a valid judgement as to whether the financial statements showed a true and fair view of the financial position.

THE DIRECTORS' REPORT

This report is a summary of the main activities that have happened during the year and details changes in those activities. An important part of the report is the statement of directors' responsibilities in connection with the annual report. The directors' report outlines the progress of the company over the past year and examines the potential future performance. It also reveals future plans for the business.

The report should contain:

- a review of the past year's trading activities
- the position at the year end
- a summary of future trading prospects
- significant changes to non-current assets
- recommendations for dividends for the current year
- any significant financial events that have happened since the date of the statement of financial position that is likely to affect future operations
- other items that are non-financial in nature, including information about environmental matters (including the impact of the company's business on the environment), the company's employees, and social and community issues.

ACTIVITY 10 SKILLS COMMUNICATION

CASE STUDY: COMPANY REPORT RESEARCH – AUDITORS' AND DIRECTORS' REPORTS, CORPORATE GOVERNANCE

1 Using the internet or hard copy company reports, research, either individually or in small groups, the relevant contents of the reports, looking in particular at the sections on corporate governance and the auditor's report.

Note: Company reports tend to be very long and contain very specific business and accounting terms. Do not be put off by this – focus on those areas you have studied.

CONTINUING AND DISCONTINUED ACTIVITIES

If financial statements are to be of use to stakeholders, they must show a true and fair view of the business. This allows comparisons over time to be made on the performance of the company. However, companies operate in a dynamic economic environment that is constantly changing. As a result, companies are continually evolving – bringing out new products, relocating manufacturing plants to different countries and closing departments. These changes make comparisons of performance over time much more difficult.

To help stakeholders distinguish the past from the present and the future, IAS 1 states that the financial statements must separate the revenues and profits arising from continuing operations from those that have arisen from discontinued operations.

Continuing operations refer to the activities that the company expects to be engaged in for the future, and discontinued operations are those activities that have stopped, been sold or been disposed of. Presenting these separately in the statement of profit or loss and other comprehensive income enables stakeholders, especially potential investors, to see the revenues that will not be generated in future years.

At the same time, the separation of continuing and discontinued activities gives the users of the financial information the benefit of seeing the potential future revenues and profits of a company. They are also more able to accurately predict the future expected performance of a company.

EXCEPTIONAL ITEMS

These are items falling within the ordinary activities of a business that need to be disclosed to the users of financial information because of their size or frequency. Characteristics of exceptional items include the following.

- They occur during the normal operating activities of the company.
- They are not expected to be recurring, that is, they are expected to be one-off.
- Their nature and amount are material to the users of the financial statements.

Examples of exceptional items include the disposal of non-current assets, restructuring costs linked to the closure of a factory, and redundancy payments for staff. Revenues from any large one-off contract will also be included.

IAS 1 states that these additional items may be required in the statement of profit or loss and other comprehensive income, and they allow the users of the financial statements to see the value of revenue and expenses that will not be repeated in the future. This information may help stakeholders make better decisions about the company.

ACTIVITY 11

SKILLS INTERPRETING

CASE STUDY: COMPANY REPORT RESEARCH – CONTINUING/DISCONTINUED ACTIVITIES AND EXCEPTIONAL ITEMS

1 Using actual online company reports, examine the statement of profit or loss and other comprehensive income of different companies to identify those that have reported discontinued activities or exceptional items.
2 Compare the actual financial statements in these reports to those you have produced in this chapter. You may well find significant differences, but do not worry about this.

EVALUATE

In the examination, you will be asked to evaluate many things. It is important when doing so to look at both the advantages and disadvantages, or the benefits and limitations, before reaching a conclusion. Below is an example relating to the role of the auditor and the audit report in the presentation of limited company financial statements.

Advantages	Disadvantages
External auditors will take an objective view of financial records and statements and so should be free from bias.	Auditors may not be totally independent as they are paid by the company, and this may make the report less useful.
Auditors may provide an unqualified opinion stating that the accounts represent a true and fair view of the company's financial position, and this may help obtain external finance.	Auditors may give an opinion that is qualified or adverse and this may harm the company in terms of obtaining additional finance.
The audit may detect errors and omissions in the financial statements and may detect fraud.	Owing to time constraints and sampling size, the audit does not cover all records, and therefore undetected errors, omissions and fraud may still exist.
External audit is required by company law and IAS.	Ultimately, the audit report is a matter of opinion and is not totally factual.

Table 1.1 Evaluating the role of the auditor and the audit report

CHECKPOINT

1 A limited company is a separate legal entity. True or false?

2 Limited companies are owned by stakeholders. True or false?

3 State four categories of cost/expense found in the statement of profit or loss and other comprehensive income of limited companies.

4 Define the term 'intangible asset'.

5 State two examples of intangible assets.

6 State three examples of reserves.

7 Identify the three missing words:

Opening equity + equity ___________ + ___________ earnings + profit after ___________ – dividends = closing equity.

8 Explain how the share premium account is created.

9 External auditors are employees of the company. True or false?

10 What is meant by the term 'corporate governance'?

11 State three possible audit opinions.

12 State two possible items that might be considered exceptional items.

SUBJECT VOCABULARY

auditor an accountant independent of the limited company and responsible for checking the accounts and providing an opinion on the extent to which the accounting information gives a true and fair view of the financial position of the limited company

corporation tax the tax paid by the limited company to the national government

debentures loans provided to limited companies on which interest is paid

dividends rewards given to the shareholders of a limited company in return for them investing in it

equity funds provided by the shareholders in the form of shares and reserves

intangible assets assets without physical substance but which have a monetary value, such as goodwill and patents

legal entity a company or an organisation that has legal rights and responsibilities, for example the right to make contracts and the responsibility to pay debts

limited liability the liability of shareholders for the debts of a limited company that is restricted to the value of their investment including unpaid amounts on calls

shareholders people or a company who own shares in a company and therefore get part of the company's profits and the right to vote on how the company is controlled

statement of changes in equity a financial statement showing the changes in the value of the shareholders' investment in a company over time

EXAM PRACTICE

CASE STUDY: VENTALIGHT PLC

SKILLS EXECUTIVE FUNCTION, DECISION MAKING

Ventalight plc manufactures roof ventilation products in its own factory. These are then transferred to the warehouse before being shipped to customers worldwide.

At 30 April 2020, the following balances were extracted from the books.

Ventalight plc
Trial balance at 30 April 2020

	£	£
	Dr	**Dr**
Bank loan – 2024		400 000
Bank loan interest	10 000	
Cash and cash equivalents	160 000	
Debenture 6% – 2029		1 800 000
Direct materials	4 200 000	
Factory at cost	3 000 000	
Factory – provision for depreciation		50 000
Goodwill	800 000	
Interest on debenture	108 000	
Inventory at 1 May 2019	300 000	
Land at cost	3 000 000	
Marketing	750 000	
Motor vehicles at cost	150 000	
Motor vehicles – provision for depreciation		50 000
Office expenses	180 000	
Ordinary shares £1		2 500 000
Rent (warehouse)	200 000	
Retained earnings		658 000
Revaluation reserve		100 000
Revenue		9 060 000
Shipping expenses	490 000	
Trade payables		525 000
Trade receivables	595 000	
Wages	1 200 000	
	15 143 000	15 143 000

Additional information at 30 April 2020:

- inventory £350 000
- interest owing on bank loan £20 000
- rent on the warehouse for the year £15 000 per month
- wages apportioned factory ½, Office staff ¼ and warehouse staff ¼
- depreciation on the factory to be charged at 2 per cent using the straight-line method
- motor vehicles depreciated over 5 years with no residual value
- corporation tax provision calculated at £152 000, payable by 31 December 2020.

Q

1 In accordance with International Accounting Standard 1, prepare the following:
   (a) a statement of profit or loss and other comprehensive income for the year ended 30 April 2020 **(23 marks)**
   (b) a statement of financial position at 30 April 2020. **(17 marks)**

2 Evaluate the importance of reporting continuing and discontinued activities separately in the financial statements of limited companies. **(6 marks)**

2 CAPITAL STRUCTURE OF LIMITED COMPANIES

UNIT 2
2.1.4–2.1.11

LEARNING OBJECTIVES

After you have studied this chapter, you should be able to:

- explain how different capital reserves and revenue reserves are created and utilised
- explain authorised, issued and called-up share capital
- explain rights issues of shares and bonus issues of shares
- prepare ledger accounts and journal entries to record the issue of new shares, bonus issues and rights issues
- explain the features of shares and debentures
- explain capital gearing and its implications
- explain the creation and features of provisions.

GETTING STARTED

Have you ever considered how limited companies acquire their capital from potential investors? Do you think they return all the profit to shareholders? If they do not, how do they account for this? If you were a director of a company, would you issue more shares to expand the business, use retained profits, or would you finance this with long-term borrowing?

CAPITAL RESERVES AND REVENUE RESERVES

When a sole trader earns a profit, in the following financial year this profit is added to the capital figure that appears in the statement of financial position. In partnerships the profit is entered into the current accounts of the partners, which then appears in the equity section of the statement of financial position. For limited companies any profits that are not distributed to the shareholders as dividends are kept in accounts known as reserves or **retained earnings**. These accounts appear in the statement of financial position, listed below the share capital (much like the profit appearing below the capital in sole-trader statements of financial position).

Essentially, reserves are simply an appropriation of profit and are part of the capital of the company. They may arise from normal trading activities or from non-trading activities such as the revaluation of property. It is important to understand that reserves are not cash and cash equivalents but are profits retained in the business. All reserves are not a source of cash but are amounts that are represented by assets. It is often thought that if there are reserves then the company can pay out increased dividends. This is far from the truth, as all too often these reserves have been invested in non-current assets for future growth of the company. Therefore, they are not liquid enough to be used for payment of dividends.

The reserves are divided into **revenue reserves** and **capital reserves**. It is important that you can recognise the difference between the two types as they are created from different transactions and can only be used for specific purposes.

Revenue reserves

Revenue reserves are an appropriation of distributable profits (which belong to the ordinary shareholders).

These reserves are created from the undistributed profit generated by the company over time. The profit that has not been distributed to shareholders as dividends is labelled as **retained earnings** in the statement of financial position.

As you will recall from your introduction to the statement of changes in equity, the profit for the year after taxation is added to the retained earnings. This is an important point to remember – this profit has been earned from the normal operating activities of the company. It belongs to the shareholders and so can be utilised in the distribution of profit to shareholders in the form of dividends.

Other reserves may be created by transferring profits from retained earnings into reserves created for a specific purpose. While these reserves have distinct names and are created for a specific purpose, it is important to realise that they remain undistributed profits and do not have to be used for the purpose for which they were set up. The main reason they are set up is to recognise that in the future some of the profits may be needed to fund large-scale expenditure. These reserves could include:

- **Capital replacement reserve** – this reserve may be created to indicate that at some point in the future the company may need to allocate funds for the replacement of non-current assets and therefore it would be prudent to highlight this fact in the statement of financial position so that the users of the financial statements are aware of this. The reserve is created by transferring amounts from retained earnings into the reserve and can be used for the payment of dividends.

- **Foreign exchange reserve** – companies that trade internationally will need to buy and sell inventories using money of different countries. The value of one currency in terms of another will often fluctuate significantly. If the currency falls in value, then this will make the cost of materials more expensive and thus reduce profit. It is therefore prudent to set aside retained profits into a foreign exchange reserve. As with all revenue reserves, they can be utilised to pay dividends to shareholders should the need for the reserve no longer exist.
- **General reserve** – because a specific revenue reserve does not have to be used for the purpose for which it was created, many companies do not set up specific revenue reserves but rather transfer amounts from retained earnings into a general reserve. This reserve then highlights that the company has retained profits that it may need to utilise on expenditure items in the future and that it is being prudent by recognising this.

The important characteristics of revenue reserves are that they are created from the profits generated from normal operating activities and that they can be distributed to shareholders as dividends.

Capital reserves

Capital reserves arise through the non-trading activities of a company. They are not an appropriation of trading profits. As a result, capital reserves cannot be used to pay cash dividends. Capital reserves are created to protect trade payables. The main types of capital reserves you need to know are:

Share premium reserve – this reserve is created when ordinary shares are sold at more than the nominal value (face value) of the share. This transaction is covered in detail later in the chapter (see 'Rights and bonus issues') and the account will appear in the statement of changes in equity. The value of the additional amount of cash received (a debit entry) will be credited to the **share premium** account and it will appear in the equity section of the statement of financial position. As this profit has not arisen from normal trading activities, it is classified as a capital reserve and cannot be used for the payment of dividends. It can, however, be utilised in the issue of bonus shares to existing shareholders (see the section on rights and bonus issues). The share premium account could be used to write off preliminary expenses or share issue expenses.

Revaluation reserve – if non-current assets, normally land and buildings, appreciate in value then the value shown in the assets of the statement of financial position would increase. The contra to this debit transaction would be the creation or increase in the **revaluation reserve** in the equity section of the statement of financial position. This is a non-cash transaction and the 'profit' generated by the revaluation is not distributable to shareholders, as it has not arisen from normal operating activities. The revaluation reserve would appear in the statement of changes in equity. The reserve is maintained until the gain is realised (the revalued non-current asset is actually sold). At this point the revaluation reserve would be transferred to retained earnings.

Capital redemption reserve – this is created when a company buys back its own shares without issuing new shares to fund the redemption. When a company issues shares, they are sometimes issued as 'redeemable'. This means that the company can buy them back at a future date. This process is known as redemption. The retained earnings would be reduced by the value of the transaction and the **capital redemption reserve** would be credited. This reserve can be used for the issue of bonus shares. Its existence helps maintain sufficient working capital and acts as a creditors' buffer.

Creation and use of reserves

Revenue reserves		
Type	**Creation**	**Use**
Retained earnings	From trading profits built up from previous years and current year	• Payment of dividends to ordinary shareholders • Growth of the company • Issue of bonus shares if the balance in capital reserves is insufficient
General	Transferred from retained earnings	• Any unspecified use the company thinks it is prudent to provide for • Issue of bonus shares • Transfer back to retained earnings
Capital replacement	Transferred from retained earnings	• Replacement of non-current assets • Issue of bonus shares • Transfer back to retained earnings
Foreign exchange	Transferred from retained earnings	• Covering a loss caused by fluctuations in the exchange rates of foreign currencies • Issue of bonus shares • Transfer back to retained earnings

▲ Table 2.1 The creation and use of revenue reserves