FINANCIAL STATEMENTS OF LIMITED COMPANIES

STUDY TEXT

Qualifications and Credit Framework

AQ2016

This Study Text supports study for the following AAT qualifications:

AAT Professional Diploma in Accounting – Level 4

AAT Level 4 Diploma in Business Skills

AAT Professional Diploma in Accounting at SCQF – Level 8

Published by:

Kaplan Publishing UK
Unit 2 The Business Centre
Molly Millar's Lane
Wokingham
Berkshire
RG41 2QZ

ISBN 978-1-78740-516-5

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This document references IFRS® Standards and IAS® Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2018 IFRS Standards Red Book.

INTRODUCTION

HOW TO USE THESE MATERIALS

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chance of success in your AAT assessments.

They contain a number of features to help you in the study process.

The sections on the Unit Guide, the Assessment and Study Skills should be read before you commence your studies.

They are designed to familiarise you with the nature and content of the assessment and to give you tips on how best to approach your studies.

STUDY TEXT

This study text has been specially prepared for the revised AAT qualification introduced in September 2016.

It is written in a practical and interactive style:

- key terms and concepts are clearly defined
- all topics are illustrated with practical examples with clearly worked solutions based on sample tasks provided by the AAT in the new examining style
- frequent practice activities throughout the chapters ensure that what you have learnt is regularly reinforced
- 'pitfalls' and 'examination tips' help you avoid commonly made mistakes and help you focus on what is required to perform well in your examination
- 'Test your understanding' activities are included within each chapter to apply your learning and develop your understanding.

ICONS

The chapters include the following icons throughout.

They are designed to assist you in your studies by identifying key definitions and the points at which you can test yourself on the knowledge gained.

Definition

These sections explain important areas of knowledge which must be understood and reproduced in an assessment.

Example

The illustrative examples can be used to help develop an understanding of topics before attempting the test your understanding exercises.

Test your understanding

These are exercises which give the opportunity to assess your understanding of all the assessment areas.

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Progression

There are two elements of progression that we can measure: first how quickly students move through individual topics within a subject; and second how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

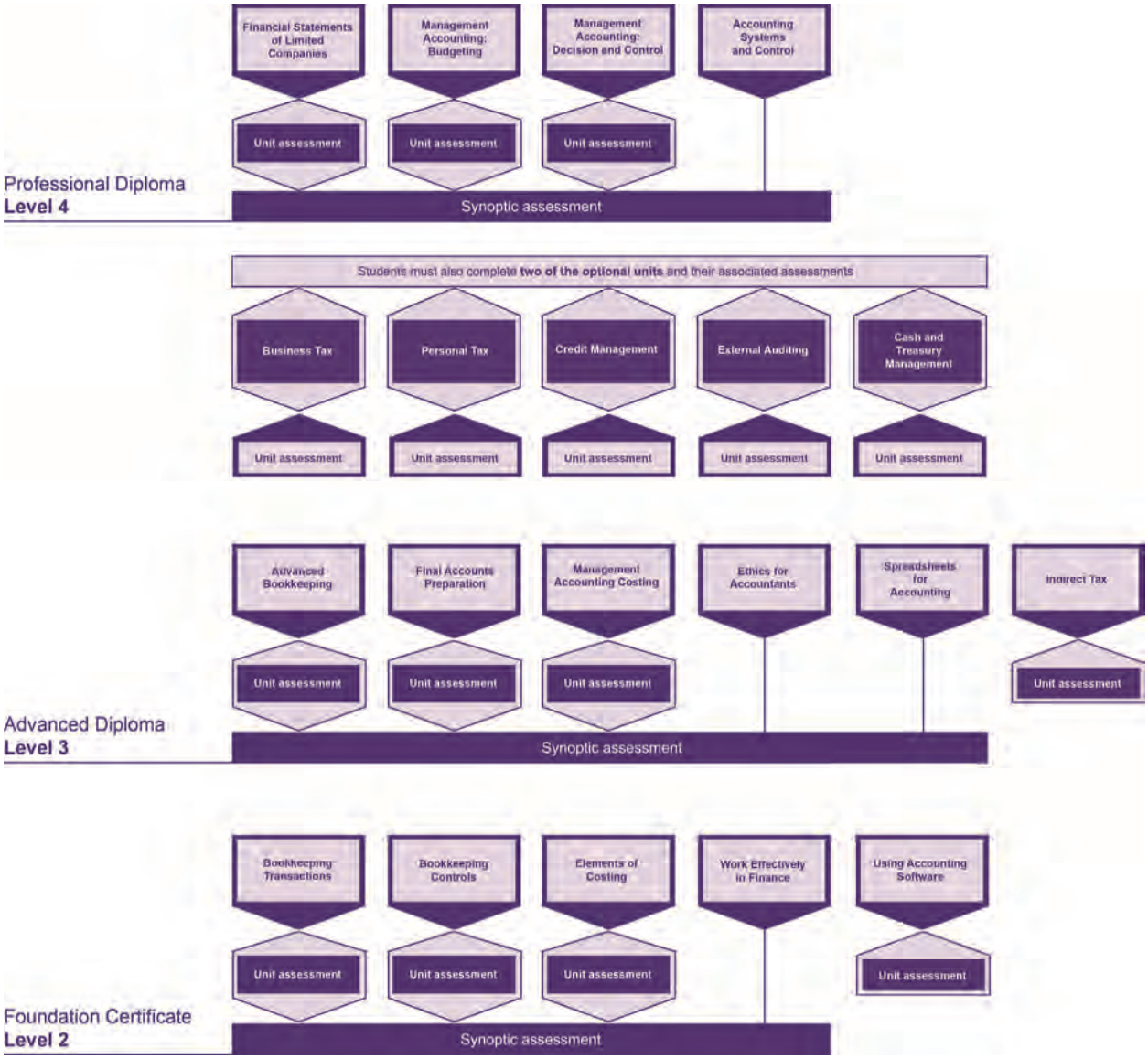
A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress.


Professional Diploma
Level 4
Financial Statements of Limited Companies
Management Accounting: Budgeting
Management Accounting: Decision and Control
Accounting Systems and Control
Unit assessment
Synoptic assessment
Students must also complete two of the optional units and their associated assessments
Business Tax
Personal Tax
Credit Management
External Auditing
Cash and Treasury Management
Advanced Diploma
Level 3
Advanced Bookkeeping
Final Accounts Preparation
Management Accounting Costing
Ethics for Accountants
Spreadsheets for Accounting
Indirect Tax
Foundation Certificate
Level 2
Bookkeeping Transactions
Bookkeeping Controls
Elements of Costing
Work Effectively in Finance
Using Accounting Software

UNIT GUIDE

Introduction

This unit is concerned with the drafting, analysis and interpretation of financial statements of limited companies. This builds on the Foundation and Advanced levels, where the emphasis of the financial accounting units is on identifying and recording transactions in accounts and ledgers following the principles of double-entry bookkeeping, and drafting the financial statements of unincorporated organisations from the accounts and records prepared.

On successful completion of this unit, a student could be expected to be able to draft the financial statements of single limited companies and groups of companies with little supervision. A student could also analyse and interpret financial statements of limited companies by means of ratio analysis for the purposes of assisting outside user groups in their decision making, thereby fulfilling a useful role within an accounting team.

The unit provides students with the skills and knowledge for drafting the financial statements of single limited companies and consolidated financial statements for groups of companies. It ensures that students will have a proficient level of knowledge and understanding of international accounting standards, which they will be able to apply when drafting the financial statements, and will have a sound appreciation of the regulatory and conceptual frameworks that underpin the preparation of limited company financial statements.

Finally, the unit will equip students with the tools and techniques that will enable them to analyse and interpret financial statements effectively.

Financial Statements of Limited Companies is a **mandatory** unit.

Learning outcomes

On completion of this unit the learner will be able to:

- understand the reporting frameworks and ethical principles that underpin financial reporting
- understand the key features of a published set of financial statements
- draft statutory financial statements for a limited company
- draft consolidated financial statements
- interpret financial statements using ratio analysis.

Scope of content

Note on the Conceptual Framework

The Conceptual Framework for Financial Reporting 2010 identifies one assumption underlying the preparation of financial statements – the going concern assumption. However, the AAT have confirmed that the unit specification for Financial Statements of Limited Companies departs from this and states that there are two underlying assumptions – going concern and the accruals basis.

To perform this unit effectively you will need to know and understand the following:

		Chapter
1	**Demonstrate an understanding of the reporting frameworks and ethical principles that underpin financial reporting**	
1.1	**Explain the regulatory framework that underpins financial reporting** Students need to know: • the purpose of financial statements • the different types of business organisation (sole traders, partnerships, limited liability partnerships. Companies, not-for-profit organisations (charities, clubs and societies), public sector organisations (local authorities, central government and the National Health Service) and cooperatives • the types of limited company • how the financial statements of limited companies differ from those of sole traders and partnerships • forms of equity, reserves and loan capital • the reasons for the existence of a regulatory framework • sources of regulation: international accounting standards and company law (Companies Act 2006) • the purpose of accounting standards • the duties and responsibilities of the directors in respect of financial statements.	1, 2

Delivering this unit

Unit name	Content links	Suggested order of delivery
Not applicable	This unit integrates with a number of other units in the qualification, all of which are concerned with financial accounting. At Foundation level, Bookkeeping Transactions and Bookkeeping Controls introduce students to basic bookkeeping skills and the books of prime entry. These units lead into the two Advanced level units, Advanced Bookkeeping and Final Accounts Preparation, which cover the theoretical foundations of financial accounting, together with practical skills for the preparation of financial statements for unincorporated traders. The knowledge and skills gained in the Foundation level and Advanced level financial accounting units are drawn on and developed at Professional level in Financial Statements of Limited Companies, which focuses on the drafting, analysis and interpretation of the financial statements of limited companies.	Students may find it useful to have studied the Foundation level and Advanced level bookkeeping units before this unit.

THE ASSESSMENT

Test specification for this unit assessment

Assessment type	Marking type	Duration of exam
Computer based unit assessment	Partially computer/ partially human marked	2 hours 30 minutes

The assessment for this unit consists of 8 compulsory tasks.

The competency level for AAT assessments is 70%.

Learning outcomes		Weighting
1	Understand the reporting frameworks and ethical principles that underpin financial reporting	7%
2	Understand the key features of a published set of financial statements	18%
3	Draft statutory financial statements for a limited company	27%
4	Draft consolidated financial statements	20%
5	Interpret financial statements using ratio analysis	28%
Total		**100%**

UNIT LINK TO THE SYNOPTIC ASSESSMENT

AAT AQ16 introduced a Synoptic Assessment, which students must complete if they are to achieve the appropriate qualification upon completion of a qualification. In the case of the Professional Diploma in Accounting, students must pass all of the mandatory assessments and the Synoptic Assessment to achieve the qualification.

As a Synoptic Assessment is attempted following completion of individual units, it draws upon knowledge and understanding from those units. It may be appropriate for students to retain their study materials for individual units until they have successfully completed the Synoptic Assessment for that qualification.

With specific reference to this unit, the following learning objectives are also relevant to the Professional Diploma in Accounting Synoptic Assessment:

LO1 Understand the reporting frameworks and ethical principles that underpin financial reporting

LO5 Interpret financial statements using ratio analysis

STUDY SKILLS

Preparing to study

Devise a study plan

Determine which times of the week you will study.

Split these times into sessions of at least one hour for study of new material. Any shorter periods could be used for revision or practice.

Put the times you plan to study onto a study plan for the weeks from now until the assessment and set yourself targets for each period of study – in your sessions make sure you cover the whole course, activities and the associated questions in the workbook at the back of the manual.

If you are studying more than one unit at a time, try to vary your subjects as this can help to keep you interested and see subjects as part of wider knowledge.

When working through your course, compare your progress with your plan and, if necessary, re-plan your work (perhaps including extra sessions) or, if you are ahead, do some extra revision/practice questions.

Effective studying

Active reading

You are not expected to learn the text by rote, rather, you must understand what you are reading and be able to use it to pass the assessment and develop good practice.

A good technique is to use SQ3Rs – Survey, Question, Read, Recall, Review:

1 **Survey the chapter**

Look at the headings and read the introduction, knowledge, skills and content, so as to get an overview of what the chapter deals with.

2 **Question**

Whilst undertaking the survey ask yourself the questions you hope the chapter will answer for you.

3 **Read**

Read through the chapter thoroughly working through the activities and, at the end, making sure that you can meet the learning objectives highlighted on the first page.

1 Regulatory frameworks

Introduction

In this initial chapter we will be covering background information that is essential for your understanding of the preparation of financial statements for many types of organisation, in particular for limited companies.

ASSESSMENT CRITERIA

Explain the regulatory framework that underpins financial reporting (1.1)

Explain the International Accounting Standards Board (the Board) Conceptual Framework for Financial Reporting ('the Framework') that underpins financial reporting (1.2)

CONTENTS

1 Introduction
2 The purpose of financial statements
3 The legal framework
4 Accounting standards

1 Introduction

1.1 Background knowledge

In previous units of your accounting studies you were introduced ledger accounting, and progressed on to preparation of an extended trial balance. When preparing an extended trial balance you would have made a number of adjustments for items such as inventories, accruals, prepayments, depreciation, irrecoverable debts and allowances for receivables. Each account on the extended trial balance was then balanced and extended into either the statement of profit or loss columns or the statement of financial position columns depending upon whether the account was an item of income, expense, an asset, a liability or equity/capital.

In this unit, your knowledge of financial accounting will be developed further.

1.2 Drafting financial statements

This unit includes the drafting of the relevant financial statements for limited companies. You must be able to prepare a statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows in accordance with all of the applicable regulations (the Companies Act 2006, accounting standards, etc).

1.3 Interpretation of financial statements

The unit also includes interpretation of financial statements. It is concerned with being able to analyse and understand the structure and purpose of financial statements of limited companies. It requires a sound understanding of the knowledge and skills required to prepare financial statements and an ability to interpret the relationships between the various components of the financial statements by using ratio analysis.

In order to understand and interpret limited company financial statements you must be able to understand how they have been prepared. Therefore your knowledge from Bookkeeping Transactions and Advanced Bookkeeping is extremely important as the knowledge and skills from these units will assist you to understand how the financial statements of limited companies are prepared.

In this chapter and the next, however, we will consider the background to the preparation of financial statements for limited companies by considering the regulatory framework and then the Conceptual Framework for Financial Reporting (‘the Framework’) within which financial statements are prepared.

2 The purpose of financial statements

2.1 Introduction

The main purpose of financial statements is to provide information to a wide range of users.

The **statement of financial position** provides information on the financial position of a business (its assets and liabilities and capital/equity at a point in time).

The **statement of profit or loss and other comprehensive income** provides information on the performance of a business (the profit or loss which results from trading over a period of time) as well as gains or losses that are not recognised in profit or loss.

The **statement of changes in equity** provides information about how the equity of the company has changed over the period.

The **statement of cash flows** provides information on the financial adaptability of a business (the movement of cash into and out of the business over a period of time).

2.2 Stewardship

Financial statements also show the results of the stewardship of an organisation. Stewardship is the accountability of management for the resources entrusted to it by the owners or the Government. This applies to the financial statements of limited companies as well as to others who prepare financial statements for stakeholders, such as central and local government, National Health Service, a board of trustees for a charity or the committee of a sports and social club.

2.3 Needs of users

All users of financial statements need information on financial position, performance and financial adaptability of the organisation they are interested in. However, many different groups of people may use financial statements and each group will particular information needs.

Users of financial statements may include investors, management, employees, customers, suppliers, lenders, the government and the public. User groups are considered in more detail on the following chapter.

2.4 Legal requirements

Law in the United Kingdom (UK) and many other countries requires limited companies to prepare annual financial statements. These financial statements must be filed with the Registrar of Companies and are then available to all interested parties. Most organisations, whether incorporated or not, are required to produce financial statements for submission to HM Revenue and Customs.

In the UK, the form and content of limited company accounts is specified by the Companies Acts. The preparation of limited company accounts is also subject to regulations issued by the Financial Reporting Council if the company is applying UK accounting standards or by the International Accounting Standards Board (the Board) if the company has adopted international financial reporting standards (IFRS Standards).

3 The legal framework

3.1 Introduction

The financial statements of limited companies must be prepared within the legal framework relevant to that company. In the case of UK companies, the Companies Act 2006 contains guidance and rules on:

- formats for the financial statements
- fundamental accounting principles
- valuation of items included in the financial statements.

The Companies Act 2006 allows companies to use the format of accounts set out in IAS 1 (revised) *Presentation of Financial Statements* if they have adopted IFRS® Standards or continue to use the format in the Act if they have not.

4 Accounting standards

4.1 IFRS Standards and IAS Standards

Accounting standards give guidance in specific areas of accounting. The Financial Statements syllabus follows International standards which consist of the following:

- **International Financial Reporting Standards (IFRS® Standards)**

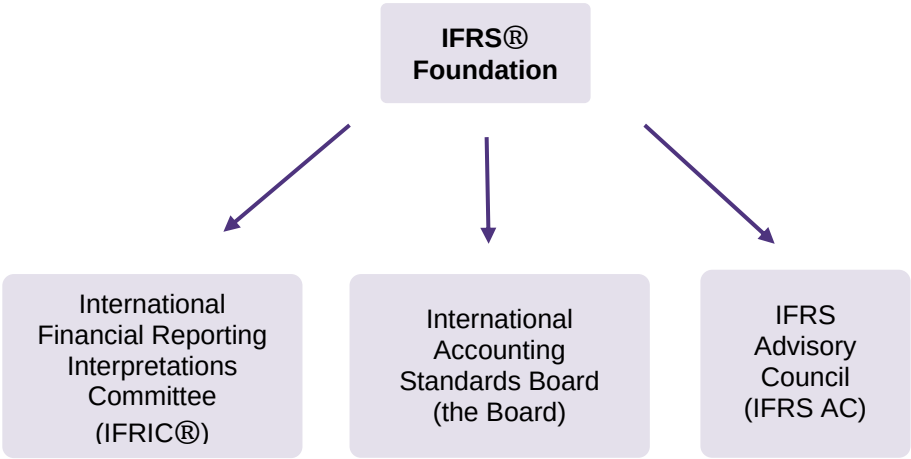
  IFRS Standards are issued by the International Accounting Standards Board (the Board). Many countries have used IFRS Standards for some years. In 2002, the Council of Ministers of the European Union (EU) decided that any company which is listed on a European Stock Exchange must prepare their consolidated accounts in accordance with IFRS Standards with effect from 1 January 2005.

- **International Accounting Standards (IAS® Standards)**

  IAS Standards were created by the International Accounting Standards Committee (IASC) which was the predecessor of the Board. When the Board was formed it adopted the IAS Standards then in issue. Subsequently, many IAS Standards have been withdrawn and superseded by IFRS Standards, although some remain in issue.

4.2 The structure of the regulatory bodies

The structure of the International Financial Reporting Standards Foundation and its subsidiary bodies is shown below:



4.3 The IFRS Foundation ('the Foundation')

The IFRS Foundation is an independent not-for-profit foundation based in the USA. The Trustees of the Foundation appoint the members of the International Accounting Standards Board, the IFRS Advisory Council and the IFRS Interpretations Committee. They are also responsible for setting and approving the budgets of the various bodies, determining strategic direction and promoting IFRS Standards.

4.4 The International Accounting Standards Board ('the Board')

The Board has sole responsibility for the setting of international accounting standards. The Board's objectives are to:

(a) develop a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements

(b) promote the use and rigorous application of those standards, and

(c) work actively with national standard setters to bring about convergence of national accounting standards and IFRS Standards.

IFRS Standards set out the recognition, measurement, presentation and disclosure requirements of transactions and events that are important in accounting. They apply to all general purpose financial statements and any limitation in scope of a standard is stated within that standard.

The Board cooperates with other accounting standard setters with the aim of achieving harmony of accounting practice throughout the world. This has been the case in the UK as the Financial Reporting Council has adopted recently issued IFRS Standards. There will be relatively little difference in accounting practice for UK companies who have adopted IFRS Standards and those who have not.

4.5 International Financial Reporting Interpretations Committee ('IFRIC')

The aim of the IFRIC is to assist the Board in establishing and improving standards of financial accounting and reporting. It promotes the rigorous and uniform application of IFRS Standards. They provide timely guidance on:

1 newly identified financial reporting issues not specifically covered by an accounting standard, and

2 unsatisfactory interpretations that have developed or may develop.

The guidelines IFRIC publishes are called IFRIC Interpretations. If a company complies with IFRS Standards, then it is also presumed that this includes compliance with IFRIC Interpretations.

4.6 IFRS Advisory Council ('IFRS AC')

The Council provides a forum for organisations and individuals to input into the standard-setting process. Its overall objectives are to:

(a) give advice to the Board on agenda decisions and priorities

(b) inform the Board of the views of organisations and individuals, and

(c) give other advice to the Board or the Trustees.

4.7 The standard-setting process

There are a number of steps in the process to develop and issue a new accounting standard by the Board as follows:

(a) staff are asked to identify and review all issues associated with a topic and to consider the application of the Framework to the issues

(b) study of national accounting requirements and practice and an exchange of views about the issues with national standard-setters

(c) consulting the Council about the advisability of adding the topic to the Board agenda

(d) formation of an advisory group to give advice to the Board on the project

(e) publication of a discussion document for public comment

(f) publication of an 'exposure draft' for public comment which has been approved by at least eight members of the Board, including any dissenting opinions held by Board members

(g) publication within an exposure draft a basis for conclusions

(h) consideration of all comments received within the comment period on the discussion documents and exposure drafts

(i) consideration of whether to hold a public hearing and to conduct field tests and, if necessary, holding such hearings and conducting such tests

(j) approval of a standard by at least eight members of the Board and inclusion in the published standard of any dissenting opinions, and

(k) publication within a standard a basis for conclusions explaining, amongst other things, the steps in the Board due process and how the Board dealt with public comments on the exposure draft.

Test your understanding 1

1 What are the four principal financial statements that would be included in a set of financial statements?

2 What is meant by the term ‘stewardship’?

3 What does IFRS stand for?

4 What is the role of the Board?

5 What is the role of IFRIC?

5 Summary

The regulatory framework for a UK company preparing financial statements in accordance with IFRS Standards consists of:

- the Companies Act which applies to all UK companies regardless of whether they follow UK or International accounting rules
- the International Accounting Standards Board ('the Board') and its associated bodies who are responsible for the development, approval and publication of IFRS Standards.

Test your understanding answers

Test your understanding 1

1 Statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows.

2 Stewardship is the accountability of management for the resources entrusted to it by the owners of a business or the Government.

3 International Financial Reporting Standard.

4 The role of the Board is to develop, approve and publish International Financial Reporting Standards.

5 IFRIC assists the Board by producing IFRIC Interpretations which provide guidance on new accounting issues that are not covered by an IFRS Standard and provide guidance on the appropriate interpretation and application of an IFRS Standard.