AAT

Financial Statements of Limited Companies

Pocket Notes

These Pocket Notes support 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

KAPLAN PUBLISHING

British library cataloguing-in-publication data

A catalogue record for this book is available from the British Library.

Published by:
Kaplan Publishing UK
Unit 2 The Business Centre
Molly Millars Lane
Wokingham
Berkshire
RG41 2QZ

ISBN 978-1-78740-547-9

Printed and bound in Great Britain.

Acknowledgements

This Product includes propriety content of the International Accounting Standards Board which is overseen by the IFRS Foundation, and is used with the express permission of the IFRS Foundation under licence.

CONTENTS

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

Preface

These Pocket Notes contain the key things that you need to know for the exam, presented in a unique visual way that makes revision easy and effective.

Written by experienced lecturers and authors, these Pocket Notes break down content into manageable chunks to maximise your concentration.

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, or follow the link to the feedback form in MyKaplan.

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.

A guide to the assessment

- Note on the conceptual framework.
- Examinable International Financial Reporting Standards (both IFRS and IAS).

The assessment

This unit is concerned with competence in drafting and interpreting the financial statements of limited companies.

Learners will have already attained competence at Levels 2 and 3 in the process of identifying and recording financial transactions in accounts and ledgers following the principles of double entry bookkeeping. They will already be able to draft the financial statements of sole traders and partnerships. This unit develops and applies these competencies further by focusing on the drafting and interpretation of financial statements of limited companies.

Learners are also introduced to tools and techniques that can be used to analyse and interpret the financial performance and financial position of a company.

Examination

Financial Statements of Limited Companies (FSLC) is assessed by means of a computer based assessment (CBA). The CBA will last for two and a half hours and will consist of 8 tasks.

In any one assessment, learners may not be assessed on all content, or on the full depth or breadth of a piece of content. The content assessed may change over time to ensure validity of assessment, but all assessment criteria will be assessed over time.

Learning outcomes and weighting

1.	Demonstrate an understanding of the reporting frameworks and ethical principles that underpin financial reporting	7%
2.	Demonstrate an understanding of 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%

Pass mark

To pass a unit assessment, students need to achieve a mark of 70% or more.

This unit contributes 15% of the total amount required for the Professional Diploma in Accounting qualification.

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.

Examinable International Financial Reporting Standards (both IFRS® Standards and IAS® Standards)

IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 10	Events After the Reporting Period
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IFRS 3	Business Combinations
IFRS 10	Consolidated Financial Statements
IFRS 15	Revenue from Contracts with Customers
IFRS 16	Leases

Additional reading

A student's guide to International Financial Reporting Standards
by Clare Finch

ISBN 978 1 84710 708 4

chapter

1

The reporting frameworks, types of business organisation and ethical principles

- Overview.
- IFRS foundation.
- Legal framework.
- The framework.
- IAS 1 Presentation of Financial Statements.
- Different types of business organisation.
- Differences between preparing accounts for a sole trader and a limited company.
- Differences between a private and a public company.
- The fundamental principles of the AAT Code of Professional Ethics.
- The threats.
- Safeguards.

Overview

This chapter gives information on:

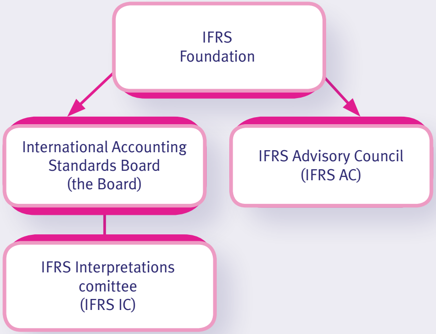
- the regulatory environment (company law and the IFRS Foundation)
- the conceptual framework (the Conceptual Framework for Financial Reporting).

CBA focus

You may be required to discuss or explain topics in this chapter as part of an examination task.

IFRS foundation

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



Key Point

- The IFRS Foundation is an independent not for profit foundation based in the US whose trustees appoint the members of the Board, IFRS AC and IFRS IC.
- The Board is responsible for developing and issuing new accounting standards. The Board issues International Financial Reporting Standards (IFRS® Standards) and has adopted the previous International Accounting Standards (IAS® Standards)..
- The IFRS AC advises the Board on priorities in its work and informs the Board of the implications of proposed standards for users and preparers of financial statements.
- The IFRS IC draws up interpretations if a new problem arises or gives guidance on the application of a standard where unsatisfactory interpretations exist.

Legal framework

- In the UK, companies must prepare their financial statements following the rules laid out in the Companies Act 2006 (CA06).
- The CA06 has been amended to reflect the fact that some companies prepare their financial statements based upon the application of IFRS Standards.
- In the UK, the Financial Reporting Council (FRC) prepares accounting standards. In recent years there has been a process of harmonisation between UK and International standards and the majority of UK standards are now equivalent to IFRS Standards.

The framework

The Framework for Financial Reporting identifies the principles on which accounting standards are to be developed. It aims to assist in the preparation of financial statements, development of new standards and to reduce alternative accounting treatments.

Key Point

- The underlying assumption of financial statements is that they are prepared on a going concern basis.
- There are two fundamental qualitative characteristics together with four enhancing characteristics:

The two fundamental qualitative characteristics:

- **Relevance** – financial information is regarded as relevant if it capable of influencing the decision of users.
- **Faithful representation** – this means that financial information must be complete, neutral and free from error.

The four enhancing qualititative characteristics:

- **Comparability** – it should be possible to compare an entity over time and with similar information about other entities.
- **Verifiability** – if information can be verified (e.g. through an audit) this provides assurance to the users that it is both credible and reliable.
- **Timeliness** – information should be provided to users within a timescale suitable for their decision making purposes.
- **Understandability** – information should be understandable to those that might want to review and use it. This can be facilitated through appropriate classification, characterisation and presentation of information.

Elements of the financial statements

Asset: '**a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity**'. [F4.4 (a)].

Liability: '**a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits**'. [F4.4 (b)].

Equity: '**the residual interest in the assets of the entity after deducting all its liabilities**'. [F4.4 (c)].

Income: income consists of both revenue and gains. Revenue arises from a business's ordinary activities such as the sale of goods. Gains represent increases in economic benefits such as a gain on disposal of a non-current asset and are not normally shown within revenue.

Expenses: expenses are losses as well as expenses that arise in the normal course of business such as cost of sales, wages and depreciation. Losses represent a decrease in economic benefits such as losses on disposal of non-current assets or disasters such as fire or flood and are often shown separately in the financial statements.

Recognition of items in the financial statements

Recognition of (i.e. recording) an item in the financial statements occurs if:

- the item meets the definition of an element
- it is probable that any future economic benefit associated with the item will flow to or from the entity
- it can be measured at a monetary amount with sufficient reliability.

IAS 1 Presentation of Financial Statements

IAS 1 provides formats for the statement of profit or loss, statement of financial position and statement of changes in equity as well as setting out six accounting concepts that should be applied:

- **going concern** – the business will continue in operation for the foreseeable future
- **accruals** – the effects of transactions and other events are recognised as they occur and not as cash or its equivalent is received or paid
- **consistency of presentation** – items in the financial statements are presented and classified in the same way from one period to the next unless there is a change in the operations of the business or a new standard requires a change in presentation
- **materiality and aggregation** – each material class of similar items shall be presented separately in the financial statements
- **offsetting** – assets and liabilities and income and expenses cannot be offset unless a standard requires it
- **comparative information** – should be shown for all amounts reported in the financial statements.

Accounting policies should be selected so that the financial statements comply with all international standards and interpretations.

An entity must make an explicit statement in the notes to the financial statements that they comply with IFRS Standards.

Different types of business organisation

For profit organisations are businesses whose primary goal is making money (a profit).

Not-for-profit organisations are non-profit making. They are usually charities, clubs and societies.

Sole traders are businesses which are owned and run by one individual. The owner is responsible for any business debts.

Partnerships are businesses which are owned and run by two or more persons. The partners are responsible for any business debts.

Limited companies are classed as their own legal entity where the shareholders (investors) are the owners.

Limited liability partnerships (LLPs) are partnerships where some or all of the partners have limited liabilities similar to shareholders in a company.

Charities are organisations which meet the definition of a charity set out in the Charities Act 2011. It must be established for charitable purposes only, meaning that it must be for the general benefit of the public. It needs to be established for specific purposes for example the advancement of education, the advancement of religion and the advancement of arts and culture.

Public sector organisations are responsible for providing all Public Services in the UK. From Healthcare to Education, Social Care to Housing, Refuse Collection to International Development, Tourism Promotion to Pensions. Funding comes through taxation, collected locally and centrally and through revenue earning activities.

Differences between preparing accounts for a sole trader and a limited company

Legal requirements

There is no legal requirement for sole traders and partnerships to prepare accounts but they may find it useful to assess the financial performance and position of their business

Limited companies have a legal requirement to prepare final accounts annually in line with the relevant accounting standards. If the company has adopted IFRSs then it must prepare accounts in the format outlined by International Accounting Standard 1 (IAS 1).

Tax

Sole traders and partners in a partnership pay income tax on their share of the taxable profits. Companies pay corporation tax on their taxable profits and this will be charged to the statement of profit or loss as an expense.

Borrowings

Sole traders and partners in a partnership are free to borrow from the business bank account how they wish, this is classed as drawings. If the business bank account runs to an overdraft then the owners are personally liable for the debts. Directors (only) in a company can sometimes withdraw cash from the company provided it is within the limits set out in Companies Act 2006.

Differences between a private and a public company

There are two types of Limited Company.

PLC means Public Limited Company and Ltd means Private Limited Company. The terminology which needs to be included in the name, shows that the two are different – one is public limited and the other is private limited.

Both the Public Limited Company and the Private Limited Company raise their capital through shares. The difference is that the PLC can quote the shares in a stock exchange whereas the Ltd Company can't.

In a PLC the shares can be bought and sold through the stock exchange. The shares of Ltd companies are normally sold to family and close friends.

The fundamental principles of the AAT Code of Professional Ethics

Outlined below are the key principles of the AAT Code of Professional Ethics;

Professional competence and due care

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques.

Objectivity

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

Confidentiality

A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose.

Professional behaviour

A person should not act in any way that is unprofessional or does not comply with relevant laws and regulations.

Integrity

A person should be straightforward and honest in performing professional work and in all business relationships.

The threats

The following are all examples of behaviour that could threaten an accountant's objectivity or independence from their clients:

The self-interest threat – may occur because of a financial or other interest held by the accountant or a family member.

The advocacy threat – may occur when an accountant is asked to promote or represent their client in some way. In this situation the accountant would have to be biased in favour of the client and therefore cannot be objective.

The self-review threat – when work you have previously prepared needs review – you cannot audit your own work.

The familiarity or trust threat – this occurs when the accountant is too sympathetic or trusting of the client because of a close relationship with them.

The intimidation threat – may occur when an accountant may be deterred from acting objectively by threats – actual or perceived.

Safeguards

Safeguards are controls to reduce or eliminate threats. They fall into two broad categories:

(i) Safeguards created by the profession, legislation or regulation. Examples of these include:

- Educational, training and experience requirements for entry into the profession.
- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- External review by a legally empowered third party of the reports, returns, communications or information produced by a professional accountant.

(ii) Safeguards in the work environment. Examples of these include:

- Policies and procedures to implement and monitor quality control of engagements.
- A disciplinary procedure to promote compliance with policies and procedures.
- Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.