



Mock Exam One

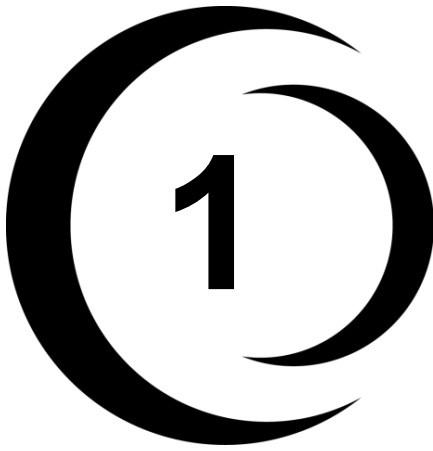
AAT Level 4 Financial Accounting

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This practice assessment is one of a set of five AAT mock practice assessments which have been published for this subject. They are produced by our expert team of AAT tutors, giving real AAT exam style and standard tasks, that ensure the very best for exam success. All practice assessments are relevant for the current syllabus.

Our AAT tutors work extensively to produce study material that is first class and absolutely focused on passing your exam. We hope very much that you enjoy this product and wish you the very best for exam success! For feedback please contact our team aatlivelearning@gmail.com or safina@acornlive.com

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Mock Exam One

AAT Level 4 Financial Accounting

Assessment information:

You have **2 hours and 30 minutes** to complete this Financial Accounting practice assessment.

- This assessment contains **9 tasks** and you should attempt to complete **every** task.
- Each task is independent. You will not need to refer to your answers to previous tasks, however Task 1 and Task 2 refer to the same set of data.
- The total number of marks for this assessment is **120**.
- Read every task carefully to make sure you understand what is required.
- Where the date is relevant, it is given in the task data.
- Both minus signs and brackets can be used to indicate negative numbers **unless** task instructions state otherwise.
- You must use a full stop to indicate a decimal point. For example, write 100.57 **not** 100,57 or 100 57.
- You may use a comma to indicate a number in the thousands, but you don't have to. For example, 10000 and 10,000 are both acceptable.
- You will need to double click to enter values into a gapfill or cell within a table.

Task 1 (24 marks)

This task is about drafting financial statements for limited companies.

This task contains parts (a) to (b).

You have been asked to help prepare the financial statements of a company for the year ended 30 September 20X6.

The company's trial balance as at 30 September 20X6 and further information is shown below.

Trial Balance as at 30 September 20X6

	Debit £000	Credit £000
Share Capital (25 pence ordinary shares)		500
Share Premium		800
Dividends paid	100	
Inventories as at 1 October 20X5	950	
Purchases	9,870	
Sales revenue		20,840
Sales returns	670	
Administration expenses	830	
Retained earnings as at 1 October 20X5		1,028
Corporation tax	34	
Premises at cost	8,000	
Carriage inwards	29	
Motor vehicles at cost	1,600	
Motor vehicles: accumulated depreciation		320
Trade Receivables	1,500	
Allowance for doubtful debts as at 1 October 20X5		25
Trade Payables		280
Bank	670	
VAT Payable		514
Revaluation surplus as at 1 October 20X5		200
Bank loan		150
Distribution costs	404	
	24,657	24,657

Further information

- Closing inventory on 30 September 20X6 is valued at £240,000 (purchase cost), with an additional £18,000 paid during the year for transport, handling, and duty not yet included.
- The company's building will be revalued from £8,000,000 to £9,000,000 and reflected in the financial statements for the year ended 30 September 20X6.
- Administration expenses include £9,000 interest paid on a bank loan.
- An allowance for doubtful debts of £25,000 was made in the previous financial year for a specific customer who had been sold goods on credit but had not paid for more than 8 months. This customer paid the full amount in the current year ended 30 September 20X6. Allowances for doubtful debts are included in administration expenses.
- Estimated corporation tax for the year ended 30 September 20X6 is £2,029,000. The trial balance includes a £34,000 corporation tax underestimation from the prior year.
- VAT payable is reported in trade and other payables within the financial statements.
- Motor vehicle depreciation is 20% per annum (diminishing balance basis), to be split: 30% to cost of sales, 70% to distribution costs.
- All business operations are continuing operations.

(a) Draft a statement of profit or loss and other comprehensive income for the year ended 30 September 20X6. (16 marks)

- Additional notes and disclosures are not required.
- You do not have to use the workings tables to achieve full marks on the task; however, any data that you enter into the workings tables will be taken into consideration if you make errors in the main proforma.
- Show any items that need to be deducted as negative figures, using minus signs.
- Round all your workings to the nearest £000.

Statement of profit or loss and other comprehensive income for the year ended 30 September 20X6

	£
Continuing operations	
Revenue	
Cost of sales	
Gross profit	
Distribution costs	
Administrative expenses	
Operating profit	
Profit before financing and income taxes	
Interest expense	
Profit before income taxes	
Income tax expense	
PROFIT	
Other comprehensive income	
TOTAL COMPREHENSIVE INCOME	

Workings

Picklist for workings: Opening inventories, Distribution costs (trial balance), Sales revenue, Sales returns, Tax - current year, Tax - previous year, Administration expenses (trial balance), Allowance for doubtful debts – adjustment, Interest paid, Purchases, Depreciation charges, Carriage inwards, Closing inventories.

Revenue	£000

Cost of sales	£000

Distribution costs	£000

Administration expenses	£000

Income tax expense	£000

(b) Draft a statement of changes in equity for the year ended 30 September 20X6.

(8 marks)

- **Additional notes and disclosures are not required.**
- **Show any items that need to be deducted as negative figures, using minus signs.**
- **Round all your workings to the nearest £000.**

	Share capital £000	Share premium £000	Retained earnings £000	Revaluation surplus £000	Total equity £000
Balance at 1 October 20X5					
Changes in equity					
Total comprehensive income					
Dividends					
Balance at 30 September 20X6					

End of Task

Task 2 (16 marks)

This task is a continuation of the scenario in task 1 and uses the same data. You have been asked to help prepare the financial statements of a company for the year ended 30 September 20X6.

The company's trial balance as at 30 September 20X6 and further information is shown below.

Trial Balance as at 30 September 20X6

	Debit £000	Credit £000
Share Capital (25 pence ordinary shares)		500
Share Premium		800
Dividends paid	100	
Inventories as at 1 October 20X5	950	
Purchases	9,870	
Sales revenue		20,840
Sales returns	670	
Administration expenses	830	
Retained earnings as at 1 October 20X5		1,028
Corporation tax	34	
Premises at cost	8,000	
Carriage inwards	29	
Motor vehicles at cost	1,600	
Motor vehicles: accumulated depreciation		320
Trade Receivables	1,500	
Allowance for doubtful debts as at 1 October 20X5		25
Trade Payables		280
Bank	670	
VAT Payable		514
Revaluation surplus as at 1 October 20X5		200
Bank loan		150
Distribution costs	404	
	24,657	24,657

Further information

- Closing inventory on 30 September 20X6 is valued at £240,000 (purchase cost), with an additional £18,000 paid during the year for transport, handling, and duty not yet included.
- The company's building will be revalued from £8,000,000 to £9,000,000 and reflected in the financial statements for the year ended 30 September 20X6.
- Administration expenses include £9,000 interest paid on a bank loan.
- An allowance for doubtful debts of £25,000 was made in the previous financial year for a specific customer who had been sold goods on credit but had not paid for more than 8 months. This customer paid the full amount in the current year ended 30 September 20X6. Allowances for doubtful debts are included in administration expenses.
- Estimated corporation tax for the year ended 30 September 20X6 is £2,029,000. The trial balance includes a £34,000 corporation tax underestimation from the prior year.
- VAT payable is reported in trade and other payables within the financial statements.
- Motor vehicle depreciation is 20% per annum (diminishing balance basis), to be split: 30% to cost of sales, 70% to distribution costs.
- All business operations are continuing operations.

Draft a statement of financial position as at 30 September 20X6. (16 marks)

- **Additional notes and disclosures are not required.**
- **You do not have to use the workings tables to achieve full marks on the task; however, any data that you enter into the workings tables will be taken into consideration if you make errors in the main proforma.**
- **Show any items that need to be deducted as negative figures, using minus signs.**
- **Round all your workings to the nearest £000.**

Picklist for the statement of financial position: Cash and cash equivalents, Inventories, Property, plant and equipment, Retained earnings, Share capital, Share premium, VAT Payable, Bank loan, Trade and other payables, Trade and other receivables, Revaluation surplus, Tax liability.

Statement of financial position as at 30 September 20X6

	£000
Assets	
Non-current assets	
Current assets	
Total assets	
EQUITY AND LIABILITIES	
Equity	
Total equity	
Non-current liabilities	
Current liabilities	
Total liabilities	
Total equity and liabilities	

Workings

Picklist for workings: Trade payables, VAT Payable, Retained earnings at 1 October 20X5, Profit for the year, Dividends, Premises at cost, Revaluation, Motor vehicles at cost, Motor vehicles: accumulated depreciation, Depreciation charge for the year, Trade receivables, Allowance for doubtful debts as at 1 October 20X5, Increase in allowance for doubtful debts, Decrease in allowance for doubtful debts.

Property, plant and equipment		£000
	↓	
	↓	
	↓	
	↓	
	↓	

Trade and other receivables		£000
	↓	
	↓	
	↓	

Trade and other payables		£000
	↓	
	↓	

Retained earnings		£000
	↓	
	↓	
	↓	

End of Task

Task 3 (15 marks)

This task is about drafting statements of cashflows.

You have been asked to help prepare extracts from the statement of cashflows for XYZ Ltd for the year ended 31 August 20X9.

XYZ Ltd's most recent statement of financial position (with comparatives for the previous year), statement of profit or loss and further information is shown below.

XYZ Ltd - Statement of financial position as at 31 August 20X9

	20X9 £000	20X8 £000
Assets		
Non-current assets		
Property, plant and equipment	11,380	9,800
Current assets		
Inventories	278	340
Trade receivables	255	430
Cash and cash equivalents	31	670
	564	1,440
Total assets	11,944	11,240
EQUITY AND LIABILITIES		
Equity		
Share capital (£1 ordinary shares)	6,000	5,000
Share premium account	1,000	2,000
Revaluation reserve	2,000	0
Retained earnings	2,091	2,189
Total equity	11,091	9,189
Non-current liabilities		
Loan certificates	500	1,500
Current liabilities		
Trade payables	250	452
Tax liabilities	103	99
	353	551
Total liabilities	853	2,051
Total equity and liabilities	11,944	11,240

XYZ Ltd - Statement of profit or loss for the year ended 31 August 20X9

	£000
Continuing operations	
Revenue	2,450
Cost of sales	-845
Gross profit	1,605
Loss on disposal of PPE	-300
	1,305
Distribution costs	-420
Administrative expenses	-230
Operating profit	655
Profit before financing and income taxes	655
Interest expense	-150
Profit before income taxes	505
Income tax expense	-103
PROFIT	402
Other comprehensive income	2,000
TOTAL COMPREHENSIVE INCOME	2,402

Further information

- Total depreciation charged for the year was £180,000 and is included within administration and distribution expenses.
- There were no prepaid expenses or accrued expenses at the beginning or end of the year. All sales and purchases were on credit.
- Property, plant and equipment with a carrying value of £700,000 was sold in the year.
- A 1 for 5 bonus issue occurred for shareholders during the year out of the share premium account.
- A property was revalued upwards during the year by £2.0 million.
- A dividend was paid in the year of £500,000.










(a) (i) Draft a reconciliation of operating profit to net cash from operating activities for the year ended 31 August 20X9.

(13 marks)

- Additional notes and disclosures are not required.
- Show any items that need to be deducted as negative figures, using a minus sign.

Picklist for the statement below: Operating profit, Depreciation, Proceeds on disposal of PPE, Purchases of PPE, Loan certificates, Loss on disposal of PPE, Adjustment in respect of inventories, Adjustment in respect of trade receivables, Adjustment in respect of trade payables, Dividends paid, Interest paid, Income taxes paid.

Reconciliation of operating profit to net cash from operating activities

	£000
	
Adjustments for:	
	
	
	
	
	
	
	
Cash from operating activities before income taxes	
	
Net cash from operating activities	



(a) (ii) Identify TWO benefits of using cash flow information.

(2 marks)

Benefits of cash flow information	
Provides a comprehensive summary for a company to understand its profitability and make data-driven decisions.	<input type="checkbox"/>
Provides vital insights into a company's liquidity, solvency and operational efficiency.	<input type="checkbox"/>
Provides a critical snapshot of a company's financial health at a specific moment, detailing its assets, liabilities and equity.	<input type="checkbox"/>
Provides a comprehensive summary for a company to manage its debt obligations and make informed decisions to avoid insolvency.	<input type="checkbox"/>

End of Task

Task 4 (12 marks)

This task is about reporting frameworks, the accounting process and presentation and disclosure in financial statements.

This task contains parts (a) to (e).

(a) Identify whether the following statements about limited companies are true or false. (3 marks)

	True	False
A private limited company (Ltd) must file its financial statements to Companies House, within 6 months after its accounting year end.	<input type="checkbox"/>	<input type="checkbox"/>
A public limited company (Plc) requires a minimum of two directors.	<input type="checkbox"/>	<input type="checkbox"/>
A private limited company (Ltd) has a legal maximum of 20 directors.	<input type="checkbox"/>	<input type="checkbox"/>

(b) Complete the following sentences about using daybooks. (3 marks)

A sales invoice for £3,600 issued to a customer for the sale of goods on credit would be recorded in the

A small transaction of £3.40 paid in cash for postage stamps would be recorded in the

A credit note received from a supplier for a prompt payment discount would be recorded in the

Picklist: Sales Day Book, Sales Returns Day Book, Discounts Allowed Day Book, Purchase Day Book, Purchase Returns Day Book, Discounts Received Day Book, Petty Cash Book.

(c) Reconciliation of a cash book balance to the bank statements, or a payables ledger account balance to a supplier statement received, is more likely to support which one of the following qualitative characteristics of useful financial information. Choose ONE answer only. (1 mark)

- Verifiability
- Timeliness
- Comparability
- Relevance

(d) Complete the following sentences about accounting principles.

(3 marks)

The concept is an accounting rule that exercises conservatism and caution when making judgements about accounting transactions under conditions of uncertainty.

The concept means to recognise the business can continue to operate and remain in business for the foreseeable future.

The concept states that business transactions and the personal transactions of its owner are different for accounting purposes.

Picklist: Materiality, Going concern, Consistency, Separate entity, Money measurement, Prudence.

(e) Which TWO statements are requirements of IFRS 18 Presentation and Disclosure in Financial Statements.

(2 marks)

Requirement	
The statement of profit or loss must present five mandatory categories, operating, investing, financing, income taxes and discontinued operations.	<input type="checkbox"/>
Reporting cash flows must use the direct or indirect method, along with disclosure of the components of cash equivalents and reconciliation with the statement of financial position.	<input type="checkbox"/>
Companies must present two new mandatory subtotals in the statement of profit or loss, Operating Profit and Profit Before Financing and Income Taxes.	<input type="checkbox"/>
Inventory is carried at the lower of cost or net realisable value (NRV). NRV is the estimated selling price minus costs to complete and sell.	<input type="checkbox"/>

End of Task

Task 5 (11 marks)

This task is about non-current assets.

This task contains parts (a) to (e).

A company purchased a new machine and is registered for VAT.

(a) Drag and drop two items that would be included in the initial cost as capital expenditure and two items that would be excluded. (2 marks)

VAT	Costs included	Costs excluded
Site preparation costs		
Delivery cost		
Revenue expenditure		

A new machine has been purchased at a cost of £18,930. The company plans to sell the new machine in 5 years, its estimated residual value is £2,000. The new machine is to be depreciated using the straight-line method. A full year's depreciation is charged in the year of purchase.

(b)(i) Calculate the depreciable amount for the new machine.

(1 mark)

£

(b)(ii) Calculate annual depreciation charges for the new machine using the straight-line method.

(1 mark)

£

(c) Identify whether the following statements about intangible assets are true or false. (3 marks)

Statement	True	False
Internally generated goodwill is recognised as a non-current asset in the statement of financial position.	<input type="checkbox"/>	<input type="checkbox"/>
The amortisation of software or patents can use the straight-line or reducing balance method.	<input type="checkbox"/>	<input type="checkbox"/>
Brands must be identifiable, controlled by the company and purchased to be recognised as a non-current asset in the statement of financial position.	<input type="checkbox"/>	<input type="checkbox"/>

The following measures relate to a non-current asset owned by a company.

- Carrying value £20,000.
- Fair value less costs of disposal £18,000.
- Value in use £22,000.

(d) The recoverable amount of the asset is:

(1 mark)

£18,000	<input type="checkbox"/>
£20,000	<input type="checkbox"/>
£22,000	<input type="checkbox"/>

A company owns a building. The original cost was £1,000,000 and it has not been depreciated. The building was recently revalued in the financial statements on 31 October 20X6 at a market value of £1,800,000. The economic climate has now deteriorated, causing the company to carry out an impairment review of its assets for the year ended 31 October 20X7. The building was valued by a professional surveyor at a market value of £1,500,000 on 31 October 20X7.

(e) Identify for the year ended 31 October 20X7 whether the following statements are true or false.

(3 marks)

	TRUE	FALSE
The building must be impaired by £300,000 and this loss of value charged as an expense in the statement of profit or loss.	<input type="checkbox"/>	<input type="checkbox"/>
The building must be impaired by £300,000 and this loss of value posted to the revaluation reserve in the statement of financial position.	<input type="checkbox"/>	<input type="checkbox"/>
The building must be revalued by £500,000 and this unrealised gain posted to the revaluation reserve in the statement of financial position.	<input type="checkbox"/>	<input type="checkbox"/>




End of Task

Task 6 (10 marks)

This task is about the Basis of Preparation of Financial Statements, Inventories, Events after the reporting period and Provisions, contingent liabilities and contingent assets.

This task contains parts (a) to (d).

(a) Identify whether the following statements are a change in accounting policy, or accounting estimate. (3 marks)

Statement	
A machine previously estimated to last 10 years is now expected to last only 8 years, which will increase annual depreciation charges.	<input type="text"/> 
An allowance for closing inventory needs to be revised because of slow-moving or obsolete items.	<input type="text"/> 
The company wants to move from an historical cost model to a revaluation model for measuring its property, plant, and equipment, which will increase annual depreciation charges.	<input type="text"/> 

Picklist: Change in accounting estimate, Change in accounting policy.

A Ltd is an on-line clothing retailer. It has 5000 winter coats which cost the company £35 per item, but spring is fast approaching. The only way to sell the winter coats is by reducing the price to £25 per item and paying delivery and sales commission estimated at £6 per item.

(b) Calculate the value of closing inventory that should be reflected in the financial statements. (2 marks)

£

WDC Ltd is currently finalising its financial statements for the year ended 30 September 20X1 and is considering the following matters.

(c) Which ONE of the following matters would be classified as a non-adjusting event according to IAS 10 *Events After The Reporting Period*.

(2 marks)

WDC was notified on 5 November 20X1 that one of its customers was insolvent and was unlikely to repay any of its debts. The balance outstanding at 30 September 20X1 was £42,000.

On 30 September WDC had an outstanding court action against it. WDC had made a provision in its financial statements for the year ended 30 September 20X1 for damages awarded against it of £22,000. On 29 October 20X1 the court awarded damages of £18,000.

On 5 October 20X1 a serious fire occurred in WDC's main production centre and severely damaged the production facility.

The year end inventory balance included £50,000 of goods from a discontinued product line. On 1 November 20X1 these goods were sold for a net total of £20,000.

A company is currently assessing amounts to include as provisions in its financial statements.

(d) Identify if the following accounting matters should be treated as a provision, or contingent liability.

(3 marks)

The legal obligation arising from a company's published policy and established practice to refund its customers if they are not satisfied.	<input type="checkbox"/>
A lawsuit against the company, its legal counsel advises that it is not probable (less than a 50% chance) that the company will lose the case.	<input type="checkbox"/>
An income tax assessment received from HMRC that the company is formally contesting. Tax advisors have stated any tax liability is only a possibility.	<input type="checkbox"/>

Picklist: Provision, Contingent liability.

End of Task

Task 7 (8 marks)

This task is about Leases and Revenue from contracts with customers.

This task contains parts (a) to (c).

On 1 January 20X0, a company leased a car for four years, paying the first lease payment of £1,800 in advance. There is a further three annual lease payments of £1,800 to be paid on the 31 December each year, the present value of the three annual lease payments is £5,092. The rate of interest implicit in the lease is 3% per year. The car's useful life is eight years and ownership does not transfer at the end of the lease term.

(a) Calculate the amounts to be included in the company's financial statements for the year ended 31 December 20X0. Round all your answers to the nearest whole pound (£). (5 marks)

Year ended 31 December 20X0	£
Statement of financial position	
Non-current assets	
Current liabilities	
Non-current liabilities	
Statement of profit or loss	
Depreciation charges	
Finance charge	

(b) Identify if the following statement is true or false.

(1 mark)

	True	False
A lessee is the owner of an asset who grants the right to use it to another party.	<input type="checkbox"/>	<input type="checkbox"/>

PQR Ltd publishes newspapers and has a contract with a large supermarket chain for the supply of several newspaper titles. PQR has agreed the following terms with supermarket chain:

- The same quantities and value of each newspaper will be supplied each month.
- Payment is made six months in advance.

The supermarket paid £150,000 to PQR on 1 September 20X7 for six months' supply of newspapers for the period 1 September 20X7 to 28 February 20X8. PQR is preparing its financial statements for the year ended 31 October 20X7.

(c) How much sales revenue should be recognised as income in PQR's financial statements for the year ended 31 October 20X7. (2 marks)

<u>£25,000</u>	<input type="checkbox"/>
<u>£50,000</u>	<input type="checkbox"/>
<u>£100,000</u>	<input type="checkbox"/>
<u>£150,000</u>	<input type="checkbox"/>

End of Task

Task 8 (12 marks)

This task is about calculating, interpreting and analysing ratios.

This task contains parts (a) to (b).

You have the financial statements of PQR Ltd for the year ending 30 June 20X6. You are required to prepare financial ratios to help your manager analyse the company, using the statement of profit or loss statement and financial position shown below.

PQR Ltd - Statement of financial position as at 30 June 20X6	
	£000
Assets	
Non-current assets	
Property, plant and equipment	1,300
Current assets	
Inventories	150
Trade receivables	250
Cash and cash equivalents	530
	930
Total assets	2,230
EQUITY AND LIABILITIES	
Equity	
Share capital (£1 ordinary shares)	600
Share premium account	150
Retained reserves	245
Total equity	995
Non-current liabilities	
Bank loans	900
Current liabilities	
Trade and other payables	250
Tax liability	85
	335
Total liabilities	1,235
Total equity and liabilities	2,230

PQR Ltd - Statement of profit or loss for the year ended	
	£000
Continuing operations	
Revenue	4,500
Cost of sales	-3,845
Gross profit	655
Distribution costs	-142
Administrative expenses	-155
Operating profit	358
Profit before financing and income taxes	358
Interest expense	-150
Profit before income taxes	208
Income tax expense	-85
PROFIT	123

(a) Calculate each of the following ratios to ONE decimal place.

(8 marks)

Asset turnover (non-current assets) times

Inventory holding period days

Current ratio : 1

Return on equity %

The following ratios have been calculated from the financial statements of a company.

	20X8	20X7
Gearing	145%	85%
Interest cover	1.7 times	3.1 times

(b)(i) Identify whether each ratio is better or worse in the current year 20X8 compared to the previous year 20X7. (2 marks)

Gearing

	Better	Worse
Gearing	<input type="checkbox"/>	<input type="checkbox"/>

Interest cover

	Better	Worse
Interest cover	<input type="checkbox"/>	<input type="checkbox"/>

(b)(ii) Identify TWO reasons that could explain the change in interest cover in the current year 20X8 compared to the previous year 20X7. (2 marks)

The company experienced a decline in operating income due to lower sales and market decline during the year.

The company has taken on additional debt during the year.

The company has improved its credit score during the year.

The company has improved its cost management and operational efficiency during the year.

End of Task

Task 9 (12 marks)

This task is about interpreting and analysing ratios.

This task contains parts (a) to (e).

The following ratios have been calculated from the financial statements of a company.

	20X8	20X7
Working capital cycle (days)	19	21
Inventory holding period (days)	32	26
Trade payables payment period (days)	54	42
Trade receivables collection period (days)	41	37

(a) Identify TWO reasons that could explain the change in trade receivables collection period in the current year compared to the previous year. (2 marks)

Delayed invoicing by the company.

Early settlement discounts taken by customers.

Lower risk of irrecoverable debts for the company.

Invoice disputes and errors by the company.

(b) Identify TWO actions the company could implement to improve its trade receivables collection period. (2 marks)

Analyse receivable aging reports weekly rather than monthly.

Abolishing late fee penalties for slow paying customers.

Make it easier for customers to pay via electronic methods.

Selling products to customers with poor credit history.

(c) Identify if the following statements are true or false.

(3 marks)

Statement	True	False
A higher inventory holding period allows the company to pay its suppliers faster.	<input type="checkbox"/>	<input type="checkbox"/>
A higher inventory holding period is more likely to improve a company's solvency.	<input type="checkbox"/>	<input type="checkbox"/>
An ideal balance involves a low inventory holding period and high trade payables payment period to manage solvency.	<input type="checkbox"/>	<input type="checkbox"/>

(d) Identify TWO reasons why reliance on working capital ratios is likely to be misleading.

(2 marks)

Ratios do not necessarily predict future performance.

The underlying reasons supporting each ratio is not provided.

A single ratio provides a full picture of a company's financial health.

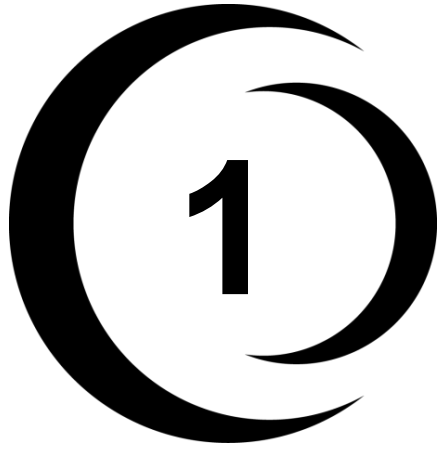
There was a change in accounting policy.

(e) Identify THREE reasons that could explain a decrease in the working capital cycle.

(3 marks)

Reasons	
The company's sales have dropped significantly.	<input type="checkbox"/>
The company has adopted a just-in-time (JIT) manufacturing strategy.	<input type="checkbox"/>
The company intentionally delays payments to suppliers to maximise cash-flows.	<input type="checkbox"/>
The company pays suppliers earlier to take advantage of prompt payment discounts.	<input type="checkbox"/>
The company uses a factoring company to sell customer invoices.	<input type="checkbox"/>
The company's products have become outdated.	<input type="checkbox"/>

End of Task



Mock Exam One Solutions

**AAT Level 4
Financial Accounting**

Task 1 - Solutions (24 marks)

Exam note: During your AAT examination, autosum function will calculate totals and subtotals in the main proforma, streamlining the process and saving you time as you input each figure.

(a) Draft a statement of profit or loss and other comprehensive income for the year ended 30 September 20X6. (16 marks)

- Additional notes and disclosures are not required.
- You do not have to use the workings tables to achieve full marks on the task; however, any data that you enter into the workings tables will be taken into consideration if you make errors in the main proforma.
- Show any items that need to be deducted as negative figures, using minus signs.
- Round all your workings to the nearest £000.

Statement of profit or loss and other comprehensive income for the year ended 30 September 20X6

	£
Continuing operations	
Revenue	20170
Cost of sales	-10668
Gross profit	9502
Distribution costs	-583
Administrative expenses	-796
Operating profit	8123
Profit before financing and income taxes	8123
Interest expense	-9
Profit before income taxes	8114
Income tax expense	-2063
PROFIT	6051
Other comprehensive income	1000
TOTAL COMPREHENSIVE INCOME	7051

Workings

Revenue	£000
Sales revenue	20840
Sales returns	-670
	20170

Cost of sales	£000
Opening inventories	950
Purchases	9870
Depreciation charges	77
Carriage inwards	29
Closing inventories	-258
	10668

Distribution costs	£000
Distribution costs (trial balance)	404
Depreciation charges	179
	583

Administration expenses	£000
Administration expenses (trial balance)	830
Allowance for doubtful debts - adjustment	-25
Interest paid	-9
	796

Income tax expense	£000
Tax - current year	2029
Tax - previous year	34
	2063

(b) Draft a statement of changes in equity for the year ended 30 September 20X6.

(8 marks)

- **Additional notes and disclosures are not required.**
- **Show any items that need to be deducted as negative figures, using minus signs.**
- **Round all your workings to the nearest £000.**

	Share capital £000	Share premium £000	Retained earnings £000	Revaluation surplus £000	Total equity £000
Balance at 1 October 20X5	500	800	1028	200	2528
Changes in equity					
Total comprehensive income			6051	1000	7051
Dividends			-100		-100
Balance at 30 September 20X6	500	800	6979	1200	9479

Workings:

Closing inventory

Closing inventory on 30 September 20X6 is valued at £240,000 (purchase cost), with an additional £18,000 paid during the year for transport, handling, and duty not yet included.

According to UK accounting standards, delivery costs (carriage inwards) are included in the valuation of inventory. Costs directly attributable to bringing inventory to its present location and condition must be added to the purchase price, not treated as an expense.

The accounting adjustment for closing inventories within the financial statements would be $£240,000 + £18,000 = £258,000$.

- **Debit** Inventories £258,000 (current asset in the financial position).
- **Credit** Inventories £258,000 (reduction to cost of sales in the profit or loss account).

Revaluation of building

The company's building will be revalued from £8,000,000 to £9,000,000 and reflected in the financial statements for the year ended 30 September 20X6.

The building currently has a carrying value of £8,000,000 (as per the trial balance) and is to be revalued for the year by £1,000,000 (revaluation £9,000,000 less carrying value £8,000,000).

- **Debit** £1,000,000 Property, plant and equipment (non-current asset in the financial position).
- **Credit** £1,000,000 Revaluation surplus (a reserve in the financial position).

The revaluation surplus is included in the profit or loss account as other comprehensive income (OCI), because it represents an unrealised gain on long-term assets (such as a property). It reflects a change in fair value rather than operating profit, because the gain has not been realised through an actual sale of the property, so recognising it directly in the profit or loss account would create artificial volatility of operating earnings. The unrealised gain will also be shown in the statement of changes in equity.

Interest paid

Administration expenses include £9,000 interest paid on a bank loan.

This amount must be removed from administration expenses and represented in the profit or loss account as interest expenses.

- **Debit** Interest expense £9,000 (increase expenses in the profit or loss account).
- **Credit** Administration expenses £9,000 (decrease expenses in the profit or loss account).

Allowance for doubtful debts reversal

An allowance for doubtful debts of £25,000 was made in the previous financial year for a specific customer who had been sold goods on credit but had not paid for more than 8 months. This customer paid the full amount in the current year ended 30 September 20X6. Allowances for doubtful debts are included in administration expenses.

The customer has now paid in full during the current financial year and therefore this provision must be 'reversed' in the current financial year.

- **Debit** Allowance for doubtful debts £25,000 (decrease this provision in the financial position).
- **Credit** Administration expenses £25,000 (decrease administration expenses in the profit or loss account).

Corporation tax provision for the current year

Estimated corporation tax for the year ended 30 September 20X6 is £2,029,000.

- **Debit** Income tax expense £2,029,000 (in the profit or loss account).
- **Credit** Tax liability £2,029,000 (in the financial position).

The corporation tax liability is not normally included in trade and other payables in the statement of financial position (balance sheet). While it is a current liability, it is distinct from trade payables and reported separately. This is because corporation tax is a statutory charge on profits paid to HMRC, making it fundamentally different from regular trading liabilities.

Corporation tax under-estimated in the prior year

The trial balance includes a £34,000 corporation tax underestimation from the prior year. The corporation tax balance included in the trial balance of £34,000 is the result of under estimating the corporation tax liability in the previous financial year.

- **Debit** Income tax expense £34,000 (increase tax expense in the profit or loss account).
- **Credit** Tax liability £34,000 (in the financial position to remove the balance).

£34,000 'under provided in the previous financial year' means that £34,000 more in tax needs to be provided for in the current financial year. As per the trial balance the £34,000 is represented as a debit balance (increasing tax expenses for the current financial year). Alternatively, if the company had over provided for its tax liability in the previous financial year, there would be a credit balance in the trial balance, which means the tax expense for the current financial year would be reduced (not increased).

VAT payable

VAT payable is included in trade and other payables within the financial statements. VAT payable is typically included under trade and other payables (current liabilities) in the statement of financial position (balance sheet).

Depreciation charges for the current year

Motor vehicle depreciation is 20% per annum (diminishing balance basis), to be split: 30% to cost of sales, 70% to distribution expenses. Motor vehicles at cost £1,600,000 less Motor vehicles: accumulated depreciation £320,000 = £1,280,000 carrying value. £1,280,000 carrying value x 20% depreciation = £256,000 depreciation charge for the year ended 30 September 20X6.

Depreciation charges for the year ended must be apportioned 30% to cost of sales and 70% to distribution expenses. The amount apportioned to cost of sales would be £256,000 x 30% = £76,800 (rounded up to £77,000). The amount apportioned to distribution expenses would be £256,000 x 70% = £179,200 (rounded down to £179,000). The task stated to round all your workings to the nearest £000.

Task 2 - Solutions (16 marks)

Workings for this task are explained in task 1.

Draft a statement of financial position as at 30 September 20X6. (16 marks)

- **Additional notes and disclosures are not required.**
- **You do not have to use the workings tables to achieve full marks on the task; however, any data that you enter into the workings tables will be taken into consideration if you make errors in the main proforma.**
- **Show any items that need to be deducted as negative figures, using minus signs.**
- **Round all your workings to the nearest £000.**

Statement of financial position as at 30 September 20X6

	£
Assets	
Non-current assets	
Property, plant and equipment	10024
Current assets	
Inventories	258
Trade and other receivables	1500
Cash and cash equivalents	670
	2428
Total assets	12452
EQUITY AND LIABILITIES	
Equity	
Share capital	500
Share premium	800
Revaluation surplus	1200
Retained earnings	6979
Total equity	9,479
Non-current liabilities	
Bank loan	150
Current liabilities	
Trade and other payables	794
Tax liability	2029
	2823
Total liabilities	2,973
Total equity and liabilities	12,452

Workings

Property, plant and equipment	£000
Premises at cost	8000
Revaluation	1000
Motor vehicles at cost	1600
Motor vehicles: accumulated depreciation	-320
Depreciation charge for the year	-256
	10024

Trade and other receivables	£000
Trade receivables	1500
Allowance for doubtful debts as at 1 October 20X5	-25
Decrease in allowance for doubtful debts	25
	1500

Trade and other payables	£000
Trade payables	280
VAT Payable	514
	794

Retained earnings	£000
Retained earnings at 1 October 20X5	1028
Profit for the year	6051
Dividends	-100
	6979

Task 3 - Solutions (15 marks)

Exam note: During your AAT examination, autosum function will calculate totals and subtotals in the main proforma, streamlining the process and saving you time as you input each figure.

(a) (i) Draft a reconciliation of operating profit to net cash from operating activities for the year ended 31 August 20X9.

(13 marks)

- Additional notes and disclosures are not required.
- Show any items that need to be deducted as negative figures, using a minus sign.

Reconciliation of operating profit to net cash from operating activities

	£000
Operating profit	655
Adjustments for:	
Depreciation	180
Loss on disposal of PPE	300
Adjustment in respect of inventories	62
Adjustment in respect of trade receivables	175
Adjustment in respect of trade payables	-202
Cash from operating activities before income taxes	1170
Income taxes paid	-99
Net cash from operating activities	1071

The statement above converts operating profits that have been prepared using an accruals basis into 'real actual cash-flows' received or paid. Operating profit (before interest and income tax paid) for the period is adjusted for the following items:

- **Non-cash items** e.g. depreciation (of tangible non-current assets), amortisation (of intangible non-current assets), changes for inventory, changes for trade receivables, changes for trade payables and gains/losses on disposal. Adjusting for non-cash items converts operating profit to actual cash-flows generated by business operations.

- **Items related to investing or financing activities** (these items are independent from business operations and appear instead in the statement of cash-flows) e.g. purchase or sale of property, plant and equipment (PPE), dividends paid (or received), interest paid (or received), proceeds from share issues (equity), proceeds from or the repayment of borrowing (debt) such as bank loans, preference shares, debentures, loan certificates or loan stock.

Adjustments for inventories, trade receivables and trade payables

Changes in the balances for inventories, trade receivables and trade payables from one year to another, will cause a difference between accrued sales and purchases recognised in the profit or loss account and the actual cash-flows received from customers or paid to suppliers in a cash-flow statement.

An acronym which may help you to recall whether you add or deduct changes in the balances for inventories, trade receivables and trade payables in a cash-flow statement is **A** P **o** l **i** c **e** s **t** a **l** e **s** i **n** a **l** o **n** d **c** a **r** p **a** r **k** (**APC** in an **LPC**).

- The **A** is for **Assets** such as inventories and trade receivables.
- The **L** is for **Liabilities** such as trade payables.
- The **P** is the **Previous** year's figure in the statement of financial position.
- The **C** is the **Current** year's figure in the statement of financial position.

The above acronym indicates the order in which you deduct the current or previous year's figures for an asset or liability, to get the right answer in your calculator as a positive or negative value. If the answer is positive it indicates that you add the difference calculated to operating profit and if negative it indicates that you deduct the difference calculated from operating profit.

- Inventory is an **Asset (APC)** so deduct the **P**revious year's figure (340) from the **C**urrent year's figure (278) and the difference is +62. So, add back £62,000 to operating profit.

Purchases in the profit or loss account have been adjusted by the valuation of opening and closing inventories in order to calculate cost of sales. Inventory adjustments in the profit or loss account are non-cash items. Given inventory levels have fallen from the previous year, then £62,000 more has been charged to cost of sales in the profit or loss account, compared with the real purchases figure. This would have reduced operating profit by £62,000 as a 'non-cash' adjustment and so must be added back.

- Trade receivables is an **Asset (APC)** so deduct the **P**revious year's figure (430) from the **C**urrent year's figure (255) and the difference is +175. So, add back £175,000 to operating profit.

Sales in the profit or loss account have been accrued (included as earned for the period, whether or not the cash was actually received by customers). Given trade receivables have fallen from the previous year, more money was collected compared

with sales earned in the statement of profit or loss. £175,000 more cash was collected compared with sales earned in the profit or loss account, therefore £175,000 is added to operating profit.

- Trade payables is a **Liability (LCP)** so deduct the **C**urrent year's figure (250) from the **P**revious year's figure (452) and the difference is -202 (negative). So, deduct £202,000 from operating profit.

Purchases in the profit or loss account have been accrued (included as expenses for the period, whether or not the cash was actually paid to suppliers). Given trade payables have fallen from the previous year, more money was paid to suppliers compared with purchases (expenses) recognised in the statement of profit or loss. £202,000 more cash was paid to suppliers compared with purchases (expenses) in the profit or loss account, therefore £202,000 is deducted from operating profit.

Adjustments for depreciation and loss on disposal of PPE

Depreciation and the loss on disposal of PPE have been deducted from operating profit (both expenses) in the profit or loss account, but these are not cash-flows. Both items are non-cash items and added back to operating profit to move closer to the actual cash generated by the business.

Tax paid

The cash flow statement started with operating profit (before tax). So a tax paid figure needs to be included as a cash outflow for the year. The payment of tax based on the previous year's figure (£99,000) in the statement of financial position, was paid during the year. The current year's tax charge of £103,000 in the statement of profit or loss is represented as a liability (unpaid) in the statement of financial position, so this has not been paid during the year.

Watch out also for tax under or over provided in the previous financial year as this may further complicate the calculation of income tax paid. In this case the tax liability of £103,000 for 20X9 is the same as the income tax expense of £103,000 for 20X9, which means no income tax has been under or over provided for in the previous financial year. Otherwise, the income tax expense in the profit or loss account would have been higher (if tax had been under provided for in the previous year) or lower (if tax had been over provided for in the previous year), than the tax liability in the financial position.

(a) (ii) Identify TWO benefits of using cash flow information.

(2 marks)

Benefits of cash flow information	
Provides a comprehensive summary for a company to understand its profitability and make data-driven decisions.	<input type="checkbox"/>
Provides vital insights into a company's liquidity, solvency and operational efficiency.	<input checked="" type="checkbox"/>
Provides a critical snapshot of a company's financial health at a specific moment, detailing its assets, liabilities and equity.	<input type="checkbox"/>
Provides a comprehensive summary for a company to manage its debt obligations and make informed decisions to avoid insolvency.	<input checked="" type="checkbox"/>

- Provides a comprehensive summary for a company to understand its profitability and make data-driven decisions. This would be a benefit of a statement of profit or loss.
- Provides a critical snapshot of a company's financial health at a specific moment, detailing its assets, liabilities and equity. This would be a benefit of a statement of financial position.

Cash flow information provides vital insights into a company's liquidity, solvency, and operational efficiency by tracking the net movement of money into and out of a business. It helps a business ensure it can pay bills, manage debt obligations, plan for growth and make informed strategic decisions to avoid insolvency.

The benefits of cash flow information

- Helps forecast and identify potential cash shortfalls.
- Helps evaluate any availability of free cash generated.
- Helps distinguish between profitability and cash generation, regardless of what the profit or loss statement shows
- Helps manage working capital and optimise cash generation.

Task 4 - Solutions (12 marks)

(a) Identify whether the following statements about limited companies are true or false. (3 marks)

	True	False
A private limited company (Ltd) must file its financial statements to Companies House, within 6 months after its accounting year end.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
A public limited company (Plc) requires a minimum of two directors.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
A private limited company (Ltd) has a legal maximum of 20 directors.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

- A private limited company (Ltd) must file its financial statements to Companies House, within 6 months after its accounting year end. **This statement is false.** This is the deadline for a public limited company (Plc). A private limited company (Ltd) must file its financial statements to Companies House, within 9 months after its accounting year end.
- A public limited company (Plc) requires a minimum of two directors. **This statement is true.** A private limited company (Ltd) requires a minimum of one director.
- A private limited company (Ltd) has a legal maximum of 20 directors. **This statement is false.** There is no legal maximum number of directors for either a Plc or Ltd, although it could be limited by the company's Articles of Association.

(b) Complete the following sentences about using daybooks.

(3 marks)

A sales invoice for £3,600 issued to a customer for the sale of goods on credit would be recorded in the **Sales Day Book**.

A small transaction of £3.40 paid in cash for postage stamps would be recorded in the **Petty Cash Book**.

A credit note received from a supplier for a prompt payment discount would be recorded in the **Discounts Received Day Book**.

(c) Reconciliation of a cash book balance to the bank statements, or a payables ledger account balance to a supplier statement received, is more likely to support which one of the following qualitative characteristics of useful financial information. Choose ONE answer only. (1 mark)

- Verifiability
- Timeliness
- Comparability
- Relevance

Verifiability gives ‘assurance for information’. Timeliness would mean to receive information on time to make effective decisions. Comparability would mean the information can be compared with other years or to other businesses. Relevance means information is both material and useful for its users.

(d) Complete the following sentences about accounting principles. (3 marks)

The **prudence concept** is an accounting rule that exercises conservatism and caution when making judgements about accounting transactions under conditions of uncertainty.

The **going concern** concept means to recognise the business can continue to operate and remain in business for the foreseeable future.

The **separate entity** concept states that business transactions and the personal transactions of its owner are different for accounting purposes.

(e) Which TWO statements are requirements of IFRS 18 Presentation and Disclosure in Financial Statements. (2 marks)

Requirement	
The statement of profit or loss must present five mandatory categories, operating, investing, financing, income taxes and discontinued operations.	<input checked="" type="checkbox"/>
Reporting cash flows must use the direct or indirect method, along with disclosure of the components of cash equivalents and reconciliation with the statement of financial position.	<input type="checkbox"/>
Companies must present two new mandatory subtotals in the statement of profit or loss, Operating Profit and Profit Before Financing and Income Taxes.	<input checked="" type="checkbox"/>
Inventory is carried at the lower of cost or net realisable value (NRV). NRV is the estimated selling price minus costs to complete and sell.	<input type="checkbox"/>

- The first and third statement is correct, these are requirements of IFRS 18 Presentation and Disclosure in Financial Statements.
- Reporting cash flows must use the direct or indirect method, along with disclosure of the components of cash equivalents and reconciliation with the statement of financial position. This is a requirement of IAS 7 Statement of Cash Flows.
- Inventory is carried at the lower of cost or net realisable value (NRV). NRV is the estimated selling price minus costs to complete and sell. This is a requirement of IAS 2 Inventories.

Task 5 - Solutions (11 marks)

(a) Drag and drop two items that would be included in the initial cost as capital expenditure and two items that would be excluded. (2 marks)

Costs included	Costs excluded
Site preparation costs	VAT
Delivery cost	Revenue expenditure

The company is registered for VAT and would recover input VAT from HMRC, therefore VAT would not be capitalised. Revenue expenditure is always expensed to the profit or loss account, therefore would not be capitalised.

(b)(i) Calculate the depreciable amount for the new machine.

(1 mark)

£16930.

(b)(ii) Calculate annual depreciation charges for the new machine using the straight-line method.

(1 mark)

£3386.

The depreciable amount is the cost of the asset minus its estimated residual value, representing the total value to be expensed as depreciation over its useful life. Cost - Residual Value (£18,930 - £2,000) = £16,930 depreciable amount.

The straight-line method calculates a fixed amount of depreciation for each year. Straight line depreciation (per annum) = (Cost - Residual Value) / Useful Life of Asset = (£18,930 - £2,000) / 5 years = £3,386 each year.

(c) Identify whether the following statements about intangible assets are true or false. (3 marks)

Statement	True	False
Internally generated goodwill is recognised as a non-current asset in the statement of financial position.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
The amortisation of software or patents can use the straight-line or reducing balance method.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Brands must be identifiable, controlled by the company and purchased to be recognised as a non-current asset in the statement of financial position.	<input checked="" type="checkbox"/>	<input type="checkbox"/>

- Internally generated goodwill is recognised as a non-current asset in the statement of financial position. **This statement is false.**

Internally generated goodwill is never recognised as an asset in the statement of financial position under IAS 38 because it is not an identifiable, controllable resource that can be reliably measured. Costs for internal goodwill, brands, or training are not normally recognised as non-current assets, whereas internally developed software or patents can be capitalised and included.

- The amortisation of software or patents can use the straight-line or reducing balance method. **This statement is true.**

Amortisation is the process of spreading the cost of an intangible asset over its useful life and common methods include straight-line and reducing balance. Intangible assets with finite useful lives should be amortised, while those with indefinite lives should still undergo annual impairment reviews.

- Brands must be identifiable, controlled by the company and purchased to be recognised as a non-current asset in the statement of financial position. **This statement is true.**

Intangible assets are non-physical resources such as software, copyrights, patents, brands, trademarks and goodwill. They are typically recorded at cost less accumulated amortisation and impairment, but must be identifiable, controlled by the company, and purchased to be recognised.

(d) The recoverable amount of the asset is: (1 mark)

£18,000	<input type="checkbox"/>
£20,000	<input type="checkbox"/>
£22,000	<input checked="" type="checkbox"/>

According to IAS 36 Impairment of assets, the recoverable amount is the higher of the assets fair value less costs of disposal and its value in use. It is the threshold used to determine if an asset is impaired; an impairment loss exists, whenever the carrying value exceeds the recoverable amount.

The recoverable amount is the higher of:

- The **fair value** amount which is the estimated price to sell an asset in an orderly transaction, less any costs of disposal (£18,000). Costs of disposal directly attributable to the disposal of an asset (excluding financing costs and income tax expenses) must be deducted to determine the fair value. Examples include selling expenses, legal fees and costs of removing the asset.
- The **value in use** is an estimate of the present value of future cash flows expected to arise from an asset's continued use and ultimate disposal (£22,000).

Whenever an assets recoverable amount falls below its net book value (carrying value in the statement of financial position is £20,000), it is prudent to write down the net book

value of the asset to its recoverable amount. Impairment is recognised as an expense in the profit or loss account. In this case no impairment is necessary.

(e) Identify for the year ended 31 October 20X7 whether the following statements are true or false. (3 marks)

	TRUE	FALSE
The building must be impaired by £300,000 and this loss of value charged as an expense in the statement of profit or loss.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
The building must be impaired by £300,000 and this loss of value posted to the revaluation reserve in the statement of financial position.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
The building must be revalued by £500,000 and this unrealised gain posted to the revaluation reserve in the statement of financial position.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

The original revaluation gain of £800,000 (£1.8m - £1.0m) on 31 October 20X6 would have been posted to a revaluation reserve and presented as equity reserves in the statement of financial position. The unrealised gain would have been reported as other comprehensive income in the statement of profit or loss.

- Debit Buildings at cost (increase) £800,000.
- Credit Revaluation reserve (increase) £800,000.

The subsequent revaluation loss of £300,000 (£1.8m - £1.5m) on 31 October 20X7 can be offset against the revaluation reserve (gain) held previously for this building, within the statement of financial position. This unrealised amount should be included under other comprehensive income (as a loss) within the statement of profit or loss.

- Debit Revaluation reserve (decrease) £300,000.
- Credit Buildings at cost (decrease) £300,000.

Impairment losses as an expense to the statement of profit or loss account will only be considered if the building subsequently falls in value by more than £500,000, which is the revaluation surplus remaining in the statement of financial position.

Task 6 - Solutions (10 marks)

(a) Identify whether the following statements are a change in accounting policy, or accounting estimate. (3 marks)

Statement	
A machine previously estimated to last 10 years is now expected to last only 8 years, which will increase annual depreciation charges.	Change in accounting estimate
An allowance for closing inventory needs to be revised because of slow-moving or obsolete items.	Change in accounting estimate
The company wants to move from an historical cost model to a revaluation model for measuring its property, plant, and equipment, which will increase annual depreciation charges.	Change in accounting policy

- **Accounting policies** are the specific principles and rules a company chooses to apply to its financial statements e.g. straight-line or reducing balance method to depreciate its non-current assets. Changes in accounting policies are applied retrospectively, meaning the previous financial statements must be restated as if the new policy had always been applied.
- **Accounting estimates** are monetary amounts affected by measurement uncertainty therefore require estimation e.g. general allowance for doubtful debts, useful life of assets, or product warranty provisions. Changes in accounting estimates are applied prospectively, which means they only affect the current and future financial statements.

(b) Calculate the value of closing inventory that should be reflected in the financial statements. (2 marks)

£95000.

IAS 2 requires inventories to be measured at the lower of cost or net realisable value (NRV). Cost includes purchase, conversion, and other costs to bring inventory to its present location and condition. NRV is the estimated selling price in the ordinary course of business less estimated costs of completion and estimated costs necessary to make the sale. Inventories must be measured at the lower of cost or NRV, normally on an 'item by item' basis.

Calculation

- Since NRV (£25 - £6 = £19) is lower than Cost (£35), the inventory should be written down to £19 per unit.
- 5000 items x £19 per unit = £95,000.

(c) Which ONE of the following matters would be classified as a non-adjusting event according to IAS 10 Events After The Reporting Period.

(2 marks)

WDC was notified on 5 November 20X1 that one of its customers was insolvent and was unlikely to repay any of its debts. The balance outstanding at 30 September 20X1 was £42,000.

On 30 September WDC had an outstanding court action against it. WDC had made a provision in its financial statements for the year ended 30 September 20X1 for damages awarded against it of £22,000. On 29 October 20X1 the court awarded damages of £18,000.

On 5 October 20X1 a serious fire occurred in WDC's main production centre and severely damaged the production facility.



The year end inventory balance included £50,000 of goods from a discontinued product line. On 1 November 20X1 these goods were sold for a net total of £20,000.

IAS 10 Events After the Reporting Period states that a company should adjust its financial statements for events occurring between its financial year end date and the date the financial statements are authorised for issue (signed by the directors). It requires adjustment for events providing evidence of conditions existing at year-end, while disclosing material non-adjusting subsequent events.

- **Adjusting events** provide evidence of conditions that existed at the end of the reporting period e.g. settlement of a court case or bankruptcy of a customer, they require adjustment to the financial statements.
- **Non-adjusting events** indicate conditions that arose after the reporting period e.g. destruction of a major asset or market declines, they do not require adjustment, but if they are a material event then it must be disclosed in the financial statements.

WDC was notified on 5 November 20X1 that one of its customers was insolvent and was unlikely to repay any of its debts. The balance outstanding at 30 September 20X1 was £42,000. **This is an adjusting event as it provides evidence about a trade receivable value (a condition) that existed at the year-end date.**

On 30 September WDC had an outstanding court action against it. WDC had made a provision in its financial statements for the year ended 30 September 20X1 for damages awarded against it of £22,000. On 29 October 20X1, the court awarded damages of £18,000. **This is an adjusting event as it provides evidence about an amount of provision (a condition) that existed at the year-end date.**

On 5 October 20X1, a serious fire occurred in WDC's main production centre and severely damaged the production facility. **The event (a fire) occurred after the year ended 30 September 20X1, so it does not affect the year end statement of**

financial position (a condition which did not exist as at 30 September 20X1), it is therefore a non-adjusting event.

The year-end inventory balance included £50,000 of goods from a discontinued product line. On 1 November 20X1, these goods were sold for a net total of £20,000. **This is an adjusting event as it provides evidence about an amount of provision (a condition) that existed at the year-end date, in this case the impairment of inventory.**

(d) Identify if the following accounting matters should be treated as a provision, or contingent liability. (3 marks)

The legal obligation arising from a company's published policy and established practice to refund its customers if they are not satisfied.	Provision
A lawsuit against the company, its legal counsel advises that it is not probable (less than a 50% chance) that the company will lose the case.	Contingent liability
An income tax assessment received from HMRC that the company is formally contesting. Tax advisors have stated any tax liability is only a possibility.	Contingent liability

IAS 37 Provisions, Contingent Liabilities and Contingent Assets defines and sets recognition or measurement criteria for liabilities of uncertain timing or amount.

A provision is defined as a liability of uncertain timing or amount. It represents a present obligation (legal or constructive) arising from past events, where an outflow of resources is probable, and a reliable estimate of the amount can be made.

Provisions are recognised when a present legal or constructive obligation exists from past events, a probable (> 50%) outflow of resources is required, and a reliable estimate can be made. Examples include expected repair or replacement costs for goods sold, based on past experience, or provisions for damages arising from lawsuits, where legal counsel deems it probable the company will lose, or obligations arising from a company's published policy or established practice to refund its customers.

A contingent liability is a possible obligation arising from past events whose existence is confirmed only by uncertain future events not fully controlled by the entity. It also includes present obligations not recognised because an outflow of resources is not probable, or the amount cannot be measured reliably. Examples include a lawsuit against the company where legal counsel advises that it is not probable (less than 50% chance) that the company will lose the case, or a customer alleges a major fault caused by the company's product, but independent testing is ongoing, making liability only a possibility, or a tax assessment received from HMRC that the company is formally contesting.

Provisions should be recognised in the financial statements by way of adjustment, whereas contingent liabilities not recognised but disclosed as a note in the financial statements, unless the possibility of outflow is remote. Contingent assets should not be recognised, only disclosed when an inflow of economic benefits is probable.

Task 7 - Solutions (8 marks)

(a) Calculate the amounts to be included in the company's financial statements for the year ended 31 December 20X0. Round all your answers to the nearest whole pound (£). (5 marks)

Year ended 31 December 20X0	£
Statement of financial position	
Non-current assets	5169
Current liabilities	1697
Non-current liabilities	1748
Statement of profit or loss	
Depreciation charges	1723
Finance charge	153

Under IFRS 16, a right-of-use (ROU) asset represents a lessee's right to use an underlying asset over the lease term. IFRS 16 mandates that lessees must recognise a ROU asset and a lease liability for most leases, eliminating the distinction between operating and finance leases for lessees. Short-term leases (<12 months) and low-value asset leases such as computers can be exempted from ROU recognition.

Right-of-use (ROU) asset

The ROU asset equals the initial lease liability (the present value of all lease payments). The £1,800 lease payment in advance was paid today (1 January 20X0) so its present value is £1,800. The present value of the three future annual lease payments was £5,092. The total present value of future lease payments (ROU asset) is £6,892 (£5,092 + £1,800) and this amount would be capitalised as a non-current asset (ROU asset) in the statement of financial position. Depreciation charges (see below) were £1723, so the carrying value in the statement of financial position would be £6,892 - £1723 = £5,169.

Depreciation

ROU assets are typically depreciated on a straight-line basis, though other methods may be used if they better reflect consumption. The ROU asset is depreciated over the shorter of its useful life, or the lease term.

The ROU asset is recognised in the financial statements at £6,892. The company leased the car for four years (its useful life is 8 years). So, depreciation would be $£6,892 \div 4 \text{ years} = £1,723.00$ for each accounting period (straight-line method).

Lease liability

A workings table has been provided below to help calculate the lease liability. In the exam you would only need to calculate up to the year ended 31 December 20X1 to get the right figures you need. There is a £0.55 difference in the workings due to rounding. The present value of all lease payments (ROU asset) is £6,892, £1,800 was paid in advance, therefore the remaining liability would be the present value of the three annual lease payments which was £5,092.

Lease liability	Opening balance	3% interest	Instalment paid	Closing balance
Year ended 31 December 20X0	5,092.00	152.76	-1,800.00	3,444.76
Year ended 31 December 20X1	3,444.76	103.34	-1,800.00	1,748.10
Year ended 31 December 20X2	1,748.10	52.44	-1,800.00	0.55

The lease liability for the year ended 31 December 20X0 would be £3,444.76. In the financial statements this figure needs to be broken down into current liabilities (amounts falling due within one year) and non-current liabilities (amounts falling due after more than one year).

Current liabilities (amounts falling due within one year)

For the year ended 31 December 20X0 the lease liability would be £3,444.76 (see above workings). For the year ended 31 December 20X1 the lease liability would be £1,748.10. Therefore, $£3,444.76 - £1,748.10 = £1,696.66$ liability that would be repaid for the year ended 31 December 20X1. This amount represents current liabilities (amounts falling due within one year) of £1,696.66, rounded to £1,697 for the year ended 31 December 20X0. **Exam note:** never round your workings figures, only round your final answer.

Non-current liabilities (amounts falling due after more than one year)

Given for the year ended 31 December 20X0 the lease liability is £3,444.76 and that current liabilities (calculated earlier) were £1,696.66. Then the remaining balance outstanding must be non-current liabilities (amounts falling due after more than one year) of £1,748.10 ($£3,444.76 - £1,696.66$), rounded to £1,748. **Exam note:** never round your workings figures, only round your final answer.

(b) Identify if the following statement is true or false.

(1 mark)

	True	False
A lessee is the owner of an asset who grants the right to use it to another party.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

A lessor (not lessee) is the owner of an asset who grants the right to use it to another party. A lessee is the user who rents the asset, making regular payments for that right. The lessor retains ownership and the lessee gains temporary possession of the asset.

(c) How much sales revenue should be recognised as revenue in PQR's financial statements for the year ended 31 October 20X7.

(2 marks)

£25,000	<input type="checkbox"/>
£50,000	<input checked="" type="checkbox"/>
£100,000	<input type="checkbox"/>
£150,000	<input type="checkbox"/>

IFRS 15 Revenue from Contracts with Customers mandates a five-step model for revenue (income) recognition: identify the contract, identify performance obligations, determine transaction price, allocate price, and recognise revenue when, or as obligations are satisfied.

Workings

- £150,000 was received from the supermarket on 1 September 20X7 for 6 months' supply of newspapers (the same quantity and value supplied each month).
- This equates to £25,000 per month ($£150,000 \div 6$ months), so for the year ended 31 October 20X7 PQR had earned 2 months of revenue ($2 \times £25,000$) = £50,000 which should be recognised as income for the year ended 31 October 20X7.
- The remaining £100,000 received would be shown as deferred income in the statement of financial position at the year end, and would not be recognised as income in the statement of profit or loss for the year ended 31 October 20X7.

Task 8 - Solutions (12 marks)

(a) Calculate each of the following ratios to ONE decimal place.

(8 marks)

Asset turnover (non-current assets)	<input type="text" value="3.5"/> times
Inventory holding period	<input type="text" value="14.2"/> days
Current ratio	<input type="text" value="2.8"/> : 1
Return on equity	<input type="text" value="12.4"/> %

Workings (all calculations rounded to one decimal place):

Asset turnover (non-current assets) = revenue / non-current assets (Answer equals X times). **Asset turnover (non-current assets) = 4500 / 1300 = 3.5 times.** This ratio shows how efficient and productive non-current (long-term) assets are at generating sales (revenue).

Inventory holding period (days) = inventories / cost of sales x 365 (days). **Inventory holding period (days) = 150 / 3845 x 365 = 14.2 days.** This ratio shows the length of time (days) that inventories are held before sale to customers.

Current ratio = current assets / current liabilities (Answer equals X:1). **Current ratio = 930 / 335 = 2.8 : 1.** This ratio shows the liquidity (or solvency) position of the business to cover its short-term liabilities (current liabilities), from the current assets that it holds.

Return on equity = profit after income taxes / total equity x 100%. **Return on equity = 123 / 995 x 100% = 12.4%.** This ratio shows the financial returns to equity (ordinary) shareholders of the business, from profits after tax the business has generated.

(b)(i) Identify whether each ratio is better or worse in the current year 20X8 compared to the previous year 20X7. (2 marks)

Gearing

	Better	Worse
Gearing	<input type="checkbox"/>	<input checked="" type="checkbox"/>

Gearing = total debt / total debt + total equity x 100%. Where total debt is all non-current liabilities only. The rise in gearing suggests the company is carrying too much long-term debt. This increases the financial risk of the company as more cash generated from

operations is required to meet debt and interest payments. A rise in gearing could also mean it is more difficult for the company to obtain more loans in the future. Gearing is inter-related strongly with interest cover, because when debt (gearing) rises, then interest cover tends to worsen as interest payments will normally rise.

Interest cover

	Better	Worse
Interest cover	<input type="checkbox"/>	<input checked="" type="checkbox"/>

Interest cover = profit before financing and income taxes / interest expense = X times. Low interest cover indicates less operating profit is available after interest payments from borrowing (debt) has been consumed. This makes the company higher financial risk to investors (equity) and lenders (debt). The worsening position is either caused by less profits available to meet interest payments, or higher interest payments. More debt (higher gearing) tends to make this ratio worse because interest payments tend to rise as the company takes on more debt. This could make it more difficult for the company to obtain more finance in the future.

(b)(ii) Identify TWO reasons that could explain the change in interest cover in the current year 20X8 compared to the previous year 20X7. (2 marks)

The company experienced a decline in operating income due to lower sales and market decline during the year.

The company has taken on additional debt during the year.

The company has improved its credit score during the year.

The company has improved its cost management and operational efficiency during the year.

Interest cover = profit before financing and income taxes / interest expense = X times.

The ratio has got worse (decreased) compared with the previous year.

The following reasons are more likely to cause interest cover to worsen (decrease).

- The company experienced a decline in operating income due to lower sales and market decline during the year. This is likely to cause profit before financing and income taxes to fall which will cause the interest cover to fall (worsen).
- The company has taken on additional debt during the year. Additional debt is likely to increase interest expenses in the statement profit or loss which will cause the interest cover to fall (worsen).

The following reasons are more likely to cause interest cover to improve (increase).

- The company has improved its credit score during the year. This is likely to lower interest expenses in the statement profit or loss which will cause interest cover to rise (improve).
- The company has improved its cost management and operational efficiency during the year. Greater efficiency and cost control is likely to cause profit before financing and income taxes to rise which will cause interest cover to rise (improve).

Task 9 - Solutions (12 marks)

(a) Identify TWO reasons that could explain the change in trade receivables collection period in the current year compared to the previous year. (2 marks)

- Delayed invoicing by the company.

- Early settlement discounts taken by customers.

- Lower risk of irrecoverable debts for the company.

- Invoice disputes and errors by the company.

The trade receivables collection period (days) has increased by 4 days compared to the previous year.

Delayed invoicing by the company

Delayed invoicing typically increases the trade receivables collection period by extending the time between sale completion and receipt of customer payment. It also increases the risk of bad debts.

Early settlement discounts taken by customers

Early settlement (prompt payment) discounts taken by customers typically decreases the trade receivables collection period, by speeding up the collection of receivables days, or weeks earlier than standard credit terms.

Lower risk of irrecoverable debts for the company

A lower risk of irrecoverable debts typically decreases the trade receivables collection period, it indicates that a company is more efficient at collecting its debts and that customers are paying in a timely manner.

Invoice disputes and errors by the company

Invoice disputes and errors initiated by a company typically increases the trade receivables collection period, inaccurate invoices means that customers often withhold payments on multiple invoices, until a dispute can be resolved.

(b) Identify TWO actions the company could implement to improve its trade receivables collection period. (2 marks)

- Analyse receivable aging reports weekly rather than monthly.

- Abolishing late fee penalties for slow paying customers.

- Make it easier for customers to pay via electronic methods.

- Selling products to customers with poor credit history.

Analyse receivable aging reports weekly rather than monthly

This typically helps speed up customer payments, analysing receivable aging reports weekly rather than monthly will help to identify slow-paying customers and adjust credit collection strategies.

Abolishing late fee penalties for slow paying customers

Failing to apply late fees or penalties can lead customers to prioritise other obligations over paying the company’s invoices.

Make it easier for customers to pay via electronic methods

This typically helps speed up customer payments, reliance on paper cheques or postal systems, rather than electronic payment methods, can add several days to collection times.

Selling products to customers with poor credit history

Selling to customers with poor credit history or failing to perform due diligence on new customers, increases the risk of late payments and irrecoverable debts.

(c) Identify if the following statements are true or false. (3 marks)

Statement	True	False
A higher inventory holding period allows the company to pay its suppliers faster.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
A higher inventory holding period is more likely to improve a company’s solvency.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
An ideal balance involves a low inventory holding period and high trade payables payment period to manage solvency.	<input checked="" type="checkbox"/>	<input type="checkbox"/>

- A higher inventory holding period allows the company to pay its suppliers faster. **This statement is false.** A lower inventory holding period is more likely to allow a company to pay its suppliers faster. If a company turns over inventory quicker, it generates cash faster, creating flexibility to pay suppliers faster.
- A higher inventory holding period is more likely to improve a company’s solvency. **This statement is false.** A higher inventory holding period is more likely to lead to a potential liquidity crises. When inventory sits unsold for too long, it ties up cash. This can lead to a shortage of funds, preventing the company from paying suppliers on time.
- An ideal balance involves a low inventory holding period and high trade payables payment period to manage solvency. **This statement is true.** Increasing the time you take to pay suppliers (higher payables period) helps offset the time cash is tied up in unsold inventory, thus minimising the working capital cycle.

(d) Identify TWO reasons why reliance on working capital ratios is likely to be misleading. (2 marks)

Ratios do not necessarily predict future performance.	<input checked="" type="checkbox"/>
The underlying reasons supporting each ratio is not provided.	<input type="checkbox"/>
A single ratio provides a full picture of a company's financial health.	<input type="checkbox"/>
There was a change in accounting policy.	<input checked="" type="checkbox"/>

- Ratios do not necessarily predict future performance. This statement would be true and it is a limitation of using ratio analysis.
- The underlying reasons supporting each ratio is not provided. Further non-financial information could be helpful, but not likely to make the working capital ratios misleading.
- A single ratio provides a full picture of a company's financial health. This statement is false since a single ratio does not provide a full picture of a company's financial health.
- There was a change in accounting policy. This statement could be true e.g. inventory valuation methods may distort the comparison of the inventory holding period and therefore the working capital cycle.

(e) Identify THREE reasons that could explain a decrease in the working capital cycle. (3 marks)

Reasons	
The company's sales have dropped significantly.	<input type="checkbox"/>
The company has adopted a just-in-time (JIT) manufacturing strategy.	<input checked="" type="checkbox"/>
The company intentionally delays payments to suppliers to maximise cash-flows.	<input checked="" type="checkbox"/>
The company pays suppliers earlier to take advantage of prompt payment discounts.	<input type="checkbox"/>
The company uses a factoring company to sell customer invoices.	<input checked="" type="checkbox"/>
The company's products have become outdated.	<input type="checkbox"/>

The company's sales have dropped significantly. A significant drop in a company's sales usually has a detrimental impact on the working capital cycle, causing it to increase. This lengthening occurs because unsold inventory sits longer and receivables generally take longer to collect, this ties up cash and severely strains liquidity.

The company has adopted a just-in-time (JIT) manufacturing strategy. Adopting strategies like Just-In-Time (JIT) manufacturing means smaller and more frequent ordering cycles, which reduces total inventory held. This decreases the inventory holding period and therefore decreases the working capital cycle.

The company intentionally delays payments to suppliers to maximise cash-flows. Companies may intentionally delay payments to maximise cash-flows. This would increase the trade payables payment period and therefore decrease the working capital cycle.

The company pays suppliers earlier to take advantage of prompt payment discounts. Companies often pay earlier to take advantage of prompt payment discounts which can be more cost-effective than holding cash. This would reduce the trade payables payment period and therefore increase the working capital cycle.

The company uses a factoring company to sell customer invoices. Factoring companies improve a company's cash flow by purchasing their outstanding customer invoices at a discount. Factoring means selling outstanding invoices to a third party (like a bank) for immediate cash. This dramatically decreases the trade receivables collection period and decreases the working capital cycle.

The company's products have become outdated. Holding onto unsold products that have become outdated due to technological change or shifting market trends, typically increases the inventory holding period and therefore increases the working capital cycle.