

A Level Accounting: financial accounting notes

These revision notes cover the A Level (Paper 3) financial accounting content of Cambridge International AS & A Level Accounting (9706). They broadly follow the syllabus topics: preparing financial statements, manufacturing businesses, not-for-profit organisations, limited companies, the International Accounting Standards named in the syllabus, auditing and stewardship, business purchase and merger, consignment and joint venture accounts, computerised accounting systems, and analysing and communicating accounting information. Some topics, such as limited company statements and ratio analysis, build on work you met at AS Level. Every business and figure is invented. Each worked example shows every step and balances. Negative figures appear in brackets, as they do in exam answers. The notes end with short quick-check questions and three full-length exam-style questions with model answers.

1. Preparation of financial statements: purpose and users

Financial statements summarise a business's financial performance over a period (the income statement) and its financial position at the end of that period (the statement of financial position). A limited company also prepares a statement of changes in equity and a statement of cash flows, and adds notes.

Key idea: the objective of general purpose financial reporting

The IASB Conceptual Framework sets out the purpose of financial reporting. In short, it gives investors, lenders and other creditors (both existing and potential) financial information about the entity. They use this information for two things: to decide whether to provide resources to the entity, and to judge how well management has looked after the resources it already controls (stewardship).

User	Main interest	Statements or ratios they look at most
Shareholders (current and potential)	Return on investment, dividends, share price growth	Income statement, EPS, P/E ratio, dividend yield
Lenders (banks, debenture holders)	Whether interest and capital will be repaid	Gearing, interest cover, cash flows, security in non-current assets
Trade payables (suppliers)	Whether invoices will be paid on time	Current ratio, liquid (acid test) ratio, payables days
Employees	Job security and whether wage rises are affordable	Profit trends, cash position
Government and tax authorities	Assessing tax and gathering economic statistics	Profit before tax, revenue
Managers	Planning, control and decision making	All statements, often in more detail and more often

Useful financial information has two **fundamental qualitative characteristics**: **relevance** (it can make a difference to decisions) and **faithful representation** (it is complete, neutral and free from error). Four

enhancing characteristics make it more useful: comparability, verifiability, timeliness and understandability.

2. Manufacturing businesses

A manufacturer buys raw materials and turns them into finished goods. Before the income statement, it prepares a **manufacturing account** to work out the cost of the goods it produced in the period.

Definitions to learn

- **Direct costs** can be traced to each unit made: direct materials, direct labour and direct expenses such as royalties paid per unit.
- **Prime cost** = direct materials consumed + direct labour + direct expenses.
- **Factory overheads** (indirect manufacturing costs) are production costs that cannot be traced to individual units, for example the factory supervisor's wages, factory rent, factory power and depreciation of machinery.
- **Work in progress (WIP)** is production that has been started but not finished at the end of the period.
- **Cost of production** = prime cost + factory overheads + opening WIP – closing WIP.

Factory profit and unrealised profit

Some businesses transfer finished goods from the factory to the warehouse at a **transfer price** above cost. The mark-up is called **factory profit**. It lets managers compare the factory with the cost of buying the goods in from outside, and it rewards factory managers for efficiency. The business as a whole has not earned this profit until the goods are sold to customers. Any factory profit still inside closing finished goods inventory is therefore **unrealised**, and a **provision for unrealised profit** removes it.

Unrealised profit formula

Provision = finished goods inventory at transfer price × mark-up % ÷ (100 + mark-up %)

The income statement is charged only with the **increase** in the provision; a decrease is added back. In the statement of financial position, finished goods are shown at transfer price less the provision, which brings them back to cost as IAS 2 requires.

Worked example 1: Rahbar Furniture Works

Rahbar Furniture Works makes chairs and moves them to its warehouse at production cost plus 20%. The figures for the year ended 31 December 2026 are (\$): inventories at 1 January: raw materials 18,000, work in progress 12,000, finished goods (at transfer price) 36,000. Inventories at 31 December: raw materials 21,000, work in progress 14,000, finished goods (at transfer price) 48,000. Raw materials purchased 142,000; carriage inwards on raw materials 4,000; returns of raw materials to suppliers 2,000; direct wages 96,000; royalties per unit 7,000; indirect factory wages 28,000; factory rent 18,000; factory power 11,000; depreciation of machinery 15,000; revenue 520,000; administrative expenses 70,000; selling and distribution expenses 41,000.

Manufacturing account for the year ended 31 December 2026

Item	\$	\$
Inventory of raw materials 1 January		18,000
Purchases of raw materials	142,000	
Carriage inwards	4,000	
Less returns outwards	(2,000)	144,000
		162,000
Less inventory of raw materials 31 December		(21,000)
Cost of raw materials consumed		141,000
Direct labour		96,000
Direct expenses (royalties)		7,000
Prime cost		244,000
Factory overheads: indirect wages	28,000	
Factory rent	18,000	
Factory power	11,000	
Depreciation of machinery	15,000	72,000
		316,000
Add opening work in progress	12,000	
Less closing work in progress	(14,000)	(2,000)
Cost of production		314,000
Factory profit (20% × 314,000)		62,800
Finished goods transferred to warehouse at transfer price		376,800

Unrealised profit workings

- Opening provision: $36,000 \times 20/120 = 6,000$
- Closing provision: $48,000 \times 20/120 = 8,000$
- Increase in provision: $8,000 - 6,000 = 2,000$, charged to the income statement

Income statement for the year ended 31 December 2026

Item	\$	\$
Revenue		520,000
Opening inventory of finished goods	36,000	
Transferred from factory	376,800	
Less closing inventory of finished goods	(48,000)	
Cost of sales		(364,800)

Gross profit		155,200
Factory profit	62,800	
Less increase in provision for unrealised profit	(2,000)	60,800
		216,000
Administrative expenses	(70,000)	
Selling and distribution expenses	(41,000)	(111,000)
Profit for the year		105,000

Check: with everything valued at cost, cost of sales = $30,000 + 314,000 - 40,000 = 304,000$, and $520,000 - 304,000 = 216,000$. That matches the 216,000 above, so the factory profit adjustments are correct. In the statement of financial position, finished goods = $48,000 - 8,000 = \$40,000$.

Exam tip: put factory overheads in the manufacturing account and office or selling costs in the income statement. When a cost such as rent or insurance is shared, split it in the ratio the question gives, for example $\frac{3}{4}$ factory and $\frac{1}{4}$ office.

3. Not-for-profit organisations

Clubs, societies and charities exist to provide a service to their members, not to make profit for owners. The vocabulary therefore changes:

Business term	Not-for-profit equivalent
Capital	Accumulated fund
Income statement	Income and expenditure account
Profit / loss	Surplus (excess of income over expenditure) / deficit
Cash book summary	Receipts and payments account

Receipts and payments account	Income and expenditure account
Summary of the cash and bank book	Similar to an income statement
Records only cash actually received and paid	Follows the accruals concept
Includes capital items (e.g. buying equipment)	Revenue items only; depreciation is included
Starts and ends with a cash or bank balance	Ends with a surplus or deficit for the period

Definitions to learn

- **Accumulated fund:** the total of a not-for-profit organisation's assets less its liabilities. It plays the same part as capital in a business.
- **Subscriptions in arrears:** subscriptions due for the period that members have not yet paid. They are a current asset (an accrued income).
- **Subscriptions in advance:** subscriptions received for a future period. They are a current

liability (deferred income).

A club that runs a bar, café or shop to make money prepares a separate **trading account** for that activity. The profit or loss from it goes into the income and expenditure account as one line. Smaller activities such as a dinner or a tournament are shown net (receipts less costs).

Worked example 2: Clifton Hockey Club

At 1 January 2026: equipment 24,000; bar inventory 3,200; bank 5,600; subscriptions in arrears 900; subscriptions in advance 600; amounts owed to bar suppliers 1,400.

Receipts in 2026: subscriptions 18,400; bar takings 26,000; tournament entry fees 2,500.

Payments: bar purchases 14,800; groundsman's wages 9,500; pitch hire 6,000; new equipment 5,000; tournament expenses 1,700; general expenses 1,300.

At 31 December 2026: subscriptions in arrears 700; subscriptions in advance 1,100; bar inventory 2,900; owed to bar suppliers 1,800; all equipment valued at 23,500.

Step 1: opening accumulated fund

Assets $24,000 + 3,200 + 5,600 + 900 = 33,700$. Liabilities $600 + 1,400 = 2,000$. Accumulated fund $= 33,700 - 2,000 = \$31,700$.

Step 2: receipts and payments account for the year ended 31 December 2026

Receipts	\$	Payments	\$
Balance b/d (bank)	5,600	Bar purchases	14,800
Subscriptions	18,400	Groundsman's wages	9,500
Bar takings	26,000	Pitch hire	6,000
Tournament entry fees	2,500	New equipment	5,000
		Tournament expenses	1,700
		General expenses	1,300
		Balance c/d (bank)	14,200
	52,500		52,500

Check: $5,600 + (18,400 + 26,000 + 2,500) - (14,800 + 9,500 + 6,000 + 5,000 + 1,700 + 1,300) = 5,600 + 46,900 - 38,300 = \$14,200$.

Step 3: subscriptions account

Debit	\$	Credit	\$
Balance b/d (arrears)	900	Balance b/d (in advance)	600
Income and expenditure	17,700	Bank	18,400
Balance c/d (in advance)	1,100	Balance c/d (arrears)	700
	19,700		19,700

Subscriptions for the year = $18,400 - 900 + 600 + 700 - 1,100 = \$17,700$.

Step 4: bar trading account

Purchases = $14,800 - 1,400 + 1,800 = 15,200$. Cost of sales = $3,200 + 15,200 - 2,900 = 15,500$.

Bar profit = $26,000 - 15,500 = \$10,500$.

Step 5: income and expenditure account for the year ended 31 December 2026

Item	\$	\$
Subscriptions		17,700
Profit on bar		10,500
Tournament: fees 2,500 less expenses 1,700		800
		29,000
Groundsman's wages	9,500	
Pitch hire	6,000	
General expenses	1,300	
Depreciation of equipment ($24,000 + 5,000 - 23,500$)	5,500	(22,300)
Surplus for the year		6,700

Step 6: statement of financial position at 31 December 2026

Item	\$	\$
Equipment (valuation)		23,500
Bar inventory	2,900	
Subscriptions in arrears	700	
Bank	14,200	17,800
Bar payables	(1,800)	
Subscriptions in advance	(1,100)	(2,900)
Net assets		38,400
Accumulated fund at 1 January		31,700
Add surplus for the year		6,700
Accumulated fund at 31 December		38,400

Some clubs apply prudence and count subscriptions in arrears only when they are received, because members who leave often never pay. Follow the policy the question states. Life membership fees are usually held as deferred income and moved to the income and expenditure account in equal instalments over an agreed number of years.

4. Limited companies

Published financial statements

Under IAS 1 a company's financial statements must include a statement of financial position, a statement of profit or loss and other comprehensive income (the published income statement), a statement of changes in equity, a statement of cash flows, and notes, including a summary of accounting policies. Comparative figures for the previous period are required.

Worked example 3: Margalla Traders plc, published income statement for the year ended 31 March 2026

Item	\$
Revenue	1,450,000
Cost of sales	(870,000)
Gross profit	580,000
Distribution costs	(162,000)
Administrative expenses	(214,000)
Profit from operations	204,000
Finance costs (10% loan notes, \$180,000)	(18,000)
Profit before tax	186,000
Tax	(58,000)
Profit for the year	128,000

Dividends paid do not appear in the income statement. They are shown in the statement of changes in equity.

Bonus issues and rights issues

Feature	Bonus issue	Rights issue
What happens	Free shares go to existing shareholders in proportion to their holdings	Existing shareholders are offered new shares for cash, usually below market price
Cash raised	None	Yes
Source	Reserves are capitalised; share premium and other capital reserves are used first	New cash; any amount above nominal value goes to share premium
Effect on total equity	No change; only its make-up changes	Increases by the cash received
Double entry	Dr reserve(s), Cr share capital	Dr bank; Cr share capital (nominal); Cr share premium (excess)
Why a company does it	To bring reserves in line with share capital, lower the market price per share or signal confidence	To raise finance without taking on debt; control stays with existing shareholders if they take up their rights

Reserves

- **Capital reserves** (not distributable as cash dividends): share premium and revaluation reserve. Share premium may be used for bonus issues and to write off share issue expenses.
- **Revenue reserves** (distributable): retained earnings and general reserve. The general reserve is created by a transfer out of retained earnings.

Worked example 4: Margalla Traders plc, statement of changes in equity

At 1 April 2025 equity was: ordinary shares of \$1 each 400,000; share premium 60,000; general reserve 50,000; retained earnings 210,000. In the year:

1. The final dividend for the previous year, \$0.10 per share on 400,000 shares, was paid: \$40,000.
2. A 1 for 4 rights issue at \$1.50 per share was fully taken up: 100,000 shares, raising \$150,000 (share capital 100,000, share premium 50,000).
3. A 1 for 5 bonus issue was then made on the 500,000 shares in issue: 100,000 shares, funded from share premium.
4. Land was revalued upwards by \$35,000.
5. Profit for the year was \$128,000, and \$20,000 was transferred to the general reserve.

	Share capital \$	Share premium \$	Revaluation reserve \$	General reserve \$
At 1 April 2025	400,000	60,000	–	50,000
Dividend paid				
Rights issue	100,000	50,000		
Bonus issue	100,000	(100,000)		
Revaluation of land			35,000	
Profit for the year				
Transfer to general reserve				20,000
At 31 March 2026	600,000	10,000	35,000	70,000

	Retained earnings \$	Total \$
At 1 April 2025	210,000	720,000
Dividend paid	(40,000)	(40,000)
Rights issue		150,000
Bonus issue		–
Revaluation of land		35,000
Profit for the year	128,000	128,000
Transfer to general reserve	(20,000)	–

At 31 March 2026	278,000	993,000
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Check: $600,000 + 10,000 + 35,000 + 70,000 + 278,000 = 993,000$, and $720,000 - 40,000 + 150,000 + 35,000 + 128,000 = 993,000$.

Statement of financial position at 31 March 2026

Item	\$	\$
Non-current assets: property, plant and equipment		1,067,000
Current assets: inventory	96,000	
Trade receivables	84,000	
Cash and cash equivalents	35,000	215,000
Total assets		1,282,000
Equity: ordinary shares of \$1		600,000
Share premium		10,000
Revaluation reserve		35,000
General reserve		70,000
Retained earnings		278,000
Total equity		993,000
Non-current liabilities: 10% loan notes		180,000
Current liabilities: trade payables	51,000	
Tax payable	58,000	109,000
Total equity and liabilities		1,282,000

5. International Accounting Standards

International Accounting Standards (IAS) make financial statements more consistent and comparable between companies and countries, reduce how much managers can choose to present, and make the statements more credible to users. The table below summarises the standards named in the 9706 syllabus. Check the list against the syllabus for your examination year.

Standard	What it requires (key points)
IAS 1 Presentation of Financial Statements	Sets out the full set of statements and their minimum content. Requires fair presentation, going concern, accruals, consistency of presentation, materiality and aggregation, no offsetting (unless a standard allows it), and comparative information. Assets and liabilities are split into current and non-current.

IAS 2 Inventories	Inventory is valued at the lower of cost and net realisable value . Cost includes purchase price, conversion costs and costs of bringing items to their present location and condition, but not selling costs or abnormal waste. FIFO or weighted average cost may be used; LIFO is not allowed. NRV = estimated selling price – costs to complete – costs to sell.
IAS 7 Statement of Cash Flows	Cash flows are classified under operating, investing and financing activities. Operating cash flow may use the direct or indirect method. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value.
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors	A change in accounting policy is allowed only if a standard requires it, or if the change makes the financial statements give reliable and more relevant information. It is applied retrospectively. A change in an estimate (e.g. useful life) is applied prospectively. Material prior-period errors are corrected retrospectively.
IAS 10 Events after the Reporting Period	Adjusting events give evidence of conditions that already existed at the reporting date (e.g. a customer's insolvency revealing that a year-end receivable is irrecoverable); the figures are changed. Non-adjusting events arise after the date (e.g. a fire destroying a warehouse after year end); they are disclosed if material, not adjusted. Dividends declared after the reporting date are not a liability at that date.
IAS 16 Property, Plant and Equipment	PPE is first measured at cost (including costs to bring it into working condition). Afterwards the cost model or the revaluation model is used; revaluations must be kept up to date and cover the whole class of asset, and gains go to revaluation surplus. Depreciation spreads the depreciable amount over the useful life; residual value, useful life and method are reviewed at least each year. Land is not normally depreciated.
IAS 36 Impairment of Assets	An asset is impaired when its carrying amount exceeds its recoverable amount , the higher of fair value less costs of disposal and value in use. The impairment loss is recognised straight away. Goodwill must be tested for impairment every year.
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	A provision is recognised when there is a present obligation from a past event, an outflow is probable and the amount can be reliably estimated. A contingent liability is disclosed in the notes unless the outflow is remote. A contingent asset is disclosed only when an inflow is probable, and is never recognised until virtually certain.
IAS 38 Intangible Assets	An intangible asset is recognised only if it is identifiable, controlled, likely to bring future economic benefits and its cost can be measured reliably. Internally generated goodwill is never recognised . Research costs are expensed. Development costs are capitalised only when all of these criteria are met: (1) completing the asset is technically feasible; (2) the entity intends to complete it and use or sell it; (3) it is able to use or sell it; (4) it can show how the asset will generate probable future economic benefits (for example, a market exists for its output, or the asset is useful internally); (5) adequate technical, financial and other resources are available to complete it; (6) the development expenditure can be measured reliably.

The IASB sometimes renames or replaces standards. IFRS 18 *Presentation and Disclosure in Financial Statements* replaces IAS 1 for periods beginning on or after 1 January 2027, and IAS 8 is renamed *Basis of Preparation of Financial Statements*. In the exam, use the standards and titles printed in the syllabus for your examination year.

6. Statement of cash flows (indirect method)

Profit is not the same as cash. The indirect method starts from profit from operations and adjusts it for non-cash items and for changes in working capital.

Exam tip: if the question gives profit before tax instead, add back finance costs (and deduct any investment income) to reach profit from operations first. Interest paid is then shown as a separate line.

Adjustment to profit from operations	Add or deduct?	Reason
Depreciation, amortisation, impairment	Add	Expense with no cash outflow
Loss on disposal of non-current assets	Add	Non-cash; the proceeds are shown under investing
Profit on disposal	Deduct	Non-cash gain; the proceeds are shown under investing
Increase in inventory or trade receivables	Deduct	Cash tied up
Decrease in inventory or trade receivables	Add	Cash released
Increase in trade payables	Add	Cash payment delayed
Decrease in trade payables	Deduct	More cash paid out

Worked example 5: Zarak Engineering Ltd, year ended 30 June 2026

Profit from operations 96,000; finance costs 8,000 (all paid); tax charge 22,000. Depreciation 34,000. A machine costing 20,000, with accumulated depreciation of 12,000, was sold for 5,000. Inventory rose from 41,000 to 50,000; trade receivables fell from 38,000 to 34,000; trade payables rose from 27,000 to 33,000. Tax payable was 18,000 at the start and 20,000 at the end. PPE at carrying amount was 310,000 at the start and 355,000 at the end. Shares were issued for 40,000 cash; 30,000 of a bank loan was repaid; dividends of 25,000 were paid. Cash and cash equivalents at 1 July 2025 were 12,000.

Workings

- Disposal: carrying amount 20,000 – 12,000 = 8,000; proceeds 5,000; loss = **3,000**.
- Tax paid = 18,000 + 22,000 – 20,000 = **20,000**.
- PPE purchased = closing 355,000 + depreciation 34,000 + disposal carrying amount 8,000 – opening 310,000 = **87,000**.

Statement of cash flows for the year ended 30 June 2026	\$	\$
Cash flows from operating activities		
Profit from operations	96,000	
Depreciation	34,000	

Loss on disposal	3,000	
Increase in inventory	(9,000)	
Decrease in trade receivables	4,000	
Increase in trade payables	6,000	
Cash generated from operations	134,000	
Interest paid	(8,000)	
Tax paid	(20,000)	
Net cash from operating activities		106,000
Cash flows from investing activities		
Purchase of PPE	(87,000)	
Proceeds from sale of PPE	5,000	
Net cash used in investing activities		(82,000)
Cash flows from financing activities		
Proceeds from issue of shares	40,000	
Repayment of bank loan	(30,000)	
Dividends paid	(25,000)	
Net cash used in financing activities		(15,000)
Net increase in cash and cash equivalents		9,000
Cash and cash equivalents at 1 July 2025		12,000
Cash and cash equivalents at 30 June 2026		21,000

IAS 7 lets interest paid go under operating or financing activities, and dividends paid under financing or operating activities. Choose one presentation and apply it consistently.

7. Auditing and stewardship of limited companies

Shareholders own a company, but its directors run it. **Stewardship** is the directors' responsibility to look after the company's resources on the shareholders' behalf and to account for how they have used them. The annual financial statements are the main way directors report on their stewardship.

Directors' duties (main points)

- Keep proper accounting records that show the company's transactions and financial position at any time.
- Prepare annual financial statements that give a **true and fair view** and follow company law and the applicable accounting standards.
- Choose suitable accounting policies, apply them consistently, and make reasonable and prudent judgements and estimates.
- Safeguard the company's assets and take reasonable steps to prevent and detect fraud and

other irregularities, for example through internal controls.

- Act in good faith in the interests of the company, avoid conflicts of interest and use reasonable skill and care.
- Prepare the financial statements on a going concern basis unless that is inappropriate.

The external auditor

The external auditor is an independent, professionally qualified accountant. The shareholders appoint the auditor, usually at the annual general meeting, and the auditor reports to them, not to the directors. The auditor examines the records and evidence and gives an **opinion** on whether the financial statements give a true and fair view and have been properly prepared under the applicable financial reporting framework and company law.

Key idea: the auditor gives reasonable assurance, not a guarantee

An audit is based on testing samples and on judgement about materiality, so it gives **reasonable** assurance that the statements contain no **material** misstatement. It does not certify that every figure is correct, and it does not guarantee that all fraud will be found. The directors, not the auditor, are responsible for preparing the financial statements.

Type of audit opinion	When it is given
Unmodified (a "clean" report)	The statements give a true and fair view in all material respects
Qualified ("except for")	A misstatement, or a lack of evidence, is material but not pervasive
Adverse	Misstatements are material and pervasive, so the statements do not give a true and fair view
Disclaimer of opinion	The auditor could not obtain enough evidence, and the possible effects are material and pervasive

Contents of the auditor's report include: the addressee (the members), the auditor's opinion, the basis for the opinion, a statement of the directors' responsibilities, a statement of the auditor's responsibilities, any material uncertainty about going concern, and the auditor's signature, address and date.

8. Business purchase and merger

When one business buys another, the buyer pays a **purchase consideration**. This may be cash, shares, debentures or a mix. The buyer records the assets and liabilities it takes over at their **fair values**, which are often different from the seller's book values.

Definitions to learn

- **Purchased goodwill** = purchase consideration – fair value of the net assets acquired.
- Purchased goodwill is a non-current intangible asset. Under IFRS it is **not amortised**; it is tested for impairment every year (IAS 36). Only goodwill that has been paid for is recognised; internally generated goodwill is never recognised (IAS 38).

- *For awareness only:* if the consideration is **less** than the fair value of net assets, the difference is a gain on a bargain purchase (sometimes called negative goodwill). After the fair values have been rechecked it is recognised as a gain in profit or loss. This rule comes from IFRS 3, which the syllabus does not name.

Worked example 6: Noor Ltd buys the business of Sana Traders

Sana Traders' book values: premises 120,000; equipment 30,000; inventory 22,000; trade receivables 16,000; bank 5,000; trade payables 13,000. Noor Ltd takes over every asset except the bank account, and takes over the trade payables. Agreed fair values: premises 150,000; equipment 24,000; inventory 20,000; trade receivables 15,000; trade payables 13,000. The consideration is 120,000 ordinary shares of \$1 issued at \$1.40, plus \$50,000 in cash.

Step 1: purchase consideration: shares $120,000 \times \$1.40 = 168,000$; cash 50,000; total **\$218,000**.

Step 2: net assets at fair value: $150,000 + 24,000 + 20,000 + 15,000 - 13,000 = \$196,000$.

Step 3: goodwill: $218,000 - 196,000 = \$22,000$.

Step 4: journal entry in Noor Ltd's books

Account	Dr \$	Cr \$
Premises	150,000	
Equipment	24,000	
Inventory	20,000	
Trade receivables	15,000	
Goodwill	22,000	
Trade payables		13,000
Bank		50,000
Ordinary share capital (120,000 × \$1)		120,000
Share premium (120,000 × \$0.40)		48,000
Totals	231,000	231,000

Narrative: assets and liabilities of Sana Traders taken over at fair value, and consideration paid by share issue and cash.

Merger. Two or more businesses may combine, for example two partnerships or sole traders forming a new limited company. Each old business's assets and liabilities are revalued. The new company records them at the agreed values, issues shares to each set of former owners in proportion to the net assets (and any agreed goodwill) each contributed, and recognises goodwill only when it has been paid for (here, with shares).

Worked example 7: Amina and Bashir merge to form Crescent Ltd

Two sole traders, Amina and Bashir, merge their businesses into a new company, Crescent Ltd,

on 1 July 2026. Agreed values (\$):

Item	Amina	Bashir
Premises	60,000	90,000
Equipment	–	20,000
Inventory	15,000	18,000
Trade receivables	12,000	9,000
Bank	3,000	5,000
Trade payables	(10,000)	(22,000)
Net assets at agreed values	80,000	120,000
Agreed goodwill	20,000	10,000
Total value contributed	100,000	130,000

Crescent Ltd pays each owner in ordinary shares of \$1 issued at par.

Step 1: shares issued: Amina $100,000 \div \$1 = 100,000$ shares; Bashir $130,000 \div \$1 = 130,000$ shares; total 230,000 shares. Amina holds $100/230 = 43.5\%$ of the company and Bashir 56.5%.

Step 2: Crescent Ltd statement of financial position at 1 July 2026

Item	\$	\$
Non-current assets: goodwill (20,000 + 10,000)	30,000	
Premises (60,000 + 90,000)	150,000	
Equipment	20,000	200,000
Current assets: inventory (15,000 + 18,000)	33,000	
Trade receivables (12,000 + 9,000)	21,000	
Bank (3,000 + 5,000)	8,000	62,000
Total assets		262,000
Equity: ordinary shares of \$1 (100,000 + 130,000)		230,000
Current liabilities: trade payables (10,000 + 22,000)		32,000
Total equity and liabilities		262,000

Check: net assets 80,000 + 120,000 + goodwill 30,000 = 230,000 = share capital.

Reasons for buying another business: growth and economies of scale, removing a competitor, gaining new markets, products, skills or brands, and securing supplies. **Points to evaluate:** the price paid, whether profits can be kept up, the cost of integration, the effect on gearing if loans finance the purchase, and dilution of control if shares are issued.

9. Consignment and joint venture accounts

Consignment accounts

In a consignment, the **consignor** sends goods to an agent, the **consignee**, who sells them for commission. Ownership stays with the consignor until the goods are sold, so goods sent on consignment are **not** sales. The consignor opens a consignment account to find the profit on that consignment, and an account for the consignee.

Key idea: valuing unsold goods held by the consignee

Unsold goods = cost + a proportional share of **non-recurring** expenses (freight, insurance in transit, import duty, landing charges). **Recurring** expenses such as selling costs, advertising and commission are not included.

Worked example 8: Hunza Dry Fruits consigns to an agent in Dubai

Hunza Dry Fruits sent 500 boxes costing \$40 each (\$20,000) to Gulf Star Agencies. Hunza paid freight and insurance of \$1,500. Gulf Star paid landing charges of \$1,000 and selling expenses of \$700, sold 400 boxes at \$70 each, deducted 5% commission on sales, and sent the balance by bank transfer.

Workings

- Sales: $400 \times 70 = 28,000$. Commission: $5\% \times 28,000 = 1,400$.
- Unsold inventory (100 boxes): cost $100 \times 40 = 4,000$; freight share $1,500 \times 100/500 = 300$; landing share $1,000 \times 100/500 = 200$; total **4,500**.
- Remittance: $28,000 - 1,000 - 700 - 1,400 = \mathbf{24,900}$.

Consignment to Gulf Star Agencies account

Debit	\$	Credit	\$
Goods sent on consignment	20,000	Gulf Star: sales	28,000
Bank: freight and insurance	1,500	Inventory on consignment c/d	4,500
Gulf Star: landing charges	1,000		
Gulf Star: selling expenses	700		
Gulf Star: commission	1,400		
Income statement: profit on consignment	7,900		
	32,500		32,500

Gulf Star Agencies account (the consignee)

Debit	\$	Credit	\$
Consignment: sales	28,000	Consignment: landing charges	1,000
		Consignment: selling expenses	700

		Consignment: commission	1,400
		Bank	24,900
	28,000		28,000

Check: cost of boxes sold 16,000 + four-fifths of non-recurring costs ($2,500 \times \frac{4}{5} = 2,000$) + selling 700 + commission 1,400 = 20,100; $28,000 - 20,100 = 7,900$. The goods sent on consignment account (Cr 20,000) is closed to purchases or trading so that those goods are not counted as ordinary sales.

Joint venture accounts

A joint venture is a short-term partnership between two or more parties for one project, after which it ends. When each party keeps its own records, each opens a **joint venture with [other party]** account in its own books, and a **memorandum joint venture account** (outside the double entry) combines everyone's figures to find the total profit.

Worked example 9: Asif and Bilal, sharing profits equally

Asif bought goods for \$12,000 and paid packing of \$800. Bilal paid transport of \$1,200, sold goods for \$19,000, paid selling expenses of \$600 and took unsold goods for his own business at an agreed value of \$1,000. The venture was then settled in cash.

Memorandum joint venture account

Debit	\$	Credit	\$
Asif: purchases	12,000	Bilal: sales	19,000
Asif: packing	800	Bilal: goods taken over	1,000
Bilal: transport	1,200		
Bilal: selling expenses	600		
Profit: Asif $\frac{1}{2}$	2,700		
Profit: Bilal $\frac{1}{2}$	2,700		
	20,000		20,000

In Asif's books: joint venture with Bilal account

Debit	\$	Credit	\$
Bank: purchases	12,000	Bank: received from Bilal	15,500
Bank: packing	800		
Income statement: share of profit	2,700		
	15,500		15,500

In Bilal's books: joint venture with Asif account

Debit	\$	Credit	\$
Bank: transport	1,200	Bank: sales	19,000
Bank: selling expenses	600	Purchases: goods taken over	1,000
Income statement: share of profit	2,700		
Bank: paid to Asif	15,500		
	20,000		20,000

Feature	Consignment	Joint venture
Relationship	Principal and agent	Temporary partners
Who bears the risk	Consignor only	All co-venturers share it
Reward for the other party	Commission	A share of profit
Duration	Can be continuing	Ends when the project is complete

10. Computerised accounting systems

Advantages	Disadvantages
Fast processing of large numbers of transactions	Cost of hardware, software, licences and upgrades
Arithmetic is accurate; ledgers and trial balance are updated automatically	Staff need training, and some may resist the change
Up-to-date reports (aged receivables, inventory levels, management accounts) on demand	Risk of viruses, hacking and data loss; backups are essential
Integration of sales, purchases, payroll and inventory modules	Wrong inputs still give wrong outputs ("garbage in, garbage out")
Less paper and storage space; easier audit trail if set up properly	System failures or power cuts can stop work
Fewer staff may be needed over time	Errors of principle or omission are not detected automatically

Introducing a new system: assess needs and costs; choose and test the software; train staff; transfer and check opening balances; run the old and new systems in **parallel** for a period; set user passwords and access levels; plan regular backups stored off-site or in the cloud; keep to data protection laws.

11. Analysis and communication of accounting information

Worked example 10: Kaghan Foods Ltd, year ended 31 December 2026

Revenue (all on credit) 800,000; cost of sales 520,000; gross profit 280,000; profit from operations 120,000; finance costs 10,000 (8% debentures of \$125,000); profit before tax 110,000; tax 30,000; profit for the year 80,000.

Non-current assets 600,000; inventory 65,000 (opening inventory 55,000); trade receivables 88,000; cash 17,000; trade payables 55,000; tax payable 30,000; 8% debentures 125,000. Equity: 500,000 ordinary shares of \$0.50 (250,000) plus reserves 310,000, total 560,000. Check: 600,000 + 170,000 – 85,000 – 125,000 = 560,000. Dividend paid \$0.06 per share; market price \$2.40 per share. There are no preference shares.

Capital employed = equity + non-current liabilities = 560,000 + 125,000 = 685,000. Purchases = 520,000 + 65,000 – 55,000 = 530,000 (all on credit).

Ratio	Formula	Calculation	Result
Gross margin	Gross profit ÷ revenue × 100	280,000 ÷ 800,000 × 100	35.0%
Profit margin (operating)	Profit from operations ÷ revenue × 100	120,000 ÷ 800,000 × 100	15.0%
ROCE	Profit from operations ÷ capital employed × 100	120,000 ÷ 685,000 × 100	17.5%
Current ratio	Current assets : current liabilities	170,000 : 85,000	2.00 : 1
Liquid (acid test) ratio	(Current assets – inventory) : current liabilities	105,000 : 85,000	1.24 : 1
Inventory turnover	Cost of sales ÷ average inventory	520,000 ÷ 60,000	8.67 times
Inventory days	Average inventory ÷ cost of sales × 365	60,000 ÷ 520,000 × 365	42.1 days
Trade receivables days	Trade receivables ÷ credit sales × 365	88,000 ÷ 800,000 × 365	40.2 days
Trade payables days	Trade payables ÷ credit purchases × 365	55,000 ÷ 530,000 × 365	37.9 days
Non-current asset turnover	Revenue ÷ non-current assets	800,000 ÷ 600,000	1.33 times
Gearing	Non-current liabilities ÷ capital employed × 100	125,000 ÷ 685,000 × 100	18.2%
Interest cover	Profit from operations ÷ finance costs	120,000 ÷ 10,000	12 times
Earnings per share	(Profit for the year – preference dividends) ÷ number of ordinary shares	(80,000 – 0) ÷ 500,000	\$0.16
Price/earnings ratio	Market price ÷ EPS	2.40 ÷ 0.16	15 times
Dividend yield	Dividend per share ÷ market price × 100	0.06 ÷ 2.40 × 100	2.5%

Dividend cover	Profit attributable to ordinary shareholders (after preference dividends) ÷ ordinary dividends paid	80,000 ÷ 30,000	2.67 times
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EPS and dividend cover use profit attributable to ordinary shareholders, which is profit for the year less any preference dividends. Kaghan has no preference shares, so here it equals profit for the year.

Working capital cycle = inventory days + receivables days – payables days = 42.1 + 40.2 – 37.9 = **44.4 days**.

Interpretation (sample comments): Liquidity looks comfortable. The current ratio is 2 : 1 and the liquid ratio is above 1 : 1, so the company can meet its short-term debts without selling inventory, provided receivables are collected on time. Cash itself is only \$17,000, so the liquid ratio depends on collecting the \$88,000 of receivables. Working capital may be higher than needed, with funds tied up in inventory and receivables rather than cash. Receivables take about 40 days to pay while Kaghan pays its suppliers in about 38 days, so it pays out slightly faster than it collects; tighter credit control would help cash flow. Gearing of 18.2% is low and interest is covered 12 times, so there is room to borrow more. A P/E of 15 suggests reasonable market confidence in future earnings. If it is above the industry average or competitors' P/E, investors expect Kaghan's earnings to grow faster than theirs, so compare it with a benchmark before concluding. The 2.5% dividend yield is modest, but the dividend is covered 2.67 times, so it looks safe.

Some textbooks and questions define gearing as debt ÷ equity, or include preference shares with debt. Use the definition the question gives, and state your formula when it is not given.

Limitations of ratio analysis

- Ratios come from historical figures and may not predict the future.
- Different accounting policies (depreciation methods, revaluation, inventory valuation) make comparisons between companies unreliable.
- The statement of financial position shows one date only; year-end figures may be unrepresentative (seasonal trade) or deliberately improved ("window dressing").
- Inflation distorts comparisons over time, and assets held at historical cost can overstate ROCE.
- Non-financial factors are left out: staff morale, product quality, the economy, competitors and the environment.
- A ratio means little without a benchmark: last year, a competitor, the industry average or a budget.
- Different companies may calculate the same ratio differently.

Key terms

Term	Definition
Prime cost	Total of direct materials consumed, direct labour and direct expenses.
Cost of production	Prime cost plus factory overheads, adjusted for opening and closing work in progress.
Factory profit	The mark-up added to cost of production when goods move from factory to warehouse at a transfer price.

Unrealised profit	Factory profit included in finished goods that have not yet been sold to outside customers.
Accumulated fund	Net assets of a not-for-profit organisation; the equivalent of capital.
Surplus	Excess of income over expenditure in a not-for-profit organisation.
Bonus issue	Free shares issued to existing shareholders by capitalising reserves.
Rights issue	An offer of new shares for cash to existing shareholders in proportion to their holdings.
Capital reserve	A reserve that cannot be paid out as cash dividends, e.g. share premium or revaluation reserve.
Net realisable value	Estimated selling price less costs to complete and costs to sell.
Recoverable amount	The higher of an asset's fair value less costs of disposal and its value in use.
Provision	A liability of uncertain timing or amount.
Stewardship	Directors' responsibility to look after and account for the resources shareholders have entrusted to them.
True and fair view	Financial statements free from material misstatement that faithfully represent performance and position.
Purchased goodwill	Excess of the purchase consideration over the fair value of the net assets acquired.
Consignee	Agent who sells goods on behalf of the owner (consignor) in return for commission.
Joint venture	A temporary business arrangement between two or more parties for a specific project.
Capital employed	Equity plus non-current liabilities.
Working capital cycle	Inventory days plus receivables days less payables days.

Quick check

1. Define the term *prime cost*. [2]
2. State **two** differences between a receipts and payments account and an income and expenditure account. [2]
3. A chess club received subscriptions of \$9,600 during the year. At the start of the year subscriptions of \$400 were in arrears and \$250 had been received in advance. At the end, \$300 was in arrears and \$500 had been received in advance. Calculate the subscriptions income for the income and expenditure account. [3]
4. Explain why a manufacturer that uses a transfer price must make a provision for unrealised profit. [2]
5. Explain the difference between the directors' responsibility and the external auditor's responsibility for a company's financial statements. [4]

6. A company has 800,000 ordinary shares of \$0.50 each. It makes a 1 for 5 rights issue at \$0.90 per share, which is fully taken up. Calculate the increase in share capital, share premium and bank. [3]
7. A company has 600,000 ordinary shares of \$1, share premium of \$90,000 and a general reserve of \$200,000. It makes a 1 for 4 bonus issue, using reserves in the way that keeps the most distributable reserves. Prepare the journal entry. Narratives are not required. [3]
8. An item of inventory cost \$5,400. It can be sold for \$5,000 after repairs of \$350. State the value at which it should be included in inventory under IAS 2, and give your reason. [2]
9. Profit from operations was \$50,000. Depreciation was \$12,000 and there was a profit on disposal of \$2,000. Inventory fell by \$3,000, trade receivables rose by \$5,000 and trade payables fell by \$1,000. Calculate cash generated from operations. [4]
10. A company buys a business whose net assets have a fair value of \$140,000. It pays by issuing 90,000 ordinary shares of \$1 at \$1.60 each and \$20,000 in cash. Calculate the goodwill, and state how it must be treated in later years. [4]
11. A consignor sent 300 units costing \$25 each and paid freight of \$900. The consignee paid unloading charges of \$300. At the year end, 60 units were unsold. Calculate the value of inventory on consignment. [3]
12. A company's year ends on 31 December 2026 and its financial statements are approved on 20 March 2027. State whether each event is adjusting or non-adjusting under IAS 10, and how it is treated. (a) On 15 February 2027 a customer who owed \$6,000 at the year end was declared bankrupt. (b) On 10 February 2027 a fire destroyed inventory worth \$20,000. (c) Inventory that cost \$8,000 at the year end was sold in January 2027 for \$6,500. [3]
13. A customer is suing a company for \$40,000 over a faulty product supplied last year. State how the claim is treated under IAS 37 if the company's lawyers advise that the company (a) will probably lose, (b) could possibly lose but probably will not, (c) is very unlikely to lose. [3]
14. Cara and Dev enter a joint venture, sharing profits in the ratio 3 : 2. Cara buys goods for \$9,000. Dev pays expenses of \$1,000 and sells all the goods for \$14,000. Calculate the profit on the venture and the amount Dev must pay Cara to settle. [4]
15. An investor is choosing between shares in two companies. **P plc**: market price \$3.00, EPS \$0.25, dividend per share \$0.15. **Q plc**: market price \$4.80, EPS \$0.30, dividend per share \$0.12. Calculate the P/E ratio, dividend yield and dividend cover for each company, and advise which company the investor should choose. Justify your answer. [10]

Answers

1. Prime cost is the total of all direct production costs [1]: direct materials consumed, direct labour and direct expenses [1].
2. Any two: the receipts and payments account records only cash received and paid, while the income and expenditure account follows the accruals concept; the receipts and payments account includes capital items, while the income and expenditure account contains revenue items only (including depreciation); the receipts and payments account ends with a cash or bank balance, while the income and expenditure account ends with a surplus or deficit. [1 each]
3. $9,600 - 400 + 250 + 300 - 500 = \$9,250$. [1 for adjusting the opening balances correctly, 1 for the closing balances, 1 for the answer]

4. Factory profit is added when goods move to the warehouse, but the business as a whole has made no profit until the goods are sold outside it [1]. The provision removes the factory profit contained in unsold finished goods. This stops profit being overstated and values inventory at cost, as the realisation concept, prudence and IAS 2 require [1].
5. The directors must keep proper records and prepare financial statements that give a true and fair view and follow company law and accounting standards [1]. As stewards they must also safeguard assets and prevent and detect fraud [1]. The external auditor is independent and prepares nothing. The auditor examines evidence and gives the shareholders an opinion on whether the statements give a true and fair view [1]. This gives reasonable, not absolute, assurance [1].
6. New shares = $800,000 \div 5 = 160,000$. Share capital + $160,000 \times \$0.50 = \$80,000$; share premium + $160,000 \times \$0.40 = \$64,000$; bank + **\$144,000**. [3]
7. Bonus shares = $600,000 \div 4 = 150,000 \times \$1 = \$150,000$. Dr share premium **90,000**; Dr general reserve **60,000**; Cr ordinary share capital **150,000**. [3]
8. NRV = $5,000 - 350 = \$4,650$, which is lower than cost of $\$5,400$, so the item is valued at **\$4,650** [1]. IAS 2 requires the lower of cost and net realisable value [1].
9. $50,000 + 12,000 - 2,000 + 3,000 - 5,000 - 1,000 = \$57,000$. [1 for depreciation and profit on disposal, 2 for the working capital changes, 1 for the answer]
10. Consideration = $90,000 \times 1.60 + 20,000 = 144,000 + 20,000 = 164,000$ [1]. Goodwill = $164,000 - 140,000 = \$24,000$ [1]. It is shown as an intangible non-current asset and is not amortised [1]. It is tested for impairment every year under IAS 36, and any impairment is written off to profit or loss [1].
11. Cost $60 \times 25 = 1,500$; freight $900 \times 60/300 = 180$; unloading $300 \times 60/300 = 60$. Inventory = **\$1,740**. [3]
12. (a) **Adjusting**: the bankruptcy confirms the debt was already irrecoverable at the year end, so write off the $\$6,000$ receivable [1]. (b) **Non-adjusting**: the fire happened after the year end, so the figures are not changed; disclose it in the notes if material [1]. (c) **Adjusting**: the sale gives evidence of NRV at the year end, so write the inventory down from $\$8,000$ to $\$6,500$ (less any costs to sell) [1].
13. (a) Recognise a **provision**: Dr expense, Cr provision $\$40,000$, shown as a liability [1]. (b) Do not recognise it; disclose a **contingent liability** in the notes [1]. (c) The outflow is remote, so **nothing** is recognised or disclosed [1].
14. Profit = $14,000 - 9,000 - 1,000 = \$4,000$ [1]. Cara's share $4,000 \times 3/5 = 2,400$; Dev's share $1,600$ [1]. Cara is owed her outlay plus her profit: $9,000 + 2,400 = \$11,400$ [1]. Check from Dev's side: cash held $14,000 - \text{expenses } 1,000 - \text{his profit } 1,600 = 11,400$ [1].
15. See the table and evaluation below.

Answer 15

Ratio	P plc	Q plc
P/E	$3.00 \div 0.25 = 12$ times	$4.80 \div 0.30 = 16$ times
Dividend yield	$0.15 \div 3.00 \times 100 = 5.0\%$	$0.12 \div 4.80 \times 100 = 2.5\%$

Dividend cover	$0.25 \div 0.15 = 1.67$ times	$0.30 \div 0.12 = 2.5$ times
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[6: 1 per correct ratio]

Evaluation [4]. **P plc** gives twice the dividend yield, so it suits an investor who wants income now. Its lower cover (1.67) means the dividend is less secure if profits fall, and it keeps less profit for growth. **Q plc** has a higher P/E than P plc, so the market expects its earnings to grow faster. It keeps more of its profit (cover 2.5), which may fund growth and future dividend rises, and its dividend is safer. Q's shares are relatively more expensive, though, and give less income now.

Advice: an investor who needs regular income should choose P plc; one seeking long-term capital growth should choose Q plc. The investor should also compare trends over several years, gearing and industry averages, because one year's ratios are not enough to decide.

Exam-style practice (full Paper 3 length)

These three questions are the length and style of Paper 3 structured questions. Try each one under timed conditions (about 1.2 minutes per mark) before reading the model answer.

Question 1: Tarbela Pumps (manufacturing with unrealised profit) [22]

Tarbela Pumps makes water pumps and transfers them to its warehouse at cost of production plus 25%. Figures for the year ended 30 June 2026 (\$):

Item	\$
Inventory of raw materials: 1 July 2025	25,000
Inventory of raw materials: 30 June 2026	30,000
Work in progress: 1 July 2025	18,000
Work in progress: 30 June 2026	16,000
Finished goods at transfer price: 1 July 2025	50,000
Finished goods at transfer price: 30 June 2026	60,000
Purchases of raw materials	210,000
Carriage inwards on raw materials	6,000
Direct wages	150,000
Direct expenses	9,000
Indirect factory wages	40,000
Rent and insurance ($\frac{3}{4}$ factory, $\frac{1}{4}$ office)	36,000
Electricity ($\frac{2}{3}$ factory, $\frac{1}{3}$ office)	24,000
Factory machinery at cost (depreciate 10% per year, straight line)	200,000
Revenue	900,000
Office salaries	85,000

Selling expenses

60,000

1. Prepare the manufacturing account for the year ended 30 June 2026. [9]
2. Prepare the income statement for the year ended 30 June 2026. [7]
3. Calculate the value of finished goods in the statement of financial position at 30 June 2026. [2]
4. An outside supplier offers to supply the same number of pumps for \$560,000 a year. Advise the owners whether they should close the factory and buy from the supplier. Justify your answer. [4]

Model answer: Question 1
(a) Manufacturing account for the year ended 30 June 2026

Item	\$	\$
Inventory of raw materials 1 July 2025		25,000
Purchases of raw materials	210,000	
Carriage inwards	6,000	216,000
		241,000
Less inventory of raw materials 30 June 2026		(30,000)
Cost of raw materials consumed		211,000
Direct wages		150,000
Direct expenses		9,000
Prime cost		370,000
Indirect factory wages	40,000	
Rent and insurance ($\frac{3}{4} \times 36,000$)	27,000	
Electricity ($\frac{2}{3} \times 24,000$)	16,000	
Depreciation of machinery ($10\% \times 200,000$)	20,000	103,000
		473,000
Add opening work in progress	18,000	
Less closing work in progress	(16,000)	2,000
Cost of production		475,000
Factory profit ($25\% \times 475,000$)		118,750
Transferred to warehouse at transfer price		593,750

Marks: raw materials consumed [2]; prime cost [1]; rent, electricity and depreciation apportioned correctly [3]; work in progress adjustment [1]; cost of production [1]; factory profit and transfer price [1].

(b) Income statement for the year ended 30 June 2026

Workings: opening provision $50,000 \times 25/125 = 10,000$; closing provision $60,000 \times 25/125 = 12,000$; increase 2,000.

Item	\$	\$
Revenue		900,000
Opening inventory of finished goods	50,000	
Transferred from factory	593,750	
Less closing inventory of finished goods	(60,000)	
Cost of sales		(583,750)
Gross profit		316,250
Factory profit	118,750	
Less increase in provision for unrealised profit	(2,000)	116,750
		433,000
Office salaries	(85,000)	
Rent and insurance ($\frac{1}{4} \times 36,000$)	(9,000)	
Electricity ($\frac{1}{3} \times 24,000$)	(8,000)	
Selling expenses	(60,000)	(162,000)
Profit for the year		271,000

Marks: revenue and cost of sales [2]; gross profit [1]; factory profit added and increase in provision deducted [2]; office expenses with correct shares [1]; profit for the year [1]. Check at cost: cost of sales = $40,000 + 475,000 - 48,000 = 467,000$; $900,000 - 467,000 = 433,000$, which agrees.

(c) Finished goods = $60,000 - \text{provision } 12,000 = \text{\$48,000}$ (at cost). [1 for the provision, 1 for the value]

(d) The comparison should be with the factory's **cost** of production (\$475,000), not the transfer price (\$593,750), because factory profit is only an internal mark-up [1]. Making the pumps costs \$85,000 less than buying them ($560,000 - 475,000$) [1]. Some costs, such as office rent and possibly part of the factory rent, may continue even if the factory closes, which makes buying in even less attractive [1]. Non-financial points: control over quality and delivery, redundancies and staff morale, and the risk of relying on one supplier. **Advice:** keep the factory. The 25% mark-up is set higher than the outside price justifies, so the owners may want to review the transfer price [1].

Question 2: Indus Textiles Ltd (statement of cash flows) [22]

Profit before tax for the year ended 31 December 2026 was \$142,000, after finance costs of \$12,000. The tax charge was \$38,000, so profit for the year was \$104,000.

Statement of financial position at 31 December	2026 \$	2025 \$
Property, plant and equipment (carrying amount)	699,000	639,000

Inventory	62,000	70,000
Trade receivables	67,000	55,000
Cash and cash equivalents	40,000	18,000
Total assets	868,000	782,000
Ordinary shares of \$1	360,000	300,000
Share premium	80,000	50,000
Retained earnings	254,000	210,000
Loan notes	100,000	150,000
Trade payables	36,000	40,000
Interest accrued	3,000	2,000
Tax payable	35,000	30,000
Total equity and liabilities	868,000	782,000

Additional information: depreciation for the year was \$45,000. Equipment that cost \$30,000, with accumulated depreciation of \$21,000, was sold for \$13,000. No assets were revalued. The only other movement in retained earnings was dividends paid.

1. Prepare the statement of cash flows for the year ended 31 December 2026, using the indirect method. [18]
2. Explain **two** reasons why cash rose by only \$22,000 when profit for the year was \$104,000. [4]

Model answer: Question 2

Workings

- Profit from operations = 142,000 + 12,000 = 154,000.
- Disposal: carrying amount 30,000 – 21,000 = 9,000; proceeds 13,000; profit 4,000.
- Interest paid = 2,000 + 12,000 – 3,000 = 11,000.
- Tax paid = 30,000 + 38,000 – 35,000 = 33,000.
- PPE purchased = 699,000 + 45,000 + 9,000 – 639,000 = 114,000.
- Share issue = (360,000 + 80,000) – (300,000 + 50,000) = 90,000.
- Dividends paid = 210,000 + 104,000 – 254,000 = 60,000.

(a) Statement of cash flows for the year ended 31 December 2026

Item	\$	\$
Cash flows from operating activities		
Profit from operations	154,000	
Depreciation	45,000	
Profit on disposal	(4,000)	

Decrease in inventory	8,000	
Increase in trade receivables	(12,000)	
Decrease in trade payables	(4,000)	
Cash generated from operations	187,000	
Interest paid	(11,000)	
Tax paid	(33,000)	
Net cash from operating activities		143,000
Cash flows from investing activities		
Purchase of PPE	(114,000)	
Proceeds from sale of PPE	13,000	
Net cash used in investing activities		(101,000)
Cash flows from financing activities		
Proceeds from issue of shares	90,000	
Repayment of loan notes	(50,000)	
Dividends paid	(60,000)	
Net cash used in financing activities		(20,000)
Net increase in cash and cash equivalents		22,000
Cash and cash equivalents at 1 January 2026		18,000
Cash and cash equivalents at 31 December 2026		40,000

Marks [18]: profit from operations with finance costs added back [1]; depreciation [1]; profit on disposal deducted [1]; three working capital changes [3]; interest paid [1]; tax paid [1]; net cash from operating activities [1]; PPE purchased, with working [2]; disposal proceeds [1]; share issue [1]; loan repaid [1]; dividends paid, with working [2]; net increase [1]; opening and closing cash [1].

(b) Any two, each explained [2 each]:

- The company spent \$114,000 on new PPE. This is a cash outflow, but only the depreciation charge (\$45,000) reduces profit.
- Dividends of \$60,000 and the loan repayment of \$50,000 used cash, but neither is an expense in the income statement.
- Trade receivables rose by \$12,000 and payables fell by \$4,000, so profit was earned faster than cash was collected, and suppliers were paid faster.
- Tax and interest are charged on an accruals basis. The amounts paid (\$33,000 and \$11,000) differ from the charges.

Question 3: Riverside Tennis Club (income and expenditure account and statement of financial position) [24]

At 1 January 2026 (\$): clubhouse and courts (carrying amount) 180,000; equipment (valuation)

12,000; café inventory 1,500; subscriptions in arrears 600; subscriptions in advance 400; owed to café suppliers 900; bank 4,300; 5% bank loan 20,000.

Receipts and payments account for the year ended 31 December 2026

Receipts	\$	Payments	\$
Balance b/d	4,300	Café purchases	8,100
Subscriptions	24,200	Café wages	3,000
Café takings	15,600	Coach's fees	12,000
Dance ticket sales	3,200	Court repairs	2,700
		Dance expenses	1,400
		Loan interest	1,000
		Loan repayment	5,000
		New equipment	4,000
		General expenses	2,100
		Balance c/d	8,000
	47,300		47,300

At 31 December 2026: subscriptions in arrears 800; subscriptions in advance 700; café inventory 1,800; owed to café suppliers 1,200. The clubhouse and courts are depreciated by \$3,600 for the year. All equipment is valued at \$13,000. The loan interest paid is the full charge for the year.

1. Calculate the accumulated fund at 1 January 2026. [3]
2. Calculate the profit on the café for the year. [4]
3. Prepare the income and expenditure account for the year ended 31 December 2026. [8]
4. Prepare the statement of financial position at 31 December 2026. [7]
5. Explain why a club might decide not to include subscriptions in arrears as an asset. [2]

Model answer: Question 3

(a) Assets $180,000 + 12,000 + 1,500 + 600 + 4,300 = 198,400$ [1]. Liabilities $400 + 900 + 20,000 = 21,300$ [1]. Accumulated fund = $198,400 - 21,300 = \$177,100$ [1].

(b) Café purchases = $8,100 - 900 + 1,200 = 8,400$ [1]. Cost of sales = $1,500 + 8,400 - 1,800 = 8,100$ [1]. Gross profit = $15,600 - 8,100 = 7,500$ [1]. Less café wages 3,000: café profit = **\$4,500** [1].

(c) Income and expenditure account for the year ended 31 December 2026

Workings: subscriptions = $24,200 - 600 + 400 + 800 - 700 = 24,100$. Equipment depreciation = $12,000 + 4,000 - 13,000 = 3,000$.

Item	\$	\$
Subscriptions		24,100

Profit on café		4,500
Dance: tickets 3,200 less expenses 1,400		1,800
		30,400
Coach's fees	12,000	
Court repairs	2,700	
Loan interest	1,000	
General expenses	2,100	
Depreciation: clubhouse and courts	3,600	
Depreciation: equipment	3,000	(24,400)
Surplus for the year		6,000

Marks [8]: subscriptions with working [2]; café profit [1]; dance shown net [1]; equipment depreciation [1]; clubhouse depreciation [1]; other expenses, with the loan repayment and new equipment correctly left out [1]; surplus [1].

(d) Statement of financial position at 31 December 2026

Item	\$	\$
Non-current assets: clubhouse and courts (180,000 – 3,600)	176,400	
Equipment (valuation)	13,000	189,400
Current assets: café inventory	1,800	
Subscriptions in arrears	800	
Bank	8,000	10,600
Current liabilities: café payables	(1,200)	
Subscriptions in advance	(700)	(1,900)
Non-current liabilities: 5% bank loan (20,000 – 5,000)		(15,000)
Net assets		183,100
Accumulated fund at 1 January 2026		177,100
Add surplus for the year		6,000
Accumulated fund at 31 December 2026		183,100

Marks [7]: non-current assets [2]; current assets [2]; current liabilities [1]; loan at 15,000 [1]; accumulated fund agreeing with net assets [1].

(e) Prudence: members who owe subscriptions often leave the club and never pay, so the asset may not be recovered [1]. Leaving it out avoids overstating assets and the surplus; the income is recorded only when the cash is received [1].