3.2 Final accounts

Name: _____ Class: _____ Date: _____ **Total: 30 marks**

KEY WORDS statement of profit or loss • statement of financial position • gross profit • current liabilities • depreciation • goodwill

Objective

Build the skills to answer exam questions on **final accounts** : the statement of profit or loss, the statement of financial position, and how stakeholders use them.

You must be able to:

- explain the purpose of final accounts for different stakeholders and the principles of ethical accounting
- construct and read a statement of profit or loss
- construct and read a statement of financial position
- distinguish current and non-current assets and liabilities
- explain intangible assets and calculate depreciation by the straight-line and reducing-balance methods

1 Key knowledge and worked examples

■ Final accounts

Purpose: shareholders judge profit and dividends; managers plan and control; lenders judge whether loans can be repaid; employees judge job security and pay; the government checks tax; suppliers judge whether they will be paid. Accounts should be accurate, honest and follow accounting rules; **window dressing** (making accounts look better than they are) is unethical.

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Statement of profit or loss (one year)

line	how to get it
sales revenue	price × quantity sold
− cost of sales	direct cost of the goods sold
= gross profit	
− expenses	rent, salaries, marketing, administration
= profit before interest and tax	
− interest	on loans
= profit before tax	
− tax	
= profit for the period	split into dividends and **retained profit**

Statement of financial position (at one date)

assets	liabilities and equity
non-current assets: kept for over a year (buildings, machines, vehicles)	**current liabilities**: due within a year (overdraft, **trade payables** / creditors, short-term loans)
current assets: cash, **trade receivables** (debtors), **inventories** (stock)	**non-current liabilities**: long-term loans, mortgages
	equity: share capital + retained earnings

Net assets = total assets − total liabilities = equity. **Working capital** = current assets − current liabilities.

AHL: intangible assets have no physical form but give value: patents, copyrights, trademarks, brand names, **goodwill** (the amount paid for a business above the value of its net assets). They are hard to value. **Depreciation** spreads the cost of a non-current asset over its useful life. **Straight-line:** annual depreciation $= \dfrac{\text{cost} - \text{residual value}}{\text{useful life}}$. **Reducing balance:** each year, depreciation = net book value × a fixed percentage, so it is largest in the early years.

Answer shapes: lay out the statement line by line → label each subtotal → interpret for the stakeholder in the question.

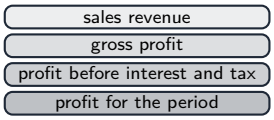
2 Practice

2.1 Define **current assets**, giving **one** example. [2]



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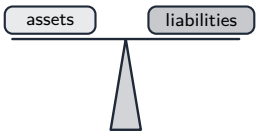
2.2 Distinguish between gross profit and profit for the period. [2]



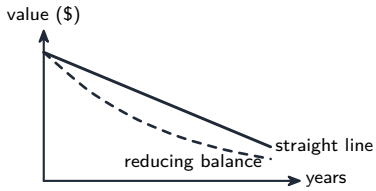
2.3 A firm's data for last year ($000): sales revenue 500, cost of sales 300, expenses 120, interest 10, tax 14. Construct its statement of profit or loss. [4]

line	$000
sales revenue	500
cost of sales	300
gross profit	
…	

2.4 A firm has non-current assets of $400,000, current assets of $150,000, current liabilities of $90,000 and non-current liabilities of $160,000. Calculate its net assets. [2]



2.5 A machine costs $50,000, has a residual value of $5,000 and a useful life of 5 years. (a) Using the straight-line method, calculate the annual depreciation and the net book value after 2 years. (b) Using the reducing-balance method at 30%, calculate the net book value after 2 years. [4]



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3 Exam-style questions

3.1 Rivera Furniture makes tables and chairs. Extracts from its accounts are shown ($000).

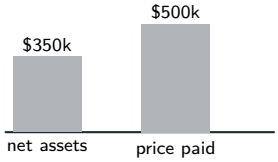
Using the data, discuss what Rivera's final accounts tell its shareholders, its employees and its bank. [10]

$000	year 1	year 2
sales revenue	800	950
cost of sales	480	620
gross profit	320	330
expenses	200	230
profit before interest and tax	120	100
cash	60	15
long-term loans	100	220

3.2 Rivera Furniture paid $500,000 to buy a rival firm whose net assets were valued at $350,000.

(a) Calculate the goodwill paid. [2]

(b) Explain **two** difficulties of valuing intangible assets such as goodwill and brand names. [4]



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Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

2.1

assets that will be turned into cash or used within one year; e.g. cash, inventories, trade receivables

2.2

gross profit: sales revenue minus cost of sales; profit for the period: what remains after all expenses, interest and tax are also taken away

2.3

gross profit $= 500 - 300 =$ **200**; profit before interest and tax $= 200 - 120 =$ **80**; profit before tax $= 80 - 10 =$ **70**; profit for the period $= 70 - 14 =$ **56** ($000), with correct labels and layout

2.4

$400\,000 + 150\,000 - 90\,000 - 160\,000 =$ $\mathbf{300\,000}$

2.5

(a) $(50\,000 - 5\,000) \div 5 =$ $\mathbf{9\,000}$ per year; NBV after 2 years $= 50\,000 - 18\,000 =$ $\mathbf{32\,000}$; (b) year 1: $50\,000 \times 0.3 = 15\,000$, NBV $35\,000$; year 2: $35\,000 \times 0.3 = 10\,500$, NBV $=$ $\mathbf{24\,500}$

3.1

award up to [10]: revenue rose from 800 to 950 (about 19%); but gross profit rose only from 320 to 330, so cost of sales grew faster than revenue; gross profit margin fell from 40% to about 35%; profit before interest and tax fell from 120 to 100 as expenses rose; shareholders: lower profit may mean lower dividends and share value; employees: growing sales support jobs, but falling profit may lead to cost cuts; bank: cash fell from 60 to 15 and loans more than doubled to 220: higher risk of not repaying; limits: only two years, no data on competitors or the economy; balanced judgement

3.2

(a) $500\,000 - 350\,000 =$ $\mathbf{150\,000}$

(b) any two, explained: no physical form and no market price, so the value is an estimate; value can change quickly, e.g. a brand damaged by a scandal; different valuers or methods give different figures, allowing window dressing

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