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Financial Accounting Fundamentals

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Financial Accounting Fundamentals

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Certificate Level Paper C2

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Who uses accounts?

User groups

- Existing and potential shareholders
- Existing and potential creditors
- Employees
- Analysts
- Customers
- Suppliers
- Government
- General public
- Strategic/Tactical/Operational management

Definition

Accounting provides information (financial position, performance and flexibility) regarding the business to its users

Study tip

Learn definitions, as many form the basis for single part questions

Characteristics of useful information

Features include:

- Accuracy
- Reliability
- Relevance
- Timeliness
- User friendliness
- Comparability
- Cost-effectiveness

Definition

Exception reporting – giving information to management on a need to know basis only

Financial vs management accounting

Financial accounting is generally:

- External, rather than internal, information
- Produced on an annual basis
- Subject to precise layouts and legislation
- Summarised to protect the interests of the business
- Measured in monetary terms

Definitions

Bookkeeping – recording monetary transactions of a business

Financial accounting – classifying monetary transactions according to guidelines and presenting the information in appropriate statements

Management accounting – processing of information to facilitate planning, control and decision making

What is a business organisation?

Profit-making organisations

- Sole traders
- Partnerships
- Private limited companies
- Public limited companies

Non-profit-making organisations

- Central and local government
- Charities
- Clubs and societies

Definition

Business – an entity that enters into transactions that are expected to result in the achievement of monetary aims

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Framework of Accounts

Examining the basic concepts involved in the preparation of accounting statements

Topics

- Basic concepts
- The balance sheet
- The profit and loss account
- Key features

Key study system questions

3.2 Key features

Basic concepts

Separate entity concept

For accounting purposes, the business is treated as a separate entity from the owner(s) of it. Thus, the accounting information reflects the activities of the business only

Accounting equation

It is always true that assets equal liabilities plus capital. This fundamental statement forms the basis for the preparation of the accounting records and financial statements. When rearranged, the equation forms the basis of the balance sheet presentation, i.e.

Capital = Assets − Liabilities

Study tip

Don't underestimate the importance of this equation. It is particularly useful for incomplete records questions

Basic concepts

Definitions

Assets – resources used by the business in order to gain future revenue. They may be held on a long-term basis, e.g. buildings (tangible fixed assets) and goodwill (intangible fixed assets); or held on a short-term basis (current assets), e.g. debtors and stocks/inventories

Liabilities – obligations of the business to transfer economic benefit as a result of past events. These may also be long term (more than one year) or current/short term (less than one year) and include creditors and bank overdraft

Capital – a specific kind of liability that relates to the owners' investment in the business

Study tip

It is essential that these terms be thoroughly understood

The balance sheet

Balance Sheet as at . . .	£000	£000
Fixed assets		
Buildings	X	
Equipment	X	
Current assets		X
Stock	X	
Debtors	X	
Bank/cash	X	
	X	
Current liabilities		
Creditors	X	
Net current assets		X
Long term liabilities		
Bank loan		(X)
Net assets employed		X
Financed by		
Capital		X

Note

This can also be presented in a horizontal format. The question is likely to indicate which version is required. It is only the layout that changes, not the calculations involved in arriving at the contents

The balance sheet

Note – horizontal format

Balance Sheet as at . . .	£000	£000		
Fixed assets			Capital	X
Buildings	X		Long-term liabilities	
Equipment	X		Bank loan	X
Current assets		X	Current liabilities	
Stock	X		Creditors	X
Debtors	X			X
Bank/cash	X	X		
Total assets		X		

Note

This presentation ties in well with double entry, as DR balances are on the left and CR balances are on the right, BUT this is not part of the double entry system

The profit and loss account

Profit and loss a/c for period ending . . .	£000	£000
Sales		X
Less cost of goods sold		
Opening stock	X	
Purchases	X	
Closing stock	(X)	
		(X)
Gross profit		X
Less expenses		(X)
Net profit		X

Note

Sales represents the income generated from trading and, to get to a gross profit, then the cost of those items sold must be established. To arrive at the net profit, then business expenses are deducted. Remember that drawings do not represent expenses in a sole trader's business, but are shown in the balance sheet as a reduction in capital

Key features

Profits and cash

It is important to recognise that a business may be profitable, but not necessarily increase its cash supply. This can be due to many reasons but includes:

- Not all customers will pay cash but remain as debtors on the balance sheet
- Suppliers may remain unpaid as creditors
- Cash drawings only impact the capital figure in the balance sheet

Study tip

This distinction between profit and cash is particularly important when looking at the cash-flow statement

Capital and revenue

Capital transactions relate to items that enhance the long term economic benefits of the business, e.g. purchase or disposal of fixed assets. These are shown on the balance sheet (BS)

Revenue transactions relate to items that are consumed in the period, e.g. running expenses. These are shown in the profit and loss account (P&L)

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Accounting System in Action

Examining the accounting system together with sales, purchases and nominal ledger accounting

Key study system questions

1.1 Double entry
2.1 Double entry
3.5 Double entry
28 Double entry

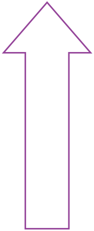
Topics

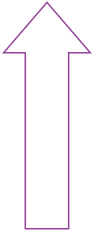
- Double entries
- Balancing off the accounts

Double entries

General rules

DR	CR
Asset/Expense	Liability/income





Study tip

Vice versa for decreases

Double entries

Trade goods – purchases

Purchases a/c

	£		
Creditor	X		

Creditor a/c

	£		£
		Purchases	X

Trade goods – sales

Debtor a/c

	£		
Sales	X		

Sales a/c

	£		£
		Debtor	X

Double entries

Definitions

Ledger a/c – single record of transactions, represented by debits (DR) on the left and credits (CR) on the right – also known as a T a/c

Double entry bookkeeping – system of record keeping involving the concept of duality, i.e. every transaction has two equal and opposite effects

Nominal ledger – main 'book' of records

Columnar ledger a/cs – alternative layout for bank a/cs

Balancing off the accounts

Purpose

- To establish a balance at any point in time

Calculation

- Cast the figures on each side
- Enter in the biggest amount as a total
- Balance the opposite side by entering the balancing figure
- This represents either a balance carried forward (bal c/f) or a transfer to the P&L
- Bal c/f figures are then written as bal b/f on the opposite side

Study tip

Practice makes perfect!

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Summarising the Ledger Accounts

Examining the preparation of the trial balance (TB), trading and profit and loss (P&L) and balance sheet (BS)

Key study system questions

1.5 P&L
2.2 TB
2.12 BS
3.8 TB
4.4 TB
5.5 BS

Topics

- Preparation of the TB
- Preparation of the P&L
- Preparation of the BS

Preparation of the TB

Example

	DR	CR
Capital		X
Cash	X	
Bank overdraft		X
Purchases	X	
Creditor		X
Debtor	X	
Sales		X
Opening stock	X	
Rent	X	
Wages	X	
Buildings	X	
Drawings	X	
Total	X	X

Study tip

Remember the general bookkeeping rules, DR = expense/asset whilst CR = income/liability

Definition

Trial balance (TB) – list of balances on the nominal ledger where the total DRs should equal the total CRs. Can to some extent be used to check the accuracy of the double entry system

Preparation of the TB

Errors which can lead to non-balancing of the TB

- Incorrect posting of transactions
- Incorrect balancing of accounts
- Incorrect transfer of accounts to TB

Errors which can lead to balancing of the TB

- Errors of omission (transaction not included)
- Errors of commission (similar type but wrong a/c)
- Errors of principle (wrong type of a/c)
- Errors of original entry (wrong amounts used)
- Reversal of entries (double entry wrong way round)
- Duplication of entries (transaction entered twice)
- Compensating errors (multiple errors that cancel out)

Preparation of the P&L

Trading account

Compares trading income with cost of goods sold. It is a ledger account and thus follows the rules of double entry. Ledger a/cs are closed by transferring the balances to the trading account. The statement can be presented in horizontal or vertical formats

Trading account – layout

Sales		X	
Less returns inwards		(X)	
Net sales			X
Less cost of sales			
Opening stock		X	
Purchases	X		
Less returns outwards	(X)		
Net purchases		X	
Carriage inwards		X	
Closing stock		(X)	
Cost of sales			(X)
Gross profit			X

Preparation of the P&L

Profit and loss – layout

Gross profit	(X)
Less expenses, e.g.	
Wages	(X)
Rent	(X)
Discounts allowed and received	(X)
Carriage outwards	(X)
Net profit	X

Study tip

This is often examined as one combined statement with the trading account

Notes

- Gross profit margin = profit as % of sales
- Gross profit mark up = profit as % of cost of sales
- Carriage costs are shown separately in the P&L. Carriage inwards as part of the cost of sales and carriage outwards as expenses
- Trade discounts are deducted from the original figures and thus only the net figure is recorded in the ledgers
- Cash discounts are shown as expenses in the P&L and also reduce the debtor (discounts allowed) or creditor (discounts received)
- The balance on the P&L is transferred to the capital a/c at the end of the year

Preparation of the BS

BS layout

Balance Sheet as at . . .	£000	£000
Fixed assets		
Buildings	X	
Equipment	X	
		X
Current assets		
Stock	X	
Debtors	X	
Bank/cash	X	
	X	

Current liabilities		
Creditors	(X)	
Bank overdraft	(X)	
Net current assets		X
Long-term liabilities		
Bank loan		(X)
Net assets employed		X
Financed by		
Capital		X
Profit		X
Drawings		(X)
		X

Preparation of the BS

Notes

- Bal b/f remaining on TB following P&L preparation are summarised on the BS
- There is NO double entry to transfer to the balance sheet
- Following the preparation of the BS, a final balancing off of a/cs takes place
- Drawings are then closed by transferring the balance to capital a/c

Study tip

Repetition of layouts (even with additional items) will help memorise them, but this is no real substitute for lots of question practice

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Further Aspects of Ledger Accounting

Examining the preparation of accounts for indirect taxes, payroll, accrual and prepayments and bad and doubtful debts

Key study system questions

2.3	VAT
2.14	VAT
3.9	Accruals
4.6	Payroll
5.13	Bad debts
34	Accruals

Topics

- VAT
- Payroll
- Accruals and prepayments
- Bad and doubtful debts

VAT

Theory

- VAT on the purchase of new cars and spending on entertaining expenses cannot be reclaimed and, therefore, must be included in the cost of the items
- Non-registered businesses (below the threshold) and exempt supplies (e.g. gambling) cannot claim VAT, since they do not charge it. This results in all costs being shown, inclusive of VAT. No VAT a/c needs to be maintained
- Zero-rated businesses charge 0% and, therefore, can claim VAT on purchases. The balance on the VAT a/c would be DR and, thus, appears under current assets in the BS
- Mixed supplies should be treated separately
- Exports should be treated as zero-rated

VAT

Bookkeeping for VAT

- Vat on sales = output tax = payable to C&E = CR to ledger a/c
- Vat on purchases = input tax = receivable from C&E = DR to ledger a/c
- If balance on ledger a/c = DR = current asset (to claim from C&E)
- If balance on ledger a/c = CR = current liability (to pay to C&E)

Customs & excise or VAT a/c

	£		£
Creditors a/c	X	Debtors a/c	X
Bal c/f (owed by C&E)	X	Bal c/f (owed to C&E)	X
	X		X

Study tip

Common examination area

Payroll

Theory

- Gross pay forms part of the cost to the business of being an employer
- Gross pay = net pay to the employee + statutory and voluntary deductions

Bookkeeping for payroll

- Gross pay = DR wages a/c
- Net pay = CR bank a/c
- PAYE/employees' NI = CR inland revenue a/c
- Pension = CR creditor a/c
- Other deductions = CR relevant creditor a/c
- Employers NI = DR wages a/c and CR inland revenue a/c

Accruals and prepayments

Theory

- Accrued expenses are those not yet charged by suppliers and should be reflected as a liability in the BS and an increase in the P&L expenses
- Prepaid expenses are those charged in advance by suppliers and should be reflected as an asset in the BS and a reduction in the P&L expenses
- Vice versa for accrued and prepaid incomes
- Since the true values may not be known, estimates may have to be made at year end
- It is usual to calculate on time-based pro-rata
- Prudence will overrule this matching concept should a conflict arise. This is particularly common with income, which should not be accrued unless reasonably certain of its receipt

Study tip

These accounting concepts are commonly examined

Bookkeeping

- Accrued expenses = DR expense a/c and CR accruals a/c
- Prepaid expenses = CR expense a/c and DR prepayments a/c
- Accrued income = CR income a/c and DR accrued income a/c
- Prepaid income = DR income a/c and CR deferred income a/c

Accruals and prepayments

At year end

- Following the balance sheet preparation, the accruals and prepayments are reversed
- This means that the assets and liabilities return to zero
- The expense and income a/cs are automatically corrected when the supplier's transactions are entered in the normal way

Study tip

The bookkeeping should be mastered but it is more important to be able to reflect the appropriate figures in the P&L and BS

Bad and doubtful debts

Theory

- Bad debts are those debtors certain not to pay and should be written off the P&L and the debtor (reducing current assets in the BS)
- Doubtful debts are debtors felt not likely to pay and should be written off the P&L and used to create a provision which acts to reduce current assets in the BS
- Provision for doubtful debts = specific provision (known customer) + general provision (% of remaining debtors)
- Any subsequent cash recovered from a bad debt effectively reverses the entry. No specific entry is necessary in the case of the provision for doubtful debts

Bookkeeping

- Bad debts = DR bad debt a/c and CR debtors a/c
- Doubtful debts = DR doubtful debts a/c and CR provision for doubtful debts a/c
- Recovery of cash = DR debtor a/c and CR bad debt a/c and DR cash a/c and CR debtor a/c
- Reduction in provision = DR provision for doubtful debts and CR doubtful debts a/c
- Note that the expense a/cs may be combined into one bad and doubtful debts a/c

Bad and doubtful debts

Bad debt a/c

	£		£
Debtors a/c – write off	X	Debtors a/c – recovery of cash	X
		P&L	X
	X		X

Debtors a/c

	£		£
Bal b/f	X	Bad debt a/c – Write off	X
Bad debt a/c – Recovery of cash	X	Bal c/f	X
	X		X

Provision for doubtful debts a/c

	£		£
		Bal b/f	X
Bal c/f	X	P&L (increase in provision)	X
	X		X

Study tip

Note that the bad debt and provision for doubtful debts a/cs may be combined into one bad and doubtful debts a/c

Bad and doubtful debts

Exchange of goods

- Where goods/services are used as part or full payment
- No contra should take place
- Record each transaction as full amounts in each party's books
- Bartering follows the prudence concept

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Accounting for Fixed Assets

Examining the methods of valuing assets, calculating depreciation and preparing a fixed asset register

Key study system questions

2.7 Depreciation
3.3 Record keeping
4.5 Depreciation
5.2 Record keeping
5.11 Intangible assets
5.12 Depreciation

Topics

- Depreciation
- Record keeping
- Intangible fixed assets

Depreciation

Theory

- Depreciation is the process where the cost of a tangible fixed asset is spread over its useful economic life
- Depreciation is shown as an expense in the P&L and as a provision in the BS
- BS shows the cost of the fixed asset less provision for depreciation (or accumulated depreciation), i.e. it shows the net book value (NBV)
- Depreciation is a non-cash item and does not guarantee funds remaining are being set aside for any asset replacement
- NBV does not necessarily equate to market value

Calculations of annual depreciation

- Charge using straight line method = original cost − residual value/useful economic life
- Charge using reducing balance method = % of net book value
- Charge using rate of usage method = (original cost − residual value/total output) × output for the period
- Charge using revaluation method is as above, but based on revised, rather than original, cost

Study tip

It is more common to be examined on the use of straight line and reducing balance methods

Depreciation

Acquisitions and disposals

Depreciation should normally be calculated on a pro-rata time basis for the acquisition and disposal years, but many companies base the depreciation on a full amount in the year of acquisition and none in the year of disposal

Study tip

Check the wording of the questions carefully

Balance sheet – typical layout

	Cost	Provision for dep'n	Net book value
Buildings	X	(X)	X
Fixtures and fittings	X	(X)	X
Office equipment	X	(X)	X
Vehicles	X	(X)	X
Plant	X	(X)	X
	X	(X)	X

Record keeping

Double entry

- Acquisition = DR fixed assets a/c and CR bank or creditor a/c
- Depreciation charge for the year = DR depreciation expense a/c and CR provision for depreciation a/c
- Disposal original cost = DR disposals a/c and CR fixed assets a/c
- Disposal accumulated depreciation = DR provision for depreciation a/c and CR disposals a/c
- Disposal cash = DR bank a/c and CR disposals a/c
- Close the disposals a/c by transferring the balancing figure to the P&L as a profit or a loss on disposal
- Profit on disposal is CR to P&L

Example – disposals a/c

	£		£
Fixed asset at cost a/c	X	Provision for depreciation a/c	X
		Bank	X
P&L (profit on disposal)	X	P&L (loss on disposal)	X
	X		X

Study tip

It may be quicker in examination questions to calculate profit or loss on disposal as NBV – cash proceeds from sale

Record keeping

Fixed asset register

- Used as an aid to controlling the tangible fixed assets of a business
- Usually contains description of asset, date purchased, supplier's name, cost, location, useful economic life, method of depreciation, depreciation charges, net book value, disposal details, repairs information, insurance details and asset number
- Likely to be computerised to improve accuracy, speed and report generation

Intangible fixed assets

Goodwill

- Unlike tangible assets, it does not have physical identity
- Represents, for example, brand name, management team, business contacts, staff relations
- Purchased goodwill can be valued as price paid – fair value of the assets. Since it has an objective valuation it can be recorded in the accounts
- Similar to tangible assets, the original value is reduced by the process of depreciation (except, for intangible assets, it is called amortisation instead)
- Non-purchased goodwill is a subjective judgement and thus is not recorded in the accounts

Final Accounts with Adjustments

Examining the preparation of P&L and BS from TB

Key study system questions

20 P&L and BS
27 P&L and BS

Topics

- Suggested approach
- Proforma P&L
- Proforma BS

Suggested approach

Labelling the TB

- Often presented in examination questions prior to adjustments
- Generally, DR = assets (BS) or expenses (P&L) and CR = liabilities (BS) or income (P&L)
- Includes all the transactions that have already been posted to ledger a/cs
- Could label each item with P&L or BS

Study tip

Be aware of time keeping in the examination. This exercise should be done quickly – guess or ignore an a/c if you don't recognise it

Preparing workings

- Review each post-TB adjustment (e.g. accruals/ prepayments, depreciation, bad debts, closing stock) and make the necessary calculations by showing as workings
- All workings should be shown clearly, as marks are awarded for the method employed
- Cross-reference workings appropriately

Study tip

Workings should help you complete the answer, so use a layout that you can easily read

Suggested approach

Preparing the accounts

- Once all the figures have been calculated, simply 'slot' into the relevant place in the final accounts
- If you cannot remember how to calculate a figure, simply omit it and continue with what you do know
- NB. These steps may seem a little 'over the top' for a CBA, but this is a good technique to nurture as a habit

Study tip

It is possible that a BS will fail to balance in the examination – remember to move on to the next question, rather than wasting time trying to find your error

Proforma P&L

Sales less returns		X
Less cost of sales		
Opening stock	X	
Purchases less returns	X	
Carriage inwards	X	
Closing stock	(X)	(X)
Gross profit		(X)
Less expenses, e.g.		
rent, rates, loan interest (inc. acc/ppy)		(X)
Discounts allowed and received		(X)
Carriage outwards		(X)
Bad and doubtful debts		(X)
Depreciation		(X)
Loss on disposal		(X)
Net profit		X

Study tip

Plenty of question practice consolidates knowledge of earlier topics and helps you to learn proformas

Proforma BS

	£	£	£
Fixed assets			
Buildings	X	(X)	X
Current assets			
Stock		X	
Debtors (less provision d/debts)		X	
Prepayments		X	
Bank		X	X
Current liabilities			
Creditors		(X)	
Accruals		X	(X)
Long-term liabilities			
Loan			X
			X
Financed by			
Capital			X
Profit			X
Drawings			X
			X

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Organising the Bookkeeping System

Examining the various elements of the accounting system

Key study system questions

Topics

- Organising the overall system
- Daybooks
- Cash and petty cash books
- Journals
- Stock

Organising the overall system

Dividing the ledger

- Sales/debtors ledger (personal a/cs)
- Purchases/creditors ledger (personal a/cs)
- Cashbook
- Petty cash book
- Nominal ledger

Advantages

- Easier to trace a/cs
- Develops staff expertise
- Workload can be shared
- Segregation of duties
- Allows other error/fraud prevention measures

Books of prime entry

- Sales daybook
- Purchases daybook
- Returns inwards daybook
- Returns outwards daybook
- Cashbook
- Petty cash book
- Journal

Source documents

- Evidence the details of transactions, e.g. invoices show – number, date, names and addresses, description of goods, gross/net/VAT amounts, discount details, due date

Daybooks

Recording data

- Source documents are listed in the appropriate book
- Details are entered in the relevant columns
- Figures are totalled on a regular basis

Layout includes

- Date
- Document number
- Personal details
- Goods value
- VAT amount
- Total invoice/credit note value

Ledger entries

- Individual customer/supplier entered to debtor/creditor a/c
- Totals of daybooks entered to nominal ledger
- Entries cross-referenced for ease of tracking transactions

Extended use

- Extra columns cater for the wide range of nominal ledger a/cs, as necessary

Daybooks

Extended layout includes

- Date
- Document number
- Details
- Purchases
- Stationery
- Heating and lighting
- Motor expenses
- VAT amount
- Total value

Study tip

Understanding the use of daybooks is the key to being able to answer control a/c reconciliation questions too

Cash and petty cash books

Cashbooks

- Records money paid and received
- Book of prime entry and also part of the ledger
- As well as receipts on the left (DR) and payments on the right (CR), discounts columns may also be shown
- Often show a range of analysis columns that are totalled on a regular basis

Layout includes

- Date
- Details
- Receipts from debtors
- Other income
- Total receipts
- Date
- Details
- Payments to creditors
- Petty cash transfer
- Wages
- VAT
- Sundry
- Total paid

Cash and petty cash books

Banking system

- Cheques are made out by the drawer to the payee
- Until the cash is removed from the drawer's funds, the cheque is uncleared and could even be dishonoured
- Direct debits and standing orders are automated transfers of funds
- Bank initiated transactions include bank charges

Study tip

Understanding the use of cashbooks should help in solving bank reconciliation questions too

Cash and petty cash books

Petty cash book

- Similar to the main cashbook, but it caters for small cash receipts and payments
- Usually operates on an imprest system (maintenance of an agreed fixed balance or a float)
- Petty cash vouchers act as evidence of expenditure and represent the reimbursement amount from the cash a/c

Layout includes

- Date
- Details
- Total value
- Stationery
- Cleaning
- Entertainment
- Travel
- Postage

Note

This daybook often becomes a key investigation area for auditors, as cash is viewed as high risk

Journals

Used for:

- Purchase and sale of fixed assets on credit
- Bad debt write off
- Doubtful debts provision increase/decrease
- Depreciation provision
- Accruals and prepayments
- Transfers between a/cs, such as profit and capital, drawings and capital
- Correction of errors, such as those involved in suspense a/c corrections

Authorisation

- These adjustments often have no source documentation and thus provide little audit trail
- Explanations should be as detailed as possible (in practice, but in examinations this may not be feasible)
- Signatures and cross-referencing acts as approval

Journals

Layout includes:

- Date
- Folio/reference
- Account name
- DR/CR
- Explanation
- Each journal is generally totalled to prove it balances

Study tip

Read the requirements very carefully, examination questions commonly request journals, rather than ledger entries

Stocks

Valuation

- Lower of cost and net realisable value (NRV)
- Cost includes all the costs incurred in getting the product to its present location and condition
- NRV implies final sales value, less any costs incurred in getting the product into a saleable state
- To give stocks a proper valuation will involve physical measurement of inventory (stock take)
- Details of movements of stocks are often recorded using bin cards/stores ledger cards

Study tip

You would be expected to make the decision to make the necessary adjustments, if NRV should be used rather than cost

Stocks

Methods of stock valuation

- FIFO (First in first out) means that issues are valued at old prices and thus stock is left at recent prices
- LIFO (Last in first out) means that issues are at recent prices and thus stock is left at old prices, which is not acceptable under accounting standards
- AVCO (weighted average) means that issues are at a weighted average price and thus stock valuation will be in between FIFO and LIFO figures. This weighted average price is calculated as

$$\frac{\text{Previous balance} + \text{new receipts value}}{\text{Previous units} + \text{new units}}$$

Note

This list represents those examinable, not all the methods that exist. FIFO is the most likely one used in practice, but all the three methods get examined regularly

Stocks

Store ledger card layout

- Date
- Receipts – units
- Receipts – price per unit
- Receipts – total value
- Issues – units
- Issues – price per unit
- Issues – total value
- Balance – units
- Balance – price per unit
- Balance – total value

Definitions

Receipts – goods coming into stores and thus represents purchases or returns from customers

Issues – goods sent out of stores and thus represents sales or returns to suppliers

Study tip

If you are just asked for FIFO closing stock, then a quicker working than using a stores record card would be to multiply the closing stock quantity by the most recent price(s)

Controlling the Bookkeeping System

Examining the need for and types of financial controls

Key study system questions

1.16 and 3.7	Computerisation
3.4 and 4.7	Bank reconciliations
6, 9 and 32	Suspense a/cs
7	Supplier statements
18 and 33	Control a/cs

Topics

- Errors
- Bank reconciliations
- Supplier statement reconciliations
- Control a/cs
- Suspense a/cs
- Computerisation
- Coding

Errors

Prevention

- Segregation of duties
- Organisation (including documentation)
- Authorisation procedures
- Personnel – recruitment and training
- Safeguarding assets
- Physical controls
- Accounting and arithmetic controls
- Management of staff (including supervision)

Detection

- Spot checks
- Comparison with external evidence
- Produce TB
- Bank reconciliation
- Supplier statement reconciliation
- Control a/c reconciliation
- Carry out an audit

Study tip

Consider the use of mnemonics to help memory, e.g. SOAPSPAM

Bank reconciliations

Steps

- Match the cash book items to the bank statement
- Amend the cash book for any necessary items, e.g. bank charges, dishonoured cheques
- Produce a reconciliation statement of timing differences (uncleared lodgements and/or unpresented cheques)

Study tip

Essential topic as it is highly examinable

Example bank reconciliation

Balance as per the cash book	X
Bank charges omitted	(X)
Dishonoured cheque omitted	(X)
Corrected cash book balance	X
Balance as per bank statement	X
Uncleared lodgements	X
Unpresented cheques	(X)
Balance as per corrected cash book	X

Supplier statement reconciliation

Steps

- This is done in a very similar way to bank reconciliations
- The creditors ledger control a/c is compared to the statement sent by the supplier, as opposed to the cash book (or cash a/c) being compared to the bank statement
- Any reconciling items would still be due to omitting items from the ledger, or from the timing differences

Control a/cs

Theory

- Represents total of the ledger
- Prepared using totals from the books of prime entry
- Bal b/f on the control a/c should equal the total of the individual a/cs
- If used, then individual debtors/creditors are not part of the double entry system, but recorded in memorandum

Examples

Sales ledger control a/c (SLCA)

	£		£
Bal b/f	X	Cash	X
Sales	X	Discounts allowed	X
Dishonoured		Returns inwards	X
cheque	X	Bad debts	X
		Purchase ledger	
		contra	X
		Bal c/f	X
	X		X

Study tip

The bal c/f should normally be a CR, but it is possible to find a small amount of DR (due to overpayments, for example)

Control a/cs

Purchases ledger control a/c

	£		£
Cash	X	Bal b/f	X
Returns outwards	X	Purchases	X
Discounts received	X		
Sales ledger contra	X		
Bal c/f	X		
	X		X

Study tip

The bal c/f should normally be a DR, but it is possible to find a small amount of CR (due to overpayments, for example)

Advantages of their use

- Checks the accuracy of the accounts
- Allows segregation of duties
- Reduces the volume of nominal ledger a/cs

Disadvantages

- Duplication of effort
- Reconciliations are necessary

Control a/cs

Reconciliations

- Differences may occur, due to errors in the ledgers and/or the control a/cs
- Need to check all the individual entries, casting of daybooks, totals of list of balances and transfers to control a/cs

Example

List of sales ledger balances	X
Credit balance listed as debit	(X)
Debtor omitted from list	X
Revised list	X
Balance per SLCA	X
Incorrect total in sales daybook	X
Bad debt omitted	(X)
Discounts allowed entered as DR	(X)
Balance per corrected SLCA	X

Note

The list of balances and SLCA should now balance. This is only an example – check the question for the errors found. The reconciliation of the purchase ledger control a/c would follow a similar pattern. T a/cs can also be used for the reconciliation instead

Study tip

Essential topic, as it is highly examinable

Suspense a/cs

Theory

- Used to 'plug' TB, i.e. force it to balance until errors can be found
- For example, if DRs exceed CRs, then a suspense a/c would be needed with a CR balance on it
- Journals (and ledger a/cs, if necessary) are used to make corrections

Suggested approach

- Decide what the correct entry should be
- Work out what entry was actually made
- The difference between these entries determines the correction necessary

Note

Not all corrections will affect the suspense a/c

Study tip

Highly examinable topic, as it thoroughly tests your knowledge of double entry bookkeeping

Computerisation

Advantages of computerisation

- Speed
- Flexibility
- Accuracy
- Storage facilities
- Automated checking

Study tip

This obviously leads to a lack of audit trail and thus walk through tests and computer-aided auditing techniques may become necessary

Disadvantages of computerisation

- Errors and omissions difficult to identify
- System processing difficult to follow

Typical configurations

- Mainframe + PCs
- Networked computers
- Standalone computers

Coding system

Codes should be

- Unique = only one possible code per item
- Useful = required to improve information to the users of the output
- Compact = brief enough to be learned
- Standardised = each code contains the same number and type of character
- Relevant = give some meaning by being connected to the transaction it represents
- Self-checking = validation process to give immediate feedback as to whether the code exists
- Flexible = allow expansion of the coding system

Study tip

Although a brief topic, this is commonly examined

Regulatory Framework

Examining accounting concepts, bases, policies, conventions and regulations, together with the role of an audit

Key study system questions

1.6 Roles
2.4 Concepts
3.1 Concepts
5.1 Conventions
5.4 Roles
8 Roles

Topics

- Accounting concepts, bases and policies
- Conventions
- Accounting regulations
- Roles of auditor and management

Accounting concepts, bases and policies

Concepts

- Business entity implies that the business is separate from its owners
- Money measurement refers to the fact that all events are expressed in money terms
- Cost refers to the fact that transactions are recorded at cost to maintain reliability
- Objectivity implies the need to avoid bias
- Dual aspect refers to the double effect of transactions
- Realisation implies that items are shown when realised (for example, in cash terms)
- Periodicity assumes transactions can be allocated in time
- Materiality refers to the practice of recording significant items
- Matching implies that expenses are matched to income
- Going concern assumes that the business will continue into the foreseeable future
- Consistency implies treating similar items the same way
- Prudence reflects the pessimistic view that prevents profits being overstated

Study tip

These are key terms that should be learned

Accounting concepts, bases and policies

Bases

- Methods used to apply concepts, e.g. depreciation follows the matching concept

Policies

- Actual bases chosen by organisation, e.g. straight line 25%

Conventions

Historic cost accounting

- Values based on original costs
- Can lead to overstating profits and understating assets in times of inflation

Note

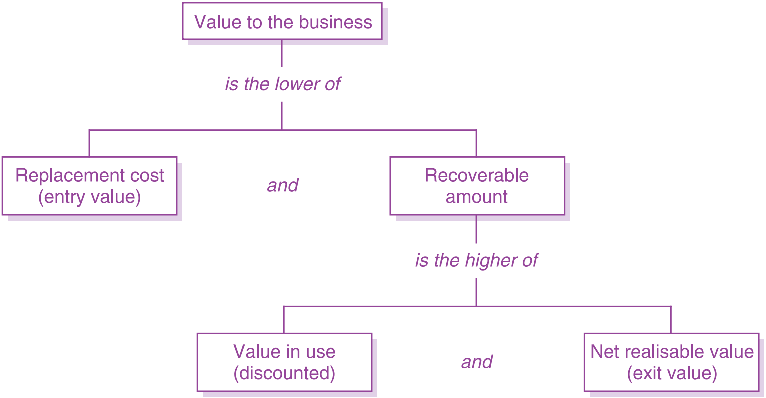
You should be able to explain these conventions, including their impact on profit and balance sheet values. Consider stock bought at the beginning of the year at £100 and what the implication is of a 10% rise in that price

Capital maintenance

- Assumes the need to maintain sufficient capital to support the desired level of activity
- Current purchasing power (CPP) = revaluation of items using Retail Price Index to reflect holding gains/losses. Monetary items would suffer losses/gains, whilst non-monetary items are assumed not to
- Current cost accounting (CCA) = revaluation of items, using specific price changes that affect that particular business, i.e. separate inflation rates for each monetary item
- Market value involves the revaluation of items to current valuation
- Economic value = future benefit derived from owners in today's terms

Conventions

Economic value to a business



Accounting regulations

Sources

- Companies Act 1985 = format and layout of company accounts and other guidance and principles
- Accounting profession and members qualified by examinations and practical experience
- Accounting standards = FRS, SSAP, SAS, GAAP, IAS
- ASB's statement of principles and guidance on presenting accounts
- IASB framework = similar guidance to ASB

Roles of auditor and management

Role of an auditor

- True and fair view = accounts fairly reflect the position of the business
- Substantive tests = checks on transactions and balances
- Compliance tests = checks on procedures
- External auditor forms opinion on financial reports (not necessarily look for fraud)
- Internal auditor = carry out checks for management and advise on systems
- VFM audit = investigation of effectiveness, efficiency and economy

Role of management

- Safeguard assets
- Act as stewards to the owners

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Incomplete Records, I&E a/c

Examining income and expenditure a/c and the preparation of accounts from incomplete information

Key study system questions

3.14 Incomplete records
5.6 I&E a/c
5.7 I&E a/c
5.8 Incomplete records
14 Incomplete records
26 I&E a/c

Topics

- Incomplete records
- Non-profit making organisations

Incomplete records

Calculating missing figures

- Use the accounting equation (assets = liabilities + capital)
- Use sales ledger control a/c or total sales a/c
- Use purchase ledger control a/c or total purchases a/c
- Use other T a/cs as appropriate
- Use bank and cash summaries

Study tip

Difficult topic, but provides an excellent revision of bookkeeping and presentation of accounts

Non-profit making organisations

Accounts

- Either receipts and payments a/c (cash items only) or income and expenditure a/c (including some accruals)
- Balance sheet

Complications

- May need to produce several separate trading a/cs (e.g. for bar or social events)
- May need to deal with accrued/deferred subscription income
- Entrance fees and life memberships need to be apportioned to I&E a/c over the period stated

Non-profit making organisations

Proforma I&E a/c

Income	
Subscriptions (W1)	X
Life memberships	X
Interest received	X
Bar profit (W2)	X
	X
Expenditure	
Dinner dance loss	(X)
Maintenance	(X)
General expenses	(X)
Depreciation	(X)
	(X)
Surplus for the year	X

Study tip

Always properly reference to any workings, e.g. W1, W2, etc.

Non-profit making organisations

Proforma BS

Fixed assets (NBV)		X
Current assets		
Bar stocks	X	
Subscriptions in arrears	X	
Bank	X	
Current liabilities		
Creditors	(X)	
Subscriptions in advance	(X)	
Accruals	(X)	
Net current assets		X
		X
Financed by		
Accumulated fund		X
Surplus for the year		X
Life membership fund		X
		X

Non-profit making organisations

W1 Bar trading a/c

Takings		X
Cost of sales		
Opening stock	X	
Purchases	X	
Closing stock	(X)	(X)
Gross profit		X
Steward's wages		(X)
Cleaning		(X)
Profit from bar		X

W2 Subscriptions a/c

	£		£
Bal b/f (reverse subs in arrears)	X	Bal b/f (reverse subs in advance)	X
I&E a/c	X	Cash	X
Bal c/f (subs in advance)	X	Bal c/f (subs in arrears)	X
	X		X

Manufacturing a/c

Examining the preparation of the manufacturing a/c

Key study system questions

2.10 Manufacturing a/c
3.12 Manufacturing a/c
4.12 Manufacturing a/c
5.9 Manufacturing a/c

Topics

- Theory
- Proformas

Theory

Salient points

- Forms a necessary preliminary statement to the trading a/c for a business that makes in-house goods for resale
- Stocks may include raw materials, work-in-progress, finished goods and bought-in goods
- Statement shows only costs
- Ledger a/cs as usual, but may apportion some costs
- Manufacturing a/c = part of double entry

Definitions

Direct costs – attributable to product and includes material, labour and expenses

Prime cost – total of direct costs

Indirect costs – overheads

Factory costs – direct costs + factory overheads

Work-in-progress (WIP) – part complete units

Proformas – Manufacturing a/c

Opening stock – raw material		X
Purchases – raw material		X
Closing stock – raw material		(X)
Raw material consumed		X
Direct labour		X
Direct expenses		(X)
Prime cost		X
Production overheads	X	
e.g. factory rates, heating	X	(X)
Factory cost		X
Opening WIP		X
Closing WIP		(X)
Factory cost of goods completed (to transfer to trading a/c)		X

Study tip

This simply collects the factory costs together

Proformas – Manufacturing a/c

Trading account

Sales	X	
Less returns inwards	(X)	
Net sales		X
Less cost of sales		
Opening stock of finished goods	X	
Factory cost of goods completed	X	
Closing stock of finished goods	(X)	
Cost of sales		(X)
Gross profit		X

Study tip

Almost the same as that for a sole trader, but purchases are replaced with the total from the manufacturing a/c

Proformas – Manufacturing a/c

P&L

Gross profit	(X)
Less expenses, e.g.	
Wages	(X)
Heating and lighting	(X)
Administration	(X)
Rent	(X)
Discounts allowed and received	(X)
Carriage outwards	(X)
Net profit	X

Note

It is possible that an examination question would give a total figure, e.g. heating and lighting, that you would need to split across factory (thus manufacturing a/c) and warehouse/offices (P&L). This percentage split would have to be given in the question

Study tip

This is essentially the same as for the sole trader

Proformas – Manufacturing a/c

BS

Balance Sheet as at . . .	£000	£000
Fixed assets		
Buildings	X	
Equipment	X	
Current assets		X
Stock – raw materials	X	
Stock – WIP	X	
Stock – Finished goods	X	
Debtors	X	
Bank/cash	X	
	X	
Current liabilities		
Creditors	(X)	
Bank overdraft	(X)	
Net current assets		X
Long-term liabilities		
Bank loan		(X)
Net assets employed		X
Financed by		
Capital		X
Profit		X
Drawings		(X)
		X

Study tip

The major difference from the sole trader is the inclusion of various types of stock

Accounts of Limited Companies

Examining the preparation of financial statements for limited companies

Key study system questions

12 Company accounts
16 Cash-flows
17 Company accounts
21 Cash-flows
25 Company accounts
30 Company accounts

Topics

- Comparison to a sole trader
- Sources of finance
- Proformas
- Cash-flows

Comparison to sole trader

Legal position

- Company = separate legal entity and pays corporation tax on earnings (shown in P&L)
- Sole trader = owner and manager and pays income tax on profits (as personal tax only)

Accounting statements

- Company shows appropriation a/c (movement on reserves)
- Company follows strict layout (not fully examinable – internal, not published accounts, could be assessed)

Owners return

- Company = dividends (interim paid and final proposed) that are shown in the P&L (both) and the BS liabilities (proposed)
- Sole trader = drawings shown in the BS in the capital section

Sources of finance

Debentures

- Loan usually secured on fixed assets
- Interest is generally fixed percentage of capital
- Details of repayments may be given
- Capital shown in the BS as liability – creditors less than, or more than one year, as appropriate
- Interest is shown in the P&L as an expense (on an accrual basis)
- For example, if 10% debenture = £20,000, then £2000 (i.e. 10% × 20000) should appear in the P&L, so, if only £500 has been paid, it automatically means that £1500 must be accrued

Study tip

The most commonly omitted item in BS examination answers is accrued interest

Sources of finance

Ordinary share capital

- Equity shareholders often entitled to vote, but risk no dividend return and no priority over funds on break-up
- Dividend charge = number of shares × price per share (accruals basis)
- Show called up share capital and share premium as separate figures in BS
- Authorised share capital = amount the company is allowed to issue = for information only

Preference share capital

- Shareholders have fixed return and priority on break-up, but not involved in the management of the business
- Dividend charge = % × share value (accruals basis and prior to ordinary dividends)

Reserves

- Capital and statutory (non-distributable)
- Revenue (distributable)

Proformas

Profit and loss a/c

Turnover	X
Cost of sales	(X)
Gross profit	X
Distribution costs	(X)
Administrative expenses	(X)
Interest payable	(X)
Net profit before tax	X
Taxation	(X)
Profit after tax	X
Dividends	(X)
Retained profit for the year	X
Transfer to reserves	(X)
Retained profit b/f	X
Retained profit c/f	X

Calculations

⇨ Expenses should ideally be split into factory (cost of sales), sales and marketing (distribution) and others (administration), but this is not essential

⇨ Taxation may include provision for the current year, adjusted by over/under provision for the previous year

⇨ Dividends include interim paid and final proposed

Proformas

Balance sheet

Fixed assets – tangible			X
Fixed assets – intangible			X
Current assets			
Stocks	X		
Debtors	X		
Bank	X	X	
Creditors < 1 year			
Trade creditors	(X)		
Taxation	(X)		
Proposed dividends	(X)	(X)	
Net current assets			X
Total assets – current liabilities			X
Creditors > 1 year = debenture			(X)
			X
Share capital			X
Share premium			X
Retained profit c/f			X
			X

Study tip

Take care with creditors less than 1 year, as this is the most common area for errors

Cash-flows

Net cash-flow from operating activities

- Start cash-flow with actual cash from operations
- Note that profit does not equal cash due, e.g. to accruals, depreciation, raising of finance
- Direct method = use bank and cash a/cs
- Indirect method = use P&L profit figure and then adjust to get the cash figure (preferred method)

Note

This statement adds back to the profit figure items not realised in cash. The items would be deducted if they were the opposite movements, e.g. increase in stocks. It is possible that operating profit may need to be calculated as a separate workings first (e.g. profit after tax, add back tax and interest)

Reconciliation proforma

Operating profit (PBIT)	X
Depreciation	X
Amortisation	X
Loss on disposal	X
Decrease in stocks	X
Decrease in debtors	X
Increase in trade creditors	X
Net cash flow	X

Cash-flows

Cash-flow proforma

Net cash-flow	X
Interest paid	(X)
Tax paid	(X)
Dividends paid	(X)
Purchase fixed assets	(X)
Disposal of fixed assets	X
Issue of shares	X
Repayment of debenture	(X)
Net increase in cash	X

Calculations

- Each figure should be the actual cash paid or received, so a working may be necessary to adjust the P&L figure by any accruals
- Using the movement on the bank and cash a/cs, it is possible to check the final net increase

Interpretation of Accounts

Examining basic ratios

Key study system questions

2.13	Efficiency
3.15	Efficiency
4.13	Profitability
4.14	Capital structure
4.15	Liquidity
10	Profitability
19	Various ratios

Topics

- Ratio analysis
- Profitability ratios
- Liquidity ratios
- Efficiency ratios
- Capital structure ratios

Ratio analysis

Why?

- To give additional information to different users of the accounts
- Calculated ratios + meaning = interpretation

Calculations

- Compare to budget or government statistics, or another time period, or another company
- Use % or X:1 or times

Types

- Performance or profitability
- Solvency or liquidity (short term)
- Efficiency or working capital (employment of assets)
- Gearing or capital structure (long-term liquidity)

Profitability ratios

Gross profit margin

- Gross profit/sales × 100
- Increase could be due to selling price increase, sales volume increase, cost reduction, e.g. discounted materials, less skilled labour, increase in stocks (valuation or quantity)

Net profit margin

- Net profit/sales × 100
- Increase could be due to above and/or decrease in other expenses, e.g. bad debt write offs, advertising spend, legal fees

Return on capital employed (ROCE)

- Operating profit/(shareholders funds + debentures) × 100
- There are many variations of this formula
- Increase could be due to higher profits (as above) or lower capital employed, e.g. due to high depreciation charges

Study tip

Check the question carefully for the examiner's preferred formula, if given

Liquidity ratios

Current ratio/working capital ratio

- Current assets/current liabilities: 1
- High ratio implies that future cash outlays can easily be met with the incoming cash, but it depends on the make up of assets and liabilities and may imply inefficient use of working capital

Quick ratio/liquid ratio/acid test

- (Current assets – stock)/Current liabilities: 1
- This has a similar interpretation to the above, but should exclude slow cash conversion items

Efficiency ratios

Asset turnover

- Sales/assets
- High figure means high sales are generated from the asset base and could imply good use of resources or low assets, due to high depreciation or lack of investment

Stock turnover

- Cost of sales/average stock = times per annum
- Average stock/cost of sales $\times$ 365 = days held
- Increase in stock days may be due to holding stock for a longer time to satisfy new customers, reduce ordering costs, a change in buying patterns. It can lead to higher insurance costs, risk of obsolescence, etc.

Debtor collection days

- Debtors/sales $\times$ 365
- Increase may be due to poor debt collection, inaccurate invoicing, new customers, extended credit terms, changes in regulations, such as VAT

Efficiency ratios

Creditor payment days

- Trade creditors/purchases × 365
- Increase may be due to taking advantage of longer credit terms, etc., but could lead to problems, such as supply stoppages and court action for recovery of cash

Total working capital

- Stock days + debtor days − creditor days
- Reflects the cash conversion cycle
- Increase may indicate a need to raise finance

Capital gearing ratios

Gearing ratios

- Equity gearing = debt/equity × 100
- Total gearing = debt/(debt + equity) × 100
- Reflects the prior charge or debt-sourced finance (e.g. preference share capital + debentures) to equity-sourced finance (e.g. ordinary share capital + reserves)
- High gearing implies greater risk to the ordinary shareholder, since profits will be used to 'fund' preference dividends and interest payments first. Loans may also be secured on fixed assets
- Management should make extra effort to create profits to cover these fixed charges and also maintain the fixed asset base. This could mean that ordinary shareholders gain high returns

Interest cover

- Operating profit/interest payable
- Reflects how comfortably the business is able to meet its interest charges

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