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CIMA Certificate in Business Accounting 2006 Syllabus

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Fundamentals of Financial Accounting

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Fundamentals of Financial Accounting

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CIMA Certificate in Business Accounting C02

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Elsevier Butterworth-Heinemann
Linacre House, Jordan Hill, Oxford OX2 8DP
30, Corporate Drive, Burlington, MA 01803

First published 2006

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data
A catalogue record for this book is available from the Library of Congress

ISBN 10: 0 7506 8104 7
ISBN 13: 978 0 7506 8104 9

For information on all Elsevier Butterworth-Heinemann publications visit our website at http://books.elsevier.com

Printed and bound in Great Britain

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- Refer to relevant questions found within the Preparing for the Examination section of the Learning System
- Provide you with plenty of exam tips and hints

Ensure exam success by revising with the only revision cards endorsed by CIMA.

TABLE OF CONTENTS

About the Assessment

- Taking the exam
- Weighting of subjects

Weighting of subjects

- Computer-based assessment lasting two hours
- Attempt all questions. There are 50, mostly worth 2 marks each, with a few longer questions worth 4 or 6 marks
- You are allowed to take a non-programmable calculator into the assessment
- You will be provided with paper for workings and the following tables:- Logarithms; Normal Distribution; Present Values; Cumulative Present Values
- You will also be provided with a list of key formulae
- The questions in the assessment closely mirror the weighting of subjects

Conceptual and regulatory framework	20%
Accounting systems	20%
Control of accounting systems	15%
Preparation of accounts for single entries	45%

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The Accounting Scene

Examining the objectives of accounting information

Key learning system questions

1.12 Users
1.13 Characteristics

Topics

- Who uses financial statements (FS)?
- Qualitative characteristics of FS
- Financial vs management accounting
- What is a business organisation?

Who uses FS?

User groups

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

Definition

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

Study tip

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

Qualitative characteristics of FS

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 Financial Statements (FS)

Examining the basic concepts involved in the preparation of FS

Key learning system questions

3.2 Key features

Topics

- Basic concepts
- The balance sheet
- The income statement
- 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.

Assets = Capital + 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 non-current) and goodwill (intangible non-current assets); or held on a short-term basis (current assets) e.g. receivables and inventories

Liabilities – obligations of the business to transfer economic benefit as a result of past events. These may also be non-current (more than one year) or current (less than one year) and include payables 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

HiTech Engineering

Balance Sheet as at date	$000	$000
Assets		
Non-current assets		
Buildings	X	
Equipment	X	
		X
Current assets		
Inventories	X	
Receivables	X	
Bank/cash	X	
		X
		X
Capital and liabilities		
Capital		X
Non-current liabilities		
Bank loan		X
Current liabilities		
Trade payables	X	
Other payables	X	
		X
		X

Note

You should study this layout very carefully

You should note:

- The name of the business
- The title – balance sheet as at date
- The currency – $000

The income statement

- The headings, e.g. Assets, Capital
- The inset of figures, e.g. buildings and equipment
- The underlining and sub-totals

HiTech Engineering

Income statement for year ending date	\$000	\$000
Sales		X
Opening inventories	X	
Purchases	X	
Closing inventories	(X)	
Cost of goods sold		X
Gross profit		X
Less expenses		X
Net profit		X

Note

Sales represents the revenue 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 receivables on the balance sheet
- Suppliers may remain unpaid as payables
- 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 non-current 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 income statement(IS)

Accounting System in Action

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

Key learning system questions

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

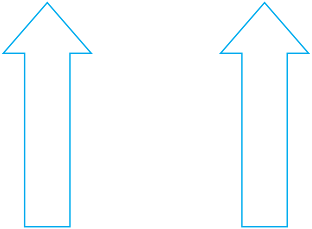
Topics

- Double entry
- Balancing off the ledger accounts

Double entry

General rules

DR	CR
Asset/Expense	Liability/Capital/Revenue



Study tip

Vice versa for decreases

Double entry

Trade goods – purchases

Purchases a/c

	$		$
Payable	X		

Payable a/c

	$		$
		Purchases	X

Trade goods – sales

Receivable a/c

	$		$
Sales	X		

Sales a/c

	$		$
		Receivable	X

Double entry

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, similar to bank statement style a/cs

Balancing off the ledger accounts

Purpose

- To establish a balance at any point in time

Calculation

- Add the figures on each side
- Enter the larger amount in as a total
- Balance the opposite side by entering the balancing figure
- This represents either a balance carried forward (bal c/f) or transfer to the income statement
- 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), income statement (IS) and balance sheet (BS)

Key learning system questions

1.5	IS
2.2	TB
2.12	BS
3.8	TB
4.4	TB
5.5	BS

Topics

- Preparation of the TB
- Preparation of the IS
- Preparation of the BS

Preparation of the TB

Example

	DR	CR
Capital		X
Cash	X	
Bank overdraft		X
Purchases	X	
Payable		X
Receivable	X	
Sales		X
Opening inventories	X	
Rent	X	
Wages	X	
Buildings	X	
Drawings	X	
Total	X	X

Study tip

Remember the general bookkeeping rules,
DR = expense/asset whilst
CR = revenue/capital/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 IS

Trading account

Compares trading sales with cost of sales. 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

JW Engineering
Income Statement
Year ended 31 December 20X7
Trading account – layout

	$000	$000	$000
Sales		X	
Less returns inwards		(X)	
Net sales			X
Less cost of sales			
Opening inventories		X	

Preparation of the IS

Purchases	X		
Less returns outwards	(X)		
Net purchases		X	
Carriage inwards		X	
Closing inventories		(X)	
Cost of sales			(X)
Gross profit			X

Gross profit	X
Less expenses e.g.	
Wages	(X)
Rent	(X)
Net discounts allowed/received	(X)
Carriage outwards	(X)
Net profit	X

Study tip

This may be examined as the whole of the IS, or just the trading account part, or just from gross profit onwards

Preparation of the IS

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 IS. 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 IS and also reduce the receivable (discounts allowed) or payable (discounts received)
- The balance on the IS is transferred to the capital a/c at the end of the year

Preparation of the BS

BS layout

JW Engineering		
Balance Sheet as at 31 Dec 20X7	$000	$000
Assets		
Non-current assets		
Buildings	X	
Equipment	X	
		X
Current assets		
Inventories	X	
Receivables	X	
Bank/cash	X	
		X
		X

Capital and liabilities		
Capital		X
Profit		X
Drawings		(X)
		X
Long-term liabilities		
Bank loan		X
Current liabilities		
Payables	X	
Bank overdraft	X	
		X
		X

Preparation of the BS

Notes

- Bal b/f remaining on TB following IS 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

Further Aspects of Ledger Accounting

Examining the preparation of accounts for indirect taxes, payroll, accruals and prepayments, bad debts and allowance for receivables

Key learning system questions

2.3	Sales tax
2.14	Sales tax
3.9	Accruals
4.6	Payroll
5.13	Bad debts
34	Accruals

Topics

- Sales tax
- Payroll
- Accruals and prepayments
- Bad debts
- Allowance for receivables a/c

Sales tax

Theory

- Sales tax on some items, for example, in the UK the purchase of new cars and the amount spent on entertaining expenses, cannot be reclaimed and therefore must be included in the cost of the items
- Non-registered businesses and exempt supplies (e.g. gambling) cannot claim input sales tax since they do not charge it. This results in all costs being shown inclusive of sales tax. No sales tax a/c needs to be maintained
- Zero-rated businesses charge 0% and therefore can claim input sales tax on purchases. The balance on the sales tax a/c would be DR and thus appears under current assets in the BS

Bookkeeping for sales tax

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

Sales tax

Sales tax a/c

	$		$
Payables a/c	X	Receivables a/c	X
Bal c/f (owed by tax authorities)	X	Bal c/f (owed to tax authorities)	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
- Employees' income tax/employees' social security = CR tax authority a/c
- Pension = CR payable a/c
- Other deductions = CR relevant payable a/c
- Employers social security = DR wages a/c and CR tax authorities 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 IS expenses
- Prepaid expenses are those charged in advance by suppliers and should be reflected as an asset in the BS and a reduction in IS 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 convention should a conflict arise. This is particularly common with revenue which should not be accrued unless reasonably certain of its receipt

Study tip

These accounting conventions 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 revenue = CR revenue a/c and DR accrued revenue a/c
- Prepaid revenue = DR revenue a/c and CR deferred revenue 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 revenue 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 IS and BS

Bad debts

Allowance for receivables

Theory

- Bad debts are those receivables, certain not to pay and should be written off to the IS and the receivable (reducing current assets in the BS)
- Receivables felt not likely to pay should be written off to the IS and used to create an allowance which acts to reduce current assets in the BS
- Allowance for receivables = specific allowance (known customer) + general allowance (% of remaining receivables)
- Any subsequent cash recovered from a bad debt effectively reverses the entry. No specific entry is necessary in the case of the allowance for receivables

Bookkeeping

- Bad debts = DR bad debt a/c and CR receivable a/c
- Doubtful debts = DR bad debts a/c and CR allowance for receivables
- Recovery of cash = DR receivable a/c and CR bad debt a/c and DR cash a/c and CR receivable a/c
- Reduction in allowance = DR allowance for receivables and CR bad debts a/c
- Note that the expense a/cs may be shown separately as ‘bad debts’ and ‘change in allowance for receivables’

Bad debts

Bad debts a/c

	$		$
Receivables a/c – write off	X	Receivables a/c – recovery of cash	X
		IS	X
	X		X

Receivables a/c

	$		$
Bal b/f	X	Bad debts a/c – write off	X
Bad debts a/c – recovery of cash	X	Bal c/f	X
	X		X

Allowance for Receivables a/c

	$		$
		Bal b/f	X
Bal c/f	X	IS (increase in allowance)	X
	X		X

Study tip

Note that the 'bad debts' and 'change in allowance for receivables' a/cs may be combined into one bad debts a/c

Allowance for receivables a/c

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 parties books
- Bartering follows the prudence convention

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Accounting for Non-current Assets

Examining the methods of accounting for assets, calculating depreciation and preparing a non-current asset register

Key learning 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 non-current assets

Depreciation

Theory

- Depreciation is the process where the cost of a tangible non-current asset is spread over its useful life
- Depreciation is shown as an expense in the IS and as accumulated depreciation in the BS
- BS shows the cost of the non-current asset less accumulated depreciation, i.e. it shows the carrying amount
- Depreciation is a non-cash item and does not guarantee funds remaining are being set aside for any asset replacement
- Carrying amount does not necessarily equate to fair value

Calculations of annual depreciation

- Charge using straight line method = original cost − residual value/useful life
- Charge using reducing balance method = % of carrying amount
- Charge using machine hour/units of production method = (original cost − residual value/total output) × output for the period
- Charge for small-asset values is as above but based on revised, rather than original cost. This may be referred to as the 'revaluation method'

Study tip

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

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	Accum. dep'n	Carrying amount
Buildings	X	(X)	X
Fixture 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 non-current assets a/c and CR bank or payable a/c
- Depreciation charge for the year = DR depreciation expense a/c and CR accumulated depreciation a/c
- Disposal original cost = DR disposals a/c and CR non-current assets a/c
- Disposal accumulated depreciation = DR accumulated 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 IS as a profit or loss on disposal
- Profit on disposal is CR to IS

Example – disposals a/c

	$		$
Non-current asset at cost a/c	X	Accum. depreciation a/c	X
		Bank	X
IS (profit on disposal)	X	IS (loss on disposal)	X
	X		X

Study tip

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

Record keeping

Non-current asset register

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

Intangible non-current assets

Goodwill

- Unlike tangible assets it does not have physical substance
- Represents for example brand name, management team, business contacts, staff relations
- Purchased goodwill can be valued as price paid – fair value of the assets less liabilities. Since it has an objective valuation it can be recorded in the financial statements
- Goodwill is not amortised, but is subject to annual impairment review (impairment is ‘carrying amount’ less ‘lower revised value’)
- Non-purchased goodwill is a subjective judgement and thus is not recorded in the financial statements

Other Intangibles

- Other intangible non-current assets, e.g. patents, are stated in the BS at cost and ‘depreciated’, except that for intangibles it is called amortisation instead

Preparation of Financial Statements with Adjustments

Examining the preparation of IS and BS from TB

Key learning system questions

20 IS and BS
27 IS and BS

Topics

- Suggested approach
- Proforma IS
- Proforma BS

Suggested approach

Labelling the TB

- Often presented in computer-based assessment (CBT) questions prior to adjustments
- Generally, DR = assets (BS) or expenses (IS) and CR = capital (BS); liabilities (BS); or revenue (IS)
- Includes all transactions that have already been posted to ledger a/cs
- Could label each item with IS or BS

Study tip

Be aware of time keeping in the CBT. 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 inventories) and make the necessary calculations by showing as workings
- All workings should be shown clearly
- 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 financial statements

- Once all the figures have been calculated, simply 'slot' into the relevant place in the financial statements
- If you cannot remember how to calculate a figure simply omit it and continue with what you 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 CBA – remember to move on to the next question rather than wasting time trying to find your error

Proforma IS

Sales less returns		X
Less cost of sales		
Opening inventories	X	
Purchases less returns	X	
Carriage inwards	X	
Closing inventories	(X)	(X)
Gross profit		(X)
Less expenses e.g.		
Rent, loan interest (inc. acc/ppy)		(X)
Discounts allowed and received		(X)
Carriage outwards		(X)
Bad 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

Assets			
Non-current assets	$	$	$
Buildings	X	(X)	X
Current assets			
Inventories		X	
Receivables (less allowance)		X	
Prepayments		X	
Bank		X	
			X
			X

Capital and liabilities		$
Capital		X
Profit		X
Drawings		(X)
		X
Non-current liabilities		
Loan		X
Current liabilities		
Creditors	X	
Accruals	X	X
		X

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Organising the Bookkeeping System

Examining the various elements of the accounting system

Key learning system questions

3.10	Cashbooks
5.3	Petty cash
15	Daybooks
24	Daybooks
29	Inventories

Topics

- Organising the overall system
- Daybooks
- Cash and petty cashbooks
- Journals
- Inventories

Organising the overall system

Dividing the ledger

- Sales/receivables ledger (personal a/cs)
- Purchases/payables ledger (personal a/cs)
- Cashbook
- Petty cashbook
- 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 cashbook
- Journal

Source documents

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

Daybooks

Recording data

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

Layout includes

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

Ledger entries

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

Daybooks

Extended use

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

Extended layout includes

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

Study tip

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

Cash and petty cashbooks

Cashbooks

- Records money paid and received
- Book of prime entry and also part of the ledger
- As well as receipts on left (DR) and payments on 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 customers
- Other revenue
- Total receipts
- Date
- Details
- Payments to suppliers
- Petty cash transfer
- Wages
- Sales tax
- Sundry
- Total paid

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

Cash and petty cashbooks

Study tip

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

Petty cashbook

- Similar to the main cashbook but it caters for small cash receipts and payments
- Usually operates on an imprest system (maintenance of agreed fixed balance or 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 non-current assets on credit
- Bad debt write off
- Allowance for receivables
- Depreciation
- Accruals and prepayments
- Transfers between a/cs such as IS 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 the computer-based assessment 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

Inventories

Measurement

- Lower of cost and net realisable value (NRV)
- Cost includes all 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 inventories a proper valuation will involve physical inventory count
- Details of movements of inventories 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

Cost formula – note: cost formulas are methods of valuing inventories

- FIFO (first in first out) means that issues are valued at old prices and thus inventory is left at recent prices
- LIFO (last in first out) means that issues are at recent prices and thus inventory is left at old prices. Note – LIFO not acceptable for external financial statements

Inventories

- AVCO (weighted average) means that issues are at a weighted average price and thus inventories 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 three formulas get examined regularly

Store ledger card layout

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

Inventories

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 inventories then a quicker working than using a stores record card would be to multiply the closing stock quantity by the most recent price(s)

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Controlling the Bookkeeping System

Examining the need for and types of financial controls

Key learning 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 system

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 cashbook items to the bank statement
- Amend the cashbook 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 cashbook	X
Bank charges omitted	(X)
Dishonoured cheque omitted	(X)
Corrected cashbook balance	X
Balance as per bank statement	X
Uncleared lodgements	X
Unpresented cheques	(X)
Balance as per corrected cashbook	X

Supplier statement reconciliations

Steps

- This is done in a very similar way to bank reconciliations
- The payables (or purchase) ledger control a/c is compared to the statement sent by the supplier as opposed to the cashbook (or cash a/c) being compared to the bank statement
- Any reconciling items would still be due to omitting items from the ledger or 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 receivables/payables are not part of the double entry system but recorded in memorandum

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 e.g.)

Examples

Sales ledger control a/c (SLCA)

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

Control a/cs

Purchase 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 e.g.)

Advantages of their use

- Checks the accuracy of the ledger 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 individual entries, additions in 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 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

Disadvantages of computerisation

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

Study tip

This obviously leads to a lack of audit trail

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 learnt
- 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 conventions, together with the role of audit

Key learning system questions

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

Topics

- Conventions
- Accounting regulations
- Roles of auditor and management

Accounting conventions

Conventions

- 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
- Historical 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
- Accruals and matching implies that expenses are matched to income
- Stable monetary unit means that inflation is ignored.
- Going concern assumes that the business will continue into the foreseeable future
- Consistency implies treating similar items, the same way
- Prudence reflects the view that prevents profits/ assets being overstated and expenses/liabilities being understated

Accounting conventions

Study tip

These are key terms that should be learnt

Policies

- Methods used when calculating the assets and liabilities, revenue and expenses, in the financial statements

Estimation techniques

- Specific methods of making estimates when applying policies, e.g. straight line depreciation 25%

Conventions

Historical 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 inventories bought at the beginning of the year at $100 and what the implication is of 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 item
- Fair value involves the revaluation of items to what they could be sold for
- Value in use = future benefit derived from an asset in today's terms

Value to the business

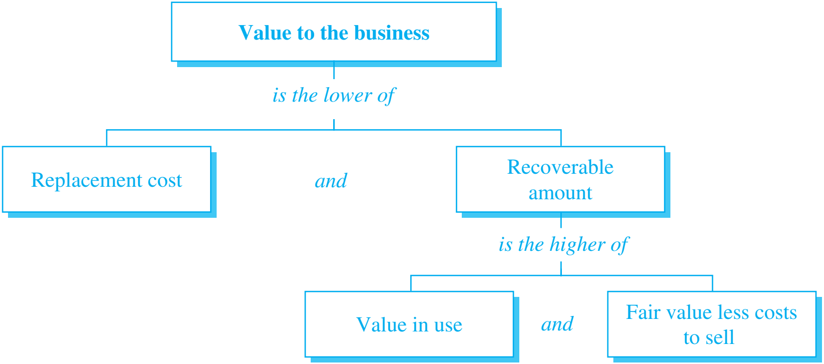

Figure 10.1 Value to the business

Accounting regulations

Sources

- Company law = format and layout of company accounts and other guidance and principles
- Accounting profession and members qualified by examinations and practical experience
- Accounting standards = IFRS, IAS
- IASB 'Framework' = underlies all accounting standards and future standards

Roles of auditor and management

Role of auditor

- True and fair view (or fair presentation) = 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 statements (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 FS

Examining income and expenditure FS and the preparation of financial statements from incomplete information

Key learning system questions

3.14	Incomplete records
5.6	I&E FS
5.7	I&E FS
5.8	Incomplete records
14	Incomplete records
26	I&E FS

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 excellent revision of bookkeeping and presentation of financial statements

Non-profit-making organisations

Financial statements

- Either receipts and payments (cash items only) or income and expenditure (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 FS over period stated

Proforma I&E FS

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

Non-profit-making organisations

Study tip

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

Proforma BS

Assets

Non-current assets (carrying amount)		X
Current assets		
Bar inventories	X	
Subscriptions in arrears	X	
Bank	X	
		X
		X

Accumulated fund and liabilities

Accumulated fund		X
Surplus for the year		X
Life membership fund		X
		X
Current liabilities		
Creditors	X	
Subscriptions in advance	X	
Accruals	X	
		X
		X

Non-profit-making organisations

W1 bar trading a/c

Takings		X
Cost of sales		
Opening inventories	X	
Purchases	X	
Closing inventories	(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	X	Cash	X
Bal c/f (subs in advance)	X	Bal c/f (subs in arrears)	X
	X		X

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Manufacturing a/c

Examining the preparation of the manufacturing a/c

Key learning 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 part of the income statement for a business that makes in-house goods for resale
- Inventories may include raw materials, work-in-progress, finished goods and bought-in goods
- Statement shows only expenses
- Ledger a/cs as usual but may need to apportion some expenses
- Manufacturing a/c = part of double entry

Definitions

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

Prime cost – total of direct expenses

Indirect costs – overheads

Factory costs – direct costs + factory overheads

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

Proforma – Income statement

Sales			X
Less returns inwards			(X)
Net sales			X
Opening stock of finished goods		X	
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 overhead			
e.g. factory rent, heating	X		
Factory cost	X		
Opening WIP	X		
Closing WIP	(X)		
Factory cost of goods completed		X	
		X	
Less closing inventories of finished goods		(X)	
Cost of goods sold			X
Gross profit			X

Study tip

The manufacturing account collects the factory expenses together

Proforma – Income statement

Study tip

The trading account almost the same as that for a sole trader but 'purchases' are replaced by 'factory cost of goods completed'

Income statement (continued)

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 a computer-based assessment question would give a total figure for say heating and lighting that you would need to split across factory (thus manufacturing a/c) and warehouse/ offices (S&D and Admin. in IS.). This percentage split would be given in the question

Study tip

From gross profit to net profit is essentially the same as for the sole trader

Proforma – Balance sheet

BS

Balance sheet as at.	$000	$000
Assets		
Non-current assets		
Buildings	X	
Equipment	X	
		X
Current assets		
Inventories – raw materials	X	
Inventories – WIP	X	
Inventories – finished goods	X	
Receivables	X	
Bank/cash	X	
		X
		X
Capital and liabilities		
Capital		X
Profit		X
Drawings		X
		X
Non-current liabilities		
Bank loan		X
Current liabilities		
Payables	X	
Bank overdraft	X	
		X
		X

Study tip

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

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Financial Statements of Limited Companies

Examining the preparation of financial statements for limited companies

Key learning system questions

Topics

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

Comparison to sole trader

Legal position

- Company = separate legal entity and pays income tax on company profits (shown in IS)
- Sole trader = owner and manager and pays personal tax on profits (because it is personal tax, it does not appear in the financial statements)

Accounting statements

- Company has a statement of changes in equity (SCE) (movement on equity during the year)
- Company financial statements follow strict layout (not fully examinable – internal rather than published financial statements are assessed in the CBA)

Owners return

- Company = dividends (interim paid and final declared) that are shown in the SCE (both) and the BS liabilities (declared)
- Proposed dividends are ignored – they are not recognised in financial statements until they are declared or paid
- Sole trader = drawings shown in the BS in the capital section

Sources of finance

Debentures

- Loan usually secured on non-current assets
- Interest is generally fixed percentage of loan
- Details of repayments may be given
- Loan shown in the BS as liability – current or non-current as appropriate
- Interest is shown in the IS as an expense (on an accrual basis)
- For e.g. if 10% debenture = \$20,000, then \$2000 (i.e. 10% × 20,000) should appear in the IS 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 × dividend per share
- 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 nominal value
- Learning System (LS) assumes all preference shares are irredeemable; preference dividends in the LS will always be paid; no need to make any adjustment for accruals

Reserves

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

Proformas

Income statement

Turnover	X
Cost of sales	(X)
Gross profit	X
Distribution costs	(X)
Administrative expenses	(X)
Operating profit	X
Interest receivable	X
Interest payable	(X)
Profit before tax	X
Income tax	(X)
Profit for the period	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 accrual for the current year adjusted by over/under provision for the previous year

Statement of changes in equity

	Share Capital	Share Premium	General Reserve	Retained Earnings	Total
Balance at start of period	X	X	X	X	X
Profit for the period				X	X
Dividends paid/declared				(X)	(X)
Transfer to General Reserve			X	(X)	
Issue of shares	X	X			X
Balance at end of period	X	X	X	X	X

- ⇨ Dividends could include: interim paid current year; final declared current year (if any); final proposed last year, paid in current year
- ⇨ Dividends will **not** include any proposed dividends in the current year

Proformas

Balance sheet

Assets		
Non-current assets – tangible		X
Non-current assets – intangible		X
		X
Current assets		
Inventories	X	
Receivables	X	
Bank	X	
		X
		X
Equity and liabilities		
Share capital		X
Share premium		X
Retained earnings		X
		X
Non-current liability		
Debenture		X
Current liabilities		
Trade payables	X	
Income tax	X	
Declared dividends	X	
		X
		X

Study tip

Take care with current liabilities as this is the most common area for errors

Cash flows statements

Cash flows from operating activities

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

Reconciliation proforma

Cash flows from operating activities		
Operating profit		X
Depreciation		X
Amortisation		X
Loss on disposal		X
Decrease in inventories		X
Decrease in receivables		X
Increase in payables		X
Cash generated from operations		X
Interest paid		(X)
Income tax paid		(X)
		X
Cash flows from investing activities		
Purchase of non-current assets	(X)	
Proceeds sale of non-current assets	X	
Interest received	X	
Dividends received	X	
		X

Cash flows statements

Cash flows from financing activities		
Proceeds from issue of shares	X	
Proceeds from issue of loans	X	
Repayment of loans	(X)	
Dividends paid	(X)	
		X
Net increase/decrease in cash		X
Cash at beginning of period		X
Cash at end of period		X

Calculations

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

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Interpretation of Financial Statements

Examining basic ratios

Key learning 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 FS
- 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

- Profitability or performance
- Liquidity or solvency
- Efficiency – non-current assets and working capital (employment of assets)
- Capital structure (long-term liquidity)

Profitability ratios

Gross profit margin

- Gross profit/sales $\times$ 100
- Increase could be due to e.g. selling price increase, cost reduction, discounted materials

Operating profit margin

- Operating profit/sales $\times$ 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/(equity + debentures) $\times$ 100
- Increase could be due to higher profits (as above) or lower capital employed e.g. repayment of debentures

Return on equity (ROE)

- Profit for the period/equity
- Decrease could be due to lower profit, or higher equity e.g. after issue of shares

Study tip

Check the question carefully to see which return on capital ratio is required

Liquidity ratios

Current ratio/working capital ratio

- Current assets/current liabilities : 1
- High ratio implies the 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 – inventories)/Current liabilities : 1
- This has a similar interpretation to above but excludes slow cash conversion item of inventories

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

Inventories days

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

Receivables days

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

Efficiency ratios

Payables days

- Trade payables/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

- Inventories days + receivables days − payables days
- Reflects the cash conversion cycle
- Increase may indicate a need to raise finance

Capital structure ratios

Gearing ratios

- Gearing ratio = debt/(debt + equity) × 100
- Alternative gearing ratio = debt/equity × 100
- Reflects the interest-bearing debt sourced finance (e.g. 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 pay interest payments first. Loans may also be secured on non-current assets
- Management should make extra effort to create profits to cover these fixed charges and also maintain the non-current 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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