Answers

1 An introduction to the role of the accountant in business

Now test yourself

1 Any four from:
- Provide reliable and relevant information for various stakeholders of a business.
- Prepare financial statements on behalf of a business.
- Carry out auditing, which means checking whether the financial statements prepared by a business provide a true and fair view of its financial performance.
- Introduce accounting procedures for new businesses.
- Analyse financial information to provide advice about where the financial performance could be improved.
- Produce budgets for businesses.
- Ensure that financial statements and tax returns are submitted by deadlines.

2 Management accounting focuses on planning, control and decision making within the business. The information that is obtained from these activities is for internal use, because it will be used by the managers and senior employees (internal stakeholders) to make decisions. The information is not intended for use by external stakeholders.

3 Financial accounting uses historical information to prepare financial statements such as income statements, statements of financial position and statements of cash flows.

4 Bookkeepers are responsible for recording day-to-day transactions:
- maintaining accounting records
- entering transactions in the books of prime entry and the ledgers
- checking the accuracy of accounting records.
- They may also assist in the preparation of financial statements by preparing the trial balance.

Exam practice questions

1 Management accounting focuses on the planning, control and decision making. It is prepared for internal use, to provide information for internal rather than external stakeholders (e.g. owners and senior employees).
Financial accounting used historical information produced by the business to prepare financial statements. These statements will include income statements, statements of financial position, statements of cash flows and the annual report. The financial statements are prepared for external stakeholders; mainly the shareholders, but also for the government (HMRC), banks and potential investors.

2 Accountants are responsible for the actual preparation of the financial statements, such as the income statements and statements of financial position. They make sure that accounting concepts have been applied and that the financial statements show a true and fair view of the business.
Bookkeepers are responsible for recording day-to-day transactions. Their role includes maintaining accounting records, entering transactions in the books of prime entry and the ledgers and checking the accuracy of accounting records. They may also assist in the preparation of financial statements by preparing the trial balance. However, in some businesses, the bookkeeper may prepare the financial statements and the accountant may be involved in the bookkeeping.

2 Types of business organisation

2.1 Business organisation

Now test yourself

1 Any two advantages of being a sole trader from:
- the owner keeps all the profits
- the owner is his/her own boss
- it is quicker and easier to set up than a partnership or limited company.

2 Any two disadvantages of being a sole trader from:
- the owner (plus what he/she can borrow) is the only source of capital
- there may be long working hours

- the owner probably loses money if sick or on holiday
- the owner has unlimited liability – he/she has to pay any debts that the business is unable to pay, even if that means selling own possessions.

3 Any two advantages of being a partnership from:
- there is more than one source of capital (not necessarily equal amounts)
- the workload is shared
- partners can specialise (they can concentrate on what they do best)
- it is quicker and cheaper to set up than a limited company.

4 Any two disadvantages of being a partnership from:
- profits have to be shared between the partners (not necessarily equally)
- there can be disagreements between the partners
- the owners still have unlimited liability.

5 Any two advantages of being a limited company from:
- more capital can be raised by selling shares
- shareholders have limited liability, which means less risk. The most that shareholders can lose is what they paid for their shares. Shareholders do not have to provide any more money to pay the company's debts.

6 Any two disadvantages of being a limited company from:
- they are slower and more expensive to set up than a sole trader or partnership
- there is more paperwork and additional costs each year than a sole trader or partnership
- the profits have to be shared with the shareholders
- the owner loses control of the business if they own fewer than 50 per cent of the shares
- financial statements are no longer confidential as anyone can obtain them from Companies House or, for a plc, from the company's website.

7 A business would benefit from becoming a public limited company because large amounts of capital can be raised by issuing shares through the stock market. The extra capital can be used to expand the business, which leads to higher levels of profits.

8 Any two disadvantages of becoming a plc from:
- profits have to be shared with a large number of shareholders
- the original owners probably lost control as they own fewer than 50 per cent of the shares
- higher annual costs and more paperwork for auditing and submitting the accounts
- the financial statements are freely available on the company's website.

Exam practice questions

1 c) **2** a) **3** d)

2.2 Sources of finance

Now test yourself

1

	Internal or external	Permanent, long term or short term	Costs, repayments or profit distribution
Owner's capital	Internal	Permanent	Owner's drawings
Partners' capital	Internal if existing partners, external if new ones	Permanent	Partners' drawings
Share capital	Internal if existing shareholders, external if new ones	Permanent	Dividends
Debentures	External	Long term	Annual interest Lump sum repayment
Bank loan	External	Long term	Monthly interest and repayments
Mortgage	External	Long term	Monthly interest and repayments
Bank overdraft	External	Short term	Interest is regularly charged, and it is repaid when enough funds are credited to the account

2

	Effect on profit sharing	Effect on control of the business	Effect on capital gearing	Is security needed?
Owner's capital	None	None	Decreases gearing	No
Partners' capital	Shared with partners in the profit sharing ratio	Depends on the partnership agreement	Decreases gearing	No
Share capital	Shareholders are paid dividends based on number of shares held	Original owners lose control if they have less than 50% of the shares	Decreases gearing	No
Debentures	None	None	Increases gearing	Sometimes
Bank loan	None	None	Increases gearing	Probably
Mortgage	None	None	Increases gearing	Yes
Bank overdraft	None	None	No effect on gearing	Sometimes

Exam practice questions

1 d)
2 c)
3 b)
4 Debentures would not be the right way to finance the purchase of inventory, as this would involve using a long-term source to finance a short-term need. The company would be paying interest on the debentures for many years after the inventory has been sold and cash received for it. Although there are cash flow benefits in not having to repay the debentures for many years, the interest would be an unnecessary cost once customers have paid for the goods.
A bank overdraft would be a much better way to finance the purchase of the inventory, as it involves matching a short-term source of finance with a short-term need. As soon as the inventory has been sold and paid for, the business should be able to repay the overdraft without incurring unnecessary amounts of interest.

3 The double entry model

3.1 Source documents

Now test yourself

1 a) Bank statement
b) Purchase invoice
c) Bank statement
d) Till roll
e) Credit note
f) Paying-in slip counterfoil
g) Sales invoice
h) Credit note
i) Cash receipt
j) Cheque counterfoil

Exam practice question

Trade discount is given for buying in bulk. It is shown on the invoice, but not recorded in the books of prime entry (e.g. purchases journal or cash book).

Cash discount is offered to encourage quick payment. The sales invoice will state what percentage cash discount can be claimed, and how quickly the invoice must be paid in order to claim the discount. It is recorded in the cash book if payment is made quickly enough.

3.2 Books of prime entry and ledgers

Now test yourself

1 The six books of prime entry and their contents are:
- The sales journal lists the invoices for credit sales.
- The purchases journal lists the invoices for credit purchases.
- The sales returns journal lists the credit notes issued by the business.
- The purchases returns journal lists the credit notes received by the business.
- The cash book records bank receipts and bank payments, as well as cash discount allowed and cash discount received.
- The general journal records non-routine transactions.

2 The receivables ledger includes T-accounts for each credit customer. For each customer, it shows invoices, credit notes, payments, discounts and the amount owed by that customer.
3 The payables ledger includes T-accounts for each credit supplier. For each supplier, it shows invoices, credit notes, payments, discounts and the amount owed to that supplier.
4 The general ledger includes T-accounts for every item that will appear in the financial statements.
5 The left-hand side of a cash book shows receipts and discount allowed.
6 The right-hand side of a cash book shows payments and discount received.

Exam practice question

Note: Answers must NOT include the sales journal or the sales returns journal because all sales will be on a cash basis.

Any two answers from:

- The purchases journal is the book of prime entry that lists the invoices for credit purchases.
- The purchase returns journal is the book of prime entry that lists the credit notes received by the business.
- The cash book is the book of prime entry that is used to record bank receipts and bank payments, as well as cash discount allowed, and cash discount received.
- The general journal is the book of prime entry that is used to record non-routine transactions.

3.3 Double entry system

Exam practice questions

1

Transaction	Source document	Book of prime entry	Account debited	Account credited
The business owner transfers £10 000 into the business bank account.	Bank statement	Cash book	Bank	Capital
The business pays rent by standing order.	Bank statement	Cash book	Rent	Bank
The business buys goods on credit from 'Supplier'.	Purchases invoice	Purchases journal	Purchases	Supplier
The business returns some of the goods that it had bought on credit.	Credit note	Purchase returns journal	Supplier	Purchase returns
The business sells goods on credit to 'Customer'.	Sales invoice	Sales journal	Customer	Revenue
The business receives a cheque in payment for the goods sold on credit.	Paying-in-slip counterfoil	Cash book	Bank	Customer
The business pays its credit supplier by cheque.	Cheque counterfoil	Cash book	Supplier	Bank
The business pays its electricity bill by direct debit.	Bank statement	Cash book	Electricity	Bank

2

Receivable account for John Phillips					
Date	Details	£	Date	Details	£
1 Nov	Balance b/d	4 974	6 Nov	Returns	232
21 Nov	Sales	789	15 Nov	Bank	2 167
22 Nov	Dishonoured cheque	2 167	15 Nov	Discount	96
22 Nov	Discount lost	96	30 Nov	Contra	860
			30 Nov	Balance c/d	4 671
		8 026			8 026
1 Dec	Balance b/d	4 671			

3.4 Capital expenditure and revenue expenditure

Now test yourself

1 Capital expenditure means expenditure on the purchase, alteration or improvement of non-current assets.

2 The five types of capital expenditure that may be summarised by 'LIDIA' are:
- legal costs of buying property
- installation of non-current assets
- delivery of non-current assets
- improvement (but not repair) of non-current assets
- as well as the basic cost of non-current assets.

Exam practice questions

1 Computers for resale = £98 000 – £12 000 = £86 000
Maintenance and repairs = £73 240 – £4 100 = £69 140
Training = £2 160
Insurance = £1 290 × 8 ÷ 12 = £860
Total revenue expenditure in the above items = £158 160

2 c)

3.5 Income statement

Now test yourself

1 Cost of sales = Opening inventory + Purchases – Purchase returns + Carriage in – Closing inventory

2 Gross profit = Revenue – Cost of sales

3 'Carriage in' means the cost of transporting goods purchased by the business, and is included as part of cost of sales. 'Carriage out' means the cost of transporting goods sold by the business and is included as an expense.

4 'Discount received' is cash discount obtained from suppliers. It is added after gross profit when calculating profit for the year. 'Discount allowed' is cash discount given to customers. It is one of the expenses that are subtracted when calculating profit for the year.

5 Profit for the year = Gross profit + Other income – Expenses

6 The income statement for a service business does not include cost of sales or gross profit.

7 See inventory account below:

Inventory account

Date	Details	£	Date	Details	£
20-7			20-8		
1 April	Balance b/d	<u>75 200</u>	31 Mar	Income statement	<u>75 200</u>
20-8					
31 Mar	Income statement	<u>58 900</u>	31 Mar	Balance c/d	<u>58 900</u>
1 April	Balance b/d	58 900			

Exam practice questions

1 a)
2 b)
3 d)

3.6 Introducing statements of financial position

Now test yourself

1 Non-current assets (e.g. land, buildings, machinery, equipment, furniture and vehicles) are resources owned by the business that it intends to keep for more than one year. Current assets (e.g. inventory, trade receivables, prepayments, bank and cash) are resources that are owned by a business and are already cash or are intended to be cash within the next 12 months.

2 Current liabilities (e.g. trade payables, overdraft and accruals) are amounts owed by the business that must be repaid within one year. Non-current liabilities (e.g. bank loan and mortgage) are amounts owed by a business that will be fully repaid after more than one year.

3 Trade receivables are customers that owe money to the business because they have bought goods on credit. Trade payables are suppliers that are owed money by a business because they have sold goods to the business on credit.

4 Drawings are money or goods taken out of the business by the owner.

5 Capital = Balance at start of the year + Capital introduced + Profit for the year – Drawings

Exam practice questions

1 d)
2 c)
3 b)

3.7 Prepayments, accruals and irrecoverable debts

Now test yourself

1 A prepayment decreases the 'Rent paid' expense in the income statement and is a current asset in the statement of financial position (debit 'Prepayment' and credit 'Rent').
2 An accrual increases the 'Electricity' expense in the income statement and is a current liability in the statement of financial position (debit 'Electricity' and credit 'Accrual').
3 An irrecoverable debt is an expense in the income statement and decreases 'Trade receivables' in the statement of financial position (debit 'Irrecoverable debts' and credit 'Trade receivables').

Exam practice questions

1 Laura:
a) Prepaid rent = £16 500 ÷ 12 × 2 = £2 750.
Prepaid rates = £2 340 ÷ 6 × 5 = £1 950
b) The expense for rent and rates in the income statement = £25 760 – £2 750 – £1 950
= £21 060
2 Sharon:
a) The accrual for insurance = £960 ÷ 12 × 8
= £640
b) The expense for insurance in the income statement = £1 285 + £640 = £1 925

3.8 Depreciation and the disposal of non-current assets

Now test yourself

1 Depreciation expense on the income statement = (£12 000 − £2 000) ÷ 5 years = £2 000.
Provision for depreciation at the end of the year = £6 000 + £2 000 = £8 000
2 Depreciation expense on the income statement = 25% × £4 800 = £1 200
Provision for depreciation at the end of the year = £2 400 + £1 200 = £3 600
3 Depreciation expense on the income statement = 20% × (£9 600 – £3 800) = £1 160
Provision for depreciation at the end of the year = £3 800 + £1 160 = £4 960
4 Net book value = £13 600 − £7 100 = £6 500
Profit or loss on disposal = £7 000 − £6 500 = profit of £500
5 Net book value = £7 900 − £6 800 = £1 100
Profit or loss on disposal = £750 − £1 100 = loss of £350.

Exam practice question

1 Working:
Rates prepayment = £3 540 ÷ 12 × 5 months = £1 475
Rent and rates expense = £19 660 − £1 475 = £18 185
Depreciation on equipment = 20% × (£6 800 − £2 300) = £900
Provision for depreciation on equipment = £2 300 + £900 = £3 200
Depreciation on vehicle = (£12 600 − £1 400) ÷ 8 years = £1 400
Provision for depreciation on vehicle = £4 200 + £1 400 = £5 600
Bank account = £4 500 capital introduced − £3 160 overdraft = £1 340
Trade receivables = £19 880 − £1 430 irrecoverable debt = £18 450
Wages and salaries = £55 800 + £1 470 = £57 270

Mary Bryant

Income statement for the year ended 31 October 20–8

	£	£
Revenue		311 660
Returns in		(490)
		311 170
Opening inventory	50 840	
Purchases	169 720	
Carriage in	430	
	220 990	
Closing inventory	37 880	
Cost of sales		183 110
Gross profit		128 060
Discounts received		720
		128 780
Discount allowed	570	
General expenses	9 250	
Motor expenses	4 220	
Rent and rates	18 185	
Wages and salaries	57270	

→

Irrecoverable debt	1 430	
Depreciation on equipment	900	
Depreciation on vehicle	1 400	
		93 225
Profit for the year		35 555

Mary Bryant's statement of financial position in the **new** layout used by AQA in the exams:

Mary Bryant

Statement of financial position at 31 October 20–8

	£ Cost	£ Accumulated depreciation	£ Net book value
Non-current assets			
Equipment	6 800	3 200	3 600
Vehicle	12 600	5 600	7 000
			10 600
Current assets			
Inventory		37 880	
Trade receivables		18 450	
Prepayment		1 475	
Bank account (cash and cash equivalents)		1 340	
			59 145
Total assets			69 745
Capital account			
Capital at 1 November 2017			36 200
Capital introduced			4 500
Profit for the year			35 555
			76 255
Drawings			(28 000)
			48 255
Current liabilities			
Trade payables		17 420	
Accrual		1 470	
Loan repayable within 12 months		2 600	
			21 490
Total capital and liabilities			69 745

Mary Bryant's statement of financial position in the **old** layout that students may use in the AQA exams:

Mary Bryant

Statement of financial position at 31 October 20–8

	£ Cost	£ Provision for depreciation	£ Net book value
Non-current assets			
Equipment	6 800	3 200	3 600
Vehicle	12 600	5 600	7 000
			10 600
Current assets			
Inventory	37 880		
Trade receivables	18 450		
Prepayment	1 475		
Bank account	1 340		
	59 145		
Current liabilities			
Trade payables	17 420		
Accrual	1 470		
Loan repayable within 12 months	2 600		
	21 490		
Net current assets			37 655
			48 255
Non-current liabilities			0
Net assets			48 255
Capital account			
Capital at 1 November 2017			36 200
Capital introduced			4 500
Profit for the year			35 555
			76 255
Drawings			(28 000)
			48 255

3.9 Further adjustments to financial statements

Now test yourself

1 The double entry for income due is:
Debit 'Income due' (a current asset on the statement of financial position).
Credit the source of income on the income statement (e.g. increase 'rent receivable').

2 The double entry for income received in advance is:
Debit the source of income on the income statement (e.g. decrease 'rent receivable').
Credit 'Income received in advance' (a current liability on the statement of financial position).

3 The double entry for an irrecoverable debt that has been recovered is:
Debit: 'Bank account'.
Credit: 'Irrecoverable debts recovered' (added after gross profit on the income statement).

4 The new provision for doubtful debts =
4% × £21 700 = £868
The increase in doubtful debts =
£868 − £750 = £118
The effects on the financial statements are:
- 'Increase in doubtful debts' £118 is an expense in the income statement
- 'Trade receivables' in the statement of financial position = £21 700 − £868 = £20 832

5 The new provision for doubtful debts
= 5% × £32 800 = £1 640
The decrease in doubtful debts
= £2 010 − £1 640 = £370
The effects on the financial statements are:
- 'Decrease in doubtful debts' £370 is added after gross profit in the income statement.
- 'Trade receivables' in the statement of financial position = £32 800 − £1 640 = £31 160

Exam practice questions

1 d) 2 b) 3 b)

4 Verification of accounting records

4.1 Trial balance

Now test yourself

1 The four types of error that will be revealed by a trial balance, because they cause the total debits to be different to the total credits, are:
- addition error – mathematical errors when calculating balances on ledger accounts or totals in the books of prime entry
- partial omission error – a transaction has only been entered as a debit or as a credit
- transposition error – an amount has been posted with two numbers the wrong way around
- unequal posting error – different amounts have been debited and credited.

2 The six types of error that will not be revealed by a trial balance, because they do not cause the total debits to be different to the total credits are:
- error of omission – a transaction has been completely omitted
- complete reversal – the debit and credit have been entered the wrong way around
- error of commission – a transaction has been entered in the wrong account but the right type of account
- error of principle – a transaction has been entered in the wrong type of account
- error of original entry – the correct accounts have been used, but the wrong amount was entered in both of them
- compensating errors – two errors cancel each other out.

Exam practice question

Some types of errors will be shown by a trial balance as the total debits will not be equal to the total credit. Some examples of these errors are as follows:
- Addition error, where there have been mathematical errors when calculating balances on accounts or when calculating totals in books of prime entry.
- Partial omission error, where an item has only been entered once.
- Transposition error, where an amount has been posted with two numbers the wrong way around.
- Unequal posting error, where different amounts have been debited and credited.

However, some errors will not be shown by a trial balance as the total debits will be equal to the total credits. Examples of these errors are as follows:
- Error of omission, where a transaction has been completely omitted from the accounting records.
- Complete reversal, where the debit and credit entries have been made the wrong way around.
- Error of commission, where a transaction has been entered in the wrong account but the right type of account (e.g. in the wrong expense or wrong account in the receivables ledger).
- Error of principle, where a transaction has been entered in the wrong type of account (e.g. 'motor expenses' instead of 'motor vehicles').

- Error of original entry, where the correct accounts have been used, but the wrong amount was entered in both of them.
- Compensating errors, where two errors cancel each other out.

In conclusion, the trial balance is of limited use for verifying the accuracy of the ledgers as even when it does show that an error has taken place, it does not show where it has been made. The trial balance is only of limited use for verifying the accuracy of the ledgers as there are so many errors that it does not reveal.

4.2 Bank reconciliation statements

Now test yourself

1 Any four of the following benefits of producing bank reconciliation statements:

- They enable missing entries in the cash book to be identified.
- They enable errors in the cash book to be corrected.
- They enable errors in the bank statement to be investigated.
- They enable out-of-date cheques to be identified.
- They help prevent fraud.
- They enable you to identify dishonoured cheques.

2 The main limitation is that the bank reconciliation statement will not immediately show whether a payment or receipt has been left out of the cash book or incorrectly entered in the cash book if the payment or receipt is also unpresented.

Exam practice question

1 a)

Nikki Dickson					
Dr		**Cash book**			**Cr**
Date	**Details**	**£**	**Date**	**Details**	**£**
21 Dec	Bank interest	33	24 Dec	Balance b/d	643
			21 Dec	Bank charges	52
			23 Dec	Correction: A. Ramirez	36
			23 Dec	Unpaid cheque – H. Hussain	70
24 Dec	Balance c/d	1 209	24 Dec	Standing order	441
		1 242			1 242
			25 Dec	Balance b/d	1 209

b) Bank reconciliation statement

Bank reconciliation statement as at 24 December 2018		
	£	**£**
Balance per bank statement		(1177)
Less: Unpresented payments		
H. Keith		(177)
		(1 354)
Add: Amounts not yet credited		
B. Montgomery		145
Balance as per cash book		(1 209)

4.3 Control accounts

Now test yourself

1 Apart from the balances, three items that are debited to a sales ledger control account are credit sales from the sales journal, dishonoured cheques from receivables and interest charged to receivables.

2 Apart from the balances, five items that are credited to a sales ledger control account are money from receivables, discounts allowed, sales returns, irrecoverable debts and contra entries.

3 Three benefits of using control accounts are that they show if an arithmetical error has taken place, they immediately provide total figures for trade receivables and trade payables and they help to prevent fraud.

4 Two limitations of control accounts are that they do not prove that each individual account balance is correct and, if an error has occurred, they do not show where in the receivables ledger or purchases ledger it has taken place.

Exam practice question

Ann Jin					
Purchases ledger control account					
Dr			**Cr**		
Date	**Details**	**£**	**Date**	**Details**	**£**
31 Aug	Discount received	1 132	1 Aug	Balance b/d	35 128
31 Aug	Payments to trade payables	59 556	31 Aug	Dishonoured cheque	2 290
31 Aug	Returns outwards	2363	31 Aug	Interest charged	187
31 Aug	Contra	644	31 Aug	Purchases journal	46 180
31 Aug	Balance c/d	20 476	31 Aug	Debit balances c/d	386
		84 171			84 171
1 Sept	Debit balances b/d	386	1 Sept	Balance b/d	20 476

4.4 The general journal and suspense account

Now test yourself

Any five items from the following may be included in the general journal:

- opening entries at the start of a business
- accruals and prepayments
- irrecoverable debts and provisions for doubtful debts
- depreciation
- correction of errors
- purchase or sale of non-current assets
- incorporating inventory into the records.

Exam practice question

1 a)

General journal		
Account	**Dr (£)**	**Cr (£)**
Motor expenses	90	
Suspense		90
Purchases	500	
Suspense		500
Suspense	20	
Carriage out		20
Suspense	700	
Sales revenue		700
Suspense	720	
Rent received		720
Discount received	555	
Suspense		555
Discount allowed	555	
Suspense		555

b) Suspense account

Suspense account			
Dr		**Cr**	
Details	**£**	**Details**	**£**
Balance b/d	260	Motor expenses	90
Carriage out	20	Purchases	500
Sales revenue	700	Discount received	555
Rent received	720	Discount allowed	555
	1 700		1 700

Note:

The £260 balance brought down is the balancing figure in the suspense account.

The balance carried down at the end of the accounting period is zero.

4.5 Correcting profits and statements of financial position

Exam practice questions

1 Adjusted profit calculation

		Effect on profit	
		£	**£**
Profit for the year			**60 500**
1	Rent paid in advance	+ 990	
2	Electricity accrual	(850)	
3	Inventory overstated	(2 000)	
4	Motor vehicle depreciation	(5 150)	

➜

5 Cheque received from trade receivable	0	
6 Trade receivable balance written off	(255)	
7 Loan repayment	0	
Adjusted profit for the year		**53 235**

2 Recalculating profit for the year

	£
As currently stated	41 000
Capital introduced	0
Depreciation	(6 300)
Irrecoverable debt	(4 000)
Rent accrual	800
Inventory	(2 900)
Drawings/purchases	2 500
Carriage	(3 500)
Profit for the year	27 600

Other workings:

Provision for depreciation = £18 400 + £6 300 = £24 700

Inventory = £41 000 – £2 900 = £38 100

Bank account = £8 000 – £6 000 = £2 000

Accruals = £4 100 – £800 = £3 300

Drawings = £22 000 + £2 500 = £24 500

David Williams

Statement of financial position at 31 July 20–8

	£ Cost	£ Accumulated depreciation	£ Net book value
Non-current assets			
Motor vehicles	42 000	24 700	17 300
Current assets			
Inventory		38 100	
Trade receivables		14 000	
Prepayment		2 000	
Bank account (cash and cash equivalents)		2 000	
			56 100
Total assets			73 400
Capital account			
Balance at 1 November 20–7			28 000
Capital introduced			8 000
Profit for the year			27 600
			63 600
Drawings			(24 500)
			39 100
Non-current liabilities			
Bank loan			22 000
Current liabilities			
Trade payables		9 000	
Accruals		3 300	12 300
Total capital and liabilities			73 400

David Williams' statement of financial position in the **old** layout that students may use in the AQA exams:

David Williams

Statement of financial position at 31 July 20–8

	£ Cost	£ Provision for depreciation	£ Net book value
Non-current assets			
Motor vehicles	42 000	24 700	17 300
Current assets			
Inventory	38 100		
Trade receivables	14 000		
Prepayment	2 000		
Bank account	2 000		
	56 100		
Current liabilities			
Trade payables	9 000		
Accrual	3 300		
	12 300		
Net current assets			43 800
			61 100
Non-current liabilities			
Bank loan			(22 000)
Net assets			39 100
Capital account			
Capital at 1 August 20–7			28 000
Capital introduced			8 000
Profit for the year			27 600
			63 600
Drawings			(24 500)
			39 100

5 Accounting concepts used in the preparation of accounting records

Now test yourself

1 The ten accounting concepts are:
- Money measurement: Only transactions and events that are capable of being measured in monetary terms are recognised in the financial statements.
- Duality: Every financial transaction has two effects, described as a 'debit' and a 'credit', which are recorded in two separate accounts.
- Cost: Assets and liabilities are recorded at their historical cost than estimating what they are now worth. The only exception is when there is a valid reason for revaluing non-current assets.
- Going concern: The business to which the financial statements relate will continue to operate in the foreseeable future.
- Accruals: Costs and revenue are matched to the time period in which they arose.
- Consistency: Businesses should always use the same accounting treatment for similar transactions. They should not change accounting policies unless there is a valid reason to do so.
- Prudence: Do not risk overstating revenue or assets or understating expenses or liabilities. If in doubt, include a figure that will cause profit or the value of assets to be lower rather than higher.
- Materiality: Some items are not worth recording separately because their low value means that they do not affect decisions taken by the users of the financial statements.
- Realisation: Revenue and purchases are recorded at the date when the goods or services are provided, and not when payment is made for them.
- Business entity: The financial statements must only include transactions relating to a specific business and not the people who own or run it.

2 Example of how each accounting concept affects the financial statements:
- Money measurement: Financial statements do not include items that cannot be expressed in money terms, e.g. employee motivation or the quality of goods and services that have been produced.
- Duality: Any examples of double entry. The trial balance and the statement of financial position should balance.
- Cost: Non-current assets are listed at cost before the provision for depreciation is subtracted. No assets or liabilities are adjusted for inflation.
- Going concern: The net book value of non-current assets assumes that they will be used for several years. The rate of depreciation would be higher if that was not the case.
- Accruals: Income and expenses are adjusted for prepayments and accruals, cost of sales is adjusted for opening and closing inventory and non-current assets are depreciated over the lifetime of an asset.
- Consistency: The same methods and rates of depreciation are consistently applied to all items within a particular category of non-current assets (e.g. machinery, vehicles, equipment).
- Prudence: Valuing inventory at the lower of cost and net realisable value. Estimates of accruals and prepayments, estimates of lifetime and residual value of non-current assets when calculating depreciation. Also irrecoverable debts and provision for doubtful debts.
- Materiality: Small expense items are grouped together as 'general expenses' or 'sundries'. Low cost non-current assets are treated as an expense on the income statement, such as stationery items or small tools that will be used for more than a year.
- Realisation: Revenue and purchases are included in the income statement even if they are credit transactions and the buyer has not yet paid for them. Treatment of goods sold on 'sale or return' basis.
- Business entity: The financial statements must not include any personal income, expenditure, assets or liabilities of the owners of the business. The treatment of 'capital introduced' and 'drawings' on the statement of financial position.

Exam practice questions

1 b)
2 a)
3 c)

6 Preparation of financial statements of sole traders

Now test yourself

1 a) The net realisable value of the damaged goods = £3 550 − £470 = £3 080
This is the new valuation of the damaged goods, as it is lower than their cost.
The decrease in the value of the damaged goods = £3 400 − £3 080 = £320

b) The new figure for gross profit = £15 544 − £320 = £15 224

2 a) The net realisable value of the damaged goods = £37 800 − £5 100 = £32 700
This is the correct value of the damaged goods as it is lower than their cost.
The decrease in the value of the damaged goods = £34 500 − £32 700 = £1 800

b) The new figure for 'Cost of sales' = £612 389 + £1 800 = £614 189

Exam practice question

Working:

- Revenue = £198 500 − £9 100 = £189 400
- Purchases = £94 300 − £456 = £93 844
- Calculation of closing inventory:
  Net realisable value of damaged goods = £2 250 − £640 = £1 610
- Decrease in value of these goods = £1 800 cost − £1 610 net realisable value = £190
- Also, closing inventory should include cost of goods on sale or return.
- Closing inventory = £7 200 − £190 + £4 200 = £11 210
- Rent receivable = £2 130 + £350 = £2 480
- Provision for doubtful debts = 2.5% × £16 800 = £420
- Increase in doubtful debts = £420 − £310 = £110
- Depreciation on furniture and equipment = 25% × (£5 400 − £2 900) = £625
- Net book value of vehicle that was sold = £6 700 − £5 800 = £900
- Profit or loss on disposal = £700 − £900 = a loss of £200

Donald Brown

Income statement for the year ended 31 October 20–8

	£	£
Revenue		189 400
Opening inventory	9 800	
Purchases	93 844	
	103 644	
Closing inventory	11 210	
Cost of sales		92 434
Gross profit		96 966
Rent receivable		2 480
Irrecoverable debt recovered		544
		99 990
Increase in doubtful debts	110	
Depreciation of furniture and equipment	625	
Loss on disposal of vehicle	200	
Other expenses	74 100	
		75 035
Profit for the year		24 955

7 Limited company accounts

Now test yourself

1 a) The number of issued shares = £20 000 ÷ £0.50 = 40 000

b) Dividends paid = 40 000 × £0.03 = £1 200

2 a) The number of issued shares = £75 000 ÷ £0.30 = 250 000

b) Dividends paid = 250 000 × £0.025 = £6 250

Exam practice questions

1 a) Finance cost = £65 000 × 6% × 8 ÷ 12 = £2 600

b) Profit before tax = £210 540 − £2 600 = £207 940 corporation tax = 20% × £207 940 = £41 588

c) Profit for the year = £207 940 − £41 588 = £166 352

2 Number of shares at the start of the year = 200000 ÷ £0.50 = 400000
Number of shares when the dividend was paid = 400000 + 100000 = 500000

a) Dividend paid = 500000 × £0.135 = £67 500

Nominal value of share issue = 100000 × £0.50 = £50 000
Share premium from the share issue = 100000 × £0.25 = £25 000

b) Statement of changes in equity.

	Issued shares (£)	Share premium (£)	Retained earnings (£)	Total (£)
Balance at the start of the year	200 000	30 000	182 366	412 366
Share issue	50 000	25 000		75 000
Profit for the year			166 352	166 352
Dividends paid			(67 500)	(67 500)
Balance at the end of the year	250 000	55 000	281 218	586 218

8 Analysis and evaluation of financial information

Now test yourself

1 Profitability ratios
- Gross profit margin = Gross profit ÷ Revenue × 100
- Mark-up = Gross profit ÷ Cost of sales × 100
- Profit in relation to revenue = Profit for the year before tax ÷ Revenue × 100
- Return on capital employed = Operating profit ÷ Capital employed × 100

2 Liquidity ratios
- Current ratio = Current assets ÷ Current liabilities
- Liquid capital ratio = (Current assets − Inventory) ÷ Current liabilities

3 Capital structure ratio
- Capital gearing = Non-current liabilities ÷ Capital employed × 100

4 Efficiency ratios
- Expenses in relation to revenue = Expenses ÷ Revenue × 100
- Inventory turnover ('times') = Cost of sales ÷ Average inventory
- Inventory turnover ('days') = Average inventory ÷ Cost of sales × 365
- Trade receivable days = Trade receivables ÷ Credit sales × 365
- Trade payable days = Trade payables ÷ Credit purchases × 365

5 Any three of the following:
- Outflows that do not affect the income statement at all (e.g. dividends, tax paid, loan repayments or drawings).
- Payments for non-current assets, where the whole cost is an outflow but only the depreciation affects the income statement.
- Timing differences such as offering longer credit terms to customers than those received from suppliers.
- Increasing levels of inventory.

6 Any four of the following:
- They contain historical data from the past which may not reflect what will happen in the future or what is currently happening.
- The income statement for a limited company is in summary format. It does not show individual expenses, which may limit its usefulness.
- The values of assets may be inaccurate due to policies regarding depreciation, inventory valuation and doubtful debts.
- Financial statements do not include items that cannot be measured financially, e.g. quality and morale of the workforce or external factors that will affect the business in the future.
- Efficiency ratios are based on assets or liabilities whose values at the end of the year may not be typical of the whole year, e.g. inventory turnover, receivable days and payable days.

Exam practice questions

1 d)
2 a)
3 b)
4 c)

9 Budgeting

9.1 Budgeting (AS and A-level)

Now test yourself

1 Revenue variance = £6 000 (ADV). Costs variance = £3 000 (FAV).

2 Any four of the following: target setting, improved planning, control, monitoring, communication, co-ordination and improved decision-making.

3 Any three of the following: inaccurate figures, being restrictive and preventing improved performance, demotivating staff if unreasonable, being time-consuming to prepare and monitor and increases short-term costs.

4 Zero-based budgeting means that budgets are set at zero and managers have to justify every item of expenditure. Incremental budgeting means adding a small percentage to the previous year's budget or actual performance.

Exam practice questions

Workings:

- Old selling price = £390 000 revenue ÷ 6 500 units = £60
- New selling price = £60 × 95% (due to 5% decrease) = £57
- Number of units sold = 6 500 units × 1.3 (due to 30% increase) = 8450
- Revenue = 8 450 units × £57 new selling price = £481 650
- Number of units in closing inventory = 320 × 50% (due to 50% decrease) = 160 units
- Number of units to be purchased = 8 450 sales − 320 opening inventory + 160 closing inventory = 8 290
- Old cost of each unit purchased = £217 800 purchases ÷ 6 600 units = £33
- New cost of each unit purchased = £33 old purchase price + £2 increase = £35
- Purchases = 8 290 units (calculated above) × £35 (new purchase price) = £290 150
- Closing inventory = 160 units × £35 new purchase price = £5 600
- Carriage out = £2.00 × 8 450 units sold = £16 900
- Rent = £1 700 per month × 12 months = £20 400
- Wages = £62 000 × 1.02 (due to 2% increase) = £63 240
- Other expenses = £53 500 × 0.8 (due to 20% decrease) = £42 800

Danilo

Budgeted income statement for the year ended 30 November 20–9

	£	£
Revenue (8 450 units)		481 650
Opening inventory (320 units)	10 560	
Purchases (8 290 units)	290 150	
	300 710	
Closing inventory (160 units)	5 600	
Cost of sales		295 110
Gross profit		186 540
Carriage out (£2.00 per unit)	16 900	
Rent	20 400	
Wages	63 240	
Advertising	9 800	
Other expenses	42 800	
		153 140
Profit for the year		33 400

9.2 Budgeting (A-level only)

Now test yourself

1 Net cash flow = Total inflows − Total outflows
Closing balance = Opening balance + Net cash flow

2 The sales budget includes sales in units and sales revenue.

3 The level of production = Sales – Opening inventory + Closing inventory

4 The purchases budget includes sales, opening inventory, closing inventory, purchases in units and purchase cost.

5 The labour budget includes units produced, labour hours and labour cost. You may also be asked to include the number of employees and any surpluses or shortfalls of labour hours.

Exam practice questions

Workings:

Credit sales/cash from receivables	April	May	June	July	August
Total sales revenue	28 000	34 000	20 000	24 000	30 000
1 month's credit (received 1 month later)	21 000	25 500	15 000	18 000	22 500
2 months' credit	7 000	8 500	5 000	6 000	7 500
2 months' credit less 1% irrecoverable debts (received 2 months' later)	6 930	8 415	4 950	5 940	7 425

Drawings:

June = 10% × £20 000 = £2 000

July = 10% × £24 000 = £2 400

August = 10% × £30 000 = £3 000

Loan repayments:

Loan repayments = £18 000 ÷ 30 = £600 per month from July

Harry

Cash budget for June, July and August

	June	July	August
	£	£	£
Inflows			
Cash from receivables – 1 month	25 500	15 000	18 000
Cash from receivables – 2 months	6 930	8 415	4 950
Loan	18 000		
Total inflows	**50 430**	**23 415**	**22 950**
Outflows			
Purchases	18 000	10 000	12 000
Rent	1 600	1 600	1 600
Other expenses	3 800	4 700	5 100
Non-current assets	9 200		
Drawings	2 000	2 400	3 000
Loan repayments	600	600	600
Loan interest	140	140	140
Total outflows	**35 340**	**19 440**	**22 440**
Net cash flow	15 090	3 975	510
Opening balance	(17 920)	(2 830)	1 145
Closing balance	(2 830)	1 145	1 655

10 Marginal costing

10.1 Categorisation of costs and break-even analysis

Now test yourself

1 **a)** Contribution per unit = £10 – (£3 + £1) = £6
b) Break-even point = £7 200 ÷ £6 = 1 200 units per month
c) Margin of safety = 1 400 units − 1 200 unit = 200 units
d) Contribution sales ratio = £6 ÷ £10 = 0.6
e) Break-even point in revenue using the sales contribution ratio = £7 200 ÷ 0.6 = £12 000. The answer to part (b) was 1 200 units, which, multiplied by £10 selling price is equal to £12 000 revenue.

2 Any three of:
- To assess the viability of a new business.
- To set sales targets to help achieve the objectives of the business.
- To evaluate changes to the business.
- To support applications for bank loans.

3 Any two of:
- Assumptions about costs and selling prices may be incorrect.
- Fixed costs eventually increase if the business is to produce more than certain levels of output.
- Assumptions about how likely a business is to achieve the target level of sales may be incorrect.

Exam practice questions

1 d)
2 c)
3 b)
4 a)

10.2 The use of marginal costing in decision making

Now test yourself

1 If the marginal cost of making the product in-house plus the contribution from lost work is lower than the price that would be paid to the other supplier, then the business should make the product itself.

2 The three conditions for deciding to accept additional work at lower than usual selling prices are that the selling price of the products is greater than their marginal cost, the business must have enough spare capacity and the customer will not then sell the goods to other firms at a price below that charged by the original business.

3 Selling price = marginal cost × 1.4 = (£5.50 + £1.50) × 1.4 = £9.80. Ignore the fixed costs because the mark-up is 40 per cent of marginal cost.

4 A loss-making line or production department should not be closed if it is making a positive contribution and it is not preventing the business from operating another line or production department that would generate a higher contribution.

5 The number of units that must be sold = (£3 200 + £1 600) ÷ (£20 − £8) = 400

6 The required revenue = (£3 200 + £1 600) ÷ (£12 ÷ £20) = £8 000. This is consistent with Question 5 because 400 units × £20 selling price = £8 000 revenue.

Exam practice questions

1 a)

	Product A	Product B	Product C
Contribution per unit	£63 = £120 – (£42 + £15)	£52 = £100 – (£28 + £20)	£44 = £75 – (£21 + £10)
Contribution per labour hour	£42 = £63 ÷ 1.5 hours per unit	£26 = £52 ÷ 2 hours per unit	£44 = £44 ÷ 1 hour per unit

b) Start with Product C, which is ranked 1.
8 000 units × 1 hour each = 8 000 labour hours
This leaves 38 000 labour hours for Product A and Product B.
Then Product A, which is ranked 2
20 000 units × 1.5 hours each = 30 000 labour hours.
This leaves 8 000 labour hours for Product B.
Finally, Product B, which is ranked 3
8 000 hours only allows 4 000 units of Product B to be produced.

	Product A	Product B	Product C
Output	20 000 units	4 000 units	8 000 units
Hours	30 000 hours	8 000 hours	8 000 hours

Even though there is a shortfall of 3 000 units for Product B, this production plan will produce the highest possible profit given the number of labour hours available.

11 Standard costing and variance analysis

Now test yourself

1 Materials price sub-variance = Actual quantity × (Standard price per unit − Actual price per unit)

2 Materials usage variance = Standard price × (Standard quantity − Actual quantity)

3 Labour rate sub-variance = Actual labour hours × (Standard hourly rate − Actual hourly rate)

4 Labour efficiency sub-variance = Standard rate × (Standard hours − Actual hours)

5 Sales price sub-variance = Actual quantity × (Standard selling price − Actual selling price)

6 Sales volume sub-variance = Standard price × (Standard quantity − Actual quantity)

Exam practice questions

1 a) Budgeted cost per kilo of materials = £6
Actual cost per kilo of materials =
£96 000 ÷ 12 000 kilos = £8
Variance per kilo of materials = £2 (ADV)
Materials price sub-variance = 12 000 × £2 (ADV) = £24 000 (ADV)
Standard quantity of material per unit =
£18 ÷ £6 = 3 kilos
Standard quantity of materials to produce 4 400 units = 4 400 × 3 = 13 200 kilos
Actual quantity of materials to produce 4 400 units = 12 000 kilos
Variance in terms of number of kilos = 1200 kilos (FAV)
Materials usage sub-variance = £6 × 1 200 (FAV) = £7 200 (FAV)

b) Budgeted hourly labour rate = £12.
Actual hourly labour rate = £113 400 ÷ 8 100 hours = £14
Variance per labour hour = £2 (ADV)
Labour rate sub-variance = 8 100 × £2 (ADV) = £16 200 (ADV)
Standard number of labour hours per unit = £24 ÷ £12 = 2 hours

Standard number of labour hours for 4400 units = 4 400 × 2 = 8 800 hours
Actual number of labour hours = 8 100
Variance in terms of labour hours = 700 (FAV)
Labour efficiency sub-variance = £12 × 700 (FAV) = £8 400 (FAV)

c) **Cost reconciliation statement**

	£ ADV	£ FAV	£
Budgeted costs (4400 units × (£18 materials + £24 labour)			184 800
Material price variance	24 000		
Material usage variance		7 200	
Labour rate variance	16 200		
Labour efficiency variance		8 400	
	40 200	15 600	
Total variances			(ADV) 24 600
Actual costs			209 400

(£96 000 materials + £113 400 labour)

2 a) Revenue = 30 000 × £70 = £2 100 000
Variable costs = 30 000 × (£15 + £25) = £1 200 000
Expected contribution = £2 100 000 – £1 200 000 = £900 000
Expected profit = £900 000 − £480 000 = £420 000

b) Standard materials cost for producing 25 000 units = 60 × £0.25 × 25 000 = £375 000
Actual materials cost for producing 25 000 units = £420 000
Direct materials variance = £45 000 (ADV)
Standard labour cost for producing 25 000 units = 2.5 × £10 × 25 000 = £625 000
Actual labour cost for producing 25 000 units = £660 000
Direct labour variance = £35 000 (ADV)

c) Budgeted selling price = £70 per unit
Actual selling price = £75 per unit
Sales price variance = 25 000 × £5 (FAV) = £125 000 (FAV)
Budgeted sales volume = 30 000 units
Actual sales volume = 25 000 units
Sales volume variance = £70 × 5 000 (ADV) = £350 000 (ADV)

d) Profit reconciliation statement
Workings
Lost contribution due to lower level of sales.
Budgeted contribution per unit = £70 − (£15 materials + £25 labour) = £30
Lost contribution = £30 × 5 000 units = £150 000

Profit reconciliation statement

	£	£	£
	ADV	FAV	
Budgeted profit			420 000
Lost contribution due to lower level of sales			150 000
Budgeted profit on actual level of sales			270 000
Sales price variance		125 000	
Material variance	45 000		
Labour variance	35 000		
	80 000	125 000	
Total variances			(FAV) 45 000
Actual profit			**315 000**

(25 000 × £75) – (420 000 + 660 000 + 480 000)

12 Absorption and activity based costing

12.1 Absorption costing

Now test yourself

1 Marginal costing means the cost of producing one extra unit of output; it does not include the fixed costs of the business. Absorption costing means that the total costs of the business are charged to cost units – indirect/fixed costs as well as direct/variable costs.

2 Allocation means that costs are entirely charged to a specific cost centre. Apportionment means that overheads are shared between relevant cost centres.

3 A cost centre that is labour intensive (i.e. requires more labour hours than machine hours) will use a labour hour basis**.** A cost centre that is capital intensive (i.e. requires more machine hours than labour hours) will use a machine hour basis.

4 Under-absorption means that the value of overheads absorbed by production costs is lower than the actual value of overheads. Over-absorption means that the value of overheads absorbed by production costs is higher than the actual value of overheads.

5 Any two of:
- It allows you to calculate the contribution per unit.
- It can be used for break-even calculations.
- It can be used with decisions such as make or buy, acceptance of additional work and optimum production plans.

6 Any two of:
- It does not ensure full cost recovery, as it does not include overheads.
- The mark-up percentage for the selling price will be higher than using absorption costing or activity based costing.
- It is not acceptable under international accounting standards for a valuation of inventory.

Exam practice questions

1 a) Total overheads = £110 700 + £6 100 + £88 700 + £32 500 = £238 000
OAR per labour hour = £238 000 ÷ 40 000
= £5.95

b) Direct costs per unit = (£220 000 + £180 000) ÷ 20 000 = £20
Overheads per unit = £5.95 × 2 hours = £11.90
Absorption cost (full cost) = £20 + £11.90
= £31.90 per unit
Selling price per unit at a 50 per cent mark-up = £31.90 × 1.5 = £47.85

c) Any two of:
- The OAR will be inaccurate if the estimated figures for overheads and the level of production are inaccurate.
- The use of labour hours to calculate the OAR may not be relevant to all overheads.
- Improvements in technology may lead to the use of labour hours not being a relevant basis for absorption costing.

Note: The limitation about bases to apportion overheads between cost centres is not relevant as the business only makes a single product, so all of the overheads have been apportioned to that product. The limitation about not being useful for break-even analysis and other decisions is not relevant because the question concerns the calculation of selling prices.

2 a)

	Assembly department	Finishing department	Maintenance department
Overheads	£160 000	£420 000	£60 000
Reapportioned overheads	75% ×£60 000 = £45 000	25% ×£60 000 = £15 000	(£60 000)
Total overheads	£205 000	£435 000	£0

The assembly department OAR = £205 000 ÷ 50 000 = £4.10 per machine hour.

The assembly department OAR is based on machine hours as it uses more machine hours than labour hours.

The finishing department OAR = £435 000 ÷ 60 000 = £7.25 per labour hour.

The finishing department OAR is based on labour hours as it uses more labour hours than machine hours.

b) Direct costs per unit = £46
Assembly department overheads = £4.10 × 3 hours = £12.30
Finishing department overheads = £7.25 × 2 hours = £14.50
Full cost (absorption cost) per unit = £72.80
Selling price of one unit of product XYZ = £72.80 × 1.4 = £101.92

c) Any two of:
- It ensures full cost recovery, as, unlike marginal costing, it does include overheads.
- The mark-up percentage for the selling price will be lower than using marginal costing.

Note: The benefit about absorption costing being acceptable for valuing inventory is not relevant as the question is about price setting.

12.2 Activity based costing

Now test yourself

1 Cost pools are groups of overheads that are caused by the same activity.

2 Cost drivers are activities that influence the level of costs.

3 Any three of:
- the number of machine set-ups
- the number of quality inspections
- the number of production runs
- the number of orders that need to be processed for customers or suppliers.

4 Activity based costing means that the overheads are attributed to output on the basis of relevant activities, which are called cost drivers.

Exam practice questions

1 Any three of:
- It produces more accurate cost information as the cost driver which is used to attribute the cost on a more objective basis.
- It does not require an arbitrary apportionment of overheads based on labour hours or machine hours.
- More accurate unit costs can lead to a more accurate establishment of selling prices.
- It enables management to have a greater understanding of why costs are incurred and therefore how to control costs.
- It takes into account the fact that batch sizes influence indirect costs (e.g. set-up costs per unit are more expensive for small batches).
- It is more accurate than absorption costing for capital intensive businesses where overheads are complex in nature.

2 Any two of:
- Not all expenses can be related to cost drivers (e.g. rent, insurance and business rates), so there will still have to be some arbitrary apportionment of overheads.
- It is more time-consuming than absorption costing because of the need for detailed record keeping.
- It is doubtful whether a single cost driver can explain the cost behaviour of an activity.

13 Capital investment appraisal

Now test yourself

1 Any two of:
- It is easier to understand than net present value.
- It is easier to calculate than net present value.
- It is more likely to be accurate than net present value.

2 Any two of:
- It ignores the profitability of the investment.
- It ignores how long the asset is expected to last after the payback period.
- It ignores the timing of cash flows within the payback period.
- The predicted cash flows may be inaccurate (although also true for net present value).

3 Any two of:
- It calculates the profitability of the investment.
- It considers the timing of cash flows.

4 Any two of:

- It is harder to understand for some users of the information.
- The predicted rate of interest may be incorrect.
- The predicted cash flows may be inaccurate (although also true for payback).

5 Any three of:

- Which investment project has the shorter payback period or the higher NPV.
- Whether the payback period and/or NPV meet criteria set by the business.
- The effects of the investment on profits and cash flow.
- Whether there is enough finance available to pay the initial costs.
- How long until the items bought need to be replaced.

6 Any three of:

- How the investment affects stakeholders such as employees, customers and suppliers.
- How the investment affects the image of the business.
- The reliability of the figures for the cash flows. Whether there are any environmental issues or ethical issues.

Exam practice questions

1 a) Workings:

Inflows = Output × £50 selling price

Direct costs per unit = (0.4 × £20) + (0.75 × £16)
= £8 + £12 = £20

Net cash flows = Inflows – (Direct costs + Maintenance + Other fixed costs)

Year	Output	Inflows (£)	Direct costs (£)	Maintenance (£)	Other fixed costs (£)	Net cash flows (£)
1	7000	350000	140000	2500	36000	171500
2	8000	400000	160000	2500	36000	201500
3	9000	450000	180000	5500	36000	228500

Calculation of net present value:

Net present value = Net cash flow × Discount factor

Year	Net cash flow (£)	Discount factor	Present value (£)
1	171500	0.870	149205
2	201500	0.756	152334
3	228500	0.658	150353
Total			**451892**

Net present value of the investment

= £451 892 – £400 000 Initial cost = £51 892

1 b) Calculation of payback:

Cumulative cash flow means the running total of the annual net cash flows.

Year 2's cumulative cash flow = Year 1 net cash flow + Year 2 net cash flow.

Year 3's cumulative cash flow = Year 2 cumulative cash flow + Year 3 net cash flow.

Year	Net cash flow (£)	Cumulative cash flow (£)
1	171500	171500
2	201500	373000
3	228500	601500

Cash flows needed after Year 2 to reach the initial cost

= £400 000 – £373 000 = £27 000

Number of months into Year 3 needed to reach the initial cost

= 27 000 ÷ 228 500 × 12 = 1.42

Payback period = 2 years and 1.42 months

14 Accounting for organisations with incomplete records

14.1 Accounting for incomplete records: statement of affairs

Exam practice question

Jamal
Statement of affairs

	1 December 20–7 (£)	30 November 20–8 (£)
Assets		
Cash in hand	350	780
Equipment	13820	13870
Prepayment	520	680
Inventory	5950	2090
Trade receivables	2900	4400
Vehicles	26715	18900
Total assets	50255	40720

Liabilities		
Bank overdraft	5 320	5 170
Accrual	455	680
Trade payables	2 145	2 995
Total liabilities	7 920	8 845
Net assets	42 335	31 875

Capital account	
	£
Balance at the start of the year	42 335
Add: capital introduced	0
Add: profit for the year	Unknown
Less: drawings	23 020
Balance at the end of the year	31 875

£42 335 − £23 020 = £19 315

Profit for the year = £31 875 − £19 315 = £12 560

14.2 Producing financial statements from incomplete records

Exam practice questions

1

Sales ledger control account			
	£		£
Balance b/d	2 830	Receipts from receivables	34 120
Credit sales	?	Balance c/d	3 120
			37 240

Credit sales = £37 240 − £2 830 = £34 410

Total sales revenue = £34 410 credit sales + £42 430 cash sales = £76 840

Purchases ledger control account			
	£		£
Paid to payables	49 230	Balance b/d	1 650
Balance c/d	1 295	Credit purchases	?
	50 525		

Credit purchases = £50 525 − £1 650 = £48 875

Purchases = £48 875 credit purchases + £3 200 cash purchases = £52 075

Cash account			
	£		£
Balance b/d	260	Cash banked	23 890
Cash sales	42 430	General expenses	1 520
		Purchases	3 200
		Drawings	9 900
		Balance c/d	310
	42 690		38 820

Cash stolen = £42 690 − £38 820 = £3 870

Calculation of goods taken for personal use by Tariq:

If there is a 60 per cent mark-up,

Cost of sales = £76 840 sales revenue ÷ 1.6 = £48 025

Without this adjustment, cost of sales = £4 350 opening inventory + £52 075 purchases − £5 270 closing inventory = £51 155

The difference is due to goods taken by the owner for personal use. Therefore, the £3 130 goods taken is the missing figure.

Expenses in the income statements:

Rent and rates = £6 100 − £370 − £435 = £5 295

Loss on disposal of vehicle = £2 360 − £2 000 = £360

Depreciation on equipment = £4 190 − £3 070 = £1 120

Depreciation on vehicles = £19 220 − £2 360 − £14 530 = £2 330

Tariq

Income statement for the year ended 30 April 20–8

	£	£
Revenue		76 840
Opening inventory	4 350	
Purchases	52 075	
Goods taken by owner	(3 130)	
	53 295	
Closing inventory	5 270	
Cost of sales		48 025
Gross profit		28 815
Wages	7 590	
Rent and rates	5 295	
General expenses	1 520	
Cash stolen	3 870	
Loss on disposal	360	
Depreciation on equipment	1 120	
Depreciation on vehicles	2 330	
		22 085
Profit for the year		6 730

2 Workings:

Completion of trading account:

Gross profit = 40% × revenue = £94 300 × 40% = £37 720

Cost of sales = £94 300 − £37 720 = £56 580

Closing inventory = £8 260 + £53 190 − £56 580 = £4 870

Completion of income statement:

Depreciation = £68 600 × 20% = £13 720

Profit for the year:

£37 720 – (£3 690 + £13 800 + £4 740 + £13 720) = £1 770

Non-current assets = £68 600 − £13 720 = £54 880

Current assets:

We have already worked out that inventory = £4 870

Calculation of trade receivables using the sales ledger control account:

Sales ledger control account

	£		£
Balance b/d	8 240	Received from receivables	79 200
Credit sales (revenue)	94 300	Balance c/d	?
	102 540		

Trade receivables = £8 240 + £94 300 − £79 200 = £23 340

Rent prepaid = £650 + £15 260 – £13 800 = £2 110

Current liabilities:

Calculation of trade payables using the purchases ledger control account:

Purchases ledger control account

	£		£
Paid to payables	48 730	Balance b/d	5 160
Balance c/d	?	Credit purchases	53 190

Trade payables = £5 160 + £53 190 − £48 730 = £9 620

Telephone accrued = £430 + £3 690 − £3 450 = £670

Bank overdraft (from the bank account) = £9 370

Perry Holder

Statement of affairs at 1 May (or 30 April) 20–7

	£	£
Assets		
Non-current assets		68 600
Trade receivables		8 240
Inventory		8 260
Rent prepaid		650
Bank account		2 310
		88 060
Liabilities		
Trade payables	5 160	
Accrual	430	
		5 590
Capital brought forward at 1.5.–7		82 470

Perry Holder's statement of financial position in the new layout used by AQA in the exams:

Perry Holder

Statement of financial position for the year ended 30 April 20–8

	£	£
Non-current assets		54 880
Current assets		
Inventory	4 870	
Trade receivables	23 340	
Prepaid expense	2 110	
		30 320
Total assets		85 200
Capital account		
Capital brought forward		82 470
Profit for the year		1 770
		84 240
Drawings		(18 700)
		65 540
Current liabilities		
Trade payables	9 620	
Accrued expenses	670	
Bank overdraft	9 370	
		19 660
Total capital and liabilities		85 200

Perry Holder's statement of financial position in the old layout that students may use in the AQA exams:

Perry Holder

Statement of financial position for the year ended 30 April 20–8

	£	£
Non-current assets		54 880
Current assets		
Inventory	4 870	
Trade receivables	23 340	
Prepaid expense	2 110	
	30 320	
Current liabilities		
Trade payables	9 620	
Accrued expenses	670	
Bank overdraft	9 370	
	19 660	
Net current assets		10 660
Net assets		65 540
Capital account		
Capital brought forward		82 470
Profit for the year		1 770
		84 240
Drawing		(18 700)
		65 540

14.3 Disadvantages of keeping incomplete records

Now test yourself

1 Any four of:
- More errors being made.
- Less ability to verify the accuracy of the bookkeeping.
- It is harder to prepare financial statements.
- Greater danger of fraud or theft.
- Less management information is available.
- Less evidence to support applications for loans.
- Inaccurate information being provided for tax purposes.
- Poor credit control.

2 Any two of:
- Owner's lack of knowledge.
- Cost of employing a bookkeeper or training the owner.
- Time-consuming to carry out bookkeeping.

15 Partnership accounts

15.1 Partnership financial statements and current accounts

Now test yourself

1 If there is no partnership agreement, partners must contribute equal amounts of capital, any loans to the business by partners carry interest at 5 per cent per annum, no partner may be charged interest on drawings, no partner is entitled to interest on capital, no partner is entitled to a salary and profits or losses are to be shared equally.

2 Interest on drawings is added. Interest on partners' loans, partners' salaries and interest on capital are subtracted.

3 The three items that may be debited to a partnership current account are interest on drawings, drawings and share of losses.

4 The four items that may be credited to a partnership current account are interest on partner's loans, partners' salaries, interest on capital and share of profits.

Exam practice questions

1 a) Workings:

Profit for four months from April to July = £36 900 × 4 ÷ 12 = £12 300

Profit for eight months from August to March = £36 900 × 8 ÷ 12 = £24 600

Interest on loan from April to July = £15 000 × 5% × 4 ÷ 12 = £250

Interest on loan from August to March = £15 000 × 3% × 8 ÷ 12 = £300

Interest on capital (Flanagan) = £90 000 × 5% × 8 ÷ 12 = £3 000

Interest on capital (Allan) = £75 000 × 5% × 8 ÷ 12 = £2 500

Salary to Flanagan = £18 300 × 8 ÷ 12 = £12 200

Flanagan and Allan		
Partners' appropriation account for year ended 31 March 20–8		
	April to July 20–7	**August 20–7 to March 20–8**
	£	**£**
Draft profit before interest on loan	12 300	24 600
Interest on Allan's loan	(250)	(300)
Profit for the period	12 050	24 300
Interest on drawings – Flanagan		604
Interest on drawings – Allan		501
Interest on capital – Flanagan		(3 000)
Interest on capital – Allan		(2 500)
Salary to Flanagan	–	(12 200)
Profit to be shared between partners	12 050	7 705
Flanagan	6 025	4 623
Allan	6 025	3 082
	12 050	7 705

(= Draft profit – Interest)

Flanagan's share of profits = £7 705 × 3 ÷ 5 = £4 623

Allan's share of profits = £7 705 × 2 ÷ 5 = £3 082

The profits for the period from April to July 20–7 are split equally as there was no partnership agreement.

The profits from August 20–7 to March 20–8 are split in the ratio 3:2 in accordance with the partnership agreement from 1st August.

b)

Current account					
Debit (Dr)	**Flanagan**	**Allan**	**Credit (CR)**	**Flanagan**	**Allan**
Balance b/d		7 321	Balance b/d	9 170	
Drawings	20 200	14 100	Interest on loan		550
Interest on drawings	604	501	Interest on capital	3 000	2 500
			Salary	12 200	0
			Share of profits 1	6 025	6 025
Balance c/d	14 214		Share of profits 2	4 623	3 082
			Balance c/d		9 765
	35 018	21 922		35 018	21 922
Balance b/d		9 765	Balance b/d	14 214	

Flanagan's balance c/d = £35 018 – (£20 200 + £604) = £14 214

Allan's balance c/d = £21 922 – (£550 + £2 500 + £6 025 + £3 082) = £9 765

15.2 Accounting for changes in partnerships

Now test yourself

1 a)
2 d)

Exam practice questions

1

Revaluation account			
Debit (Dr)	£	Credit (Cr)	£
Inventory	5400	Non-current assets	9000
Capital accounts	3600		
	9000		9000

Increase in value of non-current assets = £218 000 – £209 000 = £9 000

Decrease in value of inventory = £21 800 – £16 400 = £5 400

The amount allocated to the capital accounts will be split in the OLD profit sharing ratio:

Dennis = £3 600 × 4 ÷ 9 = £1 600

Geoff = £3 600 × 3 ÷ 9 = £1 200

John = £3 600 × 2 ÷ 9 = £800

Goodwill account			
	£		£
Goodwill created – Geoff	16 000	Goodwill written off – Dennis	27 000
Goodwill created – Dennis	12 000	Goodwill written off – Geoff	9 000
Goodwill created – John	8 000		
	36 000	Balance b/d	36 000

Goodwill created is shared in the OLD profit-sharing ratio

Goodwill written off is shared in the NEW profit-sharing ratio

Capital accounts							
Debit (Dr)				Credit (Cr)			
	Dennis	Geoff	John		Dennis	Geoff	John
	£	£	£		£	£	£
Goodwill written off	27 000	9 000		Balance b/d	98 000	79 000	41 000
Current account			5 033	Revaluation	1 600	1 200	800
Loan account			44 767	Goodwill created	16 000	12 000	8 000
Balance c/d	88 600	83 200					
	115 600	92 200	49 800		115600	92 200	49 800
				Balance b/d	8 860	83 200	0

The balance transferred from John's capital account to a loan account = £49 800 – £5 033
= £44 767

2

Goodwill account			
Debit (Dr)	£	Credit (Cr)	£
Goodwill created – Amina	37 800	Goodwill written off – Amina	28 000
Goodwill created – Sarah	25 200	Goodwill written off – Sarah	21 000
		Goodwill written off – Janet	14 000
	63 000	Balance b/d	63 000

Goodwill created is shared in the OLD profit-sharing ratio
Goodwill written off is shared in the NEW profit-sharing ratio

Revaluation account			
Debit (Dr)	£	Credit (Cr)	£
Inventory	1 220	Non-current assets	20 000
Amina (£18 780 × 3 ÷ 5)	11 268		
Sarah (£18 780 × 2 ÷ 5)	7 512		
	20 000		20 000

Increase in value of non-current assets = £156 000 – £136 000 = £20 000

Decrease in value of inventory = £18 340 – £17 120 = £1 220

Capital accounts							
Debit (Dr)				Credit (Cr)			
	Amina	Sarah	Janet		Amina	Sarah	Janet
	£	£	£		£	£	£
Goodwill written off	28 000	21 000	14 000	Balance b/d	73 000	56 000	
				Goodwill created	37 800	25 200	
				Revaluation	11 268	7 512	
Balance c/d	94 068	67 712	31 000	Bank			45 000
	122 068	88 712	45 000		122 068	88 712	45 000
				Balance b/d	94 068	67 712	31 000

16 Accounting for limited companies

16.1 Statements of cash flow

Now test yourself

1 'Operating activities' include profit from operations, depreciation, profit or loss on disposal of non-current assets, changes in inventory, trade receivables and trade payables, interest paid and tax paid.

2 'Investing activities' include proceeds from the sale of non-current assets, purchase price of additional non-current assets, interest received and dividends received.

3 'Financing activities' include cash received from issuing shares (including share premium), cash received from new loans or debentures, repayment of loans, debentures or shares and dividends paid.

4 **a)** Purchases of non-current assets

	£
Cost of non-current assets at the start of the year	98 200
Less: cost of asset that was sold	(18 000)
	80 200

Cost of non-current assets at the end of the year = £126 700

Purchase of non-current assets = £126 700 − £80 200 = £46 500

b) Depreciation for the year

	£
Provision for depreciation at the start of the year	41 300
Less: provision for depreciation on asset that was sold	(7 800)
	33 500

Provision for depreciation at the end of the year = £42 400

Depreciation for the year = £42 400 − £33 500 = £8 900

Exam practice questions

1

Calculation of interest paid	
	£
Interest on old debenture = £20 000 × 5%	1 000
Interest on new debenture (9 months only) = £24 000 × 5% × 9 ÷ 12	900
Total interest paid	1 900

Calculation of operating profit	
	£
Operating profit	?
Interest paid	(1 900)
Tax on profit for the year	(27 290)
Profit for the year	134 000

Operating profit = £134 000 + £27 290 + £1 900 = £163 190

Calculation of depreciation	
	£
Net book value of non-current assets at the start of the year	92 400
Less: net book value of disposal during the year	(4 200)
Profit for the year	88 200

Net book value of non-current assets at the end of the year = £75 900

Depreciation = £88 200 − £75 900 = £12 300

Calculation of loss on disposal:

Loss on disposal = £4 200 − £3 800 = £400

Calculation of tax paid	
	£
Tax liability for last year	29 200
Tax on this year's profit	27 290
Profit for the year	56 490
This year's liability	(24 000)
Tax paid during the year	32 490

Channon plc

Extract from statement of cash flow for the year ended 30 November 20–8

	£
Operating activities	
Operating profit	163 190
Add: depreciation	12 300
Add: loss on disposal of non-current asset	400
Add: decrease in inventories (= £12 900 – £11 400)	1 500
Less: increase in trade receivables (= £21 400 – £18 700)	(2 700)
Add: increase in trade payables (= £14 680 – £11 040)	3 640
Cash from operating activities	178 330
Less: interest paid	(1 900)
Less: tax paid	(32 490)
Net cash from operating activities	143 940

Note: The question only asks for 'operating activities'.

16.2 Schedules of non-current assets including revaluations

Exam practice questions

Deano Ltd

Schedule of non-current assets for the year ended 30 June 20–8

	Land and buildings	Motor vehicles	Furniture and fittings
	£	£	£
Cost			
At 1 July 20–7	192 500	127 500	44 000
Additions		18 950	6 400
Disposals		(28 400)	
Revaluation	107 500		
At 30 June 20–8	300 000	118 050	50 400
Depreciation			
At 1 July 20–7	46 250	64 215	19 500
Disposals		(12 425)	
Revaluation	(46 250)		
Charge for the year	13 500	16 565	10 080
At 30 June 2018	13 500	68 355	29 580
Net book value at 30 June 20–8	286 500	49 695	20 820
Net book value at 30 June 20–7	146 250	63 285	24 500

Net book value at 30 June 20–8 = Cost at 30 June 20–8 − Depreciation at 30 June 20–8

Net book value at 30 June 20–7 = Cost at 1 July 20–7 − Depreciation at 1 July 20–7

Workings:

Revaluation of land and buildings = £300 000 − £192 500 = £107 500

Depreciation of land and buildings = £300 000 × 4.5% = £13 500

Initial cost of vehicle that was sold:

NBV when sold was £15 975 (= NBV at 30 June 20–7)

NBV at 30 June 20–6 = £15 975 ÷ 0.75 = £21 300

Cost on 1 May 20–5 = £21 300 ÷ 0.75 = £28 400

Depreciation on vehicle that was sold = £28 400 − £15 975 = £12 425

Depreciation on vehicles at 25 per cent reducing balance method:

Net book value at start of the year = £63 285

Less net book value of vehicle that was sold = £63 285 − £15 975 = £47 310

Add cost of new vehicle = £47 310 + £18 950
= £66 260

Depreciation = £66 260 × 25% = £16 565

Depreciation on fixtures and fittings at 20 per cent straight line method

Cost of fixtures and fittings = £44 000 + £6 400
= £50 400

Depreciation = £50 400 × 20 per cent = £10 080

16.3 Rights issues and bonus issues

Now test yourself

1 A rights issue involves shares being offered to existing shareholders at a price a little below the market value but often above nominal value, which creates share premium.

2 A bonus issue involves issuing free shares to existing shareholders out of capital or revenue reserves.

3 Original number of shares = £6 000 ÷ £1.50
= 4 000

Number of shares in the rights issue = 4 000 ÷ 2 × 3 = 6 000

Nominal value of rights issue = 6 000 × £1.50
= £9 000

Share premium from the rights issue = 6 000 × £1
= £6 000

Effects on the statement of financial position and the statement of changes in equity:

- issued share capital increases by £9 000 and share premium increases by £6 000.

The other effect on the statement of financial position:

- Cash and cash equivalents increase by £15 000.

4 Bonus issue = £4 000 ÷ 2 = £2 000

Effects on the statement of financial position and the statement of changes in equity:

- Issued share capital increases by £2 000 and share premium decreases by £2 000.
- If the directors did not want to keep reserves in their most distributable form, £2 000 would have been subtracted from retained earnings instead of share premium.

Exam practice questions

1 a)
2 c)
3 d)

16.4 Published accounts and international accounting standards

Now test yourself

1 Published accounts are required by law. They provide information for shareholders and potential shareholders. They provide information for lenders and credit suppliers because shareholders are protected by limited liability.

2 Any three of:
- Shareholders and potential shareholders – likelihood and level of future dividends and implications for future share prices.
- Employees – job security and pay increases or bonuses.
- Suppliers/trade payables – likelihood of being paid on time, possibility of not being paid at all and deciding whether to review credit terms.
- Customers – likelihood that the company will continue to supply products.
- Lenders – whether the company will be able to afford repayments and interest.

3 Any two of:
- They are historical data from previous years.
- The income statement is in summary format, and does not show individual expenses.
- The values of assets may be inaccurate.
- The accounts do not show non-financial considerations.

4 Any six of:
- income statement
- statement of financial position
- statement of cash flow
- statement of changes in equity

- notes to the accounts
- statement of accounting policies
- directors' report
- auditors' report
- comparative figures from the previous year.

Exam practice questions

The purposes/importance of international accounting standards are to ensure that financial statements are …

You then need to state and explain any five of the following points to earn 10 marks plus a further 2 marks for the quality of your written communication.

- complete – containing all the main documents, i.e. income statement, statement of financial position, statement of cash flow, statement of changes in equity and the notes to the accounts
- understandable – for different stakeholders, such as shareholders, employees and suppliers
- reliable – showing a true and fair view, and not containing any errors, bias, fraud or window dressing
- comparable – across different years for that business, across different businesses and in different countries
- relevant for decision making – for example, whether a bank should agree to a loan
- in line with accounting concepts – for example, prudence, consistency and accruals
- consistent with the auditors' report – when the auditors are stating their opinion about the financial statements.

17 Interpretation, analysis and communication of accounting information

17.1 Interpretation and analysis of accounting information

Now test yourself

1 a) Dividend per share = £24 000 ÷ 100 000 = £0.24
 b) Dividend yield = £0.24 ÷ £2.50 × 100 = 9.6%
 c) Earnings per share = 17 600 000p ÷ 100 000 = 176p
 d) Price earnings = £2.50 ÷ £1.76 = 1.42
 e) Dividend cover = £176 000 ÷ £24 000 = 7.33
 f) Interest cover = £176 000 ÷ £48 000 = 3.67

2 Cash means money that is immediately available. Profit = Revenue – Total costs.

3 Any four of:
- credit sales
- credit purchases
- sales returns
- purchase returns
- depreciation
- irrecoverable debts
- changes in the provision for doubtful debts.

4 Any four of:
- cash received from trade receivables
- cash paid to trade payables
- share issues
- loans received
- loan repayments
- dividends paid
- purchase of non-current assets (apart from depreciation on the non-current assets).

Exam practice questions

1 b)
2 c)
3 a)
4 d)
5 b)

17.2 Communication of accounting information

Now test yourself

1 Any two of:
- The owner(s) of a sole trader or partnership business – the profits of the business, how much they can take out in drawings and how much tax needs to be paid.
- Shareholders in a limited company – the profits of the business, how much can be paid out in dividends and the likely impact on the value of their shares.
- Managers and other employees – they expect to be paid by the business and want job security. They may also want pay increases or bonuses.

2 Any three of:
- Suppliers – they want to receive orders from the business and also to be paid on time. New suppliers might need to decide whether to sell on credit.
- Customers – they want the business to continue to supply products.
- Lenders (banks and debenture holders) – they want to know whether they will be repaid and whether the business can afford to pay the interest.

- HM Revenue & Customs – they want to be paid the correct amount of tax.
- Local community – they want jobs to be created and protected, and no pollution, waste products or traffic congestion.

3 Any three of:
- Computerised bookkeeping is much faster than doing it manually.
- Balances on accounts (e.g. receivables and payables ledgers) are always up to date.
- Financial statements are available much more quickly and are available whenever needed.
- Accounting software will not make mathematical errors.
- May save money by not having to employ a bookkeeper or accountant.
- Increased privacy if no need to employ a bookkeeper or accountant.

4 Any three of:
- The cost of buying and installing the accounting software.
- The figures will not be available if the system crashes.
- Danger of viruses or people hacking into the system from outside of the business.
- Time needed to train staff or the owner on how to use the software.
- Staff resistance to changing from a manual system to a computerised system.
- Possible health and safety problems from employees spending too much time using a computer.

5 Any two of:
- Easier than double entry; minimal training is required.
- Quicker than double entry; leaves more time for running the business.
- Cheaper than employing a bookkeeper to complete double entry records.

6 Any two of:
- Greater likelihood of mistakes being made and not noticed.
- It will take longer to produce the end-of-year financial statements.
- Higher accountancy fees to produce the end-of-year financial statements.

7 Any two of:
- Less likelihood of mistakes being made and not noticed.
- It will be quicker to produce the end-of-year financial statements.
- Lower accountancy fees to produce the end-of-year financial statements.

8 Any two of:
- Harder than single entry; training is required.
- Slower than single entry; leaves less time for running the business.
- Employing a bookkeeper to complete double entry records increases costs.

Exam practice questions

1 b) **2** d)

18 The impact of ethical considerations

18.1 The principles of ethical behaviour

Now test yourself

1
- Integrity – accountants must be straightforward and honest in all professional and business relationships.
- Objectivity – accountants must not allow bias, conflict of interest or undue influence of others to override professional judgments.
- Professional competence and due care – accountants must maintain professional knowledge and skills at the level required to ensure that a client or employer receives competent professional services.
- Confidentiality – accountants must not disclose any information obtained through their professional duties to third parties without specific permission or a legal duty to do so.
- Professional behaviour – accountants must comply with relevant laws and regulations and avoid any action that discredits the profession.

2 'In business' means that an accountant is employed to carry out duties for a specific organisation. 'In public practice' means that an accountant is employed by an accountancy firm to carry out duties for the clients of that firm.

3 Any five of:
- To act within their powers.
- To promote the success of the company.
- To exercise independent judgement.
- To exercise reasonable care, skill and diligence.
- To avoid conflicts of interest.
- To not accept benefits from third parties.
- To disclose an interest in any proposed transactions involving the company.

4 Any four of:
- To ensure that the financial statements are accurate and that they show a true and fair view of the company's financial position.
- To ensure that the financial statements have been prepared in accordance with international accounting standards and accounting concepts.
- To prepare the directors' report on the activities and performance of the company.
- To appoint auditors to check the financial statements and report to the shareholders.
- To ensure that the financial statements are completed in time for submission to the Registrar of Companies.

5 The auditors' report will be 'unqualified' if the auditors believe that the financial statements provide a true and fair view of the company's performance and financial position, the financial statements have been properly prepared and the directors' report is consistent with the contents of the financial statements.
The auditors' report will be 'qualified' if the auditors believe that any parts of the financial statements have not been prepared correctly and that this is significant enough to be brought to the attention of any of the users of the accounts.

6 A remuneration committee is established to ensure that remuneration arrangements support the strategic aims of a business and enable the recruitment, motivation and retention of senior executives, while also complying with the regulations.
It must have at least three members, all of whom must be non-executive directors who are not involved in the day-to-day running of the company.

7 Corporate governance refers to the systems and processes in place to monitor and control how a business is run. Its main aim is to protect the interests of the shareholders of a company.

8 Corporate social responsibility means the duties of a business towards its stakeholders and the environment.

18.2 Legal and regulatory frameworks and the role of professional bodies

Now test yourself

1 The Finance Reporting Council (FRC) is the UK's regulator for the accounting sector. Its mission is to promote transparency and integrity in the profession. Its role includes issuing accounting standards and auditing standards, issuing the code of practice for corporate governance in the UK, monitoring the conduct of companies, accountants and auditors and issuing sanctions to any who have not complied with the FRC's regulations.

2 The Department for BEIS (previously BIS) is responsible for business, industrial strategy, science, research and innovation, energy and clean growth and climate change. It provides information to support businesses, and helps them to obtain finance. It contributes to regulation by promoting responsible business practices. It is also involved in drafting business regulations and company law.

3 The main expectation of the European Union is that companies produce their financial statements in line with international accounting standards. When the UK leaves the EU, this will not change. UK companies will continue to adhere to IASs as they are applicable worldwide. They are not restricted to countries that belong to the EU.

4 CIMA and the professional bodies that belong to CCAB provide codes of conduct that outline the five underlying principles of ethical behaviour in the accounting sector. They also aim to enforce their codes of conduct by disciplining members who do not meet reasonable ethical and professional expectations. In addition, they provide a framework that helps their members to identify and evaluate threats to compliance with ethical principles. They apply safeguards to eliminate threats or reduce those threats to an acceptable level.

18.3 How to act ethically

Now test yourself

1 Self-interest – the threat that a financial or other interest will inappropriately influence the accountant's judgement or behaviour.
- Self-review – the threat that an accountant will not appropriately evaluate the results of a previous judgement made or professional services performed.
- Advocacy – the threat that an accountant will promote a client's or employer's position to the point that the accountant's objectivity is compromised.
- Familiarity – the threat that due to a long or close relationship with a client or employer, an accountant will be too sympathetic to their interests or too accepting of their work.
- Intimidation – the threat that an accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.

2 Any five of:
- educational, training and experience requirements for entry into the profession
- requirements for ongoing professional development
- regulations regarding corporate governance and other professional standards
- procedures for monitoring and disciplining individuals within the profession
- external checks of the reports, returns, communications or information produced by a professional accountant or auditor
- laws such as The Companies Acts
- regulations such as international accounting standards
- organisations such as the Finance Reporting Council and professional bodies within the accounting sector.

3 Any four from:
- internal control systems to monitor standards of ethical behaviour
- disciplinary procedures to deal with instances of unethical behaviour
- encouraging individuals to keep detailed records of potentially contentious issues
- well-publicised complaint systems which enable colleagues, clients and members of the public to draw attention to unethical behaviour
- an expectation that employees will report any breaches of ethical requirements.

4 The following steps should be followed:
- Identify the relevant facts.
- Identify the role and position of the people involved.
- Identify the relevant ethical principle(s).
- Identify and evaluate the relevant threat(s) to the ethical principle(s).
- Follow internal procedures to deal with the threat to ethical principle(s).
  If necessary, refer the matter to external bodies.

Exam practice question

1

A02 – Application
What is at risk?
Expected behaviour – integrity, objectivity, professional competence, confidentiality and professional behaviour may be at risk in the given situations.
Explanation of risks
Audit fee may be too large and endanger objectivity.
Conflict of interest with partner's wife – also confidentiality.
Audit report – threat to professional competence.
Drug company – public interest requirement of professional accountant.
Relating the codes of practice and regulatory guidelines to the scenario:
A03 – Analysis and evaluation
Procedure/assessment
Assess whether there is a real problem and is it their problem
Is more information required?
For example:
Audit fee – could the business afford to lose 30% of income?
Wife – does the partner deal with the firm of which his wife is MD?

A03 – Analysis and evaluation
Audit report – how sure are they that standards not applied and how likely are directors to appoint new auditors – will they be supported by shareholders?
Price fixing – how confident are they that price fixing has taken place?
Which fundamental principles threatened?
Self-interest threats
Self-review threats
Advocacy threats
Familiarity threats
Intimidation threats.
What safeguards can be put in place to reduce risk?
What course of action?
For example:
Audit – if objectivity threatened:
consider sharing audit with other firms to reduce fee income;
increase fee income – potential for merger or new partner.
Wife – if confidentiality threatened.
Ensure partner involved does not work with that client.
Require confidentiality agreement from partner.
If threat significant then may have to refuse work from that client.
Audit report – if professional competence called into question:
Possibly present report to shareholders with explanation of situation.
Other firms may refuse to take on audit in these circumstances.
Price fixing – if proven:
Report to regulatory body.

Note: Not all content needs to be covered to gain full marks.

The indicative content is not exhaustive; other creditworthy material should be awarded marks as appropriate.

Mark scheme:

Level	Marks	Description
5	21–25	A clear and balanced response that presents a coherent and logically reasoned judgement and conclusion/solution that is supported by an astute consideration of a wide range of evidence including other factors relevant to the wider context. There is an insightful assessment of the significance and limitations of the evidence used to support the judgement.
4	16–20	A reasoned, but in places unbalanced, judgement and conclusion/solution is presented that is supported by an evaluation of a wide range of evidence, including a narrow consideration of other factors relevant to the wider context. There is a partial assessment of the significance and limitations of the evidence used to support the judgement.
3	11–15	An underdeveloped judgement and conclusion/solution is presented that is supported by an evaluation of a range of evidence provided in the question; however, there may be inconsistencies and the reasoning may contain inaccuracies. A comprehensive and relevant selection of information is analysed, showing a developed logical chain of reasoning. The results of any appropriate calculation/s are integrated into the analysis and evaluations offered on most. Comprehensive and relevant knowledge and understanding of principles/concepts/techniques is drawn together and applied successfully to the context. Where appropriate, a thorough selection of relevant calculations is attempted; these may include minor errors.
2	6–10	A basic judgement and conclusion/solution is presented; it is supported by a limited evaluation of evidence provided in the question, containing significant inaccuracies. A limited but relevant selection of information is analysed, starting to develop a logical chain of reasoning. The results of the calculation/s are integrated into the analysis but with weak evaluations. Limited but relevant knowledge and understanding of principles/concepts/techniques is drawn together and applied successfully to the context. Where appropriate, a limited selection of relevant calculations is attempted; these may include minor errors.
1	1–5	A judgement and conclusion/solution may be asserted, but it is unsupported by any evidence. Responses present a limited selection of information that is not wholly relevant with an attempt at analysis. A chain of reasoning ranges from being barely present to undeveloped. Fragmented items of knowledge and understanding of principles/concepts/techniques relevant to the contexts are present. These are likely to be descriptive, with limited application to the context. Where appropriate, some calculations are attempted; these are likely to contain errors and may not be relevant to the context. Results of the calculations are stated with little or no evaluation.
0	0	Nothing written worthy of credit.