	Financial Accounting	Management Accounting
Purpose	Record historic transactions	• assist in controlling the business operations • planning how the business will develop • making decisions between alternatives
Audience	External parties – particularly shareholders, lenders and regulators	Internal management and owners of the organisation
Legal requirements	• prepare financial statements (in accordance with legal requirements) • prepare accounts for tax authorities	• No legal requirement to prepare • No set format for presentation

	Financial Accounting	Management Accounting
Format	Must conform to accounting and legal requirements	Presented in such a format as to be easily understood by managers
Perspective	Historic performance (i.e. backwards looking only)	Both future perspective (for planning and decision-making) and historic perspective (for control)
Nature of Information	Almost entirely financial	Both financial and non-financial
Frequency of Preparation	Usually once a year	As often as necessary – daily, weekly preparation or monthly, depending upon the needs of managers.

9.1 Sources of data

The first part of the accounting process, i.e. recording business transactions is often driven by various **source documents** that provide evidence for the transaction and give all the relevant details. These documents include:

Quotation	A written offer to provide goods or services at a particular price. No transaction has taken place yet and therefore nothing is recorded in the accounts.
Sales order	An order note for goods required by a customer.
Purchase order	An order note for goods required from a supplier
Goods received note	A list of goods received from a supplier. Prepared by the recipient business.
Goods despatched note	A list of goods sent to a customer. Prepared by the seller.
Invoice	A demand for payment sent to a customer.
Statement	A document sent to a customer listing all transactions between the business and that customer.
Credit note	A note sent to a customer who returns goods or overpays. This reduces the amount owed by that customer.
Debit note	A note sent to a supplier to whom goods have been returned. It is in effect a request for them to issue a credit note.
Remittance advice	A document sent to a supplier alongside any payment sent to them. It details which invoices are being paid.
Receipt	A note to confirm that payment has been received.

9.2 Books of prime entry – part of the accounting process

When a business is involved in a transaction, it is usual for this transaction to be recorded initially in a book of prime entry.

A book of prime entry is not part of the ledger or double entry system, but simply a list of transactions of the same type. The common books of prime entry and the types of transaction recorded in them are:

Book of prime entry	Transaction type
Sales day book (SDB)	Credit sales
Purchases day book (PDB)	Credit purchases
Sales returns day book (SRDB)	Returns of goods sold on credit
Purchases returns day book (PRDB)	Returns of goods purchased on credit

Asset accounts are	DEBITS
Liability accounts are	CREDITS
Capital accounts are	CREDITS
Revenue accounts are	CREDITS
Expense accounts are	DEBITS

- An asset account collects information about particular assets of a business. It mainly consists of debit entries.
- A liability account collects information about particular liabilities of a business. It mainly consists of credit entries.
- Asset and liability accounts appear on the statement of financial position at the end of the accounting period.
- An expense account collects information about particular costs of a business. It mainly consists of debit entries.
- A revenue account collects information about particular income of a business. It mainly consists of credit entries.
- Revenue and expenses appear in the statement profit or loss in order to compute profit for an accounting period.

Ledger account

	£		£
Debit side (Dr)		Credit side (Cr)	
Entries on the DEBIT side: increases in		Entries on the CREDIT side: increases in	
Assets		Liabilities	
Expenses		Income	
Drawings		Capital	

- Purchase price, plus:
- Import duties and other taxes, plus
- Transport, handling and any other cost directly attributed to the acquisition of finished goods, services and materials, less
- Trade discount, rebate and other similar amounts (eg subsidies)

- Costs which are specifically attributed to unit of production, example, direct labour cost, direct expenses and subcontracted work
- Fixed and variable production overheads that are incurred in converting materials into finished goods.
- Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, example, cost of factory management and administration.
- Variable production overheads are those indirect costs of production that vary directly or nearly directly, with the volume of production, example, indirect materials and labour.

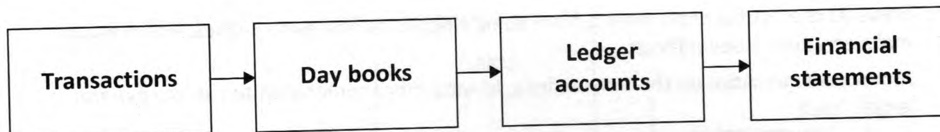
- A tangible non-current asset can be bought in its useable state and it could also be purchased and additional work may need to done on it to bring it to a working condition.
- IAS 16, the accounting standard that deals with tangible non-current assets, requires that the cost includes all costs directly attributable to bringing the asset to its location and working condition for its intended use (i.e. to operate normally). It includes:
  - Initial purchase price
  - Delivery costs
  - Non-refundable import taxes
  - Installation costs
  - Initial training costs
  - Legal fees
  - Stamp duty
- Subsequent expenditure which increases the economic benefit generated by the asset can be capitalised.
- Other expenditure is revenue expenditure and must be expensed in the statement or profit or loss.

Research expenditure: This should be written off as an expense as it is incurred.

Tangible non-current assets used for research purposes: These should be capitalised, and depreciated over their useful lives.

Development expenditure: An intangible asset arising from development (or from the development phase of an internal project) may be recognised if an enterprise can demonstrate all of the following:

- The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- The intention to complete the intangible asset and use or sell it.
- The ability to use or sell the intangible asset.
- How the intangible asset will generate probable future economic benefits.
- The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- The ability to measure reliably the expenditure attributable to the intangible asset during its development.



Day books or **books of prime entry**: individual transactions are entered first here.

Ledger accounts: are in the general ledger or nominal ledger, which form the double entry books of account. They contain all the balances necessary to produce financial statements, i.e. asset, liability, income and expense accounts. They include:

Control accounts: most notably receivables and payables control accounts. These are ledger accounts which summarise a large number of transactions.

Receivables and **payables ledgers** are subsidiary or memorandum ledgers which record detailed transactions and allow staff to identify individual supplier (payable) and customer (receivable) balances. They are separate from the general ledger and are not usually part of the double entry system.

Degree of probability	Degree of probability	Contingent liabilities	Contingent assets
Virtually certain (therefore not contingent)	Probability above 95%	Provide	Recognise
Probable	Probability above 50% and up to 95%	Provide	Disclose by note
Possible	Probability 5% to 50%	Disclose by note	No disclosure
Remote	Probability below 5%	No disclosure	No disclosure

Glossary

Accounting records	Any listing or book which records the transactions of a business in a logical manner.
Accrued expense	An expense which has been incurred but not paid by the end of the accounting period.
Assets	Any tangible or intangible possession which has value.
Statement of financial position	A statement of assets, liabilities and equity at a point in time.
Equity	The residual interest in a company, paid to the owners when the business ceases to trade.
Capital expenditure	Expenditure on acquiring or improving non-current assets for use in the business and not for resale. Reported in the statement of financial position
Statement of cash flows	Provides information about cash receipts and cash payments during an accounting period.
Credit note	Records goods returned by a customer or the reduction of monies owed by a customer.
Current asset	Assets which the business intends to use, sell, or change regularly in the normal course of business. E.g. inventory, receivables and cash.
Current liability	A liability which is payable within 12 months of the reporting date.

Day books	Record the transactions of each day, and are used as an initial 'store' of information of the business transactions prior to recording the information in the ledger accounts.
Debit note	Sometimes raised by a purchaser of goods. It is a formal request for a credit note to be issued by the supplier.
Financial accounting	Concerned with accounting to users **outside** the enterprise for the way in which the business's funds have been used. Done by presenting a statement of financial position and income statement at least once every year.
Financial management	Seeks to ensure that financial resources are obtained and used in the most effective way to secure attainment of the objectives of the organisation. It is largely to do with the management of cash and investments.
Statement of profit or loss and other comprehensive income.	A summary of income and expenditure for a period of time, showing the profit or loss made in an accounting period, together with any items of other comprehensive income arising in the same accounting period.
Ledger accounts	Also known as 'T' accounts. Pages in a book (the ledger) with a separate page reserved for transactions of the same type.
Liabilities	The financial obligations of an enterprise

Management accounting	An integral part of management activity inside the enterprise, concerned with identifying, presenting and interpreting detailed information used for formulation of strategy, planning and controlling activities, decision taking and optimising the use of resources.
Non-current asset	Any asset, tangible or intangible, acquired for retention by an entity for the purpose of providing a service to the business, and not held for resale in the normal course of trading.
Non-current liability	A liability which is payable more than 12 months after the reporting date.
Prepayment	An expense which has been paid in advance for a period which extends beyond the end of the current accounting period.
Provision	An amount written off to provide for the diminution in value of an asset (e.g. a provision for depreciation) or an amount retained to provide for a known liability whose amount cannot be determined with accuracy. A provision is treated as an expense in the income statement.
Purchase order	An agreement to purchase goods/services from a business. It is prepared by the purchaser.
Revenue expenditure	Expenditure on acquiring current assets, on running the enterprise and on maintaining non-current assets. Reported in the income statement.

Sales invoice	A formal record of the amount of money due from the customer as a result of the sale transaction.
Sales order	An agreement to sell goods/services to a business. It is prepared by the seller.
Source document	An individual record of a business transaction.

Accruals Concept

Income and expenditure should be matched to the period in which it relates rather than when cash is received or paid

Accrued expenditure

This arises when the expenditure relating to the period has not been paid.

The amount owing at the end of the period is adjusted as follows:

Dr Expense (P&L) Cr Accrued expenditure (SFP liability)

In an ongoing business there could be an opening and a closing accrual.

Accrued expenditure – Proforma expense T account

Expense			
		Bal b/d (opening accrued expense)	X
Bank (total paid during the year)	X	SOCI (total expense for the year)	X
Bal c/d (closing accrued expense)	X		
	X		X
		Bal b/d (opening accrued expense)	X

Accrued Income

Accrued income arises when the income has been earned in the period but has not been received.

The accrued income will be accounted for as follows:

Dr Accrued income (SFP) Cr Income (P&L)

Prepayments

Prepaid expenditure

This arises when the expenditure relating to the period has been paid in advance.

The amount prepaid at the end of the period is adjusted as follows:

Dr Prepayment (SFP asset) Cr Expense

In an ongoing business there could be an opening and a closing prepayment.

Prepaid expenditure – Proforma expense T account

Expense			
Bal b/d (opening prepaid expense)	X	SOCI (total expense for the year)	X
Bank (total paid during the year)	X	Bal c/d (closing prepaid expense)	X
	X		X
Bal b/d (opening prepaid expense)	X		

Prepaid Income

Prepaid income arises when the income has been received in the period but relates to the next accounting period.

The prepaid income will be accounted for as follows:

Dr Income (P&L) Cr Prepaid/ deferred income (SFP)

Methods of depreciation

Straight line method

% on cost

or: $\frac{\text{Cost – Residual Value}}{\text{Useful economic life}}$

Reducing balance method

This method results in higher depreciation charges in earlier years. A percentage is applied to cost in the first period and to net book value in subsequent years.

Take care! If assets have been sold during the year, the accumulated depreciation b/f must be reduced by the accumulated depreciation on the disposals, before the current year's charge is calculated.

Type of income	Recognition
Sale of goods	In addition to the above general principles, the seller must: • have transferred the '**significant risks and rewards of ownership**' to the buyer • not retain effective control (or a continuing management involvement) over the goods sold.
Providing services	Recognise by reference to **degree of completion of transaction** as at the end of the reporting period, provided that: • the **stage of completion** can be **measured reliably**, and • the costs incurred and the **costs to be incurred** to complete the transaction can be **reliably measured**. When these conditions are not met, revenue should be recognised only to the extent of the expenses recognised that are recoverable.
Interest	Recognise on a time proportion basis taking account of the yield on the asset.
Royalties	Recognise on an accruals basis in accordance with the relevant agreement
Dividends	Recognise when the shareholder's right to receive payment has been established.

Intangible assets: IAS 38

The main area for examination in this standard is that of Research and Development

Research – Definition	Recognition
'**Original** and planned **investigation** undertaken with the prospect of gaining new scientific or technical knowledge and understanding'.	Expenditure on research should be recognised as an **expense** in the period in which it is incurred.

Development – Definition	Recognition
'The **application** of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use'. **The cost of an internally generated development work** The sum of all directly attributable costs to create the asset and make it ready for use in the manner intended by management. E.g. • costs of materials, services and labour • fees to register a legal right. Only expenditure incurred from the time that the intangible asset was recognised is included. Expenditure incurred during the research phase cannot be re-classified from an expense to an intangible asset.	Recognise as an **intangible asset**, if and only if all the following can be demonstrated: • the **technical feasibility** of completing the development • the **intention** of the company to **complete** the development • the **ability** of the company to **use or sell** the item • how the intangible asset will generate future **economic benefits** • the **availability** of adequate technical, financial and other **resources to complete** the asset • the **ability to measure reliably** expenditure on the intangible asset during its development. When the requirements can all be demonstrated, **subsequent** expenditure should be classified as an intangible asset.

Amortisation

Capitalised development costs must be **amortised** once commercial exploitation begins. The **method** should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used.

Errors not revealed by the trial balance

Error of omission	• **no entry** for a transaction has been made at all.
Error of commission	• an amount has been correctly posted, but to the **wrong account**. E.g. a sale on credit to G Brown has been posted to the account of J Brown.
Error of principle	• an item is posted to the **wrong type of account**. E.g. a new tyre for a van has been posted to the Van account (non-current asset) rather than to the Motor Repairs account (expense).
Error of original entry	• an **incorrect amount** is posted to both the accounts in question
Compensating error	• two or more **errors cancel out each other**. They are difficult to locate and fortunately tend not to occur frequently.
Reversal of entries	• the correct amounts have been posted to the correct accounts, but on the **wrong side**.
Transposition errors	• e.g. $527 is recorded as $725. (The difference the error creates is always divisible by 9.) Not revealed by the trial balance if the same figure has been used on both sides of the double entry.

Errors revealed by the trial balance

- **Single sided entry** – Only one side of the double entry has been made, e.g. the debit, but not the credit.
- Debit and credit entries have been made, but using **different figures**.
- **Both entries** have been made on the **same side**.
- An individual account has been **miscast** (i.e. added up incorrectly).
- An opening balance has not been brought down.
- **Extraction error** – the balance in the trial balance is different from the balance in the account.

The suspense account

Definition

A **suspense account** is an account in which debits or credits are held temporarily until sufficient information is available for them to be posted to the correct accounts.

Why are suspense accounts created?

- Differences on a trial balance: when debits are not equal to the credits, the difference is put to a suspense account.
- Book-keeping uncertainty: where it is not clear to a book-keeper where to post one side of an entry, it may be debited or credited to a suspense account.

Statement of financial position

Statement of financial position of ABC Company
As at 31 December 20XX

Assets	$m	$m
Non-current assets		
Property, plant and equipment	x	
Intangible assets	x	
Investments	x	x
Current assets		
Inventories	x	
Trade and other receivables	x	
Cash	x	
		x
Total assets		x

→ Present all assets and liabilities in order of liquidity.

→ Present non-current assets separately from current assets.

→ Asset = current if:
- part of operating cycle, or
- held for trading purposes, or
- expected to be realised within 12 months of BS date, or
- cash or a cash equivalent.

Equity and liabilities	$m	$m	
Equity			
Issued capital	x		
Reserves	x		
Retained earnings	x		→ Sum of the accumulated profits and losses
		x	
Non-current liabilities			
Long-term loans		x	
Current liabilities			→ Liability = current if:
Trade and other payables	x		– expected to be settled in the normal course of the operating cycle of the entity, or
Short-term borrowings (bank overdraft)	x		– held primarily for the purpose of being traded, or
Tax	x		– due to be settled within 12 months of the reporting date, or
		x	– no unconditional right to defer settlement to at least 12 months after the reporting date.
Total equity and liabilities		x	

Statement of profit or loss and other comprehensive income

ABC Company
Statement of profit or loss and other comprehensive income for the year ended 31 December 20XX

	$m	
Revenue	x	
Cost of sales	x	
	x	
Other income	(x)	
Distribution costs	(x)	→ Analysis of expenses may be on the face of the IS or in the notes.
Administrative expenses	(x)	
	x	
Finance costs	(x)	
Profit before tax	x	
Tax expense	(x)	
Profit for the period	x	
Other Comprehensive income:		
Revaluation Gain/Loss	x/(x)	
Total Comprehensive Income	x	

Statement of changes in equity

This shows all of the changes which have affected the various classes of equity (previously referred to as share capital and reserves).

ABC Company
Statement of changes in equity for the year ended 31 December 20XX

	Share capital	Share premium	Revaluation reserve	Retained earnings	Total
	$000	$000	$000	$000	$000
Balance at 31 December Year 1	x	x	x	x	x
Change in accounting policy	–	–	–	(x)	(x)
Re-stated balance	x	x	x	x	x
Changes in equity for Year 2					
Surplus on revaluation of properties			x		x
Deficit on revaluation of properties			(x)		(x)
Net gains and losses not recognised in the SOCI			x		x
Net profit for the period			–	x	x
Dividends paid				(x)	(x)
Issue of share capital	x	x	–	–	x
Balance at 31 December Year 2	x	x	x	x	x

Margin v mark-up

With **gross profit margin** the percentage of profit is given by reference to **sales revenue**.

Gross profit percentage or profit margin =

$$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$

Margin × sales = Gross profit

Thus if we know that sales revenue totals $8,000 and the gross profit percentage is 25%, the following can be deduced:

	$	%
Sales revenue	8,000 (given)	100
Less: Cost of sales	6,000	75
Gross profit	2,000	25 (given)

The gross profit is calculated as follows:
25% × $8,000 = £2,000

All the other items are derived as balancing items

With **gross profit mark-up** the percentage of profit is given by reference to **cost of sales.**

Gross profit mark-up percentage =

$$\frac{\text{Gross profit}}{\text{Cost of sales}} \times 100$$

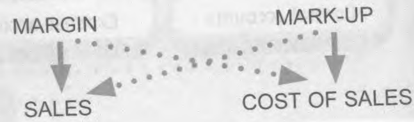
Mark-up × cost of sales = Gross profit

Thus if we know that cost of sales is $6,000 and the mark-up is one third, we can set out the following:

	$	Ratio
Sales revenue	8,000	4
Cost of sales	6,000 (given)	3
Gross profit	2,000	1

The gross profit is calculated as follows:
1/3 × $6,000 = $2,000

Exam trick



Exam focus

An exam question will often provide you with margin and cost of sales or mark-up and sales. You will then be required to calculate the remaining figures in the trading account. This can be done using the following 'relationship' columns:

Margin 25%		**Mark-up 25%**	
Sales	2. 100%	Sales	3.100+ratio
Cost of sales	3. 100-ratio	Cost of sales	2. 100%
Gross profit	1. Ratio	Gross profit	1. Ratio

Statement of cash flows for the year ended 31 December 20X7

	$	$
Net cash flow from operating activities		
Net profit before taxation	X	
Adjustments for		
Interest payable (interest expense)	X	
Depreciation/amortisation	X	
Loss on disposal of non current assets	X	
Profit on disposal of non current assets	(X)	
Operating profit before working capital changes		X
(Increase)/decrease in inventories		(X)/X
(Increase)/decrease in trade receivables		(X)/X
Increase/(Decrease) in trade payables		X/(X)
Cash generated from operations		X
Interest paid	(X)	
Income taxes paid	(X)	
		(X)
Net cash from operating activities		X

	$	$
Cash flows from investing activities		
Purchase of property, plant and equipment/intangible non current assets	(X)	
Proceeds of sale of non current assets	X	
Interest/dividends received	X	
Net cash used in investing activities		X/(X)
Cash flows from financing activities		
Proceeds from issue of shares	X	
Receipt of loans	X	
Dividends paid	(x)	
Repayment of loans	(X)	
Net cash used in financing activities		X/(X)
Net increase/(decrease) in cash and cash equivalents		X/(X)
Cash and cash equivalents at the beginning of the period		X/(X)
Cash and cash equivalents at the end of the period		X/(X)