<u>A-LEVEL ACCOUNTING (9706)</u>

<u>1. Financial Accounting</u>

1.1 Preparation of Financial Statements

→ Manufacturing businesses

- Manufacturing account: an a/c prepared at the end of a financial period to calculate the production cost of manufactured goods
  - Only includes information about the factors & actual manufacturing process
  - All other non-production costs (ie. administration, finance, distribution costs) recorded in IS
  - COP = Factory overheads + prime cost
  - Factory profit: percentage added to the factory cost of production to arrive at the transfer price
  - Work in progress: inventory of partly finished goods in the factory at any point in time
  - Prime cost/direct cost: the total of direct materials, direct labour & direct expenses
  - Factory overheads/indirect costs: costs incurred from factory operations
    - Includes indirect factory wages & depreciation of factory machinery
- Transfer price: production cost of completed goods plus a percentage mark-up
- Factory/manufacturing profit: profit made from manufacturing the goods compared to the cost buying-in
  - Percentage added to COP as profit from manufacturing
  - "Manufacturing profit" & "gross profit on trading"
    - Must be kept separate until they are aggregated in the profit & loss a/c
  - If the COP exceeds the cost of buying the goods, we get a factory loss
  - Treatment of manufacturing profit/loss
    - If there is a manufacturing profit
      - Add factory profit to COP
      - Add factory profit to operating profit
    - If there is a manufacturing loss
      - Deduct factory loss from COP
      - Deduct factory loss from operating profit
- Unrealised profit from unsold inventory
  - Unrealised profit: profit which is not recognised until the inventory is sold & a contract of sale has been negotiated
    - $\frac{Value\ of\ finished\ goods\ including\ unrealised\ profit}{100+percentage\ of\ profit} \times percentage\ of\ profit$
    - If transfer price is used, finished inventories will include unrealised profit
    - Unrealised profit is the factory profit that is attached to the finished goods
    - Not recorded in SOFP (against realisation, prudence & IAS 2)
    - Provision for unrealised profit used to:
      - Remove unrealised profit from the IS
        - Profits are overstated by the amount of unrealised profit
      - Remove unrealised profit from the inventory of finished goods within the current assets on the SOFP
        - Inventories aren't overvalued; valued at cost, not cost + percentage mark-up
    - Recording provision for unrealised profit (same format as provision for doubtful debt)
      - Increase in provision
        - Dr IS
        - Cr Provision a/c with the amount of the increase
      - Decrease in provision
        - Dr Provision a/c
        - Cr IS with the amount of the decrease
    - Prudence, realisation & consistency
      - Profits/assets not overstated
      - Profit is unrealised because the finished goods haven't been sold to third party
      - Increase/decrease in PFUP is adjusted in IS
      - PFUP is deducted from the transfer value of finished goods inventory
        - Reflects true cost of the finished goods inventory

        - Select the accounting policies to be applied to the business books of a/c
        - State whether international standards have been applied
        - Report on the state of the company's affairs
        - Ensure that the financial statements are signed by two members of the board of directors
- Importance of true & fair view in financial statements
    - True & fair view: a principle stating that financial statements should show a 'true & fair view' of the profit/loss & the business' financial position
        - True: if financial statements indicate that a transaction has taken place, then it has taken place
        - Fair: transaction/assets are shown in accordance with accepted accounting rules of cost/valuation
    - Importance:
        - True & fair view means that the statements are free from misstatements
            - Faithfully represent the financial performance & position of xx
        - Shareholders will have confidence
            - Report will confirm the accuracy of the statements & the professional opinion should be trusted due to the expertise/independence of the auditor
            - Share prices might increase
                - Shareholders may be encouraged to invest more/not sell their shares
            - Lenders may be more willing to lend to the business which will improve potential profits for the shareholders
    - Window dressing: attempts by directors to make a SOFP to show the financial position of the company to be better than it really is
        - Substance over form is intended to give a true & fair view
        - Companies Act sets out rules for presentation of company accounts

1.2 Business Purchase & Merger

→ Introduction

- Amalgamation/merger: 2 or more businesses combining to form a partnership business
- Types of amalgamation
    - Sole trader amalgamate with another sole trader to form a partnership
    - Sole transfer amalgamate with a partnership
    - 2 or more partnerships amalgamate to form a partnership
- Purchase price: the price paid for a business
- Purpose of amalgamation
    - Firms have worked together well in the past
    - Businesses are similar; amalgamation enable them to achieve economies of scale
    - Businesses are complementary (eg. car sales & car servicing)
    - Variety of skills, expertise & experience may be concentrated in one firm
- Purchased goodwill: goodwill which has been paid for by the purchasing business
- Inherent goodwill: goodwill which has not been paid for
    - Built up within the business by the owners
- Goodwill can arise because:
    - Many customers will continue to trade with the new owner
    - Business has a good reputation
    - Business workforce is experienced, efficient & are eligible
    - Business is situated in a good location
    - Business has long term, good relationships with its suppliers
- Prior to amalgamation
    - Each individual firm must revalue their business' goodwill & assets
        - Adjustments made in the capital a/c of the partners to reflect the changes
        - Firms will transfer the revalued amounts to new partnership
- Accounting procedure
    - Adjusting the partner's capital a/c for goodwill & profit/loss on revalued assets
    - Deal with any assets not being transferred to the new firm

                - Destroys the advantage of trend analysis in management reporting & simplicity in record keeping
            - Availability of input data
                - Variances accounting depends on source documents that are accurate
                - Imposes heavy workload on staff
                    - May be unskilled/little interest in accounting requirements
        - Process to which applied
            - Task of setting & maintaining standards is justified only where operations are conducted on a repetitive basis
            - Standard costing is most suited for mass production operations including the manufacture of standardised components which are subsequently incorporated into unique/non standard product
- Determining the standard cost of a product
    - Standard cost card
        - Prepared for each product
        - Normally shows quantity & price of each direct material to be consumed

EXAMPLE OF A STANDARD COST CARD

		$
Direct Material	Mat X 3kg@$4/kg	12
	Mat Y 2kg@$3.5/kg	7
Direct Labor	Grade A 6 hrs@2/hr	12
	Grade B 4 hrs@2.5/hr	10
	Standard Prime Cost	41
Variable overhead	10 hrs@$1.50/hr	15
Fixed Production overhead	5hrs@$2/hr	10
Admin + marketing overhead		14
Standard cost of production		80
Standard profit (25% on cost)		20
Standard selling price		100

→ Calculation of variances

- Variance analysis
    - Comparing actual costs with predetermined costs
        - Difference between the standard performance & the actual performance
        - Standard costs must be set prior to the commencement of the budget period
            - To provide a basis for measurement of actual performance
        - Actual performance is compared periodically with predetermined standard costs & cost variance is established
        - Variable may be:
            - Fabourable (ie. where actual cost < standard costs)
            - Adverse (ie. where actual costs > standard costs)
    - Direct material cost variance
        - Standard costs of direct material comprises of price & quantity
        - Price variance
            - Portion of the direct material cost variance
                - Difference between the standard price & the actual prices paid for the direct material used
            - $Direct\ Material\ Price\ Variance\ =\ (Std\ Price\ -\ Act\ Price) \times Actual\ Qty\ bought$
        - Usage variance
            - Portion of the direct material cost variance
                - Difference between the standard quantity specified for the production whether used or not & actual quantities used
            - $Direct\ Materials\ Usage\ Variance\ =\ (Std\ Qty\ -\ Act\ Qty) \times Std\ Price$
    - Direct labour cost variance
        - Standard costs of labour comprised of rate & efficiency
        - Rate variance
            - Portion of the direct wages cost variance
                - Difference between the standard rate of pay specified & actual rates paid
            - $Direct\ Labour\ Rate\ Variance\ =\ (Std\ Rate\ -\ Act\ Rate) \times Actual\ hours$
        - Efficiency Variance
            - Difference between the standard direct wage cost for the production achieved whether completed or not & actual hours at standard rates
            - $Direct\ Labour\ Efficiency\ Variance\ =\ (Std\ Hrs\ -\ Act\ Hrs) \times Std\ Rate$
- Sales value variance
    - Sales value variance can be calculated on the basis of turnover
    - $Sales\ value\ variance\ =\ budgeted\ sales\ -\ Actual\ sales$

(A) FORMAT OF INCOME STATEMENT/TRADING AND PROFIT AND LOSS ACCOUNT

OF A MANUFACTURING BUSINESS

(Name of business)

Income Statement/Trading and Profit and Loss Account for the year ended (date) (month) (year)

Sales			X
Less: Sales Returns			X
			X
Less: Cost of Sales			
Opening inventory	X		
Add: Transfer price	X		
Purchases of Finished Goods	X		
Less: Purchases Returns	X		
	X		
Add: Carriage Inwards(on finished goods)	X		
Import duty on purchases(finished goods)	X		
Other Expenses on purchases(finished goods)	X		
Cost of goods to be sold	X		
Less: Closing inventory	X		
			X
Gross Profit			X
Add: Other Income			
Discount received		X	
Rental received		X	
Interest Income		X	
Commission received		X	
Profit on sale of non-current assets		X	
Decrease in provision for doubtful debts		X	
Bad debts recovered		X	
			X