

FINANCIAL ACCOUNTING: PREPARING FINANCIAL STATEMENTS

STUDY TEXT

Qualifications and Credit Framework

Q2022

This Study Text supports study for the following AAT qualifications:

AAT Level 3 Diploma in Accounting

AAT Level 3 Certificate in Bookkeeping

AAT Diploma in Accounting at SCQF Level 7

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STUDY TEXT

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INTRODUCTION

HOW TO USE THESE MATERIALS

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chance of success in your AAT assessments.

They contain a number of features to help you in the study process.

The sections on the Unit Guide, the Assessment and Study Skills should be read before you commence your studies.

They are designed to familiarise you with the nature and content of the assessment and to give you tips on how best to approach your studies.

STUDY TEXT

This study text has been specially prepared for the revised AAT qualification introduced in February 2022.

It is written in a practical and interactive style:

- key terms and concepts are clearly defined
- all topics are illustrated with practical examples with clearly worked solutions based on sample tasks provided by the AAT in the new examining style
- frequent activities throughout the chapters ensure that what you have learnt is regularly reinforced
- 'pitfalls' and 'examination tips' help you avoid commonly made mistakes and help you focus on what is required to perform well in your examination
- 'Test your understanding' activities are included within each chapter to apply your learning and develop your understanding.

ICONS

The chapters include the following icons throughout.

They are designed to assist you in your studies by identifying key definitions and the points at which you can test yourself on the knowledge gained.



Definition

These sections explain important areas of Knowledge which must be understood and reproduced in an assessment.



Example

The illustrative examples can be used to help develop an understanding of topics before attempting the activity exercises.



Test your understanding

These are exercises which give the opportunity to assess your understanding of all the assessment areas.



Foundation activities

These are questions to help ground your knowledge and consolidate your understanding on areas you're finding tricky.



Extension activities

These questions are for if you're feeling confident or wish to develop your higher level skills.

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Double-entry bookkeeping

Introduction

A sound knowledge of double entry underpins many of the learning outcomes and skills required for Financial Accounting: Preparing Financial Statements. It is essential knowledge in order to pass this unit and learners will be assessed on double-entry bookkeeping in the examination and so this must be very familiar ground. Although much of the content of this chapter should be familiar, it is essential that it is covered in order to build upon this basic knowledge in later Chapters.

ASSESSMENT CRITERIA

Use of the accounting equation (2.1)
 Classification of ledger accounts (2.2)
 Purpose and use of books of prime entry and ledger accounting (2.3)
 Carry out financial period end routines (2.4)
 Prepare an initial trial balance (6.1)
 Prepare an adjusted trial balance (6.2)

CONTENTS

- 1 Principles behind double-entry bookkeeping
- 2 Overview of the accounting system
- 3 Rules of double-entry bookkeeping
- 4 Double entry – cash transactions
- 5 Double entry – credit transactions
- 6 The trial balance and balancing a ledger account
- 7 The financial statements
- 8 Digital bookkeeping systems

1

Principles behind double-entry bookkeeping

1.1 Introduction

Double-entry bookkeeping is based upon three basic principles:

- the dual effect principle
- the separate entity principle
- the accounting equation.

1.2 The dual effect



Definition – The dual effect principle

The principle of the dual effect is that each and **every** transaction that a business makes has **two** effects.

For example, if a business buys goods for cash then the two effects are that cash has decreased and that the business now has made purchases. The principle of double-entry bookkeeping is that each of these effects must be shown in the ledger accounts by a **debit entry** in one account and an equal **credit entry** in another account.

Each and every transaction that a business undertakes has **two equal and opposite effects**.

1.3 The separate entity concept



Definition – The separate entity concept

The separate entity concept is that the business is a completely separate accounting entity from the owner.

Therefore, if the owner pays personal money into a business bank account this becomes the capital of the business which is owed back to the owner. Similarly, if the owner takes money out of the business in the form of drawings then the amount of capital owed to the owner is reduced.

The business itself is a completely separate entity in accounting terms from the owner of the business.

**Test your understanding 3**

Musgrave starts in business with capital of £20,000, in the form of cash £15,000 and non-current assets of £5,000.

In the first three days of trading Musgrave has the following transactions:

- Purchases inventory £4,000 on credit terms, supplier allows one month's credit.
- Sells some inventory costing £1,500 for £2,000 and allows the customer a fortnight's credit.
- Purchases a motor vehicle for £6,000 and pays by cash.

The accounting equation at the start would be:

Assets less liabilities	=	Ownership interest
£20,000 – £0	=	£20,000

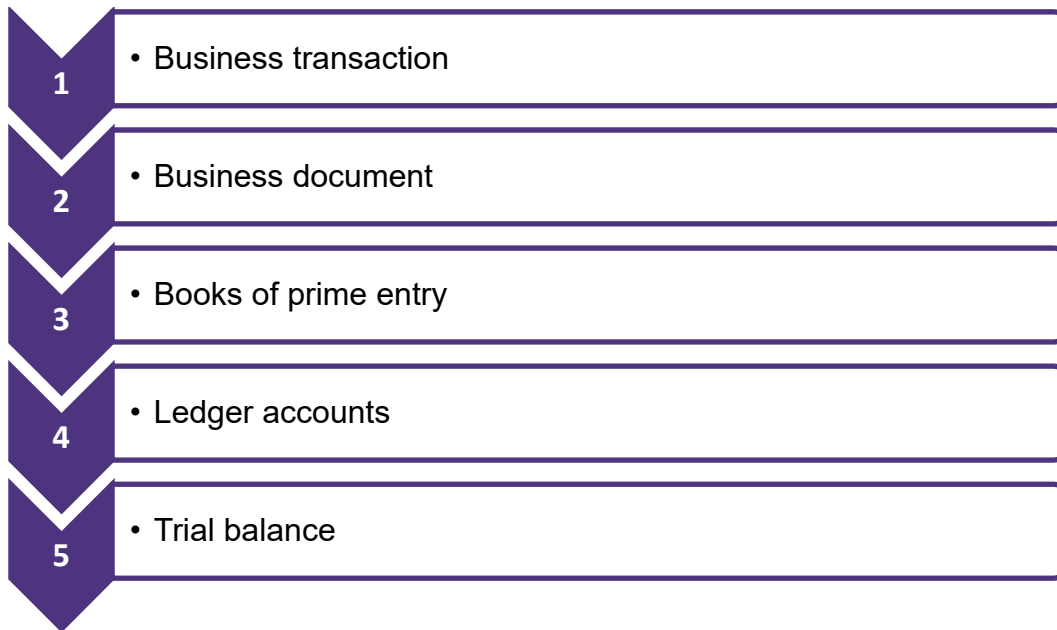
Required:

Re-state in values the accounting equation after all the transactions had taken place.

2**Overview of the accounting system****2.1 Overview of the accounting system**

A business may enter into a large number of transactions on a daily basis. It is quite clear that keeping track of all transactions can be a detailed process.

To ensure that a business does keep track of all sales earned, purchases and expenses incurred, the transactions are recorded in an accounting system.



- 1 Initially a **business transaction** will take place; a credit sale, a credit purchase, a cash sale, a cash purchase, another expense either paid from the bank or by cash, cash paid into the bank, withdrawal of cash from the bank and owner's drawings.
- 2 A **business document** will be produced e.g. an invoice.
- 3 The transaction and details from the business document will be entered into the **books of prime entry**. A book of prime entry is where a transaction is first recorded. There are several books of prime entry which may also be referred to as 'day books'.
- 4 The transactions that have been recorded in the books of prime entry are transferred into **ledger accounts** as part of the **general ledger** on a regular basis. Ledger accounts are used as part of the double-entry accounting system.
- 5 An initial **trial balance** is a list of all of the ledger accounts in the accounting system and is used as a control to check that transactions have been recorded correctly in the double-entry system prior to the preparation of the financial statements.

2.2 Books of prime entry

A book of prime entry is the place where the transaction (which is detailed on a business document) is first recorded in the books of the business. Books of prime entry may also be referred to as day books. There are several day books which will be briefly reviewed in this chapter:

Sales day book	Purchases day book	Sales returns day book
Purchases returns day book	Cash book	Petty cash book
Discounts allowed day book	Discounts received day book	Journal

**Definition – Sales day book**

The sales day book is simply a list of the sales invoices that are to be processed for a given period (e.g. a week).

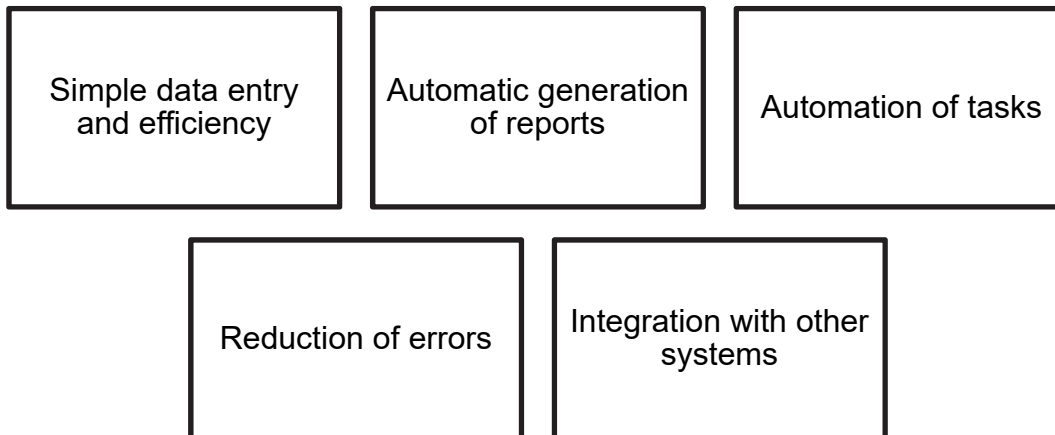
**Definition – Sales returns day book**

The sales returns day book is simply a list of the credit notes that are to be processed for a given period (e.g. a week).

**Definition – Purchases day book**

The purchases day book is simply a list of the purchases invoices that are to be processed for a given period (e.g. a week).

8.2 Benefits of using digital bookkeeping systems



Simple data entry and efficiency

- Manual data entry is more time consuming than processing transactions digitally.

Automatic generation of reports

- Automatically creates a trial balance from the general ledger accounts.

Automation of tasks

- Processes recurring entries.



Definition – Recurring entries

A recurring entry is a journal entry that is recorded in every accounting period.

- Makes duplication of automated and manual entries possible.
- Automatically balances the cash book.
- Automatically completes the transfer of data from the books of prime entry to the ledgers.
- Automatically completes the transfer of data into the control accounts.
- Automatically reconciles the receivables and payables ledgers to their respective control accounts.



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Interested in the full version?