ACCA Diploma in Financial and Management Accounting (RQF Level 3)

FA2

---

# Maintaining Financial Records

---

STUDY TEXT

# CONTENTS

| | | Page |
|---|---|---|
| Introduction | | P.5 |
| Syllabus and study guide | | P.7 |
| The examination | | P.13 |
| Study skills and revision guidance | | P.15 |
| **Chapter** | | |
| **1** | Accounting principles, concepts and characteristics | 1 |
| **2** | Principles and process of bookkeeping | 17 |
| **3** | Recording transactions and events | 37 |
| **4** | Inventory | 57 |
| **5** | Current and non-current assets | 69 |
| **6** | Non-current assets | 85 |
| **7** | Accruals and prepayments | 109 |
| **8** | Receivables | 125 |
| **9** | Payables, provisions, liabilities and capital | 137 |
| **10** | Bank and supplier statement reconciliations | 151 |
| **11** | Initial trial balance and the correction of errors | 169 |
| **12** | Accounting for year-end adjustments | 185 |
| **13** | Sole trader financial statements | 195 |
| **14** | Partnership financial statements | 209 |
| **15** | Incomplete records | 229 |
| **16** | Answers to activities and end-of-chapter questions | 253 |
| **17** | References | 315 |
| Index | | 317 |

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.

Chapter 1

# ACCOUNTING PRINCIPLES, CONCEPTS AND CHARACTERISTICS

**In this chapter, a number of accounting principles and concepts are introduced and explained. The chapter then progresses to consider the qualitative characteristics of financial information if it is to be useful. Whilst this may be regarded as accounting theory, it will provide a firm basis upon which to build your understanding of accounting for transactions entered into by an entity. It is also examinable and can be a good source of marks in an exam.**

**This chapter covers syllabus areas A1, A2, A3.**

---

## CONTENTS


**1** The basic principles of accounting

**2** Characteristics of useful financial information

**3** Users of financial information and their information needs

**4** Accounting records

**5** The regulatory framework


---

## LEARNING OUTCOMES

At the end of this chapter, you should be able to:

- explain and apply the basic principles and concepts of accounting
- explain and apply the characteristics of useful financial information
- explain who the users of financial information are and explain their information needs
- explain the regulatory framework and the purpose of International Accounting Standards and International Financial Reporting Standards.

# 1 THE BASIC PRINCIPLES OF ACCOUNTING

## 1.1 INTRODUCTION

**Definition** **Accounting principles** are conventions or accepted practice which apply generally to accounting for transactions.

These accounting principles have been developed by accountants over time. The principles can be used to determine:

- which assets and liabilities are recorded in a statement of financial position
- how assets and liabilities are valued
- what income and expenditure is recorded in the statement of profit or loss
- at what amount income and expenditure is recorded.

Many of the principles noted below are contained in the Conceptual Framework for Financial Reporting (the Framework)

## 1.2 THE BUSINESS ENTITY

**Definition** Financial accounting information relates only to the activities of the **business entity** and not to the personal activities of its owners.

The financial statements are prepared as though the business is an entity that is separate from its owner.

Sole traders and partnerships are **not legally separate** from their owners. For example, a sole trader is liable for the debts of the entity and personal assets must be sold to meet them if the entity does not have sufficient resources. Even so, for accounting purposes, the entity is **regarded** as being a separate entity and financial statements are prepared for the entity separately from the trader's own personal financial dealings.

In contrast, a limited company is a separate legal entity distinct from its owners.
A company can enter into legal contracts in its own right. If it becomes insolvent, the owners are only liable for the sum that they have invested.

You will not be asked to prepare the financial statements of a limited company for this syllabus, although the principles discussed throughout the chapter are the same.

## 1.3 DUALITY

**Definition** Every transaction has **two** effects.

Duality underpins the principles of double-entry bookkeeping to record accounting transactions in the form of an .

## 1.4 HISTORICAL COST

**Definition** The **historical cost accounting system** is a system of accounting in which all values are based on the cost or price of a transaction when it occurred.

The figure shown in the financial statements for an item is the value of the item when the transaction occurred, not a current market value.

For example, a property is shown in the financial statements at its original cost, not at a value that the property could be currently sold for. Although this may not show a true value of the entity, it is at least objective, in that the original cost of the property is a fact. Any current market valuations would be based on opinions of the various valuers and thus would be subjective.

In practice, although most assets and liabilities are held at historical cost, some entities might 'revalue' certain non-current assets, especially land and buildings, to a current value. This is outside the syllabus for this syllabus.

## 1.5 MATERIALITY

**Definition** **Materiality** is a threshold quality that is demanded of all information in the financial statements. Financial statements should separately disclose items that are significant (material) enough to affect decisions made by users of financial statements.

The understandability (clarity) and relevance of the financial statements is improved if only significant (material) items are included. Information is material if its omission or misstatement would influence decisions made on the basis of the financial statements.

What is and what is not significant will differ from organisation to organisation. For example, suppose that a sale of $100 has been recorded in error as a sale of $1,000.

- If total sales are $10 million, the error will not affect a user's overall view of the entity's performance given by the statement of profit or loss (and so the amount is said to be immaterial).

- If total sales are only $10,000, the error is material. If it is not corrected the statement of profit or loss will be misleading.

## 1.6 GOING CONCERN

**Definition** Financial statements are usually prepared on the assumption that the entity will **continue in operational existence for the foreseeable future**.

This means that the financial statements prepared on the assumption that there is **no intention or necessity to close down the entity**.

If the financial statements are not prepared using the going concern basis then they must be prepared on what is known as the break-up basis.

The break-up basis reflects the following:

- Some assets may be sold at less than their value in the statement of financial position because, whilst an entity may have a use for a particular machine, it may be scrap metal to another entity.

- In contrast, property may be sold for a value in excess of that shown in the statement of financial position based on original cost.

- If the entire inventory is sold at once then it will not be sold for as much money as if it were sold in the normal way.

- Some customers may decide not to pay the entity if it is known the entity is about to go into liquidation.

In most cases, financial statements are prepared on a going concern basis. The going concern concept justifies a range of other practices. For example, assets are valued in a manner that may not reflect their current market value. That does not really matter because the going concern concept suggests that the assets will be retained and continue to be used in the entity. A more accurate valuation would mean very little because there is no question of the sale of the assets.

## 1.7 ACCRUAL ACCOUNTING

**Definition** Income is recognised in the financial statements as it is earned, not when the cash is received. Expenditure is recognised as it is incurred, not when it is paid for. When income is earned over time (e.g. rental income) or expenditures are time-related (e.g. rental payments), the income and expenditure recognised in the statement of profit or loss should relate to the time period, not to the receipts or payments of cash.

## 1.8 CONSISTENCY

**Definition** An entity should be consistent in its accounting treatment of similar items, both **within** a particular accounting period and **between** one accounting period and the next.

Consistency prevents, for example, similar items of expenditure being treated as capital items and included as non-current assets one year, but as revenue items deducted from profit in another year.

## 1.9 PRUDENCE

The issue of prudence in the preparation of financial statements is underpins the qualitative characteristics of useful financial information considered elsewhere within this chapter. Prudence supports the presentation of financial information in a manner that is neutral – i.e. it is not biased.

**Definition** In conditions of uncertainty, a cautious approach should be taken, so that gains and assets are not overstated and losses and liabilities are not understated.

You are viewing a sample

Interested in the full version?