

ASSOCIATION OF ACCOUNTING TECHNICIANS

GUIDANCE NOTES

AAT Accounting Qualification (Diploma Pathway)

UNIT 5, Financial Accounting

Introduction

This document should be read in conjunction with the Standards for the unit.

This unit relates to the maintenance of accounts from the preparation of an initial trial balance through to the production of a set of final accounts. The unit requires students to extract and manipulate information to prepare trial balances, extended trial balances, profit and loss accounts and balance sheets of sole traders and partnerships. As part of the processes it may be necessary to make adjustments and corrections to information and carry out reconciliations to ensure accuracy in the maintenance of the records. The knowledge and understanding refers to restructuring accounts from incomplete evidence, and this will be used in the examination as a means of testing a number of the performance criteria.

At all stages, it is necessary to follow the organisation's policies and procedures and to ensure that discrepancies, unusual features or queries are identified and either resolved or referred to the appropriate person. Communicating in an appropriate and understandable manner, whilst at the same time maintaining confidentiality, is essential in carrying out tasks, handling queries and making suggestions for improvement in the record keeping of the organisation.

Terminology

Throughout the unit ledgers will be referred to as main ledger, sales ledger and purchases ledger. This is consistent with the Level 2 standards. Candidates will be expected to understand these terms.

'Profit and Loss Account' should be taken to read 'Trading and Profit and Loss Account' where appropriate.

Assessment strategy

This unit is assessed by an examination.

Examination

Each examination will last for three hours (with an additional 15 minutes reading time) and will be divided into two sections. The lengths of the two sections will not necessarily be equal, (guidance on time allocation will be given) and the case studies on which they are based may be different.

Examinations will contain practical tests linked to the performance criteria, and will also focus on underpinning knowledge and understanding. Candidates should expect each examination to contain tasks taken from across a broad range of the standards.

Repetitive tasks will be avoided as this is not an effective use of examination time. Therefore double entry book-keeping will not be tested by requiring candidates to write up all the ledger accounts of an organisation. Instead candidates will be asked to complete a number of accounts. For example, the cash book, disposal account or purchases ledger control account might be requested. This could be in section 1 or section 2 or both. Double entry book-keeping will also be tested by use of the journal. Candidates must know the difference between writing up an account and preparing a journal entry. Dates and narratives will not be required, in order to save time, but will probably be required in AAT simulations.

Either or both sections will normally contain a memo or letter-style task. This will often be linked to a previous task where the student will be expected to justify an accounting entry or explain an adjustment.

The extensive use of computers in accounting is recognised, but in order to meet the requirements of the standards it will often be necessary to base the tasks on an organisation or organisations using manual systems of accounting. If a scenario using a computerised system is used, it will be based on an integrated system of ledgers, which could include an integrated stock ledger. Where records are kept, these will consist of a main ledger, where double entry takes place, a sales ledger and a purchases ledger. Candidates can assume (but will also be told) that the sales ledger control account and purchases ledger control account will be contained in the main ledger, forming part of the double entry. The individual accounts of debtors and creditors will be in the sales ledger and purchases ledger and will therefore be regarded as memoranda accounts.

Section 1

This section aims to cover the performance criteria and knowledge and understanding relating to element 5.2. Aspects of element 5.1 may be tested in either section. Therefore this section will consist of a number of tasks concerned with the processing, restructuring and production of information for a sole trader or partnership, and the production of a trial balance to test the integrity and accuracy of their processes and calculations.

Sample tasks:

- Produce information from data given and/or incomplete records for either a sole trader or a partnership.
- Provide brief explanations, calculations, accounting entries, or select from a number of given answers.
- Process, restructure and produce information including, for example:
 - o Calculation of opening and/or closing capital.
 - o Restructuring the cash and/or bank account.
 - o Preparation of sales ledger control account and purchases ledger control account to calculate, for example, sales and purchases.
- Use mark-up and margin to calculate or check sales or purchases figures.
- Restructure ledger accounts, for example to calculate expenses paid, accruals and prepayments, profit or loss on the sale of an asset.
- Draft journal entries.
- Produce a trial balance or extended trial balance from reconstructed accounts or information.
- Produce a memo, letter or notes in response to a client or supervisor.

(As well as using the specimen paper for guidance, students could practice techniques by using section 2 of the “old” standards and extend the tasks to produce a trial balance.)

Section 2

This section focuses on covering the performance criteria and knowledge and understanding relating to element 5.3, but aspects of element 5.2 may also be tested. Aspects of element 5.1 may be tested in either section. Therefore this section will be concerned with taking the accounts from trial balance stage to final accounts.

Students will be given a trial balance or extended trial balance. They will then be expected to carry out tasks that lead to the production of final accounts. Adjustments may be required, and it might be appropriate for an extended trial balance to be produced or completed. Following this, students will be required to produce either the profit and loss account or the balance sheet, or both, in good form,

including the correct headings. In the case of a partnership the appropriation account will be requested. The statement of recognised gains and losses will not be required.

Sample tasks:

- Preparation of journal entries to clear the suspense account or make adjustments.
- Preparing capital accounts or journal entries for changes to partnerships (see guidance below)
- Completion of the extended trial balance.
- Preparation of profit and loss account for sole trader or partnership, in good form.
- Preparation of appropriation account for partnerships.
- Preparation of current accounts for partnerships.
- Preparation of balance sheet for sole trader or partnership, in good form.
- Short questions, explanations, letters or memos concerning the underpinning knowledge relating to the tasks undertaken.

Guidance on Knowledge and Understanding

All three elements contain the following under the heading of knowledge and understanding:

SSAPs and FRSs

International Accounting Standards (IAS) will NOT be assessed in Unit 5. There is no provision in the accounting standards for assessing them, and as the organisations relevant to this unit are sole traders and partnerships, neither does it seem appropriate. However, if a candidate who is familiar with IAS uses references or terminology from IAS they will not be penalised.

SSAP5

Students should have a knowledge and understanding of the treatment of VAT within an accounting system. Their knowledge and understanding should include in particular the following:

- The nature of VAT input tax and output tax, and how to account for them.
- How the balance on the VAT Control account in the main ledger is generated and what it means.

SSAP9

Students should have knowledge and understanding of how SSAP9 affects the valuation of stock for the final accounts of a business. They should expect to be assessed on:

- The principle of valuation of stock—lower of cost and net realizable value.
- How to calculate net realizable value.
- Methods of stock valuation i.e. LIFO, FIFO and average cost.

SSAP 13 is no longer assessed

SSAP21

This will no longer be assessed in Unit 5.

FRS 15

Candidates should have knowledge and understanding of the term depreciation as set out in FRS 15. They should be able to apply their knowledge and understanding by doing the following:

- Explaining the purpose of depreciation and how it is an application of the accruals concept.
- Calculating depreciation using the straight line method or reducing balance method and explaining why a particular accounting policy might be adopted, including an explanation of the factors which affect depreciation.
- Explaining under what circumstances depreciation rates and/or methods can be changed.

The Statement of Principles and FRS 18

Students should be able to apply the concepts of going concern and accruals (FRS18), and show understanding of the objectives used in selecting accounting policies - relevance, reliability, comparability and understandability, as defined in the Statement of Principles. They should understand and be able to explain that if information is not material, then it cannot be useful or have any of the four qualitative characteristics. They should understand and be able to briefly and simply explain the theoretical basis for accounting adjustments such as doubtful debt provision, depreciation provision, accruals and prepayments. This could be tested by practical application in a numeric task or by requiring the student to explain its application in a written task. It is very likely that a written explanation will be linked to a preceding practical task, and students who understand and use that link will be more successful in demonstrating their competence in the examination. This tests both the underpinning knowledge and understanding, and communication skills.

The importance of maintaining the confidentiality of business transactions

Students should understand the need for care when communicating on business matters. They should appreciate the need to consider at all times the confidentiality of the data and the appropriate level of information to which employees or external agents should have access.

Principles of double entry accounting

Although many of the principles of double entry are assessed at the Foundation Stage, students need to appreciate that a sound knowledge and understanding of all the principles underpin a substantial number of the performance criteria at Intermediate Stage. Students must expect to be assessed on double entry in both skills tests and examinations. This aspect of the unit is particularly important for students who have not taken the Foundation Stage but will be expected to be familiar with all double entry principles.

The ways the accounting systems of an organisation are affected by its organisational structure, its administrative systems and procedures, and the nature of its business transactions.

Students need to appreciate that accounting systems are not exactly the same in all organisations. For example, differences will exist between a retail organisation and a service organisation. This unit will examine differences in accounting systems from one type of organisation to another by presenting students with different scenarios within and between examinations and skills tests.

Guidance by element

Element 5.1 Maintaining records relating to capital acquisition and disposal

The following notes are intended to provide clarification, where this is likely to be required, and should be read in conjunction with the performance criteria, range statement and knowledge and understanding.

Element 5.1 is concerned with maintaining records relating to capital acquisition and disposal. The range statement refers to:

- Asset registers
- Books of original entry
- Ledgers

Whenever an asset is purchased, sold, scrapped or otherwise disposed of, authorisation should take place and the correct amounts involved should be identified and entered into the records together with appropriate details of the asset.

In order that a purchase can take place, appropriate funding is required. Students require a knowledge and understanding of methods of funding, which should include:

- Borrowing
- Hire purchase (see SSAP21 guidance above)
- Leasing (see SSAP21 guidance above)
- Part exchange

Having created fixed asset registers, it becomes necessary to set up and maintain systems of control. These should include:

- Reconciliations with actual fixed assets
- Reconciliations with the main ledger

Depreciation features prominently within the standards and will always be tested in the examination. Students should be able to explain the purpose of depreciation (see FRS15 above) and be in a position to make:

- Calculations using straight line and reducing balance methods
- Calculations for depreciation for assets acquired or disposed of during the accounting period in accordance with the policies of the organisation
- Entries into provision for depreciation account, asset register, asset disposals account and profit and loss calculations

When a fixed asset is disposed of, students should be able to calculate depreciation to the date of disposal of an asset, transfer the necessary amounts into an asset disposal account and calculate the final profit or loss on disposal.

Additionally students should appreciate:

- The distinction between capital and revenue expenditure and the implications of that distinction.
- The differences between fixed assets and current assets, and tangible assets and intangible fixed assets (namely, goodwill).

In the examination, element 5.1 will be assessed as an integral part of the section 1 or the section 2 scenario.

Element 5.2 Collecting and collating information for the preparation of final accounts

Guidance

The following notes are intended to provide clarification, where this is likely to be required, and should be read in conjunction with the performance criteria, range statement and knowledge and understanding.

Element 5.2 is concerned with dealing with accounting information ready for the preparation of final accounts from a trial balance or extended trial balance. This includes ensuring that information is accurate and complete by the use of checks and controls.

Reconciliations

Students must be able to reconcile lists of balances from the subsidiary ledgers to the control accounts in the main ledger. (sales ledger control, purchases ledger control and stock). They must also be able to explain why the differences might have occurred, correct the discrepancies and explain the purpose and importance of the reconciliations. Examples of differences that might arise:

- Errors in either the subsidiary or the main ledger.
- Timing differences, for example goods in transit.
- Errors in period end cut-off, for example stock included in valuation but subsequently dispatched and the sale included in the ledger.

Having established any differences, students should be able to correct them by use of the journal, or refer them to the appropriate person.

Trial Balance

Students should be:

- Able to close off the revenue accounts in the ledger
- Able to accurately prepare a trial balance either from a list of balances or from ledger accounts
- Able to accurately prepare a trial balance from incomplete records
- Aware of the types of errors detected and not detected by the trial balance.
- Able to open a suspense account and take the appropriate action to clear it by use of the journal if the trial balance does not balance.

Adjustments

Students should be able to make adjustments to the trial balance in accordance with the organisation's policies and procedures. Examples of adjustments required:

- Depreciation
- Writing off bad debts
- Adjustment to doubtful debt provision, or the creation of a doubtful debt provision
- Adjustment to stock valuation by applying principles of SSAP9 (see above)
- Accruals and prepayments
- Correction of errors

These adjustments will often be made by use of the journal. The student may be asked to transfer these to the extended trial balance. The list of adjustments might include the correction of errors required to clear the suspense account. It might also include items that do not affect the suspense account, and students must be able to distinguish between these.

Students need to be able to explain their reasons for making adjustments by reference to the underpinning accounting legislation and regulations.

Care should be taken by students when identifying specific accounts. For example, labeling the sales ledger control account and purchases ledger control account "debtors" and "creditors" will not be acceptable. Systems used may also refer to day books, and students should be familiar with the purpose and use of these as books of original entry.

Students should be in a position to make appropriate entries in the accounting system of a particular organisation in accordance with that organisation's policies and procedures. For example, if the task states that insurance costs are charged to general expenses, then the general expenses account should be used to make the required adjustment. The student should not open a new insurance account. Organisations will take the form of sole traders or partnerships.

Partnerships

Students will need to understand the use of the capital and current accounts and be able to explain what each represents. They will be expected to make the following entries and adjustments:

- Appropriation of profit, including salaries, interest on capital accounts and share of profit or loss
- Drawings
- Admission of a new partner to an existing partnership with capital injection in the form of cash paid to bank
- Introduction of goodwill
- Subsequent elimination of goodwill
- Retirement of a partner, with settlement in the form of cash or loan
- Change in profit share during the period

Students will be expected to deal with partnerships with up to three partners. The details of the partnership agreement, in as far as they are needed in the examination, will be provided as part of the data for the tasks. Therefore the default provisions of the Partnership Act 1890 will not need to be recalled by the students.

They will *not* be expected to deal with:

- More than 3 partners
- Admission **and** retirement of partners in one scenario
- Revaluation of fixed assets
- Formation of a partnership from a sole trader
- Dissolution of a partnership
- Introduction of capital in any form other than cash paid to bank
- Retirement of a partner with settlement in any form other than cash or loan
- Limited Liability Partnerships (LLP)

Restructuring accounts from incomplete evidence

Included under the knowledge and understanding for element 5.2 and 5.3 is methods of restructuring accounts from incomplete evidence. In the examination this will usually take the form of preparing control accounts and making calculations (for example mark-up and margin) in a structured task that will lead the student through the logical process required. This process might follow with the production of a trial balance to test the accuracy of the balances produced, and might further be followed with the production of final accounts. However, the task is unlikely to be identical, either in order or process, to any previously set. Therefore students need to fully understand what they are doing, apply their knowledge to the new context, and not approach this area of the standards by rote learning previous examinations.

Element 5.3 Preparing the final accounts of sole traders and partnerships

Guidance

The following notes are intended to provide clarification, where this is likely to be required, and should be read in conjunction with the performance criteria, range statement and knowledge and understanding.

Students should be able to prepare:

- Trading and Profit and Loss Accounts for sole traders and partnerships
- Balance Sheets for sole traders and partnerships
- Partnership appropriation accounts (see 5.2 for guidance on scope of partnership transactions)