CfE

HIGHER ACCOUNTING

BrightRED PUBLISHING

BrightRED Study Guide

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ACCOUNTING

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INTRODUCING HIGHER ACCOUNTING

Accounting is often defined as 'the language of business'. Accountants aim to collect, classify, organise, analyse, present and communicate financial information to the owners of a business and other interested parties.

TYPES OF ACCOUNTING

Financial accounting focuses on presenting general-purpose financial statements (Income Statements and Statements of Financial Position) mainly for use by stakeholders outside of the business. These financial statements must be prepared in line with Statements of Standard Accounting Practice.

Management accounting involves providing the management of a business with the information they need to keep the business 'financially healthy'. This information is not normally distributed outside of the business. Much of this information will be based on estimates and projections based on various assumptions. Examples include the preparation of production budgets and estimating the selling price for quoting new jobs.

Today, many of the recording, organising and presenting aspects of accounting have been automated as a result of the advances in computer technology.

This Higher Study Guide will help you to understand and interpret both financial and management accounting information and will equip you with the necessary skills to undertake a range of accounting tasks. It will also help you to develop and apply skills for learning, skills for work and skills for life.

HIGHER COURSE CONTENT

The Higher course contains two main units of study:

Preparing financial accounting information (Higher)

This unit will focus on the role of financial accounting. Financial accounting is concerned with reporting on the past, chiefly for the benefit of the business owners, trade payables and potential investors. In this unit, you will develop the skills, knowledge and understanding to prepare financial statements (Income Statements and Statements of Financial Position) for a range of business organisations including partnerships, private and public limited companies and manufacturing organisations. You will also develop the accounting skills relating to the interpretation and analysis of financial information to enable you to report on an organisation's current financial position using investment ratios. A study of investment appraisal will also enable you to compare investment options available to a business and to offer financial advice based on accounting data.

This unit will also highlight the importance of International Accounting Standards as well as key accounting concepts and conventions.

Preparing management accounting information (Higher)

Management accounting is concerned with the future and seeks to provide internal management with the accounting information it needs to run the business on a day-to-day basis. In this unit, you will develop the skills, knowledge and understanding to carry out a range of costing techniques including overhead analysis, job costing, process costing, service costing and the preparation of budgets. You will gain an understanding of the impact that management accounting has on making decisions about the planning, control and future success of a business organisation. In particular, you will consider how a business can make decisions that will maximise profits under conditions of a limiting factor.

COURSE ASSESSMENT

Internal assessment

Each of the two units above will have a formal unit assessment. Unit assessments will require you to prepare accounting statements as well as to be able to apply knowledge and understanding of key accounting concepts. All internal unit assessments will be undertaken in accordance with SQA assessment specifications. All unit assessments will be marked as a pass or a fail and will be subject to external verification by the SQA.

External assessment: question paper

The question paper will have 120 marks, and you will be expected to attempt all questions. This will be an end-of-course examination paper set by the SQA. The examination paper has two sections:

- Section 1 is worth 80 marks and contains two 40 mark questions.
- Section 2 is worth 40 marks and contains two 20 mark questions.

The question paper will be a closed-book assessment, and you will not know in advance what areas of the course content will be assessed.

Candidates have 2 hours and 30 minutes to complete the question paper.

External assessment: assignment

The assignment will have 60 marks. It will require you to work through a series of integrated tasks to prepare accounting information and financial statements. You will also be required to use accounting information to aid decision-making, to analyse an organisation's financial position or to make recommendations for the future.

Topics within the assignment can come from any areas outlined in the course specification; and one task will be required to be completed using spreadsheet software. You will be required to make use of complex spreadsheet formulae such as conditional formatting, for example IF statements.

To ensure you are well prepared for both the question paper and the assignment, tasks in this Study Guide should be completed manually and using spreadsheet software.

The assignment will be completed within presenting centres (in one sitting of 2 hours and 30 minutes, but marked externally by the SQA.

HOW THIS BOOK CAN HELP YOU

This Study Guide (supported by the Digital Zone) explains clearly and precisely all the financial and management accounting concepts you need to know and understand to pass the internal and external elements of the Higher Accounting course. It also has a wide range of challenging tasks and activities which provide you with the opportunity to develop your accounting skills.

The Study Guide will also ensure that the following generic skills for learning, life and work are fully developed:

Numeracy	ICT	Decision-making	Presentation	Analysing
Evaluating	Thinking	Employability	Enterprise	Analytical

International Accounting Standards (IAS)

Adoption of International Accounting Standards (IAS) requires a change in the terminology used in the preparation of the final accounts of business organisations. This Study Guide makes use of International Accounting Standards (IAS) terminology throughout.

ONLINE

Go to the Digital Zone to find out more about International Accounting Standards.

PREPARING FINANCIAL ACCOUNTING INFORMATION

THE ROLE OF THE FINANCIAL ACCOUNTANT

INTRODUCTION

Financial accounting is concerned mainly with the recording function (often referred to as double-entry book-keeping) and the preparation of final accounting statements (Income Statements and Statements of Financial Position) for different types of business organisations.

The objectives of financial accounting

The main objectives of financial accounting are:

1. To ensure that the preparation of financial statements complies with the law (Companies Act), particularly for public limited companies.
2. To prepare a historical record of the financial affairs of a business – financial accounting statements are prepared at the end of an accounting period.
3. To provide financial accounting statements for both internal and external purposes and to make these statements available to shareholders, lenders and other stakeholders.
4. To ensure that financial accounting statements comply with the principles outlined in statements of accounting standards laid down by professional accounting bodies.
5. To ensure that financial accounting statements/information shows the stewardship of the organisation and the accountability of the board of directors to shareholders and other stakeholders.
6. To provide financial accounting information to the management of a business organisation for decision-making purposes.

DON'T FORGET

Financial Accounting Statements must be prepared in line with legal requirements and statements of accounting standards.

Duties of a financial accountant

The financial accountant will undertake a range of duties including the following:

1. Reporting to the owners of a business the effects of managerial decisions on the financial performance of the business.
2. Keeping accurate records of the daily financial transactions of the business.
3. Checking the financial records to maintain accuracy and reduce fraud.
4. Preparing periodic financial statements – Income Statements and Statements of Financial Position.
5. Preparing accounts for auditing and publication as and if required.
6. Ensuring that the business is adhering to and operating within the rules laid down by government legislation and/or professional accounting bodies.
7. Taxation calculations.
8. Ratio analysis to compare the current performance of the business with past performance or to the performance of similar businesses.

ONLINE

Head to www.brightredbooks.net to find out more about accounting standards.

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Disadvantages of financial accounting

1. Financial accounting is historical and deals with operations which have already occurred. In a business, you can control what is happening or about to happen, but you cannot change what has already happened.
2. Financial accounting is concerned with the whole business. A business may make an annual profit for the year of £250,000 from manufacturing and selling 3 separate products, but this does not tell us whether all 3 products are making a profit.

DON'T FORGET

Financial accounting information is historical.

PREPARING FINANCIAL ACCOUNTING INFORMATION

Introduction to company accounts

Companies can be divided into two types:

1. A **public** limited company, which is shown as **plc**.
2. A **private** limited company, which is shown as **Ltd**.

DON'T FORGET

Plc indicates a public limited company; Ltd indicates a private limited company.

A public limited company issues **shares** on the Stock Exchange. Investors buy these, and this forms the company's equity. A private company does not sell shares to the public. It is usually owned by a few people (shareholders), usually close friends or family.

A limited company (both plc and Ltd) means that the liability of the shareholders is limited to the amount they have invested, that is, to the number of shares they own. A sole trader or a partner in a partnership agreement has **unlimited liability**, and so his/her personal possessions (for example, personal assets such as their house or car) can be seized should their business fail.

If a company has a fixed equity of £100,000, then only £100,000 can be claimed by the creditors although the actual debts may be much greater.

Marks & Spencer is an example of a public limited company

Tunnock's is an example of a private limited company

ONLINE

Find exercises on company accounts at www.brightredbooks.net

ONLINE TEST

Test yourself on preparing financial accounting information online at www.brightredbooks.net

THINGS TO DO AND THINK ABOUT

Specimen exam-style questions

1. Outline the main objectives of financial accounting.
2. Describe three duties that may be undertaken by a financial accountant.
3. Discuss the limitations of financial accounting information.

MANUFACTURING ACCOUNTS

WHAT IS A MANUFACTURING ACCOUNT?

Manufacturing accounts are prepared by manufacturing businesses to show the cost of producing their goods.

A manufacturing account is prepared **before** the income statement. The cost of goods manufactured is transferred to the trading section of the income statement and replaces the figure for purchases which would be found if the business was buying and selling completed goods.

Examples of manufacturing concerns are white goods such as washing machines and fridges and everything from computers and cars to furniture and food.

Any business organisation which is involved in a manufacturing or production process should prepare a manufacturing account. The manufacturing account is used to show:

(a) the cost of the goods manufactured;

(b) the profit (or unusually the loss) on the manufacturing process.

Trading businesses purchase finished goods (from a wholesaler or cash and carry), but a manufacturing firm's purchases consist of raw materials that it uses in its manufacturing processes.

Examples of raw materials

DON'T FORGET

The manufacturing account is prepared **before** the income statement.

DON'T FORGET

A business involved in manufacturing the products it sells will purchase raw materials.

TYPES OF COSTS SHOWN IN A MANUFACTURING ACCOUNT

A manufacturer needs to distinguish clearly between the different types of costs incurred in the production of its products – and the manufacturing account reflects this. Costs are divided into two types – **direct costs** and **indirect costs**.

Direct costs

These are the costs incurred which can be identified with the items being produced – they are part of the actual item being made. These costs include:

Direct materials	The raw materials actually used in the manufacture of the product, such as cloth used to produce shirts, flour used to produce bread, or wood used in the production of furniture.
Direct manufacturing wages	The wages of those workers actually engaged in the manufacturing process, such as the wages of a sewing-machine operator, baker or skilled craft worker.
Direct expenses	Expenses which can be traced directly to the units manufactured. Direct expenses can include royalties and licence fees etc. which have to be paid to other persons for the right to produce their products or to use their processes. They could also include the hire of specialised equipment to produce a unique batch of goods.

DON'T FORGET

Manufacturing costs are split into direct costs and indirect costs.

DON'T FORGET

Direct costs can be traced directly to the goods being manufactured.

DON'T FORGET

There are three main direct costs to consider when preparing a manufacturing account.

contd

Prime cost

The prime cost is the total of all direct costs. Prime cost should be clearly labelled in the manufacturing account.

Prime cost = direct materials + direct manufacturing wages + direct expenses

Indirect costs

These are costs that are not directly related to the manufacturing process. However, without these costs it would be impossible to manufacture the products. These indirect costs are referred to as **overheads**. Examples include:

(a) factory light and heat
(b) store person's wages
(c) factory manager's salary
(d) factory rent and rates
(e) repairs
(f) general maintenance.

It is often the case that indirect costs, for example rent and rates or heat and light, have to be apportioned (shared) between the factory and other areas of the business, for example the office. The manufacturing account should only include the overheads that were incurred in the factory.

Work in progress (WIP)

When there is work in progress, that is, goods only part-completed at the beginning and end of an accounting period, an adjustment is needed.

Goods only part-complete at the end of an accounting period must be carried forward to the next accounting period, since this is when they will actually be completed.

Goods only part-complete at the beginning of the current accounting year must be dealt with in that period, since this is the accounting year in which they will become completed goods.

So, the general rule is:

- Add work in progress at the beginning of an accounting period.
- Subtract work in progress at the end of an accounting period.

DON'T FORGET

The total prime cost should be clearly labelled in the manufacturing account.

MANUFACTURING PROFIT

Manufacturing concerns like to compare their cost of manufacture with the wholesale cost of their output. They do this to see whether it has been more or less profitable to manufacture the product rather than purchase the items and sell them on.

The business will calculate the profit on manufacture by comparing the cost of manufacture with the wholesale cost of buying the same product.

Example:

Profit on manufacture = wholesale cost of output – manufacturing cost of output
= £250,000 – £200,000
= £50,000

The profit on manufacture is added to the manufacturing cost of output in the manufacturing account, and the wholesale cost of the output is shown.

The wholesale cost-of-output figure is transferred to the income statement (increasing the cost of goods sold and so reducing gross profit), and the profit on manufacture is added to the gross profit figure (increasing the profit for the business).

ONLINE

Head to www.brightredbooks.net for questions and exercises on manufacturing accounts.

THINGS TO DO AND THINK ABOUT

1 Explain what is meant by prime cost.
2 Outline the procedures to be followed for dealing with work in progress when preparing a manufacturing account.
3 Explain what is meant by a manufacturing profit.

ONLINE TEST

Test yourself on manufacturing accounts at www.brightredbooks.net

DECISION-MAKING: CONTRIBUTION ANALYSIS 2

DON'T FORGET

Fixed costs do not vary with the level of production – they vary with time.

DON'T FORGET

The main aim in contribution analysis is to aid decision-making.

DON'T FORGET

The main aims of business include profit maximisation, growth and survival.

THE IMPORTANCE OF CONTRIBUTION ANALYSIS

Given that the main aims of business include **profit maximisation**, **survival** and **growth**, it is essential that these outcomes are planned for and not left to chance. Companies can plan for changes in circumstances, market conditions or availability and prices of raw materials, as well as shortages of raw materials, labour or machine time.

It is vital that detailed records are kept regarding sales, demand and costs of production in order that any decisions made are accurate. This information can be historical data based on actual performance, or projected data based on market conditions and research.

Examples of the decisions that are normally based on analysis of variable costs and contribution include:

- the decision to close an unprofitable department or halt production of a product
- the decision to alter the product mix due to a limiting factor
- the decision to accept or reject a special order
- the decision to make or buy a product or component.

Example – Decision to halt production of a product or close a department, branch or factory (or not)

Companies are always looking at the profitability of products, departments or even branches, and will not continue to invest in areas of the business that do not look as though they are financially viable. However, the right course of action is not always obvious, and an analysis of the contribution can make the management think again.

Norcroft Electronics make three products – electronic cars, robots and pets. They are considering halting production of the toy that shows the least profit. The data relating to each toy is as follows:

	Cars	Robots	Pets
No. of units produced per year	10,000	10,000	10,000
	£	£	£
Unit selling price	30	10	38
Variable cost per unit	20	5	18

Fixed costs for the year are £100,000.
Calculate the effect this would have on the total profit for the year, and advise Norcroft plc whether or not they should halt production.

contd

Solution:

First, we need to work out exactly how much profit or loss the company is making.

	Cars	Robots	Pets	Total
No. of units produced per year	10,000	10,000	10,000	
	£	£	£	
Sales	300,000	100,000	380,000	
Variable costs	200,000	50,000	180,000	
Contribution	100,000	50,000	200,000	350,000
Fixed costs				100,000
Profit/loss				250,000

Under the current proposal, production of robots would be halted, since they are showing the lowest contribution.
Second, we need to work out what change in profits that would bring about for the company.

	Cars	Robots	Pets	Total
No. of units produced per year	10,000	0	10,000	
	£	£	£	
Sales	300,000	0	380,000	
Variable costs	200,000	0	180,000	
Contribution	100,000	0	200,000	300,000
Fixed costs				100,000
Profit/loss				200,000

The overall profit for the company has decreased by £50,000. This is because the sales of robots were contributing £50,000 towards the fixed costs of the company. Closing down production of the robots means that overall contribution has decreased to £300,000 – and, since fixed costs have remained the same, there has been a corresponding drop in profits of £50,000. Therefore closing down the production of robots would not be a good idea unless we could find something else more profitable to invest in.

DON'T FORGET

Any decrease in contribution will result in a proportionate decrease in profit.

THINGS TO DO AND THINK ABOUT

1. Outline two of the main aims of business where contribution analysis could be useful.
2. Describe two examples of the decisions that are normally based on analysis of variable costs and contribution.
3. Explain what is meant by the statement 'Fixed costs do not vary with the level of production – they vary with time'.
4. Describe the main aim of contribution analysis.
5. Explain why a company would continue to invest in a product that is making a total loss.

ONLINE

Head to www.brightredbooks.net for further exercises on decision-making.

ONLINE TEST

Test yourself on decision-making at www.brightredbooks.net

BrightRED Study Guides

CfE HIGHER

ACCOUNTING

Helen Lang and William Reynolds

This BrightRED Study Guide is the ultimate companion to your CfE Higher Accounting studies! Written by our trusted authors and experienced Accounting teachers, Helen Lang and William Reynolds, this book is full-colour and packed with clear and accessible information, excellent examples, activities and advice. Inside, you will find:

- **All the essential course information, fully up-to-date with SQA course changes,** arranged in easily digestible double-page topic spreads.
- **Detailed full-colour** diagrams, illustrations and data boxes to make sure all that study sticks!
- ***Don't forget*** pointers offering advice on the key facts to remember, and on how to avoid common mistakes.
- ***Things to do and think about*** sections encouraging the regular review of key points covered.
- ***Digital Zone* activities and tests** to supercharge your learning efforts online!
- **An index** of key terms to help when revising.

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