

O Level
Accounting (7707)



Concepts and Formats

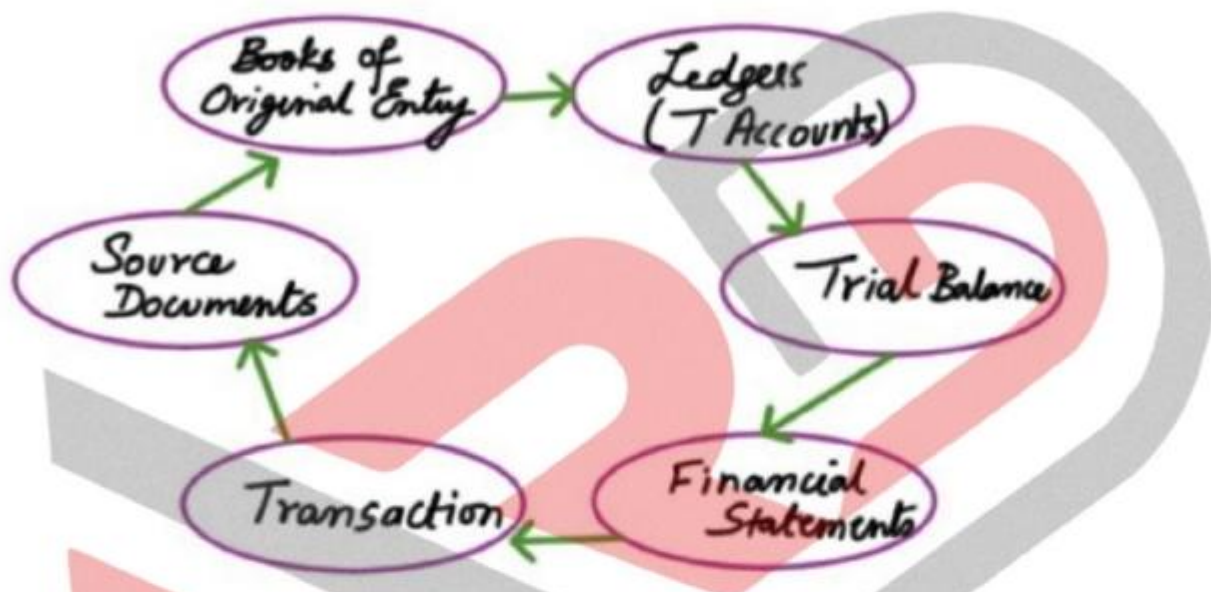
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Books of Prime Entry & Ledgers

Accounting Cycle



Transaction: In Business Context any Commercial Event is known as a transaction. This means we are exchanging some thing for another. Eg Buy or Sell Goods or Services, Receipt or Payment by Cash or Cheque, Return of Goods etc

Documentary Records

A Source Document is a proof or Evidence of a transaction that is carried out in business. eg Sales Invoice, Receipt, Credit Note etc

Type of Transaction	Source Document
1) Sale of Goods/Services on Credit	→ Sales Invoice
2) Purchase of Goods/Services on Credit	→ Purchase Invoice
3) Sale/Purchase of Goods on Cash	→ Receipt
4) Returned Goods by Customer	→ Credit Note (Issued to Customer)
5) Returned Goods to Supplier	→ Credit Note (Received from Supplier)
6) Recording/Payment of Wages or Salaries	→ Pay Slip/Wage Sheet
7) Payment to Supplier or Any Other Expense by Cheque	→ Cheque Counterfoil
8) Sent Summary of transactions to Customer	→ Statement of Account
9) Summary of transactions received from Bank	→ Bank Statement
10) Sale/Purchase NCA on credit	→ Invoice
11) Deposit Cash into the bank	→ Pay in Slip

Books of Prime Entry

Books of Original Entry are books in which transactions are first recorded through Source Documents.

Types of Transactions

Book of Original Entry

- 1) Sale of Goods/Services on Credit → Sales Journal (Day Book)
- 2) Purchase of Goods/Services on Credit → Purchase Journal (Day Book)
- 3) Returned Goods from Customer → Return Inward Journal (Sales Return Day Book)
- 4) Returned Goods to Supplier → Return Outwards Journal (Purchase Return Day Book)
- 5) Receipt/Payment by Cash or Cheque → Cash Book
OR Sales/Purchase by Cash or Cheque
- 6) All Other Non Routine Transactions → The Journal (General Journal)

Eg. Purchase/Sale of NCA on Credit

- Correction of Errors
- Drawing of Goods (Stock)
- Expense Inured on Credit
- Bad Debts, Provision for Doubtful Debt
- Depreciation etc.

Account : Collection of transactions is known as an Account.
A T Account is an Account prepared in T form.
It has two sides. Left hand side is Debit side & Right hand side is Used for Credit.

Dv	Account Title (Mr X)		Cr
	\$		\$
1 Balance b/d	1000	7 Return Inwards	100
5 Sales	500	8 Bank	1000
		30 Balance c/d	400
	<u>1500</u>	Dec	<u>1500</u>
1 Jan Balance b/d	400		

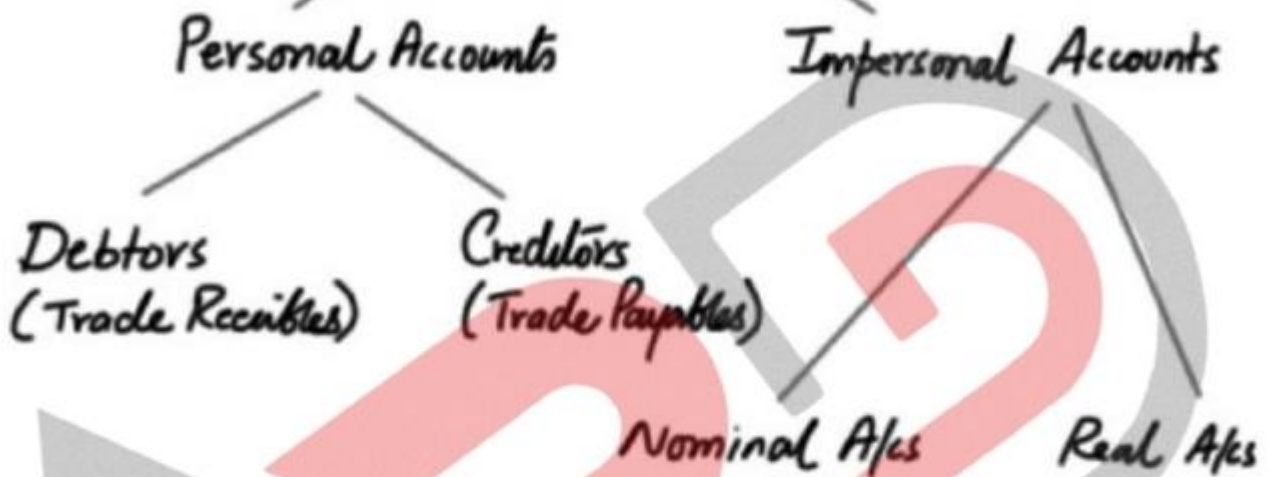
3 Column / Running Balance Account

It is an Alternate form of Account which Contains three Columns. Debit, Credit & a Balance Column. The Benefit of 3 Column Account is that we get an updated balance after Each transaction & there is no need to balance the Account at period End.

Eg

Three Column Account (Mr X)				
Date	Particulars	Debit	Credit	Balance
	Opening Balance			1000 DY
5	Sales	500		1500 DY
7	Return Inwards		100	1400 DY
8	Bank		1000	400 DY

Types of Accounts



Nominal Accounts

Nominal Accounts contain All Income Statement Items eg Sales, Purchases, Return Inwards, Return Outwards, Income & Expenses etc. These are also known as temporary Accounts.

Real Accounts

Real Accounts contain all Statement of financial Position Items eg Assets, Liabilities & Capital etc. Real Accounts are also known as permanent Accounts.

Ledger

A Ledger is a Collection of Accounts. It is a Book Containing Accounts.

Types of Ledgers

There are Three types of Ledgers.

1) Sales Ledger

It Contains only Customer / Debtor T A/cs

2) Purchase Ledger

It Contains only Supplier / Creditors T A/cs

3) General / Nominal Ledger

It Contains all Accounts (Other than Debtors & Creditors) Ex Sales, Purchases, Return Inwards, Return Outwards, Cash Bank, Assets, Liabilities, Income, Expenses, Capital, Drawings etc.

Effect on Capital

Capital of the business Is Affected by following transaction

Transaction

Effect on Capital

1) Introduce Additional Capital

Increase

2) Drawings in Cash or Goods form

Decrease

3) Profit / Gain / Income

Increase

4) Loss / Expense

Decrease

Types of Discounts



Trade/Bulk Purchase Discount

It is a discount received or given at the time of Purchase which is applied on list price of Goods. It is given or received when selling or buying Goods in Bulk Quantity or when we are selling goods to a regular Customer or a trader so that he may also earn some profit upon resale.

It is 'Never' recorded in the Books of Either Seller or Buyer means no Entry to be recorded.

Cash Discount: It is discount at the time of Payment. Always recorded in the books of Customer & Supplier.

Discount Allowed: It is Allowed to Customer when He/She pays us Early. It is an Expense which is recorded as a Debit Entry which will reduce the Customer's Balance.

Discount Received: It is Received when we Pay our Supplier Early. It is an Income which is Credited which will reduce our Supplier Account i.e. Liability.

Documentary Records / Source Documents

Invoice

It is a commercial document issued by a seller to a buyer as a request for payment, relating to a sale of product. Usually an invoice contains the following information;

- the name and address of the supplier,
- the name and the address of the customer,
- date (on which it is issued)
- list of the products supplied
- its quantities
- agreed price (per unit and total)

Payment terms are usually stated on the invoice. These may specify that the buyer has a maximum number of days in which s/he has to pay, and is sometimes offered a trade discount (offered only on bulk purchases) or cash discount (only if paid before the due date).

Sample - Invoice


COMMERCIAL INVOICE

Bill To
Rodney Sanders
1007 Mountain Drive
sebring
NY10029 NY

INV-000380
02 Jul 2018

Terms : Due end of next month

Due Date : 31 Aug 2018



Zylker
7455 Drew Court
White City
Kansas
66872
U.S.A
270-510-0585

#	Item & Description	Qty	Rate	Amount
1	Onyx Vase Beautifully designed and crafted	1.00	150.000	150.000
2	Rosewood Frame Proudly display your achievements	5.00	70.000	350.000
			Sub Total	500.000
			Total	\$500

It was wonderful doing business with you. Thank you!

Terms & Conditions

Please make payment within 30 days of issue of the invoice.

Debit note

The customer should check that goods received are in a satisfactory condition and that they are exactly what was ordered (in respect of price, quantity and quality). The supplier must be informed of any shortages, overcharges and faults. This is done by issuing a debit note to the supplier.

Each business has its own format or style of debit note, but they all contain the following information:

- the name and address of the supplier,
- the name and the address of the customer,
- date (on which it is issued)
- full details and quantities / price of the goods returned or overcharged.

When a price is included on a debit note it is the price which the customer was actually charged for those goods (the price after the deductions of trade discount).

Sample - Debit note

M/S AKBAR & CO.		1218, Ram Nagar, Nagpur, 29 th August, 2011
No. 2318	DEBIT NOTE	
Against : M/s Kabir and Sons, New Delhi		
Goods returned as per delivery		
Challan No.		
(Details of goods returned)		
(Rupees Ten thousand only)		₹ 10,000/- M. Karuna Sagar Manager

Credit note

These are only issued if an adjustment has to be made. E.g. Goods returned by the debtor, overcharged value of goods sold on credit and allowance for faulty / damaged goods. If the supplier sends the wrong product to the buyer then the supplier will give him a credit note for the value of the goods incorrectly supplied. Similarly, if an error was made by the supplier on the invoice, for example the correct goods were delivered but were charged at the wrong piece of rate/unit on the invoice, then the supplier would send a credit note to the buyer. Seller records credit notes (Issued) in sales return journal while Buyer records credit notes (received) in purchases return journal.

- the name and address of the supplier (creditor),
- the name and the address of the customer (debtor),
- date (on which it is issued)
- full details and quantities/price of the goods returned or overcharged.

Capital & Revenue Expenditure

Capital expenditure is incurred when a business spends money either to:

- buy fixed assets, or
- add to the value of an existing fixed asset.

Included in such amounts should be spending on:

- acquiring fixed assets
- bringing them into the business
- legal costs of buying buildings
- carriage inwards on machinery bought
- any other cost needed to get a fixed asset ready for use.

Capital expenditure not only consists of the cost of purchasing a fixed asset, but also includes other costs necessary to get the fixed asset operational.

Revenue Expenditure which is not spent on increasing the value of fixed assets, but on running the business on a day-to-day basis, is known as revenue expenditure. The difference between revenue expenditure and capital expenditure can be seen clearly with the total cost of using a van for a business. Buying a van is capital expenditure. The van will be in use for several years and is, therefore, a fixed asset. Paying for petrol to use in the van is revenue expenditure. This is because the expenditure is used up in a short time and does not add to the value of fixed assets.

1 If expenditure is directly incurred in bringing a fixed asset into use for the first time, it is capital expenditure.

2 If expenditure improves a fixed asset (by making it superior to what it was when it was first owned by the organization, e.g. building an extension to a warehouse), it is capital expenditure.

3 All other expenditures are revenue expenditure.

Differences between capital and revenue expenditure

Expenditure	Type of Expenditure
1 Buying van	Capital
2 Petrol costs for van	Revenue
3 Repairs to van	Revenue
4 Putting extra headlights on van	Capital
5 Buying machinery	Capital
6 Electricity costs of using machinery	Revenue
7 We spent \$1,500 on machinery: \$1,000 was for an item (improvement) added to the machine; and \$500 was for repairs	Capital \$1,000 Revenue \$500
8 Painting outside of new building	Capital
9 Three years later – repainting outside of building in (8)	Revenue

Examples of Capital expenditures

1. Acquiring fixed, and in some cases, intangible assets.
2. Repairing an existing asset so as to improve its useful life.
3. Upgrading an existing asset if its results in a superior performance
4. Preparing an asset to be used in business
5. Restoring property or adapting it to a new or different use.
6. Starting or acquiring a new business.
7. Paint on a new building
8. Head Lights on vehicle for better visibility.
9. Training cost.
10. Any legal cost to acquire non-current assets.

Examples of Revenue expenditures:

1. Salaries and wages
2. Heat and Lighting
3. Repair and maintenance
4. Insurance
5. Paint on an old building.
6. Sundry expenses.
7. Rent and rates.

Incorrect treatment of expenditure

If one of the following occurs:

1 capital expenditure is incorrectly treated as revenue expenditure, or
2 revenue expenditure is incorrectly treated as capital expenditure,
then both the balance sheet figures and trading and profit and loss account figures will be incorrect.

This means that the net profit figure will also be incorrect and, if the expenditure affects items in the trading account part of that statement, the gross profit figure will also be incorrect.

Capital and revenue receipts

When an item of capital expenditure is sold, the receipt is called a capital receipt. Suppose a van is bought for \$5,000, and sold five years later for \$750. The \$5,000 was treated as capital expenditure. The \$750 received is treated as a capital receipt and credited to the fixed asset account in the General Ledger.

Revenue receipts are sales and other revenue items that are added to gross profit, such as rent receivable and commissions receivable.

Capital receipts A capital receipt is a receipt which is derived from sale or purchase of capital assets like plant and machinery, furniture, investment (long term) etc which shall not be occurring all the time. Capital receipts refer to incoming cash flows (receipts) originating from one of the following sources:

- Cash from the sale of fixed assets (either or intangible) (Can also include a payment associated with an insurance claim from a damaged fixed asset).
- Cash from the sale of shares in the business
- Cash from the issuance of a debt instrument

REVENUE RECEIPT

A revenue receipt is something which is carried out from daily activities like sale of goods or purchase of goods etc. A revenue receipts shall be repetitive in nature and shall be shown (credited) in the profit and loss account.

Receipt which is recurring (received again and again) by nature and which are available for meeting all day to day expenses (revenue expenditure) of a business concern are known as Revenue receipts, e.g. sale proceeds of goods interest received, commissions received, rent received, dividend received etc.

DISTINCTION BETWEEN CAPITAL RECEIPT AND REVENUE RECEIPT

The main differentiate between revenue receipts and capital receipts is that revenue receipts are recurring in nature, which the company can expect to receive year after year, whereas capital receipts are a kind of one time income. E.g. the salary you receive is your revenue receipt and the income you receive by selling your home is capital receipt.

Revenue Receipt		Capital Receipt	
1.	It has short term effect. The benefit is enjoyed within one accounting period.	1.	It has long term effect. The benefit is enjoyed for many years in future.
2.	It occurs repeatedly. Its recurring and regular	2.	It doesn't occur repeatedly. Its non recurring and irregular
3.	It is shown in profit and loss account on the credit side.	3.	It is shown in the Balance Sheet on the liability side.
4.	It does not produce capital receipt	4.	Capital receipt, when invested, produces revenue receipt e.g. when capital is invested by the owner business gets revenue receipt (i.e. sale proceeds of goods etc).
5.	This does not increase or decrease the value of asset or liability	5.	The capital receipt decreases the value of asset or increases the value of liability e.g. sale of a fixed asset, loan from bank etc.
6.	Sometimes, expenses of capital nature are to be incurred for revenue receipt, e.g. purchase of shares of a company is capital expenditure but dividend received on shares is a revenue receipt.	6.	Sometimes expenses of revenue nature are to be incurred for such receipt e.g. on obtaining loan (a capital receipt) interest is paid until its repayment.

Joint expenditure

Sometimes one item of expenditure will need to be divided between capital and revenue expenditure



Qualitative Characteristics of Financial Statements

- **Understandability.** The information must be readily understandable to users of the financial statements. This means that information must be clearly presented, with additional information supplied in the supporting footnotes as needed to assist in clarification.
- **Relevance.** The information must be relevant to the needs of the users, which is the case when the information influences the economic decisions of users. This may involve reporting particularly relevant information, or information whose omission or misstatement could influence the economic decisions of users.
- **Reliability.** The information must be free of material error and bias, and not misleading. Thus, the information should faithfully represent transactions and other events, reflect the underlying substance of events, and prudently represent estimates and uncertainties through proper disclosure.
- **Comparability.** The information must be comparable to the financial information presented for other accounting periods, so that users can identify trends in the performance and financial position of the reporting entity.

Accounting concepts

The historical cost concept

It means that assets are normally shown at original cost price, and that this is the basis for valuation of the asset.

The money measurement concept

The money measurement concept in financial reporting is that an item should not be 'recognised' and included in the financial statements unless it has a money value that can be measured reliably and objectively.

For example land can be included in the financial statements because its value can be measured objectively, either at its original cost or at its current market value (which can be determined objectively from a professional valuation).

On the other hand, the value of a skilled and experienced employee is not included in a statement of financial position, partly because the cost or value of an employee to the business cannot be measured objectively.

The business entity concept

A concept used in financial reporting is that a business entity is an entity that is separate from its owners. In other words, the business entity and its owners are different.

For example, suppose that ARD sets up a sole trader business as a builder, and he calls the business 'ARD Builders'. For the purpose of financial reporting, the business (ARD Builders) and ARD, the owner of the business, are different and separate from each other.

The dual aspect concept

This states that there are two aspects of accounting, one represented by the assets of the business and the other by the claims against them. The concept states that these two aspects are always equal to each other. In other words, this is the alternate form of the accounting equation: $\text{Assets} = \text{Capital} + \text{Liabilities}$. Double entry is the name given to the method of recording transactions under the dual aspect concept.

Accounting Year

One of the underlying principles of accounting, the accounting year concept, is that financial statements are prepared at regular intervals of one year. For internal management purposes they may be prepared far more frequently, possibly on a monthly basis or even more frequently.

Going concern Basis

The going concern basis of accounting is that all the items of value owned by a business, such as inventory and property, plant and equipment, should be valued on the assumption that the business will continue in operation for the foreseeable

future. The business will not close down or be forced to close down and sell off all its items (assets). This assumption affects the value of assets and liabilities of an entity, as reported in the financial statements.

For example, if a business entity is not a going concern, and is about to be closed down and liquidated, the value of its assets would be their estimated value in the liquidation process. Assets are valued differently on a going concern basis.

Consistency

It states that when a business has once fixed a method for the accounting treatment of an item, it will enter all similar items that follow in exactly the same way. However, it does not mean that the business has to follow the method until the business closes down. A business can change the method used, but such a change is made with a lot of consideration.

Prudence (conservatism)

The accountant should make certain that assets are not valued too highly. Similarly, liabilities should not be shown at values that are too low. The accountant should always exercise caution when dealing with uncertainty while, at the same time, ensuring that the financial statements are neutral – that gains and losses are neither overstated nor understated. It also states that if we can foresee loss it should be recorded immediately but income should not be recorded once it's realized.

The accruals / matching concept

The accruals basis of preparing financial statements, which is also called the 'matching concept', is based on the following assumptions.

- The cost of sales in the income statement (or within profit and loss in the statement of comprehensive income) must be matched with the sales. Sales income and 'matching' expenses must be reported in the same financial period.
- Other expenses should be charged in the period to which they relate, not the period in which they are paid for.
- Income, such as sales, should be reported in the period when the income arises. This might not be the same as the period when the cash is received.

With the accruals basis, financial transactions and other events are recognised in the financial statements when they occur, and not when the cash relating to the transaction is received or paid.

Materiality

Anything that appears in a financial statement should be 'material'. Means It should be of interest to the stakeholders, those people who make use of financial accounting statements. It need not be material to every stakeholder, but it must be material to a stakeholder before it merits inclusion. Do not waste your time in the elaborate recording of trivial items. Example small items of assets should be treated as expenses

Realization

The realization principle is the concept that revenue can only be recognized once the underlying goods or services associated with the revenue have been delivered or rendered, respectively. Thus, revenue can only be recognized after it has been earned.

Accruals & Prepayments

Accrued Expenses: Expenses Incurred but not paid for (Current Liability)

Prepaid Expenses: Expenses Paid for but not Incurred (Current Asset)

Accrued Income: Income Earned but not received yet (Current Asset)

Prepaid Income: Income Received but not earned yet (Current Liability)

Expense Account			
	\$		\$
P Balance b/d	XXX	A Balance b/d	XXX
Bank / Cash	XXX	Income Statement	XXX
A Balance c/d	<u>XXX</u>	P Balance c/d	<u>XXX</u>
	<u>XXX</u>		<u>XXX</u>
Income Account			
	\$		\$
A Balance b/d	XXX	P Balance b/d	XXX
Income Statement	XXX	Bank / Cash	XXX
P Balance c/d	XXX	A Balance c/d	XXX
	<u>XXX</u>		<u>XXX</u>

Role of Information Technology

In the last two decades computers played an important role in all aspects of business and it increased the efficiency and productivity of the accounting and finance department as well. This technology has been applied to accounting systems in such a way that the business is able to cope up with large amount of Information very efficiently.

ADVANTAGES OF ICT (Information and Communications Technology)

1. Accuracy
2. Ability to process high volumes of Information
3. Speed of processing Information.
4. Performing reconciliations.
5. High volume storage capacity for data
6. Quick reporting system
7. Ease in transforming data from one place to another
8. Less chances of errors and automated corrections available
9. Better confidentiality
10. Strict controls
11. Ease in keeping data back-up.
12. Flexibility

DRAWBACKS OF ICT (Information and Communications Technology)

1. High cost of installing computerized systems
2. Requires training for staff members
3. Increased dependency
4. Un-Employment increase
5. Computer Failure or electricity issues can stuck recording or accounting activities.

PROFESSIONAL ETHICS IN ACCOUNTING

Ethics is a branch of Philosophy and is about the way people judge the rights and wrongs of their actions. "ETHICS BEGINS WHERE LAW ENDS"

Ethical realism accepts that although morality does not apply internationally, the ethical values of a trading partner should be respected.

According to the accounting point of view an ethical approach covers things like:

- 1) Honesty
- 2) Trust worthiness
- 3) Prevention of Fraud
- 4) Prevention of corruption

The Increased use of IT in book-keeping and accounting brings additional ethical problems such as computer based fraud.

Petty Cash Book

There is a second type of cash book, called the **Petty Cash Book**, which many businesses use to record small amounts paid for in cash. Every business has a number of transactions of very small value which, were they all recorded in the Cash Book, would only serve to make it more difficult to identify the important transactions that businesses need to keep a close eye upon. **Just like the Cash Book, the Petty Cash Book is both a book of original entry and a ledger account.**

The **advantages** of using a Petty Cash Book can be summarized as follows:

- ❖ The task of handling and recording small cash payments can be given by the cashier (the person responsible for recording entries in the Cash Book) to a junior member of staff. This person is known as the 'Petty Cashier'. The cashier, who is a more senior and, consequently, higher paid member of staff would be saved from routine work.
- ❖ If small cash payments were entered into the main Cash Book, these items would then need posting one by one to the ledgers. For example, if travelling expenses were paid to staff on a daily basis, this could mean approximately 250 postings to the staff travelling expenses account during the year, i.e. 5 days per week × 50 working weeks per year. However, by using a Petty Cash Book, it would only be the monthly totals for each period that need posting to the General Ledger. If this were done, only twelve entries would be needed in the staff travelling expenses account instead of approximately 250.

The imprest system

It is all very well having a Petty Cash Book but, where does the money paid out from it come from? The **imprest system** is one where the cashier gives the petty cashier enough cash to meet the petty cash needs for the following period. Then, at the end of the period, the cashier finds out the amounts spent by the petty cashier, by looking at the entries in the Petty Cash Book. At the same time, the petty cashier may give the petty cash vouchers to the cashier so that the entries in the Petty Cash Book may be checked. The cashier then passes cash to the value of the amount spent on petty cash in the period to the petty cashier. In other words, the cashier tops up the amount remaining in petty cash to bring it back up to the level it was at when the period started. This process is the imprest system and this topped-up amount is known as the petty cash **float**.

Mr ARD
Petty Cash Book for the month ended June 2019

Total Received	Date	Details	Total Paid	Motor Expense	Postage & Stationery	Ledger Accounts
\$	2019		\$	\$	\$	\$
X	1 June	Balance b/d				
XX	2 June	Bank				
	3 June	Car fuel	X	X		
	8 June	Stamps	X		X	
	11 June	Mr X (Supplier)	XX			XX
			XX	XX	XX	XX
	30 June	Balance c/d	XX			
XX			XX			
X	1 July	Balance b/d	X			

Bad Debts & Provision for Doubtful Debts

Bad / Irrecoverable debts

When Business sells goods on credit and the debtor doesn't pay us the amount due to us the debt is said to be bad / Irrecoverable. It must be charged to profit and loss as an expense when calculating the profit or loss for the period.

There are a range of possible scenarios that may exist concerning a bad debt:

- The debtor may be refusing to pay one of a number of invoices
- The debtor may be refusing to pay part of an invoice
- The debtor may owe payment on a number of invoices and has indicated that only a proportion of the total amount due will ever be paid because the debtor's business has failed
- The debtor's business has failed and nothing is ever likely to be received.

Double Entry

1) Bad debts	XXX	
Trade Receivable		XXX
2) Income Statement	XXX	
Bad Debts		XXX

Provisions for doubtful debts

Provision for Doubtful debts is an estimate by management of the amount that can be turned bad in future.

Provision for Doubtful Debts in made considering factors such as:

- Past Experience
- Specific knowledge about a customer
- The State of the Economy (Recession etc)
- Present Market and Industry conditions
- Consistency concept
- Industry average
- Age of debtors
- Size of debtors
- Comparison with previous years or competitors
- Press release about the customer

Bad debts account: This expense account is used when a debt is believed to be irrecoverable and is written off.

Bad Debts Account

2015	\$		2015	\$
Mr. A		XX		
Mr. B		<u>XX</u>		
		<u>XXX</u>	Income Statement	<u>XXX</u>
2016		XX	2016	
Mr. C		<u>XX</u>		
Mr. D		<u>XXX</u>	Income Statement	<u>XXX</u>

Provision for Doubtful Debts Account

	\$			\$
			Balance b/d	XXX
			Income Statement (Increase / Expense)	XXX
Balance c/d		<u>XXX</u>		<u>XXX</u>
			Balance b/d	XXX
Income Statement (Decrease / Income)		XXX		
Balance c/d		<u>XXX</u>		<u>XXX</u>
			Balance b/d	XXX

INCOME STATEMENT EXTRACT

Gross Profit	XXX
Add: Other Income	
Decrease in Provision for doubtful debts	X
Bad Debts Recovered	X
Less: Expenses:	
Bad debts expense	(XXX)
Increase in Provisions for doubtful debts	(XXX)

STATEMENT OF FINANCIAL POSITION EXTRACT

Current Assets

Trade receivable (After Bad Debts)	XXX
Less: Provision for doubtful debts	<u>(XXX)</u>
	<u>XXX</u>

Q. Identify and explain the relevance of two accounting concepts that must be followed when setting a Provision for doubtful debt account.

A. A provision for doubtful debts is an estimate of the amount which a business will lose in a financial year because of bad debts. At the end of their financial year, many businesses try to anticipate the amount which will be lost because of bad debts. This ensures that the net profit is not over stated and the amount of account receivable in the balance sheet is shown at a realistic level. This is an application of the principle of PRUDENCE. By maintaining a provision for doubtful observes the principle of MATCHING.

Accounting for Non-Current Assets / Depreciation

Depreciation

Depreciation is that part of the original cost of a fixed asset that is consumed during its period of use by the business. It needs to be charged to profit and loss every year. The amount charged in a year to profit and loss for depreciation is based upon an estimate of how much of the overall economic usefulness of a fixed asset has been used up in that accounting period.

CAUSES OF DEPRECIATION

There are four causes of depreciation

1) **Physical deterioration**

- Wear and tear (usage) e.g. Motor Vehicles, Machinery, Fixtures
- Erosion, rust, rot and decay. E.g. metals, wood in assets

2) **Economic Factors**

- Obsolescence (Process of becoming out of date) e.g. musical, medical equipment
- Inadequacy (not up to the required use) e.g. boat, machine

3) **Time factor (due to time)** e.g. lease of building, patents (Amortization)

METHODS OF DEPRECIATION

1) **Straight Line / Cost Method.**

Straight line method normally used for

- 1) Furniture
- 2) Fixtures & Fittings
- 3) Buildings

Under straight line method, amount of depreciation remains same throughout its useful life.

$$\text{Straight line method} = \frac{\text{Cost} - \text{Scrap value}}{\text{Useful life}}$$

OR

$$(\text{Cost} - \text{Scrap Value}) \times \text{Rate}\%$$

Cost = Historical cost / Original cost / Purchase price / List price

Scrap value / salvage value / Residual Value

Useful life / estimated life / Life

Advantages of Straight line Method

- It is very simple, easy to understand and apply
- If we are generating equal benefit from a Non-Current Asset each year its cost shall also be spread equally. Straight line is the method which charges equal depreciation
- Asset can be depreciation to scrap value or zero, thus it helps to distribute full depreciable cost over useful life of the asset
- Every year, same amount is charged as depreciation to income statement, this makes comparison of profits of different years easy
- It is suitable for assets whose useful life can be estimated accurately and where the use of the asset is consistent from year to year

Disadvantages of Straight line Method

- This method is based on the unrealistic assumption of same utility of the asset in different accounting periods.
- As the asset gets older, repair and maintenance cost increases, but the depreciation remains the same, therefore increasing overall expense

2) Reducing Balance Method / Diminishing Balance Method:

Reducing Balance normally used for Technological Assets:

- 1) Machine
- 2) Equipment / Computers
- 3) Motor vehicles

Under reducing balance method amount of depreciation decreases year by year.

Reducing balance method = (Cost – Accumulated depreciation) x Rate%

Accumulated depreciation = Total depreciation / Provision for depreciation.

<i>In the early years</i> A higher charge for depreciation + A lower charge for repairs and upkeep	will tend to be fairly equal to	<i>In the later years</i> A lower charge for depreciation + A higher charge for repairs and upkeep
--	---------------------------------	--

Advantages of Reducing Balance Method

- Technological assets such as Equipment, Motor Vehicles lose more of its value and utility in early years, therefore it is fair to charge higher depreciation in early years.
- In early years of life low repair and maintenance cost is incurred therefore higher rate of depreciation is charged and vice versa
- As the large proportion of cost is depreciation in early years, loss due to obsolescence gets reduced.

Disadvantages of Reducing Balance Method

- As depreciation is calculated as a percentage of NBV each year, the value of the asset can never be zero
- It is difficult to ascertain a suitable rate of depreciation

3) Revaluation Method

Revaluation method normally used for low cost items such as:

- 1) Loose tools
- 2) Laboratory items
- 3) Crockery

Asset NBV Account (Loose Tools, Crockery etc)

Balance b/d	xxx	Disposal	xxx
Bank / Payable (Addition)	<u>xxx</u>	Income Statement (Current Year Depreciation)	xxx
	<u>xxx</u>	Balance c/d	<u>xxx</u> <u>xxx</u>

Shortcut formula

Depreciation = Opening Value + Addition - Disposal - Closing Value

Advantages of Revaluation Method

- A more realistic depreciation expense used is charged to income statement
- Value in statement of financial position is realistic market value
- It is simple and straight forward to use
- Avoids the need for keeping detailed records

Disadvantages of Revaluation Method

- Value of the asset at end of the year is not an objective value rather it is just an opinion by the appraiser
- It produces a different figure for depreciation expense each year even when there is no difference in the use of asset
- To value the asset accurately at end of the year is time consuming

Policies for Charging Depreciation:

1) Charge full year's depreciation in the year of purchase of asset but no depreciation in the year of disposal **(Use when required in question or when dates are not given and no other information is given)**

2) Charge depreciation on Pro-rata / Time proportion basis **(Use when required in question or when dates are given in question)**

DOUBLE ENTRY FOR DEPRECIATION

Income statement	xxx	
Provision for depreciation		xxx

(To record the depreciation expenses for the year)

DISPOSAL ENTRIES

1) **To write off cost of an asset**

Disposal account	xxx	
Machine/Vehicle/Equipment		xxx

(To write off an assets account on its disposal)

2. **To write off total depreciation charged from the date of purchase to date of sale.**

Accumulated Dep / Provision for depreciation	xxx	
Disposal Account		xxx

(To write off the total depreciation of the asset sold)

3. **To record the cash or cheque receipt on disposal**

Cash/Bank/Debtor	xxx	
Disposal account		xxx

(To record the cash or cheque received on sale)

4. To record the Gain or loss on disposal

Gain Entry

Disposal Account	xxx	
Income Statement (Gain)		xxx
(To record the gain on disposal)		

Loss Entry

Income Statement (Loss)	xxx	
Disposal Account		xxx
(To record the loss on Disposal)		

Asset Account (Equipment / Machine / Vehicle / Building)

Balance b/d	xxx	Disposal	xxx
Bank / Payables (Addition)	<u>xxx</u>	Balance c/d	<u>xxx</u>
	xxx		xxx
Balance b/d	xxx		

Provision for Dep / Accumulated Dep (Machine / Vehicle / Building)

Disposal	xxx	Balance b/d	xxx
Balance c/d	<u>xxx</u>	Income Statement (Current Year Depreciation)	<u>xxx</u>
	xxx		xxx
		Balance b/d	xxx

Disposal Account

(Machine / Vehicle / Building)	xxx	Provision for Dep / Acc Dep	xxx
Income Statement (Gain)	<u>xxx</u>	Bank / Cash / Debtor Name	xxx
	xxx	Income Statement (Loss)	<u>xxx</u>
			xxx

Income Statement Extract

Gross Profit	XXX	
Add: Other Income		
Gain on Disposal of Asset	<u>XX</u>	
		XXX

Less: Expenses

Depreciation (Building)	XXX	
Depreciation (Equipment)	XXX	
Loss on Disposal of Asset	XXX	<u>(XXX)</u>

STATEMENT OF FINANCIAL POSITION EXTRACT

Non Current Assets	<u>Cost</u>	<u>Accumulated Dep</u>	<u>NBV</u>
Buildings	XXX	(XX)	XX
Equipment	XXX	(XX)	XX
Motor Vehicles	XXX	(XX)	<u>XX</u>
			<u>XXX</u>

Depreciation provisions and the replacement of assets

Making a provision for depreciation does not mean that money is invested somewhere to finance the replacement of the asset when it is put out of use. It is simply a bookkeeping entry, and the end result is that lower net profits are shown because the provisions have been charged to the profit and loss account.

Q. Why do we charge depreciation?

Ans. Depreciation is charged to spread the cost of asset over its useful life

Q. Why Land does not depreciate.

Ans. Because Land has an indefinite life.

Q. Explain why depreciation is in application of the matching/accruals principle

Ans. Accrual concept means recording of current year expenses and revenues in the current year, irrespective of expense paid or not and Income received or not. In depreciation we charge an expense against fixed asset for decrease in the value due to the different reasons, although there could be no cash outflow but we do record the depreciation expense every year.

Q. Depreciation is a non cash expense, Explain?

Ans. Depreciation is a non-cash expense the reason is that company does not pay any cash or cheque against depreciation expense, like other expense (Rent, Insurance)

Final Accounts for Sole Traders with Adjustments

Adjustment can be done separately or directly in final accounts if required or according to the need. There are mainly five adjustments in O' level syllabus, those are as follows:

1) Prepaid Expense

(Paid in advance / before time). Prepaid is an asset and recorded in Balance Sheet under current assets).

GENERAL ENTRY

Other Receivable (Rent/insurance/Salaries)	XXX	
Expense A/c		XXX

2) Accrued Expense

(Amount that we owe/work done but payment is not made yet. Accrued is our liability and recorded in Balance sheet under current liabilities).

GENERAL ENTRY

Insurance/Wages/Maintenance Expense	XXX	
Other Payable Insurance/Wages		XXX

3) Depreciation Expense

(Decrease in value of a Non-Current asset. Depreciation is our expense and recorded in Income Statement under operating expenses)

GENERAL ENTRY

Income Statement	XXX	
Provision for depreciation		XXX

4) Bad & Doubtful Debts

(Bad & Doubtful debts are an expense and recorded in P&L under operating expenses).

GENERAL ENTRIES

Income Statement (Expense)	XXX	
Trade Receivable		XXX

(Above entry is for bad / Irrecoverable debts)

Income Statement (Expense)	XXX	
Provision for doubtful debts		XXX

(Above entry is for **increase in doubtful debts**)

Provision for doubtful debts	XXX	
Income Statement (Income)		XXX

(Above entry is for **decrease in doubtful debts**)

5) Drawings

(Cash / Cheque / Goods or any other asset taken for personal use by the owner)

GENERAL ENTRY

Drawing	XXX	
Cash / Bank / Purchases / Equipment		XXX

Advantages of Sole Traders

- You have full control over daily and strategic decision making
- There's far less red tape and regulations than a Limited Company
- Starting your business is quick and easy
- All financial data is kept private
- No annual accounts to prepare as sole traders add income and expenses to their tax return

Disadvantages of Sole Traders

- You have full personal liability for any debts
- It may be difficult to bid and accept larger contracts
- It's difficult to scale a business on your own
- You can't leverage buying power due to your small size
- You have to buy-in knowledge and expertise if you don't have it yourself

ARD Traders
Income Statement for the year ended 31 Dec, 2020

	\$	\$
Sales	XXX	
Less: Return inward / Sales Returns	(XXX)	XX
Less: COST OF SALES		
Opening Inventory	XXX	
Add: Purchases	XXX	
Add: Carriage Inwards	XX	
Add: Custom duty	XX	
Less: Return outward / Purchases return	(XX)	
Less: Closing Inventory	(XXX)	
Cost of Sales		(XXX)
Gross Profit		XXX
Add: OTHER INCOME		
Discount received	XXX	
Commission received	XXX	
Reduction in Provision for Doubtful Debts	XXX	
Gain on Disposal of NCA	XXX	XXX
Less: EXPENSES		
Salaries and wages	XXX	
Rent expenses	XXX	
Insurance expense	XXX	
Heating and Lighting	XXX	
Sundry expenses	XXX	
Depreciation expense	XXX	
Increase in Provision for Doubtful debts	XXX	
Discount allowed	XXX	
Carriage outward / Carriage on sales	XXX	
Bad debt expense	XXX	
Financial cost (interest expense)	XXX	
Repair and maintenance	XXX	(XXX)
Profit / (Loss) for the year		XX/(XX)

Carriage on purchases / Transportation Inward / freight charges

ARD Traders
Statement of Financial Position as at 31 December 2020

Assets	\$	\$	\$
Non-Current Assets	Cost	Accumulated Depreciation	NBV
Land	XXX	-	XX
Building	XXX	(XX)	XX
Equipment	XXX	(XX)	XX
			XXX
Current Assets			
Inventory		XXX	
Trade Receivables / Debtors	XXX		
Less: Provision for doubtful debts	(XXX)	XXX	
Other Receivables			
Expense (Prepaid)		XXX	
Income (Accrued)		XXX	
Bank		XXX	
Cash		XXX	XXX
Total Assets			XXX
Capital and Liabilities			
Opening Capital		XXX	
Add Profit for the year / Less (Loss) for the year		XX/(XX)	
Less: Drawings		(XXX)	XXX
Non Current Liabilities			
10% Bank Loan 2025			XXX
Current Liabilities			
Trade payables / Creditors		XXX	
Bank O/D (Over Draft)		XXX	
Other Payables			
Expense (Accrued)		XXX	
Income (Prepaid)		XXX	XXX
Total Capital and Liabilities			XXX

Financial Statements for Service Sector

The City School
Income Statement for the year ended 31 Dec 2020

Income		
Fees Income (w)	XXX	
Gain on disposal of Asset	XXX	
Photo Copy Income	XXX	
Income from Canteen	XXX	
Rent from Auditoriums	XXX	XXX
Less: Expenditure		
Staff Salaries	XXX	
Loss on disposal of asset	XXX	
Depreciation of Furniture and Fixtures	XXX	
Interest on loan	XXX	
Administration Expenses	XXX	
Maintenance	XXX	
Utilities	XXX	(XXX)
Profit / (Loss) for the year		XX / (XX)

Fees Income Account

	\$		\$
A Balance b/d	XXX	P Balance b/d	XXX
Income Statement	XXX	Bank / Cash	XXX
		Bad Debts	XXX
P Balance c/d	XXX	A Balance c/d	XXX
	<u>XXX</u>		<u>XXX</u>

Bank Reconciliation

Bank Statement / Statement of Account

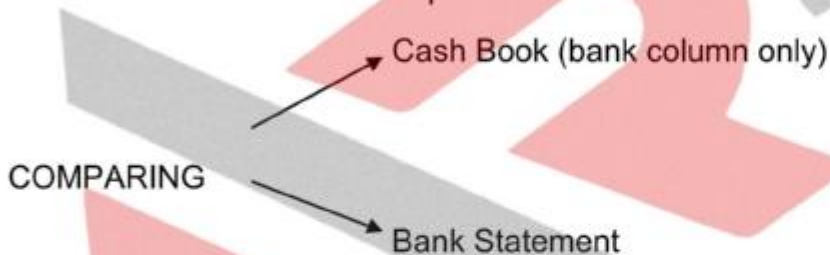
A bank statement is a copy of the customer's account in the books of the bank. It is a detailed statement of customer transactions for a given period of time (All deposits and withdrawals).

- When money is deposited into the bank, it is credited in the customer account.
- When money taken out / withdrew from the bank. It would be debited in his account.

Cash Book (Bank Column):

It is an account prepared by the company to show all the deposits into the bank and withdrawals from the bank.

Re-conciliation means to compare or match.



Reasons for Disagreement

1. Un-credited Cheques / Deposits / Bank Lodgment.
2. Un-presented Cheques / Outstanding
3. Credit Transfer / Bank Giro / Direct-Transfer
4. Dishonored Chq / Unpaid Chq / Un-cleared Chq
5. Dividends
6. Interest Credited / Received
7. Interest Debited / Interest Charged
8. Standing Order
9. Direct Debits
10. Bank Charges

Cheques

Cheque is a mode of payment through bank from current account or a deposit account|

Cheque Book

It is a book containing cheques (25, 50 or 100), to pay someone

Current Account

A bank account that is normally used for day to day transactions and it does not carry interest

Savings / Deposit Account

These Accounts generally earn interest and are not accessible on frequent or regular basis

Pay-in-Slip

When we want to deposit cash or cheque into our account or any other account we use pay-in-slip to deposit funds into our account. We need to write account no, name of account holder amount with date and signature.

Validity of Cheque

Cheques remains valid for six months from the date of issue. Cheque can be cleared transferred in an account in minimum one day and maximum three days.

Cheques / Deposits / Bank Lodgment

Cheques deposited in the bank, but they are still in banking channel. Not yet appeared in bank statement

Un-Presented Cheques / Outstanding Cheques

Cheques issued to suppliers, but the supplier has not presented them to the bank for payment. Bank has not yet deducted the amount from our account

Credit Transfer / Bank Giro / Direct Transfer.

When bank directly collects money from the customer of the company it is known as Direct transfer which has been recorded in bank but not yet recorded in cashbook.

Dishonored Cheques / Unpaid Cheques / Uncleared Cheques.

When a cheque is received from a customer and paid into the bank, it is recorded on the debit side of the Cash Book. It is also shown on the bank statement as a deposit increasing the balance on the account. However, at a later date it may be found that the customer's bank will not pay the amount due on the cheque. The customer's bank has failed to 'honor' the cheque. The cheque is described as a dishonored cheque.

Dividend

When company invests money in shares, it receives dividend as income directly into the bank, it is already recorded in bank but not yet added in cashbook.

Interest Credited / Interest Received

when company receives interest on its deposits it is known interest received, Bank has already credited it into our account, but not recorded yet in cashbook. So we have to add amount in the cashbook.

Interest Debited / Interest Charged

When companies pay the interest on loan known as interest debited, it has been deducted from the company's bank account, but not yet deducted from cashbook so we will do it.

Standing Order

When companies instruct its bank to pay fixed amount regularly at stated dates to a particular firm/person, it is known as standing order. It has been already deducted from bank, but we have to make an adjustment in cashbook.

Direct Debits

these are payments which have to be made, such as gas bills, electricity bills, telephone bills, rates, and insurance premiums. Instead of asking the bank to pay the money, as with standing orders, you give permission to the creditor to obtain the money directly from your bank account. This is particularly useful if the amounts payable may vary from time to time, as it is the creditor who changes the payments, not you. With standing orders, if the amount

is ever to be changed, *you* have to inform the bank. With direct debits it is *the creditor* who informs the bank.

Bank Charges

Amount deducted by the bank directly from company's bank account for the services they are providing to the company (e.g. Account operation, safe deposit, cheque book, deposit slip etc). We have to deduct this amount from cashbook.

Updated / Revised / Amended Cash Book

Balance b/d	XXX	OR	Balance b/d (Overdraft)	XXX
Trader's Credit / Transfer	XXX		Direct Debit	XXX
Interest Credited	XXX		Standing Order	XXX
Dividend Received	XXX		Bank Charges	XXX
Debtor Paid Directly	XXX		Interest Charged	XXX
		OR	Dishonored / Unpaid Cheque	XXX
Balance c/d (Overdraft)	<u>XXX</u>		Balance c/d	<u>XXX</u>
	<u>XXX</u>			<u>XXX</u>
Balance b/d	XXX		Balance b/d (Overdraft)	XXX

Bank Reconciliation Statement

Bal as per Updated Cash book	XXX
Add: Un-Presented cheques	XXX
Less: Un-Credited lodgments	(XXX)
Balance as per bank statement	XXX

Control Accounts

Every Organization maintains individual debtors and creditors personal T accounts in an alphabetical order. These are called subsidiary ledgers. When these personal Accounts increases in numbers as the business grows there are chances of mistakes, errors along with misappropriation and fraud. To minimize these chances of errors company prepares total of these accounts known as debtors or creditors control account.

Control Accounts only record credit sales and credit purchases and does not include sales and purchase on cash terms.

- **Customer's / Debtors / Sales Ledger Control Account (SLCA)**
- **Supplier's / Creditor's / Purchase Ledger Control Account (PLCA)**

Advantages / Uses of Control Accounts

- Locate Errors
- Proof of Arithmetical Accuracy of subsidiary Ledgers
- They provide total figures of account receivable and account payable
- Help to reduce fraud and misappropriations of funds
- Help in preparation of final accounts

Contra – Set off

Accounts that can offset against each other e.g. If Co. A owes money to Co. B and Co B also owes money to Co. A then the lower amount can be set off against each other so that only the difference then needs to be paid by one party

Action Required = Dr PLCA and Cr SLCA with the lower amount.

Refunds to Customer

When a customer paid more of the amount which was due to him then company owes that customer which needs to be refunded.

Action Required = Dr SLCA and Cr Bank

Refunds from supplier

When we paid more of the amount which was due to a supplier then supplier owes us the excess amount which he will refund us.

Action Required = Dr Bank and PLCA Cr

Interest charged on overdue account

When the amount is due on a customer and he require more time for the payment. Then company usually charge interest on the amount due to him. Customer would have to pay the original amount and interest.

Action required = Debit SLCA with the interest amount and credit Interest Income

Sources of Information for control accounts

Sales Ledger Control Account

Item	Source of Information
1 Opening debtors	List of debtors' balances drawn up at the end of the previous period
2 Credit sales	Total from the Sales Day Book
3 Returns inwards	Total of the Returns Inwards Day Book
4 Cheques received	Cash Book: bank column on received side. List extracted or the total of a special column for cheques which has been included in the Cash Book
5 Cash received	Cash Book: cash column on received side. List extracted or the total of a special column for cash which has been included in the Cash Book
6 Discounts allowed	From Discount Allowed column in 3 Column Cash book
7 Closing debtors	List of debtors' balances drawn up at the end of the period

Purchase Ledger Control Account

Item	Source of Information
1 Opening creditors	List of creditor's balances drawn up at the end of the previous period
2 Credit Purchases	Total from the Purchase Day Book
3 Returns Outwards	Total of the Returns Outwards Day Book
4 Cheques Paid	Cash Book: bank column on payment side. List extracted or the total of a special column for cheques which has been included in the Cash Book
5 Cash Paid	Cash Book: cash column on payment side. List extracted or the total of a special column for cash which has been included in the Cash Book
6 Discounts received	From Discount received column in 3 Column Cash book
7 Closing creditors	List of creditor's balances drawn up at the end of the period

Total debtors account or Sales Ledger Control Account (SLCA)

Balance b/d	xxx	AND / OR	Balance b/d (Cr)	xx
Sales	xxx		Bank	xxx
Bank (Dishonored Cheque)	xxx		Discount Allowed	xxx
Interest Charged to debtors	xxx		Return inward	xxx
Bank (Refunds to Debtors)	xxx		Bad Debts	xxx
			Contra - PLCA	xxx
Balance c/d (Cr)	xx	AND / OR	Balance c/d	xxx
Totals	xxx		Totals	xxx
Balance b/d	xxx	AND / OR	Balance b/d (Cr)	xx

State why SLCA may have a credit balance?

Credit balance in SLCA shows the amount that a company owes to debtor/customer.

- Due to over/duplicated payment by the customer.
- Sales return after the settlement of an account.
- Advance payment from the customer

Total Creditors account or Purchase Ledger Control Account (PLCA)

Balance b/d (Dr)	xx	AND / OR	Balance b/d	xxx
Bank	xxx		Purchases	xxx
Discount Received	xxx		Interest Charged by Suppliers	xxx
Return Outwards	xxx		Bank (Refunds from Creditors)	xxx
Contra - SLCA	xxx			
Balance c/d	xxx	AND / OR	Balance c/d (Dr)	xx
Totals	xxx		Totals	xxx
Balance b/d (Dr)	xx	AND / OR	Balance b/d	xxx

State why PLCA may have a debit balance?

Debit balance in PLCA shows the amount that a supplier owes to company

- Due to over/duplicated payment by us
- Purchase return after the settlement of an account.
- Advance payment by us

Interpretation / Ratios Analysis

It is necessary to analyze and interpret the final accounts of a business in order to assess its performance and progress. Analysis consists of a detailed examination of the information in a set of final accounts of a business. Interpretation can include comparing the results with other similar businesses or comparing the results with previous years or with the targets and budgets.

Profit Markup vs. Profit Margin

Markup – Cost
Margin – Sales

$$\frac{\text{Markup}}{100 + \text{Markup}}$$

$$\frac{\text{Margin}}{100 - \text{Margin}}$$

Note: Profit Markup will be always greater than Profit Margin because Markup is applied on cost which is lower than sales figure. We have to apply greater percentage on lower figure.

1). Profitability Ratios

$$\text{Gross Profit Margin (Gross profit to revenue)} = \frac{\text{Gross Profit}}{\text{Revenue}} \times 100$$

$$\text{Gross Profit Mark up} = \frac{\text{Gross Profit}}{\text{Cost of Sales}} \times 100$$

$$\text{Net Profit to Sales Ratio (Net Profit margin)} = \frac{\text{Net Profit}}{\text{Revenue}} \times 100$$

$$\text{Return on Capital Employed (ROCE)} = \frac{\text{Net Profit for the year}}{\text{Capital Employed}} \times 100$$

[Capital Employed = Owner's capital + Non Current liabilities]

or

[Total Assets – Current Liabilities]

2) Liquidity Ratios

Current ratio
(Working Capital Ratio) = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Quick Ratio
(Acid Test / Liquid Ratio) = $\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$

Rate of Inventory Turnover (times) = $\frac{\text{Cost of Sales}}{\text{Average Inventory}}$

OR

Inventory turnover (In Days) = $\frac{\text{Average Inventory}}{\text{Cost of Sales}} \times 365$

Trade Receivable Turnover (Days) = $\frac{\text{Trade Receivables}}{\text{Credit Sales}} \times 365$

Trade Payables Turnover (Days) = $\frac{\text{Trade Payables}}{\text{Credit Purchases}} \times 365$

Expenses to Sales Ratio = $\frac{\text{Expenses}}{\text{Net sales}} \times 100$

<p>TURNOVER / Net Sales = Sales – Return Inwards</p> <p>OR</p> <p>Cost of sales + Gross profit</p> <p>Gross Profit = Net Sales – Cost of sales</p> <p>OR</p> <p>Net Profit + Expenses</p>	<p>Cost of Sales = Net sales – Gross profit</p> <p>OR</p> <p>Inventory turnover x Average stock</p> <p>OR</p> <p>Opening Inventory + Purchases – Closing Inventory</p> <p>Net Profit = Gross Profit – Expenses</p> <p>Expenses = Gross Profit – Net Profit</p>
--	---

Solvency / Liquidity Ratios

In order to find the Information that indicates whether or not the business will be able to pay its creditors, expenses, loans falling due at correct time are known as liquidity ratios or solvency ratios.

Working Capital = Current assets – Current liabilities

It calculates the capital available to meet the day-to-day expenses

Current Ratio

It shows that how much current assets are available against current liabilities.

Quick / Acid Test Ratio

It shows that how much quick assets are available against current liabilities.

Reasons for decrease in Current Ratio

- Current asset decreases, without a corresponding decrease in a current liability
- Current liability increases without a corresponding increase in a current asset
- Inventory levels are low
- High levels of trade payables
- Using up of a prepaid expense (debit to expense, credit to prepaid exp)
- Recording an expense, such as payroll, or taxes, with an increase with the credit side of the entry recorded to a current liability.

Reasons for decrease in Quick (Acid Test) Ratio

- Inventory levels are high resulting in high trade payables
- The business has no cash available to meet trade payables
- High levels of trade payables
- Cash or accounts receivable decrease, without a corresponding decrease in current liabilities
- increase in a current liability without a corresponding increase in cash or accounts receivables
- Cash spent to acquire fixed assets
- Cash spent to pay off a long term debt or to pay dividends

Why Quick ratio is better than Current ratio?

- The inventory may be difficult or take a long time to sell.
- Inventory may deteriorate or become obsolete.
- Inventory is two stages away from cash.
- Debtors are one stage away from cash.
- Only liquid assets are included in acid test ratio

Reasons for decrease in Liquidity

- Purchase of Non-Current Assets
- Cash drawings
- Loss from business operations
- Bank overdraft funds used to help finance purchase of non-current asset
- Non/late payments by trade receivables
- Fall in cash sales
- Loan may have been paid off
- Rate of inventory turnover may have decreased
- Early payment to trade payables to avail cash discounts
- Increase in inventory
- Increase in expenses e.g. rent, wages etc

How liquidity / Bank balance could be improved

- Bring in more **personal capital** / Issue of Shares
- Consider raising funds through **bank loans**
- Reduce **personal drawings**
- Carry out review of non-current assets **with a view to selling off surplus to requirements**
- Chase **late payers** or offer settlement discounts
- Delay **payments to trade payables**
- Sales on **cash basis**
- Adopt policies to make business profitable
- Sell inventory faster

Reasons for decrease in stock turnover

- Increased mark up / selling price on goods
- No advertising and market awareness
- Reduced quality of the goods purchased
- Reduced variety and range of goods for sale
- Stock increased during the year because sale is slow
- Some stock may be obsolete and remains in stores.
- Sales activity may be slower because of competition.
- Changed circumstances may mean closing stock figures are higher in current year affecting ratio
- Falling demand due change in fashion / taste / better products available
- Stocks may be piling up and not being sold or keeping stock which is more than required

How can stock turnover be improved?

- Reduce inventory levels
- Reduce mark-up / Prices to be more competitive
- Promotions / advertisements / bargain offers
- Offer cash discounts to encourage sales
- Only replace stock when needed
- Dispose of obsolete stock

Drawbacks of holding too much inventory

- Deterioration / Damage of inventory
- Obsolescence
- Space required for storage
- Cost of storage (holding costs)
- Risk of theft
- Opportunity cost of money tied up
- Liquidity problems

Reasons for decrease in Gross Profit Margin

- Reduction in Selling price due to competition, low demand or to win sales orders
- Increase in Cost of sales / purchases due to less supply, new supplier, increase in demand, different quality of material
- An increase in profit in absolute terms does not imply a rise in profitability of sales
- A decrease in selling price with no decrease in cost of goods sold
- A decrease in selling price with a less than proportionate decrease in cost of goods sold
- An increase in cost of goods sold with no increase in selling price
- An increase in cost of goods sold with a less than proportionate increase in selling price
- Over valuation of opening inventory
- Under valuation of closing inventory
- Poor stock control / damage / stolen / obsolete
- Change in sales mix means low sales of high margin products or vice versa

Reasons for decrease in Net Profit Margin

- Expenses have increased at a faster rate than sales
- Reduction in gross profit margin
- Increase in gross profit margin but more than proportionate increase in expenses

What does GP Margin tell us? How can it be used!

- Enables business to see how well it has performed
- How profitable sales for the year are
- Results can be compared with previous years, competitors, similar business, industry average, targets
- It may act as a warning sign since a fall in the ratio may indicate a fall in profitability of sales
- It shows the %age gross profit on sales earned

Reasons for decrease in Net Profit (\$)

- Reduction in revenue
- Increase in cost of sales
- Reduction in GP Margin
- Increase in expenses

Reasons for decrease in ROCE (Return on Capital Employed)

- Reduction in net profit due to decrease in SP / increase in COS / Expenses
- Increase in capital employed due to more equity / debt capital invested
- A lower net profit has been earned in relation to capital invested
- Inefficient / lack of control over expenses / costs

Limitations of accounting statements

- Ratios are based on accounting data and firms differ in their treatment of such items as depreciation, inventory valuation, taxes etc
- Ratios reflect book values not market or fair values
- Does not take size differences of companies into account
- Identify problem areas but not causes
- Inflation can distort financial figures
- Companies can use window dressing to manipulate their financial statements
- Different divisions may need comparison to different industry averages
- Financial accounting information is affected by estimates and assumptions
- Ratio analysis explains relationships between past information while users are more concerned about current and future information.
- Non-Financial Factors are equally important which are not highlighted using financial ratios

SINGLE ENTRY / INCOMPLETE RECORDS

Statement of Affairs vs. Statement of Financial Position

Statement of Affairs and Balance Sheet are two varying terms, but they too nearly resemble which causes confusion in distinguishing them. For overcoming from these doubts regarding the two entities, you need to understand their meaning clearly along with their differences. The major differences between Statement of Affairs and Balance Sheet are disclosed in detail below, so have a look on them.

Definition of Statement of Affairs

Statement of Affairs is a statement in which there are two sections left and right. The left section represents liabilities, whereas the right one is for assets. It is prepared on the basis of a single entry system of bookkeeping. As incomplete records are maintained, many times assumed figures are taken into consideration to find out the opening or closing capital (as the case may be). This opening or closing capital is also spelled as net assets because it is the result of assets over liabilities.

Statement of Affairs is prepared on the opening date if the purpose is to trace out opening capital. Likewise, it is made on the closing date if the purpose is to trace out the closing capital.

Nowadays it is mandatory for every company to maintain their books of accounts as per double entry system, but there are still some small businessman and traders who keep their books as per single entry system. In this way, proper and systematic records are not maintained by them.

Definition of Statement of Financial Position

A Balance Sheet is a statement which highlights the financial status of the company at a particular date. It has two sections, assets, and equity & liabilities. As equity is considered as a part of liabilities, it is included in the liabilities section. The assets represent the amount which the company owns. On the contrary, liabilities represent the amount which the company owes.

The preparation of Balance Sheet is obligatory for every company. It is prepared on the basis of the double entry system of bookkeeping. In a double entry system of bookkeeping, complete recording of every transaction is done along with various stages. The final stage is the preparation of Balance Sheet. If it is not prepared correctly or if some asset or liability is omitted, then the amount of sides will not be identical. It is a mark of its exactitude.

KEY DIFFERENCES BETWEEN STATEMENT OF AFFAIRS AND BALANCE SHEET

BASIS FOR COMPARISON	STATEMENT OF AFFAIRS	BALANCE SHEET
MEANING	Statement of Affairs is a statement showing liabilities, assets and capital of the entity prepared on the basis of a single entry system of a book-keeping.	A Balance Sheet is a statement showing assets, liabilities and equity of the company prepared on the basis of the double entry system of bookkeeping.
PART OF FINANCIAL STATEMENTS	No	Yes
OBJECTIVES	To find out the Opening and Closing Capital	To show the company's Financial Position
ESTIMATION OF VALUES	Yes	No
ACCURACY	Very Less	More
COMPULSION OF PREPARATION	No	Yes
FORMAT	Not Specified	Specified

Conclusion

The concept of both the statements is almost same, but experts consider Balance Sheet as more accurate, reliable and versatile as it follows a complete procedure. Statement of Affairs lacks such attributes. When the double entry system was not present people used to keep the records of their transaction as per single entry system, and that is why it is the oldest one.

Single Entry / Incomplete Records

Accounting records which have not been maintained according to double entry principles are usually referred to as "Incomplete Records or Single Entry". This does not necessarily mean that the records are unsatisfactory.

Statement of affairs

When a list of assets and liabilities is prepared without the use of a set of double entry records it is known as a statement of affairs rather than a "Balance Sheet". Statement of affairs calculates the amount of "Capital."

Capital = Assets – Liabilities

Opening statement of affairs means "Opening Capital".

Closing statement of affairs means "Closing Capital".

(Opening capital = opening assets – opening liabilities)

(Closing capital = Closing assets – closing liabilities)

CALCULATION OF NET PROFIT / LOSS

If the assets, liabilities and capitals are known and no further information is available, the only way in which the profit can be calculated is.

Opening Capital	XXX	-	
Add: Profit / Less Loss	XX/(XX)	?	
Add: Additional Investment	XXX	-	
Less: Drawings	<u>(XXX)</u>	+	
= Closing Capital	<u>XXX</u>		

Net Profit / Loss = Closing Capital + Drawings – Additional Investment - Opening Capital

The above method of calculating Net Profit / Loss is not completely satisfactory, because it does not show the details about cost of goods sold, gross profit, expenses and other income. It is not possible to analyze the results and take decisions for the future time period.

Total sales

Total sales = cash sales + credit sales

Sales Ledger Control Account

Balance b/d	XXX	Bank / Cash	XXX
Sales	XXX	Discount Allowed	XXX
		Bad Debts	XXX
		Return Inwards	XXX
	XXX	Balance c/d	XXX
			XXX

Total purchases

Total purchases = cash purchases + credit purchases

Purchase Ledger Control Account

Bank / Cash	XXX	Balance b/d	XXX
Discount Received	XXX	Purchases	XXX
Return Outwards	XXX		
Balance c/d	XXX		XXX
	XXX		

Incomplete Records and Missing Figures

Cash Book

	Cash	Bank		Cash	Bank
Balance b/d	XXX	-	Balance b/d (OD)	-	XXX
Cash Sales	XXX	-	Drawings	XXX	XXX
Receipt from Debtors	?	XXX	Payment to Suppliers	XXX	XXX
Sale of NCA	XXX	-	Expenses paid	XXX	XXX
Balance c/d (OD)	-	XXX	Balance c/d	XXX	-
	XXX	XXX		XXX	XXX

Profit Markup vs. Profit Margin

Markup – Cost

Margin – Sales

$$\frac{\text{Markup}}{100 + \text{Markup}}$$

$$\frac{\text{Margin}}{100 - \text{Margin}}$$

Profit Markup will be always greater than Profit Margin because Markup is applied on cost which is lower than sales figure. We have to apply greater %age on lower figure.

Errors Not Affecting Trial Balance

6 Types of Errors that do not affect trial balance

1 Errors of Commission – this type of error occurs when the correct amount is entered but in the wrong person's account, e.g. where a sale of \$11 to ARD is entered in the account of AKD. It will be noted that the correct class of account was used; both the accounts concerned being personal accounts.

2 Errors of Omission – where a transaction is completely omitted from the books. If we sold \$90 goods to ARD, but did not enter it in either the sales or ARD's personal account, the trial balance would still 'balance'.

3 Errors of Principle – where an item is entered in the wrong class of account, e.g. if purchase of a fixed asset, such as a van, is debited to an expenses account, such as motor expenses account.

4 Complete Reversal of entries – where the correct accounts are used but each item is shown on the wrong side of the account. Suppose we had paid a cheque to ARD for \$200, the double entry of which is Cr Bank \$200, Dr ARD \$200. In error it is entered as Cr ARD \$200, Dr Bank \$200. The trial balance totals will still agree.

5 Errors of Original entry – where the original figure is incorrect, yet double entry is still observed using this incorrect figure. An instance of this could be where there were sales of \$150 goods but an error is made in calculating the sales invoice. If it were calculated as \$130, and \$130 were credited as sales and \$130 were debited to the personal account of the customer, the trial balance would still balance.

6 Compensating errors – where errors cancel each other out. If the sales account was added up to be \$10 too much and the purchases account was also added up to be \$10 too much, then these two errors would cancel out in the trial balance. This is because the totals of both the debit side and the credit side of the trial balance will be \$10 too much.

Errors & Suspense Account

Suspense Account

At the End of financial year, all organizations prepare trial balance for the sake of preparing income statement and balance sheet. Sometimes due to errors, total of the trial balance do not agree and the balance of debit side is different as compared to credit side. It is a responsibility of an accountant to find out the error, and balance it off. When errors cannot be found, the trial balance totals can be made to agree with each other by inserting the difference of the amount as a **"SUSPENSE ACCOUNT"**.

Suspense account can only be originated due to error on only one side of an account. Other side Dr. or Cr. Recorded correctly. If the errors occurred on **both** side with the same effect it won't disagree the totals of trial balance

Suspense account = is the difference of debit and credit side balance.

It is a temporary account till the errors cannot be rectified and eliminated. Suspense account can be recorded in the balance sheet, if the balance of suspense account is on the debit side then it would be recorded as an asset and if the balance is on the credit side it would be recorded as a liability.

Due to the errors there is a possibility that our net/gross profit affected or we need some alteration in balance sheet, it all depends on the errors. We should be well aware how these errors have affected our financial statements.

Casting	=	Totaling
Over-casted	=	over addition / over totaled / extra added / over recorded
Under-casted	=	less added / under added / under recorded

Errors which affect trial balance

- Incorrect additions in any account.
- Making an entry on only one side of the accounts, e.g. a debit but no credit; a credit but no debit.
- Entering a different amount on the debit side from the amount on the credit side.

SOME COMMON ERRORS AFFECTING TRIAL BALANCE

1. Purchases were over / under casted
2. Sales were over / under casted
3. Expense recorded twice
4. Discount allowed recorded in discount received and discount received recorded in discount allowed
5. Withdraw goods for personal use, recorded correctly in drawing account, but no other entry was recorded
6. A/c Receivable (debtors) A/c Payables (Creditors) were listed wrongly

Partnership Accounts

The need for partnerships

This is a long-term commitment to operate in business together. The people who own a partnership are called partners. They do not have to be based or work in the same place, though most do. However, they maintain one set of accounting records and share the profits and losses.

Nature of a partnership

A partnership has the following characteristics:

- 1) It is formed to make profits.
- 2) It must obey the law as given in the Partnership Act
- 3) Normally there can be a minimum of two partners and a maximum of twenty partners. Exceptions are banks, where there cannot be more than ten partners; and there is no maximum for firms of accountants, solicitors, stock exchange members, surveyors, auctioneers, valuers, estate agents, land agents, estate managers, or insurance brokers.
- 4) Each partner (except for limited partners described below) must pay their share of any debts that the partnership could not pay. If necessary, they could be forced to sell all their private possessions to pay their share of the debts. This can be said to be unlimited liability.
- 5) Partners who are not limited partners are known as general partners.

Limited partnerships

Limited partnerships are partnerships containing one or more limited partners. They must be registered with the Registrar of Companies. Limited partners are not liable for the debts. Limited partners have the following characteristics and restrictions on their role in the partnership:

- 1) Their liability for the debts of the partnership is limited to the capital they have put in. They can lose that capital, but they cannot be asked for any more money to pay the debts unless they contravene the regulations relating to their involvement.
- 2) They are not allowed to take out or receive back any part of their contribution to the partnership during its lifetime.
- 3) They are not allowed to take part in the management of the partnership or to have the power to make the partnership take a decision. If they do, they become liable for all the debts and obligations of the partnership up to the amount taken out or received back or incurred while taking part in the management of the partnership.
- 4) All the partners cannot be limited partners, so there must be at least one general partner with unlimited liability.

Partnership agreements

Agreements in writing are not necessary. However, it is better if a written agreement is

drawn up by a lawyer or an accountant. Where there is a proper written agreement there will be fewer problems between partners. A written agreement means less confusion about what has been agreed.

Contents of partnership agreements

- Names of all the partners
- the capital to be contributed by each partner.
- The ratio in which profits (or losses) are to be shared.
- The rate of interest, if any, to be paid on capital before the profits are shared.
- The rate of interest, if any, to be charged on partners' drawings.
- Salaries to be paid to partners.
- Arrangements for the admission of new partners.
- Procedures to be carried out when a partner retires or dies.

Where no partnership agreement exists

- Profits and losses are to be shared equally.
- There is to be no interest allowed on capital.
- No interest is to be charged on drawings.
- Salaries are not allowed.
- Partners who put a sum of money into a partnership in excess of the capital they have agreed to subscribe are entitled to interest at the rate of 5% per annum on such an advance.

Loan from partners

A partnership may borrow money from one of the partners if extra finance is required. Loans from partners are not part of the capital of the business and are treated in the same way as any other loan. In absence of partnership agreement / dispute a fix rate of interest of 5% is allowed to partner, on loan.

ARD Partnership
Appropriation Account for the year ended December 31, 2017

	Profit for the year		XXX
Add	Interest on drawings		
	Mr. A	XXX	
	Mr. R	XXX	XXX
Less:	Interest on capital		
	Mr. A	XXX	
	Mr. R	XXX	(XXX)
Less:	Salaries / Bonus / Commission:		
	Mr. A	XXX	
	Mr. R	XXX	(XXX)
	Residual Profits		XXX
	Mr. A (Remaining profit X share)	XX	
	Mr.R (Remaining profit X share)	XX	XXX

Current Account

	A	R			A	R
Balance b/d (Dr)	XXX	XXX	OR	Balance b/d	XXX	XXX
Drawings	XXX	XXX		Interest on Capital	XXX	XXX
Interest on Drawings	XXX	XXX		Salaries	XXX	XXX
Share of Loss	XXX	XXX		Bonus / commission	XXX	XXX
Salary Drawing	XXX			Profit share	XXX	XXX
				Interest on Loan	XXX	XXX
Balance c/d	XXX	XXX	OR	Balance c/d (Dr)	XXX	XXX
	XXX	XXX			XXX	XXX
Balance b/d (Dr)	XXX	XXX	OR	Balance b/d	XXX	XXX

If current accounts are not maintained by the company, then we record all the items in capital account, in the same way as we do in current account, using the opening balances of capital account.

STATEMENT OF FINANCIAL POSITION EXTRACT

Equity			
Capital Accounts	– A	XXX	
	– B	XXX	XXX
Current Accounts	– A	XX	
	– B	(XX)	XX
Total Partners Equity / Net Assets			XXX

Goodwill

Goodwill is an intangible asset. It can only exist if the business was purchased and the amount paid was greater than the value of the net assets. In many cases, goodwill represents the value of the reputation of the business at the time it was purchased.

Reasons for payment of goodwill

- A Large number of regular customers who will continue to deal with the new owner.
- The business has a good reputation.
- It has experienced, efficient and reliable employees
- The business is situated in a good location.
- It has good contacts with suppliers

- It has well-known brand names that have not been valued and included as assets.

Existence of goodwill

Goodwill does not necessarily exist in a business. If a business has a bad reputation, an inefficient labour force or other negative factors, it is unlikely that the owner would be paid for goodwill on selling the business.

Exam Focused theory Questions

Q. What do we record in partnership appropriation account?

A. Appropriation account is the extension of income statement. It records the distribution of profit. Appropriation account records interest on drawings, interest on capital, salaries of partners, bonus or commission and at last profit share according to the ratios given.

Q. What is the rate of interest allowed to a partner's loan, provided by a partner to a partnership? In the absence of partnership agreement.

- A. If a partner provided a loan to the partnership, he would be allowed a fixed rate of 5% interest in the absence of a partnership agreement.

Q. What is the difference between partnership and companies?

Partnership	Companies
<ul style="list-style-type: none"> • Minimum two and maximum twenty partners. • Less legal requirements as compared to companies. • Unlimited liability on the partners • Admission/death and retirement can cease partnership operations. 	<ul style="list-style-type: none"> • Minimum twenty and no limits on maximum. • Needs to accomplish complex legal requirements. • Limited liability. • Operations cannot be affected due to admission, death and retirement.

Q. What is the difference between company's appropriation and partnership appropriation account?

A. Appropriation account is the extension of income statement. It records the distribution of profit. Company's appropriation shows the distribution of profits as dividend together with the reserves and retained profit. But in partnership appropriation account net profit would be divided among the partners. Basic purpose of the appropriation is to distribute the profit between its partners/share holders.

Q. State two accounting principles which support goodwill not being included in the balance sheet.

A. Goodwill not being recorded is supported by

1. Money measurement concept

Goodwill has no specific value and cannot be measured accurately.

2. Prudence concept

Goodwill is the estimated value and not confirmed whether it will be realized or not

Company Accounts

Need for limited companies

Limited liability companies, more commonly referred to as **limited companies**, came into existence originally because of the growth in the size of businesses, and the need to have a lot of people investing in the business who would not be able to take part in its management.

Difference between Partnership and Limited Company

	Partnership	Company
Legal Status	It is not a separate legal entity so acts of partnership are treated as acts of company	It is a separate legal entity distinct and different from the owners of the company.
Rights of Property	Property of partnership is jointly owned by partners	A company can own property in its own name, sue and be sued
Management of business	All partners (except partner with limited liability) are entitled to manage the business	All Shareholders have no say in the company's management rather it vests in the hands of a few directors elected by shareholders
Liability of the owners	Liability of the partners towards the partnership debts is unlimited. i.e. if the business is unable to meet its debts from its assets then private assets of partners may be used to pay off the unpaid debts (unless he is a limited partner)	The liability of ordinary shareholders is limited to the fully paid amount of the shares they own
Transferability of ownership	A partner cannot transfer his share within the partnership without the consent of other partners	A shareholder can easily transfer/sell his shares without the consent of other shareholders
No of Owners	Minimum no of partners is two with max no limited to 20 (exceptions are professionals such as lawyers, accountants)	Min no of shareholders is two with no max limit except no of authorized shares which can also be increased
Statutory Regulations	No major statutory regulations	It is required to comply with various statutory regulations under companies Act and IFRS
Audit of Accounts	There are no legal requirements to audit accounts	Companies are bound to audit its accounts annually
Tax	Partnerships are not required to pay tax on their profits.	Companies are liable to pay tax at specified rates on its

	However partners have to pay taxes individually on their personal incomes (including their share of profit from partnership)	profits after charging all expenses. Shareholders may be required to pay tax again on their dividends.
Min amount of capital	There is no minimum requirement of capital however it can be setup through agreement	For a public limited company there must be a minimum authorized capital of \$50,000 of which ¼ must be paid up.

Advantages of a Limited Company

- Separate legal identity
- Limited liability
- Perpetual succession
- Easy transferability of shares
- Divorce of ownership and management
- Financing

Disadvantages of a Limited Company

- Statutory Regulations
- No Secrecy
- Limited power of shareholders
- More secretarial expenses

Limited liability

the capital of a limited company is divided into **shares**. Shares can be of any nominal value 10p, 25p, \$1, \$5, \$10, or any other amount per share. To become a member of a limited company, or a **shareholder**, a person must buy one or more of the shares. If shareholders have paid in full for their shares, their liability is limited to what they have already paid for those shares. If a company loses all its assets, all those shareholders can lose is their share. They cannot be forced to pay anything more in respect of the company's losses. Shareholders who have only partly paid for their shares can be forced to pay the balance owing on the shares, but nothing else.

Public vs. Private companies

In the Companies Acts, a public company is defined as one which fulfils the following conditions:

- Its memorandum (a document that describes the company) states that it is a public company, and that it has registered as such.
- It has an authorized share capital of at least \$50,000.
- Minimum membership is two. There is no maximum.
- Its name must end with the words 'public limited company' or the abbreviation 'PLC'.

The main differences between a private company and a public company are that a private company

- can have an authorized capital of less than \$50,000, and
- cannot offer its shares for subscription to the public at large, whereas public companies can.

Directors of the company

the day-to-day business of a company is *not* carried out by the shareholders. The possession of a share normally confers voting rights on the holder, who is then able to attend general meetings of the company. At one of these general meetings, normally the **Annual General Meeting** or AGM, the shareholders vote for **directors**, these being the people who will be entrusted with the running of the business. At each AGM, the directors report on their stewardship, and this report is accompanied by a set of financial statements for the year – the 'annual report'.

Legal status of a limited company

a limited company is said to possess a 'separate legal identity' from that of its shareholders. Put simply, this means that a company is not seen as being exactly the same as its shareholders. For instance, a company can sue one or more of its **shareholders**, and similarly, a shareholder can sue the company. This would not **be the case** if the company and its shareholders were exactly the same thing, as one cannot sue oneself. This concept is often referred to as the **veil of incorporation**.

Share capital

Shareholders of a limited company obtain their reward in the form of a **share** of the profits, known as a **dividend**. The **directors** consider the amount of profits and decide on the amount of profits which are placed to reserves. Out of the profits remaining the directors then propose the payment of a certain amount of dividend. It is important to note that the shareholders cannot propose a higher dividend for themselves than that already proposed by the directors.

There are two main types of shares:

1 Preference shares. Holders of these shares get an agreed percentage rate of dividend before the ordinary shareholders receive anything.

2 Ordinary shares. Holders of these shares receive the remainder of the total profits available for dividends. There is no upper limit to the amounts of dividends they can receive.

The two main types of preference shares are non-cumulative preference shares and cumulative preference shares:

1 Non-cumulative preference shares. These can receive a dividend up to an agreed percentage each year. If the amount paid is less than the maximum agreed amount, the shortfall is lost by the shareholder. The shortfall cannot be carried forward and paid in a future year.

2 Cumulative preference shares. These also have an agreed maximum percentage dividend. However, any shortfall of dividend paid in a year can be carried forward. These arrears of preference dividends will have to be paid before the ordinary shareholders receive anything.

Share capital: Different meanings

- 1) Issued share capital.** This is the total of the share capital actually issued to shareholders. If all of the authorized share capital has been issued, then 1 and 2 above would be the same amount.
- 2) Called-up capital.** Where only part of the amount payable on each issued share has been asked for, the total amount asked for on all the issued shares is known as the called-up capital.
- 3) Uncalled capital.** This is the total amount which is to be received in future relating to issued share capital, but which has not yet been asked for.
- 4) Calls in arrears.** The total amount for which payment has been asked for (i.e. 'called for'), but has not yet been paid by shareholders.
- 5) Paid-up capital.** This is the total of the amount of share capital which has been paid for by shareholders.

Dividends (Preference and Ordinary)

The amount given to shareholders as their share of profits in the company.

Interim Dividend

Dividend issued during the financial year, could be after 3 months, 6 months or 8 months or at any other period within the year.

Final Dividend

Dividend issued at the end of the financial term.

Proposed Dividend

Dividend announced or declared, but not yet issued to the shareholders. It is considered to be a liability or disclosed through notes to the accounts.

Debentures

When a limited company receives money on loan, and certificates called debenture certificates are issued to the lender. Interest will be paid to the holder, the rate of interest being shown on the certificate. They are not always called debentures; they are often known as loan stock or as loan capital. Debenture interest has to be paid whether profits are made or not. They are, therefore, different from shares, where dividends depend on profits being made.

Debenture interest

The interest payable for the use of the money is an expense of the company, and is payable whether profits are made or not. This means that debenture interest is charged as an expense in the profit and loss account itself. Contrast this with dividends which are dependent on profits having been made.

Difference between

Ordinary shares	Preference shares	Debentures
No fix rate of dividend	Carry fix rate of dividend	Carry fix rate of interest
Dividend cannot be accumulated	Dividends can be accumulated in case of Cumulative Preference Shares.	Interest must be paid in the year, cannot be accumulated
Can vote in AGM	Cannot vote in AGM	Cannot vote in AGM
Last one to get paid upon liquidation	They get paid after debenture holders get paid	First one to get paid upon liquidation
Most Risk	Moderate Risk	Least Risk
Highest Return	Moderate Return	Lowest Return

Bonus shares

Bonus shares are 'free' shares issued to shareholders without their having to pay anything for them.

Directors' remuneration

As directors exist only in companies, this type of expense is found only in company accounts. Directors are legally employees of the company, appointed by the shareholders. Their remuneration is charged to the profit and loss account.

Trading and profit and loss accounts of companies

The trading and profit and loss accounts for both private and public companies are drawn up in exactly the same way.

Reserves are surplus not yet distributed as profit among its share holders. It is the profit which is not appropriated as dividends. Reserves represent the claim that owners have because of the wealth created by the company over the years but not distributed to them.

There are two types of reserves.

1. **Revenue reserves** Those generally result from profits earned by the company but not appropriated as dividend. These represents increase in company's wealth and are available for the distribution of dividends to the shareholders.

Examples are: Retained Earnings / General Reserve/ Non Current Asset Replacement Reserve

2. **Capital reserves** Undistributed profits of a company that for various reasons are not regarded as distributable to share holders as dividend. These include certain profits on the revaluation of capital assets and sum received from the issuance of share over it's per value (Share premium). Capital reserves are also known as "UNDISTRIBUTABLE RESERVES".

Examples are: Share Premium / Revaluation Reserve (Surplus)

Statement of changes in equity

A set of financial statements for a company must include a statement of changes in equity (SOCIE) in order to comply with the requirements of IAS1: **Presentation of financial statements**.

The SOCIE is a part of the financial statements of a company, together with the statement of financial position, statement of comprehensive income, statement of cash flows and notes to the financial statements.

For each 'component of equity', a SOCIE shows the amount at the beginning of the period for that component of equity, changes during the period, and **its** amount at the end of the period.

The purpose of the statement is simply to show how the total amount of equity has changed during the year, and which parts of equity have increased or decreased in amount, and by how much.

ARD Limited
Statement of Changes in Equity for the year ended 31 Dec 2020

	<u>Preference Share Capital</u>	<u>Ordinary Share Capital</u>	<u>General Reserve</u>	<u>Retained Earnings</u>	<u>Total Equity</u>
Balance at Start	XXX	XXX	XXX	XXX	XXXX
Profit / (Loss) after interest				XX(XX)	XX(XX)
Dividends paid				(XX)	(XX)
Transfer to General Reserve			XX	(XX)	nil
Balance at End	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>	<u>XXXX</u>

(w) Calculation of Profit after interest

Profit before interest	XXX
Less: Debentures / Loan interest (Debentures Amount X Rate%)	(XXX)
Profit after interest	XXX

ARD Limited
Statement of Financial Position Extract for the year ended Dec 31, 2020

Equity & Reserves			
ISSUED / CALLED UP / PAID UP SHARE CAPITAL			
Preference share Capital	XXX		
Ordinary Share Capital	XXX	XXX	
General Reserves		XXX	
Retained Earnings		XXX	
Total Shareholder funds			XXX
Add: Debentures / Bank Loan			XXX
Capital Employed			XXX

Exam Focused theory Questions

Q. Why company use general reserves

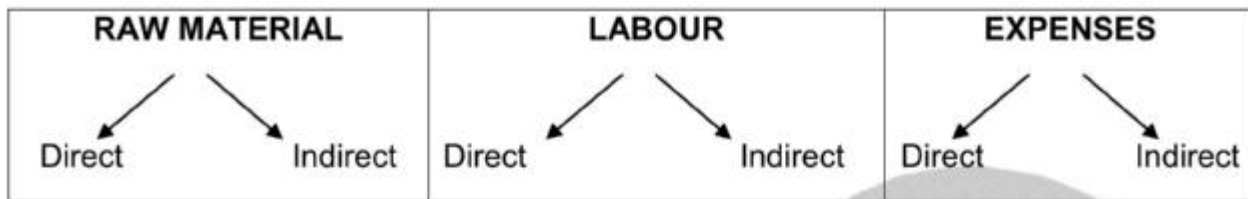
A. A general reserve is a retained profit for a non-specific purpose. It can be used for general growth of the business and its assets. It can be used to cover future shareholders dividend. To conserve cash and working capital.

Q. Why a limited company might not distribute all of the profit for the year as dividend.

A. To retain cash/money/profit.
To increase working capital
to fund further growth of the business and its assets.
To reinvest in the business
to keep for emergencies/contingencies
to cover/pay future dividends.

Manufacturing Accounts

Costs Classification



Prime cost = Direct Material + Direct Labour + Direct Expense

Overheads = Indirect Material + Indirect Labour + Indirect Expense

Overheads

- Production / Factory / Manufacturing Overheads
- Non Production / Non Factory / Non-Manufacturing Overheads (E.g. Selling, Marketing, administration, Distribution, Office, Finance, R and D etc)

Building up of Costs

Direct Material	XX
Direct Labour	XX
Direct Expenses	<u>XX</u>
Prime Cost	XX
Add: Production Overheads	<u>XX</u>
Production Costs	XX
Add: Non Production Overheads	<u>XX</u>
Total Cost	<u>XX</u>

Direct costs

Direct cost are cost that can be traced / identified easily in the product or service being manufactured e.g. direct material, direct labour & direct expenses the sum of all the direct costs is known as the prime cost

Examples

- Cost of raw materials including carriage inwards on those raw materials.
- Labour directly involved in producing a unit or providing a service
- Hire of special machinery for a job or royalty expense

Indirect cost

indirect costs are costs that cannot be easily traced / identified in the product or service being manufactured or we treat them indirect because costs are negligible e.g. indirect material, indirect labour & indirect expenses the sum of all the indirect costs is known as the overheads

Examples

- wages of cleaners
- wages of crane drivers
- rent of a factory
- depreciation of plant and machinery
- costs of operating forklift trucks
- factory power
- factory lighting

Administration expenses

'Administration expenses' consist of such items as managers' salaries, legal and accountancy charges, the depreciation of accounting machinery and secretarial salaries.

Selling and distribution expenses

'Selling and distribution expenses' are items such as sales staff's salaries and commission, carriage outwards, depreciation of delivery vans, advertising and display expenses.

Financial charges

'financial charges' are expense items such as bank charges, discounts allowed and lease costs

Manufacturing Account

An account or statement where a company calculates cost of production/manufacturing cost. This helps in future decision making by comparing per unit cost with same products available in the market.

GOODS / INVENTORY:

An item of inventory could be in three different stages.

1. **Raw material** (product could be in raw shape like wood, sand, cement, nails etc)
2. **Work in process** (when goods are partly completed, needs more work to be done to complete).
3. **Finished goods** (when product is fully completed, ready for sale)

ARD Textiles
Manufacturing Account for the year ended Dec 31, 2020

	\$	\$
Direct Raw material		
Opening inventory of RM	XX	
Add: Purchases of RM	XX	
Less: Purchases return RM	(XX)	
Add: Carriage Inwards RM	XX	
Closing inventory of RM	(XX)	
Cost of Raw material consumed		XX
Add: Direct Labour / Factory wages		XX
Add: Direct Expense / Royalty		XX
Prime Cost		XXX
Add: Factory Overheads / Indirect Cost		
Salaries & wages (Factory Supervisor/Mgt salary)	XXX	
Insurance (factory)	XXX	
Indirect overheads (Factory)	XXX	
Heat and lighting (Factory)	XXX	
Rent (Factory)	XXX	
Depreciation (Factory equipment)	XXX	
Sundry expenses (factory)	XXX	XXX
		XXX
Add: WIP (Opening)	XXX	
Less: WIP (Closing)	(XXX)	XX(XX)
Production / Manufacturing cost		XXX

ARD Textiles
Income Statement for the year ended Dec 31, 2020

	\$	\$
Sales Revenue (Finished Goods)		XXX
Less: Cost of Sales		
Opening Inventory of (FG)	XXX	
Add: Production / Manufacturing cost	XXX	
Purchase of finished goods (FG)	XXX	
Less: Purchases return (FG)	(XXX)	
Closing inventory (FG)	(XXX)	
Cost of Sales		(XXX)
Gross profit		XXX
Add: Other Income		
Interest received	XXX	
Decrease in Provision for doubtful debts	XXX	
Discount received	XXX	XXX
Less: Non-Manufacturing Overheads		
Heat and lighting (Office)	XXX	
Office salaries	XXX	
Rent (Office)	XXX	
Depreciation (Office Related Assets)	XXX	
Carriage Outward / Distribution Costs	XXX	
Bad debts	XXX	
Increase in Provision for doubt debts	XXX	
Interest expense / financial cost	XXX	(XXX)
Profit / (Loss) for the year		XX/(XX)

ARD Textiles
Statement of Financial Position as at 31 December 2020

Assets	\$	\$	\$
Non-Current Assets	Cost	Acc Dep	NBV
Land	XXX	-	XX
Building	XXX	(XX)	XX
Equipment	XXX	(XX)	XX
			XXX
Current Assets			
Inventory			
Raw Material	XX		
Work in Progress	XX		
Finished Goods	XX	XXX	
Trade Receivables / Debtors	XXX		
Less: Provision for doubtful debts	(XXX)	XXX	
Prepaid Expense		XXX	
Accrued Income		XXX	
Bank		XXX	
Cash		XXX	XXX
Total Assets			XXX
Capital and Liabilities			
Opening Capital		XXX	
Add Profit for the year / Less (Loss)		XX/(XX)	
Less: Drawings		(XXX)	XXX
Non Current Liabilities			
6% Bank Loan 2025			XXX
Current Liabilities			
Trade payables / Creditors		XXX	
Bank O/D (Over Draft)		XXX	
Accrued Expenses		XXX	
Prepaid Income		XXX	XXX
Total Capital and Liabilities			XXX

Exam Focused theory Questions

Q. Why do we calculate manufacturing cost?

A. Manufacturing cost give us the cost incurred on producing/Manufacturing goods. We calculate it because we would like to have per unit cost, which helps us in comparing cost with the same product available in the market. It helps us in future decision making, whether to continue production process or not it also helps us in controlling cost and other overheads.

Q. Explain the term Prime cost?

A Prime cost is the primary cost to produce any item/product/good without which it cannot be produced. It is the initial cost of production. Prime cost is the direct cost of production it includes direct raw material, direct labor and direct expense or we can say that , it we add all direct cost we can have the value of prime cost.

Not for Profit / Club Accounts

Non-profit-oriented organizations are whose primary objective is not profit maximization. They make profit but which is incidental to its other social objectives and the profit / surplus cannot be distributed among its members as dividends instead it should be reinvested for the same cause. Examples are clubs, associations, charity and other non-profit oriented organizations. As their main purpose is to provide recreational facilities like (Swimming, chess, cricket and other facilities) charities and other welfare activities for the members rather than to make profit from the members.

Difference in Terminologies

Profit Making Organization	Non-Profit Organization
Income statement / Trading Profit & Loss Account	1) Trading Account (Refreshment / Canteen etc)
	2) Income and expenditure account (For Entire Club including Canteen)
Net profit	Surplus (Only in Income & Expenditure Ac)
Net loss	Deficit (Only in Income & Expenditure Ac)
Capital	Accumulated fund
Cash Book	Receipt & Payment Account

Receipt and Payments Account

Receipt and payments account is the summary of the cash/bank for the period. Receipts and payments account only shows the cash/bank balance at the end of the period. It includes all (Capital and revenue) receipts and all (Capital & revenue) expenditure.

Income and Expenditure Account

an income and expenditure account follows the same rules as an income statement. The only differences are the terms used. It only includes revenue receipts and expenditures (as per law).

Difference between Receipt & Payments A/C & Income and Exp A/C

Receipt & Payment Account	Income & Expenditure Account
It includes all capital & revenue Receipts and payments	It shows only revenue receipts and payments
It is a cash/bank summary	It is summary of income and expenses in the period.
It reveals only cash/bank balance at the end	It reveals surplus/deficit at an end of the period.

Subscription Account (Income)

	\$		\$
A Balance b/d	XXX	P Balance b/d	XXX
Subscription refund	XXX		
Income & Expenditure A/c	XXX	Bank (Subscription received During the year)	XXX
		Bad Debts	XXX
P Balance c/d	<u>XXX</u>	A Balance c/d	<u>XXX</u>
	<u>XXX</u>		<u>XXX</u>

Member's subscription

it is the main source of income for a Club. It is the fee charged by members for the use of club facilities.

Subscription in arrears

Subscription not received for the previous years, it is an asset/receivable for an organization.

Subscription In Advance

Subscription received in advance for the future periods. It is a liability for an organization.

Donations

Income for an organization received for some charitable purpose which has to be credited to the income and expenditure account in the year they received. If donations are specified as capital income then it has to be recorded in balance sheet instead of I & E account.

Locker Fees

The club may provide lockers for rent to the members to deposit their personal belongings. The fees collected are another source of income for the club, and it also credited in income and expenditure account.

Entrance fees

Those are the fees paid by the members when they first join the organization and it is also credited to I & E a/c in the year in which they are received.

Profit from Bar / Snacks / Refreshments / Canteen / Cafeteria

Most non-trading concerns have bar or lounge to sell refreshment and light snacks to the members and the profit from such sales is another source of income for the organization. It is therefore necessary to prepare a bar trading account to determine the bar profit, that would be transferred to the I & E account.

Legacy

Legacy means, "Will" of a person or an organization and it is a capital receipt for non-trading organization. It would be recorded in balance sheet as permanent capital.

Life membership

In some clubs and societies, members can make a payment for life membership. This means that by paying a fairly substantial amount now members can enjoy the facilities of the club for the rest of their lives. Such a receipt should not be treated as income in the income and expenditure account solely in the year in which the member paid the money. It should be credited to a life membership account, and transfers should be made from that account to the credit of the income and expenditure account of an appropriate amount annually.

Donations

Any donations received are usually shown as income in the year that they are received.

Entrance fees

When they first join a club, in addition to the membership fee for that year, new members often have to pay an entrance fee. Entrance fees are normally included as income in the year that they are received. A club could, however, decide to treat them differently, perhaps by spreading the income over a number of years. It all depends on the circumstances.

Accumulated Fund

It is same as a capital account in non-profit organization we prepare statement of accumulated fund instead of capital a/c as we prepare in sole trader and in partnership.

In sole trader or partnership CAPITAL = ASSETS – LIABILITIES	In a non-profit organization ACCUMULATED FUND = ASSETS – LIABILITIES
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OPENING ACCUMULATED FUND

	\$	\$
OPENING ASSETS		
Cash / Bank	XXX	
Inventory of refreshment	XXX	
Equipment	XXX	
Subscription in arrears	XXX	
Prepaid Expense	XXX	
Premises	XXX	XXX
Less: OPENING LIABILITIES		
Subscription in advance	XXX	
Accrued/Owings to supplier	XXX	
Overdraft / Loan	XXX	(XXX)
Opening Accumulated fund		XXX

Exam Focused theory Questions

Q. Why do members prefer to have income & expenditure account instead of receipt and payment account? OR What is the difference between income & expenditure account and receipt and payment account?

- A. Income and expenditure account works on the income statement principle. It records only current year incomes and current year expenses, which shows the performance of current year as Surplus or Deficit. It is more accurate statement to judge and evaluate the efficiency of any organization. On the other hand receipt and payment account records the cash received or paid during the period including opening and closing cash/bank balance, in other words it is just a cash book of the company. Receipt and payment account does not, account for any adjustments of prepaid and accrued, it does not distinguish between capital and revenue receipts and expenses; it does not include any non monetary item like depreciation. But income and expenditure account includes all the above as mentioned.

Q. How matching / accrual concept supports in recording subscription Income?

- A. While calculating subscription income for the year, we consider the subscription in arrears (opening and closing values) and subscription in advance (Opening and closing values), we add or deduct them accordingly, and calculate the current year subscription for the income and expenditure account. Matching or accrual concept also states that current year income should be recorded in current year whether we have received it or not.

ARD Club
Refreshments Trading Account for the year Ended 31 Dec 2020

	Sale of refreshment		XXX
Less	Cost of Sales:		
	Opening inventory of refreshment	XXX	
Add	Purchase of refreshment	XXX	
Less	Closing inventory of refreshment	(XXX)	(XXX)
	Gross profit		XXX
Less	Expenses (Only related to Refreshments)		(XXX)
	Profit from refreshment Trading		XXX

ARD Club
Income & Expenditure Account for the year Ended 31 Dec 2020

Income		
Profit on sale of refreshment	XXX	
Gain on disposal of Asset	XXX	
Sale of tickets	XXX	
Subscriptions Income (w)	XXX	
Rent of hall/premises	XXX	
Donations (if specified as revenue receipt)	XXX	XXX
Less: Expenditure		
Wages – Grounds man and assistant	XXX	
Loss on disposal of asset	XXX	
Depreciation of ground equipment	XXX	
Interest on loan	XXX	
Secretary's expenses	XXX	
Ground upkeep	XXX	
Utilities	XXX	(XXX)
Surplus / Deficit for the year		XX / (XX)

ARD Club
Statement of Financial Position as at 31 December 2020

Assets	\$	\$	\$
Non-Current Assets	Cost	Acc Dep	NBV
Land	XXX	-	XX
Building	XXX	(XX)	XX
Equipment	XXX	(XX)	XX
			XXX
Current Assets			
Inventory		XXX	
Subscriptions in Arrears / Owing		XXX	
Prepaid Expense		XXX	
Bank		XXX	
Cash		XXX	XXX
Total Assets			XXX
Total Liabilities			
Opening Accumulated Fund		XXX	
Add Surplus / Less (Defecit)		XX/(XX)	
Add: Donations (Capital) / Legacy / Gift		XXX	XXX
Non-Current Liabilities			
6% Loan 2025			XX
Current Liabilities			
Trade payables / Creditors		XXX	
Bank O/D (Over Draft)		XXX	
Accrued Expenses		XXX	
Subscriptions Advance / Prepaid		XXX	XXX
Total Liabilities			XXX