

introduction to accounting

distinguish between book-keeping & accounting

chapter one

- accounting is the process of recording, summarising, analysis, interpreting and reporting.
- book-keeping is one part of the accounting process which involves only the recording of business transactions.

Accounting

Recording → summarising → Analysing → Interpreting → Reporting

Book-keeping

roles (purposes) of Accounting

- Accounting plays 2 major roles in businesses; stewardship & decision-making.

① stewardship

- A steward does not own the business but is given the responsibility to manage the resources of the business.
- ↳ Example: Accountant, sales manager
- As a steward, the accountant sets up a system to collect, record and report the financial information to the business owner to help him make decisions on how to manage and operate the business.

② decision-making

- To help people (stakeholders) who are interested in the business to make decisions relating to the business.

Stakeholders

- The people who are interested in financial information of a business are known as stakeholders.
- Different stakeholders require different types of information to make decisions.

① Internal stakeholders [responsible for day-to-day running of the business]

Internal stakeholders	Financial info interested in	Decisions made by stakeholders & why they need the financial information
Sole proprietors and managers	All information	Make decision on how to plan, control, monitor and operate the business.
Employees	Profit & Cash	Whether to continue working for the business or not. If the business is profitable to evaluate their career prospects with the business and whether to expect any bonuses. Whether the business has sufficient cash to pay their salaries promptly.

② External stakeholders [not involved in the day-to-day running of the business]

External stakeholders	Financial info interested in	Decisions made by stakeholders & why they need the financial information
Shareholders and Investors	Profit, assets & liabilities. The amt received in return for the investment made.	Existing shareholders and investors evaluate whether they should maintain, increase/decrease their investment. Potential investors decide if they should invest in the business.
Banks and Lenders	Profit, assets and liabilities.	Whether to grant the business loans. Based on the business profit, assets and existing debt amount, the lender evaluates whether the business will be able to repay the loan principal and pay interest.
Suppliers	Profit, cash and liabilities.	Whether to grant the business credit or not. Based on the business profit, cash and existing debts owed to suppliers, the supplier evaluates whether the business will be able to pay for its credit purchases.
Customers	Profit	Whether the business will be able to provide after-sales support.
Government	Income and Profit	How much tax to collect from the business.
Public	Income and Profit	Affect the public's decisions on how their assets are invested, whether to change job etc.
Competitors	Income and Profit	Compare their performance against the business and decide how to improve.

Ethics of Accounting

Why are professional ethics important in accounting?

- Stakeholders rely on financial reports to make decisions. If they are given false / inaccurate information about the business, they are likely to make poor decisions. Hence, it is important that financial reports are fairly prepared.

① Integrity

- To have integrity is to be straightforward and honest in all professional and business relationships.

② Objectivity

- To be objective is to be unbiased when making a professional judgement in the accounting process.

- Decisions are made based on facts and not being influenced by personal feelings, personal gains / other people when deciding on what financial information is to be recorded and how it is reported.

What are the different types of organisations?

① Business Organisations

- Trading Business (buy & sell goods)

↳ Supermarket, Furniture Shop

- Service Business (provide services)

↳ Hairdressing salon, Bus company

- Manufacturing Business (Manufacture goods)

↳ Car Manufacturer, Toy Manufacturer

Profit Making

② Non-Business Organisations

- Government

- Charities

- Community / Religious Organisations

Non-Profit Making

Accounting information system

CHAPTER TWO

What is a business transaction?

- A business transaction is an activity carried out by the business to provide such goods and services in exchange for money.

2 Types of Business Transactions

① Cash Transaction

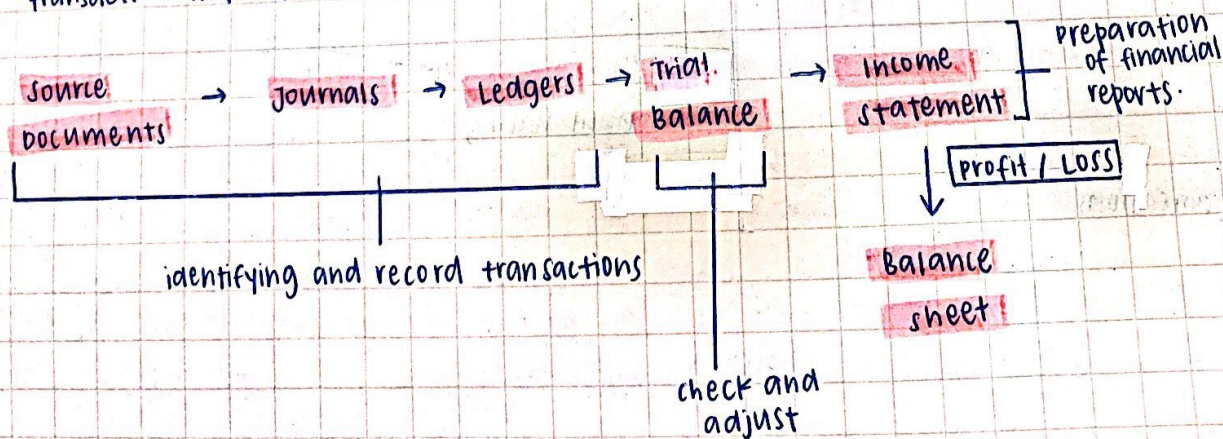
- money from the purchase / sale is paid or received at the same time as the purchase / sale.

② Credit Transaction

- money from the purchase / sale is paid or received at a later date from the purchase / sale.

The Accounting Information System

- A system that is used to record the business transactions, summarises them and report these transactions in the financial reports.



4 stages of accounting cycle within the system

1. identifying and recording transactions phase
2. adjusting phase
3. reporting phase
4. closing phase

Definitions

Source Documents:

- A source document captures information about the business transaction. (date, description of the transaction, the value and parties involved.)

Journals:

- All business transactions are first recorded in the journals. Different types of business transactions classified and recorded in different journals.

Ledgers:

- All transactions recorded in the journals are posted into the relevant ledger accounts. This is for the purpose of consolidating similar information together to compute an outcome. Different ledger accounts are group under different ledgers — General and Subsidiary.

Source Documents

① Invoice

- seller issue to buyer for selling goods on credit.
- states the amount buyer owes to the seller.

② Receipt

- seller issue to buyer at the point when money was received (cash / cheque)

③ Credit Note

- seller issue to buyer when goods are returned by customer (reduces the amount owing)

④ Debit Note

- seller issue to buyer to correct an under charge (increases the amount owing)

Debit
Undercharge
Credit
Overcharge

Internal Documents

⑤ Bank Statement

- Track and check cash at bank account.
- Evidence for dishonoured cheque.

⑥ Payment voucher

- To approve and authorise payment to creditors.

⑦ Petty cash Voucher

- To approve payment for small claims via petty cash account.

Journals

(Special Journals - goods related)

① Sales Journal

- Record sale of goods on credit.

② Purchases Journal

- Record purchase of goods on credit.

③ Sales Returns Journal

- Record goods returned by customers.

④ Purchases Returns Journal

- Record goods returned to suppliers.

(Others)

⑤ Cash Book

- Record all cash / cheques paid or received.

⑥ General Journal

- Record all other transactions that does not fall under ① to ⑤.

Ledgers

(Subsidiary Ledgers)

① Trade Receivables Ledger (Sales Ledger)

- consists of all individual trade receivable ledger accounts.

② Trade Payables Ledger (Purchases Ledger)

- consists of all individual trade payable ledger accounts.

General Ledger

- consists of all other ledger accounts.

Flowchart for answering theory qns on stating which journal for which transaction

Does the transaction affect CAB/CIH (including cash disc.)

yes

Cash Book

NO

Is the transaction related to goods?

yes

Special Journals

- Sales Journal
- Purchases Journal
- Sales Returns Journal
- Purchases Returns Journal

NO

General Journal

Accounting concepts / theories

① Monetary concept

- only business activities that have monetary values are recorded.

② Historical cost concept

- business transactions are recorded at their original cost, which is the amount stated in the source documents.

③ Objectivity Concept

- transactions are recorded based on information that is reliable and verifiable. Source documents serve as evidence of the transactions that had taken place and indicate the values related to those transactions.

④ Going concern concept

- it is assumed that the business has an indefinite economic life.

⑤ Accounting period concept

- The life of a business is divided into regular time intervals.

↳ example:

1 Jan 2015 to 31 Dec 2015

1 Apr 2015 to 31 Mar 2016

1 Aug 2013 to 31 Jul 2014

1 Oct 2015 to 30 Sept 2016

1 Jul 2015 to 30 Jun 2016

⑥ Accounting Entity concept

- Accounting records the business activities but not the personal activities of the business owner. The business and the owner are separate and distinct entities.

elements of financial statement & accounting equation

Chapter Three

The Accounting Elements

- Assets
- Liabilities
- Equity
- Income / Revenue
- Expenses

Assets

- resources that are usually owned / controlled by the business to carry out its business activities.
- expected to generate future benefits.

① Non-current Assets

- Motor vehicles
- Property (Land & Buildings)
- Plant & Equipment
- Fixtures & Fittings (Office Equipment & Furnitures)

② Current Assets

- cash in hand
- cash at bank
- Inventory
- Trade & Other Receivables
- prepaid Expenses
- Income Receivables

→ Amount owed by debtors to whom the business sells the goods/services on credit.

→ Amount owed by debtors for reasons other than the sale of goods/services on credit.

Liabilities

- amounts that the business owes to other businesses / people.

① Non-current Liabilities

- Mortgage loan.
↳ property (house)
- Loan from other business / person (> 1 year)
- Bank loan (> 1 year)

- ② Current Liabilities:
 - Trade Payables
 - Other Payables
 - Short Term Borrowings
 - Current Portion of Long Term Debt
 - Income tax payable
 - Accrued Expenses

Equity

- the amount of capital contributed by the owners
- Profit or loss
- Owners' Equity = Capital + Retained Earnings
- ↳ Resources provided by the business

- ② current liabilities
- Trade Payables → Amount owed to creditors by the business for buying goods / services on credit.
 - Other Payables → Amount owed to creditors for reasons other than the buying goods / services on credit.
 - Short Term Borrowings (Bank overdraft) → Money owed to the bank when the bank a/c is overdrawn. (- CAB)
 - Current portion of Long Term Borrowing → Portion of the LTB repayable within 1 year from the date of the B/S.
 - Income received in advance
 - Accrued Expenses

Equity

- the amount contributed by the owner.
- Profit generated by the business.

• Owner's Equity (Sole Proprietorship)

$$= \text{Capital} - \text{Drawings} + \text{Profit}$$

↓
 Resources contributed
 by the owner to the
 business.

↓
 Income - Expenses

↓
 Resources taken away
 from the business by the owner.

Income

① Revenue / Income :

- Sales Revenue is the amount a trading business earns from selling goods.
- Service fee Income is the amount a service business earns from providing services.

② Other Income :

- Income that is not earned from normal sale of goods and services.
- ↳ Interest Income, Commission Income, Rental Income

③ Other Gains:

- Arise when business sell its assets.

Expenses

- A business incurs expenses so as to generate income and the benefits only last within the current accounting period.
- The benefits generated from expenses do not last into the future.

Examples:

- Cost of sales
- Salaries / wages
- Rental Expenses
- Utilities

The Accounting Equation

$$\text{Total Assets} = \text{Total Liabilities} + \text{Total Equity}$$

$$\text{Total Assets} = \text{Total Liabilities} + [\text{Capital} - \text{Drawings} + \text{Profit}]$$

$$\text{Total Assets} = \text{Total Liabilities} + [\text{Capital} - \text{Drawings} + \{\text{Income} - \text{Expenses}\}]$$

*NOTE:

↑ Expense	↓ Equity	} see equation (+ / -)
↑ Capital	↑ Equity	
↑ Drawings	↓ Equity	
↑ Income	↑ Equity	

the double entry concept

Chapter Four

How does a business record its business transactions?

- A transaction is first recorded in a journal then posted into the ledger accounts affected by that transaction.

General Journal				Debit \$	Credit \$
Date <year> <date>	Particulars <name of ledger account affected> <name of the ledger account affected> <narration of the transaction> ↳ summarised description of transactions	A/c to debit first followed by A/c to credit.			

The Ledger Accounts

- A ledger account is the basic unit used to record all the business transactions.
- To keep track of increases and decreases in the individual accounting elements e.g asset, liability and owner's equity components of a business enterprise

What is the format of the ledger accounts?

<name of ledger account>				Debit \$	Credit \$	Balance \$
Date <year> Dec 1 3	<name of ledger account affected> <name of the ledger account affected>					

The Double Entry Rule

1) Assets, Expenses, drawings A/c's are debit nature accounts.

↳ Dr side (+)

2) Liabilities, Revenue (Income), Capital A/c's are credit nature accounts.

↳ Cr side (+)

Balancing & closing of ledger accounts

- All assets, liabilities and capital

↳ Bal b/d to the 1st day of the next month.

- Drawings

↳ Transfer out the final balance to the capital account.

- All incomes & expenses

↳ close to 'profit & loss a/c' at the last day of the month / year.

- Sales Revenue, sales returns and cost of sales

↳ close to trading account at the last day of the month / year.

Recording discounts & dishonoured cheques

Chapter 6-1 / 6-2 / 14.1 / 15.1

TRADE & CASH DISCOUNTS

	Trade discount	Cash discount
Why is it given?	To encourage bulk purchase.	To encourage prompt payment
How is it calculated?	Reduction off the list price.	Reduction in the invoice amount.
When is it given?	At the point of sale of goods	Upon payment of amount previously owed.
Is it recorded in ledger account?	No	Yes, recorded in discount allowed / received account

DISHONOURRED CHEQUE

- When cheque is rejected by bank and business did not receive money.

- Reasons:

- ① Cheque is expired.
- ② Cheque is post-dated.
- ③ Information on cheque is incomplete (i.e. no date, no signature)
- ④ Information on cheque is inconsistent (i.e. signature is not consistent with the authorized version / amount written in figures does not match with amount written in words.)
- ⑤ Party who issued the cheque do not have sufficient funds to pay from his bank account / his account was closed.

WHAT TO DO WHEN WE RECEIVE A DISHONOURRED CHEQUE!

- Reverse original double entry
- ↳ CR(-), TR(+)

Dr Trade Receivables - XXX	\$\$\$
Cr Cash At Bank	\$\$\$

bank reconciliation

Chapter 7

BANK STATEMENT

- The bank and business maintain separate and independent records of the business money from its point of view.
- The bank sends a bank statement to the owner at the end of every month.
- While the business owner keeps track of the cash it deposits into the bank via the CAB a/c.
- To the bank, the money in the business bank account is a liability.
- The money deposited into the account does not belong to the bank, hence the bank reflects it as a 'credit balance' on the bank statement.
- Aim of Bank Reconciliation: To explain the differences between the ending balances of the bank statement & CAB a/c.

BANK RECONCILIATION

- Purpose:
 1. To find out the transactions that cause the differences / discrepancies between the CAB a/c balances and the bank statement balances.
 2. To identify any errors in the bank statement / CAB a/c.
 3. To calculate the accurate CAB balance after updating the CAB a/c.
 4. To act as a deterrence against fraud.
- due to timing of transaction

EXPLAIN WHY A DR BAL IN THE CAB A/C IS PRESENTED AS CR BAL IN THE BANK STATEMENT?

Answer: A deposit in the CAB a/c is an asset to the business, therefore presented as a debit balance. However, the bank statement is prepared in the bank's point of view. As such a deposit in the bank is a liability to the bank, therefore presented as credit.

trial balance

Chapter 8

What is a trial balance?

- List of all ledger accounts and its balances extracted from general ledger on a given date (usually end of the accounting period)

Purpose of trial balance

1. Check for arithmetic (mathematical) errors that may have occurred.
2. Help in preparation of financial statements.

income statement & balance sheet

Chapter 9 & 10

PURPOSE OF INCOME STATEMENT

- Shows how much income, expense and profit/loss of a business has over a period of time.
- Aim of a business organisation is to make profit.

INCOME STATEMENT MEASURES THE PROFITABILITY OF A BUSINESS

- An income statement measures the profitability of a business organisation by measuring the profit/loss for the year which is $\text{total income} - \text{total expense}$.
- Profitability refers to whether the business earns enough income to cover its expenses.

WHAT IS A BALANCE SHEET?

- A financial statement that lists the assets, liabilities and equity of a business at a given point in time.

accruals & prepayments

chapter 11

ACCRUAL CONCEPT

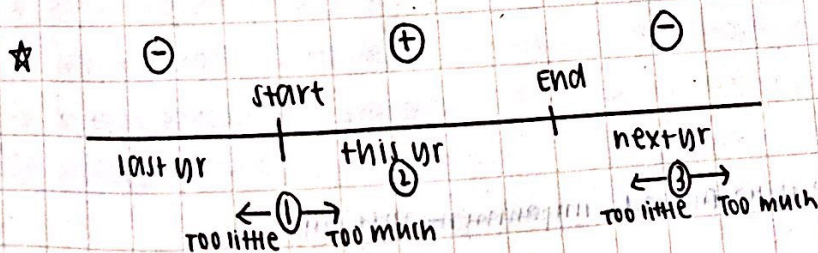
- income is recorded in the financial period that is earned regardless of when money is received.
- expenses are recorded in the financial period that they are incurred regardless whether the payment is made.

MATCHING CONCEPT

- For a given financial period, the expenses incurred should be recognized to match against income earned during the same period.
- This is so to prepare a better financial statement to present a true & fair profit figure.

NEW LEDGER A/Cs

	current Asset	current Liabilities
Expenses	<u>Prepaid Expense</u> → an amount paid in current financial period for an expense that will be incurred the next period. → "paid too much"	<u>Accrued Expense</u> → an amount incurred during the current financial period for an expense that will be paid in the next period. → "paid too less"
income	<u>Income Receivables</u> → amount of income earned in the current financial period but will only be received next financial period. → "Received Too Little"	<u>Income Received In Advance</u> → amount received in the current financial period that is only earned in the next financial period. → "Received Too Much"



inventory

CHAPTER 12

cost of purchase

- cost of purchase includes cost price of good and any expenses incurred to obtain it.
- Examples:
 - cost price of goods
 - delivery charges
 - packing materials
 - salaries & wages paid to workers
 - insurance for goods
 - import duties / taxes

Fifo

(FIRST IN FIRST OUT)

Method used to calculate cost of sales and ending inventory.

- Assumes that goods that are purchased earliest are to be sold first.

NRV

(NET REALIZABLE VALUE)

Inventory is valued at NRV or at cost, whichever is lower.

Reason:

- prudence concept: losses that is likely to incur must be reported and adjusted even though losses may not be confirmed yet. This is so as not to overstate the value of the assets & profits for the period.

recording losses of inventory

- REASONS FOR LOSS: FLOODS / FIRES / THEFT

- What To DO?

- ① Write down (reduce) the inventory at the point of loss

Dr Impairment LOSS on Inventory
 Cr Inventory

- ② When insurance is processed and the amount claimable is confirmed, impairment loss will reduce accordingly.

Dr Insurance Claim Receivable
 Cr Impairment LOSS on Inventory

non-current assets

Chapter 13

HOW IS THE PURCHASES OF A NCA ACCOUNTED FOR?

- Non-current assets are assets that a business buys to help the business to generate profit.
- Non-current assets used for:
 - ① Production or supply of goods and services
 - ② Rental to others
 - ③ Administrative purposes
- Non-current assets are expected to be used for more than 1 accounting period.
- Non-current assets are recorded at original cost, which includes the amount incurred to get the asset ready for use. This is in accordance with the going concern & historical cost concept.

JOURNAL ENTRY:

Dr Non-current Assets
 Cr Cash At Bank / Cash In Hand / Other payables

WHAT IS THE DIFFERENCE BETWEEN CAPITAL & REVENUE EXPENDITURE?

- Capital Expenditure
 - consists of:
 - ① Cost to buy non-current assets
 - ② all expenditures to bring the non-current asset to a ready-to-use condition.
 - ③ Capital expenditure provides benefit that lasts for more than a year.
 - ④ It is recorded in the non-current asset account and shown in balance sheet.
- Revenue Expenditure
 - consists of:
 - ① Cost to operate/run the non-current asset.
 - ② Cost to repair and maintain the non-current asset in working condition.
 - ③ Revenue expenditure provides benefits that only lasts within that accounting period.
 - ④ Recorded in the expense account and shown in income statement.

MATERIALITY CONCEPT

- A transaction / item is considered material (significant) if it makes a difference to decision-making. The value of a transaction / item is usually compared to the size and nature of the business.
- If the transaction / item is not material, the business need not record it in accordance with accounting principle.
- Thus a capital expenditure may be recorded as revenue expenditure if it is considered immaterial.

HOW IS DEPRECIATION ACCOUNTED FOR?

- Depreciation is the allocation of the cost of a non-current asset over its useful life.
- It is an expense reported in the income statement.
- The accounting of depreciation is in accordance with the matching concept where a portion of the cost of a non-current asset is matched against the income earned from using the non-current asset.

Journal Entry:

Dr Depreciation Expense
 Cr Accumulated depreciation

Accumulated depreciation

- Total depreciation to date
- Contra-Asset and is presented as a deduction against the original cost of a non-current asset in the balance sheet.

CAUSES OF DEPRECIATION

- ① Usage
- ② wear and Tear
- ③ Obsolescence (outdated)
- ④ Legal Limits (copyrights)

METHODS OF DEPRECIATION

- ① Straight-Line Method
 - An equal amount of depreciation is recorded for each financial period over its useful life of the non-current asset.
 - This method assumes that the non-current asset benefits uniformly throughout its useful life.

Depreciation

$$a) = (\text{original cost} - \text{scrap value}) / \text{Expected useful life}$$

$$b) = \text{Rate of Depreciation (in \%)} \times (\text{original cost} - \text{scrap value})$$

- ② Reducing Balance Method

- Higher amount of depreciation is recorded in the earlier financial periods and a lower amount in the later financial periods.
- This method assumes that the non-current asset provides more benefits in the earlier years of its useful life than its later years.

Depreciation
= Rate of depreciation

CONSISTENCY

- The accounting method can be meaningful.
- Inconsistency in different classes of the asset is decided, more accurate.

SALE

Steps:

- ① Remove cost
- ② Remove accumulated depreciation
- ③ Record profit or loss
- ④ Record gain or loss

Formula:

~ if a
~ if

ST

Purch

Dr

D

Depreciation

Netbook value

$$\text{Rate of Depreciation (in \%)} \times (\text{Original Cost} - \text{Accumulated Depreciation})$$

CONSISTENCY CONCEPT

- The accounting methods used by the business must be consistent from period to period so that its financial performance can be meaningfully compared across financial periods.
- Inconsistency may result in misleading figures in the financial statement.
- Different classes of assets can have different depreciation methods that best reflect how the benefits from the asset is derived.
- Once decided, the method should be applied consistently from year to year unless new methods provide more accurate information about its transactions.

SALE OF NCA

Steps:

- Remove cost of NCA from a/c
- Remove accumulated depreciation of NCA
- Record proceeds from the sale of NCA
- Record gain/loss and transfer to profit and loss at year end.

Formula: gain/loss in the sale of NCA = sales proceeds - NBV

~ if ans is '+' = gain

~ if ans is '-' = loss

STANDARD JOURNAL ENTRIES

Purchase of NCA

Dr NCA
cr Cash At Bank / Cash In Hand / other payable

Dr Depreciations of NCA
cr Accumulated Dep. of NCA

Sale of NCA

Dr Sale of NCA
cr NCA

Dr Accumulated Dep. of NCA
cr Sale of NCA

Dr Cash At Bank / Cash In Hand / other Receivables
cr Sale of NCA

Loss:

Dr Profit & Loss
cr Sale of NCA

Gain:

Dr Sale of NCA
cr Profit and Loss

trade receivables

Chapter 14

impairment loss on trade receivables account

- loss that the business suffers when a debtor fails to pay up.
- expense recorded in income statement.

when to recognise impairment loss on trade receivables

- at the end of the financial year, the business will review how much it may not be able to collect from its debtors.
- based on objective evidence, if a debt is unlikely to be collected, the business will recognise it as an impairment loss.

examples of objective evidence

- ① debt is overdue and debtor refuse to pay after numerous reminders.
- ② there is market rumour of the debtor is having financial difficulties.
- ③ after repeated reminders, debtor sends a cheque for payment but the cheque is dishonoured.
- ④ business unable to contact debtor and debtor's premises was shut.

- at the end of the year, the business records an impairment loss on trade receivables based on review:

Journal Entry

Dr Impairment loss on Trade Receivables
Cr Allowance for impairment of trade receivables

- allowance for impairment of trade receivables represents the estimated future uncollectible amounts set aside to be written off in future.

Net Trade Receivables

= Trade Receivables - Allowance for impairment for TR

Why is it necessary for businesses to have allowance for impairment of trade receivables?

Prudence concept

business record expected losses due to fall in value of assets as an expense to avoid overstating the profit & assets.

Matching concept

possible losses incurred due to debts estimated to be uncollectible are matched against income earned from the debtors in the same accounting period.

Regarding write-off trade receivables

When it is certain that the debts are no longer collectible due to the following reasons:

- ① Bankrupt
- ② Death of debtor
- ③ Debtor goes to prison
- ④ Debtor went missing

- the business should write-off trade receivables on the day the loss was confirmed before reviewing and adjusting the year end allowance for impairment of trade receivables.

Journal Entry

DR Allowance for Impairment of TR
IR TR

Control account

Chapter 16

SPECIAL JOURNALS

- used to record credit transactions
- 4 special journals used to record different types of credit transactions
 1. Sales Journal
 2. Purchase Journal
 3. Sales Return Journal
 4. Purchase Return Journal

Purpose	Special Journal	Source Document
Records the purchase of goods from credit supplier.	Purchase Journal	Invoice (Received)
Records the return of goods to credit supplier.	Purchase Return Journal	Credit Note (Received)
Records the sale of goods to credit customer.	Sales Journal	Invoice (Issued)
Records the return of goods from credit customer.	Sales Return Journal	Credit Note (Issued)

HOW ARE TRANSACTIONS RELATING TO TR RECORDED?

- A controlled account summarises the transaction recorded in the individual a/c's.
 1. Trade Receivable Control A/c
 2. Trade Payable Control A/c
- The amounts recorded in the control a/c is the sum of the amounts recorded in the individual a/c's.
 - Control A/c's are kept in the general ledger.
 - The individual TR & TP a/c's are kept in the sales ledger and purchase ledger respectively.

PURPOSE

- Independent check on accuracy of the entries made in the individual TR & TP a/c's.
- Prevent overcrowding of general ledger
- Information of the total TR & TP are easily obtainable
- Prevent fraudulent activities.

CONTRA-ENTRY

Sometimes a credit customer may also be a credit supplier to the business, thus, the business offsets the amount owing from the 2 a/c's by passing an entry.

Trade Receivables Control Account		Dr £	Cr £	Balance £
Particulars				X Dr
Bal b/d				
Sales Revenue		X		
Sales Returns			X	
Cash At Bank / Cash In Hand			X	
Discount Allowed			X	
Cash At Bank (Dishonoured Cheque)		X		
Discount Allowed (Reversal)		X		
Interest Income		X		
Allowance of Impairment of Trade Receivables			X	
Trade Payables Control (Contra-Asset)			X	

Trade Payables Control Account		Dr £	Cr £	Balance £
Particulars				X Cr
Bal b/d				
Inventory (Purchase)			X	
Inventory (Purchase Return)		X		
Cash At Bank / Cash In Hand		X		
Discount Received			X	
Interest Expense		X		
Trade Receivables Control (Contra-Asset)		X		

Correction of errors

Chapter 17

What are errors not revealed by a Trial Balance?

There are 6 types of errors not revealed by a Trial Balance, these errors have one / all of the following problems:

- ① Posted to the wrong a/c
- ② Wrong amount is posted
- ③ Posted on wrong side of the a/c

The 6 types of errors are:

- ① Error of omission
- when a transaction is not recorded at all.
- ② Error of commission
→ transaction is recorded in the wrong a/c of the same class and it is recorded on the correct side with the correct amount.
- ③ Error of principle
→ transaction is recorded in the wrong a/c of a different class and recorded on the correct side with the correct amount.
- ④ Error of original entry
→ transaction posted in the correct a/c and recorded on correct side of each a/c. However, the amount is recorded wrongly.
- ⑤ Error of complete reversal
→ correct a/c with correct amount but the entry is made on the wrong side of each a/c.
- ⑥ compensating error
→ 2 / more errors cancel out each other.

Financial Statement Analysis

Chapter 20

PROFITABILITY

- measures the ability of the business to generate enough income to cover its expenses.

(a) GROSS PROFIT MARGIN

- refers to how much gross profit is earned for every dollar of net sales revenue earned by the business.

$$\text{Gross Profit Margin (\%)} = \frac{\text{Gross Profit}}{\text{Net Sales Revenue}} \times 100$$

- ↑ ratio

- business is earning more money

1. Selling goods at high prices
2. Buying goods at low prices

- ↓ ratio

- business is earning less money

1. Selling goods at low prices.
2. Buying goods at high prices.

(b) MARK-UP ON COST

- refers to how much gross profit the business earns for every dollar of its cost of sales.

$$\text{Mark-up on cost (\%)} = \frac{\text{Gross Profit}}{\text{Cost of Sales}} \times 100$$

- ↑ ratio

- business is earning more money

1. Selling goods at high prices
2. Buying goods at low prices

- ↓ ratio

- business is earning less money

1. Selling goods at low prices
2. Buying goods at high prices

(1) PERCENTAGE OF EXPENSES TO NET SALES REVENUE

- refers to how much expenses are incurred to earn every dollar of net sales revenue.

$$\text{Percentage of expenses to net sales revenue (\%)} = \frac{\text{Expenses}}{\text{Net sales revenue}} \times 100$$

- ↑ ratio

- business is earning less money
~ high expenses to run the business
↳ It means the business is inefficient in managing its operating expenses.

- ↓ ratio

- business is earning more money
~ low expenses to run the business.
↳ It means the business is efficient in managing its operating expenses.

(2) PROFIT MARGIN

- refers to how much profit is earned for every dollar of net sales revenue earned by the business.
- based on the profit earned after deducting all expenses.

$$\text{Profit Margin (\%)} = \frac{\text{Profit for the year}}{\text{Net sales revenue}} \times 100$$

(3) RETURN ON EQUITY

- measures amount of profit earned for every dollar of equity.

$$\text{Return on equity (\%)} = \frac{\text{Profit for the year}}{(\text{Average Equity})} \times 100$$

↳ $\frac{\text{Beginning equity} + \text{Ending equity}}{2}$

- ↑ ratio

- business is earning more money for the business owners.

- ↓ ratio

- business is earning less money for the business owners.

HOW TO ↑ PROFITABILITY

- ① ↑ the selling price
- ② ↓ cost of production
- ③ ↓ business operating cost

o ↑ ratio

- earning more money

- 1. Selling goods at high prices
- 2. Buying goods at low prices
- 3. Low expenses

o ↓ ratio

- earning less money

- 1. Selling goods at low prices
- 2. Buying goods at high prices
- 3. High expenses

LIQUIDITY

- ability of the business to repay its current liabilities when they fall due.
- measures the ability of the business to convert its current assets into cash to pay for its current liabilities.

(a) WORKING CAPITAL

- refers to the excess of current assets over current liabilities

$$\text{Working Capital (£)} = \text{Total current Assets} - \text{Total current liabilities}$$

- ↑ ratio

- business has more liquidity

1. ↑ in current assets
2. ↓ in current liabilities

- ↓ ratio

- business has less liquidity

1. ↓ in current assets
2. ↑ in current liabilities

(b) WORKING CAPITAL RATIO (CURRENT RATIO)

- measures the ability of a business to pay its short-term debts using its current assets.

$$\text{Working Capital Ratio} = \frac{\text{Total current Assets}}{\text{Total current liabilities}}$$

(RHL)

2:1

- ↑ ratio

- business has more liquidity

1. ↑ in current assets
2. ↓ in current liabilities

- ↓ ratio

- business has less liquidity

1. ↓ in current assets
2. ↑ in current liabilities

(c) QUICK RATIO (ACID TEST) ★

- measures the ability of a business to pay its short-term debts using its quick assets.

Quick Assets: more liquid assets & this is stricter measurement of liquidity.

$$\text{Quick Ratio} = \frac{\text{Total current Assets} - \text{Inventory} - \text{Prepayment}}{\text{Total current liabilities}}$$

(RHL)

1:1

- ↑ ratio

- business has more liquidity

1. ↑ in current assets
2. ↓ in current liabilities

- ↓ ratio

- business has less liquidity

1. ↓ in current assets
2. ↑ in current liabilities

HOW TO ↑ LIQUIDITY

✓ increase current assets

- ① contribution of capital in terms of cash from owners / share holders
- ② selling of surplus non-current asset
- ③ obtaining a long-term loan

INVENTORY MANAGEMENT

• measures how efficient the business maintain its inventory to meet the expected demand from customers.

$$\text{Inventory turnover rate (times)} = \frac{\text{cost of sales}}{\text{(Average inventory)}} \\ \downarrow \frac{\text{Beginning inventory} + \text{Ending inventory}}{2}$$

• ↑ ratio

- sells more goods

- 1. High demand for goods
- 2. Low selling price

• ↓ ratio

- sells less goods

- 1. unpopular goods
- 2. High selling price

business entities

[LIMITED COMPANIES]

LIMITED COMPANIES

What is a company?

① SOLE PROPRIETORSHIP → owner's equity (owner)

- owner
- manages business himself and has full control.
- may hire professionals
- Assumes all the profits and losses of business.
- If business fails, the sole proprietor has to pay all debts. → unlimited liability
- easier and less expensive to set up and maintain the business.
- Banks may be less willing to lend funds.
- Personal funds are usually used.
- It is more difficult for the owner to transfer ownership.

② COMPANY → shareholders' equity

- minimum of 1 owner.
- private company = 50 shareholders
- public company = no limit on shareholders
- usually not involved in managing business.
- hires professionals.
- shareholders are given a portion of the profits (called dividends).
- if business fails, the share holders will lose everything they have invested.
- more complicated and expensive to set up and maintain the business.
- Banks are more willing to lend funds.
- Able to issue shares to raise funds.
- It is easier for the owner to transfer ownership.

ISSUED SHARE CAPITAL

- shares that company issues to share holders.
- recorded in issued share capital a/c.
- An increase in issued share capital will increase equity.
- When company issues shares, it receives cash.
- Journal Entry:

Dr Cash At Bank

Cr Issued Share Capital

Issued Share Capital = Total Number of Shares Issued × Unit Issue Price

★ RETAINED EARNINGS ★

- Profits that are not distributed to the shareholders.
- Profit / Loss is calculated in the P&L A/c, & transferred to the retained earnings a/c at the EoY.
- Profit increases retained earnings and loss decreases retained earnings.

Journal Entry (Profit)

Dr Profit and Loss /
Cr Retained Earnings

Journal Entry (Loss)

Dr Retained Earnings /
Cr Profit and Loss

Financial Statement:

Retained Earnings: (Beginning RE + Profit / - Loss - Dividends)

★ DIVIDENDS ★

- Profits distributed to shareholders.
- Amount is distributed for each share owned → dividend rate.
- Distributions are recorded in dividends account, and transferred to the retained earnings a/c at the EoY.
- Dividends reduce retained earnings.
- When dividends are declared, the dividends a/c is debited.

Dr Dividends

Cr Dividends Payable

- The dividends may / may not be paid immediately when declared.
- Paid subsequently:

Dr Dividends Payable

Cr Cash At Bank

- Paid at the same time:

Dr Dividends

Cr Cash At Bank

- $\text{Dividends} = \text{Total Number of Shares Issued} \times \text{Dividend Rate}$

- Transfer Dividends to Retained Earnings a/c at EoY:

Dr Retained Earnings

Cr Dividends

★ FORMAT ★

- Income statement is similar for both sole proprietorship and limited company
- Balance sheet is slightly different:
 - ↳ Sole Proprietor: Owners' Equity + BB + Profit / - Loss - Drawing
 - ↳ Limited Company: Shareholders' Equity + Issued Share Capital + Retained Earnings

★ CHANGES IN SHAREHOLDERS' EQUITY ★

- $\text{Shareholders' Equity} = \text{Issued share capital} + \text{beginning Retained Earnings} + \text{profit} - \text{dividend}$
- Shareholders' Equity $\uparrow$, the change is due to the sum of issued share capital and retained earnings more than the dividend declared.
- Shareholders' Equity $\downarrow$, the change is due to the sum of issued share capital and retained earnings less than the dividend declared.

incomplete records

How is financial information reconstructed?

- ① The capital comparison method uses the owner's equity section of the balance sheet to calculate profit/loss for the period.

▷ Owner's Equity

- Beginning balance
- Add: Additional capital
- Add: Profit for the period / Less: Loss for the period
- Less: Drawings
- Ending balance

▷ Ending Balance = Beginning Balance + Additional Capital + Profit - Drawings

▷ Profit = Ending balance + Drawings - Additional Capital - Beginning Balance

▷ Statement of Profit/Loss for the year ended [end date]

Ending capital
 Less: Beginning capital
 Less: Additional capital
 Add: Drawings
 Profit/Loss for the year

↓

XX

▷ Capital = Assets - Liabilities * Ending!

- ② The accounting analysis method uses the relationship between accounts to derive the missing info.

▷ Sales Revenue & Inventory Purchased

• Total sales revenue = Cash sales + Credit sales

• Net sales revenue = Total sales revenue - Sales returns

• Total inventory purchased = Cash purchase + Credit purchase

• Net inventory purchased = Total inventory purchased - Purchase returns

} TR control

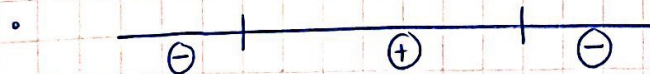
} TP control

▷ Cost of sales

• Inventory a/c → Credit purchase, Cash purchase
 → Purchase returns

▷ Other income earned & Expenses incurred

• Profit & Loss → (AB always) +!



▷ Depreciation

$$\bullet \text{ depreciation} = \text{NBV as at the beginning of the period} + \text{Additional NCA} - \text{NBV as at the end of the period}$$

Petty Cashbook

Chapter 4

PURPOSE OF PETTY CASH FUND

- A small sum of money set aside to pay for low-value expenditures.
- The records of the petty cash fund transactions are kept in the petty cashbook using the imprest system.
- Source documents used to record payments from the petty cash fund is called the petty cash voucher.

HOW DOES AN IMPREST SYSTEM WORK?

- A fixed amount of cash known as float/imprest amount is provided to start a petty cash fund to make small payments for a given period (petty cash cycle).
- At the end of that given period, the petty cash balance will be reimbursed to restore the float/imprest amount. The petty cashier will request for the amount to be reimbursed from the chief cashier maintaining the cash book for the top-up.

R/S BETWEEN A PETTY CASH BOOK & A CASHBOOK

- The cash book will record the outflow of money to the petty cash book as the reimbursement to restore the imprest account before the start of the next petty cash cycle.

Dr Petty Cash (CA+) } start a petty cash fund
Cr Cash At Bank / Cash In Hand (CA-)

Dr Total Expense 1 (exp+) } record the reimbursement to restore the petty
Dr Total Expense 2 (exp+) } cash float before the start of the next petty
Dr Total Expense 3 (exp+) } cash cycle.
Cr Cash At Bank / Cash In Hand (CA-)

ADVANTAGES OF AN IMPREST SYSTEM

- A deterrence against fraud.
 - ▷ by setting a fixed amount of float, the amount paid out plus the remaining amount must exactly be equal to the imprest amount at any one time.
 - ▷ if the physical cash does not agree with the recorded amount, then it would be an indication that some cash may have been misplaced.

Float / IMPREST AMOUNT = balance left in the petty cash fund + reimbursement amt.

OR

= balance left in the petty cash fund + payments made.