

ZNOTES.ORG

UPDATED TO 2022 SYLLABUS

CAIE AS LEVEL
ACCOUNTING
(9706)

SUMMARIZED NOTES ON THE THEORY SYLLABUS

1. The Accounting System

1.1. The Double Entry Bookkeeping for Cash Items

- Accounting system is a process of identifying, analysing, and recording accounting event of a company to provide useful information to stakeholders to make decisions
- Ex: Selling goods/purchasing raw materials
- Double-Entry Bookkeeping is a process which means that there are two sides for each transaction. Golden rule: For every debit entry in a ledger account there must be an equal credit entry in another ledger account.
- Ex: You pay \$5 for a candy to a shopkeeper (one) and the shopkeeper receives \$5(second) • Both aspects are recorded
- Ex A cash sale:
- Debit Cash a/c (Increase in Assets)
- Credit Sales a/c (increase in income)
- Double Entry Book entries are displayed in "T" shape

Debit	Credit
Increase Assets	Decrease Assets
Increase Expenses	Decrease Expenses
Decrease Liabilities	Increase Liabilities
Decrease Income	Increase Income

1.2. Double entry bookkeeping for credit transaction

- Credit Transaction:- where there is no exchange of payment at the time of the transaction.
 - In Seller's books
 - Credit Sales a/c
 - Debit Customer a/c
- Debtor: A customer (or other party) that owes the business money.
- Creditor: Suppliers (or other parties) to whom the business owes money
- Trade discount: A reduction in the selling price of goods made by one trader to another who are in the same line of business
- Cash (or settlement) discount: An allowance given by a seller to a customer to encourage the customer to pay an invoice before its due date for payment.
 - Discount received: Cash discount received by the purchaser from the seller of goods, treated as an income
 - Discount allowed: Cash discount allowed by the seller to the purchaser of goods, treated as an expense.
- Cash discounts are always recorded in the ledgers while trade discounts are only mentioned in the source documents.

- The accounting Equation is **Assets = Liabilities + Owner's Equity**
 - This Equation will be used throughout the chapters and the equation will always be true.
 - Use this equation to cross-check your answers in future questions:)
 - Purchases returns always go to a purchases returns account. They are never entered on the credit side of the purchases account

1.3. Source Documents

- The information entered into the prime entry books are from the **source documents** these may be
 - Invoice:** a document that a business issues to its customers, asking the customers to pay for the goods and services that the business has supplied to them.
 - Statement:** Issued by the supplier. Checked with other documents to ensure that the amount owing is correct.
 - Credit note:** A receipt given to a customer who has returned goods, which can be offset against future purchases.
 - Debit note:** Issued by the entity receiving the goods. Cross referred to the credit note issued by the supplier.
 - Receipt:** Issued by the selling entity indicating the payment received
 - Cheque counterfoil:** this is part of a cheque that is kept when you give the other part to another entity
 - Pay in slip:** this is used to deposit money into a bank account
 - Petty cash voucher:** used as a receipt whenever cash is withdrawn from a petty cash box
 - Delivery note:** document that accompanies a shipment of goods
 - Purchase order:** this is the first official issue to the seller placing an order
 - Remittance advice notes:** a proof of payment document sent by a customer to a business
 - Bank statement:** document sent by the bank to the account holder every month summarizing all the transaction that occurred in that month

1.4. Books of prime entry

- Books of Prime Entry are used to list all transactions of a kind before being posted on ledgers.
 - Ex. All sales transactions will be posted on a 'Sales Journal' before being posted on ledgers.
- There are 6 types of Books of Prime Entry:
 - Sales Journal
 - Sales Returns Journal
 - Purchases Journal
 - Purchases Returns Journal
 - Cash Book
 - Journal

- A book of Prime Entry has its own functions:
 - Each transaction is recorded chronologically for future references.
 - Each transaction is analysed into the debit and credit aspect to learn the effect it has to the business financially.

Books Of Prime Entry	Use
Sales Journal	Record Credit Sales from invoices.
Sales Returns Journal	Record goods returned from Credit Customers.
Purchases Journal	Record Credit Purchase
Purchases Returns journal	Record goods returned to suppliers
Cash Book	Record all Cash and Bank Transactions (check payments included) as well as discounts allowed (dr side) and discount received (cr side)
Journal	Record Transactions for which there isn't any other entry. Correcting errors, adjustments to the accounts, transfers between accounts.

- Limitations of Books of Prime Entry:
 - Huge and Bulky in size - A single journal for a business would be a lot of work to operate and handle
 - Balance of accounts not available at a glance - As there are numerous transactions in a business, it would take a lot of time to find a particular transaction.
 - Difficulty in Reconciling Cash Book - If a business has all transactions recorded in journal(s) and no cash book maintained then it would be difficult to reconcile daily cash balance.
 - Repetitive transactions - A business would have similar kinds of transactions every day and to record them would require extra labour.

1.5. Balancing accounts

- This process includes finding which side has the greater side in a ledger account.
- Accounts are usually balanced at frequent intervals as its vital for the business to know how much money is in the bank, accounts of customers and suppliers are balanced monthly.

1.6. Classification of Accounts and Division of Ledgers

- Types of ledgers.
 - Sales ledger – accounts of customers
 - Purchase ledger – accounts of suppliers

- General ledger – impersonal accounts
- Private ledger – owners' capital and drawings
- Cash book
- Petty cash book
- Division of ledgers are essential as it allows staff to be trained in different aspects of the business, it helps detect and prevent errors as well as fraud, this is referred to as internal check.
- Accounts are classified in two ways
 - Personal - It is an account which is related to a person
 - Accounts for trade receivables
 - Account for trade payables
 - Accounts of capital and drawings
 - Impersonal accounts - It is every other account other than personal account
 - Accounts with debit balance
 - Asset's a/c – non current and current
 - Nominal a/c
 - Expense a/c
 - Revenue a/c

Preparation of a ledger

2019	Particulars
March 8	Mr. Aaron started a business with a capital on \$200000
March 12	He purchased motor vehicles for \$40,000
March 15	He purchased goods for \$70,000
March 22	He sold goods for \$70,000
March 29	He paid salaries amounting to \$30,000

Transactions → Journal Entry

Date	Particular	Amount	Amount
March 8	Cash A/c Dr. \n Capital A/c Cr.	200,000	200,000
March 12	Motor Vehicles A/c Dr. \n Cash A/c Cr.	40,000	40,000
March 15	Purchases A/c Dr. \n Cash A/c Cr.	70,000	70,000
March 22	Cash A/c Dr. \n Sales A/c Cr.	70,000	70,000
March 29	Salaries A/c Dr. \n Cash A/c Cr.	30,000	30,000

Journal → Ledger

1. Cash A/c Ledger

Date	Particulars	Amount	Date	Particulars	Amount
2019				2019	
Mar 8	Capital A/c	200,000	Mar 12	Motor Vehicles A/c	40,000
Mar 22	Sales A/c	70,000	Mar 15	Purchases A/c	70,000
			Mar 29	Salaries A/c	30,000
				Bal c/d	130,000

Date	Particulars	Amount	Date	Particulars	Amount
	Total	270,000		Total	270,000

1. Capital A/c

Date	Particulars	Amount	Date	Particulars	Amount
2019			2019		
Mar 29	Bal c/d	200,000	Mar 8	Cash A/c	200,000
	Total	200,000		Total	200,000

1. Motor Vehicles A/c

Date	Particulars	Amount	Date	Particulars	Amount
2019			2019		
12 Mar	Cash A/c	40,000		Bal c/d	40,000
	Total	40,000		Total	40,000

1. Purchases A/c

Date	Particulars	Amount	Date	Particulars	Amount
2019			2019		
15 Mar	Bal c/d	70,000		Cash A/c	70,000
	Total	70,000		Total	70,000

1. Salaries A/c

Date	Particulars	Amount	Date	Particulars	Amount
2019			2019		
29 Mar	Cash A/c	30,000		Bal c/d	30,000
	Total	30,000		Total	30,000

1.7. Trial Balances

- It is a list of balances on each account to check if the

Debit side equals the credit side extracted from the ledger accounts at a particular date

- Zabine has balanced each account in her ledger, together with the cash book at 31 March 2016. She has then prepared a trial Balance by listing each account and balance on it at that date as follows.

A/c	Debit Balances	Credit Balances
	(\$)	(\$)
Premises	70000	
Machinery	10000	
Office Furniture	5000	
Sales		100000
Sales Returns	700	
Purchases	6900	
Purchases Returns		1000
Trade Receivables	1100	
Trade Payables		1575

A/c	Debit Balances	Credit Balances
Rent Payable	1600	
Wages & Salary	4080	
Heating & Light	960	
Other Operating Expenses	1430	
Cash	500	
Bank	12600	
Loan		2000
Capital		13000
Drawings	2705	
Total	117575	117575

- If trial Balances do not balance, it can be because of six things
 - Errors of Omission: Transactions which is completely omitted from the books.
 - Errors of commission: Transaction which is posted to a wrong account but which is of the same class such as telephone bill put into heat & lighting.
 - Errors of Principle: Transactions posted into a wrong account and not in the same class.
 - Errors of Original Entry: A wrong amount is entered into the journal
 - Complete Reversal of Entries: Account which should have been debited has been credited
 - Compensating Errors: Two or more errors cancel each other out.
- What to do if trial balance does not agree
 - Check Additions of the trial balance
 - If the difference is divisible by 2 look for a balance equal to half the difference which may have been entered on the wrong side
 - If the difference is divisible by 9, two figures may have been transposed in a balance
 - If it's still not agreeing then go back to the start and check if you have transferred them correctly.

2. Financial Accounting

2.1. Income Statements

- Sole trader is the owner of the business who runs the business on their own.
- Financial statements (generally):**

Income Statement	Trading A/c (give gross profit) and Profit and Loss A/c (give net profit)
Balance Sheet/Statement of Financial Position	Show that ASSETS= CAPITAL + LIABILITIES

- The aim of business is to make a profit; this is calculated in the financial statements which are usually prepared at

the end of a financial year.

- Financial statements are prepared from the trial balance
- Trading A/C:** concerned with buying and selling goods, calculates gross profit (SPOG- COS).
 - SPOG (of goods sold) = net sales (Sales less returns)
 - COS= total cost of goods only sold, i.e. Not always all the goods bought.
 - COS= OS+P (net purchases, less any additional purchases drawings and/or returns)- CS
 - P(net)= Purchases - Purchases Returns + Carriage inwards- goods for own use.

NOTE: Cash discount/discount allowed and discount received will not be included in the trading A/C as they arise from the early payment of debts, and are not sales related.

- The income statement (PNL and Trading A/C) should have a heading regarding the financial year/period covered and the name of the business trading.
- A trading A/C can be prepared using a horizontal format (similar to a T Ledger A/C) or a vertical format.
- The profit and loss A/C is concerned with profits, loss, gains and expenses and other income (e.g. commission)/expenses (running expenses). This gives you the profit for the year/ net profit (Gross profit + other income -other expenses)
- The expenses/ income A/C have to be credited/debited (respectively) to be transferred to the IS
- Only the expenses & income that pertain to the financial year end date have to be transferred to the income statement- matching concept
- In the income/expenses A/C, whenever details are not given and only totals are given, they can be entered as 'totals to date'
- Other than the inventory, gross profit and net profit, only one entry is made (IN THE INCOME STATEMENT) to transfer the balances to the IS.
- The opening stock of one year is equivalent to the closing stock of the previous year.
- The income statement has 2 entries regarding the inventory A/C (IN THE INCOME STATEMENT), one to transfer the balance at the start of the year as the opening stock/inventory and at the end of the year from the income statement to the inventory A/C to show the closing stock/inventory (indirectly credited from IS as it is shown as a deduction from the expenses)
- The net profit is the return received by the owner for their investment (increases amount owed to owner) and shall be debited from IS and credited to the capital A/C and vice versa for a net loss (as it reduces the amount owed to the owner.)
- The income statement of a service business (E.g.: accountant) (One who does not buy or sell goods) will not have a trading A/C as no goods are bought and sold/ Only a PNL is prepared, however the balance sheet stays the same. There will be only the titles of Income and Expenses

Income statement for the year ending 31 dec 2020

	\$	\$
revenue		
Less : return inwards		
Less : cost of sales		
Opening inventory		
purchases		
Less : purchase returns		
Less : goods for drawings		
Add: carriage inward		
Less : closing inventory		
Cost of sales		
Gross profit		
Add : other income (discount received, rent received)		
Less : expenses (wages and salaries, rent and rates, telephone, insurance, etc)		
Operating profit		

2.2. Statement of financial position

- A SOFP of a business on a certain date and shows the assets of a business (what the business owns/ its resources) as being equal to its capital (amount owed to the owner by the business/owner's investment/equity) plus any other liabilities (amount owed to any external entity other than the owner). i.e. The assets show how the resources are being used and the liabilities (including the capital- for this case) show where these resources come from.
- Non-current liabilities are those which are not due in the next 12 months (E.g.: long term loans)
- Current liabilities are short term ones (due within the next 12 months) and arise from the regular trading activities of the business whose values constantly change (E.g.: trade payables)
- Assets and liabilities are arranged in different groups:
 - Assets are divided into current (Values are constantly changing, short term assets which arise from the regular trading of the business, E.g.: Inventory) and non-current assets (long term assets which are not used for resale but help the business earn revenue. E.g.: Motor Vehicles)
 - Non-current assets are listed in order of increasing liquidity (liquid= least permanent) (The ability to be converted into cash), typically: Land and buildings, Machinery, Fixtures and equipment and motor vehicles.
 - Current assets are also listed in order of increasing liquidity (furthest away from cash shown first), typically: Inventory, Trade receivables, Other receivables, Bank, Cash. Trade receivables are said to be more liquid as compared to the inventory as they can be sold to other businesses.
 - Current and Non-current liabilities appear in ascending order of which liability will have to be paid

first. Note: Other payables will appear after trade payables.

- A SOFP should have the heading to the date to which it relates and must include the trading name of the business.
- SOFPs can be prepared in the horizontal (2 sided) (typically assets on the left and liabilities on the right, but reverse is acceptable) or a vertical format, which looks like an arithmetical calculation
- After all the financial statements are prepared every item on the trial balance must have one effect (either IS or SOFP) on the financial statements and additional notes will have 2 effects on the financial statements (one on the IS and the other on the SOFP)
- The balance of the capital A/C will increase in the SOFP if the business has made a profit or decrease if the business has made a loss.
- If a vertical format of a SOFP has been prepared, the liabilities are shown after the assets to show where the resources come from (reverse is OK).
- If more than one current liability is present it is listed in the first column and then totalled and taken to the second column.
- The main advantage of a vertical SOFP is that it shows the net current assets/working capital (current assets-current liabilities) which is very important .
- The non-current liabilities can be listed before or after the capital.
- In the vertical format of SOFP, the Assets-Liabilities = Capital. Other formats keeping in line with the accounting equation are also acceptable.
- When the business makes a profit, it is added to the capital as the amount owed by the business increases and thus it can be concluded that a profit is an increase in net assets (capital)
- Amounts to be subtracted are be put in parenthesis to make sure they are not added.

Statement of financial position as at 31 dec 2020

	\$	\$
Non Current asset		
Premises		
Motor van		
Office furniture		
Current asset		
Closing inventory		
Trade receivables		
Cash and cash equivalents		
Total assets		
Capital and liabilities		
Capital at 1 January		
Add : profit for the year		
Less : loss for the year		
Less : drawings		
Capital at 31 dec		

	\$	\$
Non current liabilities		
Loan from Noor		
Current liabilities		
Trade payables		
Other payables		
Bank overdraft		
Total liabilities and capital		

2.3. Accounting Principles and concepts

- Accounting principles are rules applied when recording transactions and preparing financial statements.
- Objectives of a set of financial statements is that they provide a true and fair view of the profit or loss of the company for the year, and that the SOFP likewise gives a true and fair view of the state of affairs of the company at the end of the financial year; true indicates if the transaction actually took place, fair implies transactions are shown in accordance with accepted accounting rules of cost and valuation.
- There are 11 accounting principles and concepts
 - **Duality** is the understanding that there are two aspects of each transaction. Credit and Debit. It also involves the accounting equation.
 - **Business Entity** - It is when the business and its owner are regarded as separate existence. A clear example of this concept is when the owner puts in capital into the business. The credit in the capital a/c shows that the business owes money to its owner.
 - **Money Measurement** - Transactions which can be measured in monetary terms are recorded in ledgers. The limitation is that non-monetary values such as skill/satisfaction cannot be measured.
 - **Historic Cost** - Transactions are recorded at their cost to the business. This ensures objectivity but however doesn't consider the changing value of money.
 - **Realisation** - Revenue is accounted by the seller when it is **earned** whether cash is received or not
 - **Consistency** - Transactions of a similar nature must be recorded in the same way.
 - **Materiality** - Businesses might not record some transactions using the accounting principles as the transaction might be considered insignificant.
 - **Matching/accruals** - Revenue and income must not be earned more or less same applies to expenses which must not be more or less.
 - **Prudence** - Profits should not be overstated and losses should be provided for as soon as they are recognized
 - **Going Concern** - It is when there is no intention to stop the business in the coming future.
 - **Substance over form** - When recording a transaction, this concept states that the substance of the transaction should be recorded rather than its legal

form. Ex. Legally, if a company doesn't fulfil the payment of a machine it goes back to the seller, but in substance the machine is the same as the others, its being used in the process, hence substance over form.

- Goods on sale or return basis – when a trader sells on sale or return basis to a customer, no sale takes place until the customer informs the seller that he has decided to buy them

2.4. Accruals and prepayments (the matching concept)

- Accruals are an expense which is due withing an accounting period but which has not been paid, in the statement of financial position, it is known as other payables.
- Prepayments are payments made by the business in advance of the benefits to be derived from them, this is entered as other receivables in the statement of financial position.
- **Accrued expenses – amount owed to a creditor**

Expense account

2020	\$	2020	\$
Jan bal. b/d (previous year prepaid)	xx	Jan Bal b/d (previous year owing)	xx
Jan-nov bank	xxx	Dec 31 income statement	xxx
Dec 31 bal c/d (current year owing)	xx		
	XXX		XXX
		Jan 1 bal. b/d	xx

- Only xxx has been paid but a different amount (amount relevant to the year) will be dr in the Income Statement as it is the cost relating to that year, the bal. b/d will be shown in the SOFP under current liabilities as accrued expenses.
- The accrued amount is added to the expense account.
- **Prepaid expenses – payment in advance (debtor)**

expense account

2020	\$	2020	\$
Jan bal. b/d (previous year prepaid)	xx	Jan Bal b/d (previous year owing)	xx
Jan-dec bank	xxx	Dec 31 income statement	xxx
		Dec 31 bal c/d (current year prepaid)	xxx
	XXX		XXX
Jan 1 balance b/d	xx		

- The payments during the year add up by the bank but the income statement has been debited with rent for one

year, the amount that relates to the next financial year is subtracted from the total amount and this amount is entered under the SOFP as other receivables under current assets.

- This amount is deducted from the expense amount in the trial balance while including in the IS.
- Inventory of stores as an expense accounts – inventories of consumable stores may be unused at the end of the year, as per matching concept these should not be charged against the profit as they are an asset, this is carried down as a dr balance hence why an expense account may have both dr and cr balances.
- Example: In the year ended 31 dec 2020, Mr. Ceyard had paid 1200 dollars for stationery, at year end he owed 270 dollars for stationery and had an inventory of unused stationery of 400 dollars.

Stationery Account

2020		\$	2020		\$
Jan 1			Dec 31	Income statement	1070
Dec 31	Bank	1200	Dec 31	Inventory c/d	400
Dec 31	Amt owing c/d	270			
		1470			1470
2021			2021		
Jan 1	balance b/d	400	Jan 1	Balance b/d	270

- The amt owing is carried down and it is included under current liabilities as other payables in the SOFP while the 400 dollars of unused inventory would be under current assets as inventory of unused stationery.
- Adjusting for income prepayments – incomes received in advance of its due dates is a payable (income prepaid) and is therefore a credit balance and is under current liabilities in the SOFP. The amount prepaid is misused from the amount paid in the IS.
- Adjusting for income accrued – incomes accrued at the date it is due indicates existence of debtors and is therefore a debit balance, this is hence under current assets as other receivables in the SOFP, and it is added to the amount received in the bank in the IS.

Income account

	\$		\$
Balance b/d (owing previous year)	xxx	Bal b/d (previous year prepaid)	xx
Income statement	xxx	Bank account	xxx
Balance c/d (prepaid current year)	xxx	Bal c/d (current year owing)	xxx
	XXX		XXX
Balance b/d	xxx	Balance b/d	xxx

2.5. Provision for the depreciation of non current asset

- **Capital income:** Capital income is when the sale of an asset generates income.
- **Revenue incomes:** Revenue income is income received by the sale of goods and services daily; day to day operations.
- **Capital expenditure:** it is the use of funds by a company to purchase non current assets such as machinery which benefits the business over more than a year
- **Revenue expenditure:** it is the use of funds by a company to run the day to day operations such as lunch for employees, fuel.
- **Depreciation** is a part of the cost of a non current asset that is consumed during the period its used.
- Ex if a machine which lasts for 5 years is used for 1 year then the depreciation is the value of the machine which is used for a year. Depreciation has 2 methods to calculate the percentage or value to be reduced.
- **Purpose of depreciation:** the main purpose of depreciation is to spread the cost of the non-current asset to the useful life to cover the total cost within the period of usefulness. In simpler ways, it's to cover the cost with the money earned using the asset.
- **Concepts that comply with depreciation:**
 - Prudence concept – to avoid overstating the asset value
 - Matching concept –if cost of using non current asset was not included in the income statement or profit would be overstated.
 - Consistency – the same method is to be applied each year to reflect the usage of the asset.
- **Reasons for depreciation**
 - Wear and tear
 - Obsolescence
 - Passage of time
 - Using up or exhaustion (physical deterioration)
- **How to calculate depreciation:**
 - **Straight line method:** the total amount of depreciation is the total cost- the residual value or the value after it completes its period of usefulness . After finding that value ,it is then spread over the years of usefulness. Calculation formula:
 - cost of non current asset - residual value/period of usefulness in years
 - Ex. A machine worth 100,000 dollars has a usefulness of 10 years after which it would be sold for 1000 dollars. The total depreciation is $100,000 - 1000 = 99,000$ which when spread over 10 years comes around 9900 dollars per annum.
 - **Reducing Balance method:** the depreciation is taken by a fixed percentage on the net book value (written down value) of assets every year.
 - Ex. A machine costs 100,000 dollars and has a period of usefulness over 6 years. Depreciation is used to calculate for 20% per annum on reducing balance. Therefore, the results are in the table below.

	Calculation
Cost	100,000
Year1(20% x 100,000)	(20,000)
Net book value	80,000
Year2(20% x 80,000)	(16,000)
	64,000
Year3(20% x 64,000)	(12,800)
	51,200
Year4(20% x 51,200)	(10,240)
	40,960
Year5(20% x 40,960)	(8,192)
	32,768
Year6(20% x 32,768)	(6,554)
	26,214

Henceforth, the residual value is 26,214 dollars moreover if the company sells the machine for more than the residual value the company makes a profit where as if the company sells it for lesser than the residual value then the company makes a loss.

- **Revaluation method:** Used to calculate the cost of consumption in the accounting period of small non current asset such as power tool.
 - This is used to find how much to charge as an expense to the income statement when each tool may have a different useful life while their total value is large, and it may not cost enough to treat them separately.
 - **Opening valuation + purchase during year – closing value = depreciation charge**

When to choose which Depreciation.

- **Straight line:** usually used for assets that are expected to earn revenue evenly over useful life. Also for assets whose earning power is uncertain. This method is used for assets that have fixed lives (leases); easier to calculate, less risk of mistakes than reducing balance as the provision doesn't change annually.
- **Reducing balance method:** used when assets earning power will diminish as the asset ages. This is also used where assets loses more of its value in the early stages of life. Example; motor vehicles, computers. Advancements in technology affects value. Reducing charges for depreciation compensates for increasing repair costs as it ages.
- *Accounting for disposal of non current assets:*

1. Debit: Disposal a/c
Credit: Non current assets a/c (original cost)**)
2. Debit: Provision for depreciation a/c
Credit: Disposal a/c
3. Debit: Bank a/c
Credit: Disposal a/c
4. A debit balance is a loss on disposal

	Calculation
--	-------------

A credit balance is a profit on disposal
Following are the three accounts when accounting for disposal.

Non current asset at Cost a/c

2020		\$	2020		\$
Jan 21	Bal b/d	xxxx	Dec 21	Non current asset disposal	xxx

Provision for depreciation for non current asset account

2020		\$	2020		\$	
	Dec 21	Non current asset disposal	xxx	Jan 21	Bal b/d	xxx

Non current asset disposal a/c

2020		\$	2020		\$
Dec 21	Non current asset at cost	xxx	Dec 21	Provision for depreciation	xxx
				Bank(proceeds)	xxx
			Dec 31	Income statement (loss on disposal)	xx
		xxx			xxx

- Part exchange: In part exchange, the company gives the machinery in exchange for a new machine. In this case, the exchange value of the asset being disposed will be debited to the non current assets a/c and then credited to the disposal a/c (in place of the proceedings as per usual procedure).
- A business may depreciate its assets either:
 - A full years depreciation
 - Month by month basis
 - Exceptional depreciation : when the amount recoverable on disposal is below it net book value this asset is said to be impaired, in this case this asset needs to be immediately written down to the amount which would be received if sold.

2.6. Provision for the depreciation of non current asset

- Capital income: Capital income is when the sale of an asset generates income.
- Revenue incomes: Revenue income is income received by the sale of goods and services daily; day to day operations.
- Capital expenditure: it is the use of funds by a company to purchase non current assets such as machinery which benefits the business over more than a year
- Revenue expenditure: it is the use of funds by a company to run the day to day operations such as lunch for employees, fuel.
- Depreciation is a part of the cost of a non current asset that is consumed during the period its used.

- Ex if a machine which lasts for 5 years is used for 1 year then the depreciation is the value of the machine which is used for a year. Depreciation has 2 methods to calculate the percentage or value to be reduced.
- Purpose of depreciation: the main purpose of depreciation is to spread the cost of the non-current asset to the useful life to cover the total cost within the period of usefulness. In simpler ways, it's to cover the cost with the money earned using the asset.
- Concepts that comply with depreciation:
 - Prudence concept - to avoid overstating the asset value
 - Matching concept -if cost of using non current asset was not included in the income statement or profit would be overstated.
 - Consistency - the same method is to be applied each year to reflect the usage of the asset.
- Reasons for depreciation
 - Wear and tear
 - Obsolescence
 - Passage of time
 - Using up or exhaustion (physical deterioration)
- How to calculate depreciation:
 - Straight line method:** the total amount of depreciation is the total cost- the residual value or the value after it completes its period of usefulness . After finding that value ,it is then spread over the years of usefulness. Calculation formula:
 - cost of non current asset - residual value/period of usefulness in years
 - Ex. A machine worth 100,000 dollars has a usefulness of 10 years after which it would be sold for 1000 dollars. The total depreciation is $100,000 - 1000 = 99,000$ which when spread over 10 years comes around 9900 dollars per annum.
 - Reducing Balance method:** the depreciation is taken by a fixed percentage on the net book value (written down value) of assets every year.
 - Ex. A machine costs 100,000 dollars and has a period of usefulness over 6 years. Depreciation is used to calculate for 20% per annum on reducing balance. Therefore, the results are in the table below.

	Calculation
Cost	100,000
Year1(20% x 100,000)	(20,000)
Net book value	80,000
Year2(20% x 80,000)	(16,000)
	64,000
Year3(20% x 64,000)	(12,800)
	51,200
Year4(20% x 51,200)	(10,240)
	40,960
Year5(20% x 40,960)	(8,192)
	32,768

	Calculation
Year 6 (20% x 32,768)	(6,554)
	26,214

Henceforth, the residual value is 26,214 dollars moreover if the company sells the machine for more than the residual value the company makes a profit whereas if the company sells it for less than the residual value then the company makes a loss.

- **Revaluation method:** Used to calculate the cost of consumption in the accounting period of small non-current assets such as power tools.
 - This is used to find how much to charge as an expense to the income statement when each tool may have a different useful life while their total value is large, and it may not cost enough to treat them separately.
 - **Opening valuation + purchase during year – closing value = depreciation charge**

When to choose which Depreciation.

- **Straight line:** usually used for assets that are expected to earn revenue evenly over useful life. Also for assets whose earning power is uncertain. This method is used for assets that have fixed lives (leases); easier to calculate, less risk of mistakes than reducing balance as the provision doesn't change annually.
- **Reducing balance method:** used when assets earning power will diminish as the asset ages. This is also used where assets lose more of their value in the early stages of life. Example; motor vehicles, computers. Advancements in technology affect value. Reducing charges for depreciation compensates for increasing repair costs as it ages.
- *Accounting for disposal of non-current assets:*

1. Debit: Disposal a/c

Credit: Non-current assets a/c (original cost)**)

2. Debit: Provision for depreciation a/c

Credit: Disposal a/c

3. Debit: Bank a/c

Credit: Disposal a/c

4. A debit balance is a loss on disposal

A credit balance is a profit on disposal

Following are the three accounts when accounting for disposal.

Non-current asset at Cost a/c

2020		\$	2020		\$
Jan 21	Bal b/d	xxxx	Dec 21	Non-current asset disposal	xxx

Provision for depreciation for non-current asset account

2020		\$	2020		\$

2020		\$	2020		\$
	Dec 21	Non-current asset disposal	xxx	Jan 21	Bal b/d xxx

Non-current asset disposal a/c

2020		\$	2020		\$
Dec 21	Non-current asset at cost	xxx	Dec 21	Provision for depreciation	xxx
				Bank (proceeds)	xxx
			Dec 31	Income statement (loss on disposal)	xx
		xxx			xxx

- **Part exchange:** In part exchange, the company gives the machinery in exchange for a new machine. In this case, the exchange value of the asset being disposed will be debited to the non-current assets a/c and then credited to the disposal a/c (in place of the proceeds as per usual procedure).
- A business may depreciate its assets either:
 - A full year's depreciation
 - Month by month basis
 - **Exceptional depreciation:** when the amount recoverable on disposal is below its net book value this asset is said to be impaired, in this case this asset needs to be immediately written down to the amount which would be received if sold.

2.7. Irrecoverable and doubtful debts

- Irrecoverable debt is a debt due from a customer which it is expected will never be paid to them.
- When the debtor has become bankrupt and is unable to pay
 - DR: Irrecoverable debt account
 - CR: debtor
- At end of the financial year, this balance will be transferred to the income statement as an expense.
 - DR: income statement
 - CR: irrecoverable debts

Irrecoverable debts accounts

2020		\$	2020		\$
Nov 1	Debtor 1	xxx	Dec 31	Income Statement	xxx
	Debtor 2	xxx			
		xxx			xxx

- The irrecoverable debts are deducted from the trade receivables in the SOFP
- Irrecoverable debts recovered
 - A debt that has been written off as irrecoverable may be recovered at a later date if the customer is able to pay
 - The debt must first be recorded once more on the sales ledger via journal entry

- DR customers account
- CR irrecoverable debts recovered
- Once the amount has been received
 - DR : cash book
 - CR : customers account
- The balance of irrecoverable debts recovered account will be credited in the income statement, it must be shown under gross profit added as part of other incomes.
- Provisions for doubtful debts
 - a debt due from a customer where it is uncertain whether or not it will be repaid by them, it may eventually be irrecoverable. It would therefore overstate the assets if this is not removed making the SOFP misleading however it may be wrong to write it off as an expense as its not yet irrecoverable.
- When the provision is first created :
 - DR : income statement
 - CR : provision for doubtful debt
- Afterwards in the year following any increase in the amounts will be DR in the income statement and CR in the provision for doubtful debts, (treated as an expense), while in the case of a decrease in the amount the reverse is followed hence (treated as an income).
- The provision for doubtful debts is deducted from the trade receivables in the SOFP.
- How to calculate the amount of a provision for doubtful debts :
 - *Specific* – the provision will be equal to the total of those doubtful debts, this amount is based on specific knowledge the owner has of the customers financial position.
 - *General* – provision calculated as a percentage of the total trade receivables.
 - *Specific and general* – provision is made up of debts that are thought to be doubtful plus a % of the remainder.
- Specific provisions must always be deducted from trade receivables first, before the general provision is calculated. $[\text{total receivables} - \text{specific}] \times \text{general}\% = \text{general provision.}$

Provision for doubtful debts account

	\$		\$
Balance c/d (transferred to SOFP)	xxx	Balance b/d	xxx
		Income statement (increase in provision)	xxx

- Provisions for doubtful debts and the concepts
 - **Prudence** – the trade receivables should not be overstated in the SOFP, the IS should hence provide for the loss and not overstate profit.
 - **Matching** – the possible loss of revenue should be provided in the relevant period in which the revenue was earned.

2.8. Bank reconciliation statements

What is a bank reconciliation statement?

- This is a statement that is prepared periodically to ensure that the bank account in the business cash book matches the business bank account shown on the bank statement.
- This may be due to
 - Timing difference – delay between items being entered in the cash book and the entry on the bank statement
 - Items on the bank statement that have not been entered in the cash book (bank charges, interest, direct debits, standing orders, et).
- How to prepare a bank reconciliation statement?
 - Compare the entries in the cash book with the bank statement. Check out the ones that coincide with both places
 - Enter into the cash book the items that remain unticked in the bank statement and then calculate the updated cash book balance accordingly.
 - Prepare the reconciliation statement. First start with the balance on the bank statement and adjust for any items that are unticked in the cash book. The result should equal with the balance in the updated cash book.
- Therefore this figure will now be able to be recorded in the statement of financial position.
- This division of duties is called internal check in which external auditors rely on to help them verify the accuracy of the financial data
- Unpresented cheques are cheques payments recorded in the cash book but not yet appearing on the bank statement
- Uses of bank reconciliation
 - Reveal the correct amount of cash at bank, without the reconciliation the bank statement and cash book will be misleading.
 - Ensure that the correct bank amount is entered in the statement of financial position
 - They are a crucial system of control – unintended drawings can be avoided, surplus of cash at bank can be highlighted, if reconciliations prepared regularly errors can be discovered early.
 - Since its prepared by someone else, the chances of fraud is reduced.
- The formats for the reconciliation include

Bank reconciliation statement at 31 march 2016

	\$	\$
Balance as per bank statement		xx
Add: items not credited in the bank statement		xxx
		xxx
Deduct: cheques not presented	xxx	
	xxx	(xxx)
Balance as per cash book		xxx

Alternative format : Bank reconciliation statement at 31 march 2016

	\$	\$
Balance as per cash book		xx
Add: unrepresented cheques	xxx	
Deduct: items not credited on the bank statement	(xxx)	
	xxx	(xxx)
Balance as per bank statement		xxx

2.9. Control accounts

- Control accounts contains the totals of all postings made to the accounts in a particular ledger.
- These are usually maintained for sales and purchase ledgers, the totals of the books of prime entry are made to the ledger, hence the balance of the control account should equal to the total of the balance of the ledger it controls.
- A control checks on the arithmetical accuracy of a single ledger while a trial balance checks the accuracy of all the ledgers. Not part of the double entry.
- A difference between a control account balance and the total of the balance of the ledger it controls, helps show where a cause of a difference on a trial balance may be found.
- The Purchase Ledger and Its Control Account (trade payables control acc)

Purchase ledger control account

Bal b/d (total of purchase ledger dr balances from previously if any)	Bal b/d
Purchase returns (purchase returns journal)	Total credit purchases (purchase journal_)
Cash paid to suppliers (cash book)	Refunds from supplied (cash book)
Cash discounts received (cash book)	Interest charged on overdue invoices (purchases journal)
Purchase ledger bal set off (journal)	Total of dr balance (if any) at end of period in purchase ledger c/d
Balance c/d (to agree with the total of cr balance in purchase ledger)	

- Debit balances in the purchase ledger must never be netted against (deducted from) the credit balances. The credit balances come under current liabilities as trade payables while debit balance are under current assets as trade receivables In the SOFP.

- only credit purchases are entered in the purchase ledger control account. No cash purchases are entered.
- The sales ledger and its control account (trade receivables control account).

Sales ledger control account

Bal b/d	Bal b/d (total of sales ledger credit balance)
Credit sales (sales journal)	Sales returns (total of sales returns journal)
Refunds to credit customers (cash book)	Cash received from credit customers (cash book)
Dishonoured cheques (cash book)	Cash discounts allowed (cash book)
Interest charged on overdue acc (sales journal/cash book)	Irrecoverable debts (journal)
Total of credit balance (if any)	Sales ledger balances set off (journal)
c/d	Balance c/d to agree with total of debit balances in sales ledger

- Only credit sales should be entered in the sales ledger control account. Never enter cash sales or provisions for doubtful debts in a sales ledger control account.
- Reasons why a credit balance may occur in a customers account [if reversed between buyer and seller, reasons why debit balances occur in a suppliers account]
 - Customer may have overpaid their invoice
 - Customers may have paid in advance
 - Customer may have paid invoice in full and later returned some or all of the goods
- Uses of control account
 - It alerts possible errors in the ledgers they control if totals of the balances
 - May identify the ledger in errors have been made
 - Totals of trade receivables and trade payables are provided quickly
 - Reduces fraudulent activity as a control account is prepared by someone not involved in maintaining ledgers [internal check].
 - When businesses don't maintain full double entry systems, control accounts are a vital part of preparing financial statements.
- Limitations of using control account
 - Control accounts may contain errors themselves
 - They don't guarantee the accuracy of individual ledger accounts.
 - It may add to business costs although a computerised accounting system will prepare it automatically, individual with specialist knowledge is required to verify the accuracy.
- How to reconcile control accounts with ledgers
- When there's a difference between the balance on the control account as well as the total of balance on the ledger it controls, it has to be reconciled

- Error of omission: If a transaction is omitted from a journal, it will be omitted from the personal account in the sales or purchase ledger and from the control account. Both records will be wrong and the control account will not reveal the error, hence it will be adjusted in both places
- Error of original entry: If a transaction is incorrectly entered in a journal, this error will be repeated in the ledger it controls and hence in the control account. Both records will be wrong and the control account will not reveal the error; both will need to be adjusted.
- If an item is copied incorrectly from the journal to a personal account in the sales or purchase ledger, the control account will not be affected, and it will reveal the error.
- If the total in a day book is incorrect, the control account will be incorrect but the sales or purchase ledger will not be affected. The control account will reveal that an error has been made.

2.10. Suspense account

- Suspense account: An account opened to record a difference between the debit and credit totals of the trial balance.
- The following checks are useful:
 - Check the additions of the trial balance
 - If difference is divisible by 2 then look for balance of half the difference on the wrong side
 - If the difference is divisible by 9 look for balances where digits have been reversed like 345 dollars entered instead of \$354
 - Check totals of sales and purchase ledger against the control accounts
 - Check extraction of the balances
- If the cause of difference has not been found then a suspense account may be opened in order to temporarily balance the trial balance.
- A suspense account is opened in the general ledger with the balance on whichever side of the account will make the trial balance agree when the balance is inserted. If the total of the debit side of the trial balance is 200 dollars less than the credit side, the suspense account is opened will have a debit balance of \$200
- Types of errors that call for a suspense account to be opened include:
 - When it's a single entry instead of a double entry
 - When entries have been made on the same side of two separate accounts
 - When the entries have been made on the correct side but the figures differ.
 - An item on the wrong side of an account must be corrected by an adjustment equal to twice the amount of the original error (once to cancel the error and once to place the item on the correct side of the account).
- Some errors do not affect the double entry; an example would be a balance on a sales ledger account copied

incorrectly onto a summary of balances for inclusion in the trial balance. The summary of balances should be amended and a one-sided entry in the journal prepared to correct the suspense account. Such errors are not required to be corrected by debit and credit entries

- The types of errors that don't affect the trial balance and are hence not corrected by a suspense accounts are; error of original entry, error of principle, error of omission, error of commission, error of complete reversal and compensating errors.
- Note whether or not a narrative is required when preparing the journal entries.
- Revised profit or loss is calculated from the nominal account entries in the journal.

2.11. Incomplete accounts

- Incomplete records: Any method of recording transactions that is not based on the double-entry model. Usually maintained by small business owners who lack sufficient knowledge of double entry hence resort to single entry bookkeeping.
- Capital is calculated by listing the assets and liabilities in a statement of affairs. This is similar to a SOFP. However, in the statement of affairs the assets and liabilities are only listed. Headings such as non-current assets or current liabilities are not included.
- Profit/(loss) = closing capital + drawing in the period – new capital introduced – opening capital
- Capital or net assets = assets – liabilities
- When an asset is valued at more or less than cost, it should be included in a statement of affairs at valuation
- Preparing an income statement and a statement of financial position from incomplete records
 - prepare opening statement of affairs, this allows opening capital to be calculated
 - prepare receipts and payment account (similar to a cash or bank account), this is needed to calculate the closing bank/cash balances for the closing SOFP
 - prepare control accounts for trade receivables and trade payables in order to calculate sales and purchases
 - Adjust the receipts and payments for accruals and prepayments at the beginning and end of the period.
 - Calculate provisions for doubtful debts, depreciation and any other matters not mentioned above.
 - Prepare the income statement and statement of financial position from the information now available.
- Valuing the inventory at selling price goes against three important accounting principles:
 - realisation – profit was shown as realised in the year ended 31 December 2015 even though no sale had taken place.
 - matching – the profit has not been matched to the time the sale took place.
 - prudence – the profit was overstated in 2015; it was not even certain then that the goods could be sold at a profit.

- It is an important principle that inventory should never be valued at more than cost. Valuing inventory at historic cost observes the principles of realisation, matching and prudence.
- Another important principle is that the method used to value inventory should be used consistently from one accounting period to the next.
- Incorrectly valuing inventory, either by mistake or deliberately, will result in the income statement showing the wrong gross profit and profit for the year as well as the current assets in the SOFP will be incorrect. Which is hence misleading leading to wrong decisions being made.
- Inventories should be valued at the lower of cost and net realisable value. Cost has already been considered. net realisable value is the price that may be expected to be received from the sale of the goods, less the cost of putting them into a saleable condition.
- Margin and mark-up
 - Margin is gross profit expressed as a percentage or fraction of selling price:
 - Profit/selling price x 100
 - Mark-up is gross profit expressed as a percentage or fraction of cost of sales.
 - Profit/cost price x 100
- If margin is 1/3 then markup is $1/(3-1)=1/2$
- If markup is 1/6 then margin is $1/(6+1)=1/7$
- Markup and margin is useful in calculating inventory lost in fire or theft.
- Advantages of keeping full accounting records
 - Allows financial statements of business to be prepared quickly soon after year end
 - Allows financial statements to be prepared more than once a year which may help the manager run more efficiently
 - Helps guard against errors and possible fraud by employees as inventory or cash loss can be picked up early
 - Accuracy of the ledgers can be improved
 - May be a legal requirement to keep certain records
- Disadvantages of keeping full accounting records
 - Time taken to set up and maintain them
 - Cost of purchasing a computer package along with training cost
 - Business owners may lack expert knowledge on how to prepare double entry which may lead them to employ a specialist which may be costly.
- How far owners go to keeping financial records for business depends on
 - Accounting knowledge and skill of owner
 - Time available to write up records
 - Cost of employing a member to prepare accounting records

2.12. Partnership accounts

- A partnership is formed when two or more people carry on business together with the intention of making profit

- Partnership agreement: An agreement, usually in writing, setting out the terms of the partnership
- Partnership Act 1890: The rules which govern a partnership in the absence of a formal partnership agreement
 - All partners are entitled to contribute equally to the capital
 - Partners aren't entitled to interest on capital
 - Partners aren't entitled to salaries
 - No interest charged in their drawings o Partners will share profit and losses equally
 - Partners entitled to interest at 5% per annum on loans made to partnership (this will be considered as an expense and treated as any other loan; debited into the income statement)
- Appropriation account: An account prepared after the income statement. It is used to show how the profit for the year is divided between each partner.
 - Partnership salary : a share of the partnership profit for the year paid to one (or more) of the partners in addition to their normal profit share usually for extra skill or work undertaken, these are never debited to the income statement as expense.
 - Interest on partners capital : A share of the profit for the year (usually) based on a percentage of the amount of fixed capital each partner has contributed to the partnership
 - Interest on drawings: A charge made on the annual drawings made by each partner, usually calculated as a percentage of the drawings made.

Draft of appropriation account

	\$	\$
Profit for the year		xxx
Add: Interest on drawings - A	xxx	
- B	xxx	xxx
		xxx
Less: Interest on capital - A	xxx	
- B	xxx	(xxx)
Less: Partners salaries - A		(xxx)
		xxx
Profit share - A (profit share %)	xxx	
- B (profit share %)	xxx	(xxx)
		0

- Preparing partnership accounts
 - Capital account An account to record the sum of money which a partner introduces into the partnership. It is only adjusted for any further capital introduced, any capital withdrawn, any share of goodwill or any profit on the revaluation of partnership assets. Partnership capital account

	A	B		A	B
--	---	---	--	---	---

	A	B		A	B
Capital Withdrawn			Balance b/d (profit from share from appropriation acc)		
:pss share (from appropriation acc)			Capital introduced		
Revaluation loss			Revaluation gain		
Balance c/d					

- Current account: An account which records a partner's share of profits and any drawings made by them.
Partners current account

	A	B		A	B
	\$	\$		\$	\$
Drawings	x	x	Balance b/d	x	x
Interest on drawings	x	x	Interest on loan	x	x
Balance c/d	xxx	xxx	Interest on capital	x	x
			Partners salary	x	x
			Share of profit	x	x
	xxx	xxx		xxx	xxx
			Balance b/d	xxx	xxx

- Drawings account
 - If partners do not maintain current accounts, the double entry for interest, their salaries and shares of profit must be completed in their capital accounts
 - Advantages of partnerships
 - The capital invested by partners is often more than can be raised by a sole trader.
 - A greater fund of knowledge, experience and expertise in running a business is available to a partnership.
 - A partnership may be able to offer a greater range of services to its customers (or clients).
 - The business does not have to close down, or be run by inexperienced staff, in the absence of one of the partners; the other partner(s) will provide cover.
 - Losses are shared by all partners.
 - Disadvantages of partnerships
 - A partner doesn't have the same freedom to act independently as a sole trader has.
 - A partner may be frustrated by the other partner(s) in their plans for the direction and development of the business.
 - Profits have to be shared by all partners.
 - A partner may be legally liable for acts of the other partner(s)

2.13. Partnership changes

- When partners agree to change the profit/loss share
 - The profits/losses incurred before the change in the shares must be shared among the partners in the old

profit share ratio, afterwards once the change is imposed the profit/loss following must be shared in the new ratio. Hence causing realised or unrealised profit or losses to occur.

- Realised profit/loss : recognised in the income statement such as revenue or expenses these are apportioned on a time basis however exceptional cases such as a change in the interest of a partners loan would require it to be apportioned on an actual basis o Unrealised profit/loss : gains/losses arising from revaluation of assets and liabilities at the date of the change resulting in adjustments to partners capital.
- Revaluation of an asset in a partnership : this is done to reward the existing partners for their efforts in building up the business over its life. In the case the partner retires it is only fair they are rewarded for their efforts as well
 - step 1 : DR revaluation account CR asset account(book value of being revalued)
 - step 2 : CR revaluation account DR liability account(book value of the liability)
 - step 3 : CR revaluation account DR asset account(new value of the asset)
 - step 4 : DR revaluation account CR liability account(new value of the liability)
 - an alternative method could include
 - Revaluation account

Decrease in asset value	Increase in asset value
Increase in liability value	Decrease in liability value
Profit on revaluation	Loss on revaluation
- Partner A	- Partner A
- Partner B	- Partner B

- The remaining balance will be the profit or loss on revaluation which will be shared between the partners in the current profit sharing ratio in the capital account
- If the balance was on the debit side it will be a profit on revaluation, if the balance was on the credit side it will be a loss on revaluation.
- Accounting for goodwill : Goodwill is the amount by which the value of the entity or partnership as a going concern exceeds the net value of its assets if they were sold individually. It is an intangible asset
- There are two types of goodwill : purchased goodwill and inherent goodwill
- Purchased goodwill arises when one business buys another, if the purchaser pays more than the net book value of the assets the difference is goodwill, IAS allows this to be shown as an intangible non current asset in the SOFP
- Inherent goodwill is internally generated and is not paid for and so does not have an objective value.
- Goodwill is never brought into the revaluation account or current account.

- Goodwill is not recorded for two reasons; value placed on goodwill is difficult to justify and if goodwill is included it would be difficult to convince a buyer to pay more for the business.
- When there's a change in the partnership (change in profit sharing ratio or admission/retirement of an existing partner) goodwill will need to be adjusted, the following could be done :
 - Goodwill could be opened and maintained: DR goodwill CR old partners capital [old ratio]
 - Or goodwill account can be opened and removed subsequently
 - Step 1 : CR partners capital account with share of goodwill in the old profit sharing ratio DR goodwill
 - Step 2 : DR partners capital account with share of goodwill in the new profit share ratio CR goodwill
 - Capital account

	X	Y		X	Y
Goodwill (shared in new ratio; step 2)	xxx	xxx	Goodwill (shared in old ratio; step 1)	xxx	xxx

- When apportioning profit while there's a change in the profit share ratio in the middle of the financial year
- If the profit is assumed to have been earned evenly throughout the year, it should be divided between the old and new partnerships on a time basis
- Some expenses may not have been incurred on a time basis and must be allocated to the period they belong these expenses will be specified, this can be done by splitting the gross profit between the two trading periods before and after the change in the terms of agreement
- Admission of a partner/when a partner leaves
 - When a partner leaves or a new partner joins, it suggests the end of partnership and the start of a new one, the following accounts must be taken care of
 - \
 1. Asset revaluation – calculate the profit/loss on revaluation
 - \
 1. Adjustments for Goodwill
 - \
 1. Prepare the income and appropriation account for the two periods before and after the admission
 - \
 1. Changes in the profit share ratio
 - \
 1. Prepare the current account
- Death/retirement of a partner
 - The following takes place when a partner retires
 - Revaluation of the assets and liabilities
 - Goodwill adjustment
 - Settlement of retiring partner : transfer the current account balance of the retiring partner to the capital account

- After revaluation and goodwill entries in the capital account balance the retiring partners column in the capital account the missing figure is the amount payable to the retiring partner, shown below
 - A pay cash or cheque DR retiring partners capital CR cash/bank
 - B retiring partner takes asset of the business DR retiring partner capital account CR asset account
 - C transfer amount payable to a loan account by DR retiring partners capital account CR loan a/c
- Partnership dissolution
 - This is the process by which all the assets of the partnership are sold and liabilities paid where the partnership ceases trading
 - Reasons for dissolution
 - Partnership is no longer profitable
 - Partners disagree on borrowing the partnership and can no longer work together
 - Partner has died, retired or being declared bankrupt and remaining partners agree to close down the business
 - When a partnership business is being taken over by a limited company or by another partnership or being merged with another business
 - Steps involved with partnership dissolution
 - Transfer all assets and liabilities to the realisation account except the bank balance. Realisation account: An account prepared when a partnership is ceasing to trade, to record the book value of the assets and liabilities and how much is received for them if sold, or paid out in respect of liabilities. The result will be a profit or loss on realisation.
 - Enter the bank balance in the bank account
 - Enter the capital balance in the capital account
 - If there is a current account balance transfer them to the capital account
 - Show all the entries related with the sale of the asset settlement by DR bank CR realisation
 - Show the entries of the dissolution expenses by DR realisation account CR cash/bank
 - Balance the realisation account and transfer it to the capital account, if the balance is one the debit side of the realisation then it is a realisation profit and should be credited to the capital account in the profit sharing ratio.
 - Balance the partners capital account and transfer the missing figure to the bank account
 - The bank account should balance

DR realisation CR asset account DR liabilities CR realisation
Realisation Account

	\$	\$
Non current asset (at cost)		Trade payables
Inventory		Other payables
Trade receivables		
Other receivables		

2.14. Limited companies

- A limited company is a separate legal entity whose existence is separate from its owners; the liabilities of the members are limited to the amounts paid (or to be paid) on the shares issued to them i.e. limited liability
- when a company is formed certain documents are registered by people who are the founders with the registrar of companies and various fees and duties are paid to the registrar
- the two documents needed are the articles of association (this is the main constitutional document of a company that defines the existence of the company and regulates the structure and control of the company and its members) and the memorandum of association (this forms part of the article and defines the relationship of the company to the rest of the world)
- the main difference between private and public companies is that public companies are allowed to offer their shares to the public and may arrange for the shares to be bought and sold on the stock exchange while private companies cannot.
- Capital structure of a limited company
 - Authorised share capital – the share capital the company is allowed by law to issue to the public.
 - Issued capital – total amount the company has issued on the stock exchange
 - Called up capital – the amount of shares taken up by shareholders without having to pay the entire amount, usually in instalments
 - Paid up share capital – part of share capital for which the company has actually received cash from shareholders
- Classes of shares
 - Ordinary share capital – also known as equity of the company, they are entitled to attend the AGM and vote on propositions, they are paid a dividend on the profit that remains after preference dividend id paid, they are hence the risk takers as they may not receive dividends at all, all the reserves also belong to them
 - Preference share capital – a share which doesn't give the owner any ownership rights in the company, dividends are normally received at a fixed rate, payable before dividends to ordinary shareholder. These may be redeemable or non redeemable, if its redeemable companies can buy back the shares and hence will appear under non current liabilities. Non redeemable would mean the company cannot buy them back and will appear as equity along with ordinary shares.
 - Non cumulative preference share – not entitled to have any arrears of dividends carried forward to future years if profits are insufficient to pay dividends in full
 - Cumulative preference shares – entitled to have arrears of dividends carried forward to future years If profits are insufficient

- Shares issued at a premium – this is the excess over the nominal or par value of a share when it is issued, this is known as a capital reserve and is hence non distributable: DR bank/cash account (with the total cash received for the issue)
- CR share capital account (with the nominal value of the share)
- CR share premium (with the premium received)
- **Revenue reserves** – The profits made by a company which have not been distributed to shareholders, these are created by transferring an amount from profit for the year. These may be created for a specific purpose (replacement of non current asset, planned expansion, etc) or general reserve to strengthen the financial position of the company. These are usually distributable and used to pay dividends; retained earnings and general reserve come under this class of reserve
- **Capital reserve** - Gains which (usually) arise from non-trading activities, such as the revaluation of a company's non current assets, they represent gains that haven't been realised yet, these may include
 - Share premium – usually to pay up unissued shares to existing shareholder as fully paid bonus issue, to write off expenses arising on new share issue at premium and to write off any commission paid on new share issue at premium
 - Capital redemption reserve – created when a company redeems or buys back shares from existing shareholders without using the proceeds from issue of new shares created by DR retained earnings CR capital redemption
 - Revaluation reserve - A company may revalue its non-current assets and any gain on the revaluation must be credited to a revaluation reserve; it is an unrealised profit and must not be credited to the income statement. May be used in bonus issues.
- Income statement for a limited company as per IAS 1

X's income statement for the year ended

	\$
Revenue	
(-) cost of sales	
Gross profit	
(+) operating income	
(-) distribution costs	
(-) administrative expenses	
Profit/loss from operations	
(+) finance income	
(-) finance cost	
Profit before tax	
(-) taxation	
Profit for the year	

- The statement of financial position as per IAS 1

X Limited's statement of financial position as at

	\$
Non current asset (net book value):	
Plant Property Equipment	
Intangible assets (goodwill)	
Long term investments	
Current assets:	
Inventory	
Trade receivables	
Other receivables	
Short term investments	
Cash and cash equivalents	
Total assets	
Equity:	
Ordinary share capital	
Retained earnings	
Share premium	
General reserve	
Non current liabilities:	
Bank loans	
Debentures	
Current liabilities:	
Trade payables	
Other payables	
Tax payable	
Bank overdraft	
Total equity and liabilities	

	SHARECAPITAL	SHAREPREMIUM	GENERALRESERVE
BONUS ISSUE	X	(X)	
TRANSFER TO GENERAL RESERVE			X
TOTAL (BAL C/D)			

- The above format is for accounts which will be published by the company and available for the general public to look at, internal accounts will be in much more detail than this.
- IAS 1 allows for alternative ways of setting out the statement of changes in equity. One such alternative is to prepare a statement of recognised income and expenses. This is much less detailed, as it includes such things as the profit for the year and gains on revaluation of non-current assets. But no dividends paid or share issue
- Statement of changes in equity
- This is a statement prepared to show the changes in a company's share capital, reserves and retained earnings over a reporting period.

Statement of changes in equity for the year ended ...

	SHARECAPITAL	SHAREPREMIUM	GENERALRESERVE	RETAINED EARNING	TOTAL
OPEN BAL	X	X	X		
PROFIT				X	X
DIVIDEND				(X)	(X)
SHARE ISSUE	X	X			
RIGHTS ISSUE	X	X			

- Any dividends that proposed will not be shown in the financial statements
 - Provisions are an amount set aside out of profits to reduce the recorded value of an asset or to cover an expected liability even if the exact amount or timing of the liability is uncertain.
 - Dividends of two types, interim dividends and final dividends, interim dividends are paid to existing shareholders during the year given the directors are satisfied with the profits and cash resources are sufficient while final dividends are paid after the end of the financial year while director can only recommend the amount of dividend to be paid, shareholders must approve the payment
 - Distributable profits consists of accumulated realised profits which has been undistributed and its accumulated realised loss which haven't been previously written off.
- Difference between shares and debentures

Share	Debentures
Shareholders are members of the company.	§ Debenture holders are creditors to the company
Shown in the statement of financial position under equity	Shown in the SOFP under non current liability
Shareholders are the last people to be repaid when a company is wound up	Debenture holders are entitled to be repaid before shareholders are wound up
Dividends can only be paid if distributable profits are available	Interest on debentures must be paid even if no profits are made
Dividends are an appropriation of profit.	They receive an interest which is shown under finance cost as an expense in the income statement

- Bonus share issue** - this is an issue of free shares to existing shareholders from the accumulated reserves of the company usually in proportion to the existing ordinary shares using their reserves with no payment
- The capital reserves are used for this (share premium)
 - Share capital will increase on the SOFP
 - Reserves will decrease

Example : if directors made a bonus issue of shares on the basis of three for every five shares held
 $\frac{3}{5} \times$ the number of issued shares \times par value
 DR reserves CR share capital
 If its in the most flexible form the least flexible reserves are used first the least being share premium and most flexible being general reserve.

- Rights issue – the purpose of rights issue is to raise finance further for the company, this offers existing shareholders opportunity to purchase additional shares at a price below the current market price, the shareholders can either take up the shares and pay for it or sell the rights on the stock market.

Example, the company made a rights issue of one new share for every five shares already held. Then
 $\frac{1}{5} \times$ no. of issued shares \times selling price
 DR cash/bank [total amount received]
 CR share capital [rights issue \times par value]
 CR share premium [rights issue \times share premium]

Rights and bonus issues compared

Rights issue	Bonus issue
Subscribers pay for shares	§ Shareholders don't pay for shares
The company net assets increased by cash received	The net assets of the company are unchanged
Shareholders do not have to exercise their right to subscribe for the new shares	All the ordinary shareholders will receive their bonus shares
Shareholders may sell their rights if they do not wish to exercise them	Shareholders may sell their bonus shares if they do not wish to keep them

- Other sources of finance for a limited company may include
 - Bank loans
 - Bank overdrafts
 - Hire purchase - Hire purchase enables a purchaser to have the beneficial use of an asset while the ownership of the asset remains with the hire purchase company, at the end of the agreement the company may own the asset
 - Leasing – the asset is leased to the company for a rental charge by a leasing company who will own the asset, the asset will never be owned by the company
 - Long term capital
 - Trade payables
 - Working capital

2.15. Analysis and communication of accounting information to stakeholders

- Stakeholder concept : individuals who are interested in the decisions taken by the business and are as a result affected by it

Internal stakeholders	Reasons for interest
Owner [in the case of a sole trader or partnership]	To assess business performance. \n To identify areas of problem and take corrective action.
Existing shareholders	Assess overall performance. Consider the security of their investment. Return in terms of dividends and capital growth
Managers and directors	Salary and bonus often linked with business performance.
Workers	To see if future pay or salary increases will be made and if they have job security
External stakeholders	Reasons for interest
Banks	Assess if loan overdraft should be granted. Interested to see if the business can be able to pay back existing loans
Future shareholders	Comparing several returns from several businesses and decide which to invest in
Investors [an individual who has been asked by the owner to invest fund]	Determine the return they will receive and the security of any investment
Supplier of the business	Whether or not to supply to the business. To check if the business is liquid enough to pay back
Customers of the business	Assess performance to see if business will be able to supply to them In the future
Government	Level of tax charged on profit. To decide whether or not to give a grant. Check if business is in compliance with laws and regulations
Local community	If the business will provide employment
Trade unions	Assess their profitability to see if their members pay could increase
General community	Whether or not the business is operating ethically

- The purpose of financial statements, such as the income statement and statement of financial position, is to present information in a meaningful way. To be useful, information must be clear, complete, reliable and timely.
- Limitations of published accounts
 - Not clear to people who have insufficient knowledge on accounting

- Information given isn't complete, crucial data may be confidential.
- Comparability is limited as accounting policies used differ
- Historic nature; information relates to past and circumstances may have changed.
- Accounting ratios**
- Profitability ratios**
 - Return on capital employed*
 - Formula:
 - $\text{Operating profit/capital employed} \times 100$
 - Comment: how much profit was generated per 100 dollars invested in the form of equity, reserves and long term liabilities. This measures the overall efficiency of a company in employing the resources available to it, this should be compared with the previous years ROCE, with competitors and the industry average. The higher it is the better, this indicates the business is efficiency managing its equity.
 - Gross margin*
 - Formula:
 - $\text{gross profit/operating profit} \times 100$
 - Comment: how much gross profit was generated per 100 dollars in sales, how efficient the trading activities of the business. The higher the figure the greater the business is at converting revenue to gross profit. A lower gross profit would indicate that
 - A rise in the price of goods purchased which weren't passed onto customers.
 - Purchase of goods from a difference supplier at a higher price.
 - Selling price may have been cut to increase volume of sales, to fight competition, as an introductory offer for a new product, as a result of seasonal sales, to get rid of old inventory, to increase cash flow.
 - The cost of sales may have increased by the theft of inventory.
 - Profit margin:*
 - Formula:
 - $\text{profit for the year/sales} \times 100$
 - Comment: how much profit is generated from revenue, this indicates how efficiently the business can convert revenue to profits, a lower percentage would indicate that the business has not been able to control its expenses.
 - Mark up*
 - Formula:
 - $\text{gross profit/cost of sales} \times 100$
 - Comment: how much business has marked up costs before arriving at the selling price. A fall in this ratio is bad for the company as it indicates they may have has to buy from more expensive suppliers and unable to pass the full increase in purchase price to its customers. A business may

have had to reduce its mark up because of more competition.

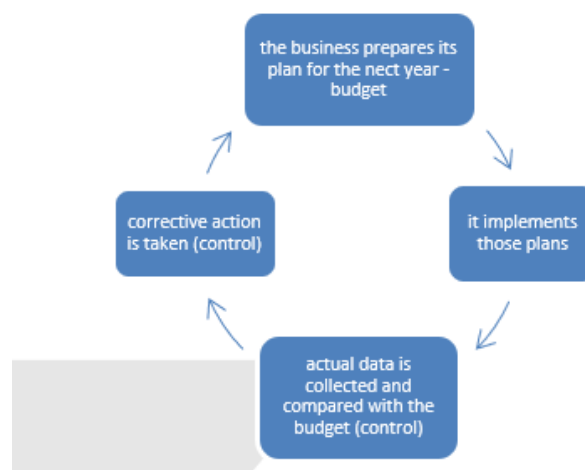
- Expenses to revenue ratio*
 - Formula:
 - $\text{operating expenses/revenue} \times 100$
 - Comment: how effective are the managers in controlling business expenses. In some cases. overheads may increase as a percentage of sales, but the increase may not match the increase in gross margin. The reason is that most overheads, such as rent, do not vary as a result of an increase in sales. Other overheads may vary although not in proportion to sales.
- Liquidity ratios**
 - Current ratio*
 - Formula:
 - $\text{Current assets/current liabilities} : 1$
 - Comment: shows the relationship between current assets and current liabilities, if the business is liquid enough to pay creditors. A higher ratio may indicate the business has enough funds to pay the current liabilities. A favourable range for this ratio would be 1.5-2 : 1. But this depends on the kind of business, a low ratio could mean danger, a high ratio could mean the resources aren't put to efficient use and capital is lying idle as a result instead of being used profitably.
 - Liquid ratio [acid test ratio]*
 - Formula:
 - $\text{current assets - inventory/current liabilities} : 1$
 - Comment: excludes inventory from the calculation and shows liquid assets that is available to pay the current liabilities. A good range would be 1-1.5 : 1. Businesses like supermarkets would expect their sales on a daily basis having a constant inflow of cash, while they enjoy a period of credit to pay suppliers their ratio may not exceed 0.8:1. A motor manufacturer on the contrary would have more current assets then current liabilities making it seem unfavourable without knowing the business, hence making acid test ratio more suitable.
- Efficiency ratio**
 - Non current asset turnover
 - Formula:
 - $\text{net revenue/total net book value of non current assets}$
 - Comment: number of times the non current assets are turned over, how well the non current assets are used to generate revenue. The main reason for purchasing a non-current asset is for it to either generate revenue for the business or reduce cost, both of which will hopefully increase the profit. The higher the ratio is better.
 - Trade receivables turnover [in days]
 - Formula:
 - $\text{trade receivables/credit sales} \times 365$

- Comment: how long it takes credit customers to pay back (credit period). The longer customers take to pay, the company may be losing control over its customers and deteriorating cash flow, the risk of incurring irrecoverable debts is higher.
- Trade payables turnover [in days]
 - Formula:
 - $\text{trade payables/credit purchases} \times 365$
 - Comment: length of time the business takes to pay its creditors. The longer it takes to pay its creditors would mean that cash outflow would be less, however this may result in suppliers may withdraw their credit facilities in the future.
- Inventory turnover [in days]
 - Formula:
 - $\text{average inventory/cost of sales} \times 365$
 - Comment: how it takes for the inventory to be sold. The quicker the inventory is sold, the sooner the profit is realised and the more times profit is earned. A slow turnover would mean excessive inventory is held and risk of obsolete or spoiled inventory increases, hence inventory being locked up would mean it is not earning revenue. Days must be rounded up.
- Rate of inventory turnover times
 - Formula:
 - $\text{cost of sales/average inventory}$
 - Average inventory is found by adding up the opening and closing inventory divided by 2.
 - Comment: the number of times a year the inventory is turned over. Businesses like supermarkets would have a higher turnover than a for instance a business like a diamond retailer.
- Working capital cycle
 - Formula:
 - $\text{inventory days} + \text{trade receivables days} - \text{trade payables days}$
 - Comment: The working capital cycle measures the time it takes for cash to circulate around the working capital system. It calculates the interval that occurs between the time a business has to pay its creditors (trade payables) and the time it receives cash from its customers.
- Limitations of ratio
 - Some useful information may not be disclosed
 - Information may not be timely available only available at year end
 - Ratios don't explain the cause of the change in results
 - Ratios don't recognise seasonal factor

3. Elements of costing and management accounting

3.1. Costing for materials, labour and overheads

- Cost accounting is a method of accounting where all costs relating to a certain activity are grouped together, classified and recorded
- Management accounting is the process of preparing reports and accounts to be used by internal parties such as managers for decision making on future performance of the business
- Direct costs are costs incurred with directly relate to the production of the good or service example: raw materials, carriage inwards, royalties.
- Indirect costs are costs that aren't directly linked with the production of goods and services example: cleaning materials, supervisor salary, factory managers.
- Fixed costs are costs that remain unchanged while the level of output or activity increases or decreases, example: rent
- Stepped fixed cost is cost that does not change within certain high or low threshold of the activity but which will change once these thresholds are breached



- Variable costs are costs that varies on the level of output of activity, example: direct costs that vary in proportion to the number of units produced
- Cost unit is the unit of output of a business to which costs can be charged
- IAS 2 allows two different methods for valuing direct material inventory.
- LIFO is another inventory costing method where the most recently produced items are sold first; opposite to FIFO. This is appropriate for businesses that mainly deal with seasonal demand.
- First In First Out (FIFO) – assumes that the first goods received by the business will be the first one to be delivered to the final customer of the department requisitioning the good; goods used in the order they were purchased.
 - The benefits of using FIFO;
 - Based on most recent prices
 - Generally realistic, sales made from the oldest item of inventory first especially if perishable
 - Acceptable under IAS 2
 - Issued prices based on prices actually paid for purchase
 - Relatively simple system to use
 - The drawbacks of using FIFO;

- In times of inflation, closing inventory will be priced at the latest prices causing a lower cost of sales and higher gross profit.
- Identical items from batches bought at different times for similar jobs will be charged at a different price, making it unreliable.
- Average cost (AVCO) – requires calculation each time new goods are received, when materials are returned to stock they should be valued at price of issue, this is a perpetual inventory system this is valued by adding the new purchased invoice to the present inventory and dividing it by the purchased quantity and the existing number quantity to obtain weighted average.
 - The benefits of using AVCO;
 - Avoids inequality of identical items being charged differently for similar jobs.
 - Smoothen variation in production costs making comparisons more meaningful.
 - Closing inventory valued fairly close to latest price
 - Acceptable under IAS 2.
 - Weighted average price recognises all issues have equal importance.
 - The drawbacks of using AVCO;
 - Average price must be calculated after every purchase.
 - Average price does not represent any price actually paid for inventory.
- Periodic inventory system is where the business calculates the value of the closing inventory at the end of a period instead of prior to each receipt. Closing inventory is calculated by **opening inventory + purchased qty – issued qty**
- If its FIFO per unit will be the last purchased price and if its AVCO per unit of closing inventory will be:
 - $\frac{\text{Opening inventory (amount) + purchases(amount)}}{\text{opening inventory (units) + purchases(units)}}$
- Ways in which labour is paid
 - Hour rate – common method direct workers
 - Piece rate – based on the level of output
 - Annual salary – usually for office staff or managers as an indirect labour cost.
 - Employees may also receive additional amount such as overtime and bonus payments
 - Using overtime and bonus payments are beneficial as;
 - Increase productivity
 - Greater number of units, maybe increase total profits.
 - However,
 - Rush workers at the expense of quality.
 - If Extra production cannot be sold, inventory holding cost will increase.
 - May not be able to pass the extra cost to customers

3.2. Absorption costing

- Apportionment of overheads to cost centres.

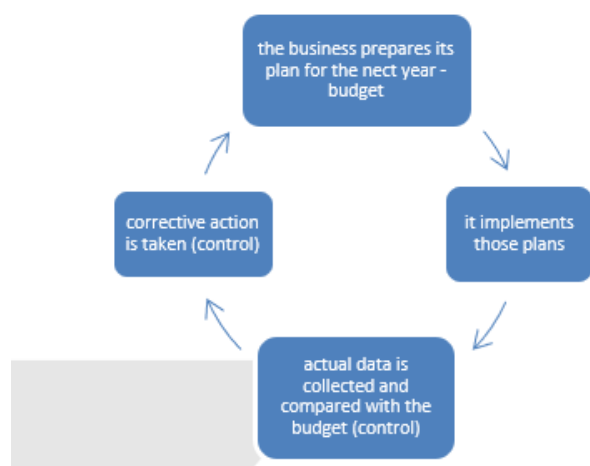
- Cost centres are any location in a department to which costs may be attributed.
- Production cost centres are locations which are directly involved in producing goods
- Service cost centre are locations which are not involved in the production of goods but provide services for the production cost centres eg, stores.
- Allocation of costs is charging costs directly to the cost centres which can be directly identified with them, for instance wood, metal, plastic, components and chemicals are allocated to the production department. Packing materials are allocated to the packing department.
- Apportionment of cost is the process of charging costs to cost centres using a suitable basis, these costs cannot be directly identified with a single cost centre.

Overhead	Basis of apportionment
Rent and rates, heating and lighting, building depreciation, insurance, building expenses, rent	Floor area
Actual consumption	Power
Depreciation, insurance of plant and other machinery	Cost or replacement value of asset
Storekeeping costs, material handling costs	Store requisition
Welfare costs, canteen costs, administration costs, supervision	No. of employees
Machines repairs	Machine hours

- Steps to absorption costing
 - if a manufacturer has four production cost centres; moulding, machining, painting and packaging, Given basis for each department for rent is floor area of $1000m^2$, $700m^2$, $500m^2$ and $300m^2$ respectively. If rent was 45000 dollars, the cost will be apportioned as below

Expense	Moulding	machining	Painting	Packaging	
Rent		18000	12600	9000	5400

- This is known as primary apportionment Overhead analysis sheet



- After apportionment, If the service cost centres provided services to the production cost centres they will need to be reapportioned to the production centres on suitable bases, the simplest and quickest method is the elimination method (this is where the service costs are apportioned using bases which don't involve the service cost centre in question).
- Another method is the reciprocal method as shown below where the cost centres are apportioned until they reach immaterial values

	Assembly \$	Finishing \$	Maintenance \$	Canteen \$	Total \$
Total from above	17,350	23,970	18,600	6,600	66,520
Reapportion canteen	2,200	3,300	1,100	(6,600)	-
Reapportion maintenance	9,850	7,880	(19,700)	1,970	-
Reapportion canteen	657	985	328	(1,970)	-
Reapportion maintenance	164	131	(328)	33	-
Reapportion canteen	11	17	5	(33)	-
Reapportion maintenance	3	2	(5)	0	-
Total	30,235	36,285	0	0	66,520

- Calculating the Overhead Absorption Rate [OAR] : rate at which costs are apportioned to a cost centre are charged to the cost unit passing through it, OARs are used to calculate overhead attributed per unit, it is calculated by:
 - budgeted production overheads/budgeted activity level (labour hours or machine hours)
- Usually both direct labour and machine hours are given**, always** choose the greatest and **never** add the two sets together
- Once the OAR rate is found this will be multiplied by the number of hours used to make the product to obtain the amount of overhead absorbed per unit
- Under/over absorption is calculated by:

Actual overheads	XXX
(less) absorbed overhead (OAR * actual hours)	(xxx)
Under absorbed	xxx

- If absorbed overheads was however greater than actual overheads then this will result in over absorbed
- Reasons for under absorption
 - Actual expenditure is greater than budgeted
 - Production is less than the planned level, not enough overheads has been charged to production.
- Reasons for over absorption
 - Actual expenditure is less than budgeted expenditure
 - Actual production is more than the planned level, too much overhead was charged to production.
- Benefits of absorption costing
 - Acceptable under IAS as well as GAAP
 - Accounting for all production cost not just direct cost hence giving a complete picture of the cost per unit, more realistic selling price as a result
 - Gives a better view on profitability than variable cost especially if not all products are used during the same period.
 - Better suited for companies which have constant demand for products
- Drawbacks of absorption costing
 - As this is based on both fixed and variable costs, this method cannot be used for management decision making or planning further actions like budgeting
 - Absorption makes it difficult to do cost volume profit analysis, as with additional fixed cost, the variations in the variable cost becomes difficult to determine. Making it difficult to assess efficiency and effectiveness.
 - Profits are needed to be adjusted for over and under absorption of fixed costs, this can make the calculation of profits difficult and complicated especially when the company has too many products.

3.3. Unit, job and batch costing

- Continuous operations are typically those in which a single type of good is produced and the cost units are identical. Production may involve a sequence of continuous or repetitive operations such as oil refining. Continuous costing is used to find the cost of a single unit of production [unit costing = total cost/output]
- Specific order operations are those which are performed in response to special orders received from customers, this may be job or batches
- Job costing is a costing method that calculates the cost of meeting a specific customer order or job such as re painting a house

A job quotation may look like

Job no.282

Installation of central heating at xxx

	Estimated costs \$	Actual cost \$
Materials	2800	2670
Labour	1800	2150
Overhead	3500	3380
Total cost	8100	8200

	Estimated costs \$	Actual cost \$
Add: profit 25% of cost		
Amount of quotation	2025	1925
	10125	10125

- Once the quotation is accepted the costs will be recorded on the job card as incurred, the actual costs may however differ from the quoted amount, in that case the business is only charging the quoted selling price hence causing profit to either increase or decrease
- Job cards would provide useful information the next time the business receives a request for a similar job, directors can identify areas of overspend and take corrective action for future jobs since they are focused on a specific area.
- Batch costing is where the costing procedure to find the cost of a number of identical items produced
- Similar to job costing the selling price on the quotation will be agreed and fixed, if everything goes as per plan the same profit may be made however if costs prices or labour hours deviate this might cause profits to fall
- This allows the business to plan for its future.

Costs for a batch of 500 chairs

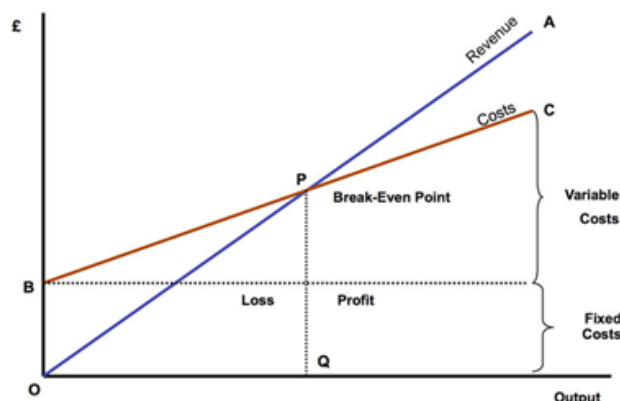
	\$	\$
Direct materials		X
Direct labour : Machining	x	
Finishing	x	
Assembly	x	
Prime cost		x
Production overhead recovered (no of hours * OAR)		x
Machining		x
Finishing		x
Assembly		x
Cost of production		x
Add: administration costs		x
Total cost of batch of 500 chairs		
Profit		x
Selling price		xx

3.4. Marginal costing

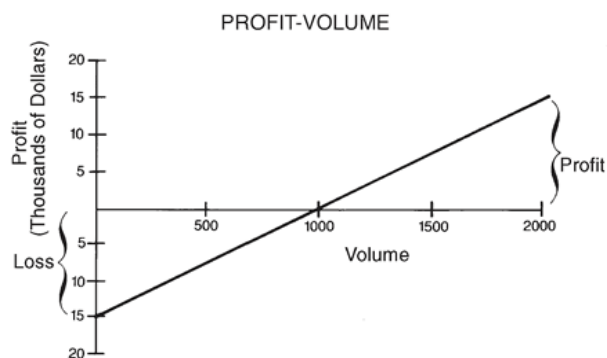
- Marginal costing is the cost of making an extra unit of output.
- Contribution is the difference between the selling price and the variable cost of a unit of output.
 - selling price - variable cost per unit
- Contribution to sales ratio (C/S ratio) is the ratio of contribution to the selling price, calculated by;
 - $\frac{\text{contribution}}{\text{sales}} \times 100$
- Break even point is the level of output in which the business makes neither a profit nor a loss, total contribution is exactly equal to total fixed costs.
 - $\frac{\text{total fixed costs}}{\text{contribution per unit}}$ to find the breakeven sales this is multiplied by the selling price or the following

equation can also be used; $\frac{\text{total fixed cost}}{\text{ratio}}$

- If there the business has a target profit set the breakeven level of output will be calculated by:
 - $\frac{\text{fixed cost} + \text{target profit}}{\text{contribution per unit}}$
- Breakeven charts are diagrammatic representation of profit or loss to be expected from the sale of a product at various levels of activity.



- Cost volume profit analysis is a way of finding out how changes in variable and fixed cost affect a firms profit. These are used by companies to see how many units they need to sell to breakeven or reach a certain minimum profit margin.
- Margin of safety is the difference between the breakeven point and the level of sales, this is found by total units sold - breakeven level of output or the following equation is used to calculate margin of safety rate $\frac{\text{profit}}{\text{ratio}}$
- Profit volume chart is a type of breakeven chart which only shows the profit of loss at each level of output.
- At 1000 units of output the business incurs neither a profit nor a loss, the units exceeding the BEO is the margin of safety which is 1000 units.



- Limitations of breakeven charts
 - it assumes there are no changes in the level of inventory, everything produced is assumed to be sold during that period which is unrealistic.
 - It doesn't allow for a mix of products and is usually calculated for a single product which.
 - Cost behaviour is assumed to be either fixed or variable, so semi variable costs are not considered. Similarly stepped costs are also not included
 - Variable costs are assumed to be perfectly linear with the level of production so changes in costs such as

bulk purchase discounts or overtime rates aren't considered.

- The selling price is assumed to remain fixed throughout the year so seasonal sales or discounts aren't considered, this is misleading.
- Advantages of breakeven analysis
 - Charts are easy to construct and understand
 - Provides useful guideline for managers like breakeven points, safety margins when taking decisions such as on ordering raw materials and budgeting.
 - Comparison between different options and draw a new chart to show changing situations such as a price increase.
- Acceptance of orders below normal selling price
 - When the order results in a contribution to cover fixed costs, the selling price must exceed marginal cost of production
 - To maintain production and avoid laying off skilled workforce during off season
 - To promote a new product.
 - To dispose of slow moving or redundant inventory
 - The business should consider if they have the available spare capacity.
- Make or buy decisions
 - if the marginal cost of production is below the price quoted by the supplier then the offer should be rejected.
 - The business should consider
 - Will the price offered by the suppliers change?
 - The quality of the supplies offered by the external supplier.
 - Will there be delays in delivery?
 - Is there an alternative use for the resources?
 - Will the business lose the services of skilled workers which may be difficult to replace at a later date?
- dropping a product
 - if a business is dealing with a range of products and one of which is deemed to be unprofitable, it may consider dropping the item from its range.
 - When the contribution is negative, but if the product has a positive contribution and a negative profit, it is favourable to continue the production as it would still be covering some of the fixed cost.
- choice of product where a limiting factor exist
 - a limiting factor is anything that limits the quantity of goods that a business may produce. This may include the shortage of materials, labour and demand for a particular product.
 - When making the best use of limited resources the product must be ranked according to the amount of contribution they make from each unit of the scarce resource.
 - Step 1: calculate the contribution per unit
 - Step2: identify the limiting factor and limiting factor per unit
 - Step 3: find $\frac{\text{contribution}}{\text{limiting factor per unit}}$

- Step 4: based on the answer, state the rank in descending order
- Step 5: calculate the optimum production capacity, produce a revised production plan considering the shortage

- Marginal costing VS absorption costing
 - Marginal costing: using this method, fixed costs are treated as period costs and written off each period. Finished goods and work in progress are valued at marginal cost only i.e. variable costs.
 - In inventory valuation, when using marginal costing the closing inventory will only include the variable cost. While, in absorption the variable as well as some of the fixed overhead will be included hence giving a greater gross profit for absorption as closing inventory is valued more than marginal. This difference arises purely due to the way the fixed overheads are treated.

Format of an operating statement (marginal costing)

	\$	\$
Sales		x
(-) variable cost:		
Materials	x	
Labour	x	
Overheads	x	
(+) opening inventory	x	
(-) closing inventory \n $\frac{\text{total variable production cost}}{\text{total units produced}} \times \text{closing inventory}$	(x)	(x)
		x
(-) selling variable expenses		(x)
Contribution		x
(-) fixed costs		
Admin costs	x	
Production costs	x	(x)
Profit for the year		X

- Absorption costing uses all costs which are absorbed into production and thus operation statements do not distinguish between fixed and variable cost. Valuation of both finished and work in progress inventory contain both fixed and variable costs.

Format of an operating statement (absorption)

	\$	\$
Sales		x
(-) production costs		
materials	x	
labour	x	
fixed overheads	x	
(+) opening inventory	x	
(-) closing inventory $\frac{\text{total variable production cost}}{\text{total units produced}} \times \text{closing stock units}$	(x)	x

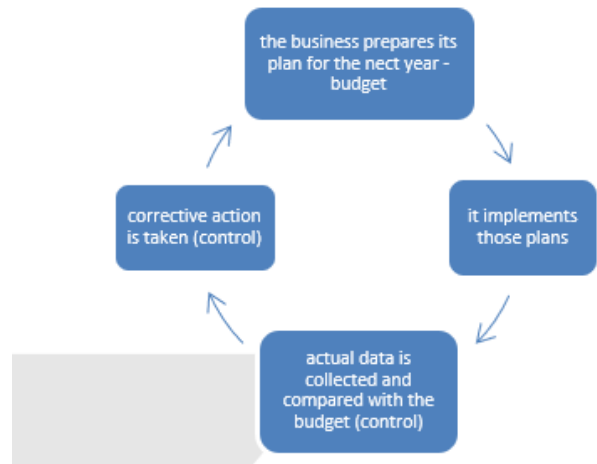
	\$	\$
gross profit		x
(-) fixed and variable operating expenses		
admin expenses		(x)
selling and distribution expenses		(x)
profit for the year		x

- Uses of marginal costing
 - Clear distinction between variable and fixed costs which is helpful in short term decision making.
 - Sees costs allocated to a time period so that it may be argued that profits for the time period is more accurate.
 - It is prudent to write off costs in the time period incurred and therefore marginal costing methods include accurate inventory valuation of and as well as profits.
 - Easy to operate but relied upon cost being split into fixed and variable. No arbitrary apportionment of fixed costs.
 - Shows clearly the impact on profit of fluctuations in the volume of sales.
 - Under and over absorption is not a problem hence no need to calculate and OAR
 - Can also be used with standard costing.
 - Shows relative contributions to profit that are made by each product and shows where the sales effort should be contracted.
- Disadvantages of marginal costing
 - Not all costs can be split into variable and fixed
 - Fixed costs don't in reality remain constant and variable costs do not vary according to levels of output, in the long run all costs are variable
 - Assumes production method remains constant which isn't the case in reality.
 - Contribution may vary if new techniques are followed in the production process.
 - It isn't useful for business with a range of products as allocating fixed costs to each product will be difficult with any degree of accuracy, making difficult to calculate the breakeven point.
- Uses of absorption costing
 - Includes all costs to product there it could be useful for management when fixing prices or reviewing of a product has been profitable.
 - It could be said that profit gives a true and fair view according to absorption costing
 - Helps set prices.
 - Used in the long run rather than short run.
 - More acceptable and realistic for financial statements.
- High low method : this technique uses the units and total cost at one level of activity compared to the units and total costs incurred at another level to calculate the variable cost per unit. This is used to split and find the fixed element and the variable element of a semi variable costs. Once variable cost is found, fixed costs can be found by deducting the variable cost from the total cost.

$$\bullet \frac{\text{highest cost} - \text{lowest cost}}{\text{highest activity} - \text{lowest activity}} = \text{variable cost per unit}$$

3.5. The application of accounting to business planning

- A budget is a short term financial plan of standard cost and revenue prepared for the future to control resources so that the business objectives can be achieved.
- Budgeting is the preparation of the budget for each budget centre.
- The planning process includes



- Planning – managers are responsible for planning and controlling a business and budgets are an essential tool for planning and controlling
- Rolling budgets is where as each year passes it is deleted from the budget and a budget for another year is added, making one year detailed and the following years less precise. Top down budgets are prepared by top management and handed down to departmental managers. Bottom up budget is prepared by departmental managers and although they tend to reflect local conditions better, they may be set easily achievable and may not fit with overall plan.
- Managers should concentrate their attention on items with adverse variance (where the actual performance deviates negatively from the budgeted) management accounts may report only the items with adverse variance this is known as management by exception or exception reporting.
- The need for budgeting
 - A forecast of income and expenditure (thereby profitability) helps figure out long term goals and works towards them.
 - A tool for decision making
 - A means to monitor business performance
 - Ensure the business doesn't spend money they don't have.
 - Helps build investment contribution into your budget
 - Helps the business be prepared in unforeseen instances

- Helps identify unnecessary expenditure and cut down on these
 - Ensure the business has money for future projects
 - Budgetary control refers to the responsibility that each budget centre has to justify the use of resources, control costs, achieve activities set by the budget in accordance with the business objectives.
 - Budgetary control delegates financial planning to manage it evaluates managers performance by comparing actual results with those set in the budget.
 - Advantages of budgeting and budgetary control
 - Facilitates long term planning, leads managers to think about the future and the direction in which the business is heading.
 - Promotes coordination between department.
 - Enables monitoring and control.
 - Acts as a motivator for employees.
 - Helps allocation and use of resources.
 - May provide a framework for delegation.
-
- Helps in decision making.
 - Helps identify areas where improvement is required before start of a financial period.
 - May help in securing finance as banks and lenders requires budget information.
 - Disadvantages of budgeting and budgetary control.
 - May demotivate staff if targets are set too challenging.
 - Time consuming and costly, requires specialist knowledge.
 - Can cause conflicts between department about resource allocation.
 - Can discourage innovation – budgets restrict activity managers fail to take advantages of unexpected opportunities as actions are restricted.
 - If managers are paid on their performance against the budget, they may build extra costs and reduce the revenue from the expected target to ensure they always beat it, this is referred to as budgetary slack.

CAIE AS LEVEL

Accounting (9706)

Copyright 2022 by ZNotes

These notes have been created by Qadirah Israth and Arcot Mohammed Ammar for the 2022 syllabus

This website and its content is copyright of ZNotes Foundation - © ZNotes Foundation 2022. All rights reserved.

The document contains images and excerpts of text from educational resources available on the internet and printed books. If you are the owner of such media, text or visual, utilized in this document and do not accept its usage then we urge you to contact us and we would immediately replace said media.

No part of this document may be copied or re-uploaded to another website without the express, written permission of the copyright owner. Under no conditions may this document be distributed under the name of false author(s) or sold for financial gain; the document is solely meant for educational purposes and it is to remain a property available to all at no cost. It is current freely available from the website www.znotes.org

This work is licensed under a Creative Commons Attribution-NonCommercial-ShareAlike 4.0 International License.