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AS- Level Accounting Unit 2 Revision Notes

Benstead Revision Notes:

Types of Business Organisation:

Sole Traders:

Advantages:

- Faster decision making
- Independence
- Quicker and cheaper to establish
- All profits belong to the sole trader
- Competitors know less about the business's success as the accounts don't have to be published

Disadvantages:

- Unlimited liability-can lose both business's assets and their own personal possessions.
- Capital is limited to the wealth of one individual. May limit business growth.
- Have to work long hours and have poor holidays and rewards

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- May feel isolated
- Ownership cannot be changed

Partnerships:

Advantages:

- More access to finance as there are more people to contribute
- More skills and expertise
- Management and responsibilities shared
- Workload and ideas can also be shared between partners

Disadvantages:

- Unlimited liability
- Profits or debts shared
- More difficult decision making as all partners have to agree
- Partnerships can be short lived due to death, retirement or withdrawal
- More complicated, expensive and time consuming to set up than sole traders

Limited Liability companies-both PLC and LTD:

Advantages:

- Limited liability-owners can only lose what they invest
- Can raise large amounts of finance through the selling of shares
- Separate legal entity to owners meaning that ownership can changes
- Ideas and be shared

Disadvantages:

- Complicated to establish-lots of legal requirements
- Annual accounts have to be sent to the registrar of companies
- People who originally establish the company can lose control as whoever owns 50+%of shares with voting rights controls the company

Accounting Concepts (BOGCRAMP):

- Business Entity-only information relevant to that business must be recorded. Not any personal uses.
- Objectivity-Factual information only must be recorded in the business accounts.

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- Going Concern-Assumes that the business will continue to trade for the foreseeable future.
- Consistency-requires that the business applies the same policies and procedures from one year to the next. E.g. depreciation.
- Realisation-Money should only be recorded when it is certain that it will be received.
- Accruals-Money, payments and receipts are matched for a time period when recording profit.
- Materiality-Only record significant expenses, e.g. paper clips wouldn't be recorded.
- Prudence-where there is doubt in the value of Assets, or the level of profit, the lower value must always be used. This makes sure that profit is not overstated.

Further Aspects of the Preparation of the Final Accounts and Balance Sheets of Sole Traders:

Sole Trader Income Statement Layout:

XXX Income statement for the year ending XXX

Sales

Less Cost of Sales

Opening stock

Purchases

Less closing stock

Gross Profit

Other Income

Less Expenses:

Rent

Wages

Rates

Advertising

Insurance

Motor Expenses

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Etc

Net Profit

Sole Trader Balance Sheet

XXX Balance Sheet as at (date)

Fixed Asset

Motor vehicles

Machinery

Current Assets:

Trade Receivables

Bank

Closing stock

Prepayments

Less Current Liabilities:

Trade Payables

Overdraft

Accruals

Less Long-Term Liabilities

Bank Loan

Balancing figure

Represented By:

Capital

+ Profit

-Drawings

Balancing Figure

Adjustments:

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Bad Debts Recovered-

This is recorded under 'Other Income' as bad debts recovered. This is added to gross profit.

Income due and received in advance-

Income due is added to the relevant income so that the business is able to keep a track of how much money they are owed. An example of when income might be due is interest due. The amount owed would be added to the relevant income, in this case interest due, which would be added to Gross profit under other income.

Income received in advance is included in other income added to gross profit. For example you this could happen with Rent: Only rent received for this year should be included in this year's profit and loss account. This means that if there are any payments for the next financial year, you have to deduct the extra amount from the amount from this year in the other income section of the income statement. E.g. if a business received a total payment of £42,000 for rent in advance, and £300 of it was for the next financial year, you would include only the £39,000 in this year's income statement under the other income section.

Provisions for Doubtful Debts-

Used to record the amount written off each year and shows the total depreciation to date.

Credit provision for depreciation with New Year's amounts

Debit income statement as an expense.

Depreciation-

Purpose-

The reason for recording depreciation is that it would allow the business to be prudent as the depreciation charge would be deducted from profit. This means that the loss of value of the fixed asset would be recorded.

Depreciation is the loss of value of fixed assets due to:

- Usage/wear and tear
- Passage of time
- Depletion (Not-Complete)
- Obsolescence (Out of Date)

There are two main methods of depreciation:

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1. **Straight line method-when you take off the same amount every year from your asset. Usually a % of the original cost**
2. **When you deduct as % of the latest value each year. This method is more realistic as it properly reflects the way assets lose value.**

Provision for Depreciation Account:

Used to record the amount written off each year and shows the total depreciation to date.

Credit provision for depreciation with New Year's amounts

Debit income statement as an expense.

Entries in the Ledgers-

Provision for Depreciation account-

For each new depreciation charge each year, you debit the new balance to the account, and then credit the account with the charge to the income statement. For example:

Balance b/f	5000	31st December 2007-P+L account	5000
		Balance c/d	5000
31st December '08 bal b/f	10,000	31st December 2008 P+L Account	5,000
		Balance c/d	10,000

Disposal of Fixed Assets account-

For Example (using the straight line method)

A Tractor worth £40,000, useful life of 5 years expected to be resold for £20,000.

Total loss of value: £20,000

Number of years: 5

Loss per year: £4,000

Accounts-

Provision for Depreciation Account:

Balance b/f	4,000	Yr1 Income statement	4,000
		Balance c/d	4,000
Balance b/f	8,000	Yr. 2 income statement	4,000
		Balance c/d	20,000

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Tractor Account:

Cash Book	40,000	Disposal	40,000

Disposal of Asset Account:

Tractor	40,000	Provision for depreciation Bank (Sale of Tractor)	20,000 15,000
		Loss on Sale (put on income statement as an expense)	5,000

Note: this is the same for reducing balance, just depreciation is calculated in the reducing balance way.

Also if a profit was made on the sale, the disposals account would be debited with 'profit on sale' and the amount. This would then be included under other income on the income statement added to Gross profit.

Capital and Revenue Expenditure and Income-

Expenditure:

Revenue-

Revenue expenses are costs in for the day to day running of the business for example servicing a machine, spare parts etc. Revenue expenditure is normally charged against profit in the Income statement in the year it is expensed.

Capital-

Capital expenditure is on an item that will help generate profits over the longer term (12 months or more) so a purchase of a machine or van etc.

Income:

Revenue-

Revenue income is all the income you get as part of your normal trade - say from the sale of goods or services.

Capital-

Capital income normally arises from the disposal of capital items - say if you sold one of the buildings from which you trade then the profit would be capital income. (But if your trade was dealing in property then the profit on the sale of a building would probably be revenue income.)

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Internal Final Accounts of Limited Companies:

Limited Liability:

Limited liability is when the owner can only loose what they have invested into the business. This means that no owners of the business cannot lose their personal possessions.

Authorised Capital:

Authorised Capital is how many of each type of share that the business had been authorised to sell. This is stated in the memorandum and articles of association.

Issued Capital:

This shows the actual number of each type of share that the company has issued to its shareholders. This cannot exceed the authorised share capital.

Ordinary Shares:

These are the most common type of share. They have voting rights meaning that they have the potential to take control of the company. Ordinary shareholders can decrease the dividend for the sake of the business, but they are not allowed to increase it for their own sake. Ordinary shares will receive their final dividends out of how much spare profit is left after the preference shareholders have been paid. The dividend that the ordinary shareholders get paid varies with the amount of profit.

Preference Shares:

They receive a fixed dividend that is expressed as a percentage of the nominal value of the share. They will only get a dividend if the company makes enough profit, but they do get paid before ordinary shareholders.

Preference shares are less risky investments as if the business were to go into liquidation, the preference shareholders would be paid first and therefore would be less likely to lose their investment.

Capital Reserves:

These are amounts set aside out of profits but that are not provisions. They arise from capital transactions and adjustments to the capital structure of the business. They are not available for transfer to the income statement so they are not available for cash dividend. Capital reserves include:

- **Share premium accounts**
- **Revaluation reserve**

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Revenue Reserves:

These reserves arise from the normal trading activities of the business. They are profits that have been held back from dividend distribution in order to strengthen the financial position of the company. If the directs do choose to use them, they can be distributed to the shareholders in the form of cash dividends. The two most common types of revenue reserves are:

- The general reserve
- Retained earnings

Shareholder's Funds:

This is made up of the share capital of the company and also all of their reserves. All of the reserves belong to the ordinary shareholders of the company as reserves are part of the shareholder's equity.

Loan Capital:

This is a form of long term borrowing such as a debenture.

Debentures are long-term loans to the company. A debenture is the legal document issued by the company that is managing their debt. Debentures are usually secured against the business's assets. Like all borrowing, the business has to pay regular interest. This interest charge is recorded as an expense on the income statement. This interest has to be paid whether the business makes a profit or not.

Debentures have either effect on the balance sheet:

1. Increase bank balance and increase non-current liabilities
2. Decrease bank overdraft and increase non-current liabilities

Debenture holders are not shareholders.

Debentures appear on the balance sheet as a non-current liability.

Evaluate Shares and Loans as Sources of Finance:

Loan:
This can take several forms, but the most common are a **bank loan** or **bank overdraft**.

A bank loan provides a **longer-term** kind of finance for a start-up, with the bank stating the fixed period over which the loan is provided (e.g. 5 years), the rate of interest and the timing and amount of repayments. The bank will usually require that the start-up provide some security for the loan, although this security normally comes in the form of personal guarantees provided by the entrepreneur. Bank loans are good for financing investment in fixed

assets and are generally at a lower rate of interest that a bank overdraft. However, they don't provide much flexibility.

A bank overdraft is a more short-term kind of finance which is also widely used by start-ups and small businesses. An overdraft is really a loan facility – the bank lets the business "owe it money" when the bank balance goes below zero, in return for charging a high rate of interest. As a result, an overdraft is a flexible source of finance, in the sense that it is only used when needed. Bank overdrafts are excellent for helping a business handle seasonal fluctuations in cash flow or when the business runs into short-term cash flow problems (e.g. a major customer fails to pay on time). Two further loan-related sources of finance are worth knowing about:

Share Capital- Outside Investors

For a start-up, the main source of outside (external) investor in the share capital of a company is **friends and family** of the entrepreneur. Opinions differ on whether friends and family should be encouraged to invest in a start-up company. They may be prepared to invest substantial amounts for a longer period of time; they may not want to get too involved in the day-to-day operation of the business. Both of these are positives for the entrepreneur. However, there are pitfalls. Almost inevitably, tensions develop with family and friends as fellow shareholders.

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Layout of limited company income statement:

Example of an Income Statement Layout:

Income Statement for X for the year ending XXXX

	£	£
Sales		
Less Returns In		
Less Costs of Goods Sold		
Opening Inventory		
+ Purchases		
- Returns Out		
- Closing Inventory		
Gross Profit		
Less Expenses		

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	XXXXXXX
	(XX)
	XXXXX
XX	
XXX	
(X)	
(XX)	
	(XX)
	XXX
	(X)
	XX
(X)	

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Layout of limited company balance sheet:

Balance Sheet Example

Balance Sheet for X as at 31st March XXXX

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	£	£	£
Fixed Assets:			
Van	XXXXX	(XX)	XXX
Current assets:			
Trade Receivables	XX		
Prepayment	X		
Bank	XX		
		XXXXX	
Current Liabilities:			
Trade Payables	X		
Accruals	XX		
		(XXX)	
			XX
			XXXXX
Long Term Liabilities			
Bank Loan			(XXX)
Balancing Figure-			XX
Shareholder's equity			
Ordinary shares of £1 each fully paid	XXX		
Share premium account of £1.50 each fully paid	XX		
General Reserve	(XXX)		
Revaluation reserve			XX
Retained Earnings			
Balancing figure			

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Operating profits are the profits that have been made by the business from their everyday trading activities.

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Interim dividends:

These are dividends that are paid half way through the financial year. They are based on the half-yearly profits. This is recorded in the income statement deducted from profit for the year.

Final dividends:

These are the dividends that are paid at the end of the year. They are also recorded in the income statement deducted from profit from the year.

Share Premium:

This is the shares that are sold above the nominal value. This are recorded on the balance sheet under the shareholder's equity.

Provisions for Corporation Tax:

Corporation tax is the tax that the business has to pay. It is deducted from profit for the year on the income statement.

Account for the revaluation of fixed assets:

Non-Current Assets Account

Balance b/f	400,000		
Revaluation Reserve	200,000		

Provision for Depreciation of non-current assets account

Revaluation Reserve	50,000	Balance b/d	50,000

Revaluation Reserve

		Non-current assets	200,000
		Depreciation of non-current assets	50,000

The Difference between a rights issue and a bonus issue of shares and the effect on the balance sheet:

Bonus:

Bonus issues are shares issued free of charge to shareholders. When a company accumulates a large fund from profits, much beyond its needs, the directors decide to distribute a part of it among the shareholders in the form of bonus

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Rights:

Right shares are issued to existing shareholders who have the privilege to buy a specified number of new shares from the firm a specified price within a specified time, the intention is to raise the capital

Ratio Analysis:

Profitability-

- **Gross Profit Margin-Gross Profit x 100 = X%**

  Sales

Gross Profit margin shows what percentage of sales revenue ends up as gross profit. If DIRECT COSTS (costs directly related, materials, direct labour, direct expenses.) Are rising, this percentage will fall. If this percentage is low, it allows the owner to identify problems with direct costs.

- **Gross Profit Mark Up: Gross Profit X 100 = X%**
  Costs of goods sold

This measures how much the selling price is adjusted from the costs of purchase of raw materials to make profit.

- **Net Profit Margin-Net Profit x 100% = X%**
  Sales

Net profit margin shows what percentage of sales revenue ends up as net profit. If it starts to fall over the years it is because the indirect costs (overheads-rent, wages etc) are getting out of control.

- **Return on Capital Employed (R.O.C.E)**
  Net Profit X 100 = X%
  Capital Employed (the balancing figure from Balance sheet)

Shareholders like to see this figure. It shows what percentage of the money invested into the business is being returned as net profit each year. If this figure falls, the company is not using the money invested well enough.

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Liquidity-

- **Current Ratio: Current Assets / Current Liability = X:1**

This shows how many pounds worth of current assets there are for every pounds worth of current liability. A company should aim to have between £1-£2 of current assets with which they can pay off their current liabilities.

- The Acid Test: Current Assets-Stock / Current Liability = X:1

Stock is difficult to sell and turn into cash quickly. If we take stock out of our equation we can see how well the business can pay off it's short term liabilities with their most liquid assets.

This should be at least 1:1. The company should have just enough cash to cover short-term debts.

Efficiency Ratios:

- Debtor Collection Period: debtors / Credit sales X 365 = X days

This shows how many days it takes for debtors to pay up. 30 days is the longest this should be. The company needs to encourage early payment by introducing a credit control system, where by reminder letters are sent out, then interest is charged on outstanding amounts.

- Creditor Payment Period: Creditors / Credit purchase X 365 = X Days

This shows how many days it takes for the business to pay their creditors. Again, it shouldn't be any longer than 30 days. It is best to settle up soon and avoid interest charges-or even worse-losing discounts or other benefits with that supplier.

- **Rate of Stock Turnover**

Average Stock (opening stock +closing stock /2) X 365 = X Days

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Costs of Goods Sold

This shows how many days it takes to turn stock into sales. The more times the stock if turned over, the more chances the business has to make a profit. It is important that a company avoids holding too much stock, in order to avoid the following costs:

Warehousing Costs

Risk of theft or deterioration of stock

Insurance

Ordering stock too often, though can result in high delivery charges, ideally, a company will aim for a 'happy balance' that suits their needs-known as the economic order quality (EOQ).

- **Overheads in relation to turnover:**

$$\frac{\text{Expenses}}{\text{Sales}} \times 100 = X\%$$

This ratio shows how much of their sales has to be used to pay the expenses of running the business. Reducing expenses will improve this figure.

- **Gearing:** $\frac{\text{Creditors falling due after more than one year}}{\text{Capital and Reserves}} \times 100 = X\%$

This ratio should be less than 50%. This means that the business should have £2 of assets for every £1 of long term debt.

Over 50%-highly geared

Less than 50% low geared

High gearing put the business at risk as the external lenders could ask for their money back at any time if they see a chance of the business failing. They could also raise interest rates payable to reflect the risk. However, the business may not be seen to be performing at its full potential if it is very lowly geared. This ratio can be improved by repaying some long term loans.

Difference between Cash and Profit and the Effect of Transactions on Profitability and Liquidity

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Profits and cash are not necessarily the same for the following reasons. Some accounting entries have an effect on profit but not effect on cash:

- Depreciation of fixed assets
- Provisions for doubtful debts

Some accounting entries have an effect on cash but no effct on the calculation of net profit:

- Purchasing fixed assets
- Borrowing money (including debentures in the case of a limited company)
- Repaying loans (including debentures in the case of a limited company)
- Owner's drawing (or dividends in the case o limited companies)
- Additional capital introduced by the owner (or the issue of shares in the case of limited companies)
- Payment of tax

Some other transactions have an immediate effect on profit but a delayed effect on cash:

- Credit Sales
- Credit Purchases
- Expense Accruals

Some other transactions have an immediate effect on cash, but a delayed effect on profit:

- Unsold stock
- Prepayments
- Purchase of a fixed asset (leading to depreciation of the fixed asset)

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There are limitations of accounting statements and ratios when assessing a business:

- Ratios deal mainly in numbers – they don't address issues like product quality, customer service, employee morale and so on (though those factors play an important role in financial performance)
- Ratios largely look at the past, not the future. However, investment analysts will make assumptions about future performance using ratios
- Ratios are most useful when they are used to compare performance over a long period of time or against comparable businesses and an industry – this information is not always available
- Financial information can be "massaged" in several ways to make the figures used for ratios more attractive. For example, many businesses delay payments to trade creditors at the end of the financial year to make the cash balance higher than normal and the creditor days figure higher too.

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Budgeting and budgetary control:

Budgets are a plan of finances.

The Benefits include:

- **Allows business to make good financial decisions**
- **Incomes and outgoings are planned**
- **Helps when setting targets**
- **Can help motivate different departments**
- **Major part of overall strategic plans**
- **Helps make management of resources more efficient and better cost control**

Limitations:

- **Budgets are only as good as the information used to create them**
- **Can become an overriding goal leading to misuse of resources**
- **Budgets can be demotivating if not agreed and negotiated but imposed**
- **Can lead to compliancy or underperformance**
- **Can lead to department rivalry**

Master Budgets:

Made up of

1. **A budget manufacturing account**
2. **A budgeted trading account**
3. **A budgeted income statement**
4. **A budgeted balance sheet**

Master budgets are where all of the different department's budgets are pulled together.

Budgetary Control:

Performance is evaluated continuously by comparing actual results achieved to those set in the budget.

Cash Budget Layout:

	May	June	July
Receipts:			
Cash Sales			
Trade Receivables 1 month			

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Trade Receivables 2 month

Payments:

Trade Payables

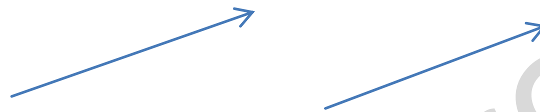
Rent

Wages etc.

Net Cash Flow (Receipts – Payments)

Opening Balance

Closing Balance



The previous months closing balance becomes the next month's opening balance.

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The Impact of ICT in Accounting:

ICT can be used in accounting for keeping and updating the double entry system, stock records, debtor analysis and the preparation of budgets.

Benefits:

- Greater accuracy-automatic and error free
- Greater speed
- Simultaneous updating
- Improved accessibility
- More information available
- Cuts in staff costs

Drawbacks:

- Capital expenditure-cost of machines and software. Economic life can be quite short
- Training costs-of training the staff to use the equipment
- Staff morale could be lowered
- Risk of data loss and security breaches can be vulnerable to crashes, viruses and hacking.

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