

Executive Summary

Firstly, the report lists out the benefits of keeping a proper accounting records and followed by, a brief description of how a computerized accounting system works.

Secondly, it lists out the possible benefits gained from the setup of a cost accounting system and a brief description job costing, the most suitable costing method in your business.

Finally, it states out the disadvantages of a sole trader and both advantages and disadvantages of a limited company.

The report recommends the immediate setup of both accounting and job costing system. The changeover of current business into a form of limited company is to be delayed.

CONTENTS

Executive Summary	0
1 Introduction	2
2 Findings	3
2.1 Records Keeping	3
2.2 Cost Information.....	7
2.3 Personal Exposure	10
3 Conclusions	13
4 Recommendations.....	14
Appendix - Reference and Bibliography	15

1 Introduction

On 29 October 2001, I was appointed by you, Mr. Godfrey Boycott, in carrying a brief review of your business operations and to recommend any improvements if found.

It is noted that you are running a special engineering business which consists of 5 employees and operated as a sole trader's business. You are concerned about the preparatory works within your business in matching the possible expansion of your business you foresee in the near future. You are also interested in the benefits of turning your business into a limited company.

This report analyses the findings of my review and lists out my recommendations for your consideration.

2 Findings

Findings fall mainly into three categories: namely, records keeping, cost information and personal exposure.

2.1 Records Keeping

It is found that there is no proper accounting records and a summary of bank statements was prepared and submitted to the Inland Revenue every year. The current record keeping method is insufficient and if not improving, a lot of troubles might come out. At least, annual financial statements which include profit and loss account and balance sheet should be prepared for the reasons stated below.

2.1.1 Reasons for improving daily record keeping

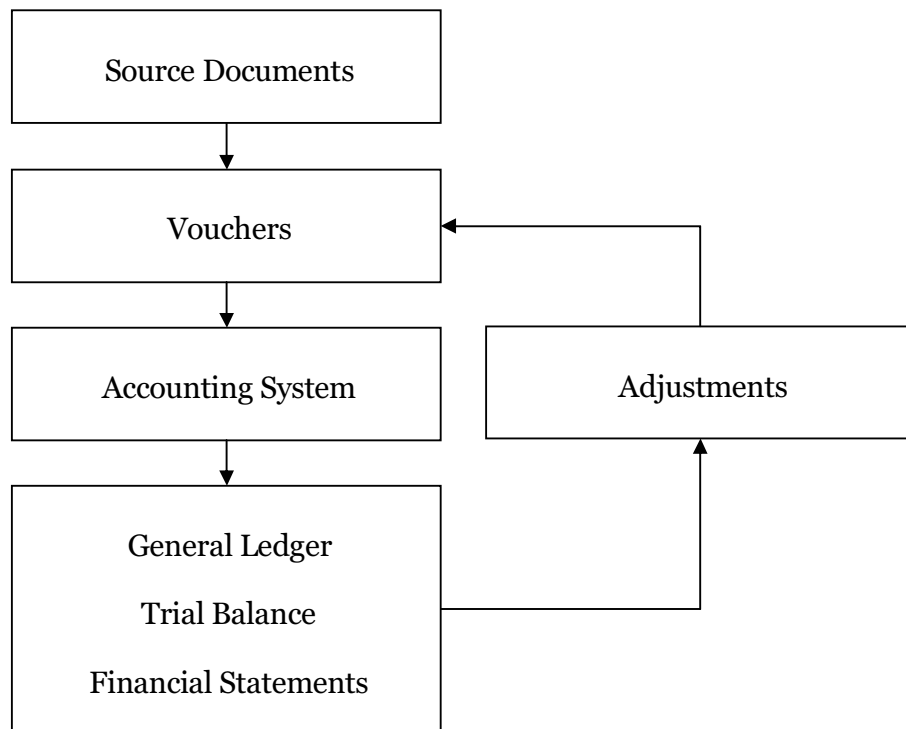
- (a) *Business failure*: The success or failure of a business usually depends on the result of a few important business decisions. More often, those who failed, were not because of the insufficient efforts put by them, but rather, had made improper or poor business decisions based on inaccurate and outdate information.
- (b) *Good defense for tax*: There would be nothing better than having a proper set of documents supporting the profits return filed to Inland Revenue when investigated by the tax inspector from a random sample return he chose. A summary of the bank statement is not sufficient and does not show a complete picture of how the business performed as some of the business transactions may be in the form of cash.

- (c) *Business performance:* It is very important to know - whether the business is making profit or loss; what the financial position of the business is at a particular time; who owes the business and to whom the business owes; how the cash comes into the business and how the cash drains out. This can only be done if and only if a proper accounting system is kept. These kinds of financial information are very important and would form the bases of many crucial decisions, such as expand the business or not.
- (d) *For others:* You are the only person who knows and keeps controls of everything to your business. No one else knows what has gone on in the past, with no records system to provide continuity. Moreover, it is very often that bankers or other lenders are primarily concerned with borrower's ability to pay interest and repay of capital in future and of the possibility and the consequences of a default. They need the financial statements to tell the story.

With the help of modern information technology, keeping records is not as complicate as before. A brief description of the accounting system is listed out to let you have a rough idea on how it works.

2.1.2 Brief description of an accounting system

- (a) Nowadays, most of accounting records are kept by computer because both the hardware and software are much cheaper than ten years before. Thus, the illustration will be on a computerized accounting system and shown in the following diagram:



- (b) *Source documents:* These are the documents to substantiate transactions of a business, for example, an electricity bill, a purchase invoice, a bank advice, a cheque, etc.
- (c) *Vouchers:* Based on the source document, a voucher is prepared and is keyed into the accounting system once the voucher is authorized by a suitable person.
- (d) *Accounting system:* The accounting system will then make a simple reasonableness check of the voucher, like, existence of the account, reasonableness of the amount, whether the voucher itself is balanced etc., before it ask for the permission to post permanently to the accounting systems.

- (e) *General ledger, etc.:* After all the vouchers are keyed and posted into the system, the accounting system is able to produce general ledger, trial balance and financial statements. General ledger is a book showing all the accounts with details of all transactions recorded inside each account. Trial balance is a list of all account balances. Financial statements generally mean a statement of profit and loss account and a balance sheet. Profit and loss account shows whether the business is making a profit or loss and a balance sheet lists out the assets and liabilities of the business.
- (f) *Adjustments:* There might be at times, errors or omissions are found that the accounts have to be adjusted. Then an adjusting voucher will be prepared to correct the mistake.

2.2 Cost Information

During the review, it is noted that there is no cost accounting system at all. This is often detrimental to a business in the long run.

Before elaborating more on the benefits to be gained from a cost accounting system, perhaps, a brief description of a costing method would help you understand more on this subject. Due to the nature of your business, job costing is the most suitable costing method to be applied and hence, it is used as an illustration here.

2.2.1 Brief description of job costing

- (a) *Job Costing*: Simply, it is the ascertainment of all the costs attributable to the order.
- (b) *Basic formula*: Put it in formula, it would be like this:

$\text{Job cost} = (\text{Direct costs} + \text{Overheads absorbed}) \text{ of order}$

The direct costs in this formula are the direct material, wages and expenses used on the order. Overheads are those costs other than direct costs.

- (c) *Job card*: A job card is usually required for collecting cost data, like, the direct material, expenses, wage rates, labour hours, workshop overheads, selling and distribution costs. A specimen is available if required.

- (d) *Brief details:* Each order is given a job card with a specific job number that identifies it from every other job. All direct costs and overheads are recorded in the job card. Finally, when the job is sold and delivered, a share of selling and distribution costs is also added to the job card. Now the total cost of the job can then be added up and profit (or loss) of the job can be easily calculated.

With some background on job costing method, benefits on implementing the cost accounting system are listed as follows:

2.2.2 Benefits from implementation of cost accounting system

- (a) *Pricing:* Quite often, your customers will ask for a quote for a specific job and certainly, you, being an expert in this field, have a rough idea of how much to charge for the job by adding up the required material costs, labour costs and a honourable percentage of profit. Unless all the costs and the time required for the completion of the job are definitely known, there may be cases of undercharging or in fact, making an actual loss.
- (b) *Performance:* Here it does not merely mean the profitability of each job; it broadly includes performance of all economic resources in the business, like the efficiency of workers, the productivity of machinery, the utilization of the business capacity etc. With a proper cost accounting system and the application of variance analysis (mentioned below), economic performance of business resources can be measured.

- (c) *Cost control:* Having ascertained all the costs, whether direct or indirect, during the implementation of the costing system, it would become easier to identify areas for cutting or monitoring the costs.

For example, keeping certain materials in the store is a kind of cost: the cost of space and the cost of funding for the material. To cope with this issue, there are inventory controls like, economic ordering quantity and reorder stock level. But this kind of inventory control requires the implementation of a costing system.

- (d) *Budgets:* Budget is defined as a planned result that a business aims to attain. The possible expansion of the business requires a lot of plans beforehand which need to be quantified into meaning budgets. Costing system will assist in providing some useful data for the preparation of those budgets.
- (e) *Variance analysis:* As budgets were set up, actual results can then be compared with the budgets to obtain variances. From the analysis of the variances, performance of the business resources can be measured.
- (f) *Decision-making:* For making a business decision, it has to be based on some solid data which is relevant to the decision. In other words, by ascertaining and comparing all the relevant costs of each alternative, a fair decision can be made in view of monetary factor. Surely, there might be other factors need to be considered as well for the best decision to be made.

2.3 Personal Exposure

It is noted that in order to guarantee a bank overdraft for the business, you have given the bank a second mortgage of your house as security. If something adverse to the business occurs, your house will be sold by the bank to settle the debts. It seems that it is unwise to give the bank a second mortgage. In fact, it is not the case and will be discussed in the following section.

2.3.1 Disadvantages of your current business setup

- (a) *Unlimited liability:* The sole trader is personally liable for the debts and liabilities of his business. The owner is not separate from his business, if he cannot settle his business debts; his creditors can look to his house, car or other personal assets.

In your case, the bank can always ask for the sale of your house to settle the overdraft which is default in payment. Surely, the bank would ask for a second mortgage on your house because it can have a second priority ranking to obtain payment other than the first mortgagor.

- (b) *Absence of continuity:* Once the sole trader lost his ability to run the business, which might due to severe illness or death, the business will be terminated.
- (c) *Restrictions on expansion:* A sole trader runs the business on his own, he has no partners nor can he introduce other people to invest in the business.

As more and more businesses are set up in the form of a limited company, both advantages and disadvantages of a limited company are discussed below:

2.3.2 Advantages of a limited company

- (a) *Limited liability*: The owners are called shareholders who own the limited company but will not be liable for the debts incurred by the company in the course of business. Thus their personal assets can be protected.
- (b) *Ability to raise finance*: It is much easier for a limited company to raise finance for business which can be done by way of issuance of additional shares to existing shareholders or to new shareholders, or issuance of debenture, or execution of floating charges on company's assets to borrow money.
- (c) *Perpetual succession*: The death of any shareholder will not affect the life or continuity of a limited company because the shares can be transferred from the deceased shareholder to his estate.
- (d) *Transfer of ownership*: The ownership of a limited company can be changed smoothly without disrupting the operations of the business as a going concern. Whereas in the case of sole trader, such a transfer would be hardly completed without disruption of the operations.
- (e) *Expansion and size*: It is easier for a limited company to expand its size since it can have up to 50 shareholders in case of private company (and no such limitation to public company). Whereas by law, the maximum number of partners in a partnership is only 20.

2.3.3 Disadvantages of a limited company

- (a) *Pre-incorporation expenses and annual formality expenses:* A limited company is formed by registration under the Companies Act and must comply with a number of formalities such as preparation of the Memorandum and Articles of the Association of the company; payment of registration fee; convening of the annual general meeting every year; costs relating to annual return and audited account. All these formalities usually required professional assistance from either accountants or solicitors. Also, most of the information concerning a company is open to public, for example the identity of directors or shareholders are registered with the Registrar of Companies and can be searched by the public.
- (b) *Tax Rate:* Compared with sole trader, limited companies are subject to a higher tax rate.
- (c) *Difficulties and expenses in closed down the business:* The only way to terminate the operation of a company is to wind up the company. This involves complicated legal procedures, lengthy in time and would require a lot of expenses.

3 Conclusions

It is found that the current record keeping method is not sufficient and a proper accounting system is definitely needed. Also, a proper costing system based on the job costing method would enhance performance evaluation of business resources and provide information for better decision making.

Whether the current form of business as a sole trader needs to be turned into a limited company, would largely depends on how the business would expand and how the funding for the expansion can be obtained. In view of the current economy, a budget for the expansion is required before the decision can be made.

4 Recommendations

On the basis of the above findings and conclusions, it is recommended that :

A proper accounting system should be set up as soon as possible and in the same time a job cost accounting system can be set up as well, in order to avoid possible duplication of works and to enhance the integration of the two systems during the set up.

Moreover, the changeover of current business as sole trader to a limited company should be postponed until a concrete expansion of business is feasible.

Appendix - Reference and Bibliography

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