Topic Overview	
Topic	Strategies and Management E4: Resources Management – Concepts of incomes, expenses and retained earnings
Level	S3
Duration	3 lessons (40 minutes per lesson)

Learning Objectives:

1. Understand the concept of income, expenses and retained earnings in accounting sense,
2. Understand the definition of periodicity assumption, and know its importance in income measurement,
3. Define and apply both the accrual basis of accounting, and
4. Understand the importance of the matching principle to expense recognition and income measurement.

Overview of Contents:	
Lesson 1	Concepts and Characteristics of Incomes
Lesson 2	Concepts and Characteristics of Expenses
Lesson 3	Concepts and Characteristics of Net Profits and Retained Earnings

Resources:

- Topic Overview and Teaching Plan
- PowerPoint Presentation

Suggested Activities:

- Class Discussion
- In-class exercise

Lesson 1	
Theme	Concepts and Characteristics of Incomes
Duration	40 minutes

Expected Learning Outcomes:

Upon completion of this lesson, students will be able to:

1. describe the concept of accounting income,
2. define the periodicity assumption, and know its importance in income measurement, and
3. describe and apply the concept of accrual for the calculation of income.

Teaching Sequence and Time Allocation:

Activities	Reference	Time Allocation
Part I: Introduction		
✧ Teacher starts the lesson by a discussion regarding how to determine the financial performance of a business.	PPT #2	3 minutes
Part II: Content		
✧ Teacher defines income, introduces the concept of accrual principle and explains the characteristics of income.	PPT #3 – 5	7 minutes
✧ **Activity 1: Class discussion** ■ Students are invited to give examples of incomes for themselves and their parents. ■ Teacher compares the answers provided and points out there are only very few types of income. In fact, it is the same as business income.	PPT #6 PPT #7	5 minutes 2 minutes
✧ Teacher explains the concepts of income in business. ✧ Teacher further explains the concept by using an example of sales of goods.	PPT #8 – 11 PPT #12 – 13	12 minutes 4 minutes
✧ **Activity 2: In-class Exercise** ■ Based on the illustrative example, students are required to do the same calculation. ✧ Teacher goes through the answers and makes conclusion.	PPT #14 PPT #15	3 minutes 2 minutes
Part III: Conclusion		
✧ Teacher concludes the lesson by reviewing the key points covered.		2 minutes

Lesson 2	
Theme	Concepts and Characteristics of Expenses
Duration	40 minutes

Expected Learning Outcomes:

Upon completion of this lesson, students will be able to:

1. describe the importance of the matching principle to expense recognition and income measurement,
2. describe the concept of accounting expenses,
3. apply the concept of accrual for the calculation of expenses,
4. distinguish between cost of goods sold, operating expenses.and loss, and
5. describe the concept of capital expenditure.

Teaching Sequence and Time Allocation:

Activities	Reference	Time Allocation
Part I: Introduction		
✧ Teacher introduces the concept of matching and its importance for the recognition of an expense.	PPT #2	3 minutes
Part II: Content		
✧ Teacher explains the definition and characteristics of expense.	PPT #3 – 4	5 minutes
✧ **Activity 1: Class discussion** ■ Students are invited to suggest examples of expenses for themselves and their parents. ■ Teacher compares the answers provided and points out there are many types of expenses, then goes to the discussion of business expenses.	PPT #5 – 6	5 minutes
✧ Teacher explains different types of expenses including cost of goods sold, operating expenses and loss.	PPT #7 – 9	10 minutes
✧ **Activity 2: Class discussion** ■ Students identify expenses from assets ✧ Teacher goes through answers, explains why mortgage loan repayment is not an expense and makes conclusion.	PPT #10 PPT #11-12	2 minutes 5 minutes
✧ Teacher explains expenses in business with examples.	PPT #13	3 minutes
✧ Teacher explains the definition of capital expenditures	PPT #14	3 minutes

✧ **Activity 3: In-class exercise** ■ Students are required to match 5 items to the 5 elements of financial statement. ✧ Teacher goes through answers with students and makes conclusion.	PPT #15 PPT #16	1 minute 1 minute
Part III: Conclusion		
✧ Teacher concludes the lesson by reviewing the key points covered.		2 minutes

Lesson 3	
Theme	Concepts and Characteristics of Net Profits and Retained Earnings
Duration	40 minutes

Expected Learning Outcomes:

Upon completion of this lesson, students will be able to:

1. describe the concept of net profits and retained earnings.

Teaching Sequence and Time Allocation:

Activities	Reference	Time Allocation
Part I: Introduction		
✧ Teacher recaps the concepts of incomes and expenses and then introduces the concept of net profits.	PPT #2	2 minutes
Part II: Content		
✧ Teacher explains the concept net profits and demonstrates the calculations of net profits.	PPT #3 – 4	6 minutes
✧ **Activity 1: In-class exercise** ■ Students are required to calculate the net profit of a business. ✧ Teacher goes through the answer with students and makes conclusion.	PPT #5 PPT #6 – 7	8 minutes 5 minutes
✧ Teacher recaps the concept of capital by discussing paid-in capital and retained earnings and explains the concept of retained earnings. ✧ Teacher illustrates with an example.	PPT #8 – 10 PPT #11 – 12	6 minutes 6 minutes
✧ **Activity 2: In-class exercise** ■ Students are required to calculate the retained earnings of a business. ✧ Teacher goes through the answer with students and makes conclusion.	PPT #13 PPT #14	3 minutes 2 minutes
Part III: Conclusion		
✧ Teacher concludes the lesson by reviewing the key points covered.		2 minutes

Concepts of Incomes, Expenses and Retained Earnings

Lesson 1 – Concepts and Characteristics of Incomes

1

Introduction

- When running a business, it is important to know how much income it has earned for the period it operated.

2

What is Income?

- Benefit inflows by means of increases in assets or decreases in liability during the accounting period (usually one year).
- Examples
  - Amounts received [or to be received]* from product sold or service rendered.
  - Amounts received [or to be received]* from interest on bank deposits or investments.
  - Loan is waived by lender (liability is decreased)

[or to be received]* : cash (asset) increases if the amounts are received

Received or To Be Received

- Income must be recorded in the accounting period in which it is earned.
- It is not necessary to have the cash received.
- For the amount which is receivable is still our income.
- E.g. You have given your ruler to your classmate and he agrees to pay you $10 by tomorrow. This agreement has already contributed an income.
- In accounting term, we call it accrual. i.e. we record the transaction when it is occurred, not when cash is received.

Characteristics of Income

1. Increases in economic benefits during the accounting period.
2. Increases in assets or decreases in liabilities.
3. That result in increases in capital (retained earnings).

5

Activity 1 – Types of Income

- What kinds of income you have earned this year?

- What kinds of income your father and mother have earned this year?

6

Activity 1 – Types of Income

Your incomes	Your parent's incomes
1. Pocket money/petty cash	1. Salaries
2. Red pocket money/cash gift	2. Investment
3. Sale of secondhand mobile phone	3. Rentals
4. ……	4. …….

7

Income in Business

- Most companies have only a few types of income.
- The two major types of income are:
- Sale Revenue: Income earned from normal business activities of the company, that should be measured at gross amount;
- Gains: Income that does not arise from the core business of the company, that should be measured at a net amount, i.e. gross receipt less its cost.

8

Revenue or Gain?

- The major source of revenue of a business is the income generated from sales of goods.
- If the business sells an asset item, income from the transaction would be classified as a gain rather than sale revenue.

9

Is Saving a Kind of Accounting Income?

- When a company earns money from business activities e.g. sale of goods, and then keeps the money in the bank as a saving. The saving itself is not an accounting income.
- It is because the amount has been reflected as income at the time of sale.
- There is no more increase in the economic benefit and asset from the increase in saving. i.e. it is not an accounting income. It is an asset.
- However, interest income derived from saving is an accounting income as it will increase both the economic benefit (cash inflow) and asset (cash).

10

Common Sources of Incomes in Business

- Sale revenue generated from the sale of goods or provision of services.
- Interest received on a bank deposit.
- Dividend earned from investments.
- Rentals received on property leased by the company.

11

How to Calculate Income?

- Example – Sales of Goods
- On 1 March, the company had a cash sale amounted to $10,000. All money deposited into the bank account on the same day.
- On 15 March, the company sold goods at $15,000 on credit with the sum to be received on 14 April.
- On 28 March, the company received $8,000 deposit from its customer with the goods to be delivered on 1 April.
- How much will you earn for the period end at 31 March?

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How to Calculate Income?

- Sales earned for the period ended 31 March include:

Cash sales	$10,000
Credit sales	$15,000
Total	$25,000

- $8,000 deposit from customer is not included as the sales transaction has not been completed unless goods are sent to the customers. As there is still an obligation to deliver the goods to customer after receiving the money, the amount should be regarded as a liability of the business.

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Activity 2 – Calculations of Income

- On 2 December, the company had a cash sale amounted to $38,000. All money deposited into the bank account on the same day.
- On 17 December, the company sold goods at $26,000 on credit with the sum to be received on 14 April.
- On 29 December, the company received $22,000 deposit from its customer with the goods to be delivered on 3 January.
- How much will you earn for the period end at 31 December?

14

Activity 2 – Answer

- Sales earned for the period ended 31 December include:

Cash sales	$38,000
Credit sales	$26,000
Total	$64,000

- $22,000 deposit from customer is not included as the sales transaction has not been completed unless goods are sent to the customers. As there is still an obligation to deliver the goods to customer after receiving the money, the amount should be regarded as a liability of the business.

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The End

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Concepts of Incomes, Expenses and Retained Earnings

Lesson 2 – Concepts and Characteristics of Expenses

1

Introduction

- When running a business, we generate income by sales of goods or provision of services. Meanwhile we incur expenses in order to obtain income.
- Expenses are matched with incomes irrespective of whether it is paid or not. This reflects the basic accounting principle known as matching principle.

2

What is Expense?

- Monetary value of assets or services used up in the process of earning the revenue.
- Benefit outflows by means of decreases in assets or increases in liability during the accounting period (usually one year).

3

Characteristics of Expense

1. Decreases in economic benefits during the accounting period.
2. Decreases in assets or increases in liabilities.
3. That result in decreases in capital (retained earnings).

4

Activity 1 – Types of Expense

- What kinds of expense you have spent this year?

- What kinds of expense your father and mother have spent this year?

5

Activity 1 – Types of Expense

Your expenses	Your parent's expenses
1. Food	1. Housing
2. Transportation	2. Transportation
3. Stationery	3. Household items
4. Clothes	4. Entertainment
5.	5. .....

6

Expenses

- There are various types of expenses in a business:

1. Cost of goods sold, which is the main expense incurred by a company. In order to sell goods and generate income, the company must purchase goods for resale. The corresponding purchases of goods are regarded as cost of goods sold.
2. Operating expenses, which include wages and salaries, selling, administrative and borrowing expenses etc.

7

Revenue Expenditure

Cost of Goods Sold

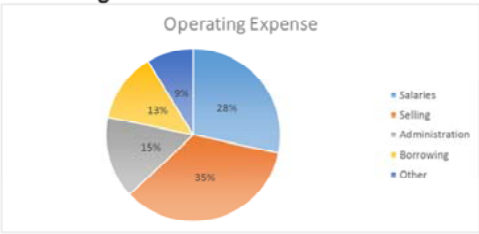
- It is the cost that a company pays directly for the products/services it sells/provides to customers.

8

Revenue Expenditure

Operating Expenses

- Expenditures that a business has incurred as a result of performing its normal business operations.
- On-going cost for running a business.



9

Activity 2

- Which of the following items are expenses of a business?
  - Salaries
  - Mortgage loan repayment
  - Sales of goods
  - Motor car
  - Rent
  - Electricity
  - Furniture
  - Loan interest

Expenses?

10

Activity 2 – Answer

- Salaries
- Rent
- Electricity
- Loan interest

11

Mortgage Loan Repayment ≠ Expense

- Mortgage loan repayment reduces the liability only. It is not an expense because it will not decrease in retained earnings.
- However, the interest payment derived from the mortgage loan is an expense!

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Examples of Expenses

- Cost of goods sold
- Electricity and water
- Insurance
- Rent and rate
- Repairs and maintenance fee
- Salaries and wages
- Transportation cost
- Interest expense

13

Capital Expenditures

- They are expenditures that create future benefits.
- A capital expenditure is incurred when a business spends money either to buy non-current assets or to add to the value of an existing non-current asset with a useful life extending beyond one year.
- It is not treated as an expense when it is incurred but treated as asset.
- Example: expenditure for buying a motor car.

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Activity 3 – Matching

- Matching

Electricity	•	•	Asset
Interest income	•	•	Liability
Land	•	•	Capital
Loan	•	•	Income
Retained earnings	•	•	Expense

15

Activity 3 – Matching

- Answer

Electricity	•	•	Asset
Interest income	•	•	Liability
Land	•	•	Capital
Loan	•	•	Income
Retained earnings	•	•	Expense

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The End

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Concepts of Incomes, Expenses and Retained Earnings

Lesson 3 – Concepts and Characteristics of Net Profits and Retained Earnings

1

Net Profits

- Excess of incomes over expenses for an accounting period.
- Helps to evaluate whether a business is successful or not.

2

Net Profit Calculation

- ABC Company has the following incomes and expenses for the last 12 months.

	$
Sales	110,000
Cost of goods sold	60,000
Salaries	15,000
Electricity	8,000
Rent	22,000

- What is the net profit for ABC Company last year?

3

Net Profit Calculation

	$	$
Sales		110,000
Cost of goods sold	60,000	
Salaries	15,000	
Electricity	8,000	
Rent	22,000	105,000
Net Profit		5,000

4

Activity 1

- Your elder sister's online business had the following receipts and payments for the first year.
- Please help her calculate the net profit of her business.

• Started business with $200,000 in the bank	• Bought a computer at a cost of $12,000
• Borrowed $50,000 from bank	• Sales of accessories $280,000
• Cost of accessories sold totaled $168,000 as	• Repair expense of $2,000
• $11,300 for the delivery of accessories to customers	• Interest income $1,000
• Interest expense $1,500	• Electricity $8,000
• Postage $1,800	• Stationery $5,200
• Internet and telephone $4,800	• Bought a digital camera at a cost of $14,800

5

Activity 1 – Answer

Income Statement		$	$
Income:	Sales of accessories	280,000	
	Interest income	1,000	290,000
Expenses:	Cost of accessories sold	(168,000)	
	Delivery	(11,300)	
	Electricity	(8,000)	
	Interest expense	(1,500)	
	Internet and telephone	(4,800)	
	Postage	(1,800)	
	Repair	(2,000)	
	Stationery	(5,200)	(202,600)
Net profit			87,400

6

Activity 1 – Answer

- Started business with $200,000 in the bank ➡ Capital
- Bought a computer at a cost of $12,000 ➡ Asset
- Borrowed $50,000 from bank ➡ Liabilities
- Bought a digital camera at a cost of $14,800 ➡ Asset

7

Retained Earnings

- Remember in accounting equation, capital can be divided into two categories: paid-in capital & retained earnings.
- Paid-in capital is the amount invested by its owners.
- Retained earnings are the amount of surplus income that are kept for future uses by the business.
  - ✓i.e. accumulated profits from prior years

8

Retained Earnings

- Retained earnings are affected by three types of transactions:
  - Incomes
  - Expenses
  - } Net Profits
  - Drawings –earnings withdrawn from the owner of the business

9

Effects of the Three Types of Transactions to Retained Earnings

Transactions	Effects to Retained Earnings
Increase in incomes	Increase
Decrease in incomes	Decrease
Increase in expenses	Decrease
Decrease in expenses	Increase
Drawings	Decrease

10

Retained Earnings – Example

- ABC Company earned $5,000 in year 1 and $8,000 in year 2.
- The owner of the company withdrew $1,000 from the earnings in year 2 and left the remaining money for future business use.
- What is the retained earnings at the end of year 2?

11

Retained Earnings – Example

Retained Earnings at the end of Year 2	**$**
Profits from Year 1	5,000
Profits from Year 2	8,000
Drawings in Year 2	(1,000)
	12,000

12

Activity 2

- Further to Activity 1, your sister's online business earned $102,600 in year 2.
- She withdrew $2,000 from the earnings in year 2 and left the remaining money for future business use.
- What is the retained earnings at the end of year 2?

13

Activity 2 – Answer

Retained Earnings at the end of Year 2	**$**
Profits from Year 1	87,400
Profits from Year 2	102,600
Drawings in Year 2	(2,000)
	188,000

14

The End

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Section A: Multiple Choice Questions (@1, total 10 marks)

1. Accrual basis revenue is generally recognized at the time when:

A. goods are delivered.
B. cash is received.
C. expense is incurred.
D. goods are received.

Level of difficulty: *

2. Which of the following is not income of a business?

A. Interest received on a bank deposit.
B. Dividend earned from investments.
C. Sale of an old equipment with a cost of $5,000 for $2,000.
D. Rentals received from tenant.

Level of difficulty: **

3. At the end of the current accounting period, ABC Company failed to record the electricity consumed during the period. ABC Company will pay for this during the next accounting period. As a result, current period assets, liabilities, equity, and income, respectively, are:

A. overstated, overstated, correct, correct
B. correct, understated, overstated, correct
C. overstated, understated, overstated, overstated
D. overstated, understated, correct, correct

Level of difficulty: ***

4. Expense can be described as:

A. present obligation of a company which is required to be settled in future.
B. monetary value of the assets used up in the process of earning the revenue.
C. resources controlled by the company so as to obtain future economic benefit.
D. residual interest of the company.

Level of difficulty: *

5. Which of the following spending is not an expense of a company?

A. Transportation.
B. Salaries.
C. Computer.
D. Rent.

Level of difficulty: *

6. Which of the following statements is correct?

A. Borrowing is a kind of capital expenditure.
B. The purchase of a production equipment for the use of manufacturing is a kind of operating expenses.
C. Delivery of goods is recorded when proceed is received.
D. A capital expenditure is incurred when a business spends money to buy non-current assets.

Level of difficulty: **

7. A company had a revenue of $100,000 and had paid the following for the year:
cost of sales: $52,000; salaries: $10,000; motor car: $120,000; and electricity: $7,000. What is the net profit/loss of the company for the year?

A. A profit of $31,000.
B. A profit of $48,000.
C. A loss of $72,000.
D. A loss of $89,000.

Level of difficulty: **

8. Retained earnings can be defined as:

A. amount invested by its owners.
B. amount earned by income-producing activities and kept for use in the business.
C. income received for the year.
D. assets minus liabilities.

Level of difficulty: *

9. When there is an increase in income and other things being constant, the retained earnings will _____.

A. increase.
B. decrease.
C. not change.
D. none of the above.

Level of difficulty: *

10. When there is a distribution of dividend, the retained earnings will _____.

A. increase.
B. decrease.
C. not change.
D. none of the above.

Level of difficulty: **

Section B: Short Questions (20 marks)

*** 1. A Ltd sold and delivered goods to X Ltd on 12 October. X Ltd paid for the goods received on 11 November. Discuss when A Ltd should record the income. (7 marks)

* 2. Briefly discuss the difference between revenue expenditure and capital expenditure. (6 marks)

** 3. ABC Ltd had the following receipts and payments for the year. Calculate the net profit of ABC Ltd. (7 marks)

Deposit of $300,000 for start up the business.
Bought a computer at a cost of $20,000.
Sales of goods $180,000.
Borrowings from bank $60,000.
Salaries: $30,000
Cost of goods sold: $110,000
Interest expense: $2,000.

Suggested Solutions

Section A: MCQs

1. A	2. C	3. B	4. B	5. C
6. D	7. A	8. B	9. A	10. B

Section B: Short Questions.

Question 1

A Ltd earns income when the goods are sold, not when cash is received. (3 marks)
This is the application of accrual concept, i.e. we record the transaction when it is occurred, not when cash is received. (2 marks)
Therefore income is recognised on 12 October when the goods are delivered to X Ltd. (2 marks)

Question 2

Revenue expenditure is incurred as a result of a business performing its normal business operations. It is the on-going cost for running a business. (2 marks)

A capital expenditure is incurred when a business spends money either to buy non-current assets or to add to the value of an existing non-current asset with a useful life extending beyond one year. (2 marks)

Revenue expenditure is treated as an operating expense while capital expenditure is treated as asset. (2 marks)

Question 3

Income:	Sales of goods		180,000
Expenses:	Cost of goods sold	(110,000)	
	Interest expense	(2,000)	
	Salaries	(30,000)	(142,000)
Net profit			38,000

(1 mark for correct treatment of each item, total 7 marks)