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# Essential Accounting

*for Cambridge* **IGCSE<sup>®</sup> & O Level**

Third Edition

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# Introduction

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This book is designed specifically for Cambridge International Examinations (Cambridge) IGCSE® & O Level Accounting. Experienced examiners have been involved in all aspects of the book, including detailed planning to ensure that the content adheres to the syllabus as closely as possible.

Using this book will ensure that you are well prepared for the exam at this level, and also studies beyond the IGCSE level in Accounting. The features below are designed to make learning as interesting and effective as possible:

## STUDY TIP

*These give you hints on how to avoid common errors or provide useful advice on how to tackle questions.*

## LEARNING OBJECTIVE

These are at the start of each spread and will tell you what you should be able to do at the end of the spread.



## LINKS...

These provide useful links between topics and information on where a concept is explained further.

## Illustration

## Subject

These are real-life examples to illustrate the subject matter within the unit, and are accompanied by questions to test your understanding.

## KEY TERMS

These summarise the most important terms to learn from the spread.

## DID YOU KNOW?

These are interesting facts chosen to stimulate your interest in accounting. Make sure you read them all, as some “Did you know?” facts are needed for the examination.

At the end of each chapter, you will find examination-style practice questions, as well as general revision questions. These include both short-answer summary questions to test your understanding and learning of the unit just covered, and longer-answer questions preceded by a short scenario.

All the questions feature the command words that you will find in the exam.

The questions, example answers, marks awarded and/or comments that appear in this book and on our website were written by the authors. In examination, the way marks would be awarded to answers like these may be different.

At the end of the book, you will find a glossary of the key terms highlighted in bold in the text.



The most important aim of this Introduction is to welcome you to your study of principles of accounts.

At this stage it is likely that you are not really sure what accounting is about. So this introductory section sets out to give you an overview of the subject you are about to study.

## What is accounting?

There is nothing new about keeping careful records of financial information. Even thousands of years ago individuals wanted to be well informed about what they received and spent, so that they could have some idea about whether they were well off or not. Nowadays these same questions apply to individuals and organisations.

## Who uses accounting information?

It is surprising just how many individuals, groups and organisations are affected by even the most basic form of business, and are, therefore, concerned about the business's financial situation. For example, just thinking about your local store, the following **interested parties** can be identified:

- The owner: who has invested personal savings in setting up the business and who is dependent on the business's success for their livelihood.
- The customers: who depend on the business being successful in order that they have a reliable source of goods to buy when they need them.
- Suppliers: who provide goods for the business to sell. They are concerned that they are paid on time and that the business will be successful so that repeat orders, and perhaps increasingly large orders, are likely.
- The bank may have lent the business funds to get started or develop. Any organisation lending money will be concerned about the success of the business because this affects whether repayments with interest will be made in accordance with the loan agreement.
- Employees: are dependent on the success of the business for their wages or salaries and for continued employment.
- Government: checks the amounts due to be paid in taxation.

### KEY TERMS

**Interested parties:** individuals and organisations who are affected by or concerned about how a business performs.

## Types of business organisation

What is a business? Businesses are organisations that provide goods and/or services in order to make a profit. There are a number of ways of classifying businesses.

It is possible to think about businesses by what they do, for example by:

- providing raw materials by way of mining, farming, fishing, etc.
- manufacturing goods, turning raw materials into finished products
- selling goods to the general public (retailers) or to other businesses (wholesalers)
- providing services for businesses and the general public

It is also possible to think about businesses in terms of who owns them, for example:

- Sole trader: where one individual owns the business. The individual controls the business. If successful, the profits made by the business belong to this individual; if unsuccessful, the individual can lose whatever has been invested and private resources too.

## Questions and answers in this book

A wide range of practice material has been provided at the end of each chapter.

Under the heading 'Developing your skills' there are questions which give users the opportunity to try out the techniques explained in each chapter. Questions are in pairs, so that teachers have the opportunity to demonstrate a new technique using the first question in the pair and students have the opportunity to try out the technique for themselves using a second, similar question.

At the end of each topic users also have the chance to apply their learning to multiple-choice questions and 'other questions', taking them one step further towards being prepared for the examination.

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# The purpose of accounting

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- explain the difference between book-keeping and accounting
- state the main concerns of the owner(s) of a business
- explain how accounting provides information for monitoring progress and decision-making.

## What is accounting?

The owners of a business need to know:

- whether they are making a profit, because this is the main reason for engaging in business activity
- that they have enough money to pay for their commitments on time
- that they are making the best use of the funds they have invested in their business.

In the modern world, business activity can vary in scale and be extremely complex. Even a really simple form of business organization (e.g. a market stall) can involve a great deal of financial activity, including handling money, buying goods to sell, paying wages and so on. Accounting is about providing accurate and comprehensive financial information to those involved in making decisions, so that businesses can survive, be successful and run efficiently.

All financial transactions need to be recorded in a systematic way so that the owner of the business can be provided with the information they need to make decisions. This record-keeping aspect of accounting is called **book-keeping**.

However, these records can contain vast amounts of detail. It is important to select, classify and summarise information so that owners and other users can be given the appropriate information. The preparation of financial statements, providing analysis and interpretation is called **accounting**.

## KEY TERMS

**Book-keeping:** the recording of financial information, particularly transactions, in a systematic way.

(Note: candidates give this definition as 'the recording of financial information', and this is marked as too vague.)

**Accounting:** the selecting, classifying and summarizing of financial information in a way that provides owners of a business with useful information to help them assess performance and plan future activity.



## LINKS...

Accounting principles are introduced throughout the book. All the principles are summarised and explained further in the glossary.



## **What are the main financial statements?**

Owners, managers and other interested parties will wish to examine the following to help them monitor progress and provide the information they need to make well-informed decisions.

### **For information about profit and loss**

Income statements are the chief source of information about profits and losses for sole traders, partnerships and limited companies. Clubs and societies record information about surpluses and deficits (rather than profits and losses), and record these in income and expenditure accounts.

### **For information about the ability to meet commitments on time**

The statement of financial position (see 1.3) provides details of the resources owned (e.g. cash and bank balances, money due to be received soon) by a business, club or society that can be used to meet commitments (e.g. overheads and running costs, money owed to suppliers).

### **For information about the efficient use of resources**

The statement of financial position can also be used to determine how successful the owners, managers or club officials have been in using their resources efficiently.

## **Accounting principles**

Accounting involves the processing of large amounts of data by many individuals working for a variety of organisations, each with their own objectives, needs and interests. As a result, financial records might be distorted (accidentally) or even manipulated (deliberately). To ensure that accounting statements are prepared properly, there are a set of rules, often referred to as accounting principles, to ensure that information is accurate.

## **Technology**

Book-keeping and accounting used to be done by hand (manually). Now, computer technology is used by most businesses. However, whether manual or computerised systems are used, records are based on the same processes and accounting principles.

# Assets, liabilities and capital

## What are assets?

All businesses own resources such as cash, vehicles, furniture and premises. These resources are known as assets. The owner of a business will have provided or purchased each asset to ensure that the enterprise can trade or provide a service effectively.

**Assets** have a monetary value and provide a benefit to the business.

### Examples of business assets

- Land
- Buildings
- Machinery
- Equipment
- Fittings
- Inventories

The rule in accounting is that assets should always be valued at their cost (i.e. whatever was paid for the asset).

Cash is an important asset for all businesses. This asset is separated into two categories as follows:

- Cash in hand: money in the form of notes, coins, cheques, and so on, which is at the business premises (probably locked in a safe or till).
- Cash at bank: all money that has been transferred by the owner of the business to the business's bank account.

Some businesses provide goods or services to their customers on credit. This means that the customer agrees to pay for the goods or services some time after they have been sold to the customer. The amount due from credit customers is referred to as **trade receivables**.

## What are liabilities?

Businesses often owe money to other businesses or organisations. Amounts owing to other businesses or organisations are called **liabilities**. For example, many businesses buy goods on credit from their suppliers. In other words, the goods are purchased, but payment for them is made at some later date. The suppliers to whom the business owes money are referred to as **trade payables**.

### Examples of liabilities

- Loans from banks and from other providers
- Bank overdrafts

## What is capital?

Businesses only exist because their owners have invested private funds in the business. As a result, businesses then acquire the kinds of asset described earlier. Maybe other businesses and organisations also provide some finance – the liabilities described before. The finance or investment provided by the owner is called **capital**.

### LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- explain the terms 'asset', 'liability' and 'capital'.

### STUDY TIP

*You will notice that assets do not include employees. Assets have to be owned by the business.*



### LINKS...

In Section 7 you will learn more about the fundamental rules that all accountants use and why assets should have a monetary value and be valued at cost.

### KEY TERMS

**Assets:** resources with a monetary value that are owned by the business or amounts that are owed to the business.

**Liabilities:** amounts owed by a business to other businesses, organisations or individuals.

**Capital:** the investment made by the owner(s) of a business. This is sometimes referred to as 'equity', particularly in the case of a limited company.

**Trade receivables:** are amounts owed to the business by customers. They are assets of the business.

**Trade payables:** are amounts owed by a business to suppliers. They are liabilities of the business.

You can now try questions 1–2 on page 8.



# The accounting equation and simple statements of financial position



Starting up a business – owning your own premises is an asset

## LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- explain what is meant by the accounting equation and prepare a simple statement of financial position.

## KEY TERMS

**Accounting equation:** this links the three elements that are a feature of all businesses, i.e. assets, liabilities and capital. The equation is:  $\text{Assets} = \text{Capital} + \text{Liabilities}$

You can now try questions 3–4 on page 8.

## What is the accounting equation?

There is a simple link between the three elements: assets, liabilities and capital. This link, called the **accounting equation**, is based on the following idea:

- Each business has a number of assets. These assets have either been provided by the owner of the business (capital) or by using funds provided by other businesses or organisations (liabilities).
- It follows that whatever the scale of the business:  
 $\text{Assets} = \text{Capital} + \text{Liabilities}$

## Illustration 1

### The accounting equation

John is the owner of a general store. The business has assets with a total value of \$75 000. John provided \$60 000 from his private resources to buy these assets; the remaining \$15 000 of assets was purchased by asking for a loan from the bank.

Summary:  $\text{Assets } \$75\,000 = \text{Capital } \$60\,000 + \text{Liabilities } \$15\,000$

The accounting equation can be useful for calculating otherwise unknown facts about businesses. So, if you know that the business has assets of \$40 000 and liabilities of \$5000, it is possible to work out that the owner's capital must be \$35 000. In other words:

$$\begin{array}{rcl} \text{Assets} & = & \text{Capital} + \text{Liabilities} \\ \$40\,000 & = & ? + \$5000 \\ \text{So, } \$40\,000 & = & \$35\,000 + \$5000 \end{array}$$



## KEY TERMS

### Statement of financial position:

a statement that shows an organisation's assets, liabilities and capital at a particular date, which is prepared at the end of a financial period.

## How to prepare a simple statement of financial position

A **statement of financial position** is a document detailing a business's assets, liabilities and capital at a particular date.

There are precise rules about how a statement of financial position should be prepared. The following example illustrates how these rules are applied.

### Illustration 2 Preparing a simple statement of financial position

The following information is available about John's General Store on 1 August 2018.

|                       | \$      |
|-----------------------|---------|
| Shop premises         | 240 000 |
| Fixtures and fittings | 30 000  |
| Delivery vehicle      | 24 000  |
| Inventory             | 18 000  |
| Trade receivables     | 4 000   |
| Cash at bank          | 10 000  |
| Cash in hand          | 2 000   |
| Bank loan             | 40 000  |
| Trade payables        | 8 000   |

Step 1: Calculate the total value of assets: \$328 000.

Step 2: Calculate the total value of liabilities: \$48 000.

Step 3: Use the accounting equation to find the missing capital figure:  $\$328 - \$48\,000 = \$280\,000$

Step 4: Proceed to produce a statement of financial position, starting with a title. The title for a statement of financial position should include the name of the business (or the name of the owner of the business). The correct wording for the title of a statement of financial position is always: Statement of financial position [at a particular date]. For example: Statement of financial position at 1 August 2018. It is best to show the date in full, avoiding any abbreviations.

Step 5: Write a subheading 'Assets' and list all of the assets and their values using two columns. The money column should be headed '\$'.

Step 6: Record the total of assets.

Step 7: Continue by recording the business's capital and liabilities. Start by writing 'Capital' as a subheading and recording the value of capital (\$280 000); head the money column '\$'. Now write the subheading 'Liabilities' and list the liabilities and their values.

Step 8: Record the total of capital and liabilities.

#### John's General Store Statement of financial position at 1 August 2018

|                       | \$      |
|-----------------------|---------|
| <b>ASSETS</b>         |         |
| Shop premises         | 240 000 |
| Fixtures and fittings | 30 000  |
| Delivery vehicle      | 24 000  |
| Inventory             | 18 000  |
| Trade receivables     | 4 000   |
| Cash at bank          | 10 000  |
| Cash in hand          | 2 000   |
|                       | <hr/>   |
|                       | 328 000 |
|                       | <hr/>   |
|                       | \$      |
| <b>CAPITAL</b>        | 280 000 |
| <b>LIABILITIES</b>    |         |
| Bank loan             | 40 000  |
| Trade payables        | 8 000   |
|                       | <hr/>   |
|                       | 328 000 |
|                       | <hr/>   |

You can now try questions 5–6 on page 8.

# Preparing a classified statement of financial position

## KEY TERMS

**Non-current assets:** assets that should be of benefit to the business for a long time (more than one year).

**Current assets:** assets that are quickly turned into cash and are of benefit to the business for less than one year.

**Order of permanence:** the sequence used to list items on a statement of financial position. It begins with items that are likely to be longest lasting and ends with items that are likely to be shortest lasting.

**Non-current liabilities:** liabilities that will be settled in longer than one year.

**Current liabilities:** liabilities that will be settled in the near future (in less than one year).

The presentation of a statement of financial position can be improved by dividing assets into two categories:

- **Non-current assets:** these are assets that the business intends to keep and make use of for more than one year. Non-current assets include: premises, machinery, equipment, vehicles, furniture, fittings, and so on.
- **Current assets:** these are assets that are frequently changing in value such as inventory, trade receivables, bank and cash. So, any one item of inventory, or an amount owing from a particular customer, will only be an asset for the business for less than one year.

Assets are shown on statements of financial position in a particular order. The order corresponds to how long the asset will belong to the business. So premises would be shown first, and cash in hand (which is, of course, constantly changing in value) will be shown last. This way of ordering assets is referred to as the **order of permanence**. The following guidance should help you to place assets in the right order:

- Non-current assets: place land first, followed by premises; thereafter, place other non-current assets in order of their value (unless you happen to know a little more about how long the non-current assets will belong to the business).
- Current assets: place current assets in the following order: inventory, trade receivables, bank, and cash.

Similarly, liabilities can be subdivided into two categories:

- **Non-current liabilities:** amounts due that are likely to be repaid in a future financial period (after more than one year). Non-current liabilities would normally include bank loans.
- **Current liabilities:** amounts due that will be repaid within the financial period (less than one year). Examples of current liabilities are trade payables and bank overdrafts.

It is also useful to the owner of a business if the statement of financial position shows separate subtotals for non-current assets, current assets and, if appropriate, for non-current liabilities and current liabilities.

### Illustration 3

Preparing a classified statement of financial position in order of permanence

Here is the statement of financial position for John's General Store rewritten to follow the rules about classified statement of financial position.

| John's General Store                             |         |
|--|---------|
| Statement of financial position at 1 August 2018 |         |
|  | \$      |
| NON-CURRENT ASSETS                               |         |
| Shop premises                                    | 240 000 |
| Fixtures and fittings                            | 30 000  |
| Delivery vehicle                                 | 24 000  |
|  | <hr/>   |
|  | 294 000 |
| CURRENT ASSETS                                   |         |
| Inventory  | 18 000  |
| Trade receivables                                | 4 000   |
| Cash at bank                                     | 10 000  |
| Cash in hand                                     | 2 000   |
|  | <hr/>   |
|  | 34 000  |
|  | <hr/>   |
|  | 328 000 |
|  | <hr/>   |
|  | \$      |
| CAPITAL  | 280 000 |
| NON-CURRENT LIABILITIES                          |         |
| Bank loan  | 40 000  |
| CURRENT LIABILITIES                              |         |
| Trade payables                                   | 8 000   |
|  | <hr/>   |
|  | 328 000 |
|  | <hr/>   |

**Note:** in this version of the statement of financial position there are two money columns. The first column is used to record the detail about individual items (in this case about non-current assets and current assets). The second column is used to show the subtotal for each category.

You can now answer questions 7–8 on page 9.



## DEVELOPING YOUR SKILLS

### 1 Identifying assets, liabilities and capital

Here is a list of assets and liabilities and references to capital. Read through the list, and then identify whether the items are assets, liabilities or capital.

- |   |                            |
|---|----------------------------|
| <b>A</b> Vehicle                            | <b>F</b> Inventory         |
| <b>B</b> Shop fittings                      | <b>G</b> Trade receivables |
| <b>C</b> Cash at bank                       | <b>H</b> Bank overdraft    |
| <b>D</b> Bank loan                          | <b>I</b> Trade payables    |
| <b>E</b> Owner's investment in the business | <b>J</b> Machinery         |

### 2 Identifying assets, liabilities and capital

Here is a list of assets and liabilities and references to capital. Read through the list, and then identify whether the items are assets, liabilities or capital.

- |                                     |   |
|-------------------------------------|---|
| <b>A</b> Cash in hand               | <b>G</b> Value of owner's stake in the business |
| <b>B</b> Equipment                  | <b>H</b> Amounts owed by customers              |
| <b>C</b> Amounts owing to suppliers | <b>I</b> Cash at bank                           |
| <b>D</b> Furniture                  | <b>J</b> Fittings                               |
| <b>E</b> Land                       |   |
| <b>F</b> Loan from a friend         |   |

### 3 Using the accounting equation

The following table shows details about some businesses' total assets, total liabilities and capital. For each business calculate the missing figure, making use of the accounting equation.

|            | Total assets | Total liabilities | Capital               |
|------------|--------------|-------------------|-----------------------|
|            | Assets       | =                 | Liabilities + Capital |
|            | \$           | \$                | \$                    |
| Business A | 80 000       | 20 000            |                       |
| Business B | 42 000       | 11 000            |                       |
| Business C | 57 000       |                   | 24 000                |
| Business D | 650 000      |                   | 490 000               |
| Business E |              | 20 000            | 170 000               |
| Business F |              | 82 000            | 558 000               |

### 4 Using the accounting equation

The following table shows details about some businesses' total assets, total liabilities and capital. For each business calculate the missing figure, making use of the accounting equation.

|            | Total assets | Total liabilities | Capital               |
|------------|--------------|-------------------|-----------------------|
|            | Assets       | =                 | Liabilities + Capital |
|            | \$           | \$                | \$                    |
| Business A | 220 000      | 30 000            |                       |
| Business B | 912 000      | 86 000            |                       |
| Business C | 325 000      |                   | 273 000               |
| Business D | 560 000      |                   | 483 000               |
| Business E |              | 52 000            | 865 000               |
| Business F |              | 42 000            | 220 000               |

### 5 Preparing simple statements of financial position

Donnie owns a business making computer software programs. The following information is available about her business's assets and liabilities on 31 October 2018.

|                            | \$      |
|----------------------------|---------|
| Equipment                  | 90 000  |
| Cash in hand               | 4 000   |
| Premises                   | 300 000 |
| Bank loan (repayable 2023) | 60 000  |
| Inventory                  | 16 000  |
| Delivery vehicle           | 32 000  |
| Trade receivables          | 14 000  |
| Bank overdraft             | 8 000   |
| Trade payables             | 22 000  |

- Calculate the total value of assets.
- Calculate the total value of liabilities.
- Use the accounting equation to calculate the business's capital.
- Prepare a simple statement of financial position at 31 October 2018.

**6** Preparing simple statements of financial position

Kisha owns a restaurant. The following information is available about her business's assets and liabilities on 31 January 2018.

|   | \$      |
|---|---------|
| Restaurant premises                     | 570 000 |
| Bank loan (repayable 2024)              | 120 000 |
| Furniture and fittings                  | 45 000  |
| Cash in hand                            | 6 000   |
| Equipment                               | 51 000  |
| Inventory (food, etc.)                  | 24 000  |
| Trade payables                          | 18 000  |
| Trade receivables                       | 3 000   |
| Loan from friend (repayable March 2018) | 9 000   |
| Cash at bank                            | 12 000  |

- A** Calculate the total value of assets.
- B** Calculate the total value of liabilities.
- C** Use the accounting equation to calculate the business's capital.
- D** Prepare a simple statement of financial

position at 31 January 2018.

**7** Preparing classified statements of financial position

Look again at question 3. Prepare a classified statement of financial position at 31 October 2018.

**8** Preparing classified statements of financial position

Look again at question 4. Prepare a classified statement of financial position at 31 January 2018.

# Sources and recording of data

## What this section is about

In this section you are going to learn about transactions and how they can be recorded in a straightforward way.

## Transactions

Transactions are financial events. All businesses operate by buying, selling, spending money, receiving money, and so on. Each purchase, sale, payment and receipts is a transaction.

Many transactions involve the receipt or payment of money. Money transactions can involve notes, coins, cheques, credit cards, debit cards, on-line payments, etc. They are all referred to as cash transactions whatever method has been used.

Credit transactions are those where the payment or receipt of money does not occur at the time of purchase or sale, but at some later date.

Many businesses use credit to buy goods from suppliers which are intended for resale (a credit transaction) but pay their suppliers later (a cash transaction). Some businesses sell their goods on credit to customers (a credit transaction) and receive payment from the customers some time later (a cash transaction).

### KEY TERMS

**Transaction:** a financial activity or financial event.

**Cash transactions:** financial activities involving the immediate use of money.

**Credit transactions:** financial activities when the payment or receipt of money is delayed.

## Recording transactions

In Chapter 2.1 you will learn how transactions affect items in a statement of financial position.

In Chapters 2.2 and 2.3 you will learn how to record transactions using simple ledger accounts

In Chapters 2.4 and 2.5 you will learn how to use a wider range of ledger accounts

In Chapter 2.6 you will learn how to prepare a trial balance which enables you to check the accuracy of the ledger accounts you have prepared

In Chapters 2.7, 2.8 and 2.9 you will see how profits and losses are calculated using the information recorded in ledger accounts

In Chapters 2.10 and 2.11 you will see how accounts are balanced or closed

The focus throughout is on accounting for business organisations.



# The effect of transactions on items in a statement of financial position

## LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- record a set of transactions by preparing a sequence of statements of financial position.

In the illustrations that follow you can see how a variety of transactions affect the statement of financial position of one business over a period of a few days. The illustrations include both cash and credit transactions. They show transactions that affect:

- assets only
- assets and liabilities
- assets and capital.

## KEY TERMS

**Drawings:** the withdrawal of money by the owner of a business for private use.

### Illustration 1 Buying a vehicle and paying by cheque

The summarised statement of financial position of a business on 1 December 2018 is shown below.

#### Statement of financial position at 1 December 2018

|                |        |    |
|----------------|--------|----|
|                |        | \$ |
| <b>ASSETS</b>  |        |    |
| Equipment      | 25 000 |    |
| Bank           | 45 000 |    |
|                | <hr/>  |    |
|                | 70 000 |    |
|                | <hr/>  |    |
|                |        | \$ |
| <b>CAPITAL</b> | 70 000 |    |

On 2 December 2018 the owner of the business purchased a vehicle for use by the business and paid by cheque \$15 000.

Step 1: Work out how the transaction affects items on the statement of financial position:

- A new asset will appear on the statement of financial position: Vehicle + \$15 000.

- The asset bank will have to be reduced because a payment has been made: Bank – \$15 000.

You will notice that the capital figure of \$70 000 is not affected by this transaction. This is because the value of the owner's investment in this business has not changed. All that has happened is that one asset has been exchanged for another asset.

Step 2: The redrafted statement of financial position is as follows:

#### Statement of financial position at 2 December 2018

|                |               |    |
|----------------|---------------|----|
|                |               | \$ |
| <b>ASSETS</b>  |               |    |
| Equipment      | 25 000        |    |
| <b>Vehicle</b> | <b>15 000</b> |    |
| <b>Bank</b>    | <b>30 000</b> |    |
|                | <hr/>         |    |
|                | 70 000        |    |
|                | <hr/>         |    |
|                |               | \$ |
| <b>CAPITAL</b> | 70 000        |    |

Did you notice that two items on the statement of financial position were affected by the transaction?

### Illustration 2 Buying furniture on credit

On 3 December 2018 the business purchased some furniture, costing \$10 000, on credit.

Step 1: Work out how the transaction affects items on the statement of financial position:

- A new asset will appear on the statement of financial position: Furniture + \$10 000.

- A liability will appear on the statement of financial position: Other payables + \$10 000.

In this transaction, the business has acquired one more asset, but rather than paying for it immediately it has purchased the asset on credit (i.e. it has delayed paying until some future date). So the business now has a liability (i.e. an other

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payable). Once again, you will notice there is no change to the figure for capital. This is because the business has acquired an extra asset and a liability, so the net value of the business has not changed.

Step 2: The redrafted statement of financial position is as shown:

**Statement of financial position at 3 December 2018**

|                       |               |
|-----------------------|---------------|
|                       | \$            |
| <b>ASSETS</b>         |               |
| Equipment             | 25 000        |
| Vehicle               | 15 000        |
| <b>Furniture</b>      | <b>10 000</b> |
| Bank                  | 30 000        |
|                       | <hr/> 80 000  |
|                       | \$            |
| <b>CAPITAL</b>        | 70 000        |
| <b>LIABILITY</b>      |               |
| <b>Other payables</b> | <b>10 000</b> |
|                       | <hr/> 80 000  |

Once again, did you notice that two items on the statement of financial position were affected by the transaction?

**Illustration 3** The owner takes \$1000 from the bank account for private use

On 4 December 2018 the owner of the business withdrew \$1000 from the business's bank account for private use. The withdrawal of money from the business by the owner for private use is called **drawings**.

Step 1: Work out how the transaction affects items on the statement of financial position:

- The asset bank will be reduced by \$1000: Bank – \$1000.
- The owner's investment in the business will be reduced by \$1000: Capital – \$1000.

In this transaction, the value of one of the business's assets has been reduced. At the same time the owner has deliberately reduced the amount invested in the business, so capital has been reduced.

Step 2: The redrafted statement of financial position is as follows:

**Statement of financial position at 4 December 2018**

|                  |               |
|------------------|---------------|
|                  | \$            |
| <b>ASSETS</b>    |               |
| Equipment        | 25 000        |
| Vehicle          | 15 000        |
| Furniture        | 10 000        |
| <b>Bank</b>      | <b>29 000</b> |
|                  | <hr/> 79 000  |
|                  | \$            |
| <b>CAPITAL</b>   | <b>69 000</b> |
| <b>LIABILITY</b> |               |
| Other payables   | 10 000        |
|                  | <hr/> 79 000  |

You can now try questions 1–10 on pages 13–17.

Once again, two items on the statement of financial position were affected by this transaction.

**Illustration 4** Some more typical transactions

|   |   | <b>Assets</b>                       | <b>=</b> | <b>Capital</b>     | <b>+</b> | <b>Liabilities</b>        |
|---|---|-------------------------------------|----------|--------------------|----------|---------------------------|
| 1 | An individual started a business by paying \$35 000 into a bank account | Bank + \$35 000                     |          | Capital + \$35 000 |          |                           |
| 2 | Machinery worth \$12 000 was purchased on credit                        | Machinery + \$12 000                |          |                    |          | Other payables + \$12 000 |
| 3 | Purchased equipment for \$5000 and paid by cheque                       | Equipment + \$5000<br>Bank – \$5000 |          |                    |          |                           |
| 4 | Owner withdrew a cheque for \$4000 for private use                      | Bank – \$4000                       |          | Capital – \$4000   |          |                           |
| 5 | Paid the trade payables \$2000 by cheque                                | Bank – \$2000                       |          |                    |          | Trade payables – \$2000   |

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## DEVELOPING YOUR SKILLS

**1** Recording transactions using statement of financial position

Adam opened his business on 1 March 2018. His business's first statement of financial position is shown below.

| Adam<br>Statement of financial position at 1 March 2018 |              |
|---|--------------|
|   | \$           |
| ASSETS  |              |
| Vehicle   | 12 000       |
| Bank  | 28 000       |
|   | <hr/> 40 000 |
|   | \$           |
| CAPITAL   | 40 000       |

In the first few days that the business was in operation the following transactions occurred.

- March
- Purchased equipment for \$15 000 and paid by cheque
  - Purchased furniture for \$8 000 on credit
  - Borrowed \$15 000 from the bank (i.e. a bank loan). These funds were paid into the business's bank account
  - Adam withdrew a cheque for \$3 000 for private use (i.e. drawings)
  - Paid the trade payables \$6 000 by cheque

Prepare an updated statement of financial position after each transaction.

**2** Recording transactions using statement of financial position

Tiffany opened a business on 1 January 2018. Her business's first statement of financial position was as follows:

| Tiffany<br>Statement of financial position at 1 January 2018 |               |
|--|---------------|
|  | \$            |
| ASSETS   |               |
| Premises   | 90 000        |
| Bank   | 20 000        |
|  | <hr/> 110 000 |
|  | \$            |

CAPITAL 110 000

In the first few days that the business was in operation the following transactions occurred:

- Jan
- Purchased a vehicle for \$15 000 and paid by cheque
  - Borrowed \$12 000 from the bank (i.e. a bank loan). The funds were paid into the business's bank account
  - Purchased equipment for \$24 000 on credit
  - Tiffany made an additional investment in her business of \$8 000 (i.e. additional capital). The funds were paid into the business's bank account
  - Paid the trade payables \$20 000 by cheque

Prepare an updated statement of financial position after each transaction.

**3** Identifying how transactions affect statements of financial position

In the following table, recalculate the figure for total assets, capital and total liabilities after each transaction has occurred. (The effect of the first transaction has already been worked out for you.)

|                  |   | Total assets | Capital | Total liabilities |
|------------------|---|--------------|---------|-------------------|
|                  |   | A            | =       | C + L             |
|                  |   | \$           | \$      | \$                |
| Starting figures |   | 40 000       | 30 000  | 10 000            |
| 1                | Owner withdrew cheque \$4 000 for private use   | 36 000       | 26 000  | 10 000            |
| 2                | Purchased new vehicle for \$16 000 on credit  |              |         |                   |
| 3                | Repaid \$2 000 of a loan from the bank. The funds were taken from the business's bank account |              |         |                   |
| 4                | Purchased some machinery for \$7 000 and paid by cheque                                       |              |         |                   |
| 5                | Paid trade payables \$5 000 by cheque   |              |         |                   |



|   |  |  |  |  |
|---|--|--|--|--|
| 6 | Sold some equipment worth \$3000 and received a cheque for this amount |  |  |  |
|---|--|--|--|--|

#### 4 Identifying how transactions affect statements of financial position

In the following table, recalculate the figure for total assets, capital and total liabilities after each transaction has occurred. (The effect of the first transaction has already been worked out for you.)

|                  |  | Total assets | Capital | Total liabilities |
|------------------|--|--------------|---------|-------------------|
|                  |  | A            | = C     | + L               |
|                  |  | \$           | \$      | \$                |
| Starting figures |  | 90 000       | 75 000  | 15 000            |
| 1                | Paid trade payables \$8000 by cheque                               | 82 000       | 75 000  | 7 000             |
| 2                | Purchased a new vehicle and paid \$17 000 by cheque                |              |         |                   |
| 3                | The owner withdrew a cheque for \$1000 for private use             |              |         |                   |
| 4                | Purchased some new equipment for \$10 000 on credit                |              |         |                   |
| 5                | Some old machinery worth \$6000 was sold on credit for this amount |              |         |                   |

#### 5 Comparing statements of financial position to see what transactions have occurred

Here are some statements of financial position for one business. By comparing each statement of financial position with the previous statement of financial position, you should be able to work out what transaction has occurred.

The first answer is shown as an example.

##### Statement of financial position at 1 February 2018

\$

|        |        |
|--------|--------|
| ASSETS |        |
| Bank   | 60 000 |
|        | \$     |

|         |        |
|---------|--------|
| CAPITAL | 60 000 |
|---------|--------|

##### Statement of financial position at 2 February 2018

\$

|         |        |
|---------|--------|
| ASSETS  |        |
| Vehicle | 18 000 |
| Bank    | 42 000 |
|         | 60 000 |
|         | \$     |
| CAPITAL | 60 000 |

Answer: A vehicle has been purchased for \$18 000 and paid for by cheque.

##### Statement of financial position at 3 February 2018

\$

|         |        |
|---------|--------|
| ASSETS  |        |
| Vehicle | 18 000 |
| Bank    | 39 000 |
|         | 57 000 |
|         | \$     |
| CAPITAL | 57 000 |

##### Statement of financial position at 4 February 2018

\$

|           |        |
|-----------|--------|
| ASSETS    |        |
| Vehicle   | 18 000 |
| Equipment | 16 000 |
| Bank      | 39 000 |
|           | 73 000 |
|           | \$     |

|                |               |
|----------------|---------------|
| CAPITAL        | 57 000        |
| LIABILITY      |               |
| Other payables | 16 000        |
|                | <u>73 000</u> |

**Statement of financial position at  
5 February 2018**

|                |               |
|----------------|---------------|
|                | \$            |
| ASSETS         |               |
| Vehicle        | 18 000        |
| Equipment      | 16 000        |
| Bank           | 33 000        |
|                | <u>67 000</u> |
|                | \$            |
| CAPITAL        | 57 000        |
| LIABILITY      |               |
| Other payables | 10 000        |
|                | <u>67 000</u> |

**6 Comparing statements of financial position to see  
what transactions have occurred**

Here are some statements of financial position for one business. By comparing each statement of financial position with the previous statement of financial position, you should be able to work out what transaction has occurred.

**Statement of financial position at  
1 December 2018**

|         |           |
|---------|-----------|
|         | \$        |
| ASSETS  |           |
| Bank    | 92 000    |
|         | <u>\$</u> |
| CAPITAL | 92 000    |

**Statement of financial position at  
2 December 2018**

|           |                |
|-----------|----------------|
|           | \$             |
| ASSETS    |                |
| Equipment | 22 000         |
| Bank      | 92 000         |
|           | <u>114 000</u> |
|           | \$             |
| CAPITAL   | 92 000         |

|                |                |
|----------------|----------------|
| LIABILITY      |                |
| Other payables | 22 000         |
|                | <u>114 000</u> |

**Statement of financial position at 3 December  
2018**

|                |                |
|----------------|----------------|
|                | \$             |
| ASSETS         |                |
| Equipment      | 22 000         |
| Bank           | 107 000        |
|                | <u>129 000</u> |
|                | \$             |
| CAPITAL        | 92 000         |
| LIABILITY      |                |
| Bank loan      | 15 000         |
| Trade payables | 22 000         |
|                | <u>129 000</u> |

**Statement of financial position at 4 December  
2018**

|                   |                |
|-------------------|----------------|
|                   | \$             |
| ASSETS            |                |
| Equipment         | 16 000         |
| Trade receivables | 6 000          |
| Bank              | 107 000        |
|                   | <u>129 000</u> |
|                   | \$             |
| CAPITAL           | 92 000         |
| LIABILITY         |                |
| Bank loan         | 15 000         |
| Trade payables    | 22 000         |
|                   | <u>129 000</u> |

**Statement of financial position at 5 December  
2018**

|                   |                |
|-------------------|----------------|
|                   | \$             |
| ASSETS            |                |
| Equipment         | 16 000         |
| Trade receivables | 3 000          |
| Bank              | 110 000        |
|                   | <u>129 000</u> |
|                   | \$             |

|                |                |
|----------------|----------------|
| CAPITAL        | 92 000         |
| LIABILITY      |                |
| Bank loan      | 15 000         |
| Trade payables | 22 000         |
|                | <u>129 000</u> |

### 7 Further practice at recording transactions using statements of financial position

Tarek opened a hardware store on 1 March 2018. The business's statement of financial position on that date was as follows:

#### Tarek Statement of financial position at 1 March 2018

|                  |               |
|------------------|---------------|
|                  | \$            |
| ASSETS           |               |
| Equipment        | 14 100        |
| Bank             | 28 200        |
| Cash             | 600           |
|                  | <u>42 900</u> |
|                  | \$            |
| CAPITAL          | 32 900        |
| LIABILITY        |               |
| Bank Loan (2016) | 10 000        |
|                  | <u>42 900</u> |

The following transactions occurred during the period 1–7 March 2018:

- Mar 2 Purchased a delivery van on credit for \$19 600
- 3 Purchased shop fittings for \$7200 and paid by cheque
- 4 Tarek withdrew \$500 cash for private use
- 5 Tarek decided to sell some of the equipment, with a value of \$2400, for that amount on credit
- 6 Paid the trade payables \$11 500 by cheque
- 7 Received a cheque for \$1200 from the trade receivables

Prepare an updated statement of financial position after each transaction. The last statement of financial position (at 7 March) should be set out as a fully classified statement of financial position.

### 8 Further practice at recording transactions using statement of financial position

Karita owns a hairdressing business which she opened on 1 April 2018. The business's statement of financial position on that date was as follows:

#### Statement of financial position at 1 April 2018

|                   |               |
|-------------------|---------------|
|                   | \$            |
| TRADE RECEIVABLES |               |
| Equipment         | 11 000        |
| Receivables       | 2 900         |
| Bank              | 6 300         |
| Cash              | 800           |
|                   | <u>21 000</u> |
|                   | \$            |
| CAPITAL           | 17 600        |
| LIABILITY         |               |
| Trade payables    | 3 400         |
|                   | <u>21 000</u> |

The following transactions occurred during the period 1–7 April 2018:

- Apr 2 Purchased some additional equipment on credit for \$4100
- 3 Received \$200 cash from the trade receivables
- 3 Arranged a long-term bank loan for \$9000. The funds were paid into the business's bank account
- 5 Karita withdrew \$400 cash for private use
- 6 Sold some unwanted equipment, with a value of \$1500, for that amount on credit
- 7 Paid the trade payables \$6200 by cheque

Prepare an updated statement of financial position after each transaction. The last statement of financial position (at 7 April) should be set out as a fully classified statement of financial position.



**9 Further practice at recording transactions using statements of financial position**

Gary owns a sports shop called Play to Win. The business's statement of financial position on 1 August 2018 was as follows:

**Statement of financial position at  
1 August 2018**

|                              | \$            |
|------------------------------|---------------|
| <b>ASSETS</b>                |               |
| Shop furniture and equipment | 26 400        |
| Trade receivables            | 1 800         |
| Bank                         | 3 200         |
| Cash                         | 900           |
|                              | <u>32 300</u> |
|                              | \$            |
| <b>CAPITAL</b>               | 22 600        |
| <b>LIABILITIES</b>           |               |
| Bank loan                    | 6 000         |
| Trade payables               | 3 700         |
|                              | <u>32 300</u> |

The following transactions occurred during the period 2-8 August 2018:

- Aug 2 Purchased new shop furniture on credit for \$3 100
- 3 Sold some unwanted shop equipment for cash \$400
- 4 Transferred cash \$700 to the business bank account
- 5 Gary withdrew a cheque for \$600 for private use
- 6 Paid trade payables \$3 100 by cheque
- 7 Received a cheque for \$1 500 from a trade receivable
- 8 Repaid part of the bank loan \$900 by transfer from the business bank account

Prepare an updated statement of financial position after each transaction. The last statement of financial position (at 8 August 2018) should be set out as a fully classified statement of financial position.

**10 Further practice at recording transactions using statements of financial position**

Amy opened a health food store called Glowing with Health on 1 July 2018. The business's first statement of financial position was as follows:

**Statement of financial position at  
1 July 2018**

|                             | \$            |
|-----------------------------|---------------|
| <b>ASSETS</b>               |               |
| Shop furniture and fittings | 18 400        |
| Motor vehicle               | 16 200        |
| Bank                        | 6 500         |
| Cash                        | 200           |
|                             | <u>41 300</u> |
|                             | \$            |
| <b>CAPITAL</b>              | 35 200        |
| <b>LIABILITIES</b>          |               |
| Trade payables              | 6 100         |
|                             | <u>41 300</u> |

The following transactions occurred during the period 2-8 July 2018:

- July 2 Paid trade payable \$4 300 by cheque
- 3 Arranged a bank loan for \$5 000; funds were transferred to the business bank account
- 4 Purchased additional shop fittings and paid by cheque \$4 000
- 5 Cash was withdrawn from the bank for business use \$800
- 6 Amy withdrew cash \$400 for private use
- 7 Some shop furniture was sold on credit \$1 200
- 8 Amy invested a further \$3 000 in the business from her private funds; the amount was paid into the business's bank account

Prepare an updated statement of financial position after each transaction. The last statement of financial position (at 8 July 2018) should be set out as a fully classified statement of financial position.

# Using T accounts

## LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- record transactions using T accounts.

## KEY TERMS

**T account:** a two-sided form used to record transactions affecting a particular aspect of a business's financial activities.

## How to use T accounts

The following illustration shows how T accounts can be used to record the amounts involved in transactions.

### Illustration 1 Using T accounts

Dale owns a village store. The business's statement of financial position on 1 May 2018 was as follows:

| Dale<br>Statement of financial position at 1 May 2018 |        | \$ |
|---|--------|----|
| <b>ASSETS</b>   |        |    |
| Equipment   | 37 000 |    |
| Bank  | 8 000  |    |
|   | <hr/>  |    |
|   | 45 000 |    |
|   | <hr/>  |    |
|   | \$     |    |
| <b>CAPITAL</b>  | 40 000 |    |
| <b>LIABILITY</b>                                      |        |    |
| Trade payables  | 5 000  |    |
|   | <hr/>  |    |
|   | 45 000 |    |

During the first few days of May several transactions occurred. Here is the first of these transactions:

- Transaction 1: some additional equipment was purchased and a payment of \$6000 was made by cheque.

Step 1: Prepare T accounts for each item shown in the statement of financial position and record the opening amount for each item in the appropriate T account.

It is important to note that accounts work in the following way:

| Asset account                         |                                       |
|---------------------------------------|---------------------------------------|
| INCREASE (+)<br><i>Starting value</i> | DECREASE (–)                          |
| <hr/>                                 |                                       |
| Liability account                     |                                       |
| DECREASE (–)                          | INCREASE (+)<br><i>Starting value</i> |
| <hr/>                                 |                                       |

### Capital account

DECREASE (–)

INCREASE (+)  
*Starting value*

Asset accounts work in one way while liability and capital accounts work in the opposite way. This reflects the fact they are shown as opposites in the accounting equation.

Here are the updated accounts:

### Equipment account

37 000

### Bank account

8 000

### Capital account

40 000

### Trade payables account

5 000

You will notice that the opening amounts are recorded on the 'increase' (positive) side of the relevant account.

Step 2: Record each transaction in these accounts. You already know that whatever the transaction, two accounts will be affected, so it will be necessary to make two entries.

First work out which two accounts will be affected by the transaction and how each account will be affected.

Here is a summary for the first transactions:

- Equipment + \$6000
- Bank – \$6000

and the updated accounts are shown below:

| Equipment account      |        |
|------------------------|--------|
| 37 000                 |        |
| 6 000                  |        |
| Bank account           |        |
| 8 000                  | 6 000  |
| Capital account        |        |
|                        | 40 000 |
| Trade payables account |        |
|                        | 5 000  |

You will see that:

- In the Equipment account an entry has been made on the left-hand, positive, side of the account because there has been an increase in equipment.
- In the Bank account an entry has been made on the right-hand, negative, side of the account because there has been a decrease in bank.

### Illustration 2 Recording Dale's second transaction

Here is a summary of the decisions to be made for the second transaction:

- Transaction 2: Dale pays the trade payables \$1000 by cheque.

| Decision   | Answer  |
|--|---|
| Which two accounts are affected by the transaction?                              | Bank<br>Trade payables  |
| How is each account affected by the transaction ( <b>increase or decrease</b> )? | Bank: decrease<br>Trade payables: decrease                                    |
| On <b>which side</b> of each account should an entry be made?                    | Bank: right-hand (decrease) side<br>Trade payables: left-hand (decrease) side |

Here are the updated accounts:

| Equipment account      |                |
|------------------------|----------------|
| 37 000                 |                |
| 6 000                  |                |
| Bank account           |                |
| 8 000                  | 6 000<br>1 000 |
| Capital account        |                |
|                        | 40 000         |
| Trade payables account |                |
| 1 000                  | 5 000          |

### Illustration 3 Recording Dale's third transaction

Here are the decisions for the third transaction:

- Transaction 3: Dale withdraws a cheque for \$200 for his private use (i.e. drawings).

| Decision   | Answer   |
|--|--|
| Which two accounts are affected by the transaction?                              | Bank<br>Capital  |
| How is each account affected by the transaction ( <b>increase or decrease</b> )? | Bank: decrease<br>Capital: decrease                                    |
| On <b>which side</b> of each account should an entry be made?                    | Bank: right-hand (decrease) side<br>Capital: left-hand (decrease) side |

Here are the updated accounts:

| Equipment account      |                       |
|------------------------|-----------------------|
| 37 000                 |                       |
| 6 000                  |                       |
| Bank account           |                       |
| 8 000                  | 6 000<br>1 000<br>200 |
| Capital account        |                       |
| 200                    | 40 000                |
| Trade payables account |                       |
| 1 000                  | 5 000                 |

You can now answer questions 1–4 on page 22.



# Preparing ledger accounts

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- use the terms 'debit' and 'credit' when recording transactions
- prepare ledger accounts making detailed entries.

## KEY TERMS

**Debit:** the left-hand side of an account.

**Credit:** the right-hand side of an account.

**Ledger:** the book in which all financial accounts are kept.

## LINKS...

In 2.4 you will be shown how to record drawings in a separate account

## LINKS...

For convenience, one account is used for all trade payables and one account for all trade receivables. In 2.13 you will be shown how to use separate accounts for each trade payable and each trade receivable.

## Using the terms 'debit' and 'credit'

You may have noticed that in working through the illustrations on the previous pages, there was always a left-hand entry and a right-hand entry in the T accounts. This is the most important consequence of arranging asset accounts to work in the opposite way to liability and capital accounts. You will find that whatever transaction you record in an accounting system, it always results in a left-hand and a right-hand entry. This is a very useful outcome. It means that even if you are trying to work out how to record an unfamiliar or complex transaction, you will know that you must have a left-hand and right-hand entry.

The term **debit** is used for entries on the left-hand side of any account, and **credit** is used for entries on the right-hand side of any account.

## How do accounts work?

Here is a summary of how accounts work:

| Any account                                   |   |
|---|---|
| <i>Debit (left-hand) side</i>                 | <i>Credit (right-hand) side</i>                 |
| Asset account                                 |   |
| INCREASE (+)<br><i>Debit (left-hand) side</i> | DECREASE (–)<br><i>Credit (right-hand) side</i> |
| Liability account                             |   |
| DECREASE (–)<br><i>Debit (left-hand) side</i> | INCREASE (+)<br><i>Credit (right-hand) side</i> |
| Capital account                               |   |
| DECREASE (–)<br><i>Debit (left-hand) side</i> | INCREASE (+)<br><i>Credit (right-hand) side</i> |

Or:

| Debit Entries                   | Credit Entries                    |
|---------------------------------|-----------------------------------|
| Debit an increase in an ASSET   | Credit a decrease in an ASSET     |
| Debit a decrease in a LIABILITY | Credit an increase in a LIABILITY |
| Debit a decrease in CAPITAL     | Credit an increase in CAPITAL     |

## Ledger accounts

When recording transactions in accounts it is helpful to record not just the amounts, but also the date of the transaction and a narrative. In order to do this, simple T accounts become a little more advanced.

At one time all accounts were kept in a single book, called the **ledger**, hence the expression 'ledger accounts'. Nowadays most accounting records are electronic and make use of accounting software programs.

#### Illustration 4 Using ledger accounts

Here is a new version of the T accounts as shown in Illustration 3. This time they are set out as proper ledger accounts. This means the accounts now show:

- a date for each entry (using the columns for month and day)
- a narrative about each entry written in the details column:
  - for the opening entry the word 'balance' is used
  - the rule for other entries is to name the other account involved in the transaction.

You will also notice that each account now shows the abbreviation Dr (for debit) on the left-hand side of each account and the abbreviation Cr (for credit) on the right-hand side of each account.

| Dr  |   |         |        | Equipment account      |  |  |  | Cr  |   |               |        |
|-----|---|---------|--------|------------------------|--|--|--|-----|---|---------------|--------|
| May | 1 | Balance | 37 000 |                        |  |  |  |     |   |               |        |
|     | 2 | Bank    | 6 000  |                        |  |  |  |     |   |               |        |
| Dr  |   |         |        | Bank account           |  |  |  | Cr  |   |               |        |
| May | 1 | Balance | 8 000  |                        |  |  |  | May | 2 | Equipment     | 6 000  |
|     |   |         |        |                        |  |  |  |     | 3 | Trade payable | 1 000  |
|     |   |         |        |                        |  |  |  |     | 4 | Capital       | 200    |
| Dr  |   |         |        | Capital account        |  |  |  | Cr  |   |               |        |
| May | 4 | Bank    | 200    |                        |  |  |  | May | 1 | Balance       | 40 000 |
| Dr  |   |         |        | Trade payables account |  |  |  | Cr  |   |               |        |
| May | 3 | Bank    | 1 000  |                        |  |  |  | May | 1 | Balance       | 5 000  |

**Note:** once the name of the month is recorded on the debit and/or credit side of an account, there is no need to repeat this detail on succeeding lines.

#### What about statements of financial position?

It is possible to prepare a statement of financial position at any time based on all of the detailed information recorded in ledger accounts.

In Illustration 4, for example, it is relatively easy to work out an updated figure for each of the four ledger accounts:

|                |          |   |
|----------------|----------|---|
| Equipment      | \$43 000 | (the total of the two entries on the debit side)                                    |
| Bank           | \$800    | (the difference between the debit total \$8000 and the credit total \$7200)         |
| Capital        | \$39 800 | (the difference between the debit total of \$200 and the credit total of \$40 000)  |
| Trade payables | \$4 000  | (the difference between the debit total of \$1 000 and the credit total of \$5 000) |

So, the (simple) statement of financial position on 4 May after the transactions had been recorded would look like this:

| Dale  |              |
|---|--------------|
| Statement of financial position at 4 May 2018 |              |
|   | \$           |
| ASSETS  |              |
| Equipment                                     | 43 000       |
| Bank  | 800          |
|   | <hr/> 43 800 |
|   | \$           |
| CAPITAL                                       | 39 800       |
| LIABILITY                                     |              |
| Trade payables                                | 4 000        |
|   | <hr/> 43 800 |

Statements of financial position are a very important financial statement. They are prepared whenever required, but most businesses prepare them at the end of every financial year.

You can now answer questions 5–8 on page 23.

#### STUDY TIP

It is easy to overlook some point of detail when you are preparing a set of accounts. When you think you have completed a task, do have a look through to see if you have missed out a date or some narrative.

You can now answer questions 9 and 10 on page 24.



## DEVELOPING YOUR SKILLS

## 1 Recording transactions using simple T accounts

Padma owns a business which provides a delivery service. On 1 January 2018 the business's statement of financial position was as follows:

| Padma<br>Statement of financial position at 1 January<br>2018 |              |
|---|--------------|
|   | \$           |
| ASSETS  |              |
| Vehicles  | 40 000       |
| Bank  | 19 000       |
|   | <hr/> 59 000 |
|   | \$           |
| CAPITAL   | 47 000       |
| LIABILITY   |              |
| Bank loan   | 12 000       |
|   | <hr/> 59 000 |

The following transactions occurred during the following few days:

- Jan 2 Purchased an additional vehicle for \$14 000 and paid by cheque  
 3 Borrowed an additional \$4000 from the bank. The funds were paid directly into the business's bank account  
 4 Padma withdrew a cheque for \$2000 for private use

Record these details in simple T accounts. Record amounts only.

## 2 Recording transactions using simple T accounts

John owns a café. His business's statement of financial position on 1 June 2018 was as follows:

| John<br>Statement of financial position at 1 June 2018 |              |
|--|--------------|
|  | \$           |
| ASSETS   |              |
| Equipment  | 27 000       |
| Bank   | 8 000        |
|  | <hr/> 35 000 |
|  | \$           |
| CAPITAL  | 29 000       |
| LIABILITY  |              |
| Trade payables   | 6 000        |
|  | <hr/> 35 000 |

The following transactions occurred during the next few days:

- June 2 Purchased some additional equipment and paid \$4000 by cheque  
 3 Paid the trade payables \$2000 by cheque  
 4 John withdrew a cheque for \$700 for private use

Record these details in simple T accounts. Record amounts only.

## 3 Deciding how accounts are affected by transactions

Complete the table shown below for each of the transactions.

| Transaction  | First account affected |                   | Second account affected |                   |
|--|------------------------|-------------------|-------------------------|-------------------|
|  | Account                | Increase/decrease | Account                 | Increase/decrease |
| Owner started business by investing money in a business bank account |                        |                   |                         |                   |
| Purchased a vehicle and paid by cheque                               |                        |                   |                         |                   |
| Purchased some equipment on credit                                   |                        |                   |                         |                   |
| The owner withdrew a cheque for private use                          |                        |                   |                         |                   |

## 4 Deciding how accounts are affected by transactions

Complete the table shown below for each of the transactions.

| Transaction  | First account affected |                   | Second account affected |                   |
|--|------------------------|-------------------|-------------------------|-------------------|
|  | Account                | Increase/decrease | Account                 | Increase/decrease |
| Some furniture was purchased by cheque                                       |                        |                   |                         |                   |
| A bank loan was arranged. The funds were paid into the business bank account |                        |                   |                         |                   |
| Purchased a vehicle on credit  |                        |                   |                         |                   |
| Sold some unwanted furniture on credit                                       |                        |                   |                         |                   |



## 5 Using the terms 'debit' and 'credit'

Will owns a business selling fruit and vegetables. On 1 July 2018 the business's statement of financial position was as follows:

| Will   |              |
|--|--------------|
| Statement of financial position at 1 July 2018 |              |
|  | \$           |
| ASSETS   |              |
| Vehicle  | 14 000       |
| Bank   | 7 000        |
|  | <hr/> 21 000 |
|  | \$           |
| CAPITAL  | 17 000       |
| LIABILITY                                      |              |
| Trade payables                                 | 4 000        |
|  | <hr/> 21 000 |

The following transactions occurred during the next few days:

- July
- 2 Purchased some equipment on credit for \$9 000
  - 3 Will withdrew a cheque for \$300 for private use
  - 4 Arranged a bank loan for \$6 000. The funds were paid directly into the business's bank account
  - 5 Purchased some additional equipment and paid by cheque \$9 200
  - 6 Paid the trade payables \$2 500

Record these details in simple T accounts. Record amounts only. Open additional accounts as necessary. Include the abbreviations 'Dr' and 'Cr' in the account titles.

## 6 Using the terms 'debit' and 'credit'

Sachin owns a plumbing business. On 1 May 2018 the business's statement of financial position was as follows:

| Sachin  |              |
|---|--------------|
| Statement of financial position at 1 May 2018 |              |
|   | \$           |
| ASSETS  |              |
| Vehicle                                       | 13 000       |
| Equipment                                     | 8 000        |
| Bank  | 4 000        |
| Cash  | 400          |
|   | <hr/> 25 400 |
|   | \$           |
| CAPITAL                                       | 24 200       |
| LIABILITY                                     |              |
| Trade payables                                | 1 200        |
|   | <hr/> 25 400 |

The following transactions occurred during the following few days:

- May
- 2 Sachin withdrew \$200 cash for private use
  - 3 The trade payables were paid \$1 000 by cheque
  - 4 Sold some unwanted equipment with a value of \$800 on credit for that amount
  - 5 Purchased some new equipment on credit for \$5 000
  - 6 Received \$100 cash from the trade receivables

Record these details in simple T accounts. Record amounts only. Open additional accounts as necessary. Include the abbreviations 'Dr' and 'Cr' in the account titles.

## 7 Using the terms 'debit' and 'credit'

Here is a list of transactions. In each case decide which two accounts are affected by the transaction and whether each account will increase or decrease in value. State whether you would debit or credit each of the accounts concerned. The first transaction has been completed for you.

| Transaction                         | Accounts affected | Increase/decrease | Debit/credit |
|-------------------------------------|-------------------|-------------------|--------------|
| Purchased some furniture by cheque  | Furniture         | Increase          | Debit        |
|                                     | Bank              | Decrease          | Credit       |
|                                     |                   |                   |              |
| Paid a trade payable by cheque      |                   |                   |              |
|                                     |                   |                   |              |
|                                     |                   |                   |              |
| Owner withdrew cash for private use |                   |                   |              |
|                                     |                   |                   |              |
|                                     |                   |                   |              |
| Purchased a vehicle on credit       |                   |                   |              |
|                                     |                   |                   |              |

## 8 Using the terms 'debit' and 'credit'

Here is a list of transactions. In each case decide which two accounts are affected by the transaction and whether each account will increase or decrease in value. State whether you would debit or credit each of the accounts concerned.

| Transaction                   | Accounts affected | Increase/decrease | Debit/credit |
|-------------------------------|-------------------|-------------------|--------------|
| Purchased equipment on credit |                   |                   |              |
|                               |                   |                   |              |
|                               |                   |                   |              |

| Transaction                     | Accounts affected | Increase/decrease | Debit/credit |
|---------------------------------|-------------------|-------------------|--------------|
| Paid the trade payables in cash |                   |                   |              |
|                                 |                   |                   |              |

| Transaction                              | Accounts affected | Increase/decrease | Debit/credit |
|--|-------------------|-------------------|--------------|
| Sold some unwanted furniture on credit   |                   |                   |              |
|  |                   |                   |              |
| Received cash from the trade receivables |                   |                   |              |
|  |                   |                   |              |

## 9 Preparing detailed ledger accounts

Ross owns a music business. His business's statement of financial position at 1 January 2018 was as follows:

### Ross Statement of financial position at 1 January 2018

|           |         |
|-----------|---------|
|           | \$      |
| ASSETS    |         |
| Premises  | 90 000  |
| Equipment | 12 000  |
| Vehicle   | 9 000   |
| Bank      | 3 300   |
| Cash      | 700     |
|           | <hr/>   |
|           | 115 000 |
|           | <hr/>   |
|           | \$      |
| CAPITAL   | 100 000 |
| LIABILITY |         |
| Bank loan | 15 000  |
|           | <hr/>   |
|           | 115 000 |

The following transactions occurred during the next few days:

- Jan 2 Repaid \$1000 of the bank loan transferring funds from the business's bank account
- 3 Purchased some additional equipment on credit for \$4100
- 4 Ross withdrew \$300 cash for private use
- 5 Sold some unwanted equipment with a value of \$500 on credit for that amount
- 6 Ross introduced some additional capital by paying in a cheque for \$4000 from his private funds
- 7 Transferred \$200 cash to the bank account

Prepare detailed ledger accounts to record this information. Record dates, narratives and amounts. Open additional accounts as necessary. Include the abbreviations 'Dr' and 'Cr' in the account titles.

Prepare a new (classified) statement of financial position dated 7 January 2018 when all of the transactions have been recorded. Assume the bank loan is a long-term liability.

## 10 Preparing detailed ledger accounts

Becky owns an interior design business. Her business's statement of financial position at 1 April 2018 was as follows:

### Becky Statement of financial position at 1 April 2018

|                   |        |
|-------------------|--------|
|                   | \$     |
| ASSETS            |        |
| Vehicle           | 16 000 |
| Furniture         | 11 000 |
| Trade receivables | 4 400  |
| Bank              | 2 800  |
| Cash              | 900    |
|                   | <hr/>  |
|                   | 35 100 |
|                   | <hr/>  |
|                   | \$     |
| CAPITAL           | 32 900 |
| LIABILITY         |        |
| Trade payables    | 2 200  |
|                   | <hr/>  |
|                   | 35 100 |

The following transactions occurred during the next few days:

- April 2 Purchased some additional furniture for \$2400 and paid by cheque
- 3 Becky withdrew a cheque for \$200 for her private use
- 4 Received a cheque from the trade receivables for \$2900
- 5 Arranged a long-term loan with the bank for \$7200. The funds were paid into the business's bank account
- 6 Paid the trade payables \$400 in cash
- 7 Transferred \$100 cash to the bank account

Prepare detailed ledger accounts to record this information. Record dates, narratives and amounts. Open additional accounts as necessary. Include the abbreviations 'Dr' and 'Cr' in the account titles.

Prepare a new statement of financial position dated 8 April 2018 when all of the transactions have been recorded.

# Using expense, purchases, sales and drawings accounts

You are now going to apply the rules of **double entry** to a further important group of transactions: the payment of expenses, the purchase of goods for resale, the sale of goods, and owner's drawings.

## What are expenses?

**Expenses** are the everyday running costs of a business, such as electricity, wages, rent, telephone charges, and so on. All businesses make regular payments for items like these. The important feature of an expense is that the benefit received from the payment is very short-lived. After just a few days or weeks, the business will be making another payment for the same thing. Contrast this with, say, a business buying some equipment (an asset). In this situation the benefit to the business lasts over several years. On the other hand, if a business pays the shop rent (an expense) the benefit lasts just a few weeks, and then the next rent payment has to be made. This distinction is important in accounting and the terms 'revenue expenditure' (for expenses) and 'capital expenditure' (for non-current assets) are used.

These are some typical expenses for a small business:

- Administration expenses (e.g. postage, stationery)
- Advertising
- Carriage (delivery charges)
- Electricity
- General expenses (covering a wide range of running costs)
- Insurance
- Interest charges
- Maintenance costs
- Motor expenses (e.g. fuel charges, servicing and maintenance of vehicles)
- Operating expenses
- Repairs
- Salaries
- Selling expenses
- Telephone charges
- Wages
- Water charges

### LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- record some new transactions involving expense payments
- record purchases and sales of goods in ledger accounts
- make entries for drawings in ledger accounts.

### KEY TERMS

**Double entry:** the process of making two entries for every transaction.

**Expenses:** payments made to purchase goods or services to run the business on a day-to-day basis.



### LINKS...

There is more about the terms 'revenue expenditure' and 'capital expenditure' in 4.4



### STUDY TIP

The purchases account is only used when goods for resale are purchased. This account is not used for the purchase of an asset. When an asset is purchased (e.g. a new vehicle) the asset account is debited.

## Recording expenses

When payment is made for an expense a record must be kept in the accounting system. Any payment made by cheque or cash is recorded as follows:

|       |      |           |                        |
|-------|------|-----------|------------------------|
| Asset | Bank | decreases | so credit bank account |
| Asset | Cash | decreases | so credit cash account |

Following the rules of double entry, the second entry will be:

Debit Expense account

So, expense accounts are debited when payments are made.

### Illustration 1 Recording the payment of wages

On 31 May 2018 the owner of a business paid \$210 wages in cash. The two accounts involved are: Cash and Wages.

| Dr  |    |      |     | Cash account  |    | Cr    |     |
|-----|----|------|-----|---------------|----|-------|-----|
|     |    |      |     | May           | 31 | Wages | 210 |
| Dr  |    |      |     | Wages account |    | Cr    |     |
| May | 31 | Cash | 210 |               |    |       |     |

## Buying goods for resale

The main activity of many businesses is buying goods from suppliers in order to sell them to customers at a profit. When goods for resale are purchased by cheque the entries required will be:

● Debit Purchases account ● Credit Bank account

If the goods for resale were purchased on credit the entries would be:

● Debit Purchases account ● Credit Trade payable account

### Illustration 2 Recording the purchases of goods for resale

On 4 May 2018 a business purchased some goods for resale, value \$420, and paid by cheque. On 5 May the business purchased some goods on credit, value \$1700. The accounts should show the following entries:

| Dr  |   |                |      | Purchases account      |   | Cr        |      |
|-----|---|----------------|------|------------------------|---|-----------|------|
| May | 4 | Bank           | 420  |                        |   |           |      |
|     | 5 | Trade payables | 1700 |                        |   |           |      |
| Dr  |   |                |      | Bank account           |   | Cr        |      |
|     |   |                |      | May                    | 4 | Purchases | 420  |
| Dr  |   |                |      | Trade payables account |   | Cr        |      |
|     |   |                |      | May                    | 5 | Purchases | 1700 |

### LINKS...

See 2.7 for information about how businesses calculate profits and losses.

## Selling goods

Every time goods are sold, the owner of the business will be pleased, not only because the business will receive money (or the promise of money to be received in the future), but also because the business will make a profit on the sale.

If goods are sold for cash the entries required will be:

- Debit      Cash account      ● Credit      Sales account

Of course, the money from the customer might be banked immediately, in which case the debit entry would be in the bank account.

If goods are sold on credit the entries required will be:

- Debit      Trade receivables account      ● Credit      Sales account



### LINKS...

See 4.1–4.3 for more information about inventories.



### LINKS...

There is more about the business entity principle in 7.2

#### Illustration 3 Recording the sale of goods

On 8 May 2018 a business sold goods for \$920 and received payment by cheque. On 9 May the business sold some goods on credit for \$380. The accounts should show the following entries:

| Sales account |       |                     |     | Bank account |       |     |    |
|---------------|-------|---------------------|-----|--------------|-------|-----|----|
| Dr            |       |                     | Cr  | Dr           |       |     | Cr |
|               | May 8 | Bank                | 920 | May 8        | Sales | 920 |    |
|               |       | 9 Trade receivables | 380 |              |       |     |    |

| Trade receivables account |       |       |     |  |  |  |  |
|---------------------------|-------|-------|-----|--|--|--|--|
| Dr                        |       |       | Cr  |  |  |  |  |
|                           | May 9 | Sales | 380 |  |  |  |  |

## What about inventories?

Of course, throughout a period of trading the owner of a business will be holding inventories (unsold goods). Information about how inventories are recorded in the accounting records is covered in 4.1–4.3.

## The drawings account

So far, any drawings have been debited immediately to the capital account. It is usually considered a better idea, however, to keep a separate record of drawings throughout a financial year.

So the entries for recording drawings now become:

- Debit      Drawings account      ● Credit      Bank or cash account

It is important to remember that drawings are a reduction in the investment of the owner in the business. Drawings are not an expense of the business. Drawings result from decisions made by the owners of a business about their personal affairs and are not directly related to the needs of the business. On the other hand, expenses result from the business's everyday trading activities. The idea of separating out from the business's affairs any transactions that relate to the owner's private affairs is referred to as the 'business entity principle'.

### STUDY TIP

The sales account is only used to record the sale of goods. It is not used to record the sale of a non-current asset. If an asset is sold (e.g. some unwanted equipment), it is the asset account that is credited.

You can now answer questions 1 and 2 on page 30.

You can now answer questions 3 and 4 on page 30–31.

#### Illustration 4 Using a drawings account

The owner of a business has invested capital of \$80 000. The owner withdrew a cheque for \$200 for private use on 1 August 2018. The accounting records will be as follows:

| Capital account |       |         |        | Drawings account |      |     |    |
|-----------------|-------|---------|--------|------------------|------|-----|----|
| Dr              |       |         | Cr     | Dr               |      |     | Cr |
|                 | Aug 1 | Balance | 80 000 | Aug 1            | Bank | 200 |    |

| Bank account |       |          |     |  |  |  |  |
|--------------|-------|----------|-----|--|--|--|--|
| Dr           |       |          | Cr  |  |  |  |  |
|              | Aug 1 | Drawings | 200 |  |  |  |  |

# Getting used to the new accounts

## How to think about these new accounts and the rules of double entry

It is possible to identify expense, purchase, sales and drawings accounts as part of the information about the capital of the business.

This means that these new accounts work in the same way as a capital account. A debit entry in an expense or drawings account indicates a decrease in capital, i.e. the value of the business has decreased. The purchases account can be regarded as a temporary expense account. Capital is increased by the difference between the value of sales and purchases (i.e. the profit made on selling goods).

### Update: Summary of the rules for double entry

| Asset accounts |               | Liability accounts |               | Capital accounts (and subdivisions) |               |                          |                          |
|----------------|---------------|--------------------|---------------|-------------------------------------|---------------|--------------------------|--------------------------|
| Dr             | Cr            | Dr                 | Cr            | Dr                                  | Cr            | Dr                       | Cr                       |
| Increase<br>+  | Decrease<br>- | Decrease<br>-      | Increase<br>+ | Decrease<br>-                       | Increase<br>+ | Decrease<br>-            | Increase<br>+            |
|                |               |                    |               | Dr                                  | Cr            | Dr                       | Cr                       |
|                |               |                    |               | Expenses                            |               | Sales                    |                          |
|                |               |                    |               | Entries decrease capital            |               |                          | Entries increase capital |
|                |               |                    |               | Dr                                  | Cr            | Dr                       | Cr                       |
|                |               |                    |               | Drawings                            |               | Purchases                |                          |
|                |               |                    |               | Entries decrease capital            |               | Entries decrease capital |                          |

### Illustration 5 Applying the rules of double entry

Vladim is the owner of 'ForU', a shop that sells some of the latest technology.

#### ForU

#### Statement of financial position at 1 October 2018

|                        |        |
|------------------------|--------|
|                        | \$     |
| ASSETS                 |        |
| Furniture and fittings | 27 000 |
| Vehicle                | 25 000 |
| Trade receivables      | 2 800  |
| Bank                   | 5 900  |
| Cash                   | 200    |
|                        | <hr/>  |
|                        | 60 900 |
|                        | <hr/>  |
|                        | \$     |
| CAPITAL                | 57 100 |
| LIABILITIES            |        |
| Trade payables         | 3 800  |
|                        | <hr/>  |
|                        | 60 900 |
|                        | <hr/>  |

Here is a table showing the transactions that occurred in October and how the correct entries have been worked out.

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| Transactions |  | Which accounts are affected    | Accounts by classification     |                |                              | Entries required                           |                                       |
|--------------|--|--------------------------------|--------------------------------|----------------|------------------------------|--|---------------------------------------|
|              |  |                                | Asset                          | Liability      | Capital and its subdivisions | Debit                                      | Credit                                |
| Oct 3        | Paid trade payables \$2100 by cheque                   | Bank<br>Trade payables         | Bank                           | Trade payables |                              | Trade payables (decrease in liability)     | Bank (decrease in asset)              |
| 6            | Paid general expenses \$100 in cash                    | Cash<br>General expenses       | Cash                           |                | General expenses             | General expenses (decrease in capital)     | Cash (decrease in asset)              |
| 8            | Cash sales totalled \$1430                             | Cash<br>Sales                  | Cash                           |                | Sales                        | Cash (increase in asset)                   | Sales (increase in capital)           |
| 11           | Vladim withdrew cash \$240 for private use             | Cash<br>Drawings               | Cash                           |                | Drawings                     | Drawings (decrease in capital)             | Cash (decrease in asset)              |
| 14           | Purchased some new shop fittings; paid \$850 by cheque | Bank<br>Furniture and fittings | Bank<br>Furniture and fittings |                |                              | Furniture and fittings (increase in asset) | Bank (decrease in asset)              |
| 19           | Received a cheque for \$2400 from a trade receivable   | Bank<br>Trade receivables      | Bank<br>Trade receivables      |                |                              | Bank (increase in asset)                   | Trade receivables (decrease in asset) |
| 23           | Paid rent by cheque \$920                              | Bank<br>Rent                   | Bank                           |                | Rent                         | Rent (decrease in capital)                 | Bank (decrease in asset)              |
| 26           | Sold goods on credit for \$3100                        | Trade receivables<br>Sales     | Trade receivables              |                | Sales                        | Trade receivables (increase in asset)      | Sales (increase in capital)           |
| 30           | Purchased goods for resale and paid \$480 in cash      | Cash<br>Purchases              | Cash                           |                | Purchases                    | Purchases (decrease in capital)            | Cash (decrease in asset)              |

Here are the accounts recording all of this information.

|   |   |
|---|---|
| <b>Dr Bank account Cr</b><br>Oct 1 Balance 5900<br>19 Trade receivables 2400      | <b>Dr General expenses account Cr</b><br>Oct 6 Cash 100   |
| <b>Dr Capital account Cr</b><br>Oct 1 Balance 57100                               | <b>Dr Trade payables account Cr</b><br>Oct 3 Bank 2100<br>Oct 1 Balance 3800                      |
| <b>Dr Cash account Cr</b><br>Oct 1 Balance 200<br>8 Sales 1430                    | <b>Dr Purchases Cr</b><br>Oct 30 Trade payables 480   |
| <b>Dr Drawings account Cr</b><br>Oct 11 Cash 240                                  | <b>Dr Trade receivables account Cr</b><br>Oct 1 Balance 2800<br>26 Sales 3100<br>Oct 19 Bank 2400 |
| <b>Dr Furniture and fittings account Cr</b><br>Oct 1 Balance 27000<br>14 Bank 850 | <b>Dr Rent account Cr</b><br>Oct 23 Bank 920  |
|   | <b>Dr Sales account Cr</b><br>Oct 8 Cash 1430<br>26 Trade receivables 3100                        |
|   | <b>Dr Vehicle account Cr</b><br>Oct 1 Balance 25000   |

**1 Recording expenses, purchases and sales**

Warren opened a business selling electrical goods on 1 February 2018.

| Warren   |        |
|--|--------|
| Statement of financial position at 1 February 2018 |        |
|  | \$     |
| ASSETS   |        |
| Bank   | 12 000 |
| Cash   | 400    |
|  | <hr/>  |
|  | 12 400 |
|  | <hr/>  |
|  | \$     |
| CAPITAL  | 12 400 |

The following transactions occurred during February 2018:

- Feb      2 Purchased goods for resale and paid by cheque, \$1200  
             4 Paid two weeks' rent by cheque, \$420  
             5 Cash sales totalled \$330  
             8 Paid insurance by cheque, \$180  
            11 Purchased goods for resale on credit, \$840  
            14 Sales on credit totalled \$910  
            18 Paid two weeks' rent by cheque, \$420  
            19 Paid insurance, \$40 in cash  
            21 Received cheques totalling \$520 for the sale of goods which were paid into the bank  
            24 Purchased goods for resale and paid in cash, \$60

Record this information in suitable ledger accounts.

**2 Recording expenses, purchases and sales**

Jenny opened a business selling shoes on 1 June 2018.

| Jenny  |        |
|--|--------|
| Statement of financial position at 1 June 2018 |        |
|  | \$     |
| ASSETS   |        |
| Bank   | 14 400 |
| Cash   | 700    |
|  | <hr/>  |
|  | 15 100 |
|  | <hr/>  |
|  | \$     |
| CAPITAL  | 15 100 |

The following transactions occurred during June 2018:

- June      2 Purchased goods for resale and paid by cheque, \$4700  
             3 Paid one month's rent by cheque, \$740  
             6 Cash sales totalled \$490

- June      7 Paid wages in cash, \$580  
            11 Purchased goods for resale on credit, \$1 470  
            13 Sales on credit totalled \$1 420  
            14 Paid wages in cash, \$490  
            19 Paid electricity charges by cheque, \$210  
            21 Received cheques totalling \$810 for the sale of goods which were paid into the bank  
            24 Purchased goods for resale and paid in cash, \$110

Record this information in suitable ledger accounts.

**3 Using expense, purchases, sales and drawings accounts**

Alex owns a business selling footwear. The business's opening statement of financial position on 1 April 2018 was as follows:

| Alex  |        |
|---|--------|
| Statement of financial position at 1 April 2018 |        |
|   | \$     |
| ASSETS  |        |
| Equipment                                       | 6 200  |
| Bank  | 8 400  |
| Cash  | 300    |
|   | <hr/>  |
|   | 14 900 |
|   | <hr/>  |
|   | \$     |
| CAPITAL   | 14 900 |

The following transactions occurred during April:

- April      4 Purchased goods for resale on credit, \$3600  
             5 Cash sales totalled \$1230  
             8 Alex withdrew a cheque for private use, \$240  
             9 Sold goods on credit, \$470  
            11 Purchased goods for resale and paid by cheque, \$510  
            13 Paid wages in cash, \$620  
            18 Purchased some additional equipment and paid by cheque, \$1020  
            19 Alex withdrew cash \$90 for private use  
            21 Sales of \$720 were paid into the bank  
            27 Paid wages in cash, \$580

Record this information in suitable ledger accounts, including a separate account for drawings.

**4 Using expense, purchases, sales and drawings accounts**

Paloma owns a grocery store. The business's opening statement of financial position on 1 October 2018 was as shown on the following page:

**Paloma**  
**Statement of financial position at 1 October 2018**

|                |        |
|----------------|--------|
|                | \$     |
| <b>ASSETS</b>  |        |
| Fittings       | 8 600  |
| Bank           | 7 800  |
| Cash           | 700    |
|                | 17 100 |
|                | \$     |
| <b>CAPITAL</b> | 17 100 |

The following transactions occurred during October:

- Oct 4 Purchased goods for resale and paid in cash, \$500  
 6 Purchased goods for resale on credit, \$4240  
 7 Cash sales totalled \$990  
 11 Paid rent for the month by cheque, \$770  
 12 Paloma withdrew cash \$110 for private use  
 15 Sales on credit totalled \$440  
 18 Sold some unwanted fittings with a value of \$300 and received cash for this amount  
 22 Paid the trade payables \$3000 by cheque  
 25 Received cash \$210 from the trade receivables  
 29 Paloma withdrew a cheque for \$390 for private use

Record this information in suitable ledger accounts, including a separate account for drawings.

**5 Identifying transactions**

The following accounts show a record of transactions over a period of five days. There is one transaction per day.

| Dr    | Purchases account         | Cr                      |
|-------|---------------------------|-------------------------|
| Jan 1 | Bank 6 000                |                         |
| 5     | Trade payables 2 290      |                         |
| Dr    | Sales account             | Cr                      |
|       | Jan 2                     | Cash 3 200              |
|       | 4                         | Trade receivables 1 730 |
| Dr    | General expenses account  | Cr                      |
| Jan 3 | Bank 320                  |                         |
| Dr    | Bank account              | Cr                      |
|       | Jan 1                     | Purchases 6 000         |
|       | Jan 3                     | General exp 320         |
| Dr    | Cash account              | Cr                      |
| Jan 2 | Sales 3 200               |                         |
| Dr    | Trade receivables account | Cr                      |
| Jan 4 | Sales 1 730               |                         |
| Dr    | Trade payables account    | Cr                      |

|  |       |           |       |
|--|-------|-----------|-------|
|  | Jan 5 | Purchases | 2 290 |
|--|-------|-----------|-------|

Identify the transactions that occurred on 1, 2, 3, 4 and 5 January.

**6 Identifying transactions**

The following accounts show a record of transactions over a period of five days. There is one transaction per day.

| Dr    | Bank account              | Cr                      |
|-------|---------------------------|-------------------------|
| May 5 | Trade receivables 2 000   |                         |
| Dr    | Cash account              | Cr                      |
|       | May 2                     | Wages 280               |
|       | 3                         | Purchases 170           |
| Dr    | Trade receivables account | Cr                      |
| May 1 | Sales 3 790               |                         |
|       | May 5                     | Bank 2 000              |
| Dr    | Trade payables account    | Cr                      |
|       | May 4                     | Purchases 1 200         |
| Dr    | Wages account             | Cr                      |
| May 2 | Cash 280                  |                         |
| Dr    | Sales account             | Cr                      |
|       | May 1                     | Trade receivables 3 790 |
| Dr    | Purchases account         | Cr                      |
| May 3 | Cash 170                  |                         |
| 4     | Trade payables 1 200      |                         |

Identify the transactions that occurred on 1, 2, 3, 4 and 5 May.

**7 Recording a variety of transactions**

Salman owns a small retail store. His business's statement of financial position on 1 March 2018 was as follows:

**Salman**  
**Statement of financial position at 1 March 2018**

|                    |         |
|--------------------|---------|
|                    | \$      |
| <b>ASSETS</b>      |         |
| Premises           | 120 000 |
| Vehicle            | 11 500  |
| Equipment          | 8 900   |
| Trade receivables  | 7 300   |
| Bank               | 6 400   |
| Cash               | 800     |
|                    | 154 900 |
|                    | \$      |
| <b>CAPITAL</b>     | 116 000 |
| <b>LIABILITIES</b> |         |
| Bank loan          | 30 000  |



|                |                |
|----------------|----------------|
| Trade payables | 8 900          |
|                | <u>154 900</u> |

The following transactions occurred during March:

- March
- 3 Paid a trade payable \$1700 by cheque
  - 4 Cash sales totalled \$1470
  - 5 Paid cash \$800 into the bank account
  - 8 Purchased goods for resale on credit, \$3200
  - 10 Paid insurance by cheque, \$420
  - 12 Paid wages of shop assistants in cash, \$580
  - 15 Received cheque from a trade receivable for \$2800
  - 17 Sold some unwanted equipment valued at \$400 and received a cheque for that amount
  - 18 Paid loan interest of \$120. This amount was transferred from the business bank account
  - 19 Salman withdrew cash \$250 for private use
  - 22 Cash sales totalled \$1 280
  - 24 Purchased some new equipment and paid by cheque, \$2800
  - 26 Paid wages of shop assistants in cash, \$630
  - 29 Paid insurance in cash, \$180
  - 30 Paid vehicle expenses by cheque, \$230

Record this information in suitable ledger accounts.

## 8 Recording a variety of transactions

Nicolette owns a bookshop. Her statement of financial position on 1 November 2018 was as follows:

### Nicolette Statement of financial position at 1 November 2018

|                   |               |
|-------------------|---------------|
|                   | \$            |
| ASSETS            |               |
| Equipment         | 9 400         |
| Fittings          | 8 700         |
| Trade receivables | 1 210         |
| Bank              | 3 760         |
| Cash              | 490           |
|                   | <u>23 560</u> |
|                   | \$            |
| CAPITAL           | 17 590        |

|                |               |
|----------------|---------------|
| LIABILITIES    |               |
| Bank loan      | 5 000         |
| Trade payables | 970           |
|                | <u>23 560</u> |

The following transactions occurred during November:

- Nov
- 1 Cash sales totalled \$910
  - 2 Paid rent by cheque for the month, \$750
  - 4 Purchased goods for resale and paid by cheque, \$1440
  - 5 Paid assistant's wages, \$520 in cash
  - 8 Purchased some new fittings worth \$1300 and paid by cheque
  - 11 Made a repayment of the bank loan, \$500. The funds were transferred from the business bank account
  - 12 Received a cheque from a trade receivable, \$480
  - 15 Sales totalled \$1280 and this was paid into the bank account
  - 17 Paid advertising charges, \$130 by cheque
  - 18 Paid a trade payable, \$640 by cheque
  - 22 Sales on credit totalled \$390
  - 23 Paid assistant's wages, \$820 in cash
  - 24 Sold some unwanted equipment valued at \$250 and received a cheque for that amount
  - 26 Nicolette withdrew a cheque for \$610 for her private use
  - 30 Purchased goods for resale on credit, \$2080

Record this information in suitable ledger accounts.

# How to prepare a trial balance

Now that you are used to recording a variety of transactions in ledger accounts, it is time to think about how you can make a check to ensure that you have not made a mistake and broken any of the rules of double entry. This check is called a **trial balance**.

Double entry means that for any transaction there has to be a debit entry and a matching credit entry. The trial balance is based on this rule and, in effect, it checks whether the total of debit entries in a set of accounts equals the total of credit entries. So, it is often said that a trial balance checks the arithmetical accuracy of the double entry.

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- prepare a trial balance to check the accuracy of the double-entry records
- explain the uses of a trial balance.

### Illustration 1 The idea behind a trial balance

Here is a very simple set of accounts that have been correctly maintained using the rules of double entry.

| Dr            | Bank account |                      | Cr    |
|---------------|--------------|----------------------|-------|
| Jan 1 Balance | 13 000       | Jan 4 Trade payables | 2 000 |
| 10 Sales      | 4 000        |                      |       |

| Dr | Capital account |               | Cr     |
|----|-----------------|---------------|--------|
|    |                 | Jan 1 Balance | 11 000 |

| Dr         | Trade payables account |               | Cr    |
|------------|------------------------|---------------|-------|
| Jan 3 Bank | 2 000                  | Jan 1 Balance | 2 000 |
|            |                        | 7 Purchases   | 3 000 |

| Dr              | Purchases account |  | Cr |
|-----------------|-------------------|--|----|
| Jan 7 Purchases | 3 000             |  |    |

| Dr | Sales account |              | Cr    |
|----|---------------|--------------|-------|
|    |               | Jan 10 Sales | 4 000 |

There are very few entries, so it is fairly easy to see that total debit entries are \$22 000 and total credit entries are also \$22 000. So, because total debit entries equal total credit entries, it appears that the rules of double entry have been followed. You can check the detail in the following table:

| Account        | Total of debit entries \$ | Total of credit entries \$ |
|----------------|---------------------------|----------------------------|
| Bank           | 17 000                    | 2 000                      |
| Capital        | –                         | 11 000                     |
| Trade payables | 2 000                     | 5 000                      |
| Purchases      | 3 000                     | –                          |
| Sales          | –                         | 4 000                      |
| Totals         | 22 000                    | 22 000                     |

A trial balance provides a check on double entry, but it also provides some useful information for those using the accounts. Here is a trial balance based on these accounts:

#### Trial balance at 10 January 2018

|                | Dr     | Cr     |
|----------------|--------|--------|
|                | \$     | \$     |
| Bank           | 15 000 |        |
| Capital        |        | 11 000 |
| Trade payables |        | 3 000  |
| Purchases      | 3 000  |        |
| Sales          |        | 4 000  |
|                | 18 000 | 18 000 |

Instead of showing total debit entries and total credit entries for each account, a trial balance shows the *net amount* in each account (the net amount is called the balance). So a trial balance can provide users with a quick update of the balance on each account in the system, which is required, for example, when preparing a statement of financial position. These benefits are in addition to providing a check on whether the double-entry procedures have been followed correctly.

A trial balance can be prepared at any time, but usually it is prepared monthly. It is always produced at the end of a business's accounting year.

The totals of a trial balance will only agree if the double entry is correct. In other words, trial balance totals only agree if for each debit entry there has been a matching credit entry.

## KEY TERMS

**Trial balance:** a list of all the balances taken from the ledger which provides a check on the arithmetical accuracy of the double entry.



## Illustration 2 How to prepare a trial balance

Step 1: List all of the accounts in the ledger.

Step 2: Calculate the net value of each account. Do this by adding up and totalling all debit entries and adding up and totalling all credit entries in the account and then find the difference between the two. Here is an example:

| Dr  |          | Any account |     | Cr       |       |
|-----|----------|-------------|-----|----------|-------|
| May | 4 Entry  | 3 000       | May | 6 Entry  | 2 000 |
|     | 7 Entry  | 6 000       |     | 18 Entry | 5 000 |
|     | 26 Entry | 1 000       |     |          |       |

In this account:

- total debit entries are \$10 000
- total credit entries are \$7000.

So, the difference between the two sides is \$3000.

Step 3: Record the net amount (the balance) in the trial balance. The amount should be recorded on the debit side in the trial balance if the debit

total exceeds the credit total. Alternatively, the amount should be recorded on the credit side of the trial balance if the credit total exceeds the debit total.

In the example, the net amount of \$4000 should be recorded in the debit column in the trial balance, because the debit total of \$10 000 exceeds the credit total of \$6000.

### Trial balance at 31 May 2018

|             | Dr   | Cr |
|-------------|------|----|
|             | \$   | \$ |
| Any account | 4000 |    |

Step 4: Continue to calculate the balance (net amount) on each account and record the figure as either a debit or a credit in the trial balance. When all of the account details are entered, total the trial balance. If the totals agree, it is assumed that the double entry has been completed correctly.

When trial balance totals do not agree this should instantly alert you to the fact that there is a mistake (or several mistakes) in the double-entry records. Here are some examples of typical errors which will result in a trial balance where the totals do not agree:

- Partial omission: only one part of the double entry has been made.
- Entries do not match: the amount of the debit entry is not the same as the amount of the credit entry.
- Arithmetical error: a mistake is made in calculating the balance of an account and so the wrong amount is entered in the trial balance.

### Summary: where accounts appear in a trial balance

Here is a table that shows where various types of accounts should appear in a trial balance.

| Trial balance |               |
|---------------|---------------|
| Debit column  | Credit column |
| Assets        | Capital       |
| Expenses      | Liabilities   |
| Purchases     | Sales         |
| Drawings      |               |

You can now answer questions 1–8 on pages 35–37.



## DEVELOPING YOUR SKILLS

### 1 Preparing a trial balance from a set of accounts

Here is a completed set of accounts. Prepare a trial balance to check the accuracy of the double entry. Follow the procedure:

- List all of the accounts in a trial balance headed 'At 31 December 2018'.
- Calculate the balance of each account.
- Enter the balance in the appropriate column in the trial balance.

| Furniture account         |                   |        |        | Dr                | Cr     |
|---------------------------|-------------------|--------|--------|-------------------|--------|
| Dec 1                     | Balance           | 14 500 |        |                   |        |
| 22                        | Bank              | 700    |        |                   |        |
| Trade receivables account |                   |        |        | Dr                | Cr     |
| Dec 1                     | Balance           | 3 200  | Dec 13 | Bank              | 2 500  |
| 20                        | Sales             | 1 900  |        |                   |        |
| Bank account              |                   |        |        | Dr                | Cr     |
| Dec 1                     | Balance           | 2 400  | Dec 5  | Purchases         | 2 300  |
| 13                        | Trade receivables | 2 500  | 14     | Trade payables    | 1 200  |
|                           |                   |        | 22     | Furniture         | 700    |
| Cash account              |                   |        |        | Dr                | Cr     |
| Dec 1                     | Balance           | 500    | Dec 6  | Drawings          | 300    |
| 8                         | Sales             | 1 200  | 15     | Wages             | 600    |
|                           |                   |        | 29     | Wages             | 500    |
| Capital account           |                   |        |        | Dr                | Cr     |
|                           |                   |        | Dec 1  | Balance           | 17 900 |
| Trade payables account    |                   |        |        | Dr                | Cr     |
| Dec 14                    | Bank              | 1 200  | Dec 1  | Balance           | 2 700  |
|                           |                   |        | 11     | Purchases         | 1 800  |
| Purchases account         |                   |        |        | Dr                | Cr     |
| Dec 5                     | Bank              | 2 300  |        |                   |        |
| 11                        | Trade payables    | 1 800  |        |                   |        |
| Sales account             |                   |        |        | Dr                | Cr     |
|                           |                   |        | Dec 8  | Cash              | 1 200  |
|                           |                   |        | 20     | Trade receivables | 1 900  |
| Wages account             |                   |        |        | Dr                | Cr     |
| Dec 15                    | Cash              | 600    |        |                   |        |
| 29                        | Cash              | 500    |        |                   |        |
| Drawings account          |                   |        |        | Dr                | Cr     |
| Dec 6                     | Cash              | 300    |        |                   |        |

### 2 Preparing a trial balance from a set of accounts

Here is a completed set of accounts. Prepare a trial balance to check the accuracy of the double entry. Follow the procedure:

- List all of the accounts in a trial balance headed 'At 31 January 2018'.
- Calculate the balance of each account.
- Enter the balance in the appropriate column in the trial balance.

| Vehicle account           |                   |        |        | Dr             | Cr     |
|---------------------------|-------------------|--------|--------|----------------|--------|
| Jan 1                     | Balance           | 11 400 |        |                |        |
| 25                        | Bank              | 7 500  |        |                |        |
| Trade receivables account |                   |        |        | Dr             | Cr     |
| Jan 1                     | Balance           | 6 200  | Jan 3  | Bank           | 2 900  |
| Bank account              |                   |        |        | Dr             | Cr     |
| Jan 1                     | Balance           | 3 700  | Jan 8  | Bank loan      | 2 000  |
| 3                         | Trade receivables | 2 900  | 11     | Drawings       | 800    |
| 20                        | Sales             | 5 100  | 25     | Vehicle        | 7 500  |
|                           |                   |        | 31     | Cash           | 300    |
| Cash account              |                   |        |        | Dr             | Cr     |
| Jan 1                     | Balance           | 400    | Jan 18 | Rent           | 900    |
| 7                         | Sales             | 1 400  | 30     | Trade payables | 700    |
| 31                        | Bank              | 300    |        |                |        |
| Capital account           |                   |        |        | Dr             | Cr     |
|                           |                   |        | Jan 1  | Balance        | 10 200 |
| Trade payables account    |                   |        |        | Dr             | Cr     |
| Jan 30                    | Cash              | 700    | Jan 1  | Balance        | 3 500  |
|                           |                   |        | 14     | Purchases      | 5 600  |
| Bank loan account         |                   |        |        | Dr             | Cr     |
| Jan 8                     | Bank              | 2 000  | Jan 1  | Balance        | 8 000  |
| Purchases account         |                   |        |        | Dr             | Cr     |
| Jan 14                    | Trade payables    | 5 600  |        |                |        |
| Sales account             |                   |        |        | Dr             | Cr     |
|                           |                   |        | Jan 7  | Cash           | 1 400  |
|                           |                   |        | 20     | Bank           | 5 100  |
| Rent account              |                   |        |        | Dr             | Cr     |
| Jan 18                    | Cash              | 900    |        |                |        |
| Drawings account          |                   |        |        | Dr             | Cr     |
| Jan 11                    | Bank              | 800    |        |                |        |

### 3 Preparing a trial balance from a list of accounts

On 31 December 2018 the owner of a business extracted the following list of balances from the accounting system:

|                   | \$     |
|-------------------|--------|
| Advertising       | 600    |
| Bank loan         | 7 000  |
| Capital           | 10 500 |
| Cash at bank      | 1 200  |
| Drawings          | 2 300  |
| General expenses  | 700    |
| Purchases         | 6 100  |
| Sales             | 8 800  |
| Trade payables    | 400    |
| Trade receivables | 900    |
| Vehicle           | 14 900 |

Prepare a trial balance dated 31 December 2018.

### 4 Preparing a trial balance from a list of accounts

On 31 March 2018 the owner of a business extracted the following list of balances from the accounting system:

|                   | \$     |
|-------------------|--------|
| Capital           | 13 700 |
| Cash at bank      | 600    |
| Cash in hand      | 100    |
| Drawings          | 2 200  |
| Electricity       | 300    |
| Furniture         | 14 900 |
| Loan interest     | 500    |
| Purchases         | 7 700  |
| Salaries          | 11 200 |
| Sales             | 22 700 |
| Trade payables    | 2 500  |
| Trade receivables | 1 400  |

Prepare a trial balance dated 31 March 2018.

### 5 Redrafting an incorrect trial balance

The following draft trial balance was prepared by an accounts clerk with limited experience. All of the figures are correctly shown, but some of the items have been recorded in the wrong columns and, as a result, the trial balance totals did not agree.

#### Draft trial balance at 31 May 2018

|                         | Dr      | Cr      |
|-------------------------|---------|---------|
|                         | \$      | \$      |
| Administration expenses | 4 480   |         |
| Bank overdraft          | 660     |         |
| Capital                 |         | 85 770  |
| Cash in hand            | 140     |         |
| Drawings                | 17 910  |         |
| Furniture and equipment |         | 19 300  |
| Premises                | 80 000  |         |
| Purchases               |         | 73 820  |
| Sales                   | 136 170 |         |
| Trade payables          | 5 100   |         |
| Trade receivables       |         | 7 260   |
| Wages and salaries      | 24 790  |         |
|                         | 269 250 | 186 150 |

Prepare a new trial balance at 31 May 2018 correcting all of the errors made by the accounts clerk.

### 6 Redrafting an incorrect trial balance

Kirk prepared the following draft trial balance on 31 August 2018. However, he was not sure in which column to enter some of the account balances and as a result the totals did not agree.

|                        | Dr      | Cr      |
|------------------------|---------|---------|
|                        | \$      | \$      |
| Capital                | 31 300  |         |
| Cash at bank           | 4 950   |         |
| Delivery vehicle       | 22 900  |         |
| Drawings               | 27 480  |         |
| Furniture and fittings |         | 14 500  |
| General expenses       |         | 16 430  |
| Loan interest          |         | 970     |
| Loan (repayable 2020)  | 17 500  |         |
| Purchases              | 127 810 |         |
| Rent                   | 14 460  |         |
| Sales                  |         | 184 360 |
| Trade payables         |         | 11 120  |
| Trade receivables      | 14 780  |         |
|                        | 261 180 | 186 150 |

Prepare a new trial balance at 31 August 2018 correcting all the errors made by Kirk.

## 7 Recording transactions and checking the double entry with a trial balance

Wei Xuan owns a business selling fishing equipment. The business's statement of financial position on 1 April 2018 was as follows:

| Wei Xuan  |        |
|---|--------|
| Statement of financial position at 1 April 2018 |        |
|   | \$     |
| ASSETS  |        |
| Vehicle   | 14 800 |
| Equipment                                       | 11 200 |
| Trade receivables                               | 4 700  |
| Bank  | 3 100  |
| Cash  | 500    |
|   | <hr/>  |
|   | 34 300 |
|   | <hr/>  |
|   | \$     |
| CAPITAL   | 30 700 |
| LIABILITIES                                     |        |
| Trade payables                                  | 3 600  |
|   | <hr/>  |
|   | 34 300 |
|   | <hr/>  |

During April the following transactions occurred:

- April
- 1 Purchased goods for resale on credit, \$1100
  - 4 Cash sales totalled \$1000
  - 7 Wei Xuan withdrew cash \$200 for private use
  - 9 Paid rent by cheque, \$700
  - 11 Purchased some additional equipment and paid by cheque, \$800
  - 12 Paid cash into the bank account, \$600
  - 15 Paid wages in cash, \$500
  - 18 Received a cheque from a trade receivable for \$2700
  - 19 Wei Xuan withdrew a cheque for \$600 for private use
  - 20 Paid trade payables, \$2000 by cheque
  - 22 Sales on credit totalled \$1600
  - 25 Cash sales totalled \$800
  - 28 Paid wages in cash, \$900

Record this information in suitable ledger accounts. Prepare a trial balance dated 30 April 2018.

## 8 Recording transactions and checking the double entry with a trial balance

Aziza owns a health food store. The business's statement of financial position on 1 May 2018 was as follows:

| Aziza   |        |
|---|--------|
| Statement of financial position at 1 May 2018 |        |
|   | \$     |
| ASSETS  |        |
| Equipment                                     | 8 500  |
| Fittings                                      | 7 900  |
| Trade receivables                             | 900    |
| Bank  | 2 200  |
| Cash  | 800    |
|   | <hr/>  |
|   | 20 300 |
|   | <hr/>  |
|   | \$     |
| CAPITAL                                       | 14 600 |
| LIABILITIES                                   |        |
| Bank loan                                     | 4 000  |
| Trade payables                                | 1 700  |
|   | <hr/>  |
|   | 20 300 |
|   | <hr/>  |

During May the following transactions occurred:

- May
- 2 Paid wages in cash, \$400
  - 4 Purchased goods for resale and paid by cheque, \$600
  - 6 Repaid part of the bank loan \$700. Funds were transferred from the business bank account
  - 9 Cash sales totalled \$1300
  - 10 Cash \$900 was transferred to the bank account
  - 12 Paid loan interest, \$300. Funds were transferred from the business bank account
  - 13 Trade receivables paid, \$700 in cash
  - 16 Aziza withdrew cash \$500 for her private use
  - 19 Paid wages in cash, \$600
  - 20 Some unwanted equipment worth \$1000 was sold for this amount. The cheque was paid into the business's bank account
  - 23 Some new fittings were purchased by cheque, \$1300
  - 29 Sales on credit totalled \$1700

Record this information in suitable ledger accounts. Prepare a trial balance dated 31 May 2018.



# Preparing simple income statements

## LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- calculate a business's gross profit and profit for the year.

## KEY TERMS

**Profit:** the difference between a business's income (sales) and expenditure (purchases and expenses).

## LINKS...

In Unit 4 you will find that carrying inventories (i.e. holding quantities of unsold goods) also affects the profit calculation.

A high priority for the owner of any business will be to make a profit. Making a profit is a mark of success for any business, for not only can the owner feel justified in withdrawing cash from the business for private use, they can also feel that there is the possibility of building up the business over a period of time.

## What is profit?

A profit occurs when a business makes a net gain in its value over a period of time due to successful trading.

To take a simple example, suppose a business started with just one asset: a bank balance of \$10 000. The value of the business at this point would also be \$10 000.

If the owner of the business spent \$6000 on some goods for resale, and was able to sell all of these goods for \$11 000, the business's value would increase by \$5000. The business's bank balance would now be \$15 000. The business's capital would keep in step with the value of the business and would now also be \$15 000. The increase in capital is called **profit** and the profit is reflected in the increase in the value of the business's resources (i.e. its assets).

Of course, business activity is more complicated than in this simple example. For example, no business can operate without payments being made for running costs (expenses).

So, profit is the increase in value of a business caused by trading activity, and it is calculated as follows:

$$\text{Profit} = \text{Sales} - (\text{Purchases} + \text{Expenses})$$

## Calculating profits and losses

Here is an illustration showing how profits (or losses) can be calculated. The process involves two stages:

Stage 1: calculating a **gross profit** – the profit made by buying and selling goods.

Stage 2: calculating a profit – the profit made having taken into account the running costs of the business.

### KEY TERMS

**Gross profit:** the difference between the income from sales and the expenditure on goods sold.

#### Illustration 1 Calculating profits from a simple list of transactions

Andy owns a market stall. His statement of financial position on 1 May 2018 was as follows:

| Andy<br>Statement of financial position at 1 May 2018 |        |
|---|--------|
|   | \$     |
| ASSETS  |        |
| Vehicle   | 12 000 |
| Market stall  | 5 200  |
| Bank  | 1 800  |
|   | 19 000 |
|   | \$     |
| CAPITAL   | 15 000 |
| LIABILITIES   |        |
| Bank loan   | 4 000  |
|   | 19 000 |

During May the following transactions occurred (all transactions affected the business's bank account):

|                            | \$     |
|----------------------------|--------|
| Purchased goods for resale | 4 000  |
| Sales of goods             | 12 000 |
| Vehicle running costs      | 500    |
| Wages of assistant         | 100    |
| Loan interest              | 200    |

Step 1: Calculate the difference between sales and purchases to give what is called the 'gross profit'.

|                     | \$     |
|---------------------|--------|
| <b>Revenue</b>      | 12 000 |
| Less purchases      | 4 000  |
| <b>Gross profit</b> | 8 000  |

You will notice that in the statement sales of goods is referred to as 'revenue'.

Step 2: Calculate what is called the 'profit' by deducting all of the expenses from the gross profit.

|                     | \$           |
|---------------------|--------------|
| Gross profit        | 8 000        |
| Less total expenses | 800          |
| <b>Profit</b>       | <b>7 200</b> |

Finally, we will prepare a new statement of financial position for Andy's business for the end of May. During May the bank account has changed because of the transactions listed above, and the business has made a profit of \$7200. The other asset and liability accounts in this simple example have not changed during May.

The business's bank account for May would be as follows:

| Dr  |         | Bank account |     | Cr            |       |
|-----|---------|--------------|-----|---------------|-------|
| May | Balance | 1 800        | May | Purchases     | 4 000 |
|     | Sales   | 12 000       |     | Vehicle       | 500   |
|     |         |              |     | running costs |       |
|     |         |              |     | Wages         | 100   |
|     |         |              |     | Loan interest | 200   |

The updated balance on the bank account is \$9000.

Here is the updated statement of financial position:

#### Statement of financial position at 31 May 2018

|                    | \$            |
|--------------------|---------------|
| <b>ASSETS</b>      |               |
| Vehicle            | 12 000        |
| Market stall       | 5 200         |
| Bank               | 9 000         |
|                    | <u>26 200</u> |
|                    | \$            |
| <b>CAPITAL</b>     | 22 200        |
| <b>LIABILITIES</b> |               |
| Bank loan          | 4 000         |
|                    | <u>26 200</u> |

Looking at the updated statement of financial position confirms:

- the value of the business has increased through successful trading; the assets of the business are now worth more (+\$7200)
- the increase in the net value of the business is shown by an increase in the capital of the business (+\$7200).

When a profit is made (because the net value of a business increases) the extra value belongs to the owner of the business.

You can now answer questions 1 and 2 on page 46.

#### KEY TERMS

**Income statement:** an end-of-financial-period statement that shows a business's gross profit and profit for that period (usually a year).

**Revenue:** in an income statement it is the value of a business's sales of goods (or services).

#### How do accounting records show a business's profit (or loss)?

In order to show information about a business's profit (or loss) in the accounting records, it is necessary to prepare an **income statement**. This statement is only prepared at the end of the accounting period, it is not required in the books of account at other times. In an income statement a business's sales of goods is referred to as **revenue**.



# Preparing the first part of the income statement

Here is the story of Andy's business for May 2018 again. This time, however, the transactions are recorded in the ledger accounts.

Here are the ledger accounts for May 2018.

## LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- make entries in the accounts to show a business's gross profit and profit for the year.

### Illustration 2

| Dr  |   |         |        | Vehicle account      |                       |         |        | Cr |  |
|-----|---|---------|--------|----------------------|-----------------------|---------|--------|----|--|
| May | 1 | Balance | 12 000 |                      |                       |         |        |    |  |
| Dr  |   |         |        | Market stall account |                       |         |        | Cr |  |
| May | 1 | Balance | 5 200  |                      |                       |         |        |    |  |
| Dr  |   |         |        | Bank account         |                       |         |        | Cr |  |
| May | 1 | Balance | 1 800  | May                  | Purchases             | 4 000   |        |    |  |
|     |   | Sales   | 12 000 |                      | Vehicle running costs | 500     |        |    |  |
|     |   |         |        |                      | Wages                 | 100     |        |    |  |
|     |   |         |        |                      | Loan interest         | 200     |        |    |  |
| Dr  |   |         |        | Capital account      |                       |         |        | Cr |  |
|     |   |         |        | May                  | 1                     | Balance | 15 000 |    |  |

| Dr  |  |      |       | Bank loan account             |     |   |         | Cr     |  |
|-----|--|------|-------|-------------------------------|-----|---|---------|--------|--|
|     |  |      |       |                               | May | 1 | Balance | 4 000  |  |
| Dr  |  |      |       | Sales account                 |     |   |         | Cr     |  |
|     |  |      |       |                               | May |   | Bank    | 12 000 |  |
| Dr  |  |      |       | Purchases account             |     |   |         | Cr     |  |
| May |  | Bank | 4 000 |                               |     |   |         |        |  |
| Dr  |  |      |       | Vehicle running costs account |     |   |         | Cr     |  |
| May |  | Bank | 500   |                               |     |   |         |        |  |
| Dr  |  |      |       | Wages account                 |     |   |         | Cr     |  |
| May |  | Bank | 100   |                               |     |   |         |        |  |
| Dr  |  |      |       | Loan interest account         |     |   |         | Cr     |  |
| May |  | Bank | 200   |                               |     |   |         |        |  |

The business's trial balance at the end of May would be as follows:

### Trial balance at 31 May 2018

|                       | Dr            | Cr            |
|-----------------------|---------------|---------------|
|                       | \$            | \$            |
| Vehicle               | 12 000        |               |
| Market stall          | 5 200         |               |
| Bank                  | 9 000         |               |
| Capital               |               | 15 000        |
| Bank loan             |               | 4 000         |
| Sales (i.e. Revenue)  |               | 12 000        |
| Purchases             | 4 000         |               |
| Vehicle running costs | 500           |               |
| Wages                 | 100           |               |
| Loan interest         | 200           |               |
|                       | <u>31 000</u> | <u>31 000</u> |

At the end of the month the first part of the income statement should be prepared to reveal the gross profit.

The income statement would appear as shown. Notice the formal title which includes a clear reference to the time period covered by the income statement, and that a vertical presentation is used.

**Income statement for the month ended 31 May 2018**

\$                      \$

In order for this statement to show the gross profit, it is necessary to make transfers from the sales and purchases accounts.

**Illustration 3** Transferring sales and purchases to the income statement

To transfer information about sales, the following entries are necessary:

| Dr  | Sales account           | Cr              |
|---|-------------------------|-----------------|
| May 31  | Income statement 12 000 | May Bank 12 000 |
| <b>Income statement for the month ended 31 May 2018</b> |                         |                 |
| Revenue   |                         | 12 000          |

To transfer information about purchases to the income statement the following entries are necessary:

| Dr  | Purchases account | Cr                     |
|---|-------------------|------------------------|
| May Bank 4 000  | May 31            | Income statement 4 000 |
| <b>Income statement for the month ended 31 May 2018</b> |                   |                        |
| Revenue   |                   | \$ 12 000              |
| Less purchases  |                   | (4 000)                |

**Notes:**

- 1 It is important to notice that the sales account is now empty. There is no balance on the account because the total sales for the month have now been transferred to the income statement.
- 2 The purchases account is now also empty. The purchases account does not have a balance; because total purchases has now been transferred to the income statement.

**How is gross profit recorded?**

If you look at the income statement you will see that the difference between sales and purchases is the gross profit of \$8000, which is recorded as follows:

**Income statement for the month ended 31 May 2018**

|                     |              |
|---------------------|--------------|
|                     | \$           |
| Revenue             | 12 000       |
| Less purchases      | (4 000)      |
| <b>Gross profit</b> | <b>8 000</b> |

# Preparing the second part of the income statement

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- make entries in the accounts to show a profit or a loss for a year
- prepare simple income statements.

## How are expenses recorded in the second part of the income statement?

### Illustration 4

Each expense is transferred to the second part of the income statement.

Here, for example, is the transfer of the vehicle running costs to the income statement.

| Dr  |      | Vehicle running costs account |     |    |                  | Cr  |
|-----|------|-------------------------------|-----|----|------------------|-----|
| May | Bank | 500                           | May | 31 | Income statement | 500 |

#### Income statement for the month ended 31 May 2018

|                            |     |         |
|----------------------------|-----|---------|
|                            |     | \$      |
| Revenue                    |     | 12 000  |
| Less purchases             |     | (4 000) |
| Gross profit               |     | 8 000   |
| Less vehicle running costs | 500 |         |

The other expenses will also be transferred to the income statement. The accounting records will show:

| Dr  |      | Wages account |        | Cr               |     |
|-----|------|---------------|--------|------------------|-----|
| May | Bank | 100           | May 31 | Income statement | 100 |

| Dr  |      | Loan interest account |        | Cr               |     |
|-----|------|-----------------------|--------|------------------|-----|
| May | Bank | 200                   | May 31 | Income statement | 200 |

#### Income statement for the month ended 31 May 2018

|                              |     |         |
|------------------------------|-----|---------|
|                              |     | \$      |
| Revenue                      |     | 12 000  |
| Less purchases               |     | (4 000) |
| Gross profit                 |     | 8 000   |
| Less vehicle running expense | 500 |         |
| Wages                        | 100 |         |
| Loan interest                | 200 | (800)   |

### Notes:

- 1 The vehicle running costs account is now empty. The balance of the account has been transferred to the income statement.
- 2 The expenses details are shown in the first column, and then subtotaled.



## How is the profit recorded in the accounts?

### Illustration 5

If you look at the second part of the income statement, you will see that the difference between the two sides is the profit of \$7200. The profit is recorded as follows:

#### Income statement for the month ended 31 May 2018

|                             | \$  | \$                  |
|-----------------------------|-----|---------------------|
| Revenue                     |     | 12 000              |
| Less purchases              |     | (4 000)             |
|                             |     | <u>8 000</u>        |
| Less Vehicle running costs  | 500 |                     |
| Wages                       | 100 |                     |
| Loan interest               | 200 | (800)               |
| <b>Profit for the month</b> |     | <b><u>7 200</u></b> |

A credit entry for the profit is made in the capital account since it represents an increase in the value of the business.

| Dr | Capital account         | Cr           |
|----|-------------------------|--------------|
|    | May 1 Balance           | 15 000       |
|    | 31 Profit for the month | <b>7 200</b> |

The statement of financial position for the end of May is shown below. It is important to remember that many of the accounts used during May are empty (i.e. they have no balance), so they do not appear on the statement of financial position.

The list of accounts that are now empty (have no balance), and can be ignored when preparing the statement of financial position, is as follows:

- Sales
- Purchases
- Vehicle running costs
- Wages
- Loan interest
- Income statement

Here is the statement of financial position:

#### Statement of financial position at 31 May 2018

|                    | \$            |
|--------------------|---------------|
| <b>ASSETS</b>      |               |
| Vehicle            | 12 000        |
| Market stall       | 5 200         |
| Bank               | 9 000         |
|                    | <u>26 200</u> |
|                    | \$            |
| <b>CAPITAL</b>     | 22 200        |
| <b>LIABILITIES</b> |               |
| Bank loan          | 4 000         |
|                    | <u>26 200</u> |

You can now answer questions 3 and 4 on pages 46–47.

## What happens if a business makes a loss?

A loss occurs when a business's expenses are greater than the gross profit made from selling goods. A loss means the business has lost some of its resources (net assets) and that its capital has decreased. A loss will appear as a negative figure in the income statement and will be entered as a debit entry in the capital account.

You can now answer questions 5 and 6 on page 47–48.

## Completing the capital account at the end of a financial period

At the end of a financial period – usually every year – the capital account is completed by recording the profit or loss for the year and by transferring the total drawings for the year to the debit side of the account.

### Illustration 6 Completing a capital account

On 31 March 2018, the end of a business's financial year, the following information was available:

|                             | \$     |
|-----------------------------|--------|
| Capital, 1 April            | 82 000 |
| Profit for the year         | 18 900 |
| Total drawings for the year | 17 300 |

The capital and drawings accounts would appear as follows:

| Dr | Drawings account | Cr     |
|----|------------------|--------|
|    | Balance 17 300   |        |
| Dr | Capital account  | Cr     |
|    | April 1 Balance  | 82 000 |
|    | March 31 Profit  | 18 900 |

At this point the total amount shown in the drawings account would be transferred to the capital account. The double entry required is:

Debit Capital

Credit Drawings

The accounts would now appear as follows:

| Dr                | Drawings account             | Cr     |
|-------------------|------------------------------|--------|
|                   | Balance 17 300               |        |
|                   | March 31 Capital             | 17 300 |
| Dr                | Capital account              | Cr     |
| March 31 Drawings | 17 300                       |        |
|                   | April 1 Balance              | 82 000 |
|                   | March 31 Profit for the year | 18 900 |

**Note:** after the transfer of the balance of the drawings account, the drawings account would be empty (i.e. it would have no balance).

You can now answer questions 7 and 8 on page 48–49.

## DEVELOPING YOUR SKILLS

## 1 Calculating gross profit and profit for the year

Stella owns a retail outlet. Her business's statement of financial position on 1 February 2018 was as follows:

**Statement of financial position at 1 February 2018**

|                | \$     |
|----------------|--------|
| ASSETS         |        |
| Fittings       | 19 400 |
| Equipment      | 6 200  |
| Bank           | 2 300  |
|                | <hr/>  |
|                | 27 900 |
|                | <hr/>  |
|                | \$     |
| CAPITAL        | 26 000 |
| LIABILITIES    |        |
| Trade payables | 1 900  |
|                | <hr/>  |
|                | 27 900 |
|                | <hr/>  |

During February the following transactions occurred (all transactions affected the business's bank account):

|                               | \$     |
|-------------------------------|--------|
| Purchased goods for resale    | 7 500  |
| Sales of goods (i.e. Revenue) | 16 300 |
| Rent                          | 2 500  |
| Wages of assistant            | 900    |
| Insurance                     | 800    |

- Calculate the business's gross profit.
- Calculate the business's profit for the month.
- Prepare the business's bank account for February 2018.
- Prepare an update of the business's statement of financial position at 28 February 2018.

## 2 Calculating gross profit and profit for the year

Henri owns a business selling electronic gadgets. His business's statement of financial position on 1 June 2018 was as follows:

**Statement of financial position at 1 June 2018**

|               | \$      |
|---------------|---------|
| ASSETS        |         |
| Shop premises | 92 000  |
| Vehicle       | 18 000  |
| Bank          | 3 500   |
|               | <hr/>   |
|               | 113 500 |
|               | <hr/>   |
|               | \$      |
| CAPITAL       | 88 500  |
| LIABILITIES   |         |
| Bank loan     | 25 000  |
|               | <hr/>   |
|               | 113 500 |
|               | <hr/>   |

During June the following transactions occurred (all transactions affected the business's bank account):

|                               | \$     |
|-------------------------------|--------|
| Purchased goods for resale    | 11 800 |
| Sales of goods (i.e. Revenue) | 22 500 |
| Wages of shop assistants      | 4 200  |
| Light and heat                | 500    |
| Administration expenses       | 900    |

- Calculate the business's gross profit.
- Calculate the business's profit for the month.
- Prepare the business's bank account for June 2018.
- Prepare an update of the business's statement of financial position at 30 June 2018.

## 3 Preparing the income statement

Amy owns a café and snack bar. The business's statement of financial position on 1 August 2018 was as follows:

**Statement of financial position at 1 August 2018**

|                | \$     |
|----------------|--------|
| ASSETS         |        |
| Equipment      | 11 600 |
| Furniture      | 10 500 |
| Bank           | 2 900  |
|                | <hr/>  |
|                | 25 000 |
|                | <hr/>  |
|                | \$     |
| CAPITAL        | 23 900 |
| LIABILITIES    |        |
| Trade payables | 1 100  |
|                | <hr/>  |
|                | 25 000 |
|                | <hr/>  |

During August the following transactions occurred (all transactions affected the business's bank account):

|                               | \$    |
|-------------------------------|-------|
| Purchased goods for resale    | 3 200 |
| Sales of goods (i.e. Revenue) | 9 900 |
| Wages of assistants           | 800   |
| Rent                          | 700   |
| Light and heat                | 600   |

- Calculate the business's gross profit.
- Calculate the business's profit for the month.
- Record the transactions in ledger accounts.
- Prepare the first part of an income statement for the month ended 31 August 2018 by transferring sales and purchases to this statement and recording the gross profit.



- e Prepare the second part of the income statement for the month ended 31 August 2018 by transferring expenses to this statement.
- f Update the capital account with the profit for the month.
- g Prepare a statement of financial position at 31 August 2018.

#### 4 Preparing the income statement

Monty owns a bakery. The business's statement of financial position on 1 September 2018 was as follows:

##### Statement of financial position at 1 September 2018

|                    | \$     |
|--------------------|--------|
| <b>ASSETS</b>      |        |
| Premises           | 65 000 |
| Equipment          | 12 200 |
| Bank               | 4 400  |
|                    | 81 600 |
|                    | \$     |
| <b>CAPITAL</b>     | 73 600 |
| <b>LIABILITIES</b> |        |
| Bank loan          | 8 000  |
|                    | 81 600 |

During September the following transactions occurred (all transactions affected the business's bank account):

|                               | \$     |
|-------------------------------|--------|
| Purchased goods for resale    | 2 100  |
| Sales of goods (i.e. Revenue) | 10 300 |
| Insurance                     | 700    |
| Loan interest                 | 200    |
| Wages                         | 1 100  |

- a Calculate the business's gross profit.
- b Calculate the business's profit for the month.
- c Record the transactions in ledger accounts.
- d Prepare the first part of an income statement for the month ended 30 September 2018 by transferring sales and purchases to this statement and recording the gross profit.
- e Prepare the second part of the income statement for the month ended 30 September 2018 by transferring expenses to this statement.
- f Update the capital account with the profit for the month.
- g Prepare a statement of financial position at

30 September 2018.

#### 5 Preparing the income statement where there is a loss

Winston owns a gift shop. The business's statement of financial position on 1 July 2018 was as follows:

##### Statement of financial position at 1 July 2018

|                    | \$     |
|--------------------|--------|
| <b>ASSETS</b>      |        |
| Furniture          | 11 200 |
| Equipment          | 3 200  |
| Bank               | 1 800  |
|                    | 16 200 |
|                    | \$     |
| <b>CAPITAL</b>     | 13 600 |
| <b>LIABILITIES</b> |        |
| Trade payables     | 2 600  |
|                    | 16 200 |

During July the following transactions occurred (all transactions affected the business's bank account):

|                               | \$    |
|-------------------------------|-------|
| Purchased goods for resale    | 5 300 |
| Sales of goods (i.e. Revenue) | 7 700 |
| Rent                          | 1 100 |
| Light and heat                | 600   |
| Wages                         | 1 300 |

- a Calculate the business's gross profit.
  - b Calculate the business's profit for the month.
  - c Record the transactions in ledger accounts.
  - d Prepare the first part of an income statement for the month ended 31 July 2018 by transferring sales and purchases to this statement and recording the gross profit.
  - e Prepare the second part of the income statement for the month ended 31 July 2018 by transferring expenses to this statement.
  - f Update the capital account with the loss for the month.
  - g Prepare a statement of financial position at 31 July 2018.
- #### 6 Preparing the income statement where there is a loss

Cleo owns a business selling sportswear. The business's statement of financial position on 1 April 2018 was as follows:

### Statement of financial position at 1 April 2018

|                    | \$      |
|--------------------|---------|
| <b>ASSETS</b>      |         |
| Premises           | 105 000 |
| Equipment          | 16 000  |
| Bank               | 2 700   |
|                    | <hr/>   |
|                    | 123 700 |
|                    | <hr/>   |
|                    | \$      |
| <b>CAPITAL</b>     | 83 700  |
| <b>LIABILITIES</b> |         |
| Bank loan          | 40 000  |
|                    | <hr/>   |
|                    | 123 700 |
|                    | <hr/>   |

During April the following transactions occurred (all transactions affected the business's bank account):

|                               | \$     |
|-------------------------------|--------|
| Purchased goods for resale    | 9 200  |
| Sales of goods (i.e. Revenue) | 12 900 |
| Wages                         | 3 100  |
| Administration expenses       | 1 300  |
| Loan interest                 | 800    |

- Calculate the business's gross profit.
  - Calculate the business's loss for the month.
  - Record the transactions in ledger accounts.
  - Prepare the first part of an income statement for the month ended 30 April 2018 by transferring sales and purchases to this statement and recording the gross profit.
  - Prepare the second part of the income statement for the month ended 30 April 2018 by transferring expenses to this statement.
  - Update the capital account with the loss for the month.
  - Prepare a statement of financial position at 30 April 2018.
- 7** Preparing a full set of accounts starting from a trial balance

Asif is the owner of a general store. His business has been trading for 11 months and its trial balance at the end of this period is as follows:

### Trial balance at 1 December 2018

|                         | Dr      | Cr      |
|-------------------------|---------|---------|
|                         | \$      | \$      |
| Administration expenses | 8 250   |         |
| Bank                    | 3 190   |         |
| Bank loan               |         | 8 000   |
| Capital                 |         | 31 870  |
| Cash                    | 340     |         |
| Drawings                | 21 210  |         |
| Fittings                | 8 920   |         |
| Loan interest           | 640     |         |
| Purchases               | 83 470  |         |
| Rent                    | 13 230  |         |
| Sales                   |         | 141 300 |
| Trade payables          |         | 3 480   |
| Trade receivables       | 570     |         |
| Vehicle                 | 13 500  |         |
| Wages                   | 31 330  |         |
|                         | <hr/>   | <hr/>   |
|                         | 184 650 | 184 650 |

During December the following transactions occurred:

- Dec    2    Purchased goods for resale and paid by cheque, \$2200
- 3    Cash sales totalled \$5220
- 6    Received cash \$330 from a credit customer
- 8    Paid rent by cheque, \$1250
- 10    Repaid part of bank loan, \$500. Funds were transferred from the bank account
- 13    Sales on credit totalled \$210
- 15    Paid wages in cash, \$1620
- 16    Asif withdrew cash \$600 for private use
- 17    Paid administration expenses in cash, \$440
- 20    Cash sales totalled \$3130
- 22    Paid trade payables, \$2600 by cheque
- 23    Purchased additional fittings and paid by cheque, \$970
- 28    Paid wages in cash, \$1880
- 29    Cash sales totalled \$2440
- 30    Paid cash, \$6200 into the bank account

- Prepare ledger accounts to record these transactions.
- Prepare a trial balance at 31 December 2018.
- Prepare an income statement for the year ended 31 December 2018.
- Complete the capital account by transferring the profit and total drawings for the year.
- Prepare a classified statement of financial position at 31 December 2018.

## 8 Preparing a full set of accounts starting from a trial balance

Pat is the owner of a computer software business. Her business has been trading for 11 months and its trial balance at the end of this period is as follows:

| Trial balance at 1 March 2018 |         |         |
|-------------------------------|---------|---------|
|                               | Dr      | Cr      |
|                               | \$      | \$      |
| Bank                          | 4 530   |         |
| Bank loan                     |         | 24 000  |
| Capital                       |         | 94 140  |
| Cash                          | 820     |         |
| Drawings                      | 23 880  |         |
| Equipment                     | 18 500  |         |
| Insurance                     | 8 440   |         |
| Loan interest                 | 1 850   |         |
| Premises                      | 95 000  |         |
| Purchases                     | 120 480 |         |
| Sales                         |         | 216 480 |
| Trade payables                |         | 7 880   |
| Trade receivables             | 5 290   |         |
| Vehicle                       | 18 400  |         |
| Wages                         | 45 310  |         |
|                               | 342 500 | 342 500 |

During March the following transactions occurred:

|       |    |  |
|-------|----|--|
| March | 2  | Cash sales totalled \$4840   |
|       | 4  | Paid wages in cash, \$2270   |
|       | 7  | Pat withdrew cash \$630 for her private use  |
|       | 9  | Purchased goods for resale on credit, \$3600   |
|       | 11 | Repaid part of bank loan, \$800. Funds were transferred from the business bank account |
|       | 14 | Sales on credit totalled \$4300  |
|       | 16 | Paid insurance by cheque, \$470  |
|       | 17 | Purchased some new equipment, \$2000 and paid by cheque                                |
|       | 21 | Paid loan interest, \$140. Funds were transferred from the business bank account       |
|       | 22 | Paid wages in cash, \$2490   |
|       | 23 | Cash sales totalled \$3990   |
|       | 24 | Transferred cash, \$2500 to the bank   |
|       | 25 | Paid trade payables, \$4500 by cheque  |
|       | 28 | Sales totalled \$3750. All money received was paid into the bank account               |
|       | 30 | Pat withdrew a cheque for \$820 for her private use                                    |

- Prepare ledger accounts to record these transactions.
- Prepare a trial balance at 31 March 2018.
- Prepare an income statement for the year ended 31 March 2018.
- Complete the capital account by transferring the profit and total drawings for the year.
- Prepare a classified statement of financial position at 31 March 2018.



# How to balance accounts

## LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- explain why accounts are balanced
- balance ledger accounts.

## KEY TERMS

**Balancing accounts:** the process of calculating the net amount remaining in an account and clearly stating this as a debit or credit balance at the beginning of the next accounting period.

**Closing accounts:** the process of completing an account that does not have a balance.

Over a period of time many of the ledger accounts you have been preparing could grow very large. Even the smallest business will have hundreds or possibly thousands of transactions to record over a period of a few months.

In this chapter you will learn about **balancing accounts**. This process is important because it has the following benefits:

- breaking up each record into more manageable segments based on time periods
- bringing many accounts to a neat conclusion with a clear statement or update on the net value shown in the account, which is called the balance
- bringing other accounts to a neat conclusion by clearly showing that there is no balance and that the account is now closed
- providing a summary of information required for the preparation of the trial balance and other financial statements.

The owner of a business will balance and close accounts at regular intervals. This could be monthly for many accounts, possibly weekly for others. All accounts should be balanced or closed at the end of the financial year.



Accounts are balanced following a clear set of rules or steps which can be applied to almost every ledger account that has some net value at a particular date.

### Illustration 1 Balancing an asset account

Here is a typical set of entries in a bank account:

| Dr   |    |                   | Bank account |      |    | Cr             |       |  |
|------|----|-------------------|--------------|------|----|----------------|-------|--|
| Sept | 1  | Balance           | 1 800        | Sept | 6  | Purchases      | 200   |  |
|      | 14 | Sales             | 8 000        |      | 10 | Trade payables | 3 500 |  |
|      | 22 | Trade receivables | 5 300        |      | 14 | Loan interest  | 100   |  |
|      |    |                   |              |      | 21 | Drawings       | 800   |  |
|      |    |                   |              |      | 30 | Salaries       | 4 200 |  |

In order to balance the account the following steps are necessary.

Step 1: Calculate the balance. Here the total debit entries are \$15 100 and the total credit entries are \$8800. So the balance is \$6300 (i.e. \$15 100 – \$8800).

Step 2: Start the balancing process by recording the balance on the side of the account that has the smaller total value. With an asset account, the side with **the smaller total value** in the bank account is the credit side (i.e. the credit total of \$8800 is less than the debit total of \$15 100).

| Dr     |                   | Bank account |        | Cr             |              |
|--------|-------------------|--------------|--------|----------------|--------------|
| Sept 1 | Balance           | 1 800        | Sept 6 | Purchases      | 200          |
| 14     | Sales             | 8 000        | 10     | Trade payables | 3 500        |
| 22     | Trade receivables | 5 300        | 14     | Loan interest  | 100          |
|        |                   |              | 21     | Drawings       | 800          |
|        |                   |              | 30     | Salaries       | 4 200        |
|        |                   |              |        |                | <b>6 300</b> |

Now label this entry with the date 30 September, which is the last day of the month, and the narrative 'Balance c/d'. The abbreviation 'c/d' means 'carry down'.

| Dr   |    |                   | Bank account |           | Cr                 |              |
|------|----|-------------------|--------------|-----------|--------------------|--------------|
| Sept | 1  | Balance           | 1 800        | Sept 6    | Purchases          | 200          |
|      | 14 | Sales             | 8 000        | 10        | Trade payables     | 3 500        |
|      | 22 | Trade receivables | 5 300        | 14        | Loan interest      | 100          |
|      |    |                   |              | 21        | Drawings           | 800          |
|      |    |                   |              | 30        | Salaries           | 4 200        |
|      |    |                   |              | <b>30</b> | <b>Balance c/d</b> | <b>6 300</b> |

Step 3: By making the credit entry for \$6300, the two sides of the account now total the same amount (\$15 100). The next step is to record this total on each side of the account.

| Dr   |    |                   | Bank account |      | Cr |                |              |
|------|----|-------------------|--------------|------|----|----------------|--------------|
| Sept | 1  | Balance           | 1800         | Sept | 6  | Purchases      | 200          |
|      | 14 | Sales             | 8000         |      | 10 | Trade payables | 3500         |
|      | 22 | Trade receivables | 5300         |      | 14 | Loan interest  | 100          |
|      |    |                   |              |      | 21 | Drawings       | 800          |
|      |    |                   |              |      | 30 | Salaries       | 4200         |
|      |    |                   |              |      | 30 | Balance c/d    | 6300         |
|      |    |                   | <b>15100</b> |      |    |                | <b>15100</b> |

You will notice that the totals appear on the same line and that the next available line has been used.

Step 4: You cannot make a credit entry in the accounts without also having a matching debit entry. So to complete the balancing process, make a matching debit entry in the bank account for the balance. This time label the balance 'b/d' (brought down) and for the date use the first day of the next month (here 1 October).

| Dr   |    |                   | Bank account |      | Cr |                |        |
|------|----|-------------------|--------------|------|----|----------------|--------|
| Sept | 1  | Balance           | 1 800        | Sept | 6  | Purchases      | 200    |
|      | 14 | Sales             | 8 000        |      | 10 | Trade payables | 3 500  |
|      | 22 | Trade receivables | 5 300        |      | 14 | Loan interest  | 100    |
|      |    |                   |              |      | 21 | Drawings       | 800    |
|      |    |                   |              |      | 30 | Salaries       | 4 200  |
|      |    |                   |              |      | 30 | Balance c/d    | 6 300  |
|      |    |                   | <hr/>        |      |    |                | <hr/>  |
|      |    |                   | 15 100       |      |    |                | 15 100 |
|      |    |                   | <hr/>        |      |    |                | <hr/>  |
| Oct  | 1  | Balance b/d       | 6 300        |      |    |                |        |

You will see that the bank account is now ready for use during October, and that all of September's transactions have been neatly summarised by stating the net value at the end of September.



## Illustration 2 Balancing a liability account

Here is a typical liability account.

| Dr           | Trade payables account |                |     |       | Cr |
|--------------|------------------------|----------------|-----|-------|----|
| June 10 Bank | 2 400                  | June 1 Balance |     | 3 300 |    |
|              |                        | 22 Purchases   | 500 |       |    |

Follow the same four steps:

Step 1: The balance on the account is: \$3800 – \$2400 = \$1400

Step 2: The balance c/d dated 30 June will appear on the debit side because this is the side with the smaller total value.

Step 3: Record the totals on both sides of the account.

Step 4: Make a matching entry for the balance – in this case a credit entry. The balance b/d should be dated 1 July.

| Dr             | Trade payables account |                    |     |              | Cr    |
|----------------|------------------------|--------------------|-----|--------------|-------|
| June 10 Bank   | 2 400                  | June 1 Balance     |     | 3 300        |       |
| 30 Balance c/d | 1 400                  | 22 Purchases       | 500 |              |       |
|                | <b>3 800</b>           |                    |     | <b>3 800</b> |       |
|                |                        | July 1 Balance b/d |     |              | 1 400 |

You can now answer questions 1 and 2 on page 55.

## Illustration 3 Some more examples of balanced accounts

### Balancing a capital account

Before balancing:

| Dr              | Capital account |                        |        |        | Cr |
|-----------------|-----------------|------------------------|--------|--------|----|
| Oct 31 Drawings | 21 500          | Oct 1 Balance          |        | 65 000 |    |
|                 |                 | 31 Profit for the year | 11 500 |        |    |

After balancing:

| Dr              | Capital account |                        |        |               | Cr     |
|-----------------|-----------------|------------------------|--------|---------------|--------|
| Oct 31 Drawings | 21 500          | Oct 1 Balance          |        | 65 000        |        |
| 31 Balance c/d  | 55 000          | 31 Profit for the year | 11 500 |               |        |
|                 | <b>76 500</b>   |                        |        | <b>76 500</b> |        |
|                 |                 | Nov 1 Balance b/d      |        |               | 55 000 |

### Balancing an account where entries are all on one side

Before balancing:

| Dr              | Trade receivables account |  |  |  | Cr |
|-----------------|---------------------------|--|--|--|----|
| April 1 Balance | 6 000                     |  |  |  |    |
| 13 Sales        | 2 000                     |  |  |  |    |
| 27 Sales        | 1 000                     |  |  |  |    |

After balancing:

| Dr                | Trade receivables account |                      |  |              | Cr |
|-------------------|---------------------------|----------------------|--|--------------|----|
| April 1 Balance   | 6 000                     | April 30 Balance c/d |  | 9 000        |    |
| 13 Sales          | 2 000                     |                      |  |              |    |
| 27 Sales          | 1 000                     |                      |  |              |    |
|                   | <b>9 000</b>              |                      |  | <b>9 000</b> |    |
| May 1 Balance b/d | 9 000                     |                      |  |              |    |

Sometimes accounts have entries that are all on one side. Here the only transactions affecting trade receivables have been additional sales on credit. You notice that the step-by-step balancing technique can be followed in the same way as in all the previous examples.

### Accounts where there is only one entry

Before balancing:

| Dr              | Vehicles account |  |  |  | Cr |
|-----------------|------------------|--|--|--|----|
| March 1 Balance | 24 500           |  |  |  |    |

After balancing:

| Dr              | Vehicles account |  |  |  | Cr |
|-----------------|------------------|--|--|--|----|
| March 1 Balance | 24 500           |  |  |  |    |

Nothing needs to be done with an account with just one entry. Some accounts rarely have entries made in them. Do not be tempted to waste time balancing an account with just one entry – you will only end up where you started.



Many accounts do not have a balance at the end of an accounting year. This is often because the contents of the account have been transferred elsewhere. In Chapter 2.10, accounts such as those for sales, expenses and drawings were closed at the year end by transferring their contents to the income statement or capital account.

Where accounts have no balance, all that is necessary is to record a total at the end of the accounting period. Here are some examples.

## LEARNING OBJECTIVE

When you have reached the end of this section you will be able to:

- close accounts that do not have a balance.

#### Illustration 4 Closing accounts at the end of the financial period

## Closing a sales account

Before closing:

| Dr  |    |                  |       | Sales account |    |                   | Cr    |
|-----|----|------------------|-------|---------------|----|-------------------|-------|
| Dec | 31 | Income statement | 9 200 | Dec           | 3  | Cash              | 2 100 |
|     |    |                  |       |               | 5  | Trade receivables | 600   |
|     |    |                  |       |               | 17 | Cash              | 3 800 |
|     |    |                  |       |               | 30 | Cash              | 2 700 |

After closing:

| Dr  |    |                  |              | Sales account |    | Cr                |              |
|-----|----|------------------|--------------|---------------|----|-------------------|--------------|
| Dec | 31 | Income statement | 9 200        | Dec           | 3  | Cash              | 2 100        |
|     |    |                  |              |               | 5  | Trade receivables | 600          |
|     |    |                  |              |               | 17 | Cash              | 3 800        |
|     |    |                  |              |               | 30 | Cash              | 2 700        |
|     |    |                  | <b>9 200</b> |               |    |                   | <b>9 200</b> |

## Closing a drawings account

Before closing:

| Dr  |    |      |       | Drawings account |    |         |       | Cr |  |  |  |
|-----|----|------|-------|------------------|----|---------|-------|----|--|--|--|
| Jan | 1  | Bank | 600   | Jan              | 31 | Capital | 2 000 |    |  |  |  |
|     | 8  | Cash | 300   |                  |    |         |       |    |  |  |  |
|     | 22 | Bank | 1 100 |                  |    |         |       |    |  |  |  |

After closing:

| Dr  |    |      |              | Drawings account |    |         |      | Cr |  |              |  |
|-----|----|------|--------------|------------------|----|---------|------|----|--|--------------|--|
| Jan | 1  | Bank | 600          | Jan              | 31 | Capital | 2000 |    |  |              |  |
|     | 8  | Cash | 300          |                  |    |         |      |    |  |              |  |
|     | 22 | Bank | 1 100        |                  |    |         |      |    |  |              |  |
|     |    |      | <b>2 000</b> |                  |    |         |      |    |  | <b>2 000</b> |  |

### Closing an expense account

Before closing:

| Dr     |      | Wages account |        | Cr               |      |
|--------|------|---------------|--------|------------------|------|
| May 14 | Cash | 750           | May 31 | Income statement | 1500 |
| 28     | Cash | 750           |        |                  |      |

After closing:

| Dr  |    |      |              | Wages account |    |           |  | Cr           |  |  |  |
|-----|----|------|--------------|---------------|----|-----------|--|--------------|--|--|--|
| May | 14 | Cash | 750          | May           | 31 | Income    |  |              |  |  |  |
|     | 28 | Cash | 750          |               |    | statement |  | 1 500        |  |  |  |
|     |    |      | <u>1 500</u> |               |    |           |  | <u>1 500</u> |  |  |  |

### Closing an asset account with no balance

Before closing:

| Dr  |    |         |       | Trade receivables account |    |      |  | Cr    |  |  |  |
|-----|----|---------|-------|---------------------------|----|------|--|-------|--|--|--|
| Aug | 1  | Balance | 2 400 | Aug                       | 21 | Bank |  | 3 600 |  |  |  |
|     | 11 | Sales   | 1 200 |                           |    |      |  |       |  |  |  |

You will notice that the trade receivables have paid all that they owed, so the account has no balance.

After closing:

| Dr  |    |         |              | Trade receivables account |    |      |  | Cr           |  |  |  |
|-----|----|---------|--------------|---------------------------|----|------|--|--------------|--|--|--|
| Aug | 1  | Balance | 2 400        | Aug                       | 21 | Bank |  | 3 600        |  |  |  |
|     | 11 | Sales   | 1 200        |                           |    |      |  |              |  |  |  |
|     |    |         | <u>3 600</u> |                           |    |      |  | <u>3 600</u> |  |  |  |

### Closing an account with just one entry on each side

Here is an account with just one entry on each side and no balance.

Before closing:

| Dr  |    |      |       | Insurance account |    |           |  | Cr    |  |  |  |
|-----|----|------|-------|-------------------|----|-----------|--|-------|--|--|--|
| Nov | 12 | Bank | 1 600 | Nov               | 30 | Income    |  | 1 600 |  |  |  |
|     |    |      |       |                   |    | statement |  |       |  |  |  |

In this situation, it is unnecessary to record the total (which is, of course, the same as the amount of the entries). To show that the account is closed, just show total lines.

After closing:

| Dr  |    |      |       | Insurance account |    |           |  | Cr    |  |  |  |
|-----|----|------|-------|-------------------|----|-----------|--|-------|--|--|--|
| Nov | 12 | Bank | 1 600 | Nov               | 30 | Income    |  | 1 600 |  |  |  |
|     |    |      |       |                   |    | statement |  |       |  |  |  |

## The rules for balancing and closing accounts

| Balancing accounts                               |                              | Closing accounts               |                             |
|--|------------------------------|--------------------------------|-----------------------------|
| Accounts with at least two entries               | Accounts with just one entry | Several entries on either side | Just one entry on each side |
| Step 1 Calculate balance                         | Do not balance               | Record totals                  | Record total lines          |
| Step 2 Record balance on side with smaller total |                              |                                |                             |
| Step 3 Record totals                             |                              |                                |                             |
| Step 4 Bring balance down with a matching entry  |                              |                                |                             |

You can now answer questions 3 and 4 on page 55.

You can now answer questions 5 and 6 on page 56.

## DEVELOPING YOUR SKILLS

## 1 Balancing various accounts

Make a copy of the following accounts.

| Dr  |    |         |     | Cash account |    |           |     | Cr |  |  |  |
|-----|----|---------|-----|--------------|----|-----------|-----|----|--|--|--|
| Aug | 1  | Balance | 370 | Aug          | 12 | Purchases | 120 |    |  |  |  |
|     | 14 | Sales   | 130 |              | 28 | Drawings  | 210 |    |  |  |  |

| Dr  |    |          |        | Capital account |    |                     |        | Cr |  |  |  |
|-----|----|----------|--------|-----------------|----|---------------------|--------|----|--|--|--|
| Aug | 31 | Drawings | 11 900 | Aug             | 1  | Balance             | 39 400 |    |  |  |  |
|     |    |          |        |                 | 31 | Profit for the year | 18 400 |    |  |  |  |

| Dr  |   |         |        | Premises account |  |  |  | Cr |  |  |  |
|-----|---|---------|--------|------------------|--|--|--|----|--|--|--|
| Aug | 1 | Balance | 74 000 |                  |  |  |  |    |  |  |  |

| Dr |  |  |  | Trade payables account |    |           |       | Cr |  |  |  |
|----|--|--|--|------------------------|----|-----------|-------|----|--|--|--|
|    |  |  |  | Aug                    | 1  | Balance   | 2 100 |    |  |  |  |
|    |  |  |  |                        | 11 | Purchases | 800   |    |  |  |  |
|    |  |  |  |                        | 25 | Purchases | 1 300 |    |  |  |  |

Balance each account as appropriate.

## 2 Balancing various accounts

Make a copy of the following accounts.

| Dr  |    |         |       | Bank account |    |          |       | Cr |  |  |  |
|-----|----|---------|-------|--------------|----|----------|-------|----|--|--|--|
| Jan | 1  | Balance | 3 240 | Jan          | 8  | Rent     | 1 050 |    |  |  |  |
|     | 15 | Sales   | 620   |              | 14 | Drawings | 450   |    |  |  |  |
|     | 28 | Sales   | 290   |              | 29 | Salaries | 2 140 |    |  |  |  |

| Dr  |    |          |       | Capital account |    |                     |        | Cr |  |  |  |
|-----|----|----------|-------|-----------------|----|---------------------|--------|----|--|--|--|
| Jan | 31 | Drawings | 3 870 | Jan             | 1  | Balance             | 62 100 |    |  |  |  |
|     |    |          |       |                 | 31 | Profit for the year | 15 080 |    |  |  |  |

| Dr  |   |         |        | Fittings account |  |  |  | Cr |  |  |  |
|-----|---|---------|--------|------------------|--|--|--|----|--|--|--|
| Jan | 1 | Balance | 14 900 |                  |  |  |  |    |  |  |  |

| Dr  |    |         |       | Equipment account |  |  |  | Cr |  |  |  |
|-----|----|---------|-------|-------------------|--|--|--|----|--|--|--|
| Jan | 1  | Balance | 4 980 |                   |  |  |  |    |  |  |  |
|     | 18 | Bank    | 3 070 |                   |  |  |  |    |  |  |  |

Balance each account as appropriate.

## 3 Closing accounts

Make a copy of the following accounts.

| Dr  |    |                |       | Purchases account |    |                  |       | Cr |  |  |  |
|-----|----|----------------|-------|-------------------|----|------------------|-------|----|--|--|--|
| Oct | 14 | Bank           | 3 820 | Oct               | 31 | Income statement | 5 910 |    |  |  |  |
|     | 29 | Trade payables | 2 090 |                   |    |                  |       |    |  |  |  |

| Dr  |    |                  |       | Sales account |    |                   |       | Cr |  |  |  |
|-----|----|------------------|-------|---------------|----|-------------------|-------|----|--|--|--|
| Oct | 31 | Income statement | 7 070 | Oct           | 5  | Cash              | 1 250 |    |  |  |  |
|     |    |                  |       |               | 11 | Bank              | 3 780 |    |  |  |  |
|     |    |                  |       |               | 25 | Trade receivables | 2 040 |    |  |  |  |

| Dr  |    |      |       | Rent account |    |                  |       | Cr |  |  |  |
|-----|----|------|-------|--------------|----|------------------|-------|----|--|--|--|
| Oct | 11 | Bank | 3 750 | Oct          | 31 | Income statement | 3 750 |    |  |  |  |

| Dr  |    |      |       | Drawings account |    |         |       | Cr |  |  |  |
|-----|----|------|-------|------------------|----|---------|-------|----|--|--|--|
| Oct | 15 | Bank | 1 980 | Oct              | 31 | Capital | 1 980 |    |  |  |  |

Close each account.

## 4 Closing accounts

Make a copy of the following accounts.

| Dr    |    |                  |       | Sales account |    |                   |       | Cr |  |  |  |
|-------|----|------------------|-------|---------------|----|-------------------|-------|----|--|--|--|
| April | 30 | Income statement | 5 810 | April         | 7  | Bank              | 3 720 |    |  |  |  |
|       |    |                  |       |               | 14 | Trade receivables | 2 090 |    |  |  |  |

| Dr    |    |      |       | Wages account |    |                  |       | Cr |  |  |  |
|-------|----|------|-------|---------------|----|------------------|-------|----|--|--|--|
| April | 14 | Cash | 2 640 | April         | 30 | Income statement | 4 910 |    |  |  |  |
|       | 28 | Cash | 2 270 |               |    |                  |       |    |  |  |  |

| Dr    |    |      |     | General expenses account |    |                  |     | Cr |  |  |  |
|-------|----|------|-----|--------------------------|----|------------------|-----|----|--|--|--|
| April | 6  | Bank | 320 | April                    | 30 | Income statement | 410 |    |  |  |  |
|       | 18 | Cash | 90  |                          |    |                  |     |    |  |  |  |

| Dr    |    |      |     | Insurance account |    |                  |     | Cr |  |  |  |
|-------|----|------|-----|-------------------|----|------------------|-----|----|--|--|--|
| April | 17 | Bank | 560 | April             | 30 | Income statement | 560 |    |  |  |  |

Close each account.



**5 Preparing a set of accounts and balancing and closing the accounts at the end of the accounting period**

Mike is the owner of a business that sells furniture. His business's trial balance on 30 November 2018 was as follows:

| Trial balance at 30 November 2018 |                |                |
|-----------------------------------|----------------|----------------|
|                                   | Dr             | Cr             |
|                                   | \$             | \$             |
| Bank                              | 2 040          |                |
| Capital                           |                | 124 650        |
| Cash                              | 310            |                |
| Drawings                          | 17 490         |                |
| Equipment                         | 12 200         |                |
| General expenses                  | 2 080          |                |
| Insurance                         | 3 650          |                |
| Premises                          | 88 000         |                |
| Purchases                         | 142 300        |                |
| Sales (i.e. Revenue)              |                | 238 560        |
| Trade payables                    |                | 5 840          |
| Trade receivables                 | 3 140          |                |
| Vehicle                           | 31 000         |                |
| Wages                             | 66 840         |                |
|                                   | <u>369 050</u> | <u>369 050</u> |

During December the following transactions occurred:

- Dec 1 Sales on credit totalled \$4560  
 5 Paid trade payables \$5840 by cheque  
 8 Received cheques from trade receivables, \$6400  
 14 Purchased goods for resale and paid by cheque, \$1290  
 18 Purchased some additional equipment and paid by cheque, \$860  
 22 Cash sales totalled \$2180  
 23 Paid wages in cash, \$1450  
 28 Mike withdrew cash for private use, \$290
- Open accounts for each item listed in the trial balance on 30 November 2018.
  - Record the transactions for December 2018.
  - Prepare a trial balance at 31 December 2018.
  - Prepare an income statement for the year ended 31 December 2018.
  - Complete the capital account by transferring the profit and total drawings for the year.
  - Complete the ledger accounts by closing or balancing accounts.
  - Prepare a classified statement of financial position at 31 December 2018.

**6 Preparing a set of accounts and balancing and closing the accounts at the end of the accounting period**

Linda is the owner of business that sells household equipment. Her business's trial balance on 30 April 2018 was as follows:

| Trial balance at 30 April 2018 |                |                |
|--------------------------------|----------------|----------------|
|                                | Dr             | Cr             |
|                                | \$             | \$             |
| Bank                           | 1 720          |                |
| Bank loan                      |                | 8 000          |
| Capital                        |                | 62 810         |
| Cash                           | 690            |                |
| Drawings                       | 23 460         |                |
| Furniture                      | 18 500         |                |
| Light and heat                 | 890            |                |
| Loan interest                  | 430            |                |
| Premises                       | 67 500         |                |
| Purchases                      | 102 480        |                |
| Sales (i.e. Revenue)           |                | 184 360        |
| Trade payables                 |                | 3 210          |
| Trade receivables              | 1 490          |                |
| Wages                          | 41 220         |                |
|                                | <u>258 380</u> | <u>258 380</u> |

During May the following transactions occurred:

- May 4 Paid loan interest, \$70. Funds were transferred from the bank account  
 5 Received cheques from trade receivables totalling \$1490  
 8 Purchased goods for resale on credit, \$950  
 14 Linda withdrew a cheque, \$380, for private use  
 18 Purchased some additional furniture and paid by cheque, \$1300  
 22 Cash sales totalled \$3130  
 23 Paid wages in cash, \$870  
 28 Borrowed an additional \$5 000 from the bank. Funds were transferred into the bank account
- Open accounts for each item listed in the trial balance at 30 April 2018.
  - Record the transactions for May 2018.
  - Prepare a trial balance at 31 May 2018.
  - Prepare an income statement for the year ended 31 May 2018.
  - Complete the capital account by transferring the profit and total drawings for the year.
  - Complete the ledger accounts by closing or balancing accounts.
  - Prepare a classified statement of financial position at 31 May 2018.

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapters 2.1 to 2.11).

### MULTIPLE-CHOICE QUESTIONS

- 7 Which of the following would provide the owner of a business with a statement of the business's financial position?
- A Bank account  
B Capital account  
C Income statement  
D Statement of financial position
- 8 Which of the following contains only assets?
- A Bank loan, equipment, trade receivables, vehicles  
B Bank overdraft, equipment, machinery, trade payables  
C Cash, equipment, machinery, trade receivables  
D Cash, fixtures, furniture, trade payables
- 9 The following balances appear in the accounts of a retailer.

|                   | \$     |
|-------------------|--------|
| Bank loan         | 8 000  |
| Cash at bank      | 3 100  |
| Trade payables    | 800    |
| Trade receivables | 1 400  |
| Vehicle           | 18 200 |

What is the owner's capital?

- A \$12 700  
B \$13 900  
C \$15 500  
D \$31 500
- 10 The accounts of a retailer include an amount for cash drawings.
- How will drawings affect the profit, current assets and capital?
- |   | Profit    | Current assets | Capital   |
|---|-----------|----------------|-----------|
| A | Decrease  | Increase       | Decrease  |
| B | Decrease  | No effect      | Increase  |
| C | Increase  | Decrease       | No effect |
| D | No effect | Decrease       | Decrease  |
- 11 Kwame prepares a trial balance for his business's accounts every month. Why should he prepare a trial balance?

A To balance all the ledger accounts.

- B To calculate the monthly figure for profit.  
C To check if any transactions have been omitted.  
D To check the arithmetical accuracy of the double entry in the ledgers.
- 12 Martha purchased goods from Jacob on credit. How should this transaction be recorded in Jacob's books of account?

|   | Account to be debited | Account to be credited |
|---|-----------------------|------------------------|
| A | Purchases             | Martha                 |
| B | Martha                | Sales                  |
| C | Martha                | Purchases              |
| D | Sales                 | Martha                 |

- 13 On 1 March 2018 trade receivables totalled \$2700. During March credit sales totalled \$1200 and \$700 was paid by credit customers. What was the total of trade receivables at 31 March 2018?
- A \$800  
B \$2 200  
C \$3 200  
D \$4 600
- 14 Stella owns a grocery store. Recently she purchased a delivery van for use by her business and paid by cheque. How should this transaction be recorded in her business's accounts?

|   | Account to be debited | Account to be credited |
|---|-----------------------|------------------------|
| A | Bank                  | Vehicles               |
| B | Purchases             | Vehicles               |
| C | Vehicles              | Bank                   |
| D | Vehicles              | Purchases              |

- 15 Which of the following accounts should be entered in the debit column of a trial balance?
- A Capital  
B Drawings  
C Sales  
D Trade payables
- 16 Which of the following accounts should be entered in the credit column of a trial balance?
- A Cash  
B Purchases  
C Sales

## D Wages

**17\*** On 30 September 2018 a credit supplier was owed \$3200. During September goods, \$1700, were purchased from this supplier and \$2100 was paid to this supplier. What was the balance of this supplier's account at the beginning of September?

- a \$600
- b \$2800
- c \$3600
- d \$7000

**18\*** Which transaction has been recorded correctly?

| Transaction |                                | Debit         | Credit           |
|-------------|--------------------------------|---------------|------------------|
| A           | Paid a credit supplier in cash | Trade payable | Cash             |
| B           | Repaid a bank loan by cheque   | Bank          | Loan             |
| C           | Sold goods on credit           | Sales         | Trade receivable |
| D           | Withdrew cash for private use  | Cash          | Drawings         |

## OTHER QUESTIONS

**19** Mustafa opened his hotel business on 1 March 2018 by paying \$70 000 into a business bank account.

- a Name the account that should be credited with this transaction.

Since 1 March, Mustafa has purchased many non-current assets for his business.

- b State what is meant by the term 'non-current asset'.
- c Give **three** examples of non-current assets that Mustafa is likely to have purchased for his hotel business.

Mustafa prepared a trial balance on 31 August 2018. However, the totals of this trial balance did not agree.

- d Explain **one** possible reason why the totals of this trial balance did not agree.
- e Mustafa was not sure of the double entry for the following transactions. Complete the table below to show the account that should be debited and the account that should be credited for each transaction.

| Transaction |  | Account to be debited | Account to be credited |
|-------------|--|-----------------------|------------------------|
| 1           | Paid for some stationery for office use in cash                    |                       |                        |
| 2           | A hotel guest paid by cheque                                       |                       |                        |
| 3           | Mustafa withdrew a cheque for private use                          |                       |                        |
| 4           | A supplier had been overpaid and sent Mustafa a cheque as a refund |                       |                        |
| 5           | Mustafa made a gift of \$50 to a friend using the business's cash  |                       |                        |

**20** Cherry recently opened a business selling sports equipment. On the first day of trading, 1 September 2018, the business had the following assets and liabilities:

|                            | \$      |
|----------------------------|---------|
| Bank loan (repayable 2023) | 30 000  |
| Cash at bank               | 3 000   |
| Equipment                  | 8 000   |
| Inventory                  | 14 000  |
| Shop fittings and fixtures | 12 000  |
| Shop premises              | 220 000 |
| Trade payables             | 9 000   |

- a State what is meant by the term 'non-current liability'.
- b Calculate the business's capital on 1 September 2018.
- c Prepare the business's classified statement of financial position at 1 September 2018.

**21** Farad owns a furniture store. He purchases most goods for resale on credit (i.e. he uses credit to buy the goods that he resells). The following information about trade payables is available for the months of August and September 2018.

|           |                       | \$     |
|-----------|-----------------------|--------|
| August    | Opening balance       | 11 900 |
|           | Purchases on credit   | 7 300  |
|           | Payments to suppliers | 15 300 |
| September | Purchases on credit   | 9 300  |
|           | Payments to suppliers | 13 200 |

- a State one advantage to Farad of using credit to buy goods for resale.
- b Prepare the trade payables account in Farad's books of account for each of the months of August and September 2018.



Where a traditional T account is used, it should be balanced at the end of August and again at the end of September.

- c State **one** advantage of balancing ledger accounts.

22 Kalpna owns a taxi business. She has recently prepared an income statement for the year ended 30 April 2018.

- a List **four** typical expenses for a taxi business that are likely to have appeared in Kalpna's income statement.

Kalpa did not realise that drawings should not be included in the income statement.

- b Explain why drawings are not included in a business's income statement.

23 Tony, the owner of a grocery store, is not very experienced at keeping accounting records. Recently he made the following entries in his business's accounts. Some of the entries he made were incorrect.

Check the entries made by Tony in the following table. Complete the final column, indicating for each transaction whether you think the entries were correct (✓) or incorrect (✗).

|   | Transaction                                       | Account debited | Account credited | Indicate:<br>✓ if correct<br>✗ if incorrect |
|---|---|-----------------|------------------|---|
| a | Paid wages in cash                                | Wages           | Cash             |   |
| b | Sold some unwanted shop fittings for cash         | Cash            | Shop fittings    |   |
| c | Purchased goods for resale on credit              | Purchases       | Bank             |   |
| d | Tony withdrew cheque for own use                  | Bank            | Drawings         |   |
| e | Sold goods for cash                               | Cash            | Sales            |   |
| f | Paid a credit supplier by cheque                  | Trade payables  | Bank             |   |
| g | Purchased some equipment for office use by cheque | Purchases       | Bank             |   |

24 Ahmad prepared the following trial balance. However, he made some mistakes when entering ledger account balances in the debit and credit columns. Check the trial balance and indicate

whether or not you think the entries were correct (✓) or incorrect (✗).

| Trial balance at 31 March 2018 |        |        |   |
|--------------------------------|--------|--------|---|
|                                | Dr     | Cr     | Indicate:<br>✓ if correct<br>✗ if incorrect |
|                                | \$     | \$     |   |
| Bank overdraft                 | 750    |        |   |
| Bank loan                      |        | 2 100  |   |
| Capital                        | 18 020 |        |   |
| Drawings                       |        | 12 960 |   |
| General expenses               |        | 6 180  |   |
| Non-current assets             | 22 500 |        |   |
| Purchases                      |        | 31 640 |   |
| Sales (i.e. Revenue)           | 49 930 |        |   |
| Trade payables                 | 2 480  |        |   |
|                                | 93 680 | 52 880 |   |

25 Salma was preparing her business's trial balance at 31 December 2018. She has almost finished this task, but still has to record the following account balances:

|                      | \$      |
|----------------------|---------|
| Capital              | 145 000 |
| Drawings             | 18 300  |
| Purchases            | 92 400  |
| Sales (i.e. Revenue) | 161 900 |
| Trade payables       | 8 100   |
| Trade receivables    | 6 200   |

- a Complete Salma's trial balance by entering the account balances in the correct column. Total the trial balance columns.

| Trial balance at 31 December 2018 |         |        |  |
|-----------------------------------|---------|--------|--|
|                                   | Dr      | Cr     |  |
|                                   | \$      | \$     |  |
| Total of entries made by Salma    | 236 600 | 44 300 |  |
| Capital                           |         |        |  |
| Drawings                          |         |        |  |
| Purchases                         |         |        |  |
| Sales (i.e. Revenue)              |         |        |  |
| Trade payables                    |         |        |  |
| Trade receivables                 |         |        |  |

- b Explain to Salma what the totals of the trial balance reveal.
- c Salma finds preparing trial balances useful as a check on the arithmetical accuracy of her ledger accounts. State **one** other advantage of preparing trial balances.

# Sources and recording of date: business documents

## What this section is about

At this stage in your study of accounting, you will be familiar with:

- recording a range of transactions in ledger accounts
- producing a trial balance to check the accuracy of the your record keeping
- preparing income statements to show the gross profit and profit for the year made by the business
- preparing a statement of financial position which summarises the business's assets, liabilities and capital at a particular date

In the second part of Section 2 the accounting system is going to be extended to take account of the following developments.

- Details of accounting transactions are found on what are called 'source documents'.
- Key facts about transactions are recorded first in what are called books of prime entry, before entries are made in ledger accounts
- Instead of having just one account to record transactions affecting trade payables, from now on each credit supplier will have a personal account. These personal accounts will be collected together and kept in a 'purchases ledger'.
- A similar process will apply to credit customers. There will be a separate account for each trade receivable, and these individual personal accounts will be collected together and kept in a 'sales ledger'.

You will also learn about trade and cash discounts.

There are seven books of prime entry as follows:

Purchases journal (see Chapter 2.13)

Sales journal (see Chapter 2.14)

Purchase returns journal (see Chapter 2.16)

Sales returns journal (see Chapter 2.17)

Cash book (see Chapter 2.18)

Petty cash book (see Chapter 2.22)

General journal (see Chapter 2.25)

### KEY TERMS

**Books of prime entry:** this is where transactions are listed prior to being posted to the double-entry records.



# Source documents and credit purchases

## What are source documents?

So far you have been used to preparing accounting records from a list of transactions presented in date order. However, in reality, whoever prepares the accounting records of a business relies on the information shown on documents – known as **source documents** – rather than in a neat list of transactions.

These documents are received from, or sent out to, other businesses and organisations. Each document is used as a source of information. As each document is received or issued by the business, the bookkeeper or accounts clerk extracts whatever details are needed for the accounting records.

### Illustration 1 Source document for credit purchases

Whenever a business purchases goods for resale on credit, as well as taking delivery of the goods, it will receive a document from the supplier called a **purchase invoice**. Here is an example of a purchase invoice.

|                               |                 |            | No.    | J3082 |
|-------------------------------|-----------------|------------|--------|-------|
| PURCHASE INVOICE              |                 |            |        |       |
| West Bay Supplies             |                 |            |        |       |
| To:                           | Kingford Stores |            |        |       |
| Date:                         | 14 June 2018    |            |        |       |
| Quantity                      | Description     | Unit price | Total  |       |
|                               |                 | \$         | \$     |       |
| 40 packets                    | Kitchen roll    | 1.20       | 48.00  |       |
| 15 cartons                    | Tastie snacks   | 2.80       | 42.00  |       |
| 20 tins                       | Supa cookies    | 0.90       | 18.00  |       |
| TOTAL AMOUNT DUE              |                 |            | 108.00 |       |
| Terms: Payment within 30 days |                 |            |        |       |

This document tells you that:

- Kingford Stores has purchased goods from a supplier, West Bay Supplies
- the transaction is dated 14 June 2018
- the total amount due for the goods received is \$108.

These are the key facts that Kingford Stores' bookkeeper will need to know in order to update the business's accounting records.

The purchase invoice also has a number (J3082) which could be

### LEARNING OBJECTIVE

When you have reached the end of this chapter you will be able to:

- identify the source document used for recording credit purchases
- prepare a purchases journal.

### KEY TERMS

**Source documents:** written documents that provide information from which accounting records can be prepared. They provide evidence that particular transactions took place.

**Purchase invoice:** the source document that provides information about goods purchased on credit and the amount due.

### DID YOU KNOW?

Invoices contain a considerable amount of additional information which is likely to be of value to the business, though this information will not normally be required for the accounting records. Examples include:

- the address of the supplier and/or customer
- purchase order references
- contact names.



useful in identifying this particular document.

At the end of the invoice there is a reference to 'terms'. These are the conditions for payment. In other words the supplier expects Kingford Stores to pay this invoice within 30 days (i.e. before 14 July 2018). The owner of Kingford Stores will need to be aware of this information to ensure that payment is made by this date, or risk upsetting an important supplier.

### KEY TERMS

**Purchases journal:** the book of prime entry used to record purchases of goods on credit. The information required to prepare this journal is taken from purchase invoices.

## Recording credit purchases in a purchases journal

As purchase invoices are received, the following important information is recorded first in what is called a **purchases journal**:

- Date
- Name of supplier
- Invoice number
- Amount due

### Illustration 2

#### Recording purchase invoices in a purchases journal

Elizabeth owns a hardware store. During April 2018 she received the following purchase invoices from her suppliers for goods for resale.

|       |    |              |   |
|-------|----|--------------|---|
| April | 7  | Invoice 2845 | Purchase invoice received from P Bell for goods \$785   |
|       | 11 | Invoice 3901 | Purchase invoice received from R Khan for goods \$1450  |
|       | 22 | Invoice 0783 | Purchase invoice received from H Aldo for goods \$2440  |
|       | 29 | Invoice 0442 | Purchase invoice received from L Samson for goods \$635 |

As each invoice is received the following entries would be made in the purchases journal:

| Purchases journal |    |                 |                |      |
|-------------------|----|-----------------|----------------|------|
| Date              |    | Supplier        | Invoice number | \$   |
| April             | 7  | P Bell          | 2845           | 785  |
|                   | 11 | R Khan          | 3901           | 1450 |
|                   | 22 | H Aldo          | 0783           | 2440 |
|                   | 29 | L Sampson       | 0442           | 635  |
|                   |    | Total purchases |                | 5310 |

### Notes:

- 1 The purchases journal is just a listing of important information shown on individual invoices.
- 2 The purchases journal is **not** part of the double-entry records.
- 3 The purchases journal only contains information about credit purchases of goods for resale. It does not include information about cash purchases or about the purchase of non-current assets.
- 4 The details should be recorded in strict date order.
- 5 The purchases journal should be totalled at agreed intervals (e.g. monthly), but this could be more frequent if there is a large volume of transactions.

### STUDY TIP

Do not forget that the purchases journal is only used to record credit purchases of goods for resale. It is easy to enter cash purchases or the purchase of a non-current asset in the purchases journal by mistake.

### DID YOU KNOW?

E&OE: some invoices show this abbreviation at the end of the document. It means 'errors and omissions excepted'. In other words, if a mistake has been made in preparing the invoice, the business sending the invoice has the right to make a correction.

# Posting the purchases journal

## Posting credit purchases of goods for resale

The correct double entry for the purchase of goods for resale on credit is:

Debit Purchases

Credit Trade payables

This rule still applies. However, instead of having just one account for trade payables, each supplier will be given their own account. It is important that the owner of the business knows how much is owed to each trade payable, not just the total amount owing to all suppliers. The accounts of trade payables are normally maintained in a separate ledger called the **purchases ledger**.

Instead of making a separate debit entry in the purchases account for each transaction, it is usual to make use of the total shown at the end of the purchases journal and update the purchases account with credit purchases say once a month.

The purchases account (along with all the other accounts except trade receivables and trade payables accounts) will be found in what is called the **nominal ledger**.

The information to make these entries will be taken from the purchases journal. This process is called 'posting the purchases journal'.

### LEARNING OBJECTIVE

When you have reached the end of this chapter you will be able to:

- post a purchases journal to the purchases ledger and nominal ledger.

### KEY TERMS

**Purchases ledger:** a part of the double-entry system that is used to keep the personal accounts of trade payables.

**Nominal ledger:** a part of the double-entry system that is used to keep all of the accounts, other than those for trade payables (kept in the purchases ledger) and trade receivables (kept in the sales ledger).

### Illustration 3 Posting a purchases journal

Here is the purchases journal again, followed by the ledger accounts to which the information has now been posted.

| Purchases journal |    |                 |                |      |
|-------------------|----|-----------------|----------------|------|
| Date              |    | Supplier        | Invoice number | \$   |
| April             | 7  | P Bell          | 2845           | 785  |
|                   | 11 | R Khan          | 3901           | 1450 |
|                   | 22 | H Aldo          | 0783           | 2440 |
|                   | 29 | L Sampson       | 0442           | 635  |
|                   |    | Total purchases |                | 5310 |

Following are the double-entry records for these purchases on credit.

#### DID YOU KNOW?

All invoices (and other source documents) must be kept carefully by a business and stored in such a way that any individual source document can be found easily. Source documents are the proof that a transaction took place, so they might be required at any time to justify an entry in the accounting system.

Now you can answer questions 1 and 2 on page 70.

#### DID YOU KNOW?

The nominal ledger is sometimes referred to as the 'general ledger'.

#### PURCHASES LEDGER

| Dr | P Bell account    |    |           | Cr   |
|----|-------------------|----|-----------|------|
|    | April             | 7  | Purchases | 785  |
| Dr | R Khan account    |    |           | Cr   |
|    | April             | 11 | Purchases | 1450 |
| Dr | H Aldo account    |    |           | Cr   |
|    | April             | 22 | Purchases | 2440 |
| Dr | L Sampson account |    |           | Cr   |
|    | April             | 29 | Purchases | 635  |

#### NOMINAL LEDGER

| Dr    | Purchases account |                   |      | Cr |
|-------|-------------------|-------------------|------|----|
| April | 30                | Purchases journal | 5310 |    |

#### Notes:

- 1 The posting to each trade payable account should be made as soon as possible after the purchase invoice has been listed in the purchases journal. This will ensure that the owner has up-to-date information about how much is owed to each trade payable.
- 2 The single entry in the purchases account matches the four individual credit entries. The usual narrative used is 'purchases journal'.



**LEARNING OBJECTIVE**

When you have reached the end of this chapter you will be able to:

- identify the source document used to record credit sales
- prepare a sales journal.

**Processing credit sales**

When a business sells goods on credit it will issue an invoice to the customer. The business will keep a copy of this source document – a **sales invoice** – which can then be used to make entries in its books of account in the following sequence:

Step 1: Key details from the sales invoice will be recorded in the **sales journal**.

Step 2: An account for the trade receivable will be opened in the **sales ledger** and a debit entry made to record the amount the customer owes.

Step 3: At regular intervals (usually monthly) the total of the sales journal will be credited to the sales account which is kept in the nominal ledger.

**KEY TERMS**

**Sales invoice:** the source document that provides information about goods sold on credit and the amount due.

**Sales journal:** the book of prime entry used to record sales of goods on credit. The information required to prepare this book of prime entry is taken from sales invoices.

**Sales ledger:** a part of the double-entry system that is used to keep the personal accounts of trade receivables.

**Illustration 4** Recording credit sales

Jamie owns a furniture store. During March 2018 he issued the following invoices to credit customers:

|       |    |             |  |
|-------|----|-------------|--|
| March | 3  | Invoice 377 | Sales invoice sent to Batfo for \$1080   |
|       | 14 | Invoice 378 | Sales invoice sent to H Denman for \$740 |
|       | 18 | Invoice 379 | Sales invoice sent to Jakex for \$2320   |
|       | 22 | Invoice 380 | Sales invoice sent to Quilfon for \$1440 |

As these invoices are issued the following record should be made in the sales journal:

| Sales journal |    |             |                |       |
|---------------|----|-------------|----------------|-------|
| Date          |    | Customer    | Invoice number | \$    |
| March         | 3  | Batfo       | 377            | 1 080 |
|               | 14 | H Denman    | 378            | 740   |
|               | 18 | Jakex       | 379            | 2 320 |
|               | 22 | Quilfon     | 380            | 1 440 |
|               |    | Total sales |                | 5 580 |

Each entry in the sales journal should be posted immediately to an individual account for each trade

receivable in the sales ledger. The owner of the business will want to have up-to-date information about how much is owed by each individual customer.

By the end of March the following entries should have been made:

**SALES LEDGER**

| Dr Batfo account Cr    |    |       |       |  |
|------------------------|----|-------|-------|--|
| March                  | 3  | Sales | 1 080 |  |
| Dr H Denman account Cr |    |       |       |  |
| March                  | 14 | Sales | 740   |  |
| Dr Jakex account Cr    |    |       |       |  |
| March                  | 18 | Sales | 2 320 |  |
| Dr Quilfon account Cr  |    |       |       |  |
| March                  | 22 | Sales | 1 440 |  |

At the end of the month the sales account should be updated with just one total entry to match

### STUDY TIP

The sales journal is only used to record sales of goods on credit. Do not be tempted to include cash sales or the sales of non-current assets in this book of prime entry.

Now you can answer questions 3 and 4 on page 70.

these four debit entries. This requires the posting of the total of the sales journal.

#### NOMINAL LEDGER

| Dr | Sales account         | Cr    |
|----|-----------------------|-------|
|    | March 3 Sales journal | 5 580 |

#### Notes:

- 1 The sales journal is **not** part of the double-entry records.
- 2 The sales journal only contains information about credit sales. It does not include information about cash sales or about the sale of non-current assets.
- 3 The details should be recorded in strict date order.

### DID YOU KNOW?

33.33% is not exactly one-third (because it should be written as 33.33 recurring).

66.66% or 66.67% is not exactly two-thirds (because it should be written as 66.66 recurring).

If you are using your calculator with these percentages you are in danger of getting a slightly inaccurate result if you key in 33.33% or 66.66%.

When using a calculator always divide by 3 (one-third) for 33.33%; always multiply by 2 and divide by 3 (two-thirds) for 66.67%.

As an experiment try working out  $33\frac{1}{3}\%$  (i.e. one-third) of 9. The answer is 3.

If you key 33.33% into your calculator, however, you are likely to obtain the answer: 2.9997!

### NUMERACY SKILLS

#### Working with percentages

In 2.15 on the next page you are going to prepare accounting records when there has been a trade discount. These discounts are normally given as percentages, so you may like to remind yourself how to work with percentages.

You will probably remember that 1 per cent means one in every hundred. So fractions and decimals can also be expressed as percentages.

$$1\% = \frac{1}{100} = 0.01$$

Here is a quick reminder about some percentages that are often used in accounting.

$$5\% = \frac{5}{100} \text{ (or } \frac{1}{20}) = 0.05$$

$$10\% = \frac{10}{100} \text{ (or } \frac{1}{10}) = 0.1$$

$$15\% = \frac{15}{100} \text{ (or } \frac{3}{20}) = 0.15$$

$$20\% = \frac{20}{100} \text{ (or } \frac{1}{5}) = 0.2$$

$$25\% = \frac{25}{100} \text{ (or } \frac{1}{4}) = 0.25$$

$$50\% = \frac{50}{100} \text{ (or } \frac{1}{2}) = 0.5$$

$$75\% = \frac{75}{100} \text{ (or } \frac{3}{4}) = 0.75$$

There are two percentages that need care:

$33\frac{1}{3}\%$ : this is the equivalent of  $\frac{1}{3}$  (one-third) but it is sometimes written as 33.33%.

$66\frac{2}{3}\%$ : this is the equivalent of  $\frac{2}{3}$  (two-thirds) but it is sometimes written as 66.66% or 66.67%.



A **trade discount** is a reduction in the price to be charged for goods. However, the following important conditions normally apply to this type of discount:

- Trade discount is only offered to other businesses engaged in the same line of activity.
- Trade discounts are often given for large orders.
- Trade discount is *not* normally available to private individuals.

#### Illustration 5 Trade discounts

GCK Wholesalers sell refrigerators. Their price list shows that the normal selling price of Model 2TB is \$320.

GCK Wholesalers has just received two orders:

- A private individual wishes to purchase one refrigerator Model 2TB.
- J Hudson, a retailer of electrical goods, wishes to purchase 10 refrigerators, Model 2TB.

The private individual will be charged the normal selling price of \$320.

But, J Hudson, a retailer in the same line of business, could be offered a trade discount. Trade discounts are usually expressed as percentages and can be large in amount. So, if the retailer, J Hudson, was allowed a trade discount of say 25 per cent, the amount charged for the order would be:

|  | \$    |
|--|-------|
| 10 refrigerators Model 2TB normal price \$320 each | 3 200 |
| Less: 25% trade discount                           | 800   |
| AMOUNT CHARGED                                     | 2 400 |

The retailer pays only \$240 for each refrigerator, but the private individual is charged the full price of \$320.

#### KEY TERMS

**Trade discount:** a reduction in price given as a reward for buying in large quantities.

#### DID YOU KNOW?

Wholesalers are businesses that purchase goods from manufacturers or producers and sell these on to retailers.

Retailers are businesses that provide goods for private individuals.

#### STUDY TIP

Do not be misled into thinking that the purchases account should appear in the purchases ledger, or that the sales account should be in the sales ledger.

Remember the purchases account and the sales account are both part of the nominal ledger.

#### Accounting records and trade discount

Invoices usually show detailed information about the normal price for the goods and any trade discount that is being deducted.

Now you can answer questions 5 and 6 on pages 70–71.



### STUDY TIP

Remember that the amount of the trade discount is not recorded in the accounting system. Only the net amount after deducting trade discount is shown in the books of prime entry and ledger accounts. There is no such thing as a trade discount account.

### Illustration 6

### Purchase invoice including trade discount

| PURCHASE INVOICE    |                          |               |          |
|---------------------|--------------------------|---------------|----------|
| Batford Wholesalers |                          |               |          |
| To:                 | Saintford Retail Stores  |               |          |
| Date:               | 31 Aug 18                |               |          |
| Quantity            | Description              | Unit price \$ | Total \$ |
| 300 tins            | Emulsion paint code 3D24 | 2.40          | 720.00   |
| 500 tins            | Emulsion paint code 4X68 | 2.80          | 1 400.00 |
| SUBTOTAL            |                          |               | 2 120.00 |
| LESS                | 20% trade discount       |               | 424.00   |
| AMOUNT DUE          |                          |               | 1 696.00 |

In this example, the most important fact is the amount charged: \$1696. It is this figure that will be recorded in the accounting system. No record will be made of the normal price of the paint or the trade discount. What matters is always the amount actually charged.

### Illustration 7

### Accounting records and trade discount

Lendford Wholesalers received the following invoice during September 2018:

Sept 8 Purchase invoice T2734 received from JFZ Manufacturers. The normal price of the goods was \$7500. However, the invoice showed the deduction of a 20% trade discount

Lendford Wholesalers issued the following invoice during September 2018:

Sept 12 Sales invoice N835 sent to Amberly Stores. The normal price of the goods was \$2800. However, the invoice showed the deduction of a 10% trade discount.

Step 1: Calculate the amount actually charged for the goods on each of these invoices.

Purchase invoice:

|                                 |       |
|---------------------------------|-------|
| JFZ Manufacturers (8 September) | \$    |
| Goods at normal selling price   | 7 500 |
| Less: 20% trade discount        | 1 500 |
| AMOUNT CHARGED                  | 6 000 |

Sales invoice:

|                               |       |
|-------------------------------|-------|
| Amberly Stores (12 September) | \$    |
| Goods at normal selling price | 2 800 |
| Less: 10% trade discount      | 280   |
| AMOUNT CHARGED                | 2 520 |

Step 2: Prepare the purchases and sales journals.

| Purchases journal |   |                   |                |       |
|-------------------|---|-------------------|----------------|-------|
| Date              |   | Supplier          | Invoice number | \$    |
| Sept              | 8 | JFZ Manufacturers | T2734          | 6 000 |
|                   |   | Total purchases   |                | 6 000 |

| Sales journal |    |                |                |       |
|---------------|----|----------------|----------------|-------|
| Date          |    | Customer       | Invoice number | \$    |
| Sept          | 12 | Amberly Stores | N835           | 2 520 |
|               |    | Total sales    |                | 2 520 |

Step 3: Post the journals to the purchases, sales and general ledgers.

#### PURCHASES LEDGER

| Dr | JFZ Manufacturers account | Cr    |
|----|---------------------------|-------|
|    | Sept 8 Purchases          | 6 000 |

#### SALES LEDGER

| Dr            | Amberly Stores account | Cr |
|---------------|------------------------|----|
| Sept 12 Sales | 2 520                  |    |

#### NOMINAL LEDGER

| Dr                        | Purchases account     | Cr    |
|---------------------------|-----------------------|-------|
| Sept 30 Purchases journal | 6 000                 |       |
| Dr                        | Sales account         | Cr    |
|                           | Sept 30 Sales journal | 2 520 |

Reminder: there are now three subdivisions of the ledger. There is the purchases ledger (for the accounts of trade payables), the sales ledger (for the accounts of trade receivables), and the nominal ledger (for all other ledger accounts). This division of the ledger into three is often used because it makes it possible to spread the work of keeping a business's books of accounts between a number of individuals. For example, in a large business there could be sales ledger clerks whose responsibility it is to keep the accounts of trade receivables up to date in the sales ledger.

**Note:** the amount entered in the journal is the net amount actually charged by the supplier or charged to the customer.

Now you can answer questions 7–10 on page 71.

## DEVELOPING YOUR SKILLS

**1 Recording credit purchases in a purchases journal and posting to ledger accounts**

Beth owns a shoe shop. During May 2018 she received the following purchase invoices:

|     |    |         |  |
|-----|----|---------|--|
| May | 3  | Invoice | Purchase invoice received from Whiteford for |
|     |    | 2730    | \$1230                                       |
|     | 11 | Invoice | Purchase invoice received from P Sackley for |
|     |    | 9702    | \$2720                                       |
|     | 24 | Invoice | Purchase invoice received from A Hereton     |
|     |    | 1818    | for \$990                                    |
|     | 27 | Invoice | Purchase invoice received from Whiteford for |
|     |    | 2823    | \$2440                                       |

Prepare the accounting records necessary to record these transactions as follows:

- Purchases journal
- Trade payable accounts in the purchases ledger
- Purchases account in the nominal ledger

**2 Recording credit purchases in a purchases journal and posting to ledger accounts**

Ahmed owns a retail unit selling men's clothing. During January 2018 he received the following purchase invoices:

|     |    |         |   |
|-----|----|---------|---|
| Jan | 6  | Invoice | Purchase invoice received from Disley for   |
|     |    | 3372    | goods, \$630                                |
|     | 11 | Invoice | Purchase invoice received from P Harlew for |
|     |    | 4941    | goods, \$1080                               |
|     | 21 | Invoice | Purchase invoice received from Disley for   |
|     |    | 3418    | goods, \$1250                               |
|     | 27 | Invoice | Purchase invoice received from P Harlew for |
|     |    | 5053    | goods, \$1640                               |

Prepare the accounting records necessary to record these transactions as follows:

- Purchases journal
- Trade payable accounts in the purchases ledger
- Purchases account in the nominal ledger

**3 Recording credit sales in a sales journal and posting to ledger accounts**

Amy owns a shop selling the latest music technology. During August 2018 she issued the following sales invoices to customers:

|     |    |         |   |
|-----|----|---------|---|
| Aug | 5  | Invoice | Sales invoice sent to Dartford for goods,   |
|     |    | T339    | \$1480                                      |
|     | 10 | Invoice | Sales invoice sent to J Williams for goods, |
|     |    | T340    | \$920                                       |
|     | 23 | Invoice | Sales invoice sent to Dartford for goods,   |
|     |    | T341    | \$2840                                      |
|     | 28 | Invoice | Sales invoice sent to J Williams for goods, |
|     |    | T342    | \$1550                                      |

Prepare the accounting records necessary to record these transactions as follows:

- Sales journal
- Trade receivable accounts in the sales ledger
- Sales account in the nominal ledger

**4 Recording credit sales in a sales journal and posting to ledger accounts**

Salim owns a retail unit selling kitchen equipment. During June 2018 he issued the following sales invoices to customers:

|      |    |         |  |
|------|----|---------|--|
| June | 2  | Invoice | Sales invoice sent to Hopford Kitchens for |
|      |    | W1131   | goods, \$3740                              |
|      | 12 | Invoice | Sales invoice sent to A Bandle for goods,  |
|      |    | W1132   | \$2670                                     |
|      | 15 | Invoice | Sales invoice sent to Hopford Kitchens for |
|      |    | W1133   | goods, \$5090                              |
|      | 29 | Invoice | Sales invoice sent to A Bandle for goods,  |
|      |    | W1134   | \$1480                                     |

Prepare the accounting records necessary to record these transactions as follows:

- Sales journal
- Trade receivable accounts in the sales ledger
- Sales account in the nominal ledger

**5 Calculating trade discounts**

Orto is a wholesaler of kitchen equipment.

During January 2018 the company received the following invoices from credit suppliers:

|     |    |   |
|-----|----|---|
| Jan | 12 | Purchase invoice received from Polonix: 24 electric       |
|     |    | kettles at \$25 each, less a trade discount of 10%        |
|     | 19 | Purchase invoice received from Quelta: 18 dishwashers     |
|     |    | at \$267 each, less a trade discount of $33\frac{1}{3}\%$ |

During January 2018 the company sent sales invoices to the following credit customers:

|     |    |  |
|-----|----|--|
| Jan | 9  | Sales invoice sent to Alto Cuisines: 16 food mixers at   |
|     |    | \$140 each, less a trade discount of 15%                 |
|     | 18 | Sales invoice sent to Prozel Restaurants: 8 ice-cream    |
|     |    | makers at \$295 each, less a trade discount of 20%       |
|     | 27 | Sales invoice sent to Alto Cuisines: 24 coffee makers at |
|     |    | \$115 each, less a trade discount of 12.5%               |

Calculate the actual amount charged for each purchase and sale.



## 6 Calculating trade discounts

Stravage is a wholesaler of computer equipment. During October 2018 the following invoices were received from credit suppliers:

- Oct 13 Purchase invoice received from Inbell for 25 laptop computers model T529 at \$750 each, less a trade discount of 20%
- 19 Purchase invoice received from Albi Supplies for 30 printers model X400 at \$120 each, less a trade discount of  $33\frac{1}{3}\%$
- 29 Purchase invoice received from Albi Supplies for 22 computer workstations at \$90 each, less a 12.5% trade discount

During October 2018 the company sent the following sales invoices to credit customers:

- Oct 4 Sales invoice sent to Arbri for 18 external hard drives at \$54 each, less a trade discount of 25%
- 19 Sales invoice sent to Telcaz Stores for 24 computer monitors at \$105 each, less a trade discount of 10%

Calculate the actual amount charged for each purchase and sale.

## 7 Preparing books of prime entry

Referring to the information in question 5, prepare the following books of prime entry in the books of Orto:

- a Purchases journal
- b Sales journal

**Note:** It is not necessary to post the information to ledger accounts.

## 8 Preparing books of prime entry

Referring to the information in question 6, prepare the following books of prime entry in the books of Stravage:

- a Purchases journal
- b Sales journal

**Note:** It is not necessary to post the information to ledger accounts.

## 9 Calculating trade discounts and recording invoices in books of prime entry and ledger accounts

Alvo is a bicycle wholesaler.

The company buys goods from a number of bicycle manufacturers. Manufacturers offer trade discounts for large orders.

During October 2018 the following invoices were received:

- Oct 12 Purchase invoice received from Melfin for 20 bicycles with a price of \$160 each. The invoice showed the deduction of a trade discount of 25%
- 28 Purchase invoice received from Harvey Bikes for 15 bicycles with a price of \$430 each. The invoice showed the deduction of a trade discount of  $33\frac{1}{3}\%$

Alvo sells bicycles to many retailers.

During October 2018 the following invoices were issued:

- Oct 7 Sales invoice sent to W Gifford for 6 cycles with a price of \$400 each. The invoice showed the deduction of a trade discount of 20%
- 26 Sales invoice sent to T Perry for 8 cycles with a price of \$330 each. The invoice showed the deduction of a trade discount of 15%

- a Calculate the actual amount charged for each purchase and sale.
- b Prepare the following accounting records in the books of Alvo:
  - i Purchases journal
  - ii Sales journal
  - iii Purchases ledger accounts
  - iv Sales ledger accounts
  - v Appropriate nominal ledger accounts

## 10 Calculating trade discounts

Belvo Wholesale sells fishing equipment.

The company buys goods from a number of manufacturers of fishing equipment. Manufacturers offer trade discounts for large orders.

During June 2018 the following invoices were received:

- June 5 Purchase invoice received from Seaspray & Co. for fishing equipment with a price of \$8 400. The invoice showed the deduction of a trade discount of 25%
- 19 Purchase invoice received from Angling Supplies for fishing equipment with a selling price of \$5 800 each. The invoice showed the deduction of a trade discount of 20%

Bevo Wholesale sells fishing equipment to many retailers.

During June 2018 the following invoices were issued:

- June 8 Sales invoice sent to McEwan & Sons for fishing equipment with a price of \$1200. The invoice showed the deduction of a trade discount of 15%
- 23 Sales invoice sent to Jarel Fishing Supplies for equipment with a price of \$1830. The invoice showed the deduction of a trade discount of  $33\frac{1}{3}\%$

- a Calculate the actual amount charged for each purchase and sale.
- b Prepare the following accounting records in the books of Belvo Wholesale:
  - i Purchases journal
  - ii Sales journal
  - iii Purchases ledger accounts
  - iv Sales ledger accounts
  - v Appropriate nominal ledger accounts

**11 Prepare a full accounting system including purchases and sales journals up to the trial balance**

Yi Ting owns a wholesale business. Her business's trial balance on 30 April 2018 was as follows:

| Trial balance at 30 April 2018 |         |         |
|--------------------------------|---------|---------|
|                                | Dr      | Cr      |
|                                | \$      | \$      |
| Bank                           | 12 580  |         |
| Capital                        |         | 166 000 |
| Cash                           | 2 180   |         |
| Drawings                       | 38 600  |         |
| Furniture and fittings         | 37 300  |         |
| General expenses               | 28 900  |         |
| Purchases                      | 147 200 |         |
| Sales (i.e., Revenue)          |         | 232 440 |
| Trade payables                 |         |         |
| TBX Manufacturing              |         | 8 300   |
| Universal Supplies             |         | 10 100  |
| Trade receivables              |         |         |
| Shivan Retail Unit             | 11 300  |         |
| Williams Retail Chain          | 5 780   |         |
| Vehicles                       | 44 800  |         |
| Wages                          | 88 200  |         |
|                                | 416 840 | 416 840 |

During May 2018 the following transactions occurred.

Invoices were received from suppliers as follows:

- May 14 TBX Manufacturing (invoice 3251): for goods worth \$6200, less a trade discount of 25%
- 26 Universal Supplies (invoice 4481): for goods worth \$9600, less a trade discount of  $33\frac{1}{3}\%$

Invoices were sent to customers as follows:

- May 7 Shivan Retail Unit (invoice 1082): for goods worth \$3600, less a trade discount of 15%
- 17 Williams Retail Chain (invoice 1083): for goods worth \$5500, less a trade discount of 20%

Other transactions:

- May 4 Cash sales totalled \$2800
- 9 Paid general expenses by cheque, \$1700
- 13 Received a cheque from Shivan Retail Unit for \$8400
- 16 Paid Universal Supplies by cheque in full settlement of the amount due at this date
- 20 Purchased goods for resale and paid by cheque, \$4900
- 25 Paid wages in cash, \$3900
- 28 Yi Ting withdrew a cheque for \$800 for private use

Prepare the following:

- Purchases journal
- Sales journal
- Purchases ledger accounts
- Sales ledger accounts
- Nominal ledger accounts
- Trial balance at 31 May 2018

Note: It is not necessary to balance accounts.

End-of-year financial statements are not required.

**12 Prepare a full accounting system including purchases and sales journals up to the trial balance**

Rakesh owns a wholesale business providing office supplies. His business's trial balance on 31 July 2018 was follows:

| Trial balance at 30 July 2018 |           |           |
|-------------------------------|-----------|-----------|
|                               | Dr        | Cr        |
|                               | \$        | \$        |
| Bank                          | 14 850    |           |
| Bank loan                     |           | 50 000    |
| Bank loan interest            | 3 360     |           |
| Capital                       |           | 426 000   |
| Cash                          | 4 970     |           |
| Drawings                      | 38 450    |           |
| General expenses              | 31 375    |           |
| Premises                      | 600 000   |           |
| Purchases                     | 535 280   |           |
| Sales (i.e., Revenue)         |           | 847 685   |
| Trade payables                |           |           |
| Kingbridge Manufacturing Co.  |           | 36 380    |
| Leon Products                 |           | 22 410    |
| Trade receivables             |           |           |
| Latoya Retail Unit            | 12 320    |           |
| Murray Stationery             | 5 440     |           |
| Vehicles                      | 68 000    |           |
| Wages                         | 68 430    |           |
|                               | 1 382 475 | 1 382 475 |

During August 2018 the following transactions

occurred (see overleaf).

Invoices were received from suppliers as follows:

- Aug 5 Kingbridge Manufacturing Co. (invoice 384): for goods worth \$26 700, less a trade discount of  $33\frac{1}{3}\%$   
21 Leon Products (invoice 8630): for goods worth \$15 600, less a trade discount of 25%

Invoices were sent to customers as follows:

- Aug 9 Latoya Retail Unit (invoice 2293): for goods worth \$8300, less a trade discount of 20%  
23 Murray Stationery (invoice 2294): for goods worth \$4400, less a trade discount of 15%

Other transactions:

- Aug 6 Rakesh withdrew cash for private use, \$700  
8 Purchased goods for resale and paid by cheque, \$5400  
11 Paid loan interest, \$380. Funds were transferred from the business bank account  
17 Paid Leon Products by cheque in full settlement of the amount due at this date  
22 Cash sales totalled \$6860  
24 Paid wages in cash, \$5580  
27 Received a cheque from Latoya Retail Unit for the amount due on this date  
29 Paid general expenses by cheque, \$2150

Prepare the following:

- Purchases journal
- Sales journal
- Purchases ledger accounts
- Sales ledger accounts
- Nominal ledger accounts
- Trial balance at 31 August 2018

**Note:** It is not necessary to balance accounts.

End-of-year financial statements are not required.

### 13\* Completing a purchases invoice

Kai Li owns a general store. On 1 December 2018 he purchased goods on credit from a supplier, Helix Supplies:

- 60 cartons of detergent at \$8.20 per carton
- 20 containers of breakfast cereals at \$11.40 per container
- 30 boxes of tinned fruit at \$12.50 per box

It was agreed that Kai should be given a 20% trade discount on this order.

Prepare a purchases invoice recording these details, showing clearly the final amount due.

### 14\* Completing a sales invoice

Huan owns a wholesale business selling kitchen appliances. On 23 September 2018 she received the following order from Tao's Kitchen Stores:

- 30 microwave ovens model T72 at \$95 each
- 10 dishwashers model LS726 at \$420 each
- 25 food mixers model SP31 at \$213 each

Huan agreed to give this customer a trade discount of  $33\frac{1}{3}\%$  on this order.

Prepare a sales invoice dated 10 October 2018 recording these details.



# Recording purchases returns

## KEY TERMS

**Credit note:** the source document that records the amount to be deducted from (or allowed against) a previous invoice to avoid a business being overcharged. Usually the business has returned goods to the supplier.

**Purchase returns:** goods sent back by a business to the supplier.

## LEARNING OBJECTIVE

When you have reached the end of this chapter you will be able to:

- prepare a purchases returns journal
- post details from a purchases returns journal to the purchases and nominal ledgers.

## Source document for purchases returns

The usual source document for purchases returns is a **credit note**, which is sent by the supplier to the business that has received damaged or unwanted goods to notify them of the amount that can be deducted from the amount owed on the invoice.

## Notes:

- 1 The customer – Highbury Retail Stores – has returned some damaged goods to the supplier, McKoy Wholesale Ltd.
- 2 This credit note has been prepared by the supplier and sent to the customer to confirm the amount that can be deducted (\$146.88).
- 3 The owner of Highbury Retail Stores will use this credit note as the source document for preparing the double-entry records.

## Illustration 1

## Credit note

| CREDIT NOTE                              |                         | No. 623          |             |
|--|-------------------------|------------------|-------------|
| McKoy Wholesale Ltd                      |                         |                  |             |
| To:                                      | Highbury Retail Stores  |                  |             |
| Date:                                    | 18 Aug 18               |                  |             |
| Quantity                                 | Description             | Unit price<br>\$ | Total<br>\$ |
| 12 boxes                                 | Detergent               | 15.30            | 183.60      |
|  | Less 20% trade discount |                  | 36.72       |
| NET                                      |                         |                  | 146.88      |
| <i>Goods returned damaged in transit</i> |                         |                  |             |

## Purchases returns journal

The book of prime entry used to list all credit notes received from suppliers before posting information to the ledger is called the **purchases returns journal**.

## KEY TERMS

**Purchases returns journal:** the book of prime entry used to list in date order details shown on credit notes relating to goods returned to suppliers.

## Illustration 2 Preparing and posting a purchases returns journal

Here is an example of a completed purchases returns journal which has been posted to the relevant ledger accounts:

| Purchases returns journal |    |               |                    |     |
|---------------------------|----|---------------|--------------------|-----|
| Date                      |    | Supplier      | Credit note number | \$  |
| Sept                      | 14 | Bennett & Co. | 347                | 112 |
|                           | 27 | Mungroo Ltd   | 1279               | 273 |
| Total purchases returns   |    |               |                    | 385 |

Here are the double-entry records for these purchases returns:

### PURCHASES LEDGER

| Dr      | Bennet & Co. account |     | Cr |
|---------|----------------------|-----|----|
| Sept 14 | Purchases returns    | 112 |    |

| Dr      | Mungroo Ltd account |     | Cr |
|---------|---------------------|-----|----|
| Sept 27 | Purchases returns   | 273 |    |

### NOMINAL LEDGER

| Dr | Purchases returns account |                           | Cr  |
|----|---------------------------|---------------------------|-----|
|    | Sept 30                   | Purchases returns journal | 385 |

### Notes:

- 1 Credit notes received from suppliers are listed in date order in the purchases returns journal. The personal accounts in the purchases ledger are updated immediately.
- 2 At the end of the month (or more frequently if desired) the journal is totalled and the total of purchases returns is posted to the general ledger account.

### DID YOU KNOW?

If a trade discount was shown on a purchase or sales invoice it must also be deducted on returned items.

At the end of a financial period the total of purchases returns is deducted from total purchases to give a net figure for purchases for the period.

Now you can answer questions 1 and 2 on page 78.

### Debit notes

A purchaser could send a debit note to the seller of goods to notify them that some of the goods are not required or are damaged and are being returned. The debit note will state the items being returned by the purchaser and the amount the purchaser expects to be deducted from the amount due. When a debit note is used in this way, it should be regarded as a request for a deduction in an invoice. No entries should be made in the purchaser's books until a credit note is received from the supplier.

### KEY TERMS

**Debit note:** a source document used by a **purchaser** to notify the **seller** that goods are being returned and the amount that should be deducted from the amount due.

**LEARNING OBJECTIVE**

When you have reached the end of this chapter you will be able to:

- prepare a sales returns journal
- post the details in the sales returns journal to the sales and nominal ledgers.

**KEY TERMS**

**Sales returns journal:** the book of prime entry used to list in date order details shown on copies of credit notes relating to goods returned by customers.

Now you can answer questions 3–8 on pages 78–80.

Businesses that receive goods back from credit customers will need to make a record of these sales returns.

The accounting procedures follow a similar sequence to that described for purchases returns.

The basic double entry for sales returns is:

Debit A sales returns account

Credit The account of the trade receivable

At the end of the financial period the total of sales returns will be deducted from the total revenue to give the net sales for the period.

A business receiving back goods from a dissatisfied credit customer will make out a credit note, send the original version to the customer, and keep a copy from which the accounting records can be prepared. Copies of credit notes are used to prepare the **sales returns journal**, which is the book of prime entry used to make the first record of sales returns.

**Illustration 3** Preparing and posting a sales returns journal

Here is an example of a completed sales returns journal which has been posted to the relevant ledger accounts:

| Sales returns journal |    |                     |                    |     |
|-----------------------|----|---------------------|--------------------|-----|
| Date                  |    | Customer            | Credit note number | \$  |
| Jan                   | 9  | Garcia Ltd          | 103                | 23  |
|                       | 23 | Rampersad & Co.     | 104                | 119 |
|                       |    | Total sales returns |                    | 142 |

Here are the double-entry records for these sales returns:

**SALES LEDGER**

| Dr | Garcia Ltd account |   |               | Cr |
|----|--------------------|---|---------------|----|
|    | Jan                | 9 | Sales returns | 23 |

| Dr | Rampersad & Co. account |    |               | Cr  |
|----|-------------------------|----|---------------|-----|
|    | Jan                     | 23 | Sales returns | 119 |

**NOMINAL LEDGER**

| Dr  | Sales returns account |                       |     | Cr |
|-----|-----------------------|-----------------------|-----|----|
| Jan | 31                    | Sales returns journal | 142 |    |

**Notes:**

- 1 Copies of credit notes issued to customers are listed in date order in the sales returns journal. The personal accounts in the sales ledger are updated immediately.
- 2 At regular intervals the journal is totalled and the total of sales returns is posted to the general ledger account.



## Recording returns in the financial statements

At the end of a financial year it is important to remember to transfer the totals of the returns accounts in the general ledger to the income statement.

### Illustration 4 Recording returns in the income statement

On 31 December 2018 the following accounts appeared in the books of Perrier & Sons:

|                   | \$      |
|-------------------|---------|
| Purchases         | 430 000 |
| Purchases returns | 30 000  |
| Sales             | 680 000 |
| Sales returns     | 40 000  |

The ledger accounts should appear as shown opposite. They have been closed on transfer of the balances to the first section of the income statement.

| NOMINAL LEDGER |                  |                           |        |                  |         |
|----------------|------------------|---------------------------|--------|------------------|---------|
| Dr             |                  | Purchases account         |        | Cr               |         |
| Dec 31         | Balance          | 430 000                   | Dec 31 | Income statement | 430 000 |
| Dr             |                  | Purchases returns account |        | Cr               |         |
| Dec 31         | Income statement | 30 000                    | Dec 31 | Balance          | 30 000  |
| Dr             |                  | Sales account             |        | Cr               |         |
| Dec 31         | Income statement | 680 000                   | Dec 31 | Balance          | 680 000 |
| Dr             |                  | Sales returns account     |        | Cr               |         |
| Dec 31         | Balance          | 40 000                    | Dec 31 | Income statement | 40 000  |

And here is the income statement:

#### Income statement for the year ended 31 December 2018

|                        | \$      | \$      |
|------------------------|---------|---------|
| Revenue                | 680 000 |         |
| Less sales returns     | 40 000  | 640 000 |
| Purchases              | 430 000 |         |
| Less purchases returns | 30 000  | 400 000 |
| Gross profit           |         | 240 000 |

**Notes:** You will see that the idea is to show net purchases and net revenue in the income statement.

#### STUDY TIP

A common mistake is to mix up the entries for returns in the income statement.

Remember:

- total purchases returns is deducted from purchases
- total sales returns is deducted from revenue.

Now you can answer questions 9–12 on pages 80–82.

## DEVELOPING YOUR SKILLS

## 1 Recording purchases returns

Ken owns a shop supplying fishing tackle. During March 2018 he returned goods that had previously been purchased on credit to suppliers.

|       |    |                 |   |
|-------|----|-----------------|---|
| March | 11 | Credit note 242 | Goods returned to Scott with a value of \$275   |
|       | 18 | Credit note 375 | Goods returned to Taylor & Sons with a value of \$328   |
|       | 29 | Credit note 247 | Goods returned to Scott. These goods had been invoiced at \$550, less a trade discount of 20% |

Prepare the records required in Ken's books of account to record these transactions as follows:

- Purchases returns journal
- Trade payable accounts in the purchases ledger
- Purchases returns account in the nominal ledger

## 2 Recording purchases returns

Fay owns a shop selling household goods. During July 2018 she returned goods that had previously been purchased on credit to suppliers.

|      |    |                 |   |
|------|----|-----------------|---|
| July | 4  | Credit note 331 | Goods returned to Segicore with a value of \$297  |
|      | 15 | Credit note 829 | Goods returned to J Howell with a value of \$115  |
|      | 26 | Credit note 337 | Goods returned to Segicore. These goods had been invoiced at \$840 less a trade discount of 25% |

Prepare the records required in Fay's books of account to record these transactions as follows:

- Purchases returns journal
- Trade payable accounts in the purchases ledger
- Purchases returns account in the nominal ledger

## 3 Recording sales returns

Mike is the owner of a business supplying car accessories to local garages and car dealers. During June 2018 credit customers returned goods that had been sold to them on credit.

|      |    |                 |   |
|------|----|-----------------|---|
| June | 11 | Credit note 454 | Goods returned by Parsed Garages with a value of \$220  |
|      | 13 | Credit note 455 | Goods returned by Beretta Car Dealers with a value of \$507   |
|      | 24 | Credit note 456 | Goods returned by Parsed Garages. These goods had been invoiced at \$1500, less a trade discount of $33\frac{1}{3}\%$ |

Prepare the records required in Mike's books of account to record these transactions as follows:

- Sales returns journal
- Trade receivable accounts in the sales ledger
- Sales returns account in the nominal ledger

## 4 Recording sales returns

Mona is the owner of a business supplying designer clothes to retailers in the region. During October 2018 credit customers returned goods that had been sold to them on credit.

|     |    |                 |   |
|-----|----|-----------------|---|
| Oct | 9  | Credit note 756 | Goods returned by Castries Designwear with a value of \$474                                     |
|     | 20 | Credit note 757 | Goods returned by Garcia with a value of \$232  |
|     | 23 | Credit note 758 | Goods returned by Garcia. These goods had been invoiced at \$1640, less a trade discount of 15% |

Prepare the records required in Mona's books of account to record these transactions as follows:

- Sales returns journal
- Trade receivable accounts in the sales ledger
- Sales returns account in the nominal ledger

## 5 Preparing the four journals

Simon's Catering Supplies is a wholesale business. The following source documents were received or issued during the week beginning 20 August 2018.

|     |    |                           |   |
|-----|----|---------------------------|---|
| Aug | 20 | Purchase invoice 8806     | From TDH for goods, \$960                                       |
|     | 21 | Sales invoice T449        | To Seaview Café for goods, \$480                                |
|     | 22 | Credit note received 2721 | From TDH for goods, \$32  |
|     | 23 | Purchase invoice 33902    | From Datrix Supplies for goods, \$2400, less 20% trade discount |
|     | 24 | Credit note issued 74     | To Seaview Café for goods, \$39                                 |
|     | 24 | Credit note received 884  | From Datrix Supplies for goods, \$420, less 20% trade discount  |

Prepare the following books of prime entry for the week ending 24 August 2018:

- Purchases journal
- Sales journal
- Purchases returns journal
- Sales returns journal

**Note:** The journals should be totalled at the end of the week. Ledger accounts are not required.



## 6 Preparing the four journals

Wilma owns Altitude, a wholesale business supplying equipment for mountain climbers. The following source documents were received or issued during the week beginning 16 January 2018.

|        |                           |   |
|--------|---------------------------|---|
| Jan 16 | Sales invoice 44932       | Sent to Trentview Sports for goods, \$1832                          |
| 17     | Purchase invoice X8832    | Received from Supahike & Co. for goods, \$2775                      |
| 17     | Credit note received 113  | From Bergpeak for goods, \$384                                      |
| 18     | Credit note issued 484    | To Trentview Sports for goods, \$331                                |
| 18     | Sales invoice 44933       | Sent to Torpoint & Sons for goods, \$861, less 33½ % trade discount |
| 19     | Credit note received T902 | From Supahike for goods, \$183                                      |
| 20     | Credit note issued 485    | To Torpoint & Sons for goods, \$72, less 33½ % trade discount       |

Prepare the following books of prime entry for the week ending 20 January 2018:

- Purchases journal
- Sales journal
- Purchases returns journal
- Sales returns journal

**Note:** The journals should be totalled at the end of the week. Ledger accounts are not required.

## 7 Preparing a full accounting system including all journals up to the trial balance

Raju owns a wholesale business supplying music technology to retailers in the region. His business's trial balance on 31 January 2018 was as follows.

| Trial balance at 31 January 2018 |         |         |
|----------------------------------|---------|---------|
|                                  | Dr      | Cr      |
|                                  | \$      | \$      |
| Administration expenses          | 36 480  |         |
| Bank                             | 3 620   |         |
| Capital                          |         | 381 400 |
| Cash                             | 1 850   |         |
| Drawings                         | 27 280  |         |
| Non-current assets               | 440 000 |         |
| Purchases                        | 348 200 |         |
| Purchases returns                |         | 6 490   |
| Sales (i.e., Revenue)            |         | 585 000 |
| Sales returns                    | 5 860   |         |
| Selling expenses                 | 11 200  |         |
| Trade payables                   |         |         |
| HTL Manufacturing                |         | 11 450  |
| Khan's Supplies                  |         | 6 380   |
| Trade receivables                |         |         |
| Hunter & Sons                    | 2 690   |         |
| Quinlan Music Shop               | 3 200   |         |
| Wages and salaries               | 110 340 |         |
|                                  | 990 720 | 990 720 |

During February 2018 the following transactions occurred.

Invoices were received from suppliers as follows.

- Feb 6 HTL Manufacturing (invoice 559): for goods, \$7500, less a trade discount of 33½ %  
 19 Khan's Supplies (invoice T307): for goods, \$6200, less a trade discount of 25%

Invoices were sent to customers as follows.

- Feb 5 Hunter & Sons (invoice 4561): for goods \$1550 less a trade discount of 20%  
 20 Quinlan Music Shop (invoice 4562): for goods \$3300 less a trade discount of 25%

Credit notes were received from suppliers as follows.

- Feb 12 HTL Manufacturing (credit note 308): for goods supplied on 6 February, \$420, less a trade discount of 33½ % – not as ordered  
 28 Khan's Supplies (credit note R119): for goods supplied on 19 February, \$880, less a trade discount of 25% – damaged in transit

Credit notes were issued to customers as follows.

- Feb 8 Hunter & Sons (credit note 181): for goods supplied on 5 February, \$250, less a trade discount of 20% – received in a damaged condition  
 27 Quinlan Music Shop (credit note 182): for goods supplied on 20 February, \$260, less a trade discount of 25% – not as ordered

Other transactions:

- Feb 5 Paid administration expenses in cash, \$380  
 9 Received a cheque from Hunter & Sons for the amount due on 1 February  
 11 Cash sales totalled \$15 450  
 12 Cash, \$15 200, was paid into the business bank account  
 15 Paid HTL Manufacturing by cheque in full settlement of the amount due at 1 February  
 18 Purchased goods for resale and paid by cheque, \$3 200  
 25 Paid wages and salaries by cheque, \$6120  
 28 Raju withdrew cash for private use, \$740

Prepare the following:

- Purchases journal
- Sales journal
- Purchases returns journal
- Sales returns journal
- Purchases ledger accounts
- Sales ledger accounts
- Nominal ledger accounts
- Trial balance dated 28 February 2018

**Note:** It is not necessary to balance accounts.

End-of-year financial statements are not required.



## 8 Preparing a full accounting system including all four journals up to the trial balance

Sally is the owner of a business that supplies local retailers with kitchen equipment. Her business's trial balance on 30 September 2018 was as follows:

| Trial balance at 30 September 2018 |         |         |
|------------------------------------|---------|---------|
|                                    | Dr      | Cr      |
|                                    | \$      | \$      |
| Bank                               | 7 310   |         |
| Capital                            |         | 224 900 |
| Cash                               | 940     |         |
| Drawings                           | 35 480  |         |
| General expenses                   | 4 600   |         |
| Non-current assets                 | 212 000 |         |
| Purchases                          | 264 270 |         |
| Rent                               | 36 350  |         |
| Sales returns                      | 4 490   |         |
| Purchases returns                  |         | 7 060   |
| Sales (i.e., Revenue)              |         | 409 510 |
| Trade payables                     |         |         |
| LPC Kitchen Supplies               |         | 4 480   |
| Nana's Kitchens                    |         | 8 460   |
| Trade receivables                  |         |         |
| Johnson Kitchen Shop               | 1 070   |         |
| TK Watson                          | 4 320   |         |
| Wages                              | 83 580  |         |
|                                    | 654 410 | 654 410 |

During October 2018 the following transactions occurred.

Invoices were received from suppliers as follows.

- Oct 3 LPC Kitchens (invoice 617): for goods, \$5120, less a trade discount of 25%
- 11 Nana's Kitchens (invoice W311): for goods, \$4800, less a trade discount of 20%

Invoices were sent to customers as follows.

- Oct 14 Johnson Kitchen Shop (invoice 2121): for goods, \$6240, less a trade discount of  $33\frac{1}{3}\%$
- 23 TK Watson (invoice 2122): for goods, \$1600, less a trade discount of 15%

Credit notes were received from suppliers as follows.

- Oct 7 LPC Kitchens (credit note 113): for goods supplied on 3 October, \$320, less a trade discount of 25% – some goods received in a damaged condition
- 18 Nana's Kitchens (credit note D008): for goods supplied on 11 October, \$680, less a trade discount of 25% – not as ordered

Credit notes were issued to customers as follows.

- Oct 22 Johnson Kitchen Shop (credit note 226): for goods supplied on 14 October, \$420, less a trade discount of  $33\frac{1}{3}\%$  – not as ordered
- 30 TK Watson (credit note 227): for goods supplied on 23 October, \$200, less a trade discount of 15% – damaged items

Other transactions:

- Oct 4 Paid rent \$3100 by cheque
- 8 Paid Nana's Kitchens the amount due on 1 October
- 11 Purchased goods for resale by cheque, \$2700
- 16 Sally withdrew \$400 cash for her private use
- 21 Paid general expenses by cheque, \$680
- 25 Cash sales totalled \$3660
- 28 Received a cheque from Johnson Kitchen Shop in full settlement of the amount due on this date
- 29 Paid cash into bank so as to leave a cash balance of \$750

Prepare the following:

- Purchases journal
- Sales journal
- Purchases returns journal
- Sales returns journal
- Purchases ledger accounts
- Sales ledger accounts
- Nominal ledger accounts
- Trial balance dated 31 October 2018

**Note:** It is not necessary to balance accounts. End-of-year financial statements are not required.

## 9 Preparing income statements including returns

Raslinda owns a retail outlet. The following balances remained in her business's nominal ledger at the end of the financial year, 31 August 2018.

|                         | \$      |
|-------------------------|---------|
| Administration expenses | 5 360   |
| Bank loan               | 6 800   |
| Bank loan interest      | 720     |
| Cash at bank            | 390     |
| Capital                 | 30 000  |
| Delivery vehicles       | 31 500  |
| Drawings                | 25 200  |
| Furniture and equipment | 20 450  |
| Purchases               | 82 370  |
| Purchases returns       | 1 140   |
| Rent of shop premises   | 8 280   |
| Sales (i.e., Revenue)   | 161 380 |
| Sales returns           | 460     |
| Wages                   | 24 990  |

Prepare the business's income statement for the year ended 31 August 2018, selecting the information required from the details provided.

## 10 Preparing income statements including returns

From the following information prepare an income statement for the year ended 31 December 2018 for the business called Bolero's Shoes owned by Miranda Blake.

|                        | \$      |
|------------------------|---------|
| Bank overdraft         | 4 980   |
| Capital                | 262 712 |
| Cash in hand           | 392     |
| Drawings               | 17 078  |
| Electricity charges    | 993     |
| Furniture and fittings | 22 400  |
| General expenses       | 647     |
| Office expenses        | 1 182   |
| Purchases              | 111 372 |
| Purchases returns      | 849     |
| Sales (i.e., Revenue)  | 204 711 |
| Sales returns          | 683     |
| Shop premises          | 249 000 |
| Trade payables         | 840     |
| Trade receivables      | 3 812   |
| Wages                  | 65 338  |
| Water charges          | 1 195   |

Select the information required from the details provided.

## 11 Preparing financial statements

The following trial balance was extracted from the books of P Hosein at the end of the business's financial year.

| Trial balance at 31 December 2018 |         |         |
|-----------------------------------|---------|---------|
|                                   | Dr      | Cr      |
|                                   | \$      | \$      |
| Bank                              | 5 950   |         |
| Bank loan                         |         | 20 000  |
| Bank loan interest                | 1 540   |         |
| Capital                           |         | 115 000 |
| Cash                              | 2 020   |         |
| Drawings                          | 32 600  |         |
| Furniture and fittings            | 48 400  |         |
| General expenses                  | 17 590  |         |
| Purchases                         | 288 470 |         |
| Purchases returns                 |         | 5 440   |
| Rent                              | 33 800  |         |
| Sales (i.e., Revenue)             |         | 403 810 |
| Sales returns                     | 7 130   |         |
| Trade payables                    |         | 22 420  |
| Trade receivables                 | 16 380  |         |
| Vehicle                           | 38 500  |         |
| Wages                             | 74 290  |         |
|                                   | 566 670 | 566 670 |

Prepare the following:

- Income statement for the year ended 31 December 2018
- Statement of financial position at 31 December 2018 (classified)

## 12 Preparing financial statements

Tina owns a retail business. Her business's financial year ended on 31 August 2018 when the following trial balance was extracted from the books of account.

| Trial balance at 31 August 2018 |           |           |
|---------------------------------|-----------|-----------|
|                                 | Dr        | Cr        |
|                                 | \$        | \$        |
| Administration expenses         | 3 580     |           |
| Bank                            | 8 410     |           |
| Capital                         |           | 421 400   |
| Cash                            | 720       |           |
| Drawings                        | 28 400    |           |
| Equipment                       | 33 600    |           |
| Insurance                       | 7 150     |           |
| Premises                        | 520 000   |           |
| Purchases                       | 407 380   |           |
| Purchases returns               |           | 9 360     |
| Salaries                        | 105 400   |           |
| Sales (i.e., Revenue)           |           | 737 770   |
| Sales returns                   | 11 210    |           |
| Selling expenses                | 5 030     |           |
| Trade payables                  |           | 22 480    |
| Trade receivables               | 24 730    |           |
| Vehicle                         | 35 400    |           |
|                                 | 1 191 010 | 1 191 010 |

Prepare the following:

- Income statement for the year ended 31 August 2018
- Statement of financial position at 31 August 2018 (classified)

### 13 Preparing financial statements

Alex owns a furniture store. The following trial balance was extracted from the business's books at the end of a recent financial year.

**Trial Balance at 31 October 2018**

|                              | Dr             | Cr             |
|------------------------------|----------------|----------------|
|                              | \$             | \$             |
| Bank overdraft               |                | 3 670          |
| Cash                         | 140            |                |
| Capital                      |                | 50 900         |
| Delivery van                 | 23 800         |                |
| Drawings                     | 25 250         |                |
| General expenses             | 3 090          |                |
| Insurance                    | 2 420          |                |
| Purchases                    | 168 930        |                |
| Rent                         | 14 400         |                |
| Returns                      | 2 050          | 1 490          |
| Sales (i.e., Revenue)        |                | 246 300        |
| Shop furniture and equipment | 31 300         |                |
| Trade payables               |                | 17 200         |
| Trade receivables            | 14 980         |                |
| Wages                        | 33 200         |                |
|                              | <u>319 560</u> | <u>319 560</u> |

Prepare the following:

- Income statement for the year ended 31 October 2018
- Statement of financial position at 31 December 2018 (classified)

### 14 Preparing financial statements

Sophia owns a health food store. She extracted the following trial balance from her business's books at the end of the business's most recent financial year.

**Trial Balance at 30 June 2018**

|                            | Dr             | Cr             |
|----------------------------|----------------|----------------|
|                            | \$             | \$             |
| Bank loan (repayable 2019) |                | 12 000         |
| Bank loan interest         | 940            |                |
| Cash at bank               | 4 890          |                |
| Capital                    |                | 95 600         |
| Drawings                   | 19 420         |                |
| Electricity                | 880            |                |
| Furniture and fittings     | 11 400         |                |
| Insurance                  | 630            |                |
| Property taxes             | 4 420          |                |
| Purchases                  | 103 700        |                |
| Returns                    | 750            | 420            |
| Sales (i.e., Revenue)      |                | 185 300        |
| Staff wages and salaries   | 32 400         |                |
| Shop premises              | 120 000        |                |
| Trade payables             |                | 6 110          |
|                            | <u>299 430</u> | <u>299 430</u> |

Prepare the following:

- Income statement for the year ended 30 June 2018
- Statement of financial position at 30 June 2018 (classified)



# Books of prime entry: the cash book

## Introduction

You will now be used to the idea that a fully developed accounting system requires:

- the use of source documents
- the recording of transactions in books of prime entry
- the posting of information from the books of original entry to complete the double entry in the ledgers.

This process will now be applied to the recording of money transactions.

The book of prime entry used to record all money transactions is called a cash book. Like all of the books of prime entry, the cash book is a listing in date order of relevant transactions with information taken from source documents.

## Source documents for money transactions

The following tables summarise some of the main ways of receiving and paying money.

### LEARNING OBJECTIVES

When you have reached the end of this chapter you will be able to:

- identify the source documents used when recording cash and bank transactions
- prepare a two-column cash book and post details to ledger accounts
- explain why cash discounts may be offered
- prepare a three-column cash book and post details to ledger accounts.

| Cash transactions |  |  |                    |
|-------------------|--|--|--------------------|
|                   | Source document                          | Explanation  | Entry required     |
| Receipts          | <b>Cash register tapes or till rolls</b> | Used as evidence of cash sales: cash registers retain a record of every individual 'cash' transaction. Cash sales would include the receipt from the customer of notes and coins, cheques, debit card payments, credit card payments     | <b>Debit cash</b>  |
|                   | <b>Copy of cash receipt</b>              | Occasionally a handwritten cash receipt could be issued to those giving the business cash (notes, coins, cheques, etc.) – for example for cash sales   |                    |
| Payments          | <b>Cash receipt</b>                      | Used as evidence of payment of cash (notes, coins). The receipt could be in printed form as dispensed by a cash register, or occasionally it might be a handwritten document – for example for the purchase of stationery for office use | <b>Credit cash</b> |

| Bank transactions |                                    |  |                    |
|-------------------|------------------------------------|--|--------------------|
|                   | Source document                    | Explanation  | Entry required     |
| Receipts          | <b>Paying-in slip counterfoils</b> | Used as evidence that money (notes, coins, cheques) has been paid into the business's bank account   | <b>Debit bank</b>  |
|                   | <b>Bank statement</b>              | Funds can be transferred directly from a customer's account to the business's bank account by using electronic facilities provided by banks  |                    |
| Payments          | <b>Cheque counterfoils</b>         | The cheque itself will not be available as a source document, because it will have been handed over in the process of payment. The cheque stub or counterfoil should be used to record the main details about the payment  | <b>Credit bank</b> |
|                   | <b>Bank statement</b>              | The bank statement will provide evidence of charges made by the bank for providing current account facilities and for interest on any overdraft. It can also be useful as evidence (and a reminder) of payments the business has authorised using standing orders and direct debits (see Chapter 23) |                    |

# The two-column cash book

## The cash book



### KEY TERMS

**Cash book:** a book of prime entry in which all cash and bank transactions are recorded.

The **cash book** is the book of prime entry used to record all money transactions. There are several different forms of the cash book. The simplest version takes the cash and bank accounts out of the general ledger and puts them side by side to form a two-column cash book.

### Illustration 1 Two-column cash book

On 1 September 2018 a business had \$740 cash in hand and cash at bank of \$7280.

The following source documents are available:

| Date   | Source document            | Transaction   |
|--------|----------------------------|---|
| Sept 5 | Cheque counterfoil         | Payment of a credit supplier, G Lee, \$1420             |
| 8      | Till roll                  | Cash sales totalling \$1580                             |
| 11     | Cash receipt               | Payment of general expenses in cash, \$110              |
| 14     | Paying-in slip counterfoil | Transfer of cash to the bank account, \$1400            |
| 21     | Bank statement             | Bank charges for the month totalled \$180               |
| 28     | Paying-in slip counterfoil | Cheque received from a credit customer, T Evans, \$3170 |

Below is the two-column cash book for September. The cash book has been balanced at the end of the month.

| Dr   |                | Cash book |        |      |                     | Cr    |        |
|------|----------------|-----------|--------|------|---------------------|-------|--------|
|      |                | Cash      | Bank   |      |                     | Cash  | Bank   |
|      |                | \$        | \$     |      |                     | \$    | \$     |
| Sept | 1 Balances b/d | 740       | 7 280  | Sept | 5 G Lee             |       | 1 420  |
|      | 8 Sales        | 1 580     |        |      | 11 General expenses | 110   |        |
|      | 14 Cash        |           | 1 400  |      | 14 Bank             | 1 400 |        |
|      | 28 T Evans     |           | 3 170  |      | 21 Bank charges     |       | 180    |
|      |                | 2 320     | 11 850 |      | 30 Balances c/d     | 810   | 10 250 |
| Oct  | 1 Balances b/d | 810       | 10 250 |      |                     |       |        |
|      |                |           |        |      |                     | 2 320 | 11 850 |

#### Notes:

- 1 The format used always has the cash column before the bank column.
- 2 The cash book has a double role: it is a book of prime entry (the first record of money transactions), but it is also part of the double-entry system because it replaces the cash and bank accounts that would otherwise have been found in the nominal ledger.
- 3 When cash is transferred to the bank, or cash is withdrawn from the bank, both aspects of the double entry appear within the cash book. This transfer is referred to as a **contra entry**.
- 4 The usual rules for balancing accounts can be applied to the cash book.

#### KEY TERMS

**Contra entry (cash book):** the transfer of cash to the bank, or the withdrawal of cash from the bank. These transactions result in both the debit entry and credit entry for the transaction being recorded in the cash book columns.

You can now answer questions 1 and 2 on page 90.



## KEY TERMS

**Cash discount:** a reduction in the amount paid by credit customers, or to credit suppliers, when accounts are settled within an agreed time limit.

## Cash discounts

Businesses depend on their cash resources to run the business effectively and so it is important that amounts due from trade receivables are received as soon as possible. To encourage trade receivables to pay promptly, some businesses offer their credit customers a **cash discount**.

**Illustration 2** Recording discount allowed

Tricia sells goods on credit to Chadee Brothers. Each invoice sent to this customer has a footnote stating 'Terms: 5%, 30 days'.

On 1 May 2018 Tricia sold goods valued at \$1200 to Chadee Brothers. On 19 May 2018 the amount due was settled, less the cash discount.

**Note:** The invoice footnote 'Terms: 5%, 30 days' means that the customer can reduce the amount paid by 5 per cent if payment is made within 30 days. Cash discounts are usually in the range 2–5 per cent.

Step 1: The sale on credit would be entered in the sales journal in the usual way and then posted to the customer's account in the sales ledger.

## SALES LEDGER

| Dr          | Chadee Brothers Ltd account | Cr |
|-------------|-----------------------------|----|
| May 1 Sales | 1200                        |    |

Step 2: When the customer pays on 19 May, the amount paid will be \$1200 less a 5 per cent cash discount (i.e. \$1140). The receipt of the cheque will

be recorded in the usual way in the cash book with a debit entry in the bank account. The credit entry will be as follows:

| Dr    | Chadee Brothers Ltd account |      |        |      | Cr   |
|-------|-----------------------------|------|--------|------|------|
| May 1 | Sales                       | 1200 | May 19 | Bank | 1140 |

Step 3: It is now necessary to make entries to record the discount that this customer deducted from the amount due. Discounts given to credit customers are called discounts allowed.

The double entry for discounts allowed is:

| Dr  |   |       |      | Chadee Brothers Ltd account |    |                      |  | Cr   |  |
|-----|---|-------|------|-----------------------------|----|----------------------|--|------|--|
| May | 1 | Sales | 1200 | May                         | 19 | Bank                 |  | 1140 |  |
|     |   |       |      |                             | 19 | Discounts<br>allowed |  | 60   |  |

## NOMINAL LEDGER

| Dr                     | Discounts allowed account | Cr |
|------------------------|---------------------------|----|
| May 19 Chadee Brothers | 60                        |    |

## Notes:

- The double entry for discounts allowed is:  
Debit Discounts allowed  
Credit Trade receivable
- The credit entry in the customer's account cancels the remaining debt.
- The debit entry in the discount allowed account records a loss to the business. The loss is tolerated in order to receive the cash due as soon as possible.
- The discounts allowed account is, therefore, an expense account. At the end of the year the total of discounts allowed will be transferred to the second part of the income statement.

Cash discounts might be offered to a business by a supplier, since suppliers will also be anxious to be paid as soon as possible.

### Illustration 3 Recording discounts received

Tricia's main supplier is BL Trading Ltd. This supplier always offers Tricia a cash discount of 4 per cent if debts are settled within 30 days. On 4 May 2018 Tricia purchased goods worth \$2400 from BL Trading Ltd. On 24 May Tricia settled the amount due, less the 4 per cent cash discount.

The purchase will be recorded in the purchases journal in the usual way, and the payment will be recorded in the cash book.

The entries in the personal account and in the discounts account are shown on the right.

| PURCHASES LEDGER |    |                        |       |     |   |           |       |
|------------------|----|------------------------|-------|-----|---|-----------|-------|
| Dr               |    | BL Trading Ltd account |       |     |   | Cr        |       |
| May              | 24 | Bank                   | 2 304 | May | 4 | Purchases | 2 400 |
|                  | 24 | Discounts received     | 96    |     |   |           |       |

| NOMINAL LEDGER |  |                            |  |     |    |                |    |
|----------------|--|----------------------------|--|-----|----|----------------|----|
| Dr             |  | Discounts received account |  |     |    | Cr             |    |
|                |  |                            |  | May | 24 | BL Trading Ltd | 96 |

#### Notes:

- 1 Cash discounts available from suppliers are called 'discounts received'.
- 2 The double entry for discounts received is:  
Debit Trade payable  
Credit Discounts received
- 3 For Tricia the discount received is a small gain – she has paid her supplier less than expected.
- 4 The total of a discounts received account is transferred to the second part of the income statement at the end of the year, where it will increase the profit made by the business.

## Statements of account

Many businesses send out a document called a **statement of account** to each of their credit customers at monthly intervals. The statement is a summary of the customer's account and is designed to remind the customer of how much is outstanding. The customer may also use the statement to check their own accounting records. Businesses also receive statements of account from their suppliers.

### KEY TERMS

**Statement of account:** a summary of transactions that have taken place between a supplier and a credit customer. The statement provides a means of checking the accuracy of accounts and of reminding customers how much they owe.

### Illustration 4 A statement of account

Here is a typical statement of account. You will see that it is set out to show a running balance.

| STATEMENT OF ACCOUNT                                    |    |                  |   |     |         |
|---|----|------------------|---|-----|---------|
| Dress in Style<br>Cambridge Street<br>Waterbury         |    |                  | Supa Fashion Wholesalers<br>Queens Road, Buryford |     |         |
|   |    |                  | Account number: 373<br>31 May 2018                |     |         |
| Date  |    | Details          | Dr  | Cr  | Balance |
|   |    |                  | \$  | \$  | \$      |
| May   | 1  | Balance          |   |     | 640     |
|   | 6  | Payment received |   | 624 | 16      |
|   | 6  | Cash discount    |   | 16  | 0       |
|   | 21 | Invoice 2729     | 1 320   |     | 1 320   |
|   | 27 | Credit note 481  |   | 230 | 1 090   |
| AMOUNT NOW DUE  |    |                  |   |     | 1 090   |
| Terms: 2.5% cash discount for settlement within 14 days |    |                  |   |     |         |

You can now answer questions 3 and 4 on page 90.



# The three-column cash book

An alternative version of the cash book is often used by businesses; it has a third column to make a note of any cash discounts arising from payments to credit suppliers or receipts from credit customers. The additional column is convenient for noting cash discounts, but it is important to realise that the discount column is **not** part of the double-entry records.

## Illustration 5 The three-column cash book

Robin is the owner of a wholesale business. He offers his credit customers a 2 per cent cash discount for prompt payment of amounts due. Robin's suppliers also offer a cash discount of 5 per cent for prompt payment.

On 1 May 2018 Robin's cash book showed balances as follows: cash \$1350, bank \$7480.

The following money transactions occurred during May 2018:

| Date  | Source document            | Transaction  |
|-------|----------------------------|--|
| May 3 | Cheque counterfoil         | Payment of a trade payable, Campbell Traders. The amount owed was \$2600. This amount was settled, less 5% cash discount |
| 5     | Paying-in slip counterfoil | Receipt of cheque from trade receivable, K Scott, who owed \$1600. This amount was settled, less 2% cash discount        |
| 9     | Till rolls                 | Cash sales totalling \$4540  |
| 16    | Cheque counterfoil         | Payment of a trade payable, LT Wright. The amount owed was \$4480. This amount was settled, less 5% cash discount        |
| 21    | Paying-in slip counterfoil | Paid cash, \$4200, into the bank account   |
| 28    | Paying-in slip counterfoil | Receipt of a cheque from trade receivable, D Pitts, who owed \$900. This amount was settled, less 2% cash discount       |

| Dr   |    |              |    | Cash book         |       |        |     | Cr                 |                  |       |        |
|------|----|--------------|----|-------------------|-------|--------|-----|--------------------|------------------|-------|--------|
|      |    |              |    | Discounts allowed | Cash  | Bank   |     | Discounts received | Cash             | Bank  |        |
|      |    |              |    | \$                | \$    | \$     |     | \$                 | \$               | \$    |        |
| May  | 1  | Balances     |    |                   | 1 350 | 7 480  | May | 3                  | Campbell Traders | 130   | 2 470  |
|      | 5  | K Scott      | 32 |                   |       | 1 568  |     | 16                 | LT Wright        | 224   | 4 256  |
|      | 9  | Sales        |    |                   | 4 540 |        |     | 21                 | Bank             | 4 200 |        |
|      | 21 | Cash         |    |                   |       | 4 200  |     | 31                 | Balances c/d     | 1 690 | 7 404  |
|      | 28 | D Pitts      | 18 |                   |       | 882    |     |                    |                  |       |        |
|      |    |              |    | 50                | 5 890 | 14 130 |     |                    | 354              | 5 890 | 14 130 |
| June | 1  | Balances b/d |    |                   | 1 690 | 7 404  |     |                    |                  |       |        |

The discount columns are totalled and the totals posted to the discount accounts in the general ledger.

### NOMINAL LEDGER

| Dr  |    |           |    | Discounts allowed account  |  |  |  | Cr  |    |           |     |
|-----|----|-----------|----|----------------------------|--|--|--|-----|----|-----------|-----|
| May | 31 | Cash book | 50 |                            |  |  |  |     |    |           |     |
| Dr  |    |           |    | Discounts received account |  |  |  | Cr  |    |           |     |
|     |    |           |    |                            |  |  |  | May | 31 | Cash book | 354 |



### Notes:

- 1 An entry in the discounts allowed column is a note that a discount was given to customer – it is **not** a debit entry for that discount.
- 2 An entry in the discounts received column is a note that a discount was received from a supplier – it is **not** a credit entry for that discount.
- 3 Because the discount columns are just lists of discounts allowed and discounts received, the columns are not balanced at the end of the month. Instead the columns are totalled and the totals are used to make one entry per month in the discounts allowed account and discounts received account in the nominal ledger. These entries for discount totals replace what would otherwise have been individual debit/credit entries every time a discount was allowed or received.

### DID YOU KNOW?

The idea that part of the information shown in the double-entry system is only a note about something important – as with the discount columns in the cash book – is properly described as ‘memorandum’ information. The word ‘memorandum’ means a note of something to be remembered.

You can now answer questions 5 and 6 on page 91.

### STUDY TIP

It is a common mistake to try to balance the two discounts columns in the cash book. This can happen when it is not understood that the discount columns are only notes of discounts rather than debit or credit entries.

## What happens when a bank account becomes overdrawn?

When a business spends more than it has paid into its bank account, then the balance becomes overdrawn. Businesses usually arrange an overdraft facility to cover this eventuality. Banks, of course, charge interest on overdrawn balances, and they set a limit on the amount by which the business can become overdrawn. From the bookkeeping point of view, no special action is required when a payment causes the bank account to be overdrawn. When the bank account is balanced, the balance brought down is shown as a credit balance (indicating that it is a current liability) rather than a debit balance.

### Illustration 6 A bank account that is overdrawn

Here is the bank account of a business that becomes overdrawn during a particular month. For convenience, just the bank columns from the cash book are shown here.

| Dr   |    |          |     | Cash book (bank columns only) |      |    |           | Cr  |        |
|------|----|----------|-----|-------------------------------|------|----|-----------|-----|--------|
|      |    |          |     | Bank                          |      |    |           |     | Bank   |
|      |    |          |     | \$                            |      |    |           |     | \$     |
| June | 1  | Balances |     | 2 400                         | June | 8  | Rent      |     | 1 400  |
|      | 8  | Cash     |     | 3 700                         |      | 15 | Drawings  |     | 1 100  |
|      | 18 | Sales    |     | 3 400                         |      | 18 | Equipment |     | 8 600  |
|      | 30 | Balance  | c/d | 2 090                         |      | 28 | Insurance |     | 490    |
|      |    |          |     |                               |      |    |           |     |        |
|      |    |          |     | 11 590                        |      |    |           |     | 11 590 |
|      |    |          |     |                               |      |    |           |     |        |
|      |    |          |     |                               | July | 1  | Balance   | b/d | 2 090  |

### Notes:

- 1 The bank account actually becomes overdrawn on 18 June when the large payment is made for new equipment.
- 2 However, it is only when the account is balanced at the end of the month that the overdraft balance is formally recorded.

You can now answer questions 7–12 on pages 92–94.

## DEVELOPING YOUR SKILLS

## 1 Preparing a two-column cash book

On 1 March 2018 Faizah's business had cash in hand of \$1340 and a balance at bank of \$6270. The following source documents are available for money transactions during March 2018.

| Date    | Source document            | Transaction  |
|---------|----------------------------|--|
| March 4 | Cash receipt               | Purchase of stationery for office use, \$60          |
| 7       | Cheque counterfoil         | Payment of water rates, \$290                        |
| 11      | Till roll                  | Cash sales totalling \$3180                          |
| 15      | Paying-in slip counterfoil | Transfer of cash, \$3000, to the bank account        |
| 21      | Paying-in slip counterfoil | Cheque received from trade receivable, T Ram, \$2240 |
| 23      | Cheque counterfoil         | Payment of trade payable, D Thomas, \$2350           |
| 27      | Bank statement             | Bank charges for the month totalling \$130           |

Prepare the business's two-column cash book for March 2018. Balance the cash book on 31 March 2018. Ledger accounts are not required.

## 2 Preparing a two-column cash book

On 1 August 2018 Simon's business had cash in hand of \$370 and a balance at bank of \$4120. The following source documents are available for money transactions during August 2018.

| Date  | Source document            | Transaction   |
|-------|----------------------------|---|
| Aug 3 | Till roll                  | Cash sales totalling \$4820                           |
| 7     | Paying-in slip counterfoil | Transfer of cash, \$4600, to the bank account         |
| 11    | Cheque counterfoil         | Payment of general expenses, \$490                    |
| 16    | Bank statement             | Bank charges of \$110                                 |
| 20    | Paying-in slip counterfoil | Cheque received from trade receivable, T Lall, \$1470 |
| 27    | Cheque counterfoil         | Payment of trade payable, TX Supplies, \$880          |
| 30    | Cash receipt               | Payment of vehicle running costs, \$150               |

Prepare the business's two-column cash book for August 2018. Balance the cash book on 31 August 2018. Ledger accounts are not required.

## 3 Preparing a statement of account

Tony owns a wholesale business. At the end of each month he sends statements of account to each of his credit customers. The following information is about a trade receivable, Blackford Retail Stores, for the month of April 2018.

|  | \$   |
|--|------|
| April 1 Amount due                           | 1820 |
| 4 Invoice (number 7781) sent to customer     | 2300 |
| 14 Cheque received from customer             | 1729 |
| 14 Discount allowed                          | 91   |
| 22 Credit note (number 277) sent to customer | 80   |

Prepare a statement of account to remind Blackford Retail Stores of the amount due at 30 April 2018.

## 4 Preparing a statement of account

Carla owns a furniture store and at the end of each month she sends statements of account to each of her credit customers. The following account of a trade receivable for the month of October 2018 appeared in her business's sales ledger.

| Dr  |    |          |      | Marco Lemelin |    |                     |      | Cr |  |  |  |
|-----|----|----------|------|---------------|----|---------------------|------|----|--|--|--|
|     |    |          |      | \$            |    |                     |      | \$ |  |  |  |
| Oct | 1  | Balances | 2400 | Oct           | 6  | Bank                | 2340 |    |  |  |  |
|     | 16 | Sale     | 600  |               | 6  | Discount<br>allowed | 60   |    |  |  |  |
|     | 28 | Sale     | 700  |               | 21 | Sales return        | 70   |    |  |  |  |
|     |    |          |      |               | 29 | Sales return        | 110  |    |  |  |  |

Prepare a statement of account to remind Marco Lemelin of the amount due at 31 October 2018.



### 5 Preparing a three-column cash book, personal accounts and discount accounts

The following balances were extracted from the books of Apex Universal, a wholesaler, on 1 November 2018.

|                    | \$    |
|--------------------|-------|
| Cash in hand       | 2 190 |
| Cash at bank       | 7 330 |
| Trade payables:    |       |
| TM Davis           | 1 600 |
| Ryan & Co.         | 2 300 |
| Trade receivables: |       |
| Fray               | 900   |
| VK Watson          | 1 650 |

Trade payables give a cash discount of 5 per cent if accounts are settled within 30 days.

Apex Universal gives a cash discount of 2 per cent to its credit customers if they settle their accounts within 30 days.

During November 2018, the following transactions occurred.

| Date  | Source document            | Transaction   |
|-------|----------------------------|---|
| Nov 5 | Cheque counterfoil         | Payment of amount due to TM Davis on 1 November, less 5% cash discount                                  |
| 8     | Paying-in slip counterfoil | Cheque received from Fray in full settlement of their account on 1 November, less 2% cash discount      |
| 14    | Till roll                  | Cash sales totalling \$1420   |
| 17    | Paying-in slip counterfoil | Transfer of cash to bank, \$1250  |
| 21    | Cheque counterfoil         | Payment of amount due to Ryan & Co. on 1 November, less 5% cash discount                                |
| 24    | Paying-in slip counterfoil | Cheque received from VK Watson in full settlement of their account on 1 November, less 2% cash discount |

Prepare the business's three-column cash book for November 2018. Balance the cash book on 30 November 2018 and total the discount columns on that date.

Post entries to the personal accounts in the purchases and sales ledgers; post the totals of the discount columns to the discount accounts in the nominal ledger.

### 6 Preparing a three-column cash book, personal accounts and discount accounts

The following balances were extracted from the books of the business owned by Safina on 1 June 2018.

|                    | \$    |
|--------------------|-------|
| Cash in hand       | 450   |
| Cash at bank       | 2 720 |
| Trade payables:    |       |
| N Singh            | 3 200 |
| Zamran Stores      | 1 500 |
| Trade receivables: |       |
| K Gobin            | 600   |
| QR Pulchan         | 2 080 |

Trade payables give a cash discount of 5 per cent if accounts are settled within 30 days.

Safina gives a cash discount of 5 per cent to her credit customers if they settle their accounts within 30 days.

During June 2018, the following transactions occurred.

| Date   | Source document            | Transaction  |
|--------|----------------------------|--|
| June 5 | Cheque counterfoil         | Payment of amount due to N Singh on 1 June, less 5% cash discount                                    |
| 8      | Paying-in slip counterfoil | Cheque received from K Gobin in full settlement of their account on 1 June, less 5% cash discount    |
| 14     | Till roll                  | Cash sales totalling \$3920  |
| 17     | Paying-in slip counterfoil | Transfer of cash to bank, \$3800   |
| 21     | Cheque counterfoil         | Payment of amount due to Zamran Stores on 1 June, less 5% cash discount                              |
| 24     | Paying-in slip counterfoil | Cheque received from QR Pulchan in full settlement of their account on 1 June, less 5% cash discount |

Prepare the business's three-column cash book for June 2018. Balance the cash book on 30 June 2018 and total the discount columns on that date.

Post entries to the personal accounts in the purchases and sales ledgers; post the totals of the discount columns to the discount accounts in the nominal ledger.



## 7 Preparing a three-column cash book with an overdrawn bank balance

Ombeya owns a retail business. On 1 April 2018, his business's cash in hand was \$580 and cash at bank was \$2260. During April the following transactions occurred.

| Date    | Source document            | Transaction  |
|---------|----------------------------|--|
| April 4 | Cheque counterfoil         | Paid trade payable, B Elias, in full settlement of their account, \$1800, less 5% cash discount                    |
| 7       | Till roll                  | Cash sales totalling \$830   |
| 13      | Paying-in slip counterfoil | Transferred cash to bank, \$750  |
| 14      | Paying-in slip counterfoil | Cheque received from trade receivable, H Carr, in full settlement of their account, \$480, less 2.5% cash discount |
| 21      | Cheque counterfoil         | Purchase of new office furniture, \$2950   |
| 22      | Cash receipt               | Payment of general expenses, \$240   |
| 26      | Cheque counterfoil         | Paid trade payable, T Ellis, in full settlement of their account, \$2700, less 5% cash discount                    |
| 28      | Bank statement             | Bank charges for the month totalled \$220  |

Prepare the business's three-column cash book for April 2018. Balance the cash book on 30 April 2018 and total the discount columns. Ledger accounts are not required.

## 8 Preparing a three-column cash book with an overdrawn bank balance

Carla owns a beachwear business. On 1 May 2018, her business's cash in hand was \$1270 and cash at bank was \$1480. During May the following transactions occurred.

| Date  | Source document            | Transaction  |
|-------|----------------------------|--|
| May 5 | Till roll                  | Cash sales totalling \$930   |
| 8     | Cheque counterfoil         | Paid trade payable, Nico, in full settlement of their account, \$2600, less 5% cash discount                             |
| 11    | Paying-in slip counterfoil | Transferred cash to bank, \$740  |
| 19    | Cash receipt               | Payment of travelling expenses, \$140  |
| 22    | Paying-in slip counterfoil | Cheque received from trade receivable, Amin Supplies, in full settlement of their account, \$1200, less 4% cash discount |

| Date   | Source document    | Transaction   |
|--------|--------------------|---|
| May 24 | Cheque counterfoil | Carla withdrew a cheque for her private use, \$450  |
| 30     | Cheque counterfoil | Paid trade payable, BL Stores, in full settlement of their account, \$3400, less 5% cash discount |

Prepare the business's three-column cash book for May 2018. Balance the cash book on 31 May 2018 and total the discount columns. Ledger accounts are not required.

## 9 Preparing a full accounting system including a three-column cash book up to the trial balance

Janet Watson opened a business on 1 September 2018. On that date her business's assets and liabilities were as follows.

|                    | \$    |
|--------------------|-------|
| Cash in hand       | 1380  |
| Cash at bank       | 1750  |
| Non-current assets | 86500 |
| Bank loan          | 15000 |

During September the following transactions occurred.

| Date   | Source document            | Transaction   |
|--------|----------------------------|---|
| Sept 4 | Purchase invoice (2361)    | From TM Bennett for goods, \$2800, less 25% trade discount  |
| 6      | Cash receipt               | Paid general expenses in cash, \$180  |
| 7      | Credit note received (G09) | From TM Bennett for goods not as ordered, \$240, less 25% trade discount                                |
| 12     | Till roll                  | Cash sales totalling \$1090   |
| 14     | Cheque counterfoil         | Paid TM Bennett in full settlement of their account at this date, less 5% cash discount                 |
| 15     | Sales invoice (0001)       | To KS Maharaj for goods, \$2000, less 20% trade discount  |
| 19     | Cheque counterfoil         | Rent for three months, \$2480   |
| 21     | Paying-in slip counterfoil | Transfer of cash to bank, \$730   |
| 23     | Cash receipt               | Janet withdrew cash, \$280, for her private use   |
| 26     | Credit note issued (01)    | To KS Maharaj for damaged items sold on 15 September, \$125, less 20% trade discount                    |
| 28     | Paying-in slip counterfoil | Cheque received from KS Maharaj in full settlement of their account at this date, less 2% cash discount |
| 30     | Bank statement             | Bank charges for the month totalled \$70  |

Prepare the following books of prime entry for September 2018:

- Three-column cash book
- Purchases journal
- Sales journal
- Purchases returns
- Sales returns

Post the entries in the books of prime entry to the purchases, sales and nominal ledgers.

The cash book should be balanced at 30 September 2018 and the discount columns totalled and posted to the nominal ledger. It is not necessary to balance or close any other accounts.

Prepare a trial balance at 30 September 2018.

#### 10 Preparing a full accounting system including a three-column cash book up to the trial balance

MJ Hall Wholesale's trial balance on 1 December 2018 was as follows.

| Trial balance at 1 December 2018 |           |           |
|----------------------------------|-----------|-----------|
|                                  | Dr        | Cr        |
|                                  | \$        | \$        |
| Bank                             | 1650      |           |
| Bank charges                     | 480       |           |
| Capital                          |           | 613 640   |
| Cash                             | 820       |           |
| Discounts allowed                | 690       |           |
| Discounts received               |           | 770       |
| Drawings                         | 34 580    |           |
| Insurance                        | 8 240     |           |
| Non-current assets               | 725 000   |           |
| Purchases                        | 505 300   |           |
| Purchases returns                |           | 4 290     |
| Rent                             | 44 680    |           |
| Salaries                         | 151 400   |           |
| Sales (i.e., Revenue)            |           | 852 370   |
| Sales returns                    | 3 130     |           |
| Trade payable: Carter & Sons     |           | 13 400    |
| Trade receivable: JM McNee       | 8 500     |           |
|                                  | 1 484 470 | 1 484 470 |

During December the following transactions occurred.

| Date  | Source document            | Transaction   |
|-------|----------------------------|---|
| Dec 3 | Sales invoice (339)        | To JM McNee for goods, \$9 600, less 33 $\frac{1}{3}$ % trade discount                                |
| 4     | Cheque counterfoil         | Paid insurance, \$1050  |
| 7     | Credit note issued (074)   | To JM McNee for goods, \$450, less 33 $\frac{1}{3}$ % trade discount, returned as unsatisfactory      |
| 9     | Purchase invoice (D487)    | From Carter & Sons for goods, \$8840, less 25% trade discount   |
| 12    | Cheque counterfoil         | Paid Carter & Sons in full settlement of their account at 1 December, less 5% cash discount           |
| 15    | Credit note received (449) | From Carter & Sons for goods, \$620, less 25% trade discount, that were damaged in transit            |
| 17    | Cheque counterfoil         | Rent, \$3850  |
| 18    | Till roll                  | Cash sales totalling \$13 250   |
| 19    | Paying-in slip counterfoil | Transfer of cash to bank, \$13 800  |
| 23    | Cheque counterfoil         | Paid salaries, \$11 620   |
| 27    | Cheque counterfoil         | MJ Hall withdrew a cheque, \$800, for private use   |
| 29    | Paying-in slip counterfoil | Cheque received from JM McNee in full settlement of their account at this date, less 5% cash discount |
| 30    | Bank statement             | Bank charges for the month totalled \$240   |

Prepare the following books of prime entry for December 2018:

- Three-column cash book
- Purchases journal
- Sales journal
- Purchases returns
- Sales returns

Post the entries in the books of prime entry to the purchases, sales and nominal ledgers.

The cash book should be balanced at 31 December 2018 and the discount columns totalled and posted to the nominal ledger. It is not necessary to balance or close any other accounts.

Prepare a trial balance at 31 December 2018.

## 11 Preparing financial statements including discounts

On 31 March 2018 the following trial balance was extracted from the books of Khalid Supplies.

| Trial balance at 31 March 2018 |                |                |
|--------------------------------|----------------|----------------|
|                                | Dr             | Cr             |
|                                | \$             | \$             |
| Bank overdraft                 |                | 5 870          |
| Capital                        |                | 109 320        |
| Cash                           | 440            |                |
| Discounts allowed              | 1 220          |                |
| Discounts received             |                | 1 590          |
| Drawings                       | 22 480         |                |
| Equipment and furniture        | 185 000        |                |
| Office expenses                | 31 480         |                |
| Purchases                      | 212 400        |                |
| Purchases returns              |                | 1 120          |
| Rent                           | 18 500         |                |
| Sales (i.e., Revenue)          |                | 386 990        |
| Sales returns                  | 840            |                |
| Trade payables                 |                | 14 730         |
| Trade receivables              | 8 360          |                |
| Wages and salaries             | 38 900         |                |
|                                | <u>519 620</u> | <u>519 620</u> |

Prepare the following:

- Income statement for the year ended 31 March 2018
- Statement of financial position at 31 March 2018 (classified)

## 12 Preparing financial statements including discounts

On 30 September 2018 the following trial balance was extracted from the books of Pinebeach Books, owned by Ruth Williams.

| Trial balance at 30 September 2018 |                |                |
|------------------------------------|----------------|----------------|
|                                    | Dr             | Cr             |
|                                    | \$             | \$             |
| Administration expenses            | 5 530          |                |
| Bank overdraft                     |                | 720            |
| Capital                            |                | 374 140        |
| Cash                               | 320            |                |
| Discounts allowed                  | 190            |                |
| Discounts received                 |                | 510            |
| Drawings                           | 28 800         |                |
| Furniture and fittings             | 15 500         |                |
| Insurance                          | 3 260          |                |
| Premises                           | 390 000        |                |
| Purchases                          | 98 360         |                |
| Purchases returns                  |                | 970            |
| Sales (i.e., Revenue)              |                | 205 350        |
| Sales returns                      | 430            |                |
| Trade payables                     |                | 6 280          |
| Trade receivables                  | 920            |                |
| Wages                              | 44 660         |                |
|                                    | <u>587 970</u> | <u>587 970</u> |

Prepare the following:

- Income statement for the year ended 30 September 2018
- Statement of financial position at 30 September 2018 (classified)



# Books of prime entry: the petty cash book

## Introduction

In some businesses where there are a large number of transactions in cash, the decision is sometimes made to operate a second cash book which is used to record minor cash transactions, known as **petty cash** transactions.

Often the task of preparing the petty cash book is given to a more junior member of the accounts team, who is called the petty cashier. Responsibility for handling the business's cash has to be tightly controlled.

- The petty cashier is only allowed to handle a maximum amount of petty cash at any one time. This maximum amount is called the float or **imprest**. The size of the float or imprest is decided by the owner or manager of the business and is fixed at a specific amount (e.g. \$100).
- The amount of the float or imprest is calculated to be sufficient to cover payments for a set period of time, for example, a week or a month.
- The petty cashier is only allowed to give cash to employees to reimburse them for payments they have made on behalf of the business when evidence is produced (e.g. a receipt).
- For each payment made, the petty cashier is required to complete a **petty cash voucher**. The voucher has to be signed by the person receiving the cash as well as by the petty cashier. Other evidence of the transaction (e.g. the receipt) is attached to the voucher.
- Occasionally a small cash receipt is also recorded in a **petty cash book**.
- For security, petty cash is kept under lock and key.
- The petty cash book is another example of a book of prime entry.

## LEARNING OBJECTIVES

When you have reached the end of this chapter you will be able to:

- identify the source documents used when recording petty cash transactions
- prepare a petty cash book with analysis columns using the imprest system
- post the details recorded in the petty cash book to general ledger and purchases ledger accounts.

## KEY TERMS

**Petty cash:** small cash payments.

**Imprest:** a system for maintaining a petty cash book which gives the petty cashier responsibility for a fixed petty cash float.

**Petty cash voucher:** the source document for each petty cash payment.

**Petty cash book:** the book of prime entry used to make the first record of petty cash payments.

# Recording petty cash payments

## Source documents

The source document for petty cash transactions is a petty cash voucher.

**Illustration 1** A petty cash voucher

|   |        |       |
|---|--------|-------|
| Number  |        | 302   |
| PETTY CASH VOUCHER  |        |       |
| Item  | Amount |       |
| Interviewee's travel expenses   | \$     | 33.74 |
| Authorised by <span style="border: 1px solid black; padding: 2px;">Lewis Pitts</span> |        |       |
| Received by <span style="border: 1px solid black; padding: 2px;">Irene Johnson</span> |        |       |

**Notes:**

- 1 An individual (Irene Johnson) has been given \$33.74 for travel expenses for attending an interview.
- 2 The interviewee, Irene Johnson, has signed the petty voucher to confirm that she received the amount stated.
- 3 The petty cashier, Lewis Pitts, has signed the voucher to indicate that he was responsible for making this payment.
- 4 Lewis will attach a receipt or receipts for the travelling expenses to the voucher. These could be for a taxi, bus, train ticket, and so on.
- 5 You will notice that the voucher has a number – 302. This number will be used in preparing the accounting records. There will be a pad of petty cash vouchers and they will be numbered consecutively.

## How petty cash transactions are recorded

An illustration of a completed petty cash voucher is shown above. An illustration of a completed petty cash book is shown on page 98. The steps to be followed in completing a petty cash book can be summarised as follows.



## A petty cashier at work

### Receiving the float

Step 1: The petty cashier will receive the fixed float/imprest in the form of cash or a cheque that needs to be cashed. The double entry required will be:

Debit     Petty cash

Credit    Cash or bank column in main cash book

### Recording each petty cash payment

Step 2: Using information shown on each petty cash voucher the petty cashier will make the following record in the petty cash book:

Credit    Petty cash

Then they will make a second entry in the appropriate **analysis column**.

If you were wondering about the debit entry to go with this credit entry, see Step 4 below.

### Balancing the petty cash book

Step 3: The petty cash account is balanced in the usual way and the balance is brought down to start the week or month. At this point the petty cashier will need more cash to cover the next week's or month's petty cash payments. The petty cashier will be reimbursed for the previous period's payments and will debit the petty cash account with the amount received. By receiving back exactly what was spent in the previous period the float/imprest is restored to the original amount.

### Totalling and posting the analysis columns

Step 4: Finally, the analysis columns are totalled and each total is posted to the relevant ledger accounts. Usually these postings are to expense accounts, but in some cases it is possible that a trade payable is paid in petty cash because only a very small amount is due. These debit entries complete the double-entry process.

#### KEY TERMS

**Analysis column:** in a petty cash book this is a means of classifying each payment to provide *totals* to be posted to nominal ledger accounts.

#### STUDY TIP

An exam question may ask you to state how much should be given to a petty cashier to 'restore the imprest' every week or month (i.e. how much should be given to top up the petty cash float). The answer is always the same as the total of petty cash payments made during that week or month.



# Preparing a petty cash book

## Illustration 2 An analysed petty cash book

The owner of a business decided to maintain a petty cash book. It was agreed that the imprest would be \$150. The following transactions occurred:

|      | Voucher number |   |
|------|----------------|---|
| May  | 1              | Petty cashier received a cheque for \$150             |
|      | 2              | 1 Stationery, \$32.62                                 |
|      | 8              | 2 Postage, \$26.29                                    |
|      | 11             | 3 Travel expenses, \$18.40                            |
|      | 15             | 4 Postage, \$11.83                                    |
|      | 20             | 5 Purchases ledger account of D Morris, \$20.70       |
|      | 23             | 6 Stationery, \$11.37                                 |
|      | 27             | 7 Travel expenses, \$19.11                            |
| June | 1              | The imprest was restored with the receipt of a cheque |

Here is the petty cash book based on this information:

| Petty cash book |      |    |            |                |                |                  |               |              |                           |
|-----------------|------|----|------------|----------------|----------------|------------------|---------------|--------------|---------------------------|
| Receipts<br>\$  | Date |    | Details    | Voucher<br>no. | Payments<br>\$ | Stationery<br>\$ | Postage<br>\$ | Travel<br>\$ | Purchases<br>ledger<br>\$ |
| 150.00          | May  | 1  | Bank       |                |                |                  |               |              |                           |
|                 |      | 2  | Stationery | 1              | 32.62          | 32.62            |               |              |                           |
|                 |      | 8  | Postage    | 2              | 26.29          |                  | 26.29         |              |                           |
|                 |      | 11 | Travel     | 3              | 18.40          |                  |               | 18.40        |                           |
|                 |      | 15 | Postage    | 4              | 11.83          |                  | 11.83         |              |                           |
|                 |      | 20 | D Morris   | 5              | 20.70          |                  |               |              | 20.70                     |
|                 |      | 23 | Stationery | 6              | 11.37          | 11.37            |               |              |                           |
|                 |      | 27 | Travel     | 7              | 19.11          |                  |               | 19.11        |                           |
|                 |      |    |            |                | 140.32         | 43.99            | 38.12         | 37.51        | 20.70                     |
|                 |      |    |            |                | 9.68           |                  |               |              |                           |
| 150.00          |      |    |            | 150.00         |                |                  |               |              |                           |
| 9.68            | June | 1  | Balance    | b/d            |                |                  |               |              |                           |
| 140.32          |      | 1  | Bank       |                |                |                  |               |              |                           |

| Dr |  |      |      | Cash book |   |            |      | Cr  |  |
|----|--|------|------|-----------|---|------------|------|-----|--|
|    |  | Cash | Bank |           |   | Cash       | Bank |     |  |
|    |  | \$   | \$   |           |   | \$         | \$   |     |  |
|    |  |      |      | May       | 1 | Petty cash |      | 150 |  |

Here are examples of the posting of analysis column totals and the payment to the credit supplier:

### NOMINAL LEDGER

| Dr  |    |            |       | Stationery account |  |  |  | Cr |  |
|-----|----|------------|-------|--------------------|--|--|--|----|--|
| May | 31 | Petty cash | 43.99 |                    |  |  |  |    |  |
| Dr  |    |            |       | Postage            |  |  |  | Cr |  |

|                         |    |               |       |           |
|-------------------------|----|---------------|-------|-----------|
| May                     | 31 | Petty cash    | 38.12 |           |
| <b>Dr</b>               |    | <b>Travel</b> |       | <b>Cr</b> |
| May                     | 31 | Petty cash    | 37.51 |           |
| <b>PURCHASES LEDGER</b> |    |               |       |           |

|           |    |                 |       |           |
|-----------|----|-----------------|-------|-----------|
| <b>Dr</b> |    | <b>D Morris</b> |       | <b>Cr</b> |
| May       | 20 | Petty cash      | 20.70 |           |

#### Notes:

- The cheque received by the petty cashier on 1 May and 1 June would be cashed to provide notes and coins to make petty cash payments.
- The matching entry in the cash book for 1 May would appear as shown:
  - In the petty cash book the receipts column is the equivalent of the debit side of the petty cash account; the payments column is the equivalent of the credit side.
  - Each payment must be cross-referenced to the relevant voucher.
  - Each payment is analysed under appropriate headings for the most regularly occurring expenses. These would be decided in advance by the owner or manager of the business. Theoretically there can be as many analysis columns as are required.
  - The balancing process is almost exactly the same as usual, but the payments column is first subtotalled before balancing.
  - The analysis columns are totalled at agreed intervals – weekly or monthly – and the totals are posted to the relevant ledger accounts. This process saves much time as otherwise separate entries would have to be made in the ledger accounts of every petty cash payment, however small the amount involved.
  - The one exception to this procedure is that each individual entry in the purchases ledger analysis column is debited to the account of credit supplier on the date of the payment, and the analysis column total is not used for this purpose. This exception is made necessary by the fact that there are many individual accounts of trade payables rather than just one account for all trade payables.

### What you should do with the balance of the petty cash book

You can now answer questions 1–6 on pages 100–102.

The balance of the petty cash book is one of the business's assets. Like any cash balance it should be recorded as a debit entry in the trial balance and as the most liquid of the business's current assets on the statement of financial position.

#### STUDY TIP

To help avoid arithmetical errors with the balancing process and totalling of analysis columns, it is a good idea to cross-check that the subtotal for payments actually agrees with the total of the analysis columns.

#### STUDY TIP

When you see the item 'petty cash (in hand)' in a trial balance remember this is a reference to the petty cash balance. This item should be recorded as a current asset in the statement of financial position. It is a common mistake to think that this item is a reference to petty cash expenses and record the amount in the income statement by mistake.



## DEVELOPING YOUR SKILLS

**1** Preparing a petty cash book and posting to ledger accounts

Janet has decided that her business should use a petty cash book starting in October 2018 and that the imprest should be \$200. She also decided that the petty cash book should have analysis columns as follows:

- Postage
- Stationery
- Travel
- Cleaning
- General expenses
- Purchase ledger accounts

During the first month of operation the following petty cash transactions occurred.

|     | Voucher number |  |
|-----|----------------|--|
| Oct | 1              | Petty cashier received a cheque for \$200                          |
|     | 3              | 1 Postage, \$24.52   |
|     | 5              | 2 Office cleaning, \$35.00   |
|     | 8              | 3 Travel expenses, \$11.80   |
|     | 12             | 4 Trade payable, D Chadee, \$14.48                                 |
|     | 16             | 5 General expenses, \$10.60  |
|     | 17             | 6 Office cleaning, \$35.00   |
|     | 20             | 7 Travel expenses, \$7.38  |
|     | 22             | 8 Stationery, \$14.23  |
|     | 24             | 9 Cleaning materials, \$12.22                                      |
|     | 30             | 10 Trade payable, M Carr, \$21.37                                  |
|     | 31             | The petty cash book was balanced and the analysis columns totalled |
| Nov | 1              | The imprest was restored with the receipt of a cheque              |

Prepare the petty cash book for October 2018. Balance the petty cash book and restore the imprest on 1 November. Post the details of the analysis columns to the accounts in the nominal and purchases ledgers.

**2** Preparing a petty cash book and posting to ledger accounts

Jamal's business makes use of a petty cash book. On 1 February 2018 the balance of petty cash in hand was \$14.55. The petty cash book operates with an imprest of \$220 and with the following analysis columns:

- Postage
- Stationery

- Vehicle expenses
- Casual labour
- Office expenses
- Purchase ledger accounts

During February 2018 the following petty cash transactions occurred:

|     | Voucher number |  |
|-----|----------------|--|
| Feb | 1              | Petty cashier received a cheque to restore the imprest             |
|     | 2              | 141 Stationery, \$9.70   |
|     | 8              | 142 Vehicle fuel, \$35.50  |
|     | 10             | 143 Postage, \$11.10   |
|     | 13             | 144 Casual labour, \$38.25   |
|     | 15             | 145 Office expenses, \$8.42  |
|     | 18             | 146 Trade payable, Ryan & Co., \$17.11                             |
|     | 21             | 147 Vehicle fuel, \$34.22  |
|     | 23             | 148 Trade payable, BY Scott, \$9.28                                |
|     | 25             | 149 Postage, \$8.56  |
|     | 26             | 150 Casual labour, \$21.80   |
|     | 28             | The petty cash book was balanced and the analysis columns totalled |
| Mar | 1              | The imprest was restored with the receipt of a cheque              |

Prepare the petty cash book for February 2018. Balance the petty cash book and restore the imprest on 1 March. Post the details of the analysis columns to the accounts in the nominal and purchases ledgers.

**3** Preparing cash books

Melanie owns a small department store. Her accounting system includes the following.

- Petty cash book: this operates with a monthly imprest of \$200. Petty cash is used to make all payments of less than \$40. The petty cash book has the following analysis columns:
  - Vehicle expenses
  - Postage
  - Office expenses
  - Cleaning
- Two-column cash book: this has columns for bank and discounts. All payments of more than \$40 are made by cheque.



The following information is available for June 2018.

- June
- 1 Petty cash in hand, \$19; cash at bank, \$3880
  - 2 Petty cashier received cheque to restore the imprest
  - 3 Banked cash sales of \$832
  - 7 Paid office expenses, \$8.82
  - 8 Paid for vehicle fuel, \$32.30
  - 10 Received a cheque from trade receivable, Y Khan, in full settlement of the amount due, \$640, less a 2.5% cash discount
  - 11 Paid for office expenses, \$1.28
  - 15 Paid cleaner's wages, \$37.32
  - 16 Paid trade payable, A Mohammed, in full settlement of the amount due, \$1400, less a 5% cash discount
  - 18 Purchased postage stamps, \$14
  - 21 Paid for office expenses, \$7.11
  - 22 Received a cheque from trade receivable, B Taylor, in full settlement of the amount due, \$880, less 2.5% cash discount
  - 23 Banked cash sales of \$902
  - 24 Paid for vehicle fuel, \$25
  - 25 Paid trade payable, J Ram, in full settlement of the amount due, \$1860, less a 5% cash discount
  - 26 Paid office expenses, \$45
  - 27 Purchased postage stamps, \$17.14
  - 28 Paid cleaner's wages, \$31.26
  - 29 Paid for vehicle fuel, \$48
  - 30 Paid wages, \$1580
  - 30 The petty cash book and cash book were balanced. Analysis columns and discount columns were totalled

Prepare the business's petty cash book and cash book for the month of June 2018. Invent suitable voucher numbers for petty cash transactions. Entries do not have to be posted to ledger accounts.

#### 4 Preparing cash books

Marcus owns a wholesale business providing building materials. His business makes use of two cash books:

Petty cash book: this operates with a monthly imprest of \$300. Petty cash is used to make all

payments of less than \$60. The petty cash book has the following analysis columns:

- Stationery
- Travel expenses
- Vehicle running expenses
- General expenses

Two-column cash book: this has columns for bank and discounts. All payments for more than \$60 are made by cheque.

The following information is available for March 2018:

- Mar
- 1 Petty cash in hand, \$34; cash at bank, \$1724
  - 2 Petty cashier received cheque to restore the imprest
- Mar
- 4 Paid for general expenses, \$18.49
  - 6 Received cheque from trade receivable, Dass & Co., in full settlement of their account, \$2360, less 5% cash discount
  - 7 Banked cash sales of \$1460
  - 9 Paid employee's travel expenses, \$37.33
  - 10 Paid trade payable, P Nanan, in full settlement of the amount due, \$4580, less 5% cash discount
  - 11 Purchased stationery, \$14.37
  - 12 Paid for vehicle fuel, \$45.60
  - 14 Paid rent, \$780
  - 15 Purchased stationery, \$25.31
  - 17 Paid vehicle repairs, \$56
  - 18 Paid employee's travel expenses, \$18.42
  - 20 Paid wages, \$2480
  - 21 Received a cheque from trade receivable, MV Tammy, in full settlement of the amount due, \$3300, less 5% cash discount
  - 23 Banked cash sales of \$782
  - 24 Paid vehicle repairs, \$83
  - 25 Paid employee's travel expenses, \$24.89
  - 27 Paid for vehicle fuel, \$41.45
  - 28 Paid for general expenses, \$64
  - 31 The petty cash book and cash book were balanced. Analysis columns and discount columns were totalled

Prepare the business's petty cash book and cash book for the month of March 2018. Invent suitable voucher numbers for petty cash transactions. Entries do not have to be posted to ledger accounts.

## 5 Preparing financial statements including a petty cash balance

Emily Williams owns a shoe shop. Her business's financial year ended on 31 October 2018 when the following trial balance was extracted from the business's books of account.

| Trial balance at 31 October 2018 |                |                |
|----------------------------------|----------------|----------------|
|                                  | Dr             | Cr             |
|                                  | \$             | \$             |
| Bank charges                     | 387            |                |
| Bank overdraft                   |                | 1 028          |
| Capital                          |                | 26 346         |
| Cleaning expenses                | 114            |                |
| Discounts allowed                | 559            |                |
| Discounts received               |                | 782            |
| Drawings                         | 30 385         |                |
| Furniture and fittings           | 27 500         |                |
| Insurance                        | 2 194          |                |
| Office expenses                  | 1 183          |                |
| Petty cash                       | 32             |                |
| Purchases                        | 118 548        |                |
| Purchases returns                |                | 803            |
| Rent                             | 18 340         |                |
| Sales (i.e., Revenue)            |                | 199 281        |
| Sales returns                    | 258            |                |
| Travel expenses                  | 173            |                |
| Trade payables                   |                | 5 523          |
| Trade receivables                | 2 804          |                |
| Wages                            | 31 286         |                |
|                                  | <u>233 763</u> | <u>233 763</u> |

Prepare the following:

- Income statement for the year ended 31 October 2018
- Statement of financial position at 31 October 2018 (classified)

## 6 Preparing financial statements including a petty cash balance

Omar owns a car accessories business. His business's financial year ended on 31 August 2018 when the following trial balance was extracted from the business's books of account.

| Trial balance at 31 August 2018 |                |                |
|---------------------------------|----------------|----------------|
|                                 | Dr             | Cr             |
|                                 | \$             | \$             |
| Administration expenses         | 4 483          |                |
| Bank charges                    | 511            |                |
| Bank                            | 3 700          |                |
| Bank loan (repayable May 2019)  |                | 18 000         |
| Bank loan interest              | 1 040          |                |
| Capital                         |                | 49 910         |
| Discounts allowed               | 302            |                |
| Discounts received              |                | 181            |
| Drawings                        | 22 119         |                |
| Equipment and fittings          | 45 000         |                |
| General expenses                | 3 906          |                |
| Petty cash                      | 18             |                |
| Purchases                       | 285 480        |                |
| Purchases returns               |                | 2 205          |
| Rent                            | 31 360         |                |
| Sales (i.e., Revenue)           |                | 432 276        |
| Sales returns                   | 1 414          |                |
| Stationery and postage          | 308            |                |
| Trade payables                  |                | 8 470          |
| Trade receivables               | 3 374          |                |
| Vehicles                        | 53 240         |                |
| Vehicle running expenses        | 6 407          |                |
| Wages                           | 48 380         |                |
|                                 | <u>511 042</u> | <u>511 042</u> |

Prepare the following:

- Income statement for the year ended 31 August 2018
- Statement of financial position at 31 August 2018 (classified)

# Books of prime entry: the general journal

## Introduction

The double-entry accounting system works on the basis that all transactions should first be recorded in a book of prime entry before entries are made in ledger accounts. So far, books of prime entry have been put in place for:

- |  |  |
|--|--|
| Money transactions   | → Two- or three-column cash book<br>Petty cash book  |
| Credit transactions (for goods in which the business trades) | → Purchases journal<br>Sales journal<br>Purchases returns journal<br>Sales returns journal |

At first sight this arrangement might seem to cover every possibility. However, there is a small group of entries in the accounting system that falls outside these categories. In order to provide the first record for these entries, the **general journal** is used.

The general rule for the use of the general journal is that it should be used whenever the cash books or four other journals are not appropriate. The following broad categories give some idea of when these situations occur:

- Purchase and sale of non-current assets on credit
- Cancelling entries and correcting errors in accounts
- Transferring information from one account to another
- End-of-year transfers from expense accounts to the income statement
- Opening a new set of books.

For convenience, the 'general journal' is often referred to as the 'journal'.

## LEARNING OBJECTIVES

When you have reached the end of this chapter you will be able to:

- identify situations when it is appropriate to use the general journal
- make entries in the general journal
- post the details recorded in the general journal to ledger accounts.

## KEY TERMS

**General journal:** a book of prime entry used to make the first record of transactions that it would not be appropriate to record in the other books of prime entry (cash books and other journals).

## DID YOU KNOW?

The books of prime entry are an important part of a business's accounting system. They provide the only clear record of what has happened in date order, and they also provide an important connection between the evidence for each transaction (i.e. the source documents) and the entries in the accounting system.



# How to make journal entries

## DID YOU KNOW?

There is a wide range of possible source documents for journal entries. As well as invoices for the purchase of a non-current asset, there could be letters or emails received from other businesses or organisations, and internal notes or emails written by the owner, managers or other employees.

A journal entry is a record of which account is to be debited and which account is to be credited for a particular transaction. When preparing a journal entry the following procedures should be followed:

- 1 A journal entry requires the following details:
  - a Date of the transaction
  - b Account to be debited and the amount
  - c Account to be credited and the amount
  - d Short description of the transaction – called the narrative
- 2 It is usual to slightly indent the name of the account to be credited in the detail column.
- 3 Each journal entry is separated from the next one by ruling off the details column.

### Illustration 1 Purchase of a non-current asset on credit

On 4 July 2018 the owner of a business purchased a new vehicle, \$32 000, for business use on credit from Blue River Motors Ltd.

The journal entry is shown below.

| General journal |  |              |              |
|-----------------|--|--------------|--------------|
| Date            | Details  | Dr           | Cr           |
| July 4          | Vehicles<br>Blue River Motors Ltd<br>Purchase of vehicle on credit,<br>invoice number 4872 | \$<br>32 000 | \$<br>32 000 |

#### NOMINAL LEDGER

| Dr     |                       | Vehicles account | Cr |
|--------|-----------------------|------------------|----|
| July 4 | Blue River Motors Ltd | 32 000           |    |

#### PURCHASES LEDGER

| Dr |        | Blue River Motors Ltd account | Cr     |
|----|--------|-------------------------------|--------|
|    | July 4 | Vehicle                       | 32 000 |

**Note:** the journal entry would be posted through to the relevant ledger accounts.

### Illustration 2 Sale of a non-current asset on credit

Here is another example of a situation when a journal entry would be required.

On 22 May the owner of a business selling groceries sold some unwanted equipment on credit to Linda MacDonald for \$450.

The journal entry is as follows.

| General journal |  |           |           |
|-----------------|--|-----------|-----------|
| Date            | Details  | Dr        | Cr        |
| May 22          | Linda MacDonald<br>Equipment<br>Sale of non-current assets on credit | \$<br>450 | \$<br>450 |

This journal entry should be posted as follows.

#### NOMINAL LEDGER

| Dr | Equipment account      | Cr  |
|----|------------------------|-----|
|    | May 22 Linda MacDonald | 450 |

#### SALES LEDGER

| Dr     | Linda MacDonald account | Cr |
|--------|-------------------------|----|
| May 22 | Equipment 450           |    |

### Illustration 3 Correcting errors

It is inevitable that errors will be made in the accounts from time to time. The rule is always that errors should be corrected by making additional entries. It would never be acceptable to cross out or try to remove the wrong entries as this could look as if the accounts had been tampered with.

On 5 August 2018 a business's bookkeeper recorded the payment of rent by cheque, \$345, as \$354 in both the bank account and rent account.

The journal entry to record the correction of these entries is:

| General journal |   |         |         |
|-----------------|---|---------|---------|
| Date            | Details   | Dr      | Cr      |
| Aug 5           | Bank<br>Rent<br>Correction of error in recording the amount paid for rent | \$<br>9 | \$<br>9 |

Here are the entries in the bank account and in the rent account, showing the original entries and the posting of the corrections.

| Dr    | Cash book (bank columns) | Cr             |
|-------|--------------------------|----------------|
|       | Bank                     | Bank           |
|       | \$                       | \$             |
| Aug 5 | Rent 9                   | Aug 5 Rent 354 |

#### NOMINAL LEDGER

| Dr    | Rent account | Cr           |
|-------|--------------|--------------|
| Aug 5 | Bank 354     | Aug 5 Bank 9 |

**LINKS...**  
There is much more about the correction of errors in Chapter 3.1–3.4.

#### Illustration 4 End-of-year transfers to the income statement

At the end of each accounting year many accounts are closed and their balances transferred to the income statement. These transfers from one account to another should all be journalised first.

On 31 December 2018 the end-of-year financial statements of the business owned by Laura Cousins were prepared. This included the transfer of sales, \$193 400, and wages, \$32 480, to the income statement.

These transfer entries should be journalised as follows.

| General journal |  |               |               |
|-----------------|--|---------------|---------------|
| Date            | Details  | Dr            | Cr            |
| Dec 31          | Sales<br>Income statement<br>Transfer of sales to income statement | \$<br>193 400 | \$<br>193 400 |
| 31              | Income statement<br>Wages<br>Transfer of wages to income statement | 32 480        | 32 480        |

#### Illustration 5 Opening a new set of books

When a new business starts up and the books of account are opened for the first time, a journal entry is used to record the starting position in the asset, liability and capital accounts. This situation occurs just once in the lifetime of any business.

On 1 January 2018 Jo Anderson opened a business with the following.

|           | \$     |
|-----------|--------|
| Bank      | 55 000 |
| Vehicle   | 43 000 |
| Bank loan | 20 000 |
| Capital   | 78 000 |

The journal entry to record the opening of the books of account is:

| General journal |  |                        |                        |
|-----------------|--|------------------------|------------------------|
| Date            | Details  | Dr                     | Cr                     |
| Jan 1           | Bank<br>Vehicle<br>Bank loan<br>Capital<br>Entries to record assets, liabilities and capital at 1 January 2018 | \$<br>55 000<br>43 000 | \$<br>20 000<br>78 000 |

You can now answer all the questions on pages 107–112.



## DEVELOPING YOUR SKILLS

## 1 Preparing journal entries

Prepare journal entries to record the following transactions.

- July 3 Purchases new equipment, \$3600, for business use on credit from J Rajah – invoice number 7361
- 14 It was noticed that the bookkeeper had made a mistake when recording the sale of goods, \$780, on credit to TM Williams. The correct entry had been made in the sales account, but the account of T Williams had been debited in error. Entries were made to correct this mistake
- 19 Some of the equipment purchased from J Rajah on 3 July was returned to the supplier as it was damaged in transit. The supplier sent a letter agreeing to the deduction of \$520 from the amount due
- 31 At the end of the business's accounting year total purchases of \$156 000 were transferred to the income statement
- 31 The balance of the discounts received account, \$943, was transferred to the income statement

Show how all of the journal entries would be posted to ledger accounts.

## 2 Preparing journal entries

Prepare journal entries to record the following transactions:

- May 1 The owner of a business opened the books of account with the following: bank \$5000, fixtures and fittings \$23 000, bank loan \$8000 and capital \$20 000
- 12 An error was made when the purchase of stationery, \$105, was posted to the debit side of the purchases account rather than the debit side of the administration expenses account. This mistake was corrected
- 15 Some fixtures, \$1050, were purchased for business use on credit from Albo Shelving, invoice number 3088
- 31 Monthly financial statements were prepared and the total of the sales account, \$28 700, was transferred to the income statement.
- 31 The balance of the rent account, \$750, was transferred to the income statement.

Show how all the journal entries would be posted to ledger accounts.

## 3 Selecting the correct book of prime entry

During the month of February 2018 the following transactions occurred affecting the accounts of Rishi, a trader. Rishi maintains all seven books of prime entry as part of his books of account. In the case of each transaction, decide which

subsidiary book should be used to make the first entry in the accounting system.

- Feb 4 Received an invoice for goods for resale
- 7 Paid a trade payable by cheque
- 11 A voucher showed the payment of travel expenses in cash
- 15 Received a credit note from a trade payable for goods damaged in transit
- 18 A cheque was drawn for the payment of wages
- 22 Received an invoice for a new vehicle for business use
- 24 Issued a credit note to a trade receivable for goods returned as unsuitable
- 28 Corrected a mistake in the accounts where the wrong amount had been debited and credited in the ledger accounts

## 4 Selecting the correct book of prime entry

Renea is the owner of a retail unit. Her business's accounting system includes all seven books of prime entry as part of her books of account. The following transactions were among those that occurred during September 2018. In each case decide which subsidiary book should be used to make the first record of the transaction.

- Sept 3 Received an invoice for some new equipment for business use
- 6 Cheque stub showed the payment of rent for the month
- 11 Entries were made to correct a mistake made by the bookkeeper
- 14 Invoice was issued for the sale of goods on credit
- 15 Credit note was issued for the return of goods by a customer
- 20 A voucher showed the purchase of postage stamps
- 23 Invoice was received for goods for resale
- 25 Some of the new equipment was found to be faulty and was returned to the supplier
- 30 Expense accounts were closed and their balances transferred to the income statement for the year ended on this date

## 5 Preparing a full accounting system including journal entries up to the trial balance

On 1 January 2018 Carmen opened a new business with the following:

|              | \$     |
|--------------|--------|
| Cash at bank | 3 500  |
| Vehicle      | 36 000 |
| Equipment    | 19 000 |
| Capital      | 58 500 |

Carmen has decided to maintain the following books of prime entry:

- General journal
- Three-column cash book
- Purchases journal
- Sales journal
- Purchases returns journal
- Sales returns journal

During January the following transactions occurred.

- Jan 4 Received an invoice (number 302) from MJT for goods for resale, \$6400, less 25% trade discount  
 7 Till rolls showed cash sales totalling \$1240  
 10 Paid operating expenses in cash, \$280  
 11 Banked cash, \$800  
 14 Received a credit note (number 073) from MJT for goods returned as damaged, \$200, less 25% trade discount  
 15 Received an invoice (number 478) for some additional equipment for business use from Bridge Products, \$880  
 16 Issued an invoice (number 001) to Geeta Stores for goods, \$1200, less 15% trade discount  
 19 Returned some of the additional equipment, \$90, purchased on 15 January from Bridge Products  
 22 Issued a credit note (number 001) to Geeta Stores for goods, \$100, less 15% trade discount  
 24 Paid MJT in settlement of their account at this date, less 2% cash discount  
 29 Received a cheque from Geeta Stores in full settlement of their account at this date, less a cash discount of \$24

Record these transactions in the books of prime entry and post to the ledger accounts. Balance the cash book and total the discount columns. Prepare a trial balance at 31 January 2018. There is no need to balance or close any other accounts.

## 6 Preparing a full accounting system including journal entries up to the trial balance

Omar owns a wholesale business supplying computer accessories to retailers in the region. His business's trial balance on 1 November was as follows.

| Trial balance at 1 November 2018 |         |         |
|----------------------------------|---------|---------|
|                                  | Dr      | Cr      |
|                                  | \$      | \$      |
| Bank overdraft                   |         | 1480    |
| Capital                          |         | 103 560 |
| Cash                             | 440     |         |
| Discounts allowed                | 1320    |         |
| Discounts received               |         | 1890    |
| Drawings                         | 37 320  |         |
| Furniture and equipment          | 180 000 |         |
| Operating expenses               | 45 360  |         |
| Purchases                        | 578 270 |         |

|                       |         |         |
|-----------------------|---------|---------|
| Purchases returns     |         | 5 130   |
| Sales                 |         | 732 340 |
| Sales returns         | 4 890   |         |
| Trade payables        |         |         |
| LDZ                   |         | 4 500   |
| M Chin                |         | 3 200   |
| Trade receivables     |         |         |
| Oldbridge Retail Unit | 2 800   |         |
| Peterson Stores       | 1 700   |         |
|                       | 852 100 | 852 100 |

During November 2018 the following transactions occurred.

| Date  | Source document            | Details   |
|-------|----------------------------|---|
| Nov 1 | Cash receipt               | For operating expenses, \$380   |
| 3     | Invoice                    | From LDZ (number 891) for goods for resale, \$4500, less 33 $\frac{1}{3}$ % trade discount                                      |
| 7     | Paying-in slip counterfoil | Cheque received from Oldbridge Retail Unit in settlement of their account at this date, less 5% cash discount                   |
| 8     | Credit note                | Received from LDZ (number 223) for goods purchased on 3 November, not as ordered, \$330, less 33 $\frac{1}{3}$ % trade discount |
| 12    | Till roll                  | Cash sales totalling \$2460   |
| 13    | Cheque counterfoil         | Omar withdrew \$720 for private use   |
| 17    | Invoice                    | Sent to Peterson Stores (number 407) for goods, \$2450, less 20% trade discount   |
| 18    | Paying-in slip counterfoil | Banked cash, \$1 800  |
| 20    | Invoice                    | For additional equipment for business use, \$1460, received from Deva Office Supplies (invoice number 2789)                     |
| 22    | Credit note                | Sent to Peterson Stores (number 082) for goods damaged in transit, \$150, less 20% trade discount                               |
| 25    | Cheque counterfoil         | Paid M Chin the amount due at this date, less 5% cash discount  |
| 29    | Paying-in slip counterfoil | Cheque received from Peterson Stores in settlement of their account at this date, less a cash discount of \$110                 |

Prepare the following:

- General journal
- Three-column cash book
- Purchases journal
- Sales journal
- Purchases returns journal
- Sales returns journal
- Purchases ledger accounts
- Sales ledger accounts
- Nominal ledger accounts
- Trial balance dated 30 November 2018

Balance the cash book on 30 November 2018 and total the discount columns. End-of-year financial statements are *not* required.



## PREPARING FOR THE EXAMINATION

(The following questions cover Chapters 2.16–2.26)

### MULTIPLE-CHOICE QUESTIONS

- 7 Entries in the purchases journal are taken from which of the following documents?
  - A Credit notes
  - B Delivery notes
  - C Invoices
  - D Receipts
- 8 To check the accuracy of the purchases returns journal, which of the following should be examined, referring to copies if necessary?
  - A Credit notes issued
  - B Credit notes received
  - C Invoices issued
  - D Invoices received
- 9 Which of the following source documents should be used to make entries in the sales journal?
  - A A credit note received from a supplier
  - B A debit note sent to a supplier
  - C An invoice sent to a customer
  - D A petty cash voucher for travelling expenses
- 10 A paying-in slip counterfoil is used to make entries in the:
  - A Cash book
  - B Petty cash book
  - C Purchases journal
  - D Sales returns journal
- 11 Which of these transactions should be entered in the general journal?
  - A Correction of error in recording purchases returns
  - B Owner's cash drawings
  - C Purchase of new equipment by cheque
  - D Returns of goods to a supplier
- 12 The owner of a business purchased a new delivery vehicle for business use. A cash deposit of 10 per cent was paid at the time of purchase; the balance is to be paid in four months' time. Which

subsidiary book(s) should be used to record this information?

- A General journal
  - B General journal and cash book
  - C Purchases journal
  - D Purchases journal and cash book
- 13 The following totals were shown in the discount columns of a business's cash book.
 

| Cash book |      |      |           |      |      |
|-----------|------|------|-----------|------|------|
| Dr        |      |      | Cr        |      |      |
| Discounts | Cash | Bank | Discounts | Cash | Bank |
| 610       |      |      | 450       |      |      |

What entries should be made in the nominal ledger?

  - A Debit discounts allowed \$450  
Credit discounts received \$610
  - B Debit discounts allowed \$610  
Credit discounts received \$450
  - C Debit discounts received \$450  
Credit discounts allowed \$610
  - D Debit discounts received \$610  
Credit discounts allowed \$450
- 14 On 1 August Salma sold goods to Riaz. Riaz returned some of these goods a week later. In which order will Salma issue documents to Riaz during April?
  - A Credit note, invoice, statement of account
  - B Invoice, credit note, statement of account
  - C Invoice, statement of account, credit note
  - D Statement of account, invoice, credit note
- 15 Adam is responsible for keeping a petty cash book for his employer. The monthly imprest is \$200. During January the following petty cash payments were made: travel expenses \$82; postage \$45; office cleaning \$39.
 

How much should Adam receive at the end of January to restore the imprest?

  - A \$34
  - B \$166
  - C \$200
  - D \$366



- 16** A retailer purchased \$2000 of goods from a supplier on the following terms: 25 per cent trade discount, 10 per cent cash discount if the invoice is paid within 30 days.

The retailer paid the invoice 20 days after it was received. How much should the retailer pay?

- A \$1300
- B \$1350
- C \$1500
- D \$1800

- 19\*** Asif owns a shoe shop. Recently he purchased some furniture on credit from Salman. Which entries are required to record this transaction in Asif's books?

|   | Book of prime entry | Account debited | Account credited |
|---|---------------------|-----------------|------------------|
| A | general journal     | furniture       | Salman           |
| B | general journal     | Salman          | furniture        |
| C | purchases journal   | furniture       | Salman           |
| D | purchases journal   | Salman          | furniture        |

- 20\*** Haroon purchased goods on credit from Sophia. Which statement is true about a credit note?

- A Haroon sends this to Sophia when he purchases goods from her
- B Haroon sends this to Sophia when he returns goods to her
- C Sophia sends this to Haroon when she sells goods to him
- D Sophia sends this to Haroon when he returns goods to her

## OTHER QUESTIONS

- 23** Yeung prepared the following cash book for his business.

| Dr  |    |             |  | Cash book |       | Cr  |    |              |       |
|-----|----|-------------|--|-----------|-------|-----|----|--------------|-------|
|     |    |             |  | Cash      | Bank  |     |    |              |       |
|     |    |             |  | \$        | \$    |     |    |              |       |
| Oct | 1  | Balances    |  | 370       | 320   | Oct | 5  | Rent         | 1 450 |
|     | 8  | Sales       |  | 940       |       |     | 11 | Stationery   | 45    |
|     | 14 | Cash        |  |           | 1 100 |     | 14 | Bank         | 1 100 |
|     | 31 | Balance c/d |  |           | 140   |     | 21 | Bank charges | 110   |
|     |    |             |  |           |       |     | 31 | Balance c/d  | 165   |
|     |    |             |  | 1 310     | 1 560 |     |    |              |       |
| Nov | 1  | Balance b/d |  | 165       |       | Nov | 1  | Balance b/d  | 140   |

- 17** The purchases journal in the accounts of a food retailer is the book of prime entry for which of the following transactions?

- A Fittings purchased on credit
- B Goods for resale purchased for cash
- C Goods for resale purchased on credit
- D The purchase of stationery

- 18** Which of the following should **not** be entered in the general journal?

- A Correction of an error
- B Entries to open new books of account
- C The purchase of a non-current asset for cash
- D Transfer of wages to the income statement

- 21\*** Yasmin sold goods on credit to Bridge Stores with a list price of \$800. Yasmin allows her customers a trade discount of 25% and a cash discount of 5%.

What was the value of the sales invoice?

- A \$560
- B \$570
- C \$600
- D \$800

- 22\*** Khalid sold goods on credit to Omar, \$300. Omar settled the amount due to Khalid less a 5% cash discount.

Which entries record the settlement of the amount due in Khalid's books?

| Accounts debited |                   |       | Accounts credited |  |       |
|------------------|-------------------|-------|-------------------|--|-------|
| A                | bank              | \$285 | Omar              |  | \$300 |
|                  | discount allowed  | \$15  | Omar              |  | \$300 |
| B                | bank              | \$285 | bank              |  | \$285 |
|                  | discount received | \$15  | discount allowed  |  | \$15  |
| C                | Omar              | \$300 | bank              |  | \$285 |
| D                | Omar              | \$300 | discount received |  | \$15  |

- a** Name the source document that would have provided the information required for the entries on:
- i** 5 October
  - ii** 8 October
  - iii** 11 October
  - iv** 14 October
  - v** 21 October
- b** What do the balances of the cash book on 1 November mean?

**24** Vivian sells two types of surfboard: Excel and Supa. Recently she sold some surfboards to one of her regular customers, Peter Green.

- a** Complete the missing items (i to vii) (words or figures) in the following extract from the invoice that Vivian sent to Peter Green.

No. K488

INVOICE

| Quantity | Description      | Unit price<br>\$ | Total<br>\$    |
|----------|------------------|------------------|----------------|
| 6        | Excel surfboards | 320              | (i)            |
| (ii)     | Supa surfboards  | 380              | 1 900          |
| TOTAL    |                  |                  | (iii)          |
| Less 20% |                  | (iv)             | discount       |
|          |                  |                  | NET AMOUNT DUE |
|          |                  |                  | (v)            |
|          |                  |                  | (vi)           |

Terms: Payment within 30 days  
5% (vii) discount for settlement within 20 days

- b** Which book of prime entry will Vivian use to record this information?
- c** If Peter Green returns some of these surfboards, which document will Vivian need to send to Peter to show the amount to be deducted from the total due?

|    |   |  |  |  |
|----|---|--|--|--|
| v  | A petty cash voucher showed a payment for stationery      |  |  |  |
| vi | An invoice showed the purchase of a new till for shop use |  |  |  |

**25** Tony runs a general store. Complete the table below to show how the transactions listed should be recorded in this business's books of account.

|     | Transaction  | Book of prime entry | Account to be debited | Account to be credited |
|-----|--|---------------------|-----------------------|------------------------|
| i   | A cheque counterfoil showed the payment of rent  |                     |                       |                        |
| ii  | Bank statement showed the deduction of bank charges  |                     |                       |                        |
| iii | A paying-in slip counterfoil showed that a cheque from a customer, AZX & Co., was paid into the bank |                     |                       |                        |
| iv  | A credit note was received from a supplier, BTX Ltd  |                     |                       |                        |

**26** Robbie is a trainee accounts clerk at Preston Supplies. He has been asked to file a collection of source documents.

- a** Explain why source documents are important when preparing accounting records.
- b** Complete the following table to identify the source document that is appropriate for each transaction.

|     | Transaction  | Source document |
|-----|--|-----------------|
| i   | Some new office furniture was purchased on credit                                  |                 |
| ii  | Some goods were returned to a supplier   |                 |
| iii | Cash sales were paid into the bank   |                 |
| iv  | An employee was repaid the amount he had spent on travel on behalf of the business |                 |
| v   | Goods were sold on credit  |                 |

**27** Candy keeps a petty cash book for her employer. The monthly float is \$180. During July 2018 she recorded petty cash vouchers for expense payments totalling \$140 and the payment of the accounts of two trade payables totalling \$30.

- a** What is the name of the system for keeping petty cash that makes use of a float?
- b** How much should Candy receive to restore the float at the end of July 2018?
- c** Candy's employer will prepare an income statement for the month of July 2018. How will the information given about petty cash transactions affect the income statement?
- d** Candy's employer will also prepare a statement of financial position at 31 July 2018. What entry, if any, will result from the information about petty cash?

**28** Abdul is a wholesaler of electrical goods. Recently the following transactions occurred, all of which required entries in the general journal.

- The sale of some office furniture on credit to Tom Cheung for \$230
  - The purchase of a new delivery vehicle on credit from Bestride Motors for \$15 400
  - The transfer of general expenses for the year, \$3910, to the income statement
- a** Describe the purpose of the general journal in an accounting system.
  - b** Prepare journal entries to record each of the transactions.

**29** Paloma's accounting system includes a three-column cash book. On 30 June 2018 the cash book showed that she had cash in hand of \$124; a bank overdraft of \$4156; the discounts allowed column totalled \$339, and the discounts received column totalled \$271.

- a** How will this information be recorded in Paloma's statement of financial position at 30 June 2018?
- b** Explain why discount columns were totalled rather than balanced in a three-column cash book.
- c** Explain one reason why Paloma allows her credit customers a cash discount.
- d** What entries will be made in Paloma's nominal ledger for the information about discounts?



# Verification of accounting records

## What this unit is about

It is of great importance that a business's accounting records are accurate, otherwise the owner of the business will not have the right information on which to assess the business's performance. Inaccuracies could lead to poor decision making which would have an impact on the future performance of the business. Fortunately, there are some processes which can be used to check the accuracy of the books of account and these are the subject of this section.

**The trial balance** (syllabus reference 3.1) with which you are already familiar. You will recall that the trial balance's main function is to check the arithmetical accuracy of the double-entry records. In effect it checks that the total of debit entries matches the total of credit entries. In general as long as you have made a matching debit and credit entry your trial balance totals will agree.

**Correction of errors** (syllabus reference 3.2). However, in this section you will learn that there are six types of error that are not revealed by a trial balance. You will learn how to correct these errors and the procedures used where the totals of a trial balance do not agree. You will also learn how to deal with errors which have affected the calculation of profit and errors in a statement of financial position.

**Bank reconciliation** (syllabus reference 3.3). This process is used to ensure the bank columns of a cash book are up to date and contain correct information, using a bank statement to identify omissions and errors.

**Control accounts** (syllabus reference 3.4) provide a means of checking the arithmetical accuracy of the purchases ledger and the sales ledger.

All these processes are in common use and are of great assistance in alerting those responsible for the accounting records to inaccuracies. However, it is important to understand that each process has its limitations.

# Errors not revealed by the trial balance

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- identify three types of error not revealed by a trial balance
- make journal entries to correct these errors.

## DID YOU KNOW?

When errors are made in a set of accounts they should never be crossed out. This is because any attempt to cross out or alter figures could look as if someone was tampering with the accounting records. Instead, additional entries have to be made which have the effect of both cancelling any mistakes and recording the correct entries.

## Notes:

- 1 A trial balance would not have detected this error because there was a matching debit and credit entry (although the debit entry was actually in the wrong account).
- 2 By making a credit entry in K Rajah's account the incorrect entry is cancelled. The matching debit entry in M Rajiv's account records the correct entry.

There are six types of error that would not be revealed by a trial balance and these are described below. In each case you will see that:

- there is always a matching debit and credit entry (so the trial balance totals would agree)
- a journal entry is necessary to correct the error
- the accounts before and after the correction are shown.

## Error of commission

### Illustration 1 Correcting an **error of commission**

On 23 February a supplier, M Rajiv, was paid \$1100 by cheque in settlement of the amount due. The entries made were as follows.

| Dr |  | Cash book (bank columns) |    | Cr      |       |
|----|--|--------------------------|----|---------|-------|
|    |  | Feb                      | 23 | M Rajiv | 1 100 |

| Dr  |    | K Rajah account |       | Cr |  |
|-----|----|-----------------|-------|----|--|
| Feb | 23 | Bank            | 1 100 |    |  |

| GENERAL JOURNAL |    |  |  |       |       |
|-----------------|----|--|--|-------|-------|
| Feb             | 23 | M Rajiv  |  | \$    |       |
|                 |    | K Rajah  |  |       | \$    |
|                 |    | Correction of error of commission: payment incorrectly credited to M Rajiv's account instead of the account of K Rajah |  | 1 100 | 1 100 |

| Dr  |    | K Rajah account |       | Cr      |       |
|-----|----|-----------------|-------|---------|-------|
| Feb | 23 | Bank            | 1 100 | Feb     | 23    |
|     |    |                 |       | M Rajiv | 1 100 |

| Dr  |    | M Rajiv account |       | Cr |  |
|-----|----|-----------------|-------|----|--|
| Feb | 23 | K Rajah         | 1 100 |    |  |

## KEY TERMS

**Error of commission:** where a debit or credit entry is made in the wrong account of the correct type.

**Error of omission:** where a transaction is overlooked so that no debit and credit entry is made in the accounts.

## Error of omission

### Illustration 2 Correcting an **error of omission**

On 8 April a sales invoice was received from a customer Jarel Ltd for \$330. However, no entries were made for the invoice because it was misplaced. The invoice was found on 22 June.



| GENERAL JOURNAL                |    |  |           |               |
|--------------------------------|----|--|-----------|---------------|
| June                           | 22 | Jarel Ltd<br>Sales<br>Correction of error of omission of invoice number B372 | \$<br>330 | \$<br>330     |
| <b>Dr Jarel Ltd account Cr</b> |    |  |           |               |
| June                           | 22 | Sales  | 330       |               |
| <b>Dr Sales account Cr</b>     |    |  |           |               |
|                                |    | June   | 22        | Jarel Ltd 330 |

#### Notes:

- 1 You will notice that no attempt is made to correct the book of prime entry. This is because at this stage it is the accuracy of the ledger accounts that matters; the book of prime entry has served its purpose.
- 2 The correction puts in place the entries in the ledger accounts that should have been made when the sales invoice was originally received.

#### KEY TERMS

**Error of principle:** where a debit or credit entry is made for the correct amount but in the wrong class of account.

## Error of principle

### Illustration 3 Correcting an error of principle

On 17 August a cheque for \$490 was paid for repairs to machinery. The accounts clerk made the following entries for this transaction:  
Dr Machinery \$490; Cr Bank \$490.

Here is the journal entry to correct this error.

| GENERAL JOURNAL                |           |   |            |                           |
|--------------------------------|-----------|---|------------|---------------------------|
| Aug                            | 17        | Repairs<br>Machinery<br>Correction of error of principle: machinery repairs debited in error to the machinery account | \$<br>490  | \$<br>490                 |
| <b>Dr Machinery account Cr</b> |           |   |            |                           |
| Aug                            | 17        | Bank  | 490        | <b>Aug 17 Repairs 490</b> |
| <b>Dr Repairs account Cr</b>   |           |   |            |                           |
| <b>Aug</b>                     | <b>17</b> | <b>Machinery</b>  | <b>490</b> |                           |

#### Notes:

- 1 A trial balance would not have detected this error because there was matching debit and credit entry (although the debit entry was actually in the wrong class of account).
- 2 The journal entry cancels the incorrect entry by crediting the machinery account, and records the correct debit entry in the repairs account.

#### DID YOU KNOW?

It is easy to confuse an error of commission with an error of principle. An error of commission occurs when an entry is made in the *right type* of account (e.g. a mix up with the names of trade receivables, or a mix up with two expense accounts such as carriage inwards and carriage outwards). An error of principle occurs when an entry occurs in the *wrong class* of account (e.g. mixing up an asset with an expense, mixing up an item of income with a liability etc.).



# More errors not revealed by the trial balance

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- identify the three other types of error not revealed by a trial balance
- prepare journal entries to correct these errors.

## DID YOU KNOW?

It is worth noting that when an entry is made on the wrong side of an account, it always requires double the amount to put the error right. (See error of complete reversal on page 117.)

**Note:** the correction requires entries to be made for the difference in the amount (\$978 – \$798, i.e. \$180).

**Note:** a trial balance would not have detected this error because there was a matching debit and credit entry (although for the wrong amount).

## Error of original entry

### Illustration 4

### Correcting an **error of original entry**

On 27 January an invoice was sent to a customer, KT Evans, for \$978. The accounts clerk misread the figure as \$798. As a result the entry in the sales journal was for the wrong figure and the following double entry was made: Dr KT Evans \$798; Cr Sales \$798.

#### GENERAL JOURNAL

|     |    |   | \$  | \$  |
|-----|----|---|-----|-----|
| Jan | 27 | Trade receivable: KT Evans  | 180 |     |
|     |    | Sales   |     | 180 |
|     |    | Correction of error of original entry: recording a sales invoice for \$978 as \$798 |     |     |

Here are the ledger accounts recording the additional entries required to correct the error.

| Dr  |    | KT Evans account |     | Cr |
|-----|----|------------------|-----|----|
| Jan | 27 | Sales            | 798 |    |
|     | 27 | Sales            | 180 |    |

| Dr | Sales account |    |          | Cr  |
|----|---------------|----|----------|-----|
|    | Jan           | 27 | KT Evans | 798 |
|    |               | 27 | KT Evans | 180 |

## KEY TERMS

**Error of original entry:** when a mistake is made transferring an amount from a source document to a subsidiary book so both the debit entries and credit entries are incorrect.

**Compensating error:** where two or more errors of the same amount cancel each other out.

## Compensating error

### Illustration 5

### Correcting a **compensating error**

An accounts clerk made the following errors during September.

|      |    |  |
|------|----|--|
| Sept | 14 | The entries made for the payment of wages in cash of \$760 were: Dr Wages \$670; Cr Cash \$760   |
|      | 30 | The sales journal was incorrectly totalled. The correct total was \$5 390, but the accounts clerk entered \$5 300 in the sales journal and credited the sales account with \$5 300 as a result |

Here are the relevant ledger accounts showing the incorrect entries.

| Dr      | Wages account |     |  |  | Cr |
|---------|---------------|-----|--|--|----|
| Sept 14 | Sales         | 670 |  |  |    |

| Dr | Sales account |                |       |  | Cr |
|----|---------------|----------------|-------|--|----|
|    | Sept 30       | Sales day book | 5 300 |  |    |

The journal entry required to correct the errors is as follows.

| GENERAL JOURNAL |    |   |    |    |  |
|-----------------|----|---|----|----|--|
|                 |    |   | \$ | \$ |  |
| Sept            | 30 | Wages   | 90 |    |  |
|                 |    | Sales   |    | 90 |  |
|                 |    | Correction of compensating error: recording wages of \$760 as \$670 and the incorrect undercasting of the sales journal by \$90 |    |    |  |

Here are the ledger accounts showing the corrections to the errors:

| Dr      | Wages account |       |    |  | Cr |
|---------|---------------|-------|----|--|----|
| Sept 14 | Sales         | 670   |    |  |    |
|         | 30            | Sales | 90 |  |    |

| Dr | Sales account |                |       |    | Cr |
|----|---------------|----------------|-------|----|----|
|    | Sept 30       | Sales day book | 5 300 |    |    |
|    |               | 30             | Wages | 90 |    |

**Note:** there is no connection between the two mistakes. By chance the mistake in the wages account of \$90 is matched by a mistake in the sales account for the same amount.

## Error of complete reversal

### Illustration 6 Correcting an error of complete reversal

On 28 October the owner of a business withdrew a cheque for \$400 for private use. The accounts clerk made the following entries: Dr Bank \$400; Cr Drawings \$400. Here are the ledger accounts showing the errors made by the accounts clerk.

| Dr     | Cash book (bank columns) |     |  |  | Cr |
|--------|--------------------------|-----|--|--|----|
| Oct 28 | Drawings                 | 400 |  |  |    |

| Dr | Drawings account |      |     |  | Cr |
|----|------------------|------|-----|--|----|
|    | Oct 28           | Bank | 400 |  |    |

| GENERAL JOURNAL |    |  |     |     |  |
|-----------------|----|--|-----|-----|--|
|                 |    |  | \$  | \$  |  |
| Oct             | 28 | Drawings                                 | 800 |     |  |
|                 |    | Bank                                     |     | 800 |  |
|                 |    | Correction of error of complete reversal |     |     |  |

| Dr     | Cash book (bank columns) |     |        |          | Cr  |
|--------|--------------------------|-----|--------|----------|-----|
| Oct 28 | Drawings                 | 400 | Oct 28 | Drawings | 800 |

| Dr     | Drawings account |     |        |      | Cr  |
|--------|------------------|-----|--------|------|-----|
| Oct 28 | Bank             | 800 | Oct 28 | Bank | 400 |

### Notes:

- 1 A trial balance would not have detected this error because there was a matching debit and credit entry (although both of these entries were on the wrong sides of the two accounts involved).
- 2 The correction is for twice the amount of the original entry. This is because \$400 is required to cancel the errors, and a further \$400 is required to record the correct entries.

### KEY TERMS

**Error of complete reversal:** when the account that should have been debited is credited in error, and the account that should have been credited is debited in error.

You can now answer questions 1–4 on page 123.



# Errors that are revealed by the trial balance

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- explain the correct process to follow when trial balance totals do not agree
- prepare journal entries to include entries in a suspense account

## KEY TERMS

**Suspense account:** a temporary account used to make the totals of a trial balance agree.

**Note:** the entry in the suspense account is made on the same side as the entry in the trial balance – in this case on the debit side. (Like all entries in a trial balance, the column used matches where the balance appears in the ledger account.)

What is the correct procedure when trial balance totals do not agree? The answer is to temporarily add an extra amount to either the debit or credit column, as appropriate, to make the totals agree. This extra entry is labelled **suspense account**. At the same time it will be necessary to open a suspense account in the nominal ledger to record this amount.

### Illustration 7

### Procedure where trial balance totals do not agree

An accounts clerk found that the totals of a trial balance did not agree. The trial balance was as follows.

#### Trial balance at 31 August 2018

|                                  | Dr     | Cr     |
|----------------------------------|--------|--------|
|                                  | \$     | \$     |
| Total of ledger account balances | 38 400 | 38 800 |

Step 1: Make the trial balance totals agree by adding an extra amount – in this case this is \$400 and it needs to be added to the debit column.

#### Trial balance at 31 August 2018

|                                  | Dr         | Cr     |
|----------------------------------|------------|--------|
|                                  | \$         | \$     |
| Total of ledger account balances | 38 400     | 38 800 |
| <b>Suspense account</b>          | <b>400</b> |        |
|                                  | 38 800     | 38 800 |

The totals now agree.

Step 2: Open a suspense account in the nominal ledger to record this item.

| Dr             | Suspense account | Cr |
|----------------|------------------|----|
| Aug 31 Balance | 400              |    |

Once a suspense account is set up, it is necessary to check the accounts to find any situation where a debit entry has not been matched by a credit entry. As each of these errors is found a correction is made in the ledger account containing the error, and a matching entry (debit or credit as appropriate) is made in the suspense account. When all of the errors in matching the double entry have been found, the suspense account will close, because at that point a revised trial balance would show agreement of the totals. Errors not revealed in the trial balance (see 3.1 and 3.2 above) are not corrected through the suspense account as they do not cause the trial balance totals to disagree.



### Illustration 8

Correcting errors where the double entry does not match

Referring to the situation in Illustration 7, the following *three* errors were discovered where the double entry did not match. In each case the illustration shows the journal entry to correct the error and the ledger accounts once the journal entries have been posted.

**Error 1:** The payment of water charges by cheque, \$420 had been recorded as follows: Dr Water charges \$240; Cr Bank \$420.

The error is in the water charges account where the existing entry is for less than it should be (the bank account is correct).

#### GENERAL JOURNAL

|  |  |   |     |     |
|--|--|---|-----|-----|
|  |  |   | \$  | \$  |
|  |  | Water charges   | 180 |     |
|  |  | Suspense  |     | 180 |
|  |  | Correction of misposting of payment for water charges |     |     |

| Dr |  | Water charges account |            | Cr |
|----|--|-----------------------|------------|----|
|    |  | Bank                  | 240        |    |
|    |  | <b>Suspense</b>       | <b>180</b> |    |

| Dr  |    | Suspense account |     | Cr                       |
|-----|----|------------------|-----|--------------------------|
| Aug | 31 | Balance          | 400 |                          |
|     |    |                  |     | <b>Water charges</b> 180 |

**Error 2:** The total of the discounts allowed column in the cash book was **miscast**. The correct total should have been \$70, but the total given by the accounts clerk was \$90.

The error is in the discounts allowed account. The entries for discounts allowed in the accounts of credit customers are correct because the individual entries in the discounts allowed column are correct.

#### GENERAL JOURNAL

|  |  |   |    |    |
|--|--|---|----|----|
|  |  |   | \$ | \$ |
|  |  | Suspense  | 20 |    |
|  |  | Discounts allowed   |    | 20 |
|  |  | Correction of posting of miscast discounts allowed column |    |    |

| Dr |  | Discounts Allowed account |    | Cr                 |
|----|--|---------------------------|----|--------------------|
|    |  | Cash book                 | 90 |                    |
|    |  |                           |    | <b>Suspense</b> 20 |

| Dr  |    | Suspense account         |           | Cr                |
|-----|----|--------------------------|-----------|-------------------|
| Aug | 31 | Balance                  | 400       |                   |
|     |    | <b>Discounts allowed</b> | <b>20</b> |                   |
|     |    |                          |           | Water charges 180 |

#### Notes:

- 1 Correcting this error has reduced the balance on the suspense account, which now stands at \$220.
- 2 If a revised trial balance was prepared at this stage, the gap between the totals would be \$220.

#### Notes:

- 1 The correction of this error has increased the balance of the suspense account to \$240.
- 2 If a revised trial balance was prepared at this point, the gap between the totals would be \$240.

#### KEY TERMS

**Miscast:** incorrectly totalled. Undercast would mean that a total is too small; overcast would mean that a total is too large.

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### Notes:

- 1 The correction of this entry has left the suspense account with a nil balance.
- 2 When a revised trial balance is prepared after these corrections, the totals will agree.

### DID YOU KNOW?

It is often quite difficult to work out the right journal entries when faced with the description of an error. You may find it helpful to quickly draw up the accounts involved and record the error. You should then find it easier to visualise the entries required to correct the mistakes.

You can now try questions 5–10 on pages 123–124.

*Error 3:* Cash drawings of \$240 had been correctly entered in the cash book, but no entry had been made in the drawings account.

The error is in the drawings account (the cash book is correct).

## GENERAL JOURNAL

|  |  |   |     |     |
|--|--|---|-----|-----|
|  |  |   | \$  | \$  |
|  |  | Drawings  | 240 |     |
|  |  | Suspense  |     | 240 |
|  |  | Entries required to correct omission of entry from drawings account |     |     |

|    |                   |    |
|----|-------------------|----|
| Dr | Drawings account  | Cr |
|    | Suspense      240 |    |

| Dr  |    | Suspense account  |     | Cr              |            |
|-----|----|-------------------|-----|-----------------|------------|
| Aug | 31 | Balance           | 400 | Water charges   | 180        |
|     |    | Discounts allowed | 20  | <b>Drawings</b> | <b>240</b> |
|     |    |                   | 420 |                 | <b>420</b> |



# Correcting profits and statements of financial position

## Correcting draft profit figures

Errors are not always easily found and it can take some time to trace errors and correct them. As a result it is possible that a draft financial statement will be prepared which contains some incorrect information. When this happens, it is necessary to prepare a statement correcting the draft profit as soon as any errors are found. In these situations, care has to be taken to distinguish between errors that affect the calculation of profits and those which do not. In general, where items recorded in an income statement are incorrect the draft profit will also be incorrect, but errors in items that are not recorded in an income statement will have no effect on the draft profit.

### Illustration 9 Correction of a draft profit figure

Best Grocery Store's draft income statement for the year ended 31 December 2018 showed a draft profit of \$68 300. However, it was found that errors had been made in the accounts, some of which affected the calculation of the draft profit. The errors were as follows.

- 1 Insurance, \$500, had been omitted from the income statement.
- 2 Sales had been overstated by \$360.
- 3 Trade payables had been mistotalled at \$14 360 instead of \$15 360.
- 4 Rent, \$440, had been prepaid at the year end, but this had been overlooked when preparing the income statement.
- 5 Purchases returns of \$600 had been omitted.
- 6 Discount allowed, \$450, was added to the gross profit in the income statement rather than deducted.

Here is a detailed statement showing how the draft profit figure should be corrected.

#### Best Grocery Store Correction of draft profit for the year ended 31 December 2018

|                         | Increases to<br>draft profit | Decreases in<br>draft profit | Profit        |
|-------------------------|------------------------------|------------------------------|---------------|
|                         | \$                           | \$                           | \$            |
| <b>Draft profit</b>     |                              |                              | <b>68 300</b> |
| 1 Insurance             |                              | (500)                        |               |
| 2 Sales                 |                              | (360)                        |               |
| 3 Trade payables        | no effect                    | no effect                    |               |
| 4 Prepaid rent          | 440                          |                              |               |
| 5 Purchases returns     | 600                          |                              |               |
| 6 Discount allowed      |                              | (900)                        |               |
| <b>Totals</b>           | <b>1 040</b>                 | <b>(1 760)</b>               | <b>(720)</b>  |
| <b>Corrected profit</b> |                              |                              | <b>67 580</b> |

### LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- prepare statements to correct draft profits
- correct draft statements of financial position

### DID YOU KNOW?

Sometimes it needs careful thought to make the right correction to a draft profit figure. How would a mistake in returns outwards affect the profit calculation? The answer is not that easy to work out! So, it is suggested where there is a problem working out the answer, an experimental income statement is drawn up, so that the effect of correcting errors can be visualised and worked out.

Remember that if an item is placed on the 'wrong side' in the income statement, it will require a correction of double the amount to put things right.

### Notes:

- 1 It is good practice to present the corrections in a formal statement such as in the illustration. You will notice the proper title, the clear labelling of each item, and the fact that the statement starts with the draft figure and ends with the clearly labelled correct profit figure.
- 2 Item 5: The inclusion of purchases returns in the income statement will reduce purchases. This will lead to a larger gross profit and larger profit for the year.
- 3 Item 6: discount allowed was recorded on the wrong side of the income statement, so it is necessary to double the amount to correct the mistake.



## Correcting a draft statement of financial position

If there are undetected errors in a business's accounts they may affect not only the income statement but also the statement of financial position. When the totals of a draft statement of financial position do not agree it is possible to *make* the totals agree by making a temporary entry for a suspense account.

### Illustration 10 Correcting a draft statement of financial position

Here is a table showing how to correct some errors made by an inexperienced bookkeeper when preparing a statement of financial position. Assume the bookkeeper has made a suspense account entry of \$1600 in the assets section of the statement of financial position.

| Error  | How to correct the draft statement of financial position  |
|--|---|
| The balance of equipment account was understated by \$700                              | Increase the value of non-current assets (equipment) by \$700. The suspense account figure will reduce by \$700.    |
| No entries had been made to record a payment of \$500 to a credit supplier             | Reduce bank balance and trade payables by \$500. There will be no change in the suspense account figure.            |
| Drawings of \$17600 had been entered in the statement of financial position as \$16700 | Reduce the closing capital balance by \$900. The suspense account will reduce by \$900 (and will now be eliminated) |

You can now answer questions 11 and 12 on page 125.

You can now answer questions 13–23 on pages 125–128.

## DEVELOPING YOUR SKILLS

## 1 Identifying errors not revealed by a trial balance

The following errors were made by an accounts clerk during a recent financial year. In each case identify the type of error that has occurred.

|   | Error   | Type of error |
|---|---|---------------|
| 1 | An invoice received from a supplier for \$657 was recorded in the purchases journal as being for \$567  |               |
| 2 | A sales returns of \$89 from a trade receivable, S McNee, was credited to the account of S McKoy  |               |
| 3 | Cash sales of \$820 were recorded in the accounts as Dr Cash \$820 Cr Sales \$800. The total of the travel expenses analysis column in the petty cash book was mistotalled at \$30 rather than the correct figure of \$50 |               |
| 4 | A cheque counterfoil for rent \$680 was entirely overlooked   |               |
| 5 | The purchase of some new office equipment, \$2 300, was debited to the purchases account  |               |
| 6 | The entries made for the payment of a credit supplier, L Mohammed, by cheque \$320 were: Dr Bank \$320, Cr L Mohammed \$320   |               |

## 2 Identifying errors not revealed by a trial balance

The following errors were made by an accounts clerk during a recent financial year. In each case identify the type of error that has occurred.

|   | Error   | Type of error |
|---|---|---------------|
| 1 | A till roll showed that cash sales had totalled \$2 320. The entries in the accounts were Dr Cash \$2 230 and Cr Sales \$2 230                              |               |
| 2 | A petty cash voucher for stationery \$18 was mislaid  |               |
| 3 | Discounts allowed of \$28 were debited to the credit customer's account and credited to the discounts allowed account                                       |               |
| 4 | The payment of interest \$110 was debited to the insurance account  |               |
| 5 | The payment of vehicle running costs, \$80, was debited to the motor vehicles account   |               |
| 6 | The sales returns journal was mistotalled at \$170 instead of \$160. Rent received from a tenant of \$380 was entered in the rent received account as \$390 |               |

## 3 Correcting errors with journal entries

Referring to the errors listed in question 1, make journal entries to correct the errors.

## 4 Correcting errors with journal entries

Referring to the errors listed in question 2, make journal entries to correct the errors.

## 5 Correcting errors involving the suspense account

An accounts clerk was unable to get the totals of a trial balance to agree. The totals were Dr \$82 500, Cr \$81 100.

Subsequently, the following errors were discovered where there was a mismatch between the debit entry and credit entry.

Error 1: Cash sales of \$3640 had been correctly entered in the cash book, but had been credited to the sales account as \$3240.

Error 2: The total of the purchases journal, \$700, had not been posted to the ledger account.

Error 3: Rent received of \$1700 had been correctly entered in the cash book, but had not been posted to the rent received account.

- Prepare journal entries to correct these errors.
- Prepare the suspense account.

## 6 Correcting errors involving the suspense account

An accounts clerk was unable to get the totals of a trial balance to agree. The totals were Dr \$38 620, Cr \$38 420.

Subsequently, the following errors were discovered where there was a mismatch between the debit entry and credit entry.

Error 1: The total of the discounts received column in the cash book of \$720 had not been posted to the discounts received account.

Error 2: The sales returns journal had been undercast by \$90.

Error 3: The payment of wages in cash, \$980, had been correctly entered in the cash book, but had been posted to the debit of the wages account as \$750.

- Prepare journal entries to correct these errors.
- Prepare the suspense account.



**7 Correcting errors involving the suspense account where the difference in the trial balance totals is unknown**

The totals of a business's trial balance failed to agree. Subsequently the following errors were discovered.

Error 1: A cheque for \$360 received from a credit customer had been correctly entered in the cash book but posted to the credit customer's account as \$630.

Error 2: The total of the postage column in the petty cash book, \$70, had not been posted to the ledger account.

Error 3: The purchases returns journal had been undercast by \$380.

- a Prepare journal entries to correct these errors.
- b Prepare the suspense account and identify the original difference in the trial balance totals.

**8 Correcting errors involving the suspense account where the difference in the trial balance totals is unknown**

The totals of a business's trial balance failed to agree. Subsequently the following errors were discovered.

Error 1: The sales journal had been overcast by \$410.

Error 2: The payment of rent by cheque, \$730, had not been posted from the cash book.

Error 3: The total of the 'discounts allowed' column in the cash book of \$110 had been posted to the discounts allowed account as \$100.

- a Prepare journal entries to correct these errors.
- b Prepare the suspense account and identify the original difference in the trial balance totals.

**9 Correcting errors, some of which affect the suspense account**

When Janet Spencer prepared her business's trial balance on 31 October 2018 the totals failed to agree. The total of the debit column was \$178 440, whereas the total of the credit column was \$176 970.

The accounting records were checked and the following errors were discovered.

Error 1: Sales returns of \$370 had been credited to the account of Joseph Wright instead of Joshua Wright.

Error 2: The receipt of \$830 from a credit customer, T Patel, had been correctly entered in the cash book but had not been posted to the account of the credit customer.

Error 3: The total of the general expenses analysis column in the petty cash book, \$40, had not been posted to the nominal ledger.

Error 4: A cheque for \$780 in payment of the supplier, JK Samson, had been entered in the accounts as \$870.

Error 5: The total of the purchases returns journal, \$680, had not been posted to the purchases returns account.

Error 6: A payment by cheque for insurance, \$350, had been debited in the cash book and credited to the insurance account.

- a Identify whether or not each error would be revealed by the trial balance.
- b Prepare journal entries to correct the errors.
- c Prepare the suspense account.

**10 Correcting errors, some of which affect the suspense account**

The totals of a business's trial balance did not agree. The totals were: Dr \$423 890, Cr \$425 290. The following errors were found.

Error 1: The total of the discounts received column in the cash book had been overcast by \$300.

Error 2: A sale on credit to Steven Taylor, \$830, had not been posted from the sales journal to the customer's account.

Error 3: A cash receipt for stationery, \$40, had been mislaid and no entries had been made in the accounts.

Error 4: The total of the sales returns journal, \$470, had been posted to the sales returns account as \$740.

Error 5: The payment of water charges by cheque, \$340, had been correctly entered in the cash book, but had not been posted to the water charges account.

Error 6: The entries made for cash sales of \$690 were Dr Sales \$690, Cr Cash \$690.



- a Identify whether or not each error would be revealed by the trial balance.
- b Prepare journal entries to correct the errors.
- c Prepare the suspense account.

### 11\* Correcting a draft profit figure

Sharon Lee recently prepared the end-of-year income statement for her business. The income statement showed a draft profit of \$89 500 for the year ended 30 November 2018. However, the following errors in the accounting records were discovered.

Error 1: The purchases figure was understated by \$400 in the income statement.

Error 2: The loan account was incorrectly balanced. The balance brought down should have been \$11 500, not \$10 500.

Error 3: Carriage outwards, \$720, was recorded in the wrong section of the income statement.

Error 4: The expense, rent \$4700, was added to the gross profit rather than deducted.

Error 5: Sales returns \$3280 was overlooked when preparing the income statement.

Prepare a statement showing the effect of correcting these errors on the draft profit for the year ended 30 November 2018.

### 12\* Correcting a draft profit figure

The draft income statement for the year ended 30 September 2018 for Zero Stores showed a draft profit of \$132 850. However, the following errors were found in the accounting records.

Error 1: General expenses totalling \$2140 had been entirely omitted from the income statement.

Error 2: Sales had been overstated by \$710 when preparing the income statement.

Error 3: The balance of trade receivable account, \$1240, had been brought down as \$2140.

Error 4: Discounts received, \$480, had been added directly to sales in the income statement.

Error 5: Purchases returns were overstated by \$300 when preparing the income statement.

Prepare a statement showing the effect of correcting these errors on the draft profit for the year ended 30 September 2018.

### 13\* Correcting a draft statement of financial position

Monty produced the following draft statement of financial position at 31 December 2018.

|                     | \$       | \$      |
|---------------------|----------|---------|
| Non-current assets  |          | 400 000 |
| Current assets      |          |         |
| Trade receivables   | 18 000   |         |
| Cash at bank        | 7 000    |         |
|                     |          | 25 000  |
|                     |          | 425 000 |
| Capital             |          |         |
| Opening balance     | 362 000  |         |
| Add profit for year | 53 000   |         |
|                     | 415 000  |         |
| Less drawings       | (31 000) |         |
|                     |          | 384 000 |
| Current liabilities |          |         |
| Trade payables      |          | 18 000  |
| Suspense account    |          | 23 000  |
|                     |          | 425 000 |

Monty has made the following discoveries:

- Furniture \$4 000 had been counted twice when totalling non-current assets
- The balance of cash at bank should have been recorded as an overdraft
- The balance of the drawings account had been incorrectly calculated; it should have been \$26 000.

Prepare a correct statement of financial position at 31 December 2018.

#### 14 Correcting a draft statement of financial position

Amhari produced the following draft statement of financial position at 31 July 2018.

|                     | \$       | \$      |
|---------------------|----------|---------|
| Non-current assets  |          | 135 000 |
| Current assets      |          |         |
| Trade receivables   |          | 20 000  |
| Suspense account    |          | 3 000   |
|                     |          | 158 000 |
| Capital             |          |         |
| Opening balance     | 137 000  |         |
| Add profit for year | 24 000   |         |
|                     | 161 000  |         |
| Less drawings       | (20 000) |         |
|                     |          | 141 000 |
| Current liabilities |          |         |
| Trade payables      | 11 000   |         |
| Bank overdraft      | 6 000    |         |
|                     |          | 17 000  |
|                     |          | 158 000 |

Amhari discovered the following errors had been made in the accounting records:

- The total of trade receivables had been understated by \$5 000
- The payment of salaries by cheque \$1400 on 31 July 2018 had not been recorded in the accounts.
- A bank loan of \$2 000 (repayable 2021) had been overlooked.

Prepare a correct statement of financial position at 31 July 2018.

## PREPARING FOR THE EXAMINATION

(The following questions cover 3.1–3.4)

### MULTIPLE-CHOICE QUESTIONS

- 15** What is the purpose of a trial balance?
- A** To calculate the profit or loss
  - B** To check that all of the transactions have been included in the books of account
  - C** To check that there are no bookkeeping errors
  - D** To check the arithmetical accuracy of the double entry
- 16** Griffin posted \$650 to the debit of T Smith's account instead of to the debit of T Smythe's account. What is this mistake known as?
- A** A compensating error
  - B** An error of commission
  - C** An error of omission
  - D** An error of principle
- 17** Chen entered the purchase of a non-current asset in the purchases account. What is this mistake known as?
- A** An error of commission
  - B** An error of complete reversal
  - C** An error of original entry
  - D** An error of principle
- 18** A trial balance had the following totals: Dr \$82 600, Cr \$82 800. Which of the following errors could have caused this disagreement?
- A** A computer printer, cost \$200, purchased for office use had been debited to the purchases account
  - B** Drawings of \$200 had been completely omitted from the books
  - C** Telephone charges, \$200, had been debited to the stationery account
  - D** The sales returns journal had been overcast by \$200

- 19** Which of the following errors would affect the agreement of the totals of a trial balance?
- A** A credit note received from a supplier for \$300 was completely omitted from the books
  - B** A purchase invoice for \$670 was entered in the purchases journal as \$760
  - C** Owner's drawings of \$300 was debited to the bank account and credited to the drawings account
  - D** The total of the travel expenses column in the cash book was overcast by \$40
- 20** The purchase of goods for resale had been debited to the office equipment account by mistake. How would this error affect the business's end-of-year financial statements?

|          | Profit   |         | Non-current assets |         |
|----------|----------|---------|--------------------|---------|
|          | Too high | Too low | Too high           | Too low |
| <b>A</b> |          | ✓       |                    | ✓       |
| <b>B</b> |          | ✓       | ✓                  |         |
| <b>C</b> | ✓        |         | ✓                  |         |
| <b>D</b> | ✓        |         |                    | ✓       |

- 21** An amount of \$70 has been entered on the credit side of an account instead of the debit side. How will this error affect the totals of a trial balance?
- A** Debit total is \$70 less than credit total
  - B** Debit total is \$140 less than credit total
  - C** Debit total is \$70 more than credit total
  - D** Debit total is \$140 more than credit total
- 22** It was discovered that a discount of \$40 received had been debited to the trade payables account and debited to the discount received account. In order to correct this error which of the following entries were required?
- A** Debit discount received \$40  
Credit suspense account \$40
  - B** Debit discount received \$80  
Credit suspense account \$80
  - C** Debit suspense account \$40  
Credit discount received \$40
  - D** Debit suspense account \$80  
Credit discount received \$80



## OTHER QUESTIONS

**23\*** Nimesh entered a purchases invoice \$870 in the purchases journal as \$780. What is this mistake known as?

- a** a compensating error
- b** an error of commission
- c** an error of complete reversal
- d** an error of original entry

**24\*** An error was made when preparing a statement of financial position. The account of a credit supplier \$400 had been included in the total of trade receivables.

How will the correction of this error affect the difference in the totals of the statement of financial position.

- a** decrease \$400
- b** decrease \$800
- c** increase \$400
- d** increase \$800

**25** On 31 October 2018, Morag prepared her business's trial balance but found that the totals did not agree. The total of debit entries was \$92 340 and the total of credit entries was \$93 770. She found the following errors.

Error 1: Cash drawings of \$120 had been entirely omitted from the accounts.

Error 2: A payment by cheque for insurance, \$830, had been correctly entered in the bank account but no entry had been made in the insurance account.

Error 3: Cash purchases of \$300 had been correctly entered in the cash book but had been credited to the purchases account.

- a** Prepare journal entries to correct these errors.
- b** Prepare the suspense account.

Morag had used the trial balance as the basis for preparing a draft income statement for the year ended 31 October 2018. The draft income statement showed a profit for the year of \$16 380.

- c** Prepare a statement to show a correction of the draft profit of \$16 380.

**26\*** On 31 March 2018 Xing prepared a trial balance. However, the totals did not agree. She found the following errors.

Error 1: a sales invoice \$760 had been entered in the sales journal as \$670.

Error 2: the total of the discounts received column in the cash book, \$330, had not been posted to the nominal ledger.

Error 3: the entries made for a payment of wages in cash \$520 were Dr Cash \$520 Cr Wages \$520.

- a** Prepare journal entries to correct these errors.
- b** Prepare the suspense account. Show the original difference in the trial balance totals.

Xing had used the trial balance to prepare her business's income statement for the year ended 31 March 2018. The draft income statement showed a loss of \$4 220.

- c** Prepare a statement to show a correction of the draft loss of \$4 220.

# Bank reconciliation statements

## Introduction

In this chapter you will learn how to check that a business's record of its bank transactions as recorded in the cash book is accurate and up to date. The process involves comparing the bank columns in the business's cash book with the relevant **bank statement** issued by the business's bank.

First, it is important to understand how a bank statement works.

Banks keep computerised records of each customer's account using the running balance method.

It is very important to realise that from the bank's point of view each customer's account (assuming it has a positive balance) is a liability account. The reason for this is that any funds in an account do not belong to the bank; they belong to the customer. In effect the bank owes these funds to the customer; hence the balance is a liability. However, if the account becomes overdrawn, then the customer owes the bank the amount of the overdrawn balance, and at that point the account is one of the bank's assets. A bank statement is a copy of the bank's record of a customer's account which is sent to the customer at regular intervals – perhaps on a monthly basis – or on request.



Cash book bank balances and bank statement balances rarely agree

In this chapter you will learn how to prepare bank statements and about some of the facilities that banks provide for their customers.

When a business receives its bank statement, it is usual practice to check the bank statements against the bank account in the cash book. It is often the case that the two records are not identical. In this chapter you will learn why this is so and you will find out about the procedure used to make sure that the two records can be made to agree.

## LEARNING OBJECTIVES

When you have reached the end of Chapters 3.5, 3.6, 3.7 and 3.8 you will be able to:

- explain some terms used in bank statements
- prepare simple bank statements
- compare the cash book (bank columns) with the bank statement to identify differences
- update a cash book using information overlooked or not available until the bank statement was available
- prepare a statement reconciling the updated cash book balance with that shown on the bank statement
- prepare bank reconciliation statements when the bank balance is overdrawn
- explain the benefits of preparing bank reconciliation statements.

## KEY TERMS

**Bank statement:** a copy of a customer's bank account, sent to the customer at regular intervals.



# How to prepare a bank statement

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- explain some terms used in bank statements
- prepare simple bank statements

## Illustration 1 Preparing a bank statement

Here are some straightforward transactions that affect the current account of a business called Beachspray which banks with Anybank plc.

|       |    |  |
|-------|----|--|
| March | 1  | Balance at bank \$800  |
|       | 3  | Paid insurance \$360 (cheque number 303472)  |
|       | 5  | Paid telephone charges \$230 (payment made by direct debit)  |
|       | 11 | Drawings by cheque \$250 (cheque number 303473)  |
|       | 18 | Banked cash takings \$890  |
|       | 21 | Paid rent \$280 (payment made by standing order)   |
|       | 24 | One of business's trade receivables (M Lee) paid \$480 directly into Beachspray's account (using credit transfer facility) |
|       | 27 | Bank deducted charges of \$80  |

Here is the bank statement recording these details.

### ANYBANK plc

#### Bank statement for Beachspray

| Date  | Details                          | Dr  | Cr  | Balance \$ |    |
|-------|----------------------------------|-----|-----|------------|----|
|       |                                  | \$  | \$  |            |    |
| March | 1 Balance                        |     |     | 800        | Cr |
|       | 5 303472 General Assurance plc   | 360 |     | 440        | Cr |
|       | 5 DD Regional Telecoms plc       | 230 |     | 210        | Cr |
|       | 14 303473                        | 250 |     | 40         | Dr |
|       | 18 Cash and cheques              |     | 890 | 850        | Cr |
|       | 21 SO Landward Properties plc    | 280 |     | 570        | Cr |
|       | 24 Credit transfer – Michael Lee |     | 480 | 1 050      | Cr |
|       | 27 CHR                           | 80  |     | 970        | Cr |

### Notes:

- 1 A credit balance on a bank statement is a positive balance for the customer and is a liability for the bank. The balance is owed by the bank to the customer.
- 2 When the account has a negative balance it is described as Dr (an asset from the bank's point of view) – this is the balance owed by the customer to the bank. This is the situation on 14 March.
- 3 Additions to the balance are recorded in the credit column; deductions from the balance are recorded in the debit column.
- 4 Banks record information in the details column in a number of ways. For example:
  - a cheque numbers are identified
  - b 'CHR' is an abbreviation for charges.
- 5 DD, SO and Credit transfer are banking facilities and these are explained opposite.
- 6 Banks use a variety of descriptions and abbreviations. Those shown above are just a few examples of the entries that could be made.
- 7 The bank statement shows that on 27 March Beachspray has a positive balance of \$970 at the bank.



## Some specialist banking facilities explained

- **Direct debit:** a banking facility that enables the bank's customer to give the bank the authority to make payments for the customer to particular organisations who request payment. In the illustration, the bank's customer (Beachspray) has instructed the bank to pay its telephone charges automatically whenever the telephone company (Regional Telecoms plc) requests payment. Beachspray would set an upper limit to the amount that can be paid. Because the payment is made automatically by the bank, the customer may not be aware that the payment has happened until the bank statement is received. The abbreviation 'DD' has been used by Anybank plc to indicate a direct debit payment.
- **Standing order:** a banking facility that enables the bank's customer to give the bank the authority to make regular payments of an agreed amount to named organisations. In the illustration the bank has paid Beachspray's rent of \$280 to the company owning the property (Landward Properties plc). This payment will be made automatically by the bank, say every month, and the payment will always be \$280, until Beachspray changes its instructions to the bank. Again, it is quite likely that the bank's customer will overlook the standing order payment (because it is automatic) and the bank statement will act as a reminder. The abbreviation SO has been used by Anybank plc to indicate a standing order payment.
- **Credit transfer:** it is possible for a business's customers to pay the amount they owe directly into that business's bank account using a facility known as a credit transfer. In the illustration, one of Beachspray's customers (Michael Lee) has paid Beachspray \$480 by using this facility. Michael Lee has authorised his bank to make this payment. Michael Lee's bank has then made an automatic transfer of funds from Michael Lee's account to Beachspray's account held by Anybank plc. This automatic transfer of funds between banks is faster, more secure and generally more convenient for all concerned. The bank statement will act as a reminder that this credit transfer has occurred.
- **Bank charges:** at regular intervals banks charge their business customers for operating their current accounts (i.e. processing cheques, direct debits, standing orders, etc). Charges will include interest on any overdrawn balances. The bank's customer will not normally be aware of the amount of the charge until the bank statement is received.

### KEY TERMS

**Direct debit:** authority is given to a bank by one of its customers to make payments on its behalf to another organisation. The amount paid will be the sum requested by that organisation up to a specified limit.

**Standing order:** a bank's customer gives instructions for the automatic payment to another organisation of a fixed amount at regular intervals.

**Credit transfer:** the automatic transfer of funds into a business's bank account by one of the business's customers.

**Bank charges:** payments deducted automatically from a current account at regular intervals as a reward to the bank for operating the account.

### DID YOU KNOW?

The key difference between a direct debit and a standing order is that the amount can vary in the case of a direct debit (up to an agreed limit), but in the case of a standing order the amount is always the same.

### DID YOU KNOW?

Credit transfers are also sometimes referred to as BACS transfers. BACS stands for 'Bankers Automated Clearing Services'. It is also becoming common to use telephone and online banking to arrange payments.

You can now answer questions 1 and 2 on page 137.

# Comparing a cash book (bank columns) with a bank statement

There are several reasons why a business's cash book (bank columns) will not exactly match the detail shown in a bank statement for the same period.

## Timing differences affecting the bank statement

It takes time for banks to process transactions. As a result some cheques paid by the business towards the end of the period may not appear on the bank statement. It is possible, of course, that a recipient of a cheque may have taken some time to pay the cheque into their own current account, adding to the delay. Cheque payments made by a business which do not appear on a bank statement are called **unpresented cheques**. These cheques are very likely to appear on the next bank statement unless the recipient loses the cheque or fails to pay the cheque into their bank account.

In the same way, money paid into the bank by a business may not appear on the bank statement for a few days while the transaction is processed by the bank. So details on paying-in slips completed towards the end of a month may be missing from the bank statement. Money paid into a current account but which has not yet appeared on the bank statement is referred to as **uncredited deposits**. These amounts will appear on the next month's bank statement.

### KEY TERMS

**Unpresented cheques:** cheques that have not been cleared by the bank and have not yet been recorded on a business's bank statement.

**Uncredited deposits:** amounts paid into a business's bank statement but which have not yet been recorded on the bank statement as credit entries.

## Information missing from the cash book

Although the cash book will have been prepared with great care, it may be that some details will be missing because of an oversight by the business's cashier or because the information was not available until the bank statement arrived. Here are some common examples:

- **Oversights:** automatic payments made by the bank that have been overlooked (standing order and direct debit payments perhaps); receipts from customers made by credit transfer, or interest added to the account by the bank.
- **Information not available:** bank charges and/or bank interest charges will not be known to the cashier until the bank statement arrives.

### Illustration 2

#### Comparing a cash book record with a bank statement

In Illustration 1 Beachspray's bank statement for March 2018 was prepared. Opposite is an extract from Beachspray's cash book for the same month showing the bank columns.



**BOOKS OF BEACHSPRAY**  
**Cash book (bank columns only)**

| Dr    |    |                |              | Cr    |    |                                  |              |
|-------|----|----------------|--------------|-------|----|----------------------------------|--------------|
| March | 1  | Balance        | 800          | March | 3  | Insurance<br>(chq 303472)        | 360          |
|       | 16 | Sales          | 890          |       | 11 | Drawings<br>(chq 303473)         | 250          |
|       | 27 | Sales          | 750          |       | 19 | P Joseph<br>(chq 303474)         | 440          |
|       |    |                |              |       | 27 | Water<br>charges<br>(chq 303475) | 220          |
|       |    |                |              |       | 31 | Balance c/d                      | 1 170        |
|       |    |                | <u>2 440</u> |       |    |                                  | <u>2 440</u> |
| April | 1  | Balance<br>b/d | 1 170        |       |    |                                  |              |

Just a glance at this cash book shows that there are differences with the bank statement. The most obvious point is that the closing balances shown in the two documents are different: the cash book balance is \$1 170, but the bank statement shows a balance of \$970 (both positive).

It is important to use a systematic way to find all of the possible reasons for a difference, particularly as, in reality, a business's cash book and the matching bank statement may be many pages long.

The technique to use is to match every item that appears in *both* documents and place a tick (✓) beside the entry in each document. Always start by checking whether the opening balances agree and then work systematically through the documents.

Here are the two statements showing ticked entries.

**BOOKS OF BEACHSPRAY**  
**Cash book (bank columns only)**

| Dr    |    |             |              | Cr    |    |                            |              |
|-------|----|-------------|--------------|-------|----|----------------------------|--------------|
| March | 1  | Balance     | ✓800         | March | 3  | Insurance (chq 303472)     | ✓360         |
|       | 16 | Sales       | ✓890         |       | 11 | Drawings (chq 303473)      | ✓250         |
|       | 27 | Sales       | 750          |       | 19 | P Joseph (chq 303474)      | 440          |
|       |    |             |              |       | 27 | Water charges (chq 303475) | 220          |
|       |    |             |              |       | 31 | Balance c/d                | 1 170        |
|       |    |             | <u>2 440</u> |       |    |                            | <u>2 440</u> |
| April | 1  | Balance b/d | 1 170        |       |    |                            |              |

Here is a reminder of the bank statement for this month.

**ANYBANK plc**

**Bank statement for Beachspray**

| Date  | Details | Dr                            | Cr   | Balance |          |
|-------|---------|-------------------------------|------|---------|----------|
|       |         | \$                            | \$   | \$      |          |
| March | 1       | Balance                       |      | ✓800    | Cr       |
|       | 5       | 303472 General Assurance plc  | ✓360 | 440     | Cr       |
|       | 5       | DD Regional Telecoms plc      | 230  | 210     | Cr       |
|       | 14      | 303473                        | ✓250 | 40      | Dr       |
|       | 18      | Cash and cheques              |      | ✓890    | 850 Cr   |
|       | 21      | SO Landward Properties plc    | 280  | 570     | Cr       |
|       | 24      | Credit transfer – Michael Lee |      | 480     | 1 050 Cr |
|       | 27      | CHR                           | 80   | 970     | Cr       |

Items that are not ticked will have caused the two closing balances to be different. The unticked items will have arisen for the reasons described above. Here is a summary of the unticked items.

Timing differences:

- Unpresented cheques (cheques not shown on the bank statement): P Joseph, \$440; Water charges \$220.
- Uncredited deposits (amounts paid in not shown on bank statement): \$750.

Oversights by, or information not available to, Beachspray staff:

- Direct debit for \$230; standing order for \$280; credit transfer for \$480; bank charges \$80.

You can now answer questions 3 and 4 on page 138.



# The reconciliation process

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- prepare bank reconciliation statements when the bank balance is overdrawn
- explain the benefits of preparing bank reconciliation statements.

## Updating the cash book

The next step is to correct those oversights in the cash book that have become apparent from looking at the bank statement and to use any information on the bank statement that was not previously available. So, additional entries are made in the cash book and a new, up-to-date balance is extracted.

### Illustration 3 Updating the cash book

Here is an updated version of the cash book starting with the balance that had been brought down on 1 April.

| BOOKS OF BEACHSPRAY           |   |             |              |       |   |                        |              |
|-------------------------------|---|-------------|--------------|-------|---|------------------------|--------------|
| Cash book (bank columns only) |   |             |              |       |   |                        |              |
| Dr                            |   |             |              | Cr    |   |                        |              |
| April                         | 1 | Balance b/d | 1 170        | April | 1 | Telephone charges (DD) | 230          |
|                               | 1 | Michael Lee | 480          |       | 1 | Rent (SO)              | 280          |
|                               |   |             |              |       | 1 | Bank charges           | 80           |
|                               |   |             |              |       | 1 | Balance c/d            | 1 060        |
|                               |   |             | <u>1 650</u> |       |   |                        | <u>1 650</u> |
| April                         | 1 | Balance b/d | 1 060        |       |   |                        |              |

At the same time the double entry would be recorded in the ledger accounts in the usual way.

You can now answer questions 5 and 6 on page 138.

## KEY TERMS

**Bank reconciliation statement:** a document prepared by businesses at regular intervals (say monthly) to check that their bank records agree with those provided by the bank.

## DID YOU KNOW?

The word 'reconcile' – as used in 'bank reconciliation statement' – means to make two apparently conflicting things (the cash book balance and the bank statement balance) consistent with each other.

## Completing the process: the bank reconciliation statement

Having updated the cash book, the business's accounts team will want to know if the bank statement balance would agree with the updated cash book if the bank statement was brought up to date. To do this they will prepare a **bank reconciliation statement**. This statement makes use of the list of timing differences discovered when comparing the cash book and the bank statement. When this has been done the two balances should agree. However, if the balances do not agree it means that somewhere there is an error – or errors. (The errors could be in the business's accounting records, but they could be in the bank's record keeping. Banks do sometimes make mistakes!)

#### Illustration 4 Preparing a bank reconciliation statement

Here is one version of the statement that begins with the bank statement balance.

| BEACHSPRAY<br>Bank reconciliation statement at 1 April 2018 |     |       |
|---|-----|-------|
|   | \$  | \$    |
| Balance as per <b>bank statement</b>                        |     | 970   |
| Less: unrepresented cheque                                  |     |       |
| P Joseph (303474)   | 440 |       |
| Water charges (303475)                                      | 220 |       |
|   |     | (660) |
|   |     | 310   |
| Add: uncredited deposits                                    |     | 750   |
| Balance as per <b>cash book</b>                             |     | 1 060 |

Alternatively, some individuals prefer to start the bank reconciliation statement with the updated cash book balance.

| BEACHSPRAY<br>Bank reconciliation statement at 1 April 2018 |     |       |
|---|-----|-------|
|   | \$  | \$    |
| Balance as per <b>cash book</b>                             |     | 1 060 |
| Add: unrepresented cheque                                   |     |       |
| P Joseph (303474)   | 440 |       |
| Water charges (303475)                                      | 220 |       |
|   |     | 660   |
|   |     | 1 720 |
| Less: uncredited deposits                                   |     | (750) |
| Balance as per <b>bank statement</b>                        |     | 970   |

#### Notes:

- 1 In this alternative approach, the reconciliation statement starts with the updated cash book balance.
- 2 The process is now as follows:
  - a Unrepresented cheques: if these had not been issued, the cash book balance would have been higher – so the unrepresented cheques are added back.
  - b Uncredited deposit: if this was removed from the cash book the balance would be lower – so the item is deducted.

#### Notes:

- 1 When the timing differences are taken into account, the reconciliation statement shows that the bank statement balance and the updated cash book balance would agree. So, all appears to be well.
- 2 In this version, which starts with the bank statement balance, the thinking process is:
  - a Unrepresented cheques: when these are included in the bank statement, the balance will decrease – hence they are deducted.
  - b Uncredited deposits: when this item is included in the bank statement, the balance will increase – hence the amount is added.
- 3 It is useful to list all of the unrepresented cheques with their numbers (as shown above) because this will help to trace them when the next bank statement arrives.

You can now answer questions 7–20 on pages 139–142.

You can now answer questions  
11 and 12 on pages 141–142.

## What about overdrawn balances?

Sometimes the reconciliation process will take place when the cash book balance or the bank statement balance (or both) are overdrawn. Where this happens, follow the same processes as described above, but remember that an overdrawn figure should be recorded as a negative, with a reverse consequence for any arithmetical process.

## Advantages of the reconciliation process

The main benefits:

- The process checks that if the cash book and bank statement are different, the difference is caused by timing differences rather than errors.
- The process enables a business's cashier to make sure that the cash book is fully updated at monthly intervals by including transactions undertaken automatically by the bank.
- Because there are frequent checks on this important business financial record, it helps to reduce the risk of fraud taking place.

You can now answer questions  
13–20 on pages 142–144.



## DEVELOPING YOUR SKILLS

## 1 Preparing a bank statement

Natalie Clarke is the owner of Natalie's Jewellery Store. Her business banks with Anybank plc. The following information is available about the business's current account for the month of May 2018.

| Date | Transaction details  | Amount<br>\$ |
|------|--|--------------|
| May  | 1 Balance of cash at bank (positive)   | 1 400        |
|      | 4 Payment of general expenses by cheque (number 27204)                           | 320          |
|      | 8 Bank made direct debit payment for electricity charges to Interstate Power plc | 670          |
|      | 12 Payment to supplier, Latoya Fray, by cheque (number 27205)                    | 820          |
|      | 15 Cash takings were paid into the bank account                                  | 1 780        |
|      | 20 Bank made standing order payment for rent to Ford Holdings plc                | 480          |
|      | 24 Credit transfer of funds from customer, Smartjewels Ltd                       | 950          |
|      | 29 Bank charges were deducted  | 110          |

Use these details to prepare Natalie's Jewellery Store's bank statement for May 2018. Use the running balance style of presentation and use appropriate terms and abbreviations in the details column of the bank statement.

## 2 Preparing a bank statement

The following details are available concerning the current account of the business owned by Tahir, called Tahir's Sports Supplies. The information is for July 2018.

| Date | Transaction details  | Amount<br>\$ |
|------|--|--------------|
| July | 1 Balance of cash at bank (positive)   | 930          |
|      | 6 Payment to supplier, TMT Ltd, by cheque (number 787891)                      | 640          |
|      | 11 Drawings made by cheque (number 787892)                                     | 310          |
|      | 12 Bank made standing order payment for loan repayment to Quality Finances plc | 450          |
|      | 17 Cash takings were paid into the bank account                                | 1 370        |
|      | 19 Credit transfer of funds from customer, Nana Retail                         | 590          |
|      | 23 Bank made direct debit payment for telephone charges to Telecoms plc        | 220          |
|      | 28 Bank charges were deducted  | 140          |

Use these details to prepare the Tahir's Sports Supplies bank statement for July 2018. Use the running balance style of presentation and use appropriate terms and abbreviations in the details column of the bank statement.

### 3 Comparing a cash book with a bank statement

Referring to the situation in question 1, here is the cash book (bank columns only) record for Natalie's Jewellery Store as maintained by Natalie's cashier for May 2018.

#### BOOKS OF NATALIE'S JEWELLERY STORE

##### Cash book (bank columns only)

| Dr   |    |             |              | Cr  |    |                              |              |
|------|----|-------------|--------------|-----|----|------------------------------|--------------|
| May  | 1  | Balance     | 1 400        | May | 2  | General expenses (chq 27204) | 320          |
|      | 13 | Sales       | 1 780        |     | 9  | Latoya Fray (chq 27205)      | 820          |
|      | 28 | Sales       | 1 240        |     | 23 | Supagems (chq 27206)         | 740          |
|      |    |             |              |     | 28 | Drawings (chq 27207)         | 480          |
|      |    |             |              |     | 31 | Balance c/d                  | 2 060        |
|      |    |             | <u>4 420</u> |     |    |                              | <u>4 420</u> |
| June | 1  | Balance b/d | 2 060        |     |    |                              |              |

Compare this cash book with the bank statement prepared in answer to question 1. Place ticks alongside entries that appear in both documents (include a check on whether the opening balances matched). Identify and list any items that are not ticked.

### 4 Comparing a cash book with a bank statement

Referring to the situation in question 2, here is the cash book (bank columns only) record for Tahir's Sports Supplies as maintained by Tahir's cashier for July 2018.

#### BOOKS OF TAHIR'S SPORT SUPPLIES

##### Cash book (bank columns only)

| Dr   |    |             |              | Cr   |    |                         |              |
|------|----|-------------|--------------|------|----|-------------------------|--------------|
| July | 1  | Balance     | 930          | July | 3  | TMT Ltd (chq 787891)    | 640          |
|      | 13 | Sales       | 1 370        |      | 8  | Drawings (chq 787892)   | 310          |
|      | 29 | Sales       | 990          |      | 20 | Stationery (chq 787893) | 100          |
|      |    |             |              |      | 29 | Salary (chq 787894)     | 1 700        |
|      |    |             |              |      | 31 | Balance c/d             | 540          |
|      |    |             | <u>3 290</u> |      |    |                         | <u>3 290</u> |
| Aug  | 1  | Balance b/d | 540          |      |    |                         |              |

Compare this cash book with the bank statement prepared in answer to question 2. Place ticks alongside entries that appear in both documents (include a check on whether the opening balances matched). Identify and list any items that are not ticked.

### 5 Updating a cash book

Referring to the information in questions 1 and 3, update the cash book balance of \$2060 for Natalie's Jewellery Store.

### 6 Updating a cash book

Referring to the information in questions 2 and 4, update the cash book balance of \$540 for Tahir's Sports Supplies.

## 7 Preparing a bank reconciliation statement

Referring to all of the information available for Natalie's Jewellery Store in questions 1, 3 and 5, prepare a bank reconciliation statement dated 1 June 2018.

## 8 Preparing a bank reconciliation statement

Referring to all of the information available for Tahir's Sports Supplies in questions 2, 4 and 6, prepare a bank reconciliation statement dated 1 August 2018.

## 9 The complete process

On 1 November 2018, the following bank statement covering October was received by the head of the accounts team at Vecki Wholesale Flowers.

| MIDBAY BANK plc                            |                                |       |       |         |    |
|--|--------------------------------|-------|-------|---------|----|
| Bank statement for Vecki wholesale flowers |                                |       |       |         |    |
| Date                                       | Details                        | Dr    | Cr    | Balance |    |
|  |                                | \$    | \$    | \$      |    |
| Oct  | 1 Balance                      |       |       | 4 310   | Cr |
|  | 3 447802 JKJ Imports           | 2 730 |       | 1 580   | Cr |
|  | 11 Cash and cheques            |       | 1 640 | 3 220   | Cr |
|  | 13 CHR                         | 240   |       | 2 980   | Cr |
|  | 18 447804                      | 630   |       | 2 350   | Cr |
|  | 21 DD Regional Telecoms plc    | 550   |       | 1 800   | Cr |
|  | 23 Cash and cheques            |       | 1 890 | 3 690   | Cr |
|  | 25 Credit transfer: M Deosaran |       | 490   | 4 180   | Cr |
|  | 26 447805 Gobin Traders        | 1 480 |       | 2 700   | Cr |
|  | 27 SO Transcity Properties     | 820   |       | 1 880   | Cr |
|  | 28 Interest                    |       | 50    | 1 930   | Cr |

The business's cash book (bank columns) for the same month was as follows.

| BOOKS OF VECKI WHOLESALE FLOWERS |    |             |             |     |    |                |                      |
|----------------------------------|----|-------------|-------------|-----|----|----------------|----------------------|
| Cash book (bank columns only)    |    |             |             |     |    |                |                      |
| Dr                               |    |             |             | Cr  |    |                |                      |
| Oct                              | 1  | Balance     | 4 310       | Oct | 1  | JKJ Imports    | (chq 447802) 2 730   |
|                                  | 7  | Sales       | 1 640       |     | 3  | Electricity    | (chq 447803) 490     |
|                                  | 20 | Sales       | 1 150       |     | 12 | Admin expenses | (chq 447804) 630     |
|                                  | 20 | M Lall      | 740         |     | 23 | Gobin Traders  | (chq 447805) 1 480   |
|                                  | 28 | Sales       | 1 370       |     | 26 | L Thomas       | (chq 447806) 810     |
|                                  |    |             |             |     | 27 | Rent           | (standing order) 820 |
|                                  |    |             |             |     | 31 | Balance        | c/d 2 250            |
|                                  |    |             | <hr/> 9 210 |     |    |                | <hr/> 9 210          |
| Nov                              | 1  | Balance b/d | 2 250       |     |    |                |                      |

**a** Compare the two records.

**b** Tick all items that appear in both documents.



- c Update the cash book balance at 1 November 2018.
- d Prepare a bank reconciliation statement dated 1 November 2018.

#### 10 The complete process

On 1 June 2018, the following bank statement covering May was received by the accounts department of the business called Elite Publishing.

**WESTOWN BANK plc**  
**Bank statement for Elite publishing**

| Date  | Details                              | Dr    | Cr    | Balance |    |
|-------|--------------------------------------|-------|-------|---------|----|
|       |                                      | \$    | \$    | \$      |    |
| May 1 | Balance                              |       |       | 7 328   | Cr |
| 5     | Cash and cheques                     |       | 3 395 | 10 723  | Cr |
| 6     | 110744 MLD Books                     | 2 242 |       | 8 481   | Cr |
| 8     | 110747 Abbey Stationery Ltd          | 1 631 |       | 6 850   | Cr |
| 14    | Credit transfer: investment interest |       | 480   | 7 330   | Cr |
| 17    | DD Hydro water                       | 722   |       | 6 608   | Cr |
| 19    | 110746 Circle Wholesales             | 1 039 |       | 5 569   | Cr |
| 20    | Cash and cheques                     |       | 4 437 | 10 006  | Cr |
| 22    | CHR                                  | 330   |       | 9 676   | Cr |
| 29    | SO Publishers Society membership     | 350   |       | 9 326   | Cr |
| 30    | Interest                             |       | 90    | 9 416   | Cr |

The business's cash book (bank columns) for the same month was as follows.

**BOOKS OF ELITE PUBLISHING**  
**CASH BOOK (Bank columns only)**

| Dr   |    |                |               | Cr  |    |                                   |               |
|------|----|----------------|---------------|-----|----|-----------------------------------|---------------|
| May  | 1  | Balance        | 7 328         | May | 2  | MLD Books (chq 110744)            | 2 242         |
|      | 2  | Sales          | 2 595         |     | 3  | Palmleaf Stores (chq 110745)      | 1 833         |
|      | 2  | Dass Books Ltd | 800           |     | 3  | Circle Wholesales (chq 110746)    | 1 039         |
|      | 18 | Sales          | 4 437         |     | 5  | Abbey Stationery Ltd (chq 110747) | 1 631         |
|      | 27 | Sales          | 3 375         |     | 18 | General expenses (chq 110748)     | 538           |
|      |    |                |               |     | 31 | Balance c/d                       | 11 252        |
|      |    |                | <u>18 535</u> |     |    |                                   | <u>18 535</u> |
| June | 1  | Balance b/d    | 11 252        |     |    |                                   |               |

- a Compare the two records.
- b Tick all items that appear in both documents.
- c Update the cash book balance at 1 June 2018.
- d Prepare a bank reconciliation statement dated 1 June 2018.

**11 The bank reconciliation process when there is an overdrawn bank balance**

Mara Black, the owner of Best Value Carpets, has made the following records available for her business.

| CITYCHOICE BANK plc                   |                              |       |       |         |    |
|---------------------------------------|------------------------------|-------|-------|---------|----|
| Bank statement for Best Value Carpets |                              |       |       |         |    |
| Date                                  | Details                      | Dr    | Cr    | Balance |    |
|                                       |                              | \$    | \$    | \$      |    |
| April 1                               | Balance                      |       |       | 4 500   | Dr |
| 5                                     | 800602 Mungroo Wholesale Ltd | 2 300 |       | 6 800   | Dr |
| 8                                     | Cash and cheques             |       | 4 700 | 2 100   | Dr |
| 14                                    | DD Eastern Electricity Ltd   | 800   |       | 2 900   | Dr |
| 18                                    | 800605 Taylor Textiles       | 1 400 |       | 4 300   | Dr |
| 28                                    | CHR                          | 500   |       | 4 800   | Dr |

The business's cash book (bank columns) for the same month was as follows.

| BOOKS OF BEST VALUE CARPETS   |             |              |         |                                    |              |
|-------------------------------|-------------|--------------|---------|------------------------------------|--------------|
| Cash book (bank columns only) |             |              |         |                                    |              |
| Dr                            |             |              | Cr      |                                    |              |
| April 3                       | Sales       | 4 700        | April 1 | Balance                            | 4 500        |
| 28                            | Sales       | 4 200        | 2       | Mungroo Wholesale Ltd (chq 800602) | 2 300        |
| 30                            | Balance c/d | 400          | 7       | Drawings (chq 800603)              | 400          |
|                               |             |              | 12      | Rent (chq 800604)                  | 700          |
|                               |             |              | 13      | Taylor Textiles (chq 800605)       | 1 400        |
|                               |             | <u>9 300</u> |         |                                    | <u>9 300</u> |
|                               |             |              | May 1   | Balance b/d                        | 400          |

- Update the cash book balance at 1 May 2018.
- Prepare a bank reconciliation statement dated 1 May 2018.

## 12 The bank reconciliation process when there is an overdrawn bank balance

The bank statement and cash book (bank columns) for June 2018 have been made available by John Stevens, the owner of Cycle Stores.

### SECURE BANK plc Bank statement for Cycle Stores

| Date   | Details                             | Dr    | Cr    | Balance |    |
|--------|-------------------------------------|-------|-------|---------|----|
|        |                                     | \$    | \$    | \$      |    |
| June 1 | Balance                             |       |       | 4 233   | Dr |
| 6      | Credit transfer: Cycle World Retail |       | 1 220 | 3 013   | Dr |
| 9      | 374112 Lakeford Ltd                 | 1 885 |       | 4 898   | Dr |
| 11     | DD Regional Power Supplies plc      | 478   |       | 5 376   | Dr |
| 16     | CHR                                 | 612   |       | 5 988   | Dr |
| 17     | 374116                              | 675   |       | 6 663   | Dr |
| 21     | Cash and cheques                    |       | 2 083 | 4 580   | Dr |
| 26     | 374113                              | 417   |       | 4 997   | Dr |
| 28     | SO Best Properties plc              | 840   |       | 5 837   | Dr |

The business's cash book (bank columns) for the same month was as follows.

### BOOKS OF CYCLE STORES Cash book (bank columns only)

| Dr   |    |             |       | Cr   |    |                        |                   |
|------|----|-------------|-------|------|----|------------------------|-------------------|
| June | 17 | Sales       | 2 083 | June | 1  | Balance                | 4 233             |
|      | 29 | Sales       | 4 114 |      | 3  | Lakeford Ltd           | (chq 37412) 1 885 |
|      | 30 | Balance c/d | 3 183 |      | 8  | General expenses       | (chq 37413) 417   |
|      |    |             |       |      | 9  | Water charges          | (chq 37414) 630   |
|      |    |             |       |      | 12 | Castle Furnishings plc | (chq 37415) 592   |
|      |    |             |       |      | 13 | Drawings               | (chq 37416) 675   |
|      |    |             |       |      | 24 | Lakeford Ltd           | (chq 37417) 948   |
|      |    |             | 9 380 |      |    |                        | 9 380             |
|      |    |             |       | July | 1  | Balance                | b/d 3 183         |

- Update the cash book balance at 1 July 2018.
- Prepare a bank reconciliation statement dated 1 July 2018.
- Explain why John Stevens' business benefits from the monthly preparation of bank reconciliation statements.

## 13 Working from a list of items – bank statement balance not stated

On 30 November 2018 the cashier at Eton Ltd discovered that the balance at bank as shown in the business's cash book did not agree with the balance shown on the bank statement. The balance shown in the cash book was \$7432 (debit).

A comparison of the two records produced the following information:

- The bank had not yet recorded the total of cash and cheques, \$1733, paid in on 29 November.
- A direct debit payment of \$871 for electricity charges had been omitted from the cash book.



- Two cheques had not yet been presented for payment: T Pulchan \$775 and KT Singh \$903.
  - No record had been made in the cash book of bank charges, \$261, deducted from the Elton Ltd's account or interest of \$50 which had been added to the account.
- a** Update Eton Ltd's cash book balance on 30 November 2018.
- b** Prepare a bank reconciliation statement dated 30 November 2018 that shows the original balance shown on the bank statement received on this date.

#### 14 Working from a list of items – bank statement balance not stated

On 31 July 2018, Sophia Thomas received a bank statement for her business that showed a closing balance which differed from that recorded in her cash book. On this date the cash book balance was overdrawn by \$885.

The following discrepancies between the two records were found:

- Bank charges of \$96 had been omitted from the cash book.
  - A cheque sent to a supplier, H Khan, for \$947, did not appear on the bank statement.
  - The bank statement showed a credit transfer of \$1040 from a customer, Excel Products Ltd, which had not been recorded in the cash book.
  - The bank had yet to record cash sales of \$2108 paid in on 29 July 2018.
  - A standing order payment of \$481 for insurance premiums had not yet been recorded in the cash book.
- a** Update Sophia Thomas's cash book balance on 31 July 2018.
- b** Prepare a bank reconciliation statement dated 31 July 2018 that shows the original balance shown on the bank statement received on that date.

### PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 3.5–3.8)

#### MULTIPLE-CHOICE QUESTIONS

- 15** For what reason is a bank reconciliation statement prepared?
- A** It allows the business's cashier to compare the business's cash book bank balance with the actual bank balance
- B** It allows the business's cashier to reconcile the petty cash balance with the bank balance
- C** It enables the bank to compare the business's receipts with the business's payments
- D** It enables the business's cashier to calculate the liquid capital
- 16** A business has just received a bank statement and the process of updating the cash book is underway. Which of the following items will increase the bank balance in the cash book?
- A** Bank charges
- B** Credit transfers received
- C** Direct debit payment
- D** Standing order payment
- 17** Raslinda was preparing her business's bank reconciliation statement and she was aware of the following details:
- Bank balance in the cash book, \$6000 debit
  - Unpresented cheques, \$1500
  - Uncredited deposits by the bank, \$900.
- What is the balance shown on the bank statement?
- A** \$1600
- B** \$5600
- C** \$6600
- D** \$8400
- 18** The owner of a business has just updated his business's cash book on receipt of a bank statement. The owner will now prepare the bank reconciliation statement. Which of the following items should appear in this statement?
- A** Credit transfers received
- B** Direct debits
- C** Standing orders
- D** Unpresented cheques

- 19** The bank columns of a business's cash book showed a balance of \$2000 credit. When the bank statement was received, the following additional entries were made in the bank columns of the cash book:

- Bank charges \$600
- Interest received \$400

What was the bank balance as shown by the updated cash book?

- A** \$1000 credit
- B** \$1800 credit
- C** \$2200 credit
- D** \$3000 credit

- 20\*** Salman has received his business's bank statement. His cash books shows a balance of \$150 overdrawn. There are uncredited deposits \$700 and unpresented cheques \$500.

What is the closing balance on the bank statement?

- A** \$50 credit
- B** \$150 credit
- C** \$50 debit
- D** \$150 debit

- 21\*** Kate's cash book (bank account) has a debit balance of \$350 on 31 March 2018. These unrecorded items accounted for the difference in the cash book (bank account) and bank statement balances on this date:

|                     | \$  |
|---------------------|-----|
| Bank charges        | 40  |
| Uncredited deposits | 380 |
| Standing order      | 150 |
| Unpresented cheque  | 290 |

What will be the updated cash book (bank account) balance?

- A** \$160
- B** \$260
- C** \$440
- D** \$540

## OTHER QUESTIONS

- 22** Samah has been comparing her cash book (bank columns) for May 2018 with her business's bank statement for this period. Her cash book shows a balance at bank of \$840 on 31 May 2018.

She has noticed that a payment by cheque for \$720 shown as a credit entry in her cash book appears correctly as a debit entry in the bank statement.

- a** Explain why items shown in the cash book are recorded differently in the bank statement.

Samah has identified the following items in her bank statement which have not yet been recorded in her cash book.

|                               | \$  |
|-------------------------------|-----|
| Bank charges                  | 90  |
| Standing order payments       | 620 |
| Bank interest received        | 50  |
| Credit transfer from customer | 880 |

- b** Prepare Samah's cash book at 31 May 2018 to find the updated balance.

Samah has noticed that the following items recorded in her cash book have not yet been recorded on the bank statement:

- A cheque payment to a supplier, \$550
  - Cash sales paid into the bank on 30 May, \$640
- c** Complete the following bank reconciliation statement at 31 May 2018.

|   | \$ |
|---|----|
| Balance as per updated cash book at 31 May 2018 |    |
| Unpresented cheque                              |    |
| Uncredited deposits                             |    |
| Balance as per bank statement at 31 May 2018    |    |

- d** State two advantages of preparing bank reconciliation statements.



## Introduction

The accounts of payables are kept in a purchases ledger and the accounts of receivables are kept in a sales ledger. In the books of account of some businesses, these ledgers can be very extensive, including possibly hundreds or even thousands of personal accounts. You can imagine how useful it would be if it was possible to check the accuracy of these two ledgers with simple processes that take only a few minutes to carry out. Fortunately, there are such processes. They are called 'control accounts' and they are explained in this chapter.

## The sales ledger control account

A control account checks the arithmetical accuracy of part of the accounting system (in this case the sales ledger). It is made up of totals of all of the transactions that have been posted to that part of the accounting system (in this case transactions that affect credit customers).

### LEARNING OBJECTIVES

When you have reached the end of 3.9–3.12 you will be able to:

- describe why businesses use sales and purchases ledger control accounts
- identify the sources of information used for making control account entries
- prepare purchases ledger and sales ledger control accounts.

### KEY TERMS

**Sales ledger control account:** a process for checking the arithmetical accuracy of the sales ledger.

#### Illustration 1 The idea behind a sales ledger control account

You are told the following:

- Total trade receivables at 1 January was \$10 000.
- Total credit sales for the year was \$100 000.
- Total amounts received from credit customers was \$95 000.

It only takes a moment to work out that the total of all the trade receivables account balances at 31 December should be \$15 000.

If you put this information in account form, it would look like this.

| Dr              |                |             | Cr |                |
|-----------------|----------------|-------------|----|----------------|
|                 | \$             |             |    | \$             |
| Opening balance | 10 000         | Receipts    |    | 95 000         |
| Credit sales    | 100 000        | Balance c/d |    | 15 000         |
|                 | <u>110 000</u> |             |    | <u>110 000</u> |
| Balance b/d     | 15 000         |             |    |                |

This is a simple version of a **sales ledger control account**. You can see that the account is, in effect, a total trade receivables account.

The account shows that the total of the trade receivables accounts should be \$15 000. You could then check with the sales ledger and see if all of the individual balances on the trade receivables accounts (and there could be many of them) total \$15 000. If so, then it is assumed that the sales ledger has been prepared correctly.



# Preparing sales and purchases ledger control accounts

## STUDY TIP

The sales ledger control account is only concerned with information about trade receivables. So, for example, do not enter cash sales in the control account.

## Sales ledger control account

To check a sales ledger you need to make sure that the sales ledger control account contains the totals of all the transactions that have affected receivables. Here is a list of the most likely transactions. The list also shows where you would obtain the totals that you need to prepare the sales ledger control account.

| Transactions            | Source of information |
|-------------------------|-----------------------|
| Total credit sales      | Sales journal         |
| Total receipts          | Cash book             |
| Total discounts allowed | Cash book             |
| Total sales             | Sales returns journal |

## Illustration 2 Preparing a sales ledger control account

At the end of March 2018, the owner of a business checked the accuracy of the sales ledger. The following information was obtained relating to March 2018.

| Transactions                                   | Source of information        | \$     |
|--|------------------------------|--------|
| Total of trade receivables balances on 1 March | Control account for February | 12 000 |
| Total credit sales                             | Sales journal                | 83 000 |
| Total receipts                                 | Cash book                    | 71 000 |
| Total discounts allowed                        | Cash book                    | 3 000  |
| Total sales returns                            | Sales returns journal        | 4 000  |

Here is the control account for March 2014.

| Dr    |    |                     |  | Sales ledger control account |       |    |                   | Cr            |  |
|-------|----|---------------------|--|------------------------------|-------|----|-------------------|---------------|--|
| March | 1  | Opening balance b/d |  | 12 000                       | March | 31 | Receipts          | 71 000        |  |
|       | 31 | Credit sales        |  | 83 000                       |       | 31 | Discounts allowed | 3 000         |  |
|       |    |                     |  |                              |       | 31 | Sales returns     | 4 000         |  |
|       |    |                     |  |                              |       | 31 | Balance c/d       | 17 000        |  |
|       |    |                     |  | <u>95 000</u>                |       |    |                   | <u>95 000</u> |  |
| April | 1  | Balance b/d         |  | 17 000                       |       |    |                   |               |  |

## Notes:

- 1 A sales ledger control account always resembles a trade receivables account. However, the control account is not part of the double-entry accounting system.
- 2 The sales ledger control account tells you that the total of all trade receivables at 31 March should be \$16 000. This should correspond to the total of all the balances in the sales ledger at that date.

You can now try question 1 on page 153.

## Purchases ledger control account

The purchases ledger can also be checked using this system of taking totals from the books of prime entry.

Here is a list of the most likely transactions to affect trade payables and the source of information for preparing the **purchases ledger control account**.

| Transactions             | Source of information     |
|--------------------------|---------------------------|
| Total credit purchases   | Purchases journal         |
| Total payments           | Cash book                 |
| Total discounts received | Cash book                 |
| Total purchases returned | Purchases returns journal |

### KEY TERMS

**Purchases ledger control account:** a process for checking the arithmetical accuracy of the purchases ledger.

You can now try questions 2 to 4 on page 153.

### Illustration 3 Preparing a purchases ledger control account

At the end of May 2018, the owner of a business checked the accuracy of the purchases ledger. The following information was obtained for May 2018.

| Transactions                              | Source of information     | \$     |
|---|---------------------------|--------|
| Total of trade payables balances on 1 May | Control account for April | 23 000 |
| Total credit purchases                    | Purchases journal         | 61 000 |
| Total payments                            | Cash book                 | 57 000 |
| Total discounts received                  | Cash book                 | 2 000  |
| Total purchases returns                   | Purchases returns journal | 5 000  |

Here is the control account for May 2018.

| Dr Purchases ledger control account Cr |        |                           |        |
|--|--------|---------------------------|--------|
| May 31 Payments                        | 57 000 | May 1 Opening balance b/d | 23 000 |
| 31 Discounts received                  | 2 000  | 31 Purchases              | 61 000 |
| 31 Purchases returns                   | 5 000  |                           |        |
| 31 Balance c/d                         | 20 000 |                           |        |
|  | 84 000 |                           | 84 000 |
|  |        | June 1 Balance b/d        | 20 000 |

### Notes:

- 1 A purchases ledger control account always resembles a trade payables account. However, the control account is not part of the double-entry accounting system.
- 2 The purchases ledger control account tells you that the total of all trade payables at 31 May should be \$20 000. This should correspond to the total of all the balances in the purchases ledger at that date.

### Benefits of control accounts

Control accounts are very useful for the following reasons:

- They provide a quick **check on the arithmetical accuracy** of the sales and purchases ledgers.
- They provide **information about total trade receivables and total trade payables** for inclusion in a trial balance and financial statements.
- They **help prevent fraud** because the work of the individuals who keep the sales and purchases ledger will be checked regularly by a more senior member of staff.

### Limitations of control accounts

It is possible for the closing balance on a control account to match the total of the balances in the ledger, but for there still to be errors that have not been detected. For example there could be errors of commission in the sales ledger which would not have any effect on the total of sales ledger balances. There could also be errors of omission or original entry which would have the same impact on both records.

### STUDY TIP

A purchases ledger account is only concerned with information about trade payables. So, for example, do not enter cash purchases in the control account.



# Other entries in control accounts

There are some more unusual transactions that can affect the accounts of trade receivables and trade payables and that must, therefore, be taken into account when preparing control accounts.

## Credit balances on sales ledger accounts

Occasionally a trade receivables account will have a credit balance. This may sound rather strange at first, but it can happen if a customer overpays their account.

### STUDY TIP

Always remember that a sales ledger control account resembles a total trade receivables account.

A purchases ledger control account resembles a trade payables account.

### DID YOU KNOW?

Control accounts are sometimes called 'total accounts', for example 'sales ledger total account'.

#### Illustration 4 Trade receivables account with a credit balance

Jody Dass is a customer of Home Developments Ltd. The following transactions took place during June 2018.

June 12 Goods were sold to Jody, \$850  
June 29 Jody paid the amount due by cheque, \$850

So on 29 June, Jody's account is cleared.

However, on 30 June Jody noticed that some of the goods sold to her on 12 June with a value of \$120 were faulty. It would be necessary to make an entry for returns. When the account is balanced on 30 June it will appear as follows.

| Dr   |    |             |     | Jody Dass account |    |               |     | Cr |  |  |  |
|------|----|-------------|-----|-------------------|----|---------------|-----|----|--|--|--|
| June | 12 | Sales       | 850 | June              | 29 | Bank          | 850 |    |  |  |  |
|      | 30 | Balance c/d | 120 |                   | 30 | Sales returns | 120 |    |  |  |  |
|      |    |             | 970 |                   |    |               | 970 |    |  |  |  |
|      |    |             |     | July              | 1  | Balance b/d   | 120 |    |  |  |  |

In effect Jody has overpaid, and her account temporarily shows a credit balance. Home Developments Ltd may have to send Jody a cheque to refund the \$120 that has been overpaid. If any sales ledger accounts have credit balances, this fact needs to be reflected when the sales ledger control account is prepared.

It is also possible that a trade payables account could show a debit balance. It follows that this will occur when a business overpays a supplier. Any debit balance on a trade payables account must be considered when preparing a purchases ledger control account.

## Dishonoured (returned) cheques

A business can receive a cheque from a credit customer in payment of the amount due, only to find that the bank will not accept that cheque when it is paid into the business's bank account. This normally happens because the customer has insufficient funds in their own account to cover the amount of the cheque. In the business's books of accounts the entries for the receipt of the cheque are cancelled out as follows:



Debit Trade receivables account  
Credit Bank column of cash book

As you know, any transaction that affects the account of a trade receivable must also be reflected in the sales ledger control account. In the case of **dishonoured cheques** the information will be obtained from the cash book.

## Contra entries

A business could find that one of its suppliers is also one of its customers. For example, a business that provides an office cleaning service could find that it purchases cleaning materials from one of its customers. Where this situation arises it is usual for only the net amount due to be paid off.

### STUDY TIP

Any contra entry must be recorded in both the sales ledger control account and the purchases ledger control account.

#### Illustration 5 Contra entries

During June, Webb's Cleaning Services purchased cleaning materials on credit from Deepclean Ltd, value \$300. Webb's Cleaning Services also charged Deepclean Ltd \$180 for cleaning the company's offices.

In this situation Webb's Cleaning Services can send a cheque to Deepclean Ltd for the net amount due, \$120. This would happen after the balance in the sales ledger had been transferred to the purchases ledger. The accounts would then appear as follows:

| PURCHASES LEDGER      |    |                              |     |      |    |                                  |     |
|-----------------------|----|------------------------------|-----|------|----|----------------------------------|-----|
| Dr                    |    |                              | Cr  |      |    |                                  |     |
| Deepclean Ltd account |    |                              |     |      |    |                                  |     |
| June                  | 30 | Deepclean Ltd (sales ledger) | 180 | June | 12 | Purchases                        | 300 |
|                       | 30 | Bank                         | 120 |      |    |                                  |     |
|                       |    |                              | 300 |      |    |                                  | 300 |
| SALES LEDGER          |    |                              |     |      |    |                                  |     |
| Dr                    |    |                              | Cr  |      |    |                                  |     |
| Deepclean Ltd account |    |                              |     |      |    |                                  |     |
| June                  | 17 | Sales                        | 180 | June | 30 | Deepclean Ltd (purchases ledger) | 180 |

#### Notes:

- 1 A journal entry should be used to record this transfer.
- 2 The effect of contra entries is to reduce the balance on each of the personal accounts involved.
- 3 Similar entries would be required if it was necessary to transfer the balance of the purchases ledger account to the sales ledger account.

Since a **contra entry** affects both the account of a receivable and of a payable, it will also need to be recorded in the sales ledger control account and purchases ledger control account.

## Refunds

A **refund** occurs when money is returned to a credit customer, perhaps because they have overpaid the amount due. Refunds to credit customers are recorded as follows:

Debit Trade receivable account  
Credit Bank account

It is also possible for a credit supplier to pay a refund following an overpayment. Refunds from credit suppliers are recorded as follows:

Debit Bank account  
Credit Trade payable

Where refunds occur entries need to be made in the control account and the information is obtained from the cash book.

### KEY TERMS

**Dishonoured cheque:** a cheque that a bank will not accept for payment because the payee (individual making the payment) does not have enough funds in their account to cover the amount being paid.

**Contra entry (control accounts):** when a business deals with another business or organisation as both a customer and a supplier, the balances of the two accounts are set off against one another to find the net balance.

**Refund:** a repayment to a customer who has overpaid, or a repayment made by a supplier who has been overpaid.

# More about preparing control accounts

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- prepare purchases ledger and sales ledger control accounts.

## KEY TERMS

**Irrecoverable debt:** an amount owed by a credit customer that will not be paid.

There is more information about irrecoverable debts in 4.15.

## Interest charged on overdue accounts

One way of trying to encourage credit customers to pay on time is to charge interest on overdue accounts. The double entry for any interest charged to the customer is:

|        |                           |
|--------|---------------------------|
| Debit  | Trade receivables account |
| Credit | Interest received account |

Of course, a supplier may also encourage a business to settle their account more promptly by charging interest on overdue accounts.

|        |                          |
|--------|--------------------------|
| Debit  | Interest charges account |
| Credit | Trade payables account   |

A journal entry is required to initiate these entries. Interest received and interest charged will need to be shown in the relevant control account.

## Sales ledger control account

### Irrecoverable debts

Sometimes it is necessary to write off a credit customer's account because they are unable to pay the amount due. The account written off is referred to as an **irrecoverable debt**. The following entries are required:

|        |                     |
|--------|---------------------|
| Debit  | Irrecoverable debts |
| Credit | Trade receivable    |

The general journal is used to initiate these entries in the ledger accounts.

### Illustration 6

#### Preparing a more advanced sales ledger control account

Here are some details to be used in the preparation of a sales ledger control account.

|   |        |
|---|--------|
| Debit balances in the sales ledger on 1 November 2018   | 16 350 |
| Credit balances in the sales ledger on 1 November 2018  | 490    |
| Credit sales  | 43 270 |
| Sales returns   | 1 150  |
| Receipts from trade receivables                         | 37 240 |
| Discounts allowed                                       | 680    |
| Dishonoured cheques                                     | 300    |
| Interest charged on overdue accounts                    | 220    |
| Refunds to trade receivables                            | 70     |
| Contra entries  | 480    |
| Bad debts written off                                   | 510    |
| Debit balances in the sales ledger on 30 November 2018  | ?      |
| Credit balances in the sales ledger on 30 November 2018 | 130    |



Here is the sales ledger control account. The more unusual items are shown in bold.

| Sales ledger control account |    |                            |            | Dr  | Cr                            |
|------------------------------|----|----------------------------|------------|-----|-------------------------------|
| Nov                          | 1  | Opening balance            | 16 350     | Nov | 1 <b>Opening balance</b> 490  |
|                              | 30 | Sales                      | 43 270     |     | 30 Sales returns 1 150        |
|                              | 30 | <b>Dishonoured cheques</b> | <b>300</b> |     | 30 Bank 37 240                |
|                              | 30 | <b>Interest charges</b>    | <b>220</b> |     | 30 Discounts allowed 680      |
|                              | 30 | <b>Refunds</b>             | <b>70</b>  |     | 30 Contras 480                |
|                              | 30 | <b>Closing balance c/d</b> | <b>130</b> |     | 30 Bad debts 510              |
|                              |    |                            |            |     | 30 Closing balance c/d 19 790 |
|                              |    |                            | 60 340     |     | 60 340                        |
| Dec                          | 1  | Balance b/d                | 19 790     | Dec | 1 <b>Balance b/d</b> 130      |

## Purchases Ledger Control Account

### Illustration 7

Preparing a more advanced purchases ledger control account

Here are some details to be used in the preparation of a purchase ledger control account.

|   |        |
|---|--------|
| Debit balances in the purchases ledger on 1 June 2018   | 520    |
| Crebit balances in the purchases ledger on 1 June 2018  | 18 390 |
| Credit purchases  | 26 880 |
| Purchases returns                                       | 420    |
| Payments to payables                                    | 19 750 |
| Discounts received                                      | 770    |
| Interest charged on overdue accounts                    | 90     |
| Refunds from trade payables                             | 120    |
| Contra entries  | 660    |
| Debit balances in the purchases ledger on 30 June 2018  | 410    |
| Credit balances in the purchases ledger on 30 June 2018 | ?      |

Here is the purchases ledger control account. The more unusual items are shown in bold.

| Purchases ledger control account |    |                        |            | Dr   | Cr                            |
|----------------------------------|----|------------------------|------------|------|-------------------------------|
| June                             | 1  | <b>Opening balance</b> | <b>520</b> | June | 1 Opening balance 18 390      |
|                                  | 30 | Purchases returns      | 420        |      | 30 Purchases 26 880           |
|                                  | 30 | Bank                   | 19 750     |      | 30 <b>Interest charges</b> 90 |
|                                  | 30 | Discounts received     | 770        |      | 30 <b>Refunds</b> 120         |
|                                  | 30 | <b>Contras</b>         | <b>660</b> |      | 30 <b>Closing balance</b> 410 |
|                                  | 30 | Closing balance c/d    | 23 770     |      |                               |
|                                  |    |                        | 45 890     |      | 45 890                        |
| July                             | 1  | <b>Balance b/d</b>     | <b>410</b> | July | 1 Balance b/d 23 770          |

## When the control account balance and ledger account total do not agree

If the final balance of a sales ledger control account and the total of the balances in the sales ledger do not agree, this would indicate that there is an error (or errors) in the accounting system.

For example, an error could have been made in a sales ledger account. Perhaps the sales ledger accounts clerk has misread a figure in the sales journal and entered this figure in a trade receivables account (e.g. in the sales journal the sale is recorded as \$997, but it has been posted as \$979).

Alternatively, perhaps the sales ledger control account is not correct. This could happen if there is an error in the total of one of the relevant books of prime entry because the entries have not been totalled correctly.

A similar set of explanations will apply if the purchases ledger control account balance does not agree with the total of the balances extracted from the purchases ledger.

You can now answer questions 5–13 on pages 153–155.



## DEVELOPING YOUR SKILLS

## 1\* Preparing a sales ledger control account

Prepare a sales ledger control account for June 2018 from the following information.

| Transactions                                  | Source of information   | \$     |
|---|-------------------------|--------|
| Total of trade receivables balances on 1 June | Control account for May | 9 000  |
| Total credit sales                            | Sales journal           | 37 000 |
| Total receipts                                | Cash book               | 31 000 |
| Total discounts allowed                       | Cash book               | 3 000  |
| Total sales returns                           | Sales returns journal   | 5 000  |

## 2 Preparing a purchases ledger control account

Prepare a purchases ledger control account for the month ended 31 March 2018 from the following information.

| Transactions                                | Source of information        | \$      |
|---|------------------------------|---------|
| Total of trade payables balances on 1 March | Control account for February | 53 480  |
| Total credit purchases                      | Purchases journal            | 185 920 |
| Total payments                              | Cash book                    | 161 310 |
| Total discounts received                    | Cash book                    | 4 370   |
| Total purchases returns                     | Purchases returns journal    | 11 990  |

## 3\* Preparing control accounts

The following information was extracted from a business's subsidiary books on 31 May 2018.

|                                 | \$     |
|---------------------------------|--------|
| Totals                          |        |
| Sales journal                   | 18 460 |
| Purchases journal               | 11 270 |
| Sales returns journal           | 980    |
| Purchases returns journal       | 1 110  |
| Cash book                       |        |
| Receipts from trade receivables | 16 440 |
| Payments to trade payables      | 10 950 |
| Discounts allowed               | 730    |
| Discounts received              | 520    |

On 1 May 2018 the following balances appeared in the control accounts:

- Purchases ledger control account \$3 640
- Sales ledger control account \$5 220

Prepare the business's control accounts for May 2018.

## 4\* Preparing control accounts

The following information is to be entered in a business's control accounts for March 2018.

| Transactions                    | \$     | Source of information |
|---------------------------------|--------|-----------------------|
| Credit sales                    | 63 490 |                       |
| Credit purchases                | 42 110 |                       |
| Discounts allowed               | 370    |                       |
| Discounts received              | 260    |                       |
| Payments to trade payables      | 39 650 |                       |
| Purchases returns               | 580    |                       |
| Receipts from trade receivables | 59 120 |                       |
| Sales returns                   | 240    |                       |

On 1 March 2018 the following balances appeared in the control accounts:

- Purchases ledger control account \$8 830
- Sales ledger control account \$10 370

**a** Complete the column to show the source of each item of information required for the control accounts.

**b** Prepare the control accounts for March 2018.

## 5 Preparing a sales ledger control account including other details

The following information is to be entered in a business's sales ledger control account for January 2018.

|   | \$     |
|---|--------|
| Sales ledger balances at 1 January 2018                                     |        |
| Debit   | 7 400  |
| Credit  | 230    |
| Totals for the month:   |        |
| Credit sales  | 27 480 |
| Sales returns   | 620    |
| Receipts from trade receivables   | 21 930 |
| Discounts allowed   | 330    |
| Refunds to trade receivables  | 110    |
| Irrecoverable debts   | 80     |
| Interest charged on overdue accounts  | 70     |
| Dishonoured (returned) cheques  | 190    |
| Contras (sales ledger account balances transferred to the purchases ledger) | 490    |
| Sales ledger balances at 30 November 2018                                   |        |
| Debit   | ?      |
| Credit  | 390    |

Prepare the sales ledger control account for January 2018.

The sales ledger clerk reported that the total of debit balances in the sales ledger on 31 January 2018 was \$11 960. What conclusions should you draw from this information?

## 6 Preparing a purchases ledger account including other details

The following information is to be entered in a purchases ledger control account for October 2018.

|   | \$     |
|---|--------|
| Purchases ledger balances at 1 October 2018                         |        |
| Debit   | 830    |
| Credit  | 31 620 |
| Totals for the month:   |        |
| Credit purchases  | 82 880 |
| Purchases returns   | 5 370  |
| Payments to trade payables  | 75 060 |
| Discounts received  | 2 240  |
| Refunds from trade payables   | 90     |
| Interest charged on overdue accounts                                | 250    |
| Contras (purchases ledger balances transferred to the sales ledger) | 270    |
| Purchases ledger balances at 31 October 2018                        |        |
| Debit   | 990    |
| Credit  | ?      |

Prepare the purchases ledger control account for October 2018.

The purchases ledger clerk reported that the total of debit balances in the purchases ledger on 31 October 2018 was \$31 760. What conclusions should you draw from this information?

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 3.9–3.12)

### MULTIPLE-CHOICE QUESTIONS

- 7 Which one of the following should be entered in a sales ledger control account?
- A Cash sales
  - B Discounts allowed
  - C Discounts received
  - D Purchases
- 8 A sales ledger control account contained the following items at the end of the month

|  | \$     |
|--|--------|
| Debit balance at beginning of the month            | 8 000  |
| Credit sales for the month                         | 12 500 |
| Sales returns for the month                        | 700    |
| Cash received from receivables                     | 9 600  |
| Interest charged on overdue accounts for the month | 150    |

How much was owed by credit customers at the end of the month?

- A \$10 050
  - B \$10 350
  - C \$11 450
  - D \$11 750
- 9 Which one of the following should be entered in a purchases ledger control account?
- A Cash purchases
  - B Discounts received
  - C Refunds to trade receivables
  - D Sales
- 10 What does the final balance on a correctly prepared purchases ledger control account represent?
- A Profit on goods purchased and sold
  - B Total of cash purchases
  - C Total trade payables of the business
  - D Value of unsold purchases

## OTHER QUESTIONS

- 11** The following entries were included in a business's sales ledger control account.

Which of the following shows a correct set of entries?

| Debit entries   | Credit entries  |
|---|---|
| <b>A</b> Credit sales                                 | Refunds to trade receivables<br>Sales<br>Discounts received |
| <b>B</b> Credit sales<br>Refunds to trade receivables | Discounts allowed<br>Sales                                  |
| <b>C</b> Credit sales                                 | Discounts received<br>Sales<br>Dishonoured cheques          |
| <b>D</b> Dishonoured cheques<br>Credit sales          | Receipts from trade receivables<br>Discounts allowed        |

- 12** The owner of a business recently decided that it would be a good idea if control accounts were prepared at the end of each month.

- a** Identify and explain one benefit that would result from this decision.

Anthony is responsible for preparing purchases ledger and sales ledger control accounts for this business. On 30 April 2018 Anthony extracted the following information from the business's accounting records.

|  | \$     |
|--|--------|
| Balances at 1 April 2018                           |        |
| Sales ledger debit balance                         | 14 790 |
| Sales ledger credit balance                        | 330    |
| Purchases ledger debit balance                     | 640    |
| Purchases ledger credit balance                    | 22 470 |
| Sales  |        |
| Credit sales                                       | 51 830 |
| Cash sales   | 22 450 |
| Purchases  |        |
| Credit purchases                                   | 48 410 |
| Cash purchases                                     | 8 350  |
| Sales returns (from sales returns journal)         | 1 240  |
| Purchases returns (from purchases returns journal) | 930    |
| Payments to trade payables                         | 45 700 |
| Receipts from trade receivables                    | 52 600 |
| Discounts allowed                                  | 440    |
| Discounts received                                 | 760    |
| Balances at 30 April 2018                          |        |
| Sales ledger debit balance                         | ?      |
| Sales ledger credit balance                        | 480    |
| Purchases ledger debit balance                     | 210    |

|                                 |   |
|---------------------------------|---|
| Purchases ledger credit balance | ? |
|---------------------------------|---|

- b** Prepare a purchases ledger control account and sales ledger control account for April 2018. Select the relevant information from the details provided.

- 13** Cynthia has extracted the following details from her business's books of account on 31 January 2018.

|  | \$     |
|--|--------|
| Balances at 1 January 2018                                   |        |
| Sales ledger debit balance                                   | 33 640 |
| Sales ledger credit balance                                  | 730    |
| Purchases ledger debit balance                               | 440    |
| Purchases ledger credit balance                              | 29 780 |
| Sales journal total for January 2018                         | 95 460 |
| Purchases journal total for January 2018                     | 73 550 |
| Sales returns journal total for January 2018                 | 3 110  |
| Purchases returns journal total for January 2018             | 4 830  |
| General journal totals for January 2018                      |        |
| Irrecoverable debts  | 970    |
| Interest charged on customer's overdue accounts              | 80     |
| Interest charged by supplier's on overdue accounts           | 140    |
| Cash book totals for January 2018                            |        |
| Receipts from trade receivables                              | 85 370 |
| Payments to trade payables                                   | 64 390 |
| Cash sales   | 48 470 |
| Cash purchases   | 3 260  |
| Refunds to trade receivables who had overpaid their accounts | 280    |
| Dishonoured cheques received from trade receivables          | 730    |
| Discounts allowed  | 1 140  |
| Discounts received   | 2 080  |
| Balances at 31 January 2018                                  |        |
| Sales ledger debit balance                                   | ?      |
| Sales ledger credit balance                                  | 490    |
| Purchases ledger debit balance                               | 820    |
| Purchases ledger credit balance                              | ?      |

Prepare a purchases ledger control account and sales ledger control account for January 2018. Select the relevant information from the information provided.



## What this section is about

In this section you will learn more about the preparation of income statements and statements of financial position. Accounting has many precise rules which are used to ensure that a business's profit properly reflects its performance over an accounting period and that assets are valued fairly. As a result business owners and managers can have confidence in the information with which they are provided. So in this section you will learn some new techniques:

**Valuation of inventory** (syllabus section 4.5) which introduces the procedures used to record the value of unsold goods in a trading business and how to value these goods.

**Revenue and capital expenditure and receipts** (syllabus section 4.1) which helps establish how to treat payments and receipts, ensuring that profits are accurately reported.

**Accounting for depreciation and disposal of non-current assets** (syllabus section 4.2) which covers the ways in which the inevitable reduction in the value of non-currents assets is recorded and the procedure used to record the sale of non-currents assets.

**Other payables and other receivables** (syllabus section 4.3) which introduces the techniques used to ensure a business's profit is based not just on payments and receipts but on the actual expenses and income for a financial period.

**Irrecoverable debts and provision for doubtful debts** (syllabus section 4.4) which covers how to record the loss to a business when the accounts of credit customers have to be written off and how to ensure that the value of trade receivables on a statement of financial position more closely reflects the amounts which are likely to be received.

# The effect of inventory on gross profit

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- record opening and closing inventories in the general ledger and income statements.

## KEY TERMS

**Inventory:** goods owned by a business that have not yet been sold.

**Closing inventory:** goods unsold at the end of a trading year.

**Cost of sales:** the value at cost price of goods sold during a trading year. It is found as follows: Opening inventory + Purchases – Closing inventory.

## LINKS...

There is more about inventories, in particular how to value inventories correctly, in Chapter 7.

## KEY TERMS

**Opening inventory:** goods unsold at the beginning of a trading year. The amount will be the same as the closing inventory from the previous year.

## Notes:

- The entry in the inventory account for the closing inventory is on the debit side of the account because this is the record of an asset.
- This asset will appear on the statement of financial position at this date. It is listed as the first of the current assets.

So far, gross profit has been calculated by deducting net purchases from net revenue for a year. However, if a business did not sell everything it purchased (i.e. it had an inventory at the end of the trading year) then this would affect the calculation. Unsold goods are referred to as **inventory**.

## Illustration 1 Closing inventory

During a financial year a retailer purchased goods for \$150 000; revenue totalled \$220 000.

At this stage it looks as if this business has a gross profit of \$70 000 (revenue \$220 000, less purchases \$150 000).

Now, suppose the business did not sell everything it purchased and had a **closing inventory** valued at \$30 000.

It is necessary to deduct the value of a closing inventory from the figure for purchases to find the **cost of sales**.

Here is a revised calculation of the gross profit.

|                                   | \$       | \$        |
|-----------------------------------|----------|-----------|
| Revenue                           |          | 220 000   |
| Less value of goods actually sold |          |           |
| Purchases                         | 150 000  |           |
| Less closing inventory            | (30 000) |           |
| Cost of sales                     |          | (120 000) |
| Gross profit                      |          | 100 000   |

## Notes:

- The idea here is to find the value of the goods that the business actually sold.
- In accounting statements the value at cost price of goods actually sold is called 'cost of sales'.

The closing inventory is entered in the income statement as a deduction from purchases. An inventory of unsold goods is a business asset, so the other entry in the double-entry system is to record this asset in the general ledger.

## Illustration 2 Recording a closing inventory in the general ledger

Here is the inventory account recording the closing inventory of \$30 000. Assume the accounting year end is 31 December.

| NOMINAL LEDGER |    |                   |        |
|----------------|----|-------------------|--------|
| Dr             |    | Inventory account |        |
| Dec            | 31 | Income statement  | 30 000 |

The next thing to consider is the effect of this closing inventory when looking at the next trading year. The answer is that one year's closing inventory becomes the **opening inventory** for the next year.



### Illustration 3 Opening inventory

The business starts the next financial year with an opening inventory of \$30 000.

Purchases total \$200 000 and revenue is \$300 000 during this financial year. At end of the year there is a closing inventory of \$40 000.

The important question to ask is: What goods were actually sold during the financial year?

Here is the calculation required to establish this figure based on the details above.

Calculating the value of goods actually sold

|   | \$       |
|---|----------|
| Inventory at the beginning of the year        | 30 000   |
| Add purchases                                 | 200 000  |
| Total of goods that COULD be sold             | 230 000  |
| Less inventory of unsold goods at end of year | (40 000) |
| Value of goods ACTUALLY sold (cost of sales)  | 190 000  |

#### Notes:

- 1 The opening inventory plus purchases gives a figure for what could be sold ...
- 2 ... and, what could be sold minus closing inventory gives the value of goods actually sold (cost of sales).

The calculation of gross profit will be as follows:

|                                   | \$             | \$               |
|-----------------------------------|----------------|------------------|
| Revenue                           |                | 300 000          |
| Less value of goods actually sold |                |                  |
| Opening inventory                 | 30 000         |                  |
| Purchases                         | 200 000        |                  |
|                                   | <u>230 000</u> |                  |
| less closing inventory            | (40 000)       |                  |
| Cost of sales                     |                | <u>(190 000)</u> |
| Gross profit                      |                | <u>110 000</u>   |

## The inventory account

At the beginning of the year the inventory account will show a debit balance (i.e. the figure for closing inventory for the previous year), which is \$30 000. During the course of the year the inventory account is **entirely ignored**. This may seem a little strange as you may think that the level of inventory in the business will be changing all the time. The inventory account is just used to record the opening inventory and closing inventory and nothing else. All other changes in inventory levels are recorded in the accounting system as follows:

- Increases in inventory are shown in the purchases account (an 'inventory in' account).
- Decreases of inventory are shown in the sales account (an 'inventory out' account).

Here is the inventory account based on the information in Illustration 3:

| Dr                      | Inventory account       | Cr            |
|-------------------------|-------------------------|---------------|
| Yr 1                    | Yr 2                    |               |
| Dec 31 Income statement | Dec 31 Income statement | 30 000        |
|                         |                         | <u>30 000</u> |
| Yr 2                    |                         |               |
| Dec 31 Income statement |                         | 40 000        |

*This is Years 2's closing inventory*

*This entry is to transfer Year 2's opening inventory to the income statement*

*This is last year's closing inventory – the opening inventory for Year 2*

#### STUDY TIP

Do not be tempted to make any entries in the inventory account during the course of a trading year. The inventory account is only used at the end of a year to transfer the opening inventory to the income statement, and to record the closing inventory for the year. All movements in inventory during the year are recorded in the purchases, sales and returns accounts.

You can now answer questions 1 and 2 on page 162.

You can now answer questions 3 and 4 on page 162.



# More about the income statement

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- record carriage inwards in an income statement
- record goods taken for own use by the owner of a business.

Here is an example of how to prepare the first part of an income statement including inventories.

In the illustration the columns have been used as follows:

- The column *furthest on the right*: is used to record the significant figures: net revenue, cost of sales and gross profit.
- The *middle money column*: is used to show how these key figures were arrived at.
- The *first money column*: is used where there is yet more detailed working out to do (here, to show purchases less purchases returns).

### Illustration 4 Preparing the first section of an income statement

Miguel owns a retail business. On 31 December 2018 the following information was taken from his books of account.

|                                      | \$      |
|--------------------------------------|---------|
| Purchases                            | 75 000  |
| Purchases returns                    | 2 000   |
| Revenue                              | 145 000 |
| Sales returns                        | 3 000   |
| Inventories                          |         |
| 1 January 2018 (opening inventory)   | 10 000  |
| 31 December 2018 (closing inventory) | 15 000  |

The first part of the income statement will be as shown opposite.

#### Miguel Income statement for the year ended 31 December 2018

|                        | \$      | \$       | \$       |
|------------------------|---------|----------|----------|
| Revenue                |         | 145 000  |          |
| less sales returns     |         | (3 000)  |          |
|                        |         |          | 142 000  |
| Opening inventory      |         | 10 000   |          |
| Add purchases          | 75 000  |          |          |
| less purchases returns | (2 000) |          |          |
|                        |         | 73 000   |          |
|                        |         | 83 000   |          |
| Less closing inventory |         | (15 000) |          |
| Cost of sales          |         |          | (68 000) |
| Gross profit           |         |          | 74 000   |

#### Notes:

- 1 The figure for cost of sales, \$68 000, should be clearly labelled.
- 2 Record the gross profit (\$74 000) – do not forget to label this figure.

You can now answer questions 5 and 6 on pages 162–163.

## KEY TERMS

**Goods for own use:** a transaction where the owner of a business keeps goods for private use which would otherwise have been available for sale. This transaction is referred to as inventory drawings.

## Goods taken for own use

The owner of a business may take **goods for own use**. For example, the owner of a grocery store might take goods from the shelves for private use at home as part of the week's food shopping. The correct double entry for this transaction is:

Debit Drawings  
Credit Purchases

This transaction should first be recorded in the general journal. The debit entry probably seems obvious. However, the credit entry in the purchases account is perhaps a little more puzzling. The effect of the credit entry is to reduce the balance of the purchases account. The idea is that if the owner has taken the goods for their own use, those goods would not be available for sale and so should not be included in the total figure for purchases.

You can now answer questions 7 and 8 on page 163.

## Carriage inwards and carriage outwards

Many businesses have to pay for the delivery of the goods they purchase. This expense is called **carriage inwards**. When preparing an income statement, carriage inwards should be added to the figure for purchases to show the true cost of buying goods. To achieve this, the balance of the carriage inwards account is transferred to the first part of the income statement when preparing the end-of-year financial statements.

### KEY TERMS

**Carriage inwards:** the cost of transporting goods, paid by a business on its own purchases. This expense is added to purchases in the first part of the income statement.

### Illustration 5

Income statement including goods taken for own use and carriage inwards

Here is Miguel's income statement from Illustration 4. However, this time it is assumed that Miguel took home goods valued at \$7000 for his own use during the year and that he had to pay carriage inwards of \$4000.

#### Miguel Income statement for the year ended 31 December 2018

|   | \$     | \$       | \$       |
|---|--------|----------|----------|
| Revenue   |        | 145 000  |          |
| Less sales returns  |        | (3 000)  |          |
|   |        |          | 142 000  |
| Opening inventory   |        | 10 000   |          |
| Purchases (\$75 000 less goods taken for own use \$7 000) | 68 000 |          |          |
| Carriage inwards  | 4 000  |          |          |
|   |        | 72 000   |          |
| Less purchases returns                                    |        | (2 000)  |          |
|   |        |          | 70 000   |
|   |        | 80 000   |          |
| Less closing inventory                                    |        | (15 000) |          |
| Cost of sales   |        |          | (65 000) |
| Gross profit  |        |          | 77 000   |

### Notes:

- 1 The figure for purchases has been reduced by the amount of goods taken for own use.
- 2 Carriage inwards is transferred from the carriage inwards account in the general ledger.
- 3 It is preferable to deduct returns outwards before adding carriage inwards.
- 4 Carriage inwards has the effect of increasing the cost of sales and, therefore, reducing the gross profit.

### KEY TERMS

**Carriage outwards:** the cost of transporting goods, paid by a business on its sales to customers. This expense is recorded in the second part of the income statement.

There is also an expense called **carriage outwards**. This is the cost of delivering goods to customers. The correct treatment for carriage outwards is to include it in the second part of the income statement along with all of the other business running costs.

You can now answer questions 9 and 10 on pages 163–164.



**LEARNING OBJECTIVES**

When you have reached the end of this section you will be able to:

- determine the monetary value of unsold goods
- calculate the net realizable value of damaged inventory.

**LINKS...**

There is more about this rule – called the prudence principle – in 7.1 on page 316.

The procedure is as follows:

1. Calculate the cost of the damaged items.
2. Calculate the normal selling price of the damaged items, minus any costs which will arise in making the items saleable. This is called the net realizable value.
3. Value the items at whichever calculation is lower. When goods for resale have lost their original value, they should be valued at either their cost price, or the net realisable value – whichever is lower.

**KEY TERMS**

**Net realisable value:** sale value less any costs to be incurred in order to make items saleable.

Like all assets, inventories are valued on the basis of their cost. Finding the value of closing inventory requires a detailed calculation involving counting the number of each type of unsold item and multiplying this by the cost price. Even in a small business, this is likely to be a very large-scale task. Fortunately, most businesses these days computerize their records of inventories, which makes establishing the total value of inventories at any one time much more straightforward.

There is one important exception to this rule, which arises when goods for resale lose their value – perhaps because they have become damaged in some way. In this situation, it is important to ensure that profits and asset values are not overstated.

**The importance of inventory valuation**

Any errors made in valuing inventories could have serious consequences for a business. If incorrect values are used when compiling an income statement, then inevitably gross profit will be incorrect and this will lead to an incorrect figure for profit for the year. The statement of financial position will also be affected, along with the totals of current assets and closing capital.

It is not easy to work out the effect of overstating or understating the value of inventories. If closing inventory is understated does this mean gross profit will be overstated or understated?

**Illustration 1**

## Calculating the value of unsold goods

Abdul has been calculating the value of his inventory of goods for resale at 31 December 2018, the end of the accounting year. So far, he has valued items at cost \$13 400. However, he has yet to add the value of certain items which were slightly damaged in the storeroom. There are 12 of these items, which each cost \$20. He would normally sell each item for \$25. He expects to spend \$7 on each item to put them in a saleable condition.

So, the cost of the damaged items is:  $12 \times \$20 \text{ each} = \$240$

The net realisable value of the items is:  $12 \times (\$25 \text{ sale price less } \$7 \text{ repair cost}), \text{ i.e. } 12 \times \$18 = \$216.$

The damaged items must be valued at the lower of cost \$240 and net realisable value \$216, i.e. net realisable value \$216.

The total value of Abdul's closing inventory is:

|   | \$     |
|---|--------|
| Items already valued                    | 13 400 |
| Damaged items (at net realisable value) | 216    |
|   | 13 616 |



**Illustration 2** The effect of an incorrect valuation of closing inventory

The following extract from an income statement shows an incorrect valuation of closing inventory.

**Income statement for the year ended  
31 December 2018 (Extract)**

|                   | \$              | \$               |
|-------------------|-----------------|------------------|
| Revenue           |                 | 280 000          |
| Opening inventory | 15 000          |                  |
| Purchases         | 161 000         |                  |
|                   | <u>176 000</u>  |                  |
| Closing inventory | <u>(12 000)</u> |                  |
| Cost of sales     |                 | <u>(164 000)</u> |
| Gross profit      |                 | <u>116 000</u>   |

It is easier to work out the effect of errors in valuing inventory if the income statement is redrafted with updated figures.

**ERRORS WITH CLOSING INVENTORY**

| Closing inventory OVERVALUED by \$2000   |                 |                  | Closing inventory UNDERVALUED by \$2000  |                 |                  |
|--|-----------------|------------------|--|-----------------|------------------|
| Revised income statement for the<br>year ended 31 December 2018 (Extract)                |                 |                  | Revised income statement for the<br>year ended 31 December 2018 (Extract)                  |                 |                  |
|  | \$              | \$               |  | \$              | \$               |
| Revenue  |                 | 280 000          | Revenue  |                 | 280 000          |
| Opening inventory  | 15 000          |                  | Opening inventory  | 15 000          |                  |
| Purchases  | 161 000         |                  | Purchases  | 161 000         |                  |
|  | <u>176 000</u>  |                  |  | <u>176 000</u>  |                  |
| Closing inventory  | <b>(10 000)</b> |                  | Closing inventory  | <b>(14 000)</b> |                  |
| Cost of sales  |                 | <b>(166 000)</b> | Cost of sales  |                 | <b>(162 000)</b> |
| Gross profit   |                 | <b>114 000</b>   | Gross profit   |                 | <b>118 000</b>   |
| Correcting an overvalued closing inventory leads to<br>a <b>decrease</b> in gross profit |                 |                  | Correcting an undervalued closing inventory leads<br>to an <b>increase</b> in gross profit |                 |                  |

**ERRORS WITH OPENING INVENTORY**

| Opening inventory OVERVALUED by \$2000  |                 |                  | Opening inventory UNDERVALUED by \$2000   |                 |                  |
|---|-----------------|------------------|---|-----------------|------------------|
| Revised income statement for the<br>year ended 31 December 2018 (Extract)                 |                 |                  | Revised income statement for the<br>year ended 31 December 2018 (Extract)                 |                 |                  |
|   | \$              | \$               |   | \$              | \$               |
| Revenue   |                 | 280 000          | Revenue   |                 | 280 000          |
| Opening inventory   | <b>13 000</b>   |                  | Opening inventory   | <b>17 000</b>   |                  |
| Purchases   | 161 000         |                  | Purchases   | 161 000         |                  |
|   | <u>174 000</u>  |                  |   | <u>178 000</u>  |                  |
| Closing inventory   | <u>(12 000)</u> |                  | Closing inventory   | <u>(12 000)</u> |                  |
| Cost of sales   |                 | <b>(162 000)</b> | Cost of sales   |                 | <b>(166 000)</b> |
| Gross profit  |                 | <b>118 000</b>   | Gross profit  |                 | <b>114 000</b>   |
| Correcting an overvalued opening inventory leads<br>to an <b>increase</b> in gross profit |                 |                  | Correcting an undervalued opening inventory leads<br>to a <b>decrease</b> in gross profit |                 |                  |

## DEVELOPING YOUR SKILLS

**1** Calculating gross profit when there is a closing inventory

During a financial year a retailer purchased goods for \$200 000; revenue totalled \$340 000. However, the retailer was not able to sell all of the goods that had been purchased and was left with an unsold inventory at the year end valued at \$20 000.

Calculate the gross profit made by the retailer during the year.

**2** Calculating gross profit when there is a closing inventory

During a financial year a retailer purchased goods for \$450 000; revenue totalled \$660 000.

At the end of the year the retailer had a closing inventory, value \$40 000.

Calculate the gross profit made by the retailer during the year.

**3** Calculating gross profit when there are opening and closing inventories

A retailer provided the following information for the year ended 31 December 2018.

|                               | \$      |
|-------------------------------|---------|
| Inventory at 1 January 2018   | 20 000  |
| Purchases                     | 480 000 |
| Revenue                       | 710 000 |
| Inventory at 31 December 2018 | 60 000  |

Calculate the following:

- a** The cost of sales during the year
- b** The gross profit for the year

**4** Calculating gross profit when there are opening and closing inventories

A wholesaler provided the following information for the year ended 31 December 2018.

|                               | \$        |
|-------------------------------|-----------|
| Inventory at 1 January 2018   | 80 000    |
| Purchases                     | 880 000   |
| Revenue                       | 1 200 000 |
| Inventory at 31 December 2018 | 50 000    |

Calculate the following:

- a** The cost of sales during the year
- b** The gross profit for the year

**5** Preparing an income statement with inventories

Billal owns a retail business. His business's financial year ended on 30 November 2018. The following information is available.

|                     | \$      |
|---------------------|---------|
| Purchases           | 365 800 |
| Purchases returns   | 4 100   |
| Revenue             | 551 000 |
| Sales returns       | 3 700   |
| Inventories         |         |
| At 1 December 2017  | 45 200  |
| At 30 November 2018 | 56 900  |

Prepare the first section of the business's income statement for the year ended 30 November 2018, and calculate the gross profit. Complete the inventory account in the nominal ledger.

## 6 Preparing an income statement with inventories

Raslinda is a wholesaler. Her business's financial year ended on 31 December 2018. The following information is available:

|                     | \$      |
|---------------------|---------|
| Purchases           | 568 300 |
| Purchases returns   | 9 500   |
| Revenue             | 945 600 |
| Sales returns       | 7 200   |
| Inventories         |         |
| At 1 January 2018   | 48 000  |
| At 31 December 2018 | 39 000  |

Prepare the first part of the business's income statement for the year ended 31 December 2018, and calculate the gross profit. Complete the inventory account in the nominal ledger.

## 7 Preparing an income statement including goods for own use

Wilma owns a shoe shop. Her business's financial year ended on 31 October 2018. The following information is available:

|                    | \$      |
|--------------------|---------|
| Purchases          | 176 000 |
| Purchases returns  | 1 900   |
| Revenue            | 351 000 |
| Sales returns      | 2 400   |
| Inventories        |         |
| At 1 November 2017 | 11 300  |
| At 31 October 2018 | 13 500  |

No record has yet been made of goods taken for own use by Wilma during the year ended 31 October 2018. The value of shoes taken for own use was \$600.

Prepare the following:

- General Journal entry to record the goods taken for own use
- The first part of the income statement for the year ended 31 October 2018, showing clearly an amended figure for purchases

## 8 Preparing an income statement including goods for own use

Ralph owns a shop selling sports equipment. His business's financial year ended on 31 August 2018. The following information is available.

|                     | \$      |
|---------------------|---------|
| Purchases           | 365 800 |
| Purchases returns   | 5 900   |
| Revenue             | 777 400 |
| Sales returns       | 4 700   |
| Inventories         |         |
| At 1 September 2017 | 29 300  |
| At 31 August 2018   | 28 200  |

No record has yet been made of goods taken for own use by Ralph during the year ended 31 August 2018. The value of sports equipment taken for own use was \$3700.

Prepare the following:

- General Journal entry to record the goods taken for own use
- The first section of the income statement for the year ended 31 August 2018, showing clearly an amended figure for purchases

## 9 Preparing an income statement including carriage inwards

Kavita owns a wholesale business providing bathroom fittings. Her business's financial year ended on 30 June 2018. The following information is available.

|                   | \$      |
|-------------------|---------|
| Carriage inwards  | 8 000   |
| Purchases         | 105 000 |
| Purchases returns | 4 000   |
| Revenue           | 200 000 |
| Sales returns     | 3 000   |
| Inventories       |         |
| At 1 July 2017    | 7 000   |
| At 30 June 2018   | 6 000   |

Prepare the first part of the business's income statement for the year ended 30 June 2018. Complete the inventory account in the nominal ledger.



## 10 Preparing an income statement including carriage inwards

Henry owns a retail unit selling men's clothing. His business's financial year ended on 31 July 2018. The following information is available.

|                   | \$      |
|-------------------|---------|
| Carriage inwards  | 3 000   |
| Purchases         | 98 000  |
| Purchases returns | 5 000   |
| Revenue           | 184 000 |
| Sales returns     | 2 000   |
| Inventories       |         |
| At 1 August 2017  | 10 000  |
| At 31 July 2018   | 14 000  |

Prepare the first part of the business's income statement for the year ended 31 July 2018. Complete the inventory account in the nominal ledger.

### 11\* Valuing inventory

Shahid has been calculating the value of his business's closing inventory on 30 September 2018. Almost all the unsold goods have been valued at cost \$8240. However, there are 24 damaged items which have yet to be valued.

The damaged items each cost \$37 and would normally sell for \$43. Shahid will have to spend \$8 on each item in repair costs before the item can be sold.

- Calculate the total cost of the damaged items.
- Calculate the net realisable value of the damaged items.
- Prepare a statement to show the total value of all the inventory at 30 September 2018.

### 12\* Valuing inventory

Amia owns a retail business. When she checked her business's storeroom she found 34 items which had cost \$72 each had been damaged when a shelf collapsed. Each of these items would normally be sold for \$88.

Amia has checked that all the items could be sold if some repairs and repackaging work was carried out.

All the items need repackaging at a cost of \$9 per item.

In addition, 21 items will need some repairs costing \$10 per item.

Calculate the total value of these items for inclusion in the business's closing inventory.

# Capital and revenue expenditure

Any money spent by the owner or manager of a business for business purposes can be divided into categories:

- **Capital expenditure** is money spent on non-current assets.
- **Revenue expenditure** is money spent on everyday running costs.

Capital expenditure is shown on a statement of financial position, but revenue expenditure is charged to the income statement.

## Capital expenditure

A more complete definition of the term 'capital expenditure' would state that the benefit from this type of payment arises over a period of more than one accounting year. Here are situations where capital expenditure has taken place:

- All payments to purchase non-current assets are capital expenditure because businesses buy non-current assets to benefit the business for several years.
- Money spent on improving non-current assets is also regarded as capital expenditure. So if a business extended its premises, or installed air conditioning into its existing buildings, the money spent in both these situations would be capital expenditure because the benefit from the expenditure is intended to last for several years and the value of the non-current asset would increase.
- Capital expenditure also includes some items that sound as if they are routine expenses, but which in fact will benefit the business for a longer period. For example, carriage charges on some new office equipment should be treated as capital expenditure and added to the cost of the office equipment. Legal charges paid in connection with the purchase of business premises should also be included as part of the value of the premises. In both these cases, the 'capitalisation' of the payments for these two expenses is correct, because the view is taken that the benefit from the payments will last as long as the business is using the office equipment and the business premises.

## Revenue expenditure

A more complete definition of the term 'revenue expenditure' is that the benefit from this type of payment lasts for less than one accounting year. A feature of most revenue expenditure is that it is recurring (i.e. it has to be paid for again and again). So expense payments qualify as revenue expenditure, such as rent, electricity costs, water charges, wages, salaries, and so on.

It is important to note that money spent on repairs, renewals, maintenance and servicing is also regarded as revenue expenditure. For each of these items the view is taken that there has not been any

### LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- define the terms capital expenditure and revenue expenditure.

### KEY TERMS

**Capital expenditure:** money spent on non-current assets that is intended to be of benefit for more than one accounting year.

**Revenue expenditure:** money spent on running costs that benefits only the current financial year.

### DID YOU KNOW?

If a business purchased a delivery vehicle but sold it only a few months later because it had not proved satisfactory, the payment would still count as capital expenditure. This is because presumably the original intention was that the delivery vehicle would benefit the business for a several years.

improvement to the non-current asset being repaired or serviced, the non-current asset is merely being kept in its original state. If there was any improvement then the amount spent should be regarded as capital expenditure. For example, contrast a payment made to decorate a new extension to a business's premises: this would be regarded as capital expenditure because it is an improvement to the non-current asset. On the other hand, a payment made to redecorate the existing premises would be regarded as revenue expenditure because the non-current asset is being brought back to its original state and no improvement is taking place.

### Illustration 1

### Separating capital and revenue expenditure

Gabrielle owns a business that delivers groceries to customers. Recently she purchased a new delivery vehicle for business use. The following information is available.

|   | \$     |
|---|--------|
| New delivery van  | 18 500 |
| Addition of shelving in the van for improved storage    | 600    |
| Fuel to fill tank                                       | 50     |
| Insurance premium                                       | 320    |
| Cost of painting business's name on exterior of the van | 140    |

The capital expenditure arising from this purchase is as follows.

|  | \$     |
|--|--------|
| New delivery van                             | 18 500 |
| Addition of shelving for improved storage    | 600    |
| Cost of painting business's name on exterior | 140    |
|  | 19 240 |

Each of these payments will benefit the business for more than one financial year.

The revenue expenditure arising from these purchases is as follows.

|                   | \$  |
|-------------------|-----|
| Fuel to fill tank | 50  |
| Insurance premium | 320 |
|                   | 370 |

Each of these payments will benefit the business for less than one financial year (assuming the insurance is an annual premium or covers a period of less than one year).

In the business's accounting system \$19 240 should be debited to the delivery vehicle account.

The revenue items will be debited to the appropriate expense accounts.

You can now answer questions 1–4 on page 169.



# Capital and revenue receipts

## Capital receipts

**Capital receipts** arise from selling off non-current assets or from the owner(s) or lenders providing additional investment in the business. Capital receipts do not appear in the income statement but are shown in the statement of financial position.

## Revenue receipts

### Illustration 2 Recording capital receipts

Marietta owns a book shop. Recently the following transactions occurred:

- Marietta increased her investment in the business by providing \$3000 from her private funds which was paid into the business bank account.
- Marietta's car, value \$14 000, which had previously been used only for personal use, was in future to be used exclusively for business purposes.
- A bank loan was arranged for \$15 000. The funds were paid into the business's bank account.

The correct double entry for each of these transactions is as follows.

|                             |                     |                       |
|-----------------------------|---------------------|-----------------------|
| Additional money invested:  | Dr Bank \$3 000     | Cr Capital \$3 000    |
| Car to be used by business: | Dr Vehicle \$14 000 | Cr Capital \$14 000   |
| Bank loan:                  | Dr Bank \$15 000    | Cr Bank loan \$15 000 |

### LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- define the terms capital receipts and revenue receipts
- explain the importance of correctly distinguishing between capital and revenue expenditure
- explain the importance of correctly distinguishing between capital and revenue receipts.

### Notes:

- 1 Each of these transactions is a capital receipt.
- 2 All of the entries in the accounting system will directly affect items on a statement of financial position.
- 3 None of the entries in the accounting system will directly affect the income statement.

**Revenue receipts** arise from normal business activities (i.e. the sale of goods or services). Some revenue receipts can be incidental to the main business activity: rent received from a tenant; commission received; or interest on investment accounts are all good examples. Revenue receipts are credited to the income statement and so directly affect the calculation of profit (or loss).

## Why does the distinction between capital and revenue matter?

Revenue receipts and expenditure directly affect a business's income statement and so if items are wrongly classified, the business's profit or loss will be inaccurate.

On the other hand, capital receipts and expenditure directly affect a business's statement of financial position. If items are wrongly classified a statement of financial position could show incorrect totals for assets, liabilities and capital.

### KEY TERMS

**Capital receipts:** money received that is of benefit to the business for more than one accounting year.

**Revenue receipts:** money received that is of benefit for less than one accounting year.

Errors in end of year financial statements can have serious consequences. Any inaccuracies in profit, capital or asset values could mislead those who depend on these figures and result in poor decision making.

### Illustration 3

The importance of correctly classifying capital and revenue items

#### Notes:

- 1 The error in the accounts led to the owner making an unwise decision.
- 2 The increase in drawings was not justified and could lead to the business being short of funds during the months ahead.

#### Error in an income statement

Hasib was recently presented with a copy of his business's financial statements. Unfortunately an error was made by the accounts clerk who incorrectly classified a capital receipt as a revenue receipt. The accounts clerk included a bank loan of \$20 000 in the income statement by mistake. As a result the income statement showed a profit of \$30 000 instead of just \$10 000.

Hasib, who was unaware of the error and pleased with the reported profit of \$30 000, decided to increase his monthly drawings from the business.

#### Notes:

- 1 Raslinda could be misled by the understated profit and make cuts in expenditure that are not justified.
- 2 If Raslinda were to sell her business, a potential purchaser could be undercharged because the non-current assets are incorrectly valued.

#### Error in a statement of financial position

Raslinda owns a retail business. Her accounts clerk made a mistake when valuing assets to be shown on her business's statement of financial position at 31 December 2014. During the year ended 31 December 2018 \$10 000 had been spent on installing air conditioning throughout the shop premises. The accounts clerk had treated this item as revenue expenditure instead of adding this amount to the value of the shop premises.

As a result of this error:

- the business's profit would be too low because it includes some capital expenditure of \$10 000
- the shop premises will be undervalued on the business's statement of financial position by \$10 000

You can now answer questions 5–17 on pages 169–171.



## DEVELOPING YOUR SKILLS

## 1 Classifying revenue and capital expenditure

Payments were made for the following by Marie, the owner of a retail business:

- Electricity charges
- Office furniture
- Interest on a loan
- Shelving for shop
- Repairs to delivery van

In each case, state whether the transactions represent revenue expenditure or capital expenditure and give reasons for your decision.

## 2 Classifying revenue and capital expenditure

Payments were made for the following by Josh, the owner of a wholesale business:

- Telephone charges
- Staff wages
- Delivery vehicle
- Maintenance charges on office equipment
- Computer printer

In each case, state whether the transactions represent revenue expenditure or capital expenditure and give reasons for your decision.

## 3 Calculating total revenue and capital expenditure

Paula is the manager of a wholesale business. Recently a new computer system was installed in her office. The amounts paid were as follows.

|                   | \$  |
|-------------------|-----|
| Computer hardware | 900 |
| Printer cartridge | 24  |
| Computer software | 170 |
| Paper for printer | 30  |
| Computer printer  | 140 |

Calculate the total revenue expenditure and total capital expenditure.

## 4 Calculating total revenue and capital expenditure

Marco owns a successful catering business. Recently he has made the following payments.

|  | \$    |
|--|-------|
| Servicing charges for existing catering equipment          | 340   |
| Purchase of some additional second-hand catering equipment | 1 080 |
| Payments to upgrade second-hand catering equipment         | 230   |
| Redecoration of kitchen                                    | 440   |
| Carriage paid to deliver second-hand catering equipment    | 90    |

Calculate the total revenue expenditure and total capital expenditure.

## 5 Classifying revenue and capital receipts

Philo owns a restaurant. Recently the following amounts were received:

- Rent from the tenant who lives in the flat above the restaurant
- One week's cash takings
- Additional investment by Philo from his private funds
- Loan from a friend due for repayment in 2020

In each case, state whether the transactions represent a revenue receipt or a capital receipt and give reasons for your decision.

## 6 Classifying revenue and capital receipts

Kalpna owns a bakery. Recently the following amounts were received:

- Kalpna received interest on one of her business's investment accounts
- Kalpna transferred furniture from her home to be used in her office at the bakery
- Cash sales
- A bank loan was arranged and the funds were paid into the business's bank account

In each case, state whether the transactions represent a revenue receipt or a capital receipt and give reasons for your decision.



## 7 Further practice at classifying items

The following table lists items of capital and revenue expenditure and capital and revenue receipts. Identify which type of expenditure or receipt is appropriate by placing a tick under one of the column headings.

|   | Expenditure |         | Receipt |         |
|---|-------------|---------|---------|---------|
|   | Capital     | Revenue | Capital | Revenue |
| Paid for extension to office block                              |             |         |         |         |
| Bank loan arranged to pay for extension                         |             |         |         |         |
| Rent received from tenant who is using part of new office block |             |         |         |         |
| Paid wages of office staff                                      |             |         |         |         |
| Paid for installation of air conditioning in new office block   |             |         |         |         |

## 8 Further practice at classifying items

Mumtaz owns a furniture store. The following table lists items of capital and revenue expenditure and capital and revenue receipts that occurred recently. Identify which type of expenditure or receipt is appropriate by placing a tick under one of the column headings.

|   | Expenditure |         | Receipt |         |
|---|-------------|---------|---------|---------|
|   | Capital     | Revenue | Capital | Revenue |
| Purchased furniture for resale  |             |         |         |         |
| Mumtaz made an additional investment in the business from private funds |             |         |         |         |
| Purchased furniture for use in the business's accounts office           |             |         |         |         |
| Sold furniture in the showroom to a credit customer                     |             |         |         |         |
| Sold some unwanted office furniture for cash                            |             |         |         |         |

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 4.4–4.5)

### MULTIPLE-CHOICE QUESTIONS

- 9 Which of the following should be treated as capital expenditure in the accounts?
- A Purchase of a new stapler for the office for \$16
  - B Purchase of two vehicles costing \$31 000
  - C Quarterly office rent, \$14 300
  - D Repairs to the air conditioning unit for \$440
- 10 Which of the following should be treated as revenue expenditure in the accounts?
- A Building repairs
  - B Delivery cost of new machinery
  - C Legal costs of a new lease
  - D Wages of employees building a new extension

- 11 Which one of the following items should be treated as a capital receipt in the books of a hotel?
- A Interest received on business savings account
  - B Receipts from guests using the restaurant
  - C Rent received from tenant
  - D Sale of unwanted furniture
- 12 During a recent period the owner of a taxi business made the following payments from the business's bank account.

|  | \$    |
|--|-------|
| Taxi driver's wages                    | 2 200 |
| Servicing of taxi                      | 400   |
| Cost of adapting seating in a new taxi | 900   |

The business's revenue expenditure amounted to which of the following:

- A \$900
- B \$2200
- C \$2600
- D \$3500

- 13** Capital expenditure should include which of the following:
- A** An increase in non-current assets
  - B** A payment for the hire of machinery
  - C** A purchase of inventory for resale
  - D** The payment for maintenance of machinery
- 14** Revenue receipts should be credited to which of the following:
- A** A customer's account
  - B** An asset account
  - C** The capital account
  - D** The income statement
- 15** Which of the following lists contains only revenue receipts?
- A** Additional capital, cash takings, rent received
  - B** Cash takings, discounts received, commission received
  - C** Commission received, additional capital, bank loan
  - D** Rent received, proceeds of sale of non-current asset, bank loan
- 16** Which one of following lists contains only revenue expenditure?
- A** Maintenance of machinery, machine operator's wages, replacement of worn part
  - B** New computer system, new printer, printer cartridges
  - C** Redecoration of staff rest room, new furniture for rest room, wages of catering staff
  - D** Repairs to equipment, staff salaries, carriage on new non-current asset

## OTHER QUESTION

- 17** Electra opened a business selling children's toys a few months ago.

She is not very experienced at keeping financial records and believes she made some mistakes recently. Electra recorded the cost of some new equipment, \$11 000, in her business's income statement for the first three months in operation. The income statement showed a loss of \$5000 for this three-month period.

- a** State what is meant by the term 'revenue expenditure'.
- b** Give two examples of revenue expenditure that could apply to Electra's business.
- c** State the correct profit or loss made by Electra's business for the first three months that it was in operation.
- d** Explain why making errors in an income statement could be serious.

# Depreciation and the disposal of non-current assets

## LEARNING OBJECTIVES

When you have reached the end of this chapter you will be able to:

- explain the term 'depreciation'
- calculate depreciation charges using three different methods
- record depreciation in the general journal and ledger accounts
- prepare financial statements taking account of depreciation
- prepare accounting records to record the disposal of a non-current asset.

## DID YOU KNOW?

The basic principle that non-current assets should be valued at cost is adopted by accountants because cost is an objective means of valuation. In other words, cost will be a matter of fact (i.e. it will be supported by evidence such as an invoice for the non-current asset) rather than opinion.

## KEY TERMS

**Depreciation:** the loss in value of a non-current asset over its useful life.

## Introduction

One of the basic principles of accounting is that non-current assets should be valued at cost.

A non-current asset might lose value because of the following factors:

- **Usage:** non-current assets lose value as they are used by a business. The idea of usage causing a loss in value is often expressed as 'wear and tear'.
- **Technological change:** equipment (e.g. computers) can rapidly become out of date and therefore lose the ability to meet the needs of the business that owns them.
- Some non-current assets might become *inadequate* as a business grows and they lose their value to the business as result. For example, the office photocopier might be unable to cope with increased demand if the business rapidly grew in size.
- **Time factor:** the life of some assets has a legal limit. For example, some business premises are held on what is called a lease where there is an agreement to pay rent for a period of years. The lease is likely to have no value when the expiry date is reached.

**Depreciation** is an *expense* and so it needs to be taken into account when calculating profit. Depreciation is another example of the accruals (or matching) principle, which will be more fully explained in Chapter 7.1.

You may be wondering whether there are any non-current assets that are not subject to depreciation. There is just one obvious example: land can increase in value (except where the land is used for mining or quarrying purposes).

In this chapter you will learn how to record depreciation in a business's accounting records. You will also learn how to make entries to record the disposal of a non-current asset.





# How to calculate depreciation

Depreciation is an estimate of the loss in value over the period of time when the asset is useful to the business. There are many ways of making this estimate, but three are in common use:

- Straight-line method
- Reducing balance method
- Revaluation method

## Illustration 1 The straight-line method of depreciation

A business purchased a delivery vehicle for \$50 000. The owner of the business has decided that the vehicle will be of use to the business for four years.

The **straight-line method** always charges depreciation evenly over the lifetime of the asset. In this case the annual charge would be:

$$\frac{\$50\,000}{4}$$

4

i.e. \$12 500 per year.

So, the depreciation charge is 25 per cent of the cost per year.

Sometimes, the owner of the business might take account of the fact that the vehicle will have some value when it is sold – this is called the **residual value**. So, in this example, if the owner estimated that the vehicle would have a residual value of \$6000, the annual depreciation charge would have been calculated as follows:

Total loss in value over four years is \$50 000 – \$6000 residual value = \$44 000

Therefore the annual depreciation charge is  $\frac{\$44\,000}{4}$

i.e. \$11 000 per year.

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- explain the term 'depreciation'
- calculate depreciation charges using three different methods.

## KEY TERMS

**Straight-line method:** where the annual depreciation charge is based on the cost of the non-current asset and is the same amount each year.

**Residual value:** the value of a non-current asset at the end of its useful life – sometimes referred to as the scrap value.

**Reducing balance method:** where the annual depreciation charge is based on the net book value of the non-current asset at the beginning of the year under review, so that the amount charged reduces each year.

## Illustration 2 The reducing balance method

This method of calculating depreciation takes into consideration the fact that non-current assets do not necessarily lose the same amount of value each year. It recognises that some non-current assets lose more value in the first years and less in the final years of their useful life. The method is referred to as the **reducing balance method**.

Take the example of the owner of a business who bought some equipment for \$20 000. The owner would need to decide on an annual rate of depreciation – say 20 per cent.

Here is how the annual depreciation charge would be calculated:

## DID YOU KNOW?

The basic principle that non-current assets should be valued at cost is adopted by accountants because cost is an objective means of valuation. In other words, cost will be a matter of fact (i.e. it will be supported by evidence such as an invoice for the non-current asset) rather than opinion.

## KEY TERMS

**Net book value:** the value of a non-current asset that takes account of its cost less the total depreciation to date.

**Revaluation method:** where the annual depreciation charge is based on comparing the estimated value of a group of non-current assets at the end of a financial year with the value at the beginning of the financial year.

| Year | Calculation                          | Depreciation charge | Net book value |
|------|--------------------------------------|---------------------|----------------|
| 1    | $20\% \times \text{cost } \$20\,000$ | \$4 000             | \$16 000       |
| 2    | $20\% \times \$16\,000$              | \$3 200             | \$12 800       |
| 3    | $20\% \times \$12\,800$              | \$2 560             | \$10 240       |
|      | <i>and so on</i>                     |                     |                |

**Note:** in this method the annual depreciation charge is based on the value of the asset at the **beginning of the year** in which the charge is to be made. This value is referred to as the **net book value**.

You can now answer questions 1 and 2 on page 181.



## LINKS...

Depreciation is another example of the accruals (or matching) principle explained in 7.1.

## DID YOU KNOW?

There is just one example of a non-current asset that is not subject to depreciation: land, which can increase in value (except where the land is used for mining or quarrying purposes).

## Illustration 3 The revaluation method

In some situations the owner of a business may find it too time consuming to keep detailed records of some groups of non-current assets that individually are of rather limited value. For example, in a vehicle repair workshop it might be difficult to keep detailed records of all of the tens or even hundreds of tools used by the mechanics. Or in a large office there may be numerous items of low-value equipment. In these situations the **revaluation method** of depreciation is used. The depreciation charge is based on an estimate of the fall in the value of the **group** of non-current assets during a financial year. The method requires the non-current assets to be revalued at the end of each financial year.

Here are some details about the crockery owned by the Regent Restaurant.

|                                       | \$    |
|---------------------------------------|-------|
| Value of crockery on 1 January 2018   | 4 800 |
| New crockery purchased during 2018    | 1 400 |
| Value of crockery on 31 December 2018 | 5 300 |

The depreciation charge using the revaluation method based on these figures is \$900. Here are the calculation details:

|  | \$      |
|--|---------|
| Value of crockery at 1 January 2018        | 4 800   |
| Add new crockery                           | 1 400   |
|  | 6 200   |
| Less value of crockery at 31 December 2018 | (5 300) |
| Depreciation charge for 2018               | 900     |

This method is simple to use and avoids the practical problems of attempting to physically count and value many individual items.



# Recording depreciation in the accounts

Businesses keep separate records of the cost of each type of non-current asset and the accumulating depreciation on each type of non-current asset. So, in the nominal ledger you will find, for example, the following two accounts:

- Vehicles (at cost) account
- Provision for depreciation of vehicles account

At the end of each financial year the provision for depreciation account is updated with the annual depreciation charge. The procedure is as follows:

**Step 1** General journal: record the annual depreciation charge



**Step 2** Post the journal entry to the accounts:  
Debit depreciation in the income statement and credit provision for depreciation

The income statement is debited with depreciation to ensure that profits are reduced for the year under review; the credit entry in the provision account has the effect of reducing the value of the non-current asset to be shown on the statement of financial position.

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- record depreciation in the general journal and ledger accounts

### Illustration 4 Accounting records for depreciation

A business owns equipment that cost \$50 000 and was purchased at the beginning of year 1. The policy is to depreciate equipment by 20 per cent per annum using the straight-line method.

Let us look at how to depreciate this equipment at the end of year 1 and year 2.

*Year 1*

Step 1: Calculate the depreciation charge:  
 $20\% \times \$50\,000$ , i.e. \$10 000.

Step 2: Make a journal entry at the end of the year to record the depreciation.

| General journal |   |              |              |
|-----------------|---|--------------|--------------|
| Date            | Details   | Dr           | Cr           |
| Yr 1<br>Dec 31  | Income statement<br>Provision for depreciation (equipment)<br>Entries to charge depreciation of equipment at the year end | \$<br>10 000 | \$<br>10 000 |

Step 3: Post the entries in the general journal to the accounts.

| Dr            | Equipment account | Cr       |
|---------------|-------------------|----------|
| Yr 1<br>Jan 1 | Balance 50 000    | \$<br>\$ |

| Dr | Provision for depreciation of equipment account | Cr                      |
|----|---|-------------------------|
|    | \$  | Yr 1<br>Dec 31          |
|    |   | Income statement 10 000 |

#### Income statement for the year ended 31 December year 1

|                           |        |    |
|---------------------------|--------|----|
|                           | \$     | \$ |
| Gross profit              |        | xx |
| Expenses                  | xx     |    |
| Depreciation of equipment | 10 000 |    |
|                           |        | xx |
| Profit for year           |        | xx |

*Year 2*

Step 1: Calculate the depreciation charge – as the business uses the straight-line method the depreciation charge is again \$10 000.

Step 2: At the end of the year prepare the journal entry to record depreciation for the second year.



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| General journal |   |        |        |
|-----------------|---|--------|--------|
| Date            | Details   | Dr     | Cr     |
| Yr 2            |   | \$     | \$     |
| Dec 31          | Income statement  | 10 000 |        |
|                 | Provision for depreciation (equipment)                      |        | 10 000 |
|                 | Entries to charge depreciation of equipment at the year end |        |        |

Step 3: Post the entries in the general journal to the accounts.

| Dr     | Equipment account | Cr |
|--------|-------------------|----|
| Year 1 | \$                | \$ |
| Jan 1  | Balance 50 000    |    |

| Dr | Provision for depreciation of equipment account | Cr                      |
|----|---|-------------------------|
|    | \$  | \$                      |
|    | Yr 1  |                         |
|    | Dec 31  | Income statement 10 000 |
|    | Yr 2  |                         |
|    | Dec 31  | Income statement 10 000 |

Income statement for the year ended 31 December year 2

|                           |        |    |
|---------------------------|--------|----|
|                           | \$     | \$ |
| Gross profit              |        | xx |
| Expenses                  | xx     |    |
| Depreciation of equipment | 10 000 |    |
|                           |        | xx |
| Profit for year           |        | xx |

# Depreciation and the statement of financial position

When a statement of financial position is prepared at the end of each financial year, it will show the net book value of each non-current asset.

Taking the information about equipment in Illustration 4, here are extracts from the business's statements of financial position for each of Years 1 and 2.

## Illustration 6 Statement of financial position and depreciation

Summary of information about equipment:

| Year   | Cost   | Balance of provision account at end of year | Net book value of equipment at end of year |
|--------|--------|---|--|
|        | \$     | \$  | \$   |
| Year 1 | 50 000 | 10 000                                      | 40 000                                     |
| Year 2 |        | 20 000                                      | 30 000                                     |

Here is an extract from the business's statement of financial position at the end of year 1.

### Statement of financial position at 31 December year 1 (extract)

|                         | \$<br>Cost | \$<br>Total<br>depreciation | \$<br>Net<br>book<br>value |
|-------------------------|------------|-----------------------------|----------------------------|
| NON-CURRENT ASSETS      |            |                             |                            |
| Equipment               | 50 000     | 10 000                      | 40 000                     |
| CURRENT ASSETS          |            |                             |                            |
| Inventory               |            | xx                          |                            |
| Trade receivables, etc. |            | xx                          |                            |

And here is a similar extract but for the statement of financial position at the end of year 2.

### Statement of financial position at 31 December year 2 (extract)

|                    | \$<br>Cost | \$<br>Total<br>depreciation | \$<br>Net<br>book<br>value |
|--------------------|------------|-----------------------------|----------------------------|
| NON-CURRENT ASSETS |            |                             |                            |
| Equipment          | 50 000     | 20 000                      | 30 000                     |

### CURRENT ASSETS

|                         |    |
|-------------------------|----|
| Inventory               | xx |
| Trade receivables, etc. | xx |

In the case of the crockery, the statement of financial position will show only the updated value of the non-current asset.

### Regent Restaurant Statement of financial position at 31 December year 2018 (extract)

|                         | \$ | \$ | \$<br>Net<br>book<br>value |
|-------------------------|----|----|----------------------------|
| NON-CURRENT ASSETS      |    |    |                            |
| Crockery at valuation   |    |    | 5 300                      |
| CURRENT ASSETS          |    |    |                            |
| Inventory               |    | xx |                            |
| Trade receivables, etc. |    | xx |                            |

### STUDY TIP

When using the straight-line and reducing balance methods of depreciation it is important to remember that the income statement for a particular year will only show that year's depreciation. However, the statement of financial position entries must take account of the original cost and the total depreciation to date.

### Notes about the Regent Restaurant:

- As there is no separate record of cost and depreciation, just the net book value is shown on the statement of financial position.
- It is good practice to add the words 'at valuation' as shown. This makes it clear to anyone using the statement of financial position that this non-current asset's value has been estimated by the owner or manager of the business.

You can now answer questions 5 and 6 on page 182.



# Recording the disposal of a non-current asset

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- prepare accounting records to record the disposal of a non-current asset.

## DID YOU KNOW?

A non-current asset might lose value because of the following factors:

- **Technological change:** equipment (e.g. computers) can rapidly become out of date.
- Some non-current assets might become **inadequate** as a business grows. For example, the office photocopier might be unable to cope with increased demand if the business rapidly grew in size.
- **Time factor:** the life of some assets has a legal limit. Some business premises are held on what is called a lease where there is an agreement to pay rent for a period of years. The lease is likely to have no value when the expiry date is reached.
- **Usage:** wear and tear.

## Notes:

- 1 The transfer entries will be made on the date of the disposal.
- 2 As a result of the transfer, the vehicle account shows that the business no longer owns a vehicle and so the account can be closed.

When a business sells a non-current asset it will be necessary to:

- establish whether a profit or loss was made on the disposal
- remove all details of the non-current asset from the accounting records.

## Illustration 7 How to record a disposal

Robbie owns a business and the end-of-year financial statements are prepared annually on 31 December. On 8 May 2018 Robbie sold his business's vehicle for \$3500 and received a cheque for that amount. On that date the accounting records for the vehicle were as follows:

| Dr   |   | Vehicle account |        | Cr |  |
|------|---|-----------------|--------|----|--|
| 2018 |   | \$              |        | \$ |  |
| Jan  | 1 | Balance         | 30 000 |    |  |

| Dr |     | Provision for depreciation of equipment account |         | Cr |        |
|----|-----|---|---------|----|--------|
|    |     | \$  | 2018    | \$ |        |
|    | Jan | 1   | Balance |    | 24 000 |

So the accounting records show that the vehicle has a net book value of \$6000.

Step 1: Open a disposal account to record the transactions relating to the sale of the non-current asset.

| Dr |  | Vehicle disposal account |  | Cr |  |
|----|--|--------------------------|--|----|--|
|    |  | \$                       |  | \$ |  |

Step 2: Remove the record of the cost of the vehicle from the vehicle account by transfer to the vehicle disposal account. A journal entry is required to make this transfer.

| General journal |   |        |        |
|-----------------|---|--------|--------|
| Date            | Details   | Dr     | Cr     |
| 2018            |   | \$     | \$     |
| May 8           | Vehicle disposal                                      | 30 000 |        |
|                 | Vehicle   |        | 30 000 |
|                 | Entries to transfer the cost of vehicle upon disposal |        |        |

The ledger records will now show:

| Dr   |   | Vehicle account |       | Cr               |        |
|------|---|-----------------|-------|------------------|--------|
| 2018 |   | \$              | 2018  | \$               |        |
| Jan  | 1 | Balance         | May 8 | Vehicle disposal | 30 000 |
|      |   | 30 000          |       |                  |        |

| Dr   |   | Vehicle disposal account |        | Cr |  |
|------|---|--------------------------|--------|----|--|
| 2018 |   | \$                       |        | \$ |  |
| May  | 8 | Vehicle                  | 30 000 |    |  |



Step 3: Make a journal entry to transfer the accumulated depreciation of the vehicle to the disposal account and update the ledger accounts.

#### General journal

| Date          | Details  | Dr           | Cr           |
|---------------|--|--------------|--------------|
| 2018<br>May 8 | Provision for depreciation of vehicle<br>Vehicle disposal<br>Entries to transfer the provision for depreciation upon disposal of the vehicle | \$<br>24 000 | \$<br>24 000 |

The ledger records will now show:

| Dr            | Vehicle account |                        | Cr     |
|---------------|-----------------|------------------------|--------|
| 2018          | \$              | 2018                   | \$     |
| Jan 1 Balance | 30 000          | May 8 Vehicle disposal | 30 000 |

| Provision for depreciation of equipment account |                  |        |       |         |
|---|------------------|--------|-------|---------|
| Dr  |                  |        |       | Cr      |
| 2018  |                  | \$     | 2018  | \$      |
| May 8   | Vehicle disposal | 24 000 | Jan 1 | Balance |
|   |                  |        |       | 24 000  |

| Dr   |           | Vehicle disposal account |      | Cr                           |        |
|------|-----------|--------------------------|------|------------------------------|--------|
| 2018 |           | \$                       | 2018 |                              | \$     |
| May  | 8 Vehicle | 30 000                   | May  | 8 Provision for depreciation | 24 000 |

Step 4: The amount received for the vehicle is now recorded in the disposal account.

| Dr    | Vehicle disposal account |        |       |                            | Cr     |
|-------|--------------------------|--------|-------|----------------------------|--------|
| 2018  |                          |        |       |                            | \$     |
| May 8 | Vehicle                  | 30 000 | 2018  |                            | \$     |
|       |                          |        | May 8 | Provision for depreciation | 24 000 |
|       |                          |        | 8     | Bank                       | 3 500  |

Step 5: At 31 December, the accounting year end, the disposal account will be closed and the balance transferred to the income statement.

| Dr   | Vehicle disposal account |         |  |               | Cr   |    |                                     |  |               |
|------|--------------------------|---------|--|---------------|------|----|-------------------------------------|--|---------------|
| 2018 |                          |         |  |               | 2018 |    |                                     |  |               |
| May  | 8                        | Vehicle |  | \$ 30 000     | May  | 8  | Provision for depreciation          |  | \$ 24 000     |
|      |                          |         |  |               |      | 8  | Bank                                |  | 3 500         |
|      |                          |         |  |               | Dec  | 31 | Income statement (loss on disposal) |  | 2 500         |
|      |                          |         |  | <u>30 000</u> |      |    |                                     |  | <u>30 000</u> |

#### Notes:

- 1 As a result of the transfer, the depreciation has been removed from the accounting system and the provision account can be closed.
- 2 At this point the disposal account shows, on balance, the net book value of \$6000.

**Note:** the debit entry for the cheque will have been made in the cash book.

#### Notes:

- 1 In the illustration the disposal account has a final credit balance of \$2500. This amount represents a loss on the sale of the non-current asset.
- 2 The loss on disposal can be thought of as an under-provision for depreciation.
- 3 The other entry for the loss is in the second part of the income statement.

### DID YOU KNOW?

In some businesses it may be the policy to depreciate a non-current asset in the year of its disposal. In the illustration above, it was assumed that this was not the business's policy.

It is possible for a business to make a profit on a disposal. In this situation, there will be a debit balance on the asset disposal account. A profit on disposal can be thought of as arising from an over-provision for depreciation.

### Illustration 8 Recording a profit on a disposal

On 11 August 2018 Salma sold some unwanted office equipment and received a cheque for \$900. The equipment had cost \$3800 and had been depreciated by \$3450. The business's accounting year end is 31 December.

Here is the equipment disposal account showing a profit on the sale of the equipment:

| Dr   |    |                                       |       | Equipment disposal account |  |  |  | Cr   |   |                            |       |    |  |  |  |
|------|----|---------------------------------------|-------|----------------------------|--|--|--|------|---|----------------------------|-------|----|--|--|--|
| 2018 |    |                                       |       | \$                         |  |  |  | 2018 |   |                            |       | \$ |  |  |  |
| Aug  | 11 | Equipment                             | 3 800 |                            |  |  |  | May  | 8 | Provision for depreciation | 3 450 |    |  |  |  |
| Dec  | 31 | Income statement (profit on disposal) | 550   |                            |  |  |  |      | 8 | Bank                       | 900   |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
|      |    |                                       |       |                            |  |  |  |      |   |                            |       |    |  |  |  |
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## DEVELOPING YOUR SKILLS

## 1 Calculating depreciation

Amina opened a hotel. On 1 January 2017 the following non-current assets were purchased.

|                        | Cost<br>\$ |
|------------------------|------------|
| Equipment              | 25 000     |
| Furniture and fittings | 20 000     |
| Crockery               | 5 000      |

Amina has made the following decisions about annual depreciation charges:

- The equipment should be depreciated using the straight-line method. It is expected to have a useful life of five years and have a residual value of \$2000.
- Furniture and fittings should be depreciated using the reducing balance method. The rate of depreciation to be used is 20 per cent.
- There are many items of crockery, each of which has a relatively small value, so Amina has decided to use the revaluation method.

At 1 January 2018, crockery was valued at \$4300. During the year ended 31 December 2018, Amina purchased additional items of crockery costing \$1300. At 31 December 2018 the crockery was revalued at \$4700.

Complete a table to show depreciation charges on each non-current asset for each of the years ended 31 December 2017 and 31 December 2018. Show all your working in full.

## 2 Calculating depreciation

Edward opened his car repair business on 1 January 2017. On that date the following non-current assets were purchased.

|           | Cost<br>\$ |
|-----------|------------|
| Machinery | 120 000    |
| Fixtures  | 30 000     |
| Tools     | 11 200     |

Edward has made the following decisions about annual depreciation charges:

- Machinery should be depreciated using the straight-line method. It has a useful life of five years.
- Fixtures should be depreciated using the reducing balance method. The rate of depreciation to be used is 30 per cent.
- There are many tools, each of which has a low value, so the revaluation method of depreciation will be used.

At 1 January 2018, tools were valued at \$9900. During the year ended 31 December 2018 Edward purchased additional tools costing \$2600. On 31 December 2018 tools were revalued at \$11 100.

Complete a table to show depreciation charges on each non-current asset for each of the years ended 31 December 2017 and 31 December 2018. Show all your working in full.



### 3 Accounting records for depreciation

Refer to your answer for question 1 and prepare the accounting records to record information about non-current assets and depreciation charges for both 2017 and 2018. Include the following:

- Journal entries
- Non-current asset accounts
- Provision for depreciation accounts (for vehicles and furniture and fittings)
- Extracts from the income statements

### 4 Accounting records for depreciation

Refer to your answer for question 2 and prepare the accounting records to record information about non-current assets and depreciation charges for both 2017 and 2018. Include the following:

- Journal entries
- Non-current asset accounts
- Provision for depreciation accounts (for machinery and fixtures)
- Extracts from the income statements

### 5 Statement of financial position and depreciation

Refer to your answer for question 3 and prepare extracts from the statement of financial position for the end of 2017 and 2018 to show how information about non-current assets should be recorded.

### 6 Statement of financial position and depreciation

Refer to your answer for question 4 and prepare extracts from the statement of financial position for the end of 2017 and 2018 to show how information about non-current assets should be recorded.

### 7 Preparing a disposal account

Sherelle owns a music store. The business's financial year ends on 31 December.

On 1 January 2018 the business's general ledger included the following accounts.

|  |                  |
|--|------------------|
| Furniture and fittings (at cost)                     | Balance \$21 000 |
| Provision for depreciation of furniture and fittings | Balance \$16 400 |
| Fixtures and fittings                                | Dr \$21 000      |
| Provision for fixtures and fittings                  | Cr \$16 400      |

On 10 August 2018 Sherelle sold all of the furniture and fittings for \$2500 and received a cheque for that amount.

Prepare the following accounting records to record the disposal:

- Journal entries
- Furniture and fittings account
- Provision for depreciation of furniture and fittings account
- Furniture and fittings disposal account

It is the policy not to provide depreciation on a non-current asset in the year of disposal.

### 8 Preparing a disposal account

Samir recently sold one of his business's delivery vehicles. The business's accounting year ends on 31 December. The following accounts appeared in the business's books on 1 January 2018.

|   |                  |
|---|------------------|
| Delivery vehicles (at cost)                     | Balance \$88 000 |
| Provision for depreciation of delivery vehicles | Balance \$39 000 |
| Fixtures and fittings                           | Dr \$21 000      |
| Provision for fixtures and fittings             | Cr \$16 400      |

The delivery vehicle had originally cost \$22 000 and had been depreciated by \$17 500. The vehicle was sold for \$5800 and a cheque for that amount was received on 14 March 2018.

Prepare the following accounting records to record the disposal:

- Journal entries
- Delivery vehicles account
- Provision for depreciation of delivery vehicles account
- Delivery vehicle disposal account

It is the policy not to provide depreciation on a non-current asset in the year of disposal.

**9\* Preparing end-of-year financial statements including depreciation for a business, Year 1**

Great Value Stores was opened on 1 January 2018. At the end of the business's first year of trading the following trial balance was extracted from the books of account after the gross profit for the year had been calculated.

| Trial balance at 31 December 2018 |         |         |
|-----------------------------------|---------|---------|
|                                   | Dr      | Cr      |
|                                   | \$      | \$      |
| Capital                           |         | 68 000  |
| Cash at bank                      | 6 000   |         |
| Drawings                          | 37 000  |         |
| Furniture and fittings            | 41 000  |         |
| Gross profit                      |         | 100 000 |
| Inventory at 31 December 2018     | 12 000  |         |
| Office equipment                  | 3 000   |         |
| Other operating expenses          | 24 000  |         |
| Rent                              | 13 000  |         |
| Trade payables                    |         | 18 000  |
| Trade receivables                 | 15 000  |         |
| Vehicles                          | 35 000  |         |
|                                   | 186 000 | 186 000 |

The depreciation policy is as follows:

- Furniture and fittings should be depreciated over a four-year period using the straight-line method taking account of the expected residual value of \$4000.
- Vehicles are to be depreciated by 25 per cent per annum using the reducing balance method.
- Office equipment is to be depreciated using the revaluation method. On 31 December 2018 office equipment was revalued at \$2400. No equipment was bought during the year.

Prepare the IS for the year and the SoFP at 31 December 2018.

**10\* Preparing end-of-year financial statements including depreciation for a business, Year 1**

Jody opened her coffee bar on 1 January 2018. At the end of the business's first year of trading the following trial balance was extracted from the books of account after the gross profit

for the year had been calculated.

| Trial balance at 31 December 2018 |        |         |
|-----------------------------------|--------|---------|
|                                   | Dr     | Cr      |
|                                   | \$     | \$      |
| Bank overdraft                    |        | 11 300  |
| Capital                           |        | 41 300  |
| Crockery etc.                     | 6 400  |         |
| Drawings                          | 42 400 |         |
| Equipment                         | 23 000 |         |
| Fixtures and fittings             | 30 000 |         |
| Gross profit                      |        | 145 700 |
| Insurance                         | 8 400  |         |
| Inventory at 31 December 2018     | 14 900 |         |
| Other operating expenses          | 75 300 |         |
| Trade payables                    |        | 6 200   |
| Trade receivables                 | 4 100  |         |

The depreciation policy is as follows:

- Equipment should be depreciated over a five-year period using the straight-line method, taking account of the expected residual value of \$2000.
- Fixtures and fittings are to be depreciated by 40 per cent per annum using the reducing balance method.
- Crockery is to be depreciated using the revaluation method. On 31 December 2018 Jody revalued the crockery at \$5700. No equipment was bought during the year.

Prepare the IS for the year and the SoFP at 31 December 2018.

**11 Preparing an income statement for an established business including a profit on disposal of a non-current asset**

Esther was preparing her business's income statement for the year ended 31 May 2018. She was able to provide the following information:

- The business made a gross profit of \$234 000 during the year ended 31 May 2018.
- The following amounts should be charged to the income statement for business expenses: administration expenses \$4800, electricity charges \$7200, general expenses \$6600, wages and salaries \$63 780.



- On 1 February 2018 Esther sold a delivery vehicle for \$5400. The vehicle had cost \$22 000 and had been depreciated by \$17 500.
- Esther's policy is to depreciate her business's non-current assets by 25 per cent per annum using the reducing balance method. Depreciation should be based on a net book value of \$156 000.

Prepare an income statement for the year ended 31 May 2018.

### 12\* Preparing an income statement for an established business including a loss on disposal of a non-current asset

Ombeya was preparing his business's income statement for the year ended 30 November 2018. He was able to provide the following information:

- The business made a gross profit of \$382 500 during the year ended 30 November 2018.
- The business received some additional income from renting out its premises. During the year ended 30 November 2018 the tenant had paid \$8400 in rent.
- The following amounts should be charged to the income statement for business expenses: general expenses \$10 120, electricity charges \$7140, insurance \$8890, repairs and maintenance \$3540, wages \$47 800, water charges \$4810.
- On 17 October 2018 Ombeya sold some unwanted office equipment for \$850. The office equipment had cost \$9500 and had been depreciated by \$7800.
- Ombeya depreciates some of his business's non-current assets by 20 per cent per annum using the straight-line method. These non-current assets cost \$112 000. Other non-current assets are depreciated using the revaluation method. At 1 December 2017 these non-current assets were valued at \$15 400; at 30 November 2018 they were revalued at \$13 800.

Prepare an income statement for the year ended 30 November 2018.

### 13\* Preparing financial statements for an established business including a profit on disposal of a non-current asset

Kavita owns a health-food wholesale business which was opened three years ago on 1 January 2016. The following trial balance has been extracted from the business's books of account at the end of the third year of trading.

**Trial balance at 31 December 2018**

|  | Dr<br>\$ | Cr<br>\$ |
|--|----------|----------|
| Capital                                      |          | 44 850   |
| Cash at bank                                 | 11 850   |          |
| Drawings                                     | 29 900   |          |
| Electricity                                  | 7 840    |          |
| Furniture and fittings                       |          |          |
| Cost   | 32 000   |          |
| Provision for depreciation                   |          | 12 800   |
| Gross profit                                 |          | 137 230  |
| Inventory at 31 December 2018                | 15 600   |          |
| Office equipment                             | 3 780    |          |
| Profit on disposal of fittings               |          | 840      |
| Rent   | 14 190   |          |
| Selling expenses                             | 3 860    |          |
| Trade payables                               |          | 11 210   |
| Trade receivables                            | 7 470    |          |
| Vehicles                                     |          |          |
| Cost   | 48 000   |          |
| Provision for depreciation at 1 January 2018 |          | 21 000   |
| Wages  | 53 440   |          |

The business's depreciation policy is as follows:

- Furniture and fittings are depreciated by 20 per cent per annum using the straight-line method.
- Vehicles are depreciated by 25 per cent per annum using the reducing balance method.
- Office equipment is depreciated using the revaluation method. On 31 December 2018, Kavita revalued office equipment at \$3100.

Prepare the business's income statement for the year ended 31 December 2018 and a statement of financial position at that date.



**14\*** Preparing financial statements for an established business and including a loss on disposal of a non-current asset

'Samad Fresh Foods' is a retail unit opened three years ago by Samad Abbas. The following trial balance has been extracted from the business's books of account at the end of the third year of trading.

| Trial balance at 31 December 2018            |         |         |
|--|---------|---------|
|  | Dr      | Cr      |
|  | \$      | \$      |
| Bank overdraft                               |         | 2 370   |
| Capital                                      |         | 24 000  |
| Carriage outwards                            | 470     |         |
| Drawings                                     | 33 500  |         |
| Furniture and fittings                       |         |         |
| Cost   | 28 000  |         |
| Provision for depreciation at 1 January 2018 |         | 16 800  |
| General expenses                             | 3 340   |         |
| Insurance                                    | 7 290   |         |
| Inventory at 1 January 2018                  | 15 510  |         |
| Loss on disposal of a vehicle                | 1 700   |         |
| Office equipment                             | 2 850   |         |
| Purchases                                    | 247 610 |         |
| Returns                                      | 2 210   | 3 720   |
| Revenue                                      |         | 382 880 |
| Trade payables                               |         | 4 830   |
| Trade receivables                            | 4 020   |         |
| Vehicles                                     |         |         |
| Cost   | 60 000  |         |
| Provision for depreciation                   |         | 39 280  |
| Wages  | 67 380  |         |
|  | 473 880 | 473 880 |

Additional information:

- The inventory on 31 December 2018 was valued at \$16 530.

The business's depreciation policy is as follows:

- Furniture and fittings are depreciated by 20 per cent per annum using the straight-line method.
- Vehicles are depreciated by 20 per cent per annum using the reducing balance method.
- Office equipment is depreciated using the revaluation method. On 31 December 2018, Samad revalued office equipment at \$2 280.

Prepare the business's income statement for the year ended 31 December 2018 and a statement of financial position at that date.

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- record ledger entries to adjust expenses for accruals and prepayments.

## KEY TERMS

**Expense accrual:** an amount owing for expenses at the end of a financial period.

## Notes:

- Start by making sure you transfer the correct amount to the income statement (i.e. \$23 000). You will remember from 2.26 that this transfer will appear first as a journal entry in the general journal.
- Record the unpaid invoice of \$1000 as a balance on the account.
- The balance brought down is a credit balance, so an accrued expense is a current liability as it is an amount owed. It is shown on the statement of financial position as 'other payables'.

## Making adjustments to expenses

The rule when preparing an annual income statement is to ensure that any expense item represents the accounting of that expense for that year – whether it has been paid or not. As a result some expenses need adjusting at the year end because there is an amount due but unpaid when the financial statements are prepared. The amount due but unpaid is referred to as an **expense accrual**. This is an example of the accruals (matching) principle which is explained in more detail in Section 7.1 on page 316.

### Illustration 1

### Recording an accrual

Natalie is preparing her business's income statement on 31 December 2018. Her electricity account at that date is as follows.

| Dr          | Electricity account | Cr |
|-------------|---------------------|----|
| 2018        | \$                  | \$ |
| Jan to Bank |                     |    |
| Dec         | 22 000              |    |

The account shows that so far \$22 000 has been paid in electricity charges and this is the figure that should appear in the end-of-year trial balance.

Natalie tells you that she has received an invoice for electricity for \$1000 for the last weeks of the year.

How much is the electricity charge for the year? *Answer:* \$23 000 (i.e. \$22 000 + accrual of \$1000).

It is \$23 000 that will appear in the income statement (i.e. the full amount for the year whether it has been paid or not).

Here are the entries required in the electricity account to reflect this.

| Dr     |         |     |        | Electricity   |      |    |                  | Cr |     |        |               |  |  |
|--------|---------|-----|--------|---------------|------|----|------------------|----|-----|--------|---------------|--|--|
| 2018   |         |     |        | \$            | 2018 |    |                  |    |     | \$     |               |  |  |
| Jan to |         |     |        |               |      |    |                  |    |     |        |               |  |  |
| Dec    | Bank    |     | 22 000 |               | Dec  | 31 | Income statement |    |     | 23 000 |               |  |  |
| Dec    | Balance | c/d | 1 000  |               |      |    |                  |    |     |        |               |  |  |
|        |         |     |        | <u>23 000</u> |      |    |                  |    |     |        | <u>23 000</u> |  |  |
|        |         |     |        |               | 2019 |    |                  |    |     |        |               |  |  |
|        |         |     |        |               | Jan  | 1  | Balance          |    | b/d | 1 000  |               |  |  |

You can now answer questions 1 and 2 on page 193.

In the case of some expenses, payments will have been made that cover the business beyond the current accounting year. In this situation the business will have a **prepaid expense**. The same principle applies: it is essential to charge the exact amount of this year's expense to the income statement.

### KEY TERMS

**Prepaid expense:** the payment of an expense in advance of the accounting year to which it relates.

#### Illustration 2 Recording a prepaid expense

Natalie reports that this year she has paid \$38 000 for insurance. Here is the insurance account in the general ledger.

| Dr     | Insurance account | Cr |
|--------|-------------------|----|
| 2018   | \$                | \$ |
| Jan to | Bank 38 000       |    |
| Dec    |                   |    |

It appears that this sum includes insurance for the first two months of the next accounting year, \$2000.

What is the annual charge for insurance? *Answer:* \$36 000 (i.e. payment \$38 000 – prepayment \$2000).

It is \$36 000 that will be charged to the income statement. The remaining \$2000 is regarded as a current asset as it represents money spent from which the benefit is still to come.

Here are the entries required to reflect this.

| Dr     |             | Insurance account |        |                  |               | Cr |
|--------|-------------|-------------------|--------|------------------|---------------|----|
| 2018   |             | \$                | 2018   |                  | \$            |    |
| Jan to | Bank        | 38 000            | Dec 31 | Income statement | 36 000        |    |
| Dec    |             |                   | 31     | Balance          | c/d 2 000     |    |
|        |             | <u>38 000</u>     |        |                  | <u>38 000</u> |    |
| 2019   |             |                   |        |                  |               |    |
| Jan 1  | Balance b/d | 2 000             |        |                  |               |    |

#### Notes:

- 1 As before, start by making sure you transfer the correct amount to the income statement (i.e. \$36 000). Again a journal entry will be made first in the general journal.
- 2 Record the prepayment of \$2000 as the balance to carry down on the account.
- 3 The balance brought down is a debit balance as it is a current asset. It is shown on the statement of financial position as 'other receivables'.

You can now answer questions 3 and 4 on page 193.



## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- record ledger entries to adjust income accounts for income accrued and income prepaid.

## DID YOU KNOW?

A debit balance on an income account records an amount due to a business at the end of a year. The amount due would be settled early in the next year as soon as the next amount of income is received.

## Notes:

- The account shows that the tenant has paid \$15 000 in rent so far.
- As this is a gain for the business, the account has been credited and the bank account debited with the amount received.
- Rent received will appear as an entry in the credit column of the trial balance prepared before the end-of-year financial statements are drafted.

**Note:** the transfer of rent received to the income statement will be recorded first as an entry in the general journal.

Sometimes a business will earn income in addition to sales. For example, if a business owns its own property, some unused space could be sublet and rent would then be received from the tenant – this is called ‘rent received’.

It is quite likely, taking the example of rent received, that the tenant could owe money to the business at the financial year end, or the tenant could have paid ahead for part of the next financial period. Where these situations arise, it will be necessary to make adjustments in the accounts to ensure that the correct amount of income for the year is transferred to the income statement.

**Illustration 3** Adjusting income for income accrued

Omar is preparing his business's income statement at 31 December 2018. The business sublets part of its premises to another business and receives rent. Here is the rent received account on 31 December 2018.

| Dr |  | Rent received account |            | Cr   |        |
|----|--|-----------------------|------------|------|--------|
|    |  | \$                    | 2018       |      | \$     |
|    |  |                       | Jan to Dec | Bank | 15 000 |

Suppose that the tenant had failed to pay \$1 000 in rent for the last few weeks of the year. How much will be transferred to the second part of the income statement? *Answer:* \$16 000 (i.e. \$15 000 + amount due \$1 000).

Here is the updated rent received account showing the transfer of rent received to the income statement.

| Dr     |                  | Rent received account |            | Cr   |        |
|--------|------------------|-----------------------|------------|------|--------|
| 2018   |                  | \$                    | 2018       |      | \$     |
| Dec 31 | Income statement | 16 000                | Jan to Dec | Bank | 15 000 |

The rent received account will then be balanced as follows:

| Dr     |                  | Rent received account |            | Cr          |        |
|--------|------------------|-----------------------|------------|-------------|--------|
| 2018   |                  | \$                    | 2018       |             | \$     |
| Dec 31 | Income statement | 16 000                | Jan to Dec | Bank        | 15 000 |
|        |                  |                       | Dec 31     | Balance c/d | 1 000  |
|        |                  | 16 000                |            |             | 16 000 |
| 2019   |                  |                       |            |             |        |
| Jan 1  | Balance          | b/d                   | 1 000      |             |        |

## Notes:

- Balance the account, recording the amount due from the tenant.
- The balance is a debit balance when brought down.
- The balance brought down is a current asset. This is because the business is owed money by the tenant. It is shown on the statement of financial position as ‘other receivables’.

#### Illustration 4 Adjusting for income prepaid

Here is another example where a business is receiving rent from a tenant. However, this time the tenant has paid more than is necessary for the year under review by sending money to cover the first weeks of the next accounting year.

| Dr | Rent received account | Cr    |
|----|-----------------------|-------|
|    | \$ 2018               | \$    |
|    | Jan to Dec Bank       | 8 500 |

Suppose that the tenant has paid \$700 for rent for the first few weeks of 2019. How much will be transferred to the income statement (second section)? Answer: \$7800 (\$8500 – amount received in advance \$700).

Here is the rent received account showing the transfer of rent received to the income statement.

| Dr                            | Rent received account | Cr    |
|-------------------------------|-----------------------|-------|
| 2018                          | \$ 2018               | \$    |
| Dec 31 Income statement 7 800 | Jan to Dec Bank       | 8 500 |

The rent received account will then be balanced as follows:

| Dr                            | Rent received account | Cr    |
|-------------------------------|-----------------------|-------|
| 2018                          | \$ 2018               | \$    |
| Dec 31 Income statement 7 800 | Jan to Dec Bank       | 8 500 |
| 31 Balance c/d 700            |                       |       |
|                               | 8 500                 | 8 500 |
|                               | 2019                  |       |
|                               | Jan 1 Balance b/d 700 |       |

#### DID YOU KNOW?

A credit balance on an income account records income received in advance at the end of a year.

**Note:** the transfer of rent received to the income statement will first appear in the general journal.

#### Notes:

- 1 Balance the account with the amount received in advance from the tenant.
- 2 The balance will appear as a credit balance when brought down.
- 3 The balance brought down is a current liability. This is because the business owes the tenant this money which has been received ahead of the year to which it relates. It is shown on the statement of financial position as '**other payables**'.

#### STUDY TIP

A great deal of care is needed when calculating the amount of an adjustment. For example, suppose a business receives rent of \$900 quarterly in advance from a tenant and the most recent quarterly payment had been received at the beginning of the quarter that commenced on 1 December 2018. If the business's financial year ended on 31 December, the tenant would have prepaid rent for two months, and the balance on the rent received account would be \$600.

You can now answer questions 5 and 6 on page 194.

#### KEY TERMS

**Other receivables:** term used on a statement of financial position to include prepaid expenses and income accrued.

**Other payables:** term used on a statement of financial position to include accrued expenses and income prepaid.



# Preparing financial statements with adjustments to expenses and income

## LEARNING OBJECTIVES

When you have reached the end of this section you will be able to:

- prepare income statements taking accounts of adjustments to expenses and income.

### Illustration 5

The second part of an income statement including adjustments and extracts from the statement of financial position

Yasmin is preparing her income statement for the year ended 31 December 2018. Her business has made a gross profit of \$125 000. Her trial balance includes the following items.

#### Trial balance at 31 December 2018 (extract)

|                   | Dr     | Cr     |
|-------------------|--------|--------|
|                   | \$     | \$     |
| General expenses  | 26 000 |        |
| Insurance         | 9 000  |        |
| Interest received |        | 7 000  |
| Rent received     |        | 14 000 |
| Wages             | 75 000 |        |

Yasmin provides the following additional information at 31 December 2018.

- General expenses is to be accrued, \$4 000
- Insurance is prepaid, \$1 000
- Interest received is to be accrued, \$2 000
- Rent received has been prepaid, \$3 000
- Wages is to be accrued, \$5 000.

Work out the effect of the adjustments. Here is a table summarising the effects.

|                   | Amount in trial balance | Adjustment                         | Amount to be recorded in the income statement | Adjustment in statement of financial position |
|-------------------|-------------------------|------------------------------------|---|---|
|                   | \$                      |                                    | \$  | \$  |
| General expenses  | 26 000                  | Accrual \$4 000                    | 30 000  | Current liability \$4 000                     |
| Insurance         | 9 000                   | Prepayment \$1 000                 | 8 000   | Current asset \$1 000                         |
| Interest received | 7 000                   | Amount receivable accrued \$2 000  | 9 000   | Current asset \$2 000                         |
| Rent received     | 14 000                  | Amount received in advance \$3 000 | 11 000  | Current liability \$3 000                     |
| Wages             | 75 000                  | Accrual \$5 000                    | 80 000  | Current liability \$5 000                     |

Here are the journal entries that would be needed to transfer the expense and income items to the income statement.

| General journal |   |         |        |
|-----------------|---|---------|--------|
| Date            | Details   | Dr      | Cr     |
| 2018<br>Dec 31  | Income statement                                      | \$      | \$     |
|                 | General expenses                                      | 118 000 | 30 000 |
|                 | Insurance   |         | 8 000  |
|                 | Wages   |         | 80 000 |
|                 | Transfer of expenses for the year to income statement |         |        |
|                 | Interest received                                     | 9 000   |        |
|                 | Rent received   | 11 000  |        |
|                 | Income statement                                      |         | 20 000 |
|                 | Transfer of income for the year to income statement   |         |        |



Here are the expense and income accounts recording these adjustments and balanced.

### GENERAL LEDGER

| Dr   |    |                  |     | General expenses account  | Cr         |    |                  |                  |
|--|----|------------------|-----|---------------------------|------------|----|------------------|------------------|
| 2018   |    |                  |     | \$                        | 2018       |    |                  | \$               |
| Jan to Dec   |    | Bank             |     | 26 000                    | Dec        | 31 | Income statement | 30 000           |
| Dec  | 31 | Balance          | c/d | 4 000                     |            |    |                  |                  |
|  |    |                  |     | <u>30 000</u>             |            |    |                  | <u>30 000</u>    |
|  |    |                  |     |                           | 2019       |    |                  |                  |
|  |    |                  |     |                           | Jan        | 1  | Balance          | b/d              |
|  |    |                  |     |                           |            |    |                  | 4 000            |
| Dr   |    |                  |     | Insurance account         | Cr         |    |                  |                  |
| 2018   |    |                  |     | \$                        | 2018       |    |                  | \$               |
| Jan to Dec   |    | Bank             |     | 9 000                     | Dec        | 31 | Income statement | 8 000            |
|  |    |                  |     | <u>9 000</u>              |            | 31 | Balance          | c/d              |
|  |    |                  |     |                           |            |    |                  | 1 000            |
|  |    |                  |     |                           |            |    |                  | <u>9 000</u>     |
| 2019   |    |                  |     |                           |            |    |                  |                  |
| Jan  | 1  | Balance          | b/d | 1 000                     |            |    |                  |                  |
| Dr   |    |                  |     | Wages account             | Cr         |    |                  |                  |
| 2018   |    |                  |     | \$                        | 2018       |    |                  | \$               |
| Jan to Dec   |    | Bank             |     | 75 000                    | Dec        | 31 | Income statement | 80 000           |
| Dec  | 31 | Balance          | c/d | 5 000                     |            |    |                  |                  |
|  |    |                  |     | <u>80 000</u>             |            |    |                  | <u>80 000</u>    |
|  |    |                  |     |                           | 2019       |    |                  |                  |
|  |    |                  |     |                           | Jan        | 1  | Balance b/d      | 5 000            |
| Dr   |    |                  |     | Interest received account | Cr         |    |                  |                  |
| 2018   |    |                  |     | \$                        | 2018       |    |                  | \$               |
| Dec  | 31 | Income statement |     | 9 000                     | Jan to Dec |    | Bank             | 7 000            |
|  |    |                  |     | <u>9 000</u>              | Dec        | 31 | Balance          | c/d              |
|  |    |                  |     |                           |            |    |                  | 2 000            |
|  |    |                  |     |                           |            |    |                  | <u>9 000</u>     |
| 2019   |    |                  |     |                           |            |    |                  |                  |
| Jan  | 1  | Balance          | b/d | 2 000                     |            |    |                  |                  |
| Dr   |    |                  |     | Rent received account     | Cr         |    |                  |                  |
| 2018   |    |                  |     | \$                        | 2018       |    |                  | \$               |
| Dec  | 31 | Income statement |     | 11 000                    | Jan to Dec |    | Bank             | 14 000           |
|  | 31 | Balance          | c/d | 3 000                     |            |    |                  |                  |
|  |    |                  |     | <u>14 000</u>             |            |    |                  | <u>14 000</u>    |
|  |    |                  |     |                           | 2019       |    |                  |                  |
|  |    |                  |     |                           | Jan        | 1  | Balance          | b/d              |
|  |    |                  |     |                           |            |    |                  | 3 000            |
| Income statement for the year ended 31 December 2018 |    |                  |     |                           |            |    |                  |                  |
|  |    |                  |     |                           |            |    |                  | \$               |
| Gross profit   |    |                  |     |                           |            |    |                  | 125 000          |
| Add other income                                     |    |                  |     |                           |            |    |                  |                  |
| Interest received                                    |    |                  |     | 9 000                     |            |    |                  |                  |
| Rent received  |    |                  |     | <u>11 000</u>             |            |    |                  |                  |
|  |    |                  |     |                           |            |    |                  | <u>20 000</u>    |
| Less expenses  |    |                  |     |                           |            |    |                  | 145 000          |
| General expenses                                     |    |                  |     | 30 000                    |            |    |                  |                  |
| Insurance  |    |                  |     | 8 000                     |            |    |                  |                  |
| Wages  |    |                  |     | <u>80 000</u>             |            |    |                  |                  |
|  |    |                  |     |                           |            |    |                  | <u>(118 000)</u> |
| Profit for the year                                  |    |                  |     |                           |            |    |                  | <u>27 000</u>    |

Here is an extract from the statement of financial position at 31 December showing how the five adjustments will appear.

**Statement of financial position at 31 December 2018 (extract)**

|   | \$    | \$ |
|---|-------|----|
| <b>CURRENT ASSETS</b>                         |       |    |
| Inventory                                     | xx    |    |
| Trade receivables                             | xx    |    |
| Other receivables                             |       |    |
| Income accrued (interest)                     | 2 000 |    |
| Expense prepaid (insurance)                   | 1 000 |    |
| Cash at bank                                  | xx    |    |
|   |       | xx |
|   | \$    | \$ |
| <b>CURRENT LIABILITIES</b>                    |       |    |
| Trade payables                                | xx    |    |
| Other payables                                |       |    |
| Income prepaid (rent)                         | 3 000 |    |
| Expenses accrued (general expenses and wages) | 9 000 |    |
|   |       | xx |

**KEY TERMS**

**Accruals principle:** in order to calculate a true and fair profit, income for a financial year is matched exactly with expenses that relate to that accounting year whether paid or not. This principle is also called the matching principle.

**LINKS...**

There is more about the accruals principle in 7.1.

**Summary: the accruals (matching) principle**

The process of making adjustments to expense and income accounts at the year end results from a rule known as the **accruals principle** (also called the 'matching' principle). This rule requires profits to be calculated on the basis that the income for an accounting year (whether received or not) should be matched against expenses for that accounting year (whether paid or not).

**STUDY TIP**

While you are getting used to making these adjustments, it is easy to make a mistake when entering details on the statement of financial position. Remember that current assets represent amounts owed to the business (expenses prepaid and income accrued); while current liabilities represent amounts owed by the business (expense accruals and income prepaid).

## DEVELOPING YOUR SKILLS

## 1 Recording expense accruals

A business's trial balance includes the following information about expenses paid during the year ended 30 June 2018.

|                  | \$     |
|------------------|--------|
| Electricity      | 7 900  |
| General expenses | 11 800 |

The owner of the business provides the following additional information about expense accruals at 30 June 2018:

- An invoice for electricity, \$700, is due but unpaid.
- General expenses, \$300, relating to the year ended 30 June 2018, remains unpaid.

Prepare the following ledger accounts recording this information. The accounts should be balanced and the balances brought down.

- Electricity
- General expenses

## 2 Recording expense accruals

A business's trial balance includes the following information about expenses paid during the year ended 31 March 2018.

|                         | \$      |
|-------------------------|---------|
| Administration expenses | 15 500  |
| Salaries                | 109 600 |

The owner of the business provides the following additional information about expense accruals at 31 March 2018:

- Administration expenses, \$900, remains unpaid.
- Salaries \$3200 are due but unpaid.

Prepare the following ledger accounts recording this information. The accounts should be balanced and the balances brought down.

- Administration expenses
- Salaries

## 3 Recording expense prepayments

A business's trial balance includes the following information about expenses paid during the year ended 31 August 2018.

|           | \$     |
|-----------|--------|
| Insurance | 9 100  |
| Rent      | 27 600 |

The owner of the business provides the following additional information about expense prepayments at 31 August 2018:

- The payments for insurance includes \$800 relating to the following year.
- Rent, \$1200, is prepaid.

Prepare the following ledger accounts recording this information. The accounts should be balanced and the balances brought down.

- Insurance
- Rent

## 4 Recording expense prepayments

A business's trial balance includes the following information about expenses paid during the year ended 28 February 2018.

|                  | \$     |
|------------------|--------|
| Electricity      | 14 400 |
| Selling expenses | 19 500 |

The owner of the business provides the following additional information about expense prepayments at 28 February 2018:

- The payments for electricity include \$500 relating to the following year.
- Selling expenses, \$700, is prepaid.

Prepare the following ledger accounts recording this information. The accounts should be balanced and the balances brought down.

- Electricity
- Selling expenses



### 5 Recording adjustments to income accounts

A business obtains income from subletting part of its premises and from interest on an investment.

During the year ended 30 November 2018 the business received the following amounts.

|                        | \$     |
|------------------------|--------|
| Rent received          | 22 400 |
| Loan interest received | 7 300  |

At 30 November 2018, the business has received rent, \$600, in advance, but is owed interest of \$200.

Prepare the following ledger accounts recording this information. The accounts should be balanced and the balances brought down.

- Rent received
- Loan interest received

### 6 Recording adjustments to income accounts

A business sublets some unused space to two tenants.

The following information is available about the year ended 31 December 2018 concerning Tenant 1:

|                                    | \$     |
|------------------------------------|--------|
| Rent received during the year      | 16 200 |
| Rent due but unpaid at 31 December | 1 100  |

The following information is available about the year ended 31 December 2018 concerning Tenant 2:

|   | \$     |
|---|--------|
| Rent received during the year           | 18 200 |
| Rent received in advance at 31 December | 900    |

Prepare two rent received accounts (one for each tenant) for the year ended 31 December 2018. Balance both accounts at the year end.

# Irrecoverable debts and provisions for doubtful debts

## Introduction

In this chapter you are going to learn how to deal with a potentially serious problem for any business: an irrecoverable debt. You will also learn how businesses that experience irrecoverable debts try to make sure that their financial statements give a fair view of the value of trade receivables.

## Irrecoverable debts

Sometimes businesses have to face the serious problem that a credit customer is unable or unwilling to pay the amount due. This might arise when the customer concerned disputes the amount owed or when the customer has gone out of business. Why is this serious? The answer is that a business, faced with an **irrecoverable debt**, is going to lose not only some of the profit it had expected to make, but also the cash that the trade receivable should have been paying.

## Provisions for doubtful debts

Since businesses can experience irrecoverable debts from time to time, it follows that the owners of those businesses continually face some uncertainty about whether all of their trade receivables will actually be received. The question then arises as to whether it is right to show the total of trade receivables on a statement of financial position without indicating that a portion of the amount due may never be received, i.e. that some debts are doubtful.

To ignore the possibility of doubtful debts would be a breach of an important accounting principle, and that is that all accounting statements should present a **true and fair** view of the business's financial position. To overcome this problem many statements of financial position include what is called a **provision for doubtful debts**.

### LEARNING OBJECTIVES

When you have reached the end of Chapters 4.15–4.18 you will be able to:

- explain the term 'irrecoverable debt'
- record irrecoverable debts in the accounts
- record recovery of debts written off in the accounts
- explain why some businesses have a provision for doubtful debts
- prepare the accounting records for a provision for doubtful debts.

### KEY TERMS

**Irrecoverable debt:** an amount owed by a credit customer that will not be paid.

**True and fair:** the principle that accounting records should be factually accurate and present a reasonable estimate of the financial position.

**Provision for doubtful debts:** an amount set aside from profits to take account of the likelihood that some trade receivables will not pay the amount due and so will reduce the value of trade receivables on a statement of financial position.

# Irrecoverable debts and the recovery of debts written off

When the owner of a business becomes aware that a credit customer will not pay the amount outstanding, it is important that action is taken immediately and the amount due is written off.

## How to write off irrecoverable debts

Accounting records need amendment when an irrecoverable debt occurs so that the account of the credit customer is closed and profits are reduced.

### KEY TERMS

**Prudence principle:** an accounting principle that requires that where there is doubt, asset and profit values are understated rather than overstated, and that losses and liabilities are overstated rather than understated.

### Illustration 1 Writing off an irrecoverable debt

Kimberly owns a business that sells goods on credit to many customers, one of which is Oasis. This customer's account in Kimberly's sales ledger shows that a sale took place on 11 January 2016 and the amount due was \$1800. However, by 15 May 2016 it became clear that this debt would not be paid. Kimberly decided that the debt should be written off and the account closed.

Here are the required entries in Kimberly's books of account, starting with a journal entry.

#### GENERAL JOURNAL

| Date           | Details   | Dr         | Cr         |
|----------------|---|------------|------------|
| 2016<br>May 15 | Irrecoverable debts<br>Trade receivable: Oasis Ltd<br>Entries to write off bad debt | \$<br>1800 | \$<br>1800 |

#### SALES LEDGER

| Dr                   | Oasis account | Cr                               |
|----------------------|---------------|----------------------------------|
| 2016<br>Jan 11 Sales | \$<br>1800    | 2016<br>May 15 Bad debts<br>1800 |

#### NOMINAL LEDGER

| Dr                       | Irrecoverable debts account | Cr |
|--------------------------|-----------------------------|----|
| 2016<br>May 15 Oasis Ltd | \$<br>1800                  | \$ |

### Notes:

- 1 The account of Oasis is now closed.
- 2 The irrecoverable debts account is an expense account.
- 3 At the financial year end the irrecoverable debts account will be closed and the total of irrecoverable debts for the year will be transferred to the income statement.

## The prudence principle

When Kimberly wrote off the irrecoverable debt she was following another important accounting rule which is called **prudence**. This rule requires all businesses to ensure that users of their accounts are not misled into thinking that assets and profits have a greater value than is realistic, or that losses and liabilities are less than is the case. So, in this



case Kimberly was right to recognise the irrecoverable debt as soon as she was reasonably certain that no money would be received. To have kept the account of Oasis open in her books of account could have given others the idea that the business had a valuable asset, when this was not the case.

## Recovery of debts

The amount lost when an irrecoverable debt is written off may be covered at a later date. **Recovery of debts** can occur many months, even years, after the original debt was written off. Usually the former customer is prompted to make a settlement because he or she is anxious to restore good relationships with the owner of the business and hopes to be given credit facilities again.

You can now answer questions 1 and 2 on page 204.

**LINKS...**  
There is more about prudence and other principles in 7.1.

### KEY TERMS

**Recovery of debts:** when a debt that has previously been written off is paid by the customer.

#### Illustration 2 Recording a bad debt recovered

On 12 February 2018, Kimberly received a cheque for \$1800 from Oasis in settlement of the company's account which had been written off in 2016 (see Illustration 1).

Here are the accounting records to record this transaction:

#### GENERAL JOURNAL

| Date           | Details   | Dr         | Cr         |
|----------------|---|------------|------------|
| 2018<br>Feb 12 | Trade receivable: Oasis<br>Recovery of debts<br>Entries to reinstate customer's account | \$<br>1800 | \$<br>1800 |

#### Cash book (bank columns only)

| Dr     | Bank       | Cr | Bank |
|--------|------------|----|------|
| 2018   | \$         |    | \$   |
| Feb 12 | Oasis 1800 |    |      |

#### SALES LEDGER

| Dr     |  |  |  | Oasis account          |  |  |  | Cr     |  |  |  |           |  |  |  |
|--------|--|--|--|------------------------|--|--|--|--------|--|--|--|-----------|--|--|--|
| 2018   |  |  |  | \$                     |  |  |  | 2018   |  |  |  | \$        |  |  |  |
| Feb 12 |  |  |  | Recovery of debts 1800 |  |  |  | Feb 12 |  |  |  | Bank 1800 |  |  |  |

#### NOMINAL LEDGER

| Dr     |  |  |  | Recovery of debt account |  |  |  | Cr     |  |  |  |            |  |  |  |
|--------|--|--|--|--------------------------|--|--|--|--------|--|--|--|------------|--|--|--|
| 2018   |  |  |  | \$                       |  |  |  | 2018   |  |  |  | \$         |  |  |  |
| Dec 31 |  |  |  | Income statement 1800    |  |  |  | Feb 12 |  |  |  | Oasis 1800 |  |  |  |

#### Income statement for the year ended 31 December 2018

|                   |      |      |
|-------------------|------|------|
|                   | \$   | \$   |
| Gross profit      | xxx  |      |
| Other income      |      |      |
| Recovery of debts | 1800 |      |
| etc.              | xxx  |      |
|                   |      | xxxx |

#### Notes:

- The first step is to reinstate the customer's account and that requires a journal entry. So a debit entry is made for the amount due in the customer's account in the sales ledger and a matching credit entry is made in a recovery of debts account in the nominal ledger.
- The cheque is debited to the bank account and a credit entry is made in the customer's account which is now closed.
- The recovery of debts account is closed at the end of the financial year and the balance is transferred to the income statement where it is shown as part of the business's 'other income'.

You can now answer questions 3 and 4 on page 204.

# Provisions for doubtful debts

Businesses must ensure that their statement of financial position gives a true and fair view of trade receivables not just by stating the total of all the balances in the sales ledger, but also by making a deduction for an estimate of doubtful debts, called a provision for doubtful debts.

Provisions are usually calculated at the year end using one of the following methods:

- The estimate of doubtful debts is often based on past experience of irrecoverable debts and is usually expressed as a percentage of trade receivables. For example, the owner of a business could check what has happened in previous years and calculate that, on average, 3 per cent of trade receivables become irrecoverable debts.
- In some cases, however, the provision might be based on a detailed end-of-year review of each trade receivable. This means preparing an analysis of how long debts have been outstanding, usually referred to as an **ageing schedule of trade receivables**. The view might be taken that the longer a debt has been outstanding the more doubtful it has become. A sliding scale of percentages is used to calculate the provision, with the oldest debts receiving the highest percentage.

## Illustration 3

Using an ageing schedule of trade receivables to calculate a provision for doubtful debts

Mustafa & Sons is a wholesaler. The business's provision for doubtful debts is based on the length of time debts have been outstanding. Here is its ageing schedule of trade receivables showing the calculation of the provision for doubtful debts.

| Length of time outstanding (weeks) | Amount | Estimated likely bad debts as a percentage | Provision for doubtful debts |
|------------------------------------|--------|--|------------------------------|
|                                    | \$     |  | \$                           |
| 5–10                               | 12 000 | 1  | 120                          |
| 11–25                              | 8 000  | 2  | 160                          |
| 26–40                              | 3 000  | 5  | 150                          |
| 41+                                | 1 000  | 50   | 500                          |
| Total provision for doubtful debts |        |  | 930                          |

## KEY TERMS

### Ageing schedule of trade receivables:

a list of all amounts due from credit customers shown in a sequence based on how long the debt has been outstanding.

A provision for doubtful debts is a further example of the principle of prudence i.e. businesses taking care not to overstate the value of assets and profits. It is also a further illustration of the accruals principle i.e. ensuring that the profit for a year is based on matching the income for a year with the costs for that year.

#### Illustration 4

Statements of financial position and provisions for doubtful debts

On 31 December Year 1 Ralph's trial balance showed total trade receivables to be \$40 000. However, based on past experience Ralph is doubtful that 5 per cent of this amount will be received.

Here is an extract from Ralph's statement of financial position showing a true and fair view of trade receivables.

##### Statement of financial position at 31 December year 1 (extract)

|                                   | \$      | \$     | \$ |
|-----------------------------------|---------|--------|----|
| CURRENT ASSETS                    |         |        |    |
| Inventory                         |         | xx     |    |
| Trade receivables                 | 40 000  |        |    |
| Less provision for doubtful debts | (2 000) |        |    |
|                                   |         | 38 000 |    |

### Ledger accounts and provisions for doubtful debts

When a business creates a provision for doubtful debts, it is not enough to show this information on the statement of financial position, it is important to complete a double-entry record too.

The accounting entries to create a provision for doubtful debts are:

Debit Income statement

Credit Provision for doubtful debts account

#### Illustration 5

Accounting entries to create a provision for doubtful debts

Taking the information about Ralph's provision for doubtful debts in Illustration 4, here are the accounting records starting with a journal entry.

##### GENERAL JOURNAL

| Date   | Details  | Dr    | Cr    |
|--------|--|-------|-------|
| Yr 1   |  | \$    | \$    |
| Dec 31 | Income statement                                 | 2 000 |       |
|        | Provision for doubtful debts                     |       | 2 000 |
|        | Entries to create a provision for doubtful debts |       |       |

##### NOMINAL LEDGER

| Dr | Provision for doubtful debts account | Cr    |
|----|--------------------------------------|-------|
|    | \$ Yr 1                              | \$    |
|    | Dec 31 Income statement              | 2 000 |



**Notes:**

- 1 Creating a provision for doubtful debts reduces the profits of the year in which it is created. So the provision is debited in the income statement and treated as an expense.
- 2 The provision for doubtful debts account is deducted from trade receivables on the statement of financial position (see Illustration 4).

**Income statement for the year ended 31 December year 1**

|                                     |              |          |
|-------------------------------------|--------------|----------|
|                                     | \$           | \$       |
| Gross profit                        |              | xx       |
| Less expenses                       | (xx)         |          |
| <b>Provision for doubtful debts</b> | <b>2 000</b> |          |
|                                     | <hr/>        | xx       |
| Profit                              |              | <hr/> xx |

Once a provision for doubtful debts account has been created it remains in the business's books of account. The credit balance on the account will appear on any trial balance that is prepared.

### Avoiding irrecoverable debts; credit control

Many businesses depend on selling their goods (or services) on credit, but naturally they want to minimise the risk of irrecoverable debts. It is important, therefore, for the owner of a business to give some attention to the idea of credit control. The following procedures could be put in place:

- Credit facilities are only made available to a potential customer whose creditworthiness has been investigated, usually by means of acquiring references from, for example, the customer's bank. Sometimes it is also possible to use a specialist agency to check an individual's credit rating.
- Once a customer has been allowed credit, it is usual to set a limit on the amount of credit available at any one time. All customer accounts should be reviewed carefully to ensure the credit limit is not exceeded.
- Payment should be encouraged in the case of outstanding debts with reminders and statements of account issued at regular intervals.

# Keeping a provision for doubtful debts up to date

Once a provision for doubtful debts is created it will be reviewed annually.

## When should a business increase its provision for doubtful debts?

If there is an increase in the total of trade receivables at the year end, then the provision should be increased to keep in step with this change.

The entries required to increase a provision for doubtful debts are:

Debit      Income statement *with the amount of the increase*

Credit     Provision for doubtful debts account *with the amount of the increase*

## When should a business decrease its provision for doubtful debts?

The total of trade receivables could decrease from one year to the next. In this situation the amount of the provision for doubtful debts should be decreased to keep in step with the decrease in trade receivables.

The entries required to *decrease* a provision for doubtful debts are:

Debit      Provision for doubtful debts account *with the amount of the decrease*

Credit     Income statement *with the amount of the decrease*

### DID YOU KNOW?

As well as responding to changes in the total of trade receivables at the year end, a provision for doubtful debts could be changed because the business's experience of actual irrecoverable debts has decreased or increased.

### Illustration 6      Changing the provision for doubtful debts

Returning to the case of Ralph's business, at the end of year 1 a provision for doubtful debts of \$2000 was created.

- At the end of year 2 trade receivables totalled \$46 000.
- At the end of year 3 trade receivables totalled \$34 000.

Ralph wishes to maintain the provision for doubtful debts at 5 per cent of trade receivables.

So, the provision needs to change to \$2300 at the end of year 2 (i.e. 5 per cent of \$46 000). At the end of year 3 the provision needs to change to \$1700 (i.e. 5 per cent of \$34 000).

Setting the changes out as a calculation:

| End of year 2   | \$    |
|---|-------|
| Provision at the end of year 2 to be $5\% \times \$46\,000$ | 2 300 |
| Existing provision (at end of year 1)                       | 2 000 |
| <b>Increase</b> in provision for doubtful debts             | 300   |

| End of year 3   | \$    |
|---|-------|
| Provision at the end of year 3 to be $5\% \times \$34\,000$ | 1 700 |
| Existing provision (at end of year 2)                       | 2 300 |
| <b>Decrease</b> in provision for doubtful debts             | 600   |

Here are the entries in the accounting system for year 2 and year 3 to put into effect the changing value of the provision for doubtful debts.

*Year 2 (increasing the provision)*

#### GENERAL JOURNAL

| Date   | Details  | Dr  | Cr  |
|--------|--|-----|-----|
| Yr 2   |  | \$  | \$  |
| Dec 31 | Income statement                                     | 300 |     |
|        | Provision for doubtful debts                         |     | 300 |
|        | Entries to increase the provision for doubtful debts |     |     |

| Dr   |    |         |     |       | Provision for doubtful debts account |                         |                  |     | Cr           |    |
|------|----|---------|-----|-------|--------------------------------------|-------------------------|------------------|-----|--------------|----|
| Yr 2 |    |         |     |       | \$                                   | Yr 1                    |                  |     |              | \$ |
| Dec  | 31 | Balance | c/d | 2 300 | Dec                                  | 31                      | Income statement |     | 2 000        |    |
|      |    |         |     |       | Yr 2                                 |                         |                  |     |              |    |
|      |    |         |     |       | <b>Dec 31</b>                        | <b>Income statement</b> |                  |     | <b>300</b>   |    |
|      |    |         |     |       | <u>2 300</u>                         |                         |                  |     | <u>2 300</u> |    |
|      |    |         |     |       | Yr 3                                 |                         |                  |     |              |    |
|      |    |         |     |       | Jan                                  | 1                       | Balance          | b/d | 2 300        |    |

#### Income Statement for the year ended 31 December Year 2

|   |            |      |
|---|------------|------|
|   | \$         | \$   |
| Gross profit                                    |            | xx   |
| Less expenses                                   | (xx)       |      |
| <b>Increase in provision for doubtful debts</b> | <b>300</b> |      |
|   |            | (xx) |
| Profit  |            | xx   |

The statement of financial position will show the latest position.

#### Statement of financial position at 31 December year 2 (extract)

|                                   |         |        |    |
|-----------------------------------|---------|--------|----|
|                                   | \$      | \$     | \$ |
| CURRENT ASSETS                    |         |        |    |
| Inventory                         |         | xx     |    |
| Trade receivables                 | 46 000  |        |    |
| Less provision for doubtful debts | (2 300) |        |    |
|                                   |         | 43 700 |    |

#### STUDY TIP

When preparing the end-of-year financial statements always check to see if there is already a provision for doubtful debts. If there is, remember any increase or decrease in the provision is recorded in the income statement, but the full amount is shown on the statement of financial position. Also, do not use informal abbreviations like PDD. Financial statements are very formal documents, so PDD is not correct.

You can now answer questions 5–12 on pages 204–206.



Year 3 (decreasing the provision)

### GENERAL JOURNAL

| Date   | Details  | Dr  | Cr  |
|--------|--|-----|-----|
| Yr 3   |  | \$  | \$  |
| Dec 31 | Provision for doubtful debts                         | 600 |     |
|        | Income statement                                     |     | 600 |
|        | Entries to decrease the provision for doubtful debts |     |     |

| Dr     |                  |     |      |      | Provision for doubtful debts account |                  |     |      |    | Cr |  |  |  |      |
|--------|------------------|-----|------|------|--------------------------------------|------------------|-----|------|----|----|--|--|--|------|
| Yr 2   |                  |     |      | \$   | Yr 1                                 |                  |     |      | \$ |    |  |  |  |      |
| Dec 31 | Balance          | c/d | 2300 |      | Dec 31                               | Income statement |     | 2000 |    |    |  |  |  |      |
|        |                  |     |      |      | Yr 2                                 |                  |     |      |    |    |  |  |  |      |
|        |                  |     |      |      | Dec 31                               | Income statement |     | 300  |    |    |  |  |  |      |
|        |                  |     |      | 2300 |                                      |                  |     |      |    |    |  |  |  | 2300 |
| Yr 3   |                  |     |      |      | Yr 3                                 |                  |     |      |    |    |  |  |  |      |
| Dec 31 | Income statement |     |      | 600  | Jan 1                                | Balance          | b/d | 2300 |    |    |  |  |  |      |
| Dec 31 | Balance          | c/d | 1700 |      |                                      |                  |     |      |    |    |  |  |  |      |
|        |                  |     |      | 2300 |                                      |                  |     |      |    |    |  |  |  | 2300 |
|        |                  |     |      |      | Yr 4                                 |                  |     |      |    |    |  |  |  |      |
|        |                  |     |      |      | Jan 1                                | Balance          | b/d | 1700 |    |    |  |  |  |      |

### Income statement for the year ended 31 December year 3

|  |            |    |
|--|------------|----|
|  | \$         | \$ |
| Gross profit   | xx         |    |
| Other income:  |            |    |
| <b>Add: decrease in provision for doubtful debts</b> | <b>600</b> |    |
|  |            | xx |
| Less expenses  | xx         |    |
| Expenses   | (xx)       |    |
|  |            | xx |
| Profit   |            | xx |

The statement of financial position will show the latest position.

### Statement of financial position at 31 December year 3 (extract)

|                                   |         |        |    |
|-----------------------------------|---------|--------|----|
|                                   | \$      | \$     | \$ |
| CURRENT ASSETS                    |         |        |    |
| Inventory                         |         | xx     |    |
| Trade receivables                 | 34 000  |        |    |
| Less provision for doubtful debts | (1 700) |        |    |
|                                   |         | 32 300 |    |

## DEVELOPING YOUR SKILLS

## 1 Writing off an irrecoverable debt

The following balances appeared in the sales ledger of a business on 1 March 2016.

|             | \$    |
|-------------|-------|
| Bestservice | 3 850 |
| Q&A Ltd     | 840   |

By 31 August 2016 it was apparent that neither of these trade receivables would be able to pay the amount due and their accounts were written off as irrecoverable debts.

Prepare the journal entries and ledger accounts to show how this information should be recorded in the books of account.

## 2 Writing off an irrecoverable debt

The following balances appeared in the sales ledger of a business on 1 July 2016.

|                | \$    |
|----------------|-------|
| Murray Lee     | 540   |
| Shantal Watson | 1 720 |

By 30 September 2016 it was apparent that neither of these trade receivables would be able to pay the amount due and their accounts were written off as irrecoverable debts.

Prepare the journal entries and ledger accounts to show how this information should be recorded in the books of account.

## 3 Recording the recovery of a debt written off

Refer to the information given in question 1. On 3 September 2018 a cheque was received from Bestservice for \$3850 in payment of the debt written off in 2016.

Prepare the journal entries and ledger accounts to show how the recovery of debt should be recorded in the books of account.

## 4 Recording the recovery of a debt written off

Refer to the information given in question 2. On 9 October 2018 a cheque was received from Murray Lee for \$540 in payment of the debt written off in 2016.

Prepare the journal entries and ledger accounts to show how the recovery of debt should be recorded in the books of account.

## 5 Calculating provisions for doubtful debts

The owner of a business decided to create a provision for doubtful debts. It was agreed that the provision should be maintained at 5 per cent of trade receivables at each year end.

Trade receivables at 31 December:

Year 1 \$36 800 Year 2 \$39 200 Year 3 \$35 200

Complete the following table recording information about the business's provision for doubtful debts.

| Year | Provision for doubtful debts | Amount to be entered in the income statement | Entry in the provision for doubtful debts account: enter debit or credit |
|------|------------------------------|--|--|
|      | \$                           | \$   |  |
| 1    |                              |  |  |
| 2    |                              |  |  |
| 3    |                              |  |  |

## 6 Calculating provisions for doubtful debts

The owner of a business decided to create a provision for doubtful debts. It was agreed that the provision should be maintained at 2.5 per cent of trade receivables at each year end.

Trade receivables at 31 December:

Year 1 \$48 000 Year 2 \$36 000 Year 3 \$56 000

Complete the following table recording information about the business's provision for doubtful debts.

| Year | Provision for doubtful debts | Amount to be entered in the income statement | Entry in the provision for doubtful debts account: enter debit or credit |
|------|------------------------------|--|--|
|      | \$                           | \$   |  |
| 1    |                              |  |  |
| 2    |                              |  |  |
| 3    |                              |  |  |

## 7 Accounting records for provisions for doubtful debts

Using the information in question 5, prepare the following accounting records for each of the years 1, 2 and 3 relating to provisions for doubtful debts:

- General Journal entries
- Extract from income statement
- Provision for doubtful debts account
- Extract from statement of financial position

### 8 Accounting records for provisions for doubtful debts

Using the information in question 6, prepare the following accounting records for each of the years 1, 2 and 3 relating to provisions for doubtful debts:

- General Journal entries
- Extract from income statement
- Provision for doubtful debts account
- Extract from statement of financial position

### 9 Preparing financial statements including the creation of a provision for doubtful debts

Tricia owns a retail store. Her business's financial year end is 31 December. The following trial balance was extracted from the business's books of account on 31 December 2018.

|  | Dr<br>\$ | Cr<br>\$ |
|--|----------|----------|
| Capital                                      |          | 62 210   |
| Cash at bank                                 | 3 890    |          |
| Drawings                                     | 31 300   |          |
| Equipment                                    |          |          |
| Cost   | 35 000   |          |
| Provision for depreciation at 1 January 2018 |          | 14 000   |
| Gross profit                                 |          | 151 270  |
| Irrecoverable debts                          | 850      |          |
| Inventory at 31 December 2018                | 29 480   |          |
| Operating expenses                           | 57 610   |          |
| Recovery of debts                            |          | 190      |
| Rent   | 25 400   |          |
| Trade payables                               |          | 11 660   |
| Trade receivables                            | 27 000   |          |
| Vehicles                                     |          |          |
| Cost   | 45 000   |          |
| Provision for depreciation at 1 January 2018 |          | 16 200   |
|  | 255 530  | 255 530  |

Additional information at 31 December 2018:

- Rent, \$1320, was prepaid.
- Operating expenses, \$2080, were due but unpaid.
- Tricia decided to create a provision for doubtful debts of 5 per cent of trade receivables at the year end.
- Depreciation was charged on non-current assets as follows:
  - Equipment – 20 per cent per annum using the straight-line method.
  - Vehicles – 20 per cent per annum using the reducing balance method.

Prepare end-of-year financial statements.

### 10 Preparing financial statements including the creation of a provision for doubtful debts

Patrick, a wholesaler, extracted the following trial balance from his business's books of account at 31 August 2018.

|   | Dr<br>\$ | Cr<br>\$ |
|---|----------|----------|
| Capital                                   |          | 72 688   |
| Cash at bank                              | 9 872    |          |
| Discounts                                 | 889      | 2 071    |
| Drawings                                  | 44 482   |          |
| Electricity                               | 3 783    |          |
| Fixtures and fittings                     |          |          |
| Cost                                      | 45 000   |          |
| Provision for depreciation at 1 Sept 2017 |          | 27 000   |
| Gross profit                              |          | 194 356  |
| Insurance                                 | 7 794    |          |
| Inventory at 31 August 2018               | 58 384   |          |
| Irrecoverable debts                       | 1 475    |          |
| Recovery of debts                         |          | 246      |
| Trade payables                            |          | 22 373   |
| Trade receivables                         | 18 360   |          |
| Vehicles                                  |          |          |
| Cost                                      | 80 000   |          |
| Provision for depreciation at 1 Sept 2017 |          | 48 250   |
| Wages and salaries                        | 96 945   |          |
|   | 366 984  | 366 984  |

Additional information at 31 August 2018:

- Prepaid expenses were: insurance \$375; electricity \$446.
- Expenses due but unpaid were: wages and salaries, \$2970.
- Patrick decided to create a provision for doubtful debts of 5 per cent of trade receivables at the year end.
- Depreciation was charged on non-current assets as follows:
  - Fixtures and fittings – 20 per cent per annum using the straight-line method.
  - Vehicles – 25 per cent per annum using the reducing balance method.

Prepare end-of-year financial statements.

### 11 Preparing financial statements including revising the provision for doubtful debts

The following trial balance was extracted from the books of Magna, a wholesale business, on 31 July 2018.



|   | Dr<br>\$  | Cr<br>\$  |
|---|-----------|-----------|
| Capital                                       |           | 476 620   |
| Carriage inwards                              | 4 620     |           |
| Cash at bank                                  | 3 080     |           |
| Discounts                                     | 450       | 1 730     |
| Drawings                                      | 45 450    |           |
| Equipment                                     |           |           |
| Cost  | 58 000    |           |
| Provision for depreciation at 1 August 2017   |           | 11 600    |
| General expenses                              | 24 490    |           |
| Inventory at 1 August 2017                    | 62 330    |           |
| Irrecoverable debts                           | 320       |           |
| Premises                                      |           |           |
| Cost  | 480 000   |           |
| Provision for depreciation at 1 August 2017   |           | 9 600     |
| Provision for doubtful debts at 1 August 2017 |           | 820       |
| Purchases                                     | 568 380   |           |
| Recovery of debts                             |           | 130       |
| Rent received                                 |           | 26 380    |
| Returns                                       | 6 360     | 8 940     |
| Revenue                                       |           | 909 490   |
| Trade payables                                |           | 33 670    |
| Trade receivables                             | 18 900    |           |
| Vehicles                                      |           |           |
| Cost  | 70 000    |           |
| Provision for depreciation at 1 August 2017   |           | 17 500    |
| Wages   | 138 580   |           |
| Water charges                                 | 15 520    |           |
|   | 1 496 480 | 1 496 480 |

Additional information at 31 July 2018:

- Inventory was valued at \$47 370.
- Prepaid expenses were: general expenses, \$805.
- Expenses due but unpaid were: wages \$4110, water charges \$660.
- Rent received, \$1270, is due but unpaid.
- The policy is to maintain the provision for doubtful debts at 5 per cent of trade receivables at the year end.
- Depreciation was charged on non-current assets as follows:
  - Premises – 2 per cent per annum using the straight-line method.
  - Equipment – 20 per cent per annum using the straight-line method.
  - Vehicles – 25 per cent per annum using the reducing balance method.

Prepare the business's income statement for the year ended 31 July 2018 and a statement of financial position at that date.

## 12 Preparing financial statements including revising the provision for doubtful debts

Leon Fray is the owner of Palm Beach Store. The business's trial balance on 31 May 2018 was as follows.

|   | Dr<br>\$  | Cr<br>\$  |
|---|-----------|-----------|
| Administration expenses                     | 8 480     |           |
| Bank overdraft                              |           | 8 490     |
| Capital                                     |           | 567 150   |
| Carriage outwards                           | 4 470     |           |
| Drawings                                    | 52 390    |           |
| Equipment and furniture                     |           |           |
| Cost  | 140 000   |           |
| Provision for depreciation at 1 June 2017   |           | 61 250    |
| Insurance                                   | 11 820    |           |
| Inventory at 1 June 2017                    | 34 230    |           |
| Irrecoverable debts                         | 960       |           |
| Premises                                    |           |           |
| Cost  | 500 000   |           |
| Provision for depreciation at 1 June 2017   |           | 45 000    |
| Provision for doubtful debts at 1 June 2017 |           | 930       |
| Purchases                                   | 375 300   |           |
| Recovery of debts                           |           | 340       |
| Rent received                               |           | 14 800    |
| Revenue                                     |           | 502 810   |
| Trade payables                              |           | 16 660    |
| Trade receivables                           | 14 400    |           |
| Wages                                       | 75 380    |           |
|   | 1 217 430 | 1 217 430 |

Additional information at 31 May 2018:

- Inventory was valued at \$36 200.
- Prepaid expenses were: administration expenses \$340, insurance \$770
- Expenses due but unpaid were: wages, \$1190.
- The policy is to maintain the provision for doubtful debts at 5 per cent of trade receivables at the year end.
- Depreciation was charged on non-current assets as follows:
  - Premises – 3 per cent per annum using the straight-line method.
  - Equipment and furniture – 25 per cent per annum using the reducing balance method.

Prepare the business's income statement for the year ended 31 May 2018 and a statement of financial position at that date.

# Preparation of financial statements

## What This Section is About

In this section you will apply your skills in preparing financial statements and making end of financial period adjustments (from Section 4).

You will prepare income statements and statements of financial position and other financial statements required by

- **Sole traders** (syllabus reference 5.1)
- **Partnerships** (syllabus reference 5.2)
- **Limited companies** (syllabus reference 5.3)

and learn about the advantages and disadvantages of each of these types of business ownership. The focus will be on both trading and service businesses.

In addition you learn about the financial statements prepared by

- **Clubs and societies** (syllabus reference 5.4)
- **Manufacturing organisations** (syllabus reference 5.5)

Finally you will learn how to prepare the financial statements of sole traders where there are limited accounting records, i.e.

- **Incomplete records** (syllabus reference 5.6)

## Service businesses

Many businesses do not sell goods but instead provide services for their customers. Service businesses are a very important part of the economy of many countries. The accounting records of both types of business are very similar, but in this chapter you will learn about the differences in the end of year financial statements of a service business.

Typical examples of service businesses include:

- |               |               |                    |
|---------------|---------------|--------------------|
| ● Accountant  | ● Cleaner     | ● Health club      |
| ● Beautician  | ● Electrician | ● Home maintenance |
| ● Bookkeeper  | ● Gardener    | ● Legal services   |
| ● Car repairs | ● Hairdresser | ● Plumber          |





# Sole trader financial statements

## LEARNING OBJECTIVES

When you have reached the end of this chapter you will be able to

- explain the advantages and disadvantages of operating as a sole trader
- understand the importance of financial statements to the owner of a business
- the difference between a trading business and a service business
- prepare the financial statements of a service business

## LINKS...

There is more about risk and the idea of unlimited liability for a business's debts on page 217.

## Why become a sole trader?

### Advantages of sole ownership

Many individuals decide to open a business as a sole trader to enjoy the following benefits:

- the owner has full control of the business and how it is run because the individual is the only decision-maker and as a result key decisions can be made quickly
- all the profits made by the business belong to the owner and do not have to be shared with anyone else
- as sole trader businesses tend to be small-scale, capital requirements can be relatively low
- setting up in business as a sole trader is relatively inexpensive and straightforward compared to other forms of ownership.

### Disadvantages of sole ownership

However, the drawbacks of sole ownership need to be considered and these are summarised as follows.

- The owner has unlimited liability for the debts of the business. This means that in a situation where the business is failing and its debts are greater than its assets, the owner risks losing private possessions (savings, home, etc.).
- Running a business as a sole trader can be very demanding, sometimes requiring long hours with few opportunities to take holidays.
- Sole trader businesses tend to be relatively small in scale and so they tend to find it difficult to bulk buy and gain economies of scale resulting sometimes in uncompetitive pricing of their products and services.
- Sometimes poor decisions might be made because a sole trader may not have the opportunity to discuss with ideas with others and enjoy the benefit of their expertise. It is unlikely that one individual will be skilful in every aspect of running a business.

## Importance of financial statements

Financial statements provide the owner(s) of a business with important information which can be used to assess current performance leading to decisions about how to overcome any problems and build on any successes.

**Income statements** provide information about the profit (or loss) for the year. Questions to be asked could include:

- Is the profit sufficient?
- Is the profit increasing year-on-year?
- Can drawings be increased?
- Are there ways in which profit can be increased?



**Statements of financial position** provide information about resources (assets), debts (liabilities) and the net value of the business (capital). Questions to be asked could include:

- Is the value of the business increasing year-on-year?
- Is the investment in the business bringing a good, and growing, return?
- Are the business's resources appropriate for the future?
- Has the business sufficient funds to pay debts as they fall due?

## Financial statements of a service business

A service business's financial statements are prepared in very much the same way as for all the businesses you have studied so far. One important difference, however, is that the first part of the income statement is not required, because a service business does not sell goods. Instead only the second part of the income statement is required, starting with the revenue from providing the service less all the business's expenses, ending with a figure for profit or loss for the year.

**LINKS...**  
There is more about assessing business performance and making use of financial statements on pages 237–238.

### Illustration 1 Example of a service business's income statement

Here is a typical income statement of a service business:

#### Snippets Hairdressing Salon Income Statement for the year ended 31 August 2018

|                                   | \$     | \$       |
|-----------------------------------|--------|----------|
| Revenue (receipts from customers) |        | 98,000   |
| Less: expenses                    |        |          |
| Administration expenses           | 5,000  |          |
| Depreciation (equipment, etc.)    | 18,000 |          |
| Electricity                       | 3,500  |          |
| Insurance                         | 4,100  |          |
| Wages of assistants               | 39,500 |          |
| Water charges                     | 4,200  |          |
|                                   |        | (74,300) |
| Profit for the year               |        | 23,700   |

A service business's statement of financial statement will closely resemble that of trading business but the current asset section will not include an inventory of goods for resale.

You can now try questions 1–4 on page 213–214.

# Sole trader financial statements: more about statements of financial position

## LEARNING OBJECTIVES

When you have reached the end of this chapter you will be able to

- explain and calculate capital employed for a sole trader's business
- explain what is meant by the term intangible asset
- explain what is meant by the term goodwill
- prepare the financial statements of a sole trader including goodwill

## LINKS...

In **Section 6** there is more about capital employed and how these amounts are used in deciding how well a business is performing.

## Capital employed

An important figure from the information shown on a statement of financial position is **capital employed**. Capital employed is the total of longer-term finance being used by a business: it is made up of the owner's capital and the non-current liabilities, in other words the finance which will be available to the business well into the future. It is helpful to know a business's capital employed because the figure needs to be considered when analysing how well a business has performed.

## Intangible assets

There is another group of assets which have no physical presence but do have a monetary value. These assets are called **intangible assets**; here are some examples:

- goodwill (for more information see below)
- brand names (the ownership of designer labels, for example)
- film rights
- copyright on books and written articles.

## KEY TERMS

**Net current assets:** at term often used instead of working capital. When the figure is negative the term used should be 'net current liabilities'.

**Capital employed:** the total of capital and non-current liabilities. The amount is a key element when assessing how well a business has performed.

**Intangible assets:** assets which have a monetary value but have no physical presence.

## Illustration 2

Preparing a statement of financial position including goodwill; calculating working capital and capital employed.

### Xi Ling – Accountant

#### Statement of financial position at 31 December 2018

|                                   | \$             | \$                    | \$             |
|-----------------------------------|----------------|-----------------------|----------------|
|                                   | Cost           | Accumulated<br>Deprcn | Net            |
| <b>NON-CURRENT ASSETS</b>         |                |                       |                |
| Goodwill                          | 50 000         |                       | 50 000         |
| Premises                          | 260 000        | 10 000                | 250 000        |
| Furniture and equipment           | 40 000         | 15 000                | 25 000         |
|                                   | <u>350 000</u> | <u>35 000</u>         | <u>325 000</u> |
| <b>CURRENT ASSETS</b>             |                |                       |                |
| Trade receivables                 | 30 000         |                       |                |
| Less provision for doubtful debts | <u>(1 000)</u> |                       |                |
|                                   |                | 29 000                |                |
| Other receivables                 |                | <u>3 000</u>          |                |
|                                   |                |                       | <u>32 000</u>  |
|                                   |                |                       | <u>357 000</u> |
| <b>CAPITAL</b>                    |                |                       |                |
| Opening balance                   |                | 313 000               |                |
| Add profit                        |                | <u>60 000</u>         |                |
|                                   |                | 373 000               |                |
| Less drawings                     |                | <u>(40 000)</u>       |                |
|                                   |                |                       | 333 000        |
| <b>NON-CURRENT LIABILITIES</b>    |                |                       |                |
| Bank loan                         |                |                       | 20 000         |
| <b>CURRENT LIABILITIES</b>        |                |                       |                |
| Trade payables                    |                | 3 000                 |                |
| Bank                              |                | <u>1 000</u>          |                |
|                                   |                |                       | <u>4 000</u>   |
|                                   |                |                       | <u>357 000</u> |

#### Notes:

- 1 The illustration is for a service business so there is no inventory in the current asset list and no figure for trade payables. The business does buy goods for resale or hold an inventory of goods for resale.
- 2 Goodwill is shown first in the list of non-current assets. The fact that there is figure of \$50 000 shown in this statement means that this amount was recently paid to purchase another business.
- 3 Capital employed is \$353 000 (i.e. closing capital \$333 000 plus non-current liabilities \$20 000). Alternatively capital employed could be calculated by adding together non-current liabilities \$325 000 and working capital \$28 000.

You can now answer questions 5–8 on pages 214–216.

## Goodwill

When a business is sold it can often be sold for more than the net value shown by the statement of financial position, i.e. all assets less all liabilities. Why is this? From the purchaser's point of view there is likely to be less risk in buying an established business rather than setting up one from scratch. The purchaser of an existing business is, therefore, prepared to pay for the advantage of acquiring a well-established organisation, and that advantage is referred to as **goodwill**.



### KEY TERMS

**Goodwill:** the additional value acquired by a successful business over and above the value of its tangible assets.

An established business will have a record of just how successful it has been. It will be clear whether or not the business has regular customers, is well located, has a good reputation, etc. Whereas, setting up a completely new business can so easily fail if it turns out that the location is not quite right, or that the owner and staff do not have the skills and knowledge to make the business work well.

An important rule in accounting is that goodwill can only be shown on a statement of financial position when it has been paid for. A business could have built up goodwill over several years, but its value cannot be recognised until the business is sold. In other words it is not possible for the owner of a business to estimate the value of the goodwill and record this figure on the statement of financial position. This is because accounting information needs to be as factual as possible, to ensure that users have confidence in the reliability of the data shown.

Goodwill is shown as the first item in a list of non-current assets.

## DEVELOPING YOUR SKILLS

### 1 Preparing the income statement of a service business

Chen is the owner of a business called "Sorted" which provides bookkeeping services for local businesses. On 30 September 2019 he was able to provide the following information for the financial year ended on that date.

|  | \$      |
|--|---------|
| Electricity charges                      | 3 680   |
| Equipment at net book value              | 21 300  |
| Furniture and fittings at net book value | 14 800  |
| Insurance                                | 1 880   |
| Manager's salary                         | 38 800  |
| Office expenses                          | 4 190   |
| Rent                                     | 14 370  |
| Revenue                                  | 249 500 |
| Staff wages                              | 6 840   |

Additional information:

- Electricity \$330 and staff wages \$720 were due but unpaid at 30 September 2019
- Insurance \$150 and rent \$630 were prepaid at 30 September 2010
- Chen's policy is to depreciate all non-current assets by 20% per annum using the reducing balance method.

Prepare an income statement for the year ended 30 September 2019.

### 2 Preparing the income statement of a service business

Fay owns an interior design business. On 30 June 2019 the following information was available about her business's financial year ended on that date.

|   | \$      |
|---|---------|
| Advertising charges                         | 810     |
| Insurance                                   | 1 470   |
| Irrecoverable debts                         | 380     |
| Non-current assets                          |         |
| cost  | 36 500  |
| provision for depreciation at 1 July 2018   | 18 250  |
| Provision for doubtful debts at 1 July 2018 | 680     |
| Revenue                                     | 173 200 |
| Travelling expenses                         | 790     |
| Wages                                       | 48 320  |

Additional information

- Advertising charges \$80 were prepaid at 30 June 2019
- Wages \$550 were due but unpaid at 30 June 2019
- The provision for doubtful debts should be increased to \$450
- Depreciation is provided at 25% per annum using the straight-line method.

Prepare an income statement for the year ended 30 June 2019.

### 3 Preparing financial statements for a service business

Kisha owns "Venus Beauty Studios". Her business's financial year ended on 31 May 2019 when the following trial balance was extracted from her business's books of account.

**Trial Balance at 31 May 2019**

|   | \$      | \$      |
|---|---------|---------|
| Capital                                   |         | 45 580  |
| Bank                                      | 8 580   |         |
| Drawings                                  | 31 850  |         |
| Electricity                               | 8 810   |         |
| Equipment                                 |         |         |
| cost                                      | 56 000  |         |
| provision for depreciation at 1 June 2018 |         | 14 000  |
| Furniture and fittings                    |         |         |
| cost                                      | 28 000  |         |
| provision for depreciation at 1 June 2018 |         | 5 600   |
| General expenses                          | 9 440   |         |
| Materials (cosmetics, etc.)(expense)      | 25 320  |         |
| Profit from sale of old equipment         |         | 270     |
| Rent                                      | 18 150  |         |
| Revenue                                   |         | 192 990 |
| Trade payables (cosmetics, etc.)          |         | 1 820   |
| Wages of assistants                       | 66 370  |         |
| Water charges                             | 7 740   |         |
|   | 260 260 | 260 260 |

Additional information at 31 May 2019

- Rent \$630 was due but unpaid; general expenses \$490 were prepaid.
- Depreciation should be provided as follows: equipment 25% per annum using the straight-line method; furniture and fittings 20% per annum using the reducing balance method.

Prepare an income statement for the year ended 31 May 2019 and a statement of financial position at that date.

#### 4 Preparing financial statements for a service business

Zamran owns "Zamran's Taxis". His business's financial year ended on 31 July 2019 when the following trial balance was extracted from his business's books of account.

**Trial Balance at 31 July 2019**

|                            | \$      | \$      |
|----------------------------|---------|---------|
| Bank loan (repayable 2021) |         | 25 000  |
| Bank                       |         | 4 050   |
| Capital                    |         | 167 120 |
| Drawings                   | 41 580  |         |
| Drivers' wages             | 95 420  |         |
| Furniture and equipment    |         |         |
| cost                       | 18 500  |         |
| provision for depreciation |         | 3 700   |
| 1 August 2018              |         |         |
| Insurance                  | 14 340  |         |
| Office expenses            | 5 570   |         |
| Loan interest              | 3 320   |         |
| Loss on sale of vehicle    | 760     |         |
| Rent                       | 22 240  |         |
| Revenue                    |         | 174 330 |
| Trade payables             |         | 640     |
| Trade receivables          | 770     |         |
| Vehicle fuel charges       | 22 730  |         |
| Vehicle repairs            | 5 610   |         |
| Vehicles                   |         |         |
| cost                       | 180 000 |         |
| provision for depreciation |         | 36 000  |
| 1 August 2018              |         |         |
|                            | 385 540 | 385 540 |

Additional information at 31 July 2019

- Drivers' wages \$1450 were due but unpaid; insurance \$860 was prepaid.
- Depreciation should be provided as follows: furniture and equipment 20% per annum using the straight-line method; vehicles 20% per annum using the reducing balance method.

Prepare an income statement for the year ended 31 July 2019 and a statement of financial position at that date.

#### 5 Preparing financial statements for a trading business including goodwill

The following trial balance was extracted from the books of a sole trader's business called "Aquasupreme".

**Trial Balance at 31 December 2019**

|                              | \$      | \$      |
|------------------------------|---------|---------|
| Administration expenses      | 11 470  |         |
| Capital                      |         | 115 380 |
| Bank                         | 3 720   |         |
| Discounts                    | 280     | 310     |
| Drawings                     | 31 500  |         |
| Goodwill                     | 40 000  |         |
| Insurance                    | 2 740   |         |
| Inventory 1 January 2019     | 33 000  |         |
| Non-current assets           |         |         |
| cost                         | 84 600  |         |
| provision for depreciation   |         | 42 300  |
| 1 January 2019               |         |         |
| Provision for doubtful debts |         | 790     |
| 1 January 2019               |         |         |
| Purchases                    | 184,400 |         |
| Rent                         | 13 100  |         |
| Revenue                      |         | 309 340 |
| Trade payables               |         | 23 290  |
| Trade receivables            | 18 800  |         |
| Wages and salaries           | 67 800  |         |
|                              | 491 410 | 491 410 |

Additional information at 31 December 2019

- Inventory was valued at \$36 400.
- Insurance \$170 was prepaid.
- Rent \$390 was due but unpaid.



- The provision for doubtful debts should be adjusted to \$940.
- Depreciation should be provided at the rate of 25% per annum using the straight-line method.

Prepare an income statement for the year ended 31 December 2019 and a statement of financial position at that date. Calculate the business's (i) working capital, (ii) capital employed at 31 December 2019.

## 6 Preparing financial statements for a trading business including goodwill

The following trial balance was taken from the books of a sole trader, Hosein.

**Trial Balance at 31 May 2019**

|  | \$      | \$      |
|--|---------|---------|
| Bank loan (repayable 2024)               |         | 14 000  |
| Bank loan interest                       | 1 310   |         |
| Capital                                  |         | 65 220  |
| Bank                                     |         | 320     |
| Drawings                                 | 28 860  |         |
| Electricity                              | 2 080   |         |
| General expenses                         | 3 160   |         |
| Goodwill                                 | 15 000  |         |
| Inventory 1 June 2018                    | 14 330  |         |
| Non-current assets                       |         |         |
| cost                                     | 75 000  |         |
| provision for depreciation 1 June 2018   |         | 15 000  |
| Provision for doubtful debts 1 June 2018 |         | 270     |
| Purchases                                | 224 360 |         |
| Returns                                  | 1 640   | 2 220   |
| Salaries                                 | 83 450  |         |
| Revenue                                  |         | 341 000 |
| Trade payables                           |         | 18 300  |
| Trade receivables                        | 4 890   |         |
| Water charges                            | 2 250   |         |
|  | 456 330 | 456 330 |

Additional information at 31 May 2019

- Inventory was valued at \$11 840.
- Salaries \$780 were due but unpaid; general expenses \$440 were prepaid.

- Depreciation of non-current assets for the year is \$15 000.
- The provision for doubtful debts should be reduced by \$50.

Prepare an income statement for the year ended 31 May 2019 and a statement of financial position at that date. Calculate the business's (i) working capital, (ii) capital employed at 31 May 2019.

## 7 Sole trader's financial statements (service business)

Salman recently opened a business called "Salman's Garden Maintenance". He provides gardening services to private individuals who pay in cash and to local businesses who are offered credit terms.

- (a) State **three** reasons why X may have chosen to operate as a sole trader.

At 31 December 2019 the following information was extracted from the business's books.

|  | \$     |
|--|--------|
| Administration expenses                          | 1 460  |
| Bank loan (repayable 2023)                       | 8 000  |
| Capital  | 15 680 |
| Bank (debit balance)                             | 3 740  |
| Discounts allowed                                | 130    |
| Drawings   | 19 570 |
| Equipment  |        |
| at cost  | 2 400  |
| provision for depreciation at 1 January 2019     | 720    |
| Garden tools                                     |        |
| at valuation 1 January 2019                      | 870    |
| purchases during the year ended 31 December 2019 | 190    |
| Insurance  | 810    |
| Interest on bank loan                            | 440    |
| Irrecoverable debts written off                  | 260    |
| Motor vehicle                                    |        |
| at cost  | 22 400 |
| provision for depreciation at 1 January 2019     | 4 500  |
| Recovery of debts written off                    | 90     |
| Revenue  | 36 120 |
| Trade receivables                                | 2 130  |
| Vehicle running costs                            | 770    |
| Wages of assistant                               | 9 940  |

- At 31 December 2019 expenses due but unpaid were: wages \$220; interest on bank loan for December 2019 at 6% per annum.
  - At 31 December 2019 expenses prepaid were: administration expenses \$180; an insurance premium for the quarter ended 29 February 2020 \$450.
  - Depreciation is charged at 15% per annum on equipment using the straight-line method; at 20% per annum on the motor vehicle using the reducing balance method. Garden tools were valued at \$850 on 31 December 2019.
- (b) Prepare an income statement for the year ended 31 December 2019.
- (c) Prepare a statement of financial position at 31 December 2019.
- (d) Calculate the business's (i) working capital, (ii) capital employed at 31 December 2019.

### 8 Sole trader's financial statements (retail business)

Noor owns three fashion stores called "Cool Glamour".

- (a) State **three** potential disadvantages of being a sole trader.

Additional information

At 31 October 2019 the following balances were extracted from the business's records.

- Inventory at 31 December 2019 was valued at \$33 300.
- During the year Noor had taken goods for her own use valued at cost \$1440. No entries had been made for these goods in the business's accounts.
- Interest on the bank loan of \$70 was due but unpaid at 31 December 2019.
- Rent \$17 400 for three months ended 31 January 2020 had been paid in advance.
- Furniture and fittings should be depreciated by 20% using the reducing balance method.
- Noor has decided to create a provision for doubtful debts of 5% of trade receivables at 31 December 2019.

|                                  | \$      |
|----------------------------------|---------|
| Bank loan (repayable March 2020) | 2 400   |
| Capital                          | 46 300  |
| Carriage inwards                 | 1 560   |
| Bank (debit balance)             | 880     |
| Discounts allowed                | 140     |
| Discounts received               | 290     |
| Drawings                         | 22 280  |
| Furniture and fittings           |         |
| cost                             | 48 900  |
| provision for depreciation       | 17 500  |
| Goodwill                         | 42 000  |
| Insurance                        | 1 760   |
| Inventory at 1 November 2018     | 38 400  |
| Interest on bank loan            | 210     |
| Profit on sale of fittings       | 320     |
| Purchases                        | 188 300 |
| Purchases returns                | 1 410   |
| Rent                             | 63 400  |
| Sales returns                    | 630     |
| Revenue                          | 391 000 |
| Trade payables                   | 14 440  |
| Trade receivables                | 12 000  |
| Wages and salaries               | 53 200  |

- (b) Prepare an income statement for the year ended 31 October 2019.
- (c) Prepare a statement of financial position at 31 October 2019.
- (d) Calculate the business's (i) working capital, (ii) capital employed at 31 October 2019.

## Introduction

In this chapter you will learn how to produce the accounting records required by partnerships.

## What is a partnership?

A **partnership** is a form of business ownership in which there are at least two owners, called partners, who share the profits or losses made by the business.

## Why form a partnership?

A partnership has several benefits that do not apply to a sole trader:

- There is the opportunity to raise more capital than would normally be possible if there was just one owner.
- The specialist skills and expertise of each partner can be brought together for the benefit of the business.
- With more than one owner, it may become easier to manage the business because the workload can be shared.

However, there are some disadvantages:

- Each partner will have **unlimited liability** for the debts of the business. Each partner is equally responsible for the debts of the partnership and could lose not just the capital contributed but also personal assets if the business fails. This is exactly the same disadvantage that is experienced by a sole trader.
- Decision making can take longer because the agreement of all the partners will be required for key aspects of running the business. Sometimes a good idea will not be implemented because one of the partners does not support it.
- All of the partners are jointly responsible for the debts of the partnership, even if an individual partner played no direct part in incurring the debt.
- A partnership business may be somewhat short-lived because it may have to close if one of the partners retires or dies.
- There has to be a high level of mutual trust between the partners. So for a partnership to be successful good relationships have to be maintained. This may not always be easy with the everyday stresses and strains of running a business.

### LEARNING OBJECTIVES

When you have reached the end of 5.3–5.7 you will be able to:

- explain the advantages and disadvantages of partnerships
- explain the importance of partnership agreements
- prepare appropriation accounts to show how profits or losses are shared among partners
- prepare ledger accounts to record partners' capitals
- prepare partners' current accounts to record drawings and shares of profits or losses
- record a partner's loan and loan interest
- prepare a partnership's income statement and statement of financial position.

### KEY TERMS

**Partnership:** a form of business ownership where two or more individuals work together with the intention of making a profit.

**Unlimited liability:** in a partnership each partner is equally responsible for the debts of the partnership and could lose not just the capital contributed but also personal assets if the business fails. In the case of a sole trader, the owner could also lose not just the capital contributed but also personal assets if the business fails.



# Sharing profits and losses

Normally partners make an agreement about how they intend to share the profits (or losses) made by the business and other key matters that could affect their relationship with each other. Once an agreement is made each partner must abide by its terms. It is considered wise for partners to have a formal written agreement because this can reduce the chance of disputes. However, this is not essential – the partners could just agree orally how they intend to share profit or losses.

## KEY TERMS

### Profit and loss sharing ratio:

the ratio that is used to share any residual profit or loss of the partnership.

Partners can make the profit/loss sharing arrangement very straightforward by simply agreeing to split profit or losses equally or in some other ratio, the **profit and loss sharing ratio**.

In addition partners will often agree:

- about the amount of capital to be invested in the business by each partner
- the responsibilities each partner will have in the management and running of the business
- a limit on each partner's drawings.

In many **partnerships** partners agree that the capital invested should be fixed, so that an individual partner cannot increase or decrease their capital contribution without the agreement of the other partners.

The formal written document drawn up by partners stating how they

## NUMERACY SKILLS

### Reminder: how to work with ratios

Here is a reminder how to use ratios when working out answers in partnership accounts.

**Step 1:** Identify the ratio to be used (e.g. 5 : 3) and the profit/loss to be divided in the ratio (e.g. \$64 000).

**Step 2:** Add up each element in the ratio to give the number of 'parts': 5 + 3 (i.e. 8 parts).

**Step 3:** Divide the profit (or loss) by the number of parts:  $\frac{\$64\,000}{8}$ . This would give \$8000 per 'part'.

**Step 4:** Return to the ratio and take each element in turn to divide up the profit. So taking 5 parts first: the profit share would be  $5 \times \$8000 = \$40\,000$

**Step 5:** Take the other element(s) in the ratio. So taking 3 parts: the profit share would be  $3 \times \$8000 = \$24\,000$ .

**Step 6:** Double check to make sure the profit shares add up to the right figure. So:  $\$40\,000 + \$24\,000 = \$64\,000$  – which is correct!

You can now answer questions 1 and 2 on page 226.

will work together and how they share profits and losses is called the **deed of partnership**.

It is quite common for partners to make more elaborate arrangements to ensure that partners are fairly rewarded for the various ways in which they have contributed to the business. There are a number of possibilities as follows:

- **Interest on capital:** each partner may be allocated a share of profits based on the relative size of their capital contributions. This is put into effect by giving each partner what is called **interest on capital** at some agreed rate per annum. As a result, the partner who has made the largest capital contribution receives a greater reward than the other partners who have contributed less.
- **Partnership salary:** a partner who has taken on a special role in the business and has, therefore, contributed more to the management and running of the partnership than the others, can be allocated an agreed amount of profit each year called a **partnership salary**.
- The partnership salary is a means of allocating some profit to a partner. This is not the same as an employee's salary, which would be charged as an expense in the income statement.

### KEY TERMS

**Deed of partnership:** the formal agreement between partners that states how profit and losses will be shared and the rules under which the partners will work together.

**Interest on capital:** a reward for each partner in the form of a share of profits that is based on the amount of capital contributed by each partner.

**Partnership salary:** a reward in the form of a share of profits for any partner who has particular responsibilities in running the business.

You can now answer questions 3 and 4 on page 226.

### Illustration 1 Sharing profits and losses in a partnership

Rakesh and Stacy are in partnership sharing profits and losses in the ratio 2 : 1.

The partners' capital contributions are: Rakesh \$100 000; Stacey \$160 000.

The partners have agreed that there should be interest on capital of 10 per cent per annum.

Stacy takes the most responsibility for managing the business. As a result the partners have agreed that Stacy should receive a partnership salary of \$15 000 per annum.

During the year ended 31 October 2018 the partnership made a profit of \$125 000.

Following the terms of their agreement, Rakesh and Stacy will share the profit of \$125 000 as follows.

|  | Rakesh | Stacy  |
|--|--------|--------|
| Profit to be shared \$125 000  | \$     | \$     |
| Interest on capital (10% × capital)  | 10 000 | 16 000 |
| Salary   |        | 15 000 |
| <b>Residual profit</b> (\$125 000 less interest on capital \$26 000 and less salary \$15 000) \$84 000 shared in ratio 2 : 1 | 56 000 | 28 000 |
| Total share of profit  | 66 000 | 59 000 |

### KEY TERMS

**Residual profit:** the profit of a partnership after all agreed rewards have been allocated to partners. (Residual *loss* is the loss of a partnership after all agreed rewards have been allocated.)

You can now try questions 5–8 on pages 226–227.

**Note:** each reward given to a partner reduces the amount of profit left to be shared out.



# More about sharing profits and losses

## KEY TERMS

**Interest on drawings:** a penalty whereby a partner is charged interest on drawings. The interest takes account of the amount of the drawings.

- **Interest on drawings:** as well as rewarding partners for positive aspects of their contributions towards the success of the business, a partnership agreement can penalise partners for actions that could have had an adverse effect on the business's progress. Every time a partner takes cash drawings from the business, there is less money available to spend on running the business. As a result, some agreements contain a clause that charges each partner interest on drawings at a specified rate per annum. It should be noted that interest on drawings is *added* to the profit for the year. As 'rewards' for partners reduce the profit available for sharing, it follows that, as interest on drawings is a penalty, the reverse should apply (i.e. it is added to profit).
- **Calculating interest on drawings:** interest on drawings is calculated by multiplying a partner's total drawings for the year by the agreed interest percentage.

## Illustration 2

### Calculating interest on drawings

Ken and Jane are in partnership sharing profits and losses equally. However, they have agreed that interest of 5 per cent should be charged on drawings. During the year ended 31 December 2018, partners' drawings were:

|      | \$     |
|------|--------|
| Ken  | 30 000 |
| Jane | 14 000 |

The partnership's profit for the year ended 31 December 2018 was \$82 000.

Following the terms of their agreement, Ken and Jane will share the profit of \$82 000 as follows.

|  | Ken     | Jane   |
|--|---------|--------|
| Profit to be shared \$82 000                                       | \$      | \$     |
| Interest on drawings (5% × drawings)                               | (1 500) | (700)  |
| Residual profit (\$82 000 <b>add</b> interest on drawings \$2 200) | 42 100  | 42 100 |
| \$84 200 shared equally  |         |        |
| Total share of profit  | 40 600  | 41 400 |

## Notes:

- 1 Interest on drawings increases the amount of profit left to be shared out.
- 2 As a result of charging interest on drawings, Ken's total share of profits is less than Jane's. This reflects the fact that Ken deprived the business of more cash resources than Jane during the year.



## LINKS...

See Illustration 3 for a further example of how interest on drawings is calculated and recorded in the books of a partnership.

## Extra accounting records

In most partnerships, the partners keep a separate record of their main capital contributions in a fixed capital account. Their drawings and shares of profits or losses are recorded in a separate current account. In addition, when preparing end-of-year financial statements, it is necessary to include a statement setting out how the profits and losses have been allocated.



The usual arrangement is as follows:

- **Drawings accounts:** recording each partner's drawings during the year. This account is closed at the year end and the total drawings are transferred to the partner's current account.
- **Capital accounts:** recording the main capital contribution of each partner and any additions or withdrawals of capital. Changes to a partner's fixed capital would be an unusual event and would normally have to be agreed by all of the partners.
- **Current accounts:** recording each partner's total drawings for the year and allocations of profits or losses at the year end. The balance of the current accounts can be:
  - credit (indicating that the partners are 'owed' money by the partnership because profit shares have exceeded drawings)
  - debit (indicating that the partners 'owe' money to the partnership because drawings have exceeded profit shares).
- **Appropriation account:** is prepared annually as part of the business's financial statements. The appropriation account records the profit or loss for the year (transferred from the income statement) and sets out the details of how the profit or loss is shared among the partners following the terms of the partnership agreement.

You can now answer questions 9 and 10 on pages 227–228.

### KEY TERMS

**Fixed capitals:** each partner's capital contribution remains unchanged unless all partners agree to an alteration.

**Appropriation account:** a part of the income statements of a partnership recording how the profit or loss for the year is shared between the partners.

**Current accounts:** a record of each partner's annual drawings and shares of profits or loss.

### Illustration 3 Preparing the partners' accounting records (part 1: information)

George and Huanna entered into partnership on 1 January 2018. The partners' **fixed capitals** are as follows:

|        | \$      |
|--------|---------|
| George | 150 000 |
| Huanna | 180 000 |

The terms of the partnership agreement are:

- interest on total drawings is to be charged at 6 per cent per annum
- partners are entitled to interest on capital at 10 per cent per annum
- Huanna should receive a salary of \$16 000 per annum for taking a leading role in managing the business
- remaining profits or losses are to be shared in the ratio: George, Huanna – 3 : 2 respectively.

Partners' drawings totalled:

|        | \$     |
|--------|--------|
| George | 32 000 |
| Huanna | 38 000 |

Interest on drawings will amount to the following.

|        |                        | \$    |
|--------|------------------------|-------|
| George | $\$32\,000 \times 6\%$ | 1 920 |
| Huanna | $\$38\,000 \times 6\%$ | 2 280 |

During the year ended 31 December 2018 the partnership made a profit of \$74 000. (Continued on page 222).

# Preparing the accounting records

**Note:** you will see that in the example there is just one capital account, but with separate columns for each partner. This form of presenting partners' accounts has the advantage of saving time in making entries. It is recommended that this style of presentation is adopted rather than preparing individual accounts for each partner.

## Illustration 3 (Continued)

Preparing the partners' accounts  
(part 2: the accounting records)

Step 1: Here are the capital accounts of the partners.

| Dr |        | Capital accounts |                | Cr      |         |
|----|--------|------------------|----------------|---------|---------|
|    | George | Huanna           |                | George  | Huanna  |
|    | \$     | \$               |                | \$      | \$      |
|    |        |                  | 2018           |         |         |
|    |        |                  | Jan 1 Balances | 150 000 | 180 000 |

Step 2: During the year each partner's drawings should be debited to the drawings account. At the year end the drawings account is closed off and the total drawings for the year are transferred to the current accounts.

Here are the drawings accounts of the partners.

| Dr      |        | Drawings accounts |                         | Cr     |        |
|---------|--------|-------------------|-------------------------|--------|--------|
|         | George | Huanna            |                         | George | Huanna |
|         | \$     | \$                |                         | \$     | \$     |
| 2018    |        |                   | 2018                    |        |        |
| Jan–Dec | Bank   | 32 000 38 000     | Dec 31 Current accounts | 32 000 | 38 000 |

Step 3: At the end of the year the way profits and losses have been shared out between the partners is set out in detail as part of the end-of-year financial statements. It is important to follow strictly the terms of the partnership agreement.

Here is the appropriation account.

### George and Huanna

#### Appropriation account for the year ended 31 December 2018

|                          |        |          |
|--------------------------|--------|----------|
|                          | \$     | \$       |
| Profit for the year      |        | 74 000   |
| Add interest on drawings |        |          |
| George                   | 1 920  |          |
| Huanna                   | 2 280  |          |
|                          |        | 4 200    |
|                          |        | 78 200   |
| Less interest on capital |        |          |
| George (10% × \$150 000) | 15 000 |          |
| Huanna (10% × \$180 000) | 18 000 |          |
|                          |        | (33 000) |
|                          |        | 45 200   |

### STUDY TIP

Do not forget to provide a full and correct title for all final accounting statements (e.g. 'Appropriation account for the year ended 31 December 2018'). Make a point of labelling each entry in the appropriation account. Also, remember to bring down balances on current accounts as shown in the illustration.



|                                |        |                |
|--------------------------------|--------|----------------|
| Less salary, Huanna            | \$     | \$<br>(16 000) |
|                                |        | 29 200         |
| Less shares of residual profit |        |                |
| George (3/5ths)                | 17 520 |                |
| Huanna (2/5ths)                | 11 680 |                |
|                                |        | (29 200)       |

**Note:** it is usual to start by recording the interest on drawings first (as an addition) before dealing with the rewards (which are deducted).

Step 4: finally, prepare the current accounts of each partner, showing the profit shares allocated to each partner and also each partner's total drawings for the year.

Here are the partners' current accounts.

| Current accounts        |        |        |                            |        |        |
|-------------------------|--------|--------|----------------------------|--------|--------|
| Dr                      |        |        |                            |        | Cr     |
|                         | George | Huanna |                            | George | Huanna |
|                         | \$     | \$     |                            | \$     | \$     |
| 2018                    |        |        | 2018                       |        |        |
| Dec 31 Drawings         | 32 000 | 38 000 | Dec 31 Interest on capital | 15 000 | 18 000 |
| 31 Interest on drawings | 1 920  | 2 280  | 31 Salary                  |        | 16 000 |
| 31 Balance c/d          |        | 5 400  | 31 Residual profit         | 17 520 | 11 680 |
|                         |        |        | 31 Balance c/d             | 1 400  |        |
|                         | 33 920 | 45 680 |                            | 33 920 | 45 680 |
| Jan 1 Balance b/d       | 1 400  |        | Jan 1 Balance b/d          |        | 5 400  |

#### Notes:

- 1 Total drawings are transferred from the drawings account at the year end.
- 2 Interest on drawings is transferred from the appropriation account and is debited to the current accounts so that each partner is penalised.
- 3 Interest on capitals, partners' salaries and residual profit shares are credited to the current accounts so that each partner is rewarded.
- 4 Huanna has a credit balance on her current account because her drawings have been less than her total share of profits. Huanna is 'owed' \$5400 by the partnership.
- 5 George has a debit balance on his current account because his drawings has exceeded his profit share. George owes \$1400 to the partnership.
- 6 Once a partnership is established, each partner's current account will start with either a debit or credit balance brought forward from the previous year.
- 7 The closing balances on the current accounts are taken to the capital section of the statement of financial position.

#### STUDY TIP

It is easy to forget that interest on drawings is an addition to the profit for the year in the appropriation account. It is a common mistake to deduct this item.

You can now answer questions 7 and 8 on page 227.



# Partnership statements of financial position

## Partnership statements of financial position

The statement of financial position of a partnership will record assets and liabilities in exactly the same way as that of a sole trader. However, the capital section will need to reflect the fact that there are a number of owners and that each partner has a capital account and a current account.

### Illustration 4

Preparing a partnership statement of financial position

Here is the second part of the statement of financial position based on the accounting records of George and Huanna in Illustration 3.

|                      | \$                | \$                | \$      |
|----------------------|-------------------|-------------------|---------|
| Capital accounts     | George<br>150 000 | Huanna<br>180 000 | 330 000 |
| Current accounts     |                   |                   |         |
| Interest on capital  | 15 000            | 18 000            |         |
| Salary               |                   | 16 000            |         |
| Residual profit      | 17 520            | 11 680            |         |
|                      | 33 920            | 45 580            |         |
| Drawings             | (32 000)          | (38 000)          |         |
| Interest on drawings | (1 920)           | (2 280)           |         |
|                      | (1 400)           | 5 400             | 4 000   |
|                      |                   |                   | 334 000 |

An alternative presentation of the statement of financial position may be required, where only the final balances of the current accounts are shown. In this version, the second part of the statement of financial position would appear as follows.

|                  | \$      | \$      |
|------------------|---------|---------|
| Capital accounts |         |         |
| George           | 150 000 |         |
| Huanna           | 180 000 |         |
|                  |         | 330 000 |
| Current accounts |         |         |
| George           | (1 400) |         |
| Huanna           | 5 400   |         |
|                  |         | 4 000   |
|                  |         | 334 000 |

### Notes:

- 1 It is important to keep the capital accounts and the current accounts of the partners separate in the second part of the statement of financial position. So the capital account balances are shown with a subtotal line.
- 2 In the first version of the statement of financial position the current accounts are shown in detail. Where this is required, provide each partner with a column and start the details with the opening balance (which could, of course, be negative). List all of the positive items first and then deduct negative items (such as drawings). The column should end with the current account balance at the date of the statement of financial position. Use brackets to indicate negative figures.

## Partner's loans and the income statement

Sometimes a partner may make a loan to the partnership over and above any capital contribution. A **partner's loan** should be recorded as a non-current liability on the partnership statement of financial position, assuming it is not due for repayment within the next financial year. The partner making the loan will expect to be rewarded with interest on the loan. The rate of interest will be agreed by all of the partners and will be recorded in the deed of partnership. From the accounting point of view it is important that the loan interest is recorded in the income statement just like all interest charges; it should not be recorded in the appropriation account. Interest on a partner's loan should be credited to the partner's current account because it increases the amount that the partnership owes the partner. In all other respects a partnership's income statement resembles that of a sole trader.

Here is a summary of how to treat a partner's loan.

|  | Double-entry records       |                           |
|--|----------------------------|---------------------------|
|  | Debit                      | Credit                    |
| When a partner makes a loan                | Bank                       | Loan                      |
| When a partner's loan is repaid            | Loan                       | Bank                      |
| When interest is given on a partner's loan | Income statement (expense) | Partner's current account |

### KEY TERMS

**Partner's loan:** amounts lent by a partner over and above the partner's capital contribution. Interest on the loan is debited to the income statement and credited to the partner's current account.

You can now answer questions 9–21 on pages 227–230.

## DEVELOPING YOUR SKILLS

## 1 Calculating profit share

Oliver, Penelope and Rajiv are planning to enter into partnership. They have not yet decided what profit/loss sharing ratio they should adopt. They have considered the following possibilities:

- a Equal shares
- b Oliver, Penelope, Rajiv – 5 : 3 : 2 respectively
- c Oliver, Penelope, Rajiv – 4 : 2 : 1 respectively.

They expect to make a profit of \$63 000 during the first year.

Calculate each partner's share of this profit for each of the profit sharing arrangements a, b and c above.

## 2 Calculating profit share

Jamal, Karen and Lewis are planning to enter into partnership. They have not yet decided what profit/loss sharing ratio they should adopt. They have considered the following possibilities:

- a Equal shares
- b Jamal, Karen and Lewis – 6 : 3 : 1 respectively
- c Jamal, Karen and Lewis – 2 : 3 : 7 respectively.

They expect to make a profit of \$84 000 during the first year.

Calculate each partner's share of this profit for each of the profit sharing arrangements a, b and c above.

## 3 Calculating profit share when there is interest on capitals and a partnership salary

Andy and Beverley are in partnership sharing profits and losses equally. They have agreed that each partner should be entitled to interest on capital at 10 per cent per annum and that Andy should be given a salary of \$10 000 per annum for managing the business. The partners' capitals are:

|          | \$     |
|----------|--------|
| Andy     | 65 000 |
| Beverley | 72 000 |

Calculate each partner's share of the profit for the year ended 30 September 2018, when the partnership made a profit of \$83 000.

## 4 Calculating profit shares when there is interest on capitals and a partnership salary

Robin, Sharla and Trevor are in partnership sharing profits and losses in the ratio 3 : 2 : 1. The partners have agreed that each partner should be entitled to interest on capital at 8 per cent per annum and that Sharla should be given a partnership salary of \$9 000 per annum. The partners' capitals are:

|        | \$      |
|--------|---------|
| Robin  | 200 000 |
| Sharla | 360 000 |
| Trevor | 240 000 |

Calculate each partner's share of the profit for the year ended 31 October 2018, when the partnership made a profit of \$190 000.

## 5 Sharing profit and loss where there is interest on drawings

Keith and Louis are in partnership sharing profit and losses equally. The partners have agreed that interest should be charged on drawings at 12 per cent per annum.

During the year ended 31 December 2018 each partner's drawings were as follows:

|       | \$     |
|-------|--------|
| Keith | 19 000 |
| Louis | 11 000 |

The partnership made a profit of \$24 400 for the year ended 31 December 2018.

Calculate the following:

- a Interest on Keith's drawings
- b Interest on Louis's drawings
- c Each partner's share of the profit for the year ended 31 December 2018.



## 6 Sharing profit and loss where there is interest on drawings

Jackie and Keri are in partnership sharing profit and loss in the ratio 2 : 1 respectively. However, the partners have agreed that interest should be charged on drawings at 6 per cent per annum.

During the year ended 31 December 2018 each partner's drawings were as follows:

|        | \$     |
|--------|--------|
| Jackie | 15 000 |
| Keri   | 22 000 |

The partnership made a profit of \$33 780 for the year ended 31 December 2018.

Calculate the following:

- Interest on Jackie's drawings
- Interest on Keri's drawings
- Each partner's share of the profit for the year ended 31 December 2018.

## 7 Preparing partners' accounts

Donna and Elwin entered into partnership on 1 January 2018. The partners agreed that:

- Interest on total drawings should be charged at 7 per cent per annum
- Each partner should receive interest on fixed capitals of 10 per cent per annum
- Elwin should receive an annual salary of \$12 000
- Remaining profits or losses should be shared equally.

The following additional information is available.

|       | Fixed capitals | Drawings for the year ended 31 December 2018 |
|-------|----------------|--|
|       | \$             | \$   |
| Donna | 160 000        | 22 000                                       |
| Elwin | 140 000        | 24 000                                       |

The partnership made a profit of \$58 000 during the year ended 31 December 2018.

Prepare the following:

- Partners' capital accounts
- Partners' drawings accounts
- Appropriation account for the year ended 31 December 2018
- Partners' current accounts.

## 8 Preparing partners' accounts

Nicholas and Penelope entered into partnership on 1 April 2018. The partners agreed that:

- Interest on total drawings should be charged at 12 per cent per annum
- Interest should be allowed on fixed capitals at 10 per cent per annum
- Nicholas should receive a salary of \$60 000 per annum
- Remaining profits and losses should be shared in the ratio Nicholas, Penelope – 3 : 2 respectively.

The following additional information is available.

|          | Fixed capital | Drawings for the year ended 31 March 2018 |
|----------|---------------|---|
|          | \$            | \$  |
| Nicholas | 360 000       | 75 000                                    |
| Penelope | 600 000       | 91 000                                    |

The partnership made a profit of \$216 000 during the year ended 31 March 2018.

Prepare the following:

- Partners' capital accounts
- Partners' drawings accounts
- Appropriation account for the year ended 31 March 2018
- Partners' current accounts.

## 9 Preparing end-of-year financial statements of a partnership including a partner's loan

Ishaka and Joshua are in partnership sharing profits and losses: Ishaka 60 per cent, Joshua 40 per cent.

At the end of the financial year, 30 September 2018, the following balances were extracted from the

books of the partnership after calculation of the gross profit for the year.

**Trial balance at 30 September 2018**

|   | Dr<br>\$  | Cr<br>\$  |
|---|-----------|-----------|
| Bank  | 31 000    |           |
| Capital accounts                                |           |           |
| Ishaka  |           | 240 000   |
| Joshua  |           | 200 000   |
| Current accounts                                |           |           |
| Ishaka  | 4 000     |           |
| Joshua  |           | 7 000     |
| Drawings  |           |           |
| Ishaka  | 47 000    |           |
| Joshua  | 35 000    |           |
| General expenses                                | 68 000    |           |
| Gross profit                                    |           | 237 000   |
| Inventory                                       | 63 000    |           |
| Loan account (Ishaka)                           |           | 40 000    |
| Non-current assets                              |           |           |
| Cost  | 820 000   |           |
| Provision for depreciation at<br>1 October 2017 |           | 340 000   |
| Trade payables                                  |           | 24 000    |
| Trade receivables                               | 20 000    |           |
|   | 1 088 000 | 1 088 000 |

Additional information:

- Non-current assets should be depreciated by 20 per cent per annum using the reducing balance method.
- General expenses due but unpaid at 30 September 2018 totalled \$5000.
- The partners have decided that it is necessary to create a provision for doubtful debts amounting to 5 per cent of trade receivables at 30 September 2018.

The partnership agreement includes the following terms:

- Ishaka is entitled to interest of 10 per cent per annum on her loan.
- Interest is charged on drawings. For the year under review interest on drawings amounts to: Ishaka, \$4700; Joshua \$3500.
- Joshua is to receive a partnership salary of \$28 000 per annum.

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Prepare:

- An income statement for the year ended 30 September 2018
- An appropriation account for the year ended 30 September 2018
- Partners' current accounts
- A statement of financial position at 30 September 2018. The statement of financial position should show only the balances on the partners' current accounts at this date.

### 10\* End-of-financial-year statements of a partnership

Geeta and Henry are in partnership sharing profits and losses. The following trial balance was extracted from the business's books of account on 31 August 2018, the last day of the partnership's financial year.

**Trial balance at 31 August 2018**

|   | Dr<br>\$ | Cr<br>\$ |
|---|----------|----------|
| Bank  |          | 7 000    |
| Capital accounts                                  |          |          |
| Geeta   |          | 250 000  |
| Henry   |          | 300 000  |
| Current accounts                                  |          |          |
| Geeta   | 6 000    |          |
| Henry   |          | 8 000    |
| Discounts   | 11 000   | 15 000   |
| Drawings  |          |          |
| Geeta   | 40 000   |          |
| Henry   | 60 000   |          |
| Furniture and equipment                           |          |          |
| Cost  | 220 000  |          |
| Provision for depreciation,<br>1 September 2017   |          | 66 000   |
| General expenses                                  | 19 000   |          |
| Gross profit                                      |          | 291 000  |
| Insurance   | 27 000   |          |
| Inventory, 31 August 2018                         | 68 000   |          |
| Loan from Geeta                                   |          | 20 000   |
| Premises at cost                                  | 351 000  |          |
| Provision for doubtful debts,<br>1 September 2017 |          | 6 000    |
| Trade payables                                    |          | 18 000   |
| Trade receivables                                 | 40 000   |          |
| Wages and salaries                                | 139 000  |          |
|   | 981 000  | 981 000  |

- Insurance \$3 was prepaid at 31 August 2018.
- Wages and salaries due but unpaid totalled \$12 at 31 August 2018.
- Depreciation should be provided on furniture and fittings at 20 per cent per annum using the straight-line method.
- The provision for doubtful debts should be maintained at 5 per cent of trade receivables.

The partnership agreement includes the following terms:

- Geeta is entitled to receive interest on her loan at 5 per cent per annum.
- Interest should be charged on total drawings at 10 per cent per annum.
- Geeta is entitled to receive a partnership salary of \$8000 per annum.
- Partners are entitled to receive interest on capital at the rate of 10 per cent.

Prepare:

- An income statement for the year ended 31 August 2018
- An appropriation account for the year ended 31 August 2018
- Partners' current accounts
- A statement of financial position at 31 August 2018. The statement of financial position should show only the balances on the partners' current accounts at this date.

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 5.3–5.7)

### MULTIPLE-CHOICE QUESTIONS

- A partnership appropriation account should include the following:
  - Shares of residual loss, partnership salaries, drawings, interest on partners' loans
  - Shares of residual loss, partnership salaries, interest on partners' loans, interest on partners' loans
  - Shares of residual profit, partnership salaries, drawings, interest on capitals
  - Shares of residual profit, partnership salaries, interest on drawings, interest on capitals
- Fred and Garca are in partnership sharing profits and losses in the ratio 3 : 2 respectively. This year the partnership has made a loss of \$90 000. Which entry should be made in Fred's current account?
  - Credit \$36 000
  - Credit \$54 000
  - Debit \$36 000
  - Debit \$54 000
- Sara and Tarek are in partnership. They share profits and losses equally, but Tarek is entitled to receive a partnership salary of \$18 000 per annum. The partnership made a profit of \$72 000 this year. What is the total amount that should be credited to Tarek's current account?
  - \$27 000
  - \$36 000
  - \$45 000
  - \$54 000
- Which of the following is debited to a partnership appropriation account?
  - Interest on drawings
  - Interest on a partner's loan
  - Partner's salary
  - Share of loss
- Tina and Unitali are in partnership sharing profits and losses equally. Both partners are entitled to receive a partnership salary: Tina \$15 000 and Unitali \$5000. This year the partnership made a small profit of \$10 000.

What is Tina's net share of the partnership's profit for the year?

  - \$2500
  - \$5000
  - \$10 000
  - \$20 000



- 16** Martin and Nancy are in partnership with capitals of \$240 000 and \$120 000 respectively. The partners are entitled to interest on capital at 10 per cent per annum and remaining profits are shared equally. For the year ended 31 December 2018, the business made a profit of \$144 000.

What is Martin's total share of profits from the business for the year ended 31 December 2018?

- A** \$54 000
- B** \$72 000
- C** \$78 000
- D** \$96 000

- 17** Yeung and Zara are partners in a business. The following current account of Yeung has been prepared by an inexperienced bookkeeper.

|                     | \$      |             | \$      |
|---------------------|---------|-------------|---------|
| Interest on capital | 36 000  | Balance b/d | 1 500   |
| Salary              | 45 000  | Drawings    | 75 000  |
| Balance c/d         | 85 500  | Profit      | 90 000  |
|                     | 166 500 |             | 166 500 |

Assuming Yeung's opening balance is correctly recorded, what is the correct closing balance on his current account?

- A** \$25 500
- B** \$67 500
- C** \$82 500
- D** \$97 500

- 18** In the books of a partnership, which account should be debited with interest on drawings?

- A** Appropriation account
- B** Bank account
- C** Partners' current accounts
- D** Partners' drawings accounts

- 19** In the books of a partnership, the ledger entries for interest on drawings should be:

- A** Debit Appropriation account  
Credit Partners' current accounts
- B** Debit Partners' current accounts  
Credit Appropriation account
- C** Debit Partners' current accounts  
Credit Partners' drawings accounts
- D** Debit Partners' drawings accounts  
Credit Partners' current accounts

- 20** During the year ended 31 October 2018, the partnership of Electra and Farad made a profit of \$85 000. Partners share profits equally after charging interest on drawings. For the year ended 31 October 2018, interest on drawings was: Electra \$4 000 and Farad \$7 000.

What was Farad's net share of the profits for the year?

- A** \$30 000
- B** \$41 000
- C** \$44 000
- D** \$55 000

### OTHER QUESTIONS

- 21** Kirk and Linda recently agreed to form a partnership.

- a** State two possible disadvantages that Kirk and Linda might experience by being in partnership.

Kirk and Linda prepared a deed of partnership which included an agreement to give each partner interest on capital, and to charge interest on drawings.

- b** Give one reason why the partners have agreed to give each partner interest on capital.
- c** Give one reason why the partners have agreed to charge interest on drawings.

The following appropriation account was prepared at the end of the partners' first financial year:

| Kirk and Linda   |        |          |
|--|--------|----------|
| Appropriation account<br>for the year ended 31 December 2018 |        |          |
|  | \$     | \$       |
| Profit for the year  |        | 65 000   |
| Add interest on drawings                                     |        |          |
| Kirk (5% × \$26 000)   | 1 300  |          |
| Linda (5% × \$18 000)  | 900    |          |
|  |        | 2 200    |
|  |        | 67 200   |
| Less interest on capitals                                    |        |          |
| Kirk (10% × \$80 000)  | 8 000  |          |
| Linda (10% × \$60 000)                                       | 6 000  |          |
|  |        | (14 000) |
|  |        | 53 200   |
| Less shares of residual profit                               |        |          |
| Linda  | 26 600 |          |
| Kirk   | 26 600 |          |
|  |        | (53 200) |

- d** Prepare the partners' current accounts for the year ended 31 December 2018.

## Introduction

In the following sections you are going to learn how to prepare the end-of-year financial statements of limited companies. You will learn about how a company is financed by issuing shares and by a special type of loan called a debenture, and about the special advantage of limited liability, which is given to the owners of limited liability companies i.e. the shareholders.

'Limited company' is a convenient shortening of the more technically correct term **limited liability company**.



## What is a limited company?

A limited company is a form of business organisation whose capital is divided into units called shares. Those who invest in a company own shares and are referred to as **shareholders**.

The most important feature of ownership of a limited company is that each shareholder's responsibility for the debts of the organisation is limited to the amount invested in the company. This means that should the organisation run into serious difficulties and face closure, shareholders cannot be asked to make any further contribution so that the company can pay its debts. This is in contrast to a sole trader or a partner who would have to use private funds if their business faced this situation. The correct term for this special privilege enjoyed by shareholders is **limited liability**, hence the term limited liability company. Individuals are far more likely to be inclined to invest in a company as a result of the benefit of limited liability because there is a clear limit to the risk they are taking. As a result, companies can be very large organisations with many shareholders, almost all of whom do not play any part in the day-to-day running of the organisation.

## LEARNING OBJECTIVES

When you have reached the end of 5.8–5.12 you will be able to:

- explain the advantages and disadvantages of operating as a limited company
- explain the meaning of the term 'limited liability'
- explain the terms 'authorised capital', 'issued capital', 'called-up share capital' and 'paid-up share capital'
- explain the differences between ordinary shares, preference shares and debentures
- calculate dividends
- prepare a company's appropriation account
- prepare a company's statement of financial position.

## KEY TERMS

### Limited liability company:

an organisation owned by its shareholders whose liability for the debts of the company is limited to their shareholding.

**Shareholders:** the owners of the share capital of a limited company.

**Limited liability:** the liability of any shareholder for the debts of the company is limited to the amount of their fully paid shares.



# Limited companies: the background

## DID YOU KNOW?

Ltd and plc are used in the UK. However, different terminology may be found in some countries. For example, Pty Ltd or SA is used in some African countries, and Inc. is used in the US.

## KEY TERMS

**Private limited company:** a company whose shares are not available to the general public. The name of the company includes the abbreviation Ltd (limited).

**Public limited company:** a company whose shares are available to the general public on the stock market. The name of the company includes the abbreviation plc (public limited company).

**Authorised share capital:** the maximum amount of share capital that a limited company may issue.

**Issued share capital:** the amount of share capital that has actually been issued by a limited company.

**Directors:** individuals who are appointed by shareholders to manage the company on their behalf.

**Annual general meeting (AGM):** a yearly meeting where directors report on the performance of the company to the shareholders.

**Ordinary shares:** shares that receive a variable rate of dividend that is dependent on the profits available for distribution. These shares have voting rights.

## Types of limited company

A **private limited company** is one where the ownership of shares is restricted to members of a family, their friends and possibly employees. They are generally small organisations with few shareholders. Members of the general public cannot invest in a private limited company. Shares in a private limited company are bought and sold privately and only with the consent of **all** the existing shareholders. A private limited company could have just one shareholder. The abbreviation 'Ltd' appears in the title of a private limited company.

A **public limited company** is one in which the general public can invest. Shares in a public limited company are traded on stock exchanges. They are large organisations with hundreds or even thousands of shareholders. The abbreviation 'plc' appears in the title of a public limited company.

## The capital of a limited company

When a limited company is formed a decision has to be made as to the maximum amount of capital that can be raised. This amount is known as the **authorised share capital**. It is not necessary to actually raise this amount immediately because initially the company will not require resources of that value. The capital actually raised is called the **issued share capital**.

## The management of a limited company

Although shareholders are the owners of a limited company, they will not take part in the day-to-day running of the company. Instead, shareholders appoint **directors** to manage the company. Directors report to shareholders every year at an **annual general meeting (AGM)**. At this meeting shareholders take part in the election of directors.

## Shares

### Ordinary shares

All companies have **ordinary shares** which are also called *equity shares*.

- Ordinary shares have a face value or *nominal value*. Many ordinary shares have a nominal value of \$1, but it is possible for shares to have a face value of, say, 50c, \$2, etc.
- The owner of an ordinary share would expect to be rewarded for investing in the company by receiving an annual payment called a **dividend**. The amount of the annual dividend will depend partly on how much profit the company makes and partly on how much the directors feel the company can afford to pay, so the dividend varies from year to year.



- Ordinary shares have voting rights that can be used at the AGM, for example in the election of directors.
- Ordinary shareholders are owners of the company.

### Preference shares

Some companies also issue **preference shares**.

- Preference shares also have a nominal value (e.g. \$1) and preference shareholders also expect to receive a dividend.
- However, the amount of dividend that can be paid to a preference shareholder is a fixed percentage of the amount invested. Preference shareholders are entitled to receive their fixed dividend as long as the company has made a profit. There is no guarantee of a dividend if profits are insufficient.
- Preference shareholders are allocated their dividend before the allocation of a dividend to ordinary shareholders, and they would have their investment returned before ordinary shareholders should the company be wound up – hence the term ‘preference’ share.
- However, preference shareholders do not normally have any voting rights.
- Preference shares can be redeemable which means the company can buy back the shares directly from the shareholders by some future date.
- Alternatively, preference shares can be non-redeemable which means the shares cannot be bought back by the company.

### KEY TERMS

**Dividend:** the reward paid to shareholders out of the profits of a limited company.

**Preference shares:** shares that are entitled to receive a fixed rate of dividend and that are ranked before ordinary shares for the payment of a dividend. Shares can be redeemable or non-redeemable.

**Called-up share capital:** the part of the issued share capital of a company for which payment has been requested.

**Paid-up share capital:** the part of the called-up share capital of a company for which payment has been received.

### Issuing shares

When a company issues shares, the directors might decide that the full amount should be paid immediately. Alternatively, shareholders can be asked to pay for shares in instalments. The instalments that are due make up the **called-up share capital** of the company. The amounts actually received from shareholders make up the **paid-up share capital** of the company.

You can now answer questions 1 and 2 on page 242.

#### Illustration 1 Issuing shares

Albrex Ltd was formed on 1 January 2018 with a maximum capital of 100 000 6 per cent preference shares of \$1 each and 800 000 ordinary shares of \$1 each. On that date all of the preference shares and three-quarters of the ordinary shares were issued. Shareholders were required to pay in full for the preference shares on that date and to pay 50c per share for the ordinary shares. By 15 January 2018 all of the amounts due on the preference shares had been received and 90 per cent of the amount due on the ordinary shares had been received.

Here is a summary of Albrex's capital at 15 January 2018.

|                         | Total<br>\$ | Breakdown and calculations   |
|-------------------------|-------------|--|
| Authorised capital      | 900 000     | \$800 000 in ordinary shares<br>\$100 000 in preference shares   |
| Issued capital          | 700 000     | \$600 000 in ordinary shares (i.e. $75\% \times \$800\,000$ )<br>\$100 000 in preference shares                    |
| Called-up share capital | 400 000     | \$300 000 from ordinary shareholders (i.e. $50\% \times \$600\,000$ )<br>\$100 000 from the preference shareholder |
| Paid-up share capital   | 370 000     | \$270 000 from ordinary shareholders (i.e. $90\% \times \$300\,000$ )<br>\$100 000 from the preference shareholder |

# Debentures and dividends

## KEY TERMS

**Debentures:** long-term loans that carry a **fixed rate of interest** which must be paid each year and which is debited to the company's income statement.

## Debentures

**Debentures** are a form of loan to a limited company. Debentures have a fixed rate of interest that is paid annually, usually in two six-monthly instalments. Debenture interest must be paid whether or not the company is making a profit. The interest is treated as an expense, just like any other interest payment, so it is charged to the company's income statement.

It is important to avoid confusing debentures, which are liabilities, with ordinary shares and preference shares, which are part of the capital of the company.

Debentures are repaid sometime in the future, but ordinary share capital is not repaid. So when debentures are issued, the date of repayment is normally clearly stated, so '8 per cent debentures 2024' refers to debentures with an 8 per cent interest rate that will be repaid in 2024. If a company should be wound up, debenture holders are repaid before preference shareholders and before ordinary shareholders.

## Distribution of profit

A company's directors must decide how any profits made by the company are to be used. Profits can be used to finance dividends or they can be retained in the company. When directors announce dividends they have to bear in mind that this will lead to a cash payment to shareholders. Directors have to consider not just whether the company has been profitable but also whether the company will have sufficient cash funds to pay the dividends. The directors may feel that some of the cash that would be spent on dividends could be better used for the benefit of the company. For example, the directors could be thinking of purchasing new non-current assets or replacing some existing non-current assets that are coming to the end of their life. On the other hand, directors will also be concerned to make sure that shareholders are rewarded for their investment in the company.

## Dividend calculations

Dividends are always based on the nominal value of the issued share capital of the company. Dividends can be expressed as a percentage of the issued share capital or as an amount per share.



**Illustration 2** Calculating ordinary share dividends

A company's authorised capital includes 800 000 ordinary shares of \$1 each. The company has issued half of these ordinary shares. The directors have announced an ordinary share dividend of 10 per cent.

The ordinary share dividend is:

$$\$400\,000 \text{ (issued capital)} \times 10\% = \$40\,000$$

**Illustration 3** Calculating preference share dividends

A company's authorised capital includes 150 000 8 per cent preference shares of \$1 each. The company has issued 100 000 of these shares.

The annual dividend on preference shares is:

$$\$100\,000 \text{ (issued capital)} \times 8\% = \$8000$$

**Illustration 4** More dividend calculations

A company's authorised capital consists of 900 000 shares of \$0.50 each. The company's issued capital is \$400 000. The directors have announced a dividend of \$0.05 per share.

Step 1: Calculate the number of issued shares.

Since the shares are \$0.50 each, and the total issued capital is \$400 000, the directors must have issued 800 000 shares.

Step 2: Calculate the ordinary share dividend.

$$800\,000 \times \$0.05, \text{ i.e. } \$40\,000$$

You can now answer questions 3 and 4 on page 242.

## Recording dividends

Only dividends paid during a financial year are recorded in a limited company's financial statements. Dividends paid are recorded in the statement of changes in equity (see 5.12).



## KEY TERMS

**Retained earnings:** profits that have not been used to finance the payment of dividends nor have been transferred to a general reserve.

**General reserve:** part of the undistributed profits that have not been distributed as dividends and are set aside for some future use.

## Undistributed profits

Any profits not distributed by the directors remain as a balance of undistributed profits called **retained earnings**. In future years these retained earnings can be used to finance dividends if the directors so desire. Directors can transfer some of the undistributed profits to what is called a **general reserve**. This would indicate to shareholders that the directors are not likely to use these profits for dividend purposes in the future and that they wish to strengthen the company's financial position. All undistributed profits are sometimes referred to as 'reserves'.

## Advantages and disadvantages of operating as a limited company

Advantages include:

- Shareholders have limited liability for the debts of the company
- Access to different forms of finance including issuing shares and funding by means of debenture loans.
- a company has a separate legal identity from its owners. This means that legal action is taken against the company rather than a shareholder. It also means that a company continues to exist when there are changes in its ownership arising, for example, from the death of a shareholder.

However, there are some disadvantages:

- Limited companies are subject to far greater regulation. For example, directors must complete an annual report and accounts which is sent to every shareholder and debenture holder.
- Greater regulation leads to increased administration costs.
- accounting requirements for companies are more complex and time consuming.

A limited company's financial statements consist of three important elements:

- an income statement, which shows the profit (or loss) for the year
- a **statement of changes in equity**, which shows how retained profits have been distributed
- a statement of financial position.

### The income statement

A limited company's income statement is similar to that of a sole trader or a partnership. However, the following will be included:

- Directors' fees and salaries: these are amounts paid to the directors for the work they do in running the company; also referred to as directors' remuneration.
- Debenture interest

It is also important to note that the income statement is designed to show a figure for **profit (or loss) from operations**. Profit (or loss) from operations is found by deducting expenses from gross profit with the exception of finance charges (e.g. debenture interest).

In effect, a limited company's income statement has three sections:

- the first section is designed to find the profit on trading activities leading to the gross profit
- the second section is designed to find the operating profit
- the third section shows the deduction of finance charges from the operating profit and so completes the calculation of the profit (or loss) for the year.

#### KEY TERMS

**Statement of changes in equity:** a record of changes to the retained earnings and general reserve of a limited company.

**Profit (or loss) from operations:** a limited company's profit or loss before the deduction of finance charges.

#### Illustration 5 Preparing a limited company's income statement

Riverflow Ltd's financial year ended on 31 December 2018. On that date the following information was available:

|                     | \$         |
|---------------------|------------|
| Business expenses   | 73 700     |
| Cost of sales       | 104 800    |
| Debenture interest  | see note 1 |
| Directors' salaries | 62 400     |
| Revenue             | 415 000    |

### STUDY TIP

Don't forget to label subtotals in an income statement. In the case of a limited company's income statement this means: gross profit, profit (or loss) from operations, profit (or loss) for the year.

### Notes:

The new subtotal 'profit from operations' has been shown in bold.

The company has 8% debenture of \$80 000.  
Here is the company's (summarised) income statement.

| Riverflow Ltd  |        |           |
|--|--------|-----------|
| Income statement for the year ended 31 December 2018 |        |           |
|  | \$     | \$        |
| Revenue  |        | 415 000   |
| Less cost of sales                                   |        | (104 800) |
| Gross profit   |        | 310 200   |
| Less expenses  |        |           |
| Business expenses                                    | 73 700 |           |
| Directors' salaries                                  | 62 400 |           |
|  |        | (136 100) |
| <b>Profit from operations</b>                        |        | 174 100   |
| Debenture interest (8% × \$80,000)                   |        | (6400)    |
| Profit for the year                                  |        | 167 700   |

You can now answer questions 5 and 6 on page 243.



# Statements of change in equity

Limited companies prepare statements of changes in equity to show how share capital, retained profits and general reserve have changed during a financial year. The statement records important decisions made by directors: dividends actually paid during the year and any transfers to general reserves. The main elements in the statement of changes in equity are, therefore:

- balances of share capital, retained earnings and any general reserve at the beginning of the year
- profit or loss for the year
- dividends paid during the year
- transfers to general reserve
- balances of share capital, retained earnings and any general reserve at the end of the year
- a total column.

## Illustration 6 Preparing a statement of changes in equity

Cortexic Ltd's financial year ended on 31 December 2018. The following information is available:

At 1 January 2018 the company had retained earnings of \$275 000 and a general reserve of \$130 000.

During the year ended on 31 December 2018 the company made a profit for the year of \$112 000.

The directors paid an ordinary share dividend of 15c per share. The issued share capital of the company consists of 600 000 ordinary shares of \$1 each.

The directors also decided to transfer \$50 000 to a general reserve.

Here is the statement of changes in equity:

### Cortexic Ltd

#### Statement of changes in equity for the year ended 31 December 2018

|                                    | Ordinary<br>share<br>capital | General<br>reserve | Retained<br>earnings | Total     |
|------------------------------------|------------------------------|--------------------|----------------------|-----------|
|                                    | \$                           | \$                 | \$                   | \$        |
| Balances, 1 January 2018           | 600 000                      | 130 000            | 275 000              | 1 005 000 |
| Add: profit for the year           |                              |                    | 112 000              | 112 000   |
| Less: ordinary share dividend paid |                              |                    | (90 000)             | (90 000)  |
| Transfer to general reserve        |                              | 50 000             | (50 000)             |           |
| Balances, 31 December 2018         | 600 000                      | 180 000            | 247 000              | 1 027 000 |

### Exam TIP

When you prepare a statement of changes in equity, remember to cross-check your arithmetic. Make sure when the column totals are added together they match the final total of the total column.

You can now answer questions 7 and 8 on page 243–244.

# Statements of financial position

The statement of financial position of a limited company resembles that of a sole trader or partnership. However, there are some important differences:

- Non-current liabilities include debentures.
- The capital section will show details of issued capital and undistributed profits (the general reserve and retained earnings).

## Illustration 7

### Preparing a company's statement of financial position

Sentrex Ltd has an authorised capital of 100 000 7% preference shares of \$1 each and 900 000 ordinary shares of 50c each. On 31 December 2018 the following information was available.

|   | \$      |
|---|---------|
| 10% Debentures 2024                                 | 120 000 |
| Bank  | 16 700  |
| General reserve                                     | 60 000  |
| Inventories   | 30 000  |
| Issued capital                                      |         |
| 700 000 ordinary shares of 50c each fully paid      | 350 000 |
| 100 000 7% preference shares of \$1 each fully paid | 100 000 |
| Non-current assets                                  |         |
| cost  | 800 000 |
| provision for depreciation                          | 130 000 |
| Other payables                                      | 600     |
| Other receivables                                   | 300     |
| Retained earnings                                   | 89 200  |
| Trade payables                                      | 7 000   |
| Trade receivables                                   | 9 800   |

Here is the company's statement of financial position.

| Sentrex Ltd   |         |                          |                |
|---|---------|--------------------------|----------------|
| Statement of financial position at 31 December 2018 |         |                          |                |
|   | \$      | \$                       | \$             |
| ASSETS  | Cost    | Accumulated depreciation | Net book value |
| Non-current assets                                  | 800 000 | 130 000                  | 670 000        |
| CURRENT ASSETS                                      |         |                          |                |
| Inventory   |         | 30 000                   |                |
| Trade receivables                                   |         | 9 800                    |                |
| Other receivables                                   |         | 300                      |                |
| Bank  |         | 16 700                   |                |
|   |         |                          | 56 800         |
| Total assets  |         |                          | 726 800        |
| EQUITY  |         |                          |                |
| SHARES AND RESERVES                                 |         |                          |                |
| Issued share capital                                |         |                          |                |
| 700 000 ordinary shares of 50c each fully paid      |         | 350 000                  |                |
| 100 000 7% preference shares of \$1 each fully paid |         | 100 000                  |                |
| General reserve                                     |         | 60 000                   |                |
| Retained earnings                                   |         | 89 200                   |                |
| Total equity  |         |                          | 599 200        |
| NON-CURRENT LIABILITIES                             |         |                          |                |
| 10% Debentures 2024                                 |         |                          | 120 000        |
| CURRENT LIABILITIES                                 |         |                          |                |
| Trade payables                                      |         | 7 000                    |                |
| Other payables                                      |         | 600                      |                |
|   |         |                          | 7 600          |
| Total equity and liabilities                        |         |                          | 726 800        |

#### Notes:

- 1 Ordinary shares should precede preference shares in the list of issued capital.
- 2 The 'capital' section of the statement of financial position consists of share capital and reserves. The list is preceded with the overall heading '**equity**'.
- 3 It is good practice to show labels for three of the key figures: 'total assets', 'total equity' and 'total equity and liabilities'.

#### DID YOU KNOW?

It is now common to see the term 'cash and cash equivalents' used on statements of financial position instead of separate entries for cash in hand and cash at bank.

#### KEY TERMS

**Equity:** the heading used for the capital and reserves section of a limited company's statement of financial position.

You can now answer questions 9 to 18 on pages 244–246.



## DEVELOPING YOUR SKILLS

## 1 Identifying capital

Steve and Anna decided to form a private limited company on 1 July 2018 with an authorised capital of \$500 000 consisting of 400 000 \$1 ordinary shares and 100 000 8 per cent \$1 preference shares. On that date Steve agreed to purchase all of the preference shares and 180 000 ordinary shares; Anna agreed to purchase 120 000 ordinary shares.

- a State the value of the authorised share capital.
- b State the value of the issued share capital.

Steve and Anna agreed that the shares should be paid for as follows:

- Preference shares in full
- Ordinary shares: \$0.50 immediately; \$0.50 on 1 July 2018.

- c State the value of the called-up share capital on 1 July 2018.

By 31 July 2018, Steve had paid in full for the preference shares and had paid \$75 000 towards the ordinary shares; Anna had paid \$55 000 towards the ordinary shares.

- d State the value of the paid-up share capital on 31 July 2018.

## 2 Identifying capital

Nimesh decided to form a private limited company on 1 April 2018 with an authorised capital of \$1 200 000 consisting of 2 000 000 \$0.50 ordinary shares and 200 000 7 per cent \$1 preference shares. On that date Nimesh agreed to purchase all of the preference shares and 600 000 ordinary shares. Nimesh's friend Rajinder agreed to purchase 100 000 ordinary shares, and another friend, Serena, agreed to purchase 80 000 ordinary shares.

- a State the value of the authorised share capital.
- b State the value of the issued share capital.

Nimesh, Rajinder and Serena agreed that the shares should be paid for as follows:

- Preference shares in full
- Ordinary shares: \$0.30 immediately; \$0.20 on 1 April 2018.

- c State the value of called-up share capital on 1 April 2018.

By 31 July 2018, Nimesh had paid in full for the preference shares and had paid \$150 000 towards the ordinary shares; Rajinder had paid \$22 000 towards the ordinary shares; Serena had paid in full for her ordinary shares.

- d State the value of paid-up share capital on 31 July 2018.

## 3 Calculating dividends

## Part 1

Helixa Ltd has an authorised capital of 80 000 6 per cent preference shares of \$1 each and 500 000 ordinary shares of \$1 each. At 31 December 2018 all of the preference shares had been issued and were fully paid up, and half of the ordinary shares had been issued and were fully paid up.

On 31 December 2018 the directors paid the preference share dividend for the year and an ordinary share dividend of 12 per cent.

Calculate:

- The preference share dividend
- The ordinary share dividend.

## Part 2

Iberon Ltd has an issued share capital consisting of 850 000 ordinary shares of \$0.50 each.

On 31 December 2018 the directors paid an ordinary share dividend of \$0.10 per share.

Calculate the ordinary share dividend.

## 4 Calculating dividends

## Part 1

Torsa Ltd has an authorised capital of 120 000 8 per cent preference shares of \$1 each and 1 000 000 ordinary shares of \$1 each. At 31 December 2018 all of the preference shares had been issued and were fully paid up, and three-quarters of the ordinary shares had been issued and were fully paid up.

On 31 December 2018 the directors paid the

preference share dividend for the year and an ordinary share dividend of 15 per cent.

Calculate:

- The preference share dividend
- The ordinary share dividend.

#### Part 2

Uveron Ltd has an issued share capital consisting of 740 000 fully paid ordinary shares of \$0.50 each.

On 31 December 2018 the directors paid an ordinary share dividend of \$0.08 per share.

Calculate the ordinary share dividend.

### 5 Preparing a company's income statement

The following information has been taken from the books of Hayford Ltd at the end of its financial year, 31 August 2018.

|  | \$      |
|--|---------|
| Business expenses                              | 78 400  |
| Debenture interest (see note)                  |         |
| Directors' salaries                            | 52 900  |
| Inventories                                    |         |
| 1 September 2017                               | 33 800  |
| 31 August 2018                                 | 44 900  |
| Non-current assets                             |         |
| Cost   | 460 000 |
| Provision for depreciation at 1 September 2017 | 80 000  |
| Purchases                                      | 250 000 |
| Revenue  | 640 000 |

#### Additional information:

- Business expenses prepaid at 31 August 2018 were \$1800.
- Depreciation should be provided on non-current assets at 25 per cent per annum using the reducing balance method.
- The company borrowed \$140 000 in the form of 10 per cent debentures some years ago.

Prepare an income statement for the year ended 31 August 2018. Identify gross profit, profit from operations and profit for the year.

### 6 Preparing a company's income statement

The following information has been taken from the books of Sahera Ltd at the end of its financial year, 31 May 2018.

|   | \$      |
|---|---------|
| Business expenses                           | 34 700  |
| Debenture interest (see note)               |         |
| Directors' salaries                         | 32 400  |
| Inventories                                 |         |
| 1 June 2017                                 | 17 100  |
| 31 May 2018                                 | 14 200  |
| Non-current assets                          |         |
| Cost  | 85 000  |
| Provision for depreciation at 1 June 2017   | 34 000  |
| Provision for doubtful debts at 1 June 2017 | 1 100   |
| Purchases                                   | 182 800 |
| Revenue                                     | 395 000 |

#### Additional information:

- Business expenses accrued at 31 May 2018 were \$1800.
- Depreciation should be provided on non-current assets at 20 per cent per annum using the straight-line method.
- The provision for doubtful debts should be increased by \$600.
- The company borrowed \$50 000 in the form of 8 per cent debentures some years ago.

Prepare an income statement for the year ended 31 May 2018. Identify gross profit, profit from operations and profit for the year.

### 7 Preparing a statement of changes in equity

Avalon Ltd's financial year ended on 30 September 2018. The following information is available:

- At 1 October 2017 the company's retained earnings were \$143 000 and the balance of the general reserve account was \$60 000.
- During the year ended 30 September 2018 the company made a profit of \$165 000.
- During the year ended 30 September 2018 the directors paid a dividend of \$0.10 per share on the issued capital of 1 200 000 ordinary shares of \$1 each.



- At 30 September 2018 the directors transferred \$25 000 to the general reserve.

Prepare a statement of changes in equity for the year ended 30 September 2018.

### 8 Preparing a statement of changes in equity

Zedtrex Ltd has an issued share capital of 1 500 000 ordinary shares of \$1 each. The following information is available about the financial year ended on 31 August 2018:

- At 1 September 2017 the company's retained earnings were \$372 000 and the balance on the general reserve was \$130 000.
- During the year ended 31 August 2018 the company made a profit of \$666 000.
- During the year ended 31 August 2018 the directors paid an ordinary share dividend of \$0.40 per share.
- At 31 August 2018 the directors transferred \$25 000 to the general reserve.

Prepare a statement of changes in equity for the year ended 31 August 2018.

### 9 Preparing company statement of financial position

Wenfod Ltd has an authorised capital of 40 000 8 per cent preference shares of \$1 each and 800 000 ordinary shares of \$1 each. On 31 December 2018 the following information was available.

|  |         |
|--|---------|
| 7% debentures 2022                                 | 50 000  |
| Bank   | 38 800  |
| General reserve                                    | 72 400  |
| Inventories  | 17 100  |
| Issued capital                                     |         |
| 600 000 ordinary shares of \$1 each fully paid     | 600 000 |
| 40 000 8% preference shares of \$1 each fully paid | 40 000  |
| Non-current assets                                 |         |
| Cost   | 960 000 |
| Provision for depreciation                         | 162 000 |
| Other payables                                     | 500     |
| Other receivables                                  | 700     |
| Retained earnings                                  | 98 800  |
| Trade payables                                     | 12 400  |
| Trade receivables                                  | 19 500  |

Prepare a statement of financial position at 31 December 2018.

### 10 Preparing company statement of financial position

Emprix Ltd has an authorised capital of 140 000 7 per cent preference shares of \$1 each and 1 400 000 ordinary shares of \$0.50 each. All of the preference shares and half of the ordinary shares are issued and are fully paid.

On 31 July 2018 the following additional information was available.

|                              |         |
|------------------------------|---------|
| 9% debentures 2024           | 30 000  |
| Bank                         | (8 400) |
| General reserve              | 41 000  |
| Inventories                  | 34 800  |
| Non-current assets           |         |
| Cost                         | 765 000 |
| Provision for depreciation   | 183 200 |
| Other receivables            | 400     |
| Provision for doubtful debts | 400     |
| Retained earnings            | 43 600  |
| Trade payables               | 11 700  |
| Trade receivables            | 8 100   |

Prepare a statement of financial position at 31 July 2018.

### 11 Preparing end-of-year financial statements of a limited company

Jimplex Ltd's most recent financial year ended on 31 December 2018. On that date the following information was available.

|   | \$        | \$        |
|---|-----------|-----------|
| 10% debentures 2025                         |           | 120 000   |
| Administration and selling expenses         | 68 000    |           |
| Bank  | 15 000    |           |
| Debenture interest                          | 12 000    |           |
| Ordinary share dividends paid               | 50 000    |           |
| Inventories at 1 January 2018               | 25 000    |           |
| Issued capital: 500 000 \$1 ordinary shares |           | 500 000   |
| Non-current assets at net book value        | 900 000   |           |
| Purchases                                   | 384 000   |           |
| Retained earnings at 1 January 2018         |           | 115 000   |
| Revenue                                     |           | 704 000   |
| Trade payables                              |           | 28 000    |
| Trade receivables                           | 13 000    |           |
|   | 1 467 000 | 1 467 000 |



Additional information at 31 December 2018:

- Inventories were valued at \$32 000.
- Administration and selling expenses prepaid totalled \$4000.
- Non-current assets should be depreciated by 20 per cent per annum using the reducing balance method.

Prepare the following:

- An income statement for the year ended 31 December 2018
- A statement of changes in equity for the year ended 31 December 2018
- A statement of financial position at 31 December 2018

## 12 Preparing end-of-year financial statements of a limited company

Ortigon Ltd's financial year ended on 30 June 2018. On that date the following information was available.

|                                     | \$000 | \$000 |
|-------------------------------------|-------|-------|
| 10% debentures                      |       | 30    |
| Administration and selling expenses | 172   |       |
| Bank                                |       | 18    |
| Cost of sales                       | 543   |       |
| Debenture interest                  | 3     |       |
| General reserve                     |       | 44    |
| Inventories at 30 June 2018         | 31    |       |

|                                      |       |       |
|--------------------------------------|-------|-------|
| Issued share capital:                |       |       |
| 1m ordinary shares of \$1 each       |       | 1 000 |
| 6% preference shares of \$1 each     |       | 400   |
| Non-current assets at net book value | 1 960 |       |
| Ordinary share dividends paid        | 150   |       |
| Retained earnings at 1 July 2017     |       | 206   |
| Revenue                              |       | 1 167 |
| Trade payables                       |       | 31    |
| Trade receivables                    | 37    |       |
|                                      | 2 896 | 2 896 |

Additional information at 30 June 2018 (all amounts in \$000):

- Administration and selling expenses were accrued \$9.
- Non-current assets should be depreciated by 10 per cent per annum using the reducing balance method.
- The directors have decided to transfer \$25 to the general reserve.

Prepare the following:

- An income statement for the year ended 30 June 2018
- A statement of changes in equity for the year ended 30 June 2018
- A statement of financial position at 30 June 2018

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 5.8–5.13)

### MULTIPLE-CHOICE QUESTIONS

- What does the abbreviation 'Ltd' mean at the end of the name of a business?
  - The number of shareholders has a fixed limit
  - The shareholders' liability for the debts of the business is limited
  - There is a limit to the number of debentures that can be issued
  - There is a limit to the amount of sales revenue this business can achieve
- Which item is shown in the income statement of a limited liability company?
  - Debenture interest
  - General reserve
  - Ordinary share dividend paid
  - Retained earnings
- A limited company has an authorised capital of 200 000 ordinary shares of \$1 each. Half of the ordinary shares have been issued. The directors have required the payment of \$0.50 per share. So far \$0.40 per share has been received from shareholders.

What is the company's called-up share capital?

- A \$40 000
- B \$50 000
- C \$100 000
- D \$200 000

- 16 A limited company has an authorised capital of 500 000 ordinary shares of \$1 each. Eighty per cent of the ordinary shares have been issued. The directors have required the payment of \$0.50 per share. So far \$0.40 per share has been received from shareholders.

What is the company's paid-up share capital?

- A \$160 000
- B \$200 000
- C \$400 000
- D \$500 000

- 17 Which item is shown in a limited company's statement of changes in equity?

- A Debentures interest
- B Directors' fees
- C Ordinary share dividend paid
- D Preference share dividend proposed

### OTHER QUESTIONS

- 18 Treble Clef Ltd has a maximum capital of 1 800 000 ordinary shares of \$1 each and 200 000 7 per cent preference shares of \$1 each.

On 31 December 2018 the company had issued half of the preference shares and three-quarters of the ordinary shares. These shares were fully paid.

- a State the total value of the company's authorised share capital.
- b State the total value of the company's issued share capital.
- c Explain what is meant by the term 'paid-up share capital'.

On 31 December 2018 the directors announced that the company had made an profit from operations of \$427 000 for the year ended on that date. The directors have:

- Paid the debenture interest for the year of \$4 800
- Paid the preference share dividend for the year
- Paid an ordinary share dividend of \$0.20 per share
- Planned to transfer \$47 000 to a general reserve.

The retained profits brought forward from the previous year amounted to \$88 000 and the balance of the general reserve on 1 January 2018 was \$130 000.

- d Calculate the amount of the preference share dividend.
- e Calculate the amount of the ordinary share dividend.
- f Prepare the company's statement of changes in equity for the year ended 31 December 2018.

On 31 December 2018 the following additional information was available.

|  | \$        |
|--|-----------|
| Bank   | 49 600    |
| 6% debentures 2024                             | 80 000    |
| Inventories                                    | 57 100    |
| Non-current assets                             |           |
| Cost   | 2 000 000 |
| Provision for depreciation at 31 December 2018 | 240 000   |
| Trade payables                                 | 32 500    |
| Trade receivables                              | 59 000    |

- h Explain why debentures are described as 6 per cent and 2024.
- i Prepare a statement of financial position at 31 December 2018.



## Introduction



Clubs and societies exist for the benefit of their members and their main objective is to provide facilities for their members to use and enjoy. Unlike businesses, they are not formed with the aim of making a profit for the owner(s), so they are referred to as non-profit-making organisations.

In this chapter you will learn about the accounting records that are prepared for small clubs and societies. Accounting records are more limited than those of a business because the provision of activities is more important than financial affairs. Members appoint a **treasurer** who reports to the annual general meeting at the year end on:

- the cash position, because, just like a business, a club or society must be able to pay its debts on time
- whether the club has sufficient income to cover its running costs and has sufficient finances to maintain or improve its existing resources
- the overall picture of the club's financial position.

In larger clubs and societies a full double-entry system could be maintained, but for smaller organisations the treasurer is likely to prepare:

- a cash book, which is summarised in the form of a **receipts and payments account** for presentation to the club committee and members at the annual general meeting
- an **income and expenditure account**, which is similar to an income statement but is designed to show whether running costs have been covered by income and whether there is a surplus or deficit for the year
- a statement of financial position to show members an overall picture of the financial position.

**Note:** for convenience throughout the following units reference is made only to clubs. However, all of the points made could apply equally well to a society.

## LEARNING OBJECTIVES

When you have reached the end of this chapter you will be able to:

- prepare a receipts and payments account
- prepare an income and expenditure account
- prepare accounting records for subscriptions
- prepare accounting records for other fund-raising activities
- make adjustments to income and expenses
- calculate the accumulated fund
- prepare the statement of financial position of a club.

## KEY TERMS

**Treasurer:** the individual appointed by the members of a club or society to manage its financial affairs.

**Receipts and payments account:** an annual summary of a club's cash book.

**Income and expenditure account:** an annual summary that shows whether a club made a surplus or a deficit.



## Preparing a receipts and payments account

### Recording money transactions

Clubs may receive money from a variety of sources. Here are some typical examples:

- Members: it is usual for members to pay an annual subscription which enables them to use the club's facilities. Sometimes members pay a one-off membership fee when they first join the club.
- Money-raising activities: although clubs do not set out to make a profit, they may raise funds to help run the club or make improvements. For example, a club might sell refreshments, sell tickets for social evenings and competitions, etc.
- Loans: a club might be able to arrange a loan.
- Donations: individuals or organisations might be prepared to make a donation to a club.

The club treasurer, with the approval of a committee of members, will be responsible for making the following payments:

- Running costs: including expenses such as electricity, telephone, wages of anyone employed by the club, repairs to the club's assets, rent or hire of land and buildings used by the club.
- Expenses of money-raising activities: for example the cost of refreshments, prizes for competitions, etc.
- Purchase of non-current assets: from time to time existing assets will need to be replaced and new and better facilities may be purchased.
- Repayment of loans.

### The receipts and payments account

The majority of transactions will be in cash. However, there could be credit suppliers of inventories for a cafe or shop.

During the course of a year a club's treasurer will keep a detailed record of every receipt and payment of money in a cash book. At the end of the year a summary will be prepared of these items to present to the club committee and, possibly, all of the club's members. The summary is called a receipts and payments account. The receipts and payments account will inform members of the reasons behind any increase or decrease in the club's cash funds.

**Illustration 1** A club's receipts and payments account

The treasurer of the Emden Community Film Club presented the following summary of the club's cash book. Here is the club's receipts and payments account.

**EMDEN COMMUNITY FILM CLUB**  
**Receipts and payments account**  
**for the year ended 31 December 2018**

| RECEIPTS   | \$    | PAYMENTS   | \$    |
|--|-------|--|-------|
| Opening balance of cash in hand and cash at bank | 854   | Hire of community hall                           | 740   |
| Members' subscriptions                           | 2 840 | Refreshment costs                                | 182   |
| Sales of refreshments                            | 337   | Hire of films                                    | 885   |
| Donation from local business                     | 200   | Interest on loan from member                     | 24    |
| Loan from bank                                   | 300   | Purchase of projecting equipment                 | 2 200 |
|  |       | Club secretary's expenses                        | 108   |
|  |       | Closing balance of cash in hand and cash at bank | 392   |
|  | 4 531 |  | 4 531 |

**Notes:**

- 1** The account is set out using a very simple format so that members who do not have any special knowledge of accounting can easily understand the contents.
- 2** Some treasurers may prefer to use a vertical style of presentation.
- 3** The opening and closing balances shown in a receipts and payments account are the total balances of cash in hand and at bank as recorded in the treasurer's cash book for the period.
- 4** Members will find this account helpful in understanding why the club's cash funds have reduced by \$462 during the year.

You can now answer questions 1 and 2 on page 257.

# Preparing an income and expenditure account

## The income and expenditure account

If a club is to survive it must make sure that its income is sufficient to cover its running costs. In order to provide members with a detailed answer to this key point, the treasurer will prepare an income and expenditure account.

This account is similar in many ways to a business's income statement and it should be drawn up following the same principles, including the accruals principle. As a result, adjustments will have to be made to expenses for accruals and prepayments, and depreciation of non-current assets will have to be taken into account.

It is likely that the amount received from members for their subscriptions will also need to be adjusted to take account of the fact that some members will have failed to pay their annual subscription on time, or that some other members may have paid their subscriptions for next year.

### Illustration 2 Preparing a simple income and expenditure account

Here is the film club's income and expenditure account based on the information in Illustration 1 and the following additional information:

- The amount paid for the hire of the community hall includes charges of \$60 which are for the next financial year.
- The club's secretary has not yet paid an amount due for expenses of \$40.
- Some members have not yet paid their subscription for 2018 and a total of \$320 is owed.
- In addition to the new projecting equipment, the club has non-current assets that cost \$4 700. All non-current assets should be depreciated by 20 per cent per annum on cost.

#### EMDEN COMMUNITY FILM CLUB Income and expenditure account for the year ended 31 December 2018

| INCOME   | \$    | \$      |
|--|-------|---------|
| Subscriptions (received \$2 840 + due \$320)                       | 3 160 |         |
| Refreshment sales  | 337   |         |
| Donation   | 200   |         |
|  |       | 3 697   |
| EXPENDITURE  |       |         |
| Hire of community hall (paid \$740 – prepaid \$60)                 | 680   |         |
| Cost of refreshments   | 182   |         |
| Hire of films  | 885   |         |
| Loan interest  | 24    |         |
| Secretary's expenses (paid \$108 + due \$40)                       | 148   |         |
| Depreciation of non-current assets (20% × (\$4 700 + new \$2 200)) | 1 380 |         |
|  |       | (3 299) |
| Surplus of income over expenditure                                 |       | 398     |



### Notes:

- 1** The account records only income and expenses, so assets such as the cash balances and the purchase of the film projector are not included, and liabilities such as the bank loan are not included.
- 2** Donations and gifts are usually regarded as part of the club's income unless told otherwise.
- 3** The account shows that income has been greater than expenditure. Instead of the word 'profit' the term 'surplus' is used. If expenditure exceeds income, then the term 'deficit' is used rather than the word 'loss'.
- 4** The club members will be able to use this account to understand how the club made enough income to more than cover its running costs.

## Adjustments to expenditure

It may be necessary to consider opening as well as closing adjustments when calculating the correct amount of an expense to charge to a club's income and expenditure account. Here is an example of how to approach this situation.

You can now answer questions 3 and 4 on page 257.

### Illustration 3

Preparing an expense account with opening and closing adjustments

The Topgear Cycle Club rents its clubhouse. For the year ended 31 December 2018 the treasurer is able to provide the following information:

- 1 January 2018: rent due was \$180
- January–December 2018: payments for rent totalled \$3850
- 31 December 2018: rent prepaid for 2017 was \$250

It is possible to make an arithmetical calculation or prepare a ledger account to calculate the correct amount to charge to the income and expenditure account.

By arithmetical calculation:

|   | \$    |
|---|-------|
| Rent paid during the year                   | 3 850 |
| Less amount due on 1 January for 2018       | (180) |
| Less amount prepaid on 31 December for 2018 | (250) |
| Clubhouse rent for 2018                     | 3 420 |

Using an expense account:

| Dr                    | Rent account                                | Cr    |
|-----------------------|---|-------|
| Bank (payments) 3 850 | Opening balance (due) 180                   |       |
|                       | <b>Income and expenditure account 3 420</b> |       |
|                       | Closing balance (prepaid) c/d 250           |       |
|                       | 3 850                                       | 3 850 |
| Balance b/d 250       |   |       |

### DID YOU KNOW?

When dealing with adjustments to income or expense items, always use the accruals principle. This means that: information that is to do with the current year should be included; information that relates to any other year should be excluded. You may find it easier to remember this idea with the simple statement: this year IN; any other year OUT.

# Subscriptions and fund-raising activities

## Preparing subscription accounts

Calculating the correct amount of subscription income for a year is done using the accruals principle. It is possible to work out the correct figure to use by making a calculation or by using a subscriptions account.

### Notes:

- 1 The amount of cash received is credited to the subscriptions account. This entry would be matched by a debit entry in the club's bank account.
- 2 The income for the year is debited to the subscriptions account. The matching credit entry would be on the credit side of the income and expenditure account.
- 3 Subscriptions due is a debit balance brought down, so it is a current asset to the club.
- 4 Subscriptions received in advance is a credit balance brought down, so it is a current liability to the club.

### Illustration 4 Calculations of subscription income

The Double-Fault Tennis Club charges its members a subscription of \$40 per annum. During the year ended 31 December 2017, the club received \$880 for subscriptions. This sum included \$120 received from members for their subscriptions for 2018. Four members failed to pay their subscriptions for 2017 on time.

Here are two ways of calculating the subscription income.

By arithmetical calculation:

|  | \$    |
|--|-------|
| Subscriptions received during the year                         | 880   |
| Less subscriptions received for 2018                           | (120) |
| Add subscriptions due but not yet received ( $4 \times \$40$ ) | 160   |
| Income from subscriptions for 2017                             | 920   |

Using a subscriptions account:

| Dr  | Subscriptions account |                           | Cr          |
|---|-----------------------|---------------------------|-------------|
| Income and expenditure account            | 920                   | Bank (amounts received)   | 880         |
| Closing balance (received in advance) c/d | 120                   | Closing balance (due) c/d | 160         |
|   | <hr/> 1 040           |                           | <hr/> 1 040 |
| Balance b/d                               | 160                   | Balance b/d               | 120         |

### Exam TIP

When preparing a subscriptions account remember to state that the transfer is to the income and expenditure account. It is a common mistake to write 'IS' or income statement instead.

In Illustration 5 the calculation of subscription income becomes more complicated because there are adjustments to be made at the *beginning* of the year as well as at the end of the year.

### Illustration 5 More calculations of subscription income

During the year ended 31 December 2018 the Double-Fault Tennis Club continued to charge its members an annual subscription of \$40 per member. During the year ended on that date a total of \$1200 was received from members; this included the \$160 due from the previous year. At 31 December 2018, six members had paid their subscription for 2019 in advance, but nine members had yet to pay their subscription for 2018.



Arithmetical calculation:

|  | \$    |
|--|-------|
| Subscriptions received during the year                   | 1 200 |
| Less subscriptions due from 2017                         | (160) |
| Add subscriptions for the current year received in 2017  | 120   |
| Add subscriptions due for 2018 ( $9 \times \$40$ )       | 360   |
| Less subscriptions received for 2019 ( $6 \times \$40$ ) | (240) |
| Income from subscriptions for 2018                       | 1 280 |

Using a subscriptions account:

| Dr                                    |              | Subscriptions account         |       | Cr |
|---------------------------------------|--------------|-------------------------------|-------|----|
| Balance b/d                           |              | Balance b/d                   |       |    |
| (due from 2017)                       | 160          | (received in advance in 2017) | 120   |    |
| <b>Income and expenditure account</b> | <b>1 280</b> | Bank (amounts received)       | 1 200 |    |
| Balance c/d (received in advance)     | 240          | Balance c/d (due)             | 360   |    |
|                                       | 1 680        |                               | 1 680 |    |
| Balance b/d                           | 360          | Balance b/d                   | 240   |    |

You can now answer questions 5 to 8 on page 258.

## Fund-raising activities

When a club tries to raise extra funds from specific activities and events, members should be provided with information about their success or otherwise.

### Illustration 6 How to show a profit (or loss) from fund-raising

In the case of the Emden Community Film Club (see Illustrations 1 and 2) you may remember the income and expenditure account showed separate details about refreshments: income \$337 and expenditure \$182. Members may have found it helpful if the account had made it clear that this activity made a profit for the club of \$155. Here is how this could be done.

#### EMDEN COMMUNITY FILM CLUB (Extract)

##### Income and expenditure account for the year ended 31 December 2018

| INCOME                           | \$           | \$         | \$ |
|----------------------------------|--------------|------------|----|
| Subscriptions                    |              | xxx        |    |
| <b>Refreshment sales</b>         | <b>337</b>   |            |    |
| <b>Less cost of refreshments</b> | <b>(182)</b> |            |    |
| <b>Profit on refreshments</b>    |              | <b>155</b> |    |
| Donation                         |              | xxx        |    |
|                                  |              |            | xx |
| EXPENDITURE                      |              |            |    |
| Hire of community hall           |              | xxx        |    |
| etc.                             |              | xxx        |    |



Where the information about an activity or event is more complicated, it is recommended that a separate account is prepared first to calculate the profit or loss on the activity.

### Illustration 7

Preparing a separate account to calculate profit or loss

The Appendix Book Club raises funds by selling second-hand books in the local village. The following information is available for the year ended 30 September 2018.

|                                 | \$    |
|---------------------------------|-------|
| Sales of second-hand books      | 3 870 |
| Purchases of second-hand books  | 2 140 |
| Inventory of second-hand books: |       |
| 1 October 2017                  | 480   |
| 30 September 2018               | 710   |

The treasurer prepared the following account to show the profit made on this activity:

#### Second-hand books account for the year ended 30 September 2018

|  | \$    | \$      |
|--|-------|---------|
| Revenue from book sales                  |       | 3 870   |
| Less: cost of sales                      |       |         |
| Opening inventory                        | 480   |         |
| Add purchases                            | 2 140 |         |
|  | 2 620 |         |
| Less closing inventory                   | (710) |         |
|  |       | (1 910) |
| Profit on second-hand books for the year |       | 1 960   |

The profit of \$1960 should be entered in the income section of the annual income and expenditure account.

#### STUDY TIP

If you prepare a separate account to calculate the profit or loss made on an event or activity, do not forget to enter the profit or loss in the income and expenditure account.

# Club statements of financial position

## The accumulated fund

In a business the owners invest their private funds, which is referred to as the capital of the business, and during a financial year owners can withdraw funds in the form of drawings.

However, in the case of a club, members do not make a similar investment and so are not allowed to make any withdrawals of funds. Over a period of time, if a club makes an annual surplus (see 5.15 above) this will gradually accumulate over many years, and this figure is referred to as the club's **accumulated fund**. The accumulated fund can be calculated by subtracting the total amount of liabilities from the total value of assets.

### KEY TERMS

**Accumulated fund:** the total of a club's surpluses over a period of years. It is the equivalent of a business's capital.

#### Illustration 8 Calculating a club's accumulated fund

The Hereton Social Club had the following assets and liabilities at 1 January 2018.

|  | \$      |
|--|---------|
| Amounts due to suppliers of refreshments | 240     |
| Bank                                     | 450     |
| Clubhouse                                | 180 000 |
| Furniture and equipment                  | 8 200   |
| Inventory (refreshments)                 | 720     |
| Long-term bank loan                      | 3 200   |
| Subscriptions due from members           | 360     |

The club's accumulated fund at 1 January 2018 is as follows.

|                                | \$      | \$      |
|--------------------------------|---------|---------|
| Total assets                   |         |         |
| Bank                           | 450     |         |
| Clubhouse                      | 180 000 |         |
| Furniture and equipment        | 8 200   |         |
| Inventory (refreshments)       | 720     |         |
| Subscriptions due from members | 360     |         |
|                                |         | 189 730 |
| Less total liabilities         |         |         |
| Refreshments suppliers         | 240     |         |
| Long-term bank loan            | 3 200   |         |
|                                |         | (3 440) |
| Accumulated fund               |         | 186 290 |

## Preparing a club's statement of financial position

Club statements of financial position resemble those of businesses. They will show members the details of the club's assets and liabilities at a particular date. However, the capital section of the statement of financial position will be replaced by the accumulated fund. This section will show details of the balance of the accumulated fund brought forward from the previous year with the surplus for the year added or deficit for the year subtracted.

### DID YOU KNOW?

Many small clubs do not prepare statements of financial positions or income and expenditure accounts because their affairs are very straightforward. For example, these clubs may not possess any non-current assets or have accruals or prepayments. In these situations, the club treasurer may report to members by just preparing a receipts and payments account.

### STUDY TIP

It is easy to make a mistake when entering information about subscriptions on a statement of financial position. Subscriptions due should be recorded as a current asset – this item represents money due to the club. Subscriptions received in advance should be recorded as a current liability, as the amount is, in effect, owed back to the members at the date of the statement of financial position.

You can now answer questions 9–18 on pages 258–261.

### Illustration 9 Preparing a club's statement of financial position

The treasurer of the MegaWave Surf Club reported that the club had made a surplus of \$6300 for the year ended 31 October 2018. The treasurer also provided the following information.

|                                       | \$     |
|---------------------------------------|--------|
| Accrual: secretary's fee              | 160    |
| Accumulated fund, 1 November 2017     | 19 180 |
| Bank (overdraft)                      | 1 870  |
| Prepaid administration expenses       | 220    |
| Subscription due                      | 480    |
| Subscriptions received in advance     | 990    |
| Surfboards and equipment at valuation | 27 800 |

Here is the club's statement of financial position for 31 October 2018.

#### MEGAWAVE SURF CLUB

##### Statement of financial position at 31 October 2018

|   | \$     | \$     |
|---|--------|--------|
| <b>NON-CURRENT ASSETS</b>                           |        |        |
| Surfing equipment at valuation                      |        | 27 800 |
| <b>CURRENT ASSETS</b>                               |        |        |
| Other receivables (prepaid administration expenses) | 220    |        |
| Other receivables (subscriptions due)               | 480    |        |
|   |        | 700    |
|   |        | 28 500 |
| <b>ACCUMULATED FUND</b>                             |        |        |
| Balance at 1 November 2017                          | 19 180 |        |
| Add surplus for year                                | 6 300  |        |
|   |        | 25 480 |
| <b>CURRENT LIABILITIES</b>                          |        |        |
| Other payables (subscriptions received in advance)  | 990    |        |
| Other payables (accrual: secretary's fees)          | 160    |        |
| Bank  | 1 870  |        |
|   |        | 3 020  |
|   |        | 28 500 |



## DEVELOPING YOUR SKILLS

**1 Preparing a receipts and payments account**

The treasurer of the Newtown Sports Club records all of the club's money transactions in a cash book. At the end of the club financial year, 31 December, the treasurer summarises all of the details in the cash book to prepare a receipts and payments account. The treasurer has supplied the following information about the year ended 31 December 2018.

On 1 January the club had total cash balances (Bank) of \$720.

The club received money from the following sources:

- Members' subscriptions totalled \$3850
- Entrance fees for sports competition raised \$620
- A local businessman donated \$500 to the club
- A member lent the club \$800 to help pay for some new sports equipment.

The treasurer made the following payments:

- Rent of sports grounds, \$1200
- Purchase of new sports equipment, \$2700
- Competition prizes, \$450
- Loan interest, \$40
- Coach hire for away matches, \$900
- Administration expenses, \$170.

Prepare the club's receipts and payments account for the year ended 31 December 2018.

**2 Preparing a receipts and payments account**

Students at the Kingstown High School have formed a Music Society. One of the students has been acting as the society's treasurer. The treasurer has provided the following information about the year ended 31 July 2018.

At 1 August 2017 the society had total cash funds of \$840.

Receipts during the year were from the following:

- Members' subscriptions: each member pays an annual subscription of \$25. Subscriptions were received from 230 members.
- Ticket sales for performances raised \$930.

- A loan from the school of \$1000 helped with the purchase of musical instruments.
- Parents of some of the students made gifts of money totalling \$450.

Payments during the year were for the following:

- Tuition fees for music lessons, \$2500
- Hire of school facilities for performances, \$480
- Purchase of musical instruments, \$3800
- Cost of refreshments for performances, \$280
- Loan interest, \$50
- Administration costs, \$140.

Prepare the club's receipts and payments account for the year ended 31 July 2018.

**3 Preparing an income and expenditure account**

Using the information in question 1 and taking account of the following additional information, prepare the club's income and expenditure account for the year ended 31 December 2018.

Additional information:

- Some members have not paid their subscription for 2018 and owe the club \$420.
- Some other members have paid their 2019 subscription during the year ended 31 December 2018, \$80.
- Rent of sports ground was prepaid, \$240, at 31 December 2018.
- Administration expenses, \$30, were due at 31 December 2018.
- At 1 January 2018 the club's sports equipment was valued at cost \$11 300 – all sports equipment should be depreciated by 20 per cent on cost for the year.

**4 Preparing an income and expenditure account**

Using the information in question 2 and taking account of the following additional information, prepare the club's income and expenditure account for the year ended 31 July 2018.

Additional information:

- Five members had not paid their subscription for the year under review, but eight other members had paid their subscription for

the current year and for the year ending 31 July 2019.

- Tuition fees, \$320, were due but unpaid at 31 July 2018.
- Administration costs, \$80, were prepaid at 31 July 2018.
- The society owned musical instruments with a value of \$18400 at 1 August 2017 – all musical instruments should be depreciated by 10 per cent on cost for the year.

#### 5 Calculating subscription income and using subscription accounts

The Pageturner Book Club charges its members an annual subscription of \$30 each. During the year ended 31 December 2017 the club's treasurer received \$810 in subscriptions. This sum included \$150 received from members for subscriptions for 2018. At 31 December 2017 three members had failed to pay their 2017 subscription.

- Calculate the club's subscription income for 2017.
- Prepare a subscriptions accounts for 2017.

#### 6 Calculating subscription income and using subscription accounts

The GoforGold Athletics Club charges its members an annual subscription of \$70 each. During the year ended 31 December 2017, \$2310 was received from members for their annual subscriptions. This sum included subscriptions from eight members for 2018. At 31 December 2017, five members had failed to pay their 2017 subscription.

- Calculate the club's subscription income for 2017.
- Prepare a subscriptions accounts for 2017.

#### 7 Calculating subscription income and using subscription accounts

The following information is available for the Pageturner Book Club for the year ended 31 December 2018 (see also question 5).

As well as the opening balances on the subscription account on 1 January 2018 (see question 5) the following additional information is available.

The club has maintained the annual subscription rate at \$30 per member. The sum of \$1110 was received from members for annual subscriptions during the year ended 31 December 2018. This

included the subscriptions due at the beginning of the year and \$120 received from members for their 2019 subscription. By 31 December 2018, six members had failed to pay their subscription for 2018.

- Calculate the club's subscription income for 2018.
- Prepare a subscriptions accounts for 2018.

#### 8 Calculating subscription income and using subscription accounts

The following information is available for the GoforGold Athletics Club for the year ended 31 December 2018 (see also question 6).

As well as the opening balances on the subscription account on 1 January 2018 (see question 6) the following additional information is available.

The club has maintained the annual subscription rate at \$70 per member. The sum of \$2870 was received from members for annual subscriptions during the year ended 31 December 2018. This included the subscriptions due at the beginning of the year and \$350 received from members for their 2019 subscription. By 31 December 2018, two members had failed to pay their subscription for 2018.

- Calculate the club's subscription income for 2018.
- Prepare a subscriptions accounts for 2018.

#### 9 Preparing a club's statement of financial position

The Merlin Sailing Club's most recent financial year ended on 30 April 2018. On that date the club's treasurer reported a surplus for the year of \$3390 and provided the following additional information.

|   | \$     |
|---|--------|
| Accumulated fund at 1 May 2017                    | 45 750 |
| Other receivable (boathouse rent prepaid)         | 440    |
| Bank (asset)                                      | 1 130  |
| Loans from members (repayable 2022)               | 4 000  |
| Sailing equipment at valuation                    | 52 300 |
| Other payable (secretary's expenses due)          | 110    |
| Other receivable (subscriptions due)              | 770    |
| Other payable (subscriptions received in advance) | 1 390  |

Prepare the club's statement of financial position at 30 April 2018.



## 10 Preparing a club's statement of financial position

The Matchpoint Badminton Club's treasurer has reported a deficit of \$2850 for the year on 31 August 2018. At this date the following additional information is available.

|  | \$    |
|--|-------|
| Accumulated fund at 1 September 2017                 | 2 960 |
| Badminton equipment at valuation                     | 2 180 |
| Bank (overdraft)                                     | 1 650 |
| Other receivable (general expenses prepaid)          | 80    |
| Other payable (hire of badminton court: charges due) | 330   |
| Inventory (refreshments)                             | 450   |
| Loans from members                                   | 800   |
| Other receivable (subscriptions due)                 | 410   |
| Other payable (subscriptions received in advance)    | 230   |

**Note:** the loans from members are due for repayment in October 2018.

Prepare the club's statement of financial position at 31 August 2018.

## 11 Preparing end-of-year financial statements

The Curtain-up Drama Club was formed several years ago. The club's treasurer is able to supply the following information about the year ended 31 December 2018.

At 1 January the club had the following assets and liabilities.

|                                      | \$     |
|--------------------------------------|--------|
| Costumes and stage sets at valuation | 11 900 |
| Prepaid hire of community centre     | 270    |
| Subscriptions due from members       | 90     |
| Bank (asset)                         | 3 150  |
| Administration expenses due          | 140    |
| Subscriptions received in advance    | 320    |

### Receipts and payments account for the year ended 31 December 2018

| RECEIPTS                     | \$            | PAYMENTS                                | \$            |
|------------------------------|---------------|---|---------------|
| Balance 1 January 2018       | 3 150         | Hire of community centre                | 1 740         |
| Members' subscriptions       | 3 200         | Purchase of new costumes and stage sets | 5 800         |
| Gifts from members           | 350           | Administration expenses                 | 490           |
| Ticket sales for productions | 4 480         | Competition prizes                      | 380           |
| Competition receipts         | 630           | Balance 31 December 2018                | 3 400         |
|                              | <u>11 810</u> |   | <u>11 810</u> |

On 31 December:

- members' subscriptions due were \$220
- members' subscriptions received in advance were \$110
- \$180 was owing for hire of the community centre
- some administration expenses were prepaid, \$50
- costumes and stage sets were revalued at \$13 500.



Prepare the following:

- a** A calculation of the club's accumulated fund at 1 January 2018
- b** A subscriptions account for the year ended 31 December 2018
- c** An income and expenditure account for the year ended 31 December 2018
- d** A statement of financial position at 31 December 2018

## 12 Preparing end-of-year financial statements

The treasurer of the Glades Social Club is able to provide the following information about the club's financial year which ended on 30 June 2018.

Assets and liabilities at 1 July 2017 were as follows.

|   | \$      |
|---|---------|
| Bank (asset)                              | 3 840   |
| Club buildings cost                       |         |
| Cost                                      | 280 000 |
| Provision for depreciation                | 21 000  |
| Club furniture and equipment at valuation | 17 500  |
| Inventory: refreshments                   | 870     |
| Subscriptions due                         | 650     |
| Subscriptions received in advance         | 210     |
| General expenses due                      | 380     |

### Receipts and payments account for the year ended 30 June 2018

| RECEIPTS               | \$     | PAYMENTS                            | \$     |
|------------------------|--------|-------------------------------------|--------|
| Balance 1 July 2017    | 3 840  | Purchase of refreshments            | 1 750  |
| Members' subscriptions | 6 750  | General expenses                    | 4 440  |
| Bank loan              | 600    | Purchase of furniture and equipment | 6 750  |
| Sales of refreshments  | 2 470  | Balance 30 June 2018                | 720    |
|                        | 13 660 |                                     | 13 660 |

Additional information at 30 June 2018:

- The bank loan is interest free and is to be repaid in October 2018.
- Suppliers of refreshments were owed \$310.
- General expenses were prepaid, \$60.
- There was a refreshments inventory valued at \$380.
- Members' subscriptions, \$480, were due.
- Members' subscriptions, \$710, had been received in advance for the year ended ending 30 June 2019.
- The club buildings should be depreciated by 2.5 per cent on cost.
- The treasurer revalued the furniture and equipment at \$20 500.

Prepare the following:

- a** A calculation of the club's accumulated fund at 1 July 2017
- b** A subscriptions account for the year ended 30 June 2018
- c** A refreshments account for the year ended 30 June 2018
- d** An income and expenditure account for the year ended 30 June 2018
- e** A statement of financial position at 30 June 2018

## PREPARING FOR THE EXAMINATION

(The following questions cover 5.14 to 5.17)

### MULTIPLE-CHOICE QUESTIONS

- 13** Which one of the following statements concerning the purpose of a receipts and payments account of a social club is correct?
- A** It does not include any capital expenditure
  - B** It shows how much club members owe for subscriptions
  - C** It shows the surplus or deficit for the year
  - D** It summarises the details shown in the cash book

- 14** The treasurer of a social club was preparing the income and expenditure account for the year ended 31 December 2018. The following information was available about the cost of hiring the community centre in 2018:
- On 1 January the club owed \$320 in hire charges.
  - During the year ended 31 December 2018 \$1740 was paid in hire charges.
  - On 31 December the club owed \$410 in hire charges.

What was the correct amount to be charged to the income and expenditure account?

- A** \$1010
- B** \$1650
- C** \$1830
- D** \$2450

- 15** The Jubilee Sports Club raises funds by providing refreshments at all sporting events. The following information is available about the year ended 31 August 2018.

|                  | \$     |
|------------------|--------|
| Inventory        |        |
| 1 September 2017 | 3 200  |
| 31 August 2018   | 3 800  |
| Purchases        | 8 200  |
| Revenue          | 12 100 |

How much profit will this activity have made for the club?

- A** \$3100
- B** \$3900
- C** \$4500
- D** \$7100

- 16** The Sparta Athletics Club charges its members an annual subscription of \$60 each. During the year ended 31 May 2018, \$960 was received in subscriptions. However, this included subscriptions from six members who had paid their subscription for the year ended 31 May 2019 in advance. At 31 May 2018, eight members had failed to pay their subscription for the year ended on that date.

What was the club's subscription income for the year ended 31 May 2018?

- A** \$600
- B** \$840
- C** \$960
- D** \$1080

- 17** The Singalong Choral Society received \$8400 in subscriptions from members during the year ended 31 December 2018. At 1 January 2018 the club had received \$370 in advance for subscriptions for 2018. At 31 December 2018, \$420 was owing from members for subscriptions for 2018.

What was the club's subscription income for the year ended 31 December 2018?

- A** \$8350
- B** \$8400
- C** \$8450
- D** \$9190

- 18** The treasurer of a social club provided the following information.

|                                 | \$  |
|---------------------------------|-----|
| Donation received from a member | 100 |
| Loans received from members     | 500 |
| Profit on social evenings       | 300 |
| Subscriptions for the year      | 600 |

What was the club's income for the year?

- A** \$600
- B** \$1200
- C** \$1400
- D** \$1500

## OTHER QUESTIONS

**19** Rackets Tennis Club's financial year ended on 30 September 2018 when the treasurer was able to provide the following information.

At 1 October 2017 the club's statement of financial position included the following.

|  | \$    |
|--|-------|
| Accumulated fund                               | 7 230 |
| General expenses prepaid                       | 30    |
| Subscriptions due from members                 | 240   |
| Subscriptions received from members in advance | 80    |
| Tennis equipment at net book value             | 6 300 |

### Receipts and payments account for the year ended 30 September 2018

|                                      | \$    |  | \$    |
|--------------------------------------|-------|--|-------|
| Balance 1 October 2017               | 740   | Transfer of funds to a savings account | 1 800 |
| Members' subscriptions               | 2 990 | General expenses                       | 490   |
| Tennis competition receipts          | 680   | Tennis competition expenses            | 520   |
| Interest received on savings account | 110   | Purchase of tennis equipment           | 1 500 |
|                                      |       | Balance 30 September 2018              | 210   |
|                                      | 4 520 |  | 4 520 |

At 30 September 2018:

- subscriptions due but unpaid totalled \$320
- general expenses prepaid were \$90
- competition expenses due were \$40.

The treasurer depreciates all tennis equipment by 10 per cent per annum based on the value of equipment at the end of the financial year.

- a** Prepare a subscriptions account to show the club's income from subscriptions for the year ended 30 September 2018.
- b** Prepare an income and expenditure account for the year ended 30 September 2018.
- c** Select two items that appear in the receipts and payments account that should not be included in the income and expenditure account and explain why they should not appear.
- d** Select one item that appears in the income and expenditure account that was not shown in the receipts and payments account and explain why it does not appear.



## Introduction

Previous chapters have covered the accounts of businesses that trade in goods or provide services. Trading businesses buy goods from suppliers and sell them on to other businesses or private individuals. In this chapter it will be possible to look at the accounts of manufacturing organisations that produce goods rather than purchasing them.

A manufacturer's accounting system will be similar to those already considered. For example, end-of-year financial statements will include an income statement and statement of financial position prepared from the detailed double-entry records.

The main difference is that it is necessary to work out just how much was spent on producing goods rather than purchasing them from elsewhere. This additional information is recorded in a manufacturing account which is prepared before an income statement.

## How to work out the cost of making a product

Whatever product you think of, there are almost certain to be some particular costs that are bound to arise in making that product. For example, perhaps at the moment you are sitting at a desk. Here are some of the costs that are likely to be involved in making a desk:

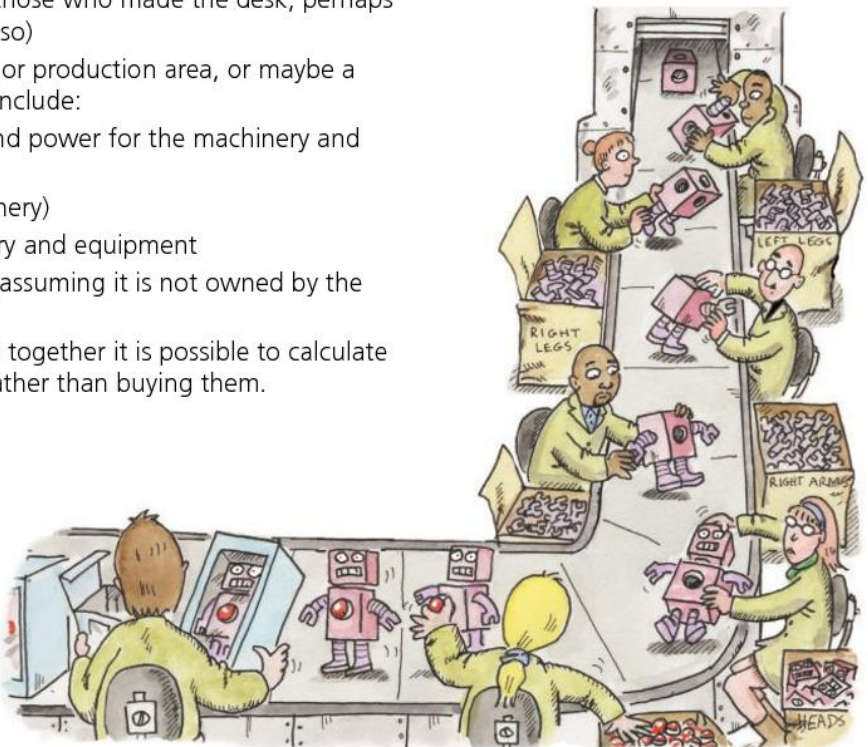
- Raw materials (probably wood, perhaps some metal)
- Labour costs (i.e. payments to those who made the desk, perhaps using tools or machinery to do so)
- Cost of operating a workshop, or production area, or maybe a factory building, which would include:
  - electricity (to provide light and power for the machinery and equipment)
  - insurance (e.g. of the machinery)
  - depreciation of the machinery and equipment
  - rent of the production area (assuming it is not owned by the business)

When all of these costs are added together it is possible to calculate the cost of producing the desks rather than buying them.

### LEARNING OBJECTIVES

When you have reached the end of 5.18–5.20 you will be able to:

- distinguish between direct material, direct labour, prime cost and overhead costs
- understand and make adjustments for work in progress
- calculate the factory cost of production
- prepare manufacturing financial statements: income statements and statements of financial position
- make adjustments to financial statements.





# Preparing a manufacturing account

## KEY TERMS

### Manufacturing account:

the first part of the end-of-year financial statements of a manufacturing organisation that shows the total cost of producing goods.

**Direct costs:** manufacturing costs that are attributable to a single product, particularly direct materials and direct labour.

**Prime cost:** the total of direct costs.

### Cost of raw materials consumed:

the direct cost of raw materials used during a financial year.

**Indirect costs:** manufacturing costs that cannot be attributed to one product.

**Factory overheads:** the total of indirect costs.

A manufacturing account is used to show the total cost of producing goods during a financial year. The account lists the costs that can be associated with the production area, which could be anything from a small workshop to a large factory. In a simple **manufacturing account** the costs are organised in two groups:

- **Direct costs:** these are the manufacturing costs that can be associated with an individual product (raw materials and wages paid to those who actually make the goods). These two direct costs are the first to be shown in the manufacturing account and are subtotalled to show a figure called the **prime cost**. The term 'direct' is used because it is known exactly how much should be spent on raw materials and wage cost involved in making one unit of production. The direct cost of materials is based on purchases of raw materials, with an adjustment made for opening and closing inventories of raw materials, to give a figure called the **cost of raw materials consumed**.
- **Indirect costs:** these are the other costs that can be linked to the manufacturing process; they are the costs of operating a separate area for the production of goods (the workshop or factory). Indirect costs are independent of the quantity of goods being prepared. These would include all of the costs arising from having machinery and equipment, as well as electricity, insurance, rent, and so on. Also included in this category would be wages or salaries (*indirect labour*) paid to employees who work in the production area, but who do not actually produce goods, e.g (supervisors and factory managers). The term 'indirect' is used because it would not be possible to know exactly how much of any of these costs could be linked to the production of one unit. Indirect costs are shown as the second section in a manufacturing account, and the costs are subtotalled to give a figure for total **factory overheads**.

## STUDY TIP

Indirect costs should only include costs that are to do with manufacturing. It is important that the costs of administration, distributing goods, selling goods and any financial charges are not included in this category. Non-manufacturing costs should continue to appear in the income statement.

## Work in progress

It is very unlikely that all products will be completely finished at the moment when the end-of-year financial statements are prepared. On the production line there will be some items that are nearly finished, whereas other items will be in the early stages of being turned into the finished article. The cost of unfinished goods is called **work in progress**. An opening inventory of work in progress should be added to the cost of production, as these items will have been completed during the year under review. The closing inventory of work in progress is deducted from the cost of production for the year, ensuring that the cost of production represents only amounts spent on goods actually finished during that year.

### Illustration 1 Preparing a manufacturing account

Arbour Ltd manufactures sports equipment. The following information was taken from the company's books of account for the year ended 30 September 2018.

|                                     | \$      |
|-------------------------------------|---------|
| Depreciation of factory machinery   | 40 000  |
| Direct wages                        | 165 000 |
| Factory electricity                 | 17 000  |
| Factory insurance                   | 3 000   |
| Indirect factory wages and salaries | 47 800  |
| Inventories: raw materials          |         |
| 1 October 2017                      | 19 500  |
| 30 September 2018                   | 23 200  |
| Purchases of raw materials          | 132 100 |
| Rent of factory                     | 22 000  |
| Repairs to factory machinery        | 1 800   |

Here is the company's manufacturing account.

#### ARBOUR LTD

#### Manufacturing account for the year ended 30 September 2018

|                                       | \$       | \$      |
|---------------------------------------|----------|---------|
| Raw materials                         |          |         |
| Opening inventory                     | 19 500   |         |
| Add purchases                         | 132 100  |         |
|                                       | 151 600  |         |
| Less closing inventory                | (23 200) |         |
| <b>Cost of raw materials consumed</b> |          | 128 400 |
| Direct wages                          |          | 165 000 |
| <b>Prime cost</b>                     |          | 293 400 |
| Factory overheads                     |          |         |
| Depreciation of machinery             | 40 000   |         |
| Electricity                           | 17 000   |         |
| Insurance                             | 3 000    |         |
| Indirect wages and salaries           | 47 800   |         |
| Rent                                  | 22 000   |         |
| Repairs to machinery                  | 1 800    |         |
|                                       |          | 131 600 |
| <b>Cost of production</b>             |          | 425 000 |

#### Notes:

- 1 Direct costs are shown first and subtotaled; the subtotal is labelled prime cost.
- 2 Factory overheads are shown in a second section with a heading and are subtotaled.
- 3 The total of all the manufacturing costs is labelled 'cost of production'. This figure represents the cost of producing finished goods, which is then transferred to the income statement and replaces the item 'purchases'.

#### KEY TERMS

**Work in progress:** partly finished goods.

#### STUDY TIP

Do not forget to show the labels 'Cost of raw materials consumed', 'Prime cost' and 'Cost of production' when preparing a manufacturing account. This is an important part of the proper presentation of this account.

You can now answer questions 1 and 2 on page 269.



# Manufacturer's financial statements

## Adjustments and the financial statements

It will be necessary to make adjustments for prepayments, accruals, and so on, when preparing a manufacturer's end-of-year financial statements. It will also be necessary to share certain costs between the different sections of the business. For example, a manufacturer could pay rent for all of the premises occupied by the business. It would then be necessary to charge part of the total rent to the factory and part to the offices of the business. As a result an appropriate amount of rent would be charged to the manufacturing account and the remainder to the income statement.

### Illustration 2 Making adjustments and recording work in progress

Quills Ltd manufactures writing equipment. On 30 June 2018, the following information was available.

|                                | \$      |
|--------------------------------|---------|
| Cost of raw materials consumed | 240 000 |
| Depreciation of machinery      | 50 000  |
| Direct wages                   | 180 000 |
| Indirect wages                 | 44 000  |
| Insurance of factory           | 8 500   |
| Rent                           | 12 000  |
| Work in progress               |         |
| 1 July 2017                    | 2 800   |
| 30 June 2018                   | 3 400   |

Additional information at 30 June 2018:

- 1 Direct wages due but unpaid totalled \$6300.
- 2 Rent is to be shared: three-fifths to the factory, two-fifths to administration.
- 3 Insurance \$1700 was prepaid.

Here is the manufacturing account based on this information.

| QUILLS LTD  |        |         |
|---|--------|---------|
| Manufacturing account for the year ended 30 June 2018 |        |         |
|   | \$     | \$      |
| <b>Cost of raw materials consumed</b>                 |        | 240 000 |
| Direct wages (\$180 000 + \$6 300 due)                |        | 186 300 |
| <b>Prime cost</b>                                     |        | 426 300 |
| Factory overheads                                     |        |         |
| Depreciation of machinery                             | 50 000 |         |
| Indirect wages and salaries                           | 44 000 |         |
| Insurance (\$8 500 – \$1 700 prepaid)                 | 6 800  |         |
| Rent ( $\frac{3}{5}$ of \$12 000)                     | 7 200  |         |
|   |        | 108 000 |
|   |        | 534 300 |
| Add opening work in progress                          |        | 2 800   |
|   |        | 537 100 |
| Less closing work in progress                         |        | (3 400) |
| <b>Cost of production</b>                             |        | 533 700 |

You can now answer questions 3 and 4 on page 269–270.

## A manufacturer's income statement

Just like any other business, a manufacturer's income statement is designed to show the gross profit on selling goods (i.e. finished goods) and the profit or loss for the year. The first part of the income statement will include the cost of production and this will replace the item 'purchases'. All of the information in this section of the income statement will be about finished goods.

The second part of a manufacturer's income statement will show the deduction of non-factory costs from the gross profit.

### Illustration 3 Preparing a manufacturer's income statement

Here is an income statement for Quills Ltd (see also Illustration 2).

#### QUILLS LTD

##### Income statement for the year ended 30 June 2018

|  | \$       | \$        |
|--|----------|-----------|
| Revenue                                  |          | 885 000   |
| Less opening inventory of finished goods | 32 300   |           |
| Add cost of production                   | 533 700  |           |
|  | 566 000  |           |
| Less closing inventory of finished goods | (29 000) |           |
| Cost of sales of finished goods          |          | (537 000) |
| Gross profit                             |          | 348 000   |
| Less expenses                            |          |           |
| Depreciation of office equipment         | 5 500    |           |
| Financial charges                        | 3 200    |           |
| Insurance ( $\frac{2}{5}$ of \$12 000)   | 4 800    |           |
| Selling expenses                         | 11 400   |           |
|  |          | (24 900)  |
| Profit for the year                      |          | 323 100   |

## Manufacturers' statements of financial position

The statement of financial position of a manufacturer is the same as the statement of financial position for other types of business. There is just one important point of difference: a manufacturer's statement of financial position will show three figures for inventories: raw materials, work in progress and finished goods.

### DID YOU KNOW?

Sometimes a manufacturer might have to buy in finished goods from another supplier. This can happen if there are problems running the factory that cause a loss of normal production – perhaps a machine has broken down or there has been an industrial dispute. It could be that the manufacturer has a contract to supply goods to a customer and that the only way this order can be completed is by buying in goods.

Sometimes a manufacturer might find it cheaper to buy than produce; sometimes customer demand might be greater than full production capacity.

Purchases of finished goods should be included as an extra cost in the first section of the income statement.

#### Illustration 4

#### Preparing the statement of financial position of a manufacturer

The following summarised information is available about Kontex, a manufacturing business, at the end of its financial year, 30 November 2018.

|                                      | \$      |
|--------------------------------------|---------|
| Capital                              | 174 600 |
| Bank                                 | 4 800   |
| Drawings                             | 32 100  |
| Inventories                          |         |
| raw materials                        | 17 400  |
| work in progress                     | 2 300   |
| finished goods                       | 14 900  |
| Non-current assets at net book value | 149 800 |
| Profit for the year                  | 45 300  |
| Trade payables                       | 12 500  |
| Trade receivables                    | 11 100  |

#### Kontex

#### Statement of financial position at 30 November 2018

|                                      | \$            | \$            | \$      |
|--------------------------------------|---------------|---------------|---------|
| NON-CURRENT ASSETS at net book value |               |               | 149 800 |
| CURRENT ASSETS                       |               |               |         |
| <b>Inventories</b>                   |               |               |         |
| <b>raw materials</b>                 | <b>17 400</b> |               |         |
| <b>work in progress</b>              | <b>2 300</b>  |               |         |
| <b>finished goods</b>                | <b>14 900</b> |               |         |
|                                      |               | <b>34 600</b> |         |
| Trade receivables                    |               | 11 100        |         |
| Bank                                 |               | 4 800         |         |
|                                      |               |               | 50 500  |
|                                      |               |               | 200 300 |
| CAPITAL                              |               |               |         |
| Opening balance                      |               | 174 600       |         |
| Add profit for the year              |               | 45 300        |         |
|                                      |               | 219 900       |         |
| Less drawings                        |               | (32 100)      |         |
|                                      |               |               | 187 800 |
| CURRENT LIABILITIES                  |               |               |         |
| Trade payables                       |               |               | 12 500  |
|                                      |               |               | 200 300 |

You can now answer questions 5–14 on pages 270–273.



## DEVELOPING YOUR SKILLS

## 1 Preparing a manufacturing account

Zenuf & Co. manufactures bicycle alarm systems. The following information is available about the business's most recently completed financial year ended 31 March 2018.

|                                   | \$      |
|-----------------------------------|---------|
| Depreciation of factory machinery | 36 500  |
| Direct wages                      | 184 800 |
| Factory insurance                 | 4 700   |
| Factory maintenance and repairs   | 2 200   |
| Factory power                     | 15 300  |
| Factory supervisor's wages        | 44 900  |
| Inventories: raw materials        |         |
| 1 April 2017                      | 28 100  |
| 31 March 2018                     | 25 600  |
| Purchases of raw materials        | 164 900 |

Prepare a manufacturing account for the year ended 31 March 2018. Show clearly the cost of raw materials, prime cost, total factory overheads, cost of production.

## 2 Preparing a manufacturing account

Argo & Sons are boatbuilders. The following information is available about the business's most recently completed financial year ended 31 August 2018.

|                                     | \$      |
|-------------------------------------|---------|
| Direct wages                        | 345 000 |
| Factory insurance                   | 18 700  |
| Factory fuel charges                | 32 300  |
| General factory expenses            | 7 100   |
| Indirect factory wages and salaries | 64 200  |
| Inventories: raw materials          |         |
| 1 September 2017                    | 54 200  |
| 31 August 2018                      | 61 700  |
| Machinery maintenance charges       | 4 400   |
| Purchases of raw materials          | 406 000 |
| Rent of factory premises            | 64 800  |

**Note:** the annual charge for the depreciation of machinery is based on taking 20 per cent of the cost of all machinery held at the year end. On 31 August 2018 the business owned machinery that cost \$480 000.

Prepare a manufacturing account for the year ended 31 August 2018. Show clearly the cost of raw materials, prime cost, total factory overheads, cost of production.

## 3 Making adjustments and recording work in progress

Marco Enterprises manufactures children's toys. On 31 October 2018 the following information was available about the business's financial year which ended on that date.

|                               | \$      |
|-------------------------------|---------|
| Direct wages                  | 157 340 |
| Electricity charges           | 6 640   |
| Factory insurance             | 4 380   |
| Factory manager's salary      | 38 430  |
| Inventories: raw materials    |         |
| 1 November 2017               | 17 830  |
| 31 October 2018               | 16 590  |
| Inventories: work in progress |         |
| 1 November 2017               | 3 830   |
| 31 October 2018               | 2 750   |
| Machinery repairs             | 3 550   |
| Purchases of raw materials    | 148 600 |

Additional information at 31 October 2018:

- Factory machinery should be depreciated by \$23 000.
- Factory manager's salary due but unpaid, \$560.
- Factory insurance \$480 was prepaid.
- Electricity charges should be shared:  $\frac{5}{8}$  factory;  $\frac{3}{8}$  office.

Prepare a manufacturing account for the year ended 31 October 2018.

#### 4 Making adjustments and recording work in progress

Crossgrain Ltd are furniture manufacturers. On 31 March 2018 the information on the following page was available about the business's financial year which ended on that date.

|                               | \$      |
|-------------------------------|---------|
| Direct wages                  | 188 750 |
| Factory electricity charges   | 4 450   |
| Indirect wages                | 32 360  |
| Inventories: raw materials    |         |
| 1 April 2017                  | 27 490  |
| 31 March 2018                 | 26 120  |
| Inventories: work in progress |         |
| 1 April 2017                  | 4 450   |
| 31 March 2018                 | 4 990   |
| Rent of factory buildings     | 15 440  |
| Purchases of raw materials    | 211 360 |
| Water charges                 | 4 640   |

Additional information at 31 March 2018:

- Factory machinery should be depreciated by 25 per cent per annum using the reducing balance method. On 1 April 2017 the net book value of machinery was \$88 000.
- Factory electricity charges, \$390, were due but unpaid.
- Rent of factory buildings, \$1080, was prepaid.
- Water charges should be shared: factory  $\frac{3}{4}$ ; office  $\frac{1}{4}$ .

Prepare a manufacturing account for the year ended 31 March 2018.

#### 5 Preparing income statements and statements of financial position

The Belford Manufacturing Company's financial year ended on 31 December 2018. On this date the following information was available after the preparation of the business's manufacturing account.

|  | \$      |
|--|---------|
| Bank (dr)  | 3 400   |
| Capital  | 69 900  |
| Drawings   | 27 000  |
| Inventory at 1 January 2018: finished goods          | 13 600  |
| Inventories at 31 December 2018                      |         |
| Raw materials  | 15 700  |
| Work in progress                                     | 4 800   |
| Finished goods                                       | 12 500  |
| Machinery at net book value on 31 December 2018      | 66 000  |
| Office equipment at net book value on 1 January 2018 | 14 000  |
| Office wages   | 23 200  |
| Revenue  | 332 000 |
| Selling expenses                                     | 11 000  |
| Trade payables                                       | 7 200   |
| Trade receivables                                    | 6 400   |

#### Notes:

- 1 The manufacturing account showed that the cost of production for 2018 was \$224 000.
- 2 Office wages due on 31 December 2018 totalled \$400.
- 3 The office equipment should be depreciated by \$1800.

Prepare the following:

- a An income statement for the year ended 31 December 2018
- b A statement of financial position at 31 December 2018

## 6 Preparing income statements and statements of financial position

Hashmi owns a manufacturing business. The following information was available after the preparation of his business's manufacturing account for the year ended 31 October 2018.

|   | \$      |
|---|---------|
| Administration expenses   | 14 300  |
| Bank (cr)   | 2 900   |
| Capital   | 434 600 |
| Cost of production  | 385 000 |
| Drawings  | 41 600  |
| Factory non-current assets at net book value on 31 October 2018 | 440 000 |
| Interest charges  | 1 100   |
| Inventories at 1 November 2017                                  |         |
| Finished goods  | 38 600  |
| Inventories at 31 October 2018                                  |         |
| Raw materials   | 45 300  |
| Work in progress  | 5 700   |
| Office non-current assets at net book value on 1 November 2017  | 16 400  |
| Revenue   | 563 000 |
| Selling expenses  | 8 400   |
| Trade payables  | 17 900  |
| Trade receivables   | 22 000  |

### Notes:

- The manufacturing account showed that the cost of production for 2018 was \$424 600.
- The inventory of finished goods was valued at \$42 300 on 31 October 2018.
- Selling expenses \$300 were prepaid on 31 October 2018.
- The office non-current assets should be depreciated by \$2200.

Prepare the following:

- An income statement for the year ended 31 October 2018
- A statement of financial position at 31 October 2018

## 7 Preparing financial statements for a manufacturer

Paula Osborne owns a manufacturing business. On 31 July 2018 she prepared the following trial balance to show information about the business's financial year which ended on that date.

| Trial balance at 31 July 2018      |         |         |
|------------------------------------|---------|---------|
|                                    | Dr      | Cr      |
|                                    | \$      | \$      |
| Administration expenses            | 8 200   |         |
| Bank (dr)                          | 4 400   |         |
| Capital                            |         | 113 200 |
| Carriage inwards on raw materials  | 4 70    |         |
| Direct wages                       | 147 350 |         |
| Drawings                           | 28 240  |         |
| General expenses                   | 72 500  |         |
| Indirect wages and salaries        | 31 550  |         |
| Inventories at 1 August 2017       |         |         |
| Raw materials                      | 12 490  |         |
| Work in progress                   | 2 780   |         |
| Finished goods                     | 9 380   |         |
| Machinery at net book value        | 64 000  |         |
| Office equipment at net book value | 12 400  |         |
| Office salaries                    | 23 880  |         |
| Purchases of raw materials         | 180 750 |         |
| Revenue                            |         | 488 230 |
| Trade payables                     |         | 5 170   |
| Trade receivables                  | 8 210   |         |
|                                    | 606 600 | 606 600 |

Additional information:

- Inventories at 31 July 2018 were valued as follows: raw materials \$11 120; work in progress \$3280; finished goods \$7420.
- Direct wages due but unpaid at 31 July 2018 totalled \$1370.
- General expenses should be shared: factory  $\frac{9}{10}$ ; office  $\frac{1}{10}$ .
- Depreciation should be provided as follows: machinery \$12 800; office equipment \$1240.

Prepare the following:

- A manufacturing account for the year ended 31 July 2018



- b** An income statement for the year ended 31 July 2018
- c** A statement of financial position at 31 July 2018

### 8 Preparing financial statements for a manufacturer

Suman's Enterprises manufactures car accessories. The following trial balance was extracted from the business's books of account on 31 May 2018.

| Trial balance at 31 May 2018              |         |         |
|---|---------|---------|
|   | Dr      | Cr      |
|   | \$      | \$      |
| Bank                                      |         | 2 490   |
| Capital                                   |         | 125 500 |
| Direct wages                              | 229 400 |         |
| Drawings                                  | 34 500  |         |
| Factory plant and machinery               |         |         |
| Cost                                      | 330 000 |         |
| Provision for depreciation at 1 June 2017 |         | 132 000 |
| Financial charges                         | 1 800   |         |
| Inventories at 1 June 2017                |         |         |
| Raw materials                             | 36 000  |         |
| Work in progress                          | 4 500   |         |
| Finished goods                            | 10 880  |         |
| Office equipment at net book value        | 18 400  |         |
| Office running costs                      | 17 300  |         |
| Other factory expenses                    | 22 400  |         |
| Purchases of finished goods               | 1 770   |         |
| Purchases of raw materials                | 182 370 |         |
| Rent                                      | 28 700  |         |
| Revenue                                   |         | 662 100 |
| Selling expenses                          | 7 120   |         |
| Trade payables                            |         | 14 340  |
| Trade receivables                         | 11 290  |         |
|   | 936 430 | 936 430 |

Additional information:

- Inventories at 31 May 2018 were valued as follows: raw materials \$27 800; work in progress \$3 800; finished goods \$14 810.
- Other factory expenses due at 31 May 2018 totalled \$540.
- Office running costs prepaid at 31 May 2018 totalled \$390.
- Rent should be shared: factory  $\frac{6}{7}$ ; office  $\frac{1}{7}$ .
- Provide for depreciation of non-current assets as follows: factory plant and machinery at 20 per cent per annum on cost; office equipment \$2760.

Prepare the following:

- a** A manufacturing account for the year ended 31 May 2018
- b** An income statement for the year ended 31 May 2018
- c** A statement of financial position at 31 May 2018

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 5.18–5.20)

### MULTIPLE-CHOICE QUESTIONS

- 9 Which one of the following factory costs is a direct cost?
- A Insurance
  - B Production workers' wages
  - C Rent
  - D Supervisor's salary
- 10 Which one of the following is required when calculating prime cost?
- A Depreciation of machinery
  - B Direct wages
  - C Factory overheads
  - D Office expenses
- 11 Ignoring work in progress, which of the following statements correctly defines cost of production?
- A Prime costs less direct costs
  - B Prime costs less factory overheads
  - C Prime costs plus direct costs
  - D Prime costs plus factory overheads
- 12 The following details appeared in a manufacturer's trial balance.

|                        | \$      |
|------------------------|---------|
| Direct wages           | 80 000  |
| Factory rent           | 40 000  |
| Indirect wages         | 30 000  |
| Machinery depreciation | 20 000  |
| Raw materials          | 100 000 |

Which of the following figures represented the manufacturer's prime cost?

- A \$130 000
- B \$180 000
- C \$240 000
- D \$270 000

- 13 The following information has been provided from which it is possible to calculate a manufacturer's cost of production.

|                   | \$      |
|-------------------|---------|
| Prime cost        | 100 000 |
| Factory overheads | 30 000  |
| Work in progress  |         |
| Opening inventory | 20 000  |
| Closing inventory | 10 000  |

The cost of production is:

- A \$60 000
  - B \$80 000
  - C \$120 000
  - D \$140 000
- 14 What is the purpose of a manufacturing account?
- A To calculate the cost of production
  - B To calculate the total of factory overheads
  - C To calculate the profit or loss for the year
  - D To calculate the work in progress
- 15 A manufacturer's records included the following details.

|                                      | \$     |
|--------------------------------------|--------|
| Opening inventory of finished goods  | 15 000 |
| Closing inventory of finished goods  | 20 000 |
| Cost of production                   | 85 000 |
| Goods taken by owner for private use | 6 000  |

What was the cost of sales?

- A \$74 000
- B \$80 000
- C \$86 000
- D \$90 000

## OTHER QUESTIONS

**16** Whizzo Products is an organisation that manufactures sports equipment. The business's most recent financial year ended on 31 August 2018. The owner of the business is Rakesh Somaya who has provided the following information.

Inventories:

|                  | At 1 September<br>2017 | At 31 August<br>2018 |
|------------------|------------------------|----------------------|
|                  | \$                     | \$                   |
| Raw materials    | 37 800                 | 42 900               |
| Work in progress | 5 250                  | 4 790                |
| Finished goods   | 39 600                 | 32 700               |

For the year ended 31 August 2018:

|                             | \$      |
|-----------------------------|---------|
| Direct factory wages        | 75 600  |
| Factory running costs       | 27 300  |
| Factory supervisor's salary | 32 400  |
| Purchases of raw materials  | 92 500  |
| Revenue                     | 440 000 |

Additional information:

- Direct factory wages \$2400 was due but unpaid at 31 August 2018.
  - Depreciation should be provided on factory plant and machinery at 20 per cent per annum using the straight-line method. The cost of factory plant and machinery was \$270 000.
- a** Explain to Rakesh Somaya the reason for preparing a manufacturing account.
- b** Prepare a manufacturing account for the year ended 31 August 2018.
- c** Calculate the business's gross profit for the year ended 31 August 2018. Show the details of your calculation.



## Introduction

The owners of some small businesses do not keep a full set of accounting records. This may be because they feel they do not have the time to keep proper records. Also, small businesses do not need to keep full accounting records due to the low volume of business they do. Owners may be satisfied with the information they can obtain from more basic record keeping.

If only basic records are kept, the owner or manager of the business will not enjoy all of the benefits of having a full accounting system and they are less likely to understand how well, or otherwise, the business is performing. It will mean, for example, that comprehensive financial information about the business will not be available. Detailed accounting records are an important aid to decision making, so it is likely that the effective management of a business could be impaired where there are incomplete records. A lack of detailed accounting records is also likely to incur an extra expense for the business because it may be necessary to pay an accountant to prepare the most important financial statements.

In this chapter you will learn about two methods that can be used to discover important aspects of a business's performance despite the fact that there are limited accounting records.

- 1 The first method enables the profit or loss to be calculated where a business has the minimum information available.
- 2 The second method enables the preparation of more detailed financial statements for a business that can supply more than the minimum information used in method 1 above.

### LEARNING OBJECTIVES

When you have reached the end of 5.21–5.25 you will be able to:

- prepare opening and closing statements of affairs
- calculate profits or losses from changes in capital over time
- calculate sales, purchases and other information so that an income statement can be prepared
- use accounting ratios to arrive at missing figures.



# Calculating profits and losses from minimal information

## Preparing statements of affairs

### KEY TERMS

**Statement of affairs:** a summary of a business's assets, liabilities and capital at a given date.

If the value of a business's assets and liabilities at the beginning and end of a financial period is known, it is possible to calculate a figure for capital at each of these dates. This is the first stage in calculating the profit (or loss) made by a business where there is very limited financial information. The details about assets and liabilities are set out in a **statement of affairs**. A statement of affairs closely resembles a statement of financial position.

### Illustration 1 Preparing statements of affairs

Suzi owns a retail business. She has kept very limited financial records. However, she has been able to provide the following information about her business's assets and liabilities at the beginning and end of the trading year that ended on 30 September 2018.

|                              | 1 October<br>2017 | 30 September<br>2018 |
|------------------------------|-------------------|----------------------|
|                              | \$                | \$                   |
| Cash at bank                 | 3 600             | 5 200                |
| Delivery vehicle             | 18 000            | 16 000               |
| Inventory                    | 14 400            | 15 300               |
| Shop furniture and equipment | 11 900            | 13 800               |
| Trade payables               | 1 700             | 1 100                |

Here are the statements of affairs for each of these dates.

#### Statement of affairs at 1 October 2017

|                              | \$     | \$            |
|------------------------------|--------|---------------|
| <b>NON-CURRENT ASSETS</b>    |        |               |
| Delivery vehicle             | 18 000 |               |
| Shop furniture and equipment | 11 900 |               |
|                              |        | 29 900        |
| <b>CURRENT ASSETS</b>        |        |               |
| Inventory                    | 14 400 |               |
| Bank                         | 3 600  |               |
|                              |        | 18 000        |
|                              |        | 47 900        |
| <b>CAPITAL</b>               |        | <b>46 200</b> |
| <b>CURRENT LIABILITIES</b>   |        |               |
| Trade payables               |        | 1 700         |
|                              |        | 47 900        |

#### Statement of affairs at 30 September 2018

|                              | \$     | \$            |
|------------------------------|--------|---------------|
| <b>NON-CURRENT ASSETS</b>    |        |               |
| Delivery vehicle             | 16 000 |               |
| Shop furniture and equipment | 13 800 |               |
|                              |        | 29 800        |
| <b>CURRENT ASSETS</b>        |        |               |
| Inventory                    | 15 300 |               |
| Bank                         | 5 200  |               |
|                              |        | 20 500        |
|                              |        | 50 300        |
| <b>CAPITAL</b>               |        | <b>49 200</b> |
| <b>CURRENT LIABILITIES</b>   |        |               |
| Trade payables               |        | 1 100         |
|                              |        | 50 300        |



## Calculating profit or loss for a financial year

By comparing the capital figures shown in the statements of affairs it is possible to see that the net value of the business has increased during the year. This begins to give a picture of whether the business has made a profit or loss during the period, but it is not the full story. It is also necessary to consider whether the change in the figure for capital has also been affected by drawings and/or by further investment in the business by the owner.

### Illustration 2 How to calculate the profit or loss for a financial year

Returning to the story of Suzi's business (see Illustration 1), Suzi withdrew cash during the year totalling \$18 300 for private use. Suzi has also said that she won \$1800 in a competition on 1 May 2018 which she invested in the business.

Here is an arithmetical calculation of the profit or loss for the year.

|                                 | \$       |
|---------------------------------|----------|
| Capital at 30 September 2018    | 49 200   |
| Less capital at 1 October 2017  | (46 200) |
| Increase in capital during year | 3 000    |
| Add back drawings               | 18 300   |
|                                 | 21 300   |
| Less additional capital         | (1 800)  |
| Profit for the year             | 19 500   |

The following steps should be taken in order to calculate the profit for the year:

Step 1: Calculate whether capital has increased or decreased during the year by deducting the opening capital from the closing capital.

Step 2: Add back drawings. Drawings are added back to show the change in capital that would have occurred if there had been no drawings.

Step 3: Deduct any additional capital. Additions to capital are deducted to show what the change

in capital would have been had the additions not taken place.

Step 4: The final figure, if positive, is profit for the year; a negative figure would indicate a loss for the year.

Here is an alternative approach that uses the capital section format for a statement of financial position as a template for the calculation.

|                        |          |        |
|------------------------|----------|--------|
| CAPITAL                |          |        |
| Opening balance        | 46 200   |        |
| Add profit             | ?        |        |
|                        | ?        |        |
| Add additional capital | 1 800    |        |
| Less drawings          | (18 300) |        |
|                        |          | 49 200 |

The missing figure can then be inserted by working backwards through the information to show:

|                        |               |        |
|------------------------|---------------|--------|
| CAPITAL                |               |        |
| Opening balance        | 46 200        |        |
| Add profit             | <b>19 500</b> |        |
|                        | <b>65 700</b> |        |
| Add additional capital | 1 800         |        |
| Less drawings          | (18 300)      |        |
|                        |               | 49 200 |

You can now answer questions 1 and 2 on page 286.



# Preparing end-of-year financial statements from basic records

## Preparing an income statement

It is possible to prepare end-of-year financial statements for a business with limited accounting records. This is possible where the owner is able to provide:

- details of assets and liabilities at the beginning and end of the year, and
- details of money transactions (perhaps in the form of a simple cash book or perhaps from summarising the details shown in the business's bank statements).

## Calculating sales and purchases figures

In order to start preparing an income statement it will be necessary to have information about sales and purchases. Where a business has only cash sales and cash purchases, these figures can be taken directly from the summarised cash book. Where a business has credit sales and purchases, it will be necessary to prepare calculations using:

- opening balances of trade receivables and trade payables
- receipts from credit customers and payments to credit suppliers
- discounts allowed to credit customers and discounts received from credit suppliers
- closing balances of trade receivables and trade payables.

### LINKS...

The technique used to calculate credit sales and credit purchases is to prepare total trade receivables and total trade payables accounts along exactly the same lines as described in 3.10

### Illustration 3 Calculating credit sales

Saleem can only provide limited accounting records for his business. For the year ended 30 June 2018 he is able to inform you of the following.

|                   | At 1 July 2017 | At 30 June 2018 |
|-------------------|----------------|-----------------|
|                   | \$             | \$              |
| Trade receivables | 6 700          | 9 100           |

#### Cash book (extract)

|                                      | \$     | \$ |
|--------------------------------------|--------|----|
| Total receipts from credit customers | 56 100 |    |

Credit sales can be calculated as follows.

Step 1: Prepare a total receivables account and record the information given above.

#### Total trade receivables account

|                 | \$    |                     | \$     |
|-----------------|-------|---------------------|--------|
| Opening balance | 6 700 | Bank                | 56 100 |
|                 |       | Closing balance c/d | 9 100  |

Step 2: Close the total receivables account, inserting the missing figure for credit sales as the balancing item.

#### Total trade receivables account

|                     | \$            |                     | \$     |
|---------------------|---------------|---------------------|--------|
| Opening balance     | 6 700         | Bank                | 56 100 |
| <b>Credit sales</b> | <b>58 500</b> | Closing balance c/d | 9 100  |
|                     | 65 200        |                     | 65 200 |
| Balance b/d         | 9 100         |                     |        |

Alternatively, the same result can be obtained as the result of an arithmetical calculation.

|   | \$            |
|---|---------------|
| Total receipts                            | 56 100        |
| Less opening balance of trade receivables | (6 700)       |
|   | 49 400        |
| Add closing balance of trade receivables  | 9 100         |
| Credit sales                              | <b>58 500</b> |

In the arithmetical method, the accruals principle is applied by deducting the opening balance of trade receivables because it relates to sales for the previous year. The closing balance of receivables is added because it relates to sales for the current year.

#### Illustration 4 Calculating credit purchases

Returning to Saleem's business, he is able to provide the following additional information.

|                | At 1 July 2017 | At 30 June 2018 |
|----------------|----------------|-----------------|
|                | \$             | \$              |
| Trade payables | 4 300          | 3 700           |

##### Cash book (extract)

| \$                                 | Discounts received | Bank   |
|------------------------------------|--------------------|--------|
|                                    | \$                 | \$     |
| Total payments to credit suppliers | 900                | 27 200 |

Following similar procedures, credit purchases can be calculated as follows.

Step 1: Record the available information.

##### Total trade payables account

| \$                  | \$            |
|---------------------|---------------|
| Bank                | 27 200        |
| Discounts received  | 900           |
| Closing balance c/d | 3 700         |
|                     | 31 800        |
| Opening balance b/d | 4 300         |
| Credit purchases    | <b>27 500</b> |

Step 2: Close the account and enter the missing figure for credit purchases as the balancing item.

##### Total trade payables account

| \$                  | \$            |
|---------------------|---------------|
| Bank                | 27 200        |
| Discounts received  | 900           |
| Closing balance c/d | 3 700         |
|                     | 31 800        |
| Opening balance b/d | 4 300         |
| Credit purchases    | <b>27 500</b> |

Using the alternative, arithmetical approach.

|  | \$            |
|--|---------------|
| Total payments                         | 27 200        |
| Add discounts received                 | 900           |
| Total amount settled                   | 28 100        |
| Less opening balance of trade payables | (4 300)       |
|  | 23 800        |
| Add closing balance of trade payables  | 3 700         |
| Credit purchases                       | <b>27 500</b> |

In the arithmetical method, the accruals principle is applied by deducting the opening balance of trade payables as this relates to the previous year's credit purchases. The closing balance of trade payables is added because it relates to the current year's credit purchases.

### Expenses and the income statement

The summarised cash book will provide the main source of information for expenses to be included in the income statement. However, it will be necessary to make adjustments to the amounts paid during the financial year for accruals and prepayments. It will also be necessary to include an appropriate depreciation charge on non-current assets.

You can now answer questions 3–6 on pages 286–287.

### STUDY TIP

If a business has allowed and/or received cash discounts, remember to include them in the total trade receivables and trade payables account when calculating credit sales and credit purchases.

#### Discounts allowed

Dr Income statement  
Cr Total trade receivables

#### Discounts received

Dr Total trade payables  
Cr Income statement

It is possible that some expenses will need to be adjusted for accruals and prepayments at the beginning of the year as well as at the end of the year.

### DID YOU KNOW?

The technique of using a total trade receivables account could also be used to find the closing balances of trade receivables if this was not known. In this situation, the owner of the business would need to provide information about the opening balance, total receipts from receivables and credit sales for the year in question.

A similar process could be used to find the closing balance of trade payables.

### LINKS...

The techniques used to calculate the correct expense charge for a year using the accruals principle where there are opening and closing adjustments was demonstrated in 5.15

You can now answer questions 7 and 8 on pages 287–288.



# Using ratios to find missing figures

Where the owner of a business is able to provide information about any or all of the following ratios, it is possible to develop techniques for finding the missing figures required in the income statement:

- Gross margin
- Rate of inventory turnover
- Mark up

## Illustration 5 Using mark up to find revenue

Zi Ting has not been able to provide full information about her business's financial affairs for the year ended 30 June 2018. She wants to know her business's total sales for the year ended on that date. She is able to provide the following details:

- The cost of sales for the year ended 30 June 2018 was \$140 000.
- The business always applies a mark up of 50 per cent on cost of sales when pricing goods for sale.

Revenue can be calculated as follows.

Step 1: Prepare the first section of the income statement.

### Income statement (extract) for the year ended 30 June 2018

|               | \$        |
|---------------|-----------|
| Revenue       | ?         |
| Cost of sales | (140 000) |
| Gross profit  | ?         |

Step 2: Use the information about mark up to calculate the gross profit, i.e. 50 per cent of cost of sales = \$70 000.

### Income statement (extract) for the year ended 30 June 2018

|               | \$        |
|---------------|-----------|
| Revenue       | ?         |
| Cost of sales | (140 000) |
| Gross profit  | 70 000    |

Step 3: Complete the outline section from the income statement to show the missing revenue figure, which must be \$210 000.

### Income statement (extract) for the year ended 30 June 2018

|               | \$        |
|---------------|-----------|
| Revenue       | 210 000   |
| Cost of sales | (140 000) |
| Gross profit  | 70 000    |

## NUMERACY SKILLS

### Using ratios

Ratios are covered in Chapter 6.2. Here is how they are calculated:

$$\text{Gross margin is: } \frac{\text{Gross profit} \times 100}{\text{Revenue}}$$

$$\text{Rate of inventory turnover is: } \frac{\text{Cost of sales}}{\text{Average inventory}}$$

$$\text{Mark up is: } \frac{\text{Gross profit} \times 100}{\text{Cost of sales}}$$

## DID YOU KNOW?

Mark up is a measure of how much profit is made on each product sold compared to its cost. Many trading businesses operate with a mark-up policy that is applied to every product that they sell.



## LINKS...

There is more about accounting ratios in Chapter 6.2.

### Illustration 6

### Using gross margin to calculate purchases

Josh has not kept full accounting records. He wishes to know his business's total purchases for the year ended 31 December 2018. He is able to supply the following information.

|                        | \$     |
|------------------------|--------|
| Inventory              |        |
| 1 January 2018         | 7 200  |
| 31 December 2018       | 8 900  |
| Total revenue for 2018 | 84 000 |

Josh has maintained a strict pricing policy in force throughout 2018 so that his gross margin has always been 25 per cent on sales.

Purchases can be calculated as follows.

Step 1: Prepare the first section of the income statement and insert the three available figures.

Step 2: Use the gross margin of 25 per cent to find the missing gross profit figure, i.e. 25 per cent of \$84 000 is \$21 000.

#### Income statement (extract) for the year ended 31 December 2018

|                        | \$    | \$     |
|------------------------|-------|--------|
| Revenue                |       | 84 000 |
| Less opening inventory | 7 200 |        |
| Add purchases          | ?     |        |
|                        | ?     |        |
| Less closing inventory | 8 900 |        |
| Cost of sales          |       | ?      |
| Gross profit           |       | 21 000 |

Step 3: Work backwards through the missing items to find the missing purchases figure.

- First of all the cost of sales must be \$63 000 (sales less gross profit).
- Then the subtotal before the closing inventory must be \$71 900 (cost of sales plus the closing inventory).
- Finally the purchases must be \$64 700 (previous figure of \$71 900 less the opening inventory).

Here is the final version of the extract from the income statement:

#### Income statement (extract) for the year ended 31 December 2018

|                        | \$            | \$       |
|------------------------|---------------|----------|
| Revenue                |               | 84 000   |
| Less opening inventory | 7 200         |          |
| <b>Add purchases</b>   | <b>64 700</b> |          |
|                        | 71 900        |          |
| Less closing inventory | (8 900)       |          |
| Cost of sales          |               | (63 000) |
| Gross profit           |               | 21 000   |

**Illustration 7** Using rate of inventory turnover to find purchases

Tony is not able to provide full details about his business's financial position at the end of the accounting year, 31 March 2018. However, he has been able to provide the following information:

|  | \$      |
|--|---------|
| Inventory                                      |         |
| 1 April 2017                                   | 8 000   |
| 31 March 2018                                  | 10 000  |
| Total revenue for the year ended 31 March 2018 | 150 000 |

The business achieves a rate of inventory turnover 12 times a year.

Purchases can be calculated as follows.

Step 1: Prepare the first section of the income statement in outline, recording any known figures.

**Income statement (extract)  
for the year ended 31 December 2018**

|                        | \$       | \$      |
|------------------------|----------|---------|
| Revenue                |          | 150 000 |
| Less opening inventory | 8 000    |         |
| Add purchases          | ?        |         |
|                        | ?        |         |
| Less closing inventory | (10 000) |         |
| Cost of sales          |          | ?       |
| Gross profit           |          | ?       |

Step 2: The rate of inventory turnover can be used to find the cost of sales. Here is the formula:

$$\frac{\text{Cost of sales}}{\text{Average inventory}} \text{ i.e. } \frac{\text{Cost of sales}}{9\,000} \text{ so cost of sales is } \$108\,000 \text{ (i.e. } \$9\,000 \times 12)$$

Step 3: The purchases figure can now be calculated as follows:

- Cost of sales add closing inventory gives  
\$108 000 + \$10 000 = \$118 000
- Deduct opening inventory (\$118 000 – \$8 000 = \$110 000)

Step 4: The gross profit is revenue \$150 000 less cost of sales \$108 000 = \$42 000

Here is completed extract.

**Income statement (extract) for the year ended  
31 December 2018**

|                        | \$             | \$        |
|------------------------|----------------|-----------|
| Revenue                |                | 150 000   |
| Less cost of sales     |                |           |
| Opening inventory      | 8 000          |           |
| <b>Add purchases</b>   | <b>110 000</b> |           |
|                        | 118 000        |           |
| Less closing inventory | (10 000)       |           |
|                        |                | (108 000) |
| Gross profit           |                | 42 000    |



# Preparing end-of-year financial statements: an illustration

## Illustration 8 Preparing financial statements from incomplete records

Rajiv owns a small wholesale business. He has not kept a full accounting system but is able to provide the following information about the financial year ended on 31 October 2018.

All purchases and sales were on credit.

The business's assets and liabilities were as follows:

|  | 1 November 2017 | 31 October 2018 |
|--|-----------------|-----------------|
|  | \$              | \$              |
| Bank                                     | 1 180           | 2 650           |
| Fittings and equipment at net book value | 67 500          | 63 400          |
| Inventories                              | 13 860          | 14 920          |
| Rent prepaid                             | 740             | —               |
| Trade receivables                        | 11 920          | 10 820          |
| Trade payables                           | 8 450           | ?               |
| Wages due                                | 560             | 690             |

A summary of the business's bank statements is as follows.

### Summarised bank account

|                     | \$      |                     | \$      |
|---------------------|---------|---------------------|---------|
| Opening balance b/d | 1 180   | Trade payables      | 78 400  |
| Trade receivables   | 165 500 | Drawings            | 25 400  |
|                     |         | Rent                | 9 800   |
|                     |         | Wages               | 50 430  |
|                     |         | Closing balance c/d | 2 650   |
|                     | 166 680 |                     | 166 680 |

Rajiv's policy is to achieve a gross margin of 50 per cent on sales.

*Preparing the answer*

Start by finding as many of the missing figures as possible.

Step 1: Calculate the opening capital.

### Statement of affairs at 1 November 2017

|                        | \$     | \$            |
|------------------------|--------|---------------|
| NON-CURRENT ASSETS     |        |               |
| Fittings and equipment |        | 67 500        |
| CURRENT ASSETS         |        |               |
| Inventory              | 13 860 |               |
| Trade receivables      | 11 920 |               |
| Rent prepaid           | 740    |               |
| Bank                   | 1 180  |               |
|                        |        | 27 700        |
|                        |        | 95 200        |
| <b>CAPITAL</b>         |        | <b>86 190</b> |
| CURRENT LIABILITIES    |        |               |
| Trade payables         | 8 450  |               |
| Wages due              | 560    |               |
|                        |        | 9 010         |
|                        |        | 95 200        |

Step 2: Calculate credit sales.

### Total trade receivables account

|                     | \$             |                     | \$      |
|---------------------|----------------|---------------------|---------|
| Opening balance     | 11 920         | Bank                | 165 500 |
| <b>Credit sales</b> | <b>164 400</b> | Closing balance c/d | 10 820  |
|                     | 176 320        |                     | 176 320 |
| Balance b/d         | 10 820         |                     |         |

Step 3: Calculate other costs to be entered in the income statement.

|  |               |
|--|---------------|
| Rent                                   | \$            |
| Amount paid                            | 9 800         |
| Add opening balance prepaid            | 740           |
|  | <b>10 540</b> |
| Wages                                  | \$            |
| Amount paid                            | 50 430        |
| Less opening balance due               | (560)         |
|  | 49 870        |
| Add closing balance due                | 690           |
|  | <b>50 560</b> |
| Depreciation of fittings and equipment | \$            |
| Net book value at 1 November 2017      | 67 500        |
| Less net book value at 31 October 2018 | (63 400)      |
|  | <b>4 100</b>  |

Step 4: Prepare the income statement (which will also show the missing figure for purchases). The cost of sales has first been derived using the information about gross margin (which is 50 per cent of revenue). The purchases figure could then be derived from adding back the closing inventory and deducting the opening inventory.

#### Rajiv

##### Income statement for the year ended 31 October 2018

|  |               |          |
|--|---------------|----------|
|  | \$            | \$       |
| Revenue                                |               | 164 400  |
| Less opening inventory                 | 13 860        |          |
| <b>Add purchases</b>                   | <b>83 260</b> |          |
|  | 97 120        |          |
| Less closing inventory                 | (14 920)      |          |
| Cost of sales                          |               | (82 200) |
| Gross profit                           |               | 82 200   |
| Less:                                  |               |          |
| Rent                                   | 10 540        |          |
| Wages                                  | 50 560        |          |
| Depreciation of fittings and equipment | 4 100         |          |
|  |               | (65 200) |
| Profit for the year                    |               | 17 000   |

Step 5: Now the purchases figure is known, it is possible to calculate the trade payables at 31 October 2018.

| Total trade payables account |               |                  |        |
|------------------------------|---------------|------------------|--------|
|                              | \$            |                  | \$     |
| Bank                         | 78 400        | Opening balance  | 8 450  |
| <b>Closing balance c/d</b>   | <b>13 310</b> | Credit purchases | 83 260 |
|                              | 91 710        |                  | 91 710 |
|                              |               | Balance b/d      | 13 310 |

Step 6: Prepare the statement of financial position at 31 October 2018.

##### Statement of financial position at 31 October 2018

|                         | \$       | \$     |
|-------------------------|----------|--------|
| NON-CURRENT ASSETS      |          |        |
| Fittings and equipment  |          | 63 400 |
| CURRENT ASSETS          |          |        |
| Inventory               | 14 920   |        |
| Trade receivables       | 10 820   |        |
| Bank                    | 2 650    |        |
|                         |          | 28 390 |
|                         |          | 91 790 |
| CAPITAL                 |          |        |
| Opening balance         | 86 190   |        |
| Add profit for the year | 17 000   |        |
|                         | 103 190  |        |
| Less drawings           | (25 400) |        |
|                         |          | 77 790 |
| CURRENT LIABILITIES     |          |        |
| Trade payables          | 13 310   |        |
| Wages due               | 690      |        |
|                         |          | 14 000 |
|                         |          | 91 790 |

You can now answer questions 9–18 on pages 289–291.

## DEVELOPING YOUR SKILLS

**1** Preparing statements of affairs and comparing capitals

Sherelle recently set up in business. She has little experience of keeping accounting records, but she needs to let the tax authorities know how much profit or loss she made during her first year of trading. She is able to supply the following information.

|                       | 1 January<br>2018 | 31 December<br>2018 |
|-----------------------|-------------------|---------------------|
|                       | \$                | \$                  |
| Bank loan             | —                 | 25 000              |
| Cash at bank          | 80 000            | 3 600               |
| Delivery van          | 14 000            | 12 000              |
| Fixtures and fittings | —                 | 8 500               |
| Inventories           | 7 400             | 11 200              |
| Shop premises         | —                 | 95 000              |
| Trade payables        | 6 300             | 8 900               |

Sherelle withdrew \$21 700 from the business bank account during the year for private use. On 1 July 2018 she received a cheque for \$4000 from her parents as a gift to help her run the business. The cheque was paid into the business bank account.

- Prepare statements of affairs at 1 January 2018 and 31 December 2018.
- Set out a calculation of the business's profit or loss for 2018.

**2** Preparing statements of affairs and comparing capitals

Zak owns a retail unit. He has not found it possible to keep detailed accounting records and prefers to pay an accountant to calculate his business's annual profit or loss.

The following information is available for the year ended 31 May 2018.

|                          | 1 June 2017 | 31 May 2018 |
|--------------------------|-------------|-------------|
|                          | \$          | \$          |
| Bank overdraft           | —           | 5 180       |
| Cash at bank             | 6 290       |             |
| Furniture and equipment  | 17 300      | 14 900      |
| Inventories              | 11 200      | 13 340      |
| Loan from JL Finance Ltd |             | 8 000       |
| Prepaid rent             | 740         |             |
| Trade payables           | 4 710       | 5 580       |
| Trade receivables        | 3 760       | 3 130       |
| Wages due                |             | 530         |

Zak's drawings for the year ended 31 May 2018 totalled \$23 520. On 1 February 2018 Zak won \$25 000 in a competition. He paid half of this prize into the business's bank account.

- Prepare statements of affairs at 1 June 2017 and 31 May 2018.
- Set out a calculation of the business's profit or loss for the year ended 31 May 2018.

**3** Calculating credit sales and credit purchases

Hooper does not have a full set of accounting records for his business. However, he is able to supply the following information relating to the year ended 30 April 2018.

Concerning trade receivables:

- Balance of \$8700: amount due from trade receivables 1 May 2017.
- Receipts of \$53 600 from trade receivables during the year ended 30 April 2018.
- Balance of \$7200: amount due from trade receivables 30 April 2018.

Concerning trade payables:

- Balance of \$4900: amount owing to trade payables 1 May 2017.
- Payments of \$37 300 to trade payables during the year ended 30 April 2018.
- Balance of \$5200: amount owing to trade payables 30 April 2018.



Calculate the following for the year ended 30 April 2018:

- a Total credit sales
- b Total credit purchases

#### 4 Calculating credit sales and credit purchases

The following information has been extracted from the incomplete accounting records kept by Jasmine for her business. The information relates to the year ended 31 August 2018.

|                   | At 1 September 2017 | At 31 August 2018 |
|-------------------|---------------------|-------------------|
|                   | \$                  | \$                |
| Trade receivables | 19 150              | 22 860            |
| Trade payables    | 14 320              | 11 970            |

##### Cash book (extract)

|                                       |         |                                  |        |
|---------------------------------------|---------|----------------------------------|--------|
|                                       | \$      |                                  | \$     |
| Total receipts from trade receivables | 103 820 | Total payments to trade payables | 85 400 |

Calculate the following for the year ended 31 August 2018:

- a Total credit sales
- b Total credit purchases

#### 5 More calculations of credit sales and credit purchases

Anisa has not had time to keep full accounting records for her business. However, the following information is available concerning the year ended 31 May 2018.

|                   | At 1 June 2017 | At 31 May 2018 |
|-------------------|----------------|----------------|
|                   | \$             | \$             |
| Trade receivables | 9 420          | 11 130         |
| Trade payables    | 6 280          | 5 910          |

##### Cash book (extract)

|                   | Discounts allowed | Bank   |                | Discounts received | Bank   |
|-------------------|-------------------|--------|----------------|--------------------|--------|
|                   | \$                | \$     |                | \$                 | \$     |
| Trade receivables | 880               | 48 760 | Trade payables | 490                | 31 570 |

Calculate the following for the year ended 31 May 2018:

- a Total credit sales
- b Total credit purchases

#### 6 More calculations of credit sales and credit purchases

Vikesh has not been able to keep a full double-entry system to record his business's financial affairs. However, he is able to provide the following information about trade receivables and trade payables.

At 1 January 2018:

- trade receivables owed \$21 390
- trade payables were owed \$15 990.

During the year ended 31 December 2018:

- trade receivables paid \$112 300
- trade payables were paid \$66 530
- discounts received totalled \$1340
- an irrecoverable debt, \$140, was written off.

At 31 December 2018:

- trade receivables owed \$20 720
- trade payables were owed \$17 010.

Calculate the following for the year ended 31 December 2018:

- a Total credit sales
- b Total credit purchases

#### 7 Preparing financial statements from incomplete records

Tarek, the owner of Bestprice Furniture Stores, has not maintained a full set of accounts during the year ended 30 June 2018. However, he is able to provide the following information about his business.

##### Cash book (extract)

|                   | Discounts allowed | Bank   |                | Discounts received | Bank   |
|-------------------|-------------------|--------|----------------|--------------------|--------|
|                   | \$                | \$     |                | \$                 | \$     |
| Trade receivables | 880               | 48 760 | Trade payables | 490                | 31 570 |

Assets and liabilities as follows:

|   | 1 July 2017 | 30 June 2018 |
|---|-------------|--------------|
|   | \$          | \$           |
| Bank  | 8 420       | 1 570        |
| Shop fittings and equipment at net book value | 22 400      | 19 900       |
| Inventories                                   | 14 180      | 12 380       |
| Prepaid rent                                  | 850         | 720          |
| Trade payables                                | 8 240       | 9 780        |
| Trade receivables                             | 11 550      | 12 690       |
| Wages accrued                                 | 420         | 710          |

**Cash book (extract)**

|                                       | \$      |                                  | \$      |
|---------------------------------------|---------|----------------------------------|---------|
| Balance 1 July 2017 b/d               | 8 420   | Rent                             | 11 470  |
| Total receipts from trade receivables | 116 510 | General expenses                 | 15 220  |
|                                       |         | Drawings                         | 8 000   |
|                                       |         | Wages                            | 31 460  |
|                                       |         | Total payments to trade payables | 57 210  |
|                                       |         | Balance 30 June 2018 c/d         | 1 570   |
|                                       | 124 930 |                                  | 124 930 |

- Calculate the business's capital at 1 July 2017.
- Calculate the following missing figures for the year ended 30 June 2018:
  - Credit sales
  - Credit purchases
  - Rent
  - Wages
  - Depreciation of shop fittings and equipment
- Prepare the income statement for the year ended 30 June 2018 and a statement of financial position at that date.

**8 Preparing financial statements from incomplete records**

Alex has never kept full accounting records. However, at 30 April 2018, the end of his business's financial year, he is able to provide the following information.

At 1 May 2017 the business's statement of affairs contained the following details.

|                                    | \$     |
|------------------------------------|--------|
| Bank                               | 2 300  |
| Delivery vehicle at net book value | 22 400 |
| Electricity charges accrued        | 350    |
| General expenses prepaid           | 480    |
| Inventory                          | 16 600 |
| Trade payables                     | 4 300  |
| Trade receivables                  | 6 140  |
| Capital                            | 43 270 |

**Cash book (extract)**

|                                       | \$     |                                  | \$     |
|---------------------------------------|--------|----------------------------------|--------|
| Balance 1 July 2017 b/d               | 2 300  | Rent                             | 6 820  |
| Total receipts from trade receivables | 82 980 | General expenses                 | 11 240 |
| Bank loan                             | 10 000 | Electricity charges              | 4 110  |
|                                       |        | Loan repayments                  | 2 000  |
|                                       |        | Drawings                         | 24 900 |
|                                       |        | Total payments to trade payables | 45 120 |
|                                       |        | Balance 30 June 2018 c/d         | 1 090  |
|                                       | 95 280 |                                  | 95 280 |

At 30 April 2018 the following additional information was available:

- Inventory was valued at \$19 300.
- General expenses were prepaid \$270.
- Electricity charges accrued, \$440.
- The delivery vehicle was revalued at \$19 700.
- Trade receivables totalled \$7 480.
- Trade payables totalled \$3 950.

- Calculate the following missing figures for the year ended 30 April 2018:
  - Credit sales
  - Credit purchases
  - General expenses
  - Electricity charges
  - Depreciation of the delivery vehicle
- Prepare the income statement for the year ended 30 April 2018 and a statement of financial position at that date.

## 9 Using ratios to find missing figures

### Using mark up to find revenue

- a** A business had cost of sales of \$85 000 for the year ended 31 December 2018. The business's policy is to use a mark up of 20 per cent to calculate selling prices.

Prepare a summarised extract from an income statement for the year ended 31 December 2018 to show revenue.

### Using gross margin to find purchases

- b** A business had total revenue for the year ended 28 February 2018 of \$380 000. The business always achieves a gross profit margin of 25 per cent. At 1 March 2017 inventories were valued at \$18 900; on 28 February 2018 inventories were valued at \$16 500.

Prepare an extract from an income statement for the year ended 28 February 2018 to show purchases.

### Using rate of inventory turnover to find purchases

- c** A business normally achieves a rate of inventory turnover of 20 times a year. On 1 September 2017 the business had inventories valued at \$16 000; on 31 August 2018 inventories were valued at \$14 000.
- i** Calculate the business's cost of sales for the year ended 31 August 2018.
- During the year ended 31 August 2018 the business's total revenue was \$420 000.
- ii** Prepare an extract from the business's income statement for the year ended 31 August 2018 to show the gross profit for the year.

## 10 Using ratios to find missing figures

### Using mark up to find revenue

- a** A business had cost of sales of \$240 000 for the year ended 31 March 2018. The business's policy is to use a mark up of 25 per cent to calculate selling prices.

Prepare a summarised extract from an income statement for the year ended 31 March 2018 to show revenue.

### Using gross margin to find purchases

- b** A business had total revenue for the year ended 30 November 2018 of \$880 000. The business always achieves a gross margin of 15 per cent. At 1 December 2017 inventories were valued at \$42 100; on 30 November 2018 inventories were valued at \$33 700.

Prepare an extract from an income statement for the year ended 30 November 2018 to show purchases.

### Using rate of inventory turnover to find purchases

- c** A business normally achieves a rate of inventory turnover of 15 times a year. On 1 July 2017 the business had inventories valued at \$23 500; on 30 June 2018 inventories were valued at \$26 500.
- i** Calculate the business's cost of sales for the year ended 30 June 2018.
- During the year ended 30 June 2018 the business's total revenue was \$505 000.
- ii** Prepare an extract from the business's income statement for the year ended 30 June 2018 to show the gross profit for the year.

## 11 Preparing financial statements from incomplete records using ratios

Alice has not been able to maintain a full set of accounting records for her wholesale business, Alice Catering Supplies. However, she has been able to provide the following information about the year ended 30 September 2018.

Assets and liabilities were as follows.

|                                      | At 1<br>October<br>2017 | At 30<br>September<br>2018 |
|--------------------------------------|-------------------------|----------------------------|
|                                      | \$                      | \$                         |
| Non-current assets at net book value | 590 000                 | 560 000                    |
| Inventories                          | 72 400                  | ?                          |
| Trade receivables                    | 33 100                  | 33 700                     |
| Trade payables                       | 19 400                  | 22 100                     |
| Insurance prepaid                    | 800                     | —                          |
| Wages accrued                        | —                       | 1 100                      |
| Bank                                 | 11 200                  | 25 100                     |

A summarised bank account for the year ended 30 September 2018 was as follows overleaf.



| Bank Account     |         |                   |         |
|------------------|---------|-------------------|---------|
|                  | \$      |                   | \$      |
| Balance          |         | Drawings          | 53 700  |
| 1 October 2017   |         | Total payments to |         |
| b/d              | 11 200  | trade payables    | 219 800 |
| Amounts received |         |                   |         |
| from trade       |         | Insurance         | 16 200  |
| receivables      | 449 400 | General expenses  | 51 500  |
|                  |         | Wages             | 94 300  |
|                  |         | Balance           |         |
|                  |         | 30 September 2018 |         |
|                  |         | c/d               | 25 100  |
|                  | 460 600 |                   | 460 600 |

Alice always achieves a gross margin of 50 per cent.

On 30 September 2018 she was unable to check the value of inventories.

- a Calculate the following missing figures:
  - i Capital at 1 October 2017
  - ii Revenue and purchases for the year ended 30 September 2018
  - iii Expenses to be charged to the income statement for the year ended 30 September 2018
- b Prepare an income statement for the year ended 30 September 2018. Use the gross profit margin to calculate the gross profit, the cost of sales and the closing inventory.
- c Prepare a statement of affairs at 30 September 2018.

## 12 Preparing financial statements from incomplete records using ratios

John can only provide limited information about his business's financial year which ended on 30 June 2018.

Assets and liabilities at 1 July 2017 were as follows.

|                                      | \$      |
|--------------------------------------|---------|
| Non-current assets at net book value | 285 000 |
| Inventories                          | 17 480  |
| Trade receivables                    | 6 580   |

|                          | \$    |
|--------------------------|-------|
| Trade payables           | 8 190 |
| General expenses prepaid | 460   |
| Rent accrued             | 290   |
| Bank                     | 4 140 |

Summarised bank account for the year ended 30 June 2018 was as follows.

| Bank Account     |        |                    |        |
|------------------|--------|--------------------|--------|
|                  | \$     |                    | \$     |
| Balance          |        | General expenses   |        |
| 1 July 2017 b/d  | 4 140  |                    | 14 440 |
| Amounts received |        | Total payments to  |        |
| from trade       |        | trade payables     | 43 800 |
| receivables      | 94 880 |                    |        |
|                  |        | Rent               | 8 180  |
|                  |        | Drawings           | 17 220 |
|                  |        | Non-current assets | 15 000 |
|                  |        | Balance            |        |
|                  |        | 30 June 2018 c/d   | 380    |
|                  | 99 020 |                    | 99 020 |

Additional information at 30 June 2018:

- Inventories are valued at \$18 520.
- The amount due from trade receivables is \$8340.
- John has revalued the non-current assets at \$291 000.
- Rent prepaid is \$440.
- General expenses due are \$310.

The business has a rate of inventory turnover of three times a year.

- a Calculate the following:
  - i Revenue for the year ended 30 June 2018
  - ii Expenses to be charged to the income statement
- b Prepare an income statement for the year ended 30 June 2018 using the rate of inventory turnover to calculate the cost of sales and missing purchases figure.

**Note:** a statement of affairs at 30 June 2018 is not required.

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 5.21–5.25)

### MULTIPLE-CHOICE QUESTIONS

**13** Which of the following does not appear in a statement of affairs?

- A** Non-current assets
- B** Prepayments
- C** Purchases
- D** Trade payables

**14** The following information is available about a business for the year ended 31 December 2018:

|  | \$     |
|--|--------|
| Capital 1 January 2018                       | 49 000 |
| Capital 31 December 2018                     | 58 000 |
| Drawings for the year ended 31 December 2018 | 12 000 |
| Additional capital introduced during 2018    | 4 000  |

What is the business's profit for the year ended 31 December 2018?

- A** \$1 000
- B** \$13 000
- C** \$17 000
- D** \$21 000

**15** The owner of a business is able to supply the following information about the year ended 31 March 2018.

|                   | At 1 April 2017 | At 31 March 2018 |
|-------------------|-----------------|------------------|
|                   | \$              | \$               |
| Total assets      | 85 000          | 96 000           |
| Total liabilities | 11 000          | 9 000            |

There were no owner's drawings during the year ended 31 March 2018, but the owner did make an additional investment in the business of \$6 000.

What is the business's profit for the year ended 31 March 2018?

- A** \$3 000
- B** \$7 000
- C** \$17 000
- D** \$19 000

**16** The following information is available about a business that does not have a full set of accounting records.

|  | \$      |
|--|---------|
| Trade receivables 1 October 2017                                     | 12 500  |
| Trade receivables 30 September 2018                                  | 10 000  |
| Receipts from trade receivables for the year ended 30 September 2018 | 228 500 |

What is the business's revenue for the year ended 30 September 2018?

- A** \$226 000
- B** \$228 500
- C** \$231 000
- D** \$251 000

**17** Michael has not kept a full set of accounting records for his business. However, he is able to provide the following information.

|  |          |
|--|----------|
| Inventories at 1 January 2018                                  | \$16 000 |
| Inventories at 31 December 2018                                | \$18 000 |
| Rate of inventory turnover for the year ended 31 December 2018 | 10 times |

What is the business's purchases for the year ended 31 December 2018?

- A** \$160 000
- B** \$168 000
- C** \$172 000
- D** \$180 000

### OTHER QUESTIONS

**18\*** How is the closing balance of total trade receivables account calculated?

- A** Opening trade receivables + credit sales – payments by trade receivables
- B** Opening trade receivables + credit sales + payments by trade receivables
- C** Opening trading receivables – credit sales – payments to trade receivables
- D** Opening trade receivables – credit sales + payments to trade receivables

- 19\*** Anne started in a business with a capital of \$72 000. During her first year in business she withdrew cash \$8 000 for private use, made a loss of \$3 000, but made her privately owned motor vehicle available for business use. At the end of the year her capital was valued at \$74 000.

What was the value of the motor vehicle?

- A** \$3 000
- B** \$7 000
- C** \$9 000
- D** \$13 000

- 20** Jane Pulchan has not kept a full set of accounting records for her business for the year ended 31 July 2018. All of her business's purchases and sales are on credit. She is able to provide the following information.

At 1 August 2017:

|                                   | \$     |
|-----------------------------------|--------|
| Amounts owed by trade receivables | 14 480 |
| Amounts owed to trade payables    | 11 140 |

For the year ended 31 July 2018:

|   | \$     |
|---|--------|
| Amounts received from trade receivables | 85 750 |
| Amounts paid to trade payables          | 58 400 |
| Discounts allowed                       | 1 320  |
| Discounts received                      | 860    |

At 31 July 2018:

|                                   | \$     |
|-----------------------------------|--------|
| Amounts owed by trade receivables | 12 690 |
| Amounts owed to trade payables    | 9 480  |

- a** Calculate Jane Pulchan's credit sales and credit purchases for the year ended 31 July 2018.

Jane's gross margin for the year ended 31 July 2018 was 25 per cent. Her inventory on 1 August 2017 was \$7450. Unfortunately she was not been able to value her inventory on 31 July 2018.

- b** Explain what is meant by gross profit margin.
- c** Prepare an extract from the business's income statement for the year ended 31 July 2018 showing the gross profit for the year and the closing inventory.

- 21\*** Paul has not kept a full set of accounting records for his business.

- a** State **two** reasons why he may have decided not to keep a full set of accounting records.

All the business's transactions are conducted on a cash basis.

The following information is available about the year ended 31 December 2018.

|                                 | 1 January 2018 | 31 December 2018 |
|---------------------------------|----------------|------------------|
|                                 | \$             | \$               |
| Insurance prepaid               | —              | 370              |
| General expenses accrual        | 80             | 120              |
| Inventory                       | 3 940          | 4 290            |
| Non-current assets at valuation | 27 400         | 29 650           |

#### Bank account summary

|   | \$            |  | \$            |
|---|---------------|--|---------------|
| Balance, 1 January 2018                 | 3 790         | Purchases                                | 49 620        |
| Sales                                   | 84 550        | Insurance                                | 2 850         |
| Proceeds from sale of non-current asset | 440           | General expenses                         | 93 80         |
|   |               | Purchase of additional non-current asset | 11 300        |
|   |               | Balance, 31 December 2018                |               |
|   | <u>88 780</u> |  | <u>88 780</u> |

A profit of \$110 was made on the sale of the non-current asset.

- b** Prepare an income statement for the year ended 31 December 2018.



# Analysis and interpretation

## Introduction

You know that a lot of hard work goes into preparing accounting records! However, some of this effort may be wasted if the financial statements are not used by interested parties to discover how well or badly the business is performing. In this unit you are going to learn how to calculate the ratios that are used to analyse a business's accounts. You will also learn about what to look for when you have calculated a set of ratios, including:

- inter-firm comparison (syllabus reference 6.3)
- return on capital employed (ROCE) (syllabus reference 6.1)
- the limitations of accounting statements (syllabus reference 6.5)
- the difference between the gross margin and the profit margin as an indicator of a business's efficiency (syllabus reference 6.2).

## How useful are accounting ratios?

Ratios provide a very valuable means of analysing and comparing the performance of a business:

- from one year to the next
- with other similar businesses.

They enable changes in important aspects of a business's performance to be pinpointed and quantified. When ratios are calculated year after year, it is possible to see where any significant trends are becoming apparent.

However, it is not enough just to calculate ratios. Ratios have to be interpreted and this requires skill and judgement if the owner or manager of a business is to be well informed when making important decisions.

## Who are the interested parties?

The following table lists most of the individuals and groups who would take an interest in a business's financial statements. The table also shows some of their key concerns.

| Interested party  | Main concerns  |
|---|--|
| Owners  | How well is the business performing? Is it profitable and can it pay its debts on time?                  |
| Managers  | Do we have the information needed to make decisions that are in the best interests of the business?      |
| Suppliers   | Can the business pay the amounts due on time? Is there a chance of more orders in the future?            |
| Investors (relevant to limited companies, see 9.9)      | How safe is the investment? Can the business afford to pay the expected return on the investment?        |
| Banks   | Can the business fulfil the terms of the loan? Will repayments of the loan and interest be made on time? |
| Club members (relevant to club and societies, see 5.14) | Has the club/society sufficient funds to maintain or develop the facilities provided by the club?        |
| Government/tax authorities                              | Is the business liable to pay taxes and can these taxes be paid on time?                                 |

## LEARNING OBJECTIVES

When you have reached the end of 6.1 you will be able to:

- identify a range of ratios that can be used to analyse the performance of a sole trader
- state the formula to be used when calculating each accounting ratio
- calculate ratios based on the end-of-year financial statements of a sole trader.

# Income statement and statement of financial position ratios

## KEY TERMS

**Gross margin:** gross profit in relation to revenue (measured as a percentage).

**Rate of inventory turnover:** cost of sales divided by average inventory (expressed as 'so many times' in a particular financial year, e.g. '12 times').

**Profit margin** profit in relation to revenue (measured as a percentage).

There are three important ratios that can be used to analyse an income statement. They are:

**Gross margin**

$$\frac{\text{Gross profit} \times 100}{\text{Revenue}}$$

**Rate of inventory turnover**

$$\frac{\text{Cost of sales}}{\text{Average inventory}}$$

**Profit margin**

$$\frac{\text{Profit} \times 100}{\text{Revenue}}$$

## NUMERACY SKILLS

### How to calculate an average inventory

To calculate the rate of inventory turnover ratio you need to work out an average figure for inventory. To do this, take the following steps:

**Step 1** add together the figures for the opening inventory (\$16 000) and closing inventory (\$14 000) which gives \$30 000.

**Step 2** divide this total by the number of inventory figures you have used in your calculation, i.e. 2.

**Step 3** calculate the average:  

$$\frac{\$30\,000}{2} = \$15\,000$$

Now you can answer questions 1 and 2 on page 297.

### Illustration 1 Calculating income statement ratios

Here is an example of how to calculate the three income statement ratios.

#### Income statement for the year ended 31 December 2018

|                        | \$       | \$        |
|------------------------|----------|-----------|
| Revenue                |          | 240 000   |
| Opening inventory      | 16 000   |           |
| Add purchases          | 178 000  |           |
|                        | 194 000  |           |
| Less closing inventory | (14 000) |           |
| Cost of sales          |          | (180 000) |
| Gross profit           |          | 60 000    |
| Less expenses          |          |           |
| General expenses       | 10 000   |           |
| Depreciation           | 14 000   |           |
|                        |          | (24 000)  |
| Profit                 |          | 36 000    |

$$\text{Gross margin} = \frac{\text{Gross profit} \times 100}{\text{Revenue}} = \frac{\$60\,000 \times 100}{\$240\,000} = 25\%$$

$$\text{Rate of inventory turnover} = \frac{\text{Cost of sales}}{\text{Average inventory}} = \frac{\$180\,000}{\$15\,000} = 12 \text{ times}$$

$$\text{Profit margin} = \frac{\text{Profit} \times 100}{\text{Revenue}} = \frac{\$36\,000}{\$240\,000} = 15\%$$



## Statement of financial position ratios

Five important ratios are used to analyse a statement of financial position. They are:

|  |  |
|--|--|
| <b>Current ratio</b>                     | Current assets : current liabilities                                     |
| <b>Liquid (acid test) ratio</b>          | Liquid assets (i.e. current assets less inventory) : current liabilities |
| <b>Return on capital employed (ROCE)</b> | $\frac{\text{Profit} \times 100}{\text{Capital employed}}$               |
| <b>Trade receivables turnover</b>        | $\frac{\text{Trade receivables} \times 365}{\text{Credit sales}}$        |
| <b>Trade payables turnover</b>           | $\frac{\text{Trade payables} \times 365}{\text{Credit purchases}}$       |

**Note:** The trade receivables collection and trade payables payment period is expressed in days. It is usual to give the answer in whole days and to always round upwards, so a ratio of 30.21 days would become 31 days.

### KEY TERMS

**Current ratio:** current assets in relation to current liabilities. The ratio is always expressed in the form xx : 1, e.g. 1.8 : 1.

**Liquid (acid test) ratio:** liquid assets in relation to current liabilities. Liquid assets are all of a business's current assets excluding inventories. It is also expressed in the form xx : 1.

**Return on capital employed (ROCE):** the profit made by the business in relation to the funds invested in the business (i.e. owner's capital and non-current liabilities). The ratio is expressed as a percentage.

**Trade receivables turnover:** trade receivables in relation to credit sales. The ratio is usually expressed in days.

**Trade payables turnover:** trade payables in relation to credit purchases. The ratio is usually expressed in days.

### Illustration 2 Calculating statement of financial position ratios

| Statement of financial position at 31 December 2018 |         |                     |         |
|---|---------|---------------------|---------|
|   | \$      | \$                  | \$      |
| NON-CURRENT ASSETS                                  | Cost    | Accumulated deprecn | Net     |
|   | 350 000 | 125 000             | 225 000 |
| CURRENT ASSETS                                      |         |                     |         |
| Inventory   |         | 15 000              |         |
| Trade receivables                                   |         | 30 000              |         |
| Other receivables                                   |         | 3 000               |         |
| Bank  |         | 2 000               |         |
|   |         |                     | 50 000  |
|   |         |                     | 275 000 |
| CAPITAL   |         |                     |         |
| Opening balance                                     |         | 195 000             |         |
| Add profit  |         | 60 000              |         |
|   |         | 255 000             |         |
| Less drawings                                       |         | (40 000)            |         |
|   |         |                     | 215 000 |
| NON-CURRENT LIABILITY                               |         |                     |         |
| Bank loan   |         |                     | 30 000  |
| CURRENT LIABILITIES                                 |         |                     |         |
| Trade payables                                      |         | 26 000              |         |
| Other payables                                      |         | 4 000               |         |
|   |         |                     | 30 000  |
|   |         |                     | 275 000 |

**Note:** the business had credit sales of \$372 000 and credit purchases of \$300 000 for the year ended 31 December 2018.



| Ratio                             | Formula  | Calculation                               | Answer     |
|-----------------------------------|--|---|------------|
| Current ratio                     | Current assets : current liabilities   | \$50 000 : \$30 000                       | = 1.67 : 1 |
| Liquid (acid test) ratio          | Liquid assets (i.e. current assets less inventory) : current liabilities                       | \$35 000 : \$30 000                       | = 1.17 : 1 |
| Return on capital employed (ROCE) | $\frac{\text{Profit} \times 100}{\text{Capital employed (capital + non-current liabilities)}}$ | $\frac{\$60\,000 \times 100}{\$245\,000}$ | = 24.49%   |
| Trade receivables turnover        | $\frac{\text{Trade receivables} \times 365}{\text{Credit sales}}$                              | $\frac{\$30\,000 \times 365}{\$372\,000}$ | = 30 days  |
| Trade payables turnover           | $\frac{\text{Trade payables} \times 365}{\text{Credit purchases}}$                             | $\frac{\$26\,000 \times 365}{\$300\,000}$ | = 32 days  |

### STUDY TIP

When you are asked to calculate a ratio it is a good idea to:

- state the formula
- select the appropriate figures
- calculate the final answer.

Always check that you have given the answer in the right form (i.e. each answer should have an appropriate descriptor, e.g. xx%, xx times, xx : 1, xx days, etc.).

Unless you are told otherwise, work to two decimal places for most ratios.

You can now answer questions 3–12 on pages 297–300.

## DEVELOPING YOUR SKILLS

## 1 Calculating income statement ratios

The following extract from an income statement was prepared for the business owned by David McKoy.

Look at the income statement and calculate the following ratios:

- Gross margin
- Rate of inventory turnover
- Profit margin

In each case state the formula used and if necessary work to two decimal places.

**Income statement for the year ended 31 January 2018**

|                        | \$       | \$        |
|------------------------|----------|-----------|
| Revenue                |          | 800 000   |
| Opening inventory      | 29 000   |           |
| Add purchases          | 646 000  |           |
|                        | 675 000  |           |
| Less closing inventory | (35 000) |           |
| Cost of sales          |          | (640 000) |
| Gross profit           |          | 160 000   |
| Less expenses          |          |           |
| Office expenses        | 14 000   |           |
| Rent                   | 28 000   |           |
| Depreciation           | 18 000   |           |
|                        |          | (60 000)  |
| Profit for the year    |          | 100 000   |

## 2 Calculating income statement ratios

The following extract from an income statement was prepared for the business owned by Deva Wray.

Look at the next income statement and calculate the following ratios:

- Gross margin
- Rate of inventory turnover
- Profit margin.

In each case state the formula used and if necessary work to two decimal places.

**Income statement for the year ended 31 October 2018**

|                         | \$       | \$        |
|-------------------------|----------|-----------|
| Revenue                 |          | 720 000   |
| Opening inventory       | 32 500   |           |
| Add purchases           | 475 000  |           |
|                         | 507 500  |           |
| Less closing inventory  | (27 500) |           |
| Cost of sales           |          | (480 000) |
| Gross profit            |          | 240 000   |
| Less expenses           |          |           |
| Administration expenses | 58 900   |           |
| Carriage outwards       | 7 300    |           |
| Wages and salaries      | 71 000   |           |
| Depreciation            | 45 200   |           |
|                         |          | (182 400) |
| Profit for the year     |          | 57 600    |

## 3 Calculating statement of financial position ratios

The following statement of financial position (see over) was prepared for the business owned by Jackie Davis at the end of its financial year.

The business had credit sales of \$224 000 and credit purchases of \$154 000 for the year ended 31 December 2018.

Look at the statement of financial position and calculate the following ratios:

- Current ratio
- Liquid (acid test) ratio
- Return on capital employed (ROCE)
- Trade receivables turnover
- Trade payables turnover

In each case state the formula used and if appropriate work to two decimal places.

**Statement of financial position at 31 December 2018**

|                       | \$      | \$                  | \$      |
|-----------------------|---------|---------------------|---------|
| NON-CURRENT ASSETS    | Cost    | Accumulated deprecn | Net     |
|                       | 490 000 | 196 000             | 294 000 |
| CURRENT ASSETS        |         |                     |         |
| Inventory             |         | 17 000              |         |
| Trade receivables     |         | 16 000              |         |
| Other receivables     |         | 1 000               |         |
| Bank                  |         | 2 000               |         |
|                       |         |                     | 36 000  |
|                       |         |                     | 330 000 |
| CAPITAL               |         |                     |         |
| Opening balance       |         | 283 000             |         |
| Add profit            |         | 45 000              |         |
|                       |         | 328 000             |         |
| Less drawings         |         | (37 000)            |         |
|                       |         |                     | 291 000 |
| NON-CURRENT LIABILITY |         |                     |         |
| Bank loan             |         |                     | 15 000  |
| CURRENT LIABILITIES   |         |                     |         |
| Bank loan             |         | 7 000               |         |
| Trade payables        |         | 14 000              |         |
| Accruals              |         | 3 000               |         |
|                       |         |                     | 24 000  |
|                       |         |                     | 330 000 |

**4 Calculating statement of financial position ratios**

The following statement of financial position was prepared for the business owned by Rudy Cousins at the end of its financial year.

The business had credit sales of \$72 000 and credit purchases of \$429 000 for the year ended 30 June 2018.

Look at the statement of financial position below and calculate the following ratios:

- Current ratio
- Liquid (acid test) ratio
- Return on capital employed (ROCE)
- Trade receivables turnover
- Trade payables turnover

In each case state the formula used and if appropriate work to two decimal places.

**Statement of financial position at 30 June 2018**

|                        | \$      | \$                  | \$      |
|------------------------|---------|---------------------|---------|
| NON-CURRENT ASSETS     | Cost    | Accumulated deprecn | Net     |
|                        | 860,000 | 215,000             | 645,000 |
| CURRENT ASSETS         |         |                     |         |
| Inventory              |         | 54,000              |         |
| Trade receivables      |         | 8,000               |         |
| Other receivables      |         | 2,000               |         |
| Bank                   |         | 8,000               |         |
|                        |         |                     | 72,000  |
|                        |         |                     | 717,000 |
| CAPITAL                |         |                     |         |
| Opening balance        |         | 639,000             |         |
| Add profit             |         | 75,000              |         |
|                        |         | 714,000             |         |
| Less drawings          |         | (59,000)            |         |
|                        |         |                     | 655,000 |
| NON-CURRENT LIABILITY  |         |                     |         |
| Loan from DDKT Finance |         |                     | 22,000  |
| CURRENT LIABILITIES    |         |                     |         |
| Trade payables         |         | 39,000              |         |
| Accruals               |         | 1,000               |         |
|                        |         |                     | 40,000  |
|                        |         |                     | 717,000 |



## PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 6.1)

### MULTIPLE-CHOICE QUESTIONS

- 5 A sole trader is able to provide the following information about his business.

|               | \$      |
|---------------|---------|
| Revenue       | 800 000 |
| Cost of sales | 600 000 |
| Expenses      | 100 000 |

What is the business's gross margin?

- A** 12.5%  
**B** 25%  
**C** 62.5%  
**D** 75%

- 6 During a year a business sold goods that had cost \$720 000. The inventory at the beginning of the year was \$70 000 and at the end \$90 000.

What was the annual rate of inventory turnover?

- A** 4.5 times  
**B** 7.2 times  
**C** 9 times  
**D** 12 times

- 7 Which of the following is not required when calculating the liquid (acid test) ratio?

- A** Cash at bank  
**B** Cash in hand  
**C** Inventory  
**D** Trade receivables

- 8 Martin had the following assets and liabilities.

|                       | \$     |
|-----------------------|--------|
| Fixtures and fittings | 21 000 |
| Delivery vehicle      | 16 000 |
| Inventory             | 8 000  |
| Trade receivables     | 9 000  |
| Trade payables        | 7 500  |
| Bank loan (2 years)   | 30 000 |
| Bank (debit balance)  | 14 500 |

What was his liquid (acid test) ratio?

- A** 2.27 : 1  
**B** 3 : 1  
**C** 3.13 : 1  
**D** 4.2 : 1

- 9 Pat had the following assets and liabilities.

|                      | \$     |
|----------------------|--------|
| Premises             | 90 000 |
| Equipment            | 40 000 |
| Inventory            | 12 000 |
| Trade receivables    | 8 000  |
| Trade payables       | 6 000  |
| Bank loan (6 months) | 18 000 |
| Bank                 | 4 000  |

What was her current ratio?

- A** 1 : 1  
**B** 1 : 2  
**C** 2 : 1  
**D** 4 : 1

- 10 The following figures were taken from a business's financial statements.

|               | \$        |
|---------------|-----------|
| Revenue       | 700 000   |
| Expenses      | 110 000   |
| Gross profit  | 440 000   |
| Capital       | 1 000 000 |
| Cost of sales | 260 000   |

What was the percentage of profit on capital employed (ROCE)?

- A** 23%  
**B** 33%  
**C** 44%  
**D** 59%

## OTHER QUESTIONS

- 11** Abdullah has prepared the following income statement at the end of his business's financial year, 31 December 2018. However, there are several blank spaces that need to be completed.

| Abdullah<br>Income statement (extract)<br>for the year ended 31 December 2018 |           |         |         |
|---|-----------|---------|---------|
|   |           | \$      | \$      |
| Revenue   |           |         | 320 000 |
| Opening inventory   |           | 17 000  |         |
| Purchases   | 253 000   |         |         |
| Add carriage  | (i) 3 000 |         |         |
|   |           | 256 000 |         |
|   |           | 273 000 |         |
| Closing inventory   |           | 33 000  |         |
| Cost of sales   |           |         | (ii)    |
| Gross profit  |           |         | 80 000  |
| Discounts   | (iii)     | 2 000   |         |
| General expenses  |           | 8 000   |         |
| Wages and salaries  |           | (iv)    |         |
| Depreciation  |           | 11 000  |         |
|   |           |         | 64 000  |
| (v)   |           |         | 16 000  |

- a** Insert the missing word or figures into each of the blank spaces labelled (i)–(v).
- b** Calculate the following ratios:
- (i) Gross margin
  - (ii) Rate of inventory turnover
  - (iii) Profit margin
- 12** Sherelle produced the following statement of financial position for her business at the end of its financial year, 30 June 2018. However, there are several blank spaces that need to be completed.

### Statement of financial position at 30 June 2018

|                     | \$      | \$                 | \$      |
|---------------------|---------|--------------------|---------|
| NON-CURRENT ASSETS  | Cost    | Accumulated deprcn | Net     |
|                     | 440,000 | 220,000            | (i)     |
| CURRENT ASSETS      |         |                    |         |
| Inventory           |         | 14,000             |         |
| Trade receivables   |         | 13,000             |         |
| Other receivables   |         | 5,000              |         |
| Bank                |         | 8,000              |         |
|                     |         |                    | (ii)    |
|                     |         |                    | 260,000 |
| CAPITAL             |         |                    |         |
| Opening balance     |         | 200,000            |         |
| Add profit          |         | 80,000             |         |
|                     |         | 280,000            |         |
| Less drawings       |         | (iii)              |         |
|                     |         |                    | (iv)    |
| CURRENT LIABILITIES |         |                    |         |
| Trade payables      |         | (v)                |         |
| Other payables      |         | 3,000              |         |
|                     |         |                    | 20,000  |
|                     |         |                    | (vi)    |

#### Additional information:

- Total credit sales for the year ended 30 June 2018 were \$155 000.
  - Total credit purchases for the same period were \$204 000.
- a** Insert the missing words or figures in each of the blank spaces (i)–(vi).
- b** Calculate the following ratios:
- (i) Current ratio
  - (ii) Liquid (acid test) ratio
  - (iii) Return on capital employed (ROCE)
  - (iv) Trade receivables turnover
  - (v) Trade payables turnover

# Interpreting accounting statements

## Introduction

You are now able to calculate eight accounting ratios. These ratios can be used to analyse how well or badly a business has been performing and to provide a basis for helping owners, managers and other users to make improvements to their businesses. It is necessary to focus on two matters when interpreting a business's performance:

- **Profitability:** Are the owners and managers of a business successful in increasing the business's value over time through trading or providing services?
- **Liquidity:** Are the business's resources well managed so that the business can pay its short-term debts, including running costs, without difficulty from one week to the next, and also provide the owner with a reasonable income?

Businesses can fail if their owners or managers do not give these issues enough attention. There are many cases of profitable businesses that have not survived, for example, because their liquidity has been inadequate.

## LEARNING OBJECTIVES

When you have reached the end of 6.2–6.7 you will be able to:

- explain what each accounting ratio can tell you about a business
- make judgements about the strengths and weaknesses of a business's performance
- prepare inter-firm comparisons
- make recommendations that will enable the business's performance to improve
- explain the limitations of inter-firm comparisons and ratio analysis.



## KEY TERMS

**Profitability:** a measure of performance highlighting profit in relation to the resources used in the business.

**Liquidity:** a business's ability to have available sufficient cash to pay its short-term debts.



# Interpreting ratios: the income statement

## What does the gross margin tell you about a business's performance?

The percentage of gross margin tells you:

- how much gross profit is being made in relation to revenue
- how much gross profit (in cents) is being made for every \$1 of revenue.

If you have a business's results for several years you can make a comparison of the ratios, and investigate the following.

If the percentage is *increasing* from one year to the next this means one of the following:

- The business has changed its pricing policy and has put selling prices per unit up.
- The business is paying less per unit for the goods it sells.
- Some combination of both of these factors has occurred.

If the percentage is *decreasing* from one year to the next this means one of the following:

- The business has changed its pricing policy and has put selling prices per unit down.
- The purchase cost per unit has increased.
- Some combination of both of these factors has occurred.

There could be a variety of reasons behind any changes in the percentages, for example:

- the need to face up to increasing competition, so selling prices have had to be reduced
- the desire to try to make more gross profit to help cover the business's running costs has led to an increase in selling prices
- suppliers are charging more for the goods they supply.

If you have information about the performance of similar businesses you could comment on whether:

- the selling price is out of step with these similar businesses
- the business is paying too much or too little for the goods it sells.

The idea of comparing one business with another is usually referred to as making an **inter-firm comparison**.

### KEY TERMS

#### Inter-firm comparison:

analysing the performance of similar businesses and using the results to indicate success or under-achievement.

## What does the profit margin tell you about a business's performance?

The profit margin tells you:

- how much profit is being made in relation to revenue
- how much profit (in cents) is being made for every \$1 of revenue.

Comparing one year with a previous year you may find the following.

The percentage is *increasing*, due to one of the following:

- The business is making more gross profit.
- Costs have been held at previous levels or reduced.
- Other income has increased.
- Some combination of these factors is occurring.

The percentage is *decreasing* due to one of the following:

- The business is making less gross profit.
- Costs have risen above previous levels.
- Other income has decreased.
- Some combination of these factors has occurred.

If you can make an inter-firm comparison, you can comment on whether the control of costs is more or less effective.

### What does the rate of inventory turnover tell you about the business's performance?

This ratio:

- compares average inventory to the total cost of inventory sold during a period
- indicates how quickly inventory is sold.

If the rate is *increasing*:

- the business is selling more inventory, or
- the closing inventory is being reduced.

If the rate is *decreasing*:

- the business is selling less inventory, or
- the closing inventory is being increased.

It would normally be a positive sign if a business's rate of inventory turnover increases. However, it is important to find out just why it was selling more goods. If, for example, the selling price per unit has been reduced and the price cuts have been too severe, this might reduce profits.

If inventory levels have changed, it is important to investigate the reasons for the change. If inventory levels were too high, a reduction could be welcome because it would reduce wastage and storage costs. However, if levels were reduced too severely, this could mean that opportunities for a sale were lost and revenue will be less.

Knowing the average for other similar businesses can help users to interpret how well a business is doing.

### How can a business improve its profitability as shown in the income statement?

**Profitability** could be improved by:

- *increasing revenue*: by reviewing pricing policy to make the business more competitive, or by considering the quality or range of the products sold, or by reviewing marketing strategies
- *reducing costs*: by reducing wastage, finding cheaper suppliers of goods and other services
- *improving control of inventories*: by reducing inventory levels so that there is less wastage and reduced storage costs, or by reviewing how inventories are ordered to ensure that every item is always available for sale

#### DID YOU KNOW?

Businesses can fail if their owners or managers do not give these issues enough attention. There are many cases of profitable businesses that have not survived, for example, because their **liquidity** has been inadequate.

You can now answer questions 1 and 2 on page 310.

# Interpreting ratios: the statement of financial position

## What does the return on capital employed (ROCE) ratio tell you about a business's performance?

The return on capital employed ratio measures:

- profit in relation to the capital employed
- how much profit (in cents) is made for every \$1 of capital employed.

Comparing one year with a previous year you may find the following.

The percentage is *increasing* because:

- the business is making more profit
- the business has less capital employed
- some combination of the above factors
- the business is using its resources more effectively.

The percentage is *decreasing* because:

- the business is making less profit
- the business has more capital employed
- some combination of the above factors
- the business is using its resources less effectively.

If you can make an inter-firm comparison, you should be able to judge which business is using its resources more effectively.

### DID YOU KNOW?

It is also possible to consider how well the owner of the business might do if the capital was invested and earning interest, and if the owner was in employment earning a salary. In making such a comparison it would be important to bear in mind just how risky it is to own a business, and how relatively safe it is to invest in some form of savings account.

## What do the current ratio and liquid (acid test) ratio tell you about a business's ability to meet its everyday commitments?

The *current ratio* measures:

- current assets in relation to current liabilities
- the funds the business has available to pay the short-term debts of the business.

The liquid (acid test) ratio is similar because it measures:

- liquid assets (current assets excluding inventories) compared to current liabilities
- the amount of liquid assets available to pay the short-term debts of the business.

Both of these ratios measure what is often called liquidity. The difference between these two ratios is one of timing. The current ratio looks further ahead than the quick assets ratio. The liquid (acid test) ratio is a more immediate measure of liquidity, hence the term 'acid test ratio'.



If the two ratios are *increasing*:

- this could mean that the business will find it easier to pay its debts (this is a strength)
- but it could mean that it has too many resources tied up as current or liquid assets (this is a weakness).

If the two ratios are *decreasing*:

- this could imply that the business will find it more difficult to pay its debts (this is a weakness)
- but it could mean that it has reduced the resources tied up as current or liquid assets and so it is making more effective use of these resources (this is a strength).

When commenting on liquidity ratios it is important to know about the typical ratios for the type of business you are looking at. Levels of liquidity vary considerably depending on the goods or services the business provides. For example, think about your local food retailer where most of the goods will be sold within a short space of time and where all sales will be for cash. This situation is very different to, say, a furniture store, where much of the inventory is slow moving and where credit sales are far more likely.

A business could improve liquidity/working capital in a number of ways:

- *Increased profit*: this will benefit liquidity, perhaps by increasing revenue but also keeping control of costs. The business will find that there is increased cash flowing into the business. This may not be immediate because the business will have to wait for trade receivables to pay.
- *Reduced drawings*: if the owner can take less cash from the business, this will have a positive impact on liquidity. However, the owner's personal commitments may not make this possible.
- *Increasing non-current liabilities*: the business may be able to arrange a long-term loan. This would instantly boost liquidity. However, loans will have to be repaid and interest charges could be high and will, of course, reduce profits.
- *Delaying expenditure on non-current assets*: the owner of the business could delay plans to replace or increase non-current assets. This would mean that cash that would otherwise have been spent is retained within the business. However, the delay could have a negative impact on the quality of the business's operations if its non-current assets are deteriorating.

#### DID YOU KNOW?

Short-term debts of the business include all of the transactions on which the business will need to use cash resources in the near future. In other words, all of the payments to which the business is committed for the next few weeks and months. Here is a list of possible short-term debts:

- trade payables
- most expenses
- loan repayments
- owner's drawings
- payment of taxes
- purchase of new non-current assets.

# Interpreting ratios: more on the statement of financial position

## What does the trade receivables turnover and trade payables turnover tell you about the business's performance?

### Trade receivables turnover

The *trade receivables turnover* measures how many days on average a credit customer takes to pay. The normal credit period is 30 days.

If the turnover ratio is increasing, this tells you that credit customers are taking longer to pay than previously.

An *increase* could be interpreted as being:

- a weakness, because it could imply that credit control is not being as carefully managed as previously and this could lead to an increase in irrecoverable debts
- a strength if previously credit control was too tight and that had deterred some potential customers.

A *decrease* could be interpreted as being:

- a strength because it could imply that credit control is being managed more carefully than previously with an improvement in cash flow and a reduction in the incidence of irrecoverable debts
- a weakness if previous credit control was about right, and the change has resulted in a decline in credit sales because some customers can get longer credit terms elsewhere.

### Trade payables turnover

The *trade payables turnover ratio* measures how many days on average it takes to pay a credit supplier. Again the normal credit period is 30 days.

If the payment period is increasing, this tells you that the business is taking longer to pay its suppliers.

An *increase* could be interpreted as being:

- a weakness, because the business is taking longer to pay its trade payables, and if the credit terms are being exceeded, the suppliers may cease to offer credit facilities
- a strength, because cash is being retained in the business longer.

If the payment period is decreasing, the business will have reduced the time it takes to pay its suppliers.

A *decrease* could be interpreted as being:

- a strength because it could mean that payments to suppliers are being managed more effectively and that problems with suppliers over exceeding their credit terms no longer occur
- a weakness if the business is paying suppliers earlier than necessary, resulting in a negative impact on cash flow as cash is leaving the business sooner than required.

Changes in the ratio may cause cash discounts to be gained or lost, and this, in turn, will have an effect on profits.



usually the trade receivable collection period should be shorter than the trade payable payment period, because this will be beneficial for the business's cash flow.

## Difficulties making inter-firm comparisons

The owner of a business could learn valuable lessons from comparing ratios with those of another similar business. However, it will be important to take account of the following:

- Business A and Business B have broadly similar non-current assets. However, Business A uses the straight-line method of depreciation, but Business B uses the reducing balance method. These differences in accounting policies will affect the results shown in the businesses' income statements and valuations shown as statements of financial position.
- Business C owns its premises but Business D rents its premises. As a result Business C will have a larger capital employed (it owns more assets), but Business D will have more expenses to charge to its income statement. In all other respects, the businesses could appear identical, but the accounting ratios would be greatly affected by this important difference.
- Business E and Business F report quite different returns on their capital employed. It would be easy to jump to the conclusion that one business is better than the other. However, it could be that each business has used a different definition of capital employed, so that a direct comparison of the ratio cannot be used.
- Business G appears to have performed much better than Business H. However, it has now emerged that Business H was closed for six weeks because of serious flooding, so its results were not really typical.

In addition, it may be difficult to obtain all of the information required about similar businesses, particularly performance trends.

## Limitations of accounting ratios

Using ratios to investigate the relative success or otherwise of businesses is a valuable procedure. However, the following should be borne in mind:

- By the time a business has been able to produce its financial statements, important events may have occurred that are not shown in the accounts. Perhaps there has been some bad economic news which could have serious consequences for the future performance of the business, for example a recession or an oil crisis.
- Ratio analysis ignores what can be important non-financial aspects of a business. For example, the fact that the management and/or workforce in one business is highly motivated and committed to the success of a business, or the fact that a business is well located.
- The valuation of non-current assets can be quite different depending on when the asset was bought. Two businesses may occupy very similar premises, but one business could have been established many years ago when property prices were low and the other business could have been established quite recently when property prices were much higher. As a result the capital employed by each business could be significantly different.
- Inflation is generally ignored when comparing financial statements, but this can distort the analysis. For example, this year's total revenue may seem much higher than that of three years ago, but if inflation has been high during this period, the real difference in the business's revenue performance may not be that great.



# Interpreting a business's results

## How to comment on a business's performance

When you compare a business's results from one year to the next, the following steps are a useful guide:

Step 1: Prepare a table that summarises the ratios you have calculated. Have a column for each year in the review.

Step 2: Look to see if the trend in revenue is upward or downward. Often the trend in revenue figures is the most important key to understanding all of the other aspects of a business's performance.

Step 3: What has happened to each of the ratios? What trend emerges in each case? Is the overall picture one of improving or declining ratios – or is the picture more mixed?

Step 4: Make it clear what the strengths for the business are and what the weaknesses are, and explain why you are making this judgement. Can you suggest reasons for the changes in each ratio?

Step 5: Overall do you feel the business is improving? Make suggestions about how the business could improve its performance; recommend actions that would help to overcome any weaknesses.

### Illustration 1 Commenting on performance

Here is an example of how to interpret a business's performance following the approach set out above.

Laura Edwards has calculated the following accounting ratios based on the end-of-year financial statements for each of the years ended 31 December 2017 and 2018.

|                                   | 2017     | 2018     |
|-----------------------------------|----------|----------|
| Gross margin                      | 35%      | 37%      |
| Profit margin                     | 18%      | 16%      |
| Return on capital employed (ROCE) | 12%      | 15%      |
| Current ratio                     | 1.6 : 1  | 1.4 : 1  |
| Liquid (acid test) ratio          | 0.7 : 1  | 0.9 : 1  |
| Rate of inventory turnover        | 13 times | 11 times |
| Trade receivables turnover        | 35 days  | 31 days  |
| Trade payables turnover           | 27 days  | 32 days  |

The following information is also available.

Total revenue in each of the years ended 31 December:

|      |           |
|------|-----------|
| 2017 | \$440 000 |
| 2018 | \$500 000 |

Some typical ratios for this type of business are:

|                          |         |
|--------------------------|---------|
| Current ratio            | 1.7 : 1 |
| Liquid (acid test) ratio | 0.9 : 1 |

Here are the main points to be made in a report based on this information following the step-by-step approach above.

*Look at the trend in revenue.*

There has been a substantial increase in revenue (\$60 000) – around 14% comparing 2018 with 2017.

*Look at each ratio and comment on performance.*

Strengths:

- The gross margin has increased by 2%, meaning that the business is making more gross profit per \$1 of revenue. This could be due to an increase in selling prices that has not led to a fall in demand. This change could account for the increase in revenue.
- The return on capital employed (ROCE) has also increased by 3%, meaning that the business is making more profit per \$1 of capital invested by the owner. This could result from a more effective use of the business's resources so that the business is earning more profit than before.
- The liquid (acid test) ratio has increased (from 0.7 : 1 to 0.9 : 1) and is now near to the average for this type of business. This means the business will be in a better position to pay its more immediate short-term debts and that the business is managing its liquid resources effectively.
- The trade payables turnover has increased slightly (by five days) and it is now longer than the receivable collection period. This change will improve the business's cash flow, and because it is only a slight change it should not concern suppliers unduly.
- The receivables turnover has decreased slightly (by four days). This means that money is being collected more quickly from customers. This should improve cash flow and reduce the risk of irrecoverable debts through poor credit control.

Weaknesses:

- The profit margin percentage has fallen by 2%. This has happened despite an improvement in revenue and in the gross profit margin. The problem appears to be that operating expenses have not been controlled as effectively as in the past and this has had a negative effect on profit.

- The current ratio has decreased (from 1.6 : 1 to 1.4 : 1) and has moved further away from the average for this type of business. This means that the business will have more difficulty paying short-term debts and that the business is not managing its current assets effectively. Since the liquid (acid test) ratio has improved, it is likely that the problem lies with inventories. The business might have too much money tied up in inventory, and that means inventory levels are unnecessarily high.
- The rate of inventory turnover has declined (from 13 to 11 times). Since the figure for revenue has increased, this could be due to the business increasing its average inventory. This appears to have had a negative effect on liquidity and may increase the risk of some inventory deteriorating.

*Finally, look at the overall picture.*

What could the owner do to improve performance?

Overall the business's performance has improved comparing 2018 with 2017. However, profit as a percentage of revenue has fallen due to a failure to control operating expenses. There is evidence that the money tied up in inventories has not been managed effectively, leading to a decline in the rate of inventory turnover and a decline in the current ratio.

To improve the business's performance the owner should aim to:

- control operating expenses more effectively by reducing waste or finding ways of paying less for some of the costs
- reduce the amount of money tied up in inventories, but without reducing choice or quality for customers, which could have a negative effect on revenue.

You can now answer questions 5–15 on pages 311–314.



## DEVELOPING YOUR SKILLS

### 1 Commenting on income statement ratios

The following ratios have been calculated as a result of analysing the financial statements of Horizon Stores, a business owned by Robbie Spencer.

|                            | For year ended 31 December |          |          |
|----------------------------|----------------------------|----------|----------|
|                            | 2016                       | 2017     | 2018     |
| Gross margin               | 40%                        | 38%      | 37%      |
| Profit margin              | 14%                        | 13%      | 11%      |
| Rate of inventory turnover | 9 times                    | 10 times | 12 times |

Revenue figures for each of these years are as follows.

|      |           |
|------|-----------|
| 2016 | \$600 000 |
| 2017 | \$580 000 |
| 2018 | \$570 000 |

Comment on the trend in revenue and on the business's performance during the three-year period. For each ratio:

- describe the trend and state whether this is a strength or a weakness
- explain what may have caused the change.

### 2 Commenting on income statement ratios

The following ratios have been calculated as a result of analysing the financial statements of the retail business owned by Wilma Morris.

|                            | For year ended 31 December |          |          |
|----------------------------|----------------------------|----------|----------|
|                            | 2016                       | 2017     | 2018     |
| Gross margin               | 20%                        | 23%      | 26%      |
| Profit margin              | 9%                         | 10%      | 12%      |
| Rate of inventory turnover | 18 times                   | 15 times | 14 times |

Revenue figures for each of these years are as follows.

|      |           |
|------|-----------|
| 2016 | \$700 000 |
| 2017 | \$730 000 |
| 2018 | \$780 000 |

Comment on the trend in revenue and the business's performance during the three-year period. For each ratio:

- describe the trend and state whether this is a strength or a weakness
- explain what may have caused the change.

### 3 Commenting on statement of financial position ratios

The following ratios have been calculated as a result of analysing the financial statements of Horizon Stores, a business owned by Robbie Spencer (see also question 1).

|                                   | For year ended 31 December |         |         |
|-----------------------------------|----------------------------|---------|---------|
|                                   | 2016                       | 2017    | 2018    |
| Return on capital employed (ROCE) | 12%                        | 11%     | 10%     |
| Current ratio                     | 1.7 : 1                    | 1.6 : 1 | 1.5 : 1 |
| Liquid (acid test) ratio          | 0.9 : 1                    | 0.8 : 1 | 0.7 : 1 |
| Trade receivables turnover        | 26 days                    | 30 days | 35 days |
| Trade payables turnover           | 32 days                    | 31 days | 27 days |

The typical ratios for this type of business are:

|                            |         |
|----------------------------|---------|
| Current ratio              | 1.8 : 1 |
| Liquid (acid test) ratio   | 0.8 : 1 |
| Trade receivables turnover | 30 days |
| Trade payables turnover    | 30 days |

Comment on the business's performance as shown by these statement of financial position ratios during the three-year period. For each ratio:

- describe the trend and state whether this is a strength or a weakness
- explain what the trend means for the business.



#### 4 Commenting on statement of financial position ratios

The following ratios have been calculated as a result of analysing the financial statements of the retail business owned by Wilma Morris (see also question 2).

|                                   | For year ended 31 December |         |         |
|-----------------------------------|----------------------------|---------|---------|
|                                   | 2016                       | 2017    | 2018    |
| Return on capital employed (ROCE) | 13%                        | 15%     | 16%     |
| Current ratio                     | 1.1 : 1                    | 1.2 : 1 | 1.4 : 1 |
| Liquid (acid test) ratio          | 0.4 : 1                    | 0.5 : 1 | 0.6 : 1 |
| Trade receivables turnover        | 37 days                    | 36 days | 35 days |
| Trade payables turnover           | 27 days                    | 28 days | 30 days |

The typical ratios for this type of business are:

|                            |         |
|----------------------------|---------|
| Current ratio              | 1.2 : 1 |
| Liquid (acid test) ratio   | 0.9 : 1 |
| Trade receivables turnover | 30 days |
| Trade payables turnover    | 30 days |

Comment on the business's performance as shown by these statement of financial position ratios during the three-year period. For each ratio:

- describe the trend and state whether this is a strength or a weakness
- explain what the trend means for the business.

#### 5 Commenting on performance

Omar has been looking at his business's financial statements for each of the years ended 31 December 2017 and 2018. He has worked out the following accounting ratios based on these statements.

|                            | 2017    | 2018     |
|----------------------------|---------|----------|
| Gross margin               | 40%     | 43%      |
| Profit margin              | 8%      | 7%       |
| Rate of inventory turnover | 9 times | 10 times |
| Return on capital employed | 11%     | 7%       |
| Current ratio              | 1.2 : 1 | 1.3 : 1  |
| Liquid (acid test) ratio   | 0.8 : 1 | 0.6 : 1  |
| Trade receivables turnover | 29 days | 35 days  |
| Trade payables turnover    | 36 days | 30 days  |

The following information is available about revenue in each of the years ended 31 December.

|      |           |
|------|-----------|
| 2017 | \$200 000 |
| 2018 | \$180 000 |

Typical liquidity ratios for this type of business are:

|                          |         |
|--------------------------|---------|
| Current ratio            | 1:3 : 1 |
| Liquid (acid test) ratio | 0.8 : 1 |

Comment on this business's performance.

#### 6 Commenting on performance

Samah has been looking at her business's financial statements for each of the years ended 31 December 2017 and 2018. She has worked out the following accounting ratios based on these statements.

|                            | 2017     | 2018     |
|----------------------------|----------|----------|
| Gross margin               | 27%      | 26%      |
| Profit margin              | 10%      | 9%       |
| Rate of inventory turnover | 11 times | 10 times |
| Return on capital employed | 11%      | 12%      |
| Current ratio              | 1.1 : 1  | 1.4 : 1  |
| Liquid (acid test) ratio   | 0.9 : 1  | 0.8 : 1  |
| Trade receivables turnover | 38 days  | 31 days  |
| Trade payables turnover    | 37days   | 30 days  |

The following information is available about revenue in each of the years ended 31 December.

|      |           |
|------|-----------|
| 2017 | \$320 000 |
| 2018 | \$360 000 |

Typical liquidity ratios for this type of business are:

|                          |         |
|--------------------------|---------|
| Current ratio            | 1:2 : 1 |
| Liquid (acid test) ratio | 0.8 : 1 |

Comment on this business's performance.

## 7 Making an inter-firm comparison

The following table has been prepared to show comparative ratios for two similar retail businesses for the year ending 30 September 2018: Garford Stores and Hobson Stores.

|                                   | Garford Stores | Hobson Stores |
|-----------------------------------|----------------|---------------|
| Gross margin                      | 33%            | 31%           |
| Rate of inventory turnover        | 14 days        | 16 days       |
| Profit margin                     | 9%             | 11%           |
| Return on capital employed (ROCE) | 14%            | 12%           |
| Current ratio                     | 1.4 : 1        | 1.1 : 1       |

Additional information: the usual current ratio for this type of retail business is 1.2 : 1.

Compare the performance of these two businesses.

- For each ratio identify which business you think is stronger and give reasons for your choice.
- In each case where a business is performing less well than the other business, make *one* suggestion that could improve that business's performance.
- State *one* reason why these ratios may not be strictly comparable.

## 8 Making an inter-firm comparison

The following table has been prepared to show comparative ratios for two similar wholesale

businesses for the year ending 30 June 2018: Anwar & Sons and Mopsa Wholesale.

|                                   | Anwar & Sons | Mopsa Wholesale |
|-----------------------------------|--------------|-----------------|
| Gross margin                      | 38%          | 43%             |
| Rate of inventory turnover        | 8 days       | 5 days          |
| Profit margin                     | 10%          | 13%             |
| Return on capital employed (ROCE) | 16%          | 11%             |
| Liquid (acid test) ratio          | 1.1 : 1      | 0.9 : 1         |
| Trade receivables turnover        | 34 days      | 31 days         |
| Trade payables turnover           | 38 days      | 36 days         |

Additional information for this type of wholesale business:

- The usual liquid (acid test) ratio is 0.9 : 1.
- The usual receivables turnover is 34 days.
- The usual turnover period is 36 days.

Compare the performance of these two businesses.

- For each ratio identify which business you think is stronger and give reasons for your choice.
- In each case where a business is performing less well than the other business, make *one* suggestion that could improve that business's performance.
- State *one* reason why it may be difficult to make a fair comparison of these two businesses.

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapters 6.2–6.6)

### MULTIPLE-CHOICE QUESTIONS

- A business's liquid (acid test) ratio changed from 0.9 : 1 to 1.2 : 1 during the course of one financial period. Which one of the following statements is a correct explanation of the effect of this change?
  - The business increased the value of inventories
  - The business improved its gross profit
  - The business improved its liquidity position
  - The business reduced its profit

- A business increased its rate of inventory turnover during a financial period. Which of the following is a correct explanation of the reason for this increase?
  - The business improved its profitability
  - The business improved its quick assets ratio
  - The business purchased more goods for resale
  - The business reduced its average inventory

- 11 A business wishes to improve its profit margin. The business could achieve this by which one of the following?

A Increasing the value of average inventories  
 B Offering cash discounts  
 C Reducing drawings  
 D Reducing running costs

- 12 The table shows a comparison of the performance of business P and business Q for the same financial period.

| Business | Gross margin | Profit margin |
|----------|--------------|---------------|
| P        | 28%          | 8%            |
| Q        | 24%          | 11%           |

Which one of the following statements is a correct explanation of this information:

- A Business P has a higher cost of sales than Business Q  
 B Business P is more effective at controlling expenses than Business Q  
 C Business Q has a higher cost of sales than Business P  
 D Business Q is more effective at controlling expenses than Business P
- 13 Alison's business has a larger return on capital employed (ROCE) than Beth's business. Which one of the following statements is a correct explanation of this information:
- A Alison's business has more liquidity than Beth's business  
 B Alison's business is more effective at using its resources than Beth's business  
 C Beth's business achieves a lower profit than Alison's business  
 D Beth's business is less effective at controlling its costs than Alison's business

### OTHER QUESTIONS

- 14 Sally is a trader. She wanted to compare her business's results for the year ended 31 December 2018 with the results for the year ended 31 December 2017.

She is able to provide the following information about the year ended 31 December 2017.

|                                   |         |
|-----------------------------------|---------|
| Gross margin                      | 35%     |
| Profit margin                     | 11%     |
| Return on capital employed (ROCE) | 13%     |
| Current ratio                     | 1.4 : 1 |

She can also provide the following information about the year ended 31 December 2018.

|                     | \$      |
|---------------------|---------|
| Revenue             | 480 000 |
| Cost of sales       | 288 000 |
| Total running costs | 153 600 |
| Current assets      | 66 000  |
| Current liabilities | 60 000  |
| Capital employed    | 256 000 |

- a Prepare a table to show the following ratios for the year ended 31 December 2018:
- (i) Gross margin  
 (ii) Profit margin  
 (iii) Return on capital employed (ROCE)  
 (iv) Current ratio

Set out the table to show the ratios for both of the years for which there is information.

- b Give **one** reason that would explain the change in the gross margin from 2017 to 2018.
- c Do you think Sally will be pleased with the profit margin percentage for the year ended 31 December 2018? Give a reason for your answer.
- d Sally is concerned about the change in the current ratio from 2017 to 2018. Describe **two** ways in which she could improve this ratio in future.
- e Give **one** reason for the change in the return on capital employed ratio from 2017 to 2018.
- f Sally is aware that financial statements are of limited value when looking at how well her business has performed. For example, Sally realises that the effects of price inflation have been ignored in her financial records. Explain one other way that financial statements may be of limited value when looking at how well her business has performed.



- 15** Samir wants to compare his business's performance with that of a similar business owned by Kim. The most recent financial year for both businesses ended on 30 September 2018.

Kim is able to provide the following information about her business.

|                            |          |
|----------------------------|----------|
| Rate of inventory turnover | 17 times |
| Liquid (acid test) ratio   | 0.8 : 1  |
| Trade receivables turnover | 29 days  |
| Trade payables turnover    | 32 days  |

Samir has extracted the following information from his business's financial statements.

|                             | \$      |
|-----------------------------|---------|
| Credit sales                | 384 000 |
| Credit purchases            | 264 900 |
| Inventory 1 October 2017    | 16 300  |
| Inventory 30 September 2018 | 18 700  |
| Trade receivables           | 34 718  |
| Bank                        | 1 482   |
| Trade payables              | 21 773  |

Samir confirms that there were no other current assets or current liabilities at 30 September 2018. Samir's accountant has said that the usual liquid (acid test) ratio for this type of business is 1.5 : 1.

- a** Prepare a table to show the following ratios for the year ended 30 September 2018:

- (i) Rate of inventory turnover
- (ii) Liquid (acid test) ratio
- (iii) Trade receivables turnover
- (iv) Trade payables turnover

Set out the table to show the ratios for both businesses.

- b** Which of the business has the better rate of inventory turnover? Give **one** reason why this business may have a better ratio than the other business.
- c** Which business has the better liquid (acid test) ratio? Give **one** benefit that could arise because this business has a better ratio.
- d** Samir feels that Kim's business has a better position in regard to its trade receivables turnover and trade payables turnover. Explain why Samir's view is correct. Describe **one** way in which Samir could improve the trade receivables turnover.
- e** Samir is aware that there are limitations to making inter-firm comparisons. Describe **two** of these limitations.

# Accounting principles and policies

## Introduction

Now is a good opportunity to review the **accounting principles** that have been mentioned throughout the preceding chapters and to introduce some additional principles. The benefits of international accounting standards will also be covered. These principles and standards have to be considered by business owners and managers when deciding the **accounting policies** that will be followed by the business (i.e. the rules and procedures will be used when producing financial statements).

## Why have accounting principles?

Accounting techniques and procedures can often seem very clear cut, leaving no room for disagreement or uncertainty. However, businesses can be very complex organisations, and keeping the accounting records for even a small business can involve recording countless transactions and making many important decisions. As a result, there can be occasions when an accountant or bookkeeper is faced with making the right decision about the correct treatment of a financial matter and what procedures should be put in place when producing financial statements.

### Illustration 1 Making the right decision

A business owns a delivery vehicle which cost \$30 000 when it was purchased two years ago. It is expected to have a useful life of four years, so the owner of the business has provided for depreciation of \$7500 at the end of year 1. At the end of year 2 it appears that the business has not performed well, so the owner has suggested to the accountant that no charge should be made for depreciation in order that the business can avoid reporting a small profit figure.

Accounting principles help in situations like these because they provide those responsible for producing financial statements with clear rules to be followed. In this case the accountant will be able to give a very definite 'No!' to the owner's suggestion. The accountant will no doubt explain that accounting is designed to give a *true and fair view* of a business's affairs, and this applies whether a business is doing well or badly. It is not the job of an accountant to manipulate information to provide a desirable outcome. In this particular case, the specific rule is that profit must be based on matching the business's income for the year with the costs for the year which were necessary to achieve that income. Depreciation of the vehicle is one of the business's costs for the year and has to be shown in the income statement and statement of financial position.

## LEARNING OBJECTIVES

When you have reached the end of Chapters 7.1–7.3 you will be able to:

- identify the most important accounting principles
- explain the benefits that accounting principles and policies provide
- explain the rule covered by each principle
- apply accounting principles to a variety of situations.

## KEY TERMS

**Accounting principles:** the basic rules that are to be applied by all those who prepare accounting records; these are also called accounting concepts.

**Accounting policies:** the rules and procedures that are adopted by a business when producing its financial statements.



# The main accounting principles (part 1)

## KEY TERMS

**Accruals principle:** in order to calculate a true and fair profit, income for a financial year is matched exactly with expenses that relate to that accounting year whether paid or not. This principle is also called the matching principle.

**Prudence principle:** an accounting principle that requires that where there is doubt, asset and profit values are understated rather than overstated, and that losses and liabilities are overstated rather than understated.

**Lower of cost or net realisable value:** the rule that must be applied to the valuation of inventories.

## Accruals (matching) principle

This is the idea that profits or losses should be based on an accounting year and be based on taking the income for the year, whether actually received or not, and matching this with all of the costs that were necessary to achieve that income, whether paid for or not. For that reason this rule, which is usually called the **accruals principle**, is also called the 'matching principle'.

This rule means that when an annual income statement is put together, great care has to be taken to ensure that every entry relates to the year in question, not to some other accounting period, and every entry presents a full picture for that year.

### Illustration 2

### Applying the accruals principle

Here are two examples of the accruals principle in practice.

- *Expenses and accruals and prepayments:* each expense is reviewed to ensure that the amount recorded in the income statement is the correct amount for the current year under review, adjusting for any amount due but unpaid (accruals) or amounts paid that relate to the next accounting period (prepayments).
- *Depreciation:* non-current assets are purchased so that they can help a business to make a profit. Each non-current asset will have a number of years over which it can benefit the business by earning income. So, when calculating profit an estimate is made of the contribution made towards earning income for that particular year. In this way the cost of the asset is matched with the income it generates.

## Prudence principle

Accountants have to ensure that financial statements do not mislead users into thinking that a business is doing better than is really the case. The **prudence principle** is used in situations where there is some doubt about the value of an asset or the amount of profit being made, by ensuring that in those cases the lower value for an asset or profit is reported. The principle also ensures that where there is some doubt, losses and liabilities are never understated; losses have to be written off immediately once they are recognised.



### Illustration 3

Applying the prudence principle to the valuation of trade receivables

Tom, a trader, has had to write off the accounts of trade receivables as irrecoverable every year for the last few years. He estimates that about 4 per cent of all amounts due from credit customers are written off in this way.

Tom's accountant has advised him to create a provision for doubtful debts at the end of the financial year. The accountant says that this will ensure that a fairer view of trade receivables on his statement of financial position, and avoid giving an over-optimistic view of his profits for the year. As a result no one will be misled by overstated asset values and profits.



### LINKS...

There is more about provisions for doubtful debts in Chapter 4.17.

## Historic cost principle

The principle of historic cost states that all transactions should be recorded using the original cost of purchase. This ensures that asset values are shown in the accounts based on objective (factual) information rather than someone's opinion.

### KEY TERMS

**Historic cost:** all transactions should be recorded using the original cost of purchase.

### Illustration 4

Applying the historic cost principle

Dalal purchased some machinery a few years ago for \$19 000. She has been told that it would now cost \$24 000 to replace this machinery. She wonders whether she should adjust the value of the machinery in her accounts to take account of replacement values. Her accountant has told to ignore the replacement value because this is by no means certain, and continue to use the original cost (historic cost) of the machinery in her financial statements.

### KEY TERMS

**Materiality:** financial statements should not take account of items which are trivial or which may be misleading.

## Materiality principle

The principle of materiality states that financial statements should not take account of items that are trivial or may be misleading. In other words, the information in the accounts should be significant to the users of those accounts.

### Illustration 5

Applying the materiality principle

Kamal purchases a new calculator for his office for \$8. Kamal expects the calculator to be of use for three years. His accountant has said that although it could be regarded as a non-current asset, the amount involved is so small that there would be no benefit in depreciating the item of equipment over its three-year life. Instead the amount should be written off in the income statement for the year of purchase.

# The main accounting principles (part 2)

## KEY TERMS

**Consistency principle:** accounting policies should be carried out in the same way year on year.

## DID YOU KNOW?

If the owner of a business could make a strong case for changing a business policy, it is possible to do so. For example, perhaps the percentage used to calculate the provision for doubtful debts needs to be increased because the business experiences much higher levels of irrecoverable debts during a difficult time for the national economy. However, financial statements must indicate that there has been a change of policy, and alternative figures using the former policy should also be provided.

## KEY TERMS

**Business entity principle:** a business's transactions and the owner's private transactions are recorded separately in a business's accounting system.

You can now answer questions 1–6 on pages 322–323.

## Consistency principle

The owners of businesses have choices to make when preparing financial statements. Having made a decision, the **consistency principle** requires that the business keeps to that decision from one year to another. This ensures that financial statements are prepared on the same basis each year. As a result, those comparing results can be sure that their comparisons will not be distorted in any way, and so the decisions based on these comparisons are more likely to be valid.

### Illustration 6

Example of where the consistency principle should be applied

*Depreciation method:* Having chosen a depreciation method (e.g. straight-line), the business should continue to use that method from one year to the next, otherwise depreciation charges and profits will not be comparable.

## Business entity principle

The **business entity principle** ensures that transactions recorded in an organisation's accounting system clearly distinguish between those relating to the business's affairs and the owner's private affairs. The most important application of this principle is that a sole trader's accounting records focus on how that business is performing, and the owner's private affairs are not part of that story.

### Illustration 7

Applying the entity principle

Farad is the owner of a retail business. Recently Farad paid for his family to fly to a nearby island to stay with some relatives. The payment came from Farad's private bank account, so this transaction was not recorded in the business's accounts because it does not affect the business.

If Farad had paid for the trip from the business's bank account, it would have been necessary to debit the drawings account and credit the business bank account – it would have been wrong to have debited the business's travel expenses account. These correct entries ensure that the business's profit was not affected in any way by the non-business cost.

## Duality principle

When preparing accounting records there are always two ways of looking at a transaction. This basic rule means that for any transaction it is necessary to consider the following aspects:



- 1 How does the transaction affect the business's resources (i.e. its assets)?
  - 2 How does the transaction affect the way in which those resources have been financed (i.e. the business's capital and liabilities)?
- The **duality principle** leads to the idea of double-entry bookkeeping and making a debit and credit entry for each transaction in a business's accounting system (the processes you have been putting into practice since Chapter 1.3).

#### KEY TERMS

**Duality principle:** every transaction has two aspects leading to the making of two entries for each transaction in the accounting system.

**Money measurement principle:** in accounting, only transactions that have a definite monetary value are recorded.

#### Illustration 8 Applying the duality principle

Here are some transactions in which the two aspects above have been considered:

| Transaction                              | Aspect 1  | Aspect 2  |
|--|---|---|
| Sold goods on credit                     | Business has an extra asset (trade receivable)        | Business has gained value (increase in capital)                                   |
| Paid an expense in cash                  | Business has a decrease in assets (cash)              | Business has lost value (decrease in capital)                                     |
| Business borrows money from bank         | Business has an increase in assets (additional money) | Business gains an additional source of finance (non-current liability, bank loan) |
| Owner withdraws a cheque for private use | Business has a decrease in assets (bank)              | Business has lost value (decrease in capital)                                     |

### Money measurement principle

Financial statements can only record information that has a monetary value. This is known as the **money measurement principle** and means that some aspects of business activity cannot be recorded because they are too difficult to value. For example, it would not be possible to value whether or not a business:

- has a dedicated and highly skilled workforce
- has good customer relationships
- has high-quality management
- is well located.

#### Illustration 9 Applying the money measurement principle

Amhari owns a very successful hotel in a local resort. Her business has an exceptional reputation which is illustrated by the fact that several of the hotel's guests have been coming for many years. The hotel guests are enthusiastic about Amhari's hard work and management skills and the outstanding service provided by her skilful staff. Although important to the success of the business, management skills, effective staff and a good reputation with customers cannot be directly recorded in the accounting records because their value is only a matter of a opinion.



# The main accounting principles (part 3)

## KEY TERMS

**Going concern principle:** while a business continues to trade, assets are valued at cost less depreciation. When a business ceases to trade, assets are valued at their realisable value.

## Going concern principle

When preparing accounting records it is assumed that the business will continue to trade or provide a service for many years to come (i.e. that the business is a going concern). As a result of applying the **going concern principle**, the potential resale value of any of the business's assets is not considered to be relevant, and so is not recorded in the accounts. When a business is no longer a going concern – perhaps it is being shut down – assets should be recorded at their realisable values. You have probably noticed how goods and other assets are often sold off very cheaply when a business has a closing down sale.

## Notes:

- 1 While the business is a going concern Robbie's assets have been valued at cost less depreciation in accordance with the going concern principle.
- 2 When the business is closing down, the going concern principle no longer applies, and assets are shown at their estimated realisable value.

## Illustration 10 Applying the going concern principle

Robbie's business owns some furniture and fittings which were purchased some years ago for \$10 000. As Robbie's business has been a going concern these assets have been shown in the financial statements at cost less a provision for depreciation. In the statement of financial position at 31 March 2018, these assets were shown at cost less a provision for depreciation of \$4000.

However, falling profits led Robbie to decide to close down his business on 1 July 2018 when the assets were sold off. The value of the furniture and fittings was reduced considerably in the financial statements at the time of closing the business to just \$1500 because this was considered a realistic resale value.

## KEY TERMS

**Realisation principle:** a sale occurs when the customer pays or when an invoice is issued for the goods or services.

## Realisation principle

When does a sale of goods or services actually take place? Is it when the customer makes an order, receives the goods, is sent an invoice, pays the supplier? This question is important because it also raises the issue of exactly when a business makes a profit from trading or providing services. The **realisation principle** gives a clear ruling on this question: a sale takes place when the customer either pays the supplier (i.e. cash sales) or when the customer agrees to pay the supplier (credit sales), which in effect means when the invoice is issued. Invoices will be issued when the goods have been delivered and accepted or when the service has actually been provided. This principle prevents a business from claiming to have made profits that are not yet definite.

### Illustration 11 Applying the realisation principle

Yasmin prepares her business's end-of-year financial statements on 31 December. On 31 December 2018 Yasmin received an order from a regular customer for goods with a resale value of \$2300. Yasmin thought it would be sensible to include this amount in the total sales for 2018 on the grounds that this particular customer was very reliable. However, Yasmin's accountant disagreed and said that the order could not be included, arguing that the customer could cancel the order, or Yasmin might find that she was unable to provide the goods needed in time. The accountant pointed out that only when the customer paid for the goods or when Yasmin had sent out an invoice could the sale (and therefore the profit) be said to be definite and recordable.

You can now answer questions 7–12 on pages 323–324.

## International accounting standards

In recent years progress has been made to ensure that financial statements are prepared using the same rules and guidelines internationally. A team of leading accountants drawn from many countries has the task of preparing these **international accounting standards**.

The standards are designed to protect those who use accounting statements and stop them being misled. They ensure:

- comparability
- relevance
- reliability
- understandability.

*Comparability* means that users of financial statements can use them to make valid comparisons of the results and financial activities of businesses from a wide range of countries.

Standards ensure that financial information is of *relevance* to those making business decisions.

The international standards have done much to increase the *reliability* of accounting statements. Users will know that information provided in statements would have been much the same whoever had prepared them, so the information will be objective (factual and free from bias) rather than subjective (a matter of opinion). The basis for every standard is that accounting statements must present a true and fair view of the financial position.

Those who produce the standards are also required to ensure that accounting statements are *understandable*. In other words, the needs of users are given a high priority when standards are designed, so that decisions made on the basis of financial statements will be reliable and valid.

### KEY TERMS

**International accounting standards:** a set of rules and guidelines that businesses in many countries must follow in producing financial statements.

### DID YOU KNOW?

At the time of writing there are well over 40 standards and over 150 countries have adopted them with many more countries moving to adopt them in the near future.

You can now answer questions 13–27 on pages 324–325.



## DEVELOPING YOUR SKILLS

## 1 Identifying accounting principles

Here are some recent transactions that affected a retail business. Complete the table, identifying the name of the principle that has been applied in each case.

| Transaction   | Relevant principle |
|---|--------------------|
| When preparing the income statement an adjustment was made to an expense account to record a prepayment   |                    |
| Occasionally items are damaged in a business's stockroom. These items are often valued at net realisable value because it is less than cost     |                    |
| A business always makes a provision for doubtful debts based on 5% of trade receivables at the year end   |                    |
| The owner purchased a birthday gift for a member of the family using the business's money. The amount spent was debited to the drawings account |                    |
| A non-current asset has been recorded in the accounts using its purchase price.   |                    |

## 2 Identifying accounting principles

Here are some recent transactions that affected a retail business. Complete the table, identifying the name of the principle that has been applied in each case.

| Transaction   | Relevant principle |
|---|--------------------|
| The business has always used the straight-line method of depreciation at 20% per annum every year   |                    |
| A customer's account which has been unpaid for 12 weeks has now been written off as a bad debt  |                    |
| The owner paid the business's rent from his private funds. In the business's accounts a debit entry was made in the rent account and a credit entry in the drawings account |                    |
| The business receives rent from a tenant. The amount transferred to the income statement took account of the fact that the tenant owed an amount for rent at the year end   |                    |
| New computer software to be used for at least three years was written off because it had cost very little.  |                    |

## 3 Summarising accounting principles

Complete the following table about two of the accounting principles.

| Principle     | One key point about this principle | Example of the principle being used |
|---------------|------------------------------------|-------------------------------------|
| Accruals      |                                    |                                     |
| Prudence      |                                    |                                     |
| Historic cost |                                    |                                     |

## 4 Summarising accounting principles

Complete the following table about two of the accounting principles.

| Principle       | One key point about this principle | Example of the principle being used |
|-----------------|------------------------------------|-------------------------------------|
| Consistency     |                                    |                                     |
| Business entity |                                    |                                     |
| Materiality     |                                    |                                     |

## 5 Applying the prudence principle to inventory valuation

Jason, a retailer, recently found that some items in the stockroom had been damaged. The following facts are available:

- There are eight damaged items.
- The cost of each damaged item was \$20.
- The items would normally be sold for \$30 each.
- Jason thinks the damaged items could now be sold for just \$22 each.
- It will be necessary to spend \$5 per item on minor repairs before the items can be sold at \$22 each.

- a Calculate the total value of the damaged items

- (i) At cost
- (ii) At normal selling price
- (iii) At current realisable value
- (iv) At net realisable value

- b State which value should be used for valuing the damaged items.

- c Explain why this is the correct method of valuation.



## 6 Applying the prudence principle to inventory valuation

Miriam is a wholesaler of kitchen appliances. Recently some microwave ovens were slightly damaged in her stockroom. The following facts are available:

- There are four damaged items.
- The cost of each damaged item was \$40.
- The items would normally be sold for \$60 each.
- Miriam thinks the damaged items could now be sold for just \$43 each.
- It will be necessary to spend \$8 per item on minor repairs and repackaging before the items can be sold at \$43 each.

**a** Calculate the total value of the damaged items

- At cost
- At normal selling price
- At current realisable value
- At net realisable value

**b** State which value should be used for valuing the damaged items.

## 7 Identifying accounting principles

Here are some recent transactions that affected a retail business. Complete the table, identifying the name of the principle that has been applied in each case.

| Transaction  | Relevant principle |
|--|--------------------|
| The owner sent some samples to a potential new customer. However, this transaction has not been entered in the sales account                               |                    |
| The fittings could be sold for far less than is shown on the statement of financial position. However, no changes have been made to the accounting records |                    |
| When a bank loan was repaid two entries were made in the accounting records affecting an asset account and a liability account                             |                    |
| No record has been made in the accounting system of the fact that the workforce had a very high morale   |                    |

## 8 Identifying accounting principles

Here are some recent transactions that affected a retail business. Complete the table, identifying the name of the principle that has been applied in each case.

| Transaction  | Relevant principle |
|--|--------------------|
| The payment of interest has resulted in making two entries in the accounting system  |                    |
| The staff have been praised for their very positive customer relations. No record has been made of this in the accounting system   |                    |
| The business has been very successful, but no record has been made of the value of goodwill in the accounts  |                    |
| Goods have just been sent to a customer. No payment has been made by the customer and the invoice for the goods will not be sent until next week. No entries have been made for this sale so far |                    |

## 9 Matching concepts and their definitions

In the table below there are definitions of some accounting principles. Identify the principle being described in each case by selecting from the following list:

Accruals  
Duality  
Business entity  
Realisation

| Definition  | Principle |
|---|-----------|
| Accounting for a sole trader's business is clearly separated from accounting for the owner's private transactions                 |           |
| A sale occurs when money or the promise of money is received  |           |
| Accounting systems are based on the idea that there is a two-fold aspect to every transaction                                     |           |
| Profits are assessed on the basis of amounts due or receivable for a period of time rather than amounts actually paid or received |           |

## 10 Matching principles and their definitions

In the table below there are definitions of some accounting principles. Identify the principle being described in each case by selecting the appropriate item from the following list:

Going concern  
Prudence  
Consistency  
Money measurement

| Definition   | Principle |
|--|-----------|
| The assumption is made that the business will continue to trade indefinitely when valuing assets                               |           |
| A business should endeavour to maintain the same accounting policies from one year to the next to aid comparability of results |           |
| Some important aspects of a business's performance cannot be quantified in financial terms                                     |           |
| Where there is doubt, the lower value for an asset or profit is preferred  |           |

## 11 Summarising accounting principles

Complete the following table about two of the accounting principles.

| Principle   | One key point about this principle | Example of the principle being used |
|-------------|------------------------------------|-------------------------------------|
| Duality     |                                    |                                     |
| Realisation |                                    |                                     |

## 12 Summarising accounting principles

Complete the following table about two of the accounting principles.

| Principle         | One key point about this principle | Example of the principle being used |
|-------------------|------------------------------------|-------------------------------------|
| Money measurement |                                    |                                     |
| Going concern     |                                    |                                     |

## 13 International accounting standards

Describe two ways in which international accounting standards are likely to help the users of financial statements.

## 14 International accounting standards

Describe two ways (not mentioned in answer to question 13) in which international accounting standards are likely to help the users of accounting statements.

## PREPARING FOR THE EXAMINATION

(The following questions cover Chapter 7.1–7.3)

### MULTIPLE-CHOICE QUESTIONS

15 The owner of a business recently introduced a policy of providing for doubtful debts.

Which principle is being applied?

- A Accruals
- B Business entity
- C Consistency
- D Prudence

16 A trade receivables account was written off as an irrecoverable debt as soon as it became clear that no money would be received.

Which principle is being applied?

- A Business entity
- B Consistency
- C Money measurement
- D Prudence

17 The owner of a business paid for a friend's birthday present from the business's bank account. The accounts clerk correctly recorded the amount in the drawings account in the business's general ledger.

Which principle is being applied?

- A Accruals
- B Business entity
- C Consistency
- D Realisation

- 18** The owner of a business considered switching from using the reducing balance method of depreciation to the straight-line method. The owner has been advised to continue using the straight-line method so that one year's accounts can be compared with another year's accounts on the same basis.

Which principle is being applied?

- A** Business entity
- B** Consistency
- C** Duality
- D** Prudence

- 19** When preparing financial statements it is important to consider not only what cash has been paid for an expense but also what should have been paid for the expense for that time period.

Which principle is being applied?

- A** Accruals
- B** Business entity
- C** Consistency
- D** Realisation

- 20** Some damaged inventory was valued at the lower of cost and net realisable value. Which accounting principle was applied to the valuation of the damaged inventory?

- A** Business entity
- B** Duality
- C** Going concern
- D** Prudence

- 21** The owner of a business paid for some building work at his home from his private bank account. This transaction was recorded in the business's books of account. Which accounting principle was wrongly applied?

- A** Accruals
- B** Business entity
- C** Consistency
- D** Prudence

- 22** The owner of a business has decided to create a provision for doubtful debts. Which accounting principles are being applied?

- A** Accruals and business entity
- B** Accruals and prudence
- C** Business entity and consistency
- D** Consistency and prudence

- 23** When should sale on credit be recorded in the accounts?

- A** When the customer pays for the goods
- B** When the goods are delivered to the customer
- C** When the invoice is sent to the customer
- D** When the order is received from the customer

- 24** A payment of wages in cash has been debited to the wages account and credited to the cash account. This is an example of which principle?

- A** Accruals principle
- B** Duality principle
- C** Money measurement principle
- D** Realisation principle

- 25** It is assumed that a business will continue to trade for many years to come. Which accounting principle is based on this assumption?

- A** Business entity principle
- B** Going concern principle
- C** Money measurement principle
- D** Prudence principle

- 26\*** The owner of a business based the valuation of a motor vehicle on the amount paid for it.

Which principle is being applied?

- A** Business entity
- B** Historic cost
- C** Money measurement
- D** Prudence

- 27\*** Some items of office equipment of low value were treated as expenses in a business's income statement.

Which principle is being applied?

- A** Accruals
- B** Consistency
- C** Materiality
- D** Prudence



- 28\*** Financial statements must be prepared in such a way as to ensure they present a true and fair view of the financial position.

Which accounting policy is being applied?

- A** Comparability
- B** Relevance
- C** Reliability
- D** Understandability

### OTHER QUESTIONS

- 29** Khalaf sells music technology. At his business's financial year end, he is unsure how to value a loudspeaker system that cost \$160. One of the speakers has been slightly dented and the packaging has been badly torn. However, this item is still in good working order. Khalaf believes he could repackage the loudspeaker system at a cost of \$5 and sell it at a reduced price of \$150. Complete the following sentences.

- a** Khalaf should value the loudspeaker system at \$ ...
- b** Khalaf should value the loudspeaker at the lower of ..... or .....
- c** This is an example of using the ... principle.

- 30** Beth sells washing machines. At the end of her business's financial year she had 23 unsold washing machines in her stockroom. Each of these machines had cost \$320 when purchased. They normally sell at \$400 each. Beth has noticed that four machines (machines A, B, C and D) have become damaged in the stockroom.

Machine A can be sold as shop soiled at a reduced price of \$330. The other three machines (machines B, C and D) will need some relatively minor repairs, costing \$40 per machine. Beth estimates that once they are repaired she can sell each of these machines for \$340.

- a** Calculate the total value of the Beth's undamaged inventory of washing machines.
- b** State the correct valuation of washing machine A.
- c** Calculate the correct total valuation of washing machines B, C and D.

## A

**Accounting** the selecting, classifying and summarising of financial data in a way that provides the owners of businesses (and others) with useful information in order to help them assess performance and plan future activities.

**Accounting equation** this links the three elements that are a feature of all businesses, i.e. assets, liabilities and capital. The equation is:  $\text{Assets} = \text{Capital} + \text{Liabilities}$ .

**Accounting policies** the rules and procedures that are adopted by a business when producing its financial statements.

**Accounting principles** the basic rules that are to be applied by all those who prepare accounting records; these are also called accounting concepts.

**Accruals principle** in order to calculate a true and fair profit, income for a financial year is matched exactly with expenses that relate to that accounting year whether paid or not. This principle is also called the matching principle.

**Accumulated fund** the total of a club's surpluses over a period of years. It is the equivalent of a business's capital.

**Ageing schedule of trade receivables** a list of all amounts due from credit customers shown in a sequence based on how long the debt has been outstanding.

**Amounts not yet credited** amounts paid into a business's bank statement but which have not yet been recorded on the bank statement as credit entries.

**Analysis column** in a petty cash book this is a means of classifying each payment to provide totals to be posted to general ledger accounts.

**Annual general meeting (AGM)** a yearly meeting of shareholders where directors report on the performance of the company.

**Appropriation account** a part of the end-of-year income statements of a partnership recording how the profit or loss for the year is shared between the partners.

**Assets** resources with a monetary value that are owned by a business.

**Authorised share capital** the maximum amount of share capital that a limited company may issue.

## B

**Bad debt** an amount owed by a credit customer that will not be paid.

**Bad debt recovered** when a debt that has previously been written off is settled by the customer.

**Balancing accounts** the process of calculating the net amount left in an account and clearly stating this as a debit or credit balance at the beginning of the next accounting period.

**Bank charges** payments deducted automatically from a current account at regular intervals as a reward to the bank for operating the account.

**Bank reconciliation statement** a document prepared by businesses at regular intervals (say monthly) to check that their bank records agree with those provided by the bank.

**Bank statement** a copy of a customer's bank account, sent to the customer at regular intervals.

**Bookkeeping** the recording of financial information, particularly transactions, in a systematic way.

**Books of prime entry** this is where transactions are listed prior to being posted to the double-entry records. Sometimes referred to as subsidiary books.

**Business entity principle** a business's transactions and the owner's private transactions are recorded separately in a business's accounting system.

## C

**Called-up share capital** the part of the issued share capital of a company for which payment has been requested.

**Capital** the investment made by the owner(s) of a business.

**Capital employed** the total of capital and non-current liabilities, which is a key element in the analysis of how well a business has performed. Alternatively, the same figure can be found by adding non-current assets and working capital.

**Capital expenditure** money spent on non-current assets that is intended to be of benefit in future financial years.

**Capital receipts** money received that is of long-term (more than one year) benefit to the business.

**Carriage inwards** the cost of transporting goods, paid by a business on its own purchases. This expense is added to purchases in the first section of the income statement.

**Carriage outwards** the cost of transporting goods, paid by a business on its sales to customers. This expense is recorded in the second part of the income statement.

**Cash book** a book of prime entry in which all cash and bank transactions are recorded.

**Cash discount** a reduction in the amount paid by credit customers, or to credit suppliers, when accounts are settled within an agreed time limit.

**Cash transactions** financial activities involving the immediate use of money.

**Closing accounts** the process of completing an account that does not have a balance.

**Closing inventory** goods unsold at the end of a trading year.

**Compensating error** where two or more errors of the same amount cancel each other out.

**Consistency principle** accounting policies should be carried out in the same way year on year.

**Contra entry (cash book)** the transfer of cash to the bank, or the withdrawal of cash from the bank. These transactions result in both the debit entry and credit entry for the transaction being recorded in the cash book columns.

**Contra entry (control accounts)** when a business deals with another business or organisation as both a customer and a supplier, the balance of the two accounts are set off against one another to find the net balance.

**Cost of raw materials consumed** the direct cost of raw materials used during a financial year.

**Cost of sales** the value at cost price of goods sold during a trading year. It is found as follows:  $\text{Opening inventory} + \text{Purchases} - \text{Closing inventory}$ .

**Credit** the right-hand side of an account.

**Credit note** the source document that records the amount to be deducted from (or allowed against) a previous invoice to avoid a business being overcharged. Usually the business has returned goods to the supplier.

**Credit transactions** financial activities when the payment or receipt of money is delayed.

**Credit transfer** the automatic transfer of funds into a business's bank account by one of the business's customers.



**Current accounts** a record of each partner's annual drawings and shares of profits or loss.

**Current assets** assets that are quickly turned into cash and are of benefit to the business for a short time (less than one year).

**Current liabilities** liabilities that will be settled in the near future (in less than one year).

**Current ratio** current assets in relation to current liabilities. The ratio is sometimes called the working capital ratio. It is always expressed in the form  $xx : 1$ , e.g.  $1.8 : 1$ .

**Debentures** long-term loans that carry a fixed rate of interest which must be paid each year and which is charged to the company's income statement.

**Debit** the left-hand side of an account.

**Debit note** a source document used by a purchaser to notify the seller that goods are being returned and the amount that should be deducted from the amount due. Alternatively, a debit note is occasionally issued by the seller of goods to notify the purchaser of an undercharge.

**Deed of partnership** the formal agreement between partners that states how profit and losses will be shared and the rules under which the partners will work together.

**Depreciation** the loss in value of a non-current asset over its useful life.

**Direct costs** manufacturing costs that are attributable to a single product, particularly direct materials and direct labour.

**Direct debit** authority is given to a bank by one of its customers to make payments on its behalf to another organisation. The amount paid will be the sum requested by that organisation up to a specified limit.

**Directors** individuals who are appointed by shareholders to manage the company on their behalf.

**Dishonoured cheque** a cheque that a bank will not accept for payment because the payee (individual making the payment) does not have enough funds in their account to cover the amount being paid.

**Dividend** the reward paid to shareholders out of the profits of a limited company.

**Double entry** the process of making two entries for every transaction.

**Drawings** the withdrawal of money by the owner of a business for private use.

**Duality principle** every transaction has two aspects leading to the making of two entries for each transaction in the accounting system.

## E

**Equity** the heading used for the capital and reserves section of a limited company's statement of financial position.

**Error of commission** where a debit or credit entry is made in the wrong account.

**Error of complete reversal** when the account that should have been debited is credited in error, and the account that should have been credited is debited in error.

**Error of omission** where a transaction is overlooked so that no debit and credit entry is made in the accounts.

**Error of original entry** when a mistake is made transferring an amount from a source document to a book of prime entry so both the debit entries and credit entries are incorrect.

**Error of principle** where a debit or credit entry is made for the correct amount but in the wrong class of account.

**Expense accrual** an amount owing for expenses at the end of a financial period.

**Expenses** payments made to purchase goods or services to run the business on a day-to-day basis.

## F

**Factory overheads** the total of indirect costs.

**Fixed capitals** each partner's capital contribution remains unchanged unless all partners agree to an alteration.

## G

**General journal** a book of prime entry used to make the first record of transactions that it would not be appropriate to record in the other books of prime entry (cash books and other journals).

**General ledger** a part of the double-entry system that is used to keep all of the accounts, other than those for trade payables (kept in the purchases ledger) and trade receivables (kept in the sales ledger).

**General reserve** part of the undistributed profits that have not been distributed as dividends and are set aside for some future use.

**Going concern principle** while a business continues to trade, assets are valued at cost less depreciation. When a business ceases to trade, assets are valued at their realisable value.

**Goods for own use** a transaction where the owner of a business keeps goods for private use which would otherwise have been available for sale. This transaction is sometimes referred to as inventory drawings.

**Goodwill** the additional value of an established and successful business, above the value of its tangible assets. Goodwill is an intangible asset.

**Gross profit** the difference between the income from sales and the expenditure on goods sold.

## I

**Imprest** a system for maintaining a petty cash book which gives the petty cashier responsibility for a fixed petty cash float.

**Income and expenditure account** an annual summary that shows whether a club made a surplus or a deficit.

**Income statement** an end-of-financial-period statement that shows a business's gross profit and profit for that period (usually a year).

**Indirect costs** manufacturing costs that cannot be attributed to one product.

**Intangible assets** assets which have a monetary value but which do not have a physical presence

**Interest on capital** a reward for each partner in the form of a share of profits that is based on the amount of capital contributed by each partner.

**Interest on drawings** a penalty whereby a partner is charged interest on drawings. The interest takes account of the amount of the drawings.

**Interested parties** individuals and organisations who are affected by or concerned about how a business performs.

**Inter-firm comparison** analysing the performance of similar businesses and using the results to indicate success or under-achievement.

**International accounting standards** a set of rules and guidelines that businesses in many countries must follow in producing financial statements.



**Inventory** goods owned by a business that have not yet been sold.

**Issued share capital** the amount of share capital that has actually been issued by a limited company.

## L

**Ledger** the book in which all financial accounts are kept.

**Liabilities** amounts owed by a business to other businesses, organisations or individuals.

**Limited liability** the liability of any shareholder for the debts of the company is limited to the amount of their fully paid shares.

**Limited liability company** an organisation owned by its shareholders whose liability for the debts of the company is limited to their shareholding.

**Liquidity** a business's ability to have available sufficient cash to pay its short-term debts.

**Lower of cost or net realisable value** the rule that must be applied to the valuation of inventories.

## M

**Manufacturing account** the first part of the end-of-year financial statements of a manufacturing organisation that shows the total cost of producing goods.

**Miscast** incorrectly totalled. Undercast would mean that a total is too small; overcast would mean that a total is too large.

**Money measurement principle** in accounting, only transactions that have a definite monetary value are recorded.

## N

**Net book value** the value of a non-current asset which takes account of its cost less the total depreciation to date.

**Net current assets** a term often used instead of working capital and calculated in the same way: i.e. current assets less current liabilities. When the figure is negative the term should be 'net current liabilities'.

**Net realisable value** sale value less any costs to be incurred before a sale can take place.

**Non-current assets** assets that should be of benefit to the business for a long time (more than one year).

**Non-current liabilities** liabilities that will be settled in the longer term (longer than one year).

## O

**Opening inventory** goods unsold at the beginning of a trading year. The amount will be the same as the closing inventory from the previous year.

**Operating profit** profit before the deduction of finance charges.

**Order of permanence** the sequence used to list items on a statement of financial position. It begins with items that are likely to be longest lasting and ends with items that are likely to be shortest lasting.

**Ordinary shares** shares that receive a variable rate of dividend that is dependent on the profits available for distribution. These shares have voting rights.

**Other payables** term used on a statement of financial position to include accrued expenses and income prepaid.

**Other receivables** term used on a statement of financial position to include prepaid expenses and income accrued.

## P

**Paid-up share capital** the part of the called-up share capital of a company for which payment has been received.

**Partner's loan** amounts lent by a partner over and above, and quite separate from, the partner's capital contribution. Interest on the loan is charged to the income statement and credited to the partner's current account.

**Partnership** a form of business ownership where two or more individuals work together with the intention of making a profit.

**Partnership salary** a reward in the form of a share of profits for any partner who has particular responsibilities in running the business.

**Percentage of gross profit to revenue (gross profit margin)** gross profit in relation to revenue (measured as a percentage).

**Percentage of profit to revenue (profit margin)** profit in relation to revenue (measured as a percentage).

**Petty cash** small cash payments.

**Petty cash book** the book of prime entry used to make the first record of petty cash payments.

**Petty cash voucher** the source document for each petty cash payment.

**Preference shares** shares that are entitled to receive a fixed rate of dividend and that are ranked before ordinary shares for the payment of a dividend.

**Prepaid expense** the payment of an expense in advance of the accounting year to which it relates.

**Prime cost** the total of direct costs.

**Private limited company** a company whose shares are not available to the general public. The name of the company includes the abbreviation Ltd (limited).

**Profit** the difference between a business's income (sales) and expenditure (purchases and expenses). At one time this final profit figure was called 'net profit'.

**Profit and loss sharing ratio** the ratio that is used to share any residual profit or loss of the partnership.

**Profitability** a measure of performance highlighting profit in relation to the resources used in the business.

**Provision for doubtful debts** an amount set aside from profits to take account of the likelihood that some trade receivables will not pay the amount due and so will reduce the value of this asset on a statement of financial position. Sometimes the alternative name 'provision for bad debts' is used.

**Prudence principle** an accounting principle that requires that where there is doubt, asset and profit values are understated rather than overstated, and that losses and liabilities are overstated rather than understated.

**Public limited company (plc)** a company whose shares are available to the general public. The name of the company includes the abbreviation plc.

**Purchase invoice** the source document that provides information about goods purchased on credit and the amount due.

**Purchases journal** the book of prime entry used to record purchases of goods on credit. The information required to prepare this journal is taken from purchase invoices.

**Purchases ledger** a part of the double-entry system that is used to keep the personal accounts of trade payables.

**Purchases ledger control account** a technique for checking the arithmetical accuracy of the purchases ledger

**Purchases returns** goods sent back by a business to the supplier.

**Purchases returns journal** the book of prime entry used to list in date order details shown on credit notes relating to goods returned to suppliers.



## Q

**Quick ratio** liquid assets in relation to current liabilities. Liquid assets are all of a business's current assets excluding inventories. This ratio is often referred to as the 'acid test ratio' or 'liquid ratio' and is also expressed in the form  $xx : 1$ .

## R

**Rate of inventory turnover** cost of sales divided by average inventory (expressed as 'so many times' in a particular financial year, e.g. '12 times').

**Realisable value** sale value.

**Realisation principle** a sale occurs when the customer pays or when an invoice is issued for the goods or services.

**Receipts and payments account** an annual summary of a club or society's cash book.

**Reducing balance method** where the annual depreciation charge is based on the value of the non-current asset at the beginning of the year under review. This method is also referred to as the diminishing balance method.

**Refund** a repayment to a customer who has overpaid, or a repayment made by a supplier who has been overpaid.

**Residual profit** the profit of a partnership after all agreed rewards have been allocated to partners. (Residual loss is the loss of a partnership after all agreed rewards have been allocated.)

**Residual value** the value of a non-current asset at the end of its useful life – sometimes referred to as the scrap value.

**Retained earnings** profits that have not been used to finance the payment of dividends nor have been transferred to a general reserve.

**Return on capital employed (ROCE)** the profit made by the business in relation to the funds invested in the business (i.e. owner's capital and non-current liabilities). The ratio is expressed as a percentage.

**Revaluation method** where the annual depreciation charge is based on comparing the estimated value of a group of non-current assets at the end of a financial year with the value at the beginning of the financial year.

**Revenue** in an income statement it is the value of a business's sales of goods (or services).

**Revenue expenditure** money spent on running costs that benefits only the current financial year.

**Revenue receipts** money received that is of short-term (less than one year) benefit to the business.

## S

**Sales invoice** the source document that provides information about goods sold on credit and the amount due.

**Sales journal** the book of prime entry used to record sales of goods on credit. The information required to prepare this book of prime entry is taken from sales invoices.

**Sales ledger** a part of the double-entry system that is used to keep the personal accounts of trade receivables.

**Sales ledger control account** a technique for checking the arithmetical accuracy of the sales ledger.

**Sales returns** goods sent back to a business by a customer.

**Sales returns journal** the book of prime entry used to list in date order details shown on copies of credit notes relating to goods returned by customers.

**Shareholders** the owners of the share capital of a limited company.

**Source documents** written documents that provide information from which accounting records can be prepared. They provide evidence that particular transactions took place.

**Standing order** a bank's customer gives instructions for the automatic payment to another organisation of a fixed amount at regular intervals.

**Statement of account** a summary of transactions that have taken place between a supplier and a credit customer. The statement provides a means of checking the accuracy of accounts and of reminding customers how much they owe.

**Statement of affairs** a summary of a business's assets, liabilities and capital at a given date.

**Statement of changes in equity** a record of changes to the retained earnings and general reserve of a limited company.

**Statement of financial position** a statement that shows an organisation's assets, liabilities and capital at a particular date which is prepared at the end of a financial period.

**Straight-line method** where the annual depreciation charge is based on the cost of the non-current asset and is the same amount each year. This method is also called the equal instalment method.

**Suspense account** a temporary account used to make the totals of a trial balance agree.

## T

**T account** a two-sided form used to record transactions affecting a particular aspect of a business's financial activities.

**Trade discount** a reduction in price given as a reward for buying in large quantities.

**Trade payables** are amounts owed by a business to suppliers.

**Trade payables payment period** trade payables in relation to credit purchases. The ratio is usually expressed in days.

**Trade receivables** are amounts owed to the business by customers.

**Trade receivables collection period** trade receivables in relation to credit sales. The ratio is usually expressed in days.

**Transaction** a financial activity or event.

**Treasurer** the individual appointed by the members of a club or society to manage its financial affairs.

**Trial balance** a summary of all the accounts in a business's books of account which provides a check on the accuracy of the double entry.

**True and fair** the principle that accounting records should be factually accurate and present a reasonable estimate of, or judgement about, the financial position.

## U

**Unlimited liability** in a partnership each partner is responsible for the debts of the partnership and could lose not just the capital contributed but also personal assets if the business fails. If a sole trader's business fails, the owner could lose not just the capital contributed but also personal assets.

**Unpresented cheques** cheques that have not been cleared by the bank and not yet recorded on a business's bank statement.

## W

**Work in progress** partly finished goods.

**Working capital** the difference between total current assets and current liabilities. The figure (which can be positive or negative) gives some idea of the funds available to run the business on a day-to-day basis.

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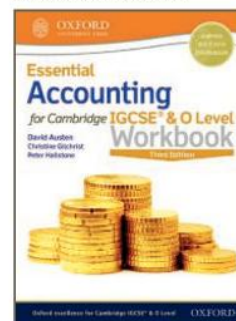
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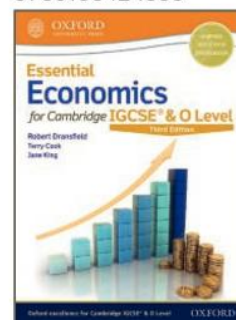
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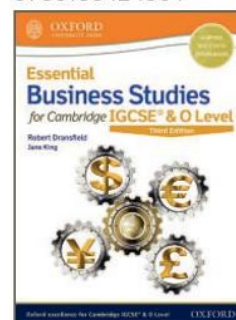
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