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Catherine Coucom

Cambridge IGCSE[®] and O Level

Accounting

Coursebook

Second edition

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Introduction

The aim of this book is to provide an up-to-date text covering the Cambridge IGCSE and O Level Accounting syllabuses (0452 and 7707).

This book covers all the topics included on the latest syllabuses for IGCSE Accounting and O Level Accounting. The topics are not necessarily included in the order in which they appear in the syllabus. They have been presented in what the author's long teaching experience has shown to be a suitable order for an accounting student commencing a course at this level. However, there is some flexibility in the sequence in which the topics are studied. Whichever the order in which the topics are studied, it is essential that the whole of the syllabus is covered. The table on page v shows the chapter(s) of the book in which each section of the syllabus may be found. The learning objectives at the beginning of each chapter are exactly the same as the syllabus topics with the following exceptions. The syllabus topics (4.3) '*prepare ledger accounts and journal entries to record accrued and prepaid expenses*' and '*prepare ledger accounts and journal entries to record accrued and prepaid incomes*' have each been split into two learning objectives across two separate chapters. Chapter 11 contains '*prepare ledger accounts to record accrued and prepaid expenses*' and '*prepare ledger accounts to record accrued and prepaid incomes*.' Chapter 15 contains '*prepare journal entries to record accrued and prepaid expenses*' and '*prepare journal entries to record accrued and prepaid incomes*.'

No prior knowledge of accounting is required as this book provides an introduction to accounting and covers all the topics on the syllabus. Each chapter is complete in itself and contains appropriate walkthroughs. There are also short-answer questions at regular intervals which students can use to test their understanding of each section. There are exam-style questions at the end of each chapter and also at the end of each section. Answers to all questions in this Coursebook are provided on the accompanying Teacher's Resource.

In common with most accounting textbooks, dates used in the examples, walkthroughs and questions throughout this book are expressed as 20–0, 20–1, 20–2, and so on.

Where to find each section of the syllabus

Chapter	Syllabus																						
	1		2			3			4				5					6			7		
	1	2	1	2	3	1	2	3	4	1	2	3	4	5	6	1	2	3	4	5	1	2	
One	✓															✓							
Two		✓																					
Three						✓																	
Four		✓			✓																		
Five					✓																		
Six					✓																		
Seven					✓																		
Eight		✓														✓							
Nine																✓							
Ten										✓				✓								✓	✓
Eleven												✓											
Twelve											✓												
Thirteen													✓										
Fourteen												✓											
Fifteen													✓	✓									
Sixteen															✓								
Seventeen																							✓
Eighteen																				✓			
Nineteen																							
Twenty																							✓
Twenty one																							✓
Twenty two																							✓

How to use this book

The book is designed to be a practical guide to help build knowledge and understanding of accounting terms, principles and procedures and assumes no prior knowledge of the topics. The book is aligned to the syllabus and will enable you to analyse and present information in the appropriate accounting form as well as interpret and evaluate accounting data so you can draw reasoned conclusions.

Each chapter focuses on developing knowledge and understanding using easy-to-follow walkthroughs that explain accounting concepts. Key terms are highlighted and there are regular opportunities to check progress, test understanding and practice accounting skills.

Learning objectives

In this chapter you will learn to:

- understand and explain the difference between book-keeping and accounting 1.1
- state the purposes of measuring business profit and loss 1.1
- explain the role of accounting in providing information for monitoring progress and decision-making 1.1
- explain the meaning of assets, liabilities and owner's equity 1.2
- explain and apply the accounting equation 1.2
- understand that statements of financial position record assets and liabilities on a specified date. 5.5

Learning objectives – Each chapter begins with the key accounting concepts that you will learn to help you navigate your way through the book and remind you what is important about each topic for your revision. The number after each learning objective refers to the topic number in the syllabus.

LINK

You will learn more about double entry book-keeping in Chapter 4.

Link – Links show you where you can find additional information about related topics.

Walkthrough 22.9

Using the financial statements shown in **Walkthrough 22.1**, calculate (to the nearest whole day) Arun's trade payables turnover.

$$\frac{\$12\,500}{\$97\,000} \times \frac{365}{1} = 47.04 \text{ days} = 48 \text{ days}$$

Walkthrough – Walkthroughs guide you step-by-step through different accounting processes, helping to build your knowledge and skills.

TIP

If you know two elements of the accounting equation you can easily calculate the third element.

Tip – Tips provide additional context, reminders and useful information about key points.

KEY TERMS

Carriage is the cost of transporting goods.
Carriage inwards is the cost of bringing the goods to the business and **carriage outwards** is the cost of delivering the goods to the customer.

Key terms – Definitions help you identify and understand important accounting terminology and concepts.

TEST YOURSELF 2.1

- 1 Explain why it is necessary to make a double entry in the ledger for each transaction.
- 2 Explain the use of the folio column in a ledger account.

Test yourself – Test yourself questions aid self-assessment and reinforce knowledge and understanding.

Revision checklist

- A trial balance is a list of the balances on the accounts in the ledger at a certain date.
- A trial balance is prepared to check the arithmetical accuracy of the double entry book-keeping.
- If a trial balance fails to balance, it indicates that an error has been made.
- There are six types of error which are not revealed by a trial balance.

Revision checklist – Checklists at the end of each unit provide a useful summary of the learning points covered.

Exam-style questions

- 1 Which account will appear in the sales ledger?
- A** Dan, a credit supplier **B** Gill, a credit customer
C Sales **D** Sales returns

- 2 Mariam is a trader. On 1 March 20–2 the balances in her cash book were:

Cash	\$100 debit
Bank	\$494 credit

The following transactions took place in March 20–2:

March 4	Paid for repairs to office equipment by cheque, \$293
7	Received a cheque from Nawaz, \$110
11	Purchased motor vehicle paying by credit transfer, \$5 130
13	Took \$1 500 from the bank for personal use
19	Paid \$286 to Anwar by credit transfer
21	Paid office expenses in cash, \$67
27	Cash sales, \$2 150
28	Paid wages in cash, \$953
31	Paid all cash into bank except \$150

- a** Prepare Mariam's cash book for March 20–2. Balance the book and bring down the balances on 1 April 20–2.
- b** Explain the significance of the credit balance on the bank column on 1 March 20–2.
- c** Explain why it is not possible to have a credit balance on the cash column.
- d** Explain the term 'contra'. Illustrate your answer with reference to an appropriate entry in the cash book in **a**.
- 3 Raminder paid a cheque, \$975, to Kumar in full settlement of a debt of \$1 000. How did Kumar record this?

	Debit	\$	Credit	\$
A	bank discount allowed	975 25	Raminder	1 000
B	bank discount received	975 25	Raminder	1 000
C	Raminder	1 000	bank discount allowed	975 25
D	Raminder	1 000	bank discount received	975 25

Exam-style questions – Exam-style questions will help you familiarise yourself with the style of the questions seen in examination, and assess your own understanding and skills to answer them.

Practice questions – Additional questions at the end of each section help to practice both multiple choice and structured questions relating to the section's topics.

Section 4: Practice questions

- 1 A trader's cash book had a credit balance of \$480. On the same date, his bank statement showed a credit balance of \$389. The difference in the balances was caused by bank charges, \$25, which appeared only on the bank statement, and a cheque not yet presented. What was the amount of the unrepresented cheque?
- A** \$66 **B** \$116 **C** \$848 **D** \$894

- 2 Goods returned by Zeena, \$100, were debited to her account as \$1 000. What entries are required to correct this error?

	Account to be debited	\$	Account to be credited	\$
A	suspense	900	Zeena	900
B	suspense	1 100	Zeena	1 100
C	Zeena	900	suspense	900
D	Zeena	1 100	suspense	1 100

- 3 Gary is both a customer and a supplier to Leroy. On 28 June Leroy's account in Gary's purchases ledger had a credit balance of \$275, and his account in Gary's sales ledger had a debit balance of \$140. A contra entry was made to set the balance of one account against the balance of the other account. What entry will be made in the control accounts prepared on 30 June?

	Debited	\$	Credited	\$
A	purchases ledger control account	135	sales ledger control account	135
B	purchases ledger control account	140	sales ledger control account	140
C	sales ledger control account	135	purchases ledger control account	135
D	sales ledger control account	140	purchases ledger control account	140

- 4 A sports club provided the following information at the end of its first financial year:

	\$
Subscriptions received for the current year	9 750
Subscriptions received in advance for the following year	150
Expenses of sports competition	2 040
Rates and insurance	1 986
General expenses	787
General expenses accrued at the end of the year	103
Balance at bank at the end of the year	7 403
Receipts from sports competition entry fees	?

How much was received from the sports competition entry fees?

- A** \$2 316 **B** \$2 466 **C** \$3 103 **D** \$3 253

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Section 1

Chapter 1

Introduction to accounting

Learning objectives

In this chapter you will learn to:

- understand and explain the difference between book-keeping and accounting 1.1
- state the purposes of measuring business profit and loss 1.1
- explain the role of accounting in providing information for monitoring progress and decision-making 1.1
- explain the meaning of assets, liabilities and owner's equity 1.2
- explain and apply the accounting equation 1.2
- understand that statements of financial position record assets and liabilities on a specified date. 5.5

1.1 Introduction

Accounting is regarded as the language of business. Accounting can be divided into two sections:

Book-keeping

Book-keeping is a process of **detailed recording of all the financial transactions of a business**. It is necessary for even the smallest business to make a record of every transaction which affects the business. If the records are not maintained, it is likely that something will be forgotten or overlooked. The basis of maintaining these detailed records is **double entry book-keeping**. The actual records maintained by one business may vary from those maintained by another business because each business is different. However, all businesses apply the same principles while maintaining double entry records.

Accounting

Accounting uses the book-keeping records to prepare financial statements at regular intervals. The owner of a business needs to know whether the business is making a profit or a loss. Periodically (often at yearly intervals), an **income statement** is drawn up. This shows the calculation of the profit or loss earned by the business. If the business has earned a profit then the owner is receiving a return on his investment and funds are available for expanding or improving the business. However, if the business has made a loss then it may eventually close down as the owner is not receiving any return on his investment and funds are not available for running or maintaining the business.

You can now answer Question 1 at the end of this chapter.

The owner of the business also needs to know the financial position at regular intervals so a **statement of financial position** is prepared. This shows what the business owns and what is owing to it, its **assets**; and what the business owes, its **liabilities**. The term **financial statements** is often used as a collective name for an income statement and a statement of financial position.

The progress of the business can be measured by comparing the financial statements of one year with those of previous years, or with those of other similar businesses. The calculation of various accounting ratios is used to measure the relationship between figures within a set of financial statements. These are also useful for comparison purposes.

The information provided by the financial statements shows the owner of the business what has happened during a certain period of time and helps in monitoring the progress of the business. The plans for the future development of the business are also based on these financial statements.

TEST YOURSELF 1.1

- 1 Define the term book-keeping.
- 2 Define the term accounting.
- 3 State **two** reasons why it is necessary to prepare financial statements at regular intervals.
- 4 State what is included in the term financial statements.



KEY TERMS

Book-keeping is the detailed recording of all the financial transactions of a business.

Accounting is using book-keeping records to prepare financial statements and to assist in decision-making.

A **statement of financial position** shows the assets and liabilities of a business on a certain date.



LINK

You will learn more about financial statements in Chapters 8 and 9.



LINK

You will learn more about assets and liabilities in Chapter 9.



KEY TERMS

Capital is the total resources provided by the owner and represents what the business owes the owner.

Assets represent anything owed by or owing to the business.

Liabilities represent anything owed by the business.

1.2 Assets, liabilities and capital

It is important to remember that the accounting records of a business relate only to the business. From an accounting viewpoint, the owner of that business is regarded as being completely separate from the business.

When a person decides to start a business he will have to provide the necessary funds (resources). This is often in the form of monetary funds, but may consist of buildings, motors, goods and so on. Any resources provided by the owner of the business are known as **capital**. This represents the amount owed by the business to the owner of that business.

Once the business is formed and capital introduced, the business will own the money or other items provided by the owner. Things owned by the business (or owed to the business) are regarded as the resources of the business or the **assets** of the business.

In addition to the owner, other people may also provide assets to the business. The amount owed by the business to these people is known as **liabilities**.



TIP

Anything provided for a business by the owner represents capital. This is not necessarily in the form of money.

Many businesses are set up and operated by one person. These are known as **sole traders**. The early chapters in this book cover accounts maintained by sole traders.



LINK

You will learn about the accounting records of partnerships and limited companies in Chapters 19 and 21.

TEST YOURSELF 1.2

- 1 Define **each** of the following terms.
a assets **b** liabilities **c** capital

1.3 The accounting equation

Like any other mathematical equation, the two sides of the equation will always be equal. The formula for this equation is:

$$\text{Assets} = \text{Capital} + \text{Liabilities.}$$

Capital is sometimes referred to as **owner's equity**. So the previous equation can also be written as:

$$\text{Assets} = \text{Owner's equity} + \text{Liabilities.}$$

Like any mathematical equation, the accounting equation can be used to find any one of the three elements if the other two are present.

This equation illustrates that the assets of a business (the resources used by a business) are always equal to the liabilities and capital of a business (the resources provided for the business by others). The assets represent how the resources are used by the business and the liabilities and capital represent where these resources come from.



TIP

If you know two elements of the accounting equation you can easily calculate the third element.

Walkthrough 1.1

20–7

- January 1 Leena set up a business to trade under the name of The Dress Shop. She opened a business bank account and paid in \$20 000 as capital.
- 2 The business purchased premises, \$15 000, and paid by cheque.
- 3 The business purchased goods, \$3 000, on credit.
- 4 The business sold goods, at the cost price of \$1 000, on credit.

Show the accounting equation after **each** of the above transactions.

Date	Assets	=	Capital	+	Liabilities
1 January	Bank \$20 000		<u>\$20 000</u>		Nil
2 January	Premises 15 000 Bank 5 000 \$20 000		<u>\$20 000</u>		Nil
3 January	Premises 15 000 Inventory 3 000 Bank 5 000 \$23 000		<u>\$20 000</u>		Trade payable <u>\$3 000</u>
4 January	Premises 15 000 Inventory 2 000 Trade receivable 1 000 Bank 5 000 \$23 000		<u>\$20 000</u>		Trade payable <u>\$3 000</u>

- 1 January The assets of the business are equal to the capital of the business.
- 2 January The money in the bank has decreased because a new asset has been bought. The total assets are equal to the capital.
- 3 January Purchasing on credit means that the business does not pay immediately. A new asset **inventory** has been acquired, but the business has also acquired a liability as it owes money to the supplier (who is known as a **creditor**). In a statement of financial position this is described as a **trade payable**. The total assets are equal to the capital plus the liabilities.
- 4 January Selling on credit means that the business does not immediately receive the money. The inventory has decreased but a new asset has been acquired in the form of money owing to the business by a customer (who is known as a **debtor**). In a statement of financial position this is described as a **trade receivable**. The total assets are equal to the capital plus the liabilities. (For the sake of simplicity, the goods were sold to the customer at cost price. In practice, they need to be sold at a price above cost price to enable the business to make a profit.)



LINK

You will learn more about buying and selling on credit in Chapter 2.



KEY TERMS

Inventory is the goods a business has available for resale.

Trade payables represent the amount the business owes to the credit suppliers of goods (the trade creditors).

Trade receivables represent the amount owed to the business by its credit customers (the trade debtors).

TEST YOURSELF 1.3

1 Fill in the missing figures in the following table.

	Assets	Capital	Liabilities
	\$	\$	\$
a	35 000	?	12 500
b	?	44 400	19 300
c	67 300	55 000	?

You can now answer Question 2 at the end of this chapter.

1.4 The statement of financial position

The accounting equation may be shown in the form of a statement of financial position. This shows the three elements of the accounting equation – the assets, the capital and the liabilities. The statement of financial position will be affected every time the business makes changes to the assets, liabilities or capital.

Walkthrough 1.2

Prepare the statement of financial position of The Dress Shop after **each** of the transactions shown in Walkthrough 1.1.

The Dress Shop			
Statement of financial position at 1 January 20–7			
Assets	\$	Liabilities	\$
Bank	20 000	Capital	20 000
	<u>20 000</u>		<u>20 000</u>

The Dress Shop			
Statement of financial position at 2 January 20–7			
Assets	\$	Liabilities	\$
Premises	15 000	Capital	20 000
Bank	5 000		
	<u>20 000</u>		<u>20 000</u>

The Dress Shop			
Statement of financial position at 3 January 20–7			
Assets	\$	Liabilities	\$
Premises	15 000	Capital	20 000
Inventory	3 000	Trade payable	3 000
Bank	5 000		
	<u>23 000</u>		<u>23 000</u>

The Dress Shop
Statement of financial position at 4 January 20–7

Assets	\$	Liabilities	\$
Premises	15 000	Capital	20 000
Inventory	2 000	Trade payable	3 000
Trade receivable	1 000		
Bank	5 000		
	23 000		23 000

TEST YOURSELF 1.4

- 1 Give **two** examples of **each** of the following (excluding those shown in **Walkthrough 1.1** and **1.2**):
 - a asset
 - b liability.
- 2 Explain the meaning of **each** of the following terms:
 - a trade payable
 - b trade receivable

The statements of financial position shown in **Walkthrough 1.2** were presented in a horizontal format. There are different ways to present a statement of financial position and these are explained in Chapter 9. A statement of financial position is also more useful if the assets and liabilities are divided into different types (see Chapter 9).

Walkthrough 1.1 showed that every single transaction involves a change to the assets and/or the liabilities and/or the capital. This means that it is necessary to prepare a statement of financial position after every single transaction, as shown in **Walkthrough 1.2**. However, this is not possible in practice as many transactions can take place every hour of each working day. In practice, the day-to-day business transactions are recorded using **double entry book-keeping** and a statement of financial position is prepared only periodically. This is usually done at the closing of a business on the last day of the financial year as part of the **financial statements**. As the business can be started on any day of the year, its financial year may not necessarily match the calendar year (i.e. from 1 January to 31 December). The financial statements are prepared for 12 month periods from the date the business started.

You can now answer Questions 3–6 at the end of this chapter.



LINK

You will learn more about statements of financial position in Chapter 9.



TIP

The totals of a statement of financial position must always agree: if they do not you know that there is an error.



LINK

You will learn more about double entry book-keeping in Chapters 2 and 4.

Revision checklist

- Book-keeping is the detailed recording of all the financial transactions of a business. Accounting uses these book-keeping records to prepare financial statements.
- It is necessary to prepare financial statements to show the profit or loss of the business and the financial position of the business and to help in decision-making.
- The accounting equation shows that the assets are always equal to the capital plus the liabilities of the business.
- A statement of financial position shows the assets and liabilities of a business on a certain date.

Exam-style questions

- 1** Which task is performed by a book-keeper?
- A** analysing the trading results
 - B** entering transactions in the ledger
 - C** preparing year-end financial statements
 - D** providing information for decision-making

- 2** A trader provided the following information:

	\$
Premises	180 000
Inventory	23 420
Trade payables	26 180
Trade receivables	21 710
Office fixtures and fittings	32 600
Loan from bank	80 000
Cash at bank	2 550
Motor vehicles	15 900

- a** Calculate the value of the assets.
 - b** Calculate the value of the liabilities.
 - c** Use the accounting equation to calculate the trader's capital.
- 3** What is a statement of financial position?
- A** a calculation of the amount owed to the owner of the business
 - B** a list of assets and liabilities of a business on a certain date
 - C** a list of everything owned by and owed to a business
 - D** a summary of money paid to and received by a business
- 4** A business had \$9 420 in its bank account. The following transactions took place:

	\$
Bought goods on credit	250
Sold goods on credit	1 100
Repaid a loan by cheque	5 000

How much was there in the bank after these transactions?

- A** \$3 570 **B** \$4 420 **C** \$4 670 **D** \$5 270

- 5 Complete the following table to show the effect of each of the following transactions. The first one has been completed as an example.

- a Bought a motor vehicle and paid by cheque
- b Bought goods on credit from a credit supplier
- c Received a cheque from a credit customer
- d Sold goods on credit
- e Paid off a loan in cash

	Effect on assets	\$	Effect on liabilities	\$
a	Motor vehicles Bank	Increase Decrease	No effect	
b				
c				
d				
e				

- 6 The statement of financial position of Bharwani Traders on 31 October 20–4 is shown below.

Bharwani Traders			
Statement of financial position at 31 October 20–4			
Assets	\$	Liabilities	\$
Machinery	19 000	Capital	35 000
Motor vehicles	6 000	Trade payables	8 000
Inventory	4 900		
Trade receivables	3 000		
Bank	<u>10 100</u>		
	<u>43 000</u>		<u>43 000</u>

On 1 November 20–4 the following transactions took place:

A cheque for \$3 000 was paid to a credit supplier.

A credit customer paid \$500 in cash.

A loan for \$8 000, which was paid into the bank, was received from Lenders Limited.

A cheque for \$7 000 was paid for an additional machine.

Prepare the statement of financial position of Bharwani Traders on 1 November 20–4 after the above transactions have taken place.

Chapter 2

Double entry book-keeping – Part A

Learning objectives

In this chapter you will learn to:

- outline the double entry system of book-keeping 2.1
- process accounting data using the double entry system 2.1
- prepare ledger accounts 2.1
- post transactions to the ledger accounts 2.1
- balance ledger accounts as required 2.1
- interpret ledger accounts and their balances. 2.1

2.1 Introduction

A business would find it impossible to prepare a statement of financial position after every single transaction. The day-to-day transactions are recorded in the books of a business using the **double entry system of book-keeping**. The term **double entry** is used because the two effects of a transaction (a **giving** and a **receiving**) are both recorded in the ledger.

A business maintains a separate ledger account for each type of asset, expense, liability and income and also for each individual debtor and creditor. Every transaction is recorded in the ledger account relating to that particular item or person.

A **ledger** is traditionally a bound book where each account appears on a separate page. Over the years, the ledger has developed into a looseleaf folder with separate sheets, each containing a ledger account. Recent developments have seen the introduction of a computer file divided into separate ledger accounts.

The layout of a ledger account is as follows:

Account name							
Debit				Credit			
Date	Details	Folio	\$	Date	Details	Folio	\$

Ledger accounts are divided into two sections, this can be shown by a central vertical line, in this text book the central vertical line is not shown. The left-hand-side is known as the **debit** side and the right-hand-side is known as the **credit** side. The term debit is usually abbreviated to '**dr**' and the term credit is usually abbreviated to '**cr**'. On either side of the account there are columns to record the date, details and amount of each transaction.

A folio number column is used for reference purposes. The use of folio numbers is not required when answering questions. However, folio numbers have been included in examples present up to Chapter 7 so that you can appreciate their use and purpose.

In order to record the two aspects of every transaction, every transaction is entered twice – on the debit side of one account and on the credit side of another account. The account which is receiving or gaining the value is debited and the account which is giving the value is credited.

Walkthrough 2.1

20–7

- January 1 Ajay began business. He opened a business bank account and invested \$80 000 as capital **a**
- 2 Fixtures and equipment costing \$30 000 were bought and paid for by cheque **b**

Enter these transactions in Ajay's ledger.



KEY TERM

Double entry book-keeping is the process of making a debit entry and a credit entry for each transaction.



TIP

The debit side of a ledger account is the side which is receiving or gaining value and the credit side of a ledger account is the side which is giving value.

Ajay							
Bank account							
				Page 1			
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Jan 1 a	Capital	2	80 000	Jan 2 b	Fixtures and equipment	3	30 000

Capital account							
				Page 2			
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 1 a	Bank	1	80 000

Fixtures and equipment account							
				Page 3			
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 2 b	Bank	1	30 000				

- The first transaction **a** is debited in the bank account, as this is the account which is receiving the money, and credited in the capital account, as this is where the money is coming from.
- The second transaction **b** is debited in the fixtures and equipment, to show the value being received, and credited in the bank account, as this is where the money is coming from.
- In each transaction, the details column shows the name of the account in which the other half of the double entry is made.
- The folio number is used for reference purposes and shows the page of the ledger on which the account named in the details column appears.

It is important that a double entry is made for every transaction.

In practice, the information entered in the accounting records is obtained from business documents.

In practice, each ledger account has its own page or sheet.

**TIP**

It is important to ensure that every transaction is entered twice, once on the debit side and once on the credit side.

**LINK**

You will learn more about business documents in Chapter 6.

TEST YOURSELF 2.1

- 1 Explain why it is necessary to make a double entry in the ledger for each transaction.
- 2 Explain the use of the folio column in a ledger account.

2.2 Double entry records for assets and liabilities

A ledger account is opened for each type of asset and liability. Applying the double entry principles, every transaction is entered twice. The account which is receiving the money is debited and the account which is giving the money is credited.

Walkthrough 2.2

20–7

- January 1 Ajay began business. He opened a business bank account and invested \$80 000 as capital
- 2 Fixtures and equipment costing \$30 000 were bought and paid for by cheque
 - 3 A short-term loan of \$10 000 was received from AB Loans
 - 5 A motor vehicle costing \$9 000 was bought and paid for by cheque
 - 6 A long-term loan of \$5 000 was received from Ajay's sister Mallika

Enter these transactions in Ajay's ledger.

Ajay Bank account								Page 1
Date	Details	Folio	\$	Date	Details	Folio	\$	
20–7				20–7				
Jan 1	Capital	2	80 000	Jan 2	Fixtures and equipment	3	30 000	
	3 AB Loans	4	10 000		5 Motor vehicles	5	9 000	
	6 Mallika loan	6	5 000					

Capital account								Page 2
Date	Details	Folio	\$	Date	Details	Folio	\$	
				20–7				
				Jan 1	Bank	1	80 000	

Fixtures and equipment account								Page 3
Date	Details	Folio	\$	Date	Details	Folio	\$	
20–7								
Jan 2	Bank	1	30 000					

AB Loans account							Page 4
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 3	Bank	1	10 000

Motor vehicles account							Page 5
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
Jan 5	Bank	1	9 000				

Mallika loan account							Page 6
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 6	Bank	1	5 000

2.3 Double entry records for expenses and income

A ledger account is opened for each type of expense and income. The same double entry principles applied to assets and liabilities are applied to expenses and income. The account which is receiving the money is debited and the account which is giving the money is credited.

Walkthrough 2.3

20-7

- January
- 1 Ajay began business with a capital of \$80 000 in the business bank account
 - 1 He paid rent of premises, \$400, by cheque
 - 2 Fixtures and equipment costing \$30 000 were bought and paid for by cheque
 - 3 He paid insurance, \$250, by cheque
 - 3 A short-term loan of \$10 000 was received from AB Loans
 - 5 A motor vehicle costing \$9 000 was bought and paid for by cheque
 - 5 He paid motor expenses, \$50, by cheque
 - 6 A long-term loan of \$5 000 was received from Ajay's sister Mallika
 - 7 Part of the premises were rented out to another business and a cheque for \$95 was received

Enter these transactions in Ajay's ledger.

Ajay							
Bank account							
							Page 1
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Jan 1	Capital	2	80 000	Jan 1	Rent payable	7	400
3	AB Loans	4	10 000	2	Fixtures and equipment	3	30 000
6	Mallika loan	6	5 000	3	Insurance	8	250
7	Rent receivable	10	95	5	Motor vehicles	5	9 000
					Motor expenses	9	50

Capital account							
							Page 2
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 1	Bank	1	80 000

Fixtures and equipment account							
							Page 3
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 2	Bank	1	30 000				

AB Loans account							
							Page 4
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 3	Bank	1	10 000

Motor vehicles account							
							Page 5
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 5	Bank	1	9 000				

Mallika loan account							
							Page 6
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 6	Bank	1	5 000

Rent payable account							Page 7
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 1	Bank	1	400				

Insurance account							Page 8
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 3	Bank	1	250				

Motor expenses account							Page 9
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 5	Bank	1	50				

Rent receivable account							Page 10
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 7	Bank	1	95

- The motor expenses such as fuel and repairs are shown in an expense account as they do not increase the value of the motor vehicle.
- The rent received from a tenant is shown in an income account and is kept separate from the expense of rent payable.
- No lines are left blank in the middle of ledger accounts as each entry is made on the next available line.
- In practice, for ease of reference, accounts of the same type (e.g. assets, expenses and so on) are kept in the same area of the ledger.

**TIP**

When an item such as rent is both paid and received by a business, separate accounts are maintained, one for rent payable and one for rent receivable.

TEST YOURSELF 2.2

- For **each** of the following transactions, state the name of the account which will be debited and the name of the account which will be credited.
 - Paid rates by cheque
 - Bought machinery and paid by cheque
 - Received commission by cheque for work done for another business
 - Repaid, by cheque, money borrowed from XYZ Loan Co

2.4 Double entry records for drawings

Whenever the owner of a business takes value from the business for his/her own use this is known as **drawings**. This value may be in the form of money, non-current assets or goods from the inventory held by the business. It is usual to open a **drawings account** to record these values so that the capital account does not have a large number of entries.

Any drawings are debited in the drawings account to show the value going into that account. The credit entry will be in the account giving the value. When money is withdrawn, either the cash or bank account will be credited. When a non-current asset is withdrawn, the appropriate non-current asset account will be credited. When goods are withdrawn, the purchases account will be credited. This is because these goods were originally purchased for resale and the amount of goods available for resale is reduced when goods are taken by the owner.

At the end of the financial year, the total of the drawings account is transferred to the capital account. This reduces the amount owed by the business to the owner of the business.



KEY TERMS

Drawings represent any value taken from the business by the owner of that business.

A **balance** on a ledger account is the difference between the debit side and the credit side.

TEST YOURSELF 2.3

- 1 For **each** of the following transactions, state the name of the account which will be debited and the name of the account which will be credited.
 - a The owner of a business invested more money in the business.
 - b The owner of a business took an unused motor vehicle for personal use.
 - c The owner of a business took goods for personal use.

2.5 Balancing ledger accounts

At the end of each month, it is usual to **balance** any account of assets and liabilities which contain more than one entry. The **balance is the difference between the two sides of the account** and represents the amount which is left in that account.

The steps necessary to balance a ledger account are summarised as follows:

- On a calculator or a separate sheet of paper, add up each side of the account and find the difference between the two sides.
- Enter this difference on the next available line on the side which is the smaller in money. Enter the date (usually the last day of the month) in the date column and the word 'balance' in the details column. It is usual to insert 'c/d' in the folio column. This is the abbreviation for 'carried down' and indicates where the double entry for this item will be made.
- Total each side of the account. This is done by drawing total lines and inserting the figure between these lines. It is usual to show a single line above the total and either a single or a double line below the total. The totals of an account must be on the same level and must be the same figure.
- Make the double entry for the balance carried down. On the line below the totals, write the amount of the balance on the opposite side to where the words 'Balance c/d' were written. Enter the date (usually the first day of the next month) in the date column and the word 'balance' in the details column. It is usual to insert 'b/d' in the folio column. This is the abbreviation for 'brought down' and indicates where the double entry for this item was made.



TIP

When balancing an account, add up each side of the account and find the difference between them before drawing total lines and before writing the word 'balance'.

Walkthrough 2.4

The bank account prepared in **Walkthrough 2.3** shows the entries made by Ajay during the first week of trading. Balance the bank account in Ajay's books on 7 January 20–7.

Ajay							
Bank account							
Page 1							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7				20–7			
Jan 1	Capital	2	80 000	Jan 1	Rent payable	7	400
3	AB Loans	4	10 000	2	Fixtures and equipment	3	30 000
6	Mallika loan	6	5 000	3	Insurance	8	250
7	Rent receivable	10	95	5	Motor vehicles	5	9 000
					Motor expenses	9	50
				7	Balance	c/d	55 395
			<u>95 095</u>				<u>95 095</u>
20–7							
Jan 8	Balance	b/d	55 395				

You can now answer Question 1 at the end of this chapter.

2.6 Double entry records for sales, purchases and returns

It is necessary to open an account to record goods which are purchased for resale and also an account to record goods which are sold by the business. Whilst these are actually the same goods coming into the business and going out of the business, it is necessary to record them in separate accounts as the purchases will be at cost price and the sales at selling price. A **purchases account** and a **sales account** are used rather than a goods account. An **inventory account** is only used to record the goods left at the end of the financial year and not for day-to-day transactions.

The same double entry principles applied to assets and liabilities are applied to purchases, sales and returns.

Purchases

a Goods purchased for cash or cheque

Whenever goods are purchased, the purchases account will be debited as the goods are coming into the business and the purchases account is receiving that value. The double entry will be a credit in either the cash account or the bank account depending on whether the amount was paid in cash or by cheque.

b Goods purchased on credit

It is common for businesses to buy on credit and pay for the goods at a later date rather than at the time of purchase. The purchases account will be debited in the usual way.

The credit entry will be made in the account of the supplier of the goods to show the value coming from that person. The supplier of goods is known as a **trade creditor**.

When payment is made to the supplier, the bank or cash account will be credited (to show value going out of that account) and the account of the supplier will be debited (to show value going into that account).

Walkthrough 2.5

20–7

- January 9 Ajay bought goods, \$650, on credit from Kolkata & Co
 10 Ajay bought goods, \$150, and paid by cheque
 13 Ajay paid the amount owing to Kolkata & Co by cheque

Enter these transactions in Ajay's ledger.

Ajay Bank account								Page 1
Date	Details	Folio	\$	Date	Details	Folio	\$	
20–7								
Jan 10	Purchases	11	150					
	13 Kolkata & Co	12	650					

Purchases account								Page 11
Date	Details	Folio	\$	Date	Details	Folio	\$	
20–7								
Jan 9	Kolkata & Co	12	650					
10	Bank	1	150					

Kolkata & Co account								Page 12
Date	Details	Folio	\$	Date	Details	Folio	\$	
20–7								
Jan 13	Bank	1	<u>650</u>	Jan 9	Purchases	11	<u>650</u>	
			<u>650</u>				<u>650</u>	

- The account of Kolkata & Co is 'in balance' as both sides equal \$650. The account has been totalled to indicate that the account is now closed.
- It is not necessary to write the month against each transaction, only when it is the first entry for the month.
- If there is more than one entry on the same side of an account on the same date, it is not necessary to write the day of the month each time.



TIP

Only goods bought for resale are entered in the purchases account.

Sales

a Goods sold for cash or cheque

Whenever goods are sold, the sales account will be credited as the goods are going out of the business and the sales account is giving out that value. The double entry will be a debit in either the cash account or the bank account depending on whether the amount was received in cash or by cheque.

b Goods sold on credit

Just as a business may purchase goods and pay for them at a later date, it may also sell goods on credit. The sales account will be credited in the usual way. The debit entry will be made in the account of the customer to whom the goods were sold to show the value going to that person. The customer who bought the goods on credit is known as a **trade debtor**. When payment is received from the debtor, the bank or cash account will be debited (to show value coming into that account) and the account of the debtor will be credited (to show value going out of that account).

Walkthrough 2.6

20–7

- January 16 Ajay sold goods, \$175, for cash
 17 Ajay sold goods, \$770, on credit to Prerna
 20 Prerna gave Ajay a cheque for \$500 on account

Enter these transactions in Ajay's ledger.

Ajay							
Bank account							
							Page 1
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7							
Jan 20	Prerna	15	500				

Cash account							
							Page 13
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7							
Jan 16	Sales	14	175				

Sales account							
							Page 14
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7							
				Jan 16	Cash	13	175
				17	Prerna	15	770

Prerna account							Page 15
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7				20–7			
Jan 17	Sales	14	770	Jan 20	Bank	1	500
				20	Balance	c/d	<u>270</u>
			<u>770</u>				<u>770</u>
20–7							
Jan 21	Balance	b/d	270				

- The term 'on account' indicates that only part of the amount outstanding is being paid. The remainder will be paid at a later date.
- Prerna's account has been balanced following the stages mentioned previously in this chapter (though this is usually done at the end of the month).
- On 21 January, Prerna is Ajay's debtor as an amount of \$270 is owing to Ajay.

**TIP**

When goods (originally purchased for resale) are sold they are recorded in the sales account.

Returns

Sometimes goods which have been purchased have to be returned to the supplier. They may be faulty, damaged or not what was ordered. These goods are known as **purchases returns** or **returns outward**. A special account known as a purchases returns account (or returns outward account) is opened and any returns are credited to this account to show the value going out. The debit entry will be made in the account of the supplier to whom the goods are being returned (to show the value going to that person).

Similarly, a customer may return goods to the business. These goods are known as **sales returns** or **returns inwards**. An account known as the sales returns account (or returns inwards account) is opened and any returns are debited to this account to show the value coming in. The credit entry will be made in the account of the customer who returned the goods (to show the value coming from that person).

Walkthrough 2.7

20–7

- January
- 21 Ajay sold goods, \$245, on credit to Xavier Traders
 - 22 Xavier Traders returned damaged goods, \$55, to Ajay
 - 23 Ajay purchased goods, \$820, on credit from Varun
 - 25 Xavier Traders paid their account by cheque
 - 27 Ajay returned faulty goods, \$44, to Varun
 - 30 Ajay gave Varun a cheque for \$700 on account

Enter these transactions in Ajay's ledger.

Ajay							
Bank account							
Page 1							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Jan 25	Xavier Traders	16	190	Jan 30	Varun	18	700

Purchases account							
Page 11							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 23	Varun	18	820				

Sales account							
Page 14							
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 21	Xavier Traders	16	245

Xavier Traders account							
Page 16							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Jan 21	Sales	14	245	Jan 22	Sales returns	17	55
				25	Bank	1	190
			<u>245</u>				<u>245</u>

Sales returns account							
Page 17							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 22	Xavier Traders	16	55				

Varun account							Page 18
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Jan 27	Purchases returns	19	44	Jan 23	Purchases	11	820
30	Bank	1	700				
31	Balance	c/d	76				
			<u>820</u>				<u>820</u>
				20-7			
				Jan 21	Balance	b/d	76

Purchases returns account							Page 19
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-7			
				Jan 27	Varun	18	44

You can now answer Questions 2–4 at the end of this chapter.

2.7 Double entry records for carriage inwards and carriage outwards

The term **carriage** refers to the **cost of carrying or transporting goods**. **Carriage inwards** is part of the cost of purchasing goods as it occurs when a business has to pay for goods it has purchased to be delivered to its premises. **Carriage outwards** is a selling expense as it occurs when a business pays for goods to be delivered to the customer's premises. It is important that these two expenses are treated separately in the accounts.

Applying the double entry principle to carriage inwards, the carriage inwards account is debited as this is the account receiving the money and the cash account (or the bank account if the money is paid by cheque) is credited as the money is coming from this account. Similarly, if the payment relates to carriage outwards, the cash account or bank account is credited and the carriage outwards account is debited.

If the carriage is not actually paid for at the time, the account of the supplier of the carriage service will be credited instead of the cash account or bank account.

TEST YOURSELF 2.4

- 1 Explain how to balance a ledger account.
- 2 Explain the meaning of the term credit purchases.
- 3 State **two** reasons why it may be necessary to return goods to a supplier.
- 4 State an alternative name for sales returns.
- 5 Explain the difference between carriage inwards and carriage outwards.

You can now answer Question 5 at the end of this chapter.



KEY TERMS

Carriage is the cost of transporting goods.

Carriage inwards is the cost of bringing the goods to the business and **carriage outwards** is the cost of delivering the goods to the customer.



LINK

You will learn more about double entry book-keeping in Chapter 4.

2.8 Three column running balance accounts

The ledger accounts presented so far have been in the traditional form. This form is also known as the 'T' account format.

There is another method of presenting ledger accounts which is commonly used on computer-generated accounts which is known as the three column running balance format. This form of presentation uses only one column each for the date, details and folio and has three money columns side-by-side – one for debit, one for credit and one for balance after each transaction. The layout of a ledger account using this format is as follows:

Date	Details	Folio	Debit \$	Credit \$	Balance \$
------	---------	-------	-------------	--------------	---------------

The advantage of this method is that it shows the balance of the account after every transaction. When the accounts are prepared manually, it involves extra calculations which may lead to errors.

Walkthrough 2.8

20–7

- January 1 Ajay began business. He opened a business bank account and invested \$80 000 as capital
- 1 Paid rent of premises, \$400, by cheque
 - 2 Fixtures and equipment costing \$30 000 were bought and paid for by cheque
 - 3 Paid insurance, \$250, by cheque
 - 3 A short-term loan of \$10 000 was received from AB Loans
 - 5 A motor vehicle costing \$9 000 was bought and paid for by cheque
 - 5 Paid motor expenses, \$50, by cheque
 - 6 A long-term loan of \$5 000 was received from Ajay's sister Mallika
 - 7 Part of the premises were rented out to another business and a cheque for \$95 was received

Enter these transactions in the bank account in Ajay's ledger using the three column running balance format.

Ajay Bank account						Page 1
Date	Details	Folio	Debit \$	Credit \$	Balance \$	
20-7						
Jan 1	Capital		80 000		80 000	dr
	Rent payable			400	79 600	dr
2	Fixtures and equipment			30 000	49 600	dr
3	Insurance			250	49 350	dr
	AB Loans		10 000		59 350	dr
5	Motor vehicles			9 000	50 350	dr
	Motor expenses			50	50 300	dr
6	Mallika loan		5 000		55 300	dr
7	Rent receivable		95		55 395	dr

- It is common for the abbreviation 'dr' or 'cr' to appear after the figure in the balance column to indicate the nature of the balance.

2.9 Interpreting ledger accounts and their balances

It is necessary to be able to understand the entries made in a ledger account and to be able to explain those entries.

Walkthrough 2.9

The following account appeared in the ledger of Ajay.

Ajay Xavier Traders account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Mar 1	Balance	b/d	122	Mar 9	Cash		122
8	Sales		650	12	Returns		98
20	Sales		820	29	Bank		550
				31	Balance	c/d	822
			<u>1 592</u>				<u>1 592</u>

Explain each entry in the account of Xavier Traders and state where the double entry for each item will be found.

- March 1 Xavier Traders owe Ajay \$122 for goods supplied on credit in previous months
Double entry: Xavier Traders account for February 20-7 credit side
- 8 Ajay sold goods on credit to Xavier Traders, \$650
Double entry: Sales account credit side

- 9 Ajay received cash, \$122, from Xavier Traders
Double entry: Cash account debit side
- 12 Xavier Traders returned goods, \$98, to Ajay
Double entry: Sales returns account debit side
- 20 Ajay sold goods on credit to Xavier Traders, \$820
Double entry: Sales account credit side
- 29 Xavier Traders paid Ajay \$550 by cheque (or by bank transfer)
Double entry: Bank account debit side
- 31 Xavier Traders owe Ajay \$822
Double entry: Xavier Traders account for April 20–7 on the debit side

You can now answer Question 6 at the end of this chapter.

As students often find the traditional form of ledger accounts easier to understand, the 'T' format is used in all ledger accounts throughout this book. However, either form of presentation is acceptable.

Revision checklist

- Every transaction must be entered twice – on the debit side of one account and on the credit side of another account.
- The debit entry is made in the account which is receiving the value and the credit entry is made in the account which is giving the value.
- Each type of asset, liability, expense and income has its own ledger account.
- Any value taken from the business by the owner of the business is known as drawings.
- At the end of the period, the accounts of assets and liabilities which contain more than one entry should be balanced.
- The entries for purchases and sales, and purchases returns and sales returns, are recorded in separate accounts.
- Carriage is the cost of transporting goods.

Exam-style questions

- 1 Mahela is a trader. He took goods costing \$100 for his own use.
How would Mahela record this in his ledger?

	Account to be debited	Account to be credited
A	drawings	inventory
B	drawings	purchases
C	inventory	drawings
D	purchases	drawings

- 2 Jaswant purchased goods from Ali and paid in cash.
Which entries would Ali make in his ledger?

	Account to be debited	Account to be credited
A	cash	sales
B	Jaswant	sales
C	sales	Jaswant
D	sales	cash

- 3 Dinesh returned goods to his credit supplier, Thisara.
How would Dinesh record this in his ledger?

	Account to be debited	Account to be credited
A	sales returns	Thisara
B	purchases returns	Thisara
C	Thisara	sales returns
D	Thisara	purchases returns

- 4 On 1 July 20–6 Mumtaz started a business. The following are her transactions for the first two weeks of trading:

- July 1 Mumtaz paid capital, \$50 000, into the business bank account
- 2 Bought premises, \$25 000, and paid by cheque
- 4 Bought equipment, \$4 000, and paid by cheque
- 6 Bought goods, \$1 500, on credit from Mayur Vihar Traders
- 7 Paid advertising expenses, \$60, by cheque
- 9 Sold goods, \$200, and received a cheque

- 12 Sold goods, \$310, on credit, to Ridhima
- 13 Ridhima returned damaged goods, \$20
- 14 Paid \$1 000 by cheque on account to Mayur Vihar Traders

Enter these transactions in the ledger of Mumtaz. Balance the bank account and the accounts of Mayur Vihar Traders and Ridhima on 14 July and bring down the balances on 15 July 20–6.

- 5** Katie is a trader. On 1 October 20–4 she had the following balances in her ledger:

	\$	
Capital	15 000	
Inventory	3 400	
Fixtures and fittings	10 100	
Trade receivable – Daisy	1 110	
Trade payable – Zara	1 760	
Loan from AB Finance	2 000	
Bank	4 150	debit

- a** Enter these balances in the appropriate accounts.

The following transactions took place in October 20–4:

- | | | |
|---------|----|---|
| October | 2 | Bought goods on credit from Zara, \$1 500 |
| | 7 | Returned goods to Zara, \$80 |
| | 10 | Repaid the loan by cheque |
| | 14 | Paid Zara a cheque for the amount owing on 1 October 20–4 |
| | 21 | Cash received from sales of goods, paid directly into the bank, \$940 |
| | 28 | Katie took goods for her own use, \$140 |
| | 30 | Daisy paid the amount due by cheque |

- b** Enter these transactions in Katie's ledger. Balance the bank account and Zara's account and bring down the balances on 1 November 20–4.

- 6** The following account appeared in the ledger of Marine Drive Stores:

Central Wholesalers account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–4				20–4			
May 17	Returns		120	May 1	Balance	b/d	180
20	Bank		300	10	Purchases		410
31	Balance	c/d	170				
			590				590

Explain **each** entry in this account and also state where the double entry for **each** entry will be found.

Chapter 3

The trial balance

Learning objectives

In this chapter you will learn to:

- understand that a trial balance is a statement of ledger balances on a particular date 3.1
- outline the uses and limitations of a trial balance 3.1
- prepare a trial balance from a given list of balances and amend a trial balance which contains errors 3.1
- identify and explain those errors which do not affect the trial balance – commission, compensating, complete reversal, omission, original entry, principle. 3.1

**KEY TERM**

A **trial balance** is a list of balances on the accounts in the ledger at a certain date.

**TIP**

A trial balance is a list of balances: it is not part of the double entry system.

3.1 Introduction

A **trial balance** is a list of the balances on the accounts in the ledger at a certain date.

A trial balance is prepared to check the arithmetical accuracy of the double entry book-keeping. The name of each account is listed in the trial balance. The balance on each account is shown according to whether it is a debit balance or a credit balance. The trial balance will show if the total of the debit balances is equal to the total credit balances.

It is important to remember that the trial balance is **not** a part of the double entry system of book-keeping as it is simply a list of balances. If the ledger accounts are balanced monthly then a trial balance may also be drawn up at the end of each month.

The trial balance should be headed with the term 'trial balance' along with the date on which it was prepared.

The layout of a trial balance is as follows:

Trial balance at *			
Details	Folio	Debit \$	Credit \$

*The date at which it is prepared.

3.2 The purpose of a trial balance

- 1 The trial balance can help in locating arithmetical errors. However, the balancing of the trial balance is not proof that the entries in the ledger accounts are completely free from errors.
- 2 A trial balance is useful in preparing financial statements.

3.3 The preparation of a trial balance

All the ledger accounts which are 'open' (those which still have an amount of money showing in the account) are listed together with the balance on each account. If the debit side of the account is larger in money than the credit side then that account has a debit balance and the amount of the balance (or difference) is entered in the debit column of the trial balance. If the credit side of the account has more money than the debit side then that account has a credit balance and the amount of the balance (or difference) is entered in the credit column of the trial balance.

The debit column and the credit column are totalled. If the totals agree, it indicates that the double entry book-keeping is arithmetically correct.

Walkthrough 3.1

Ajay started his business on 1 January 20–7. His transactions for his first week of trading were shown in the solution to **Walkthrough 2.3** in Chapter 2.

Prepare a trial balance for Ajay on 7 January 20–7.

**TIP**

A trial balance is a useful list from which to prepare a set of financial statements.

**LINK**

You will learn about financial statements in Chapters 8 and 9.

Ajay Trial balance at 7 January 20–7			
	Folio	Debit \$	Credit \$
Bank	1	55 395	
Capital	2		80 000
Fixtures and equipment	3	30 000	
AB Loans	4		10 000
Motor vehicles	5	9 000	
Mallika loan	6		5 000
Rent payable	7	400	
Insurance	8	250	
Motor expenses	9	50	
Rent receivable	10		95
		95 095	95 095

- Folio numbers do not always appear in a trial balance.
- It is common to find the words 'debit' and 'credit' abbreviated to 'dr' and 'cr'.
- In this particular example, the totals of the trial balance are same as the totals of the bank account. This will not always be the case. It occurred in this example as all the transactions passed through the bank account.

TEST YOURSELF 3.1

- 1 Explain what a trial balance is.
- 2 State **two** purposes of preparing a trial balance.
- 3 Explain what determines whether the balance of an account is entered in the debit column or the credit column of a trial balance.
- 4 Explain what is indicated if the totals of a trial balance agree.

In practice, a trial balance is drawn up using the actual ledger accounts. It is necessary to know the type of accounts which have a debit balance and those which have a credit balance. These are shown in the following table:

Debit balances	Credit balances
Assets	Liabilities
Expenses	Incomes
Drawings	Capital
Purchases	Sales
Sales returns	Purchases returns

You can now answer Questions 1 and 2 at the end of this chapter.

Walkthrough 3.2

The following trial balance was prepared by an inexperienced book-keeper and contains errors. Prepare a corrected trial balance at 31 December 20–9.

Jasmine		
Trial balance for the year ended 31 December 20–9		
	Debit \$	Credit \$
Cash		300
Bank overdraft	3 000	
Capital		42 500
Drawings		750
Land and buildings	30 000	
Office equipment		1 050
Loan from AB Company	2 200	
Inventory	7 500	
Purchases		9 850
Sales	10 650	
Sales returns		940
Purchases returns	1 030	
Carriage inwards		400
Wages	1 500	
Rent receivable	830	
Sundry expenses	1 290	
Trade receivables		12 300
Trade payables	5 670	
	63 670	68 090

Jasmine		
Corrected trial balance at 31 December 20–9		
	Debit	Credit
	\$	\$
Cash	300	
Bank overdraft		3 000
Capital		42 500
Drawings	750	
Land and buildings	30 000	
Office equipment	1 050	
Loan from AB Company		2 200
Inventory	7 500	
Purchases	9 850	
Sales		10 650
Sales returns	940	
Purchases returns		1 030
Carriage inwards	400	
Wages	1 500	
Rent receivable		830
Sundry expenses	1 290	
Trade receivables	12 300	
Trade payables		5 670
	65 880	65 880

**TIP**

The opening inventory is included in a trial balance. The closing inventory does not appear on the books when a trial balance is prepared so cannot be included in a trial balance.

- The heading of the trial balance was incorrect and required amending.
- Each item had to be considered to decide whether it was in the correct column or it required amending.

You can now answer Question 3 at the end of this chapter.

TEST YOURSELF 3.2

- 1 State the column of a trial balance in which the balance of **each** of the following accounts would appear. Give a reason for your answer in each case.
 - a Loan from WQ Loans
 - b Motor expenses
 - c Motor vehicles
 - d Bank overdraft
 - e Carriage outwards
 - f Commission receivable

3.4 The trial balance and errors

If the trial balance fails to balance

When a trial balance fails to balance, it is obvious that an error has been made somewhere. This may be:

- 1 an error of addition within the trial balance
- 2 an error of addition within one of the ledger accounts
- 3 entering a different figure on the credit to that entered on the debit when making a double entry in the ledger
- 4 making a single entry for a transaction rather than a double entry
- 5 entering a transaction twice on the same side of the ledger



TIP

If the totals of a trial balance do not agree you know an error has been made in the ledger or in the preparation of the trial balance.

Checklist for locating errors

- Check the addition of the trial balance.
- Check the addition of the balance of each ledger account.
- Check that each ledger account balance has been entered in the correct column of the trial balance.
- Check that every ledger account balance has been entered in the trial balance.
- Look for a transaction equal to the difference in the trial balance and check that a double entry has been made for that transaction.
- Look for a transaction equal to half the difference in the trial balance and check if it has been entered twice on the same side of the ledger rather than once on each side.
- Check the double entry for every transaction entered in the books since the date of the last trial balance.

If the trial balance balances

When a trial balance balances, it simply means that the total of the debit balances is equal to the total of the credit balances. It does not imply that the double entry is error-free. The trial balance will still balance if any of the following errors are made:

Name of error	Description of error	Example
Error of commission	This occurs when a transaction is entered using the correct amount and on the correct side, but in the wrong account of the same class.	Cash received from Malini credited to Mallika's account.
Error of complete reversal	This occurs when the correct amount is entered in the correct accounts, but the entry has been made on the wrong side of each account.	Cash drawings debited to the cash account and credited to the drawings account.
Error of omission	This occurs when a transaction has been completely omitted from the accounting records. Neither a debit entry nor a credit entry has been made.	Payment of wages not entered in the books.



TIP

There are six types of error which may occur that a trial balance will not reveal.

Name of error	Description of error	Example
Error of original entry	This occurs when an incorrect figure is used when a transaction is first entered in the accounting records. The double entry will therefore use the incorrect figure.	Goods, \$100, bought on credit but recorded as \$1 000.
Error of principle	This occurs when a transaction is entered using the correct amount and on the correct side, but in the wrong class of account.	Motor expenses debited to the motor vehicles account.
Compensating errors	These occur when two or more errors cancel each other out.	Purchases account under-added by \$100 and sales returns account over-added by \$100.

**TIP**

In addition to learning the names of the types of error not revealed by a trial balance, you must be able to explain and provide examples of each of these types of error.

TEST YOURSELF 3.3

- 1 For **each** of the following state the type of error which has been made.
 - a Rent of premises debited to the premises account
 - b Sales to R Singh debited to H Singh's account
 - c Balance on cash account overstated by \$10 and balance on sales account overstated by \$10
 - d Cash sales debited to the sales account and credited to the cash account

**LINK**

You will learn more about errors in the accounting records in Chapter 15.

You can now answer Questions 4–6 at the end of this chapter.

Revision checklist

- A trial balance is a list of the balances on the accounts in the ledger at a certain date.
- A trial balance is prepared to check the arithmetical accuracy of the double entry book-keeping.
- If a trial balance fails to balance, it indicates that an error has been made.
- There are six types of error which are not revealed by a trial balance.

- 4 The totals of a trial balance did not agree.
Which error may have caused this?
- A Expenses paid in cash omitted from the accounting records
 - B Goods sold on credit to Jones debited in Jenson's account
 - C Repairs to machinery debited to machinery account
 - D Total of the purchases returns account overcast
- 5 Rent received from a tenant in cash, \$450, was entered in the accounts as \$460.
How will this affect the trial balance?

	Debit balances in trial balance	Credit balances in trial balance
A	cash overstated	no effect
B	cash overstated	rent receivable overstated
C	no effect	rent receivable overstated
D	rent receivable overstated	cash overstated

- 6 A trial balance drawn up at the end of Jim's financial year balanced. The following errors were then discovered:
- 1 Goods returned to K Weston had been debited to K Wilton.
 - 2 Repairs to office equipment had been debited in the office equipment account.
 - 3 An invoice, \$1 000, for goods sold on credit to Jacob & Co had been recorded in the accounts as \$100.
 - 4 Goods purchased on credit from Brixton Ltd had been debited in Brixton's account and credited in the purchases account.
- a State the type of error made in **each** of the errors 1–4.
 - b Name **two** further errors not revealed by a trial balance.

Chapter 4

Double entry book-keeping – Part B

Learning objectives

In this chapter you will learn to:

- recognise the division of the ledger into the sales ledger, the purchases ledger and the nominal (general) ledger 2.1
- explain the use of, and process, accounting information in the cash book 2.3
- distinguish between and account for trade discount and cash discount 2.3
- explain the dual function of the cash book as a book of prime entry and as a ledger account for bank and cash 2.3
- explain the use of, and record, payments and receipts made by bank transfers and other electronic means. 2.3

4.1 Introduction

Chapter 2 introduced the basic principles of double entry book-keeping. It was explained how a ledger account is opened for each type of asset, expense, liability and income, and for every individual debtor and creditor. As the business grows, so does the number of ledger accounts, so it becomes necessary to divide the ledger into different sections.

4.2 Division of the ledger into specialist areas

Dividing the ledger into sections makes it more convenient to use as the same type of accounts can be kept together and the task of maintaining the ledger can be divided between several people. It also enables checking procedures (in the form of control accounts) to be introduced and may reduce the possibility of fraud.

The ledger is usually divided into the following specialised areas:

- **Sales ledger:** This is also referred to as the **debtors ledger or trade receivables ledger**. All the **personal** accounts of credit customers are kept in the sales ledger.
- **Purchases ledger:** This is also referred to as the **creditors ledger or trade payables ledger**. All the **personal** accounts of credit suppliers are kept in the purchases ledger.
- **Nominal ledger:** This is also referred to as the **general ledger**. Apart from the cash account, the bank account and the accounts of credit customers and credit suppliers, all the remaining accounts are kept in the nominal ledger. This ledger will contain accounts of assets, liabilities, expenses, incomes, sales, purchases and returns. Asset accounts are known as **real** accounts. Accounts for expenses, income and capital are known as **nominal** accounts.
- **Cash books:** These contain the main cash book (see Section 4.3) and the petty cash book.



KEY TERMS

Sales ledger: the ledger in which the accounts of credit customers are maintained.

Purchases ledger: ledger in which the accounts of credit suppliers are maintained.

Nominal (general) ledger: the ledger where all the other accounts are maintained.

TEST YOURSELF 4.1

- 1 State **one** advantage of dividing the ledger into specialist areas.
- 2 State in which ledger **each** of the following accounts would appear.
 - a Rent account
 - b AB Finance Co loan account
 - c XY Stores account (a supplier)
 - d Capital account
 - e Sales returns account
 - f Gee Tee Traders account (a customer)



LINK

You will learn more about control accounts in Chapter 16.



TIP

Only the personal accounts of credit customers are recorded in the sales ledger. The sales account is recorded in the nominal (general) ledger.



TIP

Only the personal accounts of credit suppliers are recorded in the purchases ledger. The purchases account is recorded in the nominal (general) ledger.



LINK

You will learn about petty cash books in Chapter 5.

You can now answer Questions 1–3 at the end of this chapter.

4.3 The two column cash book

Chapter 2 explained how two separate accounts – a cash account and a bank account – are maintained to record the movements of money. In practice, it is common for these accounts to be moved from the ledger and shown in a separate book known as the cash book. The cash account and the bank account appear side-by-side in the cash book.

The rules of double entry book-keeping are still applied. Any money received is debited in the cash book. If the money is placed in the cash till, it will be entered in the cash column and if it is paid into the bank, it will be entered in the bank column. Any money paid out is credited in the cash book. If the money is paid in cash, it will be entered in the cash column and if it is paid out of the bank, it will be entered in the bank column.

Whilst the cash account and the bank account appear side-by-side, they still keep their own identity and must be balanced separately as described in Chapter 2.

Since the cash book is part of the double entry system, it represents ledger accounts for both cash and bank. It is, however, also a **book of prime entry** because it is one of the books in which transactions should be recorded before being entered in the ledger.



LINK

You will learn more about books of prime entry in Chapter 7.



KEY TERM

A **Contra entry** is one which appears on both sides of the cash book.

4.4 Contra entries

Sometimes surplus cash is paid into the bank, or money may be withdrawn from the bank to place in the cash. Such transactions are known as **contra entries** because they appear on both sides of the cash book, debited to one account and credited to the other. These transactions are recorded by applying the usual rules of double entry by debiting the account receiving the money and crediting the account giving the money. The name of the account where the double entry is made is written in the details column. The entries are summarised as follows:

- 1 **To record surplus cash paid into the bank**
 - Debit the bank account and write 'cash' in the details column.
 - Credit the cash account and write 'bank' in the details column.
- 2 **To record cash withdrawn from the bank for office use**
 - Debit the cash account and write 'bank' in the details column.
 - Credit the bank account and write 'cash' in the details column.

In each case, the letter 'c' is usually entered in the folio column to indicate that the double entry is on the opposite side of the same book.

In addition to making payments by cheque, businesses can pay by electronic means. These are much quicker and safer means than payments made by cheque. A person can pay another by means of a credit transfer which involves instructing their bank to transfer an amount to the bank account of the other person. Payments can also be made by standing order and direct debit. A standing order is when a person instructs the bank to pay a fixed sum at fixed intervals to another person. A direct debit is when a person notifies the bank that permission has been given for a named person to collect an amount directly from their bank account. Direct debits are used for recurring payments where the amounts and dates vary. Other popular means of payment are debit cards and credit cards. When a person uses a debit card, the money comes directly from his/her bank account. When a person uses a credit card, the credit card company pays the person to whom money is owed and the cardholder pays some or all of the money back to the card company (usually at monthly intervals).



TIP

To make a contra entry:

- In the details column on the debit side, write the name of the account where the money has come from.
- In the details column on the credit side, write the name of the account to which the money is going.

Walkthrough 4.1

20–6

- December 1 Mamata started business with a capital of \$20 000 which she transferred into a business bank account
- 2 Paid rent of premises, \$650, by standing order
- 5 Purchased goods, \$9 500, on credit from Lodi Road Traders
- 9 Withdrew \$150 from the bank account for office use
- 14 Paid advertising expenses, \$90, in cash
- 18 Sold goods, \$4 120, on credit to Central Dealers
- 23 Paid Lodi Road Traders' account by cheque
- 26 Bought motor vehicle, \$5 760, and paid by credit transfer
- 28 Mamata took \$3 000 from the business bank account for personal use

Enter these transactions in the books of Mamata. The cash account and the bank account should be shown in a two column cash book. The ledger should be divided into sales ledger, purchases ledger and nominal ledger. Balance the cash book on 31 December.

Mamata Sales ledger Central Dealers account								Page 1
Date	Details	Folio	\$	Date	Details	Folio	\$	
20–6								
Dec 18	Sales	nl 5	4 120					

Purchases ledger Lodi Road Traders account								Page 1
Date	Details	Folio	\$	Date	Details	Folio	\$	
20–6								
Dec 23	Bank	cb 1	<u>9 500</u>	Dec 5	Purchases	nl 3	<u>9 500</u>	
			<u>9 500</u>				<u>9 500</u>	

Nominal ledger Capital account								Page 1
Date	Details	Folio	\$	Date	Details	Folio	\$	
20–7								
				Dec 1	Bank	cb 1	20 000	

Rent payable account							Page 2
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6							
Dec 2	Bank	cb 1	650				

Purchases account							Page 3
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6							
Dec 5	Lodi Road Traders	pl 1	9500				

Advertising account							Page 4
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6							
Dec 14	Cash	cb 1	90				

Sales account							Page 5
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-6			
				Dec 18	Central Dealers	sl 1	4 120

Motor vehicles account							Page 6
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6							
Dec 26	Bank	cb 1	5 760				

Drawings account							Page 7
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6							
Dec 28	Bank	cb 1	3 000				

Mamata Cash book										Page 1
Date	Details	Folio	Cash \$	Bank \$	Date	Details	Folio	Cash \$	Bank \$	
20-6					20-6					
Dec 1	Capital	nl 1		20 000	Dec 2	Rent payable	nl 2		650	
9	Bank	c	150		9	Cash	c		150	
					14	Advertising	nl 4	90		
					23	Lodi Road Traders	nl 1		9 500	
					26	Motor vehicles	nl 6		5 760	
					28	Drawings	nl 7		3 000	
					31	Balance	c/d	60	940	
			<u>150</u>	<u>20 000</u>				<u>150</u>	<u>20 000</u>	
20-7										
Jan 1	Balance	b/d	60	940						

TEST YOURSELF 4.2

- 1 Explain what is meant by a contra entry in a cash book.
- 2 Give **two** examples of contra entries in a cash book.

4.5 Bank overdraft

As explained earlier, the cash column and the bank column of a cash book are balanced separately as they represent two separate accounts.

The balance on the cash column will always be brought down as a debit balance at the start of the next trading period. The only exception to this is when there is no cash left in the cash account, in which case the balance will be nil. **It is not possible to have a credit balance on a cash account.**

It is, however, possible to have a credit balance on a bank account. The bank may allow the business to have a **bank overdraft**. This means that the bank allows the business to pay out more from the bank than is put into the bank (interest will be charged by the bank on the amount overdrawn). In the cash book, the bank account is balanced in the usual way and the balance will be brought down on the credit side. This represents the amount the business owes the bank and is a liability.

**KEY TERM**

A **bank overdraft** occurs when more has been paid out of the bank than was put into the bank account.

**TIP**

A bank loan is different to a bank overdraft because:

- it is a fixed amount which is paid into the business bank account
- it must be repaid by an agreed date
- interest at a fixed rate is payable on the total amount borrowed.

Walkthrough 4.2

Mamata started business on 1 December 20–6. Her transactions for the first month of trading were the same as those shown in **Walkthrough 4.1**, except that her drawings on 28 December amounted to \$5 000 rather than \$3 000.

Enter Mamata's transactions for December 20–6 in her two column cash book. Balance the book on 31 December and bring down the balances on 1 January 20–7.

Mamata									
Cash book									
Page 1									
Date	Details	Folio	Cash \$	Bank \$	Date	Details	Folio	Cash \$	Bank \$
20–6					20–6				
Dec 1	Capital	nl 1		20 000	Dec 2	Rent payable	nl 2		650
9	Bank	c	150		9	Cash	c		150
31	Balance	c/d		1 060	14	Advertising	nl 4	90	
					23	Lodi Road Traders	nl 1		9 500
					26	Motor vehicles	nl 6		5 760
					28	Drawings	nl 7		5 000
					31	Balance	c/d	60	
			<u>150</u>	<u>21 060</u>				<u>150</u>	<u>21 060</u>
20–7					20–6				
Jan 1	Balance	b/d	60		Jan 1	Balance	b/d		1 060

You can now answer Question 4 at the end of this chapter.

4.6 The three column cash book

Many businesses maintain a three column cash book rather than a two column cash book. The difference is that a three column cash book has an extra money column on each side to record **cash discount**.

KEY TERM

Cash discount is an allowance given to a customer when an account is settled within a time limit set by the supplier.

Cash discount

Cash discount is an allowance given to a customer when an account is settled within a time limit set by the supplier. An account does not have to be paid in cash to qualify for cash discount. The **time** of payment is the deciding factor rather than **how** the account is paid. Cash discount is a means of encouraging customers to pay their accounts promptly. The supplier will receive an amount slightly less than the due amount. However, the money is paid earlier and so it is available for use within the business.

TIP

An account does not necessarily have to be paid in cash to qualify for cash discount.

Discount allowed is the discount a business allows its credit customers (debtors) when they pay their accounts within a set time. This is an expense of the business as it is the cost of having debts settled promptly. **Discount received** is the discount a business receives from its credit suppliers (creditors) when it pays their accounts within a set time. This is an income of the business as it is the benefit received from settling debts promptly. It is important to realise

that discount received does not involve the receipt of money: the supplier simply accepts less money in settlement of the account.

In addition to recording the cash or cheque in settlement of debt, it is also necessary to record cash discount. The entries are summarised as follows:

1 When an account is paid by a debtor and a discount is allowed

Credit the discount in the debtor's account to show that this amount is no longer owing.
Enter the amount of the discount in the discount allowed column of the cash book.

2 When an account of a creditor is paid and a discount is received

Debit the discount in the creditor's account to show that this amount is no longer owing.
Enter the amount of the discount in the discount received column of the cash book.

The discount columns in the cash book are **not** a part of the double entry system. They are used for convenience to make a note of discount at the time an account is paid or received. At the end of the trading period the totals must be transferred to the double entry system. The steps for this are as follows:

- 1 Total each discount column.
- 2 Debit the discount allowed account in the nominal ledger with the total of the discount allowed column. This now represents the double entry for all the individual credits in the accounts of debtors.
- 3 Credit the discount received account in the nominal ledger with the total of the discount received column. This now represents the double entry for all the individual debits in the accounts of creditors.

Trade discount must not be confused with cash discount. Trade discount is a reduction in the price of goods when goods are purchased, rather than when payment is made and is often dependent on the quantity purchased.

You can now answer Questions 5 and 6 at the end of this chapter.

4.7 Dishonoured cheque

A **dishonoured cheque** is a cheque received which the debtor's bank refuses to pay. This may occur because the debtor does not have enough money in his/her bank account, or it may be because of an error on the cheque, e.g. no signature, no date, the amount in words and the amount in figures do not agree.

If a cheque is dishonoured, it is returned to the business that paid the cheque into the bank. The business must record the return of this cheque by crediting the bank account and debiting the debtor's account (the reverse of the entries made when the cheque was received). The business will also inform the debtor that this amount is unpaid.



TIP

Do not attempt to balance the discount columns in the cash book. They represent different types of cash discount: the column on the debit side is discount allowed and the column on the credit side is discount received.



LINK

You will learn more about trade discount in Chapter 6.



KEY TERM

A **dishonoured cheque** is a cheque received which the debtor's bank refuses to pay.

TEST YOURSELF 4.3

- 1 Explain why it is **not** possible to have a credit balance brought down in the cash column of a cash book.
- 2 Explain the meaning of the term bank overdraft.
- 3 Explain why a business may allow its credit customers cash discount.
- 4 Explain the meaning of the term 'dishonoured cheque'.

Walkthrough 4.3

Enter the following transactions in the books of Mamata. She maintains a three column cash book and divides the ledger into three sections – sales ledger, purchases ledger and nominal ledger.

Balance the cash book on 31 January 20–7 and transfer the totals of the discount columns to the relevant accounts in the nominal ledger. Balance the accounts in the sales and purchases ledgers where necessary.

20–7

- January 1 Mamata had a cash balance of \$60 and a bank overdraft of \$1 060
- 4 Bought goods, \$5 200, on credit from Lodi Road Traders
- 8 Returned goods, \$200, to Lodi Road Traders
- 12 Sold goods, \$770, on credit to A & J Singh
- 14 Cash sales \$680
- 17 Paid \$650 cash into the business bank account
- 21 Received a cheque from A & J Singh in settlement of their account
- 24 Sold goods, \$1 200, on credit to North East Stores
- 26 A & H Singh's cheque was dishonoured and returned by the bank
- 28 Paid Lodi Road Traders the amount due, by credit transfer, after deducting a discount of $2\frac{1}{2}\%$
- 31 North East Stores paid the amount due by credit transfer, less a cash discount of 3%

Mamata							
Sales ledger							
A & J Singh account							
							Page 2
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7				20–7			
Jan 12	Sales	nl 5	770	Jan 21	Bank	cb 2	770
26	Bank (dishonoured cheque)	cb 2	770	31	Balance	c/d	770
			<u>1 540</u>				<u>1 540</u>
20–7							
Feb 1	Balance	b/d	770				

North East Stores account							Page 3
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Jan 24	Sales	nl 5	1200	Jan 31	Bank	cb 2	1164
					Discount	cb 2	36
			<u>1200</u>				<u>1200</u>

Purchases ledger							
Lodi Road Traders account							Page 1
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Jan 8	Purchases			Jan 4	Purchases	nl 3	5200
	Returns	nl 8	200				
28	Bank	cb 2	4875				
	Discount	cb 2	<u>125</u>				
			<u>5200</u>				<u>5200</u>

Nominal ledger							
Purchases account							Page 3
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 4	Lodi Road Traders	pl 1	5200				

Sales account							Page 5
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
				Jan 12	A & J Singh	sl 2	770
				14	Cash	cb 2	680
				24	North East Stores	sl 3	1200

Purchases returns account							Page 8
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
				Jan 8	Lodi Road Traders	pl 1	200

Discount allowed account							Page 9
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 31	Total for month	cb 2	36				

Discount received account							Page 10
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Jan 31	Total for month	cb 2	125				

Mamata Cash book												Page 2
Date	Details	Folio	Discount allowed \$	Cash \$	Bank \$	Date	Details	Folio	Discount received \$	Cash \$	Bank \$	
20-7												
Jan 1	Balance	b/d		60		Jan 1	Balance	b/d			1 060	
14	Sales	nl 5		680		17	Bank	c		650		
17	Cash	c			650	26	A & J Singh					
21	A & J Singh	sl 2			770		(dishonoured cheque)	sl 2			770	
31	North East Stores	sl 3	36		1 164	28	Lodi Road Traders	pl 1	125		4 875	
	Balance	c/d			4 121	31	Balance	c/d		90		
			<u>36</u>	<u>740</u>	<u>6 705</u>				<u>125</u>	<u>740</u>	<u>6 705</u>	
20-7												
			nl 9						nl 10			
Feb 1	Balance	b/d		90		Feb 1	Balance	b/d			4 121	

Revision checklist

- The ledger is usually divided into three specialist areas – sales ledger, purchases ledger and nominal (general) ledger.
- The cash account and the bank account are usually kept side-by-side in a cash book.
- A contra entry appears on both sides of a cash book.
- Payments can be made by cheque, credit transfer, direct debit, standing order and credit and debit cards.
- A credit balance brought down in the bank column of a cash book indicates a bank overdraft.
- Cash discount is given to encourage customers to pay their accounts within a set time limit.
- The totals of the discount columns in the cash book are transferred to the discount accounts in the ledger.

- 4** Where is the total of the discount column on the credit side of a cash book posted?
- A** To the credit side of the discount allowed account
B To the credit side of the discount received account
C To the debit side of the discount allowed account
D To the debit side of the discount received account
- 5** Samuel maintains a full set of accounting records including a three column cash book. He provided the following information for October 20–5.

Oct 1 Cash \$110, bank \$5 150 (debit)
 Trade receivables – Paul \$160, Jasmine \$880
 Trade payables – Adele \$350

4 Paid a cheque to Adele in settlement of her account of \$350 less 2% discount
 9 Purchased a motor vehicle, \$9 500, and paid by credit transfer
 12 Cash sales, \$1 270, of which \$1 220 was paid into the bank
 15 Received a cheque, \$160, from Paul
 19 Took \$1 000 from the bank for personal use
 24 Paid office expenses in cash, \$35
 26 Received a cheque from Jasmine for \$858 in settlement of her account of \$880
 29 The cheque received from Paul on 15 October was returned dishonoured
 30 Paid all cash into the bank except \$80

- a** Enter the balances in the appropriate accounts on 1 October.
b Enter the transactions in the cash book and the ledgers. Balance the cash book on 31 October and bring down the balances on 1 November 20–5.
c Transfer the totals of the discount columns in the cash book to the ledger.
d Total or balance the accounts of the trade receivables and trade payables as required.

- 6** Kalpana is a trader. On 1 February 20–8 she had the following balances on her books:

	\$
Cash book – Cash	100
Bank overdraft	480
Sales ledger – Srivastava	200
Purchases ledger – Ahmed	320
Nominal ledger – Premises	60 000
Fixtures and fittings	5 500
Capital	65 000

- a** Enter these balances in the appropriate accounts on 1 February 20–8.

The following transactions took place during the month of February 20–8:

- February 3 Sold goods, \$300, on credit to Srivastava
7 Srivastava returned faulty goods, \$50
11 Purchased goods, \$390, paying by cheque
Paid \$10 by cheque for carriage on goods purchased
15 Cash sales, \$610, of which \$600 was paid into the bank
19 Srivastava paid the amount owing on 1 February by credit transfer, after deducting 3% cash discount
21 Paid general expenses, \$75, in cash
23 Paid Ahmed by credit transfer the amount due, less a cash discount of $2\frac{1}{2}\%$
25 Sublet part of the premises and received \$400 rent in cash
27 Paid \$15 by cheque for repairs to fixtures
28 Paid all the cash into the bank except \$100
- b** Enter these transactions in the books of Kalpana.
c Balance the cash book and the personal accounts on 28 February. Transfer the totals of the discount columns to the nominal (general) ledger on 28 February.
d Draw up a trial balance at 28 February 20–8.

Chapter 5

Petty cash books

Learning objectives

In this chapter you will learn to:

- explain the use of, and process, accounting data in the petty cash book 2.3
- explain and apply the imprest system of petty cash. 2.3

5.1 Introduction

A **petty cash book** is used to record low-value (petty) cash payments. These may include postages and stationery, cleaning, travelling expenses and even small cash payments to creditors.

The petty cash book serves two purposes: **a** it lists the transactions for transferring to ledger accounts; **b** it acts as a ledger account for petty cash transactions. Like the cash book, the petty cash book is a book of prime entry and since it is part of the double entry system, it is also a ledger account.

Maintaining a petty cash book means that it is not necessary to record small cash payments individually in either the cash book or the ledger. This reduces the number of entries in these books.

The task of maintaining a petty cash book is often given to a junior member of staff who is given an amount of cash to act as a **float** from which to make small cash payments. Whilst this allows the chief cashier to concentrate on more important tasks, it also provides valuable training for a junior member of staff. The chief cashier must check the work of the petty cashier at regular intervals.

When a member of staff wishes to obtain some petty cash, he/she should present the petty cashier with a completed **petty cash voucher**. This should show the purpose for which the money is required, the date and the signature of the person receiving the cash. At regular intervals the petty cashier should check these vouchers against the total cash spent.



LINK

You will learn more about books of prime entry in Chapter 7.



KEY TERMS

A **petty cash book** is used to record low-value cash payments.

The **imprest system** of petty cash is where the amount spent each period is restored so that the petty cashier starts each period with the same amount.

TEST YOURSELF 5.1

- 1 State **two** advantages of maintaining a petty cash book.
- 2 Explain the purpose of a petty cash voucher.

5.2 The imprest system

Most petty cash books are maintained using the **imprest system**. Under this system the petty cashier starts each period (week, fortnight, month and so on) with a fixed amount of money. This is known as the **imprest amount** or the **float**. During the period, payments are made out of this cash and are recorded in the petty cash book. At the end of the period, after the petty cash book is balanced, the chief cashier will provide the petty cashier with enough cash to restore the balance to the amount of the imprest (float). The petty cashier therefore starts each period with the same amount of cash.

Under this system the chief cashier is aware of exactly how much petty cash has been spent in each period. This means that the petty cash expenditure can be controlled. The amount of the imprest can be adjusted as necessary if it is too much or not enough. The imprest system can also help to reduce fraud.

**TIP**

The imprest is sometimes referred to as 'the float'.

TEST YOURSELF 5.2

- 1 Explain the meaning of the imprest system of petty cash.
- 2 Explain what the petty cashier should do if he/she thinks that the imprest amount is inadequate.

**KEY TERM****Analysis columns**

are used to divide the payments into different categories.

5.3 The layout of a petty cash book

A petty cash book resembles a ledger account with several money columns on the credit side. These are known as **analysis columns** and are used to divide the payments into different categories. A column is used for each of the main types of expenses paid out of petty cash. Instead of a folio column on the credit side there is a column for recording the number of the voucher to which the payment relates.

The number of columns and the main types of expenses will be determined by each individual business.

A layout of a petty cash book is shown as follows:

Petty cash book										
Dr						Cr				
Date	Details	Folio	Total received	Date	Details	Vo. no.*	Total paid	Analysis columns		
			\$				\$	\$	\$	\$

*'Vo. no.' is the abbreviation for 'voucher number'.

5.4 Preparation of a petty cash book

The entries in a petty cash book are summarised as follows:

During the period

1 Money received

- a Debit the total received column with any money received from the chief cashier. Insert the word 'cash' or 'bank' in the details column.
- b Debit the total received column with any money received from any other source. Insert the name of the account to be credited in the details column, e.g. the name of a debtor (where a debtor pays an account in cash), travel expenses (where an employee reimburses the petty cash for private travel expenses), telephone expenses (where an employee reimburses the petty cash for private telephone calls) and so on.

2 Money paid

Credit the total paid column with any money paid out and also enter the amount in the analysis column for that particular expense. A brief description of the reason for the payment should be entered in the details column.

At the end of the period

- 1** Add the total paid column. Insert the total.
- 2** Add each of the analysis columns and insert the totals. If these totals are then added horizontally they should agree with the total paid column. The analysis columns are now complete.
- 3** Balance the total received column and the total paid column in the same way as balancing any other ledger account. Carry down the balance from the credit side to the debit side to start the new period.
- 4** When the imprest is restored, enter as described earlier.
- 5** Complete the double entry for the totals of the analysis columns.
 - a** The totals of the analysis columns for expenses should be debited to the appropriate expense account in the nominal ledger. To indicate that the double entry has been completed the folio number of the relevant account is often written below the total of the appropriate analysis column in the petty cash book.
 - b** Any entries in the analysis column headed 'ledger accounts' should be debited individually to the purchases ledger account of the creditor who made the payment.

**TIP**

Every payment should be entered in the appropriate analysis column as well as the total paid column.

**TIP**

Each of the analysis columns should be totalled. Check the arithmetic by making sure that these are equal to the total amount paid.

Walkthrough 5.1

Maitreyi keeps an analysed petty cash book using the imprest system. The amount of the imprest is \$150. She provided the following information:

20-1		\$	Voucher number
November	1	Balance	150
	5	Paid window cleaner	10 1
	8	Bought pens and pencils	4 2
	14	Paid H Singh, a credit supplier	20 3
	17	Paid taxi fare	9 4
	21	Bought computer paper	7 5
	25	Paid bus fares	3 6
	27	Paid A Sharma, a credit supplier	32 7
	29	Paid office cleaner	30 8

- a** Write up Maitreyi's petty cash book for the month of November 20-1. The petty cash book should have four analysis columns – cleaning, stationery, travel expenses and ledger accounts.
- b** Balance the petty cash book on 30 November and carry down the balance. Show the restoration of the imprest on 1 December 20-1.
- c** Make the necessary entries in Maitreyi's nominal ledger and purchases ledger on 30 November 20-1.

a & b

Maitreyi											
Petty cash book											Page 1
Date	Details	Fo	Total received	Date	Details	Vo	Total paid	Cleaning	Stationery	Travel expenses	Ledger accounts
			\$				\$	\$	\$	\$	\$
20-1				20-1							
Nov 1	Balance	b/d	150	Nov 5	Window cleaner	1	10	10			
				8	Pens and pencils	2	4		4		
				14	H Singh	3	20				20
				17	Taxi fare	4	9			9	
				21	Computer paper	5	7		7		
				25	Bus fares	6	3			3	
				27	A Sharma	7	32				32
				29	Office cleaner	8	30	30			
							115	40	11	12	52
				30	Balance	c/d	35	nl 11	nl 17	nl 24	
			<u>150</u>				<u>150</u>				
20-1											
Dec 1	Balance	b/d	35								
	Cash		115								

56

c

Maitreyi							
Nominal ledger							Page 11
Cleaning account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-1							
Nov 30	Petty cash	pcb1	40				

Maitreyi							
Stationery account							Page 17
Date	Details	Folio	\$	Date	Details	Folio	\$
20-1							
Nov 30	Petty cash	pcb1	11				

Travel expenses account							Page 24
Date	Details	Folio	\$	Date	Details	Folio	\$
20-1							
Nov 30	Petty cash	pcb1	12				

Purchases ledger							Page 73
H Singh account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-1							
Nov 14	Petty cash	pcb1	20				

A Sharma account							Page 69
Date	Details	Folio	\$	Date	Details	Folio	\$
20-1							
Nov 27	Petty cash	pcb1	32				

**TIP**

At the end of the period:

- the total of each expense analysis column is transferred to the appropriate ledger account
- the individual entries in the ledger account column are transferred to the personal accounts of the credit suppliers.

- Each of the accounts in the purchases ledger would have shown a credit balance representing the amount due. The payment from petty cash will cancel this amount.

TEST YOURSELF 5.3

- 1 Explain the use of analysis columns in a petty cash book.
- 2 State where the double entry will be made for **each** of the following items appearing in a petty cash book:
 - a amount received to restore the imprest
 - b payment from petty cash to a credit supplier.

You can now answer Questions 1–6 at the end of this chapter.

Revision checklist

- A petty cash book is used to record small cash payments (and occasionally small cash receipts).
- The imprest system of petty cash means that the petty cashier starts each period with the same amount.
- A petty cash book is a book of prime entry and also a ledger account.
- The totals of the analysis columns are posted to the appropriate nominal ledger accounts at the end of each period.
- Any payments to credit suppliers are posted individually to the purchases ledger account of the supplier to whom the payment was made.

Exam-style questions

- 1** A trader maintains a petty cash book using the imprest system. The monthly imprest is \$120. The petty cash transactions during August were:

		\$
Payments	Taxi fare	12
	Stationery	31
	Postage	8
	Waheed, a credit supplier	43
Receipts	Refund for damaged stationery	11

How much was given to the petty cashier on 1 September to restore the imprest?

- A** \$26 **B** \$37 **C** \$83 **D** \$94
- 2** A trader provided the following extract from her petty cash book:

Date	Details	Total paid	Cleaning	Office expenses	Ledger accounts
		\$	\$	\$	\$
April 4	Tea and coffee	10		10	
18	Thomas	33			33
21	Copy paper	18		18	
29	Cleaning	250	250		

What entries are made in the ledger on 30 April?

- A** Credit cleaning account, office expenses account, ledger accounts
B Credit cleaning account, office expenses account, Thomas account
C Debit cleaning account, office expenses account, ledger accounts
D Debit cleaning account, office expenses account, Thomas account.
- 3** On 1 August the petty cash balance equalled the imprest amount of \$100. During August the petty cashier spent \$83 and received \$20 from a member of staff in repayment of a loan. What entry will be made on 31 August to restore the imprest?

	Debit	\$	Credit	\$
A	bank	63	petty cash book	63
B	bank	83	petty cash book	83
C	petty cash book	63	bank	63
D	petty cash book	83	bank	83

- 4** Robin is a sole trader. He operates a petty cash book using the imprest system with a float of \$100 at the beginning of each month. The imprest was restored on 30 April so there is an opening balance of \$100 on 1 May.

Details of petty cash vouchers presented during May were as follows:

		Voucher number	Total amount \$
May 1	Milk, tea and sugar	9	5.20
6	Postage stamps	10	10.50
14	Cleaner's wages	11	30.00
17	Envelopes	12	7.40
21	Parcel postage	13	2.90
24	Milk and tea	14	3.10
28	Cleaner's wages	15	30.00
30	Computer paper	16	4.70

- a** Write up Robin's petty cash book for May. Use analysis columns for postages, cleaning, stationery and refreshments. Total and balance the book on 31 May.
- b i** State **one** reason why a business may operate a petty cash book.
- ii** State **one** advantage of operating the imprest system of petty cash.
- 5** Abdul maintains a petty cash book with an imprest amount of \$150, which is restored on the first day of each month.

He provided the following information on 31 August:

	\$
Total of sundry expenses column	13
Total of postage column	19
Total of cleaning column	45
Total of ledger accounts column	62

- a** Explain the imprest system of petty cash.
- b** State the total amount spent by the petty cashier in August.
- c** State the double entry which will be made for the total of the sundry expenses column on 31 August.
- d** State how the double entry will be made in the ledger for the items in the ledger accounts column.
- e** State what entry will appear for petty cash in the statement of financial position on 31 August.
- f** State how much the petty cashier will receive on 1 September to restore the imprest.

- 6** Shilpa is a sole trader. She pays all receipts into the bank at the end of each day's trading and all payments are made by cheque, except for those less than \$20 which are regarded as petty cash items.

She provided the following information:

Date	Detail	Amount	
20–9		\$	
Feb 21	Balance at bank	3 120	
	Petty cash imprest	50	
22	Paid South West Traders	721	to settle an account of \$750
24	Received cheques:		
	Janpath Stores	410	to settle an account of \$425
	AB Trading	220	
26	Paid:		
	Window cleaner	7	
	Speedy Motors	85	
	Petrol	11	
27	Paid:		
	Refreshments	5	
	Ghandi Stores	12	

- a** Write up the petty cash book for the week ended 28 February 20–9. Use analysis columns for refreshments, cleaning, motor expenses and ledger accounts. Balance the book on 27 February 20–9 and restore the imprest on 28 February 20–9.
- b** Write up the cash book for the week ended 28 February 20–9. Balance the book at 28 February 20–9 (after the restoration of the petty cash imprest).

Section 1: Practice questions

- Which task is **not** performed by an accountant?
 - monitoring the progress of the business
 - preparing a statement of financial position
 - reporting on the trading results
 - writing up a three column cash book
- What is the accounting equation?
 - assets = capital – liabilities
 - capital = assets + liabilities
 - capital = assets – liabilities
 - liabilities = assets + capital

- The following account appeared in Anna's ledger:

Jodie account					
		\$			\$
Jan 5	Sales	500	Jan 7	Returns	20
				29 Bank	300
				31 Balance c/d	<u>180</u>
		<u>500</u>			<u>500</u>

Which statement is correct?

- On 5 January Jodie sold goods, \$500, to Anna.
 - On 7 January Anna returned goods, \$20, to Jodie.
 - On 29 January Anna paid Jodie \$300.
 - On 31 January Jodie owed Anna \$180.
- What is the purpose of a trial balance?
 - to calculate the capital of the business
 - to prove the arithmetical accuracy of the double entry
 - to summarise the assets and liabilities
 - to locate and correct errors in the ledger accounts
 - Which transaction will be entered in both the purchases ledger and the nominal (general) ledger?
 - cash paid for goods for resale
 - purchase of office furniture by cheque
 - returns of goods by a credit customer
 - returns of goods to a credit supplier

6 Waseem had the following assets, liabilities and capital on 1 April 20–6:

	\$
Premises	100 000
Machinery	48 000
Fixtures	8 800
Cash	590
Cash at bank	3 320
Trade receivables	4 130
Inventory	5 140
Trade payables	4 980
Capital	165 000

- a** Explain the meaning of each of the terms ‘assets’, ‘liabilities’ and ‘capital’.
- b** State why the assets are always equal to the total of the liabilities and capital.
- c** Complete the following table to state the effect of each transaction which took place on 2 April 20–6. The first one has been completed as an example. If the transaction does not affect the assets or liabilities write ‘no effect’.

Transaction	Effect on assets	\$	Effect on liabilities	\$
Obtained a loan, \$10 000, from AB Finance	Bank	+ 10 000	Loan	+ 10 000
Bought goods for resale, \$500, for cash				
Paid a credit supplier \$2 100 by cheque				
Bought machinery, \$4 000, and paid by cheque				
Sold out of date goods at cost price, \$190, on credit				

- d** Prepare the statement of financial position on 2 April 20–6 after these transactions have taken place.

7 The following balances appeared in the books of Fabice on 30 June 20–7:

	\$
Machinery and equipment	108 000
Motor vehicles	31 000
Trade payables	7 800
Balance at bank	3 830
Trade receivables	11 500
Carriage inwards	380
Carriage outwards	440
Sales	131 000
Purchases	101 900
Rent receivable	3 600
Rent payable	8 400
Inventory	13 200
Commission receivable	1 950
Administration expenses	9 600
Capital	?

- a State **two** reasons why a trial balance is prepared.
 - b Prepare a trial balance for Fabice on 30 June 20–7, inserting a figure for the capital account.
 - c Name and explain three errors which will not be revealed by a trial balance.
- 8 Mahendra started a business on 1 November 20–7. He provided the following information for his first month of trading:
- Nov 1 Introduced \$160 000 capital into the business, of which \$158 500 was transferred into a business bank account and the rest was placed in the business cash box
- 2 Purchased premises, \$95 000, paying by credit transfer
- 5 Bought goods for resale, \$2 600, on credit from Duleep
- 10 Returned goods, \$150, to Duleep
- 14 Paid general expenses in cash, \$275
- 19 Paid rates in cash, \$395
- 21 Sold goods on credit to Anila, \$124
Paid carriage on good sold, \$95, in cash
- 24 Paid Duleep \$1 000 by cheque on account
- 28 Took goods costing \$250 for personal use
- 30 Rented out part of the premises and received \$260 rent by cheque

- a** Enter these transactions in the cash book and ledgers. Balance the cash book and Duleep's account. Bring down the balances on 1 December 20–7.
- b** Prepare a trial balance on 30 November 20–7.
Mahendra is considering allowing credit customers a cash discount for prompt payment.
- c** Explain the effect that this suggestion may have on Mahendra's cash flow.
- d** State how this discount would be recorded if Mahendra decided to proceed with this suggestion.

- 9** Rachel is a trader. Her cash book for March 20–3 is shown below.

Rachel Cash book						
20–3		Cash	Bank	20–3		
		\$	\$			
Mar 1	Capital	200	49 800	Mar 4	Rent	300
21	Loan		10 000	6	Office furniture	4 100
30	Sales	17 500		10	Purchases	15 250
31	Cash		15 500	19	Office expenses	414
				31	Wages	950
					Bank	15 500
					Balances	1 250
		<u>17 700</u>	<u>75 300</u>			<u>55 236</u>
						<u>17 700</u>
						<u>75 300</u>

Explain each entry in the cash book. State where the double entry for each transaction would be made.

- 10** Habib maintains a three column cash book and also a petty cash book.

The petty cash imprest is \$80. All payments under \$30 are made from petty cash. The petty cash book has analysis columns for travel, stationery and ledger accounts. The balances on 1 February 20–9 were:

	\$
Petty cash	44
Cash	200
Bank overdraft	2 968

The following transactions took place in February 20–9:

- Feb 1 Petty cash restored from business bank account
- 4 Paid for taxi fares, \$18
- 14 Received a cheque from Nadira in settlement of her account of \$440, less $2\frac{1}{2}\%$ cash discount
- 19 Bought copy paper, \$12
- 24 Paid Uzma \$343 by credit transfer after deducting 2% cash discount
- 26 Paid Bashir, a credit supplier, \$25
- 27 Cash sales, \$1962
- 28 Paid all office cash into the bank except \$150

Write up the petty cash book and the cash book for February 20–9. Balance the books on 28 February and bring down the balances on 1 March 20–9.

Section 2

Chapter 6

Business documents

Learning objectives

In this chapter you will learn to:

- recognise and understand the following business documents: invoice, debit note, credit note, statement of account, cheque, receipt 2.2
- complete proforma business documents 2.2
- understand the use of business documents as sources of information 2.2
- account for trade discount. 2.3



LINK

You will learn more about using business documents in Chapter 7.



KEY TERMS

An **invoice** is a document issued by the supplier of goods on credit showing details, quantities and prices of goods supplied.

Trade discount is a reduction in the price of goods: the rate often increases according to quantity purchased.



LINK

You have already learned about cash discount in Chapter 4.



TIP

Trade discount is shown as a deduction on an invoice, but cash discount is not deducted on an invoice.

6.1 Introduction

As explained in Chapter 2, the entries in the accounting records of a business are made using business documents. Both documents received and issued by a business are used.

The main business documents and their uses are described in this chapter.

6.2 Invoice

When a business sells goods on credit it will issue an **invoice** to the purchaser. Each business has its own style of invoice, but they all contain the following information:

- the name and address of the supplier
- the name and address of the customer
- the date
- full details, quantities and prices of the goods supplied.

Sometimes the supplier allows the customer **trade discount**. This is a reduction in the price of the goods: the rate of this discount often increases according to the quantity purchased (so encouraging customers to buy in bulk). It is also given to businesses in the same trade. Such businesses will not be prepared to pay the full rate as they need to make a profit when they sell the goods.

It is important to distinguish between **cash discount** and **trade discount**. Cash discount was explained in Chapter 4. **Trade discount** is shown as a deduction on the invoice. Cash discount is not shown as a deduction from an invoice as it is only allowed if the invoice is paid within a set time limit.

TEST YOURSELF 6.1

- 1 State **two** reasons why a supplier may allow a customer trade discount.
- 2 Explain the difference between trade discount and cash discount.

You can now answer Question 1 at the end of this chapter.

Walkthrough 6.1

Sew and Sew is a curtain making business. On 3 April 20–9 goods were purchased on credit from The Weaving Shed and the following invoice was received:



Invoice

The Weaving Shed
14 Industrial Street
Hightown
Telephone 111 01357

Invoice
no I 3624

Sew and Sew
92 The Avenue
Lowtown

3 April 20–9

Quantity	Description	Unit price \$	Amount \$
30 metres	Brocade fabric Design: B320 Colour: Crimson	15	450 00
10 metres	Polycotton fabric Design: P21 Colour: Lemon	6	<u>60 00</u>
			510 00
	Less 20% trade discount		<u>102 00</u>
			<u>408 00</u>
	Terms: 2½% cash discount if account paid by 31 May 20–9		



TIP

From the supplier's viewpoint an invoice may be described as a sales invoice; from the customer's viewpoint it may be described as a purchases invoice.

- The customer receives the original invoice and uses it to record the purchase of goods on credit.
- The supplier keeps a copy of the invoice and uses it to record the sale of goods on credit.

TEST YOURSELF 6.2

- 1 List **four** items of information shown on an invoice.
- 2 Karnail sells goods on credit to Harbhajan and issues an invoice.
 - a Name the account to be debited and the account to be credited in Karnail's books.
 - b Name the account to be debited and the account to be credited in Harbhajan's books.

6.3 Debit note

The customer should check that goods received are in a satisfactory condition and that they are exactly what was ordered (in respect of price, quantity and quality).

The supplier must be informed of any shortages, overcharges and faults. This is done by issuing a **debit note** to the supplier. Each business has its own style of debit note, but they all contain the following information:



KEY TERM

A **debit note** is a document issued by a purchaser of goods on credit to request a reduction in the invoice received.

**TIP**

Debit notes are never entered in the accounting records.

- the name and address of the supplier
- the name and address of the customer
- the date
- full details and quantities (and sometimes the prices) of the goods returned or overcharged.

When a price is included on a debit note, it is the price which the customer was actually charged for those goods (the price after the deduction of trade discount).

Walkthrough 6.2

On 6 April 20–9 Sew and Sew returned goods to The Weaving Shed and issued the following debit note.

DEBIT NOTE		Debit note number 29
<i>Sew and Sew</i>		
92 The Avenue		
Lowtown		
The Weaving Shed		
14 Industrial Street		
Hightown		6 April 20–9
The following goods have been returned:		
	Unit price \$	Amount \$
10 metres polycotton fabric Design: P21 Colour: Lemon	6	60 00
Less 20% trade discount		<u>12 00</u>
		<u>48 00</u>
Reason for return: Wrong colour supplied		
Please issue a credit note		

- Neither the supplier nor the customer makes any entries in their accounting records in respect of a debit note.
- A debit note is merely a request to the supplier to reduce the total of the original invoice.

TEST YOURSELF 6.3

- 1 State **two** reasons why a customer may send a debit note to a supplier of goods on credit.

Where there has been an undercharge on an invoice most businesses will issue an additional invoice. However, some businesses may issue a debit note instead. This will be entered in the books of both the supplier and the customer in the same way as the original invoice.

6.4 Credit note

When goods are returned, reported faulty, or where there has been an overcharge on an invoice, the supplier may issue a **credit note**. As with all documents, each business has its own style of credit note, but they all contain the following information:

- the name and address of the supplier
- the name and address of the customer
- the date
- full details, quantities and prices of the goods returned or overcharged.

To distinguish them from invoices, credit notes are sometimes printed in red.



KEY TERM

A **credit note** is a document issued by a seller of goods on credit to notify of a reduction in an invoice previously issued.

Walkthrough 6.3

On 6 April 20–9 Sew and Sew returned goods to The Weaving Shed and issued a debit note. The Weaving Shed issued the following credit note to Sew and Sew on 9 April 20–9:

Quantity	Description	Unit price \$	Amount \$
10 metres	Polycotton fabric Design: P21 Colour: Lemon	6	60 00
	Less 20% trade discount		<u>12 00</u>
			<u>48 00</u>
	Reason for issue of credit note: Wrong colour supplied		

- The customer receives the original credit note and uses it to record the purchases returns.
- The supplier keeps a copy of the credit note and uses it to record the sales returns.

TEST YOURSELF 6.4

- 1 State **two** reasons why a supplier may send a credit note to a customer.
- 2 Harbhajan issues a credit note to Karnail.
 - a Name the account to be debited and the account to be credited in Karnail's books.
 - b Name the account to be debited and the account to be credited in Harbhajan's books.

You can now answer Questions 2 and 3 at the end of this chapter.

6.5 Statement of account

At the end of each month, a supplier will usually issue each customer with a **statement of account**. This is a summary of the transactions for the month. The style of a statement of account may vary, but they all contain the following information:

- the name and address of the supplier
- the name and address of the customer
- the date
- the balance owing at the start of the period
- invoices and credit notes issued
- payments received
- any cash discounts allowed
- the balance owing at the end of the period.



KEY TERM

A **statement of account** is a document issued by the seller of goods on credit to summarise the transactions for the month.

Walkthrough 6.4

The Weaving Shed issued the following statement of account to Sew and Sew on 30 April 20–9.

 Statement of account				
Sew and Sew 92 The Avenue Lowtown			The Weaving Shed 14 Industrial Street Hightown Telephone 111 01357	
			30 April 20–9	
Date	Reference	Debit \$	Credit \$	Balance \$
20–9				
April 3	Invoice number I 3624	408 00		408 00
9	Credit note number C529		48 00	360 00
The last amount shown in the balance column is the amount due. Terms: $2\frac{1}{2}\%$ cash discount if account is paid by 31 May 20–9.				

- Neither the supplier nor the customer makes any entries in their accounting records in respect of a statement of account.
- A statement of account is a reminder to the customer of the amount outstanding. This can be checked against the customer's own records to ensure that no errors have been made by either the supplier or the customer.

**TIP**

A statement of account is never entered in the accounting records.

TEST YOURSELF 6.5

- 1 State **one** purpose of a statement of account.

You can now answer Questions 4 and 5 at the end of this chapter.

6.6 Cheque

Many accounts are paid by means of a cheque. Other methods of payment through the banking system are credit transfers and standing orders. A **cheque** is a written order to a bank to pay a stated sum of money to the person or business named on the order. A book of preprinted cheques is issued by the bank, and the customer is only required to complete the necessary details of date, amount and payee (the person or business to whom the money is to be paid).

**KEY TERM**

A **cheque** is a written order to a bank to pay a stated sum of money to the person or business named on the order.

Walkthrough 6.5

On 28 May 20–9 Sew and Sew sent a cheque to The Weaving Shed for the amount due on that date less cash discount. The cheque and its counterfoil are shown as follows:

Date <u>28 May 20–9</u>	THE ABC BANK LIMITED SOUTH DISTRICT BRANCH, DELHI	Date <u>28 May 20–9</u>
Payee <u>The Weaving Shed</u>	Pay <u>The Weaving Shed</u>	<u>\$351-00</u>
<u>\$351-00</u>	<u>Three hundred & fifty one dollars only</u>	<u>S. Dhoni</u>
		<u>Trading as Sew and Sew</u>
Cheque no 00039	Cheque no 00039	Branch sort code 05 22 30
		Account no 3996829

Cheque counterfoil

Actual cheque

- The supplier receives the cheque. A paying-in slip is completed when the cheque is paid into the bank. The counterfoil of this paying-in slip is used to make the entry in the cash book to show the money paid into the bank and to make a note of the discount in the discount allowed column.
- The customer keeps the cheque counterfoil and uses it to make the entry in the cash book to show the money paid out of the bank and to make a note of the discount in the discount received column.

**KEY TERM**

A **receipt** is a written acknowledgement of money received and acts as proof of payment.

6.7 Receipt

A **receipt** is a written acknowledgement of money received and acts as proof of payment. Since a cheque passes through the banking system it can act as a receipt, so many businesses do not issue receipts if accounts have been paid by cheque. Where goods are sold for cash, the customer is usually provided with a receipt.

Walkthrough 6.6

The Weaving Shed issued the following receipt to Sew and Sew on 30 May 20–9.

RECEIPT**Receipt no 44**

The Weaving Shed 14 Industrial Street Hightown

Received from Sew and Sew the sum of \$351 (three hundred and fifty one dollars) by cheque

30 May 20–9 *K Singh* Chief cashier

You can now answer Question 6 at the end of this chapter.

Revision checklist

- A supplier of goods on credit issues an invoice to the customer.
- A supplier may allow a customer trade discount if the businesses are in the same trade and also for buying in bulk.
- If goods are returned or there is an overcharge, a customer may issue a debit note to the supplier asking for a reduction in the invoice.
- A supplier issues a credit note to notify the customer of any reduction in the total of an invoice.
- A supplier issues a statement of account at the end of each month to notify the customer of the amount owing and provide a summary of the account.
- Many accounts are paid by cheque, in which case it is not necessary to issue a receipt as proof of payment.

Exam-style questions

- 1 On 4 February Ann purchased goods, list price \$5 200, on credit from Maria. The terms of trade were:

20% trade discount on orders over \$5 000.

$2\frac{1}{2}\%$ cash discount if account paid by the end of the month.

Which amount did Ann enter in her accounts on 4 February?

- A** \$4 056 **B** \$4 160 **C** \$5 070 **D** \$5 200
- 2 Certain items are missing from the following business document:

<i>Credit note</i>		
AB Jones Unit 4 Industrial Estate Hightown		
Tom Brown 123 High Street Anytown	11 May 20-2	
	Unit price \$	Amount \$
46 tins of paint Less 20% ii discount	11.50	i _____ iii _____ iv _____

- a** Insert the missing words or figures in **i** to **iv** on the document.
- b** Name the person who issued the credit note.
- c** Suggest one reason why the credit note was issued.
- d** Name the document which may have been issued to request this credit note.
- e** State the entry AB Jones would make to record this credit note.

Account to be debited	Account to be credited

- 3** Kate sells goods on credit to Kylie. Kate does not allow cash discount. On 1 May Kylie owed Kate \$350.

The following documents were exchanged in May:

		\$
May 4	invoice	420
8	debit note	112
10	credit note	92
19	cheque	350
26	invoice	170

How much did Kylie pay on 31 May to settle her account?

- A** \$148 **B** \$386 **C** \$498 **D** \$610
- 4** Zodwa sold goods on credit to Elspeth.
Which document did Elspeth issue when she returned these goods?
- A** credit note **B** debit note **C** invoice **D** statement
- 5** There are some figures missing from the following document which Dinesh received:

Trade Supplies 345 London Road Hightown				
Dinesh 110 Long Road Northwood			31 October 20–1	
Date 20–1	Details	Debit \$	Credit \$	Balance \$
Oct 1	Balance	950		950
4	Sales	1 120		2 070
11	Sales returns		110	1 960
27	Cheque		931	?
	Discount		19	?

- a** Name this document.
- b** Suggest one reason for the issue of the document.
- c** State the amount owing by Dinesh on 31 October 20–1.
- d** Name the document sent by Trade Supplies to Dinesh on 4 October and 11 October.
- e** Calculate the percentage rate of discount allowed on 27 October.
- f** Suggest one reason why this discount was allowed.

- 6 Bill is a credit customer of Rick. The following documents were exchanged in June. Complete the following table to name the person who issued each document and the entries (if any) made in the books of Bill and Rick.

Document	Person issuing document	Entries in Bill's books		Entries in Rick's books	
		Debit	Credit	Debit	Credit
Invoice					
Debit note					
Credit note					
Statement of account					



Chapter 7

Books of prime entry

Learning objectives

In this chapter you will learn to:

- understand the use of business documents as sources of information 2.2
- explain the advantages of using various books of prime entry 2.3
- explain the use of, and process, accounting data in the books of prime entry – sales journal, purchases journal, sales returns journal and purchases returns journal 2.3
- post the ledger entries from the books of prime entry 2.3
- account for trade discount. 2.3

7.1 Introduction

In Chapter 4 it was explained how the ledger is divided into specialist areas and how the cash and the bank account are usually maintained in a cash book rather than in the ledger. Businesses use **books of prime entry** to record goods sold on credit, goods purchased on credit, sales returns and purchases returns. These books are basically listing devices, grouping similar types of transactions, which is useful when posting to the ledger. The use of these books means that a lot of detail is removed from the ledger. It also means that book-keeping can be divided between several people. Books of prime entry assist in the collating and summarising of accounting information and are useful when preparing control accounts.

Books of prime entry are also known as **books of original entry** or **subsidiary books**. The name of these books has arisen because all transactions should be recorded in one of these books **before** they are entered in the ledger.

The books of prime entry are:

- Cash book
- Petty cash book
- Sales journal
- Purchases journal
- Sales returns journal
- Purchases returns journal
- General journal



LINK

You have already learnt about cash books and petty cash books in Chapters 4 and 5.



LINK

You will learn about the general journal in Chapter 14.

This chapter concentrates on the sales, purchases and returns journals.

7.2 Sales journal

The **sales journal** is a list of the names of businesses to which credit sales were made, the value of the sales and the dates on which the sales were made. The sales journal is sometimes referred to as the **sales book** or the **sales day book**.

This journal is written up using copies of the invoices sent to the customers. The entries are summarised as follows:

1 When goods are sold on credit

- Enter the date, customer name and the invoice total in the sales journal.
- Debit the customer's account in the sales ledger with the invoice total.

2 At the end of the month

- Credit the sales account in the nominal ledger with the sales journal total.
- This will now form the double entry for all the individual debit entries in the sales ledger.



LINK

You will learn about control accounts in Chapter 16.



TIP

Books of prime entry may be referred to as books of original entry or subsidiary books.



KEY TERMS

A **book of prime entry** is one in which transactions are recorded before being entered in the ledger.

The **sales journal** shows a list of the names of businesses to which credit sales have been made, the value of the goods sold and the date on which the sales were made.



TIP

Only the total of the sales journal is posted to the sales account at the end of the month, not the individual transactions.

**KEY TERM**

The **sales returns journal** shows a list of the names of businesses which have returned goods previously sold on credit, the value of the goods returned and the date on which the returns were made.

**LINK**

You learnt about trade discount in Chapter 6.

7.3 Sales returns journal

The **sales returns journal** is a list of the names of businesses, the value of goods returned and the dates on which the returns were made. The sales returns journal is also known as the **sales returns book** or the **returns inwards book** (or **returns inwards journal**).

This journal is written up using copies of the credit notes sent to the customers. The entries are summarised as follows:

1 When goods are returned by a credit customer

- Enter the date, customer name and credit note total in the sales returns journal.
- Credit the customer's account in the sales ledger with the credit note total.

2 At the end of the month

- Debit the sales returns account in the nominal ledger with the sales returns journal total.
- This will now form the double entry for all the individual credit entries in the sales ledger.

TEST YOURSELF 7.1

- 1 List **seven** books of prime entry.
- 2 When a trader sells goods on credit, he lists them in the sales journal and debits the accounts of customers. Explain where and when the double entry for these debit entries is made.

Walkthrough 7.1

20–9

- April 3 The Weaving Shed issued an invoice to Sew and Sew for goods, \$510, subject to a trade discount of 20%
- 9 The Weaving Shed issued a credit note to Sew and Sew for goods returned, list price \$60
- 13 The Weaving Shed sold goods on credit to Fine Furnishings, \$1 000, subject to a trade discount of 25%, and issued an invoice on the same day
- 20 The Weaving Shed sent Jaffar & Company an invoice for \$220 for goods supplied on credit
- 28 The Weaving Shed issued a credit note to Jaffar & Company for \$10 because of an overcharge

Make the necessary entries in the books of The Weaving Shed for April 20–9

The Weaving Shed				
Sales journal				Page 1
Date	Name	Invoice number	Folio	Amount \$
20–9				
April 3	Sew and Sew	I 3624	sl 22	408
13	Fine Furnishings	I 3625	sl 14	750
20	Jaffar & Company	I 3626	sl 16	<u>220</u>
30	Transfer to sales account		nl 35	<u>1378</u>

Sales returns journal				
				Page 1
Date	Name	Credit note number	Folio	Amount \$
20–9				
April 9	Sew and Sew	C 529	sl 22	48
28	Jaffar & Company	C 530	sl 16	<u>10</u>
30	Transfer to sales returns account		nl 36	<u>58</u>

Sales ledger							
Sew and Sew account				Page 22			
Date	Details	Folio	\$	Date	Details	Folio	\$
20–9				20–9			
April 3	Sales	sj 1	408	April 9	Sales returns	srj 1	48

Fine Furnishings account							
				Page 14			
Date	Details	Folio	\$	Date	Details	Folio	\$
20–9							
April 13	Sales	sj 1	750				

Jaffar & Company account							
				Page 16			
Date	Details	Folio	\$	Date	Details	Folio	\$
20–9				20–9			
April 20	Sales	sj 1	220	April 28	Sales returns	srj 1	10

Nominal ledger							
Sales account							
				Page 35			
Date	Details	Folio	\$	Date	Details	Folio	\$
				20–9			
				April 30	Credit sales for month	sj 1	1378

Sales returns account							
				Page 36			
Date	Details	Folio	\$	Date	Details	Folio	\$
				20–9			
				April 30	Returns for month	srj 1	58

**TIP**

Trade discount may be shown in the journals for information but is never entered in the double entry records. Only the net value of the goods is recorded.

- Trade discount does **not** appear in the ledger accounts. Trade discount **may** be shown in the books of prime entry for information purposes only.
- The entry in the sales account on 30 April is the double entry for the three individual debits in the customers' accounts in the sales ledger.
- The entry in the sales returns account on 30 April is the double entry for the two individual credits in the customers' accounts in the sales ledger.

**KEY TERM**

The **purchases journal** shows a list of the names of businesses from which credit purchases have been made, the value of the goods purchased and the date on which the purchases were made.

7.4 Purchases journal

The **purchases journal** is a list of the names of businesses from which credit purchases were made, the value of the purchases and the dates on which the purchases were made. The purchases journal is also called the **purchases book** or the **purchases day book**.

This journal is written up using the invoices received from suppliers. The entries are summarised as follows:

1 When goods are purchased on credit

- Enter the date, supplier name and the invoice total in the purchases journal.
- Credit the supplier's account in the purchases ledger with the invoice total.

2 At the end of the month

- Debit the purchases account in the nominal ledger with the purchases journal total.
- This will now form the double entry for all the individual credit entries in the purchases ledger.

**TIP**

Only the purchases journal total is posted to the purchases account at the end of the month, not the individual transactions.

7.5 Purchases returns journal

The **purchases returns journal** is a list of the names of businesses, the value of goods returned and the dates on which the returns were made. The purchases returns journal is also known as the **purchases returns book** or the **returns outward book** (or **returns outward journal**).

This journal is written up using credit notes received from suppliers. The entries are summarised as follows:

1 When goods are returned to a credit supplier

- Enter the date, supplier name and the credit note total in the purchases returns journal.
- Debit the supplier's account in the purchases ledger with the credit note total.

2 At the end of the month

- Credit the purchases returns account in the nominal ledger with the purchases returns journal total.
- This will now form the double entry for all the individual debit entries in the purchases ledger.

TEST YOURSELF 7.2

- 1 State **two** advantages of maintaining sales, purchases and returns journals.
- 2 Complete the following sentence. The total of the purchases journal is to the account in the ledger.



KEY TERM

The **purchases returns journal** shows a list of the names of businesses to which goods, previously purchased on credit, have been returned, the value of the goods returned and the date on which the returns were made.



TIP

At the end of the month the total of the sales returns journal is posted to the sales returns account and the total of the purchases returns journal is posted to the purchases returns account.

Walkthrough 7.2

20–9

- April 3 Sew and Sew received an invoice for goods purchased from The Weaving Shed for \$510, less a trade discount of 20%
- 9 Sew and Sew received a credit note from The Weaving Shed for goods returned, list price \$60
- 24 Sew and Sew received an invoice for goods purchased on credit from The Curtain Company for \$280, less 15% trade discount
- 29 Sew and Sew discovered that half of the goods purchased on 24 April were faulty and these goods were returned to The Curtain Company who issued a credit note

Make the necessary entries in the books of Sew and Sew for April 20–9.

Sew and Sew				
Purchases journal				
				Page 1
Date	Name	Invoice number	Folio	Amount \$
20-9				
April 3	The Weaving Shed	I 3624	pl 8	408
24	The Curtain Company	I 117	pl 5	<u>238</u>
30	Transfer to purchases account		nl 4	<u>646</u>

Purchases returns journal				
				Page 1
Date	Name	Credit note number	Folio	Amount \$
20-9				
April 9	The Weaving Shed	C 529	pl 8	48
29	The Curtain Company	C 43	pl 5	<u>119</u>
30	Transfer to purchases returns account		nl 5	<u>167</u>

Purchases ledger							
The Weaving Shed account							
				Page 8			
Date	Details	Folio	\$	Date	Details	Folio	\$
20-9				20-9			
April 9	Purchases returns	prj 1	48	April 3	Purchases	pj 1	408

The Curtain Company account							
				Page 5			
Date	Details	Folio	\$	Date	Details	Folio	\$
20-9				20-9			
April 29	Purchases returns	prj 1	119	April 24	Purchases	pj 1	238

Nominal ledger							
Purchases account							
				Page 4			
Date	Details	Folio	\$	Date	Details	Folio	\$
20-9							
April 30	Credit purchases for month	pj 1	646				

Purchases returns account							Page 5
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-9			
				April 30	Returns for month	prj 1	167

**TIP**

If trade discount was allowed when goods were purchased (or sold), then it must be deducted when those goods are returned so that the price actual charged for those goods is recorded in the accounts.

- Trade discount does **not** appear in the ledger accounts. Trade discount **may** be shown in the books of prime entry for information purposes only.
- The entry in the purchases account on 30 April is the double entry for the two individual credits in the suppliers' accounts in the purchases ledger.
- The entry in the purchases returns account on 30 April is the double entry for the two individual debits in the suppliers' accounts in the purchases ledger.
- The Weaving Shed and Sew and Sew each record the transactions between the two businesses from their own viewpoint – The Weaving Shed is selling the goods and Sew and Sew are purchasing the goods.

You can now answer Questions 1–6 at the end of this chapter.

Revision checklist

- All transactions should be entered in a book of prime entry before they are entered in the ledger.
- The sales journal is written up from copies of invoices sent to customers and the sales returns journal is written up from copies of credit notes sent to customers.
- The purchases journal is written up from invoices received from suppliers and the purchases returns journal is written up from credit notes received from suppliers.
- At the end of each month the totals of the sales, purchases and returns journals are transferred to the sales, purchases and returns accounts, respectively.

Exam-style questions

- 1 Ava maintains a full set of books of prime entry.
- State **one** advantage of maintaining purchases and sales journals.
 - Complete the following table to name the business documents which Ava will use to make entries in her books of prime entry):

Book of prime entry	Business document
sales journal	
purchases journal	
sales returns journal	
purchases returns journal	

- State how Ava would enter the monthly totals of the following books of prime entry in her ledger. The first one has been completed as an example.

Book of prime entry	Ledger entry
sales journal	sales account credit
purchases journal	
sales returns journal	
purchases returns journal	

- Name **two** other books of prime entry which Ava may use.
- Name the ledger in which Ava will maintain the following accounts:
 - sales account
 - purchases returns account
 - Charles (a credit customer)

Ava provided the following information about Charles, one of her credit customers:

20–1

June 1 Charles owed \$450

5 Charles purchased goods, list price \$580, less 20% trade discount

13 Charles returned goods, list price \$300, purchased on 5 June

23 Charles purchased goods, list price \$200 (no trade discount was granted)

28 Charles paid the balance of his account on 1 June by cheque and deducted 2% cash discount

- Write up the account of Charles in the ledger of Ava. Balance the account and bring down the balance on 1 July 20–1.
- 2 Dale purchased goods, list price \$2800, on credit from Jennie. Jennie offers Dale 20% trade discount and a $2\frac{1}{2}\%$ cash discount for prompt payment. Which entry will Jennie make in her books of prime entry?
- | | |
|------------------------------------|------------------------------------|
| A purchases journal \$2 184 | B purchases journal \$2 240 |
| C sales journal \$2 184 | D sales journal \$2 240 |

The following transactions took place in March 20–1.

- March 4 Sold goods on credit to Musa, list price \$800, less 20% trade discount
11 Musa returned half of the goods purchased on 4 March
17 Purchased goods on credit from Siwela, list price \$900, less 15% trade discount
20 Returned goods to Siwela, purchased on 17 March, list price \$300
27 Paid Siwela a cheque for the amount owing on 1 March less 2% cash discount
30 Musa paid \$1 000 by credit transfer on account

- a** Enter the balances on 1 March in the appropriate accounts.
- b** Enter the transactions for March in the sales journal, purchases journal, sales returns journal and purchases returns journal.
- c** Post the entries from the journals to the ledger accounts.
- d** Enter the transactions on 27 and 30 March in the accounts of Siwela and Musa respectively.
- e** Balance the accounts of Musa and Siwela and bring down the balances on 1 April 20–1.

Section 2: Practice questions

- 1** Which statement about a credit note is correct?
- A** It is sent to a customer when there has been an overcharge on an invoice.
 - B** It is sent to a customer when there has been an undercharge on an invoice.
 - C** It is sent to a supplier when there has been an overcharge on an invoice.
 - D** It is sent to a supplier when there has been an undercharge on an invoice.
- 2** Which book of prime entry is part of the double entry system?
- | | |
|----------------------------|--------------------------|
| 1 cash book | 2 petty cash book |
| 3 purchases journal | 4 sales journal |
- A** 1 only **B** 1 and 2 **C** 3 and 4 **D** 1, 2, 3 and 4
- 3** Ryan buys and sells on credit terms and keeps a full set of accounting records. Where does he maintain the accounts of his credit customers?
- A** sales journal
 - B** sales ledger
 - C** purchases journal
 - D** purchases ledger
- 4** Cheyenne sells goods on credit terms and allows her customers a trade discount of 25%. In June the list price of goods returned by customers totalled \$2 400. What entry will Cheyenne make in her nominal ledger on 30 June?
- A** sales returns account \$1 800 debit
 - B** sales returns account \$2 400 debit
 - C** purchases returns account \$1 800 credit
 - D** purchases returns account \$ 2400 credit
- 5** On 1 May Sally owed William \$400. On 21 May she purchased goods, list price \$1 440, subject to a trade discount of 25%. She returned one third of these goods on 24 May. How much did Sally owe William on 31 May?
- A** \$630
 - B** \$720
 - C** \$1 030
 - D** \$1 120

- 6** Phayo is a trader. He maintains a full set of accounting records.
- a** Complete the following table to name one source document from which Phayo will complete each book of prime entry.

Book of prime entry	Source document
Purchases journal	
Sales journal	
Purchases returns journal	
Sales returns journal	
Petty cash book	
Cash book	

Phayo sells good on credit to Phupho. On 1 May 20–7 Phupho owed Phayo \$1 350.

They exchanged the following documents during May 20–7:

- Invoice \$1 500
- Debit note \$120
- Credit note \$100
- Statement of account \$1 750
- Cheque \$1 350

- b** For each document name the person who issued that document and suggest one reason for the issue of that document.
- c** Prepare the account of Phupho as it would appear in the ledger of Phayo for the month of May 20–7. Balance the account and bring down the balance on 1 June 20–7.
- d** Name the ledger in which Phayo would maintain the account of Phupho.
- 7** Aryan is a retailer. He trades with Mikhail, a wholesaler.
- The following business documents were exchanged in May:
Cheque, credit note, debit note, invoice, receipt, statement of account.
- a** List these documents in the order in which they would be issued. Name the person who issued each document.
- b** Explain why each document was issued.
- c** Name the book of prime entry in which each trader would record the documents. If the document would not be recorded in a book of prime entry give a reason for this.

- 8 Nelson sells goods on credit. He maintains a full set of accounting records.

The following information was extracted from his accounting records for October 20–4.

1 October 20–4	\$
Debit balances in sales ledger: Jamil	600
Nawaz	140

Sales journal				
			\$	\$
Oct 4	Jamil	Goods	490	
		Trade discount	98	392
13	Nawaz	Goods		154
24	Jamil	Goods	310	
		Trade discount	62	248
31	Total for month			<u>794</u>

Sales returns journal				
			\$	\$
Oct 15	Nawaz	Goods		93
26	Jamil	Goods	200	
24		Trade discount	40	160
31	Total for month			<u>253</u>

Extract from debit side of cash book				
		\$	\$	\$
		Discount allowed	Cash	Bank
Oct 7	Jamil	18		582
21	Nawaz		90	
28	Jamil			400

- Write up the following accounts for the month of October 20–4: sales, sales returns, Jamil and Nawaz. Balance the accounts of Jamil and Nawaz and bring down the balances. There is no need to total or balance the other accounts.
- Suggest **two** differences between cash discount and trade discount.
- Calculate the rate of trade discount that Nelson allowed Jamil on 4 October.
- Calculate the rate of cash discount that Nelson allowed Jamil on 7 October.

- 9** Annie opened a wholesale clothing business on 1 August 20–6. She received the following documents during August 20–6:

Invoices

- August 4 From Sue, for goods, list price \$1 960 less 25% trade discount
 15 From Amos, for goods, list price \$290
 21 From Jane, for goods, list price \$2 950 less 20% trade discount

Credit notes

- August 10 From Sue, for return of faulty goods, list price \$120, purchased on 4 August
 26 From Jane, for return of all the goods purchased on 21 August as not what was ordered

Annie issued the following documents during August 20–6:

Invoices

- August 7 To Andrew, for goods, list price \$2 100
 18 To Ben, for goods, list price \$3 150 less 20% trade discount
 27 To Andrew, for goods, list price \$1 820

Credit note

- August 29 To Andrew, for half of the goods purchased on 27 August returned as faulty

- a** Make the necessary entries in the purchases journal, sales journal, purchases returns journal and sales returns journal.
- b** Make the necessary posting to the appropriate accounts in the purchase ledger, sales ledger and nominal ledger. It is not necessary to balance or total any of the accounts.
- c** Suggest **two** reasons why Annie allowed Andrew a trade discount.
- d** Name the document which Annie may have issued before she received a credit note from Sue on 10 August.
- e** Explain why Annie may issue a statement of account to each credit customer at the end of every month.

On 21 September 20–6 Annie paid the amount owing to Sue on 31 August, less a cash discount of 3%.

- f** Calculate the amount paid to Sue on 31 August 20–6.

Section 3

Chapter 8

Financial statements – Part A

Learning objectives

In this chapter you will learn to:

- explain the advantages and disadvantages of operating as a sole trader 5.1
- explain the importance of preparing income statements 5.1
- explain the difference between a trading business and a service business 5.1
- prepare income statements for trading businesses and for service businesses 5.1
- make adjustments for goods taken by the owner for own use 5.1
- balance ledger accounts as required and make transfers to financial statements. 2.1

8.1 Introduction

All the previous chapters have covered the book-keeping records maintained by a sole trader. Similar records will be maintained by other types of businesses.

When a person is operating a business alone as a sole trader, he/she is entitled to all the profits the business makes, but will be responsible for any losses the business makes. Business decisions may be made quickly, as consultation is not necessary, but there is no one with whom to share the decision-making or the workload. The capital of the business will be restricted to what the trader is able to invest, whereas other forms of business have access to capital invested by other owners of the business.

When a person starts a business his/her aim is to make a profit. The profit (or loss) is calculated in the financial statements which are usually prepared at the end of each financial year. Financial statements basically consist of two parts:

- 1 An **income statement** which consists of two sections:
 - a **trading section** in which the **gross profit** of the business is calculated
 - a **profit and loss section** in which the **profit for the year** of the business is calculated.

The trading section and the profit and loss section of the income statement are part of the double entry system.

- 2 A **statement of financial position** shows the **assets and liabilities** of the business at a certain date. The statement of financial position is not part of the double entry system.

Financial statements are usually prepared from a trial balance. **Every item in a trial balance appears once in a set of financial statements.** As each item is used, it is useful to place a tick (✓) against the item. This ensures that no items are overlooked.

It is common to find notes accompanying a trial balance about various adjustments which are to be made (these are explained in the following chapters). **Any notes to a trial balance are used twice in a set of financial statements.** To ensure that this is done, it is useful to place a tick (✓) against the notes each time they are used.



TIP

Every item in a trial balance is used once within a set of financial statements; any notes to a trial balance are used twice within a set of financial statements.



LINK

You will learn about partnerships and limited companies in Chapters 19 and 21.



KEY TERM

An **income statement** is a statement prepared for a trading period to show the gross profit and profit for the year.



LINK

You will learn more about statements of financial position in Chapter 9.



TIP

Tick off the items from a trial balance and the notes to a trial balance as you use them so that nothing is omitted.

Walkthrough 8.1

The following trial balance was extracted from the books of Samir at 31 May 20–8.

This trial balance will be used in Walkthrough 8.2 to Walkthrough 8.7.

Samir		
Trial balance at 31 May 20–8		
	Dr	Cr
	\$	\$
Revenue		95 700
Sales returns	1 000	
Purchases	65 000	
Purchases returns		500
Carriage inwards	1 500	
Inventory 1 Jun 20–8	7 100	
Discount received		400
Discount allowed	900	
Wages	11 200	
General expenses	2 800	
Property tax	600	
Loan interest	500	
Premises	80 000	
Fixtures and equipment	13 900	
Trade receivables	7 500	
Trade payables		7 800
Bank	3 300	
Cash	100	
Long-term loan		10 000
Capital		90 000
Drawings	9 000	
	<u>204 400</u>	<u>204 400</u>

**TIP**

The term 'revenue' is used instead of 'sales' in a trial balance and in an income statement.

- The inventory at 31 May 20–8 was valued at \$7 600.
- During the year ended 31 May 20–8, Samir took goods costing \$300 for his own use. No entries have been made in the accounting records.

8.2 Trading section of the income statement

The **trading section** is concerned with buying and selling, and its purpose is to calculate the profit earned on the goods sold. This is known as the **gross profit**. The formula for calculating gross profit is:

$$\text{Gross profit} = \text{Selling price of goods} - \text{Cost of sales}$$

The selling price represents the total sales less any sales returns.

The cost of sales represents the total cost of the goods actually sold. This is not necessarily the cost of goods purchased during the year: some goods may have been in stock at the start of the year, and some of the goods purchased during the year may remain unsold at the end of the year. The formula for calculating cost of sales is:

$$\text{Cost of sales} = \text{Opening inventory} + \text{Purchases} - \text{Closing inventory}$$

The purchases figure represents the total cost of purchases less any purchases returns. If carriage inwards has been paid on goods purchased this must be added to the purchases as it increases the cost of the goods. If the owner of the business has withdrawn goods for personal use the cost of these is credited to the purchases account, so reducing the cost of goods available for sale. If goods taken by the owner have not already been recorded they must be deducted from the purchases. The formula for calculating the net purchases figure is:

$$\text{Net purchases} = \text{Purchases} - \text{Purchases returns} + \text{Carriage inwards} - \text{Goods for own use}$$

The calculation of gross profit is shown in the trading section of the income statement. This must have a heading which includes the period of time covered by the statement. It is also usual to include the name under which the business trades.



KEY TERM

The **gross profit** is the difference between the selling price and the cost of those goods.

TEST YOURSELF 8.1

- 1 State what is calculated in:
 - a a trading account section of an income statement
 - b a profit and loss account section of an income statement.
- 2 State the formula for calculating gross profit.
- 3 State the formula for calculating cost of sales.

There are two ways in which a trading section of an income statement can be prepared – **horizontal** and **vertical**.

The **horizontal format** is similar to a traditional ledger account. Using this method, the revenue is shown on the credit side and the cost of sales on the debit side. The difference (or balance) between the two sides equals the gross profit.

Walkthrough 8.2

Using the trial balance and accompanying notes shown in **Walkthrough 8.1**, prepare the trading section of the income statement of Samir for the year ended 31 May 20–8. Use the horizontal format.

Samir					
Income statement (trading section) for the year ended 31 May 20–8					
	\$	\$		\$	\$
Opening inventory		7 100	Revenue	95 700	
Purchases	65 000		Less Sales returns	<u>1 000</u>	94 700
Less Purchases returns	<u>500</u>				
	64 500				
Less Goods for own use	<u>300</u>				
	64 200				
Carriage inwards	<u>1 500</u>	65 700			
		<u>72 800</u>			
Less Closing inventory		<u>7 600</u>			
Cost of sales		65 200			
Gross profit c/d		<u>29 500</u>			
		<u>94 700</u>			<u>94 700</u>

- As these items are entered in the trading section of the income statement, they should be ticked-off in the trial balance and accompanying notes.
- The gross profit is carried down to the profit and loss section (see Section 8.3).
- The first money column on each side has been used for adding and subtracting items and the final column had been used for the section total.

A trading section of an income statement can also be prepared using the **vertical format**. This is the format used by most businesses. A statement prepared using this method contains the same information as a horizontal account, but looks like an arithmetic calculation.

Walkthrough 8.3

Using the trial balance and accompanying notes shown in **Walkthrough 8.1**, prepare the trading section of the income statement of Samir for the year ended 31 May 20–8. Use the vertical format.

Samir			
Income statement (Trading Section) for the year ended 31 May 20–8			
	\$	\$	\$
Revenue		95 700	
Less Sales returns		<u>1 000</u>	94 700
Less Cost of sales			
Opening inventory		7 100	
Purchases	65 000		
Less Purchases returns	<u>500</u>		
	64 500		
Less Goods for own use	<u>300</u>		
	64 200		
Carriage inwards	<u>1 500</u>	65 700	
		<u>72 800</u>	
Less Closing inventory		<u>7 600</u>	65 200
Gross profit			<u>29 500</u>

- The first two money columns have been used for adding and subtracting items and the final column for the final section total. For example, the first column has been used to adjust the purchases for returns, carriage and goods for own use and the final cost of purchases has been entered in the second column.

You can now answer Questions 1 and 2 at the end of this chapter.

8.3 Profit and loss section of the income statement

The **profit and loss** section of an income statement is concerned with profits and losses, gains and expenses. Its purpose is to calculate the final profit after all running expenses and other items of income. This is known as the **profit for the year**. The formula for calculating profit for the year is:

$$\text{Profit for the year} = \text{Gross profit} + \text{Other income} - \text{Expenses}$$

The profit and loss section of an income statement must have a heading which includes the period of time covered by the statement. It is also usual to include the name under which the business trades.

As with a trading section of an income statement, a profit and loss section can be prepared using either the **horizontal** or the **vertical** method. Using the horizontal format, the gross profit and any other income are shown on the credit side and the expenses are shown on the debit side. The difference (or balance) between the two sides equals the **profit for the year** (if the credit side is the largest) or the **loss for the year** (if the debit side is the largest).

Walkthrough 8.4

Using the trial balance and accompanying notes shown in **Walkthrough 8.1**, prepare the profit and loss section of the income statement of Samir for the year ended 31 May 20–8. Use the horizontal format.



KEY TERM

The **profit for the year** is the final profit after any other income has been added to the gross profit and the running expenses have been deducted.

Samir				
Income statement (profit and loss section) for the year ended 31 May 20–8				
	\$	\$		\$
Discount allowed		900	Gross profit	b/d 29 500
Wages	11 200		Discount received	400
General expenses	2 800			
Property tax	600			
Loan interest	500			
Profit for the year	<u>13 900</u>			
		<u>29 900</u>		<u>29 900</u>

- As these items are entered in the profit and loss section of the income statement they should be ticked-off in the trial balance and accompanying notes.
- The gross profit is brought down from the trading section where it was calculated.

A profit and loss section of an income statement can also be prepared using the vertical format. This format is used by most businesses. A statement prepared using this method contains the same information but looks like an arithmetic calculation.

Walkthrough 8.5

Using the trial balance and accompanying notes shown in **Walkthrough 8.1**, prepare the profit and loss section of the income statement of Samir for the year ended 31 May 20–8. Use the vertical format.

Samir			
Income statement (profit and loss section) for the year ended 31 May 20–8			
	\$	\$	\$
Gross profit			29 500
Add Discount received			<u>400</u>
			29 900
Less Discount allowed		900	
Wages		11 200	
General expenses		2 800	
Property tax		<u>600</u>	<u>15 500</u>
Profit from operations			14 400
Less Loan interest		<u>500</u>	
Profit for the year			<u>13 900</u>

- Using the vertical presentation it is easy to show the profit earned from the normal trading or operating activities and then final profit for the year after the deduction of any finance costs.

TEST YOURSELF 8.2

- 1 Suggest **six** business expenses (excluding those shown in the walkthroughs).
- 2 State the formula for calculating profit for the year.

The two sections of the income statement are usually presented in the form of one combined statement, which is normally presented in vertical format. The profit and loss section follows on immediately after the trading section, with the words 'gross profit' being written only once. The heading of the income statement includes the period of time covered by the statement and the name under which the business trades.

As most businesses prepare their income statements using the vertical format this method will be followed in the remainder of this book.

Walkthrough 8.6

Using either the trial balance and accompanying notes shown in **Walkthrough 8.1** or the separate sections of the income statement prepared in **Walkthroughs 8.3** and **8.5**, prepare the income statement of Samir for the year ended 31 May 20–8.

Samir			
Income statement for the year ended 31 May 20–8			
	\$	\$	\$
Revenue		95 700	
Less Sales returns		<u>1 000</u>	94 700
Less Cost of sales			
Opening inventory		7 100	
Purchases	65 000		
Less Purchases returns	<u>500</u>		
	64 500		
Less Goods for own use	<u>300</u>		
	64 200		
Carriage inwards	<u>1 500</u>	65 700	
		<u>72 800</u>	
Less Closing inventory		<u>7 600</u>	65 200
Gross profit			<u>29 500</u>
Add Discount received			<u>400</u>
			29 900
Less Discount allowed		900	
Wages	11 200		
General expenses	2 800		
Property tax	<u>600</u>		15 500
Profit from operations			<u>14 400</u>
Less Loan interest		<u>500</u>	
Profit for the year			<u>13 900</u>



You will learn more about income statements in Chapters 11, 12 and 13.

You can now answer Questions 3 and 4 at the end of this chapter.

d

Wages account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
May 31	Total to date		<u>11 200</u>	May 31	Income statement		<u>11 200</u>
			<u>11 200</u>				<u>11 200</u>

- The entries shown as ‘totals to date’ represent the total of the individual entries made in the account for the year ended 31 May 20–8.
- All the other items in the income statement (excluding inventory, gross profit and profit for the year) have similar transfers from the appropriate ledger accounts.
- The gross profit technically has a double entry within the income statement as it is transferred from the trading account section to the profit and loss account section (refer to **Walkthroughs 8.2 and 8.4**).
- The entries for inventory and profit for the year are explained next.

There are two entries for inventory in the income statement – the inventory at the start of the year and the inventory at the end of the year. The inventory account will have a debit balance representing the inventory at the start of the year – this is credited to the inventory account and transferred to the debit of the income statement. The inventory at the end of the year is shown as a deduction from the debit entries in the income statement (which is equal to a credit entry), so this must be debited in the inventory account.

Walkthrough 8.8

Using the income statement prepared for Samir in **Walkthrough 8.6**, prepare the inventory account in Samir’s ledger on 31 May 20–8.

Samir Nominal ledger Inventory account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7				20–8			
Jun 1	Balance	b/d	<u>7 100</u>	May 31	Income statement		<u>7 100</u>
			<u>7 100</u>				<u>7 100</u>
20–8							
May 31	Income statement		7 600				

- The entry of \$7 600 on the debit side, representing the inventory at the end of the financial year on 31 May 20–8, becomes the opening inventory for the year beginning 1 June 20–8.



TIP

The income statement consists of the trading account and the profit and loss account which are part of the double entry system.

A profit for the year represents the return on the owner’s investment. This will appear as a debit entry in the income statement and should be transferred to the credit of the capital account as it increases the amount the business owes the owner. A loss for the year will

appear as a credit entry in the income statement and should be transferred to the debit of the capital account as it reduces the amount the business owes the owner.

As explained in Chapter 2, the total of the drawings account is transferred to the capital account at the end of the year.

Walkthrough 8.9

On 1 June 20–7 the credit balance on Samir’s capital account was \$90 000. During the year ended 31 May 20–8 he had withdrawn \$9 000 in cash and \$300 in goods. His profit for the year ended 31 May 20–8 was \$13 900.

Prepare the capital account and the drawings account in Samir’s ledger on 31 May 20–8.

Samir Nominal ledger Capital account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–7			
May 31	Drawings		9 300	Jun 1	Balance	b/d	90 000
	Balance	c/d	94 600	20–8			
				May 31	Profit		13 900
			<u>103 900</u>				<u>103 900</u>
				20–8			
				Jun 1	Balance	b/d	94 600

Drawings account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
May 31	Total to date			May 31	Capital		9 300
	Cash		9 000				
	Purchases		<u>300</u>				
			<u>9 300</u>				<u>9 300</u>



TIP

If a business makes a profit it is credited to the capital account as it increases the owner’s capital. If a business makes a loss it is debited to the capital account as it reduces the owner’s capital.

TEST YOURSELF 8.3

- 1 Explain why it is necessary to make two transfers from the income statement to the inventory account at the end of the financial year.
- 2 Explain why a loss for the year is debited to the owner’s capital account.

You can now answer Question 5 at the end of this chapter.

8.5 Income statement of a service business

A **service business** is one which does not buy and sell goods, such as an accountant, an insurance company, a travel agent, a hairdresser and so on. At the end of the financial year, these businesses still need to prepare financial statements. However, the trading account section of the income statement is not prepared as no goods are bought and sold. Only the profit and loss section of the income statement and a statement of financial position are prepared.

In the income statement all the items of revenue receivable such as fees from clients, commission and other income are credited and expenses are debited. The statement of financial position is exactly the same as the statement of financial position of a **trading business**.



KEY TERMS

A **service business** is one which provides a service.

A **trading business** is one which buys and sells goods.

Walkthrough 8.10

Anita is a business consultant. She provided the following information at the end of her financial year on 30 September 20–5.

	\$
Property tax	6 400
General expenses	8 950
Insurance	2 670
Printing and stationery	4 560
Loan interest	1 500
Wages	43 500
Rent receivable	7 300
Commissions received	92 150

- a Prepare the income statement for Anita for the year ended 30 September 20–5. Use the horizontal format.

Anita				
Income statement for the year ended 30 September 20–5				
	\$	\$	\$	\$
Property tax	6 400	Commissions received	92 150	
General expenses	8 950	Rent receivable	7 300	
Insurance	2 670			
Printing and stationery	4 560			
Loan interest	1 500			
Wages	43 500			
Profit for the year	31 870			
	<u>99 450</u>			<u>99 450</u>

**TIP**

The income statement of a service business does not have a trading account section.

- b** Prepare the income statement for Anita for the year ended 30 September 20–5. Use the vertical format.

Anita			
Income statement for the year ended 30 September 20–5			
	\$	\$	\$
Commissions received			92 150
Add Rent receivable			<u>7 300</u>
			99 450
Less Property tax		6 400	
General expenses		8 950	
Insurance		2 670	
Printing and stationery		4 560	
Wages		<u>43 500</u>	<u>66 080</u>
Profit from operations			33 370
Less Loan interest			<u>1 500</u>
Profit for the year			<u>31 870</u>

You can now answer Question 6 at the end of this chapter.

Revision checklist

- The difference between the selling price and the cost price is known as the gross profit. This is calculated in the trading account section of the income statement.
- The difference between the gross profit, plus other income, less expenses is known as the profit for the year. This is calculated in the profit and loss account section of the income statement.
- All the items appearing in the income statement are transferred from the ledger accounts to complete the double entry.
- A profit for the year is transferred to the credit of the capital account and a loss for the year is transferred to the debit of the capital account.
- A business which provides a service only prepares the profit and loss account section of the income statement.

Exam-style questions

1 How is the cost of sales calculated?

- A opening inventory + purchases – carriage inwards – purchases returns – closing inventory
- B opening inventory + purchases – carriage inwards + purchases returns – closing inventory
- C opening inventory + purchases + carriage inwards – purchases returns – closing inventory
- D opening inventory + purchases + carriage inwards + purchases returns + closing inventory

2 At the end of his first year of trading, Rashid provided the following information.

	\$
Revenue	72 500
Purchases	49 700
Closing inventory	4 800
Carriage inwards	1 150
Carriage outwards	2 950

What was Rashid's gross profit?

- A \$22 800
- B \$24 650
- C \$26 450
- D \$27 600

3 Mai, a fashion retailer, did not record goods costing \$500 taken for personal use.

What was the effect of this error?

	Gross profit		Profit for the year	
	Overstated	Understated	Overstated	Understated
A	✓		✓	
B		✓		✓
C	✓			✓
D		✓	✓	

- 4 Leo is a wholesaler. He has little knowledge of accounting. He prepared the following income statement which contains some errors.

Leo			
Income statement for the year ended 30 April 20–1			
		\$	\$
Revenue			82 300
Add	Discount received		110
	Opening inventory		<u>4 910</u>
			87 320
Less	Purchases	49 520	
	Returns from customers	<u>1 190</u>	
		50 710	
	Less Closing inventory	<u>5 080</u>	<u>45 630</u>
	Profit on goods		41 690
Add	Discount allowed		<u>220</u>
			41 910
Less	Rent payable	8 100	
	Less Rent receivable	<u>6 000</u>	
		2 100	
	Wages	12 100	
	Carriage inwards	100	
	Sundry expenses	<u>960</u>	<u>15 260</u>
	Final profit		<u>26 650</u>

Prepare a corrected income statement for Leo for the year ended 30 April 20–1.

- 5 Oliver has been in business as a retailer for one year. He is unsure about some of the terms used in business.
- a Explain the difference between the following terms and how they are recorded in an income statement:
 - i gross profit and profit for the year
 - ii carriage inwards and carriage outwards
 - iii discount allowed and discount received
 - iv purchases returns and sales returns

Oliver provided the following totals for the year ended 31 December 20–5:

	\$
Rates	3 140
Office expenses	1 170
Commissions received	5 830
Sales returns	1 480

- b** Enter these totals in the appropriate accounts. Close the accounts by making transfers to the income statement.

- 6** Candy provided the following information at the end of her financial year on 30 September 20–3:

	\$
Capital at 1 October 20–2	198 000
Fees received from clients	82 300
Staff wages	49 600
Rent and rates	7 420
Insurance	3 830
Commissions received	4 810
Light and heat	2 180
Office expenses	1 730
Drawings	18 750

- a** State whether Candy’s business is a trading business or a service business. Give a reason for your answer.
- b** Prepare Candy’s income statement for the year ended 30 September 20–3.
- c** Prepare Candy’s capital account on 30 September 20–3. Balance the account and bring down the balance on 1 October 20–3.

Chapter 9

Financial statements – Part B

Learning objectives

In this chapter you will learn to:

- explain the importance of preparing statements of financial position 5.1
- understand that statements of financial position record assets and liabilities on a specified date 5.1
- recognise and define the content of a statement of financial position: non-current assets, intangible assets, current assets, current liabilities, non-current liabilities and capital 5.1
- understand the inter-relationship of items in a statement of financial position 5.1
- prepare statements of financial position for trading businesses and service businesses. 5.1

9.1 Introduction

As explained in Chapter 8, the financial statements are prepared at the end of each financial year. These consist of an **income statement** and a **statement of financial position**.

A **statement of the financial position** shows the assets of a business (what the business owns and what is owing to the business) and the liabilities of a business (what the business owes) on a certain date. The assets show how the resources are being used and the liabilities show where they come from.

TEST YOURSELF 9.1

- 1 Define a statement of financial position.
- 2 Explain the meaning of **each** of the following terms:
 - a asset
 - b liability



KEY TERMS

A **statement of financial position** is a statement of the assets and liabilities of a business on a certain date.

Non-current assets are assets which are obtained for use and not for resale, which help the business earn revenue.



TIP

If the totals of a trial balance are equal, the totals of the statement of financial position should balance. If they do not there is an error somewhere in the financial statements.



LINK

You learned how to prepare elementary statements of financial position in Chapter 1.

It is usual to arrange the assets and liabilities into different groups according to their type.

9.2 Assets

Assets are divided into two types. These are:

1 Non-current assets

There are two types of **non-current assets**:

a Tangible non-current assets

Tangible non-current assets are long-term assets which are obtained for use rather than for resale. They help the business earn revenue. **Examples** of tangible non-current assets include land and buildings, machinery, fixtures and motors.

In a statement of financial position, it is usual for the **non-current assets** to be **arranged in increasing order of liquidity**. This means that the most permanent assets are shown first.

A typical order for showing tangible non-current assets in a statement of financial position is as follows:

- Land and buildings
- Machinery
- Fixtures and equipment
- Motor vehicles

b Intangible non-current assets

Intangible non-current assets are long-term assets which do not have material substance (they cannot be seen or touched). However, they belong to the business



TIP

An intangible asset is something owned by a business which cannot be touched.



LINK

You will learn more about goodwill in Chapter 22.



KEY TERMS

Goodwill is the amount by which the value of a business as a whole exceeds the value of the separate assets and liabilities.

Current assets are short-term assets whose amounts are constantly changing.

Non-current liabilities are amounts owed which are not due for repayment within the next 12 months.

Current liabilities are amounts owed which are due for repayment within the next 12 months.

and do have a value. **Examples** of intangible non-current assets include **goodwill**, brand names and trademarks.

In a statement of financial position the intangible non-current assets are shown before the tangible non-current assets.

2 Current assets

Current assets are short-term assets. Because they arise from the normal trading activities of the business their amounts are constantly changing. These are assets which are either in the form of cash or which can be turned into cash relatively easily.

Examples of current assets include inventory, trade receivables, bank and cash.

In a statement of financial position, it is usual for **current assets** to be **arranged in increasing order of liquidity**. This means that the assets furthest away from cash are shown first.

A typical order for showing current assets in a statement of financial position is:

- Inventory
- Trade receivables
- Bank
- Cash

9.3 Liabilities

Liabilities are divided into three types. These are:

1 Capital

Capital represents the owner's investment in the business and is the amount owed by the business to the owner.

2 Non-current liabilities

Non-current liabilities are amounts owed by the business which are not due for repayment within the next 12 months.

Examples of non-current liabilities include long-term loan and mortgage.

3 Current liabilities

Current liabilities are short-term liabilities. Since current liabilities, like current assets, arise from the normal trading activities of the business, their amounts are constantly changing. They are amounts owed by the business which are due for repayment within the next 12 months.

Examples of current liabilities include trade payables and bank overdraft.

TEST YOURSELF 9.2

- 1 Define the term non-current assets. Illustrate your answer by giving **two** examples.
- 2 State the order in which current assets are arranged in a statement of financial position.
- 3 Explain how to distinguish between a non-current liability and a current liability.

A statement of financial position must have a heading which includes the date to which it relates. It is also usual to include the name under which the business trades.

There are two ways in which a statement of financial position can be prepared – **horizontal** and **vertical**. A **horizontal** statement of financial position is prepared in a two-sided format. It is usual for the assets to be listed on the left and the liabilities to be listed on the right.

Walkthrough 9.1

The following trial balance was extracted from the books of Samir at 31 May 20–8.

This trial balance was used in Chapter 8 to prepare an income statement for the year ended 31 May 20–8.

The profit for the year of \$13 900 was calculated in the income statement.

Samir		
Trial balance at 31 May 20–8		
	Dr	Cr
	\$	\$
✓ Revenue (sales)		95 700
✓ Sales returns	1 000	
✓ Purchases	65 000	
✓ Purchases returns		500
✓ Carriage inwards	1 500	
✓ Inventory 1 Jun 20–8	7 100	
✓ Discount received		400
✓ Discount allowed	900	
✓ Wages	11 200	
✓ General expenses	2 800	
✓ Property tax	600	
✓ Loan interest	500	
Premises	80 000	
Fixtures and equipment	13 900	
Trade receivables	7 500	
Trade payables		7 800
Bank	3 300	
Cash	100	
Long-term loan		10 000
Capital		90 000
Drawings	9 000	
	204 400	204 400

- The inventory at 31 May 20–8 was valued at \$7 600.
- During the year ended 31 May 20–8 Samir took goods costing \$300 for his own use.
- No entries have been made in the accounting records.

As explained in Chapter 8, every item within a trial balance is used once in the preparation of a set of financial statements, and any notes to a trial balance are used twice. The items already used in the preparation of the income statement in Chapter 8 have been ticked.

Walkthrough 9.2

Using the trial balance and accompanying notes shown in **Walkthrough 9.1**, prepare a balance statement of financial position for Samir at 31 May 20–9. Use the horizontal format.

Samir					
Statement of financial position at 31 May 20–9					
	\$	\$		\$	\$
Non-current assets			Capital		
Premises		80 000	Opening balance		90 000
Fixtures and equipment		13 900	Plus Profit for the year		13 900
		<u>93 900</u>			<u>103 900</u>
Current assets			Less Drawings		
			(9 000 + 300)		9 300
Inventory	7 600				<u>94 600</u>
Trade receivables	7 500		Non-current liabilities		
Bank	3 300		Loan		10 000
Cash	<u>100</u>	18 500	Current liabilities		
			Trade payables		7 800
		<u>112 400</u>			<u>112 400</u>

- As these items are entered in the statement of financial position they should be ticked-off in the trial balance and accompanying notes.
- Once the statement of financial position is completed all the items in the trial balance should have a tick and the notes to the trial balance should have two ticks.
- The assets and liabilities have been arranged in their different categories.
- The balance on the capital account has increased because the business made a profit (which the business owes to the owner of the business), but has decreased because the owner made drawings (money and goods).

If a statement of financial position is prepared using the **vertical** format, the assets are listed (showing how the resources are used) and underneath them the liabilities are listed (showing where the resources have come from).



TIP

There are several acceptable formats for presenting statements of financial position. Whichever format is selected it is important to classify the assets and liabilities into the different types.

Walkthrough 9.3

Using the trial balance and accompanying notes shown in **Walkthrough 9.1**, prepare a statement of financial position for Samir at 31 May 20–9. Use the vertical format.

Samir			
Statement of financial position at 31 May 20–9			
	\$	\$	\$
Assets			
Non-current assets			
Premises			80 000
Fixtures and equipment			13 900
			<u>93 900</u>
Current assets			
Inventory			7 600
Trade receivables			7 500
Bank			3 300
Cash			100
			<u>18 500</u>
Total assets			<u>112 400</u>
Capital and liabilities			
Capital			
Opening balance			90 000
Plus Profit for the year			13 900
			103 900
Less Drawings (9 000 + 300)			9 300
			<u>94 600</u>
Non-current liabilities			
Loan			10 000
Current liabilities			
Trade payables			7 800
Total capital and liabilities			<u>112 400</u>

- The first section of the statement shows how the resources are being used and the second section shows where those resources have come from.

**TIP**

When the statement of financial position is completed, every item in the trial balance should have a tick against it and each note to the trial balance should have two ticks against it.

As most businesses prepare their statement of financial position using the vertical format, this method will be followed in the remainder of this book.

You can now answer Questions 1–6 at the end of this chapter.

Revision checklist

- A statement of financial position shows the assets and liabilities of a business on a certain date.
- Non-current assets are long-term assets. In a statement of financial position the most permanent are shown first.
- Current assets are short-term assets and their values are constantly changing. In a statement of financial position the furthest away from cash are shown first.
- Non-current liabilities are amounts which are not due for repayment within the next 12 months.
- Current liabilities are amounts which are due for repayment within the next 12 months.

Exam-style questions

- 1 Lydia is a wholesaler. She has very little knowledge about accounting, but attempted to prepare a statement of financial position. The statement she prepared contains errors.

Lydia			
Statement of financial position at 31 July 20–5			
Assets	\$	Liabilities	\$
Premises	82 500	Trade receivables	2 140
Capital	100 000	Drawings	16 120
Cash	250	Loan (repayable in 5 years)	20 000
Profit for the year	14 350	Cash at bank	4 360
Fixtures and fittings	11 980		
Inventory	2 480		
Motor vehicle	16 500		
Trade payables	1 980		
	<u>230 040</u>		<u>52 620</u>

Prepare a corrected statement of financial position at 31 July 20–5. Use the vertical format.

- 2 Dwayne's assets and liabilities on 29 September 20–1 were as follows:

	\$
Fixtures and fittings	49 500
Inventory	9 050
Trade payables	7 450
Trade receivables	8 150
Cash at bank	750

Dwayne invested \$10 000 additional capital on 30 September 20–1.

What was Dwayne's capital after this transaction?

- A** \$62 500 **B** \$67 450 **C** \$70 000 **D** \$77 450

- 3 A trader took cash from the business for personal use.
What effect would this have on the financial statements?

	Current assets	Profit for the year
A	decrease	increase
B	decrease	no effect
C	increase	decrease
D	increase	increase

- 4 A trader repaid a long-term loan of \$10 000. She used all the money in the business bank account, \$7 000, and paid the balance from her personal bank account. How did this affect the statement of financial position?

	Assets	Liabilities	Capital
A	no effect	decrease \$3 000	increase \$3 000
B	decrease \$7 000	decrease \$10 000	increase \$3 000
C	decrease \$10 000	decrease \$7 000	decrease \$3 000
D	decrease \$10 000	decrease \$10 000	no effect

- 5 Ayesha is a business adviser. Her financial year ends on 30 September. She provided the following trial balance at 30 September 20–3:

	\$	\$
Capital		125 000
Drawings	15 200	
Premises	95 000	
Office equipment	21 600	
Fees from clients		65 950
Insurance	3 110	
Printing and stationery	2 480	
Wages	59 650	
Office expenses	3 120	
Rent receivable		6 000
Trade receivables	6 150	
Bank overdraft		9 510
Cash	206 150	206 460
	<u>206 460</u>	<u>206 460</u>

Prepare Ayesha's income statement for the year ended 30 September 20–3 and a statement of financial position at 30 September 20–3.

6 Abhinav is a trader.

Using the following information taken from Abhinav's books on 30 June 20–8:

- a** prepare a trial balance at 30 June 20–8
- b** prepare an income statement for the year ended 30 June 20–8
- c** prepare a statement of financial position at 30 June 20–8.

	\$
Capital	54 400
Drawings	1 300
Premises	30 000
Fixtures	4 000
Revenue	82 000
Purchases	70 100
Inventory 1 July 20–7	18 600
Carriage inwards	400
Carriage outwards	1 500
Trade receivables	14 000
Trade payables	8 000
Discount received	210
Insurance	390
Sundry expenses	340
Wages	10 300
Rates	1 200
Loan interest	500
Long-term loan from ABC Loans	10 000
Cash at bank	1 980

Inventory at 30 June 20–8 was valued at \$20 100.

Chapter 10

Accounting rules

Learning objectives

In this chapter you will learn to:

- explain and recognise the application of the following accounting principles: business entity, consistency, duality, going concern, historic cost, matching, materiality, money measurement, prudence, realisation 7.1
- recognise the influence of international accounting standards and understand the following objectives in selecting accounting policies: comparability, relevance, reliability and understandability 7.2
- distinguish between and account for capital expenditure and revenue expenditure 4.1
- distinguish between and account for capital receipts and revenue receipts 4.1
- calculate and comment on the effect on profit of incorrect treatment 4.1
- calculate and comment on the effect on asset valuations of incorrect treatment 4.1
- understand the basis of the valuation of inventory at the lower of cost and net realisable value 4.5
- prepare simple inventory valuation statements 4.5
- recognise the importance of valuation of inventory and the effect of an incorrect valuation of inventory on gross profit, profit for the year, equity and asset valuation. 4.5

10.1 Introduction

Accounting has developed a number of rules which must be applied by everyone who is involved with the recording of financial information. If every accountant or book-keeper followed their own rules it would be impossible for others to fully understand the financial position of a business. In the same way, it would be impossible to make a comparison between the financial results of two or more businesses if they had each applied their own rules in the preparation of their accounting statements. The accounting principles which must be applied by every business are explained in this chapter.

It also describes how capital and revenue expenditure and capital and revenue receipts should be recorded. It is important that all businesses follow the same procedures for these items. Similarly, all businesses should apply the same principles of inventory valuation. This is also explained in Section 10.5.

TEST YOURSELF 10.1

- 1 State **one** reason why accounting rules are necessary.

10.2 Accounting principles

Accounting principles are sometimes referred to as **concepts** and **conventions**. A **concept** is a rule which sets down how the financial activities of a business are recorded. A **convention** is an acceptable method by which the rule is applied to a given situation. Some of the main accounting principles have already been applied to the practical accounting examples in the previous chapters.

The main accounting principles are explained next.

Business entity

The **business entity principle** is also known as the **accounting entity principle**. This means that the **business is treated as being completely separate from the owner of the business**. The personal assets of the owner, the personal spending of the owner, etc. do not appear in the accounting records of the business. The accounting records relate only to the business and record the assets of the business, the liabilities of the business, the money spent by the business and so on. Everything is recorded from the viewpoint of the business.

If there is a transaction concerning both the business and its owner then it is recorded in the accounting records of the business. When the owner introduces capital into the business, it is credited to the capital account (to show the funds coming from the owner). The capital account shows a credit balance representing the amount owed by the business to the owner. When the owner makes drawings from the business a debit entry will be made in the drawings account (to show the value going to the owner) which reduces the amount owed by the business to the owner.

Consistency

There are some areas of accounting where a choice of method is available. For example, there are several different ways to calculate the depreciation of a non-current asset.



TIP

In addition to learning the names of the principles, you must be able to explain and provide examples of each principle.



KEY TERM

The **business entity principle** means that the business is treated as being completely separate from the owner of the business.



LINK

The practical application of the principle of business entity has already been explained in Chapters 2, 4 and 9.



LINK

You will learn about depreciation in Chapter 12.



KEY TERMS

The **consistency principle** means that accounting methods must be used consistently from one accounting period to the next.

The **principle of duality** means that every transaction is recorded twice – once on the debit side and once on the credit side.

The **going concern principle** means that the accounting records are maintained on the basis that the business will continue to operate for an indefinite period of time.

The **historic cost principle** means that all assets and expenses are initially recorded at their actual cost.

Where a choice of method is available, the one with the most realistic outcome should be selected. Once a method has been selected, **the method must be used consistently from one accounting period to the next**. This is known as the **consistency principle**. If this is not done, a comparison of the financial results from year to year is impossible, and the profit of a particular year can be distorted.

There may be a good reason why it is necessary to change a method or valuation. In such a situation, the change may be made, but the effects of this should be noted in the financial statements.

TEST YOURSELF 10.2

- 1 Explain the meaning of the term business entity.
- 2 State why a business should apply the principle of consistency.

Duality

The **principle of duality** is also referred to as the **dual aspect principle**. It has been explained in Chapter 2 how **every transaction has two aspects – a giving and a receiving**. The term **double entry** is used to describe how these two aspects of a transaction are recorded in the accounting records.

Going concern

The accounting records of a business are always maintained on the basis of assumed continuity. This means that **it is assumed that the business will continue to operate for an indefinite period of time and that there is no intention to close down the business or reduce the size of the business by any significant amount**. This is the **going concern principle**.

This continuity means that the non-current assets shown in a statement of financial position will appear at their book value, which is the original cost less depreciation (see Chapter 12), and inventory will appear at the lower of cost or net realisable value (see Section 10.5).

If it is expected that the business will cease to operate in the near future, the asset values in the statement of financial position will be adjusted. Assets will be shown at their expected sale values which are more meaningful than their book value in this situation.

Historic cost

The **historic cost principle** requires that **all assets and expenses are initially recorded in the ledger accounts at their actual cost**. It is closely linked to the money measurement principle. Cost is a known fact and can be verified.

Applying this principle makes it difficult to make comparisons about transactions occurring at different times because of the effect of inflation.

Sometimes it is necessary to adopt a more prudent approach to ensure that the non-current assets are shown at a more realistic value, so the cost price is reduced by depreciation (see Chapter 12).

Matching

The **matching principle** is also referred to as the **accruals principle**. This is an extension of the realisation principle to include other income and expenses. **The revenue of the accounting period is matched against the costs of the same period** (the timing of the actual receipts and payments is ignored).

The figures shown in an income statement must relate to the period of time covered by that statement, whether or not any money has changed hands. This means that a more meaningful comparison can be made of the profits, sales, expenses, and so on from year to year.



LINK

In Chapter 11 you will learn why it is sometimes necessary to adjust the items of income and expense in an income statement for amounts prepaid or accrued.



LINK

You will learn how the matching principle is applied to capital and revenue expenditure later in this section.



KEY TERMS

The **matching principle** means that the revenue of the accounting period is matched against the costs of the same period.

The **materiality principle** means that individual items which will not significantly affect either the profit or the assets of a business do not need to be recorded separately.

Materiality

The **materiality principle** applies to items of very low value (items which are not 'material') which are not worth recording as separate items. Other principles can be ignored if the time and cost involved in recording such low value items far outweigh any benefits to be gained from the strict application of these principles. For example, a pocket calculator purchased for office use is strictly a non-current asset, part of its value being 'lost' each year through normal usage. The cost of calculating and recording this each year would amount to more than the cost of the asset. Instead of the calculator being recorded as a non-current asset, it would be regarded as an office expense in the year of purchase. What is material for one business may not be so for another business. A laptop computer may be regarded as immaterial for a large multi-national business, but would be material for a small sole trader. A large business may decide that non-current assets costing less than \$1 000 will be regarded as immaterial and be charged as expenses. A small business may have a much lower figure.

This principle is also applied by entering small expenses in one account known as 'general expenses' or 'sundry expenses' rather than having individual ledger accounts for office expenses like light bulbs, flower displays and so on. Materiality is also applied in relation to inventories of office supplies like envelopes when the total cost of envelopes purchased during the year is treated as an expense even though there are some left at the end of the year.

TEST YOURSELF 10.3

- 1 Explain how the principle of duality is carried out in recording the day-to-day transactions of a business.
- 2 State **one** situation when the principle of going concern is **not** applied.
- 3 Explain what is meant by the principle of matching.
- 4 Explain why the principle of materiality may be applied to the purchase of an office stapler.



KEY TERMS

The **money measurement principle** means that only information which can be expressed in terms of money can be recorded in the accounting records.

The **prudence principle** means that profits and assets should not be overstated and losses and liabilities should not be understated.

The **realisation principle** means that revenue is only regarded as being earned when the legal title to goods passes from the seller to the buyer.

Money measurement

The **money measurement principle** means that **only information which can be expressed in terms of money can be recorded in the accounting records**. Money is a recognised unit of measure and is a traditional way of valuing transactions. It does not rely on personal opinions and it is factual.

There are many aspects of a business which cannot be measured in terms of money and, therefore, do not appear in the accounting records. The morale of the workforce, the effectiveness of a good manager, the benefits of a staff training course all play an important part in the success of the business, but they will not appear in the accounting records as their value cannot be expressed in monetary terms. In a similar way, the launch of a rival product or increased competition cannot be recorded in the accounting records as their effects cannot be measured in monetary terms.

Prudence

The **prudence principle** is also known as the principle of **conservatism**. This principle ensures that the accounting records present a realistic picture of the position of the business. However, the exercise of prudence does not allow the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses. In short, prudence does not permit bias. **Accountants should ensure that profits and assets are not overstated and that liabilities are not understated**. The phrase ‘**never anticipate a profit, but provide for all possible losses**’ is often used to describe the principle of **prudence**. Profit should only be recognised when it is reasonably certain that such a profit has been realised and all possible losses should be provided for.

Prudence is a very important principle. If a situation arises where applying another accounting principle would be contrary to the principle of prudence, then the principle of prudence is applied. For example, under the realisation principle, profit is earned when goods actually change hands; but if the customer fails to pay after a reasonable time, the principle of prudence may be applied and the debt is written off.

Realisation

The **realisation principle** emphasises the importance of not recording a profit until it has actually been earned. This means that **revenue is only regarded as being earned when the legal title to goods or services passes from the seller to the buyer**, who has then an obligation (liability) to pay for those goods.

When an order is placed by a customer no goods change hands, and no profit is earned. Profit is regarded as being realised when the goods actually change hands. This is the same even if the goods are sold on credit and the customer does not pay for them immediately.

TEST YOURSELF 10.4

- 1 No entry is made in the accounting records of Park Street Stores when a competitor reduces his prices by 15%. Explain why.
- 2 ‘If in doubt, understate profits and overstate losses’. State which accounting principle is being described.
- 3 A customer orders goods on 2 February. The goods are delivered to the customer on 16 February. A cheque in full settlement is received from the customer on 28 February. State the date on which the revenue is regarded as realised. Give a reason for your answer.

You can now answer Questions 1 and 2 at the end of this chapter.



LINKS

You will learn about providing for the loss in value of non-current assets in Chapter 12.

You will learn about providing for the loss when customers do not pay their accounts in Chapter 13.

10.3 International accounting standards

International accounting standards ensure that financial statements are prepared using the same rules and guidelines internationally. Knowledge of the individual accounting standards is outside the scope of the syllabus.

The objectives of the standards are to ensure that users of financial statements are protected and not misled. The quality of information contained in financial statements determines the usefulness of these statements. This quality of information can be measured in terms of four factors – comparability, relevance, reliability and understandability.

Comparability

The information contained in financial statements can be useful if it can be compared with similar information about the same business for another accounting period or at another point in time. It is also useful to be able to compare the information with similar information about other business.

In order to make comparisons, it is necessary to be aware of any different policies used in the preparation of the financial statements, any changes in these policies and the effects of such changes. It is important to be able to identify similarities and differences between the information in the financial statement and the information relating to other accounting periods or other businesses.

Relevance

Financial statements provide information about a business's financial performance and position. These can be used as the basis for financial decisions. It is important that the information is provided in time for these decisions to be made: information not available when required is of little use.

It is also important that the information is relevant to users of the financial statements. This means that it can be used to confirm, or correct, prior expectations about past events and also to help forming, revising or confirming expectations about the future.

Reliability

The information provided in financial statements can be reliable if it is:

- capable of being depended upon by users as being a true representation of the underlying transactions and events which it is representing
- capable of being independently verified
- free from bias
- free from significant errors
- prepared with suitable caution being applied to any judgements and estimates which are necessary.

Understandability

It is important that financial statements can be understood by the users of those statements. This depends partly on the clarity of the information provided.

**TIP**

You need to be able to explain these four accounting objectives.

It also depends on the abilities of the users of the financial statements. It is normally assumed that users of financial statements have a reasonable knowledge of business and economic activities and accounting and that they will be reasonably diligent when studying the financial statements. However, information should not be omitted from financial statements because it is decided that it is too difficult for users to understand.

TEST YOURSELF 10.5

- 1 State **two** ways in which information can be regarded as being relevant.
- 2 State **three** ways in which information can be regarded as being reliable.
- 3 Explain why it is necessary to know any changes in accounting policy when comparing financial statements with those of a previous year.
- 4 Explain the meaning of the term 'understandability'.

**KEY TERMS****Capital expenditure**

is money spent on purchasing, improving or extending non-current assets.

Revenue

expenditure is money spent on running a business on a day-to-day basis.

A **capital receipt** is money received by a business from a source other than the normal trading activities.

10.4 Capital and revenue expenditure and receipts

Capital expenditure

Capital expenditure is money spent by a business on purchasing non-current assets and improving or extending non-current assets. This includes all the legal costs incurred in the purchase of non-current assets, costs of carriage for the delivery of non-current assets and costs of installing non-current assets.

These costs will appear as non-current assets in the statement of financial position of a business. They should **not** be charged as expenses in the year of purchase as they benefit the business for several years. The value of non-current assets often decreases because of depreciation (see Chapter 12). This cost will be **matched** against the annual revenue which the non-current asset has helped the business to earn.

Revenue expenditure

Revenue expenditure is money spent on running a business on a day-to-day basis. This includes the administration expenses, the selling expenses, the financial expenses and the cost of maintaining and running non-current assets. It also includes the cost of goods purchased for the purpose of resale.

These costs will appear in the income statement. They are **matched** against the revenue of the period.

If these two types of expenditure are treated incorrectly the profit for the year will be inaccurate and the statement of financial position (whilst still balancing) will also be incorrect. For example, if repairs to a machine were treated as an improvement to that machine the expenses in the income statement would be understated, so the profit for the year would be overstated. In the statement of financial position, the non-current assets would be overstated and the capital would also be overstated because of the incorrect profit for the year.

Capital receipt

A **capital receipt** occurs when money is received other than from normal trading activities. This includes the receipt of capital from the owner, the receipt of loans and the proceeds of sale of a non-current asset.

A capital receipt should **not** be entered in the income statement. If, however, a profit or loss is made on the sale of a non-current asset then this will be included in the income statement for the year in which the asset was sold.

Revenue receipt

A **revenue receipt** is money received by a business from normal trading activities.

These include revenue from the sale of goods, fees from clients and other income such as rent received, commission received, discount received and so on.

Because these arise from the normal trading activities they are entered in the income statement.



LINK

You will learn about the disposal of non-current assets in Chapter 12.



KEY TERM

A **revenue receipt** is money received by a business from normal trading activities.

TEST YOURSELF 10.6

- 1 Explain why it is important to distinguish between capital expenditure and revenue expenditure.
- 2 Give **one** example of **each** of the following: **a** capital receipt, **b** revenue receipt.

You can now answer Questions 3 and 4 at the end of this chapter.

10.5 Inventory valuation

It is necessary for a business to value its inventory at the end of each financial year.

Inventory is always valued at the **lower of cost or net realisable value**. This is an application of the principle of **prudence** as overvaluing the inventory causes both the profit and the assets to be overvalued.

The cost of the inventory is the actual purchase price plus any additional costs (such as carriage inwards) incurred in bringing the inventory to its present position and condition. The net realisable value is the estimated receipts from the sale of the inventory, less any costs of completing the goods or costs of selling the goods.

Usually the cost of the inventory will be lower than the net realisable value. It may happen that the goods are damaged or there is no demand for such type of goods because of change in taste or fashion. In this situation, the net realisable value will be lower than cost.



TIP

Inventory must always be valued at the lower of cost and net realisable value.

TEST YOURSELF 10.7

- 1 State the basis on which inventory should be valued.
- 2 Explain the meaning of the term 'net realisable value'.

Walkthrough 10.1

Dhaval sells two different types of goods (Type A and B). He provided the following information at 31 December 20–6:

Type	Units	Cost price per unit	Net realisable value per unit
A	94	\$20	\$18
B	38	\$15	\$19

The cost price per unit of Type A does not include carriage inwards of \$1 per unit.
It will cost \$0.50 per unit to bring Type A goods into a saleable condition
12 units of Type B were damaged and would only be able to be sold for \$10 per unit.
Prepare a statement to show the value of the closing inventory at 31 December 20–6.

Dhaval		
Valuation of inventory at 31 December 20–6		
	\$	\$
Type A – 94 units at \$17.50		1 645
Type B – 12 units at \$10	120	
26 units at \$15	<u>390</u>	<u>510</u>
		<u>2 155</u>

Calculations

Type A Cost \$20 + Carriage \$1 = \$21
Net realisable value \$18 – costs to complete \$0.50 = \$17.50
Valued at net realisable value as it is lower than cost

Type B 12 units Cost \$15
Net realisable value \$10
Valued at net realisable value as it is lower than cost
26 units Cost \$15
Net realisable value \$19
Valued at cost as it is lower than net realisable value

You can now answer Question 5 at the end of this chapter.



You will learn about correcting errors in Chapter 15.

As explained earlier, the inventory at the end of one year becomes the inventory at the start of the next year. If an incorrect value is placed on the inventory it will affect the gross profit and the profit for the year for both the current financial year and the following financial year. Incorrect values will also be shown for both current assets and capital in the statement of financial position.

Walkthrough 10.2

After the preparation of his financial statements for the year ended 31 December 20–7 Dhaval discovered that he had over-valued his closing inventory by \$50

Complete the following table by placing a tick in the correct columns to show the effect of this.

	Overstated	Understated	No effect
gross profit for the year ended 31 December 20–7	✓		
gross profit for the year ending 31 December 20–8		✓	

	Overstated	Understated	No effect
profit for the year ended 31 December 20–7	✓		
profit for the year ending 31 December 20–8		✓	
Dhaval's capital at 31 December 20–7	✓		
Dhaval's capital at 31 December 20–8			✓
current assets at 31 December 20–7	✓		
current assets at 31 December 20–8			✓

Over-valuing the inventory at 31 December 20–7 will affect the financial statements for that year because

- the cost of sales is under-stated so both the gross profit and the profit for the year will be overstated
- over-stating the profit for the year means that the balance of the capital account on 31 December 20–7 will also be over-stated
- the total of the current assets at 31 December 20–7 will be over-stated if the inventory at that date is over-valued.

Over-valuing the inventory at 31 December 20–7 will affect the financial statements for the year ending 31 December 20–8 because

- the cost of sales is over-stated so both the gross profit and the profit for the year will be under-stated
- under-stating the profit for the year means that the balance of the capital account on 31 December 20–7 will have been corrected at 31 December 20–8
- the total of the current assets at 31 December 20–8 will not be affected.

You can now answer Question 6 at the end of this chapter.

Revision checklist

- Accounting has developed a set of principles which are applied in the preparation of accounting statements.
- The main accounting principles are – business entity, consistency, duality, going concern, historic cost, matching, materiality, money measurement, prudence and realisation.
- The quality of information contained in financial statements can be measured in terms of four factors – comparability, relevance, reliability and understandability.
- It is important to distinguish between capital and revenue expenditure and also between capital and revenue receipts. If these items are treated incorrectly the financial statements will also be inaccurate.
- At the end of every financial year inventory must be valued. It is always valued at the lower of cost or net realisable value.

5 Abeba provided the following information about her closing inventory:

	Number of units	Cost price per unit	Net realisable value per unit
Product X	500	\$1.00	\$1.80
Product Y	2000	\$2.00	\$1.90

200 units of Product Y were damaged and unsaleable.

What was the value of Abeba's inventory?

- A** \$3920 **B** \$4100 **C** \$4320 **D** \$4700

- 6 **a** Explain the meaning of the terms 'cost' and 'net realisable value'.
b State how a trader should value the inventory at the end of the financial year.
c At the end of the financial year on 30 June 20–6, a trader discovered that he had undervalued his closing inventory by \$1 000.

Complete the following table by placing a tick in the correct columns to show the effect of this:

	Overstated	Understated	No effect
Profit for the year ended 30 June 20–6			
Gross profit for the year ended 30 June 20–7			
Current assets on 30 June 20–7			

Chapter 11

Other payables and other receivables

Learning objectives

In this chapter you will learn to:

- recognise the importance of matching costs and revenues 4.3
- prepare ledger accounts to record accrued and prepaid expenses 4.3
- prepare ledger accounts to record accrued and prepaid incomes 4.3
- make adjustments for accrued and prepaid expenses and accrued and prepaid incomes. 5.1

11.1 Introduction

It is often necessary to make adjustments to the accounting records in order to present a more accurate view of the profit or loss of the business and the financial position of the business. Such adjustments are referred to as **year-end adjustments**.

The examples used in previous chapters assumed that all the expenses in the profit and loss section of the income statement were paid until the end of the financial year, with nothing paid beyond that date and nothing unpaid. A similar approach was used in relation to revenue items within the profit and loss section of the income statement when it was assumed that all the items were received up to the end of the financial year with nothing relating to a period beyond that date and nothing outstanding. In practice, this is rarely the case: it is common to find expenses or income unpaid, or to find expenses or income paid in one financial year but which relate to other financial years.

Only items relating to that particular time period should be included in the statement: the timing of the actual receipts and payments is not relevant.

An income statement is prepared for a definite period of time (the period of time covered by the statement being included as part of the statement heading).

This is a practical application of the **matching principle**.

It is necessary to adjust the items within an income statement for amounts **prepaid** or **accrued**. This means that the profit or loss will be shown at a more accurate figure, and it allows for more meaningful comparisons of the financial statements from year to year.

The use of a simple diagram is often helpful when calculating the expense or income relating to a particular financial year. This is illustrated in the examples used in this chapter.

11.2 Accrued and prepaid expenses

Accrued expenses

An **accrual** is an amount due in an accounting period which remains unpaid at the end of that accounting period. Where an expense is accrued it means that some benefit or service has been received during the accounting period but this benefit or service has not been paid for by the end of the period.

To apply the **matching principle**, the amount transferred to the income statement should represent the expense for the accounting period covered by that account. This means that **any amount due but unpaid at the end of the financial year must be added to the amount paid** and the total expense relating to the accounting period transferred to the income statement.

The expense account will now show a balance equal to the amount unpaid. To complete the double entry, this **balance is brought down on the credit side of the ledger account**. As the balance represents an amount owing, due for payment in the near future, it will be included as a **current liability** in the **statement of financial position**.



LINK

You will learn more about year-end adjustments in Chapters 12 and 13.



LINK

You learned about income statements in Chapter 8.



LINK

You learned about the matching principle in Chapter 10.



TIP

Only those expenses and incomes which relate to the current financial year are included in the income statement.



KEY TERM

An **accrued expense** is an expense relating to a particular accounting period which is unpaid at the end of that period.



LINK

You learned in Chapter 8 how the totals of the expense accounts and income accounts are transferred to the income statement at the end of the financial year.

The entries are summarised as follows:

During the year – debit the expense account and credit the cash book with the amount paid.

At the year-end – debit the expense account with any amount due but unpaid and carry down as a credit balance

credit the expense account and debit the income statement with the difference on the expense account (this represents the expense for the year)

include the balance on the expense account as a current liability in the statement of financial position.

TEST YOURSELF 11.1

- 1 State what is meant by an accrued expense.
- 2 State where an accrued expense is shown in a statement of financial position.
- 3 Explain why accrued expenses should be included when calculating the profit.

Walkthrough 11.1

Salman started a business on 1 April 20–7.

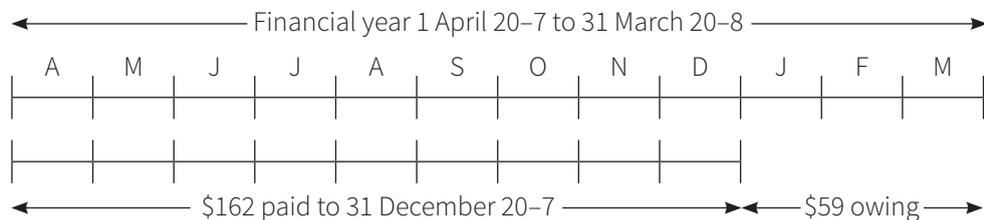
He receives an invoice for telephone expenses quarterly in arrears. During the year ended 31 March 20–8 his payments for expenses included the following:

- 20–7 30 June Telephone expenses paid in cash, \$44
- 4 October Telephone expenses paid by credit transfer, \$56
- 20–8 3 January Telephone expenses paid by credit transfer, \$62

An invoice for telephone expenses for \$59 was received on 31 March 20–8. This was for telephone expenses up to the end of March, but was not paid until 5 April 20–8.

- a Write up the telephone expenses account in Salman’s nominal ledger for the year ended 31 March 20–8.
- b Prepare a relevant extract from Salman’s income statement for the year ended 31 March 20–8.
- c Prepare a relevant extract from Salman’s statement of financial position at 31 March 20–8.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to add the amount owing at the end of the year.

a

Salman Nominal ledger Telephone expenses account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7				20–8			
Jun 30	Cash		44	Mar 31	Income statement		221
Oct 4	Bank		56				
20–8							
Jan 3	Bank		62				
Mar 31	Balance	c/d	59				
			<u>221</u>				<u>221</u>
				20–8			
				Apr 1	Balance	b/d	59

b

Salman Extract from income statement for the year ended 31 March 20–8	
	\$
Expenses – Telephone expenses	221

c

Salman Extract from statement of financial position at 31 March 20–8	
	\$
Current liabilities	
Other payables	59

- The telephone expenses relating to the financial year ended on 31 March 20–8 amount to \$221, which is the total paid plus the amount unpaid.
- The telephone expenses would be listed with the other expenses in the income statement and deducted from the gross profit.
- Where there are several accrued expenses it is usual to show one combined figure in the statement of financial position under 'other payables' rather than showing the amount of each separate accrual.

**KEY TERM**

A **prepaid expense** is an expense paid during the financial year which relates to a future accounting period.

Prepaid expenses

A **prepayment** is an amount that is paid in advance. Where an expense is prepaid it means that a payment has been made during the financial year for some benefit or service to be received in a future accounting period.

As with accrued expenses, the **matching principle** must be applied so that the amount transferred to the income statement represents the expense for the accounting period covered by that statement. Any amount paid during the financial year relating to a future accounting period must be deducted from the amount paid so that only the expense relating to the accounting period is transferred to the income statement.

The expense account will now show a balance equal to the amount paid in advance. To complete the double entry, this **balance is brought down on the debit side of the ledger account**. As the balance represents a short term benefit, which the business has paid for but which is not used up, it will be included as a **current asset** in the **statement of financial position**.

The entries are summarised as follows:

During the year – debit the expense account and credit the cash book with the amount paid.

At the year-end – credit the expense account with any amount paid in advance and carry down as a debit balance

credit the expense account and debit the income statement with the difference on the expense account (this represents the expense for the year)

include the balance on the expense account as a current asset in the statement of financial position.

TEST YOURSELF 11.2

- 1 State what is meant by a prepaid expense.
- 2 State where a prepaid expense is shown in a statement of financial position.
- 3 Explain how the matching principle is applied to expenses shown in the income statement.

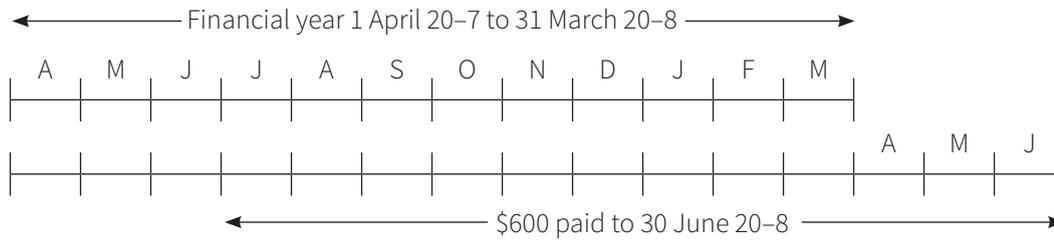
Walkthrough 11.2

Salman started a business on 1 April 20–7.

Salman rented premises until 1 July 20–7 when he purchased premises. He paid a cheque for \$600 for one year's insurance on his premises on 1 July 20–7.

- a Write up the insurance account in Salman's nominal ledger for the year ended 31 March 20–8.
- b Prepare a relevant extract from Salman's income statement for the year ended 31 March 20–8.
- c Prepare a relevant extract from Salman's statement of financial position at 31 March 20–8.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to deduct that portion of the \$600 which falls outside the financial year (3 months/12 months or $\frac{1}{4}$ of \$600 relates to the following financial year).

a

Salman Nominal ledger Insurance account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-8			
Jul 1	Bank		600	Mar 31	Income statement		450
					Balance	c/d	150
			<u>600</u>				<u>600</u>
20-8							
Apr 1	Balance	b/d	150				

b

Salman	
Extract from income statement for the year ended 31 March 20-8	
Expenses – Insurance	\$ 450

c

Salman	
Extract from statement of financial position at 31 March 20-8	
Current assets	\$
Other receivables	150

- The insurance relating to the financial year ended on 31 March 20-8 amounts to \$450, which is the insurance from 1 July 20-7 to 31 March 20-8.
- The insurance expense would be listed with the other expenses in the income statement and deducted from the gross profit.
- Where there are several prepaid expenses it is usual to show one combined figure in the statement of financial position under 'other receivables' rather than showing the amount of each separate prepayment.

If a business has an inventory of stationery, postage stamps, wrapping paper and so on at the end of a financial year, this can be regarded as a prepaid expense. Money has been spent, but the benefit will not be received until the following accounting period, when these are actually used. The entries are similar to those for a prepaid expense.

Walkthrough 11.3

Salman started a business on 1 April 20–7.

During the year ended 31 March 20–8 he purchased stationery costing \$113.

On 31 March 20–8 the inventory of stationery was valued at \$36.

Write up the stationery account in Salman's nominal ledger for the year ended 31 March 20–8.

Salman Nominal ledger Stationery account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Mar 31	Bank/cash		113	Mar 31	Income statement		77
					Balance	c/d	36
			<u>113</u>				<u>113</u>
20–8							
Apr 1	Balance	b/d	36				

- The date of 31 March 20–8 has been used for the total paid as no individual dates and amounts were shown in the question.
- The expense of \$77 would be listed with the other expenses in the income statement and deducted from the gross profit.
- The balance representing the inventory at 31 March 20–8 would appear as a current asset in the statement of financial position.
- The inventory of stationery must not be included in the inventory of goods for resale.

You can now answer Questions 1–3 at the end of this chapter.

11.3 Opening balances on expense accounts

The trader mentioned in **Walkthrough 11.1** to **11.3** was in his first year of business, so none of the expense accounts prepared in these examples had an opening balance. There was, however, a closing balance on each account which became the opening balance for the second year of trading. This must be considered when calculating the expense relating to the next financial year.

Walkthrough 11.4

Salman's financial year ends on 31 March.

He receives an invoice for telephone expenses quarterly in arrears.

On 1 April 20–8 the telephone expenses account in Salman's nominal ledger showed a credit balance of \$59.

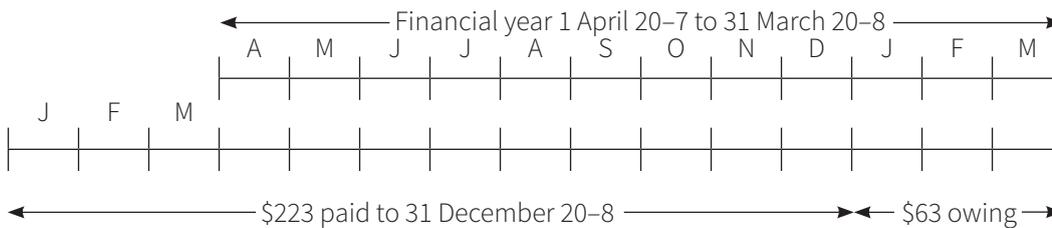
During the year ended 31 March 20–9 his payments for expenses included the following:

20–8	5 April	Telephone expenses paid in cash, \$59
20–8	30 June	Telephone expenses paid by cheque, \$60
	2 October	Telephone expenses paid by credit transfer, \$48
	31 December	Telephone expenses paid by credit transfer, \$56

An invoice for telephone expenses for \$63 was received on 31 March 20–9. This was for telephone expenses up to the end of March, but was not paid until 2 April 20–9.

Write up the telephone expenses account in Salman's nominal ledger for the year ended 31 March 20–9.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to:

- deduct that portion of the \$223 which falls outside the financial year (\$59 was paid during this financial year but related to the previous accounting period)
- add the \$63 owing at the end of present financial year.

Salman							
Nominal ledger							
Telephone expenses account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Apr 5	Cash		59	Apr 1	Balance	b/d	59
Jun 30	Bank		60	20–9			
Oct 2	Bank		48	Mar 31	Income statement		227
Dec 31	Bank		56				
20–9							
Mar 31	Balance	c/d	<u>63</u>				
			<u>286</u>				<u>286</u>
				20–9			
				Apr 1	Balance	b/d	63

Walkthrough 11.5

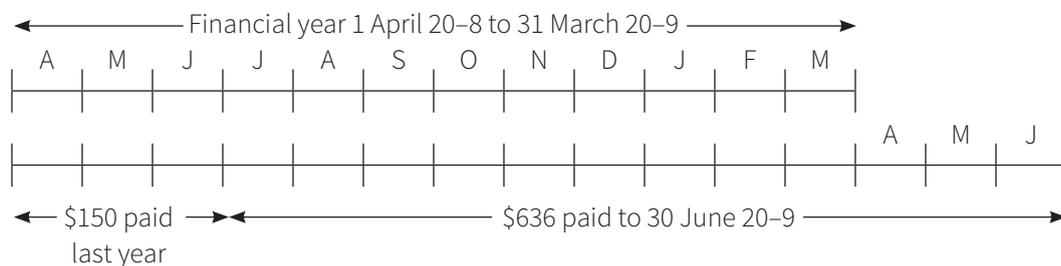
Salman’s financial year ends on 31 March.

On 1 April 20–8 the insurance account in Salman’s nominal ledger showed a debit balance of \$150.

He paid \$636 for one year’s insurance on his premises by direct debit on 1 July 20–8.

Write up the insurance account in Salman’s nominal ledger for the year ended 31 March 20–9.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to:

- deduct that portion of the \$636 which falls outside the financial year (3 months/12 months or $\frac{1}{4}$ of \$636 relates to the following financial year)
- add the \$150 paid in the previous financial year as it falls within the present financial year.

Salman							
Nominal ledger							
Insurance account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–9			
Apr 1	Balance	b/d	150	Mar 31	Income statement		627
Jul 1	Bank		<u>636</u>		Balance	c/d	<u>159</u>
			<u>786</u>				<u>786</u>
20–9							
Apr 1	Balance	b/d	159				

TEST YOURSELF 11.3

- 1** Anisha started business on 1 April 20–1. Property tax amounted to \$800 for the year ended 31 March 20–2 and \$880 for the year ended 31 March 20–3. Property tax of \$600 was paid during the year ended 31 March 20–2 and \$860 was paid during the year ended 31 March 20–3.

For **each** of the years ended 31 March 20–2 and 31 March 20–3 state:

- the amount charged for property tax in the income statement
- the amount shown for property tax in the statement of financial position, indicating whether it is a current asset or a current liability.

**TIP**

Where an item of expense or income requires adjustment it is recommended that the calculation is shown. This can be done in brackets after the wording and the final figure shown in the money column.

11.4 Combined expense accounts

Sometimes a business may use one ledger account for two different, but related, expenses. The same principles are applied as those used for an account containing a single expense. The only difference is that there may be two opening and closing balances.

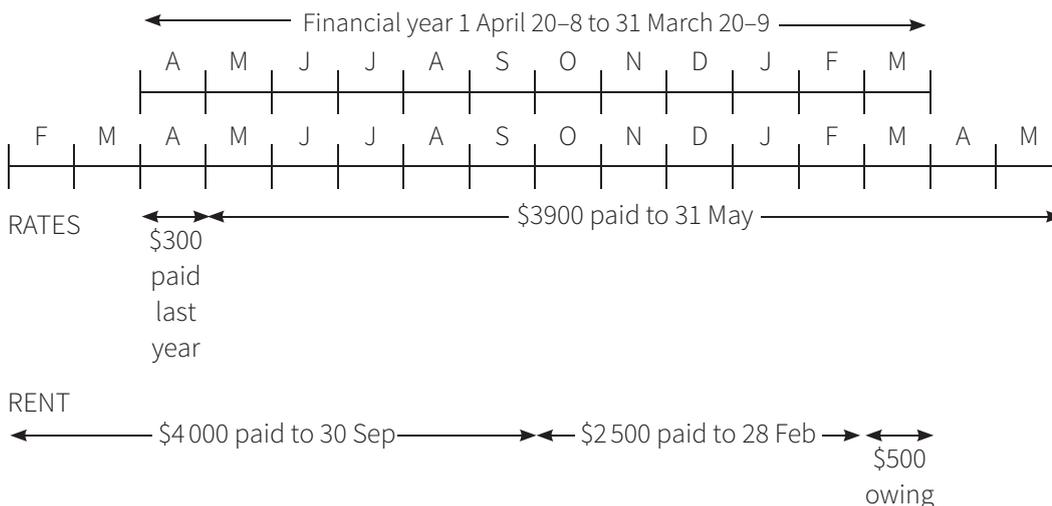
Walkthrough 11.6

Mary's financial year ends on 31 March. She maintains a combined account for rent and rates. On 1 April 20–8 Mary had prepaid one month's rates, \$300, and owed two months' rent, \$1 000. During the year ended 31 March 20–9 Mary made the following payments by cheque:

20–8		\$
1 May	Rent for 8 months to 30 September 20–8	4 000
1 June	Rates for 13 months to 31 May 20–9	3 900
1 December	Rent for 5 months to 28 February 20–9	2 500

Write the rent and rates account in Mary's nominal ledger for the year ended 31 March 20–9.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



Apply the same principles as used in **Walkthrough 11.4** and **11.5** by deducting anything which falls outside the financial year and adding anything which falls within the present financial year.

Mary Nominal ledger Rent and rates account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-8				20-8			
Apr 1	Balance (rates)	b/d	300	Apr 1	Balance (rent)	b/d	1 000
May 1	Bank (rent)		4 000	20-9			
Jun 1	Bank (rates)		3 900	Mar 31	Income statement		
Dec 1	Bank (rent)		2 500		Rent	6 000	
20-9					Rates	<u>3 600</u>	9 600
Mar 31	Balance (rent)	c/d	<u>500</u>		Balance (rates)	c/d	<u>600</u>
			<u>11 200</u>				<u>11 200</u>
20-9				20-9			
Apr 1	Balance (rates)	b/d	600	Apr 1	Balance (rent)	b/d	500

**KEY TERM**

Accrued income is income relating to a particular accounting period which has not been received at the end of that period.

11.5 Accrued and prepaid income

Accrued income

Where **an item of income is accrued** it means that another person receiving a benefit or service from the business during the accounting period has not paid for that benefit or service by the end of the period.

The totals of income accounts in the nominal ledger are transferred to the income statement at the end of the financial year. The **matching principle** is applied to income in the same way as it is to expenses so that the amount transferred to the income statement represents the income for the accounting period covered by that statement. This means that **any amount due but not received at the end of the financial year must be added to the amount received** and the total income relating to the accounting period transferred to the income statement.

The income account will now show a balance equal to the amount not yet received. To complete the double entry, this **balance is brought down on the debit side of the ledger account**. As the balance represents an amount owing to the business, due to be received in the near future, it will be included as a **current asset** in the **statement of financial position**.

The entries are summarised as follows:

- During the year** – credit the income account and debit the cash book with the amount received
- At the year-end** – credit the income account with any amount due but not received and carry down as a debit balance

debit the income account and credit the income statement with the difference on the income account (this represents the income for the year)
include the balance on the income account as a current asset in the statement of financial position.

Walkthrough 11.7

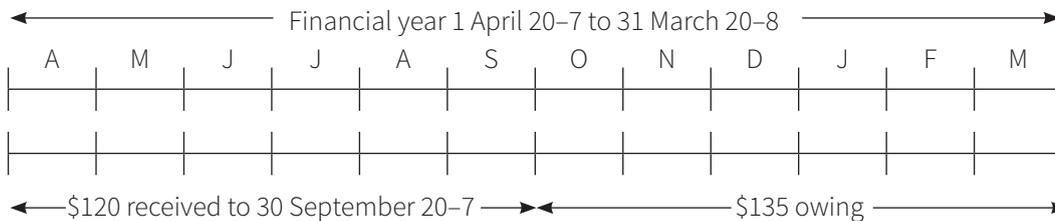
Salman started a business on 1 April 20–7.

On that date he also agreed to act as an agent for Kohli & Company. Salman was to be paid a commission six monthly in arrears on all goods sold for Kohli & Company.

Commission of \$120 was received by direct debit on 1 October 20–7 and \$135 was received by direct debit on 2 April 20–8.

- a** Write up the commission receivable account in Salman’s nominal ledger for the year ended 31 March 20–8.
- b** Prepare a relevant extract from Salman’s income statement for the year ended 31 March 20–8.
- c** Prepare a relevant extract from Salman’s statement of financial position at 31 March 20–8.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



The diagram shows that the income received does not match the period covered by the financial year, so it is necessary to add the amount not yet received at the end of the year.

a

Salman							
Nominal ledger							
Commission receivable account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–7			
Mar 31	Income statement		255	Oct 1	Bank		120
				20–8			
				Mar 31	Balance	c/d	135
			<u>255</u>				<u>255</u>
20–8							
Apr 1	Balance	b/d	135				

b

Salman	
Extract from income statement for the year ended 31 March 20–8	
	\$
Gross profit	xxx
Add Commission receivable	255

c

Salman	
Extract from statement of financial position at 31 March 20–8	
	\$
Current assets	
Income accrued	135

- The commission receivable relating to the financial year ended on 31 March 20–8 amounts to \$255, which is the total received plus the amount due but not yet received.
- The commission received would be listed with the other items of income in the income statement and added to the gross profit.
- The commission due but not yet received would appear in the statement of financial position as a current asset under the description of income accrued. Alternatively, it could be included in the other receivables (in this case a note to the statement of financial position would show the breakdown of this figure).

**KEY TERM**

Prepaid income is income received during the financial year which relates to a future accounting period.

Prepaid income

Where **an item of income is prepaid**, it means that a person had paid for a benefit or service from the business, but this has not been provided by the business at the end of the financial year.

Once again, the **matching principle** must be applied so that the amount transferred to the income statement represents the income for the accounting period covered by that statement. Any amount received during the financial year relating to a future accounting period must be deducted from the amount received so that only the income relating to the accounting period is transferred to the income statement.

The income account will now show a balance equal to the amount received in advance. To complete the double entry, this **balance is brought down on the credit side of the ledger account**. This balance will be included as a **current liability** in the **statement of financial position** as the business has a liability to provide some service or benefit for which the business has already been paid.

The entries are summarised as follows:

- During the year** – credit the income account and debit the cash book with the amount received.
- At the year-end** – debit the income account with any amount received in advance and carry down as a credit balance
debit the income account and credit the income statement with the difference on the income account (this represents the income for the year)
include the balance on the income account as a current liability in the statement of financial position.

Walkthrough 11.8

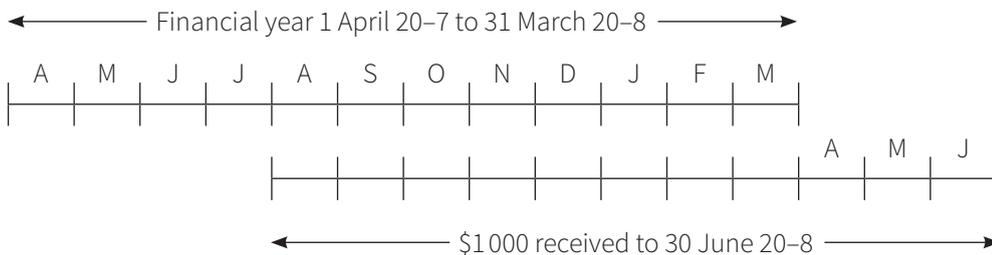
Salman started a business on 1 April 20–7.

Salman rented premises until 1 July 20–7 when he purchased premises. On that date he rented out part of his premises to another trader at an annual rent of \$1 000, payable quarterly in advance.

The tenant paid rent of \$250 by direct debit on 1 July 20–7, 1 October 20–7, 31 December 20–7 and 30 March 20–8.

- a Write up the rent receivable account in Salman's nominal ledger for the year ended 31 March 20–8.
- b Prepare a relevant extract from Salman's income statement for the year ended 31 March 20–8.
- c Prepare a relevant extract from Salman's statement of financial position at 31 March 20–8.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



The diagram shows that the income received does not match the period covered by the financial year, so it is necessary to deduct that portion of the \$1 000 which falls outside the financial year (\$250 relates to the following financial year).



TIP

In a statement of financial position, the individual items of other receivables and other payables can be shown in brackets after the wording and the total figure entered in the money column.

a

Salman							
Nominal ledger							
Rent receivable account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-8				20-7			
Mar 31	Income statement		750	Jul 1	Bank		250
	Balance	c/d	250	Oct 1	Bank		250
				Dec 31	Bank		250
				20-8			
				Mar 30	Bank		250
			<u>1000</u>				<u>1000</u>
				20-8			
				Apr 1	Balance	b/d	250

b

Salman	
Extract from income statement for the year ended 31 March 20-8	
	\$
Gross profit	xxx
Add Rent receivable	750

c

Salman	
Extract from statement of financial position at 31 March 20-8	
	\$
Current liabilities	
Income prepaid	250

- The rent receivable relating to the financial year ended on 31 March 20-8 amounts to \$750, which is the rent received for the period 1 July 20-7 to 31 March 20-8.
- The rent received would be listed with the other items of income in the income statement and added to the gross profit.
- The rent received in advance would appear in the statement of financial position as a current liability under the description of income prepaid. Alternatively, it could be included in the other payables (in this case a note to the statement of financial position would show the breakdown of this figure).

TEST YOURSELF 11.4

- 1 Explain why income received in advance is shown as a current liability in a statement of financial position.
- 2 Explain why accrued income is shown as a current asset in a statement of financial position.

11.6 Opening balances on income accounts

In the second and subsequent years of trading, a business may have opening balances on income accounts as well as opening balances on expense accounts. These must be considered when calculating the income relating to the particular financial year for which the accounts are prepared.

Walkthrough 11.9

Salman's financial year ends on 31 March.

He acts as an agent for Kohli & Company and is paid a commission six monthly in arrears on all goods sold for Kohli & Company.

On 1 April 20–8 the commission receivable account in Salman's nominal ledger showed a debit balance of \$135.

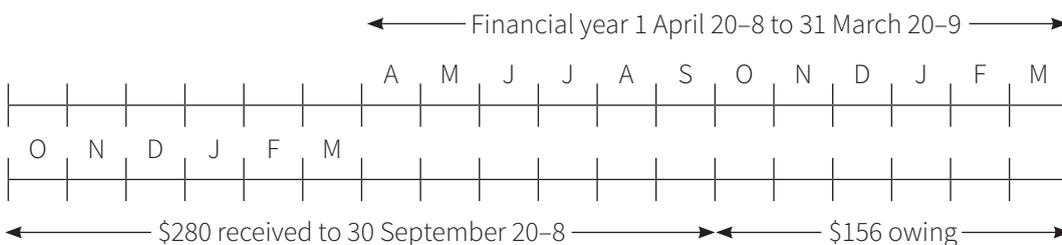
During the year ended 31 March 20–9 he received direct debits for commission as follows:

20–8	2 April	\$135
	1 October	\$145

At 31 March 20–9 commission due but not yet received amounted to \$156.

Write up the commission receivable account in Salman's nominal ledger for the year ended 31 March 20–9.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



The diagram shows that the income received does not match the period covered by the financial year, so it is necessary to:

- deduct that portion of the \$280 which falls outside the financial year (\$135 was received during this financial year but related to the previous accounting period)
- add the \$156 owing at the end of present financial year.

Salman Nominal ledger Commission receivable account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-8				20-8			
Apr 1	Balance	b/d	135	Apr 2	Bank		135
20-9				Oct 1	Bank		145
Mar 31	Income statement		301	20-9			
			<u>436</u>	Mar 31	Balance	c/d	<u>156</u>
							<u>436</u>
20-9							
Apr 1	Balance	b/d	156				

Walkthrough 11.10

Salman’s financial year ends on 31 March.

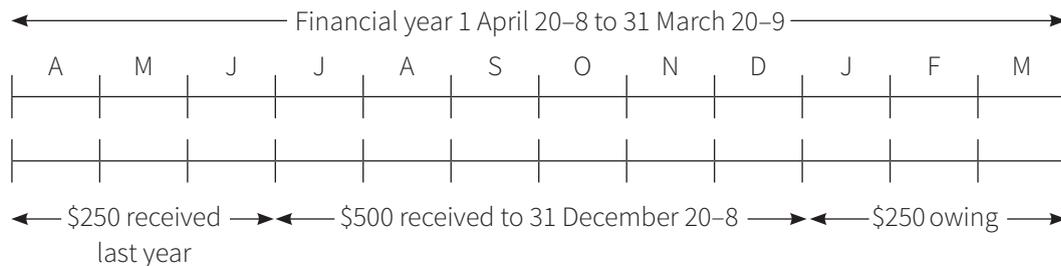
He rents part of his premises to another trader at an annual rent of \$1 000, payable quarterly in advance.

On 1 April 20-8 the rent receivable account in Salman’s nominal ledger showed a credit balance of \$250.

The tenant paid rent of \$250 by direct debit on 1 July 20-8 and 2 October 20-8. The rent due on 1 January 20-9 was not received until 2 April 20-9.

Write up the rent receivable account in Salman’s nominal ledger for the year ended 31 March 20-9.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.



The diagram shows that the income received does not match the period covered by the financial year, so it is necessary to:

- add the \$250 due but not received at the end of the financial year
- add the \$250 received in the previous financial year as it falls within the present financial year.

Salman							
Nominal ledger							
Rent receivable account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Mar 31	Income statement		1 000	Apr 1	Balance	b/d	250
				Jul 1	Bank		250
				Oct 2	Bank		250
				20–9			
				Mar 31	Balance	c/d	250
			<u>1 000</u>				<u>1 000</u>
20–9							
Apr 1	Balance	b/d	250				

TEST YOURSELF 11.5

- 1** Whabi & Company's financial year ends on 31 December. They act as agent for another business and receive a commission on goods sold.

The following information is provided:

- 20–6 Jan 1 Commission, \$94, was owing to Whabi & Company
 Dec 31 Commission, \$1 350, was received
 Commission, \$76, was owing to Whabi & Company
 20–7 Dec 31 Commission, \$1 480, was received

For **each** of the years ended 31 December 20–6 and 31 December 20–7 state:

- a** the amount shown for commission receivable in the income statement
b the amount (if any) shown for commission receivable in the statement of financial position, indicating whether it is a current asset or a current liability.

You can now answer Questions 4–6 at the end of this chapter.

Revision checklist

- The expenses for an accounting period must be matched against the income of that particular period.
- An accrual is an amount due in an accounting period which remains unpaid at the end of that period. A prepayment is an amount that has been paid or received in one accounting period which relates to a future period.
- In the income statement an accrued expense is added to the total paid. The accrued amount is a current liability in the statement of financial position.
- In the income statement a prepaid expense is deducted from the total paid. The prepaid amount is a current asset in the statement of financial position.
- In the income statement accrued income is added to the total received. The accrued amount is a current asset in the statement of financial position.
- In the income statement income received in advance is deducted from the total received. The amount received in advance is a current liability in the statement of financial position.

Exam-style questions

- 1** Zaid's financial year ends on 31 October. On 1 November 20–6 he owed advertising costs of \$40. During the year ended 31 October 20–7 he paid advertising costs of \$530. This included \$270 for an advertising campaign for six months to 29 February 20–8. How much did Zaid charge to the income statement for the year ended 31 October 20–7 for advertising costs?

A \$220 **B** \$260 **C** \$310 **D** \$350

- 2** Aryani started a fashion boutique on 1 March 20–6. On that date she purchased stationery, \$395. During the year she took stationery, \$15, for her own use. On 28 February 20–7 the stationery was valued at \$174. Which amount was charged to the income statement for the year ended 28 February 20–7 for stationery?

A \$206 **B** \$221 **C** \$236 **D** \$380

- 3** Nasir's financial year ends of 31 December. On 1 April 20–9 she paid \$1800 for one year's insurance on new premises.

What entry would be made for insurance in the statement of financial position on 31 December 20–9?

A \$450 asset **B** \$450 liability **C** \$1 350 asset **D** \$1 350 liability

- 4** William is a trader. His financial year ends on 31 December. He rents business premises. The monthly rent of \$1 350, payable in advance on the first day of each month, was increased to \$1 380 from 1 July 20–1. William paid six months' rent in advance by direct debit on the following dates in 20–1: 1 January, 1 July and 31 December.

a i Prepare the rent payable account in William's ledger for the year ended 31 December 20–1.

Balance the account and bring down the balance on 1 January 20–2.

ii Prepare a relevant extract from William's statement of financial position at 31 December 20–1.

William sublets part of his business premises to a tenant. The monthly rent is \$450. The rent receivable account in William's ledger for the year ended 31 December 20–1 was as follows:

William							
Rent receivable account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-1				20-1			
Jan 1	Balance	b/d	900	Jan 10	Bank		3 600
Dec 31	Income statement		5 400	Jun 1	Bank		4 050
	Balance	c/d	<u>1 350</u>				
			<u>7 650</u>				<u>7 650</u>
				20-2			
				Jan 1	Balance	b/d	1 350

- b i** Name the ledger in which this account would appear.
- ii** Explain each entry in the account.
- iii** State where the balance on the account on 31 December 20-1 would appear in the statement of financial position.

On 1 January 20-1 William had stationery valued at \$80. During the year ended 31 December 20-1 the following transactions took place:

February 1 Purchased stationery, \$64, and paid in cash.

August 31 Purchased stationery, \$18, using petty cash.

William's inventory of stationery on 31 December 20-1 was valued at \$75.

- c** Write up the stationery account in William's ledger for the year ended 31 December 20-1. Balance the account and bring down the balance on 1 January 20-2.
- 5** Miriam is a business consultant. She provided the following information at the end of her first year on 30 September 20-4.

	\$
Office expenses	7 250
Wages	27 500
Insurance	1 800
Rates	800
Motor vehicle expenses	1 840
Fees received from clients	40 900
Commission receivable	5 600

The following information is also available:

- The office expenses include stationery. On 30 September 20-4 the inventory of stationery was valued at \$250.
- It is estimated that half of the motor vehicle expenses relate to Miriam's personal use.

- 3 On 30 September 20–4:
 - Rates due amounted to \$160
 - Office expenses due amounted to \$45
 - Commission receivable outstanding amounted to \$250.
- 4 The insurance covers a period of 15 months to 31 December 20–4.
- 5 Wages paid in cash, \$115, have not been entered in the accounting records.

Prepare Miriam's income statement for the year ended 30 September 20–4.

- 6 Luc owns a wholesale furniture store. His financial year ends on 30 June. He provided the following trial balance on 30 June 20–1:

	\$	\$
Revenue		112 650
Purchases	86 270	
Purchases returns		410
Inventory 1 Jul 20–0	7 010	
Premises	80 000	
Fixtures and fittings	19 700	
Trade payables		7 136
Trade receivables	9 175	
Bank	867	
Rent receivable		840
Discount received		170
Insurance	728	
Rates	600	
Wages	25 600	
Office expenses	256	
Capital		101 000
Drawings	2 000	
3% 10 year loan from AB Finance	<u>232 206</u>	<u>10 000</u>
	<u>232 206</u>	<u>232 206</u>

Additional information:

- 1 At 30 June 20–1:
 - Inventory was valued at \$6 840
 - Rent receivable prepaid amounted to \$60
 - Insurance prepaid amounted to \$104
 - Rates accrued amounted to \$120
 - A whole year's interest on the loan is outstanding.
- 2 During the year ended 30 June 20–1 Luc took goods, \$930, for his own use. This was not entered in the accounting records.

Prepare an income statement for the year ended 30 June 20–1 and a statement of financial position on 30 June 20–1.

Chapter 12

Accounting for depreciation and disposal of non-current assets

Learning objectives

In this chapter you will learn to:

- define depreciation 4.2
- explain the reasons for accounting for depreciation 4.2
- name and describe the straight line, reducing balance and revaluation methods of depreciation 4.2
- prepare ledger accounts for the provision of depreciation 4.2
- prepare ledger accounts to record the sale of non-current assets, including the use of disposal accounts 4.2
- make adjustments for provision for depreciation using the straight line, reducing balance and revaluation methods. 5.1



LINK

You learned about the year-end adjustments for accruals and prepayments in Chapter 11 and will learn about other year-end adjustments in Chapter 13.



KEY TERM

Depreciation is an estimate of the loss in value of a non-current asset over its expected working life.



LINK

You learned about capital expenditure in Chapter 10.



LINK

You learned about the accounting principles of matching, prudence and historic cost in Chapter 10.

12.1 Introduction

As explained in Chapter 11, it is often necessary to include year-end adjustments in a set of financial statements. This ensures that the accounts provide a more accurate view of the profit or loss of the business and the financial position of the business. This chapter focuses on the year-end adjustments made for depreciation of non-current assets.

Depreciation is an estimate of the loss in value of a non-current asset over its expected working life. Most of the non-current assets of a business lose value over a period of time that they are used by the business. If the accounting records continue to show these assets at their cost prices then the accounts will provide misleading information. It is, therefore, necessary to record an estimate of the loss in value. The records can only show an **estimate** of the loss in value of a non-current asset because of depreciation. The **exact** amount will only be known when the asset is disposed of or sold. Buildings depreciate over time but land does not usually lose value (unless it is something like a well or mine when value is removed from the land).

The purchase of a non-current asset is **capital expenditure**.

The cost of a non-current asset is not charged as an expense in the year of purchase as it benefits the business for several years. **Matching** the capital expenditure against the sales it has helped the business to earn is done by an annual charge for depreciation. **This means that the cost of the non-current asset is spread over the years which benefit from the use of that asset.** The depreciation for the year is included in the expenses in the income statement, so the profit for the year is not overstated. This is an application of the **principle of prudence**. If the profit is overstated, the owner of a business may be tempted to withdraw more cash than the business can actually afford.

The principle of prudence is also applied in the statement of financial position as the non-current assets are recorded at a figure less than the cost price (this is known as the **net book value** or the **written down value**). This overrides the **historic cost principle** as it ensures that the non-current assets are shown at more realistic values.

12.2 Causes of depreciation

The four main causes of depreciation are physical deterioration, economic reasons, passage of time and depletion.

Physical deterioration

This is the result of 'wear and tear' due to the normal usage of the non-current asset. It can also be because the asset falls into a poor physical state due to rust, rot, decay and so on.

Economic reasons

The non-current asset may become inadequate as it can no longer meet the needs of the business. It can also be because the non-current asset has become obsolete as newer and more efficient assets are now available.

Passage of time

This arises where a non-current asset, for example a lease, has a fixed life of a set number of years.



TIP

Depreciation is a non-monetary expense as it does not involve an outflow of money, nor does it provide a cash fund to use for the replacement of a non-current asset.

Depletion

This arises in connection with non-current assets such as wells and mines. The worth of the asset reduces as value is taken from the asset.

TEST YOURSELF 12.1

- 1 Explain the meaning of depreciation.
- 2 Explain how depreciation is an application of the matching principle.
- 3 List **four** causes of depreciation of non-current assets.

12.3 Methods of calculating depreciation

There are several methods used to calculate the estimated loss in value of a non-current asset. Different types of non-current assets are often depreciated using different methods. The method selected should be the one which spreads the cost of the asset as fairly as possible over the periods which benefit from its use. Once a method has been selected for a particular non-current asset, it should be applied each year. This is an application of the **principle of consistency**.

In practice, many factors are considered before a depreciation method is selected. These are:

- How long is the asset expected to last?
- How much will the asset be sold for when it is put out of use?
- How can the benefits from the use of the asset be measured?

There are three main methods of depreciation:

- Straight line method
- Reducing balance method
- Revaluation method

These are explained below. There are several other methods, but they are outside the scope of the syllabus.

Straight line method of depreciation

This is also known as the **fixed instalment method**.

The formula used for calculating the annual depreciation using this method is:

$$\frac{\text{Cost of asset}}{\text{Number of expected years of use}}$$

This expresses the annual depreciation as an amount of money. The answer to this formula is expressed as a percentage of the total cost.

This method applies the **same amount of depreciation (or the same percentage rate of the cost price) each year**. The value of the asset can fall to nil if there is no residual value (see below).

This method is used where each year is expected to benefit equally from the use of the asset.



LINK

You learned about the principle of consistency in Chapter 10.



KEY TERM

The **straight line method of depreciation** is where the same amount of depreciation is charged each year.

Walkthrough 12.1

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years.

Calculate the annual depreciation charge:

- a** as an amount of money
b as a percentage.

$$\mathbf{a} \quad \frac{\$25\,000}{4 \text{ years}} = \$6\,250$$

$$\mathbf{b} \quad \frac{\$6\,250}{\$25\,000} = 25\%$$

**KEY TERM**

The **residual value** is the value of a non-current asset at the end of its useful life.

Where it is estimated that the asset will have some value at the end of its working life, this must be included in the calculation. Such a value is known as a **residual value**. The formula then becomes:

$$\frac{\text{Cost of asset} - \text{Residual value}}{\text{Number of expected years of use}}$$

Walkthrough 12.2

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years and then be able to sell them for \$3 000.

Calculate the annual depreciation charge:

- a** as an amount of money
b as a percentage (based on the original cost).

$$\mathbf{a} \quad \frac{\$25\,000 - \$3\,000}{4 \text{ years}} = \$5\,500$$

$$\mathbf{b} \quad \frac{\$5\,500}{\$25\,000} \times \frac{100}{1} = 22\%$$

**TIP**

Advantages of the straight line method of depreciation.

- 1 It is relatively easy to calculate.
- 2 It is useful when a non-current asset provides equal benefit for each year of its useful life.

Disadvantages of the straight line method of depreciation.

- 1 It is necessary to estimate the useful life and the residual value of the non-current asset.
- 2 It ignores the actual rate at which the non-current asset will lose value.

Reducing balance method of depreciation

As the name implies, the amount of depreciation reduces each year. **The same percentage rate is applied, but it is calculated on a different value each year.** At the end of the first year the depreciation for that year is calculated on the cost of the asset. The depreciation for the following year is calculated (using the same percentage) on the cost of the asset less the depreciation previously written off. The figure of cost less depreciation is known as the **net book value** (or **written down value**) of the asset.

The value of the asset can never fall to nil as the depreciation is always calculated as a percentage of the net book value.

This method is used where the greater benefits from the use of the asset will be gained in the early years of its life. Assets depreciated by this method often have lower maintenance costs in the early years. This method is often used for those assets which quickly become out of date because of advancing technological progress.

Any residual value is taken into consideration when the percentage rate is selected.



KEY TERMS

The **reducing balance method of depreciation** is where the depreciation charged each year decreases as it is calculated on the net book value rather than the cost.

The **net book value** of a non-current asset is the cost price minus the total depreciation to date.

Walkthrough 12.3

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years and then be able to sell them for \$3 000.

Calculate the depreciation for **each** of the four years of the fixtures' working life using the reducing balance method at the rate of 40% per annum.

	\$
Cost	25 000
Depreciation for year ended 30 June 20–4 at 40%	<u>10 000</u>
Book value at 1 July 20–4	15 000
Depreciation for year ended 30 June 20–5 at 40%	<u>6 000</u>
Book value at 1 July 20–5	9 000
Depreciation for year ended 30 June 20–6 at 40%	<u>3 600</u>
Book value at 1 July 20–6	5 400
Depreciation for year ended 30 June 20–7 at 40%	<u>2 160</u>
Book value at 1 July 20–7	<u>3 240</u>



TIP

Advantages of the reducing balance method of depreciation.

- 1 It matches costs with revenue.
- 2 It is useful for those non-current assets where greater benefits are gained in the early years of usage.

Disadvantages of the reducing balance method of depreciation.

- 1 The depreciation has to be recalculated each year.
- 2 The depreciation charge against profit is greater in the early years of the non-current asset's life.



TIP

Depreciation is always expressed in units of whole dollars so it may be necessary to adjust a figure to eliminate any cents.

You can now answer Questions 1 and 2 at the end of this chapter.



KEY TERM

The **revaluation method of depreciation** is where the opening and closing value of a non-current asset are compared (after adjusting for any additions during the year) to determine the depreciation for the year.

Revaluation method of depreciation

This method is used where it is not practical, or it is difficult, to keep detailed records of certain types of non-current assets. If detailed records are not available then the straight line and the reducing balance methods of depreciation cannot be calculated. Small items of equipment used in offices and laboratories, packing cases, loose tools, etc. are usually depreciated using the revaluation method as no detailed records are kept for these assets.

The assets are valued at the end of each financial year. This value is compared with the value at the end of the previous financial year (or with the cost if it is the first year of ownership). **The amount by which the value of the asset has fallen is the depreciation for the year.**

Walkthrough 12.4

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She decided to revalue the fixtures at the end of each year.

On 30 June 20–4 the fixtures were valued at \$20 500.

Calculate the depreciation for the year ended 30 June 20–4.

	\$
Cost of fixtures on 1 July 20–3	25 000
Value of fixtures on 30 June 20–4	<u>20 500</u>
Depreciation for the year ended 30 June 20–4	<u>4 500</u>



TIP

Advantages of the revaluation method of depreciation.

- 1 It is not necessary to estimate the useful life and the residual value of the non-current asset.
- 2 No complex calculations are required.

Disadvantages of the revaluation method of depreciation.

- 1 The non-current asset has to be revalued at the end of each year.
- 2 The valuation may be based on personal opinion.

TEST YOURSELF 12.2

- 1 Explain the straight line method of depreciation.
- 2 Explain how, using the reducing balance method, the **amount** of depreciation decreases each year even though the same **percentage rate** is applied.
- 3 State when the revaluation method is used to depreciate non-current assets.

You can now answer Question 3 at the end of this chapter.

12.4 Recording depreciation in the ledger

Recording depreciation using the straight line method and the reducing balance method

The procedure for entering depreciation calculated using the straight line method and the reducing balance method is exactly the same.

Each type of non-current asset has two ledger accounts:

- an account for recording the cost of the asset (the asset account)
- an account for recording the depreciation (the provision for depreciation of asset account).

The asset account always has a debit balance and the provision for depreciation always has a credit balance. These two accounts must always be considered together. The difference between the balances of these accounts represents the net book value of the asset.

The entries are summarised as follows:

During the year – when the asset is purchased

debit the asset account and credit either the cash book or the supplier's account with the cost price.

At the year-end – debit the income statement and credit the provision for depreciation account with the depreciation for the year

balance the provision for depreciation account and carry down as a credit balance

balance the asset account if there have been any transactions during the year and carry down as a debit balance.

Walkthrough 12.5

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years and then be able to sell them for \$3 000.

Kavita decided to use the reducing balance method of depreciation at 40% per annum.

Make the entries in Kavita's nominal ledger accounts for **each** of the years ended 30 June 20–4, 20–5, 20–6 and 20–7.

Kavita							
Nominal ledger							
Fixtures account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–3							
Jul 1	Bank		25 000				

Provision for depreciation of fixtures account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-4				20-4			
Jun 30	Balance	c/d	<u>10 000</u>	Jun 30	Income statement		<u>10 000</u>
			10 000				10 000
20-5				20-4			
Jun 30	Balance	c/d	<u>16 000</u>	Jul 1	Balance	b/d	10 000
			16 000	20-5			
				Jun 30	Income statement		<u>6 000</u>
							16 000
20-6				20-5			
Jun 30	Balance	c/d	<u>19 600</u>	Jul 1	Balance	b/d	16 000
			19 600	20-6			
				June 30	Income statement		<u>3 600</u>
							19 600
20-7				20-6			
Jun 30	Balance	c/d	<u>21 760</u>	Jul 1	Balance	b/d	19 600
			21 760	20-7			
				June 30	Income statement		<u>2 160</u>
							21 760
				20-7			
				Jul 1	Balance	b/d	21 760

- The asset account was not balanced at the end of each year as there is only one entry in the account.
- Before the transfer to the income statement can be made each year it is necessary to calculate the depreciation for the year. The calculations have been shown in **Walkthrough 12.3**.
- The difference between the balance on the asset account and the balance on the provision for depreciation account on the same date represents the net book value of the fixtures on that date.
- If the straight line method of depreciation had been selected the entry in the fixtures account would be exactly the same.
- If the straight line method of depreciation had been selected the entries in the provision for depreciation of fixtures account would be very similar. The transfer to the income statement would be \$5 500 each year, so the totals and balances on the account would differ to those shown earlier.

TEST YOURSELF 12.3

- 1 Referring to **Walkthrough 12.5**:
 - a state the total amount of depreciation up to 30 June 20–6
 - b state the net book value of the fixtures on 30 June 20–7.
- 2 Explain why the asset account and the provision for depreciation account of that asset should both be referred to when the asset is being considered.

Where a non-current asset is purchased **during** the financial year, a business may decide to charge depreciation from the date of purchase. This means that in the first year of ownership only a proportion of the annual depreciation will be charged to the income statement.

Walkthrough 12.6

Kavita's financial year ends on 30 June.

On 1 July 20–4 she purchased a motor vehicle costing \$9 000 and paid by credit transfer. On 1 April 20–5 an additional motor vehicle costing \$8 000 was purchased and paid for by credit transfer.

She decided to use the straight line method of depreciation at 20% per annum, depreciation to be calculated from the date of purchase.

Make the entries in Kavita's nominal ledger accounts for the year ended 30 June 20–5.

Kavita							
Nominal ledger							
Motor vehicles account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–4				20–5			
Jul 1	Bank (A)		9 000	Jun 30	Balance	c/d	17 000
20–5							
Apr 1	Bank (B)		8 000				
			<u>17 000</u>				<u>17 000</u>
20–5							
Jul 1	Balance	b/d	17 000				

Provision for depreciation of motor vehicles account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–5				20–5			
Jun 30	Balance	c/d	2 200	Jun 30	Income statement		
					(A) 1 800		
					(B) <u>400</u>		<u>2 200</u>
			<u>2 200</u>				<u>2 200</u>
				20–5			
				Jul 1	Balance	b/d	2 200

Sometimes a business may decide to ignore the date of purchase when calculating depreciation. This means that a whole year's depreciation will be charged on all the assets held at the end of the financial year.

Recording depreciation using the revaluation method

The cost of the asset and the depreciation are recorded in the same account.

The entries are summarised as follows:

During the year – when the asset is purchased

debit the asset account and credit either the cash book or the supplier's account with the cost price.

At the year-end – credit the asset account with the value of the asset at that date and carry down as a debit balance

transfer the difference on the account to the income statement as this is the depreciation for the year.

Walkthrough 12.7

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She decided to revalue the fixtures at the end of each year.

On 30 June 20–4 the fixtures were valued at \$20 500.

Make the entries in the fixtures account in the nominal ledger for the year ended 30 June 20–4.

Kavita							
Nominal ledger							
Fixtures account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–3				20–4			
Jul 1	Bank		25 000	Jun 30	Balance	c/d	20 500
					Income statement		4 500
			<u>25 000</u>				<u>25 000</u>
20–4							
Jul 1	Balance	b/d	20 500				

12.5 Recording depreciation in the financial statements

Recording depreciation in the income statement

The depreciation for the year for each type of asset is credited to the provision for depreciation account in the nominal ledger and is debited to the income statement. This reduces the business's profit for the year. As depreciation is a non-monetary expense, it is usually shown after the monetary expenses in the income statement.

If the business is a manufacturing business, depreciation of assets used in the manufacturing process will be debited to the manufacturing account rather than the income statement. This increases the cost of manufacturing which, in turn, reduces the profit for the year.



You will learn about preparing manufacturing accounts in Chapter 20.

Recording depreciation in the statement of financial position

It is usual to show the total cost of each type of non-current asset less the total depreciation written off up to the date of the statement of financial position (referred to as **accumulated depreciation** or **depreciation to date**). The difference between these figures is the net book value.

Walkthrough 12.8

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years and then be able to sell them for \$3 000.

Kavita decided to use the reducing balance method of depreciation at 40% per annum.

- Prepare a relevant extract from Kavita's income statement for **each** of the years ended 30 June 20–4 and 30 June 20–5.
- Prepare a relevant extract from Kavita's statement of financial position at 30 June 20–4 and at 30 June 20–5.

a

Kavita	
Extract from income statement for the year ended 30 June 20–4	
	\$
Expenses – Depreciation of fixtures	10 000

Kavita	
Extract from income statement for the year ended 30 June 20–5	
	\$
Expenses – Depreciation of fixtures	6 000

b

Kavita			
Extract from statement of financial position at 30 June 20–4			
	\$	\$	\$
Non-current assets	Cost	Accumulated depreciation	Net book value
Fixtures	25 000	10 000	15 000

Kavita			
Extract from statement of financial position at 30 June 20–5			
Non-current assets	\$ Cost	\$ Accumulated depreciation	\$ Net book value
Fixtures	25 000	16 000	9 000



You learned how to prepare financial statements in Chapters 8 and 9.

The financial statements are prepared from a trial balance and its accompanying notes. In the trial balance, the balances on the asset accounts are shown in the debit column and the balances on the provision for depreciation accounts are shown in the credit column. One of the notes will indicate the depreciation to be charged for the current financial year.

The depreciation for the year will appear twice in the financial statements: It is an expense in the income statement, and it is included in the statement of financial position as part of the provision for depreciation (the depreciation for the year is added to the balance shown in the trial balance).

Walkthrough 12.9

Kavita’s financial year ends on 30 June.

She depreciates her fixtures using the reducing balance method of depreciation at 40% per annum.

Her trial balance drawn up on 30 June 20–6 included the following:

	Dr \$	Cr \$
Fixtures	25 000	
Provision for depreciation of fixtures		16 000

- Prepare a relevant extract from Kavita’s income statement for the year ended 30 June 20–6.
- Prepare a relevant extract from Kavita’s statement of financial position at 30 June 20–6.

a

Kavita	
Extract from income statement for the year ended 30 June 20–6	
Expenses – Depreciation of fixtures	\$ 3 600

b

Kavita			
Extract from statement of financial position at 30 June 20–6			
Non-current assets	\$ Cost	\$ Accumulated depreciation	\$ Net book value
Fixtures	25 000	19 600	5 400



TIP
An income statement includes the depreciation of non-current assets for that particular year. A statement of financial position includes the cost and the accumulated depreciation to date of non-current assets.

- The depreciation relating to the current financial year is included as an expense in the income statement.
- In the statement of financial position the total depreciation up to that date (\$16 000 shown in the trial balance plus the depreciation for the year of \$3 600) are deducted from the cost price of the asset.

TEST YOURSELF 12.4

- 1 Explain why depreciation is a non-monetary expense.
- 2 Referring to **Walkthrough 12.9**, explain why the figure of \$16 000 provision for depreciation does not actually appear in the financial statements.

You can now answer Question 4 at the end of this chapter.

12.6 Disposal of non-current assets

Because the purchase of a non-current asset is **capital expenditure** it is recorded in an account for the non-current asset rather than in the purchases account. When a non-current asset is sold it is a **capital receipt** and is recorded in a special account known as a **disposal of non-current asset account** rather than in the sales account.

When a non-current asset is sold or disposed of, it must be removed from the ledger records. The cost of the asset and the depreciation on the asset are removed from the asset account and the provision for depreciation account and transferred to a disposal account. The proceeds of sale are also entered in this account. It is quite likely that this account will not balance. This is because the depreciation was only an estimate of the loss in value. Only when the asset is sold can the actual loss in value be calculated. The difference on the disposal account represents either a loss on disposal (when the actual depreciation proved to be more than the estimate) or a profit on disposal (when the actual depreciation proved to be less than the estimate).

The entries are summarised as follows.

- On the date of sale** – credit the asset account and debit the disposal of non-current asset account with the original cost price (of the asset being sold)
- debit the provision for depreciation account and credit the disposal of non-current asset account with the total depreciation charged (on the asset being sold)
- credit the disposal of non-current asset account and debit either the cash book or the debtor's account with the proceeds of sale.
- At the year-end** – transfer any difference on the disposal of non-current asset account to the income statement.

Walkthrough 12.10

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She decided to depreciate the fixtures using the reducing balance method.

On 1 July 20–7 the provision for depreciation of fixtures account showed a credit balance of \$21 760.

Kavita sold all the fixtures on credit to Traders Ltd for \$3 100 on 1 July 20–7.

Make the entries in Kavita's nominal ledger accounts for the year ended 30 June 20–8.

Kavita							
Nominal ledger							
Fixtures account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–3				20–7			
Jul 1	Bank		25 000	Jul 1	Disposal		25 000
			<u>25 000</u>				<u>25 000</u>

Provision for depreciation of fixtures account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7				20–7			
Jul 1	Disposal		21 760	Jul 1	Balance	b/d	21 760
			<u>21 760</u>				<u>21 760</u>

Disposal of fixtures account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7				20–7			
Jul 1	Fixtures		25 000	Jul 1	Provision for depreciation		21 760
					Traders Ltd		3 100
				20–8			
				Jun 30	Income statement		140
			<u>25 000</u>				<u>25 000</u>

- The difference on the disposal account remains in that account until the end of the financial year when it is transferred to the income statement.
- In this case the depreciation had been under-provided so there was a small loss of \$140 to transfer to the income statement.
- If the total of the credit side of the account had exceeded the debit side, there would have been an over-provision of depreciation. The transfer to the income statement would have been shown on the debit of this account and on the credit of the income statement.

If only some of the assets of a particular type are being sold, it is important that only the entries relating to the assets being sold are removed from the ledger records.

Businesses may operate different policies in relation to depreciation where an asset is sold or disposed of part-way through the year. Some ignore depreciation in the year of sale; others charge depreciation up to the date of disposal of the asset. Once a method has been selected it should be employed **consistently**.

You can now answer Questions 5 and 6 at the end of this chapter.

Revision checklist

- Depreciation is an estimate of the loss in value of a non-current asset over its expected working life.
- The main causes of depreciation are physical deterioration, economic reasons, passage of time and depletion.
- The three main methods of calculating depreciation are straight line, reducing balance and revaluation.
- Depreciation is shown as an expense in the income statement.
- In the statement of financial position the total depreciation to date is deducted from the cost of the asset.
- When a non-current asset is sold it is removed from the ledger records by transfer to a disposal of non-current asset account.

Exam-style questions

- 1** Halima's financial year ends on 31 October. She depreciates her motor vehicles using the reducing balance method at 20% per annum. On 1 November 20–6 she bought a motor vehicle for \$14 200. What was the charge for depreciation for the year ended 31 October 20–8?

A \$2 272 **B** \$2 840 **C** \$5 110 **D** \$5 680

- 2** Salim purchased machinery for \$15 000 on 1 January 20–1. He decided to depreciate it using the straight line method at 10% per annum. On 31 December 20–2 he incorrectly charged depreciation using the reducing balance method at 10% per annum.

What was the effect on the profit for the year ended 31 December 20–2?

A overstated by \$150 **B** understated by \$150
C overstated by \$1 350 **D** understated by \$1 350

- 3** Zareb started a business on 1 April 20–4. He decided to use the revaluation method to calculate the depreciation on his fixtures and fittings.

Fixtures and fittings, \$9 800 were purchased on 1 April 20–4 which Zareb expected to have a useful life of four years. Additional fixtures and fittings, \$1 200, were purchased during the year. On 31 March 20–5 Zareb valued his fixtures and fittings at \$8 700.

What was the depreciation charge for the year ended 31 March 20–5?

A \$1 100 **B** \$2 300 **C** \$2 450 **D** \$2 750

- 4** Elsa's financial year ends on 31 March. She depreciates her office equipment at 20% per annum on cost. Depreciation is calculated from the date of purchase.

On 1 April the balances in Elsa's books included the following:

	\$
Office equipment	2 500
Provision for depreciation of office equipment	750

She purchased additional office equipment by cheque on the following dates:

	\$
31 August 20–4	1 200
1 December 20–4	900

- a** Write up the office equipment account and the provision for depreciation of office equipment account for the year ended 31 March 20–5. Balance the accounts and bring down the balances on 1 April 20–5.
- b** Prepare a relevant extract from Elsa's income statement for the year ended 31 March 20–5.
- c** Prepare a relevant extract from Elsa's statement of financial position at 31 March 20–5.

- 5 Beketele started a business on 1 July 20–6. On that date she made the following payments.

	\$
Premises	215 000
Legal costs relating to purchase of premises	2 150
Motor vehicle	9 800
Delivery costs of motor vehicle	200
Fuel for motor vehicle	50
Insurance of motor vehicle	495

- a State whether each of these payments is capital expenditure or revenue expenditure.

Beketele decided to depreciate the motor vehicle by 20% per annum using the straight line method.

- b Calculate the accumulated depreciation on the motor vehicle on 1 July 20–8.

On 1 July 20–8 Beketele decided that the motor vehicle was no longer suitable and sold it for \$5 600 which was received in cash.

- d Complete the following table to show the debit and credit entries Beketele would make to record the disposal of the motor vehicle.

		Account debited \$	Account credited \$
i	transfer of original cost from motor vehicle account		
ii	transfer of accumulated depreciation from provision for depreciation account		
iii	receipt of the proceeds from the sale of motor vehicle		

- 6 Tebogo owns an advertising agency. His financial year ends on 31 May. He provided the following information for the year ended 31 May 20–1:

	\$
Fees received from clients	37 130
Office expenses	9 435
Rates	2 125
Wages of assistant	19 500
Rent received from tenant	2 300
Cash drawings	9 000

The following additional information is also available:

- On 31 May 20–1 fees due from clients amounted to \$1 030.
- The rent received includes \$200 which was accrued on 1 June 20–0 and \$300 which was prepaid for the year ending 31 May 20–2.
- The wages paid included \$180 which was accrued on 1 June 20–0. On 31 May 20–1 wages accrued amounted to \$210.

- 4 Office equipment was sold on 1 September 20–0 for \$2 200. This had cost \$3 650 and had been depreciated by \$1 560 at the date of sale.
- 5 New office equipment, \$4 200, was purchased on 1 September 20–0. This is to be depreciated at the rate of 20% per annum from the date of purchase.
- 6 On 1 June 20–0 Tebogo’s capital was \$82 000.
 - a Prepare Tebogo’s income statement for the year ended 31 May 20–1.
 - b Prepare Tebogo’s capital account for the year ended 31 May 20–1. Balance the account and bring down the balance on 1 June 20–1.

Chapter 13

Irrecoverable debts and provisions for doubtful debts

Learning objectives

In this chapter you will learn to:

- understand the meaning of irrecoverable debts and recovery of debts written off 4.4
- prepare ledger accounts to record irrecoverable debts 4.4
- prepare ledger accounts to record recovery of debts written off 4.4
- explain the reasons for maintaining a provision for doubtful debts 4.4
- prepare ledger accounts to record the creation of, and adjustments to, a provision for doubtful debts 4.4
- make adjustments for irrecoverable debts and provisions for doubtful debts. 5.1



KEY TERMS

An **irrecoverable debt** is an amount owing to a business which will not be paid by the credit customer.

A **debt written off** may be recovered if a credit customer pays some, or all, the amount owed, after the amount was written off.



LINK

You learned about the principle of prudence in Chapter 10.

13.1 Introduction

When goods are sold on credit the customer is allowed to pay for the goods at a later date.

There is always a risk that the customer may not pay for those goods. An **irrecoverable debt is an amount owing to a business which will not be paid by the credit customer**. This may be because the customer has disappeared, has gone out of business or because he is unable to pay.

If all reasonable steps to obtain payment have failed the debt is **written off**.

The account of the customer is closed by transferring the amount written off to the irrecoverable debts account. At the end of the year, the total of the irrecoverable debts account is transferred to the income statement where it is regarded as an expense for the year.

The entries are summarised as follows:

When the debt is written off – credit the customer's account and debit the irrecoverable debts account.

At the year-end – credit the irrecoverable debts account and debit the income statement.

Writing off irrecoverable debts is an example of the application of the principle of **prudence**. If a debt cannot be regarded as an asset it is written off so that the assets are not overstated. The amount of the irrecoverable debt is regarded as a loss for the year so must be included in the income statement otherwise the profit for the year will be overstated.

You can now answer Question 1 at the end of this chapter.

13.2 Recovery of debts written off

A debt written off may be recovered if a credit customer pays some, or all, of the amount owed, after the amount was written off.

As the account of the customer has been closed, the amount received is debited in the cash book and credited to a debts recovered account. An alternative method is to reinstate the debt by crediting the debts recovered account and debiting the customer with the amount previously written off. The amount received would then be entered by debiting the cash book and crediting the customer. The advantage of this method is that all the transactions relating to that customer appear in their account.

The entries are summarised as follows:

When the amount is received – debit the cash book and credit the debts recovered account
or debit the cash book and credit the customer, debit the customer and credit debts recovered account

At the year-end – debit the debts recovered account and credit the income statement
or credit the irrecoverable debts account.



TIP

At the end of the year the total of the debts recovered account can either be transferred to the income statement (as income for the year) or transferred to the credit of the irrecoverable debts account (where it reduces the debts written off during the year).

Walkthrough 13.1

Sachin is a trader who sells goods on credit. He offers customers a cash discount of 2% if accounts are paid within 30 days.

Sachin's financial year ends on 31 December.

Sachin sold goods, \$400, on credit to Bhuvan's Stores on 1 February 20–2. The account was settled by cheque on 28 February 20–2. On this date Bhuvan's Stores purchased further goods, \$150, on credit. After many attempts to recover the amount due, Sachin wrote off Bhuvan's Stores account as an irrecoverable debt on 30 December 20–2.

Sachin received a cheque from Bhuvan's Stores for \$150 on 31 October 20–3.

During the year ended 31 December 20–3 Sachin wrote off irrecoverable debts totalling \$820.

Write up the following accounts in Sachin's ledgers for **each** of the years ended 31 December 20–2 and 20–3 – Bhuvan's Stores account, irrecoverable debts account and debts recovered account.

Sachin							
Sales ledger							
Bhuvan's Stores account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–2				20–2			
Feb 1	Sales		400	Feb 28	Bank		392
	28 Sales		150		Discount		8
				Dec 30	Irrecoverable debts		150
			<u>550</u>				<u>550</u>

Nominal ledger							
Irrecoverable debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–2				20–2			
Dec 30	Bhuvan's Stores		150	Dec 31	Income statement		150
			<u>150</u>				<u>150</u>
20–3				20–3			
Dec 31	Debtors written off		820	Dec 31	Income statement		820
			<u>820</u>				<u>820</u>

Debts recovered account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–3				20–3			
Dec 31	Income statement		150	Oct 31	Bank (Bhuvan's Stores)		150
			<u>150</u>				<u>150</u>

- The words 'debtors written off' have been used as no individual names, dates and amounts details have been provided.
- Alternatively, the debt could have been reinstated by debiting Bhuvan's Stores account and crediting debts recovered. The cheque would then be debited to the bank and credited to Bhuvan's Stores account.
- Alternatively, the debts recovered account could have been transferred to the credit of the irrecoverable debts account. This would result in \$670 being transferred from irrecoverable debts to the income statement on 31 December 20–3.

13.3 Reducing the possibility of irrecoverable debts

The only certain way of avoiding irrecoverable debts is not to sell goods on credit. In practice, this is not always an option. All possible steps must be taken to avoid irrecoverable debts. Before allowing credit to a new customer, credit references should be obtained – one from the customer's bank and one from a present or previous supplier. A credit limit is usually fixed for each customer, which places an upper limit on the amount the customer can owe at any one time (this credit limit can be reviewed periodically). The establishing of a credit limit and the later monitoring of the customer's account is known as **credit control**.

Invoices and month-end statements of account should be issued promptly. The sales ledger accounts should be carefully monitored. Any overdue accounts should be investigated and the customers contacted by letters, emails and telephone calls if necessary. No further goods should be supplied until the amount due is paid. A more extreme measure involves taking legal action against the customer, but sometimes the amount of the debt is too small to justify costly legal proceedings.

Some businesses may make use of factoring and invoice discounting, but these are outside the scope of the syllabus.

TEST YOURSELF 13.1

- 1 Explain how writing off irrecoverable debts is an application of the principle of prudence.
- 2 List **three** ways in which the possibility of irrecoverable debts may be reduced.

13.4 Provision for doubtful debts

A provision for doubtful debts is an estimate of the amount which a business will lose in a financial year because of irrecoverable debts.

At the end of their financial year, many businesses try to anticipate the amount which will be lost because of irrecoverable debts. This ensures that the profit for the year is not overstated and the amount of trade receivables in the statement of financial position is shown at a realistic level. This is an application of the principle of **prudence**. By maintaining a **provision for doubtful debts**, a business also observes the principle of **matching**. The amount of sales for which the business is unlikely to be paid is regarded as an expense of the year in which those sales are made (rather than an expense of the year in which the debt is actually written off).

In order to make a provision for doubtful debts, it is necessary to estimate the amount of irrecoverable debts. The amount of the provision may be established by:

- looking at each individual credit customer's account and estimating which ones will not be paid
- estimating, on the basis of past experience, the percentage of the total amount owing by credit customers that will not be paid
- considering the length of time debts have been outstanding by means of an ageing schedule. A provision of a higher percentage may be made on older debts (the longer a debt is outstanding the greater the risk it may become irrecoverable).

TEST YOURSELF 13.2

- 1 Explain the meaning of a provision for doubtful debts.
- 2 Explain how maintaining a provision for doubtful debts is an application of both the principle of matching and the principle of prudence.

You can now answer Questions 2 and 3 at the end of this chapter.

13.5 Creating a provision for doubtful debts

Once it is decided to create a provision for doubtful debts and the amount or percentage has been decided, this can be recorded in the books. These entries are made at the end of the financial year.

The entries are summarised as follows:

- Debit the income statement and credit the provision for doubtful debts account.
- In the statement of financial position deduct the balance on the provision for doubtful debts account from the trade receivables.

Walkthrough 13.2

Sachin's financial year ends on 31 December.

During the year ended 31 December 20–4 he wrote off irrecoverable debts totalling \$950.

On 31 December his trade receivables amounted to \$25 000. He decided to create a provision for doubtful debts of 4% of the trade receivables.

- a Write up the irrecoverable debts account and the provision for doubtful debts account in Sachin's nominal ledger for the year ended 31 December 20–4.
- b Prepare a relevant extract from Sachin's income statement for the year ended 31 December 20–4.



KEY TERM

A **provision for doubtful debts** is an estimate of the amount which a business will lose in a financial year because of irrecoverable debts.



LINK

You learned about the principles of prudence and matching in Chapter 10.

- c Prepare a relevant extract from Sachin’s statement of financial position at 31 December 20–4.

a

Sachin							
Nominal ledger							
Irrecoverable debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–4				20–4			
Dec 31	Debtors written off		<u>950</u>	Dec 31	Income statement		<u>950</u>
			<u>950</u>				<u>950</u>

Provision for doubtful debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
				20–4			
				Dec 31	Income statement		1 000

- The words ‘debtors written off’ have been used in the irrecoverable debts account as no individual names, dates and amounts have been provided.
- The provision has been calculated at 4% of \$25 000.

b

Sachin	
Extract from income statement for the year ended 31 December 20–4	
	\$
Expenses – Irrecoverable debts	950
Provision for doubtful debts	1 000

c

Sachin		
Extract from statement of financial position at 31 December 20–4		
	\$	\$
Current assets		
Trade receivables	25 000	
Less Provision for doubtful debts	<u>1 000</u>	24 000

- Only the amount which is actually expected to be received from the trade receivables is added to the other current assets in the statement of financial position.

13.6 Adjusting a provision for doubtful debts

In future years it may be decided to maintain the provision for doubtful debts using the same percentage of the trade receivables. If the amount owing has increased, the provision needs to be increased and vice versa. If the original provision for doubtful debts was based on an amount of money rather than a percentage, it may be decided that this amount needs to be changed. This adjustment to the provision for doubtful debts is made at the end of the financial year.

The entries are summarised as follows:

- Debit the provision for doubtful debts account with the **new** provision and carry down as a credit balance.
- Transfer the difference on the provision for doubtful debts account to the income statement.
- In the statement of financial position deduct the balance on the provision for doubtful debts account (the **new** provision) from the trade receivables.

Walkthrough 13.3

Increasing a provision for doubtful debts

Sachin's financial year ends on 31 December.

On 31 December 20–4 Sachin created a provision for doubtful debts of \$1 000.

During the year ended 31 December 20–5 Sachin wrote off debts totalling \$990.

On 31 December 20–5 his trade receivables amounted to \$28 000. He decided to maintain the provision for doubtful debts at the rate of 4% of the trade receivables.

- Write up the irrecoverable debts account and the provision for doubtful debts account in Sachin's nominal ledger for the year ended 31 December 20–5.
- Prepare a relevant extract from Sachin's income statement for the year ended 31 December 20–5.
- Prepare a relevant extract from Sachin's statement of financial position at 31 December 20–5.

a

Sachin							
Nominal ledger							
Irrecoverable debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–5				20–5			
Dec 31	Debtors written off		990	Dec 31	Income statement		990
			<u>990</u>				<u>990</u>

**TIP**

When a provision for doubtful debts is created, the total amount is entered in the income statement. In later years, only the amount by which the provision increases or decreases is entered in the income statement.

Provision for doubtful debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–5				20–4			
Dec 31	Balance statement	c/d	1 120	Dec 31	Income statement		1 000*
				20–5			
				Dec 31	Income statement		120
			<u>1 120</u>				<u>1 120</u>
				20–6			
				Jan 1	Balance	b/d	1 120

- The words ‘debtors written off’ have been used in the irrecoverable debts account as no individual names, dates and amounts have been provided.
- The item indicated with * was entered in the account on 31 December 20–4 at the end of the previous financial year.
- The new provision has been calculated at 4% of \$28 000.

b

Sachin	
Extract from income statement for the year ended 31 December 20–5	
	\$
Expenses – Irrecoverable debts	990
Provision for doubtful debts	120

- Only the amount by which the provision needs to be increased is included in the expenses in the income statement.

c

Sachin		
Extract from statement of financial position at 31 December 20–5		
	\$	\$
Current assets		
Trade receivables	28 000	
Less Provision for doubtful debts	<u>1 120</u>	26 880

- The amount of the provision for doubtful debts at 31 December 20–5 (the balance on the provision account) is deducted from the trade receivables to show the amount expected to be received.

Walkthrough 13.4

Reducing a provision for doubtful debts

Sachin’s financial year ends on 31 December.

On 31 December 20–5 Sachin’s provision for doubtful debts amounted to \$1 120.

On 31 December 20–6 his trade receivables amounted to \$24 000. He decided to maintain the provision for doubtful debts at the rate of 4% of the trade receivables.

- a** Write up the provision for doubtful debts account in Sachin’s nominal ledger for the year ended 31 December 20–6.
- b** Prepare a relevant extract from Sachin’s income statement for the year ended 31 December 20–6.
- c** Prepare a relevant extract from Sachin’s statement of financial position at 31 December 20–6.

a

Sachin							
Nominal ledger							
Provision for doubtful debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–6				20–6			
Dec 31	Income statement		160	Jan 1	Balance	b/d	1 120
	Balance	c/d	960				
			<u>1 120</u>				<u>1 120</u>
				20–7			
				Jan 1	Balance	b/d	960

- The new provision has been calculated at 4% of \$24 000.

b

Sachin	
Extract from income statement for the year ended 31 December 20–6	
	\$
Gross profit	xxx
Add Reduction in provision for doubtful debts	160

- The surplus provision is added to the gross profit in the income statement.
- Any irrecoverable debts would be included in the expenses in the income statement in the usual way.

**TIP**

In the statement of financial position the total amount of the provision for doubtful debts at that date is deducted from the trade receivables.

c

Sachin		
Extract from statement of financial position at 31 December 20–6		
	\$	\$
Current assets		
Trade receivables	24 000	
Less Provision for doubtful debts	<u>960</u>	23 040

- The amount of the provision for doubtful debts at 31 December 20–6 (the balance on the provision account) is deducted from the trade receivables to show the amount expected to be received.

You can now answer Questions 4–6 at the end of this chapter.

Revision checklist

- An irrecoverable debt is an amount owing to a business which will not be paid by a credit customer. Irrecoverable debts are shown as an expense in the income statement.
- A debt written off may later be recovered when a credit customer pays some, or all, of the debt. Debts recovered are added to the gross profit in the income statement.
- A provision for doubtful debts is an estimate of the amount which a business will lose in a financial year because of irrecoverable debts.
- The amount required to create or increase a provision for doubtful debts is shown as an expense in the income statement. Any surplus provision is added to the gross profit in the income statement.
- The provision for doubtful debts is deducted from the trade receivables in the statement of financial position.

Exam-style questions

- 1 At the end of his financial year Kahili wrote off a debt owed by a credit customer. What was the effect of this?

	Trade Receivables	Profit for the year	Capital	Balance at bank
A	decreased	decreased	decreased	no effect
B	decreased	no effect	no effect	no effect
C	no effect	no effect	decreased	decreased
D	no effect	decreased	no effect	decreased

- 2 Wendy maintains a provision for doubtful debts. Which statements are correct?

- 1 It is an application of the matching principle.
- 2 It is an application of the prudence principle.
- 3 It is an estimate of what may be lost because of irrecoverable debts.
- 4 It is money set aside to cover losses because of irrecoverable debts.

- A** 1, 2 and 3 **B** 1 and 4 **C** 2 and 3 **D** 2, 3 and 4

- 3 Abi maintains a provision for doubtful debts at 2% of trade receivables. On 1 January 20–5 the provision for doubtful debts was \$426. The trade receivables on 31 December 20–4 amounted to \$20 550.

What entries did Abi make on 31 December 20–4 to adjust the provision for doubtful debts?

	Debit	\$	Credit	\$
A	income statement	15	provision for doubtful debts	15
B	income statement	411	provision for doubtful debts	411
C	provision for doubtful debts	15	income statement	15
D	provision for doubtful debts	411	income statement	411

4 K Dhoni is a business consultant.

The following trial balance is provided at 30 September 20–1:

	\$	\$
Capital		94 000
Drawings	12 250	
Premises at cost	82 000	
Office equipment at cost	19 000	
Provision for depreciation of office equipment		1 900
Trade receivables	5 000	
Loan (repayable 20–9)		10 000
Irrecoverable debts	100	
Provision for doubtful debts		150
Fees from clients		75 300
Insurance	2 400	
Printing and stationery	3 150	
Wages	47 000	
Office expenses	2 950	
Rent receivable		5 400
Cash	200	
Bank	12 700	186 750
	<u>186 750</u>	<u>186 750</u>

The following additional information is supplied:

- 1 At 30 September 20–1 – rent received in advance amounted to \$1 800
insurance prepaid amounted to \$600
printing expenses owing amounted to \$150
loan interest owing amounted to \$500.
 - 2 The office equipment is being depreciated at the rate of 10% per annum using the straight line method.
 - 3 The provision for doubtful debts is maintained at 4% of the trade receivables.
- a Prepare the income statement of K Dhoni for the year ended 30 September 20–1.
 - b Prepare the statement of financial position of K Dhoni at 30 September 20–1.

- 5 Harry is a trader selling goods on credit. His financial year ends on 31 December. The balances on his books on 1 January 20–3 included the following:

	\$
Provision for doubtful debts	300
Jane, a credit customer	900 debit

Harry's transactions for the year ended 31 December 20–3 included the following:

January 4	Received a cheque from Jane in full settlement of her account less a cash discount of 2%
March 5	Sold goods on credit to Jane, list price \$200, less trade discount of 20%
May 18	Received \$100 cash from Sarah whose account had been written off two years ago
December 30	Jane was declared bankrupt. She left the country and could not be traced. Her account was written off
December 31	Harry decided to increase his provision for doubtful debts by \$50

Write up the accounts for Jane, irrecoverable debts, debts recovered and provision for doubtful debts for the year ended 31 December 20–3. Balance or total the accounts or make an appropriate year-end transfer as necessary.

- 6 Lakshmi runs a secretarial agency. The following trial balance was prepared on 31 January 20–1:

	\$	\$
Capital 1 February 20–0		98 000
Drawings	5 000	
10 year loan from AB Loans		15 000
Premises at cost	90 000	
Office equipment at cost	10 500	
Motor vehicles at cost	16 900	
Provision for depreciation of office equipment		4 200
Provision for depreciation of motor vehicles		6 480
Trade receivables	7 800	
Provision for doubtful debts		172
Bank		2 888
Fees		21 820
Commission receivable		490
Wages	10 200	
Insurance	2 250	
Rates	3 200	
Office expenses	2 450	
Loan interest	149 750	149 050
	<u>149 050</u>	<u>149 050</u>

Additional information:

- 1 At 31 January 20–1:
 - commission receivable outstanding amounted to \$30
 - wages accrued amounted to \$320.
 - 2 The insurance is for 15 months from 1 February 20–0.
 - 3 Lakshmi occupies a flat above the business premises and one quarter of the rates relate to this flat.
 - 4 Office equipment is being depreciated at 20% per annum on cost.
 - 5 Motor vehicles are being depreciated at 20% per annum using the reducing balance method.
 - 6 The provision for doubtful debts is to be maintained at 2% of the trade receivables.
- a** Prepare the income statement for the year ended 31 January 20–1.
- b** Prepare the statement of financial position at 31 January 20–1.

- 6** Anais owns a general store. She makes payments of both capital and revenue items and has both capital and revenue receipts.
- a** Complete the following table by placing a tick (✓) to indicate how each item could be classified.

	Capital expenditure	Revenue expenditure	Capital receipt	Revenue receipt
Loan from AB Limited				
Purchase of additional premises				
Legal fees for purchase of additional premises				
Insurance of additional premises				
Cash sales				
Purchase of inventory				
Proceeds of sale of old motor vehicle at book value				
Discount received				

When calculating her profit for the year ended 29 February 20–4, Anais discovered some errors had been made in the accounting records.

- Error 1 Redecorating of the original premises had been debited to the premises account.
- Error 2 Payment of loan interest had been debited to the loan account.
- Error 3 Commission received had been credited to the sales account.
- Error 4 Proceeds of sale of office fixtures at book value had been credited to the sales account.

- b** Complete the following table by placing a tick (✓) to indicate the effect of each error on the profit for the year.

Error	Effect on the profit for the year		
	Overstated	Understated	No effect
error 1			
error 2			
error 3			
error 4			

- 7 Nazeer is a trader. He provided the following information about his inventory at 30 November 20–8:

Inventory code number	Number of units in inventory	Cost per unit \$	Selling price per unit \$
BD20	300	1.50	2.30
BD23	119	0.95	0.80
BD29	410	1.78	1.85

Nazeer had to pay carriage inwards on inventory code number BD20 at the rate of \$5 per 100 units (not included in the cost per unit shown in the table).

- a Explain the meaning of the following terms used in connection with inventory valuation:
- cost
 - net realisable value
- b Name one accounting principle Nazeer should apply when valuing his inventory.
- c Calculate the total value of Nazeer's inventory on 30 November 20–8.

After the preparation of the financial statements for the year ended 30 November 20–8 Nazeer discovered that the inventory had been understated by \$15.

- d Complete the following table by placing a tick (✓) to show the effect of this error.

	Overstated	Understated	No effect
current assets at 30 November 20–8			
profit for the year ended 30 November 20–8			
gross profit for the year ended 30 November 20–9			

- 8 Karima's financial year ends on 31 December.

She maintains one combined account for rates and insurance.

On 1 January 20–4 she owed \$560 for 4 months' rates and had paid 6 months' insurance, \$580, in advance.

During the year ended 31 December 20–4 Karima made the following payments:

			\$
February	28	Rates for 8 months by cheque	1 120
April	30	Rates for 5 months by cheque	700
July	1	Insurance for 12 months by credit transfer	1 200

- a Prepare the rates and insurance account for the year ended 31 December 20–4. Balance the account and bring down the balances on 1 January 20–5.
- b Prepare relevant extracts from the statement of financial position on 31 December 20–4.
- c Explain why it is important to make adjustments for accrued and prepaid expenses at the end of the financial year.

- 9** Tanvir is a trader. His financial year ends on 31 December.

Tanvir purchases all of his office stationery from Tabitha. He provided the following information for the year ended 31 December 20–8:

			\$
January	1	Inventory of stationery	44
April	1	Purchased stationery on credit from Tabitha	313
	18	Returned damaged stationery to Tabitha	22
June	1	Paid amount owing to Tabitha by cheque	
December	31	Inventory of stationery	65

- a** Prepare the following ledger accounts for the year ended 31 December 20–8:

- i** Tabitha account
- ii** Stationery account

The accounts should be balanced, totalled or transferred to the income statement as appropriate.

Tanvir is supplied with electricity by EE Limited. He pays by bank transfer after receipt of invoices which are issued every six months by EE Limited.

Tanvir provided the following information relating to the year ended 31 December 20–8:

			\$
January	1	Balance owing to EE Limited for electricity supplied	239
	30	Paid balance owing to EE Limited by bank transfer	
July	1	Received an invoice from EE Limited for electricity supplied	445
August	2	Paid balance owing to EE Limited by bank transfer	
December	31	Estimate of amount of electricity used since July	388

- b** Prepare the following ledger accounts for the year ended 31 December 20–8.

- i** EE Limited account
- ii** Electricity expense account

The accounts should be balanced, totalled or transferred to the income statement as appropriate.

- 10** Chibuzo's financial year ends on 31 December. He depreciates his motor vehicles at 20% per annum on the cost of motor vehicles held at the end of each financial year.

Chibuzo provided the following information:

- 1 January 20–7 Purchased motor vehicle A for \$15 000 and motor vehicle B for \$18 000
- 1 July 20–9 Motor vehicle A was sold for \$8 600. On the same date motor vehicle C was purchased for \$21 000

- a** Calculate the profit or loss on disposal of motor vehicle A.
- b** Calculate the depreciation charge for motor vehicles for the year ended 31 December 20–9.

Chibuzo provided the following additional information for the year ended 31 December 20–9:

	\$
Revenue	108 200
Wages	10 300
Rent and rates	2 100
Purchases	81 140
Inventory 1 January 20–9	5 410
Administration and selling expenses	2 230
Commission receivable	2 050
Provision for doubtful debts 1 January 20–9	540

Additional information:

1 On 31 December 20–9

Inventory	5 550
Wages accrued	120
Rates prepaid	300
Commission receivable outstanding	420
Provision for doubtful debts to be reduced to	450

2 Office equipment was valued at \$4 320 on 1 January 20–9. Office equipment, \$1 200, was purchased during the year. No office equipment was disposed of during the year. On 31 December 20–9 the office equipment was valued at \$5 250.

c Prepare the income statement for the year ended 31 December 20–9.

11 Nadia's financial year ends on 31 August. She depreciates her office fixtures by 25% per annum on cost. Depreciation is calculated from the date of purchase. No depreciation is charged in the year of disposal.

a Name and explain two accounting principles Nadia is observing by depreciating her office fixtures.

On 1 September 20–3 the following balances appeared in Nadia's ledger:

	\$
Office fixtures at cost	4 500
Provision for depreciation of office fixtures	2 100

On 1 December 20–3 Nadia purchased additional office fixtures, \$2 400, on credit from AB Limited.

On 1 March 20–4 Nadia sold office fixtures for \$120 which was received in cash. The office fixtures had been purchased on 1 September 20–0 for \$1 000.

b Write up the office fixtures account, the provision for depreciation of office fixtures account and the disposal of office fixtures account for the year ended 31 August 20–4. Balance the accounts where necessary and bring down the balances on 1 September 20–4.

c Prepare a relevant extract from Nadia's statement of financial position on 31 August 20–4.

- 12** Charlotte maintains a provision for doubtful debts at $2\frac{1}{2}\%$ of her trade receivables at the end of each financial year.
- Explain the meaning of each of the following terms:
 - irrecoverable debt
 - provision for doubtful debts
 - Explain how Charlotte is observing the accounting principle of prudence by maintaining a provision for doubtful debts.
 - Name one other accounting principle Charlotte is observing by maintaining a provision for doubtful debts.
 - Suggest two ways in which Charlotte may reduce the possibility of irrecoverable debts.

At the end of her financial year on 31 July 20–3 Charlotte provided the following information:

		\$
On 1 August 20–2	Trade receivables	8 400
During the year ended 31 July 20–3	Debts written off as irrecoverable	167
On 31 July 20–3	Trade receivables	7 546
	It was decided to write off a debt as irrecoverable	66

The provision for doubtful debts should be maintained at $2\frac{1}{2}\%$ of the trade receivables.

- Prepare the provision for doubtful debts account for the year ended 31 July 20–3. Balance the account and bring down the balance on 1 August 20–3.
- Prepare relevant extracts from the income statement for the year ended 31 July 20–3.
- Prepare a relevant extract from the statement of financial position at 31 July 20–3.

- 13** Sharif is a trader. He maintains a full set of accountings records. His financial year ends on 30 April.

The balances on his ledger accounts on 30 April 20–7 included the following:

	\$
Sales	49 750
Rent receivable	2 000
Irrecoverable debts	960
Provision for doubtful debts	1 400
Stationery and office expenses	3 210
Inventory (1 May 20–6)	4 520
Office fixtures at cost	14 500
Provision for depreciation of office fixtures	5 800
Disposal of office fixtures account	–

- a** Open an account for each of the items and enter the balance on 30 April 20–6.

Sharif provided the following additional information on 30 April 20–7.

- 1 Inventory was valued at \$4970.
- 2 Inventory of stationery was valued at \$45.
- 3 Rent receivable outstanding amounted to \$400.
- 4 \$116 owed by Halijah should be written off as irrecoverable.
- 5 The provision for doubtful debts should be increased by \$100.
- 6 Office fixtures were sold on 28 April. The proceeds of sale, \$780, had been debited in the cash book, but no other entries had been made. The fixtures originally cost \$2000 and had been depreciated by \$800.
- 7 The remaining office fixtures should be depreciated by 10% per annum on cost.

- b** Record this information in the accounts opened in **a**. Close the accounts by balancing or by making a transfer to the income statement.

- 14** Priti is a trader. Her financial year ends on 31 March. Her trial balance on 31 March 20–4 was as follows:

	\$	\$
Capital		390 000
Drawings	54 000	
Trade receivables	49 270	
Trade payables		43 500
Bank	21 335	
Premises at cost	300 000	
Fixtures and fittings at cost	35 000	
Motor vehicles at cost	24 000	
Provision for depreciation of fixtures and fittings		14 000
Provision for depreciation of motor vehicles		10 500
Provision for doubtful debts		2 360
Revenue		644 000
Inventory 1 April 20–3	36 000	
Purchases	528 850	
Sales returns	1 050	
Carriage inwards	750	
Commission receivable		1 030
Rates and insurance	10 400	
Wages	39 400	
Administration expenses	111 5335	1 105 390
	<u>1 105 390</u>	<u>1 105 390</u>

Additional information:

1 At 31 March 20–4:

Inventory was valued at \$41 050.

Commission receivable outstanding amounted to \$110.

Insurance prepaid amounted to \$180.

Rates accrued amounted to \$260.

Wages accrued amounted to \$1 600.

2 A debt of \$150 should be written off as irrecoverable and the provision for doubtful debts should be maintained at 5% of the remaining trade receivables.

3 Fixtures and fittings are being depreciated at 20% per annum using the straight line method.

4 Motor vehicles are being depreciated at 25% per annum using the reducing balance method.

a Prepare the income statement for the year ended 31 March 20–4.

b Prepare the statement of financial position at 31 March 20–4.