

Section 4



Chapter 14

Bank reconciliation statements

Learning objectives

In this chapter you will learn to:

- understand the use and purpose of a bank statement 3.3
- update the cash book for bank charges, bank interest paid and received, correction of errors, credit transfers, direct debits, dividends and standing orders 3.3
- understand the purpose of, and prepare, a bank reconciliation statement to include bank errors, uncredited deposits and unrepresented cheques. 3.3

14.1 Introduction

A bank will send a statement at regular intervals to its customers detailing the transactions that have taken place during the period covered by the statement and showing the bank balance at the end of the period. This is similar to the **statement of account** issued by its suppliers to the customers who have purchased goods on credit.

A **bank statement** is a copy of the customer's account in the books of the bank. This is a record of transactions as they affect the bank. When money is paid into the bank the customer's account will be credited, as this is the amount owed by the bank to the customer and when money is taken out of the bank, the customer's account will be debited, as this reduces the amount owed by the bank to the customer. A positive bank balance will appear as a credit balance and an overdrawn balance as a debit balance.

When the entries on a bank statement are compared to those in the bank account, in the cash book it will be found that they are recorded on opposite sides of the account. The bank account is a record of transactions as they affect the business. Money paid into the bank is debited (the bank is a debtor for this amount) and money withdrawn from the bank is credited (the bank is a creditor for this amount).

It is important to compare the bank statement and the bank account in the cash book. If the two balances disagree, it is necessary to **reconcile** them to explain why the differences have arisen.

TEST YOURSELF 14.1

- 1 State why bank reconciliation should be carried out.
- 2 Explain why money paid into the bank appears on the debit of the bank account but on the credit of the bank statement.



KEY TERM

A **bank statement** is a copy of a customer's account in the books of the bank which is sent to the customer at regular intervals.



TIP

The entries in the bank column of the cash book will appear on the opposite side to that on which they are recorded on the bank statement.



LINK

You learned about cash books in Chapter 4.

14.2 Reasons why the bank account and the bank statement may differ

Differences between the two records usually occur because of:

- the different times at which the same items are recorded
- the business not recording certain items in the cash book.

Timing differences

These are usually due to:

1 Cheques not yet presented

These are cheques that have been paid by the business and entered on the credit of the cash book, but which do not appear on the bank statement. This may be because the payee has not paid the cheque into his bank or because the cheque is still in the banking system and has not yet been deducted from the business's account.

2 Amounts not yet credited

These are cash and cheques that have been paid into the bank and entered on the debit side of the cash book, but which do not appear on the bank statement. It usually takes a few days before the money paid into the bank is recorded in the customer's account.

Items not recorded in the cash book

It often happens that the business does not record certain items until the bank statement is received. These include:

1 Bank charges and bank interest

The bank may deduct an amount from the customer's account to cover the cost of running the account and for any interest charged on overdrafts and loans.

2 Dishonoured cheques

A cheque paid into the bank may be returned because the drawer did not have sufficient funds in the account.

3 Amounts paid directly into the bank

These are **credit transfers**, **standing orders** and **direct debits** where a person has instructed their bank to pay an amount of money directly into the bank account of the business.

4 Amounts paid directly by the bank to others

These include credit transfers, standing orders and direct debits which the business has instructed the bank to pay directly from the account of the business.

Any other differences between the two records must be investigated. **Errors made by the business** should be corrected and **errors made by the bank** should be notified to the bank.

The differences between the bank account in the cash book and the bank statement are summarised as follows:

Items in cash book not in bank statement

Cheques not yet presented
Amounts not yet credited
Errors in cash book

Items in bank statement but not in cash book

Bank charges and bank interest
Dishonoured cheques
Standing orders
Credit transfers
Direct debits
Errors on bank statement
Dividends

TEST YOURSELF 14.2

- 1 Explain the term 'cheque not yet presented'.
- 2 Explain the term 'dishonoured cheque'.
- 3 Give an example of an expense which may be paid by standing order.



You learned about dishonoured cheques in Chapter 4.

14.3 Stages of bank reconciliation

1 Compare the bank account in the cash book with the bank statement

The debit side of the bank account should be compared with the credit side of the bank statement and the credit side of the bank account compared with the debit side of the bank statement. Put a tick (✓) against those items which appear in both records.

2 Update the cash book

Enter in the cash book any items which appear on the bank statement but which have not yet been entered in the cash book.

- a Items debited on the bank statement (e.g. bank charges, credit transfers paid by the bank, etc.) should be credited to the bank account in the cash book.
- b Items credited on the bank statement (e.g. credit transfers and direct debits paid into the bank) should be debited to the bank account in the cash book.

3 Correct any errors in the cash book

4 Balance the cash book and carry down the balance

This balance is the correct bank balance. If it is the end of the financial year, this is the balance which should appear in the statement of financial position.

5 Prepare a bank reconciliation statement

This should show why the balance on the updated cash book does not agree with the balance shown on the bank statement.

- a Start with the balance shown on the bank statement.
- b Add any items which appear on the debit side of the cash book but which do not appear on the bank statement (e.g. amounts not yet credited).
- c Deduct any items which appear on the credit side of the cash book but which do not appear on the bank statement (e.g. cheques not yet presented).
- d Make any adjustments for bank errors by adding amounts debited in error by the bank and deducting amounts credited in error by the bank.
- e The total of this calculation should equal the updated bank balance in the cash book.

It is possible to start the bank reconciliation statement with the updated bank account balance. In this case, it is necessary to reverse items **b**, **c** and **d**.

A bank reconciliation statement does not form part of the double entry records of the business. It is a statement which shows that, on a certain date, the bank account and the bank statement balances were reconciled.



KEY TERM

A **bank reconciliation statement** is a document prepared by a business to explain why the updated bank balance in the cash book does not agree with the balance on the bank statement.



TIP

The updated bank balance in the cash book appears in the statement of financial position.

Walkthrough 14.1

The bank columns of Fatima's cash book for the month of April 20–8 are:

Cash book (bank columns only)							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Apr 1	Balance		2970	Apr 10	Purchases		234
14	J Dhatwani		420	19	B Malukani		110
26	ABC Stores		217	29	TeeDee Co		1372
28	Sales		1460	30	Dobhal Ltd		517
					Balance	c/d	2834
			<u>5067</u>				<u>5067</u>
20–8							
May 1	Balance	b/d	2834				

Fatima's bank statement for the month of April 20–8 is:

REGIONAL BANK LTD				
West District				
Account: Fatima Goyal			Account no: 987654	
			Date: 30 April 20–8	
Date	Details	Debit	Credit	Balance
		\$	\$	\$
20–8				
April 1	Balance			2970 Cr
13	Cheque no 2388	243		2727 Cr
19	Credit no 6983		420	3147 Cr
20	Credit transfer (dividend)		150	3297 Cr
24	Cheque no 2389	110		3187 Cr
30	Bank charges	95		3092 Cr

It is discovered that Fatima has made an error on 10 April and recorded purchases as \$234, when the correct figure was \$243.

- Make any additional entries that are required in Fatima's cash book. Balance the bank account and bring down the balance on 1 May 20–8.
- Prepare a bank reconciliation statement at 30 April 20–8.

The first thing to do is to compare the entries in the cash book with those on the bank statement. Place a tick (✓) against the items appearing in both the records.

The cash book and the bank statement should now look like this:

Cash book (bank columns only)							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Apr 1	Balance	✓	2970	Apr 10	Purchases		234
14	J Dhatwani	✓	420	19	B Malukani	✓	110
26	ABC Stores		217	29	TeeDee Co		1372
28	Sales		1460	30	Dobhal Ltd		517
					Balance	c/d	2834
			<u>5067</u>				<u>5067</u>
20–8							
May 1	Balance	b/d	2834				

REGIONAL BANK LTD				
West District				
Account: Fatima Goyal			Account no: 987654	
			Date: 30 April 20–8	
Date	Details	Debit \$	Credit \$	Balance \$
20–8				
April 1	Balance			2970 Cr ✓
13	Cheque no 2388	243		2727 Cr
19	Credit no 6983		420 ✓	3147 Cr
20	Credit transfer (dividend)		150	3297 Cr
24	Cheque no 2389	110 ✓		3187 Cr
30	Bank charges	95		3092 Cr

It is now possible to update the bank account in the cash book. Firstly, the error on 10 April must be corrected. Items appearing in the debit column of the bank statement which have not been ticked off (excluding 13 April which has now been corrected in the bank account) must be credited in the bank account. Items appearing in the credit column of the bank statement which have not been ticked off must be debited in the bank account.

a

Cash book (bank columns only)							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-8				20-8			
May 1	Balance	b/d	2 834	May 1	Correction of error		9
	Dividend		150		Bank charges		95
			<u> </u>		Balance	c/d	2 880
			2 984				<u>2 984</u>
20-8							
May 1	Balance	b/d	2 880				

The bank reconciliation statement can now be prepared.

b

Fatima			
Bank reconciliation statement at 30 April 20-8			
		\$	\$
Balance shown on bank statement			3 092
Add Amounts not yet credited – ABC Stores		217	
	Sales	1 460	<u>1 677</u>
			4 769
Less Cheques not yet presented – TeeDee Co		1 372	
	Dobhal Ltd	<u>517</u>	<u>1 889</u>
Balance shown in cash book			<u>2 880</u>

It is important to remember that the bank columns are actually part of the main three column cash book – not a separate ledger account.

TEST YOURSELF 14.3

- 1** On 31 May a trader's bank account showed a he had \$250 in the bank. On the same day his bank statement showed a credit balance of \$198. The cash book was updated and the new balance showed there was \$141 in the bank.

In the trader's statement of financial position on 31 May:

- a** Under what heading will bank be shown?
b What amount will be entered for bank?

14.4 Bank reconciliation when there is a bank overdraft

Walkthrough 14.1 showed how to update the cash book and prepare a bank reconciliation statement when there is a positive bank balance. Exactly the same principles are followed when there is a bank overdraft. In this case, it is important to take great care with the arithmetic calculations and it is helpful to place brackets around overdrawn amounts. A bank overdraft will appear as a credit balance in the bank account in the cash book of the business and as a debit balance on the bank statement.

Walkthrough 14.2

On 31 July 20–8 the bank account in Fatima’s cash book showed an overdrawn balance of \$1 121. On the same date her bank statement showed a debit balance of \$1 091.

When comparing the cash book and the bank statement it was found that the following items appeared only in the cash book:

- 1 A cheque paid to PJ Motors for \$163 on 29 July.
- 2 Cash sales amounting to \$1 010 paid into the bank on 31 July.

The following items appeared only on the bank statement and not in the cash book:

- 1 Rent received paid directly into the bank \$190.
 - 2 Bank charges of \$213.
 - 3 A credit balance on 1 July was shown as \$2 100 instead of \$1 200.
- a** Make any additional entries that are required in Fatima’s cash book. Balance the bank account and bring down the balance on 1 May 20–8.
- b** Prepare a bank reconciliation statement at 31 July 20–8.

The comparison of the cash book with the bank statement has already been completed and the differences are shown, so it is possible to start with the updating of the cash book.

a

Cash book (bank columns only)							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Aug 1	Rent received		190	Aug 1	Balance	b/d	1 121
	Balance	c/d	<u>1 144</u>		Bank charges		<u>213</u>
			<u>1 334</u>				<u>1 334</u>
				20–8			
				Aug 1	Balance	b/d	1 144

b

Fatima	
Bank reconciliation statement at 31 July 20–8	
	\$
Balance shown on bank statement	(1 091)
Add Amounts not yet credited – Sales	1 010
	<u>(81)</u>
Less Cheques not yet presented – PJ Motors	163
	<u>(244)</u>
Less Bank error	900
Balance shown in cash book	<u>(1 144)</u>

14.5 Advantages of bank reconciliation

The advantages of reconciling the balance on the bank statement with that shown on the bank account in the cash book are:

- 1 After updating the bank account an accurate bank balance is available.
- 2 Errors in the bank account or on the bank statement can be identified.
- 3 It assists in discovering fraud and embezzlement.
- 4 Amounts not credited by the bank can be identified.
- 5 Cheques not yet presented can be identified.
- 6 Any 'stale' cheques (these are usually those which are over six months old, which will not be met by the bank) can be identified and written back into the bank account.

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

Revision checklist

- The purpose of bank reconciliation is to explain the differences between the bank balance shown in the cash book and the balance on the bank statement.
- Most of the differences between the balances are caused by differences in the time at which items are recorded and because some items cannot be recorded in the cash book until the bank statement is received.
- The cash book should be updated by entering those items which appear on the bank statement but not in the cash book.
- The bank reconciliation statement shows the balance on the bank statement adjusted for amounts not yet credited, cheques not yet presented and any bank errors. The final figure should agree with the balance shown in the bank account in the cash book.

Exam-style questions

- 1 Which statement is correct about a bank reconciliation statement?
- A It contains bank charges and standing orders.
 - B It is part of the double entry book-keeping records.
 - C It is prepared by the bank.
 - D It is prepared by the trader.
- 2 A bank reconciliation statement was prepared starting with the balance at bank shown on the bank statement. Which item would be deducted?
- A bank error resulting in the account being incorrectly debited
 - B cash book error resulting in the balance being overstated
 - C cheque not yet credited
 - D cheque not yet presented
- 3 The bank column of a trader's cash book showed a debit balance of \$952. This did not agree with the balance on the bank statement on the same date. The following differences were found:

	\$
Cheque not yet presented	134
Bank charges	11
Rent paid by credit transfer	310

What was the balance on the bank statement?

- A \$765 credit B \$765 debit C \$1 139 credit D \$1 139 debit
- 4 Zafar is a trader. He maintains a three column cash book and compares this with his bank statement at the end of every month and prepares a bank reconciliation statement.
- a Suggest two reasons why it is useful for Zafar to reconcile his cash book with the bank statement every month.
 - b Explain the difference between a cheque not credited and a cheque not presented.
 - c Complete the following table by placing a tick in the correct column to indicate whether each item would be used to update the cash book or would appear in the bank reconciliation statement.

	Updating cash book	Bank reconciliation statement
unpresented cheque		
bank charges		
direct debit paid for electricity		
credit transfer from Waseem		
cash sales not yet credited		
bank error		
cheque from Adil dishonoured		

- 5 The cash book (bank columns) of Ella for the month of May 20–7 were as follows:

Cash book (bank columns only)							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–7				20–7			
May 1	Balance	b/d	398	May 10	Lily		113
	14 William		87	29	James		246
	31 Sales		684	31	Balance	c/d	910
			<u>1 169</u>				<u>1 269</u>
20–7				20–7			
June 1	Balance	b/d	910				

Ella's bank statement for May 20–7 showed the following:

Date	Details	Debit	Credit	Balance
20–7		\$	\$	\$
May 1	Balance		398	398 Cr
	18 Counter credit 99870		87	485 Cr
	20 Cheque 404	113		372 Cr
	24 Dishonoured cheque	87		285 Cr
	30 SO Motor insurance company	36		249 Cr
	31 Bank charges	12		237 Cr

The following errors were discovered:

- 1 Ella had overcast the debit side of her cash book by \$100.
 - 2 The bank should have charged the motor insurance to Ella's personal bank account not the business bank account.
 - a Update Ella's cash book. Bring down the updated balance on 1 June 20–7.
 - b Prepare a bank reconciliation statement for Ella at 31 May 20–7.
 - c Prepare a relevant extract from Ella's statement of financial position at 31 May 20–7 showing the entry for the bank balance.
- 6 Yatish is a trader. He compared his cash book with his bank statement on 30 June. The cash book showed an overdrawn balance of \$2 356.

The following differences between the cash book and the bank statement were discovered:

- 1 Cheques not yet presented for payment

	\$
Hemisha	428
Ben	910

- 2 Cash sales, \$950, were not recorded on the bank statement.
- 3 The bank had debited \$50 to the business bank account which should have been debited to Yatish's personal bank account.
 - a Prepare a bank reconciliation statement to show the balance on the bank statement.
 - b Explain the difference between a bank statement and a bank reconciliation statement.
 - c Explain why the entries on a bank statement are on the opposite side to where they appear in the cash book.

Chapter 15

Journal entries and correction of errors

Learning objectives

In this chapter you will learn to:

- explain the use of, and process accounting data in, the book of prime entry – the general journal 2.3
- post the ledger entries from the general journal 2.3
- prepare journal entries for the provision for depreciation 4.2
- prepare journal entries to record the sale of non-current assets 4.2
- prepare journal entries to record accrued and prepaid expenses 4.3
- prepare journal entries to record accrued and prepaid incomes 4.3
- prepare journal entries to record irrecoverable debts 4.4
- prepare journal entries to record the recovery of debts written off 4.4
- prepare journal entries to record the creation of, and adjustments to, a provision for doubtful debts 4.4
- correct errors by means of journal entries 3.2
- explain the use of a suspense account as a temporary measure to balance the trial balance 3.2
- correct errors by means of suspense accounts 3.2
- adjust a profit or loss for an accounting period after the correction of errors 3.2
- understand the effect of correction of errors on a statement of financial position. 3.2

15.1 Introduction

The **journal** or **general journal** is a book of prime entry. Chapter 7 explained how all transactions are recorded in a book of prime entry **before** they are entered in the ledger.

The **journal** is not a part of the double entry book-keeping. It is regarded as a diary in which transactions are noted before they are entered in the ledger. **Anything which is not entered in one of the books of prime entry must be entered in the journal before being recorded in the ledger.**

A journal entry shows:

- the date of the transaction
- the name of the account to be debited and the amount
- the name of the account to be credited and the amount
- a narrative

The narrative consists of a brief explanation of what is being recorded and why the entry is being made. This is useful because it is impossible to remember the reason for every entry and the entries in the journal sometimes involve unusual transactions.

The layout of the journal is as follows:

Journal				
Date	Details	Folio	Debit \$	Credit \$

The items usually recorded in the journal are:

- opening entries
- purchase and sale of non-current assets
- non-regular transactions such as year-end transfers
- correction of errors

15.2 Opening journal entries

As the name suggests, opening journal entries are made when the business starts (or when the business first keeps accounting records). An opening journal entry lists the assets owned by the business (shown in the debit column), the liabilities owed by the business (shown in the credit column) and the capital of the business (also shown in the credit column).

After the journal entry has been prepared, the items are posted to the appropriate ledger accounts.

Walkthrough 15.1

Chandra started business on 1 November 20–4. He did not maintain any accounting records during his first year of trading.

On 1 November 20–5 he was able to provide the following information about his business:

- | | |
|-------------|---|
| Assets | Premises \$56 000, fixtures \$19 400, motor vehicles \$12 500, inventory \$3 100, trade receivables \$4 700, cash \$200 |
| Liabilities | Trade payables \$5 600, bank overdraft \$2 300 |



KEY TERM

The **journal** is a book of prime entry used to record transactions which cannot be recorded in any other book of prime entry.



LINK

You learned about the other books of prime entry in earlier chapters. In Chapters 4 and 5 you learned about cash books and petty cash books and in Chapter 7 you learned about sales, purchases and returns journals.

Prepare an opening journal entry for Chandra at 1 November 20–5.

Make the appropriate entries in Chandra's ledger and cash book.

Chandra Journal Assets, liabilities and capital to open the books.				
Date	Details	Folio	Debit \$	Credit \$
20–5				
Nov 1	Premises		56 000	
	Fixtures		19 400	
	Motor vehicles		12 500	
	Inventory		3 100	
	Trade receivables		4 700	
	Cash		200	
	Trade payables			5 600
	Bank			2 300
	Capital			88 000
			<u>95 900</u>	<u>95 900</u>

- It is usual to show the debit entries first.
- It is usual to slightly indent the credit entries.
- It is usual to draw a line after each separate journal entry.
- The capital was calculated as the difference between the assets and the liabilities.

Chandra Nominal ledger Premises account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–5							
Nov 1	Balance		56 000				

Fixtures account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–5							
Nov 1	Balance		19 400				

Motor vehicle account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-5							
Nov 1	Balance		12 500				

Inventory account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-5							
Nov 1	Balance		3 100				

Capital account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-5							
Nov 1	Balance		88 000				

Cash Book							
Date	Details	Cash	Bank	Date	Details	Cash	Bank
		\$	\$			\$	\$
20-5				20-5			
Nov 1	Balance	200		Nov 1	Balance		2 300

- No names and amounts of individual credit customers and credit suppliers were provided in this question. In practice, these will be known.
- In the sales ledger an account will be opened for each credit customer and the account will be debited with the balance owed by that customer.
- In the purchases ledger an account will be opened for each credit supplier and the account will be credited with the balance owed to that supplier.

TEST YOURSELF 15.1

- 1 Name **three** transactions for which a journal entry would be made.
- 2 In connection with a journal entry:
 - a explain the meaning of a narrative
 - b explain why a narrative is necessary.

15.3 Purchase and sale of non-current assets

As the purchase and sale of non-current assets are not recorded in one of the other books of prime entry, they should be entered in the journal before being posted to the ledger.

After the journal entry has been completed, the transaction is posted to the appropriate ledger accounts.



LINK

You learned about disposal of non-current assets in Chapter 12.

Walkthrough 15.2

Chandra's financial year ends on 31 October.

Prepare the journal entries to record the following transactions on 1 September 20–6.

- Purchased additional fixtures, \$1 300, on credit from Office Supplies.
- Sold the motor vehicle (cost \$12 500) for \$7 400 on credit to Used Vehicles Ltd.

Chandra Journal				
Date	Details	Folio	Debit \$	Credit \$
20–6				
Sep 1	Fixtures		1 300	
	Office Supplies			1 300
	Purchase of fixtures on credit			
	Disposal of motor vehicle		12 500	
	Motor vehicles			12 500
	Used Vehicles Ltd		7 400	
	Disposal of motor vehicle			7 400
	Transfer of motor vehicle to disposal account and sale of motor on credit			
Oct 31	Income statement		5 100	
	Disposal of motor vehicle			5 100
	Loss on disposal transferred to income statement			

15.4 Non-regular transactions

As explained earlier, any transactions which cannot be recorded in another book of prime entry are recorded in the journal. These often consist of transactions which are not occurring regularly and year-end transfers to the income statement. The transaction is posted to the appropriate ledger accounts after the journal entry is completed.

Walkthrough 15.3

Chandra's financial year ends on 31 October. He provided the following information for the year ended 31 October 20–6.

- Irrecoverable debts written off up to 30 October 20–6 amounted to \$140.
- On 31 October 20–6 it was decided to:

Write off as irrecoverable a debt of \$50 owing by Ansari Stores

Create a provision for doubtful debts of \$250

- a** Prepare journal entries to record the decisions made on 31 October 20–6 and any necessary year-end transfers.
- b** Show the appropriate ledger accounts after posting these entries.

a

Chandra Journal				
Date	Details	Folio	Debit \$	Credit \$
20–6				
Oct 31	Irrecoverable debts Ansari Stores Writing off irrecoverable debt		50	50
	Income statement Provision for doubtful debts Creation of provision for doubtful debts		250	250

b

Chandra Sales ledger Ansari Stores account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–6				20–6			
Oct 1	Balance	b/d	50	Oct 31	Irrecoverable debts		50
			<u>50</u>				<u>50</u>

Nominal ledger Irrecoverable debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–6				20–6			
Oct 30	Debtors written off		140	Oct 31	Income statement		190
31	Ansari Stores		<u>50</u>				<u>190</u>
			<u>190</u>				<u>190</u>

Provision for doubtful debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6				20-6			
Oct 31	Balance	c/d	250	Oct 31	Income statement		250
			<u>250</u>				<u>250</u>
				20-6			
				Nov 1	Balance	b/d	250

- On 31 October 20-7 Chandra:
 - agreed to accept equipment valued at \$100 from Khalid in settlement of a debt written off during the year ended 31 October 20-6.
 - decided to increase the provision for doubtful debts to \$310.
- c** Prepare journal entries to record the above information, including year-end transfers.
- d** Show the appropriate ledger accounts after posting these entries.

c

Chandra Journal				
Date	Details	Folio	Debit \$	Credit \$
20-7				
Jun 30	Equipment		100	
	Debts recovered			100
	Equipment accepted in settlement of debt previously written off			
Oct 31	Income statement		60	
	Provision for doubtful debts			60
	Adjustment to provision for doubtful debts			

d

Chandra Nominal ledger							
Debits recovered account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7				20-7			
Oct 31	Income statement		<u>100</u>	Jun 30	Equipment		100
			<u>100</u>				<u>100</u>

Equipment account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-7							
Oct 31	Debts recovered		100				

Provision for doubtful debts account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6				20-6			
Oct 31	Balance	c/d	250	Oct 31	Income statement		250
			<u>250</u>				<u>250</u>
20-7				20-6			
Oct 31	Balance	c/d	310	Nov 1	Balance	b/d	250
				20-7			
				Oct 31	Income statement		60
			<u>310</u>				<u>310</u>
				20-7			
				Nov 1	Balance	b/d	310

- The alternative ways of recording debts recovered are explained on Page 172:

Walkthrough 15.4

Chandra's financial year ends on 31 October. He provided the following information:

- At 31 October 20-6 Chandra's ledger accounts included the following:
 - Purchases for the year \$39 000
 - Sales returns for the year \$2 460
 - Insurance \$1 500, which included a prepayment of \$300
 - Inventory at 1 November 20-5 \$3 100
 - General expenses for the year \$1 350
 - Rent receivable \$1 200 (part of the premises had been let to a tenant on 1 October 20-6 at an annual rent of \$2 400)
 - On 31 October 20-6:
 - Inventory was valued at \$3 900
 - The motor vehicle should be depreciated by \$2 500
 - General expenses accrued amounted to \$75
- Prepare journal entries to record the year-end transfers.
 - Show the ledger accounts after posting these entries.

a

Chandra Journal				
Date	Details	Folio	Debit \$	Credit \$
20-6				
Oct 31	Income statement		39 000	
	Purchases			39 000
	Transfer of purchases for the year to the income statement			
	Income statement		2 460	
	Sales returns			2 460
	Transfer of sales returns for the year to the income statement			
	Income statement		1 200	
	Insurance			1 200
	Transfer of insurance for the year to the income statement			
	Income statement		3 100	
	Inventory			3 100
	Transfer of opening inventory to the income statement			
	Inventory		3 900	
	Income statement			3 900
	Transfer of closing inventory to the income statement			
	Income statement		1 425	
	General expenses			1 425
	Transfer of general expenses for the year to the income statement			
	Rent receivable		200	
	Income statement			200
	Transfer of rent receivable for the year to the income statement			
	Income statement		2 500	
	Provision for depreciation of motor vehicle			2 500
	Annual depreciation charge transferred to the income statement			

b

Chandra Nominal ledger Purchases account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6				20-6			
Oct 31	Total to date		39 000	Oct 31	Income statement		39 000
			<u>39 000</u>				<u>39 000</u>

Sales returns account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6				20-6			
Oct 31	Total to date		2 460	Oct 31	Income statement		2 460
			<u>2 460</u>				<u>2 460</u>

Insurance account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6				20-6			
Oct 31	Total paid		1 500	Oct 31	Income statement		1 200
			<u>1 500</u>		Balance	c/d	300
							<u>1 500</u>
20-6							
Nov 1	Balance	b/d	300				

Inventory account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-5				20-6			
Nov 1	Balance		3 100	Oct 31	Income statement		3 100
			<u>3 100</u>				<u>3 100</u>
20-6				20-6			
Oct 31	Income statement		3 900	Oct 31	Balance	c/d	3 900
			<u>3 900</u>				<u>3 900</u>
20-6							
Nov 1	Balance		3 900				

General expenses account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6				20-6			
Oct 31	Total paid		1 350	Oct 31	Income statement		1 425
	Balance	c/d	<u>75</u>				<u>1 425</u>
			<u>1 425</u>				<u>1 425</u>
				20-6			
				Nov 1	Balance	b/d	75

Rent receivable account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6				20-6			
Oct 31	Income statement		200	Oct 31	Total received		1 200
	Balance	c/d	<u>1 000</u>				<u>1 200</u>
			<u>1 200</u>				<u>1 200</u>
				20-6			
				Nov 1	Balance	b/d	1 000

Provision for depreciation of motor vehicle account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-6				20-6			
Oct 31	Balance	c/d	<u>2 500</u>	Oct 31	Income statement		<u>2 500</u>
			<u>2 500</u>				<u>2 500</u>
				20-6			
				Nov 1	Balance	b/d	2 500

Walkthrough 15.5

Chandra's financial year ends on 31 October. Prepare journal entries to record the following:

- On 30 September 20-6 he wrote off \$50 owing by Ansari Stores as irrecoverable.
- At 31 October 20-6 Chandra's ledger accounts include the following:
 - Purchases for the year \$39 000
 - Irrecoverable debts for the year \$190
 - Insurance, \$1 500, which includes a prepayment of \$300
 - Inventory at 1 November 20-5 \$3 100.
- On 31 October 20-6 Chandra's ledger accounts include the following:
 - Inventory was valued at \$3 900
 - Fixtures are to be depreciated by \$2 070
 - A provision for doubtful debts is to be created of \$250.

Chandra
Journal

Date	Details	Folio	Debit \$	Credit \$
20–6				
Sept 30	Irrecoverable debts		50	
	Ansari Stores			50
	Writing off irrecoverable debt			
Oct 31	Income statement		39 000	
	Purchases			39 000
	Transfer of purchases for the year to the income statement			
	Income statement		190	
	Irrecoverable debts			190
	Transfer of total irrecoverable debts to the income statement			
	Income statement		1 200	
	Insurance			1 200
	Transfer of insurance for the year to the income statement			
	Income statement		3 100	
	Inventory			3 100
	Transfer of opening inventory to the income statement			
	Inventory		3 900	
	Income statement			3 900
	Transfer of closing inventory to the income statement			
	Income statement		2 070	
	Provision for depreciation of fixtures			2 070
	Annual depreciation charge transferred to the income statement			
	Income statement		250	
	Provision for doubtful debts			250
	Creation of provision for doubtful debts			



LINK

You learned about irrecoverable debts and provisions for doubtful debts in Chapter 13.



LINK

You learned about depreciation of non-current assets in Chapter 12.



LINK

You learned about other payables and other receivables in Chapter 11.

TEST YOURSELF 15.2

- 1** Prepare a journal entry to record **each** of the following transactions:
 - a** Goods costing \$200 taken by the business owner for personal use.
 - b** Drawings, \$5 000, transferred from drawings account to capital account.
 - c** The profit for the year, \$15 000, transferred from the income statement to the capital account.

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

15.5 Correction of errors

Errors made in the recording of the day-to-day transactions can be divided into those which are not revealed by the trial balance and those which result in the trial balance not balancing.

Errors which are not shown by a trial balance

There are six types of error which can be made which will not be revealed by the trial balance. These are:

- Error of commission
- Error or complete reversal
- Error of omission
- Error of original entry
- Error of principle
- Compensating errors

When such errors are discovered, they should be corrected by means of a journal entry before making entries in the appropriate ledger accounts.

Walkthrough 15.6

Chandra's financial year ends on 31 October.

The totals of the trial balance prepared on 31 October 20–7 agreed, but the following errors were later discovered.

- a** The purchase of stationery, \$30, had been debited to the purchases account.
- b** A cheque, \$500, received from K Singh had been credited to the account of H Singh.
- c** The wages account had been under-cast by \$100 and the purchases account had been overcast by \$100.

Prepare the necessary journal entries to correct these errors.

**LINK**

You learned about these errors in Chapter 3.

**TIP**

It is often helpful to prepare working notes in the form of ledger accounts before attempting more complex journal entries such as those to correct errors.

Chandra Journal					
Date	Details	Folio	Debit \$	Credit \$	
20-7					
a	Oct 31 Stationery		30		
	Purchases			30	
	Error in posting stationery to purchases now corrected				
b	H Singh		500		
	K Singh			500	
	Error in posting cheque to wrong personal account now corrected				
c	Wages		100		
	Purchases			100	
	Wages under-cast and purchases over-cast, now corrected				

Errors which affect a trial balance

Some errors may occur that result in the totals of the trial balance not balancing.

If the errors are not found immediately, the trial balance is balanced by inserting the difference between the two sides in a **suspense account**. This is regarded as a temporary account in which the difference on the trial balance is held until the errors are discovered.



TIP

A suspense account ensures the balancing of the trial balance and allows draft financial statements to be prepared. It also allows errors to be corrected by using double entry and ensures that all errors are found.

As the errors are found, they are corrected by means of a journal entry. The appropriate entries are then made in the ledger accounts. When all the errors have been found and corrected, the suspense account will close automatically.



TIP

If all the errors affecting the balancing of a trial balance are discovered and corrected, the suspense account will automatically close. A balance remaining on a suspense account indicates that there are still some errors in the accounting records.



KEY TERM

A **suspense account** is a temporary account opened in order to make the totals of a trial balance agree.



LINK

You learned about the types of errors which result in the totals of a trial balance not balancing in Chapter 3.

Walkthrough 15.7

Chandra's financial year ends on 31 October.

The totals of the trial balance prepared on 31 October 20–8 failed to agree. The difference of \$260 was a shortage on the debit side. This was entered in a suspense account.

The following errors were later discovered:

- a** The purchases account had been over-cast by \$110.
- b** No entry had been made for office expenses, \$20, paid in cash.
- c** Credit sales, \$630, to Anil had been correctly entered in the sales account but debited as \$360 in Anil's account.
- d** Capital introduced by Chandra, \$5 000 (paid into the bank), has been debited to the capital account and credited to the bank account.
- e** A cheque, \$200, received from a debtor, Yuvraj, has been correctly entered in the bank account, but no other entry has been made.
- f** Sales returns, \$150, have been correctly entered in the credit customer's account but have been credited to the purchases returns account.

Prepare the necessary journal entries to correct these errors.

Write up the suspense account in Chandra's ledger.

Chandra Journal				
Date	Details	Folio	Debit \$	Credit \$
20–8				
a	Oct 31 Suspense		110	
	Purchases			110
	Purchases over-cast, now corrected			
b	Office expenses		20	
	Cash			20
	Omission of cash paid for office expenses, now corrected			
c	Anil		270	
	Suspense			270
	Sales, \$630, incorrectly entered in Anil's account as \$360, now corrected			
d	Bank		10 000	
	Capital			10 000
	Capital introduced debited to capital and credited to bank, now corrected			

e	Suspense	200	
	Yuvraj		200
	Cheque received from Yuvraj entered only in the bank, now corrected		
f	Sales returns	150	
	Purchases returns	150	
	Suspense		300
	Sales returns incorrectly credited to purchases returns, now corrected		

Chandra Nominal ledger Suspense account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Oct 31	Difference on trial balance		260	Oct 31	Anil		270
	Purchases		110		Sales returns		150
	Yuvraj		<u>200</u>		Purchases returns		<u>150</u>
			<u>570</u>				<u>570</u>

- An entry was required in the suspense account to correct errors **a**, **c**, **e** and **f** as all these affected the balancing of the trial balance.
- No entry was required in the suspense account to correct errors **b** and **d** as these did not affect the balancing of the trial balance.
- Error **f** required two accounts to be debited – the sales returns and the purchases returns – with the corresponding credits in the suspense account in order to correct the error.
- Where an entry has been reversed (as in error **d**) it is necessary to double the amount of the error in order to correct it and to restore the accounts to the correct amount.

TEST YOURSELF 15.3

- 1 Explain when it is necessary to open a suspense account.
- 2 It is found that machinery repairs have been debited to the machinery account. Explain:
 - a the type of error that has been made
 - b whether a correcting entry is required in the suspense account, giving a reason.

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

15.6 Effect on profit of correcting errors

If errors are discovered after the income statement has been prepared, it may be necessary to amend the profit figure. Any corrections made to items appearing in the trading section of the income statement will affect both the gross profit and the profit for the year. Any corrections made to items appearing in the profit and loss section of the income statement will affect the profit for the year.

Walkthrough 15.8

Chandra's financial year ends on 31 October.

The totals of the trial balance prepared on 31 October 20–8 failed to agree. The difference was entered in a suspense account and draft financial statements were prepared. The profit for the year was \$15 000.

The following errors were later discovered:

- a** The purchases account had been over-cast by \$110.
- b** No entry had been made for office expenses, \$20, paid in cash.
- c** Credit sales, \$630, to Anil had been correctly entered in the sales account but debited as \$360 in Anil's account.
- d** Capital introduced by Chandra, \$5 000 (paid into the bank), has been debited to the capital account and credited to the bank account.
- e** A cheque, \$200, received from a credit customer, Yuvraj, has been correctly entered in the bank account, but no other entry has been made.
- f** Sales returns, \$150, have been correctly entered in the credit customer's account but have been credited to the purchases returns account.

Prepare a statement to show the corrected profit for the year ended 31 October 20–8.

Chandra		
Statement of corrected profit for the year ended 31 October 20–8		
	\$	\$
Profit for the year from income statement		15 000
Add Purchases over-cast		110
		<u>15 110</u>
Less Office expenses omitted	20	
Sales returns understated	150	
Purchases returns overstated	150	320
Corrected profit for the year		<u>14 790</u>

- Errors **c**, **d** and **e** do not affect the calculation of the profit.
- If the purchases are over-cast, the profit will be understated and therefore \$110 must be added.
- If expenses have been omitted, the profit will be overstated and therefore \$20 must be deducted.

- If the sales returns have been understated, the profit will be overstated and so \$150 must be deducted.
- If the purchases returns have been overstated, the profit will also be overstated and therefore \$150 must be deducted.

15.7 Effect on statement of financial position of correcting errors

If errors are discovered and corrected after the preparation of financial statements, the statement of financial position may have to be amended. If the profit for the year has been corrected this will affect the capital section of the statement, but other items may also need to be amended.

Walkthrough 15.9

Chandra's financial year ends on 31 October.

The totals of the trial balance prepared on 31 October 20–8 failed to agree. The difference was entered in a suspense account and draft financial statements were prepared.

The following errors were later discovered:

- a** The purchases account had been over-cast by \$110.
- b** No entry had been made for office expenses, \$20, paid in cash.
- c** Credit sales, \$630, to Anil had been correctly entered in the sales account but debited as \$360 in Anil's account.
- d** Capital introduced by Chandra, \$5 000 (paid into the bank), has been debited to the capital account and credited to the bank account.
- e** A cheque, \$200, received from a credit customer, Yuvraj, has been correctly entered in the bank account, but no other entry has been made.
- f** Sales returns, \$150, have been correctly entered in the credit customer's account but have been credited to the purchases returns account.

The corrected profit for the year ended 31 October 20–8 was \$14 790.

Explain how correcting **each** of these errors will affect the statement of financial position at 31 October 20–8.

Errors **a**, **b**, and **f** do not affect items within the statement of financial position directly, but are used in the calculation of the corrected profit for the year. The profit which is added to the capital in the statement will need to be amended to the correct figure of \$14 790.

To correct error **c** the figure for trade receivables in the current assets section of the statement will have to be increased by \$270.

To correct error **d** the capital figure will have to be increased by \$10 000. The figure for bank in the current assets section of the statement will also have to be increased by \$10 000.

To correct error **e** the figure for trade receivables in the current assets section of the statement will have to be reduced by \$200.

TEST YOURSELF 15.4

No entries have been made for goods, \$500, sold on credit to Mitali.

- 1** State the type of error made.
- 2** State what correcting entries are required.
- 3** State the effects on the profit for the year after correcting this error.

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

Revision checklist

- A journal can be regarded as a diary in which transactions are noted before they are entered in the ledger.
- A narrative is a brief explanation of what is being recorded in the journal entry and why the entry is being made.
- Journal entries are made to open the accounting records, to record the purchase and sale of non-current assets, to record non-regular transactions, and to correct errors.
- A suspense account is opened if a trial balance fails to balance. This means that the draft financial statements can be prepared.
- Errors affecting the balancing of the trial balance are corrected by making an entry in the suspense account.

Exam-style questions

- 1** Shayni's financial year ends on 31 May. She maintains a provision for doubtful debts at 4% of the trade receivables at the end of each financial year. On 1 June 20–2 Shayni's provision was \$480. On 31 May 20–3 her trade receivables amounted to \$10 800.

Which journal entry would Shayni make on 31 May 20–3?

	Debit \$	Credit \$
A Income statement Provision for doubtful debts	48	48
B Income statement Provision for doubtful debts	432	432
C Provision for doubtful debts Income statement	48	48
D Provision for doubtful debts Income statement	432	432

- 2** Shaheel's financial year ends on 31 March. On 1 April 20–7 he purchased furniture costing \$4 400 for use in the office. He decided to depreciate the furniture using the reducing balance method at 15% per annum.

Which journal entry did Shaheel make on 31 March 20–9?

	Debit \$	Credit \$
A Income statement Provision for depreciation of furniture	561	561
B Income statement Provision for depreciation of furniture	660	660
C Provision for depreciation of furniture Furniture	99	99
D Provision for depreciation of furniture Depreciation of furniture	1 221	1 221

- 3** Jenny owns a retail store. Her financial year ends on 31 July. On 31 July 20–1:
- Jenny purchased stationery, \$112, on credit from AB Supplies
 - Jenny took goods, costing \$130, for personal use
 - Jenny depreciated her shop fittings by \$180.

- a** Prepare journal entries to record these items. Narratives are required.

On 31 July 20–1 the balances in Jenny’s ledger included the following:

	\$
Rent	3 120
Sales	95 600
Purchases returns	1 720

One quarter of the rent relates to Jenny’s apartment above the shop.

- b** Prepare journal entries to adjust the rent and to record the year-end transfers to the income statement for the three accounts. Narratives are required.
- 4** Lindelwa discovered that goods sold on credit to Zack, \$260, had been incorrectly credited to Zachary’s account.

Which journal entry corrects this error?

		Debit \$	Credit \$
A	Suspense	520	
	Zachary		260
	Zack		260
B	Zachary	260	
	Zack	260	
	Suspense		520
C	Zachary	260	
	Zack		260
D	Zack	260	
	Zachary		260

- 5** At the end of his financial year on 31 July 20–4, Silas opened a suspense account with a credit balance of \$70.

- a** Suggest one reason why this account was required.

After preparing draft financial statements Silas discovered the following errors:

- The purchases returns journal was overcast by \$100.
- Carriage inwards, \$195, had been debited to the carriage outwards account.
- The total of the analysis column for travelling expenses in the petty cash book, \$42, had not been transferred to the ledger.
- \$420 paid to Amina, a credit supplier, had been debited to the account of Amira, another credit supplier.
- The balance of the petty cash book, \$150, had not been entered in the trial balance.
- The total of the discount received column in the cash book, \$181, has been debited to the discount allowed account in the ledger.

- b Prepare the suspense account. Balance or total the account as necessary.
- c Prepare journal entries to correct the errors. Narratives are not required.
- 6 Alberto is a clothing wholesaler. His draft profit for the year ended 30 September 20–3 was \$24 920. He then discovered the following errors:
- 1 One page of the sales journal had been overcast by \$1 000.
 - 2 Drawings by Alberto from the business bank account, \$900, had been recorded as capital introduced.
 - 3 No entry had been made for office expenses paid in cash, \$40.
 - 4 No entry had been made for the sale of a motor vehicle. This had originally cost \$22 500 and had been depreciated by \$10 980. A cheque was received for \$12 000.
 - 5 No entry had been made for cash discount, \$50, received from Ted, a credit supplier.
 - 6 \$1 450 paid to Kaleem, a credit supplier, had been debited to the account of Kalid, another credit supplier.

Complete the statement of corrected profit for the year ended 30 September 20–3. Where an error does not affect the profit write 'no effect'.

Alberto			
Statement of corrected profit for the year ended 30 September 20–3			
			\$
Draft profit for the year			-----
	Effect on profit		
	Increase	Decrease	
	\$	\$	
Error 1	-----	-----	
Error 2	-----	-----	
Error 3	-----	-----	
Error 4	-----	-----	
Error 5	-----	-----	
Error 6	=====	=====	
	-----	-----	-----
Corrected profit for the year			=====

Chapter 16

Control accounts

Learning objectives

In this chapter you will learn to:

- understand the purposes of purchases ledger and sales ledger control accounts 3.4
- identify the books of prime entry as sources of information for the control account entries 3.4
- prepare purchases ledger and sales ledger control accounts to include credit purchases and sales, receipts and payments, cash discounts, returns, irrecoverable debts, dishonoured cheques, interest on overdue accounts, contra entries, refunds, opening and closing balances (debit and credit within each account). 3.4

16.1 Introduction

Control accounts are also known as **total accounts**. If the trial balance fails to balance and the error cannot be readily located, it is necessary to check all the accounting records. This can take a considerable amount of time. The checking process can be speeded up if a control account for the sales ledger (which contains the accounts of the debtors) and a control account for the purchases ledger (which contains the accounts of the creditors) have been prepared. These accounts act as a check on the individual accounts within these ledgers.

Like the trial balance, however, these accounts can only check the arithmetical accuracy: errors such as omission and commission will not be revealed by a control account.

16.2 Advantages of control accounts

Where a full set of accounting records is maintained, it is usual to prepare a **sales ledger control account** and a **purchases ledger control account**. The advantages of preparing these accounts are as follows:

- 1 They can assist in locating errors when the trial balance fails to balance.
- 2 They are proof of the arithmetical accuracy of the ledgers they control.
- 3 The balances on these accounts are regarded as being equal to the total of the trade receivables and the total of the trade payables, so this information is available immediately.
- 4 Draft financial statements can be prepared quickly because of the balances provided by the control accounts.
- 5 They help to reduce fraud as the control accounts are prepared by someone who has not been involved in making the entries in those particular ledgers.
- 6 They provide a summary of the transactions affecting the trade receivables and trade payables for each financial period.

TEST YOURSELF 16.1

- 1 Name the account which summarises all the sales ledger accounts.
- 2 Name the account which summarises all the purchases ledger accounts.
- 3 State **three** reasons for preparing control accounts.

16.3 Sales ledger control account

This is also referred to as a **total trade receivables account**. This account resembles the account of a credit customer, but instead of containing transactions concerned with just one person or business it contains transactions relating to *all* the debtors. A typical sales ledger control account is shown here.



LINK

You learned about the division of the ledger in Chapter 4.



LINK

You learned about the errors not revealed by a trial balance in Chapter 3.



KEY TERMS

A **sales ledger control account** is an account summarising all the accounts of the trade receivables and a **purchases ledger control account** is an account summarising all the accounts of the trade payables.

Nominal ledger							
Sales ledger control account							
Date	Details	Folio	\$	Date	Details	Folio	\$
	Balance	b/d			Sales returns		
	Sales				Cash		
	Bank				Bank		
	(dishonoured cheque)				Discount allowed		
	Bank/Cash (refunds)				Irrecoverable debts		
	Interest charged		_____		Balance	c/d	_____
	Balance	b/d	_____				_____

As this account acts as a check on the individual credit customers' accounts, it should be prepared independently and information in the individual accounts of the credit customers must **not** be used. (An error in the sales ledger would not be revealed if the control account is prepared from the accounts in that ledger.) **The information to prepare a sales ledger control account is obtained from the books of prime entry.** The sources of information are summarised as follows:

Item	Source of information
Sales	Sales journal
Sales returns	Sales returns journal
Receipts from credit customers	Cash book
Discounts allowed to credit customers	Cash book
Dishonoured cheques	Cash book
Refunds to credit customers	Cash book
Irrecoverable debts written off	Journal
Interest charged on overdue accounts	Journal

The sales ledger control account is drawn up at the end of the financial period (often monthly) and balanced. The total of the balances on all the individual credit customers' accounts should agree with the balance on the control account. If they differ, it indicates that there is an error in one of the customers' accounts or an error in the control account, so further checks are required.

**TIP**

A sales ledger account is a summary of the accounts of credit customers (trade receivables) so will not include items which do not appear in the account of a credit customer, such as cash sales and provision for doubtful debts.

Walkthrough 16.1

Shweta maintains a full set of accounting records and prepares control accounts at the end of each month.

She provided the following information:

		\$	
20-8	March 1	Sales ledger control account balance	1 200 debit
	March 31	Totals for the month:	
		Sales journal	4 890
		Sales returns journal	250
		Cheques and bank transfers received from credit customers	3 892
		Discount allowed to credit customers	8
		Cash received from credit customers	120
		Cash refunds to credit customers	19
		Cheque received (included in the above figure) later dishonoured	80
		Irrecoverable debts written off	94

Prepare Shweta's sales ledger control account for the month of March 20-8.

Shweta Nominal ledger Sales ledger control account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-8				20-8			
Mar 1	Balance	b/d	1 200	Mar 31	Sales returns		250
31	Sales		4 890		Cash		120
	Bank (dishonoured cheque)		80		Bank		3 892
	Cash (refunds)		19		Discount allowed		8
					Irrecoverable debts		94
					Balance	c/d	<u>1 825</u>
			<u>6 189</u>				<u>6 189</u>
20-8							
Apr 1	Balance	b/d	1 825				

16.4 Purchases ledger control account

This is also known as a **total trade payables account**. This account resembles the account of a credit supplier, but instead of containing transactions concerned with just one person or business it contains transactions relating to **all** the creditors. A typical purchases ledger control account is shown here.

Nominal ledger							
Purchases ledger control account							
Date	Details	Folio	\$	Date	Details	Folio	\$
	Purchases returns				Balance	b/d	
	Cash				Purchases		
	Bank				Interest charged		
	Discount received				Bank/Cash (refunds)		
	Balance	c/d	_____				_____
			_____		Balance	b/d	_____

This account serves a similar purpose to the sales ledger control account. It acts as a check on the individual credit suppliers' accounts and must be prepared independently and **not** from information in the individual accounts of the credit suppliers. **The information to prepare a purchases ledger control account is obtained from the books of prime entry.** The sources of information are summarised as follows:

Item	Source of information
Purchases	Purchases journal
Purchases returns	Purchases returns journal
Payments to credit suppliers	Cash book
Discounts received from credit suppliers	Cash book
Refunds from credit suppliers	Cash book
Interest charged on overdue accounts	Journal

Like the sales ledger control account, the purchases ledger control account is drawn up at the end of the financial period (often monthly) and balanced. The total of the balances on all the individual credit suppliers' accounts should agree with the balance on the control account. If they differ it indicates that there is an error in one of the suppliers' accounts or the control account, so further checks are required.



TIP

A purchases ledger account is a summary of the accounts of credit suppliers (trade payables) so will not include items which do not appear in the account of a credit supplier such as cash purchases.



TIP

The accounts in the sales and purchases ledgers are not used to provide information for preparing a control account otherwise errors in the ledgers would not be revealed.

Walkthrough 16.2

Shweta maintains a full set of accounting records and prepares control accounts at the end of each month.

She provided the following information:

			\$
20–8	March 1	Purchases ledger control account balance	1 880 credit
	March 31	Totals for the month:	
		Purchases journal	4 230
		Purchases returns journal	180
		Cheques and bank transfers paid to credit suppliers	3 900
		Discount received from credit suppliers	104
		Cheque refunds from credit suppliers	100
		Interest charged on overdue account	12

Prepare Shweta's purchases ledger control account for the month of March 20–8.

Shweta							
Nominal ledger							
Purchases ledger control account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Mar 31	Purchases returns		180	Mar 1	Balance		1 880
	Bank		3 900	31	Purchases		4 230
	Discount received		104		Bank (refunds)		100
	Balance	c/d	<u>2 038</u>		Interest charged		<u>12</u>
			<u>6 222</u>				<u>6 222</u>
				20–8			
				Apr 1	Balance	b/d	2 038

**LINK**

You will learn about the use of total accounts for calculating missing information in Chapter 17.

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

TEST YOURSELF 16.2

- 1** Explain why the information used for preparing control accounts must be obtained from books of prime entry.
- 2** State the source of information for **each** of the following:
 - a** purchases returns
 - b** discount allowed
 - c** irrecoverable debts.

16.5 Balances on both sides of a control account

Occasionally a credit customer's account may show a credit balance. This may occur due to:

- an overpayment by the customer
- the customer returning goods after paying the account
- the customer paying in advance for the goods
- cash discount not being deducted before payment was made.

In the sales ledger control account it is usual to keep any credit balance separate from the debit balance. The control account will, therefore, have two balances – the usual debit balance representing money owing **by** credit customers, and the more unusual credit balance representing money owing **to** credit customers. Any credit balance is entered on the debit side of the control account and carried down as a credit balance. The account can then be balanced in the usual way.

Walkthrough 16.3

Shweta maintains a full set of accounting records and prepares control accounts at the end of each month.

She provided the following information:

			\$
20–8	April 1	Sales ledger control account balance	1825 debit
	April 30	Totals for the month:	
		Sales journal	4910
		Sales returns journal	210
		Cheques and bank transfers received from credit customers	4788
		Discount allowed to credit customers	12
		Interest charged on overdue account	10
	May 1	Sales ledger credit balances	115

Prepare Shweta's sales ledger control account for the month of April 20–8.

Shweta							
Nominal ledger							
Sales ledger control account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
Apl 1	Balance	b/d	1825	Apl 30	Sales returns		210
30	Sales		4910		Bank		4788
	Interest charged		10		Discount allowed		12
	Balance	c/d	<u>115</u>		Balance	c/d	<u>1850</u>
			<u>6860</u>				<u>6860</u>
20–8				20–8			
May 1	Balance	b/d	1850	May 1	Balance	b/d	115

In a similar way, a credit supplier's account can show a debit balance. This may occur due to:

- an overpayment to the supplier
- returning goods to the supplier after paying the account
- paying the supplier in advance for the goods
- cash discount not being deducted before payment was made.

As in the sales ledger control account, the debit balance and the credit balance are shown separately in the purchases ledger control account. The purchases ledger control account will, therefore, have two balances – the usual credit balance representing money owing **to** credit suppliers, and the more unusual debit balance representing money owing **by** credit suppliers. Any debit balance is entered on the credit side of the control account and carried down as a debit balance. The account can then be balanced in the usual way.

TEST YOURSELF 16.3

- 1 Explain how it is possible for a customer's account to have a credit balance.

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

16.6 Contra entries in control accounts

Contra entries are also known as **inter-ledger transfers** or **set-offs**.

It may happen that a business sells goods to another business and also buys different goods from that business. This means that there will be two ledger accounts for that business – one in the sales ledger and the other in the purchases ledger.

Rather than each business sending the other a cheque to cover the amount due, they may agree to set one account off against the other. Any remaining amount will be settled by one business issuing a cheque.



KEY TERM

Contra entries may be referred to as inter-ledger transfers or set-offs and are when a transfer is made from an account in the sales ledger to an account of the same business/person in the purchases ledger.

Walkthrough 16.4

Shweta provided the following information:

20–8

- May 15 Sold goods, \$190, on credit to Mansingh Road Stores
- 22 Bought goods, \$320, on credit from Mansingh Road Stores
- 30 The balances of the two accounts for Mansingh Road Stores were set-off and Shweta sent a cheque for the remaining balance.

Record these transactions in the account for Mansingh Road Stores in the sales ledger and the account for Mansingh Road Stores in the purchases ledger.

Shweta							
Sales ledger							
Mansingh Road Stores account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
May 15	Sales		190	May 30	Purchases ledger		190
			<u>190</u>				<u>190</u>

**TIP**

A contra entry, sometimes known as an inter-ledger transfer or set-off, is recorded in both the sales ledger control account and the purchases ledger control account.

Purchases ledger
Mansingh Road Stores account

Date	Details	Folio	\$	Date	Details	Folio	\$
20–8				20–8			
May 30	Sales ledger		190	May 22	Purchases		320
	Bank		<u>130</u>				<u>320</u>
			<u>320</u>				<u>320</u>

- A journal entry would be made for the transfer of \$190 on 30 May as it is a non-regular transaction.
- As the transfer of \$190 on 30 May affected both the accounts in sales ledger and purchases ledger, it would affect both the sales ledger control account and the purchases ledger control account. See Walkthrough 16.5.

Walkthrough 16.5

Shweta provided the following information for the month of May 20–8.

	\$
20–8	
May 1	
Sales ledger control account debit balance	1 850
Sales ledger control account credit balance	115
Purchases ledger control account credit balance	2 118
31	
Totals for the month:	
Sales journal	5 360
Purchases journal	5 110
Sales returns journal	134
Purchases returns journal	216
Cheques and bank transfers received from credit customers	4 965
Cheques and bank transfers paid to credit suppliers	4 508
Discount received from credit suppliers	92
Irrecoverable debt written off	35
Interest charged by credit supplier on overdue account	14
Contra entry	190
June 1	
Sales ledger control account debit balance	?
Purchases ledger control account credit balance	?
Purchases ledger control account debit balance	135

Prepare Shweta's sales ledger control account and purchases ledger control account for the month of May 20–8. Balance the accounts and bring down the balances on 1 June 20–8.

Shweta Nominal ledger Sales ledger control account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-8				20-8			
May 1	Balance	b/d	1 850	May 1	Balance	b/d	115
	31 Sales		5 360	31	Sales returns		134
					Bank		4 965
					Irrecoverable debt		35
					Contra entry		190
					Balance	c/d	1 771
			<u>7 210</u>				<u>7 210</u>
20-8							
June 1	Balance	b/d	1 771				

Shweta Nominal ledger Purchases ledger control account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-8				20-8			
May 1	Purchases returns		216	May 1	Balance	b/d	2 118
	Bank		4 508	31	Purchases		5 110
	Discount received		92		Interest charged		14
	Contra entry		190		Balance	c/d	135
	Balance	c/d	<u>2 371</u>				
			<u>7 377</u>				<u>7 377</u>
20-8				20-8			
June 1	Balance	b/d	135	June 1	Balance	b/d	2 371

TEST YOURSELF 16.4

- In connection with control accounts, explain the meaning of a contra entry.

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

Revision checklist

- The main purpose of control accounts is to assist in locating errors in the sales ledger and the purchases ledger.
- A sales ledger control account resembles the account of a credit customer but contains transactions affecting all credit customers.
- A purchases ledger control account resembles the account of a credit supplier but contains transactions affecting all credit suppliers.
- The information to prepare control accounts is obtained from the books of prime entry.
- It is possible to have a balance on each side of a control account.
- If a business is both a customer and a supplier, a contra entry may be made to transfer a balance from the sales ledger account to the purchases ledger account.

Exam-style questions

- 1 What is the purpose of preparing a sales ledger control account?
 - A to calculate the total credit sales for the period
 - B to calculate the total sales for the period
 - C to check the arithmetical accuracy of the sales account
 - D to check the arithmetical accuracy of the sales ledger accounts

- 2 What may appear on the debit side of a purchases ledger control account?
 - A credit purchases
 - B discount allowed
 - C payments to credit suppliers
 - D returns by credit customers

- 3 Shilpa's sales ledger control account had an opening credit balance. What does this mean?
 - A total amount owing by credit customers
 - B goods returned by credit customers
 - C interest charged on credit customers' accounts
 - D overpayment made by credit customers

- 4 Hamir is a trader who maintains full set of accounting records. He divides his ledger into three sections – nominal (general), sales and purchases.
 - a State **one** advantage of dividing the ledger into these sections.
 - b State **two** advantages of maintaining a purchases ledger control account.

Hamir provided the following information for the month of May 20–1:

		\$
May 1	Debit balances in purchases ledger	105
	Credit balances in purchases ledger	4 897
May 31	Totals for the month:	
	Credit purchases	5 424
	Purchases returns	657
	Payments to suppliers	4 312
	Discount received	88
	Interest charged by credit supplier	20
June 1	Debit balances in purchases ledger	76

- c Prepare the purchases ledger control account for the month of May 20–1. Balance the account and bring down the balances on 1 June 20–1.
- d Name the book of prime entry Hamir would use to provide information about:
 - i interest charged by credit supplier
 - ii purchases returns
 - iii discount received.

- 5 a** Complete the following table to state where the items would appear in a purchases ledger control account. For each item name the book of prime entry from which the information would be obtained.

		Entry in purchases ledger control account		Source of information
		Debit	Credit	
i	payments to credit suppliers			
ii	cheques paid to credit suppliers later dishonoured			
iii	credit purchases			
iv	contra entry to sales ledger account			
v	discount received			
vi	interest charged by supplier on overdue account			
vii	returns to credit suppliers			

- b** Explain why the information required to prepare a purchases ledger control account is not obtained from the purchases ledger.
- c** Explain the contra entry to the sales ledger and why it was needed.

- 6** Eva is a trader who maintains a full set of accounting records and prepares control accounts at the end of each month. She provided the following information:

20–5		\$
February 1	Debit balance in the sales ledger control account	2470
	Credit balance in the sales ledger	110
	Provision for doubtful debts	100
February 28	Totals for the month:	
	Credit sales	3480
	Cash sales	1950
	Returns by credit customers	118
	Cheques received from credit customers	3403
	Cheque received from credit customer (included in the cheques received above) later dishonoured	104
	Discount allowed	144
	Discount received	176
	Irrecoverable debts written off	200
	Contra entry	240
March 1	Debit balance in the sales ledger control account	?
	Credit balance in the sales ledger control account	95

- a** Select the relevant figures and prepare the sales ledger control account for the month of May 20–1. Balance the account and bring down the balances on 1 June 20–1.
- b** For each entry (excluding the balances) in the sales ledger control account prepared in **a** name the book of prime entry which would be used as a source of information.
- c** Select **two** items listed that should not appear in a sales ledger control account and explain why they do not appear.
- d** Suggest **two** reasons for the credit balance on the sales ledger control account on 1 March 20–1.

Chapter 17

Incomplete records

Learning objectives

In this chapter you will learn to:

- explain the disadvantages of not maintaining a full set of accounting records 5.6
- prepare opening and closing statements of affairs 5.6
- calculate profit for the year from changes in capital over time 5.6
- calculate sales, purchases, gross profit, trade receivables and trade payables and other figures from incomplete information 5.6
- prepare income statements and statements of financial position from incomplete records 5.6
- make adjustments to financial statements 5.6.6
- apply the techniques of mark-up, margin and inventory turnover to arrive at missing figures. 5.6

17.1 Introduction

Sometimes businesses, small businesses in particular, do not maintain a full set of accounting records. This means that a trial balance cannot be drawn up and the financial statements cannot be prepared until a certain amount of preparatory calculations have been carried out. Much depends on the records and information available as to whether a full set of financial statements can be prepared.

17.2 Advantages of maintaining double entry records

Maintaining a full set of double entry record is important and provides many benefits. These include the following:

- 1 Full details are available about the assets, liabilities, revenues and expenses of the business.
- 2 The preparation of financial statements is relatively straightforward.
- 3 The calculation of the profit or loss for the year is likely to be reliable and accurate.
- 4 More informed decision-making is possible.
- 5 A greater degree of control over business activities can be exercised.
- 6 The possibility of fraud is reduced.
- 7 Comparisons with the results of previous years and with other businesses are possible.
- 8 Detailed records are available for reference purposes.
- 9 Information required by a bank or other lender is readily available.

17.3 Statement of affairs

If the only records available are those relating to the assets and liabilities of the business it is not possible to prepare an income statement. **These assets and liabilities are listed in a statement of affairs which is similar to a statement of financial position.**

When a list of assets and liabilities is prepared without the use of a set of double entry records it is known as a statement of affairs rather than a statement of financial position.

If the assets, liabilities and capital of the business are known and no further information is available, the only way in which the profit can be measured is to compare the change in the capital over the financial period. Capital increases when a profit is made and decreases when a loss is incurred. The basic formula for calculating profit is:

$$\text{Closing capital} - \text{Opening capital} = \text{Profit}$$

Part of the difference between the two capital figures may be caused by drawings made by the owner. If drawings have taken place during the period, the formula must be modified to:

$$\text{Closing capital} - \text{Opening capital} + \text{Drawings} = \text{Profit}$$

If additional capital has been introduced during the period, this will also account for some of the difference between the two capital figures. The formula must be modified to:

$$\text{Closing capital} - \text{Opening capital} + \text{Drawings} - \text{Capital introduced} = \text{Profit}$$

An alternative way to calculate profit is to construct a capital account and insert the missing figure of profit:



KEY TERM

A **statement of affairs** is a summary of the financial position of a business on a certain date. It is prepared instead of a statement of financial position when double entry records have not been maintained.



LINK

You learned how to prepare a statement of financial position in Chapter 9.

Capital account							
Date	Details	Folio	\$	Date	Details	Folio	\$
Year 1				Year 1			
Dec 31	Drawings		xxx	Jan 1	Balance	b/d	xxx
	Balance	c/d	xxx	Dec 31	Bank		xxx
			—		Profit		?
			—				xxx
Year 2				Year 2			
				Jan 1	Balance	b/d	xxx

- The dates of 1 January and 31 December have been used for convenience. The first and last days of the financial year of the particular business are used in practice.

Calculating profit by comparing the change in the capital is very unsatisfactory. Only an estimate of the profit for the year is possible: it is not possible to show details about gross profit, sales, purchases, expenses and so on. It is not possible to analyse the results and informed decisions about the future cannot be made.

TEST YOURSELF 17.1

- 1 Explain the meaning of a statement of affairs.
- 2 State the circumstances in which a statement of affairs is prepared.
- 3 State why it is not satisfactory to measure profit by changes in capital.



TIP

The difference between the opening and closing capital (adjusted for capital introduced and drawings during the year) represents the profit (or loss) for the year.

Walkthrough 17.1

Vijay is a sole trader. He has not kept a full set of double entry records, but is able to provide the following information about his assets and liabilities:

	1 May 20–8	30 April 20–9
	\$	\$
Premises at cost	30 000	30 000
Equipment at cost	9 000	9 000
Motor vehicle at cost	8 000	8 000
Inventory	14 000	16 000
Trade receivables	8 500	9 400
Trade payables	8 000	9 200
Bank	1 200	–
Bank overdraft	–	900
Other payables	–	100
Other receivables	120	130

During the year ended 30 April 20–9 Vijay purchased additional equipment for the business, costing \$7 000, out of his personal funds. This is in addition to the equipment listed. His cash drawings during the year amounted to \$5 000, and he also took goods costing \$3 000 for personal use.

On 30 April 20–9 it was decided that **all** the equipment should be depreciated by 10%, and the motor vehicle should be depreciated by 25%. It was also decided to create a provision for doubtful debts of 2% of the trade receivables.

- a** Prepare a statement of affairs of Vijay at 1 May 20–8.
- b** Prepare a statement of affairs of Vijay at 30 April 20–9.
- c** Calculate Vijay's profit for the year ended 30 April 20–9.

a

Vijay			
Statement of affairs at 31 May 20–8			
	\$	\$	\$
Non-current assets			Cost
Premises			30 000
Equipment			9 000
Motor vehicle			8 000
			<u>47 000</u>
Current assets			
Inventory			14 000
Trade receivables			8 500
Other receivables			120
Bank			1 200
			<u>23 820</u>
Total assets			<u>70 820</u>
Capital and liabilities			
Capital			
Balance			62 820
Current liabilities			
Trade payables			8 000
Total capital and liabilities			<u>70 820</u>

b

Vijay			
Statement of affairs at 30 April 20–9			
	\$ Cost	\$ Accumulated depreciation	\$ Net book value
Non-current assets			
Premises	30 000		30 000
Equipment	16 000	1 600	14 400
Motor vehicles	8 000	2 000	6 000
	<u>54 000</u>	<u>3 600</u>	<u>50 400</u>
Current assets			
Inventory			16 000
Trade receivables		9 400	
Less Provision for doubtful debts		<u>188</u>	9 212
Other receivables			130
			<u>25 342</u>
Total assets			<u>75 742</u>
Capital and liabilities			
Capital			
Balance			<u>65 542</u>
Current liabilities			
Trade payables			9 200
Other payables			100
Bank overdraft			900
			<u>10 200</u>
Total capital and liabilities			<u>75 742</u>

- In **a** and **b** the capital figure has been inserted to make the statement of affairs balance.

c

Vijay		
Calculation of profit for the year ended 30 April 20–9		
	\$	\$
Capital at 30 April 20–9		65 542
Less Capital at 1 May 20–8		<u>62 820</u>
		2 722
Add Drawings: cash	5 000	
goods	<u>3 000</u>	8 000
		10 722
Less Capital introduced		<u>7 000</u>
Profit for the year		<u>3 722</u>

c Alternative presentation

Vijay Capital account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-9				20-8			
Apr 30	Drawings		5 000	May 1	Balance		62 820
	Purchases		3 000	20-9			
	Balance	c/d	65 542	Apr 30	Equipment		7 000
					Profit		3 722
			<u>73 542</u>				<u>73 542</u>
				20-9			
				May 1	Balance	b/d	65 542

- The profit is inserted as a 'missing figure', in order to balance the account.

If no instructions are provided to the contrary, the profit calculation can be shown **within** the closing statement of affairs. In this case the profit for the year or the loss for the year will be inserted to make the statement of affairs balance.

Walkthrough 17.2

Vijay is a sole trader. He has not kept a full set of double entry records.

A statement of affairs on 1 May 20-8 was shown in **Walkthrough 17.1**.

Assume that the calculation of the profit is to be shown within the statement of affairs on 30 April 20-9. The first section of the statement of affairs on 30 April 20-9 would be as shown in **Walkthrough 17.1**. The capital section of the statement of affairs is shown as follows:

	\$	\$	\$
Capital			
Opening balance			62 820
Add Capital introduced			7 000
Profit for the year			<u>3 722</u>
			73 542
Less Drawings (5 000 + 3 000)			<u>8 000</u>
			<u>65 542</u>

TEST YOURSELF 17.2

- 1 Manan is a trader. The following information is provided:
 Capital 1 January 20–5 \$40 000, capital 31 December 20–6 \$50 000, profit for the year \$8 500, capital introduced during the year \$5 000.
 Calculate, by means of a capital account, Manan's drawings for the year.

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

Even when a business has not maintained the double entry records it is sometimes able to provide information in addition to details of the assets and liabilities. If details of money received and paid are available, it is possible to calculate the sales, purchases and expenses. This means that, after various calculations, a set of financial statements can be prepared.

Walkthrough 17.3

Anjali is a sole trader. She maintains a bank account, but not a full set of double entry records. She provided the following information:

	1 July 20–4 \$	30 June 20–5 \$
Premises at cost	60 000	60 000
Equipment (cost \$22 500)	18 000	?
Inventory	28 100	29 800
Trade receivables	23 800	26 800
Trade payables	19 700	20 200
Other payables (accrued general expenses)	200	–
Other receivables (prepaid general expenses)	–	340
Bank	12 700	?

Summary of receipts and payments for the year:

Receipts	\$	Payments	\$
Receipts from debtors	331 600	Payments to creditors	249 400
Cash sales	12 000	General expenses	19 620
		Drawings	38 400
		Wages	40 000
		Property tax	3 800
		Insurance	1 900
		Equipment	8 000

During the year ended 30 June 20–5 Anjali took goods costing \$4 000 for her own use.

On 30 June 20–5 equipment should be depreciated by 10% on the cost of equipment owned at that date. On that date, it was decided to create a provision for doubtful debts of $2\frac{1}{2}\%$ of the trade receivables.

Prepare the income statement of Anjali for the year ended 30 June 20–5 and a statement of financial position at 30 June 20–5.

Before attempting to answer a question of this nature it is necessary to calculate the following:

- 1 Opening capital
- 2 Revenue for the year
- 3 Purchases for the year
- 4 Closing bank balance

Calculations

1 Opening capital

Statement of affairs at 1 July 20–4			
	\$ Cost	\$ Accumulated depreciation	\$ Net book value
Non-current assets			
Premises	60 000		60 000
Equipment	22 500	4 500	18 000
	<u>82 500</u>	<u>4 500</u>	<u>78 000</u>
Current assets			
Inventory			28 100
Trade receivables			23 800
Bank			12 700
			<u>64 600</u>
Total assets			<u>142 600</u>
Capital and liabilities			
Capital			
Balance			122 700
Current liabilities			
Trade payables			19 700
Other payables			200
			<u>19 900</u>
Total capital and liabilities			<u>142 600</u>

2 Revenue for the year

i Credit sales

The amount received from the credit customers is not necessarily equal to the actual sales. Some of the money received is to settle the amount owed by credit customers at the start of the year (for goods sold in the previous financial year). Money is owed by the credit customers at the end of the year for goods sold during the present financial year.

The credit sales can be calculated as follows:

	\$
Receipts from credit customers	331 600
Less Trade receivables 1 July 20–4	<u>23 800</u>
	307 800
Plus Trade receivables 30 June 20–5	<u>26 800</u>
Credit sales for the year	<u>334 600</u>

Alternatively, the credit sales can be calculated by inserting a ‘missing figure’ in a total trade receivables account:

Total trade receivables account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–4				20–5			
Jul 1	Balance	b/d	23 800	Jun 30	Bank		331 600
20–5					Balance	c/d	26 800
Jun 30	Sales*		<u>334 600</u>				<u>358 400</u>
			<u>358 400</u>				<u>358 400</u>
20–5							
Jul 1	Balance	b/d	26 800				

ii Total revenue

	\$
Credit sales	334 600
Cash sales	<u>12 000</u>
Total revenue	<u>346 600</u>

3 Purchases for the year

i Credit purchases

The amount paid to the credit suppliers is not necessarily equal to the actual purchases. Some of the money paid is to settle the amount owed to credit suppliers at the start of the year (for goods bought in the previous financial year). Money is owed to the credit suppliers at the end of the year for goods bought during the present financial year.

The credit purchases can be calculated as follows:

	\$
Payments to credit suppliers	249 400
Less Trade payables 1 July 20–4	<u>19 700</u>
	229 700
Plus Trade payables 30 June 20–5	<u>20 200</u>
Credit purchases for the year	<u>249 900</u>

Alternatively, the credit purchases can be calculated by inserting a ‘missing figure’ in a total trade payables account:

Total trade payables account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–5				20–4			
Jun 30	Bank		249 400	Jul 1	Balance	b/d	19 700
	Balance	c/d	<u>20 200</u>	20–5			
			<u>269 600</u>	Jun 30	Purchases*		<u>249 900</u>
							<u>269 600</u>
				20–5			
				Jul 1	Balance	b/d	20 200

ii Total purchases

As there are no cash purchases the total purchases are equal to the credit purchases calculated.

4 Closing bank balance

The bank balance on 1 July 20–4 is given together with details of receipts and payments. A summary of the bank account can be prepared to calculate the closing bank balance. It is not usually necessary to itemise all the transactions.

Bank account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–4				20–5			
Jul 1	Balance	b/d	12 700	Jun 30	Total payments		361 120
20–5							
Jun 30	Total receipts		343 600				
	Balance	c/d	<u>4 820</u>				
			<u>361 120</u>				<u>361 120</u>
				20–5			
				Jul 1	Balance	b/d	4 820

Anjali			
Income statement for the year ended 30 June 20–4			
	\$	\$	\$
Revenue			346 600
Less Cost of sales			
Opening inventory		28 100	
Purchases	249 900		
Less Goods for own use	<u>4 000</u>	<u>245 900</u>	
		274 000	
Less Closing inventory		<u>29 800</u>	<u>244 200</u>
Gross profit			102 400
Less General expenses		19 080	
Wages		40 000	
Property tax		3 800	
Insurance		1 900	
Provision for doubtful debts		670	
Depreciation of equipment		<u>3 050</u>	<u>68 500</u>
Profit for the year			<u>33 900</u>

- The figures for revenue and purchases have come from previous calculations.
- The general expenses have been calculated \$19 620 – \$200 – \$340.
- The provision for doubtful debts has been calculated at $2\frac{1}{2}\%$ of \$26 800.
- The depreciation of equipment has been calculated at 10% of (\$22 500 + \$8 000).

**TIP**

Total accounts are prepared using the same principles as those used for control accounts which you learned about in Chapter 16.

Anjali			
Statement of financial position at 30 June 20–5			
	\$	\$	\$
	Cost	Accumulated depreciation	Net book value
Non-current assets			
Premises	60 000		60 000
Equipment	<u>30 500</u>	<u>7 550</u>	<u>22 950</u>
	<u>90 500</u>	<u>7 550</u>	<u>82 950</u>
Current assets			
Inventory			29 800
Trade receivables		26 800	
Less Provision for doubtful debts		<u>670</u>	26 130
Other receivables			<u>340</u>
			<u>56 270</u>
Total assets			<u>139 220</u>
Capital and liabilities			
Capital			
Opening balance			122 700
Plus Profit for the year			<u>33 900</u>
			156 600
Less Drawings			<u>42 400</u>
			<u>114 200</u>
Current liabilities			
Trade payables			20 200
Bank overdraft			<u>4 820</u>
			<u>25 020</u>
Total capital and liabilities			<u>139 220</u>

- The depreciation to date on equipment has been calculated $\$4\,500 + \$3\,050$.
- The figure for bank overdraft has come from a previous calculation.
- The drawings have been calculated $\$38\,400 + \$4\,000$.

TEST YOURSELF 17.3

- 1 A trader's financial year ends on 31 May. The following information is provided – Cash purchases \$4 000, cheques paid to creditors \$23 300, trade payables at 1 June 20–7 \$2 500, trade payables at 31 May 20–8 \$3 100. Calculate the purchases for the year.

When a business allows its credit customers a cash discount if the account is paid within the set time limit this will affect the calculation of the credit sales. Similarly, any discount received from credit suppliers will affect the calculation of the credit purchases.

**LINK**

You learned how to prepare a full set of financial statements with adjustments in Chapters 11, 12 and 13.

Walkthrough 17.4

Anjali is a sole trader. She maintains a bank account, but not a full set of double entry records. She provided the following information:

	1 July 20–4	30 June 20–5
	\$	\$
Trade receivables	23 800	26 800
Trade payables	19 700	20 200

During the year ended 30 June 20–5 receipts from credit customers totalled \$331 600 (after the deduction of \$8 200 cash discount). \$249 400 was paid to credit suppliers (after the deduction of \$6 780 cash discount).

Calculate the credit sales and credit purchases for the year ended 30 June 20–5.

Total trade receivables account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–4				20–5			
Jul 1	Balance	b/d	23 800	Jun 30	Bank		331 600
20–5					Discount allowed		8 200
Jun 30	Sales*		<u>342 800</u>		Balance	c/d	<u>26 800</u>
			<u>366 600</u>				<u>366 600</u>
20–5							
Jul 1	Balance	b/d	26 800				

**TIP**

Cash discount allowed and received must be included in calculations of credit sales and credit purchases. The discounts must also be recorded in the profit and loss section of the income statement.

Total trade payables account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–5				20–4			
Jun 30	Bank		249 400	Jul 1	Balance	b/d	19 700
	Discount received		6 780	20–5			
	Balance	c/d	<u>20 200</u>	Jun 30	Purchases*		<u>256 680</u>
			<u>276 380</u>				<u>276 380</u>
				20–5			
				July 1	Balance	b/d	20 200

- The amounts shown for sales and purchases would appear in the trading account section of the income statement.
- The amounts for discount allowed and discount received would appear in the profit and loss account section of the income statement.

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

17.5 Mark-up, margin and inventory turnover

When dealing with incomplete records, it is sometimes necessary to use percentages to calculate missing information.



KEY TERMS

Mark-up is the gross profit expressed as a percentage of cost price.

Margin is the gross profit expressed as a percentage of the selling price.

Mark-up and margin

These both measure the gross profit as a percentage.

The **mark-up** is the gross profit measured as a percentage of the cost price.

The **margin** is the gross profit measured as a percentage of selling price.

Walkthrough 17.5

A trader's turnover for the year were \$20 000 and the cost of goods sold was \$15 000.

Calculate:

- a the margin
- b the mark-up.

$$\text{a The margin } \frac{\text{Gross profit}}{\text{Sales}} \times \frac{100}{1} = \frac{\$5\,000}{\$20\,000} \times \frac{100}{1} = 25\%$$

$$\text{b The mark-up } \frac{\text{Gross profit}}{\text{Cost of sales}} \times \frac{100}{1} = \frac{\$5\,000}{\$15\,000} \times \frac{100}{1} = 33.33\%$$

Applying either margin or mark-up, it is possible to calculate any one unknown figure in the trading account section of an income statement.

Walkthrough 17.6

The financial year of North West Traders ends on 30 November. The following information is provided:

	\$
Inventory 1 December 20–3	4 600
Inventory 30 November 20–4	5 200
Revenue	72 000

The mark-up is at a standard rate of 25%.

Calculate, by means of a trading account section of an income statement, the purchases for the year ended 30 November 20–4.

North West Traders		
Income statement for the year ended 30 November 20–4		
	\$	\$
Revenue		72 000
Less Cost of sales		
Opening inventory	4 600	
Purchases	58 200 d	
	<u>62 800 c</u>	
Less Closing inventory	<u>5 200</u>	<u>57 600 b</u>
Gross profit		<u>14 400 a</u>

- An outline statement was prepared and the figures for revenue, opening inventory and closing inventory were inserted, with gaps left for purchases, cost of sales and gross profit.
- The gross profit was calculated. The mark-up is 25% so the gross profit is 25% of the cost of sales, so the selling price equals 125%. The gross profit is $\frac{25}{125}$ of the revenue which is $\frac{1}{5}$ or 20% of \$72 000. The gross profit is, therefore, \$14 400, **a**.
- The cost of sales was inserted as the difference between the revenue and the gross profit. Alternatively, it can be calculated at $\frac{100}{125}$ of the revenue which is $\frac{4}{5}$ or 80% of \$72 000. The cost of sales is, therefore, \$57 600, **b**.
- The purchases figure was calculated by working 'backwards' from the cost of sales. The cost of sales plus the opening inventory amounted to \$62 800, **c**. This figure less the opening inventory equals the purchases of \$58 200, **d**.

TEST YOURSELF 17.4

- 1 Explain the difference between margin and mark-up.
- 2 A trader purchased goods for \$4 000 and sold them for \$5 000. Calculate the percentage margin and the percentage mark-up.



LINK

You will learn about the importance of the rate of inventory turnover in Chapter 22.

Rate of inventory turnover

It is sometimes necessary to use calculations relating to the rate of inventory turnover in order to calculate an unknown figure in the trading account section of an income statement.

The **rate of inventory turnover** is the number of times a business replaces its inventory in a given period of time.

The formula for calculating the rate of inventory turnover is:

$$\frac{\text{Cost of sales}}{\text{Average inventory}}$$



KEY TERM

The **rate of inventory turnover** is the number of times a business replaces its inventory in a given period of time.

Walkthrough 17.7

M Parmar is a trader. The financial year ends on 31 October. The following information is provided:

Inventory 1 November 20–1 12 000

Inventory 31 October 20–2 8 000

The margin is at a standard rate of 20%.

The rate of inventory turnover is 15 times a year.

Calculate, by means of the trading account section of an income statement, the purchases for the year ended 31 October 20–2.

M Parmar			
Income statement for the year ended 31 October 20–2			
	\$	\$	
Revenue		187 500	e
Less Cost of sales			
Opening inventory	12 000		
Purchases	146 000		c
	<u>158 000</u>		b
Less Closing inventory	<u>8 000</u>	<u>150 000</u>	a
Gross profit		<u>37 500</u>	d

- An outline of the statement was prepared and the figures of opening inventory and closing inventory were inserted, with gaps left for revenue, purchases, cost of sales and gross profit.
- The average inventory was calculated.

$$\begin{aligned} \text{Average inventory} &= \frac{\text{Opening inventory} + \text{Closing inventory}}{2} \\ &= \frac{12\,000 + 8\,000}{2} = \$10\,000 \end{aligned}$$

- The cost of sales was calculated:

$$\begin{aligned} \text{Rate of inventory turnover} &= \frac{\text{Cost of sales}}{\text{Average inventory}} \\ &= \frac{\text{Cost of sales}}{10\,000} = 15 \end{aligned}$$

The cost of sales is, therefore \$150 000.

- The cost of sales was inserted in the statement, **a**.
- The purchases figure was calculated by working 'backwards' from the cost of sales, **b** and **c**.

- The gross profit was calculated. The margin is 20% so the gross profit is 20% of the revenue (sales). The selling price equals 100%, the gross profit equals 20%, so the cost of sales equals 80%. The gross profit is $\frac{20}{80}$ of the cost of sales which is $\frac{1}{4}$ or 25% of \$150 000. The gross profit is \$37 500, **d**.
- The revenue figure was calculated by working 'backwards'. The gross profit plus the cost of sales equals the sales (revenue), **e**.

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

Revision checklist

- A statement of affairs is similar to a statement of financial position and is prepared when a full set of accounting records is not maintained.
- Profit can be measured from the change in the capital over a period of time, taking into consideration drawings and capital introduced.
- The amount received from credit customers does not necessarily equal the credit sales: the amount paid to credit suppliers does not necessarily equal the credit purchases.
- When a record of money paid and received is available as well as the assets and liabilities, it is possible to prepare a set of financial statements after calculating revenue and purchases (and possibly the capital and the bank balances).
- Gross profit can be expressed as margin (on selling price) and as mark-up (on cost price).
- The rate of inventory turnover is the number of times a business replaces its inventory in a given period of time.

Exam-style questions

- 1** Halina's capital on 1 January 20–7 was \$25 900. On 31 December 20–7 her capital was \$27 600. During the year she had invested a further \$5 000 and had withdrawn goods costing \$900 for personal use. How much was the profit or loss for the year?

A \$2 400 loss **B** \$2 400 profit **C** \$5 800 loss **D** \$5 800 profit

- 2** Leroy is a trader. He does not maintain a full set of accounting records, but was able to provide the following information on 1 June 20–8:

	\$
Fixtures and fittings at valuation	6 000
Motor vehicle at cost	14 000
Inventory	3 800
Trade receivables	4 250
Trade payables	2 950
Long-term loan from Lenders Ltd	5 000
Other receivables	360
Bank overdraft	2 410

During the year ended 31 May 20–9 he borrowed a further \$3 500 from Lenders Ltd. He took \$2 000 from the bank for personal use.

On 31 May 20–9 it was decided that the motor vehicle should be depreciated by 20% on cost and that the fixtures and fittings should be valued at \$5 600.

On 31 May 20–9 the inventory was valued at \$4 100, the trade receivables totalled \$4 660, the trade payables totalled \$3 140 and there was \$380 in the bank.

- a** Prepare a statement of affairs of Leroy on 1 June 20–8 showing the total capital at that date.
- b** Prepare a statement of affairs of Leroy on 31 May 20–9 showing the total capital at that date.
- c** Prepare a capital account for Leroy for the year ended 31 May 20–9 showing the profit or loss for the year.
- 3** Sally's financial year ends on 31 October. On 1 November 20–4 her trade receivables owed \$5 840. During the year ended 31 October 20–5 she received \$66 640 from trade receivables, after allowing cash discount of \$1 360. Sales returns during the year totalled \$2 430. On 31 October 20–5 the trade receivables owed \$6 760.
- How much were the credit sales?

A \$65 490 **B** \$69 510 **C** \$69 990 **D** \$71 350

- 4 Mohan is a sole trader who does not maintain a full set of accounting records. He was able to provide the following information:

On 1 May 20–8:

	\$
Fixtures (cost \$31 000)	24 800
Motor vehicle (cost \$15 000)	9 000
Inventory	19 600
Trade receivables	17 300
Balance at bank	9 750
Trade payables	16 450

For the year ended 20 April 20–9:

	\$
Receipts – From trade receivables	458 800
Payments – To trade payables	371 820
For motor expenses	15 070
For general expenses	25 500
For new fixtures	4 000
For Mohan’s personal use	20 000

On 30 April 20–9:

	\$
Inventory	23 080
Trade receivables	21 500
Trade payables	15 510

Fixtures should be depreciated by 10% per annum on the cost of fixtures held at the end of the year. The motor vehicle should be depreciated by 25% per annum on cost.

- a** Prepare the income statement of Mohan for the year ended 30 April 20–9.
b Prepare the statement of financial position of Mohan at 30 April 20–9.
 Show all calculations.

- 5 Aisha applies a mark-up of 25% to obtain the selling price of her goods. She provided the following information:

	\$
Opening inventory	4 800
Closing inventory	6 200
Revenue	70 000

How much were Aisha’s purchases for the year?

- A** \$51 100 **B** \$53 900 **C** \$54 600 **D** \$57 400

6 Pradeep is a trader. He provided the following information:

	\$
Inventory at cost on 1 August 20–5	1 600
For the year ended 31 July 20–6:	
Purchases	39 200
Revenue	48 000

On the evening of 31 July 20–6 a fire destroyed a quantity of goods. The cost of the goods salvaged from the fire was \$700.

Pradeep marks up the goods by 25% on cost when calculating the selling price.

- a Calculate, by means of a trading account section of an income statement, the cost of the goods which were destroyed.
- b Explain the difference between mark-up and margin.
- c Calculate Pradeep's rate of inventory turnover. Use the total inventory before the fire on 31 July 20–6 when calculating the average inventory.
- d State what the answer to the calculation in c indicates.

Chapter 18

Accounts of clubs and societies

Learning objectives

In this chapter you will learn to:

- distinguish between receipts and payments accounts and income and expenditure accounts 5.4
- prepare receipts and payments accounts 5.4
- prepare accounts for revenue-generating activities, e.g. refreshments, subscriptions 5.4
- prepare income and expenditure accounts and statements of financial position 5.4
- make adjustments to financial statements 5.4
- define and calculate the accumulated fund. 5.4



KEY TERMS

A **non-trading organisation** is an organisation formed to provide facilities and services for members. They are not formed with the aim of making a profit.

Subscriptions are amounts members of an organisation pay, usually annually, to use the facilities provided by the club or society.

A **receipts and payments account** is a summary of the cash book which is prepared annually by a non-trading organisation.

18.1 Introduction

This chapter concentrates on the accounts of **non-trading organisations** such as clubs and societies. The main aim of these organisations is to provide some facilities and services for their members; making a profit is not the main objective. Examples of such organisations include youth clubs, sports clubs, amateur dramatic groups, golf clubs, scout groups, etc.

In some cases a full set of double entry records is written up each year, but it is more usual to find that only a record of money received and paid is maintained.

The main source of income of a society is **subscriptions**. These are the amounts members pay, usually annually, to use the facilities provided by the club or society.

A person is appointed to act as treasurer and be responsible for collecting any money due to the society and for paying money owed by the society. At the end of the financial year the treasurer will usually present financial statements to the members. These financial statements may consist of a **receipts and payments account**, possibly a **trading account section of an income statement**, an **income and expenditure account** and a **statement of financial position**.

18.2 Preparation of a receipts and payments account

A **receipts and payments account** is regarded as a **summary of the cash book** for the financial year. All money received is debited and all money paid is credited. The account is balanced and the balance carried down to become the opening balance for the following financial year. This account does not usually distinguish between cash and bank transactions, so the balance may represent actual cash, money in the bank or a combination of the two. A debit balance is an asset and represents money owned by the society whereas a credit balance is a liability and represents a bank overdraft.

A receipts and payments account, just like a cash book, records all money received and paid. It is important to remember that:

- no adjustments are made for accruals and prepayments
- no distinction is made between capital receipts and revenue receipts
- no distinction is made between capital expenditure and revenue expenditure
- non-monetary items such as depreciation are not included.

Walkthrough 18.1

The Apollo Athletics Club was formed some years ago to provide various sporting facilities for its members. The club also has a shop where members can purchase sportswear.

On 1 August 20–7 the club had \$2 200 in the bank. The treasurer provided the following list of receipts and payments for the year ended 31 July 20–8:

	\$
Subscriptions received	5 860
Receipts from shop sales	3 960
Purchases of goods for resale	2 130
Wages – shop assistant	1 300
athletics coach	2 700
Rates and insurance	328
General expenses	1 120
Purchase of new sports equipment	2 950
Athletics competition – entrance fees received	1 100
cost of prizes	660

All receipts are paid into the bank and all payments are made by cheque.

Prepare the receipts and payments account of the Apollo Athletics Club for the year ended 31 July 20–8.

Apollo Athletics Club						
Receipts and payments account for the year ended 31 July 20–8						
Receipts			\$	Payments		
			20–7	20–8		
Aug 1	Balance	b/d	2 200	Jul 31	Purchases	2 130
20–8					Wages	
					shop assistant	1 300
Jul 31	Subscriptions		5 860		athletics coach	2 700
	Receipts from shop		3 960		Rates and insurance	328
	Competition				General expenses	1 120
	entrance fees		1 100		Sports equipment	2 950
					Competition prizes	660
			<u>13 120</u>		Balance	c/d 1 932
						<u>13 120</u>
20–8						
Aug 1	Balance	b/d	1 932			

**TIP**

A receipts and payments account includes all money paid and received, ignoring the year to which it relates, and includes both capital and revenue items.

TEST YOURSELF 18.1

- 1 Name **three** financial statements that the treasurer of a club may prepare at the end of the financial year.
- 2 Explain the term 'subscriptions' in connection with a club or society.
- 3 Explain the purpose of a receipts and payments account.

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

18.3 Preparation of an income statement of a club or society

Although buying and selling is not the main purpose of a club or society, many do carry out a trading activity. Many clubs operate a shop or a café where goods are bought and sold. At the end of the financial year **an income statement (trading section only)** should be prepared for each separate trading activity to show the profit earned on that activity.

The trading section of an income statement of a club or society is prepared in exactly the same way as that for a business. Any expenses which arise as a result of running the trading activity such as wages of café assistants, depreciation of café equipment and so on, should be added to the cost of the goods sold in order to calculate the correct profit or loss.

The profit on a trading activity is calculated in the income statement and then transferred to the income and expenditure account (see later in this chapter).

Walkthrough 18.2

The Apollo Athletics Club was formed some years ago to provide various sporting facilities for its members. The club also has a shop where members can purchase sportswear.

The treasurer provided the following information for the year ended 31 July 20–8:

	\$
Receipts from shop sales	3 960
Purchases of goods for resale	2 130
Shop inventory 1 August 20–7	240
Shop inventory 31 July 20–8	310
Wages of shop assistant	1 300

Prepare the shop income statement of the Apollo Athletics Club for the year ended 31 July 20–8.

Apollo Athletics Club		
Shop income statement for the year ended 31 July 20–8		
	\$	\$
Revenue		3 960
Less Cost of sales		
Opening inventory	240	
Purchases	2 130	
	<u>2 370</u>	
Less Closing inventory	310	
Cost of goods sold	<u>2 060</u>	
Wages of shop assistant	1 300	3 360
Profit on shop (transferred to income and expenditure account)		<u>600</u>



TIP

Where an income statement is prepared for a particular activity, the profit or loss on that activity must be transferred from the income statement to the income and expenditure account.

TEST YOURSELF 18.2

- 1 Explain when it is necessary for a club or society to prepare a trading section of an income statement as part of the financial statements.

18.4 Preparation of an income and expenditure account

An **income and expenditure account** compares the gains of the club with the expenses of running the club. If the gains are more than the expenses the difference is referred to as a **surplus** or **excess of income over expenditure** (this is known as the profit for the year in a business). If the gains are less than the expenses the difference is referred to as a **deficit** or **excess of expenditure over income** (this is known as the loss for the year in a business).

An income and expenditure account is prepared using the same principles as those applied in the preparation of an income statement of a trading business.

It is important to remember that:

- adjustments must be made for accruals and prepayments
- capital receipts and capital expenditure are not included
- only revenue receipts and revenue expenditure are included
- non-monetary items such as depreciation are included
- assets and liabilities at the beginning and end of the financial year are not included.

Where the club or society holds a fundraising activity, the income and the expenses of that activity should be set off against each other in the income and expenditure account. In this way, the profit or loss on that particular activity can be calculated.

Walkthrough 18.3

The Apollo Athletics Club was formed some years ago to provide various sporting facilities for its members. The club also has a shop where members can purchase sportswear.

The following receipts and payments account was prepared for the year ended 31 July 20–8:

**KEY TERMS**

An **income and expenditure account** is prepared annually by a non-trading organisation. It compares the gains and the expenses to calculate the surplus or deficit.

A **surplus** arises when the gains of a non-trading organisation exceed the expenses.

A **deficit** arises when the expenses of a non-trading organisation exceed the gains.

**LINK**

You learned how to prepare an income statement of a business in Chapters 8, 11 and 12.

Apollo Athletics Club							
Receipts and payments account for the year ended 31 July 20–8							
Receipts			\$	Payments			\$
20–7				20–8			
Aug 1	Balance	b/d	2 200	Jul 31	Purchases		2 130
20–8					Wages		
					shop assistant		1 300
Jul 31	Subscriptions		5 860		athletics coach		2 700
	Receipts from shop		3 960		Rates and insurance		328
	Competition				General expenses		1 120
	entrance fees		1 100		Sports equipment		2 950
					Competition prizes		660
					Balance	c/d	1 932
			<u>13 120</u>				<u>13 120</u>
20–8							
Aug 1	Balance	b/d	1 932				

The treasurer also provided the following additional information:

1 On 31 July 20–8:

- insurance prepaid amounts to \$16
- wages of athletics coach, outstanding amount of \$400
- 15 members still owe their annual subscription of \$20 each for the current financial year
- eight members have paid their annual subscription of \$20 each for the following financial year
- sports equipment is to be depreciated by \$1 715.

2 The profit on the club's shop for the year ended 31 July 20–8 was \$600 (calculated in the shop income statement).

Prepare the income and expenditure account of the Apollo Athletics Club for the year ended 31 July 20–8.

Apollo Athletics Club
Income and expenditure account for the year ended 31 July 20–8

	\$	\$
Income		
Subscriptions (5 860 + 300 – 160)		6 000
Profit on shop		600
Competition – entrance fees	1 100	
cost of prizes	660	440
	<u> </u>	<u> </u>
		7 040
Expenditure		
Wages – athletics coach (2 700 + 400)	3 100	
Rates and insurance (328 – 16)	312	
General expenses	1 120	
Depreciation of equipment	1 715	6 247
	<u> </u>	<u> </u>
Surplus for the year		<u> 793 </u>

TEST YOURSELF 18.3

- State the equivalent term used by a business for **each** of the following terms used by a club:
 - deficit
 - income and expenditure account.
- Explain why a club should set off the expenses of any fund-raising activity against the income from that activity.

267

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

18.5 Preparation of a statement of financial position of a club or society

The principles applied when preparing a statement of financial position of a club or society are similar to those applied in the preparation of a statement of financial position of a business. The statement of financial position of a club or society shows non-current assets, current assets, non-current liabilities and current liabilities in exactly the same way as a statement of financial position of a trading organisation.

The main difference is that there is **no capital in the statement of financial position of a club or society** whereas a business is usually financed by an investment of capital from the owner(s). Members of a club or society do not invest money in the same way as the proprietor of a business. Because of this, the members are not entitled to make any drawings if a club or society makes a surplus. This means that these surpluses will accumulate within the organisation to form a capital fund known as the **accumulated fund**. If the club makes a deficit then the accumulated fund will decrease. This **accumulated fund replaces capital in the statement of financial position of a club or society**.

**LINK**

You learned how to prepare a statement of financial position of a business in Chapters 9, 11 and 12.

**KEY TERM**

The **accumulated fund** consists of the surpluses (less any deficits) which have accumulated over the life of the organisation. It replaces capital in the statement of financial position of a club or society.

Walkthrough 18.4

The Apollo Athletics Club was formed some years ago to provide various sporting facilities for its members. The club also has a shop where members can purchase sportswear.

On 1 August 20–7 the following balances appeared in the books of the club:

	\$
Premises at cost	20 000
Equipment at cost	14 200
Provision for depreciation of equipment	5 680
Balance at bank	2 200
Shop inventory	240
Accumulated fund	30 960

The income and expenditure account for the year ended 31 July 20–8 showed a surplus of \$793.

During the year ended 31 July 20–8 new equipment costing \$2 950 was purchased. The depreciation on equipment for the year amounted to \$1 715.

On 31 July 20–8:

	\$
Balance at bank	1 932
Shop inventory	310
Insurance prepaid	16
Wages of athletics coach outstanding	400
Subscriptions owing by members	300
Subscriptions paid in advance by members	160

Prepare the statement of financial position of the Apollo Athletics Club at 31 July 20–8.

Apollo Athletics Club			
Statement of financial position at 31 July 20–8			
	\$ Cost	\$ Accumulated depreciation	\$ Net book value
Non-current assets			
Premises	20 000	–	20 000
Equipment	<u>17 150</u>	<u>7 395</u>	<u>9 755</u>
	<u>37 150</u>	<u>7 395</u>	<u>29 755</u>
Current assets			
Shop inventory		310	
Subscriptions accrued		300	
Other receivables		16	
Bank		<u>1 932</u>	
			<u>2 558</u>
Total assets			<u>32 313</u>
Accumulated fund and liabilities			
Accumulated fund			
Opening balance			30 960
Plus Surplus for the year			<u>793</u>
			<u>31 753</u>
Current liabilities			
Other payables			400
Subscriptions prepaid			<u>160</u>
			<u>560</u>
Total liabilities			<u>32 313</u>

- The subscriptions owing could have been included under other receivables and the subscriptions prepaid could have been included under the other payables. In this case a note to the statement of financial position would show the breakdown of these figures.

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

18.6 Comparison of accounting terms used by a business and those used by a club or society

Business	Club or society
–	Receipts and payments account
Profit and loss account section of income statement	Income and expenditure account
Profit for the year	Surplus
Loss for the year	Deficit
Capital	Accumulated fund

TEST YOURSELF 18.4

- 1 State the term used by a business to describe the equivalent of the accumulated fund in a club.
- 2 Explain how **each** of the following will affect the accumulated fund of a club.
 - a surplus
 - b deficit

18.7 Subscriptions

The receipts and payments account shows the amount of subscriptions **received** during the financial year, but the income and expenditure account shows the amount of subscriptions **relating** to the financial year. This means that the amount received must be adjusted for any subscriptions owed by members and any subscriptions paid in advance by members (see **Walkthrough 18.3**). The calculation of the amount relating to the financial year may be shown in the form of a ledger account known as a **subscriptions account**.

This may be regarded as the account of the members in the books of the organisation. Subscriptions owing by members will appear as a debit balance as they are a current asset to the club or society. Subscriptions paid in advance by members will appear as a credit balance as they are a current liability because the club or society has an obligation to provide a period of membership which has already been paid for. It is possible to have two balances on a subscriptions account as the account is for **all** the members and some may have paid subscriptions in advance and some may not have paid their subscription.

At the end of the financial year the account is closed by a transfer to the income and expenditure account of the amount relating to that financial year.

Walkthrough 18.5

The Apollo Athletics Club was formed some years ago to provide various sporting facilities for its members.

On 1 August 20–7 there were no subscriptions owing by members and no members had paid their subscriptions in advance.

During the year ended 31 July 20–8 the club received subscriptions totalling \$5 860 from members. This included subscriptions of \$20 each from eight members for the following financial year. On 31 July 20–8 subscriptions of \$20 each for the current financial year were still outstanding from 15 members.

During the year ended 31 July 20–9 the club received subscriptions from members totalling \$6 020. On 31 July 20–9 there were subscriptions outstanding of \$120.

Prepare the subscriptions account in the books of the Apollo Athletics Club for **each** of the **two** years ended 31 July 20–8 and 31 July 20–9.

**TIP**

Subscriptions owing by members are a debit balance on the subscriptions account and a current asset in the statement of financial position. Subscriptions prepaid by members are a credit balance on the subscriptions account and a current liability in the statement of financial position.

Apollo Athletics Club Subscriptions account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-8				20-8			
July 31	Balance	c/d	160	July 31	Bank/cash		5860
	Income & expenditure		<u>6000</u>		Balance	c/d	<u>300</u>
			<u>6160</u>				<u>6160</u>
20-8				20-8			
Aug 1	Balance	b/d	300	Aug 1	Balance	b/d	160
20-9				20-9			
July 31	Income & expenditure		<u>6000</u>	July 31	Bank/cash		6020
			<u>6300</u>		Balance	c/d	<u>120</u>
							<u>6300</u>
20-9							
Aug 1	Balance	b/d	120				

A club may have a policy that subscriptions which remain unpaid after a certain period of time are written off. The entries are similar to those made when a business writes off an irrecoverable debt. The subscriptions account is credited with the amount written off before the subscriptions for the year are transferred to the income and expenditure account. These irrecoverable debts will be included in the expenses in the income and expenditure account.

TEST YOURSELF 18.5

- 1 Explain why the amount received from members appears on the credit of a subscriptions account.
- 2 Explain why subscriptions prepaid by members are a current liability of a club.
- 3 Explain why the amount shown for subscriptions in a receipts and payments account is not necessarily the same as that shown in an income and expenditure account.

18.8 Calculation of sales and purchases

As the accounts of a club or society are often incomplete it is often necessary to calculate credit purchases (and sometimes credit sales if goods are sold on credit) before the preparation of the income statement.

The same principles applied when calculating these figures for a business which has not got a complete set of accounting records are followed.



LINK

You learned how to calculate purchases and sales for businesses which do not have complete accounting records in Chapter 17.

Walkthrough 18.6

The Apollo Athletics Club has a shop where members can purchase sportswear. All the sales are made for cash and all purchases are made on credit terms.

The treasurer provided the following information:

	\$
Trade payables 1 August 20–5	155
Trade payables 31 July 20–6	215
Amount paid to credit suppliers during the year ended 31 July 20–6	2980

Calculate the purchases for the year ended 31 July 20–6.

Apollo Athletics Club							
Total trade payables account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20–6				20–5			
July 31	Bank		2980	Aug 1	Balance	b/d	155
	Balance	c/d	215	20–6			
			<u>3 195</u>	July 31	Purchases		<u>3 040*</u>
							<u>3 195</u>
				20–6			
				Aug 1	Balance	b/d	215

* This represents the purchases for the year and will appear in the shop income statement.

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

18.9 Calculation of accumulated fund

It is sometimes necessary to calculate the accumulated fund of a club or society. This can be calculated by applying the same formula used to calculate the capital of a business.

$$\begin{array}{l} \text{In a business} \quad \text{Assets} = \text{Capital} + \text{Liabilities} \\ \text{In a club or society} \quad \text{Assets} = \text{Accumulated fund} + \text{Liabilities} \end{array}$$

Walkthrough 18.7

On 1 August 20–6 the assets and liabilities of the Apollo Athletics Club were as follows:

	\$
Premises at cost	20 000
Equipment at cost	14 200
Provision for depreciation of equipment	4 260
Balance at bank	1 700
Shop inventory	285
Trade payables for shop supplies	215

Calculate the accumulated fund on 1 August 20–7.

Calculation of accumulated fund on 1 August 20–6

		\$	\$
Assets	Premises at cost		20 000
	Equipment at cost	14 200	
	Less Provision for depreciation	<u>4 260</u>	9 940
	Balance at bank		1 700
	Shop inventory		<u>285</u>
			<u>31 925</u>
Liabilities	Trade payables		<u>215</u>
Accumulated fund			<u>31 710</u>

TEST YOURSELF 18.6

- 1 Explain why the amount shown for purchases in the café income statement of a club is not necessarily equal to the amount paid to credit suppliers.
- 2 State the formula for calculating accumulated fund.

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

Revision checklist

- A club or society is often referred to as a non-trading organisation.
- At the end of the financial year a club will usually prepare a receipts and payments account which is a summary of the cash book.
- If a club carries out a trading activity it may be necessary to prepare a trading section of an income statement at the end of the financial year.
- At the end of the financial year a club will prepare an income and expenditure account which is similar to the profit and loss section of the income statement.
- The statement of financial position of a club is very similar to that of a business except that the capital is replaced by the accumulated fund.
- The main source of income for a club is the subscriptions received from its members for the use of the facilities provided by the club.

Exam-style questions

- 1 The treasurer of the YY Club provided the following information:

	\$
Bank balance 1 May 20–7	4 734 overdraft
Subscriptions received:	
for the year ended 30 April 20–7	1 200
for the year ended 30 April 20–8	12 000
for the year ending 30 April 20–9	800
Profit on sale of old sports equipment	
(book value \$520: proceeds of sale \$580)	60
Cost of new sports equipment	3 100
Rent paid for 15 months to 31 July 20–8	3 000
Insurance	520
Loan from a member of the club	4 000
Running expenses	?
Bank balance 1 May 20–8	3 324 debit

Prepare a receipts and payments account for the year ended 30 April 20–8 showing the amount paid for running expenses during the year.

- 2 A club provided the following information:

	\$
Subscriptions outstanding at the start of year	250
Subscriptions received during the year	2 450
Subscriptions prepaid at the end of the year	200

How much was included for subscriptions in the income and expenditure account?

- A** \$2 000 **B** \$2 250 **C** \$2 400 **D** \$2 500

- 3 A sports club was formed on 1 January 20–4. During the year ended 31 December 20–4 the club purchased sports equipment by cheque.

In which of the financial statement would this be included?

	Receipts and payments account	Income and expenditure account	Statement of financial position
A	✓	✓	✓
B	✓	✓	
C	✓		✓
D		✓	✓

- 4** The WS Music Club was formed on 1 June 20–8. The following information was provided for the year ended 31 May 20–9:

		\$
Receipts	Subscriptions	12 100
	Tickets for concert	1 400
	Loan from AB Music Group	1 000
Payments	Rent of rehearsal rooms	5 000
	Insurance (15 months to 31 August 20–9)	600
	General expenses	1 720
	Concert expenses	990
	Musical instruments	3 000

Additional information:

- 1** The club has 240 members. The annual subscription is \$50. On 31 May 20–9 eight members had not paid their subscription and ten members had paid their subscription in advance for the following year.
 - 2** On 31 May 20–9 general expenses accrued amounted to \$30 and rent accrued amounted to \$200.
 - 3** A ten-year loan from the AB Music Group was received on 1 December 20–8. Interest is payable at 5% per annum.
 - 5** Musical instruments are to be depreciated at the rate of 10% per annum based on the cost of instruments owned at the end of the financial year.
 - a** Prepare the income and expenditure account for the year ended 31 May 20–9.
 - b** Prepare a statement of financial position at 31 May 20–9.
- 5** In addition to providing sports facilities for members, the HJ Club also has a shop selling sports clothing to members and guests. All purchases are made on credit terms and all sales are made for cash.

The following information is available:

	1 July 20–4	30 June 20–5
	\$	\$
Shop inventory	1 030	1 680
Subscriptions owing by members	200	–
Subscriptions prepaid by members	–	300
Rent payable accrued	–	450
Amounts owing to credit suppliers	920	870
Sports equipment at cost	18 200	?
Provision for depreciation of sports equipment	7 280	?
During the year ended 30 June 20–5:		
Receipts		
Subscriptions	15 500	
Receipts from shop sales	14 100	
Competition entrance fees	1 350	
Payments		
New sports equipment	2 000	
Credit suppliers to shop	8 520	
Rent	3 150	
Competition prizes	1 220	
Wages – shop assistant	4 500	
sports trainer	3 630	
General expenses	5 470	

The sports equipment is being depreciated at the rate of 20% per annum using the straight line method. A full year's depreciation is charged in the year of purchase.

- a** Prepare the shop income statement for the year ended 30 June 20–5.
- b** Prepare the income and expenditure account for the year ended 30 June 20–5.
- 6** On 1 January 20–4 the accumulated fund of a club amounted to \$14 240. The only item of income during the year was subscriptions of \$9 500. The expenses for the year included running costs of \$9 360 and depreciation of \$830. How much was the accumulated fund on 1 January 20–5?
- A** \$13 550 **B** \$14 100 **C** \$14 380 **D** \$14 930

Chapter 19

Partnerships

Learning objectives

In this chapter you will learn to:

- explain the advantages and disadvantages of forming a partnership 5.2
- outline the importance and contents of a partnership agreement 5.2
- explain the purpose of an appropriation account 5.2
- prepare income statements, appropriation accounts and statements of financial position 5.2
- record interest on partners' loans, interest on capital, interest on drawings, partners' salaries and the division of the balance of profit or loss 5.2
- make adjustments to financial statements 5.2
- explain the uses of, and differences between, capital and current accounts 5.2
- draw up partners' capital and current accounts in ledger account form and as part of a statement of financial position. 5.2

**KEY TERM**

A **partnership** is a business in which two or more people work together as owners with a view to making profits.

**LINK**

You learned about financial statements of sole traders in Chapters 8 and 9.

19.1 Introduction

The earlier chapters (except Chapter 18) related to businesses which were owned by only one person (a sole trader). Another very common form of business is a **partnership**. A **partnership is a business in which two or more people work together as owners with a view to making profits**. Normally, there cannot be more than 20 partners in a business.

Professional people such as accountants and solicitors often operate as partnerships. A large number of family businesses also run as partnerships. Sometimes a new business is formed as a partnership, sometimes a partnership is formed when a sole trader wishes to expand his/her business, sometimes a partnership is formed when two or more sole traders agree to amalgamate their businesses.

A partnership business will maintain double entry records in the same way as a sole trader. At the end of the financial year, an income statement and a statement of financial position are prepared. However, a partnership will prepare an extra account after the income statement. This is known as a **profit and loss appropriation account**.

19.2 The advantages and disadvantages of partnership businesses

Before agreeing to enter into a partnership business a person must consider the likely advantages and disadvantages of such an arrangement. The advantages and disadvantages are summarised as follows:

Advantages	Disadvantages
Additional finance is available.	Profits have to be shared among the partners.
Additional knowledge, experience and skills are available.	Decisions have to be recognised by all partners.
The responsibilities are shared.	Decisions may take longer to put into effect.
The risks are shared.	One partner's actions on behalf of the business are binding on all the partners.
Discussions can take place before decisions are taken.	Disagreements can occur.
	All partners are responsible for the debts of the business.

TEST YOURSELF 19.1

- 1 Define a partnership.
- 2 Rahul is a sole trader. He forms a partnership with Anuradha. State:
 - a two benefits this may have for Rahul
 - b two drawbacks this may have for Rahul.

**LINK**

You learned about the advantages and disadvantages of sole trader businesses in Chapter 8.

19.3 Partnership agreement

Although it is not legally necessary to draw up a **partnership agreement** when forming a partnership, it is advisable to do so. Drawing up an agreement can avoid misunderstandings and arguments later. The clauses of a partnership agreement cover many aspects of the business. Those relating to the accounting usually include the following:

Amount of capital invested by each partner	Partners do not need to invest equal amounts.
How profits and losses are to be shared	Profits and losses may be shared equally, in proportion to capital invested or in some other ratio.
If interest on partners' capital is to be paid, and if so, at what rate	This interest is a reward for investing in the business rather than elsewhere. If all partners invest the same amount it may not be necessary to pay interest. Where partners invest different amounts, interest can be a form of compensation to the person who has invested most capital.
If partners' salaries are to be paid, and if so, what amount	If all partners share the work and responsibilities equally it may be not necessary to pay salaries. A salary can be a form of compensation where one partner has a greater share of the work and responsibilities.
If an upper limit is to be placed on partners' drawings, and if so, what amount	The business will benefit if partners keep drawings as low as possible.
If interest on partners' drawings is to be charged, and if so, at what rate	This is a method of discouraging partners from making drawings from the business (especially early in the financial year). Interest on the amount withdrawn is calculated from the date of withdrawal until the end of the financial year.
If interest on partners' loans is to be paid, and if so, at what rate	If extra finance is required a partner may make a loan to the business. To compensate for the loss of interest they could otherwise earn, interest on the loan may be paid.



KEY TERM

A **partnership agreement** is a document setting out the rules under which the partners will operate the business, including profit-sharing arrangements.

19.4 Loans from partners

A partnership may borrow money from one of the partners if extra finance is required (particularly if it is needed for a fixed period of time). Loans from partners are **not** part of the capital of the business and are treated in the same way as any other loan. Unlike investing additional capital, money lent to a partnership business by a partner will be repaid at an agreed time. Interest on the loan is a business expense and is not affected by the amount of profit or loss.

**TIP**

Interest on a loan from a partner is an expense in the income statement; it is not an appropriation of profit.

When a loan is obtained from a partner

Debit bank account	Credit loan from partner X account
--------------------	------------------------------------

When a loan is repaid to a partner

Debit loan from partner X account	Credit bank account
-----------------------------------	---------------------

The loan account appears as a non-current liability in the statement of financial position

Interest on loan paid

Debit interest on loan account	Credit bank account
--------------------------------	---------------------

Interest on loan due but not paid

Debit interest on loan account	Credit partner X current account*
--------------------------------	-----------------------------------

The interest on loan account is transferred to the debit of the income statement

*See Section 19.6.

**KEY TERMS**

A partnership **appropriation account** is part of the year-end financial statements. It shows the division of the profit or loss between the partners.

The **residual profit** is the profit remaining after adjusting the profit for the year for interest on drawings, interest on capital and partners' salaries. It is divided between the partners in the agreed profit-sharing ratio.

19.5 Preparation of a profit and loss appropriation account of a partnership business

The profit and loss **appropriation account** for the financial year is prepared after the income statement and shows how the profit for the year is shared between the partners.

The profit for the year is transferred to this account from the income statement. Any interest on drawings charged to the partners increases the amount available to share and this must be added to the profit. The **appropriations** (profit shares) detailed in the partnership agreement for interest on capital and partners' salaries are deducted. The remaining figure is known as the **residual profit** and is shared between the partners in the agreed profit-sharing ratio.

Walkthrough 19.1

Sumit and Padma are in partnership. Their financial year ends on 31 May. They provide the following information:

		\$
Capital on 1 June 20–8	Sumit	40 000
	Padma	20 000
Drawings for the year ended 31 May 20–9	Sumit	11 000
	Padma	8 000
Profit for the year ended 31 May 20–9		24 680

The partnership agreement includes the following terms:

Interest on capital is allowed at 5% per annum

Interest on drawings is charged at 3% per annum

Padma is entitled to a partnership salary of \$9 500 per annum

Residual profits are shared in proportion to capital invested

Prepare the profit and loss appropriation account for the year ended 31 May 20–9.

Sumit and Padma			
Profit and loss appropriation account for the year ended 31 May 20–9			
		\$	\$
Profit for the year			24 680
Add Interest on drawings	Sumit	330	
	Padma	240	570
			<u>25 250</u>
Less Interest on capital	Sumit	2 000	
	Padma	1 000	3 000
Partner's salary	Padma	9 500	12 500
			<u>12 750</u>
Profit shares*	Sumit	8 500	
	Padma	4 250	<u>12 750</u>

*The profit shares are calculated.

$$\text{Sumit } \frac{40\,000}{60\,000} \times \frac{12\,750}{1} \quad \text{Padma } \frac{20\,000}{60\,000} \times \frac{12\,750}{1}$$

TEST YOURSELF 19.2

- 1 Explain why partners may agree to charge interest on drawings.
- 2 Explain why partners may agree to allow interest on capital.
- 3 Explain the term residual profit.

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

19.6 Partners' ledger accounts

Capital accounts

Similar to a sole trader each member of the partnership business has their own capital account in the nominal ledger. These usually record permanent increases or decreases in the capital invested by the individual partner. Capital accounts prepared in this way are referred to as **fixed capital accounts**.

A capital account has a credit balance as the business owes this to the partner.

Current accounts

Each member of a partnership business also has a current account. Anything which the partner becomes entitled to such as interest on capital, interest on loan, partner's salary and profit share is credited to this account. Anything which the partner is charged with, such as drawings and interest on drawings, is debited to this account.

**TIP**

Only permanent increases and decreases in capital are entered in a partner's capital account. Anything to which a partner becomes entitled, or is charged with, during the year is entered in the partner's current account.

A credit balance on a current account represents the amount owed to the partner and a debit balance represents the amount owed by the partner to the business. If a partner's drawings are more than his/her total share of profit, the current account will have a debit balance as the partner owes this to the business. If a partner's drawings are less than his/her total share of profit, the current account will have a credit balance as the business owes this to the partner.

If current accounts are not maintained, interest on capital, partners' salaries, profit share, drawings and interest on drawings are recorded in the capital account.

Drawings accounts

A drawings account is maintained for each partner. The total of this account is transferred to the partner's current account at the end of the financial year.

Walkthrough 19.2

Sumit and Padma are in partnership. Their financial year ends on 31 May. They provide the following information:

	Sumit \$	Padma \$
On 1 June 20–8:		
Capital account	40 000	20 000
Current account	130 cr	910 dr
For the year ended 31 May 20–9:		
Drawings	11 000	8 000
Interest on drawings	330	240
Interest on capital	2 000	1 000
Partner's salary		9 500
Profit share	8 500	4 250

Prepare the capital account and the current account of Sumit for the year ended 31 May 20–9.

Sumit and Padma							
Sumit capital account							
Date	Details	Folio	\$	Date	Details	Folio	\$
				20-8			
				Jun 1	Balance	b/d	40 000

Sumit current account							
Date	Details	Folio	\$	Date	Details	Folio	\$
20-9				20-8			
May 31	Drawings		11 000	Jun 1	Balance	b/d	130
	Interest on drawings		330	20-9			
				May 31	Interest on capital		2 000
					Profit share		8 500
					Balance	c/d	700
			<u>11 330</u>				<u>11 330</u>
20-9							
Jun 1	Balance	b/d	700				

**TIP**

Maintaining both a capital account and a current account for each partner means it is easy to see the amount invested and to calculate the interest on capital. The current account shows the profit retained and whether the drawings exceed the total profit share.

It saves time to show partners' capital accounts and current accounts side-by-side using a column for each partner.

Walkthrough 19.3

Using the information in **Walkthrough 19.2** prepare the capital and current accounts of Sumit and Padma for the year ended 31 May 20-9. Prepare the accounts in columnar format.

Sumit and Padma									
Capital accounts									
Date	Details	Sumit		Padma		Sumit		Padma	
		Fo	\$	\$		Fo	\$	\$	
					20-8				
					Jun 1	Balance	b/d	40 000	20 000

Current accounts									
		Sumit			Padma				
Date	Details	Fo	\$	\$	Date	Details	Fo	\$	\$
20–8					20–8				
Jun 1	Balance	b/d		910	Jun 1	Balance	b/d	130	
20–9					20–9				
May 31	Drawings		11 000	8 000	May 31	Interest on			
	Interest on					capital		2 000	1 000
	drawings		330	240		Salary			9 500
	Balance	c/d		5 600		Profit share		8 500	4 250
						Balance	c/d	700	
			<u>11 330</u>	<u>14 750</u>				<u>11 330</u>	<u>14 750</u>
20–9					20–9				
Jun 1	Balance	b/d	700		Jun 1	Balance	b/d		5 600

You can now answer Questions 3–5 at the end of this chapter.

TEST YOURSELF 19.3

- 1 A partner has a debit balance on her current account.
 - a Explain what may have caused this.
 - b Explain whether it represents money owed by the business to the partner or by the partner to the business.

19.7 Preparation of a statement of financial position of a partnership business

A statement of financial position of a partnership is same as that of a sole trader with the exception of the capital section. This must show that the capital account and current account balances for each partner separately.

It is not necessary to show all the details of the transactions affecting the current accounts. It is adequate to show the closing balance on each account.

Walkthrough 19.4

Sumit and Padma are in partnership. Their financial year ends on 31 May. Their current accounts are shown in **Walkthrough 19.3**.

Prepare a relevant extract from the statement of financial position of Sumit and Padma at 31 May 20–9.

Sumit and Padma			
Extract from statement of financial position at 31 May 20–9			
	Sumit	Padma	Total
	\$	\$	\$
Capital accounts	40 000	20 000	60 000
Current accounts	(700)*	5 600	4 900
	<u>39 300</u>	<u>25 600</u>	<u>64 900</u>

* The debit balance on Sumit's current account is shown as a minus, which reduces the amount owed by the business to Sumit.

Sometimes the partners may wish to show the full details of the current accounts in the statement of financial position.

Walkthrough 19.5

Sumit and Padma are in partnership. Their financial year ends on 31 May. Their current accounts are shown in **Walkthrough 19.3**.

Prepare a relevant extract from the statement of financial position of Sumit and Padma on 31 May 20–9 showing full details of their current accounts.

Sumit and Padma			
Extract from statement of financial position at 31 May 20–9			
	Sumit	Padma	Total
	\$	\$	\$
Capital accounts	<u>40 000</u>	<u>20 000</u>	60 000
Current accounts			
Opening balance	130	(910)	
Interest on capital	2 000	1 000	
Partner's salary		9 500	
Profit share	<u>8 500</u>	<u>4 250</u>	
	<u>10 630</u>	<u>13 840</u>	
Less Drawings	11 000	8 000	
Interest on drawings	<u>330</u>	<u>240</u>	
	<u>11 330</u>	<u>8 240</u>	
	<u>(700)</u>	<u>5 600</u>	4 900
			<u>64 900</u>

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

Revision checklist

- A partnership is a business in which two or more people work together as owners with a view to making profits.
- There are both advantages and disadvantages of being a member of a partnership business.
- It is advisable to draw up a partnership agreement when the partnership is formed.
- A partner may make a loan to the business. This is treated in a similar way to all other loans.
- A profit and loss appropriation account is prepared after the income statement to share out the profit between the partners.
- Each partner usually has a capital account and a current account.
- In the statement of financial position of a partnership the balances on each partner's capital account and current account must be shown separately.

Exam-style questions

1 Cindy is a sole trader. She is considering forming a partnership with Lora. What is a disadvantage of being a partner?

- A** additional capital is available **B** additional skills are available
C profits are shared **D** risks are shared

2 Which items may appear as deductions from the profit for the year in the appropriation account of a partnership?

	Drawings	Interest on capital	Interest on loan	Partner's salary
A	✓	✓		
B	✓	✓	✓	
C				✓
D			✓	✓

3 Hao and Quan are partners. Hao's capital is \$100 000 and Quan's is \$50 000. The partnership agreement provides for interest on capital at 3% per annum and an annual salary for Quan of \$6 000. Profits and losses are shared in proportion to capital invested.

The profit for the year ended 31 December 20–5 was \$18 900. How much was credited to Quan's current account on 31 December 20–5?

- A** \$6 300 **B** \$10 300 **C** \$11 700 **D** \$13 800

4 Diksha and Padmaja are in partnership. Their financial year ends on 31 July. Their partnership agreement provides for:

- interest on capital at 4% per annum
- an annual salary of \$4 000 for Padmaja
- interest on drawings at $2\frac{1}{2}\%$ per annum
- residual profits and losses to be shared in the ratio of 2:1.

The following information is available:

	Diksha \$	Padmaja \$
Capital account at 1 August 20–4	50 000	40 000
Current account at 1 August 20–4	4 200 (Cr)	200 (Dr)
Drawings during the year	3 000	5 000

The profit for the year ended 31 July 20–5 was \$11 240.

- a** Prepare the profit and loss appropriation account for the year ended 31 July 20–5.
- b** Write up Padmaja’s current account for the year ended 31 July 20–5. Balance the account and bring down the balance on 1 August 20–5.
- c** Suggest **two** reasons why partners maintain both a capital and a current account for each partner.
- 5** Beth and Kate are in partnership. Their financial year ends on 31 December. On 1 January 20–5 their capitals were: Beth \$90 000 and Kate \$70 000. The uncompleted current accounts for the year ended 31 December 20–5 were as follows.

		Beth	Kate			Beth	Kate
		\$	\$			\$	\$
20–5				20–5			
Jan 1	Balance	b/d	9 000	Jan 1	Balance	b/d	5 000
Dec 31	Drawings	16 000	8 000		Capital		10 000
	Interest on drawings	320	160	Dec 31	Salary	9 000	
	Share of loss	6 300	4 200		Interest on capital	4 500	3 000
					Interest on loan	200	

- a** Explain the entry on 1 January ‘Capital \$10 000’.
- b** Calculate the profit or loss for the year before appropriations.
- c** Calculate the percentage rate of interest on capital the partners received.
- d** Calculate the ratio in which the partners shared the loss.
- e** State the balance on each partner’s current account on 1 January 20–6, indicating whether each balance is debit or credit.
- f** Explain what a credit balance on a partner’s current account means.
- g** Explain how a debit balance on a partner’s current account may arise.
- h** Suggest one reason why Beth made a loan to the business instead of investing additional capital.

- 6** Manu and Zahur are in partnership. The total capital of the business is \$600 000, which was contributed by Manu and Zahur in the ratio of 2:1. Profits and losses are shared in the same ratio. Interest on capital is allowed at 5% per annum. Zahur is entitled to an annual salary of \$14 000.

The following information is available:

	\$
Current account 1 May 20–7	
Manu	9 000 credit
Zahur	1 000 debit
Drawings during the year ended 30 April 20–8	
Manu	30 000
Zahur	29 600
Profit for the year ended 30 April 20–8	59 000
At 30 April 20–8:	
Premises at cost	400 000
Plant and machinery at book value	190 000
Fixtures and fittings at book value	34 000
10% Loan from CFU Limited	25 000
Trade payables	37 450
Trade receivables	26 170
Other payables	320
Other receivables	450
Inventory	29 350
Bank	9 800 credit

- a** Prepare the profit and loss appropriation account for the year ended 30 April 20–8.
- b** Prepare the statement of financial position at 30 April 20–8 (showing the current accounts in full).

Chapter 20

Manufacturing accounts

Learning objectives

In this chapter you will learn to:

- distinguish between direct and indirect costs 5.5
- understand direct material, direct labour, prime cost and factory overheads 5.5
- understand and make adjustments for work in progress 5.5
- calculate factory cost of production 5.5
- prepare manufacturing accounts, income statements and statements of financial position 5.5
- make adjustments to financial statements 5.5

20.1 Introduction

The previous chapters (except Chapter 18) relate to businesses which are involved in trading (such as wholesale or retail businesses which buy goods and sell them without changing the goods in any way) or service businesses. There are, of course, manufacturing businesses which buy raw materials and convert these into finished products which they then sell.

A manufacturing business will maintain double entry records similar to those of retail and wholesale businesses. At the end of the financial year, in addition to an income statement (and possibly an appropriation account) and statement of financial position, a manufacturing business will also prepare a **manufacturing account**. The purpose of preparing this account is to calculate how much it has cost the business to manufacture the goods produced in the financial year.

20.2 The elements of cost

The cost of manufacture is made up of four main elements. These are outlined below.

Direct material

The first thing a manufacturer needs is raw material to make the finished goods. This raw material takes many forms depending on the type of business – a baker will need flour, a furniture maker will need wood, a car maker will need steel and so on.

Direct labour

The next essential cost for a manufacturer is the cost of the wages of the people who are employed in the factory making the goods. Depending on the type of business, these may be bakers, carpenters, machine operators and so on. This cost is sometimes referred to as **direct wages**.

The term direct labour includes only those people who are actually involved in the production of the finished goods. It does not include the wages of supervisors, maintenance staff, factory cleaners and so on. These people have an important role to play within the factory, but are regarded as indirect labour.

Direct expenses

These are any expenses which a manufacturer can directly link with the product being manufactured. It may be that for every item produced, a manufacturer has to pay a fee (known as a **royalty**) to the person who originally invented the product. A manufacturer may have to hire a special piece of equipment to complete the manufacturing process. Such expenses are regarded as direct expenses.

Factory overheads

These are sometimes referred to as **indirect factory expenses**. They include all the costs involved in operating the factory which cannot be directly linked with the product being manufactured. Expenses such as factory rent and rates, factory heat and light, factory machinery repairs, depreciation of factory machinery, indirect factory wages and so on are all regarded as factory overheads.



LINK

You learned about income statements and statements of financial position in Chapters 8 and 9.



KEY TERM

A **manufacturing account** is part of the annual financial statements and is used to calculate the cost of goods produced.

TEST YOURSELF 20.1

- 1 Explain the difference between direct factory wages and indirect factory wages.
- 2 Give **two** examples of direct expenses.
- 3 For **each** of the following state whether it is direct material, direct labour or a factory overhead of a clothing factory:
 - a electricity used in the factory
 - b purchase of suiting fabric
 - c wages of factory supervisors
 - d wages of sewing machinists
 - e purchase of spare parts for machine
 - f purchase of buttons and threads

20.3 Preparation of a manufacturing account

The cost of manufacturing the goods produced is calculated in the manufacturing account.

The first item in a manufacturing account is **direct material**. The cost of the raw material used during the year is calculated in a similar way to that in which a retailer calculates the cost of goods sold. The cost of raw material actually used during the year is calculated as:

- Opening inventory of raw material
- + Purchases of raw material
- + Carriage inwards on raw material
- Closing inventory of raw material

The cost of the **direct labour** is then added to the direct material. Any **direct expenses** are then added.

The total of these three elements of cost is known as the **prime cost**.

$$\text{Direct material} + \text{Direct labour} + \text{Direct expenses} = \text{Prime cost}$$

The total **cost of production** is found by adding the **factory overheads** to the prime cost.

$$\text{Prime cost} + \text{Factory overheads} = \text{Cost of production}$$



KEY TERMS

Prime cost is the total of the direct materials, direct labour and direct expenses. It is the cost of the essentials necessary for production.

Cost of production is prime cost plus factory overheads, adjusted for any work in progress at the start and at the end of the year. It is the total cost of manufacturing the goods completed.

Walkthrough 20.1

The following information was provided by the Kapoor Manufacturing Company on 30 April 20–6:

	\$
Raw materials – Inventory 1 May 20–5	14 900
Inventory 30 April 20–6	15 300
Purchases	181 200
Carriage on purchases	3 300
Factory wages – Direct	166 100
Indirect	93 800
Royalties	10 000
Factory insurance	2 070
Factory rent and rates	2 930
Factory general expenses	6 350
Depreciation of factory machinery	9 500

Prepare the manufacturing account of the Kapoor Manufacturing Company for the year ended 30 April 20–6.

Kapoor Manufacturing Company		
Manufacturing account for the year ended 30 April 20–6		
	\$	\$
Cost of material consumed		
Opening inventory of raw material	14 900	
Purchases of raw material	181 200	
Carriage on purchases	3 300	
	<u>199 400</u>	
Less Closing inventory of raw material	15 300	184 100
Direct wages		166 100
Direct expenses		
Royalties		<u>10 000</u>
Prime cost		360 200
Factory overheads		
Indirect wages	93 800	
Insurance	2 070	
Rent and rates	2 930	
General expenses	6 350	
Depreciation of machinery	9 500	
	<u>114 650</u>	114 650
Cost of production		<u>474 850</u>

**TIP**

It is important to remember that revenue does not appear in a manufacturing account. Only costs relevant to the manufacture of goods are included.

**TIP**

The factory overheads must be added to the prime cost.

TEST YOURSELF 20.2

- 1 Explain the term prime cost.
- 2 State an alternative term for factory overheads.

20.4 Work in progress



KEY TERM

Work in progress

is the goods which are partly completed at the end of the financial year.

Goods which are partly completed at the end of the financial year are known as **work in progress**. The work in progress is excluded from the cost of production as these goods cannot be sold until they are completed. They do have some value however, as it has cost something to get them to their present condition – some material has been used and some direct wages have been incurred and so on. It is therefore necessary to place a value on the work in progress.

The partly-made goods at the end of the financial year are known as **closing work in progress**. These goods will, of course, become the **opening work in progress** at the start of the following financial year.

In a manufacturing account, it is necessary to adjust the cost of production so that it represents only the cost of goods actually completed in the year. This adjustment is done in the same way as for any other type of inventory – the opening inventory is added and the closing inventory is deducted.

Walkthrough 20.2

The following information was provided by the Kapoor Manufacturing Company on 30 April 20–6.

	\$
Prime cost	360 200
Factory overheads	114 650
Work in progress – Inventory 1 May 20–5	8 790
Inventory 30 April 20–6	8 640

Prepare the manufacturing account of the Kapoor Manufacturing Company for the year ended 30 April 20–6.

Kapoor Manufacturing Company		
Manufacturing account for the year ended 30 April 20–6		
	\$	\$
Prime cost*		360 200
Factory overheads*		114 650
		474 850
Add Opening work in progress		8 790
		483 640
Less Closing work in progress		8 640
Cost of production		475 000

* Full details would be shown as in Walkthrough 20.1.

TEST YOURSELF 20.3

- 1 Explain the term 'work in progress'.
- 2 State why it is necessary to adjust the cost of production for work in progress.

20.5 Calculation of unit cost

Where a manufacturer makes only one type of identical product, the cost of making one article can be found by dividing the cost of goods completed by the number of articles manufactured.

Walkthrough 20.3

The Kapoor Manufacturing Company makes one type of identical product. The cost of production during the year ended 30 April 20–6 was \$475 000, and a total of 20 000 articles were completed.

Calculate the unit cost.

$$\text{Unit cost} = \frac{\text{Cost of production}}{\text{Number of units produced}} = \frac{\$475\,000}{20\,000} = \$23.75$$

20.6 Preparation of a trading section of an income statement of a manufacturing business

The gross profit of a manufacturing business is calculated in the trading section of the income statement. This is very similar to that prepared by a wholesale or retail business. The main difference is that because the business actually makes the goods it sells, the item for purchases is replaced by the production cost of goods completed. Sometimes, however, a manufacturing business may purchase some finished goods which it does not manufacture itself. This may occur:

- when production does not meet demand
- when it is cheaper to buy the goods rather than make them
- when those particular items cannot be made by the business.

Purchases of finished goods are added to the production cost of goods completed in the income statement.

In the trading section of the income statement the proceeds from the sale of finished goods is compared with the cost of those finished goods. This means that the inventories included are the inventories of finished goods held by the manufacturer at the start and end of the financial year.

Walkthrough 20.4

The following information was provided by the Kapoor Manufacturing Company on 30 April 20–6:

	\$
Cost of production*	475 000
Revenue	661 500
Finished goods – Inventory 1 May 20–5	31 000
Inventory 30 April 20–6	23 250
Purchases	15 500

*Calculated in the manufacturing account.

Prepare the trading section of the income statement of the Kapoor Manufacturing Company for the year ended 30 April 20–6.

Kapoor Manufacturing Company		
Income statement for the year ended 30 April 20–6		
	\$	\$
Revenue		661 500
Less Cost of sales		
Opening inventory of finished goods	31 000	
Cost of production	475 000	
Purchases of finished goods	15 500	
	521 500	
Less Closing inventory of finished goods	23 250	498 250
Gross profit		163 250

TEST YOURSELF 20.4

- 1** Explain why the cost of production of goods completed appears in a trading section of the income statement of a manufacturing business.
- 2** Explain why a manufacturer may sometimes purchase finished goods from another manufacturer.

20.7 Preparation of a profit and loss section of an income statement of a manufacturing business

The profit for the year of a manufacturing business is calculated in the profit and loss section of the income statement. This is very similar to that prepared by a wholesale or retail business. Expenses relating to the manufacturing process have already been entered in the manufacturing account, so only administration expenses, selling and distribution expenses, and financial expenses will appear in the profit and loss section of the income statement.

Where an expense relates to the whole of the business it may be necessary to share this out between the factory and the offices. Expenses such as insurance of buildings, rent and rates, and heat and light often have to be apportioned in this way. For example, the insurance of the buildings may be apportioned $\frac{2}{3}$ to the factory and $\frac{1}{3}$ to the offices. This means that if the total cost of insurance was \$900 an amount of \$600 would be included in the manufacturing account and \$300 in the profit and loss section of the income statement.

20.8 Preparation of a statement of financial position of a manufacturing business

The statement of financial position of a manufacturing business is similar to that prepared by a wholesale or retail business. There is only one main difference which is that a manufacturer may have three different inventories – raw material, work in progress and finished goods. It is usual to show each of these inventories separately in the current asset section of the statement of financial position.

Walkthrough 20.5

On 30 April 20–6 the Kapoor Manufacturing Company had inventories valued as follows:

	\$
Raw material	15 300
Work in progress	8 640
Finished goods	23 250

Prepare a relevant extract from the statement of financial position of the Kapoor Manufacturing Company at 30 April 20–6.

Kapoor Manufacturing Company		
Extract from statement of financial position at 30 April 20–6		
	\$	\$
Current assets		
Inventories – Raw materials	15 300	
Work in progress	8 640	
Finished goods	<u>23 250</u>	47 190

20.9 Year-end adjustments

This chapter has concentrated on the difference between the financial statements of a manufacturing business and those of a trading business. In order to emphasise these differences none of the examples included year-end adjustments. A manufacturer may well have to make year-end adjustments for such things as accruals, prepayments, provision for doubtful debts and so on.

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



You learned about year-end adjustments in Chapters 11, 12 and 13.

Revision checklist

- A manufacturing account is used to calculate the cost of making goods produced in the financial year. It consists of direct materials + direct labour + direct expenses + factory overheads.
- Direct materials + direct labour + direct expenses = prime cost.
- The cost of production may have to be amended for the goods partly made at the end of the financial year (known as work in progress).
- In the trading section of the income statement of a manufacturer, the cost of production is included together with any purchases of finished goods.
- In the statement of financial position of a manufacturer, it may be necessary to show three different inventories.

Exam-style questions

- 1** How is cost of production calculated?
- A** prime cost + factory overheads + increase in work in progress
B prime cost + factory overheads – increase in work in progress
C prime cost – factory overheads + increase in work in progress
D prime cost – factory overheads – increase in work in progress
- 2** What may be included in prime cost?
- 1 salary of factory manager
 2 salary of supervisor of production workers
 3 wages of machine maintenance workers
 4 wages of production workers
- A** 1, 2 and 3 **B** 2, 3 and 4 **C** 3 and 4 **D** 4 only

- 3** A manufacturer provided the following information:

	\$
Prime cost	132 000
Factory overheads	17 000
Opening work in progress	11 000
Closing work in progress	13 000

How much was the cost of production?

- A** \$113 000 **B** \$117 000 **C** \$147 000 **D** \$151 000
- 4** The financial year of Leeford Manufacturers Ltd ends on 30 September. They supplied the following information:

	\$
At 1 October 20–7:	
Inventory – raw materials	41 800
finished goods	62 300
work in progress	18 600

For the year ended 30 September 20–8:

Purchases of raw materials	495 800
Purchases of finished goods	4 300
Revenue	824 000
Wages – factory direct wages	52 750
factory indirect salaries	29 760
office and sales salaries	36 890
Factory expenses	41 840

At 30 September 20–8:

Inventory – raw materials	43 200
finished goods	60 750
work in progress	17 850

- a** Select the relevant figures and prepare the manufacturing account of Leeford Manufacturers Ltd for the year ended 30 September 20–8.
- b** Select **two** of the items in this list which should **not** appear in a manufacturing account and explain why they are not included.
- 5 a** Explain the difference between:
- i** direct costs and indirect costs
 - ii** prime cost and cost of production.
- b** Explain the meaning of the term ‘work in progress’.
- c** Explain why a manufacturer may purchase finished goods as well as raw materials.

Iftikhar is a manufacturer. He provided the following information for the year ended 31 May 20–9:

	\$
1 June 20–8 Inventory of raw materials	4 750
Inventory of work in progress	5 600
31 May 20–9 Inventory of raw materials	4 850
Inventory of work in progress	4 300

For the year ended 31 May 20–9:

Purchases of raw materials	49 590
Direct factory wages	61 940
Indirect factory wages	29 660
Carriage on raw materials	3 710
Factory direct expenses	2 960
Factory indirect expenses	48 930

- d i** Calculate the prime cost.
- ii** Calculate the cost of production.

- 6 Farouk started a manufacturing business on 1 April 20–5. He provided the following information:

\$

On 1 April 20–5:

Cost of factory machinery	28 000
Cost of factory hand tools	800
Cost of office fixtures and fittings	6 500

For the year ended 31 March 20–6:

Purchases of raw materials	22 800
Purchases of finished goods	12 200
Carriage on raw materials	1 300
Revenue	100 400
Wages and salaries – factory operatives	27 200
office staff	15 400
factory supervisors	10 400
General expenses	4 800
Rent and rates	5 100

At 31 March 20–6:

Inventory – raw materials	2 520
work in progress	2 140
finished goods	5 210
Value of factory hand tools	650

Additional information:

- 1 The rent and rates and the general expenses are to be apportioned $\frac{2}{3}$ to the factory and $\frac{1}{3}$ to the office.
 - 2 The factory machinery is to be depreciated at 25% per annum on cost and the office fixtures and fittings by 10% per annum on cost. No additional non-current assets were purchased during the year.
- a** Prepare the manufacturing account for the year ended 31 March 20–6.
- b** Prepare the income statement for the year ended 31 March 20–6.

Chapter 21

Limited companies

Learning objectives

In this chapter you will learn to:

- explain the advantages and disadvantages of operating as a limited company 5.3
- understand the meaning of the term limited liability 5.3
- understand the meaning of the term equity 5.3
- understand the capital structure of a limited company comprising preference share capital, ordinary share capital, general reserve and retained earnings 5.3
- understand and distinguish between issued, called-up and paid-up share capital 5.3
- understand and distinguish between share capital (preference shares and ordinary shares) and loan capital (debentures) 5.3
- prepare income statements, statements of changes in equity and statements of financial position 5.3
- make adjustments to financial statements. 5.3

21.1 Introduction

A **limited company** is a legal entity which has a separate identity from its shareholders, whose liability for the company's debts is limited.

Sometimes a new business is formed as a limited company; sometimes a limited company is formed when a sole trader or partnership wishes to expand their business.

21.2 The nature of a limited company

One person acting alone can form a limited company and there is no maximum number of members. The **capital of a company is divided into units known as shares** which can be of any monetary amount. The **members (shareholders) of the company are only liable for the debts of the company up to the amount they agree to pay for their shares**. Since a company can have a large number of members whose liability is limited, a large amount of capital can be raised. The shares of a company have a face value (par value) such as \$5, \$1, \$0.50, etc. **Profits are distributed among the members in the form of dividends** which are often stated in terms of a percentage of the face value of the shares.



KEY TERM

A **limited company** is a legal entity which has a separate identity from its shareholders, whose liability for the company's debts is limited.

Walkthrough 21.1

Dass Limited has a total capital of 200 000 shares of \$2 each and decides to pay the shareholders a dividend of 10%.

- a** What is the total amount payable?
 - b** What is the amount payable per share?
- a** Total amount payable is \$40 000 ($\$400\,000 \times 10\%$).
 - b** Amount payable per share is \$0.20 (10% of \$2).

There are two types of limited company – a **public limited company** which may offer its shares to the public and a **private limited company** which is usually a smaller company and is not allowed to offer its shares to the public.

From the viewpoint of the individual, the main benefit of being a member of a limited company is the fact that the liability for the debts of the company is limited to the amount the member agreed to contribute. It is also beneficial that a limited company has a separate legal entity to its shareholders so legal actions are taken against the company not the individual shareholders. Apart from very small limited companies, it is not usually practical for shareholders to take an active part in the running of the business, so a board of directors is appointed to run the business on a daily basis. If shares are held in a public limited company, it is easy to buy and sell shares.

From the viewpoint of the business, being a limited company means that it is possible to access greater capital than is possible for a sole trader or partnership business. Loans can often be obtained more easily by a limited company than by a sole trader or a partnership business. A company has continuity of existence, unlike a sole trader or a partnership business. However, there are many legal requirements in relation to forming and running a limited company and annual financial statements must be prepared and provided to shareholders.

TEST YOURSELF 21.1

- 1 Define a limited liability company.
- 2 'A member of a company has limited liability'. Explain.
- 3 Name **two** types of limited company.
- 4 State the name for profits distributed to members of a limited company.



KEY TERMS

Issued share capital is the amount of capital issued to the shareholders.

Called up capital is that part of the issued share capital for which payment has been requested from shareholders.

Paid up capital is that part of the called up share capital for which the company has received payment from shareholders.

21.3 Share capital

When a limited company is formed the amount of share capital required will be issued to the shareholders (members) and this is known as the **issued share capital**. If more capital is required at a later date, further shares can be issued.

A company may not immediately require all the money due on the shares it issues. In this case shareholders may be allowed to pay in 'instalments' at times and amounts fixed by the company. The total amount a company has requested from the shareholders is known as the **called up capital**. This may be less than the issued capital as a company may only 'call up' the amount it actually requires at that date. The term **paid up capital** refers to that part of the called up capital for which a company has actually received cash from its shareholders.

Walkthrough 21.2

Mishra Limited was formed on 1 January 20–8. A total of 300 000 \$1 shares were issued immediately and shareholders were asked to pay 50% of the sum due immediately and the other 50% in January 20–9.

By 1 May 20–8 holders of 290 000 shares had paid the amount due.

State:

- a The issued capital of Mishra Limited on 1 May 20–8.
 - b The called up capital of Mishra Limited on 1 May 20–8.
 - c The paid up capital of Mishra Limited on 1 May 20–8.
-
- a The issued capital is \$300 000 consisting of 300 000 shares of \$1 each.
 - b The called up capital is \$150 000 consisting of \$0.50 called up on 300 000 shares.
 - c The paid up capital is \$145 000 consisting of \$0.50 paid up on 290 000 shares.

21.4 Types of shares

The share capital of a limited company may be divided into different types of shares. The most common ones are **preference shares** and **ordinary shares**.

Preference shares

As the name implies, these get preference over the ordinary shares. They receive a fixed rate of dividend (based on the face value of the shares) which is payable before any dividend is payable to the ordinary shareholders. The dividend is the same every year (provided that the profit of the company is enough to cover this amount). If a company is wound

up (closed down) any money left after paying outside liabilities is used to pay back the preference shareholders before anything is returned to the ordinary shareholders. Preference shareholders are not usually entitled to vote at shareholders' meetings.

There are several types of preference shares, and most of these are outside the scope of this book. However, it is necessary to understand the difference between redeemable and non-**redeemable preference shares** as this affects the treatment of dividend and how the shares appear in the statement of financial position. If the preference shares are redeemable, the dividend is included as a finance cost in the profit and loss section of the income statement (with any accrued dividend appearing in the current liabilities in the statement of financial position). The preference shares are shown as a non-current liability in the statement of financial position. If the preference shares are non-redeemable, the dividend paid is included in the statement of changes in equity (see Section 21.7) and the preference shares are included in the equity and reserves section (see Section 21.8) of the statement of financial position.

Ordinary shares

These are also known as **equity shares**. The dividend on ordinary shares is only payable after that on the preference shares has been accounted for. The dividend is not a fixed amount, but can vary according to the profits of the company. If the trading results are poor the ordinary shareholders may receive no dividend at all, but if trading results are good they may be awarded high dividends. If a company is wound up, the outside liabilities and the preference shareholders are repaid before any monies are returned to the ordinary shareholders. This may result in very little being returned to the ordinary shareholders if the company was short of funds. However, the ordinary shareholders may receive a return higher than their original capital investment if the company had adequate funds. Ordinary shareholders are usually entitled to vote at shareholders' meetings on the basis of one vote per share.

21.5 Debentures (Loan notes)

In addition to the funds provided by the owners (shareholders), a company may also obtain funds from **debentures**, which are long-term loans. Like most loans, debentures carry a fixed rate of interest, which is payable whether or not the company makes a profit. This loan interest appears as a finance cost in the profit and loss section of the income statement. If the company is wound up, the debenture holders will be repaid before any capital is repaid to shareholders. Debenture holders are not members of the company and so are not entitled to vote at shareholders' meetings.

TEST YOURSELF 21.2

- 1 State **three** differences between preference shares and ordinary shares.
- 2 State **three** differences between ordinary shares and debentures.

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

21.6 Income statement of a limited company

An annual income statement is prepared for a limited company in exactly the same way as it is prepared for a sole trader or a partnership business. The only difference is that in the finance costs there may be debenture interest and dividend on redeemable preference shares.



KEY TERMS

Redeemable preference shares are those preference shares which must be bought back by the company at an agreed date and for an agreed price.

Equity is the total funds provided by the shareholders of the company.

A **debenture** is a long-term loan which has a fixed rate of interest, payable irrespective of the profit of the company.



TIP

Debenture interest appears in the income statement under 'finance costs'.

21.7 Statement of changes in equity

Chapter 19 explained how it was necessary to prepare a profit and loss appropriation account for a partnership business to show how the profit was divided between the partners. In a similar way, a limited company must prepare a statement showing how the profit for the year is used. This statement is known as a **statement of changes in equity**. It summarises the changes during the year to the ordinary share capital, non-redeemable preference share capital, retained earnings and general reserve.

It has already been explained that profits are distributed to the shareholders of a limited company in the form of dividends. Any ordinary share dividend (and any dividend on non-redeemable preference shares) which has actually been paid during the financial year is recorded in the statement of changes in equity for that particular year.

Sometimes the directors will recommend an interim dividend (half way dividend) to be paid during the year on ordinary shares (and also on non-redeemable preference shares). This will appear in the statement of changes in equity for that particular year.

At the end of each financial year the directors of a company propose that ordinary share dividends (and possibly dividends on non-redeemable preference shares) are paid and these will be paid early in the following year. These proposed dividends are not included in the financial statements for the current year (but may appear as a note). They are included in the statement of changes in equity in the year in which they are actually paid. Very often limited companies do not distribute the whole of the profit for the year as dividends. Even if a limited company wished to distribute the whole profit it would not be possible if there was not enough cash available. Any profit that is not appropriated for dividends is carried forward to the following year. This is known as **retained earnings** and will appear in the equity and reserves section of the statement of financial position

In addition to leaving a balance of retained earnings, many companies will transfer an amount from the profit for the year to a general reserve. This is another means of **ploughing back profits** into the company to help it grow. The general reserve also appears in the equity and reserves section of the statement of financial position.

Walkthrough 21.3

Anand Limited was formed on 1 July 20–3. By 30 June 20–6 a total of 200 000 5% redeemable preference shares of \$1 each and 600 000 ordinary shares of \$0.50 each had been issued and were fully paid.

The following information is provided:

- 1 The profit for the year ended 30 June 20–6 **before** the preference share dividend was \$58 000.
- 2 On 1 July 20–5 the retained earnings brought forward amounted to \$41 000 and the general reserve amounted to \$45 000.
- 3 Half of the preference share dividend was paid on 31 December 20–5. On 30 June 20–6 the remaining preference share dividend was outstanding.
- 4 The proposed final ordinary share dividend of \$30 000 for the year ended 30 June 20–5 was paid on 30 September 20–5.
- 5 An interim dividend of \$24 000 was paid on 31 March 20–6.
- 6 On 30 June 20–6 the directors recommended a transfer of \$8 000 to the general reserve and the payment of an ordinary share dividend of 8%.

Prepare a statement of changes in equity of Anand Limited for the year ended 30 June 20–6.

Anand Limited				
Statement of changes in equity for the year ended 30 June 20–6				
	Ordinary share capital	General reserve	Retained earnings	Total
	\$	\$	\$	\$
Balance at 1 July 20–5	300 000	45 000	41 000	386 000
Profit for the year			48 000	48 000
Dividend paid (final)			(30 000)	(30 000)
Dividend paid (interim)			(24 000)	(24 000)
Transfer to general reserve		8 000	(8 000)	
Balance at 30 June 20–6	<u>300 000</u>	<u>53 000</u>	<u>27 000</u>	<u>380 000</u>

**TIP**

Check the arithmetic in a statement of changes in equity by adding each column vertically and then cross-checking by adding the totals of the columns horizontally.

- After entering the opening balances, each item is entered in the appropriate column and also in the total column.
- The profit for the year of \$58 000 was reduced by the preference share dividend for the year of \$10 000.
- The final dividend paid relates to the previous year but is entered in the statement as the dividend was paid during the current year.
- The interim dividend is entered on the statement as it was paid in the year.
- The dividend proposed at the end of the current year does not appear as it has not yet been paid.
- A figure in brackets indicates that it is reducing the amount in that column.
- The totals should be added vertically and then cross-checked horizontally.

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

TEST YOURSELF 21.3

- 1 Explain the term retained earnings.
- 2 Explain the term interim dividend.
- 3 Explain the difference between dividends paid and dividends proposed.

21.8 Statement of financial position of a limited company

In the statement of financial position of a limited company the assets section and the current liabilities section are presented in exactly the same way as for a sole trader or a partnership.

The non-current liabilities section may include redeemable preference shares, debentures and any other non-current liabilities. The capital section has to be modified so that it shows details of the shares and reserves of the company. The general reserve and the retained earnings are added to the share capital as they represent profits which have been retained in the company, and, as such, belong to the ordinary shareholders.

**LINK**

You learned about statements of financial position of sole traders in Chapter 9.

Walkthrough 21.4

Using the information and the statement of changes in equity provided in **Walkthrough 21.3**, prepare an appropriate extract from the statement of financial position of Anand Limited at 30 June showing the capital and reserves.

**TIP**

The totals of the columns in the statement of changes in equity are used to enter the items in the equity and reserves section of the statement of financial position.

Anand Limited	
Extract from statement of financial position at 30 June 20–6	
	\$
Equity and liabilities	
Equity	
Ordinary share capital	300 000
General reserve	53 000
Retained earnings	<u>27 000</u>
	<u>380 000</u>

- The amounts for share capital, general reserve and retained earnings are obtained from the statement of changes in equity (see **Walkthrough 21.3**).
- The preference shares are redeemable so would appear in the non-current liabilities section.

TEST YOURSELF 21.4

- 1 State how debentures are recorded in the statement of financial position of a limited company.
- 2 Explain why reserves such as general reserve and retained earnings are added to the ordinary share capital in the statement of financial position of a limited company.

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

Revision checklist

- A limited company is a legal entity which has a separate identity from its shareholders, whose liability is limited.
- The share capital actually issued to shareholders is known as the issued capital.
- There are two main types of shares – preference shares and ordinary shares.
- Debentures are a form of long-term loan.
- A statement of changes in equity summarises the changes during the year to ordinary share capital, non-redeemable preference share capital, retained earnings and general reserve.

Exam-style questions

- 1 Which statement about debentures is correct?
- A** Debentures carry a fixed rate of dividend.
B Debentures carry a fixed rate of interest.
C Debentures are part of the equity of a limited company.
D Debenture holders are allowed to vote at shareholders' meetings.
- 2 XZ Limited was formed on 1 August 20–1. Which items may appear in the statement of changes in equity for the year ended 31 July 20–2?

	Debenture interest paid	Ordinary share dividend paid	Ordinary share dividend proposed	Transfer to general reserve
A	✓	✓	✓	
B	✓			✓
C		✓	✓	✓
D		✓		✓

- 3 a Explain the difference between the following:
- i called-up share capital and paid-up share capital
 - ii preference shares and ordinary shares
 - iii ordinary share dividend paid relating to the current financial year and ordinary share dividend proposed relating to the current year.

Silsford Ltd provided the following information:

	\$
6% redeemable preference shares of \$1 each	50 000
Ordinary shares of \$1 each	80 000
Retained earnings	14 300

During the financial year ended 31 December 20–9 an interim dividend of \$2 400 was paid on the ordinary shares.

The profit for the year ended 31 December 20–9 before preference share dividend was \$33 000.

On 31 December 20–9 it was decided to:

- pay the dividend due on the redeemable preference shares
- pay a final dividend of 5% on the ordinary shares
- transfer \$5 000 to general reserve.

- b Calculate:
- i the profit for the year after preference share dividend
 - ii the retained earnings at 31 December 20–9.

4 Which items are included in the equity section of the statement of financial position of a limited company?

- | | |
|--------------------------|--------------------------|
| 1 bank overdraft | 2 debentures |
| 3 general reserve | 4 ordinary shares |

- A** 1 and 2 **B** 1 and 3 **C** 2 and 4 **D** 3 and 4

5 Tiwari & Company Ltd have issued 100 000 5% redeemable preference shares of \$1 each and 600 000 ordinary shares of \$0.50 each. All the shares are fully paid.

Tiwari and Company Ltd provided the following information relating to the year ended 30 June 20–8:

		\$
20–7		
July 1	Retained earnings	9 500
	General reserve	12 000
Dec 31	Dividends paid:	
	Half year dividend on preference shares	
	Interim dividend of 5% on ordinary shares	
20–8		
June 30	Profit for the year before preference share dividend	59 000
	Dividend paid:	
	Half year dividend on preference shares	

On 30 June 20–8 it was decided to transfer \$10 000 to the general reserve and to pay a final dividend of 10% on the ordinary shares.

- a** Calculate the profit for the year ended 30 June 20–8 after the preference share dividend. Show your workings.
- b** Prepare the statement of changes in equity of Tiwari & Company Ltd for the year ended 30 June 20–8.
- c** Prepare a relevant extract from the statement of financial position of Tiwari & Company Ltd at 30 June 2008 showing the equity and reserves section.
- d** Explain which dividends (if any) would appear in the statement of financial position of Tiwari and Company Ltd at 30 June 20–8. Give reasons for your answer.
- 6** AK Limited provided the following information:

	\$
On 1 May 20–4:	
Ordinary share capital	400 000
General reserve	20 000
Retained earnings	51 500
On 1 August 20–4 the final ordinary share for the year ended 30 April 20–4 was paid	16 000
On 1 November 20–4 an interim ordinary share dividend for the year ended 30 April 20–5 was paid	10 000
Profit for the year ended 30 April 20–5	79 500

On 30 April 20–5 the directors decided to:

- transfer 17 500 to general reserve
- proposed an final ordinary share dividend of 3%.

Additional information at 30 April 20–5:

	\$
Premises at cost	425 000
Equipment at cost	124 000
Motor vehicles at cost	80 000
Provision for depreciation of equipment	93 000
Provision for depreciation of motor vehicles	25 000
Trade payables	38 700
Trade receivables	32 000
Other payables	770
Other receivables	1 520
Provision for doubtful debts	800
5% debentures	30 000
Balance at bank	15 000
Inventory	35 750

- Prepare the statement of changes in equity for the year ended 30 April 20–5.
- Prepare the statement of financial position at 30 April 20–5.

Chapter 22

Analysis and interpretation

Learning objectives

In this chapter you will learn to:

- calculate and explain the importance of the following ratios: gross margin, profit margin, return on capital employed, current ratio, liquid (acid test) ratio, rate of inventory turnover, trade receivables turnover, trade payables turnover 6.1
- prepare and comment on simple statements showing comparison of results for different years 6.2
- make recommendations and suggestions for improving profitability and working capital 6.2
- understand the significance of the difference between the gross margin and the profit margin as an indicator of a business's efficiency 6.2
- explain the relationship of gross profit and profit for the year to the valuation of inventory, rate of turnover, revenue, expenses and equity 6.2
- understand the problems of inter-firm comparison 6.3
- apply accounting ratios to inter-firm comparison 6.3
- explain the uses of accounting information by interested parties for decision making 6.4
- recognise the limitations of accounting statements. 6.5

22.1 Introduction

It is necessary to analyse and interpret the financial statements of a business in order to assess its performance and progress. **Analysis** consists of a detailed examination of the information in a set of financial statements of a business. The results of this analysis are then interpreted in order to assess the performance of the business. **Interpretation** can include comparing to the results of other similar businesses and also comparing within the business (with the results for previous years and with targets and budgets).

To enable this comparison to be carried out in a meaningful way the results are usually expressed as accounting ratios. This is a general term which includes calculations in the form of ratios, percentages and time periods. Ratios are usually divided into two main groups – profitability ratios and liquidity ratios.

Working capital is the difference between the current assets and the current liabilities and is the amount available for the day-to-day running of the business (it is also known as **net current assets**). **Capital owned** is the amount owed by a business to the owner(s) of the business on a certain date. **Capital employed** is the total funds which are being used by a business. This may be calculated as the owner's capital plus any non-current liabilities (alternatively, it may be calculated as non-current assets plus net current assets). Capital employed can be defined in several ways: the figure at the start of the year, the figure at the end of the year, or an average of the two.



LINK

You learned about the main types of assets and liabilities in Chapter 9.

TEST YOURSELF 22.1

- 1 Name the two main groups of ratios.
- 2 Define working capital.
- 3 State what is meant by capital owned.
- 4 State **two** ways in which capital employed can be calculated.



LINK

You learned about the financial statements of a sole trader in Chapters 8 and 9.

Walkthrough 22.1

Arun is a trader who has been in business for several years. His financial year ends on 31 December.

The following financial statements will be used in **Walkthrough 22.2** to **Walkthrough 22.10**.

Arun		
Income statement for the year ended 31 December 20–7		
	\$	\$
Revenue – Cash sales	10 000	
Credit sales	110 000	120 000
	<u> </u>	
Less Cost of sales		
Opening inventory	7 500	
Purchases (all on credit)	97 000	
	<u> </u>	
	104 500	
Less Closing inventory	8 500	96 000
	<u> </u>	
Gross profit		24 000
Less Administration and selling expenses		8 000
		<u> </u>
Profit from operations		16 000
Less Loan interest		1 000
		<u> </u>
Profit for the year		15 000

Arun		
Statement of financial position at 31 December 20–7		
	\$	\$
Non-current assets (at book value)		124 250
Current assets		
Inventory		8 500
Trade receivables		10 500
Bank		12 250
		<u> </u>
		31 250
Total assets		155 500
Capital and liabilities		
Capital		
Opening balance		130 000
Plus Profit for the year		15 000
		<u> </u>
		145 000
Less Drawings		22 000
		<u> </u>
		123 000
Non-current liabilities		
Loan – AB Finance Ltd		20 000
		<u> </u>
Current liabilities		
Trade payables		12 500
		<u> </u>
Total liabilities		155 500

22.2 Profitability ratios

Profitability ratios are used to relate the profit figures to other figures within the same set of financial statements.

Return on Capital Employed (ROCE)

This is calculated using the following formula:

$$\frac{\text{Profit for the year before interest}}{\text{Capital employed}} \times \frac{100}{1}$$

Walkthrough 22.2

Using the financial statements shown in **Walkthrough 22.1** calculate Arun's return on capital employed.

Assume that capital employed equals the total of capital owned and non-current liabilities on 31 December 20–7.

$$\frac{\$16\,000}{\$143\,000} \times \frac{100}{1} = 11.19\%$$

This is a very important ratio as it shows the profit earned for every \$100 used in the business in order to earn that profit. The total funds used in the business are the capital of the owner(s) plus the non-current liabilities. The higher the return, the more efficiently the capital is being employed within the business.

Gross margin

This is calculated using the following formula:

$$\frac{\text{Gross profit}}{\text{Revenue}} \times \frac{100}{1}$$

Walkthrough 22.3

Using the financial statements shown in **Walkthrough 22.1** calculate Arun's **gross margin**.

$$\frac{\$24\,000}{\$120\,000} \times \frac{100}{1} = 20\%$$

This is also called gross profit as a percentage of turnover (turnover equals net sales less sales returns). This ratio shows the gross profit earned for every \$100 of sales. Different types of industries and trades tend to have different gross profit percentages. The same business may have a similar gross margin from year-to-year. The higher the return, the more profitable is the business. However, by reducing selling prices slightly (and so reducing the gross margin), a business may achieve a higher monetary gross profit.



KEY TERM

Profitability ratios measure the performance of the business by comparing the profit to other figures in the same set of financial statements.

The gross margin can be improved by measures such as:

- increasing selling prices
- obtaining cheaper supplies
- changing the proportions of different types of goods sold.

However, these measures may have some adverse effects. For example, increasing the selling price may result in customers going elsewhere, obtaining cheaper goods may result in a lower quality of goods, and so on.

If the gross margin changes significantly from one year to another the cause should be investigated. A fall in the gross margin may be caused by:

- increasing the rate of trade discount
- selling goods at cheaper prices
- not passing on increased costs to customers.

Profit margin

This is calculated using the following formula:

$$\frac{\text{Profit for the year}}{\text{Revenue}} \times \frac{100}{1}$$

Walkthrough 22.4

Using the financial statements shown in **Walkthrough 22.1** calculate Arun's profit margin.

$$\frac{\$15\,000}{\$120\,000} \times \frac{100}{1} = 12.50\%$$

This ratio shows the profit earned for every \$100 of revenue. The higher the return, the more profitable is the business. This ratio acts as an indicator of how well a business is able to control its expenses. If the profit margin of a business increases, it indicates that the operating expenses are being controlled. This ratio will be influenced by the different types of expense: some expenses increase in proportion to the sales (e.g. commission paid on sales made) but other expenses remain the same whatever the sales are (e.g. insurance of buildings). Any change in the gross margin will also affect the profit margin.

The profit margin can be improved by measures such as:

- increasing the gross margin
- controlling expenses
- increasing other income.

A fall in the profit margin may be caused by:

- a decrease in the gross profit
- an increase in expenses
- a decrease in other income
- a change in the type of expense.

The difference between the gross margin and the profit margin represents the percentage of the expenses to the revenue. This indicates the ability of the business to control its expenses.

TEST YOURSELF 22.2

- 1 Explain what is shown by the rate of return on capital employed.
- 2 State **two** factors which may increase the gross margin.
- 3 State the expenses as a percentage of the revenue if the gross margin is 25% and the profit margin is 14%.

22.3 Liquidity ratios

In business, the term 'liquidity' relates to money and **liquidity ratios** measure the ease and speed with which assets can be turned into cash.

Current ratio

This is calculated using the following formula:

$$\text{Current assets} : \text{Current liabilities}$$

Walkthrough 22.5

Using the financial statements shown in **Walkthrough 22.1** calculate Arun's **current ratio**.

$$\$31\,250 : \$12\,500 = 2.50 : 1$$

This is also referred to as the **working capital ratio**. It compares the assets which are in the form of cash, or which can be turned into cash relatively easily within the next 12 months, with the liabilities which are due for repayment within that period of time. This measures the ability of a business to meet its current liabilities when they fall due.

Ratios between 1.5 : 1 and 2 : 1 are generally regarded as satisfactory, but it is important to consider the size and type of business. Some businesses necessarily need a large amount of non-current assets whereas other businesses have a higher proportion of current assets; some businesses always purchase goods on credit whereas others always pay cash; some businesses obtain long-term loans whereas others make use of short-term loans or a bank overdraft. If the current ratio is over 2 : 1 it may indicate poor management of the current assets.

The working capital of a business must be adequate to finance the day-to-day trading activities. A business which is short of working capital may encounter the following problems:

- cannot meet immediate liabilities when they are due
- experience difficulties in obtaining further supplies on credit
- cannot take advantage of cash discounts
- cannot take advantage of business opportunities when they arise.



KEY TERM

Liquidity ratios

measure the ability of the business to turn assets into cash to pay its short term debts.

Ways to improve the working capital position include:

- introduction of further capital by the owner(s)
- obtaining long-term loans/non-current liabilities
- selling surplus non-current assets
- delaying purchasing non-current assets
- increasing profit
- reducing drawings by the owner(s) (or reduction in dividends).

The actual cash position can also be improved by measures such as delaying payments to credit suppliers, increasing the proportion of cash sales, and reducing the period of credit allowed to credit customers. These measures may also have some adverse effects such as the refusal of further supplies on credit, customers moving to other suppliers where longer credit is allowed, and so on.

Liquid (acid test) ratio

This is calculated using the following formula:

$$\text{Current assets} - \text{Inventory} : \text{Current liabilities}$$

Walkthrough 22.6

Using the financial statements shown in **Walkthrough 22.1** calculate Arun's liquid (acid test) ratio.

$$(\$31\,250 - \$8\,500) : \$12\,500 = 1.82 : 1$$

The liquid (acid test) ratio compares the assets which are in the form of money, or which will convert into money quickly, with the liabilities which are due for repayment in the near future. This is a similar calculation to the current ratio, but the liquid (acid test) ratio excludes inventory as this is not regarded as a liquid asset. Inventory is two stages away from being money: the goods have to be sold and then the money has to be collected from the debtors.

Ratios between 0.7: 1 and 1: 1 are usually regarded as satisfactory, but, as with the current ratio, the size and type of business should also be considered. A ratio of 1 : 1 indicates that the immediate liabilities can be met out of the liquid assets without having to sell inventory. (Where inventory has to be sold immediately it can sometimes only be done at a reduced price.) If the liquid (acid test) ratio is over 1 : 1 it may indicate poor management of liquid assets such as having too high a balance on a bank current account.

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

TEST YOURSELF 22.3

- 1 State **two** disadvantages of a shortage of working capital.
- 2 State **two** ways of improving the working capital.
- 3 Explain the difference between the current ratio and the liquid (acid test) ratio.

Rate of inventory turnover

This is calculated using the following formula:

$$\frac{\text{Cost of sales}}{\text{Average inventory}}$$

This gives the number of times inventory is sold and replaced in the period.

An alternative calculation uses the following formula:

$$\frac{\text{Average inventory}}{\text{Cost of sales}} \times \frac{365}{1}$$

This gives the number of days on average the inventory is held before being sold.



You learned about the effects of an incorrect inventory valuation in Chapter 10.

Walkthrough 22.7

Using the financial statements shown in **Walkthrough 22.1**, calculate Arun's rate of inventory turnover to show the following:

- a the number of times in the year inventory is replaced
- b the number of days inventory is held before being sold.

$$\text{a } \frac{\$96\,000}{(\$7\,500 + \$8\,500) \div 2} = 12 \text{ times}$$

$$\text{b } \frac{\$8\,000}{\$96\,000} \times \frac{365}{1} = 30.42 \text{ days} = 31 \text{ days}$$

The rate of inventory turnover is sometimes referred to as **inventory turnover**. This ratio calculates the number of times a business sells and replaces its inventory in a given period of time. The rate of inventory turnover will obviously vary according to the type of business. Businesses selling luxury goods such as expensive jewellery and private jet planes will have a low rate of inventory turnover whereas businesses selling low value 'everyday' requirements such as fresh bread and newspapers will have a high rate of inventory turnover. The same business may have a similar rate of inventory turnover from year-to-year. If the rate increases it may indicate improved efficiency; if the rate decreases it may indicate that the business has too much inventory or that the sales are slowing down. The quicker the rate of inventory turnover, the less time funds are tied up in inventory which is regarded as the least liquid of the current assets.

The rate of inventory turnover can affect the profit of the business. If business activity slows down both the gross profit and the profit for the year will be adversely affected.

A lower rate of inventory turnover can be caused by factors such as:

- lower sales (resulting in higher inventory levels)
- inventory over-purchased
- too high selling prices
- falling demand
- business activity slowing down
- business inefficiency.



You learned about the rate of inventory turnover in Chapter 17.

Trade receivables turnover

This is calculated using the following formula:

$$\frac{\text{Trade receivables}}{\text{Credit sales}} \times \frac{365}{1} \text{ to give an answer in days}$$

Using alternative formulae, an answer can be obtained in weeks or months:

$$\frac{\text{Trade receivables}}{\text{Credit sales}} \times \frac{52}{1} \text{ to give an answer in weeks}$$

$$\frac{\text{Trade receivables}}{\text{Credit sales}} \times \frac{12}{1} \text{ to give an answer in months}$$

Walkthrough 22.8

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

$$\frac{\$10\,500}{\$110\,000} \times \frac{365}{1} = 34.84 \text{ days} = 35 \text{ days}$$



You learned about irrecoverable debts in Chapter 13.

This may also be referred to as the **trade receivables/sales ratio**. It measures the average time the credit customers take to pay their accounts. The answer to this calculation – the length of time credit customers actually take to pay their accounts – should be compared with the term of credit allowed to them. The quicker the customers pay their accounts, the better it is; the money can then be used for other purposes within the business. The longer a business has to wait for a debt to be paid the greater the risk of it becoming irrecoverable.

The same business may have a similar trade receivables turnover from year-to-year. If the period decreases it may indicate that the credit control policy is being applied more effectively; if the period increases it may indicate that the credit control policy is inefficient, or that longer credit terms are being allowed in order to maintain the quantity of credit sales.

The rate of the trade receivables turnover can be improved by measures such as:

- improving credit control policy (sending regular statements of account, 'chasing' overdue accounts and so on)
- offering cash discount for early settlement
- charging interest on overdue accounts
- refusing further supplies until any outstanding debt is paid
- invoice discounting and debt factoring.*

*For a fee, a debt factor will maintain the sales ledger, collect the debts and advance money against those debts. For a fee, a discounter will advance money against certain debts, but does not maintain the sales ledger.

Trade payables turnover

This is calculated using the following formula:

$$\frac{\text{Trade payables}}{\text{Credit purchases}} \times \frac{365}{1} \text{ to give an answer in days}$$

Using alternative formulae, an answer can be obtained in weeks or months:

$$\frac{\text{Trade payables}}{\text{Credit purchases}} \times \frac{52}{1} \text{ to give an answer in weeks}$$

$$\frac{\text{Trade payables}}{\text{Credit purchases}} \times \frac{12}{1} \text{ to give an answer in months}$$

Walkthrough 22.9

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

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

This may also be referred to as the **trade payables/purchases ratio**. It measures the average time taken to pay the accounts of credit suppliers. The answer to this calculation should be compared with the term of credit allowed by the suppliers.

The same business may have a similar trade payables turnover from year-to-year. If the period decreases, the business is paying the suppliers more quickly; if the period increases it may indicate that the business is short of immediate funds and is finding it difficult to meet debts when they fall due. This ratio can also be influenced by the trade receivables turnover: if the credit customers do not settle their accounts promptly the business may not be able to pay the credit suppliers promptly. Taking longer to pay the suppliers means that the business can use the funds for other purposes, but there can be adverse effects such as:

- the supplier refusing credit in the future
- the supplier refusing further supplies
- the loss of any cash discount for early settlement
- damage to the relationship with the supplier.

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

TEST YOURSELF 22.4

- 1 State the formula for calculating rate of inventory turnover.
- 2 State **two** reasons why the rate of inventory turnover may fall.
- 3 State the formula for calculating trade receivables turnover.
- 4 A trader allows his credit customers 30 days credit. The trade receivables turnover is 40 days. State whether the trader will be satisfied. Give a reason for your answer.
- 5 A trader's credit suppliers allow him 45 days credit. State **one** advantage and **one** disadvantage to the trader if he pays after 45 days.



TIP

When attempting questions which require the calculation of ratios it is advisable to show workings. In this way some of the available marks may be earned even if the final answer is incorrect.



TIP

When stating the answer to a ratio calculation the figure should be accompanied by the appropriate description such as %, 'times' and 'days'.

22.4 Inter-firm comparison

Comparing the ratios calculated for the current financial year with those of previous years can measure the progress and performance of a business and indicate the trends in profitability, liquidity and so on.

Another useful comparison is to compare the ratios with those of a similar business.

Walkthrough 22.10

Arun is a trader who has been in business for several years. Renu started a similar business in another town two years ago. The financial year for both businesses ends on 31 December.

Renu allows Arun access to her financial records. The following information is available:

	Arun \$	Renu \$
On 1 January 20–7:		
Inventory	7 500	5 100
For the year ended 31 December 20–7:		
Revenue – cash sales	10 000	–
credit sales	110 000	100 000
Purchases – cash	–	26 600
credit	97 000	50 000
Cost of sales	96 000	76 000
Administration and selling expenses	8 000	13 000
Finance costs	1 000	500
On 31 December 20–7:		
Inventory	8 500	5 700
Trade receivables	10 500	10 900
Bank	12 250	–
Bank overdraft	–	6 600
Trade payables	12 500	5 000
Capital employed	143 000	115 000

- a** For **each** business calculate the following ratios:
- i** return on capital employed
 - ii** gross margin
 - iii** profit margin
 - iv** current ratio
 - v** liquid (acid test) ratio
 - vi** rate of inventory turnover
 - vii** trade receivables turnover
 - viii** trade payables turnover.
- b** Using the ratios calculated in **a**, compare the performance of the two businesses.

a	Arun \$	Renu \$
i Return on capital employed	11.19%	$\frac{\$11\,000}{\$115\,000} \times \frac{100}{1} = 9.57\%$
ii Gross margin	20%	$\frac{\$24\,000}{\$100\,000} \times \frac{100}{1} = 24\%$
iii Profit margin	12.50%	$\frac{\$10\,500}{\$100\,000} \times \frac{100}{1} = 10.50\%$
iv Current ratio	2.50 : 1	\$16 600 : \$11 600 = 1.43 : 1
v Liquid (acid test) ratio	1.82 : 1	\$10 900 : \$11 600 = 0.94 : 1
vi Rate of inventory turnover	12 times	$\frac{\$76\,000}{\$5\,400} = 14.07$ times
vii Trade receivables turnover	35 days	$\frac{\$10\,900}{\$100\,000} \times \frac{365}{1} = 40$ days
viii Trade payables turnover	48 days	$\frac{\$5\,000}{\$50\,000} \times \frac{365}{1} = 37$ days

- The detailed calculations for Arun's business have been shown earlier in this chapter.

b Comparison of the ratios:

Profitability

Arun is employing more capital and has a higher return on capital employed than Renu. For every \$100 of capital employed Arun had a return of 11.19%, whereas Renu only achieved \$9.57. This may indicate that Renu is not employing the capital in the most effective way.

Both businesses earned the same amount of gross profit, but Renu achieved a higher gross margin. It may be that Arun failed to pass on increased costs, or sold goods at cheaper prices in order to achieve greater sales. Renu may have been selling the goods at higher prices or buying goods at a cheaper price than Arun.

Despite both businesses earning the same amount of gross profit, Arun achieved a higher amount of profit for the year by controlling his expenses. Arun's expenses as a percentage of revenue were 8.50% compared with 13.50% for Renu. This resulted in Arun having a higher profit margin.

Liquidity

Arun's current ratio of 2.50 : 1 is quite satisfactory as his current assets are two and a half times the current liabilities. Renu's current ratio of 1.43 : 1 may be regarded as too low as her current assets are only 1.43 times greater than her current liabilities. Renu may find it difficult to meet her current liabilities when they fall due and may not be able to take advantage of cash discounts or business opportunities when they arise. The introduction of additional capital or a long-term loan to replace part (or all) of the bank overdraft would improve her working capital position.

Arun's liquid (acid test) ratio is also satisfactory (some may even regard it as a little too high). Renu's liquid (acid test) ratio is quite reasonable as her liquid assets and her current liabilities are almost equal. However, her only liquid asset is trade receivables, so

**TIP**

When comparing the ratios of two businesses, offer suggestions on how the difference has occurred and the consequences of low or high ratios. Do not limit the answer to basic comments such as 'X had a higher ratio than Y'.

she is dependent on credit customers paying their accounts before she is able to pay her current liabilities.

Renu has achieved a slightly quicker rate of inventory turnover than Arun. This may indicate that Renu is more efficient. Arun could consider reducing his inventory levels and try to increase his rate of sales.

Arun's credit sales are only slightly higher than Renu's. The amount of trade receivables of each business is very similar. Arun's credit customers are paying their accounts in an average of 35 days, Renu's credit customers are taking an average of 40 days to pay their accounts. It may be that Renu's credit control policy is inefficient or that she is not offering cash discounts. To be more meaningful, these figures should be compared to the credit allowed by each business.

The amount of Arun's credit purchases was much higher than that of Renu. The total of Arun's trade payables is much greater than that owed by Renu. Arun's credit suppliers are being paid in an average of 48 days, Renu takes an average of 37 days to pay her credit suppliers. This may be linked to the fact that Renu is relying on a bank overdraft for short-term finance, and her trade payables much less than Arun's.

22.5 Problems of inter-firm comparison

A business can often obtain valuable information by comparing their accounting ratios with those of another business, but the business must be aware of the limitations of such a comparison. Every business is different and has different requirements and accounting policies. A comparison is only meaningful if it is between two or more businesses of the same type, of the same size and in the same trade. The problems of comparison include the following:

- The businesses may apply different accounting policies, for example they may use different methods of depreciation.
- The businesses may apply different operating policies such as renting premises or purchasing premises, obtaining long-term finance from capital only or using capital and long-term loans. Such policies will affect both the profit for the year and the statement of financial position.
- Non-monetary items such as the skill of the workforce, the goodwill of the business and so on do not appear in the accounting records, but are very important in the success of the business.
- It is not always possible to obtain all the information about another business which is needed to make a true comparison. For example, the inventory shown in the financial statements may not represent the average amount held during the year; the financial statements do not show the age of the non-current assets and when they need replacing.
- The information relating to other businesses may be for one financial year only, so it is not possible to calculate business trends. That particular year may also not be a 'typical' year.
- The financial years may end on different dates which can make comparison difficult. For example, the year end for one business may be at a time when inventories are particularly low; the year end for another business may be when inventories are particularly high.
- The accounts are based on historic cost and do not show the effects of inflation.

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

TEST YOURSELF 22.5

- 1 State and explain **four** problems of inter-firm comparison.

22.6 Users of accounting statements

It is not only the owner who is interested in analysing and interpreting the financial statements of an organisation. Various other people are also interested in different aspects of the accounts. The users of accounting statements can be divided into two main groups – internal users and external users.

Internal users

1 Owner(s)

The owners of a business such as a sole trader or partners will be interested in all aspects of the business, both profitability and liquidity, in order to assess the business's performance and progress. Any potential partners are interested in the profitability of the business. The shareholders and potential shareholders of a limited company are interested in the profitability of the company and also in various investment ratios (which are outside the scope of this book).

2 Manager(s)

In many small businesses, the owners manage the business. In some cases, management may be carried out by an employee. Like the owners, managers are interested in all aspects of the business. They may use ratios to assess past performance, plan for the future and take remedial action where necessary.

External users

1 Bank manager

If a business requests a bank loan or an overdraft facility the bank manager will require the financial statements of the business. The bank manager will need to know whether there is adequate security to cover the amount of the loan or overdraft, whether it can be repaid when due, and whether interest can be paid when due.

2 Other lenders

Anyone who has made a loan to a business (and any potential lenders) will be interested in the security available, the repayment of the loan when due and the payment of interest when due.

3 Trade payables

Anyone who has supplied a business with goods on credit terms (and any potential credit supplier) is interested in the liquidity position and the trade payables turnover. These factors may be considered when determining the credit limit and the length of credit allowed. In practice, it may not be possible to obtain the accounts of sole traders and partnership businesses, so other means of checking creditworthiness are employed.

4 Potential buyers of the business

Anyone with an interest in purchasing the business or making a takeover bid will be interested in the profitability of the business and the market value of the assets of the business.

**TIP**

In addition to naming the users of financial statements you must be able to explain the reason for their interest in the statements.

5 Customers

Customers of the business are interested in ensuring the continuity of supplies.

6 Employees and trade unions

Employees and trade unions want to know that the company is able to continue operating, and so maintain jobs and continue to pay adequate wages (and, in some cases, contribute to pension schemes).

7 Government departments

Government department may want information for purposes such as compiling business statistics and checking that the correct amount of tax is being paid.

8 Club members

The members of a club or society want to know that the club is being well-managed financially so that it will be able to continue in existence and provide the facilities to members.

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

22.7 Limitations of accounting statements

Accounting statements and the ratios calculated from them provide valuable information about a business. They do, however, have limitations and are not able to provide a complete picture of the performance and position of a business. Their limitations include the following.

Time factor

The accounting statements are a record of what has happened in the past, not a guide to the future. Additionally, there is a gap between the end of the financial year and the preparation of the accounting statements. In that time significant events such as changes in inventory levels and purchasing of non-current assets may have taken place.

Historic cost

The only way to record financial transactions is to use the actual cost price. However, comparing transactions taking place at different times can be difficult because of the effect of inflation. For example, in times of inflation, it would cost more to buy a machine in 20–8 identical to one purchased in 20–1.

Accounting policies

All businesses should apply the accounting principles of **prudence** and **consistency** which should help in making comparisons. However, there are several acceptable accounting policies which may be applied, for example there are several different methods of calculating depreciation. Where businesses have used different accounting policies it is difficult to make a meaningful comparison of their results. Similarly, where a business changes its policy, a comparison with the results of previous years is difficult.

Different definitions

Where a business has borrowed money, for example in the form of loans or debentures, the income statement may show the profit from operations and then deduct the finance costs to give the profit for the year. Another business may not show this distinction. Businesses may use a different definition of 'profit' when calculating profitability ratios.

**LINK**

You learned about the principles of prudence and consistency in Chapter 10.

A comparison of profit and profitability ratios is only meaningful if 'like is compared with like' and the same definitions are applied.

Money measurement

Accounts only record information which can be expressed in monetary terms. This means that there are many important factors which influence the performance of a business which will not appear in the accounting statements.

The factors which are within the control of the business include the quality of management, the skill and reliability of the workforce, the goodwill of the business, the age and condition of the non-current assets and the ability to adapt in response to changing market conditions.

Other factors are outside the control of the business. These include government policies, competition, impact of new technology, and future long-term prospects for the particular trade or industry.



LINK

You learned about historic cost and money measurement in Chapter 10.

TEST YOURSELF 22.6

- 1 Name **three** business people who would be interested in the accounts of a sole trader. Explain the reason for their interest in each case.
- 2 Explain **three** limitations of the accounting statements of a business.

Revision checklist

- There are three ratios which measure profitability: return on capital employed, gross margin and profit margin.
- There are five ratios which measure liquidity: current ratio, liquid (acid test) ratio, rate of inventory turnover, trade receivables turnover and trade payables turnover.
- Ratios can be used to compare the current year with previous years and with other similar businesses. Problems can arise when making inter-firm comparisons.
- Certain aspects of the accounting statements of a business are of interest to users such as owner(s), managers, lenders, trade payables, potential buyers, customers, employees and trade unions, and government departments.
- Accounting statements and the ratios calculated from them provide valuable information, but they have limitations and are not able to provide a complete picture of the performance and position of a business.

- 4 Vijay runs a wholesale furniture business. All goods are sold on credit terms. He provided the following information at the end of his third year of trading:

	\$
On 1 January 20–2:	
Inventory	5 600
Capital employed	130 000
For the year ended 31 December 20–2:	
Revenue	66 000
Cost of sales	48 840
Loan interest	1 500
Profit for the year	5 610
At 31 December 20–2:	
Inventory	6 200
Trade receivables	5 120

Vijay decided to compare his results with those of AK Limited, an old-established food wholesaler.

- a Complete the following table to show the ratios for Vijay's business for the year ended 31 December 20–2. The answers should be correct to two decimal places.

	Vijay	AK Limited
Gross margin		17.50%
Profit margin		9.25%
Return on capital employed		6.76%
Rate of inventory turnover		16.44

- b Suggest **two** reasons for the difference in the gross margin.
- c State which business has better control of its expenses. Give a reason for your answer.
- d Suggest **two** reasons for the difference in the rate of inventory turnover.
- e Suggest **four** factors which Vijay should consider when comparing his results with those of AK Limited.
- 5 Why may John, a credit supplier, be interested in the financial statements of Paul, a new customer?
- A** to calculate Paul's current assets
- B** to calculate Paul's trade payables turnover
- C** to set the rate of trade discount to be allowed to Paul
- D** to set the rate of cash discount to be allowed to Paul.

- 6** Rita is a trader. She provided the following information on 31 July 20–2:

	\$
Inventory	3 140
Cash at bank	2 650
Trade payables	3 670
Trade receivables	2 960
Loan repayable 30 September 20–2	2 500

- a** State the formula for the calculation of the liquid (acid test) ratio.
- b** Calculate the liquid (acid test) ratio.
- c** Comment on your answer to **b**.
- d** State why the liquid (acid test) ratio is a more reliable indicator of liquidity than the current ratio.
- e** Complete the table by stating the effect of each of the following on Rita's current ratio and liquid (acid test) ratio. The first one has been completed as an example.

	Current ratio	Liquid (acid test) ratio
Sold old inventory at cost price to credit customer	<i>no effect</i>	<i>increase</i>
Purchased a new machine paying by cheque		
Purchased inventory on credit		
Arranged for loan repayment date to be extended for two years		

- f** Name **four** interested parties, apart from Rita, who may wish to look at the financial statements of Rita. Give a reason in each case.

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 unpresented 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

- 5** In addition to purchasing raw materials a manufacturer also purchased a quantity of finished goods. The cost of carriage inwards on the raw materials was incorrectly recorded as carriage inwards on finished goods.

How did this error affect the cost of production and the gross profit?

	Cost of production			Gross profit		
	Overstated	Understated	No effect	Overstated	Understated	No effect
A	✓				✓	
B		✓			✓	
C		✓				✓
D			✓	✓		

- 6** Omar maintains a three column cash book. On 1 March 20–4 he had a cash balance of \$150 and a bank overdraft of \$3 940.

Omar's transactions for March 20–4 included the following:

- March 8 Withdrew \$1 500 from the bank for personal use
 14 Cash sales paid directly into the bank, \$2 310
 18 Paid Mariam a cheque to settle her account of \$320, less 2½% cash discount
 21 Abdul paid his account of \$110 by credit transfer
 25 Zaffar paid \$490 by cheque in full settlement of his account of \$500
 29 Cash sales, \$2 462
 30 Paid operating expenses in cash, \$242
 31 Paid all cash into bank except \$200

Omar received his bank statement for March. He compared the two records and found the following differences:

- Item appearing on the bank statement but not recorded in the cash book:

	\$
Bank charges	21
 - The bank had not recorded the transactions which took place on the following dates:
 - 25 March
 - 31 March
 - The bank had made an error and recorded the cash paid in on 14 March as \$3 210.
- a** Write up Omar's cash book, including all relevant entries, for March 20–4. Balance the cash book and bring down the balances on 1 April 20–4.
- b** Prepare a bank reconciliation statement at 31 March 20–4 showing the balance on the bank statement at that date.

- 7** Darren started a business on 1 February 20–8. He transferred \$120 000 from his private bank account to a business bank account. He obtained a long-term loan from his family of \$50 000 which was also paid into the business bank account.

On the same date he purchased premises, \$125 000, shop fittings, \$17 500, and inventory, \$5 320, all of which were paid by credit transfer.

- a** Prepare the opening journal entry on 1 February 20–8. A narrative is required.

The following transactions took place in August 20–8:

- August 1 Darren took goods, \$440, from the business for personal use.
 12 Darren transferred his personal motor vehicle to the business at a valuation of \$16 250.

- b** Prepare journal entries to record these transactions. Narratives are required.

Darren made year-end transfers to the income statement on 31 January 20–9 and also made some year-end adjustments.

- c** Prepare journal entries to record the following. Narratives are required.

- 1 Writing off a debt of \$150 owed by Paula as irrecoverable.
- 2 Transferring the balance of the irrecoverable debts account to the income statement.
- 3 Transferring the balance of the purchases returns account, \$1 075, to the income statement.
- 4 Transferring the balance of the operating expenses account, \$13 620, to the income statement.
- 5 Creating a provision for doubtful debts of \$550.
- 6 Depreciating shop fittings by 10% on cost.

- 8** Uzma's trial balance drawn up at the end of her financial year did not balance, but she proceeded to prepare draft financial statements. The statement of financial position she prepared is provided.

Draft statement of financial position at 31 October 20–6	
	\$
Non-current assets at book value	26 000
Inventory	8 500
Trade receivables	6 270
Bank	700
	<u>41 470</u>
Capital	
Opening balance	28 000
Plus draft profit for the year	2 860
	<u>30 860</u>
Less Drawings	12 900
	<u>17 960</u>
Long-term loan	15 000
Trade payables	10 150
	<u>43 110</u>
Less Suspense account	1 640
	<u>41 470</u>

The following errors were later discovered:

- 1** No adjustment had been made for prepaid rent at 31 October 20–6 of \$480.
 - 2** The balance of the petty cash book, \$120, had been omitted from the trial balance.
 - 3** \$200 paid to a credit supplier by bank transfer had been recorded in the cash book but not in the supplier's account.
 - 4** Purchases on credit, \$990, have not been entered in the accounting records.
 - 5** The sales journal was overcast by \$1 000.
 - 6** The total of the discount allowed account, \$320, had been omitted from the trial balance (and consequently omitted from the income statement).
- a** Write up the suspense account. Close or balance the account as necessary.
 - b** Calculate the correct profit for the year.
 - c** Prepare a corrected statement of financial position at 31 October 20–6.

- 9 Violetta is a trader. She maintains a full set of accounting records and prepares monthly control accounts.
- a State **two** advantages to Violetta of preparing a monthly sales ledger control account.
- b Explain the meaning of the word 'contra' in connection with control accounts and explain when such an entry is required.

Violetta provided the following information:

	\$
On 1 May 20–1:	
Debit balances in sales ledger	3 020
Credit balances in sales ledger	35

Totals for the month of May 20–1:	
Credit sales	3 965
Cash sales	1 400
Receipts from credit customers	2 695
Returns by credit customers	166
Returns to credit suppliers	205
Discount allowed	55
Discount received	79
Irrecoverable debts	114
Provision for doubtful debts	120
Interest charged by credit supplier	14
Interest charged to credit customer	10
Contra entry	150

On 31 May 20–1:	
Debit balances in sales ledger	?
Credit balances in sales ledger	20

- c Select the relevant figures and prepare the sales ledger control account for May 20–1. Balance the account and bring down the balances on 1 June 20–1.

On 10 May Violetta had the following transactions:

- 1 Wrote off \$95 owing by Wilma as irrecoverable.
 - 2 Transferred the balance of \$200 on Jim's account in the sales ledger to his account in the purchases ledger.
- d Prepare journal entries to record these transactions. Narratives are required.

- 10** Veena's financial year ends on 30 November. All sales are made on credit terms and the selling price is calculated by marking-up the cost price by 20%.

He does not maintain a full set of double entry records but was able to provide the following information:

	\$
On 1 December 20–0:	
Trade receivables	3 620

During the year ended 30 November 20–1:	
Amounts received from trade receivables	36 750
Discount allowed to trade receivables	750
Irrecoverable debts	860

On 30 November 20–1:	
Trade receivables	4 020

- a** Calculate the credit sales for the year ended 30 November 20–1.
- b** Calculate the gross profit for the year ended 30 November 20–1.
- c** Calculate the cost of sales for the year ended 30 November 20–1.
- d** Suggest to Veena three advantages of maintaining a full set of double entry records.

- 11** Jamal is a trader. He does not maintain a full set of accounting records. All money received is banked and all payments are made by credit transfer.

Jamal provided the following information:

	\$
On 1 October 20–3:	
Balance at bank	11 440
Trade receivables	3 166
Trade payables	4 095

During the year ended 30 September 20–4:	
Receipts from credit customers	34 125
Cash sales	19 420
Payments to credit suppliers	?
Credit purchases	49 420
Credit sales	?
Irrecoverable debts	134
Discount allowed to credit customers	875
Discount received from credit suppliers	1 452
Returns from credit customers	2 066
Purchase of non-current assets	12 600
Operating expenses	?

On 30 September 20–4:

Bank overdraft	1 340
Trade receivables	3 256
Trade payables	5 115

- a** Prepare a total trade receivables account to calculate the credit sales.
- b** Prepare a total trade payables account to calculate the payments to credit suppliers.
- c** Prepare a bank account to calculate the operating expenses paid.

- 12** The CK Club was formed some years ago. The club has 200 members and the annual subscription is \$120. The financial year ends on 31 December.

The treasurer of the CK Club provided the following information:

On 1 January 20–7:

- 14 members still owed their subscription for 20–6
- Five members had paid their subscription for 20–7 in advance

During the year ended 31 December 20–7:

- Ten members had paid their outstanding subscription for 20–6
- 187 members had paid their subscription for 20–7
- Six members had paid their subscription for 20–8

On 31 December 20–7 it was decided to write off the subscriptions still outstanding for 20–6 as irrecoverable.

- a** Prepare the subscriptions account for the year ended 31 December 20–7. Balance the account and bring down the balances on 1 January 20–8.
- b** Explain the meaning of each of the following terms:
 - i** subscriptions
 - ii** income and expenditure account
 - iii** receipts and payments account
 - iv** accumulated fund
- c** Explain why it may be necessary for an income statement to be prepared for a club.

- 13** Hamid and Waheed are in partnership. Their financial year ends on 31 August. The partnership agreement provides for the following:

- Interest on capital at 4% per annum
- Interest on drawings at 3% per annum
- Partnership salary for Waheed at \$5 000 per annum
- Residual profits and losses to be shared 3:2

The balances on the partners' accounts on 1 September 20–5 were:

	Hamid \$	Waheed \$
Capital account	90 000	70 000
Current account	1 950 debit	12 050 credit

Hamid invested \$20 000 additional capital on 1 March 20–6. On the same date the partners decided to amend the partnership agreement to increase Waheed's salary to \$7 000 per annum.

During the year ended 31 August 20–6 the partners' drawings were: Hamid \$4 200 and Waheed \$7 200.

Profit for the year ended 31 August 20–6 was \$19 463.

- a** Prepare the profit and loss appropriation account for the year ended 31 August 20–6.
- b** Prepare the partners' current accounts for the year ended 31 August 20–5. Balance the accounts and bring down the balances on 1 September 20–5.
- c** Prepare an extract from the statement of financial position at 31 August 20–6 to show the capital and current accounts of the partners. Full details of the current accounts are not required.

Waheed transferred \$10 000 from his current account to his capital account on 1 September 20–6. On the same date he transferred office equipment, \$2 000, to the business.

- d** Prepare journal entries to record these transactions. Narratives are required.

- 14** Beth and Zara are in partnership. They provide office services to local businesses. Their financial year ends on 31 August. They share profits and losses in the ratio of 3:2 respectively.

The balances on the partners' accounts on 1 September 20–1 were:

	Beth \$	Zara \$
Capital account	36 000	24 000
Current account	4 000 credit	1 500 debit

During the year ended 31 August 20–2 the partners made the following drawings:

	Beth \$	Zara \$
	3 000	4 000

The partially completed profit and loss appropriation account for the year ended 31 August 20–2 showed the following:

	\$	\$
Profit for the year		5 460
Interest on drawings – Beth	60	
Zara	<u>1 80</u>	<u>1 140</u>
		5 600
Interest on capital – Beth	1 440	
Zara	<u>960</u>	
	2 400	
Salary – Zara	<u>5 000</u>	<u>7 400</u>
Residual profit available for distribution		<u>(1 800)</u>

On 31 August 20–2 the following balances remained in the books of the partnership:

	\$
Office furniture and equipment	36 850
Motor vehicles	18 250
Trade payables	4 200
Trade receivables	6 120
Other payables	150
Other receivables	310
Balance at bank	3 780

- a** Prepare the statement of financial position at 31 August 20–2. Full details of the current accounts should be shown within the statement.
- b i** Calculate the rate of interest which has been charged on partners' drawings.
- ii** Calculate the rate of interest allowed on partners' capital.

Beth and Zara are considering converting their partnership into a limited company.

- c i** State **one** advantage to Beth and Zara of converting the partnership to a limited company.
- ii** State **one** disadvantage to Beth and Zara of converting the partnership to a limited company.

As an alternative to converting to a limited company, Beth is considering making a loan to the partnership.

- d** Suggest **two** advantages to Beth of making a 5% five year loan to the partnership rather than investing additional capital.

- 15** Pierre is a furniture manufacturer. His financial year ends on 31 March. He provided the following information:

	At 1 April 20–5	At 31 March 20–6
	\$	\$
Inventory – raw materials	30 460	31 850
work in progress	18 020	17 470
finished goods	62 000	71 060
Factory machinery at cost	154 000	?
Provision for depreciation of factory machinery	61 600	?
Office equipment at cost	32 000	?
Provision for depreciation of office equipment	8 880	?
		\$

For the year ended 31 March 20–6:

Revenue	1 036 500
Purchases of raw materials	364 510
Purchases of finished goods	38 720
Carriage on purchases of raw materials	9 430
Carriage on purchases of finished goods	1 240
Rent, rates and insurance	28 480
Operating expenses	33 780
Wages – factory operatives	296 770
factory supervisors	87 400
office and sales staff	82 300

Additional information:

- At 31 March 20–6 wages of factory operatives accrued amounted to \$1 830.
 - At 31 March 20–6 rates and insurance prepaid amounted to \$1 040.
 - Rent, rates and insurance are apportioned $\frac{3}{4}$ to the factory and $\frac{1}{4}$ to the offices.
 - Operating expenses are apportioned $\frac{2}{3}$ to the factory and $\frac{1}{3}$ to the offices.
 - Factory machinery, \$18 000, was purchased on 1 October 20–5. No machinery was disposed of during the year. Factory machinery is being depreciated at 20% per annum on cost, from the date of purchase.
 - Office equipment is being depreciated at 15% per annum using the reducing balance method.
- Prepare the manufacturing account for the year ended 31 March 20–6.
 - Prepare the income statement for the year ended 31 March 20–6.
 - Name the accounting principle Pierre is observing by valuing his inventories at the lower of cost and net realisable value.
 - Explain how Pierre is observing the principle of matching by making an adjustment for the prepaid rates and insurance.
 - Name the accounting principles Pierre is observing by depreciating his non-current assets.

- 16** The financial year of LS Limited ends on 30 June. The income statement for the year ended 30 June 20–3 showed a profit for the year of \$7 300.
- a** Complete the following partially prepared statement of changes in equity for the year ended 30 June 20–3.

	Ordinary share capital \$	General reserve \$	Retained earnings \$	Total \$
On 1 July 20–6	100 000	15 000	8 900	123 900
Issue of ordinary shares	20 000	.....	.....	.....
Profit for the year	.....	.....	.....	7 300
Ordinary share dividend for year ended 30 June 20–5	.....	.....	.....	(5 000)
Transfer to general reserve	.....	3 000	.....	.....
On 30 June 20–7	.....	.....	.....	.....

The following additional information is provided on 30 June 20–3:

	\$
Land and building at cost	98 000
Fixtures and equipment at cost	50 000
Motor vehicles at cost	36 000
Trade payables	8 450
Trade receivables	16 800
Other payables	870
Other receivables	650
Inventory	15 680
Provision for doubtful debts	420
Provision for depreciation of fixtures and equipment	13 550
Provision for depreciation of motor vehicles	22 500
5% debentures (repayable in 10 years)	20 000
Bank overdraft	5 140

- b** Prepare the statement of financial position at 30 June 20–3.

The directors of LS Limited are hoping to expand the business and estimate that \$45 000 will be required. They discussed whether to issue ordinary shares or 5% debentures and decided to issue 5% debentures.

The directors do not expect the expansion to have any impact on the operating profit for the first three years. After that the annual operating profit is expected to increase by 10%.

- c** State **two** features of ordinary shares.
- d** State **two** features of debentures.
- e** Calculate the annual profit after interest the company is expected to earn over each of the next three years.

- f** Calculate the annual profit after interest the company is expected to earn in Year 4.
- g** Suggest how the ordinary shareholders may be affected if it is decided to issue debentures rather than additional ordinary shares.

17 DC Limited was formed some years ago. The financial year ends on 30 April.

The following information is available:

	\$
On 1 May 20–8:	
Ordinary share capital (300 000 shares of \$0.50 each)	150 000
General reserve	35 000
Retained earnings	13 500
On 31 August 20–8:	
Ordinary share dividend of \$0.05 was paid	
On 1 November 20–8:	
An issue of 5% debentures was made	40 000
For the year ended 30 April 20–9:	
Operating profit for the year	65 500

On 30 April 20–9:

The directors recommended a transfer to general reserve of \$6 000 and the payment of an ordinary share dividend of \$0.10.

- a** Explain each of the following terms:
 - i** issued share capital
 - ii** called-up share capital
 - iii** paid-up share capital.
- b** State **two** differences between ordinary shares and debentures.
- c** Explain why DC Limited retains some profit each year.
- d** State **one** reason why DC Limited pays a dividend to ordinary shareholders.
- e** Calculate the profit for the year ended 30 April 20–9.
- f** Calculate the retained earnings on 30 April 20–9.
- g** Prepare an extract from the statement of financial position on 30 April 20–9 to show the capital and reserves section.

18 Marcus is a trader selling and buying on both cash and credit terms.

He provided the following information on 28 February 20–9:

	\$
Inventory	7 600
Trade payables	5 460
Trade receivables	6 150
Loan repayable 30 September 20–9	4 000
Balance at bank	650

The total sales for the year ended 28 February 20–9 amounted to \$110 000, of which \$36 800 represented cash sales. Marcus allows his credit customers 30 days' credit. The total purchases for the year ended 28 February 20–9 amounted to \$88 800, of which one quarter represented cash purchases. Marcus is allowed 21 days credit by his credit suppliers.

- a**
- i** State the formula for the calculation of the current ratio.
 - ii** Calculate the current ratio.
 - iii** Comment on your answer to **ii**.
- b**
- i** State the formula for the calculation of the liquid (acid test) ratio.
 - ii** Calculate the liquid (acid test) ratio.
 - iii** Comment on your answer to **ii**.
- c**
- i** State the formula for the calculation of the trade receivables turnover.
 - ii** Calculate the trade receivables turnover.
 - iii** Comment on your answer to **ii**.
 - iv** Suggest **two** ways in which the trade receivables turnover may be improved.
- d**
- i** State the formula for the calculation of the trade payables turnover.
 - ii** Calculate the trade payables turnover.
 - iii** Suggest **one** advantage to the credit suppliers of your answer to **ii**.
 - iv** Suggest **one** disadvantage to the credit suppliers of your answer to **ii**.

- 19** The financial year of YZ Limited ends on 30 November. The capital consists of ordinary shares of \$1 each. No additional shares were issued during the year ended 30 November 20–7. The company has no non-current liabilities.

The following information is available:

For the year ended 30 November 20–6:

Gross margin	23.50%
Profit margin	9.25%
Return on capital employed	5.54%

For the year ended 30 November 20–7:

	\$
Revenue	360 000
Expenses	44 500
Gross margin	20.00%

On 30 November 20–7:

	\$
Non-current assets	543 000
Current assets	119 500
Current liabilities	92 500

- a** Suggest **two** reasons for the change in the gross margin over the two years.
- b**
 - i** Calculate the profit for the year ended 30 November 20–7.
 - ii** Calculate the profit margin (to two decimal places) for the year ended 30 November 20–7.
 - iii** State in which year the company had better control of the expenses. Give a reason for your answer.
- c**
 - i** Calculate the return on capital employed.
 - ii** Comment on the change in the return on capital employed over the two years.
 - iii** State, giving reasons, how each of the following transactions would affect the return on capital employed:

Transaction 1 Sale for cash of surplus non-current assets at book value.

Transaction 2 Issue of additional ordinary shares.

Transaction 3 Receipt of a long-term loan.

Glossary

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

Accrued expense is an expense relating to a particular accounting period which is unpaid at the end of that period.

Accrued income is income relating to a particular accounting period which has not been received at the end of that period.

Accumulated fund consists of the surpluses (less any deficits) which have accumulated over the life of the organisation. It replaces capital in the statement of financial position of a club or society.

Analysis columns are used to divide the payments into different categories.

Assets represent anything owed by or owing to the business.

Balance on a ledger account is the difference between the debit side and the credit side.

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

Bank reconciliation statement is a document prepared by a business to explain why the updated bank balance in the cash book does not agree with the balance on the bank statement.

Bank statement is a copy of a customer's account in the books of the bank which is sent to the customer at regular intervals.

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

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

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

Called up capital is that part of the issued share capital for which payment has been requested from shareholders.

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

Capital expenditure is money spent on purchasing, improving or extending non-current assets.

Capital receipt is money received by a business from a source other than the normal trading activities.

Carriage inwards is the cost of bringing the goods to the business.

Carriage is the cost of transporting goods.

Carriage outwards is the cost of delivering the goods to the customer.

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

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

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

Contra entries may be referred to as inter-ledger transfers or set-offs and are when a transfer is made from an account in the sales ledger to an account of the same business/person in the purchases ledger.

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

Cost of production is prime cost plus factory overheads, adjusted for any work in progress at the start and at the end of the year. It is the total cost of manufacturing the goods completed.

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

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

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

Debenture is a long-term loan which has a fixed rate of interest, payable irrespective of the profit of the company.

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

Debt written off may be recovered if a credit customer pays some, or all, the amount owed, after the amount was written off.

Deficit arises when the expenses of a non-trading organisation exceed the gains.

Depreciation is an estimate of the loss in value of a non-current asset over its expected working life.

Dishonoured cheque is a cheque received which the debtor's bank refuses to pay.

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

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

Equity is the total funds provided by the shareholders of the company.

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.

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

Gross profit is the difference between the selling price and the cost of those goods.

Historic cost principle means that all assets and expenses are initially recorded at their actual cost.

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.

Income and expenditure account is prepared annually by a non-trading organisation. It compares the gains and the expenses to calculate the surplus or deficit.

Income statement is a statement prepared for a trading period to show the gross profit and profit for the year.

Inventory is the goods a business has available for resale.

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

Irrecoverable debt is an amount owing to a business which will not be paid by the credit customer.

Issued share capital is the amount of capital issued to the shareholders.

Journal is a book of prime entry used to record transactions which cannot be recorded in any other book of prime entry.

Liabilities represent anything owed by the business.

Limited company is a legal entity which has a separate identity from its shareholders, whose liability for the company's debts is limited.

Liquidity ratios measure the ability of the business to turn assets into cash to pay its short term debts.

Manufacturing account is part of the annual financial statements and is used to calculate the cost of goods produced.

Margin is the gross profit expressed as a percentage of the selling price.

Mark-up is the gross profit expressed as a percentage of cost price.

Matching principle means that the revenue of the accounting period is matched against the costs of the same period.

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.

Money measurement principle means that only information which can be expressed in terms of money can be recorded in the accounting records.

Net book value of a non-current asset is the cost price minus the total depreciation to date.

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

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

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

Non-trading organisation is an organisation formed to provide facilities and services for members. They are not formed with the aim of making a profit.

Paid up capital is that part of the called up share capital for which the company has received payment from shareholders.

Partnership is a business in which two or more people work together as owners with a view to making profits.

Partnership agreement is a document setting out the rules under which the partners will operate the business, including profit-sharing arrangements.

Partnership appropriation account is part of the year-end financial statements. It shows the division of the profit or loss between the partners.

Petty cash book is used to record low-value cash payments.

Prepaid expense is an expense paid during the financial year which relates to a future accounting period.

Prepaid income is income received during the financial year which relates to a future accounting period.

Prime cost is the total of the direct materials, direct labour and direct expenses. It is the cost of the essentials necessary for production.

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

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.

Profitability ratios measure the performance of the business by comparing the profit to other figures in the same set of financial statements.

Provision for doubtful debts is an estimate of the amount which a business will lose in a financial year because of irrecoverable debts.

Prudence principle means that profits and assets should not be overstated and losses and liabilities should not be understated. 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.

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.

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

Purchases ledger control account is an account summarising all the accounts of the trade payables.

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.

Rate of inventory turnover is the number of times a business replaces its inventory in a given period of time.

Realisation principle means that revenue is only regarded as being earned when the legal title to goods passes from the seller to the buyer.

Receipt is a written acknowledgement of money received and acts as proof of payment.

Receipts and payments account is a summary of the cash book which is prepared annually by a non-trading organisation.

Redeemable preference shares are those preference shares which must be bought back by the company at an agreed date and for an agreed price.

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.

Residual profit is the profit remaining after adjusting the profit for the year for interest on drawings, interest on capital and partners' salaries. It is divided between the partners in the agreed profit-sharing ratio.

Residual value is the value of a non-current asset at the end of its useful life.

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.

Revenue expenditure is money spent on running a business on a day-to-day basis.

Revenue receipt is money received by a business from normal trading activities.

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.

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

Sales ledger control account is an account summarising all the accounts of the trade receivables.

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.

Service business is one which provides a service.

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

Statement of affairs is a summary of the financial position of a business on a certain date. It is prepared instead of a statement of financial position when double entry records have not been maintained.

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

Straight line method of depreciation is where the same amount of depreciation is charged each year.

Subscriptions are amounts members of an organisation pay, usually annually, to use the facilities provided by the club or society.

Surplus arises when the gains of a non-trading organisation exceed the expenses.

Suspense account is a temporary account opened in order to make the totals of a trial balance agree.

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

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).

Trading business is one which buys and sells goods.

Trial balance is a list of balances on the accounts in the ledger at a certain date.

Work in progress is the goods which are partly completed at the end of the financial year.

Index

- accounting, definition 3, 345
- accounting entity principle 121
- accounting equation 4–6
- accounting ratios 313
- accounting rules 121–9
- accounting statements
 - limitations 326–7
 - users 325–6
- accruals 133
- accruals principle 123
- accrued expenses 133–5, 345
- accrued income 142–4, 345
- accumulated depreciation 163
- accumulated fund 267, 272–3, 345
- adjustments, year-end 133, 297
- analysis and interpretation
 - inter-firm comparison 322–4
 - limitations of accounting statements 326–7
 - liquidity ratios 317–21, 346
 - overview 313–14
 - profitability ratios 315–17, 347
 - users of accounting statements 325–6
- analysis columns 54, 345
- appropriation accounts 280, 347
- asset accounts 159
- assets
 - definition 4, 345
 - recorded in ledger accounts 13–14
 - recorded in statements of affairs 242
 - recorded in statements of financial position 111–12
 - see also* current assets; non-current assets
- balances, opening 138–41, 147–9
- balancing ledger accounts 17–18, 345
- bank charges 196
- bank interest 196
- bank managers 325
- bank overdrafts 43–4, 201–2, 345
- bank reconciliation
 - and overdrafts 201–2
 - differences between records 195–6
 - stages of 197–200
- bank reconciliation statements 197, 345
- bank statements 195–6, 345
- boards of directors 303
- book-keeping 3, 345
 - see also* double entry book-keeping
- books of prime (original) entry 40, 79, 345
- business entity principle 121, 345
- called up capital 304, 345
- capital
 - definition 4, 112, 345
 - employed 313
 - of clubs and societies 267
 - owned 313
 - profit calculated by changes in 242–3
 - working 313
- capital accounts 17, 103–4, 242–3, 281
- capital expenditure 126, 154, 345
- capital receipts 126–7, 165, 345
- carriage 23, 345
- carriage inwards 23, 345
- carriage outwards 23, 345
- cash
 - floats 53
 - goods purchased for 18
 - goods sold for 20
 - not yet credited 195
- cash books
 - bank overdrafts in 43–4
 - contra entries in 40–3
 - errors in 196
 - items not recorded in 196
 - three column 44–5
 - two column 40
 - see also* petty cash books
- cash discount 44–5, 68, 252, 345
- cheques
 - dishonoured 45, 196, 346
 - goods purchased for 18
 - goods sold for 20
 - not yet credited 195
 - not yet presented 195
 - payments by 73, 345
- closing capital 242–3
- closing work in progress 294
- clubs and societies
 - accounting terms used by 269
 - as non-trading organisations 262
 - calculation of accumulated fund 272–3
 - calculation of sales and purchases 271–2
 - members 326
 - membership subscriptions 262, 270–1, 348
 - preparation of income and expenditure accounts 265–7
 - preparation of income statements 264
 - preparation of receipts and payments accounts 262–3
 - preparation of statements of financial position 267–9
- combined expense accounts 141–2
- commission, errors of 34, 218
- comparability of financial statements 125
- compensating errors 35, 218
- complete reversal, errors of 34, 218
- concepts (accounting principles) 121
- conservatism (prudence principle) 124, 347
- consistency principle 122, 345
- contra entries
 - in cash books 40–3, 345
 - in control accounts 235–7, 345
- control accounts
 - advantages 229
 - balances on both sides of 234–5
 - contra entries 235–7, 345
 - purchases ledger 232–3, 347
 - purpose 229
 - sales ledger 229–31, 347
- conventions (accounting principles) 121
- correction of errors 218–21
- cost of production 292, 345
- cost of sales 97
- costs, historic 326
- credit
 - goods purchased on 18–19, 82
 - goods sold on 20, 79
- credit balances 234–5
- credit cards 40
- credit control 174
- credit limits 174
- credit notes 71–2, 345
- credit purchases 249
- credit sales 248
- credit side of a ledger account 11
- credit transfers 40, 196
- creditors, trade 5, 19
- creditors ledgers (purchases ledgers) 39, 347
- current accounts 281–2
- current assets 112, 136, 345
- current liabilities 112, 133, 345
- current ratio 317–18
- customers 326
- debentures 305, 345
- debit balances 234–5
- debit cards 40
- debit notes 69–71, 345
- debit side of a ledger account 11
- debtors, trade 5, 20
- debtors ledgers (sales ledgers) 39, 347
- debts
 - irrecoverable 172, 174, 346
 - written off 172–4, 345

- debts recovered accounts 172
- deficits 265, 345
- depletion of non-current assets 155
- depreciation
 - accumulated 163
 - causes 154–5
 - definition 154, 346
 - in the financial statements 162–5
 - in the ledger 159–62
 - methods of calculating 155–8
- depreciation to date 163
- deterioration of non-current assets 154
- direct debits 40, 196
- direct expenses 291
- direct labour costs 291
- direct material costs 291, 292
- direct wages 291
- directors, boards of 303
- discount
 - cash 44–5, 68, 252, 345
 - trade 68, 82, 85, 348
- discount allowed 44–5
- discount received 44–5
- dishonoured cheques 45, 196, 346
- disposal of non-current assets 165–7
- dividends 303, 304–5, 306
- double entry book-keeping
 - advantages 242
 - definition 3, 346
 - principles 11–12
 - see *also* ledger accounts
- drawings 17, 346
- drawings accounts 282
- dual aspect principle 122, 347

- economic reasons for depreciation 154
- electronic payments 40
- employees 326
- equity 305, 346
- errors
 - compensating 35, 218
 - correction of 218–21
 - effects on profit 222–3
 - effects on statements on financial position 223
 - of commission 34, 218
 - of complete reversal 34, 218
 - of omission 34, 218
 - of original entry 35, 218
 - of principle 35, 218
- excess of expenditure over income (deficit) 265, 345
- excess of income over expenditure (surplus) 265, 348
- expense accounts
 - combined 141–2
 - opening balances of 138–41
- expenses
 - accrued 133–5, 345
 - in ledger accounts 14–16
 - manufacturing 291
 - prepaid 136–8
- external users of accounting statements 325–6

- factory overheads 291
- financial statements 3, 125–6
- financial year 7
- fixed instalment method of depreciation (straight line method) 155–6, 159–62, 348
- floats, cash 53
- folio numbers 11
- fundraising activities 265

- general journals see journals (general journals)
- general ledgers (nominal ledgers) 39, 346
- going concern principle 122, 346
- goods purchased for cash or cheque 18
- goods purchased on credit 18–19, 82
- goods returned 21–3, 83
- goods sold for cash or cheque 20
- goods sold on credit 20, 79
- goodwill 112, 346
- government departments 326
- gross margin 315–16
- gross profit 97, 254, 295, 346
- gross profit as a percentage of turnover (gross margin) 315–16

- historic cost principle 122, 154, 346
- historic costs 326
- horizontal format
 - income statements 97, 99
 - statements of financial position 113

- imprest system 53, 346
- income
 - accrued 142–4
 - in ledger accounts 14–16
 - prepaid 144–6, 347
- income accounts, opening balances of 147–9
- income and expenditure accounts 265–7, 346

- income statements
 - definition 3, 95, 346
 - horizontal and vertical formats 97–8, 99–100
 - of clubs and societies 264
 - of limited companies 305
 - of service businesses 105–6
 - profit and loss section of 99–101, 296–7
 - recording accrued and prepaid expenses in 133–8
 - recording accrued and prepaid income in 142–6
 - recording depreciation in 162–3
 - recording irrecoverable debts in 172
 - recording provision for doubtful debts in 175–80
 - trading section of 97–9, 264, 295–6
 - transferring ledger account totals to 102–4
- incomplete records 242–57
- indirect factory expenses 291
- intangible non-current assets 111–12
- interest, bank 196
- inter-firm comparison 322–4
- inter-ledger transfers (contra entries) 235–7, 345
- internal users of accounting statements 325
- international accounting standards 125–6
- interpretation see analysis and interpretation
- inventory
 - at the end of the year 103
 - at the start of the year 103
 - definition 5, 346
 - manufacturing 294
 - of stationery etc. 138
 - turnover 255–6, 319, 347
 - valuation 127–9
- inventory accounts 18, 103
- invoices 68–9, 346
- irrecoverable debts 172, 174, 346
- irrecoverable debts accounts 172
- issued share capital 304, 346

- journals (general journals)
 - correction of errors 218–21
 - definition 207, 346
 - non-regular transactions 210–18
 - opening entries 207–9
 - purchase and sale of non-current assets 209–10

- labour costs 291
- ledger accounts
 - balancing 17–18
 - in partnerships 281–4
 - interpretation 25–6
 - layout 11, 24–5
 - recording assets and liabilities in 13–14
 - recording carriage inwards and carriage outwards in 23
 - recording drawings in 17
 - recording expenses and income in 14–16
 - recording sales, purchases and returns in 18–23
 - transferring totals to income statements 102–4
 - see *also* cash books; nominal ledgers (general ledgers); purchases ledgers; sales ledgers
- ledgers, definition 11
- lenders 325
- liabilities
 - current 112, 133, 345
 - definition 4, 346
 - non-current 112, 346
 - recorded in ledger accounts 14–16
 - recorded in statements of affairs 242
 - recorded in statements of financial position 112–15
- lifespan of non-current assets 154
- limited companies
 - debentures 305, 345
 - definition 303, 346
 - income statements 305
 - nature of 303
 - share capital 304–5
 - statements of changes in equity 306–7
 - statements of financial position 307–8
- liquid (acid test) ratio 318
- liquidity ratios 317–21, 346
- loan notes (debentures) 305, 345
- loans, from partners 278–9
- loss for the year 99, 103–4

- managers 325
- manufacturing accounts
 - adjustment for work in progress 294
 - calculation of unit cost 295
 - definition 291, 346
 - preparation 292–3
- manufacturing businesses
 - elements of cost of manufacture 291
 - preparation of profit and loss section of income statement 296–7
 - preparation of statement of financial position 297
 - preparation of trading section of income statement 295–6
 - year-end adjustments 297
 - see *also* manufacturing accounts
- margin 254, 346
- mark-up 254, 346
- matching principle
 - applied to expenses 133, 136
 - applied to income 142, 144
 - definition 123, 346
- material costs 291, 292
- materiality principle 123, 346
- membership subscriptions 262, 270–1, 348
- money measurement principle 124, 346
- money paid 54
- money received 54

- narratives, in journals 207
- net book value 154, 157, 346
- net current assets 313
- net purchases 97
- net realisable value of inventory 127
- nominal accounts 39
- nominal ledgers (general ledgers) 39, 346
- non-current assets
 - capital expenditure on 126
 - definition 346
 - disposal of 165–7
 - low-value items 123
 - recording purchase and sale of 209–10
 - tangible and intangible 111–12
 - see *also* depreciation
- non-current liabilities 112, 346
- non-redeemable preference shares 305
- non-regular transactions 210–18
- non-trading organisations 262, 346
- see *also* clubs and societies

- obsolescence of non-current assets 154
- omission, errors of 34, 218
- opening balances
 - expense accounts 138–41
 - income accounts 147–9
- opening capital 242–3
- opening journal entries 207–9
- opening work in progress 294

- ordinary shares 305
- original entry, errors of 35, 218
- ‘other payables’ 135
- ‘other receivables’ 137
- overdrafts, bank 43–4, 201–2, 345
- overdue accounts 174
- overheads, factory 291
- owners, business 325
- owner’s equity (capital) see capital

- paid up capital 304, 346
- partnership agreements 279, 346
- partnership appropriation accounts 280, 347
- partnerships
 - advantages and disadvantages 278
 - agreements 279, 346
 - definition 278, 346
 - loans from partners 278–9
 - partners’ ledger accounts 281–4
 - preparation of appropriation accounts 280–1
 - preparation of statements of financial position 284–5
- petty cash books
 - definition 53, 347
 - imprest system 53–4
 - layout 54
 - preparation 54–7
- petty cash vouchers 53
- physical deterioration of non-current assets 154
- ploughing back profits 306
- potential buyers of a business 325
- preference shares 304–5
- prepaid expenses 136–8, 347
- prepaid income 144–6, 347
- prepayments 136
- prime cost 292, 347
- prime entry, books of 40, 79, 345
- principle, errors of 35, 218
- principle of consistency 122, 345
- principle of duality 122, 347
- principle of prudence 124, 347
- private limited companies 303
- production, cost of 292, 345
- profit
 - calculated by changes in capital 242–3
 - different definitions of 326
 - effect of correcting errors 222–3
 - for the year 99, 103, 347
 - gross 97, 254, 295, 346
 - margin 316–17
 - ploughing back 306
 - residual 280, 347

- profit and loss section of income statements 99–101, 296–7
- profit for the year 99, 103, 347
- profit margin 316–17
- profitability ratios 315–17, 347
- provision for depreciation accounts 159
- provision for doubtful debts
 - adjusting 177–80
 - creating 175–6
 - definition 174–5, 347
- prudence principle 124, 347
- public limited companies 303
- purchases accounts 18–19
- purchases journals (purchases books; purchases day books) 82, 347
- purchases ledger control accounts 232–3, 347
- purchases ledgers 39, 347
- purchases returns 21
- purchases returns journals (purchases returns books) 83–5, 347

- rate of inventory turnover 255–6, 319, 347
- raw materials 291, 292
- realisation principle 124, 347
- receipts 74, 347
- receipts and payments accounts 262–3, 347
- reconciliation, bank *see* bank reconciliation
- redeemable preference shares 305, 347
- reducing balance method of depreciation 157, 347
- relevance of financial statements 125
- reliability of financial statements 125
- residual profit 280, 347
- residual value 156, 347
- retained earnings 306
- return on capital employed (ROCE) 315
- returned goods 21–3, 83
- returns inwards 21
- returns inwards books (sales returns journals) 80–2, 347
- returns outward 21
- returns outward books (purchases returns journals) 83–5, 347
- revaluation method of depreciation 158, 162, 347
- revenue 96
- revenue expenditure 126, 347
- revenue receipts 127, 347
- ROCE (return on capital employed) 315
- royalties 291

- sales, cost of 97
- sales accounts 20–1
- sales journals (sales books; sales day books) 79, 347
- sales ledger control accounts 229–31, 347
- sales ledgers 39, 347
- sales returns 21
- sales returns journals (sales returns books) 80–2, 347
- service businesses 105–6, 347
- set-offs (contra entries) 235–7, 345
- share capital 304
- shareholders 303
- shares 303–5
- societies *see* clubs and societies
- sole traders 4, 95
- standing orders 40, 196
- statements of account 72–3, 348
- statements of affairs 242–53, 348
- statements of changes in equity 306–7
- statements of financial position
 - content 6–7
 - definition 3, 111, 348
 - effect of correcting errors 223
 - horizontal and vertical formats 113–14
 - of clubs and societies 267–9
 - of limited companies 307–8
 - of manufacturing businesses 297
 - of partnerships 284–5
 - recording accrued and prepaid expenses in 133–5
 - recording accrued and prepaid income in 142–6
 - recording assets in 111–12
 - recording depreciation in 163
 - recording liabilities in 112–15
 - recording provision for doubtful debts in 175–80
- stationery, inventory of 138
- straight line method of depreciation 155–6, 159–62, 348
- subscriptions, membership 262, 270–1, 348
- subscriptions accounts 270
- subsidiary books (books of prime entry) 40, 79, 345
- surpluses 265, 348
- suspense accounts 219, 348

- ‘T’ account format 24
- tangible non-current assets 111
- three column cash books 44–5
- three column running balance accounts 24–5
- time, depreciation over 297

- timing differences
 - and accounting statements 327
 - and bank statements 195
- total accounts *see* control accounts
- total trade payables accounts (purchases ledger control accounts) 232–3, 347
- total trade receivables accounts (sales ledger control accounts) 229–31, 347
- trade creditors 5, 19
- trade debtors 5, 20
- trade discount 68, 82, 85, 348
- trade payables 5, 325, 348
- trade payables ledgers (purchases ledgers) 39, 347
- trade payables/purchases ratio 321
- trade payables turnover 321
- trade receivables 5, 348
- trade receivables ledgers (sales ledgers) 39, 347
- trade receivables/sales ratio 320
- trade receivables turnover 320
- trade unions 326
- trading businesses 105, 348
- trading section of income statements 97–9, 264, 295–6
- treasurers of clubs and societies 262
- trial balances
 - and financial statements 95
 - definition 30, 348
 - errors affecting 219
 - errors in 34–5
 - errors not shown by 218
 - preparation 30–3
 - purpose 30
- two column cash books 40

- understandability of financial statements 125–6
- unit cost 295

- vertical format
 - income statements 98, 100
 - statements of financial position 114

- wages 291
- wear and tear on non-current assets 154
- work in progress 294, 348
- working capital 313
- working capital ratio 317–18
- written down value (net book value) 154, 157, 346
- written off debts 172–4, 345

- year-end adjustments 133, 297