CA

The Institute of
Chartered Accountants
of Pakistan

2013

INTRODUCTION TO ACCOUNTING

STUDY TEXT

CAF- 01

ICAP

P

Introduction to accounting

The Institute of
Chartered Accountants
of Pakistan

First edition published by
Emile Woolf International
Bracknell Enterprise & Innovation Hub
Ocean House, 12th Floor, The Ring
Bracknell, Berkshire, RG12 1AX United Kingdom
Email: info@ewiglobal.com
www.emilewoolf.com

C

Contents

S

Syllabus objective and learning outcomes

CERTIFICATE IN ACCOUNTING AND FINANCE

INTRODUCTION TO ACCOUNTING

Objective
To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

Learning Outcome	
On the successful completion of this paper candidates will be able to:	
1	understand the nature of accounting, elements of accounts and double entry rules.
2	identify financial transactions and make journal entries.
3	prepare general ledger accounts and a trial balance.
4	make period end adjustments prior to the completion of financial statements
5	prepare basic financial statements
6	prepare partnership accounts and account for transactions of admission, retirement etc.

Grid	Weighting
Introduction to accounting and book keeping	40
Adjustments prior to completion of financial statements	20
Preparation of final accounts of sole traders	20
Accounting for partnerships	20
Total	**100**

Contents	Level	Learning Outcome
Introduction to accounting and bookkeeping		
Introduction to accounting		
Meaning of business	1	**LO1.1.1:** Explain the characteristic of a business **LO1.1.2:** Classify transactions that fall under the definition of business transactions
Mode of business organization (meaning) - sole proprietorship; partnership; limited company	1	**LO1.2.1:** Describe the key features of sole proprietorship, partnership and limited company **LO1.2.2:** Differentiate the features of sole proprietorship, partnership and limited company
Fundamental accounting concepts - accrual, consistency, true and fair view, materiality, prudence, completeness, going concern, substance over form	2	**LO1.3.1:** Describe and illustrate the main concepts, namely, accrual, consistency, and completeness **LO1.3.2:** Demonstrate familiarity with the concepts of true and fair view, materiality, prudence, going concern and substance over form **LO1.3.3:** Apply the concepts of accrual, consistency and completeness to simple and well explained circumstances.
Financial statements- components, responsibility, presentation, users	1	**LO1.4.1:** List the components of a set of financial statements. **LO1.4.2:** Explain the characteristics and purpose of the statement of financial position and the statement of comprehensive income. **LO1.4.3:** Identify the responsibility to prepare and present financial statements **LO1.4.4:** Describe the basic presentation layout of statements of financial position and statements of comprehensive income. **LO1.4.5:** Identify users of financial information and describe how the information is useful to them

Contents	Level	Learning Outcome
Bookkeeping		
Elements of financial statements (meaning) - Assets, liabilities, equity, income, expense	2	**LO2.1.1:** Define and give examples of assets, liabilities, equity, income and expenses **LO2.1.2:** Apply the underlying concepts of assets, liabilities, income and expenses in simple and well explained circumstances.
Chart of accounts	1	**LO2.2.1:** Understand the meaning of a chart of accounts **LO2.2.2:** Explain the purpose of establishing a chart of accounts **LO2.2.3:** Construct a chart of accounts using given data
Double entry system, accounting equation and rules of debit and credit	2	**LO2.3.1:** Understand and apply, the accounting equation (Assets = Liabilities + Equity) in simple practical and common scenarios **LO2.3.2:** identify financial and non-financial transactions in a well defined scenario **LO2.3.3:** Understand and apply the concept of double entry accounting to simple and common business transactions
General journal	2	**LO2.4.1:** List and describe the basic contents of the general journal **LO2.4.2:** prepare and use the general journal to record journal entries
Sales journal and the sales ledger	2	**LO2.5.1:** Describe the basic contents of the sales day book and the customer/debtors ledger **LO2.5.2:** record entries in the sales day book and the customer/debtors ledger.
Purchase journal and the purchase ledger	2	**LO2.6.1:** Describe the basic contents of the purchase journal and purchase ledger/creditors ledger. **LO2.6.2:** record entries in the purchase journal and purchase ledger/creditors ledger.

Contents	Level	Learning Outcome
General ledger and trial balance		
General ledger	2	**LO3.1.1:** Describe the main features of the general ledger **LO3.1.2:** Post entries in the general ledger
Trial balance	2	**LO3.2.1:** Understand the purpose of the trial balance **LO3.2.2:** Understand and demonstrate mapping between general ledger balances and the trial balance **LO3.2.3:** Identify the limitations of a trial balance.
Adjustments before final accounts		
Straight line, diminution balance, sum-of-years-digit, number of units produced methods and recording of depreciation on fixed Assets	2	**LO4.1.1:** Calculate depreciation expense using straight line, diminution balance, sum-of-digits and number of units produced methods **LO4.1.2:** Post journal entry to record depreciation expense
Allowance for bad debts and write off	2	**LO4.2.1:** Estimate allowance for bad debts based on a given policy **LO4.2.2:** Post journal entry to record bad debt expense **LO4.2.3:** Compute and record write off and understand its impact on allowance for bad debts.
Prepayments and accruals	2	**LO4.3.1:** Understand the matching concept that applies to prepayments and accruals. **LO4.3.2:** Post journal entries and ledger entries for prepayments and accruals. **LO4.3.3:** Post adjusting entries to recognize revenues or expenses

Contents	Level	Learning Outcome
Adjustments before final accounts (continued)		
Closing entries of inventory	2	**LO4.4.1:** Understand the concepts of periodic and perpetual inventory system **LO4.4.2:** Identify the need to post the adjustment entries of inventory at the end of the period in case of periodic inventory system. **LO4.4.3:** Pass the adjusting entries and ledger entries at the end of the period.
Bank reconciliation and related adjustments	2	**LO4.5.1:** Understand the need for a bank reconciliation **LO4.5.2:** Identify the main reasons for differences between the cash book and bank statements. **LO4.5.3:** Prepare a bank reconciliation statement in the circumstance of simple and well explained transactions. **LO4.5.4:** Correct cash book errors and post journal entries after identifying the same in bank reconciliation statement.
Control accounts - reconciliation and adjustments	2	**LO4.6.1:** Understand the mapping between control accounts and subsidiary ledger for accounts receivable and accounts payable. **LO4.6.2:** Prepare control accounts and subsidiary ledger from well explained information provided. **LO4.6.3:** Perform control accounts reconciliation for accounts receivable and accounts payable. **LO4.6.4:** Identify errors after performing reconciliation **LO4.6.5:** Identify and correct errors in control account and subsidiary ledgers.

Contents	Level	Learning Outcome
Adjustments before final accounts (continued)		
Correction of errors in record keeping	2	**LO4.7.1:** Identify the types of error which may occur in a record keeping system **LO4.7.2:** Calculate and understand the impact of errors on the financial statements within a reporting period **LO4.7.3:** Prepare journal entries to correct errors that have occurred within a reporting period
Preparation of final accounts of a sole trader		
Statement of financial position	2	**LO5.1.1:** Understand the purpose of the statement of financial position **LO5.1.1:** Prepare simple statements of financial position from information provided.
Statement of comprehensive income	2	**LO5.1.1:** Understand the purpose of the statement of comprehensive income **LO5.1.1:** Prepare simple statements of comprehensive income from information provided
Receipt and payment accounts	2	**LO5.1.1:** Understand the purpose of a receipts and payments account. **LO5.1.1:** Prepare a simple receipts and payments account from information provided.

Contents	Level	Learning Outcome
Accounting for partnerships		
Preparation of partnership accounts	2	**LO6.1.1:** Define a partnership and state its essential elements **LO6.1.1:** Understand goodwill **LO6.1.1:** Prepare • Capital account • Current account **LO6.1.1:** Prepare a profit and loss account and a statement of financial position of a partnership.
Admission and amalgamation	2	**LO6.1.1:** Process the necessary adjustments on the admission of a new partner, namely: • Revaluation of assets and liabilities of the firm • Treatment of goodwill • Application of new profit sharing ratio **LO6.1.1:** Prepare the nominal accounts, profit and loss account and statement of financial position upon amalgamation of two partnerships.
Retirement, death, dissolution, liquidation	2	**LO6.1.1:** Make journal entries in the case of the dissolution of a partnership to record: • transfer and sale of assets and liabilities to third parties and partners, • payment of realization expenses, • closing of the realization account and • settlement of partners' capital account. **LO6.1.1:** Process the necessary adjustments on the death or retirement of a partner: • adjustments relating to goodwill, accumulated reserves and undistributed profits • revaluation account • adjustment and treatment of partners' capital; • application of new profit sharing ratio

CHAPTER 1

Introduction to business and accounting

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 1	**Understand the nature of accounting, elements of accounts and double entry rules.**
LO1.1.1	*Meaning of business:* Explain the characteristic of a business
LO1.1.2	*Meaning of business:* Classify transactions that fall under the definition of business transactions
LO1.2.1	*Mode of business organisation:* Describe the key features of sole proprietorship, partnership and limited company
LO1.2.2	*Mode of business organisation:* Differentiate the features of sole proprietorship, partnership and limited company
LO1.4.1	*Financial statements:* List the components of a set of financial statements.
LO1.4.2	*Financial statements:* Explain the characteristics and purpose of the statement of financial position and the statement of comprehensive income.
LO1.4.3	*Financial statements:* Identify the responsibility to prepare and present financial statements
LO1.4.4	*Financial statements:* Describe the basic presentation layout of statements of financial position and statements of comprehensive income.
LO1.4.5	*Financial statements:* Identify users of financial information and describe how the information is useful to them

1 TYPES OF BUSINESS

Section overview

- Types of business entity
- Advantages and disadvantages of different types of business entity

1.1 Types of business entity

The word ***business*** is used in different contexts. It is used to describe an economic process and to describe entities that participate in that process.

Definitions: Business

Business is an economic system where goods and services are exchanged for one another or for money.

There is no single definition of a business. Some possible definitions include the following.

Definitions: A business entity

A business entity is a commercial organisation that aims to make a profit from its operations.

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return to investors or other owners.

An organisation or enterprising entity engaged in commercial, industrial or professional activities.

Characteristics of business

All businesses share certain characteristics.

- Businesses exist to make profits.
- Businesses make profit by supplying goods or services to others (customers).
- Businesses that supply goods might make those goods or buy them from other parties (for example, food retailers buy food off food producers and sell it to their customers).
- Profit is the reward for accepting risk. For example, a food retailer might buy 100 kgs of bananas but might not be able to sell them all. In other words, he runs the risk of paying for bananas that he will have to throw away. He is willing to run the risk because if he does not buy bananas he has no chance of selling them for a profit.
- The profit of a business belongs to its owners. A share of the profits might be paid to the owners periodically.

There are three main types of business entity:

- a sole proprietorship;
- a business partnership;
- a company (a limited liability company).

Sole proprietor or Sole trader

The business of a sole trader is owned and managed by one person. Any individual, who sets up in business on his/her own, without creating a company, is a sole trader.

Important features of a sole trader business are as follows.

- There is no legal distinction between the proprietor and the business.
  - The owner of the business is personally liable for any unpaid debts and other obligations of the business.
  - The profits of a sole proprietor business are treated as income of the owner, for the purpose of calculating the amount of tax payable on income.
  - The proprietor is wholly liable for the debts of the business, borrowing money in his/her own name.
  - When a sole proprietor dies the business ceases to exist (there is no perpetual succession as the business does not exist independently of the owner).
- The profits of the business belong to the sole proprietor.
- The assets of the business belong to the sole proprietor.
- The sole proprietor can extract cash and other assets from the business (known as drawings).
- The business may be financed by a mixture of owner's capital (including retained earnings) and loans.
- A sole proprietor business might employ many people but it is usual for the proprietor to take a very active role in the business exercising a high degree of control.
- A sole proprietorship business can be sold as a going concern by its owner.

Example:

If a business owes a supplier Rs. 1,000 for goods it has purchased, but does not have the money to make the payment, the owner of the business is personally liable to make the payment out of his/her other assets.

Partnership

A business partnership is an entity in which two or more individuals (partners) share the ownership of a business. Each partner contributes funds ('capital') to set up the business.

Partnerships in Pakistan are subject to rules set out in The Partnership Act 1932.

Definition: Partnership

The relationship between persons who have agreed to share the profits of a business carried on by all or any of them, acting for all.

Important features of a partnership are as follows:

- There must be an association of two or more persons to carry on a business.
- The owners of the business are personally liable as individuals for the unpaid debts and other obligations of the business.
- The profits of a partnership are shared between the partners in an agreed way, and each partner's share of the profits is treated as personal income, for the purpose of calculating the amount of tax payable on his or her income.
- When a partner dies the partnership comes to an end (there is no perpetual succession).
- The profits of the business belong to the partners in an agreed ratio.
- The assets of the business belong to the partners in an agreed ratio.
- The partners can extract cash and other assets from the business (known as drawings).
- The business may be financed by a mixture of partners' capital (including retained earnings) and loans.
- A partnership might employ many people but it is usual for the partners to take a very active role in the business exercising a high degree of control.
- A partnership can be sold as a going concern by its owner.

Example:

If a partnership owes a supplier Rs. 1,000 for goods it has purchased, but does not have the money to make the payment, the partners are personally liable to make the payment.

Company (limited liability company)

A company is a special form of business entity. Nearly all companies in business are limited liability companies with liability limited by shares.

- Ownership of the company is represented by ownership of shares.
  - A company might issue any number of shares, depending largely on its size. A large stock market company will have millions of shares in issue.
  - If a company has issued 100 shares, ownership of 40 shares would represent 40% of the ownership of the company.
  - Large companies usually have a large number of shares in issue, and a large number of shareholders. This means that the owners (the shareholders) do not manage the business. Managers are employed (the executive directors of the company) to run the company on behalf of the shareholders. This is sometimes referred to as the 'separation of ownership from control'.
- Unlike a sole trader or a partnership, a company has the status of a 'legal person' in law.
  - A company can be the legal owner of business assets, and can sue or be sued in its own right in the law.
  - A company is also taxed separately from its owners (the profits of a sole trader and business partners are taxed as personal income of the business owners).
  - A company is liable for its own debts. If a company owes a supplier Rs. 1,000 for goods it has purchased, but does not have the money to make the payment, the company alone is liable for the debt. The owners (shareholders) are not personally liable to make the payment. The liability of shareholders is limited to the amount of capital they have invested or agreed to invest in the company.

When the shareholders are not the managers of their company, it becomes essential that information about the position and performance of the company should be reported regularly by the management to the shareholders. This is the main purpose of financial reporting.

However, there might be a risk that the managers of a company would make false reports to shareholders about the financial position and performance of the company. To reduce this risk, the laws on financial reporting and auditing are generally much stricter for companies than for other types of business entity.

1.2 Advantages and disadvantages of different types of business entity

The advantages and disadvantages of operating as each type of business entity may be summarised briefly as follows:

Business structure	Sole trader	Partnership	Company
Owned by…	One person	Several individuals working together	Shareholders
Liability for the unpaid debts and other obligations of the business	Personal liability of owner	Personal liability of partners	Limited
Management	Business managed by its owner	Business managed by its owners	Larger companies are managed by professional managers
Raising capital	Capital for the business is provided by its sole owner. Likely to be limited in amount.	Capital for the business is provided by its owners. Often limited in amount	Capital for the business is provided by its shareholders. Public companies can raise new capital from investors in the stock market. Most very large businesses are companies.
Financial accounting and auditing	Some financial accounts needed for tax purposes.	Financial accounts needed for the benefit of the partners and for tax purposes.	Fairly strict regulation of financial reporting by companies. Also legal requirements for audit.

2 INTRODUCTION TO FINANCIAL ACCOUNTING

Section overview

- The purpose of financial accounting
- Accounting systems
- Financial statements
- Regulation of financial reporting

2.1 The purpose of financial accounting

Financial accounting is a term that describes:

- maintaining a system of accounting records for business transactions and other items of a financial nature; and
- reporting the financial position and the financial performance of an entity in a set of financial statements.

The term ***entity*** is used to describe any type of organisation. Business entities include companies, business partnerships and the businesses of 'sole traders'

2.2 Accounting systems

Business entities operate a system to record business transactions in accounting records. This system is called a ***book-keeping system***. All large businesses (and many small ones) have a book-keeping system for recording the financial details of their business transactions on a regular basis. The bookkeeping records of a business are often referred to as ***the accounts*** of the business.

The content of financial statements might vary depending on whether a business is a sole trader, partnership of company. However, the basic process used to record transactions is similar for all types of entity. The techniques used is called double entry bookkeeping and is explained in detail later.

2.3 Financial statements

Double entry bookkeeping is used to record transactions in systems designed to allow the management of the business to monitor its progress and produce periodic financial statements and performance reports.

The information recorded in the book-keeping system (ledger records) is analysed and summarised periodically (typically each year) and the summarised information is presented in financial statements. Typically these might include:

- a statement of financial position; and
- a statement of comprehensive income

The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

The information explains the financial position of an entity at the end of a period (usually a year) and the financial performance of the entity over that period.

Financial statements relate to a given period of time, known as the 'financial year', 'accounting period' or 'reporting period'. They are prepared from information held in the financial accounting records (the ***books***, ***ledgers*** or ***accounts***), although some adjustments and additions are required to complete the financial statements, especially for companies.

The financial statements are often referred to as ***a set of accounts*** of the business.

The business entity concept

Financial reports are constructed as if the business entity is separate from its owners. In other words, the business entity and its owners are different. This is known as the ***business entity concept***.

This concept has legal ‘reality’ in the case of companies. A company by law is a legal person, separate from its owners (the shareholders). However, the concept is also applied to sole traders and partnerships.

Illustration:

Imran Khan sets up a sole trader business as a builder, and he calls the business ‘IK Builders’.

Legally, IK Builders does not have a separate legal personality. The debts of IK Builders are debts of Imran Khan.

However, for the purpose of financial reporting, the business is accounted for as an entity separate from Imran Khan.

Responsibility for preparing financial statements

Type of entity	Responsibility
Sole trader	There may be no obligation to prepare financial statements (other than for tax purposes) but if so the owner of the business is responsible. The owner might employ a person or persons to maintain the accounting records and prepare financial statements.
Partnership	There may be no obligation to prepare financial statements (other than for tax purposes) but if so the partners are responsible. They might employ a person or persons to maintain the accounting records and prepare financial statements.
Company	Companies must prepare financial statements for shareholders and for filing with relevant regulatory bodies. It is the responsibility of the directors to ensure that this is done. Usually the work is delegated to employees.

Financial reporting by sole traders and partnerships

The financial statements of a sole trader are private and do not have to be disclosed, except to the tax authorities (and possibly also to a lending bank). These must be prepared according to accepted accounting principles and practice, but need not conform to all the requirements of accounting standards.

Similarly, the financial statements of a business partnership are private and do not have to be disclosed.

Financial reporting by companies

The financial statements of a company are prepared for the shareholders of the company and are usually subject to audit. Audit is the examination of the financial statements by an independent expert who expresses an opinion as to whether they are fairly presented (show a true and fair view).

Company law requires that financial statements are filed with a government agency, where they can be accessed and read by any member of the general public.

Companies whose shares are traded on a major stock market make their financial statements generally available to the public, often on the company's web site.

The financial statements of a company are subject to more regulation than those of a sole trader or a partnership.

2.4 Regulation of financial reporting

Generally accepted accounting principles

Financial reporting is regulated and controlled. Regulations help to ensure that information reported in financial statements has the required qualities and content.

The concepts, principles, conventions, laws, rules and regulations that are used to prepare and present financial statements are known as ***Generally Accepted Accounting Principles*** or ***GAAP***.

The main sources of GAAP in a jurisdiction are:

- Company Law; and
- Accounting standards

GAAP varies from country to country, because each country has its own legal and regulatory system. For example, there is Pakistan GAAP, US GAAP etc.

Accounting standards

The accountancy profession has developed a large number of regulations and codes of practice that professional accountants are required to use when preparing financial statements. These regulations are **accounting standards**.

Accounting standards are applied by companies rather than sole traders and partnerships though they are written for all entities..

Many countries and companies whose shares are traded on the world's stock markets have ***adopted International Financial Reporting Standards*** or ***IFRS***. These are issued by the International Accounting Standards Board (IASB).

3 THE COMPONENTS OF FINANCIAL STATEMENTS

Section overview

- Financial statements
- The statement of financial position
- The statement of comprehensive income
- Relationship between the statement of comprehensive income and the statement of financial position

3.1 Financial statements

A full set of financial statements would include the following:

- a statement of financial position;
- a statement of comprehensive income;
- a statement of changes in equity (not in this syllabus);
- a statement of cash flows (not in this syllabus) and
- notes to the financial statements (not in this syllabus).

Those components not in the syllabus are mentioned for completeness only.

The statement of financial position and statement of comprehensive income will be described in more detail in later chapters. The remainder of this section will explain the contents and basic structure of the statement of financial position and the statement of comprehensive income.

3.2 The statement of financial position

A statement of financial position is a list of the assets and liabilities of an entity as at a particular date. It also shows the equity (capital) of the entity. Each of these is explained more fully in later sections.

A statement of financial position (formerly called a balance sheet) reports the financial position of an entity as at a particular date, usually the end of a financial year. The financial position of an entity is shown by its assets, liabilities and equity (owners' capital).

Assets

An asset is something that an entity owns, a resource that it controls or something that it is owed. (This is not a strictly accurate definition but will do at this point. A detailed technical definition of an asset is given in the next chapter).

Assets are presented in the statement of financial position under two main categories:

- **Current assets**: assets that are expected to provide economic benefit in the short term.
- **Non-current assets**: assets that have a long useful life and are expected to provide future economic benefits for the entity over a period of several years.

Example: Current assets

Inventory,cash, trade receivables (money owed by customers who have purchased goods or services on credit).

Example: Non-current assets

Property, machinery, patent rights

Liabilities

A liability is an amount that the entity owes to another party. (This is not a strictly accurate definition but will do at this point. A detailed technical definition of a liability is given in the next chapter).

Liabilities are presented in the statement of financial position under two main categories:

- **Current liabilities**: Amounts payable by the company within 12 months
- **Non-current liabilities**: Amounts not payable within the next 12 months

Example: Liabilities

Trade payables (amounts owed to suppliers for goods purchased)

Bank loans

Equity

Equity is the residual interest in the business that belongs to its owner or owners after the liabilities have been deducted from the assets. Equity is sometimes referred to as the 'net assets' of the business. (Net assets means assets minus liabilities).

Equity represents the amount the entity 'owes' to its owners, and liabilities are the amounts it owes to others. The total assets 'owned' are equal to the total amount of equity plus liabilities that it 'owes'.

This can be represented as the accounting equation.

Formula: Accounting equation

Assets – Liabilities = Equity or Assets = Liabilities + Equity

The statement of financial position is a detailed representation of this equation.

Format of a statement of financial position

A simple statement of financial position is divided into two parts:

- The top half of the statement shows the assets of the business, with non-current assets first, and current assets below the non-current assets.
- The lower half of the statement shows equity, followed by liabilities. The liabilities are shown with non-current (long-term) liabilities first, and then current liabilities.

The figure for total assets in the top part of the statement must always equal the total of equity plus liabilities in the bottom half.

Example: statement of financial position

Lahore Shipping Limited: Statement of financial position as at [date]

Assets	Rs.(000s)	Rs. (000s)
Non-current assets:		
Land and buildings		400,000
Plant and equipment		100,000
Motor vehicles		80,000
		580,000
Current assets:		
Inventory	20,000	
Receivables	30,000	
Cash	5,000	
		55,000
Total assets		635,000
Equity and liabilities		
Equity:		
Owner's capital		440,000
Non-current liabilities:		
Bank loan		170,000
Current liabilities:		
Bank overdraft	10,000	
Trade payables	15,000	
		25,000
Total equity and liabilities		635,000

The statement of financial position is not a statement of value.

The value of a business is determined by the profits that the business is expected to generate using the assets that it owns. There is no way of telling what a business is worth by looking at the financial statements. (Further analysis would be required to arrive at a valuation).

3.3 The statement of comprehensive income

This statement provides information about the performance of an entity in a period. It consists of two parts:

- A statement of profit or loss – a list of income and expenses which result in a profit or loss for the period; and
- a statement of other comprehensive income – a list of other gains and losses that have arisen in the period.

Transactions that would appear in the statement of other comprehensive income are not in your syllabus. Statements of comprehensive income in this syllabus include only those items which would be recognised in the statement of profit or loss part of the statement or comprehensive income.

A detailed technical definition of income and expense is given in the next chapter. For the time being the text provides simple examples of these.

Income

Income consists of:

- revenue from the sale of goods or services
- other items of income such as interest received from investments
- gains from disposing of non-current assets for more than the amount at which they are carried in the records (carrying amount). For example, if a machine is sold for Rs. 15,000 when its value in the statement of financial position is Rs. 10,000, there is a gain on disposal of Rs. 5,000.

The term '**revenue**' means income earned in the course of normal business operations. In a statement of comprehensive income , revenue and 'other income' are reported as separate items.

Expenses

Expenses consist of:

- expenses arising in the ordinary course of activities, including the cost of sales, wages and salaries, the cost of the depletion of non-current assets, interest payable on loans and so on
- losses arising from disasters such as fire and flood, and also losses from disposing of non-current assets for less than their carrying value in the statement of financial position.

Format of a simple statement of comprehensive income

The order of presentation is usually as follows:

- revenue (sales)
- the cost of sales
- gross profit (sales minus the cost of sales)
- other income, such as interest income and gains on the disposal of non-current assets
- other expenses, which might be itemised in some detail. (There is no rule about the sequence of expenses in the list, but it is usual to show expenses relating to administration, followed by expenses relating to selling and

distribution, and finally expenses relating to financial matters, such as interest charges, bad debts and audit fees.)

- net profit (gross profit plus other income and minus other expenses).

A company's statement of comprehensive income would also include the tax charge on the company's profits.

Example: Statement of comprehensive income

Lahore Shipping Limited: Statement of comprehensive income for the year ended [date]		
	Rs. (000s).	Rs. (000s)
Revenue		800,000
Cost of sales		500,000
Gross profit		300,000
Other income:		
Gain on disposal of non-current asset		10,000
		310,000
Expenses		
Employees' salaries	120,000	
Depreciation	10,000	
Rental costs	30,000	
Telephone charges	15,000	
Advertising costs	30,000	
Selling costs	40,000	
General expenses	20,000	
Interest charges	3,000	
Bad debts	2,000	
		270,000
Net profit		40,000

Gross profit and net profit

It is usual to show both the gross profit and the net profit in a statement of comprehensive income .

- Gross profit is the sales revenue minus the cost of sales in the period, and
- Net profit (or loss) is the profit after taking into account all other income and all other expenses for the period.

The expenses included in 'cost of sales' differ according to the activities or type of industry in which the entity operates. For example:

- in a retailing business, the cost of sales might be just the purchase cost of the goods that have been sold
- in a manufacturing business, the cost of sales might be the cost of producing the goods sold during the period.

3.4 Relationship between the statement of comprehensive income and the statement of financial position

The statement of financial position shows the equity of a business at a point in time.

The statement of comprehensive income ends with a figure showing net profit for the period. Profit belongs to the owner (or owners) of the business. It is therefore an addition to equity.

The statement of comprehensive income links last year's statement of financial position to that constructed at the end of this year.

4 THE NEEDS OF USERS

Section overview

- The objective of financial reporting
- Informational needs of those who use financial statement

4.1 The objective of financial reporting

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

Most users cannot insist that businesses supply them with specific information. Instead they have to rely on the financial statements produced by a business for much of the financial information they need.

In other words, financial statements are drafted to provide information that should be useful to most users but will not necessarily satisfy all of their needs. The users also have to look elsewhere.

4.2 Informational needs of those who use financial statements

Investors

Investors in a business entity are the providers of risk capital. Unless they are managers as well as owners, they invest in order to obtain a financial return on their investment. They need information that will help them to make investment decisions.

In the case of shareholders in a company, these decisions will often involve whether to buy, hold or sell shares in the company. Their decision might be based on an analysis of the past financial performance of the company and its financial position, and trying to predict from the past what might happen to the company in the future. Financial statements also give some indication of the ability of a company to pay dividends to its shareholders out of profits.

Lenders

Lenders, such as banks, are interested in financial information about businesses that borrow from them. Financial statements can help lenders to assess the continuing ability of the borrower to pay interest, and its ability to repay the loan principal at maturity.

Suppliers and other trade creditors

Financial information about an entity is also useful for suppliers who provide goods on credit to a business entity, and 'other trade creditors' who are owed money by the entity as a result of debts incurred in its business operations (such as money owned for rent or electricity or telephone charges). They can use the financial statements to assess how much credit they might safely allow to the entity.

Government

The government and government agencies are interested in the financial statements of business entities. They might use this information for the purpose of business regulation or deciding taxation policies.

The public

In some cases, members of the general public might have an interest in the financial statements of a company. The IASB Framework comments: 'For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers.'

Employees

Employees need information about the financial stability and profitability of their employer. An assessment of profitability can help employees to reach a view on the ability of the employer to pay higher wages, or provide more job opportunities in the future.

Customers

Customers might be interested in the financial strength of an entity, especially if they rely on that entity for the long-term supply of key goods or services.

Managers

Managers are not included in this list of users by the IASB Framework, because management should have access to all the financial information they need, and in much more detail than financial statements provide. However, management is responsible for producing the financial statements and might be interested in the information they contain.

5 BUSINESS TRANSACTIONS

Section overview

- Introduction
- The difference between capital transactions and revenue transactions
- Capital and revenue expenditure
- Revenue income and capital receipts

5.1 Introduction

A business transaction is an interaction between a business and customer, supplier or any other party with whom they do business. It is an economic event that must be recorded in the business's accounting system.

There are many different types of business transaction including:

- Cash sales of goods or services.
- Credit sales of goods or services.
- Receipt of cash from a customer to whom a sale on credit has been made.
- Cash purchase of raw materials or goods.
- Credit purchase of raw materials or goods.
- Payment of cash to a supplier from whom a credit purchase has been made.
- Receipt of loan proceeds.
- Repayment of a loan.
- Payments made to employees.
- Payments made to the government (for example taxes).
- Purchase of non-current assets.

There are many mores examples.

Classification of business transactions

Business transactions can be classified in a number of ways including:

- Simple transactions and complex transactions
- One-off transactions and ongoing transactions
- Capital transactions and revenue transactions

Simple or complex

Many transactions involve simple exchanges. For example, the sale of a Samsung Galaxy phone by a retailer to a customer for cash is a simple transaction. If the same sale is made on credit (where the customer does not pay immediately) the transaction is more complex. In this case it might involve a series of payments and some of the amount received might constitute interest.

One-off transactions and ongoing transactions

Many transactions might occur on a single occasion. However, there are some relationships which lead to a series of transactions of an ongoing nature. For example, a person buying a Samsung Galaxy would need a contract with a mobile phone network. This contract would involve a series of commitments by each party and result in a series of payments by the owner of the phone to the network provider in return for the provision of service of a specified level.

One of the most important ongoing relationships is that between a person or a business and their banks. These may last for many years and involve the provision of a series of different services through a whole series of transactions.

5.2 The difference between capital transactions and revenue transactions

A business entity normally operates over many years, but prepares financial statements annually (at the end of each financial year).

- It spends money for both the long term, by investing in machinery, equipment and other assets. It also spends money on day-to-day expenses, such as paying for supplies and services, and paying wages or salaries to employees.
- It receives income from its business operations. It might also receive income from other sources, such as a new bank loan, or new capital invested by its owner.

A distinction is made between ‘capital’ and ‘revenue’ items:

- Items of a long-term nature, such as property, plant and equipment used to carry out the operating activities of the business, are ‘capital items’.
- Items of a short-term nature, particularly items that are used or occur in the normal cycle of business operations, are ‘revenue items’.

As a rough guide (but which is not strictly accurate):

- capital items will be reported in the statement of financial position, because they are of a long-term nature
- revenue items are at some stage reported as income or expenses in the statement of comprehensive income.

5.3 Capital and revenue expenditure

Capital expenditure is expenditure made to acquire or improve long term assets that are used by the business:

Examples include:

- purchase of property, plant and equipment, office equipment; and motor vehicles;
- installation costs associated with new equipment;
- improvements and additions to existing non-current assets (for example, building extensions, installation of air-conditioning etc.)

Fees paid to raise long term finance are also deemed to be capital in nature.

- To pay fees associated with raising long term finance

A 'capital asset' is a '**non-current asset**'

The IASB defines '**capitalisation**' as recognising a cost as an asset or part of the cost of as an asset. So when an item of cost is '**capitalised**' it is treated as an asset rather than an expense.

Revenue expenditure is expenditure on day-to-day operating expenses.

Examples include:

- Purchase of goods meant for resale in the normal course of business;
- Purchase of raw materials and components used to manufacture goods for resale in the normal course of business;
- Expenditures made to meet the day to day running costs of a business (for example, rent, energy, wages etc.)
- Expenditures made to repair non-current assets.
- Expenditures made to distribute goods to customers.
- Costs of administering a business (for example, accounting services, licence fees etc.)

Revenue expenditure is reported as expenditure in the statement of comprehensive income.

It is not always easy to distinguish between capital and revenue transactions.

Illustration:

A business has two identical vehicles each with engine problems.

Vehicle A engine is repaired – costs associated with the repair are revenue expenditure

Vehicle B engine is replaced – this is capital expenditure.

5.4 Revenue income and capital receipts

Revenue income is income arising from the normal operations of a business from its investments.

Examples include:

- ❑ Revenue from the sale of goods.
- ❑ Commissions and fees received and receivable from the provision of a service.
- ❑ Interest received and receivable from savings.
- ❑ Rent received and receivable from letting out property.

Revenue is reported in the statement of profit or loss in the statement of comprehensive income.

Capital receipts are receipts of 'long term' income, such as money from a bank loan, or new money invested by the business owners (which is called 'capital').

Capital receipts affect the financial position of an entity, but not its financial performance. Capital receipts are therefore excluded from the statement of comprehensive income.

Illustration:

A business entity borrows $100,000 from a bank for five years and pays interest of $8,000 on the loan for the first year.

The loan is a non-current liability (and part of the long-term 'capital' of the business – a capital receipt) but the interest is an expense (revenue expenditure).

A business has two identical vehicles each with engine problems.

The engine of one is repaired – costs associated with the repair are revenue expenditure

The engine of the second is replaced – this is capital expenditure.

CHAPTER 2

Accounting concepts and terminology

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 1	**Understand the nature of accounting, elements of accounts and double entry rules.**
LO1.3.1	Fundamental accounting concepts: Describe and illustrate the main concepts, namely, accrual, consistency, and completeness
LO1.3.2	*Fundamental accounting concepts:* Demonstrate familiarity with the concepts of true and fair view, materiality, prudence, going concern and substance over form
LO1.3.3	*Fundamental accounting concepts:* Apply the concepts of accrual, consistency and completeness to simple and well explained circumstances.
LO 2	**Identify financial transactions and make journal entries**
LO2.1.1	*Elements of financial statements:* Define and give examples of assets, liabilities, equity, income and expenses
LO2.1.2	*Elements of financial statements:* Apply the underlying concepts of assets, liabilities, income and expenses in simple and well explained circumstances.

1 ACCOUNTING CONCEPTS

Section overview

- Introduction
- Accruals basis (matching concept)
- Consistency
- Completeness
- True and fair view (faithful representation)
- Materiality
- Prudence
- Going concern basis
- Substance over form

1.1 Introduction

The IASB (International Accounting Standards Board) have published a document called the ***Conceptual Framework***. This document sets out the fundamental concepts that provide a foundation for financial reporting.

In effect it provides a series of answers to fundamental questions.

Example:

Question: What is the objective of financial reporting?

Answer: The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

The Conceptual Framework is in the process of being revised. This has resulted in the removal of certain concepts from the document. However, accounting standards have historically taken these into account so it is still important to know about them.

Note also that some concepts are explained in IAS 1 Presentation of Financial Statements. Detail of this standard is beyond the scope of your syllabus but is covered by later syllabuses.

Knowledge of the following concepts is required by your syllabus.

- Accounting concepts
  - Accruals basis
  - Completeness
  - True and fair view/faithful representation
  - Materiality
  - Prudence
  - Going concern basis
  - Substance over form
- The elements of financial statements

1.2 Accruals basis (matching concept)

Accruals basis accounting (accruals accounting, the accruals concept) depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

- Revenue from sales and other income should be reported in the period when the income arises (which might not be the same as the period when the cash is received).
- The cost of sales in the statement of comprehensive income must be matched with the sales. Income and 'matching' expenses must be reported in the same financial period.
- Other expenses should be charged in the period to which they relate, not the period in which they are paid for.

Illustration: Statement of comprehensive income

	Rs
Revenue (from sales made in the period)	X
Cost of sales (costs matched with sales made in the period	(X)
Gross profit	X
Other costs (charged in the period in which the benefit paid for is used)	(X)
Net profit	X

Example 1: Accruals basis

A company prepares its financial statements to the 30 June each year.

It sells goods for Rs. 50,000 to a customer on 6 June Year 2, but does not receive a cash payment from the customer until 15 August Year 2.

Accruals basis:

The sale is recognised as income in the year to 30 June Year 2, even though the cash is not received until after the end of this financial year.

Example 2: Accruals basis

A company starts in business on 1 September Year 1. It acquires an office for which it pays one year's rent in advance, to 31 August Year 2.

The cost of the annual rental is Rs. 120,000. The company prepares its financial statements for a financial period ending on 31 December each year.

Accruals basis:

The office rental cost in the period to 31 December Year 1 is the cost of just four months' rent.

The expense is therefore Rs. 40,000 (Rs. 120,000 × $^{4}/_{12}$) in Year 1, and there has been a prepayment for Rs. 80,000 that relates to the next financial period, the year to 31 December Year 2.

Definitions

Prepayment.

A prepayment is an amount of money paid in advance for benefits that will be received in the next accounting period.

A prepayment in Year 1 of some expenses relating to Year 2 should not be charged as an expense in Year 1, but should be treated as an expense in Year 2.

Accrued expense or accrual.

An accrual or accrued expense is an amount that an entity owes in respect of a benefit it has received in a period but for which it has not yet been invoiced. An accrual is an estimate of the cost of the benefit received.

Example: Accrual

A company rents office space at a cost of Rs. 6,000,000 per year paid 12 months in arrears (this means that the company pay the rent at the end of the year).

The first payment is due on 30 June Year 2.

The company prepares its financial statements to 31 December each year.

Accruals basis:

The company will not have received an invoice for the rent when it is preparing its financial statements for 31 December Year 1

However, it knows that it has occupied the office space for six months. The company would recognise a liability for rental costs for six months (Rs. 3,000,000) and also include this as an expense in profit and loss for Year 1.

This is described as accruing an expense or making an accrual.

Accounting for accruals and prepayments is described in detail in a later chapter.

1.3 Consistency

The content of the financial statements must be presented consistently from one period to the next.

The presentation can be changed only if necessary to improve the quality of information presented in terms of its usefulness to the users or if a new rule requires a change.

Example: Consistency

A manager of a business has been promised a bonus if he can improve gross profit to more than 10% above what it was last year.

In the event the results of the business have been exactly the same but the manager has prepared the financial statements on a slightly different basis.

	2012	2013
	Rs.000	Rs.000
Sales	25,000	25,000
Cost of sales:		
Production costs	10,000	10,000
Warehousing costs	10,000	
	(20,000)	(10,000)
Gross profit	5,000	15,000
Less: Other expenses	(4,000)	(14,000)
Net profit	1,000	1,000

The manager has presented the information in a different way. This year's presentation is inconsistent with last year's.

This might mislead the user of the financial statements (in this case the person who will decide if the manager will receive a bonus).

It might be that the manager's presentation is correct but in this case the previous year's results should be represented onto a consistent basis in order to prevent a misleading impression.

1.4 Completeness

The objective of financial reporting is to provide useful information. Information is only useful if a person can rely on it.

To be reliable, information should be complete, subject to materiality and cost. (There is no need to include information if it is not material, and greater accuracy is not required if the cost of obtaining the extra information is more than the benefits that the information will provide to its users).

Materiality is explained below.

Completeness refers to whether all transactions that occurred during the period have been recorded.

Example: Completeness

The accruals example can be used to illustrate this.

A company rents office space at a cost of Rs. 6,000,000 per year paid 12 months in arrears (this means that the company pay the rent at the end of the year).

The first payment is due on 30 June Year 2.

The company prepares its financial statements to 31 December each year.

The company will not have received an invoice for the rent when it is preparing its financial statements for 31 December Year 1

If the company does not accrue for the expense that relates to the 6 months to 31 December year 1 the information would be incomplete.

1.5 True and fair view (faithful representation)

Financial statements should give a ***true and fair view*** of the financial position, financial performance and changes in financial position of an entity. Another way of saying this is that financial statements should provide a ***faithful representation*** of these.

This is achieved by following all the rules set out in law and accounting standards

Faithful representation

Financial reports represent economic phenomena by depicting them in words and numbers.

To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent.

A perfectly faithful representation would have three characteristics. It would be:

- complete – the depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.
- neutral – the depiction is without bias in the selection or presentation of financial information; and
- free from error – where there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

1.6 Materiality

The relevance of information is affected by its materiality.

Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

An error which is too trivial to affect a user's understanding of financial statement is referred to as immaterial.

There is no absolute measure of materiality that can be applied to all businesses. In other words there is no rule that says any item greater than 5% of profit must be material. Whether an item is material or not depends on its magnitude or its nature or both in the context of the specific circumstances of the business.

Magnitude

Whether an item of a given size is deemed to be material depends on the context of the number in relation to other numbers in the financial statements.

Example: Materiality

Two similar businesses prepare financial statements that show that each has non-current assets of Rs. 10,000,000 and each has a profit for the year of Rs. 100,000.

Each business discovers a Rs. 20,000 error.

	Error	Comment
1:	**This relates to how Business A arrived at the total of non-current assets which are now overstated by Rs. 20,000.**	**This is immaterial. Rs. 20,000 is a small error in the context of the non-current asset figure and its omission would not be misleading.**
2	**This relates to how Business B arrived at the profit for the year which is now overstated by Rs. 20,000.**	**This is material. Omitting this amount means that profit is misstated by 20%**

Example: Materiality

A business owes Mr A Rs. 1,000,000 and is owed Rs. 950,000 by Mr B.

Instead of showing an asset of Rs. 950,000 and a liability of Rs. 1,000,000, the business shows a single liability of Rs. 50,000.

This is a material misstatement. Although the amount is correct it hides the fact that the amount is in fact made of two much larger amounts. A user would be unable to judge the risk associated with Mr B's ability of pay unless the two amounts are shown separately.

Nature

Businesses are sometimes placed under a legal obligation to disclose certain information in their financial statements (for example, companies must disclose directors' remuneration). Omission of such amounts is always a material misstatement regardless of the size of the amount in relation to the other numbers in the financial statements.

This is only mentioned for illustrative purposes. Examples of this kind are beyond the scope of this syllabus.

1.7 Prudence

Financial statements must sometimes recognise the uncertainty in business transactions. For example, if a business is owed Rs. 1,000,000 by a number of its customers, there will be some uncertainty as to whether all the money will actually be collected. Prudence involves allowing for some caution in preparing financial statements, by making reasonable and sensible allowances in order to avoid overstating assets or income and to avoid understating expenses or liabilities.

As a general indication of prudence, rules exist to prevent a business recognising an asset in its financial statements at an amount greater than the cash it will generate. When such a circumstance arises the asset is reduced in value down to the cash expected to result from the ownership of the asset.

Example: Prudence

A company has receivables of Rs. 10,000,000.

The company knows from experience that about 2% of its receivables will not be collected because of customers being in financial difficulty.

It is prudent to make an allowance for doubtful debts to 2% of receivables (but it would be inappropriate to make an excessive allowance, say 10% of receivables).

The company would recognise an allowance of Rs. 200,000 to set against the receivable in the statement of financial position showing a net amount of Rs. 9,800,000 (10,000,000 less 200,000).

The Rs.200,000 would also be recognised as an expense in the statement of comprehensive income.

Accounting for bad and doubtful debts is described in detail in a later chapter.

1.8 Going concern basis

This means that financial statements are prepared on the assumption that the entity will continue to operate for the foreseeable future, and does not intend to go into nor will be forced into liquidation. The going concern assumption is particularly relevant for the valuation of assets.

The going concern basis of accounting is that all the items of value owned by a business, such as inventory and property, plant and equipment, should be valued on the assumption that the business will continue in operation for the foreseeable future. The business will not close down or be forced to close down and sell off all its items (assets). This assumption affects the value of assets and liabilities of an entity, as reported in the financial statements.

If a business entity is not a going concern, and is about to be closed down and liquidated, the value of its assets would be their estimated value in the liquidation process. Assets are valued differently on a going concern basis.

1.9 Substance over form

The use of the term faithful representation (see above) means more than that the amounts in the financial statements should be materially correct. It implies that information should present clearly the transactions and other events that it is intended to represent.

To provide a faithful representation, financial information must account for transactions and other events in a way that reflects their substance and economic reality (in other words, their true commercial impact) rather than their legal form. If there is a difference between economic substance and legal form, the financial information should represent the economic substance.

IFRSs contain many rules that are based on this concept.

Example: Substance over form (leases)

Alpha rents (leases) an asset from Beta.

The asset is expected to be useful for 10 years after which it will be scrapped.

Alpha has a contract to use the asset for 10 years.

Analysis:

The substance of the transaction is that Alpha has bought the asset from Beta.

Beta would only agree to let Alpha use the asset for all of its useful life if the rentals received from Alpha covered Beta's costs of buying the asset and gave Beta a financial return. This is the same as Alpha borrowing money and buying the asset.

Alpha must recognise the leased asset as if it owns it and also must recognise a liability to pay for the asset.

Example: Substance over form (sale and repurchase agreements)

Gamma sells an asset to Delta for Rs. 1,000,000.

There is a contract in place under which Gamma must buy the asset back off Delta for Rs. 1,100,000 in 12 months' time.

Gamma continues to use the asset in exactly the same way as before, even though Delta is now its legal owner.

Analysis:

The substance of the transaction is that Gamma has not sold the asset to Delta but has borrowed money from Delta.

Gamma must recognise a liability for Rs. 1,000,000.

2 THE ELEMENTS OF FINANCIAL STATEMENTS

Section overview

- Introduction
- Assets
- Liabilities
- Equity
- Income
- Expenses
- Measurement of assets and other elements

2.1 Introduction

The objective of financial reporting is to provide useful information. In order to be useful information must be understandable. A large company enters into thousands of transactions so in order for users to be able to understand the impact of these they must be summarised in some way.

Financial statements group transactions into broad classes according to their economic characteristics. These broad classes are called the elements of financial statements.

- The elements directly related to the measurement of financial position in the statement of financial position are assets, liabilities and equity.
- The elements directly related to the measurement of performance in the statement of comprehensive income are income and expenses.

2.2 Assets

An asset is defined as:

- a resource controlled by the entity;
- as a result of past events; and
- from which future economic benefits are expected to flow to the entity.

Resource controlled by the entity

Control is the ability to obtain economic benefits from the asset, and to restrict the ability of others to obtain the same benefits from the same item.

An entity usually uses assets to produce goods or services to meet the needs of its customers, and because customers are willing to pay for the goods and services, this contributes to the cash flow of the entity. Cash itself is an asset because of its command over other resources.

Many assets have a physical form, but this is not an essential requirement for the existence of an asset.

The result of past events

Assets result from past transactions or other past events. An asset is not created by any transaction that is expected to occur in the future but has not yet happened. For example, an **intention** to buy inventory does not create an asset.

Expected future economic benefits

An asset should be expected to provide future economic benefits to the entity. Providing future economic benefits can be defined as contributing, directly or indirectly, to the flow of cash (and cash equivalents) into the entity.

2.3 Liabilities

A liability is defined as:

- a present obligation of an entity
- arising from past events
- the settlement of which is expected to result in an outflow of resources that embody economic benefits.

Present obligation

A liability is an obligation that already exists. An obligation may be legally enforceable as a result of a binding contract or a statutory requirement, such as a legal obligation to pay a supplier for goods purchased.

Obligations may also arise from normal business practice, or a desire to maintain good customer relations or the desire to act in a fair way. For example, an entity might undertake to rectify faulty goods for customers, even if these are now outside their warranty period. This undertaking creates an obligation, even though it is not legally enforceable by the customers of the entity.

Past transactions or events

A liability arises out of a past transaction or event. For example, a trade payable arises out of the past purchase of goods or services, and an obligation to repay a bank loan arises out of past borrowing.

Future outflow of economic resources

The settlement of a liability should result in an outflow of resources that embody economic benefits. This usually involves the payment of cash or transfer of other assets. A liability is measured by the value of these resources that will be paid or transferred.

Some liabilities can be measured only with a substantial amount of **estimation**. These may be called **provisions**.

2.3 Equity

Equity is the residual interest in an entity after the value of all its liabilities has been deducted from the value of all its assets. It is a ‘balance sheet value’ of the entity’s net assets. It does not represent in any way the market value of the equity.

Equity of companies may be sub-classified into share capital, retained profits and other reserves.

2.4 Income

Financial performance is measured by profit or loss. Profit is measured as income less expenses. Income includes both revenue and gains.

- **Revenue** is income arising in the course of the ordinary activities of the entity. It includes sales revenue, fee income, royalties' income, rental income and income from investments (interest and dividends).
- **Gains** include gains on the disposal of non-current assets. Realised gains are often reported in the financial statements net of related expenses. They might arise in the normal course of business activities. Gains might also be unrealised. Unrealised gains occur whenever an asset is revalued upwards, but is not disposed of. For example, an unrealised gain occurs when marketable securities owned by the entity are revalued upwards.

2.5 Expenses

Expenses include:

- **Expenses** arising in the normal course of activities, such as the cost of sales and other operating costs, including depreciation of non-current assets. Expenses result in the outflow of assets (such as cash or finished goods inventory) or the depletion of assets (for example, the depreciation of non-current assets).
- **Losses** include for example, the loss on disposal of a non-current asset, and losses arising from damage due to fire or flooding. Losses are usually reported as net of related income. Losses might also be unrealised. Unrealised losses occur when an asset is revalued downwards, but is not disposed of. For example, and unrealised loss occurs when marketable securities owned by the entity are revalued downwards

2.6 Measurement of assets and other elements

Assets, liabilities, income and expenses can be measured in the following ways according to circumstance:

- Historical cost. This is the actual amount of cash paid or received. For example, the historical cost of an item of equipment is the amount that it cost to buy (at some time in the past).
- Current cost. Assets might be valued at the amount that would have to be paid to obtain an equivalent current asset 'now'. For example, if a company owns shares in another company, these assets might be valued at their current market value. Similarly, a company that owns a building might choose to value the building at its current market value, not the amount that it originally cost.
- Realisable value or settlement value. Assets might be valued at the amount that would be obtained if they were disposed of now (in an orderly disposal).
- Present value. This is a current value equivalent of an amount that will be receivable or payable at a future time.

The most common method of measurement is historical cost, but the other methods of measurement are also used in certain cases. These cases are not in your syllabus.

2.7 Other terms

Accounts

The word account is used in a number of ways:

Term	Meaning
An account	A record of an individual type of asset, liability, income, expense or equity. A record of amounts owed by an individual customer (an asset) or amounts owed to an individual supplier (a liability.
The accounts	A term used to refer to the accounting records of a business.
A set of accounts	A term used to refer to a set of financial statements.

Statement of comprehensive income

This is a statement of performance with two sections:

- a statement of profit or loss; and
- a statement of other comprehensive income.

Only specified transactions are recognised in the statement of other comprehensive income and these are all outside the scope of your syllabus. Therefore, any statement of comprehensive income within your syllabus comprises only a statement of profit or loss.

Recognition

This refers to putting an item into the bookkeeping system (performing double entry on it (see chapter 4). You will see phrases like “this item is recognised as an asset”.

Sometimes you will see a statement that an item should be taken to profit or loss. This simply means that it should be recognised in the statement of comprehensive income.

Cost

The amount of cash or cash equivalents paid or the value of the other consideration given to acquire an asset at the time of its acquisition or construction.

Cash refers to actual cash on hand and amounts held in demand deposits (those that can be instantly accessed)

Cash equivalents are short-term, highly liquid investments. (This is a simplified definition and only given for completeness. The term is outside the scope of your syllabus).

Net

This refers to the result of adding a positive and negative number together. The result might be a net asset, net liability, net income or net expense.

CHAPTER 3

The accounting equation

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 2	**Identify financial transactions and make journal entries**
LO2.3.1	*Double entry:* Understand and apply, the accounting equation (Assets = Liabilities + Equity) in simple practical and common scenarios

1 THE ACCOUNTING EQUATION

Section overview

- A simple representation of the statement of financial position
- The effect of financial transactions on the accounting equation
- Drawings
- Links between the statement of comprehensive income and the statement of financial position
- Using the accounting equation

1.1 A simple representation of the statement of financial position

The accounting equation is a simplified way of showing a statement of financial position. The equation is:

Formula: Accounting equation

Assets	=	Equity	+	Liabilities
A	**=**	**E**	**+**	**L**

Each new financial transaction affects the numbers in the accounting equation, but the accounting equation must always apply. Total assets must always be equal to the combined total of equity plus liabilities.

The accounting equation is a useful introduction to the preparation of a simple statement of comprehensive income and statement of financial position. It is also a useful introduction to the principles of double-entry book-keeping, and the **duality concept** that every transaction has two aspects that must be recorded.

The accounting equation and the business entity concept

The use of the accounting equation is based on the business entity concept, that a business is a separate entity from the person or persons who own it. The owner puts capital into the business, and the business 'owes' this to the owner.

Illustration:

Farid sets up a business 'Farid's Security Services' and puts some capital into the business.

The accounting system of the business would consider that 'Farid's Security Services' is an entity on its own, separate from Farid, and that Farid is an owner to which the business owes the capital.

1.2 The effect of financial transactions on the accounting equation

The effect of financial transactions on the accounting equation will be explained by looking at a series of business transactions for a newly-established sole trader's business.

Example : Abbas – Transaction 1

Setting up a business by introducing capital

Abbas has decided to set up in business selling football shirts from a stall in the market place.

He begins by putting Rs. 30,000 into a bank account for the business.

This transaction is recorded in the accounting equation as follows:

	Assets	=		Equity	+		Liabilities
	Rs.			Rs.			Rs.
Cash	30,000		Capital	30,000			
	30,000	=		**30,000**	+		

Capital has been introduced into the new business. This is recorded as the owner's capital.

The new business also has cash in the bank, which is an asset.

Assets and equity have both increased by Rs. 30,000.

Example : Abbas – Transaction 2

Borrowing money

Abbas borrows Rs. 40,000 from his brother to purchase a motor van for the business.

The business acquires a new asset – a motor van – but has also acquired a liability in the form of the loan.

After the van has been purchased, the accounting equation changes to:

Assets		=	Equity		+	Liabilities	
	Rs.			Rs.			Rs.
Cash	30,000						
Van	40,000		Capital	30,000		Loan	40,000
	70,000	=		**30,000**	+		**40,000**

Assets and liabilities have both increased by Rs. 40,000.

Example : Abbas – Transaction 3

Buying an asset for cash

Abbas buys a market stall and pays Rs. 5,000 in cash.

The business has used one asset (cash) to acquire a different asset (a stall). There is no change in the total assets, simply a change in the make-up of the assets.

After the stall has been purchased, the accounting equation changes to:

	Assets	=		**Equity**	+		**Liabilities**
	Rs.			**Rs.**			**Rs.**
Cash	25,000						
Stall	5,000						
Van	40,000		Capital	30,000		Loan	40,000
	70,000	=		**30,000**	+		**40,000**

Example : Abbas – Transaction 4

Buying assets (inventory) on credit

Abbas now buys some football shirts for Rs. 18,000. He buys these on credit, and does not have to pay for them immediately.

The business has acquired more assets (shirts = inventory). In doing so, it has created another liability, because it now owes money to its supplier, who is recorded as a 'trade payable'.

Both assets and liabilities have increased by the same amount.

After the shirts have been purchased, the accounting equation changes to:

Assets		=	**Equity**		+	**Liabilities**	
	Rs.			**Rs.**			**Rs.**
Cash	25,000						
Inventory	18,000						
Stall	5,000					Loan	40,000
Van	40,000		Capital	30,000		Payables	18,000
	88,000	=		**30,000**	+		**58,000**

Example : Abbas – Transaction 5

Making a cash payment to settle a liability

Abbas pays Rs. 10,000 to his suppliers for some of the shirts he purchased.

The payment reduces the liabilities of the business, but also reduces its assets (cash) by the same amount.

After the payment has been made the accounting equation changes to:

	Assets	=		**Equity**	+		**Liabilities**
	Rs.			**Rs.**			**Rs.**
Cash	15,000						
Inventory	18,000						
Stall	5,000					Loan	40,000
Van	40,000		Capital	30,000		Payables	8,000
	78,000	=		**30,000**	+		**48,000**

Example : Abbas – Transaction 6

Cash sales (leading to recognising cost of sales and profit)

Abbas sells 50% of the shirts (cost = Rs. 9,000) for Rs. 12,000 in cash.

The business has sold assets that cost Rs. 9,000. It has received Rs. 12,000 in cash, and the difference is the profit on the sales.

Profit is added to the owner's capital.

After the sale, the accounting equation changes to:

	Assets	=		**Equity**	+		**Liabilities**
	Rs.			**Rs.**			**Rs.**
Cash	27,000		Capital:				
Inventory	9,000		Original	30,000			
Stall	5,000		Profit	3,000		Loan	40,000
Van	40,000			33,000		Payables	8,000
	81,000	=		**33,000**	+		**48,000**

Example : Abbas – Transaction 7

Credit sales (leading to recognising cost of sales and profit)

Abbas sells shirts for Rs. 9,000, to a shop owner in another town. These shirts originally cost Rs. 5,000. He sells the shirts on credit, giving the purchaser one month to pay.

The business has sold for Rs. 9,000 assets that cost Rs. 5,000. The difference is the profit of Rs. 4,000 on the sale. Profit adds to the owner's capital, taking the total profit earned so far from Rs. 3,000 to Rs. 7,000. With this transaction, however, the business is still owed money from the customer for the sale.

Money owed by a customer for a sale on credit is called a 'trade receivable'. A trade receivable is an asset.

After the sale, the accounting equation changes to:

	Assets	**=**		**Equity**	**+**		**Liabilities**
	Rs.			**Rs.**			**Rs.**
Cash	27,000		Capital:				
Inventory	4,000		Original	30,000			
Receivable	9,000		Profit	7,000			
Stall	5,000			37,000		Loan	40,000
Van	40,000					Payables	8,000
	85,000	=		**37,000**	+		**48,000**

Practice question **1**

Continuing the Abbas example construct an accounting equation after each of the following transactions

1. Transaction 8: Abbas repays Rs. 10,000 of the loan.
2. Transaction 9: Abbas pays his trade suppliers Rs. 6,000.
3. Transaction 10: Abbas receives Rs. 8,000 of the money owed to him by the customer (trade receivable).
4. Transaction 11: Abbas purchases another Rs. 2,500 of shirts, on credit.

1.3 Drawings

The owner or owners of a business can draw out the profits that the business makes. If they wish to do so, they can draw out all their profits. In practice, however, owners usually draw some profits and leave the rest in the business, to finance the growth of the business.

- Profits that are kept in the business are called retained earnings.
- Profits that are drawn out of the business are called **drawings**, in the case of businesses owned by sole traders or partnerships. Profits paid out to the shareholders of companies are called **dividends**.

Drawings are usually in cash. However, an owner might take out some inventory from the business for his own personal use, or even a larger asset such as a motor vehicle. Taking inventory or other assets is a form of drawing, as well as cash.

Example : Abbas – Transaction 12

Suppose that the accounting equation of Abbas is as follows:

	Assets	**=**	**Equity**	**+**	**Liabilities**
	Rs.		**Rs.**		**Rs.**
Cash	19,000	Capital:			
Inventory	6,500	Original	30,000		
Receivable	1,000	Profit	7,000		
Stall	5,000		37,000	Loan	30,000
Van	40,000			Payables	4,500
	71,500	=	**37,000**	+	**34,500**

Abbas decides to take Rs. 4,000 in cash out of his business, and he also takes inventory with a value of Rs. 2,000.

The assets of the business are reduced by Rs. 6,000 (cash + inventory), and capital is reduced by the same amount.

The accounting equation now changes as follows:

Assets		**= Equity**		**+ Liabilities**	
	Rs.		**Rs.**		**Rs.**
Cash	15,000	Capital:			
Inventory	4,500	Original	30,000		
Receivables	1,000	Profit	7,000		
Stall	5,000	Drawings	(6,000)	Loan	30,000
Van	40,000	Retained profits	31,000	Payables	4,500
	65,500	=	**31,000**	+	**34,500**

1.4 Links between the statement of comprehensive income and the statement of financial position

A statement of financial position shows the financial position of a business at a given point in time and is a representation of the accounting equation.

A statement of comprehensive income shows the profit or loss for a period of time.

However, there are links between the two financial statements.

- Profit in the statement of comprehensive income affects the statement of financial position, by adding to the owner's capital.
- Drawings out of profits also affect the statement of financial position, by reducing the owner's capital.

1.5 Using the accounting equation

The accounting equation is:

Formula: Accounting equation

Assets	**=**	**Liabilities**	**+**	**Equity**	**or**	**Assets**	**–**	**Liabilities**	**=**	**Equity**
A	**=**	**L**	**+**	**E**		**A**	**–**	**L**	**=**	**E**

Assets minus liabilities is usually called ***net assets***.

A change on one side of an equation must be matched by a change on the other. Therefore, an increase in net assets means a matching increase in equity capital and a fall in net assets means a matching fall in equity capital.

Movements in equity are caused by:

- profit being added to capital or losses deducted from capital; and
- the introduction of more capital into the business (perhaps by providing it with additional cash or other assets);
- payments to the owners in the form of drawings (or dividends in the case of a company).

In other words, net assets will change in value between the beginning and end of a financial year by the amount of profit (or loss) in the period, new capital introduced and drawings or dividends taken out.

Illustration:

	Rs.
Opening equity/net assets (ONA)	**X**
Profit (P)	**X**
Capital introduced (CI)	**X**
Drawings (D)	**(X)**
Closing equity/net assets (CAN)	**X**

The value of any term can be calculated if the others are known.

Example:

Sohaib operates a business as a sole trader.

On 1 July 2013 the net assets of the business were Rs. 670,000.

During the year to 30 June 2014, the business made a profit of Rs. 250,000 and Sohaib took out Rs. 220,000 in drawings.

Due to a shortage of cash in the business, he paid in additional capital of Rs. 40,000 in early June 2014.

The net assets of the business at 30 June 2014 can be calculated as follows:

	Rs.
Opening equity (net assets)	670,000
Profit	250,000
Capital introduced	40,000
Drawings	(220,000)
Closing equity (net assets)	740,000

Example:

Nadia operates a business as a sole trader. On 31 March 2013 the net assets of the business were Rs. 950,000.

During the year to 31 March 2013, the business made a loss of Rs. 20,000 and Nadia took out Rs. 150,000 in drawings during the year. She was also required to invest a further Rs. 290,000 during the year.

The opening net assets of the business at 1 April 2012 can be calculated by working backwards to identify what they need to be in order to make the sum work.

	Rs.		Rs.
Opening equity (net assets)	?	Therefore	830,000
Loss	(20,000)		(20,000)
Capital introduced	290,000		290,000
Drawings	(150,000)		(150,000)
Closing equity (net assets)	950,000		950,000

A missing figure identified in this way is described as a balancing figure.

A balancing figure is a number identified to make a sum work.

The opening assets could also be identified using an equation based approach:

ONA – L + CI – D = CNA.

ONA – 20,000 + 290,000 – 150,000 = 950,000.

ONA = 950,000 + 20,000 – 290,000 + 150,000 = 830,000

This technique can be used in situations where the accounting records are incomplete for some reason. It is covered again in a later chapter.

2 PREPARING A SIMPLE STATEMENT OF FINANCIAL POSITION AND STATEMENT OF COMPREHENSIVE INCOME

Section overview

- Identifying the elements for a statement of financial position or statement of comprehensive income
- Useful guidelines
- Exercise

2.1 Identifying the elements for a statement of financial position or statement of comprehensive income

To prepare a statement of financial position and statement of comprehensive income, several adjustments must be made to the accounting records at the end of the financial year. These adjustments (such as adjustments for the depreciation of non-current assets, for accruals and prepayments, for bad and doubtful debts and for opening and closing inventory values) are explained in later chapters.

At this stage, however, it is a useful exercise to test your ability to prepare a simple statement of financial position and statement of comprehensive income from lists of assets, liabilities, equity, income and expenses.

2.2 Useful guidelines

The data for preparing financial statements comes from the accounting records, which are described in a later chapter.

A list of 'balances' is obtained from the accounting records, for assets, liabilities, capital, expenses and income.

In the example below, the list of balances is used to prepare a statement of comprehensive income for the period and a statement of financial position as at the period end.

Opening and closing inventory and the cost of sales

The cost of sales in the statement of comprehensive income is not the cost of goods purchased or the cost of goods produced. It must be the cost of the goods sold. The accruals or matching concept must be applied.

When there are differences between the quantity of materials purchased or made, and the quantity of materials used or sold, there is an increase or decrease in inventory during the period.

To calculate the cost of sales for a statement of comprehensive income, it is necessary to make an adjustment for changes in the amount of inventory.

Illustration: Cost of sales

	Rs.	
Opening inventory	X	
Purchases	X	
	X	This is the total amount of goods that were available to be sold.
Less: Closing inventory	(X)	This is the total amount of goods still held at the end of the period.
Cost of sales	X	Therefore, this is the total amount of goods that were sold.

Example: Cost of sales

	Rs.
Opening inventory	5,000
Purchases	45,000
	50,000
Less: Closing inventory	(12,000)
Cost of sales	38,000

The statement of comprehensive income will provide a figure for profit or loss for the period.

The statement of financial position and the statement of comprehensive income can be prepared in any order but the statement of financial position can only be completed after the profit or loss for the period is known because this figure becomes part of the equity capital.

2.3 Exercise

This is an introductory example to illustrate the basic principles. In practice there would always be adjustments to make in order to arrive at the corrected figures for inclusion in the financial statements. These are explained in later chapters.

The first step is to identify which balances are income and expenses for inclusion in the statement of comprehensive income and which balances are assets, liabilities and equity for inclusion in the statement of financial position.

Practice question **2**

Mujtaba began trading began on 1 January 2013.

The following information has been extracted from his accounting records at 30th June 2013.

	Rs.
Sales	184,620
Purchases	146,290
Salaries	21,500
Motor expenses	5,200
Rent	6,700
Insurance	1,110
General expenses	1,050
Premises	15,000
Motor vehicles	12,000
Trade receivables	19,500
Trade payables	15,380
Cash	16,940
Drawings	8,950
Capital	54,240

Inventory as at 30th June 2013 was Rs.25,480.

Prepare a statement of comprehensive income for the six months ended 30th June 2013 and a statement of financial position as at that date.

Remember that the capital at the beginning of the year is adjusted for the profit and drawings during the year, to obtain the owner's capital at the end of the year.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

1. After transaction 8 (Cash falls by 10,000; Loan falls by 10,000)

Assets		=	**Equity**		+	**Liabilities**	
	Rs.			**Rs.**			**Rs.**
Cash	17,000		Capital:				
Inventory	4,000		Original	30,000			
Receivable	9,000		Profit	7,000			
Stall	5,000			37,000		Loan	30,000
Van	40,000					Trade payables	8,000
	75,000	=		**37,000**	+		**38,000**

2. After transaction 9 (Cash falls by 6,000; Trade payables falls by 6,000)

Assets		=	**Equity**		+	**Liabilities**	
	Rs.			**Rs.**			**Rs.**
Cash	11,000		Capital:				
Inventory	4,000		Original	30,000			
Receivable	9,000		Profit	7,000			
Stall	5,000			37,000		Loan	30,000
Van	40,000					Trade payables	2,000
	69,000	=		**37,000**	+		**32,000**

3. After transaction 10 (Cash increases by 8,000; Receivables fall by 8,000)

Assets		=	**Equity**		+	**Liabilities**	
	Rs.			**Rs.**			**Rs.**
Cash	19,000		Capital:				
Inventory	4,000		Original	30,000			
Receivable	1,000		Profit	7,000			
Stall	5,000			37,000		Loan	30,000
Van	40,000					Trade payables	2,000
	69,000	=		**37,000**	+		**32,000**

Solutions **1**

4. After transaction 11 (Inventory increases by 2,500; Trade payables increase by 2,500)

Assets		**=**	**Equity**		**+**	**Liabilities**	
	Rs.			**Rs.**			**Rs.**
Cash	19,000		Capital:				
Inventory	6,500		Original	30,000			
Receivable	1,000		Profit	7,000			
Stall	5,000			37,000		Loan	30,000
Van	40,000					Trade payables	4,500
	71,500	=		**37,000**	+		**34,500**

Solution: Mujtaba: Statement of comprehensive income for the six months ended 30th June 2013. **2**

	Rs.	Rs.
Sales		184,620
Inventory at 1 January 2013	0	
Purchases	146,290	
	146,290	
Inventory at 31 December 2013	(25,480)	
Cost of sales		120,810
Gross profit		63,810
Salaries	21,500	
Motor expenses	5,200	
Rent	6,700	
Insurance	1,110	
General expenses	1,050	
		(35,560)
Net profit		28,250

Solution: Mujtaba: Statement of financial position as at 30th June 2013. **2**

	Rs.	Rs.
Non-current assets:		
Premises		15,000
Motor vehicles		12,000
		27,000
Current assets:		
Inventory	25,480	
Trade receivables	19,500	
Cash at bank	16,940	
		61,920
Total assets		88,920
Capital at 1st January 2013		54,240
Net profit for the year		28,250
		82,490
Less: Drawings		(8,950)
Capital at 30th June 2013		73,540
Current liabilities:		
Trade payables		15,380
Total capital and liabilities		88,920

CHAPTER 4

Double entry bookkeeping

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 2	**Identify financial transactions and make journal entries**
LO2.3.1	*Double entry:* Understand and apply, the accounting equation (Assets = Liabilities + Equity) in simple practical and common scenarios
LO2.3.2	*Double entry:* Identify financial and non-financial transactions in a well-defined scenario
LO2.3.3	*Double entry:* Understand and apply the concept of double entry accounting to simple and common business transactions
LO2.2.1	*Chart of accounts:* Understand the meaning of a chart of accounts
LO2.2.2	*Chart of accounts:* Explain the purpose of establishing a chart of accounts
LO2.2.3	*Chart of accounts:* Construct a chart of accounts using given data

LO 3	**Prepare general ledger accounts and a trial balance.**
LO3.1.1	*General ledger:* Describe the main features of the general ledger
LO3.1.2	*General ledger:* Post entries in the general ledger
LO3.2.1	*Trial balance:* Understand the purpose of the trial balance
LO3.2.2	*Trial balance:* Understand and demonstrate mapping between general ledger balances and the trial balance
LO3.2.3	*Trial balance:* Identify the limitations of a trial balance.

LO 2	**Identify financial transactions and make journal entries**
LO2.4.1	*General journal:* List and describe the basic contents of the general journal
LO2.4.2	*General journal:* Prepare and use the general journal to record journal entries

1 INTRODUCTION TO ACCOUNTING SYSTEMS

Section overview

- The dual nature of transactions
- Overview of accounting

1.1 The dual nature of transactions

The previous chapter explained the accounting equation. It illustrates the most important concept in accounting. That is that every transaction must be entered in two places or the equation would fail.

There is no exception to this rule. Every transaction that affects assets, liabilities, capital, income or expenses must have an offsetting effect to maintain the accounting equation. Every transaction must be recorded (entered) in two places. The process of doing this is called ***double entry book-keeping***.

The accounting equation is useful to give an overview of the accounting process but it is not very practical as a tool to account for the transactions of a business. A business might enter into many thousands of transactions and it would be very time consuming to redraft the equation after each of them. A system is needed to allow large numbers of transactions to be recorded and then summarised to allow the production of financial statements on a periodic basis.

Book-keeping

Book-keeping is the process of recording financial transactions in the accounting records (the 'books') of an entity.

All transactions are analysed into different types and are then recorded in a series of individual records called accounts. There is a separate account for each different type of transaction, or that is to say, for each type of asset, liability, income, expense, and owners' capital.

Accounts are kept together in a ***ledger***. A ledger is a term meaning a collection of related accounts.

There are different types of ledgers in an accounting system but the accounts that record the double entries for each transaction are kept in the ***general ledger***, (also known as the ***nominal ledger*** or the ***main ledger***)

This session will continue to explain the process of double entry bookkeeping but before that there is an overview of the accounting process. Later sections and chapters will add to this in detail.

1.2 Overview of accounting

Illustration:

Transactions	A business faces many thousands of transactions
Books of prime entry	This is the first place that a transaction is recorded. Instead of recording each individual sale in the general ledger an entity might record all sales in a day and then record the total in the general ledger. The entity would also need to maintain records for each individual customer so that it could manage the receivables but this would not be part of the general ledger. (Covered in chapter 5)
Accounts in the general ledger	Transactions (or transactions totals) are entered into the appropriate accounts in the general ledger.
Trial balance	A list of balances can be extracted from the general ledger as a step in the preparation of financial statements. This is called a trial balance.
	Figures in the trial balance are adjusted for period end adjustments. These are amendments put into the accounts rather than entries that are driven by transactions. (Covered in chapters 6 – 9).
Financial statements	

A trial balance can be extracted at any time but the rest of this book will assume it to be at the end of an accounting year.

Any adjustments made to the trial balance must also be reflected in the general ledger accounts. In other words, if something is added in after the trail balance is extracted it must also be added into the general ledger.

There is a large exercise to tidy up the general ledger once the year-end financial statements are produced. It involves clearing all of the income and expense accounts into a statement of comprehensive income account. The balance on this account is then transferred to equity. This is to prepare the general ledger for the next accounting period.

2 BASIC RULES OF DOUBLE ENTRY BOOKKEEPING

Section overview

- Debit and credit entries, and T accounts
- The rules of debits and credits
- Double entry book-keeping and the cash account

2.1 Debit and credit entries, and T accounts

Financial transactions are recorded in the accounts in accordance with a set of rules or conventions. The following rules apply to the accounts in the main ledger (nominal ledger or general ledger).

- Every transaction is recorded twice, as a debit entry in one account and as a credit entry in another account.
- Total debit entries and total credit entries must always be equal. This maintains the accounting equation.

It therefore helps to show accounts in the shape of a T, with a left-hand and a right-hand side. (Not surprisingly this presentation is known as a ***T account***). By convention:

- debit entries are made on the left-hand side and
- credit entries are on the right-hand side.

Illustration:

Account name

Debit side (Dr)	Rs.	Credit side (Cr)	Rs.
Debit transactions entered on this side		Credit transactions entered on this side	Amount
Enter reference to the account where the matching credit entry is made	X	Enter reference to the account where the matching debit entry is made	X

By convention, the terms ‘debit’ and ‘credit’ are shortened to ‘Dr’ and ‘Cr’ respectively.

Alternative presentation

Accounts might also be presented in columnar forms. If this presentation is used care must be taken over the meaning of debit and credit in the context of the account. For example, a debit in a credit account would be shown as a deduction. In other words, it is easier to make mistakes with this format. However, it can be useful when you want to show a single account or use a single account as a working. You will see examples of this presentation in later chapters but for now we will only use ***T accounts***.

2.2 The rules of debits and credits

In the main ledger, there are accounts for assets, liabilities, equity, income and expenses. The rules about debits and credits are as follows:

Illustration:

Account name

Debit side (Dr)	Credit side (Cr)
Record as a debit entry:	**Record as a credit entry:**
An increase in an asset	A reduction in an asset
An increase in an expense	A reduction in an expense
A reduction in a liability	**An increase in a liability**
A reduction in income	**An increase in income**
A reduction in capital (drawings, losses)	**An increase in capital** (capital introduced profit)

You need to learn these basic rules and become familiar with them. Remember that in the main ledger, transactions entered in the debit side of one account must be matched by an offsetting credit entry in another account, in order to maintain the accounting equation and record the dual nature of each transaction.

Example

A purchase invoice is received for electricity charges for Rs. 2,300

The double entry is:

Debit: Electricity charges (= increase in expense)

Credit: Total trade payables (= increase in liability)

Electricity expense

	Rs.		Rs.
Trade payables	2,300		

Expenses payables

	Rs.		Rs.
		Electricity expense	2,300

This can be written as:

Dr	Electricity expense	2,300	
	Cr Expenses payables		2,300

This is known as a journal entry (or journal for short). Journal entries are covered in more detail later in this chapter.

2.3 Double entry book-keeping and the cash account

An entity would usually keep separate accounts to record cash. One is for cash in hand and the other for cash at bank.

It might help to learn the rules of double entry by remembering that transactions involving the receipt or payment of cash into the cash at bank account (or cash in hand account) are recorded as follows:

- The cash at bank account is an asset account (money in the bank is an asset).
- Receipts of cash: These are recorded as a debit entry in the cash at bank account, because receipts add to cash (an asset).
- Payments of cash. Payments reduce cash, so these are recorded as a credit entry in the cash at bank account.

Illustration:

Cash at bank

Debit side (Dr)	Credit side (Cr)
Record as a debit entry:	**Record as a credit entry:**
Transactions that provide an INCREASE in cash	Transactions that result in a REDUCTION in cash
The matching credit entry might be to	The matching debit entry might be to
(1) a sales account for cash sales	(1) an expense account, for payments of cash expenses
(2) the total trade receivables account for payments received from credit customers	(2) the total trade payables account, for payments to suppliers for purchases on credit/amounts owing
(3) the capital account for new capital introduced by the owner in the form of cash	(3) a payment in cash for a new asset,
	(4) a drawings account, for withdrawals of profit by the business owner

Section 1 of this chapter explained the accounting equation and illustrated it with an example where Abbas set up a business. This session continues by showing how the same transactions would be recorded in ledger accounts.

The transactions are repeated on the next page for convenience.

Example: Abbas revisited

1 Abbas introduces Rs. 30,000 cash as capital.

2 Abbas borrows Rs. 40,000 to purchase a van.

3 Abbas buys a market stall for Rs. 5,000 cash.

4 Abbas buys inventory for Rs. 18,000 on credit.

5 Abbas pays his supplier Rs. 10,000.

6 Abbas sells inventory for Rs. 12,000 cash.

7 Abbas sells inventory for Rs. 9,000 on credit.

8 Abbas repays Rs. 10,000 of the loan.

9 Abbas pays his trade suppliers Rs. 6,000.

10 Abbas receives Rs. 8,000 of the money owed to him by the customer (trade receivable).

11 Abbas purchases another Rs. 2,500 of shirts, on credit.

12 Abbas drew Rs.4,000 cash out of the business and also took inventory which cost 2,500 for his own use.

Post all transactions to ledger accounts.

Example: Abbas – Transaction 1

Abbas sets up a business by putting Rs. 30,000 into a bank account.

This increases the cash of the business, and its capital.

The double entry is:

Dr Bank (or cash)	30,000	
Cr Capital		30,000

Capital

	Rs.		Rs.
		(1) Bank	30,000

Bank

	Rs.		Rs.
(1) Capital	30,000		

Note: The entry in each account shows the account where the matching debit or credit entry appears.

Example: Abbas – Transaction 2

Abbas borrows Rs. 40,000 to purchase a van.

There are two separate transactions, the loan of cash and the purchase of the van.

The double entries are:

Dr Bank	40,000	Dr Van	40,000
Cr Loan	40,000	Cr Bank	40,000

Bank

	Rs.		Rs.
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000		

Loan

	Rs.		Rs.
		(2a) Bank	40,000

Van

	Rs.		Rs.
(2b) Bank	40,000		

Example: Abbas – Transaction 3

Abbas buys a market stall for Rs. 5,000.

The double entry is:

Dr Stall	5,000
Cr Bank	5,000

Bank

	Rs.		Rs.
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000

Stall

	Rs.		Rs.
(3) Bank	5,000		

The next transaction is a purchase of inventory. This is reflected in an account called purchases rather than inventory. You will see why later.

Example: Abbas – Transaction 4

Abbas purchases inventory for Rs. 18,000 on credit.

The double entry is:

Dr Purchases	**18,000**
Cr Bank	**18,000**

Purchases

		Rs.			Rs.
(4)	Trade payables	18,000			

Trade payables

		Rs.			Rs.
			(4)	Purchases	18,000

Note on purchases of inventory

Notice that in this type of book-keeping system, there is no separate account for inventory.

Purchases of materials and goods for re-sale are recorded in a purchases account, which is an expense account.

Inventory is ignored until such time as when the business wishes to calculate profit (usually the end of an accounting period) when it is counted and valued. This value is then used in a calculation of a cost of sale figure. (This will be demonstrated a little later in this chapter and the full inventory double entry explained in chapter 9).

Example: Abbas – Transaction 5

Abbas pays Rs. 10,000 to the supplier.

The double entry is:

Dr Trade payables	**10,000**
Cr Bank	**10,000**

Bank

		Rs.			Rs.
(1)	Capital	30,000	(2b)	Van	40,000
(2a)	Loan	40,000	(3)	Stall	5,000
			(5)	Trade payables	10,000

Trade payables

		Rs.			Rs.
(5)	Bank	10,000	(4)	Purchases	18,000

Example: Abbas – Transaction 6

Abbas sells inventory for Rs. 12,000 cash.

The double entry is:

Dr Bank	12,000	
Cr Sales		12,000

Bank

		Rs.			Rs.
(1)	Capital	30,000	(2b)	Van	40,000
(2a)	Loan	40,000	(3)	Stall	5,000
(6)	Sales	12,000	(5)	Trade payables	10,000

Sales

		Rs.			Rs.
			(6)	Bank	12,000

Example: Abbas – Transaction 7

Abbas sells inventory for Rs. 9,000 on credit.

The double entry is:

Dr Trade receivables	9,000	
Cr Sales		9,000

Trade receivables

		Rs.			Rs.
(7)	Sales	9,000			

Sales

		Rs.			Rs.
			(6)	Bank	12,000
			(7)	Trade receivables	9,000

Example: Abbas – Transaction 8

Abbas repays Rs. 10,000 of the loan

The double entry is:

Dr Loan	10,000	
Cr Bank		10,000

Bank

		Rs.			Rs.
(1)	Capital	30,000	(2b)	Van	40,000
(2a)	Loan	40,000	(3)	Stall	5,000
(6)	Sales	12,000	(5)	Trade payables	10,000
			(8)	Loan	10,000

Loan

		Rs.			Rs.
(8)	Bank	10,000	(2a)	Bank	40,000

Example: Abbas – Transaction 9

Abbas pays Rs. 6,000 to the supplier.

The double entry is:

Dr Trade payables	6,000	
Cr Bank		6,000

Bank

		Rs.			Rs.
(1)	Capital	30,000	(2b)	Van	40,000
(2a)	Loan	40,000	(3)	Stall	5,000
(6)	Sales	12,000	(5)	Trade payables	10,000
			(8)	Loan	10,000
			(9)	Trade payables	6,000

Trade payables

		Rs.			Rs.
(5)	Bank	10,000	(4)	Purchases	18,000
(9)	Bank	6,000			

Example: Abbas – Transaction 10

Abbas receives Rs. 8,000 from a customer.

The double entry is:

Dr Bank	8,000	
Cr Trade receivables		8,000

Bank

		Rs.			Rs.
(1)	Capital	30,000	(2b)	Van	40,000
(2a)	Loan	40,000	(3)	Stall	5,000
(6)	Sales	12,000	(5)	Trade payables	10,000
(10)	Trade receivables	8,000	(8)	Loan	10,000
			(9)	Trade payables	6,000

Trade receivables

		Rs.			Rs.
(7)	Sales	9,000	(10)	Bank	8,000

Example: Abbas – Transaction 11

Abbas purchases inventory for Rs. 2,500 on credit.

The double entry is:

Dr Purchases	2,500	
Cr Bank		2,500

Purchases

		Rs.			Rs.
(4)	Trade payables	18,000			
(11)	Trade payables	2,500			

Trade payables

		Rs.			Rs.
(5)	Bank	10,000	(4)	Purchases	18,000
(9)	Bank	6,000	(11)	Purchases	2,500

Example: Abbas – Transaction 12

Abbas draws Rs. 4,000 cash and took inventory which cost Rs. 2,500 for his own use.

If an owner takes inventory for his own use it means that some of the purchases have not been for the business. This is reflected in the double entry by reducing purchases.

There are two transactions but they can be combined into the following double entry:

Dr Bank	6,500	
Cr Bank		4,000
Cr Purchases		2,000

Bank

	Rs.		Rs.
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000

Purchases

	Rs.		Rs.
(4) Trade payables	18,000	(12b) Drawings	2,000
(11) Trade payables	2,500		

Drawings

	Rs.		Rs.
(12a) Bank	4,000		
(12b) Bank	2,000		

There is a practice question on page 87 of this chapter.

You may attempt part a of the exercise now or you could attempt the whole exercise after you have finished section 3 of this chapter.

3 ACCOUNT BALANCES AND THE TRIAL BALANCE

Section overview

- Closing off an account (and bringing down the balance)
- Trial balance
- Preparing accounts from a trial balance

3.1 Closing off an account and bring down the balance

The balance on an account can be established at any time as the difference between the total value of debit entries and the total value of credit entries.

- If total debit entries in an account exceed total credits, there is a debit balance on the account.
- If total credit entries in an account exceed total debits there is a credit balance on the account.

When the balance on an account is established at the end of a period the process is described as closing off the account and bringing down the balance (though the same process is used whenever a balance is extracted). The figure identified in this way is called the closing balance.

- Balances on expense accounts and income accounts are transferred to the statement of comprehensive income. (**Note:** There might be some accruals and prepayments on expense accounts. These are explained in a later chapter.)
- Balances on the asset, liability and capital accounts are carried forward as closing balances at the end of the period, and become opening balances at the beginning of the next period.

Example: Closing off and bringing down a balance (Using Abbas's cash account after transaction 12)

Step 1: Add up both sides of the account

Bank

	Rs.		Rs.
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
	90,000		75,000

Example: Closing off and bringing down a balance (continued)

Step 2: Leave a line and write the biggest figure in totalling lines on each side of the account.

Bank

	Rs.		Rs.
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
	90,000		75,000
	90,000		90,000

Step 3: One side of the account will not add to the total. Insert a balancing figure describing this as ***balance c/d*** (carried down)

Bank

	Rs.		Rs.
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
	90,000		75,000
		Balance c/d	15,000
	90,000		90,000

Example: Closing off and bringing down a balance (continued)

Step 4: Write the balancing figure below the totalling lines on the other side of the account describing it as *balance b/d* (brought down)

Bank

	Rs.		Rs.
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
	90,000		75,000
		Balance c/d	15,000
	90,000		90,000
Balance b/d	15,000		

Note that it is usual to skip step 2 and not write in the subtotals but go straight to step 3.

The full working in that case would look like this:

Example: Closing off and bringing down a balance (Using Abbas's cash account after transaction 12)

Bank

	Rs.		Rs.
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
		Balance c/d	15,000
	90,000		90,000
Balance b/d	15,000		

In this example, there is a debit balance on the bank account at the end of the period. The debit balance of Rs. 15,000 is brought forward as the opening balance on the account at the beginning of the next period.

This indicates that the business has an asset (a debit balance) of cash in the bank account totalling Rs. 15,000.

Note

In the above example we used c/d and b/d as a description of the balance on the closing off of the account.

You might also use c/f (which stands for carried forward) and b/f (which stands for brought forward).

Returning to Abbas.......

Example: Abbas – All accounts closed off with balances brought down

Capital

	Rs.		Rs.
		(1) Bank	30,000
Balance c/d	30,000		
	30,000		30,000
		Balance b/d	30,000

Loan

	Rs.		Rs.
(8) Bank	10,000	(2a) Bank	40,000
Balance c/d	30,000		
	40,000		40,000
		Balance b/d	30,000

Van

	Rs.		Rs.
(2b) Bank	40,000		
		Balance c/d	40,000
	40,000		40,000
Balance b/d	40,000		

Stall

	Rs.		Rs.
(3) Bank	5,000		
		Balance c/d	5,000
	5,000		5,000
Balance b/d	5,000		

Example: Abbas – All accounts closed off

Purchases

	Rs.		Rs.
(4) Trade payables	18,000	(12b) Drawings	2,000
(11) Trade payables	2,500		
		Balance c/d	18,500
	20,500		20,500
Balance b/d	18,500		

Trade payables

	Rs.		Rs.
(5) Bank	10,000	(4) Purchases	18,000
(9) Bank	6,000	(11) Purchases	2,500
Balance c/d	4,500		
	20,500		20,500
		Balance b/d	4,500

Trade receivables

	Rs.		Rs.
(7) Sales	9,000	(10) Bank	8,000
		Balance c/d	1,000
	9,000		9,000
Balance b/d	1,000		

Sales

	Rs.		Rs.
		(6) Bank	12,000
		(7) Trade receivables	9,000
Balance c/d	21,000		
	21,000		21,000
		Balance b/d	21,000

Drawings

	Rs.		Rs.
(12a) Bank	4,000		
(12b) Bank	2,000	Balance c/d	6,000
	6,000		6,000
Balance b/d	6,000		

3.2 Trial balance

The balance extracted for any single account is the net of all of the debit and credit entries in that account.

If double entries have been posted correctly then the total of all debit entries made to all of the accounts in the general ledger must equal the total of all credit entries. It follows that if balances are extracted for every account in the general ledger the sum of the debit balances must equal the sum of the credit balances.

A trial balance is a list of all the debit balances and all the credit balances on the accounts in the main ledger. A trial balance is 'extracted' from the main ledger simply by listing the balances on every account.

The normal method of presentation is to present the balances in two columns, one for debit balances and one for credit balances.

- Debit balances are assets, expenses or drawings.
- Credit balances are liabilities, income or equity (capital including share capital and reserve accounts in the case of a company).

Example: Abbas – Trial balance as at (it would be usual to give a date)

	Dr	Cr
Bank	15,000	
Capital		30,000
Loan		30,000
Van	40,000	
Stall	5,000	
Purchases	18,500	
Trade payables		4,500
Trade receivables	1,000	
Sales		21,000
Drawings	6,000	
	85,500	85,500

The purpose of a trial balance

A trial balance has two main purposes.

- It is a starting point for producing a statement of comprehensive income and a statement of financial position at the end of an accounting period.
- It is a useful means of checking for errors in the accounting system. Errors must have occurred if the total of debit balances and total of credit balances on the main ledger accounts are not equal. (This is covered in chapter 11).

There is a practice question on page 87 of this chapter.

If you have already attempted part a then do part b now.

Otherwise do the whole exercise after completing all of section 3 of this chapter.

3.3 Preparing accounts from a trial balance

Year-end adjustments

The trial balance provides a foundation for preparing a statement of comprehensive income and a statement of financial position at the end of an accounting period.

- A trial balance is extracted from the general ledger, and various year-end adjustments are then made to the accounts.
- These adjustments (covered later in chapters 6 to 9) include adjustments for:
  - Depreciation expense (to reflect the use of non-current assets);
  - Accruals and prepayments;
  - Bad and doubtful debts; and
  - Inventory.
- Further adjustments are made as necessary to deal with items missed or incorrectly dealt with during a period.

When the year-end adjustments have been made, a statement of comprehensive income and then a statement of financial position can be prepared, using the adjusted balances.

This session will now use the trial balance of Abbas to illustrate the preparation of a set of accounts from a trial balance.

A useful first step is to identify the different types of balance (this will become automatic for you very quickly).

Example: Abbas – Trial balance as at 31 December 2013

			Which element?		
	Dr	Cr			
Bank	15,000		Asset		
Capital		30,000		Equity	
Loan		30,000		Liability	
Van	40,000		Asset		
Stall	5,000		Asset		
Purchases	18,500				Expense
Trade payables		4,500		Liability	
Trade receivables	1,000		Asset		
Sales		21,000			Income
Drawings	6,000			Equity	
	85,500	85,500			

Extra information:

The closing inventory of Abbas is Rs. 4,500

The only closing adjustment in the case of Abbas is in respect of the closing inventory.

Opening and closing inventory and the cost of sales

This appeared in the previous chapter. It is repeated here for your convenience.

The cost of sales in the statement of comprehensive income is not the cost of goods purchased or the cost of goods produced. It must be the cost of the goods sold. The accruals or matching concept must be applied.

When there are differences between the quantity of materials purchased or made, and the quantity of materials used or sold, there is an increase or decrease in inventory during the period.

To calculate the cost of sales for a statement of comprehensive income, it is necessary to make an adjustment for changes in the amount of inventory.

Illustration: Cost of sales

	Rs.	
Opening inventory	X	
Purchases	X	
	X	This is the total amount of goods that were available to be sold.
Less: Closing inventory	(X)	This is the total amount of goods still held at the end of the period.
Cost of sales	X	Therefore, this is the total amount of goods that were sold.

Inventory, at any point in time, represents goods made or purchased with the intention of selling them in the ordinary course of business, which remain unsold at that point in time.

Closing inventory is recognised as an asset and as a deduction against the cost of sales expense. (The double entry is Dr Inventory (asset) in the statement of financial position and Cr Cost of sales (reduction of an expense) in the statement of comprehensive income. This covered in detail in chapter 9).

Example: Abbas – Statement of comprehensive income for the period ending 31 December 2013

	Rs.	Rs.
Sales		21,000
Opening inventory (none as it is the first period of trading)	0	
Purchases	18,500	
	18,500	
Inventory at 31 December Year 5	(4,500)	
Cost of sales		14,000
Gross profit		7,000
Less: Expenses (none in this case)		0
Net profit		7,000

Abbas: Statement of financial position as at 31 December 2013.

	Rs.	Rs.
Non-current assets:		
Van		40,000
Stall		5,000
		45,000
Current assets:		
Inventory	4,500	
Trade receivables	1,000	
Bank	15,000	
		20,500
Total assets		65,500
Capital introduced at start of business		30,000
Net profit for the year		7,000
		37,000
Less: Drawings		(6,000)
Capital at period end		31,000
Non-current liabilities		
Loan		30,000
Current liabilities:		
Trade payables		4,500
Total capital and liabilities		65,500

Complete the practice question on page 87 of this chapter.

4 THE GENERAL JOURNAL

Section overview

- Journal entries
- Illustration using Abbas

4.1 Journal entries to record transactions

The general journal (journal for short) is a book of prime entry that is used to record transactions that are not recorded in any other book of original entry.

The journal might be used to provide a record and explanation of:

- postings from books of prime entry (explained in chapter 5);
- year-end adjustments (chapters 6 to 9);
- correction of errors (chapter 11) or
- any other adjustment.

The format of a journal entry is as follows:

Illustration:

	Debit	Credit
Name of the account with the debit entry	X	
Name of the account with the credit entry		X
Narrative explaining or describing the transaction		

In practice, not all entries are recorded in a journal or journalised but of course it is possible to write a journal for any transaction. You might be required to record double entry transactions as 'journal entries'. This is simply a requirement to show the debit and credit entries for a transaction, without preparing T accounts.

4.2 Illustration using Abbas

Example: Abbas revisited

1. Abbas introduces Rs. 30,000 cash as capital.
2. Abbas borrows Rs. 40,000 to purchase a van.
3. Abbas buys a market stall for Rs. 5,000 cash.
4. Abbas buys inventory for Rs. 18,000 on credit.
5. Abbas pays his supplier Rs. 10,000.
6. Abbas sells inventory for Rs. 12,000 cash.
7. Abbas sells inventory for Rs. 9,000 on credit.
8. Abbas repays Rs. 10,000 of the loan.
9. Abbas pays his trade suppliers Rs. 6,000.
10. Abbas receives Rs. 8,000 of the money owed to him by the customer (trade receivable).

Prepare journals for each of the above transactions.

Example: Abbas – Journalising transactions

Transaction 1	**Debit**	**Credit**
Cash	30,000	
Capital		30,000
Being: The introduction of capital at the start of a new business		
Transaction 2		
Cash	40,000	
Loan payable		40,000
Asset – Van	40,000	
Cash		40,000
Being: The borrowing of cash and the purchase of a van.		
Transaction 3		
Asset – Market stall	5,000	
Cash		5,000
Being: The purchase of a market stall		
Transaction 4	**Debit**	**Credit**
Purchases	18,000	
Payables		18,000
Being: The purchase of inventory on credit		

Example: Abbas – Journalising transactions (continued)

Transaction 5	**Debit**	**Credit**
Payables	10,000	
Cash		10,000
Being: A payment to a supplier.		
Transaction 6		
Cash	12,000	
Sales		12,000
Being: The cash sale of inventory.		
Transaction 7		
Receivables	9,000	
Sales		9,000
Being: The sale of inventory on credit.		
Transaction 8		
Loan payable	10,000	
Cash		10,000
Being: A part repayment on the loan.		
Transaction 9		
Payables	6,000	
Cash		6,000
Being: Payment to suppliers.		
Transaction10		
Cash	8,000	
Receivables		8,000
Being: Cash received from credit customer		

5 GENERAL LEDGER

Section overview

- Introduction
- Chart of accounts
- Year end exercise

5.1 Introduction

The general ledger is a document which contains all of the individual accounts which are used to record the double entries of a business. It may have physical form as a book or it may be a software application.

All of the financial transactions of a business are entered into appropriate accounts in the general ledger. The balances on these individual accounts can be extracted as a trial balance as a step in preparing financial statements for the business.

Usually a business will organise its general ledger into the specific accounts which it uses. As part of this process, it might employ a coding system under which each individual ledger account is assigned a unique code.

The list of these codes is called a chart of accounts.

5.2 Chart of accounts

This is a list of accounts created by a business to be used to organise its financial transactions into identified categories of assets, liabilities, income and expenses.

Each general ledger account is identified by a unique code and heading. This allows a business to generate instructions and policies to be followed by those members of staff responsible for recording information.

The list is typically arranged in the order of the customary appearance of accounts in the financial statements, statement of financial position general ledger accounts followed by statement of comprehensive income general ledger accounts. The structure and headings in the list aim to result in consistent posting of transactions.

A company might have complete freedom in designing its chart of accounts (within the boundaries set by the rules of accounting). In some countries, the government might issue a generic chart of accounts from which a business selects those codes that are appropriate to its needs.

The aim of the chart is to ensure that all transactions are recognised in accordance with the requirements of the business.

Illustration: Chart of accounts

Each major heading in the financial statements might be given a range of codes from which codes can be selected for individual general ledger accounts:

	Code range		Code range
Non-current assets	100–199	Income	600–699
Current assets	200–299	Expenses	700–799
Non-current liabilities	300–399		
Current liabilities	400–499		
Equity	500–599		

Individual ledger accounts within the above range for non-current assets:

Non-current assets	Code
Land	110
Office buildings	120
Warehouses	130
Factories	140

5.3 Year-end exercise

An earlier section in this chapter explained that the trial balance is a foundation for preparing a statement of comprehensive income and a statement of financial position at the end of an accounting period. The trial balance is extracted and various year-end adjustments are then made to the accounts after which a statement of comprehensive income and then a statement of financial position can be prepared, using these adjusted balances.

Any of these adjustments must also be recorded in the general ledger accounts so that these agree with balances on the financial statements.

At the end of the period there is another exercise to perform in order to prepare the general ledger for use in the next accounting period.

You may have noticed that profit is calculated after the trial balance has been extracted. This means that there is no profit figure in the general ledger. Rather, it is represented by all of the balances on the income and expense accounts.

These must all be transferred to a general ledger profit or loss account. The balance on this account will then be the profit or loss for the period. This balanced is transferred to the equity account.

Process:

Step 1: Perform double entry as necessary to capture the year-end adjustments in the general ledger accounts.

Step 2: Perform double entry to transfer all incomes statements amounts to a profit or loss general ledger account.

Step 3: Close off this account

Step 4: Transfer the balance on this account to capital.

Step 5: Transfer the balance on the drawings account to capital and close off the capital account.

This session will now use the information about Abbas to illustrate this exercise.

Example: Abbas – Trial balance (reordered for this section) before the inventory adjustment was as follows:

	Dr	Cr
Bank	15,000	
Loan		30,000
Van	40,000	
Stall	5,000	
Trade payables		4,500
Trade receivables	1,000	
Capital		30,000
Drawings	6,000	
Sales		21,000
Purchases	18,500	
	85,500	85,500

Reminder: The closing inventory of Abbas is Rs. 4,500

Step 1: Perform double entry in the general ledger for the year-end adjustments

Bank

Balance b/d	15,000		

Loan

		Balance b/d	30,000

Van

Balance b/d	40,000		

Stall

Balance b/d	5,000		

Trade payables

		Balance b/d	4,500

Trade receivables

Balance b/d	1,000		

Capital

		Balance b/d	30,000

Drawings

Balance b/d	6,000		

Sales

		Balance b/d	21,000

Purchases

Balance b/d	18,500		

Inventory (statement of comprehensive income)

		Balance b/d	**4,500**

Inventory (asset)

Balance b/d	**4,500**		

Example: Step 2: Perform double entry to transfer all incomes statements amounts to a profit or loss general ledger account.

Bank

Balance b/d	15,000		

Loan

		Balance b/d	30,000

Van

Balance b/d	40,000		

Stall

Balance b/d	5,000		

Trade payables

		Balance b/d	4,500

Trade receivables

Balance b/d	1,000		

Capital

		Balance b/d	30,000

Drawings

Balance b/d	6,000		

Profit or loss (NEW ACCOUNT)

Purchases	**18,500**	**Sales**	**21,000**
		Inventory	**4,500**

Sales

Profit or loss	**21,000**	**Balance b/d**	**21,000**

Purchases

Balance b/d	**18,500**	**Profit or loss**	**18,500**

Inventory (statement of comprehensive income)

Profit or loss	**4,500**	**Balance b/d**	**4,500**

Inventory (asset)

Balance b/d	4,500		

Step 3: Close off the profit or loss account. (Only those accounts affected are shown).

Capital

		Balance b/d	30,000

Drawings

Balance b/d	6,000		

Profit or loss (NEW ACCOUNT)

Purchases	18,500	Sales	21,000
		Inventory	4,500
Balance c/d	7,000		
	25,500		25,500
		Balance b/d	7,000

Step 4: Transfer the balance on this account to capital.

Capital

		Balance b/d	30,000
		Profit for the period	7,000

Drawings

Balance b/d	6,000		

Profit or loss (NEW ACCOUNT)

Purchases	18,500	Sales	21,000
		Inventory	4,500
Balance c/d	7,000		
	25,500		25,500
Capital	7,000	Balance b/d	7,000

Step 5: Transfer the balance on the drawings account to capital and close off the capital account.

Capital

Drawings	6,000	Balance b/d	30,000
		Profit for the period	7,000
Balance c/d	31,000		
	37,000		37,000
		Balance c/d	31,000

Drawings

Balance b/d	6,000	Capital	6,000

Final balances in the general ledger

Bank

Balance b/d	15,000		

Loan

		Balance b/d	30,000

Van

Balance b/d	40,000		

Stall

Balance b/d	5,000		

Trade payables

		Balance b/d	4,500

Trade receivables

Balance b/d	1,000		

Capital

		Balance b/d	31,000

Inventory (asset)

Balance b/d	4,500		

5.4 Year-end exercise in journals

Section 4 of this chapter explained the role of the journal.

The Abbas year end exercise would require the following journals.

Example: Abbas – end of year general ledger exercise

Step 1	Debit	Credit
Inventory asset	4,500	
Inventory (statement of comprehensive income)		4,500
Being: The recognition of closing inventory		

Step 2		
Sales	21,000	
Profit or loss		21,000
Profit or loss	18,500	
Purchases		18,500
Inventory (statement of comprehensive income)	4,500	
Profit or loss		4,500
Being: Transfer of income and expense amounts to profit or loss		

Step 4 (there was no double entry in step 3)		
Profit or loss	7,000	
Capital		7,000
Being: Transfer of profit for the period into capital		

Step 5		
Capital	6,000	
Drawings		6,000
Being: Transfer of drawings for the period into capital		

Practice question **1**

Naseer sets up a trading business, buying and selling goods.

Record the following transactions which, occurred during his first month of trading (July 2013) in the relevant ledger accounts.

1 Naseer introduced Rs. 500,000 into the business by paying money into a business bank account.

2 The business bought a motor van for Rs. 60,000. Payment was by cheque.

3 The business bought some inventory for Rs. 30,000, paying by cheque.

4 The entire inventory purchased (transaction 3) was sold for Rs. 50,000 in cash.

5 More inventory was purchased for Rs. 100,000 on credit.

6 50% of the inventory purchased in transaction 5 was sold for Rs. 80,000. All these sales were on credit.

7 A payment of Rs. 30,000 was made to a supplier for some of the purchases.

8 A payment of Rs. 40,000 was received from a customer for some of the sales on credit.

9 Naseer drew Rs. 10,000 from the bank account for his personal use.

10 Naseer paid Rs. 2,000 for diesel for the motor van using a business cheque

11 The business paid Rs. 15,000 by cheque for the premium on an insurance policy.

12 The business received a bank loan of Rs. 100,000, repayable in two years.

a) Post all transactions to ledger accounts.

b) Close off each account and extract a trial balance.

c) Prepare a statement of comprehensive income and a statement of financial position. (Assume that Naseer has closing inventory of Rs, 50,000).

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1a**

Bank

	Rs.		Rs.
(1) Capital	500,000	(2) Motor van	60,000
(4) Sales	50,000	(3) Purchases	30,000
(8) Trade receivables	40,000	(7) Trade payables	30,000
(12) Bank loan	100,000	(9) Drawings	10,000
		(10) Motor expenses	2,000
		(11) Insurance	15,000
		Balance c/d	543,000
	690,000		690,000
Balance b/d	543,000		

Capital

	Rs.		Rs.
		(1) Bank	500,000
Balance c/d	500,000		
	500,000		500,000
		Balance b/d	500,000

Motor van

	Rs.		Rs.
(2) Bank	60,000		
		Balance c/d	60,000
	60,000		60,000
Balance b/d	60,000		

Purchases

	Rs.		Rs.
(3) Bank	30,000		
(5) Trade payables	100,000		
		Balance c/d	130,000
	130,000		130,000
Balance b/d	130,000		

Solution (continued) **1a**

Sales

	Rs.		Rs.
		(4) Bank	50,000
		(6) Trade receivables	80,000
Balance c/d	130,000		
	130,000		130,000
		Balance b/d	130,000

Trade payables

	Rs.		Rs.
(7) Bank	30,000	(5) Purchases	100,000
Balance c/d	70,000		
	100,000		100,000
		Balance b/d	70,000

Trade receivables

	Rs.		Rs.
(6) Sales	80,000	(8) Bank	40,000
		Balance c/d	40,000
	80,000		80,000
Balance b/d	40,000		

Drawings

	Rs.		Rs.
(9) Bank	10,000		
		Balance c/d	10,000
	10,000		10,000
Balance b/d	10,000		

Motor expenses

	Rs.		Rs.
(10) Bank	2,000		
		Balance c/d	2,000
	2,000		2,000
Balance b/d	2,000		

Solution (continued) **1a**

Insurance

	Rs.		Rs.
(10) Bank	15,000		
		Balance c/d	15,000
	15,000		15,000
Balance b/d	15,000		

Bank loan

	Rs.		Rs.
		(12) Bank	100,000
Balance c/d	100,000		
	100,000		100,000
		Balance b/d	100,000

Solution **1b**

Naseer: Trial balance as at 31 July 2013

	Dr	Cr
Bank	543,000	
Capital		500,000
Van	60,000	
Purchases	130,000	
Trade payables		70,000
Trade receivables	40,000	
Sales		130,000
Drawings	10,000	
Motor expenses	2,000	
Insurance	15,000	
Bank loan		100,000
	800,000	800,000

Solution **1c**

Naseer: Statement of comprehensive income for the month ending 31 July 2013

	Rs.	Rs.
Sales		130,000
Opening inventory	0	
Purchases	130,000	
	130,000	
Closing inventory	(50,000)	
Cost of sales		80,000
Gross profit		50,000
Motor expenses	2,000	
Insurance	15,000	
		(17,000)
Net profit		33,000

Naseer: Statement of financial position as at 31 July 2013

	Rs.	Rs.
Non-current assets:		
Van		60,000
Current assets:		
Inventory	50,000	
Trade receivables	40,000	
Bank	543,000	
		633,000
Total assets		693,000
Capital at 1st January 2013		500,000
Net profit for the year		33,000
		533,000
Less: Drawings		(10,000)
Capital at 30th June 2013		523,000
Non-current liabilities		
bank loan		100,000
Current liabilities:		
Trade payables		70,000
Total capital and liabilities		693,000

CHAPTER 5

Sales and purchases

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 2	**Identify financial transactions and make journal entries**
LO2.5.1	*Sales journal and the sales ledger:* Describe the basic contents of the sales day book and the customer/debtors ledger
LO2.5.2	*Sales journal and the sales ledger:* Record entries in the sales day book and the customer/debtors ledger.
LO2.6.1	*Purchase journal and the purchase ledger:* Describe the basic contents of the purchase journal and purchase ledger/creditors ledger.
LO2.6.2	*Purchase journal and the purchase ledger:* Record entries in the purchase journal and purchase ledger/creditors ledger.

1 INTRODUCTION TO BOOKS OF PRIME ENTRY

Section overview

- The role of books of prime entry
- Posting transactions

1.1 The role of books of prime entry

Book-keeping is the process of recording financial transactions in the accounting records (the 'books') of an entity. Transactions are recorded in accounts, and there is a separate account for each different type of transaction.

It is often the case that individual transactions are not recorded in the ledger accounts as they occur. Instead, they are recorded initially in records called books of prime entry (also known as books of original entry). Each of these 'books' or 'journals' is used to record different types of transaction. Periodically the totals of each type of transaction are double entered into the appropriate ledger accounts in the general ledger.

Books of prime entry include the following:

Book of prime entry	Function
Sales day book,	Records sales on credit (receivables) from sales invoices.
Sales returns day book	Records items returned by credit customers (credit notes issued to customers).
Purchases day book	Records purchases on credit from suppliers (trade payables) from purchase invoices.
Purchases returns day book	Records returns of purchases on credit.
Cash book	Records cash received into the bank account and cash paid out of the bank account. Cash receipts and payments are very much a part of the sales and purchases cycles.
Journal	Records transactions that are not recorded in any of the other books of original entry.

Books of prime entry are a useful means of summarising large numbers of similar transactions like credit sales, credit purchases and cash and bank payments and receipts.

1.2 Posting transactions

You may find it useful to refer back to the diagram at paragraph 1.2 of chapter 4 before reading this section.

Books of prime entry are used to reduce the number of transactions that have to be recorded in the general ledger. For example, instead of recording 1,000 separate sales, a business could add them up and perform a single double entry on the totals. This means that the general ledger will contain one account for receivables in total rather than an account for each individual customer. This account is called the receivables control account. (Note, that in practice it might have another name but that does not affect its function).

Definition: Control account

An account which summarises a large number of transactions.

(Examples include receivables control account, payables control account and payroll control account).

However, this does create another problem. A business must have information about the individual customers to whom sales have been made and who owe them money. In order to provide this information a second record is kept of the individual balances of individual customers. This record is called the receivables ledger (or the sales ledger

The receivables control account and the receivables ledger are updated at the same time. The process of transferring the details of transactions from the books of prime entry to the accounts in the ledgers is called '**posting**' the transactions.

The balance on the receivables control account should always equal the total of the list of balances in the receivables ledger. If this is not the case an error has been made and must be investigated. This is covered in chapter 10.

The receivables control account is part of the double entry system. Any entry into the receivables control account must be accompanied by an equal and opposite entry elsewhere in the general ledger.

The receivables ledger is not part of the double entry system. Any entry in it simply reflects entries that have been made in the receivables control account in the general ledger and not the other side of those entries.). It is sometimes described as a memorandum account.

Note that all the comments above could equally have been made in respect of purchases. Purchases are recorded in a purchases day book and posted to a payables control account in the general ledger. This is supported by a payables ledger which is a list of amounts owed by the business to individual suppliers.

This is a little complicated at first sight but this chapter continues to explain the above in some detail.

2 ACCOUNTING FOR SALES

Section overview

- Documents in the sales cycle
- Recording sales
- Recording sales returns
- Discounts allowed
- Receivables control account
- Terminology

2.1 Documents in the sales cycle

A business tries to make a profit by selling goods or services to customers. This creates revenue or income for the business.

Sales might be for cash or (coin, by debit card, credit card, cheque or by some less common method such as banker's draft) or on credit.

The following documents might be used in a system designed to account for sales.

Document	Purpose	Impacts double entry?
Sales order	From the customer placing an order.	No
Goods despatched note	A notice to the customer to inform them that the goods have been despatched and are on their way.	No
Delivery note	A note that accompanies the goods. (A customer will check this to make sure that it agrees with his order and that it is consistent with what has actually been delivered.	No
Sales invoice	A request for payment from the customer for goods delivered. Invoices normally show a date, details of transaction and payment terms.	**Yes**
Statement	A document to show the customer the amount still owed at a point in time. It will be the net amount of all invoices issued less cash received by the business up to a point in time.	No
Credit note	Issued when a customer returns goods and the business agrees to this. The business issues a credit note to acknowledge that the amount specified is no longer owed to them by the customer.	**Yes**

Illustration: Credit note

A issues an invoice to a customer for Rs. 20,000.

A later agrees to reduce the amount payable by Rs. 1,000 because some of the goods were of poor quality.

A issues a credit note to the customer for Rs. 1,000.

The customer is now required to pay Rs. 19,000 which is the invoice for Rs. 20,000 less the credit note for Rs. 1,000.

2.2 Recording sales

Sales day book

The sales day book is one of the books of prime entry. It is used to make an initial record of sales on credit. Credit sales transactions are entered in the sales day book as a list.

Double entry and updating the receivables ledger

Periodically (daily, weekly, monthly) a total for all transactions is posted to sales and the receivables control account in the general ledger, and the individual amounts used to update the customers' individual balances in the receivables ledger.

- The total value of the transactions (since the previous time that entries were posted to the ledger) is transferred as a double entry to the general ledger:
- Each individual transaction is transferred to the receivables ledger and recorded in the account of the individual customer which is debited with the value of the transaction.

Illustration:

Sales on credit	Debit	Credit
General ledger:		
Receivables control account	X	
Sales		X
Receivables ledger:		
Individual customer accounts	X	

There is a diagram showing an overview of this system together with the purchases and cash system at the end of this chapter.

Responsibilities

The duty of the main accountant is to maintain the general ledger and extract financial information from it. The main accountant will also oversee accounting assistants (accounts clerks) whose duties are to maintain the day books, subsidiary ledger and thus the list of balances.

Example: Recording sales

A company made the following sales which are to be posted to the general ledger and the receivables ledger.

Sales day book:

Customer:	Sale
Danish	25,000
Fahad	10,000
Hasan	40,000
	75,000

General ledger

Receivables control account

	Rs.		Rs.
Sales	75,000		

Sales

	Rs.		Rs.
		Receivables	75,000

Receivables ledger

Danish

	Rs.		Rs.
Sales	25,000		

Fahad

	Rs.		Rs.
Sales	10,000		

Hasan

	Rs.		Rs.
Sales	40,000		

The postings to the general ledger might be recorded as a journal entry:

	Debit	Credit
	Rs.	Rs.
Receivables control account	75,000	
Sales		75,000

Being: Posting of sales from the sales day book.

2.3 Recording sales returns

Sales returns day book

The sales returns day book is a book of prime entry that records goods returned by customers (perhaps because they are damaged or of unacceptable quality).

When goods are returned, a credit note is issued to the customer.

Double entry and updating the receivables ledger

Periodically (daily, weekly, monthly) a total for all returns is posted to the general ledger and the individual amounts used to update the customers' individual balances in the receivables ledger.

Illustration:

Sales on credit	Debit	Credit
General ledger:		
Sales returns	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X

Example

A company made the following sales which are to be posted to the general ledger and the receivables ledger.

Sales day book	Rs.	
Customer: A	40,000	
Customer: B	50,000	
Customer: C	30,000	
Customer: D	20,000	
	140,000	(1)

Sales returns day book	Rs.	
Customer: A	5,000	(2)

Cash received	Rs.	
Customer: B	40,000	
Customer: C	20,000	
	60,000	(3)

Example: General ledger

Receivables control account

	Rs.		Rs.
Sales (1)	140,000	Sales returns (2)	5,000
		Cash (3)	60,000
		Balance c/d	75,000
	140,000		140,000
Balance c/d	75,000		

Sales

	Rs.		Rs.
		Receivables (1)	140,000

Sales returns

	Rs.		Rs.
Receivables (2)	5,000		

Bank

	Rs.		Rs.
Receivables (3)	60,000		

The postings to the general ledger might be recorded as journal entries

	Debit	Credit
	Rs.	Rs.
Receivables control account	140,000	
Sales		140,000
Being: Posting of sales from the sales day book.		
Sales returns	5,000	
Receivables control account		5,000
Being: Posting of sales returns from the sales returns day book.		
Bank	60,000	
Receivables control account		60,000
Being: Cash received from customers		

Example: Receivables ledger

Customer A

	Rs.		Rs.
(1a) Sales	40,000	(2a) Sales returns	5,000
		Balance c/d	35,000
	40,000		40,000
Balance c/d	35,000		

Customer B

	Rs.		Rs.
(1b) Sales	50,000	(3a) Bank	40,000
		Balance c/d	10,000
	50,000		50,000
Balance c/d	10,000		

Customer C

	Rs.		Rs.
(1c) Sales	30,000	(3b) Bank	20,000
		Balance c/d	10,000
	30,000		30,000
Balance c/d	10,000		

Customer D

	Rs.		Rs.
(1d) Sales	20,000		

The balances on the accounts in the receivables ledger in total are

	Rs.
Customer: A	35,000
Customer: B	10,000
Customer: C	10,000
Customer: D	20,000
	75,000

The **receivables ledger** contains the accounts for each customer who is sold items on credit. Each receivables account shows how much the individual customer has purchased on credit, details of sales returns (i.e. any credit notes), how much he/she has paid and what he/she currently owes.

2.4 Discounts allowed

Introduction

Businesses sometimes give discounts to customers.

There are two main types of discount:

- trade discount; and
- settlement discount (or cash discount).

Trade discount

This is price reduction given to a customer. The invoice is issued at the reduced amount so there are no double entry problems caused by this type of discount. There is simply a sale at a lower price.

Example: Trade discounts

A building merchant offers bags of cement for sale at Rs.500 per bag.

The price is reduced to Rs. 450 for any customer who buys 10 or more bags.

The reduction of Rs. 50 per bag is a trade discount.

Arif buys 20 bags off the building merchant.

If there were no discount Arif would have to pay Rs. 10,000. However, because of the discount Arif has to pay only Rs.9,000.

Note that from the builder's point of view this is a sale for Rs.9,000. There is no special accounting needed for trade discounts.

Settlement discounts

A settlement discount might be offered in order to persuade credit customers to pay earlier.

When a business makes a sale it does not know whether the customer will take advantage of the settlement discount or not so the invoice is issued at the full amount. An adjusting entry is made if a customer subsequently takes the discount.

If a discount is taken it is known as a discount allowed from the point of view of the seller and a discount received from the point of view of the buyer. Discounts received and discounts allowed are recorded in the ledger accounts.

Example: Settlement discounts

A building merchant offers credit terms to large customers.

It offers a 3% discount to any credit customer who settles an invoice within 30 days. (This means that the customer would only pay 97% of the invoice amount).

The reduction of 3% is a settlement discount.

Bashir Builders buys goods worth Rs. 80,000.

If Bashir Builders pays within 30 days it need only pay Rs.77,600.

If Bashir Builders does not pay within 30 days it must pay Rs.80,000..

Discounts allowed

Discounts allowed are settlement discounts that a business offers to its credit customers. It is up to the customer to decide whether to pay the full amount or to pay the smaller amount earlier.

Accounting for discounts allowed

A business will only know if a customer is taking a settlement discount that has been offered when the payment is received. If the customer has taken the discount then a smaller payment will be received.

Discounts allowed to customers are recorded in a discounts allowed account. This is an expense account.

Illustration: Discount allowed double entry

	Debit	Credit
Bank (cash received)	X	
Discount allowed (discount taken by the customer)	X	
Trade receivables		X

Discounts allowed do not affect the total figure for sales in the period. In this respect they differ from sales returns, which do reduce total sales revenue.

- Discounts allowed are accounted for separately as an expense for the period.
- They are not accounted for as a deduction from total sales revenue.

Example: Discount allowed

Asad has sold goods to Bashir for Rs. 80,000.

Asad offers a 3% settlement discount if payment is made within 20 days.

Bashir pays in 19 days.

Asad would record the transaction as follows:

	Debit	Credit
At date of sale:		
Trade receivables	80,000	
Sales		80,000
At date that payment is received		
Bank (cash received = 97% of 80,000)	77,600	
Discount allowed (discount taken by the customer = 3% of 80,000)	2,400	
Trade receivables		80,000

Discounts allowed and the receivables ledgers

Discounts allowed must also be recorded in the individual customer accounts in the receivables ledger.

2.5 Receivables control account

A receivables ledger control account is the name given to the account in the general ledger for total receivables. A control account is an account that records total amounts – in this case, total amounts for receivables.

The receivables ledger control account records all transactions involving credit customers.

- Debit entries in the receivables control account are transactions that add to the total amount of receivables.
- Credit entries in the receivables ledger control account are transactions that reduce the total amount of receivables.

Illustration: Double entries into receivables control account

Receivables control account

Debit side (Dr)		**Credit side (Cr)**	
Balance b/d	X		
Credit sales	X	Payments received from credit customers	X
Dishonoured cheques (see below)	X	Sales returns	X
		Discounts allowed for early payment	X
		Bad debts written off (explained later in chapter 7).	X
		Contra entries (explained later in this chapter)	X
		Balance c/d	X
	X		X
Balance b/d	X		

Dishonoured cheques

These are cheques received from customers where subsequently the bank refuses to make payment.

When a business receives a cheque from a customer it recognises that as an amount paid. If the business presents the cheque to the bank for payment and the bank refuse to accept it (perhaps because of insufficient funds in the customer's account) the business is still owed the money and must reverse the original entry (Dr Receivables, Cr Bank).

Entries not recorded in the receivables control account

Only transactions that relate to credit sales are recorded in the receivables ledger control account.

The following transactions are **not** recorded in the receivables ledger control account:

- Cash sales (for which the entry is Dr Bank, Cr Sales);
- Changes in the allowance for irrecoverable debts account (covered later in chapter 7).

The balance on the receivables control account might be described as trade receivables on the face of the statement of financial position.

2.6 Terminology

This chapter uses certain terminology to explain how sales might be accounted for. This is an area where you may see different terms used to describe what has been described above.

Used in this chapter	Common alternative
Sales day book	Sales journal
Receivables ledger	Debtors ledger, Sales ledger
Receivables control account	Receivables ledger control account Sales ledger control account Total sales control account Debtor control account Account receivable control account

3 ACCOUNTING FOR PURCHASES

Section overview

- Documents in the purchases cycle
- Recording purchases
- Recording purchase returns
- Discounts received
- Payables control account
- Contra entries
- Terminology

3.1 Documents in the purchases cycle

Businesses make purchases from suppliers. Purchases are similar in many respects to sales, except that the business is buying from a supplier rather than selling to a customer.

The following documents might be used in a system designed to account for purchases.

Document	Purpose	Impacts double entry?
Purchase order	A document sent by the business to place an order.	No
Goods received note	A document produced when goods are received. It is produced after the goods have been checked against the delivery note and what has actually been received. The GRN is sent to accounts staff who will check that what has been received is what was ordered and that the invoice agrees with what was received.	No
Purchase invoice	A request for payment from the supplier for goods delivered.	**Yes**
Statement	A document from the supplier to show the amount still owed at a point in time.	No

3.2 Recording purchases

Purchases day book

The purchases day book is one of the books of prime entry. It is used to make an initial record of purchases on credit. Purchase transactions on credit are entered in the purchases day book as a list.

There may be several categories of item or service purchased each of which must be posted to an appropriate account.

Double entry and updating the payables ledger

Periodically (daily, weekly, monthly) a total for all transactions is posted to purchases and other expense accounts with the other side of the entry posted to the payables control account in the general ledger.

In addition the individual amounts are used to update the suppliers' individual balances in the payables ledger.

The payables (purchase) ledger is also used to record purchase invoices from suppliers of other items, as well as purchases of goods. (For example the payables ledger is used to record details of invoices for rental costs, telephone expenses, and electricity and gas supplies and so on).

Details of these expenses must be posted from the purchases ledger to the relevant accounts in the general ledger.

To facilitate this, a day book might have analysis columns which show the different types of expense.

Details of each individual invoice are also posted to the account of the individual supplier in the payables ledger.

Illustration:

Purchases on credit	Debit	Credit
General ledger:		
Purchases	X	
Expense 1	X	
Expense 2 (etc.)		
Payables control account		X
Payables ledger:		
Individual customer accounts		X

There is a diagram showing an overview of this system together with the sales and cash system at the end of this chapter.

Illustration: Recording purchase

Purchase day book		Total	Purchases	Energy	Sundry
		Rs. (000)	Rs. (000)	Rs. (000)	Rs. (000)
3 May	BV Supplies	500	500		
3 May	South Electric	1,200			1,200
3 May	CD Power	3,000		3,000	
3 May	Sad Stationery	650			650
3 May	Woods Widgets	4,800	4,800		
3 May	Small Plastic	3,200	3,200		
3 May	Southern Gas	750			750
3 May	IT Solutions	500			500
		14,600	8,500	3,000	3,100

A journal can easily be constructed to affect the double entry

	Debit	Credit
	Rs.	Rs.
Purchases	8,500	
Payables control account		8,500
Energy expenses	3,000	
Payables control account		3,000
Sundry expenses	3,100	
Payables control account		3,100

3.3 Recording purchase returns

Purchases returns day book

The purchases returns day book is similar to the purchases day book, except that it records goods returned to suppliers.

When goods are returned to a supplier, a credit note is received. The purchases returns day book records the credit note details.

The total purchases returns are posted to the general ledger, by:

- debiting the total trade payables account
- crediting the purchases returns account, or possibly the purchases account.

Returns to individual suppliers are also debited in the supplier's individual account in the payables ledger.

Illustration:

Purchase returns	Debit	Credit
General ledger:		
Payables	X	
Purchase returns		X
Payables ledger:		
Individual customer accounts	X	

Example

A company made the following sales which are to be posted to the general ledger and the receivables ledger.

Purchases day book	**Rs.**	
Supplier: A	30,000	
Supplier: B	60,000	
Supplier: C	20,000	
Supplier: D	70,000	
	180,000	(1)
Purchase returns day book	**Rs.**	
Supplier: B	20,000	(2)
Cash paid to:	**Rs.**	
Supplier: A	29,000	
Supplier: D	25,000	
	54,000	(3)
Discount received	**Rs.**	
Supplier: A	1,000	(4)

Example: General ledger

Payables control account

	Rs.		Rs.
Purchase returns (2)	20,000	Purchases (1)	180,000
Bank (3)	54,000		
Discount received (4)	1,000		
Balance c/d	105,000		
	180,000		180,000
		Balance c/d	105,000

Purchases

	Rs.		Rs.
Payables (1)	180,000		

Purchase returns

	Rs.		Rs.
		Payables (2)	20,000

Bank

	Rs.		Rs.
		Payables (3)	54,000

Discount received

	Rs.		Rs.
		Payables (4)	1,000

Example: General ledger

The postings to the general ledger might be recorded as journal entries

	Debit	Credit
	Rs.	Rs.
Purchases	180,000	
Payables control account		180,000
Being: Posting of purchases from the purchases day book.		
Payables control account	20,000	
Purchase returns		20,000
Being: Posting of purchase returns from the purchase returns day book.		
Payables control account	54,000	
Bank		54,000
Being: Cash paid to suppliers		
Payables control account	1,000	
Bank		1,000
Being: Discounts received		

Example: Payables ledger

Supplier A

	Rs.		Rs.
(3a) Bank	29,000	(1a) Purchases	30,000
(4) Discount received	1,000		
	30,000		30,000

Supplier B

	Rs.		Rs.
(2) Purchase returns	20,000	(1b) Purchases	60,000
Balance c/d	40,000		
	60,000		60,000
		Balance c/d	40,000

Supplier C

	Rs.		Rs.
		(1c) Purchases	20,000

Supplier D

	Rs.		Rs.
(3b) Bank	25,000	(1d) Purchases	70,000
Balance c/d	45,000		
	70,000		70,000
		Balance c/d	45,000

The balances on the accounts in the payables ledger in total are

	Rs.
Supplier: A	–
Supplier: B	40,000
Supplier: C	20,000
Supplier: D	45,000
	105,000

The **payables ledger** contains the accounts for each supplier of goods or services on credit. Each trade payables account shows how much the entity has bought on credit from a particular supplier, details of purchase returns, how much it has paid and what it currently owes to the supplier.

3.4 Discounts received

Discounts received are settlement discounts that a business has been offered by its suppliers and which it takes up. The business pays earlier but pays less.

Accounting for discounts received

The invoice is recorded in payables at the full amount when it is received. Discount received can only be recognised when payment is earned within a given time frame so that a business becomes entitled to a discount.

Discounts received from suppliers are recorded in a discounts received account. If a business decides to take up the offer of a settlement discount by paying the smaller amount sooner, the double entry for the payment is:

Illustration: Discount received double entry

	Debit	Credit
Trade payables	X	
Bank (cash paid to supplier)		X
Discount received (discount taken by us)		X

The entry in the discount received account is a credit entry because it is effectively a reduction in an expense. In the statement of comprehensive income, it will be shown either as 'other income' or as a negative expense.

Discounts received do not affect the total figure for purchases in the period, or the total cost of sales. In this respect they differ from purchase returns, which do reduce total purchase costs.

- ❑ Discounts received are accounted for as an addition to profit in the period.
- ❑ They are not accounted for as a deduction from purchase costs.

Example: Discount received

Asad has sold goods to Bashir for Rs. 80,000.

Asad offers a 3% settlement discount if payment is made within 20 days.

Bashir pays in 19 days.

Bashir would record the transaction as follows:

	Debit	Credit
At date of purchase:		
Purchase	80,000	
Trade payables		80,000
At date of payment		
Trade payables	80,000	
Bank (cash paid = 97% of 80,000)		77,600
Discount received (discount taken by us = 3% of 80,000)		2,400

Discounts received and the payables ledgers

Discounts received are recorded in the individual supplier accounts in the payables ledger.

3.5 Payables control account

The payables ledger control account is the name given to the account in the general ledger for total trade payables.

Opening payables balance

The opening balance in the payables ledger control account is a credit balance, because amounts payable are a liability.

The payables ledger control account records all transactions involving credit purchases. Since business entities make most of their purchases on credit, the control account records virtually all purchases.

- Credit entries in the payables control account are transactions that add to the total amount of payables.
- Debit entries in the payables ledger control account are transactions that reduce the total amount of payables.

Illustration: Double entries into payables control account

Payables control account

Debit side (Dr)		**Credit side (Cr)**	
		Balance b/d	X
Purchase returns	X	Purchases	X
Payments to suppliers	X		
Discounts received for early payment	X		
Contra entries (explained later in this chapter)	X		
Balance c/d	X		
	X		X
		Balance b/d	X

The balance on the payables control account might be described as trade payables on the face of the statement of financial position.

3.6 Contra entries

A business might sell goods or services to another business, and also buy goods or services from that same business.

The other business is both a customer and a supplier, and might therefore be a receivable and a trade payable at the same time. When this happens, the two businesses might agree to offset the amounts that they owe each other, leaving a net amount payable by the business with the higher debt.

A contra entry is a double entry that offsets one amount against another.

Contra entries must be made in the general ledger and also the receivables and payables ledgers.

Illustration: Contra entry

Sales on credit	Debit	Credit
General ledger:		
Payables control account	X	
Receivables control account		X
Receivables ledger:		
Individual customer account		X
Payables ledger:		
Individual customer account	X	

Example: Contra entry

A buys goods from Z, and also sells services to Z.

A currently owes Rs. 120,000 to Z and is owed Rs. 50,000 by Z.

A and Z might agree to offset these two debts, leaving A owing the net amount of Rs. 7,000 to Z.

A contra entry is used to record this agreement in the accounting system.

Books of A:

	Debit	Credit
General ledger	Rs.	Rs.
Payables control account	50,000	
Receivables control account		50,000
(This reduces the balance on both accounts)		
Receivables ledger:		
Z's account (owed by Z)		50,000
Payables ledger:		
Z's account (owed to Z)	50,000	

3.7 Terminology

This chapter uses certain terminology to explain how purchases might be accounted for. This is an area where you may see different terms used to describe what has been described above.

Used in this chapter	Common alternative
Purchases day book	Purchases journal
Payables ledger	Creditors ledger, Purchases ledger
Payables control account	Payables ledger control account Purchases ledger control account Total purchases control account Creditor control account Account payable control account Bought ledger adjustment account

4 ACCOUNTING FOR CASH

Section overview

- The cash book
- Cash receipts
- Cash payments

4.1 The cash book

The cash book is often a book of prime entry. It is used to record receipts and payments of cash into the business bank account.

The cash book has two sides, a side for receipts of money and a side for payments. Both sides have a number of columns so that cash receipts and payments can be analysed to make it easier to construct journals for double entry.

A business can analyse the amounts received and paid in any way it chooses.

4.2 Cash receipts

Cash from cash sales is banked on a regular basis. It is entered as a cash receipt in the cash book when it has been banked.

Cash might be received from a credit customer in a number of ways. Usually payment is made by cheque or by bank transfer. Payments by cheques must be banked on a regular basis. When a cheque is received it is entered into the cash book as a cash receipt.

On a periodic basis the receipts side of the cash book is summed and totals posted to the general ledger. Amounts received from credit customers are also recognised in the customer's personal account in the receivables ledger must also be adjusted.

Some businesses might choose to use a column in the cash receipts side of the cash book to record discounts allowed. This is nothing to do with cash as such but the discounts might be recorded here so that the business is able to keep track of it. Such a record is described as being a memorandum (reminder).

A simplified example of the **cash receipts side** of the cash book is shown below.

Illustration: Cash receipts

	Total	Receivables	Other receipts	Discount allowed (memo only)
	Rs.	Rs.	Rs.	Rs.
Smith Company	28,500	28,500		1,500
K Brown	5,000	5,000		
Banking from cash sale	1,000		1,000	
Dividend	5,000		5,000	
C Cropper	57,000	57,000		3,000
VB Industries	87,000	87,000	-	
	183,500	177,500	6,000	4,500

A journal can easily be constructed to affect the double entry

	Debit	Credit
	Rs.	Rs.
Bank	183,500	
Receivables control account		177,500
Sale		1,000
Dividend income		5,000
And		
Discounts allowed	4,500	
Receivables control account		4,500

The cash received from individual customers and the discounts allowed to individual customers must be credited to their individual accounts in the receivables ledger.

4.3 Cash payments

Cash payments are recorded in a similar way to cash receipts. Payments are recorded in both the general ledger and (if the payment is to a supplier) in the account of the supplier in the payables ledger.

A business might choose to record discounts received in a memorandum column in the cash book.

A simplified example of the cash payments side of the cash book is shown below.

Illustration: Cash payments

	Total	Payables	Expenses	Discount received
	Rs.	Rs.	Rs.	Rs.
KPT Supplies	59,000	59,000		1,000
Duck Company	86,000	86,000		
Rent	74,500		74,500	
Fast Supplies	2,200	2,200	-	
	221,700	147,200	74,500	1,000

A journal can easily be constructed to affect the double entry

	Debit	Credit
	Rs.	Rs.
Payables control account	147,200	
Expenses	74,500	
Bank		221,700
And		
Discounts received		1,000
Payables control account	1,000	

The cash paid to individual suppliers and the discounts received from individual suppliers will be debited to their individual accounts in the payables ledger.

There is a diagram showing an overview of this system together at the end of this chapter.

5 PETTY CASH

Section overview

- Definition of petty cash
- Recording petty cash transactions

5.1 Definition of petty cash

Petty cash is cash (notes and coins) held by a business to pay for small items of expense, in situations where it is more convenient to pay in notes and coin than to pay through the bank account. Petty cash might be used, for example, to pay for bus fares, taxi fares, tea and coffee for the office, and so on.

5.2 Recording petty cash transactions

When petty cash transactions take place, for example petty cash is spent on tea and coffee for the office, the entity needs to record both an expense, and a reduction in the asset "petty cash".

These entries are made in the main ledger accounts as follows:

Illustration: x

	Debit	Credit
Office expenses	X	
Petty cash		X

Although the amounts involved in petty cash are, for most businesses, very small, the "cash in the tin" is one of the easiest assets to be stolen or "lost".

Usually the responsibility for looking after the petty cash is assigned to an accounts clerk who will pay out any cash to a person as long as that person is able to present an invoice for an amount spent or sign a note to say that they have received cash. The accounts clerk will also maintain a petty cash book. This is a book of prime entry and is summarised and posted to the general ledger on a periodic basis,

Imprest system

A very common petty cash system is called the imprest system. Under this system a set amount is established (say Rs.10,000). This set amount is called the imprest.

At any moment in time, the petty cash balance plus the amounts on invoices and notes should sum to the imprest. Periodically the invoices are removed and replaced by cash to re-establish the imprest in cash.

Example:

A business uses an imprest system to control its petty cash.

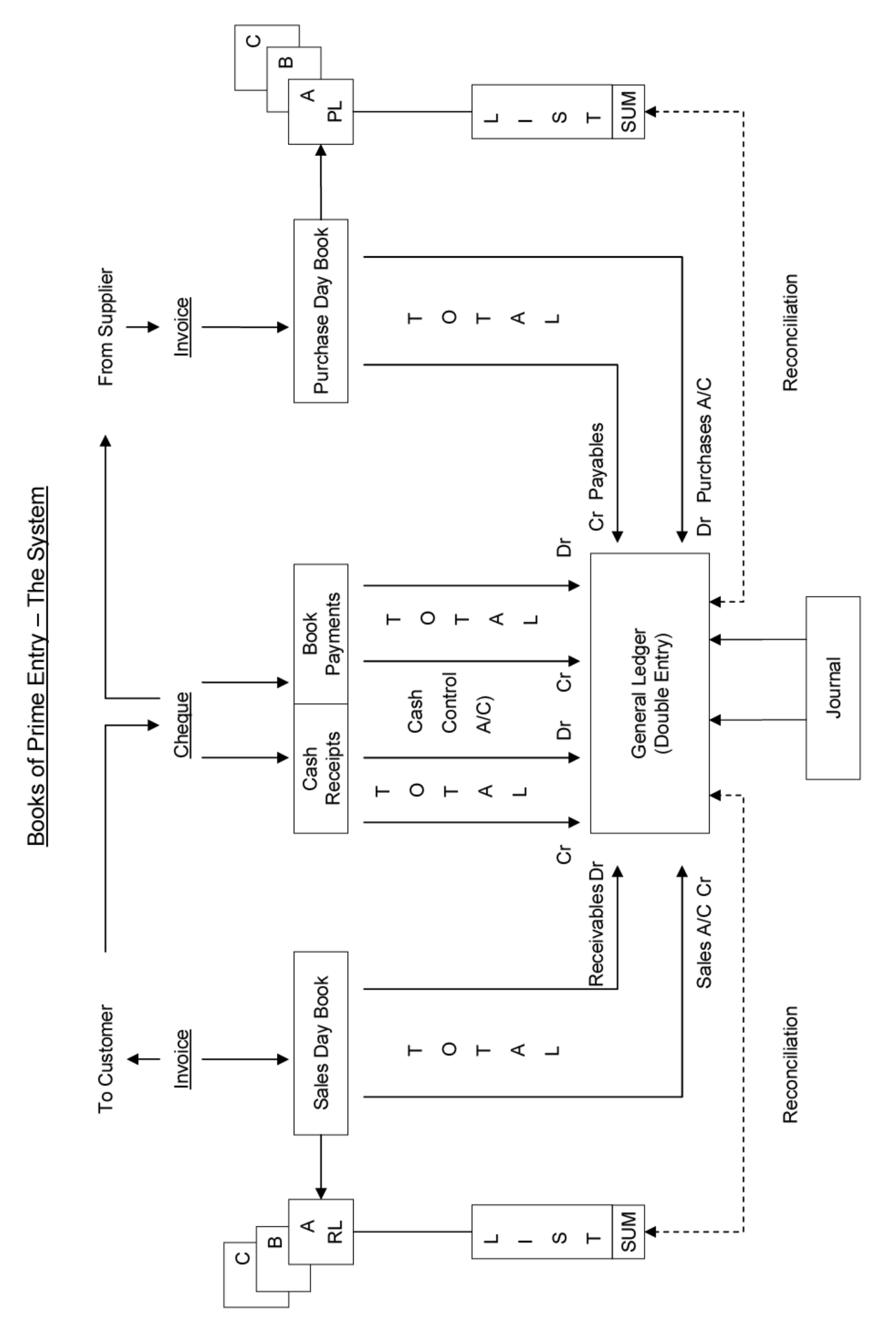
The imprest is set at Rs. 10,000.

At the start of the month there is Rs. 10,000 cash in the petty cash tin.

An amount of Rs. 600 is paid to Laila to compensate her for a payment she made out of her own pocket on behalf of the business.

After this transaction the petty cash tin will contain Rs.9,400 cash and an invoice from Laila for Rs.600. These two amounts add back to the imprest.

Illustration: Overview



CHAPTER 6

Depreciation

Contents

INTRODUCTION

LO 4	**Make adjustment at the end of the reporting period.**
LO4.1.1	*Depreciation:* Calculate depreciation expense using straight line, diminution balance, sum-of-digits and number of units produced methods
LO4.1.2	*Depreciation:* Post journal entry to record depreciation expense

1 END OF YEAR ADJUSTMENTS

Section overview

- The need for end-of-year adjustments
- Check list of end-of-year adjustments

1.1 The need for end-of-year adjustments

Start of a financial year

At the start of a financial year the asset, liability and capital accounts in the general ledger contain the balances brought forward at the end of the last year as set out in last year's statement of financial position.

The income and expense accounts in the general ledger are empty as they will have been transferred to the income and expense account for the calculation of profit.

During the financial year

During the year the business records transactions to appropriate accounts in the general ledger.

The balances on the asset and liability accounts at any one time reflect the position at the start of the year and the effect of transactions relevant to those accounts that have occurred during the period.

The balances on the income and expense accounts reflect the activity during the period.

End of a financial year

Balances on the accounts in the general ledger are extracted to produce a trial balance. The trial balance is the net effect of all of the transactions in the year and forms the basis for the preparation of the financial statements.

However, certain adjustments must be made to income, expenses, assets and liabilities before the financial statements can be finalised to take account of items not captured as regular accounting transactions.

Adjustments are needed for:

- opening and closing inventory
- accrued expenses and prepaid expenses
- bad and doubtful debts
- non-current assets and depreciation.

Having made the adjustments, a business can then prepare its financial statements, calculating the profit or loss it has made for the year and adding the resultant figure to capital.

A general ledger exercise is then carried out:

- Balances on income and expense accounts are transferred to a profit or loss account. The balance on this account is the profit or loss for the year and should agree with the profit or loss shown in the statement of comprehensive income.

- The profit for the year is added to capital, or the loss is subtracted from capital.

1.2 Check list of end-of-year adjustments

A check list showing the end-of-year adjustments required to prepare financial statements is shown below.

The first of these is explained in detail in this chapter and explanations of the rest follow in subsequent chapters.

Accounting area	Nature of the end of year adjustment	Chapter
Non-current assets and depreciation	A depreciation charge for non-current assets is calculated, and included in the statement of comprehensive income. The carrying amount of non-current assets in the statement of financial position is reduced by accumulated depreciation on those assets.	6
Bad debts and doubtful debts	Establish the amount of bad debts to be written off and the change in an allowance for doubtful debts. These items are included in the statement of comprehensive income. In the statement of financial position, total receivables are reduced by bad debts written off. In addition, the allowance for doubtful debts is set off against the figure for total receivables.	7
Accruals and prepayments	Establish the amount of accrued expenses or prepaid expenses at the end of the financial year. Opening and closing accrued expenses or prepaid expenses are needed to calculate the amount to include in the statement of comprehensive income for certain expense items. Accruals and prepayments also appear in the statement of financial position.	8
Opening and closing inventory	Establish the value of closing inventory. Use the values for opening and closing inventory to calculate the cost of sales and gross profit for the statement of comprehensive income.	9

2 NON-CURRENT ASSETS

Section overview

- Introduction
- Capital and revenue items: capital and revenue expenditure
- Depreciation and non-current assets

2.1 Introduction

The assets of a business are classified as current assets or non-current assets.

IAS 1 (***Presentation of financial statements***) defines current assets and then states that all other assets should be classified as non-current assets.

Current assets include, cash, receivables, prepayments (see chapter 7) and inventory. They are all items that will be used or recovered in the short term.

A ***non-current asset*** is an asset which is used by the business over a number of years.

Non-current assets may be:

- ***Tangible non-current assets***. These are physical assets, such as land and buildings, plant and equipment, and motor vehicles; or
- ***Intangible non-current assets***. These are assets that do not have a physical existence such as patent rights.

Non-current assets are initially recorded in the accounts of a business at their cost. The cost of an item of property, plant and machinery consists of:

- its purchase price after any trade discount has been deducted, plus any import taxes or non-refundable sales tax; and/or
- the directly attributable costs of 'bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management' (***IAS 16 Property, plant and machinery***). These directly attributable costs may include:
  - employee costs arising directly from the installation or construction of the asset
  - the cost of site preparation
  - delivery costs ('carriage inwards')
  - installation and assembly costs
  - professional fees directly attributable to the purchase.

A question might provide information about the installation cost of an asset. This is capitalised as part of the cost of the asset.

2.2 Capital and revenue items: capital and revenue expenditure

The difference between capital and revenue items, and between capital and revenue expenditure was explained in an earlier chapter.

Improvements are capitalised

Expenditure on a non-current asset after acquisition is treated as capital expenditure when it represents an improvement. This is added to the cost of the original asset.

Repairs are expensed

Expenditure on a non-current asset after acquisition is treated as revenue expenditure when it is incurred to make a repair. This is recognised as an expense in the statement of comprehensive income.

Advance payments

A business might make an advance payment towards a non-current asset.

This is recognised as a receivable known as an advance. It represents the right that the business has to receive an asset (or part of one) at some time in the future.

Illustration: Advance payments

	Debit	Credit
Receivable – Advance	X	
Cash (bank)		X

Advances are not depreciated. An advance will become part of the cost of an asset when it is purchased.

Illustration: Treatment of advance when asset is purchased

	Debit	Credit
Cost of the asset	X	
Receivable – Advance		X

2.4 Depreciation and non-current assets

A business invests in assets in order to generate profit.

The accruals concept results in the recognition of revenue and the cost of earning that revenue in the statement of comprehensive income in the same accounting period.

This is relatively straight forward for costs. For example, rent for a period enables a business to use premises that are used to make profit. The rent is charged to statement of comprehensive income.

Examples: Recognition of costs in the statement of comprehensive income

Rental expense	**Rental payments due in a period enable a business to use premises that are used to make profit.** **The rent is charged to the statement of comprehensive income.**
Energy expense	**Energy used in a period enables a business to make profit.** **Energy is charged to the statement of comprehensive income.**
Inventory	**Items sold in the period are recognised in the statement of comprehensive income at the same time as the revenue from selling those items.**

Expenditure on non-current assets is also incurred to enable a business to generate a profit. A non-current asset will help a business generate profit over several accounting periods. The cost of the benefit received from the use of such an asset must be recognised in the statement of comprehensive income in the same period that the benefit is recognised.

Depreciation

Depreciation is an expense that matches the cost of a non-current asset to the benefit earned from its ownership. It is calculated so that a business recognises the full cost associated with a non-current asset over the entire period that the asset is used. In effect, the cost of the asset is transferred to the statement of comprehensive income over the life of the asset. This may be several years.

This section explains depreciation as an expense calculated at the end of the accounting period as an end-of-year adjustment. This might be the case for small businesses but larger businesses will often use software that is able to recognise depreciation on a monthly basis.

3 DEPRECIATION AND CARRYING AMOUNT

Section overview

- Definition of depreciation
- Accounting for depreciation
- The purpose of depreciation

3.1 Definition of depreciation

Depreciation is a method of spreading the cost of a non-current asset over its expected useful life (economic life), so that an appropriate portion of the cost is charged in each accounting period.

Definitions (from IAS 16)

Depreciation: The systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable amount: The cost of an asset (or its revalued amount, in cases where a non-current asset is revalued during its life) less its residual value.

Residual value: The expected disposal value of the asset (after deducting disposal costs) at the end of its expected useful life.

Useful life: The period over which the asset is expected to be used by the business entity.

Note that the revaluation of non-current assets and the disposal (sale) of non-current assets are not in this syllabus. They are mentioned above for completeness. You will learn about these in later syllabuses.

Example: Depreciation

An item of equipment cost Rs. 300,000 and has a residual value of Rs. 50,000 at the end of its expected useful life of four years.

Depreciation is a way of allocating the depreciable amount of Rs. 250,000 (= Rs. 300,000 - Rs. 50,000) over the four years of the asset's expected life.

Depreciation should be charged as an expense in the statement of comprehensive income each year over the life of the asset.

Depreciation of a new asset commences from the date that an asset is available for use.

Most non-current assets must be depreciated, although there are some exceptions to this rule. For example, land is not depreciated because it has an indefinite useful life.

3.2 Accounting for depreciation

The double entry for depreciation is carried out using two accounts (for each category of non-current asset).

Illustration: Depreciation double entry

	Debit	Credit
Depreciation expense	X	
Accumulated depreciation		X

The balance on the depreciation expense account is taken to the statement of comprehensive income as an expense for the period.

The accumulated depreciation account contains all of the depreciation recognised to date. When the final statement of financial position is prepared it is deducted from the cost of the assets. The non-current asset figure in the statement of financial position is made up of two figures, the cost less accumulated depreciation.

The balance on the accumulated depreciation account is carried forward as a (credit) balance at the end of the period and appears in the statement of financial position as a deduction from the cost of the non-current assets. The figure that appears in the statement of financial position is known as the ***carrying amount*** (or ***net book value***).

Illustration: Carrying amount of a non-current asset

	Rs.	
Non-current asset at cost	X	
Less accumulated depreciation	(X)	
Carrying amount (net book value)	X	**This figure appears on the face of the statement of financial position**

Accounts in the ledger for non-current assets and accumulated depreciation

There are separate accounts in the general ledger for each category of non-current assets (for example, an account for land and buildings, an account for plant and machinery, an account for office equipment, an account for motor vehicles, and so on) and the accumulated depreciation for each of these categories of non-current assets.

This means that each category of non-current assets can be shown separately in the financial statements.

Example: Accounting for depreciation

A company purchases a non-current asset in Year 1 for Rs. 90,000.

In Year 1, the depreciation charge is Rs. 15,000.

These transactions should be recorded as follows:

Asset account

Year 1	Rs.		Rs.
Cash/creditors	90,000	Balance c/f	90,000
	90,000		90,000
Year 2			
Balance b/f	90,000		

Accumulated depreciation account

Year 1	Rs.		Rs.
Balance c/f	15,000	**Depreciation account**	**15,000**
	15,000		15,000
Year 2			
		Balance b/f	15,000

Depreciation account

Year 1	Rs.		Rs.
Accumulated depreciation	**15,000**	Statement of comprehensive income	15,000
	15,000		15,000

At the end of Year 1, the carrying amount of the asset in the statement of financial position is:

	Rs.
Non-current asset at cost (or valuation)	90,000
Less: Accumulated depreciation	(15,000)
Carrying amount	75,000

Example continued:

The depreciation charge In Year 2 is also Rs. 15,000.

The ledger accounts in Year 2 will be as follows:

Asset account

Year 2	Rs.		Rs.
Balance b/f	90,000	Balance c/f	90,000
	90,000		90,000
Year 3			
Balance b/f	90,000		

Accumulated depreciation account

Year 2	Rs.		Rs.
		Balance b/f	15,000
Balance c/f	30,000	**Depreciation account**	**15,000**
	30,000		30,000
Year 3			
		Balance b/f	30,000

Depreciation account

Year 2	Rs.		Rs.
Accumulated depreciation	**15,000**	Statement of comprehensive income	15,000

At the end of Year 2, the carrying amount of the asset in the statement of financial position is:

	Rs.
Non-current asset at cost (or valuation)	90,000
Less: Accumulated depreciation	(30,000)
Carrying amount	60,000

Practice question **1**

An item of equipment cost Rs. 40,000 at the beginning of Year 1. It has an expected life of 5 years.

The annual depreciation charge is Rs. 8,000.

Complete the following ledger accounts for Years 1 and 2 and calculate the carrying amount of the asset at the end of each period.

a **equipment account**

b **accumulated depreciation of equipment account**

c **depreciation of equipment account**

3.3 The purpose of depreciation

It is important to understand the purpose of depreciation. Depreciation is an application of the accruals concept or matching concept.

When a non-current asset is purchased the cost is:

- taken to the non-current asset account at cost and
- shown in the statement of financial position.

The cost is capitalised. However this asset is used within the business in order to earn profits. Therefore some element of its original cost must be charged to the statement of comprehensive income ('charged to profit and loss') each period in order to match the 'consumption' of the cost or value of the assets with the income that the asset is generating.

Depreciation is the element of the cost of the non-current asset that is charged to the statement of comprehensive income each period.

There are several ways of calculating the depreciation charge for the year.

4 METHODS OF CALCULATING DEPRECIATION

Section overview

- Straight-line method
- Reducing balance method
- Sum-of-the-digits method
- Depreciation by the number of units produced

4.1 Straight-line method

Definition: Straight line depreciation

Where the depreciable amount is charged in equal amounts to each reporting period over the expected useful life of the asset.

Formula: Straight-line depreciation

$$\text{Depreciation charge for the year} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected useful life (years)}}$$

With the straight-line method, the annual depreciation charge is the same for each full financial year over the life of the asset (unless the asset is subsequently re-valued during its life).

This is the most common method in practice, and the easiest to calculate.

Example: Straight line depreciation

A machine cost Rs. 250,000. It has an expected economic life of five years and an expected residual value of Rs. 50,000 at the end of that time.

Annual depreciation is:

$$\text{Depreciation charge} = \frac{250{,}000 - 50{,}000}{5\text{ years}} = \text{Rs. 40,000 per annum}$$

An exam question might state that a full year's depreciation is charged in the year of acquisition. This would mean that a full annual charge would be recognised even if the asset was only owned for the last few months of the year.

Example: Straight line depreciation – mid-year acquisition

A machine cost Rs. 250,000. It has an expected economic life of five years.

It is expected that the machine will have a zero scrap value at the end of its useful life.

The machine was bought on the 1st September and the company has a 31st December year end.

The depreciation charge in the first year of ownership is:

$$\text{Depreciation charge} = \frac{250{,}000}{5\text{ years}} \times \frac{4}{12} = \text{Rs. 16,667}$$

Depreciation as a percentage of cost

Another way of stating straight-line depreciation is to express the annual depreciation charge as a percentage of the cost of the asset. For example, suppose that an asset has an expected life of 10 years and zero residual value. If straight-line depreciation is used, the annual depreciation charge will be 10% of the cost of the asset.

Similarly, if an non-current asset has an expected life of six years and a residual value equal to 10% of its cost, straight-line depreciation would be 15% of cost each year (= (100% – 10%)/6 years).

4.2 Reducing balance method

Definition: Reducing balance method

Where the annual depreciation charge is a fixed percentage of the carrying amount of the asset at the start of the period.

Formula: Reducing balance depreciation

Depreciation charge for the year	**=**	**Carrying amount at the start of the year**	×	**Fixed %**

The annual depreciation charge is highest in Year 1 and lowest in the final year of the asset's economic life.

Example: Reducing balance method

A machine cost Rs. 100,000. It has an expected life of five years, and it is to be depreciated by the reducing balance method at the rate of 30% each year.

Annual depreciation and carrying amount over the life of the asset will be as follows.

Year	Carrying amount at start of year	Annual depreciation charge (at (30% of the reducing balance)	Carrying amount at end of year
	Rs.	Rs.	Rs.
1	100,000	30,000	70,000
2	70,000	21,000	49,000
3	49,000	14,700	34,300
4	34,300	10,290	24,010

Calculating the reducing balance

The reducing balance reduces the cost of an asset down to its expected residual value over its expected useful life.

The reducing balance percentage can be calculated using the following formula.

Formula: Calculation of reducing balance percentage

$$x = \sqrt[n]{\frac{\text{Residual value}}{\text{Cost}}} - 1$$

Where:

x = The reducing balance percentage

n = Expected useful life.

Example: Reducing balance

An asset cost Rs. 10,000 and has an expected residual value of Rs. 2,000 at the end of its expected useful life which is 5 years.

The reducing balance percentage is calculated as follows.

$$x = \sqrt[\text{n}]{\frac{\text{Residual value}}{\text{Cost}}} - 1 = \sqrt[5]{\frac{2{,}000}{10{,}000}} - 1 = 0.275 \text{ or } 27.5\%$$

This percentage reduces Rs.10,000 to Rs. 2,000 over 5 years.

Year	Carrying amount at start of year	Annual depreciation charge (at (27.5% reducing balance)	Carrying amount at end of year
	Rs.	Rs.	Rs.
1	10,000	2,750	7,250
2	7,250	1,994	5,256
3	5,256	1,445	3,811
4	3,811	1,048	2,763
5	2,763	763	2,000

Note that the depreciation charge in year 5 contains a rounding difference of 3.

4.3 Sum-of-the-digits method

Definition

Where depreciation is calculated by multiplying the depreciable amount by a fraction where numerator is the remaining life of the asset at the start of the period and the denominator is the sum of all the years' useful life at the start of ownership.

This is another method of depreciation that charges the highest amount in the first year and the lowest amount in the final year.

Example: Sum of the digits

A machine cost Rs. 500,000 and was expected to have a useful life of 5 years.

Annual depreciation over the life of the asset will be as follows.

Step 1: Calculate the sum of the digits (the denominator in the fraction)

	Year
	1
	2
	3
	4
	5
Sum of the digits	15

Step 2: Calculate the annual depreciation charge in each year

Year	Remaining useful life at the start of the year	Annual depreciation charge
1	5	$\frac{5}{15} \times 500{,}000 = 166{,}667$
2	4	$\frac{4}{15} \times 500{,}000 = 133{,}333$
3	3	$\frac{3}{15} \times 500{,}000 = 100{,}000$
4	2	$\frac{2}{15} \times 500{,}000 = 66{,}667$
5	1	$\frac{1}{15} \times 500{,}000 = 33{,}333$

There following formula can be used to calculate the sum of the digits:

Formula: Sum of the digits

$$\text{Sum of the digits} = \frac{n(n+1)}{2}$$

Where:

n = the useful life at the start of ownership

Example: Sum of the digits by formula

5 year useful life

$$\text{Sum of the digits} = \frac{n(n+1)}{2} = \frac{5(5+1)}{2} = \frac{30}{2} = 15$$

25 year useful life

$$\text{Sum of the digits} = \frac{n(n+1)}{2} = \frac{25(25+1)}{2} = \frac{650}{2} = 325$$

4.4 Depreciation by number of units produced

Definition

Where depreciation is calculated by expressing the useful life of an asset in terms of its expected total output and allocating the annual charge to depreciation based on actual output.

Formula: Depreciation by number of units produced

$$\text{Depreciation charge for the year} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected total output of asset over its life}} \times \text{Output this year}$$

Example: Number of units produced

A machine cost Rs. 500,000.

It is expected to produce 5,000,000 units over its useful life.

47,850 units were made in the first year of production.

The depreciation charge in the first year of ownership is:

$$= \frac{\text{Rs.}500{,}000}{5{,}000{,}000} \times 47{,}850 = \text{Rs. } 4{,}875$$

Practice questions **2**

1 An item of equipment cost Rs. 1,260,000. It has an expected useful life of six years and an expected residual value of Rs. 240,000. Using the straight-line method of depreciation:

What is the annual depreciation charge?

What will be the carrying amount of the asset after four years?

2 The financial year of a company is 1st January to 31st December. A non-current asset was purchased on 1st May for Rs. 60,000. Its expected useful life is five years and its expected residual value is zero. It is depreciated by the straight-line method.

What will be the charge for depreciation in the year of acquisition if a proportion of a full year's depreciation is charged, according to the period for which the asset has been held?

3 A non-current asset cost Rs. 64,000. It is depreciated by the reducing balance method, at the rate of 25% each year.

What is the annual depreciation charge in Year 1, Year 2 and Year 3?

4 A motor vehicle cost Rs.400,000. It has an expected residual value after 5 years of Rs.40,000.

What will be the annual charge for depreciation each year if the sum-of-the-digits method of depreciation is used?

What will be the carrying amount of the asset at the end of Year 2?

5 An office property cost Rs. 5 million, of which the land value is Rs. 2 million and the cost of the building is Rs. 3 million. The building has an estimated life of 50 years.

What is the annual depreciation charge on the property, using the straight-line method?

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

a Equipment account

YEAR 1	Rs.		Rs.
Cash	40,000	Balance c/d	40,000
	40,000		40,000
YEAR 2			
Balance b/d	40,000	Balance c/d	40,000
	40,000		40,000
Balance b/d	40,000		

b Equipment – accumulated depreciation

YEAR 1	Rs.		Rs.
		Depreciation	8,000
Balance c/d	8,000		
	8,000		8,000
YEAR 2			
		Balance b/d	8,000
Balance b/d	16,000	Depreciation	8,000
	16,000		16,000
		Balance b/d	16,000

c Depreciation expense

YEAR 1	Rs.		Rs.
Acc. depreciation	8,000	Statement of comprehensive income	8.000
	8,000		8,000
YEAR 2			
Acc. depreciation	8,000	Statement of comprehensive income	8.000
	8,000		8,000

Carrying amounts at:	Year 1 (Rs.)	Year 1 (Rs.)
Cost	40,000	40,000
Accumulated depreciation	8,000	16,000
Carrying amount	32,000	24,000

Solutions **2**

1 Annual depreciation = $^{Rs.(1,260,000 - 240,000)}/_{6 \text{ years}}$ = Rs.170,000.

After 4 years:	Rs.
Asset at cost	1,260,000
Less accumulated depreciation: Rs. 170,000 x 4)	680,000
Net book value	580,000

2 Annual depreciation = $^{Rs.(60,000 - 0)}/_{5 \text{ years}}$ = Rs.12,000.

Charge in the year of acquisition = Rs. 12,000 × $^{8 \text{ months}}/_{12 \text{ months}}$ =Rs. 8,000

3

	Rs.
Cost of the asset	64,000
Year 1 depreciation (25%)	(16,000)
Carrying amount at the end of year 1	48,000
Year 2 depreciation (25%)	(12,000)
Carrying amount at the end of year 2	36,000
Year 3 depreciation (25%)	(9,000)
Carrying amount at the end of year 3	27,000

4

Sum of the digits = 1 + 2 + 3 + 4 + 5 = 15	Rs.
Cost of the asset	400,000
Year 1 depreciation ($^5/_{15}$ × Rs.(400,000 – 40,000)	(120,000)
Carrying amount at the end of year 1	280,000
Year 2 depreciation ($^4/_{15}$ × Rs.(400,000 – 40,000)	(96,000)
Carrying amount at the end of year 2	184,000

5 Annual depreciation = $^{Rs.(3,000,000)}/_{50 \text{ years}}$ = Rs.60,000.

(Land is not depreciated (except in certain circumstances).

CHAPTER 7

Bad and doubtful debts

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 4	**Make adjustment at the end of the reporting period.**
LO4.2.1	*Bad and doubtful debts:* Estimate allowance for bad debts based on a given policy
LO4.2.2	*Bad and doubtful debts:* Post journal entry to record bad debt expense
LO4.2.3	*Bad and doubtful debts:* Compute and record write off and understand its impact on allowance for bad debts.

1 BAD DEBTS AND DOUBTFUL DEBTS

Section overview

- Introduction
- Accounting for bad debts
- Bad debts recovered

1.1 Introduction

A business might make all its sales for cash but many businesses make some or even all their sales on credit. There is often no alternative to offering credit to customers. If competitors offer credit, then a business will have little alternative but to offer credit as well so as not to lose custom. A major benefit of offering credit is that it usually increases revenue, compared to what revenue would be if all sales were for cash.

If sales are made on credit, there is always a chance that some customers will fall into financial difficulty and be unable to pay what they owe.

It would be misleading to the users of the financial statements if a business continued to show receivables where is no chance, or only a slight chance of collecting them.

The application of the concept of prudence would require that there should be an adjustment to reflect the fact that there are some receivables which the business thinks that it will not recover.

There are two categories of problem receivables for which adjustment might be required.

Bad debts (also known as irrecoverable debts or receivables)

A bad debt is an amount owed by a customer that the business believes it will never be able to collect.

Examples of circumstances that might lead to the conclusion that a receivable is irrecoverable include:

- The bankruptcy or insolvency of a customer.
- The death of a customer who has left insufficient assets to pay off his debts.
- A dispute with a customer over whether a contract has been fulfilled or not.
- The dishonesty of a customer (where a person has obtained goods on credit with no intention to pay).

Doubtful debts

A doubtful debt is an amount owed by a customer that the business believes might prove difficult to collect but they still hope to do so. For example, the business might know that the customer is in difficulty but that he might be able to work his way out of it. This casts doubt on the collectability of the receivable but it still might be possible if the customer is able to recover from his difficulties.

Examples of circumstances that might lead to the conclusion that a receivable is doubtful include:

- A customer experiencing cash flow problems.
- A customer taking an unusually long time to settle a debt.
- A customer experiencing operational difficulties which might lead to financial problems (for example, strikes, natural disasters disrupting production etc.).

Bad debts and doubtful debts are accounted for differently, although there is often just a single ***bad and doubtful debts expense account*** in the general ledger.

Prudence

A business should not show an asset in its financial statements at an amount greater than the cash it will generate. When such a circumstance arises the asset is reduced in value down to the cash expected to result from the ownership of the asset.

1.2 Accounting for bad debts

Bad debts are receivables that an entity is owed, but that it now does not expect to collect.

When a specific debt (receivable) is considered bad or irrecoverable, it is written off. This means that it is removed from the accounting system and supporting records.

Illustration: Write off of bad debt – double entry

Write off of bad debt	Debit	Credit
General ledger:		
Bad and doubtful debts expense	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X

When a bad debt is written off, it is reduced to zero in the receivables ledger (and total receivables account):

- The total value of receivables is reduced (reducing assets).
- The bad debt is recorded as an expense (reducing profit and hence capital).

Example: Write off of bad debt

A business has trade receivables of Rs. 750,000 but decides to write off a bad debt of Rs. 15,000.

Receivables control account

	Rs.		Rs.
Balance b/f	750,000	Bad and doubtful debts	15,000
		Closing balance c/f	735,000
	750,000		750,000
Opening balance b/f	735,000		

Bad and doubtful debts account (expense)

	Rs.		Rs.
Receivables	15,000		

At the end of the financial period, the bad debt expense is transferred to the statement of comprehensive income as an expense for the period.

General ledger	Rs.	Rs.
Statement of comprehensive income	15,000	
Bad and doubtful debts		15,000
(This reduces the balance on both accounts)		

The balance on the customer's account in the receivables ledger is reduced by Rs.1 5,000 (in all probability, from Rs. 15,000 to Rs. 0.)

1.3 Bad debts recovered

On rare occasions cash in respect of a debt that had been written off as bad in a previous year is subsequently received in a later period. The double entry for recording the recovery of a bad debt is:

Illustration: Subsequent recovery of bad debt – double entry

Write off of bad debt	Debit	Credit
General ledger:		
Cash	X	
Bad debt expense		X

The credit reduces the bad debt expense account. This recognises that the business had previously recognised an expense when it first wrote off the debt where, in hindsight, it need not have done so.

2 DOUBTFUL DEBTS

Section overview

- Basic double entry for doubtful debts
- Accounting for changes in the allowance account
- Bad and doubtful debts together
- Doubtful debts recovered
- Aged receivables analysis
- Summary of the rules on bad and doubtful debts

2.1 Basic double entry for doubtful debts

As stated above, a doubtful debt is an amount owed by a customer that the business believes might prove difficult to collect but they still hope to do so.

The accounting treatment has to serve two objectives.

- The exercise of prudence requires that the value of the receivable should be adjusted downwards (perhaps to zero) and an expense recognised for the loss in value; but
- The receivable must stay in the accounting records so that the business continues to chase payment.

This is achieved in the following way. Instead of writing off the debt (which would remove it from the records) a business sets up an allowance account.

Illustration: Accounting for doubtful debts – basic double entry

	Debit	Credit
General ledger:		
Bad and doubtful debts expense	**X**	
Allowance for doubtful debts		**X**
Receivables ledger:		
No entry		**X**

Note that the ***allowance account*** might also be called the ***provision for doubtful debts account***.

The allowance is a credit balance which is then set against the carrying amount of the receivables in the statement of financial position.

Illustration: Presentation of receivables in statement of financial position

In the statement of financial position:	**Rs.**
Trade receivables (net of bad debts written off)	**X**
Allowance for doubtful debts	**(X)**
Figure shown for trade receivables on the face of the statement of financial position	**X**

Measurement of the allowance

An allowance is only recognised for a debtor (receivable) if the business knows that the debtor might not pay. Therefore, when a business has information about the financial difficulties of specific debtors it would set up an allowance account for these.

In addition, a business with many debtors would know from experience that at each year end some of the debtors are in difficulty but it does not know who these are yet. In such cases a business might recognise a further general amount in the allowance. Note that the business would have to justify this amount; it cannot recognise a general allowance as it pleases. This must be based on verifiable experience.

Example: Measuring allowance for doubtful debts

The Kasur Cotton Company has receivables at the year-end of Rs.1,500,000.

It has carried out a year-end review of its receivables and discovered that a customer owing Rs.75,000 has suffered a fire at their factory which will stop production for 3 months. The chief accountant believes that this casts doubt on their ability to pay their debt.

In addition, it is The Kasur Cotton Company to recognise an allowance for 5% of its receivables. This is based on experience and the treatment has been approved by the company's auditor.

The Kasur Cotton Company would recognise the following allowance:

	Rs.
Allowance for specific receivable	75,000
General allowance:	
Total receivables	1,500,000
Less amount for which there is a specific allowance	(75,000)
	1,425,000
General allowance @ 5%	71,250
Total allowance required	146,250

In the statement of financial position:	**Rs.**
Trade receivables	1,500,000
Allowance for doubtful debts	(146,250)
Figure shown for trade receivables on the face of the statement of financial position	1,353,750

In summary, when a bad debt is written off, receivables are reduced. An allowance for irrecoverable debts is different from bad debts. When an allowance for irrecoverable debts is created, total receivables are not reduced. Instead, the allowance for irrecoverable debts is recorded in a separate account in the general ledger – an allowance for irrecoverable debts account. This always has a credit balance.

2.2 Accounting for changes in the allowance account

The double entry shown above is a little simplistic. In practice a business will recognise an allowance balance at each year end. When this is the case it is the movement on the allowance that is recognised as an expense.

Example: Accounting for change in the allowance

A business started on 1st January Year 1.

The balance on receivables and the required allowance for doubtful debts at the end of each of the first three years were as follows:

	Year 1	Year 2	Year 3
Receivables	1,000,000	1,200,000	900,000
Allowance required	20,000	24,000	18,000

The example continues on the next page.

Example: Accounting for change in the allowance

Bad and doubtful debts expense account

YEAR 1	Rs.		Rs.
Allowance account (1)	20,000	Statement of comprehensive income	20,000
	20,000		20,000
YEAR 2			
Allowance account (2)	4,000	Statement of comprehensive income	4,000
	4,000		4,000
YEAR 3			
Statement of comprehensive income	6,000	Allowance account (3)	6,000
	6,000		6,000

Allowance for doubtful debts

YEAR 1	Rs.		Rs.
Balance b/d	0	Expense account (1)	20,000
Balance c/d	20,000		
	20,000		20,000
YEAR 2			
		Balance b/d	20,000
Balance c/d	24,000	Expense account (2)	4,000
	24,000		24,000
YEAR 3			
Expense account (3)	6,000	Balance b/d	24,000
Balance c/d	18,000		
	24,000		24,000
		Balance b/d	18,000

Note that in year 3 there is a credit to the bad debt expense. This would reduce the expense recognised in the year (or may even be an item of income).

Example: Accounting for change in the allowance – Continued

The following figures would appear in the statement of financial position at each year-end:

	Year 1	Year 2	Year 3
Receivables	1,000,000	1,200,000	900,000
Allowance required	(20,000)	(24,000)	(18,000)
	980,000	1,176,000	882,000

It is not obvious in the above example but the way to calculate the expense in respect of the allowance account is to identify the movement on the allowance.

Remember that any balance on the allowance account is a credit balance.

Illustration: Change in the allowance

	Debit	Credit
Increase in allowance		
Bad and doubtful debts expense	X	
Allowance for doubtful debts		X
Decrease in allowance		
Allowance for doubtful debts	X	
Bad and doubtful debts expense		X

Example: Accounting for change in the allowance – Continued

Year 2

	Year 2	
Allowance required at the start of the year	20,000	Cr
Allowance required at the end of the year	24,000	Cr
	4,000	Cr

In order to change a credit balance of 20,000 to a credit balance of 24,000 we must:

	Dr	Cr
Bad and doubtful debts expense	4,000	
Allowance for doubtful debts		4,000

Year 3

	Year 3	
Allowance required at the start of the year	24,000	Cr
Allowance required at the end of the year	18,000	Cr
	6,000	Dr

In order to change a credit balance of 24,000 to a credit balance of 18,000 we must:

	Dr	Cr
Allowance for doubtful debts	6,000	
Bad and doubtful debts expense		6,000

2.3 Bad and doubtful debts together

Any question on this area will involve both bad debts and doubtful debts.

This is best seen with an example.

Example:

A business has trade receivables of Rs. 75,000.

It identifies that Rs. 5,000 of these debts are irrecoverable and should be written off.

An allowance for irrecoverable debts of Rs. 2,000 should be created. It is the first time that the business has opened such an account.

These transactions will be accounted for as follows:

Receivables account

	Rs.		Rs.
Opening balance b/f	75,000	Bad debt expense (1)	5,000
		Closing balance c/f	70,000
	75,000		75,000
Opening balance b/f	70,000		

Note: The balance on the trade receivables account is reduced by the bad debts written off, but not by the allowance for doubtful debts.

Bad and doubtful debts(expense)

	Rs.		Rs.
Receivables (1)	5,000	Statement of comprehensive income	7,000
Allowance (2)	2,000		
	7,000		7,000

Allowance for doubtful debts

	Rs.		Rs.
		B and DD expense (2)	2,000

In the statement of financial position, trade receivables will be reported as:

	Rs.
Trade receivables	70,000
Less: Allowance for irrecoverable debts	2,000
	68,000

Example (continued into year 2)

In year 2, credit sales were Rs. 200,000, receipts from customers were Rs. 185,000 and bad debts written off were Rs. 8,000.

The allowance for irrecoverable debts is to be reduced from Rs. 2,000 to Rs. 1,500.

These transactions can be summarised as follows:

Receivables account

	Rs.		Rs.
Opening balance b/f	70,000	Bank	185,000
Sales	200,000	Bad debt expense (1)	8,000
		Closing balance c/f	77,000
	270,000		270,000
Opening balance b/f	77,000		

Bad and doubtful debts(expense)

	Rs.		Rs.
Receivables (1)	8,000	Allowance (2)	500
		Statement of comprehensive income	7,500
	8,000		8,000

Note: The amount charged in this account as an expense for the period is the bad debt written off minus the reduction in the allowance for irrecoverable debts.

Allowance for doubtful debts

	Rs.		Rs.
B and DD expense (2) (2,000 – 1,500)	500	Opening balance b/f	2,000
Closing balance c/f	1,500		
	2,000		2,000
		Opening balance b/f	1,500

In the statement of financial position, trade receivables will be:

	Rs.
Trade receivables	77,000
Less: Allowance for irrecoverable debts	1,500
	75,500

Practice question **1**

Continuing the same example above, the following year (Year 3) sales (all on credit) were Rs. 250,000, receipts from customers were Rs. 252,000 and bad debts written off were Rs. 7,000.

It is decided to reduce the allowance for doubtful debts from Rs. 1,500 to Rs. 900. Record these transactions in the following ledger accounts:

a) Receivables control account

b) Bad and doubtful debts

c) Allowance for doubtful debts

2.4 Doubtful debts recovered

The accounting treatment to record a receipt of cash in respect of a doubtful debt is the same as for any other debt.

Illustration: Subsequent recovery of doubtful debt – double entry

	Debit	Credit
General ledger:		
Cash	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X

There is no special accounting treatment to reflect the fact that the business has received cash for a debt against which it has already recognised an expense.

Common sense suggests that the business should now recognise a credit to the statement of comprehensive income but this happens automatically through the use of basic allowance accounting.

This is because the recovered amount will no longer be included as an allowance when this is re-estimated at the year-end. If all other things are equal this will cause the allowance account to fall. This fall results in a credit to the bad and doubtful debt expense account thus reducing the expense recognised in the statement of comprehensive income.

Example: Doubtful debts recovered

At the start of a period a business has an allowance for doubtful debts made up as follows:

	Allowance	
Allowance required for customer A receivable	6,000	Cr
Allowance required for customer B receivable	2,000	Cr
	8,000	Cr

Customer B pays in full during the period.

The only necessary double entry is:

	Dr	Cr
Cash	2,000	
Receivables control account		2,000

At the period end the allowance for customer B's receivable is no longer required.

	Allowance	
Allowance required at the start of the year	8,000	Cr
Allowance required at the end of the year	6,000	Cr
	2,000	Dr

In order to change a credit balance of 8,000 to a credit balance of 6,000 we must:

	Dr	Cr
Allowance for doubtful debts	2,000	
Bad and doubtful debts expense		2,000

Therefore, the credit to the statement of comprehensive income to reflect the fact that an expense was previously recognised when, with hindsight, there was no need to do so, happens automatically when the year end allowance is remeasured.

2.5 Aged receivables analysis

Preparing an aged receivables analysis is a method of attempting to assess the likelihood of bad debts or to make an assessment of doubtful receivables. This is an analysis for each individual credit customer of their total debtor balance, showing how long each invoice has been outstanding. A typical format for an aged receivables analysis is given below:

Illustration: Aged debtors (receivables) analysis

Customer	*Credit limit* Rs.	*Total owed* Rs.	*< 30 days* Rs.	*30 – 60 days* Rs.	*60 – 90 days* Rs.	*Over 90 days* Rs.
X	20,000	5,500	3,000	–	2,500	–
Y	15,000	2,700	–	1,000	1,000	700

If a customer has old amounts outstanding, these should be investigated and an attempt should be made to collect payment. However the investigation may indicate that the amount should either be written off as a bad debt, or that an allowance should be made for an irrecoverable debt. (In other words, the debt is not written off yet, but the chances of it being paid look doubtful.)

2.6 Summary of the rules on bad and doubtful debts

The rules for dealing with bad debts and doubtful debts at the end of the financial year can be summarised as follows.

Illustration:

Annual charge in the statement of comprehensive income:	**Rs.**
Bad debts written off	**X**
Plus: increase in allowance for doubtful debts; or	**X**
Less: decrease in allowance for doubtful debts	**(X)**
	X

In the statement of financial position	**Rs.**
Trade receivables (net of bad debts written off)	**X**
Allowance for doubtful debts	**X**
Figure shown for trade receivables on the face of the statement of financial position	**X**

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Receivables control account

	Rs.		Rs.
Opening balance b/f	77,000	Bad and doubtful debts	
Sales	250,000	(bad debts written off)	7,000
		Bank	252,000
		Closing balance c/f	
		(= balancing figure)	68,000
	327,000		327,000
Opening balance b/f	68,000		

Bad and doubtful debts expense

	Rs.		Rs.
Trade receivables (= bad		Allowance for doubtful	
debts written off)	7,000	debts	
		(= reduction in allowance)	1,500
		Statement of	
		comprehensive income	
		(= balancing figure)	5,500
	7,000		7,000

Allowance for doubtful debts

	Rs.		Rs.
Bad and doubtful debts		Opening balance b/f	6,000
(= reduction in allowance)	1,500		
Closing balance c/f	4,500		
	6,000		6,000
		Opening balance b/f	4,500

CHAPTER 8

Accruals and prepayments

Contents

INTRODUCTION

LO 4	**Make adjustment at the end of the reporting period.**
LO4.3.1	*Prepayments and accruals:* Understand the matching concept that applies to prepayments and accruals.
LO4.3.2	*Prepayments and accruals:* Post journal entries and ledger entries for prepayments and accruals.
LO4.3.3	*Prepayments and accruals:* Post adjusting entries to recognize revenues or expenses

1 ACCRUALS AND PREPAYMENTS INTRODUCED

Section overview

- The accruals concept (matching concept)
- Accruals and prepayments

1.1 The accruals concept (matching concept)

Financial statements are prepared using the accruals basis of accounting rather than on a cash basis. This means that:

- sales are recognised in the same period as the related cost of making the sale;
- income is recognised in the statement of comprehensive income in the same period as the transaction that gave rise to it (not necessarily when cash is paid); and
- expenses are recognised in the statement of comprehensive income as they arise (not as they are paid).

For example, the cost of rental charges on office accommodation should be spread over the period of time to which the rental payments relate, regardless of when the actual payment of rent occurs.

Illustration: Accruals basis

A business pays annual rental is paid in advance on 1 June each year.

Rent paid on 1 June 2012 = Rs. 240,000

Rent paid on 1 June 2012 = Rs. 300,000

The financial year ends on 30 September.

The rental expense for the year ended 30 September 2013 is:

Period:	Rs.
1 October 2012 to 31 May 2013	
$^{8}/_{12}$ of 240,000 (the last 8 months of the rental year)	160,000
1 June 2013 to 30 September 2013	
$^{4}/_{12}$ of 300,000 (the first 4 months of the rental year)	100,000
	260,000

1.2 Accruals and prepayments

Accruals

A business might incur an expense before the year end but not receive an invoice until after the year-end. If this is the case the business must estimate the amount of the expense and recognise it as an expense and a liability.

The liability is known as an accrual. The business is said to be making an accrual for the expense or accruing for the expense.

Prepayments

A business might pay or at least be invoiced for some expenses in advance.

When the invoice is received the business will recognise the full liability as a debit in an expense account. It would be wrong to then clear all of this to the statement of comprehensive income in the current period. Some of it relates to the next period. This part must be recognised as an asset (it represents a right to receive some kind of service in the next period) called a prepayment.

There are two approaches to accounting for both accruals and prepayments:

- Method 1 – using two accounts; and
- Method 2 – using one account.

Each of these will be explained in turn.

2 ACCRUALS

Section overview

- Accrued expenses (accruals)
- Method 1: the two account approach for accrued expenses (accruals)
- Method 2: the one account approach for accrued expenses (accruals)

2.1 Accruals (accrued expenses)

A business might incur expenses during a period but may not have been sent the invoice by the period end.

Since there has been no payment and no invoice, a financial transaction has not yet occurred and there is not yet anything to record as a book-keeping entry in the ledgers. However, to apply the accruals basis of accounting, the expense must be charged in the statement of comprehensive income for the accounting period to which the expense relates. This is done by creating an accrued expense at the end of the accounting period.

An accrued expense (accrual) is an estimate of the cost that has been incurred in the financial period, and it is included in expenses in the statement of comprehensive income for the period and recognised as a liability (called an accrual) in the statement of financial position.

Accruals are often necessary when expenses are paid in arrears (i.e. at the end of a period of expense).

Example:

Wasif set up in business on 1 January Year 1. The business has a 31 December year end.

The business acquired a telephone system on 1 February.

Telephone charges are paid every 3 three months in arrears and telephone invoices received in Year 1 are as follows:

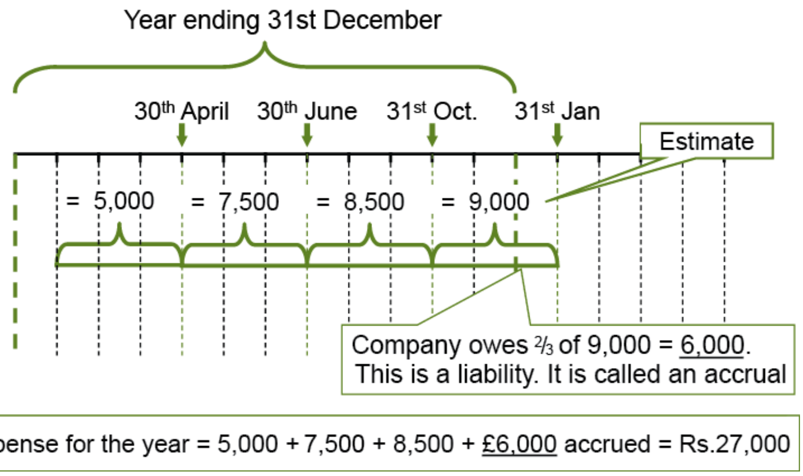
	Rs.
30 April	**5,000**
31 July	**7,500**
31 October	**8,500**

To calculate the telephone expenses for Year 1, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 2) is expected to be Rs. 9,000.

The accrual for November and December Year 1 should be Rs. 6,000 (Rs. 9,000 × $^2/_3$).

This can be represented as follows:



There are two ways of accounting for accruals at the end of an accounting period. These will be explained in turn.

2.2 Method 1: the 'two account' approach for accrued expenses

This is the easier approach. Also note that it is the method used in computerised accounting systems.

The accrued expense is recorded in an accrued expenses account. The double entry for this adjustment is as follows

Illustration: Accruals using two accounts.

	Debit	Credit
Expense account	X	
Accruals account		X

This adds the accrued expense to the expenses recognised as the result of having received invoices earlier in the current accounting period.

The credit balance on the accruals account is a liability, and is included in the statement of financial position as a current liability.

Example (continued): Year 1

Payments in the year were:

	Rs.
30 April	5,000
31 July	7,500
31 October	8,500

The accrual for November and December Year 1 is Rs. 6,000 (Rs. 9,000 × $^2/_3$).

Method 1: two account approach

Telephone expenses account

	Rs.		Rs.
Year 1			
Bank	5,000	Statement of comprehensive income	27,000
Bank	7,500		
Bank	8,500		
Accrued expense (accruals account)	6,000		
	27,000		27,000
Year 2			
		Accruals account	6,000

Accruals account

	Rs.		Rs.
Year 1			
Closing balance c/d	6,000	Telephone expenses	6,000
	6,000		6,000
Year 2			
		Opening balance b/d	6,000

The expense in the statement of comprehensive income for Year 1 is Rs. 27,000 and the accrued expense of Rs. 6,000 is included in the statement of financial position as a current liability at the end of Year 1.

Reversal of the accrual

There is a complication. At the year end the expense account is cleared to the statement of comprehensive income and there is a credit balance carried down on the accruals account.

Assume that the invoice that arrives in January is Rs. 9,500. The accounting system will record the following double entry:

Example: January invoice received

	Debit	Credit
Expense account	9,500	
Liability		9,500

However, an expense of Rs. 6,000 and a liability of Rs. 6,000 has already been recognised in respect of this invoice. If no further adjustment is made the 6,000 is being included twice.

There is a simple way to prevent this. The double entry that set up the accrual at the end of the last period is reversed:

Example: Reversal of the accrual (start of year 2)

The following double entry is processed at the start of year 2:

	Debit	Credit
Accruals account	6,000	
Expense account		6,000

This removes the accrual so that it is not counted twice as a liability and the balance on the expense account is adjusted down to the amount that has not yet been expensed for this invoiced.

Telephone expense account

Year 2			
		Accruals (reversal)	6,000
Payables	9,500		

Accruals

Year 2 (at start of the year)			
Telephone expense	6,000	Balance b/d	6,000

Example: Year 2

In Year 2, the telephone invoices are as follows:

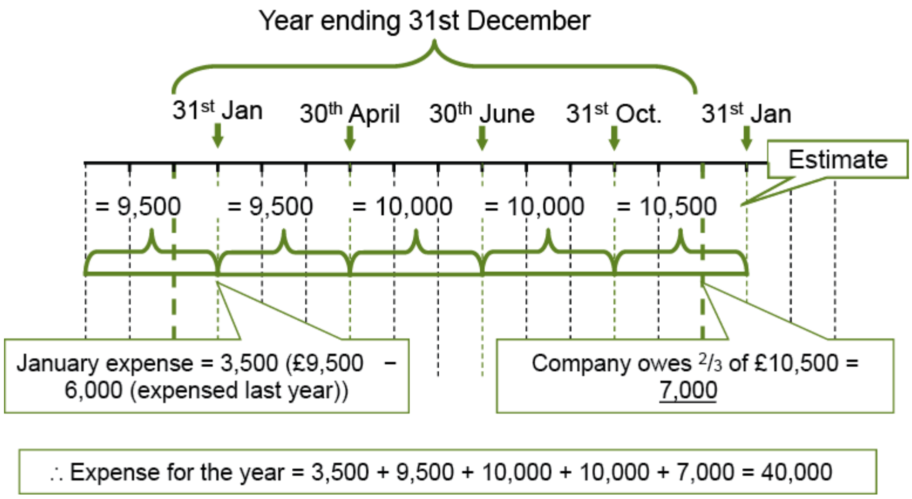
	Rs.
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be Rs. 10,500.

The accrual for November and December Year 1 should be Rs. 7,000 (Rs. 10,500 × $^2/_3$).

This can be represented as follows:



Example: Year 2

In Year 2, the telephone invoices are as follows:

	Rs.
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be Rs. 10,500.

The accrual for November and December Year 1 should be Rs. 7,000 (Rs. 10,500 × $^2/_3$).

Method 1: two account approach

Telephone expenses account

Year 2	Rs.		Rs.
Bank	9,500	Accruals account (reversal of year 1 accrual)	6,000
Bank	9,500	Statement of comprehensive income (balancing figure)	40,000
Bank	10,000		
Bank	10,000		
Accrued expense (accruals account)	7,000		
	46,000		46,000
Year 3			
		Accruals account	7,000

Accruals account

Year 2	Rs.		Rs.
Telephone expense account (reversal of Year 1 accrual)	6,000	Opening balance b/d	6,000
Closing balance c/d	7,000	Telephone expenses account	7,000
	13,000		13,000
		Opening balance b/d	7,000

The expense in the statement of comprehensive income for Year 2 is Rs. 40,000 and the accrued expense of Rs. 7,000 is included in the statement of financial position as a current liability at the end of Year 2.

2.3 Method 2: the 'one account' approach for accrued expenses

This approach is trickier to understand. The accrual is recognised in the expense account.

There are two ways of achieving this.

- The total expense can be calculated and transferred to the statement of comprehensive income (Dr Statement of comprehensive income; Cr Expense account) leaving a balancing figure on the expense account as an accrual; or
- The accrual can be calculated and recognised in the expense account leaving the amount transferred to the statement of comprehensive income (Dr Statement of comprehensive income; Cr Expense account) as a balancing figure

Example: Year 1

Wasif set up in business on 1 January Year 1. The business has a 31 December year end.

The business acquired a telephone system on 1 February.

Telephone charges are paid every 3 three months in arrears and telephone invoices received in Year 1 are as follows:

	Rs.
30 April	5,000
31 July	7,500
31 October	8,500

To calculate the telephone expenses for Year 1, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 2) is expected to be Rs. 9,000.

The accrual for November and December Year 1 should be Rs. 6,000 (Rs. 9,000 × $^2/_3$).

Method 2: one account approach

Telephone expenses account

Year 1	Rs.		Rs.
Bank	5,000	Statement of comprehensive income	27,000
Bank	7,500		
Bank	8,500		
Closing balance (accrued expense) c/d	6,000		
	27,000		27,000
		Opening balance b/d	6,000

In order to make the above work either:

1) **Calculate the expense transferred to the statement of comprehensive income (27,000) and calculate the accrual taken as a balancing figure; or**

2) **Calculate the accrual needed (6,000) and then calculate the expense transferred to the statement of comprehensive income (27,000) as a balancing figure (6,000). This is usually the easiest way.**

There is no need to reverse the accrual using the one account method as it is already in the expense account at the start of the next year.

Example (continued): Year 2

In Year 2, the telephone invoices are as follows:

	Rs.
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be Rs. 10,500.

The accrual for November and December Year 1 should be Rs. 7,000 (Rs. 10,500 × $^2/_3$).

Method 2: one account approach

Telephone expenses account

Year 2	Rs.		Rs.
Bank	9,500	Opening balance b/d	6,000
Bank	9,500	**Statement of comprehensive income**	**40,000**
Bank	10,000		
Bank	10,000		
Closing balance (accrued expense) c/d	7,000		
	46,000		46,000
		Opening balance b/d	7,000

In order to make the above work either:

1) Calculate the expense transferred to the statement of comprehensive income (40,000) and calculate the accrual taken as a balancing figure (7,000); or

2) Calculate the accrual needed (7,000) and then calculate the expense transferred to the statement of comprehensive income (40,000) as a balancing figure. This is usually the easiest way.

Calculating the expense for the statement of comprehensive income

Method 2 requires the calculation of either the closing accrual or the charge to the statement of comprehensive income, the other number being taken as a balancing figure. **It is almost always easier to calculate the accrual.**

The amount charged to the statement of comprehensive income can be calculated as follows. It is worth spending a little time trying to understand this.

Example: Charge to the statement of comprehensive income

From first principles

	Year 1
January	0
February to April	5,000
May to July	7,500
August to October	8,500
November and December (accrual)	6,000
	27,000

	Year 2
November to January	9,500
Less amount already expensed last year for November and January	(6,000)
Therefore: January	3,500
February to April	9,500
May to July	10,000
August to October	10,000
November and December (accrual)	7,000
	40,000

In fact, what is going on above can be represented by the following:

Illustration:

	Rs.
Invoices/payments for the year	X
+ Closing accrued expense	X
	X
– Opening accrued expense	(X)
= Expense for the year	X

Example:

	Year 1	Year 2
Invoices/payments for the year:		
January	0	9,500
February to April	5,000	9,500
May to July	7,500	10,000
August to October	8,500	10,000
+ Closing accrued expense	6,000	7,000
	27,000	46,000
– Opening accrued expense	0	(6,000)
= Expense for the year	27,000	40,000

3 PREPAYMENTS

Section overview

- Prepayments (prepaid expenses)
- Method 1: the two accounts method
- Method 2: the one account method

3.1 Prepayments (prepaid expenses)

Prepaid expenses are expenses that are recorded in the accounts in the current period, because a purchase invoice has been received or a payment has been made, but all or part of the expense relates to a future accounting period.

Prepaid expenses occur whenever payments are made in advance for an expense item.

To apply the accruals basis of accounting, the expenses that have been recorded in the accounts but that relate to a future accounting period should be:

- excluded from the expenses in the statement of comprehensive income for the current year and recognised as an asset (a prepayment) at the year-end; and then
- included in the expenses for the next financial period (which is the period to which they relate).

Example: Year 1

Fahad set up in business on 1 January Year 1 preparing financial statements to 31 December each year..

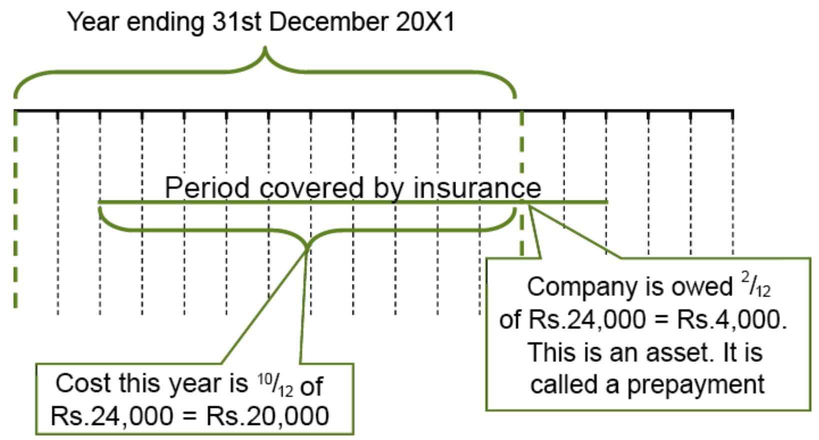
On 1 March he obtains annual insurance on his office building, starting from 1 March at cost of Rs. 24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of comprehensive income for insurance in Year 1 should therefore be Rs. 20,000 (Rs. 24,000 × $^{10}/_{12}$).

The prepaid expense for Year 2 is Rs. 4,000 (Rs. 24,000 × $^{2}/_{12}$).

This can be represented as follows:



There are two ways of accounting for prepayments at the end of an accounting period. These will be explained in turn.

3.2 Method 1: the two accounts method

This is the easier approach. Also note that it is the method used in computerised accounting systems.

The prepayment is estimated and then transferred from the expense account to a prepayment account:

Illustration: Prepayment using two accounts.

	Debit	Credit
Prepayment account (an asset)	X	
Expense account		X

The prepayment is a credit entry in the expense account therefore reducing the expense recognised in the current period.

The debit balance on the prepayments account is included in the statement of financial position as a current asset.

Example: Year 1

Fahad set up in business on 1 January Year 1 preparing financial statements to 31 December each year..

On 1 March he obtains annual insurance on his office building, starting from 1 March at cost of Rs. 24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of comprehensive income for insurance in Year 1 should therefore be Rs. 20,000 (Rs. 24,000 × $^{10}/_{12}$).

The prepaid expense for Year 2 is Rs. 4,000 (Rs. 24,000 × $^{2}/_{12}$).

Method 1: two accounts approach

Insurance expense

	Rs.		Rs.
Year 1			
Bank	24,000	Prepayments	4,000
		Statement of comprehensive income	20,000
	24,000		24,000

Prepayments account

	Rs.		Rs.
Year 1			
Insurance expense	4,000	Closing balance c/d	4,000
	4,000		4,000

Reversal of the prepayment

At the beginning of the next accounting period, the balance in the prepayments account is transferred back to the expense account so that it will be recognised as an expense in the next accounting period.

Example (continued): Reversal of the prepayment (at the start of year 2)

The following double entry is processed at the start of year 2:

	Debit	Credit
Insurance expense	4,000	
Prepayments		4,000

This reinstates the prepayment as an expense that relates to the second year.

Insurance expense

Year 2			
Prepayments (reversal)	4,000		

Prepayments

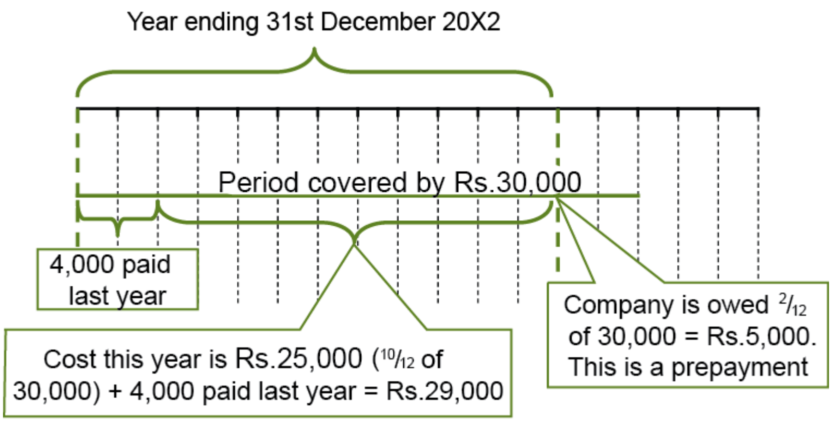
Year 2 (at start of the year)			
Balance b/d	4,000	Insurance expense	4,000

Example (continued): Year 2

In Year 2, the annual insurance premium payable on 1 March is Rs. 30,000 for the year to 28 February Year 3.

The prepaid expense at the end of Year 2 is therefore Rs. 5,000 (Rs. 30,000 × $^2/_{12}$) and the insurance expense in Year 2 is accounted for as follows:

This can be represented as follows:



Example (continued): Year 2

In Year 2, the annual insurance premium payable on 1 March is Rs. 30,000 for the year to 28 February Year 3.

The prepaid expense at the end of Year 2 is therefore Rs. 5,000 (Rs. 30,000 × $^2/_{12}$) and the insurance expense in Year 2 is accounted for as follows:

Method 1: two accounts approach

Insurance expense

Year 2	Rs.		Rs.
Prepayments	4,000	Prepayments	5,000
Bank	30,000	Statement of comprehensive income (balancing figure)	29,000
	34,000		34,000
Year 3			
Prepayments (reversal)	5,000		

Prepayments

Year 2	Rs.		Rs.
Opening balance b/d	4,000	Insurance expenses	4,000
Insurance expenses account	5,000	Closing balance c/d	5,000
	9,000		9,000
Year 3			
Opening balance b/d	5,000	Insurance expenses (reversal)	5,000

The expense in the statement of comprehensive income is Rs. 29,000.

This consists of the prepayment at the beginning of the year (Rs. 4,000 for January and February) plus the expense for the 10 months from March to December ((Rs. 30,000 × $^{10}/_{12}$) = Rs. 25,000).

The prepaid expense of Rs. 5,000 at the end of Year 2 is included in the statement of financial position as a current asset.

3.3 Method 2: the one account method

This approach is trickier to understand. The prepayment is recognised in the expense account.

There are two ways of achieving this.

- The total expense can be calculated and transferred to the statement of comprehensive income (Dr Statement of comprehensive income; Cr Expense account) leaving a balancing figure on the expense account as a prepayment; or
- The prepayment can be calculated and recognised in the expense account leaving the amount transferred to the statement of comprehensive income (Dr Statement of comprehensive income; Cr Expense account) as a balancing figure.

Example: Year 1

Fahad set up in business on 1 January Year 1 preparing financial statements to 31 December each year..

On 1 March he obtains annual insurance on his office building, starting from 1 March at cost of Rs. 24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of comprehensive income for insurance in Year 1 should therefore be Rs. 20,000 (Rs. 24,000 × $^{10}/_{12}$).

The prepaid expense for Year 2 is Rs. 4,000 (Rs. 24,000 × $^{2}/_{12}$).

Method 2: one account approach

Insurance expenses

Year 1	**Rs.**		**Rs.**
Bank	24,000	Statement of comprehensive income	20,000
		Closing balance c/d (prepayment)	4,000
	24,000		24,000
Year 2			
Opening balance b/d	4,000		

The expense in the statement of comprehensive income is Rs. 20,000 and the prepaid expense is included in the statement of financial position as a current asset at the end of Year 1.

There is no need to reverse the prepayment using the one account method as it is already in the expense account at the start of the next year.

Example (continued): Year 2

In Year 2, the annual insurance premium payable on 1 March is Rs. 30,000 for the year to 28 February Year 3.

The prepaid expense at the end of Year 2 is therefore Rs. 5,000 (Rs. 30,000 × $^2/_{12}$) and the insurance expense in Year 2 is accounted for as follows:

Method 2: one account approach

Insurance expenses

Year 2	Rs.		Rs.
Opening balance b/d	4,000	Statement of comprehensive income	
Bank	30,000	(balancing figure)	29,000
		Closing balance c/d	5,000
	34,000		34,000
Year 3			
Opening balance b/d	5,000		

3.4 Prepaid expenses: calculating the expense for the statement of comprehensive income

Method 2 requires the calculation of either the closing prepayment or the charge to the statement of comprehensive income, the other number being taken as a balancing figure. **It is almost always easier to calculate the prepayment.**

The amount charged to the statement of comprehensive income can be calculated as follows. It is worth spending a little time trying to understand this.

Example: Charge to the statement of comprehensive income

	Year 1
January, February	0
March to December:	
$^{10}/_{12}$ of 24,000	20,000

	Year 2
January, February:	
$^{2}/_{12}$ of 24,000	4,000
March to December:	
$^{10}/_{12}$ of 30,000	25,000
	29,000

The expense may also be calculated as follows:

Illustration:

	Rs.
Invoices/payments for the year	X
+ Opening prepaid expense	X
	X
– Closing prepaid expense	(X)
= Expense for the year	X

Example:

	Rs.	Rs.
Invoices/payments for the year	24,000	30,000
+ Opening prepaid expense	0	4,000
	24,000	34,000
– Closing prepaid expense	(4,000)	(4,000)
= Expense for the year	20,000	30,000

4 UNEARNED AND ACCRUED INCOME

Section overview

- Introduction
- Unearned income
- Accrued income

4.1 Introduction

A business may have miscellaneous forms of income, for example, from renting out property.

When a business entity has income from sources where payments are made in advance or in arrears. The accruals basis of accounting applies, and the amount of income to include in profit and loss for a period is the amount of income that relates to that period. It may therefore be necessary to apportion income on a time basis and there may be unearned income or accrued income to account for.

Unearned income

This is where a business has received income in advance. For example, a business might rent out a property for which the tenant must pay in advance.

Only the income that relates to the period is recognised in the statement of comprehensive income and the balance is recognised as a liability of the business. (Note that it is an asset of the tenant).

Accrued income

This is where a business receives income in arrears.

For example, a business might rent out a property for which the tenant must pay in arrears. The tenant might owe the business money at the business's year-end.

All of the income that relates to the period must be recognised in the statement of comprehensive income. It is necessary to recognise the amount owed to the business as an asset at the year-end.

4.2 Unearned income

The method of calculating income for the year when there is unearned income is the same in principle as the method of calculating an expense for the year when there is an accrued charge or a prepaid expense.

Example: Unearned income

A business rents out a part of its premises.

The rent is payable every six months, on 1 May and 1 November in advance.

The company has a year end of 31 December.

The annual rental for the year to 30 April 2013 was Rs. 48,000 (received in two amount so of Rs.24,000 on 1 May 2012 and 1 November 2012).

The annual rental and Rs. 60,000 for the year to 30 April 2014 (received in two amount so of Rs.30,000 on 1 May 2013 and 1 November 2013).

Income for the year ending 31 December 2013 is:

	Rs.
For the 4 months 1 January – 30 April 2013:	
$^4/_{12} \times$ Rs. 48,000	16,000
For the 8 months 1 May – 31 December 2013:	
$^8/_{12} \times$ Rs. 60,000	40,000
Rental income for the year to 31 December 2013	56,000

At 31 December 2012 there was unearned rental income for the period 1 January – 30 April 2013.

The amount of unearned income is $^4/_{12}$ of the Rs. 24,000 received on 1 November 2012 which came to Rs. 16,000. (This represents 4 months at Rs. 4,000 per month)

This was included as a current liability in the statement of financial position as at the end of the last financial year.

At 31 December 2013 there is unearned rental income for the period 1 January – 30 April 2014.

The amount of unearned income is $^4/_{12}$ of the Rs. 30,000 received on 1 November 2013 which comes to Rs. 20,000. (This represents 4 months at Rs. 5,000 per month)

This is recognised as a current liability as at the end of the financial year.

Unearned income (just as for prepayments and accruals) can be accounted for using either one or two accounts to record the transactions. If two accounts are used the closing unearned income liability must be reversed to the income account at the start of the next period (just as is the case for prepayments and accruals).

Method 1: Two accounts method

Income has been paid to the business but some of it relates to the next period. This amount must be transferred from the income account to a liability account

Example: Unearned income

	Debit	Credit
Income	X	
Unearned income (liability)		X

Example (continued): Unearned income

The double entry is as follows:

Rental income

		Unearned income (reversal of 2012 unearned income)	16,000
		Cash (1 May 2013)	30,000
Unearned income (to be recognised in 2014)	20,000	Cash (1 November 2013)	30,000
Statement of comprehensive income	56,000		
	76,000		76,000

Unearned income

		Balance b/d (at 1st January 2013)	16,000
Rental income (reversal of 2012 unearned income)	16,000		
Balance c/d	20,000	Rental income	20,000
	36,000		36,000
		Balance b/d	20,000

Method 2: One account method

The unearned income is brought down as a liability on the income account.

There are two ways of achieving this.

- The total income for the period can be calculated and transferred to the statement of comprehensive income (Dr Income account; Cr Statement of comprehensive income) leaving a balancing figure on the expense account as the unearned income liability; or
- The unearned income liability can be calculated and recognised in the expense account leaving the amount transferred to the statement of comprehensive income (Dr Income account; Cr Statement of comprehensive income) as a balancing figure

Example (continued): Unearned income (One account approach)

The double entry is as follows:

Rental income

		Balance b/d	16,000
		Cash (1 May 2013)	30,000
Statement of comprehensive income	56,000	Cash (1 November 2013)	30,000
Balance c/d	20,000		
	76,000		76,000
		Balance b/d	20,000

4.3 Accrued income

The method of calculating income for the year when there is accrued income is the same in principle as the method of calculating an expense for the year when there is an accrued charge or a prepaid expense.

Example: Accrued income

A business rents out a part of its premises.

Rentals are payable each quarter in arrears on 31 January, 30 April, 31 July and 31 October.

The company has a year end of 31 December.

The annual rental was Rs. 30,000 per year until 31 October 2013 (or Rs. 2,500 per month received in 4 amounts of Rs.7,500 on 31 January, 30 April, 31 July and 31 October).

The annual rental was increased to Rs. 36,000 per year from 1 November 2013 (or Rs. 3,000 per month received in 4 amounts of Rs.9,000 on 31 January, 30 April, 31 July and 31 October).

Income for the year ending 31 December 2013 is:

	Rs.
For the 10 months 1 January – 31 October 2013:	
$^{10}/_{12} \times$ Rs. 30,000	25,000
For the 2 months 1 November – 31 December 2013:	
$^{2}/_{12} \times$ Rs. 36,000	6,000
Rental income for the year to 31 December	31,000

At 31 December 2012 there was rental earned but not yet received.

This is the rental income for November and December 2012, which will not be received until 31 January 2013.

The amount of the accrued income is Rs. 5,000 ($^{2}/_{3}$ of 7,500 or 2 months at Rs. 2,500 per month) and was included in last year's income and recognised as a current asset at the end of last year financial year.

At 31 December 2013 there is rental earned but not yet received.

This is the rental income for November and December 2013, which will not be received until 31 January 2014.

The amount of the accrued income is Rs. 6,000 ($^{2}/_{3}$ of 9,000 or 2 months at Rs. 3,000 per month) and is included in income and recognised as a current asset at the end of the financial year.

Accrued income (just as for prepayments and accruals) can be accounted for using either one or two accounts to record the transactions. If two accounts are used the closing accrued income asset must be reversed to the income account at the start of the next period (just as is the case for prepayments and accruals).

Method 1: Two accounts method

Income has been earned in the current period. This amount must be recognised.

Example: Accrued income

	Debit	Credit
Accrued income (asset)	X	
Income		X

Example (continued): Accrued income

The double entry is as follows:

Rental income

Accrued income (reversal of 2012 accrued income)	5,000	Cash (31 January 2013)	7,500
		Cash (30 April 2013)	7,500
		Cash (31 July 2013)	7,500
		Cash (31 October 2013)	7,500
Statement of comprehensive income	31,000	Accrued income (for November and December 2013)	6,000
	36,000		36,000

Accrued income

Balance b/d (at 1st January 2013)	5,000		
		Rental income (reversal of 2012 accrued income)	5,000
Rental income	6,000	Balance c/d	6,000
	11,000		11,000
Balance b/d	6,000		

Method 2: One account method

The accrued income is brought down as an asset on the income account.

There are two ways of achieving this.

- The total income for the period can be calculated and transferred to the statement of comprehensive income (Dr Income account; Cr Statement of comprehensive income) leaving a balancing figure on the expense account as the accrued income asset; or
- The accrued income asset can be calculated and recognised in the expense account leaving the amount transferred to the statement of comprehensive income (Dr Income account; Cr Statement of comprehensive income) as a balancing figure

Example (continued): Accrued income (One account approach)

The double entry is as follows:

Rental income

Balance b/d	5000	Cash (31 January 2013)	7,500
		Cash (30 April 2013)	7,500
		Cash (31 July 2013)	7,500
Statement of comprehensive income	31,000	Cash (31 October 2013)	7,500
		Balance c/d	6,000
	36,000		36,000
Balance b/d	6,000		

CHAPTER 9

Inventory

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 4	**Make adjustment at the end of the reporting period.**
LO4.4.1	*Closing entries for inventory:* Understand the concepts of periodic and perpetual inventory system
LO4.4.2	*Closing entries for inventory:* Identify the need to post the adjustment entries of inventory at the end of the period in case of periodic inventory system.
LO4.4.3	*Closing entries for inventory:* Pass the adjusting entries and ledger entries at the end of the period.

1 END-OF-YEAR ADJUSTMENTS FOR INVENTORY

Section overview

- Recording inventory
- Periodic inventory method (period-end method): accounting procedures
- Perpetual inventory method: accounting procedures
- Summary of journal entries under each system

1.1 Recording inventory

In order to prepare a statement of comprehensive income it is necessary to be able to calculate gross profit. This is done by comparing the sale proceeds from the sale of items of inventory to the cost of those items. This is an application of the accruals concept (matching principle).

In order to calculate gross profit it is necessary to record opening inventory, purchases and closing inventory.

There are two main methods of recording inventory.

- Periodic inventory method (period end system)
- Perpetual inventory system

Each method uses a ledger account for inventory but these have different roles.

A question on year-end adjustments for inventories will normally require you to use the periodic inventory method but the perpetual inventory system is examinable in its own right.

1.2 Periodic inventory method (period-end method): accounting procedures

This system is based on the use of two ledger accounts:

- Purchases account which is used to record all purchases during the year; and
- Inventory account which is used to record the value of inventory at the beginning/end of the financial year.

It operates as follows:

Year 1

A business starts on 1 January Year 1. This business has no opening inventory. All inventory purchased in the year to 31 December Year 1 is recorded in the purchases account.

Illustration: Purchases through the year

	Debit	Credit
Purchases	X	
Cash or liabilities		X

At the end of the year a trial balance is extracted. One of the balances in the trial balance is the purchases figure for the year.

This is transferred to cost of sales clearing the purchases account to zero.

Illustration: Year end transfer to cost of sales

	Debit	Credit
Cost of sales	X	
Purchases		X

At the end of the year cost of sales must be calculated. Purchases are not the same as cost of sales because the company still holds some of the items that it purchased.

The number of items of inventory still held is established through an inventory count. This involves the staff of the business counting every item of inventory and making a record of this. The inventory is then valued (usually at cost). This figure is the closing inventory.

It is recognised as an asset on the statement of financial position and as a credit entry on the statement of comprehensive income (where it reduces the cost of sales expense).

Illustration: Closing inventory double entry

	Debit	Credit
Inventory (statement of financial position)	X	
Cost of sales (Statement of comprehensive income)		X

The exact location of the credit entry might be to one of several accounts but ultimately it always achieves the same purpose, that is, to set reduce cost of sales. Thus it might be a credit to a statement of comprehensive income inventory account (which is later transferred to a cost of sales account or it might be a credit to the cost of sales account.

At the end of year 1 the purchases and the credit entry for closing inventory form part of the profit for the period. The debit entry for closing inventory is carried down into year 2 as an asset.

Year 2

The closing inventory in year 1 becomes the opening inventory in year 2

All inventory purchased in the year to 31 December Year 2 is recorded in the purchases account.

At the end of the year a trial balance is extracted. One of the balances in the trial balance is the purchases figure for the year. Another of the balances is the opening inventory which has been there since the start of the year.

The purchases together with the opening inventory are what the business could have sold in the period. These are both transferred to the cost of sales.

Illustration: Year end transfer to cost of sales

	Debit	Credit
Cost of sales	X	
Purchases		X
Cost of sales	X	
Inventory (statement of financial position)		X

Note that this is the transfer of the opening inventory to cost of sales)

At the end of the financial year, the closing inventory is physically counted and valued. The closing inventory double entry is then processed.

Illustration: Closing inventory double entry

	Debit	Credit
Inventory (statement of financial position)	X	
Cost of sales (Statement of comprehensive income)		X

In summary

Opening inventory in the trial balance (a debit balance) and purchases (a debit balance) are both transferred to cost of sales.

This clears both accounts.

Closing inventory is recognised in the inventory account as an asset (a debit balance) and the other side of the entry is a credit to cost of sales.

Cost of sales comprises purchase in the period adjusted for movements in inventory level from the start to the end of the period.

Illustration: Cost of sales

	Year 1	Year 2
	Rs.	Rs.
Opening inventory (a debit)	–	X
Purchases (a debit)	X	X
	X	X
Closing inventory (a credit)	(X)	(X)
Cost of sales	X	X

Example:

Faisalabad Trading had opening inventory of Rs. 10,000.

Purchases during the year were Rs. 30,000.

Closing inventory at the end of Year 2 was Rs. 12,000.

At the year end the following entries are necessary

Purchases account

	Rs.		Rs.
Balance b/d	30,000	(1) Cost of sales	30,000

Inventory account

	Rs.		Rs.
Balance b/d	10,000	(2) Cost of sales Removal of opening inventory	10,000
(3) Cost of sales Recognition of closing inventory	12,000		
		Closing balance c/d	12,000
	22,000		22,000
Opening balance b/d	12,000		

Cost of sales

	Rs.		Rs.
(1) Purchases	30,000		
(2) Opening inventory	10,000		
		(3) Closing inventory	12,000
		Cost of sales c/f	28,000
	40,000		40,000
Cost of sales b/f	28,000		

The cost of sales total is then transferred to the statement of comprehensive income.

The cost of sales is part of the statement of comprehensive income and can be presented as follows:

	Rs.	Rs.
Sales		X
Opening inventory	10,000	
Purchases	30,000	
	40,000	
Closing inventory	(12,000)	
Cost of sales		(28,000)
Gross profit		X

Remember the following:

- In a period-end system of accounting for inventory, the double entries are between the inventory account and the statement of comprehensive income.
- The cost of opening inventory is included in the cost of sales. It is an expense, and expenses are a debit entry. So debit the statement of comprehensive income (and credit the inventory account) with the cost of the opening inventory.
- The cost of closing inventory is included in the statement of financial position as an asset, so there must be a debit balance for the closing inventory. So debit Inventory (and credit Statement of comprehensive income) with the valuation of the closing inventory.

Practice questions **1**

The following trial balance has been extracted from the ledger of Chiniot Market Traders at 30 June 2013.

	Debit	Credit
	Rs. 000	Rs. 000
Salaries	10,500	
Drawings	3,000	
Lighting and heating	500	
Sales		30,000
Trade receivables	10,000	
Rent	2,000	
Office expenses	1,000	
Capital at 1 July 2012		27,500
Purchases	14,000	
Inventory at 1 July 2012	2,000	
Trade payables		4,000
Property, plant and machinery	17,500	
Cash	1,000	
	61,500	61,500

Closing inventory at 30 June 2013 has been valued at Rs. 1,500,000.

Required

Prepare the statement of comprehensive income for the year to 30 June Year 3 and the statement of financial position as at that date.

1.3 Perpetual inventory method: accounting procedures

A single account is used to record all inventory movements. The account is used to record purchases in the period and inventory is brought down on the account at each year-end. The account is also used to record all issues out of inventory. These issues constitute the cost of sales.

When the perpetual inventory method is used, a record is kept of all receipts of items into inventory (at cost) and all issues of inventory to cost of sales.

Each issue of inventory is given a cost, and the cost of the items issued is either the actual cost of the inventory (if it is practicable to establish the actual cost) or a cost obtained using a valuation method.

Each receipt and issue of inventory is recorded in the inventory account. This means that a purchases account becomes unnecessary, because all purchases are recorded in the inventory account.

All transactions involving the receipt or issue of inventory must be recorded, and at any time, the balance on the inventory account should be the value of inventory currently held.

Example:

Faisalabad Trading had opening inventory of Rs. 10,000.

Purchases during the year were Rs. 30,000.

Closing inventory at the end of Year 2 was Rs. 12,000.

The following entries are necessary during the period.

Inventory account

	Rs.		Rs.
Balance b/d	10,000	Cost of sales	28,000
Cash or creditors (purchases in the year)	30,000		
		Closing balance c/d	12,000
	40,000		40,000
Opening balance b/d	12,000		

Furthermore, all transactions involving any kind of adjustment to the cost of inventory must be recorded in the inventory account.

Example:

Gujrat Retail (GR) had opening inventory of Rs. 100,000.

Purchases during the year were Rs. 500,000. Inventory with a cost of Rs. 18,000 was returned to a supplier. One of the purchases in the above amount was subject to an express delivery fee which cost the company an extra Rs. 15,000 in addition to the above amount.

GR sold goods during the year which had cost Rs. 520,000. Goods which had cost Rs. 20,000 were returned to the company.

Just before the year end goods which had cost Rs. 5,000 were found to have been damaged whilst being handled by GR's staff.

The following entries are necessary during the period.

Inventory account

	Rs.		Rs.
Balance b/d	100,000		
Cash or creditors		Returns to supplier	18,000
(purchases in the year)	500,000		
Special freight charge	15,000		
Returns from customers	20,000	Cost of goods sold	500,000
		Normal loss	5,000
		Closing balance c/d	112,000
	635,000		635,000
Opening balance b/d	112,000		

1.4 Summary of journal entries under each system

Entry	Periodic inventory method	Perpetual inventory method
Opening inventory	Closing inventory as measured and recognised brought forward from last period	Closing balance on the inventory account as at the end of the previous period
Purchase of inventory	Dr Purchases Cr Payables/cash	Dr Inventory Cr Payables/cash
Freight paid	Dr Carriage inwards Cr Payables/cash	Dr Inventory Cr Payables/cash
Return of inventory to supplier	Dr Payables Cr Purchase returns	Dr Payables Cr Inventory
Sale of inventory	Dr Receivables Cr Sales	Dr Receivables Cr Sales **and** Dr Cost of goods sold Cr Inventory
Return of goods by a supplier	Dr Sales returns Cr Receivables	Dr Sales returns Cr Receivables **and** Dr Inventory Cr Cost of goods sold
Normal loss	No double entry	Dr Cost of goods sold Cr Inventory
Abnormal loss	Dr Abnormal loss Cr Purchases	Dr Abnormal loss Cr Inventory
Closing inventory	Counted, valued and recognised by: Dr Inventory (statement of financial position) Cr Cost of sales (cost of goods sold)	Balance on the inventory account

2 OTHER ISSUES

Section overview

- Valuation of inventory
- Cost formulas
- Inventory and drawings

2.1 Valuation of inventory

Basic rule

The valuation of inventory can be extremely important for financial reporting, because the valuations affect both the cost of sales (and profit) and also total asset values in the statement of financial position.

Inventory must be measured in the financial statements at the **lower** of:

- cost, or
- net realisable value (NRV).

Net realisable value is the amount that can be obtained from disposing of the inventory in the normal course of business, less any further costs that will be incurred in getting it ready for sale or disposal.

- Net realisable value is usually higher than cost. Inventory is therefore usually valued at cost.
- However, when inventory loses value, perhaps because it has been damaged or is now obsolete, net realisable value will be lower than cost.

The cost and net realisable value should be compared for each separately-identifiable item of inventory, or group of similar inventories, rather than for inventory in total.

Example:

A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	Rs.		
	Cost	Sales price	Selling costs
Inventory item A1	8,000	7,800	500
Inventory item A2	14,000	18,000	200
Inventory item B1	16,000	17,000	200
Inventory item C1	6,000	7,500	150

The value of closing inventory in the financial statements:

	Lower of:	Rs.
A1	8,000 or (7,800 – 500)	7,300
A2	14,000 or (18,000 – 200)	14,000
B1	16,000 or (17,800 – 500)	16,000
C1	6,000 or (7,000 – 200)	6,000
Inventory valuation		43,300

2.2 Cost formulas

With some inventory items, particularly large and expensive items, it might be possible to recognise the actual cost of each item.

In practice, however, this is unusual because the task of identifying the actual cost for all inventory items is impossible because of the large numbers of such items.

A system is therefore needed for measuring the cost of inventory.

The historical cost of inventory is usually measured by one of the following methods:

- First in, first out (FIFO)
- Weighted average cost (AVCO)

Illustration

On 1 January a company had an opening inventory of 100 units which cost Rs.50 each.

During the month it made the following purchases:

5 April: 300 units at Rs. 60 each

14 July: 500 units at Rs. 70 each

22 October: 200 units at Rs. 80 each.

During the period it sold 800 units as follows:

9 May: 200 units

25 July: 200 units

23 November: 200 units

12 December: 200 units

This means that it has 300 units left (100 + 300 + 500 + 200 – (200 + 200 + 200 + 200 + 200)) but what did they cost?

There are various techniques that have been developed to answer this question.

The easiest of these is called FIFO (first in first out). This approach assumes that the first inventory sold is always the inventory that was bought on the earliest date. This means closing inventory is always assumed to be the most recent purchased.

In the above example a FIFO valuation would assume that the 300 items left were made up of the 200 bought on 22 October and 100 of those bought on 14 July giving a cost of Rs. 23,000 {(200 @ 80) + (100 @ 70)}

Each of these can be shown on an inventory ledger card as follows.

Example: Inventory ledger card (FIFO)

	Receipts			Issues			Balance		
Date	Qty	@	Rs.	Qty	@	Rs.	Qty	@	Rs.
1 Jan b/f	100	50	5,000				100	50	5,000
5 Apr	300	60	18,000				300	60	18,000
							400	50/60	23,000
9 May				100	50	5,000	100	50	5,000
				100	60	6,000	100	60	6,000
				200	50/60	11,000	(200)	50/60	(11,000)
							200	60	12,000
14 Jul	500	70	35,000				500	70	35,000
							700	60/70	47,000
25 Jul				200	60	12,000	(200)	60	(12,000)
							500	70	35,000
22 Oct	200	80	16,000				200	80	16,000
							700	70/80	51,000
23 Nov				200	70	14,000	(200)	70	(14,000)
							500	70/80	37,000
12 Dec				200	70	14,000	(200)	70	(14,000)
	1,100		74,000	800		51,000	300	70/80	23,000

Note: 1,100 minus 800 equals 300

74,000 minus 51,000 equals 23,000

The weighted average method calculates a new average cost per unit after each purchase. This is then used to measure the cost of all issues up until the next purchase.

Example: Inventory ledger card (weighted average method)

	Receipts			Issues			Balance		
Date	Qty	@	Rs.	Qty	@	Rs.	Qty	@	Rs.
1 Jan b/f	100	50	5,000				100	50	5,000
5 Apr	300	60	18,000				300	60	18,000
							400	57.5	23,000
9 May				200	57.5	11,500	(200)	57.5	(11,500)
							200	57.5	11,500
14 Jul	500	70	35,000				500	70	35,000
							700	66.43	46,500
25 Jul				200	66.43	13,286	(200)	66.43	(13,286)
							500	66.43	33,214
22 Oct	200	80	16,000				200	80	16,000
							700	70.31	49,214
23 Nov				200	70.31	14,062	(200)	70.31	(14,062)
							500	70.31	35,152
12 Dec				200	70.31	14,062	(200)	70.31	(14,062)
	1,100		74,000	800		52,910	300	70.31	21,090

Note: 1,100 minus 800 equals 300

74,000 minus 52,910 equals 21,090

2.3 Inventory and drawings

The owner of a sole trader business might decide to take some inventory for his or her personal use. For example, the owner of a local shop might take some of the goods bought for the shop and use them for personal consumption.

When this happens, it is important that the financial statements of the sole trader should provide a faithful representation of the financial performance of the business. In order to achieve this objective:

- Drawings by the business owner in the form of inventory should be accounted for as drawings (withdrawals of capital).
- The cost of sales should exclude the items taken by the owner as drawings.

Drawings of inventory might be common in small sole trader businesses, but are less common in bigger business entities, where stricter controls over inventory might be considered necessary. Small businesses normally use the period-end inventory system, and when the owner takes some inventory for personal use, the appropriate accounting entry in the main ledger is:

Illustration: Purchases through the year

	Debit	Credit
Drawings	X	
Purchases		X

The inventory taken by the owner is valued at cost (not selling price).

This accounting adjustment therefore reduces the total cost of purchases, so that the cost of sales will exclude the cost of the inventory taken.

If a perpetual inventory system is used, the appropriate accounting entry would be:

Illustration: Purchases through the year

	Debit	Credit
Drawings	X	
Inventory		X

CHAPTER 10

Control accounts and control account reconciliations

Contents

INTRODUCTION

LO 4	**Make adjustment at the end of the reporting period.**
LO4.6.1	*Control accounts - reconciliation and adjustments:* Understand the mapping between control accounts and subsidiary ledger for accounts receivable and accounts payable.
LO4.6.2	*Control accounts - reconciliation and adjustments:* Prepare control accounts and subsidiary ledger from well explained information provided.
LO4.6.3	*Control accounts - reconciliation and adjustments*: Perform control accounts reconciliation for accounts receivable and accounts payable.
LO4.6.4	*Control accounts - reconciliation and adjustments:* Identify errors after performing reconciliation
LO4.6.5	*Control accounts - reconciliation and adjustments:* Identify and correct errors in control account and subsidiary ledgers.

1 RECEIVABLES CONTROL ACCOUNTS AND RECEIVABLES CONTROL ACCOUNT RECONCILIATIONS

Section overview

- Receivables control accounts
- Receivables control account reconciliations

1.1 Receivables control account

Chapter 5 explained that sales and purchases transactions are recorded in day books. The totals from the day books are posted to control accounts in the general ledger. These are supported by a separate record which is a list of individual balances that comprise the total in the general ledger.

A control account is an account which represents a total value of a number of separate balances.

The receivables control account

The receivables control account is an account for recording the value of transactions in total with credit customers. The balance on the receivables control account (debit balance) is the total amount currently owed by all customers.

The receivables control account will contain some or all of the totals to date for all of the following postings to the account.

Illustration:

Receivables control account

Balance b/d	X	Cash	X
Sales	X	Discounts allowed	X
Dishonoured cheques	X	Sales returns	X
		Bad debts	X
		Contra	X
		Credit notes	X
		Balance c/d	X
	X		X
Balance b/d	X		

There must also be individual accounts for each credit customer in a separate receivables ledger.

1.2 Receivables control account reconciliation

Reconciliation means making sure that two figures or totals are consistent with each other and agree with each other. The control accounts in an accounting system can be used for control purposes, to make sure that transactions have been recorded correctly in the accounts.

This is because if the transactions have been recorded correctly the balance on the receivables control account in the general ledger should equal the total of the balances on all the individual customer accounts in the receivables ledger.

A reconciliation check can be made to make sure that these totals are the same. If they are different, the cause of the error (or errors) should be found and corrected.

A receivables control account reconciliation involves a comparison between the totals, looking for the reasons for any differences between them, and correcting errors that are discovered in the checking process.

Why might there be differences?

The balance on the receivables ledger control account might differ from the total of all the balances on the accounts in the receivables ledger for the following reasons:

Illustration: Possible errors

	Error	Correction
1	The total of the credit sales in the sales day book is correctly debited to the receivables control account but one of the individual transactions is not posted from the sales day book to the individual accounts in the receivables ledger.	Adjust the individual customer's balance
2	The total of cash received from customers, recorded in the cash book, has been posted correctly to the receivables ledger control account, but a receipt from a customer is not posted from the cash book to the individual accounts in the receivables ledger.	Adjust the individual customer's balance
3	The sales day book may be added up incorrectly so that the wrong amount is posted to the receivables ledger control but the individual accounts in the receivables ledger are correctly updated.	Adjust the receivables ledger control account in the general ledger.
4	A contra entry might be recorded in the general ledger but not in the receivables ledger (or vice versa)	Adjust the appropriate record for the missing entry

The errors described above do not result in differences in the total of debit and credit entries in the general ledger. Consequently, the existence of an error will not be discovered by preparing a trial balance.

However, these errors should be discovered by a control account reconciliation.

Preparing a receivables control account reconciliation

To make a control account reconciliation, the starting point is to compare the control account balance with the total of all the balances on the individual customer (receivables ledger) or supplier (payables ledger) accounts.

If the totals differ, the reasons for the difference need to be discovered. When the reasons are discovered, the errors must be corrected. A correction might involve:

- changing the control account balance, or
- changing one or more balances on individual customer or supplier accounts.

The two totals should be equal after all corrections have been made. If a difference still remains between the totals, this means that at least one error remains undetected.

Example:

The balance on the receivables ledger control account in the general ledger of Entity Z is Rs. 53,690.
There balances on the customer accounts in the receivables ledger are as follows:

	Rs.
Customer A	12,000
Customer B	8,000
Customer C	6,000
Customer D	11,000
Customer E	15,000
	52,000

An investigation is carried out into the difference between the total account balances in the receivables ledger and the balance on the receivables control account.

(1) **A sale on credit of Rs. 1,700 to Customer A has not been recorded in the customer's account in the receivables ledger, but is included in the control account balance.**

(2) **Customer B has supplied goods to Entity Z to the value of Rs. 400, and these have not yet been paid for by Entity Z. It has been agreed that this amount should be offset against the money owed to Entity Z by Customer B. No entries have yet been made for this 'contra' adjustment in the general ledger or the receivables and payables ledgers.**

(3) **Sales returns of Rs. 550 by Customer C have been recorded in C's individual account in the receivables ledger, but the transaction was not posted to the general ledger.**

(4) **Discounts allowed of Rs. 240 to Customer D have been recorded in D's individual account in the receivables ledger, but the transaction was not posted to the general ledger.**

(5) **Sales returns of Rs. 800 by Customer E have not been recorded in the customer's account in the receivables ledger, but are included in the control account balance.**

Example: Receivables control account reconciliation

Receivables control account

	Rs.		Rs.
Balance b/d	53,690	(2) Contra entry	400
		(3) Sales returns	550
		(4) Discounts allowed	240
		Balance c/d	52,500
	53,690		53,690
Balance b/d	52,500		

The balances on the accounts in the receivables ledger in total are

	Rs.
Total balances in receivables ledger	52,000
(1) Sale (Customer A)	1,700
(2) Contra entry (Customer B)	(400)
(5) Sales returns (Customer E)	(800)
	52,500

The balances on the accounts in the receivables ledger would all be corrected and become:

	Rs.
Customer A: 12,000 + 1,700	13,700
Customer B: 8,000 - 400	7,600
Customer C	6,000
Customer D	11,000
Customer E: (15,000 – 800)	14,200
	52,500

Practice question **1**

The balance on Vazir's receivables ledger control account on 31 December was Rs.3,800,000 which did not agree with the net total of the list of receivables ledger balances at that date.

The following errors were found:

a) Debit balances in the receivables ledger, amounting to Rs.103,000, had been omitted from the list of balances.

b) A bad debt amounting to Rs.400,000 had been written off in the receivables ledger but had not been posted to the bad debts expense account or entered in the control account.

c) An item of goods sold to Rizwan, Rs.250,000, had been entered once in the sales day book but posted to his account twice.

d) Rs.25,000 discount allowed to Etisham had been correctly recorded and posted in the books. This sum had been subsequently disallowed, debited to Etisham's account but not entered in the general ledger.

e) No entry had been made in the control account in respect of the transfer of a debit of Rs.70,000 from Qadir's account in the receivables ledger to his account in the payables ledger.

f) The discount allowed column in the cash account had been undercast by Rs.140,000.

Make the necessary adjustments in the receivables control account and bring down the corrected balance then show the adjustments to the net total of the original list of balances to reconcile with this amended balance.

2 PAYABLES CONTROL ACCOUNTS AND PAYABLES CONTROL ACCOUNT RECONCILIATIONS

Section overview

- The payables control account
- Payables control account reconciliations

2.1 The payables control account

The payables control account is an account for recording the value of credit purchase transactions in total. The balance on the payables control account (credit balance) is the total amount currently owed to all suppliers.

There must also be individual accounts for each credit suppliers in a separate payables ledger.

The payables control account is an account for recording the value of credit transactions in total with suppliers. The balance on the payables control account (credit balance) is the total amount currently owed to all trade suppliers.

The payables control account will contain some or all of the totals to date for all of the following postings to the account.

Illustration:

Payables control account

		Balance b/d	X
Cash	X	Purchases	X
Discounts received	X		
Purchase returns			
Contra	X		
Balance c/d	X		
	X		X
		Balance b/d	X

There must be individual accounts for each supplier in a separate payables ledger.

2.2 Payables control account reconciliation

A payables control account reconciliation involves a comparison between the totals on the payables control account and the list of balances in the payables ledger.

Why might there be differences?

The balance on the payables ledger control account might differ from the total of all the balances on the accounts in the payables ledger for the following reasons:

Illustration: Possible errors

	Error	Correction
1	The total of the credit purchases in the purchases day book is correctly credited to the payables control account but one of the individual transactions is not posted from the purchases day book to the individual accounts in the payables ledger.	Adjust the individual customer's balance
2	The total of cash paid to suppliers, recorded in the cash book, has been posted correctly to the payables ledger control account, but a payment to a supplier is not posted from the cash book to the individual accounts in the payables ledger.	Adjust the individual customer's balance
3	The purchases day book may be added up incorrectly so that the wrong amount is posted to the payables ledger control but the individual accounts in the payables ledger are correctly updated.	Adjust the payables ledger control account in the general ledger.
4	A contra entry might be recorded in the general ledger but not in the payables ledger (or vice versa)	Adjust the appropriate record for the missing entry

Example:

The balance on the payables control account was Rs.971,860 as at the 31 December.

Balances extracted from the payables ledger on this date totalled Rs.962,380.

1 The purchases day book was undercast by Rs.60,000.

2 A cash account total of Rs.108,580 was posted to the control account as Rs.90,580.

3 A credit balance of Rs.13,860 on the suppliers' ledger had been set off against a customer's ledger debit balance but no entry had been made in the control accounts.

4 A credit balance of Rs.37,620 had been omitted from the list of balances.

Payables control account

	Rs.		Rs.
(2) Cash error	18,000	Balance b/d	971,860
(3) Contra	13,860	(1) Purchase day book undercast	60,000
Balance c/d	1,000,000		
	1,031,860		1,031,860
		Balance b/d	1,000,000

The balances on the accounts in the receivables ledger in total are

	Rs.
Total balances in receivables ledger	962,380
(4) Omission of balance	37,620
	1,000,000

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Receivables control account

	Rs.		Rs.
Balance b/d	3,800,000	(b) Bad debt	400,000
(d) Reversal of discount allowed	25,000	(e) Contra entry	70,000
		(f) Discount allowed	140,000
		Balance c/d	3,215,000
	3,825,000		3,825,000
Balance b/d	3,215,000		

The balances on the accounts in the receivables ledger in total are

	Rs.
Total balances in receivables ledger (balancing figure)	3,362,000
(a) Omitted balances	103,000
(c) Correction of double posting	(250,000)
	3,215,000

CHAPTER 11

Bank reconciliations

Contents

INTRODUCTION

LO 4	**Make adjustment at the end of the reporting period.**
LO4.5.1	*Bank reconciliations:* Understand the need for a bank reconciliation
LO4.5.2	*Bank reconciliations:* Identify the main reasons for differences between the cash book and bank statements.
LO4.5.3	*Bank reconciliations:* Prepare a bank reconciliation statement in the circumstance of simple and well explained transactions.
LO4.5.4	*Bank reconciliations:* Correct cash book errors and post journal entries after identifying the same in bank reconciliation statement.

1 BANK RECONCILIATIONS

Section overview

- The cash book (bank account in the general ledger) and bank statements
- Differences and the need for a reconciliation
- Possible cause of confusion
- Format of a bank reconciliation statement
- Bank reconciliations and overdrawn balances

1.1 The cash book (bank account in the general ledger) and bank statements

Chapter 4 explained that the cash book is a book of prime entry used to record all receipts and payments of cash.

There are many different methods by which a business might make payment to suppliers and receive payment from customers.

Methods include

- Cash (this is quite rare in all but the smaller businesses);
- Cheques
- Bank transfers – An amount transferred directly from a bank account holder's account to the bank account of another party on the instruction of the first person.
- Credit and debit cards – People often use these to pay for goods and services purchased from businesses. Once a sale is made the business asks the credit (debit) card company to make the payment on behalf of the card holder. The credit (debit) card company then recovers the cash from the card holder.
- Many modern businesses now accept online payment for sales of goods and provision of services. Payment is often received through the use of credit cards and debit cards in the usual way or thorough the action of a third party (for example Pay pal).
- Standing order – An instruction a bank account holder (the payer) gives to their bank to pay a set amount at regular intervals to another party's (the payee's) account.
- Direct debit – A method of payment in which, a person (payee) instructs their bank to collect funds from another party's (payer's) bank account. The payer must have instructed their bank to allow this before it can happen.

Both standing orders and direct debits are very common methods of making monthly payments. A standing order allows for payment of the same amount on each payment date as the payer instructs the bank to pay this amount. A direct debit allows for different payments at each payment date as the payer instructs the bank to pay the amount the payee asks for.

Posting

Periodically, totals are posted from the cash book to the general ledger accounts. One of these accounts is the cash account. For the purposes of this section we will describe this more specifically as the cash at bank account. (A business usually also has a cash in hand account to record cash amounts physically held but the majority of cash receipts and payments are usually through the cash at bank account).

The cash at bank account in the general ledger is used to record receipts and payments of cash through the bank account. The balance on this account is the amount that the business believes that it has in its bank account (debit balance) or the size of its bank overdraft (credit balance).

The bank sends regular bank statements to a business entity. A bank statement lists all the transactions that the bank has recorded in the account for the entity since the previous statement and the current balance on the account.

Many businesses now have on-line access to their bank statements so can access a bank statement at any time.

Reconciliation

The term reconciliation refers to a process that compares two sets of records (usually the balances of two accounts, in this case the balance on the cash at bank account and the balance on the bank statement) and explains the reason for any difference between them.

A bank reconciliation compares the balance on the general ledger cash at bank account to the balance on the bank statement at a given point in time. This should be done at regular intervals (say at the end of each month).

Often the balance on the cash at bank account is referred to as the balance on the cash book. This can be confusing but remember that the reconciliation always agrees the balance on the cash at bank account to the balance on the bank statement.

Bank reconciliations are a useful check on the accuracy of accounting records for cash. In principle, the balance in the cash at bank account or cash book in the general ledger and the balance shown in the bank statement should be the same but there are often differences and some of these might relate to transactions which the business has not yet accounted for or errors which must be corrected.

1.2 Differences and the need for a reconciliation

The balance on the general ledger cash at bank account and that shown for the business in its bank statement, at a point in time, will rarely be the same.

Differences between might be caused by any of the following:

- Items recorded in the cash at bank account are not (yet) shown in the bank statement.
- Items in the bank statement that have not been recorded in the cash at bank account.
- Errors by the bank (these are quite rare but do happen).
- Errors in the cash book.

Each of these will be considered in turn.

Items recorded in the cash at bank account that have not (yet) shown in the bank statement

Some transactions might have been recorded in the cash at bank account in the general ledger, but have not yet been recorded by the bank.

Cheques received from customers, recorded in the cash book and paid into the bank and may not have been processed yet by the bank. Processing payments through the banking system might take two or three days, perhaps even longer. These are known as outstanding lodgements.

Cheques paid to suppliers are recorded as payments in accounting system of the business but they may not yet have been presented to the bank for payment (i.e. paid into the bank by the business's supplier). These are known as unpresented cheques.

Even if the cheques have been presented for payment by our supplier the bank may not have processed the deduction form the business's account yet.

These are timing differences. The transactions will eventually be processed by the bank. There are no errors or omissions in the cash book, and no further action is needed.

Items in the bank statement that have not been recorded in the cash at bank account.

A business might not know about some items until they receive a bank statement.

Examples include:

- bank charges;
- bank interest on an overdrawn balance;
- a payment from a customer that has been rejected by the bank (for example, the customer's cheque has been dishonoured).
- a bank transfer where a payment has been made directly into the business's account;
- a bank might make a mistake either crediting or debiting an incorrect amount into an account (these are rare but they do happen).

The general ledger cash at bank account should be amended to include these transactions.

When a cheque is dishonoured the business must reverse the entries that were made originally when the business thought that an amount had been received.

Illustration: Double entry for dishonoured cheque

Write back of receivable	Debit	Credit
General ledger:		
Receivables	X	
Cash at bank		X
Receivables ledger:		
Individual customer accounts	X	

The business should also consider whether the receivable should be written off as a bad debt or whether an allowance should be recognised for a doubtful debt (see chapter 7)

Errors by the bank

The bank might sometimes make an error. If so, it should be notified and asked to correct its mistake. No further action is then needed.

Errors in the cash book

Possibly, an error has been made in the cash book. This should be identified during the reconciliation of the bank statement with the cash at bank account balance. Any such errors must be corrected when discovered.

1.3 Possible cause of confusion.

The bank statement presents information as recorded in the accounting system of the bank. It always shows the banks view of things.

When a business has a positive cash balance that is an asset and as far as the business is concerned it is a debit balance. From the bank's point of view they owe the business money. Therefore they show the business as having a credit balance on the bank statement.

Similarly a bank account is overdrawn, the business owes money to the bank and shows this as a liability (a credit balance) in its financial statements. However, from the bank's point of view they have an asset and show this as a debit balance on the bank statements.

1.4 Format of a bank reconciliation statement

The purpose of a bank reconciliation is to show that the cash at bank account balance in the general ledger agrees with the bank statement balance after taking account of timing differences and making adjustments for any omissions or errors.

There is no single correct format for a bank reconciliation.

A useful approach is to correct the cash at bank balance for any omissions or errors and then adjust the balance per the bank statements for uncredited lodgements and unpresented cheques. The resultant balances should be the same.

Illustration: Bank reconciliation

The following assumes that the cash balance is positive (i.e. the business has a debit cash balance).

Balance per general ledger cash at bank account:	X
Items in bank statement not in cash book:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	X^1
Balance per bank statement	X
Items in general ledger not in bank statement	
Add: Outstanding lodgements	X
Deduct: Unpresented cheques	(X)
Corrected balance per bank statement	X^1
The balances (X^1) should now agree	

Alternative presentations are possible.

Example: Bank reconciliation

The cash at bank account of a business shows a debit balance of Rs. 4,500.

Cheques for Rs. 2,000 from customers that were recently paid into the bank have not yet been processed.

Payments totalling Rs. 6,200 made by the business to its suppliers and others have not yet been presented to the bank for payment.

The bank has charged Rs. 700 in bank charges.

A cheque for Rs. 300 from a customer, customer X, has been dishonoured.

The balance in the account according to the bank statement is Rs. 7,700.

A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	4,500
Items in bank statement not in cash book	
Bank charges	(700)
Dishonoured cheques	(300)
	(1,000)
Corrected cash at bank figure	3,500[1]
Balance per bank statement	7,700
Items in general ledger not in bank statement	
Add: Outstanding lodgements	2,000
Deduct: Unpresented cheques	(6,200)
Corrected balance per bank statement	3,500

Alternative format

This approach corrects the general ledger cash at bank account and then shows the differences between that figure and the balance as per the bank statement.

Illustration: Bank reconciliation

The following assumes that the cash balance is positive (i.e. the business has a debit cash balance).

Balance per general ledger cash at bank account:	X
Items in bank statement not in cash book:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	X¹
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(X)
Add: Unpresented cheques	X
Balance per bank statement	X¹

Example: Bank reconciliation

The cash at bank account of a business shows a debit balance of Rs. 4,500.

Cheques for Rs. 2,000 from customers that were recently paid into the bank have not yet been processed.

Payments totalling Rs. 6,200 made by the business to its suppliers and others have not yet been presented to the bank for payment.

The bank has charged Rs. 700 in bank charges.

A cheque for Rs. 300 from a customer, customer X, has been dishonoured.

The balance in the account according to the bank statement is Rs. 7,700.

A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	4,500
Items in bank statement not in cash book	
Bank charges	(700)
Dishonoured cheques	(300)
	(1,000)
Corrected cash at bank figure	3,500[1]
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(2,000)
Add: Unpresented cheques	6,200
Balance per bank statement	7,700

1.5 Bank reconciliations and overdrawn balances

For a company with a bank account, money in the bank is an asset and the cash balance in the cash book is a debit balance. If there is a bank overdraft, the cash book has a credit balance, indicating that money is owed to the bank.

For the bank, the situation is the opposite way round.

- Money held by the bank in a bank account for a customer is money that belongs to the customer. For the bank, deposits are therefore liabilities and an account is said to be in credit when there is money in it.
- If a bank allows an overdraft to a customer, the customer owes the bank. The amount of the overdraft is a form of receivable for the bank, and is an asset. To the bank, an overdraft balance on a customer's account is therefore a debit balance (= asset).

A bank statement might therefore indicate that a customer's account has a 'debit balance', such as ***Rs. 5,250 Dr***. This debit balance means 'overdraft' and for the customer it is a liability and credit balance item in their financial records.

Preparing a bank reconciliation with an overdraft balance

If you are given a question in which there is an overdraft balance in the bank statement, it is useful to make the negative balance clear by putting brackets around the balance.

Illustration: Bank reconciliation

The following assumes that the cash balance is negative (i.e, the business has a credit cash balance).

Balance per general ledger cash at bank account:	(X)
Items in bank statement not in cash book:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	(X^1)
Balance per bank statement	(X)
Items in general ledger not in bank statement	
Add: Outstanding lodgements	X
Deduct: Unpresented cheques	(X)
Corrected balance per bank statement	(X^1)
The balances (X^1 should now agree)	

Example: Bank reconciliation

A company receives a bank statement showing an overdraft balance of Rs. 20,000. The balance recorded in the company's cash book is a credit balance of Rs. 12,100.

(1) Lodgements not yet cleared by the bank (i.e. payments into the account but not recorded in the bank statement) Rs. 24,300

(2) Cheques not yet presented (i.e. payments from the account recorded in the cash book but not yet processed through the bank) Rs. 18,900

(3) Bank charges of Rs. 1,300

(4) A dishonoured cheque from a customer Rs. 1,200.

Items (3), (4) and (5) have not yet been recorded in the cash book.

A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	(12,100)
Items in bank statement not in cash book	
Bank charges	(1,300)
Dishonoured cheques	(1,200)
	(2,500)
Corrected cash at bank figure	(14,600)
Balance per bank statement	(20,000)
Items in general ledger not in bank statement	
Add: Outstanding lodgements	24,300
Deduct: Unpresented cheques	(18,900)
Corrected balance per bank statement	(14,600)

Example: Bank reconciliation

Alternatively, the bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	(12,100)
Items in bank statement not in cash book	
Bank charges	(1,300)
Dishonoured cheques	(1,200)
	(2,500)
Corrected cash at bank figure	(14,600)
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(24,300)
Add: Unpresented cheques	18,900
Balance per bank statement	(20,000)

Practice question **1**

On 30 June the cash account of Sohrab's business showed a balance at bank of Rs. 1,500,000.

The bank statements showed that cheques for Rs. 70,000, Rs.90,000 and Rs.100,000 had not been presented for payment and that lodgements totalling Rs.210,000 had not been cleared.

The balance on the bank statement at 30 June was Rs. 1,550,000.

Prepare a bank reconciliation.

Practice question **2**

The balance in Jabbar's cash account at 30 June showed an asset of Rs.1,660,000.

His bank statement showed an overdraft of Rs.450,000.

On reconciling the cash account he discovers the following.

a) The debit side of the cash account had been undercast by Rs.200,000.

b) A total on the receipts side of the cash account of Rs.2,475,000 had been brought forward as Rs.4,275,000.

c) A cheque received by Jovanovich for Rs.220,000 had bounced.

d) Bank charges of Rs.184,000 had been omitted from the cash account.

e) Unpresented cheques totalled Rs.520,000 and uncleared lodgements Rs.626,000.

Prepare a bank reconciliation.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Balance per general ledger cash at bank account:	1,500,000
Balance per bank statement	1,550,000
Items in general ledger not in bank statement	
Add: Outstanding lodgements	210,000
Deduct: Unpresented cheques	(260,000)
Corrected balance per bank statement	1,500,000

Alternative presentation:

Balance per general ledger cash at bank account:	1,500,000
Corrected cash at bank figure	
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(210,000)
Add: Unpresented cheques	260,000
Balance per bank statement	1,550,000

Solutions **2**

Balance per general ledger cash at bank account:	1,660,000
Items in bank statement not in cash book	
(a) Correction of undercast	200,000
(b) Correction of mistake	
(2,475,000 – 4,275,000)	(1,800,000)
(c) Dishonoured cheque	(220,000)
(d) Bank charges	(184,000)
	(2,004,000)
Corrected cash at bank figure	(344,000)
Balance per bank statement	(450,000)
Items in general ledger not in bank statement	
Add: Outstanding lodgements	626,000
Deduct: Unpresented cheques	(520,000)
Corrected balance per bank statement	(344,000)

Alternative presentation:

Balance per general ledger cash at bank account:	1,660,000
Items in bank statement not in cash book	
(a) Correction of undercast	200,000
(b) Correction of mistake	
(2,475,000 – 4,275,000)	(1,800,000)
(c) Dishonoured cheque	(220,000)
(d) Bank charges	(184,000)
	(2,004,000)
Corrected cash at bank figure	(344,000)
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(626,000)
Add: Unpresented cheques	520,000
Balance per bank statement	(450,000)

CHAPTER 12

Correction of errors

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 4	**Make adjustment at the end of the reporting period.**
LO4.7.1	*Correction of errors*: Identify the types of error which may occur in a record keeping system
LO4.7.2	*Correction of errors:* Calculate and understand the impact of errors on the financial statements within a reporting period
LO4.7.3	*Correction of errors:* Prepare journal entries to correct errors that have occurred within a reporting period

1 TRIAL BALANCE

Section overview

- The purpose of a trial balance
- Errors in the double entry accounting system
- Errors highlighted by the extraction of a trial balance
- Errors not highlighted by the extraction of a trial balance

1.1 The purpose of a trial balance

A trial balance is a list of all the debit balances and all the credit balances on the accounts in the general ledger. A trial balance can be 'extracted' from the general ledger simply by listing the balances on every account. The normal method of presentation is to present the balances in two columns, one for debit balances and one for credit balances.

- Accounts with debit balances will be asset accounts and expense accounts
- Accounts with credit balances will be liability accounts, capital account (or share capital and reserve accounts in the case of a company) and income accounts.

Since the accounting system uses double entry principles, the total of debit balances and the total of credit balances should be equal, because for every debit entry in the general ledger there should be a matching credit entry.

A trial balance has two main purposes.

It is a **starting point for producing a statement of comprehensive income and a statement of financial position** at the end of an accounting period. A trial balance is extracted from the general ledger, and various year-end adjustments are then made to the accounts (which are recorded as journal entries before being entered in the general ledger). Year-end adjustments include adjustments for opening and closing inventory, depreciation charges, accruals and prepayments, writing off bad debts and adjusting the allowance for irrecoverable debts.

When the year-end adjustments have been made, a statement of comprehensive income and then a statement of financial position can be prepared, using the balances in the general ledger accounts.

A second purpose of a trial balance is **to check for errors in the accounting system**. Errors must have occurred if the total of debit balances and total of credit balances on the general ledger accounts are not equal. Having identified that an error (or more than one error) must exist, the task of the bookkeeper is to find the cause of the error and correct it.

1.2 Errors in the double entry accounting system

Errors can occur in a book-keeping system, because individuals make mistakes.

The types of error that will appear in the accounting records can be classified into four broad categories:

- Errors of transposition
- Errors of omission
- Errors of commission
- Errors of principle

Errors of transposition (transposition errors)

This involves getting the digits in a number the wrong way round, for example recording Rs. 9,700 as Rs. 7,900.

Sometimes the error will be made in both the debit and the credit entries in the ledger. For example a purchase invoice might be recorded as Rs. 1,650 instead of Rs. 1,560 in both the purchases account and the payables ledger control account. The trial balance will not reveal this sort of error.

Sometimes the error of transposition will be made in one account but not the other. For example, a payment of Rs. 1,980 from a customer might be recorded correctly in the cash book but posted incorrectly as Rs. 1,890 in the receivables ledger control account.

Errors of omission.

This is where a transaction or entry is missed out. Sometimes a transaction is missed out of the ledger entirely because the bookkeeper forgets about it or is not informed about it.

A transaction may be omitted from one location only.

Errors of commission.

This means putting an entry in the wrong account, for example recording a telephone expense in the electricity expenses account. Similarly, discounts received might be recorded incorrectly in the discounts allowed account.

Errors of principle.

This is where an entry is recorded in the wrong type of account, e.g. recording capital expenditure as revenue expenditure.

For example the purchase of a machine might be entered in the machinery repairs and maintenance account. Unless corrected, this error will result in an incorrect computation of depreciation charges, running costs and profit for the period.

1.3 Errors highlighted by the extraction of a trial balance

As stated earlier, one way of finding some errors in the accounting records is to extract a trial balance from the general ledger. If the total of the debit balances does not equal the total of the credit balances on the general ledger accounts then an error or several errors have been made.

If the trial balance does not balance then this will be due to an error where the debits and credits are not the same, so that the error results in the debit entry in one account in the general ledger not being equal to the matching credit entry in another account.

Types of error which affect the balancing of the trial balance are as follows:

- A transaction might be recorded with a debit entry in one account, but the corresponding credit entry is omitted. Similarly, a transaction might be recorded with a credit entry in one account, but the corresponding debit entry is omitted. For example a payment might be recorded as a credit entry in the cash book but omitted from the payables ledger control account.
- There could be a transposition error in one account. For example, the debit entry might be Rs. 1,234 and the corresponding credit entry might be Rs. 1,324. One of the entries must be incorrect.
- A transaction might be recorded as a debit entry in two accounts, instead of as a debit entry in one account and a credit entry in the other account. For example, rental income might be recorded as a debit entry in the cash book and, in error, as a debit entry in the rental expense account.
- Similarly, a transaction might be recorded as a credit entry in two accounts, instead of being a debit entry in one account and a credit entry in the other. For example, discounts allowed might be recorded as a credit entry in the receivables ledger control account and, in error, as a credit entry in the discounts received account.
- There might be a mistake in casting one or another side of an account. This would lead to the extraction of an incorrect balance.

You need to be able to:

- identify errors in a double entry accounting system, and
- know how to correct them.

Corrections to errors in an accounting system are recorded as journal entries and then posted from the journal to the relevant accounts in the general ledger.

1.4 Errors not highlighted by the extraction of a trial balance

A trial balance is only useful in helping to identify errors where the debit and credit entries in the general ledger accounts do not match. It does not help with the identification of errors where there has not been a mismatch between debit and credit entries.

There are some types of error that do not result in a difference between total debit and total credit entries and therefore do not affect the balancing of the trial balance. For example:

- A transaction might have been omitted entirely from the general ledger, with no debit entry and no credit entry.
- The wrong figure might be double entered.

- Transactions might be recorded in the wrong account. For example, the cost of repairing a machine might be recorded incorrectly as a debit in the machinery at cost account instead of recording it as a debit in the machine repairs account. The amount of the debit entry is correct; the error is to post the transaction to the wrong account.
- There might be compensating errors. For example one error might result in debits exceeding credits by Rs. 2,000 but anther error might result in credits exceeding debits by Rs. 2,000. If this happens, the errors will 'cancel each other out' and will not be apparent from a check on the trial balance totals for debits and credits.

2 CORRECTING ERRORS

Section overview

- An approach to correcting errors
- The effect of errors on profit

2.1 An approach to correcting errors

Errors should be corrected when they are found.

- Transactions that have been omitted from the general ledger entirely should be recorded in the accounts. The omitted item can be recorded in the journal, and posted from the journal to the relevant accounts in the general ledger and, if required, the receivables or payables ledger.
- Entries that have been made incorrectly in the accounts must be corrected by means of suitable debit and credit entries in the accounts. The correction of an error should be recorded in the journal and then posted from the journal to the relevant accounts.

In order to correct errors properly, you need to be able to:

- identify an error;
- recognise what the correct entry in the accounts should have been; and
- work out how to make the correction by means of double entry adjustments.

One approach to correcting errors is to compare the entry that has been processed to the entry that should have been processed. This allows you to see what adjustment is needed. Memorandum T accounts can be used to do this.

For each account affected by an error, you can prepare two sets of memorandum T accounts for:

(1) What accounting entries have been made in the accounts, and

(2) What the accounting entries should have been.

By comparing what has been recorded in the accounts with what should have been recorded, you can then work out the double entry adjustments that are needed to get from 'where we are' to 'where we want to be'.

Some examples will help to illustrate the approach.

Example:

The total from a sales day book was Rs. 1,800.

This has been posted incorrectly as Rs. 1,080.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded | **(2) What should have been recorded**

Receivables (1)

1,080	

Receivables (2)

1,800	

Sales (1)

	1,080

Sales (2)

	1,800

The receivables control account has a debit entry of Rs. 1,080 for the transaction but it should have been Rs. 1,800.

To remove this error and increase the account balance to Rs.1,800 for the transaction, we need to debit the receivables control account with Rs. 920.

The sales account has a credit entry of Rs. 1,080 for the transaction but it should have been Rs. 1,800.

To remove this error and increase the account balance to Rs.1,800 for the transaction, we need to credit the sales account with Rs. 920.

Therefore the correcting entry is:

	Dr	Cr
Receivables	920	
Sales		920

Or using ledger accounts:

Receivables control account

	Rs.		Rs.
Before adjustment	1,080		
Sales account	920		

Sales account

	Rs.		Rs.
	920	Before adjustment	1,080
		Receivables	920

Example:

A business has recorded a repair cost of Rs. 15,000 to a machine as a debit in the machinery at cost account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded | **(2) What should have been recorded**

Machinery (at cost) account		Machine (at cost) account	
15,000		0	

Machine repairs account		Machine repairs account	
0		15,000	

The machinery (at cost) account has a debit entry of Rs. 15,000 when there should be nothing in the account for the transaction.

To remove this error and reduce the account balance to Rs. 0 for the transaction, we need to credit the machine (at cost) account with Rs. 15,000.

The machine repairs account has nothing recorded for the transaction, but there should be a debit balance of Rs. 15,000.

To correct his account, we need to debit the account with Rs. 15,000.

Therefore the correcting entry is:

	Dr	Cr
Machine repairs	15,000	
Machinery cost		15,000

Example:

A business has recorded rental income of Rs. 21,800 as a credit in the rental expense account.

(1) What has been recorded

Rental expense

Dr	Cr
	21,800

Rental income

Dr	Cr
	0

(2) What should have been recorded

Rental expense

Dr	Cr
	0

Rental income

Dr	Cr
	21,800

The rental expense account has a credit of Rs. 21,800 when there should be nothing in the account for the transaction.

To remove this error and reduce the account balance to Rs. 0 for the transaction, we need to debit the rental expense account with Rs. 21,800.

The rental income account has nothing recorded for the transaction, but there should be a credit balance of Rs. 21,800.

To correct his account, we need to credit the account with Rs. 21,800.

Therefore the correcting entry is:

	Dr	Cr
Rental expense	21,800	
Rental income		21,800

Example:

A business has recorded discounts allowed of Rs. 20,600 as a debit in the discounts received account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded | **(2) What should have been recorded**

Discounts allowed account | **Discounts allowed account**

0		20,600	

Discounts received account | **Discounts received account**

20,600		0	

The discounts allowed account has nothing recorded for the transaction, but there should be a debit balance of Rs. 20,600. To correct this account, we need to debit the account with Rs. 20,600.

The discounts received account has a debit entry of Rs. 20,600 when there should be nothing in the account for the transaction. To remove this error and reduce the account balance to Rs. 0 for the transaction, we need to credit the discounts received account with Rs. 20,600.

To correct the error, the required double entry is:

	Dr	Cr
Discounts allowed	20,600	
Discounts received		20,600

2.2 The effect of errors on profit

Unless they are corrected, accounting errors will have an effect on the reported profit for the period.

A question might ask you to quantify this effect for a given error. In a typical question of this sort, the error might involve recording a capital expenditure item as a revenue expenditure item, or a revenue expenditure item as capital expenditure.

Alternatively, a capital expenditure item might be recorded at an incorrect amount.

Example:

A bookkeeper in error recorded the purchase cost of a new item of equipment as Rs. 36,000 when it should have been Rs. 360,000.

A draft profit of Rs. 2,560,000 for the period was calculated before the discovery of the error. This included a depreciation charge of 10% (Rs. 3,600) for the equipment.

What is the correct figure for profit?

	Rs.
Draft profit	2,560,000
Add back: Depreciation incorrectly charged	3,600
	2,563,600
Deduct: Correct depreciation charge (10% × Rs. 360,000)	(36,000)
Adjusted figure for profit	2,527,600

Example:

A bookkeeper in error recorded the Rs. 60,000 purchase cost of a new machine as repairs and maintenance costs

A draft profit of Rs. 300,000 for the period was calculated before the discovery of the error.

Depreciation on machinery is charged at 20% on cost, with a full year's charge in the year of acquisition.

What is the correct figure for profit?

	Rs.
Draft profit	300,000
Add back: Repair costs incorrectly charged	60,000
	360,000
Deduct: Depreciation charge (20% × Rs. 60,000)	(12,000)
Adjusted figure for profit	348,000

3 SUSPENSE ACCOUNTS

Section overview

- Trial balance: differences in total debits and total credits
- Opening a suspense account
- Correcting errors where a suspense account is opened
- Unknown entry

3.1 Trial balance: differences in total debits and total credits

The examples of correcting errors in the previous section involve errors where the amount of the debit entry and the amount of the credit entry were the same. These errors would not be identified by extracting a trial balance.

When errors are made where the amount of the debit entry differs from the amount of the credit entry, total debit balances and total credit balances in the general ledger accounts will differ. A trial balance will demonstrate the existence of such errors.

These errors must be discovered and corrected. Until they are discovered, the first step should be to open a suspense account.

- When errors have resulted in total debit entries and total credit entries being different, the errors are corrected using a suspense account.
- A suspense account is a short-term account that is required only until the errors have been identified and corrected.

3.2 Opening a suspense account

A suspense account is opened with either a debit balance or a credit balance.

The balance entered into the suspense account should be an amount that makes the total debit balances equal to total credit balances on all the general ledger accounts (including the balance on the suspense account).

Example:

A business has prepared a trial balance of the general ledger account balances.

This shows total debit balances of Rs. 456,000 and total credit balances of Rs. 488,000.

A suspense account must be opened.

The balance on the account to make total debit and total credit balance equal is a debit balance of Rs. 32,000 (Rs. 488,000 credits less Rs. 456,000 debits).

Suspense account

	Rs.		**Rs.**
Opening balance	**32,000**		

Opening the suspense account in effect completes the missing and incorrect double entries but to the wrong place (the suspense account). The errors should be investigated and corrected. This usually involves a double entry to the suspense account.

Once the errors have been fully corrected the balance on the suspense account will be reduced to zero.

3.3 Correcting errors where a suspense account is opened

When it is clear that an error has occurred, it is often helpful to decide the answer to two questions:

- Has the error resulted in different total amounts for debit and credit entries?
  - If the answer is yes, making the correction will involve the suspense account.
  - If the answer is no, the correction should be made, but will not involve the suspense account.
- If the error has resulted in different total amounts for debit and credit entries, think about the general ledger account or accounts containing the error, and decide what needs to be done to correct the balance on that account.

The same approach used in the previous section for correcting errors can be used. For each account affected by an error, you can prepare two sets of memorandum T accounts for:

(1) What accounting entries have been made in the accounts, and

(2) What the accounting entries should have been.

By comparing what has been recorded in the accounts with what should have been recorded, you can then work out the double entry adjustments that are needed to get from 'where we are' to 'where we want to be'.

However, when the error involves different total amounts of debits and credits, a debit or credit entry in the suspense account is needed as a 'balancing figure' to make the total debits and credits equal.

Example:

A debit entry in the rent expense account has been entered as Rs. 5,000 when it should have been Rs. 5,500, but the entry in the cash book (bank account) for the payment was entered correctly as Rs. 5,500.

The debit entry in the rent account is Rs. 500 too low, resulting in a difference between total debits and total credits. The first step is to open a suspense account and enter a balance to make total debits and total credits equal.

Suspense account

	Rs.		Rs.
Opening balance	500		

Note that this completes the entry by recognising the missing debit of 500 in the suspense account

We can now look at 'where we are' and 'where we want to be'

(1) What has been recorded

Rent expense account

5,000	

Suspense account

500	

(2) What should have been recorded

Rent expense account

5,500	

Suspense account

0	

The correcting double entry is:

	Dr	Cr
Rent account	20,600	
Suspense account		20,600

Or using ledger accounts:

Suspense account

	Rs.		Rs.
Opening balance	500	Rent account	500

Rent expense account

	Rs.		Rs.
Opening balance	5,000		
Suspense account	500		

Example:

The total from a sales day book was Rs. 1,800.

This has been posted correctly to the sales account but Rs. 1,080 has been posted in error to the receivables control account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded | **(2) What should have been recorded**

(1) Receivables

Dr	Cr
1,080	

(2) Receivables

Dr	Cr
1,800	

(1) Sales

Dr	Cr
	1,800

(2) Sales

Dr	Cr
	1,800

(1) Suspense

Dr	Cr
920	

(2) Suspense

Dr	Cr
0	

The sales account has the correct entry but the receivables control account has a debit entry of Rs. 1,080, which should be Rs. 1,800.

To remove this error and increase the account balance to Rs. 1,800 for the transaction, we need to debit receivables control account with Rs. 920.

Therefore the correcting entry is:

	Dr	Cr
Receivables	920	
Suspense		920

Or using ledger accounts:

Receivables control account

	Rs.		Rs.
Before adjustment	1,080		
Suspense account	920		

Suspense account

	Rs.		Rs.
Before adjustment	920	Rent account	920

Example:

A discount allowed of Rs. 4,000 (expense) has been recorded as a credit entry in the discount received account (an income account) by mistake.

(1) What has been recorded

Discounts allowed account

0	

Discounts received account

	4,000

Suspense

8,000	

(2) What should have been recorded

Discounts allowed account

4,000	

Discounts received account

	0

Suspense

0	

As a result of this error, total credits are Rs. 4,000 higher than they should be, and total debits are Rs. 4,000 lower than they should be resulting an the total credits balances in the trial balance being 8,000 bigger than the total debits.

A suspense account with a debit balance of 8,000 would be opened.

Both the discounts allowed account and the discount received account must be corrected.

This error is corrected as follows, with an entry in the suspense account to match total debits with total credits:

	Dr	Cr
Discounts received	4,000	
Discounts allowed	4,000	
Suspense		8,000

Or using ledger accounts:

Suspense account

	Rs.		Rs.
Before adjustment	8,000	Discounts allowed/received	8,000

Discounts received account

	Rs.		Rs.
Suspense account	4,000		

Discounts allowed account

	Rs.		Rs.
Suspense account	4,000		

Example:

A payment to a supplier of Rs. 23,500 has been recorded in the cash book/bank account in the general ledger, but has not been recorded in the trade payables account.

As a result, total credits exceed total debits in the trial balance by Rs. 23,500 and a suspense account must be opened with a debit balance of Rs. 23,500.

(1) What has been recorded

Trade payables account

0	

Suspense account

23,500	

(2) What should have been recorded

Trade payables account

23,500	

Suspense account

0	

This error would be corrected as follows.

	Dr	Cr
Trade payables	23,500	
Suspense		23,500

Practice question **1**

A trial balance has been prepared, and total debits are Rs. 459,100 and total credits are Rs. 459,700.

On investigation, the following errors are found:

1 Sales returns of Rs. 800 were recorded correctly in the receivables account in the general ledger, but they have been recorded incorrectly as a credit entry in the purchases returns account.

2 In the sales day book, the column for total sales has been added up incorrectly. The total should be Rs. 26,420, but the total was undercast by Rs. 1,000. (The total was added up as Rs. 25,420).

The correct total amount receivable was entered in the receivables account in the general ledger.

Open a suspense account and record the book-keeping entries required to correct the errors.

3.4 Unknown entry

A suspense account is opened in order to make a trial balance have equal debits and credits until the errors have been discovered.

In some instances however a suspense account will be opened deliberately by the bookkeeper if the bookkeeper is uncertain of where to post one side of the double entry.

Example:

A bookkeeper has received a cheque for Rs. 1,000 but does not know who the cheque is from or what it relates to.

Rather than putting the cheque to one side until it is known what it is for the bookkeeper may decide to record the debit entry in the cash book/bank account and then, not knowing where the credit entry should go, to credit the suspense account instead.

This can then be cleared at a later date.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

The opening balance on the suspense account is a debit balance, since total credits are higher than total debits by Rs.600.

Error 1

(1) What has been recorded

Purchase returns

	800

Sales returns

(2) What should have been recorded

Purchase returns

Sales returns

800	

Error 2

(1) What has been recorded

Sales

	25,420

(2) What should have been recorded

Sales

	26,420

The correcting double entries are:

	Dr	Cr
Error 1		
Sales returns	800	
Suspense account		800
Purchases returns	800	
Suspense account		800
Error 2		
Suspense account	1,000	
Sales		1,000

CHAPTER 13

Preparing financial statements

Contents

INTRODUCTION

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 5	**Prepare basic financial statements.**
LO5.1.1	*Statement of financial position:* Understand the purpose of the statement of financial position
LO5.1.2	*Statement of financial position:* Prepare simple statements of financial position from information provided.
LO5.2.1	*Statement of comprehensive income:* Understand the purpose of the statement of comprehensive income
LO5.2.2	*Statement of comprehensive income:* Prepare simple statements of comprehensive income from information provided
LO5.3.1	*Receipt and payment accounts:* Understand the purpose of a receipts and payments account.
LO5.3.2	*Receipt and payment accounts:* Prepare a simple receipts and payments account from information provided.

1 FINANCIAL STATEMENTS

Section overview

- Purpose of financial statements
- Statement of financial position
- Statement of comprehensive income

1.1 Purpose of financial statements

This section is a brief revision of topics covered in more detail in chapter 1.

Financial statements are prepared to provide information that is useful for decision making. The information is useful in different ways to different user groups.

User	Possible area of interest
Owners	How the business has performed in the period. How much can be extracted from the business as drawings (or dividends for a company). How management has performed if the owners have appointed others to run the business for them.
Government	How much tax may be charged. Analysis of performance of all businesses in a region gives an indication of the health of the economy in that region.
Employees	Whether a pay rise can be supported. Safety of employment
Lenders	The safety of the loan. The ability of the business to meet future payments.
Customers	The level of profit relative to prices charged. The ability of the business to continue to supply the customer in the future
Suppliers	Safety of the amounts owed to them leading to the level of credit that they are willing to give the business. Whether there may be scope to increase share of the businesses purchases.

This is not an exhaustive list.

Components of financial statements

A full set of financial statements would include the following:

- A statement of comprehensive income or a statement of profit or loss followed by a statement of comprehensive income;
- A statement of financial position; and
- Statements of changes in equity and cash flows and notes to the financial statements (not in this syllabus).

1.2 Statement of financial position

The statement of financial position is a structured presentation of the assets and liabilities of the business. The difference between assets and liabilities is capital (equity).

Assets are resources controlled by the business and liabilities are amounts owed by the business.

In a statement of financial position, non-current assets are shown separately from current assets, and non-current liabilities are shown separately from current liabilities.

As a general rule, assets are current if they will be consumed or converted into cash within the next 12 months. Cash and cash equivalents are also current assets. (Cash equivalents are assets that can be converted into cash very quickly, such as money on deposit in a bank deposit account). There are some exceptions to this general rule but it is a very useful simplification.

Prepayments and accrued income are current assets.

Liabilities are current if they are payable within the next 12 months. It is therefore necessary to check the repayment dates on any bank loans or loan notes. Loans repayable within 12 months become current liabilities.

Illustration:

If a company obtains a five-year bank loan, where none of the loan principal is repayable until the end of the loan period, the loan will be a non-current liability for the first four years and will then become a current liability in fifth year when it is repayable within 12 months.

Accrued expenses (and deferred income) are current liabilities.

Illustration: Statement of financial position

Peshawar Trading Company: Statement of financial position as at 31 December 2013

	Rs. m	Rs. m	Chapter
Assets			
Non-current assets			**6**
Land and buildings	56.2		
Plant and machinery	28.0		
		84.2	
Current assets			
Inventories	16.4		**9**
Trade and other receivables	17.0		**4 and 7**
Prepayments and accrued income	2.0		**8**
Cash	1.2		
		36.6	
Total assets		120.8	
Equity and liabilities			
Capital		67.8	
Non-current liabilities			
Long-term loans		30.0	
Current liabilities			
Trade and other payables	18.0		**4**
Accruals (and prepaid income)	1.5		**8**
Short-term borrowings (bank overdraft)	3.5		
		23.0	
Total equity and liabilities		120.8	

1.3 Statement of comprehensive income

This statement provides information about the performance of an entity in a period. It consists of two parts:

- a statement of profit or loss – a list of income and expenses which result in a profit or loss for the period; and
- a statement of other comprehensive income – a list of other gains and losses that have arisen in the period.

Note that the statement of other comprehensive income is not in your syllabus.

The statement of comprehensive income shows the performance of the business in terms of its main activities. It is a structured presentation of all revenue, other income earned in a period and the costs of earning those.

Illustration: Statement of comprehensive income

Peshawar Trading Company: Statement of comprehensive income for the year ended 31 December 2013

	Rs.m	Rs.m	Chapter
Revenue		120.0	
Cost of sales			
Opening inventory	8.0		
Purchases	80.0		
	88.0		
Closing inventory	(10.0)		
		(78.0)	
Gross profit		42.0	
Other income:			
Rental income			
Expenses:			
Wages and salaries	8.0		
Depreciation	6.0		
Rental costs	4.0		
Telephone charges	3.0		
Advertising costs	5.0		
Interest charges	1.0		
Bad debts	3.0		
		(30.0)	
		12.0	

2 PREPARING FINANCIAL STATEMENTS

Section overview

- Financial statements of a sole trader, partnership and company
- Year-end
- Preparation of financial statements: Approach 1
- Preparation of financial statements: Approach 2

2.1 Financial statements of a sole trader, partnership and company

The same basic accounting approach is used in recording the transactions of a sole trader, a partnership or a company. The preparation of the financial statements of all three proceeds along the same lines.

There are some differences.

The capital of each type of entity is different in structure.

- The capital of a sole trader represents his interest in the business.
- A partnership has more than one owner and this must be reflected in the capital where each has their own capital account or accounts (this is explained in detail in the next chapter.
- For companies, equity capital is represented by share capital and reserves, not simply by 'capital'.

Sole traders have no reason to comply fully with the requirements of international accounting standards. The financial statements of a sole trader are therefore usually limited to a statement of comprehensive income and a statement of financial position.

2.2 Year-end

Earlier chapters have explained how transactions are first entered into books of prime entry and how totals from these are transferred into ledger accounts in the general ledger.

At the year end a trial balance is extracted and various year-end adjustments are then made to the accounts after which a statement of comprehensive income and then a statement of financial position can be prepared, using these adjusted balances.

All such adjustments must also be recorded in the general ledger accounts so that these agree with balances on the financial statements.

At the end of the period there is another exercise performed in order to prepare the general ledger for use in the next accounting period. This involves transferring all income and expense items into a single account (perhaps via intermediate accounts like cost of sales and statement of comprehensive income) in order to produce a single figure as profit or loss for the period which is then transferred to capital.

Earlier chapters have covered the year-end adjustments. They explained how each type of adjustment is measured and then explained the double entry necessary to account for these amounts. The double entry explanation used "T" accounts in order to explain the full workings of the double entry system.

In this exam you will be expected to prepare a statement of financial position and statement of comprehensive income from a trial balance. These questions are usually quite time pressured so you need to develop a good technique in order to execute such tasks in an effective way.

The rest of this chapter use the following example to illustrate how such questions might be approached. You will need to choose an approach and practice it.

Example:

ABC – Trial balance as at 31 December 2013

	Rs.	Rs.
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	
Heating and lighting	5,000	
Inventory as at 1 January 2013	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000
Non-current assets	146,000	
Accumulated depreciation:		32,000
Trade receivables	51,000	
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2013		121,600
	627,600	627,600

Further information:.

a) Rs. 400 is owed for heating and lighting expenses.

b) Rs. 700 has been prepaid for rent.

c) It is decided that a bad debt of Rs. 1,200 should be written off, and that the allowance for doubtful debts should be increased to Rs. 4,500.

d) Depreciation is to be provided for the year at 10% on cost

e) Inventory at 31st December 2013 was valued at Rs. 16,500.

The journals

The business needs to process the following double entries to take account of the “further information” given above.

Example: Closing journals

		Debit	Credit
a)	**Accrual**		
	Heating an lighting expense	400	
	Accrual		400
	Being: Accrual for heating and lighting expense		
b)	**Rent prepayment**		
	Prepayment	700	
	Rent expense		700
	Being: Adjustment to account for rent prepayment		
c)	**Bad and doubtful debt**		
	Bad and doubtful debt expense	1,200	
	Receivables		1,200
	Being: Write off of bad debt		
	Bad and doubtful debt expense	500	
	Allowance for doubtful debts		500
	Being: Increase in the allowance for doubtful debts		
d)	**Depreciation**		
	Depreciation expense	14,600	
	Accumulated depreciation		14,600
	Being: Depreciation for the year (10% of 146,000)		
e)	**Closing inventory**		
	Inventory (asset)	16,500	
	Inventory (cost of sales)		16,500
	Being: Recognition of inventory at the year-end		

These journals are only given to explain the double entry required. You should never write something like this in a preparation of financial statements question. It uses up too much time. You want to do double entry rather than write journals.

The chapter continues to show two possible approaches that you might follow. You do not have to do either. If you decide on a way that suits you then use it.

If you attend courses your lecture will show you how to do this. They are very experienced. Do as they advise.

2.3 Preparation of financial statements: Approach 1

Step 1: Perform double entry on the face of the question and open up new accounts as you need them in any space that you have.
(DO NOT COPY OUT THE TRIAL BALANCE).

After this your question paper should look something like the following (with the double entries are shown in bold italics):

Example: ABC – Trial balance as at 31 December 2013

	Rs.	Rs.
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	***700***[b]
Heating and lighting	5,000 + ***400***[a]	
Inventory as at **1 January 2013**	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000+ ***500***[c]
Non-current assets	146,000	
Accumulated depreciation:		32,000 + ***14,600***[d]
Trade receivables	51,000	***1,200***[c]
Trade payables		42,000
Cash	6,200	
Capital as at **1 January 2013**		121,600
	627,600	627,600
Accruals		***400***[a]
Prepayments	***700***[b]	
Bad and doubtful debt expense	***1200***[c] ***+ 500***[c]	
Depreciation expense	***14,600***[d]	
Closing inventory (asset)	***16,500***[e]	
Closing inventory (cost of sales)		***16,500***[e]

Step 2: Draft pro-forma financial statements including all of the accounts that you have identified. (A pro-forma is a skeleton document into which you can copy numbers later)

Step 3: Copy the numbers from the trial balance into the pro-forma statements. Note that if a number copied onto the financial statements is made up of a number provided in the original trial balance that has been adjusted, you must show the marker what you have done. This may involve adding in an additional explanation below the main answer or may be shown on the face of the statements.

Step 4: Calculate profit for the year.

Step 5: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:

Example: ABC – Statement of financial position

	Rs. m	Rs. m
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
		68,700
Total assets		168,100
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
		125,700
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
		42,400
Total equity and liabilities		168,100

Example: ABC – Statement of comprehensive income

	Rs.m	Rs.m
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory	(16,500)	
		(302,900)
Gross profit		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation **(W1)**	14,600	
Rent (14,000 – 700)	13,300	
Heating an lighting (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
		(99,000)
		26,100

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

2.4 Preparation of financial statements: Approach 2

Step 1: Draft pro-forma financial statements including all of the accounts that you have identified from reading the question. Leave spaces in case you have missed an account that you might need to insert later.

Step 2: Copy the numbers from the trial balance into the pro-forma statements. If you know that a number is not to be adjusted then you can copy it straight to its destination. Otherwise set up bracketed workings next to the narrative in the pro-forma.

After step 2 your answer might look like this:

Example: ABC – Statement of financial position

	Rs. m	Rs. m
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000		
Current assets		
Inventories		
Trade receivables (51,000		
Allowance for doubtful debts (4,000		
Prepayments		
Cash	6,200	
Total assets		
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year		
Drawings	(22,000)	
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)		
Total equity and liabilities		

Example: ABC – Statement of comprehensive income

	Rs.m	Rs.m
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory		
Gross profit		
Expenses:		
Wages and salaries	64,000	
Depreciation		
Rent (14,000		
Heating an lighting (5,000		
Bad and doubtful debts		

Step 3: Perform double entry on the face of your answer.

Step 4: Complete the bracketed workings and copy totals into their final destinations.

Step 5: Calculate profit for the year.

Step 6: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:

Example: ABC – Statement of financial position

	Rs. m	Rs. m
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
		68,700
Total assets		168,100
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
		125,700
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
		42,400
Total equity and liabilities		168,100

Example: ABC – Statement of comprehensive income

	Rs.m	Rs.m
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory	(16,500)	
		(302,900)
Gross profit		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation **(W1)**	14,600	
Rent (14,000 – 700)	13,300	
Heating an lighting (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
		(99,000)
		26,100

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

3 RECEIPT AND PAYMENT ACCOUNTS

Section overview

- Introduction
- Features of a receipt and payment account
- Subscriptions calculation

3.1 Introduction

Some organisations may not be required to prepare accruals based financial information. These may prepare a receipt and payments account instead. Organisations that do this might include clubs, societies and perhaps some charities.

A receipt and payment account is a summary of cash receipts and payments during the accounting period. The accruals concept is not applied so a receipt and payment account includes all cash receipts and payments in a period including capital and revenue amounts and whether they relate to that period or not.

All cash receipts are recorded on debit side (receipts side) and all cash payments are recorded on credit side (payments side) of receipts and payments account.

3.2 Features of a receipt and payment account

Feature	Comment
Summary of cash transactions	All cash receipts and payments made by the concern during the accounting period are recorded in this book. Therefore, the receipts and payments account is a summary of cash transactions.
Cash and bank items in one column.	All receipts either cash or bank are recorded in receipts column of receipts side where all cash and bank payments are recorded in one column of payment column of receipts and payments account. The cash and bank transactions are merged to avoid contra entries of cash and bank transactions.
No distinction between capital and revenue.	All cash receipts and cash payments irrespective of capital and revenue nature are recorded in receipts and payments account. No distinction is made for capital receipts, revenue receipts, capital expenditures and revenue expenditures.
Opening and closing balance of cash	A receipts and payments account shows the opening and closing balances of cash and bank. All cash and cheque receipts are recorded on debit side whereas all cash and cheque payments are recorded on credit side of receipts and payments account.

Illustration

Receipt and payment account

Balance b/d	X	Donation	X
Subscriptions	X	Repairs	X
Functions	X	Telephone	X
Sale of land	X	Extension of club house	X
Bank interest	X	Furniture	X
Bequest	X	Heat and light	X
Sundry income	X	Salary and wages	X
		Sundry expenses	X
		Balance c/d	X
Balance b/d			

A receipt and payment account gives far less information than a set of financial statements based on the accruals concept.

For all practical purposes this is a cash account just like those that you have come across in other chapters.

3.3 Subscriptions account

The main source of cash for a club will be membership fees. It may be necessary to calculate the cash received from members during the year. This can be complicated by the fact that at each year end there will usually be some members who have paid their subscriptions in advance and some who are in arrears.

- Members who pay their fees in advance are creditors of the club (the club owes them a period of membership).
- Members who are in arrears are debtors of the club.

The amount of cash received in the year can be calculated using a subscriptions T account.

- Opening and closing balances for members who have paid in advance and those who are in arrears are recognised.
- The total membership fees that should have been collected (number of members × annual fee) are debited to the account.
- The cash received is a balancing figure on the credit side of the account.

Illustration: Subscription account

Subscription account

	Rs.		Rs.
Balance b/d (members in arrears)	X	Balance b/d (members who have prepaid)	X
		Cash	X
Income and expenditure	X		
Balance c/d (members who have prepaid)	X	Balance c/d (members in arrears)	X
	X		
Balance b/d (members in arrears)	X	Balance b/d (members who have prepaid)	X

Example: Subscription account

A club has 500 members.

Annual membership fees are Rs. 1,000.

Therefore membership fees for the year should be Rs. 500,000.

The club's subscription records for the year ended 31 December 2013 show the following:

	At 31 December 2012	At 31 December 2012
Subscriptions received in advance	10,000	6,000
Subscriptions in arrears	18,000	22,000

Cash received is calculated as follows:

Subscriptions

	Rs.		Rs.
Balance b/d: Members in arrears	18,000	Balance b/d: Advance payments	10,000
Membership fees for the year	500,000	Cash (balancing figure)	492,000
Balance c/d: Advance payments	6,000	Balance c/d: Members in arrears	22,000
	524,000		524,000
Balance b/d:	22,000	Balance b/d:	6,000

CHAPTER 14

Partnership accounts

Contents

INTRODUCTION

Learning outcomes

To enable candidates to equip themselves with the fundamental concepts of accounts needed as a foundation for higher studies of accounting.

LO 6	**Prepare partnership accounts and account for transactions of admission, retirement etc.**
LO6.1.1	*Preparation of partnership accounts:* Define a partnership and state its essential elements
LO6.1.2	*Preparation of partnership accounts:* Understand goodwill
LO6.1.3	*Preparation of partnership accounts:* Prepare capital accounts and current accounts
LO6.1.4	*Preparation of partnership accounts:* Prepare a profit and loss account and a statement of financial position of a partnership.
LO6.2.1	*Admission and amalgamation:* Process the necessary adjustments on the admission of a new partner (namely revaluation of assets and liabilities of the firm, treatment of goodwill and application of new profit sharing ratio).
LO6.2.2	*Admission and amalgamation:* Prepare the nominal accounts, profit and loss account and statement of financial position upon amalgamation of two partnerships.
LO6.3.1	*Retirement, death, dissolution, liquidation:* Make journal entries in the case of the dissolution of a partnership (to record transfer and sale of assets and liabilities to third parties and partners, payment of realization expenses, closing of the realization account and settlement of partners' capital account).
LO6.3.2	*Retirement, death, dissolution, liquidation:* Process the necessary adjustments on the death or retirement of a partner (including adjustments relating to goodwill, accumulated reserves and undistributed profits, revaluation account, adjustment and treatment of partners' capital and application of new profit sharing ratio).

1 FEATURES OF PARTNERSHIPS

Section overview

- Partnerships
- Partnership accounts
- Partners' capital

1.1 Partnerships

A partnership is a type of business structure.

Definition: Partnership

The relationship between persons who have agreed to share the profits of a business carried on by all or any of them, acting for all.

They are carrying on a business in common with a view to making a profit.

Partnerships in Pakistan are subject to rules set out in The Partnership Act 1932.

Persons who have entered into partnership with one another are called individually ***partners*** and collectively a ***firm*** and the name under which their business is carried on is called the ***firm name***.

Features of a partnership

There must be an association of two or more persons to carry on a business.

There must be an agreement entered into by all the persons concerned.

The agreement must be to share the profits of a business.

The business must be carried on by all or any of the persons concerned acting for all.

Change in partners

The composition of a partnership might change on occasion with new partners being admitted or an existing partner leaving or through two separate partnerships amalgamating into a single new partnership.

Sometimes a partnership might dissolve (known as dissolution of the partnership)

Later sections explain the accounting treatment to reflect these events.

1.2 Partnership accounts

Partnership accounts are the financial accounts of a partnership business.

The financial statements of partnerships are the same as those of a sole proprietor with the exception of capital. The major difference between a partnership and a sole proprietor business is that a partnership has several joint owners.

Ownership is reflected in the capital of a business so whereas there is a single capital account in the statement of financial position of a sole proprietor the capital section of the statement of financial position of a partnership must reflect the fact that there is more than one owner.

The accounts of the partnership must record the capital and profits that are attributable to each individual partner.

The profit of a sole proprietor is simply added to the capital balance brought forward. In the case of a partnership the profit belongs to the partners so there must be a mechanism by which this is shared. Partners' shares are then added to their personal capital accounts.

1.3 Partners' capital

Each partner contributes capital to the business and shares in the profit (or loss) of the business. The capital of each partner must be identified separately.

The capital of each partner is usually contained in two accounts.

- Capital account
- Current account

Capital account

The partnership agreement usually specifies that each partner must contribute a minimum amount of 'fixed' capital and that partners cannot draw out any of their fixed capital.

In addition, each partner might retain some of his or her share of accumulated profits in the business. The partnership agreement should allow partners to draw out their share of accumulated profits, if they wish to do so.

The capital account records the fixed capital or long-term capital of the partner that the partner must retain in the business and cannot take out in drawings.

The balance on this account does not change very often.

Current account

A current account is used to record the accumulated profits of the partner and the partner's drawings.

- The profits of the business are shared between the partners. The share of each partner is credited to (added to) his or her current account.
- Each partner may take drawings out of the business. Drawings are a withdrawal of profit. These are recorded by debiting the current account of the partner (and crediting the Bank account).

Illustration: Partner X: current account

Partner X: current account	Rs.
Opening balance	X
Partner's share of profit for the year	X
Drawings by the partner during the year	(X)
Closing balance	X

2 SHARING THE PROFITS BETWEEN THE PARTNERS

Section overview

- Profit-sharing ratio
- Notional salaries for partners
- Notional interest on long-term capital
- Guaranteed minimum profit share
- Changes in the partnership agreement on profit-sharing
- Profits, drawings and the partners' current accounts

2.1 Profit-sharing ratio

The profit or loss for the financial period is calculated according to the normal rules (as described already for a sole trader). This total profit or loss figure is then divided between the partners and credited to their current account.

The partners are free to decide on how the profit (or loss) of the partnership is shared between the partners. The profit sharing arrangements are set out in the partnership agreement.

- The profit for the period might be shared in agreed profit sharing ratio. This is sometimes abbreviated as PSR. (The term profit sharing ratio covers the sharing of both profit and loss).
- Alternatively, there might be other means of allocating a first share of profit with the residual profit being shared in the agree profit sharing ratio. Methods of allocating a first share of profit include:
  - Notional salaries;
  - Notional interest on long term capital.

The first example shows the use of a profit sharing ratio without any other method of allocating a first share of profit.

Example:

The WXY Partnership has three partners, W, X and Y, who share profits and losses in an agreed ratio of 3:5:8. (Profit is divided into 16 parts {3 + 5 +8} and W, X and Y receives 3 parts, 5 parts and 8 parts respectively).

Profits for the year were Rs. 1,920,000.

The total profits are divided between the partners as follows:

Partner		Rs.
W	Rs. 1,920,000 × $^{3}/_{16}$	360,000
X	Rs. 1,920,000 × $^{5}/_{16}$	600,000
Y	Rs. 1,920,000 × $^{8}/_{16}$	960,000
		1,920,000

This might be recorded using an appropriation account.

The profit would first be transferred into the appropriation account:

Illustration:

	Debit	Credit
Statement of comprehensive income account	1,920,000	
Appropriation account		1,920,000

The profit would then be transferred from the appropriation account to the partners' current accounts:

Illustration:

	Debit	Credit
Appropriation account	1,920,000	
Partner W's current account		360,000
Partner X's current account		600,000
Partner Y's current account		960,000

2.2 Notional salaries for partners

A partnership agreement might recognise the different amount of work done by partners by awarding one or more of the partners with a notional salary.

A notional salary is an agreed amount awarded to the individual partner from the partnership profits.

Note that a notional salary is not a business expense in the same way that salary to employees is. It is a share of the partnership profits.

Also note that notional salary may not be paid to a partner in the same way that salary is paid to employees. A partner takes cash out of the business through drawings.

The salary is awarded to each partner from the profits, and the residual profit after deduction of notional salaries is then divided between the partners in the agreed profit-sharing ratio.

Example:

The PQR Partnership has three partners, P, Q and R.

The partnership agreement provides for the residual profit (or loss) to be shared between them in the ratio 4:3:2, after allowing a notional salary of Rs. 30,000 to R.

The profit for the year is Rs. 345,000.

Residual profits = Rs. 345,000 – Rs. 30,000 = Rs. 315,000.

Profits are shared as follows:

		Profit share		
	Total	**P**	**Q**	**R**
	Rs.	**Rs.**	**Rs.**	**Rs.**
Notional salary	30,000			30,000
Residual profit:				
P share				
Rs. 315,000 × 4/9	140,000	140,000		
Q share				
Rs. 315,000 × 3/9	105,000		105,000	
R share				
Rs. 315,000 × 2/9	70,000			70,000
	315,000			
Profit share	345,000	140,000	105,000	100,000

The profit share of each partner is added to the balance on their individual current accounts.

Practice question **1**

A, B and C are in partnership sharing profits and losses in the ratio of 2: 2: 1.

B is allowed a salary of Rs. 10,000 per annum and C is allowed a salary of Rs. 15,000 per annum.

The net profit for year was Rs. 100,000.

Show how profit should be shared between the partners.

2.3 Notional interest on long-term capital

The partnership agreement might provide for the partners to obtain notional interest on the long-term capital they have invested in the business. This is interest on the balance in their capital account.

Notional interest on long-term capital is not interest expense, because the capital in the partners' capital account is equity, not a liability of the business.

The notional interest is a share of the partnership profits. Like notional salaries, the notional interest is awarded to each partner in accordance with the partnership agreement.

The residual profit shared between the partners in the profit-sharing ratio is the profit after notional salaries and notional interest on capital are deducted.

Example:

Partnership DEF has three partners, D, E and F.

Partner D has contributed Rs. 100,000 of fixed capital, Partner E Rs. 120,000 and Partner F Rs. 60,000.

They have agreed to share profits in the following way.

1. **Partner D to receive a salary of Rs. 4,000 and Partner F a salary of Rs. 7,000.**
2. **All three partners receive interest at 5% on the fixed capital contributed.**
3. **Residual profit or loss to be shared between D, E and F in the ratio 3:5:2.**

The profit of the partnership for the year is Rs. 95,000.

The partnership profits would be shared between the partners as follows:

			Profit share		
		Total	**D**	**E**	**F**
		Rs.	**Rs.**	**Rs.**	**Rs.**
Notional salary		**11,000**	**4,000**		**7,000**
Notional interest at 5%		**14,000**	**5,000**	**6,000**	**3,000**
Residual profit (balance):					
D share	**Rs. 70,000 × $^3/_{10}$**	**21,000**	**21,000**		
E share	**Rs. 70,000 × $^5/_{10}$**	**35,000**		**35,000**	
F share	**Rs. 70,000 × $^2/_{10}$**	**14,000**			**14,000**
		70,000			
Profit share		**95,000**	**30,000**	**41,000**	**24,000**

Practice question **2**

G, H and I are in partnership.

The profit of the partnership for the year is Rs. 1,146,000.

Partner G has contributed Rs. 500,000 of fixed capital, Partner H Rs. 400,000 and Partner I Rs. 300,000.

The partners have agreed to share profits in the following way.

1. **Partner H should receive a salary of Rs. 50,000 and Partner I a salary of Rs. 100,000.**
2. **All three partners should receive interest at 8% on the fixed capital contributed.**
3. **Residual profit (or losses) should be shared between G, H and I in the ratio 3: 2: 1.**

Show how the partnership profits should be shared between the partners

2.4 Guaranteed minimum profit share

A partnership agreement might guarantee a minimum profit share for one (or more) of the partners.

In these cases:

- The partnership profits are shared according to the partnership agreement, ignoring the minimum profit agreement.
- If the normal sharing mechanism does not result in a partner receiving the minimum guaranteed profit the other partners must make up the shortfall out of their profit share, in their profit-sharing ratio.

Example:

The XYZ Partnership has three partners, X, Y and Z.

The partnership agreement provides for Partner X to receive a notional salary of Rs. 20,000 and residual profits or losses are shared between X, Y and Z in the ratio 2:4:6.

In addition, the agreement guarantees a minimum profit share of Rs. 32,000 to Partner Y.

The partnership profit for the current year is Rs. 80,000.

The partnership profits would be shared between the partners as follows:

			Profit share		
		Total	**X**	**Y**	**Z**
		Rs.	**Rs.**	**Rs.**	**Rs.**
	Notional salary	20,000	20,000		
	Residual profit (balance)				
X share	Rs. 60,000 × $^{2}/_{12}$	10,000	10,000		
Y share	Rs. 60,000 × $^{4}/_{12}$	20,000		20,000	
Z share	Rs. 60,000 × $^{6}/_{12}$	30,000			30,000
		60,000			
		80,000	30,000	20,000	30,000
Transfer to meet shortfall:					
X share	Rs. 12,000 × $^{2}/_{8}$		(3,000)	3,000	
Z share	Rs. 12,000 × $^{6}/_{8}$			9,000	(9,000)
				12,000	
Profit share		80,000	27,000	32,000	21,000

2.5 Changes in the partnership agreement on profit-sharing

The agreement on how the partners should share the profits of the business may be changed during a financial year. When this happens, the total profits for the year should be apportioned, on a time basis, between:

- profits of the business during the time of the ‘old’ profit-sharing arrangements, and
- profits of the business during the time of the ‘new’ profit-sharing arrangements.

The profits for each time period are then shared between the partners in accordance with the agreement for that period.

Example:

The DEF Partnership has three partners, D, E and F.

In the first half of year 1, to 30 June Year 1, Partner D and Partner F each received an annual salary of Rs. 30,000.

Residual profits or losses are shared between D, E and F in the ratio 3:5:2. (There is no interest on capital.)

In the second half of the year, from 1 July to 31 December, Partner D's salary was increased to Rs. 40,000, and the partners altered the profit-sharing ratio to 1:3:1 for D:E:F). The salary of Partner F was unchanged at Rs. 30,000 per year.

The profit for the year was Rs. 220,000 (arising evenly throughout the year).

The annual profit would be shared as follows:

		Total	D	E	F
First six months		Rs.	Rs.	Rs.	Rs.
Notional salary (6 months)		30,000	15,000		15,000
Residual profit (balance)					
D share	Rs. 80,000 × 3/10	24,000	24,000		
E share	Rs. 80,000 × 5/10	40,000		40,000	
F share	Rs. 80,000 × 2/10	16,000			16,000
		80,000			
		110,000	39,000	40,000	31,000
Second six months					
Notional salary (6 months)		35,000	20,000		15,000
Residual profit (balance)					
D share	Rs. 75,000 × 1/5	15,000	15,000		
E share	Rs. 75,000 × 3/5	45,000		45,000	
F share	Rs. 75,000 × 1/5	15,000			15,000
		75,000			
		110,000	35,000	45,000	30,000
Total for the year		220,000	74,000	85,000	61,000

2.6 Profits, drawings and the partners' current accounts

For each partner, the share of the annual profit is added to the partner's current account. Any drawings during the year are deducted.

Example:

There are three partners in the ABC Partnership, A, B and C. The capital and current accounts of the partners at the beginning of the year were as follows:

Partner	Capital account (Rs.)	Current account (Rs.)
A	100,000	6,000
B	200,000	3,000
C	160,000	8,000

The profit for the year was Rs. 103,000.

Profit sharing agreement:

Partner A is given a salary of Rs. 17,000 and Partner C has a salary of Rs. 15,000

The partners pay themselves interest on capital at 5% per year

The residual profit or loss is shared between A, B and C in the ratio 1:3:2.

During the year, drawings by each partner were:

A	Rs. 20,000
B	Rs. 25,000
C	Rs. 40,000

The profit share is as follows:

		Total	A	B	C
		Rs.	Rs.	Rs.	Rs.
Notional salary		32,000	17,000		15,000
Notional interest at 5%		23,000	5,000	10,000	8,000
Residual profit (balance)					
A share	Rs. 48,000 x $^1/_6$	8,000	8,000		
B share	Rs. 48,000 x $^3/_6$	24,000		24,000	
C share	Rs. 48,000 x $^2/_6$	16,000			16,000
		48,000			
Profit share		103,000	30,000	34,000	39,000

Example (continued):

The partners' capital accounts are the same at the end of the year as at the beginning of the year.

The current accounts are as follows (all amounts in Rs. 000):

Current accounts

	A	B	C		A	B	C
				Balance b/d	6	3	8
Drawings	20	25	40	Profit share	30	34	39
Balance c/d	16	12	7				
	36	37	47		36	37	47
				Balance b/d	16	12	7

The current accounts can also be set out in columnar form as follows:

Current accounts	**Partner A**	**Partner B**	**Partner C**
	Rs.	Rs.	Rs.
Beginning of the year	6,000	3,000	8,000
Add share of profit	30,000	34,000	39,000
	36,000	37,000	47,000
Deduct drawings	(20,000)	(25,000)	(40,000)
End of the year	16,000	12,000	7,000

Practice question **3**

X, Y and Z are in partnership.

Partner	Capital account at the start of the year	Current account at the start of the year	Drawings during the year
	Rs.	Rs.	Rs.
X	1.000,000	20,000	780,000
Y	800,000	50,000	580,000
Z	600,000	10,000	350,000

The profit for the year was Rs. 1,944,000.

Profits are shared as follows:

1 The partners pay themselves interest on capital at 6% per year.

2 The residual profit or loss is shared between X, Y and Z in the ratio 4: 3: 2.

Show how the profits should be shared between the partners, and show their capital and current accounts as at the end of the year.

3 CHANGES IN PARTNERSHIPS

Section overview

- Introduction
- Goodwill
- Accounting for a change in partnership
- Admitting a new partner
- Retirement or death of a partner

3.1 Introduction

A partnership may change due to one of the following:

- Admission of a new partner to the firm.
- Death or retirement of a partner
- Amalgamation of a partnership with another business (maybe a sole proprietor or another partnership.

The accounting problems are similar in each case (though amalgamation does have an extra dimension which will be discussed later).

In each case the old partnership comes to an end and a new partnership is formed. Usually the records of the old partnership continue as those of the new partnership with adjustments to reflect the change of ownership.

The main objective of these adjustments is to establish the capital of each partner in the old partnership. This is important in each of the above cases.

Case	
Admission of a new partner	The existing partners will want the new partner to introduce a share of capital. The size of the amount of capital the new partner must introduce depends on the existing capital of the business.
Retirement (or death) of an existing partner	The retiring partner will want to withdraw his capital so this must be measured at the date of retirement. A deceased partner's capital must be paid to his estate so that his family or other beneficiaries may benefit.
Amalgamation	It is important to establish the capital worth of each partner in the new business; to show what each partner is bringing to the new business

This may sound straightforward as capital and current accounts already exist.

However, the balance on the accounts is the partners' share of the net assets of the firm as recorded in the statement of financial position. The statement of financial position is a list of assets and liabilities, not a statement of value.

The assets of the business will be stated at cost. This may be very different to their value at the date of the change in partnership.

Illustration:

A, B and C were in partnership sharing profits or losses equally.

The firm bought a plot of land in 2001 for Rs. 2,500,000.

A left the partnership on 30 June 2013.

The land was worth Rs. 4,000,000 at that date. (This is known as its fair value).

The land has risen in value by Rs. 1,500,000 but this is not reflected in the financial statements. This means that A's capital does not include his share of the gain but clearly Rs. 500,000 of the gain belongs to him.

Somehow the extra amount must be accounted for so that A can benefit from this.

The firm's net assets are not the same as the value of the firm and each partner will be more concerned with this latter figure.

Illustration:

A, B and C were in partnership sharing profits or losses equally.

A left the partnership on 30 June 2013.

At this date the net assets of the firm were Rs. 6,000,000. The value of the firm was estimated at Rs. 9,000,000. (The difference of Rs. 3,000,000 is called goodwill and this will be explained shortly).

A's share of the net assets might be 2,000,000 but his share of the value of the firm is Rs. 3,000,000.

Somehow the extra amount must be accounted for so that A can benefit from this.

The solution to the above problems is as follows:

- The net assets must be revalued so that the partners share in any adjustment;
- The difference between the value of the firm and the net assets of the firm (goodwill) must be recognised.

3.2 Goodwill

Goodwill is the amount by which the value of a business exceeds the value of all its net assets (its assets less liabilities).

Goodwill is an intangible asset of a business, but normally it is not recognised as an asset in the financial statements.

The value of a business is usually more than the net assets of the business because it reflects the trading potential that the business, i.e. its ability to generate profits in the future. All successful businesses have goodwill, which means that buyers will be prepared to pay more to acquire the business than the value of its net assets.

Illustration: Goodwill

Value of the firm (what another party would pay for it)	X
Assets less liabilities of the firm (net assets)	(X)
Goodwill	X

Strictly speaking the assets and liabilities of the firm should be restated to their fair value in order to measure goodwill. Fair value is a very important concept in financial reporting but that is beyond the scope of this syllabus. For the purposes of this chapter it is sufficient to think of it as the market value of an asset, i.e. how much it is worth.

Example:

A firm has net assets of Rs. 1,000,000.

One of the assets held by the firm is a property at cost less accumulated depreciation of Rs.400,000. This property has a market value of Rs.600,000 (Rs. 200,000 above its book value.

The firm is valued at Rs. 1,800,000.

Goodwill calculation:	Without revaluing the asset	With revaluation of the asset
Value of the firm	1,800,000	1,800,000
Assets less liabilities as per the accounts	(1,000,000)	
Assets less liabilities (at fair value)		(1,200,000)
1,000,000 + 200)		
Goodwill	800,000	600,000
Amount shared by the partners:		
Goodwill	800,000	600,000
Revaluation gain	–	200,000
Amount shared by the partners in the profit sharing ratio:	800,000	800,000

In the above example the figure of Rs. 600,000 for goodwill is the value that most closely fits the guidance given in IFRS. However, for the purpose of measuring adjustments to partners' capital at a time of change the example demonstrates that whether the net assets are revalued or not might be is irrelevant as the overall gain to each partner is not affected.

The above example implies that there may be no point in revaluing assets in questions involving change. This is not true because questions on this topic usually provide the goodwill figure and revaluation rather than the value of the firm.

Valuing goodwill

The method of arriving at total value of the firm might be based on a formula set out in the partnership agreement.

Example:

The XYZ Partnership values has an agreed method to value the firm for purposes of change in partnership as 10× the average annual profit for the last three years for which financial statements are available.

Profit for the last three years has been as follows:

Year 3	**Rs. 100,000**
Year 2	**Rs. 90,000**
Year 1	**Rs. 80,000**

The average annual profit is: $^{100,000 + 90,000 + 80,000}/_{3}$ **= Rs. 90,000**

The valuation of the firm is: 10 × Rs. 90,000 = Rs. 900,000

Alternatively, a partnership agreement might specify a method for valuing goodwill directly. One such method is measuring goodwill as a multiple of average annual profits or a multiple of its average annual 'excess' profits.

Example:

The XYZ Partnership values its goodwill as two times the average of the annual profits in excess of Rs. 60,000 each year for the last three years.

Profit for the last three years has been as follows:

Year 3	**Rs. 100,000**
Year 2	**Rs. 90,000**
Year 1	**Rs. 80,000**

The profits in excess of Rs. 60,000 have been:

Rs. 40,000 + Rs. 30,000 + Rs. 20,000 = Rs. 90,000

The average annual excess profit is: Rs. $^{90,000}/_{3}$ **= Rs. 30,000**

The valuation of goodwill is: 2 × Rs. 30,000 = Rs. 60,000

It is very unlikely that you will have to calculate goodwill in this exam but you will have to account for it.

3.3 Accounting for a change in partnership

As previously stated, the old partnership comes to an end and a new partnership begins but the records of the old partnership continue as those of the new partnership with adjustments to reflect the change of ownership.

The adjustments aim to establish each partner's share of the worth of the firm in the old partnership. This is done by recognising goodwill and any revaluation gains (or losses).

Illustration: Journal to recognise goodwill of old partnership

	Debit	Credit
Goodwill	X	
Partners' capital (in old partnership profit sharing ratio)		X
Being: Recognition of goodwill prior to a change in partnership		

The goodwill figure is not usually retained in the accounts after the change in the partnership. It is removed as follows:

Illustration: Journals to remove goodwill from books of the new partnership

	Debit	Credit
Partners' capital (in new partnership profit sharing ratio)	X	
Goodwill		X
Being: Removal of goodwill after a change in partnership		

Similar entries to those necessary to record goodwill might also be required to recognise revaluation of a specific asset.

Other entries will involve the recognition of capital introduced by a new partner or the removal of capital by a retiring partner or taken on behalf of a deceased partner.

3.4 Admitting a new partner

When a new partner is admitted to a partnership the following steps are required when accounting for this admission:

Steps	Detail
1	Measure goodwill of the old partnership (this figure will usually be given to you)
2	Recognise goodwill sharing the credit entry to the partners of the old partnership in the old profit sharing ratio.
3	Remove the goodwill in the books of the new partnership sharing the debit entry to the partners of the new partnership in the new profit sharing ratio.
4	Account for capital introduced by the new partner

Example:

R and S are in partnership sharing profits or losses equally.

R has Rs. 80,000 of capital and S has contributed Rs. 60,000 of capital.

T is to be admitted to the partnership and will introduce capital of Rs. 50,000.

Profits or losses are to be shared in the new partnership in the ratio of 2: 2: 1.

Step 1: The goodwill of the partnership at the date of admission is agreed to be Rs. 30,000.

Step 2: Recognise goodwill

	Debit	Credit
Goodwill	30,000	
Capital – Partner R ($^1/_2$ of 30,000)		15,000
Capital – Partner S ($^1/_2$ of 30,000)		15,000

Goodwill account (Rs.000)

Capital accounts	30		

Capital accounts (Rs.000)

	R	S	T		R	S	T
				Balance b/d	80	60	
				Goodwill	15	15	

Step 3: Remove the goodwill

	Debit	Credit
Capital – Partner R ($^2/_5$ of 30,000)	12,000	
Capital – Partner S ($^2/_5$ of 30,000)	12,000	
Capital – Partner T ($^1/_5$ of 30,000)	12,000	
Goodwill		30,000

Goodwill account (Rs.000)

Capital accounts	30	Capital accounts	30

Capital accounts (Rs.000)

	R	S	T		R	S	T
				Balance b/d	80	60	
Goodwill	12	12	6	Goodwill	15	15	

Step 4: Recognise new partner's capital introduced

	Debit	Credit
Cash	50,000	
Capital – Partner T		50,000

Example (continued)

The capital accounts now look like this:

Capital accounts (Rs.000)

	R	S	T		R	S	T
				Balance b/d	80	60	
Goodwill	12	12	6	Goodwill	15	15	
				Cash			50
Balance c/d	83	63	44				
	95	75	50		95	75	50
				Balance b/d	83	63	44

Note that the balance on partner T's capital account is only Rs. 44,000 even though he has introduced Rs. 50,000. This is because he has paid for his share of the goodwill of the business.

Practice question **4**

P and Q are in partnership sharing profits or losses in the ratio of 2:1. P has contributed Rs. 600,000 of capital and Q has contributed Rs. 500,000 of capital.

They are about to admit a new partner, M, to the partnership and M has agreed to pay the partnership Rs. 400,000 of capital.

After the admission of M profits or losses will be shared between P, Q and M in the ratio of 2:2:1.

The goodwill of the partnership at the date of admission is estimated to be Rs. 150,000.

Write up the capital accounts of the partners to show the admission of M to the partnership.

3.5 Retirement or death of a partner

When a partner leaves a partnership the following steps are required when accounting for his leaving:

Steps	Detail
1	Measure goodwill of the old partnership (this figure will usually be given to you)
2	Recognise goodwill sharing the credit entry to the partners of the old partnership in the old profit sharing ratio.
3	Remove the goodwill in the books of the new partnership sharing the debit entry to the partners of the new partnership in the new profit sharing ratio.
4	Account for capital taken

Example:

P, Q and R are in partnership sharing profits or losses equally.

P has Rs. 80,000 of capital and Q has Rs. 60,000 of capital and R has Rs. 75,000 of capital.

R is to retire. He will be paid cash in the amount of Rs.50,000 and he will leave the rest as a loan to the company.

Profits or losses are to be shared equally in the new partnership.

Step 1: The goodwill of the partnership at the date of retirement is agreed to be Rs. 60,000.

Step 2: Recognise goodwill

	Debit	Credit
Goodwill	60,000	
Capital – Partner P ($^{1}/_{3}$ of 60,000)		20,000
Capital – Partner Q ($^{1}/_{3}$ of 60,000)		20,000
Capital – Partner R ($^{1}/_{3}$ of 60,000)		20,000

Goodwill account (Rs.000)

Capital accounts	60		

Capital accounts (Rs.000)

	P	Q	R		P	Q	R
				Balance b/d	80	60	75
				Goodwill	20	20	20

Example (continued)

Step 3: Remove the goodwill

	Debit	Credit
Capital – Partner P (1/2 of 60,000)	30,000	
Capital – Partner Q (1/2 of 60,000)	30,000	
Goodwill		60,000

Goodwill account (Rs.000)

Capital accounts	60	Capital accounts	60

Capital accounts (Rs.000)

	P	Q	R		P	Q	R
				Balance b/d	80	60	75
Goodwill	30	30		Goodwill	20	20	20

Step 4: Recognise amount paid to retiring partner and any other arrangement

	Debit	Credit
Cash	50,000	
Capital – Partner T		50,000

The capital accounts now look like this:

Capital accounts (Rs.000)

	P	Q	R		P	Q	R
				Balance b/d	80	60	75
Goodwill	30	30		Goodwill	20	20	20
Cash			50				
Loan			45				
Balance c/d	70	50	–				
	100	80	95		100	80	95
				Balance b/d	70	50	–

Practice question **5**

J, K and L are partners sharing profits or losses and losses equally.

Capital account balances at 31 December 2013 are Rs.320,000, Rs.210,000 and Rs.120,000.

K is to retire, leaving the amounts due to her as a loan to the partnership.

The land and buildings were revalued by Rs. 1,800,000 and goodwill was valued at Rs. 900,000.

After the change the profit share is revised to 3:1 and goodwill is not to be recorded in the books.

Show how the retirement of K should be shown in the capital accounts.

4 AMALGAMATION AND DISSOLUTION OF PARTNERSHIPS

Section overview

- Amalgamation
- Dissolution

4.1 Amalgamation

An amalgamation is where two or more partnerships combine together to form a new partnership, or where a sole trader and a partnership combine together.

There are strong similarities to the changes already covered with revaluations made in the old books and the reversals made in the new books.

You may have to construct the statement of financial position immediately after the amalgamation. The added dimension to this sort of question is that this involves merging the statements of financial position of the two businesses that are amalgamating.

(Current accounts are excluded from the following example in order to allow you to focus on the amalgamation process).

Example: Amalgamation

A and B are partners sharing profits or losses equally.

C and D are partners in another firm. They also share profits equally.

The two firms are to amalgamate with A, B, C and D sharing profits or losses in the ratio of 3; 3: 2 and 2.

The statements of financial position of each business immediately prior to the amalgamation and before any of the necessary amalgamation adjustments Were as follows:

	AB &Co	CD &Co
Non-current assets	200,000	175,000
Current assets	100,000	80,000
	300,000	255,000
Capital		
A	120,000	
B	120,000	
C		100,000
D		100,000
Liabilities	60,000	55,000
	300,000	255,000

Example (continued): Amalgamation

Step 1: Identify goodwill to be recognised and revaluations.

The goodwill of AB & Co was agreed to be Rs. 100,000.

AB & Co had non-current assets which were to be revalued by Rs. 50,000.

The goodwill of CD & Co was agreed at 80,000.

CD & Co also had non-current assets which were to be revalued by Rs. 50,000.

Step 2: Recognise the adjustments in the books of each firm.

The capital accounts of each firm (this time in columnar form) would be as follows after accounting for the above:

Books of AB & Co

Capital	A	B
Balance b/d	120,000	120,000
Goodwill (100,000 shared equally)	50,000	50,000
Revaluation (50,000 shared equally)	25,000	25,000
	195,000	195,000

Books of CD & Co

Capital	C	D
Balance b/d	100,000	100,000
Goodwill (80,000 shared equally)	40,000	40,000
Revaluation (50,000 shared equally)	25,000	25,000
	165,000	165,000

After this the statements of financial position of each firm would look as follows and can be amalgamated by adding each line together.

	AB &Co	CD &Co	New firm
Goodwill	100,000	80,000	180,000
Non-current assets	250,000	225,000	475,000
Current assets	100,000	80,000	180,000
	450,000	385,000	835,000
Capital			
A	195,000		195,000
B	195,000		195,000
C		165,000	165,000
D		165,000	165,000
Liabilities	60,000	55,000	115,000
	450,000	385,000	835,000

Example (continued): Amalgamation

Step 3: The partners in the new firm have decided that the assets ledger will be carried forward at their revalued amounts in the general ledger of the new firm but goodwill is to be eliminated. The total goodwill before elimination is Rs. 180,000.

The necessary double entry is:

Capital – Partner A ($^3/_{10}$ of 180,000)	54,000	
Capital – Partner B ($^3/_{10}$ of 180,000)	54,000	
Capital – Partner C ($^2/_{10}$ of 180,000)	36,000	
Capital – Partner D ($^2/_{10}$ of 180,000)	36,000	
Goodwill		60,000

The capital accounts of the new firm would be as follows after accounting for the above:

Books of new firm	**A**	**B**	**C**	**D**
Balance b/d	195,000	195,000	165,000	165,000
Write off of goodwill	(54,000)	(54,000)	(36,000)	(36,000)
Balance c/d	141,000	141,000	129,000	129,000

Step 4: Prepare the final statement of financial position as at the start of the new firm.

	New firm
Non-current assets	475,000
Current assets	180,000
	655,000
Capital	
A	141,000
B	141,000
C	129,000
D	129,000
Liabilities	115,000
	655,000

4.2 Dissolution of a partnership

A partnership might cease trading. When this happens the partners are said to dissolve their partnership and liquidate the firm.

The following might then happen:

- Some assets of the firm are sold at a profit or loss which must be shared between the partners in their profit sharing ratio.
- Other assets might be taken by the partner’s in part settlement of their capital.
- Liabilities are paid (though some might be accepted by a partner thus increasing his capital balance).
- Finally, the balance on the capital owed to the partners is paid off using the remaining assets of the business. Alternatively a partner might have to pay cash into the business if there is a debit balance on his capital account.

Realisation account

A realisation account is used to calculate the profit /loss on disposal of assets.

All assets to be sold and those taken over by partners at agreed values are transferred into the account at their carrying amounts (as debit balances). Note that for non-current assets this will be cost less accumulated depreciation.

The account is credited with proceeds of sale and value of assets taken over by partners. Any profit (loss) on the account is then transferred to partners’ capital in the profit sharing ratio.

Illustration: Realisation account

Realisation account

	Rs.		Rs.
Non-current assets at carrying amount	X	Proceeds from selling assets	X
Current assets:		Assets taken by partners (at an agreed value)	X
Inventory	X		
Receivables	X		
Costs of the dissolution	X		
Profit to partner’s capital in the profit sharing ratio	X		
	X		X

Detailed accounting entries to close off partnership books

Steps	Detail
1	Close each partner's current account by transferring the balances to their capital account. This is to establish a single capital figure for each partner.
2	Transfer all assets (except cash) into the realisation account. Note that for non-current assets this involves transferring in the cost of the assets and the accumulated depreciation.
3	Perform double entry to reflect the sale of any asset.
4	Perform double entry to reflect the transfer of any asset to a partner's ownership at the agreed value.
5	Strike a balance on the realisation account and transfer profit or loss to the partners in the agreed profit sharing ratio.
6	Pay off any liabilities (if there is insufficient cash the partners will have to pay more into the business first).
7	Use the remaining assets to pay the partners their capital.

Example: Dissolution

A and B are partners sharing profits or losses equally.

They decide to dissolve their partnership.

The statement of financial position of at this date is as:

	AB &Co
Non-current assets:	Rs.
Land and buildings	200,000
Plant and equipment	100,000
Current assets	
Inventory	95,000
Receivables	80,000
Cash	120,000
	595,000
Partners' capital accounts	
A	150,000
B	150,000
Partners' current accounts:	
A	110,000
B	75,000
Liabilities	110,000
	595,000

Example (continued): Dissolution

Step 1: Current and capital accounts are combined.

	Debit	Credit
Capital – Partner A	110,000	
Current – Partner A		110,000
Capital – Partner B	75,000	
Current – Partner B		75,000

Step 2: Transfer assets to be sold (and realised) to the realisation account

	Debit	Credit
Realisation account	200,000	
Land and buildings		200,000
Realisation account	100,000	
Plant and equipment		100,000
Realisation account	95,000	
Inventory		95,000
Realisation account	80,000	
Receivables		80,000

The realisation account now looks as follows:

Realisation account

Land and buildings	200,000		
Plant and equipment	100,000		
Inventory	95,000		
Receivables	80,000		

At this stage the statement of financial position is as follows:

	AB
Realisation account	
(200,000 + 100,000 + 95,000 + 80,000)	475,000
Cash	120,000
	595,000
Capital	
A	260,000
B	225,000
Liabilities	110,000
	595,000

Example (continued): Dissolution

Further information:

1 The land and buildings are sold for Rs. 300,000

2 The plant and equipment includes a car at a carrying amount of Rs. 30,000. B is to take over this car at an agreed value of Rs. 35,000.

3 The rest of the plant and equipment was sold for Rs. 90,000

4 The inventory was sold at a reduced price of Rs. 93,000 to ensure a quick sale.

5 All of the receivables were collected except for an amount of Rs. 5,000 owed by a person who had become bankrupt.

6 Dissolution costs of Rs. 8,000 were paid

Step 3: Sale of assets (and payment of expenses)

	Debit	Credit
Cash (sale of land and buildings)	300,000	
Realisation account		300,000
Cash (sale of plant and equipment)	90,000	
Realisation account		90,000
Cash (sale of inventory)	93,000	
Realisation account		93,000
Cash (collection of receivables)	75,000	
Realisation account		75,000
Realisation account	8,000	
Cash (dissolution expenses)		8,000

Step 4: Transfer of assets

Capital account – B	35,000	
Realisation account		35,000

Example (continued): Dissolution

Step 5: Strike the balance on the realisation account and share the profit between the partners:

Realisation account

Land and buildings	200,000	Proceeds of sale	
Plant and equipment	100,000	Land and buildings	300,000
Inventory	95,000	Plant and equipment	90,000
Receivables	80,000	Inventory	93,000
Dissolution expenses	8,000	Collection of receivables	75,000
		Transfer of asset	35,000
Partner A	55,000		
Partner B	55,000		
Profit on dissolution	110,000		
	593,000		593,000

At this stage the statement of financial position is as follows:

	AB
Cash	
(120,000 + 300,000 + 90,000 + 93,000 + 75,000 – 8,000)	670,000
	670,000
Capital	
A (260,000 + 55,000)	315,000
B (225,000 + 55,000 – 35,000)	245,000
Liabilities	110,000
	670,000

Step 6: Pay the liabilities

Liabilities	110,000	
Cash		110,000

Step 7: Distribute cash to the partners

Capital account – A	315,000	
Capital account – B	245,000	
Cash		560,000

All balances are now cleared (the books have been closed off).

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

			Profit share	
	Total	**A**	**B**	**C**
	Rs.	Rs.	Rs.	Rs.
Notional salary	100,000		100,000	
	150,000			150,000
Residual profit:				
P share				
Rs. 75,000 × $^2/_5$	300,000	300,000		
Q share				
Rs. 75,000 × $^2/_5$	300,000		300,000	
R share				
Rs. 75,000 × $^1/_5$	150,000			150,000
	750,000			
Profit share	1,000,000	300,000	400,000	300,000

Solutions **2**

			Profit share	
	Total	**G**	**H**	**I**
	Rs.	Rs.	Rs.	Rs.
Notional salary	150,000		50,000	100,000
Notional interest				
Fixed capital		500,000	400,000	300,000
Interest @ (8%)	96,000	40,000	32,000	24,000
Residual profit:				
G share				
Rs. 900,000 × $^3/_6$	450,000	450,000		
H share				
Rs. 900,000 × $^2/_6$	300,000		300,000	
I share				
Rs. 900,000 × $^1/_6$	150,000			150,000
	900,000			
Profit share	1,146,000	490,000	382,000	274,000

Solutions **3**

The profit share is as follows:

		Total	X	Y	Z
		Rs. (000)	Rs.	Rs.	Rs.
Notional interest					
Fixed capital			1,000,000	800,000	600,000
Interest @ (6%)		144,000	60,000	48,000	36,000
Residual profit (balance)					
X share	Rs. 1.8m x 4/9	800,000	800,000		
Y share	Rs. 1.8m x 3/9	600,000		600,000	
Z share	Rs. 1.8m x 2/9	400,000			400,000
		1,800,000			
Profit share		1,944,000	860,000	648,000	436,000

Current accounts (Rs. 000)

	X	Y	Z		X	Y	Z
				Balance b/d	20	50	10
Drawings	780	580	350	Profit share	860	648	436
Balance c/d	100	118	96				
	880	698	446		880	698	446
				Balance b/d	100	118	96

The current accounts can also be set out in coumnar form as follows:

Current accounts	**Partner X**	**Partner Y**	**Partner Z**
	Rs.	Rs.	Rs.
Beginning of the year	20,000	50,000	10,000
Add share of profit	860,000	648,000	436,000
	880,000	698,000	446,000
Deduct drawings	(780,000)	(580,000)	(350,000)
End of the year	100,000	118,000	96,000

Solutions **4**

Capital accounts (Rs. 000)

	P	Q	R		P	Q	R
				Balance b/d	600	500	
				Recognise goodwill (2:1)	100	50	
Remove goodwill (2:2:1)	60	60	30				
				Cash			400
Balance c/d	640	490	370				
	700	550	400		700	550	400
				Balance b/d	640	490	370

The capital accounts can also be set out in coumnar form as follows:

Capital accounts	**Partner P**	**Partner Q**	**Partner R**
	Rs.	**Rs.**	**Rs.**
Beginning of the year	600,000	500,000	
Recognise goodwill (2:1)	100,000	50,000	
Removal of goodwill (2:2:1)	(60,000)	(60,000)	(30,000)
Capital introduced			400,000
End of the year	640,000	490,000	370,000

Solutions **5**

Capital accounts (Rs. 000)

	J	K	L		J	K	L
				Balance b/d	320	210	120
				Revaluation (1:1:1)	600	600	600
Remove goodwill (3:1)	675	–	225	Recognise goodwill (1:1:1)	300	300	300
Transfer to loan	–	1,110	–				
Balance c/d	545	–	795				
	1,220	1,110	1,020		1,220	1,110	1,020
				Balance b/d	545	–	795

The capital accounts can also be set out in coumnar form as follows:

Capital accounts	**Partner J**	**Partner K**	**Partner L**
	Rs.	Rs.	Rs.
Beginning of the year	320,000	210,000	120,000
Revaluation (1:1:1)	600,000	600,000	600,000
Recognise goodwill (1:1:1)	300,000	300,000	300,000
Removal of goodwill (3:1)	(675,000)	–	(225,000)
Transfer to loan	–	(1,110,000)	–
End of the year	545,000	–	795,000

I

Index

a

b

c

s

t

u

v

w

y

Head Office:
Chartered Accountants Avenue
Clifton
Karachi-75600
UAN: 111-000-422
E-mail: info@icap.org.pk

Regional Office:
155-156, West Wood Colony
Thokar Niaz Baig, Raiwind Road
Lahore.
UAN: 111-000-422
E-mail: lahore@icap.org.pk

Islamabad Office:
Sector G-10/4
Mauve Area
Islamabad.
UAN: 111-000-422
Email: islamabad@icap.org.pk

Faisalabad Office:
36-Z, Commercial Centre
Madina Town
Faisalabad.
Phone: (041) 8531028
E-mail: faisalabad@icap.org.pk

Multan Office:
3rd Floor, Parklane Tower
Officers Colony, Khanewal Road
Multan.
Phone: (061) 6510511-6510611
E-mail: multan@icap.org.pk

Peshawar Office:
House # 30, Old Jamrud Road
University Town
Peshawar.
Phone: (091) 5851648
E-mail: peshawar@icap.org.pk

INTRODUCTION TO ACCOUNTING

STUDY TEXT

9 789699 330223 >

The Institute of Chartered Accountants of Pakistan

| www.icap.org.pk |