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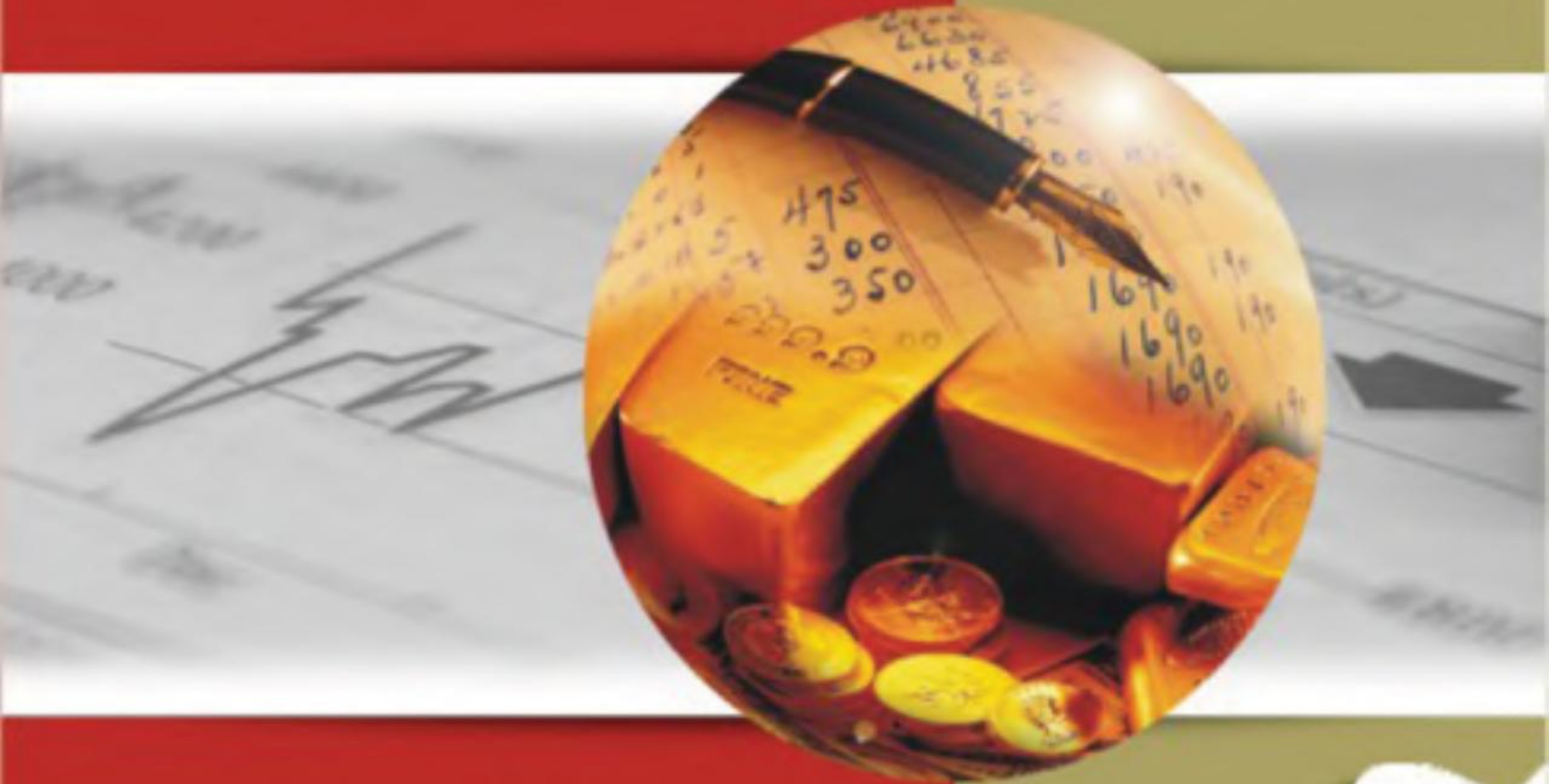

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Introduction

The aim of this book is to provide an up-to-date text covering the Cambridge International Examinations International General Certificate of Secondary Education Accounting syllabus (0452).

The IGCSE examination consists of two structured papers. Paper 1 tests knowledge and application, with some analysis and evaluation. It may contain some multiple choice questions, some short-answer questions and some structured questions. Paper 2 also tests knowledge and application, but with an emphasis on analysis and evaluation. Questions on Papers 1 and 2 may be set on any topic in the syllabus. It is recommended that students obtain a syllabus for the year in which they intend to sit the examination so that they are aware of what is required. Electronic copies are available at http://www.cie.org.uk

This book covers all the topics included on the latest syllabus for IGCSE Accounting. The topics are not necessarily included in the order in which they appear in the syllabus. They have been presented in what the author's long teaching experience has shown to be a suitable order for an accounting student commencing a course at this level. The table on page viii shows the chapter(s) of the book in which each section of the syllabus may be found.

No prior knowledge of accounting is required as this book provides an introduction to accounting and covers all the topics on the 0452 syllabus. Each chapter is complete in itself and contains appropriate examples. There are also short-answer questions at regular intervals which students can use to test their understanding of each section. The Review Questions at the end of each chapter are taken from past examinations papers wherever possible. Answers to questions marked with an asterisk (*) are given at the end of the book.

The contents of the book have been amended to reflect the move in the IGCSE Accounting syllabus towards applying international accounting terminology. At present this terminology is only used by large-scale companies, but it is probable that it will be used by all businesses in the near future. Only the new terminology will be used in the IGCSE examination papers from 2011, so it is essential that candidates are aware

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of these terms. The first time an international term is used in this book it will also show the UK equivalent term in brackets. A summary of comparative terms appears on the next page. The terms used in Review Questions which have been taken from past papers have been modified to include the new terminology.

It is always advisable to show all calculations when answering accounting questions. Candidates may respond to the same question in different ways: showing the workings is one way of ensuring that examiners see how the solution was reached. Questions are answered on the actual question paper for both Paper 1 and Paper 2, but space is provided for calculations.

In common with most accounting textbooks, dates used in the examples throughout this book are expressed as 20-0, 20-1, 20-2, and so on. Those Review Questions taken from past papers show the dates as they appeared on the actual examination paper.

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New Terminology

International usage	Traditional UK usage
Financial Statements	Final accounts
Income statement	Trading and profit & loss account
Revenue	Sales
Raw materials (ordinary goods purchased)	Purchases
Cost of sales	Cost of goods sold
Inventory (of raw materials and finished goods)	Stock
Work in progress	Work in progress
Gross profit	Gross profit
Other operating expenses	Sundry expenses
Other operating income	Sundry income
Investment revenues	Interest receivable
Finance costs	Interest payable
Profit (before tax) for the year	Net Profit
Balance sheet	Balance sheet
Non-current assets	Fixed assets
Property	Land and buildings
Plant and equipment	Plant and equipment
Investment property	Investments
Intangible assets	Goodwill etc.
Current assets	Current assets
Inventory	Stock
Trade receivables	Debtors
Other receivables	Prepayments

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International usage	Traditional UK usage
Cash (and cash equivalents)	Bank and cash
Current liabilities	Current liabilities *or* Creditors: amounts due within 12 months
Trade payables	Creditors
Other payables	Accruals
Bank overdrafts and loans	Loans repayable within 12 months
Non-current liabilities	Long term liabilities *or* Creditors: amounts falling due after more than one year
Bank (and other) loans	Loans repayable after 12 months
Capital or Equity	Capital
Share capital	Share capital

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Where to find each section of the syllabus

Chapter	Syllabus																												
	1	2				3				4					5		6						7					8	
		1	2	3	4	1	2	3	4	1	2	3	4	5	1	2	1	2	3	4	5	6	1	2	3	4	5	1	2
One	✓	✓																											
Two		✓		✓	✓																								
Three						✓																							
Four		✓		✓	✓																								
Five				✓	✓																								
Six			✓	✓																									
Seven				✓	✓																								
Eight															✓		✓												
Nine																✓	✓												
Ten										✓		✓		✓											✓			✓	✓
Eleven												✓					✓												
Twelve											✓						✓												
Thirteen													✓				✓							✓					
Fourteen								✓																					
Fifteen				✓			✓																						
Sixteen									✓																				
Seventeen																						✓							
Eighteen																				✓									
Nineteen																		✓											
Twenty																					✓								
Twenty one																			✓										
Twenty two																						✓	✓	✓	✓	✓			

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Chapter 1 Introduction to Accounting

In this chapter you will learn to:

- understand the difference between bookkeeping and accounting
- understand why businesses need to keep accounting records
- understand the meaning of the terms assets, liabilities and capital
- understand and apply the accounting equation
- prepare a simple balance sheet.

Introduction

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

Bookkeeping

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

Accounting

This uses **the bookkeeping records to prepare financial statements at regular intervals**. The owner of a business needs to know whether the business is making a profit or a loss. Periodically (often at yearly intervals),

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an income statement (trading, profit and loss account) is drawn up. This shows the calculation of the profit or loss earned by the business. If the business has earned a profit then the owner is receiving a return on his investment and funds are available for expanding or improving the business. However, if the business has made a loss then it may eventually close down as the owner is not receiving any return on his investment and funds are not available for running or maintaining the business.

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

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

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

All the accounting terms used above are explained in detail, later in this book.

Test your understanding

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

Assets, Liabilities and Capital

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

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

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

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

Test your understanding

1. Define **each** of the following terms.

(a) assets (b) liabilities (c) capital

The Accounting Equation

This is also referred to as the **balance sheet equation**. Like any other mathematical equation, the two sides of the equation will always be equal. The formula for this equation is:

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

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

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

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

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

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Example 1.1

20-7

January 1 Leena set up a business to trade under the name of The Dress Shop. She opened a business bank account and paid in $20 000 as capital.

2 The business purchased premises, $15 000, and paid by cheque.

3 The business purchased goods, $3000, on credit.

4 The business sold goods, at the cost price of $1000, on credit.

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

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

- January 1 The assets of the business are equal to the capital of the business.
- January 2 The money in the bank has decreased because a new asset has been bought. The total assets are equal to the capital.
- January 3 Purchasing on credit means that the business does not pay immediately. A new asset **inventory** (stock) has been acquired, but the business has also acquired a liability as

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it owes money to the supplier (who is known as a **creditor**). In a balance sheet this is described as a **trade payable**. The total assets are equal to the capital plus the liabilities.

- January 4 Selling on credit means that the business does not immediately receive the money. The inventory has decreased but a new asset has been acquired in the form of money owing to the business by a customer (who is known as a **debtor**). In a balance sheet this is described as a **trade receivable**. The total assets are equal to the capital plus the liabilities. (For the sake of simplicity, the goods were sold to the customer at cost price. In practice, they need to be sold at a price above cost price to enable the business to make a profit.)

Test your understanding

1. Fill in the missing figures in the following table.

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

The Balance Sheet

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

Example 1.2

Prepare the balance sheet of The Dress Shop after **each** of the transactions shown in **Example 1.1** above.

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The Dress Shop
Balance Sheet at 1 January 20-7

Assets	$	*Liabilities*	$
Bank	20 000	Capital	20 000
	20 000		20 000

The Dress Shop
Balance Sheet at 2 January 20-7

Assets	$	*Liabilities*	$
Premises	15 000	Capital	20 000
Bank	5 000		
	20 000		20 000

The Dress Shop
Balance Sheet at 3 January 20-7

Assets	$	*Liabilities*	$
Premises	15 000	Capital	20 000
Inventory	3 000	Trade payable	3 000
Bank	5 000		
	23 000		23 000

The Dress Shop
Balance Sheet at 4 January 20-7

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

Test your understanding

1. Give **two** examples of **each** of the following (excluding those shown in **Example 1.1 and 1.2**):
   (a) asset (b) liability
2. Explain the meaning of **each** of the following terms:
   (a) creditor (b) debtor

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The balance sheets shown in **Example 1.2** were presented in a horizontal format. There are different ways to present a balance sheet and these are explained in Chapter 9. A balance sheet is also more useful if the assets and liabilities are divided into different types (*see* Chapter 9).

Example 1.1 showed that every single transaction involves a change to the assets and/or the liabilities and/or the capital. This means that it is necessary to prepare a balance sheet after every single transaction, as shown in **Example 1.2**. However, this is not possible in practice as many transactions can take place every hour of each working day. In practice, the day-to-day business transactions are recorded using **double entry bookkeeping** (as explained in Chapters 2 and 4), and a balance sheet is prepared only periodically. This is usually done at the closing of a business on the last day of the financial year as part of the **financial statements**. As the business can be started on any day of the year, its financial year may not necessarily match the calendar year (i.e from 1 January to 31 December). The financial statements are prepared for twelve month periods from the date the business started.

Points to Remember

1. Bookkeeping is the detailed recording of all the financial transactions of a business. Accounting uses these bookkeeping records to prepare financial statements.
2. It is necessary to prepare financial statements to show the profit or loss of the business and the financial position of the business and it will help in decision-making.
3. The accounting equation shows that the assets are always equal to the capital plus the liabilities of the business.
4. A balance sheet is a statement of the financial position of a business on a certain date.

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Review Questions

1. Explain why the assets of a business are always equal to the capital plus the liabilities.
2. State whether each of the following is an asset or a liability.
   (a) Land and buildings
   (b) Inventory of goods
   (c) Trade payable
   (d) Trade receivable
   (e) Loan from AB Finance Company
   (f) Cash

*3. Complete the following table to show the effect of each of the following transactions.
   The first one has been completed as an example.
   (a) Bought a motor vehicle and paid by cheque
   (b) Bought goods on credit from a supplier
   (c) Received a cheque from a debtor
   (d) Sold goods on credit
   (e) Paid off a loan in cash

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

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4. The balance sheet of Bharwani Traders on 31 October 20-4 is shown below.

Bharwani Traders
Balance Sheet at 31 October 20-4

Assets	$	*Liabilities*	$
Machinery	19 000	Capital	35 000
Motor vehicles	6 000	Trade payables	8 000
Inventory	4 900		
Trade receivables	3 000		
Bank	10 100		
	43 000		43 000

On 1 November 20-4 the following transactions took place.
(a) A cheque for $3000 was paid to a creditor
(b) A debtor paid $500 in cash
(c) A loan for $8000, which was paid into the bank, was received from Lenders Limited
(d) A cheque for $7000 was paid for an additional machine
Prepare the balance sheet of Bharwani Traders on
1 November 20-4 after the above transactions have taken place.

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Chapter 2 Double Entry Bookkeeping – Part A

In this chapter you will learn to:

- understand the principles of double entry bookkeeping
- make entries in ledger accounts using double entry principles
- make entries in the ledger for drawings made by the owner of a business
- balance ledger accounts
- prepare ledger accounts using both the "T" format and the running balance format.

Introduction

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

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

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

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The layout of a ledger account is as follows:

Account name

Debit | Credit

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*

Ledger accounts are divided into two sections by a central vertical line. The left hand side is known as the **debit** side and the right hand side is known as the **credit** side. The term debit is usually abbreviated to **"dr"** and the term credit is usually abbreviated to **"cr"**. On either side of the account, there are columns to record the date, details and amount of each transaction.

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

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

Example 2.1

20-7

January 1 Ajay began business. He opened a business bank account and invested $80 000 as capital **(a)**

2 Fixtures and equipment costing $30 000 were bought and paid for by cheque **(b)**

Enter the above transactions in Ajay's ledger.

Ajay

Bank account **Page 1**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7 Jan 1 **(a)**	Capital	2	80 000	20-7 Jan 2 **(b)**	Fixtures & equipment	3	30 000

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Capital account **Page 2**

Date	Details	Folio	$	Date	Details	Folio	$
				20-7 Jan 1 **(a)**	Bank	1	80 000

Fixtures and equipment account **Page 3**

Date	Details	Folio	$	Date	Details	Folio	$
20-7 Jan 1 **(b)**	Bank	1	30 000				

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

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

In practice, the information entered in the accounting records is obtained from business documents (see Chapter 6). It is not practical for a set of business documents to be provided in examination so questions usually list the transactions.

In practice, each ledger account has its own page or sheet. As this is not possible in examination questions and exercises, it is usual to find several accounts displayed on one page.

Test your understanding

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

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Double Entry Records for Assets and Liabilities

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

Example 2.2

20-7

January 1 Ajay began business. He opened a business bank account and invested $80 000 as capital

2 Fixtures and equipment costing $30 000 were bought and paid for by cheque

3 A short-term loan of $10 000 was received from AB Loans

5 A motor vehicle costing $9000 was bought and paid for by cheque

6 A long-term loan of $5000 was received from Ajay's sister Mallika

Enter the above transactions in Ajay's ledger.

Ajay

Bank account **Page 1**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-7			
Jan 1	Capital	2	80 000	Jan 2	Fixtures & equipment	3	30 000
3	AB Loans	4	10 000	5	Motor vehicle	5	9 000
6	Mallika loan	6	5 000				

Capital account **Page 2**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-7			
				Jan 1	Bank	1	80 000

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Fixtures and equipment account **Page 3**

Date	Details	Folio	$	Date	Details	Folio	$
20-7 Jan 2	Bank	1	30 000				

AB Loans account **Page 4**

Date	Details	Folio	$	Date	Details	Folio	$
				20-7 Jan 3	Bank	1	10 000

Motor vehicles account **Page 5**

Date	Details	Folio	$	Date	Details	Folio	$
20-7 Jan 5	Bank	1	9 000				

Mallika loan account **Page 6**

Date	Details	Folio	$	Date	Details	Folio	$
				20-7 Jan 6	Bank	1	5 000

Double Entry Records for Expenses and Incomes

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

Example 2.3

20-7

January	1	Ajay began business with a capital of $80 000 in the business bank account
	1	Paid rent of premises, $400, by cheque
	2	Fixtures and equipment costing $30 000 were bought and paid for by cheque

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3 Paid insurance, $250, by cheque
3 A short-term loan of $10 000 was received from AB Loans
5 A motor vehicle costing $9000 was bought and paid for by cheque
5 Paid motor expenses, $50, by cheque
6 A long-term loan of $5000 was received from Ajay's sister Mallika
7 Part of the premises were rented out to another business and a cheque for $95 was received

Enter the above transactions in Ajay's ledger.

Ajay

Bank account — Page 1

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-7			
Jan 1	Capital	2	80 000	Jan 1	Rent	7	400
3	AB Loans	4	10 000	2	Fixtures & equipment	3	30 000
6	Mallika loan	6	5 000	3	Insurance	8	250
7	Rent received	10	95	5	Motor vehicle	5	9 000
					Motor expenses	9	50

Capital account — Page 2

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-7			
				Jan 1	Bank	1	80 000

Fixtures and equipment account — Page 3

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7							
Jan 2	Bank	1	30 000				

AB Loans account — Page 4

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-7			
				Jan 3	Bank	1	10 000

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Motor vehicles account **Page 5**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7							
Jan 5	Bank	1	9 000				

Mallika loan account **Page 6**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-7			
				Jan 6	Bank	1	5 000

Rent account **Page 7**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7							
Jan 1	Bank	1	400				

Insurance account **Page 8**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7							
Jan 3	Bank	1	250				

Motor expenses account **Page 9**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7							
Jan 5	Bank	1	50				

Rent received account **Page 10**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-7			
				Jan 7	Bank	1	95

- The motor expenses such as fuel and repairs are shown in an expense account as they do not increase the value of the motor vehicle.

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- The rent received from a tenant is shown in an income account and is kept separate from the expense of rent payable.
- No lines are left blank in the middle of ledger accounts as each entry is made on the next available line.
- In practice, for ease of reference, accounts of the same type (e.g. assets, expenses and so on) are kept in the same area of the ledger.

Test your understanding

1. For **each** of the following transactions, state the name of the account which will be debited and the name of the account which will be credited.
   (a) Paid property tax by cheque
   (b) Bought machinery and paid by cheque
   (c) Received commission by cheque for work done for another business
   (d) Repaid, by cheque, money borrowed from XYZ Loan Co.

Double Entry Records for Drawings

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

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

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

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Test your understanding

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

Balancing Ledger Accounts

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

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

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

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down" and indicates where the double entry for this item was made.

Example 2.4

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

Ajay

Bank account **Page 1**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-7			
Jan 1	Capital	2	80 000	Jan 1	Rent	7	400
3	AB Loans	4	10 000	2	Fixtures &		
6	Mallika loan	6	5 000		equipment	3	30 000
7	Rent			3	Insurance	8	250
	received	10	95	5	Motor vehicle	5	9 000
					Motor		
					expenses	9	50
				7	Balance	c/d	55 395
			95 095				95 095
20-7							
Jan 8	Balance	b/d	55 395				

Double Entry Records for Sales, Purchases and Returns

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

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

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Purchases

(a) Goods purchased for cash or cheque

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

(b) Goods purchased on credit

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

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

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

Example 2.5

20-7
January 9 Ajay bought goods, $650, on credit from Kolkata & Co.
10 Ajay bought goods, $150, and paid by cheque.
13 Ajay paid the amount owing to Kolkata & Co. by cheque

Enter the above transactions in Ajay's ledger.

Ajay

Bank account **Page 1**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-7			
				Jan 10	Purchases	11	150
				13	Kolkata & Co.	12	650

Purchases account **Page 11**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7							
Jan 9	Kolkata & Co.	12	650				
10	Bank	1	150				

Kolkata & Co account **Page 12**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-7			
Jan 13	Bank	1	650	Jan 9	Purchases	11	650
			650				650

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

Sales

(a) Goods sold for cash or cheque

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

(b) Goods sold on credit

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

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

Example 2.6

20-7
January 16 Ajay sold goods, $175, for cash
17 Ajay sold goods, $770, on credit to Prerna
20 Prerna gave Ajay a cheque for $500 on account

Enter the above transactions in Ajay's ledger.

Ajay

Bank account **Page 1**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7 Jan 20	Prerna	15	500				

Cash account **Page 13**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7 Jan 16	Sales	14	175				

Sales account **Page 14**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-7 Jan 16	Cash	13	175
				17	Prerna	15	770

Prerna account **Page 15**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7 Jan 17	Sales	14	770	20-7 Jan 20	Bank	1	500
				20	Balance	c/d	270
			770				770
20-7 Jan 21	Balance	b/d	270				

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

Returns

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

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

Example 2.7

20-7		
January	21	Ajay sold goods, $245, on credit to Xavier Traders
	22	Xavier Traders returned damaged goods, $55, to Ajay
	23	Ajay purchased goods, $820, on credit from Varun
	25	Xavier Traders paid their account by cheque
	27	Ajay returned faulty goods, $44, to Varun
	30	Ajay gave Varun a cheque for $700 on account

Enter the above transactions in Ajay's ledger.

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Ajay

Bank account **Page 1**

Date	Details	Folio	$	Date	Details	Folio	$
20-7 Jan 25	Xavier Traders	16	190	20-7 Jan 30	Varun	18	700

Purchases account **Page 11**

Date	Details	Folio	$	Date	Details	Folio	$
20-7 Jan 23	Varun	18	820				

Sales account **Page 14**

Date	Details	Folio	$	Date	Details	Folio	$
				20-7 Jan 21	Xavier Traders	16	245

Xavier Traders account **Page 16**

Date	Details	Folio	$	Date	Details	Folio	$
20-7 Jan 21	Sales	14	245	20-7 Jan 22	Sales returns	17	55
				25	Bank	1	190
			245				245

Sales returns account **Page 17**

Date	Details	Folio	$	Date	Details	Folio	$
20-7 Jan 22	Xavier Traders	16	55				

Varun account **Page 18**

Date	Details	Folio	$	Date	Details	Folio	$
20-7 Jan 27	Purchases returns	19	44	20-7 Jan 23	Purchases	11	820
30	Bank	1	700				
31	Balance	c/d	76				
			820				820
				20-7 Feb 1	Balance	b/d	76

Purchases returns account **Page 19**

Date	Details	Folio	$	Date	Details	Folio	$
				20-7 Jan 27	Varun	18	44

Double Entry Records for Carriage Inwards and Carriage Outwards

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

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

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

Test your understanding

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

Three Column Running Balance Accounts

The ledger accounts presented so far have been in the traditional form. This form is also known as the "T" account format.

There is another method of presenting ledger accounts which is commonly used on computer-generated accounts which is known as the three column running balance format. This form of presentation uses only one column each for the date, details and folio and has three money

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Ajay

Bank account **Page 1**

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

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

As students often find the traditional form of ledger accounts easier to understand, the "T" format is used in all ledger accounts throughout this book. Where ledger accounts are required in examinations, either form of presentation is acceptable.

Examination questions frequently ask candidates to show the entries in one ledger account only, rather than asking for a complete set of double entry records. This is simply an examination technique to enable greater syllabus coverage within the limited time of the examination paper.

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Points to Remember

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

Review Questions

1. A trader provides the following information.

20-7			$
February	1	Balance of cash	250
	2	Paid property tax in cash	52
	3	Cash sales	94
	4	Bought stationery and paid in cash	13
	5	Received cash from M Ghosh, a debtor	120
	6	The owner withdrew cash for personal use	50
	7	Bought goods and paid in cash	200

Enter the above transactions in the trader's cash account. Balance the account on 7 February and bring down the balance on 8 February 20-7.

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2. Copy out the following table and insert the name of the account to be debited and the name of the account to be credited for **each** transaction.

Transaction	*Account to be debited*	*Account to be credited*
(a) Sold goods for cash		
(b) Bought goods on credit from M Arora		
(c) The owner took cash for her own use		
(d) Returned goods to M Arora		
(e) Sold goods on credit to B Jindal		
(f) Paid for carriage on goods sold to B Jindal		
(g) Paid wages of employees in cash		
(h) Bought motor vehicle and paid by cheque		

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

July	1	Mumtaz paid capital, $50 000, into the business bank account
	2	Bought premises, $25 000, and paid by cheque
	4	Bought equipment, $4000, and paid by cheque
	6	Bought goods, $1500, on credit from Mayur Vihar Traders
	7	Paid advertising expenses, $60, by cheque
	9	Sold goods, $200, and received a cheque
	12	Sold goods, $310, on credit, to Ridhima
	13	Ridhima returned damaged goods, $20
	14	Paid $1000 by cheque on account to Mayur Vihar Traders

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

*4. From the following information, write up the account of Manish in the books of Rahman for the month of May 20-1. Prepare the account in three column running balance format.

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May 1 Manish owes Rahman $920
14 Rahman sold goods, $440, on credit to Manish
16 Manish returned goods, $175, to Rahman
19 Manish paid Rahman $100 in cash
21 Rahman sold goods, $93, on credit to Manish
26 Manish paid Rahman $900 by cheque

5. On 1 September 20-3 Adarsh started a business. The following are his transactions for the first month of trading.

September 1 Adarsh paid capital, $90 000, into the business bank account
2 Paid rent, $400, by cheque
4 Bought goods, $2100, on credit from Vinod
8 Cash sales $170
11 Paid sundry expenses, $32, in cash
14 Bought goods, $900, on credit from Vinod
19 Sold goods, $380, on credit to Kaveri
21 Returned faulty goods, $110, to Vinod
25 Paid shop assistant's wages in cash, $120
27 Paid the amount owing to Vinod by cheque
29 Adarsh took goods costing $130 for his own use

Enter the above transactions in the ledger of Adarsh. Balance the bank account and the cash account on 30 September and bring down the balances on 1 October 20-3.

6. The following account appears in the ledger of Marine Drive Stores.

Central Wholesalers account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-4				20-4			
May 17	Returns		120	May 1	Balance	b/d	180
20	Bank		300	10	Purchases		410
31	Balance	c/d	170				
			590				590
				20-4			
				June 1	Balance	b/d	170

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

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Chapter 3 The Trial Balance

In this chapter you will learn to:

- understand the purpose of a trial balance
- prepare a trial balance
- understand the errors which affect a trial balance
- understand the errors which do not affect a trial balance.

Introduction

A trial balance is **a list of the balances on the accounts in the ledger at a certain date**. A trial balance is prepared to check the arithmetical accuracy of the double entry bookkeeping. The name of each account is listed in the trial balance. The balance on each account is shown according to whether it is a debit balance or a credit balance. The trial balance will show if the total of the debit balances is equal to the total credit balances.

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

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

The layout of a trial balance is as follows:

Trial Balance at ……….. *

Details	*Folio*	*Debit* $	*Credit* $

*The date on which it is prepared.

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Ajay
Trial Balance at 7 January 20-7

	Folio	*Debit*	*Credit*
		$	*$*
Bank	1	55 395	
Capital	2		80 000
Fixtures & equipment	3	30 000	
AB Loans	4		10 000
Motor vehicles	5	9 000	
Mallika loan	6		5 000
Rent	7	400	
Insurance	8	250	
Motor expenses	9	50	
Rent received	10		95
		95 095	95 095

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

Test your understanding

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

In practice, a trial balance is drawn-up using the actual ledger accounts. However, in examination questions this does not always occur. Sometimes students are presented with a list of balances and asked to prepare a trial balance; sometimes a trial balance containing errors is presented and students are asked to prepare a corrected trial balance. In these situations students cannot look at the ledger account in order to determine whether the account has a debit or a credit balance. It is necessary to know the type of accounts which have a debit balance and those which have a credit balance. These are shown in the table below.

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

Example 3.2

The following trial balance was prepared by an inexperienced bookkeeper and contains errors.

Prepare a corrected trial balance at 31 December 20-9.

Jasmine
Trial Balance for the year ended 31 December 20-9

	Debit $	*Credit* $
Cash		300
Bank overdraft	3 000	
Capital		42 500
Drawings		750
Land and buildings	30 000	
Office equipment		1 050
Loan	2 200	
Inventory	7 500	
Purchases		9 850
Sales	10 650	
Sales returns		940
Purchases returns	1 030	
Carriage inwards		400
Wages	1 500	
Rent received	830	
Sundry expenses	1 290	
Trade receivables		12 300
Trade payables	5 670	
	63 670	68 090

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Jasmine
Corrected Trial Balance at 31 December 20-9

	Debit $	*Credit* $
Cash	300	
Bank overdraft		3 000
Capital		42 500
Drawings	750	
Land and buildings	30 000	
Office equipment	1 050	
Loan		2 200
Inventory	7 500	
Purchases	9 850	
Sales		10 650
Sales returns	940	
Purchases returns		1 030
Carriage inwards	400	
Wages	1 500	
Rent received		830
Sundry expenses	1 290	
Trade receivables	12 300	
Trade payables		5 670
	65 880	65 880

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

Test your understanding

1. State the column of a trial balance in which the balance of **each** of the following accounts would appear. Give a reason for your answer in each case.
   (a) loan from WQ loans
   (b) motor expenses
   (c) motor vehicles
   (d) bank overdraft
   (e) carriage outwards
   (f) commission received

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The Trial Balance and Errors

If the trial balance fails to balance

It is obvious that an error has been made somewhere. This may be:

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

Check list for locating errors

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

If the trial balance balances

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

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Name of error	Description of error	Example
Error of commission	This occurs when a transaction is entered using the correct amount and on the correct side, but in the wrong account of the same class.	Cash received from Malini credited to Mallika's account.
Error of complete reversal	This occurs when the correct amount is entered in the correct accounts, but the entry has been made on the wrong side of each account.	Cash drawings debited to the cash account and credited to the drawings account.
Error of omission	This occurs when a transaction has been completely omitted from the accounting records. Neither a debit entry nor a credit entry has been made.	Payment of wages not entered in the books.
Error of original entry	This occurs when an incorrect figure is used when a transaction is first entered in the accounting records. The double entry will therefore use the incorrect figure.	Goods, $100, bought on credit but recorded as $1000.
Error of principle	This occurs when a transaction is entered using the correct amount and on the correct side, but in the wrong class of account.	Motor expenses debited to the motor vehicles account.
Compensating errors	These occur when two or more errors cancel each other out.	Purchases account under-added by $100 and sales returns account over-added by $100.

Test your understanding

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

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Points to Remember

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

Review Questions

1. Danbi Wyske runs her business from rented premises. The following balances were extracted from her books on 30 April 2003.

	$
Inventory 1 May 2002	4 000
Sales	80 000
Purchases	62 000
Trade receivables	10 000
Trade payables	9 000
Electricity paid	3 000
General expenses	7 000
Cash at bank	5 000
Drawings	8 000
Rent and insurance paid	6 000
Equipment	29 000
Capital	?

Prepare Danbi's trial balance at 30 April 2003, showing her capital account balance. **[Based on IGCSE 2003]**

2. A trial balance drawn up at the end of Jim's financial year balanced. The following errors were then discovered.

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1. Goods returned to K Weston had been debited to K Wilton.
2. Repairs to office equipment had been debited in the office equipment account.
3. An invoice, $1000, for goods sold on credit to Jacob & Co had been recorded in the accounts as $100.
4. Goods purchased on credit from Brixton Ltd had been debited in Brixton's account and credited in the purchases account.

Required

(a) State the type of error made in **each** of the errors 1-4 above.
(b) Name **two** further errors not revealed by a trial balance.

*3. Hilota has a business supplying spare parts for cars. His financial year ends on 31 March. At 31 March 2006 his account showed the following balances.

	$
Non-current assets	12 700
Inventory at 1 April 2005	3 200
Bank balance (Dr)	4 550
Sales	56 000
Purchases	34 200
Carriage outwards	950
Rent	4 000
Wages	7 200
General expenses	2 600
Trade receivables	2 100
Trade payables	3 000
Capital	20 000
Drawings	7 500

Required

(a) Prepare Hilota's trial balance at 31 March 2006.
(b) State **one** limitation of a trial balance.
(c) State **two** uses of a trial balance.

[Based on IGCSE 2006]

4. (a) Define a trial balance.
(b) Explain the purpose of a trial balance.
(c) Explain how a trial balance is different from a balance sheet.

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(d) A trader's trial balance fails to balance. Explain how **each** of the following checks would be useful to help in discovering the error(s)
   (i) Looking for a transaction equal to the difference in the trial balance
   (ii) Looking for a transaction equal to half the difference in the trial balance.

(e) (i) List **four** types of error which would not be revealed by a trial balance
   (ii) Give an example of **each** of these four types of error
   (iii) Explain **why each** of these errors would not be revealed by a trial balance.

5. At the end of April 2000, an inexperienced bookkeeper prepared the following trial balance for Khalid Hassan.

	Dr. $	*Cr.* $
Sales	95 300	
Purchases		51 600
Inventory 1 May 1999	5 000	
Wages	18 200	
General expenses	7 300	
Repairs and maintenance		2 700
Machinery and equipment	58 550	
Motors	15 900	
Trade receivables		15 800
Trade payables	7 300	
Cash		350
Bank overdraft	3 800	
Drawings		12 000
Capital (balancing figure)		128 900
	211 350	211 350

In addition to the obvious errors in the trial balance, the accountant was also able to discover the following errors, which the trial balance failed to disclose.

1. $150 for the cost of repairing a motor had been debited to the motors account.
2. $50 cash paid for general expenses had not been recorded.

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3. Errors of addition had been made resulting in the sales being overcast by $100 and the wages being overcast by the same amount.
4. When an invoice for goods purchased on credit was recorded the amount was entered as $1000 instead of $100.
5. A cheque received from a debtor for $200 had been debited to the debtor's account and credited to the bank account.

(a) For **each** of the above items (1–5) state the type of error that was made.

(b) Prepare an amended trial balance for Khalid Hassan at 30 April showing the correct capital balance.

(c) Khalid's brother Yousef also has a business. When Yousef prepared his trial balance on 31 March 2000, he found that the credit side exceeded the debit side by $250. Describe **four** procedures that Yousef could carry out to find the errors that caused the difference on the trial balance.

[IGCSE 2000]

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Chapter 4 Double Entry Bookkeeping – Part B

In this chapter you will learn to:

- understand how the ledger is divided into specialist areas
- prepare a two column cash book
- make contra entries in a cash book
- understand cash discounts – allowed and received
- prepare a three column cash book.

Introduction

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

Division of the Ledger into Specialist Areas

Dividing the ledger into sections makes it more convenient to use as the same type of accounts can be kept together and the task of maintaining the ledger can be divided between several people. The ledger is usually divided into the following specialised areas:

Sales Ledger	This is also referred to as the **debtors ledger**. All the **personal** accounts of debtors (credit customers) are kept in the sales ledger.
Purchases Ledger	This is also referred to as the **creditors ledger**. All the **personal** accounts of creditors (credit suppliers) are kept in the purchases ledger.

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Nominal Ledger	This is also referred to as the **general ledger**. Apart from the cash account, the bank account and the accounts of debtors and creditors, all the remaining accounts are kept in the nominal ledger. This ledger will contain accounts of assets, liabilities, expenses, incomes, sales, purchases and returns. Asset accounts are known as **real** accounts. Accounts for expenses, income and capital are known as **nominal** accounts.
Cash books	These contain the main cash book (see later) and the petty cash book (see Chapter 5)

Test your understanding

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

The Two Column Cash Book

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

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

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column and if it is paid out of the bank, it will be entered in the bank column.

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

Since the cash a book is part of the double entry system, it represents ledger accounts for both cash and bank. It is, however, also a **book of prime entry** (see Chapter 7).

Contra entries

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

To record surplus cash paid into the bank
Debit the bank account and write "cash" in the details column
Credit the cash account and write "bank" in the details column

To record cash withdrawn from the bank for office use
Debit the cash account and write "bank" in the details column
Credit the bank account and write "cash" in the details column

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

Example 4.1

20-6

December	1	Mamata started business with a capital of $20 000 which she paid into a business bank account
	2	Paid rent of premises, $650, by cheque
	5	Purchased goods, $9500, on credit from Lodi Road Traders

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9 Withdrew $150 from the bank account for office use
14 Paid advertising expenses, $90, in cash
18 Sold goods, $4120, on credit to Central Dealers
23 Paid Lodi Road Traders' account by cheque
26 Bought motor vehicle, $5760, and paid by cheque
28 Mamata took $3000 from the business bank account for personal use

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

Mamata

Sales Ledger
Central Dealers account

Page 1

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-6 Dec 18	Sales	nl 5	4 120				

Purchases Ledger
Lodi Road Traders account

Page 1

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-6 Dec 23	Bank	cb 1	9 500	20-6 Dec 5	Purchases	nl 3	9 500
			9 500				9 500

Nominal Ledger
Capital account

Page 1

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-7 Dec 1	Bank	cb 1	20 000

Rent account

Page 2

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-6 Dec 2	Bank	cb 1	650				

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Purchases account **Page 3**

Date	Details	Folio	$	Date	Details	Folio	$
20-6 Dec 5	Lodi Road Traders	pl 1	9 500				

Advertising account **Page 4**

Date	Details	Folio	$	Date	Details	Folio	$
20-6 Dec 14	Cash	cb 1	90				

Sales account **Page 5**

Date	Details	Folio	$	Date	Details	Folio	$
				20-6 Dec 18	Central Dealers	sl 1	4 120

Motor vehicle account **Page 6**

Date	Details	Folio	$	Date	Details	Folio	$
20-6 Dec 26	Bank	cb 1	5 760				

Drawings account **Page 7**

Date	Details	Folio	$	Date	Details	Folio	$
20-6 Dec 28	Bank	cb 1	3 000				

Test your understanding

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

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Mamata
Cash Book

Page 1

Date	*Details*	*Folio*	*Cash* $	*Bank* $	*Date*	*Details*	*Folio*	*Cash* $	*Bank* $
20-6					20-6				
Dec 1	Capital	nl 1		20 000	Dec 2	Rent	nl 2		650
9	Bank	c	150		9	Cash	c		150
					14	Advertising	nl 4	90	
					23	Lodi Road Traders	nl 1		9 500
					26	Motor Vehicle	nl 6		5 760
					28	Drawings	nl 7		3 000
					31	Balance	c/d	60	940
			150	20 000				150	20 000
20-7									
Jan 1	Balance	b/d	60	840					

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Bank overdraft

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

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

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

Example 4.2

Mamata started business on 1 December 2006. Her transactions for the first month of trading were the same as those shown in **Example 4.1** except that her drawings on 28 December amounted to $5000 rather than $3000.

Enter Mamata's transactions for December 20-6 in her two column cash book. Balance the book on 31 December and bring down the balances on 1 January 20-7. The solution is shown on page 49.

The Three Column Cash Book

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

Cash discount

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

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Mamata
Cash Book

Page 1

Date	Details	Folio	Cash $	Bank $	Date	Details	Folio	Cash $	Bank $
20-6					20-6				
Dec 1	Capital	nl 1		20 000	Dec 2	Rent	nl 2		650
9	Bank	c	150		9	Cash	c		150
31	Balance	c/d		1 060	14	Advertising	nl 4	90	
					23	Lodi Road Traders	nl 1		9 500
					26	Motor Vehicle	nl 6		5 760
					28	Drawings	nl 7		5 000
					31	Balance	c/d	60	
			150	21 060				150	21 060
20-7					20-6				
Jan 1	Balance	b/d	60	840	Jan 1	Balance	b/d		1 060

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Discount allowed is the discount a business allows its credit customers (debtors) when they pay their accounts within a set time. This is an expense of the business as it is the cost of having debts settled promptly. **Discount received** is the discount a business receives from its credit suppliers (creditors) when it pays their accounts within a set time. This is an income of the business as it is the benefit received from settling debts promptly. It is important to realise that discount received does not involve the receipt of money: the supplier simply accepts less money in settlement of the account.

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

1. **When an account is paid by a debtor and a discount is allowed**
   Credit the discount in the debtor's account to show that this amount is no longer owing.
   Enter the amount of the discount in the discount allowed column of the cash book.
2. **When an account of a creditor is paid and a discount is received**
   Debit the discount in the creditor's account to show that this amount is no longer owing.
   Enter the amount of the discount in the discount received column of the cash book.

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

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

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Dishonoured cheque

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

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

Test your understanding

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

Example 4.3

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

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

20-7		
January	1	Mamata had a cash balance of \$60 and a bank overdraft of \$1060
	4	Bought goods, \$5200, on credit from Lodi Road Traders
	8	Returned goods, \$200, to Lodi Road Traders
	12	Sold goods, \$770, on credit to A & J Singh
	14	Cash sales \$680

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17 Paid $650 cash into the business bank account
21 Received a cheque from A & J Singh in settlement of their account
24 Sold goods, $1200, on credit to North East Stores
26 A & H Singh's cheque was dishonoured and returned by the bank
28 Paid Lodi Road Traders the amount due, by cheque, after deducting a discount of 2½%
31 North East Stores paid the amount due by cheque less a cash discount of 3%

Mamata

Sales Ledger

A & J Singh account

Page 2

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-7			
Jan 12	Sales	nl 5	770	Jan 21	Bank	cb 2	770
26	Bank (dishonoured cheque)	cb 2	770	31	Balance	c/d	770
			1 540				1 540
20-7							
Feb 1	Balance	b/d	770				

North East Stores account

Page 3

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-7			
Jan 24	Sales	nl 5	1 200	Jan 31	Bank	cb 2	1 164
					Discount	cb 2	36
			1 200				1 200

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Purchases Ledger

Lodi Road Traders account

Page 1

Date	Details	Folio	$	Date	Details	Folio	$
20-7				20-7			
Jan 8	Purchases Returns	nl 8	200	Jan 4	Purchases	nl 3	5 200
28	Bank	cb 2	4 875				
	Discount	cb 2	125				
			5 200				5 200

Nominal Ledger

Purchases account

Page 3

Date	Details	Folio	$	Date	Details	Folio	$
20-7							
Jan 4	Lodi Road Traders	pl 1	5 200				

Sales account

Page 5

Date	Details	Folio	$	Date	Details	Folio	$
				20-7			
				Jan 12	A & J Singh	sl 2	770
				14	Cash	cb 2	680
				24	North East Stores	sl 3	1 200

Purchases returns account

Page 8

Date	Details	Folio	$	Date	Details	Folio	$
				20-7			
				Jan 8	Lodi Road Traders	pl 1	200

Discount allowed account

Page 9

Date	Details	Folio	$	Date	Details	Folio	$
20-7							
Jan 31	Total for month	cb 2	36				

Discount received account

Page 10

Date	Details	Folio	$	Date	Details	Folio	$
				20-7			
				Jan 31	Total for month	cb 2	125

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Mamata
Cash Book

Page 2

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

Points to Remember

1. The ledger is usually divided into three specialist areas – sales ledger, purchases ledger and nominal ledger.
2. The cash account and the bank account are usually kept side-by-side in a cash book.
3. A contra entry appears on both sides of a cash book.
4. A credit balance brought down in the bank column of a cash book indicates a bank overdraft.
5. Cash discount is given to encourage customers to pay their accounts within a set time limit.
6. The totals of the discount columns in the cash book are transferred to the discount accounts in the ledger.

Review Questions

1. The balances on Ella's cash and bank accounts at 1 March 1999 were:

	$
Bank overdraft	2 300
Cash in hand	200

Transactions for the month of March 1999 were:

March	1	Received and banked cheque for $195 from Josiah Buko
	5	Paid cheques to C Brown, $240, and A Greenly, $288
	11	Cash sales $400
	16	Banked spare cash $300
	25	Ella paid further capital into the bank, $3000
	30	Received and banked cheque for $1170 from PQ Ltd.

Record the transactions for March 1999 in the bank and cash

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accounts in Ella's cash book and bring down the cash and bank balances on 1 April 1999.

[IGCSE 1999]

2. (a) State **two** advantages of dividing the ledger into specialist areas.
   (b) Indicate by means of a tick (✓) the ledger in which **each** of the following accounts would appear.

	Account	*Sales ledger*	*Purchases ledger*	*Nominal ledger*
(a)	Tom (a creditor)			
(b)	Jim (a debtor)			
(c)	Sales			
(d)	Purchases returns			
(e)	Drawings			

*3. Jonah is a sole trader who keeps full double entry accounting records including a three column cash book. All cheques received are banked on the same day.

On 30 June 2004, balances in his books included the following:

		$
Debtors	H Syde	500
	B Sharp	800
	M Yaveli	630
Creditors	J Teime	400
	P Mulder	1000
Cash		600
Bank (dr)		2500

Jonah's transactions for the month of July 2004 included the following:

			$
July	3	H Syde paid the amount he owed by cheque after deducting cash discount of $10	
	7	Cash was withdrawn from bank for office use	200

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10	Paid J Teime by cheque after deducting $15 cash discount	
12	Paid wages in cash	400
14	B Sharp paid the amount he owed by cheque after deducting cash discount of $20	
17	Paid P Mulder by cheque after deducting cash discount of $25	
20	Cash sales paid directly into the bank	350
21	M Yaveli paid the amount he owed by cheque	
24	Paid wages in cash	250
	Paid electricity bill by cheque	600
29	Jonah's bank returned M Yaveli's cheque for $630 as dishonoured	

(a) Enter the above transactions in Jonah's cash book. Balance the cash book at 31 July and bring down the balances on 1 August 2004.

(b) Make the entries required in the discount accounts in Jonah's ledger on 31 July 2004.

[IGCSE 2004]

4. Benjamin Ngaara started business on 1 August 2001 with a capital of $9500 which was paid into a business bank account.

Transactions for the month of August 2001 were:

August	2	Purchased furniture and equipment and paid by cheque, $2750
	4	Withdrew $200 cash from bank for business use
	6	Paid rent of premises in cash, $150
	13	Received a cheque from Tanko Ltd. for $75 which was paid into the bank
	18	Paid a cheque to Mary Jones in settlement of her account of $350 less 2% cash discount
	20	The cheque paid into the bank on 13 August was returned by the bank dishonoured
	31	Banked a cheque received from Jacob Smythe for $194 in full settlement of his account of $200

(a) Write up Benjamin's three column cash book for August 2001. Balance the cash and bank columns and bring down the balances on 1 September 2001.

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(b) Benjamin is unsure how to transfer the totals of the discount columns to the ledger.
   (i) State to which ledger account, and to which side of that account, the total of the discount allowed column is posted.
   (ii) State to which ledger account, and to which side of that account, the total of the discount received column is posted.

[IGCSE 2001]

*5. A trader's cash book includes the following entries:

Cash Book

			Discount Allowed	*Cash*	*Bank*				*Discount Received*	*Cash*	*Bank*
20-6			$	$	$	20-6			$	$	$
June 1	Balance	b/d		240		June 1	Balance	b/d			3130
2	Cash	c			200	2	Bank	c		200	
3	Rohit				500	7	ADT Ltd.		10		390
						10	Rohit (dis-honoured cheque)				500

(a) Explain **each** entry in the above cash book and also state where the double entry for **each** entry will be found.

(b) Explain the purpose of the discount columns in a three column cash book.

6. Abdul Anwar is a sole trader who keeps a full set of double entry records including a three column cash book.
The balances on his books on 1 May 2009 included the following:

	$
Cash	100
Bank	490 credit
Debtor – Sameen Atif	150
Creditor – Mohsen Ali	320

Abdul's transactions for the month of May 2009 included the following:

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May 6 Cash sales, $280, of which $200 was paid into the bank on that date

13 Received a cheque from Sameen Atif in settlement of her account

18 Paid a cheque to Mohsin Ali in settlement of his account after deducting cash discount of 2 ½%

24 Sameen Atif's cheque was dishonoured and was returned by the bank

30 Paid all the remaining cash into the bank except $50

Required

(a) Enter the above transactions in Abdul's cash book. Balance the cash book at 31 May and bring down the balances on 1 June 2009.

Abdul Anwar's financial year ends on 31 October.

Apart from those mentioned above, Abdul Anwar had no other transactions with Sameen Atif during the six months ended 31 October 2009.

Required

(b) Write up Sameen Atif's account as it would appear in Abdul's ledger for the six months ended 31 October 2009.

[IGCSE 2009]

7. Kalpana is a trader. On 1 February 20-8 she had the following balances on her books.

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

Enter the above balances in the appropriate accounts on 1 February 20-8.

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The following transactions took place during the month of February 20-8.

February	3	Sold goods, $300, on credit to Srivastava
	7	Srivastava returned faulty goods, $50
	11	Purchased goods, $390, paying by cheque Paid $10 by cheque for carriage on goods purchased
	15	Cash sales, $610, of which $600 was paid into the bank
	19	Srivastava paid the amount owing on 1 February by cheque, after deducting 3% cash discount
	21	Paid general expenses, $75, in cash
	23	Paid Ahmed a cheque for the amount due, less a cash discount of 2½%
	25	Sublet part of the premises and received $400 rent in cash
	27	Paid $15 by cheque for repairs to fixtures
	28	Paid all the cash into the bank except $100

Enter the above transactions in the books of Kalpana.

Balance the cash book and the personal accounts on 28 February.

Transfer the totals of the discount columns to the nominal ledger on 28 February.

Draw up a trial balance at 28 February 20-8.

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Chapter 5 Petty Cash Books

In this chapter you will learn to:

- understand the purpose of a petty cash book
- understand the imprest system of petty cash
- prepare a petty cash book
- post transactions to and from a petty cash book.

Introduction

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

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

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

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

When a member of staff wishes to obtain some petty cash he/she should present the petty cashier with a completed **petty cash voucher**.

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This should show the purpose for which the money is required, the date and the signature of the person receiving the cash. At regular intervals the petty cashier should check these vouchers against the total cash spent.

Test your understanding

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

The Imprest System

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

Under this system the chief cashier is aware of exactly how much petty cash has been spent in each period. The amount of the imprest can be adjusted as necessary if it is too much or not enough.

Test your understanding

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

The Layout of a Petty Cash Book

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

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The number of columns and the main types of expenses will be determined by each individual business. In examinations, guidance is given regarding the columns required.

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

Petty Cash Book

Dr | Cr

Date	*Details*	*Folio*	*Total Received* $	*Date*	*Details*	*Vo. No.*	*Total Paid* $	*Analysis Columns*		
								$	$	$

"Vo. No." is the abbreviation for "voucher number"

Preparation of a Petty Cash Book

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

During the period

1. Money received

(a) Debit the total received column with any money received from the chief cashier.
Insert the word "cash" or "bank" in the details column.

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

2. Money paid

Credit the total paid column with any money paid out and also enter the amount in the analysis column for that particular expense.

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A brief description of the reason for the payment should be entered in the details column.

At the end of the period

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

Example 5.1

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

20-1			$	Voucher Number
November	1	Balance	150	
	5	Paid window cleaner	10	1
	8	Bought pens and pencils	4	2
	14	Paid H Singh, a creditor	20	3
	17	Paid taxi fare	9	4
	21	Bought computer paper	7	5
	25	Paid bus fares	3	6

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(a) & (b)

Maitreyi
Petty Cash Book

Page 1

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

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27	Paid A Sharma, a creditor	32	7
29	Paid office cleaner	30	8

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

(c)

Maitreyi

Nominal Ledger

Cleaning account **Page 11**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-1 Nov 30	Petty cash	pcb1	40				

Stationery account **Page 17**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-1 Nov 30	Petty cash	pcb1	11				

Travel expenses account **Page 24**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-1 Nov 30	Petty cash	pcb1	12				

Purchases Ledger

H Singh account **Page 73**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-1 Nov 14	Petty cash	pcb1	20				

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A Sharma account **Page 69**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-1 Nov 27	Petty cash	pcb1	32				

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

Test your understanding

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

Points to Remember

1. A petty cash book is used to record small cash payments (and occasionally small cash receipts).
2. The imprest system of petty cash means that the petty cashier starts each period with the same amount.
3. A petty cash book is a book of prime entry and also a ledger account.
4. The totals of the analysis columns are posted to the appropriate nominal ledger accounts at the end of each period.
5. Any payments to trade creditors are posted individually to purchase ledger account of the creditor to whom the payment was made.

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Review Questions

*1. Mel Rose is a sole trader who keeps a petty cash book on the imprest system. The book has four analysis columns - stationery, postage, travel, and cleaning. The imprest amount is $100. Mel's transactions for the month of March 2002 were as follows.

			$
March	1	Balance of cash	100
	3	Travelling expenses	10
	6	Office expenses	12
	10	Postages	5
	14	Cleaner's wages	20
	17	Envelopes	3
	22	Bus fares	6
	25	Postages	4
	28	Cleaner's wages	20

(a) Write up Mel's petty cash book to record her transactions for the month of March 2002.

(b) Balance the petty cash book on 31 March 2002 and bring down the balance.

(c) Make the entry on 1 April 2002 to restore the petty cash imprest amount. **[IGCSE 2002]**

2. John Paihia, a trader, maintains a petty cash book using the imprest system.

Required

(a) Explain what is meant by the imprest system in relation to petty cash books.

John Paihia's imprest amount is $300. His transactions for the month of September 2007 were as follows:

			$
Sept	1	Balance brought down	48
		Petty cash restored to imprest amount	?
	6	Bought postage stamps	15
	11	Paid to Paul Ahipara, a creditor	95

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19	Paid cleaner	24
23	Paid travelling expenses	9
25	Bought office stationery	72
29	Received cash refund from stationery supplier for overcharge	6

Required

(b) Enter the above transactions in John Paihia's petty cash book. The book should have four analysis columns – postages and stationery, travelling expenses, cleaning and ledger accounts.

Balance the book on 30 September 2007 and carry down the balance.

Make the entry on 1 October 2007 to restore the petty cash to the imprest amount.

(c) Explain to John Paihia how the double entry is completed for the items recorded in the analysis columns of the petty cash book.

[IGCSE 2007]

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

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

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

(a) Write up Raminder's petty cash book for May. Use analysis columns for postages, cleaning, stationery, and refreshments. Total and balance the book on 31 May.

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(b) (i) State **one** reason why a business may operate a petty cash book.
(ii) State **one** advantage of operating the imprest system of petty cash.

4. Philo is in business and keeps his petty cash on the imprest system with a balance of $200.
On 31 March 2009 there was $129 in the petty cash box and on 1 April 2009 Philo's cashier made a transfer from the business bank account to restore the imprest balance. All the petty cash vouchers for March related to expenses incurred in that month.

Required

(a) What were the total expenses paid from petty cash in the month of March 2009?

When the cash was counted on 30 April 2009, there was $117.50 in the petty cash box and the following petty cash vouchers were found.

			$
April	5	Postage stamps	20.00
	10	Refreshments	17.00
	13	Menon – loan	100.00
	17	Flowers for office	21.00
	24	Stationery	14.40

Menon had repaid his loan in cash on 29 April.

Required

(b) What were the total expenses paid from petty cash in the month of April 2009?
(c) Calculate the amount of cash which **should** be in the petty cash box on 30 April.
(d) Suggest **two** reasons for the difference in the actual amount of cash in the petty cash box and the amount which should be there.

The petty cashier remembered a further petty cash payment of $10 was made on 28 April for cleaning the office windows.

Required

(e) Advise Philo's petty cashier about the importance of keeping a record of business expenditure.

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(f) Make the necessary entries for the month of April in the petty cash book. The book should have five analysis columns – postages and stationery, refreshments, flowers, cleaning, and other payments.

Balance the book and carry down the balance. Show the entry on 1 May to restore the imprest balance to the correct amount.

[IGCSE 2009]

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

She provides the following information.

Date		*Detail*	*Amount*	
20-9			$	
Feb	21	Balance at bank	3120	
		Petty cash imprest	50	
	22	Paid South West Traders	721	to settle an account of $750
	24	Received cheques:		
		Janpath Stores	410	to settle an account of $425
		AB Trading	220	
	26	Paid:		
		Window cleaner	7	
		Speedy Motors	85	
		Petrol	11	
	27	Paid:		
		Refreshments	5	
		Ghandi Stores	12	

(a) Write up the petty cash book for the week ending 28 February 20-9. Use analysis columns for refreshments, cleaning, motor expenses, and ledger accounts.
Balance the book on 27 February 20-9 and restore the imprest on 28 February 20-9.

(b) Write up the cash book for the week ending 28 February 20-9. Balance the book at 28 February 20-9 (after the restoration of the petty cash imprest).

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Chapter 6 Business Documents

In this chapter you will learn to:

- recognise and understand the use of business documents
- understand trade discounts.

Introduction

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

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

Invoice

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

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

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

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

Test your understanding

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

Example 6.1

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

INVOICE			**Invoice No. I 3624**
The Weaving Shed 14 Industrial Street Hightown Telephone 111 01357			
Sew and Sew 92 The Avenue Lowtown			3 April 20-9
Quantity	**Description**	**Unit Price $**	**Amount $**
30 metres 10 metres	Brocade fabric Design: B320 Colour: Crimson Polycotton fabric Design:P21 Colour: Lemon Less 20% Trade discount Terms: 2½% cash discount if account paid by 31 May 20-9	15 6	450 00 60 00 510 00 102 00 408 00

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

Test your understanding

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

Debit Note

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

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

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

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

Example 6.2

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

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DEBIT NOTE		**Debit Note Number 29**
Sew and Sew **92 The Avenue** **Lowtown**		
The Weaving Shed 14 Industrial Street Hightown		6 April 20-9
The following goods have been returned:		
	Price $	**Amount $**
10 Metres Polycotton Fabric Design P21 Colour Lemon	6	60 00
Less 20% Trade Discount		12 00
		48 00
Reason for return – Wrong colour supplied		
Please issue a Credit Note		

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

Test your understanding

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

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

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Credit Note

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

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

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

Example 6.3

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

Credit Note
C 529

CREDIT NOTE

The Weaving Shed
14 Industrial Street
Hightown
Telephone 111 01357

Sew and Sew
92 The Avenue
Lowtown

9 April 20-9

Quantity	Description	Unit Price $	Amount $
10 metres	Polycotton fabric Design: P21 Colour: Lemon	6	60 00
	Less 20% Trade discount		12 00
			48 00
	Reason for issue of credit note: Wrong colour supplied		

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

Test your understanding

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

Statement of Account

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

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

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Example 6.4

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

STATEMENT OF ACCOUNT				
The Weaving Shed 14 Industrial Street Hightown Telephone 111 01357				
Sew and Sew 92 The Avenue Lowtown				30 April 20-9
Date	**Reference**	**Debit $**	**Credit $**	**Balance $**
20-9				
April 3	Invoice Number I 3624	408 00		408 00
9	Credit Note Number C529		48 00	360 00
The last amount shown in the balance column is the amount due. Terms: 2½% cash discount if account is paid by 31 May 20-9.				

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

Test your understanding

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

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Cheque

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

Example 6.5

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

The ABC Bank Limited South District Branch Delhi

Cheque counterfoil	Actual cheque		
Date *28th May 20-9*			Date *28th May 20-9*
Payee *The Weaving Shed*	**Pay** *The Weaving Shed* *Three hundred & Fifty one dollars only*		*$ 351--00*
$351-00			*S. Dhoni* **Trading as Sew and Sew**
Cheque No **00039**	**Cheque No** **00039**	**Branch Sort Code** **05 22 30**	**Account No** **3996829**

Cheque counterfoil

Actual cheque

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

Receipt

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

Example 6.6

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

RECEIPT		Receipt No. 44
The Weaving Shed 14 Industrial Street Hightown		
Received from Sew and Sew the sum of $351 (three hundred and fifty one dollars) by cheque		
30 May 20-9	*K Singh*	Chief cashier

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Points to Remember

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

Review Questions

1. Give a description of the purpose of **each** of the following business documents.
   (a) invoice (b) statement of account
   (c) credit note (d) receipt

*2. (a) Zak is a trader.
   Arrange the following business documents in the order they would be issued by Zak to a credit customer.
   Statement of account: Credit note Receipt Invoice
   (b) Explain why a credit customer may send a debit note to Zak.
   (c) Give **four** items of information you would expect to find on a statement of account.

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(d) On 1 August 2007 Zak made a sale on credit to Sasha of 170 pencils at $0.85 each.
Complete the following invoice for the sale to Sasha using the information given above.

Zak Trading

Date

Quantity	Price $	Amount $

Terms: 2.5% for settlement within 14 days

(e) Zak received payment by cheque from Sasha on 12 August.
Show the entries to be made in Zak's cash book to record the payment of the invoice.

(f) Zak allows trade discount of 5% for orders of more than 200 pencils. Sasha orders 250 pencils.

(i) State the amount of the trade discount given by Zak on this order.

(ii) State the net amount of the invoice for this order.

(iii) Sasha pays this invoice within 14 days. Calculate the amount of cash discount to be allowed.

[Based on IGCSE 2007]

3. Agrotech sells farming equipment and supplies on credit. A new customer, Chalk Farm, has recently been supplied with goods shown on the invoice as follows:

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AGROTECH
INVOICE

Unit 2
Downyer Way
Midtown

Invoice No: 0/5721
Date: 6 April 2002

DESCRIPTION	QUANTITY	PRICE $		TOTAL $
Sacks of Groquick fertiliser	50 sacks	$20 per sack	(i)	
Tractor tyres (type B/6)	4	$125 each		500
	Total goods		(ii)	
	20% trade discount		(iii)	
	INVOICE TOTAL (NET GOODS)		(iv)	

Chalk Farm
Springfield
OXTON
Terms: 3% for settlement within one month

(a) Calculate the missing amounts at (i), (ii), (iii) and (iv) on the invoice.

(b) When the goods were delivered, one tractor tyre was found to be faulty. Agrotech could not replace the tyre and issued a credit note to Chalk Farm on 17 April 2002.
Calculate the net amount shown on the credit note issued by Agrotech to Chalk Farm. Show your workings.

(c) Chalk Farm paid the amount due to Agrotech from these transactions by cheque on 24 April, deducting cash discount of 3%.
Write up the ledger account of Agrotech in Chalk Farms books from the above information.

[IGCSE 2002]

4. On 2 May 2000 Marianne Jones received the document shown below from her supplier, Zen Wholesale.

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ZEN WHOLESALE

Riverside Warehouse
New Street
South Town

Tel. 0796 151023

Date	*Details*		*Dr* $	*Cr* $	*Balance* $
2000					
April 1	Balance	b/f	1 000		1 000 Dr
12	Sales		300		1 300 Dr
19	Sales returns			50	1 250 Dr
30	Bank			975	
	Discount			25	

Ms M Jones
High Street
South Town

A/c No: J/2657
Date: 30 April 2000

(a) Name the above document.
(b) Calculate the balance due from Marianne to Zen Wholesale on 30 April 2000. Show your workings.
(c) (i) For the transactions on 12 and 19 April, insert the names of the documents sent by Zen Wholesale to Marianne in the following sentences.
1 12 April Zen Wholesale sent .... to Marianne.
2 19 April Zen Wholesale sent .... to Marianne.
(ii) Complete the boxes below to show the ledger account entries recording the transactions on 12 and 19 April in the books of Zen Wholesale.

Date of transaction	*Ledger account to be debited (dr)*		*Ledger account to be credited (cr)*	
2000	Account name	Amount $	Account name	Amount $
12 April	....	....	....	....
19 April	....	....	....	....

(iii) Calculate the percentage rate of the discount allowed to Marianne on 24 April. Show your workings.

[IGCSE 2000]

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*5. Pieter Burg is in business and buys goods from the General Supply Company. He received the following invoice from them.

	GENERAL SUPPLY COMPANY		
	SALES INVOICE		
Pieter Burg			25 September 2005
Quantity	Description	Unit Price	$
(i)	Bolt fastenings	$0.40	1200 00
1000	Grommets	$0.10	(ii)
	Total		(iii)
Terms: 3%	(iv)	for payment within 14 days of invoice	

(a) Write down the missing words or figures from the invoice.
(i) .... (ii) ....
(iii) .... (iv) ....

Pieter had previously bought goods for $2500 from the General Supply Company on 28 August, and this amount was unpaid at 31 August.
Pieter paid this amount on 5 September. He did not pay the September invoice until 30 October.
An extract from the payments side of Pieter's cash book is shown below.

Date	*Details*	*Discount received* $	*Bank* $
5 Sept	General Supply Co.	(i)	(ii)
30 Oct	General Supply Co.	(i)	(ii)

(b) Write down the amounts missing from the cash book.
(i) .... (ii) ....
(iii) .... (iv) ....

(c) From the information in (a) and (b) show the entries in the General Supply Company's account in Pieter Burg's purchases ledger for the months of September and October 2005.

[IGCSE 2005]

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Chapter 7 Books of Prime Entry

In this chapter you will learn to:

- enter sales, purchases and returns of goods in the books of prime entry
- post entries relating to sales, purchases and returns of goods from the books of prime entry to ledger accounts.

Introduction

In Chapter 4 it was explained how the ledger is divided into specialist areas and how the cash and the bank account are usually maintained in a cash book rather than in the ledger. Businesses use **books of prime entry** to record goods sold on credit, goods purchased on credit, sales returns and purchases returns. These books are basically listing devices, which mean that a lot of detail is removed from the ledger. It also means that bookkeeping can be divided between several people.

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

The books of prime entry are:

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

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The cash book and the petty cash book have already been explained in Chapters 4 and 5. The uses of the journal will be explained in Chapter 15. This Chapter concentrates on the sales, purchases and returns journals.

Sales Journal

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

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

1. When goods are sold on credit

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

2. At the end of the month

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

Sales Returns Journal

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

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

1. When goods are returned by a credit customer

- Enter the date, name of the customer and total of the credit note in the sales returns journal.

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- Credit the customer's account in the sales ledger with the total of the credit note.

2. At the end of the month

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

Test your understanding

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

Example 7.1

20-9		
April	3	The Weaving Shed issued an invoice to Sew and Sew for goods, \$510, subject to a trade discount of 20%
	9	The Weaving Shed issued a credit note to Sew and Sew for goods returned, list price \$60
	13	The Weaving Shed sold goods on credit to Fine Furnishings, \$1000, subject to a trade discount of 25%, and issued an invoice on the same day
	20	The Weaving Shed sent Jaffar & Company an invoice for \$220 for goods supplied on credit
	28	The Weaving Shed issued a credit note to Jaffar & Company for \$10 because of an overcharge

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

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The Weaving Shed

Sales Journal **Page 1**

Date	*Name*	*Invoice Number*	*Folio*	*Amount $*
20-9				
April 3	Sew and Sew	I 3624	sl 22	408
13	Fine Furnishings	I 3625	sl 14	750
20	Jaffar & Company	I 3626	sl 16	220
30	Transfer to sales account		nl 35	1 378

Sales Returns Journal **Page 1**

Date	*Name*	*Credit Note Number*	*Folio*	*Amount $*
20-9				
April 9	Sew and Sew	C 529	sl 22	48
28	Jaffar & Company	C 530	sl 16	10
30	Transfer to sales returns account		nl 36	58

Sales Ledger

Sew and Sew account **Page 22**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-9				20-9			
Apl 3	Sales	sj 1	408	Apl 9	Sales returns	srj 1	48

Fine Furnishings account **Page 14**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-9							
Apl 13	Sales	sj 1	750				

Jaffar & Company account **Page 16**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-9				20-9			
Apl 20	Sales	sj 1	220	Apl 28	Sales returns	srj 1	10

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Nominal Ledger

Sales account **Page 35**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
				20-9 Apl 30	Credit sales for month	sj 1	1 378

Sales returns account **Page 36**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-9 Apl 30	Returns for month	srj 1	58				

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

Purchases Journal

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

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

1. When goods are purchased on credit

- Enter the date, name of the supplier and the total of the invoice in the purchases journal.

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- Credit the supplier's account in the purchases ledger with the total of the invoice.

2. At the end of the month

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

Purchases Returns Journal

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

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

1. When goods are returned to a credit supplier

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

2. At the end of the month

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

Test your understanding

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

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Example 7.2

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

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

Sew and Sew

Purchases Journal — **Page 1**

Date	*Name*	*Invoice Number*	*Folio*	*Amount $*
20-9				
April 3	The Weaving Shed	I 3624	pl 8	408
24	The Curtain Company	I 117	pl 5	238
30	Transfer to purchases account		nl 4	646

Purchases Returns Journal — **Page 1**

Date	*Name*	*Credit Note Number*	*Folio*	*Amount $*
20-9				
April 9	The Weaving Shed	C 529	pl 8	48
29	The Curtain Company	C 43	pl 5	119
30	Transfer to purchases returns account		nl 5	167

Purchases Ledger

The Weaving Shed account — **Page 8**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-9				20-9			
Apl 9	Purchases returns	prj 1	48	Apl 3	Purchases	pj 1	408

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The Curtain Company account **Page 5**

Date	Details	Folio	$	Date	Details	Folio	$
20-9				20-9			
Apl 29	Purchases returns	prj 1	119	Apl 24	Purchases	pj 1	238

Nominal Ledger

Purchases account **Page 4**

Date	Details	Folio	$	Date	Details	Folio	$
20-9							
Apl 30	Credit purchases for month	pj 1	646				

Purchases returns account **Page 5**

Date	Details	Folio	$	Date	Details	Folio	$
				20-9			
				Apl 30	Returns for month	prj 1	167

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

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Points to Remember

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

Review Questions

1. Ombeya sells musical instruments. In September he had the following transactions.

Date		*Details*	*Reference*	*Amount ($)*
September	4	Sale to Hales Orchestra	INV23	1200
	15	Sale to Sing Song Band	INV24	450
	17	Returns from Hales Orchestra	RT7	300
	28	Sale to Town School	INV25	700

Required

(a) Show the entries to be made for September in Ombeya's sales journal and sales returns journal.

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(b) Using the information in Ombeya's sales journal and sales returns journal, write up the following accounts in his ledger for September.
   (i) Sales account
   (ii) Sales returns account
   (iii) Hales Orchestra account
   (iv) Sing Song Band account
   (v) Town School account

[IGCSE 2008]

*2. Redd keeps full accounting records and makes up his final accounts to 31 March each year.
The following are extracts from his accounting records for March 2005.

Purchases Journal

			$
5	March	Block	320
17	March	Quayle	500
29	March	Block	270

Purchases Returns Journal

			$
8	March	Block	100

Cash Book (Cr)

			Discount Received	Bank
			$	$
30	March	Block		220
30	March	Quayle	15	485

Required

Write up the accounts of Block and Quayle in Redd's purchases ledger for the month of March 2005, showing any balances carried and brought down.

[IGCSE 2005]

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3. Ahmed is a sole trader who keeps full accounting records for all his purchases and sales on credit. Entries are posted monthly from prime (original) entry books to ledger accounts, but the entries for April 2004 have not yet been made.
   (a) The following information is provided.

	Total for April 2004
	$
Purchases journal	50 000
Sales journal	85 000
Purchases returns journal	6 000
Sales returns journal	8 000

   Make the entries required on 30 April 2004 in the following ledger accounts:

   Purchases account
   Purchases returns account
   Sales account
   Sales returns account

   (b) In which of Ahmed's ledgers are the above accounts kept?

[IGCSE 2004]

*4. On 1 September 2001 Joseph sold goods on credit to Billy Jones, a new customer, for $1000.
   On 10 September 2001, Billy Jones returned $200 worth of the goods as they were badly damaged. Joseph could not replace the goods so he made an allowance to Billy for their cost.
   (a) Complete the boxes below to show **in Billy's books**:
   (i) the names of the business documents
   (ii) the books of prime entry

   used to record the above transactions.

Date	*Transaction*	(i) *Business document used by Billy*	(ii) *Billy's prime entry book*
2001			
1 September	Goods bought	....	....
10 September	Goods returned	....	....

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(b) On 25 September 2001 Billy paid Joseph the amount he owed for the above transactions, claiming cash discount of 2½%.
How much did Billy pay? Show your workings.

(c) Joseph's records for the month of September 2001 include the following

	$
Total of sales journal	15 000
Total of sales returns journal	1 800

Complete the following sentences to show how these totals are recorded in Joseph's ledger accounts.

1. The total of the sales journal is posted to the ……………. side of the ………… account.
2. The total of the sales returns journal is posted to the ……………. side of the …………….. account.

(d) Using the information in (a) and (b), write up the ledger account of Billy Jones as it would appear **in Joseph's ledger**.

[IGCSE 2001]

5. Shilpa Bassra is a trader who keeps a full set of accounting records. She divides her ledger into three specialist areas – nominal ledger, purchases ledger and sales ledger.

Required

(a) State **one** advantage of dividing the ledger into these three areas.

Shilpa Bassra's books of prime entry show the following transactions for March 2007.

Purchases Journal

2007		$	$
March 8	Omar El Gamal		
	Goods		440
21	Mohammed El Wakil		
	Goods	380	
	Trade discount	76	304
31	Total for month		744

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Purchases Returns Journal

2007		$	$
March 24	Mohammed El Wakil		
	Goods	160	
	Trade discount	32	128
31	Total for month		128

Cash Book (credit side)

		Discount Received	Cash	Bank
2007		$	$	$
March 19	Omar El Gamal	11		429
26	Mohammed El Wakil		110	
31	Cash purchases for month			990

Required

(b) Write up the accounts of Omar El Gamal and Mohammed El Wakil as they would appear in Shilpa Bassra's purchases ledger for the month of March 2007. There were no balances on these accounts on 1 March 2007.

(c) Write up the purchases account and the purchases returns account as they would appear in Shilpa Bassra's nominal ledger for the month of March 2007.

[IGCSE 2007]

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Chapter 8 Financial Statements – Part A

In this chapter you will learn to:

- prepare the trading account section of an income statement and understand its purpose
- prepare the profit and loss account section of an income statement of a trading business and understand its purpose
- close ledger accounts by transfer to the income statement
- make transfers to, and balance the capital account at the end of the financial year
- prepare an income statement of a service business and understand its purpose

Introduction

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

1. An **income statement** which consists of two sections:
   A **trading account** in which the **gross profit** of the business is calculated
   A **profit and loss account** in which the **profit for the year**, the **net profit**, of the business is calculated.

   The trading account and the profit and loss account are both part of the double entry system.
2. A **balance sheet** which shows the **financial position** of the business at a certain date. The balance sheet is not part of the double entry system.

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

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

Example 8.1

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

This trial balance will be used in **Example 8.2** to **Example 8.7**.

Samir
Trial Balance at 31 May 20-8

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

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Notes
1. The inventory at 31 May 20-8 was valued at $7600.
2. During the year ended 31 May 20-8, Samir took goods costing $300 for his own use. No entries have been made in the accounting records.

Trading Account Section of the Income Statement

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

Gross profit	=	Selling price of goods	–	Cost of sales

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

Cost of sales	=	Opening inventory	+	Purchases	–	Closing inventory

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

Net purchase	=	Purchases	–	Purchases returns	+	Carriage inwards	–	Goods for own use

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

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Test your understanding

1. State what is calculated in
   (a) a trading account
   (b) a profit and loss account
2. State the formula for calculating gross profit.
3. State the formula for calculating cost of sales.

There are two ways in which a trading account can be prepared – **horizontal** and **vertical**.

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

Example 8.2

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

Samir
Income Statement (Trading Account Section) for the year ended 31 May 20-8

	$	$		$	$
Opening inventory		7 100	Revenue (Sales)	95 700	
Purchases	65 000		Less Sales returns	1 000	94 700
Less Purchases returns	500				
	64 500				
Less Goods for own use	300				
	64 200				
Carriage inwards	1 500	65 700			
		72 800			
Less Closing inventory		7 600			
Cost of sales		65 200			
Gross profit c/d		29 500			
		94 700			94 700

- As the above items are entered in the trading account, they should be ticked-off in the trial balance and accompanying notes.

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- The gross profit is carried down to the profit and loss account (see later in this Chapter).
- The term **revenue** is often used instead of **sales** in a trial balance and in an income statement.

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

Example 8.3

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

Samir
Income Statement (Trading Account Section) for the year ended 31 May 20-8

	$	$	$
Revenue (Sales)		95 700	
Less Sales returns		1 000	94 700
Less Cost of sales			
Opening inventory		7 100	
Purchases	65 000		
Less Purchases returns	500		
	64 500		
Less Goods for own use	300		
	64 200		
Carriage inwards	1 500	65 700	
		72 800	
Less Closing inventory		7 600	65 200
Gross profit			29 500

Profit and Loss Account Section of the Income Statement

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

$$\boxed{\text{Net profit}} = \boxed{\text{Gross profit}} + \boxed{\text{Other income}} - \boxed{\text{Expenses}}$$

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

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

Example 8.4

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

Samir
Income Statement (Profit and Loss Account Section)
for the year ended 31 May 20-8

	$	$		$	$
Discount allowed		900	Gross profit b/d		29 500
Wages		11 200	Discount received		400
General expenses		2 800			
Property tax		600			
Loan interest		500			
Profit for the year (net profit)		13 900			
		29 900			29 900

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

A profit and loss account can also be prepared using the vertical format. This format is used by most businesses. As with a vertical trading account, the vertical profit and loss account looks like an arithmetic calculation.

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Example 8.4

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

Samir
Income Statement (Profit and Loss Account Section)
for the year ended 31 May 20-8

	$	$	$
Gross profit			29 500
Add Discount received			400
			29 900
Less Discount allowed		900	
Wages		11 200	
General expenses		2 800	
Property tax		600	
Loan interest		500	16 000
Profit for the year (net profit)			13 900

Test your understanding

1. List **six** business expenses (excluding those shown in the above examples).
2. State the formula for calculating net profit.

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

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

Example 8.5

Using either the trial balance and accompanying notes shown in **Example 8.1** or the separate sections of the income statement prepared in

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Examples 8.3 and 8.4, prepare the income statement of Samir for the year ended 31 May 20-8.

Samir
Income Statement for the year ended 31 May 20-8

	$	$	$
Revenue (sales)		95 700	
Less Sales returns		1 000	94 700
Less Cost of sales			
Opening inventory		7 100	
Purchases	65 000		
Less Purchases returns	500		
	64 500		
Less Goods for own use	300		
	64 200		
Carriage inwards	1 500	65 700	
		72 800	
Less Closing inventory		7 600	65 200
Gross profit			29 500
Add Discount received			400
			29 900
Less Discount allowed		900	
Wages		11 200	
General expenses		2 800	
Property tax		600	
Loan interest		500	16 000
Profit for the year			13 900

• "Profit for the year" is often used in place of "Net profit".

Transferring Ledger Account Totals to the Income Statement

Anything appearing in the income statement must have a double entry in another account. Anything credited to the income statement must be debited in the appropriate ledger account: anything debited to the income statement must be credited in the appropriate ledger account.

When something is deducted from a debit item in the income statement this is equal to a credit entry, so a debit entry is required in the ledger. In the same way, when something is deducted from a credit item in the income statement this is equal to a debit entry, so a credit entry is required in the ledger.

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Example 8.6

Using the income statement prepared for Samir in the previous example, prepare the following ledger accounts to show how **each** is closed by transfer to the income statement:

(a) purchases account
(b) purchases returns account
(c) discount received account
(d) wages account

Samir
Nominal Ledger

(a) **Purchases account**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-8			
May 31	Total to date		65 000	May 31	Income statement		65 000
			65 000				65 000

(b) **Purchases returns account**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-8			
May 31	Income statement		500	May 31	Total to date		500
			500				500

(c) **Discount received account**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-8			
May 31	Income statement		400	May 31	Total to date		400
			400				400

(d) **Wages account**

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-8			
May 31	Total to date		11 200	May 31	Income statement		11 200
			11 200				11 200

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

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

Example 8.7

Using the income statement prepared for Samir in a previous example, prepare the inventory account in Samir's ledger on 31 May 20-8.

Samir
Nominal Ledger
Inventory account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-8			
June 1	Balance	b/d	7 100	May 31	Income statement		7 100
			7 100				7 100
20-8							
May 31	Income statement		7 600				

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- The entry of $7600 on the debit side representing the inventory at the end of the financial year on 31 May 20-8 becomes the opening inventory for the year beginning 1 June 20-8.

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

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

Example 8.8

On 1 June 20-7 the credit balance on Samir's capital account was $90 000. For the year ended 31 May 20-8 his drawings were $9000 and his profit for the year was $13 900.

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

Samir
Nominal Ledger
Capital account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-7			
May 31	Drawings		9 000	June 1	Balance	b/d	90 000
	Balance	c/d	94 900	20-8			
				May 31	Profit		13 900
			103 900				103 900
				20-8			
				June 1	Balance	b/d	94 900

Drawings account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-8			
May 31	Total to date		9 000	May 31	Capital		9 000
			9 000				9 000

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Test your understanding

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

Income Statement of a Service Business

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

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

Example 8.9

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

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

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

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Anita
Income Statement for the year ended 30 September 20-5

	$	$		$	$
Property tax		6 400	Commissions received		92 150
General expenses		8 950	Rent received		7 300
Insurance		2 670			
Printing and stationery		4 560			
Loan interest		1 500			
Wages		43 500			
Profit for the year		31 870			
		99 450			99 450

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

Anita
Income Statement for the year ended 30 September 20-5

	$	$	$
Commissions received			92 150
Add Rent received			7 300
			99 450
Less Property tax		6 400	
General expenses		8 950	
Insurance		2 670	
Printing and stationery		4 560	
Loan interest		1 500	
Wages		43 500	67 580
Profit for the year			31 870

Points to Remember

1. The difference between the selling price and the cost price is known as the gross profit. This is calculated in the trading account section of the income statement.
2. The difference between the gross profit plus other income less expenses is known as the net profit. This is calculated in the profit and loss account section of the income statement.
3. All the items appearing in the income statement are transferred from the ledger accounts to complete the double entry.

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4. A profit for the year is transferred to the credit of the capital account and a loss for the year is transferred to the debit of the capital account.
5. A business which provides a service only prepares the profit and loss account section of the income statement.

Review Questions

1. Martha Adebuyo owns a retail shop. Her financial year ends on 31 August. Her income statement for the year ended 31 August 2004 is shown below. Some words and figures are missing.
   In **each** of the boxes **(i)** to **(vii)** enter the missing word(s) or figure.

Income statement for the year ended
31 August 2004

	$	$	$
Revenue (sales)		106 000	
Less Sales returns	**(i)**	$\boxed{}$	100 000
Less Cost of goods sold			
Opening **(ii)** $\boxed{}$		12 000	
Purchases **(iii)**	$\boxed{}$		
Less Purchases returns	4 000		
	67 000		
Plus Carriage **(iv)** $\boxed{}$	5 000	72 000	
		84 000	
Less Closing inventory	**(v)**	$\boxed{}$	70 000
Gross profit			30 000
Add Rent **(vi)** $\boxed{}$			6 000
			36 000
Less Wages		14 000	
Insurance		3 000	
General expenses	**(vii)**	$\boxed{}$	
			24 000
Profit for the year			12 000

[IGCSE 2004]

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*2. Piyush is a financial adviser. He provided the following information on 31 October 20-6.

	$
Commissions earned	72 100
Interest received	2 900
Staff salaries	28 500
Rent	9 400
Postages and telephone expenses	5 700
Light and heat	1 100
Insurance	800
General expenses	3 500

Prepare Piyush's income statement for the year ended 31 October 20-6.

*3. Rani owns a retail store. For the year ended 31 December 20-9 she made a gross profit of $35 000. She provided the following information for that year.

	$
Drawings	17 000
Wages and salaries	23 000
Rent received from subletting	6 000
General expenses	13 500
Loan interest	1 000
Discount allowed	500
Discount received	870
Advertising	680
Property tax	1 240
Motor expenses	2 550

(a) Starting with the gross profit, prepare the profit and loss section of the income statement for the year ended 31 December 20-9.

(b) Prepare Rani's capital account as it would appear in her ledger for the year ended 31 December 20-9. On 1 January 20-9 her capital was $46 000.

4. (a) Explain the difference between:

(i) carriage inwards and carriage outwards

(ii) discount allowed and discount received

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The following accounts were drawn up for Jasper Cato, who has a furniture shop, by his bookkeeper who only had a limited knowledge of preparing final accounts.

Financial statements as at 30 September 2000

	$		$
Purchases	25 200	Reveneue (sales)	37 600
Inventory 1 October 1999	4 500	Returns outward	900
Inventory		Discount received	280
30 September 2000	6 000		
Profit on goods c/d	3 080		
	38 780		38 780
Carriage inwards	1 200	Profit on goods b/d	3 080
Returns inward	1 600	Discount allowed	160
Administration expenses	7 230	Carriage outwards	1 480
Sundry expenses	170	Loss for year c/d	5 480
	10 200		10 200
Loss for year b/d	5 480	Capital 1 October 1999	27 000
Capital left	21 520		
	27 000		27 000

(b) Redraft the income statement under the correct heading to show the correct gross profit (or loss) and the profit (or loss) for the year.

[IGCSE 2000]

5. Khalid earns fees and commissions from his insurance business. His capital account at 1 November 2008 showed $3000 credit.
A summary of the bank columns in his cash book for the year ended 31 October 2009 showed:

Details	Bank	Details	Bank
	$		$
Clients – fees received	12 000	Rent	9 600
Clients – commissions		Staff wages	8 800
received	32 000	Office expenses	6 400
		Motor expenses	3 600
		Drawings - Khalid	25 000

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Fees are invoiced when work is completed. Trade receivables for fees were:

	$
1 November 2008	2600
31 October 2009	4100

Required

(a) Calculate the fees earned by Khalid for the year ended 31 October 2009.

(b) From the information above and your answer to (a), prepare Khalid's income statement for the year ended 31 October 2009.

(c) Prepare Khalid's capital account for the year ended 31 October 2009 and bring down the balance at 1 November 2009.

(d) Suggest **two** ways in which Khalid might reduce or eliminate the deficit on his capital account.

[IGCSE 2009]

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Chapter 9 Financial Statements – Part B

In this chapter you will learn to:
- understand the purpose of a balance sheet
- recognise and understand the different types of assets
- recognise and understand the different types of liabilities
- prepare a balance sheet.

Introduction

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

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

Test your understanding
1. Define a balance sheet.
2. Explain the meaning of **each** of the following terms:
(a) asset
(b) liability

Some very elementary balance sheets were prepared in Chapter 1. However, it is usual to arrange the assets and liabilities into different groups according to their type.

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Assets

Assets are divided into two types. These are:

1. Non-current assets

These are long-term assets which are obtained for use rather than for resale. These assets help the business earn revenue.

Examples of non-current assets include land and buildings, machinery, fixtures and motors.

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

A typical order for showing non-current assets in a balance sheet is as follows:

Land and buildings
Machinery
Fixtures and equipment
Motor vehicles

2. Current assets

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

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

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

A typical order for showing current assets in a balance sheet is:

Inventory
Trade receivables
Bank
Cash

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Liabilities

Liabilities are divided into three types. These are:

1. Capital

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

2. Non-current liabilities

These are amounts owed by the business which are not due for repayment within the next 12 months.

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

3. Current liabilities

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

Examples of current liabilities include trade payables and bank overdraft.

Test your understanding

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

A balance sheet must have a heading which includes the date to which it relates. It is also usual to include the name under which the business trades.

There are two ways in which a balance sheet can be prepared – **horizontal** and **vertical**. A **horizontal** balance sheet is prepared in a two-sided format. It is usual for the assets to be listed on the left and the

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liabilities to be listed on the right (but it is equally correct to show the assets on the right and the liabilities on the left).

Example 9.1

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

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

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

Samir
Trial Balance at 31 May 20-8

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

Notes

✓ 1 The inventory at 31 May 20-8 was valued at $7600.

✓ 2 During the year ended 31 May 20-8 Samir took goods costing $300 for his own use. No entries have been made in the accounting records.

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

Example 9.2

Using the trial balance and accompanying notes shown in **Example 9.1**, prepare a balance sheet for Samir at 31 May 20-9. Use the horizontal format.

Samir
Balance Sheet at 31 May 20-9

	$	$		$	$
Non-current assets			**Capital**		
Premises		80 000	Opening balance		90 000
Fixtures & equipment		13 900	Plus Profit for the year		13 900
		93 900			103 900
Current assets			Less drawings		
			(9000 + 300)		9 300
Inventory	7 600				94 600
Trade receivables	7 500		**Non-current liabilities**		
Bank	3 300		Loan		10 000
Cash	100	18 500	**Current liabilities**		
			Trade payables		7 800
		112 400			112 400

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

If a balance sheet is prepared using the **vertical** format, the assets are listed (showing how the resources are used) and underneath them the

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liabilities are listed (showing where the resources have come from). It is also acceptable to list the liabilities first followed by the assets.

Example 9.3

Using the trial balance and accompanying notes shown in **Example 9.1**, prepare a balance sheet for Samir at 31 May 20-9. Use the vertical format.

Samir
Balance Sheet at 31 May 20-9

	$	$	$
Non-current assets			
Premises			80 000
Fixtures and equipment			13 900
			93 900
Current assets			
Inventory		7 600	
Trade receivables		7 500	
Bank		3 300	
Cash		100	
		18 500	
Current liabilities			
Trade payables		7 800	
Net current assets			10 700
			104 600
Non-current liabilities			
Loan			10 000
			94 600
Financed by			
Capital			
Opening balance			90 000
Plus Profit for the year			13 900
			103 900
Less Drawings (9000 + 300)			9 300
			94 600

- There is only one current liability so this has been shown in the centre column. If there had been more than one they would have been listed in the first column and the total shown in the centre column.
- The main advantage a vertical balance sheet has over a horizontal balance sheet is that it shows the figure for net current assets. This may also be called working capital. This is very important to a business. It will be explained in Chapter 24.

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- The non-current liability has been deducted in the first section of the balance sheet. Alternatively, it could have been added to the final balance of the capital account in the second section of the balance sheet.

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

Test your understanding

1. Explain the two ways in which a non-current liability may be shown in a vertical balance sheet.
2. State **one** advantage of preparing a balance sheet in vertical format.

Points to Remember

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

Review Questions

1. Bonnie Clyde makes parts for cars and her financial year ends on 31 March. After preparing her income statement for the year ended 31 March 2005, her trial balance shows the following items.

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	$	
Bank	500	Dr
Bank loan repayable 2008	2 800	
Trade payables	700	
Machinery	8 000	
Inventory	3 000	
Drawings	4 500	
Capital account at 1 April 2004	6 000	
Profit for the year	7 500	
Trade receivables	1 000	

Prepare Bonnie's balance sheet at 31 March 2005.

[Based on IGCSE 2005]

2. The balance sheet of Amy Dootes is given below with some words and figures missing.
   Enter the missing words and figures in the boxes **(i)** to **(vi)** on the balance sheet.

Balance Sheet at 31 March 2004

	$	$	$
Non-current assets			50 000
Current **(i)** [ ]			
Inventory	24 000		
Trade receivables	8 000		
Bank **(ii)**	[ ]		
		40 000	
Less Current liabilities			
Trade [ ] **(iii)**	16 000		
Short-term loan	4 000	20 000	
Working [ ] **(iv)**			20 000
			70 000
Financed by			
Capital at 1 April 2003			60 000
Add Profit for the year		**(v)**	[ ]
			80 000
Less [ ] **(vi)** for the year			10 000
			70 000

[Based on IGCSE 2004]

3. Morgan is in business as a printer. He has prepared the following trial balance (after calculating his profit for the year) from his accounting records for the year ended 31 August 2006.

Morgan
Trial Balance at 31 August 2006

	$	$
Machinery	5 600	
Office equipment	1 500	
Bank		2 200
Cash	200	
Trade payables		2 100
Trade receivables	4 100	
Loan from Nicola repayable 2011		5 000
Inventory 31 August 2006	3 900	
Capital		9 000
Drawings	21 000	
Profit for the year		18 000
	36 300	36 300

(a) Prepare Morgan's balance sheet at 31 August 2006.

(b) Morgan's business has a bank overdraft at 31 August 2006. Suggest **one** way in which he could reduce or eliminate the overdraft.

(c) Nicola has given Morgan an additional long term loan of $2000 paid into the bank on 1 September 2006.
In the table below, place a tick (P) under the correct heading to indicate the effect of the additional loan on the following items in Morgan's balance sheet:

Effect of additional loan

	Increase	*Decrease*	*No effect*
(i) Bank overdraft			
(ii) Loan account			
(iii) Net current assets			
(iv) Profit for the year			
(v) Capital			

[Based on IGCSE 2006]

*4. Prepare an income statement for the month ended 30 November 20-7 and a balance sheet at 30 November 20-7 from the following trial balance of Y Singh.

	Dr		Cr
	$		$
Inventory 1 December 20-7	1 184	Revenue (sales)	9 300
Purchases	5 937	Purchases returns	161
Sales returns	103	Trade payables	866
Carriage inwards	100	Capital	7 320
Carriage outwards	160		
Wages	1 933		
Rent and insurance	235		
Motor vehicle expenses	440		
General expenses	240		
Equipment	3 500		
Motor vehicle	2 975		
Bank	240		
Drawings	600		
	17 647		17 647

The inventory at 31 December 20-7 was valued at $980

*5. The following trial balance of Pathan Stores was drawn up after the preparation of the trading account section of the income statement for the year ended 31 December 20-1.

	Dr	Cr
	$	$
Gross profit		58 500
Wages	19 150	
Office expenses	1 300	
Rent and property tax	5 170	
Insurance	910	
Carriage outwards	4 270	
Motor expenses	7 770	
Sundry expenses	410	
Commission received		3 000
Inventory at 31 December 20-1	25 000	
Trade receivables	13 350	
Bank	9 400	
Cash	1 000	
Trade payables		8 430
Long-term loan from AB Finance		20 000
Machinery	20 000	
Motor vehicles	11 000	
Capital		38 800
Drawings	10 000	
	128 730	128 730

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(a) Prepare the profit and loss account section of the income statement of Pathan Stores for the year ended 31 December 20-1.

(b) Prepare the balance sheet of Pathan Stores at 31 December 20-1.

6. Abhinav is a trader.
Using the following information taken from Abhinav's books on 30 June 20-8, you are required to:
(a) Prepare a trial balance at 30 June 20-8
(b) Prepare an income statement for the year ended 30 June 20-8
(c) Prepare a balance sheet at 30 June 20-8

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

Inventory at 30 June 20-8 was valued at $20 100.

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Chapter 10 Accounting Rules

In this chapter you will learn to:

- understand the accounting rules which are applied in the preparation of accounting statements
- understand the ways in which the quality of information in accounting statements can be measured
- understand the difference between capital and revenue expenditure, and capital and revenue receipts
- understand the basis of inventory valuation and prepare simple inventory valuation statements.

Introduction

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

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

Test your understanding

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

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Accounting Principles

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

The main accounting principles are explained below.

Business Entity

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

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

The practical application of the principle of accounting entity has already been explained in the chapters on double entry bookkeeping and financial statements.

Duality

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

Money measurement

This accounting principle means that **only information which can be expressed in terms of money can be recorded in the accounting records**.

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Money is a recognised unit of measure and is a traditional way of valuing transactions. It does not rely on personal opinions and it is factual.

There are many aspects of a business which cannot be measured in terms of money and, therefore, do not appear in the accounting records. The morale of the workforce, the effectiveness of a good manager, the benefits of a staff training course all play an important part in the success of the business, but they will not appear in the accounting records as their value cannot be expressed in monetary terms. In a similar way, the launch of a rival product or increased competition cannot be recorded in the accounting records as their effects cannot be measured in monetary terms.

Test your understanding

1. Explain the meaning of the term business entity.
2. Explain how the principle of duality is carried out in recording the day-to-day transactions of a business.
3. No entry is made in the accounting records of Park Street Stores when a competitor reduces his prices by 15%. Explain why.

Realisation

This principle emphasises the importance of not recording a profit until it has actually been earned. This means that **profit is only regarded as being earned when the legal title to goods or services passes from the seller to the buyer**, who has then an obligation (liability) to pay for those goods.

When an order is placed by a customer no goods change hands, and no profit is earned. Profit is regarded as being realised when the goods actually change hands. This is the same even if the goods are sold on credit and the customer does not pay for them immediately.

Consistency

There are some areas of accounting where a choice of method is available. For example, there are several different ways to calculate the depreciation of a non-current asset (see Chapter 12). Where a choice of method is available, the one with the most realistic outcome should be selected. Once a method has been selected, **the method must be used consistently from one accounting period to the next**. If this is not done, a comparison of the financial results from year to year is impossible, and the profit of a particular year can be distorted.

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

Accruals

This is also referred to as the **matching principle**. This is an extension of the realisation principle. As explained earlier, profit is earned when the ownership of goods passes to the customer, not when the goods are actually paid for. The accruals principle extends this beyond the purchase and sale of goods to include other income and expenses. **The revenue of the accounting period is matched against the costs of the same period** (the timing of the actual receipts and payments is ignored).

The figures shown in an income statement must relate to the period of time covered by that statement, whether or not any money has changed hands. This means that a more meaningful comparison can be made of the profits, sales, expenses and so on from year to year. Chapter 11 will explain why it is sometimes necessary to adjust the items of income and expense in an income statement for amounts **prepaid** or **accrued**.

The accruals principle is also applied to capital and revenue expenditure. This is explained later in this chapter.

Test your understanding

1. A customer orders goods on 2 February. The goods are delivered to the customer on 16 February. A cheque in full settlement is received from the customer on 28 February. State the date on which the profit is regarded as realised. Give a reason for your answer.
2. State why a business should apply the principle of consistency.
3. Explain what is meant by the principle of accruals.

Prudence

This is also known as the principle of **conservatism**. This principle ensures that the accounting records present a realistic picture of the position of the business. **Accountants should ensure that profits and assets are not overstated and that liabilities are not understated**. The phrase **"never anticipate a profit, but provide for all possible losses"** is often used to describe the principle of **prudence**. Profit should only be recognised when

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it is reasonably certain that such a profit has been realised and all possible losses should be provided for.

Later chapters will explain how it is necessary to provide for the loss in value of non-current assets and to recognise that it may be necessary to make allowance for those customers who do not pay their accounts. If this is not done, the value of such assets will be overstated in the balance sheet.

Prudence is a very important principle. If a situation arises where applying another accounting principle would be contrary to the principle of prudence, then the principle of prudence is applied (this principle overrules all the other principles). For example, under the realisation principle, profit is earned when goods actually change hands; but if the customer fails to pay after a reasonable time, the principle of prudence may be applied and the debt is written off.

Going concern

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

This continuity means that the non-current assets shown in a balance sheet will appear at their book value, which is the original cost less depreciation (see Chapter 12), and inventory will appear at the lower of cost or net realisable value (see later in this chapter).

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

Materiality

This principle applies to items of very low value (items which are not "material") which are not worth recording as separate items. Other principles can be ignored if the time and cost involved in recording such low value items far outweigh any benefits to be gained from the strict application of these principles. For example, a pocket calculator purchased for office use is strictly a non-current asset, part of its value being "lost" each year through normal usage. The cost of calculating and recording this each year would amount to more than the cost of the asset. Instead of the calculator being recorded as a non-current asset, it would be regarded as

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Test your understanding

1. "If in doubt, understate profits and overstate losses". State which accounting principle is being described.
2. State **one** situation when the principle of going concern is **not** applied.
3. Explain why the principle of materiality may be applied to the purchase of an office stapler.
4. State **two** reasons why it is useful for the life of a business to be divided into accounting periods of one year.

Objectives in Selecting Accounting Policies

The quality of information contained in financial statements determine the usefulness of these statements. This quality of information can be measured in terms of four factors – relevance, reliability, comparability and understandability.

Relevance

Financial statements provide information about a business's financial performance and position. These can be used as the basis for financial decisions. It is important that the information is provided in time for these decisions to be made: information not available when required is of little use.

It is also important that the information is relevant to users of the financial statements. This means that it can be used to confirm, or correct, prior expectations about past events and also to help forming, revising or confirming expectations about the future.

Reliability

The information provided in financial statements can be reliable if it is

- Capable of being depended upon by users as being a true representation of the underlying transactions and events which it is representing
- Capable of being independently verified
- Free from bias
- Free from significant errors
- Prepared with suitable caution being applied to any judgements and estimates which are necessary.

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Comparability

The information contained in financial statements can be useful if it can be compared with similar information about the same business for another accounting period or at another point in time. It is also useful to be able to compare the information with similar information about other business.

In order to make comparisons, it is necessary to be aware of any different policies used in the preparation of the financial statements, any changes in these policies and the effects of such changes. It is important to be able to identify similarities and differences between the information in the financial statement and the information relating to other accounting periods or other businesses.

Understandability

It is important that financial statements can be understood by the users of those statements. This depends partly on the clarity of the information provided.

It also depends on the abilities of the users of the financial statements. It is normally assumed that users of financial statements have a reasonable knowledge of business and economic activities and accounting and that they will be reasonably diligent when studying the financial statements. However, information should not be omitted from financial statements because it is decided that it is too difficult for users to understand.

Test your understanding

1. State **two** ways in which information can be regarded as being relevant.
2. State **three** ways in which information can be regarded as being reliable.
3. Explain why it is necessary to know any changes in accounting policy when comparing financial statements with those of a previous year.
4. Explain the meaning of the term "understandability".

Capital and Revenue Expenditure and Receipts

Capital expenditure

This is money spent by a business on purchasing non-current assets and improving or extending non-current assets. This includes all the legal

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costs incurred in the purchase of non-current assets, costs of carriage for the delivery of non-current assets and costs of installing non-current assets.

These costs will appear as non-current assets in the balance sheet of a business. They should **not** be charged as expenses in the year of purchase as they benefit the business for several years. The value of non-current assets often decreases because of depreciation (see Chapter 12). This cost will be **matched** against the annual revenue which the non-current asset has helped the business to earn.

Revenue Expenditure

This is money spent on running a business on a day-to-day basis. This includes the administration expenses, the selling expenses, the financial expenses, and the cost of maintaining and running non-current assets. It also includes the cost of goods purchases for the purpose of resale.

These costs will appear in the income statement. They are **matched** against the revenue of the period.

If these two types of expenditure are treated incorrectly the profit for the year will be inaccurate and the balance sheet (whilst still balancing) will also be incorrect. For example, if repairs to a machine were treated as an improvement to that machine the expenses in the income statement would be understated, so the profit for the year would be overstated. In the balance sheet, the non-current assets would be overstated and the capital would also be overstated because of the incorrect profit for the year.

Capital Receipt

A capital receipt occurs when a capital item such as a non-current asset is sold. A capital receipt should **not** be entered in the income statement. If, however, a profit or loss is made on the sale of a non-current asset then this will be included in the income statement for the year in which the asset was sold (this is explained in the section on disposal of non-current assets in Chapter 12).

Revenue Receipt

Revenue receipts are sales or other income such as rent received, commission received, discount received and so on. These arise from the normal trading activities and are entered in the income statement.

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Test your understanding

1. Explain why it is important to distinguish between capital expenditure and revenue expenditure.
2. Give **one** example of **each** of the following (a) capital receipt (b) revenue receipt

Inventory Valuation

It is necessary for a business to value its inventory at the end of each financial year. As explained earlier, the inventory at the end of one year becomes the inventory at the start of the next year. If an incorrect value is placed on the inventory it will affect the gross profit and the net profit (profit for the year) for both the current financial year and the following financial year. Incorrect values will also be shown for both current assets and capital in the balance sheet.

Inventory is always valued at the **lower of cost or net realisable value**. This is an application of the principle of **prudence** as over-valuing the inventory causes both the profit and the assets to be over-valued.

The cost of the inventory is the actual purchase price plus any additional costs (such as carriage inwards) incurred in bringing the inventory to its present position and condition. The net realisable value is the estimated receipts from the sale of the inventory, less any costs of completing the goods or costs of selling the goods.

Usually the cost of the inventory will be lower than the net realisable value. It may happen that the goods are damaged or there is no demand for such type of goods because of change in taste or fashion. In this situation, the net realisable value will be lower than cost.

Test your understanding

1. State the basis on which inventory should be valued.
2. Explain the meaning of the term "net realisable value".

Example 10.1

Devnani Traders sell two different types of goods (Type A and B). They provide the following information at 31 December 20-6.

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Type	Units	Cost price per unit	Net realisable value per unit
A	94	$20	$18
B	38	$15	$19

Calculate the value of the closing inventory of Devnani Traders at 31 December 20-6.

Devnani Traders
Valuation of inventory at 31 December 20-6

	$
Type A – 94 units at $18 per unit	1692
Type B – 38 units at $15 per unit	570
	2262

- Type A has been valued at net realisable value as this is below the cost price.
- Type B has been valued at cost price as this is below the net realisable value.

Points to Remember

1. Accounting has developed a set of principles which are applied in the preparation of accounting statements.
2. The main accounting principles are – business entity, duality, money measurement, realisation, consistency, matching, prudence, going concern, materiality, historical cost and accounting period.
3. The quality of information contained in financial statements can be measured in terms of four factors – relevance, reliability, comparability and understandability.
4. It is important to distinguish between capital and revenue expenditure and also between capital and revenue receipts. If these items are treated incorrectly the financial statements will also be inaccurate.
5. At the end of every financial year inventory must be valued. It is always valued at the lower of cost or net realisable value.

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Review Questions

1. State what is meant by going concern.

[IGCSE 2005]

2. Name the accounting principle which is described in the following sentence. "The same accounting treatment should be applied to similar items at all times".

[IGCSE 2003]

3. Name the accounting principle which states that only the financial transactions of the business should be recorded in the business's books.

[IGCSE 2002]

4. "Profit should not be overstated by ignoring foreseeable losses and revenue should not be recorded before it is earned." Name the accounting principle described in this statement.

[IGCSE 2002]

5. The quality of the information in a set of financial statements determines how useful those statements are.
There are **four** ways in which the quality of information in a trader's financial statements can be measured. One of them is reliability. State the other **three**.

[IGCSE 2005]

*6. The quality of information in financial statements can be measured in terms of comparability and reliability.

Required

(a) Jane Joda, a trader, could compare her results for the year ended 30 April 2005 with those for the previous year.
State **one** other comparison Jane could make.

(b) Suggest **one** way in which Jane might use the results of any comparisons she makes.

(c) Jane Joda must be able to rely on the information provided in the financial statements prepared for her business.

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*9. Michael Ong started a business on 1 July 2007. He had very little knowledge of bookkeeping but attempted to prepare a set of financial statements at the end of his first year of trading.
The financial statements Michael prepared, containing errors, are shown below.

Income statement

	$	$
Sales of goods	80 000	
Sales of motor vehicle (AB 246) at book value)	2 000	82 000
Purchases of goods	60 000	
Purchase of new motor vehicle (CD 357)	8 000	
	68 000	
Closing inventory of goods	12 000	56 000
Gross profit		26 000
General expenses	10 800	
Bad debts	200	11 000
Profit for the year		15 000

Balance Sheet

	$
Equipment	2 000
Bank	1 000
Trade receivables	7 000
Closing inventory of goods	12 000
Purchases of stationery	200
Commission received	500
	22 700
Trade payables	17 000
Capital (balancing figure)	5 700
	22 700

Required

(a) (i) Explain the difference between capital expenditure and revenue expenditure.
(ii) Explain the difference between capital receipts and revenue receipts.

(b) Calculate Michael Ong's correct profit for the year ended 30 June 2008.
[N.B. Bad debts are the amounts that will not be received from debtors and are regarded as an expense to the business.]

[IGCSE 2008]

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*10. A trader provides the following information about his stock at 30 November 20-8.

Inventory code number	*Number of units in inventory*	*Cost per unit* $	*Selling price per unit* $
BD 20	300	1.50	2.30
BD 23	119	0.95	0.80
BD 29	410	1.78	1.85

The trader had to pay carriage inwards on inventory Code Number BD 20 at the rate of $5 per 100 units (not included in the cost per unit shown above).

Calculate the total value of inventory which should appear in the trader's balance sheet on 30 November 20-8. Show your calculations.

11. Ah Sung has a business buying and selling parts for machines. You are given the following information about Part Q.

At 1 April there were 200 units in the warehouse which cost $3.20 each. In the month of April purchases were:

April	Units	Cost per unit
5	100	$3.20
10	150	$3.00
27	100	$3.00

At 30 April there were 300 units in the warehouse and the net realisable value of each unit was $3.00.

Required

Calculate the following for Part Q. Show all workings.

(a) The value of inventory at 1 April.
(b) The total cost of purchases for April.
(c) The value of inventory at 30 April.
(d) The number of units sold in April.
(e) The cost of goods sold for the month of April.

[IGCSE 2008]

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Chapter 11 Other Payables and Other Receivables

In this chapter you will learn to:

- recognise and understand prepaid and accrued expenses
- recognise and understand prepaid and accrued income
- make ledger entries to record prepaid and accrued expenses and income
- make entries to record prepaid and accrued expenses and income in the financial statements.

Introduction

It is often necessary to make adjustments to the accounting records in order to present a more accurate view of the profit or loss of the business and the financial position of the business. Such adjustments are referred to as **year-end adjustments**. These adjustments are considered in this chapter and also in Chapters 12 and 13.

The examples used in previous chapters assumed that all the expenses in the profit and loss account section of the income statement were paid until the end of the financial year, with nothing paid beyond that date and nothing unpaid. A similar approach was used in relation to revenue items within the profit and loss account section of the income statement when it was assumed that all the items were received up to the end of the financial year with nothing relating to a period beyond that date and nothing outstanding. In practice, this is rarely the case: it is common to find expenses or income unpaid, or to find expenses or income paid in one financial year but which relate to other financial years.

It was explained in Chapter 8 how an income statement is prepared for a definite period of time (the period of time covered by the statement being

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included as part of the statement heading). **Only items relating to that particular time period should be included in the statement: the timing of the actual receipts and payments is not relevant**. This is a practical application of the **accruals principle** (see Chapter 10). It is, therefore, necessary to adjust the items within an income statement for amounts **prepaid** or **accrued**. This means that the profit or loss will be shown at a more accurate figure, and it allows for more meaningful comparisons of the financial statements from year to year.

The use of a simple diagram is often helpful when calculating the expense or income relating to a particular financial year. This is illustrated in the examples used in this chapter.

Accrued and Prepaid Expenses

Accrued expenses

An accrual is an amount due in an accounting period which remains unpaid at the end of that accounting period. **Where an expense is accrued it means that some benefit or service has been received during the accounting period but this benefit or service has not been paid for by the end of the period**.

It was explained in Chapter 8 how the totals of expense accounts in the nominal ledger are transferred to the income statement at the end of the financial year. To apply the **accruals principle**, the amount transferred to the income statement should represent the expense for the accounting period covered by that account. This means that **any amount due but unpaid at the end of the financial year must be added to the amount paid** and the total expense relating to the accounting period transferred to the income statement.

The expense account will now show a balance equal to the amount unpaid. To complete the double entry, this **balance is brought down on the credit side of the ledger account**. As the balance represents an amount owing, due for payment in the near future, it will be included as a **current liability** in the **balance sheet**.

The entries are summarised as follows:

During the year – debit the expense account and credit the cash book with the amount paid

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At the year end –	debit the expense account with any amount due but unpaid and carry down as a credit balance
	credit the expense account and debit the income statement with the difference on the expense account (this represents the expense for the year)
	include the balance on the expense account as a current liability in the balance sheet.

Test your understanding

1. State what is meant by an accrued expense.
2. State where an accrued expense is shown in a balance sheet.
3. Explain why accrued expenses should be included when calculating the profit.

Example 11.1

Salman started a business on 1 April 20-7.

He receives an invoice for telephone expenses quarterly in arrears. During the year ended 31 March 20-8 his payments for expenses included the following:

20-7	30 June	Telephone expenses paid in cash $44
	4 October	Telephone expenses paid by cheque $56
20-8	3 January	Telephone expenses paid by cheque $62

An invoice for telephone expenses for $59 was received on 31 March 20-8. This was for telephone expenses up to the end of March, but was not paid until 5 April 20-8.

(a) Write up the telephone expenses account in Salman's nominal ledger for the year ended 31 March 20-8.

(b) Prepare a relevant extract from Salman's income statement for the year ended 31 March 20-8.

(c) Prepare a relevant extract from Salman's balance sheet at 31 March 20-8.

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Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.

```
<------Financial Year 1 April 20-7 to 31 March 20-8------------------>
  A   M   J   J   A   S   O   N   D   J   F   M
|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|

|-----|-----|-----|-----|-----|-----|-----|-----|-----|
<   $162 paid to 31 December 20-7        ><$59 owing>
```

The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to add the amount owing at the end of the year.

(a)

Salman

Nominal Ledger

Telephone expenses account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-8			
June 30	Cash		44	Mar 31	Income		
Oct 4	Bank		56		Statement		221
20-8							
Jan 3	Bank		62				
Mar 31	Balance	c/d	59				
			221				221
				20-8			
				Apl 1	Balance	b/d	59

(b)

Salman

Extract from Income Statement for the year ended 31 March 20-8

	$
Expenses – Telephone expenses	221

(c)

Salman

Extract from Balance Sheet at 31 March 20-8

	$
Current liabilities	
Other payables	59

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Test your understanding

1. State what is meant by a prepaid expense.
2. State where a prepaid expense is shown in a balance sheet.
3. Explain how the accruals principle is applied to expenses shown in the income statement.

Example 11.2

Salman started a business on 1 April 20-7.

Salman rented premises until 1 July 20-7 when he purchased premises. He paid a cheque for $600 for one year's insurance on his premises on 1 July 20-7.

(a) Write up the insurance account in Salman's nominal ledger for the year ended 31 March 20-8.
(b) Prepare a relevant extract from Salman's income statement for the year ended 31 March 20-8.
(c) Prepare a relevant extract from Salman's balance sheet at 31 March 20-8.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.

```
<-----Financial Year 1 April 20-7 to 31 March 20-8------->
 A   M   J   J   A   S   O   N   D   J   F   M
|----|----|----|----|----|----|----|----|----|----|----|----|
                                                 A   M   J
              |----|----|----|----|----|----|----|----|----|----|----|----|
              <          $600 paid to 30 June 20-8          >
```

The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to deduct that portion of the $600 which falls outside the financial year (3 months/12 months or ¼ of $600 relates to the following financial year).

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(a)

Salman
Nominal Ledger
Insurance account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-8			
July 1	Bank		600	Mar 31	Income statement		450
					Balance	c/d	150
			600				600
20-8							
Apl 1	Balance	b/d	150				

(b)

Salman
Extract from Income Statement for the year ended 31 March 20-8

	$
Expenses – Insurance	450

(c)

Salman
Extract from Balance Sheet at 31 March 20-8

	$
Current assets	
Other receivables	150

- The insurance relating to the financial year ended on 31 March 20-8 amounts to $450, which is the insurance from 1 July 20-7 to 31 March 20-8.
- The insurance expense would be listed with the other expenses in the income statement and deducted from the gross profit.
- Where there are several prepaid expenses it is usual to show one combined figure in the balance sheet under other receivables rather than showing the amount of each separate prepayment.

If a business has an inventory of stationery, postage stamps, wrapping paper etc. at the end of a financial year, this can be regarded as a prepaid expense. Money has been spent, but the benefit will not be received until the following accounting period, when the stationery, wrapping paper etc. is actually used. The entries are similar to those for a prepaid expense.

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Salman
Nominal Ledger
Telephone expenses account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-8			
Apl 5	Cash		59	Apl 1	Balance	b/d	59
June 30	Bank		60	20-9			
Oct 2	Bank		48	Mar 31	Income		
Dec 31	Bank		56		statement		227
20-9							
Mar 31	Balance	c/d	63				286
			286				
				20-9			
				Apl 1	Balance	b/d	63

Example 11.5

Salman's financial year ends on 31 March.

On 1 April 20-8 the insurance account in Salman's nominal ledger showed a debit balance of $150.

He paid a cheque for $636 for one year's insurance on his premises on 1 July 20-8.

Write up the insurance account in Salman's nominal ledger for the year ended 31 March 20-9.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.

```
<----------Financial Year 1 April 20-8 to 31 March 20-9-------------->
  A   M   J   J   A   S   O   N   D   J   F   M
|----|----|----|----|----|----|----|----|----|----|----|----|
                                                             A   M   J
|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|
< $150 paid ><              $636 paid to 30 June 20-9                   >
   last year
```

The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to:

1. deduct that portion of the $636 which falls outside the financial year (3 months/12 months or ¼ of $636 relates to the following financial year).
2. add the $150 paid in the previous financial year as it falls within the present financial year.

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- The commission received would be listed with the other items of income in the income statement and added to the gross profit.
- The commission due but not yet received would appear in the balance sheet as a current asset under the description of income accrued. Alternatively, it could be included in the other receivables (in this case a note to the balance sheet would show the breakdown of this figure).

Prepaid income

Where an item of income is prepaid, it means that a person had paid for a benefit or service from the business, but this has not been provided by the business at the end of the financial year.

Once again, the accruals principle must be applied so that the amount transferred to the income statement represents the income for the accounting period covered by that statement. Any amount received during the financial year relating to a future accounting period must be deducted from the amount received so that only the income relating to the accounting period is transferred to the income statement.

The income account will now show a balance equal to the amount received in advance. To complete the double entry, this **balance is brought down on the credit side of the ledger account**. This balance will be included as a **current liability** in the **balance sheet** as the business has a liability to provide some service or benefit for which the business has already been paid.

The entries are summarised as follows:

During the year – credit the income account and debit the cash book with the amount received.

At the year end – debit the income account with any amount received in advance and carry down as a credit balance

debit the income account and credit the income statement with the difference on the income account (this represents the income for the year)

include the balance on the income account as a current liability in the balance sheet.

Example 11.7

Salman started a business on 1 April 20-7.

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Example 11.9

Salman's financial year ends on 31 March.

He rents part of his premises to another trader at an annual rent of \$1000, payable quarterly in advance.

On 1 April 20-8 the rent received account in Salman's nominal ledger showed a credit balance of \$250.

The tenant paid rent of \$250 by cheque on 1 July 20-8 and 2 October 20-8. The rent due on 1 January 20-9 was not received until 2 April 20-9.

Write up the rent received account in Salman's nominal ledger for the year ended 31 March 20-9.

Before attempting to answer the question it may be helpful to consider the problem by the use of a diagram.

<--------Financial Year 1 April 20-8 to 31 March 20-9------------>

A M J J A S O N D J F M

|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|

|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|

< \$250 received last year >< \$500 received to 31 December 20-8 >< \$250 owing >

The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to–

1. add the \$250 due but not received at the end of the financial year
2. add the \$250 received in the previous financial year as it falls within the present financial year.

Salman
Nominal Ledger
Rent received account

Date	*Details*	*Folio*	*\$*	*Date*	*Details*	*Folio*	*\$*
20-8				20-8			
Mar 31	Income statement		1000	Apl 1	Balance	b/d	250
				July 1	Bank		250
				Oct 2	Bank		250
				20-9			
				Mar 31	Balance	c/d	250
			1000				1000
20-9							
Apl 1	Balance	b/d	250				

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Test your understanding

1. Whabi & Company's financial year ends on 31 December. They act as agent for another business and receive a commission on goods sold.
   The following information is provided:

20-6	Jan	1	Commission, $94, was owing to Whabi & Company
	Dec	31	Commission, $1350, was received
			Commission, $76, was owing to Whabi & Company
20-7	Dec	31	Commission, $1480, was received

   For **each** of the years ended 31 December 20-6 and 31 December 20-7 state:
   (a) the amount shown for commission received in the income statement
   (b) the amount (if any) shown for commission received in the balance sheet, indicating whether it is a current asset or a current liability

Points to Remember

1. The expenses for an accounting period must be matched against the income of that particular period.
2. An accrual is an amount due in an accounting period which remains unpaid at the end of that period. A prepayment is an amount that has been paid or received in one accounting period which relates to a future period.
3. In the income statement an accrued expense is added to the total paid. The accrued amount is a current liability in the balance sheet.
4. In the income statement a prepaid expense is deducted from the total paid. The prepaid amount is a current asset in the balance sheet.
5. In the income statement accrued income is added to the total received. The accrued amount is a current asset in the balance sheet.
6. In the income statement income received in advance is deducted from the total received. The amount received in advance is a current liability in the balance sheet.

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Review Questions

1. Rupa made the following bank payments in the month of March 2008.

			$
March	6	Motor expenses – repairs	120
	12	Motor expenses – tyres	150

The bill for repairs had been received in February and $120 had been accrued in the motor expenses account at the end of the month.

Rupa received a bill for motor fuel for $80 on 219 March but the bill was not paid until 7 April.

Required

(a) Prepare the motor expenses account in Rupa's ledger for the month of March 2009. Show the amount transferred to the income statement for the month and the balance brought down on 1 April.

Mopsa has to pay $400 rent on her shop each month.

She was not able to pay all the rent due in March 2009 and $150 was outstanding on 1 April.

From 1 April, her landlord increased the rent to $450 each month.

On 27 April Mopsa made a payment of rent to her landlord of $500 in total.

Required

(b) Prepare the rent account in Mopsa's ledger for the month of April 2009. Show the amount to be transferred to the income statement for the month and balance brought down on 1 May.

Andrea does not include any accrual in her electricity account for electricity used, and invoiced, but not paid for at the end of the month.

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Required

(c) Place a tick (✓) in one of the boxes below to show whether the amount for electricity in her income statement for the month will be

understated	
overstated	

[IGCSE 2009]

2. Susie is a trader. On 1 July 20-7 her inventory of stationery was valued at $110. During the year ended 30 June 20-8 the following transactions took place.

20-7 September	1	Purchased stationery, $328, by cheque
20-8 January	4	Purchased stationery, $95, in cash
February	1	Received a cash refund, $15, for an overcharge by the stationery supplier

Susie's inventory of stationery on 30 June 20-8 was valued at $187.
Write up the stationery account in Susie's ledger for the year ended 30 June 20-8.

3. Amina Hassan's financial year ends on 30 April. She sublets part of her premises to Mariam Kamel.
Amina provided the following information.

2001	$
May 1 Mariam owed 1 month's rent	60
July 1 Mariam paid rent for 15 months to 30 June 2002 by cheque	900

Prepare the rent received account as it would appear in Amina Hassan's ledger for the year ended 30 April 2002. Show clearly the amount transferred to the income statement and the balance on 1 May 2002.

[IGCSE 2002]

*4. The following extract shows transactions recorded in Ramon's cash book for the month of April 2007.

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Ramon
Cash Book

Date	Details	Cash $	Bank $	Date	Details	Cash $	Bank $
Apl 1	Balance b/d	1100	2450	Apl 1	Rent		900
3	Sales	500		6	Electricity		120
12	Ahmed		1200	21	Drawings	800	
29	Ahmed		650	29	Wages	700	
				30	Balance c/d	100	3280
		1600	4300			1600	4300
May 1	Balance b/d	100	3280				

Additional information:
1. The balance on Ahmed's account in the ledger on 1 April was $2850 Dr.
2. Rent of $900 is payable quarterly in advance.
3. An electricity bill for $60 was accrued at 30 April.

Required

Write up the following accounts in Ramon's ledger for the month of April 2007.
Show the amounts transferred to Ramon's income statement for the month and any balances at 1 May.

(a) Sales account (b) Ahmed account (c) Rent account
(d) Electricity account (e) Drawings account (f) Wages account

[IGCSE 2007]

5. The following account appears in Ruth Tembe's nominal (general) ledger.

Business rates account

Date	Details	folio	$	Date	Details	folio	$
2008				2008			
Sept 30	Bank		1490	Aug 1	Balance	b/d	90
				2009			
				July 31	Income statement		1200
					Balance	c/d	200
			1490				1490
2009							
Aug 1	Balance	b/d	200				

Required

(a) Explain each of the entries in the business rates account as it appears in the nominal (general) ledger of Ruth Tempe. State where the double entry for each transaction would be made.

The first one has been completed as an example.

2008 Aug 1 Balance $90

Explanation *This is the amount owing for business rates for the previous financial year.*

Double entry *Debit business rates account for the year ended 31 July 2008*

2008 Sept 30 Bank $12490

2009 July 31 Income statement $1200

(b) (i) Explain the significance of the $200 shown at the end of the business rates account.

(ii) State where this amount will appear in Ruth Tembe's balance sheet at 31 July 2009.

[IGCSE 2009]

6. Elmer Gantry is a self-employed builder whose financial year ends on 30 September. His trial balance drawn up on 30 September 2003 included the following balances.

	Dr	*Cr*
	$	*$*
Revenue (sales)		100 000
Purchases	66 000	
Purchases returns		4 000
Inventory 1 October 2002	12 000	
Insurance	4 250	
Wages	6 000	
General expenses	1 000	
Motor expenses	2 600	
Rent	5 000	

You are given the following additional information.

1. On 30 September 2003 insurance prepaid was $250 and motor expenses due but unpaid were $400.

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2. Inventory on 30 September 2003 was $9000.

(a) Prepare Elmer Gantry's income statement for the year ended 30 September 2003.

(b) (i) State what is meant by the accounting principle of accruals.

(ii) Explain how the accruals principle is applied to insurance in Elmer's income statement.

[Based on IGCSE 2003]

*7. Miriam is a business consultant. She provided the following information at the end of her first year on 30 September 20-4.

	$
Office expenses	7 250
Wages	27 500
Insurance	1 800
Property tax	800
Motor vehicle expenses	1 840
Fees received from clients	40 900
Commission received	5 600

The following information is also available.

1. The office expenses include stationery. On 30 September 20-4 the inventory of stationery was valued at $250.
2. It is estimated that half of the motor vehicle expenses relate to Miriam's personal use.
3. On 30 September 20-4
   Property tax due amounted to $160
   Office expenses due amounted to $45
   Commission receivable amounted to $250.
4. The insurance covers a period of 15 months to 31 December 20-4.
5. Bank charges, $115, have not been entered in the accounting records.

Prepare Miriam's income statement for the year ended 30 September 20-4.

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Chapter 12 Depreciation and Disposal of Non-current Assets

In this chapter you will learn to:

- understand the nature and causes of depreciation
- understand the main methods of calculating depreciation
- make entries to record depreciation in the ledger
- make entries to record depreciation in the financial statements
- make entries to record disposal of non-current assets.

Introduction

As explained in Chapter 11, it is often necessary to include year-end adjustments in a set of financial statement. This ensures that the accounts provide a more accurate view of the profit or loss of the business and the financial position of the business.

Chapter 11 concentrated on accrued and prepaid expenses and income. This chapter focuses on the year-end adjustment made for depreciation of non-current assets.

Depreciation is an estimate of the loss in value of a non-current asset over its expected working life. Most of the non-current assets of a business lose value over a period of time they are used by the business. If the accounting records continue to show these assets at their cost prices then the accounts will provide misleading information. It is, therefore, necessary to record an estimate of the loss in value. The records can only show an *estimate* of the loss in value of a non-current asset because of depreciation. The *exact* amount will only be known when the asset is disposed of or sold. Buildings depreciate over time but land does not usually lose value (unless it is something like a well or mine when value is removed from the land).

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The purchase of a non-current asset is **capital expenditure** (see Chapter 10). The cost of a non-current asset is not charged as an expense in the year of purchase as it benefits the business for several years. **Matching** the capital expenditure against the sales it has helped the business to earn is done by an annual charge for depreciation. **This means that the cost of the non-current asset is spread over the years which benefit from the use of that asset**. The depreciation for the year is included in the expenses in the income statement, so the profit for the year is not overstated. This is an application of the **principle of prudence**. If the profit is overstated, the owner of a business may be tempted to withdraw more cash than the business can actually afford.

The **principle of prudence** is also applied in the balance sheet as the non-current assets are recorded at a figure less than the cost price (this is known as the **net book value** or the **written down value**). This overrides the **historical cost principle** as it ensures that the non-current assets are shown at more realistic values.

Depreciation is a **non-monetary expense** as it does not involve an outflow of money, nor does it provide a cash fund to use for the replacement of a non-current asset.

Causes of Depreciation

The four main causes of depreciation are explained below:

Physical deterioration

This is the result of "wear and tear" due to the normal usage of the non-current asset. It can also be because the asset falls into a poor physical state due to rust, rot, decay and so on.

Economic reasons

The non-current asset may become inadequate as it can no longer meet the needs of the business. It can also be because the non-current asset has become obsolete as newer and more efficient assets are now available.

Passage of time

This arises where a non-current asset, for example a lease, has a fixed life of a set number of years.

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Depletion

This arises in connection with non-current assets such as wells and mines. The worth of the asset reduces as value is taken from the asset.

Test your understanding

1. Explain the meaning of depreciation.
2. Explain how depreciation is an application of the accruals (matching) principle.
3. List four causes of depreciation of non-current assets.

Methods of Calculating Depreciation

There are several methods used to calculate the estimated loss in value of a non-current asset. Different types of non-current assets are often depreciated using different methods. The method selected should be the one which spreads the cost of the asset as fairly as possible over the periods which benefit from its use. Once a method has been selected for a particular non-current asset, it should be applied each year. This is an application of the **principle of consistency**.

In practice, many factors are considered before a depreciation method is selected. These are:

- How long is the asset expected to last?
- How much will the asset be sold for when it is put out of use?
- How can the benefits from the use of the asset be measured?

There are three main methods of depreciation:

- Straight line method
- Reducing balance method
- Revaluation method

These are explained below. There are several other methods, but they are outside the scope of the syllabus.

Straight line method of depreciation

This is also known as the **fixed instalment method**.

The formula used for calculating the annual depreciation using this method is:

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	$
Cost	25 000
Depreciation for year ended 30 June 20-4 at 40%	10 000
Book value at 1 July 20-4	15 000
Depreciation for year ended 30 June 20-5 at 40%	6 000
Book value at 1 July 20-5	9 000
Depreciation for year ended 30 June 20-6 at 40%	3 600
Book value at 1 July 20-6	5 400
Deprecation for year ended 30 June 20-7 at 40%	2 160
Book value at 1 July 20-7	3 240

- Depreciation is usually expressed in units of whole dollars, so the amounts have been adjusted to avoid cents

Revaluation method of depreciation

This method is used where it is not practical, or is difficult, to keep detailed records of certain types of non-current assets. If detailed records are not available the previous two methods of depreciation cannot be calculated. Small items of equipment used in offices and laboratories, packing cases, loose tools etc. are usually depreciated using the revaluation method as no detailed records are kept for these assets.

The assets are valued at the end of each financial year. This value is compared with the value at the end of the previous financial year (or with the cost if it is the first year of ownership). **The amount by which the value of the asset has fallen is the depreciation for the year**.

Example 12.4

Kavita's financial year ends on 30 June.

On 1 July 20-3 she purchased fixtures costing $25 000 and paid by cheque. She decided to revalue the fixtures at the end of each year.

On 30 June 20-4 the fixtures were valued at $20 500.

Calculate the depreciation for the year ended 30 June 20-4.

	$
Cost of fixtures on 1 July 20-3	25 000
Value of fixtures on 30 June 20-4	20 500
Depreciation for the year ended 30 June 20-4	4 500

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Test your understanding

1. Explain the straight line method of depreciation.
2. Explain how, using the reducing balance method, the *amount* of depreciation decreases each year even though the same *percentage rate* is applied.
3. State when the revaluation method is used to depreciate non-current assets.

Recording Depreciation in the Ledger

Recording depreciation using the straight line method and the reducing balance method.

The procedure for entering depreciation calculated using the straight line method and the reducing balance method is exactly the same.

Each type of non-current asset has two ledger accounts:

- an account for recording the cost of the asset (the asset account)
- an account for recording the depreciation (the provision for depreciation of asset account)

The asset account always has a debit balance and the provision for depreciation always has a credit balance. These two accounts must always be considered together. The difference between the balances of these accounts represents the net book value of the asset.

The entries are summarised as follows:

During the year – **when the asset is purchased**
debit the asset account and credit either the cash book or the supplier's account with the cost price

At the year end – debit the income statement and credit the provision for depreciation account with the depreciation for the year
balance the provision for depreciation account and carry down as a credit balance
balance the asset account if there have been any transactions during the year and carry down as a debit balance

Example 12.5

Kavita's financial year ends on 30 June.

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On 1 July 20-3 she purchased fixtures costing $25 000 and paid by cheque. She estimated that she would be able to use the fixtures for 4 years and then be able to sell them for $3000.

Kavita decided to use the reducing balance method of depreciation at 40% per annum.

Make the entries in Kavita's nominal ledger accounts for **each** of the years ended 30 June 20-4, 20-5, 20-6 and 20-7.

Kavita
Nominal Ledger
Fixtures account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-3							
July 1	Bank		25 000				

Provision for depreciation of fixtures account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-4				20-4			
June 30	Balance	c/d	10 000	June 30	Income statement		10 000
			10 000				10 000
20-5				20-4			
June 30	Balance	c/d	16 000	July 1	Balance	b/d	10 000
				20-5			
				June 30	Income statement		6 000
			16 000				16 000
20-6				20-5			
June 30	Balance	c/d	19 600	July 1	Balance	b/d	16 000
				20-6			
				June 30	Income statement		3 600
			19 600				19 600
20-7				20-6			
June 30	Balance	c/d	21 760	July 1	Balance	b/d	19 600
				20-7			
				June 30	Income statement		2 160
			21 760				21 760
				20-7			
				July 1	Balance	b/d	21 760

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- The asset account was not balanced at the end of each year as there is only one entry in the account.
- Before the transfer to the income statement can be made each year it is necessary to calculate the depreciation for the year. The calculations have been shown in **Example 12.3**.
- The difference between the balance on the asset account and the balance on the provision for depreciation account on the same date represents the net book value of the fixtures on that date.
- If the straight line method of depreciation had been selected the entry in the fixtures account would be exactly the same.
- If the straight line method of depreciation had been selected the entries in the provision for depreciation of fixtures account would be very similar. The transfer to the income statement would be $5500 each year, so the totals and balances on the account would differ to those shown earlier.

Test your understanding

1. Referring to **Example 12.5**:
   (a) State the total amount of depreciation up to 30 June 20-6.
   (b) State the net book value of the fixtures on 30 June 20-7.
2. Explain why the asset account and the provision for depreciation account of that asset should both be referred to when the asset is being considered.

Where a non-current asset is purchased *during* the financial year a business may decide to charge depreciation from the date of purchase. This means that in the first year of ownership only a proportion of the annual depreciation will be charged to the income statement.

Example 12.6

Kavita's financial year ends on 30 June.

On 1 July 20-4 she purchased a motor vehicle costing $9000 and paid by cheque. On 1 April 20-5 an additional motor vehicle costing $8000 was purchased and paid for by cheque.

She decided to use the straight line method of deprecation at 20% per annum, depreciation to be calculated from the date of purchase.

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Kavita
Extract from Balance Sheet at 30 June 20-5

	$	$	$
Non-current assets	**Cost**	**Depreciation to date**	**Book value**
Fixtures	25 000	16 000	9 000

As explained earlier in Chapters 8 and 9, the financial statements are prepared from a trial balance and its accompanying notes. In the trial balance, the balances on the asset accounts are shown in the debit column and the balances on the provision for depreciation accounts are shown in the credit column. One of the notes will indicate the depreciation to be charged for the current financial year.

The depreciation for the year will appear twice in the financial statements. It is an expense in the income statement: it is included in the balance sheet as part of the provision for depreciation (the depreciation for the year is added to the balance shown in the trial balance).

Example 12.9

Kavita's financial year ends on 30 June.

She depreciates her fixtures using the reducing balance method of depreciation at 40% per annum.

Her trial balance drawn up on 30 June 20-6 included the following:

	Dr $	*Cr* $
Fixtures	25 000	
Provision for depreciation of fixtures		16 000

(a) Prepare a relevant extract from Kavita's income statement for the year ended 30 June 20-6

(b) Prepare a relevant extract from Kavita's balance sheet at 30 June 20-6

(a)

Kavita
Extract from Income Statement for the year ended 30 June 20-6

	$
Expenses – Depreciation of fixtures	3 600

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Provision for depreciation of fixtures account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-7			
July 1	Disposal		21 760	July 1	Balance	b/d	21 760
			21 760				21 760

Disposal of fixtures account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-7				20-7			
July 1	Fixtures		25 000	July 1	Provision for depreciation		21 760
					Traders Ltd.		3 100
				20-8			
				June 30	Income statement		140
			25 000				25 000

- The difference on the disposal account remains in that account until the end of the financial year when it is transferred to the income statement.
- In this case the depreciation had been under-provided so there was a small loss of $140 to transfer to the income statement.
- If the total of the credit side of the account had exceeded the debit side, there would have been an over-provision of depreciation. The transfer to the income statement would have been shown on the debit of this account and on the credit of the income statement.

If only some of the assets of a particular type are being sold, it is important that only the entries relating to the assets being sold are removed from the ledger records.

Businesses may operate different policies in relation to depreciation where an asset is sold or disposed of part-way through the year. Some ignore depreciation in the year of sale; others charge depreciation up to the date of disposal of the asset. Once a method has been selected it should be employed **consistently**.

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(c) Explain how the accounting principle of prudence is observed when Joe provides for the depreciation of his equipment.

[IGCSE 2002]

4. Solomon is a sole trader and his trial balance at 31 March 2008 was as follows.

	Dr $	*Cr* $
Bank	4 050	
Capital		35 000
Cash	250	
Carriage outwards	720	
Trade payables		2 400
Trade receivables	4 000	
Drawings	24 000	
Electricity	1 800	
Motor vehicle	9 600	
Motor expenses	1 380	
Provision for depreciation of motor vehicle		4 800
Purchases	28 800	
Revenue (sales)		47 500
Rent	6 000	
Inventory 1 April 2007	1 500	
Wages	8 600	
	90 700	90 700

The following additional information is available:

1. Inventory at 31 March 2008 was $1800.
2. A bonus of $400 is to be accrued in the wages account.
3. Depreciation on motor vehicle of $2400 is to be provided for the year.
4. Rent includes $1200 paid in advance.

Required

(a) Prepare Solomon's income statement for the year ended 31 March 2008.

(b) Write up Solomon's capital account for the year ended 31 March 2008.

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(c) Suggest **two** ways in which Solomon could reduce his loss or increase his profit.

(d) Suggest **two** ways in which Solomon could increase the credit balance on his capital account.

[IGCSE 2008]

*5. Mustafa and Syed went into partnership on 1 April 2000. On that date they purchased equipment on credit from AB Ltd., for $10 000.

The partners decided to provide for a full year's depreciation on equipment in the year of purchase but no depreciation in the year of disposal. It was agreed that depreciation should be calculated on equipment owned at 31 March each year at a rate of 20% per annum, using the straight line method.

On 1 October 2001 half of the equipment was sold on credit to Zeta Ltd. for $3500.

(a) Prepare the following accounts in the ledger of Mustafa and Syed for **each** of the years ended 31 March 2001 and 31 March 2002.

(i) Equipment account
(ii) Provision for depreciation of equipment account
(iii) Disposal of equipment account

(b) On 1 April 2002 Mustafa stated:

"I suggest we change the method of depreciation of equipment to the reducing balance method for this financial year. My calculations show that if we do this the depreciation charge for the year will only be $315. This is much less than the depreciation under the straight line method, so our profits will increase."

State and explain **two** reasons why the partnership should **not** change to a different method of calculating depreciation.

[IGCSE 2002]

6. John Kamel is a sole trader whose financial year ends on 31 July.

(a) The following account appears in John's ledger.

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Disposal of motor vehicle account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
2003				2003			
Mar 12	Motor vehicles		5 000	Mar 12	Provision for depreciation		3 000
					XY Garages		1 500
				July 31	Income statement		500
			5 000				5 000

Explain **each** entry in the disposal of motor vehicles account as it appears in John Kamel's ledger.

(b) On 1 August 2001 John Kamel purchased a machine costing \$8600 on credit from Superlooms. He decided to depreciate the machine using the reducing balance method at the rate of 60% per annum.

(i) Write up the provision for depreciation of machinery account in John's ledger for **each** of the **two** years ending 31 July 2002 and 31 July 2003.

(ii) When preparing the income statement for the year ended 31 July 2003, John Kamel included depreciation of machinery at 60% of the cost price instead of 60% of the book value of the machinery.
Calculate how this error would affect John's profit for the year ended 31 July 2003. Show your workings.

[IGCSE 2003]

7. Tony and Alice Mundondo started a business on 1 March 2007 supplying and repairing computers. On that date they purchased a motor vehicle, \$9500, on credit from Valley Motors. They purchased a further motor vehicle, \$10 800, on 1 July 2008 and paid by cheque.

They decided to depreciate the motor vehicles at 20% per annum using the straight line (equal instalment) method. The depreciation was to be calculated from the date of purchase. No depreciation was to be charged in the year of disposal of a motor vehicle.

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Required

(a) Write up the following accounts in the ledger of Tony and Alice Mundondo for **each** of the years ended 29 February 2008 and 28 February 2009:
   (i) Motor vehicles account
   (ii) Provision for depreciation of motor vehicles account

(b) Prepare a relevant extract from the non-current assets section of Tony and Alice Mundondo's balance sheet at 28 February 2009.

(c) On 31 March 2009 Tony and Alice Mundondo decided that the motor vehicle purchased in 2007 was too small. On that date they purchased a larger motor vehicle from Valley Motors who agreed to accept the original motor vehicle in part exchange.

Tony and Alice Mundondo opened an account in the ledger to record the disposal of the motor vehicle.

Complete the following table to indicate the ledger accounts to be debited and credited to record the disposal of the motor vehicle on 31 March 2009.

	account to be debited	account to be credited
(i) eliminating original cost of motor vehicle from ledger		
(ii) eliminating accumulated depreciation from ledger		
(iii) recording part exchange allowance made by Valley Motors		

(d) (i) Explain the revaluation method of depreciation.
   (ii) State one type of non-current asset which is suitable for depreciation using the revaluation method.

[IGCSE 2009]

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Provision for Doubtful Debts

A provision for doubtful debts is an estimate of the amount which a business will lose in a financial year because of bad debts.

At the end of their financial year, many businesses try to anticipate the amount which will be lost because of bad debts. This ensures that the profit for the year is not overstated and the amount of trade receivables in the balance sheet is shown at a realistic level. This is an application of the principle of **prudence**. By maintaining a provision for doubtful debts, a business also observes the principle of **accruals**. The amount of sales for which the business is unlikely to be paid is regarded as an expense of the year in which those sales are made (rather than an expense of the year in which the debt is actually written off).

In order to make a provision for doubtful debts, it is necessary to estimate the amount of bad debts. The amount of the provision may be established by:

- Looking at each individual debtor's account and estimating which ones will not be paid.
- Estimating, on the basis of past experience, the percentage of the total amount owing by debtors that will not be paid.
- Considering the length of time debts have been outstanding by means of an ageing schedule. A provision of a higher percentage may be made on older debts (the longer a debt is outstanding the greater the risk it may become a bad debt).

Test your understanding

1. Explain the meaning of a provision for doubtful debts.
2. Explain how maintaining a provision for doubtful debts is an application of both the principle of accruals and the principle of prudence.

Creating a provision for doubtful debts

Once it is decided to create a provision for doubtful debts and the amount or percentage has been decided, this can be recorded in the books. These entries are made at the end of the financial year.

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Item	Overstated $	Understated $
(i) Gross profit for the year ended 31 January 2007	*No effect*	*No effect*
(ii) Net profit for the year ended 31 January 2007	....	....
(iii) Total of current assets in balance sheet at 31 January 2007	....	....

[IGCSE 2007]

5. The following trial balance was extracted from the books of Amir Sadiq at 31 March 2003.

	$	$
Capital		33 000
Drawings	2 500	
Buildings at cost	20 000	
Fixtures and equipment at valuation	3 400	
Motor vehicles at cost	8 000	
Provision for depreciation of motor vehicles		3 250
Provision for doubtful debts		200
Trade receivables	7 500	
Trade payables		6 700
Bank overdraft		2 880
Motor vehicle expenses	1 240	
General expenses	2 030	
Wages	11 940	
Insurance	1 470	
Carriage inwards	700	
Discount received		250
Revenue (sales)		92 100
Purchases	68 500	
Sales returns	1 200	
Inventory 1 April 2002	9 900	
	138 380	138 380

Additional information

1 At 31 March 2003: Inventory was valued at $10 200
Wages outstanding amounted to $1080
Insurance prepaid amounted to $210.

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is a debtor for this amount) and money withdrawn from the bank is credited (the bank is a creditor for this amount).

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

Test your understanding

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

Reasons why the Bank Account and the Bank Statement may Differ

Differences between the two records usually occur because of:

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

Timing Differences

These are usually due to:

1. **Cheques not yet presented**
   These are cheques that have been paid by the business and entered on the credit of the cash book, but which do not appear on the bank statement. This may be because the payee has not paid the cheque into his bank or because the cheque is still in the banking system and has not yet been deducted from the business's account.
2. **Amounts not yet credited**
   These are cash and cheques that have been paid into the bank and entered on the debit side of the cash book, but which do not appear on the bank statement. It usually takes a few days before the money paid into the bank is recorded in the customer's account.

Items not recorded in the cash book

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

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(d) Make any adjustments for bank errors by adding amounts debited in error by the bank and deducting amounts credited in error by the bank.

(e) The total of this calculation should equal to the updated bank balance in the cash book.

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

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

Example 14.1

The bank columns of Fatima's cash book for the month of April 20-8 are given below.

Cash Book (Bank columns only)

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-8			
April 1	Balance		2970	April 10	Purchases		234
14	J Dhatwani		420	19	B Malukani		110
26	ABC Stores		217	29	TeeDee Co.		1372
28	Sales		1460	30	Dobhal Ltd.		517
					Balance	c/d	2834
			5067				5067
20-8							
May 1	Balance	b/d	2834				

Fatima's bank statement for the month of April 20-8 is given below.

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REGIONAL BANK LTD
West District

Account: Fatima Goyal

Account No: 987654
Date: 30 April 20-8

Date	*Details*	*Debit*	*Credit*	*Balance*
20-8		$	$	$
April 1	Balance			2970 Cr
13	Cheque No 2388	243		2727 Cr
19	Credit No 6983		420	3147 Cr
20	Credit Transfer (Dividend)		150	3297 Cr
24	Cheque No 2389	110		3187 Cr
30	Bank charges	95		3092 Cr

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

(a) Make any additional entries that are required in Fatima's cash book. Balance the bank account and bring down the balance on 1 May 20-8.

(b) Prepare a bank reconciliation statement at 30 April 20-8.

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

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

Cash Book (Bank columns only)

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-8				20-8			
April 1	Balance		✓ 2970	April 10	Purchases		234
14	J Dhatwani		✓ 420	19	B Malukani		✓ 110
26	ABC Stores		217	29	TeeDee Co.		1372
28	Sales		1460	30	Dobhal Ltd.		517
					Balance	c/d	2834
			5067				5067
20-8							
May 1	Balance	b/d	2834				

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Chapter 15 Journal Entries and Correction of Errors

In this chapter you will learn to:

- understand the use of the journal as a book of prime entry
- prepare journal entries
- correct errors using journal entries and suspense accounts
- calculate the effect of correcting errors on the profit or loss
- demonstrate the effect of correcting errors on the balance sheet.

Introduction

Chapter 7 explained how all transactions are recorded in a book of prime entry (book of original entry) *before* they are entered in the ledger. It also described how sales and purchases on credit, and sales and purchases returns are entered in the sales, purchases and returns journals before being posted to the ledger. Chapters 4 and 5 explained how transactions involving cash or cheques etc. are entered in the cash book and the petty cash book before being posted to the ledger. There is one other book of prime entry which is known as the **journal** or **general journal**.

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

A journal entry shows:

The date of the transaction
The name of the account to be debited and the amount
The name of the account to be credited and the amount
A narrative

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Only one of the above errors will require a correcting entry in the suspense account. State which one and give a reason for your answer.

(c) Mary Manake is a sole trader. She has very little knowledge of bookkeeping, but attempted to prepare a trial balance and a set of final accounts.
The balance sheet she prepared is shown as follows:

Balance Sheet at 30 April 2004

	$
Non-current assets at cost	40 000
Depreciation	8 000
	32 000
Inventory	8 500
Trade receivables	6 100
	46 600
Capital at 1 May 2003	34 000
Profit for the year	8 440
	42 440
Drawings	7 300
	35 140
Trade payables	5 200
Bank overdraft	2 010
	42 350
Suspense account (difference on trial balance)	4 250
	46 600

When the books were checked the following matters were discovered.

1. No adjustment has been made for expenses prepaid at 30 April 2004 amounting to $30.
2. The bank statement received on 30April 2004 showed that the bank had debited the business's bank account with $70 for interest charged on the overdraft. No adjustment has been made for this in Mary Manake's books.
3. The total of the discount received column in the cash book, amounting to $150, has not been transferred to the discount

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The bookkeeper provided the following information for the month ended 31 July 2009.

	$
Cheques paid to suppliers	4650
Cheques received from customers	5660
Discounts allowed	75
Discounts received	90
Returns to suppliers	30
Returns to customers	41
Credit purchases	4800
Transfer from a purchases ledger account to a sales ledger account	105

Required

Select the relevant figures and prepare Ruth Tembe's purchases ledger control account for the month ended 31 July 2009. There is only one balance on the account at the end of the month.

[IGCSE 2009]

3. Mohammed Hanif maintains a full set of books or prime (original) entry and prepares a sales ledger control account and a purchases ledger control account at the end of every month.
He provided the following information for the month of April 2009.

		$	
April 1	Sales ledger balances	4100	debit
	Sales ledger balances	72	credit
April 30	Totals for the month:		
	Sales journal	5300	
	Sales returns journal	320	
	Cash sales	3900	
	Cheques received from debtors	3850	
	Cheque received from a debtor (included in the cheques received shown above) later dishonoured	65	
	Cash received relating to a bad debt written off in September 2007	250	

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Discount allowed	150
Increase in provision for doubtful debts	60
Transfer from a purchases ledger account to a sales ledger account	240

Required

(a) Select the relevant figures and prepare Mohammed Hanif's sales ledger control account for the month ended 30 April 2009. There is only one balance on the account at the end of the month.

(b) State **one** reason why it is possible to have a credit balance brought down on a sales ledger control account.

(c) State where **each** of the following items will appear in a purchases ledger control account. If the item will not appear in a purchases ledger control account write "No effect".

The first one has been completed as an example.

Item	*Entry in purchases ledger control account*
(i) Purchases returns	*Debit*
(ii) Cash purchases	....
(iii) Discount received	....
(iv) Interest charged by supplier on overdue account	....

[IGCSE 2009]

4. Susan Sawka maintains a full set of books of prime (original) entry and writes up a purchases ledger control account and a sales ledger control account at the end of every month.

On 1 March 2006 the balances brought down on Susan's purchases ledger control account were as follows:

	$
Debit balance	120
Credit balance	9500

Susan Sawka provided the following information for the month ended 31 March 2006.

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	$
Cash purchases	1660
Credit purchases	7420
Returns to credit suppliers	135
Returns by credit customers	210
Cheques paid to credit suppliers	8780
Cheques received from credit customers	9360
Discounts allowed	240
Discounts received	20
Transfer from a purchases ledger account to a sales ledger account	380

Required

(a) Select the relevant figures and prepare Susan Sawka's purchases ledger control account for the month ended 31 March 2006. There is only one balance on the account at the end of the month.
(b) State **two** reasons why it is possible to have a debit balance on a purchases ledger control account.
(c) Explain why the information used to write up Susan's purchases ledger control account is obtained from books of prime (original) entry and **not** from the purchases ledger.

[IGCSE 2006]

5. Ian Selkirk is a sole trader who maintains a full set of accounting records. He divides his ledger into three sections – general ledger, purchases ledger and sales ledger.
   (a) State and explain **one** advantage of dividing the ledger into these three sections.
   (b) Name **two** accounts which would appear in the general ledger.
   (c) Ian Selkirk prepares control accounts for his purchases and sales ledgers at the end of each month.

   On 1 April 2003 the balances brought down on the control accounts were:

	$
Purchases ledger control account	1960 credit
Sales ledger control account	1750 debit
Sales ledger control account	100 credit

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

Test your understanding

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

Example 17.1

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

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

During the year ended 30 April 20-9 Vijay purchased additional equipment for the business, costing $7000, out of his personal funds. This is in addition to the equipment listed above. His cash drawings during the year amounted to $7000, and he also took goods costing $3000 for personal use.

On 30 April 20-9 it was decided that *all* the equipment should be depreciated by 10%, and the motor vehicle should be depreciated by 25%.

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(c) Alternative presentation

Vijay
Capital account

Date	Details	Folio	$	Date	Details	Folio	$
20-9				20-8			
Apl 30	Drawings		5 000	May 1	Balance		62 820
	Purchases		3 000	20-9			
	Balance	c/d	65 542	Apl 30	Equipment		7 000
					Profit		3 722
			73 542				73 542
				20-9			
				May 1	Balance	b/d	65 542

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

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

Example 17.2

Vijay is a sole trader. He has not kept a full set of double entry records. A statement of affairs on 1 May 20-8 was shown in **Example 17.1**.

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

	$	$	$
Financed by			
Capital			
Opening balance			62 820
Plus Capital introduced			7 000
Profit for the year			3 722
			73 542
Less Drawings (5000 + 3000)			8 000
			65 542

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Example 17.4

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

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

During the year ended 30 June 20-5 receipts from debtors totalled $331 600 (after the deduction of $8200 cash discount). $249 400 was paid to creditors (after the deduction of $6780 cash discount).

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

Total trade receivables account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-4				20-5			
July 1	Balance	b/d	23 800	June 30	Bank		331 600
20-5					Discount allowed		8 200
June 30	Sales*		342 800		Balance	c/d	26 800
			366 600				366 600
20-5							
July 1	Balance	b/d	26 800				

Total trade payables account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-5				20-4			
June 30	Bank		249 400	July 1	Balance	b/d	19 700
	Discount received		6 780	20-5			
	Balance	c/d	20 200	June 30	Purchases*		256 680
			276 380				276 380
				20-5			
				July 1	Balance	b/d	20 200

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Points to Remember

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

Review Questions

*1. Rebecca Tan is a trader. Her financial year ends on 30 June. She does not keep many financial records, but is able to provide the following information.

Assets and liabilities on 30 June 2005 were as follows.

	$
Equipment at cost	13 900
Motor vehicle at cost	7 500
Trade receivables	5 200
Trade payables	4 800
Inventory	7 250
Bank overdraft	250
Other receivables	122
Other payables	146

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The following adjustments should be made on 30 June 2005.

The motor vehicle should be depreciated by 20% on cost.
The equipment should be revalued at $12 700.
A provision for doubtful debts of 2% of the trade receivables should be created.

Required

(a) Draw up a statement of affairs for Rebecca Tan at 30 June 2005 showing the total capital at that date.

Candidates who are not familiar with a statement of affairs may present their answer in the form of a balance sheet on 30 June 2005 showing the total capital of the business.

On 1 July 2004 Rebecca Tan's capital was $27 000.

On 2 July 2004 she introduced a further $5000 as capital.

During the year ended 30 June 2005 Rebecca Tan made the following drawings.

	$
Cash	3150
Goods	1250

Required

(b) Using the capital you calculated in (a) and the information provided above, calculate Rebecca Tan's profit (or loss) for the year ended 30 June 2005.
Your answer may be in the form of either a capital account or an arithmetic calculation.

[IGCSE 2005]

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

	$
Fixtures and fittings at valuation	6 000
Motor vehicle at cost	14 000
Inventory	3 800

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Inventory	19 600
Trade receivables	17 300
Bank	9 750
Trade payables	16 450

For the year ended 20 April 20-9:

		$
Receipts –	From credit customers	458 800
Payments –	To credit suppliers	371 820
	For motor expenses	15 070
	For general expenses	25 500
	For new fixtures	4 000
	For Mohan's personal use	20 000

On 30 April 20-9:

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

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

(a) Prepare the income statement of Mohan for the year ended 30 April 20-9.

(b) Prepare the balance sheet of Mohan at 30 April 20-9.

Show all calculations.

5. Pradeep is a trader. The following information is provided.

	$
Inventory at cost on 1 August 20-5	1 600
For the year ended 31 July 20-6	
Purchases	39 200
Sales	48 000

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On the evening of 31 July 20-6 a fire destroyed a quantity of goods. The cost of the goods salvaged from the fire was $700.
Pradeep marks up the goods by 25% on cost when calculating the selling price.
Calculate, by means of a trading account section of an income statement, the cost of the goods which were destroyed.

*6. Jane Joda started a business on 1 April 2003. Since that time Jane has not maintained any financial records.
She is able to provide the following information relating to her second year of trading.

	$
Inventory 1 April 2004	9 500
Inventory 31 March 2005	17 500
Purchases	22 000
Cash sales	6 600
Credit sales	?

The gross profit margin is 20%.
Calculate, by means of a trading account section of an income statement, the value of Jane Joda's credit sales for the year ended 31 March 2005.

[IGCSE 2005]

7. The following trial balance was extracted from the books of Saleem Ahmed at 31 July 2006.

	$	$
Capital		62 000
Drawings	7 200	
Premises at cost	38 000	
Fixtures at valuation	7 800	
Equipment at cost	5 000	
Provision for depreciation of equipment		950
Provision for doubtful debts		130
Trade receivables	9 000	
Bad debts recovered		170
Trade payables		7 970
Bank		4 755

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For the year ended 30 September 2008	
cheques received from customers	58 114
cheques paid to suppliers	45 930
discounts received	470
discounts allowed	1 186
bad debts written off	900
At 30 September 2008	
amounts owing by customers	4 800
amounts owing to suppliers	5 200

Required

(a) Calculate Suzan Hamouda's credit sales and credit purchases for the year ended 30 September 2008.
Your answer may be in the form of ledger accounts or calculations.

(b) Suzan sells all her goods at a mark-up of 20%.
Explain the difference between mark-up and margin.

On 1 October 2007 Suzan Hamouda's inventory was valued at $7800.
During the year ended 30 September 2008 Suzan Hamouda took goods costing $200 for her own use. No adjustments have been made for these goods.

Required

(c) Using your answers to (a) and the above information calculate, by means of a trading account section of an income statement, the value of Suzan Hamouda's inventory on 30 September 2008.

[IGCSE 2008]

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Chapter 18 Accounts of Clubs and Societies

In this chapter you will learn to:

- prepare a receipts and payments account and understand its purpose
- prepare a trading account section of an income statement of a club or society
- prepare an income and expenditure account and understand its purpose
- understand and calculate the accumulated fund of a club or society
- prepare a balance sheet of a club or society
- understand the difference between the accounts of a business and those of a club or society
- record subscriptions in the accounts of a club or society.

Introduction

This chapter concentrates on the accounts of **non-trading organisations** such as clubs and societies. The main aim of these organisations is to provide some facilities and services for their members: making a profit is not the main objective. Examples of such organisations include youth clubs, sports clubs, amateur dramatic groups, golf clubs, scout groups etc. In some case a full set of double entry records is written up each year, but it is more usual to find that only a record of money received and paid is maintained.

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

A person is appointed to act as treasurer and be responsible for collecting any money due to the society and for paying money owed by the society. At the end of the financial year the treasurer will usually present financial statements to the members. These financial statements

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may consist of a **receipts and payments account**, possibly a **trading account section of an income statement**, an **income and expenditure account** and a **balance sheet**.

Preparation of a Receipts and Payments Accounts

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

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

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

Example 18.1

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

On 1 August 20-7 the club had $2200 in the bank. The treasurer provided the following list of receipts and payments for the year ended 31 July 20-8.

	$
Subscriptions received	5860
Receipts from shop sales	3960
Purchases of goods for resale	2130
Wages – shop assistant	1300
athletics coach	2700
Rates and insurance	328
General expenses	1120
Purchase of new sports equipment	2950
Athletics competition – entrance fees received	1100
cost of prizes	660

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

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

Apollo Athletics Club
Receipts and Payments Account for the year ended 31 July 20-8

	Receipts		$		*Payments*		$
20-7				20-8			
Aug 1	Balance	b/d	2 200	July 31	Purchases		2 130
20-8					Wages – shop assistant		1 300
July 31	Subscriptions		5 860		athletics coach		2 700
	Receipts from				Rates & insurance		328
	shop		3 960		General expenses		1 120
	Competition				Sports equipment		2 950
	entrance fees		1 100		Competition prizes		660
					Balance	c/d	1 932
			13 120				13 120
20-8							
Aug 1	Balance	b/d	1 932				

Test your understanding

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

Preparation of a Trading Account Section of an Income Statements of a Club or Society

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

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Test your understanding

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

Calculation of Sales and Purchases

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

The same principles applied when calculating these figures for a business which has not got a complete set of accounting records are followed (see Chapter 17).

Example 18.6

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

The treasurer provided the following information.

	$
Trade payables 1 August 20-5	155
Trade payables 31 July 20-6	215
Amount paid to creditors during the year ended 31 July 20-6	2980

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

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2. During the year ended 30 September 2003, 280 members paid their annual subscription in full.
3. At 30 September 2003 subscriptions due from 15 members remained unpaid.

   Prepare the subscriptions account as it would appear in the ledger of the Green Jackets Sports Club for the year ended 30 September 2003. Show clearly the amount transferred to the income and expenditure account. Bring down the balance on 1 October 2003.

[IGCSE 2003]

*2. The assets and liabilities of the Safat Judo Club on 1 February 2005 were as follows:

	$
Bank	3150 debit
Motor vehicle at valuation	2000
Subscriptions owed by members	250
Rent owing	50

The treasurer provided the following information for the year ended 31 January 2006:

Receipts during the year	$	Payments during the year	$
Subscriptions	10 650	Purchase of new motor vehicle	10 000
Proceeds of sale of motor vehicle	1 750	Competition prizes	210
Competition entrance fees	800	General expenses	2 645
		Travelling expenses	830
		Rent	2 600

The following information is also available:

1 The motor vehicle is used to take members to tournaments and competitions.

The motor vehicle owned on 1 February 2005 was sold in March 2005. No depreciation is provided for in the year of sale.

A new motor vehicle was purchased on the same day. On 31 January 2006 the new motor vehicle was valued at $8500.

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(b) Prepare the income and expenditure account of the All Star Sports Club for the year ended 31 July 2004.

(c) The All Star Sports Club has been given the opportunity to purchase the clubhouse and grounds in 2006. At the end of the first year the club has a bank overdraft of $2110. The treasurer is worried that the club will not have enough money to pay for the property.
Suggest **two** ways in which the club could raise a large sum of money for this purpose. **[IGCSE 2004]**

6. The accounts maintained by non-trading organisations such as clubs and societies often use different terms to those used in the accounts of a trading business.

Required

(a) Complete the following table to name the equivalent terms used by a non-trading organisation.
The first one has been completed as an example.

Trading business	*Non-trading organisation*
(i) Cash book	*Receipts and payments account*
(ii) Loss for the year	....
(iii) Capital	....
(iv) Profit and loss account	....

The treasurer of the El Nil Sailing Club maintains a full set of accounting records. The following account appears in the ledger of El Nil Sailing Club.

Subscriptions account

2005				*$*	*2005*				*$*
Aug	1	Balance	b/d	750	Aug	1	Balance	b/d	300
2006					2006				
July	31	Income & Expenditure		4500	July	31	Bank		5850
		Balance	c/d	900					
				6150					6150
					2006				
					Aug	1	Balance	b/d	900

Chapter 19 Partnership Accounts

In this chapter you will learn to:

- recognise the advantages and disadvantages of partnerships
- understand the purpose and contents of a partnership agreement
- understand the entries necessary in connection with a loan from a partner
- prepare a partnership profit and loss appropriation account and understand its purpose
- prepare capital and current accounts in the ledger of a partnership
- prepare a balance sheet of a partnership.

Introduction

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

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

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

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

Loans from Partners

A partnership may borrow money from one of the partners if extra finance is required (particularly if it is needed for a fixed period of time). Loans from partners are **not** part of the capital of the business and are treated in the same way as any other loan.

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When a loan is obtained from a partner

Debit bank account	Credit loan from partner X account

When a loan is repaid to a partner

Debit loan from partner X account	Credit bank account

The loan account appears as a non-current liability in the balance sheet

Interest on loan paid

Debit interest on loan account	Credit bank account

Interest on loan due but not paid

Debit interest on loan account	Credit partner X current account*

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

Preparation of a Profit and Loss Appropriation Account of a Partnership Business

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

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

Example 19.1

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

*See later in this Chapter.

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Current accounts

			Sumit	Padma				Sumit	Padma
Date	*Details*	*Fo*	*$*	*$*	*Date*	*Details*	*Fo*	*$*	*$*
20-8					20-8				
June 1	Balance	b/d		910	June 1	Balance	b/d	130	
20-9					20-9				
May 31	Drawings		11 000	8 000	May31	Interest on capital		2 000	1 000
	Interest on drawings		330	240		Salary			9 500
	Balance	c/d		5 600		Profit share		8 500	4 250
						Balance	c/d	700	
			11 330	14 750				11 330	14 750
20-9					20-9				
June 1	Balance	b/d	700		June 1	Balance	b/d		5600

Test your understanding

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

Preparation of a Balance Sheet of a Partnership Business

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

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

Example 19.4

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

Prepare a relevant extract from the balance sheet of Sumit and Padma at 31 May 20-9.

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Sumit and Padma
Extract from Balance Sheet at 31 May 20-9

	$ *Sumit*	$ *Padma*	$ *Total*
Capital accounts	40 000	20 000	60 000
Current accounts	(700)*	5 600	4 900
	39 300	25 600	64 900

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

Sometimes the partners may wish to show the full details of the current accounts in the balance sheet. An examination question may also ask for details to be shown (this may also be necessary if current accounts are not prepared as part of the answer).

Example 19.5

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

Prepare a relevant extract from the balance sheet of Sumit and Padma on 31 May 20-9 showing full details of their current accounts.

Sumit and Padma
Extract from Balance Sheet at 31 May 20-9

	$ *Sumit*	$ *Padma*	$ *Total*
Capital accounts	40 000	20 000	60 000
Current accounts			
Opening Balance	130	(910)	
Interest on capital	2 000	1 000	
Partner's salary		9 500	
Profit share	8 500	4 250	
	10 630	13 840	
Less Drawings	11 000	8 000	
Interest on drawings	330	240	
	11 330	8 240	
	(700)	5 600	4 900
			64 900

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Prepare the balance sheet of the partnership at 31 August 2003. Show the working capital.

[IGCSE 2003]

2. Smith and Travers are in partnership sharing profits and losses in accordance with their partnership agreement which states the following:
   1 Interest on capital is allowed at 5% per annum
   2 Salary to be paid to Smith of $15 000 per annum
   3 Interest to be charged on each partner's drawings for the year at 4% per annum
   4 Travers and Smith share the balance of profits in the ratio 3:2.

   The balances on the partners' capital accounts at 1 October 2005 were:

Smith	$30 000
Travers	$40 000

   The partners' drawings for the year ended 30 September 2006 were:

Smith	$35 000
Travers	$15 000

   The profit of the partnership for the year ended 30 September 2006 was $89 000.

   Required

   (a) Prepare the profit and loss appropriation account for the partnership for the year ended 30 September 2006.

   Smith's current account in the partnership books showed a balance of $2300 credit at 1 October 2005.

   Required

   (b) Using the information above and your answer to Part (a), calculate the balance on Smith's current account at 30 September 2006. **[IGCSE 2006]**

*3 Raminder and Vijay Singh formed a partnership and drew up a partnership agreement.

   Required

   (a) State **two** advantages of being in partnership rather than being a sole trader.

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On 1 April 2008 Raminder transferred the balance on his current account to his capital account. He also withdrew $45 000 of his capital from the business bank account.

On 30 April 2008 Vijay paid an amount into the business bank account so that his capital was equal to Raminder's.

Required

(d) Prepare the partners' capital accounts as they would appear in the ledger for the month of April 2008.

[IGCSE Specimen Paper]

4. Ruth and Lucy Lebengo formed a partnership on 1 October 2003. They share profits and losses 2:1.They agreed that a current account and a capital account would be kept for each partner.

   The income statement for the year ended 30 September 2004 showed a profit for the year of $12 000.

   Lucy has very little knowledge of bookkeeping, but attempted to prepare a balance sheet at 30 September 2004. The balance sheet she prepared, containing errors, is shown below.

Balance Sheet at 30 September 2004

	$	$	$
Premises at cost			35 000
Motor vehicles at cost		15 000	
Less Depreciation		1 500	13 500
Office equipment			3 000
Inventory			9 300
Trade receivables			5 900
			66 700
Capital – Ruth		30 000	
Lucy		20 000	50 000
Profit for the year		12 000	
Less Drawings – Ruth	4 000		
Lucy	4 400	8 400	3 600
Trade payables			7 400
Bank overdraft			5 100
			66 100

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The following matters were then discovered.

1 No adjustment had been made in the balance sheet for the following:

	$
Depreciation of office equipment	300
Provision for doubtful debts	200

These items had been correctly charged in the income statement.

2 Cash in hand, $100, had been omitted from the balance sheet.

3 The overdraft shown on the bank statement had been entered in the balance sheet instead of the overdraft of $5300 shown in the cash book.

Taking the above matters into account, prepare a corrected balance sheet for Ruth and Lucy at 30 September 2004.

The balance sheet should be shown using a suitable form of presentation, showing the different types of assets and liabilities, the net current assets, and the capital and current accounts of each partner.

[IGCSE 2004]

*5. Archer and Bowman are partners.

Their income statement for the year ended 31 August 2003 showed a profit for the year of $18 490.

It was then found that the following errors had been made.

1 No entry had been made for inventory of stationery, $30, on 31 August 2003.

2 The inventory of goods for re-sale on 31August 2003 had been valued at selling price, $8400, instead of cost price, $7000.

3 No entry had been made for depreciation of equipment. The equipment cost $13 000 and was estimated to have a scrap value of $1000 after 6 years. All the non-current assets of the partnership are depreciated using the straight line (fixed instalment) method.

4 Discount received of $210 has been included in the expenses instead of the income in the income statement.

5 A provision for doubtful debts is maintained equal to 5% of the trade receivables at the end of each financial year. On

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1 September 2002 the provision was $400. On 31 August 2003 the trade receivables totalled $8400. No adjustment has been made to the provision for doubtful debts.

(a) Prepare a statement to show the effect of correcting each of the errors 1-5 on Archer and Bowman's original profit for the year. Calculate the corrected profit for the year. The first one has been completed as an example.

Archer and Bowman
Statement of corrected profit for the year ended 31 August 2003

				$
Profit for the year before corrections				18 490
		Effect on profit		
		+	–	
		$	$	
Error	1	30		
	2			
	3			
	4	____	____	
		____	____	_____
Corrected profit for the year				_____

Archer and Bowman's partnership agreement states that
Interest is to be allowed on capital at 5% per annum
Interest is to be charged on drawings at 5% per annum
Archer is to receive an annual salary of $6000
Profits and losses are to be shared equally.

On 31 August 2003 the following balances appeared in the partnership books.

		$
Capital account (at 1 September 2002) –	Archer	40 000
	Bowman	80 000
Drawings during the year ended 31 August 2003 –	Archer	7 000
	Bowman	3 000

(b) Using the corrected profit for the year calculated in (a), prepare the profit and loss appropriation account of Archer and Bowman for the year ended 31 August 2003.

[IGCSE 2003]

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*6. Ebor and Olicana are in partnership trading in sports goods. Their financial year ends on 31 July. After the preparation of their income statement for the year ended 31 July 2005 the following errors were discovered.

1. Olicana had taken goods costing \$500 for her own use. This had not been recorded.
2. \$15 paid for carriage inwards had been debited to the carriage outwards account.
3. The purchase of computer paper, \$30, had been debited to the purchases account.
4. Motor vehicle repairs of \$200 had been debited to the motor vehicles account. Motor vehicles are depreciated by 25% on the cost of motors held at the end of each financial year.

Required

(a) Complete the following table to show the effect of **correcting the errors** on the gross profit and the net profit. If the correction of the error does not affect the profit write 'no effect'.
The first one has been completed as an example.

Error	*Effect of correcting the error* *on the gross profit*	*on the net profit*
1	+\$500	+\$500
2		
3		
4		

Ebor and Olicana maintain a full set of books of account.
The following transactions took place on 31August 2005.

1. Olicana took further goods costing \$400 for her own use.
2. Ebor brought his own computer, valued at \$900, into the business
3. Ebor's current account showed a credit balance of \$10 000. It was agreed that he should transfer half of this to his capital account.

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Required

(b) Prepare the necessary journal entries to record the above transactions. Narratives **are** required.

[IGCSE 2005]

7. Salim and Rita Jaffer are in partnership. Their financial year ends on 31 July. They share profits and losses equally. It was agreed that a current account and a capital account would be kept for each partner.

   Their income statement for the year ended 31 July 2008 showed a profit for the year of $15 500. The accountant was unable to prepare the balance sheet immediately because of illness.

   Salim has very little knowledge of bookkeeping, but attempted to prepare a balance sheet at 31 July 2008. The balance sheet he prepared, containing errors, is shown below.

Balance Sheet at 31 July 2008

		$	$
Premises at cost			95 000
Equipment at book value at 1 August 2007			13 000
Inventory 31 July 2008			8 200
Trade receivables			6 600
Drawings – Salim Jaffer		7 700	
Rita Jaffer		6 220	13 920
			136 720
Trade payables			6 800
Provision for doubtful debts			330
Profit for the year			15 500
Capital accounts 1 August 2007 –	Salim Jaffer	40 000	
	Rita Jaffer	60 000	100 000
Current accounts 1 August 2007 –	Salim Jaffer	3 400 Cr	
	Rita Jaffer	6 100 Cr	9 500
			132 130
Balancing figure			4 590
			136 720

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The following matters were then discovered.

1 No adjustment had been made in the balance sheet for the following:

	$
Other payables	620
Other receivables	430
Depreciation of equipment	1500

These items had been correctly recorded in the income statement.

2 The bank balance had been omitted from the balance sheet. On 31 July 2008 the cash book showed a bank overdraft of $2900 and the bank statement showed an overdraft of $2200.

All the transactions appearing on the bank statement had been recorded in the cash book.

Required

(a) Prepare a corrected balance sheet for Salim and Rita Jaffer at 31 July 2008.

The balance sheet should be shown using a suitable form of presentation, showing the different types of assets and liabilities, the net current assets and the capital and current accounts of each partner.

The calculation of the current account balances may either be shown within the balance sheet or as separate calculations.

On 1 August 2008 the balances on the partners' capital accounts were the same as those on 1 August 2007.

On 1 August 2008 Rita transferred $4000 from the credit balance on her current account to her capital account.

On 31 August 2008 Salim paid an amount into the business bank account so that his capital was equal to Rita's.

Required

(b) Write up the partners' capital accounts as they would appear in the ledger for the month of August 2008.

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Salim Jaffer suggests that it would be easier to maintain only a capital account for each partner instead of both a capital account and a current account.

Required

(c) State and explain **one** advantage of maintaining both a capital and a current account for each partner.

[IGCSE 2008]

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The Elements of Cost

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

Direct material

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

Direct labour

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

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

Direct expenses

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

Factory overheads

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

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Test your understanding

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

Preparation of a Manufacturing Account

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

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

Opening inventory of raw material
\+ Purchases of raw material
\+ Carriage inwards on raw material
– Closing inventory of raw material

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

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

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

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

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

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Example 20.1

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

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

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

Kapoor Manufacturing Company
Manufacturing Account for the year ended 30 April 20-6

	$	$
Cost of material consumed		
Opening inventory of raw material	14 900	
Purchases of raw material	181 200	
Carriage on purchases	3 300	
	199 400	
Less Closing inventory of raw material	15 300	184 100
Direct wages		166 100
Direct expenses		
Royalties		10 000
Prime Cost		360 200
Factory overheads		
Indirect wages	93 800	
Insurance	2 070	
Rent and rates	2 930	
General expenses	6 350	
Depreciation of machinery	9 500	114 650
Production cost of goods completed		474 850

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Test your understanding

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

Work in Progress

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

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

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

Example 20.2

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

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

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

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Preparation of a Trading Account Section of an Income Statement of a Manufacturing Business

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

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

Purchases of finished goods are added to the production cost of goods completed in the trading account.

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

Example 20.4

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

		$
* Production cost of goods completed		475 000
Revenue (sales)		661 500
Finished goods –	Inventory 1 May 20-5	31 000
	Inventory 30 April 20-6	23 250
	Purchases	15 500

*Calculated in the manufacturing account.

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

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Preparation of a Balance Sheet of a Manufacturing Business

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

Example 20.5

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

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

Prepare a relevant extract from the balance sheet of the Kapoor Manufacturing Company at 30 April 20-6.

Kapoor Manufacturing Company
Balance Sheet at 30 April 20-6

		$	$
Current assets			
Inventories –	raw materials	15 300	
	work in progress	8 640	
	finished goods	23 250	47 190

Year-end Adjustments

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

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4. Factory machinery was valued at $19 550. It had been purchased for $21 000 on 1 January 2003. There were no other purchases or sales of machinery during the year.

(a) Prepare the manufacturing account of the Playground Company for the year ended 31 December 2003.

(b) Prepare the trading account section of the income statement of the Playground Company for the year ended 31 December 2003.

[IGCSE 2004]

*3. (a) Explain the difference between
   (i) direct costs and indirect costs
   (ii) prime cost and cost of production.

(b) Explain the meaning of the term "work in progress".

(c) Explain why a manufacturer may purchase finished goods as well as raw materials.

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

		$
1 June 20-8	Inventory of raw materials	4 750
	Work in progress	5 600
31 May 20-9	Inventory of raw materials	4 850
	Work in progress	4 300
For the year ended 31 May 20-9		
	Purchases of raw materials	49 590
	Direct factory wages	61 940
	Indirect factory wages	29 660
	Carriage on raw materials	3 710
	Factory direct expenses	2 960
	Factory indirect expenses	48 930

(d) (i) Calculate the prime cost.
   (ii) Calculate the cost of production.

*4. (a) Explain why it is necessary for a manufacturing business to prepare a manufacturing account in addition to an income statement.

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5. Gideon Yeboah is a manufacturer. He provided the following information.

		At 1 April 2007	*At 31 March 2008*
		$	*$*
Inventory –	raw materials	21 230	19 410
	work in progress	11 680	12 130
	finished goods	46 900	53 170

For the year ended 31 March 2008

	$
Revenue (sales)	825 000
Purchases of raw materials	255 620
Purchases of finished goods	13 200
Direct factory wages	194 060
Factory general expenses	133 910

The following additional information is available on 31 March 2008.

1 Direct factory wages accrued amounted to $4800.

2 The factory general expenses include insurance on the factory which is prepaid by $210.

3 The factory machinery was valued at $92 000.
On 1 April 2007 the factory machinery was valued at $103 000. Additional machinery costing $21 000 was purchased during the year. There were no sales of machinery during the year.

Required

(a) (i) State the basis on which Gideon Yeboah should value his inventories.

(ii) Name one accounting principle Gideon Yeboah is applying by valuing his inventories on this basis.

(b) Prepare the manufacturing account of Gideon Yeboah for the year ended 31 March 2008.

(c) Prepare the trading account section of the income statement of Gideon Yeboah for the year ended 31 March 2008.

[IGCSE 2008]

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Chapter 21 Limited Company Accounts

In this chapter you will learn to:

- understand the nature of a limited company
- understand the terms issued share capital, called up share capital and paid up share capital
- understand the difference between ordinary shares, preference shares and debentures
- prepare a profit and loss appropriation account of a limited company and understand its purpose
- understand the capital structure of a limited company.

Introduction

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

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

The Nature of a Limited Company

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

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among the members in the form of dividends which are often stated in terms of a percentage of the face value of the shares.

Example 21.1

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

(a) What is the total amount payable?
(b) What is the amount payable per share?

(a) Total amount payable is $40 000 ($400 000 x 10%)
(b) Amount payable per share is $0.20

It is obviously not practical for all the members to take part in the running of the company, so it is usually managed by an elected board of directors. Unlike a sole trader or the partnership business, a limited company has a separate identity from its owners (shareholders), so any legal actions can be taken against the company rather than the members of the company.

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

There are many legal requirements in relation to the formation and running of a limited company. In addition to the usual accounting records several other records must be maintained. Companies are also required to publish accounts annually. These legal requirements, additional records and published accounts are outside the scope of this book.

Test your understanding

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

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Types of Shares

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

Preference Shares

As the name implies, these get preference over the ordinary shares. They receive a fixed rate of dividend (based on the face value of the shares) which is payable before any dividend is payable to the ordinary shareholders. The dividend is same every year (provided that the profit of the company is enough to cover this amount). Preference share dividend was previously regarded as an appropriation of profit, but now should be included in the profit and loss account section of the income statement. If a company is wound up (closed down) any money left after paying outside liabilities is used to pay back the preference shareholders before anything is returned to the ordinary shareholders. Preference shareholders are not usually entitled to vote at shareholders' meetings. There are several types of preference shares, but these are outside the scope of this book.

Ordinary Shares

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

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Debentures (Loan Notes)

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

Test your understanding

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

Profit and Loss Appropriation Account of a Limited Company

Chapter 19 explained how it was necessary to prepare a profit and loss appropriation account for a partnership business to show how the profit was divided between the partners. In a similar way, a limited company must prepare an account or statement showing how the profit for the year is used. Public limited companies are required to prepare a **statement of changes in equity**. However non-public limited companies can continue to prepare a profit and loss appropriation account. The published accounts of public limited companies are outside the scope of this book. CIE guidelines state that, for IGCSE, the traditional approach will be followed.

It has already been explained that profits are distributed to the shareholders of a limited company in the form of dividends. Preference share dividend is included in the income statement but ordinary share dividend is recorded in the profit and loss appropriation account. At the end of the financial year the directors of a company propose that ordinary share dividends are paid and these will be paid early in the following year. These proposed ordinary share dividends will appear as a note to the financial statements of public limited companies and will not be

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included within the statements. Non-public limited companies following the traditional approach will show the proposed ordinary share dividends in the profit and loss appropriation account and also in the balance sheet as current liabilities (or Creditors: amounts falling due within one year). Sometimes the directors will recommend an **interim ordinary dividend** (half way dividend) to be paid during the year. This is still an appropriation of profit, but, as it has already been paid, is not included in the liabilities at the end of the year.

Very often limited companies do not distribute the whole of the net profit as dividends. Even if a limited company wished to distribute the whole profit it would not be possible if there was not enough cash available. Any profit that is not appropriated for dividends remains as a balance on the profit and loss appropriation account and is carried forward to the following year. This may be referred to as **retained profits** or **profit and loss account balance**. This will appear in the balance sheet as part of the **reserves** which are added to the share capital.

In addition to leaving a balance of undistributed profit in the profit and loss appropriation account, many companies will transfer an amount from the profit and loss appropriation account to a general reserve. This is another means of **ploughing back profits** into the company to help it grow. The general reserve also appears in the reserves section of the balance sheet which is added to the share capital.

Example 21.3

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

The profit for the year ended 30 June 20-6 *before* the preference share dividend was $58 000. On that date the retained profit brought forward amounted to $21 000.

Half of the preference share dividend was paid on 31 December 20-5. On 30 June 20-6 the remaining preference share dividend is to be accrued.

It was agreed to transfer $8000 to general reserve and to pay an ordinary share dividend of 8%.

(a) Prepare a relevant extract from the income statement for the year ended 30 June 20-6.

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(b) Prepare the profit and loss appropriation account for the year ended 30 June 20-6.

(a)

Anand Ltd.
Extract from Income Statement for the year ended 30 June 20-6

	$
Expenses – Preference share dividend (5000 + 5000)	10 000

(b)

Anand Ltd.
Profit and Loss Appropriation Account for the year ended 30 June 20-6

	$	$
Profit for the year		48 000
Less Transfer to general reserve	8 000	
Ordinary share dividend – proposed	24 000	32 000
Retained profit for the year		16 000
Retained profit brought forward		21 000
Retained profit carried forward		37 000

Test your understanding

1. State an alternative name for retained profits brought forward.
2. Explain the term interim dividend.
3. Explain the difference between dividends paid and dividends proposed.

Balance Sheet of a Limited Company

A balance sheet needs to be modified so that it is suitable for a limited company. Current liabilities are usually referred to as Creditors: amounts falling due within one year. Long-term liabilities are usually referred to as Creditors: amounts falling due after more than one year.

Where a limited company has raised funds from the issue of debentures, these are shown with the other long-term liabilities under the heading of Creditors: amounts falling due after more than one year.

In the capital section of the balance sheet, the share capital is shown, with details of the different types of shares. Any reserves such as general reserve and retained profits balance are added to the share capital. These

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Test your understanding

1. Explain how debentures are recorded in the balance sheet of a limited company.
2. Explain why reserves such as general reserve and retained profits are added to the share capital in the balance sheet of a limited company.
3. State what shareholders' funds consist of.

Points to Remember

1. A limited company is a legal entity which has a separate identity from its shareholders, whose liability is limited.
2. The share capital actually issued to shareholders is known as the issued capital.
3. There are two main types of shares – preference shares and ordinary shares.
4. Debentures are a form of long-term loan.
5. A profit and loss appropriation account shows how the profit for the year has been used.
6. The total of the issued share capital and the reserves is known as the shareholders' funds.

Review Questions

1. (a) Explain the difference between the following
   - (i) Called-up share capital and paid-up share capital
   - (ii) Preference shares and ordinary shares
   - (iii) Ordinary share dividend paid and ordinary share dividend proposed.

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

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

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

Net profit as a percentage of sales (net profit/sales)

This is calculated using the following formula:

$$\frac{\text{net profit (profit for the year)}}{\text{sales (revenue)}} \times \frac{100}{1}$$

Example 22.4

Using the financial statements shown in **Example 22.1** calculate Arun's net profit as a percentage of sales.

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

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

Test your understanding

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

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Liquidity Ratios

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

Current ratio

This is calculated using the following formula:

current assets : current liabilities

Example 22.5

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

$31 250 : $12 500 = 2.50 : 1

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

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

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

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

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business has too much inventory or that the sales are slowing down. The quicker the rate of inventory turnover, the less time funds are tied up in inventory which is regarded as the least liquid of the current assets.

A lower rate of inventory turnover can be caused by factors such as:

- lower sales (resulting in higher inventory levels)
- inventory over-purchased
- too high selling prices
- falling demand
- business activity slowing down
- business inefficiency

Collection period for trade receivables

This is calculated using the following formula:

$$\frac{\text{trade receivables}}{\text{credit sales}} \times \frac{365}{1} \quad \text{to give an answer in days}$$

$$\frac{\text{trade receivables}}{\text{credit sales}} \times \frac{52}{1} \quad \text{to give an answer in weeks}$$

$$\frac{\text{trade receivables}}{\text{credit sales}} \times \frac{12}{1} \quad \text{to give an answer in months}$$

Example 22.8

Using the financial statements shown in **Example 22.1** calculate (to the nearest whole day) Arun's collection period for trade receivables.

$$\frac{\$10\ 500}{\$110\ 000} \times \frac{365}{1} = 34.84 \text{ days} = 35 \text{ days}$$

This is also referred to as the **trade receivables/sales ratio**. It measures the average time the debtors take to pay their accounts. The answer to this calculation - the length of time debtors actually take to pay their accounts - should be compared with the term of credit allowed to debtors. The quicker the debtors pay their accounts, the better it is: the money can then be used for other purposes within the business. The longer a business has to wait for a debt to be paid the greater the risk of it becoming a bad debt.

The same business may have a similar collection period from year to year. If the period decreases it may indicate that the credit control policy

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calculation should be compared with the term of credit allowed by creditors.

The same business may have a similar payment period from year to year. If the period decreases, the business is paying the creditors more quickly: if the period increases it may indicate that the business is short of immediate funds and is finding it difficult to meet debts when they fall due. This ratio can also be influenced by the collection period for trade receivables: if the debtors do not settle their accounts promptly the business may not be able to pay the creditors promptly. Taking longer to pay the creditors means that the business can use the funds for other purposes, but there can be adverse effects such as:

- the supplier refusing credit in the future
- the supplier refusing further supplies
- the loss of any cash discount for early settlement
- damage to the relationship with the supplier

Test your understanding

1. State the formula for calculating rate of inventory turnover.
2. State **two** reasons why the rate of inventory turnover may fall.
3. State the formula for calculating the collection period for trade receivables.
4. A trader allows his debtors 30 days credit. The collection period is 40 days. State whether the trader will be satisfied. Give a reason for your answer.
5. A trader's creditors allow him 45 days credit. State **one** advantage and **one** disadvantage to the trader if he pays after 60 days.

Inter-firm Comparison

Comparing the ratios calculated for the current financial year with those of previous years can measure the progress and performance of a business and indicate the trends in profitability, liquidity and so on.

Another useful comparison is to compare the ratios with those of a similar business.

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(a)

	Arun $	Renu $
(i) Return on capital employed	10.49%	$\frac{\$10\ 500}{\$115\ 000} \times \frac{100}{1} = 9.13\%$
(ii) Gross profit as a percentage of sales	20%	$\frac{\$24\ 000}{\$100\ 000} \times \frac{100}{1} = 24\%$
(iii) Net profit as a percentage of sales	12.50%	$\frac{\$10\ 500}{\$100\ 000} \times \frac{100}{1} = 10.50\%$
(iv) Current ratio	2.50 : 1	$16 600 : $11 600 = 1.43 : 1
(v) Quick ratio	1.82 : 1	$10 900 : $11 600 = 0.94 : 1
(vi) Rate of inventory turnover	12 times	$\frac{\$76\ 000}{\$5\ 400} = 14.07$ times
(vii) Collection period for trade receivables	35 days	$\frac{\$10\ 900}{\$100\ 000} \times \frac{365}{1} = 40$ days
(viii) Payment period for trade payables	48 days	$\frac{\$5\ 500}{\$50\ 000} \times \frac{365}{1} = 37$ days

- The detailed calculations for Arun's business have been shown earlier in this chapter.

(b) Comparison of the ratios

Profitability

Arun is employing more capital and has a higher return on capital employed than Renu. For every $100 of capital employed Arun had a return of $10.49 whereas Renu only achieved $9.13. This may indicate that Renu is not employing the capital in the most effective way.

Both businesses earned the same amount of gross profit, but Renu achieved a higher gross profit as a percentage of sales. It may be that Arun failed to pass on increased costs, or sold goods at cheaper prices in order to achieve greater sales. Renu may have been selling the goods at higher prices or buying goods at a cheaper price than Arun.

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Users of Accounting Statements

It is not only the owner who is interested in analysing and interpreting the financial statements of a business. Various other people are also interested in different aspects of the accounts. The users of accounting statements can be divided into two main groups - internal users and external users.

Internal users

1. **Owner(s)**
   The owners of a business such as a sole trader or partners will be interested in all aspects of the business, both profitability and liquidity in order to assess the business's performance and progress. Any potential partners are interested in the profitability of the business. The owners of a limited company, the shareholders, and potential shareholders, are interested in the profitability of the company and also in various investment ratios (which are outside the scope of this book).
2. **Manager(s)**
   In many small businesses, the owners manage the business. In some cases, management may be carried out by an employee. Like the owners, managers are interested in all aspects of the business. They may use ratios to assess past performance, plan for the future and take remedial action where necessary.

External users

1. **Bank manager**
   If a business requests a bank loan or an overdraft facility the bank manager will require the financial statements of the business. The bank manager will need to know whether there is adequate security to cover the amount of the loan or overdraft, whether it can be repaid when due, and whether interest can be paid when due.
2. **Other lenders**
   Anyone who has made a loan to a business (and any potential lenders) will be interested in the security available, the repayment of the loan when due, and the payment of interest when due.

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Historic cost

The only way to record financial transactions is to use the actual cost price. However, comparing transactions taking place at different times can be difficult because of the effect of inflation. For example, in times of inflation, it would cost more to buy a machine in 20-8 identical to one purchased in 20-1.

Accounting policies

All businesses should apply the accounting principles of **prudence** and **consistency** which should help in making comparisons. However, there are several acceptable accounting policies which may be applied, for example there are several different methods of calculating depreciation. Where businesses have used different accounting policies it is difficult to make a meaningful comparison of their results. Similarly, where a business changes its policy, a comparison with the results of previous years is difficult.

Different definitions

The figure of profit for the year may be adjusted for loan interest, and sometimes preference share dividends in a limited company (these adjustments are outside the scope of this book). A comparison of results is only meaningful if "like is compared with like" and the same definitions are applied.

Money measurement

Accounts only record information which can be expressed in monetary terms. This means that there are many important factors which influence the performance of a business which will not appear in the accounting statements.

The factors which are within the control of the business include the quality of management, the skill and reliability of the workforce, the goodwill of the business, the age and condition of the non-current assets, and the ability to adapt in response to changing market conditions.

Other factors are outside the control of the business. These include government policies, competition, impact of new technology, and future long-term prospects for the particular trade or industry.

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At 31 January 2008

trade receivables	30 000
trade payables	20 200

Required

(a) Suggest **one** way in which the collection period for trade receivables may affect the payment period for trade payables.

(b) Calculate Miriam Rajah's collection period for trade receivables. Show your workings. Round up your answer to the nearest whole day.

(c) Calculate Miriam Rajah's payment period for trade payables. Show your workings. Round up your answer to the nearest whole day.

(d) State **two** possible advantages to Miriam Rajah of paying her trade payables before the due date.

[IGCSE 2008]

3. Mona El Tawil is a sole trader. Her financial year ends on 31 December. She provided the following information:

For the year ended 31 December 2006

		$	$
Sales –	cash	115 000	
	credit	275 000	390 000
Purchases –	cash	5 000	
	credit	465 000	470 000

At 31 December 2006

	$
Trade receivables	29 000
Trade payables	40 000
Inventory	34 000
Bank	7 000 debit
Non-current assets	180 000

Mona El Tawil decides to compare her position with that at the end of the previous financial year.

Required

(a) Complete the following table to show the ratios for Mona El Tawil's business for the year ended 31 December 2006.

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Calculations should be correct to **two** decimal places for (i) and (ii) and should be rounded up to the next whole day for (iii) and (iv).

	Ratio	*Year ended 31 December 2005*	*Year ended 31 December 2006*
(i)	Current ratio	2.25:1	....
(ii)	Quick ratio	0.75:1	....
(iii)	Collection period for trade receivables	30 days	.... days
(iv)	Payment period for trade payables	24 days	.... days

(b) Explain why the quick ratio is more reliable than the current ratio as an indicator of liquidity.

(c) State whether Mona El Tawil will be satisfied with the change in the quick ratio.

(d) Suggest **one** possible reason which could account for the change in the current ratio.

(e) State and explain whether you think Mona El Tawil will be satisfied with the change in the trade receivables collection period.
   (i) Will she be satisfied?
   (ii) Explanation

(f) Explain how the change in the trade receivables collection period may have affected the payment period for trade payables.

(g) Name one other ratio which would help Mona El Tawil assess the liquidity position.

Mona El Tawil would like to compare her results with those of other businesses.

She is aware that even comparing with a business of a similar size dealing in similar goods can produce misleading results.

Required

(h) List **four** things Mona El Tawil should consider when comparing her results with those of a similar business.

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Required

(d) Calculate, to two decimal places, the return on capital employed (ROCE) for the year ended 30 September 2008. Show your workings.

(e) State and explain whether you think Maria Maziya will be satisfied with the change in the return on capital employed (ROCE).

[IGCSE 2008]

7. In addition to the owner of a business, various other business people are interested in the financial statements.
Explain why **each** of the following business people would be interested in the financial statements.
(a) Bank manger
(b) Creditor

[IGCSE 2009]

8. Kalpna Khan started a business on 1 April 2007. On that date she rented premises larger than she required so that she had space for future expansion. She employs ten staff to make exclusive hand-made sweets and chocolates, which are sold to department stores and personal customers.
She provided the following information:

Ratio	*Year ended 31 March 2008*	*Year ended 31 March 2009*
Percentage of gross profit to sales	25%	21%
Percentage of net profit to sales	10%	9%

Required

(a) Suggest **two** reasons for the fall in the percentage of **gross** profit to sales.

(b) Explain one way in which the percentage of **net** profit to sales could be increased.

Kalpna Khan is interested in the effect of expenses on her profitability.

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Required

(h) Explain how **each** of the following affects inter-firm comparison. Use examples to illustrate your answers.
The first has been completed as an example.
  (i) Different type of expense
  One business may own premises, another may rent premises. This affects the expenses and the profit and the profitability ratios – making comparison difficult.
  (ii) Non-monetary factory
  (iii) Accounting policies **[IGCSE 2009]**

*9. Ebor and Olicana are partners and have invited Lindum to join the partnership and have given him their financial statements for the year ended 31 July 2005.

Lindum is aware that these financial statements will not provide all the relevant information he needs.

State and explain **two** limitations Lindum should be aware of when he is studying the financial statements Ebor and Olicana have provided.

[IGCSE 2005]

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Answers to Review Questions

Chapter 1

Question 3

Transaction	*Effect on assets*		*Effect on liabilities*	
		$		*$*
(b)	Inventory	Increase	Trade payables	Increase
(c)	Trade receivables Bank	Decrease Increase		
(d)	Trade receivables Inventory	Increase Decrease		
(e)	Cash	Decrease	Loan	Decrease

Chapter 2

Question 3

Mumtaz
Bank account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-6				20-6			
July 1	Capital		50 000	July 2	Premises		25 000
9	Sales		200	4	Equipment		4 000
				7	Advertising		60
				14	Mayur Vihar Traders		1 000
					Balance	c/d	20 140
			50 200				50 200
20-6							
July 15	Balance	b/d	20 140				

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Capital account

Date	Details	Folio	$	Date	Details	Folio	$
				20-6 July 1	Bank		50 000

Premises account

Date	Details	Folio	$	Date	Details	Folio	$
20-6 July 2	Bank		25 000				

Equipment account

Date	Details	Folio	$	Date	Details	Folio	$
20-6 July 4	Bank		4 000				

Purchases account

Date	Details	Folio	$	Date	Details	Folio	$
20-6 July 6	Mayur Vihar Traders		1 500				

Mayur Vihar Traders account

Date	Details	Folio	$	Date	Details	Folio	$
20-6 July 14	Bank		1 000	20-6 July 6	Purchases		1 500
	Balance	c/d	500				
			1 500				1 500
				20-6 July 15	Balance	b/d	500

Advertising account

Date	Details	Folio	$	Date	Details	Folio	$
20-6 July 7	Bank		60				

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Chapter 4

Question 3

(a)

Jonah
Cash Book

Date	Details	Folio	Discount Allowed	Cash	Bank	Date	Details	Folio	Discount Received	Cash	Bank
			$	$	$				$	$	$
2004						2004					
July 1	Balance	b/d		600	2 500	July 7	Cash	c			200
3	H Syde		10		490	10	J Teime		15		385
7	Bank	c		200		12	Wages			400	
14	B Sharp		20		780	17	P Mulder		25		975
20	Sales				350	24	Wages			250	
21	M Yaveli				630		Electricity				600
						29	M Yaveli (dishonoured cheque)				630
						31	Balance	c/d		150	1 960
			30	800	4 750				40	800	4 750
2004											
Aug 1	Balance	b/d		150	1 960						

(b)

Jonah
Discount allowed account

Date	Details	Folio	$	Date	Details	Folio	$
2004 July 31	Total for month		30				

Discount received account

Date	Details	Folio	$	Date	Details	Folio	$
				2004 July 31	Total for month		40

Question 5

(a) June 1 Balance b/d (debit side)
The business had a total of $240 in cash on this date left over from May
Double entry – credit side of cash column in cash book for May

June 1 Balance b/d (credit side)
The business had a bank overdraft of $3130 as this is owing to the bank at the end of May
Double entry – debit side of bank column in cash book for May

June 2 Cash (debit side)
This is a contra entry when $200 cash was paid into the bank from surplus office cash
Double entry – credit side of cash column in cash book

June 2 Bank (credit side)
The other entry for the contra item taking $200 surplus office cash to pay into the bank
Double entry – debit side of bank column in cash book

June 3 Rohit
A cheque received from Rohit was paid into the bank

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Double entry – credit side of Rohit's account in the sales ledger

June 7 ADT Ltd.
$390 paid to ADT Ltd. by cheque after a cash discount received of $10
Double entry – debit side of ADT Ltd.'s account in the purchases ledger

June 10 Rohit (dishonoured cheque)
The cheque received from Rohit on 3 June has been returned unpaid by the bank
Double entry – debit side of Rohit's account in the sales ledger

(b) Discount columns provide a convenient place in which to note the cash discount allowed and received at the time the payment is recorded in the cash book. Only the totals for the period are posted to the ledger so that there are only a limited number of entries in the discount accounts in the ledger.

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Question 5

(a)

Shilpa
Petty Cash Book

Date	Details	Fo	Total Received	Date	Details	Vo	Total Paid	Refresh-ments	Cleaning expenses	Motor expenses	Ledger accounts
20-9			$	20-9			$	$	$	$	$
Feb 21	Balance	b/d	50	Feb 26	Window cleaner		7		7		
					Petrol		11			11	
				27	Refreshments		5	5			
					Ghandi Stores		12				12
							35	5	7	11	12
					Balance	c/d	15				
			50				50				
20-9											
Feb 28	Balance	b/d	15								
	Bank		35								

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(c)

Pieter Burg
Purchases Ledger
General Supply Company account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
2005				2005			
Sept 5	Bank		2 425	Sept 1	Balance	b/d	2 500
30	Discount		75	25	Purchases		1 300
	Balance	c/d	1 300				
			3 800				3 800
2005				2005			
Oct 3	Bank		1 300	Oct 1	Balance	b/d	1 300
			1 300				1 300

Chapter 7

Question 2

Redd
Purchases Ledger
Block account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
2005				2005			
Mar 8	Purchases			Mar 5	Purchases		320
	returns		100	29	Purchases		270
30	Bank		220				
31	Balance	c/d	270				
			590				590
				2005			
				Apl 1	Balance	b/d	270

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(b)

General Ledger
Sales Ledger
Capital account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
20-9				20-9			
Dec 31	Drawings		17 000	Jan 1	Balance	b/d	46 000
	Loss		600				
	Balance		28 400				
			46 000				46 000
				20-0			
				Jan 1	Balance	b/d	28 000

Chapter 9

Question 4

Y Singh
Income Statement for the year ended 30 November 20-7

	$	$	$
Revenue (sales)		9 300	
Less Sales returns		103	9 197
Less Cost of sales			
Opening inventory		1 184	
Purchases	5 937		
Less Purchases returns	161		
	5 776		
Carriage inwards	100	5 876	
		7 060	
Less Closing inventory		980	6 080
Gross profit			3 117
Less Carriage outwards		160	
Wages		1 933	
Rent and insurance		235	
Motor vehicle expenses		440	
General expenses		240	3 008
Profit for the year			109

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(b)

Balance Sheet at 31 December 20-1

	$	$
Non-current assets		
Machinery		20 000
Motor vehicles		11 000
		31 000
Current assets		
Inventory	25 000	
Trade receivables	13 350	
Bank	9 400	
Cash	1 000	
	48 750	
Current liabilities		
Trade payables	8 430	
Net current assets		40 320
		71 320
Non-current liabilities		
Loan – AB Finance		20 000
		51 320
Financed by		
Capital		
Opening balance		38 800
Plus Profit for the year		22 520
		61 320
Less Drawings		10 000
		51 320

Chapter 10

Question 6

(a) Compare with results of other businesses of a similar size/type.
(b) One from – Improve profitability, analyse results and make decisions, identify and solve problems, increase sales, review inventory levels etc.
(c) Two from – capable of being independently verified, free from bias, free from significant errors, prepared with suitable caution being applied to any judgements and estimates.

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(d)

Electricity account

Date	Details	Folio	$	Date	Details	Folio	$
2007				2007			
Apl 6	Bank		120	Apl 30	Income statement		180
30	Balance	c/d	60				
			180				180
				2007			
				May 1	Balance	b/d	60

(e)

Drawings account

Date	Details	Folio	$	Date	Details	Folio	$
2007				2007			
Apl 21	Cash		800	Apl 30	Capital		800
			800				800

(f)

Wages account

Date	Details	Folio	$	Date	Details	Folio	$
2007				2007			
Apl 29	Cash		700	Apl 30	Income statement		700
			700				700

Question 7

Mirian
Income Statement for the year ended 30 September 20-4

	$	$
Fees from clients		40 900
Commission receivable (5600 + 250)		5 850
		46 750
Less Office expenses (7250 – 250 + 45)	7 045	
Wages	27 500	
Insurance (1800 – 360)	1 440	
Property tax (800 + 160)	960	
Motor vehicle expenses (1840 – 920)	920	
Bank charges	115	37 980
Profit for the year		8 770

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Chapter 12

Question 3

(a)

Joe
Equipment account

Date	Details	Folio	$	Date	Details	Folio	$
2001				2002			
Sept 1	Balance (A)	b/d	40 000	July 31	Balance	c/d	90 000
	Bank (B)		30 000				
2002							
Mar 1	Bank (C)		20 000				
			90 000				90 000
2002							
Sept 1	Balance	b/d	90 000				

Provision for depreciation of equipment account

Date	Details	Folio	$	Date	Details	Folio	$
2002				2001			
Aug 31	Balance	c/d	23 000	Sept 1	Balance	b/d	15 000
				June 30	Income statement		
					(A) 4 000		
					(B) 3 000		
					(C) 1 000		8 000
			23 000				23 000
				2002			
				July 1	Balance	b/d	23 000

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(b)

Joe
Extract from Balance Sheet at 31 August 2002

	$	$	$
Non-current assets	**Cost**	**Depreciation to date**	**Book value**
Equipment	90 000	23 000	67 000

(c) Prudence is observed:

In the income statement

The profit is not overstated as depreciation is shown as an expense. This means that the profit/loss is shown at a more realistic amount.

In the balance sheet

The non-current assets are not overstated as depreciation is deducted from the cost of the assets. This means that the non-current assets are shown at more realistic values.

Question 5

(a)

(i)

Mustafa and Syed
Equipment account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
2000				2001			
Apl 1	AB Ltd.		10 000	Oct 1	Disposal		5 000
				2002			
				Mar 31	Balance	c/d	5 000
2002			10 000				10 000
Apl 1	Balance	b/d	5 000				

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(d) 2. Net profit for the year ended 31 August 2005
Overstated
Omission of a loss in the income statement means the profit is overstated

3. Current assets at 31 August 2005
Overstated
Trade receivables are shown at a higher value than will actually be received

Chapter 14

Question 2

Mary
Bank Reconciliation Statement at 31 January 2003

	$
Balance shown on bank statement	(2310)
Add Amounts not yet credited	800
	(1510)
Less Cheques not yet presented – David	270
Balance shown in cash book	(1780)

Question 3

(a) (i) Any two – Opening bank balance, closing bank balance, amounts paid into bank, amounts withdrawn from bank, bank charges, standing orders, credit transfers, direct debits, dishonoured cheques.

(ii) Any two – find accurate bank balance, identify any errors and omissions in cash book or bank records, identify amounts not credited and cheques not presented, assists in detecting fraud, identifies any "stale" cheques.

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(b)

Sara Perez
Cash Book (Bank columns only)

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
2000				2000			
Nov 1	Balance	b/d	5264	Nov 1	Motor insurance		26
	Error correction		100		Bank charges		88
					Fine Fabrics (dishonoured cheque)		242
					Balance	c/d	5008
			5364				5364
2000							
Nov 1	Balance	b/d	5008				

(c) **Bank Reconciliation Statement at 31 October 2000**

	$
Balance shown on bank statement	4145
Add Amounts not yet credited – Sales	1078
	5223
Less Cheques not yet presented – Thai Exports	240
	4983
Add Bank error – Rent	25
Balance shown in cash book	5008

(d) Current asset - $5008

Chapter 15

Question 2

(a) (i) A narrative consists of a brief explanation of what is being recorded and why the entry is being made.
(ii) It is impossible to remember the reason for every entry and the entries in the journal sometimes involve "out of the ordinary" transactions.

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(b)

Ruth
Journal

Date	*Details*	*Folio*	*Debit* $	*Credit* $
	Drawings		60	
	Purchases			60
	Goods taken for own use			
	Motor vehicle		15 000	
	Motor vehicle expenses		600	
	PJ Motors			15 600
	Purchase of new motor vehicle on credit and repairs to old motor vehicle			
	Stationery		20	
	Purchases			20
	Error in posting stationery to purchases now corrected			

Question 4

Maria Matsa

(a)

Journal

Date	*Details*	*Folio*	*Debit* $	*Credit* $
	Stationery		50	
	Suspense			50
	Suspense		1 000	
	Sales			1 000
	Abdulla Ahmed		240	
	Abdul Ahmed			240
	Suspense		28	
	Discount allowed			14
	Discount received			14
	Joe Jones		190	
	Suspense			190

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(b)

Suspense account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
2002				2002			
Sept 30	Sales		1000	Sept 30	Difference on trial balance		788
	Discount allowed		14		Stationery		50
	Discount received		14		Joe Jones		190
			1028				1028

(c) Error 2 Increase by $1000
Error 3 No effect
Error 4 Increase by $28
Error 5 No effect

Chapter 16

Question 2

Ruth Tembe
Purchases ledger control account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
2009				2009			
July 1	Balance	b/d	15	July 1	Balance	b/d	3680
31	Bank		4650	31	Purchases		4800
	Discount received		90				
	Purchases returns		30				
	Inter ledger transfer		105				
	Balance	c/d	3590				
			8480				8480
				2009			
				Aug 1	Balance	b/d	3590

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Question 6

(a) See Chapter 16
(b) (i) Credit sales — sales journal
(ii) Discount allowed — cash book
(iii) Bad debts — journal
(c) Any one – debtor returned goods after settling account, debtor overpaid account, cash discount not deducted before account paid, payment made in advance.

(d)

David Odoyo
Purchases ledger control account

Date	*Details*	*Folio*	*$*	*Date*	*Details*	*Folio*	*$*
2002				2002			
Oct 31	Purchases returns		135	Oct 1	Balance	b/d	2950
	Bank		4120	31	Purchases		5050
	Discount received		85		Cash		100
	Balance	c/d	3760				
			8100				8100
				2002			
				Nov 1	Balance	b/d	3760

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Chapter 17

Question 1

(a)

Rebecca Tan
Statement of Affairs at 30 June 2005

	$	$	$
Non-current assets	**Cost**	**Depreciation for year**	**Book value**
Equipment	13 900	1 200	12 700
Motor vehicles	7 500	1 500	6 000
	21 400	3 700	18 700
Current assets			
Inventory		7 250	
Trade receivables	5 200		
Less Provision for doubtful debts	104	5 096	
Other receivables		122	
		12 468	
Current liabilities			
Trade payables	4 800		
Other payables	146		
Bank overdraft	250	5 196	
Net current assets			7 272
			25 972
Financed by			
Capital			
Balance			25 972

(b)

Calculation of profit for the year ended 30 June 2005

		$	$
Capital at 30 June 2005			25 972
Less Capital at 1 July 2004			27 000
			(1 028)
Add Drawings –	cash	3 150	
	goods	1 250	4 400
			3 372
Less Capital introduced			5 000
Profit for the year			(1 628)

Alternatively the calculation could be presented in the form of a capital account.

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(b) **Balance Sheet at 31 January 2006**

	$	$
Non-current assets		
Motor vehicle at valuation		8 500
Current assets		
Other receivables	100	
Bank (3150 + 13 200 – 16 285)	65	
	165	
Current liabilities		
Subscriptions prepaid by members	(400)	
		(235)
		8 265
Financed by		
Accumulated fund		
Opening balance (3150 + 2000 + 250 – 50)		5 350
Add Surplus for year		2 915
		8 265

(c) Any two from –
The receipts and payments account shows the total money paid and received
The income and expenditure account adjusts figures for accruals and prepayments
The income and expenditure account includes non-monetary items such as depreciation
The income and expenditure account includes only revenue items

Question 3

(a) (i) The income and expenditure account is equivalent to a profit and loss account of a trading organisation. It is used to calculate the annual surplus or deficit.
(ii) The accumulated fund is equivalent to the capital of a trading organisation, the difference between the assets and liabilities. The annual surpluses (less any deficits) accumulate within a non-trading organisation to form the accumulated fund.

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(b)

Siltones Music Society
Receipts and Payments Account for the year ended 31 March 2005

	Receipts		$		*Payments*		$
2004				2005			
Apl 1	Balance	b/d	2 210	Mar 31	Expenses of concert		1 250
2005					Rent of premises		1 820
Mar 31	Subscriptions		5 800		General expenses		215
	Receipts from concert		1 900		Insurance		325
	Proceeds of sale of				Musical instruments		3 350
	instruments		700		Balance	c/d	3 650
			10 610				10 610
2005							
Apl 1	Balance	b/d	3 650				

(c)

Subscriptions account

Date	*Details*	*Folio*	$	*Date*	*Details*	*Folio*	$
2004				2005			
Apl 1	Balance	b/d	1 000	Mar 31	Bank		5 800
2005							
Mar 31	Balance	c/d	800				
	Income & expenditure		4 000				
			5 800				5 800
				2005			
				Apl 1	Balance	b/d	800

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Question 6

(a)

Error	*Effect of correcting the error*	
	on the gross profit	*on the net profit*
2	–$15	No effect
3	+$30	No effect
4	No effect	–$200
		+$50

(b)

Ebor and Olicana
Journal

Date		*Details*	*Folio* $	*Debit* $	*Credit*
2005					
Aug	31	Drawings - Olicana		400	
		Purchases			400
		Goods taken by partner for own use			
		Office equipment		900	
		Capital – Ebor			900
		Computer introduced into the business by partner			
		Current - Ebor		5 000	
		Capital – Ebor			5 000
		Transfer from current account to capital account			

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(c)

El Sayed Manufacturing Company
Manufacturing Account for the year ended 31 August 2003

	$	$
Cost of material consumed		
Opening inventory of raw material	7 040	
Purchases of raw material	43 820	
	50 860	
Less Closing inventory of raw material	6 220	44 640
Direct wages (40190 + 1170)		41 360
Prime Cost		86 000
Factory overheads		
Indirect wages	18 400	
General expenses	5 340	
Rates and insurance (7500 x 4/5)	6 000	
Depreciation of machinery (42000 x 20%)	8 400	38 140
		124 140
Add Opening work in progress		810
		124 950
Less Closing work in progress		950
Production cost of goods completed		124 000

Chapter 21

Question 4

(a)

Kinto Limited
Profit and Loss Appropriation Account for the year ended 30 June 2000

	$	$
Profit for the year		16 000
Less Transfer to general reserve	5 000	
Dividends – Ordinary proposed	2 500	7 500
Retained profit for the year		8 500
Retained profit brought forward		47 200
Retained profit carried forward		55 700

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(b)

Balance Sheet at 30 June 2010

	$	$	$
Non-current assets	**Cost**	**Depreciation to date**	**Book value**
Machinery	17 000	1 900	15 100
Office equipment	2 500	500	2 000
	19 500	2 400	17 100
Current assets			
Inventory		3 900	
Trade receivables		33 500	
Other receivables		600	
Bank		25 000	
Cash		200	
		63 200	
Creditors: amounts falling due within one year			
Trade payables	1 800		
Other payables	300		
Proposed dividends	2 500	4 600	
Net current assets			58 600
			75 700
Creditors: amounts falling due after more than one year			
Bank loan (repayable 2016)			5 000
			70 700
Financed by			
Capital and reserves			
Ordinary shares of $1 each			10 000
General reserve			5 000
Retained profits			55 700
Shareholders' funds			70 700

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Question 5

(a)

	$
Profit for the year before preference share dividend	59 000
Preference share dividend paid	5 000
Profit for the year after preference share dividend	54 000

(b)

Tiwari & Company Ltd.
Profit and Loss Appropriation Account for the year ended 30 June 20-8

	$	$	$
Profit for the year			54 000
Less Transfer to general reserve		10 000	
Ordinary share dividend – paid	15 000		
proposed	30 000	45 000	55 000
Retained profit for the year			(1 000)
Retained profit brought forward			9 500
Retained profit carried forward			8 500

(c)

Tiwari & Company Ltd.
Extract from Balance Sheet at 30 June 20-6

	$
Capital and reserves	
5% Preference shares of $1 each	100 000
Ordinary shares of $0.50 each	300 000
General reserve (12 000 + 10 000)	22 000
Retained profits	8 500
Shareholders' funds	430 500

(d) As the directors decided not to apply the IAS rules regarding proposed dividends, the proposed ordinary share dividend of $30 000 which has been decided upon would appear in the balance sheet at 30 June 20-8. This would appear under Creditors: amounts falling due within one year (or current liabilities). The dividends already paid do not appear in the balance sheet as they are not liabilities.

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